

ESG's impact and M&A resilience

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Environmental, social and governance ("ESG") issues detected during due diligence were once considered risks which could lead to specific indemnities, remediation measures or even a purchase price decrease. Now, they are recognised as one of the most substantial opportunities for value creation and transformative industry shifts in our era. With sustainability and ESG considerations becoming more influential, Belgian companies are facing greater pressure to align their operations with these principles. This marks a clear shift towards integrating sustainability values into the core of business strategies and decision-making processes. Attaining ESG goals can be achieved through M&A activities to further increase customer penetration and accelerate sustainable growth across the value chain.

However, companies also falsely portray ESG commitments. "Greenwashing" includes publishing misleading information about practices or false claims about products. Companies could also associate themselves with environmental issues without taking substantive action, or while continuing environmentally harmful practices.

The EU Directive 2022/2464 on Corporate Sustainability Reporting

(the "CSRD") that came into force on January 5, 2023 represents a significant step in modernising and fortifying environmental reporting regulations. The CSRD aims to promote genuine environmental accountability. The CSRD enhances access to information critical for assessing financial risks and opportunities of sustainability issues, particularly climate change. These rules, effective from the 2024 financial year onwards, underscore the EU's commitment to sustainability, and align with international standardisation initiatives. Before this directive takes effect in Belgium, it needs to be transposed into Belgian law (by 6 July 2024 at the latest).

According to the 2022 M&A monitor report conducted by Vlerick Business School, only 35% of strategic acquisitions consider ESG. Private equity fares slightly better at 49%, but only 38% of surveyed Belgian private equity investors have a formal ESG investment policy. The implementation of the CSRD may shift companies' attitudes towards ESG in M&A, with one participant noting that private equity

firms are still assessing how to integrate ESG into investments. Although the following edition of the 2023 M&A monitor report of Vlerick Business School did not provide any numbers on this evolving trend, it does indicate a surge in M&A deals targeting firms with robust ESG credentials. Companies that can credibly demonstrate those tend to attract substantial market interest and secure higher valuations from acquirers aiming to enhance their own ESG credentials. As a result, provisions relating to ESG commitments feature more prominently in the companies' governance documentation, including shareholders' agreements.

Following an introductory analysis of the opportunities and challenges associated with achieving ESG goals, we explore how the CSRD can help strengthen companies' resilience in the context of M&A.

Opportunities and Challenges

ESG generates value across various dimensions, assisting companies in cost reduction, enhancing sales, raising prices, attracting and retaining top

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talent, and augmenting overall company value. Notably, ESG is perceived as an avenue for expanding into new business realms. This expansion might involve reimagining the core business by offering alternative products to the existing customer base, introducing new products in related markets, or establishing entirely new ventures aimed at different customer segments while leveraging existing internal knowledge.

Realising ESG ambitions does not inherently create value and is confronted by notable hurdles. Challenges include company cultures impeding ESG advancements, the underdeveloped nature of ESG in terms of regulations, standards and data availability, as well as the quest for suitable ecosystem partners. Moreover, navigating trade-offs between short-term profitability and long-term objectives is also a hurdle. These challenges are compounded by immediate pressures such as ongoing geopolitical conflicts, high inflation, and constraints within global supply chains.

The EU Directive 2022/2464 on Corporate Sustainability Reporting (the “CSRD”)

The primary obligation outlined by the CSRD for companies within its scope is the disclosure of sustainability information in conformance with the European Sustainability Reporting Standards (ESRS), which were adopted by the Delegated Regulation (EU) 2023/2772 on July 31, 2023. The ESRS comprises theme-specific standards (Environmental, Social, Governance) tailored to address the most important aspects of these themes (e.g. climate for ‘Environment’, human rights protection for ‘Social’, anti-corruption compliance for ‘Governance’). The ESRS also aims to develop sector-

specific standards tailored to address unique topics within specific sectors. Simultaneously, it includes cross-cutting standards applicable, irrespective of the sector. These cross-cutting standards require a substantial range of information categories to be disclosed, including details such as the description of the business model and strategy, sustainability risks, and transition plans. This encompasses information on sustainability policies, incentive schemes on sustainability issues, as well as measures devised to prevent and mitigate adverse impact on sustainability. Noteworthy is the principle of “double materiality,” necessitating reporting on the impact of sustainability on the company and vice versa. Cross-cutting standards also introduce reporting within the value chain, with a 3-year grace period.

Furthermore, the CSRD introduces two key reporting rules applicable to all companies within its scope. The first emphasises transparent reporting, requiring information to be clear, relevant, verifiable, and comparable. The second, the “materiality requirement,” mandates the disclosure of only relevant information. This principle is especially pertinent for topical standards, necessitating a comprehensive explanation if, after conducting a materiality assessment, a company considers a specific topical standard as not material to its operations,

particularly when the company is not engaged in that specific field.

The CSRD leaves sanctions for non-compliance to member states. Expected sanctions include financial penalties, warnings or correction orders, and criminal sanctions. Many member states are likely to retain similar sanctions from the Directive (EU) 2014/95 on Non-Financial Reporting.

Strengthening Resilience: Navigating ESG Expectations in M&A Transactions

Besides publicly listed companies, the CSRD applies to EU-based companies that satisfy at least two of the following criteria: 250 employees, a total balance sheet of EUR20m, or a net turnover of EUR40m. It includes certain qualified Small and Medium Enterprises, and exempts certain micro-enterprises. For non-EU companies, it covers EU subsidiaries or branches with a group turnover exceeding 150 million Euro in the last two years, and either an EU branch with over 40 million Euro turnover or a subsidiary meeting the EU-based criteria. In my opinion, companies falling outside the scope of the CSRD could voluntarily adhere to European Sustainability Reporting Standards (the “ESRS”). This would make them more attractive to partnerships and M&A transactions with these large companies and certain qualified SMEs. Furthermore, they may



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be required to do so if their customers fall under the scope of the CSRD and prefer their respective supply chains to accommodate them in their respective CSRD compliance programs.

According to the Belgian 2023 M&A Monitor conducted by the Vlerick Business School, there is a growing emphasis in Belgium on ESG during the due diligence of an M&A transaction and selection of partnerships. This includes the review of material agreements, examination of target companies’ ESG policies and initiatives, a target’s activities and supply chain, and scrutiny of compliance frameworks. Beyond mere legality, there is a growing interest in understanding whether the target’s current business practices align favourably with the expectations of key stakeholders, most notably investors and customers. This scrutiny extends particularly to the intricacies of the supply chain, where the perception of ethical and sustainable practices can significantly impact the overall desirability of a potential transaction. This is exacerbated by the cross-cutting



standards imposed by the CSRD which require sustainability reporting about companies with which they have direct and indirect business relations in the upstream or downstream value chain.

The transformative industry shift posed by ESG necessitates close collaboration not only among different legal disciplines (i.e. environmental, social, corporate, regulator etc.) but also with non-legal experts such as financial

or technical advisers. Furthermore, there is an anticipation that ESG considerations will gain increased prominence in the negotiation of transactional documents, such as sale and purchase agreements. This will be particularly notable concerning representations, warranties and covenants related to relevant standards, akin to how anti-money laundering processes are addressed.