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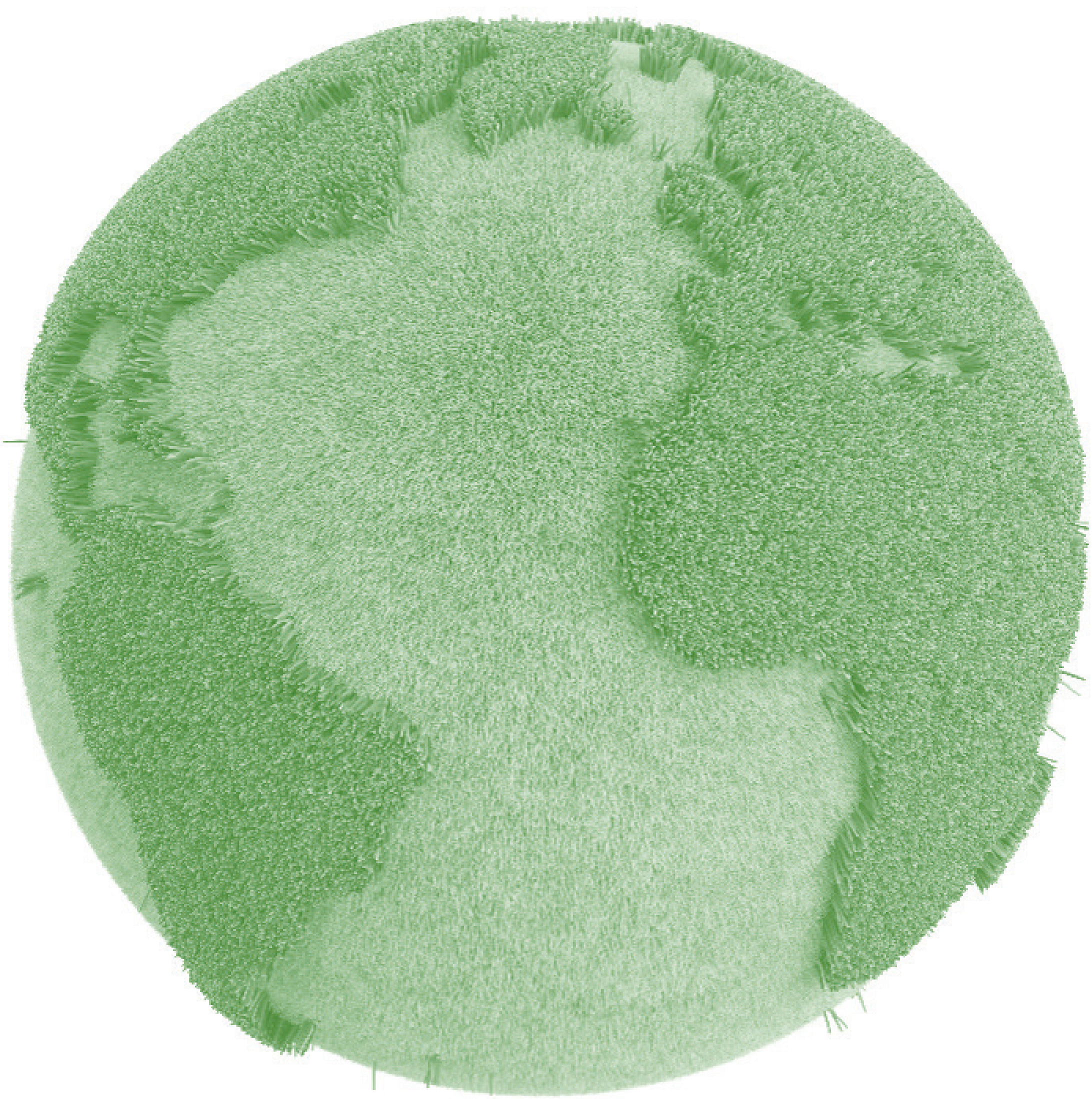

