Engaging Venture Capital GPs on ESG

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Growing Importance of Venture ESG Adoption to Asset Owners

Historically, environmental, social, and governance (ESG) integration had gained traction with private equity (PE) general partners (GPs) and their larger, later stage investments . However, high-profile incidents at startups, along with public scrutiny in recent years over end-uses of products, have prompted asset owners to focus on how venture capital (VC) investors evaluate and manage investments. Examples of incidents include Uber's $4.4 million settlement over allegations of rampant sexual harassment and retaliation, as well as highly publicized fraud accusations following FTX's bankruptcy.[1] These recent events demonstrate the importance of ESG adoption for VCs in successfully managing early-stage investments and the associated risk and opportunity set long-term. ESG adoption includes shifting mentalities from growing at all costs to building companies that can scale responsibly.

ESG criteria will increasingly be included in asset owner expectations for how VCs manage their investments. A 2022 ILPA and Bain & Company

KEY TAKEAWAYS

- Asset owners' expectations for VC GPs to adopt ESG practices are increasing, but challenges of rapid growth, competition, and influence unique to the asset class have slowed adoption
- Asset owners can still encourage VCs to adopt ESG practices as an opportunity to build strong, resilient companies
- Incorporating ESG in investment decisions and reporting on portfolio ESG KPIs will be table stakes for VC GPs looking to attract investors and complete successful exits

[1] EEOC, Uber to Pay $4.4 Million to Resolve EEOC Sexual Harassment and Retaliation Charge

ESG survey of more than 100 asset owners found that approximately 70% of respondents' organizations had investment policies with an ESG approach.[2] The survey found that focus on ESG is expected to grow: 80% of surveyed asset owners indicated that they expect to increase requests around ESG reporting from GPs across asset classes in the next three years. Further, 50% of asset owners indicated that they were most interested in receiving material ESG key performance indicators (KPIs) from their GPs to assess commitment. As integration of ESG into asset owner investment practices becomes widespread, VCs should expect more extensive ESG requirements, particularly during fundraising.

Challenges of ESG Adoption in Venture

VC has historically lagged other asset classes in ESG adoption. A 2021 review of 122 VC firms found that only 16%-24% of VC firms incorporated ESG considerations into investment practices.[3] Slower adoption can be partially attributed to VC investors facing less pressure to integrate ESG, meaning that adoption thus far has mainly been voluntary. VC firms applied fewer internal resources to responsible investing in the absence of extensive ESG reporting requirements.

As ESG integration in VC diligence is not as common or consistently requested as it is in PE/buyout, some VCs believe that its addition could cause delays, particularly during competitive processes. As minority stake investors, VCs may have limited ability to influence portfolio company management teams, particularly when portfolio companies are balancing limited resources across multiple priorities. These hurdles can make ESG integration more challenging.

Despite these challenges, poor ESG performance in VC can greatly harm the value of an investment. Early-stage companies can experience rapid growth and organizational change during a GPs' holding period, and early ESG integration presents a scaling opportunity for those companies. Successfully integrating ESG at VC-backed companies means tailoring the approach to the material risks of the business, applied through the lens of how to responsibly build and scale companies as a means of adding value.

[2] Bain & Company, Limited Partners and Private Equity Firms Embrace ESG

[3] New Private Markets, The first ESG report card is in - it's not great for most VCs

Engaging Venture GPs on ESG

Fully built-out ESG teams or committees are less common today among GPs in Venture (compared to PE). Asset owners must therefore engage with VC GPs on ESG adoption from a cross-functional perspective. Asset owners should engage investor relations and portfolio management or platform teams, as these groups are typically responsible for developing firmwide investment practices and engaging portfolio companies on a day-to-day basis.

To successfully engage with VC GPs on ESG, asset owners should right-size ESG expectations to the asset class to generate buy-in. Asset owners can better position themselves for success by intentionally communicating to their VC GPs what they expect from them in adopting ESG and where better ESG integration is needed. VCs are focused on creating value in their investments by growing companies while avoiding burdens that do not create value. Asset owners should consider two key factors in their approach:

1. How ESG can protect and increase the value of investments.
2. How ESG helps prepare companies for responsible and sustainable growth.

Protecting and Increasing the Value of Investments

Some portfolio companies will require more support than others to integrate ESG and manage risk. Asset owners should focus on how ESG risk assessments can help VC GPs identify which of their portfolio companies face material risks that are industry-specific (e.g., protecting healthcare data) or VC-specific (e.g., managing recruiting and retention at an early-stage). ESG controls that help companies manage risks can help drive responsible growth.

The value-add of ESG adoption becomes particularly tangible when highlighting how an ESG narrative can benefit portfolio companies in raising follow-on funding and preparing for exit. Public exits can introduce stringent expectations for ESG management. Finally, asset owners can emphasize to GPs that strong ESG integration creates competitive advantages, builds customer loyalty, and increases employee engagement.

Building Scalable and Responsible Companies

Building companies that can sustainably scale is a core focus of VC investors during the ownership period. While some investors may see ESG as a distraction for founders, asset owners have an opportunity to drive change in that perception. In conversations with VCs, asset owners can highlight how ESG performance can help investors and founders identify current and future risks that hinder a company's ability to scale, as well as opportunities to differentiate from competitors, retain top talent, and avoid legal fees or public scrutiny. When leveraged appropriately, ESG can enable early-stage, founder-led companies to not just scale their businesses, but to scale responsibly, with proper policies, procedures, and programs to support long-term growth.

