1. Objectives and overview

- Objectives of the ESG due diligence
  The ultimate aim of ESG DD is to allow the investment committee (IC) to make a fully informed decision about the proposed investment. In order to do so, it needs to understand:
  - The materiality of ESG risks and impacts to the business.
  - The company's compliance with applicable laws, regulations and standards as laid out in the fund's ESG Policy.
  - The adequacy of and implementation status of the company's E&S management system (ESMS).
  - The company's commitment, capacity and track record (CCTR) regarding ESG matters.
  - Materiality of gaps/improvement areas identified and resources needed to address them (typically captured in ESG Action Plans).
  - Opportunities to add value by improving ESG practices/performance.
  - How the proposed ESG improvements fit with the business plan and the fund's view of the company's likely future profitability.
  - Limitations of the DD, any assumptions made and any resulting potential unknown risks.
  - How the fund manager intends to maintain influence and oversight on ESG matters going forward
  - Understanding who the legal and beneficial owners of a company are so that appropriate 'know your customer' (KYC) checks can be undertaken.

  Ideally, a good DD process is a partnership, not an audit (though taking this approach may not always be feasible). At the end of the DD phase, the fund manager should have developed a common understanding with the business of any improvements needed, and the likely costs and benefits of implementing these. Based on this, they should be able to present the IC with all of the information needed to make a fully informed decision about the relevance, significance and nature of ESG impacts, risks and opportunities related to the proposed investment and the company's commitment, ability and/or potential to manage and address them effectively.

An overview of the activities included in the DD stage is shown in the graphic below.

Click to view diagram

- Due diligence process overview
  The ESG DD should not be left to the very final stage in the transaction's general DD process. Undertaking the ESG DD too late in the deal's overall DD process may lead to important risks and opportunities for improvement being missed due to time and capacity constraints.

  At the core of DD is a proper understanding of a company's operationsand business plan. In particular, understanding of whether and how the business might generate ESG impacts and risks and whether the company's management is committed to addressing them effectively. It is also important to determine whether management has identified ways in which better ESG management could add value to the business and taken steps to capitalise on those.

  To be comprehensive and effective, the fund manager's DD will generally start with a desk review of key documentation, followed by discussions with the company, and site visits to at least a representative sample of existing facilities and, where applicable, new project sites.

  In some situations, the fund manager is likely to have sufficient capability to carry out ESG DD without recourse to outside experts. However, in other situations (particularly for, but not limited to, 'High' and 'Medium-High' risk companies and operations), it will likely be necessary to commission consultants. Guidance on when and how to commission expert advice is provided below. Fund managers should always conduct their own DD, including transactions in which external consultants are engaged.

  It can be useful to use standard DD checklists and templates to guide the DD process. Sector profiles, such as the ones in this toolkit, can also help to ensure that no key issues are overlooked. DD works best when the team conducting it aims to truly understand the business and how it operates, not to complete an E&S checklist as quickly as possible.

It may be helpful to speak to other investors to determine whether there is a common interest and ability to align the requests being made to the company.

2. Actions

It is important that the fund manager establishes a rapport with the company during the DD phase. This will facilitate productive discussions to identify opportunities for improvement and value creation.

Refer to CDC environmental and social checklist and CDC governance and business integrity checklist as these documents contain questions and points to be discussed and assessed during due diligence. Refer to Sector profiles for guidance on key ESG aspects of each sector.

2.1 Define the scope of ESG DD

Findings at screening should be used to guide the scope of DD with a view to ensuring they key ESG aspects are well understood, and ultimately, managed. The aim of scoping is to define the boundaries of DD.

- Scope of E&S due diligence: key considerations

  The key considerations when defining the E&S scope of DD are:

  - ***Investee company/group structure:*** If investing at group or holding company level, at least a representative sample of the subsidiaries (whether wholly or partially owned) should be included in the DD scope. This is because there might be a financial and reputational exposure to the risks in those parts of the business (and it may well be necessary to prioritise or rank these subsidiaries by risk for formal DD). If investing at the subsidiary level, consideration should be given to potential reputational risks from group level or other subsidiaries and whether there is likely to be support or resistance to any necessary changes from the Group.

