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ESG in M&A Strategy

Despite many uncertainties, the sustainability megatrend, which can be quantified through ESG statistics, is gaining popularity among financial service providers worldwide. For us at Deloitte, sustainability is not just another megatrend to follow, but also a key motivating factor and a key driver for future M&A activity. The following post will outline our understanding of sustainability, set out the rationale behind our position and provide valuable guidance on implementing ESG strategies in the M&A space.

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ESG in M&A strategy
Why ESG is becoming a key driver in deal-making decisions

ESG factors are gaining more and more strategic relevance in M&A decisions – and not just as important metrics to consider throughout the M&A lifecycle. Increasingly, they are the key motivating factor for the transactions themselves. From an ESG perspective, participants pursue M&A deals either to introduce a change in corporate strategy, to mitigate future risks or to grow the overall value of the corporate portfolio. And the motivation behind the deal will also impact how it is implemented in practice.

What does sustainability mean?

Sustainability is a complex, often misunderstood term – in part because the terminology has not yet been clearly defined at the regulatory level. People often use the acronym ESG as a synonym for sustainability, breaking the issue down into three main themes of environmental protection, social justice and corporate governance. Based on these three sustainability categories, companies have to comply with reporting mandates on their economic activities as well as all non-financial opportunities and risks. We consider a company to be sustainable if it can operate profitably without adversely impacting society or the environment.

There are two ways to look at sustainability within a company. First, in terms of the business model, i.e., the environmental, social and governance impacts of a company's products and services as well as its actual operations. A sustainable business model is one in which the products and services help maintain or improve the current social and environmental status quo. Where companies go beyond the minimum legal requirements in their efforts to operate sustainably, this is known as Corporate Social Responsibility (CSR). In other words, these companies pursue responsible business activities that meet environmental and socially relevant standards in their day-to-day operations while also advancing the interests of all stakeholders. Sustainability is becoming increasingly important in the M&A space for a variety of reasons. Companies may pursue a particular target to help them meet the minimum regulatory requirements, though we are also seeing sustainability metrics become a strategic factor in all phases of the M&A process. The two main drivers behind the recent increase in deal volume is a desire to minimize risk through portfolio diversification and to enhance value through the promising future prospects of an ESG investment.

Sustainability as a motivating factor for M&A deals

The level of maturity and urgency in terms of sustainability will vary depending on the industry, company or deal in question. In the following, we will discuss ESG-focused M&A deals.

Examples of these deals are mainly found in carbon-intensive industries and companies, where the right M&A target can help buyers make the transition from CO_2-intensive processes to more climate-friendly operations. They may opt to acquire a company with more advanced technologies and practices or – when it comes to other industries and sectors – they may target deals that help them meet the consumers' expectations of or the societal shift toward sustainability. For example, companies may diversify their portfolios by closing M&A deals that give them access to renewable energy sources or that divest carbon-intensive assets. In this context, we make a distinction between internally and externally motivated deals.

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M&A transactions based on new objectives

On the one hand, there are certain objectives companies can achieve through an M&A deal, e.g., the diversification of the corporate portfolio as mentioned above or the disposal of stranded and underperforming assets. We see examples of the former when established companies use M&A deals to move their portfolios toward sustainable alternatives faster than they could achieve this organically. Whether as part of corporate strategy (which is rapidly transforming due to increased demands for sustainability) or to improve financial performance (with a higher alpha, ESG investments tend to perform better than ordinary investments), these deals offer companies an opportunity to expand their portfolios.

To name one example from the energy sector, a multi-energy company recently acquired a company that produces photovoltaic modules. The buyer is building a portfolio of renewable energy activities as part of its goal to achieve net zero greenhouse gas emissions by 2050. A majority stake in this PV manufacturer unlocks synergies with the company's own solar energy portfolio and offers B2B customers more comprehensive energy solutions.

M&A transactions can also prove extremely useful in disposing of stranded and underperforming assets, i.e., investments or resources that have stopped generating value or returns, usually due to external factors in technology, markets or societal norms.

This is particularly true for companies with assets such as coal-fired power plants. Due to new government regulations restricting the use of fossil fuels (e.g., through carbon pricing) and changes in demand (e.g., the shift toward renewables due to lower energy costs), these companies may find it challenging to sell coal-fired power plants in the future. It makes sense for corporations in carbon-intensive sectors to sell these assets as soon as possible. A multinational oil and gas company recently committed to divesting $25 billion worth of assets by 2025 to advance its strategic shift to renewable energy, divesting its stake in Omani gas fields and its oil interests in the UK North Sea last year.

And there are still companies interested in buying these stranded and underperforming assets, for example a global chemical company that buys unwanted fossil fuel companies. As a private company, it does not expect changes in regulations to have a major impact on its performance and is forecasting an increase in its own market share due to the sale of various underperforming assets[1]. Investors in this area, which are often located in the Middle East and Asia, generally expect to be compensated for holding these types of assets[2].

