Temperature's Rising

The growing importance of ESG to EMEA M&A

Presented in association with Mergermarket
An Acuris company

Contents

Introduction

The dangers of climate change and the need for the world to shift to a more sustainable and less carbon-intensive economic model have never been clearer. It is no wonder that environmental, social and corporate governance (ESG) concerns have risen up the corporate agenda in recent years from an afterthought to an essential business function, with the COVID-19 pandemic proving a major accelerant.

Investors are already pouring capital into funds that give them exposure to this long-term growth theme. More than USD 500 billion flowed into Europe-domiciled ESG-integrated open-end funds and ETFs in 2021, representing a 55 percent growth in assets under management, according to Morningstar. Globally, ESG assets are on course to surpass USD 53 trillion by 2025, more than a third of the USD 140.5 trillion in projected total global AUM.

Although climate change is a global problem and ESG issues have come to the forefront of business leaders' minds across the world, Europe as a region has led the fight. The European Commission (EC) has set forth ambitious emissions-reduction goals to become climate neutral by 2050.

Against this backdrop, we surveyed 150 European dealmakers about their views on how ESG is affecting M&A. Our survey found that there is a broad embrace and acceptance of the importance of ESG in mergers and acquisitions (M&A), although there is a wide regional variation within Europe between jurisdictions that have adopted stringent standards and those that are lagging. Moreover, the EC's bold regulatory changes also enjoy near unanimous support, despite the burden they are expected to place on businesses.

Key Findings

1. ESG is a hot issue

ESG's importance may have accelerated greatly in recent years, but it is no passing fad. Over three-quarters (76 percent) of those polled in our survey say that the importance of ESG in their organization has increased in the past 12 months and a similar proportion (73 percent) believe that it will increase further in the coming 12 months. Not only that, ESG issues are affecting deals day-to-day: A significant minority (41 percent) of respondents say that they have turned down at least one deal due to ESG concerns.

2. Regional variations remain within Europe

There is huge variation within Europe when it comes to ESG. Germany has proven to be a leader in most aspects of ESG — for example, three quarters of respondents based there say their most recent acquisition was driven by ESG. On the other end of the spectrum, respondents in Iberia were consistently behind in ESG adoption.

3. Less than half of dealmakers are conducting ESG due diligence on target supply chains

Although a significant number of those polled (46 percent) have undertaken ESG due diligence on a target's supply chain, this is still less than half of respondents. This opens bidders up to potential risk. Private equity (PE) and other financial sponsors are ahead on this issue, with 65 percent saying they conduct ESG due diligence on supply chains compared to only 27 percent of corporates.

4. Room for improvement in ESG due diligence data

Even though ESG has risen up the agenda for M&A practitioners in Europe, there is still room for improvement in terms of the availability and quality of data available. Only 16 percent of respondents say the quality and comprehensiveness of ESG due diligence data available to them in their last deal was "very good," with 30 percent merely deeming it "acceptable" and a further 19 percent who say it was "poor" or "very poor."

5. Proposed EC regulation has support despite burdensome compliance

The proposed Directive on Corporate Sustainability Due Diligence enjoys support from over half of the respondents (59 percent), with only a minority who say they are not in favor (20 percent). Despite this support, 21 percent of respondents say they view the proposed directive as "not very burdensome," with 63 percent saying they view it as "somewhat burdensome" and another 16 percent view it as "very burdensome."

Introduction & Methodology

The world is rapidly changing around us and there is a growing sense of urgency to address the climate change challenge and build a more sustainable, responsible and socially inclusive future. Europe is taking the lead in these efforts, setting the target of becoming the first climate-neutral continent by 2050, to be achieved by transitioning to renewable energies, cleaner transport and smarter technologies. The European Union is also assembling a regulatory framework for businesses and investors to prevent greenwashing, improve transparency and standardize key performance indicators to help inform more robust decision-making.

Inevitably, M&A decisions are increasingly influenced by ESG considerations. Acquirers now must assess target companies for unseen risks and uncover ways to advance their sustainability and social responsibility agendas. It is now common to see leveraged loans used for acquisition financing with ESG-linked margin ratchets attached to them, and these borrowing terms are expected to evolve and become ever more sophisticated.

Improving a company's ESG profile is not only an expectation of shareholders and investors to protect against downside risk, but a commercial imperative in delivering long-term economic value. It's a theme that has quickly gone mainstream, and ESG factors now impact a company's brand and equity valuation. Therefore, every corporate M&A or PE buyout has ESG considerations factored into it on some level and this trend is only set to continue over the coming decade.
With this in mind, we surveyed corporates and PE funds to understand their thinking as it relates to ESG and how this shapes their dealmaking. We sought to gauge how significant these matters are to M&A decision-making, due diligence, bid levels and how they view the regulatory roadmap as policymakers seek to advance this agenda over time. We hope you find this report of interest and encourage and welcome any inquiries as to how ESG may impact the terms of your next corporate M&A or PE transaction.

In Q1 2022, Mergermarket surveyed 150 senior leaders working in roles related to M&A and alternative investments, including 75 M&A corporate and 75 PE/multi-strategy funds. Respondents were equally split among France, U.K., Germany, Nordics, Benelux and Iberia. On a general basis, all charts show overall figures, except when figures based on region or type of organization are statistically significant.

ESG in Context

There is no escaping the fact that ESG now shapes virtually all corporate strategy-making and investment decisions to some extent or another. This topic has become investors' North Star, influencing their thinking and the deals they choose to execute and, importantly, which to pass on.

Our survey of European dealmakers illustrates this, with only three percent saying they were not concerned about ESG during their last M&A transaction, while 41 percent say their previous deal was driven by ESG. The remaining 56 percent say they were conscious of ESG issues during their most recent transaction, even if it wasn't a primary motivator for the deal.

