VentureESG/.

What ESG means for venture capital

VentureESG White Paper, #1

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Abstract / Executive Summary:

While ESG has recently seen a surge among venture capital investors and their technology startup portfolios, confusion about what ESG is and should be in this space abounds. In this white paper, we propose a first fit-for-purpose working definition of ESG for VC based on twelve months of conversations with hundreds of industry stakeholders, VCs, LPs and academics alike. Defining ten concrete issue areas relevant across the VC value chain – from investment decision making and internal fund management to portfolio management, support and reporting – serves as a starting point to enable further productive development for the future journey of ESG in VC. By situating ESG both in its history – between socially responsible investing, corporate social responsibility, stakeholder capitalism and sustainability – and vis-à-vis impact investing, we want to sharpen its focus in this white paper to enable a better application in practice going forward. Avoiding ESG-washing – a real danger also for the VC industry – starts with a clean definition and this is our attempt at providing that following our mission to advance ESG in VC.

Why and what now?

In his recent book *Impact,*[1] Ronald Cohen prophecies that the pie of financial assets will be cut into two kinds of investments going forward: 10% of financial assets will be committed to impact and the remaining 90%consider ESG principles in their investment decisions. ESG (environment, social, governance) principles (and impact investing) have indeed been gaining importance in the financial community at large[2], and more recently also in the venture capital (VC) sector. A recent survey of the European Investment Fund found that 70% of VCs use ESG in the investment decision-making process.[3] Similarly, a

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[1] Cohen 2020

[2] Friede et al. 2015, Velte 2017, Giese et al. 2021, Dorfleitner et al. (2020), Leins 2021

[3] Botarsi and Lang 2020; similarly, an analysis from Different Fund (2020) found a strong growth trajectory of ESG-focused venture capital. However, their methodology of not distinguishing between implicit/explicit ESG-strategies devalues their findings.

PRI/VentureESG survey[4] found that it ispredominantly the initiative of the funds themselves driving ESG into the industry accelerated by increasing regulatory pressure, particularly in Europe.[5] However, pinning down what exactly it means to "adhere to ESG principles" or to "do impact investing" has so far been mostly undefined for venture capital investors. Practitioners themselves as well as journalistic commentators talk about sustainable investing, ethical investing, responsible finance, and indeed ESG and impact, often interchangeably. Specifically, for VC, there is a general lack of a universally accepted definition, standard, or methodology for ESG. We are seeing the dangers of what such 'aggregate confusion'[6] can result in by looking at the public markets, Even when ESG rating agencies have institutionalised 'measuring ESG', they are arriving at vastly different ratings, thereby undermining the credibility of ESG assessments and opening the door for ESG-washing. For VC, a second problem comes with the asset class: existing definitions and scopes of ESG have been elaborated to suit institutional and public market investors. Early-stage investors into technology companies deal with different, fast-evolving and often novel business models. Definitions and frameworks that work for public companies are not fit for purpose for VC. Thus, the purpose of this white paper is to produce a working definition of ESG for venture capital and show how it relates to impact, to provide a solid starting point to advance the conversation and eventually practice of ESG.

Defining ESG in public markets: a historical trajectory leading to aggregate confusion

ESG is short for *environment* (E), *social* (S) and *governance* (G), and entails a set of principles guiding a firm's or a fund's management, processes, and practices. Generally, ESG can be defined as "how corporations and investors integrate environmental, social and governance concerns into their business models".[7] Historically, the term ESG as well as the widespread and formalized use of ESG measurements in investment decisions started in the early 2000s. It was first developed in a 2004 report by 20 financial institutions in response to a call from the Secretary-General of the United Nations[8]. The *Fortune 100 Best Companies to Work for* and the *United Nations Global Compact* marked important steps in the process towardsusing non-financial indicators in profit-oriented investment as a common practice.[9]

ESG as influencing investment practice builds on decades of practical and intellectual work promoting more responsible and sustainable businesses. When considering ESG as a company-wide guideline, ESG connects to three different terms. First, ESG is connected to the somewhat older concept of **corporate**

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[4] PRI 2021

[5] The Sustainable Finance Disclosure Regulation (SFDR) came into being in March 2021; it requires all investment funds active in Europe to disclose product information related to sustainability for both environmental, social, and governance (ESG)-related products and non-ESG products (see e.g. PWC 2021). The US SEC is currently considering to also introduce disclosure requirements (SEC 2021).