- ***Physical assets:*** Any assets owned by the company, such as the primary and any ancillary sites and operations should be included. Associated facilities should also be included. These are facilities that are not owned or operated by the company, but would not have been constructed or expanded if the company's assets and operations did not exist and without which the company's operations would not be viable (e.g. transmission lines, access roads, berths).

- ***Labour:*** Direct employees, direct contractors and anyone working regularly on the company's premises should always be included in the DD. Sub-contractors should be considered on the basis of risk materiality. If there is a risk that either of these groups are likely to be exposed to serious health and safety risks, child labour, forced labour or other serious labour rights abuses, then they should also be included.

- ***Supply chain:*** Where a company relies on specific or dedicated supply chains, labour and biodiversity risks in those supply chains should also be assessed (acknowledging that there may be limited opportunity to change practices, but that the scale and type of E&S risks are recognised).

- ***Time:*** The E&S implications of the business plan should be included (e.g. if the investment is growth capital and new construction or land acquisition will be involved). Equally, the potential risks associated with legacy issues should be considered (e.g. liabilities associated with contaminated land or unresolved disputes associated with historic land acquisition).

- ***Standards:*** The standards that should be applied as per the fund's ESG Policy and the LP's requirements. This includes applicable laws and regulations, as well as international standards (e.g. IFC Performance Standards). If using a consultant, they will determine which elements of each standard apply. However, if the DD is being done in-house, the fund manager will need to determine which apply.

- ***Cumulative impacts:*** It is important to consider not only the company's E&S risks and impacts, but also assess whether there are any other existing or planned facilities/developments that could significantly exacerbate the company's E&S risks and impacts, as this could have a negative impact on the investment (e.g. resettlement costs, access to water). Managing cumulative impacts could be very complex, but, in any case, fund managers should at least be aware of them.

- Scope of governance and business integrity due diligence: key considerations

  The key considerations when defining the G&BI DD are:

  - ***Company/group structure:*** In order for effective corporate governance due diligence to be done, a fund manager will need to understand how a target investment is currently organised – both at a corporate level and internally. Corporate and organisational structure charts are likely to be a key component.

  - ***Business integrity:*** Fund managers should develop an understanding of the past conduct of the target and its sponsors. There is a clear reputational risk in doing any business with known criminals or those with a poor business reputation.

  - ***Anti-corruption and whistleblower considerations:*** Fund managers should develop an understanding of the target company's approach to bribery and corruption, and whistleblowers. The way in which the senior management of the target demonstrate that these are important issues is a key consideration, as is the way they may have dealt with any previous reports of bribes being demanded or paid. Any written policies will need to be assessed to ensure that they are sufficiently detailed and current. Additionally, the way in which the company's approach and policies are communicated should be considered, and the quality of any training assessed.

  - ***Economic sanctions:*** Fund managers should check that potential investors, target companies and their major products and customers, the vendor, and (in due course) the purchaser companies and their directors and shareholders are not listed on any international sanctions database. A record of the searches should be stored as evidence that this important DD was carried out.

  - ***Documentation*:** The DD process should help the fund manager assess how effectively the board and any sub-committees are operating. Fund managers should seek to capture copies of the minutes and papers for both the board and the most significant committees (e.g. any audit or risk committees).

2.2 Perform a desk review

The next stage of the DD is usually to collect and review documentation, including publicly available information and documents requested from the company. This will enable the fund manager to start to identify how well key risks and impacts are being managed, whether there are any concerns (including gaps) with the fund's ESG Policy, and whether the company has capitalised on any ESG opportunities. This review will build upon the work started at screening.

This table provides a summary of the information sources and documents that the fund manager could review as part of the desk review. The amount of information to be reviewed will be mainly driven by the relevance of the ESG aspects of the investment (i.e. higher risks would typically involve more extensive and comprehensive information review, either directly or through consultants).

