Browne Jacobson

ESG in 3D: Governance

ESG in deals and investments

11 November 2022

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Digest:

- The ICAEW's recently published best practice guideline (authored by Deloitte), contains practical guidance on the growing importance of ESG in the corporate deal process.
- With ESG growing in importance, firms face risks and opportunities that are sector specific and depend on several factors such as operational activities and location.
- Undertaking due diligence on the ESG risks of a target business is also crucial and requires a materiality assessment of the target's business operations and value chain to determine the number of ESG risk categories.

Source/Context:

The ICAEW Corporate Finance Faculty has recently published a best practice guideline titled ESG in Deals and Investment (the "Guideline"). The Guideline notes that it is essential that firms consider what is core to the business and its long-term success, while developing an ESG approach aligned with and enabling its broader business strategy. Authored by Deloitte, it explores the role that ESG plays across the corporate deal lifecycle and provides practical guidance on how to better integrate ESG into the mergers and acquisitions (M&A) process.

What does this mean for the FS and other industries?

ESG has become a key aspect of the corporate deal process, as a driver of M&A deals and as a core consideration within non-ESG focused transactions. Its increased significance in corporate transactions means that ESG considerations could, in some instances, be a decisive factor as to whether or not a firm proceeds with a transaction. It may also lead to investors choosing not to invest in firms without first being presented with clear and sustainable ESG plans.

The Guideline draws a distinction between "ESG motivated" and "ESG conscious transactions". ESG motivated transactions refer to the situation where a firm is using corporate transactions "as a catalyst to advance their ESG priorities and rapidly respond to transitioning markets." In contrast, "ESG conscious transactions" are those "which do not have a specific ESG-related objective, but there is recognition that ESG could still play a significant role in creating or destroying value in the future". Firms should assess potential transactions in light of its broader ESG approach and long- term business strategy, and should also evaluate sector specific risks and opportunities, to determine whether an ESG motivated or an ESG conscious transaction is appropriate. The type of transaction pursued will impact the level of ESG due diligence required as the Guideline notes that whilst ESG conscious transactions will still require a degree of ESG due diligence, the target's ESG performance may not impact its valuation.

To assess the material ESG risks in either type of transaction, the Guideline suggests firms adopt a two-stage due diligence process. Firms should first focus on evaluating and understanding the target business's operations and value chain (both upstream and downstream) to identify potentially material ESG risks. Following that phase, it will be possible to overlay the associated ESG risks, prepare the diligence questions and build the overall ESG risk profile of the business. It is important that firms are aware of, and take steps to mitigate against challenges such as lack of ESG understanding and knowledge at board level, lack of standardised ESG metrics and poor data quality (especially from unlisted companies), quantification of risks and opportunities, integration of the target business into the acquirer's ESG compliance framework and greenwashing by target businesses and/or unrealistic ESG targets. Production of comprehensive and accurate ESG risk profiles for target companies will not be straightforward.

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