Professional Perspective

ESG Impacts on Chemical Industry M&A

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Environmental, social and governance (ESG) issues have increasingly become a top priority of publicly traded and privately held companies. This trend is driven by a combination of pressure from the investment community, government action (both domestically and abroad), shifting consumer preferences, and expectations of employees and recruits. Major chemicals companies have leaned into ESG by setting ambitious, long-term goals to improve their ESG performance and being increasingly transparent about their progress toward achieving these goals.

In this article, we explain the growing importance of ESG goals in the chemical industry, what ESG concerns may look like in the M&A process, and how ESG objectives and risks could influence each phase of an M&A deal.

Industry Goals

Industry leaders—such as BASF, Dow, DuPont, LANXESS, LyondellBasell, SABIC and Solvay—have all issued detailed, data-driven sustainability reports. While no two chemicals companies' ESG goals are identical, the following are common themes across the industry:

- Reduce plastic waste and advance toward a circular economy, including the use of advanced recycling technology.
- Reduce greenhouse gas emissions, including becoming carbon neutral by 2050.
- Establish energy efficiency targets and transition to renewable energy.
- Conserve water and manage wastewater responsibly.
- Introduce safer, sustainable products and manufacturing processes.
- Address social issues through interactions and communications with its workforce, customers, end users, suppliers, and the communities where it operates, including by undertaking diversity and inclusion, gender equity, and employee and community engagement initiatives.
- Adhere to corporate governance policies and best practices, including board oversight and compliance, risk management, and business transparency with the company's stakeholders and the public.

The focus on ESG performance is not a passing fad and is not simply altruism. Chemicals companies increasingly recognize that their ESG goals and performance impact their brand and reputation and create value. Early adopters who prioritized ESG—or its underlying components—before their peers now enjoy competitive advantages.

Most importantly from a chemicals company's perspective, ESG performance is directly linked to its ability to continue to operate in the future and to protect and gain market share and thereby earn long-term, durable returns for its stockholders. How chemicals companies will ultimately deliver on these ambitious ESG targets remains to be seen, but M&A is sure to play a major role, and dealmakers in the industry are starting to see ESG affect all phases of M&A transactions.

Corporate Development Strategy & Target Identification Phase

The first phase of any M&A transaction is determining a corporate development strategy and identifying a target. At this initial phase, it has always been important for the core deal team to purposefully seek input from internal stakeholders and to align on the organization's objectives for the transaction, i.e., the "transaction thesis." Now, deal teams also need to make sure that the transaction thesis specifically addresses ESG-related considerations. In certain companies, this means seeking input from the individuals responsible for ESG, such as a chief sustainability officer.

At companies like Dow, where ESG is embedded as part of its core strategy and risk management efforts, all key stakeholders are responsible for considering transactions from an ESG perspective. Thus, aligning on ESG objectives and risks may involve subject matter experts from across various disciplines, including operations, energy, EH&S, human resources, community and public relations, finance, accounting, and legal.

The degree to which ESG considerations will affect the transaction largely depends on whether the transaction is, as Bain & Company has coined it, an ESG-motivated transaction or an ESG-conscious transaction.

ESG-Motivated Transaction

Here, one or more of the parties is using M&A as a tool to further its ESG priorities, and ESG objectives are a material part of the transaction thesis. The buyer may be looking to acquire a portfolio of sustainable products, gain access to new technologies that would help improve its ESG metrics, or benefit from skilled talent that can accelerate its ESG initiatives. Alternatively, the seller may be looking to divest a legacy business that does not align with its ESG priorities.

ESG-Conscious Transaction

Here, the deal is pursued without the intent of specifically advancing any party's ESG priorities. The driving motivation is some other traditional priority, such as unlocking synergies, opening up new markets, or gaining market share. In these transactions—which for some companies will be every transaction that is not an ESG-motivated transaction—ESG is one of the many factors that need to be assessed in the value proposition, along with traditional M&A risks, e.g., litigation and product liability.

