CHENAAR GROUP

Frontier Market: Pakistan

Building a New Investment Approach

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Foreword

Frontier Market: Pakistan highlights the vast opportunities that exist in Pakistan. A broad range of sectors is explored as well as the innovation of a Social Investment Fund. Over thirty CEO's and thought leaders were interviewed for this report and it is a useful starting point when looking to explore the Pakistani Market. The team writing and delivering this report hail from Mumbai, Karachi and Washington DC. Their fresh take on this market is made available for you within this report.

This report advocates both hybrid strategies for social and commercial investment as well as a focus on fostering entrepreneurship to harness the skills of Pakistan's youth. *Frontier Market: Pakistan* gives evidence of the great economic potential in this market, placing it on par with economically burgeoning India and China.

The Chenaar Group has been pleased to support the US-Pakistan Business Conference in London 2012 and will continue to track the challenges and opportunities available in Frontier Markets.

I welcome your feedback and if you would like to find out how the Chenaar Group can support your companies needs, please do get in touch.

With best regards,

Alia H. Ayub
Founder & CEO
Chenaar Group, LLC

About Chenaar Group

The Chenaar Group, LLC (CG) is an advisory firm that offers clients a range of services surrounding market access. CG can offer support every step of the way when exploring an opportunity, engaging with prospective business partners on the ground, as well as exiting the market as and when needed. Conduct business using the Chenaar Group's prism of local knowledge in frontier markets.

The Chenaar Group also provides political risk assessments and draws from a network of indigenous specialists with expertise in South Asia, Central Asia, the Middle East and North Africa. These unique offerings include the cultural fluency and extensive networks necessary to build, test and run projects on the ground. CG provides industry access to connect local economies with the promotion of local security, corporate social responsibility advisory, Diaspora engagement, strategic communication and grass-roots dialogue with diverse stakeholders to resolve conflict. Please visit our website to follow our work: www.chenaargroup.com

Acknowledgments

About the Author

Priya Shah works in the social impact sector focusing on thought leadership, advisory work and research on Asia. She has been involved in impact investing projects in Cambodia and India, and is a Knowledge Chair on the Acumen Fund Chapter in London. Priya is originally from Mumbai, India and holds a BA in History from Brown University.

About the Co-Author & Editor

Sanya Sheikh works in communications, managing projects and brand for digital creative agencies, consulting for groups seeking to create positive social and environmental change, and coaching individuals. Sanya is originally from Karachi, Pakistan and has initiated a number of social responsibility projects in both Pakistan and India.

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The Chenaar Advisory Board for their steady guidance, support and perspectives vital to shaping the direction of this report, and in understanding the political risk relevant to entering the Pakistan market

Multinational Corporations in Pakistan

Snapshot of Coca-Cola Beverages Pakistan Ltd

The Coca-Cola Company has been operating in Pakistan since the 1950s. The company has seen a significant rise in sales in the past decade due to an increasingly diversified brand platform. The local product offering has expanded from the traditional Coca-Cola beverage to Sprite, juices and sparkling water.

Coca-Cola have achieved much of its international growth through a franchise system. Whilst the system may still involve foreign bottling companies (such as Coca-Cola Icecek, A.S,) the company has maintained consistency using a local supply chain, with packaging equipment, concentrate, sugar and coolers sourced locally, as in the case of Coca-Cola Pakistan.

The company maintains the conviction in strong local talent and long-term opportunities in Pakistan. For example, it has implemented robust training programmes for local managers in Pakistan such as a Catalyst Programme, whereby internal talent development is assessed through the lens of best practice and diverse projects.

Additionally, Coca-Cola actively supports local sustainability projects in the form of public-private partnerships, covering a range of areas such as education, healthcare, environment, empowerment of women and water supply. Key stakeholders in this arena within Pakistan include the World Wildlife Fund, the Citizens Foundation and Kashf Foundation.

Interestingly, Coke Studio, a television series showcasing a fusion of diverse local musical influences, including eastern classical, folk, and contemporary popular music, is one of the most successful brand accomplishments for Coca-Cola globally. Thus, the company finds its brand voice in each unique region creating a fundamental level of cultural engagement. There are over 1 million fans of Coke Studio Facebook, making it one of the largest social media groups worldwide.

Multinational Corporations in Pakistan

Snapshot of Zorlu Energy Pakistan

The Zorlu Group, one of Turkey's largest corporate groups, has long since maintained a bullish approach to investment in Pakistan. The company recognised the energy crisis in Pakistan's rural areas, and the need for new means to provide power beyond traditional, expensive and unsustainable sources such as coal, natural gas and oil reserves.

Zorlu Energy Pakistan Ltd, a wholly-owned subsidiary of the Zorlu Energy Group, signed an agreement in 2006 with the Pakistan Alternative Energy Development Board (AEDB) to set up wind power plants in Pakistan. Under this agreement, Zorlu Energy Pakistan established joint ventures with the Asian Development Bank and the World Bank in 2008 and 2011 to fund wind turbines in the Sindh province. This agreement takes advantage of the immense wind potential that exists in Pakistan through the well-defined wind corridor which allows for investments in this sector to be harmonised and systematised.

Whilst the leadership agrees that there is a long-term stability risk in Pakistan, Zorlu's operations have not endured significant challenges. Murat Borsa, Chief Executive of Zorlu, maintains that the local partnerships have remained loyal to their commitments with Zorlu, and so Zorlu's presence in Pakistan remains strong.

Executive Summary

After gaining independence Pakistan was viewed as an Asian tiger; a bastion of economic growth. In the early 2000s, this tiger re-emerged through the rapid development of the local economy, human talent and entrepreneurship.

Pakistan was ranked top out of three of the highest performing Asian markets by Lalcap Ltd, growing at 21% from 2011 to 2012, compared with the Philippines, 15%, and Thailand, 9%.[1]

Additionally, in 2011, 70 companies from Pakistan qualified for the Arabia Fast Growth 500[2], with the second largest number of cumulative entries indexed that year:

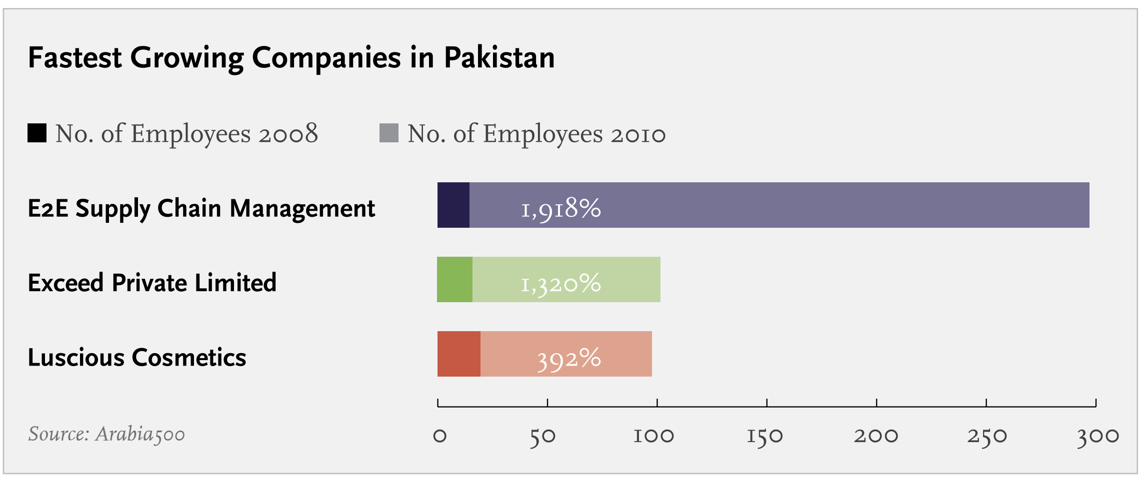


Figure 1: Fastest Growing Companies in Pakistan

Today, given the fledgling economy and its potential for growth, investors fear injecting equity or loan capital into Pakistan for the following reasons:

- The precarious law and order situation
- Inconsistencies in the political administration
- An energy crisis and limited basic amenities

The subsequent lack of investor confidence in Pakistan has led to a widespread reluctance to invest afresh in the region.

1 Deepak N. Lalwani, "India Report", Lalcap, 13 June 2012

2 Arabia Fast Growth 500, All World Network

In reality, Pakistan offers a myriad of social and commercial investment opportunities. As a frontier market, an injection of capital can yield high returns, and expand a market receptive to further reinvestment and greater return on investment.

Seen through the prism of knowledgeable investment, the country has a plethora of untapped natural assets, from mineral reserves to hydro, wind and solar power. The World Bank Doing Business 2012 report ranked Pakistan higher than three of the four BRIC nations in overall 'Ease of Doing Business.'[3]

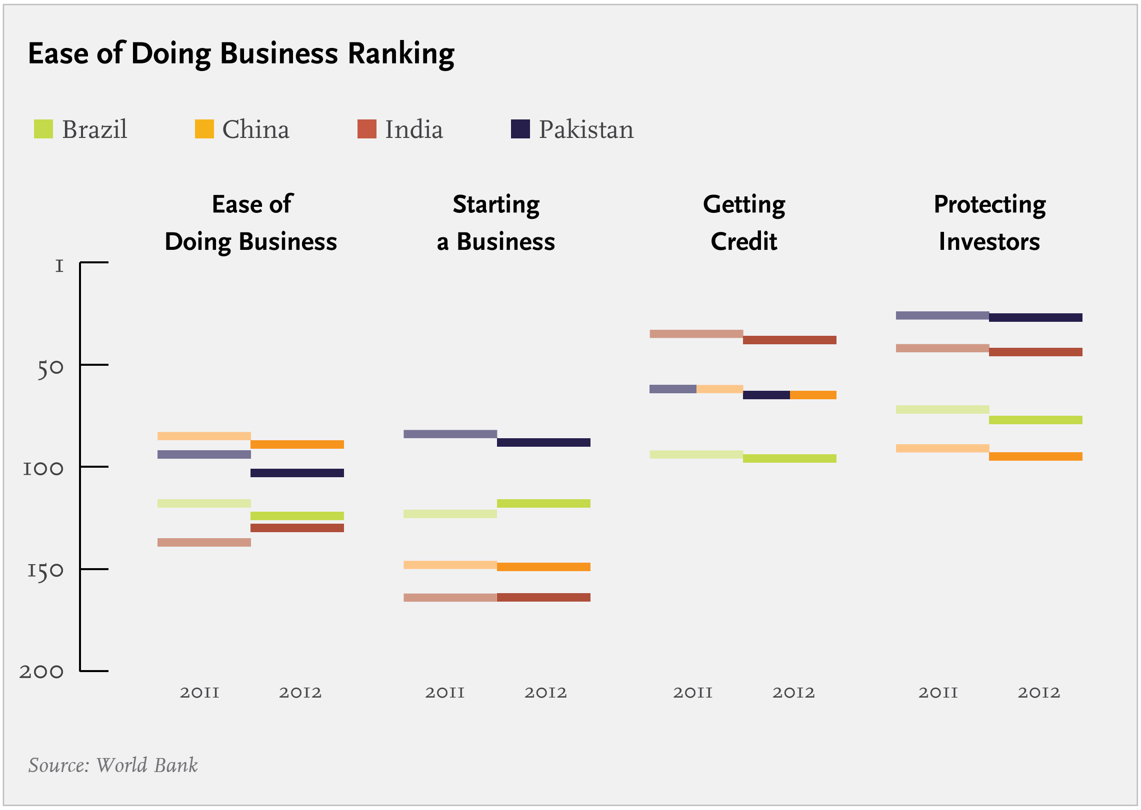


Figure 2: Ease of Doing Business Ranking

Despite low levels of infrastructure and highly populated rural areas, the informal economy provides a large consumer base.[4] A wealth of resources ensures a diverse equity portfolio.

Additionally, in 2005, the World Bank named Pakistan top reformer in the region and one of the top 10 reformers globally. Reforms include modernised customs policies, reduced barriers to import and export goods, increased efficiency and ease of transaction.

3 The World Bank "Doing Business" database has identified as the critical components of classifying the ease of initiating entrepreneurial venture globally. The ranking on each component is the simple average of the percentile rankings on its component indicators. Broadly speaking, the higher the ranking, the greater the ease of establishing a business in Pakistan. Globally, 183 economies were ranked in the study.

4 Helen Coster, "Want to Start a Company in the World's Sixth-Most Populous Country? Time to Move to Pakistan." Forbes, September 2011

Furthermore, corporate tax rates fell from 39% in 2004 to 37% in 2005 and 35% in 2006; an attractive proposition for foreign investors, compared with other BRIC countries which run an average corporate tax rate of 60%.

Tax Breakdown 2012

Indicator	Pakistan	South Asia	OECD high income
Payments (number per year)	47	28	13
Time (hours per year)	560	281	186
Profit tax (%)	17.9	18.6	15.4
Labor tax and contributions (%)	15.1	7.7	24.0
Total tax rate (% profit)	35.3	44.4	42.7

Source: World Bank

Figure 3: Tax Breakdown 2012

The pervasive impact of the world recession has incentivised Western investors to search for new growth markets. Multinational firms such as Coca-Cola, Proctor & Gamble and Nestlé have long since established operations in Pakistan, maintaining confidence in its profitability for long-term investment. With its few regulatory barriers, credit-averse middle class, and strong export advantage, it is the ideal target market.

Crucially, the country is widely acknowledged as having an ideal demographic breakdown for harnessing exponential near-term growth. As the sixth most populous country in the world, 63% of the population of 103 million is under 25 years, with 50 million of these between 15-24.[5]

According to the New Economics Foundation, Pakistan achieved a HPI score of 54.1 ahead of the United States (37.3) and the UK (47.9) and India (50.9), ranking 16 out of 151 countries overall.[6] This index considers metrics beyond GDP as a means to measure the potential for sustainable growth and population well-being by looking at key indicators such as life expectancy and ecological impact.

5 United Nations Development Programme: http://undp.org.pk/undp-and-the-youth.html

6 Happy Planet Index uses global data on life expectancy, experienced well-being and ecological footprint to calculate the HPI score: www.happyplanetindex.org

Pakistan can be effectively capitalised to facilitate the growth of four segments of the economy:

- Small to Medium Enterprises (SMEs)
- Mid-sized Manufacturing Industries
- Mid-sized Service Industries
- Large-cap Industry Sectors

Lucrative sectors for investment range from agriculture, textiles and renewable energy to manufacturing industries such as consumer goods and logistics. Similarly, service industries are rapidly evolving within segments such as media, telecommunications, information technology, education, banking and insurance.

This report will examine how investors can address the mid-cap and SME growth segments of Pakistan's economy and highlights frameworks of engagement between international and local private sector stakeholders.

