

ESG Due Diligence

A Strategic Imperative in Mergers & Acquisitions

Unlocking Value and Mitigating Risks Through ESG Integration in M&A Transactions



Overview

In today's business landscape, ESG (Environmental, Social, and Governance) factors are becoming critical to the success of businesses across sectors. Customers, employees, shareholders, investors, rating agencies, and regulators are increasingly focused on how companies conduct their business, its impact on the world, and their contribution to society.

- Climatic Change: Carbon emissions, energy efficiency
- Natural Resource Use: Water stress, biodiversity, land use
- Waste Management: Toxic emissions, electronic waste
- Environmental Initiatives: Renewables, clean tech, green building



- Human Capital: Labor management, health & safety, supply chain, employee well-being
- Product Safety: Chemical safety, financial product safety, privacy & data security
- Social Opportunities: Nutrition & health, access to communication, health & finance
- Corporate Governance: Practices & Policies, Disclosures
- Business Ethics: Corruption & Instability, Ethics & Fraud, Anti-competitive Practices
- Government & Public Policy: Financial System Instability



What is ESG Due Diligence?

Traditional due diligence focuses on deal-specific risks and opportunities, historical and projected earnings, the quality of assets, commitments, and contingencies. In addition, ESG Due Diligence (DD) offers a comprehensive assessment of material ESG risks, liabilities, and opportunities for a target, which may be a portfolio company or transactional target. It helps identify and mitigate potential risks around reputation, regulatory challenges, and financial impacts.

ESG Due Diligence serves multiple functions in a business environment, such as:



ESG DD in Investment Decision

- Strategic and financial investors with long-term value creation scout for companies with ethical, sustainable, and wellgoverned policies.
- Organizations with strong ESG metrics/ratings attract favorable investment terms.



ESG DD in Supply Chain

- Validating vendors and business partners on their ESG strategies helps mitigate long-term risks to the organization.
- To avoid reputation damage, ESG Due Diligence should be applied to validate existing suppliers and in onboarding new suppliers.





Why is ESG Due Diligence Critical?



Key measure for investors

Access to capital is increasingly focused on areas of sustainability performance, social responsibility, and governance, making ESG Due Diligence a key step in securing additional funding for the enterprise.

Advantages of ESG DD for both investor and the company



Price negotiation, premium for favourable ESG factors



Value enhancement opportunities



Quantification of post acquisition cost in M&A



Better return. compensation expected



Mitigation of Key risks

Reputation Risk

ESG covers key stakeholders such as clients, shareholders, investors, lenders, and employees. Satisfaction of key stakeholders helps mitigate the reputation risk

Regulatory Risk

Major regulatory bodies have now put stern measures on ESG, as sustainability is the key topic trending worldwide. ESG DD helps mitigate regulatory consequences

Financial Risk

ESG compliant organizations helps save on major outflow towards regulatory

fines for non-compliance and helps garner major investor funds

Strategic Risk ESG compliant organizations helps developing long term strategic partnerships which aids in achieve rapid inorganic growth



Competitive Advantage and Improved Stakeholder Relations

Incorporating ESG into the business culture provides a competitive edge over peers, resulting in market share enhancement, customer retention and loyalty, and increased investor interest. It also helps in building strong relationships among shareholders, customers, investors, lenders, and employees.



Sustainability Goals

Prioritizing ESG due diligence helps achieve the United Nations' Sustainable Development Goals (SDGs), which also offer the added benefit of gaining recognition and attracting new customers and investors.



What are the key steps?



Data room, Q&A, Documents

ESG DD starts with setting up a data room, with Q&A facility. It encompasses collating documents and information around ESG



Discussion with Key Personnel

Next in the order, includes meeting and discussion with key stakeholders (investors, customers, shareholders etc.), to understand ESG impact on the overall organisation



Background Checks

Background checks on the Key Personnel is important, to understand any backtrail violation pertaining to ESG or any other charge or prosecution



Review of financials & transactions

Analyse key line items of financials and nature of transactions, to check if any violation has been recorded or might get recorded in near future



Site visits and inspections

Site Visits/Inspections are a must in manufacturing concern, to understand if the factory/plants are compliant with regulatory norms and does not violate any ESG framework



ESG Risk Assessment

To give a conclusion, ESG risk assessment need to be performed to make sure the organisation gets a tick in terms of ESG compliant entity

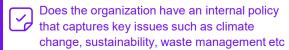


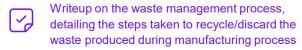


Non-Exhaustive checklist

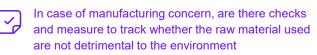


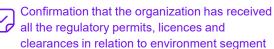
Environment









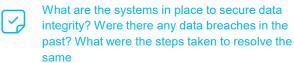


Were there any regulatory breaches that have harmed the environment? If yes, then what were the mitigatory steps taken to curtail the same in future



Social

Any survey conducted among employees regarding their satisfaction, complaints etc.?
How frequently is the survey conducted



Please confirm if the organisation adheres to the minimum wage and other regulatory requirements



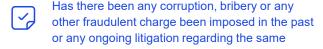
Has the gender and cultural equality maintained in the organisation.

