Good practice for fund managers

Environmental and social due diligence: mitigating risks, identifying opportunities

What is this guide for?

At CDC, we recognise the strong contribution made by private equity funds in emerging markets. Investment capital allows businesses to grow, resulting in the creation of new jobs and services.

We also recognise that high environmental and social (E&S) standards are a fundamental part of business success and long-term sustainability. As a Development Finance Institution (DFI), CDC requires its fund managers to consider the environmental and social risks, impacts and opportunities associated with investing in a business. This process starts with effective due diligence.

But just how effective is this due diligence process in reality? To find out, we commissioned an independent review of 54 Environment and Social Due Diligence (ESDD) reports to understand more about the process fund managers undertake, including the types of information they obtain. We also wanted to know what good practitioners do with the information once they have it. How do they manage risks and assess impact? And how many are using the process to spot opportunities to add real value to the business and their investment?

We're sharing the results of that exercise with you in the form of this good practice note. In one respect it perhaps confirms what we already know: every investment and therefore every ESDD report is different. However, it also reveals a wealth of tips and approaches that can be applied in a wide range of situations to help you get it right.

CDC is continually seeking to lead, develop and share best practice. This is the latest in a series of guidance notes from us. We hope you find it insightful and useful.

Diana Noble
CEO, CDC Group plc

This is the second in a series of good practice notes that are based on first-hand observations, recognising that there is a lot we can learn from each other to drive continual improvement in investment processes and outcomes.

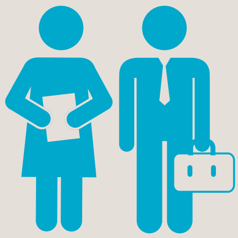
Please see **www.cdcgroup.com** for other notes.
This note complements CDC's ESG Toolkit for Fund Managers
http://toolkit.cdcgroup.com

A snapshot from CDC's review

Materials reviewed

54

This report is based on a review of 54 written ESDD reports.



54%

of ESDD reports completed by consultants external to the fund manager.

Outputs and findings

The vast majority of ESDDs use IFC Performance Standards as the reference framework but only 13 ESDDs referred to World Bank Group Environmental, Health and Safety (EHS) Guidelines.

74%

of ESDDs explored labour issues adequately.

25%

Only a quarter of ESDD reports focused on value creation opportunities from environmental and social improvements.

What's in this guide?

Introduction

These are the nine themes that should be considered when determining an appropriate ESDD process. All were identified in the independent analysis of ESDD reports. Appendices provide additional practical tools for fund managers.

For more information
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When?

At what stage of the overall due diligence should the ESDD take place?

What time should be allowed and how close to final approval?

For guidance and case studies
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Who?

Who within the fund should be involved?

When is it necessary or desirable to bring in external specialists?

Will local, regional or global E&S consultants deliver the best value for money?

What about bringing in specialist input to cover specific technical issues or consultations?

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Scope?

What falls within the scope of the ESDD (e.g. which E&S issues and what geographic boundaries)?

How many sites should be visited?

Which parts of the business should be in the scope of ESDD (supply chains, distributors, associated facilities, worker associations etc.)?

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Focus?

How can the ESDD cover all the material risks while taking a proportionate approach?

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Framework?

What reference framework should be used (e.g. local legislation, IFC Performance Standards)?

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Commitment?

How can I tell whether an investee company has sufficient capacity to implement the action plan or will commit to improvements over time?

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What actions?

What are the features of a good action plan?

How should the ESDD be discussed with investee company management?

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Limitations of independent review of ESDDs

Guidance to ensure that ESDD is adequately reflected in investment paper

ESDD report template

Pro-forma for a E&S action plan (ESAP)

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Introduction

Setting the scene

ESDD is a key part of the decision-making process prior to making a new investment. It plays a vital role in ensuring that risks are not only properly managed but potential value-adding opportunities are identified at a time when there is the best likelihood of influencing change.

As an investor in over 150 funds, CDC has been at the forefront of driving and formalising the ESDD process and has, in its role as a limited partner, seen a wide range of approaches that vary in their effectiveness. This note aims to share our experiences and is based on lessons drawn from ESDD undertaken by a sample of fund managers in our portfolio.

The importance of getting it right

For an investment in an existing business, poor ESDD can result in a failure to correct existing dangerous or damaging practices e.g. by failing to identify, diagnose and resolve the practices that lead to high accident rates. In the case of a new or expanding business, poor ESDD can result in negative environmental and social impacts e.g. a textile company setting up a new factory may not consider how its use of water in that new location will affect other users.

Poor ESDD can therefore create cost to the business in terms of fines or shut-downs, or because it requires management time and resources to resolve problems. It can also hurt a company's reputation, which may affect its ability to access new markets, attract future investors, customers and possibly employees.

Conversely, strong ESDD can create an opportunity to add value by identifying areas for greater efficiency, or for improved relationships with suppliers or customers. It can enhance the reputation of the company and brand.

It is therefore in the interest of a company, a fund manager and its investors to ensure that the work done on ESDD reports is of the highest quality.

CDC's fund portfolio in 2015

150
funds

1,331
businesses supported across all regions

About the review

In 2015, CDC commissioned a review of 54 ESDD reports that had been undertaken as part of fund managers' assessment of potential investee companies.

The ESDDs were selected from a sample of fund managers in CDC's investment portfolio, including larger and smaller-sized funds investing across a range of geographies, industry sectors and investment models. Some of CDC's own due diligences were included as well to provide balance and additional material for the review.

The aim of the review was to identify areas and examples of good and less good ESDD practices with a view to understanding and sharing examples and learning between peers who are all private equity practitioners. This guidance note summarises the findings of the external review and provides good practice guidance for those looking to invest in emerging markets.

Figures 1 and **2** illustrate some of the characteristics of the 54 ESDD documents that were reviewed. Given that 54% of ESDDs involve reports commissioned by external consultants, maximising the utility of third parties is clearly a core component of effective ESDD by fund managers. Discussing how to manage this effectively is a key part of this good practice note.

The review, by its nature, had some significant limitations. The most prominent of these are detailed in Appendix 1.

How the review informs this good practice note

The review of the ESDDs highlighted that there were common shortfalls across many of the written reports and that it would be valuable to provide guidance in a number of key areas to increase the utility of an ESDD report.

This note introduces those key areas, and outlines a range of case studies to illustrate the most common shortcomings, as well as examples of good practice that might be replicated in other ESDDs.

This note complements the CDC ESG Toolkit[1], which provides guidance for fund managers on the ESG dimensions at all stages of the investment process[2]. Specific insight is offered from the empirical study and there are 20 case studies to illustrate the points made, providing fund managers with practical guidance on identifying and managing E&S issues.

Fig. 1

Geographical spread of the 54 ESDDs reviewed

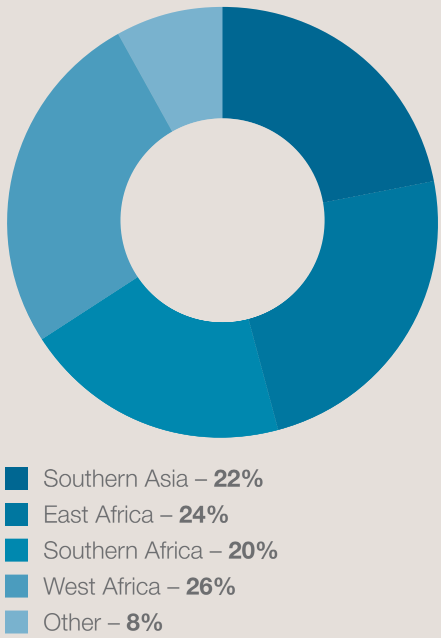
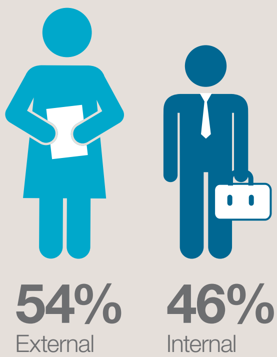


Fig 2.

Proportion of the 54 ESDDs involving internal teams or external consultants



1 ESG Toolkit: **http://toolkit.cdcgroup.com**

2 See CDC ESG Toolkit: **http://toolkit.cdcgroup.com/icycle**

When?