Global Risk Profile's 2021 ESG index shows Europe to be a global leader, with countries in the region attending to risks related to the environment, human rights and the health and safety of people, putting it head and shoulders above Oceania, South America, North America, Asia and Africa. The index has Nordic countries Finland and Sweden in the lead in first and second place, while Germany is in 16th place. According to Earth.Org's Global Sustainability Index, meanwhile, Germany ranks higher in the international standings, taking sixth place.

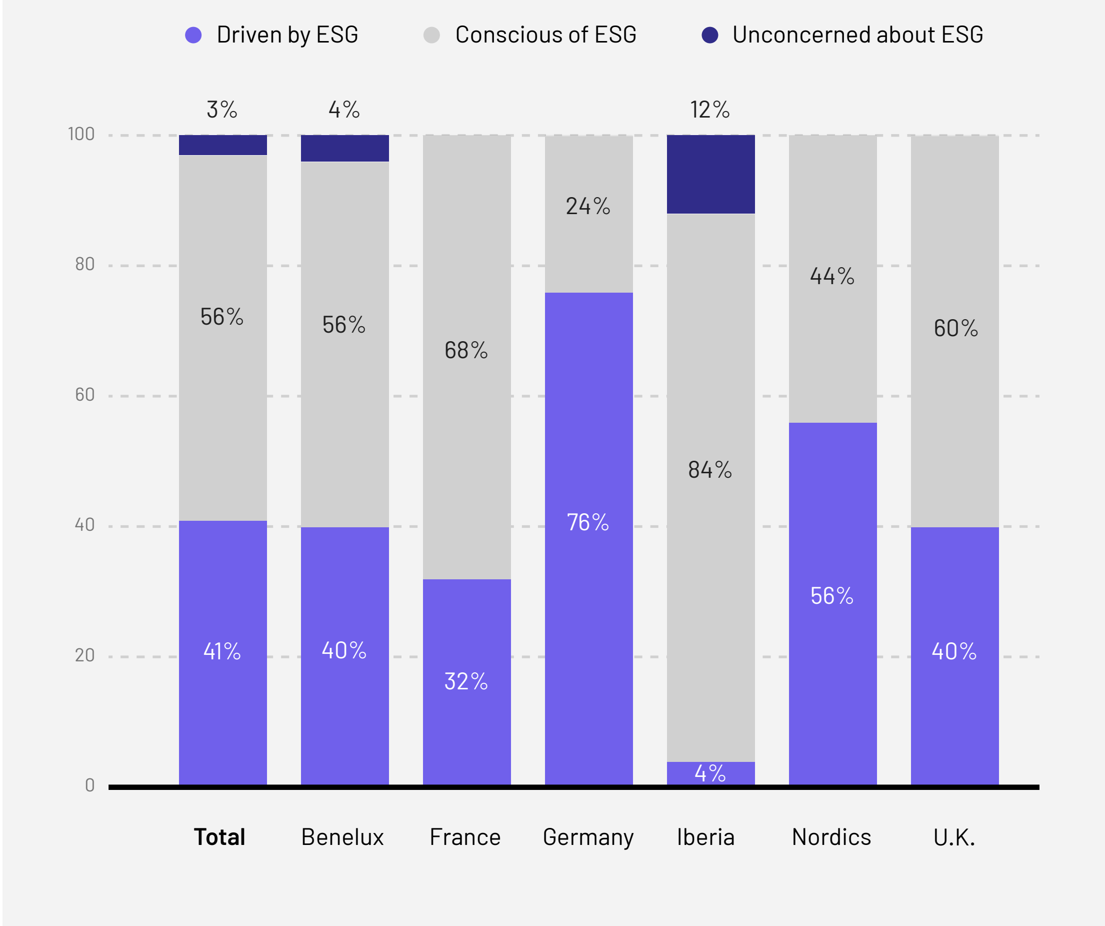
Zeroing in on M&A specifically, our research shows that Germany leads the way, with 76 percent of respondents from the country saying their last M&A transaction was primarily driven by ESG considerations, while Nordic respondents are in second place, with 56 percent sharing this view.

With Europe leading the charge globally, Germany has been a forerunner regionally, especially in Western Europe. The country aims to lead the global transition to a low-carbon economy and the government is doing everything it can to achieve this. Last year, the German federal parliament passed the Climate Protection Act, which sets out a national goal of reaching climate neutrality by 2045, although a recent concern, and which is directly influenced by the Ukraine conflict, is the country bringing coal plants back online to serve its energy needs as Russia cuts its natural gas supplies.

This Climate Protection Act was followed by the Supply Chain Act, which is due to be implemented this year and extrapolates corporate responsibility for human rights violations right through the supply chain. Complementing these efforts is the German Sustainable Finance Strategy, which aims to mobilize investments that are required for practical climate action and sustainability while also addressing the climate risks that threaten to disrupt the financial system.

According to Earth.Org's index, Spain is in 12th place globally. In 2020, the country declared a state of climate and environmental emergency and, in December 2021, a royal decree was published, setting out a series of urgent measures in the field of Energy to promote electric mobility, self-consumption and the deployment of renewable energies.
Despite this proactive approach at the national level, respondents in our research based in Iberia were the least likely to say their last M&A transaction was driven by ESG. Although 84 percent say they were conscious of ESG during their most recent deal, only four percent say it was driven by ESG. Moreover, 12 percent of Iberia-based respondents were unconcerned about ESG during their last transaction, higher than any other market in Europe.

Chart 1. During your last M&A transaction, was your team...?



An intelligent approach

Placing the right emphasis on ESG in dealmaking is as important as paying attention to these issues in the first place. Focus too little on these matters and an investment is exposed to unnecessary risk; focus too much and suffer from analysis paralysis and wasted time and costs. Striking the optimal balance is critical, and corporates and PE firms will refine their methods over time.

