ICAEW CORPORATE FINANCE FACULTY

ESG IN DEALS AND INVESTMENT

BEST-PRACTICE GUIDELINE 69

Authors: Deloitte

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Amy Smith, LSEG
Andrew Green, Addleshaw Goddard
Chris Price, Mobeus
Chris Wilford, CBI
David Petrie, ICAEW
Duncan Skailes, PwC
George Wharton, Deloitte
Hannah Mitchell, Deloitte
James Hilburn, Deloitte
James Pincus, PwC
John Cushing, mnAI
Jonathon Stokes, Deloitte
Julia Jasinska, CBI
Katerina Joannou, ICAEW
Kathy Hobbs, NorthEdge
Marc Mullen, *Corporate Financier* magazine
Michael McCartney, EY
Neil Rutledge, Amberside
Rick Thompson, Singer Capital Markets
Sandra McCavera, Grant Thornton
Sarah Gilby, Anthesis
Sarah Reay, ICAEW
Soham Gehani, PwC
Sophia Walwyn-James, 3i
Susana Costa, Deloitte
Susie Douty, Deloitte
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INTRODUCTION

This guideline explores the role that **Environmental, Social, and Governance (ESG)** plays across the mergers and acquisitions (M&A) lifecycle. It provides practical guidance drawn from recent experience on how to integrate ESG into the M&A process, identify and quantify its value and impact potential, and ultimately to create value through the transaction and over the holding period.

ESG and corporate performance are intrinsically linked. Recent studies have consistently highlighted that firms that perform strongly across all the material factors of ESG outperform the market and generate long-term value. ESG should now be regarded as a key driver of value, yet it remains highly complex to quantify ESG risks and opportunities and to value targets, predominantly due to the lack of clear, comparable data.

The need to create a more sustainable economy, with a focus on carbon emissions reduction, will require companies to transition from their status quo, and M&A will continue to play a key role in delivering that step-change. Both offensive and defensive M&A strategies will be required to capture the full spectrum of ESG risks and opportunities.

Therefore, if investors and their financiers are to curtail risks and deliver sustainable value, they will need to embed ESG across all transactions, not only those ostensibly geared to those ends. **ESG within M&A will be an important means to create growth, gain a competitive edge, and access affordable capital.** Equally, it will be essential for establishing stakeholder trust, a determining factor in companies' feasibility to survive and thrive.

1 WHY ESG MATTERS

1.1 ESG AND ITS IMPORTANCE TO STAKEHOLDERS

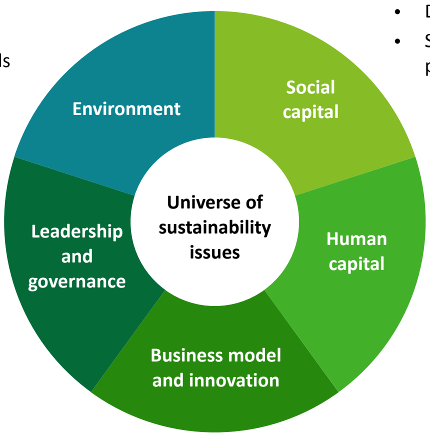
ESG is a term covering the inter-relationship between a business and the stakeholders, communities, and broader environment in which it operates. The term covers a wide range of business policies and practices, including:

- **E**nvironmental impacts, driven by the widespread acceptance of climate change and the urgent need to act to limit the severity of climate change. This is the primary reason for the rapid rise in relative importance of ESG in the eyes of regulators, consumers, and investors and, as a result, corporate executives and boards. The need for our global economy to transition to low carbon technology and sustainable business practices, and the significant investment in capital to deliver this transition creates both risks and opportunities depending on how far a business has transitioned.
- The **S**ocial impacts of a business that have come into sharp focus in recent years. Movements like Black Lives Matter and #MeToo have highlighted the role companies have to play in promoting diversity, equality and inclusion, while ensuring that fair labour conditions and living wages are provided within the organisation and the wider supply chain. Increasing inequalities is a huge risk and therefore modern slavery is a key consideration.
- **G**overnance practices that have been a long-standing focus of regulators and investors, and include areas such as risk management, corporate decision-making and business ethics.

Figure 1: ESG Universe

Environment
- Greenhouse gas (GHG) emissions
- Air quality
- Energy management
- Water and wastewater management
- Waste and hazardous materials management
- Ecological impacts
- Climate impacts

Social capital
- Community relations
- Human rights
- Access and affordability
- Customer welfare
- Data privacy and security
- Selling practices and product labelling



Leadership and governance
- Business ethics
- Competitive behaviour
- Management of legal regulatory environment
- Critical incident risk management
- Systemic risk management

Human capital
- Labour relations
- Labour practices and compensation Diversity and Inclusion
- Employee health, safety and wellbeing
- Employee recruitment and engagement

Business model and innovation
- Product design and lifecycle management
- Product packaging and distribution
- Product quality and safety
- Supply chain management
- Materials sourcing
- Investment, credit, and underwriting ESG risks
- Rate structure and pricing
- Business model resilience

Source: SASB.ORG

ESG has become a key factor for stakeholders so funds and companies cannot afford to be misaligned with stakeholder values.

The importance of ESG within a corporate environment has risen significantly in recent years as stakeholders have shifted their expectations of corporate behaviour from a "shareholder capital" approach popularised by Milton Friedman in the 1970s – which advocated a sole focus on profit generation[1] – towards a more holistic stakeholder capitalism approach, which incorporates the awareness and impact of a business on its broader environment. Many businesses are striving for a sustainable business strategy to cover ESG factors while also positively benefitting their shareholders. Another way that business leaders are approaching this is by adapting from a standard 'bottom line' to a 'triple bottom line' concept: "The triple bottom line is a business concept that posits firms should commit to measuring their social and environmental impact in addition to their financial performance, rather than solely focusing on generating profit. It can be broken down into 'three Ps': profit, people, and the planet."[2]

Examples of stakeholders embracing ESG

CONSUMERS	A recent market survey of consumer buying behaviour found that 79% of buyers are changing preferences based on sustainability[3]. This will have a direct impact on a company's topline revenue.
EMPLOYEES	Like many consumers, employees are increasingly choosing to work with companies with values that align to their own. This is particularly evident in those younger generations more attuned to environmental and social issues. A workforce survey showed that 61% of employees believe business sustainability should be mandatory for companies while 46% will only work for companies with sustainable business practices[4]. A company's ability to attract and retain the best talent will have a direct impact on the cost of hiring and training, as well as the productivity of their workforce. Companies with highly engaged employees are more likely to significantly outperform their industry peers in terms of growth in gross profit by 5% and growth in total assets by 7%.[5]
INVESTORS	Transitioning towards a low-carbon, sustainable economy will require both the investment of additional capital and a reallocation of existing capital towards more sustainable businesses. Investors have embraced this shift. Investors managing over $100 trillion of Assets Under Management (AUM) have committed to the United Nations (UN) Principles for Responsible Investment (PRI), while over $130 trillion of assets were committed to a net zero target as part of the Glasgow Financial Alliance for Net Zero (Gfanz) during the COP26 climate meeting in 2021. Beyond these commitments, a survey showed that 88% of investors monitor ESG Key Performance Indicators (KPIs) to inform investment decisions on an ongoing basis.[6] The result of this wave of capital looking for strong ESG performing companies is an increase in the demand for, and therefore the value of, ESG-aligned businesses.
REGULATORS	Regulators across the UK, European and US markets have introduced measures to standardise and drive transparency in the reporting of ESG performance. For many companies this reporting will become mandatory and will provide investors and stakeholders with the information they need to make informed decisions about which companies to invest in, work for, and trade with.

1 A Friedman doctrine – The Social Responsibility Of Business Is to Increase Its Profits – The New York Times (nytimes.com) September 13, 1970
2 Harvard Business School The triple bottom line: What it is & Why it's important
3 Capgemini Research Institute, Consumer Products and Retail: How sustainability is fundamentally changing consumer preferences, July 2020 (capgemini.com)
4 HP Workforce Sustainability Survey, Global Insights Report, April 2019 (wtwco.com)
5 The Power of Three, Willis Towers Watson (wtwco.com)
6 Edelman Trust Barometer 2020, Institutional Investor Trust Report, Nov 2020 EMPEA 2019 Global Limited Partners Survey 2020

A combination of the increased expectation from stakeholders of responsible business practices, and a growing regulatory push to promote transparency of these practices, is strengthening the importance of ESG performance. Regulators and standard setters are working towards harmonisation and standardisation of standards. An example of this is the International Financial Reporting Standards (IFRS) Foundation's creation of the International Sustainability Standards Board (ISSB) as they work towards aligning ESG performance into corporate financial reporting.

