An ever increasing focus on ESG is impacting M&A valuations and processes

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There is growing evidence that environmental, social, and governance (ESG) factors have a significant impact on business performance, and the speed at which these factors are becoming material is rapidly accelerating. This is driven by enhanced ESG data, society's evolving expectations (due to increased awareness), and the growing influence of investors who are incorporating ESG into their core due diligence processes.

As a result, ESG has become a critical factor in the Mergers & Acquisitions (M&A) landscape.

Shareholders and stakeholders now more than ever expect companies to prioritise sustainability, act responsibly, with inclusiveness and diversity, while contributing to global environmental goals. Negative incidents such as human rights violations, environmental damage, and other ethical breaches can have a significant impact on a business's reputation and financial performance.

As ESG considerations become increasingly important to stakeholders and shareholders, they present both financial and reputational risks in the context of M&A transactions. Investors are thus paying more attention to tracking and improving ESG metrics to recognise the value it brings.

This article explores the impact of ESG on the M&A process and its growing influence on valuation and investor considerations.

How transaction stakeholders are tuning into ESG

Dealmakers

97% said they are driven by (41%) or conscious of (56%) ESG through the deal process

60% of dealmakers have turned down one or more deals because of ESG concerns

Investors

88% of investors monitor ESG KPIs to inform investment decisions on an ongoing basis

$130 trillion has been committed to net zero aligned investment

> $2 trillion in AUM within dedicated impact funds[1]

Consumers

79% of buyers are changing preferences based on sustainability

36% of organisations believe consumers are willing to make this change[2]

Employees

61% believe business sustainability is mandatory for companies

46% would only work for companies with sustainable business practices[3]

Regulators

130 Countries have committed to net zero by or before 2050

Mandatory Disclosure requirements are emerging across multiple jurisdictions e.g. TCFD (UK), CSRD & EU Taxonomy, SEC Taxes & Incentives Carbon pricing, Plastics Tax, Sugar Tax, ICE Phase Outs etc.[4]

A clear focus on ESG provides organisations with a "purpose premium" that drives long-term value and generates a competitive advantage.

The tangible advantage this brings to companies can be seen across six core pillars:

1. Brand and Reputation

Greater recognition

78% of consumers were **more likely to remember** companies that exhibit a strong purpose grounded in ESG[5]

Stronger protection

Brands with strong purpose and ESG focus were

6x more likely to be protected in the face of negative publicity[6]

2. Sales and Innovation

Entry into new markets

53% of surveyed CXOs reported **new revenue streams** from socially conscious offerings[7]

Top dollar for goods and services

Sustainability-marketed products, compared with conventionally marketed products, saw a

39.5% Price premium[8]

3. Capital Access and Maret valuation

Faster growth

High-purpose brands could double their market value

4x faster[9]

Higher returns

Companies that met stakeholder expectations from an ESG perspective achieved a

6.4% higher return on equity[10]

4. Operational Efficiency

Cost savings

64% of companies with product sustainability programs **lower logistics and supply chain costs**[11]

Improved performance

A **10% improvement** in employees' connection with the organisation's mission or purpose was associated with:

12.7% ⇩ **in safety incidents**

8.1% ⇩ **in turnover**

4.4% ⇧ **in profitability**[12]

5. Talent

Employee attraction

78% of people indicated that they would **prefer to work for a purpose-driven company**[13]

Worker retention

~50% **of workers and 75% of millennial workers would take a pay cut** to work at an environmentally responsible company[14]

6. Risk Mitigation

Reduced exposure

15% of companies would be **unprofitable** if accounting for the environmental damage they caused;

32% would have their **EBITDA reduced by 25%** or more[15]

Brand trust

A negative trust-related event **eroded three companies' market cap by 20% to 56%** a combined loss in value of

$70 billion[16]