There are two key elements related to the timing of the ESDD which can affect the quality of the work.

Timing and duration of ESDD

Not allocating enough money in the budget can limit the time available for a consultant to be on-site or limit the number of sites visited – or both.

Current practice reveals that budgets are sometimes set fairly randomly, with the result that not enough money is available to do the job properly. This can lead to failure to identify important areas of risk or opportunity for the business, requiring the fund manager to allocate additional time and cost after the investment and potentially exposing the fund manager to reputational damage and investment risk.

Ideally the budget should be set according to inherent E&S risks determined by sector, the number and type of site visits required to get a representative picture of the environmental and social aspects of the company's activities, plus the estimated time required to gather appropriate data on each site.

Starting early

A good quality ESDD is sometimes compromised by the time available prior to the deadline for submission of the investment for approval.

However, in some cases, the full ESDD may even be delayed until after final Investment Committee approval because there's simply not enough time to do it beforehand.

Not allowing enough time or delaying until after approval can lead to consequences such as significant unexpected cost and inefficiencies, or missing the opportunity to influence a discount in price if E&S issues affect valuation. In the worst cases it can risk locking a fund into a poor deal. **See Case study 1.**

> We are often brought in at the very end of the deal, when deal teams are really only looking for a tick in the box. That means that we are not able to provide information to the deal team in time to develop a meaningful dialogue with the investee company management about E&S in the context of their business as a whole. And we therefore miss opportunities to investigate risks and to add value.
>
> **A consultant**

Case study

1. Delay of ESDD to after investment may present unwelcome surprises

In the case of a dairy business in West Africa (which comprised a number of facilities in several countries), the internal due diligence carried out by the fund before investment identified that disposal of solid waste from one of the dairies was not compliant with local legislation. Plans were put in place to correct this at a cost of $600,000.

After the investment, the fund manager, with some external support, undertook a more detailed investigation of further sites in additional countries and found a wide range of other areas of non-compliance. These included poor safety procedures, inadequate waste disposal procedures, and effluent was not compliant with IFC Performance Standards at any of the plants. In addition, as the site was not compliant with local legislation, post-investment analysis revealed that there was no room for the required effluent treatment plant, potentially necessitating the relocation of the whole production site at considerable cost.

Practical tips

- Set the budget and time required for the ESDD according to the necessary scope and risk of the investment
- Initiate ESDD at an early stage, so you have time for issues to be followed up
- Adequate ESDD should always take place before a final IC decision. If it's not complete, the IC paper should clearly state why, and any potential implications

"We review each new investment at an early stage to identify any 'fatal flaws' on ESG. So at that point we get a sense of how complex the ESDD is likely to be. That means that, once it seems likely that an investment will progress to Investment Committee, we can plan the ESDD in reasonable time."

A fund manager

Who?

In selecting the right people to engage on the ESDD, a fund manager may choose to use:

– internal staff within a fund
– external consultants, such as local, regional or international consultants
– industry experts
– specialists in a particular environmental or social issue

There is no hard and fast rule about when a fund manager should bring in external support for the due diligence (although DFI investors typically require external support on high risk investments). The final decision by the fund manager will depend on:

- the expertise available internally
- any particular technical knowledge required (e.g. on effluent plants, employment rights, or health and safety law)
- any particular sector or thematic expertise required (such as stakeholder consultation for investments with concerns on labour standards or community impacts)
- time pressures for the investment team, necessitating additional resource to get sufficient information in a timely fashion

This section sets out good practice guidance in leveraging the most out of technical or professional expertise.

What do private equity funds typically do?

The result of our independent review showed that the split between internal and external ESDD was roughly equal. Internal teams typically undertake a high proportion of ESDDs on lower-risk investments, while external expertise tended to be brought in for the higher-risk deals. These experts were used to complement internal decision making processes within the fund manager.

As **Fig 3.** shows, PE funds are already commissioning additional external resource to assist their assessment of E&S risks in sectors of higher inherent risk.

Historically, there have been examples of internal teams undertaking ESDD without the necessary expertise (see **Case study 2**), but there is less evidence of this in more recent investments. This may be due to a combination of more awareness of environmental and social issues, a greater number of specialist consultants and tighter standards from investors.

The review revealed that the majority of investments were likely to be categorised[1] medium-risk (66% of the ESDDs reviewed were B or B+, with 17% each in A and C categories). This highlights the importance of tailoring the ESDD to address the particular source of the risk rather than applying the same focus to due diligence in each of the medium-risk investments.

> We try to give our investment managers the tools they need to understand whether it is an investment requiring specific focus on environmental and social matters at due diligence. Then they can decide whether the scale of the risk merits the support of external consultants.
>
> **A fund manager**

1 Category A risk indicates that the investment is expected to have significant adverse environmental or social risks or impacts, including those that are potentially diverse, irreversible or unprecedented. Category B risk indicates limited adverse E&S risks or impacts that are few in number, generally site specific, largely reversible, and readily addressed. Category C means the investment entails minimal or no adverse E&S risks or impacts. The concept of B+ here is to differentiate within the large number of B projects that otherwise would have comprised the majority of the sample. Category B+ risk indicates that there are particular environmental or social risks that require more careful management than a typical B risk project due to issues related to scale, location, workforce or community or environmental vulnerability.

2 NB The sample size for each investment sector was small, so the conclusions should be treated with some care.

Fig. 3

Proportion of internal and external ESDDs in the post-2012 sample by category of environmental and social risk[2]

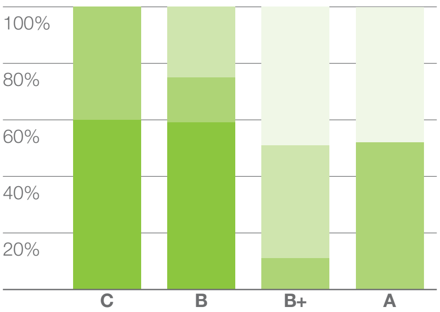
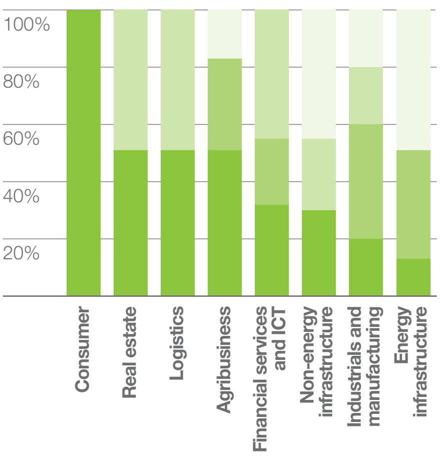


Fig. 4

Proportion of internal and external ESDDs by sector for the post-2012 sample



Key for Fig 3. and Fig 4.

Global consultants
Regional consultants
Local consultants
Internal

Does the use of external consultants differ by sector?

When looking at ESDDs by sector, some patterns emerge including:

- Fund managers commissioned proportionately more external ESDDs for industrials and manufacturing, and for infrastructure investments (see **Fig 4.**)
- Global consultants tended to be brought in mostly on infrastructure investments. It is possible this reflects not only the risk, but also the size of the investments and consequently the budget available
- Many of the infrastructure investments involved project finance rather than private equity and this would also have had an influence on the type of ESDD undertaken

While there are general patterns across sectors, it is clear that the approach depends to a large extent on the specific nature of the investment made within the sector and on the skills available to the fund manager within their internal team. So, for example, the agribusiness investments that were assessed by internal teams were processing facilities with a risk categorised as B. External specialist input was sought for a more high-risk investment categorised as B+ involving some primary production and a number of more complex issues relating to water usage, hazardous waste and workers' housing.

Although, on average, fewer concerns emerged for externally completed ESDD than internally completed ESDD; the quality of external ESDD is not always higher than internal ESDD. The review found that in some cases external consultants were using generic templates for the ESDD report and not tailoring the report sufficiently to the specific issues of the sector or geography. This could be an indication of either a weakness of the terms of reference (ToR) for due diligence or limitations in the experience or capacity of consultants.

