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A Transformative Corporate Expansion Strategy: M&A with ESG

(A Pathway Created by Deloitte)

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ABSTRACT

The changing swift of business environment with sustainability development increases demand for transforming core business strategies and private equity funds within the purview of ESG. Billions of dollars investment need to swift considering ESG along with consumer awareness, Industry requirements, Regulatory framework, and employees and stakeholder's expectation. M&A strategies are rapidly undergone a change having lasting impact. However, after COVID pandemic stakeholders are showing concern for the environment too.

Keywords: *ESG, M&A, Transformation, Change, Sustainability.*

1. INTRODUCTION

ESG means a combination of Environmental, Social and Governance. M&A, a widely used corporate expansion strategy have to consider demand for change in investment or acquisition with a view to ESG. Asset under management in ESG geared funds had crossed the USD 1 trillion threshold in 2020 by making bold sustainability acquisitions.(Siobhan Riding, 2020)[16] Corporate executives and private equity firms have to measures that objective of M&As are related to ESG in order to make it valuable and less risky. This also ensures value creation for stake holders and owners. Closing a M&A deal is to be quick and better than competitors along with due diligence and relevant framework. A transparency in basics of M&A like Strategy, identification of target, valuation, integration, due diligence associated with ESG components. ESG embedded M&A ensures company's growth, trust of stakeholders, competitive advantage, access to capital funds etc. for foreseeable future with survival and thrive. Companies moving forward with ESG in M&A will be at better positioned in highly competitive market and our sustainable placed in rapidly changing planet.

2. URGE OF CHANGE

The requirement of investment with consideration of ESG and the value of enterprise have significant impact on M&A activity. Due to environmental effect of rapidly changing climate more than 30% businesses have suffered a loss (operational loss) due to national disaster or global pandemic. (Deloitte, 2021)[6]In 2019, loss from national disaster was USD 137 billion. (Acclimatise, 2020)[1] A report published by Intergovernmental panel on climate change (IPCC-UN) said clearly that, immediate measures to be taken to avoid more adverse climate changes. (Camilla Hodgson, 2021)[4] In recent pandemic times, people witnessed the effect on environment and it made them aware about preservation of environment for future generations. It has been observed that out of 10 consumers, nearly 8 are changing their buying habits. (Capgemini, 2020)[5]Further half of the employees are deciding where they work. Institutional investor and environmental activist are creating pressure for change in enterprise and adopting climate conscious working pattern.(Edelman Intelligence, 2019)[11] Enterprises have to deal with issues other than ECG like, inequalities, safety and hygiene of employee into workplace infrastructure, remuneration, job satisfaction, legal requirements and data privacy.To preserve the environment and in response to environmental concern raised by UN, the member nation developed a framework and set certain goals. Leading nations like Europe and US has set target of zero carbon can be achieved by 2050and same can be achieved by china by 2060. (Matt McGrath, 2020)[13] In this environment M&A strategies must be developed in relevance of value creation, attract capital investment, fulfilment of regulatory requirements. In last five years, ESG stock outperformed the market by 88%, (Deloitte, 2021)[7] due to covid pandemic, 29% increase has been observed in sustainable loans and bond with issuance of USD 732 billion. (BloombergNEF, 2021)[3] UN has estimated increased ofUSD 12 Trillion by meeting set of 17 sustainable development goals (SDGs)(United Nations Global Compact, 2017)[17] with USD 23 trillion of investment opportunities by 2030 through achievement of Paris agreement objectives.

