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ESG in the DNA

How early-stage, high-growth companies can save the world

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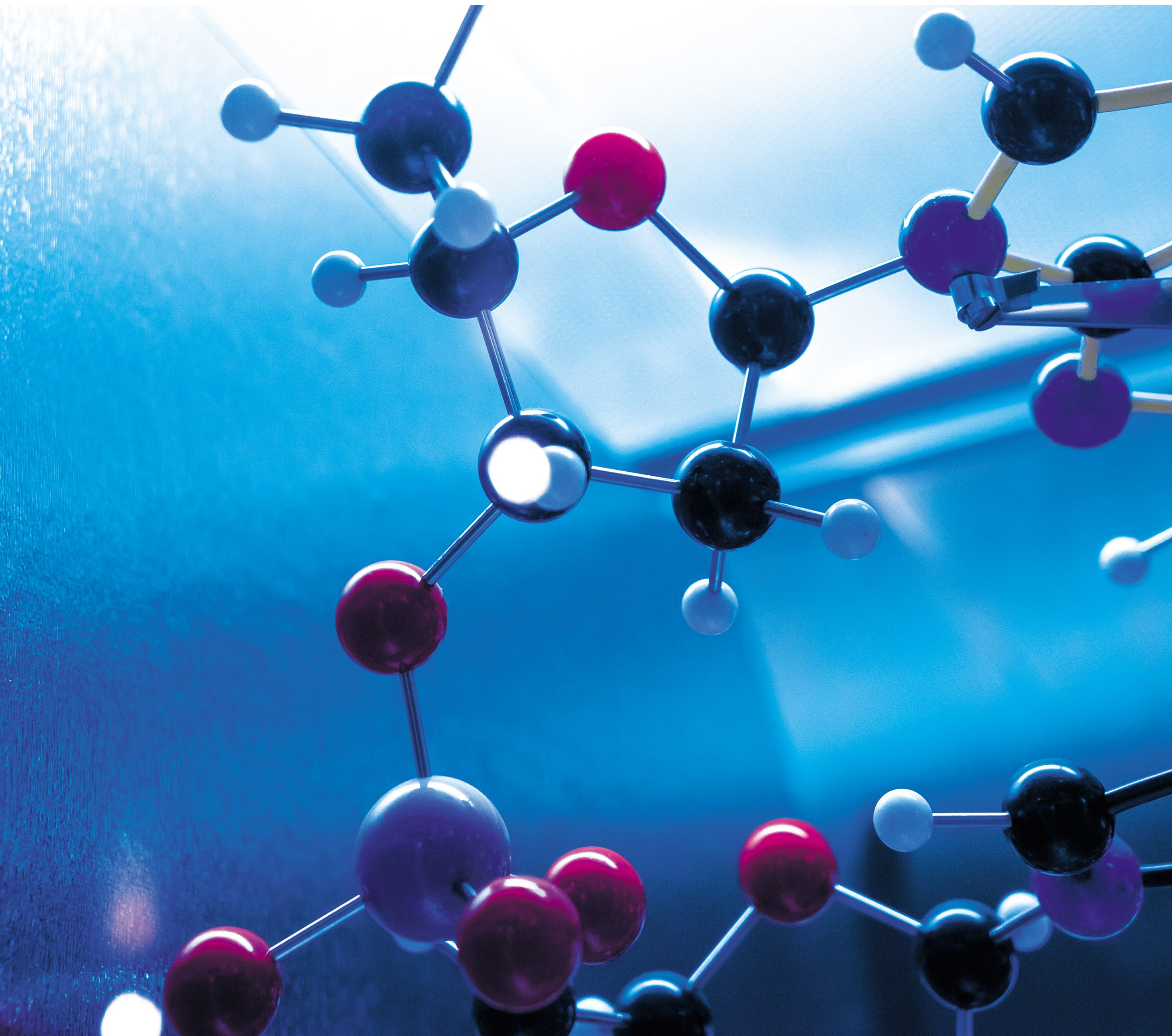

How early-stage, high-growth companies can save the world

In 2022 VentureESG (a non-profit initiative composed of venture capital funds and limited partner investors set up to push the industry on good ESG) published a white paper, seeking to define "*What ESG means for venture capital*". In taking the time to try and understand ESG in the context of venture capital, the paper is a useful trailhead, and forms part of the burgeoning conversation around ESG among venture capital investors and companies. However, neatly reflecting the industry's inherent character, compared to other sectors, the role and impact of ESG in venture capital investing is still at an early stage.

