A closer look at investment due diligence in South Korea and the K-Taxonomy

Kyung Hwa Moon, Soo Young Song and Christina Gee of Shin & Kim discuss the growing focus on ESG due diligence in deals in South Korea, the key issues to consider and the establishment of the K-Taxonomy

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During an investment process, general partners (GPs), such as managers of private equity or venture capital firms, conduct environmental, social and governance (ESG) due diligence to determine if the target company has any ESG-related issues. This ESG due diligence may be carried out as part of the typical legal due diligence or as a separate process.

The recent increase in ESG due diligence is a response to the high demand from limited partners (LPs). As of December 2021, United Nations-backed Principles for Responsible Investment (UN PRI) reported that there are 4,683 signatories with assets under management amounting to $121.3 trillion (UN PRI 2021 October – December Quarterly Signatory Update). Considering that UN PRI signatories implement the six principles set by UN PRI and annually report on the implementation of those principles, it is only natural that the LPs would request ESG due diligence when investing in GPs' vehicles.

In South Korea, some GPs had implemented investment processes that included ESG factors, but these were mostly limited to funds in which larger global LPs from Europe and the United States invested. Before 2021, very few institutions separately conducted ESG due diligence in addition to the customary legal due diligence and financial due diligence. However, due in part to the increased demand from both global LPs and LPs within South Korea, this is rapidly changing and ESG due diligence is increasingly becoming a part of the due diligence process for GPs in South Korea.

Contents of ESG due diligence

Investment process and law firm involvement

GPs' investment process is divided into five key parts: (i) fundraising, during which the GPs secure capital for funds,

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(ii) deal sourcing, during which the GPs identify the best companies for investment, (iii) due diligence, during which GPs vet companies and ensure a viable business plan, (iv) active management, during which GPs guide and foster the investment target companies and (v) exit, during which GPs ensure that investors achieve their financial return.

LPs have begun to request the implementation of a process for identifying ESG-related issues of the investment target company from the earliest stage of the GPs' investment process cycle, the fundraising stage. In particular, LPs have requested that GPs describe their processes for identifying and understanding potentially material ESG risks and ESG-related opportunities. This has led many GPs to establish steps that include ESG due diligence as part of their investment process.

South Korea is no exception. GPs in South Korea need to address ESG questionnaires sent by global LPs on the GP's ESG policies. Domestic LPs are also participating in this movement. Recently, Korea Development Bank conducted an ESG due diligence on the GPs that have been chosen to manage its funds to assess the actual implementation of ESG policies by the relevant GPs, and we expect other domestic LPs to follow.

As a result, many GPs in South Korea are beginning to adopt an ESG integration strategy that reflects ESG factors throughout their investment process. This strategy implements steps such as the ESG screening process and due diligence to select investment target companies, risk and performance tracking through ESG monitoring after investing in the companies and publication of ESG reports for both the invested companies and the investor.

Law firms in South Korea are mainly involved in establishing ESG policies for GPs including relevant internal regulations and controls and assisting in addressing ESG questionnaires from LPs. Law firms may assist in reflecting the results of ESG due diligence by LPs in the investment process of GPs by incorporating any issues spotted into the internal regulations of the GPs and assisting in setting up actual processes for the GPs to implement such regulations.

Law firms may also assist in conducting intensive ESG due diligence on the

> ***"It is expected that many South Korean financial institutions will establish internal regulations for ESG-related investment activities (especially environment-related investment activities) and make ESG-related investment decisions based on the K-Taxonomy and the Guideline"***

investment target companies before GPs' investment and duly reflecting the results of those due diligence reports in the relevant investment agreements. In addition, GPs may request that ESG-related internal policies be established and implemented within a certain period from the time of investment or specifically stipulate management's obligations such as establishing an ESG committee within the investment target company.

Issues covered in ESG due diligence in South Korea

A typical ESG due diligence covers a variety of issues. Due diligence on environmental issues aims to cover risk evaluation of the measurement of the environmental impact and sustainability of the investment target company, any environmental risks and how the company is managing those risks. Environmental criteria largely cover the company's energy use and waste. They include carbon footprint, pollution, material disposal, resource management, sustainability practices and future environmental goals. Potential red flags of an environmental due diligence report may include issues related to owning contaminated land, improperly disposing of hazardous waste and not complying with relevant governmental environmental regulations.

Due diligence on social issues explores how the investment target company interacts with and affects its employees, customers, suppliers and communities. Social criteria take a closer look at the company's business relationships, including matters relating to product safety, human rights, employee safety, protection of customers' information, diversity, equality and inclusion. Potential social due diligence reports may inquire whether the company's employees are healthy and safe and whether the company actively and regularly participates in the community through donations and volunteering.

