Why venture capital and start-ups should consider incorporating ESG into their operations and investments

The failure rate of start-ups is well documented; Niall McCarthy wrote in 2017\(^1\) that CB Insights, a tech market intelligence platform, identified 70% of start-up tech companies fail within 20 months of first raising finance (seed investment). The track record of new ‘Venture Capital Programs’ is not much better. In 2017, INSEAD reported that the average corporate venture capital program lasts four years. And, as a widely reported general rule of thumb, within a venture capital portfolio, the expectation maybe in the order of 30-40% failure, with only one or two companies in every ten delivering the success originally anticipated in the investment.

In 2019, David Horowitz of Touchdown Ventures,\(^2\) explored the top five reasons for these failures and concluded that to reduce the risk of the corporate program being shut down,

"ultimately the right formula is: hire the right team, set-up the program with the right goals and strategy, adhere to best practices and be ‘friendly’ to founders and start-ups..."

Within smaller companies of all types, environmental, social and governance (ESG) elements may be implemented instinctively / intuitively or as a result of compliance with prevailing regulation. However, as companies grow individuals within the company will have their own perceptions of appropriate behaviour and activity which will likely be divergent resulting in a loss of ESG rigour in the corporate operation. The risks that may arise from poor ESG management may be legal, financial or reputational. Just as a company would not consider having multiple methods of financial reporting, it seems logical that certain ‘rules of the road’ should be established at early stages of a company’s existence or at the initial stages of investment. The methods of working can be elaborated or expanded as the company grows and evolves so that they always align with the operation. The opportunities provided by ESG may relate to the market opportunities for a product, more efficient uses of resources, fewer claims – i.e. ESG can both protect and create value for investors. Integrated seamlessly in

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\(^1\) Forbes.com November 3, 2017
\(^2\) June 3, 2019 ‘Five Reasons Why Corporate Venture Capital Programs Fail’
http://www.touchdownvc.com/blog/page/2/
the day to day operational activities and culture of an organisation, ESG should be part and parcel of a well-run business.

This paper argues that early stage companies and venture capital (VC) companies implementing and adopting ‘beyond-compliance’ ESG practices and encouraging their adoption within their portfolio companies, is best practice and can result in competitive advantage / opportunities.

The world of venture capital is inherently competitive. An early hurdle is the competition for funds and then there is the challenge of identifying and landing the appropriate investment.

- **Competition for Funds:** Development Finance Institutions (DFIs), many Limited Partners (LPs) and Responsible Investors increasingly expect ESG management to be incorporated into the VCs own operations and approach to investing. The VC that has adopted ESG within their investment process and in their day to day operations, will attract support from these funders, i.e. conditions for securing funding include adhering to the ESG practices of the lending house or institution. For example, the European Bank of Reconstruction and Development (EBRD) incorporates environmental and social requirements into the appraisal and implementation of all Bank-funded projects based on European Union standards and international good practice. This includes the EBRD’s financial intermediaries and their portfolios.

  In support of incorporating ESG into the deal cycle and investment house, funders, such as CDC Group and the Dutch development bank, FMO, have issued guidance “Responsible Venture Capital” describing the rationale for ESG adoption in-house and within the portfolio companies.

- **Competition for investment placement:** There is evidence that VCs who understand and incorporate ESG into their work practices are more attractive to early stage companies because they offer less hostile work environments and are seen to care about their investments. In addition, it can be argued that they are less likely to overlook particular investment opportunities.

Companies and entrepreneurs seeking investment from VC are increasingly tending to favour offers coming from VCs with demonstrable track records of ethical behaviour. In an empirical study, Drover, Wood and Fassin found “robust evidence that entrepreneurs greatly prefer to partner with VCs who are perceived to have behaved ethically in the past”. Their second study showed that ethical behaviour may not be such a keystone if the risks of not accepting the investment are ‘serious’, i.e. they are likely to be less fussy. Counter-intuitively, the study also found that if the entrepreneur has a big fear of failure they are likely to be less willing to partner with unethical investors, possibly as the poor ethics may present a risk too far for the target business to accept.

VC has a reputation of being male dominated, a difficult sphere for females to work within and to seek funding. Intuitively, a VC adopting good in-house ESG principles

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3 January 2020, ‘Responsible Venture Capital – integrating environmental and social approaches in early stage investing’ CDC Group, FMO in association with ERM
within their own operations and the deal cycle will provide a more open environment and be more attractive to the female leader. This can widen the ‘net of opportunity’ for the VC. But, in 2018, only 3% of venture capital in the USA went to companies with a female CEO. The gender bias is also exhibited in Africa where capital is being invested disproportionately into male led firms.

In their paper ‘How the VC Pitch Process is Failing Female Entrepreneurs’ Hassan, Varadan and Zeisberger demonstrate that there is inherent gender bias in the opportunities coming before a VC firm and in the pitch process. Many investment opportunities are via the ‘network’ and the ‘network’ belongs to the male workforce of the VC. Secondly there is gender bias in the ‘pitch process’ where the question set may be skewed to favour male responses. Research in 2017 found that men are consistently more likely to be asked promotion type questions whereas women are more likely to be challenged by ‘preventive’ questions. These question biases were in addition to other biases such as confidence and image – a confident well-dressed handsome man has an ‘in-person’ pitch advantage. For these reasons, the paper’s writers suggest ‘ditching’ the in-person pitch as part of the investment process and using a pitch process based on a digital platform or allocating a specific pool of investment by gender.

