# *ESG Investment Due Diligence*

### August 2019

### What is the Value?

Since our launch in October 2017, **Bridge House Advisors** has delivered dozens of confirmatory environmental, social, and governance (ESG) due diligence assessments for our private equity and legal clients. These ESG screens are commonly a separate workstream from traditional environmental, health, and safety (EHS) due diligence, entail a desktop review of the target, and consider a broader range of environmental, social, and governance topics to identify risks and opportunities associated with the target's business. While the demand for ESG within private equity (particularly within the context of responsible investment) appears to be here to stay, a number of important investment stakeholders including deal teams and law firms have questioned the value of the ESG work product. We are sometimes asked, "What is the real impact of an ESG assessment on the company's bottom line?"

Sometimes there is no immediate bottom-line impact. An ESG screen may not always reveal a significant and near-term risk or opportunity associated with the target's business. In fact, the target might already be effectively managing ESG issues, have not experienced any recent ESG controversies, and is demonstrating leadership across a variety of ESG topics. While perhaps this outcome does not directly impact the deal team's final bid, the assessment itself, and the fact that it can be reported that the target is effectively managing ESG considerations, still has value in the eyes of the LP who seeks assurances that the GP is considering broader ESG factors when deploying their capital.

On the other hand, there are instances where an ESG screen can reveal areas of potential risk or real business opportunity. These results have prompted some "Aha" moments from the skeptics. Below is a selection of our favorite ESG findings from three M&A transactions, two of which offered commercial outcomes. In each of these cases, the key findings were unnoticed by other advisors retained to provide due diligence services on the transaction. The reason? It was not part of their technical scope.

### 1) Fleet Fuel Management: A $1.7 Million Cost-Saving Opportunity

Our first example explores a commercial and residential swimming pool construction and maintenance provider (Pool Co.). In order to provide on-location services, Pool Co. outfits their field technicians with vehicles, operating and maintaining a fleet of over 350 vans. Initial investigation during the ESG due diligence workstream revealed that Pool Co. had no formal program in place for energy management or fleet fuel efficiency. Given the size of the target's vehicle fleet, our preliminary finding stated that a proactive approach to fleet fuel management should produce tangible cost savings. Upon further analysis of information provided in the data room and in the public domain, Bridge House Advisors was able to estimate a potential annual vehicle fleet cost savings of **~$1.7MM**.

The analysis was based on the assumption that replacing Pool Co.'s current fleet of Transit Cargo Vans with a comparable, more fuel-efficient model (the Transit Connect Cargo Van) would not only reduce fuel costs (19 versus 27 highway miles per gallon, respectively), it would also reduce the overall vehicle purchase price ($33,000 versus $24,000 starting MSRP, respectively). Additional company-specific leasing procedures and assumptions supported the ~$1.7MM annual cost savings opportunity over a 5-year period as the leased fleet would be fully turned over during that timeframe.

The absence of an energy management and fleet fuel efficiency program, coupled with the suggestion of a potential opportunity for incremental cost savings, would have been a straightforward qualitative finding. However, by leveraging information provided in the data room and combining with research in the public domain, Bridge House Advisors quantified the business upside associated with more proactive management of this ESG factor and outlined an area of ESG focus for the portfolio company post-close.

## 2) Supply Chain Management: ESG and the Resilience of Global Supply

Example two considers a potential ESG risk that was not identified by other deal advisors for a US-based jewelry retailer whose primary customer demographic was middle income families. In order to be cost competitive, the target's stones and manufactured finished goods were sourced from several suppliers in China. As the ESG due diligence workstream progressed, it became apparent that the target did not have a comprehensive understanding of its overseas suppliers. In turn, the target was not able to comment on the potential presence of Conflict Minerals in their products and did not maintain a responsible sourcing policy that established expectations on ESG topics, such as human rights, child labor, etc.

Bridge House Advisors' standard ESG due diligence scope includes a comparative benchmarking exercise to compare the target to two or three competitors in order to provide additional market context on ESG topics. Given the potential supply chain risk identified in our research, we sought to provide additional context to our findings by investigating the supply chains of two key competitors. We found that one of the competitors, a household name jewelry brand focused on the same customer demographic, also sourced all of its products from China. However, unlike the target, all of the competitor's suppliers were certified by the Responsible Jewellery Council (RJC). We then cross-checked the names of the target's suppliers with the RJC and confirmed that none of the target's suppliers carried this same certification. As a result, a key finding reported to the deal team was, while we could not definitively say that the target had an existing ESG issue in its supply chain, one of the target's top market competitors had a much lower exposure to ESG supply chain risk due to the auditing and certification provided by the RJC.

## 3) Energy Management and Workforce Health & Safety: A One-Two Punch of Value Creation

Our final example explores a portfolio of outpatient medical imaging clinics (MRI Co.). ESG due diligence identified energy management and workforce health and safety as potential areas of value creation and cost avoidance, respectively. Our investigation revealed that MRI

Co. did not have a proactive energy management program across its 36 facilities located throughout the United States. Further energy data analysis revealed a performance spread between most and least efficient facilities in the portfolio that could not be explained by regional weather patterns. Analysis of utility cost intensity for the 36 facilities based on square footage revealed an operational cost savings potential of **$230K per year**. Extrapolated to the remainder of the facilities where utility cost data was not available, we estimated that this portfolio could likely achieve savings in excess of **$300K per year** with energy management considerations.

Bridge House Advisors was also able to obtain worker's compensation claim data and insurance provider details from the data room. For a non-industrial company, MRI Co. had a shockingly high rate of incidents and claims, which was reflected by an EMR (experience modification rate, as designated by the insurance provider) of over 2.0[1]. An EMR of 2.0 suggests the insurance carrier may adjust the target's premium up to 100% higher than the industry average. Further, an evaluation of worker's compensation claim data revealed MRI Co. was averaging approximately $350K in direct and indirect costs related to workers compensation claims annually. Additional inquiry revealed that the target had no formal health and safety training program. For this ESG factor, we conservatively determined that if the target could reduce annual injuries by **half** (via the establishment of a formal health and safety program with employee training, etc.) they could avoid costs approaching **$100-150K per year.**


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[1] An EMR value of 1.0 represents the average within a given industry sector. A score above 1.0 represents worse performance, and below 1.0 represents better performance.