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Background

Promoting Private Sector Development

In October 2009, President Obama signed into law the Enhanced Partnership for Pakistan Act. The legislation, better known as the Kerry-Lugar-Berman (KLB) bill, introduced a comprehensive policy framework for U.S. assistance to Pakistan, tripling development aid to $7.5b over five years. As part of this package, the United States prioritized support for private sector development through trade and investment.

Launching a U.S.-sponsored investment fund to support Pakistan's private sector first garnered attention when Secretary Clinton, in partnership with the Overseas Private Investment Corporation (OPIC), pledged to provide $500m for private equity investments in small- and medium-sized enterprises (SMEs) during the U.S.-Pakistan Strategic Dialogue in March 2010. That July, Senators Lugar and Kerry introduced bill S. 3685, the Pakistani-American Enterprise Fund Act. The bill, inspired by the 1969 Support for East European Democracy (SEED) Act and the 1992 Freedom Support Act, which together established 10 ‘enterprise funds’ throughout Eastern and Central Europe after the Soviet collapse, authorized an independent fund to provide loans and equity to private Pakistani enterprises, in order to create jobs and counter militant extremism.

In December 2011, Congress chose not to authorize the $600m allocation for establishing the Pakistani-American Enterprise Fund. Despite this setback, however, the U.S. Department of State, still committed to strengthening support for Pakistan’s private sector, began surveying alternative models for promoting job growth and investment in SMEs. This paper examines these alternatives and makes recommendations for which to pursue, and how best to pursue them.

Looking Beyond 2014

The U.S. partnership with Pakistan is one of the most strategically significant bilateral relationships in the world, and it will continue to be so long after the tentative withdrawal of U.S. forces from Afghanistan in 2014. Pakistan, located at a geopolitical crossroads, is locked in an enduring rivalry with neighboring India and holds close alliances with China, Saudi Arabia, and the broader Muslim world. Its geographic significance is compounded by its demographic composition and powerful military. Pakistan is a nuclear state, home to the world’s second-largest Muslim population, and is projected to become the fourth-most populous country in the world by 2050.

Several events in 2011 tested the relationship between Pakistan and the United States—in particular, the Raymond Davis incident in January, the killing of Osama bin Laden in May, and the accidental helicopter attack on a Pakistani border post in November.

The U.S.-Pakistan relationship, however, and American engagement in the country more broadly, remain crucial to ensuring Pakistan surmounts the immediate challenges it faces—which are substantial. Vital U.S. interests and the economic integration of South Asia require a stable Pakistan—but looming social, economic, and political upheaval could compromise any hope for long-term stability.

Investing in Stability

The U.S. Government has various tools at its disposal—aid, trade, technical assistance. But one that has been given relatively little emphasis in Pakistan has been investment. U.S. investment, however, has the potential to both stabilize the economy through effective economic development, and to widen and deepen American ties to powerbrokers in Pakistan—especially those outside the traditional political establishment.

Pakistan’s private sector is essential to any strategy for long-term engagement—bolstering it will increase economic stability, hamper terrorist recruitment, and draw in a wider array of political allies.

The country’s economy is beset by stagflation and a lack of competitiveness. Energy shortages and rising fuel and food costs are closing factories and pushing more Pakistanis below the poverty line. Private investment is the engine that drives economic growth; the middle class expansion that often accompanies such growth will play an important role in promoting economic stability, which undergirds political stability. A robust middle class provides a constituency for free markets, effective governance, democracy, and the rule of law.

As well, job creation is an important tool for countering violent extremism. A burgeoning youth population—an alarming 68% of all Pakistanis are under the age of 30—is engulfing Pakistan’s urban areas, where a lack of jobs, education, clean water, and access to justice cultivates a breeding ground for radicalization. An investment fund can help grow businesses, which will create new jobs. Generating employment is essential for reducing poverty and lessening the tensions that terrorist networks exploit to radicalize marginalized populations.

Finally, direct engagement with business leaders will form new alliances in Pakistani society. The value of diplomacy outside the traditional halls of power has become increasingly clear, especially after last year’s ‘Arab Spring’ uprisings. Building broader, stronger relationships throughout Pakistan is in the American interest, helping U.S. policymakers to better prepare for an unpredictable future.
The U.S. Department of State’s Coordinator for Economic and Development Assistance in Pakistan has proposed the creation of a Pakistan Private Investment Initiative (PPI), to be implemented by USAID, as an alternative to the legislated Development Fund. This study surveys a range of potential options for designing the PPI and proposes a model that, we believe, is best suited to increase economic productivity, support SMEs and to foster job creation and long-term economic growth in Pakistan. (We hereinafter refer to this collaboration between the Department of State and USAID simply as “State,” and to the Pakistan Private Investment Initiative as the PPI, “the fund,” or “the initiative.”) State has already expressed a possible interest in partnering with the Small Enterprise Assistance Funds (SEAF), as one component of the PPI—our recommendations account for and accommodate this proposal.

The Problem
Despite Pakistan’s vibrant banking sector, credit rationing is a major constraint on SME growth and investment. Interest rate spreads on commercial loans compare un-favorably to the high-interest, risk-free securities sold by the Government of Pakistan. As a consequence, voracious government borrowing is sustaining an investment climate in which banks have little incentive to extend credit to the private sector. The burden of Pakistan’s underserving banks on SMEs is magnified by a void of private equity participation in the market. Alone, the financial constraints that are problematic, but coupled with a rapidly expanding population it becomes urgent. On average, Pakistan’s economy grows 3% annually; just to absorb annual workforce additions, Pakistan will need to grow 6–7% per year. In the short term, Pakistan’s energy shortage, interest rate spread, depreciating rupee, and image as a high-risk country all serve to limit access to finance.

We recommend designing the fund using the private equity model, to support new and growing SMEs—i.e., form limited partnerships with professional fund managers to direct venture and growth capital to promising businesses. Private equity’s long-term investment horizon, emphasis on value creation, and track record in spurring growth and innovation in emerging markets has the greatest potential to address the need for financing among SMEs and to foster broader development returns, without the risk of crowdfunding.

High-quality fund management will be essential to achieving the best possible investment returns and stimulating the multiplicative impacts that will sustain the fund and develop Pakistan’s nascent private investment industry over the long run. State should look for independent and professional investment firms as the best partners for success. State should also not limit itself to a single partner but, instead, place capital with several firms to target narrower market segments.

Additionally, State should include a complementary component to provide support for the development of Pakistan’s entrepreneurial ecosystem. Specifically, the program can work with Pakistani universities to establish and support startup incubators, and it can build linkages among universities and independent entrepreneurs, in Pakistan and elsewhere, to promote knowledge-sharing and mentorship. A fund with these three components—ecosystem development, venture capital, and growth equity—can target the full spectrum of the business life cycle, which is crucial to scalable, sustainable success.

The Way Forward
Below, we provide eight core recommendations, following from our findings. Collectively, they address the financial needs of Pakistan’s private sector, mitigating risk, enhancing developmental impact, facilitating profitable investments, and improving U.S. engagement with Pakistan’s private sector.

<table>
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<th>MAJOR FINDINGS</th>
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<tbody>
<tr>
<td>1. There is an urgent need for financing among Pakistan businesses and entrepreneurs.</td>
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<td>2. Microeconomic risks posed by governance-related failures represent the most binding constraint on private investment and entrepreneurship in Pakistan.</td>
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<td>3. SMEs are the most capital-constrained businesses and disproportionately overlap with high-growth sectors of the economy.</td>
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<td>4. SMEs in both the venture and growth stages are constrained by a lack of access to long-term, risk-oriented capital and institutional support, and represent compelling investment opportunities.</td>
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<td>5. The burden of Pakistan’s underserving banks on SMEs is magnified by a void of private equity participation in the market.</td>
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<td>6. State should include a complementary component to provide support for the development of Pakistan’s entrepreneurial ecosystem.</td>
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<td>7. The burden of Pakistan’s underserving banks on SMEs is magnified by a void of private equity participation in the market.</td>
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<td>8. There is a need to better define the bounds of the SME sector and, in particular, to distinguish the differences between small and medium.</td>
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<th>RECOMMENDATIONS</th>
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<tr>
<td>1. Establish a vehicle to address Pakistan’s immediate financing needs, but acknowledge its limitations—ultimately, governance failures constrain private investment and entrepreneurship.</td>
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<td>2. Invest U.S. Government resources using the private equity fund model. Work with private sector partners.</td>
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<td>3. The private equity model is proven in emerging economies and can offer Pakistani entrepreneurs a critical experience to the partnership—both are important for PII success and attracting new investment.</td>
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<td>4. Disaggregate the “SME” space and focus on small and medium firms, separately. Define these as firms in the $50k–$1m and $1m–$10m revenue ranges, respectively. Focus on SMEs with the strongest exit prospects—target investments in companies led by promising entrepreneurs that have vision, but lack the financial and institutional support to scale.</td>
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<td>5. Structure the PII to include venture capital and growth equity components. Plan for ticket sizes of $50k–$400k and $2m–$7m, respectively. Employ the limited partnership structure common in private equity and adopted by the CDC and other major DFIs, in line with international industry standards.</td>
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<td>6. Work through multiple implementing partners, as a means to create several smaller PII funds with more targeted investment in smaller firms. Select and implement with professional fund management firms with relevant experience, local knowledge, capacity to add commercial value to portfolio companies, and ‘skin in the game.’ Consider emerging or first-time fund managers that align with the broader PII mandate, in addition to experienced teams with proven track records.</td>
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<tr>
<td>7. Structure PII fund partnerships using one or more feasible implementing mechanisms that allow for maximum flexibility, commercial sustainability, and leverage of U.S. Government resources. Prioritize the GDA model but use more traditional contracts and grants as required. Seek to leverage Pakistani private sector involvement in sourcing and leveraging investments.</td>
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<td>8. Incorporate an explicit component to develop Pakistan’s entrepreneurial ecosystem. Allocate between $10m and $20m for startup capital and other incubator initiatives. Work closely with local entrepreneurship networks and universities. Implement from the level of the PII as an overarching component or through a partner as a smaller sub-fund.</td>
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Market Analysis

**Economic Challenges**
- Low human capital
- Poor infrastructure
- Macroeconomic government failures
- Macroeconomic government failures
- Market information failures
- Market coordination failures
- Low savings & bad international finance
- Low competition
- High risk of finance
- High cost of finance

**Development Approaches**
- Technical assistance (to banks)
- Aid (to State Bank, SMEDA)
- Foreign government lending
- Nonprofit grants & lending
- Financial markets

**Financing Vehicles**
- Commercial bank lending
- Domestic government lending
- SME financing
- Microfinance

**Targeting Strategies**
- Capitalize on core strengths
- Invest where there's pent-up demand
- Consolidate fragmented markets
- Promote export competitiveness
- Focus on locuses of job creation
- Tap key demographic groups
- Look for multiplier effects
- Add U.S. value

**Segments**
- Micro
- Small
- Medium
- Large

**Operational Analysis**

**Investment Type**
- Large capital investment
- Angel investment
- Venture capital
- Buyout

**Target Size**
- Multiple partners
- 1 partner, 1 fund
- 1 partner, fund of funds

**Model & Strategy**
- Venture
- Growth equity
- Buyout

**Structure & Implementation**
- Grant to public international organization
- Request for proposals
- Global Development Alliance
- Entrepreneurial ecosystem development

**Model & Strategy**
- Social impact bonds
- Partial credit guarantees
- Feed-in tariff for renewable energy
- Trade assistance

**WHAT**
- What are the problems to address?
- How do we best address them?

**WHERE**
- Where could we place investments?
- With whom?

**WHEN**
- When should we work?

**RECOMMENDATIONS & Key Features**

**IMPACT**
- Revenue
- Employment
- Innovation

**PAKISTAN PRIVATE INVESTMENT INITIATIVE**

**SUMMARY DIAGRAM**
Research Goal
With this policy analysis exercise, we seek to inform the ongoing dialogue on U.S. economic and development assistance to Pakistan. Our core objective is to provide specific recommendations to the U.S. Department of State for the design and implementation of the proposed Pakistan Private Investment Initiative.

Methodology
The findings herein are the culmination of field research conducted in Cambridge, Mass., Washington, D.C., and Pakistan, between November 2011 and April 2012. Research included interviews with entrepreneurs, business leaders, investors, bankers, policymakers, elected officials, academics, and other experts, in Pakistan and the United States. We held meetings in Karachi, Lahore, and Islamabad, in order to gather insights into and perspectives on the investment environment in Pakistan, and the optimal design for a U.S. fund.

We also reviewed the existing literature on foreign assistance and private sector development, policy papers addressing the U.S.-Pakistan bilateral relationship, data and research on the Pakistani investment environment, and other relevant sources of information. Direct references to published sources are cited in the endnotes. Insights and observations gleaned from interviews are not cited explicitly in the document, but Appendix C includes a complete list of individuals consulted throughout our research.

Scope
Our research examines the specific proposal for a Private Investment Initiative and its role in strengthening the U.S. approach to economic development in Pakistan, but it does not address other aspects of that endeavor or this broader policy question itself.

Although we evaluated a range of viable options for the design of the fund, we chose not to elaborate on the operational details of how these recommendations would be implemented. There are thus legal and technical questions regarding the operation of the fund that are beyond the scope of this study.

Analysis of Pakistan’s economic context and market opportunities informs our recommendations for an optimal fund model. We intentionally refrained, however, from recommending specific investment decisions or strategies. Such decisions ought to be the responsibility of independent and professionally experienced fund managers with local knowledge and technical expertise.

Finally, although we consulted a diverse group of stakeholders in Pakistan to produce this study, our interviews were not exhaustive and our time in-country was limited. Further field research on Pakistan’s investment environment would make a valuable contribution to addressing the existing deficit of useful market data.

Fund Objectives
The U.S. Government has proposed the creation of the PII to increase the availability of finance for promising small- and medium-sized enterprises in Pakistan.

We define the initiative’s objectives as follows:
1. Promote job growth — Support the expansion of businesses, encourage entrepreneurship, and show positive demonstration effects that attract further private investment.
2. Foster goodwill — Establish a visible, long-term American commitment to supporting the development of Pakistan’s private sector.

Guiding Principles
We identify six overarching principles that underlie the design and implementation of an effective fund. First, the fund should optimize across three dimensions—addressing pressing economic needs, capitalizing on market opportunities, and ensuring feasibility. From this foundation, the fund should enshrine the values of independence and transparency, and of adaptability and learning. Finally, the fund’s driving motivation should be to have multiplicative impact.

Analytical Framework
Our analytical framework aims to identify the optimal balance of the three foundational principles—addressing need, capitalizing on opportunity, and ensuring feasibility—in two stages. First, we evaluate the overlaps between need and opportunity. We assess the economic constraints on growth and investment at the country level, by examining the broader economic environment. Then we identify the areas where financing need and growth opportunity most overlap at the firm level, by examining the market across two key dimensions: sectors and segments.

Second, we consider feasibility and impact. We conduct an operational analysis of the range of possible fund models, implementation structures, and alternative approaches to assess their viability and efficacy. We perform a risk and impact analysis to identify the main financial and political factors that have the potential to undermine the effectiveness of fund performance, and how best to overcome them.

We conclude with eight core recommendations, plus seven more specific design considerations. We also include two (of several potential) models for the fund’s structural design.
Any development program in Pakistan must take into account the larger economic context in which it will operate. Be it for an enterprise fund or any alternative model, the needs of Pakistani businesses, the challenges they face, and their prospects for growth are distinct from those in Eastern Europe in the early 1990s and, indeed, from many other emerging markets today. Understanding these nuances is essential for crafting the best possible policy intervention.