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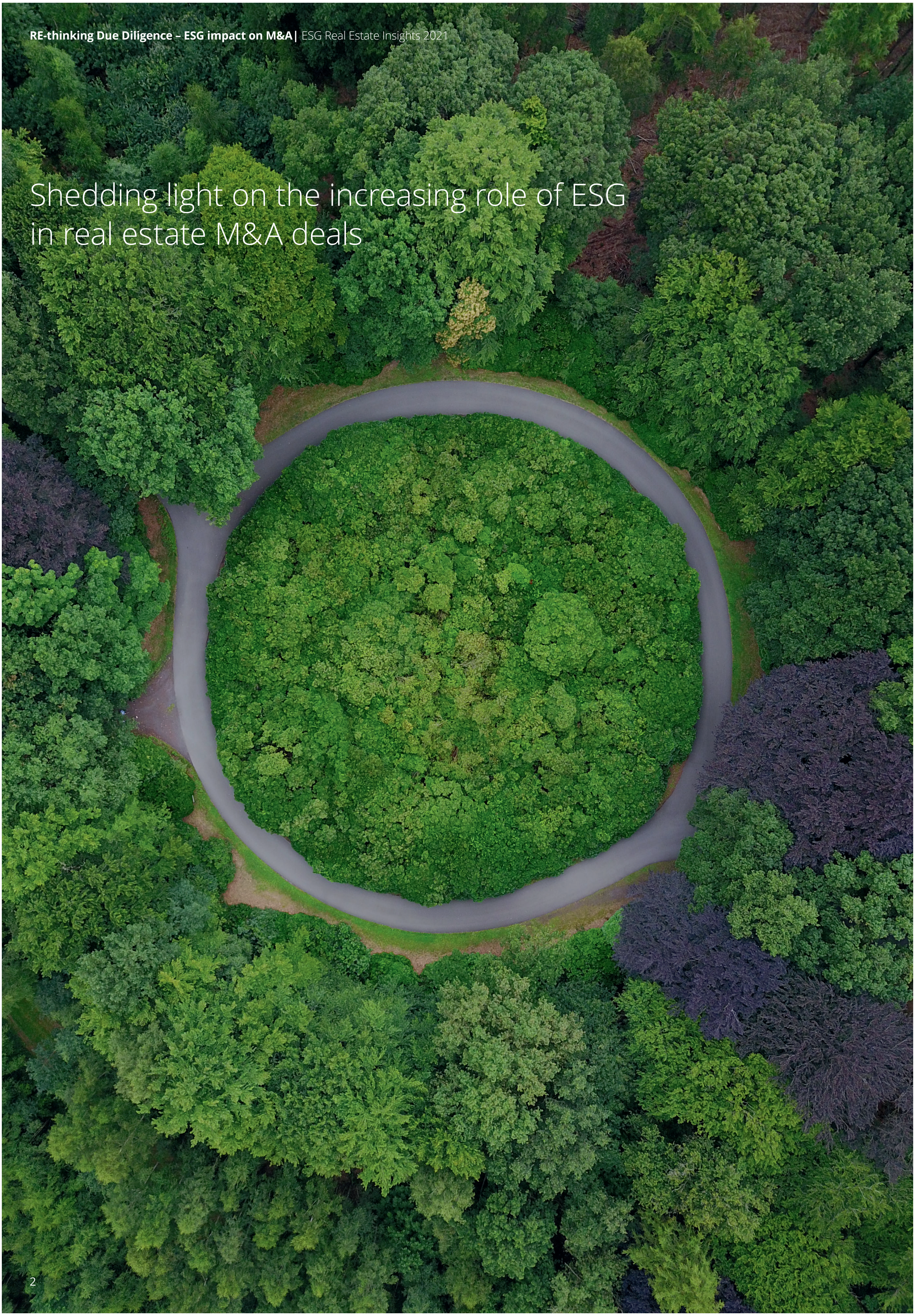
RE-thinking Due Diligence – ESG impact on M&A

MAKING AN IMPACT THAT MATTERS since 1845

Shedding light on the increasing role of ESG in real estate M&A deals



Evidence is mounting that business performance is impacted by environmental, social and governance factors and recent developments demonstrate that the speed at which those elements become material is increasing. Drivers of this accelerating change are, for example, increasing transparency based on improved data availability around environmental, social and governance (ESG) factors, society's changing expectations as public awareness of social and environmental challenges increases and growing influence of investors as they integrate ESG factors into the core due diligence process. Hence, ESG has found its way to the Mergers & Acquisitions (M&A) business. The real estate industry has been a particular focus of regulatory bodies, primarily as the sector contributes to 36% of EU CO_2 emissions[1]. ESG due diligences provide meaningful insights for investors prior to a transaction. This article sheds light on the general concept of ESG due diligences and its specifications and particularities with regards to the real estate sector.

