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Four ways ESG is reshaping M&A

How ESG is influencing M&A valuation, risk, and more

June 2023



Environmental, social, and governance (ESG) factors are redefining value and risk in business. Growing concerns over climate, sustainability, diversity and inclusion, pay equity, and more are increasingly shaping public policy—and public opinion. Businesses are starting to consider investments and activities in a new light. That includes Mergers & Acquisitions (M&A).

As in many evolving fields, ESG planning appears to lag behind awareness. Teams responsible for M&A strategy and deal-making are starting to recognize ESG's significance: Nearly 70% of those Deloitte surveyed considered ESG of high strategic importance in M&A.¹ However, they're not always clear how to act on that insight. Forty-three percent said they include ESG in M&A discussions only occasionally, rarely, or very rarely—and 39% lack clearly defined metrics for evaluating ESG.

M&A professionals are still learning how to navigate the new ESG landscape and all its uncertainties. They can start by understanding how to respond to the four key ways in which ESG is reshaping M&A:

1. ESG opens up new pathways to value
2. ESG requires a broader understanding of risk
3. ESG impacts can be quantified in dollars
4. ESG requires longer-term planning

ESG should be integral to M&A

Before we chart the mechanisms at play, it's important to establish what's at stake. Simply put, businesses should consider ESG as an integral piece of all M&A activities.

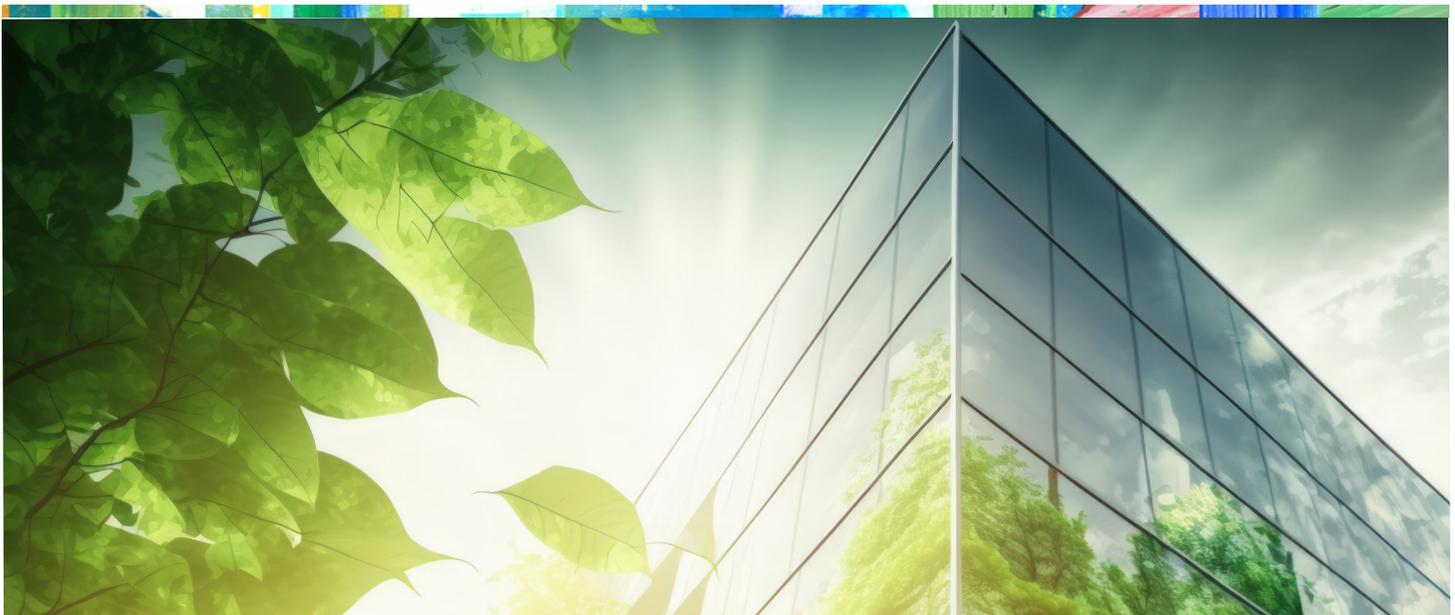
The biggest mistake deal teams can make today isn't getting ESG wrong; it's overlooking it. Failing to take ESG into account in M&A transactions can lead otherwise sound deals to go sideways. Take, for example, a consumer goods company that explored selling its agricultural farm-to-shelf business. The seller did not come prepared to talk about the ways climate change would affect the business. In the coming decades, in addition to impacts on plants, soil, and water sources, the warming climate is expected to change how products grown in certain regions will taste and smell. That has the potential to upend producers' supply chains. When the seller was unprepared to answer questions about such risks, several prospective buyers walked away.

