ESG challenges and opportunities for European venture capital funds

The core of venture capital is investing in innovation, which is one of the main pillars of transitioning to a more sustainable economy and society including investments in innovative medical technologies, technologies to track GHG emissions and biodiversity. Accordingly, VC investing is critical to ESG.

In Europe, ESG-focused funds are increasingly gaining a competitive advantage when it comes to attracting capital, especially from certain types of investors, including European Development Finance Institutions and other government-owned development banks. "*Climate tech funds are having their moment*" was the heading of the Venture Capital Journal's cover story in its November/December 2023 edition, and there are clear signs that the European clean energy mandates in 2019 and the US Inflation Reduction Act in 2022 have brought momentum into the sector.

However, delivering on ESG commitments in the VC space comes with its own challenges. In particular, smaller, less established or early-stage companies that are typically targeted by VC funds may not have access to the same level of ESG data and may also lack established or sophisticated ESG policies and procedures or reporting lines, which may make it difficult for a VC manager to implement fund level ESG commitments in relation to investee companies.

The SFDR has intensified both challenges and opportunities for ESG-focused funds in the VC space. The SFDR has been used as a de facto labelling regime: Article 9 funds (funds with sustainable investment as their objective) have been perceived by investors as the "crème de la crème" of ESG funds, whilst Article 8 funds (those promoting the environment and/or society without having ESG as their objective) have been very popular although seen as hierarchically lower than Article 9 funds (albeit whether this is justifiable or not is a separate question). However, the use of the SFDR to successfully market a fund is tied to requirements which are not always easy to meet for a VC fund manager due to the nature of the investee companies (as set out above).

All investments of an Article 9 fund must qualify as sustainable investments (within the meaning of the SFDR). This means that each investment must:

(i) have an environmental and/or social objective;

(ii) not do any significant harm to any other environmental or social objective (the "**DNSH Test**"); and

(iii) follow good governance practices.

It can be particularly challenging for a VC manager to pass the second (DNSH test) and the third of these (good governance) when investing in smaller, less established or early-stage companies as these requirements must be met at the moment the investment is made, without the VC manager having time to transition/improve the investee companies to the standards required above.

Article 8 funds investing only a part of their assets in "sustainable investments" (as described above) – the so-called "Article 8+" funds – encounter the same challenges in respect of the proportion of their portfolio that is invested in sustainable investments.

Article 8 funds without any commitment to invest in "sustainable investments" are not without challenges either, because the VC manager must still make sure that all investee companies – whether contributing to the fund's promotion of environmental and/or social characteristics or not – have good governance practices in place at the outset of the investments.

Support from VC managers is crucial for the successful implementation of ESG policies and procedures at the level of investee companies, as having the resources required to develop and maintain such policies and procedures is often a significant issue for such investee companies. A VC manager's expectations in relation to ESG policies and procedures could form part of the initial/pre-investment conversations and agreements with an investee company. Post-investment, VC managers can perform a useful role in helping to provide the necessary support to develop ESG strategies, establish ESG policies and procedures, define specific KPIs to track performance, and set up reporting and escalation procedures.

Due to the rapidly changing nature of early-stage companies, flexibility is key when it comes to ESG policies and procedures in order to enable smooth adaptation that aligns with the changing nature of the investee company's business.

For example, a growing company may be subject to changes to its governance structures or, due to changes to the business, new KPIs may be required to track progress. Accordingly, ongoing engagement and collaboration with investee companies in relation to ESG is key for any VC manager to successfully manage its investments.

The Linklaters Investment Funds team regularly benchmark funds in the market and maintain a database of fund terms across all asset classes and with a variety of fund counsel and target geographies to ensure a representative sample. One term that we are starting to see included in certain VC funds is an ESG-linked carry mechanism, whereby a manager's carried interest is partially linked to the achievement of certain sustainability targets by the fund. We are going to delve into the trends we are seeing in this area in a three-episode podcast series, the first of which is available here. Further episodes will be published on our Funds Catch-Up webpage.

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