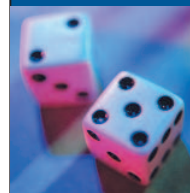


# ESG and due diligence

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When companies or private equity firms look towards a merger or acquisition they and their advisers rarely consider the target's culture and performance on social and environmental issues. Unless matters of legal compliance, they have not been regarded as significant. To reflect that, the prospectus for the just completed Myer listing gives them short shrift, with half a column offered on Myer's philanthropic activities.

Yet there are hints in the prospectus that social and environmental issues might have been reviewed further. The prospectus confirms that 'The reputation and prominence of the Myer brand are considered fundamental to its ability to attract and retain customers which in turn drives sales.'<sup>1</sup> Three of its five supporting attributes are 'supporting the community', 'trusted reputation' and 'committed to sustainable practices' (the last mention of those practices in the prospectus). So if the brand drives sales, and environmental and social issues help underpin the brand, perhaps they're worth a look.

More important is to consider the six 'key investment risks'.<sup>2</sup> They are that: economic conditions may deteriorate, Myer's growth strategies may not achieve their objectives, IT failures may occur, Myer's competitive position may deteriorate, customer preferences may change, and Myer's brand name may diminish in reputation and value. Other risks are that Myer's relationships with key brand owners, designers, concession operators, landlords and suppliers may deteriorate, Myer Melbourne rebuild may be delayed, loss of key personnel may occur, Myer may be unable to attract and retain staff, and Myer's marketing campaigns may be unsuccessful.

Aside from economic conditions and IT, each of the risks is directly affected by social and environmental issues, and by Myer's approach to them. If you're looking to buy such a company, a large part of whose value is its brand, those issues are intrinsically and explicitly relevant as more and more institutional buyers become signatories to the Principles for Responsible Investment (PRI).

This article introduces some of the whats, whys and hows of environmental, social and governance (ESG) due diligence. It is relevant if you are thinking of raising capital or investing in

- *Intangible factors drive a company's medium-term financial performance, and are heavily influenced by ESG factors*
- *While potential sources of ESG risk are infinite, each company will have material issues that must be identified and managed*
- *The converse of risk is opportunity — consider where innovation, productivity, reputation and relationships may lead*

a company, particularly if the strategy is to raise its value prior to exit. It focuses on environmental and social issues because governance is the bread and butter of this journal's readers.

## The emerging principles driving ESG

This article is not the place to consider the social and economic factors behind the emergence of ESG analysis in Australia.<sup>3</sup> But they lay the foundation for the immediate driver, the PRI.

The adoption of the PRI is a global initiative by which investors commit to incorporate ESG issues into their investment analysis, decision-making and ownership policies and practice. Launched in April 2006, the PRI have already attracted over 500 signatories, representing over US\$18 trillion dollars in assets under management. By the end of September 2009, in Australia and New Zealand, 38 superannuation funds and institutional investors and 55 fund managers had signed up to the PRI.

Significantly, half of the PRI are geared towards the further spread and implementation of the PRI. Signatories will continue to advocate ESG, and draw on resources from the PRI clearing house to work together on ESG issues.

Practically speaking, a fund manager seeking investment from a superannuation fund in Australia will increasingly have to demonstrate

that they account for ESG factors. A private equity fund manager would be 'encouraged' to undertake ESG due diligence on new acquisitions; a public markets fund manager would be 'encouraged' to monitor the ESG performance of listed companies and include that in their decisions.

If you're buying into a company, the issue is how it will perform in the future. The management and assets of the company are vital, and their track record will speak volumes. But 'intangible' assets drive performance in the

medium term: the company's reputation and brand, its networks and relationships, its intellectual property and capacity to innovate, and the quality and productive capacity of its people. And the way a company engages on its social, environment and ethical issues has a profound effect on them.

### Conducting ESG due diligence

Aside from clear environmental liabilities or inoperable reputational damage, it would be rare for ESG issues to stop an acquisition cold. It's more a question of identifying risks that may, alone or collectively, be taken to the negotiating table. Conversely, there may be opportunities that have not been factored into valuations, and which may reassure the buyer to make that additional bid.

