Incorporating ESG across the M&A process

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Prior to and during the "sixth great merger wave", lasting from 2003 to 2009, the term ESG (environmental, social and governance) was scarcely mentioned in deal-making lexicon.[1] In the years since, as the "seventh great merger wave" (2012-2022) has recently subsided, various aspects of ESG have become key considerations during many transactions. This ranges from the type of assets a firm purchases, to evaluating the management practices of target firms, to incorporating ESG assessments into due diligence checklists and valuation models, to including specific ESG provisions in the sale and purchase agreement (SPA). Companies are increasingly concluding that a more robust focus on ESG in deal-making allows for greater value to be captured.

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ESG is rapidly becoming a key factor throughout the M&A process

A recent study of 509 deals found that ESG due diligence was conducted in a third (33%) of the transactions and specific ESG provisions were included in almost half (45%) of the SPAs.[2] In another survey of 300 dealmakers from 225 corporate and 75 private equity (PE) firms, 81% of respondents said they now spend more time scrutinizing ESG factors during due diligence.[3] Finally, a direct correlation was identified between better ESG performance of target firms and their valuation. Transactions with the highest ESG scores also transacted at higher multiples, with a 10-point increase in a firm's ESG score resulting in an average 1.8x increase in the EV/EBITDA multiple.[4]

What is ESG?

ESG is a broad term that can encompass numerous aspects of a firm's operating model. Yet, as the authors of a wide-ranging global study of various aspects of mergers and acquisitions (M&A) point out, "confusion and a lack of clarity around the standards and benchmarks used to measure ESG performance is a recurring theme, with dealmakers having to navigate myriad standards that are difficult to compare and vary from region to region."[5] So, what is ESG? Exhibit 1 identifies example elements regularly included in assessing a firm's performance in the three core areas of ESG.[6]

Three key trends

Three key trends are emerging related to the ESG agenda. First, there is a focus on not only *what* a company produces, but also *how* a company produces it. For example, there is

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Exhibit 1 Example components of ESG

Environmental	*Social*	*Governance*
Biodiversity	Equal opportunities	Business ethics
Water efficiency	Health and safety	Compliance
Energy efficiency	Human rights	Board independence
Carbon intensity	Customer and products responsibility	Executive compensation
Land use	Child labor	Shareholder democracy
Use of materials		

Source: Created by authors based on the GRI Standards

increased scrutiny of how firms design operational processes to minimize water or energy use. Such is the case for the Coca-Cola company, with the firm achieving a 10% improvement in water efficiency across all operations between 2015 and 2022.[7]

Second, ESG has moved from a fringe concept to mainstream business practice. A survey of 7,500 consumers across 750 large organizations found that 80% of consumers are making ESG-based purchase choices. In response, organizations are making ESG practices a strategic priority.[8]

Third, firms are finding that what were once voluntary ESG practices, are now mandatory. Governments across the globe are issuing extensive ESG regulation and demand disclosures. For example, the EU has just passed the Corporate Sustainability Reporting Directive (CSRD) – the most comprehensive set of ESG reporting requirements to date. Mandatory expectations are also increasing outside of Europe, with firms required to achieve carbon-neutrality by 2050 in the United States and the same target by 2060 in China.[9]

Incorporating ESG across the entire M&A process

Combining M&A experience with a systemized and documented M&A process has been found to improve success.[10] Yet, despite the evidence, research has found that almost two-thirds (60%) of surveyed executives indicated their firms do not have a comprehensive end-to-end M&A process model.[11] The Deal Flow Model offers management and other M&A professionals a cross-disciplinary, end-to-end view of the M&A process consisting of ten stages across three phases.[12] The key objectives and core ESG activities across the three-phases and ten-stages of the Deal Flow Model are identified in Exhibit 2.

Phase one: pre-deal

The first phase of the Model entails formulating a strategy that leverages M&A to strengthen the firm's ESG agenda. Then, develop a pipeline of potential targets that fit the company's desired ESG profile. Finally, conduct thorough target due diligence to identify potential environmental, social, and/or governance upside and risk.

Phase two: deal

During the deal process, model the potential increase or decrease of target valuation due to strong or weak ESG performance. Likewise, negotiate for valuable ESG assets to be included in the purchase. Lastly, clearly identify ESG provisions in the sale and purchase agreement, which can include representations and warranties addressing the authenticity of the ESG assets purchased and that the ESG practices identified during due diligence are genuine.