There are a few factors that might change this. Research suggests investment and venture-capital deployment was low in 2022 (S&P found a 64.7% drop in venture capital investment year on year between February 2022 and February 2023) and that there is a substantial amount of dry powder out there. At the same time institutional investors and some sponsors have made it clear they will not invest in ESG non-compliant businesses. Could ESG-alignment help early-stage companies access capital and debt?

This article starts with the premise that for early-stage, high-growth companies seeking to build disruptive technologies and businesses ESG is more often in their DNA. When compared to established, mature businesses and sectors that are looking to pivot away from the less-sustainable, deleterious practices of old, companies seeking VC investment are more likely to have ESG factors embedded in their businesses from the start.

For this reason the sector also represents a genuine opportunity to move beyond ESG-washing, investor box-ticking and the narrower focus on pricing-led KPIs that are symptomatic of the rollout of ESG elsewhere.

It is true that ESG-alignment can mean cheaper financing, but even in a rising interest rate environment, making basis point savings is about incentivising relatively small changes for established businesses or mitigating any ESG-related risk. The bigger movement therefore - and the greatest potential return - comes from the emerging "value drivers" in supporting next-gen companies that have ESG awareness woven into the fabric of their businesses. Recent research by Amazon indicated there may be a valuation premium of 15% for start-ups with "strong sustainability credentials", demonstrating the ROI opportunity for backing entrepreneurs who are building more sustainable products and businesses.

It is a win-win for the industry where, on the buy-side, growth capital businesses can align themselves to investors' funding strategies and values and their ESG frameworks.

Evidence so far indicates that the VC industry has begun to factor in ESG principles although there are some regional divergences. For example, Pitchbook's 2022 Sustainable Investment Survey highlighted that while around 70% of European fund asset managers use ESG risk factors and impact investing strategies, the take up was between 56% and 61% in the US. Capital and debt investors on the sell-side will need to move beyond the questionnaire "tick-box" approach, by identifying those portfolio companies that have ESG in their DNA. Consequently, it is far more authentic and transparent to market your fund as a true ESG fund because it invests in businesses where ESG is embedded in everything they do.

The onus is perhaps then on prospective businesses getting the message out there that they are green, sustainable and socially-aware in all aspects of their business. Although not exclusive to early-stage companies "B Corp" certification (as set up by B Lab) represents one initiative to highlight to investors and stakeholders that a business is focused on and committed to meeting high standards of social and environmental performance, public transparency and legal accountability.

Where a genuine movement to promote and encourage ESG investment combines with portfolio companies that have ESG principles inherent in who they are and what they do, there is real potential to move beyond box-ticking and reporting and, instead, an opportunity to effect real change in the way business is done.

Why are early-stage companies a better ESG prospect?

For many sectors the focus on ESG has been on the Environmental pillar. Indeed there is a thriving industry supporting the construction and conversion of green buildings, and monitoring and reporting on carbon–reduction in premises and their usage.

For many early-stage companies, green buildings are not so high up the agenda, except perhaps to ensure that they are occupying sustainable premises, typically on a rental basis. (It is worth acknowledging that start-ups do not always score highly in terms of their low environmental impact – indeed energy-intensive crypto mining is one example.)

Similarly, while the UK Government's 2023 Green Finance Strategy notes its intention to work alongside the private sector to improve access to venture capital for 'green technologies', ESG and VC is not just about green start-ups or supporting investment in climate tech.

More likely is the fact that they will be looking to maximise efficiencies in production and throughout their supply chain from the start. Cost pressures and the benefit of looking at processes from an innovation and emerging-technology perspective may seek to hardwire in those factors that make a meaningful difference to the ESG impact of a business.