Due diligence on governance issues looks to see how the investment target company is governed at the top levels. Governance issues include factors such as communication with shareholders, accounting standards compliance, succession planning, anti-competitive behaviour, board structure and diversity and a strong ESG management process. A typical governance due diligence report may flag issues if the shareholders are not permitted to vote on important issues or if there is a lack of transparency with respect to conflicts of interest or accounting methods.

Private equity and venture capital investment

In buyout deals conducted mostly by private equity firms, there are many cases in which the investment target company has been in operation for quite some time and in which the investment is often relatively large. Recently, there has been an increase in cases where ESG due diligence has been conducted separately from legal due diligence and financial due diligence for such buyout deals. For these ESG due diligence on buyout deals, companies tend to provide information without any holdback.

However, unlike information for legal due diligence or financial due diligence, information required for ESG due diligence includes both internal and external data. Internal information includes self-reported data from investment target companies, survey data and questionnaires and these can be provided promptly by the investment target companies.

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Sometimes it is more difficult to collect external information such as third-party vendor data and public data from various resources such as social media, blog posts, consumer and employee reviews and press. As a result, it may take some time to collect and review the external data provided by public institutions, government agencies and third parties.

It is not uncommon to forego due diligence for investment target companies invested in by venture capital firms. Even if due diligence is conducted, ESG due diligence is rarely performed. Accordingly, even in the case of venture capital firms that have introduced ESG due diligence for various reasons such as at the request of LPs, there may be instances in which due diligence is not conducted smoothly if the investment target company has difficulty in providing information, if there is not enough information available as the target companies are in the early stage or when it is practically difficult to prepare the information required for ESG due diligence due to lack of human resources.

Instead, the due diligence conducted by venture capital firms typically explores matters in three sectors: product, market and team. Product due diligence looks at the overall potential of the product including its technical quality compared to other solutions in the space and its intellectual property status including patent filings. Market due diligence looks at the overall size and growth rate of the market and its position relative to the competition. Team due diligence looks at the track record and experience profile of the founders.

Application of K-Taxonomy

The Environmental Technology and Industry Support Act was amended on April 21 2021. Based on this amendment, the Ministry of Environment of South Korea established a national green taxonomy (the K-Taxonomy), which classifies green economic activities contributing to six environmental goals: greenhouse gas reduction, adaptation to climate change, sustainable water conservation, recycling, pollution prevention and management and biodiversity.

On December 30 2021, the Ministry of Environment additionally announced the K-Taxonomy Guideline. The Guideline outlines the principles and standards regarding the types of economic activities that are considered green activities. It also serves to assist in allowing more funds to be allocated to green projects and green technologies as well as in distinguishing truly green activities from those that are merely greenwashing.

Similar to the EU Taxonomy, the Guideline stipulates that green economic activities consist of (i) the 'green sector', referring to green economic activities necessary for carbon neutrality and environmental improvement and (ii) the 'transition sector', referring to the activities temporarily included in K-Taxonomy as an intermediary step towards carbon neutrality.

The green sector is further classified into greenhouse gas reduction, adaption to climate change, water, circular economy (i.e. recycling and using methane gas), pollution prevention and treatment and biodiversity. The green sector consists of 64 green economic activities in total, among which are activities related to the industry, power generation and energy and transportation. The green sector also includes specific activities such as core technologies necessary for greenhouse gas reduction, for example, electrification and electricity utilisation technology, hydrogen-reduced iron and steel, non-carbonate, mixed cement, and replacement and removal of fluorine compounds.

The transition sector is classified into five economic activities: (i) greenhouse gas reduction activities at small and medium-sized enterprises, (ii) energy production based on liquefied natural gas and mixed gas (i.e. the gas that is a mixture of two or more biogases including hydrogen, ammonia, by-product gas and liquefied natural gas), (iii) liquefied natural gas-based hydrogen (blue hydrogen) production, (iv) eco-friendly shipbuilding and (v) eco-friendly ship transportation.

The Ministry of Environment has suggested that the Guideline will be further revised and supplemented after piloting it for a year and that the Ministry will consider market trends, such as EU including nuclear power in the EU Taxonomy, in making the revisions and additions.

Under the K-Taxonomy and the Guideline, proper green economic activities must (i) contribute to the achievement of one or more of the six environmental goals above, (ii) not cause any serious damage to other environmental goals in the process of achieving the set environmental goal and (iii) not violate the laws and regulations related to human rights, labour, safety, anti-corruption and destruction of cultural properties.

Although the Guideline is not legally binding, it is expected that many South Korean financial institutions will establish internal regulations for ESG-related investment activities (especially environment-related investment activities) and make ESG-related investment decisions based on the K-Taxonomy and the Guideline.

As companies in the green sector and transition sector are expected to grow thanks to investment from many financial institutions, GPs will pay closer attention to the contents of K-Taxonomy during the various stages of their investment process.