OPINION

Park, Yong Rin

ESG Investing in Venture Capital: Current State and Implications

Venture Capital (VC) is a form of investment characterized by broad engagement in startups and plays an essential role in the wider acceptance of ESG. VC's ESG investing is subject to a range of limitations including the strong bargaining power of a startup's founder, limited economic value of ESG investing due to small-scale startup investment size, and a lack of disclosure and assessment criteria specific to startups. Nonetheless, VC firms have increasingly integrated ESG investing into their investment process thanks to the possibility of increasing investment returns through performance improvements and reputational risk control of portfolio companies, the ESG investing policy of limited partners (LPs) and disclosure regulations on VC firms' ESG investing. Wider access to standardized ESG data is needed to facilitate ESG investing by VCs. Given that many startups hardly fall into conventional industry categories, a desirable approach is to evaluate ESG factors that are selected by materiality based on features of a startup's business model, rather than producing comprehensive ESG data for portfolio companies. In Korea, VC investments are increasingly adopting the ESG investing concept with a focus on creating a checklist of investment targets and developing ESG evaluation criteria for portfolio companies. What is needed in this respect is a continuous improvement in ESG evaluation criteria, ESG integration and the expansion of the scope of ESG investing into social (S) and governance (G) dimensions.

Significance of ESG and VC Investments

Venture Capital (VC) is a type of investment characterized by engagement in startups through follow-up monitoring and support activities such as participation in corporate boards

* All opinions expressed in this paper represent the author's personal views and thus should not be interpreted as Korea Capital Market Institute's official position.

* Ph.D., Senior Research Fellow, Financial Services Industry Department, Tel: 82-2-3771-0830, E-mail: yrpark@kcmi.re.kr

of investee companies, which could catalyze the widespread adoption of ESG by startups. As VC aims to bring about economic and social changes and tackle imminent challenges by seeking innovation in technology, products and services, it partially shares the philosophy of ESG that advocates social changes. In this respect, VC can make a unique contribution to ESG investing. In addition, venture capitalists (VCs) help startups poised for substantial growth to embed ESG considerations in their corporate culture early on. Thus, VC investing could potentially minimize problems that large companies face due to the complexity surrounding organizational structure and supply chains when attempting to enhance the ESG management system. A series of mishaps related to startups arising from mismanagement of ESG risks have raised VCs' awareness about the importance of ESG investing.[1)]

ESG investing by VC: Characteristics and factors behind greater adoption

As ESG investing initially driven by traditional assets gradually expands into alternative investment assets, VC, a type of alternative investment, has become one of the latecomers in the ESG investing landscape.[2)] Such delay in adopting ESG investing stems from factors inherent in VC's investment strategy. First, a startup's founder is of great importance in VCs' investment in a startup, which may prevent VCs from gaining strong bargaining power. Second, VC investments usually represent a small proportion of the fund managed by institutional limited partners (LPs) backing VC. This means a VC investment tends to be pushed back on the ESG investing priority list of institutional investors. Third, VC firms are not convinced that ESG investing could enhance returns because any data for analyzing ESG investing performance are not available. This also explains why devoting ESG-related resources to all investee companies would intrinsically lead to inefficiencies, given that VC investments take a high risk of failure. Fourth, although overhauling the ESG criteria related to disclosure and assessment is a pending issue for all investment fields, a different set of standards specific to investments in startups should be applied to ESG investing by VCs. If the comprehensive ESG evaluation criteria primarily used by other investment fields are applied to startups, it could incur excessive costs. As for new business models launched by startups, it is worth considering the difficulties in incorporating the new business models into the existing industry classification system.

1) For example, WeWork and Theranos have issues with corporate governance, while Uber has come under controversy for its gig workers on temporary contracts.

2) A survey conducted by Preqin has found that among various alternative investments, VC, as well as hedge funds and investments in natural resources, have made the least progress in adopting ESG investing strategies (www.preqin.com, Why invest in ESG?).

Despite the constraints mentioned above, demand for ESG investing is growing among VC firms as it has the potential to improve their overall risk-return profile. As ESG investing becomes increasingly accepted in the capital market, it is expected to broaden the client base of portfolio companies and attract new investors. This would help avoid reputational damage of portfolio companies and proactively respond to ESG-related regulatory risks. But a more immediate reason for the growing adoption of ESG investing is that VC's limited partners (LPs) mostly comprised of asset holders have declared their commitment to ESG investing and thus, VC firms have no choice but to follow suit to raise LP funds.

