BUSINESS RISK RESEARCH

BERLIN RISK INSTITUTE
Eisermann & Giersch
www.berlin-risk-institute.de

Jennifer Hanley-Giersch, Business Risk Research
Dr. Carsten Giersch, Berlin Risk Institute

Reputational Due Diligence –

The key to strategic risk management*

Reputational Due Diligence supports the strategic risk management of business ventures in international markets. As introduced in the following article, the combination of *Integrity Due Diligence* with *Political Due Diligence* enables an investor to gain a comprehensive assessment of possible reputational risks attached to a business partner. This concerns compliance and corporate governance issues in relation to individuals and target companies as well as the reliability of the political environment in a specific country.

The focus on 'human' risks assigns *Reputational Due Diligence* a truly strategic attribute in the risk management process. The article discusses the relevance of reputational risk evaluation in the due diligence process. In addition, it expands on the numerous hidden sources of reputational risks than can be unveiled in the course of the Integrity and Political Due Diligence process. Examples and a case study serve to illustrate reputational risks as a serious business security matter.

The benefit of Reputational Due Diligence consists of improving an investor's chances to finding integer and reliable business partners and to enable him or her to protect his ventures from harmful political entanglements. Reputational Due Diligence ensures being in line with 'best practice' regarding compliance and corporate governance rules. Moreover, it increases the transparency of surrounding business and political networks. Providing critical information for identifying hidden and connected reputational risks at an early stage contributes to an extended decision making basis with respect to foreign investment. As a consequence, management resources can be used effectively and transaction costs optimized.

* First published in German in BERLIN RISK BRIEF No. 6, October 2010

Reputational Due Diligence – The key to strategic risk management

Carsten Giersch / Jennifer Hanley-Giersch

The careful analysis of reputational risks is as equally important as the assessment of market, legal and financial risks. When engaging in business ventures such as mergers and acquisitions, foreign direct investments and joint ventures, it is fundamental to assess the integrity of the target firm as well as the reliability of the political environment. In order to evaluate the feasibility and estimated success of a project, and to ascertain whether there is a risk that the endeavour might be impeded due to the ambivalent standing of a business partner or due to the resistance of political actors, *Reputational Due Diligence* should be undertaken. *Reputational Due Diligence* improves strategic risk management in the lead up to business transactions by assisting decision makers to identify the 'soft risks' attached to an investment by focusing on the 'human factor'.

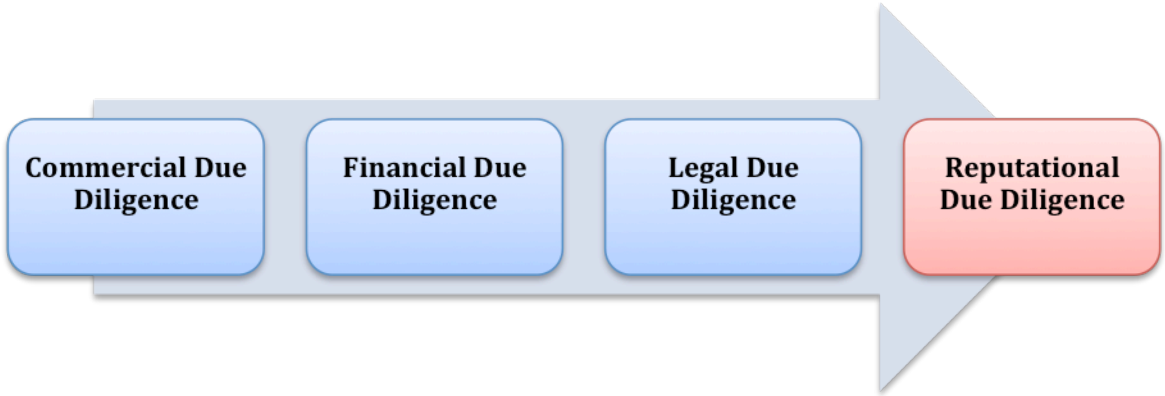
Choosing a reliable business partner is one of the main challenges facing companies seeking to expand into new markets. The annual survey 'Going International' conducted by the German Chamber of Industry and Commerce ("DIHK"), regularly confirms that the integrity and reliability of cooperation partners is the key to successful engagements in foreign markets. In addition, as a result of compliance and corporate governance standards, companies encounter increased requirements, in particular due to anti-corruption and anti-money laundering legislation, to establish the integrity, standing and reputation of their business partners.