Does regular inspection take place regarding product quality and health. Any instances incurred regarding product deterioration



Governance

What are the corporate governance policies in place? Were there any violations in implementing the same



What is the composition of board currently, are there any dedicated members from the board who looks after ESG matters





Regulatory developments are giving a big push to ESG DD

A variety of regulatory and nonregulatory bodies release guidance and standards on ESG reporting. These initiatives promote transparency and consistency in corporate disclosures. It aims to set up common frameworks and provide better information to assess the risks and opportunities related to ESG factors.

In the meantime, companies are adapting their disclosures and, in some instances, developing their own tools in order to meet the regulatory requirements and stakeholders' expectations. These disclosures help investors make informed decisions and encourage the incorporation of ESG factors in company valuations.

Global Reporting Initiative

Founded in Boston in 1997 to create the first accountability mechanism to ensure companies adhere to responsible environmental conduct principles.

Integrated Reporting Framework

Created by the International Integrated Reporting Council (IIRC) to bring together material information about an organization's strategy, governance, performance and prospects in a way that reflects the commercial, social and environmental context within which it operates.

1997

Jul 2011 Apr 2013 Oct 2014

Jul

2020

Jun

2017

Sustainability Accounting Standards Board

Independent nonprofit organization that sets standards to guide the disclosure of financially material sustainability information by companies to their investors.

Mar

2021

Jun

2021

Apr

2021

Non-Financial Reporting Directive (NFRD)

EU Regulation that requires large (500+ employees) listed companies to report on their key impacts and risks from ESG.

Task Force on Climate-Related Financial Disclosure (TCFD)

The TCFD released climate-related financial disclosure recommendations designed to help companies provide better information to support informed capital allocation.

Corporate Sustainability Reporting Directive (CSRD)

Enhances the scope of NFRD to cover all large undertakings (250+ employees), as well as all SMEs listed on EU regulated markets, and further clarifying the nonfinancial information that entities should report under European Sustainability Reporting Standards (ESRS).

Sustainable Finance Disclosure Regulation (SFDR)

Imposes mandatory ESG disclosure obligations for asset managers and other financial markets participants with substantive provisions of the regulation.

EU Taxonomy for Sustainable Activities

Classification system establishing a list of environmentally sustainable economic activities to create a clear definition of what is considered "sustainable".

Value Reporting Foundation (VRF)

The IIRC and the SASB officially merge to form the VRF.

Nov 2021

May 2022

Jun 2023

International Sustainability Standards Board

Formed to deliver a comprehensive global baseline of sustainability-related disclosure standards.

The US SEC's Enhancement and Standardization of Climate-Related Disclosures for Investors

Requires registrants to include certain climate-related disclosures in their registration statements and periodic reports and certain climate-related financial statement metrics in a note to their audited financial statements.

IFRS S1 and S2, sustainability disclosure standards released

On June 26, 2023 the IFRS foundation released sustainability disclosure standards (S1 and S2) which will help set a global baseline for sustainability disclosures.

These standards will be effective as of Jan 2024



Challenges in implementing ESG DD

Quantifying the findings ESG metrics often center around qualitative information, which poses a challenge when there's a need to quantify their financial **Data management and** impact. This becomes even more correct requisition list complicated when anticipating future liabilities arising from Managing data, particularly potential breaches. concerning regulatory requirements for disclosures, is a significant challenge for organizations. The struggle extends to collecting the right set of data and documents from the target to accurately assess its ESG framework, associated risks, and other relevant areas.

Drafting scope of work

The components of "E" (Environmental), "S" (Social), and "G" (Governance) cover a wide range of topics from greenhouse gas emissions and climate change to living wages, child labor, and business ethics. Not every topic is relevant to each transaction or target. Crafting a scope that is both meaningful and manageable is the foremost challenge when implementing ESG due diligence.

How KPMG can support – ESG Advisory

Developing responsible and sustainable strategies, business models, operations, and investments, KPMG ESG Advisory's solutions are both holistic and practical. They can guide you to drive sustainable innovation across your business and help in gaining a competitive edge.

By leveraging our industry-leading experience, data-driven technology, and global alliances, we can transform insights into actionable opportunities for your business, stakeholders, and the planet.

The ESG team comprises transformation, measurement, and reporting specialists. They can help you with:



Assess and design ESG strategy





Financial impact in case of ESG breach



ESG Risk assessment and its impact



ESG regulatory compliance & disclosures



Measure progress and tell your ESG story

Our Due Diligence specialists can support you with the diligence of your company, your target, or your investments, through an ESG lens. Together we can help you solve complex due diligence problems to facilitate strategic decision-making. We will work closely with you, while remaining objective and independent in our approach.



Contact us

We hope that you find this thought leadership of interest and value. Incase you wish to seek any further information or desire to evaluate the value of your business, please do not hesitate to contact the authors mentioned below.



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