Baker Tilly International–Acuris thought leadership campaign

Global dealmakers series 2021

Deal breakers and opportunity makers: The role of ESG in M&A

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Not only are dealmakers focusing on ESG in record levels, but daylight is emerging in the returns of a target with a strong ESG record and one with only mediocre performance. Investors report that ESG investment strategies deliver improved returns and dealmakers say investor pressure is growing. In an increasingly competitive landscape, smart dealmakers are using ESG as a lever to build value and expedite returns.

Julie Haeflinger
Baker Tilly Strego, France

Executive summary

As the world emerges from the depths of the pandemic, ESG becomes a central priority for corporations and investors.

Environmental, social and governance (ESG) themes have risen in prominence over the past five years. From the growing efforts worldwide to tackle climate change to high-profile concerns such as the Black Lives Matters campaign, societies are increasingly determined to confront a broad range of issues. Businesses are expected to show their colours in these fights.

In this research, we set out to determine how the rise of ESG is having an impact on the investment and M&A decisions made by both corporates and private equity investors. To what extent are they taking ESG factors into account when considering potential deals? What drives their ESG policies? How are they adapting due diligence and valuation processes to take account of ESG? And in which markets and sectors are these debates most advanced?

Our central findings are clear. Dealmakers are more focused on ESG than ever before. In large numbers, they confirm that ESG issues are critical both to their own organisations and also to the way they approach potential transactions. Most say they have walked away from at least one deal on ESG grounds; many say their view on valuation has been materially affected by ESG considerations that have emerged during due diligence.

Regulation is a crucial driver of this focus, but many respondents are applying an ESG lens for other reasons too. Reputation and brand management are front of mind – and dealmakers are acutely aware of the importance of ESG to other key stakeholders, including consumers and their own employees. Equally, dealmakers will need to continue to sharpen their skills and processes; many point to significant challenges in evaluating the ESG credentials of potential targets.

Still, the trajectory is clear. The evidence of this research is that ESG has already become a front and central issue in a significant majority of deal processes. That trend looks set to accelerate.

Contents

About this report: From April to May 2021, Baker Tilly International commissioned Acuris Studios, the publishing division of Acuris, to canvas the opinions of 60 dealmakers to gauge their opinions on ESG trends and global dealmaking. Respondents were evenly split and based in the following regions: Asia-Pacific, North America and Europe.

Within the graphed survey results, percentages may not sum to 100% due to rounding, or when respondents were allowed to choose more than one answer.

Key findings

65%
of dealmakers say ESG is important when considering investment

60%
say they have walked away from an investment due to a negative assessment on ESG issues at a potential target

52%
say that their ESG investment strategy has had a positive impact on overall investment returns

60%
of private equity investors have yielded positive returns from ESG investments, compared to 44% among corporates

90%
say they put improvement plans and tracked indicators in place if ESG-related issues are raised during the investment process

Regulation
is the top driver pushing the ESG agenda in most markets

87%
say they are taking ESG factors into consideration to **decrease investment risk and potential litigation**

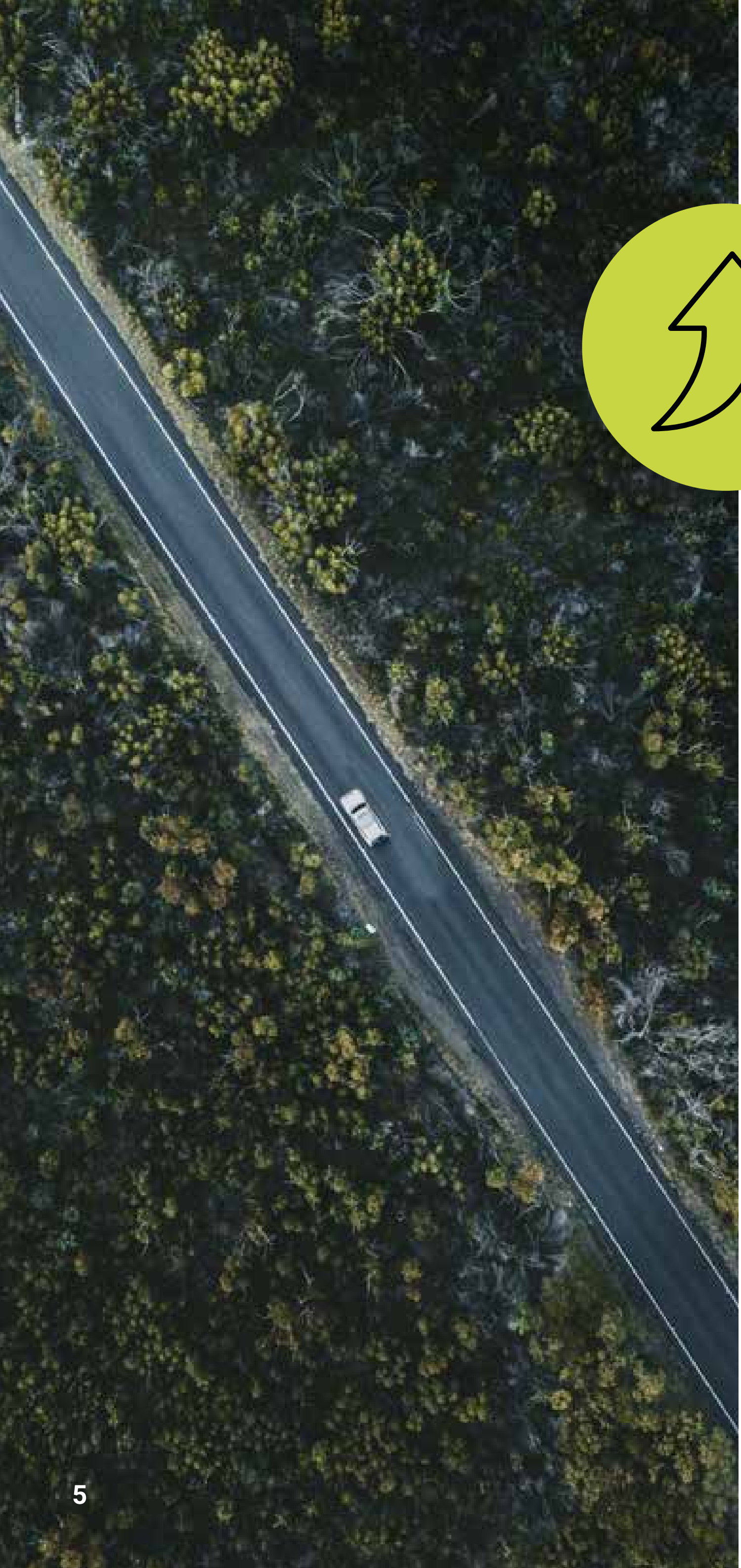
77%
say climate change is the most important ESG issue at their firm

