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An ESG Playbook for Post-Pandemic M&A

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As boards and management teams assess the economic impact on their businesses due to the Covid-19 pandemic, many are beginning to focus on what will come next. How will businesses increase revenues, profitability, and share price during what may be an extended period of potentially low growth? In some cases, the answer will be an acquisition that increases shareholder value, growth and revenue.

In assessing the appropriateness of any acquisition activity in the post-pandemic environment, boards and management teams at both potential targets and prospective buyers will need to consider environmental, social, and governance (ESG) factors in addition to strategic and financial goals.

Although ESG factors have influenced corporate decision-making for years, these issues are becoming more pervasive. Social media, social activism, an emphasis on structural and operational sustainability, and socioeconomic volatility have increased the level of ESG focus in internal deliberations. Against this backdrop, the growing impact of ESG on M&A dealmaking is both inescapable and undeniable.

M&A as Growth Driver

In the current environment, regulators are signaling that they will view increasing dividends or buying back shares as inconsistent with government efforts to provide liquidity and stimulus to the markets. Given the absence of these levers to influence share price and the challenges to organic growth, we expect that inorganic growth will become a key driver. For most companies, that will mean synergistic acquisitions.

With a renewed focus on M&A, boards and management teams will continue to address financial and strategic objectives, but also to fill gaps and vulnerabilities that the pandemic has exposed. They will also want to become stronger competitors in their respective sectors, either by acquiring smaller competitors or by acquiring new assets and technologies.

ESG Impacts on M&A

In significant ways, market participants are still refining their approach to ESG when evaluating M&A deals. Given the breadth of topics under the ESG banner, shifting priorities and evolving market standards around them, and the challenges of assessing the ESG risks and rewards associated with a particular transaction, decision-makers may struggle to develop a playbook for how and to what extent ESG should impact a deal decision.

We address five categories of key issues that dealmakers factor into an ESG playbook for post-pandemic M&A:

- Selection of targets
- Due diligence
- Valuation
- Deal financing
- Integration, corporate governance, and other post-closing considerations.

Selection of Targets

ESG Target Profiles

Buyer consideration of ESG issues when selecting a potential target is not a recent development. Dealmakers have traditionally ascribed weight to issues such as a target's long-term strategy, risk profile, human capital management, and industry and public reputation under the umbrella of "cultural fit." However, the recent increase in public and investor attention to ESG issues has heightened the focus on these issues in the M&A context.

Recent surveys confirm that senior executives at corporations, private equity, and asset management firms consider ESG an important factor when evaluating an M&A investment target. They also believe that given the public and investor attention to issues such as human and social capital management due to the pandemic and other recent events, ESG will become even more important in M&A decision-making in 2021.

ESG Halo Effect

Supplementing existing deficiencies has historically ranked among the top drivers of M&A activity, both for strategic buyers and sponsors. It is not surprising to see dealmakers apply the same principle to ESG. In this environment, if a company is looking to be acquired and can effectively highlight its ESG strengths, it stands to improve its negotiation leverage and potential valuation markedly vis-à-vis a buyer that is seeking to mitigate existing ESG liabilities or enhance its own ESG competitiveness.

In the last two years, a number of high-profile asset managers have absorbed ESG-focused funds to diversify their portfolios and amplify their management capabilities. Recently, the market has also seen strategic buyers—in particular in the energy and manufacturing sectors—consciously and aggressively pursue targets with attractive ESG prospects, such as companies that offer sustainable energy innovations, green manufacturing technology, or brand images associated with positive ESG impacts. This phenomenon may become more pronounced if there is consistent evidence that ESG-focused investing improves financial performance and shareholder returns.

Risky ESG Profiles

Besides the potential to create upside, evaluating ESG when vetting a potential target is an important component of predicting the market reaction to, and share price impact of, a deal. A number of deals have unraveled in the public eye as a result of a corporate scandal or some other ESG-related incident at the target or in the target's industry. As a result, many prospective buyers are eager to avoid the reputational hit—as well as investor and public backlash—of being associated with a risky ESG investment. On the flip side, buyers with experience managing portfolio companies' ESG performance, particularly private equity funds, may want to acquire a poor ESG performer at a depressed price, then use their expertise to amplify the transaction upside.

Increased Focus on ESG Management

Attention to ESG management is intensifying due to scrutiny from investors and other constituencies. According to the Forum for Sustainable and Responsible Investment's 2018 report, many asset managers and institutional investors are now actively seeking to reduce or avoid assets with poor ESG profiles. The effect has been a 38% jump in the total size of U.S. assets invested using ESG principles from 2016 to 2018.

