The Evolving Role of ESG in M&A

Balancing Risks and Opportunities

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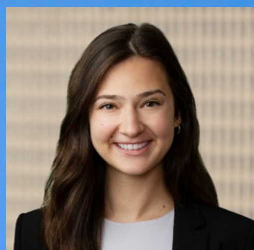

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Introduction

Environmental, social, and governance (“ESG”) considerations play an increasingly important role in M&A transactions. In any given deal, however, it can be challenging to qualitatively and quantitatively assess relevant ESG factors, perform appropriate levels of ESG due diligence, and plan for appropriate remedial steps or capture ESG opportunities post-closing. M&A acquirers should seek experienced guidance on these considerations to enhance value, mitigate risks and better incorporate financial and non-financial measures into their deal evaluations.

KPMG’s ESG Due Diligence Survey (2023) underscores a growing trend in M&A deals: ESG considerations provide value creation and differentiation for potential target companies, and acquirers should incorporate these considerations into their M&A due diligence. According to the survey, nearly 62 percent of U.S. investors attach a premium to targets with an ESG profile that complements their ESG goals.

Acquiring leading ESG performers can be a primary deal driver and accretive to the pro forma combined company, enabling acquirers to accelerate innovation, enter new markets, or diversify business lines. For example, in July 2023, ExxonMobil announced a definitive agreement to acquire Denbury Inc. for $4.9 billion, touting Denbury’s experience in carbon capture, utilization, and storage and emphasizing that the acquisition would “further accelerate ExxonMobil’s Low Carbon Solutions business and create an even more compelling customer decarbonization proposition.”

By contrast, problematic ESG traits can derail deals. The KPMG survey found that 53 percent of U.S. investors reported that adverse material ESG findings during due diligence contributed to their abandonment of a potential deal. Notably, 74 percent of respondents reported that their M&A evaluation criteria included ESG considerations, but only 51 percent felt they possessed a proper understanding of ESG risks and opportunities in evaluating an acquisition target.

From investors to employees, numerous key stakeholders expect ESG performance. Buying an “ESG halo” through M&A can often be faster, cheaper, and more credible than building it organically. Pursuing ESG enhancements inorganically can therefore accelerate capabilities, but companies should have a comprehensive understanding of how ESG issues can affect each step of an M&A transaction:

1. Identifying acquisition targets
2. Conducting due diligence and valuation
3. Financing the deal and obtaining representation and warranty (“R&W”) insurance
4. Negotiating terms and closing the deal
5. Integrating the acquisition — or establishing a strong standalone company

In this report, we examine how acquiring companies should think about ESG at each step of the deal process.

Identifying Acquisition Targets

ESG considerations are never uniform, and one acquiring company may weight certain considerations very differently than another does. It therefore becomes important for each acquirer to evaluate each target with its own ESG goals and risk tolerance in mind. In many cases, a target can distinguish itself by excelling in specific ESG areas and communicating its efforts to the market.

Responding to Deloitte's ESG in M&A Pulse Survey (2022), 91 percent of corporate leaders said that their company had planned to acquire — or had acquired — assets to improve their company's ESG profile, and 86 percent said that their company planned to divest or had divested from a company for the same reason. Among energy, resources, and industrials companies, 90 percent reported acquiring targets or assets to gain exposure to commodities and capabilities needed for a global lower-carbon future, while 85 percent reported that they may divest assets whose products are more carbon-intensive than their desired portfolio mix.

Further, 89 percent of companies said that they are attempting to acquire brands and capabilities that are sustainable, are ethical, have a lower environmental footprint, and show positive social impact, while 51 percent said that their organization has decided not to proceed with a potential acquisition because of concerns about the target's ESG performance. Similarly, in PwC's Global Private Equity Responsible Investment Survey (2023), 53 percent of respondents reported that their firm has opted against pursuing a potential deal because of ESG considerations.

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Conducting Due Diligence and Valuation

ESG due diligence can shed light on issues that conventional due diligence analyses do not typically cover, such as reputational considerations, supply chain challenges, culture risks, workforce engagement, and lifecycle assessments of products' environmental impact.

The KPMG survey found that U.S. acquirers are increasingly planning to conduct ESG diligence more regularly in future deals, with 27 percent claiming they plan to conduct ESG due diligence frequently (defined as more than 80 percent of deals), up from 16 percent in the previous two years. The Deloitte survey found that ESG due diligence approaches are shifting from a focus solely on risk to often including commercial and operational value-creation opportunities. Likewise, 57 percent of private equity firms surveyed by PwC indicated that they conducted ESG due diligence on all of their targets, while another 28 percent reporting performing ESG due diligence on more than half of their targets.

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Nevertheless, the KPMG survey found that, among U.S. buyers, 56 percent reported that selecting a meaningful, yet manageable scope of focus for ESG considerations was one of the main challenges in ESG due diligence. Further, 59 percent of U.S. buyers cited a lack of robust data or written policies at the target as a challenge. These findings suggest that many acquirers still have remaining work to meaningfully integrate ESG considerations into the due diligence process.