3. M&A AND ESG

It is an opportunity to mitigate risk through M&A with ESG in acquisition and divestment strategies. There is more than 10% increase in ESG based deals from 2020 with %92 billion to 2021 first half with USD 103 billion. (Deloitte, 2021)[8]These acquisitions are from energy, transport along with significant transactions from consumer, finance and chemical sectors. US, China and Germany are leading target market however India, Spain, France, Canada etc. are potential target markets. In comparison of 2016, deal makers are thrice times choose ESG based deal with willingness to pay 50% more for sustainable assets to prevent risk of over payment. (ERM, 2021)[12] Deal makers shall be required to pay careful attention in M&A opportunities by adopting suitable methodology, proper integration and value creation within the purview of sustainable and ethical value across the deal, due diligence and corporate governance. ESG is key lever factor though it is complex in quantifying risk and target opportunities values in absence of comparable data. M&A valuation and integration is difficult due to difference in culture, speed of M&A, associated ESG and

SDG priorities, and management objectives. Global growth in Asset Under Management (AUM) has crossed USD 1 trillion threshold in the year 2020, which is nearly twice compare to 2015 with USD 590 billion and USD 1030 billion. An investors' money invested into assets having average EBITDA multiples in renewable asset deals, Measured by sales, multiples soared from 5.4 to 14.1.(Mergermarket, 2021)[14]Elevated tolerance pricing can be understood with information about known risk and opportunity modelling.(Mergermarket, 2021)[15]UN has observed Average EBITDA multiples of 15.2 for renewable asset deals from 2019 to 2021 compared to 13.1 in prior two years of 2017-18. The Renewable asset deals have measured by sales, multiples 5.4 in 2017-18 to tremendous shift of 14.1 in 2019-20. (Deloitte, 2021)[9]Deloitte from its Pitch Book, August 31, 2021 analysis observed leading target nations in terms of deal value in **USD billion** are namely US (125), Germany 37), China and Hong kong (34), France (21), Spain (21), Canada (17), India (16), UK (16), Netherlands (10) and Australia (8). Further the report said ESG investment across sectors in **USDbillion** are; a) Future of Sustainable energy (192) through considering investment in alternative energy (163), Energy Storage (140) energy from waste (12) etc. b) Future of Industrials (86) through considering investment in waste management (73), industrial recycling (11), carbon capture (0.5) etc. c) Future of Mobility (68) through considering investment in Electric vehicle (61). d) Future of Consumer (11) through considering investment in sustainable packaging (4.8), food and nutrition (3.5), Farming (1.9) etc. e) Future of Chemicals (5) f) Future of Technology (3) through considering investment in Data analytics (1), Green data centres (0.9), Clean energy infra (0.5) etc.

With ESG, corporate executives shall be more focused on due diligence, integration and value creation, strategic alignment without high expectations in M&A deals. Implementation of ESG is long term growth perspectives on basis on environmental ground both internal and external (Micro and Macro). It is also requiring aligning strategies and policies in accordance with global standard and framework designed such as EU Taxonomy for sustainable activities, UN SDGs, Taskforce on Climate-Related Financial Disclosures (TCFD) recommendations, and(Accounting for sustainability, 2021)[2] the Sustainability Accounting Board's Standards (SASB). ESG strategies must incorporate financial and taxation benefits to be taken. A full value can be achieved in M&A by applying offensive and defensive both strategies in transaction. So that company can link others for solution development and venture investment.

4. KEY CHALLENGES OF ESG IN M&A

(Deloitte, 2022)[10]An ESG embedded M&A is bit complex due to cultural differences and due diligence. Different strategies and approaches create confusions. Lack of proper decision making by corporations and private equity firms in absence of sufficient data, fails to evaluate risk associated with standard due diligence process, policies and regulation, indirect or non-balance sheet factors. Deloitte have identified key challenges;

a) green washing - Overstatement or unproven environmental achievement,

b) Opacity - Unseen assets having different credentials, Standards and Benchmarks - Multitude of providers,

c) Limited correlation, Disclosure - Regular changes in oversight,

d) Qualitative - Lack of financial value assigned,

e) “E” focuses - Social topics more intangible,

f) Governance impacts indirect,

g) Regional differences - Opaque financial judgments,

h) Valuing intangibles - Concepts, qualitative measures, and perceptions,

i) Valuing intangibles - Concepts, qualitative measures, and perceptions,

j) Incentivization - Not linked to stakeholder expectations or inaccurately measured.

