1. Objectives and overview

- Objectives and benefits of early coverage of ESG
  1. Early identification of key issues that may have a significant impact on the investment/company (e.g. compliance with a fund's exclusion list), saving time and resources.

  2. Early identification of issues that require significant time to resolve, avoiding unnecessary delays and/or misalignment with commercial timelines.

  3. Signals to a company that the fund manager takes ESG seriously, facilitating more detailed discussions later on and enables an early assessment of whether the fund is going to be able to effectively partner with the company to address ESG matters.

  4. Enables the fund manager to plan and assign appropriate resources to ESG due diligence (DD).

An overview of the activities included in the screening and categorisation ('screening') stage is shown by the graphic below.

Click to view diagram

2. Activities

2.1 Ensure compliance with lists of excluded/prohibited activities ('exclusion lists')

LPs such as CDC and other development finance institutions (DFIs) may require a fund not to invest in certain sectors or activities. Fund managers must ensure all the investments comply with any applicable lists of excluded/prohibited activities ('exclusion lists'). If fund managers are unsure whether a potential investment complies with a fund's exclusion list, they should contact the LPs for advice.

2.2 Ensure compliance with key governance and business integrity requirements

Business integrity (BI) considerations are critical at this stage. The sector, location, sponsors or company may indicate challenging governance and business integrity issues, which could significantly impact the DD process (or even breach the fund's policies and LP's requirements). These should be highlighted early, as they may be considered 'red flags' or may require additional scrutiny during screening and/or DD.

2.3 Identify key ESG risks, impacts and opportunities

Fund managers must identify the key ESG aspects of an investment, taking into account the company's particular characteristics including scale, location, sector, sponsors and supply chain. Screening is typically a desk-based exercise.

Sector profiles highlight typical ESG impacts, risks and opportunities associated with different industries. They provide a starting point for fund managers assessing ESG aspects. Fund managers may also find E&S topics, Business integrity (BI) section and CDC environmental and social checklist and CDC governance and business integrity checklist helpful.

- ESG aspects

	ESG aspects
Relevant to most businesses/companies	- CDC guidance: Management commitment, capacity and track record (CCTR) - Quality of existing E&S topic: ESG management systems - E&S topic: Labour standards - E&S topic: Occupational, health and safety (OHS) - E&S topic: Gender - E&S topic: Resource efficiency and pollution prevention - Business integrity - Anti-corruption - Anti-money laundering

Relevant to some businesses/companies	- E&S topic: Community health, safety and security - E&S topic: Land acquisition and involuntary resettlement - E&S topic: Biodiversity and ecosystems services - E&S topic: Cultural heritage - E&S topic: Indigenous Peoples - E&S topic: Supply chains - E&S topic: Animal welfare - E&S topic: Cumulative impacts

- Information and resources feed into the screening process

  Screening is generally a desk-based exercise. Six types of information and resources may be useful in the screening process of a company: (i) a fund's ESG Policy and exclusion list; (ii) ESG guidelines and standards; (iii) publicly available information about the company; (iv) the fund manager's/LP's experience; (v) early discussions with the company; and (vi) informal referencing on the company and its promoters.

  - Fund ESG policy and exclusion list.
    - This is the reference point against which a company should be compared.
  - General and sector-specific guidelines and standards.
    - These can provide useful guidance and checklists of issues and opportunities that are likely to be encountered. However, because every company is different, it is important to always consider their unique characteristics. A detailed analysis is not required at this stage, as the aim is to have a high-level appreciation of areas that could have significant impact on the investment and/or the DD process.
    - DD questionnaires and checklists.
    - IFC Performance Standards.
    - Sector profiles, E&S topics and Business integrity.

        - World Bank Environmental Health and Safety (EHS) Guidelines.

    - Publicly available information about the company.
        - Company website and annual reports.
        - Google Search and Google Maps satellite view to show the layout of company operations and their proximity to other land uses – residential, rivers, natural habitats etc.
        - Media search (e.g. via internet and specialist data providers such as Dow Jones, World-Check, RepRisk or Arachnys).
        - Comparison to competitors (where reliable information is available).
        - DFI investors sometimes disclose the findings of their DD for companies in which they invest (e.g. IFC Projects Database).
    - Early discussions with, and information from, a company.
        - What is the understanding and attitude of senior management towards ESG?
        - Is there any evidence of policies, systems and processes already in place?
    - Drawing on the experience of others.
        - Team members or retained consultants with experience of similar companies.
        - LPs with experience of the company or sector.
    - Informal referencing on the company and its promoters.

