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Understanding the growing importance of environmental, social and corporate governance (ESG) in the world of mergers and acquisitions requires looking no further than social media. Countless posts on these social platforms demonstrate society's rising concerns around sustainability standards and corporate accountability. In fact, Elon Musk's recent attempt to acquire Twitter is the perfect example of the reach that ESG has in today's M&A market and the broader business world.

Twitter is the most high-profile acquisition on the rocks right now. While the primary reason Musk has cited for backing away from the deal is his allegation that the social media platform is infected with bots that impact fake news and, ultimately, the company's valuation, he has pointed to diversity concerns. "Musk has tweeted frequently about Twitter employing workers who are insufficiently diverse in embracing a wide variety of viewpoints and perspectives," says Dr. Michael Kraten, an ESG expert and professor of accounting at Houston Baptist University. "Ironically, the lack of diversity that he mentions involves a lack of conservative and libertarian representation." He suggests Musk's concerns represent issues around the G in ESG.

The components of ESG that are most in vogue are constantly shifting, but investors and companies alike have moved beyond viewing the standards as just another item to check off in the deal process to something that adds intrinsic value. Politics, ever-changing regulations and even the economic environment may color the way deals are evaluated at any given time. Still, the importance of ESG continues to grow, with the European Union leading the direction for where standards are heading. While countless metrics and organizations specializing in ESG due diligence have sprung up to meet rising demand, a major gap remains in the criteria used to rate ESG for major organizations and middle-market companies. As general partners and limited partners struggle to sift through the myriad components that comprise today's ESG, one thing is clear: It isn't going away and social pressures are proving to be the greatest driver of ESG adoption.

In the nearly two decades since the term ESG first entered the vernacular, the practice of looking at individual companies through environmental, social and governance lenses has evolved. ESG is no longer a token inclusion within the financial reports of major corporations; now, these factors can determine an organization's valuation and grind M&A deals to a halt.

"We're seeing a shift in folks considering ESG, not only because it's the right thing to do, but because it will make businesses more successful in the future. … In the private equity sphere, more and more people are seeing the true value in ESG and have gotten away from the 'check the box' exercise that existed five or 10 years ago," says Madelyn Tutewiler, vice president of ESG at MiddleGround Capital, a private equity firm specializing in control equity investment in middle-market B2B industrial and specialty distribution businesses.

There has also been a movement away from the perception that the benefits of a strong ESG profile are limited to businesses directly tied to the environment. "ESG analysis needs to be done across asset classes, whether or not an investor is an impact investor or a sustainable investor," says Erika Karp, executive managing director and chief impact officer of Pathstone, a family office advisory firm. "I would argue that ESG analysis must be done to get a full picture of risk adjusted returns—it's a fiduciary responsibility for an advisor to do it."

Karp notes that ESG is ultimately a proxy for quality, innovation and resilience that, when handled correctly, incorporates forward-looking factors that can impact companies, such as how they plan to approach artificial intelligence and even quantum computing. "Right now, there's this massive, orchestrated campaign to discredit the work of ESG analysis. But the truth is, those who are slamming on ESG are being ideological and, frankly, ignorant," she says. If a company can't demonstrate a strong understanding of the environment and social issues in which it operates, Karp believes that is a major red flag signaling governance issues.

SHIFTING PRIORITIES: E, S OR G?

Preserving the environment may be the first thing that comes to mind when most people think about ESG, yet all three factors are equally important for companies and investors alike when looking to identify risks a business could face.

Still, there is typically one aspect of ESG that dominates headlines at any point in time. Under the Trump administration, environmental concerns were top of mind, as more than 100 environmental rules were weakened, reversed or outright revoked. But the onset of the COVID-19 pandemic, coupled with the death of George Floyd at the hands of a Minneapolis police officer, brought greater emphasis to social considerations, such as diversity, equity and inclusion (DEI) and social equality.

The pendulum continues to swing in response to recent events. "Each time there is a killer heatwave, an enormous terrifying wildfire or the evaporation of a body of water (like the Colorado River) that we rely on for survival, the E becomes ever more prominent," says Kraten. "Each time something equally appalling occurs in the area of social justice, the S pops up. And whenever a major corporate scandal explodes across the headlines, the G takes priority."

According to Dave Brown, a partner in law firm Alston & Bird's Washington, D.C., office who specializes in M&A, the governance aspect of ESG is so deeply entrenched into due diligence that it typically takes care of itself in dealmaking. Because of that he says ESG due diligence currently focuses on the social and environmental components. "The trend is to engage in E&S diligence much earlier in the process. The focus is on understanding and mitigating risk," says Brown, noting that ESG diligence typically doesn't add time or additional costs to a deal process, though it ultimately depends on the industry. "Making money in the short and medium term is the goal, and ESG issues should not get in the way of that," he says.

