February 18, 2020

The Coming Impact of ESG on M&A

Recent months have seen institutional investors and other stakeholders, notably BlackRock and State Street, stressing the importance of comparable and decision-useful ESG disclosures by their portfolio companies. Such calls follow in the wake of growing interest among investors and other stakeholders in understanding and assessing the performance of companies based on ESG metrics. While the exact system by which companies will report on ESG issues remains to be determined by the market, it is clear that beginning in 2020, and in the years to follow, companies will be disclosing significant amounts of quantifiable information on a basis that will permit comparisons within and across industries. This information will be used by companies, investors, asset managers and other stakeholders in making real-world business decisions, including decisions relating to M&A.

The impact of the growth in ESG disclosures on M&A cannot be underestimated. In the near-term, ESG performance will be incorporated into company valuations and risk assessments, and acquirers and targets will be expected to factor in ESG performance when evaluating the impact of potential transactions. All aspects of M&A will be affected; a few are highlighted below:

Selection of Targets and Business Partners. ESG factors can be expected to increasingly influence how companies select potential targets and business partners. There is growing recognition of new business opportunities across industries and that partnering with companies with strong ESG profiles, such as businesses focused on renewables or which have a strong record of innovation, can enhance a company's ability to deliver long-term sustainable value to its stakeholders. It is expected that Fiat Chrysler's pending merger with Peugeot will help the company avoid a potential $2 billion in European carbon emissions fines. Meanwhile, Mitsubishi and Japanese utility provider Chubu Electric Power Co., Inc. beat out Royal Dutch Shell to acquire sustainable energy utility company Eneco last year. Similarly, and perhaps as a harbinger for other industries, several mainstream asset managers have acquired ESG funds in recent years in order to expand their scope, capacity and expertise in the field.

As ESG disclosure practices become more ingrained in public company practice, those companies able to showcase their capabilities in this regard stand to gain a competitive advantage and potentially demonstrate attractiveness to acquirers looking to develop or supplement their own capabilities. Similarly, consolidation to achieve or enhance scale can be expected to continue within sustainability-focused industries. In some industries, new sub-industries will be created, such as those catering to managing assets with specific impact goals tied to ESG or monitoring and indexing ESG performance. Boards will need to consider, in addition to the pro forma earnings impact of potential transactions, the pro forma ESG impact of potential transactions. To the extent that higher ESG scores remain consistent with higher stock prices, larger, more efficient companies, and those that have been at the forefront of ESG practice, may be able to utilize their ESG expertise to acquire a "lower" performer as part of a transaction.

Due Diligence. ESG will continue to be an increasing concern in transaction due diligence. Certain key ESG risks—notably, risks related to corrupt business practices, privacy and data security, climate change, greenhouse gas emissions, diversity and labor practices—are already being evaluated in the context of M&A due diligence, as is the more general consideration of the potential impact of an acquisition on the reputation, culture and integration of the combined company. The addition of so-called "Weinstein Clauses" requiring targets to disclose allegations of sexual misconduct among senior executives further reflects this growing consciousness.

Governance and Integration. In the M&A context, the consideration of ESG factors and related metrics and the broader concepts of stakeholder governance and corporate purpose are entirely consistent with traditional conceptions of directors' duties. A company's broad positioning on ESG matters, including its policies and approaches and its quantifiable successes and failures in managing sustainability, human capital and other ESG concerns, will prove insightful into a company's culture, and an important determinant of whether it is a suitable target or partner. Similarly, companies with noticeable differences in their ESG performance will need to consider whether such differences would hinder their ability to fully realize expected synergies from a potential combination, or otherwise increase integration challenges.

Reactions of Shareholders/Stakeholders. Investors, shareholders and other stakeholders are increasingly scrutinizing a company's ESG performance. Major asset managers such as BlackRock and State Street have already indicated that their investment decisions will be driven by ESG performance, and have gone so far as to design products and offerings that exclude investments in certain industries. Investors' drive to obtain actionable comparative data will also underpin future efforts to tie voting decisions to management of ESG issues. Going forward, companies will need to consider how to address the concerns of their stakeholders in transaction rollouts, investor presentations, press releases and at analyst meetings. Boards and management will need to demonstrate how ESG concerns have been handled in connection with M&A decisions, and be prepared to engage proactively with stakeholders on such matters.

Financing. Lenders have already seen the potential impact of significant ESG risks (both long term, such as the coal industry, and acute, such as PG&E) on the creditworthiness of businesses and industries. Over time, companies may find their cost and access to capital increasingly tied to their ESG performance. There is recognition that not all ESG metrics will have the same or even any impact on rates, but widespread availability of comparable data will allow lenders to determine over time which metric is most likely to be material.

***

The full ramifications of the global push for ESG disclosures are still to be fully seen, particularly as companies and their investors and other stakeholders, as well as regulators, continue to assess and revise their approach. Disclosure practices and frameworks are actively evolving, and as the market standardizes we expect new datasets will impact capital allocation and operational decisions. We will continue to monitor ongoing developments in this field.

Andrew R. Brownstein
Steven A. Rosenblum
David M. Silk
Mark F. Veblen
Sabastian V. Niles
Carmen X. W. Lu