IMPACT INVESTORS COUNCIL

The Bridgespan Group

Giving Credit Where Due

A Case for Debt Financing in Indian Impact Enterprises

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Collaborating to accelerate social impact

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Foreword

The role of debt and blended finance in Indian impact investing traditionally has been subdued. To understand the underlying reasons for this, the **Impact Investing Council of India** and **The Bridgespan Group** undertook a study of investments in 400-plus impact-focused enterprises to gain insights into debt supply and demand dynamics. This report summarises our findings of a substantial, unmet market for debt capital, a conclusion validated by industry experts. It also offers recommendations focused on improving access to debt and eliminating structural and logistical challenges.

We hope this report will provide an impetus for impact enterprises to consider debt instruments to meet their funding needs, and for funders to identify and structure instruments that align with industry needs whilst ensuring target returns. We also hope the report will motivate a variety of debt financing institutions and development agencies to work together on solutions for the unmet debt needs of impact enterprises.

We are convinced that whilst equity will continue to be a major means of raising capital, debt instruments can play a substantially larger role.

We are grateful for the support we received from data providers, industry practitioners, and legal experts.

On behalf of the team members of Impact Investing Council of India and The Bridgespan Group,

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Executive Summary

India's impact enterprises, a growing number of companies striving for social benefit and profit, have a debt problem: Not too much, but too little. They need borrowed money to fuel the growth that will advance their social or environmental goals. But most lenders steer clear, citing perceived risks and lack of creditworthiness.

To better understand the challenges Indian impact enterprises face in borrowing money, the India Impact Investors Council (IIC) and The Bridgespan Group joined in a research project to chart the debt landscape, identify the barriers to debt financing, and propose avenues for making debt more accessible. The report provides an overview of three main areas:

- **Financial data analysis**: We analyse the balance sheets of 422 leading impact enterprises to gauge their creditworthiness and estimate the gap between their current debt and their potential to absorb more. The analysis showed that 60 percent of the enterprises met our criteria for creditworthiness. Creditworthiness, however, does not necessarily mean access to credit. When we looked at debt on the books of those 422 companies and compared that to a conservative estimate of borrowing potential, the gap came to INR 1,564 crore, roughly US$216 million.
- **Barriers to debt financing**: We identify the major debt financing barriers attributable to all the major players: impact enterprises, lenders, data providers, and regulators. Banks, for instance, require collateral to backstop loans. But most impact enterprises can't meet collateral requirements, because they provide a service (such as education or healthcare) that relies on people or software, rather than on hard assets such as machinery or equipment. Young enterprises also often lack the management and data systems that underpin financial reporting required for assessing creditworthiness. Moreover, India lacks a regulatory structure that defines impact investments as a distinct asset class with standards that meet the needs of young, growing companies.
- **Potential solutions**: No one type of debt financing serves all. We highlight a continuum of approaches that meet the specific needs of underserved impact enterprises, including loan guarantees, flexible loan products, and innovative approaches to due diligence and underwriting. Alternative Investment Funds (AIFs), for example, have grown in popularity as a way for institutional or high-net-worth investors to invest in impact enterprises. And cash-flow lending addresses the collateral barrier that prevents most small to medium-size enterprises (SMEs) from obtaining loans.

The report also highlights the need for development of the debt "ecosystem" for impact enterprises. That includes partnerships between banks and impact investors, educational outreach to impact entrepreneurs to help them understand the role and sources of debt financing, and recognition of debt as an asset class that needs a regulatory framework supportive of young, growing impact enterprises.

Overcoming the barriers to debt financing for India's impact enterprises will not happen quickly. But a number of approaches show promise, and progress already is being made toward building a stronger, more vibrant debt finance ecosystem. As that ecosystem matures, credit may live up to its promise as a game-changer for India's impact enterprises.

Introduction

India has staged a spectacular growth spurt over the past decade, lifting tens of millions out of poverty. The country's rapidly emerging economy is now the world's fifth largest, swelling the ranks of a burgeoning middle class. Yet, for all its economic success, India still faces major challenges.

Close to 70 per cent of its population lives in rural areas with limited to no access to basic sanitation, health services, and electricity. Urban centres strain to cope with housing, education, and economic development. A 2019 Brookings India report estimated that the country still faces an annual financing gap of US$565 billion to meet its United Nations Sustainable Development Goals by 2030.[1]

This pervasive, unfilled need for social and economic services has given rise to a new generation of entrepreneurs dedicated to social uplift. One estimate puts the number of "impact enterprises" – businesses created to further a social or environmental purpose – in India at two million.[2] The financing needs of this vibrant sector have attracted impact investors, domestic and foreign, who want to help social entrepreneurs generate beneficial social or environmental impact alongside a financial return. Opportunity beckons. One recent report characterised India as a "breeding ground" for impact investors.[3]

Impact investing took root in India in the early 2000s, with social purpose minded investors providing venture and private equity risk capital to support nascent microfinance enterprises. Within a decade, microfinance business models matured sufficiently to attract financing from banks and other mainstream financial institutions. Since 2010, impact investors have diversified into other sectors, such as agriculture, healthcare, and education. These investors have collectively committed US$10.8 billion to for-profit impact enterprises that have touched the lives of some 490 million people.[4] (See Exhibit 1.) During that period, annual impact enterprise investments have grown from US$323 million in 2010 to US$2.7 billion in 2019.

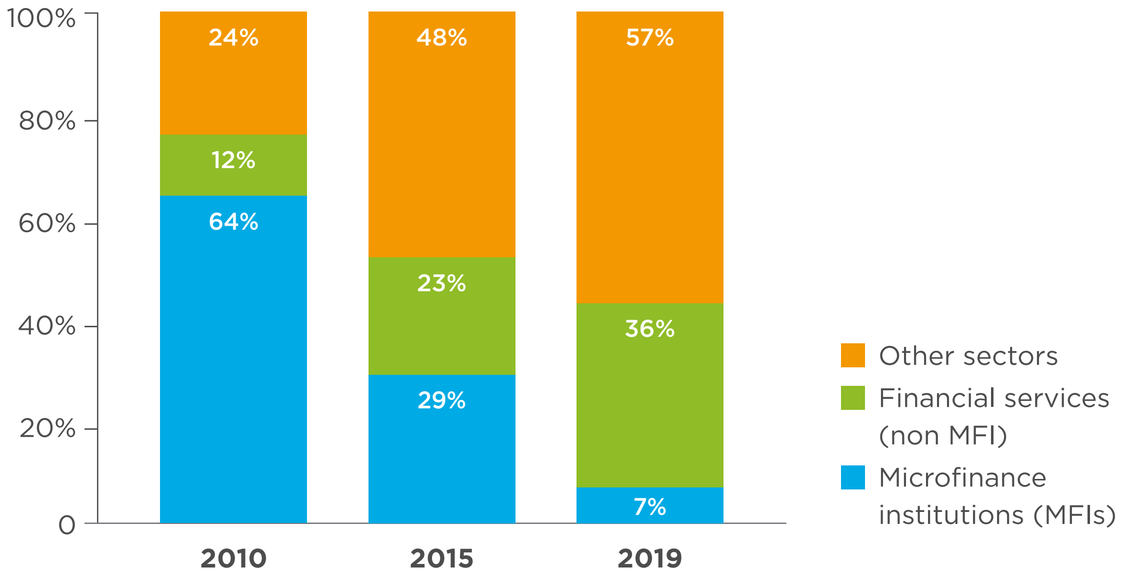
1 Usha Ganesh, Vineeth Menon, Anuja Kaushal, and Karan Kumar, *The Indian Social Enterprise Landscape: Innovation for an Inclusive Future*, Bertelsmann Stiftung, October 2018. Shamika Ravi et al., "The Promise of Impact Investing in India", Brookings India Research Paper No. 072019, July 2019.

2 *The State of Social Enterprise in India,* The British Council, 2016.

3 *Social Impact Investing in India*, Nishith Desai Associates, July 2018.