Click to view diagram

There are limitations to a documentary review, so the findings should always be considered in light of insights gained through meetings with management and site visits.

- Limitations of the desktop review
  It is important to listen and understand a company's approach to managing ESG performance, rather than to seek a series of documents to review. Some companies have no formal ESG management system, but are managing their key ESG risks relatively effectively, and all that is required is to formalise existing processes. Alternatively, advanced systems for managing ESG may be fully integrated into business operations, rather than a documented system that can be provided for desk review. By contrast, some companies may have very robust written ESG management system that have not been effectively implemented.

- Further considerations
  - The desk review should at least start prior to visiting sites and facilities.

  - CDC environmental and social checklist, CDC governance and business integrity checklist and Sector profiles should help to identify the issues that the fund manager should focus on. However, it is important to determine whether the investment might present additional ESG risks and/or opportunities.

  - If commissioning external consultants for DD, the fund team should still conduct some degree of desk review to identify the key risks and opportunities and to help to define the scope of the work of the consultant.

- Desk review: Further consideration and advice
  Find below some further recommendations and considerations for this stage. Fund managers are advised to:
  - Share the fund's policy and ESG provisions/requirements with the company early and offer a call with the fund's E&S and BI team to discuss as needed.

  - Check the information compiled during the screening phase. In some cases, more detailed online searches may need to be conducted to assess past performance and reputation.

  - Be clear on the documents needed to prevent delays.

  - Agree the processes that will be used to communicate and make documents available and accessible in advance with the company or any consultants being commissioned.

  - Where company ESG documentation is scant, a more detailed investigation into ESG management will likely be necessary during the site visit.

  - When reviewing the company's E&S policies and management systems, checking dates and versions of documents can indicate how often they are reviewed, when they were first drawn up and how often they are referred to. It may be useful to ask who accesses/refers to the documents.

  - When reviewing any ESIAs, audits or reports supplied by the company, check for the independence of the body completing these. Also check the adequacy/sufficiency of the scope of these reports (e.g. some ESIAs may not fully cover social impact assessment). Where possibly, check the qualifications of the consultants who prepared the ESIA.

- Look at any licences and/or certificates to determine whether they are valid, in date and cover all relevant operations. Also consider what they actually certify and how this compares to the fund's expectations (e.g. some certifications schemes simply certify that a management system exists but do not comment on the quality of that system). Where possible, check the qualifications of the consultants carrying out the certification and what they actually reviewed.

2.3 Assess the company's commitment, capacity and track record

At this stage, companies' management systems and performance may not meet fund manager's requirements. Therefore, it is essential to assess each company's willingness to address any weaknesses within a reasonable time frame is essential. It is also key to ensure that the company will have the necessary resources to operate in accordance with the applicable standards and to implement any ESG action plans.

Fund managers must always assess companies' commitment, capacity companies commitment, capacity and track record (CCTR) as they are leading indicators of the company's ability to achieve and maintain compliance with the applicable standards and expected performance.

2.4 Plan and conduct site visits

Site visits are very valuable in the DD phase to identify and evaluate ESG impacts, risks and opportunities. They provide the fund manager with the opportunity to gain a range of insights into the workings of the business, to confirm or change initial ESG assessments, to assess management's CCTR and assess compliance with applicable ESG standards.

- Primary benefits of conducting ESG site visits
  Site visits could be valuable in order to:
  - ***Outline expectations:*** Explain the fund manager's requirements and expectations relating to E&S issues.

- ***Understand actual risks/impacts:*** Develop a first-hand understanding of a company's operations and which risks are the most material.
- ***Assess the implementation of companies' ESMS:*** Test the strength of the ESMS (going beyond what is described on paper) and how it is applied in practice, as well as management commitment to improved E&S performance.
- ***Identify opportunities:*** Look for opportunities to add value through better E&S management.
- ***Strengthen/maintain a good relationship:*** Deepen the relationship between fund manager and the company (including with mid-level / operational staff) and agree actions in order to meet the fund's expectations.

