



ESG DUE DILIGENCE

INTEGRATING THE SUSTAINABILITY FACTOR
INTO THE INVESTMENT PROCESS

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BDO

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We aim to provide auditing and consulting services and support of the highest quality. We act with foresight, create added value and proactively approach our clients.

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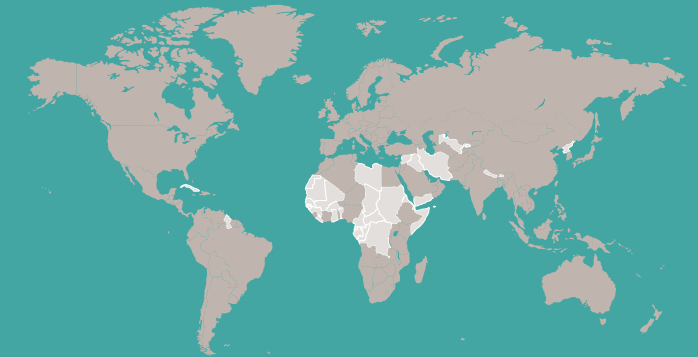
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Today, our industry experts work with leading banks, investment managers and insurance companies in the major global financial hubs as well as in most other countries in the BDO network on tailored solutions for their audit, transactional, tax and legal issues.

BDO INTERNATIONAL

US \$ 9.6 billion
2019 REVENUE

167 Countries
1,800 offices
88,000 Staff



INCREASING IMPORTANCE OF ESG ASPECTS

ESG aspects (Environmental, Social and Governance) have become an important part of due diligence processes in recent years. In addition to the financial, operational, tax and commercial analysis of targets, the focus is increasingly on their sustainability performance.

More and more investors are following the six UNPRI guidelines. The Principles for Responsible Investment (PRI) are a UN financial initiative launched in 2005 with the aim of developing principles for responsible securities management. In implementing them, signatories contribute to developing a more sustainable global financial system. The guideline integrates ESG aspects into investment processes and ownership policies.

Furthermore, the Disclosure Regulation (EU 2019/2088) represents another aspect of the EU Action Plan for the financing of sustainable growth (in short 'Sustainable Finance'). The most recent regulation will enter into force on 10 March 2021 and provides for far-reaching disclosure requirements on sustainability risks for financial market participants.

Established rating companies have also started issuing ESG ratings for companies. However, these may lead to different results. Blackrock, the world's largest asset manager, is also increasingly pushing for sustainability. Larry Fink, CEO of BlackRock, has said that as younger investors gain an increasing share of the overall market, issues related to ESG principles are set to take centre stage and the pandemic would likely serve as an accelerator for this trend.

By comparing two companies that appear to have identical financial results, an analysis of ESG criteria can help investors identify risks that would not have been addressed in a traditional due diligence process. In a best-in-class approach, an investor would then tend to invest in the company that performs best in terms of the ESG criteria compared to its competitors in the investment universe.

Basically, there is a fundamental risk that ESG risks could affect a company's profitability, for example through rising operational costs or future litigation costs. It should be noted that 'ES' risks are different depending on the industry.

Corporate governance aspects, on the other hand, must be considered due to their general relevance for all industries.

There is no exhaustive list of ESG issues. ESG issues are often interlinked and it can be a difficult to classify an ESG issue only as an environmental, social or governance matter.

In principle, it can be assumed that companies that are unable to manage ESG risks will have higher capital costs and greater volatility. In addition, it is possible that risks may not be correctly recorded in the accounting records and that irregularities may therefore occur in the annual financial statements and further reporting. As a result, ESG aspects can influence the valuation in the context of investment decisions. It must also be clear that the ESG guidelines allow investors to exclude non-compliant ESG companies from their investment universe on the basis of negative screenings. This can make it considerably more difficult to finance non-ESG compliant companies.

The challenge is to raise awareness of the ESG aspects and to integrate a ESG screening into the due diligence process. To this end, BDO has built up a strong interdisciplinary expertise, which is essential for dealing with such a complex topic. Our specialised team is recruited from industry experts who have many years of experience in advising on transactions and due diligence processes in a national and international environment. In our industry practice groups, we work together with BDO experts from the areas of auditing, tax and legal consultancy, advisory, as well as with our experts from technical and environmental consulting.

