

ESG AND TRANSACTIONS

AN INVESTOR
PERSPECTIVE ON THE
IMPACT OF ESG ISSUES
ON MERGERS AND
ACQUISITIONS
TRANSACTION

NOVEMBER 2021

KEY HIGHLIGHTS

1. ESG IMPACT ON M&A IS A TANGIBLE FACT

ESG levers already have a quantifiable impact on M&A across industry sectors and ignoring them in business valuations is likely to increase investment risks and negatively impact value creation.

2. DATA IS KEY

Investors will have to find the right market data and research which aligns with the commercial and financial rationale for the transaction as a support for deal valuations.

3. BALANCING IS CRUCIAL

In order to truly appreciate the E, S and G impacts on the financials, it is important to adopt a nuanced approach to scenario testing as each sub-topic within the ESG collective may impact the business plan in different ways.

4. ESG REQUIRES LONGER TERM FOCUS

In building ESG inclusive business plans and financial forecasts, it is important to look beyond a common 3-5 years horizon, as quite a few of the ESG impacts will be in the longer term.

FOREWORD

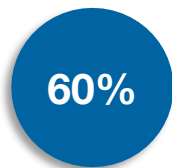
Particularly expedited by the Covid-19 pandemic, the topic of Environmental, Social and Governance (ESG) aspects of a business has been extensively covered across the media, events and conferences in the past few months. Sustainability is very high on the agenda, both for companies and investors.

However, is it really a brand-new concept? ESG, in some form or another, has been around for many decades. As Aswath Damodaran, Professor at Stern School of Business at New York University, points out in one of his articles on ESG, corporate governance was discussed extensively in the early 2000s. What is different now though, is the increased attention on environmental (climate change, biodiversity loss) and social issues (raising inequality) – in-turn driving up the focus and enhanced scrutiny on ESG.

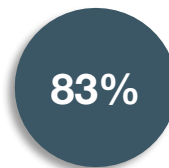
Regardless of what one thinks about ESG - is it just a fad or a fundamental shift in how businesses are run going forward? - one thing is certain – it cannot be ignored.

In this article, we set out considerations for investors as to how ESG issues might impact Mergers and Acquisitions (M&A) transactions.

Like with all strategic decisions, focus on ESG levers will have implications on M&A across industry sectors. ESG will influence and possibly expedite M&A activity, particularly for corporates and investors wanting to achieve their net-zero / sustainability targets but lack the internal technology or operational capabilities. On the flip side, an ESG overlay may also make M&A activity more selective. We have observed various instances of corporates, private equity firms and investors walking away from transactions due to negative findings/assessment on ESG grounds. A recent 2021 Baker Tilly report indicates that 60% of respondents to their survey have walked away from an investment due to a negative assessment on ESG issues of a potential target. Furthermore 83% of dealmakers say they conduct due diligence on ESG issues on investments and M&A targets.



Investors walked away due to negative assessment on ESG



Investors conduct ESG DD of a potential target

However, implications of an ESG assessment on M&A transactions now go beyond the initial Go vs. No-Go decision. Various climate-related challenges and social and governance issues are likely to have a direct or an indirect impact on deal values. Hence, ignoring ESG metrics in business valuations is likely to increase investment risks and negatively impact value creation. Boohoo, the online fashion retailer, lost 50% of its market value when negative news regarding bad labour practices in supply chain came to light. Thus, the importance of ESG cannot not be underplayed as it can have a material impact on the price and/or the value of the target's business.

APPROACH TO SCENARIO-BUILDING EXERCISE

Consider, as an example, a target which is a multinational food group, with a portfolio of products across geographies that include sustainable 'plant-based' protein options as well as traditional 'animal protein' products. In determining the value of this target, a comprehensive scenario-building exercise will need to be considered to account for different growth rates of the plant-based product industry vs. traditional animal protein sector.

Based on Bloomberg scenario analysis, global retail sales of plant-based food alternatives are forecast to grow from \$29.4 billion in 2020 to \$162 billion by 2030. This represents a 7.7% market share of the \$2.1 trillion global protein market in the base case, with a market share of 11.5% or \$242 billion in the faster growth case and 5.8% or \$122 billion in the slower growth case. Depending on the scenarios, the value of the target will differ significantly as is evident from the research. The same recommendation is also relevant for pretty much all other industry sectors (e.g., oil and gas due to transition to renewable energy, automobile due to transition to EV, etc.)

“In determining the value of a target, a comprehensive scenario-building exercise needs to be considered on the basis of available sector growth forecasts. Depending on the scenarios, the value of the target might differ significantly.”

From a cost perspective, considerations will need to be given to additional CAPEX and / or recurring expenses required to make operations more sustainable. E.g., R&D investment in more plant-based products or substituting single-used plastics in manufacturing / assembly lines with recycled plastics or alternative biodegradable materials.

Any potential ESG impact will rarely be binary - there will be direct as well as indirect implications that will need thinking through. While the CAPEX / OPEX investments might translate into lower profitability in the short-term, they might also drive top-line growth going forward. Multiple market research suggest that most consumers are willing to pay a premium anywhere of up to 5% (depending on industry sector) for sustainable products. Careful assessment will therefore have to be undertaken during the scenario-building exercise: will the additional costs be merely a sunk investment to bring the operations at-par with industry standards or will it help reduce any negative downside risk and / or drive top line growth?