A series of methodologies to harness nascent opportunities in a frontier market are outlined. In exploring the unique ambient factors specific to such a market, the report considers the ways in which they can be leveraged for successful investment. We examine the capacity of social impact as a vehicle for free market commerce, and as the most future proof method to increase medium to long term return to investment.

The report draws upon qualitative evidence of venture capitalists who, having invested in Pakistan, remain bullish of the region's potential. Tempering their initial fears, these investors have successfully maximised their returns and generated large-scale social impact. The resulting grassroots influence has in turn broadened their commercial platform, directly increasing the capacity for market expansion.

We explore human capital, intermediary institutions, knowledge sharing networks, environmental factors and economic perceptions, considering the possibilities inherent in forming a supportive dialogue and secure framework for private investors seeking to gain footholds in challenging economies with exponential growth potential. A Social Investment Fund (SIF) is also examined as a model to channel debt and equity capital to mid-cap and SME enterprises in Pakistan.

The benefits of streamlining loan and equity capital across a series of market sectors, mitigating and managing risk, as well as providing support for a strategic market exit are further considered, and the necessary conclusions are extrapolated upon.

Introduction: Pakistan as a High Potential Market

Throughout its history, Pakistan has developed a highly diversified base of manufactured products for domestic and world markets. The growth poles of Pakistan's economy have traditionally been situated along the Indus River.

The majority of industry currently thrives in the Punjab and Sindh provinces. The diversified economies of Karachi and Lahore's urban areas coexist with less developed rural regions. Balochistan, Khyber Pakhtunkhwa and Federally Administered Tribal Areas of Pakistan (FATA) offer tremendous growth potential, particularly in the underdeveloped mining and energy production sectors. Satellite cities such as Multan and Hyderabad offer new hubs of opportunity. Here key policies promoting domestic investment and providing growth assistance to local businesses have been recently implemented.

Such policies, instigated by the Board of Investment (BOI), exist to promote and develop investment opportunities for local and foreign investors. The BOI acts as a focal point of contact between potential investors and government agencies, reflecting the willingness of the Government to ensure that there is an independent institution and framework in place to support international investors in Pakistan.

Recently a new discourse has been emerging within Pakistan, reflecting the need to break challenging internal economic cycles and to end aid dependency. Following the 2008 financial crisis, the Government of Pakistan's strategy has focused on regaining macroeconomic stability and structural reforms. There is a renewed appetite for change encouraging sustained economic growth with a deeper reliance on home-grown resources.

The vision of the Government of Pakistan is to steer Pakistan's economic growth back to the range of 5-7% per year by stimulating growth through the "New Growth Framework."[7]

Substantial macroeconomic reforms, implemented in 2000, most notably in privatising the banking sector, have provided assistance to the economy. Recently, Government policies have been bolstered both by foreign investment and renewed access to global markets. 74% of the Foreign Direct Investment shares to Pakistan over the last 10 years collectively originated from USA, UAE, UK, Switzerland, China, Norway, Saudi Arabia, Hong Kong and Japan.[8] To this end, physical infrastructure networks such as gas, roads, ports and telecommunication facilities, have expanded with assistance from foreign players.

7 Dr Nadeem Ul-Haque, Deputy Chairman, Planning Commission, "Pakistan: Framework for Economic Growth", Planning Commission, Government of Pakistan, May 2011

8 Muhammad Arshad Khan and Shujaat Ali Khan, "Foreign Direct Investment and Economic Growth in Pakistan: A Sectoral Analysis", Pakistan Institute of Development Economics, Islamabad

The Government, together with the thriving non-profit and private sector, have provided critical services to the population including health, education and infrastructure. The public sector itself provides support for property rights, national security, macro-economic stability, contract enforcement, regulatory support and labour laws.

The political class needs to take an increasing role in providing leadership for sustainable inclusive growth. However, it cannot act alone; investors, entrepreneurs, the private sector and various other potential actors are critical.

The Multi-Stream Market

Frontier Market: Pakistan promotes a multi-stream investment approach. The frameworks chosen highlight high yield areas in which Pakistan is under-performing, and therefore where latent growth has not yet been realised.

The key parameters explored are:

- Understanding the risks and opportunities in the investment environment
- Focusing on the growth and development of domestic resources
- Facilitating structured investment across market sectors

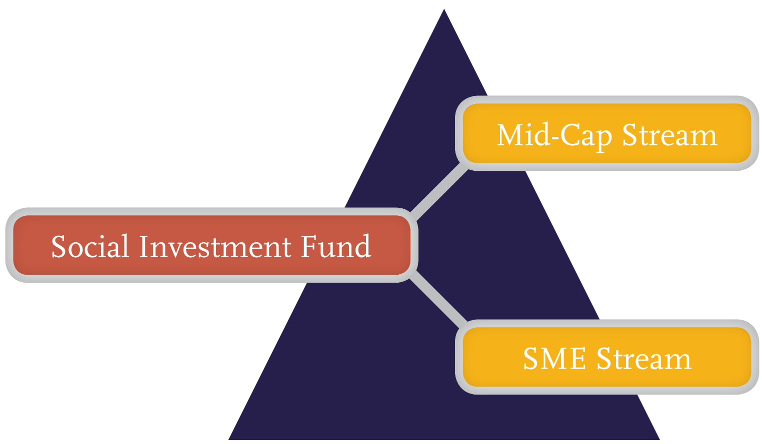


Figure 4: Multi-Stream Approach

The approach provides investors with the relevant tools to access the untapped potential of Pakistan's under-performing sectors by touching on the intricacies of governance frameworks, cultural norms and legal structures.

An investor-led economic stimulus in these streams will capitalise on latent human talent, improve income distribution, utilise natural resources and spur liquidity into the market, which in turn will yield near-term returns, as well as priming a beneficial economic environment to leverage in the future.

The Mid-Cap Stream encourages mid-cap investments into urban manufacturing and service industries, whilst the SME-stream encourages small-cap investments into SMEs. Sectors such as financial services, information technology, logistics, agriculture, renewable energy, textiles and education are explored. Finally, a Social Investment Fund (SIF) model is proposed as a mechanism to streamline debt and equity capital into the two investment streams.

The Mid-Cap Stream

The Indus Valley civilisation, which peaked in c.2500 BCE, was one of the first farming cultures in South Asia, and spearheaded the growth of several industries such as pottery, textiles, urban planning, and irrigation systems.

Pakistan was conceived from this entrepreneurial mind-set with a heritage born of conquests by numerous Central Asian, Persian, and ancient Greek empires. These nomadic movements over the centuries brought to the region's inhabitants an inherent character, thus culture, language, literature, cuisine, dress, architecture and folklore were all influenced by these unique legacies.

However, during the colonial era, institutional frameworks and governance structures stifled the entrepreneurial spirit. Educational institutions have thus tended to produce followers rather than leaders, and complex legal and regulatory frameworks have dissuaded traditional family business owners from expanding their enterprises. These structures have perpetuated into the 21st century, and the low level of confidence in the entrepreneur has impaired the growth of the entrepreneurial spirit in Pakistan's industrial sectors.

The reform of the largely feudal system to awaken the entrepreneurial mind-set both at the individual and at the community level is crucial in order to spread a wave of enterprise throughout Pakistan. By encouraging factory owners to utilise innovative business models and allow for both healthy competition and diversity, a network of self-sustaining enterprises will be successfully created. The subsequent enterprise development across sectors becomes an attractive beacon for investors eager to engage in the region.

Financial Services

Over the last decade, Pakistan has implemented several banking sector reforms which have transformed the sector into an efficient, sound and strong system. In particular, the predominantly state-owned banking system has been privatised. The legislative framework and the State Bank of Pakistan's (SBP) supervisory capacity have been improved substantially. As a result, the financial sector exhibits an increased resilience to market forces.

The foreign exchange market, once highly regulated through a system of direct exchange controls over suppliers and users has now been liberalised, with trade taking place through an active and vibrant inter-bank exchange market. Prior restrictions have been removed with full and partial capital account convertibility. Foreign investors can now transfer capital and remit profits, dividends and fees without any prior removal directly through their banks. Similarly, foreign portfolio investors can also enter and exit the market at their own discretion.

Healthy competition amongst banks has led them to offering a greater range of products and services. The borrower base of banks has expanded four-fold in the last six years as the banking sector has diversified into agriculture, SMEs, consumer financing, mortgages and other streams. Notably, the growing middle class now has disposable income whereas previously they did not. They are the largest beneficiaries of these new products and services, buying items such cars and long-term property assets.

Along with strong regulation, supervision and the enforcement capacity of the State Bank of Pakistan (SBP), a number of measures have been taken to ensure that the financial sector meets best practices and corporate governance standards:

- "Fit and proper" criteria have been prescribed for CEOs, Boards of Directors and executives
- International Accounting Standards (IAS) and the International Audit Codes adhere to global accounting and audit standards
- External audit firms are rated according to their performance and track record
- Those falling short of the acceptable standards are debarred from auditing the banks

In addition, the SBP has established units in the Bank dedicated to SME, agro-finance and microfinance lending. The Bank has initiated projects to manage the disbursement of agricultural credit in twenty-eight underserved districts in Pakistan and introduced relief packages for small-scale and marginalised farms in Khyber Pakhtunkwa and the FATA.[9]

The bank has also established:

- Refinancing for the modernisation of rice husking mills
- The market development for agricultural commodities through warehousing systems
- Facilitation of commodity trading at the exchanges
- Financial literacy training in Credit Administration & Risk Management Departments for smaller nationwide banks

Thus the SBP has led private sector banks (both Western and local) to promote small-scale lending in Pakistan, increase market liquidity and achieve large-scale social impact.

Furthermore, technology is revolutionising customer services and access. Online banking, Internet banking, ATMs, mobile phone banking and other modes of delivery have made it possible to provide convenience to customers while reducing the transaction costs to the banks. Credit Cards, Debit Cards and Smart Cards are a thriving and expanding business in Pakistan as the middle strata of the population move away from their traditionally cash-only culture.

9 Staff Report, "'Banks to revamp lending mechanism for agri financing", Daily Times, 3 March 2010, http://www.dailytimes.com.pk/default.asp?page=2010%5C03%5C03%5Cstory_3-3-2010_pg5_2 (accessed 27 January 2012)

Case study

Easypaisa is an illustration of how technological innovations have been used to access large networks in Pakistan whilst providing a vital service. Easypaisa is a banking service developed by Telenor Pakistan, a Norwegian telecommunications company eager to empower rural customers with access to mobile banking.

In 2009, Telenor partnered with Tameer Micro Finance Bank to introduce branchless banking for the first time in the country. With Easypaisa, customers have access to convenient methods of financial transaction, whether related to paying bills, sending or receiving money within Pakistan, receiving money from abroad, purchasing airtime for their mobile phones or making donations online. This innovation meets a social and commercial need for online banking, whilst tapping into the 100 million mobile phone users consumer base.

Multinational banks have recognised Pakistan as one of the fastest-growing emerging markets in Asia. Standard Chartered, which established its first commercial operations in Karachi in 1863, is an example of a British bank operating in the country. The Bank now holds roughly 176 branches across 41 cities in the country. In 2006, Standard Chartered acquired Union Bank, a domestic private sector bank, through a transaction of US$487 million, the largest ever transaction in Pakistan's banking history.[10] This established Standard Chartered Bank (Pakistan) Limited (SCBP), the first international bank in Pakistan to be locally incorporated.

After the acquisition of the Union Bank by Standard Chartered, many foreign banks, such as Barclays, entered the domestic market, acquiring local small to medium-sized banks and financial institutions, expanding their networks and businesses to leverage the growing Pakistani market. This has led to a significant influx of capital acting as a catalyst for much-needed consolidation in the banking sector.

Standard Chartered was named "Best Investment Bank in Pakistan" by Finance Asia for 2011, in part due to the eight deals closed by the structured trade finance and financing solutions group during the period. The success of this multinational bank has set a solid example for other multinational banks to ensure that they are locally embedded and for local Pakistani banks, such as SilkBank, to drive a competitive edge in the banking sector.

Nevertheless, currency devaluation still remains one of the largest concerns for the foreign investor wishing to engage in large-scale lending and avoid the exchange rate fluctuations that can have detrimental effects on market returns. The Risk Mitigation Mechanism outlined later in this report under the Social Investment Fund (SIF) refers to how this should be managed in the context of a fund structure. The SIF model showcases a form of investment strategy which takes high risk, high return investments into account across market sectors in Pakistan, whilst achieving long-term social impact, which broadens the marketplace and allows for reinvestment.

10 Ishrat Husain, Governor of State Bank of Pakistan, "Pakistan's Banking Sector: Current Situation and Critical Issues", 2004.

As widely acknowledged, the financial sector will function efficiently only if the macroeconomic situation is favourable and stable. Domestic policies to contain inflation, corporate governance and currency devaluation would need to be carefully implemented in accordance with the rising foreign investment in Pakistan. As markets are inextricably tied to policy-making, the need to maintain macroeconomic stability will remain paramount in the years to come.

The establishment of the Credit Informational Bureau within the State Bank of Pakistan has been useful in providing financial institutions with an aggregated database on borrower credit (in the form of credit reports) and enabling them to learn the credit history of their prospective customers.

Government agencies such as the Board of Investment (BOI) work towards simplifying procedures to attract investment and build linkages amongst provinces, private and public investors. This in turn helps to stabilise the macroeconomic environment by removing barriers to private sector investment.

BOI provides investors with up-to-date, public information on regulatory policies, business match-making and legal transparency to promote an investor-friendly environment in the country. Provincial investment boards (such as Sindh and Punjab), maintain their own outreach and support system for investors, which allows for a strong platform for public-private sector engagement.

Information Technology and Telecommunications

Pakistan's Information Technology (IT) sector is supported by IT institutions, notably FAST-NU, LUMS, GIK and IBA and consists primarily of small firms, many of which were started by entrepreneurs encouraged by the low barriers to entry in the industry.

> Mixit has been one of the success stories from Pakistan. Founded on Wall Street by a group of entrepreneurs, it is privately held. Since then, it has quickly grown to 100+ employees and is highly recognised as the financial industry's trusted trading technology provider. The development of the Mixit trading products has been done in Karachi by talented young professionals with the sales and management team based in the US. Mixit Technologies sold its international affiliate, Mixit Inc, in July 2011 to UK IT firm, Patsystems, for approximately £17.6m.

The IT industry sector is currently worth in excess of $2 billion a year according to the industry group, Pakistan Software Houses Association, and is projected to reach $11 billion by 2016.[11] Crucially, the IT industry is not location-dependent which allows for a greater versatility in employment opportunities.

