THE BENEFITS OF GETTING YOUR ESG DUE DILIGENCE RIGHT

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ESG (Environmental, Social, Governance) may have once been a buzzword, but it is fast becoming a staple in the day-to-day language of investors as they grapple with how to evaluate companies' performance on ESG issues.

For investors more familiar (and comfortable) with traditional evaluations of a company's assets, the growing emphasis on ESG raises due diligence to a whole new level. And with ESG benchmarking highly fragmented and lacking global standardization, it isn't always clear how to approach this increasingly important mandate.

For investors, there's a lot on the line in getting their ESG due diligence right. In 2021, ESG hauled in record amounts of investor capital[1], and the trend shows no signs of slowing, with Bloomberg Intelligence[2] predicting that global ESG assets could exceed $53 trillion by 2025. Regulators are increasing scrutiny on ESG corporate performance and ESG products, raising the stakes. And then there's growing societal pressure for business to be part of the solution to complex challenges like climate change and racial equity, not simply part of the problem.

No surprise, then, that investors are seeking to integrate ESG factors into the core due diligence process. The catch is that this cannot be a box ticking exercise. Companies need to demonstrate how they fulfill their ESG commitments, and investors need to hold them accountable. Done well, ESG due diligence reveals crucial data and insights into the success and value of a company's ESG performance and policies so that investors can make a comprehensive assessment based on all the relevant information.

In this ebook, we take a look at what's driving the focus on ESG due diligence, why it's important to get it right, how to design an effective ESG due diligence process (hint: it's not just about minimizing risk but maximizing return), the benefits it can deliver, and what's next in this rapidly changing area.

The bottom line: if 2021 marked what some are calling a sustainability investing revolution[3], 2022 is the year that investors and regulators alike will hold companies' feet to the fire to prove their ESG bona fides.

PRESSURE FOR ESG DUE DILIGENCE ON THE RISE

We're looking at a perfect storm when it comes to the trends that are making ESG due diligence a business and investment imperative.

A wide range of stakeholders, including shareholders, consumers, employees, and regulators, expect companies to prioritize ESG and sustainability as part of their core business and societal license to operate.

ESG in broad strokes refers to a company's performance on environmental issues, social responsibility, and corporate governance. But how that breaks down into specific areas runs the gamut from bribery and corruption to diversity in board composition to greenhouse gas emissions to employee rights and much more. In particular, the "S" in ESG, social issues such as diversity, equity, & inclusion (DE&I) and worker wellbeing, will remain in the spotlight in 2022[4].

There is good reason for heightened attention to how businesses handle these issues. Human

rights violations, environmental pollution, and unethical business conduct, for example, can have a substantial negative impact on individuals, communities, and the environment. Companies are expected to be credible and transparent on the actions they are taking to minimize any negative impacts and accelerate the positive impacts of the way they do business.

This demand for transparency along with better and more accessible ESG data and information is top of mind for investors as they seek to integrate ESG factors into the core due diligence process. In fact, ESG is expected to factor more significantly in mergers & acquisitions[5] (M&A) transactions in coming years.

Additionally, regulators are stepping up the pressure for companies to walk the talk on ESG. This is expected to be a pivotal year for ESG reporting[6], with the U.S. catching up with Europe in the move to make such reporting mandatory rather than voluntary for companies. In Switzerland, for example, new due diligence and reporting obligations[7] for responsible business became effective this year, including possible criminal sanctions. The U.S. Securities and Exchange Commission (SEC) is expected to announce new rules for enhanced disclosure of ESG-related filings[8] in early 2022. The SEC is also scrutinizing ESG financial products, asking ESG-labeled investment funds for the criteria[9] they use to determine sustainability.

These trends point to why leading global investment firms like Goldman Sachs believe that ESG considerations will become more relevant in 2022[10]. To meet those expectations, due diligence processes need to be strengthened so that those companies with superior ESG ratings are set apart from those who fall short and present a higher risk to investors and society.

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Risk is the operative word for why it is so important to get ESG due diligence right; as with all due diligence, risk mitigation is key.

ESG issues have direct financial, operational, and reputational impacts on business. As a result, insufficient focus on ESG carries many financial and reputational risks for companies. Gaining an understanding of all the known and potential risks associated with ESG, particularly with any new acquisition, transaction, partnership, or investment, is critical to any due diligence process.

