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The Role of Venture Capital in Sustainable Finance

Presentation to the UNEP/INSEAD workshop by Brian Pearce

7 June 2002

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Opening thoughts:

"Providing access to new capital for sustainable businesses and projects is key to promoting sustainability. Unlike project finance or private equity, SRI investment funds mostly buy stocks from other investors, rather than providing new capital to business. Their sustainability impact through this channel would be all the greater if they invested more in IPOS (initial public offerings), venture capital or other high impact assets such as property and project finance."

...and on the critical role of SME (small and medium-scale) projects and enterprises…

"The common thread running through the debate on poverty reduction, sustainable energy and water, and cleaner production is that sustainable development in developing economies depends on financing small and medium-scale projects and enterprises, through leveraging private finance…."

The London Principles project

- Analysis of the role of financial services
  - Pricing assets and exercising ownership
  - Supplying new capital
  - Risk management
- Case studies of innovations today
- Thought-leadership on innovations tomorrow
- Principles for a sustainable financial system

Pricing assets and exercising ownership

Functions	Business area	Sustainability problems	Solutions	UK innovations
Pricing assets and exercising ownership	Asset management - stock selection - corporate governance Investment banking - research - trading	Equity/debt prices not reflecting sustainability performance. Ownership not being exercised to promote sustainable asset use.	Measurement of corporate performance and impact on business value/risk. Shareholder engagement on sustainability performance. Create market in unpriced environmental asset/ service.	Pensions Act Regulations Corporate reporting on sustainability performance SRI asset management techniques (both stock selection and corporate governance) Emissions/ waste trading

Supplying new finance

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Functions	Business area	Sustainability problems	Solutions	UK innovations
Providing new finance	Commercial banking - credit - leasing Investment banking - project finance - new issues - private equity	Sustainability risks not integrated into credit risk assessment/due diligence. Access to finance difficulties for new technologies/ processes. Access to finance difficulties for the poor.	Assess and integrate sustainability risks into credit risk assessment/ due diligence. Include sustainability impacts (to project viability and bank's reputation) in project finance cost-benefit analysis. Easier listing requirements for small sustainable venture IPOs. Set up private equity/VC funds to invest in environmental technologies/ sustainable new	Specialist banks in credit, community finance, micro-credit and leasing for sustainable businesses (Triodos-UK, Coop) Investment bank due diligence (UBS Warburg's environmental risk management system). IPO capacity. Private equity/VC funds (biggest in EU, 2nd only to the US).

Risk management

Functions	Business area	Sustainability problems	Solutions	UK innovations
Risk management	Insurance - reinsurance - non-life Investment banking - derivatives	Threat to solvency of reinsurers and lack of insurance cover for business and households as a result of climate change. Contaminated-land brownfield redevelopment hindered by risks of unforeseen liabilities and clean-up cost overruns.	Transfer weather risk to capital markets through new weather hedging instruments. Encourage mitigation and adaptation by the companies and households seeking insurance for extreme weather events. Cost-cap, liability and other insurance instruments to mitigate risks and facilitate brownfield redevelopment transactions.	Environmental liability insurance. Lobbying on planning regulations and education programmes to mitigate climate risks, especially flooding. LIFFE and derivatives capacity

Regulatory drivers for SRI

- Pension fund disclosure on SEE issues
- Stock exchange rules on corporate risk management
- Company Law Review on reporting ‘material’ aspects of corporate SEE performance
- *Plus* continued popularity of SRI for individual investors

UK Institutional investors and sustainability

- Source of investment success
  - Specific business opportunities (renewable energy)
  - SEE link to corporate success (eco-efficiency etc)
- Implementation
  - Active dialogue with companies not at leading edge
  - Stock selection directing capital to leading edge
  - Private equity failure?

Example: Henderson's SRI Proposition

- Investing in sustainability solutions (Industries of the Future – entry on PE)
- Seeking out corporate responsibility leaders
- Engaging with companies
- Screening according to client values
- Policy dialogue to help shape market conditions

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Henderson:
Assessing business sustainability

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Opportunity ← → Risk

Industries of the future	Gatekeepers	Sensitive	Controversial	Extreme
•Renewable energy	•Finance	•Pharmaceuticals	•Automobiles	•Alcohol
•Education	•Retail	•Construction	•Chemicals	•Tobacco
•Mass transport	•Leisure	•Engineering	•Mining	•Gambling
•Healthcare	•Telecomms	•Forestry	•Fossil fuels	•Nuclear
•Waste management	•Media	•Food and beverage	•Air travel	•Military
•Water				