Western Europe (98%) and **North America** (82%) are the markets doing the most to promote and prioritise ESG goals and frameworks

Sectors leading the way in terms of ESG reporting:
-TMT (93%)
-Consumer (63%)
-Financial services (63%)

83%
say they conduct due diligence on ESG issues at investment and M&A targets

51%
say ESG factors have a positive impact on the value of the target



The rise of ESG

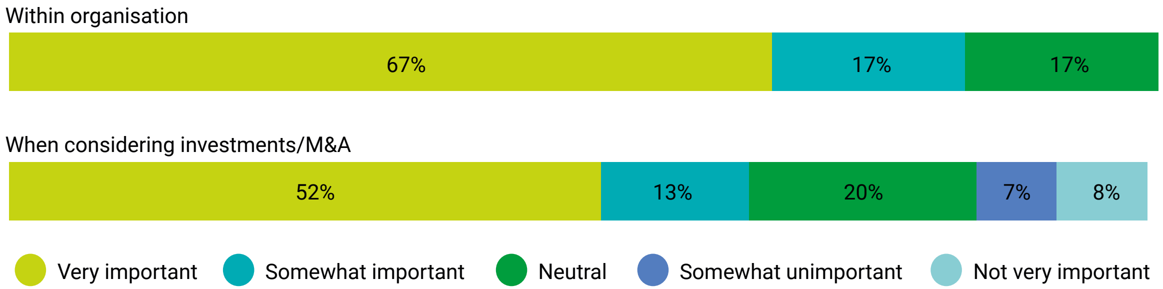
There is no doubt that ESG issues are now front of mind for dealmakers as they assess investments and the direction of their organisations.

Even before the COVID-19 crisis, the ESG investment movement showed strong momentum. Many analysts, however, believe the pandemic has turbocharged the focus on ESG, forcing people the world over to think about the way they live and to confront the interconnectedness of society.

As such, 84% of respondents to this research say ESG is important to their organisation — and almost two-thirds (65%) say ESG issues are an important consideration when looking at M&A and other investment opportunities. While many dealmakers recognise the investment case for applying an ESG lens to their business and its transactions, it is certainly also true that regulation is forcing dealmakers to think hard about ESG, from increasing demands for reporting on issues such as climate impact to new laws in many jurisdictions on diversity and inclusion.

This trend of increased regulation is only going to go one way. As the Director of Global Acquisitions at a US corporate puts it: “Unless companies manage to adapt to the changing regulatory climate, there will be continued pressure from regulators and politicians.”

Figure 1. How important is ESG within your organisation? How important is it when considering investments and M&A?



Deal or no deal

In this landscape, the ESG credentials of a business can now be a make-or-break factor in deals. Indeed, 60% of dealmakers have opted to walk away from a potential investment after uncovering problems related to an ESG issue. Corporates and PE firms in equal numbers report having made this decision.

This is a striking break from the past. Deals that would once have gone ahead based on the commercial and financial merits of the acquisition are now being abandoned for ESG reasons. The chief financial officer of a Swedish corporate recalls one such case: "We found there were environmental issues with the activities of the target and we did not want to be associated with their name."

One question for dealmakers in this regard is whether ESG issues can be resolved. Among the 40% of investors that say they have not walked away from deals, many report that while they had concerns, they opted to work with the target company. "Where our ESG assessment uncovers negative results, we start thinking innovatively about how these can be handled," says the managing director of a US private equity firm.

For others, however, ESG issues alone still do not rank highly enough to warrant giving up on an attractive investment opportunity. "If the target has a good financial record and has not faced any legal problems, we can continue with the deal," says the director of business strategy at a corporate in Hong Kong. "There is no need to be hasty and walk away."

Figure 2. Has your firm ever walked away from an investment or M&A due to a negative assessment on ESG issues at the target?

