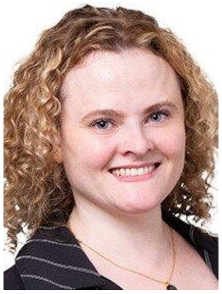
The Growing Importance Of ESG In Mergers And Acquisitions

By **Debra Hatter, Margaret Hanson and Viki Vozarova** (March 2, 2022)

Debra Hatter



Margaret Hanson

Viki Vozarova

The concept of environmental, social and governance issues is gaining importance, especially in deals. The buzzword of late, ESG's growing trend is largely due to heightened regulatory focus on disclosure and enforcement by the U.S. Securities and Exchange Commission.

In the growing regulatory framework, acquirers, targets and investors should properly account for ESG in mergers and acquisitions. A company's ESG profile is typically represented by a score that is calculated from data surrounding specific metrics related to intangible assets.[1]

ESG can be considered a corporate social credit score that is gaining more and more attention by investors — individual and institutional.

Morgan Stanley & Co. LLC recently conducted a survey that found over 90% of millennial investors were interested in sustainable investing.[2] As millennials begin to comprise a larger segment of the total pool of investors, we can expect the importance of ESG investing to grow in tandem.

Growing Pressure for Support

Investors are starting to believe that companies with strong ESG initiatives are more lucrative investments, pose less risk and are better positioned for the long term. In a survey from February 2020, companies noted that they are willing to pay premiums for targets with positive ESG records.[3] We can expect that potential premiums will affect due diligence in M&A transactions.

At the same time, institutional investors are aligning their portfolios toward better ESG performance. This signals a different approach from focusing on socially responsible or conscious funds, and instead seeing ESG as fundamental to the performance for all investments, regardless of sector or underlying asset.

In fact, many institutional investors are suggesting that including an ESG focus will improve capital raising for private equity funds, which trickles down as more dry powder to fund M&A activities.

The government is also keeping a close eye on companies' ESG initiatives. Corporate governance encompasses a wide array of areas including data privacy, cybersecurity, anti-corruption, specific transaction requirements and trade compliance. The SEC has announced a greater focus on ESG issues.[4]

The SEC's plan is to create an ESG reporting framework that would complement the current financial reporting framework and it has announced a request for public comment on climate-related risk disclosure rules.[5] In addition, the SEC stated that it will consider issuing guidance regarding human capital disclosures as well as guidance on a rulemaking regarding board diversity.

ESG Ratings

A company's ESG rating is crucial in determining its value, and the rating is based on how outsiders view an organization's performance. However, these ratings are not necessarily consistent indicators of a company's behavior relating to ESG issues, because the ratings are products of how — and against what regime or framework — a company reports its ESG activities.

While a business may have a strong policy around carbon emissions and waste reduction, or a system of transparent, performance-based promotion, if that information is not in the public domain, it will not impact its ESG score. Therefore, it is vital that companies share their ESG values and initiatives with the public.

Another issue with ESG ratings is that there is no single system for rating companies against ESG criteria. With current data not standardized, it can be difficult to make comparisons:[6]

There are a number of different ESG rating agencies, including Sustainalytics, RepRisk and MSCI, and they all provide clients with assessments based on each client's ESG performance. However, each agency uses its own methods to evaluate companies. To eliminate this apples-to-oranges issue in utilizing ratings to compare companies' ESG performance, regulators in the U.S., U.K. and Europe are considering implementing mandatory, consistent ESG disclosure rules, so that investors can compare companies more effectively.

Due Diligence

In M&A, due diligence can help buyers identify ESG-related risks that may influence a target's price and the overall deal structure. This is true, especially for companies in the energy, manufacturing, health care services and food production industries, many of which already have some form of sustainability initiatives established prior to a sale because these industries typically encounter more in-depth ESG due diligence from buyers than companies in other industries that are less traditionally ESG focused.

ESG due diligence has been expanding by focusing on the values, work culture and social responsibility of the target. Nowadays, buyers do not only focus on compliance with labor and employment laws, as well as permitting issues — environmental, regulatory and otherwise — but also examine issues relating to workplace diversity, gender inequity, sexual harassment and workplace misconduct. Therefore, it is beneficial for a target to improve its ESG rating — or at least its related practices — prior to going to market.

Similarly, outlining a company's ESG priorities, initiatives and measurements in the marketing materials used in the selling process helps to highlight the strength of the company's governance, which can increase the target's price. Investors and buyers should probe ESG areas to determine whether the target's efforts in these areas are aligned with their expectations.