4 *The India Impact Investing Story*, Impact Investors Council and Asha Impact, June 2020.

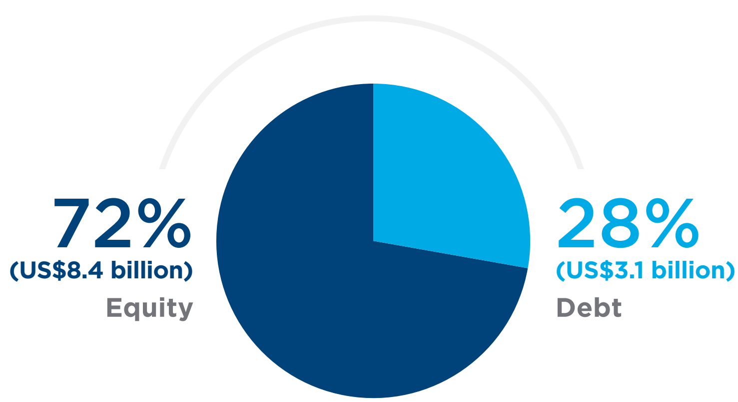
Exhibit 1: Shift in impact investments from microfinance to other sectors



Source: Impact Investors Council of India analysis of Traxcn data.

Exhibit 2: Total impact investment debt versus equity, 2015–19

Over US$11 billion in total impact investment



Source: Impact Investors Council of India and The Bridgespan Group analysis of Tracxn data.

But not all the trends point in the right direction, especially from the perspective of investment recipients. Impact investors to date heavily favour ownership equity in emerging impact enterprises over lending money for working or growth capital. (See Exhibit 2.) Debt remains particularly hard for young, growing impact enterprises to secure in large part because of perceived risk and lack of creditworthiness. Yet without an adequate supply of borrowed money, expansion and working capital needs go unmet, leaving impact enterprises unable to reach their full potential. It's a concern that weighs heavily on the sector.

"Despite tremendous investment in social enterprises and impact investing, we continually heard [from social entrepreneurs] the challenges in accessing early-stage debt for small and growing businesses," Geeta Goel, the country director at the Michael & Susan Dell Foundation India, wrote in a recent blog based on impact investing experience dating from 2006.[5] "Making credit accessible at an early stage could be a game-changer not only for them, but also for the economic development of the country."

To better understand the challenges Indian impact enterprises face in borrowing money, the India Impact Investors Council (IIC) and The Bridgespan Group joined in a research project to chart the debt landscape, identify the barriers to debt financing, and propose avenues for making debt more accessible. The IIC, supported by more than 40 leading impact investors, is uniquely positioned to pursue this work given its member base. The Bridgespan Group, a global nonprofit advisory service, collaborated with the IIC to collect and analyse impact enterprise data and to interview over two dozen impact investors and impact enterprise leaders across India. We aimed to gather a representative sample of experiences and viewpoints, rather than to conduct an exhaustive study. Nor does inclusion in the report indicate an endorsement by the IIC or Bridgespan. Our goal is to advance the discussion and potential solutions for creating more debt options for impact enterprises.

This report provides an overview of three main areas of inquiry:

- **Financial data analysis**: We analyse the balance sheets of leading impact enterprises to gauge their creditworthiness and estimate the gap between their current debt and their potential to use more.
- **Barriers to debt financing**: We identify the major debt financing barriers attributable to impact enterprises, lenders, data providers, and regulators.
- **Potential solutions**: We highlight a continuum of alternative approaches that meet the specific needs of underserved impact enterprises, including loan guarantees, flexible loan products, and innovative approaches to due diligence and underwriting. And we discuss the development of the debt ecosystem for India's impact enterprises.

Time will tell whether a more developed debt market will be a game-changer for India's vibrant impact enterprises. We hope that the data and analysis presented here will inform discussions and spur innovations to create a more robust ecosystem for impact finance that improves access to debt.

Financial Data Analysis Shows a Significant Debt Shortfall

A recent IIC and Asha Impact study found that over the past decade, impact investors have shifted from the increasingly mature microfinance market to new opportunities in agriculture, education, energy, healthcare, and technology. Annual investments in such nonfinancial enterprises doubled from 24 per cent to 57 per cent of total annual impact investments since 2010.

This report builds on the IIC and Asha Impact study and seeks to understand how available financing instruments have evolved during this period of diversification to new sectors.

5 Geeta Goel, "Impact Investment Insights: Key Learnings from On-the-ground Experience", *YourStory*, 10 December, 2019.

To examine the debt landscape, the IIC and Bridgespan identified a set of approximately 500 leading impact enterprises in the portfolios of prominent impact investors amongst the IIC membership, venture debt firms, and leading development finance institutions. To ascertain their impact credentials, we screened the enterprises to identify those that fit any one of three criteria:

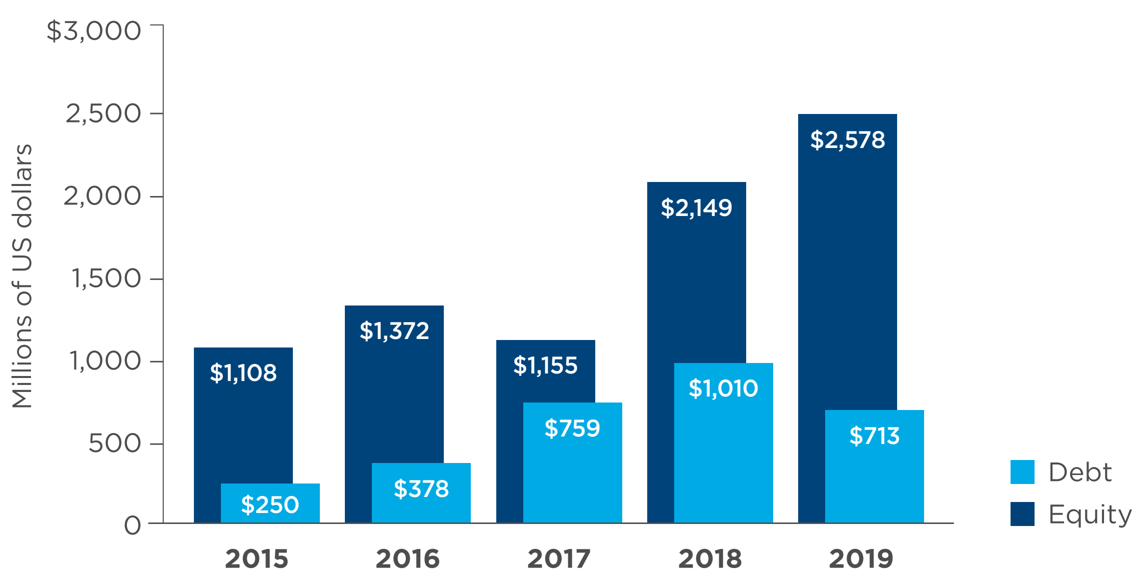
- Offer a cost efficient or affordable solution to a social or environmental problem
- Improve access to products or services for those living in rural or semi-urban areas or in cities with fewer than one million people
- Use innovative technology-based solutions to solve social problems

Using this set of companies, we sought answers to two questions: 1. How much money has flowed into debt financing for impact enterprises in recent years? and 2. Is there a gap between the creditworthiness of these enterprises and the amount of debt financing they have secured?

Investors heavily favour equity in impact enterprises

To answer the first question, we assembled five years of investment data from public and private sources for 483 impact enterprises and compared equity to debt. The data clearly show that investors favour equity over debt by a multiple of three-to-one, although the annual growth rate of investments in debt has grown faster than equity over the five-year study period. (See Exhibit 3.)