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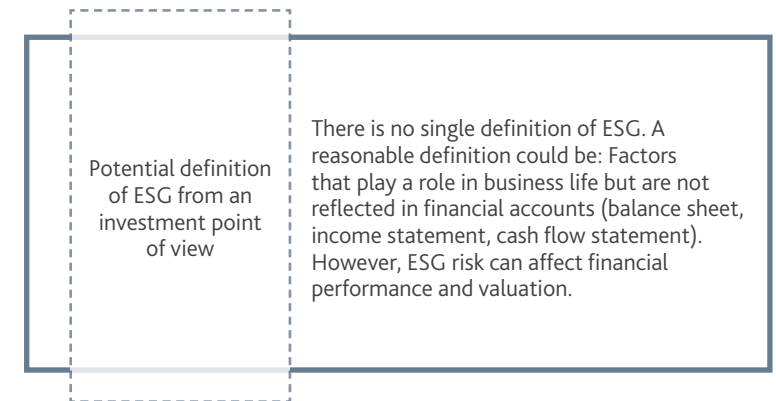
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Environmental	Social	Governance
▶ Climate strategy	▶ Freedom of association	▶ Compliance
▶ Environmental management	▶ Health and safety	▶ Independence of the supervisory board
▶ Environmental impact of the product portfolio	▶ Human rights	▶ Compensation
▶ Eco-efficiency: CO2, water waste, energy	▶ Product responsibility	▶ Shareholder democracy
▶ Energy management	▶ Social impact of the product portfolio	▶ Shareholder structure
▶ Water risks and impact	▶ Gender and diversity	▶ Whistle-blower schemes
▶ Equal opportunities	▶ Supply chain management	▶ Lobbying
	▶ Business ethics	▶ Taxes

Sources: ISS ESG; Environmental, Social, and Governance Issues in Investing, A Guide for Investment Professionals, CFA Institute



INCORPORATING ESG INTO THE DUE DILIGENCE PROCESS

When conducting an ESG due diligence, it is important to bear in mind that there is no standard that specifies the ESG assessment. Because the transaction process typically has a very short timeframe and a target company may have multiple ESG factors, it is important to focus on ESG factors that are material. Therefore, BDO tailors ESG due diligence to the prospective investment based on the industry, product or service offering, geographic reach and other factors.

A professional due diligence of ESG factors has several advantages for investors:

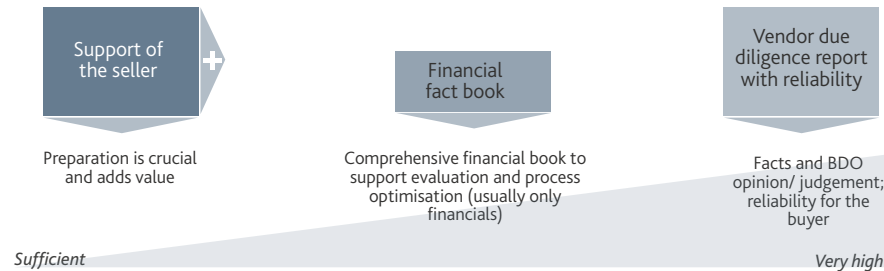
- ▶ It tackles the expensing problem: What does not appear on the balance sheet is often overlooked by investors;
- ▶ Identification of cost-relevant liability and compliance risks;
- ▶ Determination of reputational risks with an influence on the company value;
- ▶ Arguments for price negotiations;
- ▶ Determination of value enhancement opportunities;
- ▶ Valuation of post-acquisition costs of integration in the M&A process.

Transaction process (simplified)



- ▶ Recent surveys indicate that investors tend to reduce a bid price after ESG due diligence. It is not surprising that comprehensive ESG due diligence is a core part of the deal process. A complete view of all relevant risks and opportunities is critical in order to negotiate the right price and the right terms for a deal.
- ▶ Therefore, it can be also advantageous to take a proactive approach to ESG due diligence in a potential sale of a target company by carrying out a vendor due diligence that also considers ESG aspects.
- ▶ A vendor due diligence helps sellers to build a basis of trust with potential deal partners. This succeeds if the seller openly points out to the prospective buyer which weaknesses he has identified.

Sell-side services increase the company value



BDO CASE STUDY 1

Client: An automotive company with manufacturing facilities globally.

Client objective: Our client was being acquired by another company and needed to undertake a complex due diligence process.

Solution provided: Through the combination of multidisciplinary skills, we considered ESG risks to be low as the company had made significant ESG commitments and implemented relevant procedures to satisfy those commitments. The company's focus on sustainability also provided confirmation of the strength of its management policies and procedures and demonstrated the robustness of its compliance process and overall business model.

