



# A Best Practices Guide to Incorporating ESG into Due Diligence



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## ■ INTRODUCTION

In today's business world, investing is more complex than ever as issues such as diversity, equity, and inclusion (DEI) and measuring the sustainability of investments bring with them difficult and costly risks.

Due diligence professionals responsible for monitoring investment funds are now focusing on aligning due diligence practices with Environmental, Social, and Governance (ESG) principles to circumvent these concerns and mitigate risks.

## ■ WHAT IS ESG?

ESG investing is a term often used synonymously with socially responsible investing, sustainable investments, and the screening of mission-related investing.

It seeks to examine environmental issues, social equality and impact, and corporate governance criteria.

While challenging to overcome, ESG risks and liabilities also represent an opportunity to gain a competitive advantage by actively limiting environmental impact, incorporating social equality, and implementing corporate governance initiatives.

How a company manages ESG issues can affect its long-term performance and valuation. As a result, more and more investors insist that ESG factors be included explicitly in the due diligence process to better manage risk and improve performance.

Thus, ESG due diligence should include the provision of data about a company's ESG performance and policy success for each of the ESG criteria to help investors make sound, ethical investment decisions that support the primary goal of operational due diligence: risk mitigation.

## ■ WHY IS ESG DUE DILIGENCE IMPORTANT?

Environmental, Social, and Governance (ESG) issues are becoming increasingly prominent and influential in decision-making, from the board level and down, across a variety of industries.

Pressure is emerging from angles such as regulators, investors, and socio-economic communities to take a proactive approach to these issues.

ESG due diligence helps investors mitigate risk by better understanding the acquisition's risk profile and exposure.

For example, contracting with a company where human rights violations in the workplace have been discovered may incur reputational risks to the company and impact profitability by limiting investor interest and inviting regulatory sanctions.

The due diligence process helps investors identify red flags before a transaction occurs. This process also helps determine whether the company has consolidated routines and procedures that help prevent violations of relevant laws and regulations.

Investors should note that there is no one-size-fits-all approach to ESG due diligence, as standards vary widely from industry to industry.

However, several currently voluntary frameworks have emerged to support due diligence professions as they begin incorporating ESG checks into their due diligence protocols. Examples include:

- ▶ AIMA – Albourne: a diversity and inclusion questionnaire based on the 2018 ILPA DDQ supplemented by insights provided by AIMA and Albourne as well as institutional fund managers and investors.
- ▶ Diversity Project: a UK-based initiative for investment consultants and asset owners to drive standardization in how DEI data is collected from asset managers.
- ▶ ILPA DDQ: a DDQ designed by the ILPA Diversity in Action initiative, along with other partners who share a commitment to advancing DEI initiatives in private equity investing.
- ▶ PRI's LP Responsible Investment DDQ: a DDQ aimed at evaluating the processes for integrating material ESG factors into investment practices and to determine where segregation of duties in enforcing ESG.

## ■ HOW DOES THE ESG DUE DILIGENCE PROCESS WORK?

The ESG due diligence process should begin early, ideally at the same time as due diligence processes, to improve decision-making and screen for key performance indicators (KPIs) related to ESG goals.

Because ESG due diligence can reveal deal-breaking issues such as lack of diversity standards, it is best to uncover such problems as early as possible. Delaying the cycle means that considerable risks and opportunities for improvement may be missed or discovered too late.

To prepare, all stakeholders concerned should agree on a unified ESG strategy and implement an ESG framework suitable for their business. Individual ESG considerations will vary greatly depending on the investment and where its operational headquarters is located.

However, common considerations include:

- ▶ Assessing the target investments material ESG risks, depending on the sector and activity
- ▶ Interviewing company stakeholders, such as employees, board members, and senior management executives to validate ESG claims and reporting
- ▶ Background checks of crucial personnel to uncover current or past corruption
- ▶ Review of accounting and transactions
- ▶ Benchmarking the target's ESG policies against peers and industry best practices to identify gaps and opportunities for improvement
- ▶ Assessing the target's regulatory compliance and voluntary commitments, including review of existing corporate policies and governance structures

Everyone involved should clearly understand the company's operations and business plan at the end of the ESG due diligence process, have a clear view of any ESG impacts and risks, and have a plan to manage those risks.

## ■ BEST PRACTICES TO CONDUCTING ESG DUE DILIGENCE

While ESG standards and regulations are still unstructured, organizations are strongly encouraged to begin adapting now, as more stringent regulations are sure to follow in the coming years.

To that end, the investment managers are coming together to focus on a core set of best practices.

### *Develop an ESG policy*

Any investment manager that wants to take ESG issues seriously should have a formal policy shared with investors, consultants, and industry bodies, as well as accountability protocols in place, to validate any ESG claims made by potential investees.

This ESG policy documentation and subsequent validation protocols should be shared with stakeholders to guide the due diligence process. Again, one organization's policy may differ from another, but a great place to start is by reviewing voluntary ESG frameworks such as those listed above.

## *Emphasize Specific ESG Disclosures*

Because all industries and sectors are different, not all ESG issues apply to all businesses. However, you can achieve adequate due diligence by focusing solely on ESG concerns and risks related to a potential investment.

Most commonly in operational due diligence, areas of concern, as it relates to ESG, are primarily around environmentally sustainable investments, DEI commitments, and compliance with regulatory requirements.

