ESG in Venture Capital – How are early stage investors using ESG metrics to screen and support investments?

Responsible investing has swept across the investment industry over the last decade and we have seen a rise in funds looking to drive more than just financial returns - whether that be across reducing carbon emissions, increasing diversity amongst business owners, or investing in more sustainable business models.

This article is written as a part of the *Sustainable Innovation Fund* delivered by *Innovate UK*. The fund supported over 1800 businesses with short term grants. The projects funded provided solutions and the key themes of the fund; responding to COVID-19, environmental sustainability and equality, diversity and inclusion. KTN is leading a programme of support for the projects to help create a legacy to the fund through driving impact, such as connecting to funders, amplifying other support routes and sourcing partners. Given the nature of the types of companies funded, this article aims to provide guidance to those who are seeking venture capital investment to scale their innovation and impact.

A changing landscape

Until recently, the mandate of any investment house was to deliver financial returns and if asset owners had the desire for their capital to have a positive impact on the world, it would have to be conducted through philanthropic efforts with little to no financial return. The last decade has seen a shift to more *responsible investing* efforts being placed on understanding the impact of investments and portfolios to gauge the associated environmental, social, and political risks. Blackrock, one of the worlds largest asset managers, have forecasted ESG specific funds will grow from $25B in 2019 to over £400B by 2028. There are a handful of factors behind this changing investment landscape:

Increased awareness that business can not only drive commercial value but also deliver responsible operations which reduce harm on the planet and people.

The emergence of the *Sustainable Development Goals* (SDGs) – launched by the United Nations in 2015 – which provide a clear framework and amplifies societies great challenges.

The surfacing of a new wave of talent with the desire to create commercial companies that address societal challenges.

New customers are entering the market. Younger generations have different consumer behaviours to their seniors and are actively aligning choices to their personal values.

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These long term trends have led to the rise in ESG (Environmental, Social and Governance) practices and frameworks and impact investing, terms often used in the same sentence but also confused with one another yet are frequently interlinked. So what do these terms mean?

Environmental Social and Governance (ESG) are a set of frameworks or criteria that focus on a potential investment’s internal processes or operations.

Environmental criteria considers the company's impact on the climate and stewardship of the ecosystems that its operations cover. Social criteria examines risks associated with how relationships are conducted with suppliers, employees, and the wider stakeholders of concern. Governance focuses on the rules and procedures of corporations: for example, a high profile issue may be how gender diversity and parity is treated across an organisation.

Impact Investing could be seen as an asset class of its own. The strategy of an impact investment firm is to generate financial and environmental and/or social impact. Sometimes impact investing can be referred to using *double bottom line* accounting reporting on both financial results and the measured impact. Measured impact could be aligned to the *Sustainable Development Goals* (SDGs) or alternatively defined criteria such as contribution to climate reduction.

In summary, ESG principles focus on the internal process of a given investment or portfolio. This differs from impact investing, which focuses on positive external outcomes the investment generates. The two can often be confused: whilst they are stand alone topics within themselves, they are used in harmony in many cases. For example, a fund may focus on supporting its portfolio with ESG practices through policy and governance support and still seek to invest in companies with a sizable impact in the reduction of poverty, carbon emissions, and reduction in waste.

Whichever way you look at it, the shift to more responsible investing is here to stay for two broad reasons:

1. There is increased awareness and appetite across stakeholders in understanding the externalities of a corporation footprint, relating to climate change and social injustice.
2. Sustainable investment practices are now tacitly renowned for having material impact on investment valuations and have recognised value with fund managers, not only in achieving environmental and social change/impact but also in reducing costs, minimising risks, accessing talent, and driving sales.

As Sir Ronald Cohen, Chairman of the Global Steering Group for impact investing (find the recent book *here*) and perhaps the godfather of the space puts it: "In the 19th century, investors talked about financial return. In the 20th century, they talked about risk and return and in the 21st century they are beginning to talk about risk, return and impact".

So, how does this apply to early stage venture capital?

Venture capital is no different and has seen shifts towards more responsible and impact driven practices. Despite lagging behind traditional capital markets, the desire to invest in sustainable, environmentally responsible and well-governed businesses has become more prevalent. We only need to look at the last few years to see why the social media giants have begun facing scrutiny over their business models regarding selling user data, and how they uphold democracy and human rights.

Whilst traditional markets have established more standardised approaches to managing and analysing companies across ESG risks, these approaches do not sufficiently cater for early stage investing (*CDC*, 2020). This has led to many funds creating their own frameworks for measuring impact and ESG risks when screening investment opportunities and supporting their portfolios. Rest assured, the trend is positive as more and more venture capital funds are baking in impact into their investment models when raising funds from Limited Partners (*BVCA*, 2021).

Early stage investors will fund many of the next global companies using technologies across quantum, industrial biology, and clean energy to solve some of our greatest challenges. It's vital that as these companies scale in size and market share they scale in impact in a well-governed manner.

To provide real examples, I have spoken to three early stage venture capital firms in the UK to gauge a perspective on how they look at these issues through the lens of how they screen investment opportunities and also how they support portfolios with managing their operations responsibly.

Fund Name: *Zero Carbon Capital*

Investment Stages: Pre-seed to Series A.

Fund Overview: We back UK-based early-stage companies on a mission to address the hardest problems of climate change.