Exhibit 3: Debt financing has grown amongst impact enterprises but represents only a quarter of total impact investing

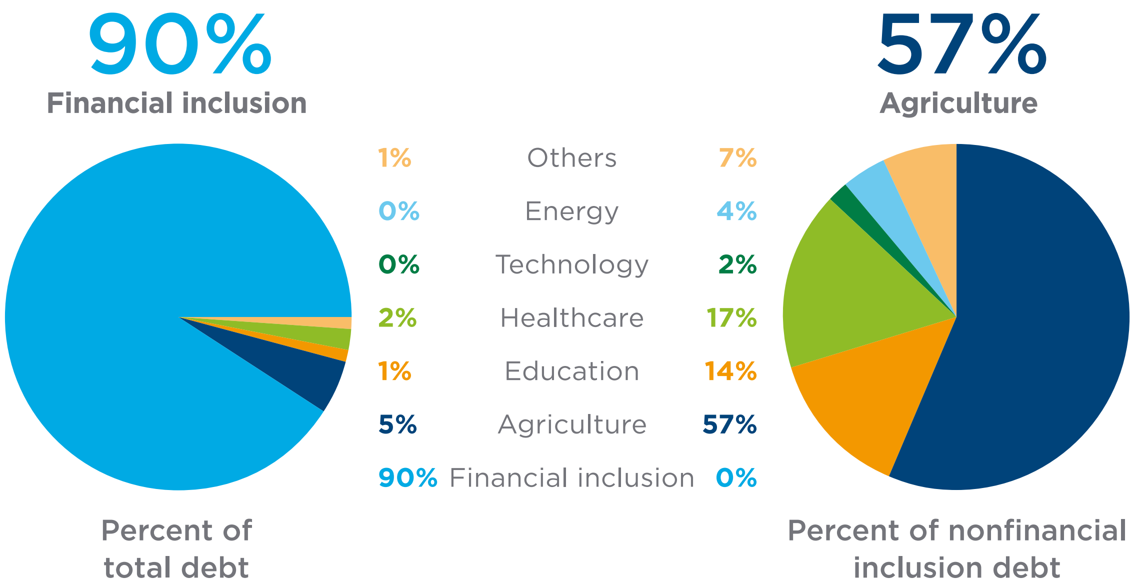


Share of debt (%)	18%	22%	40%	32%	22%	**28%** (over 5 years)

Source: Impact Investors Council of India and The Bridgespan Group analysis of Traxcn data.

Even as debt funding has diversified into a variety of sectors, 90 per cent remains concentrated in financial services outside of microfinance. (See Exhibit 4.) (With about 190 million unbanked adults, India is second only to China in the number of residents who don't have bank accounts or participate in the formal financial sector, according to the World Bank.[6])

Exhibit 4: Comparison of total debt investing to nonfinancial inclusion debt investing, 2015–19

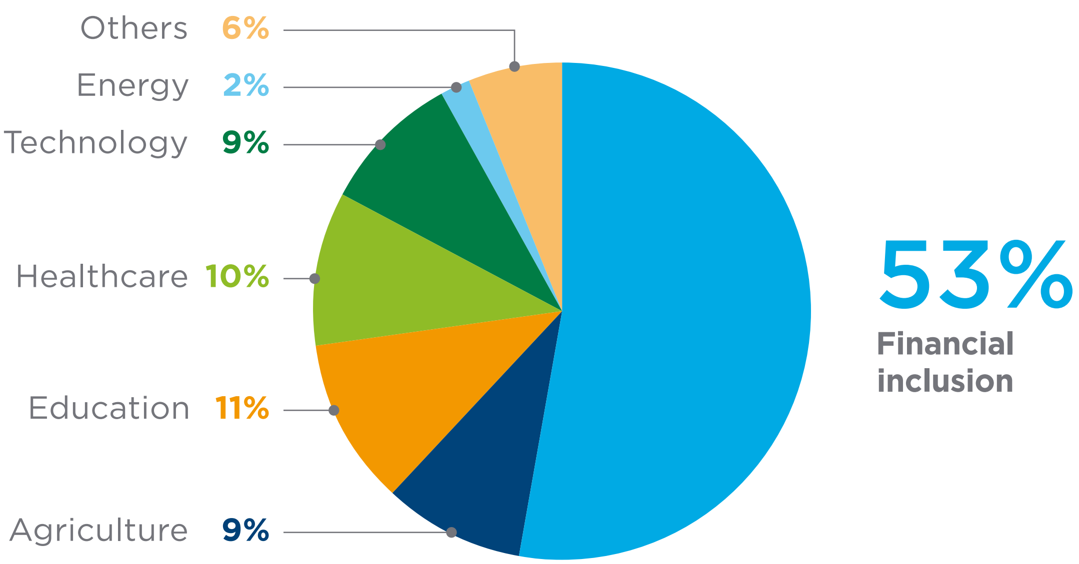


Source: Impact Investors Council of India and The Bridgespan Group analysis of Crediwatch data.

6 Asli Demirgüç-Kunt et al., *The Global Findex Database 2017: Measuring Financial Inclusion and the Fintech Revolution*, The World Bank, 2018.

By contrast, equity investments showed more diversity, with 53 per cent going to financial inclusion whilst education, technology, healthcare, and agriculture each received roughly 10 per cent (nearly US$1 billion each) of the US$9 billion in total equity investments. (See Exhibit 5.) Equity investments in education alone (US$955 million) more than doubled all the debt investments in non-financial sectors combined (US$380 million). The question is why? Are the nonfinancial sector enterprises not creditworthy, or is the debt market underdeveloped?

Exhibit 5: Distribution of equity impact investments, 2015–19



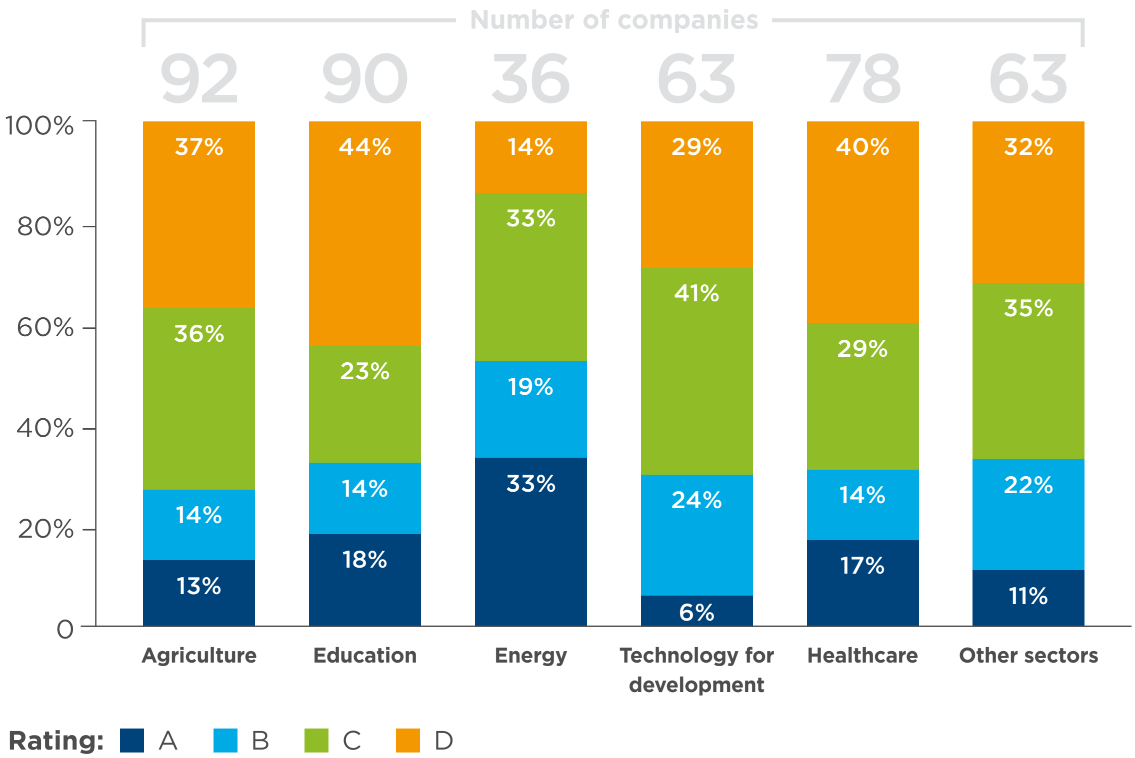
Source: Impact Investors Council of India and The Bridgespan Group analysis of Tracxn data.