The real strength in start-ups comes from building the company in the "right" way, from the ground up and where the often-overlooked pillars of Social and Governance come into play. Sustainability opportunities are routinely considered in the development of new products as well as in investment decisions in products that are not specifically focused on sustainability. For example early-stage companies:

- ⇒ are engaging with the service providers and suppliers that share the same social, ethical and environmental values;
- ⇒ have robust data privacy and security practices;
- ⇒ embrace diversity when hiring staff, and have equality-driven pay and inclusive benefits packages;
- ⇒ are set up with transparent ownership structures and board-level independence, with compliance, reporting and governance that embeds ESG criteria; and
- ⇒ design products and services responsibly, ensuring they are inclusive and accessible.

In doing so start-ups can reduce the future ESG-related risks and likely costs to their business while at the same time present a more attractive proposition to customers, future employees and potential lenders and investors.

Investors and lenders that appreciate the unique characteristics of such companies and the sectors that that they operate in may better appreciate how ESG metrics reflect those businesses.

What are the pressure points?

ESG drivers come from a variety of sources. While governmental "zero carbon" targets are catalysed by international commitments on climate change and sustainable development, the BVCA among others have noted that consumer demand, investor sentiment and firm culture have been the key drivers of various industry initiatives aimed at helping stakeholders integrate such sustainability considerations into their businesses.

Part of the cynicism or scepticism about the ability of ESG to change the world stems from understanding in whose monetary interest ESG compliance is. That is, are funds pushing for greener, more sustainable and socially-aware businesses because they, in turn, can attract more investors? Or are lenders and investors driving the agenda in an effort to gear up potentially lucrative businesses while at the same time changing the much-maligned investment banker narrative?

The truth, is hopefully, more nuanced. Certainly, the market includes serious activist impact investors funding businesses that have improving social or environment outcomes at the core of their product or service. However, ESG-based investing with its perhaps less lofty ambitions is more vulnerable to misuse or misinterpretation. Most egregiously, this might be by knowingly paying lip-service to the concepts so as to put ESG credentials on a prospectus; but also there is a more complex challenge in ESG-challenged businesses that might burnish their standing by targeting specific achievable ESG metrics, to build a "veneer of sustainability".

In that context, it is fair to say that encouraging ESG-alignment has not yet changed the world. To a large part this is because stakeholders are not yet looking at ESG criteria beyond the imposition of achievable KPIs as a means by which companies are either penalised for unsustainable practices or incentivised (in pricing terms) for hitting targets. Again, to date this approach has been calibrated to businesses and sectors that need to change, mitigate ESG-related risk or turn towards a more sustainable future rather than companies where that social responsibility and environmental ambition is baked in. Indeed the BVCA's response to the UK FCA's February discussion paper *Finance for positive sustainable change* where they note the FCA's observation that where sustainability-related risks are embedded into business, risk and capital allocation decisions this is “simply good business”.

There is a marked difference therefore in setting parameters that solely seek to rectify or mitigate ESG risks when compared with an impact investing approach that measures the success of an investment on positive social, and environmental change in lifecycle terms as well as any financial return. While VC investors and funders are looking at ESG criteria as part of the investment, data remains thin on shareholder value on a longer-term basis. In 2021, the muted response to Deliveroo's IPO was in part blamed on the company's apparent shortcomings in the treatment of its riders. Venture capital investors at the time were singled out for having no qualms in investing and citing the lack of meaningful due diligence and the weighting they may have applied to ESG, given their shorter-term investment approach. Conversely, some investors may consider ESG-focused businesses that balance profit and purpose to be at risk from diverging from building shareholder value where that might adversely impact their social or environmental impact.

The introduction of ESG criteria brings with it the inextricable growth of an entire industry dedicated to reporting and measuring the innumerable metrics. The time and cost of compliance, reporting and due diligence (on all sides and looking all the way through from customers to suppliers) is significant and even more so for early-stage companies that may lack the resources to commit to it or where embryonic business plans and growth prospects may be adversely impacted.