On the other hand, organizations that have been proactive on ESG have shown themselves better positioned to seize valuable opportunities. Brookfield Infrastructure, for example, had invested for years in developing internal capabilities and expertise around climate technologies and the green energy transition. When it acquired Inter Pipeline (IPL) in 2021, it announced plans to diversify the natural gas and chemicals business into new areas including clean hydrogen and carbon capture. This strategy aligned IPL with many of its energy customers that had joined an industry consortium committed to reaching net-zero by 2050. Brookfield emphasized this in communications to investors, calling it a significant opportunity for a firm with its expertise in decarbonization.²

Enormous opportunities like this are forming on the horizon for firms that are proactive on ESG issues, including the energy transition, electrification, the circular economy, sustainable farming, and health care equity.

These examples illustrate that we're already past the wait-and-see stage, even though some might feel more comfortable taking that approach. It's true that regulations and best practices are still taking shape, and many of the most significant ESG impacts—like physical risks from climate change—may not be felt for years. But, in our experience, sitting on the sidelines now can mean missed opportunities and exposure to unforeseen risks. The ESG landscape will evolve rapidly in the coming years; those that fall behind may see value erode.

We've found that organizations can best position themselves to capture new opportunities and avoid pitfalls by building ESG into every step of the deal process—from strategy to targeting and due diligence, all the way through exit strategy—and considering the full range of ESG factors. That means going beyond carbon footprints. It means considering ethical sourcing and supply chains, workforce inclusion, scarcity of water and other natural resources, and more. The following observations can help M&A deal-makers get a head start.



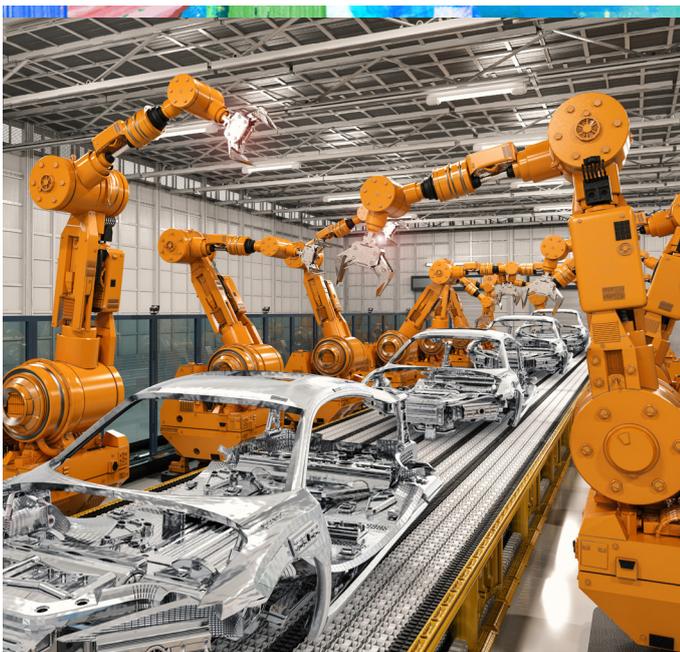
1. ESG opens up new pathways to value

Some may take a narrow view and characterize ESG considerations as simply new risks to navigate. That view is only half correct. The more important side of ESG may be the significant opportunities it affords to create new value.

Private investors reaped record value from ESG in 2021. Eighty exits by companies in fields like climate tech, clean tech, and impact investing returned \$86 billion in aggregate to investors, according to analysis by Deloitte and PitchBook.³ The five largest ESG funds globally, representing more than \$71 billion in assets, returned an average of 6.8% from 2020–2022.⁴ And studies have shown that better ESG performance correlates with higher annual returns by as much as 3.8%, leading to a compound effect of 20% to 45% over five to 10 years.⁵

We have seen many examples of organizations expanding offerings, finding new revenue opportunities, and discovering hidden value in existing assets thanks to ESG. A Deloitte team identified new revenue-generating opportunities for a fintech client while conducting ESG due diligence. These included new service offerings to help its customers tackle their ESG challenges, such as estimating upstream and downstream Scope 3 emissions from their value chains and serving underserved markets.

In another example, a life sciences company built an anaerobic digester that converted biowaste from its own and third parties' production processes into energy—and revenue. Local manufacturers paid fees to dispose of their waste in the digester, which cost less than municipal sites charged. This boosted EBITDA by about 10%.



