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Go Green or Go Home: ESG's Increasing Impact on M&A in the UK and Europe

June 22, 2023

Environmental, social and governance (ESG) has become a megatrend in mergers and acquisitions and is here to stay. ESG itself is a wide capture-all definition, with "E" recognised as relating to environmental matters (such as climate change, pollution and use of fossil fuels and renewables). "S" primarily includes social issues such as diversity and inclusion, the gender pay-gap, human rights and modern slavery. "G" is for corporate governance issues, such as anti-money laundering, bribery, corruption and cybersecurity.

In recent years, ESG's importance in M&A has grown exponentially — its impact ranges from the availability of capital and deal value, as investors come under increasing pressure to invest responsibly and remain competitive, to regulatory intervention, as governments tackle ever-changing public opinion and awareness in this area.

From a deal perspective, ESG has become increasingly prevalent in the life cycle of a typical transaction, from target screening and due diligence to post-closing synergies. With the UK, mainland Europe and the US committed to being climate-neutral by 2050, dealmakers and professional service firms are now increasingly expected to keep ESG at the forefront of their minds. We discuss below some of the key impacts this vast topic has had on M&A.

Macro changes mean more awareness of ESG issues

- The general public is becoming more ESG-conscious and with the next generation now entering the workforce, consumer habits are undoubtedly going to be increasingly led by environmental and other ESG concerns.
- According to Morningstar, assets under management in funds that invest according to ESG principles crossed the $1tn line in 2020, demonstrating the seismic shift to forward-thinking ESG strategies attracting new capital. No doubt, ESG-conscious consumers have played their part in these figures, even by simply ticking the box for ESG sustainable investing in relation to their pensions and ISAs.
- The result of these macro-shifts is innovative new businesses increasingly focused on ESG; whether in the oil and gas industry or the banking industry, start-up businesses are disrupting how traditional business is done. For example, Tred is a start-up company introducing the UK's first 'green' debit card that "*plants trees as you spend, and tracks your carbon footprint*".

Industry response to increased ESG awareness

- In addition to start-ups, established market participants are also shifting focus to improve their own ESG profile, whether through acquisitions of innovative start-ups, supply chain testing or simply re-calibrating their business model to attract new investment. For example, in 2020, Boohoo Group Plc's share price plummeted once news broke of its ill-treatment of staff in its Leicester supply chain earlier that year. This led to institutional investors reassessing their commitment to the company, with the likes of Aberdeen Standard Investments selling the majority of its shares. Retailers, such as Next, ASOS and Amazon, all removed Boohoo clothing from sale. Since then, Boohoo has publically pledged to improve its supply chain and work on responsible purchasing practices, sustainability, and ethical compliance. Moreover, Boohoo's suppliers now need independent approval on their sourcing and ethical compliance.[1]

[1] Fashion Network, "*Boohoo still faces challenges as supply chain report series completes*", Nigel Taylor, 9 March 2022.

- Governments are increasingly driving change through increased regulation and disclosure requirements. UK legislation sets down specific requirements under the Modern Slavery Act 2015, the Equality Act 2010 and the Bribery Act 2010. The UK Government's Transition Plan Taskforce's disclosure framework is aiming to build on the global Task Force on Climate Related Financial Disclosures currently required by law in ten countries. Certain financial institutions and listed companies will have to publish transition plans detailing how they will decarbonise as the UK moves towards a net zero economy by 2050.

- More widely, the European Green Deal is a set of policy initiatives aimed at making the EU climate neutral by 2050. For example, the Sustainable Finance Disclosure Regulation (SFDR) covers how sustainability should be tracked and disclosed and applies to asset managers, financial advisers and insurance providers. The EU Taxonomy is a classification system referred to in the SFDR that establishes a list of environmentally sustainable economic activities which aim to create clarity and consistency for investors so that they could easily compare the environmental performance and impact of companies and funds to inform their financial decisions. The UK Government has committed itself to bringing the EU Taxonomy onshore in the coming years.

- Companies are also able to obtain ESG credentials by registering as a certified B-Corp, certificated by B-Lab (a non-profit network). In order to be recognised as a B-Corp, a company must demonstrate a commitment to high standards of social and environmental performance and transparency, benefiting all stakeholders as opposed to just maximising profits for shareholders.

- For directors of English companies, it follows that ESG-related matters must now be considered as part of their duties under the Companies Act 2006. Section 172 of the Companies Act requires a director to act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard to, amongst other things, the impact of the company's operations on the community and the environment — clearly, this is an area where the ESG impact of a company's activities is relevant.

ESG driving value in M&A

- ESG is now a key value driver. Since 2016, an ERM survey has uncovered that there has been a three-fold increase in the perception of ESG as a positive contribution to exit multiples[2]. Private equity funds, investors and corporations should be looking to their businesses' ESG strategies to capture this value, by focusing on ESG strategy as a vision, not just a check-the-box exercise.

