MAKING RISK EXTINCT?

Extinction Rebellion has put climate change back on the front pages. And if 'value' means future profits discounted for risk, then advisers must understand how environmental factors affect every business. Grant Murgatroyd reports

It's official: we are in a climate and environment emergency. On 1 May 2019, the UK parliament issued just such a declaration. A month later the government turned words into action by introducing legislation to end the nation's contribution to global warming by 2050.

For dealmakers, climatic and environmental impacts have been moving back up the agenda over the past decade. What used to be a relatively straightforward check of liabilities about issues such as land contamination or asbestos management has turned into a more holistic approach to business sustainability.

"Investors have realised that it's not all just about the financials," explains Doug Bryden, an environmental lawyer and head of the operational risk group at Travers Smith. "If you want to make sure those numbers are sustainable, non-financial concerns need to be fully considered. For example, if you have a company that's reliant on high carbon-emitting processes (intensive coal burning for instance), even if short-term financial projections are strong, the sustainability of the current business must be questioned, be it due to increasing regulatory burden, or simply market opinion and appetite. It's not only the polluters at risk. Businesses, which are likely to suffer the adverse impacts of climate change, must also be carefully considered."

CHANGE HAS A PRICE

With the Climate Change Act 2008, the UK became the first country to pass long-term, legally binding national legislation to tackle climate change. This followed the 2006 publication of the *Stern Review on the Economics of Climate Change*. The report estimated that the cost of reducing carbon dioxide emissions to a peak of 450-550 parts per million at 1% of annual GDP. Ignoring the issue would cost up to 20% of world GDP, while addressing it would create a $500bn-a-year market for low carbon energy. But in 2008, the global financial crisis bumped climate change off the front pages.

Speaking on the 10th anniversary of the *Stern Review's* publication, Andrew Steer, president of the World Resources Institute, said: "The case for action is much more clear today, partly because technology has changed, making the transition to a low carbon future much more cost-effective. Because we're 10 years on, the problem has become more obvious. Essentially, the costs of inaction have gone up, and costs of action have come down a lot."

HOW TO MEASURE?

It is no surprise that investors and M&A advisers have been developing measurement techniques for companies' environmental, social and governance (ESG) positions. Some private equity houses have 100-plus question lists for every potential investment, regardless of sector, geography or ESG maturity.

Due diligence providers say the nature of their work is changing. "First there's the safeguarding element, making sure that the whole variety of ESG issues are being identified and properly addressed," says Neal Barker, WSP environment director. "Now there's a much greater tendency to ask advisers to identify enhancement opportunities and to use technical specialists in evaluating the investment in the context of certain areas."

Tight timetables can limit what can be done about environmental issues during an M&A process. Tim Clare, director at Anthesis, says that time is always an issue. "You can normally do enough diligence to understand which ESG issues are material and whether they are being covered. It's simply impossible to price all these issues prior to buying, unless you're saying they are unbelievably material and a potential deal-killer, which is very, very rare.

"Buyers now accept that it's something they're going to have to deal with once they own it, which wasn't historically the case."

But limited scope for meaningful negotiation does not mean environmental issues should be ignored. Sophisticated vendors are on the front foot. "One of the big changes in recent years is the focus both M&A sellers and buyers have on these ESG issues," says Bryden. "Indeed, sellers are spending an increasing amount of time and effort prepping companies for sale and improvements and evidence of good ESG management is now very much part of the narrative. The investors and managers who have chosen to ignore these recent trends will increasingly find exits as well as fundraisings more challenging."

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Dr Zhenyi Huang, research fellow, Cass Business School

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Tomas Sys, principal consultant and UK due diligence practice lead, Ramboll

COST OR INVESTMENT?

It is easy to see the soft benefits of having good environmental practices, but is there a financial benefit? Dr Zhenyi Huang and her team at Cass Business School have researched the pre- and post-deal environmental and financial performance. They found that acquirers in general enhanced environmental standards post-deal.

"Acquirers with prior deal experience do better in terms of improving the company's environmental performance," says Huang. "Acquirers might want to place more emphasis on learning how they integrate a firm's ESG practices into the newly-combined company, so that there are benefits not just for the current deal, but also on future deals."

Selina Sagayam, a partner at Gibson Dunn & Crutcher, says that the absence of measurement and standardisation of ESG performance has been a barrier to its implementation, but that this is changing: "Addressing ESG issues is an investment with a cost, but there is clear data showing the value that comes out of these investments. Financial sponsors are very focused on generating returns over their investment period, so the longer-term impacts on people, culture and communities may not be immediate enough for them.

"But there are huge opportunities to generate returns in the short-to-medium term. Some private equity firms are actually targeting investee and portfolio companies, which are slightly under-performing in terms of ESG integration and where there's room for improvement. Sometimes using the ESG lens can help them acquire an asset at a better price."