Encouragingly, across Europe, 61 percent of all respondents think that their organizations give the right weight to ESG as part of their dealmaking processes. The highest proportion can be found among French respondents, 88 percent of whom say they are giving the appropriate attention to this in their deals.

However, 31 percent of investors across Europe believe their organization gives ESG too much importance in deal processes. It's not clear whether these firms have already made significant headway and now feel that they may be overreaching, or whether these investors simply think that too much credence is being given to these matters. Notably, German corporate M&A investors and PE funds not only more commonly say their last deal was driven by ESG, as much as 60 percent say their organization put too much importance on ESG matters, suggesting overreach.

With European governments prioritizing environmental goals in their policy-setting, it comes as little surprise that climate change and greenhouse gas emissions stand out as the top ESG priorities for investors. More than half (56 percent) of respondents reported this as being their primary focus. However, social issues are also of importance. We find that 43 percent say human rights and labor standards are of concern, followed closely in third place by 41 percent who highlight the importance of diversity, equity and inclusion (DE&I) issues. In September 2019, the E.U. held its first-ever Anti-Racism and Diversity Week in the European Parliament. More recently, the Union hosted a European Anti-Racism Summit in March 2022 in cooperation with the European Parliament Anti-Racism and Diversity Intergroup and the Council of Europe, which featured a panel on national action plans against racism and discrimination. As DE&I rises up the corporate agenda, companies seek ways to ensure their hiring, incentivization and retention policies are fair and non-discriminatory, including closing any gender pay gaps.

Already, several European countries, including Norway, France and Italy, have gender-based quotas for corporate boards (see Intralinks' report, *Gender Diversity and M&A Outcomes: How Female Board-Level Representation Affects Corporate Dealmaking*, for more).

In terms of motivating factors for taking action, the majority of respondents in our research point to compliance, with 55 percent saying that regulatory requirements are one of the top two reasons for their engagement with ESG in M&A, while 38 percent see reputation as being a key driver. Meanwhile, 56 percent of Nordics-based respondents think it is a moral imperative — the highest in Europe.

Protecting brand and reputation is central to companies. The media and public increasingly hold businesses to account for failing to act on these issues. A weakened brand can quickly result in lost revenues, as clients and customers seek alternatives. Being seen to do the right thing is a strong motivator for action, but this should never be a substitute for setting clear, actionable goals and demonstrating progress in achieving those targets. Greenwashing is likely to be held in as much contempt as not taking any action at all.

Chart 2. Does your organization currently give sufficient weight to ESG as part of the dealmaking process?

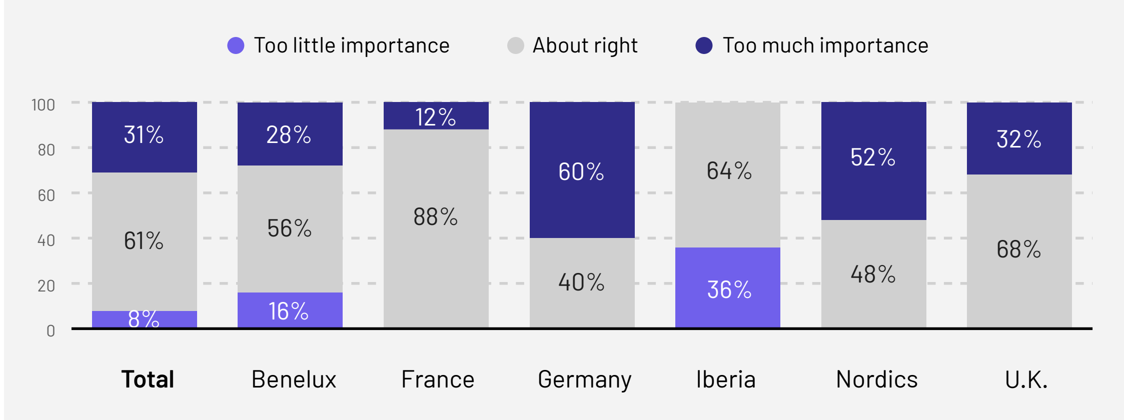


Chart 3. Has the importance of ESG to dealmaking changed over the past 12 months for your organization?

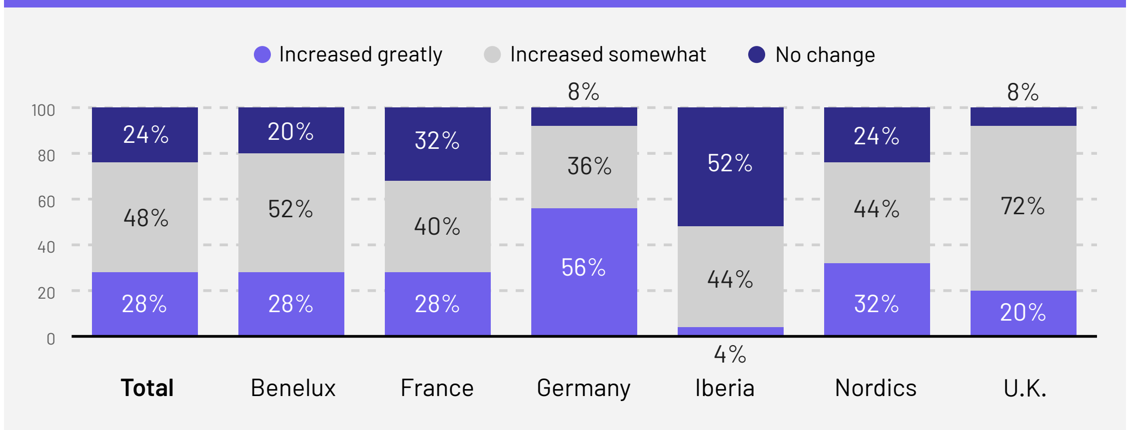


Chart 4. In the coming 12 months, do you expect the importance of ESG in dealmaking to change for your organization?

