Dechert LLP

The rising importance of ESG in M&A

It was a record-breaking year for private equity backed M&A deals, with $818.4 billion (£608.2 billion)* of transactions globally in the first nine months, more than double the figure for the same period in 2020. Meanwhile, the world faced social upheaval as we continued to navigate the pandemic. Against this backdrop, companies have increasingly focused on improving their performance on environmental, social and governance (ESG) issues. Here, Jonathan Burke and Maddie Drabble of international law firm Dechert outline some key ESG considerations for private companies.

ESG generally refers to a set of standards for company operations which focus on issues such as climate change, data security, tax transparency and diversity, equity and inclusion. Private equity firms are increasingly required to integrate ESG considerations into their operations and investment strategies. And this task is complicated by the fact that ESG priorities differ from one company – and one industry – to another.

Addressing ESG issues – the benefits...

Shareholders and employees alike should benefit if the company has a clear focus on ESG issues which reflects its values. Crucially, a strong ESG policy can position the company as a more attractive potential deal partner. Indeed, a sizeable percentage of global investors now say that ESG risks are an important factor in their investment decision making. A focus on ESG can also help a company to connect with its customers, who are becoming ever more concerned about ESG issues. For B2B businesses, their customers may also face policy pressure on ESG and so will be keen to deal with likeminded organisations.

Ultimately, performance on ESG issues has become a benchmark used by potential acquirers to assess a target company in their due diligence alongside more traditional metrics, such as sales revenues or net profit margin.

...and the challenges

For companies seeking investment or to be acquired, it can be hard to define, measure and achieve ESG goals. That's largely because there are no universally standardised ESG metrics, reporting requirements or regulations. Some companies set their own metrics, often using the UN's Sustainable Development Goals as a yardstick for their progress. Yet it is difficult to strike the right balance between generating a return for investors and meeting ESG goals. If a company lags on meeting established ESG expectations, it may have a smaller pool of potential acquirers or may find it more challenging to secure investment, particularly from private equity investors.

Meanwhile, private equity funds seeking acquisition targets can find themselves at a disadvantage when bidding for a target with material ESG risks and opportunities if a competing firm has more mature ESG capabilities to draw on. After all, there is a limited pool of ESG appropriate companies to invest in. Over 50% of private equity partners say that ESG considerations have sometimes led them to turn down investments or refuse to enter general partner agreements.

Conclusion

With private equity assets expected to increase by 30-40% worldwide over the next five years, the importance of ESG considerations in (potential) portfolio companies' operations will presumably grow. A credible ESG strategy can better position an investee company to create long-term value, differentiate its brand, strengthen its bottom line and make itself attractive to acquirers.

*Data from Refinitiv.

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