More recently, Morningstar reported that net flows into ESG funds that are available to U.S. investors totaled approximately $21 billion in 2019, representing almost a 400% increase over the record set in 2018. In addition, many asset managers have cut investments in industries such as tobacco, coal, and firearms across some or all of their funds. Where portfolio companies include manufacturers and retailers in those industries, major institutional investors such as BlackRock have stated that they will actively engage with such companies on their business practices and ESG risk management, while others—including StateStreet—have announced that they will factor ESG performance into voting decisions.

A number of pension funds, including large public pension funds such as the California State Teachers' Retirement System, have expressed support for corporate sustainability and developed dedicated units that focus on ESG investments. However, there may be limitations on the circumstances under which certain pension funds—in particular fiduciaries of ERISA-covered plans—may use ESG factors in investment decisions and strategies.

With respect to selecting an M&A target, it will be essential to anticipate ESG concerns in deal rollouts and consider how to effectively address these concerns in investor communications and messaging to other constituencies—such as employees and regulators, who are also likely to closely scrutinize the ESG implications of a proposed transaction.

Due Diligence

Core Component of M&A Process

Today, ESG due diligence is a standard component of the M&A process, with ESG inquiries becoming more and more robust over the years. A thorough investigation of a target's ESG profile is important not only in anticipating the reputational implications at deal announcement, but can also help a prospective buyer more accurately assess the extent of post-closing integration issues. These can include the feasibility of, or the amount of resources required for, remediating compliance issues and other ESG risks.

Recent data suggests that the results of ESG due diligence can often be outcome-determinative, with many company executives stating that they have walked away from an investment or M&A target due to a negative assessment of ESG issues at the target.

Shift in Topics

M&A dealmakers have long recognized the importance of conducting due diligence on certain ESG topics that can materially impact a target's capital and operating expenditures, operational capability (including in connection with workforce and regulatory compliance issues), future growth trajectory, and brand image. These topics include environmental liability and oversight, employee-related liability and business continuity risks, supply chain risks and policies (such as human rights and labor standards policies and compliance), consumer protection, product safety, and data privacy.

While these issues already comprise a notable portion of the questions on a typical M&A due diligence request list, current events are expanding the scope and depth of typical inquiries on those issues. Covid-19, for example, has highlighted the potential risks associated with relying on non-diversified offshore sourcing of materials in the face of widespread disruption to international travel and manufacturing. Many prospective buyers may also be more attentive to issues of diversity and inclusion in the workforce and have greater sensitivity to potential human capital management incidents in the target's past.

New Look at Traditional Due Diligence

For years, companies have faced shareholder and public pressure to adopt executive compensation packages that include sustainability targets as a component of performance-based pay, with shareholder proposals on this topic gaining greater traction. In response, some companies have adopted incentive awards that factor in ESG performance metrics. According to a survey of 135 companies conducted in 2019, 30% of respondents incorporated ESG considerations into their incentive awards, with an additional 21% considering taking similar steps in the future.

When reviewing a potential target's existing compensation structure, prospective buyers should check whether ESG criteria factor into the target's employee incentive plans, and if so, the prospective buyer should make sure to explore:

- How ESG criteria are assessed under the current plans
- Challenges the target experienced in administering an ESG-linked incentive award—for example, the need to focus on aspects of ESG performance that are more quantifiable or objectively verifiable, or challenges in reaching consensus on the prioritization of ESG metrics
- The target's reasons for adopting and maintaining these plans and the reactions of employees, investors, proxy advisers, and others to the plans
- Whether it would be feasible or desirable to replicate this aspect of the target's compensation practice post-closing.

Similarly, in conducting regulatory due diligence, prospective buyers should consider how relevant regulators will likely view the ESG implications of a potential transaction. In certain jurisdictions, and with respect to targets in certain industries, regulators will scrutinize the prospective buyer's ESG profile or the transaction's likely ESG impact. For example, the Committee on Foreign Investment in the U.S. (CFIUS) will scrutinize investments that may pose a threat to national security.

In addition, effective February 2020, the Foreign Investment Risk Review Modernization Act (FIRRMA), clarified that CFIUS's jurisdiction extends to foreign investments in U.S. businesses that involve critical technologies, infrastructure, or U.S. nationals' personal data, since the foreign investor could gain access to material non-public information or have substantive influence over the U.S. target's decision-making in these sensitive areas.

The focus of CFIUS and similarly situated regulators are often impacted by current sociopolitical events, therefore it is important for prospective buyers to monitor the focus areas of such regulators and understand how pressure from political actors and other stakeholders may impact their decision-making process and timeline.

In Canada, the U.K., and certain other European jurisdictions, for example, regulators will consider, and may require a prospective buyer or investor to make representations or commitments regarding, post-closing plans for a target's stakeholders in connection with the approval of a foreign investment.