- Planning and carrying out site visits: key considerations

  DD meetings and site visits should aim to deepen and test the information and impressions gathered during screening and the desk review. It is also the best time to understand the company's CCTR regarding ESG matters.

  Careful consideration should be given to which sites should be visited, as well as who to speak to during the visit. If it is not possible to visit all the company's sites, fund managers (or their consultants) should select sites which provide a representative sample of the company's operations and ESG risks, including as a minimum the sites with highest E&S risk and the head office.

  Who should conduct the site visit?

  - Investment team: All investment staff.
  - E&S Officer: At least for 'High' and 'Medium-high' inherent E&S risk transactions.
  - BI Officer: May wish to visit if there is a heightened risk of business integrity issues.

    - Consultants: ‘High’ and ‘Medium-high’ risk investments, plus whenever in-house capacity is lacking. There are significant benefits to the fund manager accompanying them in their site visits and company engagements.

  It is advisable to discuss ESG issues with at least: (i) senior management; and (ii) those directly involved at an operational level. Meeting with a selection of other employees could be helpful to gauge the implementation status of the ESG management system(s).

  Site visit findings should be discussed broadly with others in the fund’s investment team to check whether they confirm or contradict broader observations of the company. For further guidance refer to CDC guidance: Site visits.

2.5 Assess the need for ESG consultants. Engage consultants.

Fund managers may need to engage consultants to assist them with the DD. In those situations in which consultants are engaged, fund managers will still need to conduct their own DD (obviously, the fund’s DD would take into account the consultant’s findings). Engaging consultants would add very limited value to the fund’s ESG DD if the scope and reference framework/applicable standards are not appropriately defined.

- When should fund managers engage consultants?
  There is no hard and fast rule about when a fund manager should bring in external support for the DD. The decision will depend on:
    - Relevance of the ESG risks and impacts.
    - The expertise available internally.
    - The technical knowledge and skills required to properly assess the ESG aspects of the investment.
    - Time pressures for the deal team, necessitating additional resource.

  If the fund manager has sufficient capabilities in-house and capacity to conduct the ESG DD within the required timelines, it may not be necessary to hire consultants for most ‘Low’ or ‘Medium-low’ risk investments. However, where significant diverse and/or complex ESG risks and impacts have been identified, particularly if these are outside of fund team’s expertise, a consultant should be engaged to assist with deal DD. For guidance on the types of report that might be needed, refer to CDC guidance: Specialist E&S assessments and reports.

2.6 Develop and agree ESG action plans

A key output of the DD process is an ESG action plan **t**hat addresses any ESG improvements that are required to:
(i) bring the company into compliance with the fund’s ESG Policy/applicable requirements and standards; and/or
(ii) to capitalise on ESG opportunities.

Action plans should be discussed with management to ensure that the fund manager and the company have a clear understanding of what needs to be achieved.

- Elements of a good action plan
  Action plans should be discussed with management to ensure that the fund manager and the company have a clear understanding of what needs to be achieved.
  - SMART targets (i.e. those that are specific, measureable, achievable, realistic and time-delimited).
  - Actions that are tailored to the ESG impacts, risks and opportunities to be addressed with a clear prioritisation based on an assessment of materiality and an explanation of why the issue is material (for example, high cost of correction, business risk, reputational risk).
  - Description of the actions required to implement remedial measures. In some cases, one risk can require several actions to deliver remedial measures. Similarly, a description of the actions needed to capitalise on opportunities (e.g. attaining certification).
  - Actions that are prioritised and broken down to specific, realistic and credible tasks, rather than ambiguous statements (e.g. ‘deal with waste’). The number of actions should be realistic and achievable in the context of the timeline. Actions are likely to relate to specific operational issues, as well as ways to enhance the

E&S topic: Company ESMS.

