PRI Launches Much-Anticipated ESG DDQs for Venture Capital

Malk Insights — December 1, 2022

Key Takeaways

- The UN Principles for Responsible Investment (PRI) released a VC investment due diligence questionnaire (DDQ) in November 2022 to provide Limited Partners guidance on evaluating Venture Capital GPs on ESG performance
- ESG due diligence on early-stage companies should include KPI tracking, consideration of sustainability outcomes, and a forward-thinking approach to prevent risk and create value
- Malk's relationship with VC investors to date has placed clients ahead of ESG due diligence recommendations outlined in the PRI's VC DDQ

Background

The International Limited Partners Association (ILPA) and the Principles for Responsible Investment (PRI) developed an investment due diligence questionnaire (DDQ) in 2016 (updated in 2021) tailored for buyout and late-stage investors to evaluate ESG exposure throughout the fundraising process. Earlier this month, the PRI released its first guidance for venture capital investors, providing much anticipated industry-leading guidance on evaluating early-stage investments ESG exposure and further indicating the growing top-down pressure for ESG integration in venture.

Notable aspects of the VC DDQ include the critical need for KPI tracking and evaluation of sustainability outcomes - due diligence steps early-stage investors have kept limited or avoided all together due to portfolio companies' resource constraints and operational immaturity. The VC DDQ suggests a forward-thinking approach related to evaluating ESG exposure with scale and the incorporation of ESG evaluations when soliciting follow-on funding or preparing for exit opportunities, right-fitting ESG integration for VC's longer-term outlook on investing compared to Private Equity.

Given the role venture funding plays as the first institutional capital a growing company receives, VCs have increased responsibility *and opportunity* in creating sustainable, responsible operations.

Integrating ESG into the Investment Lifecycle

The VC DDQ outlines expectations for GPs to identify ESG risks and opportunities in potential investments and engage with portfolio companies on ESG outcomes during the holding period. To date, the VC space has somewhat evaded top-down sustainability pressures thought to only be pertinent to large-scale companies due to the small operations and typical industries targeted by Venture (e.g., tech).

However, the VC DDQ reflects a shift in perspective from Limited Partners (LPs), requiring the assessment of early-stage companies' ESG profile and assigns responsibility to investors to minimize portfolio companies' negative externalities. This includes ESG factors related to climate change and human rights, such as a

businesses' greenhouse gas emissions, biodiversity loss, and use of vulnerable workforces. The VC space has witnessed an uptick in downstream requirements related to human rights and climate - for the technology industry, this includes the adoption of ethical AI and the reporting of GHG emissions to fulfill potential regulatory obligations.

Rapidly scaling companies face risks that can inhibit growth and cause damaging incidents, yet due to limited resources, early-stage companies often lack necessary risk prevention practices. Establishing key controls, such as necessary policies and practices to minimize the likelihood of a data breach, discrimination and harassment incidents, or sales misrepresentation, can assist in building a strong reputation and sound operational practices. Further, fast growth can bring opportunities to capitalize on ESG value creation, such as recruiting a diverse workforce, that can lead to higher retention rates and serve as a competitive advantage.

Ultimately, the consideration of such ESG factors can fulfill industry and investor expectations while positively impacting a company's reputation, leading to greater satisfaction among customers, partners, and employees, and promoting responsible and sustainable operational development from the early days of a company.

Reporting and Disclosure

KPI tracking serves as a valuable tool for reporting portfolio wide ESG performance to investors, developing ESG goals for portfolio companies, and benchmarking against industry and competitor performances. Within certain industries (e.g., TRIR for manufacturing) and large-scale companies (e.g., businesses with 100+ employees reporting diversity data to the EEOC) KPI tracking is cornerstone practice, but this is less reflected among technology companies or early-stage companies. Today, few VC investors push for KPI tracking within portfolio companies to limit additional responsibility assigned to rapidly scaling companies' management teams and because, quite often, the structures necessary for such data collection are not in place at the time of investment. However, the VC DDQ suggests early-stage companies *should* track ESG related KPIs and use the data to support underperforming companies.

Metric tracking provides founders insight into ESG exposure, allowing leadership to preemptively mitigate risk, set goals in-line with industry peers, and remain abreast of trends and opportunities. As an example, tracking diversity and turnover data is not necessarily a common practice for early-stage companies, but for businesses who embrace this initiative, the data can be used to shape diversity retention strategies, a key differentiator when recruiting top talent and reducing turnover. Portfolio wide metric tracking also allows investors to understand trends in relation to ESG strategies, such as portfolio companies providing role-specific data privacy and security training experiencing less data breaches than companies without a training program.

Forward-Thinking ESG Evaluation Approach

Throughout the questionnaire, the PRI embodies a forward-thinking tone reflective of the venture mindset of setting companies up for scale. Beginning in investment sourcing and diligence, the VC DDQ suggests the consideration of future ESG risks and opportunities when evaluating investments. This is a departure from other ESG DDQ questions created for larger Private Equity, which present a gap in evaluating how ESG exposure will change with product expansions, rapidly changing industry trends, and pending regulatory requirements around emerging technologies and data practices; all of which point to the need for a venture-specific approach to ESG practices.

During the hold period, the DDQ indicates the importance of evaluating ESG exposure to assist with follow- on capital and possible exit opportunities. Strong ESG programs support a more lucrative exit (e.g., through attracting more customers with its robust governance program, reducing hiring costs by improving employee engagement and decreasing regrettable turnover).

Since 2020, Malk has been spearheading a tailored approach to ESG integration in Venture Capital and Growth Equity, representative of the differences in investing, portfolio management, and investment size and industry compared to traditional PE. Malk's GP advisory and portfolio support satisfies the VC DDQ's recommended approach, and positions clients well ahead of peers and anticipated LP expectations. While the VC DDQ outlines certain overarching ESG standards for VC investors, Malk works closely with our clients to create internal ESG practices appropriate for a firm based on fund size and goals while still adding value through mitigating risk and exploring competitive ESG opportunities. Moreover, Malk's monitoring services for portfolio companies throughout a holding period provides constant insight about the changes in ESG exposure with a companies' growth, providing ongoing support to scale responsibly and creating a clear narrative of ESG management at exit.

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About Malk Partners

Malk Partners is the preeminent advisor to private market investors for creating and protecting value through environmental, social, and governance ("ESG") management and impact investing. Founded in 2009, Malk Partners advises many of the world's leading alternatives managers investing across private equity, growth equity, venture capital, and private credit by helping them define ESG goals, achieve ESG results, and guide their portfolio companies in driving value creation and mitigating risks. The firm is headquartered in La Jolla, California with a second office located in New York. For more information about Malk Partners, please visit www.malk.com.