ESG-related regulations are also likely to have a profound impact on VC's greater adoption of ESG investing. Recently, the EU has introduced the disclosure regulation for ESG investing by asset management firms in the capital market. The regulation, which is called the Sustainable Financial Disclosure Regulation (SFDR), came into effect on March 10, 2021, aiming for facilitating ESG investing, enhancing the comparability of ESG financial investment instruments and devising a prevention plan for greenwashing. The SFDR obliges financial market participants (FMPs) including VCs and other asset managers to offer information regarding sustainability risk posed by investment assets under management. As most institutional investors in the EU are subject to the SFDR, the SFDR should serve as a channel through which the ESG investing policy of LPs pushes for VC firms' ESG investing, thereby encouraging portfolio companies to carry out ESG management practices.

Accessibility to standardized ESG data

What is needed most for incorporating the ESG concept into a VC investment is greater access to standardized ESG data. In particular, an agreement on unified reporting criteria is required for ESG monitoring of portfolio companies and reporting to LPs. This is because such criteria are key to efficiencies of data collection, production of comparable data and effective ESG integration. ESG data standardization necessitates international cooperation and concerted efforts made by VC market participants, which would lead to the public comment process for a considerable period. Korea's VC sector should also strive to set up its criteria in line with the ESG standardization trend of other economies. Market participants should jointly work on standardization to ensure that ESG investing creates investment value, rather than costs.

It is worth noting the ESG data standardization strategy that has been jointly proposed by Germany's KfW Capital and BCG, a global consulting firm.[3)]This strategy is designed to evaluate ESG factors based on materiality which is determined by three considerations for startups including the type of innovation in products or services, the growth stage and the exit industry[4)] for products and services, rather than producing extensive ESG data for investee companies. Like the SASB materiality criteria for 77 industry categories, the strategy intends to reflect features of startups when measuring and evaluating ESG materiality. It may be helpful because many startups including ones in blockchain and AI often operate in ambiguous industry sectors. A car-sharing platform, for example, could fall into the category of a technology/service in terms of the type of innovation, the early stage in terms of the growth stage and the transportation sector (car rental) in terms of the exit industry. In the ESG factor of customer privacy, a technology/service represents above-average materiality in terms of innovation type, below-average materiality in terms of the growth stage and neutral materiality in the transportation sector. Taken together, customer privacy for a car-sharing platform is given above-average materiality identified by a technology/service, the highest materiality among the three areas. This way, the materiality of ESG factors can be produced for a specific business type.

VCs in Korea: Challenges for wider adoption of ESG investing

The expansion of ESG investing is anticipated to have a significant impact on Korea's VC market. It is particularly notable that VC firms' assessment of ESG investing performance would affect the investment decisions of Korea's institutional LPs. Accordingly, most VC firms are likely to embrace ESG investing, which may widen the gap between medium- and large-sized VC firms equipped with ESG-related internal resources and capabilities and their smaller counterparts without such assets. In Korea, a few leading VC firms are working to expand ESG investing, with a focus on creating a checklist of investment targets and developing ESG evaluation criteria for investee companies. In this respect, the following should be put into action to ensure that ESG investing takes hold in Korea's VC market.

3) KfW Capital & BCG, 2021, Growing the Seeds of ESG: Venture Capital, Start-ups and the Need for Sustainability.

4) An exit industry refers to a traditionally classified industry to which a startup is likely integrated due to a high correlation between the industry and the startup's business model.

First, a continued improvement in the ESG evaluation criteria is needed for VC investments. Highly interested in ESG investing, Korean LPs should systemize the internal evaluation criteria for ESG investing to assess and select VC firms. Recently, Korea Venture Investment Corp. responsible for managing a government fund of funds has established a guideline for better incorporating ESG factors into the investment process and is using the guideline in the selection and management of VC firms. VCs should keep working on more effective internal evaluation criteria going forward. To this end, Korea needs to benchmark how VCs in the EU and US set up ESG investing evaluation criteria for startups. Based on this, VC market players including LPs, VC firms and startups should make concerted efforts to develop ESG evaluation criteria specific to Korea's VC landscape.

Second, VCs should push forward with ESG integration. For ESG investing to take hold, ESG factors should be fully incorporated into the entire investment process including the checklist-based ESG investing by VC firms, the monitoring of ESG risks and performance and the reporting of ESG-related improvements. ESG integration is a key tool for realizing ESG engagement in portfolio companies. Meanwhile, sustainable EGS integration requires VC firms to introduce an ESG-driven management system. In other words, they ought to build the culture and organizational structure encompassing the ESG committee, recruitment of experts and ESG-related performance review for employees and executives as well as engagement activities for portfolio companies.

Third, ESG investing pursued by Korea's VCs primarily focuses on environmental (E) factors but it needs to expand the scope into society (S) and governance (G). In contrast to overseas ESG investing geared toward society (S) and governance (G) dimensions, Korea's VCs give priority to environment (E), in particular climate tech. The target of ESG investing may vary across nations depending on cultural background. Nonetheless, ESG investing also needs to embrace social (S) and governance (G) dimensions to increase the proportion of comprehensive and balanced ESG investing in VC investments.