Recent M&A Deals With ESG Emphasis

The past year has been rich with mergers that emphasized ESG initiatives. For example, in July 2021, investment firm Blackstone Inc. acquired Sphera Solutions Inc., a leading provider of ESG software, data and consulting services, from Genstar Capital LLC.[7] This

$1.4 billion deal will reportedly allow Sphera to expand the ESG digital solutions on its software-as-a-service platform with unique data sets and differentiated consultative services throughout the world. In its announcement, Blackstone specifically acknowledged the importance of ESG in its investment strategy.

Moreover, the $9.5 billion sale by Shell Royal Dutch PLC's Shell Enterprises of its Permian Basin assets to ConocoPhillips Co., in September 2021, made headlines. According to the Wall Street Journal, "the deal shows that ESG, or environmental, social and governance issues, are becoming a more important part of large deals in the oil patch."[8]

One month later, Goldman Sachs Group Inc. agreed to acquire NN Investment Partners, the asset management business of Dutch insurer NN Group NV for $1.9 billion.[9] The acquisition of NN Investment, as a top-ranked ESG asset manager in Europe, adds new ESG offerings to Goldman's existing offerings.

Pitfalls to Avoid

Many institutional investors now actively avoid assets with poor ESG profiles. At the same time, buyers with low ESG ratings will increasingly look for targets with high ESG ratings to enhance their reputations and learn from targets how to build a better image.

There is a lesson in such a focus on image only, however: Those companies that have attempted to increase their ESG profiles by focusing on marketing without actually changing their practices are frequently maligned for greenwashing.

Greenwashing is disinformation provided by a company in order to present an environmentally responsible public image while continuing with harmful business practices. A number of large companies have been called out for intentionally misleading the public about their environmental practices.

This has resulted in plummeting stock prices and angry investors, as well as bad press, and can have serious unwanted consequences, such as lawsuits and government investigations.

To avoid greenwashing accusations and lowered prices for their businesses, sellers should ensure that their companies are in compliance with local and international regulations and law, prepare annual sustainability reports, and monitor their companies' ESG fitness through collecting statistics and reports.[10]

Businesses should also implement appropriate processes and procedures with suppliers and customers to ensure that those parties are also operating their businesses in ways that show their cognizance of the importance of ESG. Finally, buyers need to be on the lookout for these practices, not only in a target's marketing materials, but for concrete evidence of follow-through in how the business is run day-to-day.

In an effort to accomplish the above, many companies have slowed or entirely ceased some of their ESG-adverse activities. For example, Boston University joined the growing list of universities divesting from fossil fuels.[11] The university's announcement also indicated that the endowment will seek investment managers that can provide opportunities in renewable energy sources and fossil-fuel-free products.[12]

ESG References in Acquisition Agreements

We expect that M&A agreements will soon begin to reflect the growing importance of ESG. Since the beginning of the pandemic, almost every single M&A agreement adopted carveouts for COVID-19 in material adverse change clauses and interim operating covenants.

We are also seeing additional, specific representations and warranties on these topics, and it is further expected that additional provisions regarding ESG will soon appear in MAE clauses. This trend will only accelerate after ESG regulatory rules are put into force.

ESG's growing relevance in M&A calls for expanding targets' due diligence and considering targets' ESG ratings in valuation.

Debra Gatison Hatter is a partner, Margaret L. Hanson is senior counsel and Viki Vozarova is an associate at Norton Rose Fulbright.

[1] https://corporatefinanceinstitute.com/resources/knowledge/other/esg-environmental-social-governance/.

[2] https://www.morganstanley.com/assets/pdfs/2021-Sustainable_Signals_Individual_Investor.pdf.

[3] https://www.wlrk.com/docs/The_ESG_Premium_New_Perspectives_on_Value_and_Performance.pdf.

[4] https://www.sec.gov/news/press-release/2021-42.

[5] https://www.sec.gov/news/public-statement/lee-climate-change-disclosures.

[6] https://accfcorpgov.org/wp-content/uploads/2018/07/ACCF_RatingsESGReport.pdf.

[7] https://www.blackstone.com/news/press/blackstone-to-acquire-sphera-a-leading-provider-of-esg-software-data-and-consulting-services-from-genstar-capital-for-1-4-billion/.

[8] https://www.wsj.com/articles/shell-near-deal-to-sell-permian-assets-to-conocophillips-11632168002.

[9] https://www.goldmansachs.com/media-relations/press-releases/2021/announcement-19-aug-2021.html.

[10] https://www.esgthereport.com/what-is-esg-due-diligence/.

[11] https://www.bu.edu/articles/2021/boston-university-divest-from-fossil-fuel-industry/.

[12] Id.