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Unlocking transformative M&A value with ESG

Executive summary

A powerful combination of environmental, social, and governance (ESG) demands is driving private equity funds and corporations to urgently transform their core strategies. Considerable shifts in consumer awareness and spending patterns, employee expectations, regulatory frameworks, and industry perception have prompted investors to reassign billions of dollars using ESG lenses.[1,2,3]

Businesses must acknowledge this turbulent change by rapidly reshaping strategy and incorporating M&A as a cornerstone for swift and lasting improvements. **After assets under management (AUM) in ESG-geared funds crossed the $1 trillion threshold in 2020**,[1,2] the following six months saw an unprecedented $103 billion worth of corporate and fund ESG activity[3] as businesses jettisoned problematic units and launched bold sustainability acquisitions.

We believe every deal will be scrutinized on ESG parameters. Private equity funds and corporations will need to embed ESG across all transactions, not only those ostensibly geared to those ends, if they are to curtail risks and deliver value. This report examines how corporations and private equity firms can ensure M&A objectives are purposeful and aligned to allow ESG parameters to contribute to how the business creates value for owners and other stakeholders.

But the deal environment is atypical: To win and win right, you need to do it better and faster than the competition. As this report considers, 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.

Success is born from the trust of stakeholders, including customers, employees, investors, regulators, and broader society. In the tumultuous first year of the COVID-19 pandemic, long-running environmental and social issues boiled over into a widely held negative view of organizations' impact.[4]

The discontent has been exacerbated by greenwashing attempts, which companies need to avoid or eliminate and instead carry out measured, credible change that is communicated transparently. Within M&A, this means basing strategy, target identification, due diligence, valuation, integration, and value capture on material ESG components.

For the foreseeable future, ESG-assessed M&A will be an important means to create growth, a competitive edge, and access to affordable capital. Equally, it will be key in establishing stakeholder trust, a determining factor in companies' feasibility to survive and thrive.

For corporate and fund-based dealmakers, **decisive steps are needed in risk reduction and in long-term value generation.** Organizations that rapidly embrace ESG in M&A will be better positioned to grow both resolutely and sustainably on our fast-changing planet.

ESG transforms enterprise value, prompting urgent change

The urgency around ESG investment and the value at stake have a tangible effect on M&A activity. More than 30% of businesses have witnessed operational consequences from climate change,[5] and in 2019, natural disasters caused an estimated $137 billion worth of losses.[6]

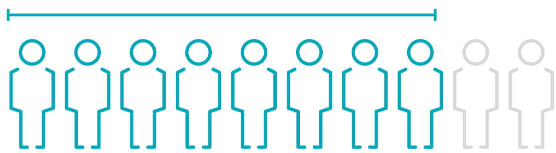
A landmark report by the United Nations' (UN) Intergovernmental Panel on Climate Change (IPCC) warns that rapid, substantial emissions cuts are required to avert catastrophe.[7]

In response to environmental concerns, nearly eight in 10 responding consumers are changing buying habits,[8] while around half of employees reconsider where they work.[9] Institutional investors recognize the dangers and are insisting companies hold climate-related voting,[10] while activists force their way onto boards to effect change.[11] Enterprises face simultaneous demands to tackle social inequality; improve working conditions; and fairly approach remuneration, tax, and data privacy.

These volatile conditions are leading governments to issue extensive regulation and demand disclosures:[12] Businesses must achieve carbon-neutrality by 2050 in Europe and the United States and the same target a decade later in China.[13,14] Business must build relevant M&A competencies that translate into regulatory compliance, capital attraction, and value generation. Over the past five years, ESG stocks outperformed the market by 88%,[15] and as COVID-19 spread throughout 2020, there was a 29% increase in sustainable loans and bond issuance to $732 billion.[16] The UN estimates $12 trillion of upsides are available by meeting its set of Sustainable Development Goals (SDGs)[17] with $23 trillion of investment potential through 2030 to meet Paris Agreement objectives.

30% of businesses witnessed operational impacts due to climate change

80% of customers are changing their buying habits due to environmental concerns



29% increase in sustainable loans and bond issuance to **$732B**

$12T of efficiencies and revenue growth is achievable by meeting SDGs by UN estimation

Capitalizing on the disruption with M&A

M&A can help mitigate risks while capitalizing on opportunities from ESG disruption. Acquisitions and divestments allow businesses to establish the necessary set of assets, skills, and technology.