"For every investment we make, the first filter we apply is an assessment of the total opportunity to reduce greenhouse gas emissions. Reducing these emissions is critical to building a safe and secure future in the face of climate change and will require the re-making of much of our economy. Our thesis is that over time, companies that can help us achieve this net-zero economy will be hugely important and valuable. We aim for every company we invest in to have the potential to impact at least 500 Mt CO2e per year in 2050 ensuring they both can have a meaningful impact (1% of global emissions) and build a big successful business." – Alex Gawley, Cofounder – Zero Carbon Capital

Zero Carbon Capital is focused on ensuring all investments make a critical impact in reducing carbon emissions. Whilst the team may invest across a range of technologies, sectors and use cases, the fund has a hard filter on the impact each investee business must meet (500 Mt CO_2e per annum). This provides a clear focus on what business to engage with to allow them to realise the impact the fund is set to create.

Fund Name: *Ada Ventures*

Investment Stages: Pre-seed to Series A – between £250,000 – £500,000

Fund Overview: Bold investment for overlooked founders and markets

"Every company we invest in at Ada has to have a positive societal impact – this is a minimum criteria for us. However, beyond that we also use a framework to consider what the type, scale and sustainability of impact the company will have on the issue or issues they are attempting to address. We also factor ESG to our decision making process at every stage. After we've made an investment we work with companies to design and implement an ESG and D&I policy. We're proud of the companies in our portfolio who are scaling highly successful and positively impactful businesses – such as Tickr, Organise and Spill." – Check Warner, Cofounder – Ada Ventures

Check and Matt at Ada Ventures actively seek to invest in diverse organisations with impact at the heart of their business model. It's worth noting that Ada has a rich scouting network to help them find and locate diverse and overlooked startups. Slightly different to Zero Carbon Capital, there is no target or threshold that is required to be met as a means of screening opportunities Yet, they actively support the portfolio companies with implementing diversity policies and governance structures at the early stages. Where resources are scarce in the early stages, this support can be vital to ensuring a strong framework to build on as companies scale.

Fund Name: *Clean Growth Fund*

Investment Stages: Seed to Series A – £500,000 – £3,000,000

Fund overview: Investing in innovations that deliver Clean Growth and accelerate the transition to net-zero.

"The CGF asks potential investee companies to complete a climate assessment report. This looks at the GHG emission reduction potential of the innovation if scaled and the cost per tonne of CO_2e. This report is then evaluated by an independent assessor to validate the assumptions made. The Climate Assessment report is considered as part of the decision making at CGF investment committee. If the investment proceeds, we ask the company to complete an ESG baseline survey that is then updated annually and reported to our investors as part of our regular reporting." – Beverley Gower-Jones, Managing Partner – Clean Growth Fund

The Clean Growth Fund takes a formal approach using a climate assessment report for screening and analysis when taking decisions at the investment committee. The ESG surveys are also used to create reporting structures to ensure ESG frameworks are being followed and monitored. This allows reporting to the Clean Growths Investors to be well structured and reported, but also allows the fund to track how the investee companies are performing on impact as simply as it is to report on financials over the funds life cycle.

Fund Name: *Playfair Capital*

Investment Stages: Pre-seed & Seed – £200,000 – £600,000

Fund overview: We invest in entrepreneurs building technology companies that rethink the way we live and work

"We are cautious of overemphasis on ESG metrics during Playfair's screening process. At the early-stage, founders have a million and one things to consider and penalising them for not having a full ESG framework in place does not seem fair in our eyes. However, a key element of our investment thesis is considering how our companies can change the world for the better. We get excited about companies that embody ESG as a mindset to create a positive societal impact; companies like Recycleye, Vinehealth and Heka. We recognise that this is only the start. Going forward, we want to support our companies' post-investment to create and implement ESG frameworks that are suitable for their stage of business, and that are robust and sustainable working practices." – Jeevan Sunner, Associate – Playfair Capital

Playfair approaches the ESG and impact question through focusing on maximising for the best deals and not to reduce the opportunity for companies at the earliest stages. Despite not having a specific thesis around impact, it's clear they value the trends and are open to investing in those companies placing impact at the heart of their business model. Again, and consistently across the funds, we see they place importance on supporting investments with ESG frameworks to ensure growth is managed in a sustainable way.

Wrap up

In summary, impact and ESG investing is here to stay. The global trend of investing in more sustainable organisations is continuing to rise, not only because it's the right thing to do, but also as financial viability and returns that can be made are becoming more evident. Venture capital has made some headway in the space, but has yet to develop a standardised approach to measuring ESG metrics or frameworks across the industry. This fragmentation has led to a wide range of approaches being taken that fit the needs of the fund and its limited partners and are actively baking frameworks into their investment models. Startups looking to pitch funds with a thesis driven on impact and ESG will need to be well researched and prepared to answer questions relating their business model, and the impact it creates now and as it scales in the future.

Should you have any questions or like to discuss ESG in venture capital further, please do reach out to jordan.fletcher@ktn-uk.org

The Sustainable Innovation Fund exists to nourish ideas and help turn them into game-changing solutions; so that the UK can recover from the pandemic, stronger, greener and fairer.

Created in June 2020, the Sustainable Innovation Fund is run by *Innovate UK*, with support from the *KTN*.

Over 1,800 projects across the UK have won grants, ranging from £25,000 to £3M – many applying for funding for the first time. The diversity of applicants means we are funding an exceptionally broad range of projects from edible and compostable ice-cream tubs, to emission-neutralising nose guards for cows, and sustainable seawater farming, through to trackable beer kegs.

The benefits go beyond funding too, from networking events to valuable business support.

The past 18 months has already shown us how fast the UK can innovate. Vaccines, remote working, new businesses have all been developed at speed. But this is just a glimpse of what is possible when we work together towards shared goals. By putting sustainability and inclusivity at the heart of innovation and nurturing it in the right way, we can go further than we ever thought possible.

> *The Sustainable Innovation Fund: building a stronger, greener and fairer UK*

Interested in hearing more about some of the projects funded:

https://bit.ly/SIF_Stories

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