# ENHANCING STARTUP VALUATION THROUGH SUSTAINABILITY

*Research Paper*

Frank Soans, SSBM, Geneva, Switzerland, frank@ssbm.ch

Dr. Bojan Kostandinovic, SSBM, Geneva, Switzerland, bojan@ssbm.ch

## Abstract

*Young, agile, innovative are some adjectives that can be used to describe startups. Known to disrupt and change markets they are also early adopters of cutting-edge practices. However, startups do have a very low success rate and a major reason is the lack of funds. Startups operate with limited assets and visibility on profit margins. Investors secure their investment based on the reputation and credit worthiness of startup founders or valuation methods. A pivotal question is, are there missing variables in these valuation approaches? The answer is, 'Sustainability'. Today there is a need for greater accountability on sustainability in businesses and sustainable funding too is increasing. Startups with a sustainable approach can be more attractive to investors. This paper proposes for startups to adapt a sustainable first approach not only in meeting societal demands but also to enhance the startup's value. Sustainable valuation will help founders and investors alike in identifying long-term benefits of a startup's sustainable approach.*

*Keywords: startups, sustainability, funding, environmental, societal, economy, design, business model, financial planning, startup valuation, sustainable valuation*

## 1   Introduction

Given rapid changes in climate, mass human migration to economically stronger countries, increased activism around social justice, inclusion, equity and diversity, sustainability is evolving not just as a good to have approach, but a necessity and a requirement. Regulations are being implemented to address it through a call for greater Environmental, Social and Governance accountability in organizations. In the European Union, the Sustainable Finance Disclosure Regulation (SFDR) is active. Across many other nations especially the G7 countries, the Task Force on Climate-Related Financial Disclosures (TCFD) framework is being adopted, S&P Global (2021) *Tracking ESG regulation* [Online]. Available at: https://www.spglobal.com/esg/insights/global-esg-regulation (Accessed: 7 Aug 2022). Similarly, the U.S. Securities and Exchange Commission (SEC), proposed to enhance and standardize climate related disclosures for investors. In India, the Securities and Exchange Board of India (SEBI) has added new requirements for corporates to report on Business Responsibility and Sustainability Reporting (BRSR) and these are just to name a few.

Sustainability is not just a regulatory choice but an ethical one too. As Bentham puts it, "Nature has placed mankind under the governance of two sovereign masters, pain, and pleasure. It is for them alone to point out what we ought to do, as well as to determine what we shall do. On the one hand the standard of right and wrong, on the other the chain of causes and effects, are fastened to their throne. They govern us in all we do, in all we say, in all we think: every effort we can make to throw off our subjection, will serve but to demonstrate and confirm it." (Bentham, 1996).

The current focus on sustainability is predominantly on existing corporations and large organizations. However, today's startups could be tomorrow's industry conglomerates. Building sustainable practices in startups will not only set a direction of sustainability in the fledglings of today but will also ensure they continue in this path as the leaders of tomorrow's businesses. However, startup entrepreneurs need to see sustainability as a profitable choice to make and not one made of compulsion to adopt.

This paper will attempt to highlight how sustainability can help increase the valuation of startups which may enable startups to not only adopt but embrace sustainability.

# 2 Literature review

## 2.1 Startups

Startups create products and services to meet requirements that have not been addressed properly (Heyets, 2015, cited in Kasych & Amelyaniuk, 2020). Profitability has been at the core of business survival (Klimek & Jędrych, 2021). However, when it comes to survival and growth, startups face a high level of failure in their initial years (Karani & Mshenga, 2021). Studying the progress from initiation to decline, Karani & Mshenga (2021) identified that it is easier for startups to sustain through a more cooperative approach and responsible innovation.

## 2.2 Sustainable Development

The UN has defined 17 sustainable development goals (United Nations, 2015, p. 14). They cover aspects from climate, energy, economy, poverty, and social justice (Elliott & Jennifer A, 2013).