11 Kazim Alam, "A thousand flowers bloom: Small firms dominate Pakistan's IT skyline", The Express Tribune, 1 Aug. 2011 (accessed 28 Dec 2011)

With a large number of global IT companies establishing operations in Pakistan, and with revenues growing by 30-40% year on year, the IT industry is possibly the most exciting and dynamic sector in the country today. The industry includes several world-class software companies and services, employs approximately 75,000 professionals, and is supported by major on-going IT tenders and projects within the government and private sectors.[12]

The convergence of communications, computing, and entertainment has benefited the sector by generating huge diversity in the products and companies now emerging as a mainstream aspect of economic activity.

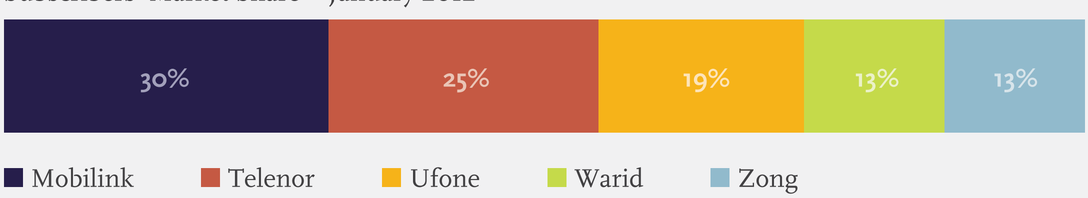
In 2004, the Government of Pakistan decided to liberalise the telecommunications sector and provide access to foreign investors. The Government announced expansive telecom deregulation, mobile and broadband policies. As a result, newly licensed companies began to roll out their networks across the country. Telenor Pakistan, explored above, was one of these companies to gain from the deregulation policies in the telecommunications sector.

Prices of telecom services dropped drastically and revenues of existing operators improved significantly. The centrepiece of the deregulation was the establishment of two categories of basic services licenses: Local Loop (LL), for fixed line telecommunication within the 14 regions under the remit of the Pakistan Telecommunications Company Ltd. (PTCL), and Long-Distance and International (LDI), for communications between regions.

By 2008, Pakistan was the world's third fastest-growing telecommunications market. The infrastructure continues to improve dramatically with foreign and domestic investments into fixed-line and mobile networks. Additionally, fibre-optic systems are being constructed throughout the country.

Top Telecommunications Companies by Market Share

Subscribers' Market Share – January 2012



Source: ProPakistani and IT News

Figure 5: Top Telecommunications Companies in Pakistan

12 Pakistan Board of Investment, "IT Sector Overview", 2004.

Approximately 90% of Pakistanis live within areas that have cell phone coverage and more than half of the population has access to a cell phone.[13] Furthermore, telecom companies are working to broaden their networks in the Azad Jammu and Kashmir and Northern Areas, which had limited connectivity until recently. Five of the seven federally administered agencies of the tribal areas have mobile coverage.

With consumer demand rising rapidly, the number of internet subscribers in Pakistan currently stands at approximately 18.5 million, approximately 10.5% of a population of 177 million.[14] This assessment serves as a strong indicator that the sector is ripe for investment and that sufficient and growing demand for a vast range of communications products will continue to spur the growth across telecoms platforms.

Consumer Goods and Retail

The retail industry in Pakistan holds large potential both in the supply and in the demand for consumer goods products in rural and urban areas. The recent trend of large outlet malls is attractive amongst the middle classes, who are increasingly financially empowered due to the high levels of disposable income and the low dependency on credit.

According to a study conducted by Standard Chartered Bank in 2007, close to 30 million Pakistanis live in households with an annual income of $10,000.[15] Local supermarkets have long-since held a presence in Pakistan; examples are Agha's Supermarket and Naheed's. The advent of Western hypermarkets and wholesalers such as Carrefour and Metro Cash & Carry has given Pakistanis a taste of choice-driven shopping experience that is likely to expand the market for consumer goods throughout the country. The Western wholesalers have in turn inspired a local response, typified in wholesale chains such as Makro (launched by conglomerate the House of Habib) and supermarket chains such as ARY.

The existence of these chains allows for a greater variety of choices for the consumer and wider accessibility to local produce. If food production companies can have lower distribution costs and easier access to a wider swathe of the consumer market, they are more likely to expand existing lines of business and introduce newer markets. In other words, food producers will transform their operations from selling raw commodities to selling higher value goods. This will not only expand consumer choice and consumption, but will also increase labour productivity and in turn, drive up incomes and expectations. As consumers develop more brand awareness through increased exposure from brand variety, the motivation to acquire higher earnings in order to afford a broader range of brands is likely to increase.

13 Pakistan Telecommunications Authority, http:// www.pta.gov.pk

14 Internet World Stats, http://www.internetworldstats.com/asia/pk

15 Farooq Tirmizi, "The changing face of retail", The Express Tribune, 27 Sept. 2010 (accessed 27 Jan 2012)

According to the Small & Medium Enterprise Development Authority (SMEDA), there are over 125,000 retail outlets across Pakistan. Approximately 94 per cent of these are corner shops and small retail outlets locally owned and operated throughout cities and villages.[16] There is immense potential for a single chain of retail outlets with its own integrated supply line, able to avoid the fragmentation of the market and increase the profitability throughout the chain. Perhaps most critically, there is no nationwide chain of retail or even wholesale outlets. This poses a challenge for investors looking to enter the consumer goods or branded textiles sector.

With a growing ability to spend, investors should note that the middle class is a thriving and willing consumer base for Pakistan's retail sector, whose demand for branded textiles could significantly contribute to national economic growth. International brands are gaining traction in Pakistan. Retailers such as Team A Ventures are introducing brands such as Mothercare, Next, Timberland and Debenhams to Pakistan. Whilst local operations follow the prerogatives of the head offices in London, there remains ample room to develop local skill-sets to expand production outlets in Pakistan.

Logistics

Pakistanis spend close to $36 billion a year on food and other retail shopping, yet businesses have difficulties in reaching the mass market of Pakistani consumers. The consumer market is not a single marketplace, but rather a distribution of tens of thousands of small shops.

Today, logistics operations have become much more complex as companies find it challenging to maintain their competitive advantage purely on the basis of innovative strategies relating to the product, price, place, or promotion. Since these competitive advantages can easily be imitated, the emphasis now is on achieving sustainability. Logistics solutions enable the centralisation, management and distribution of high-impact, high-value products; efficiency is key. Globally, centralised points of distribution enable quicker time to market, resulting in reduced costs and increased market share.

Unilever spends close to 19% on logistics in Pakistan reducing the profit margins. This can prove problematic for long-term revenue generation, even for a multinational giant. Thus, efficient supply chain management and logistics are an crucial investment. Companies such as E2E Supply Chain Management, (explored below) collaborate towards building large retail chains to allow for producers to sell directly to retailers and wholesalers, which reduces overall distribution costs.

16 Farooq Tirmizi, "The changing face of retail", The Express Tribune, 27 Sept. 2010 (accessed 27 Jan 2012)

Case study

E2E Supply Chain Management is one of the fastest growing companies in Pakistan, and one of the leading providers of logistics services. The company did not simply leverage the lack of competition in the market, but rather it sought strategies to expand organically by providing services which target both rural and urban areas, and it capitalised on the high demand for logistics both within Pakistan and internationally.

Notably, E2E has achieved success with its training, outsourcing and innovation programs to land talent from top management institutions in Pakistan. In a marketplace where, post-MBA students are oriented towards the financial sector, and senior roles within large multinational firms such as Unilever and Proctor & Gamble, E2E attracts top talent by raising the bar for high-potential team management, and inculcating a sense of ownership.

The company (after adopting the principle of Michael Porter's "visibility economics") achieved top ranking in the Arabia Fast Growth 500. Of the 70 Pakistani companies indexed, E2E ranked 1st due to its rapid growth trajectory of 1,918 per cent between 2008 and 2010, with revenues above $50 million and 297 employees.[1] Their market share has also grown significantly given the lack of successful competitors, and their model has inspired a wealth of similar companies across several sectors, all of whom have the innovative capacity to adapt to changing macroeconomic conditions, cut costs, focus on bottom-line profits and gain international recognition. As there is a large gap in the logistics market, there is a need for investment into this sector both to optimise value chains and to maximise capacity in ancillary industries.

1 Samir Saleem, "Pakistani Entrepreneurs Rock - #2 on the Arabia Fast Growth 500", The Technology Cafe, 4 Dec. 2011 (accessed 24 Dec. 2011)

The SME Stream

Pakistan has a wealth of natural resources and traditional business advantages that can be effectively harnessed to grow SME sectors such as agriculture, cottage industries, textiles and renewable energy.

Although the country has experienced recent natural disasters such as the earthquakes in 2005, as well as the devastating floods in the Sindh province, the potential for social innovation is strong given the resilience of communities and the prospect for success in these regions. Recurring policy changes, coupled with law and order instabilities, have nonetheless created a challenging investment environment and led to a dependency on bilateral aid.

To date, the Government of Pakistan, development agencies, multilateral institutions, research institutes and municipalities have orchestrated a wide range of microenterprise projects in Pakistan. These projects have had tremendous value in their scale and implementation, creating revenue streams and widening social and environmental benefits across many regions of the country.

Microenterprise development enables entrepreneurs to develop businesses at a household level, which can be scaled up over time to become community ventures with a much broader social impact. To fully command this potential, the natural capacity of entrepreneurs to identify and further opportunities need to be harnessed. Encouraging an investment in human talent rather that solely in institutions, promotes entrepreneurship, nurtures sustainable livelihoods and supports capacity-building; all three are key ingredients in creating the web of businesses that a region needs to prosper. The private sector can play a large role in encouraging individual businesses to benefit their communities as a whole.

In a substantial portion of rural areas in Pakistan, there is significant political risk of investing in provinces that are confronted with tribal disputes, fundamentalist camps and disjointed communities. Communities in these regions should be incentivised to manage entrepreneurship training programmes and incubation projects. In most cases, many communities are eager to learn new and improved skill-sets to structure their production units effectively, and carefully directed investment into these areas would give these communities an ability to transform their existing approaches to maximising potential.

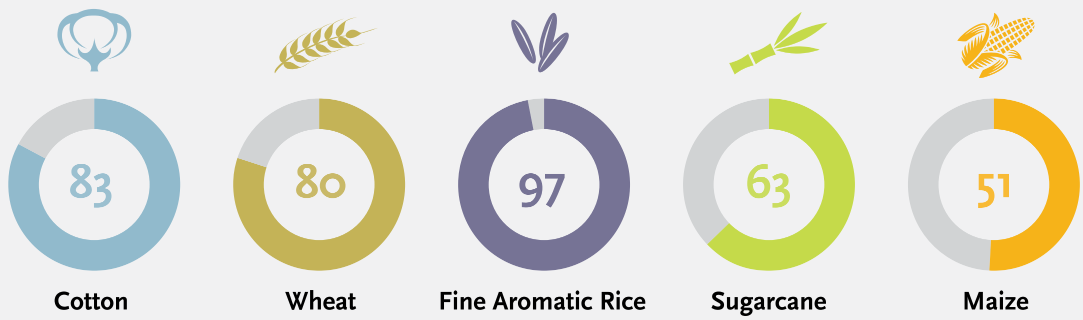
Often, development funds and initiatives are continually concentrated into the same geographical regions and sectors in Pakistan, and new areas that are willing to grow are not explored. These areas include the Northern Areas & Chitral (NAC), the Federally Administered Tribal Areas (FATA) and Khyber Pakhtunkhwa.

Agriculture

The agricultural sector in Pakistan has great potential for microenterprise development. 48% of Pakistan's labour force is employed in some form in this sector, the largest sub-sectors being wheat, dairy, rice, fruit production animal husbandry and biogas. Agriculture is the mainstay of Pakistan's economy. It accounts for 21% of the GDP and, together with agro-based products, fetches 80% of the country's total export earnings.[17]

Agricultural Production in the Punjab Province

Punjab's Production as portion of Country Production (%)



Source: AgriPunjab

Figure 6: Agricultural Production in the Punjab Province

The major share of the agricultural output originates in the Punjab province, which provides cotton, wheat, rice, sugarcane and maize. Whilst foreign investors have demonstrated their interest in Punjab as a result of its upward trajectory growth, Baluchistan's fertile land is ideal for fruit production, particularly apricots, grapes, cherries, peaches, pomegranates and apples, Sindh is expanding its production of cotton, wheat, rice and sugar, and Azad Jammu and Kashmir (AJK) has largely untapped potential in tea and corn production.

Interestingly, in the last few years, there has been a rural internal migration from urban areas, due to the high cost of living in densely populated cities. The potential for harnessing skills within the rural communities is high, given the exposure of many in the community to urban technologies, which could be implemented to great benefit in rural areas.

Agriculture would most naturally constitute a large proportion of the export market, however due to the low levels of technological investment, much of the produce remains at the subsistence level.

17 Punjab Agriculture Department, http://agripunjab.gov.pk/

Provincial governments are responsible for providing subsidies to farmers, however these are variable according to the province, thus agriculture flourishes in some regions more than others. Where subsidies are judiciously allocated, producers enjoy the opportunity to diversify both processes and products, bolstering their offering and therefore their business case for continuing subsidies.

Apna Aarsh Pakistan (AAP), a social intermediary, runs pilot agricultural projects with Engro Corporation, one of Pakistan's largest conglomerates. The Engro Corporation is a group of businesses whose activities range from fertilizer production to power generation. These projects aim to expand capacity development, technology, waste management resources and wholesale markets over an 8-12 month period, encouraging and supporting communities to become self-sufficient.

Similarly, the Entrepreneurship Development Programme was initiated by AAP, in conjunction with the International Federation of the Red Cross (IFRC) to more than 1,200 farmers in Kohistan.[18] The aim was to create clusters and cooperative nurseries based on the maximum procurable value from walnuts production. Ancillary industries such as animal fodder manufactured from walnut shells, and wooden furniture manufactured from the walnut tree were thus fostered.

AAP's extensive research in the procurable value of apricots allowed for an investment into village organisations and the provision of solar ovens to apricot cooperatives in selected regions. The result for AAP was an increase in Pakistan's apricot exports to overseas supermarket line chains such as Sainsbury's in the United Kingdom.

Dairy

In the case of dairy, for example, the diversification includes breeding, management, feeding, housing, disease control and the hygienic production of milk. Milk processing began in late 1970s but still face challenges with inadequate infrastructure to scale the size of the production and as a result, processed milk has captured a mere 4% of the total milk market.[19] These processes require innovations such as dehydration and drying facilities to maximise production outputs, revenues and profits for the individual farmer. Pakistan is the fifth largest producer of dairy products in the world, yet more than 90% of dairy farming is carried out at a subsistence level.