Economic Challenges

Pakistan faces a unique set of economic challenges—some caused by natural and demographic circumstances, others by poor policy choices. While substantial, these challenges are manageable given the right approach, from within the Pakistani government, and from outside partners like the United States. Ultimately, the prospects for resolving Pakistan's broader political and security difficulties will hinge on how effectively the country navigates this turbulent economic period.

Youth Bulge

With more than 190 million people today, Pakistan will soon be the fourth-largest country in the world—its population has tripled in less than 50 years and is projected to increase by an additional 85 million by 2030. Pakistan is also experiencing an unprecedented youth bulge. About 68% of Pakistanis are under the age of 30, and the size of the workforce is increasing at an average of 3% per year.

To meet the needs of this surging population, Pakistan’s economy has to grow at an estimated 6–7% annually, for the foreseeable future, and it must add some 36 million new jobs in the next 10 years. This ‘demographic dividend’—as the youth bulge ages and moves into the workforce, the proportion of productive workers will increase—represents both an opportunity and a tremendous challenge.

Volatility Growth

Pakistan’s ability to rise to this challenge depends on its capacity for strong, sustained growth. While the country has this potential, its economy has been extremely volatile in recent years.

After experiencing anemic growth in the 1990s, the economy bounced back with rapid economic growth in the early- to mid-2000s. But Pakistan’s external deficit in 2007 made it particularly vulnerable to the 2008 financial crisis. High inflation and low levels of domestic liquidity became unsustainable with the collapse of global demand. As a result, the IMF bailed out Pakistan to avert a balance of payments crisis. In addition to inflation, political instability and rising global commodity prices have further deterred investment and weakened Pakistan’s current account balance.

Pakistan’s economy is currently at risk of ‘overheating.’ That is, its non-accelerating inflation rate of unemployment (NAIRU), or its ‘natural’ unemployment rate, has exceeded its real unemployment rate. This suggests that growth in aggregate demand is outpacing growth in the supply of labor. In recent years, this imbalance has been stoking inflation. Currently, Pakistan is experiencing ‘stagnflation’—i.e., high inflation coupled with low growth.

Although unemployment itself is not an immediate concern, it will become one, if economic growth does not keep pace as the workforce balloons. To achieve such growth, Pakistan needs more investment in its private sector.

Immediate Constraints on Capital

In the short term, Pakistan faces a unique set of interwoven constraints on financing for investment—particularly for smaller, growing businesses.
Circular Debt

Pakistan’s most pressing economic challenge is the accumulation of circular debt in the energy sector, which has reverberating effects throughout the economy. In 2008, the Pakistan Electric Power Company (PEPCO)—the public umbrella organization for power-generation companies (GENCOs) and power-distribution companies (DISCOs)—accounting for 90% of energy production in Pakistan—began facing rising energy production costs, as worldwide prices rose, exaggerated by a depreciating rupee. At the same time, due to the government’s high external debt amidst the global financial crisis and the resultant credit crunch, public power purchasers fell short on payments. Aggravating the shortfall, high rates of energy theft remained unaddressed.

In lieu of cracking down on theft or raising tariffs, tariffs remained stagnant from 2003 to 2007, despite rising energy costs. PEPCO passed on the growing receivable burden to suppliers—extending the debt up the energy supply chain (GENCOs, refineries, and gas exploration companies, etc.).

This mounting debt reduces energy production, as upstream producers—the only ones with liquid cash reserves—are forced to pay off their receivables rather than invest in expansion. Additionally, since 2006, PEPCO has borrowed from commercial banks against government guarantees, as have independent power producers (IPPs) who supply PEPCO, since 2007.

At the end of 2011, the government formally absorbed the accumulated debt from PEPCO—Rs 391b (about $4.3b), equivalent to 1.8% of GDP—into the public debt. In this way, the energy sector feeds the larger debt problem in Pakistan, which in turn is a key factor in suppressing private-sector financing. Further, circular debt damps energy investment; this exacerbates the electricity shortage that so constrain businesses; these then limit their capacity for growth; and this makes it more difficult to raise energy tariffs—illuminating the debilitating circularity of this crisis.

Interest Rate Spread

In 2011, Pakistan’s overall public debt grew by 1.7b rupees to Rs 11 trillion (about $121.6b)—representing 60.9% of GDP. Today, interest payments themselves eat up 32.8% of government revenue. There are many pernicious effects of such a large debt burden—most immediately, though, it is not the size of the debt that poses the biggest problem, but rather how the government finances it. The government has come to rely on Pakistani commercial banks to supply the majority of its debt—by borrowing heavily from domestic lenders, the government thus crowds out private-sector borrowers.

Following the suspension of the IMF’s Stand-by Agreement (SBA), there are fewer viable sources of external debt. As a result, in 2011 the government borrowed Rs 1.1 trillion from domestic lenders (about $12.5b) and local sources now finance 91% of the deficit.6

Heavy government borrowing disincentivizes—and thus crowds out—lending to the private sector in three ways:

1) The government offers high interest rates, raising the effective discount rate for banks, and raising the hurdle rate for investing in the private sector instead;
2) Government debt is risk-free, and so banks seek a risk premium from private borrowers, further raising their lending rate;
3) Transaction costs are lower for government borrowing.

Taken together, these three factors serve to push interest rates seen by private borrowers too high to often be viable, and to reduce banks’ inclination to seek opportunities for lending to the private sector in the first place.

In 2011, for instance, while lending to the government increased by 74.5%, credit to the private sector grew only by 4%.8

Depreciating Rupee

During the financial shock of 2008, the Pakistani rupee experienced a swift devaluation—from March 2007 to October 2008, the rupee lost 57.31% of its value against the U.S. dollar. Because Pakistan’s external debt was so heavily invested in foreign exchange reserves, it was particularly vulnerable. In the years since, following a brief recovery, the exchange value against other major currencies has been in steady, gradual decline.

Currency depreciation can have ambiguous effects on an economy—for instance, a weaker rupee might strengthen Pakistan’s export sector. But volatility adds risk for investors outside Pakistan and businesses within. And, compared to neighbors like India, Pakistan has seen markedly higher volatility.

In particular, a continuous fall in the rupee against other major currencies will depreciate the value of foreign debt for Pakistani firms—a loan in U.S. dollars, for instance, will require constantly accelerating growth to repay, as local earnings have to stretch ever further to reimburse foreign debts.

Outside Perceptions of Risk

During the last two decades, foreign investment has been sensitive to instability in Pakistan. An increase in violence in the mid-1990s (much of it linked to MQM-backed political attacks in Karachi),12 saw a corresponding decrease in FDI; investment dropped each year from 1995 to 2001. Then, in the early-2000s, Pakistan experienced an economic surge—GDP growth increased each year from 2001 to 2005, rising from 1.98% at the start of the decade to 7.67% annually.11 An influx of foreign investment paralleled this boom; FDI rose each of those years, from $32.25 million in 2001, up to a peak of $5.41 billion in 2007. But the reemergence of instability in the second half of the decade, coupled with the financial crisis in 2008, saw a sharp downturn in FDI, which has dropped each year since 2007—falling to less than $1.5 billion in 2011–2012.

Pakistan’s ‘Binding Constraint’

Pakistan undoubtedly faces a host of economic challenges—from the immediate debt, financing, exchange, and perception problems, described above, to longer-term infrastructure deficiencies in the energy and education sectors, current account imbalances, and market failures related to corruption, monopolization, rent-seeking, and lack of information. It is important to ask, however, which of these are underlying ailments and which are merely symptoms, and, from a policy perspective, which constraint, if loosened, would unleash the most investment and growth—i.e., what are their ‘shadow prices’ and which has the highest ‘one’?

Ricardo Hausmann, Dani Rodrik, and Andrés Velasco10 introduced a model—called a growth diagnostic—for determining a country’s ‘binding constraint’ on investment. This methodology uses a standardized, staged process for isolating the most constraining factor in an economy. In Appendix A, we employ this approach to...
State has a core set of tools at its disposal for any program of this sort: aid, trade, technical assistance, and investment. And there are several broad approaches whereby failures could attempt an independent institution, supported by the U.S. government, to invest directly in Pakistani businesses. There are nevertheless other options for partnering with private-sector, nonprofit, or multilateral organizations to provide a conduit for such financing.

Given the nature of Pakistan’s investment climate, however, influencing and incentivizing private firms—especially, private equity and venture capital fund managers—offers a particularly attractive partnership opportunity. As such, investment, rather than traditional aid, could pose substantial benefits.

John Donahue and Richard Zeckhauser lay out four rationales for collaborating with private sector actors like these to achieve a goal usually relegated to the public sector.

- Resources—Private partners offer the opportunity to leverage American capital for greater impact. By partnering with investors who can raise their own equity—from other institutional or international investors, local investors, or the Diaspora—and can multiply its size and thus increase its effect.

- Productivity—The human capital, incentive schemes, and institutional structures of the private sector are better-equipped for making productive investments into Pakistani firms than are those of USAID or the Department of State.

- Information—Likewise, at both the institutional and individual levels, potential private-sector partners possess substantially more knowledge and on-the-ground knowledge about investment opportunities in the Pakistani market than does the Department of State, USAID, or either’s staff.

- Legitimacy—Private investors have more credibility than the U.S. Government for two reasons: 1) their track records and professional expertise render them more suitable strategic partners for Pakistani firms; 2) in Pakistan’s complicated political climate, private investors will be a step removed, and thus more insulated, from any negative connotations of U.S. involvement.

**Precedents**

The U.S. Government has engaged previously in a number of collaborations with the private sector to promote investment as a means to development. As well, a number of private financial institutions that have existed, financed by sovereign governments and multilateral organizations. We highlight below two in particular—the World Bank’s International Finance Corporation and the United Kingdom’s CDC—as potential models for the PI.

**Enterprise Funds**

Under the 1989 EEED Act, followed by the Freedom Support Act in 1992, Congress established 10 ‘enterprise funds’ covering 18 countries in Eastern and Central Europe. The funds combined lending programs (debt), equity investments, and technical assistance for establishing local financial institutions. Over their lifespan, the funds were obligated $1.17b by Congress and earned an overall return of $1.704b. They directly invested a total of $2.973b, leveraged an additional $3.581b in equity through fund managers, plus $3.861b of debt from external sources. The PI also provided significant technical assistance, including for the creation of 30 financial institutions (banks, venture capital firms, leasing companies, microfinance institutions, etc.).

The enterprise funds were private, nonprofit corporations, capitalized by USAID grants. They had independent, White House-appointed boards, which then hired in-house professional fund managers. Each fund received ‘notwithstanding authority,’ and thus was exempt from many standard rules and regulations, such as for procurement procedures or ‘Buy American’ requirements. The individual boards had significant leeway to determine investment strategy, and the funds often took divergent approaches country by country.

Today, all but one fund has fully liquidated the Western NIS fund is scheduled to liquidate by 2013—but all have been rolled over into legacy institutions, like the Polish-American Freedom Foundation and the Hungarian-American Enterprise Scholarship Fund.


**Overseas Private Investment Corporation (OPIC)**

Congress founded OPIC in 1971 as the U.S. DFI, in order to “mobilize and facilitate the participation of United Pacific Private Investment Initiative
States private capital and skills in the economic and social development of less developed countries. Under its original mandate, OPIC provided risk insurance to promote FDI. In the late 1980s, OPIC added support to private equity investment funds to its mission. OPIC provides loan guarantees to fund managers—typically for 30–65% of the fund’s total value. OPIC also provides loan financing directly to SMEs (revenues less than $250mm), and structured financing for large-scale capital projects to businesses with revenues greater than $250mm.

To date, OPIC has committed $3.6b to more than 50 private equity funds, which have then invested more than $4.6b in 470 businesses in 53 developing countries. In 2010, OPIC provided $2.4b in total financing and invested $12.2b in 518 projects in 33 developing countries.

From 1969 to 2003, OPIC supported $145b of private investment, generating more than $11b in revenues for local governments and 680,000 jobs in developing countries. OPIC’s presence has encouraged their entry into emerging markets, and has made it easier to then raise follow-on funds to sustain and grow private investment.

OPIC, by statute, cannot take equity positions, and instead focuses on the provision of debt and insurance. OPIC is authorized, however, to pilot a program for making equity investments.

Task Force for Business and Stability Operations (TFBSO) The Department of Defense (DOD) established TFBSO in 2006 to channel counterinsurgency funds directly to Iraqi businesses. TFBSO leveraged $484mm of public funding into $500mm in private commercial real estate development proposals and more than $8b in private investment commitments to state-owned enterprises. It also channeled $6b of DOD contracts to more than 4,400 local businesses.

TFBSO focuses on building institutions, providing technical assistance, and facilitating relationships between foreign investors and local businesses, to foster a more vibrant business environment and stronger global linkages. It works to form partnerships among Iraqi and multinational firms, such as GE, Boeing, Microsoft, and Google.

TFBSO places particular emphasis on operating with a business mindset. It hires employees out of the private sector (with an eye toward both country-specific and professional expertise), it encourages expanded in-country stays (rather than limited, 12- to 18-month tours), and it stresses the importance of establishing trust and strong local connections, such as by wearing civilian clothes, using civilian vehicles, and living and working “outside the wire.”

In January 2010, TFBSO expanded operations to Afghanistan, where it focuses on mining sector development, encouraging private investment in energy and IT, industrial development in traditional activities (e.g., carpet-weaving, dried fruit production, and cashmere production), and increasing women’s economic participation through skills training, literacy courses, the establishment of a center for women’s economic development, and other initiatives.

International Finance Corporation (IFC) The IFC, part of the World Bank Group, is the world’s largest development institution owned by 184 member countries and works in more than 100 developing countries. It accounts for roughly one-third of all financing provided by DFIs to the private sector in the developing world.

In 2011, the IFC invested $12.2b in 518 projects in 102 countries from its own account, and mobilized an additional $6.2b in co-financing. IFC also provided $206.7mm in technical assistance. About half of investments and two-thirds of advisory services went to poor countries (i.e., aid recipients, as designated by the International Development Association).

The IFC has three core divisions: Investment Services, Advisory Services, and Asset Management. Through these, the IFC provides direct investment (loans, equity, trade finance, structured finance, and syndications); technical assistance to individual companies, industry groups, and governments to improve the business environment; and acts as a fund manager for other investors, including sovereign funds, pension funds, and other DFIs.

CDC Group The CDC was founded in 1948 and is wholly owned by the U.K.’s Department for International Development (DFID). It is the world’s oldest DFI. CDC’s core mission is to strengthen the private sector in and attract new investment to developing countries—75% of its investments are made in countries with annual per capita GNI of less than $905. In the last five years, 44% of its new investments have been in Africa, 28% in South Asia, 20% in Asia Pacific, and 8% in the Americas.

CDF made £420mm of new investment in 2010—over the last five years, annual new investments have ranged from £257mm to £286mm. As of 2011, its active portfolio totalled to £1.933b. This is managed by 74 fund managers, and is invested in more than 1,000 businesses.

CDF has been wholly self-sufficient for more than 15 years—it has not received taxpayer money since 1995, as profits from exited investments cover all operating costs. In 2010, the CDF earned an after-tax return of £269mm.

CDF provides an excellent model for the PFI: It is a sovereign DFI with an explicit development focus. It has operated primarily as a ‘fund of funds’—i.e., investing in preexisting private equity funds—but also makes direct investments through fund managers. CDF earns competitive market returns by working through the private sector, while maintaining clear government oversight under the direct auspices of DFID.