The buyer typically is focused on whether the target presents any ESG risks that could materially harm the buyer's broader ESG goals and thereby detract from the overall value of the transaction. To the extent the target has positive ESG metrics, the buyer may view this as a competitive advantage that unlocks additional value.

While the transaction thesis may be updated following due diligence, once the initial version is developed, it should be clear whether the transaction is an ESG-motivated deal or an ESG-conscious deal, and the identified ESG-related objectives will serve as guideposts for each subsequent phase of the transaction.

Valuation Phase

ESG is also impacting how M&A transactions are valued. In an ESG-motivated deal, the buyer's deal team should value the target based, at least partly, on ESG-related attributes identified as part of the transaction thesis. The buyer's valuation should clearly articulate how such attributes are relied on in the calculation of value. That way, if such assumptions turn out to be incorrect or cannot be reasonably verified during due diligence, there is a strong basis for revisiting the valuation.

On the sell-side, to properly market the target and maximize deal value, the seller should also assess any positive or negative ESG attributes of the target. The seller should ensure that positive ESG-related attributes are appropriately reflected in the buyer's valuation. The seller should also seek to understand the buyer's ESG-related assumptions so that it can assess the firmness of the buyer's offer and valuation.

Due Diligence & Risk Assessment Phase

The focus on ESG topics during M&A due diligence is already very apparent. Unlike traditional due diligence—focusing on prior actions of the target that could potentially result in liabilities, e.g., releases of hazardous substances, compliance with laws, litigation, and workforce complaints—ESG due diligence is oriented toward the forward-looking performance of the target.

However, performing ESG due diligence can be challenging, since ESG risks and value propositions can be hard to quantify. There is currently no single standard for most ESG metrics, targets sometimes lack internal ESG expertise, data quality is often poor and has seldom been examined by independent third parties, and such third-party reviewers tend to implement standards inconsistently. These factors make it difficult to compare ESG profiles of different companies and make it less effective to use off-the-shelf ESG due diligence request lists covering a broad array of topics that are not tailored to the particular target and transaction.

A more productive approach is to have counsel craft an ESG-focused due diligence plan that is designed to address the ESG objectives included within the transaction thesis. If the transaction is ESG-motivated, the due diligence plan should be aimed at verifying the ESG value proposition. In any transaction, the ESG due diligence plan should be designed to evaluate the material ESG risks of the transaction, as well as to develop potential solutions to address any identified risks.

ESG-related areas of focus in chemicals M&A include, at a minimum, the following:

- ***Has the target been focused on ESG, or has it been more of an afterthought?*** Are ESG priorities reflected throughout the organization, including in its charter and governance? Does the board play an active and visible role in oversight? What are the target's historical ESG priorities, and what policies and practices are aimed at achieving those priorities?

- ***Has the target made any public statements about its ESG performance?*** Any such statements should be reviewed and independently verified to confirm that the target is not making unsubstantiated claims about its ESG performance, i.e., "greenwashing."
- ***Is the target complying with any of the existing ESG disclosure standards, such as GRI, SASB or TCFD?*** If so, a review of the relevant data and qualitative disclosures will be a material part of the buyer's due diligence plan. The buyer may also need to consider the impact of any different reporting standards implemented by the seller compared to the buyer's own practices and the varying quality of third-party assurance providers.
  If the target is not currently complying with any established ESG disclosure standards, the buyer will need to consider conducting in-depth ESG diligence of the target's operations. This may include the target's greenhouse gas and air emissions, energy consumption and clean energy transition strategies, water consumption and wastewater management practices, and waste generation and hazardous materials management practices.
- ***What steps, if any, is the target taking to measure and reduce plastic waste, increase energy efficiency, and/or minimize greenhouse gas emissions?*** This may be an area where the buyer will be able to unlock value if it can identify solutions that could be implemented post-closing.
- ***What safety reporting processes does the target have in place, and who is responsible for safety oversight?*** Have there been any safety issues reported, and, if so, how were they addressed?
- ***How does the target monitor its supply chain partners?*** In most cases, the buyer will also want to consider performing diligence on the target's material supply chain partners to confirm that they have historically complied with applicable regulations, sustainable sourcing practices, and social employment standards.
- ***Are there any workplace or business culture areas of concern***? What are the demographics of the target's management and broader workforce? What programs or policies does the target have in place to promote diversity and inclusion? Is there a history of sexual harassment or other worker complaints at the target?
- ***Has the target had any past or current community relations challenges?***
- ***Does the acquisition of the target risk any reputational harm to the buyer?***