Nestlé Pakistan is one illustration of the private sector which has encouraged the expansion of dairy produce beyond the subsistence level. This multinational corporation has utilised a "Milk Collection System Model" which partners with local farmers to build a network of collection centres for farmers to sell their livestock milk. Advanced inspection units and chilling systems have been built to ensure that the milk is tested for quality control and technical assistance is provided for the farmers.

18 Pakistan Textiles Exporters Association (PTEA), http://www.ptea.org/btcotton.html

19 Small and Medium Enterprises Development Authority (SMEDA), Government of Pakistan, "Pre-Feasibility Study: Environmentally Controlled Dairy Farm," June 2010.

The willingness of a large corporation to invest at the grassroots level has created local jobs and, crucially, has put in place a much needed communications and transport network. More than 900,000 farmers and their dependants have benefitted from Nestlé's Milk Collection System model.[20] In this way, private sector investment can gain traction in a new market segment, providing social innovation systems as part of a value chain approach whilst strengthening relationships and building brand loyalty by offering training programmes and self-sufficient learning.

Irrigation

Case study

Micro Drip is an example of one of the technological innovations taking place in Pakistan's SME agricultural sector. Micro Drip is a for-profit irrigation company which provides low-cost drip irrigation systems, agricultural training and after-sales support to enable farmers in Pakistan's arid regions to extract a higher yield from their land at a much lower cost of input.

By engaging with landholding farmers as potential consumers rather than recipients of philanthropic aid, Micro Drip encourages farmers to become independent local entrepreneurs. The system that Micro Drip provides is affordable, sustainable, easily employed and can be maintained with a minimal amount of technical knowledge.

Crucially, by reducing the amount of water needed to cultivate an acre of land by 50%, improving yields by 40%, and lowering input costs by 30%, its systems create efficiencies that benefit productivity and bottom-line profits.[21] Due to the fact that the system allows for year-round farming, fewer farmers and their families are forced to migrate during the dry season. Micro Drip has already reached more than 3,000 small-hold farmers, and over the next five years, has the potential to scale up to a further 20,000.

Acumen Fund Pakistan has played a critical role in transferring the irrigation technology from IDEI-India and Global Easy Water Products (GEWP) to Pakistan. Unilever agreed to help build the brand and expand the business by delegating specialised Unilever employees to Micro Drip through a resource-sharing program. In addition, Unilever supported the implementation of the technology by providing supply chain, sales and brand management expertise in the form of workshops to farmers.

Micro Drip aims to extend its market access to the rest of Pakistan by leveraging its strong linkages with Thardeep Rural Development Programme (TRDP), a non-profit organisation working in Tharparkar, Umerkot, Dadu, Jamshoro and Khairpur districts of Sindh. TRDP offer rural programs support to approximately 1.5 million households, as well as working with private and public institutional channels, allowing for a cost-effective outreach to farms traditionally considered inaccessible or unprofitable for most commercial ventures.

20 Nestlé Pakistan, http://www.Nestlé.pk/About-Nestlé/Pages/MilkCollection.aspx
21 Micro Drip, http://www.microdrip.pk/

Textiles

The foundations for the textile industry in Pakistan have historically been strong. Pakistan is the world's fourth largest producer of cotton after China, the USA and India. Whilst cotton lint, cloth, yarn and garments contribute roughly two-thirds of the country's export earnings, Pakistan's textiles yield ranks 10th in the world.

The challenges faced by this industry include the high price of inputs, water shortages, a low supply of pesticides, and poor infrastructure.[22] Therefore, one of the primary objectives for Pakistan's All Textile Mills Association (APTMA) is to expand the production of local textile industries.

Garment productions' impact in retail markets and promotion of the fashion industry is significant.

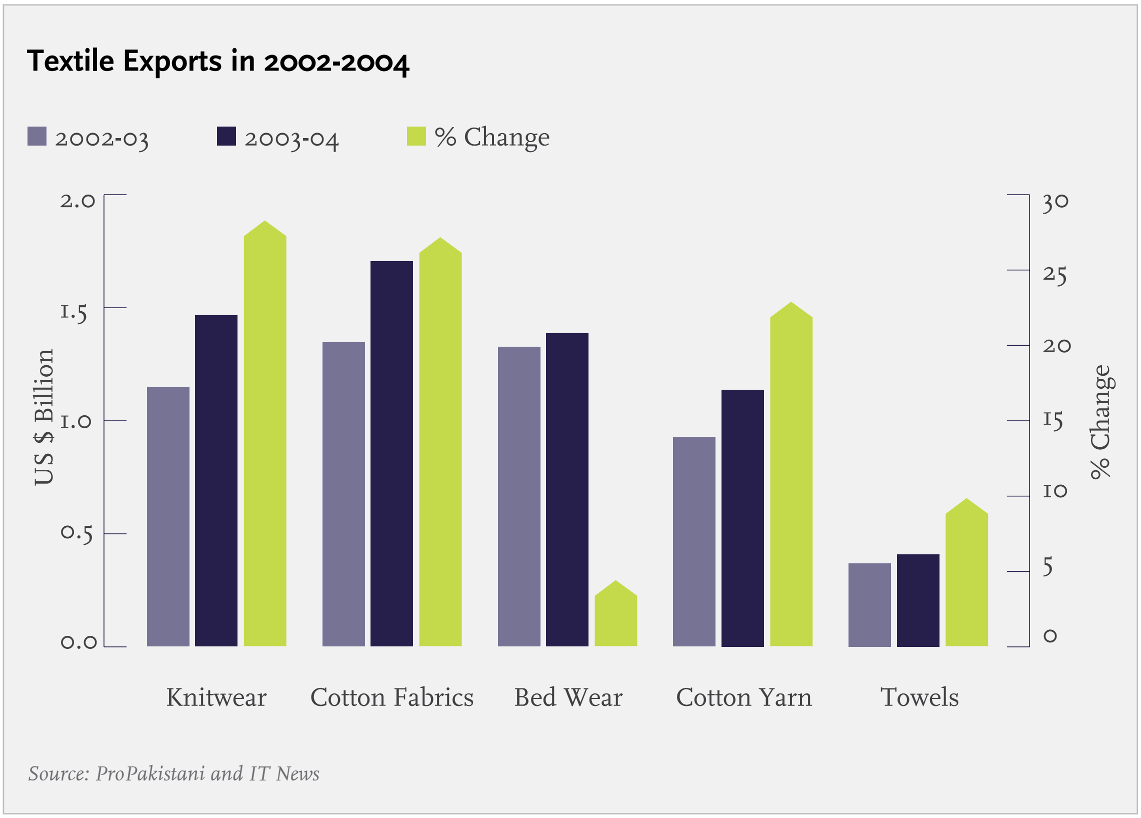


Figure 7: Textile Exports 2002-2004

In September 2011, US and Pakistani government officials met with representatives from the Pakistan Institute of Fashion & Design (PIFD), which encourages the diversification of the textiles and apparel industry in Pakistan, as part of the United States-Pakistan Trade and Investment Framework Agreement (TIFA). Discussions revolved around ways to enhance the capacity of the PIFD, including prospects for developing linkages with similar U.S. fashion institutions.

22 Pakistan Textiles Exporters Association (PTEA), http://www.ptea.org/btcotton.html

Case study

Shahkam Industries, a rapidly growing Pakistani apparel company utilising local textiles in their products, was established in 1992 as a small knitwear factory in Lahore. The company grew with six discrete expansions initially as a result of the attractive rebates being offered by the Government of Pakistan in the mid-1990s, and now exports to a number of international markets, including the Unites States. Shahkam Industries scaled their expansion through limited loans, which were repaid regularly to maintain the appropriation of finances and to resist the regular interest rate changes from lending institutions. The success of Shahkam Industries as a Small to Medium Enterprise is characterised in its annual US$70 million turnover to date, and its hands-on approach to textile production, showcased by the employment of workforce size of 7,000 individuals, of which 150 are managers.

Shahkam's business model maintains a highly labour-centric structure which caters towards the provision of large-scale employment to large pools of talent in Pakistan's labour force, trained in the specifics of textile production. High wages are prioritised to create a more motivated labour force and align employee bonuses with the overall company productivity. A high capital expenditure would necessarily increase overhead costs, which is a concern for the textile industry given that the nature of the production cycle, economies of scale, and supply and demand metrics allow for smaller enterprises to succeed in this space more effectively than larger industries.

The AHAN project is an initiative taken by the United Nations International Development Organisation (UNIDO) to promote the craft sectors in Khairpur. Partnerships were forged with SMEDA, the International Rescue Committee (IRC) and other NGO agencies in the region to promote the preservation of Khairpur's unique culture and craft system.[23]

Modelled after One Village One (OTOP), the programme is aimed at training communities on how to use their traditional craft skills and create cooperatives to manage the raw material supply, production and marketing of finished textile products. The focus is on developing the following products through household weaving programmes for home-grown products: the weaving of "khes", a patterned double weave cloth made of cotton or silk yarns; the sewing of "ralli", a patchwork multi-coloured quilt; date-palm leaf products; and lacquer work.

23 United Nations Industrial Development Organization (UNIDO), "Creative Industries and Small andMicro & Small Scale Enterprise Development," Project XP/RAS/05/002, 2006.

Renewable Energy

Pakistan currently relies heavily on imported fossil fuels for the bulk of its energy supply. However, there are mounting reasons for this reliance to be reconsidered:

- Importing fossil fuels is costly, placing a heavy burden on the foreign exchange reserve leaving the country exposed
- The heavy use of inorganic fuels deteriorates and degrades the natural environment
- Importing resources is not a basis through which Pakistan can reasonably grow
- Traditional energy systems are costly to integrate, challenging to install in mountainous terrain and carry heavy capital expenditure costs

Decentralised energy systems reduce distribution losses resulting in network-wide and national efficiency gains (measured by “energy intensity” or energy use per unit of GDP). More generally, sustainable and efficient electricity generation impacts the local environment, not least by lower greenhouse gas emissions and carrying significant climate change benefits for Pakistan, helping to achieve the objectives set out by the country under the UN Framework Convention on Climate Change.

Clean, cost-effective, efficient and self-sustaining forms of energy are increasingly in demand across the world. For the renewable energy sector to grow, the Government of Pakistan’s assistance is necessary to ensure the fulfilment of contractual obligations, transparency in licensing procedures, and the maintenance of nationwide electricity power grids.

The Government of Pakistan has recently lowered sales tax and customs duties on imported machine equipment for micro-hydro plants, wind mills and solar energy production units, creating a surge of activity in the renewable energy sector in Pakistan. This regulatory and strategic change can be harnessed at the community level to promote entrepreneurship, spearheading a self-sustaining system of renewable energy enterprises.

The business model for renewable energy in Pakistan has several strengths:

- Increasing employment opportunities for local manufacturers and service providers
- Integrating social infrastructure, e.g. educational and medical facilities, clean water supplies, sanitation and telecommunication channels
- Broadening instructional, technical and operational capacity building
- Facilitating a domestic renewable energy manufacturing base, lowering costs, improving the supply of energy, creating employment opportunities, and enhancing technical skills at the community level

Further investment into energy R&D is important to diversify microenterprise projects in rural areas of Pakistan and breadth of national electricity coverage. Village electrification is poor in the remote areas of Pakistan, leading to low productivity, an inability to take advantage of natural resources and a stagnant growth curve. Pakistan's current electricity demand is about 25,000 megawatts per day whilst the nation's current electrical production is less than 20,000 megawatts per day, resulting in a shortfall of 20 per cent, or over 5,000 megawatts per day, as demonstrated by Figure 8 below. This is an immense opportunity for any investor in renewable energy.

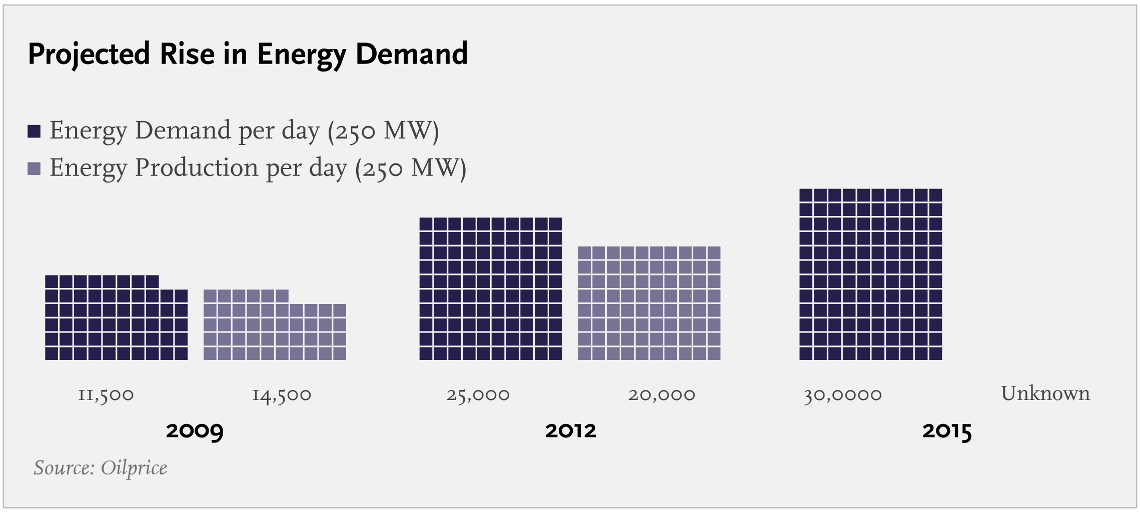


Figure 8: Projected Rise in Energy Demand

Hydroelectric

Hydroelectric generation, although seasonal, is one of the oldest forms of electricity production. In the twentieth century, hydroelectric development focused on increasing generation capacity. Today, research and entrepreneurial activity have spurred renewed interest in smaller hydroelectric generation facilities, particularly for aid-funded projects. The term "micro-hydro" commonly refers to facilities with generation capacities generally less than 100 kW, which do not significantly alter local environmental conditions or river flows.

Pakistan is ideally situated to implement micro-hydro facilities, particularly in the northern regions of the country, given the accessibility to the Indus River. Micro-hydro potential is estimated at about 50,000 MW, out of which about 6,595 MW has been developed in Pakistan.[24] This is an encouraging environment for the development of entrepreneurial hubs within the hydroelectric sector, ideally in a regional cluster integrating other services, such as drinking-water and filtration.

24 Philip Auerswald, Elmira Bayrasli, Sara Shroff, "Creating a Place for the Future: Towards a New Development Approach for the Islamic Republic of Pakistan", December 2010.