Phase three: post-deal

Prioritize integrating ESG assets and "cross-pollinating" ESG practices between the combining firms. Transfer knowledge and practices between the firms which address

Exhibit 2 Deal Flow Model – key objectives and core ESG activities

	Stage	Key Objective	Core ESG Activities
Pre-deal	Formulate	Clear M&A strategy	• Determine strategic ESG areas that can be strengthened through acquisition.
	Locate	Targets that fit the M&A strategy	• Identify potential targets (assets or entire firms) that fit the desired ESG strategic profile.
	Investigate	No surprises after deal close	• Assess ESG aspects during due diligence to identify environmental, social, and/or governance upside and risk.
Deal	Valuate	Realistic bidding range	• Determine potential increase or decrease of target valuation due to strong or weak ESG.
	Negotiate	Agreed deal terms	• Negotiate for valuable ESG assets to be included in the purchase.
	Consummate	Transaction close	• Clearly identify ESG provisions in the SPA (sales and purchase agreement).
Post-deal	Integrate	Synergy capture	• Prioritize the integration and "cross-pollination" of ESG assets and practices.
	Motivate	Maximum workforce productivity	• Communicate the focus on and achievement of integrating ESG assets and practices.
	Innovate	Additional revenue growth	• Transfer knowledge and practices between the firms that address customer ESG preferences.
	Evaluate	Measured and reported deal success	• Track and report ESG integration activities and milestones.

Source: Created by authors

customer ESG preferences. Track and report ESG integration activities and milestones to the Board, analysts, and employees. Announce the successful integration of ESG assets and practices to various stakeholders including investors, employees, and the press.

Benefits of incorporating ESG in M&A

Strategic benefits

Acquirers can achieve significant strategic benefits by incorporating ESG into their M&A process. Firms wanting to pursue a strategic shift to an ESG agenda can accelerate that shift through M&A. Examples include:

- Acquiring ESG services to broaden advisory offerings.
- Purchasing sustainable firms to achieve "green" targets and improve the firm's ESG brand image.
- Acquisitions that enhance the firm's greenhouse gas emissions standards.
- Acquiring targets that help "green" the acquirer's product portfolio.
- Acquiring suppliers and distributors with high ESG standards to strengthen ESG aspects of the firm's supply chain.

Performance benefits

Beyond the strategic benefits, acquirers also experience significant performance benefits by incorporating ESG into their M&A process. Examples include:

- Operating efficiencies such as reduced production and transportation costs resulting from lighter more environmentally friendly materials.
- Lower resource consumption and costs such as reduced energy or water usage.
- Improved employee retention rates, and a reduction in employee churn and related replacement costs.
- Augmenting customer brand loyalty, leading to increased sales and pricing power.

Research underscores the performance benefits of ESG on the M&A process. A study of 796 transactions taking place between 2011 and 2018 found that acquirers with a high ESG rating (above the median Refinitiv ESG score) achieved a significant improvement in post-deal operating performance, whereas this was not the case for acquirers with a low rating (below the median Refinitiv ESG score).[13] Another study, examining 1,556 US mergers from 1992 to 2007, found that deals completed by acquirers with high ESG scores took less time to complete, improved post-deal operating performance, and increased the long-term stock returns of these acquirers versus those with low ESG scores.[14]

Risks of ignoring ESG in M&A

Legal risks

Although substantial benefits can be achieved, there are significant legal risks of getting ESG wrong during M&A. For example, in 2018 Bayer acquired Monsanto for $63bn USD. Since the acquisition, two separate court rulings found that there was a direct causal link between glyphosate (found in Monsanto's Roundup weed killer) and cancer, giving rise to another 11,200 related lawsuits. As a result of the court cases, Bayer's share price dropped by over a third post-acquisition, wiping $28bn from Bayer's market value.[15] Likewise, in 2004 Vendanta Resources acquired Konkola Copper Mines (KCM), and in 2019 a claim was brought by 1,826 Zambian villagers against Vedanta and KCM for discharging toxic materials into waterways used for drinking and irrigation. The UK Supreme Court found Vedanta, as the parent company of KCM, to be negligent and that Vedanta owed the villagers a duty of care.[16]

Climate related risks

In addition to legal risks, climate related risks also have a significant impact on M&A. Accurately assessing and valuing assets in M&A transactions requires both buyers and sellers to understand the potential impact of climate change on their businesses today and in the future. However, there is no set formula for assessing climate risk in transactions. Climate related due diligence must be tailored to the transaction and will vary substantially depending on the industry and location of the target's operations. Examples of industry specific climate related considerations include:[17]

- The agriculture sector facing greater risks associated with water scarcity, droughts, and changing weather patterns.
- The tourism industry is susceptible to amplified weather extremes, coastal erosion, changes in precipitation patterns and snow reliability.
- The insurance industry, possibly more than any other, faces increased risks from virtually all physical impacts of climate change.