The Role of Private Equity The term ‘private equity’ (PE) covers investments of a wide array of sizes, and for a variety of purposes—but they share some common features. First, private equity involves private placements—distinguished from purchases of shares in publicly traded companies (e.g., through stock exchanges). Second, the typical private equity model, particularly in emerging markets, takes a standard structure: a general partner (fund manager), along with limited partners (additional investors), invest equity (perhaps paired with debt) into portfolio companies. The relationship among the general partner (GP) and its limited partners (LPs) is formalized in a fixed-term limited partnership, in which the GP has authority over investment decisions, while the LPs have limited liability for losses.

PE funds also have a standard incentive and profit-sharing structure, known as two-and-twenty (2&20). Fund managers are paid a set, annual management fee equivalent to 2% of the fund’s total assets. Beyond this, any profits are split 80/20 between the GP and LPs—i.e., managers are entitled to 20% of all profits (so-called ‘carried interest’). In the United States and other developed markets, we typically think of PE firms as turnaround agents—investors who buy out firms, restructure them (often with severe cost-cutting), and then sell them for a profit. But in emerging markets like Pakistan’s, the model often looks quite different. Private equity in this context usually entails minority stakes (rather than buyouts); focuses on smaller, younger companies (rather than larger, distressed ones); and its goal is to provide firms capital and strategic guidance to help them grow, rather than to restructure them into profitable businesses.
more quickly than other sectors—in terms of productivity, value addition, and employment. Private equity also either reduced or had no effect on sectors’ volatility. These results can be shown with lagged effects, indicating the direction of causality is from investment to growth (rather than PE funds having identified sectors already primed to grow).35

The report also finds that, when governments actively promote venture capital (VC), whether through direct investment, via professional funds, or through tax breaks or subsidies to incentivize venture capitalists, entrepreneurs benefit—businesses with more government VC support outperform others.36

In particular, funds with only partial or indirect government involvement (i.e., those working through private-sector partners) were more successful than fully owned government ventures.37

In emerging markets, deal sizes tend to be smaller than in developed countries—the entire investment spectrum is pushed downward. A survey of deals on the Capital IQ database from the Middle East, North Africa, and South Asia shows that the large density of private placements were under $10mn.

Capital IQ also provides a rough sense of fund valuations. EwenBenda is a proxy for an investment’s potential—high-growth (i.e., market value relative to earnings) make better targets, though these are not comparable across sectors. (Fast-growth sectors will have higher average multiples than slow-growth ones, though this does not imply the investment opportunities are necessarily better in the former.) Nevertheless, looking at the mid-range of available target multiples can give a sense of the broader investment environment fund managers see. It does underline, however, the lack of good data in these markets—and the need for more on-the-ground, qualitative due diligence when assessing investment opportunities, as well as for concerted efforts to improve the breadth and rigor of quantitative data collection.

Private equity in emerging markets also requires a longer investment horizon—typically, at least five years. The CIC, for instance, holds equity positions in a company for 10 years, on average. Some models—like Acumen Fund’s ‘patient capital’—anticipate even longer time horizons.38

PE portfolios also usually exhibit ‘J-curve’ returns—i.e., negative returns in early years, followed by growing returns as the fund begins to exit investments. In general, emerging-market portfolios will tend to see longer up-front dips, but with the prospect for steeper subsequent returns. For example, the Polish-American Enterprise Fund, which began operations in 1989, only saw a positive net return in 1997—but this was followed by consistently high returns until the fund phased out in 2008.

Recommendation 2
Invest U.S. Government resources using the private equity fund model and work with private sector partners. The private equity model is developed throughout the entire investment spectrum and private sector partners bring critical experience to the partnership—both are important for PIL success and for attracting new investment.

Targeting Investment
What is the best way to address Pakistan’s economic needs while capitalizing on its market opportunities? And what investments will best fuel the engines of growth—particularly job growth? To achieve optimal impact, the fund must be targeted, to best exploit this overlap between need and opportunity.

Disaggregating the Economy
To assess targeting strategies, we try to disaggregate Pakistan’s market. There are two basic ways to distinguish businesses: by sectors (i.e., industry), or by segments (i.e., firm size). Below, we offer detailed analysis along both dimensions.

Ultimately, we recommend focusing the fund on certain segments (namely, small- and medium-sized businesses—defined and discussed further, below), while being sector-agnostic. There are four main reasons for this approach:

1) The characteristics of the SME segments of the market align most closely with the objectives of the fund—these are both the most finance-constrained businesses, and the ones most likely to be sources of job growth.

2) While there are many valid reasons to focus on any one sector or set of sectors, these often conflict and suggest different areas of focus—instead of betting on one, it is better to take a more open approach.

3) On the other hand, not constraining by segment could encourage investments in larger businesses (as has been the trend in the limited private equity activity in Pakistan to date). While large firms may present more attractive options to highly risk-averse investors, they are less in need of financing, and such investments could feed the entrenched interests and rent-seeking behaviors underlying Pakistan’s economic problems, rather than fostering new growth.

4) It is dangerous to over- prescribe the fund’s strategy—targeting by both segments and sectors (e.g., SMEs only in the energy, ICT, and textile sectors) is likely to constrain fund managers and possibly doom the fund’s prospects.

It is important to note that there is a dearth of good firm- or sector-level data on emerging markets—especially for Pakistan. This makes effective market analysis difficult. The lack of information adds another reason not to over-constrain the strategy ex ante—market opportunities may be overlooked or overhyped, because the information is imperfect. This also points to the substantial need for collecting better information—which, itself, should be a prime objective of the fund.

Market Sectors
Performance and revenue growth in emerging markets tend to vary widely from sector to sector, even within countries. A survey of the performance of IFC-invested funds from 1978 to 2009, for instance, shows that returns fluctuated across sectors, and that sector selection can make a significant difference for fund performance.39 That said, there are myriad and often contradictory reasons for choosing one sector or another ex ante. Lack of good market data and competing objectives can make selecting sectors of focus difficult.

Pakistan’s Structural Transformation
The structure of Pakistan’s economy has evolved significantly over the past four decades. In broad strokes, agricultural sectors, which accounted for 39.9% of GDP in 1970, have declined steadily in their share of the economy, falling to 20.9% by 2011. In this period, Pakistan shifted toward a more service-based economy with service sectors now accounting for 52% of GDP. Industrial sectors’ share of the economy remained stagnant (~16%) for nearly three decades, but increased somewhat in the last 10 years to 18.7%.40

Increasingly, services have been the drivers of growth in the Pakistan economy—they hold an outsized share of GDP growth, relative to their share of overall GDP, and they have been, on average, by far the largest contributors to real GDP growth in the last decade.

In 2011, services accounted for 89.6% of real GDP growth; agriculture and industry contributed only 10.8% and -0.8%, respectively. Manufacturing (as a subset of industry) contributed 23.0%, but this gain was offset by declines in other industrial sectors—especially electricity and gas distribution.41

High-performing Sectors
Over the last half-century, export growth has been driven by the textile, garment, leather-product, and agricultural sectors. These are Pakistan’s traditional areas of dominance—and for which products it is known globally. But these have not been the sectors seeing the highest growth, or that have been driving the recent growth in the services sector. The AllWorld Network has published lists the last two years of Pakistan’s fastest-growing companies (the Pakistan 25 in 2011 and the Pakistan 100 in 2012). These lists give an indication for where Pakistan’s economy is accelerating most rapidly today.

AllWorld ranks firms according to their revenue growth over three-year periods (2007–2009 for the Pakistan 25, and 2008–2010 for the Pakistan 100). These high-performing companies grew at an average 200% overall (281% in the Pakistan 25 and 178% in the Pakistan
Prospects for Growth

Particularly relevant for investors, though, is trying to pick the next high-growth asset broad-based sectors. The Atlantic of Economic Complexity offers one useful tool for trying to project future growth. The products a country makes today determine which industries it will be most likely to make tomorrow—technology and physical and human capital expand first and most easily to products of like kind. So, the products in which a country is competitive today—that is, where it is competitive in the export market—can be a meaningful way to look at sectors where it is most likely to become competitive in the future, by mapping existing products based on their related similarities. Products closest to similar export products are good bets; clusters of export-competitive products indicate entire industries that have good prospects.

Risk-adjusted Performance

Returns only paint half the picture—the canvases investors look at is also colored by risk. It is the risk-return tradeoff that is most salient from an investment perspective. Taking volatility into account, then, we see notable changes in the growth performance of certain sectors. Small-scale manufacturing and social and community service industries, on the other hand, have sustained relatively stable, positive growth rates over the last 10 years. Other sectors that recorded strong average annual growth from 2002 to 2011—including finance and insurance, large-scale manufacturing, and construction—showed significant volatility over the same period and, consequently, a less favorable risk-adjusted performance. These findings suggest that small-scale manufacturing and some services have been relatively insulated from the challenges faced by the rest of the economy.

Government Constraints

Most of the top-100 firms listed on the Karachi Stock Exchange are in sectors characterized by substantial government protection or involvement—such as textiles, fertilizers, sugar, and oil and gas. No firm in the index is from an entrepreneurial sector like IT or retail. There is also a significant mismatch between sector contributions to economic growth and public tradability—i.e., firms in the highest-performing sectors tend not to be publicly traded. Protected sectors, despite their size, lack the rents that their firms receive, have not performed exceptionally well. For instance, only three of the top-200 textile companies have made it to the KSE Index. This mismatch, combined with Pakistan’s low market capitalization to GDP, indicates substantial untapped investment opportunity in Pakistan’s private sector.

Sector Targeting

There is a number of viable, persuasive sector-targeting strategies. Each is attractive for different reasons—and, given very particular objectives, some might prove advisable. But from a wider perspective, seeking only to maximize financial return and in order to predict it any one sectoral strategy is preferable.

Targeted sectors might include agribusiness and foods, logistics and transportation, retail and consumer products, and technology and communications.

Invest in Sectors with Punt-up Domestic Demand

Inadequate investment in a number of key, domestically focused sectors has resulted in severe service delivery shortfalls and capacity constraints. These structural supply problems, combined with a rapidly growing population, have resulted in punt-up demand opportunities for substantial private investment. This presents an opportunity to transform traditional sectors of high importance through innovative business models and increased private sector involvement. Investors would also be targeting sectors facing historic underinvestment and strong domestic consumption growth.

Targeted sectors might include social infrastructure (e.g., education, healthcare) and energy (e.g., alternative energy).

Consolidate Fragmented Markets

Many industries in Pakistan lack competitiveness because, at home, they see high competition and structural impediment, while their competitors overseas benefit from access to new technologies. Pakistan loses out in economies of scale in sectors where consolidation is an advantage, but legal and other impediments prevent it. Particularly opportunities exist in sectors like cement and steel—where Pakistan’s lack of export competitiveness makes it vulnerable. Pakistan’s export base has failed to diversify, remaining concentrated in the textile manufacturing industry. The remaining of Pakistan’s services export potential has been minimal but it has the potential to grow. This presents an opportunity to facilitate the identification of new export activities and diversify into high value-added products, as well as increase the productivity of existing export industries through knowledge and regional relationships. Look for export-oriented sectors with tradable products and regions that have the potential to compete in regional markets.

Tap the Talent of Key Demographic Groups

Karachi’s demographic composition offers opportunities that draw on parts of the population that suffer disproportionately from unemployment, including youth and women. The IT sector, for example, has low barriers to entry (the cost of a computer and Internet connection), is less constrained by traditional gender roles and favors people who may otherwise struggle with transport or mobility (women can operate an IT business from home), and it favors a younger generation more adept at using new technology.
Invest where there are multiplier effects

Look for sectors with strong backward and forward linkages, and high potential to have multiplicative impact in Pakistan's broad economy. Data collection at the IT, for example, can add human capital or develop new technologies that will have reverberating effects throughout the economy.

Invest where there is U.S. added value

A U.S. fund, in particular, can leverage American complementary resources than another fund could not. The United States is especially strong in the IT and higher-education sectors, for example—it has the most innovative technology companies and the best universities in the world. Creating strong linkages between such institutions and promising Pakistani businesses or entrepreneurs could be invaluable—as valuable as financial institutions and promising Pakistani businesses or entrepreneurs could be. SMEs by Sector

Small-scale manufacturing and social, community, and personal services—all of which have a dominant or significant SME presence—have sustained high growth and high-impact opportunities across the economy. There is a clear need to focus on SMEs (explored further, below), to best address financing needs, capitalize on market opportunities, and contribute to private sector development, rather than reinforce entrenched interests and rent-seeking behaviors. There is little reason to constrain the fund beyond this—the opportunity is simply too large for microfinance but too small to be effectively served by commercial banks. There is, of course, a financing gap across firms of all sizes in Pakistan—but it is especially deep for this middle segment of the economy.

In its 2010 Enterprise Survey, the World Bank asked business owners from where they received their financing. A large majority of SME financing came from internal sources—but the proportion from banks drops off sharply between large and medium-sized firms. About 20.5% of all financing for large firms came from banks, whereas only about 8.0% and 8.1% of medium and small firms’ financing, did, respectively. Likewise, in response to a question about the severity of constraints they faced, large portions of both small and medium enterprises listed access to finance as an obstacle to some degree—36% of medium-sized firms, and 56% of small firms.

Recommendation 3

Recommend sector-agnostic absent any more specific objectives, but seek diversification across sectors with high potential for growth and multiplicative impact in Pakistan’s economy. Prioritize further information collection, collation, and dissemination to address the deficit of good market data in Pakistan and attract new private investment. SME Focus, Sector Agnosticism

Research has shown that over-prescribing a fund’s sector focus produces lower returns in emerging markets.51 Research has shown that over-prescribing a fund’s sector focus produces lower returns in emerging markets.51 Fund managers do not have the amount of information they need to make informed decisions.52

Overall, 70% of AllWorld’s top-ranked companies would be classified as SMEs.

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SME Presence Correlates with Growth

SMEs contribute approximately 40% to Pakistan’s overall GDP and are spread across the economy with varying density. According to Pakistan’s 2005 Economic Census, SMEs operate disproportionately in the larger services sector—particularly wholesale and retail trade; restaurants and hotels; social, community, and personal services; followed by manufacturing firms, which had revenues less than $1mm, 38% with revenues of $1–5mm, and 13% with revenues of $5–10mm.

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Defining SMEs

While a continual refrain in our research has been this need to target SMEs, the notion of what, exactly, constitutes an SME is nebulous—by some definitions, as much as 99.5% of Pakistan's businesses count as SMEs. To better define 'SME' in the Pakistani context, and to decompose the term—in particular, to distinguish between 'S' and 'M'—we survey working definitions in Pakistan and then create functional classifications for 'small' and 'medium-sized' businesses (distinct from 'micro' and 'large' firms), in the context relevant to the PIT.

The Government of Pakistan has no official definition for what constitutes an SME. In fact, definitions vary widely among government organizations and other institutions operating in Pakistan, and, as a result, statistics and information on SMEs are incongruent. Almost all organizations, however, classify SMEs using one or more of three metrics: 1) headcount (i.e., number of employees), 2) maximum asset value, and 3) maximum revenue.

### Official Definitions of SMEs in Pakistan

<table>
<thead>
<tr>
<th>Organization</th>
<th>Headcount</th>
<th>Assets (Pkr)</th>
<th>Revenue (Pkr)</th>
</tr>
</thead>
<tbody>
<tr>
<td>State Bank</td>
<td>≤ 500mm</td>
<td>≤ 250mm</td>
<td>≤ 83.9k</td>
</tr>
<tr>
<td>SMEDA</td>
<td>≤ 25mm</td>
<td>≤ 250mm</td>
<td>≤ 5.03mm</td>
</tr>
<tr>
<td>SME Bank</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Fed. Bureau</td>
<td>≤ 25mm</td>
<td>≤ 250mm</td>
<td>N/A</td>
</tr>
<tr>
<td>of Statistics</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
</tbody>
</table>

Each measure returns different results, and each has benefits and drawbacks in practice and for use in policy making.