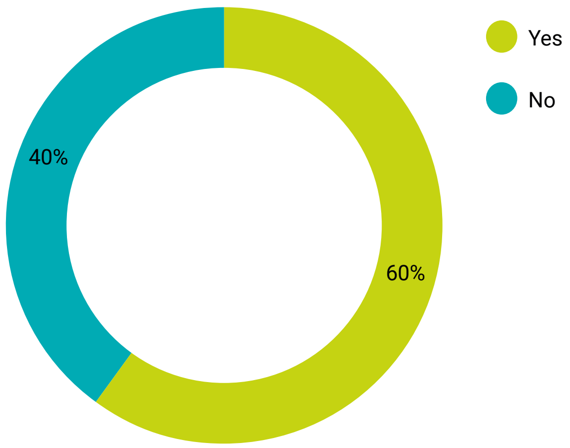
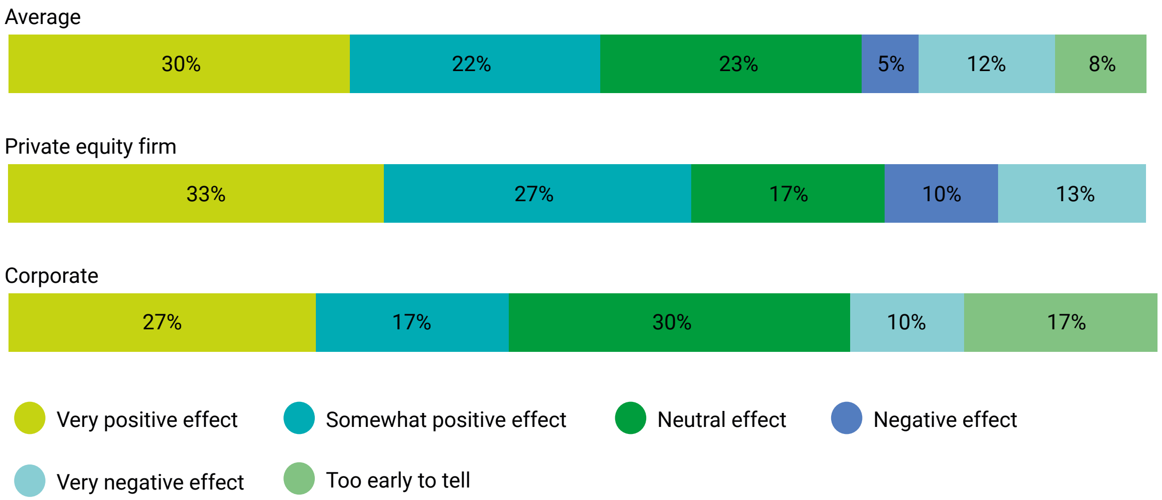


Figure 3. What effect has your ESG investment strategy had on overall investment and M&A returns over the past 1-2 years?



Investor views: Private equity sees greater returns

Still, it would be misleading to regard the connection between the investment prospects of a target business and its ESG profile. Many respondents report that the ESG element of their investment strategy has proved beneficial in terms of the returns. Close to half (44%) of corporates say their ESG investment strategy has had a positive effect on overall investment and M&A returns, and amongst PE firms this figure rises to 60%.

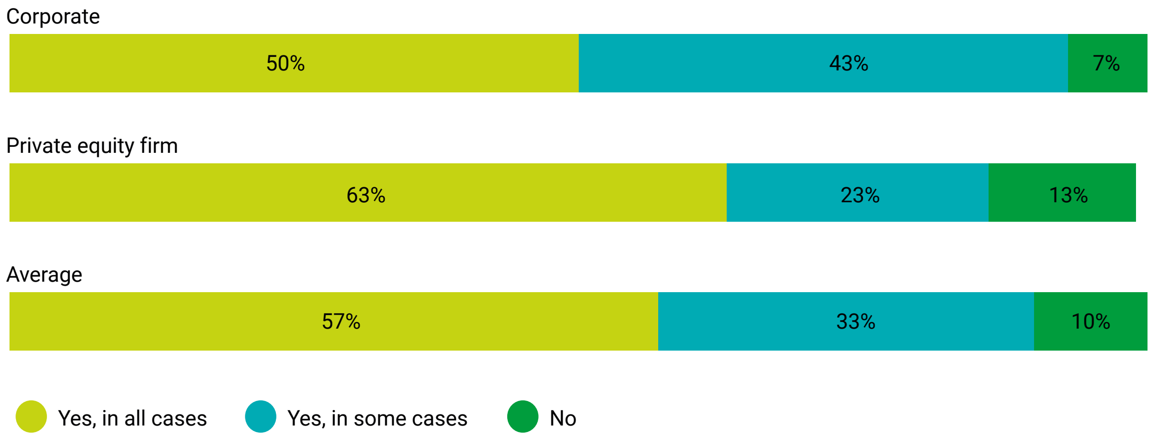
A partner in a German PE firm observes: "Our ESG objectives have certainly improved our returns – in the midst of the COVID-19 crisis, ESG has become the major subject discussed with stakeholders." Elsewhere, the chief executive of a Canadian PE firm argues simply: "The performance of companies is related to their ESG standards; those with suitable credentials have fewer problems."

The split between corporate and PE investors in this regard is interesting. The traditional view is that PE investors approach deals with shorter time horizons, focusing on driving growth in the businesses they acquire and then making an exit. That so many PE firms are seeing positive returns from an ESG focus underlines the immediacy of the ESG imperative: these are no longer issues considered important only over an extended timeframe but, rather, they are having an impact on performance today.

Corporates are still prepared to play the long game. Notably, 17% of corporate respondents say it is too early to tell whether their ESG focus is improving returns. Over time, it may be that more corporates report a positive effect.