Case study

2. Shortfalls in internal ESDD

A fund manager deployed its internal team to assess the E&S risks at a number of farms owned by the target investee company in Southern Africa. The team had deep knowledge of agricultural practices and local legislation but limited experience of relevant E&S standards (in this case the IFC Performance Standards). The report therefore did not identify the principal areas where corrective action would be required post-investment to bring the company into line with the necessary benchmarks.

The potential risks included loss of biodiversity, inappropriate use of pesticides, impacts on water quality, waste treatment and labour practices including working hours and wages, and housing for employees. All of these had the potential to cause significant delays, investment risks, and required unplanned expenditure and time-consuming interventions post-investment.

It is also important to note that external consultants very rarely addressed issues of corporate governance, whereas this tended to be a part of the internally-generated reports. The types of external consultant commissioned to undertake the ESDD report seldom have expertise in this area, so it is right that their ToRs should exclude it. However, the fund manager must ensure that governance issues are covered elsewhere in the due diligence process. And there will often be specific links between E&S management systems and overall corporate governance which may need to be connected up coherently in the 100-day plan post-investment.[1]

Skillset

The decision of whether to engage local, regional or international consultants will depend on the E&S risks associated with the sector/investment, the skills required, and will be influenced by the cost and consultant availability. The evidence from the review is that it is important for fund managers to provide very clear ToRs particularly to less experienced consultants (e.g. those that have a smaller team, or a shorter track record of similar work), providing a clear indication of the scope and the reference framework. There is a difference between the audit focused approach of many consultants and the desired outcome of a due diligence for a private equity investor which focuses on a broader range of E&S issues (including capacity and commitment, opportunities and business strategy).

When appointing an E&S consultancy, the fund manager should confirm that the organisation has relevant experience of the industry sector and adequately experienced individuals. However, there are occasions where more specific specialist input will add real value and an additional expert can usefully be included to complement the ESDD team. Where the fund manager identifies a specific risk in an investment and designs the ToRs to focus in particular on that risk, the fund manager should consider specifically requesting that the consultant outsource parts of the ESDD to specialists (e.g. food safety).

In particular, many external consultancy firms undertaking ESDD have come from a background of environmental, rather than social, assessment audits and their coverage of labour standards (including health and safety) and other social issues (e.g. stakeholder engagement, resettlement) can be quite weak. On average across the review, external and internal reports had similar shortfalls in this area. The quality of the review of labour standards across all of the ESDDs, both internal and external is illustrated by **Fig 5**.

Labour standards apply in every investment and it is critical for the ESDD to assess how a business manages its people and keeps them safe and productive.

On keeping workers safe, see CDC's: CDC Accident Prevention Report.

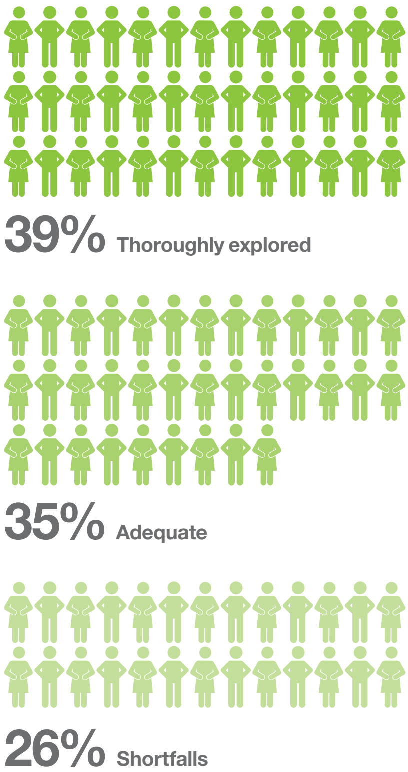
On wider labour issues, see IFC Performance Standard 2 as well as specific guidance on labour in CDC's ESG toolkit.

Take ownership of the report

Where the ESDD has drawn on external expertise, there must be a process whereby the fund manager 'internalises' the report and takes ownership of the findings. This happens best if a member of the fund manager's staff accompanies the external consultants on site visits. If that does not happen, then the fund manager must make time for a briefing from the consultant on the findings of the ESDD and any response from the investee company management during the visit.

This process of 'internalising' the external report is critical for ensuring that the conclusions of ESDD inform investment decision making; for building the on-going dialogue with the investee company management about E&S issues, and for monitoring progress against the E&S action plan.

Fig 5.
The quality of review of labour standards in the ESDDs



1 See CDC's ESG Toolkit: **http://toolkit.cdcgroup.com/esgms**

Practical tips

- Internal teams can carry out ESDD effectively if they have scoped the ESDD adequately, are systematic and report against the relevant standards and legislation, and are familiar with IFC Performance Standards
- External ESDD does not always add value, especially if the scope and reference points are poorly defined or open to interpretation or if the work is commissioned too late (see section When?, pages 8-9). This is especially the case if the consultant follows an audit approach that is more about completing a checklist to meet the ToR, rather than being guided by key areas of risk or opportunity at a company
- Use external experts for higher risk transactions, alongside internal team members who can interpret the findings
- Don't overlook labour standards and practices by making sure external consultants have appropriate experience in this area, including health and safety
- Don't forget to identify areas where improvements in environmental and social performance can be expected to add value to the business; this can be included as a specific task for external consultants in the ToR
- **See Appendix 3 for a template for a well-structured ESDD report**

"In my experience, it is very rare to find a single consultant with expertise in all environment, health and safety, labour and community issues. But the tightening cost pressures mean that funds are using one individual on the ESDD for medium-risk investments. I think this will mean that important issues are not addressed."

A fund manager

Scope?

Setting the correct scope for the ESDD is critical and involves ensuring that all relevant E&S issues are identified and that the due diligence helps identify a framework to manage relevant risks.

From our review we found that the scope can be flawed for a number of reasons, in particular:

- **Failure to allow for future growth**
  e.g. failing to scope for future growth of the company, acquisition of new assets and a substantially expanding range of operations. See **Case study 3**
- **Not visiting enough sites**
  e.g. visiting too few or insufficiently representative sites to give a complete picture of the company's current performance. See **Case study 4** and **Case study 5**
- **Not including upstream or downstream activities**
  e.g. excluding suppliers or distributors from the scope of the ESDD in cases where they're fundamental to the success of the business, and therefore require careful scrutiny
- **Not including labour conditions of subcontractors**
  e.g. not being explicit that the scope should include scrutiny of companies with subcontracted labour in either construction or operational phases

Case studies

3. The scope of ESDD does not allow for future expansion plans

At the time of the investment, a company in West Africa held one asset: a gas processing facility and pipeline in Nigeria. Consultants were engaged for the ESDD to visit the site and provide their view on the E&S risks associated with it. Their recommendations for the company were subsequently based on their view of improvements needed to that single, existing asset and excluded consideration of any issues such as future land acquisition and land clearance.

However, a significant part of the investment thesis included expansion of company operations to include acquisition and development of new gas processing facilities and infrastructure. This meant that the action plan for the company did not include issues relating to expansion planning e.g. land acquisition, management of construction workers; nor actions to ensure that the company's management systems would oversee these issues in line with the fund's E&S requirements.

4. The scope of ESDD does not allow for the construction phase

The ESDD report for a potential investment in a cinema chain highlighted the fact that, while the company managers appeared to be well-informed about the health and safety risks (particularly fire and life safety) associated with managing their cinema operations, they had much less awareness and control over health and safety in the construction phase.

Given that the investment was designed to fund substantial expansion of the company, construction at new sites should have been central to the assessment of the E&S risks of the investment, in terms of health and safety, disposal of construction waste and possibly land acquisition in an urban setting. The lack of information led to a limited action plan.

5. Designing and delivering an ESDD for multiple sites

The ESDD for an investment in an energy company in India stated the need to visit three out of 14 existing assets, which were selected to be representative of the geographical spread. As well as the site visits, the ToR for the ESDD explicitly included the need for an assessment of the capacity of the company to implement relevant standards across the whole company and in particular in any future developments.

The resulting E&S action plan was separated out into three parts: two containing specific actions arising from each of the sites visited and the remaining one containing recommendations for the management system to be developed at corporate level. The ESDD conclusions were strong because the scope had resulted in both reassurance that the company was better placed to manage future projects satisfactorily, and identification of certain deficiencies at existing sites to be remedied.