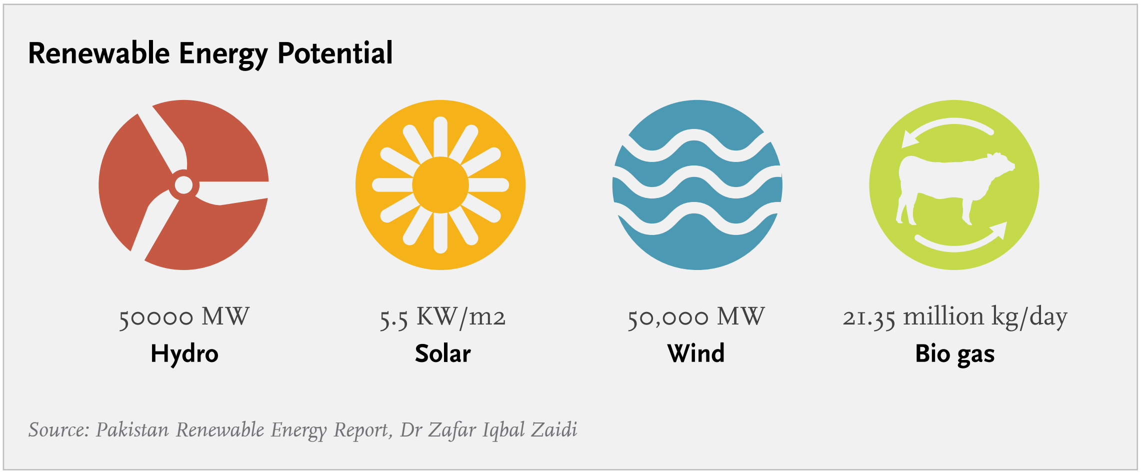


Figure 9: Renewable Energy Potential

The United States Agency for International Development (USAID) has so far made the largest progress in investing in hydropower dams in Pakistan, as shown by Figure 10 below:

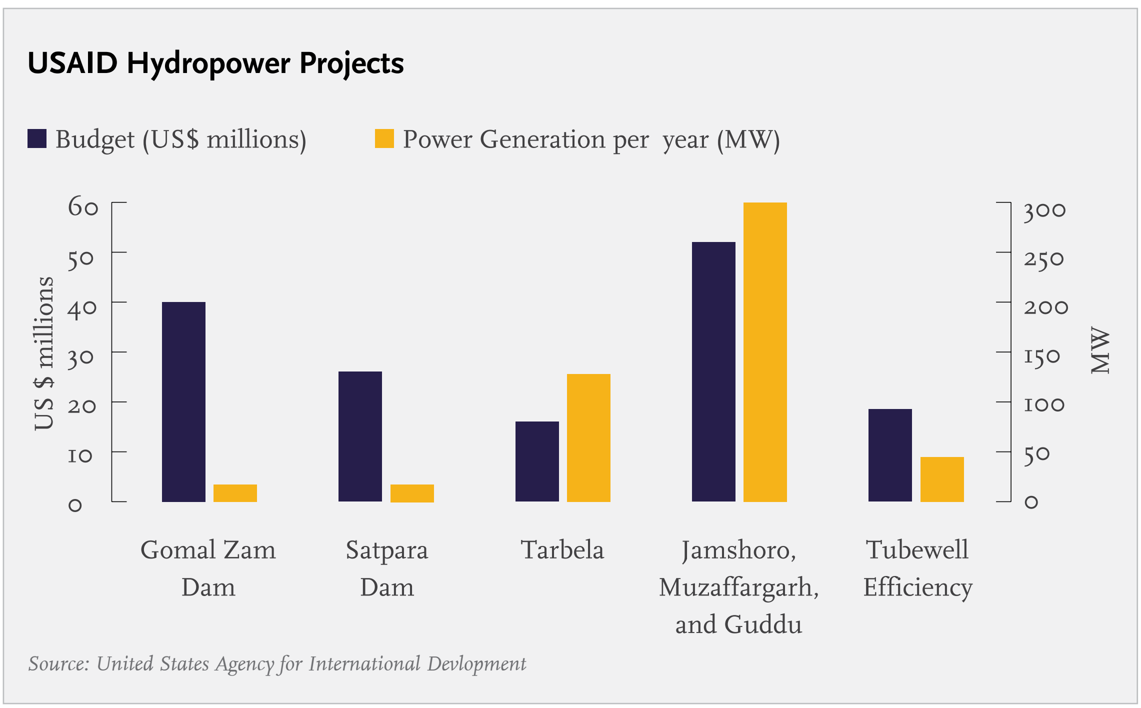


Figure 10: USAID Hydropower Projects

The Tarbela Dam hydroelectric power station in the Khyber Pakhtunkhwa Province is the largest earth-filled dam in the world. USAID is providing $16 million to modernize three generators in the dam, which, when finished, will add 128 megawatts in power generation capacity. So far, USAID has restored 108 MW of power generation capacity at the Tarbela Dam.

A second USAID project includes the Gomal Zam Dam Project, where USAID is providing $40 million to the Water and the Power Development Authority (WAPDA) to help with the completion of the Gomal Zam Dam in South Waziristan. When finished, the dam will generate 17.4 MW of hydroelectric power, control flooding, and irrigate almost 200,000 acres of land worked by on 30,000 farmers.

Moreover, a community-based Renewable Energy Development project, spearheaded by the Government of Pakistan, has invested in micro-hydro projects to serve rural communities in the Federally Administered Northern Areas and Chitraal (NAC) District of the North West Frontier Province. The project's aim was to generate electricity from 103 projects ranging in size from 30 kW to 350 kW not exceeding 15 MW of total power.[25]

These projects aimed to supply mini-grids, isolated from any regional and national grids existing in the region. Over a million people live in the region, often living below the poverty line across approximately 850 villages. Other stakeholders include the Aga Khan Rural Support Programme (AKRSP), the Government of the Netherlands, the Pakistan Poverty Alleviation Fund (PPAF), PCRET, Community Development Carbon Fund and Acumen Fund. This is an example of a successful public-private partnership which was able to influence a large number of beneficiaries by identifying a social need and creating an efficient framework around this social need.

Wind Power

Harnessing wind power to produce electricity on a commercial scale has become the fastest growing energy technologies. Pakistan is fortunate to have high wind speeds near major urban centres, allowing more than 5,000 villages to be electrified in Sindh, Balochistan and Northern Areas.

In recent years, the Government completed several projects to demonstrate that wind energy is a viable source of energy in the country. In Mirpur Sakro, 85 micro turbines power 356 homes, and in Kund Malir, 40 turbines power 111 homes. Many villages in the southern regions can be supplied with electricity through wind turbines by the Alternative Energy Development Board (AEDB), which has acquired 18,000 acres for the installation of more wind turbines.[26]

In February 2011, the Asian Development Bank (ADB) provided a loan to fund the first privately-owned wind farm, named the Zorlu Energy Project, in the Sindh province. The output will not only improve the country's energy security but will also lower its dependence on fossil fuels. Zorlu Enerji, a public company listed on the Istanbul Stock Exchange, owns and operates Turkey's largest wind farm.

It is 68% owned by Zorlu Holding AS, one of the largest conglomerates in Turkey. The total cost of the project is $147 million, with 30% financed through equity provided by Zorlu Enerji and the rest through US dollar-denominated loans from (ADB), the International Finance Corp., the ECO Trade and Development Bank and a Pakistan rupee loan from Habib Bank.[27]

25 USAID Energy Factsheet, Energy Program, September 2011

26 Government of Pakistan, Ministry of Environment, "Clean Development Mechanism: National Operational Strategy", January 2006.

27 Asian Development Bank (ADB), http://beta.adb.org/news/adb-supports-pakistans-first-privately-owned-wind-farm

Solar Energy

Regions of Southern Pakistan, Quetta valley and Central Punjab receive high solar radiation, indicating high potential for renewable solar energy. Solar Energy Research Centre (SERC) reported that connecting remote villages in the northern hilly areas to the national electricity grid by investing in household solar panels in southern areas would create an efficient transfer of electricity to previously off-grid communities.

Furthermore, the range of solar products is extensive, including: solar-powered fans, dryers, cookers, water heating systems, lighting, cook-stoves and water desalination plants. A variety of projects in Pakistan is underway to maximise the potential of this untapped sector. At the policy level, laws and taxes are being designed to encourage household energy generation through innovative solar technologies.

At the Research and Development (R&D) level, the Pakistan Council for Renewable Energy Technologies (PCRET) has developed solar cells, modules and systems. Its research laboratories are equipped with facilities to produce input materials for solar products.

Biogas

Biogas technology, composed from livestock manure, provides soot-free clean gas to meet domestic fuel needs. The raw material is available in Punjab, Khyber Pakhtunkwa, Sindh and certain areas of Baluchistan. For livestock-owning rural households in Pakistan an investment in a low-cost domestic biogas plant would result in a continuous production of combustible methane gas, to be used for cooking and basic lighting.

The process also generates 'bio-slurry' as a by-product that is used as an organic fertilizer, soil conditioner and animal or fish feed. These products offer cost savings by replacing traditional fuel sources such as firewood and dung for cooking, kerosene for lighting, and partial displacement of synthetic fertilizer for crops. A plant typically pays for itself within 4-5 years on cost savings alone.[28]

Additionally, local experience shows that the benefits of using biogas versus traditional firewood in cooking meals saves on average approximately two hours per day per family. This is additional time that could be spent on income generation, education, and recreation.

28 School of International and Public Affairs (SIPA), Columbia University, "Financial and Technical Assistance for the Pakistan Domestic Biogas Programme Wholesale Credit Facility", May 2011.

Primary and Secondary Education

As in every other country, it is through education that the raw human talent, innate skills and natural abilities will be nurtured and developed. The substantial investment in private education, through schools and tuition providers may be regarded as a traditional commercial investment, however there is the additional benefit of large-scale social impact over a sustained time period.

There are currently very few barriers to entry in the private education sector, in contrast to the state education sector, where there is no leverage by gaining school tuition fees.

In rural areas particularly, socially innovative models of education can be far-reaching in their ability to achieve scalable impact. An understanding of rural family dynamics, the greater number of dependants per family and the general attitude towards progression, both for males and females, is crucial. By offering vocational training, apprenticeship programmes, and allowing students to gain exposure across disciplines, a strategic investment into private schools can shift focus away from an overly narrow grades-focused outcome.

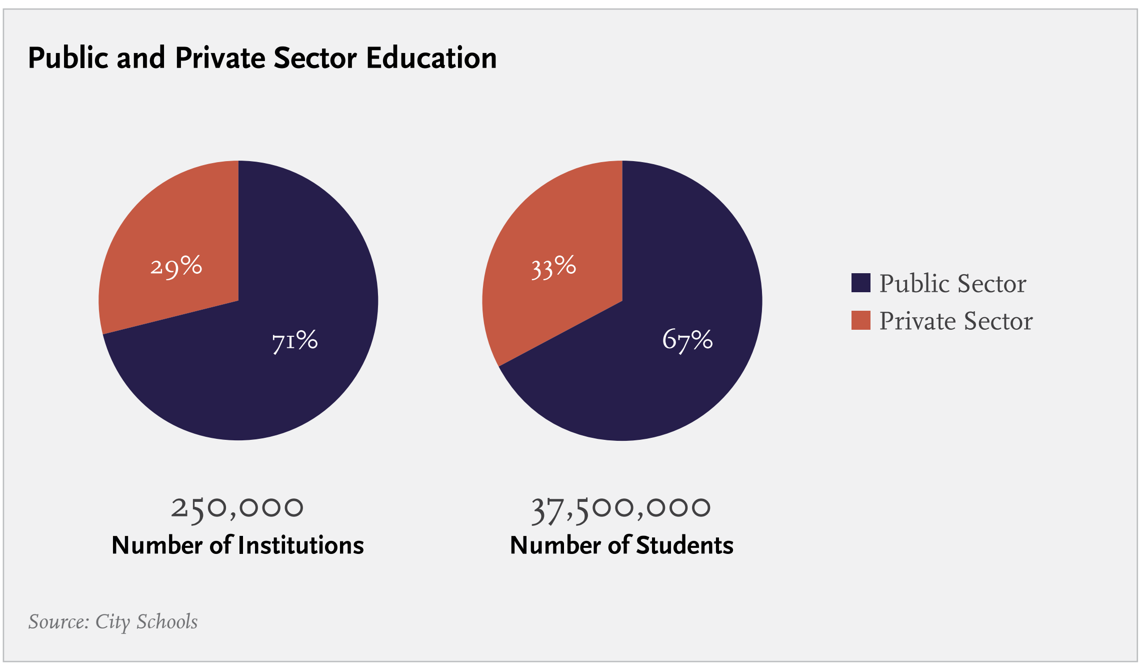


Figure 11: Public and Private Sector Education

Literacy is critical in generating employment opportunities for the population as a whole. Public school funding can no longer be viewed as the certain path to the long-term development of a workforce. The way forward can be seen in strategic investment into private schools, shifting the focus away from academic outcomes to a modular approach offering vocational training, apprenticeship programmes and cross discipline exposure.

The Department of Education and public sector organisations can work towards a needs-based sliding scale payment system in private schools, which would help to access a much broader population base, driving forward the aspirations and expectations of regions as a whole. An effective pricing system would target the needs of individual students, especially when supported by access to relevant computer software and classroom facilities.

Case study

City Schools is one of the first private and international education organisations in Pakistan. Founded in Karachi in 1978, the school has constructed campuses in several second-tier cities such as Rawalpindi, Multan and Islamabad. The organisation has also expanded to Bangladesh, the United Arab Emirates, Saudi Arabia and the Phillippines, allowing the students to experience a "classroom without walls".

An integral component of the organisation's success is the teacher-training programme held in partnership with the University of Strathclyde in Glasgow, Scotland. Designed to offer City School teachers strong professional development opportunities, the programme has been developed specifically to broaden the educational offering and build a generation of leaders.

Moving from Bilateral Aid to Social Investment

Funds to the Government of Pakistan have traditionally been channelled through various mechanisms, such as direct budgetary support; funding for federal government programs; funding to Pakistani NGOs; multi-donor trust funds and public-private partnerships.

The oft relied upon aid paradigm is shifting, the nuances of this are reflected in the changing nature of the strategic partnership between the United States and Pakistan.

In 2004,Pakistan was one of the top recipients of pledged US dollar assistance. However, by 2009, it was evident that there was a need to invest in economic stability and growth.

As a result, President Obama appointed Richard Holbrooke as Special Representative for Afghanistan-Pakistan. This change in strategy was supported by:

- White Paper by Interagency Policy Group (2009)
- Holbrooke's Enhanced Partnership with Pakistan Act (2009)
- Pakistan Assistance Strategy Report (2009)[29]

In parallel there has been a fundamental shift in thinking by many innovators in the policy making, financial and development sectors in Pakistan. The outsourced aid model, with its complicated procurement procedures and heavy reliance on a relatively small group of implementing partners, creates both complexities and inefficiencies. The execution of aid through a variety of mechanisms often does not foster long-term growth, market flexibility, nor the talent and potential of working population.