Therefore, while the initial investment scan will ask some questions, ESG due diligence itself is typically conducted at the same time as traditional commercial, legal and financial due diligence. There are two fundamental decisions to make. Does the due diligence team do it themselves, or get an ESG specialist in? If the former, would the due diligence team look into the issues as an extension of their standard

procedures and questions, or as a separate work stream? The determining matrix is the importance of ESG to the transaction, against the capacity (time, resources and ESG experience) of the due diligence team.

The process outline, if not its execution, would contain few surprises: deciding on how important ESG issues are to the proposed investment, identifying the key issues, determining how they are being addressed, assessing the company's core risk management systems and its sustainability

approaches, evaluating how these issues might affect the investment decision, and setting management plans to deal with the issue post-transaction.

### How important are your ESG issues?

Assessing the importance of ESG issues to the transaction, and to the future prospects of the company, helps determine how much you should invest in the due diligence process. You would have options on who to engage to undertake the ESG due diligence, and how much leash to give them, or whether to work it out internally.

First, consider the company's customer base, especially a business-to-business concern. Lurking in the client list (or wish list) you might find a government department or entity, a large corporation or an NGO or charitable organisation. Those clients are likely to be investing in their own ESG issues, and may expect or *require* their suppliers to share that interest. The ANZ Bank, for example, has five minimum requirements of its suppliers:<sup>4</sup>

- governance responsibility for ESG issues
- baseline measurement and stakeholder reporting on ESG issues
- an environmental management system
- compliance with occupational health and safety (OH&S) and employee human rights standards and
- processes to manage *their* suppliers' environmental and social performance.

Similarly, extend your scan beyond customers and clients to other stakeholders on whom the business health and growth depend. This might include the company's investors. How important are ESG issues to them?

These assessments apply no matter what business the company is in. However, stakeholder expectations are higher if the company's own offering is in the environmental or social sectors. Be it cleantech or health, transport or education, energy or food, stakeholders have heightened sensitivity to ESG issues.

Second, what will the company be relying on for its future, and will these things be affected by its ESG performance? There are many strategic assets a company may hold or need to access that can be affected by its ESG performance. These are not restricted to a 'clean and green' image. The company might depend on regular product or service innovation, on high levels of employee engagement or third-party endorsement, on strong corporate partnerships or privileged research and networks, or on public assets. Each reflects the strength of its key intangible assets. Each is influenced by a company's engagement on social and environmental issues.

Assessing the importance of ESG issues to the transaction, and to the future prospects of the company, helps determine how much you should invest in the due diligence process. Consider the company's customer base. Lurking in the client list (or wish list) you might find a government department or entity, a large corporation or an NGO or charitable organisation. Those clients are likely to be investing in their own ESG issues, and may expect or require their suppliers to share that interest.

The higher the brand value, the more cautious you should be. Consider a retail clothing company and the human rights and working conditions in its supply chain. Would it be enough, for example, if the clothes are made in the same Vietnamese factory as a department store's generic brand? Not necessarily. If the department store doesn't itself have strong supply chain monitoring, risks may easily exist. If your target company has a strong brand, so that the shirts sell for 20 times what they cost to make, you want to ensure there's nothing that might threaten that brand. Those with an interest in supply chain human rights will hold you to a higher standard than the department store, and could make it difficult for you to sell product to retail chains that have a stronger interest in ESG.

### Issues to consider

You don't want to hear that the list of potential ESG issues that may be relevant to a particular company is — quite literally — endless. But it is. Humanity is inventive in causing trouble for itself, so it's unlikely we've exhausted the problems to solve. There are innumerable possibilities to test a company's operations and culture — from landmines to overzealous marketing, from over-grazing to climate change, from child labour to glass ceilings.

Fortunately, there are a limited number of ESG issues that may be material to any particular company. The Global Reporting Initiative, fast becoming a standard for companies reporting on ESG issues, suggests they reveal 60 'core' and 31 'additional' pieces of information. The research firms who provide ESG data on listed companies track 300 to 350 performance issues and metrics, and can report on them. But these comprehensive lists in themselves will not satisfy your due diligence needs. As described in a previous article in this journal<sup>5</sup>, companies and their potential investors need to identify the relevant issues, the ones that are or may be material to financial performance over the medium term.

