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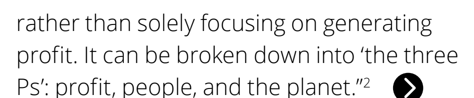
Why it Matters
Growing ESG supply-chain reporting requirements for German SMEs

Supply chain regulations at a glance
The profile of ESG within corporate environments has risen significantly in recent years as stakeholders shift their expectations of corporate behavior from a "shareholder capital" approach popularized by Milton Friedman in the 1970s – which advocated strict focus on profit generation[1] – towards a more holistic stakeholder capitalism approach incorporating the awareness and impact of a business on its broader environment. Many businesses are striving for a sustainable business strategy to cover ESG factors, while at the same time pleasing their shareholders. Another approach business leaders are taking is adapting from a standard 'bottom line' to a 'triple bottom line' concept: "The triple bottom line is a business concept that posits firms should commit to measuring their social and environmental impact in addition to their financial performance, rather than solely focusing on generating profit. It can be broken down into 'the three Ps': profit, people, and the planet."[2]



[1] A Friedman doctrine – The Social Responsibility Of Business Is to Increase Its Profits – The New York Times (nytimes.com) September 13, 1970
[2] Harvard Business School The triple bottom line: What it is & Why it's important

ESG has become a key factor for stakeholders, so funds and companies cannot afford to be misaligned with stakeholder values. ESG has been the subject of considerable attention, especially in light of recent regulations influencing business strategies, such as the EU Taxonomy Regulation and the Corporate Sustainability Reporting Directive (CSRD). Looking at corporates in particular, ESG issues affect firms of all sizes, but small and medium-sized enterprises (SMEs) have been missing from the discourse. For example, the Act on Corporate Due Diligence Obligations in Supply Chains (Lieferkettensorgfaltspflichtengesetz, LkSG) requires companies in Germany to conduct human-rights and environmental due diligence in their supply chains. Beginning January 2023, the Act initially applied to enterprises with at least 3,000 employees and from 2024, to enterprises with at least 1,000 workers as well. SMEs generally employ fewer than 250 people and account for 99% of businesses in the EU, and about 97% of the German manufacturing sector. In February 2022 the European Commission introduced the proposal for a Directive on Corporate Sustainability Due Diligence (CSDD) with the objective of fostering a "culture of no harm" in the global value chains of EU companies through mandatory obligations. The regulation is directed at two main groups: all large EU limited liability companies that on average employ more than 500 people and whose worldwide annual net turnover surpasses EUR 150 million, and to EU limited liability companies that do not reach these two thresholds but which operate in certain high-risk sectors (for example, garment, agriculture and food manufacturing, and extractive and mineral resources), and have on average more than 250 employees and a worldwide annual net turnover of over EUR 40 million.

While SME businesses do not directly fall within the scope of the CSDD (nor of the LkSG) due to their lower number of employees, they will inevitably be affected indirectly through the due diligence activities of their larger trading partners and affiliated companies. The CSDD has many similarities to, and also some significant differences from the LkSG, yet the essence of both regulations is to prevent and mitigate human rights violations and their negative impacts, with the CSDD taking in more environment-related obligations. Furthermore, the EU directive requires companies to consider the entire supply chain as users and disposers of products, and not just direct suppliers as is the case with the German law. Both regulations aim to ensure that measures are passed on contractually not only to the immediate supplier, but by the supplier to its suppliers as well.

