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ESG can make or break a merger: Here's what dealmakers are looking for

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By Heather Clancy

Miscalculating climate risk — or being unprepared for legal changes — can reduce M&A prices.

Miscalculating social and environmental risks in mergers and acquisitions can lower deal prices or result in litigation, according to experts speaking at the GreenFin 24 conference in New York. (The event was hosted by the publisher of this website.)

That's why environmental, social and governance (ESG) issues are increasingly part of M&A due diligence.

"Especially in my field, every transaction that we work on does have an ESG workstream, maybe that might be different in the U.S., but in Europe, sustainability and ESG is front and center," said Maximilian Meyer, executive director for sustainable solutions at J.P. Morgan, where he manages advisory services in Europe, the Middle East and Asia.

Although the number of corporate acquisitions has declined recently, EY predicts a 20 percent increase in transactions in 2024. A survey by KPMG also forecasts an increase in deals.

'You need to know their house is in order'
A big impetus for increased scrutiny is the European Union's Corporate Sustainability Reporting Directive, which requires large companies that do business in Europe to disclose social and environmental risks starting with the 2024 reporting year. This new requirement will complicate disclosure for any company seeking to acquire an affected firm.

"One of the very first things you need to think about is whether the target is subject to CSRD, and when, and how close are they to be ready to report," said **Betty Huber**, **partner and global ESG co-chair at law firm Latham & Watkins**, which advises on many transactions. "Once you buy them, you need to know their house is in order because it will affect what you are."

If the company making an acquisition has a more mature process for data collection and reporting than a company being bought, that could become a liability because the combined company might not have all metrics ready by the first CSRD deadlines.

"We see buyers now, increasingly, expecting a report or asking for one," Meyer said. "Those ESGs are a valuable, additional piece of information." There is often a correlation between financial performance and ESG performance, because the latter is a sign of high-quality management.

Prepare for regional differences
It may be more difficult to gather information on emissions performance or do a human rights audit depending on where the target company is headquartered. **Huber** referenced three deals with targets in Asia, Europe and Latin America. While the European company had data at the ready, the Latin American one was a challenge.

"We're struggling to get information and getting some resistance from the target, because I don't think they've done the kind of work we're looking for them to do," **Huber** said. Asian firms are willing to cooperate, because of policies coming to play in that region, she said.

The level of impending regulatory change is dizzying, said Robert Esposito, managing director and senior counsel at Apollo, a private equity firm with nearly $700 billion in assets under management. "It is an increasingly time- and cost-intensive process just to wrap your arms around everything that's coming down the pike," he said.

Consider the climate risks that M&A targets face
It's important to give someone with knowledge of ESG issues from both the buyer and seller insight into potential transactions, but this doesn't always happen, the panelists said. "There has to be at least one person who is responsible for sustainability, ESG, [environmental, health and safety], whatever iteration," Esposito said. "Sometimes it's the COO, but it just has to be someone wearing that hat. You have to have legal and compliance people involved."

J.P. Morgan's M&A team includes someone with technical expertise on climate change, who can consider the risks that acquisition targets could face from heat waves, rising sea levels, extreme weather and other changes triggered by climate change. Other individuals bring insights related to corporate governance, diversity, equity and inclusion, and labor issues, Morgan said.

Another valuable asset is knowledge of government regulations. "Being able to predict how regulators are thinking and how lobbyists are thinking is key," **Huber** said.

Lack of evidence for claims can reduce deal prices
While ESG and sustainability progress reports are a valuable source of information during due diligence, they can also leave buyers open to litigation if that data is misleading, superficial or commitments aren't delivered.

Esposito pointed to a European negotiation involving a target company where that information was shaky. "They probably don't have backup for all of the claims they are making, and getting to the bottom of that is a new and heightened risk," he said.

Target companies without detailed transition plans for delivering on climate targets could find their deal prices reduced, the panelists said.

"We have seen the first cases now where companies are backtracking and the ones that are setting up strategies as we speak, from scratch, are a lot more careful as to what they actually put out there," Meyer said.

Some, for example, are setting shorter interim goals with clearer transition paths. "Investors are fine with that, actually, as long as you can back it up," he said.

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