Many impact enterprises demonstrate reasonable credit quality

For answers, Crediwatch, a data analytics company, provided a set of core financial indicators for 422 of our selected nonfinancial impact enterprises: company age, total revenue, three-year revenue CAGR (compound annual growth rate), EBIT (earnings before interest and taxes) margin, cash runway, and current ratio. We then applied a simple rating methodology ranging from A (strongest) to D (not creditworthy) to roughly gauge the creditworthiness of each enterprise. (See Appendix A for details.) Based on the analysis, about 60 per cent scored in the creditworthy range – C or above. Thirty per cent scored either A or B, the most creditworthy. (See Exhibit 6.)

Exhibit 6: Breakdown of credit ratings by sector

60% scored in most creditworthy range



Ratings range from A (strongest credit) to D (weakest credit)

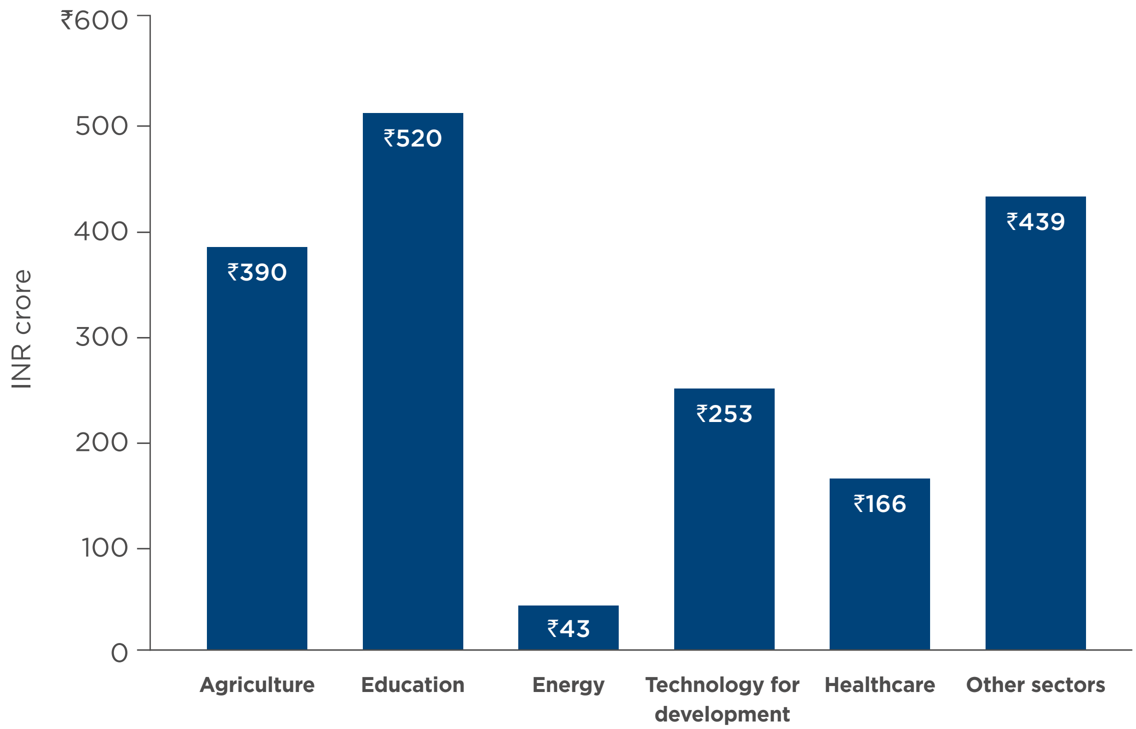
Note: Based on a balance-sheet analysis of 422 leading impact enterprises. Not all columns add to 100% due to rounding.

Source: Impact Investors Council of India and The Bridgespan Group analysis of Crediwatch data.

Credit quality, however, does not necessarily mean access to credit, as we found by comparing existing debt to a conservative estimate of each enterprise's potential to absorb more debt. From company balance sheets, we identified those with debt on the books. We then estimated each company's debt potential, the difference between existing debt and 25 per cent of an enterprise's net worth.[7] The gap between outstanding debt and potential debt came to INR 1,564 crore, roughly US$216 million, for the 422 most creditworthy (A and B rated) enterprises. The agriculture and education sectors showed the greatest gaps. (See Exhibit 7.) The debt gap widened to over INR 1,800 crore when we included C-rated enterprises.

7 Companies typically carry debt (on average) that equals between 50 and 100 per cent – or more depending on the sector – of net worth. Given the risks inherent with start-ups, we picked a conservative debt level of 25 per cent of net worth.

Exhibit 7: Gap between actual debt and estimated debt capacity



Source: Impact Investors Council of India and The Bridgespan Group analysis.

This debt-financing gap for a sample of India's impact enterprises is indicative of the struggle faced by every impact enterprise. The struggle isn't surprising. Many, if not most, impact enterprises can't meet the collateral-based lending criteria used by most banks. What they need are alternative financing approaches that go beyond collateral-based loans, plus a more flexible concept of debt. It's not one-size-fits-all. Rather, it's more useful to think of debt along a continuum of customisable tools to meet the complex needs of impact enterprises, ranging from collateral-based senior debt and unsecured junior debt, as well as quasi-equity financial support (typically structured as unsecured debt) and grant-based finance. Impact enterprises would also benefit from an active credit-guarantee market that helps them raise debt in the early stage of their funding journey and facilitates their entry into formal debt financing markets. (See Exhibit 8.)

Exhibit 8: Continuum of debt financing approaches

Source: Impact Investors Council of India and The Bridgespan Group analysis.

To illustrate, enterprises with a C or D rating in our credit scoring methodology may have a strong, but unproven, business model, little or no collateral, and no credit rating. They could enhance their credit worthiness with quasi-equity financing or a recoverable grant that permits an enterprise to build a debt repayment track record by repaying a philanthropic grant. Either form of debt avoids dilution of equity whilst the enterprise grows and delivers more beneficial products or services.

Closing the debt gap also will require addressing multiple barriers that stand in the way of supplying impact enterprises with the capital they need to develop and grow.

Barriers to Debt Financing for Impact Enterprises

Investor caution is only part of the story. Interviews with sector leaders and a review of literature led us to conclude that all the lead actors in India's debt ecosystem – impact enterprises, lenders, data providers, and government regulators – play a role, often inadvertently, in restricting access to credit. We describe below the barriers each of these groups confronts on a daily basis.

Impact enterprises struggle to find and secure loans

As the CEO of one impact start-up told us, debt is a preferred alternative to handing over a share of ownership for a cash infusion. "I want to give equity to my people who are really working hard with me. If you don't get debt at the right time and in [the] right quantum, you have to compromise your equity. Nobody wants to compromise the equity."

Yet, relinquishing a percentage of ownership for cash often is the only option for start-ups and young enterprises because they typically lack the collateral demanded for standard, asset-backed lending. Banks routinely ask for 100 per cent (or more) coverage on collateral, which can include personal property, such as an entrepreneur's home, if he or she is lucky enough to own one.

Lack of collateral isn't the only barrier. Many impact enterprises have not matured to the point where they have implemented strong management reporting systems that capture critical financial, employee, client, accounts, products, and performance data. Weak reporting systems lead to low-quality financial statements that make it difficult, if not impossible, for impact enterprises to get a good credit rating. Those that do have a credit rating typically fall below the high-quality/low credit risk rating that most lenders require. Without a strong credit rating, impact enterprises have little chance of securing a loan. This vicious cycle leads to a lack of track record in debt repayment that makes it very challenging for banks to lend to impact enterprises.