*Figure 1. SDG Poster, Source:* (United Nations, 2019)

## 2.3　Sustainable Entrepreneurship

Sustainable Entrepreneurship (SE) spans multiple disciplines like politics, environmental science, sociology, and economics (Muñoz et al., 2018; Belz and Binder, 2015; Schaefer et al., 2015, cited in Anand et al., 2021). Sustainable Entrepreneurship can be understood by focusing on the opportunity, innovation, environmental and sustainable strategies implemented (Larson, 2000).

Business leaders are shifting their strategy from pure financial interests to achieving economic, environmental, and societal goals (Elkington, 1998; Preuss, 2007; Roth, 2009, cited in Vogel & Fischler-Strasak, 2014). Sustainability has also emerged as a new opportunity for innovation and competitive advantage (Fichter 2006; Hockerts 2008; Hansen et al. 2009, cited in Vogel & Fischler-Strasak, 2014).

Startups can innovate differently and be more responsive to changing circumstances, (Bos-Brouwers 2010, cited in Heikkinen & Koskinen, 2019). These small companies also design products and processes that are environmentally friendly from the start (Isaak, 2002, cited in Heikkinen & Koskinen, 2019).

## 2.4　Business models for startups

Duchesneau & Gartner (1990) in their paper on 'A profile of new venture success and failure in an emerging industry', highlight how successful firms were found to be more flexible, participative, and adaptive, where planning and communication was important and business knowledge and a need to grow was critical for success.

There are several business models, design thinking, lean startup, experimental lab, and business model canvas (Curley and Formica, 2013, cited in Murray & Scuotto, 2020). Nordstrom innovation lab mixed Lean startup, Agile and Design Thinking where design thinking was used to discover the customer problem and agile and lean startup to develop customer solutions (Larsell Ayesa, 2019).

Design thinking is based on customer orientation (Brown, 2009, cited in Murray & Scuotto, 2020). Design thinking is a discipline that uses a designer's sensibility, and methods to match people's needs with what is technically feasible and a viable business strategy (Brown, 2008). Brown (2008) further shares that the design process is described as a system of spaces rather than predefined orderly steps. The spaces are interrelated activities that together form a continuum of innovation (Brown, 2008). The design thinking criteria for successful innovation are User Desirability, Business Viability, Technology feasibility (Brown, 2009, cited in Müller & Thoring, 2012).

Business Model Innovation (BMI) is about developing new ways to capture, create and deliver value (Preuss, 2011; Claus, 2016; Wells, 2008, cited in Phangestu et al., 2020).
According to Lindgardt et al., (2009), BMI consist of two elements each with three sub elements:

- The value proposition: To whom and what are we offering
    - Target Segment
    - Product or service offering
    - Revenue model
- The operating model: How the offering is delivered profitably
    - The value chain
    - The cost model
    - The organization

The Business Model Canvas (BMC) comprises of nine sections:

1. The customer
2. Value proposition
3. Channel for distribution
4. Customer relationships
5. Key resources
6. Key activities
7. Key partnerships
8. Revenue streams
9. Cost structure

Further, BMC describes how organizations create, deliver, and captures business value (Phangestu et al., 2020).

According to Bortolini et al., (2018), Ries coined the term Lean Startup and a methodology for organizations to experiment and iterate. The steps in the methodology are:

• Build

• Measure

• Learn

## 2.5     Business Models for Sustainable Development

Circular economy is a conceptual business model which focuses on value creation for all (Bocken et al. 2013, cited in Larsell Ayesa, 2019). According to Larsell Ayesa (2019), circular economy optimizes the use of resources, eliminates wastes, and preserves nature. It has great innovation potential and opens new business opportunities.

According to Joyce & Paquin (2016) the Triple Layered Business Model (TLBM) is an extension of the Business Model Canvas which adds two more layers to the business model canvas, an environmental layer, and a social layer. Taken together, the impact to economy, environment and society becomes obvious.