Research supports the impact of climate risk on both M&A decisions and performance. For example, a study of 1,372 deals conducted by US listed firms between 2010 and 2020 examined the effect of climate change risks on firms' decisions to engage in M&As and their subsequent performance. First, the researchers discovered that firms with higher climate change risks have a lower probability of engaging in M&As. Second, they found that share price returns upon acquisition announcement were significantly lower for acquiring firms with higher climate change risks than those with lower climate change risks.[18]

Incorporating ESG across the M&A process at Statkraft

Statkraft is the largest renewable energy generator in Europe, owned by the Norwegian state and headquartered in Norway. It has a 130-year history, predominantly focused on the development of a large fleet of hydropower plants in Norway. In recent decades it has evolved into an international company. Today it develops and operates hydro, wind and solar plants in over 20 countries on three continents, in addition to a large trading operation and exploration of new green energy solutions. The company generated 60TWh in 2022 (by comparison 22% of the entire consumption of the UK in the same year), which resulted in an underlying EBIT of NOK 54.4 billion and Net profit of NOK 28.6 billion.[19]

A commitment to high ESG standards

The company is committed to high ESG standards, aligned with the expectations expressed by its owner, the Norwegian government, in the most recent White Paper issued on state ownership.[20] In order to ensure that the ESG commitments are delivered in practice, the company has invested in building up internal competence and taken active steps to integrate ESG into business processes. In addition to a central ESG unit and experts hired in each business unit, there is a dedicated team working on ESG in procurement and the topic is fully integrated into the firm's M&A processes.

An ambitious growth strategy facilitated by M&A

Statkraft has an ambitious growth strategy, aiming to achieve an annual development rate of 4GW new wind and solar generation capacity by 2030 and the development of new energy solutions, including 2 GW of production capacity for green hydrogen by 2030.[21] Acquisitions have historically played an important role in delivering on growth targets for the company and will continue to do so going forward.

Given the consistent engagement in M&As over the years, it is not surprising that Statkraft has established a robust deal process. Every M&A process (except from simple land transactions etc.) is managed by a specialized unit. The firm's codified M&A process involves establishing a cross-functional team of experts to provide independent analysis on key topics, including legal, technical, financial, tax and ESG.

Deeper and broader ESG analysis

Inclusion of ESG topics in M&A processes is not new for Statkraft, but the treatment of these topics has evolved over time. Reflecting changes in external regulations and accumulated experience, the range of topics reviewed during the firm's transactions has expanded and the depth with which the analysis is done has increased. In addition to reviewing traditional compliance aspects, each ESG assessment covers a range of environmental, social and human rights topics, such as the target's handling of impact from its activities on nature and local communities and the management of human and labor rights in its operations.

"We always invest considerable time in assessing ESG topics as part of the due diligence we conduct and have repeatedly seen how important this is in order to be certain that the deal is right for us and that it is structured and valued correctly."

Andrew Smith, Head of Corporate Transactions, Statkraft

ESG during the pre-deal phase

Statkraft works on ESG topics throughout the M&A process, beginning with a rigorous approach to pre-deal due diligence. ESG due diligence is typically conducted by external consultants under the leadership of internal experts in the company. During the pre-deal stage, understanding the differences that exist across jurisdictions regarding ESG requirements is paramount. For an international company committed to global standards, Statkraft's ESG requirements can at times exceed those of the jurisdiction where the target is located. The review of the target's handling of ESG topics must therefore be done with both sets of expectations (local and global) in mind. If there are gaps, these need to be reflected in the deal structure and addressed post-deal. Examples of areas where Statkraft has experienced such gaps include human and labor rights. Statkraft is for instance expected to guarantee the payment of a living wage across its operations, which can entail adjustments vis-à-vis established payment practices.[22]

A key challenge resulting from the difference in companies' ESG maturity is the insufficient quality of data and information. It is often difficult during due diligence to perform the necessary assessments, as many companies have not implemented a structured approach to managing ESG issues. Information is often fragmented and incomplete, leaving greater uncertainty than desired when it comes to identifying risks and upsides.