ESG must be more than a checklist. Companies that choose to try and be more responsible must make a deep and lasting commitment to the cause. Tomas Sys, principal consultant and the UK due diligence practice lead at Ramboll, argues: "ESG is a journey. It's not something you can switch on and off. A company has to decide that it wants to adopt responsible investment principles and operate in this way, as this is not a regulatory requirement."

GREEN WASH REGULATION

Cynics will always see corporate pronouncements on environmental practices as 'greenwashing'. And they have a point. Few companies used to instigate meaningful change, but the UK's Climate Change Act has forced their hands. This is most obvious in the power sector, where carbon emissions fell 59% from 2008 to 2017 and the share of low-carbon generation rose from 20% to 52%, according to an assessment by Friends of the Earth.

Even the fossil fuel dinosaurs are making changes. In 2018, BP paid £130m for Chargemaster, the UK's largest network of electric vehicle charging stations, while Shell's CEO Ben van Beurden called for the UK to bring in the ban on the sale of new petrol and diesel vehicles from 2040.

No sector is immune, with consumer-facing businesses coming under scrutiny. "From an environmental perspective, compliance is the foundation," explains Aga Siemiginowska, managing consultant at Ramboll. "Traditional environmental, health and safety due diligence has been around for many years. Most investors understand that there is a fairly formulaic approach to identify the liabilities, quantify the risks and then assess whether they are material to the deal. The 'E' component in ESG goes beyond that and can be harder to quantify because it doesn't always necessarily fit into one little slot."

$6.5trn

Value of BlackRock's assets under management

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CUSTOMER DEMAND

In our interconnected, social media-enabled world, consumers and their preferences can change almost instantaneously. It took less than two years for the groundswell of opinion against single-use plastic straws and stirrers, five billion of which are used every year in England alone, reaching such a point that legislation banning them has been introduced.

But will consumers instigate more than cosmetic changes? A population that associates plastic straws with the death of whales appears happy to leave a tent at a festival because it is convenient. According to the Association of Independent Festivals, festivalgoers in the UK leave behind more than 250,000 tents, with a single tent using as much plastic as 8,750 straws.

One anonymous ESG adviser said: "People like to talk a good game, but when it actually comes to paying for their principles it can be different. Consumers are influenced by what's fashionable, and things change faster now than ever."