A shift in how aid is perceived in countries like Pakistan, coupled with the skills of the private sector, local entrepreneurs and the able workforce are key in unlocking the full growth potential of the market. A step towards a structure more conducive to sustainable development involving direct and democratic partnerships is required. In the medium to long-term, such methodologies would conceivably create a thriving business environment with:

i) Legal and regulatory frameworks
ii) Solid infrastructural systems
iii) Availability of human capital

29 School of International and Public Affairs (SIPA), Columbia University, "Changes in USAID funding to Nongovernmental Organizations: The Pakistan Case", May 2011.

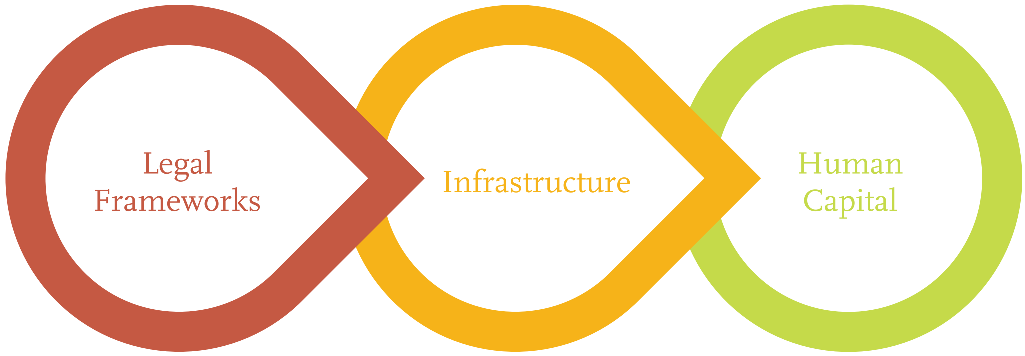


Figure 12: Outputs of sustainable structural development

Successful investment has the impact and scale to transform the way a country is cultivated, by tapping into the latent potential of a frontier market and the ingenuity of its wide range of workforce in Pakistan the hybrid model of social investment is one of the most useful for private investors.

At the heart of this inclusive framework of social investment, encapsulated in commercial return and social impact, lies the ability to energise the economy and workforce, creating growth markets and an expanded capacity for reinvestment.

The shift towards social investment relies heavily upon proven models utilised by bilateral aid throughout the world. In the move towards social investment, these models serve as beacons for private sector investors who are eager to explore frontier regions.

Creating an Enabling Environment for Investment

Emerging economies such as Pakistan should be able to advance their own private and entrepreneurial sectors. Yet limiting factors are in place. For example, the SME sector in Pakistan has not yet advanced to a level whereby it can take advantage of complex financing structures, such as mezzanine finance and derivative products.

The current legal and regulatory framework challenges local enterprises, limiting access to traditional growth capital, including debt and equity instruments. This places considerable strains on entrepreneurs through high interest rates and complex loan structures, which in turn often stifles growth at an early stage.

However, Pakistan has relatively few barriers to entry for investors compared to BRIC countries such as India, which has helped to create a strong enabling environment. The success of Pakistan as a frontier economy hinges upon carefully directed foreign investment, the flexibility of governments to implement policies to facilitate innovation and the appropriate utilisation of a motivated youth.

Foreign investment needs to focus on Pakistan's home-grown industries, trading their products and services to mutual benefit and creating a understanding between partners. A solid grasp of the in-country cultural nuances as well as policy mandates is vital to the success of structured investment in Pakistan. Developing a strong local workforce and creating greater stability in the country will also provide the competitive return on investment.

In an effort to promote foreign investment, the Government of Pakistan has employed taxation exemptions in the following industry areas: interest income on foreign currency accounts, capital gains on sales of shares of listed companies, income from manufacture of solar energy equipment (renewable energy sector) and income from fruit processing (agriculture sector).

The Government of Pakistan has also signed agreements to avoid double taxation with 39 countries. These agreements establish the ceilings on tax rates applicable to different levels of income arising in Pakistan. Additionally, they establish some basic principles of taxation, which cannot be modified unilaterally.

Increasingly, traditional growth models do not provide immediate solutions to the growth challenges posed by urbanisation, infrastructure, resource and population constraints in frontier economies. A new model of private investment will effectively tackle growth challenges across both conventional and non-conventional business streams.

This model would bridge the gap between the private sector, human capital, development, intellectualism and government, allowing for consistent and scalable growth across multiple sectors. The mobile banking industry is an example of how local firms have devised and produced innovations crucial for micro-enterprise development.
Currently, the majority of economic growth stems from large state-owned or affiliated businesses,

and structured investment now needs to focus on privately owned mid-sized and SME sectors. In the context of the larger manufacturing industry and services, Pakistan has great potential in the retail, utilities, infrastructure, commodities, financial services, information technology and education sectors.

Most pockets of entrepreneurship exist in the private sector or civil society, however there is also a huge and under-utilised able workforce located in both the urban and rural areas. Additionally, untapped sectors across the country are rapidly growing and the investor would greatly benefit from exploring them.

At present, investors maintain interest in the two metropolises: Lahore and Karachi. These cities have generated high levels of success for business ventures across market sectors. Investors have traditionally sought these cities as attractive grounds for large-cap investment. Both government and private investors have won a greater number of tenders in Karachi and Lahore than in other areas of Pakistan, due to information transparency, ease of execution and lower administrative costs than their rural counterparts.

However, the large-scale urbanisation of the more rural provinces in Pakistan is fertile ground for a skilled, motivated labour force and long-term macroeconomic growth. Second tier cities, such as Faisalabad, Multan, Rawalpindi and Bahawalpur hold significant promise.

Faisalabad has a strong industrial base including textiles, jewellery, home furniture, and pharmaceuticals, supported by the expanding transport network. Multan is home to industries such as fertilizers, cosmetics, glass manufacturing, cotton production and processing, handicrafts, flourmills, sugar and oil mills and large-scale power generation projects. Rawalpindi's economy is focused around the production of textiles and semi-finished cotton products. And, Bahawalpur is the centre for trade in wheat, cotton, millet, and rice grown in Punjab, and principal industries include cotton ginning, rice, cottonseed oil, flour milling, and the hand-weaving of textiles.

An eager potential workforce in these cities should be capitalised to fully realise the potential of Pakistan's demographic dividend. The youth in Pakistan are aspiring towards broader employment, in sectors such as media, advertising and the arts. The rural populations are increasingly seeking to move from traditional lifestyles to sustained employment. Middle class families that do not have the security of a family business are encouraging their youth to explore opportunities in diverse sectors.

The recent deregulation of media channels, increased political engagement and the desire to gain stable employment are indicators of a shift in the status quo across the country. As opportunities are created, the wider social impact will be evident through reduced income inequality, allowing for a further expansion of the market and the potential for commercial investment.

Developing Human Capital

The pressure of global competition and financial instability in the West has shifted the focus on to developing markets. In the coming decade, for the first time since the Industrial Revolution, emerging economies will add more to global growth than all advanced economies combined. In some sectors, this growth percentile will be more than 80%.[30]

Pakistan's population of 177 million is facing a youth bulge which should ideally be harnessed as a means to address the current lack of opportunities available in the country today.

Investors would be best placed to capitalise on this growing local talent pool by deploying loan or equity capital during either the seed stage, or through peer-to-peer network. This would also allow for the long-term stability of cyclical unemployment and a movement towards a more sustainable, dependable workforce.

Frequent policy changes have contributed to the dampening of education, employment opportunities, ambitions and entrepreneurial visions for success. The process to economically engage with Pakistan should begin with the wide-ranging youth.

30 McKinsey&Company, "The Power of Many: Realizing the socioeconomic potential of entrepreneurs in the 21st century", October 2011.

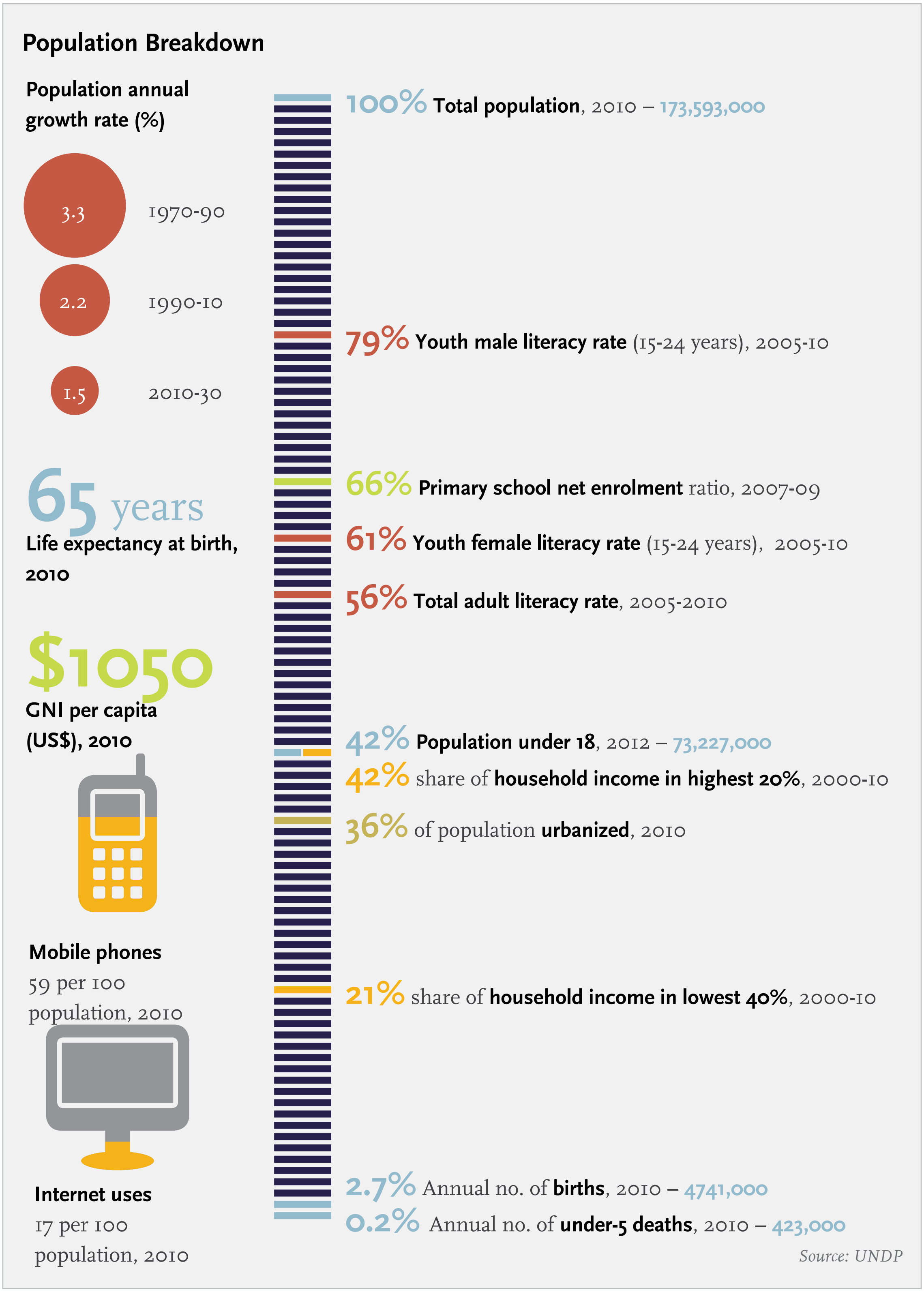


Figure 13: Population Breakdown (2010)

Investment targeted at utilising and developing human resources will stimulate the employment market and, in encouraging big thinking, will drive the growth of the SME sector.

In 2011 at the Global Entrepreneurship Summit in Istanbul, Turkey, U.S. Vice-President Joe Biden urged older entrepreneurs to mentor the younger generation by sharing their hard-earned wisdom. Self-starting an independent initiative to collaborate with Universities and corporations encourages new thought, innovations, products, industries and markets.[31] Biden rightly stated that investors must occasionally be willing to take a chance on an unknown talent and an unproven dream.

In much the same way, private investors can also leverage the able workforce. By investing in and partnering with local private sector businesses, offering an exchange of knowledge, information and finances, investors create vast employment opportunities.

The two key challenges are the creation of a stable long-term workforce and developing the latent investment potential of high-risk, low-qualified entrepreneurs.

There is a gap in the market for a Western-style approach to business in Pakistan. Investors can leverage the growing employment pool indicative and typical of a youth bulge by focusing on the gaps and shortage of the local skill-set. The country's young labour force is keen to learn, ripe for training, and well-positioned to gain expertise in management skills.

Companies such as Coca-Cola, for instance, employ factory personnel locally, and are equally supportive of exploring the potential. The company has implemented robust training programmes for local managers in Pakistan, such as the Catalyst Programme, where talent development is assisted through best practice and diverse projects.

Examples of initiatives in employee investment include business development services, financial literacy programmes, technical assistance, mentoring and access to networks. Crucially, consistent employment with suitable remuneration of regional parity is an effective method of supporting the local economy and therefore safeguarding the return on investment.

Furthermore, investment into human resources can positively reinforce a company's reputation and prestige in a frontier market, creating a level of loyalty, brand recognition and reach. Brands can be leveraged more cost effectively as they offer more 'bang for buck' compared with the same spend in a developed marketplace.

Where it is viable, partnerships with incubators or open innovation programmes within large companies nurture skills and collaborative thinking in smaller businesses.

Interestingly there is a glut of human capital in the market today, with a current over-supply of skilled labour in Pakistan. Increasingly young self-starters have an appetite for independent business ventures, with technological innovation as the core growth strategy of many of these new start-ups.

31 Global Entrepreneurship Summit (GES), http://unleashingideas.org/ges2012

Building Knowledge Sharing Networks

To create the environment for successful investment, investors must be connected with sector-specific networks linked into Pakistan's mid-cap and SME space. Foreign investors thereby have the opportunity to partner effectively with stakeholders both at the policy, peer-to-peer and the grassroots levels, increasing the diversity of their integration.

The presence of knowledge sharing structures in this context is key. Ambient peer-to-peer and mentorship networks innovate the inter-generational economy, encouraging a transfer of knowledge, and the dissemination of information, technology, future thinking and, crucially wealth.

In order to empower the growing youth bulge, and see a healthy future economy, it is necessary to break the self-perpetuating cycle of top-down investment alone, and rather focus on structured, democratic investment woven across the market place.