For example, under the Investment Canada Act, the relevant minister will evaluate whether a proposed transaction has a "net benefit" for Canada before approving it—evaluating factors such as impact on economic activity, employment, innovation, product variety, and compatibility with national industrial, economic and cultural policies. Furthermore, a prospective buyer may need to make undertakings to maintaining workforce of a certain size and at a comparable level of compensation, continuing operations in certain locations, and/or adhering to certain environmental, social, or governance practices.

In some cases, transactions may be reviewable even after closing if the acquired business or assets are in particularly sensitive sectors. For example, under the Investment Canada Act, where a proposed transaction concerns an investment in "cultural businesses," i.e., businesses in publishing, media, and similar sectors, the Canadian government has broad discretion to conduct a post-closing review.

ESG Performance Assessment Challenges

Several key factors make it difficult to gain a complete and accurate picture of a potential target's ESG profile through a traditional due diligence process. First, given the amorphous nature of ESG, which spans issues that range from operating model, regulatory compliance, and supplier management to climate change, sexual harassment, and community impact, many aspects of a target's ESG profile are inherently difficult to assess.

In a June 23, 2020 interview, Securities and Exchange Commission Chairman Jay Clayton reiterated certain challenges to assessing the potential impacts of ESG issues, specifically highlighting the fact that many ESG issues are not easily quantifiable and forward-looking, and implicate assumptions that may be subject to greater flux than those involved in traditional financial analysis.

Although Clayton spoke in the context of issuer disclosures, these factors also present obstacles to ESG due diligence in the context of M&A. For example, whereas a prospective buyer may be able to estimate the costs associated with a potential target's environmental litigation or regulatory compliance obligations, it may be impracticable to quantify the target's potential long-term gains from ESG initiatives that aim to serve the communities where the target operates with the level of reliability that can translate into value transfers in the M&A context. Also, a groundbreaking ESG initiative that has garnered initial success could become a liability overnight due to a sudden shift in the sociopolitical environment.

For example, in early 2019, a utility company known for its sustainable practices declared bankruptcy after allegations arose that it was complicit in California's wildfires. Often, the collection of consistent and reliable data is the key obstacle in assessing ESG at portfolio investments or target companies. In many cases, this problem is exacerbated by the target company's lack of responsiveness to the investor's or the prospective buyer's ESG concerns, and an unwillingness on the part of target management to devote adequate attention and resources to the exploration of ESG issues.

Management may be able to increase a company's attractiveness as a potential target by highlighting a track record of proactive investor engagement on ESG, and may be able to alleviate a prospective buyer's concerns during due diligence by making the appropriate team members available to respond thoughtfully to reasonable inquiries regarding the target's ESG risks and oversight.

Beyond Traditional Due Diligence; ESG Standards

A prospective buyer may need to conduct a deep dive of news, social media, sustainability reports, ESG scorecards, and other public disclosures, both from the target and other constituents. However, the current lack of standardized ESG disclosure requirements or universal ESG auditing framework in the U.S. means that the ESG metrics contained in a target's ESG disclosures (if any) may be subjective, making it difficult to compare across different companies in the same industry or even assess the same company's performance across the years.

A growing number of standard-makers, such as the Sustainability Accounting Standards Board, have developed frameworks aimed at quantifying ESG risks and increasing the comparability of ESG performance across different industries.

Whether or not a potential target subscribes to a particular ESG disclosure framework, it might be helpful for a prospective buyer to consider the main ESG issues highlighted by these standard-makers with respect to the target's industry in designing its due diligence process. Monitoring changes in these standard-makers' frameworks and in public statements from these organizations could also be a useful way of tracking shifts in the top priority ESG issues, which often evolve rapidly in connection with current events. Prospective buyers should also consider, in light of the level of in-house expertise and the spectrum of ESG issues likely to be implicated, whether or not it makes sense to engage a due diligence vendor and/or other advisers with specialized ESG expertise in the target's industry or line of business.

Valuation

Quantifying Impact

Understanding the pro forma ESG impact of a proposed deal is important, but quantifying the impact of ESG can be challenging. In 2020, M&A dealmakers almost universally acknowledge that ESG impacts valuation. A prospective buyer's positive assessment of ESG factors may increase valuation substantially while a negative assessment can sometimes lower valuation significantly, if the prospective buyer is not deterred from a deal altogether.

However, the same factors that make ESG due diligence challenging also impose challenges on accounting for the impact of ESG in deal valuations. With ESG integration into financial analyses still at a nascent stage, it can be especially difficult to quantify the potential upside of a transaction due to ESG factors. In many cases, attempting to quantify ESG factors becomes a referendum as to the credibility of management's long-term strategic plan and forecasts.

Transparency

If a prospective buyer can make a convincing argument that there are serious and long-term ESG issues plaguing a target company, the target's shareholders may support the prospective buyer's offer even if management believes the offer undervalues the company.

