Don’t Forget Reputational Risk When Considering ESG Investments

Environmental, Social, and Corporate Governance (ESG) is an increasingly important aspect of investment and corporate due diligence. Studies show firms that focus closely on ESG-related concerns tend to improve their overall risk management strategy and the sustainability of their returns. However, the value of previously profitable investments, such as rare earth metals or textile manufacturers, can now be significantly threatened by the detection of unjust or injurious labor sourcing. In a world of adept and informed consumers at both the individual and institutional level, having experts evaluate the ESG bona fides of potential investments is now of critical importance.

Fiveby always begins ESG investigations with a focus on reputational risk. We tailor these inquiries specifically to the needs of our client and their customers to promote solutions that drive revenue and reduce threats. Our risk intelligence team has a nuanced understanding of reputational risk that encompasses all aspects of ESG, including exposure to sanctions, money laundering, political corruption, and ties to terrorist and extremist financing, which allows FiveBy to create custom-made solutions based on our ESG+ approach.

ESG-Related Risks

To fully understand ESG related risks associated with an investment, companies need to commit to digging deep. Traditional ESG investigations are often not thorough enough to identify all possible threats – whether immediate or long-term. These include risks associated with supply chains, shipping via designated vessels, complex ownership structures, and/or dealing with Politically Exposed Persons (PEPs). The following scenarios are all based on real-world examples of hidden reputational risk that was not immediately apparent with cursory due diligence. Our analysts are well versed in digging deep to help find the risks that lurk beneath the surface.

Suppliers’ Supplier

When companies prioritize short-term profits over the potential risk posed by ESG concerns, significant long-term risks emerge. To mitigate threats to reputation and ensure all components and products are ethically sourced, firms should understand and investigate each level in their supply chains, which requires considerable due-diligence, risk-based evaluation, and a substantial time commitment. Although many businesses consider the costs of the initial investment in extra due diligence to outweigh the benefits, the potential long-term ramifications of insufficient research into prospective business partners can quickly and irreparably damage a firm’s reputation and future growth prospects.

The following two scenarios describe how firms can come up short in their investigations of potential partners’ ESG-related concerns and detail the need for a thorough understanding of the supply chain.

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Labor Violations at Component Manufacturer

A US-based car manufacturer wants to produce a new line of electric and hybrid vehicles. The firm is in the process of developing its own proprietary batteries; however, in the early stages of production, it still needs to source batteries from a foreign supplier. The firm identifies a company in China that meets its financial and volume needs. Initial due diligence reveals that the finished batteries are all produced at the company's primary factory in Guangzhou, which appears to employ labor standards that meet ESG standards; the company's ownership has no connections to sanctioned individuals or embargoed regions. However, a more in-depth examination of the Chinese firm quickly reveals a problematic series of connections in its supply chain (see Figure 1).

