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ESG and M&A in 2022: From Risk Mitigation to Value Creation

In the past twelve months, ESG investments have hit new records and attracted heightened regulatory focus on disclosure and enforcement. With stakeholder impacts, climate change, biodiversity, human capital management, diversity and inclusion and cybersecurity continuing to be top of mind for investors and regulators alike, this coming year will likely see ESG increasingly influence deal-making.

In early 2020, we [foreshadowed](#) the potential impact of ESG on the selection of targets, company valuations and assessments of deal risk. Going forward, ESG will not simply be a tool for identifying and mitigating risks, but also a lever for value creation. Acquirors and targets alike will be increasingly expected to demonstrate their ESG credentials. The impact of ESG on M&A could be further amplified by anticipated ESG disclosure rules from the U.S. Securities and Exchange Commission (“SEC”) and if the Biden Administration’s Build Back Better Act makes further headway. The continued convergence of market-led ESG disclosure frameworks, including the formation of the International Sustainability Standards Board which is expected to issue global disclosure standards this year, will further assist investors and businesses in quantifying the ESG impact of their investments.

Many critical aspects of M&A will be affected by the integration of ESG into investor decision-making; we highlight some of the key trends below:

Expansion of ESG-Oriented M&A. ESG considerations are shaping assessments of strategic fit, with both acquirors and targets looking to capitalize on synergies arising from companies with aligned ESG profiles. A company’s broad positioning on ESG matters is increasingly indicative of its culture and future growth prospects. Transactions that have been directly driven by the need to address ESG risks or to capitalize on new ESG-related opportunities have also seen growth in the past year. The growing availability of capital dedicated to ESG, ongoing pressure from investors and regulators to disclose ESG performance and set targets, particularly emissions-related targets, and improvements in decision-useful ESG data and analytics will likely help spur further ESG-oriented deal-making.

Climate change and related transition risks have already prompted restructuring efforts in the energy sector, a trend that is likely to continue as investors and regulators step up pressure on companies to reduce their emissions output. Last year, Royal Dutch Shell sold its Permian Basin assets to ConocoPhillips to reduce

its global carbon emissions. For ConocoPhillips, the transaction provided an opportunity to lower its emissions intensity. BP has committed to divesting \$25 billion of assets by 2025 to support its strategic pivot to renewables and last year divested a stake in its Omani gas fields and oil interests in the U.K. North Sea. Similarly, Public Service Enterprise Group (PSEG) divested its fossil fuel plants as part of its pivot to renewables. Commitments by major energy companies to expand their renewables businesses, coupled with heightened interest among private equity and other investors both in renewables and in assets being shed by some traditional energy producers, will continue to fuel investments in the energy sector. Views of major institutional investors continue to evolve in this area, including as to resolving the tension between divestment pressure and ensuring adequate capital is invested in, and allocated towards, an effective and responsible energy transition while meeting energy demands.

In the past year, established financial sector players have looked to expand their ESG services platforms and analytical capabilities. This shift will likely enhance the capacity of companies to integrate ESG into M&A decision-making, particularly by improving market assessments of ESG's impact on bottom lines. Moody's, Blackstone, Nasdaq, JPMorgan, AXA, BlackRock, KKR, Deutsche Börse and McKinsey all acquired data analytics and/or consulting firms with ESG expertise. In addition, Goldman Sachs' acquisition of NN Investment Partners and Affiliated Managers Group's acquisition of Parnassus reflect the integration of ESG strategies into mainstream investing and desire among major asset managers to expand their ESG investment platforms.

Valuation, Due Diligence and Contractual Innovations. In 2022, companies will be increasingly expected to follow the footsteps of investors by integrating ESG considerations into core aspects of deal-making. Over the past year, ESG has demonstrated its ability to move markets: Royal Dutch Shell and ConocoPhillips both saw their stock prices rise following announcement of the former's sale of its Permian Basin assets to the latter. A recent [survey](#) of senior management suggest they are willing to pay premiums for companies with positive ESG records.