**Headcount**

Headcount is often the easiest metric to measure but can prove problematic, as it does not account for varying labor requirements across sectors. For example, a small IT services firm with 30 employees may have an annual turnover equal to or greater than a textile mill with 100 employees. One thus fails to account for differences between more labor-intensive and more capital-intensive sectors. There are further problems when accounting for workers who are not formally employed (e.g., in firms relying heavily on subcontractors or outsourcing, or who use informal hiring practices, which are common in Pakistan).

**Assets**

Using total assets is problematic for many of the same reasons that using headcount is. Whereas headcount ignores differing labor requirements across sectors, asset value cannot account for different capital requirements. Moreover, the values of assets held in buildings or land, for instance, which can differ considerably even within a sector, may distort determinations of firm size.

**Revenue**

Annual turnover or revenue better approximates business size—it is easily quantifiable, assesses a firm’s contribution to the economy, and captures growth (in absolute and market share terms) over time. Revenue is also a metric commonly used by investment professionals to assess a firm’s value or performance. (Of- ten, in valuing an SME, potential investors use it as part of a multiple, such as EBITDA—enterprise value over earnings before interest, tax, depreciation, and amortization.)

This metric can prove difficult in a global context, as firms’ revenues may vary widely from one country to the next, even within one industry—but within a single-country context, like Pakistan’s, it is less problematic. By any metric, it is clear that Pakistan’s economy is weighted heavily toward smaller enterprises. Less than 1% of firms has revenues greater than $100k or more than 20 employees.

### Delineating the Bounds of ‘SME’

While SMEs are often distinguished from larger, many group microenterprises with small- medium-sized businesses. But, in practice—especially in Pakistan—firms in the middle of this spectrum face a unique set of opportunities and challenges, distinct from those seen by firms at both the large and small extremes of the market.

**Microenterprises**

Most SME definitions have no lower bound. Microenterprises, however—typically consisting of five or fewer employees—are vastly different from small firms in terms of sector participation, management sophistication, formalization, and revenue size.

Microenterprises tend to be informal—i.e., unregistered and tax-evasive. They less frequently provide employee benefits, such as paid sick leave or skills training. (e.g., in firms relying heavily on subcontractors or outsourcing, or who use informal hiring practices, which are common in Pakistan).

**Large Enterprises**

Large enterprises, on the other hand, are more large, on the other, is the tendency of large firms to benefit from close government connections, rent-seeking behavior, or outright corruption. From an investment perspective, there may be attractive opportun- ities on the larger end of the spectrum, and often at less risk—but a primary reason one can earn relatively high returns at relatively low risk with such investments.
is precisely because of this government cooptation. Investing in large firms of this sort may reap short-term returns, but diverges from any development objectives. Not only are these time-consuming finance-constrained, but supporting them potentially enables and encourages the government’s intrusion into the market that crowds out widespread participation and stymies business growth in the first place.

Distinguishing ‘Small’ from ‘Medium’

While small and medium firms are more different than similar when compared to their micro and large counterparts, there are also some important distinctions between these two groups. Although most organizations in Pakistan refer to ‘small’ and ‘medium’ separately, this distinction is rarely clear, and seldom manifests in policies targeting SMEs.

SMEDA and the State Bank’s SME support programs suggest that any distinction between small and medium is questionable as a used as a disposi- tion criterion for eligibility. In fact, almost all programs in Pakistan, effectively lump small- and medium-sized enterprises together as a monolithic business class.

Yet, while small- and medium-sized businesses can be functionally similar, almost always eligible for the same benefits, and academic studies seldom distinguish between the two, they do have different financing needs—both in terms of specific needs and purpose. Smaller businesses tend to be younger and less experienced—they often seek startup capital and know-how for breaking into markets. Medium-sized businesses, on the other hand, tend to be more established and mature. They often seek larger investments for achieving scale.

Revenue is an imperfect metric for segregating businesses of these two types. Except through case-by-case evaluation, however, it is difficult to draw any clear line—but revenue boundaries between ‘micrO, small’, ‘medium’, and ‘large’ will inevitably be arbitrary. Yet absent more thorough market information, this is the best heuristic available.52

A Functional Definition of SEs & MEs

We thus workable a revenue-based classification for SMEs in Pakistan:

Small enterprise: A business earning between $50k–$1mm in annual pre-tax revenue.

Medium-sized enterprise: A business earning between $1mm–$10mm in annual pre-tax revenue.

These classifications account for the composition of Pakistan’s businesses by revenue using 2005 census data, as well as qualitative feedback received during our field research.

More importantly, we believe these classifications strike an optimal balance between specificity and sensitivity. That is, a lower bound of $50k excludes the vast majority of informal microenterprises without rejeCting high-po- tential businesses with low revenue streams: a middle division of $1mm separates the bulk of young firms in need of seed, startup, or venture capital, from some-what larger firms in need of growth equity; and an upper bound of $10mm includes the high end of the range of ‘medium-sized’ businesses, but effectively excludes large corporations.

Recommendation 4

Disaggregate the ‘SME’ space and focus on small and medium firms, separately. Define these as firms in the $50k–$1mm and $1mm–$10mm revenue ranges, re- spectively. Focus on SMEs with the stron- gest growth prospects—to target investment companies led by promoted entrepreneurs that have vision, but lack the financial and institutional support to scale.

Fig. 23 SME Market Segments, Disaggregated

More importantly, we believe these classifications strike an optimal balance between specificity and sensitivity. That is, a lower bound of $50k excludes the vast majority of informal microenterprises without rejecting high-potential businesses with low revenue streams: a middle division of $1mm separates the bulk of young firms in need of seed, startup, or venture capital, from somewhat larger firms in need of growth equity; and an upper bound of $10mm includes the high end of the range of ‘medium-sized’ businesses, but effectively excludes large corporations.

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Recommendation 4

Disaggregate the ‘SME’ space and focus on small and medium firms, separately. Define these as firms in the $50k–$1mm and $1mm–$10mm revenue ranges, respectively. Focus on SMEs with the strongest growth prospects—to target investment companies led by promoted entrepreneurs that have vision, but lack the financial and institutional support to scale.
Model & Strategy

Taxonomies of private equity tend to focus on the stage of investment—early, middle, or late. Early-stage investments include angel investing, seed funding, and other support for startups, and then traditional venture capital at a slightly later stage. Middle-stage investments can include growth and expansion capital, and bridge financing for companies headed toward public offerings (IPOs). Late-stage investments include acquisitions and leveraged buyouts, sometimes of distressed companies or those otherwise in 'turnaround' situations.1

One can likewise classify investments by their size (i.e., ticket size)—and thus the scale of the target company—to SME financing, to funding for large enterprises or capital projects.

Comparing across both dimensions, then, we can specify an investment strategy that encompasses both target size and funding stage.

Our analysis, above, finds that sector-specific investment strategies would be ill-advised at this stage: there is too little good information about the market, and too many compelling reasons to focus on one sector or another. Instead, though, we find that there is both particular need and substantial opportunity to focus the fund on SMEs—i.e., small and medium-sized firms, distinguishing from both microenterprises and larger, more established corporations.

It then follows that the stage of investments will be venture capital—for smaller, younger companies—and growth equity—for the more established, scaling firms.

It is important, though, that these two strategies be pursued in parallel, but separately—e.g., through the creation of distinct funds under the PII. The nature of investment, the needs of businesses, and the expertise required of fund managers is unique and quite different between the venture and growth stages. Clearly separating these components of the larger strategy, therefore, will help ensure each prong is pursued productively.

Based on discussions with investors active in the Pakistani market, in revenue terms, the target size for the venture capital fund should be roughly $50k to $1mm, while the target size for the growth capital fund should be roughly $1mm to $10mm. Likewise, we expect ticket sizes of investments to range from $50k–$400k for the venture fund and $2mm–$7mm for the growth fund.

Recommendation 5

Structure the PII to include venture capital and growth equity components. Plan for ticket sizes of $50k–$400k and $2mm–$7mm, respectively. Employ the limited partnership structure common in private equity and adopted by the CDC and other major DFIs, in line with international industry standards.

Fig. 24 Proposed PII Investment Approach

<table>
<thead>
<tr>
<th>STRATEGY</th>
<th>Angel Investment</th>
<th>Venture Capital</th>
<th>Growth Equity</th>
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<td>TARGET SIZE</td>
<td>Microfinance</td>
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<td></td>
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</tbody>
</table>

Design & Implementation

As we note, above, the private equity market commonly operates through limited partnerships. OPIC-supported funds, for instance, are established by investment professionals and are typically structured as limited partnerships or limited liability companies.2 Fund managers raise equity capital from outside investors and make, manage, and exit investments in portfolio companies with attractive return prospects. LPs commit equity capital and may provide counsel to the Board of Directors, but are not directly involved in the management or governance of the fund.

Management & Governance

The standard private equity limited partnership model includes essential features for making the PII a viable and productive investor:

- A skilled and credentialed professional management team that uses local knowledge and technical
expertise to make and manage investments.

- A market-competitive incentive structure for fund managers, negotiated upfront to the standard 2%20 fee and carried interest system, to ensure a top-quality staff, with adequate 'skin in the game,' who are driven to optimize performance.

- An ability to leverage State’s resources through complementary investment from other donors, multilaterals, sovereign funds, private investors, and the fund managers themselves.

- An independent Board of Directors overseeing the fund manager and ensuring proper governance and accountability.

For the Advisory Board, State should seek out a diverse group of Pakistani private sector leaders with strong networks and expertise, but also a commitment to supporting aspiring entrepreneurs and fostering longer-term policy reform.

Advisory Board

Additionally, an overarching PII Advisory Board, established by State, could provide general oversight and guidance to fund managers and board members, would be an important component, given the nature of this pubic-private collaboration. Advisory committees are one of several standard channels for linking private equity funds, however, the PII Advisory Board would be most effective—and be perceived as most credible—if it comprised PII investors, including U.S. Government representatives, as well as external industry experts.

Through active participation on an Advisory Board, State can play a critical role in ensuring that taxpayer dollars are invested in a way that minimizes risk and maximizes economic returns, while safeguarding the independence of fund managers and the commercial viability of fund operation. Ideally, the Advisory Board would provide a mechanism through which State, co-investors, and investment experts work collaboratively and engage regularly with fund managers and board members to:

- Secure alignment of interests among investors, fund managers, and investors.
- Monitor PII investment processes to ensure investments are made and managed responsibly.
- Provide fund managers with knowledge and resources to support value creation at the portfolio company level.
- Collect and evaluate information on PII investments and performance.

The Advisory Board would best include a manageable number of representatives and be split equally between Americans and Pakistanis. Important considerations for membership include: 1) relevant investment or private sector experience; 2) extensive knowledge of the broader industry, in addition to specialized expertise on the Pakistani or emerging market investment context; 3) commitment to and competence in the application of risk investments in the Pakistani or emerging market context; 4) independence; 5) credibility among both American and Pakistani audiences.

While the identification of Pakistani candidates who are both highly qualified and removed from any conflict of interest may pose challenges, we believe that local participation on the Advisory Board is both essential and, based on our consultations in the country, feasible. State should seek out a diverse group of Pakistani private sector leaders with strong networks and expertise, but also a commitment to supporting aspiring entrepreneurs and fostering longer-term policy reform.

Potential Challenges

It is important to note that, historically, USAID support for PE funds—for instance, in the Equity Fund for East African Agriculture—has generally consisted of either direct commitments to the fund, or the provision of guarantees to investors. Similarly, OPIC provides long-term debt and risk insurance. There is no indication whether there has been action directly to ensure that PIIs and the PII are linked.

There are, however, alternative PE fund structures, accounting for differing investor needs (e.g., tax, regulatory, or other legal considerations), which may provide options even if the standard LP model proves difficult. These include master-feeder funds, parallel or co-investment funds,企业发展, and special-purpose vehicles (SPVs), among others.

For example, using State financing for direct equity investments appeared problematic, a fund manager or sponsor could create a SPV. USAID could then fund a SPV to provide a grant to the SPV, which could in turn invest in the fund, which would then take equity positions. Likewise, advisors to the fund’s decides on how capital is deployed. New funds could be created...
funds—who likewise seek returns but with a dual development objective, are potential co-investors. Examples include the Bill & Melinda Gates Foundation, the Rockefeller Foundation, and the Gatsby Charitable Foundation.* USAID’s East Africa agriculture fund, for example, worked with partners like these.

• Patriotic Capital—Pakistan has the seventh-largest Diaspora community in the world, with nearly five million people.* Pakistani expatriates want to give back—the World Bank ranks Pakistan #11 in terms of remittances; many Pakistanis overseas are highly skilled entrepreneurs and professionals who could provide essential support to the development of a knowledge-based economy in Pakistan. According to interviews, however, these expatriates have not invested directly in local companies, due to the perceived inability to monitor them. The PII can therefore provide expatriate Pakistanis a credible platform for investing in Pakistani enterprises. A number of private equity firms and other organizations have existing networks for mobilizing Diaspora resources, including Abraaj Capital’s Riyada Enterprise Development (RED) and OPEN Silicon Valley.

• Local Investment—Local investor participation is vital to long-term sustainability and success. Fund managers with strong local connections, as well as other partners in the program—e.g., advisory board members—can help mobilize financing from domestic sources.

Implementation Mechanisms

Number of Partners

In contrast to an enterprise fund, the PII does not need to be a monolithic institution with a single fund manager. There is scope for—and potential value in—supporting multiple investment platforms, with distinct implementing partners (i.e., GPs), under a broader PII umbrella. A key question, then, is whether it is preferable to establish a single investment vehicle—one large fund for investing in a wider range of SMEs—or to divide the pool of resources to invest in multiple, smaller, more targeted funds?

This choice presents three broad options. Each employs the general limited partnership model, and each allows the fund to be leveraged through outside investment—but they differ in the degree to which authority is dispersed and in how many partners are involved.

Option 1: One Partner, One Fund

Approach: USAID selects and then invests with one GP. The GP then establishes and manages the PII as a ‘fund of funds’ (FOF)—a strategy of pooling investor capital and investing in other equity funds, rather than directly in portfolio companies. The fund of funds establishes or invests in external funds, which in turn invest in portfolio companies.

Advantages

• Offers a streamlined management structure and the most direct investment route, facilitating State oversight of investments
• Is potentially the quickest to set up
• Provides the selected GP the largest potential return

Drawbacks

• Does not benefit from specialized management in either the venture or growth spaces
• Has no diversification across fund managers, so adds idiosyncratic risk
• Reduces the demonstration effect from multiple new investors entering the Pakistani market

Fig. 25: Option 1 – One Partner, One Fund

both venture and growth stages.

This option closely resembles the basic private equity structure, described above.

Option 2: One Partner, ‘Fund of Funds’

Approach: USAID selects and then invests with one GP. The GP then establishes and manages the PII as a ‘fund of funds’ (FOF)—a strategy of pooling investor capital and investing in other equity funds, rather than directly in portfolio companies. The fund of funds establishes or invests in external funds, which in turn invest in portfolio companies.

A fund of funds (e.g., the U.K.’s CDC) operates like a master private equity fund that spawns and manages a portfolio of sub-funds, each with its own fund manager. FOF managers may invest in sub-funds established by the same investment firm or in external funds, but generally they aim to diversify a portfolio across a variety of investment managers, investment strategies, and markets.

