CDC

ESG IN THE INVESTMENT CYCLE: GUIDANCE

Working with Consultants

CDC GUIDANCE: WORKING WITH CONSULTANTS

1. OVERVIEW

Properly briefed and with the right experience, external Environmental and Social (E&S) and/or governance and business integrity (G&BI) consultants can help build a fund manager's understanding of the ESG impacts, risks and opportunities facing a company, their approach to specific issues of concern and how these can be addressed.

There are no hard and fast rules about which types of deals consultants should or should not be engaged. It is likely their expertise will be required for higher risk or complex deals or those where due diligence (DD) has discovered questions over a company's past dealings or raised issues about the integrity or source of wealth of a member of a management team. External experts may also be required to look at particular opportunities relating to low-risk businesses or one particular aspect of a business that is a cause for concern (e.g. occupational health and safety). The knowledge and expertise of consultants should build on and complement that of in-house staff, rather than duplicate it.

Consultants can be engaged across a wide range of work, such as Environmental and Social Impact Assessments (ESIAs), more limited and focused E&S assessments, and E&S Audits/E&S DD. Business integrity (BI) due diligence may explore adverse media reports concerning a company or its shareholders or directors, look into speculation over how contracts have been won, or provide insight into political trends (e.g. A new government's approach to an issue).

They may also be contracted to do a one-off gap analysis (looking, for example at how a company's E&S management system (ESMS) might be improved), providing advice on documents produced by the portfolio company, or offering a second opinion on difficult issues.

The following guidance is intended to make working with external consultants as straightforward as possible and ensure it is done so it adds as much value as possible to the company, fund manager and other stakeholders (e.g. Limited Partners).

Refer to Downloads and Reference Materials for samples of Terms of Reference (ToR) for ESG due diligence.

2. WHEN TO ENGAGE CONSULTANTS

2.1 When might E&S consultants need to be commissioned?

External E&S expertise might be required at the following points in the investment cycle:

- ***Due diligence:*** For 'High' and 'Medium-high' risk operations or where a fund manager feels internal resources could be complemented.
- ***Monitoring 'High' and some 'Medium' risk businesses****:* Supplementing the in-house E&S function (e.g. during ownership stage to assess performance on specific ESG issues) or to assist with improvements and help build value.
- ***Mergers and acquisitions:*** During expansion phase of a portfolio company that is targeting an acquisition.
- ***Pre-exit assessment:*** To assess and quantify the value of ESG improvements compared to pre- investment. Vendor due diligence may be commissioned to provide enhanced information to potential purchasers and expedite a sale process.

Fund managers should use in-house expertise to write the Terms of Reference (ToRs), evaluate and commission proposals, interpret final reports and extract key recommendations and findings for use in key investment documents.

2.2 When might business integrity consultants need to be commissioned?

External expertise might be required at the following points in the investment cycle:

- ***Due diligence:*** When due diligence has revealed rumours or facts that call into question the business practices of the target company, its sponsor or directors.
- ***PEP***: When a politically exposed person (PEP) is involved in a transaction as a mechanism for establishing their source of wealth.
- ***Mergers and acquisitions:*** During due diligence phase as a portfolio company targets an acquisition.
- ***Pre-exit planning***: To help develop a credible and independent narrative showing improvements in G&BI processes and how they added value. Vendor due diligence reports may be commissioned to provide information to potential purchasers.

Fund managers should use in-house expertise to write the ToRs, to evaluate and commission proposals, interpret final reports and extract key recommendations and findings for use in key investment documents.

3. DRAFTING TERMS OF REFERENCE

3.1 Scope of work and deliverables

Whether contracting external expertise for due diligence or for monitoring purposes, it is important to carefully consider the scope of the work and the desired deliverables.

It is important to carefully review the target company's assets before writing the Terms of Reference (see below). If it is not feasible for the consultant to visit all assets then prioritise and ensure that a representative sample of assets/activities are visited (including those presenting the highest risks). Remember to also think about upstream and downstream risks and impacts (e.g. supply chains, distribution) and consider how these might be assessed.

Be clear about any applicable standards that will form the reference framework for the assessment (e.g. simple local legislation or supplementary requirements of IFC Performance Standards and/or other international standards). Be sure to specify if you are looking for a gap analysis of one existing study against applicable standards or against any ESG Action Plans, or whether you are looking for new information. Also highlight that the studies commissioned should not only be about compliance, but about avenues to improve the business operation and long term value, and consider the approach to be taken with this in mind.

It is important to talk to the consultants and listen to their advice. They are likely to have conducted a large number of E&S DD and monitoring audits. Ask about any perceived concerns or limitations and give them a realistic timescale to complete their work.

Be clear about the deliverables expected e.g. A detailed report, including an executive summary of key ESG risks, impacts and opportunities, ESG Action Plans to address areas of concern, or a value creation plan (VCP).

Remember that there are some observations that an external expert may prefer to discuss verbally rather than formalising in the report. The fund manager should seek to assess client commitment themselves starting with the first interactions at the business development and screening stage. For this reason, it may be useful for investment staff from the fund manager to accompany external experts to site as part of building client relations.