- Completion indicators to accompany each action (e.g. a document, physical evidence if specific facilities/treatment system should be built etc).
- Clear timeline for implementation, including indicators of completion and absolute dates (rather than ambiguous reporting periods).
- Clear allocation of responsibility (department and individual) and resources (budget or additional expert input).

2.7 Ensure influence and oversight

Fund managers need to ensure they will have sufficient influence and oversight once the investment is made, so that the company operates in accordance with the relevant standards and implements agreed action plans. The level of oversight required will depend on several factors including the level of risks/impacts, resources required on ESG management, the company's CCTR and the leverage the fund manager will have over the company.

Further information is provided in the Investment agreement and Ownership and monitoring sections. Points to be considered at this stage to ensure adequate provisions are included in the legal agreements are set out below.

- Oversight
  - ***Company's internal performance management and review:*** As part of establishing an effective E&S management system, the company should establish a mechanism for overseeing its E&S progress (e.g. board oversight). Fund managers should have access to information related to this system (e.g. board minutes, ESG sub-committee minutes).
  - ***Access to information:*** The fund manager should agree an annual monitoring template with the company, containing information on ESG performance and progress made against the action plan(s) which can be adapted to each investment. Additionally, the fund manager should have access to relevant

documentation on request.

- ***Access to site:*** Consider how often it is desirable and feasible to visit the company head office and key operational sites, depending on both their ESG risks and accessibility.

- ***Access to staff:*** It is important to ensure that investment officers and/or ESG officers build a relationship with the company's ESG staff/team. This could be achieved informally and/or through regular scheduled meetings. Appropriate lines of communication should be agreed.

- ***Certification audits:*** If the company is audited as part of a credible certification system, such audits provide a degree of independent oversight of the company's performance. It is important to be clear about the scope and objectives when commissioning an audit.

- ***Key performance indicators (KPIs):*** Considering the priorities identified during DD, the fund and the company should agree on which KPIs should be tracked to monitor the company's progress during the investment period.

- ***External support:*** If there are aspects of the E&S action plan(s) that are beyond the expertise or capacity of the fund team, it may be useful to engage consultants to provide support, either reporting to the fund directly, or to advise company management.

- Influence
  The leverage and influence the fund manager has with respect to ESG is no different from that on other matters. The fund manager can use the same skills and the same level of rigour to ensure operational improvements in ESG as in other areas where it is seeking to add value to the business.
  - ***Valued partner:*** Irrespective of the stake the fund holds in the company, if the company values and trusts the fund's advice, this is typically the single most effective way to influence the company to embrace any changes the fund is proposing. This is much easier if the fund is able to select businesses whose vision and plans for the company are aligned with its own.

- ***Board/ESG sub-committees:*** If ESG matters are of strategic importance to the business, it may be worth asking the company to include relevant items/KPIs on the regular board meeting agenda, or even to establish an ESG sub-committee to the board. If there are other management-level issues, then the fund manager can still use its board seat to raise issues of concern when necessary (e.g. management underperformance). A board seat can also be an opportunity to engage with other investors with aligned interests either to support the company in achieving its ESG objectives or initiate change when it underperforms.

- ***Legal rights:*** Ensuring that compliance with the fund's ESG Policy, access and information rights, and any action plans are incorporated into legal agreements, with appropriate provisions for non-compliance, is an important route to achieving influence.

- ***New management:*** If part of the fund's plans for the company include bringing in new management, choosing people with an interest in, and ideally experience of, implementing the types of ESG improvements the company needs to make, can be extremely effective.

2.8 Prepare due diligence reports

The document containing the DD findings can take different forms. Refer to 'Outputs' below for guidance on how to prepare DD reports.

3. Outputs

Key outputs of the DD stage:

- A record of the DD process.
- Report/document containing DD findings, including key ESG risks, impacts and opportunities, view on the company's CCTR and any gaps against applicable standards.
- Where appropriate, ESG action plan(s) agreed with management to address any gaps

and/or materialise ESG opportunities.