[6] Berg et al. 2020

[7] Gillan et al. 2021

[8] Gillan et al. 2021

[9] Dominick et al. 2021; Friede et al. 2015

social responsibility (CSR). CSR emerged after the Second World War, propagating the idea that companies should take on societal responsibility besides pure profit-maximization.[10] UNIDO defines CSR as *"a management concept whereby companies integrate social and environmental concerns in their business operations and interactions with their stakeholders*."[11] While CSR is similar to ESG, it is focused more on internal self-regulation of companies, often bordering philanthropic practices. Even thoughESG also includes a strong focus on metrics and public reporting, it cannnot and should not be reduced to that.[12] A second related concept is **stakeholder capitalism**.[13] Stakeholder capitalism implies the need for a company to focus on the wellbeing of all stakeholders beyond simply shareholders, including employees, customers, and local communities. The concept, which has seen a big push since its promotion by the 2019 Business Roundtable[14] and WEF-founder Klaus Schwab's book,[15] is closely related to ESG[16] but mostly used in a more abstract way to describe a macroeconomic shift rather than concrete and precise practices. More broadly, ESG is connected to **sustainability**, implying that a focus on long-lasting business(including environmentally) is preferable to prioritizing short term gains at all costs, again with a view on a variety of stakeholders (employees, society, the environment *and* shareholders).[17] The most widely accepted application of sustainability appears in the form of sustainable development goals (SDGs), often used by impact investors (see below).[18]

Moreover, also when considering ESG as a tool for making investment decisions, there are a number of predecessors. Historically, ESG builds on the notion of **socially responsible investing (SRI)**. SRI, which applies social and environmental criteria in investing, was developed in the 80s and 90s[19] and also became known as **sustainable investment** (investing in assets contributing to a sustainable economy). Sustainable Investment as an investment class also spurred a trend of socially responsible startups (or social enterprise[20]), thereby adding concerns about social or environmental issues to the usual calculation of risk and return as determinants of equity portfolio construction or activity.[21] SRI continues to exist today and often integrates

[10] Goodpaster et al. 2010
[11] UNIDO 2021
[12] The Sustainable Finance Disclosure Regulation (SFDR) by the European Commission – a quasi-ESG regulation for investors – for instance, requires investors to publish an SFDR/ESG policy as well as report a set of metrics.
[13] Schwab and Vanham 2021
[14] Business Roundtable 2019
[15] Schwab and Vanham 2021
[16] WEF 2021
[17] Escrig-Olmedo et al. 2019
[18] We have observed this also in the context of VC and broadly the Western ecosystem which is not what the SDGs were formulated to be applied in. They are explicitly focused on the development context to guide the work of development organisations such as USAID, DIFFID or GIZ (De Franco et al. 2021).
[19] Townsend 2020
[20] See e.g. Yunus, Mohnigeon and Lehmann-Ortega 2010
[21] Sparkes and Cowton 2003, Sparkes 2001

ESG assessments as part of the screening process.[22] Like impact investing (see below), SRI goes beyond ESG in its thematic (often exclusionary) focus rather than an adherence to 'better business practice'.[23]