Integrity and compliance touch a particularly sensitive area regarding the evaluation of a planned investment. Issues regarding reputation can have a significant influence on foreign investments, particularly the informal political risks which often exist. *Reputational Due Diligence*, which includes the assessment of reputational risks, is based on two pillars: *Integrity Due Diligence* and *Political Due Diligence*. This approach involves research and analysis of the immediate environment surrounding a transaction with a view to identifying the direct and indirect reputational risks. The strategic orientation is a key attribute of the *Reputational Due Diligence Process* (see Diagram 1).

Definition
Reputational Due Diligence concerns the careful evaluation of reputational risks attached to a business partner or target company including issues of integrity and reliability of the individuals involved, as well as the trustworthiness and predictability of the political environment.

A recent example, which highlights the relevance of *Reputational Due Diligence*, can be seen in the difficulties facing the WAZ-Group, one of Germany's leading publishing houses, as a result of its expansion activities in the Serbian market. Questionable businessmen, shady middlemen and so-called oligarchs, i.e. influential businessmen who are closely connected to the state, jeopardised the WAZ group's investment in Serbia so severely that the

Diagram 1: The Due Diligence Process



media company is now considering retreating from the Serbian market place.[1] It is particularly important to take necessary precautions regarding integrity issues when selecting a business partner in countries which lack a democratic tradition.

However, democratic countries, even within the European Union, also have had some noteworthy cases where planned transactions have become entangled in an impenetrable net of business and politics. A good example are the numerous manoeuvres undertaken by the Zapatero government in Spain in 2006/2007 which assisted Endesa in blocking the takeover by the German competitor E.ON.[2] A more detailed case study of a complex *Reputational Due Diligence* assignment is presented in a sanitised format at the end of this article (see Annex).

Reputational Due Diligence explicitly includes the following two areas, namely *Integrity Due Diligence* and *Political Due Diligence* which may entail human risks for business transactions (see Diagram 2).

[1] *Frankfurter Allgemeine Zeitung,* 9. September 2010.
[2] *Economist*, 21. August 2006, 1. March 2007, 4. April 2007.

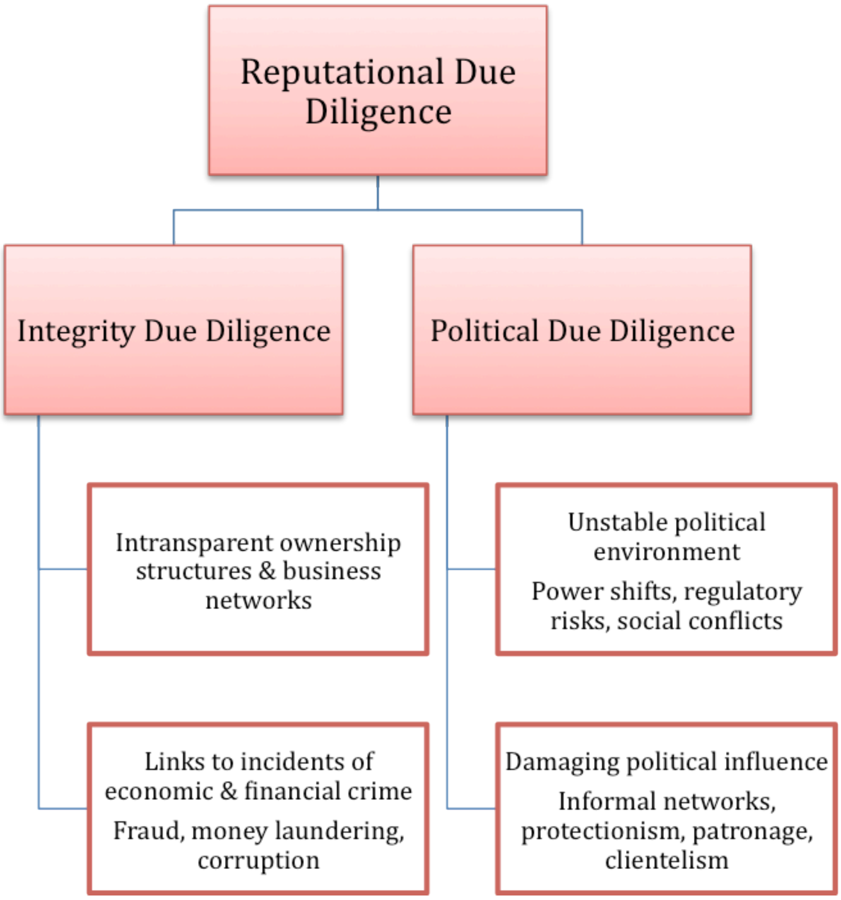
Integrity Due Diligence

With regard to the business partner or target company, the ownership structure needs to be assessed. In the lead-up to an investment, a transaction or a business corporation agreement, one would like to understand whether hidden risks are lingering in the immediate or surrounding environment of the respective business, which could negatively impact the evaluation of the target's reputation.

