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The Relation between Social Responsibility and Exit Performance of VC-Backed Entrepreneurial Firms

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Abstract

This study analyzes the probability of successful exit by venture capital (VC)-backed entrepreneurial firms that focus on "clean energy" initiatives. Such initiatives include generation from renewable sources as well as conservation. The empirical analysis, for ventures between 1990 and 2014, documents that clean energy investments have a higher probability of successful exit than do non-clean energy ventures. In addition, the results show that both solar and alternative energy VC-backed entrepreneurial firms allow their investors a shorter duration to exit.

The Relation between Social Responsibility and Exit Performance of VC-Backed Entrepreneurial Firms

An enormous body of literature has emerged concerning corporate social responsibility and corporate financial performance, but there has not been sufficient research concerning socially responsible investing and new venture performance. In studying this concept, the greatest dilemma arises in trying to measure it. There is no universally accepted measure of social responsibility, forcing researchers to create their own. In this study, a venture capital (VC)-backed entrepreneurial firm is classified as "socially responsible" if it operates in the clean-energy industry.

It is common for venture capitalists to be hesitant about clean energy ventures because of proven difficulties in producing a financial return by achieving a successful exit. If investors were given evidence that clean energy ventures can be successful, awareness for socially responsible practices would heighten. It is important that society not ignore the changing environmental, economic, and social conditions that are taking place. Opening the eyes of venture funds to entrepreneurial ventures that are beneficial to these societal changes can have a profound impact.

The 2015 New York State Energy Plan mandated that all New York companies reduce their carbon emissions 40 percent by 2030. Through this regulation, social responsibility is becoming an obligation of firms rather than a choice. Firms are going to have to start incorporating social practices into their business models as they would any other economic or financial practice. In the face of climate change, investing in the research and development of clean energy is one of the most impactful steps society can take in curbing global warming. However, evidence shows that "doing good" does not always come at a cheap price. A *Wall Street Journal* survey (2008) found

that 85 percent of U.S. investors and developers would increase business allocations to social practices if it met their risk and return criteria. In other words, hesitation to invest in a socially responsible way stems from the perception that the return/risk proposition is not beneficial. But this question has not yet been studied empirically for new ventures, a gap that this paper attempts to fill.

Literature Review

The concept of social responsibility is relatively new, and not sufficiently researched in the venture capital world. Despite the absence of literature in this area, there is no doubt that the scientific and professional public now pay increasing attention to the concept of social responsibility in both concept and practice. Social responsibility has always been recognized as a significant means to consistently maintain and reinforce the relation between companies and society, as a way to promote the general welfare through virtuous and sustainable management of resources. Through socially responsible behavior, companies demonstrate their concerns for the community and the environment in their business activities and in their connection with other stakeholders (Andonov 2015).

Because it can become expensive to act socially responsible, while also earning a profit, some companies direct their efforts toward one particular area that they consider most important or where they have the biggest influence or need to improve. Other companies attempt to integrate social responsibility in all aspects of their operation. However, if a company wants to successfully apply social responsibility in all aspects of its operation, it must be an integral part of the firm's business values and strategic planning, the specific objectives and the basic competences of the company, and both the management and the employees must be devoted to it. According to Dentchev (2004), this includes accurate formulation of the mission and the key values of the company,

application of the ethical code, application of the management code, risk analysis, providing training in ethical behavior, establishing measures and preparing reports on the social, ethical, and ecological aspects of the business.

Although a VC-backed entrepreneurial firm may not be this seasoned in its business practices, this framework still applies. A start-up firm can be considered socially responsible so long as it has a mission tied to its business practices that positively affect its community or society as a whole. A few examples include education reform, environmental sustainability, poverty alleviation, or water management and conservation.

The degree to which a firm devotes its resources and efforts to a socially responsible mission depends on legal requirements and pressure exerted by its stakeholders. A socially responsible operation and mission may provide sustainable competitive advantage, which can not only strengthen the company image, brand position, sales and market shares, but also reduce operational costs and draw a more talented and motivated work force to the business (Andonov 2015).

