Sustainable start-ups should consider corporate venture capital first

February 28 2020, by Deborah De Lange and Dave Valliere

Credit: William Fortunato from Pexels

Urgent issues like the climate crisis, environmental degradation threatening millions of species, social inequality and other challenges mean that the global economy needs to immediately transform itself to become sustainable.

Sustainable start-ups

are showing us the way with

smart business models having economic, social and environmental value.

Toronto's Ripple Farms is an example demonstrating the power of aquaponics to sustainably produce organic greens and seafood throughout the year. To connect urbanites with the land, the company's business model combines product offerings with education on urban agriculture.

Similarly, Waterloo Energy Products sells a full range of residential and commercial renewable energy designs including geothermal, solar, LED lighting equipment, water treatment solutions and much more. By offering a one-stop shop at its Sustainable Living Centre, they have made renewable energy choices much easier for consumers.

Both firms bundle products and services in different ways with a potential to expand internationally.

Many companies in Canada's sustainable sector have similar potential to export Canadian products and expertise around the world.

Finding the right investor

But Canada needs these firms to grow rapidly and substantially so they can create jobs that other unsustainable businesses are shedding as they become obsolete. Investors are key to accelerating this urgently needed start-up growth in Canada's sustainable sector.

According to the United Nations' seminal Brundtland Report, sustainable development should meet the needs of current generations without compromising the capacity of future generations, ensuring a balance between economic growth, care for the environment and social well-being.

These three main components of sustainable development are considered together, not as separate goals. Good governance is required to ensure and oversee all three of them.

In this complex business environment, finding investors to scale up new companies and, even more importantly, finding the right investors, is challenging. Start-up ventures burn through cash rapidly as they aim for a sale of the company —usually to other larger firms or on the stock market through an initial public offering.

Raising funds to grow start-up companies is an ongoing challenge that pulls management away from running the business. By finding knowledgeable, committed investors who understand the business, a firm can ease the constant stress of raising capital while legitimizing the company to consumers, clients and stock markets.

Unfortunately, sustainable ventures face additional challenges when it comes to investors compared to purely for-profit firms because they appear to have multiple competing goals.

Stiff competition

Sustainable firms often face powerful well-established competitors —renewable energy firms, for example, must overcome obstacles in a world entrenched in oil and gas.

People are hesitant about new technology even if it improves their lives.

The choice between fossil fuels and renewables is not unlike trading a typewriter in for a laptop. This fear of uncertainty gives traditional firms market advantages that new companies must overcome.

Many sustainable industries still in technological development stages are also capital-intensive, meaning that they need a lot of capital upfront before they can demonstrate viability.

In addition to their unfamiliarity to potential stakeholders, some have experienced highly publicized failures, such as Solyndra, along the way to technological maturity. This can scare off investors.

Renewable energy firms must often overcome obstacles in an oil-and-gas world. Credit: Thomas Richter/Unsplash

Advice for sustainable companies

My colleague Dave Valliere and I recently tested a quantitative model using data on 184 entrepreneurial ventures. The analysis found that sustainable start-ups are better off choosing a different type of investor, one with aligned interests who can lend it legitimacy so that others will have confidence in it.

Perhaps surprisingly, it's not so much angel investors as corporate venture capital that can help these firms grow. In this model, the corporation usually sets up a separate division that looks for investments of interest to it.

The problem for most investors is that the quality of a new venture is uncertain until after it has grown to a point where it is steadily increasing revenues and generating healthy profits.

A new venture needs to be novel enough to have a competitive advantage while familiar enough to be understood and accepted. As a result, many investors look for signs of the hidden potential of a venture. An example could be the quality of existing stakeholders in the venture, such as successful, high-profile members on the board of directors or the presence of professional investors.

Our study indicates that angel investors, venture capitalists and investment banks do not create confidence in sustainable ventures. It found that investment banks can even have adverse consequences for businesses in the sustainable sector that are seeking legitimacy.

Try a different strategy

A lack of confidence in bankers since the 2008 financial crisis could be playing a part. Usually, new ventures begin with angel investors and move on to venture capital and other types of more sophisticated financiers who can further develop and market the firm. Instead, we advise sustainable firms to use a different strategy and seek out corporate venture capital as it is uniquely more helpful to sustainable ventures.

The usual investment life cycle progression of a new venture —moving from angels to venture capital and then to more sophisticated types of investors —may not always hold.

A venture attracts additional capital by meeting an investor's screening criteria, but the most recent investors matter too. Current investors can lend legitimacy to attract other investors. According to our findings, the sustainable sector gains that legitimacy with corporate venture capital over other types of investors.

This result suggests that the credibility of corporate venture capital plays an important role in the development of sustainable businesses.

A corporate venture capital firm may choose to invest in a venture with promising technology, even if the company has weak management or an unlikely strategy; sometimes, they just want to learn from another's technology to help them make strategic choices about future technological options.

Positive reputation

If they're interested in the venture as a whole, a corporate venture capital firm can replace the management and/or the strategy of the new venture after acquisition. While the corporation offers its target more resources and strategic guidance, it also gains due to the positive reputation of the new venture.

Overall, a corporate venture capital endorsement of a new venture and its potential acquisition suggests to the market that the company is poised to be a disruptive winner in the industry. Corporate venture capital cuts through the noise that often accompanies sustainability goals. Change is in the wind for an industry, and others want to jump on the upward trajectory.

Sustainable ventures can markedly contribute to Canada's economy and employment with the right investor strategies to help them grow to medium and large size. Some of these startups are exciting in many ways. Most significantly, they will improve Canadians' lives and ensure we have a healthier environment.

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