- ▶ For insights into Sustainable Finance, an emerging shift in the investment landscape and how responsible funding and lending may contribute to sustainability, see BDO's paper 'Sustainable Finance – A New Generation of Financial Literacy':



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ESG DD – ADDRESSING KEY QUESTIONS TO ASSESS THE SUSTAINABILITY FACTOR

President of the European Commission Ursula von der Leyen said in April 2020 that the European Green Deal and hence the sustainability factor will be 'our motor for the recovery' from the Covid-19 pandemic. More strategically, ESG encompasses the entire supply chain, requiring accountability from the primary level, through the suppliers, all the way to the retailers and customers. If producing something sustainably becomes a competitive edge, this could reconfigure global supply lines that were partly developed based solely on low-cost production. Here are some of the key due diligence questions for 'E', 'S' and 'G':

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E

SELECTED KEY QUESTIONS OF ENVIRONMENTAL DUE DILIGENCE

How exposed is the company to ecological aspects?

Depending on the company resp. industry, the exposition can range from very weak to very strong.

Are environmental requirements met?

Environmental compliance may be associated with material cost implications. Also, for an investor it is crucial to know potential regulatory issues.

How is the asset and building condition?

Consider building liability conditions for dangerous building materials (e.g. asbestos, lead). These materials may not be limited to older structures.

Are there any regional variations?

Regulatory requirements may vary from region to region. Therefore, a due diligence needs to address regional regulations and how they affect the business.

Ecological aspects – questions on CO2

Does the climate change have any impact on the business activities or the business model? How high is the risk that CO2 emissions will have a negative impact on the operating result? What does the CO2 footprint over supply, production and use look like?

Ecological aspects – questions on waste

What is the optimal packaging design under sustainable aspects (consideration of costs, environmental impact, product attractiveness and eco-effect among stakeholders)?

Ecological aspects – questions on water

How is the resource water handled? How high is the consumption? Are pollutants discharged into groundwater or rivers?

S

SELECTED KEY QUESTIONS OF SOCIAL DUE DILIGENCE

How satisfied are the employees?

Employees are one of the biggest assets of any company. Employee satisfaction therefore has a positive effect on the company value.

Is there an innovation culture?

Corporate culture has a direct impact on performance measures such as revenue per employee. Today, the importance of corporate culture is not only performance-driven, but also has an important governance character.

How does supply chain disruption affect the business?

Supply disruption and reputational risk could affect volumes. Hence, necessary investments in the supply chain could result in higher operating costs.

How satisfied are the customers?

Analysis on customer opinion on company and its products as well as consideration of possible links between employee satisfaction and customer satisfaction (vicious circle).

Is there any indication on product mis-selling?

Mis-selling is a sales practice in which a product or service is deliberately misrepresented, or a customer is misled about its suitability. Mis-selling is both negligent and unethical and may lead to legal action, fines or professional censure.

Are there any security or data breaches?

Customers data breach may affect customer loyalty. This may in turn lead to loss of revenues. Potential data breaches may result in higher IT spending's to reinforce data security systems.

Is there product compliance?

If product compliance requirements are not met, this can have serious economic and legal consequences for companies. There is the threat of prohibition of sales, product recalls, fines and competition lawsuits.

G

SELECTED KEY QUESTIONS OF GOVERNANCE DUE DILIGENCE

Is the company well managed?

Precise analysis with regard to board accountability and executive compensation as well as review of relevant financial disclosures and internal controls. How are shareholders' rights implemented and complied with?

How good is the quality of the management?

Quality can be measured by a combination of qualitative and quantitative criteria (e.g. by interview, e.g. test for destructive narcissism).

Is there bribery and corruption in the company?

Is the company involved in bribery (offering of gifts/funds, in order to try and influence opinions) or corruption (actions in order to get an unfair advantage)?

How is management remunerated?

Remuneration should ensure a meaningful incentive system. Does the management fit the tasks of the company? Are they challenging but achievable? Are they related to the value of the company?

Is the independence of decisions guaranteed?

Is the management level independent? How are transactions with related parties handled? Is there transparency (i.e. dependency report, SRD II)?

How are reputation risks managed?

A high reputation risk means a higher case risk (asymmetric risk). Is there a reputation management system (controlling, monitoring)?

Is there anti-competitive behaviour?

Anti-competitive practices are practices that prevent or reduce competition in a market. This can lead to unfair (or disloyal) competition and may harm other businesses or consumers.