ESG can sometimes even breathe new life into declining assets. Brookfield Renewable capitalized on renewed interest in nuclear energy by jointly acquiring Westinghouse with Cameco, the world's largest publicly traded uranium company.⁶ Brookfield Business Partners originally purchased Westinghouse, which services about half of the world's nuclear reactors, in 2018, shortly after Westinghouse declared bankruptcy amid falling demand for nuclear energy. Now, with interest in nuclear (as an emissions-free energy source) rising, Brookfield anticipates more than 60 gigawatts of new reactors will come online by 2040.⁷ This prompted the joint acquisition that will combine Westinghouse with Brookfield's renewables portfolio and Cameco's uranium expertise. The companies say this will better position them to take advantage of new innovations in nuclear going forward, such as smaller modular reactors that are expected to see growing demand in the coming years.⁸

Businesses seeking to improve their ESG performance are also driving up the valuations of organizations that build their offerings around core ESG issues. Such businesses are in low supply compared to current demand. The number of unicorn companies (valued at more than \$1 billion) in climate tech, clean tech, and impact investing reached 36 at the end of Q3 2022, nearly double the number at the end of 2020, per the Deloitte and PitchBook analysis mentioned earlier. Median valuations for deals in these domains have grown from about \$50 million to \$95 million over that period.

In some cases, ESG-focused companies may enjoy premium valuations compared to traditional counterparts. Emerson recently sold its climate tech business, focused on energy-efficient heating, ventilation, and air conditioning (HVAC) solutions, for \$14 billion. That's more than 12x its cash flow the year prior to the acquisition, a premium compared to typical HVAC manufacturers.⁹ In renewable energy, average valuation to EBITDA multiples in M&A deals from 2019–2021 were 15.2x, compared to 6.1x–12.8x for traditional oil and gas companies.¹⁰ In another instance, Deloitte helped a consulting services provider explore a potential acquisition of an ESG consulting business that was getting valued at 8–15x sales, far higher than normal in the professional services space.

2. ESG requires a broader understanding of risk

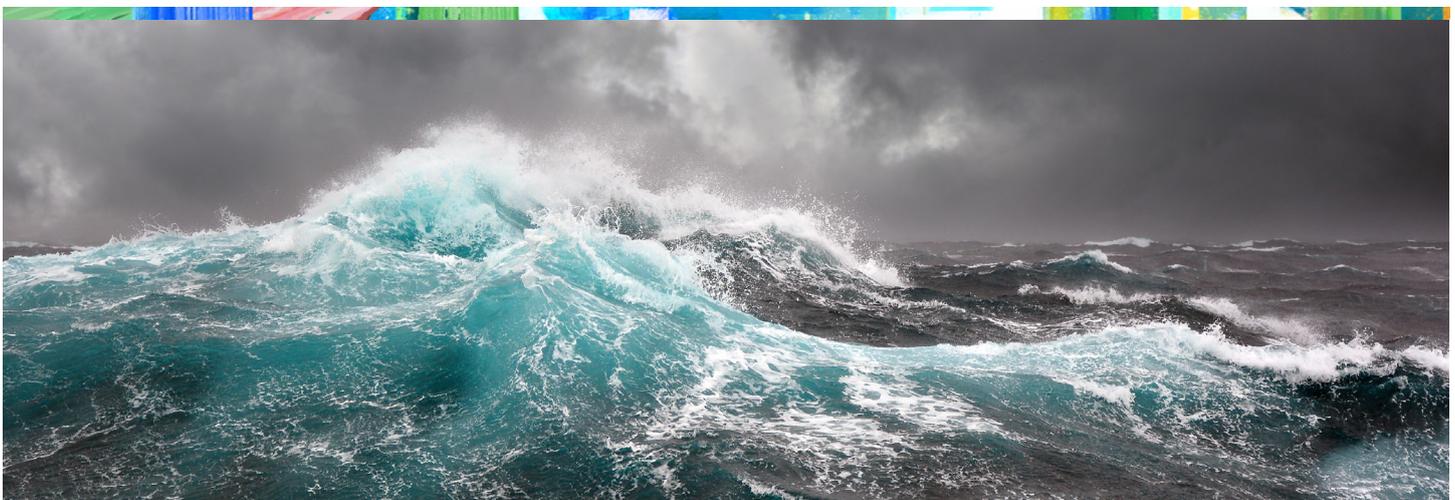
Looking at a business through an ESG lens can reveal more than new value-creating opportunities. It can also uncover potential new risks—including ones that deal teams may have little experience with. These may include physical risks related to climate change's expected impact on sea levels and weather systems, as well as risks stemming from the global transition away from fossil fuels.