SCREENING FOR ESG FACTORS IN THE MIDDLE MARKET

So far, it's rare for ESG concerns to hold up middle-market deals. "In the lower- and middle-middle-market, the aim is to invest in businesses with high growth potential, so anything that is a potential drag on valuation and growth is looked at closely. That includes ESG-related liability and reputational issues," says Randi Mason, co-head of the corporate practice at law firm Morrison Cohen, who specializes in the middle market and advises many clients on ESG-related matters.

However, she says buyers are not holding middle-market companies to the same standards as major organizations or slowing deals to shore up ESG factors. "The lens through which investors, other than impact investors, tend to look at things is, 'Will this company help or harm valuation or growth?' Not, 'How does this company rate on an ESG scale?'" she says.

While the standards for middle-market companies may be different than for their larger peers, investors are outright excluding some of the most controversial categories of businesses from their investment portfolios—producers of firearms and weapons, tobacco products, and oil and gas, for example. Instead, many are seeking value among promising businesses that might need to work on their ESG factors.

"We do utilize negative screening in assessing opportunities; however, there are assets where we see significant value in investing the capital to improve their ESG performance," says MiddleGround Capital's Tutewiler, adding that her firm is currently developing an ESG thesis that will specifically target businesses that meet

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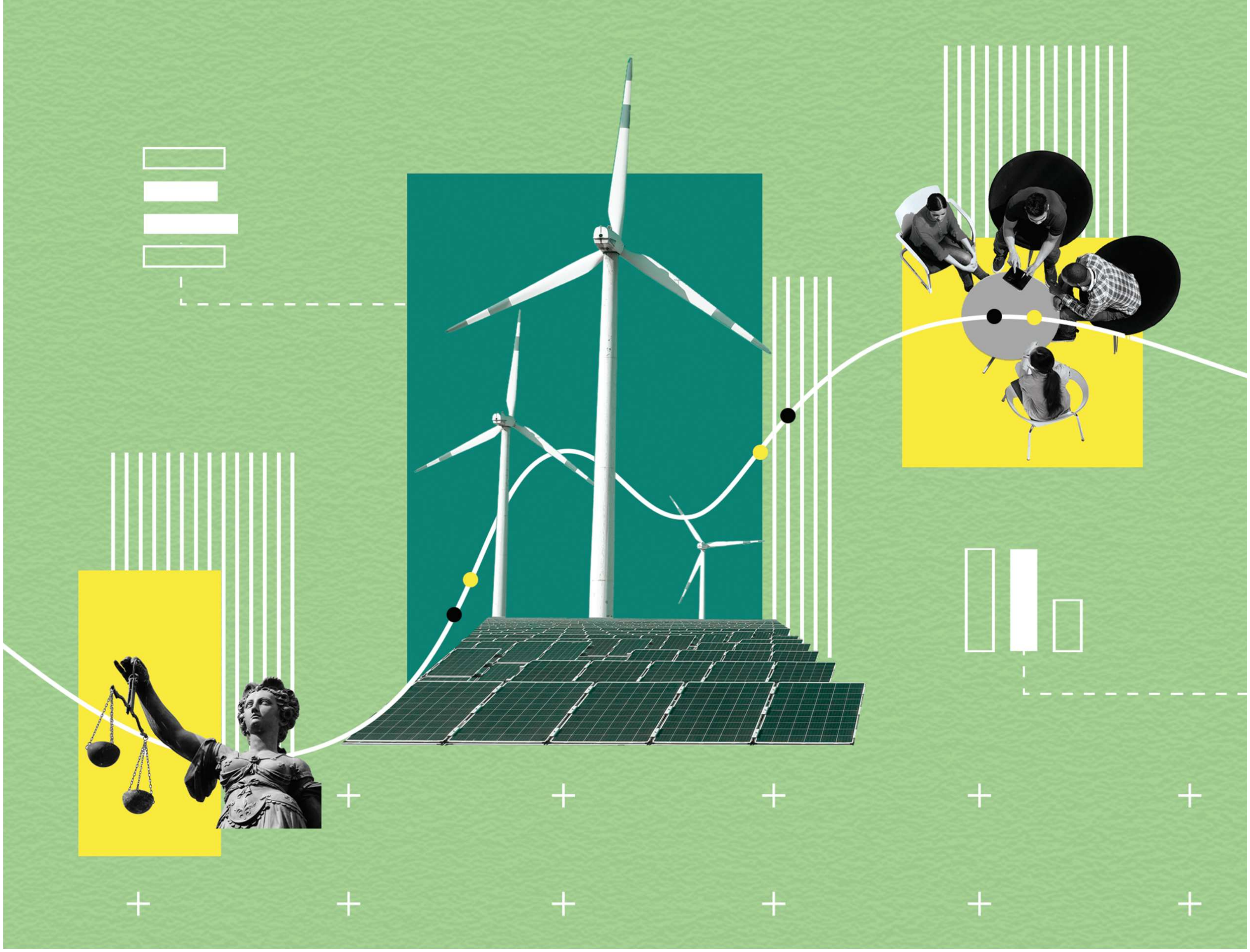

a critical need for a productive society in the future, but that may need significant investment in ESG.