ESG deals skyrocketed from $92 billion in the whole of 2020 to $103 billion in only the first half of 2021,[18] burgeoning in energy, industrials, and transport, with numerous significant acquisitions in the consumer, finance, technology, and chemicals sectors.[19] The United States, Germany, and China represented the leading target markets, with important activity in Canada, France, Spain, India, and beyond.[20] Compared with 2016, three times as many dealmakers are witnessing ESG-augmented exit multiples, with a quarter willing to pay up to 50% more for sustainable assets, presenting a risk of overpayment.[21]

For dealmakers, this voracious appetite for ESG should be harnessed. M&A opportunities include methodically capturing sustainable and ethical value across deals, such as transforming middling ESG performers into disruptors. Government energy tax credits and incentives may also render these difficult prospects viable. Due diligence can look to understand the dangers and opportunities around resources, work conditions, waste, energy, and market access, all of which can be managed through careful integration and value creation.

Businesses face stiff challenges mastering the changes

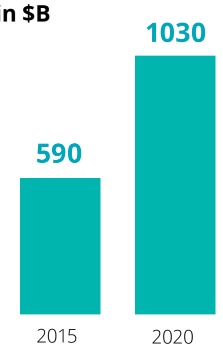
ESG should now be regarded as a key lever of value. Yet it remains highly complex to quantify ESG risks and opportunities and to value targets, complicated by the growing mass of noncomparable data; large areas of ESG are still a Wild West of standards.

As investors' money pours into assets, average EBITDA multiples in renewable asset deals, for example, rose to 15.2 in 2019 to 2021, compared with 13.1 in the prior two years. Measured by sales, multiples soared from 5.4 to 14.1.[22] However, tolerance for elevated prices should only be countenanced after informed risk and opportunity modeling.[23,24]

Extracting value from acquisitions, meanwhile, requires consistent and careful integration, yet difficulties are commonplace when cultures differ. Failure to correctly judge merger speed, align strategic ESG priorities, or motivate management can obstruct value creation. In the longer term, businesses must retain sight of their purpose, revisiting deal rationale and testing assumptions.

Global growth in sustainable AUM in $B

In 2020, assets under management in ESG-geared funds crossed the **$1 trillion** threshold



Source: Morningstar, Allianz Global Investors, UN Principles of Responsible Investing, UN Development Programs, Weltwirtschaftsforum.

Renewable asset deals

2019–2020 **15.2** COMPARED WITH 2017–2018 **13.1**

Average EBITDA multiples of **15.2** for renewable asset deals from 2019 to 2021 compared with **13.1** in prior two years

2019–2020 **14.1** 2017–2018 **5.4**

Measured by sales, multiples rocketed from **5.4** to **14.1**

Top target nations in terms of deal value ($B)

United States	Germany	China and Hong Kong	France	Spain
$125	$37	$34	$21	$21

Canada	India	United Kingdom	Netherlands	Australia
$17	$16	$16	$10	$8

Source: Deloitte analysis based on data from Refinitiv, PitchBook, August 31, 2021.

ESG investments across sectors ($B)*

Future of sustainable energy ~$192	Future of Industrials ~$86	Future of mobility ~$68	Future of consumer ~$11	Future of chemicals ~$5	Future of technology ~$3
Alternative energy ~$163	Waste management ~$73	Electric vehicles ~$61	Sustainable packaging ~$4.8		Data analytics ~$1
Energy storage ~$14	Industrial recycling ~$11		Food and nutrition ~$3.5		Green data centers ~$0.9
Energy from waste ~$12	Carbon capture ~$0.5		Farming & forestry ~$1.9		Clean energy infra ~$0.5

*Figures are rounded with major subsector investments included.
Source: Deloitte analysis based on data from Refinitiv, PitchBook, August 31, 2021.

Corporations and private equity funds need a focused, end-to-end approach

The businesses that succeed with ESG in their M&A cut through the hype and focus on strategic alignment, due diligence, execution, and value creation.

ESG M&A presents unique opportunities to step into these financial and technological tailwinds. To deal with the multiple complexities related to ESG, Deloitte has developed an end-to-end ESG M&A framework, **ESG ValueFocus®**, guiding businesses from strategy and deal origination through to due diligence, announcement, and integration and onto postdeal, long-term value creation. Some considerations are as follows:

Businesses need to embed ESG into their long-term growth strategies

Many firms have focused on environmental aspects, a crucial learning ground. They must also consider workers' rights, diversity and representation, the elimination of corruption, improvement of data privacy, and well beyond. It is essential to assess and prioritize trends and regulations, pledges from new governments, and relevant agreements such as the EU Taxonomy for sustainable activities, UN SDGs, Taskforce on Climate-Related Financial Disclosures (TCFD) recommendations, and the Sustainability Accounting Board's Standards (SASB).

An ESG strategy must also incorporate responsible tax approaches, including around intellectual property and supply chain costs, and credits and incentives to be gained.

During strategy development, companies should include relevant stakeholders such as customers, investors, employees, suppliers and nongovernmental organizations (NGOs) in an effort to address concerns transparently.

Companies should consider a combination of defensive and offensive M&A strategies to capture the full spectrum of ESG opportunities.