Many impact entrepreneurs turn to equity financing because they don't fully understand the tradeoffs and benefits of debt versus equity. Founders often do not understand the relevance of debt and the crucial role it can play in their fundraising plans. Nor do impact enterprise leaders have connections with the right funders or lending intermediaries to seek out information and referrals. "Most social entrepreneurs don't know who to approach about debt financing," said Aparna Mangla, the Shell Foundation's India regional manager. "And they don't have the money to hire advisers to facilitate match-making with lenders," she added. Commercial banks and non-banking financial companies (NBFCs), a number of which might be considered impact investors, are principal sources of loan capital and have different approaches to evaluating enterprises for creditworthiness.

NBFCs lend when banks shy away

Bank lending practices based on collateral are more suitable for conventional asset-heavy manufacturing enterprises than for asset-light impact enterprises. Many, if not most, impact enterprises have few, if any, balance sheet assets to offer as collateral. Thus, loan officers often consider small enterprises too risky to pursue, because they typically are unfamiliar with credit evaluation methods that don't involve collateral. As a result, conventional bank funding remains a struggle for most impact enterprises.

By contrast, NBFCs specialise in servicing enterprises that banks consider too risky, effectively an outsourcing arrangement banks support by investing in NBFCs. The Reserve Bank of India classifies roughly 290 NBFCs with more than INR 500 crore on their balance sheets as systemically important.[8] They come in many types, including companies that specialise in asset finance, investments, microfinance, infrastructure, housing, and venture debt. As such, they play a crucial role in India's financial system and are a prime source of debt financing for impact enterprises.

NBFCs are more nimble than banks in adapting to the specific needs of market segments. A growing number have developed credit assessment methodologies that do not rely on traditional collateral requirements.

The interest rates they offer tend to be higher, however, because their operating costs are higher than banks'. Investors lend NBFCs money, on which they must add a margin to cover operating costs and profit. Additionally, the perceived higher risk of investing in young, unproven impact enterprises pushes rates upward. High interest rates, in turn, put a strain on the cash flow of many young enterprises, making it difficult for them to accept loans, in contrast to equity capital which requires no interest or principal payments.

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8 "List of Non-Deposit taking Systemically Important (NBFC-ND-SI) companies registered with RBI", Reserve Bank of India, as of 16 July, 2020.

Lack of data hinders credit evaluations

Lenders acknowledge the need for more and better data to assess the creditworthiness of potential clients. To address this problem, the Reserve Bank of India in 2016 approved a new class of NBFCs to act as account aggregators to consolidate and digitise information from individuals and companies to make it usable by financial institutions. Regulatory issues, including personal data protection, delayed approval of the first aggregators until early in 2020. When finally up and running, aggregators will make credit accessible to people who are currently not part of the formal financial system. It will also help small businesses, including impact enterprises. (Account aggregators, however, must first get the explicit consent of individual clients before collecting and sharing data.) Several other initiatives also support the build out of independent third-party data sources and provide more efficient data and analytics to lenders to assess impact enterprises and the broader small to medium-size enterprise (SME) ecosystem in India.

1. Data and analytics platforms are emerging that can provide independent third-party data on the performance of companies. Crediwatch, our analytics partner for this report, is one such organisation that can support NBFCs and banks in their credit assessment and monitoring needs with a variety of information indicators.
2. Digital lending NBFCs and similar platforms use unique proprietary data sets to create rapid turnaround models for lending to small enterprises.

None of these approaches are fully proven yet, but performance before the COVID-19 pandemic washed over the economy has been positive. Nevertheless, lenders may need to realign themselves in the post-pandemic recovery to accommodate the dramatic shift in business conditions.

Government regulations affect domestic and offshore capital

The Indian government in recent years has taken steps to improve financing options for SMEs. For instance, Startup India, launched in 2016, is a government initiative to boost start-up culture and build a strong and inclusive ecosystem for innovation and entrepreneurship in India. Finance Minister Nirmala Sitharaman in 2019 announced the setting up of a Social Stock Exchange to create a platform to match funders looking to support development objectives with organisations delivering social or environmental impact. Successful implementation of the new exchange would facilitate an increased flow of private capital to advance India's development goals. Yet, there are still government regulations that slow and even stymie debt investment in impact enterprises in different ways.

Impact investing is not recognised as an asset class

India lacks a formal regulatory structure that defines impact investments as a distinct asset class. Designating impact investments as an asset class would allow regulators to apply a different set of standards to impact investors and enterprises.

Non-performing loan regulations lack flexibility

Strict regulations regarding overdue loans are a challenge for commercial banks. A loan that is delinquent for more than 90 days is defined as a non-performing asset. Once that happens, the bank doesn't have the flexibility to make loan modifications by delaying or revising payment schedules to accommodate fluctuations in an impact enterprise's cash flow, a common occurrence for a young business.

CSR is not available to impact enterprises

India is one of the few countries in the world mandating that its corporations set aside a part of their profits to spend on impact projects. Companies with a minimum net worth of INR 500 crore, turnover of INR 1,000 crore, or net profit of INR 5 crore are required to spend at least 2 per cent of their average profit for the previous three years on corporate social responsibility (CSR) activities. Nearly 25,000 companies spent INR 18,653 crore on CSR projects in 2018–19.[9] But regulations prohibit CSR funds from investing in for-profit impact enterprises. As a result, notwithstanding the substantial impact being generated by impact enterprises, non-governmental organisations are the primary beneficiary of CSR funding.

One exception opened up in September 2019, when government-sponsored incubators became eligible for CSR spending. That means funding that helps businesses develop science, technology, engineering, and medicine for social uplift will count as CSR expenditures. Whilst not lifting the ban on direct investments in impact enterprises, the regulatory change has the potential to catalyse the launch and growth of impact enterprises. “The decision of encouraging businesses to reroute their CSR 2 per cent spending into state-sponsored incubators will further contribute towards driving innovation and entrepreneurship with renewed vigour,” Saurabh Srivastava, chairman and cofounder of Indian Angel Network, told *Inc42*. “This falls in line with the government’s aspirational Startup India vision.”[10]

Barriers to offshore capital remain

External commercial borrowing (ECB) rules permit Indian companies to raise money in foreign currency for expansion of existing capacity as well as for new investments. Indian companies usually can borrow at more favourable rates from the United States or the Eurozone, where rates are lower. Assuming exchange rates do not fluctuate, ECBs could be a source of cheaper capital for eligible companies.[11]

Nonetheless, ECB is highly regulated by the Reserve Bank of India and comes with restrictions and guidelines that limit its appeal. For example, in certain sectors, companies must obtain Reserve Bank of India approval in advance before borrowing abroad. In other sectors, access to ECB capital can be made automatic for companies that satisfy eligibility requirements.

Investors also face drawbacks, notably the long minimum average maturity period (MAMP) on their ECB loans. The Reserve Bank of India has set a five-year MAMP for ECB loans made directly to Indian corporations.[12] NBFCs that secure ECB funds to lend are held to a seven- to 10-year MAMP. The long wait for repayment dampens offshore investor participation in ECB arrangements.[13]

9 Sachin P. Mampatta, “Companies spent Rs 11,867 cr on CSR activities in FY19; highest so far”, *Business Standard*, 12 December, 2019.

10 Bhumika Khatri, “How Will Govt-Backed Incubators Benefit From Latest CSR Regulations”, *Inc42*, 21 September, 2019.

11 “External Commercial Borrowing (ECB)”, eFinanceManagement.com.

12 “Frequently Asked Questions: External Commercial Borrowings (ECB) and Trade Credits”, Reserve Bank of India, updated as of 29 May, 2019.

13 “Notifications: External Commercial Borrowings (ECB) Policy – Rationalisation of End-use Provisions”, Reserve Bank of India, 30 July, 2019.

Another popular option for offshore investors is foreign portfolio investment (FPI), which permits equity and debt investments in Indian companies without taking an active role in company management. India received INR 1,36,835 crore as foreign portfolio investments in 2019.[14] Investors must first obtain a licence from the Securities and Exchange Board of India and adhere to the prescribed regulatory framework. When it comes to debt, foreign investors are restricted to non-convertible bonds or commercial paper issued by an Indian company. A single FPI investment may not exceed 50 per cent of the debt securities in a portfolio company and there are limits on the size of a bond holding relative to the aggregate corporate debt portfolio.