### Particular issues

Sometimes, issues become apparent from a review of the sector, or the company's stakeholders, and the company's operations and intangibles (see Triangulating the issues below). That requires an understanding of the potential risks, and of what constitutes reasonable performance on those issues. At a minimum, issues that should be reviewed might include:

- on employees, changes in the participation rates of employee share schemes, in employee engagement scores, and in ESG-related survey responses; relative to sector norms, its diversity, flexibility policies, benefits, OH&S records and workers compensation premiums; staff training

and monitoring of human rights (see UN Global Compact below)

- on environmental issues, whether the company has completed a climate change risk/opportunity analysis; a product or service life cycle analysis; a property eco-efficiency audit; a land and water stewardship analysis
- on community issues, any formal or informal investigation of product/service liability or harm; any direct or indirect benefit to the company from weaponry, gambling or other financial stalking, alcohol or drug consumption (the issue is not whether they do, but how they manage the risks); any indirect benefits from abuses of human rights (see UN Global Compact below); transparency in dealings with government
- on governance issues, whether the constitution, if any, has been duly agreed and is duly pursued; the independence of directors and audit; voting rights or benefit inequalities; communication with stakeholders; external review against ICGN principles; history of material differences at board levels; board oversight of core risk management systems; board credentials on and participation in ESG issues.

I stress though that what is important differs totally for any given company. Potential investors in a software company working on database compression technology might scan a due diligence checklist without needing to pause for coffee, while those considering a company dealing in forest protection in countries with questionable governance will have a whole other matter on their hands.

### Capacity to identify and respond to risks

Given that no topic-based list will be comprehensive forever, you need also to analyse the company's *capacity to identify and respond to* ESG risks. A minimal due diligence process, then, would consider:

- anything on which there may be formal or informal public consultation in a regulatory process
- anything that employees and key customers and markets consider important
- the extent to which CSR or sustainability approaches are integrated into the company's operational systems
- how much time the company spends with stakeholders on issues that don't have a three-month financial goal
- whether the company is involved in partnerships within or outside its value chain on issues that affect it.

Similarly, since ESG due diligence is targeting future operating and strategic risks to the company, it should examine the company's core risk management and operating systems. These fall outside financial and legal due diligence, and sometimes fall into the cracks in commercial due diligence.<sup>6</sup> But they do themselves contribute to protection against less social or environmental risks. So, consider the company's risk management, environment, OH&S, product liability, marketing and advertising, human resources, human rights and business integrity policies and practices. Are they comprehensive in themselves, with clearly documented and more importantly practiced procedures, accountabilities, KPIs, internal education, external reporting, and engagement with stakeholder and expert third parties?

OH&S practices are themselves part of ESG due diligence. Further, if a company is on top of its OH&S performance, it is likely to be aware of the stresses its people are under at work and in their wider communities — for example, bullying or financial pressures. Sometimes stresses are recurrent and documented, but management has not taken action. In these circumstances, employees are unwilling to add to their stress by leaving their work, but a change in ownership may trigger more turnover than expected.

### **The UN Global Compact**

Another element to look out for is commitments made on social and environmental issues that are unlikely to be kept in practice. Companies often sign up to broad covenants and statements of intent, without fully grasping the nature of their commitments. The UN Global Compact is one such document, which companies and investors may sign individually or by industry group.

Yet the foundation ideals of the Global Compact, to be recognised by signatories, are found in the 1948 Declaration of Human Rights, which sets out in extraordinarily detail the ideals of a free and democratic society. The Global Compact therefore calls for human rights policies and management systems, minimising and where possible eliminating involvement in arms, weaponry, pornography, gambling or financial loss, alcohol or drug consumption, and ensuring any involvement is responsible; and respecting rights to personal security, privacy, property, natural justice, participation in community, wellbeing and education, and the freedoms of assembly, conscience and religion. It should not be assumed that all companies and their owners actively support these ideals, and any dissonance between commitment and action creates a further source of risk.

### **Triangulating the issues**

There are three main angles by which to ensure that the issues most likely to affect the firm are being covered by the due diligence process. Before direct engagement with the company, two indirect reviews might be completed. They reveal the issues that the company may face immediately or in the future, perhaps without yet realising it.

The first indirect analysis identifies the key social and environmental risks facing the business, based on its sector and location. They may include, for example, risks to water or energy supply or other essential resources, repeated safety issues or industrial disputes in the supply chain, weakening markets due to media alarm over the safety or social defensibility of the product, or weakening or altered markets due to proposed government regulation in response to a social or environmental issue.