These can raise important questions: Will climate change put assets like infrastructure, real estate, or cropland at risk from rising sea levels or extreme weather events? What future regulations may make compliance more costly or challenging for certain assets? Could new climate tech innovations introduce low-carbon alternatives that disrupt markets and supply chains?

These considerations may grow more significant for all industries, but they are particularly acute for energy and oil and gas businesses navigating energy transition risk. Global investment in clean energy topped \$1 trillion last year, matching global investments in fossil fuels for the first time.¹¹ Faced with this major shift, organizations in the sector are reconsidering asset valuations, acquisition targets, and potential divestitures. In one case, Deloitte assisted a utility company targeting a natural gas distribution business. In due diligence, the utility devoted a workstream to evaluating energy transition implications on the deal's value proposition as well as alignment with the company's own decarbonization plans. The analysis found that the acquisition would actually advance decarbonization in its geographic market, given the current energy mix there. The target's growth plans included bringing natural gas to parts of the region dependent on energy sources with higher carbon intensities. Evaluating ESG risk sometimes takes more nuance than simply writing off a certain industry or asset type altogether.

Physical climate risk may also give organizations pause around acquiring certain assets, even ones with ESG-friendly attributes. In one example, Deloitte was advising on the potential acquisition of a US renewable energy business. The seller based the valuation of its renewables portfolio in part on a climate risk study of physical assets in the northeastern United States, where it primarily operated. This left a major risk unaccounted for though, as the renewables portfolio included several solar energy assets in the southwestern United States, where climate change is expected to increase the frequency of extreme heat waves.¹² This could lead to greater degradation of solar equipment and the infrastructure that connects it to the grid, shortening capital replacement cycles and increasing operational costs. Ultimately, the buyer did not proceed with the transaction. The impact of climate change is unique to geographies, so risks must be analyzed locally and regionally.

As mentioned earlier, organizations also must consider a host of ESG-related risks beyond climate and sustainability. As supply chains have geographically diversified in recent years, organizations have been exposed to labor and human rights issues that industrialized economies rarely confront. Surf wear brand Rip Curl experienced this firsthand in 2016 when it was discovered one of its suppliers used forced labor in North Korea without its knowledge. The incident, heavily covered by media, sparked significant backlash and calls from human rights organizations for greater transparency around the company's sourcing practices and factory operations.¹³ This illustrates the importance of conducting due diligence on the "S" and "G" in ESG. In response, Rip Curl committed to increasing inspections and audits of its manufacturing partners.¹⁴ It was later acquired by another clothing brand.



3. ESG impacts can be quantified in dollars

Part of the challenge in understanding ESG value and risk has been that some organizations may not know how to translate these issues into dollars. That makes it difficult to account for them in valuations and investment strategies. Getting better insights on how revenue and costs might change under different long-term scenarios is critical for understanding how to respond to these issues.

There's been notable progress in this area, though. We have advised a variety of clients on the quantitative value of ESG issues, helping them better understand their financial impact.

For instance, Deloitte helped an EU consumer products business estimate how much it would cost to bring a potential US target up to its own ESG standards. The investment required totaled \$15 million in capex and several million more annually in opex to decarbonize operations, reform sourcing practices, and more. This had a significant impact on the company's value creation plan.

In the energy sector, a Deloitte client found that a potential target had been greenwashing the extent to which its revenue (and customer base) was tied to clean energy. The target claimed that 80% of its revenue mix came from renewable fuels. It was discovered during due diligence that was only 30% of its revenue. The Deloitte team helped determine that achieving the target's decarbonization commitments, inherently linked to the proportion of revenue from green products, would cost approximately \$300 million. As a result, the client elected to walk away from the deal.

Automakers have also engaged Deloitte in exploring acquisitions of upstream assets to vertically integrate electric vehicle supply chains. In some cases, the targets lag far behind the buyers' ESG standards and net-zero progress. Addressing this gap can require significant investment—in some cases, tripling capex commitment and driving a 150% increase in opex compared to base case scenarios. However, as ESG markets mature, buyers are also likely to enjoy pricing benefits from these investments. The ability to quantify costs from ESG impacts is maturing—more deal-makers quantifying ESG benefits like these may represent the “next frontier.”

New tools and techniques can also help quantify ESG impacts. Private equity firms have been proactive in this area. For instance, several private equity investors banded together with the nonprofit Accounting for Sustainability to publish the *Essential guide to valuations and climate change*, a comprehensive framework for quantifying climate-related risks and incorporating them into valuations.¹⁵ Such efforts are helping firms better assess future exit risks, a crucial factor in delivering long-term value to investors despite ESG uncertainties.