On the valuation side, the KPMG study found that many acquirers attach a premium to targets with strong ESG profiles; so, one can deduce that many acquirers will conversely discount — or walk away from — companies they perceive to be ESG laggards. For instance, a Deloitte publication described an energy client that, after discovering that a potential target had been overstating the percentage of its revenue and customer base tied to clean energy, ascertained that the target's decarbonization roadmap would cost around $300 million, making the valuation assumptions unworkable and leading the buyer to abandon the deal.

Financing the Deal and Obtaining R&W Insurance

Even if an acquirer finds a target with an ESG profile that suits its risk tolerance or inorganic strategic priorities (regarding scale, sector, profitability, price, etc.), it could face financing challenges.

With the formation of the Net-Zero Banking Alliance and large European banks pledging to stop financing certain fossil fuel companies, companies may find it more difficult to finance acquisitions of targets with challenged ESG profiles, possibly increasing the cost of capital to execute transactions that are not purchased outright in cash. The KPMG survey underscores this phenomenon: 76 percent of debt providers for M&A deals indicated that, although they often proceeded with financing or underwriting a deal in spite of negative ESG-related due diligence findings, they sometimes added more conservative conditions in the financing terms.

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Conversely, targets with robust or positively differentiated ESG profiles may allow for easier access to capital. For example, the European Green Deal has pledged €1 trillion in sustainable investments over the next decade, the Biden Administration has launched a $20 billion investment in clean energy projects, and both will likely foster M&A deal activity with an emphasis on ESG-related factors. Green bonds can also provide an additional source of low-cost capital for sustainability-related deals.

ESG factors can also affect R&W insurance, in terms of both cost and availability. R&W insurers are increasingly covering ESG claims, with 32 percent of respondents to a 2022 Lowenstein Sandler survey reporting claims related to breaches of ESG representations in purchase agreements. As acquirers continue to ramp up due diligence on ESG matters — and as the number of claims related to breaches of ESG matters increases — obtaining R&W insurance could become more expensive.

Negotiating Terms and Closing the Deal

ESG factors can have implications for negotiations and deal closings. For example, based on findings from ESG due diligence, parties may seek to alter the transaction agreement to account for more robust R&W and indemnification, interim operating covenants, closing conditions, or adjustments to the purchase price and restructuring of the transaction itself (such as preclosing disposition of certain risky assets, creative deal structuring, or contingent consideration). According to the PwC survey, 39 percent of private equity respondents reported that their firm modified the purchase agreement — and 12 percent reduced the purchase price — due to identified ESG factors.

In some cases, however, negative ESG-related issues found in due diligence may cause the companies to seek renegotiation on the deal terms and the parties may not be able to reach a mutually acceptable resolution; in other cases, the issue may be so fundamental that it blows up the whole deal immediately. The KPMG survey found that deal abandonment was the most common consequence of a significant negative ESG finding during due diligence.

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Integrating the Acquisition — or Establishing a Strong Standalone Company

After closing, the strategic buyer will have to contend with reconciling the ESG policies and procedures of the newly acquired company, or require it to adopt the parent's policies and procedures. To ensure cohesiveness in ESG matters, the acquirer should review the ESG policies and procedures of the target well in advance of closing, and begin preparing to integrate the target within a set period of time post-closing. Proper oversight by the acquirer's board of directors is an important part of its duties to the company and its stockholders, and ensuring that any acquired company's risks and deficiencies are being appropriately mitigated, including by adoption of new policies or procedures, is a critical step in the M&A process. Depending on the magnitude of the acquisition, the acquirer's board may require ongoing reports on key ESG risks and opportunities identified by the deal team.

The parent company should take caution to ensure that the acquired company is following appropriate ESG practices and policies, but post-closing ESG liabilities can also flow to a parent if the separation of legal structures is not properly adhered to.

For a cautionary tale of integration gone wrong, consider Marriott International Inc.'s ("Marriott") $13 billion acquisition of Starwood Hotels & Resorts Worldwide ("Starwood") in 2016. In 2018, Marriott announced a data breach that exposed highly sensitive records of millions of guests and greatly harmed the company's reputation. Starwood's guest reservation database had been breached in 2014, before the deal, but the breach was not discovered until 2018. Two years after the acquisition, Marriott had still not migrated Starwood into its own reservation system, and the former Starwood hotels continued using legacy Starwood IT infrastructure, which Starwood employees had known to not be secure. Marriott had terminated much of Starwood's corporate staff following the acquisition, including those charged with managing Starwood's IT and security, so few remained who were aware of, or could deal with, these issues that should have been addressed sooner.

Separately, many acquisition targets are smaller and less sophisticated than acquirers, so while they may have positive ESG attributes that make them appealing to an acquirer, they often will have more nascent controls processes in place related to product claims, codes of conduct, risk management, and other issues that would need to be addressed soon after an acquisition. Additionally, for public company acquirers of privately held entities that may have had lower visibility pre-deal, care should be taken to identify and address any potential regulatory, litigation, and reputational threats attributable to the target.[1] These threats are often magnified once an acquired company becomes a part of a more established company that is perceived to have deeper pockets or is a more newsworthy target for ESG shareholder activism. Overseeing a corporation's reputation is a key responsibility of its board, so notable reputational risks in impactful deals should also be elevated to the acquirer's board before signing.