Practical tips

- Select the sites to be covered by the ESDD carefully, so that the investigation provides a realistic and representative view of corporate risk and opportunity
- Consider construction and operational elements of the business's operations
- Consider carefully the growth and investment strategy of the company when deciding on the applicable legislation and standards
- Where the supply chain has a significant influence on the viability of the business (e.g. textiles or agribusiness), the ESDD should seek to assess the E&S conditions in the supply chain
- Where a company's supply chain can credibly be linked to poor labour practices or environmental damage, the ESDD should investigate it, so that reputational risks are identified, along with opportunities to exert leverage and influence
- Where the company relies on storage or distribution, it may also be appropriate to assess the E&S quality of these operations, including transport-related risks and issues

"Where we consider the scope of the Terms of Reference for an ESDD to be too narrow, whether because of limited time or budget or because the fund manager has not recognised the need for extending the scope, we make it clear in our report that we have only covered a limited part of what we consider to be a complete ESDD on that deal."

A consultant

Focus?

Materiality and proportionality

It is valuable to ensure that all risks are properly assessed, and the ESDD should clearly justify any assumptions about what is not relevant in any particular investment. But, conversely, it's important to apply judgment and only include detailed commentary on an environmental or social impact where it is clearly relevant to the business, or likely to create significant adverse impact or offer significant opportunity.

Where an investment has been properly assessed to be low risk, it is inefficient to allocate time and resource to an extensive due diligence if an approach more commensurate with the risks can be found. Unnecessary work on the ESDD risks reducing the process to a box-ticking effort which can damage credibility with the portfolio company's management and potentially also with the fund manager's own Investment Committee.

Extending the boundaries

Fund managers may be missing a chance to create value in their investments if they do not consider how an investee company could benefit from opportunities in the environmental and social space. Yet the independent review of ESDDs showed that only a quarter of the ESDD reports touched on this. Many of the reports that referred to 'value added through ESG' and 'ESG opportunities' focused on how E&S interventions might add value for society or the environment only. While this is a relevant angle, identifying direct business benefits such as a positive reputation, improved productivity, energy savings, resource efficiency or a particular market could prove useful to the business as well as its wider stakeholders.

The independent review highlighted the following common issues:

- Some fund managers have unsatisfactory internal processes for assessing risk in order to decide on the appropriate level of ESDD, and these need to be revisited – see **Case study 2**
- Consultants sometimes use generic templates for ESDD which do not tailor their work, and therefore use their time inefficiently, focus on irrelevant areas (see **Case study 6**), and fail to delve deeply enough into the key areas of risk
- The best ESDDs briefly comment on how each potential area of E&S risk has been considered, and then home in on the particular areas of focus for the investment – see **Case study 5**
- Good ESDDs take account of other reports that have been carried out on the company concerned (e.g. by other investors, by environmental agencies or through customer audits), but recognise where there are gaps and do not rely upon them unduly – see **Case study 7**
- Risks should be assessed individually so that a specific area of high potential risk is not masked through being aggregated with other, lower risks – see **Case study 8**
- A section outlining how improved E&S performance will add value to the company can be useful, but only if it is tailored to the company concerned and not generic – see **Case study 9** and **Case study 10**

Case studies

6. The dangers of generic templates

An ESDD report prepared for an office-based, software company located in an office block in a capital city in West Africa, included sections on climate and meteorology, geology and hydrogeology, and a section on the ethnic groups living there historically and currently. This indicated that the report was generated from a standard structure and was not sufficiently focused on the relevant areas (e.g. labour). The result was information of little use to the investment decision, whilst other areas of risk received only limited coverage.

Case studies

7. Missing material issues raised by other reports

A fund manager used its own internal team to undertake the ESDD for a cement company in East Africa, drawing on reports carried out by the local authorities. But the team did not pick up on concerns reflected in reports by the national environment agency about the high levels of dust and the adequacy of the company's response. Plus the ESDD did not allow for the fact that a significant expansion of the business had occurred since the local reports were produced. This reliance resulted in unmanaged risk – and subsequent operational disruption – for the company.

8. Inappropriate aggregation of diverse risks

One fund manager used a system for categorising the E&S risk from an investment, which aggregated the scores of all risks from environmental, social, health and safety, governance and security issues using a point allocation system. Even though this system might correctly identify high risks in one area, these might be cancelled out by low risks in others, resulting in an acceptable overall risk score. This system fails to take into account the need to investigate high risks in any single area and could mean that risks in that area are not given the attention (and potentially the expert input) required.

9. Including a review of business opportunities presented by the ESDD into the ToRs

One fund manager in the sample reviewed explicitly asked the consultant, in the ToR for the ESDD, to "identify opportunities for value addition through social and environmental improvements and initiatives." However, even though it was included in the ToRs, the consultants did not always deliver on that task in their final report and nothing explicit on value creation was delivered.

10. Including business opportunities in the ESDD report

In a real estate investment, the deal team recognised the risks to biodiversity from cutting down trees, but also identified that preserving more trees would improve the aesthetic, and therefore financial, value of the property to potential house-buyers.

In a healthcare investment, the deal team recognised the value of tightening up the procurement process so that usable materials, such as containers, were returned and new materials were not over-ordered. This was seen to have both environmental and business benefits.

“We are, of course, guided by the needs of the fund manager, in terms of the areas of the business covered by the Terms of Reference, but if we are visiting a site it often makes sense to take a look at all of the various basic areas of social and environmental risk, because we have undertaken many of these visits and we know what is likely to be material and therefore what to look out for.

A consultant”

> Put simply, the ESDD has to be relevant to the investment decision. We don't want to do any more or any less than is necessary to inform that decision and ensure it is the right one.
>
> **A fund manager**

Practical tips

- Try to home in on the key areas of risk through early discussion with the company management and early review of available documentation. CDC's ESG Toolkit for fund managers is a resource which can be used to help identify key areas of risk in different sectors: http://toolkit.cdcgroup.com/sector-profiles
- Plan your ESDD in light of the risks and your initial judgments of the quality of the company's current E&S management systems
- If you bring in external consultants, make sure they have relevant expertise in any areas of particular concern, especially relating to social matters such as labour standards or community issues if these are a known risk

> We know that fund managers have many competing demands on their time. Our experience shows that time thoughtfully allocated to investigating the key areas of potential environmental and social risk at due diligence can substantially reduce the time and cost of managing these issues at a later stage.
>
> **Mark Eckstein**
> **Director, Environmental and Social Responsibility**
> **CDC Group plc**

Framework?

The reference framework defines E&S requirements and should be clearly referenced in the fund's E&S Policy. The industry standard, and a requirement for most funds that have DFI investors, is the IFC Performance Standards[1].

IFC Performance Standards

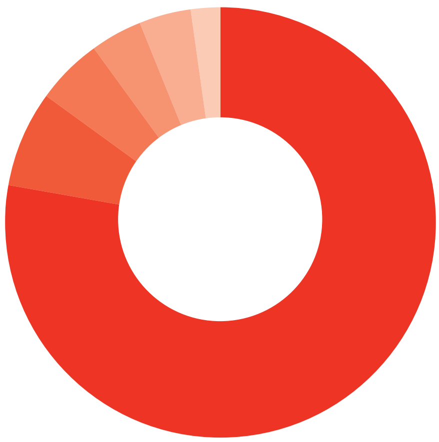
The most important points of reference from the perspective of many international investors are the IFC Performance Standards, which include reference to International Labour Organisation (ILO) core labour standards and local employment regulations. The IFC Performance Standards themselves refer to compliance with local legislation and therefore a company that is in line with the Performance Standards should automatically comply with local legislation. However, in practice the relevant checks against local legislation are not always carried out as thoroughly as is desirable. Local legislation often requires specific licences, approvals or permits and ESDD must establish whether these are in place and initiate action to resolve any inadequacies immediately.

The review showed that, of the 54 ESDDs, a significant number (78%) used the IFC Performance Standards as their principal reference framework. This provides encouraging evidence that fund managers are clear about the importance of implementing international good practice alongside compliance with local E&S laws and that this is reflected in the ToR to consultants and in the expectations of internal teams.