## *Track What You Can Measure*

Measurable ESG-related KPIs provide tangible data points by which investors can monitor and track ESG efforts—identifying a company's baseline ESG efforts before acquisition ensures that improvements, challenges, and opportunities can be identified and addressed.

Considerations include:

- ▶ What sustainable investing elements are being deployed and how is the impact measured?
- ▶ What disclosure and reporting frameworks are being leveraged?
- ▶ Are they ready for the current and imminent regulatory reporting requirements?
- ▶ What are the known gaps and what efforts can be put in place to develop portfolio-wide assessments?
- ▶ Assessing the target's regulatory compliance and voluntary commitments, including review of existing corporate policies and governance structures

## *Take ESG Beyond Your Questionnaire*

Recently, more fund managers have begun getting requests to forgo ESG questionnaires in favor of a more in-depth consultative process.

While this is a newer development, it is expected that most investors will be requiring this in the coming years.

## *Prepare for Carbon Footprint Assessments*

Fund managers are also being instructed to get carbon footprint evaluations done on their portfolio companies.

Many are inclined to deprioritize these new requirements in favor of activities that directly contribute to growth. Additionally, many believe that it is difficult to get accurate calculations for this metric.

Still, this new requirement is unlikely to go away in the coming years, so it's best now for organizations to begin assessing their carbon footprint as part of their overall ESG strategy.

### *Use ESG Risk As An Opportunity to Add Value*

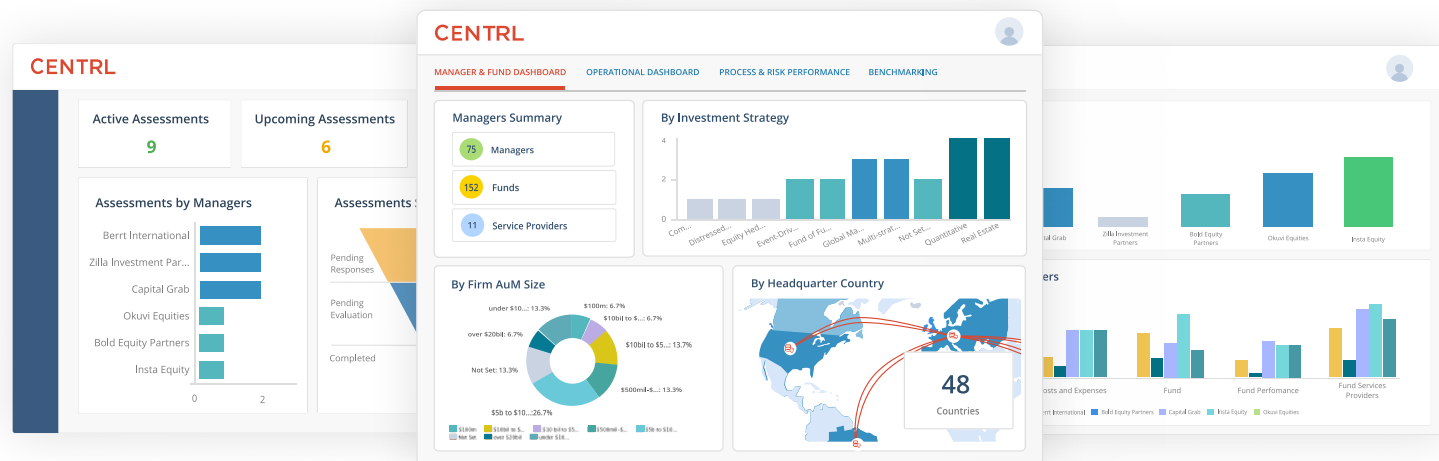
Many private equity executives view ESG risk management as an opportunity to provide additional value for their investments. This is not only good for everyone involved as all parties will be required to implement ESG risk management, but it also provides long-term sustainability for investments.

### *Manage Time Constraints*

Due diligence may be a time-consuming procedure, especially when ESG factors are added to the already extensive list of requirements involved in most due diligence questionnaires (DDQs).

While some investment managers may be tempted to cut corners on ESG due diligence due to time constraints, they are highly encouraged to prioritize thorough ESG due diligence for the long-term sustainability of investments.

# HOW DD360 CAN STREAMLINE YOUR ESG DUE DILIGENCE



Managing all these aspects when conducting ESG due diligence, in addition to existing due diligence protocols, can be a complicated task. Attempting to cover all of the criteria involved in due diligence through manual processes alone is simply impractical and unscalable.

Automation of manual due diligence processes can significantly impact your management team and greatly reduce the time burden on your resources.

DD360 is a multi-party operational due diligence software that investors and asset managers can employ to create a more efficient and automated operational due diligence process.

DD360 offers a highly intuitive user interface, extensive workflow automation capabilities, and reporting analytics to help you benchmark your existing program and provide a baseline to measure progress against.

It provides asset managers with a straightforward, clear, and fast approach to reply to DDQs, allowing them to streamline the process by updating only those data points that have changed during recertification.

DD360 boosts productivity and allows due diligence professionals to provide a better solution to their clients, allowing them to keep their clients, generate more business, and stand out in the market.

To learn more about how DD360 can help you conduct your ESG due diligence and streamline your overall due diligence workflows, schedule a demo today!



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