Shareholders and stakeholders increasingly expect their companies' management to focus on sustainability and contribute to global environmental goals, to act socially responsible and to become more inclusive and diverse. In other words, issues such as human rights violations, environmental ruthlessness or other ethical infringements can have vast negative influence on business as the companies' actions are increasingly impacting on how their stakeholders interact with and what shareholders demand of them. Consequentially, in the context of transactions, ESG aspects constitute financial and reputational risks. Investors seek for more transparency before signing a deal to avoid potential pitfalls linked to ESG concerns. This growing awareness for ESG amongst investors gives rise to ESG due diligence which is evolving from a niche to a widely known term and required competence in the M&A business.

Especially for deals in the real estate industry, ESG due diligence enjoys increasing prominence as the sector faces being closely monitored by governmental bodies and prudential authorities over its environmental impact. The EU Action Plan on Sustainable Finance should not be left unmentioned, as the included EU Taxonomy defines the criteria for ecologically sustainable activities and investments, making the impact of the investors' business on the climate and other environmental criteria transparent.

ESG due diligence takes the EU Taxonomy as well as other national and international regulations into account. Vigilant due diligences highlight red flags and may optionally also assess risks and opportunities and future value creation potential (e.g. cost reductions through increased energy efficiency).

General concept of ESG due diligences

Generally, ESG due diligences analyze the compliance of the targets with national and international regulations as binding frameworks as well as non-codified stakeholder ESG-related norms and expectations. Further, it highlights the environmental, social, and governance status quo of a company.

With regards to the environmental dimension, a due diligence includes the existence of internal policies, responsibilities and management with regards to several environmental aspects (esp. energy, CO_2 emissions, materials, water usage and waste) summarizing the ecological impact of the business model as well as how it interacts with all key environmental stakeholders and works to mitigate its impacts.

The social dimension covers policies and responsibilities concerning social aspects, such as human rights, labor standards, health & safety, diversity and equal opportunities among others.

Finally, the governance dimension constitutes of analyzing the risk management systems, the existence of corporate codes of conduct (anti-bribery, anti-corruption, etc.) and the transparency of board and management decisions and remuneration.

It is of note that the approach to ESG due diligences is not a "one size fits all" approach for all industries. Each industry presents its own array of environmental impact and stakeholder interaction that must be considered. For example, a target in the chemical industry would have a particular emphasis on the environmental factors such as disposal of hazardous waste, whereas for a target in the textile industry the focus may lay on the social factors such as child labor or poverty wages. Hence, ESG criteria need to be selected from a bouquet of KPIs taking industry-specific and target-specific factors into account.

[1] European Commission: New rules for greener and smarter buildings will increase quality of life for all Europeans, April 2019.

KPIs for the real estate industry

For the real estate business with assets in the utilization phase, environmental topics outweigh social and governance KPIs as the industry's impact on the environment stands in the foreground. Due diligences hence may focus on environmental KPIs such as the existence of an environmental policy (and a responsible team), its compliance with national and international regulations, the usage of renewable energy and the existence of monitoring systems and regular disclosure of sustainability reports. Additional focus areas are the age of the buildings, the status of modernization and the recyclability of building materials.

For targets involved in real estate project development, the list of KPIs should be extended to measures of the environmental impact of the construction phase itself, as for example drilling machines are responsible for large parts of particulate matter and noise in urban areas. Moreover, social KPIs need to include workers' health and safety, such as the exposure to hazardous chemicals or events (floods, fire, etc.), the existence of emergency response plans, trainings, and compliance checks. Especially for the project development business, governance KPIs should include policies in place such as anti-bribery, anti-corruption, and anti-money-laundering.

As time is usually short for M&A decisions, the right selection of KPIs is crucial. Only an analysis of the appropriate measures provides the management and stakeholders with the information needed for making the right decisions. An insightful ESG due diligence hence requires methodological and industry-specific expertise.

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