It is important to not only review final reports and deliverables, but also to discuss the findings with the experts. They might provide verbal feedback which will supplement the written report if there are items identified that may not have been included in the paper. Generally it is useful to do this after production of a draft final report, to discuss any areas where you feel clarification is required prior to production of the final report.

If the document includes an ESG Action Plan, fund managers should ensure this is realistic and appropriate, as the fund manager may need to negotiate/discuss the ESG Action Plan with the company post-investment without the consultant's support.

3.2 Writing the Terms of Reference

The following points should be included in the ToRs for the consultants.

Context:

- Provide background information and set the context for the expert study you intend to

commission.
- Provide an introductory paragraph about your fund, its ESG policy and strategic focal areas.
- Introduce the portfolio company or facilities to be investigated.

Nature and purpose of the study:

- Specify the nature and purpose of the study required. State the purpose of the study and what the information provided would be used for (e.g. o determine compliance, to investigate opportunities to add value, to assess possible liabilities prior to acquisition, to review an already completed study such as an ESIA, or to identify strengths and weaknesses in the ESMS).
- State the audience for whom the information/study is designed.
- Provide enough information to allow the proposed consultant to plan man-hours of appropriate team members with relevant expertise and costings for travel and other inputs. Overviews of existing or likely ESG risks and impacts are key.
- Introduce the applicable requirements against which the study should be undertaken. Specify that the IFC Performance Standards and ILO conventions are the benchmark.
- Include a minimum list of documents to be reviewed.

Timing and scope:

- Provide clear guidance on the timing of the investigation and other project milestones. Indicate when the study is likely to be commissioned and when the final report and presentation should be given.
- Give clear guidelines as to the minimum number of sites to be visited, along with clear instructions as to which sites are essential. Alert the company to imminent site visits.
- Ensure the consultant is fully briefed on any expected future growth plans for the company, especially where this involves new sites, as this will impact on the management systems that will need to be in place.

Expected outputs:

- Include a list of headings or draft contents page for the final report.
- Ask for separate recommendations for what the company should do and recommendations for what the fund manager could do to support the company.
- Indicate the maximum length of the final report.
- Indicate that a final presentation and discussion of the findings will also be required.

Ensure all additional relevant background documents are available immediately on engaging an external expert.

4. SELECTING CONSULTANTS

Fund managers should seek to hire consulting firms or individuals based on the experience and expertise of the proposed team/individual. Some fund managers select consultants by calling for capability statements, and then evaluating and interviewing applicants carefully to compile a shortlist for the deal in question. Other fund managers prefer to have a small team of experts on retainer, available at short notice and knowledgeable about the fund's ESG requirements.

Beware of conflict of interest. Ensure the selected consultant is not currently working for or has not previously worked for the company, and is not working for any other parties involved in the transaction.

It is also worth bearing in mind that E&S expertise can be sourced not only from consultancies or individual experts, but also industry experts with detailed operational experience of good practice in a particular sector. Sometimes, the work may need to be split between a number of consultancies with different specialisms (e.g. an international E&S consultancy subcontracting a specialist piece on contaminated land). How work is coordinated should be given careful consideration.

Working with consultants with the following experience and credentials are recommended:

- ***Experience with and sound understanding of the applicable standards,*** such as the IFC Performance Standards, ILO Conventions, World Bank EHS guidelines, local and international ESG laws and regulations in the countries being assessed and how these relate to both local norms and formal international standards.
- ***Relevant expertise in the specific field that needs to be evaluated***, such as the adequacy of Environmental and Social Impact Assessments or occupational health and safety management. Note that many E&S consultants have more expertise on environmental rather than social matters. Where social issues need careful consideration, ensure the consultants have suitable knowledge and experience.
- ***Geographic experience*** in the same country and/or region in which the company operates (or will operate);
- ***Industry/sector experience*** (i.e. textiles, palm oil, power, oil & gas etc.) and experience of the relevant industry or regional standards (i.e. Roundtable on Sustainable Palm Oil or Nigerian Sustainable Banking Principles).
- ***Experience in delivering transaction support*** to the financial sector can be useful as a bridge between technical E&S findings and recommendations, and the requirements and limitations of the fund manager.

It is also important to consider the scale and geographic spread of the consultant's capacity in terms of the company's operations and the fund manager's location. It is important that the consultant(s) can cover all relevant facilities and supply chains, especially if they are spread over a region and these are material to the scope of the work required.

It is not only the organisation's experience and track record that is relevant, but the capacity of the individual staff members proposed for the work. Fund managers should follow a similar approach to selecting appropriate consultants for commercial or market diligence. They should:

- Ask for CVs/resumes of the staff proposed for the work. Look for technical credentials and the relationship with the firm (e.g. are they an Associate as opposed to permanent employees) and evaluate the competencies of who is doing specific tasks.
- Ask who will be performing the different tasks such as desk research, site visits and final report review.
- Understand whether the consultancy will commission any additional locally-based expertise or partners for additional insight. Again, be clear on who will be performing the different tasks, and under how much supervision. Also check on the capacity of any locally based experts engaged.
- Ensure that at least one senior manager will take responsibility for the work and be the point-person for project management.
- Ask to see examples of previous similar work (this is unlikely to be possible for a due diligence exercise).
- Ask for references from other clients.