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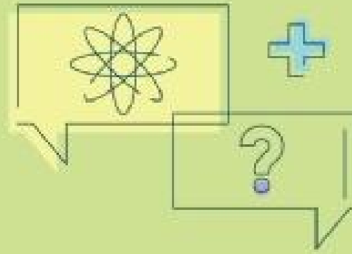

Start with why

ESG and Private Company M&A

Full-scale ESG-focussed due diligence exercises are standard fare in transactions involving publicly listed companies and the largest private companies, driven by the impact of mandatory ESG reporting requirements for such entities and increasing scrutiny from ESG-conscious shareholders. To what extent is this filtering down to the sale and purchase of smaller private companies that are not yet subject to such regulatory demands and that have, at least historically, come in for less scrutiny on ESG issues from their stakeholders?

Such detailed ESG reviews can prove challenging in the context of smaller private companies, due to a lack of data (both publicly available and internally collated) and an absence of a consistent framework for evaluating ESG-related risks in such companies. Despite these challenges, we are seeing an increased focus on ESG-related due diligence in private acquisitions, and, in this article, we look at some of the reasons why we expect that in-depth ESG due diligence exercises will steadily become a more mainstream feature of private acquisitions.

Why is ESG set to become a mainstream consideration in private M&A?

In recent years the spotlight of ESG has been steadily widening to include privately owned companies, not least because - as estimates of the scale of investment needed to decarbonise the global economy and achieve the UN Sustainable Development Goals increase - there is a growing recognition that the job cannot be done without harnessing the growing size, reach and influence of private capital and private companies.

More immediately and concretely, private companies of all types and sizes and in all sectors are under pressure to invest in improving their ESG credentials as an indirect result of new mandatory ESG disclosure requirements. These mandatory disclosure requirements, which are continuing to evolve in the UK, EU, US and developing at regional and national levels around the world, tend to bite directly on listed or the largest private companies, but are designed to cascade down through investment and supply chains.

Take, for example, the UK government's promised new Sustainability Disclosure Requirements which are expected, among other things, to mandate the publication of Net Zero (GHG Emissions) Transition Plans by the UK's most 'economically significant' companies and investors. To comply, Organisation A, within the direct scope of this requirement, will need to engage with organisations in its value chain and investment portfolio (whose emissions are part of Organisation A's total carbon footprint) to elicit their emissions data, emissions reduction targets and reduction plans. Through this cascade mechanism, all businesses will increasingly be held to the same standards of ESG practice and reporting, albeit, in the case of private companies - particularly mid-market, SMEs and growth companies - the enforcer is more likely to be a key investor or key customer than a regulator.

In this climate where all businesses must measure and disclose more ESG information and are under more scrutiny on ESG from their stakeholders, ESG is starting to drive M&A deal flow, with acquirors looking to invest in businesses that enhance their overall ESG credentials and open-up commercial opportunities in ESG-conscious markets (and in some cases to offload those businesses or activities that do not).

Private companies and investors are not just looking at ESG through the lens of increased scrutiny and risk. Large institutional investors in public equities have, for some time, been vocal about the link between strong ESG credentials and good prospects for returns. In the context of private M&A too, ESG is increasingly understood as an effective tool for value creation.

- Good ESG governance may be an indicator of good governance and effective management more generally.
- Reductions in energy use and waste can drive down operating costs.
- Strong ESG performance, data collection and reporting can be indicative of potential to attract ESG-conscious investors and access lower cost of capital – whether through sustainability-linked debt finance (where the borrower's cost of capital is reduced if ESG targets are met) and/or as result of achieving a stronger credit rating, as leading rating agencies integrate ESG factors into their analysis.
- Strong ESG credentials may also position the target well to attract and retain the best talent and to access new markets for its goods or services – whether that involves attracting and building brand loyalty with ESG-conscious consumers and/or, in B2B relationships, demonstrating to its suppliers and customers that the target is aligned with and will help them deliver on their ESG commitments
- A strong ESG strategy that is integrated into the target's business model and business planning may be indicative of its readiness to tap into ESG and decarbonisation-related commercial opportunities.

Click here to read about practical considerations for approaching ESG due diligence in a private M&A transaction.

Please email your Charles Russell Speechlys contact for more information and tailored advice as needed.

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