A fund of funds provides: (i) the experience of the CDC in selecting firms; (ii) the ability to test and verify different fund manager ideas; (iii) the ability to attract additional investors bringing additional capital; and (iv) the ability to provide additional resources to weaker funds.

Advantages

• Takes a flexible and decentralized approach
• Reduces risk through diversification
• Allows specialized sub-fund managers to target different market segments
• Potentially creates more leverage possibilities
• Lowers the barrier to entry for GP funds in terms of equity

Disadvantages

• Requires the participation of investment managers in,g and fund managers in an emerging market context. Suggested indicators for gauging the potential success of a management team include: whether the GP is locally based; the number of local staff and fund manager skill set; capacity to add value to investee companies (e.g., prior experience in running companies, as entrepreneurs or consultants); and prior experience in private equity. IFC funds that have met these criteria are overwhelmingly associated with better performance—both in terms of financial returns and overall development impact.8

Option 3: Multiple Partners, Multiple Funds

Approach: USAID selects multiple GPs to manage several smaller, specialized funds—has the greatest potential for engagement and impact, without introducing a Byzantine organizational structure.

Potential Partners

Research on emerging market private equity reveals a clear link between competent fund management and fund performance. The experience of the IFC, for instance, demonstrates that the key factor contributing to the success or failure of its funds has been the quality of the GP—not the risk that comes with a first-time fund or frontier country focus.9

State should select the most qualified investment teams to manage PII capital, while avoiding excessively high selection requirements that crowd out viable or interested candidates. Clearly, an experienced fund management firm with a proven track record of positive investment returns and successful exits would be the best candidate for a GP. The nascent nature of Pakistan’s private equity industry, however, could pose challenges to identifying candidates with long track records of success. Moreover, inherent in the PII mandate are the dual goals of generating financial return and achieving development impact and visibility. Beyond firms with track records, therefore, it is worth considering emerging fund managers and nontraditional players with missions that align with this broader PII mandate—bringing higher risk, but potentially greater rewards.

The IFC provides insight on specific criteria that may prove useful for selecting fund managers in an emerging market context. Suggested indicators for gauging the potential success of a management team include: whether the GP is locally based; the number of local staff and fund manager skill set; capacity to add value to investee companies (e.g., prior experience in running companies, as entrepreneurs or consultants); and prior experience in private equity. IFC funds that have met these criteria are overwhelmingly associated with better performance—both in terms of financial returns and overall development impact.8

Strong local knowledge and presence is especially im-
The Pakistani market, in particular, is characterized by very limited local private equity experience, and the capacity to work with seasoned local private sector and donor resources to leverage the U.S. engagement, here would be less of an opportunity for the State to work with seasoned international private sector actors to advance mutual business and development objectives, while leveraging resources from partners at a level that equals or exceeds the U.S. investment (at least a 1:1 ratio, in cash or in-kind). The model requires joint planning and management, and would thus give State a platform to share responsibility, very specifically among multilateral partners. A GDA also offers the best mechanism for raising additional private sector and donor resources to leverage the U.S. investment in the PI. Structuring one or more PI funds through a GDA consortium, in particular, would offer the potential to provide a high level of U.S. engagement with strategic partners and open the door to a wide range of co-investment and technical expertise.

The feasibility of a GDA, however, depends on partners having available funding to contribute and the ability of State to align its interests and objectives. Using a GDA to structure PI funds may require a very lengthy process of identifying and negotiating with partners, and attracting sufficient resources for leverage. Moreover, the GDA places a strong emphasis on involving local partners in the alliance as implementing or resource partners. While State should explore partnerships with Pakistani investment firms or local financial institutions, raising sufficient co-investment may pose challenges.

Option 2: Partner via competitive bidding process
State selects one or multiple firms to create and manage a PI fund through a competitive bidding process, and invests U.S. capital through a USAID contract or grant. This option may be the most straightforward means to establish a PI investment fund, although the time required to implement the process and the degree of U.S. involvement differs across grants and contracts (e.g., procurements can be lengthy but allow for high design input).

Under this scenario, State would be able to open up the bidding process to a wide range of competition, providing an opportunity to choose one or several partners from a potentially broad audience of Pakistani and international applicants. Additional or donor private investors could invest directly into the funds to leverage the U.S. investment, securing this co-investment may be challenging. USAID has contracted directly with private equity firms in the past, but further inquiry into the legal requirements may be required to know if the execution of a limited partnership model is feasible.†

Option 3: Support public international organization
State funds a public international organization (PIO) with experience investing in emerging market private equity funds and a local presence in Pakistan, such as the IFC, and grants U.S. Government resources to manage one or more investment funds with the potential to provide a high level of U.S. engagement with strategic partners and open the door to a wide range of co-investment and technical expertise.

This approach may have certain advantages—partnering with one or more private equity funds, or in Pakistan SMEs.

On the other hand, a PIO grant offers a more passive and potentially less pioneering and impactful approach to stimulating investment in Pakistan. While the built-in expertise, multi-donor coordination, and more subtle American branding associated with a PIO grant are valuable, some of the essential benefits that come with partnering directly with the private sector. There would be less of an opportunity for the U.S. to innovate and highlight American engagement, and the benefits would distribute proce-ceeds from fund liquidation would no longer be viable. Moreover, most of the key benefits of granting funding to a PIO can also be achieved by directly supporting the second two options—particularly a GDA that leverages the expertise and capital of institutions such as the IFC in a strategic public-private alliance. A PIO grant would thus be the best pursued, in the case of an emerging market, in some combination of Options 1 and 2 prove unfeasible.

Strategic Guidance
Private equity investing entails more than mere capital transfer—often, knowledge transfer is as important a component. SMEs in Pakistan need capital to grow, but

† The GDA model allows USAID to disburse funding through a variety of mechanisms and processes, but the feasibility of a Collaboration Agreement (CA) should be considered as an alternative to more standard obligating tools:

- State’s existing mandate to carry out private sector investments/2012_GDA_APS.pdf

- Option C: Partner via competitive bidding process: non-traditional partners may include private businesses, financial institutions, local enterprises, venture capitalists and investors, philanthropists, foundations, Diaspora organizations, and other for- and non-profit entities. Resource providers are organizations that contribute resources—cash and/or in-kind—to a GDA. "In-kind" services may include legal, financial, marketing, administrative, etc. See also co-investor agreements (see 52 CFR Part 203, et al.).

- For more on the GDA model and what counts as leverage, see http://asia.usembassy.gov/grants/

- Other public international organizations (PIOs) that could leverage the IFC’s existing mandate to carry out private sector investments.
some—particularly those toward the smaller end of the spectrum—arguably need mentorship and know-how even more than financing. Manager teams that provide hands-on strategic and operational support will be most likely to accelerate expansion, maximize competitiveness, and foster innovation.

Fund managers, however, are not the only source of guidance; State can design this capacity directly into the PII. A thoughtfully selected advisory board, in particular, could provide the kind of mentorship to investee firms, fund managers, and USAID staff managing the larger program.

**Complements & Alternatives**

There are compelling reasons, given its objectives, for State to focus on generating investment through the establishment of some type of fund or funds. But it is also important to consider both alternatives to this approach, as well as complementary elements that could enhance its impact. The initiatives, below, do not constitute an exhaustive list of either parallel or substitute policy options—but we identify these as some of the most promising and feasible, and those with the greatest potential for impact.

**Entrepreneurial Ecosystem Support**

The call for directly supporting entrepreneurship in Pakistan is resounding. During our fieldwork, promoting entrepreneurship was one of the most cited and most impassioned recommendations we heard for strengthening U.S. private sector assistance to Pakistan. Proponents of this type of support also made some of the most compelling arguments for its inclusion.

State has already made an effort to support Pakistan’s young entrepreneurs. In March 2012, for instance, the U.S. Embassy and the Islamabad Chamber of Commerce and Industry organized the inaugural Pakistan Young Entrepreneurs Forum. At the launch, Secretary Clinton and Ambassador-Humberto Macchio underscored the Pakistani entrepreneurial spirit and pledged support for Pakistan’s entrepreneurs. The PII can build on such programs—scaling them to maximize the impact of the initiative’s corresponding investments.

There is substantial value to be gained by complementing growth capital with startup capital and entrepreneurial ecosystem support, since each stage of the business cycle is dependent on another. Entrepreneurs need encouragement, technical assistance, and funding to start companies, and young and small companies need growth capital and technical assistance to scale—but entrepreneurs also need to know that growth capital is available, if their companies reach that stage, while venture and growth funds rely on entrepreneurs having successfully navigating the startup phase. These initiatives are thus symbiotic and their prospects of success improve if State pursues them in tandem. By using the PII to address the ‘full stream’ of the business cycle—startup to growth capital and support—State will better address deficiencies in the Pakistani market and achieve greater impact.

The overwhelming demand for entrepreneurship training and services that we observed during our fieldwork in Pakistan is reinforced by a national development strategy—the Framework for Economic Growth—that calls explicitly for entrepreneurship support and inter-university alliances to foster research and the commercialization of technology. In a February 2012 study, Robert Looney of the Naval Postgraduate School affirmed the importance of the entrepreneurial strategy outlined in the Framework. The study, through extensive qualitative analysis of countries’ growth patterns, finds that those that followed an entrepreneur-led growth strategy sustained their growth and that, in the short term, support for entrepreneurship efforts could be expanded even without national governance reform.11

Perhaps the best argument for supporting entrepreneurs, however, lies in the expected return on investment. The probability that any major commercial success will emerge from a U.S.-backed incubator is of course small—but this small chance that the PII could help develop a Pakistani Instagram, LinkedIn, or even Facebook is well worth the relatively minor investment in resources. The returns—not just financially, but in both development impact and public goodwill—would be immense.

**Defining the Entrepreneurial Ecosystem**

An entrepreneurial ecosystem, in its broadest sense, is an enabling environment for startups, at the local, regional, and national levels. This ecosystem can be divided into six domains—conducive culture, enabling policies and legal environment, availability of appropriate finance, high quality human capital, venture-friendly markets for products, and a range of institutional and infrastructure support services. In complex ways, alone, each dimension is conducive to entrepreneurship, but insufficient to sustain it.12

In Pakistan there exists a small but promising network of organizations and initiatives in place to support entrepreneurship. But there is a need to further develop and extend these efforts. When we refer to the ‘entrepreneurial ecosystems’ and Pakistan’s network of entrepreneurial organizations, we are referring to organizations and programs that promote the growth of professional entrepreneurs, both for software development and business development. Previous U.S.-sponsored interventions, such as USAID’s Pakistan Entrepreneurs program, have aimed to lift low-income, vulnerable populations out of poverty by fostering micro-entrepreneur development.13 While such programs are vital to Pakistan’s long-term stability, we focus our entrepreneurial assessment and leadership on activities that possess the most potential to strengthen Pakistan’s private sector and attract investment. Micro-enterprise development is an appropriate intervention for poverty reduction, but not for attracting professional investment in Pakistan’s existing entrepreneurial infrastructures. In the short-run there are other initiatives, which are less resource-intensive, that may be more feasible but of equal impact. Among the many entrepreneurs we met, there was a common call to establish business incubators in Pakistan’s universities. Investment and fostering entrepreneurial companies that may grow to be large firms.

11 In 2009, USAID also began Pakistan Entrepreneurs, an economic development initiative to establish micro-entrepreneurs of more than 75,000 predominantly female micro-entrepreneurs.

12 When we refer to the ‘entrepreneurial ecosystems’ and Pakistan’s network of entrepreneurial organizations, we are referring to organizations and programs that promote the growth of professional entrepreneurs, both for software development and business development. Such programs are vital to Pakistan’s long-term stability, we focus our entrepreneurial assessment and leadership on activities that possess the most potential to strengthen Pakistan’s private sector and attract investment. Micro-enterprise development is an appropriate intervention for poverty reduction, but not for attracting professional investment and fostering entrepreneurial companies that may grow to be large firms.

13 Business incubators are programs designed to support the successful development of entrepreneurial companies through an array of business support resources and services. More specifically, business incubators can enable technology transfer and innovation, assist disadvantaged communities or individuals with projects, promote
cubators can be housed within existing university building space; universities can use them as platforms to integrate entrepreneurs across the country. Given greater resources availability, building new, well-equipped physical spaces within universities, designated for use as incubators, would be especially helpful.

The university business incubator model is an inviting approach because it can be tailored to the resources, academic strengths, and location of any university in Pakistan. While some universities may resource their incubators with high technology and a full staff—such as NUST—other universities would likely benefit from a simple physical space from which to work and the part-time assistance of a professor.

It is also important that the PII takes a broad view in terms of university programming, and seeks relationships beyond just the most elite institutions (like LUMS and IBA), and beyond the biggest cities (Karachi and Lahore). A program would target a range of geographically diverse universities in both large and second-tier cities.

3) Mentorship – There is a shortage of good mentors for Pakistan’s entrepreneurs. Almost every entrepreneur we met cited the importance of mentorship. Strengthening existing entrepreneurial networks, leveraging U.S.-private-sector expertise, and connecting entrepreneurs with business leaders in Pakistan is an inviting approach to facilitate mentorship and business linkages.

4) Linkages – Current entrepreneurial initiatives in Pakistan are disjointed and exclusive. Improving linkages should be a component of any entrepreneurial support program in Pakistan. State should emphasize establishing linkages among universities, domestically and internationally, and connecting entrepreneurs with mentors and business opportunities in the United States. The incubator model would also serve as a conduit to channel startup capital and to facilitate mentorship and business linkages.

5) Regulatory reform – Entrepreneurship in Pakistan is impeded by government policy, legislation, and regulation. While State may lack the influence to directly engender policy change in Pakistan, it is in a position to affect the institutional constituencies, such as the U.S.-Pakistan Business Council, in the United States, and the American Business Council, in Pakistan, to advocate for a more pro-growth regulatory environment.

Going Forward

The guidelines, below, constitute a set of concrete steps the PII could take to help strengthen Pakistan’s entrepreneurial ecosystem. This list is informed by our field research, but it is not comprehensive, so we suggest further research to flesh out and refine these prescriptions:

- Evaluate existing entrepreneurial programs and networks in Pakistan – There is a budding network of entrepreneurial groups, university business incubators, mentorship programs, business plan competitions, and business support organizations in Pakistan. As a first step, we recommend evaluating the focus, efficiency, management, and resources of these entities to identify potential partners for a university-based business incubator program. The list we provide, at the end of Appendix B, although not exhaustive, highlights the prominent actors and initiatives in Pakistan’s entrepreneurial sector. It can be used as a starting point for this assessment.
- Develop clear objectives and a framework for the incubator program – There are many incubator types and structures. Generally, universities develop incubators to commercialize the science, technology, and intellectual property resulting from university research. There are, however, substantial differences in the research strengths of Pakistan’s universities. For this reason, the focus and structure of each incubator will likely differ to some degree. Nevertheless, it is vital to establish a clear set of objectives for each incubator, as well as for the larger network of incubators. Clear governing a framework will guide critical decision points that arise during the planning process.
- Select, improve, and integrate – University and affiliate partner selection should align closely with the initial local job creation, and help universities and R&D centers commercialize research and knowledge.

* Presently, there are a few incubators housed in Pakistan—the National University of Science and Technology (NUST) launched the Technology Incubator Center (TIC) in 2004 and the SAIF Center for Innovation. A technology incubator was established in 2008—but the quality and productive output of these programs are unknown at the time of this report. Our recommendation focuses on expanding and improving Pakistan’s incubator network by strengthening existing incubators and establishing new incubators in Pakistan’s universities.