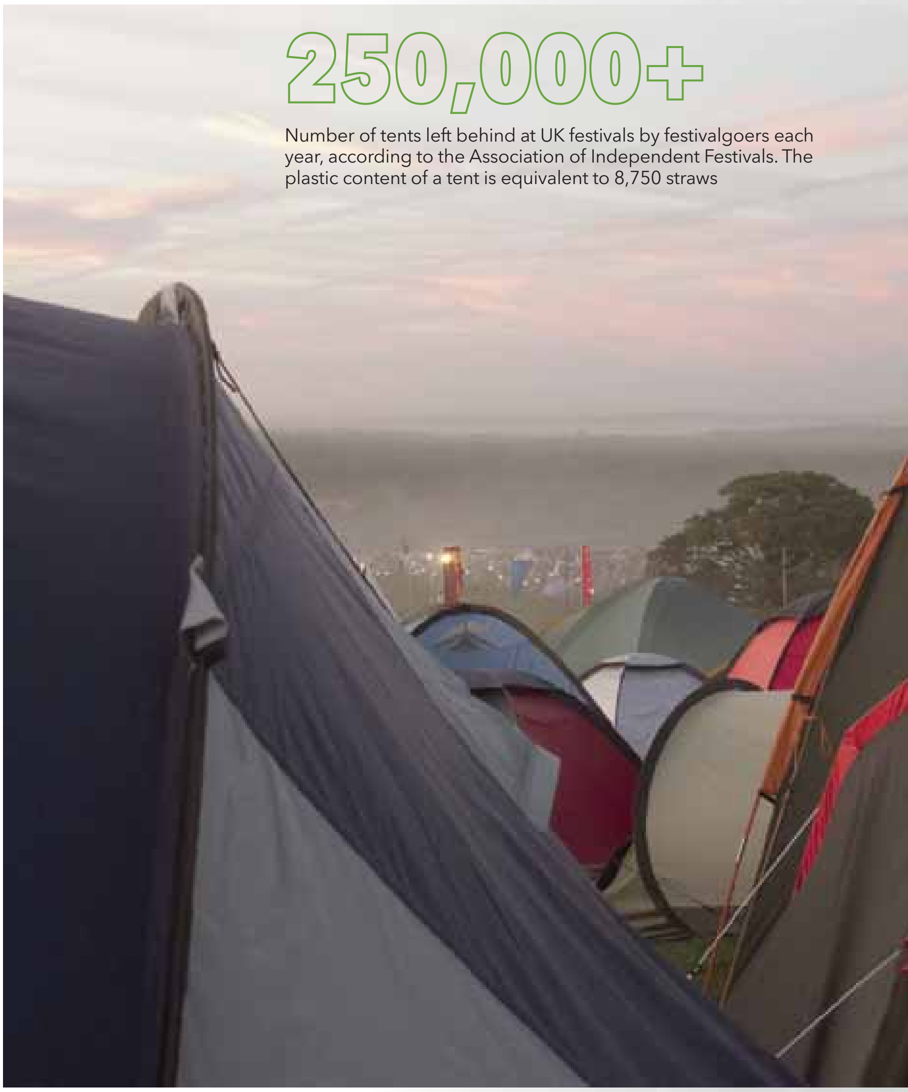
INVESTORS' BUY-IN

By 2018, $89.65trn of assets were managed by signatories to the United Nations' Principles of Responsible Investment. Crucially, the percentage using ESG when selecting investments and/or fund managers increased from 55% in 2017 to 86% in 2018, while the percentage considering ESG in monitoring increased from 53% to 78%.

Leading the way was BlackRock, the world's largest asset manager with $6.5trn under management. Speaking at the launch of a set of ESG data disclosures and portfolio analytics, BlackRock vice chairman Philipp Hildebrand said: "Increased transparency on the sustainability profile of their investment portfolios will enable investors to understand the potential ESG-related risks and opportunities they are exposed to. Strong ESG performers are more resilient and this has led to an irreversible move from an era of asking 'why?' to 'why not?' in sustainable investing."

Tim Clare of Anthesis has been a regular attendee of the Responsible Investment Forum, the big ESG get-together for the private equity industry. At this year's event he picked up on a palpable change of tone.

"People were talking about ESG in a way that genuinely grabbed me," he said. "It was clear they are taking it a lot more seriously and that it's very real. The UK has taken a leading position, but there is some concern about quite whether that position will continue if there's a no-deal Brexit and everyone becomes more focused on the immediate economic fallout."



250,000+

Number of tents left behind at UK festivals by festivalgoers each year, according to the Association of Independent Festivals. The plastic content of a tent is equivalent to 8,750 straws

CHANGING SEASONS

The clothing and apparel sector is a great example of the complex and often contradictory pressures facing business when it comes to the environment – customers want minimum environmental impact in manufacturing, but they also want cheap clothes.

Founded in 1975, Spanish retailer Zara was a pioneer of fast fashion and had a meteoric rise. The company launches more than 12,000 new designs ever year and gets products on the shelves in one week, compared to an industry average of six months.

After attracting criticism about the use of toxic chemicals and child labour, Zara joined Greenpeace's Detox Campaign and pledged not to use suppliers that hire children. Many manufacturers are taking environmental issues more seriously, with Levi's, G-Star, Nike, Adidas, Eileen Fisher, Reformation and Filippa K praised for their efforts, according to Anthesis.

US outdoor clothing brand Patagonia has a commitment to "use business to inspire and implement solutions to the environmental crisis". It uses organic cotton and recycled plastics, and has policies on labour and animal welfare. However, when marine biologist Mark Browne went looking for funding to examine microfibre pollution coming from fleece material, Patagonia was one of a host of outdoor companies that said no. Mainstream retailer Eileen Fisher funded the project, though Patagonia did fund follow-up research in 2015, and made further pledges to continue.

Plastic microfibres are estimated to account for 85% of plastic waste in the oceans, which is bad news for any company known for producing synthetic garments.

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AT THE HEART OF BUSINESS

An increasing number of private equity firms have formal ESG policies applied to every investment, regardless of sector, size or geography. Anthesis has worked with one London-based private equity house on six new acquisitions since the firm adopted a new ESG policy.

Two specialist manufacturers and a leisure business would have been expected to undergo environmental due diligence for historic contamination issues and regulatory compliance requirements.

The application of the ESG policy meant the other three – in media, financial services and specialist retail – were also subject to environmental assessments. As significant energy users all needed to be compliant with the (outgoing) UK Carbon Reduction Commitment and/or the Energy Saving Opportunities Scheme, on top of the fact that energy represented a material cost line for the businesses. There were also material issues associated around avoiding the use of single-use plastics and the trade in endangered species.

Anthesis' ESG policy required the businesses to formally determine what their key performance indicators are, and set improvement targets. This is a requirement for an increasing number of limited partners. One of those businesses is moving to phase out single-use plastics. Another is conducting an in-depth assessment of the bottom line improvement that can be achieved by significant investment in energy efficiency, and on-site generation opportunities. ●