[3] https://data.oecd.org/entrepreneur/enterprises-by-business-size.htm

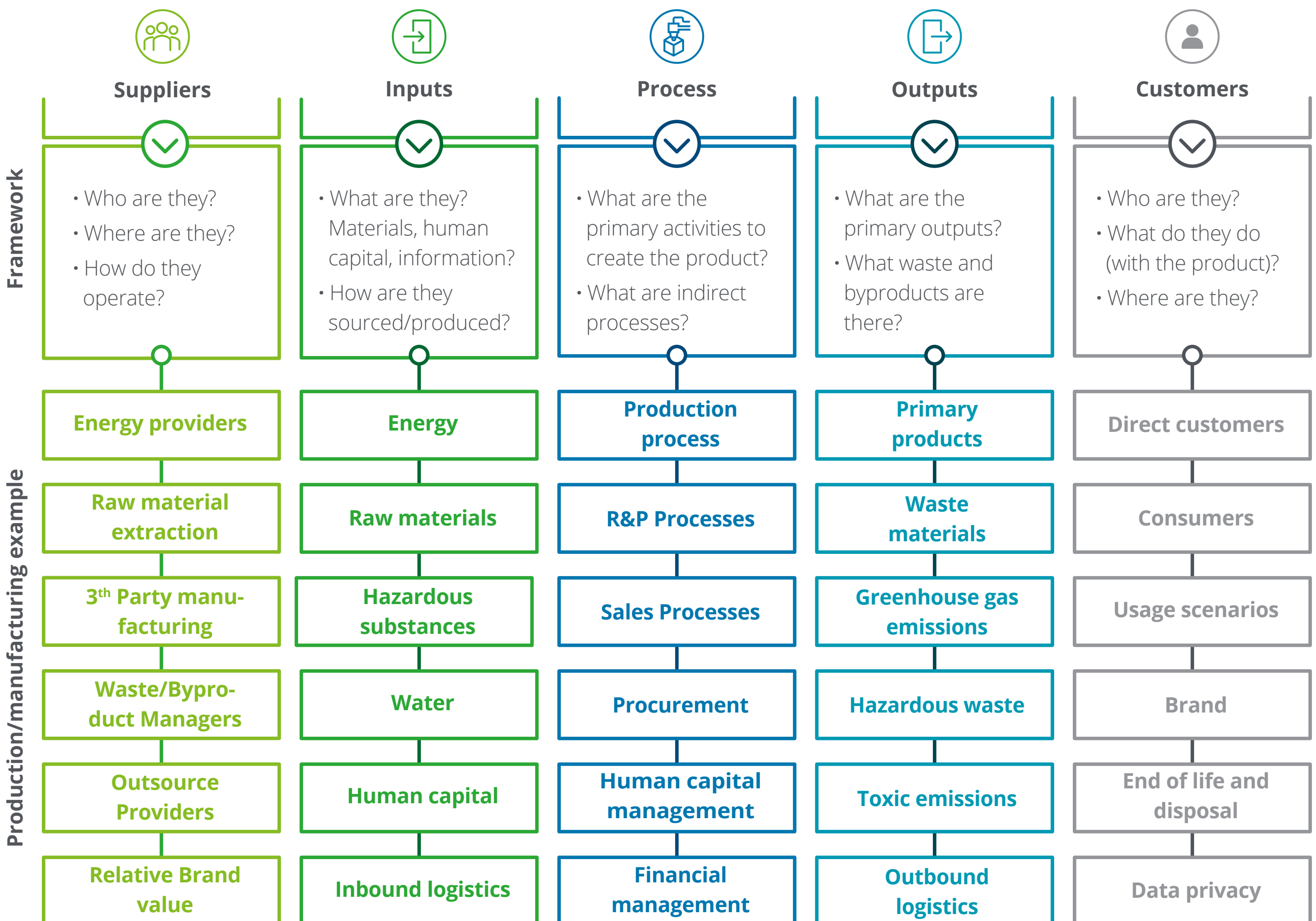
Assessing ESG within an M&A transaction

Understanding ESG risk and potentially material issues

The broader regulation, CSDD, applies to company operations and to subsidiaries and value chains (direct and indirect established business relationships). As a first step and in order to comply with corporate due diligence duty, companies must integrate ESG due diligence into policies in order to bring an end to actual impacts. They must initiate measures like establishing and maintaining a complaints procedure. The limited time frames and resources available during a due diligence process call for a methodology which can effectively identify potentially material issues and will become the focus of the ESG diligence.