What are the pressure points? continued

On the one hand, the measurement and reporting of ESG -metrics to fit a KPI-based model might be considered burdensome. One way to mitigate this is by having a more dynamic and sophisticated approach to ESG-linked funding and investment that recognises the various stages of a company's development and where the ESG factors reflect what is feasible and proportionate for companies at pre-seed and seed stage through to series A/B and beyond. For example, a technology start-up may better focus its scarce resources in demonstrating good governance on data privacy security than ensuring it has a net-zero carbon footprint.

Despite industry bodies' efforts to establish frameworks, playbooks and reporting guidelines (for example those published by the UN PRI, ESG VC, VentureESG, Invest Europe, Impact VC and the Venture Climate Alliance), the compliance side continues to suffer an ongoing lack of consistency when it comes to definitions, standards and methodologies affecting both institutional and public market investors.

Regulation is on the horizon though, at least in terms of greenwashing and the disclosure obligations of funds and how they integrate sustainability risk. The irony is that as ESG regulation becomes more standardised, stakeholders may fear the shift from best practice guidance into law. However, for those businesses that are established where ESG principles were considered at the outset and have been embedded throughout the organisation, they may take confidence in understanding the concepts more than their established peers.

It may also be more intuitive to build in ESG measurement and reporting processes from day one. Stepping away from the box-ticking and KPI approach, perhaps lenders and investors could look more closely at the DNA of early-stage companies to recognise and appreciate the ESG credentials and purpose that are baked in from the very beginning.

Conclusion

It is clear that KPI-based lending structures and box ticking are not going to change the world. True innovation and change are not likely to come from burnishing the credentials of mature businesses that have, until recently perhaps, been doing things badly.

ESG-linked margin or valuation adjustments and questionnaires represent blunt tools that at worst are open to abuse and, more generally, impose expensive monitoring and disclosure obligations that encumber early-stage companies who require support through their incubation period.

Recognising the real growth in ESG-focused funds, the venture capital industry can instead have more real-world impact by putting investment and capital behind the next generation of portfolio companies that have ESG in their DNA.

Investors and lenders in this sector have a unique opportunity to lead the way on genuine sustainable and impactful investment and in doing so should be encouraged by the value premium evident from backing high-growth companies that are ESG compliant by design.

Commenting on our thoughts above, Ben Parker, COO & Managing Director at StockCrowd UK writes:

"At StockCrowd we always start with our purpose 'to make good ideas thrive', ideas that positively impact people and the planet; from education to health to sustainability... We believe that to create a truly sustainable and profitable company, you should balance the interests of a broad set of stakeholders from the start. Like a lot of high growth startups, we believe that a stakeholder business model that incorporates and goes beyond ESG is key - this framework makes us better custodians of our investors money, as well as helps us to attract new customers, the best talent and to keep those employees and customers engaged for the long term."

Additionally, Hayden Smith, Private Debt Advisory Partner at Fuse Capital commented on the funding landscape as follows:

"We are starting to see lenders, particularly the more European centric funds, pay closer attention to ESG credentials for Borrowers. However, we are not yet seeing this materially impact on pricing or underwriting criteria for transactions. It is our expectation that over the coming years, the LP's investing in these funds will push for action and have a preference to support companies with strong ESG credentials. As is the case in the more mature mid-market and large cap space, this should open up new and additional pockets of liquidity for our Borrower clients."

Fieldfisher's Venture Debt and Growth Finance practice advises both lenders and borrowers on all types of venture debt and growth finance facilities. We have a long track record of advising banks, non-regulated lenders and borrowers in the UK and across Europe with the structuring and negotiating of these facilities. For more information, see our Venture and Growth Finance webpage.

About StockCrowd: StockCrowd is a SaaS technology company whose software converts the website and digital channels of any organisation into its own fundraising platform. Used by internationally recognised universities and charities as well as by some of the world's largest financial companies, StockCrowd is the market-leading digital fundraising software across Spanish-speaking countries and launched in the UK in 2019. Headquartered in Barcelona, the company was founded in 2015.

About Fuse Capital: Founded in 2012, Fuse Capital provide Debt Advisory Services to high-growth tech businesses across the UK, Europe & Asia. The firm has successfully supported numerous startups and established companies alike, providing them with capital, expertise, and valuable network connections. Fuse Capital is committed to fostering long-term partnerships with clients and lenders.

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