Of the three ESDDs that used local legislation alone, two were ESDDs undertaken several years ago, while the third was a low-risk investment requiring only limited ESDD. The evidence, therefore, suggests an increasing use of IFC Performance Standards as the default reference framework over time.

However, the review showed that using the IFC Performance Standards as a reference framework did not guarantee that the relevant issues were covered to sufficient depth. The eight Performance Standards cover management systems; labour and working conditions; pollution prevention; community health, safety and security; land acquisition; biodiversity conservation; indigenous peoples and cultural heritage. Of these, the first two – management systems and labour and working conditions – are applicable to every investment. The third – pollution prevention – is applicable to most investments and the fourth – community safety – often has some relevance. The remaining Performance Standards are not central to a majority of investments but they can have a very significant impact (and cost implication) in cases where they do apply, so the investment team needs to consider Performance Standards five to eight carefully before excluding them.

Fig. 6
Reference framework in the 54 ESDDs reviewed



- IFC Performance Standards – **78%**
- Fund managers' own – **7%**
- Local legislation only – **5%**
- Consultant's own – **4%**
- No reference points given – **4%**
- Other guidelines – **2%**

1 Reference frameworks evolve over time (including IFC Performance Standards) and investors are encouraged to keep tabs on evolving standards.

Consideration of sector specific issues

In light of this, it is possible to argue that using the IFC Performance Standards as a reference framework may not draw the attention of investment teams sufficiently to the most common risks specific to a particular industry sector or a particular location. One way to remedy this might be to also include the World Bank Environmental and Health & Safety (EHS[1]) Guidelines (a set of sector-specific notes that provide technical guidance on environmental and occupational health and safety issues) as a reference point[2]. Of the 54 ESDDs, 13 made reference to the specific EHS Guidelines for the sector concerned. These 13 investments were in industrials and manufacturing and in infrastructure. The EHS Guidelines for the sector provided more sector-specific detail against which the ESDD team could benchmark the performance of the proposed investee company.

The findings of the review showed that using the IFC Performance Standards as the primary reference framework did not in itself guarantee that all E&S matters were properly covered, but neither did it necessarily result in matters being poorly prioritised. Perhaps the more important aspect is whether the internal team or external consultant undertook a systematic process to assess the relevance of each element of the framework.

The ESDD review identified these important themes:

- the best ESDDs list the pieces of local legislation that are relevant to the transaction
- the best ESDDs clearly state which local permits are in place and confirm that these have been obtained – see **Case study 11**
- risks on individual projects are sometimes considered by reference to higher-risk examples and therefore given a lower-risk rating than they should be given – see **Case study 12**
- most ESDDs refer to IFC Performance Standards and check compliance against them[2], but the process for deciding which IFC Performance Standards are relevant is often flawed, especially in the light of future growth plans – see **Case study 13**
- many ESDDs do not carefully check labour standards against the requirements of IFC Performance Standard 2, even though these are applicable to every investment – see **Case study 14**
- particularly in industrials and manufacturing, and in infrastructure, the best ESDDs use the sector-specific EHS Guidelines as part of the reference framework
- although none of the ESDDs mentioned exclusion lists agreed with DFI investors, consideration of exclusion list issues is an important part of the reference framework because it is not always straightforward to identify whether a company is breaching any of the exclusions

Remembering to look for opportunities

By focusing on reference to local legislation and the IFC Performance Standards, there is also a danger that ESDD teams view the process only in terms of compliance and risk mitigation and do not consider how the company can positively benefit from the findings of the ESDD. The opportunities arising from implementing the recommendations of a good ESDD could include reduced costs, increased efficiency, enhanced revenues (perhaps from a specific market segment), improved productivity and enhanced brand and reputation. The management of the proposed investee company may buy into the E&S action plan more readily if it is presented in this way. However, only 14 out of the 54 ESDDs reviewed included a section on ESG opportunity. See **Case study 15**.

“In most investments working conditions are the most important thing to look at, especially the health and safety of workers. But it seems that this is lost amongst lots of other areas covered by the IFC Performance Standards, many of which are often irrelevant. I feel that we need to focus more on the core labour issue.”

A fund manager

Framework?

1 **www.ifc.org/ehsguidelines**
2 Another way of gauging sector-specific risks can be found in CDC's ESG Toolkit for Fund Managers.

Case studies

11. The importance of checking local permits

In the process of checking compliance with local legislation during ESDD, it became clear that a telecommunications company had built a mast that exceeded the legal limit set by local legislation. This would not have been picked up by reference to the IFC Performance Standards or EHS guidelines, and there were implications for management time and cost in resolving the issue.

12. Using an appropriate context for benchmarking risk

The ESDD for a slaughterhouse in Africa did not focus on the specific risks around food safety, animal welfare, disposal of effluent and solid waste, and control of infection. Instead it noted that the company "does not cut as many trees down as cattle ranching in the Amazon," and that the health and safety risks were "not as high as in mining or exposure to radiation." This led the ESDD report to significantly understate the site specific risks of the investment because the comparators were inappropriate.

13. Excluding IFC Performance Standards when they need to be considered

The ESDD for a road construction company in India stated that only Performance Standards 1 and 2 (assessment and management of environmental and social risks and impacts, and labour and working conditions) were relevant to the investment in question. The nature of its operations suggest the company would certainly be handling raw materials and waste, which would make Performance Standards 3 and 4 (resource efficiency and pollution prevention, and community health, safety and security) relevant as well. Also, given that the company was going to expand and acquire new land for roads, additional Performance Standards were relevant (i.e. Performance Standard 5 relating to land acquisition and involuntary resettlement and Performance Standard 6 relating to biodiversity), and should have been taken into account.

14. Focusing ESDD resource where it is most needed

The ESDD for a software technology company in East Africa focused on the environmental aspects such as air quality and waste management, and did not address the more relevant issues relating to wages and working hours for employees.

15. Identifying opportunities arising from strong E&S

The ESDD for a healthcare project in Asia highlighted the need to focus on waste minimisation, not purely because it was an E&S issue but also because of the cost savings involved.

The ESDD for a university emphasised the business case for ensuring that all undergraduates were provided with courses on how they could become more employable. This increases student satisfaction and therefore attracts more students, thereby generating additional revenue for the company.

Practical tips

- Ensure that the ESDD makes clear what reference framework it is using, both in terms of relevant local legislation and applicable IFC Performance Standards
- Where a relevant guideline exists, include World Bank Environmental and Health & Safety (EHS) Guidelines in the reference framework
- IFC Performance Standards 1 (management systems) and 2 (labour and working conditions) are always applicable and you should take particular care to ensure that every ESDD covers these areas well
- The relevant reference framework must take account of the expected future activities of the company as well as its current operations
- The reference framework will tend to direct your thinking towards risk reduction, but keep an eye on how the actions will add value to the business
- Make sure the wider spheres of influence (e.g. suppliers, logistics and transport, customers) are included, and assessed against relevant reference points
- Make sure that you consider the practical aspects of local legislation used as part of the reference framework. For example, how it might change in the near future and how it is enforced

Record?

The benefits of keeping a record

By recording what sources of information were considered in preparation for an ESDD report, the fund manager is able to have a high level of assurance about the issues that have been covered. This includes the people interviewed as well as the documents reviewed.

In addition, a clear list of sources in the ESDD report creates an audit trail that can be used in the monitoring phase and ensures that everyone in the fund can access information on the work done. This also means there's better continuity if an employee leaves the investment team.

Appropriate sources of information

Preparing a list of potential sources of information helps you decide what should, and should not, be included in the ESDD. In the end, a long list of documents is not always necessary; the list of documents requested for review should be focused principally on the particular risks that the company faces.

The best ESDD reports include the following:

- a list of the people interviewed (including local regulators and communities as necessary)
- a list of the company records examined
- a list of the sites visited (with rationale)
- details of any public records reviewed – for example, an internet search on the company, or records held by local authorities
- a list of people who the ESDD team wanted to interview but could not, together with the reason (if available)
- a list of the documents (policies, procedures, contracts and so on) requested but not made available or not in existence, together with the reasons given

Sources of information will clearly be more readily available for assets that are already operational than for those which have not yet begun operations.