The language jungle above has unfortunately also been translated into a measurement and reporting jungle. Naturally, the three sub-headings of ESG cover a very broad variety of issues: while the E, for instance,captures Scope 1-3 emissions at a minimum and often considerations of biodiversity, resource use, and waste management,[24] the S stretches across issues from human rights and workforce to community impact and 'customer welfare'.[25] When it comes to concretely measuring and reporting on ESG, this wide scope easily leads to confusion. In a recent overview survey[26] of 50+ industrial companies, GRI[27] and SASB[28] found that 20+ ESG standards were used among the group, from PRI[29] and the EU taxonomy to UN Global Compact and TCFD[30] - generating an alphabet soup of acronyms and hundreds of ESG KPIs. This large variety of frameworks makes clear and unified communication, data collection, measurement, reporting and also simply goal-setting and action complicated. Even institutionalising ESG measurement in the form of ratings done by rating agencies has not helped with what a group at MIT calls ESG's 'aggregate confusion'[31]: the spread of public market ESG ratings is very high per asset making any single rating ambiguously helpful at best and meaningless at worst.[32] All of this is indicative of the maturity of the ESG market: even in public markets, we are at the beginning of the ESG journey.

Defining ESG for VC

For the purpose of VentureESG, committed both to spreading the practical application of ESG in VC and academic rigour in its approach, we are proposing what we call a 'universe of issues' of ESG for VC. As explained above, in recent years, ESG in the public markets has increasingly become a reporting and measuring exercise, with different rating agencies providing ESG ratings and funds reporting over a hundred different KPIs for measurement. While reporting is crucial for benchmarking and tracking a fund's or company's progress on ESG issues over time, it bears the risk of losing the value-based origin of ESG. For instance, diversity can easily turn into a tick-box exercise ('hire 30% of women'), rather than a value-

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22 O'Rourke 2003

23 S&P Global 2020, Eccles and Viviers 2001; for further definitions of related terms (ethical investing, green investing, etc.) the CFA ESG exam book, page 7f.

24 Brown et al. 2009

25 Neilan et al, 2020

26 GRI & SASB, 2021

27 Global Report Initiative

28 Sustainability Accounting Standards Board

29 Principles for Responsible Investing

30 Task Force on Climate Related Financial Disclosure

31 Berg et al. 2020

32 An additional 'confusion' in the meaning of ESG can be found among geographic regions, with ESG frameworks being particularly advanced in Nordic countries and Western Europe more generally - a relationship that also holds true in the VC sector (Botsari and Lang 2020).

driven way of looking at all processes of a fund or company (investments, hiring, decision making) with a broad understanding of diversity (beyond gender).

To avoid this pitfall, a definition of ESG must balance being detailed enough to be meaningful and applicable, and yet broad enough to leave room for initiative of fund employees and evolution over the coming years. Our definition of ESG breaks it down into ten issue areas relevant and fit-for-purpose for VCs. We decompose the term ESG as it applies to both the fund and startup level in the following way:

Environmental	Direct Environmental Impact (Scope 1): Impact of the operations of the fund or startup, e.g. energy use of offices or business travel
	Indirect Environmental Impact (Scope 2): Impact of goods/services purchased as part of fund's or startup's operation, e.g. what type of electricity is used, carbon footprint of food order for business meeting
	Environmental Impact of Upstream/ Downstream Activities (Scope 3): Impact of other companies the fund or startup engages with, e.g. of investors, cleaning service, suppliers etc.
Social	Diversity, Equity and Inclusion (DEI), e.g. diverse hiring and promoting, equal pay, parental leave
	Team and Working Environment, e.g. anti-harassment, benefits, performance management / fair feedback
	Responsible Product Design, e.g. unintended consequences, inclusivity/accessibility of products
	Supply Chain (where applicable), e.g. supply chain (social/environmental) impact, disruptions
Governance	Corporate Governance, e.g. independent board, transparent reporting, ownership
	Legal & Regulatory, e.g. complying with labour and tax regulations, human rights
	Data security and privacy / data practices, e.g. collecting/storage/management of data, implementing GDPR

As a working definition of ESG for VC, we propose: 'doing ESG' [33] *for a VC fund means (re)structuring its operations and (internal) practices in accordance with a set of ESG principles in mind. The above 'universe of issues' we have written out in a full framework can serve as a guide to start this evolving process. ESG involves implementing practices across the VC value chain, from investment decision making (as part of due diligence) to fund management and portfolio management and requires continuous reflection on the VC's impact on all stakeholders, from shareholders (LPs), employees, start-ups, nature, and society more generally. ESG hence both incorporates adherence to wider ESG risk analysis but also ESG opportunities*[34].