> Companies with highly engaged employees are more likely to significantly outperform their industry peers in terms of growth in gross profit.

1.2 ESG PERFORMANCE IS A DRIVER OF BOTH OPERATING VALUE AND INVESTOR VALUATIONS

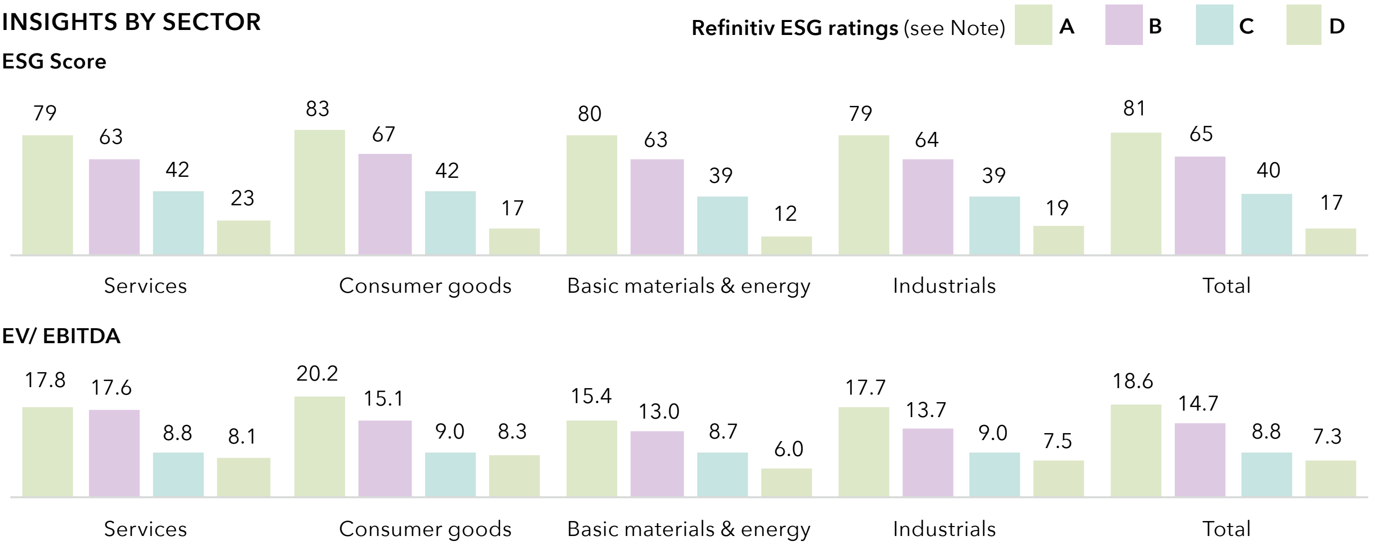
For several years there has been strong anecdotal evidence of ESG factors contributing to both value creation and destruction. This has come in the form of executive and investor surveys, and specific examples of ESG incidents that caused reputational damage and eroded shareholder value as a result.

In a survey conducted by Deloitte Global and Forbes Insights on the impact of sustainability efforts of 350 executives from the Americas, Asia and Europe, more than half of respondents indicated **a positive impact on revenue growth and overall company profitability**. It revealed that 48% of respondents reported **increased customer satisfaction**, while 38% indicated that embracing strong ESG values **enhanced their ability to attract and retain talent.**[7]

Companies that fail to improve or just demonstrate their ESG credentials will see unfavourable impacts on their overall value. For example, in 2020, Boohoo, the online fashion retailer, lost 50% of its market value when reports of bad labour practices within its UK supply chain came to light.

As more company-level ESG data has been collected these anecdotal examples are increasingly backed by an analysis of ESG and enterprise value data. A 2022 Deloitte industry report showed a clear correlation, consistent across all sectors assessed, between a company's ESG rating and the valuation multiple, as illustrated in Figure 2.

Figure 2: Alignment between ESG Score and Market Value



Source: Deloitte Analysis, Refinitiv Does a company's ESG score have a measurable impact on its market value? (deloitte.com)

Note: Refinitiv's ESG score ranges are based on combining relative ESG performance and transparency in public reporting of data. Scores of 0 to 25 **(D)**: poor ESG performance, insufficient transparency; 25 to 50 **(C)**: satisfactory ESG performance, moderate transparency; 50 to 75 **(B)**: good ESG performance and good transparency; 75 to 100 **(A)**: excellent ESG performance and high transparency. The Deloitte sample involved over 300 public companies across 6 industries. This included Basic materials, Utilities, Energy, Consumer goods, Industrials and Services.

7 Deloitte, Climate check: Business' views on environmental sustainability, April 2020

Strong ESG performers have proven more resilient during turbulent markets, as evidenced by research showing that **the top 20% of ESG-ranked stocks outperformed the US market by over 5 percentage points** during the initial period of the Coronavirus pandemic (December 2019 to March 2020).[8]

ESG performance also impacts the cost of borrowing, with green bonds and sustainability-linked loans (SLLs) offering preferential interest rates to companies that meet ESG targets. A 2020 industry trend report by MSCI found that high-rated ESG companies are less exposed to systemic risks and top quintile performers borrow debt at 6.3% lower cost of capital than bottom quintile companies.[9]

1.3 HOW COMPANIES ARE RESPONDING TO THE RISE IN IMPORTANCE OF ESG

With the disruptive market shifts presented by ESG, companies face risks and opportunities that differ dependent on sector, operational activities, and location among other factors. Companies will need to consider what is core to the business and its long-term success, while developing an ESG approach that is aligned with and enables the broader business strategy.

KEY ELEMENTS OF A CORPORATE ESG APPROACH

Assess materiality
Companies will benefit primarily from focusing on ESG in the context of their business model, rather than attempting to cover the full universe of ESG aspects; ie, identify those considerations which are most material and focus on developing a market-leading position in those. This approach directs finite resources to those activities most value-adding to the organisation and investors are more likely to reward companies that deliver on the material issues. Aligning to the material ESG topics is aided by widely adopted frameworks such as the Sustainability Accounting Standards Board (SASB) Materiality Map.

> Ultimately, companies will benefit from focusing on ESG in the context of their business model, rather than attempting to cover the full universe of ESG aspects poorly.

Engage stakeholders
Companies must embrace engagement with different stakeholder groups to understand their respective values and requirements. Stakeholder engagement can help companies to identify focus areas with greater clarity. Incorporating better ESG governance structures helps companies to convey their intentions to stakeholders.

Develop a roadmap with measurable actions
Organisations must endeavour to create roadmaps that establish an ESG strategy as part of the broader business strategy. Identifying ESG-related risks and opportunities and developing a roadmap of initiatives that can effectively mitigate risks while building out a leadership position in ESG will be vital for delivering long-term value. Setting up clear, quantifiable ESG goals and targets will aid in communication with stakeholders.

Measure and communicate progress
Companies should develop a method to monitor and report ESG progress in accordance with standard reporting frameworks such as Taskforce for Climate Related Financial Disclosure (TCFD), SASB or Global Report Initiative (GRI).

Communication of the company's ESG vision and progress should be an ongoing process, helping stakeholders to stay updated and invested in the sustainability journey, while sustaining confidence in the organisation's commitment to its ESG values.

Establish ESG incentives
Design and implement processes[10] to record progress and hold leaders accountable for achieving target metrics. Boards are increasingly expected to hold executives accountable for ESG results via such incentive arrangements.[11] A survey found that 86% of investors (and 73% of non-investors) think non-financial ESG metrics are an appropriate measure to incentivise executives.[12]

8 What are companies doing to tackle the crisis? - Schroders Australia | Livewire (livewiremarkets.com)
9 ESG and the Cost of Capital | MSCI
10 Incorporating ESG: Living up to stakeholder expectations and business opportunities (deloitte.com)
11 Incorporating ESG Measures into Executive Compensation Plans | Deloitte US
12 Harvard Law School Forum on Corporate Governance, The Evolving Role of ESG Metrics in Executive Compensation Plans, March 2022

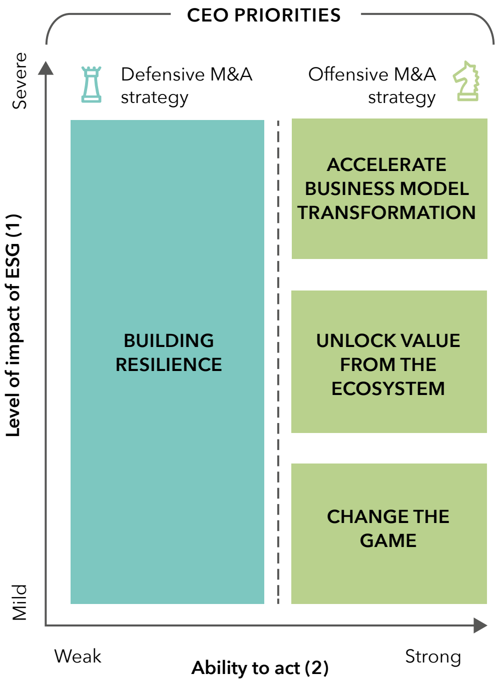
2 ESG AND M&A STRATEGY

2.1 ESG AS A KEY FACTOR IN M&A STRATEGY

ESG has become a significant aspect of a business's origination and M&A process in order to deliver long-term value for stakeholders, both as a driver of M&A deals and a core consideration within non-ESG focused transactions.