# 3     Discussion

Startups are known to create new innovations, new markets, and new opportunities. Today's startups can go on to become some of tomorrow's conglomerates. Startups also have promising ideas, agility, increased risk appetite, and an aspiration to grow (Weiblen & Chesbrough, 2015). Given that approach of risk appetite and agility, they thrive in niche and rapidly changing markets where established organizations tend to avoid (Bhide, 1992). Once successful, they soon start to disrupt markets, economies, society, and the environment.

Profitability is core to business survival (Klimek & Jędrych, 2021). However, profitability without a systemic approach can lead to challenges, including stifling growth and decline. A collaborative and sustainable approach can help increase survival in startups (Karani & Mshenga, 2021).

The UN has 17 sustainable goals covering various aspects (United Nations, 2015). While all goals may not be applicable across all sectors of industry and may also differ between organizations within the same industry, adoption of sustainable development practices from the supply chain to production to end of life will ensure a sustainable approach adapted in corporate governance. With increase in

environmental and societal changes sustainability is becoming a requirement to comply with. From the UN's corporate sustainability reporting to multiple countries specifically some of the larger economies such as the US, China, UK, EU, and India, mandating sustainability reporting to enable accountability among corporates on sustainability. Of course, the intent of these requirements is not just for reporting alone but monitoring actions that impact sustainability. However, many of these regulations predominately focus on larger organizations and exclude small and medium organizations which include startups.

Society's drive towards sustainability can be seen in the significant increase in investments in businesses enabling sustainability. The financing industry is rapidly embracing sustainability, and the sustainable finance market grew in 2021 to $5.2 trillion, a 63% increase from 2020. Assets under management of sustainable funds have gone up from $1.7 trillion in 2020 to $2.7 trillion in 2021(UNCTAD, 2022, pp. 162–165). This increase reflects the larger objective of not just governing bodies, but investors reflecting societal needs on being serious about meeting sustainable goals.

For startups choosing a sustainability first approach, the increase in sustainability funding can be a vital source of funds. Additionally, it will also help them to reduce any effort and cost to shift to sustainability at a later stage. Shifting later could turn out as a deterrent due to the increased cost of change implementation. While embracing sustainability early, it is important for startups to instill confidence in investors in their ability to provide returns, either short or long term that is comparable or even exceeding conventional startups. According to Mansouri & Momtaz, (2021), startups with environment, social and governance (ESG) goals were able to raise financing at more favorable valuations, which is an incentive for startups to adopt ESG goals. However, post-funding, financial performance of sustainable startups was found to be less than conventional startups leading to possible financial loss to investors.

When it comes to sustainable entrepreneurship, profitability should not only be based on early financial returns, but the triple bottom line of economic, environmental, and social benefits. According to Anand et al., (2021) it has been difficult to capture and evaluate the triple bottom line performance as ESG literature is limited, and there is substantial disagreement on how ESG is to be measured. Further that it is difficult to differentiate between actual sustainable entrepreneurs and those who only perceive to apply sustainable practices. Given these constraints, sustainable startups should not merely adopt sustainable practices, but should also be able to identify value out of their investment into it. This will help them determine their ability to provide long term returns and not to just base returns on short-term gains.

Startups being high on the innovation scale can identify sustainable solutions, build sustainable supply chains and sustainable end of life processes that may be difficult for larger corporations to pursue as these small companies need smaller testing grounds. Once developed, these sustainable approaches can later be absorbed by larger organizations through mergers and acquisition, consulting, outsourcing or patent sharing, which will further increase profits for these startups. This approach would not only enable proliferation of sustainability in industry but will benefit startups to increase their profitability.

Startups, however, have been observed to have a very low survival rate. Failure rate of startups could be as high as 92% in the first three years (Marmer, Hermann, Dogruttan and Berman, 2012b; StartupGenome LLC, 2018, cited in Phangestu et al., 2020). Startup failure have been attributed to many reasons such as lack of identifying market potential and customer requirements, inappropriate business models, poor financial planning, and even egos of founders. Failure rate can be reduced if appropriate tools are used for control and planning (McGrath & MacMillan, 1995, cited in Bortolini et al., 2018). Further, sharing of resources, building relationships for collaboration, responsible innovation can improve startup sustainability (Karani & Mshenga, 2021).