Existing literature on the relation between social responsibility and the performance of a firm has found three disparate results: (1) negative, (2) insignificant, and (3) positive. Moskowitz (1972) provides an initial motivation for examining the relation between corporate social responsibility and profitability. Moskowitz suggests that socially responsible firms are acceptable investment risks even though "there is at this point no real evidence that capital markets will be materially affected by social performance" (Moskowitz 1972). Moskowitz also recommends 14 firms as potential investments because of their social performance. However, he never reveals the specific criteria he uses in selecting these 14 firms. The next issue of *Business and Society Review* observes that the 14 socially responsible firms Moskowitz identified had registered a stock price increase of

7.28 percent over the previous six months, in contrast to a 4.4 percent rise for the Dow-Jones, a 5.1 percent increase for the New York Stock Exchange Index, and a 6.4 percent gain for Standard and Poors 500 during that period. This finding has been used to support the notion that socially responsible firms are good investments.

Vance (1975) challenges the findings and claims of Moskowitz. By examining the market performance of Moskowitz's original 14 recommended firms from 1972 to 1975, Vance finds that stock in all of the firms had declined in price and had performed far worse than the Dow-Jones, the New York Stock Exchange Index, and the Standard and Poors Industrials. To support his finding, Vance conducted a further analysis controlling for firms' social responsibility levels. By comparing the financial performance of the highest rated firms with that of the lowest rated, he finds that the lowest rated firms actually outperformed the highest rated firms, and he concludes that socially responsible firms underperform.

Alexander and Buchholz (1978) use the betas of each firm to adjust for the sensitivity of the firm's stock returns to overall market movements. They conclude that there is no significant relation between stock risk levels and the degree of social responsibility. Alexander concludes that "these findings suggest that the interpretations of both Moskowitz and Vance are invalid."

A number of different approaches to measuring a firm's social responsibility are taken in other studies. Bowman and Haire (1975) identify firms as low or high in social responsibility by counting the number of lines devoted to the topic in the firms' annual reports. The authors classify 82 firms into high, medium, and low social responsibility categories and then evaluate each category on the basis of a 5-year return on equity (ROE). The researchers find that the firms with medium ratings for degree of social responsibility perform the best and the firms with low ratings perform

the worst, suggesting there is a U-shaped relation between social responsibility and the performance of a firm.

Abbott and Monsen (1979) perform a content analysis on 28 items in firms' *Fortune* 500 annual reports. They construct a Social Involvement Disclosure (SID) scale that they use as a proxy for social responsibility. By dividing 450 firms from the *Fortune* 500 into high and low groups on the basis of the scale and then examining each group for profitability, Abbott and Monsen find little difference in investment yield between firms in the two groups. The study concludes that investing in socially responsible firms is neither helpful nor harmful to investors' returns.

Parket and Eilbert (1975) took yet another approach. Upon contacting firms from the *Forbes* 1971 Annual Directory, the researchers claim that the 96 firms that responded are more oriented toward social responsibility than are the nonrespondents. Parket and Eilbert then use dollar net income, profit margin, ROE, and earnings per share (EPS) for financial measures to compare the performance of the 80 allegedly socially responsible firms to the *Fortune* 500 firms. Results show that the 80 respondents who were considered to be the most socially active are more profitable.

The existing literature reflects both varying methodologies and different degrees of rigor, but all seek to find the relation between degree of social responsibility and financial performance for firms. Most arguments against the conclusions from existing studies in this area have been directed toward how to best capture a firm's degree of social responsibility and financial performance.

In the case of an entrepreneurial start-up firm, there are most likely no financial reports available to use for performance measures. This is even more likely in the case of a VC-backed entrepreneurial firm because it could still be going through funding rounds, have just gone public, merged with another firm, been acquired by another firm, or even exited without success. While there is no set measure for a company's degree of social responsibility, existing literature shows that there are various acceptable proxies.