If a substantial investment is being made in a company, these issues should be known to the acquirer, or to its advisers, though they would not typically rate a mention in the business plan, and certainly not the financials. There is also a constant flow of ESG issues through selected newswires from NGOs, CSR and sustainability websites, free and by subscription, as well as coverage in the PRI clearing house. There are several ESG data providers and ratings agencies who track social and environmental issues and their impact on listed companies. A report on a competitor listed company, either local or global, will often give an excellent review of the relevant issues, and also clearly indicate the sort of scrutiny a company may expect if it is listed in the future. You might go further and engage a social or ESG research firm to identify the issues that typically arise in a given sector, or have cost a company too much management time in the past, and get an assessment of how the target performs against that criterion.

The second and direct external process is to interview stakeholders of the company — customers, investors, regulators, suppliers, local communities — on what issues are important to *them*. Given that project confidentiality is essential, it is not always possible to conduct these interviews comprehensively. But any opportunity to ask those questions while in contact with those stakeholders for any purpose is worth taking. The due diligence process will often present opportunities, and they can often be done as an extension of market research that are otherwise being done.

With these two external reviews under your belt, the direct internal questioning of the company will be sharper, with greater awareness

of the issues, what answers should reveal, and what the follow-up questions should be.

### Leading with risk

Cbus is one of the 38 superannuation asset owners in Australia that had signed the PRI by 30 September 2009. As CEO David Atkin puts it, 'Cbus believes it is important for investment managers to properly assess all risks. This includes a thorough assessment of environmental, social and governance risks'. And that's certainly the starting point for looking at ESG issues: identifying what may undermine months of hard work and analysis, not to mention a stack of capital.

It's important to confirm what risks are relevant. In 2008, the European journal *The Banker* teamed up with New York-based Innovest Strategic Value Advisors to rank the world's best banks on their management of ESG issues. The top ranked global banks managed ESG risk as an earnings liability rather than a brand liability. ESG due diligence is managed in the risk division, as opposed to the marketing or public affairs division, and is enforced by the credit risk committee and/or the chief risk officer. This is not to say that brand risks are not relevant, but that they have to carry a clear and traceable financial outcome.

When you consider risk, you need to go deeper than a general scan of potential future compliance liabilities, which is what your legal due diligence is doing anyway. You need to ask what might be put at risk by a shift in the ecological or social environment. If you're buying a company for its strong growth prospects, look again at its business plan. Test its assumptions against potential shifts. Are there additional hidden assumptions upon which the growth prospects or particular strategies rely? If you're in mining or fish breeding, are you sure you have long-term access to reliable water supplies? Are you sure that the cost of those supplies will just roll along each year with two to three per cent CPI rises? Are you sure that there's nothing upstream which might require you to deal with more impurities than you do now?

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If you rely on technical innovation, consider the company's eco-efficiency trends, including greenhouse emissions. If the company's materials-to-value ratio is increasing while that of its competitors is decreasing, what does that say about the company's innovation culture and performance? Scanning for carbon risk goes beyond calculating \$20 per tonne liabilities on current emissions, as if the company's only choice was to pay the tax.

Likewise, if innovation will drive future value, are you sure your scientists are happy where they are? Technical professionals have a peer community in research and academia, and don't like feeling isolated. That's a risk when you look at the company with an ESG lens, and that same lens may suggest a possible solution. If the scientific staff are getting restless, due diligence will ask whether they're engaging with any other research institute or on external projects. While commercial realities sometimes make it hard for external collaborations on core technologies, it's not hard on technical solutions to environmental problems that affect the economics or communities of a region or sector, or more broadly.

Finally, consider the social and environmental risks if the key venture or business *doesn't* work out, and whether it is worth taking those on. BHP Billiton faced these decisions in developing its \$2 billion Ravensthorpe nickel mine in Western Australia, and in supporting the local businesses and community facilities upon which its workforce would depend. Even companies who think hard about community issues, like BHP Billiton, face a backlash when their best intentions unravel. When Ravensthorpe was closed without warning in January this year, reports showered independent media from Melbourne to Minnesota<sup>7</sup>, a loss of trust that will make it just that little more difficult for BHP Billiton's community planning next time. Smaller mining companies can rarely place such large bets, but they rarely undertake as thorough a community and environment analysis. And in the emerging market of community-based forest-based carbon projects in the developing world, the social risks alone warrant deep ESG due diligence.