Today there are various business models available to enable startups improve their planning. Some of them are:

- The Lean Startup which follows an incremental-iterative process of 'Build-Measure-Learn' similar in approach to Deming's 'Plan-Do-Check-Act' cycle
- The Business Model Canvas (BMC) with similarities to the Supplier-Input-Process-Output-Customer approach, compounded with a revenue and cost model built on to it. The sections in the BMC are Customer, Value Proposition, Channel for Distribution, Customer Relationships, Key Resources, Key Activities, Key Partnerships, Revenue Streams, and Cost Structure
- The Business Model Innovation (BMI) which has two main parts, the value proposition, which is customer focused, and operating model, which focuses on the internal process. The revenue model further expands into multiple different types such as Subscription, Freemium, Licensing, etc.
- Design Thinking applies a designer's approach to creative problem solving and is built on empathy and human centered innovation

While the above are more widely used, there are others that are built around sustainability. The circular design applies design thinking principles of creative problem solving and empathy to identify more environmentally friendly practices, resulting in a circular economy. The triple layered business model canvas extends the BMC taking it beyond commercial planning, by adding two more layers, one for environmental factors, and another for societal factors.

While most of these business models touch upon business planning including cost and revenue, they do miss out on financial planning. Financial planning is critical for startups not just to understand its revenue and cost plans but other factors that make it financially viable for long term stability. Another critical factor is its ability to attract funds which is needed to take it from infancy to profitability. For investors to identify the potential of a startup right from its pre-revenue stage, it needs to not only have a strong business model on revenue and cost but also factor in its pre-revenue valuation that visualizes the financial planning and viability of the startup. In a paper on the evolution of financial structure of US Startups, Cotei & Farhat (2017) share that very few studies have examined the dynamics of newly formed businesses. This they refer to, as the capital structure, in which a business finances its operations and growth over time and the need for different sources of funds. In their study they found that startup entrepreneurs rely on internal capital sources such as personal finance, family, and friends, and as it matures the proportion of external financing increases in the capital.

External capital investments require startups to prove their ability to provide returns and liquidity for which valuation is critical. Valuation of startups differ to that of stable organizations. According to mainstream finance theory, the economic value of any investment, is the present value of its future cashflows (Brealey, Myers, and Allen 2007, cited in Miloud et al., 2012). Economic value uses traditional valuation techniques like, discounted cash flow, earnings multiple valuation, net asset, and strong accounting information, which may not be feasible for startups (Miloud et al., 2012). Cotei & Farhat, (2017) share that in the early stages, startups have less assets, records of profitability, and repayment history. External providers of capital mitigate the risk by considering the reputation and credit worthiness of the entrepreneur which is longer and their personal assets which can be used as collateral (Cotei & Farhat, 2017).

There are multiple startup valuation techniques developed by researchers and investors. To name few:

- Venture capital method
- First Chicago method
- Value based balance sheet

- Berkus method
- Scorecard method
- Risk factor summation

However, many of these valuation approaches too have been observed to have limitations. According to Montani et al (2020), in a study on startup valuation methods, found that no method is perfect for startup evaluation. Each method had its own limitations and scope for improvement.

Capital investments also impact business decisions and may influence a startup's ability to adapt sustainability practices. To avoid the potential risk of devaluation or higher costs, startups may choose to tread the known path and not to adopt a sustainable approach.