The Hypotheses

Very little is known about the effect of having a socially responsible mission on the exit success of a VC-backed entrepreneurial firm. Therefore, an important question is whether such a relation exists. In testing for this relation, "socially responsible" is defined as operating in a clean energy industry, whereas a non-socially responsible venture is operating in the energy industry apart from the clean-energy sector. "Exit success" is defined here as it is throughout the literature: the firm is acquired by another (usually at a large price premium) or it is taken public in an initial public offering (IPO), again usually at a large premium over the initial investment price.

The hypotheses can be stated formally as follows.

H_0: The frequency of successful exit by VC-backed clean-energy firms is no higher than for non-clean-energy firms.

H_1: The frequency of successful exit by VC-backed clean-energy firms is higher than for non-clean-energy firms.

The null hypothesis states that the energy sector in which a venture operates is independent of its probability of successful exit. In venture capital financing, it is relatively difficult to get money

out of an investment because the VC-backed firms are generally private companies. When a firm is private, the shares cannot be sold nearly as easily as when the firm is publicly traded on a stock exchange, meaning the venture capitalists and entrepreneurs face a liquidity problem. In order to gain access, investors must "cash out" through an initial public offering (IPO) or sale of the firm to another company.

An IPO is the first sale of stock by a private company to the public. A VC-backed entrepreneurial firm seeking to become publicly traded and expand its capital would opt for an IPO as one way to exit successfully. Another route a firm could use is a merger or acquisition (M&A) with another, typically larger, firm. A M&A is a general term referring to the consolidation of companies. More specifically, a merger is a combination of two companies to form a new company, while an acquisition is the purchase of one company by another in which no new company is formed. A venture is considered to be an unsuccessful investment if the subject company does not go public, or merge with or be acquired by another company.

The alternative hypothesis is that a venture operating in a clean energy subindustry is more likely to have a successful exit than a venture operating in a non-clean energy subindustry. Clean energy ventures have a better chance of reaching success because they have a more beneficial and prolonged effect on the community in which it operates. The paybacks do not come strictly from the financial returns, but also from the environmental, social, and economic impacts the company exudes and continues to exude as it exists.

A second set of hypotheses relate to how long it takes a VC investor to exit socially responsible firms.

H_0: VC-backed entrepreneurial firms in a socially responsible (clean energy) sector realize no shorter duration to exit than firms outside the clean energy sector.

H_1: VC-backed entrepreneurial firms in a socially responsible (clean energy) sector realize a shorter duration to exit than firms outside the clean energy sector.

The second null hypothesis states that the time between when a VC-backed company receives its first investment and when it exits is not affected by the industry in which it operates. A company in a clean energy industry will have the same exit duration as a company in a non-clean energy industry.

The second alternative hypothesis declares that exit duration is dependent on company industry. It takes less time for a VC-backed firm to exit if it is in a clean energy industry. This implies that if a firm exits successfully, investors can earn financial returns faster when financing a clean energy venture as compared to a non-clean energy venture.

The Data

In order to test the hypotheses, I collect a sample of VC-backed entrepreneurial firms operating in the energy industry from VentureXpert, a source of data on venture capital and other early stage funding for companies. It contains thousands of round-level venture capital transactions for companies in various industries starting in the year 1990 through the year 2014. For each investment transaction, there is the name of the company that is receiving it, primary industry in which the company operates, date in which the investment was received, total funding the company has received to the current date, location of the company, stage the company was at when it received the investment, round number, round size, name of the venture capital fund that made the investment, and an exit date that includes whether the company went public or merged or was acquired.

By filtering the company primary industry to those just in the energy industries, the dataset falls to a total of 921 round-level transactions. Table 1 displays the primary subindustries that are classified as clean energy for the analysis: solar energy, wind energy, energy co-generation, energy conservation related, and alternative energy. Energy co-generation is a thermodynamically efficient sustainable energy process; alternative energy is any energy source that is an alternative to fossil fuels. Companies in the energy related industry are classified as non-clean energy ventures because they fall outside the clean energy categories.

In order to create the final sample, the round-level transactions are consolidated to company-level transactions, meaning there is one observation per company. The company observation with the earliest investment received date remains and all others are dropped, producing a final sample of 208 observations, or companies. Approximately 95 percent of the sample is clean energy firms with the majority in the solar energy industry, and 5 percent is non-clean energy firms, all of which operate in the energy related industry.