A business's M&A response to ESG trends will largely depend on a) the level of impact ESG has, or is expected to have, on the business model, and b) the ability of the business to actively respond using M&A. The ESG M&A framework in Figure 3 uses these parameters to demonstrate a set of defensive and offensive deal archetypes that are required to build resilient business models, accelerate transformation, unlock the potential of ecosystem alliances, and capture market leadership.

Figure 3: Defensive and offensive M&A strategies in the context of ESG



(1) **Level of impact assessment**: Consider the impact of climate change and ESG megatrends on the business model, your people, customers and the competitive environment.

(2) **Ability to act assessment**: Consider your liquidity position, balance sheet strengths and ability to raise capital from the markets in relation to the resilience of your business operating model and those of your suppliers and partners.

BUILDING A RESILIENT COMPANY	EXAMPLES
Evaluate current company/product portfolio and divest assets that are not aligned to long-term ESG transformative growth	An FMCG business divests a product line with high labour and working condition risks in order to reduce risk of devaluation of the value of its wider portfolio
Strengthen your core by acquiring competitors to consolidate the ESG marketplace, creating value through scale	A waste recycling business, which inherently has a positive impact, acquires competitors in order to generate value through economies of scale
Consider opportunistic deals to secure your customer channels, supply chain systems and customer channels	A food retailer acquires an organic food business in order to accelerate its own organic food supply and sales

CHARGING THE GROWTH ENGINE	EXAMPLES
Transform your business model by acquiring new capabilities and exploring new revenue plays in adjacencies, growth areas like digital/ESG and platform plays to extend your value chain	A fuel retailer acquires an electric vehicle charging business in order to secure forecourt customers from electric vehicles
Capture opportunities through purpose-led alliances and transactions involving non-traditional peers and ecosystem	An airline creates an alliance between jet engine manufacturers and hydrogen producers in order to accelerate the development of hydrogen/low carbon flights
Invest in disruptive innovation assets to scale at the "edge"	A food producer acquires a business developing synthesised "meat" to secure vegan and low carbon meat alternatives

Source: Deloitte

Divesting is a defensive strategy in the context of ESG and a necessary step in the transition. However, there are risks associated with this and the end goal would be for companies to align with long-term ESG transformative growth.

Largely driven by the relative impact that ESG has on the company or target, these archetypes can be grouped into transactions that are motivated by ESG topics – where the impact of ESG is naturally high – and those where persons managing a transaction need to be conscious of ESG topics. Depending on the grouping, there are implications at the various stages of strategy development through to resulting M&A and its execution.

2.2 ESG MOTIVATED VS ESG CONSCIOUS M&A

Defensive and offensive M&A strategies are typically applicable to corporate M&A and resulting acquisitions or disposals can be described as "ESG Motivated" transactions. Private equity investors seeking to acquire businesses which deliver, or have the potential to deliver significant positive social and environmental impacts are also ESG Motivated. As described above, ESG Motivated transactions include **companies using M&A as a catalyst to advance their ESG priorities and rapidly respond to transitioning markets.** This may include acquiring new technologies, skills, or assets to enhance the ESG positioning, or a rebalancing of portfolios in the face of shifting markets to capitalise on growth areas and avoid stranded assets. Similarly, it includes where ESG **is driving demand for companies that engage in sustainable activities.**

ESG Motivated M&A contrasts with "ESG Conscious" M&A. That is to say, ESG has also become a core consideration in transactions which do not have a specific ESG-related objective, but there is recognition that ESG could still play a significant role in creating or destroying value in the future. A survey found that 83% of dealmakers say they conduct due diligence on ESG issues on investments and M&A targets.[13] In these deals, careful assessment of material ESG considerations can be a mechanism to defend value, by identifying and mitigating risks, and to create value through a strong leadership position amongst peers. **There have also been instances where deals have been abandoned because of ESG issues**: a 2021 report indicates that 60% of survey respondents have walked away from an investment due to a negative assessment on ESG issues of a potential target.[14]

13 ESG and Transactions (8advisory.com)

14 Global dealmakers 2021: cross-border M&A outlook – Baker Tilly

Figure 4 sets out how market leading and market lagging approaches differ for both ESG Motivated and ESG Conscious transactions within the context of the deal archetypes set out in section 2.1. Where a business is seeking to deliver value from ESG M&A, the business needs to embed market leading practices at each stage of the M&A process, including the overall corporate strategy.

Figure 4: ESG implications on approach to M&A

DEAL ARCHETYPES				CORPORATE STRATEGY	M&A STRATEGY	M&A EXECUTION	VALUE CREATION	OUTCOME
1 TRANSFORM THE BUSINESS FOR THE FUTURE VALUE CREATION	Business models which are, or are likely to be, adversely impacted but have greater ability to respond, should consider how M&A can capture additional revenue through emerging (especially low carbon) technologies and consumer preferences for sustainable products and other ESG megatrends.	ESG MOTIVATED TRANSACTIONS	Market leading	ESG, including Net Zero and climate pathways, integral to corporate strategy, from vision to planning and implementation Inorganic aspects of corporate strategy tested against ESG strategy	ESG parameters fundamental to M&A strategy, including target identification and screening Parent/acquirer ESG objectives and material topics applied to M&A assets	Deal leads focused on critical ESG factors and performance alongside other valuation factors Diligence processes ensure sufficient time, scope and capacity to reliably assess an asset	Post-deal, including integration and/ or carve-out, plans include ESG aspects by default to maximise value achieved from improving ESG performance, utilising pre-deal diligence and planning	Assigned valuations better incorporate ESG performance Parent value (from acquisition or disposal) reflects improving ESG performance
2 DIVEST NON-CORE AND SALVAGE VALUE DIVESTMENT	Business models which are, or are likely to be, adversely impacted by ESG but have limited ability to respond, should identify assets that do not form part of the ESG-aligned long-term sector transformation or are at risk of becoming stranded assets and divestment should be considered.		Market lagging	Heritage corporate strategy, with limited consideration of mid and longer term impact of ESG macroeconomic trends flowing through to organic and inorganic strategy *(In sectors less directly impacted by ESG topics, ESG may not need to take a primary role in corporate strategy)*	ESG topics seen as an operational matter for targets/assets Inability to articulate material ESG factors at stake in M&A strategy	Minor and/or late consideration of ESG, without clarity on materiality ESG performance and risks assumed a post-deal operational matter unlikely to impact deal value	Adhoc approach to ESG post-deal, without dedicated focus in first 100 days to create alignment and identify/ confirm risks and opportunities	Sub-optimal M&A decisions as ESG impact manifests post-deal in uncontrolled manner
3 CHANGE THE GAME SEEDING	Business models which are not likely to be significantly impacted by ESG, but have a greater ability to respond should consider strategies such as investing in disruptive ESG technologies and assets to scale at the "edge" or develop purpose-led alliances.		Market leading		M&A processes incorporate ESG considerations M&A decisions influenced by ESG risk profiles ESG recognised as potential source of value	Standardised approach to ESG diligence, including materiality to asset and parent/ acquirer Clarity on data requirements, and expertise to assess asset during transaction	Post-deal value creation includes ESG opportunities alongside other areas, and filters for ESG impact As a vendor, ESG performance of parent re-assessed post-deal	Risk of unforeseen ESG downsides being acquired mitigated Broader strategies to strengthen ESG performance of asset and acquirer incorporated
4 SAFEGUARD MARKETS STEADY BUSINESS GROWTH	Business models which are not likely to be significantly impacted by ESG and have limited ability to respond, may consider ESG-related operational and product improvements or acquire technology assets to accelerate ESG transformation, and pursue strategic alliances with a wide range of players.	ESG CONSCIOUS TRANSACTIONS	Market lagging		Awareness of ESG performance not reflected in valuation models	Greenwashing insufficiently challenged KPIs not prioritised or subject to due diligence	Limited integration of asset's ESG KPIs with acquirers	Value destruction risks increased from ESG topics

2.3 M&A IN THE CONTEXT OF CLIMATE-RESILIENT PATHWAYS

The United Nations Framework Convention on Climate Change (UNFCCC) describes "climate resilient pathways"[15] as trajectories of combined mitigation and adaptation that realise the goal of sustainable development while helping to avoid "dangerous anthropogenic interference with the climate system". By this, the UNFCCC means **avoid dangerous consequences due to man-made climate change**. This definition can be applied to an M&A context: it can be used, for example, to assess the extent to which M&A strategy is aligned with climate resilience, deliver a forward-looking view on identifying climate risks as part of due diligence, or ensure that valuations and multiples reflect longer duration climate considerations.