Interpretation

Where risks need careful assessment, sources can be triangulated so that the information gathered from one can be checked against another.

In particular, useful information can be inferred from the fact that a company is unwilling or unable to provide certain documents or unable to host a visit to a particular site. The ESDD team can establish the reasons for this and determine whether this raises concerns about the management system in place, the commitment and capacity of the investee company management – or both.

Where documents are not available, this may indicate simply that the company does not keep records, but it could also show that an important process is not being undertaken – see **Case study 16.**

Case study

16. Listing source documents and using the lack of availability to indicate areas for action

The ESDD report for a chemicals company in West Africa (rated as medium-risk) included a comprehensive list of the people interviewed and the documents reviewed, together with comments on what was, and what was not, made available to the ESDD team.

The documents requested ranged from health and safety policy documents and procedures manuals, to permits from local authorities and records of recent environmental audits. Given the importance of waste disposal for a chemicals company, the ESDD team asked to view waste disposal contracts and found they were not available. This highlighted that waste was disposed in an ad hoc way, and led to an action item for the company.

Practical tips

- Create a comprehensive list of all sources and then prioritise those that are most appropriate to the investment risk
- Cross reference the sources on priority, high-risk areas, to make sure the information can be corroborated and to discover gaps
- If a source is missing, or a company seems reluctant to provide the information, consider whether this should ring alarm bells. If so, probe further and include it in any action plan
- Use the source record as an audit for the monitoring phase and continue to ask the same questions to continue to verify any assumptions made

Data?

Using specific data to complement and expand upon narrative text can be especially effective. This is because data points are able to:

- **Provide verification**
  Specific data provides a precise objective measure of a company's compliance with local regulations, in a way that's not possible with a subjective description, e.g. specific data on air emissions and waste water effluent quality can be clearly compared with legal limits
- **Highlight shortfalls**
  Any gaps are more easily identified
- **Provide a sense of scale**
  Data can help you understand the potential scale of an impact including costs and liabilities, as well as value creation opportunities e.g. of a company's waste material on the environment
- **Inform estimates of remediation costs**
  Having a clearer picture of shortfalls and scales of impact with precise figures helps with estimating remediation costs. See **Case study 17** and **Case study 18**
- **Validate management systems**
  Data can give an indication of whether current management systems can be relied upon to track performance and act on problems
- **Inform targets for improvement**
  Data can enable a fund manager to set targets for improvement and allow cost-benefit models for improvements to be developed to demonstrate the case for change

It is, of course, only possible to obtain live data from a company that has started operations, although the ESDD can gather useful (but different) data during a construction phase.

The independent review of ESDD reports indicated that the reports tend to be heavy on narrative and light on data, reflecting three main problems with collecting data:

- the limited time available for site visits, so that there is no opportunity to gather independent data either by measurement (e.g. on emissions or effluent quality) or by meaningful observation (e.g. on worker overtime or breaks)
- the immaturity of management systems in most of the companies concerned in CDC's markets means that the business itself does not collect data on E&S elements of its operations
- a lack of demand from fund managers for specific data, potentially enables the consultants to take the easier route of not providing it and commenting instead on the need to develop management systems

Case studies

17. Using data to confirm or investigate compliance with local legislation and/or good practice

The external consultant carrying out ESDD for a company constructing telecoms towers in East Africa pointed out in its report that the safety implications of working at heights constituted one of the highest potential social risks for the investment. However, the consultant did not identify that the company had two recent fatalities as a result of falls from height. Given that this was one of the most important risks to be managed, the consultant should have sought data to get a better understanding of the quality of current performance in relation to fatalities and accidents, and the efficacy of the company's response.

18. Using data to confirm or investigate performance on labour standards

In the case of a logistics company, the ESDD highlighted that the working hours of drivers was an important area of risk, because tired drivers were more likely to have accidents. The internal ESDD reported, "Overtime is closely monitored to avoid excessive working hours." However, the report provided no data to support the contention that the company's systems actually managed the risk.

Practical tips

- Request qualitative data that is material to the transaction in the ToRs for external due diligence
- Assess the potential materiality of any data gaps in determining the magnitude of any shortfalls or potential remediation post-investment
- Plan for future data collection and consider how this can be used to demonstrate value creation

> Data is absolutely critical. An ESDD report without real data on potential areas of risk – whether emissions or overtime – is pointless. If we are investigating an existing company, we always gather data and we try to save time by requesting data from the company before the site visit.
>
> **A fund manager**

Commitment?

If the investee company has not got sufficient capacity or commitment in place to address E&S issues, then expecting a company to fulfil corrective actions on environmental and social matters can be naïve. Lack of capacity can be addressed during the holding period. But lack of commitment is a more worrisome issue and is a leading indicator of investments that may struggle to achieve compliance with E&S requirements. This may create risks for funds and entail significant additional staff time and resources.

With most investments, meaningful E&S work and the implementation of E&S improvements happens subsequent to financial commitment. Therefore, it is often during the monitoring phase that a fund manager must ensure that the company takes rapid action, not only to correct deficiencies, but also to develop and implement new policies, procedures and measures to evaluate their effectiveness. Hence, if the company is not genuinely committed to the process, to improving its performance in the longer term, or is hopelessly under-resourced in terms of manpower, then remedial action will be slow and painful. It may damage business relationships and financial returns.

For these reasons, it is worthwhile to assess the motivations and capacity of the investee company management during ESDD.

Capacity

The review of current practice suggested that only a handful of written ESDDs commented in depth on whether the investee company would have the capacity to deliver an E&S action plan, or maintain current levels of E&S performance in line with the company's growth projections. And often only limited analysis was given to devising a realistic timetable for the implementation of an E&S action plan, in light of the current resources available. Moreover, if resources were not available, there was rarely a discussion of what specific skillset would be necessary to address the deficit and where the skills could be found.

It's also important to consider how capacity affects the ability of the investee company to implement E&S actions in an effective way. Based on the ESDDs reviewed, the following observations were made:

- **Occasional lack of allocation of responsibility**
  Some action plans outlined all of the E&S actions required, but provided no indication of who would take responsibility for the actions within the company. It's important for the fund manager or their Investment Committee to understand this prior to financial close of the investment, so that expectations within the company can be managed
- **Checking that those responsible have the right skills or training**
  Sometimes actions were allocated to individuals or business functions without an assessment of whether they had the capacity, skillset, seniority and influence to deliver what was asked. Often a fund manager made these judgments in-house, whereas such judgments are often better made in the context of the business's expansion plans, the outcomes of other due diligence work streams, and in conversation with company management. Such conversations can help uncover whether additional internal or external resource, or training of existing staff, is required

- **Evaluating the time needed to build in additional capacity**
  Many action plans positively highlighted the need for additional internal resource and the need for a clear allocation of responsibility to an individual in a senior management position to deliver the E&S actions. However, more thought is often needed to evaluate the time it will take to build this additional capacity. Without such thinking, there is a risk of slippage in the timetable for implementation of the E&S actions post-investment, and the possibility of frustration between fund manager and portfolio company

- **Effective treatment of capacity issues**
  Some action plans entailed specific recommendations to ensure that appropriate resources were in place to deliver within an acceptable time-frame. On occasion it was proposed and budgeted for the company to seek support from an external consultant to implement the necessary systems, policies and procedures. In other instances, fund managers proposed recruitment or additional training of individuals within the company to take on a specific E&S function. See **Case study 19** for good E&S practice

Commitment

Overall, the independent review identified very few ESDD reports (just three) where there was any commentary about the levels of commitment within the investee company. This is surprising, given its importance in underpinning and driving the E&S activities within the company. Assessing a company's commitment is essential for understanding whether it will improve its E&S performance, rectify deficiencies, and work with the fund manager post-investment[1].

One problem with assessing commitment, is that it is more subjective in nature than an assessment of environmental or social performance, and consequently third party consultants, in particular, may be reluctant to express their views in writing. In light of this, it's important to find an approach that draws the information out of the ESDD consultants in a different way.

