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2020 has unwittingly proved the significance of financial and non-financial risks in assessing resilience. Sustainable companies are seen to be able to stand through the economic turmoil with higher resistance, or at least did not deteriorate as badly as others. Due to this, more heads are turning towards the importance of the environmental, social and governance ("**ESG**") criteria in the investment decision-making process and portfolio management.

ESG has emerged as an area of focus for governments, regulators, financial institutions and commercial organisations around the world even before the coronavirus spread around the globe like a wildfire. In Malaysia, Bursa Malaysia in partnership with FTSE Russell launched the FTSE4Good ESG Index in 2014 with the aim of providing more visibility and profiling of ESG-compliant companies. Bursa Malaysia has also came out with the Sustainability Reporting Guide in 2015 to guide listed issuers on how to embed sustainability in their organisation and help to identify, evaluate and manage economic, environmental and social risks and opportunities.

The revised Malaysian Code on Corporate Governance ("**MCCG**") issued in April 2017 further enhances the ecosystem for sustainable and responsible investment in Malaysia. In November 2019, the Securities Commission of Malaysia launched the Sustainable and Responsible Investment Roadmap which aims to chart the role of the capital market in driving Malaysia's sustainable development. The newly updated MCCG 2021 also addresses the urgent need for companies to manage ESG risks and opportunity with emphasis on the need for collective action by boards and senior management.

ESG Due Diligence

The world has now gravitated towards sustainable investment more than ever. Companies with sound ESG background are preferred by investors. The question now is how ESG can be integrated into the M&A and investment decision-making process? Research done by Mergermarket, an independent M&A proprietary intelligence tool in 2019 shows that ESG due diligence has become a core element of the M&A process in line with the growing emphasis on ESG in investment decision.

ESG due diligence could provide a complete view of all relevant risks and opportunities of a target's ESG performance and policies in each of the ESG criteria. It is not only that ESG due diligence will uncover target's controversial or illegal behaviours, it will also highlight positive ESG aspects undertaken by the target. By understanding the target's ESG risk profile and exposure, the acquirer or the investor would be able to make a sound and ethical investment decision with the view of mitigating the risk that can tarnish both the target and the investor's reputation and returns.

ESG Due Diligence Process

It is prudent for the ESG due diligence to be conducted at the same time as the other due diligence process so that the ESG issues may be discovered soonest possible. Since ESG due diligence is still a relatively new concept, there are no defined screening criteria or processes to properly judge the ESG risks associated with a target.

There is also no one-size-fits-all approach to ESG due diligence. The criteria and standards vary widely from sector to sector and should be adjusted to individual companies, its nature of business, geographic regions and business model. Investor may start with creating a checklist and template that guides decision making and identifies KPIs which will assist the implementation and determine all the ESG issues to be considered.

In conducting the ESG due diligence, investors should take a step further than merely relying on the ESG data and confirmation provided by the target. Comprehensive policies can be a mere statement if the target did not actually do what they say they do. This is where ESG due diligence will come into picture. Nevertheless, some ESG issues might be more difficult to be discovered than others.

Investors may consider the following in conducting ESG due diligence:

a) Start with a desktop review by collecting, organising and merging all material documentation.

b) Interview company stakeholders such as the directors, top management personnel and employees.

c) Conduct integrity and background checks on key personnel to unveil current or previous corruption.

d) Conduct an accounting analysis or transaction testing.

e) Perform on-site visits of existing facilities or new project sites, if relevant.

f) Conduct an ESG risk assessment[1].

ESG Due Diligence Best Practices

Although there are no fixed standards and structure when it comes to the ESG due diligence, the following are some emerging best practices within the private equity industry:

a) Develop a formal ESG policy that serves as a guideline for the due diligence process.

b) Focus on the material ESG issues and risks relevant to the specific investment.

c) Take into account climate risks and issues within every company.

d) Identify and track baseline efforts and analytics prior to investment to ensure that the improvements, challenges and opportunities can be identified and addressed.

e) Incorporate ESG due diligence into the process early on to ensure better time management[2].

Looking Ahead

ESG is no longer an alien concept in the corporate world. Numerous companies are moving towards sustainability and have integrated ESG in various aspects of its activities. For example, driven by the fact that its top 10 ESG-ranked stocks outperformed the bottom-10 in the first quarter of 2020, Employee Provident Fund (EPF) declared to make all its investment based on environmental, social and governance (ESG) practices by 2030. This shows that ESG has been a rising theme in the investment and M&A climate in Malaysia and it is foreseeable that ESG due diligence will soon become an integral part of the M&A and investment decision-making process.

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[1] Lev, Helee, "ESG due diligence - How it's done and why" https://www.gobyinc.com/esg-due-diligence-how-and-why/
[2] Ibid.

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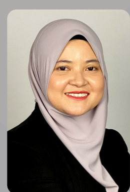

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