



ESG Due Diligence in Private Equity

Shifting Market Dynamics and Expectations

Whether you believe ESG is a political issue or a moral imperative misses the point. From a private equity (PE) perspective, ESG is simply a tool for risk management and value creation. It's a free-market reflection of measurable risk, a response to growing demand by employees, clients, and investors for products and services that are socially and environmentally sustainable. As PE firms rush to address this demand, they are questioning their approaches to identifying and addressing these ESG risks and opportunities during due diligence, pre-close planning, and post-close execution.

If you ask PE deal, operations, capital formation, and sustainability professionals what their ESG due diligence process looks like, or even what constitutes good ESG due diligence, you'll hear a variety of responses. A widely recognized ESG due diligence model comparable to traditional financial and operational due diligence frameworks just doesn't exist yet. Further, ESG issues differ across industries, geographies, business models, and company sizes, making a one-size-fits-all approach unrealistic.

Complications like these explain why so many PE firms continue to pursue a reactive or minimal approach to ESG due diligence. Before working with us, many of our clients incorporated a box-checking exercise to validate that target companies have ESG policies and regular reporting on sustainability metrics. What we hear from clients, and what we know as former investors, bankers, IR professionals, and operations specialists is that a more thorough and layered ESG due diligence approach can add tremendous value. A strong ESG diligence strategy helps identify opportunities for value creation and risk mitigation.

The high costs of missing an ESG “red flag”

Why is the tactical check-the-box method flawed? It regularly leads to an incomplete identification of ESG-related risks, risks that can be financial, operational, regulatory or reputational. It also overlooks potential areas of greenwashing, exposing the company to expensive litigation and resulting in the erosion of its brand and customer loyalty. A hasty or cursory ESG diligence process can also fail to identify opportunities to capture, streamline, and align ESG initiatives and business transformation opportunities, leaving value generating opportunities on the table.

The most proactive PE firms are raising the bar

The GPs that are leading the way recognize that ESG factors should be embedded deeply into their own operational priorities and processes as well as those of their portfolio firms and acquisition targets.

Many are seeking insight into how other forward-thinking PE firms are handling ESG due diligence challenges like their own. The goal is to avoid adding complex, time consuming ESG diligence processes on top existing practices. This will result in a failure of internal buy-in and integration of the new process. ESG diligence must be efficient, yet impactful, to be fully integrated. As a global leader in financial and operational due diligence as well as ESG, we've taken an approach that combines the best of traditional diligence and industry-leading ESG program design and development.

ESG operational due diligence looks like in the field

It's actually rare that our teams uncover clear evidence of ESG layered into the operational fabric of a target. That's because for many businesses, such a high level of integration is still largely aspirational. When examining operational fabric, we look for financial-grade data collection and management. We also look for a vendor management program that integrates material ESG topics, detailed annual sustainability reporting, feedback loops and other evidence of continuous improvement, and intentionally-designed stakeholder engagement practices.

Six tenets of a world-class approach to ESG due diligence

Enhancing the focus on ESG in the due diligence process will only drive added value. To meaningfully conduct this assessment, there are a several key considerations to consider and implement.

- **Strategic scope:** Every diligence assessment requires a clear scope focused on the right ESG topics. With respect to ESG, the evaluation should (1) identify both ESG-related risks and opportunities, (2) begin with a determination of areas with the highest ESG relevance and materiality, (3) review all or most substantive transactions, rather than a small random sampling, and (4) specify due diligence goals that align with the PE firm's broader ESG objectives, priorities, and level of commitment.

- **Integrative approach:** ESG due diligence should never be pursued as a stand-alone workstream. Instead, view the process as an extension of traditional financial and operational DD frameworks – with a sustained emphasis on the latter.
- **Operational rigor:** The review should focus on identifying ESG-related competencies and vulnerabilities at an operational level – specifically, how the business harvests value from its physical and digital assets.
- **Agility and flexibility:** There's a good chance we won't be referring explicitly to ESG in a few years – either because ESG will be fully integrated into operational due diligence or because social responsibility and environmental sustainability will go by another moniker. Consequently, the ESG due diligence framework needs to be flexible and adaptive.
- **Risk-based resourcing:** ESG due diligence cannot be conducted effectively on a shoestring budget or under a rushed schedule. PE firms need to allocate time, money, and other resources that accurately reflect the ESG-related risks in the acquisition. In some cases, the ESG due diligence is just as important as the financial and operational due diligence.
- **Actionable recommendations:** In many cases, the findings from an ESG due diligence exercise should result in recommendations to lower ESG risks or capitalize on ESG opportunities both in pre-close planning and post-close execution. What ESG factors can be “fixed” within the target business before you acquire it? How do the policies of the target align with what you want to achieve? Do its ESG KPIs need to be aligned with your PE firm's operating model?

ESG due diligence is vital

It's a new world. Companies can no longer make broad, sweeping ESG statements without the ability to backup these claims with evidence. For any PE firm looking to acquire these companies, ESG due diligence is the most effective way of validating the target's capabilities and competencies and, by extension, can be a strategic driver not just of valuation, exit planning and divestment, and key business partnerships but also long-term value creation.

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