The growing body of climate change academic research and studies points to **significant uncertainty regarding the timing and actions underpinning the global transition to net zero**. Countries and businesses will take different pathways to achieve decarbonisation consistent with avoiding the worst effects of climate change, and **these pathways present material risks that merit thorough consideration throughout the M&A lifecycle.**

A PROCESS NOT AN OUTCOME

Achieving climate-resilient pathways should be viewed as a process, rather than an outcome.[16] In this regard, a coherent M&A strategy is an effective tool that businesses can use to iterate their climate pathway towards greater resilience. For example, **using transactions to match climate risk appetite with appropriate capabilities to manage risk**. For diversified businesses which have a global footprint, carving out assets exposed to climate risks is an effective way to improve the risk profile of the remaining business.

Furthermore, **climate pathways can be used as an effective lens to deliver more robust due diligence of climate risks**. In addition to focusing on adaptation and mitigation sources of risk, advisors and analysts can supplement their climate risk due diligence with climate-pathways assessments. Framing climate risk in terms of pathways supports a more dynamic and forward-looking assessment of risks.

This approach also provides valuable pricing and exit insights, particularly for investors and private equity funds. As regulators and governments continue to take further actions to drive the transition to net zero, buy-side investors will increasingly value longer-term transition plans. This should **incentivise businesses and their investors to put in place ambitious climate risk management plans that go beyond addressing near-term risks** and instead look to re-shape and build resilience into their climate pathway. In turn, this will enhance earnings multiples and valuation at exit. Beyond this, governments, regulators, and corporations should be considering how to drive carbon out of the economy, not just passed from business to business. This is embedded in the 'Governance' aspect as businesses have a responsibility to steward the planet.

In summary, **climate pathways represent a crucial framework to help chart individual de-carbonisation trajectories**, either those of countries of those of businesses. Accordingly, **they are an important transactions consideration** that advisors and strategists must integrate into their services.

"
For diversified businesses which have a global footprint, carving out assets exposed to climate risks is an effective way to improve the risk profile of the remaining business.

15 UNFPCCC, Article 2

16 Manyena, Bernard. (2006). The Concept of Resilience Revisited.

3 ASSESSING ESG WITHIN AN M&A TRANSACTION

3.1 UNDERSTANDING ESG RISK AND POTENTIALLY MATERIAL ISSUES

A key question often asked by prospective investors is, "What are the material ESG risks for this business?". Given the limited timeframes and resources available during a due diligence process, it is rarely, if ever, possible to undertake a full materiality assessment of the universe of ESG topics. Therefore, it is necessary to have a methodology which can effectively identify potentially material issues which will become the focus of the ESG diligence. Frameworks such as the SASB Materiality Matrix, MSCI ESG Industry Materiality Map and Refinitiv Industry Materiality Matrix can be used to provide the basis for which topics should be considered material at a sector level. However, many businesses do not fall neatly into these frameworks' classifications, but instead have their own unique ESG risk profile. Therefore, those undertaking an ESG diligence 'exercise' should look to evaluate and understand the business's operations and value chain (both upstream and downstream) to identify potentially material ESG risks. Figure 5 provides a schematic of a typical value chain for a production/manufacturing business.

Figure 5: ESG risk identification in an M&A transaction

Framework		Production/manufacturing example					
SUPPLIERS	• Who are they? • Where are they? • How do they operate?	ENERGY PROVIDERS	RAW MATERIAL EXTRACTION	3RD PARTY MANUFAC-TURING	WASTE/ BY-PRODUCT MANAGERS	OUTSOURCE PROVIDERS	RELATIVE BRAND VALUE
INPUTS	• What are they? Materials, human capital, information? • How are they sourced/ produced?	ENERGY	RAW MATERIALS	HAZARDOUS SUBSTANCES	WATER	HUMAN CAPITAL	INBOUND LOGISTICS
PROCESSES	• What are the primary activities to create the product? • What are indirect processes?	PRODUCTION PROCESSES	R&D PROCESSES	SALES PROCESSES	PROCUREMENT	HUMAN CAPITAL MANAGEMENT	FINANCIAL MANAGEMENT
OUTPUTS	• What are the primary outputs? • What waste and by-products are there?	PRIMARY PRODUCTS	WASTE MATERIALS	GREEN-HOUSE GAS EMISSIONS	HAZARDOUS WASTE	TOXIC EMISSIONS	OUTBOUND LOGISTICS
CUSTOMERS	• Who are they? • What do they do (with the product)? • Where are they?	DIRECT CUSTOMERS	CONSUMERS	USAGE SCENARIOS	BRAND	END OF LIFE AND DISPOSAL	DATA PRIVACY

Source of framework: SIPOC foundation

Once the context and activities associated with the business's value chain are understood, then it is possible to overlay the associated ESG risks to build up the overall risk profile of the business. Typically, this is done intuitively by ESG advisors, with consideration to several dimensions to frame the diligence questions; examples of questions in a production/manufacturing scenario are set out in Figure 6.

Figure 6: Example of framing dimensions and questions to identify potentially material issues for a manufacturing business

FRAMING DIMENSIONS

- **Sector/industry** in which the business operates and inherent risks across the spectrum of ESG topics
- **Countries/locations** of operation and inherent risks across the spectrum of ESG topics
- **Supply chain** – nature of raw materials and products, and the associated ESG risks in their supply chain
- **Principal asset types** – depending on whether key assets of a company are physical vs intangible (technology/IP, human capital) will highly influence where focus needs to be placed during diligence questioning
- **Products** – associated regulatory, market and consumer sentiment or scrutiny regarding environmental or social impacts.
- **Mode of ownership** – private and public ownership bring different historical priorities and scope for variation in ESG focus
- **ESG positioning of asset** – its brand and its products – the public face of the company/asset will correlate to the internal operational approaches, though beware greenwashing

UPSTREAM ACTIVITIES	OWN OPERATIONS	DOWNSTREAM ACTIVITIES, PRODUCT USE AND END OF LIFE
Across E, S and G		
Are any of the raw materials or downstream operations associated with environmental pollution, hazardous processes, poor labour and working conditions or other ethical issues? Have any key suppliers been subject to ESG-related allegations, controversies or media attention?	Does the company's operations or infrastructure include potentially hazardous activities or substances with regards to environmental pollution or human health? Are such activities regulated or permitted?	What management processes are in place to reduce any negative impacts of the product use or disposal on the environment or society?
Environment		
Are any upstream production or transportation processes energy intensive? To what extent will the supply chain be impacted significantly by physical or transition risks of climate change?	Are company operations resource intensive (energy or water) relative to other sectors or competitors? Does the company produce significant amounts of toxic emissions or hazardous waste? To what extent will the company's own operations be impacted significantly by physical or transition climate change risks?	To what extent will the company's markets be impacted significantly by physical or transition climate change risks? What is the end-of-life impact of the products (and packaging) on the environment and to what extent can they be reused or recycled?
Social		
Are any raw materials likely to be subject to constraint or restriction due to emerging ESG regulations or sentiment?	Does the company hire/employ a large workforce undertaking unskilled work?	What is the social impact of the product and are there any real or perceived ethical issues?
Governance		
Does the company have a complex supply chain with a significant number of Tier 1 or Tier 2 suppliers in non-OECD countries?	Has the company, or sector, been subject to, or associated with any ESG-related allegations, controversies or media attention? Does the company operate in, or have either procurement or customer relationships in, moderate or high-risk corruption countries?	Is the product or its components likely to be subject to restriction as a result of emerging regulations?

As responses are collated to questions such as the above, the number and severity of ESG risks identified will provide a qualitative indication of the overall risk profile of the business. It will also provide an indication of which topics are likely to be material and the focus of the ESG due diligence. Once the material issues are defined, the next step is to assess performance against these issues.

ASSESSING ESG ASPECTS OF THE SUPPLY CHAIN: FROM RAW MATERIALS TO PRODUCT END OF LIFE

Accurate identification of risk is crucial to navigate key complexities. Corporate supply chains are bigger and more complex than ever before. Consumer pressure, new regulations and increasing requirements for transparency mean that **there can be large negative financial and reputational outcomes if ESG aspects of the entire value chain are not considered**.

