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At A Glance: ESG In Due Diligence

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In the advent of a post pandemic world, it has become apparent that companies with good environmental, social, and corporate governance (ESG) practices have been more resilient since the start of the COVID-19 pandemic.

Issues such as human rights violations, environmental ruthlessness or other ethical infringements have a significant negative impact on a company's business. As such, shareholders and stakeholders are compelling companies' management to focus on sustainability and contribution to global environmental goals, be socially responsible and to become more inclusive and diverse[1].

Consequentially, in the context of transactions, ESG aspects would impact financial and reputational risks as investors seek for more transparency before executing a deal to avoid potential pitfalls linked to ESG concerns.

It is also clear that regulatory authorities recognise the importance of ESG in investment decision-making process and portfolio management. For instance, Bursa Malaysia published the Sustainability Reporting Guide in 2015 to assist listed issuers in embedding sustainability in their organisations and identifying, evaluating and managing economic, environmental, social risks and opportunities. Further, the Securities Commission of Malaysia intends to publish a public consultation paper by the end of 2021 on sustainable and responsible investment taxonomy, which will provide further clarity in respect of sustainable investment assets or activities[2].

The Malaysian Code on Corporate Governance (MCCG) was also revised in 2017 to include good industry practices

[1] 'RE-Thinking Due Diligence – ESG Impact On M&A' (*Deloitte*, 2021) <https://www2.deloitte.com/ce/en/pages/real-estate/articles/ESG-due-diligence-on-the-rise.html> accessed 21 July 2021.
[2] 'SC plans to release guides on sustainable and responsible investment taxonomy by year end' (The Edge Market, 2021) < https://www.theedgemarkets.com/article/sc-plans-release-guides-sustainable-and-responsible-investment-taxonomy-year-end> accessed 21 July 2021.

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to be adopted by companies which emphasise the need for joint action by the board and senior management and to address the need for companies to manage ESG risks and opportunities with a view to reinforce the ecosystem for sustainable and responsible investment[3].

ESG Due Diligence

As transparency in respect of ESG disclosures are becoming crucial and integral to investor decisions, ESG due diligence has evolved from a niche to a widely known term and requires competence in the Mergers & Acquisitions (M&A) business space[4].

Incorporating ESG due diligence into a target company's ESG performance and policies will provide a critical perspective of the target company's relevant risks and opportunities in each of the ESG criteria.

Key Areas

In brief, ESG due diligence should cover facts and insights regarding the success and value of a company's ESG performance and policies. Pollution, exposure to extreme weather, carbon footprint and management, and the utilisation of finite, non-renewable resources are examples of environmental issues which should be identified and analysed. Product safety, human rights, workplace safety, customer data protection, diversity and inclusion are examples of social issues to be identified in the due diligence review of a target company. On the other hand, governance concerns would include factors such as accounting standards and regulatory compliance, succession planning,

[3] 'SC Updates The Malaysian Code On Corporate Governance To Promote Board Leadership And Oversight Of Sustainability' (Securities Commission Malaysia, 2021) <https://www.sc.com.my/resources/media/media-release/sc-updates-the-malaysian-code-on-corporate-governance-to-promote-board-leadership-and-oversight-of-sustainability> accessed 21 July 2021

[4] 'RE-Thinking Due Diligence – ESG Impact On M&A' (*Deloitte*, 2021) <https://www2.deloitte.com/ce/en/pages/real-estate/articles/ESG-due-diligence-on-the-rise.html> accessed 21 July 2021.

anti-competitive behaviour and a strong ESG management strategy[5].

In practical terms, it may be difficult to incorporate such concerns regarding sustainability, greenhouse gas emissions, or ethical purchasing into the M&A due diligence process. Practitioners should consider the following questions in relation to an ESG due diligence, which is relatively similar to an anti-corruption due diligence exercise:

(1) Have ESG concepts been effectively implemented within the target entity?

(2) When it comes to ESG concerns, does the target company have appropriate personnel training, whistleblowing rules, and case management?

(3) Is the ESG data of sufficient quality, especially because there are so few standardised measures available?

(4) Is ESG data from international businesses reliable and appropriate?

(5) Have the ESG risks in the target entity's supply chain been evaluated, and have these issues been resolved prior to the merger or acquisition?

(6) How can ESG principles be integrated into existing or new operational models after the deal is closed, especially when the buyer and target organisations may employ different measures?

(7) Will the post-acquisition organisation be able to satisfy management's ESG targets and deadlines?[6]

[5] 'ESG due diligence – How it's done & why' by Helee Lev (https://www.gobyinc.com/esg-due-diligence-how-and-why/)

[6] Anushka Ram, 'How Can ESG Be Worked Into M&A Due Diligence Best Practices? – ESG Clarity' (ESG Clarity, 2021) < https://esgclarity.com/how-can-esg-be-worked-into-ma-due-diligence-best-practices /> accessed 21 July 2021.

Conclusion

As ESG practices have become increasingly important in today's world, it is imperative for companies to devote adequate time and resources during the M&A process to ensure regulatory compliance and shareholder satisfaction in respect of ESG practices are met.

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