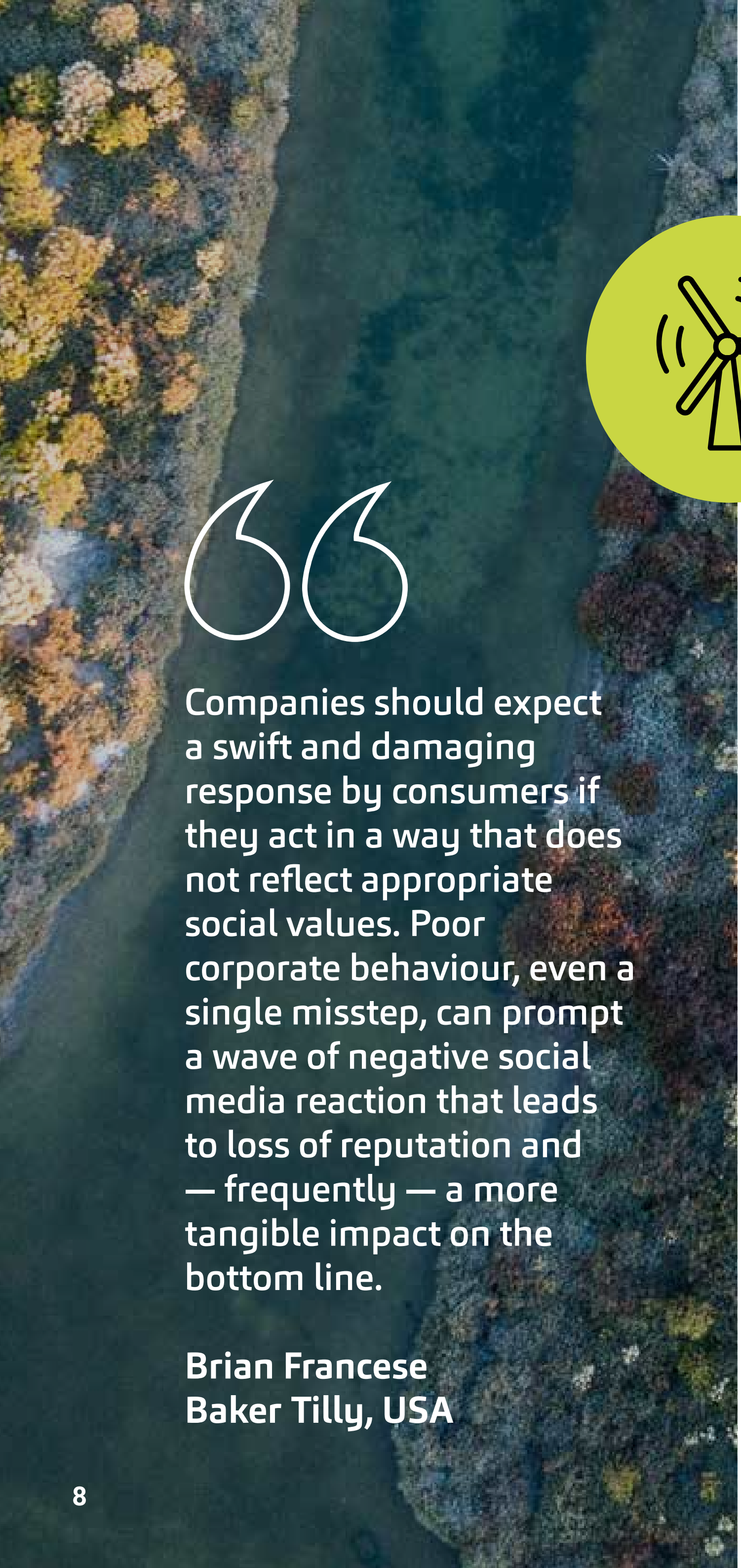
Another explanation for the discrepancy is that PE firms, with a long-established track record of making an immediate

Figure 4. If ESG-related issues are raised during the investment/M&A process, are improvement plans and tracked indicators put in place to monitor performance at the target following the investment?



impact on the businesses in which they invest, are having more success in remediating ESG issues quickly. Notably, 63% of PE investors say they always put improvement plans in place when making an acquisition where they have identified ESG issues; only 50% of corporates say the same.

For PE investors well-used to the disciplines of practices such as 100-day plans and tight performance targets, applying a similar approach to ESG issues appears to be paying off. "We need assurance that ESG issues will not be repeated," says the chief executive of a PE firm in South Korea. "We have to ensure that the teams are educated about our ESG expectations and that they know how to follow them."



> Companies should expect a swift and damaging response by consumers if they act in a way that does not reflect appropriate social values. Poor corporate behaviour, even a single misstep, can prompt a wave of negative social media reaction that leads to loss of reputation and — frequently — a more tangible impact on the bottom line.
>
> **Brian Francese**
> **Baker Tilly, USA**