Preliminary findings from the sample are exhibited in Table 1. The number of observations refers to the number of companies in each subindustry within this sample. Solar energy holds the largest portion with 82 companies, whereas energy related and alternative energy subindustries hold the smallest portions with 11 and 9 companies, respectively. The average total funding received is calculated by averaging the sums of all the round-level investments for each company. For example, a company in solar energy is estimated to receive 30.26 million dollars in funding over the duration of its venture capital financing. The average number of investors, average number of rounds, and average round size are all company-level metrics. Based on this sample, a solar energy venture can expect to receive 16.55 million dollars in each of its three rounds of financing

from six different investors. The number of investors financing each round is unknown. The average duration to exit is the time between when a company receives its first investment and when it exits. Ventures in the solar energy subindustry take approximately 5.08 years to exit. Lastly, the exit by IPO or trade sale indicates the total number of companies that have exited in these ways.

TABLE 1
Summary Statistics of VC Industry Type

VC Industry Type	Number of Observations	Average Total Funding Received (millions)	Average Number of Investors	Average Number of Rounds	Average Round Size	Average Exit Duration (years)	Exit by IPO or Trade Sale
Clean Energy	**197**	**$30.26**	**6**	**3**	**$16.55**	**5.08**	**25**
Solar Energy	82	52.33	9	3	31.21	5.18	13
Wind Energy	34	25.16	8	4	20.21	4.21	6
Energy Co-Generation	42	54.33	4	3	15.89	10.02	2
Energy Conservation Related	30	13.89	7	3	8.64	4.31	2
Alternative Energy	9	5.58	4	2	5.81	1.69	2
Non-Clean Energy	**11**	**$20.68**	**5**	**3**	**$6.42**	**5.91**	**2**
Energy Related	11	20.68	5	3	6.42	5.91	2
t-test *p*-value		0.22	0.28	0.00***	0.09*	0.26	0.00***

***Significant at the 0.01 level.
**Significant at the 0.05 level.
*Significant at the 0.10 level.

The *p*-value represents the significance of the difference between clean and non-clean energy means. The metrics from Table 1 indicate that on average, clean energy firms have more investors involved, receive more total funding, and have larger round sizes than do non-clean energy firms. However, only the differences between round sizes and number of IPOs and trade sales are significant. Before conducting any regression analyses, researchers can reason that clean energy ventures dominate the energy sector because more investors are involved and more funding is devoted to them. On the other hand, these findings can suggest that clean energy ventures require

more investors, larger rounds, and more total funding than non-clean energy ventures do to be successful or even unsuccessful. The regression analyses will provide further insight to these arguments.

The Variables

In what follows, the main variables are described and defined. Table 2 displays the descriptive statistics.

TABLE 2
Descriptive Statistics

Variable	Number of Observations	Mean	Min	Max
Success	208	0.115		
Clean	208	0.947		
Solar Energy	208	0.394		
Wind Energy	208	0.163		
Alternative Energy	208	0.043		
Energy Conservation Related	208	0.144		
Energy Co-Generation	208	0.202		
Energy Related	208	0.053		
Early Stage	208	0.279		
Seed Stage	208	0.159		
Expansion Stage	208	0.221		
Later Stage	208	0.063		
Location	208	0.264		
Log Number of Rounds	208	2.197	1.503	2.443
Log Round Size (millions)	156	1.847	-2.352	7.269
Log Number of Investors in Company	206	1.702	1.000	4.135
Log Total Financing in Company (millions)	161	2.970	-1.996	7.350

Success is a binary dummy variable used to value a venture's way of exit. As explained before, the success of a new venture is hard to measure because there are often no financial statements, no share prices, and virtually no useful public information in existence. For the purposes of this

analysis, a venture that exits by IPO or M&A takes the value 1 noting a successful exit, whereas a company that fails to exit or exits with no result takes the value 0.