ESG is finding its way as well into C-suite compensation structures. Now, nearly half of the UK's biggest 100 companies have linked executive pay to ESG performance. The likelihood of achieving ESG targets and goals needs to be considered during the valuation exercise. The growing focus on ESG has also led to the rise of a Chief Sustainability Officer and the importance of in-house sustainability teams. The scenario-building exercise during an M&A event needs to consider costs and timelines of setting up these teams for the target company.

SHIFT FROM SHORTER TO LONGER TERM FOCUS

In building business plans/ financial forecasts it is common to only look forward for the next 3–5-years. Under an ESG lens, however, we think it is important to look beyond this short-term horizon, as quite a few of the ESG impacts will be in the longer term. For example, the regulation on the sale of petrol / diesel cars. Investors will need to assess the likelihood and financial impact (if any) of potential litigation that might arise in the future, particularly while investing in traditional carbon-intensive industry sector. As an example, the District Court of The Hague ordered Royal Dutch Shell to reduce its CO2 emissions by 45% by 2030.

This shift from shorter term to longer term focus is also highlighted by the fact that Blackstone, CVC, KKR and Blackrock private equity funds have been raising longer-term funds since 2017 to be able to somewhat address the mismatched time horizons on ESG investment and incentives. In addition, appropriate ESG investment may enable a higher exit multiple for PE owners further down the line, which would need to get factored into deal pricing.

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It is worth referencing CVC’s acquisition of Żabka (EV of \$1.4 billion at EBITDA multiple of 10.7x), a Polish chain of convenience stores, in 2017. Several ESG-related cost-savings initiatives supported by CVC were identified. In 2020, three years post-acquisition, CVC supported Żabka in launching a comprehensive program to reduce CO2 emissions by at least 5% per year and reach net-zero by 2050. Through this transformation, Żabka was able to record 20% annual growth rate in sales from 2017 to 2020 while at the same time increasing gross margin by 3.9% which in turn makes the company attractive for future investors, for when CVC consider exiting.

Additionally, in traditional scenario testing, it is common to build just three financial forecasts, a high case, a base case and a low case. However, as is pointed out above, we think to truly appreciate the E, S and G impacts on the financials it is important to adopt a more nuanced approach as each sub-topic within the ESG collective may impact the business plan in different ways.

SUMMARY

Overlaying ESG onto deal pricing, therefore, often brings highly complex and technical challenges that require additional perspectives and parameters. There is now a plethora of ESG data available in the market. Investors will have to find the right market data and research which aligns with the commercial and financial rationale for the transaction as a support for deal valuations.

We do not think the importance of a valuations exercise informed by the ESG landscape lies in the pin-point accuracy of the analysis but more on commencing the process in the first place and looking to continually improve. In a similar vein, we don't think the conclusion on ESG impacts needs to be "The ESG impact is €Xm" but could be "the ESG impact based on our most recent analysis is between €Xm - €Ym"

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Everyone is still learning in this space, and it will take time to improve our collective understanding. Currently, there are multiple standards for sustainability reporting with no global consistency which makes it difficult for investors to compare companies' ESG performance. We expect more consistency amongst standards and legislations in this matter in the short to medium-term future, which will improve and standardise sustainability reporting. Until then, it is important that we do not ignore the ESG impacts due to the complexities involved - or try and simplify them - and implement a feedback loop of measurement post deal to improve the analysis and reporting.

As Voltaire once said ...

"Do not let perfect be the enemy of good."

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Expert in deal advisory. Originally started his career in KPMG's M&A tax team before transitioning over to the valuations team (where he was prior to joining Eight Advisory). Hanut has specialist experience in business and asset valuations in various contexts, including tax, legal, financial and commercial purposes. He has wide sectoral experience, across retail to industrials to infrastructure. However, his key focus area is renewable energy and the burgeoning energy transition sector. He has worked extensively with funds, as well as founder led start-ups, targeting the opportunities that arise as the economy decarbonises.



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Spandan is an ESG and a value chain management professional. He has 10 years experience in helping multinationals and PE houses design and implement value chain models, particularly during strategic events like M&A deals, international expansions, and business reorganisations. He has recently completed his MBA from Imperial College, London (class of 2021) where he specialised in strategy, climate change and sustainability. His focus areas include circular economy, decarbonisation, and sustainable business transformations. Spandan is also the co-founder of GreenAlytics, a technology solution aimed at helping organisations manage their ESG analytics and reporting requirements.



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Dhurim is active in the Valuations and Financial Modelling team covering the Benelux region. Through his experience in asset management, private equity and strategy consulting and also being a Gen Z himself, Dhurim experienced first-hand how ESG is affecting businesses and society in general. With Pareto Economics, a London-based research house, he co-authored a whitepaper on ESG Investing that got featured on "Investment Week", "ESG Clarity" and "Responsible Investor". He has wide sectorial experience ranging from consumer to infrastructure.

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