Application of ESG principles to corporate activities is symptomatic of good management. Rather than being a ‘cost’ to a business there is a growing realisation that ESG factors can have a positive outcome on investment performance. ESG factors should be considered when making medium to longer term investment decisions not least to meet investor fiduciary duty and societal expectations.

- **Performance of the investment**: The IFC outlines the business case for ESG on their website. The IFC reviewed their own portfolio and found that...

  “... 656 companies in our portfolio and found that companies with good E&S performance tend to outperform clients with worse environmental and social performance by 210 basis point (BPS) on return on equity (ROE) and by 110 bps on return on assets (ROA.)

  Clients with high E&S scores outperformed by 130 bps the MSCI Emerging Market Index—an index created to measure equity market performance in global emerging markets. Whereas a deterioration in E&S performance resulted in worse financial performance.”

The reasons for ESG companies providing ‘as good as’ or ‘better than returns’ may be multiple but essentially, ESG implementation manages risks including legal (e.g. non-compliance), reputational (e.g. poor labour and working conditions, diversity bias) and financial (e.g. operational mis-management, poor governance).

Gender diversity has been shown to improve an entity’s performance. “Organizations that are the most inclusive of women in top management achieve 35% higher ROE and 34% better total return to shareholders versus their peers – and research shows gender diversity to be particularly valuable where innovation is key.” Further supporting this, the International Finance Corporation (IFC) hosted a webinar

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5 https://www.ifc.org/wps/wcm/connect/Topics_Ext_Content/IFC_External_Corporate_Site/Sustainability-At-IFC/Business-Case/
6 2018, ‘Gender Differences in Entrepreneurship’ Illuminate Venture Capital White Paper
summarising numerous sources, concluding that female leadership improves the effectiveness of ESG within a business”. The above notwithstanding, there may also be a sectoral benefit / uplift from the implementation of ESG. Kumar et al (2016) presented a quantitative model that considers ESG factors in evaluating risk-adjusted stock performance across 12 industrial sectors. ESG was shown to reduce volatility in all stocks compared to the reference group and showed that lower risk does not necessarily lead to lower returns; in eight of the 12 sectors, ESG factors correlated with higher returns. Notably the sectors with the best positive correlation between performance and ESG included the energy, food and drink and healthcare sectors.

A meta-study considering more than 2,200 academic and investor generated papers, was completed by G. Friede et al in 2015 concluded that “the business case for ESG was well-founded”. Within their review, the authors considered which of the factors, E, S and G, had the most significant positive impact on corporate performance. Of the 644 studies where ESG factors could be distinguished, Governance factors accounted for 62.3% positive correlation but they also the ‘highest percentage of negative correlations’ 9.2%.’ This may not be considered surprising since within governance factors are the suite of operational management, anti-bribery and corruption etc. However, when the share of negative findings was subtracted from positive ones for E, S and G, there was a slight bias towards E but this was not considered to be material.

ESG aspects can be the differentiator on exit from an investment, or when seeking to secure new funds for growth capital or a new investor. All other aspects being equal, entities able to demonstrate management of ESG issues that are relevant or material to their activities will be more attractive to a wider range of potential future partners.

➢ **Transaction liquidity:** Signatories to the UN Principles of Responsible Investment (PRI), or other potential investors (e.g. DFIs) will have established requirements for ESG disclosure during due diligence. Other firms may have their own established ESG criteria.

UNPRI signatories come from the entire spectrum of the VC, Private Equity and investment managers; a list of signatories is provided on the UN PRI website. An example of a lower to mid-cap PE firm and recent UNPRI signatory is Vespa Capital LLP. Their typical investments are between £10 million and £70 million. Their website states that, “Firms with an environmentally sustainable and socially responsible way of operating significantly de-risk their business model and therefore achieve greater cost efficiencies and profitability, attracting higher valuations at realisation…” Accordingly, their investment framework for considering new investment incorporates ESG factors. At the

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7 February 2019, ‘Women in Business Leadership Boost ESG Performance’ Alexandre Di Miceli da Silveira, Ph.D, Angela Donaggio, Ph.D. (both of Direzione Management Consulting)


10 [https://www.unpri.org/signatories](https://www.unpri.org/signatories)

11 [https://www.vespacapital.com/about-us](https://www.vespacapital.com/about-us)
other end of the Private Equity scale, Kohlberg Kravis Roberts & Co LP (KKR), was an early signatory to UN PRI. KKR commits to “consider material ESG issues” in the course of its due diligence and “in the monitoring of portfolio investments to the extent reasonably practical under the circumstances…”. KKR defines 'material' as having or having the “…potential to have a direct substantial impact on an organization’s ability to create, preserve, or erode economic value, as well as environmental and social value for itself and its stakeholders.”

The presence of an ESG policy and management framework / system for managing the risks associated with the relevant ESG aspects will be a starting point for any ESG due diligence. The internal or external capacity of the entity to deliver on the commitments made or required will also be scrutinised. During due diligence, the E&S opportunities may also be identified. If the Target has a practice of reporting material ESG aspects this will provide greater comfort to the potential investor. If ESG is not managed by the Target, these elements will become conditions of the funding, to be implemented within a prescribed period of the completion of the transaction. It can be less painful for the organisation if ESG has been part of its culture in its early stages rather than being ‘retro-fitted’ under the pressure of investor scrutiny.

Next paper: How venture capital and start-ups can ESG into their operations and investments

- Integrating into the VC operations and investment process
- Encouraging ESG practices / adoption within the portfolio companies
- Using external providers to supplement in-house capacity

Emma Farthing, Director Quarter Penny Consulting Ltd

ejf@quarterpennyconsulting.co.uk

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