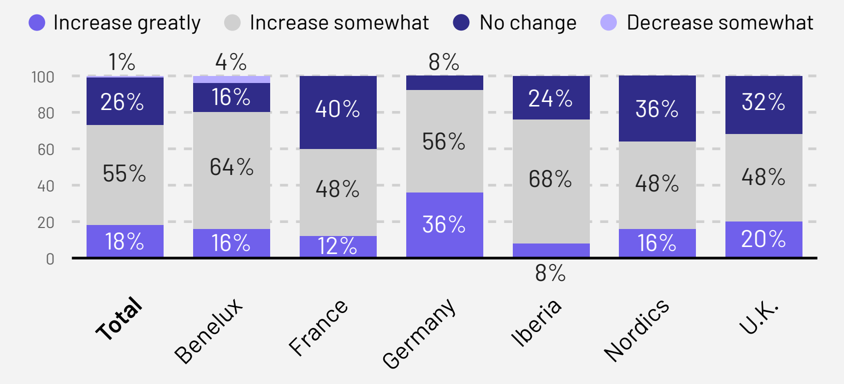


Chart 5. Which ESG considerations are key to your organization when contemplating M&A? (Select top two)

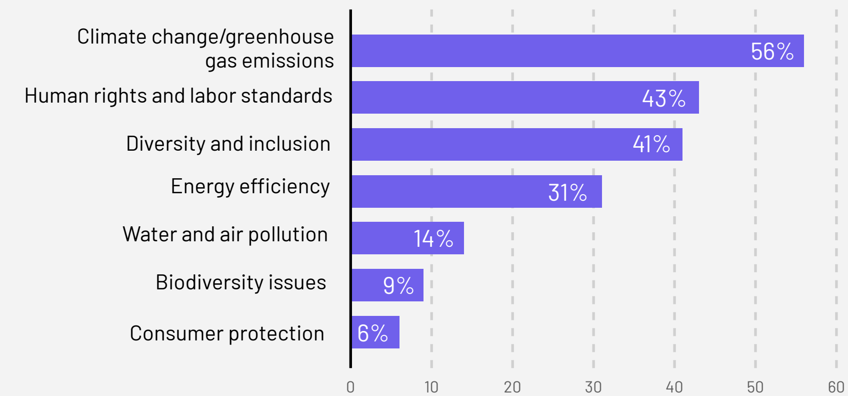
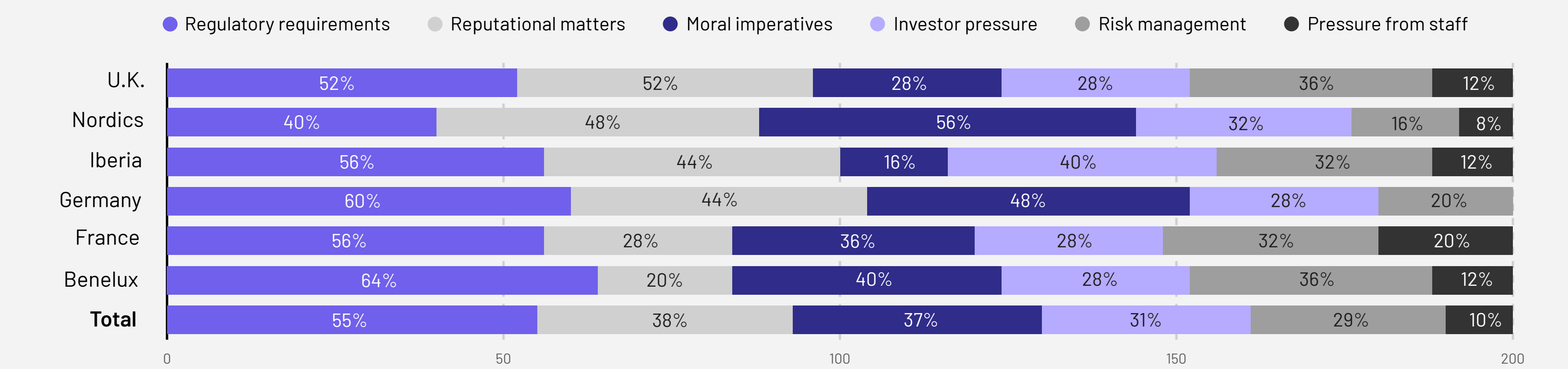


Chart 6. What is driving your organization's engagement with ESG in M&A? (Select top two)



Due Diligence and Value Creation

As acquirers pay closer attention to ESG in their deal vetting and transactions, this will inevitably turn up red flags that cause them to think twice about completing deals. Whether it involves mismanagement of waste or limited resources, or discriminatory practices in the workforce, the fact that investors are going over assets with a fine-toothed comb and using new metrics in their assessment should mean more deals being turned down.

Across Europe, 41 percent of dealmakers say that ESG concerns have led them to turn down one or more transactions. And once again it is Germany that is at the forefront. As many as 60 percent of respondents from the country say they have passed on a deal following their ESG due diligence. Tying with Germany, 60 percent of U.K. respondents also share this experience.

Consistent with our finding that Iberia-based investors are less likely to report their recent transactions being motivated by ESG considerations, only 20 percent of this cohort also say they have turned down a deal on ESG grounds.

Of those who reported rejecting deals over ESG concerns, 45 percent say that the target company's primary sector was Technology, Media and Telecom (TMT). This is potentially a function of just how many deals take place in this sector now — over 30 percent of M&A deal value globally in 2021 was for targets in the TMT space. Close to two-thirds (32 percent) say the deals they turned down were in the Industrials and Chemicals (I&C) sector — perhaps unsurprising, given the emissions involved in these business activities.