5. ESG TOOLS AND ACTION PLAN

To overcome challenges of ESG in M&A, Deloitte developed several tools and action plans. It is based on end-to-end transaction approach with transparency and covering it up in regular interval evaluation for achieving long term growth objectives from ESG embedded M&A. It has three different tools for specific tasks namely Deloitte Centre for ESG Solutions, which individual platform that helps clients into development of holistic solutions to C-Suite ESG concerns, operational challenges and compliance requirements. Second one is Deloitte Decarb Solutions, suitable for technology modules that provides physical risk assessment, climate scenario modelling, emissions pathways and abatement opportunity assessments across all industries and third is Trust IQ for Diagnostic tool that quantifies the current state of trust at an organization, assessing performance across 17 domains and comparing against leading practices

In consumer goods business, it has developed bottom-up view of key ESG measures relevant to business and its valuation. The approach created base for environmental action plan to generate value for sustainability. It also can be achieved by divesting non-core brands and emphasizing value opportunities for customers. Effective integration enables proper execution and crates long term value. ESG strategies shall be modified based on the requirement. Regular review of historical M&A shall be done. Revised ESG should be credible and suitable to the environment. All stakeholders are informed about change momentum on regular basis with at most transparency.

Another solution is given by Deloitte named decarbonisation for climate change. In ESG the centre focus is on climate or environment to get competitive edge and survive in global changing climate. This solution is technology-based tool to help client with acceleration of the delivery of climate risk and strategic projects through Climate impact assessments, Science-based target development, Decarbonisation strategies, and Emissions intensity peer benchmarking and Climate disclosure.

Further, Deloitte came up with 7 key success factors for ESG value focus on end-to-end approach in M&A.;

1) Leadership Approach: Authenticity, flexibility, and prioritization from the top to bottom embed ESG within the corporate expansion and M&A strategy.

2) Factual diligence Approach: Clear quantification of operational, cultural, financial, and tax risks and opportunities, incorporating into the post deal integration plan.

3) Dialogue Approach: Continued transparency with stakeholders, including other stakeholders like the investment community, activists, regulators, governments, customers, and employees etc.

4) Baselining Approach: Development and tracking of robust performance measures on material ESG issues, aligned with best-in-class frameworks and market sentiment.

5) Congruence (Equivalence) Approach: Standardization of ESG M&A with corporate strategies, by taking into consideration both defensive and offensive techniques for transformation.

6) Execution Approach: Focused and measured against KPIs to accelerate value extraction and supported by relevant management incentives.

7) Course correction Approach: Regular reassessment of what matters to purposeful growth after the deal.

6. IMPLICATIONS OF THE STUDY

The study's findings have significant consequences for businesses, investors, and politicians in the transaction of M&A, wherefirms should be more careful about large investments in ESG activities, especially during times of economic uncertainty. The findings imply that ESG engagement is not a resilience element in an exogenous shock like the COVID-19 pandemic for shareholders. In terms of policymaking, the sustainability disclosure framework should remain voluntary, allowing companies to report material environmental, social, and governance (ESG) issues. The study's most significant shortcoming is the lack of data on ESG performance.

CONCLUSION

ESG M&A creates deep value and trust. It considered as reshaping of business model. In future time it becomes integral part of M&A to unlock profitability, competitiveness and capital attractiveness. Further it shall create trust among all stake holders and more importantly it helps in making better sustainable planet earth. Deloitte helps in creating value for business in terms of economy and also societal expectation by focusing on ESG. Many corporations and private equity firms are working with Deloitte to transform their sustainability and build strong integrity. ESG M&A is bold leadership decision though it is central and crucial role in this endeavour. Solution models adopted by Deloitte provide the measurement, change, and amplification of trust, hand in hand with deal origination, strategy, due diligence, valuation, integration, and long-term value creation. Leading companies are already on their way to adopt and securing purpose driven success and rapid transformation in future.

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