Key Takeaways

- ESG is not just a trend, but is a new reality, driven by the pandemic, climate change, cyber incidents, supply chain challenges, economic disparities, and social justice movements.
- Purchasers are capitalising on ethical and sustainable opportunities to maximise value.
- Incorporating ESG considerations into decision-making has led to financial gain and neglecting ESG concerns may result loss of financial opportunities.

Green is the new gold

Environmental, social and governance (**ESG**) is not just a trend, it's the new reality. Investors are putting their money where their values are, and ESG principles are leading the way. The pandemic, climate change, cyber incidents, supply chain challenges, economic disparities, and social justice movements have all accelerated this trend, and businesses need to take notice.

With a growing emphasis on ESG, incorporating ESG considerations into your decision-making process can lead to financial gain. Obviously, neglecting ESG concerns may result in regulatory scrutiny and loss of financial opportunities going forward.

Rising importance of ESG

The M&A game just got a whole lot greener in Australia. A surge in M&A activity in 2022 has led companies to put ESG front and center in their deal-making process. In fact, ESG considerations are now a critical component of decision making and due diligence in acquisitions. A strong ESG profile is no longer just a "nice-to-have," it's a must-have. Purchasers are seizing sustainable opportunities to maximise value while prioritising ESG concerns.

It's not just about ticking a box anymore, a strong corporate ESG strategy is now considered a non-negotiable by dealmakers. It's no longer enough to just make money, you have to do it sustainably. So, if you want to drive long-term revenue growth and create value that lasts, make ESG a core component of your strategy. A weak ESG profile can lead to financial, reputational, and legal consequences that no purchaser wants to face.

Impact of ESG on M&A transactions

ESG consideration is relevant from deal conception and remains relevant through the due diligence process, negotiation of the agreement, and deal closure.

1. **Before the deal**

   During the early stages, investors may carry out preliminary due diligence. These investigations may involve examining publicly available information, such as annual reports, sustainability reports, regulatory filings, and news articles to assess the company's ESG profile and reputation in the market. Additionally, potential purchasers may also look into any legal or regulatory proceedings involving the target business or company.

2. **Letter of Intent / deal term sheet**

   ESG considerations may be incorporated into preliminary agreements by including specific language that addresses the ESG aspects of the deal. This may involve identifying key ESG criteria that are relevant to the transaction, such as climate risk or human rights issues, and outlining commitments to address those concerns. Additionally, preliminary agreements may include provisions for ongoing monitoring and reporting on ESG performance, as well as requirements for due diligence to identify any potential ESG risks or liabilities before signing and/or completion.

McInnesWilson LAWYERS

3. Due Diligence

Due diligence in the M&A process increasingly includes an evaluation of a company's ESG profile, as purchasers seek to identify risks that may impact the businesses long-term success.

This is particularly relevant for industries such as energy, manufacturing, healthcare services, and food production, which often have sustainability initiatives in place before a sale. Investors can use due diligence to identify ESG risks by conducting a comprehensive review of a target business' operations and financial performance. This may involve evaluating the business' environmental impact, social responsibility practices, and governance structure.

For example, a purchaser might examine the target's carbon footprint, waste management practices, and use of natural resources to assess its environmental impact. The purchaser may also review the target's employee relations, supply chain management, and community engagement to assess its social responsibility.

In terms of governance, the purchaser may evaluate the target's executive compensation practices, board composition, shareholder rights, stakeholder relationships and risk management policies to assess its corporate governance.

Effective ESG focused due diligence can assist purchasers:

1. identify potential risks and liabilities associated with a target's ESG profile;
2. highlight opportunities to improve the target's ESG performance and create value such as implementing sustainable business practices;
3. provide insight into the target's reputation and stakeholder relationships which can have a significant impact on financial performance and long-term value creation;
4. ensure compliance with relevant ESG regulations and standards which can reduce the risk of legal and regulatory scrutiny, reputational damage and potential penalties;
5. from deal conception and remains relevant through the due diligence process, negotiation of the agreement, and deal closure.

4. Structuring or renegotiating a deal

If a purchaser identifies ESG related risks during the due diligence process, they may seek to renegotiate the deal's terms to reflect these risks. Ultimately, the goal is to ensure that the purchaser is aware of any ESG-related risks and has taken them into account when determining the appropriate valuation and deal structure. A purchaser can use ESG to structure a deal in several ways:

- **Conditions precedent**: The purchaser can negotiate conditions precedent requiring the target company to implement ESG related changes, such as reducing its carbon footprint, increasing the diversity of its workforce, or improving its supply chain practices or provide proof of compliance with certain ESG regulations or standards such as environmental permits or diversity and inclusion policies. If the seller cannot satisfy these conditions precedent, the deal may not proceed or the terms may need to be renegotiated.

- **Specific representations and warranties**: The purchaser can negotiate specific representations and warranties from the seller related to ESG matters, which can be enforced through indemnity provisions in the sale and purchase agreement. Including such warranties and indemnities in a contract can provide additional protection for the purchaser and help mitigate potential ESG-related risks in the transaction.

- **Escrow accounts**: The purchaser can negotiate the establishment of an escrow account to hold a portion of the purchase price as security for any potential ESG-related liabilities that may arise post-closing.

- **Earn-out clauses**: This allows the purchaser to make payments to the seller based on the target's future performance. This type of clause can be used in relation to ESG risks by tying the earnout payments to the target's ability to achieve specific ESG targets, such as reducing carbon emissions, improving diversity and inclusion, or enhancing its supply chain sustainability.

- **Price adjustments**: ESG risks or opportunities identified during due diligence can be factored into the purchase price of the target, with adjustments made to reflect the risk or opportunity.

By incorporating ESG considerations into the deal structure, purchasers can not only mitigate risks associated with environmental and social factors, but also create long-term value by aligning the target's practices with their own sustainability goals.

As we look ahead to 2023 and beyond, it's clear that ESG will continue to play a critical role in shaping the future of M&A transactions. Also, we can expect to see the emergence of new regulations and laws relating to ESG. This trend will further reinforce the importance of ESG as a critical factor in M&A activity. With a growing emphasis on sustainability and social responsibility, we can expect to see a rise in the number of deals being structured around ESG objectives, as investors prioritise aligning their business strategies with environmental and social goals.

How can we help you?

McInnes Wilson Lawyers can help you if you are looking to acquire assets, a business or company.

We can provide end-to-end specific ESG due diligence services, from preliminary review of a targets' practices to complete assessment of the business and negotiation of the purchase agreement with an ESG perspective.

Get in touch with us today.