As the partner of a U.K. PE firm says, investors must be mindful of tightening regulatory standards when making long-term commitments to companies, since any mandatory CapEx will eat into returns: "We could not proceed with the transaction because of environmental concerns. The greenhouse gas levels of these target companies were higher than the acceptable standards. If the norms became stricter, it would have required additional investment."

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> Investors are going over assets with a fine-tooth comb and using new metrics in their assessment should mean more deals being turned down.

Chart 7A. Has your organization turned down one or more M&A deals due to ESG concerns?

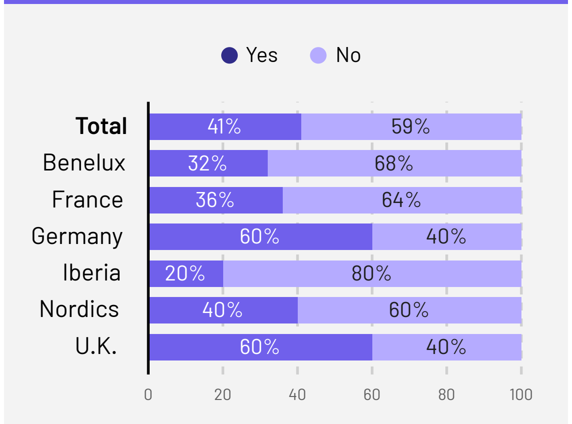
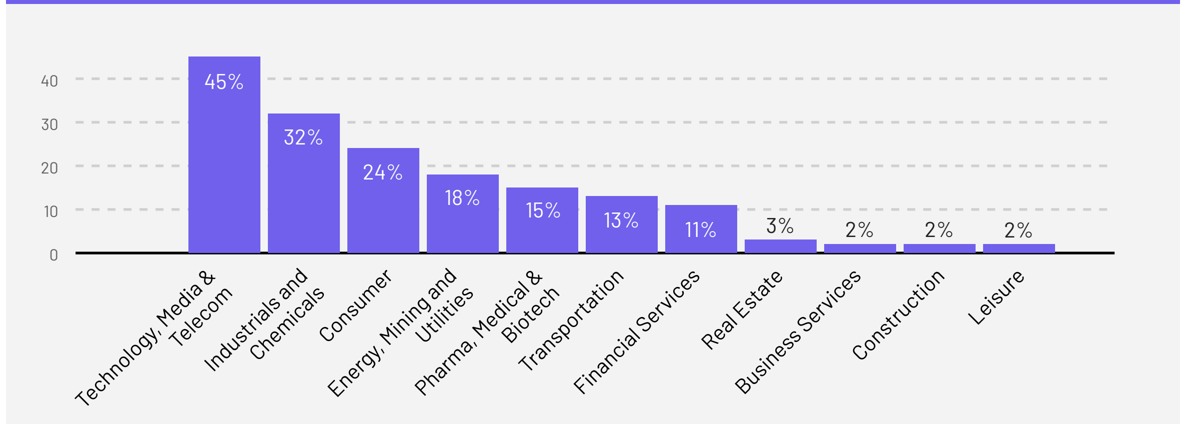


Chart 7B. What was the target company's primary sector? (Select one for each deal turned down over the last 12 months. Please select all relevant sectors, one for each deal.)



ESG due diligence is fast becoming standard practice, though there are differences from country to country. Almost two-thirds (65 percent) of all respondents say they always undertake enhanced ESG reviews as part of their dealmaking processes, the highest proportion once again being German firms with an 88 percent representation. Those in the U.K. and Nordics were also very likely to undertake enhanced ESG due diligence, with 80 percent of respondents based in both markets agreeing.

Iberia is a laggard in this respect, with fewer investors from the region embracing ESG in their activity. Only 28 percent say they always implement this kind of diligence, while 56 percent say they sometimes do.

Supply chains have been brought into sharp focus since the pandemic. But long before the disruptions that are still being felt today, greater attention was being given to third-party ESG risk, particularly environmental and human rights concerns. The U.K. introduced the Modern Slavery Act in 2015, while in 2017, France passed into law its "plan of vigilance," requiring large companies in the country to identify risks to human rights, health and security or environmental violations within their global organizations. The E.U. is looking to unify the bloc with its proposed Corporate Sustainability Due Diligence Directive.

Regarding deal targets' supply chains, less than half of respondents (46 percent) say they have undertaken ESG due diligence on this.

There is a large gap between regions, however, with nearly three-quarters (72 percent) of respondents in Germany saying they do this, followed by 56 percent of Nordics-based respondents and 52 percent of U.K.-based ones. Again, Iberian respondents are behind the curve, with only 28 percent running the rule over suppliers and further along their chains.

"We are carrying out enhanced ESG due diligence because of the emphasis on environmental and social factors throughout the supply chain," says the CEO of a Nordic corporate. "There will be many vendors and third parties to check, and the due diligence process will be longer than planned in many cases."

Tellingly, financial sponsors are far more likely than corporate buyers to undertake supply-chain due diligence on their targets — almost two-thirds (65 percent) of PE and multi-strategy funds do this compared with only 27 percent of corporates. Quite why this split exists is uncertain. In theory, corporates should be paying as much, if not more, attention to this, particularly listed companies with shareholder expectations to meet. However, strategic buyers may be able to absorb targets into their existing supply-chain networks in some cases and financial sponsors are in constant pursuit of value creation. Buying already well-positioned businesses may be seen as a hidden value lever that requires minimal ongoing effort by a PE fund.

Chart 9. Have you undertaken ESG due diligence on a target company's supply chain?