Of interest are any uncommon or exceptional links in the business network, which may raise questions surrounding the reliability and stability of the subject. Reputational risks might lie in the shady past of an individual or a company such as previous mismanagement or in a worst-case scenario, links to organised crime networks. Such a tainted track record can be drawn into the public limelight at any time and exert negative pressures on business relationships and thus jeopardise the success of cooperation when the basis of trust is destroyed.

As a result of existing compliance requirements, *Integrity Due Diligence* includes research which aims to indentify critical 'red flags' attached to an individual or a company in relation to their reputation, whereby the aim is to identify any deal breakers.

Diagram 2: Reputational Due Diligence structure



'Red flags' include, for example, economic crimes such as fraud, money laundering, corruption or embezzlement. The identification of such critical integrity risks can protect a company from becoming embroiled in criminal investigations and also from investing in businesses whose capital derived from the proceeds of crime.

Most importantly, *Integrity Due Diligence* always creates the necessary level of transparency. Through the identification of integrity risks, which are of a 'certain concern', management can put measures in place, which can assist in controlling and acceptably reducing risk. If no integrity risks can be identified as a result of a comprehensive 'background check', the investor can, with a certain amount of comfort, conclude that the business partner and/or the management of a target company have an untainted reputation and can be expected to be sufficiently reliable.

In order to comprehensively ascertain the reputational risks attached to an investment, the *Integrity Due Diligence* process should be combined with a *Political Due Diligence* process.

Political Due Diligence

The economic recovery process following the financial crisis opens new investment opportunities internationally. At the same time, events in recent years have highlighted how important the political environment of a target country can be. Of particular concern are political interests, which can jeopardise or block an investment decision.

A comprehensive analysis of reputational risks in transnational transactions should therefore also include an assessment of the reliability of the political conditions for an investment, meeting the requirements of *Political Due Diligence.* *Political Due Diligence* focuses on the political and strategic risks attached to a planned business relationship and its qualitative approach makes it different from that underlying various political risks indices.

In order to assess whether the political environment is favourable for an investment, the following rule should apply: *The extent to which political issues will influence the reliability of a local partner is defined by the strength of the democratic structures in a country and by the closeness of a business partner or middleman to the state and government bodies*.

Political Due Diligence therefore analyses reputational risks based on scenarios attached to changing political power structures. This includes a change of government, arbitrary regulation, political control of the judiciary, or populist measures undertaken at the expense of the free market. Such strategic changes in the political landscape can also strongly influence the acceptance of an investor in the concerned markets and potentially result in him or her being embroiled in social conflict.

Furthermore, a threat of damaging political influence by informal networks, in which local business partners or middlemen might be involved, also exists. Investment projects can run the risk of failing as a result of open or latent opposition in organised networks which operate between political and business circles, typically engaging in protectionism, patronage and clientelism. There is always a significant reputational risk attached to such networks, not only when the power relations shift.

Political patronage and clientelism in international markets increase the risk of unfair practices and discriminatory decision-making processes. This kind of obstruction can emerge due to the intervention of political circles as well as various interest groups, which exert influence on ministries, regulatory bodies or the justice system. *Political Due Diligence* includes an evaluation of the risk of becoming a pawn of political events, due to the changing interests of political actors, and the manipulation of decision-making processes within state authorities.

Methodology of Reputational Due Diligence

Integrity risks and political conflict risks are hidden risks and can most effectively be identified and evaluated by undertaking an independent *Reputational Due Diligence. Reputational Due Diligence* protects investors from unpleasant surprises in the 'human' environment of an investment. If integrity and trustworthiness are critical to the long-term success of an investment project, then the information concerning such issues should be obtained in advance in order to improve the basis upon which decisions are make in the lead up to the transaction (see Diagram 3).