> “We would not include a subjective statement or opinion in the formal ESDD report about the commitment and capacity of the investee company management to deliver the actions outlined in the E&S action plan, and often we do not spend long enough with the investee company managers to make a judgment about this. But we are often prepared to give informal verbal feedback to fund managers based on an impression gained during a site visit.
>
> **A consultant**”

Case study

19. Identifying the need for increased investee capacity

The ESDD for an importation, storage and distribution company identified that the investee company lacked the skills to implement the necessary improvement to environmental issues and labour standards. The report noted that no-one in senior management had responsibility for E&S issues and that the staff responsible for the environment, health and safety, labour issues, and contractor management were members of the Human Resources department, who had limited skills in some of these areas.

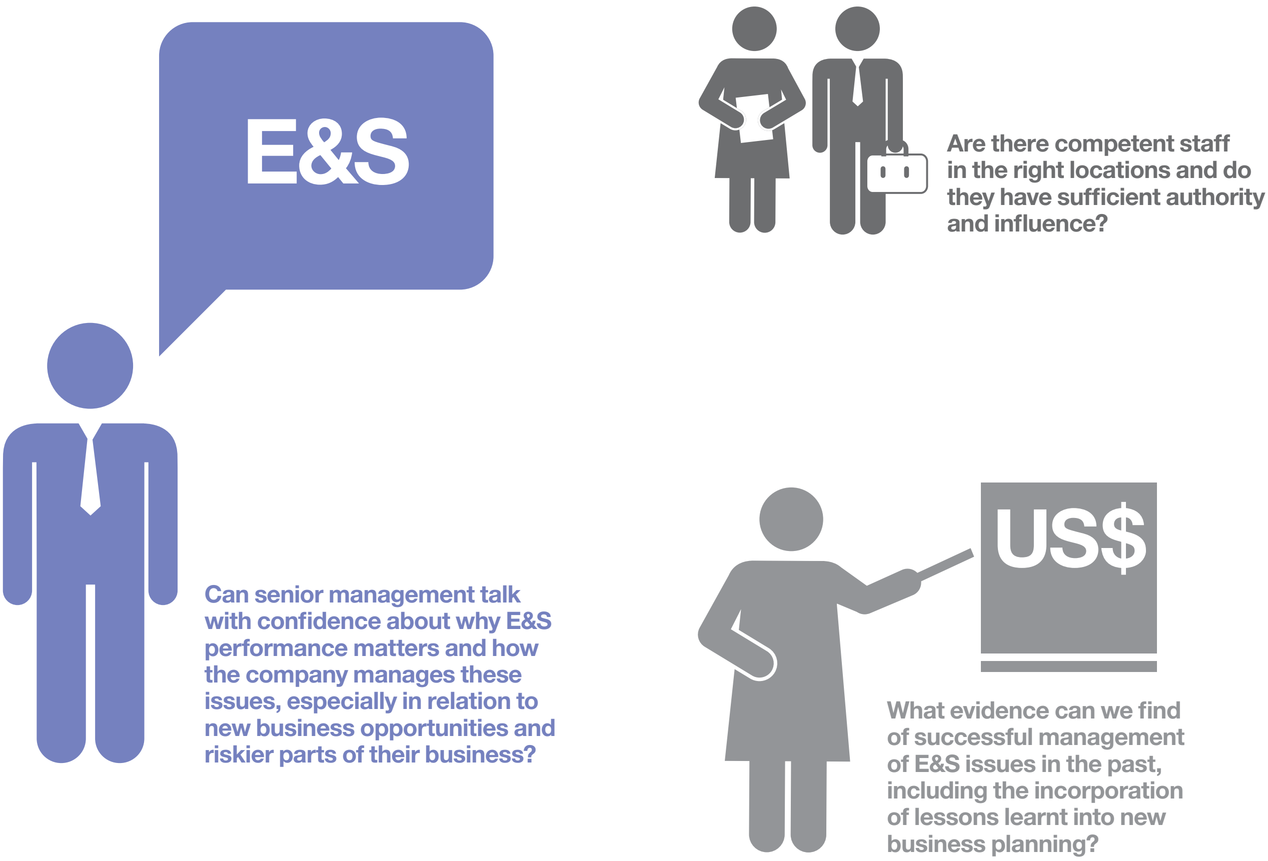
Consequently, the E&S actions included proposals that a member of senior management should take responsibility for E&S and the company should employ an external consultant to support them in developing appropriate systems. These actions acknowledged the lack of capacity and helped the company resolve immediate issues, standing it in good order to address the longer-term question of capacity-building for the company's own staff, which was important for changing corporate mentalities.

1 Guidance on assessing capacity and commitment can be found in CDC's ESG Toolkit for Fund Managers **http://toolkit.cdcgroup.com/cctr**

> For CDC, assessing commitment and capacity can often be every bit as important as assessing on-the-ground risks and impacts at ESDD.
>
> **Guy Alexander**
> **Executive, Environmental and Social Responsibility**
> **CDC Group plc**

Fig 7.

Some questions that CDC asks itself at ESDD



See also CDC ESG Toolkit:
http://toolkit.cdcgroup.com/cctr

Practical tips

- Where possible, record any factors that indicate clear commitment by the investee company management to E&S, or suggest a lack of it
- If it's not possible to get a written view from an external consultant, ask them to comment informally on their assessment
- Assess if there is Board level commitment to oversee implementation of the action plan
- Consider whether the company should budget for the support of an external consultant to build the necessary management systems
- Review the E&S action plan in the light of your knowledge of the individuals in the company responsible for delivering it
- Step back and take a realistic view of whether existing members of staff in the company have the necessary interest, skills, influence and time
- Consider whether the company should be encouraged, or required, to take on a new member of staff or train an existing one, in order to deliver the E&S action plan, and implement broader and more consistent delivery of E&S requirements
- Make time to discuss the E&S action plan with company management to gather their realistic views on whether they think it can be achieved, over what timescale, and with what support
- Include comments on commitment and capacity in the investment paper. See Appendix 2 for an investment paper template

What actions?

Corrective actions

In some cases, the ESDD will be fundamental to a decision on whether or not to invest. More often, the principal outcome of the ESDD is an E&S action plan, which identifies areas of compliance, partial compliance and non-compliance with the relevant legislation and standards, and proposes corrective action.

The best E&S action plans contain the following elements:

- A reference number to enable follow-up and monitoring and ensure that items are not removed from the action plan until they have been resolved
- The regulation/standard/requirement to which the action relates. The plan should usefully differentiate between items needed to achieve national legal compliance, and those that represent international good practice
- Observations to explain the current status, and which sources indicated that there was an issue relating to this area
- Why the item requires action. Colour-codes can be useful for added clarity
- The specific action that is recommended
- Priority and date for action, including whether it should be completed pre-investment
- Who will take responsibility for completing the action
- An estimate of cost, either CapEx or OpEx, to achieve compliance

Additionally, the best action plans provide an effective combination of recommendations on immediate remedial actions, and recommendations on the management systems that need to be put in place to enable the company to identify and address its own risks going forward – see **Case studies 20 and 21**.

These action plans clearly differentiate between:

- Immediate actions to be taken to resolve areas of concern
- Specific policies and procedures that need to be developed to address the particular risks identified
- CapEx and OpEx costs needed to achieve compliance
- Reference to capacity-building steps or new roles that will enable the other actions to be implemented in a timely and effective way (e.g. training existing staff; recruiting new staff with specific skills; input from an external expert)

They also clearly prioritised the actions to be taken within these categories. See **Case study 20** for an example of poor prioritisation.

Finally, some of the best ESDDs included SMART targets[1] and outlined how some or all of the actions were likely to add value for the company.

A suggested pro forma for the E&S Action Plan (ESAP) with example corrective actions is included in Appendix 4.

E&S action plan

The formulation of an adequate E&S action plan is a crucial output of due diligence and central to effective oversight and monitoring of an investment.