The rise of an "ESG premium" will directly impact due diligence. In addition to assessing ESG risks, such as corrupt business practices, labor law violations, cybersecurity threats and carbon emissions, acquirors will also need to examine related processes and procedures, including the degree of board oversight and the scope and quality of internal and external ESG reporting to detect latent ESG vulnerabilities. Acquirors will also need to make a determination of the pro forma ESG impact of a transaction, including the impact on reputation and culture, when assessing deal synergies. On the target side, boards and management will also need to be cognizant that ESG concerns may increasingly factor into shareholder

decisions to support or reject a proposed transaction, particularly where the deal consideration includes shares of the acquiror. Integrating ESG into reverse due diligence can help target companies make a stronger case to their shareholders.

Contractual innovations will also help bridge the gaps between due diligence and ESG risks. The pandemic saw the introduction of carve-outs for Covid-19 and related measures in MAE clauses and interim operating covenants. While references to ESG remain rare in public company M&A agreements, ESG issues could make more frequent appearances in sections such as MAE clauses, representations and warranties and interim operating covenants to reflect growing value investors place on ESG performance and risk management and as ESG controversies continue to grab headlines and regulator attention.

Financing. Lenders have already seen the potential impact of significant ESG risks on the creditworthiness of businesses and industries. S&P and Moody's have integrated ESG considerations into credit ratings. Meanwhile, the growth of sustainability-linked financing promises to lower the cost of capital for companies that commit to improving their ESG performance. In the context of M&A, cheaper financing could make ESG outperformers more desirable targets (although lenders are increasingly tightening their monitoring processes and requiring verification of ESG outcomes). Conversely, efforts to divest underperforming ESG assets may become more difficult: Chevron noted in its public disclosures that lenders are under pressure to limit funding to companies engaged in fossil fuels extraction, a trend that could impact financing costs and availability.

Investor and Stakeholder Engagement. Investors remain focused on ESG performance and companies will increasingly choose to address the ESG-related synergies and opportunities in transaction rollouts, investor presentations, press releases and at analyst and investor meetings. Boards and management should be prepared to demonstrate how ESG considerations will impact long-term performance and growth prospects and will need to engage proactively with stakeholders on such matters. For example, Canadian Pacific Railway CEO Keith Creel noted during the investor call following the transaction announcement how the acquisition of Kansas City Southern could bring supply chain stability to North America and take "thousands of trucks off the road." Following the announcement of Cimarex's acquisition of Cabot Oil and Gas, their respective CEOs touted their companies' shared commitments to environmental stewardship, sustainability and strong corporate governance and their goal to build upon ongoing efforts to improve ESG and sustainability capabilities as a combined business.

Regulatory Risks. With ESG, human capital and cybersecurity disclosures still atop the SEC's rulemaking agenda, the shifting regulatory landscape may bring

along new regulatory risks that could impact M&A. The signing into law of the Uyghur Forced Labor Prevention Act late last year has shifted the burden to U.S. companies to prove their supply chains do not utilize forced labor. Meanwhile, the stalled Build Back Better Act, if revived, would create significant new opportunities in the renewables sector.

ESG Activism Driving M&A. Engine No. 1's successful proxy campaign against ExxonMobil last year underscored the growth of ESG activism. Activists will increasingly leverage ESG issues to rally the support of key institutional shareholders in favor of broader strategic changes, including M&A. Third Point's campaigns to break up Royal Dutch Shell and Prudential and Elliott Management's efforts to separate SSE are illustrative. In addition, the evolving ESG regulatory landscape, discussed above, could pave the way for activists to push companies that are laggards or which are big losers from anticipated regulatory changes to evaluate strategic alternatives.

Post-Merger Governance and Integration. We expect ESG considerations to further shape governance structures post-acquisition, particularly at senior levels where ESG oversight and monitoring responsibilities will need to be appropriately transferred and delegated. Integration efforts will need to be sensitive to existing ESG goals, policies and procedures of the combined company, so as not to adversely impact the ESG profile of the combined company. In particular, questions relating to human capital management and compensation will require careful thought in 2022 to ensure retention of key employees and preservation of employee morale.

The full impact of ESG on M&A is still to be fully seen, particularly as companies, investors and other stakeholders, as well as regulators, continue to assess and revise their priorities. The regulatory landscape in the United States also remains in flux and the quality of ESG disclosures and decision-useful data, while improving, continues to leave much to be desired among investors. We will continue to monitor ongoing developments in this field.

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