Sustainability valuation is not new. Moro-Visconti (2022) advises the use of social capital, reputational capital and ESG metrics which are part of the SDGs for increasing corporate valuation. el Zein et al (2020) suggest companies to disclose their investment in ESG and promote it to increase their brand value. Henisz et al (2019) share from their experience and research that ESG value can be measured through:

1. ESG as a facilitator for top-line growth through new markets
2. In its ability to reduce costs on energy and water
3. Potential to minimize regulatory and legal interventions through subsidies and deregulation
4. Ability to increase employee productivity through employee morale and social credibility
5. Optimizing investments and capital expenditures through improved allocation of funds and avoid long term impact of environmental action

However, the above can't be said for startup valuation. Existing research on sustainability valuation for startups is limited. Kang (2020) suggests that startups contribute to economic development through economic growth and job creation, and it is necessary to investigate profitability of startups in relation to economic development and job creation. Moro-Visconti (2022) shares for startups to determine value from sustainability they could use technical know-how, patents, and other intangibles. However, these are just few studies that share about improving value in startups through sustainability.

As existing startup valuation methods do not specifically include these parameters as value contributors, they may miss to capture the value of sustainability as an asset. To provide visibility on this limitation in existing methods this paper looks at two prominent pre-revenue valuation methods: The score card method and the Berkus method.

The Score card method is for valuation of young companies in a specific geography. This method corrects the average value of comparable firms to get a pre-money valuation of the targeted status. The valuation is based on the following variables: Strength of the management team, Size of the opportunity, Product / Technology, Competitive Environment, Marketing/Sales Channels and Partnerships, Need for additional improvement, and Other, each with a different weightage (Montani et al., 2020). The illustration below describes the working:

| Factors | Relative weight |
|---|---|
| Strength of the Management Team | 0-30% |
| Size of the Opportunity (scalability) | 0-25% |
| Product/Technology | 0-15% |
| Competitive Environment | 0-10% |
| Marketing/Sales Channels/Partnerships | 0-10% |
| Need for Additional Investment | 0-5% |
| Other | 0-5% |

*Figure 2. Scorecard Method, Source:* (Montani et al., 2020)

Another popular valuation method is the Berkus Method. This method is used for pre-revenue stage start-ups, and valuate based on the following risk factors:

•   Sound Idea

•   Prototype

•   Quality Management team

•   Strategic relationships

•   Product Rollout or Sales

Each factor is assigned a value of $0.5 million (Montani et al., 2020).

Both these methods and other prominent startup valuation approaches do not incorporate sustainability values to determine a startup's value. Further existing research has also found it difficult to measure the triple bottom line, as many sustainable ventures focus either on the environment or societal issues which are considered non-profit in nature, and outcomes perceived as non-financial in returns.

The above discussion can be summed up as:

•   Sustainability is the need of the hour. Investors are increasing funds into sustainability

•   Startups play a critical role in bringing sustainability into the industry value chain

•   Financial planning is critical for startup survival and sustainability value can contribute to this planning

# 4      Research Problem

From preliminary literature review around startups, sustainability, business models, valuation, and value of sustainability there exists an opportunity to understand: 'Why an inclusive design approach on innovation is needed to enable sustainable growth in startups?'. This paper specifically focuses on sustainability valuation of startups: 'Can sustainability increase valuation and growth in startups?'.

# 5      Approach

This paper focuses on the section of the research thesis of 'Inclusive design for sustainable growth in startups' that is related to understanding how value can be understood and realized in startups through sustainability. However, based on gaps identified through the review of existing literature, below is a

preliminary inclusive approach for startups in achieving sustainable growth in startups which will be further researched in the research thesis:

