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ESG: A new driver in M&A

Why is sustainability and ESG becoming increasingly important to the M&A agenda?

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Determining the value and performance of environmental, social, and governance (ESG) issues to multiple stakeholders is becoming central to how many companies craft their sustainability strategy. The bar on business performance has been raised and an ESG strategy has gone from being a "nice-to-have" to a necessity, with increasing focus on how it can create value, steer reputation and culture. If your business is looking to attract external investment, be it from banks, private equity or via an IPO, a clear ESG strategy is key. Institutional investors have it high on their agenda and, in today's market, it could be viewed as a cornerstone of any strategic plan. Whilst an ESG strategy can be delivered organically, my colleagues and I are becoming increasingly aware of a shift towards M&A as a mechanism to meet the ESG strategic goals for both corporates and investors.

Whilst each business will have their own individual reasons for using M&A to improve their ESG credentials, key drivers appear to be linked to both reputational and financial considerations. Scenarios range from seeking to improve their own ESG vista through focused acquisitions to improving their supply chain. Some are looking for innovative business models, in particular sectors that could become obsolete due to ESG issues, or creating value through additional income streams or margin improvement.

Three market trends

Private equity

ESG has become a key investment criterion point for private equity when evaluating potential investments, both from a reputational and value creation perspective. Private equity is particularly attracted to high-growth, a trait of many ESG-rich sectors. This has led to:

- Growth of buy-out impact funds, purely focused on investing in corporates with a strong ESG agenda
- Significant levels of VC/growth capital being invested in earlier stage ESG focused companies.

Exit plans are also being influenced. Improving a company's ESG position ahead of private equity exiting the investment are providing an opportunity to create additional value and improve returns.

Value

ESG focused companies are typically commanding value premiums, being driven by the high growth nature of these businesses and current demand outweighing supply.

- Sub-sectors where demand is highest, such as the energy sector, have seen the most rapid change in sector activity
- Market data shows increasing EBITDA multiples for ESG businesses over the past two years, at levels often above current mid-market averages.

Investors and potential acquirers will evaluate a company's ESG strategy as part of their value positioning. A company without a robust ESG strategy may require future investment to address this; if also viewed as having fewer revenue opportunities than that of a peer, a lower base valuation is a likely outcome.

ESG sectors

High growth ESG sub-sectors, or those with potential growth, are also seeing high levels of M&A.

- Ideal opportunity for larger corporates to re-position their offering and help provide some futureproofing of revenues
- Strong levels of private equity investment either directly or via private equity backed corporates consolidating in the sector and expanding their skillset or service offering.

This trend is expected to continue, with new innovation leading to an increasing number of emerging ESG focused sub-sectors that offer strong growth opportunities. For example, sustainable food innovation, waste recycling and electric vehicle infrastructure, amongst others.

Looking at transactions over the last 12 months, ESG has already become a consideration and will continue to be a driver of M&A activity in the foreseeable future. The focus now placed on sustainability and carbon neutrality will require companies to pivot from their current operations, and M&A will play a key role in delivering that change.

Connect with us

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