

Torys' Video Podcast Series: Climate Change

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Carbon Risks and Opportunities: Implications for Investment Activity and M&A

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Patricia Koval discusses how climate change is affecting investment activity and mergers and acquisitions.



Edited transcript

Climate change has actually transformed itself from simply an environmental phenomenon to one that now affects virtually all aspects of business. We really see this in three ways. First of all, it's an issue for investors, fiduciaries and lenders; it has now entered into their investment and lending decisions. Second, it's an issue more broadly for companies in terms of how they manage climate risk and how they allow it to affect their operational decisions and optimize their strategies. And third, we think it's going to be a driver in and of itself for mergers and acquisitions activity.

We hear from lenders, private equity investors and institutional investors that climate change has really introduced a whole new element into the evaluation equation when making an investment decision or a credit decision. In fact, from a fiduciary perspective this is an issue that really can't be ignored. And there are a number of very well-known legal opinions that have been given to institutional and pension investors around the world on this very fact – that climate change is a fiduciary issue that can't be ignored for those decisions.

What we're hearing from our investment clients and our lending clients is that there's really a new four-pronged approach to climate risk valuation in both lending and investment decisions.

The first factor is really carbon risk itself, and this is the risk that's posed by complex, multifaceted and multijurisdictional regulatory regimes that are going to be regulating climate change in the jurisdictions where companies do business, where their head offices reside and where they sell their products. This of course is going to have financial impacts on companies, and those in turn are going to have competitive impacts. Of course there's also the risk that climate change may have a physical impact on companies, on their real estate assets and on their infrastructure, for example.

The second factor that investors and fiduciaries will look at is how companies in fact manage and mitigate that carbon risk. The third, perhaps surprisingly, is whether or not companies are able to take advantage of the new opportunities that climate risk is providing, both in terms of providing low carbon products and services and potentially, also, in carbon trading. And last but not least is the factor whether companies can actually improve: can they manage to improve their footprint and their entire production strategy in the context of climate change?

So what we're actually seeing is this value proposition in action; we're seeing consultants, audit firms, investment bankers and others actually analyzing companies in context of these carbon risk factors, and making recommendations and predictions about them.

We're also seeing institutional investors, private equity investors and lenders seeking more and more information about companies and how they're dealing with carbon risk. They're looking for that both through the securities regulatory disclosure framework and through the voluntary framework.

We're seeing institutional investors increasingly seeking more education on the subject. Of course, we're also seeing them get together through networks that are basically focused on climate risk. One primary example is the Investor Network on Climate Risk, which is based in the United States, but which now includes a number of our major Canadian pension funds and institutional investors. We are also seeing them actively use their voices with companies in their shareholders' meetings. The Canadian proxy season this year was rife with examples of shareholder proposals, all directed at climate change.

More frequently, we're also seeing institutional investors and lenders actually incorporate climate risk into their governance guidelines. And when I say governance guidelines, I'm talking about the obligation to require the companies they invest in not only to disclose their climate risk but also to act on it.

I tend to agree with one of the founders of the Carbon Disclosure Project, who said that there is going to be a large creation and distribution of shareholder value in the transition to the low-carbon economy. Already we are seeing analysts analyzing industries and companies within sectors to determine who the winners are going to be and, similarly, who the losers are going to be. With respect to mergers and acquisitions activity, this search for winners and losers is undoubtedly going to spawn mergers and acquisitions activity in and of itself.

On the other side of the coin though, when you look at the potential for multifaceted, complex and multijurisdictional climate change regulation, you know that companies are going to need to optimize their operational decisions, and that level of regulation, with the financial and competitive effects of regulation is going to cause companies to make decisions to rationalize their operations. Hence, I think we're going to see climate change as a driver on the sell side, particularly among emitters and other highly carbon-affected companies.

When we're acting for institutional investors, private equity investors, lenders or financial and strategic buyers in the M&A context, we find that climate change has made a big difference in terms of the legal work that we're actually doing. First of all, the climate change value proposition that I was talking about earlier really affects the due diligence process. As lawyers, we're looking to identify carbon risk, in terms of identifying either actual, existing or potential liabilities. And of course, as lawyers – to the extent we can – we are looking to identify whether there are opportunities for value creation when we are diligencing companies for our clients.

But, of course, due diligence protections underlie the very agreements that are the cornerstone of these transactions and, in that context, we need to focus on things like representation, warranties, conditions and indemnities, and in fact we're doing that quite regularly. This is a whole new world of practice, and one that we think is going to become even more important. **1**