ESG during the deal phase

A key challenge during the deal phase is incorporating ESG findings, identified during due diligence, into target valuation modeling and the structuring of the deal. As mentioned, ESG data is often imperfect, and uncertainties around ESG related costs to address gaps or legacy issues, as well as potential upsides can be hard to quantify. The quantification of ESG findings requires cross-functional collaboration and learning by the firm's valuation experts as well as its ESG professionals, who are often more used to qualitative assessments. Statkraft has learned through experience the importance of quantifying the impact of these topics in the same way as for instance technical issues, for their treatment during an M&A decision-making process to be robust. An example of a topic that can often be difficult to quantify is potential local opposition to a new development project, and understanding the impact this resistance could have in terms of securing necessary support to proceed. In addition to the valuation dimension, it is also important to ensure that findings from the due diligence are reflected in how the deal is structured, including incorporation of relevant protections in the SPA.

ESG during the post-deal phase

Statkraft's experience has also shown the critical importance of focus on ESG during the post-deal integration process. The company therefore ensures that any gaps identified in terms of ESG performance are address without delay following closing of the deal. This is also important from a cultural alignment perspective, as a company's approach to ESG topics is a key part of the wider company culture. The experience of Statkraft has also found that important upsides are achieved by ensuring that value created in the target related to ESG performance is captured and retained during integration. An example of this includes key partnerships established with suppliers on defined ESG standards, or industry-wide collaborations that have been put in place on key ESG topics.

> "While a focus on ESG during due diligence is important for us, ensuring a strong follow up post-deal is just as important. We spend considerable time and resources making sure that we have full alignment across our operations on ESG standards following an acquisition."
>
> *Fernando de Lapuerta, SVP Country Manager Statkraft Brazil*

How to build ESG into the M&A Process

Based on the lessons learned from Statkraft and other firms, Exhibit 3 identifies seven key steps that companies can work through to build ESG into their M&A process.

Takeaway

Various components of ESG have rapidly become key considerations in transactions. Firms that incorporate ESG across their M&A process, both pre- and post-deal can reap significant benefits. While firms that ignore ESG during M&A not only miss the upside potential, but also risk making damaging and costly deal mistakes.

Exhibit 3 Seven steps to build ESG into the M&A Process

Component	*Key Activities*
1. M&A ESG performance assessment	■ Identify recent M&A transactions. ■ Identify what went well and what could have been done better regarding how ESG was addressed during each stage of the Deal Flow Model). ■ Catalog key learnings to apply to future M&As during each M&A stage.
2. M&A ESG internal talent inventory	■ Identify key talent across functions with ESG knowledge and skills essential to the firm's M&A process.
3. M&A ESG external talent inventory	■ Identify key service providers used in prior M&As (e.g., legal, financial, environmental, etc.) with ESG knowledge and skills essential to the firm's M&A process. ■ Identify potential other service providers with ESG knowledge and skills essential to the firm's M&A process, and determine how each could provide support during future M&As.
4. M&A ESG tools and templates inventory	■ Conduct an M&A ESG tools and templates inventory across functions and M&A stages (e.g., ESG due diligence checklists, valuation templates, communications planning, cultural analysis and integration, etc.). ■ Identify M&A ESG tools overlaps and gaps. ■ Catalog M&A ESG tools and templates.
5. M&A ESG training	■ Identify M&A ESG training needs/objectives, based on the recent M&A ESG performance and key M&A ESG talent capabilities assessments identified above. ■ Develop ESG training content for each stage of the Deal Flow Model, designed to achieve each training objective identified. ■ Identify training participants based on the M&A ESG talent inventory above. ■ Schedule and conduct cross-functional M&A ESG training.
6. M&A ESG knowledge repository	■ Establish an M&A ESG knowledge repository, housed on the firm's intranet, for each stage of the Deal Flow Model. ■ Populate the repository with M&A ESG tools and templates across each of the ten M&A stages.
7. M&A ESG competence maintenance	■ Conduct regular reviews of the firm's M&A ESG tools, templates and talent. ■ Update tools, templates and talent in the M&A ESG repository as needed.

Source: Created by authors

Notes

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