IMPACT VS ESG – WHICH DO YOU PRIORITISE IN YOUR PORTFOLIO? DOES EITHER MAKE A DIFFERENCE IN RETURN ON INVESTMENT?

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A growing number of investors want their money to fund companies as committed to a better world as they are to their bottom line. This requires companies to have ESG plans in place and be able to show their positive impact – but does that equate to business success?

The roundtable, led by **Ed Phillips, Investment Director at Future Planet Capital**, began with ensuring attendees were on the same page regarding what impact and ESG are and a brief overview of the concepts in today's industry.

"Let's start by defining what impact is," said Ed Phillips. "I would define impact as outcomes that are outward looking from the company to society. So what are the products and services of the core business, and how do they interact with society? What are the externalities and outcomes of the company scaling its products and services in the world?

"As an investor, we want to measure that in dollar value for portfolio companies – how much return is created by addressing climate change (carbon removed) or creating vaccines that solve worldwide disease (Quality Adjusted Life Year – QALY). And usually, we want to see that impact aligned with the business model, so more carbon removal is good for the planet and shareholders. More vaccines, more revenue, more lives saved.

"An ESG policy at an early stage can be burdensome for everyone. A retrofit ESG can't be an after-thought because it needs to be measured and scaled appropriately to the stage the company is at."
Alex Shadbolt, Investment Associate, Future Planet Capital

“What is ESG – Environmental, Social and Governance? We perceive this as internal looking, operational, and about corporate policy. For a business, **Environmental** outcomes could be carbon accounting and direct emissions from your operations. Examples of **Social** activities include Diversity, Equity, and Inclusion (DEI) policies, mental health support and equal pay. And finally, **Governance** could include aspects such as integrity and risk management. As an investor, ESGs might be used as a tool to assess a company’s level of risk and threat of external impacts such as climate change, poor governance, or societal damage.

“Why is this relevant today? I think we should explore this from the perspective of three entities – Businesses, Investors and Funds.

“For investors, we’ve had two years of article 8 and article 9 funds from the EU’s Sustainable Finance Disclosures Regulation (SFDR), which is currently undergoing a large consultation with calls to rehaul. There are the UK Sustainable Disclosure Requirements (SDR) and membership groups – Principles for Responsible Investment (PRI), Global Impact Investing Network (GIIN), International Finance Corporation (IFC) and World Economic Forum (WEF). Now ESG_VC and VentureESG. There are a lot of frameworks, increasing regulations, and pull from Limited Partners (LPs), though not always clear in which direction.

“And the big question – is it competitive? How will it affect financial returns in Europe vs US companies?

“There currently isn’t massive adoption in the venture capital (VC) ecosystem. Very few firms make a good risk-adjusted return. You can see this in the churn rate of venture firms; if you look at those around 20 or even 10 years ago, most aren’t here today. It requires resources, and it adds friction. Tier 1 US VC can come in and do their due diligence in four weeks and be happy with your X (formally known as Twitter) feed as a means of reporting.

“On the LP side, over one-third of professionally managed assets are now subject to ESG criteria (worth 30 trillion), and over 80 per cent of LPs say they look at ESG in their investment decision making. But there’s no framework alignment or clear universal policy adopted by everyone – is this potential for confusion and is the increased attention creating an environment for greenwashing in the VC space? For LPs who don’t have the time (5% assets allocated to private markets) and VCs who want to tick a box, it makes sense!

“Certainly, when Future Planet Capital started out, there weren’t as many ‘challenge-led investors’; now every fund we see is retrofitting their portfolio into that box. Consumer apps are impact now!

“Most importantly for businesses, a BDO report that we contributed to in November 2023 found that zero investors placed a top three emphasis on ESG or positive impact in their investment process. Furthermore, in ESG_VC 2023, only 20% of start-up companies had an ESG policy, trending up above 30% for later-stage companies. It’s understandable when you have early-stage founder teams of 1, 2 or 3 people trying to disrupt large incumbents with limited resources. So to what extent does allocating time to ESG and impact help them build and grow a business? How important is it to long-term success? When does it add value? To a public listing? To effective collaboration or acquisition with a corporate? To access capital?