† While regulatory reform is important, it is not an objective directly tied to the activities of a business incubator. There is, however, an opportunity to integrate mentorship programs, university business incubators, and the broader business ecosystem.

‡ Private investors generally start incubators as a way to make profit by identifying, training, and investing in multiple companies and government programs may start incubators to jump-start the economy, develop priority sectors, or create jobs. While the motivations for starting an incubator may differ among participating groups, the core objectives—business creation, technology transfer/innovation, job creation, and commercialization of university knowledge—are generally shared.

§ The Framework for Economic Growth Identifies several primary ‘pseudo-clusters’—the IT cluster in Karachi, automotive manufacturing in Sindh, and airport and automobile manufacturing in Sialkot—but stresses the need to develop stronger clusters more proactively. See: http://www.lovekarachi.org/files/IT_clusters.pdf.

§ Highlights of the development cluster strategies listed above include:

1) Cluster: The expectation that incubators will expedite evaluation results and the objectives and framework of the program. The priorities selected for the program should demonstrate a long-term commitment to strengthening—or starting and strengthening—their business incubators, as well as the will and capacity to allocate physical space, professional support, and financing, if possible. The program’s overarching objective should be to improve and integrate the incubators.

As a guide, successful business incubators typically include:

- Clear, well-communicated goals.

- An incubator manager responsible for tenant selection, day-to-day operations, the setup and coordination of business development services and outreach, and for meeting the overall objectives of the incubator.

- Business services, such as management training, business plan development, access to financiers, and industry-specific technical assistance.

- Shared resources like developer software and computers, access to subscription market research, or programming assistance, plus secretarial support, high-speed Internet access, credit reports, etc.

- Physical space for working and collaborating.

- Financing through corporate partnerships, grants, permanent university funding, and, eventually, a self-sustaining capital model.

- A tenant application process and evaluation criteria to ensure the incubator support the people and business ideas that fit its mission.

Monitor, support, and develop – Establishing and strengthening a university-based incubator program is complex and far more than implementing policy alone. The program will require long-term vision and an implementation plan. Deliberate steps—from the start—to judiciously select partners, engage key stakeholders throughout the design phase, and to build on promising entrepreneurial programs already in place will best ensure success. The expectation that incubators will expand is built on further goals that will depend on other factors, such as the focus and location of each incubator.

PRIVATE INVESTMENT INITIATIVE

HARVARD KENNEDY SCHOOL POLICY ANALYSIS EXERCISE

Fig. 29 Business Incubator Model

- **Entrepreneur**
- **Business Incubator**
- **Management**
- **Employment**
- **Growth**

**Level of Technology and Support:**

- **Innovative**
- **High Technology**
- **Low Technology**

**Focus Area:**

- **Hi-Tech**
- **Agro**
- **Manufacturing**
- **Services**
- **General**

**Fig. 30 Incubator Program Decision Points**

- **Location:** Urban, Rural, Non-Cluster
- **Level of Technology:** Hi-Tech, Low-Tech
- **Focus Area:** Agro, Manufacturing, Services, General

**Polity & Security Analysis**

- **Urban**
- **Rural**
- **Non-Cluster**
develop and launch successful businesses is short-sighted. Rather, the short-term value of an incubator program is its enabling and "catalytic" effects. In other words, the initial value of an incubator is the conditions and resources that it provides to make entrepreneurial pursuits possible. While there is noticeable interest and support for the incubator program, predicting how people will respond to the program is difficult. To mitigate risk, the program should start small, be monitored closely, and adjust and scale as circumstances dictate.

The exchange of ideas, new relationships, and the pursuit of new entrepreneurial ventures will likely facilitate companies in Pakistan. This approach for financing SMEs.

**Partial Credit Guarantees (PCGs)**

Partial credit guarantees, often referred to as credit guarantee schemes (CGSs), are programs that ensure partial repayment of a delinquent loan to motivate lenders to lend to borrowers, which normally do not have access to credit from the formal sector. Within the last four years, the State Bank of Pakistan (SBP) has launched two CGSs: the Microfinance Credit Guarantee scheme in 2008, and the Credit Guarantee Scheme for Small and Medium Enterprises in 2010. Each program was funded with a $100m grant from the U.K.'s DFID and provides a 40% loan guarantee for partnering commercial banks. Although the programs are ongoing, they have already increased commercial lending to Pakistan's SMEs, and could offer State an alternative approach for financing SMEs.

If circumstances dictate, State should explore the possibility of implementing a partial credit guarantee program as an alternative to the PII. USAID’s Development Credit Authority is specialized in structuring and implementing partial credit guarantee programs and would be an ideal partner for establishing an SME loan program in Pakistan.

**Feed-in Tariff (FIT) for Renewable Energy**

A feed-in tariff is a premium rate paid for electricity that is fed back into the electricity grid from a designated renewable electricity generation source. A FIT is a mechanism designed to accelerate investments in renewable energy technologies. These programs incentivize renewable energy investment by offering long-term contracts to private renewable energy producers based on their cost of production. FIT values offer among renewable energy subsectors to account for the varying costs of production.

Many FIT programs include tariff reduction schedules, and, sometimes, staged application rounds. Each mechanism is intended to incentivize efficiency improvements:

- Under tariff reduction schedules, tariffs decline on predetermined dates over the lifespan of the contract in order to incentivize companies to cut costs and improve efficiency.
- A staged application mechanism increases tariffs over several rounds, but issues the funds on a first-come-first-served basis, thus incentivizing companies to opt in earlier at lower rates.

Energy shortages and rising fuel costs, coupled with the crippling effects of government monopolization, present tremendous challenges for Pakistan's energy sector. Several FIT program proposals have been under consideration.

For example, solar power is relatively cheap to produce compared to tidal power. Therefore, FITs for solar power are typically less than tidal power FITs.
成功地推广了可再生能源产业，包括风能和太阳能。为此，巴基斯坦政府在2009年推出了一个名为“Pakistan Energy Efficiency and Renewable Energy Program”（PEER）的计划。该计划旨在减少能源消耗，提高能源效率，并促进可再生能源的利用。PEER计划的主要目标是通过提供财务激励和政策支持，鼓励私人投资于可再生能源项目，以减少对化石燃料的依赖。该计划的目标包括推广清洁能源的使用，促进环境可持续发展，并为国家提供能源安全。

PEER计划由巴基斯坦的国家能源局（NEPRA）和国家能源和自然资源部（NERD）共同管理。该计划通过提供财务奖励和优惠政策，鼓励私人投资者投资于风能和太阳能项目。这些奖励包括税收减免、贷款担保和资金援助。PEER计划还提供技术援助，帮助私人投资者评估项目可行性，并提供培训和支持，以确保项目成功实施。

虽然PEER计划为可再生能源产业的发展提供了有利的环境，但也面临着一些挑战。例如，由于缺乏基础设施和投资环境的不确定性，许多私人投资者仍然感到犹豫。此外，由于缺乏有效的监管和政策支持，可再生能源产业的发展也面临着一些难题。因此，PEER计划需要进一步加强与政府和私营部门的合作，以克服这些挑战，并确保可再生能源产业的可持续发展。

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This program faces two principal types of risk: financial and political—though, of course, these are interrelated. It is important to acknowledge these risks—to the extent they can be mitigated, they should be. But some risk—systematic risk—is unavoidable, and this sets limitations on the PII.

Financial Risks

The most pressing risk for the PII—like with any investment vehicle—is that it will not earn a return. Historically, Pakistan has been both economically and politically volatile—both characteristics that investors have been wary—and a crisis of either kind could spawn a crisis of the other. There are also severe market distortions (e.g., monopolies, corruption, bureaucratic inefficiency), which could stymie the prospects of even promising investments. Furthermore, investment is inherently probabilistic; even the best bets on paper can pull up lame when the race is run.

It is intrinsically important that PII funds earn a return—but it is even more important that they do so because of the implications for the larger economies of the market. A key goal of the PII is to be a ‘first mover’ in order to catalyze further investment. The success of this strategy depends on the success of PII funds themselves—if the program does not work well as an investment vehicle, no other positive externalities will follow.

Fig. 34 Densities of Annual Returns on Equity Indices 1961–2011

But just because there might be a high probability of success, with a small portfolio of investments this far from guarantees actual success. This may seem an obvious point—but it is important to consider.

One way to think about this risk is with Bayesian analysis. Each new investment in the Pakistani market provides outside observers—investors in war-time and peace-time—a chance to update their ‘priors’ (i.e., their previous assessments of the probability of investing successfully in the Pakistani market). While we cannot know potential investors’ priors on Pakistan, we can make an educated guess.

To use an extremely simplified model, consider returns from the KSE 100 and S&P 500 over the last 50 years. In about 75% of years, the KSE earned positive returns, whereas in about 65% of years the S&P saw gains. Indeed, KSE stocks on average typically earn higher returns than do American stocks—but they are also much more volatile, and thus riskier.

Fig. 35 Annual Volatility vs. Returns for KSE100 & S&P500 1961–2011

To account for higher risk, investors seem to seek returns roughly twice what they would see in the United States. Anecdotally, foreign investors seek minimum IRRs of 30–35%. This is 20–25% above returns earned on average in the S&P 500. So, to proxy this high hurdle rate, assume they estimate a one-third probability that investments in Pakistan actually do have a 75% success rate, and a two-thirds probability they are more like U.S. returns (i.e., 65%)—thus, 2.1 odds against. In other words, they assume there is only about a one-in-three chance that Pakistani businesses really earn high enough returns to justify their increased risk, and a two-in-three chance their returns are more modest and thus not worth this risk. (In actuality, there is also downside risk to equity investments—i.e., that investors will lose money. But to simplify, we assume they are merely judging the probabilities of success versus failure.)

We use Bayesian updating to model the continually updated probability of an investor, over 50 investments, given actual success rates of 65%, 75%, and 85%, using a random variable. If iterated infinitely, the investor’s updated probability would converge to the true probability. With a much more limited number of investments, like PII funds are likely to see, however, there can be substantial variability. We use three trials (think: funds), with 50 iterations each (think: investments).

Even when the probability of success is in fact 75%, given a limited set of investments and the randomness of the market, investors may be no more confident after 50 trials than they were before. Their experience is also highly sensitive to changes in the actual success probability—if this moves to 85%, for instance, an investor’s assessment of whether the real probability is at least 75% becomes much more likely to be confident.

This analysis is simplified and incorrect. But it does illuminate a core problem for the PII and the Pakistani market as a whole: There is little good evidence on investment performance in Pakistan because there has been so little activity to date. Moreover, the fund is limited in what it can accomplish—it can only make so many investments, for so much value. This will in the end contribute to the increasingly informative pool of evidence on the Pakistani market. That said, even if the prospects of success are quite good, the fund may not do much to reveal this, through no fault of the capabilities of its managers or the strategy of the initiative.

There are two important conclusions to the draw from this: First, it is worth acknowledging that this fund may well not see huge financial success, due merely to chance. But second, the more the fund is able to diversify its portfolio, and to maximize the number of positions it takes (without reducing the quality of those investments), the more successful the fund will be, and the less randomness will play a pivotal role.

Political Risks

Pakistan, of course, also presents a difficult political climate. As with any U.S. program in Pakistan, even the slightest mishap is in danger of ballooning into a crisis. Recent events—the Raymond Davis incident, the Bin Laden raid, the border post confrontation—have strained the political relationship between Pakistan and the United States. The news media and the broader Pakistani public are primed to assume the worst about any U.S. intervention. While there is substantial appetite for a U.S. initiative that invests directly in Pakistan’s private sector, and significant enthusiasm for trying something new and innovative when it comes to economic development, this approach also poses certain political risks:

Financial returns are easier to measure than development impacts. If the fund does not perform well, this will be much more visible than poor performance in a traditional development project. It will thus be more subject to criticism in the case of failure, or even performance below expectations.

• Making investments in specific businesses risks the appearance of favoritism. If investment decisions are not transparent or well-justified, critics could in- dict State for picking winners and losers in the Paki- stani market.

• Though no discussion during our research sug- gested this was a major concern, it is important to note that, by working directly with Pakistan’s private sector, State is explicitly not working with the gov- ernment. As such, there is risk that this initiative could be seen as diverting assistance away from the Pakistani government, and thus be perceived as a slight against the traditional recipients of Amer- ican aid.

More than this, though, the PII’s success also depends on investors’ forming close relationships with invest- ors. Trust in Pakistan’s business world is already very weak, so a proxy for this trust is high. If invest- ment could do much to reveal this, through no fault of the PII, then, may in fact affect directly its prospects for success.

Mitigating Risks & Maximizing Impact

The uncertainties inherent even with high probabilities of success, as well as the challenges of the current po- litical context, reinforce the importance of taking every step to maximize the PII’s likelihood of success. Uti- limately, the PII’s performance as a business, develop- ment, or diplomatic venture hinges, above all, on its functioning well as an investment vehicle.

Research shows that there is a positive relationship be- tween fund performance and development impact in emerging market private equity—State will best cata- lyze follow-on effects and foster improved engagement with actors in the Pakistani economy by adopting a well- managed, commercially viable investment approach that supports business growth and delivers strong re- turns.*

This starts with hiring the best fund managers available—by looking widely and especially locally for top-quality private sector partners, and by paying them targeted market rates. Additionally, it includes giving manag- ers the broad flexibility to exercise their judgment and
expertise and not placing undue constraints on their decision-making authorities, while providing clear objectives and effective oversight to ensure alignment of interests. It allows fund managers to present themselves as an adaptable program that values learning, innovation, and transparency, and strives for multiplicative impact. Finally, it includes exhibiting patience from the outset to let investments mature.

Among the specific tools that State can leverage to minimize financial and political risks facing the PII, and maximize the program’s prospects for impact are the following:

Incentive Compensation
Incentive compensation is essential to attract and retain talented fund managers and motivate performance. Many impact investment funds have endowed impact- based incentive structures that link at least a portion of GP compensation to social and environmental performance—rather than to the maximization of profits, as is common practice in traditional private equity funds.1 This type of structure could be an effective tool to align fund managers with U.S. Government interests and foster development impact. The approach could also, however, introduce complexity and constraints on fund managers, and prove unfeasible in the absence of sufficient interest among GPs and demand from other investors.

It is important to ensure that PII investments are made and managed in a way that maximizes financial returns and minimizes financial, political, and social costs.1—but it is not clear from existing research that penalizing or rewarding fund managers based on the non-financial performance, economic performance, environmental and social performance, and broader private sector development impacts.2,3

State can also explore the feasibility of fund managers incorporating economic cost-benefit analysis into the investment decision-making process, alongside ESG factors and other more traditional financial appraisal techniques. The Millennium Challenge Corporation (MCC), for instance, uses economic rate of return (ERR) estimates and a multi-year analysis during the pre-investment stage to forecast the sustainability and likely economic impact of proposed projects.4 While the MCC

The Emerging Markets Private Equity Association (EMPAF), UNPRI, and others have outlined best practices for allocating to EI funds, there is a growing recognition that penalizing or rewarding fund managers based on the non-financial factors and more traditional financial appraisal techniques. The evaluation methodologies used by the PII Advisory Board should be to monitoring and managing the broader goals of job creation and economic performance, and broader private sector development.

The evaluation methodologies used by the Small Enterprise Assistance Fund (SEAF), DFIs such as the IFC and the International Finance Corporation (IFC) and CDC Group (EMPEA)’s “Library of Development Indicators for Private Equity Funds” are useful resources for identifying and measuring the broader performance of fund investments.5 The MCC uses the ERR—which ties the overall development impact of an investment by combining the financial rate of return with net social returns—to ensure a multiplier effect as each dollar invested in an older company generates a larger return in a young company.