Networks, and thus connectivity, are closely linked to expansion of the middle class, and their capacity to function as a large consumer base. According to McKinsey & Co, the emerging middle class in developing countries—nearly two billion strong—spends a total of $6.9 trillion annually.[32] The immense potential of this trend should not be underestimated by investors seeking to further their global market share and raise their brand visibility.

In Pakistan, the barriers to lending and credit have resulted in informal cash-dependence as a parallel economy. Over the last few years, the parallel economy has raised employment levels and facilitated job creation for the middle class by promoting the cash purchase of assets rather than the burden of credit.

This liquidity has contributed to a more prosperous middle-class in urban areas, with greater levels of disposal income equating to increased access to intellectual capital and innovation. Most recently, as a consequence of the increasing popularity of digital platforms, knowledge sharing is occurring in urban and semi-urban areas at a rapid-fire pace.

Advantageously, more fluid exchanges through these platforms allows for a reciprocal transaction amongst experts spanning a range of industries.

The democratic ability for networks to hold and share information, expertise and narratives is crucial for building brand loyalty and gaining credibility amongst the young populace.

32 David Court and Laxman Narasimhan, "Capturing the world's emerging middle class", McKinsey Quarterly, McKinsey&Company, 2010.

As innovation, ideas and aspiration are diffused more widely across various media channels, a media-savvy and connected youth is breaking out of structured norms in Pakistan. For investors, this is a key ingredient for success. Engagement and peer influence become important tools to harness when entering in a frontier market.

The significance of mobile and digital platforms in bridging the divide between urban and rural areas is crucial. Similarly, new developments and information can be spread throughout local populations via mobile or digital mechanisms, empowering communities and inspiring small-scale entrepreneurs.

Thus, knowledge sharing through networks, whether face-to-face or remotely, catalyse the sideways expansion of the potential marketplace.

The Virtual University is an example of an educational institution established by the Government of Pakistan which uses media and technology to create knowledge transfer in Pakistan. Using free-to-air satellite television broadcasts and the Internet, the Virtual University allows students to follow its rigorous programmes regardless of their physical locations. The University opened its virtual doors in 2002 and swiftly its outreach programme has reached to more than a hundred associated institutions providing structural support to students.

Local communities seeking employment and investment should also harness the Diaspora network. Strong liaisons with the Diaspora would exponentially increase the granularity and intricacy of knowledge to be shared exponentially, building strategic partnerships, providing valuable local information, testimonials and transfer of expertise.

Where the connection between Diaspora and local populous has been somewhat loosened, social intermediaries should be engaged to build network of mentors, consultants and investors, thus supporting, transferring, teaching and to support the vital skills needed in Pakistan's public and private sector.

Engaging with Intermediary Institutions

Intermediaries identify the appropriate assets and resources to scale up investment helping to drive potential returns. They protect and stabilise the local investment environment, where discrete injections of capital have a tendency to produce disruptive change, spark individual competition and create a jagged local economy. The objective is not only to provide the investor with the framework support needed to enter the marketplace, but also the tools necessary for a strategic exit.

Intermediaries can take a variety of forms:

- Networks and informal collaborations for investors
- Incubators for innovators, providing an inclusive space for dialogue and experimentation
- Mentoring and seed financing for entrepreneurs
- International partnerships creating export opportunities for owned and operated businesses

As the ideal mechanism to connect an investor and local partner in a frontier market such as Pakistan, intermediaries often:

- have vast and differentiated local networks
- understand the local culture and where it intersects with government policies
- understand standard business & legal operating procedures
- conduct due diligence for both parties
- are geographically well-placed to access remote areas
- speak local dialects and the investor's language

Figure 14: The Role of the Social Intermediary

The social intermediary model translates well into investment. In a frontier market, an intermediary can span both private and public sectors affording investors the opportunity to diversify their reach and returns. Intermediaries encouraging this integrated approach understand the inherent benefits of actively creating hybrid investments using inclusive models of commercial return and social impact.

Contact with reliable local partners is often a key ingredient for long-term profitability and scalability of business ventures. An intermediary that can source local partners and provides access to capital creates mushroom growth through scalable social impact. The result is the development of ancillary market sectors. Diversifying traditional forms of growth creates value across stakeholders and feasibly directs funds into the free market.

Given their innate cultural knowledge and the influence they hold, intermediary institutions play a crucial role in connecting interested stakeholders. Investors, policymakers, foundations and private sector corporations require secure access to local private investors, business owners, grassroots entrepreneurs and local communities.

As with any international investment, cultural sensitivities need to be acknowledged in the blended return or triple bottom line that investors choose to utilise. Thus, social intermediaries play a large role in the mutually beneficial and culturally nuanced partnership between an investor and an investee.

Early stage enterprises are the natural home for a social intermediary that can leverage their support network in remote areas, creating cross-community structures, raising employment levels, literacy levels and entrepreneurial confidence.

The Hashoo Foundation's Honeybee Project in Chitraal is an example of a social intermediary engaging in capacity-building and improving vocational training for entrepreneurs. In the Northern Areas where honey is one of the main agricultural commodities, Hashoo provided women beekeepers with beehives, as well as the associated training programmes to transfer this specialised skill-set to the wider community.

A pure venture capitalist approach would entail making a loan to the beekeeper for the optimum amount of beehives. It would also lead to an expectation of both a high interest on the loan (due to low availability of capital) and a payback guarantee over a predetermined period.

Whilst Hashoo grants the training programmes to the beekeepers and does not expect any return of investment, this model can be successfully adopted by the private sector as an efficient way to make headway into a lucrative frontier market.

Expanding the Venture Capital Approach

There is a strong need for venture capital, fund management and private equity expertise in most frontier markets. Pakistan's many national, owned and operated, small and early-stage businesses offer long-term growth potential. Businesses with limited operating history (< 5 years) look to raise funds to avoid restrictive credit and loan products sold by commercial banks.

In order to reach their desired demographic, investors need to grasp the various intricacies of community structures in Pakistan. When asserting their expertise it is essential that the investor recognise these variable metrics, allowing for a better injection of capital into mid-cap and SME businesses.

By creating a dialogue, the investor can understand the business owner as well as the business to reach nuanced and informed decisions regarding

- management
- ownership parameters
- labour structures
- long-term growth trajectory
- eventual return on investment

Additionally, investors should consider mentorship programmes when incorporating corporate responsibility measurements into their roll out. Mentorship serves to educate the rural communities on the benefits of business ownership, venture capital and market contracts, bringing up a whole community and naturally creating local demand.

The hybrid model of commercial return and social impact is widely recognised as the most potent form of investment.

The key to changing the perception of the loan-shark venture capitalists in a credit-averse culture is profit-making parity amongst investor communities. A transfer of a portion of the equity from the investor to the investee has the additional benefit of allowing for business owners to continually innovate and scale their enterprises with autonomy. Moreover, primary structured capital, rather than the cultural practice of informal money lending, benefits the stability of rural areas. Thus, venture capitalists are encouraged to be an effective lifeline for early stage businesses in more remote areas of Pakistan.

Structuring the Active Investor Circle

A circle of active investors, spearheaded by individual stakeholders, can play an important role in the financing of mid-cap investments. In turn this fuels the financing of SME sectors, facilitated by the Social Investment Fund (SIF) as explored further in this report.

Like business angels, active investors have an experienced, early adopter profile and the inclination to manage their own portfolios. However, these investors may not initially be within the same networks. Pooling a collective of investors to fund initiatives of common interest using crowdfunding is a technique increasingly being utilised.

Crowdfunding is useful to consider when incentivising the diaspora of a frontier market. The diaspora, when collaborating together and with other interested parties, are the knowledge communities that form the initial basis of the SIF.

The high-risk, high-return investments in a frontier market are split into two categories: commercial and social. The blended commercial and social return is widely recognised as the most effective form of investment in this marketplace. Thus, the active investor circle can include stakeholders from both categories, leading to a merger of seemingly disparate priorities and therefore diverse potential funding interests. Financial and social value creation can be maximised according to the circle's preference.

The structure of active investor circles:

- Promotes longevity
- Allows flexible involvement across the gamut of commercial and social sectors
- Ensures risk is spread between multiple investors and investments
- Maintains consistent deal flow
- Reinforces investor confidence

Often the objective for angel investors is to lead the first wave of mid-cap investments in industry and services sectors to achieve tangible levels of success and market return proportionate to the risks taken. In an active investor model, the circle buys in to a multi-faceted portfolio with the understanding that the levels, length, return on and measurements of their investments will necessarily vary.

A multi-faceted approach requires a substantial risk appetite. Whilst social innovation generates a large amount of interest amongst collaborative networks, this sector necessitates longer-term strategies due to issues of accessibility and the need to transform subsistence-led mind-sets.

The metrics of successful social ROI differ from a traditional investment. Payback periods are longer; which allows for the circle to gain some traction in the near-term.

If sectors of critical importance are assessed first, the growth of these will necessarily have an exponential impact on other sectors and regions of development, indirectly supporting and furthering the portfolio's ambition.

The active investor circle advocates the engagement of intermediary institutions as a vehicle for venture capital funding.   The circle will include the full spectrum of stakeholders to facilitate and support business in Pakistan: from trade representatives, business consultants and industry matchmakers to political risk analysts, insurance providers and specialists in legal compliance.

Social Investment Fund (SIF)

Macroeconomic stability remains the strategic foundation for Pakistan's growth, investment potential and global export competitiveness. The Pakistan Council for Renewable Energy Technologies (PCRET) and the Pakistan Innovation Board (PIB), have long championed political reforms in the area of enterprise innovation.

Structured investment through carefully designed mechanisms can support this aim, generating a secondary layer of sustainable growth which, if applied consistently, proliferates across sectors, reinforcing the economy.

A hybrid model of commercial and social return is the most robust investment approach to a frontier market. Investors who inject capital into a SIF understand that social inclusion and assistance will lead to a thriving market.

A Social Investment Fund (SIF) is one approach of hybrid investment. Using an enhanced venture capital model, a SIF allows for focused and structured investments into Pakistan's growth sectors. As an organised platform for investors, the SIF interfaces between the commercial and social investment sectors to facilitate a sustainable cycle of top-down and bottom-up capital growth across market sectors in Pakistan.

Steps to Create the Social Investment Fund

A SIF is responsible for investment allocation, sector due diligence and risk diversification. The circle of investors collaborating on the SIF need not solely be individuals. A crucial aspect of this platform is the experienced financial intermediary that already has a footprint in Pakistan.

Initially, the SIF would assimilate the capital deployment from active investor circles. Subsequently, the financial intermediary group would structure debt and equity products to broker transactions with mid-cap enterprises and SMEs. In a fluctuating environment, when businesses can face difficulties in accessing capital, these intermediaries also provide technical expertise.

Furthermore, financial intermediaries utilise specialised community banking models to service semi-urban and rural customers, whilst leveraging inbuilt finance units that invest in innovative and ground-breaking strategies for secondary debt market development. Their transactional capabilities have proved strong and resilient, and they would be a valuable knowledge base for incoming groups of investors.

Examples of financial intermediaries include:

1. Finance arms of government development institutions e.g. The International Finance Corporation (IFC), CDC[33] and the Asian Development Bank (ADB)
2. Microfinance Banks such as Kashf Foundation
3. CSR Funds and Corporate Venture Capital

These players would participate in a SIF by:

- assessing the financial sustainability of the SMEs
- utilising flexible models of long-term investment and business support
- assessing loan repayment rates on debt transactions
- monitoring investee performance.

Furthermore, as companies such as Gillette, Nestlé and Coca-Cola regularly allocate funds towards furthering the progress of small businesses, a SIF is the obvious candidate for the CSR budget. Large corporations proportion their budgets through a fund into community investments whilst maintaining their internal CSR metrics.

In order to build a diversified portfolio for social investment, investors should identify how their goals index against a systemic change in the market, and how they will quantify social impact versus future commercial returns.

Figure 15 below shows the projected time span of a SIF, given that certain cycles of investors would enter the fund at different stages.

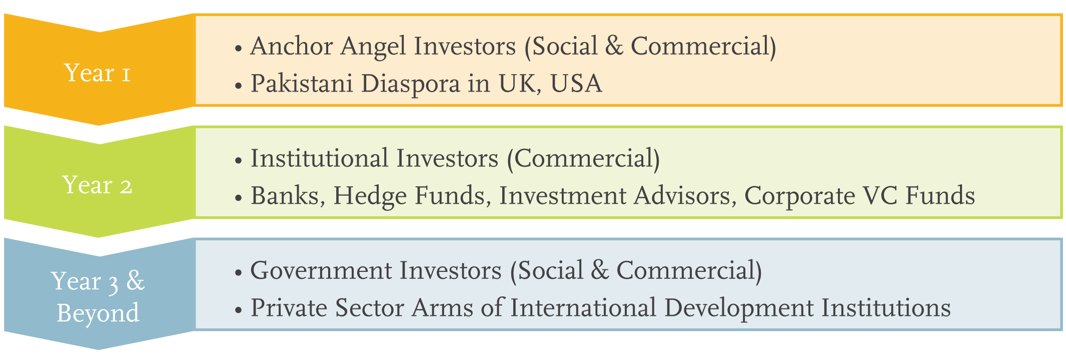


Figure 15: SIF Time Span

33 CDC Group plc (formerly the Commonwealth Development Corporation, and previous to this, the Colonial Development Corporation) is a Development Finance Institution owned by the UK Government. The Department for International Development is responsible for CDC, with shareholder duties managed by the Shareholder Executive. It has an investment portfolio valued around £2.8 billion and is focused on the emerging markets of Asia, Africa and Latin America, with particular emphasis on South Asia and sub-Saharan Africa.

The Social Investment Fund Model

The Social Investment Fund model is based on a venture capital model. An optimum mid-sized fund begins with a starting capital of US$25-US$30m and an investment ticket of $500,000, aiming for a 3-5 year exit per enterprise and a 20% Internal Rate of Return (IRR).