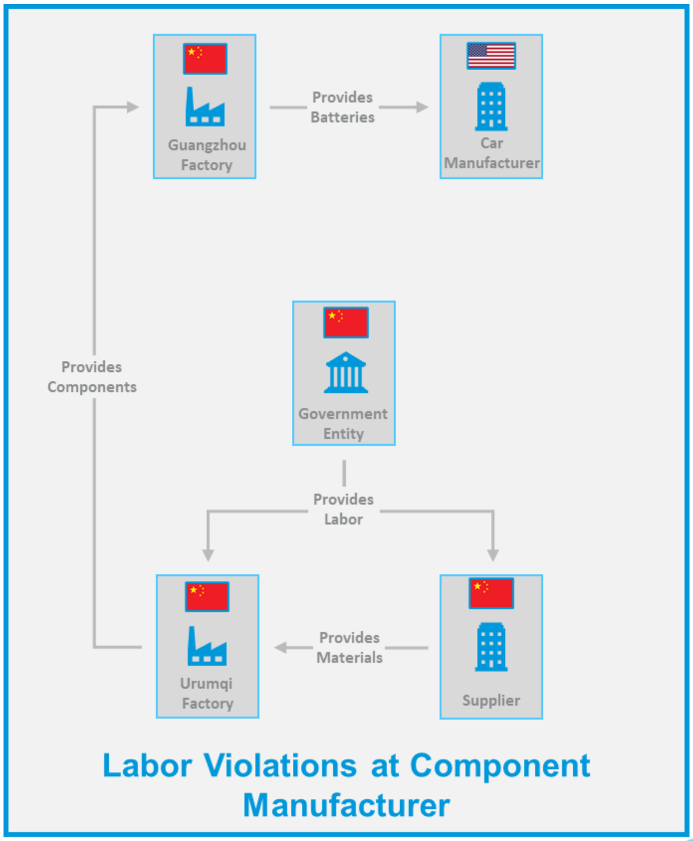

Figure 1

- The Guangzhou factory sources many of the component parts for its batteries from a factory in Urumqi—the capital of Xinjiang Province, where credible reports from reputable international organizations show evidence of forced Uyghur labor.
- In addition, the Urumqi factory receives materials to manufacture its battery components from a supplier known to receive both monetary support and labor from an entity owned by the regional government of Xinjiang, which reports directly to Beijing and has been directly implicated by the United States in forced labor practices.
- Finally, the Urumqi factory has a direct relationship with the same Xinjiang regional government-owned entity, which provides the factory with monetary incentives to use forced Uyghur labor.

An investigation into the Guangzhou factory that produces the car manufacturer's desired end product does not reveal any obvious connections to forced labor in another part of China. However, a deeper probe quickly reveals that the factory sources many of its components from a facility linked to forced labor in Xinjiang, underscoring the importance of fully researching manufacturing supply chains. Although the factory's use of components manufactured in Xinjiang is many steps removed from the investment in a US Car manufacturer, a supply chain connected to forced labor will negatively impact the ESG bona fides of the company and likely drive away ESG-sensitive investors.

Do You Know Where Your Ships Have Been?

A US-based consumer goods manufacturer's primary market is in the United States, but its production facilities are in East Asia. The company uses a competitive bidding process to select a shipping company to deliver its products to the United States. After conducting cursory due diligence on all potential suppliers, the manufacturer ultimately selects a Greek shipping company, which has solid financial indicators and no obvious reputational risks associated with owners or senior leaders of the firm. However, cursory due diligence is insufficient to reveal that the new supplier had—through a series of cutouts—used the same vessel it plans to use to ship goods to the United States to fulfill a supply contract with the Iranian government in violation of US sanctions. The previous sanctions violations could result in seizure of the vessel, and the publicity about the US consumer goods manufacturer's use of a ship that has been used to violate US sanctions can result in significant reputational risk.

Know Your PEP

Even under the most rigorous ESG-related evaluations, businesses are not expected to avoid all engagement with PEPs. However, investors do expect companies to understand completely how connections with PEPs reflect on their ESG-related commitments and threaten their overall reputation – both at a domestic and international level.

The following scenarios examine the risks of poorly vetted PEPs and demonstrate the need for scrutiny of all possible business engagements.

Problematic Advisor

A growing, US-based payment platform wants to expand its footprint and open new offices in untapped markets in Eastern Europe. One of the company's earliest developers and current executive is Latvian. He advocates strongly for the business-and-tech-friendly environment of his home country and introduces the expansion team to a prominent local businessman. Cursory due diligence identifies the individual as a former government official. Further research reveals that the local businessman helped produce the country's regulations on foreign investment and initial operating costs for international businesses. Additional investigation into some of his business dealings since leaving government shows a continued close relationship to his former government colleagues, and that his firm has received many state contracts – none of which raise any red flags. However, a deeper look into the PEP's wealth and business relationships before his time in office, reveals that much of his initial success was tied to a now-shuttered joint venture with a currently sanctioned Russian national tied to human rights abuses across Africa and Central Asia. The Russian individual also holds small stakes in many of the Latvian businessman's current enterprises, and media coverage suggests that the two remain close.

Although smaller markets pose limited initial reputational risks to a company's domestic business, engagement with entities tied to designated individuals heightens the overall risk profile and leaves firms open to potentially damaging public relations issues in the future. Without a thorough evaluation of a PEP's current and former affiliations, companies open themselves up to significant ESG-related threats that could damage their reputation locally and internationally.

Surprise Attendees

A US-based resource firm is in the final stages of a reaching deal with Azerbaijan's state energy company and has flown to Baku to discuss its terms. The business received a list of expected attendees for the meeting in advance, two new individuals who were not previously listed became involved in the proceedings at the last minute. A quick scan of the names identifies both as PEPs: one is the son of the state energy company's president, and the other is a former government representative for the Mineral Extraction and Ecology Department. Due diligence research does not show any clear reputational risk from engagement with the two individuals and the meeting proceeds as planned. However, further research into previous deals that involved these two PEPs shows that significant sums of money were diverted to an opaque charity headquartered in Nakhchivan – the home base of the country's ruling family.

Although resource deals always carry significant risk, engagement with unknown and relatively unvetted government officials presents a reputational risk for any company. Even seemingly insignificant events, such as a photo next to the PEPs, can present long-lasting threats to a company's reputation. Without a thorough evaluation of a PEP's previous engagements, companies open themselves up to significant risks.