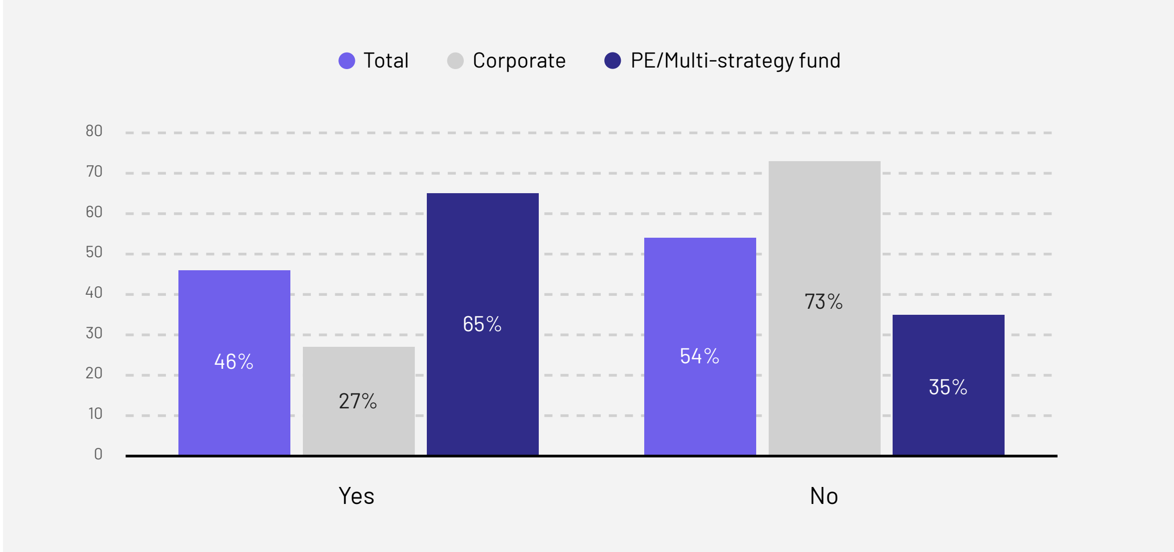


Chart 8. How frequently do you undertake enhanced ESG due diligence as part of the dealmaking process?

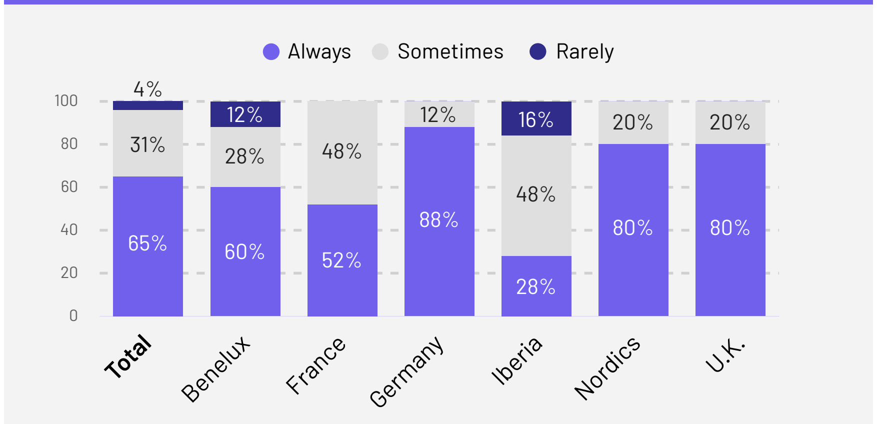
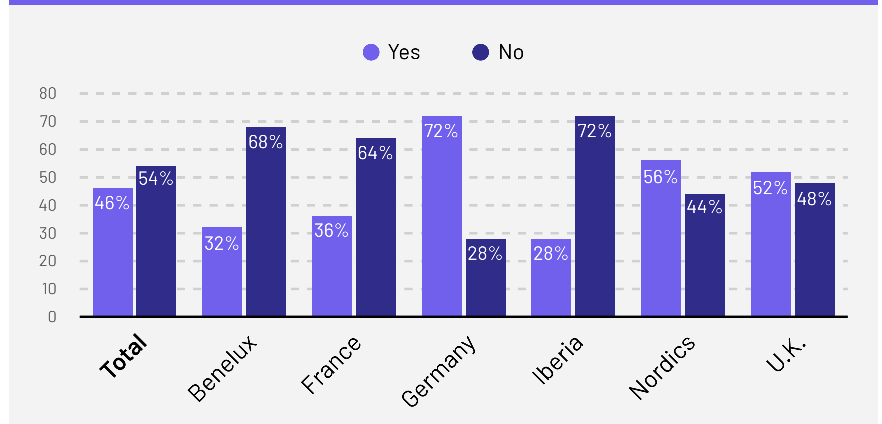


Chart 9. Have you undertaken ESG due diligence on a target company's supply chain?



ESG is not all about protecting against downside risk — far from it. The growing emphasis on sustainability and social responsibility is a secular trend that shows no signs of slowing. And companies that persistently step up to meet society's expectations will be better positioned to gain market share and grow their top lines.

Respondents almost unanimously agree that a positive ESG record is value accretive for companies. As much as 85 percent believe this to be the case, with a full 96 percent of German respondents concurring. This is closely followed by the U.K., where 92 percent agree. Iberia is once again at the back of the pack; nevertheless, a 68 percent majority of respondents from that market also agree.

The two biggest ways in which ESG progress creates value in the eyes of investors are, first, the fact that it attracts subsidies and government support (55 percent) and, second, the benefits of enhancing a business's brand (52 percent), which can have important second-order effects like growth and customer retention.

Predictably, the two sectors considered to hold the most potential for value creation thanks to a positive ESG record are Energy, Mining and Utilities (EMU) (51 percent) and I&C (35 percent). Energy is an obvious contender, with oil and gas majors investing heavily into renewables via CapEx and acquisitions as part of the ongoing energy transition. The industrial sector will undergo tectonic shifts over the coming decade as well, thanks to electric vehicles gathering critical mass and consumer brands requiring the manufacture of sustainable products.