Key principles of managing **an effective and risk-free value chain involve accurate metrics and measurement**. New technology within the sphere of value chain mapping can accurately identify specific business/suppliers along value chain tiers – identifying key high-risk countries and inherent risk factors where regulation is lacking. Source country mapping and traceability using technology can also help identify high risk industries and commodities along the value chain where further resources and scrutiny can be targeted. Clearly, accurate value chain assessment is key to identifying further opportunities and risk where regulatory requirements and stakeholder expectations are high.

Risk management has traditionally taken a compliance-based approach; however, with the opportunities ESG provides to companies' value creation, a more collaborative and common good approach to risk can be developed and enhanced. **Effective training, industry benchmarking, consortium-based solutions and community engagement can all be harnessed to effectively drive change and increase value within the ESG sphere**.

"

New technology within the sphere of value chain mapping can accurately identify specific business/suppliers along value chain tiers and identify key high-risk countries and inherent risk factors.

3.2 UNDERSTANDING ESG PERFORMANCE

Effective diligence, evaluation, and management of ESG considerations within a transaction can help mitigate risks, improve financial performance, and accelerate growth. However, determining the impact of ESG factors on a target company is not straightforward. **Some of the challenges in the context of an M&A transaction are explained below.**

Lack of ESG awareness
A lack of ESG understanding and knowledge at a board level is a big challenge. This causes difficulties from the offset when identifying ESG risks/opportunities and how they would impact the business strategy.

Lack of data and poor data quality
While most large companies report on a variety of ESG factors, the lack of clear standardised metrics and the widespread use of inconsistent data definitions make an accurate assessment of the materiality of ESG factors difficult to ascertain. In the unlisted space this challenge is more pronounced due to the relatively lower ESG maturity of targets which often struggle to meet the information requirements of acquirors.

Quantification of risks and opportunities
ESG can be difficult to quantify regardless of data availability. Intangible impacts such as the brand and reputational benefit of a strong ESG position are difficult to value with certainty and incorporate into EBITDA forecasts. The time and procedural constraints of an M&A transaction exacerbate this.

Integration
Mergers of peers requires a careful assessment of the ESG objectives, maturity, and capabilities to successfully integrate the businesses. An acquisition may introduce new skills and technologies which can be leveraged across the parent company to improve ESG performance, there may also be costs associated with bringing target companies' compliance up to the required levels or delivering on commitments such as higher labour standards or net zero carbon emissions.

Greenwashing/unrealistic target setting
Another challenge that investors will face is assessing the credibility of ESG targets that a target company has set. For example, are the net zero targets achievable? Benchmarking these ESG targets against peers to assess whether they are in line or seemingly unrealistic is a first step in assessing the credibility. When performing due diligence, it is important to review the strategy in place to achieve ESG targets. This includes, but is not limited to, assessments such as the following.

- Is sufficient funding allocated to achieve the target?
- Do they have the skills and resources?
- What KPIs are being tracked to measure progress?

A company can increase trust in their own targets through external support from a qualified external auditor, ESG consultant and/or independent agency.

Standard ESG diligence aims to address the challenges above and typically follows a similar approach to other diligence workstreams, as shown in Figure 7.

Figure 7: Example of ESG due diligence workstream

1	**Gathering and reviewing information available**
2	**Assessing the maturity and effectiveness of the target's ESG management**
3	**Benchmarking performance against peers and stakeholder expectations**
4	**Assessing the positive contribution of a business to the sustainable economy**
5	**Quantifying value of ESG**

3.2.1 GATHERING AND REVIEWING INFORMATION AVAILABLE

Good data is key to understanding real ESG performance. However, it is paramount to understand how the dynamics of deals impact data and their usefulness.

Advisors will face very different data challenges depending on which side of the transaction they sit. For example, carrying out vendor due diligence or assisting the vendor with pre-transaction strategy, advisors will typically have sufficient access to management to produce meaningful commentary and analysis. Therefore, **the challenges faced by sell-side advisors should not concern access, but rather the maturity of the ESG approach of the business, and the existence of good quality data which can serve as a strong fact-base to support the company's ESG commentary.**

Buy-side advisors and investors don't usually have such complete access to ESG data.

The challenge for buy-side advisors and investors involves supplementing the limited publicly available data, particularly if the target is a private company, with data from the target or vendor. **This requires buy-side analysts to have a sharp focus on materiality to prioritise key topics and garner the best possible responses to information requests within the limited time environment of a transaction diligence.** Where imperfect estimates feature in due diligence, it is important to consider a pragmatic margin of error to acknowledge the limitations of the data.

3.2.1.1 PUBLIC INFORMATION

Many companies now publish sustainability reports which may or may not be aligned with reporting standards such as the TCFD, SASB or GRI. The content of sustainability reports, even when independently assured, is driven by the company and can lack comprehensiveness or consistency with peers. Furthermore, sustainability performance is infrequently framed within a financial context. For example, the cost of achieving improved performance, or the impact of cost reductions, is rarely disclosed.

Third-party data providers may provide ESG ratings and underlying data, although this is largely for listed companies and the subjective weighting of various ESG issues has resulted in a low correlation of data provider ratings.[17]

In summary, understanding ESG performance based on publicly available data is currently limited and, though it can inform a view of a business, one often needs to review private information provided by a business to really evaluate ESG performance.

> The content of sustainability reports, even when independently assured, is driven by the company and can lack comprehensiveness or consistency with peers.

3.2.1.2 USING INFORMATION PROVIDED BY THE COMPANY

Many companies have meaningful ESG documents, information and data which can be made available as part of a due diligence. **There are two principal challenges when trying to understand a company's ESG performance.**

1. **Identifying which ESG performance metrics are crucial to the transaction** (ie, critical ESG metrics for both targets and buyers). Time and resource are key limitations for both buyer and seller and therefore it's rarely, if ever, possible to have complete information.
2. **Getting assurance that information presented is comprehensive and reliable**. Although companies now invest heavily in promoting the positive aspects of their business, sellers have been known to obfuscate poor performance or ESG liabilities. In order to mitigate this risk, it's important to have the experience necessary to identify ESG aspects that are higher risk issues, as well as the tenacity to drill down into these issues during diligence.

17 State Street Global Advisers, 2019, ESG Investing 2.0: Moving Toward Common Disclosure Standards

3.2.2 ASSESSING THE MATURITY AND EFFECTIVENESS OF THE TARGET'S ESG MANAGEMENT

Assessing the maturity of ESG management within a target can provide a quick and often accurate indication of the seriousness with which a company approaches ESG risks and opportunities. Companies with high maturity will have developed a clear ESG strategy, and sophisticated internal governance and execution capabilities, coupled with the ability to measure performance and report to stakeholders on this.

While this maturity is often driven by a combination of business size and the sensitivity of the sector to ESG trends, benchmarking maturity across peers can give a clear indication of areas where the target may lag the market – signalling areas of potential risk as well as focus areas for post-acquisition improvements. The diagram below is an example of a standard high-level maturity assessment framework.

Figure 8: ESG Maturity Assessment

	1	2	3	4
	NOT FORMALISED	**DEVELOPING**	**MATURE**	**BEST-IN-CLASS**
ESG PROGRAMME/STRATEGY	• No formal ESG programme in place • May have a sense for material ESG topics and some activity to address/manage	• Some (not all) material ESG topics identified with related initiatives to manage; topics not placed into a cohesive ESG/ sustainability programme • No or limited engagement with key stakeholders on material topics	• Material ESG topics identified and integrated into a cohesive programme • May maintain stakeholder map and materiality map or equivalents	• Material ESG topics identified and integrated into a cohesive narrative that links to the company's purpose • Multi-year objectives to achieve improvements over time • Clear sense of key stakeholders and engagement channels
ACCOUNTABILITY	• No clear responsibility for consolidated ESG strategy, either individual or designated committee	• Some clearly-identified responsible party for the ESG strategy, though mid-level with limited engagement from management team	• Member(s) of management team responsible for the execution of ESG programme • May be embedded into discussion with the board on an ad hoc basis	• Board-level oversight of the ESG programme • Designated management team accountability for implementation • Ownership/engagement of programme throughout the organisation
IMPLEMENTATION	• While there may be organic initiatives tied to material ESG topics, there is limited/no engagement from management on targets and/or progress	• Initiatives defined to improved performance on material ESG topics, but with no clear time-bound targets or oversight	• Specific initiatives developed with timeline, targets and accountability, but execution/success may be spotty	• Specific initiatives with clear accountabilities tied to the multi-year objectives set out in the strategy • Initiatives have clear time-bound targets that are achieved regularly
TRANSPARENCY / REPORTING	• No internal or external reporting on ESG programme	• Internal: Some board or management-level reporting on material ESG topics • External: Limited ESG or sustainability-related disclosures available on website	• Internal: Regular reporting on progress of ESG initiatives to management team • External: Website has a page dedicated to ESG/ sustainability; content may be high-level	• Internal: Regular reporting to the board on ESG initiatives/strategy • External: Website has dedicated ESG/ sustainability page that describes specific initiatives to improve performance

3.2.3 BENCHMARKING

In assessing the performance of a target on material ESG matters, it is often valuable to benchmark the company's ESG performance, targets and transparency against peers and stakeholder expectations. However, given the challenges with availability and quality of data, **relevant and comparable benchmarking can be both difficult and time consuming.** In this context, benchmarking should be viewed as **a source of triangulation for primary diligence** and evidence, and to challenge the appropriateness of an ESG-focused scope (ie, are the correct topics being prioritised). Consideration of more than one benchmark provider allows an assessment of whether the material ESG topics show consistency, or whether the company/ sector are more subjective and complex.

