ESG IN M&A TRANSACTIONS – PRESENT AND FUTURE

October 2022

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INTRODUCTION

The ESG sector has grown at a phenomenal rate over the last 5 years. It has doubled in size over that period[1] and now a quarter of all investible assets globally are being managed with some type of environmental, social or governance mandate[2].

Practice varies from region to region but the increased prominence of ESG factors in decision-making, risk analysis and valuations globally is significant for M&A professionals and investors.

There are many reasons for this upward trend. Some of this comes from grass roots with consumers significantly changing buying patterns and their investment preferences. Although there are some vocal opponents to ESG being part of investment decisions in the US, in particular, these consumer demands together with targeted shareholder activism has sent a strong signal and given a mandate to those business leaders that wish to take it.

However, there are more fundamental drivers that explain the pace and scale of this change: 30% of businesses globally witnessing operational impacts from climate change[3]. ESG factors are having such a clear impact on the risks and returns of businesses that it is hard to fully understand the value of those businesses without looking at them from an ESG perspective.

Much of the public discussion on ESG factors is driven by large financial institutions and corporates as well as having increased prominence in PE fund raising campaigns and divestitures processes. However ESG factors are not simply a 'luxury item' for large companies and institutions but are also often key to the value of smaller private companies.

It is critical for M&A professionals to understand what this means for them and the companies they advise. In this article, we explain what ESG factors are and what roles they play in M&A transactions.

ESG considerations can be relevant throughout the M&A transaction process, helping to:

(i) identify, understand and mitigate risk;
(ii) increase target value;
(iii) achieve beneficial and long-term synergies for both the buyer and the target; and
(iv) reducing friction in the deal and enhancing the likelihood that the deal will close successfully.

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1 https://www.unpri.org/annual-report-2021/how-we-work/building-our-effectiveness/enhance-our-global-footprint?adredir=1
2 https://enterprise.ft.com/en-gb/blog/new-revolution-finance-introducing-moral-money-latest-ft-newsletter/
3 https://www2.deloitte.com/global/en/pages/risk/articles/2021-climate-check-business-views-on-environmental-sustainability.html

As with other diligence topics, a buyer will want to see effective processes to deal with ESG issues. If these processes are not robust then the risk profile may be higher leading to a lower valuation; conversely, if the target can demonstrate good processes and a history of having addressed the risks, then its value can be enhanced.

If a target has strong procedures the deal can often go more smoothly and alignment on ESG issues can help in integration of the target into the buyer, particularly if the buyer is a strategic buyer.

WHAT IS ESG?

The term "ESG" (standing for Environmental, Social and Governance was first used in the 2004 United Nation's Principles for Responsible Investment (PRI) report "Who Cares Wins"[4] which was the result of the Global Compact initiative launched by Kofi Annan in 2000. As such, the term "ESG" has been in popular use for almost two decades but it has rapidly gained momentum and prominence in recent years.

When Larry Fink, founder and CEO of BlackRock wrote his seminal public letter in 2018 stating that "every company must not only deliver financial performance, but also show how it makes a positive contribution to society" it generated significant debate on what investors should value and whether ESG factors should form part of a valuation or risk-based analysis.

There are many apparently similar terms in use including Socially Responsible Investing ("**SRI**"), sustainable investing and impact investing. These are not all the same and there is a legitimate debate to be had as to whether the term "ESG" will continue to have such a wide appeal, however it does capture a number of critical issues and so we anticipate both the term and the factors it refers to having a material role in the short and medium term future of M&A transactions.

ESG factors cover a wide range of issues including environmental risk and regulation, climate change resilience, human rights impact, community engagement, workforce, HR issues, quality of decision-making, transparency and shareholder rights. As such, ESG factors cover issues that are well-established and understood as well as issues that have emerged more recently and on which there is less consistency. This helps explain why, for some people, ESG is a niche product that can be 'bolted on' to pre-existing services whereas for others it provides a fresh lens through which they can look at and understand businesses holistically.