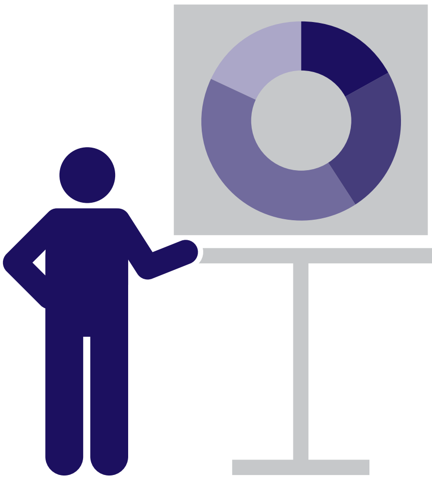
For guidance see CDC's ESG Toolkit: **http://toolkit.cdcgroup.com/esgap**

“When we put together the ToRs for an environmental and social due diligence, we make it clear to any external consultants that the primary output should be a realistic and practical action plan and not a long report.”

A fund manager

1 SMART targets are targets which are Specific Measurable, Attainable, Realistic and Timely.

Fig 8.
Nature of the E&S action plan in place for each of the ESDDs reviewed



- Clear, costed and with practical recommendations – **17%**
- In place and costed – **24%**
- In place but not costed – **41%**
- No proper action plan in place – **18%**

Case studies

20. Highlighting immediate remedial actions as well as systems requirements

The ESDD for an investment in a fertiliser import and distribution business correctly focused on issues that had been identified during a visit to the fertiliser storage facility, notably the need to improve the way sacks were stored, as this was unsafe.

However, the E&S action plan did not include an immediate action to restack the sacks correctly to prevent injury. Instead, the consultant simply included a corrective action that the company should develop and implement E&S management systems (ESMS) to identify risks and ensure they are addressed.

While the development of an ESMS is clearly important, the report should also clearly state any urgent actions required to keep people safe, or to avoid damage to the environment.

21. Imprecise or impractical items in the E&S action plan

The ESDD for an importation and storage business provided a detailed E&S action plan.

The first item on the plan was the development of a management system to address a long list of issues, from an emergency response plan to non-discrimination policies and human rights training for security guards. The list wasn't prioritised, and other aspects of the ESDD findings – e.g. the need to manage the process of removing settlers from the land – seemed to be understated.

This made it difficult to determine which actions should be taken first, especially for a company unfamiliar with international compliance standards.

Appendices

Appendix 1
Limitations of independent review of ESDDs

While it is clear that we can draw some interesting and useful conclusions from the review, we also recognise that the review of 54 ESDDs has limitations. These include the following:

(1) Written reports only. The review entailed reading the ESDD reports and associated correspondence, but it did not have access to the wider context of any additional processes or conversations that took place as part of a fund manager's due diligence. In some investments, these might have been a fundamental part of setting the scope or generating the action plan or assessing capacity/commitment of a portfolio company.

(2) Terms of Reference and budget not available. The documents available for review did not include the ToR for external consultants, so it was not possible to tell how they were directed by the fund manager in terms of scope or reference framework, except to the extent that these were outlined in the ESDD report. The review also had no information on the budget made available for the ESDD. Therefore it was not possible to establish whether the quality of the ESDD related in part to the ToRs and/or budget provided to the consultants as well as the consultants' expertise.

(3) Some of the ESDDs date back to 2008. The sample of ESDDs selected for the review deliberately included some that were quite old in order to assess changes that have taken place in ESDDs during that period. The downside of including these older reports is that it is not always possible to draw conclusions about current areas requiring improvement, when old and new are aggregated.

Appendix 2

Guidance to ensure that ESDD is adequately reflected in an investment paper

A good E&S summary in an Investment Committee paper will typically include the following information:

- **E&S inherent risk rating** assigned to the deal with a clear justification
- **A brief summary** of the ESDD process
- **ESDD conclusions, highlighting the materiality** of key E&S factors (including those related to the company's commitment, capacity and track record and gaps against applicable standards and potential opportunities)
- **Main actions to be implemented** to address identified risks/gaps and to materialise opportunities (full action plan may be provided)
- An **estimate of significant CapEx/OpEx** costs to achieve compliance and, where possible, to realise opportunities
- Summary of how the fund manager intends to **influence and monitor E&S matters** throughout the investment period

Appendices
continued

Appendix 3
ESDD report template

A good ESDD report will typically include the following (the below is fairly exhaustive for a low-risk deal):

Introduction	
Name of Company being investigated	
Name of internal or external consultants undertaking this ESDD	
Date(s) of ESDD discussions and site visits	
Anticipated date of Investment Committee submission	
Category of E&S risk	
Specific risks to be assessed (because of the sector or geography)	
Scope	
Existing sites owned by the Company (nature and number)	
Existing sites visited during this ESDD	
Rationale for selection of these sites	
Nature and scale of expected growth and acquisitions by the company	
Reference points	
List of relevant local legislation	
List of relevant IFC Performance Standards with rationale for inclusion/exclusion	
Any other relevant reference points (for example, food safety standards, EHS guidelines for specific sectors, Fairtrade certification)	
Sources of information	
List of people interviewed (name, title, role)	
List of people not available for interview	
Documents reviewed	
Documents requested but not available	

Appendix 3
continued

Findings	
Table of findings from the investigations, against each relevant reference point	
Data	
Key elements of E&S risk where data is of particular value (e.g. accident statistics, effluent quality, water usage, energy usage, CO_2 emitted)	
Current performance on these KPIs (where available)	
Target for these KPIs (based on local legislation and IFC PSs)	
E&S action plan (ESAP) (see separate suggested content in Appendix 4)	
Areas requiring action plus prioritisation and cost	
Colour coding to denote urgency – for example, 'red flags' for issues that need to be resolved as conditions precedent or part of the 100-day plan	
Specific areas of focus for E&S management systems (ESMS)	
Conclusions from discussion with investee company management	
Commentary on their response to the recommendations	
Commentary on the capacity and commitment of the investee company management to deliver the proposed actions	
Appendix	
Photographs from the site visit	

Appendices
continued

Appendix 4
Pro forma for an E&S action plan (ESAP)

A good ESAP will typically include the following headings. We've provided a couple of template actions to show how an action plan can be developed.

Reference standard	Actions	Priority [Low, Medium, High]	Responsibility	Deadline	Completion indicator	Cost
IFC Performance Standard 2	Implement an Occupational Health and Safety (OHS) plan to guide all activities on project site during site preparation, construction and operation. This includes at a minimum: – job and task-specific hazard analysis and controls for all activities – use and provision of personal protection equipment (PPE) – appropriate safety training for all personnel – review and approval of contractors' OHS plans – oversight of contractor OHS performance – recording incident statistics	High	Head of EHS Unit	Condition Precedent prior to start of construction. Maintain throughout construction and operations.	OHS plan. OHS statistics and training records.	$$$
IFC Performance Standard 3	Develop and implement emissions control plan for the concrete batch plant (air and water)	Medium	Head of EHS unit	Prior to plant operations. Maintain throughout operation of the plant.	Emissions control plan.	$$$

References

Definitions of common terms used in this guide

CapEx: Capital expenditure

E&S: Environmental and social

ESDD: Environmental and social due diligence – the process of investigating how an investment will affect the environment, workers and the wider community, in order to identify risks and mitigate actions

OpEx: Operational expenditure

PE Fund: A private equity fund makes investments directly into private companies, sometimes taking control of the company and in other cases holding a minority stake

Terms of Reference (ToR): A document that describes the purpose and structure of a project setting out how two parties will work together to achieve an agreed outcome such as an adequate ESDD

Sources of advice and further help

CDC's revised ESG Toolkit for Fund Managers **http://toolkit.cdcgroup.com/**

For further details of CDC's ESG requirements and good practice examples see **www.cdcgroup.com**

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- Environmental Resources Management Limited (ERM), London

Fund managers
- Actis Capital LLP, London
- Berkeley Energy (Singapore, Nairobi, London, Mauritius and Delhi)
- Brummer & Partners Asset Management, LLP, Bangladesh
- Development Partners International LLP, London

Disclaimer

The purpose of this guide is to share information and provide practical guidance about environmental and social due diligence. It draws on real examples of good and bad practice in the ESDD process and makes no comment on the processes in place in the funds to monitor and manage environmental and social risk at other stages of the investment process. The guide is not a substitute for professional advice in the development and implementation of due diligence procedures for a fund.

Photographs

All photographs originate from CDC's image library of investee businesses, have been supplied by investment partners, or have been taken by CDC employees on site visits. Photographs are not of companies featured in the case studies.

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