- Summary of the key DD findings for the IC paper.

Some funds have obligations to share certain ESG DD reports and/or action plans with their LPs. Where this is the case, sufficient time should be built into the DD and IC process to allow the LPs to review and comment on the information and for the fund to take that feedback into consideration.

- Record of the due diligence process

  Maintaining a file record of the DD process helps to:

  - Ensure that all key aspects of DD have been completed.
  - Provide a record of the DD findings to inform ownership and monitoring activities, if the investment is made.
  - Provides continuity if the investment is managed by someone else in the future.
  - Provide a basis and reference point for the ESG section of the IC Paper.

  The record should include:

  - A list or copies of all materials reviewed, both publicly available and from the company.
  - Notes from meetings and site visits with the company.
  - A statement outlining any limitations to the DD, any assumptions made and any resulting potential unknown risks.
  - Any reports commissioned such as consultant DD reports.
  - A summary of the main existing and potential risks, impacts and opportunities, including their materiality.

    - An analysis of whether the investment complies with the fund’s ESG policy.
    - A copy of the action plan.
    - A summary of the conclusions of the DD.

- Due diligence report
  The document containing the DD findings can take different forms, such as a completed DD checklist or a full ESG DD report for each investment (similar to those produced by consultants). In any case, a good DD report (whether produced by the fund or a consultant) would typically:
    - Be based on a representative sample of the company’s facilities and operations.
    - Summarise the DD process (including site visits and main documents reviewed) and acknowledge any limitations of the process.
    - Clearly identify and assess the materiality of ESG risks and impacts arising from the company’s current and proposed activities (this may include associated facilities and supply chains, as appropriate) and/or which could have an impact on the company.
    - Identify ESG opportunities that could add value to the company.
    - Assess the level of compliance/alignment with the requirements of the fund manager and other investors.
    - Assess the strengths and weaknesses of the company’s current ESG management, covering both the quality of the management team and adequacy of relevant management systems.
    - Include an action plan(s) designed to address risks/gaps and to create value corresponding with the risks and impacts identified and the hierarchy of significance or priority. The Action plan(s) includes clear timelines, responsibilities, completion indicators and, to the extent possible, estimated costs.

  - Conclude with a summary of key findings to feed into the investment committee (IC).

- ESG action plans
  Action plans should be presented and viewed as a negotiating point with the company given their relevance (i.e. the action plan will capture the necessary steps to be implemented to ensure the company achieves alignment with applicable standards within a reasonable timeframe). Fund managers must ensure that the company understands the action plan and is aware of the resources needed to achieve the objectives of the action plan.

- Summary of DD conclusions for the investment committee (IC)

  The summary of the DD should enable the fund and its IC to understand the following points/questions:

  - The materiality of ESG risks to the business (i.e. are they financially or otherwise significant and could they be avoided or mitigated?)

  - Does the company comply with applicable laws, regulations, international standards and guidelines on key ESG issues as laid out in the fund's ESG Policy and per the LPs' requirements?

  - Is the company's management system sufficiently well developed and implemented to manage ESG matters, or does it need to be improved?

  - Does the assessment of the company's CCTR indicate they are willing and able to undertake any necessary improvements?

  - Is an action plan required? Where there are gaps, how can these be addressed and what resources will be required to address them? It should highlight steps that should or must be taken as a condition precedent to investment or as commitments to be fulfilled during the ownership stage.

  - Are there opportunities to add value through enhanced ESG performance?

- How do the proposed ESG improvements fit with the business plan and the fund's view of the company's likely future profitability (improvements may require capital/staff time and may generate future efficiency or revenue benefits)?
- Were there any limitations to the DD and any resulting potential unknown risks?
- How does the fund intend to maintain influence and oversight on ESG matters going forward?
- Are there potential reputational risks to the fund manager and LPs?

This summary can also be used as the ESG input to the investment paper. It should be written or approved by the E&S Officer and the BI Officer.