- Using questionnaires at the screening and categorization stage

Using standard high-level ESG questionnaires can be useful at this stage. ESG questions may also be suggested by deal fundamentals (e.g. overall value proposition, a company's strategy and business plan, use of proceeds from the fund's equity investment, and presence of other investors).

- Identifying applicable standards
  Identifying key ESG factors also helps to establish the main ESG standards that are likely to apply to the investment. In addition to national ESG laws and requirements, the fund's investment policy and environmental and social management system (ESMS) may also require adherence to IFC Performance Standards and/or other international standards (particularly when DFIs are LPs). If so, the fund manager should determine which are likely to be applicable to the company being considered for investment.

2.4 Build a common understanding

A key aim of early conversations with management is to build a common understanding of the main ESG factors to be managed and to assess whether a company is willing and able to address them. Therefore, fund managers are encouraged to present the business case to companies they are considering investing in.

- Benefits of building a common understanding at screening
  Building a common understanding early on how to manage ESG factors that may have an impact on the investment significantly contributes to achieving successful outcomes. Early discussions on key ESG aspects typically expedite the investment DD and legal negotiations. It can be helpful if the Investment Officer responsible for the deal starts the conversation around main ESG requirements at screening in order to make it clear that these are relevant. The inclusion of Environmental & Social (E&S) and business integrity (BI) requirements in the Term Sheet may be a good way to engage with a company and start the conversation.

  In order to assess a company's willingness and ability to address ESG aspects, it is advisable to start a commitment, capacity and track record (CCTR) analysis at this stage and complete the CCTR at DD. Limited commitment to engage on ESG factors is often harder to address than limited capacity.

- Presenting the ESG business case to companies
  ESG factors can have significant positive and negative impacts on companies and investments. However, the management teams of some companies may not fully see the benefit of employing robust ESG practices. Therefore, fund managers are encouraged to present the business case to companies. It can be helpful to map the business case onto a table similar to the one shown below to structure the discussion and prioritise which ESG factors to address early on, as well as to highlight potential opportunities.

  Click to view diagram

- Further guidance on how to make and present the ESG business case to companies
  Management resistance typically stems from:
  - Limited understanding or fear of being asked to do things in a different way.
  - A lack of management time.
  - Budget constraints.
  - A lack of confidence in the ESG approach proposed by the fund.
  - A lack of understanding of how good ESG management might add value to the business.

  Good ways to address this resistance are to:

  - Listen to management and their key business needs. Try to understand how the fund's approach to ESG risk management aligns with the company's overall strategic and performance.
  - Tailor discussions to the specific concerns and interests of management.
  - Present a short-list of opportunities/solutions to achieve business goals. Work first on easier options to build confidence and understanding.
  - Discuss with the company's management how ESG risks and impacts can

positively influence financial performance.

2.5 Categorise an investment's inherent E&S risks and impacts

Once the main potential E&S risks and adverse impacts ('impacts') have been identified, the proposed investment should be assigned an inherent E&S risk/impact category (e.g. 'Low', 'Medium' or 'High') in accordance with the fund manager's ESMS. This categorisation may be revised later in the process as more information becomes available. At this stage, it is advisable to be cautious and if the category is unclear, assign a higher category rather than a lower one so as not to underestimate the time and resources that may be needed for DD.

- Benefits of assigning an inherent E&S risk/impact category
  Assigning an inherent E&S risk/impact category ('E&S category'):
    - Gives an indication of the likely time and resources required for DD, including the need for input from consultants.
    - Guides the level of attention required during monitoring.
    - Allows LPs to see at a glance the inherent risk profile of the fund, to understand where most attention is needed, and to judge whether the fund's ESMS is adequate to manage the risks in the portfolio.

- How to use the E&S categorisation system

  There is no single correct way to assign E&S categories. Regardless of the E&S category, it is critical to properly identify and manage the risks and maximise the opportunities. Companies assigned to the 'low risk/impact' category will still require DD covering relevant aspects (e.g. labour rights, business integrity), commensurate with the level of risks and impacts to which they are exposed.