A note on materiality

Not all ESG issues from the 'universe of issues' framework are equally important for every investment decision and portfolio support case. Certain companies in certain sectors require a more specific focus on the issues that are 'material' in their case. Defining what is 'material', i.e. financially impactful and relevant,[35] when it comes to VC and the specific sectors VCs invest in (e.g. SaaS, FinTech, crypto) has not yet been fully accomplished. The existing SASB materiality maps are not applicable to many of the specifics of VC, which is why we are working on a first set of such maps in a separate paper. It will build on the materiality ESG heatmap developed in a recent white paper by KfW Capital/BCG defining material ESG issues for startups based on their type of innovation, stage, and end-market industry.[36] This next step in the process of 'defining ESG' through a lens of materiality will help investors identify and zoom in on the problem areas of their specific case more efficiently.

ESG versus Impact Investing in VC

Many investors and commentators alike are confused by the overlap between ESG and impact. Impact investing refers to investments made with the intention to generate positive measurable, social and environmental impact alongside financial return.[37] Impact here has to be intentional, measurable and manageable. As a result, impact investing is an investment strategy (often related to a thematic investment focus, e.g. on green or clean tech) rather than a set of practice-focused principles. It is based on the

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[33] This application of ESG has to be differentiated from 'ESG investing' where ESG criteria become a definitory way of specifying an investment focus for a VC (or other) fund. While in definitions, e.g. by Berg et al. (2020) or Wood (2010), ESG refers primarily to the operations of the own company or fund, in other contexts (e.g. Halbritter and Dorfleitner 2015; NossaData 2021) ESG becomes an investment filter. In this way, impact investing (more below) becomes a sub-category of ESG investing (see e.g. Botsari and Lang 2020). For the sake of this paper, the term ESG will *not* refer to ESG investing, but used in its focus on operations.

[34] KfW Capital / BCG 2022

[35] SASB defines 'material issues' as those which are "reasonably likely to impact the financial condition or operating performance of a company"; these issues are defined by SASB through a diligent and complex process of research and stakeholder discussions *per industry or sector*.

[36] KfW Capital / BCG 2022:14

[37] GIIN 2021, NossaData 2021b; while for a proportion of impact investors (including impact VCs), impact and return are in focus to the same extent, for some lower financial returns (e.g. below market rate) are accepted and traded in for specific impact.

assumption that investors can achieve financial returns while also addressing societal and environmental challenges,[38] the so-called double- or triple-bottom-line approach.[39]

Impact Investing is related to ESG insofar as it goes beyond it and builds on it. For example, impact investing will use ESG assessments as a "positive screening" tool, i.e. allowing investors to actively target start-ups that perform especially well on ESG criteria and actively seek the opportunity of positive non-pecuniary value creation.[40] ESG, however, to refer again to Cohen's prediction, will become relevant for all investors, while pure impact investing is set to remain a specific (niche) investment strategy and asset class. Generally, both communities overlap and share a similar mind-set and philosophy to think beyond shareholders and about stakeholder needs, producing 'better' business and positive change in the economy. While there is an imperative for impact investors to also adhere to ESG principles (to avoid environmentally harmful businesses or funds who pay their employees and suppliers badly, for instance), we see many opportunities for investors and companies adhering to ESG principles to – in reverse – also think more about (positive) impact in the future. After all, both ESG and impact investing are young for VC and startups, but crucial for the VC-backed economy to contribute to addressing the most pressing challenges of our times *better*.

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[38] Bugg-Levine and Emerson 2011
[39] See e.g. Slaper and Hall 2011
[40] Botsari and Lang 2020

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