“An example of the importance of ESG recently is the near collapse of OpenAI. At one point it looked like 86bn USD worth of shareholder value was wiped out because of an unusual corporate structure, employees threatening to walk-out, investors cut from decision making and both women on the board fired.

“So let’s dive straight in and open for contribution, does ESG or positive external impact contribute to business success?”

> *“I think it does, and any hesitancy to support that is probably because of the backlash we’ve seen against the public markets and ESG, which is understood when it’s become massively conflated. There’s a whole industry making a ridiculous amount of money commercialising ESG and offsetting it and not necessarily doing it transparently or in a way, which is aligned to all these changing regulations which are coming out and being rehauled and rehashed.”*
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> **Alex Shadbolt, Investment Associate, Future Planet Capital**

Alex Shadbolt continued: "Rightly so, I think people are sceptical of ESG as an industry. A lot of it is fundamental good governance; environmentally, ensuring that the company understands the carbon footprint of their operations, so that they're prepared for when they get to a Series B, or C or even a public listing. Once the SDR comes into force, you're likely to need some grasp of what your emissions footprint is to be classified as certain companies or be eligible for loan support.

"For Social and Governance, it's vital to have good governance and ensure that massive oversight doesn't occur, and that people are treated equally and fairly within the company.

"The disconnect with ESG being important is because it's become muddied and confusing, and some people may think we need to go back to the idea of social responsibility or robust corporate revenues.

Karen Brooks, Programme Director, SETsquared had a question: "We've got quite a few investors in the room; I'm interested to know to what extent you consider ESG when looking at investment opportunities?"

> *"At Fund F, we invest in pre-seed stage companies that want to do something good and have a clean, gender diverse business model. We avoid companies that promote mindless consumption, such as fashion and manufacturing. Often at pre-seed stage the company is just one or two founders, and they don't have time to set out an ESG policy. We give them a playbook and support them to progress their ESG over time."*
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> **Jaysri Thangam, Investor, Fund F**

There was more discussion about the timing of when companies should focus on their ESG – is it best done at the start and is that possible to do?

Jack Jordan-Connelly, Ecosystem Manager, Barclays Eagle Lab, had a viewpoint based on his experience: "At SETsquared Bristol, we have 90 companies at present, pre-seed up to Series A, and we see two ESG mindsets – it's either a tick box exercise for the sake of attracting investment or it's all-encompassing to the detriment of the business."

"The motivation behind why founders are building these companies and how they want to change the world is very inspirational. They have a lot of good ideas, but their level of ESG focus is potentially damaging their business because it's too much, too early. But then you get the flipside, people who think it is just a tick box – I've done this and this, but they haven't really done it. So, ESG tends to be a seesaw between two extremes and a more balanced approach is needed."

This was interesting to **Richard Cooper, Managing Director at Oxford Innovation Finance**: "We have an EIS fund and a large angel network, and tend to invest in companies between seed and Series A. I often find that even before the founder can sell their business, they'll say how they're going to give half to charity. You've got to grow the business first before you can sell it. As an investor, you've got a responsibility to your shareholders to make a return. Yes, we're going to have ESG impacts, but returns are usually front and centre. If the company can't prove itself as a business, there's no point even discussing ESG. I think the mindset changes as you go up, from Series A to B – ESG becomes more important. The first focus should be building the business. ESG can be a marketing tool to help attract investment, but it's not as important as generating returns."

Much of the discussion centred on how creating an ESG policy should come later in a company's development and that it is a distraction for early-stage founders who need to focus on proving their business model. **Ed Phillips**, however, has the view that sooner rather than later is the best approach: "If you don't embed ESG principles at the very outset of your company, you're unlikely to do it when you're in the middle of a Series A round or Series B round, when you're commercialising and scaling up, and it's a much bigger organisation, and ESG policy and principles can be difficult to embed once the company culture is in place."

Others still shared the view that it was difficult for companies to embed ESG at the start but agreed that it was important to have an ESG mindset, education and dialogue with investors to help progress ESG in the right way. **Alex Shadbolt**: "An ESG policy at an early stage can be burdensome for everyone. A retrofit ESG can't be an afterthought because it needs to be measured and scaled appropriately to the stage the company is at. LPs need to file a report including ESG, so they send out 17 different spreadsheets to pre-seeds asking them to scope their emissions. For example, founders look at it and don't have a grip on what's being asked. When really, it's the responsibility of the investor to have a dialogue with the founder and say, okay, this is the positive stuff that we can talk through and ensure you've got responsible governance for and have those conversations at an early stage. To expect founders to have the full scope of their emissions at a pre-seed stage is just not possible."