In some cases, advisors have developed their own data pool of ESG metrics, especially around ESG-related financial metrics, which can be used to benchmark company performance. Benchmarking validates management statements on ESG. It also indicates where a company is leading in ESG and therefore, from a strategic perspective, the strengths which may be exploited. Conversely, it can indicate where the company is weaker and therefore where additional investment may be required.

Companies can use existing tools such as EcoVadis and CDP data to benchmark specific aspects of their ESG performance against peers. Furthermore, these provide an element of external validation that allows stakeholders (primarily investors) to make meaningful comparisons across the sector.

One notable trend in the ESG space has been the proliferation of ESG 'scores' that aim to capture a company's ESG profile in a single rating or grade. Stakeholders should exercise caution when using these in benchmarking exercises – unlike credit ratings, which exhibit very strong correlations between ratings providers, there remains significant variation in ESG scores between different providers. In addition, because different data providers employ different methodologies and analysis to combine ESG characteristics into a single score, there is significant ambiguity in what drives this variation in scores and which methodologies are the most valid.

Typical approach to benchmarking

1 Select suitable comparator businesses

- In many cases, comparator businesses are direct competitors of the business; however, where data on direct peers is not available, it may be necessary to use indirect peers.
- When selecting indirect peers factors to consider are company size, scope operations, geographic footprint and markets served.

2 Collect and analyse data

- Focusing on the material topics for the sector and identifying key metrics and themes based on publicly available information and third-party providers such as, RepRisk, Bloomberg and Refinitiv and, in some cases, data gathered can be placed in a hierarchy of value:
    - i. ESG metrics and indicators;
    - ii. Qualitive and defined actions and commitments; and
    - iii. Transparency and quality of public ESG disclosures.
- As ESG information can be inconsistent and heterogeneous, benchmarking is typically an iterative process.

3 Results and conclusions

- The results from the benchmarking exercise should provide an indication of how advanced the company's ESG performance, ambitions and disclosures are relative to selected peers and what drives these relative differences.

- The conclusions may provide insight into:
  i. potential reputational risks where the company is lagging;
  ii. potential areas where performance can be improved and the investment/costs and benefits associated with these improvements; and
  iii. potential leadership positions which present opportunities to exploit in terms of competitive advantage.
- It should also be considered whether, where a company is a laggard, this presents an opportunity to improve performance and use this improvement to generate value. An example of a benchmarking output is set out in Figure 9 below.

Figure 9: Benchmarking example

	Peer 1 (USA)	Peer 2 (USA)	Peer 3 (USA)	Peer 4 (EUR)	Peer 5 (EUR)	Peer 6 (EUR)	Peer 7 (EUR)	Peer 8 (EUR)
ENVIRONMENT								
GHG emissions (Scope 1, 2, 3)	■	■	■	■		■	■	■
Energy consumption			■	■				■
Emissions intensity			■	■		■		
Share of renewable energy			■					■
Waste				■				
TCFD disclosure		■	■	■				■
SOCIAL								
Board gender diversity			■	■				■
Leadership team gender diversity	■	■	■	■		■		■
Workforce gender diversity	■	■	■	■	■	■	■	■
Race diversity	■	■	■	■				
Age diversity								■
Parental leave taken			■					■
Employee engagement						■		■
Supplier spend (type and geography)				■				
Social impact on society				■				
GOVERNANCE								
Corruption incidents								■
Privacy complaints or loss of data								■

Key Takeaways

- Private equity (PE) peers report on a variety of ESG metrics across the spectrum of environmental and social issues at the firm level
- Gender diversity was the most frequently reported metric among the peer group, with all seven peers disclosing workforce gender diversity
- Seven out of eight peers reported on their Scope 1, 2 and 3 emissions (excl. investments)
- With the exception of some specific impact fund disclosures, peers' overall ESG reporting is still very much focused on outputs and outcomes across a select few metrics rather than comprehensive disclosure against strategic material topics and impacts
- Ultimately, while it is important for PE firms to report on their own ESG performance, the real opportunity to drive action is through the portfolio

Source: Deloitte

3.2.4 ASSESSING THE POSITIVE CONTRIBUTION OF A BUSINESS TO THE SUSTAINABLE ECONOMY

Companies that provide a positive environmental or social impact through their operations can tap into the vast tranches of capital looking for ESG-positive assets and are more likely to demand a premium on their value. Clearly defining and measuring this impact is a critical stage of validating the target's performance. There are several commonly used frameworks which can be used for assessing positive impact, from the more qualitative UN Sustainable Development Goals (UN SDGs) to the Impact Management Project (IMP) and the Global Impact Investor Network's IRIS+, and even the EU Taxonomy, a definition for sustainable economic activities created by the European regulators. These frameworks, while still fragmented and lacking scale across global markets, seek to provide a common language and robust approach for identifying and assessing impact.

Figure 10: UN Sustainable Development Goals

3.3 HOW TO MEASURE THE IMPACT OF ESG

The spectrum of ESG factors' impact varies from compliance risk mitigation through gender and ethnic diversity, to new business model opportunities. Other ESG factors can be blended into profit margin or growth, or customer loyalty and retention and their identification and quantification depend on the existence of data points and benchmarks. As data availability improves and value becomes more explicitly linked to EBITDA performance and valuation multiples, it is possible to identify the financial lever which ESG could impact, and through analysis or proxies to estimate the quantum of such impact.

Figure 11: How ESG issues impact financial performance

ACCOUNTING ITEM	NEGATIVE IMPACTS OF ESG FACTORS	POSITIVE IMPACTS OF ESG FACTORS
P&L: SALES/REVENUE	• ESG-related product or brand issues • Introduction of product-related ESG regulations • Physical and transition risks of climate change • Lower demand for unsustainable products which may become more expensive	• Enhance reputation for sustainable products and practices • Higher demand for sustainable products • Earn subsidies and government support • Higher staff productivity
P&L: OPERATING EXPENSES	• Increasing carbon/other ESG taxes and levies • Higher operating costs to address climate change impacts and more stringent ESG standards • Additional headcount to manage/address ESG performance	• Lower cost of producing more sustainable products • Better retention rates and talent • Lower cost of debt, capital and equity
BALANCE SHEET	• Writing down the value of assets exposed to the physical and transition impacts of climate change • Need to introduce provisions due to environmental contamination or occupational health liabilities	• Allocate capital to more sustainable plant and equipment
CASHFLOW	• Capex: Invest in plant and machinery to meet existing and emerging regulations • Invest in management systems to implement best ESG management practices • Cost of addressing poor ESG performance	• Improved ESG performance reduces expenditure on material resources, operating expenses and cost of debt

As ESG diligence issues are reported, it is essential that the deal team keeps asking "So what?". This helps them to quickly disregard issues unlikely to have a material impact on enterprise value.

Furthermore, where issues are presented as material, it's worth scrutinising the logic and assumptions applied to reach such conclusions. For example, the aggregate liability associated with employee compensation claims may be presented as a material issue. However, in many cases compensation claims are settled by the company's insurer and will not impact enterprise value.

Contingent liabilities

Another mechanism by which ESG factors can affect enterprise value is related to contingent liabilities. **The most common place these arise is where a company owns a site with potential historical contamination.** The financial statements need neither recognise nor disclose the potential costs associated with remediation if the likelihood of this obligation arising is remote (typically less than 10% likely to happen).

However, the investor's post-acquisitions growth plans may create an obligation to remediate due to an expansion or closure of operations/site. Or the buyer may consider that the likelihood of an obligation is probable within their investment timeframe.

Where such contingent liabilities are identified and can be reasonably costed, they are typically treated as debt-like items for the purpose of enterprise valuation.

3.3.1 DOUBLE COUNTING THE ESG IMPACT

Double counting refers to a situation where the value of ESG risks or opportunities are accounted for twice in the valuation exercise. It can be an important caveat when assessing ESG in a valuation context and is **most common in the four following situations**.