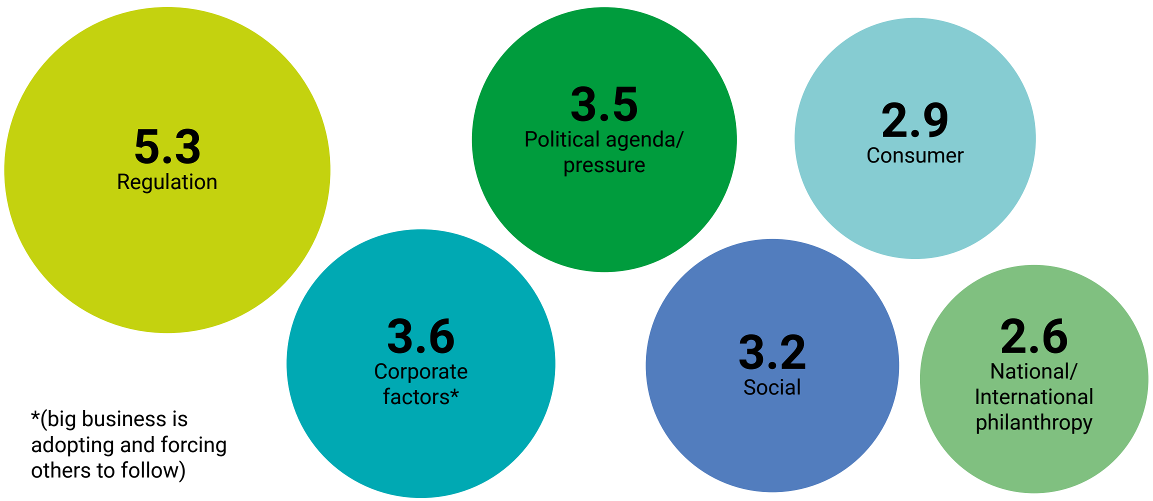
ESG drivers

A growing wave of regulation, changing consumer attitudes and the need to address climate change will drive the ESG agenda.

While many factors have contributed to the rise of the ESG agenda, regulation stands head and shoulders above any other as a primary driver. It's easy to see why: the sheer weight of regulation connected to ESG worldwide looks overwhelming. The United Nations' Principles for Responsible Investment documents more than 730 regulatory revisions in the world's 50 largest economies that require or encourage investors to consider long-term value considerations such as ESG factors[1]. At an individual level, businesses potentially targeted by investors face a raft of new regulatory requirements, particularly on reporting and disclosure.

Moreover, this surge in regulation is both international and country-specific. In the former category, for example, the Taskforce on Climate-related Financial Disclosure was developed under the auspices of the Financial

Figure 5. What are the drivers in your market/s that are pushing the ESG agenda forward? Please rank in order of importance (where 6 = most important):



Stability Board (FSB), the international body that addresses vulnerabilities to the global financial system. As for country-specific regulation, every developed nation now has legislation in place connected to a range of ESG issues.

Against this backdrop, dealmakers simply have no choice but to focus on ESG. They face compliance and reporting issues in their own businesses and must also be conscious of the regulation that applies to businesses in which they are considering making investments.

This is not to suggest regulation alone is driving the emphasis on ESG. Political pressure is another prominent factor as policymakers become increasingly willing to call out what they regard as examples of poor ESG practice. The new US President, for example, has made it clear he will focus on a wide range of ESG issues[2].

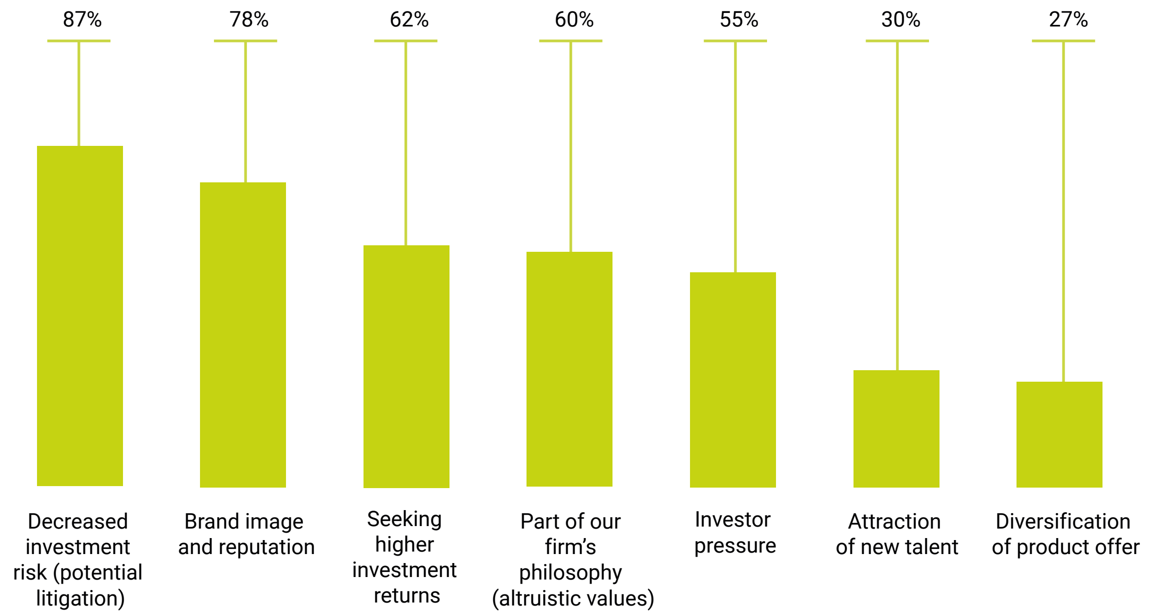
Consumer attitudes drive change

Both corporates and PE firms are also conscious of the growing importance that consumers attach to ESG. Research published during the COVID-19 crisis suggested the pandemic has accelerated this trend, with 90% of consumers saying they had become more concerned about a number of key ESG issues[3]. "Consumers influence decisions because they are the end users and without their demand, the company cannot function," points out the managing director of a US PE firm.

In the context of consumer attitudes, it is striking that 78% of respondents say concern about brand image and reputation is one of the reasons they take ESG issues into account. Clearly, there is real concern that businesses with poor ESG practices will struggle to maintain customer support, and ultimately, such problems may also damage the brands and reputations of their owners.