Companies that embody strong governance, healthy working cultures and a commitment to sustainability and social responsibility are highly sought after. Corporate acquirers may already have high standards in place that need to be met or seek a deal to improve their ESG credentials, while financial sponsors can achieve higher exit value from gold-standard companies when they sell them on.

Although most respondents (59 percent) say they would not pay a premium for a target with a demonstrably positive ESG record, there is a large gap between countries. U.K.-based

Chart 10A. Can a positive ESG record create value for companies?

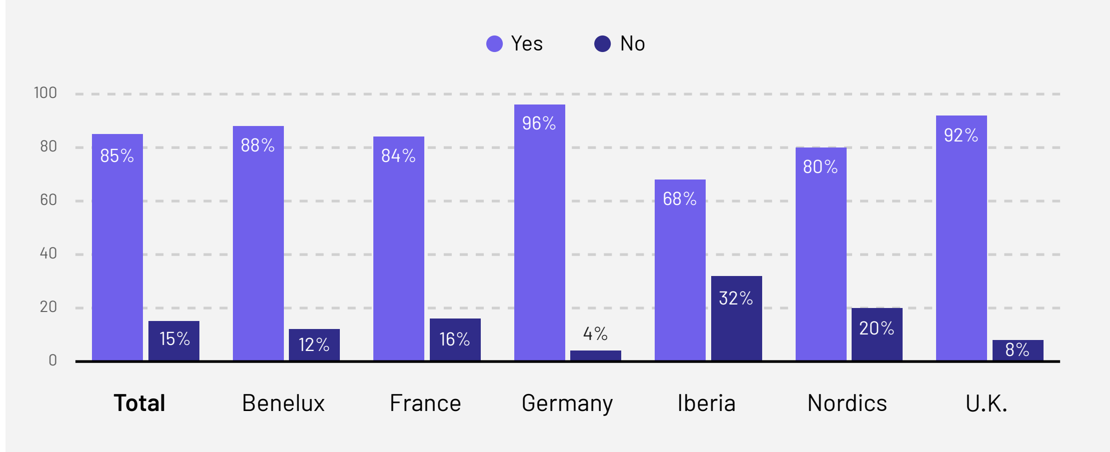
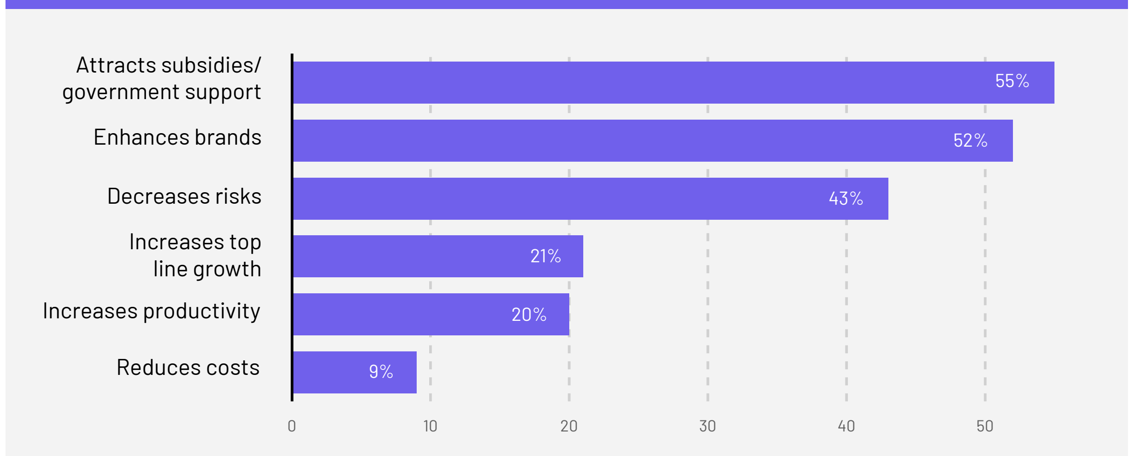


Chart 10B. How does it create value? (Select top two)



investors are most likely to say they would pay above market price, 56 percent agreeing, followed by 52 percent of German firms. Again, Iberia is far behind, with only 16 percent saying they would overbid. And of those willing to foot a premium, more than half would be willing to pay a premium of 10 percent or more.

Due diligence is an essential part of any M&A transaction process. Acquirers need to look under the hood and analyze all of the risks and opportunities of taking on a company, from understanding management quality and commercial potential to where any hidden problems might arise. ESG is now integrated into this process but executing it comes with challenges.

For 33 percent of respondents overall, the most significant difficulty they face when conducting ESG due diligence is integrating the information with financial data. This jumps to 48 percent among French firms. In the U.K.

Chart 10C. In which sectors do you see the most potential for value creation due to a positive ESG record? (Select top two)