While risk is the first port of call, its converse is opportunity. Very few asset owners currently look at ESG from that perspective. Again, look at the brand that the company has secured, the relationships it has formed, the internal innovation that may be applied to a wider market, and the level of

engagement of its people. Here can be found the potential for new growth strategies, cost-saving or quality-improving innovation and a greater confidence in staff relations and new hiring.

### Some red flags

Sometimes it is hard to assess a company's overall social and environmental approach, your best defence against future risks, among a host of single-issue questions. Here is an indication of the type of systemic weaknesses that ESG due diligence may raise as red flags:

- *lack of data* — What's measured is managed, and social and environmental risks are no different
- *absolute numbers* without reference to a ratio that offers a meaningful measure of relative year-on-year performance — Absolute numbers disguise shifts in underlying realities. Water usage may indeed have gone down, but if revenues and output went down *faster*, something is wrong. Material usage may have gone up, even faster than revenues, but if the company switched its product lines from light-framed scaffolding equipment to heavy, energy-intensive capital equipment, the performance may still be impressive. In 2006, Adidas's 63-person social and environmental affairs unit conducted 869 factory visits, audited 197 existing suppliers and 147 potential ones. While that seems impressive, you're not really sure until you knew what proportion of suppliers were audited (fewer than 25 per cent), what proportion of visits were unannounced (fewer than five per cent in this case), whether non-compliance statistics were kept and normalisation to account for factory size, product output or labour force, and whether the outcomes of the audits were pursued through the next stages of Adidas's management systems<sup>8</sup>
- *trends without analysis* — Many reports and interviews can state performance records, but have not gone far in explaining trends, or taking on responsibility for avoidable causes
- *policies and management systems* proudly declared, but with no reported incidents, and no operational changes when something is reported. — Things happen, and a clean slate is more likely to signal a lack of transparency than a perfect record. Policies may have been written internally or externally, with no budget or intent for their implementation
- *a lack of awareness or strategic planning* on social and environmental issues that clearly affect the company's supply chain — Questions would hang over a building materials firm that doesn't track the emissions intensity of its products, or the labour

practices of its suppliers. The market is moving on. Now that the advantages of eco-efficient and worker-friendly office buildings have been established, the Green Building Council of Australia's product certification project proposes ways of evaluating even office fittings and furniture

- *ESG awareness held only at low levels of the organisation*, or limited solely to the brand or corporate affairs departments. — ESG or sustainability responsibility does sometimes rest in head office. But it will have no traction if nobody from operations, marketing and finance is involved. Social and environmental issues are more likely to be misunderstood, and risks actualised
- *a lack of external engagement* on any issue beyond direct contracts and marketing. The more involvement with stakeholders on common issues, the better the risk management.

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Environment, social and governance factors can reveal significant risks and should be taken into account when considering an acquisition. With the PRI being adopted by asset owners and fund managers, integration of ESG factors into the investment decision will tighten. Directly and indirectly (as drivers of the company's key intangibles), opportunity scans can be added to risk due diligence. The factors themselves are myriad, so that the analysis must identify and account for known issues, and assess the company's capacity to identify and deal with new ones.

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### Notes

- 1 Myer Prospectus, 2009, p 62
- 2 Myer Prospectus, 2009, pp 16–20, 127–134
- 3 See also Mather E and Peres da Costa S, 2009, 'Towards a new capitalism?', *Keeping good companies*, Vol 61 No 4, pp 212–216
- 4 *ANZ Supplier Sustainability Code of Practice*, January 2009
- 5 Dowse J, 2006, 'Sustainability measures that count', *Keeping good companies*, Vol 58 No 8, pp 466–471
- 6 For a more general discussion of the commercial aspects of due diligence for acquisitions, see Thornely P, 2008, 'Due diligence — more than just a numbers game', *Keeping good companies*, Vol 60 No 8, pp 467–470
- 7 Would you believe, the Northeastern Minnesotans for Wilderness: [www.nmw.org/news/Ravensthorpe.htm](http://www.nmw.org/news/Ravensthorpe.htm) [4 November 2009]
- 8 Bernstein A, 2009, 'Quantifying Labour and Human Rights Portfolio Risk', *Capital Matters*, June ●