KEY PLAYERS

As noted above, large financial institutions have played a leading role on ESG, in particular in Europe and the US. Given their frequent role on both buy and sell sides of M&A deals, private equity (PE) firms are in an excellent position to respond to and utilise evolving understanding of ESG factors. Clearly, these PE firms need to see growth in value of their assets to meet their target returns, which could be achieved by addressing specific issues (ESG or other) and by ensuring the asset has a sustainable growth plan so that it is likely to be attractive for a potential sale down the road.

Globally, numerous environmental-friendly responsible players now exist in the form of investment funds, finance teams within traditional lenders (green bonds, green loans) as well as certification specialists.

We have also seen several investor groups evaluating their portfolio through the ESG lens and marketing externally on their ESG credentials, which can boost the appeal of these groups, particularly among the younger generation. This, in turn can, provide advantages in terms of talent recruitment or future partnerships with those more conscious of ESG elements.

The public sector, regulatory bodies and ratings agencies also have a key role to play.

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[4] https://www.unepfi.org/fileadmin/events/2004/stocks/who_cares_wins_global_compact_2004.pdf

STANDARDS

There is no single set of standards for evaluating or scoring performance of a company, investment fund or an asset manager on ESG matters. There is not even a single definition of what is and is not covered or required under the ESG umbrella. This makes it a bit more difficult to assess, requiring a more granular diligence process. Larger companies will have their own policies and standards that they will apply in the diligence and pricing process.

In the US, the SEC has proposed a new set of disclosure rules focused on ESG and it is expected that at some point in 2023-24 public companies will be required to provide extensive disclosure on their approach to many of the issues under the ESG umbrella. This would push public companies even further into assessing M&A targets through an ESG framework.

ESG regulatory landscape is generally evolving towards more mandatory regimes. However, the practice has shown a very active anticipation of the ESG issues through voluntary adoption (public image, communication and recruitment). As part of that trend, lenders as well as investors have played a role in encouraging enterprises to adopt more ESG-focused engagements.

INVESTOR STRATEGY

We have noticed a major push from investors towards sustainable, responsible investing in targets that complement or extend a buyer's ESG scores by improving their ESG credentials to create greater long-term value for their business, shareholders and other stakeholders. Therefore, unsurprisingly, investors are pursuing deals according to their own ESG principles and expectations, resulting in greener and more socially beneficial portfolios. Consequently, assets are being increasingly managed under ESG-focused funds.

Care needs to be taken to understand what ESG factors are most relevant to each business and what they are doing to address those factors. The factors that are important to one company will not necessarily be important to another and there can often be a trade-off between performance on different ESG factors. For example, ratings agencies may provide a helpful reference point but do not provide a complete picture. Typically they look at the potential harm ESG factors have on financial performance of a company but not necessarily at the overall ESG impact of that company. Accordingly, it would be misleading to interpret such an ESG rating as an indication of positive impact but it may be a good indication of corporate awareness of the risks ESG poses to it.

It is generally accepted that companies that score higher ESG metrics are typically more aware of upcoming regulatory changes, contract requirements and other changing factors that could materially affect their business.

A company's ESG regime is an increasingly important component when assessing strategic fit and financial profile. If a potential acquirer concludes that the seller's ESG strategy for the target is deficient, it may determine that the business is inherently less valuable or presents long-term risks.

Key questions may be around the target's ESG strategy: Which ESG factors has it identified as being most relevant to it and its stakeholders? What ESG procedures, policies and processes does it have in place? What ESG metrics it create and track? Does it have a record of accomplishment on ESG, either negative or positive? Is the ESG strategy and culture compatible with its own (for example, voluntary application of non-mandatory ESG regulation or best practices)? All these valid questions help identify and create an understanding of ESG risks and opportunities that could affect the operating model of the target and the perception of its brand, its community engagements and the cultural alignment of the target with the acquiring group.