Figure 16 demonstrates the projected investment stream:

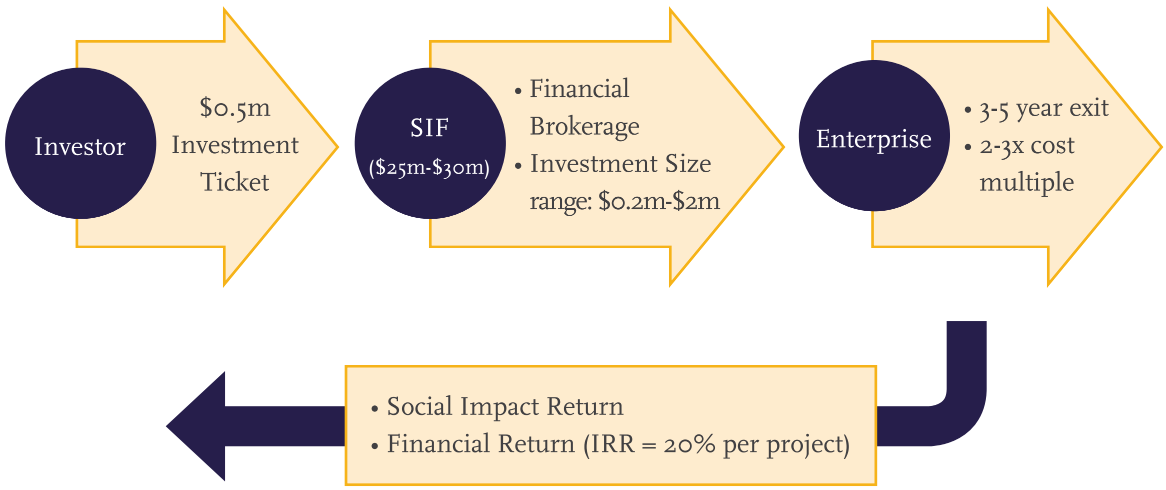


Figure 16: Projected Investment Stream

Assumptions:

i. Internal Rate of Return (IRR) is set by the expectations of the investors in the SIF and the relative risk levels compared to other investment classes
ii. Due diligence on investment portfolios range from SME to mid-sized industries
iii. Fixed life of the SIF ≈ 10 years
iv. Structure: 40% debt and 60% equity

A SIF can be established as an open fund, undergoing constant fundraising. It is ideal for a medium to long-term investment horizon, aiming for low volatility and capital preservation whilst targeting a realistic return. A beneficial strategy involves a partnership with an existing fund manager who has experience in the SME and mid-cap space, coupled with an understanding of community investment.

Measuring social impact is important and hinges upon the number and vulnerability of beneficiaries in portfolios, the quality of the intervention and the level of risk taken by investors. The social and financial returns (initially below market) will need to be identified individually by evaluating the impact risks. Stakeholders such as foundations can assist with the measurement of social impact metrics using established market indicators such as Impact Reporting and Investment Standards (IRIS).[34]

The tools to build a successful social investment structure include, on the investor side, the fixing of stable loan return rates, a set of exit strategies and default margins. Additionally it is necessary to build quantifiable and measurable targets adapted to rural and urban environments, as well as assessing the investment readiness of target enterprises.

A large portion of early-stage enterprises do not have the expertise to administer complex financial products. For this reason, and also because the risk of default is higher, fewer investors invest at the early stage. Thus, the distribution of capital is skewed towards the growth stages, and fledgling enterprises find it difficult to garner much needed capital at their inception.

To meet this demand, a SIF needs to structure itself in order that:

- the pipeline for funding or deal flow is structured across a range of risk and return scenarios
- the need for greater financial literacy is met
- financial options are implemented across all stages of the organisational lifecycle
- legal contractual mechanisms protect against mission drift and take-over
- incentives are constructed to diversify funding and income base

Concerned parties need to establish the appropriate metric system to transcend the conventional actors – the investor, the investee and the fund – and examine the broader range of possibilities in the market. In this regard, combining the guarantee of loan capital with the aforementioned mentoring system is an intriguing opportunity for the investors.

Ultimately the SIF model has not been constructed to simply grow one organisation but to grow the sector industries at large, opening opportunities for reinvestment and easing the ability to scale. The challenge for the fund managers is to identify the enterprise at an inflection point, where an injection of loan capital would catalyse a rapid growth across other sectors.

The Landscape for Social Investment

By defining and expanding the spectrum of social investment opportunities clearly, Pakistan's target sectors can be segmented and invested effectively.

34 IRIS is a set of standardised metrics that can be used to describe an organization's social, environmental, and financial performance. IRIS' performance measures help organisations assess and report on their social performance

Recognising new market opportunities available in social investment plays a vital role in bridging the current liquidity gap, as well as an active role in the development of a market. A greater degree of liquidity would facilitate capital flows and increase investor flexibility, thereby driving the growth of multiple businesses across a range of sectors.
Current private sector involvement in social investment is mainly confined to small-scale debt and equity investments. Both debt and equity have their drawbacks: whilst debt puts a strain on the investee, equity investments are subject to limited liquidity, buyout or IPO restrictions, as well as suffering from a lack of performance data and an underdeveloped social stock exchange.

Agents which could facilitate the identification of investment strategies include:

- The active investor circle
- Experienced social and commercial investor groups
- A comprehensive due diligence operation

These agents can assist in determining which type of investment strategies are likely to work for specific enterprises given their size, sector, risk levels and potential for growth.

The social investment space calls out for a different set of financial instruments to target both mid-cap and SME streams to increase the liquidity in the market. Given the nascent stage of the social investment space in Pakistan, investment is currently largely sourced from philanthropic and public funds as well as company CSR budgets. This investment varies in the extent to which it seeks a market return.

However, there are players in the market with more progressive forms of combined social and commercial venture capital. The Acumen Fund is a good example of a social venture fund which uses patient capital to fund social investments. It has over US$13 million in committed investments in Pakistan and an additional US$6 million in pipeline investments currently in various stages of due diligence.[35]

With patient capital, the investor is willing to make a financial investment in a business with no expectation of turning a quick profit in anticipation of more substantial returns down the road.

Although patient capital can be considered a traditional investment instrument, with the rise of environmentally and socially responsible enterprises it has acquired a new dimension characterised by:

- willingness to forgo maximum financial returns for social impact
- greater tolerance for risk than traditional investment capital
- longer time horizons for return on investment
- intensive support of management as they grow their enterprise

35 Acumen Fund Pakistan, http://www.acumenfund.org/investments/countries/pakistan.html

In order to facilitate new capital flows, the social investment spectrum needs to be carefully researched for investors, not only according to sector and organisational size, but also:

- investee value systems
- investee resource requirements
- risk and return characteristics
- optimum duration of investment
- exit strategies
- new risk-return measures

Social investment funding opportunities can be bundled together as investment products. In turn, these are blended across a portfolio to achieve the levels of social and commercial return required by investors.

Bundled investment products in the SIF would allow investors to be presented with different opportunities that fit with their investment needs. These needs could range from venture philanthropy to full-market return.

The process will dramatically improve the effective allocation of financial intermediaries and lower transaction costs in deal-making. It will also build bridges between conventional capital, entrepreneurial initiatives and larger businesses, helping to generate more lucrative deal flow across market sectors.

Scope for a more Liquid Marketplace

Researching and creating more sophisticated capital market instruments would add greater liquidity, deliver higher returns and maximise social impact in a frontier market.

Quasi-equity or mezzanine finance offers this possibility through hybrid debt and equity instruments such as convertible bonds, shareholder loans, preferred shares, unincorporated joint ventures and the securitisation of loans, often successfully implemented in microfinance organisations.

Further research could also explore the creation of a central loan loss reserve, a social stock exchange, a social investment index or a public metric system. Thus, institutional investors could buy structured social products which function like fixed-income instruments, combining sub and above-market rate returns and yielding high social and environmental impact.

An important area for future research involves building a range of instruments in order for the market to have close to full informational transparency around sector specific performance data and their existing metrics. Research initiatives such as these, once pioneered, would present a variety of options for investors through which to deploy capital into Pakistan's social investment space.

Risk Mitigation Mechanism

Pakistan's market systems make it challenging for commercial investors to carry out due diligence of potential investee enterprises. Foreign exchange fluctuation and the lack of appropriate hedging instruments deter commercial investors.

Traditional risks of investing in emerging markets include:

- An unbalanced informational hierarchy and lack of transparency between investors and enterprises
- The intrinsic higher risk associated with small-scale activities
- The existence of sizeable transactions costs in handling microenterprise financing
- The lack of collateral that typically characterises smaller businesses

These risks could be offset with a Risk Mitigation Mechanism, highlighted in Figure 17 below.

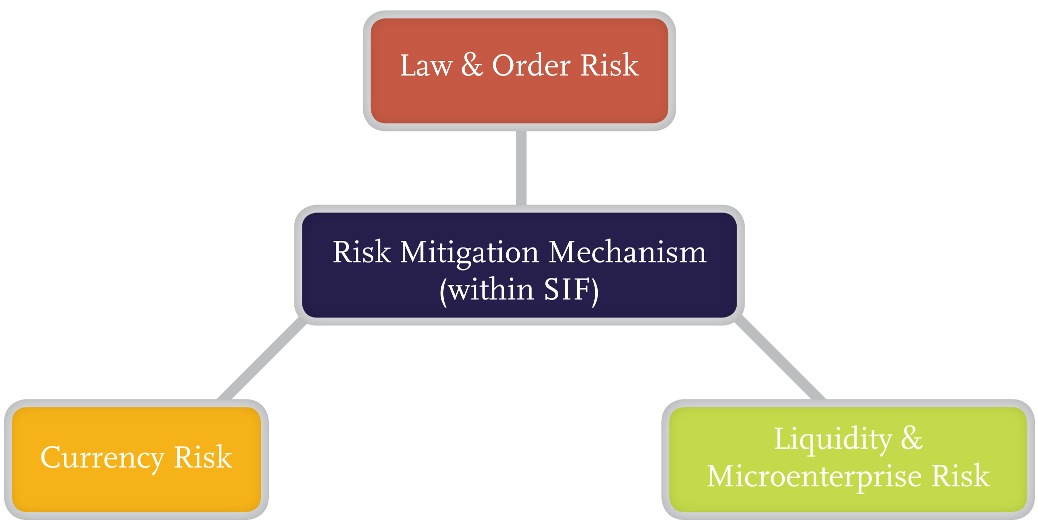


Figure 17: Risk Mitigation Mechanism

Early-stage deals often have high risks for a SIF. For example, the absence of reliable or audited financials in small businesses makes the process of assessing risk and creditworthiness resource-intensive. The Risk Mitigation model offers mechanisms to lower the level of risk associated with initial funding:

1. Geographic Presence
A process whereby designated individuals visit SME sites to assess the physical premises, inventories and employee qualifications would be prudent. Once a survey has been executed and assumptions are put into place, the SIF can make a fair assessment of output volumes and cash flows for a

particular enterprise.

2. Profit Sharing

Another method to diversify risk is through community-based profit-sharing models. Such a model is a "cluster", a geographical concentration of enterprises which produce and sell a range of related or complementary products. This model is a useful ingredient in managing venture capital injections across communities; building product capacity, promoting an organised platform for investment and generating employment opportunities.

3. Reimbursements

An important function of the Risk Mitigating Mechanism is to alleviate the transaction costs incurred by fund managers on the finalisation of small deals. A donor-funded facility reimburses fund managers for at least a portion of the expenses incurred for small equity investments.

In this way, a SIF can function as a successful platform for social investment in Pakistan once investors accumulate intelligence on the marketplace, implement measures to increase liquidity and understand how to manage risk.

Ultimately a frontier market offers high levels of activity and much untapped potential, but little available intelligence; under these pressures a collaborative approach to investment would work most effectively.

Conclusion

A quiet optimism prevails within internal and international communities. The opportunity to utilise successful hybrid commercial-social investment models in Pakistan's Mid-Cap and SME sectors could not be more timely than it is today. Pakistan's strong potential lies in its latent ability to catalyse widespread change within its own economy through social investment.

Changing the perception of Pakistan, and raising both investor and entrepreneurial confidence are critical to this process.

A multi-faceted, multi-stream approach to social investment leverages Pakistan's competitive advantage on the global stage. By establishing collaborative active investor circles and a SIF, investors will be instrumental in shaping early stage growth and unlocking the immense potential of Pakistan's economic landscape.

An engagement with human capital and knowledge sharing networks accelerate a dynamic socio-political shift, creating the space for investors to realise the latent power of Pakistan's youth bulge and propel the country from dependency on bilateral aid to a self-governing economy.

Re-envisioning successful intermediary and venture capital models through the potent prism of social investment provides the necessary framework for demonstrable, scalable and sustainable economic growth.

Investors taking advantage of this high-risk, high-return market will transform regional uncertainties into large-scale opportunities.

Preview of Large-Cap Investment Sectors

In this report, an analysis has been conducted on the mid-cap and SME space in Pakistan, addressing the need for investment into these industries. Frontier Market: Pakistan looks forward to developing further in-depth industry break-out reports, including on large-cap industries, which will capture in detail Pakistan's diverse potential for interested investors.

The **mining and quarrying industries** account for roughly 11% of industrial production. Pakistan is rich in mineral resources such as coal, copper, iron ore, limestone, and salt, and the identified resources of copper and iron ore are large. The Mineral Department of the Ministry of Petroleum and Natural Resources is responsible for the exploration, planning, development, and operation of Pakistan's mining ventures by the state-owned companies. State-owned companies own the production and marketing of chromite, coal, copper, iron ore, and steel. Private-sector companies have the jurisdiction to own and produce non-fuel minerals, mainly industrial minerals, including cement.

The **construction and real estate industries** are widely identified as two of the major drivers of growth in Pakistan. The Government has undertaken several measures to stimulate growth in this sector, for example, the issuance of a significant reduction in import duties and taxes on building materials including machinery and equipment. The new home financing schemes by local and foreign leasing as well as financial institutions, through aggressive marketing, are playing an important role for the growth in this sector. Plenty of residential, commercial mixed-use development projects are under way, expanding the demand for real estate in Pakistan.

The **pharmaceutical industry** in Pakistan is developing rapidly, with large demand for healthcare products originating from a growing population. Private sector spending on the healthcare industry accounts for roughly 65% of total healthcare expenditure sourced through out-of pocket payments, international aid and charitable institutions. Today, the pharmaceutical sector is one of the most developed hi-tech sectors within the country's economy. GlaxoSmithKline Pakistan Limited is the largest pharmaceutical company in Pakistan, initiated in 2001 through the merger of SmithKline, French of Pakistan Limited, Beecham Pakistan (Private) Limited and Glaxo Wellcome (Pakistan) Limited.

Appendix

Individuals and Organisations Interviewed for this Report

Pakistan	Mr Ghazanfar Azzam, CEO, TCS Bank and Financial Services Project
	Ms Sumbul Munir, Country Head Corporate & Investment Banking, Silk Bank
	Mr Ahmer Arif, Managing Director, Globus
	Mr Yasin Paracha, Managing Director, Team A Ventures
	Ms Saima Irtiza, Business Manager, Acumen Fund
	Mr Samir Ahmed, Chief Executive, Pakistan Mercantile Exchange Ltd.
	Dr Nadeem Ul-Haque, Deputy Chairman, Planning Commission, Government of Pakistan
	Ms Mishayl Naek, Assistant Director, State Bank of Pakistan
	Mr Ali Akbar, Country Director, Hashoo Foundation, Pakistan
	Mr Majyd Aziz, President, MHG Group
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