Integrating ESG can help VC GPs prioritize initiatives and determine where to invest a company's limited resources. For instance, after an ESG review, a GP may identify employee engagement as a core focus area of a portfolio company. As a result, the GP and portfolio company may develop a human capital roadmap to improve retention and long-term engagement to support scaling. In another ESG review, a GP may prioritize privacy of consumer data to establish a competitive advantage. Asset owners should emphasize that integrating ESG helps GPs further their goals across a portfolio.

Important Elements of an ESG Program for Venture Capital

When asset owners evaluate VCs' ESG programs, there are four elements that all programs should include:

1. ESG policy
2. Recurring training
3. ESG due diligence
4. Ongoing portfolio engagement

It is also critical for VCs to consider the culture they build internally and exhibit in their interactions with their portfolio companies. To be effective, an ESG program with these elements needs to be lived out in practice by all investment professionals in strategic discussions and day-to-day engagement with companies.

ESG policies should be tailored to the GP, their investment practices, and ongoing portfolio engagement. If a VC's ESG program is nascent, it is reasonable to keep the policy concise until a more robust program is implemented. A VC should only include programmatic elements in its ESG policy if operationalized in practice, as well as consider the tone the policy sets for a strong ESG culture. That said, asset owners should expect VC GPs to periodically update their ESG policies. As VCs continue to enhance their programs, they should reflect these changes in their policies. Once its policy is finalized, a VC should educate its team on its firm's commitments. Even if the policy and respective program are basic in nature, VC investment professionals should understand ESG integration throughout the investment lifecycle. Training can occur annually to capture program updates and train new hires. Investment professionals should understand how to evaluate ESG risks and opportunities in each investment before committing to a target that may prove too high-risk.

For VCs, incorporating ESG assessments in the due diligence process is essential. ESG diligence helps investors identify future risks to be proactively managed as a company scales, instead of retroactively patching gaps following an incident. However, diligence should aim to avoid overwhelming early-stage companies with document and data requests they cannot fulfill. Rather, it should be a collaborative process between diligence evaluators (whether third parties or internal to GPs), VC GPs, and target companies. Diligence should focus on understanding immediate risks requiring mitigating actions and anticipating future risks from near- and medium-term growth, informing the operational roadmap. Diligence can capture unique ESG opportunities to be incorporated into a value creation plan that charts action items for building an organization's culture and responsible scaling.

Once part of the portfolio, VCs should engage with portfolio companies throughout the hold period. Ongoing engagement is important at each stage of a company's development to overcome new operational challenges. VCs can provide ESG resources to support a portfolio company as it navigates ESG for the first time, particularly for companies that have limited resources. Throughout the hold period, VCs should also collect ESG data across their portfolios to document progress and identify pain points. Today, few VC investors collect ESG metrics across their portfolios due to the perceived burden of data collection. While ESG data collection can be time-intensive, VCs can right-size their approach. VCs can prioritize specific ESG metrics that are highly relevant to a portfolio company to minimize the burden on a management team while focusing on data that adds the most value for stakeholders involved – asset owners, GPs, and their portfolio companies.

Emerging Tools for ESG Adoption in Venture

To support VCs on their ESG journey, asset owners should familiarize themselves with emerging industry-standard tools that VCs can leverage. Principles for Responsible Investment (PRI) recently published a due diligence questionnaire (DDQ) designed to help asset owners evaluate VC GPs' responsible investment practices.[4] The questions included in the VC DDQ increase flexibility for venture GPs whose ESG practices are not as advanced as those of PE GPs. The questions take a forward-looking approach to assessing current and future ESG risks and opportunities for investments. They depart from the traditional ESG DDQ designed for PE, which primarily focuses on current risks and opportunities and does not account for significant changes that may occur as an early-stage company scales.

Additionally, ESG KPI frameworks like the ESG Data Convergence Initiative (EDCI) help GPs identify ESG performance metrics to track and report to asset owners, reducing the burden of collecting and reporting duplicative data.[5] Standardized reporting reduces the burden on GPs and allows them to focus on providing robust and consistent information. These ESG frameworks will also enable

[4] PRI, Responsible investment DDQ for venture capital limited partners

[5] ESG, Data Convergence Initiative

asset owners to benchmark GPs' ESG programs against peers and set right-sized ESG expectations by asset class. Leveraging existing and emerging venture-specific frameworks for ESG adoption can further minimize barriers to ESG adoption. Asset owners can encourage VC GPs to develop programs that are aligned with the expectations outlined in the PRI Venture Capital DDQ and use industry KPI frameworks to guide baseline data collection.

Leading on ESG in Venture

The four programmatic elements outlined above represent initial steps VC GPs can take in building ESG programs that mitigate risk to investment value and support value creation. For VC GPs aiming to exceed baseline expectations and position themselves as leaders in ESG, the next step for program maturity is demonstrating active management of ESG topics after investment.

Engaging with portfolio companies on initiatives to create ESG value and scale responsibly can differentiate VC GPs by showing that they are bought-in on ESG. VC GPs that take a long-term outlook on ESG, prioritize a strong ESG culture, and demonstrate how they scale their investments responsibly will develop competitive advantages in growing the value of their investments and developing sound portfolio company operations. While ESG adoption in VC is relatively nascent, asset owners can accelerate adoption through ongoing engagement and heightening expectations.