SELLERS STRATEGY

Strong performance on ESG issues clearly benefits sellers by increasing value, facilitating negotiations and shortening timing between signing and closing.

In seller-led sale processes, Sellers may wish to undertake their own vendor due diligence process well before buyers and their advisors identify any risks, including ESG related risks and processes.

As for other traditional risk items, these may include extensive multi-disciplinary pre-deal review. Sell side due diligence, complementary to the information memorandum, can also be an opportunity to demonstrate to investors and build upon a company's ESG narrative to improve its operating model, governance, compliance and stress future opportunities within reach thanks to its ESG strategy and accomplishments. Such pre-deal efforts can positively influence the deal value and sale process as well as the target selection from the acquirer's perspective as indicated above.

We have also noticed an increasing number of ESG-specific assets emerging as prime M&A targets, such as those software and services firms specializing in facilitating ESG reporting capabilities (SAAS segment).

VALUATION

ESG or sustainability factors are criteria not typically included in a target's financial statements. As mentioned earlier, current trends have brought these factors to the fore as a method to enhance value. ESG can include examination of a target's organizational and management structure, compliance with numerous applicable regulation, whether on a mandatory or voluntary basis, such as carbon limits or complicate change limits, stance on human rights and may extent to suppliers and distributors.

Potential increase in such valuation can result from either positive shareholder or wider stakeholder engagement, retention of employees and attracting new hires, attracting ESG focused investors, potential cost reduction, enhanced regulatory compliance and customer engagement etc.

In particular, investors are likely to see the quality of managers and employees of the acquired target as key factors of success in the competitive landscape. Since cash flow generation is the basis of valuation methods, the strengths and cohesion of the target's team are perceived by investors as imperative.

Integrating a robust ESG framework lowers a target's exposure to risk from future adverse event, offering resilience to potential environment or social changes while offering potential high value financial returns. As a result, ESG metrics are now frequently integrated into target valuations, albeit it is debatable as to whether there is enough transparency and common ground in evaluating such ESG process and methods.

RISKS

Clearly, ESG will increase in both the scope and the depth of due diligence with ESG factors being at the forefront of Representation & Warranties and insurance processes. Investors will require quality data on ESG issues, particularly related to opportunities and risks, so we can expect a continued rise in demand for due diligence in this area. As an example of scope expansion, environmental diligence can bring up current hazardous materials usage or current violations of environmental law, as well as expanded to include whether the company or its suppliers down the chain comply with climate/pollution-related targets.

However, appropriate ESG due diligence largely depends on the nature and type of business. There is no standard way yet. We already notice areas of increasing focus. These are wide-ranging such as environmental permits and pollution; energy use; employee engagement; workforce culture and diversity; detection and prevention of workforce abuses and maintaining labor standards in the target's supply chain; reporting on ethics, regulatory compliance, corporate governance; data protection and privacy.

Another key consideration for investors could be whether a target complies with ESG disclosure and reporting obligations, even if it is a voluntary decision adopted by private companies not yet subject to mandatory ESG reporting requirements.

A wider look at ESG-relevant due diligence can also pick up potential liabilities such as lawsuits, diminution of customer bases, supplier issues or shareholder challenges prior to signing or closing. The format of such ESG due diligence can take the form of a dedicated ESG audit, ESG criteria added to existing buy-side audit formats or a specific ESG questionnaire sent to the target /sellers. Disclosure schedules are then adjusted accordingly.

Any ESG risks identified through the due diligence process should then be considered as to whether they can be mitigated through contractual protections with a focus on potential litigation, damages and remediation as well as reputational concerns.

PRACTICAL CONSIDERATIONS

ESG factors are playing a role at every step of the M&A process, from target selection through to completion and post-completion matters.

ESG deal terms include ESG warranties and indemnities, which are becoming more utilized in M&A transactions. We should expect to see some standardization in transaction documentation as ESG considerations become a customary feature of the M&A process.