- The result for investors, fundraisers, and target businesses is that a solid ESG strategy attracts valuation premiums, while businesses where the buyer will need to implement change post-closing are seeing reduced purchase prices reflective of this fact[3].

Pre-deal – ESG due diligence

- In M&A, the due diligence process provides a buyer the chance to uncover any actual or contingent liabilities that may affect the value of the business or the assets being acquired. The results of due diligence inform which protections a buyer may wish to include in the transaction documents, or be used as a negotiating tool to reduce the purchase price. Due diligence questionnaires and warranties are also used to elicit disclosures from the sellers.

- ESG considerations have started to have a noticeable impact on the acquisition due diligence process. A potential buyer may expand and broaden its areas of concern and questioning, involving additional interdisciplinary specialist advisers to work alongside more typical financial and legal diligence. Such specialisms will of course depend on the business in question but may include experts on diversity and inclusion or wider environmental risks (such as carbon emissions or waste management) as well as regulatory experts in the relevant field.

[2] ERM, "*Eyes on the prize: Unlocking the ESG premium in private markets*".

[3] Deloitte, "*ESG: A new necessity for the M&A agenda*".

- The expansion of due diligence in these areas will inevitably have the impact of increasing Buyer costs for the transaction — with multiple experts potentially producing multiple diligence reports. Such costs are likely to add to buyer sensitivity to ESG issues at the initial stages of contemplating a potential target. However, companies with a strong ESG track record may be an attractive proposition for buyers, saving on transaction and integration costs and ultimately attracting a higher valuations on exit.
- While there remains no unified metric to assess the materiality of ESG to a particular deal, key areas of expanded ESG due diligence include:
  - *Regulation:* with increasing government regulation and best practice standards coming into effect, a buyer's diligence will need to ensure a target's compliance and measure its performance against regulatory frameworks. Examples include emission targets and supply chain legislation.
  - *Reputation:* if a potential target has a weak ESG track record, a historic record of shareholder ESG activism or has been publically shamed (like Boohoo), then it may either be off the table or require increased expenditure post-completion to bring it in line with the Buyer's own ESG standards.
  - *Greenwashing/Bluewashing:* with phrases such as "carbon-neutrality" becoming the new buzzword, buyers will need to ensure proper diligence is undertaken to verify a target's marketing materials and public claims, relating to matters such as environmental targets and social and community practices. Litigation risk attaches to companies that exaggerate their sustainability credentials, such as claims under FSMA 2000 for publishing misleading information; claims under the Companies Act 2006 for misleading statements; claims for misrepresentation and breach of warranty. Such civil liability claims are in addition to the risk of non-compliance with industry-specific regulation — and often one follows the other.
  - *Contractual Arrangements:* an increased focus on certain contractual arrangements may be required. For example, a boutique coffee making target may have a long and complicated supply chain. The onus will be on the buyer to ensure that it is comfortable that each supplier in that chain adheres to strict ESG standards, particularly with respect to labour standards.
  - *Property:* a target owning land or property will require enhanced due diligence to be undertaken on areas such as contamination and water pollution.
  - *Policies and Training:* company policies and ESG training, such as those relating to diversity and inclusion, will require a more rigorous review against relevant legislation and best practices.
- Buyers will need to look carefully at disclosures elicited during the due diligence process for any ESG-related matters, ensuring that it has all information up-front at the time of negotiating the purchase price. Material ESG flags, such as modern slavery issues in its supply chain, may well see remediation provisions and price chips or, in extreme cases, may even become deal-killers.

Funding a deal - ESG financing

- For sources of finance (such as private credit institutions and public banks), it may be difficult to justify lending to a buyer who has not reviewed ESG issues properly, or where diligence has uncovered material ESG red-flags. "Sustainability-linked" and "Green" loans are now available, demonstrating lenders taking the initiative in forcing borrowers to be ESG compliant.
- Green loans can only be made available to exclusively finance or re-finance an eligible Green Project, the core principles of which are set out in the Loan Marketing Association's guidance[4] and, as such, are inherently limited in their availability.
- Sustainability-linked loans are a type of loan instrument or facility which incentivises the borrower's achievement of certain predetermined ESG targets, such as an improvement in the energy efficiency rating of owned or leased buildings or increases in the amount of renewable energy generated/used by the borrower. While there are

[4] Loan Market Association, "*GLP Guidance*", May 2020.

currently no market standard terms for such loans and failure to meet the specified targets may not automatically constitute an event of default, a sustainability breach could have an economic impact on the borrower. For example, such loans often include a margin premium (where margins are increased if the borrower fails to hit its targets). A standardisation of market practice for a sustainability breach and borrower reporting requirements may develop in the near future, particularly in light of the EU taxonomy for sustainable activities.

