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Good Value: Incorporating **ESG** Into **M&A Due Diligence**

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A mere five years ago, a global survey of M&A dealmakers found less than one-third rated environmental, social and governance (ESG) due diligence as a "very important/important" consideration in their transactions. Two-thirds of respondents described as merely "moderately important."

Fast forward to 2020.

Last year, 86% of the more than 2,000 global respondents called it "very important/important"—an astounding 55% increase, according to polling by Datasite, a leading provider of virtual data rooms for such deals.

A cursory review of recent headlines helps explain this sea change: The #MeToo movement, the COVID-19 pandemic, the racial justice movement, irregular weather and climate events, and the rising threat of political violence have each raised the stakes in environmental, social and governance (ESG) matters, and their potential impact on transactions.

Such a rapid and profound shift suggests dealmakers must be ready to examine relevant ESG matters pre-transaction. They not only have the potential to impact the value and price of the acquisition, but increasingly, ESG matters are determining whether the deal should go forward at all.

In fact, 78% of more than 2,000 global practitioners report that "they worked on M&A transactions that have not progressed because of concerns about a target company's ESG credentials," again according to Datasite.

When a deal closes without ESG due diligence, the acquirer risks swift and significant value erosion post-transaction if ESG issues subsequently come to light.

On the other side of the coin, research suggests that M&A activity between companies that are

compatible on ESG matters can bring outsized gains.

A study by Cornerstone Capital examined 231 M&A deals, measuring whether firms involved in the same transaction were ESG compatible. The research found that ESG-compatible deals out-performed ESG-incompatible deals by an average of 21% on a five-year cumulative return basis.

Global asset managers are increasingly paying attention to ESG factors as well. Blackstone, State Street and Vanguard have all issued statements emphasizing the importance of ESG in their investment decisions.

Meanwhile, studies are finding a connection between ESG matters and a company's financial success. A *Barron's* report on sustainability

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showed returns on the 100 most sustainable companies handily beat the S&P 500 index in 2019. And McKinsey & Company reported that a "strong ESG proposition correlates with higher equity returns … [and] a reduction in downside risk" in a 2019.

A Roadmap for Acquiring Companies

While ESG matters encompass a broad array of risks, seldom will a single company have exposure to every ESG area of concern. One size simply cannot fit all. Rather, each transaction requires a customized approach that takes into account the specific ESG priorities of the acquirer.

Due diligence by legal counsel and other advisors can help acquiring companies assess where target companies have exposure and how they may hinder or complement existing ESG programs. To begin, acquirers should assess the overall ESG profile of the target by looking at the following:

- **Sector risks:** Is the industry one that is perceived to have significant environmental impacts or to employ vulnerable workers? Is it an industry known for a high incidence of bribery and corruption?
- **Location risks:** Does the target have international operations or other foreign touchpoints such as an international supply chain or cross-border labor sourcing? Are the relevant jurisdictions perceived to have limited human rights or labor rights, or be at risk for heightened environmental impacts? Are any relevant jurisdictions at increased risk for bribery and corruption?

Sourcing risks: Does the target's supply chains employ vulnerable workers, present environmental risks and/or involve hazardous conditions?

Public disclosure risks: Has the target made public disclosures on ESG-related topics, such as its environmental impact, responsible sourcing practices, commitment to diversity and inclusion, sustainability programs, or community engagement initiatives?

Developing a Process

Once these threshold questions are considered, the company must assess where to dig deeper, and how to do so most efficiently. A tailored approach often works best, based on the extent of the issues, the existing work streams, and any overlap of potential concerns.

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Where complicated ESG issues have an outsized impact on the value of the deal, it may be appropriate to develop a standalone ESG work stream to ensure coordination and a thorough review. ESG counsel can assist in developing a comprehensive due diligence work plan and then coordinating the various work streams.

For certain issues, the company may choose to leverage discrete due diligence work streams to gather relevant ESG-related information. For instance, responsible sourcing practices and community engagement initiatives may be combined as part of the anti-bribery and corruption (ABC) work stream. Poor controls and oversight relating to areas like sourcing and community engagement often correspond with greater potential for ABC risk in the target's operations. Consolidating these matters into the same work stream can build on existing subject matter synergies and leverage the particular knowledge of specialist counsel.

Similarly, issues of board diversity and composition, executive compensation and other labor and workforce issues, which all have ESG-related components, may be combined with the examination of the target's labor and employee benefits.

Other ESG components may need to be reviewed by more than one team, depending on the transaction. For example, worker safety measures could be addressed by the labor and employment diligence work stream but may also benefit from review by the environmental diligence team, as well as the regulatory team.

Digging Deeper for Relevant Information

Once a pathway is set, ESG due diligence can follow the typical information-gathering process. Information relating to ESG risk and controls should be obtained through document and information requests and interviews with the target's management (and when appropriate, interviews of personnel much farther down the chain of seniority). Counsel well versed in ESG issues can provide questions tailored to the particular risks of the target and help eliminate the potential for duplicative or overlapping requests.

If ESG-related disclosures have been made by the target, either in public filings or through other public channels, such as the target's website, document review and interviews with management present an opportunity to validate both the content of the disclosures and how the information was obtained and verified.

One of the specific initiatives of the new SEC Climate and ESG Task Force is to evaluate potential misstatements in public companies' disclosures. As ESG-related disclosures continue to be an area of interest to the SEC and other regulators, inaccuracies in disclosures is a potential source of legal and reputational exposure for acquirers.

Using ESG Findings

The relevant ESG findings identified during the due diligence process should be documented by counsel along with an analysis of potential legal or reputational risks and exposure. The ESG analysis can then be used by the acquirer to:

- Evaluate the potential transaction as whole, including a reassessment of the potential value and price of the transaction; and
- Negotiate the representations, warranties, indemnities, covenants or other provisions in the transaction documents to address the ESG issues and allocate risk between the counterparties.

Post-Acquisition

Importantly, the value of this ESG analysis lives well beyond the deal's negotiations. The analysis of the target's ESG issues and compliance program should be utilized to identify gaps and propose strategies for implementing potential solutions. The acquirer can then consider these remedial measures as part of its post-closing plan for integration.

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The acquiring company generally assumes liability for the target upon the closing of the transaction. Having a clear and detailed roadmap of changes to be implemented facilitates the integration period and minimizes the potential risk of continued misconduct that could give rise to legal or reputational issues post-acquisition.

ESG matters may have significant influence across a wide variety of post-integration business decisions, such as combining sourcing, suppliers and systems. For example, supply partners may be chosen based in part on their labor practices, rather than strictly on price. Similarly, employee incentive plans may be selected based on impact on diversity, not just cost.

Gaining a comprehensive understanding of key ESG risk areas and touchpoints during due diligence accelerates these processes.

Conclusion

Especially in the M&A context, ESG is often framed in terms of risks, but a strong public record on these matters offers the prospect of competitive advantage, as well. Investors and customers are increasingly showing their support for companies that are genuine leaders in the ESG space. Thoughtful and appropriately scoped incorporation of ESG in M&A due diligence can do more than stave off scrutiny and scorn—it can enable an acquirer to harvest even greater value from its target.