Clean is another binary dummy variable used as a proxy for social responsibility. By distinguishing clean energy ventures from non-clean energy ventures, the analysis can yield results to which one is more successful. Solar energy, wind energy, alternative energy, energy conservation related, and energy co-generation subindustries take the value 1 and those in the energy related subindustry take the value 0. For further analysis, binary dummy variables are created for each of the six subindustries: *solar energy*, *wind energy*, *alternative energy*, *energy conservation related*, *energy co-generation*, and *energy related*.

There are four main stages in venture capital financing. The earliest stage is the *seed stage*. A company in this stage has usually not yet established a continuous stream of cash to fund research and product development. This can make companies in the seed stage quite difficult business opportunities for investors, hence why outside investors do not usually come in until the *early stage*. A company that has been in business for a short time, but has not yet put its product in the marketplace is considered to be in the early stage. This stage can become very expensive for venture capital funds because new businesses can consume vast amounts of cash quickly. Once the venture exhibits substantial growth, it begins to receive venture capital funding to add fuel to the fire; it is in the *expansion stage*, a stage for enabling expansion to additional markets and the diversification and differentiation of product lines. Post expansion stage is the *later stage*, a stage when companies are seeking pathways to public markets. If all goes well, the company can IPO or M&A, and the investors may sell their shares and end their engagements with the company. All four stages of venture capital financing serve as binary dummy variables in this study. It can be concluded from

Table 2 that most of the ventures in this sample are in the early stage because it exhibits the largest mean value amongst all other stages.

The last binary dummy variable used in the regression analyses is *location*. For the purpose of this study, the variable takes the value 1 if the company operates in California, 0 otherwise. The state of California is home to Silicon Valley, a portion of the San Francisco Bay Area known for its thousands of startup companies. It accounts for one-third of all of the venture capital investment in the United States and is therefore tested for its significance in the success of this sample's ventures.

Log number of rounds is the logarithm of the total number of rounds each company received financing.

Log round size is the logarithm of the average round size across all rounds for the company.

Log number of investors in company is the logarithm of the total number of venture capital funds that have invested in the company.

Log total financing in company is the logarithm of the total amount of funding the company has received thus far.

Results

Does clean energy affect the probability of success for a venture?

As noted, the first null hypothesis is tested using a probit model. Table 3 shows the results.

The probit regression yielded no significant result between the dependent and independent variable. Since the *p*-value of the *clean* marginal increase in probability is greater than 0.10, the null

hypothesis cannot be rejected. Therefore, this analysis concludes that there is no relationship between the success of a venture and whether it operates in the clean energy industry or not. Whether the company functions in California or elsewhere is also of no significance.

TABLE 3
Determinants of Venture Capital Success, As Measured By IPO and M&A

Dependent variable: success

Independent variables	Coefficients	Marginal increase in probability
Clean	0.021	0.107
	(0.97)	
Log Number of Investors in Company	0.196	0.034
	(0.32)	
Log Total Financing in Company (millions)	0.018	0.016
	(0.84)	
Early Stage	0.749**	0.062
	(0.05)	
Expansion Stage	1.005**	0.065
	(0.03)	
Later Stage	0.879*	0.097
	(0.08)	
Location	-0.103	0.054
	(0.74)	
Number of companies = 159	Pseudo R^2 = 0.080	

The table presents results of a probit.
p-value in parentheses.
***Significant at the 0.01 level.
**Significant at the 0.05 level.
*Significant at the 0.10 level.

However, it did suggest that there is some significance between the stage a company is in when it receives its first investment and its ability to IPO or M&A. One would think that if a company was in the later stages of venture capital financing that it would have a higher probability of reaching success, but these results beg to differ. Companies in both the early and expansion stages demonstrate a greater chance of exiting successfully at the five percent significance level; companies in the later stage show a greater chance of exiting successfully at the ten percent significance

level. This implies that investors should get involved with premature ventures because they have a better chance of receiving a financial return.

Does the type of clean energy subindustry affect the probability of success for a venture?

The regression yields no significant results when all clean energy subindustries are aggregated into one clean energy industry variable. However, this is not the case when the subindustries are regressed individually against the control variables. Table 3.1 presents findings from the second regression.