For private equity deals, the resulting acquisition typically leads to a standalone portfolio company that is often wholly owned, rather than the integration of a target into a parent company. The parent company should take caution to ensure that the acquired company is following appropriate ESG practices and policies, but post-closing ESG liabilities can also flow to a parent if the separation of legal structures is not properly adhered to.[2] Adequately identifying ESG risks and opportunities during due diligence and addressing them post-closing are therefore important steps for private equity buyers.

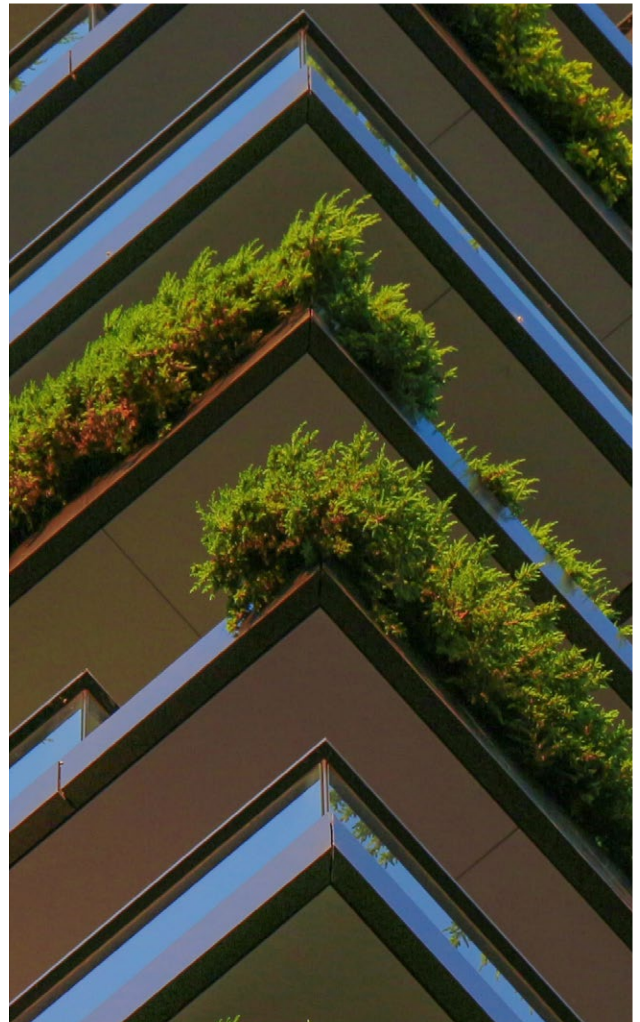
Reading the Risks and Planning Accordingly

Properly executed, M&A can help acquirers purchase assets that enhance their ESG profiles. However, a transaction process that fails to properly identify, assess and manage ESG risks can dilute the value of the acquired business and can cause a significant drag on the acquirer itself. Take, for example, Bayer AG's 2018 acquisition of Monsanto, the maker of Roundup (an herbicide). Within weeks of closing the $63 billion acquisition, Bayer lost a lawsuit alleging that Roundup causes cancer, and was ordered to pay damages totaling more than $190 million.

Bayer's legal woes linked to the Monsanto acquisition have only continued: As of December 2022, it had paid approximately $11 billion in settlement agreements linked to Roundup lawsuits, and legal challenges for the company remain. Bayer is also facing a $2.5 billion class action lawsuit by its shareholders, for allegedly making false and misleading statements to investors about the extent of its pre-acquisition due diligence. Regardless of the merits of the suit, Bayer seems to have misread the extreme level of risk, financially and reputationally, that the acquisition would pose.

Failing to understand the relevant ESG factors in an M&A transaction can lead to catastrophic results, and thus properly identifying and assessing these factors is critical for accurately valuing a target and integrating it post-closing (or, for a private equity acquisition, establishing a strong standalone portfolio company).

Please contact Vinson & Elkins if you have any questions about how to structure ESG considerations into your M&A evaluations, mitigate related risks, and capture ESG opportunities associated with your completed transactions.



Endnotes

1 When a newly acquired company has reputational or other issues, leading raters such as MSCI and Sustainalytics sometimes lower the ESG scores of the company that acquired it, even for ESG deficiencies that occurred before the acquisition. If ESG raters and resulting access to capital considerations associated with an M&A transaction are of relevance to your company, please consult with your Vinson & Elkins team, as we have significant experience in this area.

2 Veil-piercing concerns may arise when private equity firms too closely dictate the day-to-day management of the acquired company's ESG program and performance, so it is important to maintain the appropriate level of *oversight* that typically comes with some level of portfolio board representation, but *not day-to-day management* of these portfolio companies' ESG programs.

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