- W&I insurance around environmental risks has become commonplace; however, social and governance insurance is still in its infancy. This is likely due to the extensive scope and non-uniform nature of these issues. As the market develops, it is likely that buyers will need to have reviewed the relevant risks comprehensively and have prepared a detailed ESG report. It remains unclear what market practice will develop in terms of reporting on such matters and under which adviser's remit such a task will fall. Early engagement with W&I insurers on coverage of ESG matters is recommended.

ESG-specific provisions in transaction documents

- While there is currently no widespread market practice being adopted in transaction documents, ESG considerations are finding their way into key deal documents in a variety of different ways. It may be only a matter of time before certain clauses and provisions are adopted as a matter of course, much like tax compliance, environmental, anti-bribery and anti-corruption warranties are commonplace in UK SPAs. Similarly, "Weinstein Clauses" (requiring target companies to warrant that no senior executives have been involved in sexual harassment claims and no settlement agreements have been entered into over any such allegations) have become a feature in US style documents, with buyers even negotiating the right to claw back a portion of the purchase price if subsequent findings of such inappropriate behaviour damage the acquired business.

- A buyer's ESG due diligence exercise may result in ESG-targeted warranties being included in the SPA. Such warranties may cover general compliance with ESG-related matters, adequacy of ESG policies and more specific risk areas that may be important to the buyer's ESG investment strategy, such as diversity levels, the gender pay gap and supply chain sustainability.

- Including conditionality to closing is another way a buyer is able to focus the target into directing its attention on critical ESG matters. If a fundamental ESG issue has been identified and that issue is curable, then the buyer may insist on rectification being a closing condition.

- If a non-curable ESG issue is identified then the buyer may seek a specific indemnity or, in extreme cases, ring-fence the toxic asset (such as a factory), reduce the purchase price or even abort the deal.

- It is often easier to require remediation of ESG issues pre-closing, if possible, because in any post-closing warranty claim, damages must be proved. In particular, quantification of damages may be hard. For example, how are reputational damages in this area to be measured? Buyers should consider this carefully if they become aware of an ESG breach as part of diligence.

Post-deal ESG integration

- ESG issues that do not impact a buyer's appetite to close a deal may become part of its post-closing action plan. Such post-closing actions may include updating the target's policies and procedures to be in line with the buyer's ESG investment strategy, or a complete integration with its portfolio of companies, all operating to a set of ESG standards. Institutional investors may require similar standards from all portfolio companies operating within a particular sector or jurisdiction, for example, and the costs of post-deal compliance will need to be factored into the annual budget and business plan.

- ESG policies and standards should be clearly communicated to all stakeholders, including third-party suppliers.

- As mentioned above, a buyer should not underestimate the potential financial costs that may be involved in integrating a target's ESG capabilities up to the buyer's standards and should consider forecasting for this and reflecting it in the initial purchase price.

- Depending on the nature of the issues involved, earn-outs could help to hedge against non-compliance by a target of its ESG targets, by aligning the interests of sellers with ESG value creation. More generally, an element of bonus eligibility could be linked to key ESG performance indicators.
- Employees are increasingly looking for companies which are reflective of their values. As the new ESG-conscious generation enters the workforce, it is important for buyers to consider how ESG integration and/or re-alignment of ESG values can create a culture that attracts and retains top talent and engages its workforce.

ESG's importance for business will continue

In summary, ESG will continue to be a key consideration in deal-making and an important valuation metric. Unsustainable business models will no longer attract capital investment and innovative companies will continue to look for ways to disrupt the status quo with ESG considerations at the forefront of their mission.

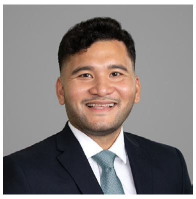
With the ever-evolving global conversation on these issues, it remains difficult to accurately pinpoint what ESG means as a market standard and what practices will follow. It does seem likely, however, that the conversation will continue to feature in business and investing news and that continued growing awareness by the general public will ensure that ESG remains relevant in M&A.

CONTACTS

For more information, please contact your Katten lawyer or any of the following:

Oliver Williams
+44 (0) 20 7770 5212
oliver.williams@katten.co.uk

Edward A. Tran
+44 (0) 20 7770 5254
edward.tran@katten.co.uk



Omar Malek
+44 (0) 20 7770 5240
omar.malek@katten.co.uk

Alex Potten
+44 (0) 20 7770 5223
alex.potten@katten.co.uk

Alex Taylor
+44 (0) 20 7776 7647
alexander.taylor@katten.co.uk

David Wood
+44 (0) 20 7776 7650
david.wood@katten.co.uk

**Maxime Chevot, a trainee in the Finance and Transactions group, contributed to this advisory.*

Katten   katten.com

Paternoster House, 65 St Paul's Churchyard • London EC4M 8AB
+44 (0) 20 7776 7620 tel • +44 (0) 20 7776 7621 fax