Once the ESG due diligence review is complete, the deal team will need to assess its findings against the original investment thesis. Because of the cross-disciplinary, risk-based nature of ESG due diligence, in-house and external counsel are particularly well equipped to help coalesce the ESG findings into a coherent, useful summary of the benefits and risks posed by the transaction. As discussed further in the pre- and post-closing integration phase discussion below, this exercise should include an effort to identify opportunities to improve the target's ESG performance, either pre- or post-closing, to unlock value and mitigate any identified risks.

The buyer is not the only party that will need to assess the ESG-associated risks of a potential transaction. Any seller in the current market needs to be prepared to address the buyer's ESG inquiries. An inability to provide meaningful responses, whether due to a lack of ESG data or expertise, will itself be a red flag.

The seller should also identify any reputational risks created by transacting with the potential buyer or divesting certain assets. These concerns are particularly acute where the seller is divesting assets to help achieve its ESG goals, as there has been a spate of negative press relating to transactions where the buyer has lower ESG standards. Sellers can protect against this risk by performing reverse due diligence of the buyer to better understand the buyer's ESG priorities and plans for operating the divested assets post-closing.

In some circumstances, it may be warranted to implement contractual measures to demonstrate that the assets are being divested in a responsible manner, such as requiring the buyer to implement certain capital improvements post-closing or to submit to certain audits of its performance. There may also be scenarios where the seller passes up the highest bid to select a more ESG-responsible buyer, or, in extreme cases, the seller may determine that its best option is to shut down the asset in a responsible manner rather than monetizing it.

Definitive Agreements Phase

At this early stage of the ESG evolution, the market is not seeing a major increase in ESG-related provisions despite the attention ESG is getting in the media and in public disclosures. On the heels of the #MeToo movement, there has been an expansion of employee-related representations and warranties to cover sexual harassment and sexual assault allegations and race and gender discrimination claims.

However, there has not been a meaningful expansion of operational representations and warranties to cover ESG metrics that are of particular concern to the chemicals industry—such as plastic waste, greenhouse gas emissions, or energy or water use—or to cover the target's adherence to its adopted ESG reporting standard. There are several explanations for this, including the lack of a uniform standard for measuring these metrics and the relatively poor quality of ESG-related data, particularly in comparison to financial data, which is customarily covered by the seller's representations and warranties. The second half of 2020 and all of 2021 were generally considered to be very seller-favorable markets, so buyers were likely reluctant to propose any "off-market" expansion of the representations and warranties out of fear they would impair their bids.

It is possible this could shift if a uniform standard emerges as a result of the SEC's climate change disclosure rulemaking or market swings. However, there will also be headwinds from the representation and warranty insurance market that will likely be keenly focused on whether the buyer is able to perform sufficient due diligence of these matters as part of the underwriting process.

Pre- & Post-Closing Integration Phase

From a buyer's perspective, one of the most important responsibilities of its ESG working group will be to identify opportunities to improve the target's ESG performance, either pre- or post-closing, to unlock value and mitigate the risks identified during due diligence. These efforts should go beyond simply identifying capital projects and new technologies that could be undertaken or implemented.

The buyer should develop a plan to align the target's ESG-related priorities, policies, practices, and culture with the buyer's own, e.g., greenhouse gas emissions, diversity and inclusion hiring practices. One thing that can help facilitate this change is making sure the target's management team is involved in developing the ESG plan and is incentivized to implement that plan.

The impact of ESG on chemicals industry M&A is dynamic, and dealmakers in the chemicals industry need to be prepared to address ESG considerations at every phase of a transaction. M&A will be a critical tool for chemicals companies to achieve their ESG objectives, and market practices will continue to evolve as the industry's focus on ESG matures.