The presence of long-term ESG underperformance or a persistent lack of transparency on important ESG risks can be extremely detrimental to a company's relationship with its shareholders, especially long-term institutional investors who are not able to nimbly exit investments. Given that many institutional shareholders now highlight a lack of responsiveness to their expressed ESG concerns as a reason to vote against directors at a portfolio company, a potential target may have a hard time resisting an unsolicited bid if investors feel that the current company leadership has not adequately addressed their ESG concerns.

In such circumstances, investors may lose faith in company management's ability to deliver on long-term value, and may be more likely to support the bidder, especially if the bidder has a plausible long-term strategic plan and a reputation for ESG-related expertise.

Emerging Trends

It is important to monitor emerging trends, especially at companies with similar ESG risk profiles as the target. ESG can influence dealmaking norms in ways that affect overall deal valuation. For example, because of the #MeToo movement, many M&A agreements now include a provision requiring the target to disclose any sexual misconduct allegations or settlements pre-closing and providing the buyer with remedies for any such allegations that arise post-closing.

Deal Financing

ESG Contingency

Availability of financing may be contingent on ESG issues. Sustainability-linked loans are on the rise, with lenders requiring borrowers to measure, report on, and meet certain agreed ESG performance metrics. Major rating agencies such as Moody's and S&P have also begun to incorporate ESG factors in their ratings reports.

A number of private funds are now targeting ESG-friendly investments to satisfy their investment criteria, which means that more private capital may be available to finance deals that have ESG-enhancing profiles. On the other hand, prospective buyers may face higher costs of financing and lower access to capital if they have consistently poor performance based on the ESG factors considered by rating agencies, or if they operate in certain high ESG-risk industries, such as coal. In some cases, companies in these circumstances may need to rely on stock deals or be out of the market.

Integration, Corporate Governance, and Other Post-Closing Considerations

Post-Closing Integration

In addition to liability exposure and valuation impact, ESG factors can, and often do, affect the extent to which a buyer will realize projected synergies and smoothly navigate post-closing business operations. ESG risk factors identified in due diligence will, in many cases, continue to be relevant after closing, and new ESG risk factors may arise as well. Therefore, where possible, it is important for the buyer and target to work together closely through the integration process to design corporate governance, risk oversight, and operational strategies and frameworks that ensure ongoing, appropriately rigorous monitoring of ESG issues.

Stakeholder Buy-In

Stakeholder buy-in is more important than ever. In planning for post-closing integration, buyers should pay special attention to crafting deal-related communications that generate buy-in from all stakeholders, not just shareholders. If possible, the buyer should work together with the target's management team to understand the composition and needs of employees, customers, vendors, impacted communities, media, regulators, and other key constituencies.

Getting to know these stakeholders and being sensitive to their concerns will, among other things, help the buyer construct messaging that resonates with each group. This in turn may help the transaction avoid resistance from regulators, become mired in political battles or social media discourse, or inflame protests from community groups. The need for stakeholder buy-in is particularly important in an election year and as a result of the socioeconomic issues highlighted by the pandemic.

Post-Closing Corporate Governance

Another important aspect of integration planning is setting up a leadership structure that is best positioned to run a successful business post-closing. In addition to the skills and experiences on the board and in top management roles, buyers should think about ESG competencies in designing a post-closing corporate governance structure.

For example, in stock-for-stock, merger-of-equals transactions, the selection of directors from each company to populate the combined company board should take into account the ESG needs of the combined company, as well as any gaps in ESG expertise—e.g., human rights, sustainability, cybersecurity—at either company, which may be filled by a director from the other company, or by recruiting an outside director.

In many cases, to achieve post-closing success in today's environment, not only will company leadership need to include those individuals who have the institutional knowledge to ensure business continuity, it is also important to have a board and C suite that represent and inspire the company's workforce, as well as the communities the company plans to serve and/or operate in, either presently or in the future. To that end, it may be beneficial to review—and if appropriate, enhance—diversity recruitment and retention policies at the board, executive and general workforce levels.

Private Equity Firms

Private equity firms will need to balance long- and short-term objectives. In deals with a private equity buyer, an important topic that impacts the alignment between the buyer and any continuing management from target with respect to post-closing operations is the horizon of the ESG strategy. Private equity buyers typically hold investments for five to seven years before exiting.

It may take a management team a substantial amount of time to turn ESG performance around, and the length of time required to achieve the anticipated ESG changes, and enjoy the related benefits, may be meaningfully extended due to unforeseeable circumstances. In considering post-closing business strategy, a private equity buyer should factor in the possibility that it may need to divest segments or business lines that are persistently poor ESG performers in order to meet investor demands.

Conclusion

We may see an increase in M&A as a tonic to slower growth. With increasing attention to ESG issues, we also expect to see deeper scrutiny of the environmental, social and governance dimensions of acquisition targets. This article provides guidance for how and to what extent ESG could impact a deal decision.