The focus on ESG is changing. "Nowadays, start-ups have a board, and ESG is always on the agenda; it wasn't three years ago, so that's a change," said **Richard Cooper**. "Having ESG as an agenda item at board meetings means the company doesn't lose sight of them as the business grows."

What support do founders have to develop their ESG over time? Should it be investor-led? There is no universal framework for how that can happen, but investors do look for business model alignment and communicate with founders, and the burden of proof lies with the investor. **Alex Shadbolt** explained how it works at Future Planet Capital: "We've co-created a list of KPIs which we send to our portfolio companies, and we say, okay, we understand you are at the seed stage; how's your business model related to these KPIs? How are you going to achieve that, and how can we look back in a year's time and evidence the achievement?"

Ed Phillips expanded further on this: "We do qualitative reporting and make clear that this is the roadmap we're pursuing. These are the KPIs that will become important in the future. And this is the business model around that. If you're managing a multi-sector portfolio of education and health and climate tech and you're trying to benchmark these companies against each other and create KPIs, it's virtually impossible. We've taken a more pragmatic approach."

Often, impact happens naturally, as **Richard Cooper** explained: "When we looked at our first five companies to invest in, we never said it was to do with impact or ESG. Then we had nine impact companies out of 11. But that wasn't what we aimed to do; we were looking for interesting companies that were helping the world but also going to make a decent return. Sometimes it just happens naturally, especially if you're a tech investor."

A lot of technology coming through is inherently aiming to make the world a better place. As **Karen Brooks** explained, drawing on her experience of working with SETsquared university spin-outs:

> *"Researchers tend to be in academia, not because they want to make lots of money but because they want to do something good with their research. So, they're born into ESG because they want to create it. Therefore, it's not a difficult concept to get across to them, but can they articulate it? Innovate UK's ICURe programme, which SETsquared is a delivery partner of, supports academics to communicate what their technology is to a commercial environment and how it relates to impact on a social and environmental perspective."*

Sara Campin, Student Enterprise Consultant, University of Southampton, acknowledged the value of the ICURe programme when encouraging academics to monetise their research and build the narrative required to show impact: "You can't just say I'm going to change the world, you have to be able to say this is going to result in this many devices being sold to this many people and that will have this impact and that financial return. Not having that narrative could affect their access to capital, so when it's not going well, the trick is to bring in professionals who can support them. This could be matching the academic with a commercial CEO to help their journey."

Having an ESG focus can help with talent acquisition, as there is a strong desire to work for companies that are doing good in the world, and this can boost company performance and therefore returns. **Sara Campin** expands on this:

> *"Working for a company with clear ESGs is desirable and often important to university students. Attracting and retaining talent can lead to higher productivity and company growth."*

Karen Brook supports this view: "Over the past few years, the younger people we've brought in want to work on Net Zero projects or projects that have a social aspect; they want to feel they're a part of something good and positive. So portraying ESG to younger professionals does help bring in new talent."

Open AI is a good example of the tension and conflict that can exist between ESG and ROI. Ultimately, the focus must be on shareholder return. **Sara Campin** agrees: "Until we stop seeing GDP growth as the final outcome – it's always going to be returns. It'd be amazing if it were shaken up. There are some projects happening that score wellness and happiness over GDP, but I think things will not change quickly."

In Summary

Investors are searching for companies that will generate impact, and that is important, but the bottom line always comes down to returns. ESG is important, too, but again, the returns are more important. A lot of discussion centred on when a start-up should focus on writing and implementing ESG policy. Doing it too early can stall your company's growth unless you have the personnel to achieve both simultaneously. The consensus around the table was largely on tackling ESG as the company grows and having the right mindset and education to achieve it. Investors can help with the development of ESG, offering playbooks and guidance to steer the company toward agreed impact KPIs.

To catch-up on all the action from the Investment Futures 24 event, go to **SETsquared.co.uk/investment-futures-24**