Refer to next page for an illustrative scope of work

ESG DUE DILIGENCE: HOW BDO CAN ASSIST

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- ▶ Integrating ESG issues into the due diligence process is important for a number of reasons, including identifying threats to business transactions, making comparisons with peer groups and industry standards, highlighting deficient practices and identifying key ESG opportunities for improvement after acquisition.
- ▶ BDO's Transaction Services practices are well-placed to assist investors and vendors in developing and executing their deal strategy, including ESG matters.
- ▶ Our general services in relation to ESG include:
 - Identification and analysis of the key ESG criteria that are relevant for the target company and derivation of the liabilities/risks or opportunities;
 - Comparison of ESG guidelines, including instructions for actions related to peer group and sector-specific best practice approach;
 - Analysis of risks related to the impact on intangible assets, such as goodwill. Considerations are given to risks related to reputation, brand, market confidence and customer and business relationships;
 - Analysis of the financial impact of the identified risks on the financial position and performance (cash flow, refinancing and transaction).
- ▶ ESG related services can be performed either as a stand-alone due diligence workstream or fully integrated into existing streams, i.e. financial, commercial, regulatory, tax, legal.
- ▶ Below are illustrative scopes of work for 'E', 'S' and 'G'.

BDO CASE STUDY 2

Client: A real estate company, market leader in its region.

Client objective: The client was seeking an independent assessment of its internal governance and controls, reflecting relevant regulations.

Solution provided: BDO's investigations extended over the overall framework for internal governance, the corporate and risk culture, the composition and effective functioning of the management body, remuneration policy and practices, risk management and internal control framework, information systems and business continuity and remediation planning.

BDO CASE STUDY 3

Client: A development bank providing debt and equity funding, long-term loans and risk capital to private companies operating in emerging markets.

Client objective: The client was considering acquiring a minority stake in an insurance company serving SMEs and retail clients in Southeast Asia.

Solution provided: BDO was engaged to carry out financial, actuarial and ESG due diligence to assess the risks associated with the acquisition. Our work highlighted the target company's strengths and weaknesses, as well as potential measures contributing to both broad and structural improvements.

E

ENVIRONMENTAL DUE DILIGENCE – ILLUSTRATIVE SCOPE OF WORK

- ▶ Review of the historical development of the site with regard to potential environmental deficiencies, such as polluting production processes in the past, war-related damage, accidents, contamination of soil and the groundwater
- ▶ Entries in the land register relating to building encumbrances/ brownfield sites
- ▶ Environmentally relevant claims and environmental crimes as well as review of existing reports concerning environmental damage
- ▶ Documentation of pollution on site (soil and groundwater pollution) and analysis of the results
- ▶ Production, storage and handling of hazardous materials
- ▶ Existing approvals and conditions issued by authorities, such as water pumping rights, waste water discharge rights, building approvals (business premises, surroundings), approvals relating to emissions (e.g. noise, exhaust air, flue gases)
- ▶ Waste requiring disposal in the foreseeable future, such as scrap, old machinery, building rubble, contaminated excavated soil, special waste

S

SOCIAL DUE DILIGENCE – ILLUSTRATIVE SCOPE OF WORK

- ▶ Customer satisfaction analysis
- ▶ Review of data protection and privacy (policies and implementation)
- ▶ Diversity and equal opportunities (HR review)
- ▶ Analysis of employee attraction and retention/ employee satisfaction
- ▶ Corporates and employees social commitments
- ▶ Government and community relations
- ▶ Human capital management (incl. training and education of employees)
- ▶ Examination of compliance with human rights
- ▶ Observance of indigenous rights
- ▶ Labour standards (incl. freedom of association and collective bargaining, child labour, forced labour, occupational health and safety and living wage)
- ▶ Labour-management relations
- ▶ Marketing communications
- ▶ Analysis of potential product mis-selling
- ▶ Product safety and liability
- ▶ Supply chain management (complexity and possible risk of interruptions)

G

GOVERNANCE DUE DILIGENCE – ILLUSTRATIVE SCOPE OF WORK

- ▶ Compliance with business ethics
- ▶ General compliance (incl. fines and other sanctions)
- ▶ Separation of chairman and CEO (supervisory and executive board)
- ▶ Stakeholder dialogue/shareholder democracy
- ▶ Review of board composition/quality of management and efficiency
- ▶ Review of audit committee structure
- ▶ Review of accounting standards
- ▶ Executive remuneration analysis/analysis of the incentive schemes
- ▶ Analysis of anti-competitive behaviour
- ▶ Bribery and corruption
- ▶ Detection of lobbying activities
- ▶ Political contributions/political spending
- ▶ General risk management
- ▶ Vulnerability of the company to reputational risk
- ▶ Existence of whistle-blower schemes
- ▶ Analysis of tax expenses and tax planning

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