A strong ESG profile is not just a measure of risk management and due diligence; it can also lead to a premium price for companies being acquired. "We're starting to see this early evolution where ESG is moving beyond a buzzword. It's becoming an ethos of how the best modern companies are run, and that's starting to be embedded into operations. A good company is just going to have strong ESG practices, full stop," says Max Hong, CEO of Malk Partners, one of the largest ESG management consultancy firms that specializes in serving middle-market private equity firms. While not all investors have been quick to embrace ESG, he says there are many cases where investors are paying a premium for companies with strong ESG profiles.

One example investors point to is shoe company Allbirds, which has built its business entirely around eco-friendly materials and a sustainable supply chain. Having a strong ESG set of practices that are well beyond anyone else in the industry has helped Allbirds differentiate itself and garner a premium for the company. Following its November 2021 IPO, Allbirds saw its valuation skyrocket to more than $4 billion.

DUE DILIGENCE BEST PRACTICES

There is no shortage of metrics that investors and companies can rely on for determining the strength of an M&A target's ESG practices. The four most common metrics investors currently use are The Global Reporting Initiative (GRI); the Sustainable Accounting Standards Board (SASB); the United Nations' Sustainable Development Goals (SDGs);

and the Task Force on Climate-Related Financial Disclosures (TCFD). The first three are comprehensive and universal systems, while the latter focuses solely on climate change. The problem is, while these metrics are extremely comprehensive, they are more relevant for major corporations and tend to be overkill for middle-market companies.

"One of the temptations as everyone is still getting used to this—particularly in the mid- and lower middle-market, is that they will try and apply a standard or an entire set of metrics that may be appropriate for a large company to a much smaller company," says Ethan Klemperer, a senior operating executive and head of the operating team at Monomoy Capital Partners. "What ends up happening is: You don't have real adoption and it's not really meaningful because people are just filling this out to check a box."

There is an industry consortium of LPs and GPs that The Carlyle Group and the pension fund CalPERS are spearheading, called the Data Convergence Project, which is a working group of about 200 private market participants that are trying to develop a core set of metrics, Hong explains. If the Data Convergence Project can right-size and standardize metrics that are more appropriate for middle-market companies and evolve into a more robust set of metrics over time, Hong believes it will help drive greater adoption.

One way that investors and companies have offset the massive amount of work needed to gauge a company's ESG health is by employing ESG-specific consultants and advisors that have sprung up to meet demand. "There's a huge service industry that's burgeoning that has to do with ensuring that companies are compliant with different ESG standards, both domestically and globally," says Francesca Lorenzini, investor relations director for alternative investment management firm Sustainable Development Capital.

With hundreds of firms now specializing in different components of ESG compliance and due diligence, it has become commonplace for investors to use these organizations to supplement their own risk reviews when evaluating potential M&A targets. "All the firms who are emerging in this space are validation that ESG's a growing market," says Hong. He points to Accenture's strategic investment in ESG data platform PulsESG and Blackstone Energy Partners' acquisition of energy and sustainability consulting firm Geosyntec as recent examples.

Investors are not only looking at ESG regarding M&A targets but also focusing the microscope on their own operations as well. "One of the ways ESG is affecting our business and our fundraising has to do with how diverse our investment committee and investment management teams are. This impacts the companies that we look at," says Lorenzini.

INTERNATIONAL STANDARDS

Not surprisingly, the European Union is leagues ahead of the United States on the ESG front. As a result, investors and companies wondering where regulations may ultimately be headed in the U.S. are best served by looking to the EU as a guide. "In the U.S., we're still trying to understand whether we care about ESG and whether or not this is a real, existential threat to the financial services community," says Lorenzini. "When I speak with investors, they often say 'There's just not a lot of clean energy or ESG deals that look really good.' But I think there are. There's an appetite for ESG deals in the U.S., but there's a mismatch in finding those deals right now."

The legislation that Sustainable Development Capital believes will have the biggest impact is the EU Commission's Fit for 55 Agenda, which aims to reduce greenhouse gas emissions by at least 55% by 2030, and the REPowerEU plan, which aims to make Europe independent from Russian fossil fuels before 2030.

As investors seek deals and companies look for funding from the private equity world, ESG will be a major determinant of how things play out. Consumers, particularly younger generations, have made it clear that ESG factors are firmly on their radar and something they will increasingly take businesses to task on. While inflation and a recession could see consumers shift their wallets toward less expensive, less sustainable brands, any such change is unlikely to last.

"People around the world are growing increasingly concerned about things like climate change and racial justice. I think there could continue to be increasing pressure on companies to do better in these areas, in spite of macroeconomic conditions," says law firm Morrison Cohen's Mason. //

BRITT ERICA TUNICK is an award-winning journalist with extensive experience writing about the financial industry and alternative investing.