In fact, only one other reason for focusing on ESG is cited more commonly: 87% of respondents say that an ESG focus reduces investment risk because it is less likely acquisitions and investee companies will face litigation. This reflects the

Figure 6. Which of the following best describes why your firm is taking ESG factors into consideration when making investment and M&A decisions? (Select all that apply)



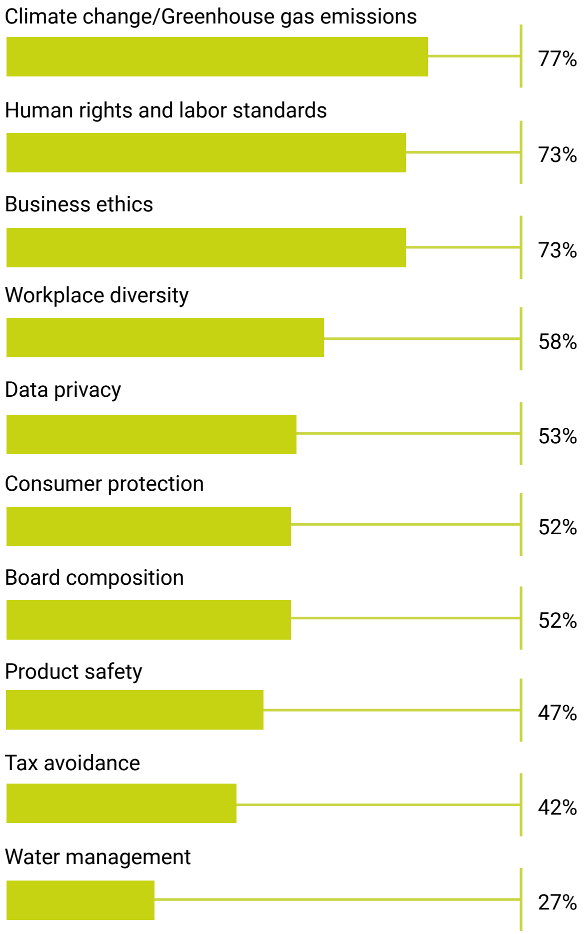
growing efforts to hold companies to account in areas where they are considered to be behaving poorly or falling short of good practice.

Climate change and other key concerns

It is also important to recognise that the drivers for ESG come from a broad range of issues that now matter to regulators, policymakers, consumers and other key stakeholders. While 77% of respondents say they regard climate change as a key issue, the issues of human rights (73%) and business ethics (73%) are cited as key concerns by almost as many.

Elsewhere, campaigns such as Black Lives Matter and legislation for gender equality have prompted 58% of respondents to highlight workplace diversity as an important issue. More than half point to data privacy, consumer protection and board composition as issues they worry about. In other words, it is not only the E of ESG that matters, with many respondents now just as focused on social and governance issues as environmental concerns.

Figure 7. Which ESG issues are most important to your firm and/or your current investor base? (Select all that apply)



The trend towards ESG investing reflects the strength of purpose-driven business, as well as customer preference for companies that are good corporate citizens. And while it is true that not every company with a good corporate social reputation is rewarded by customers, it's clear that those who are perceived as negative, who shun good governance or have a track record of poor social outcomes, are going to get punished by consumers, partners and investors alike.

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Key markets

Respondents note that advanced economies will lead the way when it comes to ESG goals and initiatives.

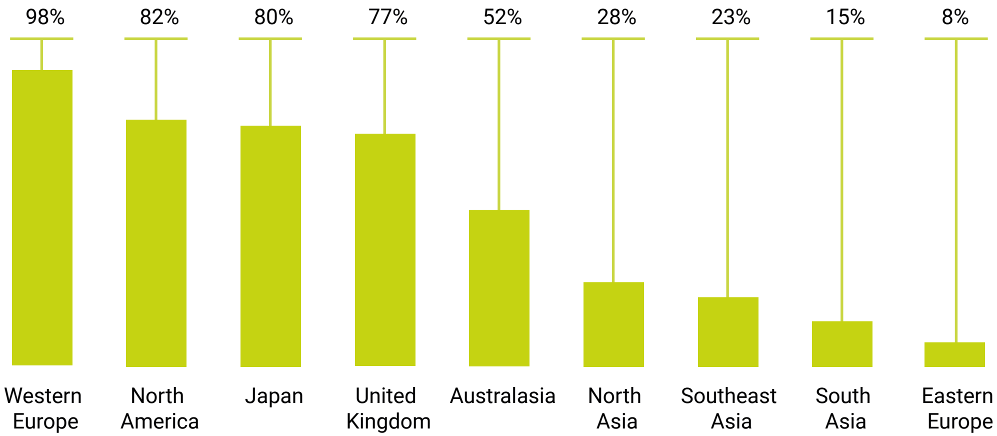
As ESG becomes a global phenomenon, key issues undoubtedly have greater prominence – and are subject to more scrutiny – in certain markets. Respondents point to the developed economies of the West as being more ESG-conscious than their developing market counterparts.

Most notably, 98% of respondents pick out Western Europe as a leader in terms of its efforts to promote ESG goals and frameworks. That reflects the broad range of ESG-linked regulation in the European Union, including the introduction earlier this year of the EU's Sustainable Finance Disclosure Regulation.

The prominence of the US in this regard might be considered more surprising. Despite the relative reluctance of the former Trump administration to make market interventions, 82% of respondents pick out North America as a region where ESG goals are prioritised.