- In an income-based valuation method, double counting can arise if the company beta (a measure of risk, which is one input for the discount rate used in the valuation) already encompasses ESG factors, and an ESG risk premium is added to the discount rate. ESG issues then become accounted for both in beta and in the ESG premium of the discount rate. The automotive industry is an often-cited example of this situation. In practice, it is difficult to understand whether ESG issues are already priced in the market (and therefore encompassed in beta), and it is equally challenging to assess a realistic premium to be factored in the discount rate.
- A second situation of double counting in an income-based valuation method is where the modelled cashflows include specific risks and opportunities associated with ESG, and where an ESG premium would be included in the discount rate. Here, ESG factors are accounted for once in the discount rate and as tangible cashflows. An example would be an energy-intensive company transitioning to a green electricity sourcing policy: the cashflows associated with its energy initiatives would be modelled in terms of outflows and inflows, and an ESG premium could be applied to account for its net-zero business. Here again, in practice, **clearly identifying ESG impacts in cashflows can be challenging, and the discount rate is likely best left untouched.**
- A third instance of double counting involving an income-based valuation is when ESG opportunities become embedded in a company's offering and business. Since ESG is part of the company's value proposition, some ESG issues will be captured in the business-as-usual cashflows. **Additional ESG cashflows will need to be clearly disentangled from the company's regular business operations to avoid double counting.** The same logic applies to the discount rate. An example can be found in the increasing number of companies operating within the framework of sustainable development goals. Given that sustainability is core to business operations, specific ESG cashflows (or an exact premium) become harder to pinpoint without double counting them in the routine operational cashflows.
- Double counting can arise when carrying out market-based valuation and applying an ESG premium to the enterprise value multiplier. Such a premium can be inferred at industry level, for instance, by looking at average implied multipliers and assessing the marginal multiplier of the industry's top ESG performers (using available ESG ratings). **Double counting can arise if part or all of that premium is already captured in the company's financials.** For example, in a case where one would consider the EBITDA to EV multiple, applying an ESG premium could result in double counting if the company is more profitable as a result of its ESG strategy (eg, by sourcing cheaper renewable electricity). ESG issues are accounted for both in the increased business profitability and in the applied ESG premium on the multiplier.

Of all four cases, this last one is perhaps the most complex to disentangle. But these considerations should not discourage the financial assessment of ESG issues in the valuation exercise. On the contrary, it **should be seen as encouragement to produce the guidelines and standards that will allow for the true value of businesses to emerge.**

3.4 OVER-DEVELOPED FOCUS ON THE "E" OF ESG

To date, as the ESG agenda gains increasing focus and momentum, there appears to be slightly more emphasis on the "E" and/or the "S". And yet **the "G" is just as important in terms of corporate social responsibility and overall commercial strategy.**[18 19 20]

3.4.1 GOVERNANCE

Many governance areas (such as anti-bribery and corruption, fraud, sanctions, code of conduct topics, and related misconduct) carry significant fines, commercial restrictions, supply chain disruption and reputational damage in the event of non-compliance.

These governance areas have long-standing legal requirements and clear consequences for violations, as well as accepted mitigating factors, when things go wrong. Given the enforcement history with these areas, there are helpful, known examples of what is required and what is considered ineffective and/or inefficient. These examples help to establish a robust governance framework that allows companies to proactively identify, manage and mitigate such risks in both a meaningful and quantifiable way.

In the event of a transaction, these governance areas may also bear the risk of strict successor liability which creates more pressure to thoroughly consider these areas as part of any transaction.

Overall, governance issues go to the heart of an organisation. Non-compliance and related misconduct issues regarding governance areas can be indicators of the culture and mindset of a company and its leadership. This can impact brand, reputation and value. Crucially, it can **affect whether a buyer, employee, stakeholder or wider society regards a company as a responsible corporate citizen.**

3.4.2 SOCIAL

The social aspect of ESG has its own standards and best practice. **Corporate conduct and its social license to operate have come under greater scrutiny since the pandemic**, and stakeholders and investors have responded by increasing their engagement on social topics.

For example, key areas of focus are treatment of workers, diversity and inclusion (D&I), as well as health and safety. Although businesses have always espoused their commitment to treat their workers well, high-profile cases in public markets concerning workers in 'gig' economies have shown that **investors will quickly sour on companies not taking the treatment of workers seriously.** D&I topics have also grown in prominence, with some investment banks making diversity on corporate boards a condition of their IPO sponsorship.

Other key social topics such as community engagement and responsible investment are important external considerations. These include decreasing inequality in a region through investments or positively impacting communities through projects that support education and health.

"Non-compliance and related misconduct issues regarding governance areas can be indicators of the culture and mindset of a company and its leadership. This can impact brand, reputation and value.

18 How Unilever's tea business became a test of private equity's conscience | Financial Times (ft.com)
19 ESG's Role in Deliveroo's Rocky IPO | Managing the Modern Workplace | Insights | Vinson & Elkins LLP (velaw.com)
20 Boohoo accused of failing to improve working conditions in its supply chain | Boohoo | The Guardian

3.5 HOW TO ENSURE POST-TRANSACTION EXECUTION ON ESG COMMITMENTS THAT MATTER

Post-transaction, investors need to ensure that management deliver ESG performance that works towards sustainability and value. Equally, the companies involved in the transaction need to manage a successful integration, particularly with regards to ESG strategy and commitments to optimise value. Focusing on three critical steps can aid new owners in delivering on ESG value post-deal.

1 Set and track targets

- One way to make sure this monitoring process is effective is by **setting KPIs that are material to the investee company's core sustainability strategy** and address the ESG challenges relevant to their industry sector. **Each KPI should have applicable sustainability performance targets (SPTs)** that are ambitious and represent a material improvement in the respective KPIs that's consistent with the investee company's overall ESG strategy.
- It's necessary to have the right metrics to track these. Data and open dialogue play an essential role post-investment to understand an investee company's ESG performance. Therefore, investors need to have clear lines of communication with the investee company, scheduling regular engagements to receive updates on ESG performance and on the strategy that has been outlined to reach ESG goals.
- With that in mind, investors should be updated on significant implementation programmes within the investee company, such as decarbonisation of the supply chain or plans to improve diversity. Investee companies should, where possible and at least once per annum, provide up-to-date information sufficient to allow monitoring of the performance of SPTs and to determine that the SPTs remain ambitious and relevant to the business.

2 Know the methodology and gain external verification

- Underlying methodology of SPT calculations and/or assumptions when reporting must also be included. At least once a year, investee companies should obtain independent and external verification of performance levels against each SPT for each KPI. For example, a review by a qualified external auditor, environmental consultant and/or independent ratings agency.
- From a data perspective, collecting and tracking metrics during the investment lifecycle enables investors to manage risk, drive value and quickly spot where an investee company is not hitting agreed ESG targets. The process can be cumbersome without technology, but platforms are emerging that bring these ESG metrics into an electronic framework, helping to aggregate portfolio data and making it easier to benchmark ESG performance with dashboards and other reports.
- ESG-linked terms and robust KPIs, such as reducing carbon emissions, monitoring energy use and ensuring diversity in the workplace, are increasingly included in the deal documentation that shapes the way post-completion performance is measured in acquired businesses.

3 Provide incentives and encourage participation

- The demand from investors, regulators, and other stakeholders for corporate ESG responsiveness continues to grow. This is driving **more boards to consider whether ESG measures should be incorporated into executive incentive plan designs** to highlight how management will be held accountable for ESG results. Provided there is a balanced approach to the types of measures used in incentive plan designs, using incentives to reward executives for driving ESG outcomes (or penalising them for failing to achieve ESG objectives) can benefit shareholders and further promote a pay-for-performance philosophy that aligns with creating long-term, sustainable value.[21]
- While still in the minority, management incentives for ESG KPIs are rapidly growing. "In 2021, 30% of Financial Times Stock Exchange (FTSE) 250 annual pay packages included ESG metrics, up from 19% the previous year. ESG targets are typically linked to 10%-20%, of an executive's incentive pay. And companies tend to include it into short-term incentive plans (such as the annual bonus) rather than long-term incentive plans."[22]

3.5.1 MARKET STANDARDS AND REPORTING

Market standards and best practice can be embedded by industry frameworks or by businesses' own efforts to improve their ESG performance. Both play a vital role in ensuring the execution of ESG commitments. They **underpin the engagement efforts of stakeholders and investors, while providing benchmarking insights for the measurement of ESG KPIs**.

As the recognition of ESG's importance to business grows, market standards and best practice are being seen across more sectors and a wider range of ESG factors. For example, from an environmental perspective, more and more companies are reporting carbon emissions and energy efficiency data to stakeholders as standard.