  Moreover, the categorisation systems used by a large number of investors, do not always take into account some key E&S factors that could have a significant impact on an investment (e.g. management CCTR or liabilities associated with soil contamination).

The categorisation system presented in this toolkit only takes into account the potential risk and impacts of an investment, as well as mitigation measures that form part of the companies' assets (e.g. wastewater treatment systems). The system does not take into account the ability of the company to address its ESG risks and impact (e.g. qualifications of the E&S team). Fund managers should always consider factors that are not included in the categorisation system, but that could significantly impact the investment.

Where the fund's LPs include DFIs such as CDC, categorisation may also be important in the context of the limited partnership agreement and/or applicable side letters. For example, some DFIs may require notification or prior consultation before the fund invests in companies with high E&S risk/potential impacts. E&S standards that DFIs expect companies to meet may also depend on the E&S category.

- Key factors that can inform the E&S categorisation
  1. ***Investment:*** When categorising, fund managers should take into account the E&S risks of the investee company, as well as any subsidiaries and/or joint ventures (as these may also present significant E&S issues).

  2. ***Business plan:*** Fund managers should consider whether companies are planning to expand existing assets, build new assets, integrate their business vertically, and/or operate in new sectors and/or geographies, as this could affect the E&S risks and impacts associated with the investment. New developments are typically associated with higher E&S risk categories.

  3. ***Sector:*** Some sectors present higher inherent risks than others. If the investment is in a diversified group, there may well be multiple sectors to consider. The categorisation rating should take into account all the activities in which the company is involved, regardless of how financially significant those operations are to the overall business.

  4. ***Technology/techniques:*** Companies operating in the same sector, location and with similar scale of operations may present different risks and impacts as a result of the use of different technologies (e.g. the use of best available

techniques will reduce the risks and impacts).

5. ***Scale:*** Different companies operating in the same sector and similar locations may present different risks and impacts depending on the size and/or production capacity of their assets (e.g. mini-hydro will have very different impacts to a large dam).

6. ***Location:*** Different companies operating in the same sector and with similar scales of operations/assets may be associated with different risks/impacts depending on the location (e.g. companies located in socially unstable areas or countries, triggering resettlement and/or impacting Critical Habitats present higher risks/impacts). Location includes country-specific, region-specific and site-specific E&S issues. Companies that have, or are likely to have, significant impacts on local communities (including Indigenous Peoples) health, safety, security and/or livelihood (e.g. resettlement) and/or biodiversity (e.g. impacts on protected areas) should be associated with medium to high E&S risks and impacts, and should be categorised accordingly.

7. ***Contractors:*** May also involve high risks that affect the overall risk rating of the business.

8. *Supply chains:* May also involve high risks that affect the overall risk rating of the business.

- Proposed categorisation system
  There is no single correct way to assign E&S categories. A typical E&S categorisation method for emerging market private equity funds is shown below. The system proposes categorising the deals as investments with ‘Low’, ‘Medium’ (may be split into ‘Medium-High’ and ‘Medium-Low’) or ‘High’ inherent risks/potential impacts.

Click to view diagram

2.6 Define the scope of and plan the ESG due diligence

One of the key outputs of the screening and categorisation phase is an understanding of the key ESG factors to be assessed at DD, as well as of the resources required to conduct adequate DD.

- Main elements of typical DD that should be considered at screening include:
  1. Desk-based review.
  2. Conversations with management.
  3. Site visit by deal team, typically including the Investment Officer and/or the ESG Officer.
  4. Engage consultants to advise on specific aspects of ESG or to do a full gap analysis against applicable ESG standards.

  See CDC environmental and social checklist and CDC governance and business integrity checklist as these will also help fund managers to plan the ESG DD.

  As indicated previously, some of the elements above may be partially covered at screening.

3. Outputs

Key outputs of the screening stage:

- Identification of ‘no go’ issues (e.g. irremediable breaches of the exclusion list or a company’s unwillingness to address key ESG issues).
- An understanding of the key ESG factors that could impact (positively or negatively) the investment, the DD process and/or the fund manager’s reputation.
- Inherent E&S risk categorisation.

- Preliminary view of a company’s commitment and ability to address ESG factors.
- Plan and budget for DD.
- ESG section in the screening memorandum prepared by the fund’s deal team for the investment committee.