To prepare divestments of noncore assets, businesses must properly measure and communicate challenges and upsides to entice buyers. Offensive M&A strategies should then be considered to open revenue streams, such as in renewables, recycling operations, or the creators of underlying ESG infrastructure. Companies can powerfully link with others for solution development and venture investment.

10 challenges of ESG in M&A

1. **Greenwashing:** Overstatement or unproven environmental achievement
2. **Opacity:** Unseen assets having different credentials
3. **Standards and benchmarks:** Multitude of providers, limited correlation
4. **Disclosure:** Regular changes in oversight
5. **Qualitative:** Lack of financial value assigned
6. **"E" focus:** Social topics more intangible, governance impacts indirect
7. **Regional differences:** Opaque financial judgments
8. **Valuing intangibles:** Concepts, qualitative measures, and perceptions
9. **Double-counting:** Value aspects already in price
10. **Incentivization:** Not linked to stakeholder expectations or inaccurately measured

Sharp quantification of risks and opportunities is imperative

Proper ESG due diligence involves close assessment of the concerns and the value potential in any prospective deal: outlining key issues and measuring performance against regulations and frameworks. This is important even when more subjective than standard due diligence processes, focusing on policies and responsibilities, noncompliance and activist risks, and factors not on balance sheets.[25]

Quantifying ESG credentials is complex, with a proliferation of approaches sowing confusion. Corporations and private equity firms often lack the data and skills for informed decisions,[26] including within supply chains, where indirect problems may lie.

To get ESG due diligence right, businesses and institutional investors can access advanced tools, frameworks, and processes and examine sector climate risks and social impacts while also considering how relevant programs are charged to subsidiaries. These need to be designed and tailored, however, to the pace and availability of data seen during an M&A process.

Once risks are understood, value creation opportunities must then be modeled and prioritized. This involves baselining the target's performance in its industry and locations, with clear metrics around the deal's impact on the reduction of carbon emissions, energy usage, water consumption, and beyond. Government sustainability, research, and societal impact credits and incentives should be quantified.[27]

With growth prospects assessed and assumptions tested, valuation decisions can be made. Negative considerations here include potential asset impairment and fine liabilities, while positive aspects include improved revenues, cost of capital, and returns. Companies may rank these in order of significance and likelihood, baselining against peers.[28] Winning the deal involves careful decision-making on premiums and transparent communication of credentials.

CASE STUDY:

Quantifying the ESG impact on M&A

A global consumer goods business brought in Deloitte to help with divesting several noncore brands and **emphasizing the value opportunity for buyers.**

Deploying its ESG ValueFocus, Deloitte built a bottom-up view of key ESG measures relevant to the business, its sector, and potential investors, setting out performance. It created a baseline of environmental intensity and potential choices for new owners, covering net-zero, waste, and greenhouse gas emissions, including third-party raw materials, factories, and deliveries. Indirect "scope 3" emissions are challenging to compute but represented more than 90% of the footprint and were critical for new owners to understand how to generate **value from sustainability.**

The client was able to provide a clear perspective of ESG performance for the new business and, consequently, buyers were able to incorporate environmental and social value opportunities in their assessment and valuation.

Effective integration enables proper execution and long-term value creation

Integration complexity hits particular heights where ESG cultures, processes, and policies differ significantly. Variations in buyer and seller profiles in these areas should be met with confident steps that reflect a clear understanding of stakeholder perspectives and priorities, with culture and management divergence approached sensitively.

Turnkey approaches may work for simpler ESG businesses. Where there is a stark difference in ESG approaches but a need for tight integration, it is prudent to develop a revised ESG strategy and set of commitments that are credible, suitably ambitious, and have buy-in from the cross-section of stakeholder groups, reflecting the opportunity to develop a stronger, more resilient ESG approach with the combined entity, leveraging best practices, skills, and technologies. It is also important to consider what a new ESG governance structure looks like and what ESG metrics are appropriate, regularly measuring and reporting against clear KPIs, and linking executive compensation to those targets. By having a clear, revised ESG strategy and set of commitments and metrics, businesses can consistently deliver tangible and valuable ESG improvements.[29]

In the longer term, it is critical to maintain value momentum. Buyers must retain sight of their ESG rationale, questioning assumptions and learning from assets acquired, with private equity firms applying new best practices across their portfolio as stakeholder expectations evolve. Deep value can be derived from being ahead of the regulatory curve, unlocking new markets and fair ways of working, and harnessing disruptive opportunities in supply chains or in how customers use products.

Businesses must consistently communicate change momentum to all stakeholders, and this includes private equity presentations to potential buyers at exit. It is essential that companies regularly step back to review their historical acquisitions, applying lessons to all processes.