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In order to best serve the financial needs of Pakistan’s private sector, as well as capitalize on opportunities for investment and improved American engagement, we provide a set of eight core recommendations to structure the PII. These recommendations take into account and accommodate the already proposed partnership with SEAF, as one component of the larger investment initiative.

**Recommendation 1**
Establish a vehicle to address Pakistan’s immediate financing needs, but acknowledge its limitations—ultimately, governance failures constrain private investment and entrepreneurship. Design the PII to invest in relatively unconstrained market areas and to act as a catalyst for reforms to improve the business environment.

**Recommendation 2**
Invest U.S. Government resources using the private equity fund model. Work with private sector partners. The private equity model is proven in emerging economies, and private sector partners bring critical experience to the PII success and attracting new investment.

**Recommendation 3**
Remain sector-agnostic absent any more specific objectives, but seek diversification across sectors with high potential for growth and multiplicative impact in Pakistan’s economy. Prioritize further information collection, collation, and dissemination to address the deficit of good market data in Pakistan and attract new private investment.

**Recommendation 4**
Disaggregate the ‘SME’ space and focus on small- and medium-sized firms, separately. Define these as firms in the $50k–$1mm and $1mm–$10mm revenue ranges, respectively. Focus on SMEs with the strongest exit prospects—target investments in companies led by promising entrepreneurs who have vision but lack the financial and institutional support to scale.

**Recommendation 5**
Structure the PII to include venture capital and growth equity components. Plan for ticket sizes of $50k–$400k and $2mm–$7mm, respectively. Employ the limited partnership structure common in private equity and adopted by the CDC and other major DFIs, in line with international industry standards.

**Recommendation 6**
Work through multiple implementing partners, as a means to create several smaller PII funds with more targeted investment strategies. Select and invest with professional fund management firms with relevant experience, local knowledge, capacity to add commercial value to portfolio companies, and ‘skin in the game.’ Consider emerging or first-time fund managers that align with the broader PII mandate, in addition to experienced teams with a proven track record.

**Recommendation 7**
Structure PII fund partnerships using one or more feasible implementing mechanisms that allow for maximum flexibility, commercial sustainability, and leverage of U.S. Government resources—prioritize the GDA model but use more traditional contracts and grants as required. Seek substantial Pakistani private sector involvement in sourcing and leveraging investments.

**Recommendation 8**
Incorporate an explicit component to develop Pakistan’s entrepreneurial ecosystem. Allocate between $10mm and $20mm for startup capital and other incubator initiatives. Work through local entrepreneurship networks and universities. Implement from the level of the PII as an overarching component or through a partner as a smaller sub-fund.
Key Considerations

We also offer a set of complementary considerations and more specific action steps. We highlight these points to guide the design and implementation of the PII, with the objective of mitigating risk and maximizing impact. In order of priority, we recommend that State:

- Develop a plan to address the full stream of investment—from startup to growth capital.
- Specify key PII features and terms in alignment with private equity standards.
- Structure an investment policy and oversight mechanism.
- Create a framework for measuring impact.
- Define U.S. added value.
- Formulate transparency and branding guidelines.
- Determine how to leverage the PII to support long-term policy reform.

Address the ‘full stream’

Structure the PII to implement all three proposed components—entrepreneurial ecosystem support, venture capital, and growth capital—simultaneously, as part of an overarching and flexible strategy to promote entrepreneurship and business growth. Ensure the three elements are interlinked, rather than compartmentalized in vertical silos, to best address deficiencies in the Pakistani entrepreneurship and business growth.

- Develop a strategy to roll out and integrate the three components, including definition of the number of fund components and appropriate implementing mechanisms. Two possible PII structures—of several options—are shown, at right.
- Consider leveraging the partnership with SEAF for entrepreneurship support and startup investments, given the organization’s track record investing in early-stage businesses and managing business accelerator programs through its Center for Entrepreneurship and Executive Development (CEED). Partner with two or more additional private investment firms to establish the growth equity and venture capital components.

Define key PII features and terms

Determine specific fund features and partnership terms, in accordance with private equity best practices and principles, at the start. Establish a clear vision for PII funds and build market-oriented principles into fund design to attract and retain top talent, and align interests and expectations among all PII stakeholders. Among the key issues that require definition:

- Criteria for success—Define what constitutes a success—e.g., breaking even or some combination of returns and development impact. Additionally, decide on trigger points that warrant a suspension or termination of the U.S. resource commitment.

- Performance incentives—Determine a feasible compensation model, management fee structure, and general partner commitment level—adopt the standard 2%20 carried interest model and require fund managers to make significant equity contributions to PII funds to best align GP-LP interests.

- Policy for handling investment proceeds—Determine, for instance, whether financial returns will be reinvested in Pakistan’s economy or go back to the U.S. Government.

Create a framework for evaluating results

Incorporate rigorous performance monitoring and evaluation into the fund’s design.

- Define a set of core performance indicators to identify and measure the financial and development effects of the fund.
- Consider using measures of “economic rate of return,” as used by the IFC, Millennium Challenge Corporation, and Acumen Fund, to gain a broader perspective on the impact of investments.

Define and measure U.S. added value

Leverage America’s greatest resources—its business and academic communities—to multiply the PII’s impact. In addition to serving as a source of capital, acting as a catalyst for third-party investment, and supporting fund performance through an Advisory Board, State should use the PII as a platform from which to engage a broader audience and assist more directly the development of a vibrant entrepreneurial culture.

- Define an explicit role for the PII in deploying American knowledge, networks, and market access connections in support of Pakistani entrepreneurs—for example, by creating linkages between U.S. and Pakistani businesses, assisting local firms in registering and filing patents, establishing university-to-university connections, and using programs such as Fulbright to foster stronger connections with mentors and investors in the Pakistani Diaspora.

- Consider including metrics of direct value added by the United States in the PII M&E framework to evaluate the amount of entrepreneurial activity, innovation, and new private investment triggered as a result of this assistance.

Structure an oversight mechanism

Develop an oversight mechanism to ensure fund managers operate in alignment with U.S. requirements and ESG standards, as well as to collect information and provide guidance. Use partnership agreements to clearly define the U.S. role—including questions regarding the authorities of State to veto transactions, suspend funding, and change fund terms in the face of violations or poor results. Otherwise, safeguard the discretion
of GPs to make and manage investments, and rely on market-based incentive structures to effectively align stakeholder interests and motivate fund performance.

- Devise an overarching PI Investment Policy to provide parameters for responsible fund investments and define exclusions, drawing from the UNPRI and DFI best practices.

- Form a PI Advisory Board with split Pakistani-American membership—and explicitly define member rights and responsibilities in PII partnership agreements. Include experienced private equity and venture capital investors from the United States, as well as dynamic Pakistani business leaders with extensive knowledge and connections, but also an eagerness to mentor younger entrepreneurs.

**Formulate transparency and branding guidelines**

Ensure that information on PII funds is as visible as possible, to demonstrate the broader value of private equity to Pakistan’s economy and attract new commercial investment. Require fund managers to disclose detailed information—financial, operational, portfolio, risk management, etc.—regarding fund investments, while observing commercial confidentiality requirements.

- Prioritize transparency but avoid the temptation to oversell America’s contribution and the value of the PII prematurely—the initiative inherently entails a long-term investment horizon and recent experience highlights the dangers of raising false expectations among the Pakistani public. Develop a subtle branding strategy and allow funds the time to work and demonstrate returns before publicizing.

**Leverage the PI to support policy reform**

The Planning Commission’s Framework for Economic Growth is a forward-thinking document—but it faces an uphill battle. Use the PI as a platform to engage with public- and private-sector actors in the ongoing dialogue about how to improve Pakistan’s business environment and relax the underlying constraints on growth.

- Incorporate in the PIIs design a function to collect and disseminate information on Pakistan’s investment opportunities and problematic aspects of the business environment that stifle entrepreneurship or limit existing firms’ productivity.

- Leverage this information and the PIIs network of partners to inform the Pakistani government about obstacles and propose policy solutions to incentivize new investment and business activity.
Conclusion | Common Ground

Throughout the course of this study, our core objective has been to offer informed, objective analysis. As best we could, we have aimed to provide evidence-based recommendations that will both engender positive change in Pakistan’s private sector and ensure the responsible stewardship of U.S. dollars. We understand that results matter, and we believe that our analytical approach and recommendations reflect that understanding, but to discount the human element of our research would be shortsighted.

The negative press that is emblematic of a strained U.S.-Pakistan relationship belies our experiences in Pakistan. We do not refute that this bilateral relationship is fragile, but for this particular initiative, support from both sides is overwhelmingly positive. We believe that establishing the Pakistan Private Investment Initiative presents a unique opportunity both to promote meaningful economic development and to strengthen incrementally the U.S.-Pakistan relationship—in particular, by forming new bonds with Pakistan’s dynamic private sector leaders and entrepreneurs.
Appendix A: Abridged Growth Diagnostic

Low Demand for vs. Low Supply of Financing

The cost of finance refers to the binding constraint on growth in Pakistan. In short, loanable funds are available and lending is relatively affordable, but demand for finance is subdued. Investment is instead held up due to uncertainty about any given firm’s ability to reliably capture the future profits of investments made today.

A country’s savings is a good indicator of access to finance—lower savings indicates a greater need for other sources of financing. Pakistan’s gross national savings rate was 23.1% of GDP in 2010 and has consistently been below those of regional peers in South Asia. Pakistan’s savings rate ranks 107th of 142 globally.

Real lending interest rates, however, have also remained low—even dropping below zero in the last 10 years. First, since 2000, Pakistan has had by far the lowest average real interest rate in South Asia.1

Pakistan’s low real interest rate would suggest that there is high bank liquidity and that lenders charge borrowers, offering incentives. But compared to other countries in South Asia, Pakistan has the lowest investment rate as a share of GDP.2 Domestic credit to the private sector in Pakistan has been low and declining in recent years.

Despite the availability and affordability of capital, there is very limited demand for funds, suggesting that there must be other factors constraining investment. For instance, investment has been relatively unresponsive to changes in the interest rate. In the latter part of 2000 when real interest rates dropped below zero, investment declined.

Likewise, there is a weak relationship between savings and investment. From 2000 to 2004, as savings increased, the investment rate remained relatively stable. Since 2008, as the savings rate increased further, the investment rate experienced a decline. So the investment rate appears to be insensitive to movements in the savings rate.

As well, while FDI has been declining in recent years,3 Pakistan’s lessonsing levels of external debt and improv-2

ing current account indicate little price to mobilize foreign savings. In Pakistan’s case, it is more compar-3

e 4ed to neighbors in South Asia and has been climbing since 2006—but the current debt is still a remarkable improvement from the 1990s and early 2000s.4 While the current account deficit improved from 2003 to 2008, the balance has been improving over the last two years and registered a deficit of only 0.85% in 2010.5

Moreover, if Pakistan’s economy were constrained by low aggregate savings, then an increase in foreign savings would result in increased investment and growth. But in Pakistan, rising remittances and re-4

mitance remittances have not translated into productive in-5

vestments or sustained growth. Increases in foreign aid and remittances in 2008 and 2009 corresponded with a decline in the investment rate.6 Despite these record-high remittances and increasing total reserves, Pakistan is actually experiencing astonishing capital flight.

Access to finance is consistently mentioned as a top concern for doing business in Pakistan.7-8 Pakistan is one of the world’s least banked nations. As noted above, the financial sector has been pricing risk up to a high spread between lending and deposit rates, indicating a profitable Pakistani banking industry. Commercial banks are highly liquid and capable of increasing fi-9

nancial intermediation. The perception is that banks are reluctant to enter the SME, agricultural credit, and housing finance markets in the face of perceived high risks and costs. The high spread of spreads makes up the dominant share of banks’ portfolios. The risk-averse banking system has no incentive to diversify its portfolios and innovate, while it continues to gain ‘monopoly rents’ from high spreads elsewhere.

So, while evidence supports the argument that financial intermediation is weak in Pakistan, there is no indication this is the binding constraint. Inefficiencies in the financial sector point to deeper governance-related prob-10

lems that hamper competition and innovation.

Low Social Returns vs. Low Appropriability

Returns to physical and human capital are low in Pakistan, but these also do not seem to be constraining in-11

vestment. Pakistan suffers from longstanding shortfalls in its physical and educational infrastructure, the World Economic Forum’s most recent “Doing Business in Pakistan” report’s ease of doing business index ranks Pakistan 138th out of 144 countries on primary, secondary, and tertiary school enrollment, respectively (WEF/GCIC). These are: 1) government instability; 2) corruption; 3) policy instability; and 4) inefficient government bureaucracy (WEF/GCIC).

Pakistan has one of the world’s worst rankings for quality of electricity supply (World Bank, Doing Business Report (WEF/GCIC)). Pakistan ranked 151st in 110 out of 144 countries on primary, secondary, and tertiary school enrollment, respectively (WEF/GCIC). These are: 1) government instability; 2) corruption; 3) policy instability; and 4) inefficient government bureaucracy (WEF/GCIC).

Governess Indicators (WBGIV) show Pakistan performing poorly across all six governance dimensions. In

the WEF/GCIC, Pakistan has one of the worst rank-12

ings worldwide for its macroeconomic environment (138/142). Uncertainty due to Pakistan’s macroeconomic risks has likely stopped investor concerns about the possibility of policy shifts that could lead to unpredictable movements in private returns. Pakistan’s poor credit rating may also have weakened investment as a result of expected losses associated with a debt crisis. Similarly, the government’s negative budget balance can increase fears of future inflation and the taxation to service the debt, further discouraging investment.

Pakistan, however, has enjoyed sustained real exchange rate stability since 2008.13 Moreover, past improvements in the macroeconomic environment have not resulted subsequently in increased investment. The fiscal deficit has been improving since 2008, but the investment rate has been declining. While the deficit and inflation are undoubtedly serious problems, there is no evidence to suggest that concerns over macroeco-14

nomic stability represent the main constraint on invest-15

ment and growth.

A number of sector- and firm-specific risks resulting from a weak institutional environment also weaken the appropriability of returns, however—and the government’s role in the economy poses a number of micro-16

economic risks that particularly discourage investment.

1 These are: 1) voice & accountability, 2) political stability & lack of violence/terrorism, 3) government effectiveness, 4) regulatory quality, 5) rule of law, and 6) control of corruption.

2 Pakistan has an estimated rating of 28.4 out of 100, and a ranking of 123/142 (WEF/GCIC).
On one side, excessive government engagement in and regulation of the economy impedes the development of efficient and competitive markets. The government actively intervenes in every sector of the economy and represents more than 50% of national income, presenting significant barriers to private sector entry and expansion. 1 While privatizations in the early-2000s decreased public ownership in sectors like telecommunications, banking, and finance, the government has since expanded its role in other industries, like agriculture, construction, and transportation. Pakistan’s long-standing policy approach of picking priority sectors to be protected and subsidized has resulted in severe economic distortions. In particular, government industrial licensing policies, price-fixing, and other restrictive regulations have led to the prevalence of monopolies.