Certain issues need to be dealt with at an early stage prior to the acquisition. Where due diligence highlights severe ESG risk, investors may seek to negotiate a downward valuation of the target, transaction insurance against risk (whether these risks are known or unknown), carve-out of the relevant part of the business that is affected to remain with the sellers, switching from share to asset deal, remedy of the relevant risk through conditions precedent, pre-closing covenants, excluded liabilities, providing holdbacks or escrows or post-completion integration process. Not all ESG matters can be financially quantifiable and thus it may be sometimes challenging for an investor to be fully compensated in the event of non-compliance by way of contractual provisions such as warranties and indemnities.

ESG considerations will also be at the heart of post-transaction integration strategy for buyers. Clearly, the higher the target scores in ESG, the more likely it is that integration will be successful.

ESG considerations may lead to an adjustment of governance structure of targets after close to ensure that it will meet its new and future ESG monitoring and responsibilities. For example, investors may require the target to sign-up to their group's ESG policies, communicate these to stakeholders and ensure these are enforced through new Key Performance Indicators (KPIs) for managers. This will be important in case of rollover equity in today's M&A transaction landscape.

Finally, lenders are increasingly incorporating ESG disclosure obligations as conditions to their loan agreements, which is a further imperative for appropriate diligence, management and monitoring of ESG risks in M&A transactions.

CONCLUSION

There is no doubt that ESG is becoming increasingly important in M&A transactions and this trend is set to continue for the foreseeable future. We should expect M&A and investment decisions to continue to use ESG factors and soon reach the stage where most if not all M&A deals shall consistently need to be analysed through an ESG lens. Future M&A transactions will also see more ESG linked performance metrics being used in both earn-outs for existing shareholders and management KPIs.

It is a sign of maturity in the market that people are no longer questioning what "ESG" stands for but whether what they stand for is accurately captured by "ESG".

If you would like to discuss these issues further please get in touch.

THE BCLP APPROACH TO ESG AND M&A

BCLP's M&A and Corporate Finance Practice has received notable recognition in multiple global rankings during the course of 2022. Especially skilled in leading mid-market transactions for buyers, sellers and private equity and financial sponsors alike, the firm has earned recognition in markets across our firm-wide footprint – from France to Israel, the UK and several regions across the U.S.

At BCLP, we can draw on a deep understanding of how ESG factors are relevant to business. We support clients across the globe on complex policy, legal, governance, business and value chain challenges, delivering legal expertise aligned with their sustainability and ESG considerations. By addressing the challenges and opportunities they face in achieving their sustainable and responsible business conduct and ESG goals, we empower them to deliver on key Board level strategic priorities, to successfully operate and contribute to a sustainable and inclusive economy. Advisers are embedded across client service groups and sectors, leveraging a deep industry-focused understanding of sustainability and ESG issues.

We increasingly:

- advise clients on how to integrate ESG risk and opportunity governance into their policy, management systems, operating and transactional approaches, to promote greater resilience, brand enhancement, and ensure goods and services are sustainably and responsibly sourced, produced and supplied.
- use our global thought leadership to develop ESG governance approaches to assist clients in managing ESG issues in a holistic and integrated manner and align their ESG and business goals to support long-term business success. Given ESG policy, regulatory approaches, industry guidance and corporate practice are dynamic and evolving; we seek to share insights with clients about early adopter and industry approaches that may influence policy and regulatory standards across jurisdictions where they operate.
- leverage our knowledge of specific industries and sectors, to enable clients to focus on their own ESG journeys to foster sustainable and responsible business conduct. This creates competitive advantages in their businesses, relationships and operating markets, which support industry collaboration models.

> BCLP's experienced practitioners impress businesses in the ESG arena with their deep sector knowledge and commitment to meticulous client service.

Chambers, 2022

Getting in touch

When you need a practical legal solution for your next business opportunity or challenge, please get in touch.

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