Due diligence is not limited to the first tier, i.e. the first stage of the supply chain, but covers the entire value chain, going far beyond the direct sphere of influence of SMEs. It is therefore crucial for SMEs in the region to overestimate the importance of ESG due diligence processes. An ESG diligence exercise should look to evaluate and understand a business's operations and value chain (both upstream and downstream) to identify potentially material ESG risks. Such agreements with SMEs should be fair, reasonable, and non-discriminatory. Figure 5 illustrates a typical value chain for a production/manufacturing business.

Fig. 1 – ESG risk identification in an M&A transaction



Source of framework: SIPOC foundation

Assessing ESG aspects of the supply chain: from raw materials to product end of life

Accurate identification of risk is crucial to navigating key complexities. Corporate supply chains are bigger and more complex than ever. Consumer pressure, new regulations, and increasing transparency requirements can translate to major negative financial and reputational outcomes if ESG aspects of the entire value chain are not considered.

The key principles of managing an effective and risk-free value chain involve accurate metrics and measurement. New technology within value-chain mapping can accurately identify specific businesses/suppliers along value chain tiers, identifying key high-risk countries and inherent risk factors where regulation is lacking. Source country mapping and tracing can also help identify high risk industries and commodities along the value chain where further resources can be targeted. Clearly, accurate value chain assessment is key to identifying further opportunities and risk where regulatory requirements and stakeholder expectations are high.

Risk management has traditionally taken a compliance-based approach. ESG provides companies with opportunities for value creation, however, necessitating a more collaborative and common-good approach to risk. Effective training, industry benchmarking, consortium-based solutions and community engagement can all be harnessed to effectively drive change and increase value within the ESG sphere.

Effective diligence, evaluation, and management of ESG considerations within a transaction can help mitigate risks, improve financial performance, and accelerate growth. But determining the impact of ESG factors on a target company is not straightforward. Some of the challenges in the context of an M&A transaction are explained below.

Lack of ESG awareness

A lack of ESG understanding and knowledge at an executive level is a big challenge, causing top-down issues from the start in identifying ESG risks/opportunities and how they would impact the business strategy.

Lack of data and poor data quality

While most large companies report on a variety of ESG factors, the lack of clear standardized metrics and widespread use of inconsistent data definitions make it difficult to accurately assess the materiality of ESG factors. In the unlisted space this challenge is more pronounced due to the relatively lower ESG maturity of targets, which often struggle to meet information requirements.

Quantification of risks and opportunities

ESG can be difficult to quantify regardless of data availability. Intangible impacts such as benefits to brand and reputation from a strong ESG position are difficult to assess and incorporate into EBITDA forecasts, and are exacerbated by the time and procedural constraints of M&A transactions.

Integration

Mergers of peers require a careful assessment of ESG objectives, maturity, and capabilities. An acquisition may introduce new skills and technologies which can be leveraged across the parent company to improve ESG performance, and there may also be costs associated with bringing target companies into compliance or delivering on commitments such as higher labor standards and net zero carbon emissions.

Greenwashing/unrealistic target setting

Another challenge investors face is assessing the credibility of ESG targets set by a target company. For example, are the net zero targets achievable? Benchmarking these ESG targets against peers to assess whether they are realistic is a first step in assessing credibility. Due diligence must review the strategy for achieving ESG targets.

Conclusion

Compliance with due diligence in supply chains is becoming a strategic, ongoing, and individual process for business. All business entities face the challenge of having to fully record, assess, and document any changes in their value network. The pressure on businesses including SMEs to meet ESG requirements is growing as a result of changing customer demands, stricter regulations, and increasing requirements from investors and stakeholders. Violations can lead to reputational damage and higher costs for SMEs and, given their more limited resources, to more severe implications than for their larger brethren.

ESG due diligence represents an opportunity for SMEs because the organizations clearly positioning and preparing themselves at an early stage will benefit from competitive advantages over their rivals. But this requires not only resources but extensive know-how. For SMEs in particular, it makes sense to rely on holistic solutions that digitally map these processes and support them in complying with all requirements.

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