The World Bank’s “Doing Business” report (WBDB) supports the view that Pakistan’s regulatory environment is not conducive to innovation, entrepreneurship, or investment. 2 Tax rates and tax regulations rank among the most problematic factors for doing business in Pakistan. The tax environment is one of the most burdensome on domestic firms—and sized firms spend twice the time preparing, filing, and paying taxes compared to their counterparts elsewhere in South Asia. 3 Tax policy also favors vested interests, and poor public administration weakens collection and enforcement. 4 As a result of exemptions and rampant evasion, Pakistan has one of the world’s lowest tax-to-GDP ratios. 5

Government policies foster monopolized markets that stifle competition and private investment through regulations that impose a high cost of doing business. By allowing for monopoly rents and regulating entry, the government encourages ubiquitous rent-seeking in the private sector—many firms vie for licenses, subsidies, tax exemptions, or tariff protection for short-term gains, rather than investing in long-term growth. Moreover, unsustainable public sector enterprises abstract 15% of GDP. Untargeted subsidies also place an enormous strain on the fiscal deficit. 6

Inefficient public sector management also adds to the cost of doing business by threatening the security of life, contract, transaction, and property—thereby weakening claims to private returns. 7 Beyond the increasing cost of business due to terrorism and violence, Pakistan’s weak institutional environment—particularly in the judicial system—places a host of informal taxes on investors. According to Transparency International’s Global Corruption Perception Index (GCI) 8 Pakistan has among the worst rankings worldwide in terms of property rights protection and contract enforcement. Pakistani entrepreneurs also confront high transaction costs in the form of corruption and lack of transparency in government policymaking. 9

Ultimately, if government failures that disincentivize investment are the most binding constraint on Pakistan’s private sector, then an investment fund—which increases the supply of finance—is not the ideal solution to this problem. That said, there is more than one constraint on the Pakistani economy—and, in the short term, Pakistan’s circular debt, interest rate spread, devalued currency, and imbalances as risky all serve to severely limit access to finance for businesses. Moreover, the United States must focus on the problems it can reasonably solve—and the financing gap is the one it is best placed to fill.

Also—importantly—there is stratification in the Pakistani economy. price-fixing, and other access to capital may not be the paramount problem, for certain segments of the economy—namely, small- and medium-sized businesses—it is often the biggest obstacle. And, importantly, it is these businesses precisely who will be the engines of job growth in Pakistan. Without capital, they will be unlikely to grow.

An investment fund can also have important, secondary effects. It demonstrates a long-term commitment to Pakistan, one not beholden to the whims of public opinion or to short-term election campaigns. By strengthening the private sector, it can foster a stronger bloc to lobby for those policy reforms so essential to improving the business environment in Pakistan.

It is important to understand the limitations of such an intervention, of course—by itself. It will not address the core problems that constrain Pakistan’s economy. Nevertheless, the Pill presents a pragmatic solution to a substantial problem, and could well have follow-on effects that help address the more entrenched deficiencies.

**SOURCES**

10 WBDB (2012).

Diagram

HARVARD KENNEDY SCHOOL POLICY ANALYSIS EXERCISE

APPENDIX B: POTENTIAL PARTNERS

<table>
<thead>
<tr>
<th>Company Name</th>
<th>Company Type</th>
<th>Investment Type</th>
<th>Industry</th>
<th>Country</th>
</tr>
</thead>
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<td>Private Equity</td>
<td>Investing</td>
<td>Technology</td>
<td>Pakistan</td>
</tr>
<tr>
<td>Aga Khan Fund for Economic Development</td>
<td>Venture Capital</td>
<td>Investing</td>
<td>Education</td>
<td>Pakistan</td>
</tr>
<tr>
<td>Acumen Fund</td>
<td>Venture Capital</td>
<td>Investing</td>
<td>Education</td>
<td>Pakistan</td>
</tr>
<tr>
<td>United Bank Limited</td>
<td>Private Equity</td>
<td>Investing</td>
<td>Health Care</td>
<td>Pakistan</td>
</tr>
<tr>
<td>Indus Basin Holding Ltd.</td>
<td>Private Equity</td>
<td>Investing</td>
<td>Agriculture</td>
<td>Pakistan</td>
</tr>
<tr>
<td>BPMC-BPML Ventures</td>
<td>Private Equity</td>
<td>Investing</td>
<td>Energy</td>
<td>Pakistan</td>
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<tr>
<td>Indus Capital</td>
<td>Venture Capital</td>
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<td>Agriculture</td>
<td>Pakistan</td>
</tr>
<tr>
<td>TMT Ventures Limited</td>
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<tr>
<td>Blackstone</td>
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<tr>
<td>Arm Capital</td>
<td>Venture Capital</td>
<td>Investing</td>
<td>Media</td>
<td>Pakistan</td>
</tr>
</tbody>
</table>

**Appendix B: Potential Partners**

**Pakistan Private Investment Initiative**

[1] Pakistan ranks 108/183, nine places lower than last year’s rank. 1 Business surveys identify corruption as a top concern for doing business in Pakistan. E.g., Transparency International’s Corruption Perception Index gives Pakistan a poor ranking of 134 out of 183 countries in terms of perceived levels of public sector corruption.
invest in Middle East, North Africa, India, China, Pakistan, and Hong Kong.

The firm typically invests in companies with sales value between $10 million and $30 million. It seeks to invest between $15 million and $30 million in Southeast Asia, and Eastern Europe for emerging markets. The firm seeks to invest in mature companies with restructuring opportunities, and leveraged buyouts. It does not make investments in for-profit companies in need of capital, and larger companies that are starting specific business lines. EMP Global seeks to invest through its fund. It primarily seeks to invest in energy, infrastructure; fixed and wireless telecommunications; cable television; power generation and transmission; oil and gas; other industrial sectors like petrochemicals, cement, and chartering, aviation, logistics, advertising and marketing, floriculture, tea, information technology and technology related companies. The firm typically invests in companies based in major cities in the MENA region (Beirut, Casablanca, Doha, Dubai, Karachi, KSA, Lagos, Jeddah, Karachi, Tehran, and Cairo) as well as in Cairo, Casablanca, Doha, Dubai, Karachi, KSA, Lagos, Jeddah, Karachi, Tehran, and Cairo.

The firm also invests in companies in the MENA region (Beirut, Casablanca, Doha, Dubai, Karachi, KSA, Lagos, Jeddah, Karachi, Tehran, and Cairo) as well as in Cairo, Casablanca, Doha, Dubai, Karachi, KSA, Lagos, Jeddah, Karachi, Tehran, and Cairo.

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**APPENDIX C: INTERVIEWS**

**PAKISTAN**

Feb. 19-26, 2012

Karachi

Adnan Afhid, Advisor to Shaukat Tarin, Silkbank Ltd.

Fawad Anwar, Owner, Al-Karam Textile Mills

Jehan Ara, President, pkSHA

Humayun Bashir, Country General Manager, IBM

Nasim Beg, CEO, Arif Habib Investments Ltd.

Abid Butt, CEO, e2e Supply Chain Management (Pvt) Ltd.

Shahjahan Chaudhary, CEO, Team Arts

Samad Dawood, CEO, Cyan Limited and Dawood Corporation

Nadeem Elahai, Managing Director and Country Head, The Resource Group

Shahid Ghaflar, CEO, HBL Asset Management Ltd.

Fahd Haroon, CNBC Pakistan

Zaid Haroon, Assistant Vice President, Marketing and Corporate Communications, JS Bank Ltd.

Syed Samir Hasani, Director, SME Finance, State Bank of Pakistan

Dr. Ishrat Hussain, Dean and Director, Institute of Business Administration

Shakir Hussain, CEO, Creative Chaos

Nadeem Hussain, President and CEO, Tameer Microfinance Bank

Ali Jameel, CEO, TPL Holdings

Iriza Kazmi, SVP and Corporate Head – South, National Bank of Pakistan

**KARACHI**

Dr. M. Mehdiz Kazmi, CEO, Asia Care Health & Life Insurance

Ghias Khan, CEO, Inbox Business Technologies (Pvt) Ltd.

Saad Amanullah Khan, President, American Business Council of Pakistan

Sabeen Mahmood, Director, PeaceNiche

William Martin, U.S. Consul General, Karachi

Asif Misbah, Managing Director, Master International (Pvt) Ltd.

Jay Murur, Political and Economic Chief, U.S. Consulate, Karachi

Mehsni Nathani, CEO, Standard Chartered Bank (Pakistan) Ltd.

Aun Rahman, Pakistan Country Director, Acumen Fund

Mir Ibrahim Rahman, CEO, GEO TV Network

Kalim ur Rahman, President and CEO, JS Bank Ltd.

Muslim Raza, Provincial Chief, SMEDA

Isfandiyar Shaheen, Head of Growth Equity Investments, Cyan Ltd.

Imran Shaikh, Vice President—Head of Marketing, JS Bank Ltd.

Rehan Shaikh, COO, HBL Asset Management Limited

Aasim Siddiqui, Director, Pakistan International Container Terminal Ltd.

Sohail Wajahat Siddiqui, Chairman, Pakistan State Oil

Shaukat Tarin, Chairman, Silk Bank Ltd.

**Lahore**

Pir Saad Ahsanuddin, Entrepreneur and investor

Zehra Ali, Lahore University of Management Sciences

Asim Fayaz, Curator, TEDxLahore

Jamal Goheer, Co-founder and CEO, Kualitam (Pvt) Ltd.

Saba Gul, Co-Founder and Executive Director, BLISS

Monis Rahman, Chairman and CEO, Nashee Networks, Inc.

Jazib Zahir, Adjunct Professor, Lahore University of Management Sciences

**Islamabad**

Vinay Chawla, Deputy Coordinator for Economic & Development Assistance, U.S. Embassy, Islamabad

Robert Ewing, Economic Counselor, U.S. Embassy, Islamabad

Bilal Gilani, Executive Director, Gallup Pakistan

Ahmad Jalal, Riyada Enterprise Development, Abraaj Capital

Aysha Majid, Islamabad Stock Exchange

Nadia Naviwala, Country Representative, U.S. Institute of Peace

Jonathan Peccia, Deputy Economic Counselor, U.S. Embassy, Islamabad
**APPENDIX D: ACRONYMS**

This appendix includes a list of acronyms, with their definitions, used throughout this study, in alphabetical order.

**2&20** – Two-and-twenty incentive structure

**CAGR** – Compound annual growth rate

**CDC** – formerly Commonwealth Development Corpora-
tion, now simply CDC Group (United Kingdom)

**CEED** – Center for Entrepreneurship & Executive De-
velopment

**CGS** – Credit guarantee scheme

**CNG** – Compressed natural gas

**DB** – Doing Business report (World Bank)

**DCCA** – Development Credit Authority (United States
Agency for International Development)

**DFI** – Development finance institution

**DFID** – Department for International Development (Unit-
ed Kingdom)

**DISCO** – Power distribution company

**DOD** – Department of Defense (United States)

**DOIS** – Department of State (United States)

**E/B/TDA** – Earnings before interest, tax, depreciation, &
amortization

**EMP** – Emerging Markets Private Equity Association

**ERR** – Economic rate of return

**ESG** – Environmental, social, & corporate governance
standards

**EV** – Enterprise value

**FDI** – Foreign direct investment

**FIT** – Feed-in tariff

**FOF** – Fund of funds

**FY** – Fiscal year

**GCI** – Global Competitiveness Index (World Economic
Forum)

**GDA** – Global Development Alliance (United States
Agency for International Development)

**GDP** – Gross domestic product

**GE** – General Electric

**GENCO** – Power generation company

**GNI** – Gross national income

**GoP** – Government of Pakistan

**GP** – General partner

**IBA** – Institute of Business Administration (Karachi)

**IBH** – Indus Basin Holdings

**ICT** – Information & communications technology

**IFC** – International Finance Corporation (World Bank)

**IMF** – International Monetary Fund

**IPO** – Initial public offering

**IPP** – Independent power producer

**IRR** – Internal rate of return

**IT** – Information technology

**KLB** – Kerry-Lugar-Berman Bill (aka Enhanced Partner-
ship for Pakistan Act)

**KSE** – Karachi Stock Exchange

**LDI** – Long distance & international

**LP** – Limited partner

**LUMS** – Lahore University of Management Sciences

**M&E** – Monitoring & evaluation

**MCC** – Millennium Challenge Corporation

**MIT** – Massachusetts Institute of Technology

**MOF** – Ministry of Finance (Pakistan)

**MOM** – Muthalif Quomi Mahaz

**NAIRU** – Non-accelerating inflation rate of unemploy-
ment

**NIS** – New independent states (Western NIS Enterprise
Fund)

**NUST** – National University of Science & Technology

**OPEN** – Organization of Pakistani Entrepreneurs

**OPIC** – Overseas Private Investment Corporation (Unit-
ed States)

**PCG** – Partial credit guarantee

**PE** – Private equity

**PEGCC** – Private Equity Growth Capital Council

**PEPCO** – Pakistan Electric Power Company

**PES** – Pakistan Economic Survey

**PII** – Pakistan Investment Initiative

**PIO** – Public international organization

**R&D** – Research & development

**SAP** – Standard & Poor’s

**SBA** – Standby agreement

**SBP** – State Bank of Pakistan

**SCI** – Saif Center of Innovation

**SEAF** – Small Enterprise Assistance Funds

**SEED** – Support for East European Democracy Act

**SIB** – Social impact bond

**SMEDA** – Small & Medium Enterprise Development Au-
thority (Pakistan)

**SMEs** – Small & medium-sized enterprises

**SPV** – Special-purpose vehicle

**TBSO** – Task Force for Business & Stability Operations
(United States)

**TIC** – Technology Incubator Center

**TIE** – The Indus Entrepreneurs

**U.K.** – United Kingdom

**UN** – United Nations

**UNP** – UN Principles for Responsible Investment

**U.S.** – United States

**USAID** – United States Agency for International Devel-
opment

**USD** – United States dollar

**USG** – United States Government

**VC** – Venture capital

**WB** – World Bank

**WDI** – World Development Indicator

**WEF** – World Economic Forum
Dustin Cathcart received a Master’s in Public Policy from Harvard University’s John F. Kennedy School of Government in 2012, with a concentration in Political and Economic Development, and is a Master in Business Administration candidate at Dartmouth’s Tuck School of Business. In the summer of 2011, he worked with the Inter-American Development Bank’s Private Sector Development Group in Port-au-Prince, Haiti. Earlier, Dustin served five years as an infantry officer in the United States Army, including a 15-month deployment to Iraq. He is a Truman National Security Fellow, Harvard Kennedy School Public Service Fellow, and a Pat Tillman Military Scholar. Dustin graduated from Norwich University in 2004 and is originally from Indianapolis, Indiana.

Meredith Gloger received a Master’s in Public Policy from Harvard University’s John F. Kennedy School of Government in 2012, with a concentration in International and Global Affairs. In the summer of 2011, she worked with the Pakistan Poverty Alleviation Fund in Islamabad. Earlier, Meredith served as Acting Resident Country Director for the International Republican Institute in Bogota, Colombia, and has more than six years of experience working on U.S. Government-funded political and economic development projects in Latin America and South Asia. Meredith is a recipient of a 2012 Boren Fellowship for Urdu study in India. She expects to begin work with the U.S. Department of State’s Bureau of South and Central Asian Affairs, Office of Press and Public Diplomacy, in the fall of 2012, as a Presidential Management Fellow. Meredith graduated from the University of Pennsylvania in 2004 and is originally from Marin County, California.

Aaron Roesch received a Master’s in Public Policy from Harvard University’s John F. Kennedy School of Government in 2012, with a concentration in International and Global Affairs. In the summer of 2011, he worked with the Aid Policy Unit of the Government of Pakistan’s Economic Affairs Division in Islamabad. Earlier, he spent more than three years with the International Rescue Committee, in Uganda, Kenya, and the United Kingdom, working on project management, budgeting, financial management, and risk analysis. He is a Harvard Kennedy School Public Service Fellow and expects to begin work with USAID’s Office of Policy in the Bureau for Policy, Planning, and Learning in the fall of 2012, as a Presidential Management Fellow. Aaron graduated from Stanford University in 2006 and is originally from New York, New York.