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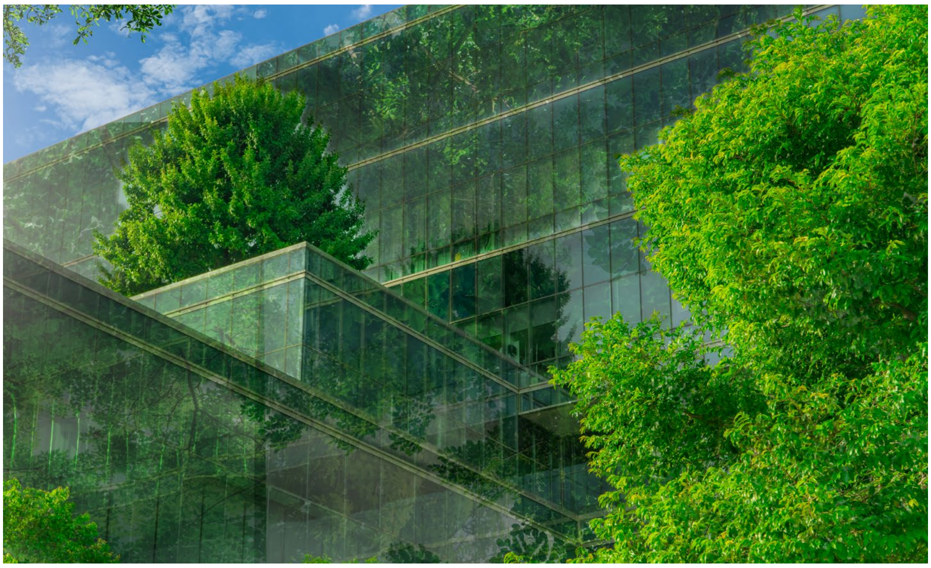

M&A transactions motivated by investors

By contrast, there are also investors in the market, e.g., private equity (PE) investors or activist shareholders, that are driving the increase in M&A deal volume.

We are seeing more and more PE investors pursue ESG-focused deals, doubling their assets under management in sustainability-driven funds from 2015 to 2020. On the one hand, this growth is motivated by private equity's general interest in fast-growing industries and companies. ESG-motivated deals are a perfect fit here, particularly with the high growth rates and potential value premium mentioned above. Studies show that sustainable energy companies are increasingly outperforming publicly-traded fossil fuel companies in this context, which is driving increased PE activity in the sector. On the other hand, the rise in deal volume is also driven by PE firms' efforts to improve their own reputations by acting sustainably in response to changing consumer behavior.

Whatever the motivation, PE firms are looking to improve their portfolio performance in the ESG area through targeted acquisitions that promise better financial performance over the long term. And these factors will give socially and environmentally conscious investors better access to capital.

In addition to PE investors, we are seeing more activist investors trying to influence corporate strategy through targeted investments. Their demands are increasingly focused on environmental and social issues, with the core message of their campaigns often directed against greenhouse gases and large oil corporations.

As an example of this,[3] a US-based hedge fund recently acquired a stake of about $750 million in a multinational oil and gas company and is now calling for the company to be split into multiple stand-alone entities to accommodate competing shareholder interests. The objective is to have one spin-off for the oil and gas production business, with another focused on renewables and liquefied natural gas.

Putting the strategy into practice

When it comes to the practical implementation of these strategies, the legal issues at play in an M&A deal are often heavily impacted by ESG factors – in particular, new legal regulations such as the Supply Chain Sourcing Obligations Act and the forthcoming EU Supply Chain Directive. Changes in the public perception of sustainability and the associated reputational risks as well as investor demands pose further challenges. These new and stricter regulatory requirements for business make it essential to at least review sustainability risks and criteria during the M&A process. In addition to minimizing risk, however, buyers may be more motivated by the potential value creation of strategic acquisitions or targeted portfolio adjustments. During the opportunity and risk assessment phase of due diligence, ESG criteria act as additional parameters to consider and, if potential targets perform accordingly, may give demanding buyers additional arguments in support of a deal.

There has also been a noticeable shift in the focus areas of legal due diligence. Although buyers have always taken individual ESG aspects into account, e.g., occupational safety and environmental protection, they generally look at them from a more traditional perspective and not in terms of sustainability. Today's buyers have broadened the scope to include even more ESG topics, which now constitute a high-profile chapter of the overall legal due diligence process, for example in the areas of labor law (e.g., social standards or occupational safety) and supply chains (e.g., ESG-related clauses in supplier and customer contracts).

More and more ESG factors and associated risks are also reflected in today's purchase contracts. We expect ESG warranties to be part of the standard warranty catalog in future, prompting warranty and indemnity insurers to explore to what extent these risks are insurable. In isolated cases, contracts may even include a material adverse change clause related to ESG factors, which entitle the buyer to terminate the deal if they find evidence of major deterioration in an ESG-related area.

It is clear that sustainability is playing an increasingly significant role along the M&A value chain. We can look at it as the motivating factor for M&A deals either to divest underperforming assets from non-sustainable industries, or as a driver for innovative investment opportunities. In addition, ESG aspects must be integrated in transaction decisions as demanding investors and regulatory requirements force companies to react. Either way, we expect developments on the market to remain exciting and will continue to closely monitor them moving forward.

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