Complex Ownership Chains & Relationships – Challenges for Investors

Complex ownership chains present significant short- and long-term risks to all institutions that invest with an eye to ESG compliance. Vetting effective "control" or significant influence over potential investments can be challenging, even when a surface level investigation would deem an investment ESG-compliant. For investors interested in ensuring ESG compliance, FiveBy's ESG+ model, which aims to understand an entity's full spectrum of reputational risks, digs deep and finds the information that hides beneath the surface.

The following two scenarios outline potential ESG investment problems in firms with unidentified and complex ownership chains, detailing the importance of completing full reputational analyses of all affiliates – not just first level connections.

Individuals with Questionable Business Practices and Origin of Wealth

A German energy company with impressive proprietary technology that operates in the green technology space is attracting interest from international investors. The business remains private, though large investors have already taken leadership positions in the firm.

A traditional assessment of the German energy company would likely reveal nothing overly risky about the entity, in which a known US institutional investor and a Luxembourgish holding company hold significant stakes. However, a deeper investigation into the ultimate beneficial owner of the holding company in Luxembourg reveals the investment would be riskier than a first glance would indicate (see figure 2).

- A deeper investigation reveals that the holding company in Luxembourg is owned by two Cypriot holding companies, which are both owned by a holding company in the Seychelles and another holding company in the British Virgin Islands (BVI). These two companies are then fully wholly owned by a Russian national.
- Further investigation the Russian national reveals that he recently purchased a number of telecom and energy assets through his close ties to the Russian government, some of which were allegedly attained via corrupt business practices.

This scenario shows the importance of completing a full reputational analysis of all entities before making an investment. For small companies that have high growth potential in ESG-compliant sectors, a full investigation into all stakeholders, no matter how small, is vitally important to ensure that the investment remains ESG compliant.

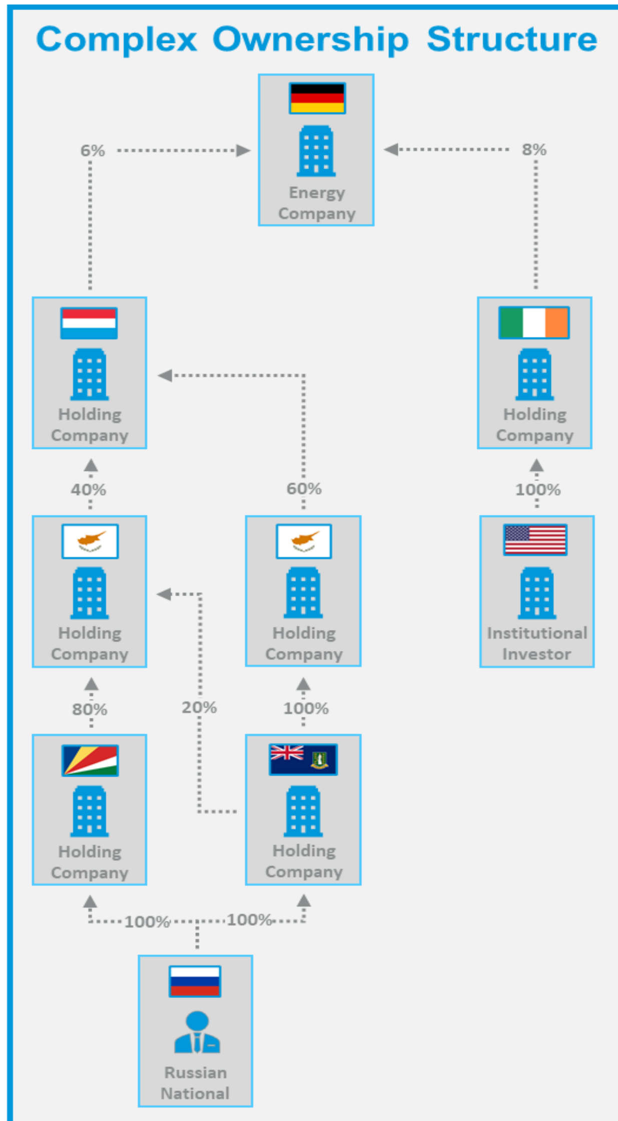

Figure 2

Problematic Bank Behind US Startup

A US cybersecurity firm with promising technology and a positive work environment has completed early rounds of funding from several venture capital (VC) funds. The firm is now looking for new investments and is attracting interest from large banks and tech companies.