Canada, certainly, has a strong track record of introducing ESG regulation and encouraging better practice, but the US has until now lagged behind. Some respondents, however, point to the US's lead on common reporting standards. There are also signs President Biden is determined to take a tougher line. "The US is emerging from its initial stance

Figure 8. Which markets are doing the most to promote/prioritise ESG goals and frameworks? (Select all that apply)



and prescribing improved governance standards in areas such as money laundering and ethical standards," argues the partner of a Malaysian PE firm.

By contrast, the Asia-Pacific region ranks relatively low, along with Eastern Europe. This may change quickly. While the developing nations of Asia have until recently been largely focused on growth and competition with more mature Western counterparts, ESG is growing in importance in the region. APAC investors' ESG investments soared last year[4], and countries across the region have adopted ambitious carbon emission targets that have moved environmentalism up the agenda[5].

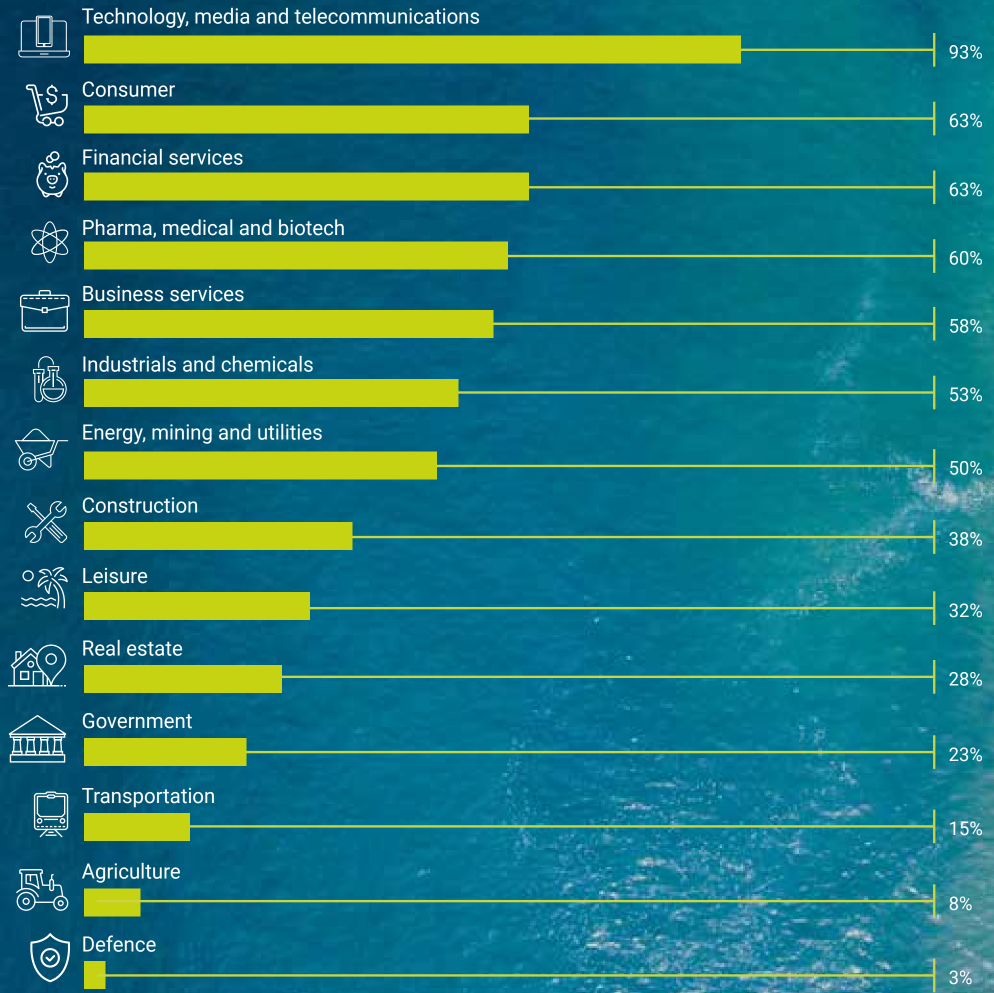
Sector focus

On a sectoral basis, technology, media and telecoms (TMT) is widely regarded as a leader on reporting grounds, according to 93% of respondents. Consumer (63%), financial services (63%) and pharma, medical and biotech (60%) also attract plaudits.

TMT does have certain advantages, including a reduced exposure to environmental risk compared to other industries (though issues such as data privacy are key concerns). It may also be that regulation focused on the sector, including the EU's General Data Protection Regulation, has concentrated minds. TMT also features a large number of new entrants, which naturally have fewer legacy ESG concerns to worry about.

Elsewhere, it is interesting to note that 50% of respondents believe the energy, mining and utilities sector is leading the way on ESG reporting. While businesses in this sector may have a heavier carbon footprint than many others, they have been forced to make progress on reporting as policymakers and regulators have targeted their emissions.

Figure 9. Which sectors do you feel are leading the way in terms of ESG reporting? (Select all that apply)



Due diligence and valuations

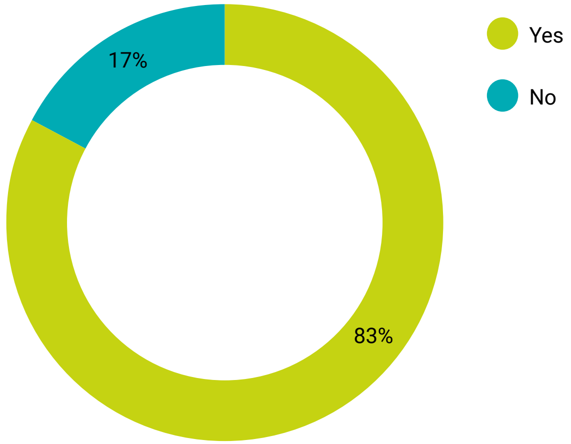
ESG is now a crucial part of the deal process and an impact factor on valuation.