4. ESG requires longer-term planning

Some ESG risks will play out over many years, if not decades—far longer than the typical three- to five-year time horizons M&A models use. This heightens exit risk for firms, given that they have limited visibility into how emerging regulations, technologies, or risks may affect a business over the long term. Governments in some geographies are starting to set aggressive emissions targets to reach net-zero in the coming decades. Future regulations could dramatically affect value in multiple ways. Demand for certain assets, such as those tied to fossil fuels, could fall precipitously as businesses shed them from their portfolios. Compliance costs could also rise for certain industries to stay in line with net-zero mandates.

These same circumstances can significantly boost value too. As one example, organizations that have worked for years on hydrogen production and storage technologies are now poised to lead in low-carbon hydrogen, a market expected to take off in the coming decades and potentially top \$100 billion, in part thanks to government funding from the Inflation Reduction Act.¹⁶ Understanding how such factors might play out and influence a business is paramount for determining exit strategies.

Going forward, valuation models should consider longer time horizons. Modeling of different scenarios will need to reflect the ways different factors could take shape over many years. It might help to analyze scenarios at planned exit for private equity, or in five to 10 years for a strategic deal.



Importantly, deal teams should be as comprehensive as possible in modeling different ESG factors. Traditionally, the aim in valuation modeling has been maximum precision. But precision is nearly impossible when looking so far into the future. Rather, teams should focus on taking a holistic view of all relevant ESG factors, even if that means weighing their impact on a basis as simple as high, medium, or low and assigning a cost estimate to each level. The big risk is not imprecision. It's missing issues altogether—like Rip Curl did.

We are already starting to see some organizations take steps toward this. The utility mentioned earlier was under pressure from owners to evaluate new commercial opportunities related to decarbonization such as clean hydrogen and carbon capture. Evaluating such early-stage opportunities was challenging given given that they may still take many years to mature. With Deloitte's support, the company is now developing a scorecard to evaluate these opportunities' future potential and alignment with current operations and long-term objectives.

We've seen in our experience with clients that, pre-transaction or post-transaction, ESG is often considered an important long-term value driver. For example, Deloitte worked with a food and beverage group on a 20-year sourcing contract with a supplier in Mexico. Analysis by the Deloitte team found that climate change could significantly alter weather patterns and crop irrigation in parts of Mexico, calling into question whether the supplier could meet the client's needs over the deal term. This was another case in which a potential buyer walked away from a deal.

Such long-term physical risks are important to consider in light of supply chains and operations. Water and precipitation can affect far more than crop irrigation. BASF halted production at a German facility in 2018 because low water levels disrupted movement of supplies along the Rhine River—and that was before the river experienced record low levels last summer that reduced cargo capacity by as much as 75%.¹⁷ Glaciers in the Alps will likely continue to melt as the climate warms, reducing water levels further and affecting nature, people, and commerce. Looking far ahead, companies that operate or look to acquire assets in the region may need to move elsewhere or risk more acute supply chain disruptions.

Such multi-decade timelines are also being considered regarding real estate. One client engaged Deloitte to help analyze physical climate risks, leading to a shift in its investment strategy. Sellers demanded a premium for properties in low-lying coastal areas, but analysis of climate risks raised uncertainties over whether the organization could find tenants, insure such properties, and exit them over a 30-year time horizon. This led it to conclude that it couldn't justify paying the premiums sellers were asking. It has since stopped investing in coastal geographies with heightened climate risks.

M&A can be an engine of ESG progress

M&A can give organizations and practitioners a unique position to help drive positive impacts for people, business, and the planet. Private equity firms that acquire a new portfolio company, for instance, potentially have better visibility into and control over operations than public investors, per *Harvard Business Review*.¹⁸ This means M&A buyers can better understand what's underlying ESG performance and how to effect positive change that also benefits financial performance. Professionals should act now on this opportunity to help make a meaningful difference on some of today's most important issues and reap the potential benefits from spearheading ESG progress.

They can start by evaluating how ESG affects their relevant markets and strategies and determine whether those factors bring their portfolios new risks, supercharged growth opportunities, or some of both. They should consider whether current metrics and due diligence processes address the full range of ESG factors (across the "E," "S," and "G") and incorporate them into their investment plans and M&A processes. That includes valuations and how they assess exit risk. Deloitte has experience throughout this process of embedding ESG into M&A strategy, due diligence, and the value creation process. Reach out to our team to get started.

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