ESG can represent a financial risk in a transaction if the conditions associated with ESG are not adequately reflected in the price. A company not in compliance with anti-bribery and corruption rules makes it vulnerable to potential fines and loss of major contracts, with a definite impact on pricing of the company.

Reputational risks can also be severe, as several high-profile cases have shown in recent

years, such as Volkswagen's emissions scandal or Johnson & Johnson's product liability[11]. When ESG guardrails are missing, it can lead to lost market share and loss of trust from key stakeholders like employees, customers, and investors. Some firms can even lose their opportunity to trade in markets that have stricter ESG regulations.

The supply chain represents the largest potential ESG risk for most companies[12], underscoring the need for a full value chain approach to ESG due diligence. Multinational companies typically have substantial supply chains, and these third-party relationships play a significant role in a company's ESG impact and goals. Global supply chains are under more pressure[13] recently due to the effects of the COVID-19 pandemic, changing global policy, and more legislative action. The EU, for example, has published new due diligence guidance to address forced labor in supply chains[14].

In M&A transactions, reputational risks can be high when ESG due diligence is not in place. Companies acquired with serious environmental pollution or human rights violations can tarnish the reputation of the third parties acquiring them. Not meeting ESG requirements could also entail a legal risk, as the entity acquiring a company can "inherit" legal liability for actions that company took in the past that have not come to the surface. If, for example, due diligence doesn't uncover corruption risk before a transaction, and the company lacks the ability to handle such risks, there is the chance of being in breach of corruption legislation after the company is acquired.

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REAPING THE BENEFITS OF A ROBUST PROCESS

Certainly, the risks are high without a robust ESG due diligence process.

But it is equally important not to overlook the opportunities that stem from being proactive in this area. While it's true that getting the process right can illuminate the problem areas, it also sheds light on positive ESG actions and programs, as well opportunities for future value creation, such as cutting costs through increased energy efficiency.

Done well, the due diligence process can make it easier to benchmark against peer and industry ESG performance. And for investors, a thorough ESG due diligence process helps communicate improvements and demonstrate value to potential buyers at the exit stage of the investment cycle.

In the financial market, it has become easier in recent years to get access to ESG-linked financial products, which carry favorable terms if certain ESG conditions are met. The growing investor demand for green bonds has resulted in what experts are calling "a greenium,"[15] where companies with strong ESG credentials gain better pricing and more attractive terms.

The European Union Green Deal is paving the way for more sustainable financing[16] capital to help the EU become more climate neutral in 2050. As a result, sustainability-linked bonds, green bonds, and social bonds will only gain momentum.

When it comes to return on investment (ROI), data shows that returns on ESG investment funds can be higher than broad base indices. Between November 2019 and March 2021, the MSCI World ESG Leaders index outperformed[17] the traditional MSCI World by +1.84%. Further, the JP Morgan ESG EMBI Global Diversified index outperformed the equivalent non-ESG index by +1.94%.

In short, when ESG due diligence is well anchored in an organization, it produces a greater return on investment for portfolios, investors, and society as a whole. Investors, customers, and employees alike are increasingly demonstrating their support for companies that show real leadership in the ESG space.

BEST PRACTICES IN ESG DUE DILIGENCE

There is no one-size-fits-all approach to ESG due diligence, as standards vary widely among different sectors.

There is no one-size-fits-all approach to ESG due diligence, as standards vary widely among different sectors. While an oil and gas company might prioritize reporting on their environmental impact, a company in the financial industry might emphasize its social and governance practices. That's why it is important to tailor any approach to a specific sector and an individual company, taking geographic regions and business models into consideration. ESG criteria need to be selected from a range of key performance indicators (KPIs) that cover many different industry-specific and target-specific factors.

ESG due diligence should start early, ideally in parallel with other due diligence processes. When ESG considerations become another layer of due diligence, the process will take more time, which is important to keep in mind. And with any number of relevant ESG factors to take into account, it's crucial to prioritize the right ones so any potential issues are uncovered as soon as possible. For example, ESG audits are often required when raising capital as debt-rating agencies and investors demand this additional data. Having a thorough ESG due diligence early in a process can make a big difference.