How to Bring More Debt Options to Impact Enterprises

The mismatch between debt financing supply – too little – and demand – too much – continues to impede the ability of social enterprises in India to fulfil their potential. Our balance sheet analysis of 422 leading non-financial impact enterprises estimated a collective shortfall in debt financing of INR 1,564 crore (US$216 million) for highly creditworthy businesses. That doesn't include thousands of other impact enterprises on the outside of the financial system looking in.

Solutions are at hand, as we heard from the impact investors and bankers we interviewed. They described a number of approaches that fall into three broad categories in the middle of a debt continuum spanning traditional debt to grants: 1. De-risk investments with loan guarantees or pooled debt offerings; 2. Offer flexible products, such as alternative investment funds, venture debt, or cash-flow lending; and 3. Develop new approaches to diligence and underwriting that identify creditworthy enterprises that can't meet traditional collateral requirements.

De-risk investments to attract reluctant investors

Loan guarantees by third parties address the real and perceived risks that can keep commercial banks, NBFCs, and impact investors from providing debt financing to impact enterprises. Guarantees typically come from foundations or development agencies. With a loan guarantee, the backer agrees to cover an investor's losses – up to a set amount and under certain agreed upon conditions – if the borrower fails to make timely repayments. Guarantees serve as a credit enhancement that shifts the balance of risk and return, making debt deals more attractive for risk-averse lenders. Payouts happen only if the borrower defaults and investors stand to lose money.

IndusInd Bank's Impact Investing division actively seeks out guarantee deals, such as the US$5 million in debt financing to Grameen Impact. The loan is backed by a guarantee from the US International Development Finance Corporation (DFC) and supports Grameen Impact's lending to local SMEs.[15]

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14 Samrat Sharma, "Foreign investors return to India in 2019; FPI shoots up amid slow economic growth", *Financial Express*, 31 December, 2019.

15 "OPIC gives $5 million loan to Grameen Impact via IndusInd Bank", *The Economic Times*, 12 June, 2018.

Rabo Foundation, the corporate Foundation of Rabobank, a Netherlands-based cooperative bank that focuses on food and agriculture sectors globally, has demonstrated how credit guarantees can work in the Indian market for agriculture. Due to regulations on offshore funding in the agriculture sector, Rabo Foundation could not offer loans directly to Indian farm cooperatives. As a workaround, six years ago it introduced credit guarantees, starting with an organic cotton farmers' cooperative. "Rabo Foundation's learnings from the initial programme led it to develop more blended finance programmes for farmer organisations and agtech companies which impact smallholder farmers," said Arindom Datta, executive director of Rural & Development Banking. Many financial institutions now participate in the guarantees by providing credit to otherwise underserved markets and organisations. Subsequently, Rabo Foundation set up a warehouse receipt financing programme, an agtech support programme, and a climate smart agriculture financing programme for farmer organisations.

Guarantees also can originate with impact investors using catalytic first-loss capital (CFLC). CFLC is a credit enhancement provided by an impact fund investor that agrees to bear initial losses in order to attract the participation of co-investors that otherwise would not join a fund. "The CFLC has gained wider recognition in impact investing discourse, especially amongst investors who are mission driven and intending to use their existing capital to achieve more impact," noted a 2018 report by Nishith Desai Associates, an international law firm headquartered in India.[16]

Despite the advantages to lenders, they don't necessarily jump at opportunities to participate in guarantee deals. USAID, the US international development agency, courted a number of lenders for months to sign up for a loan guarantee aimed at building SMEs producing non-timber forestry products. Only a few of the lenders joined due to the nascent market, said Eric Naranjo, director of the USAID's Centre for Innovation and Partnerships.

Loan guarantees have gained limited traction in large part because of the level of customisation required to structure a guarantee agreement. Customisation creates complexity that discourages greater utilisation of the tool. In addition, transactions involving guarantees often suffer from the difficulty of aligning priorities across multiple parties, which can undermine the tool's effectiveness. It's no wonder that Amit Bouri, CEO of the Global Impact Investors Network, has called guarantee agreements a valuable tool that is "extremely underutilised".[17]

Nonetheless, lender interest in loan guarantees appears to be on the rise. For its part, the Shell Foundation sees loan guarantees as "super catalytic for India", said Mangla, the India regional manager. Since early 2020, the foundation has been "thinking of ways to collaborate with funders to extend guarantees, not just for our portfolio companies, but overall for the ecosystem," she said.

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16 *Social Impact Investing in India, A Supplement to Corporate Social Responsibility & Social Business Models in India: A Legal & Tax Perspective*, Nishith Desai Associates, July 2018.

17 Hannah Schiff and Hannah Dithrich, *Scaling the Use of Guarantees in US Community Investing*, Global Impact Investing Network, 2017.

Pooled bond and loan structures provide debt financing to small enterprises that may find it difficult to access mainstream capital markets at competitive prices. Northern Arc Capital, an NBFC, launched India's first pooled bond issuance in 2014, serving as structurer and arranger.[18]

Under the pooled bond issuance (PBI) structure, companies seeking to access debt capital markets issue nonconvertible debentures, creating a bond pool. The pool is backed by a common partial guarantee that serves as credit enhancement, helping to raise the credit rating of the pool and creating access to mainstream investors. Northern Arc Capital extended the partial guarantee along with a third-party financial institution for the first bond pool and for multiple other subsequent issuances.

For Northern Arc, the PBI structure provided a scalable and efficient solution to enable access to investors and capital markets for its clients. The structure, though complex to execute, has gained in popularity. "The PBI structure offers diversification, credit support and, in combination with prudent structuring, made it possible for originators to access a diverse base of investors at competitive prices, whilst investors could invest in a product that met their risk-return objectives," said Satya Srinivasan, head of products for Northern Arc Investments, a fund management subsidiary of Northern Arc Capital.

Northern Arc's pooled loan issuance programme, launched in 2017, works in a similar manner. Under the pooled loan structure, a loan pool is backed by a common guarantee providing the same credit enhancement and diversification benefits as in the PBI structure.

Expanding access to bundled loans with partial guarantees also appeals to USAID's Naranjo. "If we can bundle enterprises and diversify the risk level to create a new middle-market asset class as an instrument of investment, maybe that's where commercial banks can get in," he said. Structuring a collateralised debt obligation – a pool of loans sold to institutional investors – with a credit guarantee would be "a very nice way to think about attracting commercial lenders to come in and get a taste of this asset class. That's much more exciting than doing these one-off guarantees," he added.

Offer flexible debt products

Alternative Investment Funds (AIFs) have grown in popularity since the Securities and Exchange Board of India (SEBI) issued regulations governing the operation of such funds in 2012. An AIF is any fund established in India that that pools investment funds from institutional or high-net-worth investors, whether Indian or foreign, in accordance with a defined investment policy. The minimum investment from a limited partner is INR 1 crore.[19] Today, more than 695 funds have registered with SEBI.[20]

There are three categories of AIFs. Debt funds fall under Category II, which governs funds that invest primarily in debt or debt securities of listed or unlisted investee companies in

18 Northern Arc debt products website.

19 "Frequently Asked Questions (FAQs) SEBI (Alternative Investment Funds) Regulations, 2012", Securities and Exchange Board of India. All the categories of AIFs in India except angel funds require a minimum investment of INR 1 crore. For the angel fund, the amount is INR 25 lakh.

20 "Registered Alternative Investment Funds", Securities and Exchange Board of India.

accordance with the stated objectives of the fund. Category II, which also includes real estate, private equity, and distressed asset funds, is the most widely used AIF structure.[21] As of June 2020, Category II funds had raised a cumulative INR 127,661 crore (US$16 billion), more than twice the combined amount raised by the other two categories.