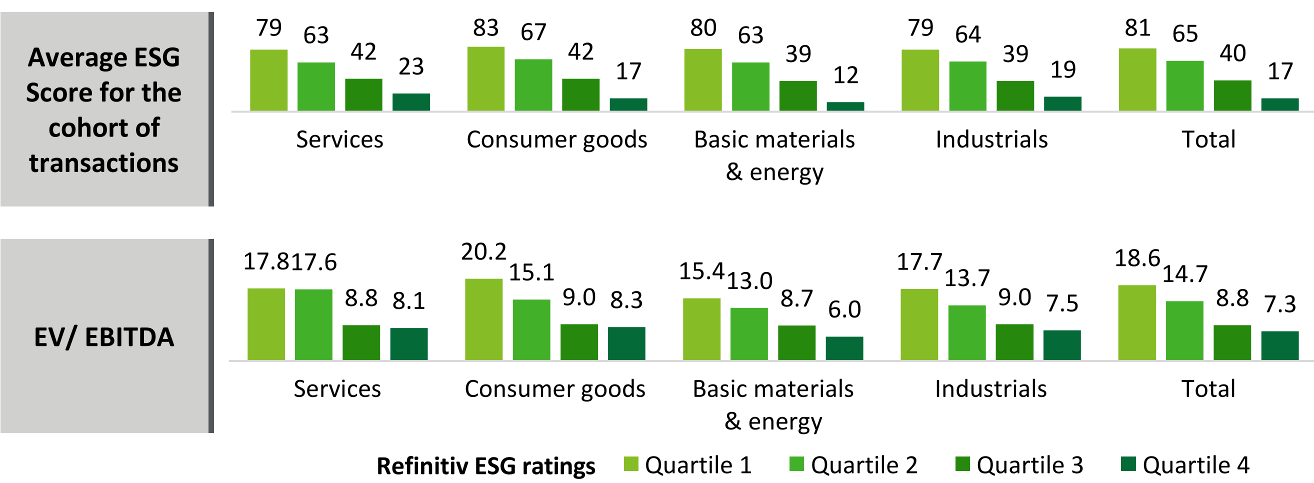
In today's business landscape, companies are increasingly recognising the value of embracing a purpose-driven approach that delivers long-term benefits for the organisation, its shareholders, and society as a whole

Investor ESG Focus

- The importance of ESG considerations is rapidly growing in the world of private equity (PE) investment. PE firms (typical holding periods of 3 years+) are realising the impact that ESG factors have on the long-term value of their investments.
- Consequently, ESG has become increasingly significant in the evaluation process, with a growing recognition of the financial risks associated with ESG issues. Companies that are seen as poor performers in terms of ESG, such as environmental sustainability or labour practices, are at increased risk of regulatory action, consumer backlash, and reputational damage. This has a significant impact on their financial performance and risk profile.
- Private equity firms understand the role that ESG can play in enhancing the value of investments, as previously demonstrated through the six core pillars. Leaders in ESG have been able to attract and retain a more talented and motivated workforce, as well as increased customer loyalty and better supplier relationships. This in turn drives higher growth and profitability, enhancing the value of the investment over the long term.

ESG impact on M&A valuations

- By categorising a substantial transaction set based on the target's ESG score (sourced from *Refinitiv*), it becomes evident that there is a **direct correlation between ESG and value**. On aggregate, transactions with the highest ESG scores also transact at higher multiples as set out in the below charts.
- While there can be other factors at play, extrapolations from this analysis indicate that increasing a company's Refinitiv ESG score by 10 points leads to a roughly 1.8x increase in the EV/EBITDA multiple.

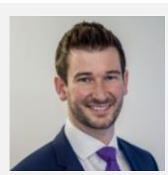


Source: Deloitte Analysis, Refinitiv

Conclusion

In conclusion, ESG considerations are playing an increasingly important role in M&A and are affecting the decisions made by investors and companies. By considering ESG factors, companies can ensure that they are making responsible and sustainable decisions, while also reducing the risk of regulatory or reputational damage.

The impact of ESG on valuations is growing, as buyers / investors begin to recognise the financial risks and value enhancement opportunities associated with ESG considerations. While the exact methods for incorporating ESG into the valuation process are still evolving, it is clear that ESG is rapidly becoming an important factor, and one that is likely to play an increasingly prominent role in the years to come.



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