1. Innovating to meet customer need through a sustainable solution
2. Take a sustainable entrepreneurship approach using appropriate business models to create sustainable operating systems, supply chains and end of life processes
3. Ensure financial planning and identify financial viability with existing valuation guidelines and sustainability value attributes
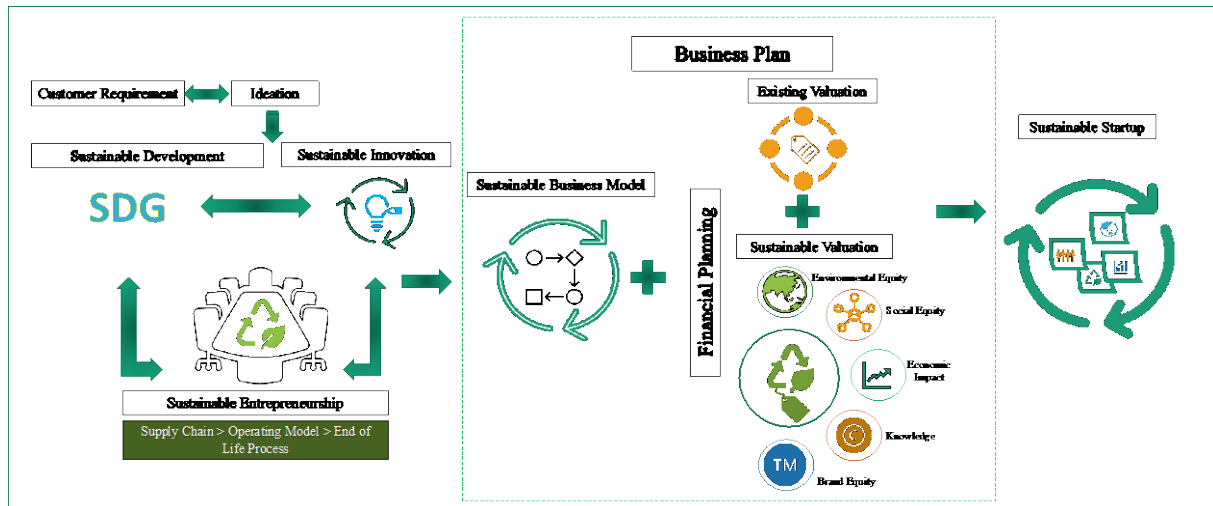4. Ensure sustainability of the startup and its impact



*Figure 3.       Framework for achieving sustainable growth in startups – Authors' illustration*

This framework integrates elements from an end-to-end perspective, starting from the business requirement right up to the establishment of a startup. This provides a comprehensive and proactive view rather than a reactive one.

To enhance startup valuation through sustainability, the following dimensions need to be explored in quantifiable terms:

- Impact to the economy from a startups' ability to increase job creation and new market developments that could lead to increased Gross Domestic Product (GDP) and economic growth
- Environmental equity factors such as reduced cost of production, government sponsored promotion, carbon credits, reduced cost, or profit from repurpose and reuse in end-of-life and incentives rather than penalties from regulatory bodies
- Societal equity such as ease of market acceptance, increased employee morale leading to higher productivity, local support in land acquisition and business setup rather than resistance and legal implications
- Increased business value from revenue streams such as knowledge acquired, which creates patent licensing, copyrights, training, outsourcing and even support in market penetration and an increased brand value through sustainability as a brand

To summarize, the following dimensions can be applied in sustainable valuation:

- Economic Equity
- Environmental Equity

- Social Equity
- Sustainable business value:
    - Sustainable brand value
    - Sustainable knowledge value

Startups can adapt these along with other broad categories of the existing valuation methods, such as the score card or Berkus method. Quantifying the values could potentially boost the overall valuation of a startup and support it in obtaining required financial backing through its growth years. This would not just help startups sustain but achieve success.

# 6      Conclusion

Sustainability valuation of startups is about determining a financial value to the impact a startup has on the macro economy, environment, and society, and in turn improving its survival. This increased valuation can help startups attract the investment backing it needs in its pre-revenue stage, not only based on its founder's credibility, business idea, stability of the process, the product's market potential, and available assets but also the potential that this investment in sustainability will deliver through increased valuation of the startup and its potential to deliver long term growth.

Adapting sustainability may be a different choice and a new one to make. However, the lens with which it is seen needs to change. A sustainability first approach should not be seen as a cost to startups in achieving outcomes for the benefit of society, environment, and the economy, but seen as an investment that help achieve long term benefits, returns, higher valuation, and credit worthiness.

This paper proposes a sustainable valuation approach based on preliminary literature review and further research is needed. Further research based on data and quantified effectiveness is also required to create a functional inclusive design that can support startups achieve sustainable valuation.

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