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ESG: A NEW ERA IN M&A DEALS

Introduction

Environmental, Social and Governance (ESG) elements is gaining traction and playing a key role in effective business and investment decisions, especially in the context of cross border M&A. ESG risk assessments in M&A deals are escalating from investor communities of world's largest economies which includes the US, EU, China and Japan and likely to become a prominent part of a due diligence in a M&A process. This is primarily due to the fact that ESG risks are far more precarious than the monetary penalties suggested in any legislation and can harm the reputation and brand of not just the target but the acquirer as well in long term.

This article navigates on material ESG issues that could become the central concern for any acquirer at a due diligence stage and could significantly impact a deal process including its transaction structure.

M&A diligence with a new lens of ESG

ESG risks are scattered across different areas of a regular legal due diligence, however, special attention is demanded by the acquirers at a much deeper level whilst undertaking ESG diligence, which is over and above the standard legal compliance checks.

ESG diligence is not a one-size-fits-all approach as ESG standards might change *vis-a-vis* the industry sector in which an acquirer operates. *For instance*, issues like climate impacts, water footprints would be more relevant in a M&A deal for companies operating in oil and gas, manufacturing and real estate sectors. A company in automobile sector would emphasize more on carbon emissions and past carbon footprints. Likewise, product sustainability, waste management issues would be on priority list of acquirers intending to acquire a target in a FMCG sector while acquirers aiming to acquire a target in a financial industry or an IT industry would emphasize more on social and governance sectors like cyber security, and data privacy, anti-corruption, etc.

An acquirer carrying out an ESG diligence would require to setup some material ESG filters, which might differ from the classic due diligence exercise, and may have to deal upfront and not be left to be considered post acquisition. Some of these filters would include:

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(i) **Child labor practices:** Target's history of use and involvement of child labor.

(ii) **Climate and carbon impacts:** Target's compliances, processes for monitoring its past greenhouse emissions, carbon footprints, evaluating if target's environmental policy include climate change issues and whether its projects have led to improvement of environmental performance.

(iii) **Supply chain risk:** Target's dealing with ESG risk in its supply chain, whether it has implemented any formal code of conduct with its key suppliers, customers, vendors, etc. and whether it has put a policy to deal with suppliers or vendors who are exposed to high ESG risks.

(iv) **Diverse board:** Target's board diversity with regard to professional background of a director including gender diversity, equality and independence of the board in making business decisions. Reviewing target's policy that supports diversity, equal opportunity and anti-discrimination policy.

(v) **Treatment of employees:** Target's policies to handle issues with respect to labor disputes, employee's working conditions, employee's health and safety, employee training and whistle blowing policies, gender equality practices. Target's suppliers past experiences and policy on resolving labor issues.

(vi) **Sustainability initiatives:** Safety of the target's products *vis-a-vis* the environment and its consumer. Target's responsibility for the environmental impacts of its products throughout its lifecycle. Target's involvement in adopting circular economies, its water usage management. Whether target has recognized any financial provisions in the accounts to address any environmental liabilities.

These checks and compliances shall be over and above the usual legal compliances on labor laws, environmental laws, material contracts assessment, appointment or resignation of directors.

Structuring Transactions

ESG factors as discussed above are likely to impact the target's valuation and acquisition price which may possibly get heavily negotiated or discounted, basis the outcomes of the ESG due diligence report.

Standard representation and warranties package in a transaction document would now need a careful revision to include ESG representations and warranties, covering a broad spectrum of ESG factors, customized industry wise. Transactional insurance and indemnities on the other hand, including specific indemnities, will need to be looked from ESG lens focusing on potential ESG risk and opportunities, that shields an acquirer from such risks. Deals with high values will need a critical ESG diligence as early as possible or simultaneously with the legal due diligence, to mitigate ESG concern prior to completion of the transaction.

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Conclusion

Recently, SEBI *vide* its circular no. *SEBI/HO/CFD/CMD-2/P/CIR/2021/562* dated May 10, 2021 has mandated the requirement of filing a business responsibility and sustainability report (BRSR) for the top 1000 listed entities based on market capitalization, from the financial year 2022-2023 describing the initiatives taken by the listed entity from an environmental, social and governance parameters. This proves that reporting of company's performance on sustainability related factors has become as vital as reporting on financial and operational performance. An investor will look at these benchmarking ESG standards irrespective whether an acquirer is listed or in an unlisted space, as a part of their investment strategies and may use BRSR standard to benchmark and streamline ESG screening process.

ESG risk may possibly affect target's valuation which will thereby impact the seller who will face major challenges in selling its shares, transferring business assets or units having negative ESG rating.

Disregarding ESG compliances in a M&A deal could be baneful and may break the deal, on the other hand, considering such factors and integrating them into the transaction would make the deal. Acquirer would always prefer a competitor that focuses on ESG values over non-ESG focused competitors. Further, an ESG focused target will enjoy the benefit of low cost of capital.

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