The added value chain

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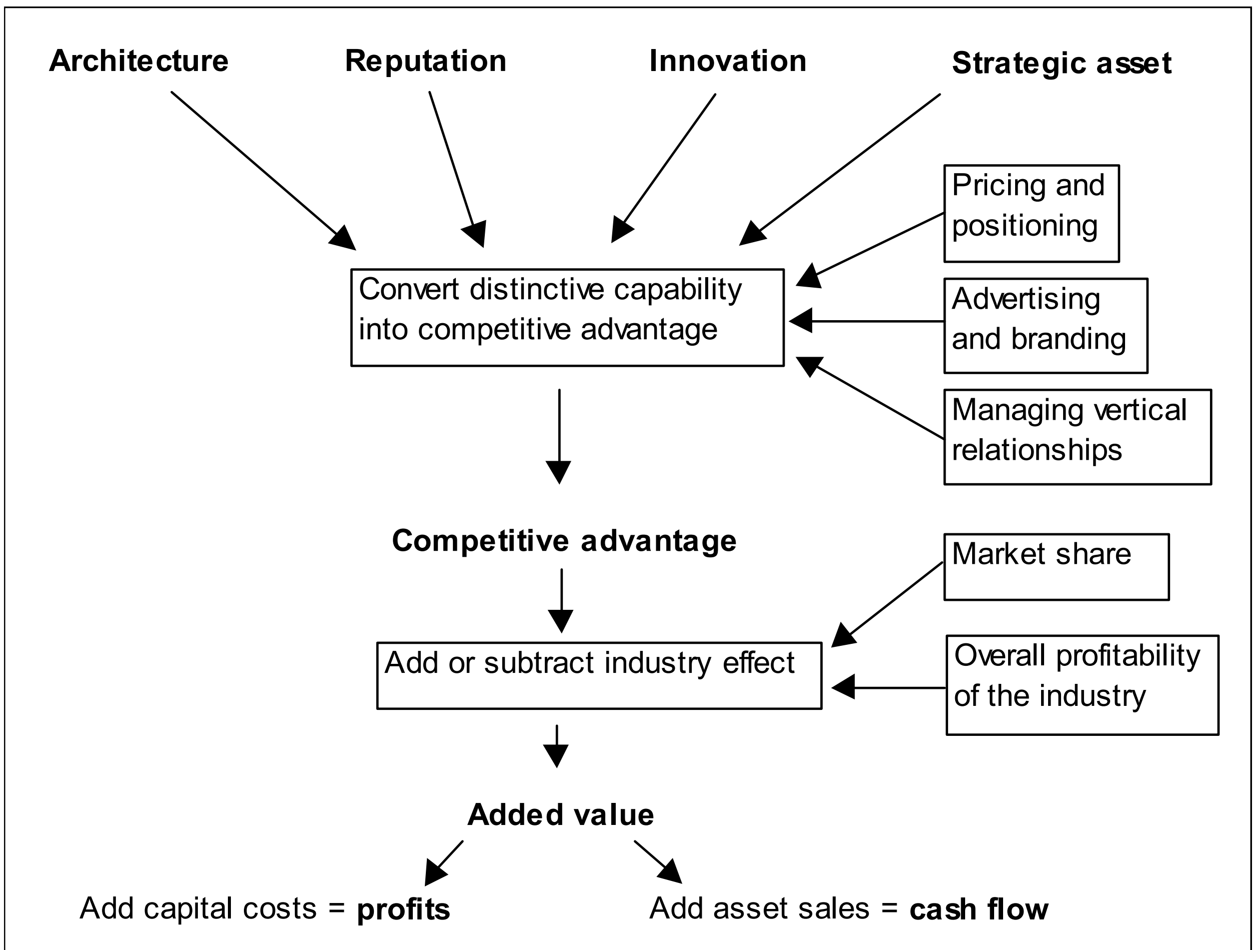
Relationship with	Financial Flow	Value (m. Euros)
XYZ company, value added statement, 1989		
Customers	Revenues (sales at market prices)	18,834
Workforce	Wages and salaries	2,354
Investors	Capital costs	1,065
Suppliers	Materials	8,844
Government	Taxes	5,846
	Added value	**725**
Environment	None	(700) from green accounts
	Added value not appropriated from the stock of natural capital	**25**

Creating competitive advantage from sustainability and CSR



Regulatory drivers for private equity

- Utilities deregulation
- Environmental regulation
- *Minus* regulatory uncertainty/poor design
- *Plus* technology and customer preferences

Private equity failure in the UK?

Rates of return on private equity by investment stage Net IRR, % pa				
Stage	**1 year**	**3 years**	**5 years**	**10 years**
UK (to end 1999)				
Early	40.9	15.8	16.7	8.7
Development	43.8	30.4	27	12.6
Large MBOs	23.9	31	26.4	23
US (to Sept 1999)				
Early/seed	91.2	47.9	46.6	24.5
Later stage	55.5	28.4	34.8	25.4
Buy-out funds	15.2	16.6	16.7	16.7

Source: Myners Review

Myners Review

- Institutional investment in private equity
  - UK 0.5-0.8% of assets
  - US 4.8-6.6% of assets
- What is the problem?
  - Supply of funds (excessive discounting by investors)
  - Supply of entrepreneurs (inadequate returns)

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