For this purpose, within the context of the *Reputational Due Diligence* process, secondary sources including media sources, corporate registry entries, relevant regulatory information, other databases and online information sources are evaluated. In a further stage, discreet interviews can be undertaken by experts in order to ascertain the reputation of target individuals or companies. Based on the information retrieved, a risk profile can be established.

Diagram 3: Reputational Due Diligence Methodology

The authenticity of a business partner's résumé will be evaluated and his or her public profile and reputation portrayed based on media coverage. His commercial interests and comments on his business and political network, as well as potentially controversial relationships with government bodies will also be researched. Other issues, which can be addressed, include any litigation or credit issues which may emerge in relation to the subject based on research of publicly available information.

Benefits

The costs attached to undertaking *Reputational Due Diligence* within the context of an entire due diligence process are comparatively low but nonetheless generate significant added value. *Vis-à-vis* the increasing complexity of compliance and corporate governance rules, undertaking *Reputational Due Diligence* ensures that companies are in line with best practice approaches in particular regarding relationships with third parties.

In addition, creating a maximum level of transparency will improve the chances of success of an investment endeavour by fulfilling the requirement to effectively evaluate the integrity of a partner and to understand associated networks. This ensures that a business relationship can be built on a stable basis of trust.

Reputational Due Diligence also adds value to the risk management process as it expands the decision-making basis and helps to identify hidden and connected risks at an early stage. As a result, limited management resources will be optimised and the transaction costs can be more effectively controlled.

The need for investment and the attractiveness of new markets on the one hand and increased business competition on the other, require more effective risk management. *Reputational Due Diligence* plays a strategically fundamental role in this regard.

Dr. Carsten Giersch, Berlin Risk Institute
Jennifer Hanley-Giersch, CAMS, Business Risk Research Limited

Annex:
Reputational Due Diligence –
a Case Study

A multinational firm plans to expand into one of Eastern Europe's regulated markets by acquiring a majority stake in a local company. The target firm holds the largest part of the market share in the regulated market place. The seller wants to retain a minority stake in the business which in itself could present a risk for the investor, who aims to float the target company on the local stock market within a couple of years following the acquisition. Based on this strategic background the client wants to clarify some issues of potential concern.

Firstly, the client plans to develop a detailed profile of the majority shareholder, including a map of his corporate interests, with the aim of assessing the seller's integrity and reputation. Furthermore, the investor wants to assure himself that the seller does not have a hidden agenda attached to the sale of his stake in the business. The investor also wants to establish a profile of the management team of the target firm and their respective reputations.

Finally, the client asks for a political risk analysis with regard to the role that various local interest groups might play. A network analysis of the relationships of the various interest groups amongst one another and to the respective regulatory authorities is requested. The key focus of this exercise is to understand the strategic aim of the regulatory authorities and to ascertain the independence of their decision-making.

The in-depth research undertaken in local and international databases and through expert interviews reveal the following key risks:

The seller is not only one of the richest and most influential businessmen in the country, but also publicly a very controversial individual, which in itself presents a reputational risk. Media sources report that the seller had previously been subject to investigations based on allegations of embezzlement. The investigations were closed leaving the allegations unsubstantiated.

Research of international press databases identifies an article published in an Italian newspaper, which claimed that the Italian state prosecutor had launched an investigation into the seller as he was suspected to have been involved in dubious activities in Italy. Research of Italian corporate filings confirms that the seller indirectly retained a stake in an Italian company. The owner of the Italian company is registered to be a Cyprus based entity, which in turn is owned by one of the seller's subsidiary companies registered in the target country.

Furthermore, research in publicly available sources reveals that the seller retains a stake in a bank, which has been subject to controversial media coverage in relation to allegations of it having been involved in money laundering activities. The company which the investor plans to acquire a stake in is indirectly, through a complex ownership structure, linked to the bank.

Research and enquiries also expose that the target's management team are known to act as puppets of the seller and that they are therefore not in a position to make independent decisions. This is of concern to the investor regarding potential future conflicts of interest, which might emerge following an acquisition. Furthermore, the seller's son-in-law is appointed as CFO. Given that the seller exerts such an influence on the management team and that he would continue to retain a minority stake in the business following the transaction, this emerges as a significant risk for the investor.

The political risk analysis highlights two final issues of concern. Firstly, according to the research undertaken, the state government prefers to see the market being held in the hand of national players, and secondly, the key person responsible for the company at the regulatory authorities, in a country, which is known to be highly corrupt, is related to one of the board directors of the target company's key competitor.