Most respondents (83%) say that ESG issues are becoming a primary focus of investigations at the early stages of a deal. Reflecting sentiments among the wide body of investors, the head of M&A at an Australian corporation says, "We do not want to find ourselves in a situation where we have not looked at ESG performance measures."

However, ESG due diligence is not always straightforward. More than a third of respondents (36%) say they sometimes find it challenging to secure permission to access relevant information – it may be that target companies are reluctant to release data beyond the core financial metrics that due diligence processes typically require. More than a quarter of respondents (28%) say it can be difficult to find relevant information at the target – smaller businesses, in particular, may not yet have ESG monitoring and reporting protocols that ensure such data is readily available to investors and buyers.

One solution to such issues mentioned by a number of respondents is to bring in specialist ESG advisors during the due diligence process. "External firms have the expertise and the technology to expedite the process, so we count on them for their advice," says the chief executive of a South Korean PE firm. Certainly, these ESG due diligence specialists are in a strong position to compare individual firms' ESG metrics to broader market indicators, another common problem during deals.

Figure 10. Does your firm conduct due diligence on ESG issues at investment and M&A targets?



Valuations

Such advice may also be increasingly useful for valuation purposes, with ESG factors now widely regarded as part of the assessment – for better or worse. More than half of respondents say ESG factors have had an impact on their valuations of a potential investment: 33% have increased their valuation following a positive ESG assessment, while 18% have downgraded their view on ESG grounds.

This makes sense. If dealmakers are increasingly focused on ESG, then ESG performance will naturally feed into the valuation process, even if it is difficult to translate such metrics into tangible impacts on cash generation or profitability. "A positive ESG assessment means we know we will not have to invest more in this aspect of the target," says the head of strategy at a corporate in Japan.

Such debates are likely to continue, particularly given the lack of consensus on standardised reporting metrics and performance indicators in the ESG field. In the absence of such data, comparisons between different businesses, even when they are in the same industry, will remain challenging.

Figure 11. If you answered 'Yes' in figure 10, what has been the biggest challenge you typically face when conducting ESG diligence? (Select one)

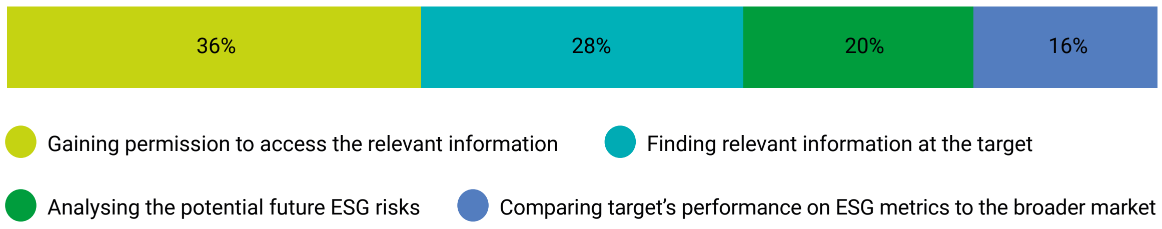
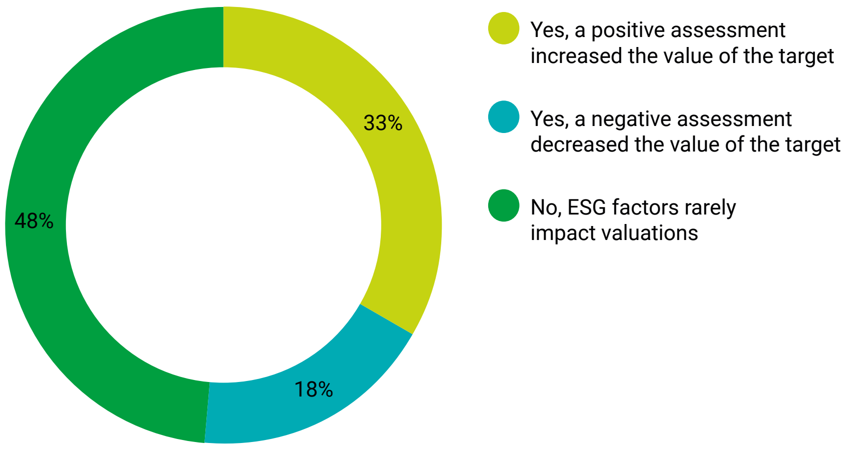


Figure 12. Has valuation of a potential investment/M&A target ever been impacted by ESG factors?



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Footnotes:

[1] Far away yet close to home. ESG Global Advisory article, published Oct 2020.

[2] "Biden impact on ESG investing will go deeper than climate." Official Monetary and Financial Institutions Forum article, published March 2021.

[3] "The pandemic is heightening environmental awareness." BCG article, published July 2020.

[4] "ESG investments surged in Asia Pacific in 2020 as sustainable investing takes off, MSCI survey finds." CNBC article, published March 2021.

[5] "Are Asia's carbon neutral pledges hot air?" Verisk Maplecroft article, published December 2020.

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