There is established best practice for an ESG due diligence process. This includes a checklist and template to guide decision making and identify KPIs. This framework will ease implementation and bring to light all the ESG issues to consider. All parties involved should agree on a common ESG strategy, policy, and execution. To get consensus on ESG principles, it's helpful to review all existing documentation, conduct interviews with key company stakeholders such as employees, board members, and C-suite executives, make on-site visits to facilities or new project sites where appropriate, and carry out an ESG risk assessment. A full analysis with recommendations should follow, with everyone having a clear understanding of the company's operations, business plan, ESG impacts and risks and how management plans to address or capitalize on those issues. It's a matter of deploying the usual diligence tools, but with an ESG lens, where compliance and ESG leaders work together with sourcing and procurement teams to ensure responsible supply chain practices and accountability.

Some best practices are emerging within the private equity industry, including creating a formal ESG policy as a guideline for the due diligence process, focusing squarely on the material ESG issues and risks, keeping climate risk front and center, and gathering and tracking measurable ESG-related KPIs.

Metrics to track ESG progress should compare performance across time, peers, other industries, and in light of changing regulatory standards. As international economist[18] Dambisa Moyo points out in the Harvard Business Review, "[Companies] need to anticipate where regulation on all aspects of ESG will land. Therefore, business leaders must maintain a dialogue with regulators and policymakers, and companies should look to cooperate and coordinate on best practices with their industry peers."

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— Dambisa Moyo

WHAT'S ON THE HORIZON

ESG due diligence will remain a moving target for the foreseeable future.

Business leaders and investors need to design a process of due diligence and flexible way of thinking about ESG that keeps pace with developments in society, the environment and the economy. As just one example, continued pressure in 2022 for more flexible working terms and conditions[19] from employees who have been forced to work remotely during the pandemic will keep workplace culture and social mobility high on the agenda. And diversity and equality will remain a hot topic, with pressure on companies to translate rhetoric into action, with the commitments, data and due diligence to back it up.

ESG due diligence processes need to be resilient and responsive to an ever-changing landscape of policy priorities and legislative mandates. For example, the U.S. Department of Labor recently issued a proposed rule stating that retirement plan fiduciaries may consider climate change and other ESG factors when making investment decisions[20] and exercising shareholder rights, in recognition that ESG factors can be financially material. The market bears this out. Goldman Sachs noted[21] in its 2022 Investment Outlook that considering ESG factors "is likely to lead to better long-term risk-adjusted returns."

Regulatory developments are bound to change the nature of ESG reporting obligations in coming years. To date, most companies provide ESG reporting in line with one of several voluntary frameworks. But with the introduction of mandatory standards in many jurisdictions, that will start to shift. Fortunately, to help clarify ESG reporting and due diligence, the Financial Reporting Standards (IFRS) Foundation has pledged to create a set of ESG corporate reporting standards[22] aimed at consolidating global standards, slated to be ready early in 2022.

Such moves will go a long way towards addressing one of the biggest obstacles to meeting growing ESG due diligence requirements: the lack of reliable and consistent data to measure and report on performance. The increasing pressure on companies to report credibly on their ESG commitments is not likely to abate any time soon, so data collection has to keep up. The uncertainty around data and disclosure has contributed to some companies dragging their feet on ESG considerations because they're unsure about the legal and reputational implications. The work of the IFRS aims to address that confusion.

One trend on the horizon that will likely get more traction is ESG-linked performance metrics on remuneration. For example, ESG-related performance metrics like employee remuneration[23] could be linked to progress towards the UN Sustainable Development Goals. We've already seen uptake on this approach from publicly listed companies, where 45% of FTSE companies now have an ESG measure in executive pay, according to PwC[24].

As the near-turn environment continues to be challenging, investors and business leaders alike will be increasingly dependent on insightful ESG due diligence that provides management and stakeholders with the information they need to make the right decisions. In seizing the opportunity for greater transparency, those companies with superior environmental stewardship who are making a positive difference in society will be the clear winners.

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Goby is the most intelligent, comprehensive, and intuitive platform for ESG (Environmental, Social, Governance) management. We help portfolios develop and implement ESG initiatives that provide an imperative to attract & retain capital, accelerate sustainable & responsible growth, and mitigate enterprise risk.

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