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The Evolving Landscape Of ESG In Public M&A

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Globally, investors are encouraging corporations to align their operating strategies with a stakeholder friendly approach to governance. There is a clear and progressive shift from the traditional shareholder primacy model of governance, to one that supports the view that value crea OPEN APP long-term is better enhanced by protecting interests of employees, customers, communities, environment and shareholders as a whole and not just the shareholders alone. In effect, investors are

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ESG and Investments

Typically, targets with higher ESG consciousness or achievements can attract higher valuations (ESG premium) and generally better deal terms. At the same time, the activism on ESG may also encourage ESG positive changes for potential investors, as the shareholders of a high ESG target may vote down a deal from potential investors that may not match the ESG performance of the target or which they believe may lack the future potential to match such performance.

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Investors and targets share a symbiotic relationship through ESG awareness. A high ESG investor acquiring a low ESG target can result in higher value creation as the investor has the required capability and processes to instill high ESG performance mechanisms in the target, and consequently, post investment integration costs may be lower. Cultural considerations, policies and organizational structures of the target ought to be considered as they may act as a hindrance to ESG integration, which may in fact be the primary reason for a low ESG performance of the target. Similarly, a lower ESG investor's acquisition of a high ESG target is likely to improve the ESG performance and overall value of the investor in the long term. While the returns may not be immediate and may even be negative in the short term, the long-term returns are likely to be positive and significant.

Overall, various studies suggest that investment arrangements between entities having similar ESG capabilities are likely to result in positive value creation, and accordingly investors are incentivized to prefer ESG friendly mergers and acquisitions (M&A). Despite evidence of value enhancement, currently there is limited integration of ESG in M&As in India – this appears to be primarily on account of lack of available ESG data on targets. To mend this gap, certain recent regulatory developments (discussed below) aim to enhance ESG disclosures, and in the process encourage ESG considerations in M&A in India.

ESG in Public M&A

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The ESG regime for Indian listed companies is fast evolving and seeks to make ESG relevant data easily accessible to the ESG conscious investor. The primary drivers for the ESG regime are: (i) the Companies Act, 2013 (CA 2013); and (ii) the Business Responsibility and Sustainability Report (BRSR) framework introduced in 2021 under the Sebi (Listing Obligations and Disclosure Requirements) Regulations, 2015 (Lodr).

Under CA 2013, ESG consideration are encapsulated in the form of director duties – with directors being entrusted, amongst other things, to act in the best interests of the company, its employees, the shareholders, the community and for the protection of the environment. The CA 2013 also promotes ESG by mandating eligible companies to undertake a minimum net worth linked spent as corporate social responsibility (CSR) expenditure, and make ESG disclosures as part of the board report in relation to energy conservation, alternate use of energy, CSR spending, compliance with other ESG related laws, including environmental/labour legislations, etc.

Under Lodr, Sebi introduced the BRSR framework for ESG related disclosures which is now mandatory for the top 1000 listed companies based on market capitalization. The framework entails disclosures against specific principles which are sub-categorized into certain essential indicators (which are mandatory) and certain leadership indicators (which are voluntary). For instance, one of the principles is that 'businesses should respect the interests of and be responsive to all its stakeholders' – with an 'essential indicator' being the process for identification of such key stakeholders and a 'leadership indicator' being the usage of stakeholder consultations to support the identification and management of environmental and social topics. Another principle is that 'businesses should respect and make efforts to protect and restore the environment' – with an 'essential indicator' being disclosures related to environmental impact assessments and a 'leadership indicator' being disclosures of energy consumption from renewable and non-renewable sources. Such disclosures are in alignment with the 'National Guidelines on Responsible Business Conduct, 2018' and the 'UN Guiding Principles on Business and Human Rights'. The BRSR thus includes disclosures in relation to stakeholders (including investors, employees, customers, communities, regulators etc.) grievance redressal mechanisms, recycling, training committees, waste management, healthy and safe workspaces, stakeholder consultation of ESG, energy usage, workforce inclusion and diversity, redressal of human rights concerns, data protection etc.

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In effect, the BRSR enables meaningful engagement between a company and its stakeholders by encouraging them to look beyond financials and towards social and environmental impacts. The BRSR framework also enables cross-referencing with certain internationally accepted reporting standards (such as the Global Reporting Initiative (GRI) or the Task Force on Climate related Financial Disclosures (TCFD), enabling easier adoption for global companies already following such ESG standards. Overall, the BRSR regime is a step in the right direction and aims to achieve quantitative and standardized disclosures on ESG parameters enabling comparability across companies, sectors and time.

Conclusion

There is an increased focus on businesses to be responsible and sustainable towards society and the environment. Accordingly, a company's ESG performance on sustainability related factors is becoming as vital as reporting on financial and operational performance – making ESG an increasingly important pillar of M&A deal making. To this end, the BRSR regime is an important framework to effectively facilitate and increase the usage of ESG metrics in public M&A. We expect ESG disclosures to evolve in time to be sector specific as such sectoral benchmarks are likely to be vital in deal valuations, negotiations, target selection and risk allocation. Considering the above, it may be beneficial for potential targets and investors to meaningfully adopt ESG strategies, and in the process be better prepared for upcoming M&A.

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