Cursory due diligence research into the firm and its early VC fund investors reveals no financial red flags and a good work culture. However, further examination of the firm and the VC funds reveal a worrying set of connections to a bank closely tied to the Chinese government that funds domestic and foreign surveillance technologies.

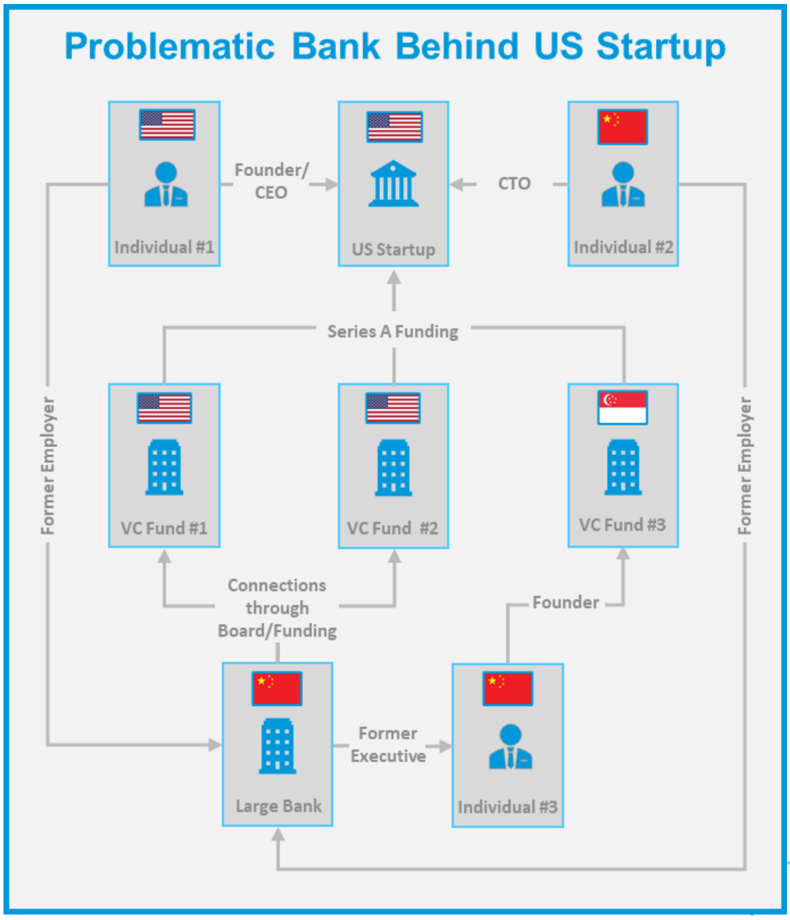

Figure 3

Founder/CEO/CTO

- The Founder/CEO, who is also the Chief Technology Officer (CTO) of the US startup previously served in technology-related roles at a large Chinese bank, both in mainland China and other branches in Asia and the United States.

Venture Capital Funds

The three VC funds that participated in the firm's Series A funding round are connected to the same large Chinese bank.

- The two US VC funds both have board members and advisors that are known to have connections to the large Chinese bank and have received funding from the bank.
- The Singaporean VC fund that invested in the startup was founded by a Chinese national who formerly served as a senior executive at the Chinese bank.

Understanding reputational risk beyond first level connections can make or break an ESG investment strategy. Although it is possible that the US startup's connections to the large Chinese bank are innocuous, the investment could eventually prove damaging to the reputation of a non-Chinese institution that has provided funding and taken a stake in the firm. This scenario highlights the importance of employing an ESG+ framework to understand all connections to assure there are no troubling ties hidden below the surface.

Evaluating ESG-related Risks with FiveBy

Companies need to evaluate many factors when investigating ESG-related risks. Investors expect businesses to operate ethically and understand how their interactions and choices affect the world around them. If companies opt to ignore or short-change these concerns, they run the risk of substantially damaging their reputations and their overall profits. FiveBy's nuanced understanding of these threats makes it uniquely skilled at providing thorough and detailed evaluations of ESG concerns. We strive to combine our diverse experience and expertise to identify unexpected reputational risks that could threaten companies' current and future opportunities.

FiveBy is a specialized risk intelligence services firm. We give you the insight you need to move faster and further with the confidence to transform your risks into opportunity. The opportunity to grow your profits, strengthen your brand, and exceed your customer expectations.

Our unique point of view brings together expertise spanning security, technology, data science, and business operations to connect your dots. By turning data into an enabler, FiveBy designs adaptable responses—whether to an ongoing incident or to implement preventive measures—tailored to your business needs and always with a human touch.