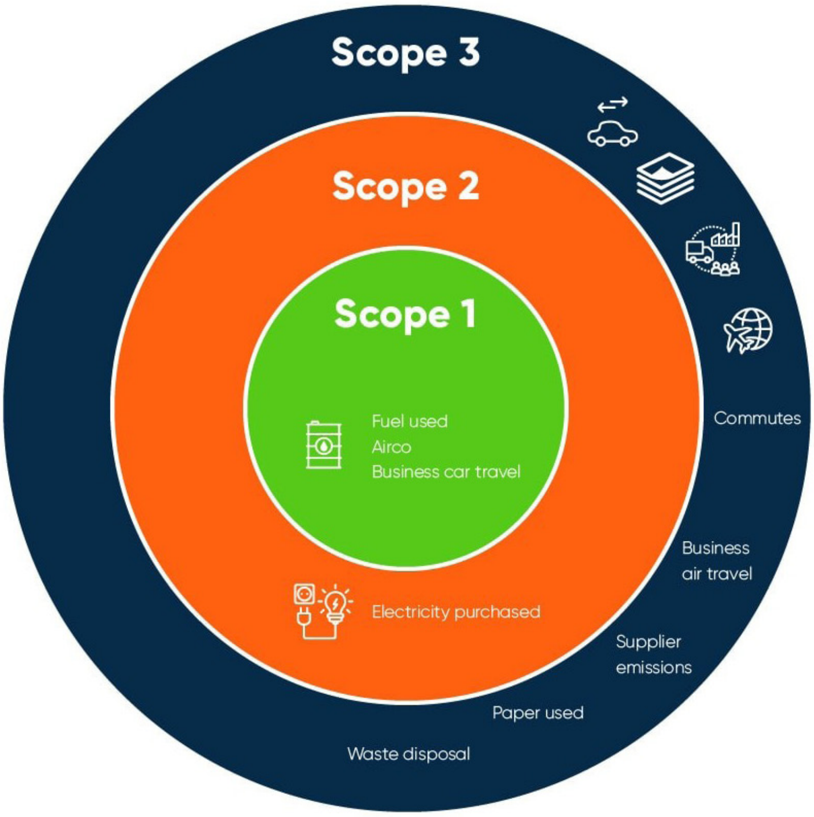
Previously, this type of reporting might have been limited to certain sectors, but companies are becoming more mindful of investors' ESG preferences (a trend underlined by inflows of data into 'sustainable' funds) while reporting by businesses is now enabled by frameworks like the GHG Protocol, Partnership for Carbon Accounting in Financials (PCAF) and the voluntary Carbon Disclosure Project (CDP).

As a result, **best practice ESG performance from an environmental perspective continues to widen in scope.** Investors and stakeholders expect measurement of Scope 1, Scope 2, and increasingly of Scope 3 (indirect, or supply chain) carbon emissions, assessments of resource usage and efficiency (with respect to both water and energy), and effective measures to reduce their waste sent to landfill.

21 The evolution of ESG-linked financial incentives: Private-equity backed companies | Travers Smith

22 The evolution of ESG-linked financial incentives: Private-equity backed companies | Travers Smith

Figure 12: Definition of Scope 1, 2 and 3 emissions overview



Source: Scope 1, 2 and 3 Emissions: Overview to Direct and Indirect Emissions – Ecochain

The TCFD framework for reporting on the impact of climate change on a business was developed by the Financial Stability Board (FSB) in 2015 and has emerged as a key market standard for climate reporting. In the UK listed and large companies are required to align annual reports to the TCFD framework, providing a common and comparable scope and language for stakeholders to assess.

Figure 13: TCFD Framework

Core Elements of Recommended Climate-Related Financial Disclosures

Governance

The organisation's governance around climate-related risks and opportunities

Strategy

The actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning

Risk Management

The processes used by the organisation to identify, assess, and manage climate-related risks

Metrics and targets

The metrics and targets used to assess and manage relevant climate-related risks and opportunities

Source: fsb-tcfd.org

3.5.2 QUALITY OF DISCLOSURE

The way investors analyse a company's ESG disclosures is similar to how they assess financial information because performance on ESG metrics can affect financial performance. Evaluating ESG information at the onset of a potential investment can help investors **determine the governance and strategies investees have developed to address material risks and opportunities.**[23 24]

Once an investment is made, investors use ESG information to monitor performance, much in the same way they use financial information. However, external assurance is the critical element of the financial reporting process that is still largely missing and needs to be institutionalised in ESG reporting.

Developing a robust governance structure, integrating internal audit and the board of directors into such structure, and obtaining external assurance (ie, the three lines of defence) can **enhance public trust and improve a company's ability to meet stakeholder expectations** for the disclosure of accurate and reliable information. It can also reduce risks related to misleading or omitted disclosures.

Implementing the three lines of defence will promote **high-quality, relevant, and meaningful non-financial disclosures,** enhance investors' reliance on reported information, permit better analysis of such information, and promote ESG investing.

“

External assurance is the critical element of the financial reporting process that is still largely missing and needs to be institutionalised in ESG reporting.

23 Evaluating the proposed scope of an ESG assurance engagement | ICAEW
24 Deloitte ESG now – Enhancing Trust in ESG Disclosures | Deloitte Ireland

4 CONCLUDING REMARKS

ESG and responsible investment considerations are profoundly reshaping business models. In the coming years, as stakeholder focus on ESG increases they will become even more intrinsically embedded across M&A. Such change is set to unlock competitiveness, profitability, and attraction of capital. But it is also essential to the trustworthiness of businesses, as customers, investors, employees, societies, and governments all expect companies to contribute towards resolving social challenges while also minimising their environmental impact.[26]

The approaches taken during the deal should reflect relevant frameworks, be backed by robust due diligence, and be carried out in a world of evolving expectations. ESG-assessed M&A will be an important means to create growth, a competitive edge, and access to affordable capital.

There is little conceivable way businesses can build a stable long-term future without ESG embedded throughout strategic processes, including their favoured M&A growth engine. Ultimately, commitment to ESG goals boils down to bold leadership. Corporate leaders need to take on the difficult choices to achieve harmony between building trust with stakeholders and shareholder value creation.

The companies at the leading edge of this change are already on their way to securing purpose-driven success and rapidly driving their future-ready transformation.[27]

26 Kate Raworth, Doughnut Economics

27 Deloitte, Unlocking transformative M&A value with ESG, 2021 Unlocking transformative M&A value with ESG (deloitte.com)

ABOUT THE AUTHORS

DELOITTE ESG M&A TEAM

ESG has migrated to being a driver of financial value and a major M&A topic. Deloitte can help clients embed ESG and maximise value in and from their M&A strategy. Our ESG M&A team are here to support throughout the entire M&A lifecycle. From defining a clear ESG M&A strategy, target screening and due diligence, to realising value post deal. Harnessing our global ESG expertise, Deloitte also supports clients across ESG strategy development, climate change risk modelling, net-zero and decarbonisation and sustainable finance.

CONTACTS

James Hilburn
Head of ESG M&A
jhilburn@deloitte.co.uk

George Wharton
ESG M&A Director
gjwharton@deloitte.co.uk

Susana Costa
ESG and Operations
M&A Director
suscosta@deloitte.co.uk

AUTHORS

Hannah Mitchell
Deloitte UK ESG M&A team

Dan Brooks
Deloitte UK ESG M&A team

Kathryn Bintcliffe
Deloitte UK ESG M&A team

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www.charteredaccountantsworldwide.com
www.globalaccountingalliance.com

ICAEW
Chartered Accountants' Hall
Moorgate Place
London
EC2R 6EA UK

T +44 (0)20 7920 8100
E generalenquiries@icaew.com
icaew.com

* includes parent companies. Source: ICAEW member data at 27 July 2022, Interbrand, Best Global Brands 2021

ABOUT THE CORPORATE FINANCE FACULTY

The Corporate Finance Faculty is ICAEW's centre of professional expertise in corporate finance. It contributes to policy development and responds to consultations by international organisations, governments, regulators and other professional bodies. It provides a wide range of services, information, guidance, events and media to its members, including its highly regarded magazine Corporate Financier and its popular series of best-practice guidelines.

The three major themes for the faculty's initiatives are: Global Investment and M&A; Innovation and Sustainable Recovery; and Future Advisory Professionals.

The faculty's international network includes member organisations and individuals from major professional services groups, specialist advisory firms, companies, banks and alternative lenders, private equity, venture capital, law firms, brokers, consultants, policy-makers and academic experts. More than 40% of the faculty's members are from beyond ICAEW.

T +44 (0)20 7920 8483
E cff@icaew.com

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