Compared to foreign portfolio investments, AIFs have more appeal to overseas debt investors. Credit concentration limits are looser for AIFs, and unlike FPIs, AIFs have no minimum residual maturity requirements. "With these conditions, AIFs are a clear winner for debt investments," concluded *Money Control*, a Mumbai-based financial news service.[22]

Venture debt refers to a variety of debt financing products offered to early and growth-stage venture capital-backed companies. It is available to companies that do not have positive cash flows or significant assets to use as collateral. Lenders combine loans with warrants, or rights to purchase equity, to compensate for the higher risk of default. Venture debt is regarded in India as a bridge to the next round of equity financing.

Venture debt has several advantages over equity alone: It results in less ownership dilution for entrepreneurs and investors; it extends the runway to the next equity investment round, allowing valuation to grow; it can finance a specific project, like inventory or equipment; and venture debt lenders do not require board seats.

The first venture debt providers entered the Indian market more than a decade ago, but only recently has venture debt begun to gain popularity. "One of the reasons for increased venture debt funding is the size of the [venture capital] ecosystem has expanded over the past three to four years, which in turn has resulted in larger opportunity as there is a bigger pool of start-ups," Ashish Sharma, CEO of InnoVen Capital India told *YourStory*.[23] Since 2015, approximately US$4 billion in venture debt has been deployed across 150-plus deals in India.[24]

In the Unites States, venture debt is roughly 10–15 per cent of the total venture capital market, said Ishpreet Gandhi, founder and managing partner of Stride Ventures, a venture debt fund. "Here, it's not even 4–5 per cent," he added. "It's a great asset class but under-penetrated." From venture debt's modest base in India, market participants expect it to grow over the years ahead. "For the Indian start-up ecosystem, the overall trend is quite positive," said Vinod Murali, managing partner at Alteria Capital. "Whilst start-ups are doing well, there is also dry [investment] powder available from an equity perspective. That means venture debt has significant headroom to grow."[25]

Cash-flow lending addresses a common complaint of SME owners in India: Businesses fail to achieve their growth potential because banks won't extend loans without collateral. Cash-flow lending allows banks, NBFCs, and fintech firms to extend loans based on the

21 Shagoofa Rashid Khan, "India: Alternative Investment Funds Comparative Guide", Mondaq, 28 September, 2020.

22 Anish Mashruwala and Sahil Shah, "AIFs can be used to make plain-vanilla debt investments", 25 November, 2019, Moneycontrol.com.

23 Sameer Ranjan and Thimmaya Poojary, "Funding: why are Indian startups taking to venture debt?" *YourStory*, 12 August, 2019.

24 Raunaq Jaisinghani, "Venture debt and the Indian startup ecosystem", Invest India Team India Blogs, 1 April, 2020.

25 Ranjan and Poojary, "Funding".

present and projected cash flows of the enterprise. Compared to conventional business loans, cash-flow lending requires less paperwork and shorter approval times, in part because it does away with the appraisal of collateral. Market observers expect cash-flow lending to be a boon for micro-, small and medium-size enterprises (MSMEs), start-ups, and impact enterprises that may not have hard assets for collateral.

A report of the Reserve Bank of India's expert committee on MSMEs recommended in June 2019 that banks should opt for cash flow-based lending.[26] And the country's largest lender, State Bank of India, announced early in 2020 that it planned to transition from asset-based lending to cash-flow lending. Whilst not aimed specifically at impact enterprises, cash-flow lending no doubt will benefit them.

"My sense is there are a lot of companies which don't have mortgage collateral, but are EBIT [earnings] positive," said Avishek Gupta, Caspian Debt's investment director. "It is very easy to address the debt requirements of those companies if people like us get access to them." Caspian offers a range of debt products to meet specific client needs without requiring mortgage collateral or three-year profitability.

Rapidly developing technology supporting data analytics and artificial intelligence, and a constantly improving IT infrastructure, all underpin the growth of cash-flow lending. NBFCs and emerging fintech companies rely on that technology to collect and analyse real-time transaction data. The emergence of account aggregators that assemble individual and enterprise data will fuel even greater interest in transitioning from collateral-based lending.

Develop new approaches to due diligence and underwriting

Deep sectoral expertise gives banks and impact investors the insight needed to meet the specific debt requirements of individual sectors. Some enterprises invest heavily in assets, others invest in intellectul property (IP). Agricultural enterprises, for instance, spend on large capital assets like tractors and other farm equipment. Educational technology enterprises, on the other hand, rely on intangible IP to create value and have very few tangible assets. Cash flow also varies by sector. Software companies typically have stable revenue streams, whereas agricultural enterprises have seasonal revenue.

Understandably, bank loan officers unfamiliar with sectoral asset and cash-flow variations utilise traditional collateral-based lending without looking closely at an enterprise's underlying business model. What loan officers need "is a lens that can see [applicants] from a sectoral perspective," said Amit Kumar Rathi, managing director of Unitus Capital, an impact-focused NBFC. Unitus, founded in 2008, has developed sectoral expertise in a number of areas, including healthcare, clean energy, and education.

Rabo Foundation has applied its deep knowledge of the food and agriculture sector to create financial structures and services that address unmet needs in the Indian market. For example, the foundation partnered with Caspian Debt to launch a US$2.5 million impact debt fund for agtech innovators. The fund, the first of its kind, supports early-stage start-ups in securing collateral-free working capital tied to cash flow. All the funds

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26 "Report of the Expert Committee on Micro, Small and Medium Enterprises", Reserve Bank of India, 25 June, 2019.

were committed within 10 days of launch. For its part, Caspian has worked "to help build a robust ecosystem to support entrepreneurs in the food and agriculture sectors," said Gupta, the investment director.

All the impact investors we interviewed have developed proprietary diligence and underwriting methods that go beyond traditional collateral-based lending to assess the creditworthiness of potential investees. The methodologies vary greatly. At Caspian Debt, each credit decision is approved by a centralised credit committee. Specialised teams conduct the due diligence through extensive desk and field research that includes facility and customer visits. The deal screening also includes a strict exclusion list for companies that do not meet environmental, social, and governance (ESG) standards. By contrast, Vivriti Capital has developed a highly automated, quick-response credit underwriting platform called CredAvenue that links enterprises in need of debt financing with potential lenders.

Whilst proprietary platforms like these can validate new ways to pursue due diligence and credit underwriting, they remain the exclusive domain of their developers. The sector would benefit from the standardised tools and platforms broadly available to banks and other financial institutions. A confluence of three emerging factors – cash-flow lending, account aggregators, and technology infrastructure – holds the potential to create the broadly accessible tools needed to put new ways of diligence and underwriting within reach of any loan officer or impact investor.

Structure development impact bonds

A development impact bond (DIB) is an outcomes-based investment instrument that functions like a loan and involves three parties: a private investor who puts up initial capital, an outcome payer, and an implementing service provider. The service provider, usually an NGO, is responsible for the project and a specific set of quantifiable outcomes that drive towards social or environmental impact. If the outcomes are achieved in full, the impact investor is repaid with interest by the outcome payer, usually a philanthropic funder or organisation. Hence DIBs are pay-for-performance investments.

The first Indian DIB was launched in 2015 with the backing of two foundations to support Educate Girls, a nonprofit that works ensure higher enrolment and school attendance for girls as well as improved learning outcomes for all children. A three-year evaluation report found that Educate Girls exceeded its target outcomes. With proof of concept established, DIBs have attracted increasing attention as a way to finance innovative social programmes and enterprises.

"There is a big appetite for pay-for-performance mechanisms right now," said USAID's Naranjo. USAID led an effort to attract CSR funding for pay-for-success outcomes despite lack of precedence in the market for CSR participation. By deconstructing the success payments, CSR funds can pay for programmatic expenses and USAID can pay the interest. "That's unlocked a lot of CSR money," said Naranjo, who hopes commercial capital, including impact investors, will follow in CSR investors' footsteps.