Deloitte ESG tools

Deloitte Center for ESG Solutions
Proprietary platform that helps clients develop holistic solutions to C-Suite ESG concerns, operational challenges and compliance requirements.

Deloitte Decarb Solutions
Suite of technology modules that provides physical risk assessment, climate scenario modeling, emissions pathways and abatement opportunity assessments across all industries.

Trust IQ
Diagnostic tool that quantifies the current state of trust at an organization, assessing performance across 17 domains and comparing against leading practices.

Managing climate impact with Deloitte Decarbonization Solutions

Climate impact should be central to every ESG strategy for businesses looking to survive and thrive in a rapidly changing global climate.

Deloitte's Decarbonization Solutions is a tech-enabled suite of modules that helps clients to accelerate the delivery of climate risk and strategic projects through:

- Climate impact assessments
- Science-based target development
- Decarbonization strategies
- Emissions intensity peer benchmarking
- Climate disclosures

Some of the world's largest organizations and single-asset operators use Deloitte Decarbonization Solutions to help them address some of their most pressing climate issues.

Conclusion: Deep value and trust from outstanding ESG M&A

ESG and responsible investment considerations are profoundly reshaping business models. In the coming years, they will become 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 play their part in creating a fairer and more sustainable planet.

Deloitte helps private equity firms and corporations across industries globally to become enterprises that methodically deliver the anticipated returns and, equally focus on the reinvention that honors societal expectations. These organizations measure, enhance, and amplify trust, employing diagnostic tools that quantify current status and inform decisive change. Acting upon the highlighted success factors for incorporating ESG in the end-to-end M&A process is the start.

There is little conceivable way businesses can build a stable long-term future without ESG embedded throughout strategic processes, including their favored 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.

Many private equity firms and corporations are working with Deloitte to transform their sustainability and build deeper integrity today. ESG M&A has a central role in this endeavor. Deloitte's end-to-end experience and suite of accelerators institutes the measurement, change, and amplification of trust, hand in hand with deal origination, strategy, due diligence, valuation, integration, and long-term 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.

Deloitte's ESG ValueFocus applies an end-to-end M&A approach to ESG founded on seven key success factors

1

Leadership:

Authenticity, resilience, and prioritization from the top to embed ESG within the corporate and M&A strategy

2

Factual diligence:

Clear quantification of operational, cultural, financial, and tax risks and opportunities, incorporating into the postdeal integration plan

3

Dialogue:

Continued transparent discourse with stakeholders, including the investment community, activists, regulators, governments, customers, and employees

4

Baselining:

Development and tracking of robust performance measures on material ESG issues, aligned with best-in-class frameworks and market sentiment

5

Congruence:

Calibration of ESG M&A with corporate strategies, considering how both defensive and offensive techniques can drive the transformation

6

Execution:

Focused and measured against KPIs to accelerate value extraction and supported by relevant management incentives

7

Course correction:

Regular reassessment of what matters to purposeful growth after the deal

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Contacts

Dr. Jason Caulfield
Deloitte UK
jcaulfield@deloitte.co.uk

James Hilburn
Deloitte UK
jhilburn@deloitte.co.uk

Karsten Hollasch
Deloitte Germany
khollasch@deloitte.de

Iain Macmillan
Deloitte UK
imacmillan@deloitte.co.uk

Daniel Markham
Deloitte Canada
dmarkham@deloitte.ca

Eiko Nagatsu
Deloitte Tohmatsu Japan
eiko.nagatsu@tohmatsu.co.jp

John O'Brien
Deloitte Australia
johnobrien@deloitte.com.au

Jen Steinmann
US, Deloitte Consulting LLP
jsteinmann@deloitte.com

Jeffery Weirens
US, Deloitte Consulting LLP
jweirens@deloitte.com

Authors

Dr. Jason Caulfield
Deloitte UK
jcaulfield@deloitte.co.uk

Susana Costa
Deloitte UK
suscosta@deloitte.co.uk

Ed Gunn
Deloitte UK
edgunn@deloitte.co.uk

Sriram Prakash
Deloitte UK
sprakash@deloitte.co.uk

Thank you to the following individuals for their insights and contributions to this report:

James Hilburn, Deloitte UK; **Rochel Hoffman**, Deloitte Australia; **Mick Kane**, Deloitte Tax LLP; **Matthew Lock**, Deloitte Switzerland; **Dan Markham**, Deloitte Canada; **Rob McConnel**, Deloitte Australia; **Bradford Nolan**, Deloitte Touche Tohmatsu Limited; **Brian Pinto**, Deloitte Tax LLP; **Chris Ruggeri**, Deloitte Transactions & Business Analytics LLP; **Tanay Shah**, Deloitte Consulting LLP, **Kyle Tanger**, Deloitte Consulting LLP; **Brooke Thiessen**, Deloitte Canada

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