ESG – A hidden Gem in M&A?

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Recent business news report AstraZeneca to be the future winner of the vaccines race because it, unlike other producers, considers its delivery of vaccines to developing countries to fulfill its Environmental, Social & Governance (**ESG)** goals. We can surely say that ESG awareness is not a temporary trend but is an investing strategy that is here to stay. This has become all the more clear as the pandemic has even heightened our sensitivity to underexposed ESG factors. These include the importance of the workforce's well-being, good supply chain management and interaction with local stakeholders—a fact that has not escaped M&A dealmakers in general, especially PE players.

The many shapes and forms of ESG

In M&A deal making, parties would have been closely monitoring the usual ESG factors such as sustainability, anti-corruption and bribery, regulatory compliance, privacy and data security, and diversity for a while now. Lately, we see these ESG factors extend to the target's performance in the areas of labor practices, workers' well-being, handling and preventing sexual harassment at the workplace, stakeholder relations, and human rights. This ESG-factor extension certainly does not come as a surprise since it is clear that ESG performance impacts every stage of an M&A transaction.

ESG performance should not be seen as only a risk factor because having a good ESG rating is certainly a unique selling point for the seller. On the other hand, having poor performance in certain key ESG factors can materially affect the purchase price. We've seen assertive bidders trying to push the price down by relying on the reported poor ESG performance of the target. However, the opposite is also true: the seller might not even want to consider a buyer's bid because of the buyer's lack of ESG awareness.

The common practice is to examine the usual ESG factors when conducting the due diligence of the target's business. The standard representations & warranties given in relation to legal, regulatory, environmental, and labor matters indeed protect a buyer against key ESG risks to a great extent. It is vital for both the seller and buyer to identify ESG risk factors early because they could eventually turn into financial liability consequent to regulations or to reputational damage.

At the later stages of an M&A transaction, ESG performance should continue to be a priority item on the agenda. For example, it will undoubtedly be challenging to integrate a low ESG-rated target into a buyer's business. Therefore, successful buyers should work and communicate diligently on the target's integration. Otherwise, they run the risk of losing their credibility as an ESG stronghold and have their reputation damaged. Conversely, low ESG-scoring buyers could "greenwash" and "social wash" their image through the acquired companies.

ESG is also rapidly making its way into the boardroom as main areas of focus. In Belgium, corporates with more than 500 employees must report on ESG performance in their annual report. For some larger corporates, there is even a recommendation to link executive pay to ESG-related KPIs. Also, the duty of a director to always act in the corporate interest is being shaped by ESG factors. This certainly calls for the corporate interest to cover the interest of a broad range of stakeholders.

Last but not least, good ESG performance does drive value and stock prices upwards. Moreover, ESG performance will soon impact parties' access to capital because many financial players must report on their consideration of ESG performance when making investment decisions.

How rare is that gem?

For now, it is quite a challenge for market players to assess and compare a company's ESG performance because common ESG reporting standards simply do not exist yet. But there are a myriad of organizations providing reporting standards voluntarily. These include rating agencies, stock exchanges, and many NGOs.

The lack of common reporting standards makes it hard for one to interpret mandatory and voluntary ESG disclosures. This is indeed a current problem that could be resolved in the near future, as the EU is looking into developing a common reporting standard. The IFRS Foundation intends to do the same globally.

Is it a nice-to-have or need-to-have?

The relative importance of ESG will certainly increase in the future. For now, a good ESG score is primarily a huge competitive advantage. But all this can change if a certain ESG-performance level becomes mandatory, thus possibly tipping the scales from being a nice-to-have for some to a need-to-have for others.