Support Development of the Debt Finance Ecosystem

The ecosystem supporting debt financing for Indian impact enterprises has emerged over the past decade but still has a lot of room to grow. "The entire (debt financing) sector is really at its infancy today," said Sukumar, Vivriti's managing director.

Developing partnerships between banks and impact investors are a sign that the ecosystem is growing up. These nascent partnerships have deployed a variety of alternative approaches to debt financing that serve the specific needs of impact enterprises**.**

For example, Stride Ventures shares its underwriting expertise with banking partners as it builds relationships between banks and potential loan recipients. Stride looks for opportunities to co-lend with banks to reduce a borrower's loan interest rate and facilitate development of a long-lasting banking relationship.

"Our aim is to bridge the gap between banks and start-ups, providing a gateway for banks and making credit much more accessible for start-ups," explained Gandhi, Stride's managing partner. "In the next five years, all of us existing players [in the venture debt space] will step up and support the [start-up] ecosystem. I think it is very important to work closely with the banks, it would really go a long way."

Conversely, banks can take the initiative in forging partnerships with impact investors. IndusInd Bank, for example, set up an impact investing unit in 2018 to finance impact enterprises overlooked by mainstream financial institutions concerned about perceived high risk. To manage its lending risks, IndusInd seeks partnerships with impact investors, foundations, development finance institutions, and others committed to supporting impact enterprises to take advantage of their experience in various sectors.

More typically, IndusInd provides a loan whilst a partner offers a guarantee to mitigate risk. Guarantees come in different forms. A first-loss default guarantee makes the provider of the guarantee liable for losses up to a certain specified limit. *Pari-passu* financing gives IndusInd and its partners equal claim to the assets used to secure a loan. In a recent example of IndusInd's partnership approach, the bank joined with the US International Development Finance Corporation (DFC) in June 2020 to extend US$5.5 million in debt financing to WayCool Foods, an agriculture and technology firm engaged in food development and distribution. IndusInd provided the loan and US DFC extended a 100 per cent guarantee.[27]

As more such partnerships develop, the cross-pollination will serve to deepen knowledge and expand the reach of debt financing in service of India's impact enterprises. It will also support other important ecosystem developments:

- **Standardisation of approaches**: The bespoke nature of alternative debt financing approaches make them time-consuming to execute, which drives up transaction costs. With experience, investors may settle on a consensus around a framework of approaches that meet the needs of enterprises whilst creating a more standardised approach to deal making.

27 "WayCool Foods receive $5.5 million debt financing from IndusInd Bank", *The Economic Times*, 11 June, 2020.

- **Educational outreach to entrepreneurs**: Many impact entrepreneurs revert to equity financing because they are unfamiliar with the uses and advantages of debt. Lenders may find it to their advantage to do more to educate leaders of early- and growth-stage impact enterprises about the benefits of alternative debt financing options.
- **Recognition of debt as an asset class**: Growing experience with alternative approaches to debt will advance the process of elevating debt to an asset class. As an asset class, alternative approaches would be better positioned to attract capital from major investors that previously sat on the sidelines.

Conclusion

India has a credit problem, and it's putting the brakes on growth. Credit finances production, consumption, and capital formation. Lack of credit constrains economic vitality. Barriers to obtaining credit affect millions of SMEs, of which impact enterprises constitute an important subset. These are the entrepreneurial businesses that aspire to deliver valued social or environmental benefits whilst making a decent profit.

Our research revealed a significant shortfall in access to credit amongst several hundred leading impact enterprises. Impact enterprises, lenders, and regulators alike share responsibility for the barriers that produce that shortfall. Whilst overcoming those barriers will not happen quickly, we heard much about pathways and progress towards building a stronger, more vibrant debt finance ecosystem. As that ecosystem matures, credit may live up to its promise as a game-changer for India's impact enterprises.

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Appendix A: Overview of Credit Rating Methodology

We developed a simple credit-rating methodology to evaluate the creditworthiness of the 422 social impact enterprises for which we obtained data. Enterprises were rated based on six core financial indicators: company age, total revenue, three-year revenue CAGR (compound annual growth rate), EBIT (earnings before interest and taxes) margin, cash runway, and current ratio. Ratings ranged from A (most creditworthy) to D (least creditworthy).

We used the six rating criteria to determine creditworthiness of all sectors. But we applied modified weighting analyses to Technology for Development and Energy due to their unique nature.

Weights for Each Financial Indicator

Criteria	Weights	Minimum Threshold
Age	20%	5 years
Revenue	15%	2 crore
Positive EBIT Margin	25%	0
Cash Runway[28]	25%	3 months
3 Year Revenue CAGR	10%	10%
Current Ratio	5%	1.0
Total	**100%**	

Credit Rating by Weighted Score

Rating	Total Score
A Rating	7 to 10
B Rating	5 to 7
C Rating	3 to 5
D Rating	Below 3

28 Companies with positive EBIT margin were marked differently for cash runway.

Scores for Each Financial Indicator

(1) Age	
Years	**Points**
0-5	0
5-7	3
7-10	6
>10	10
(2) Revenue	
INR Crore	**Points**
2	0
2 to 5	4
5 to 10	6
Greater than 10	10
(3) EBIT Margin	
%	**Points**
0	0
0-5%	5
5-10%	8
Greater than 10%	10

(4) Cash Runway	
Months	**Points**
3	0
3 to 6	4
6 to 10	7
Greater than 10	10
(5) Revenue CAGR	
Rate	**Points**
Less than 10%	0
10-20%	4
20-30%	7
Greater than 30%	10
(6) Current Ratio	
Ratio	**Points**
1	0
1 to 1.5	10
1.5 to 2	7
2 to 3	4

Illustration of Scoring for Enterprise 'X'

Parameter	Value	Score	Weight	Final Score
Age	8	6	.15	0.9
Revenue	89	10	.20	2
EBIT Margin	20%	10	.25	2.5
Cash Runway	1	4	.25	1
Revenue CAGR	35%	10	.10	1
Current Ratio	1.9	7	0.05	0.35
			Total Score	**7.75**

Appendix B: List of Interviewees

Name	Organisation
Aparna Dua	Asha Impact
Sachin Nandwana	BigHaat
Avishek Gupta, Ragini Chaudhary	Caspian
Caroline Vance	DWS
Royston Braganza	Grameen Capital
Paul Dileo	Grassroots Capital
Roopa Satish	IndusInd Bank
Nitin Goel	Inficold
Nirav Jhambhati	KaizenVest
Amit Akkihal	Logistimo/Tusker
Meyyappan Nagappan	Nishith Desai & Associates
Satya Srinivasan, Namitha Janardhan	Northern Arc
Arindom Dutta	RaboBank
Deepak Gaddhyan, Atish Mulay	RBL Bank
Aparna Mangla	Shell Foundation
Naveen Krishna	SMV Green Solutions
Ishpreet Gandhi, Apoorva Sharma	Stride Ventures
Amit Kumar	Unitus Capital
Mona Kachhwaha	Unitus Capital
Anthony Randazzo	US DFC
Eric Naranjo	USAID
Vineet Sukumar	Vivriti

About the Impact Investors Council

The Impact Investors Council (IIC) is the leading national member-based industry body to strengthen impact investing in India. It represents impact investors in India who are dedicated to accelerating this silent revolution: "impact investment". IIC has active support from leading impact investors and ecosystem players managing funds in excess of US$10 billion. IIC's mission is to encourage private capital to bridge the social investment gap in India in sectors such as financial inclusion, clean energy, education, water and sanitation, and healthcare.

About The Bridgespan Group

The Bridgespan Group is a global nonprofit organisation that collaborates with mission-driven organisations, philanthropists, and investors to break cycles of poverty and dramatically improve the quality of life for those in need. With offices in Boston, Mumbai, New York, San Francisco, and Johannesburg, Bridgespan's services include strategy consulting, leadership development, impact investing, philanthropy and nonprofit advising, and developing and sharing practical insights. Services to the institutional impact investing industry are provided by TBG Social Impact, Inc., a wholly owned subsidiary of The Bridgespan Group.

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