TABLE 3.1
Determinants of Venture Capital Success, As Measured By IPO and M&A

Dependent variable: success

Independent variables	Coefficients	Marginal increase in probability
Solar Energy	0.644*	0.059*
	(0.09)	
Wind Energy	0.297	0.070
	(0.50)	
Alternative Energy	1.027*	0.101*
	(0.10)	
Log Number of Investors in Company	0.131	0.034
	(0.53)	
Log Total Financing in Company (millions)	0.051	0.015
	(0.60)	
Early Stage	0.745*	0.059*
	(0.06)	
Expansion Stage	0.856**	0.063**
	(0.04)	
Later Stage	1.082*	0.094*
	(0.07)	
Location	-0.259	0.056
	(0.45)	
Number of companies = 159	Pseudo R^2 = 0.118	

The table presents results of a probit.
p-value in parentheses.

***Significant at the 0.01 level.
**Significant at the 0.05 level.
*Significant at the 0.10 level.

VC-backed firms in both solar and alternative energy subindustries demonstrate a higher probability of success at the ten percent significance level than do non-clean energy firms. For each new solar energy venture, chances of it exiting by IPO or trade sale increase by approximately 5.9 percent. For each new alternative energy venture, chances of it exiting by IPO or trade sale increase by about 10.1 percent. These odds provide evidence against the null hypothesis and in support of the alternative hypothesis. Investing in clean energy is not always an automatic loss like most investors think. In fact, according to these results investors have a greater chance of earning profits by financing clean energy ventures than they do financing non-clean energy ventures.

TABLE 4
Determinants of Venture Capital Duration to Exit

Dependent variable: log exit duration		
	(1)	(2)
Independent variables	Coefficients	Coefficients
Clean	-0.398	
	(0.68)	
Solar Energy		-0.824*
		(0.06)
Wind Energy		0.638
		(0.30)
Alternative Energy		-1.766***
		(0.01)
Log Number of Investors in Company	0.647*	1.262***
	(0.08)	(0.00)
Log Total Financing in Company (millions)	-0.057	-0.285*
	(0.73)	(0.07)
Stage dummies	included	included
Location dummy	included	included
Number of companies = 19	*Adj* R^2 = 0.195	*Adj* R^2 = 0.692

The table presents results of an OLS regression.
p-value in parentheses.
***Significant at the 0.01 level.
**Significant at the 0.05 level.
*Significant at the 0.10 level.

Do clean energy ventures realize a shorter duration to exit?

Solar and alternative energies reveal a greater probability of success as compared to non-clean energies, but is it taking them longer to exit? Using the *log of exit duration* for the dependent variable and the clean energy subindustries for the independent variables, the results displayed in Table 4 are obtained.

The direction of the coefficients on the solar and alternative subindustry variables represent a negative relation to the *exit duration* variable. This means that ventures in alternative and solar energy subindustries exit significantly faster than other ventures, 1.77 and 0.82 years faster, respectively. Since the coefficients are significant at the ten and one percent levels, the null hypothesis is rejected. Investors not only have a greater chance of success when investing in clean energy, they also obtain that success faster.

Conclusions

This study presents two findings to fill the gap in literature regarding social responsibility and VC-backed entrepreneurial firms. Significant results are observed for an analysis of 208 energy companies from the VentureXpert data base. Among those 208 companies, 197 are classified as socially responsible and 11 are classified as "not socially responsible." Because of the small sample size for the latter group, results should be interpreted with care. However, they likely still have some insight to offer.

The results show that clean-energy ventures are more likely to achieve success through an IPO or trade sale than are non-clean energy ventures. Thus, there is no evidence that VC investors should shun socially responsible firms operating in solar and alternative subindustries.

The second conclusion is that not only do socially responsible VC-backed entrepreneurial firms exit with greater success, they also exit faster than do non-socially responsible firms. This combination would be considered is a twofold victory for venture capitalists.

This study provides a starting point for future empirical work regarding venture capital investing in socially responsible firms. Work such as this is important as businesses and society grapple with the question of how to move toward more sustainable industrial activities.

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