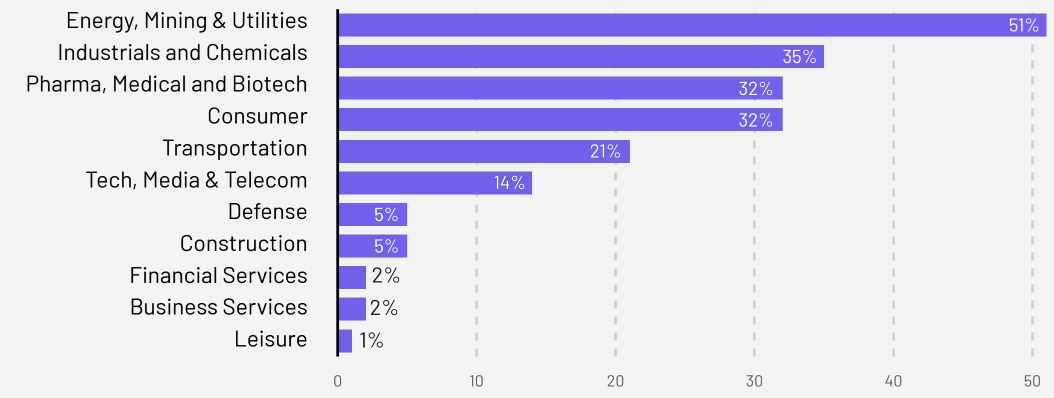
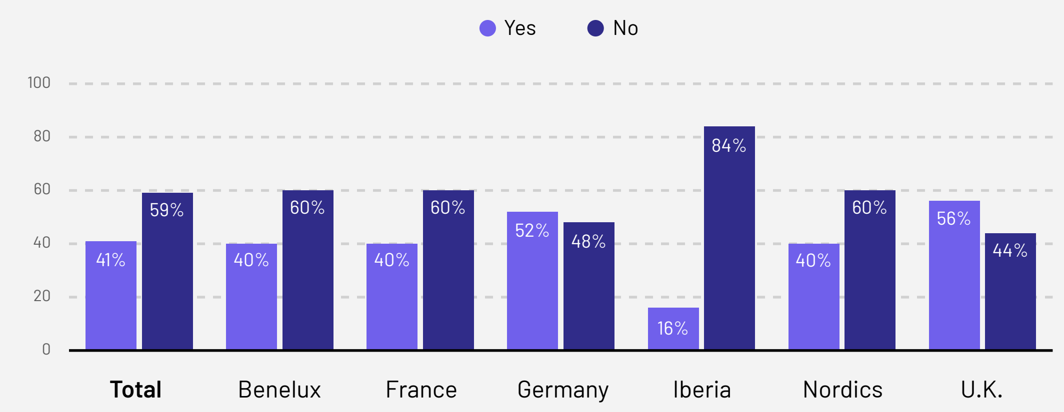


Chart 11A. Would you pay a premium for a company with a demonstrably positive ESG record?



and Nordics, however, the biggest challenge is obtaining the required information (40 percent and 36 percent respectively chose this).

On balance, most investors feel that ESG information is of credible quality. While only 16 percent of respondents across countries say the quality and comprehensiveness of ESG due diligence available in their last deal was "very good," 35 percent say it was "good," leaving 30 percent who believe it was "acceptable" and 19 percent who say it was "poor" or "very poor."

Respondents in the U.K. and Nordics were most likely to say it was very good (both saw 24 percent of respondents saying so), demonstrating the lead investors and companies in these two markets have been taking. Only those in Iberia say the quality and comprehensiveness of ESG due diligence data during their most recent deal was very poor, with eight percent choosing this option. An additional 24 percent say that it was poor. Benelux-based respondents also found the availability of comprehensive ESG due diligence data challenging, 36 percent saying the quality and comprehensiveness of this information during their most recent deal was poor. Not a single respondent based in Benelux reported this data is very good.

Chart 11B. What is the highest premium you would be willing to pay for such a company?

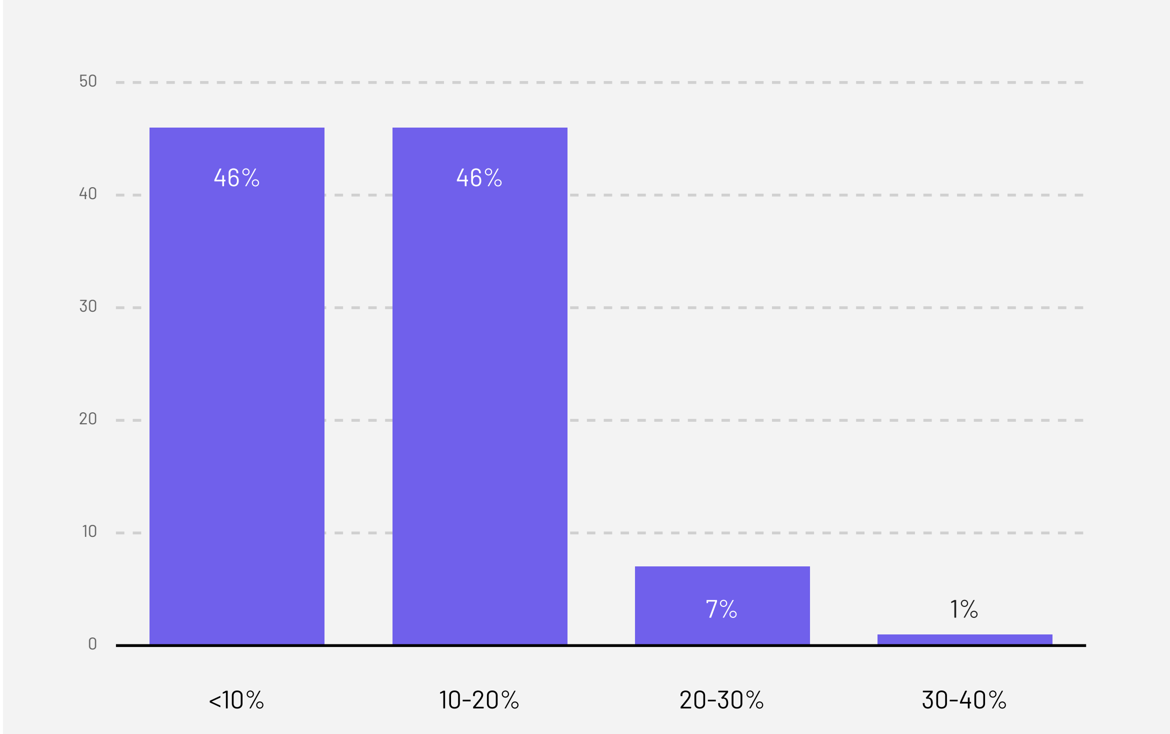


Chart 12. What is the most significant challenge you face when conducting ESG due diligence? (Select one)

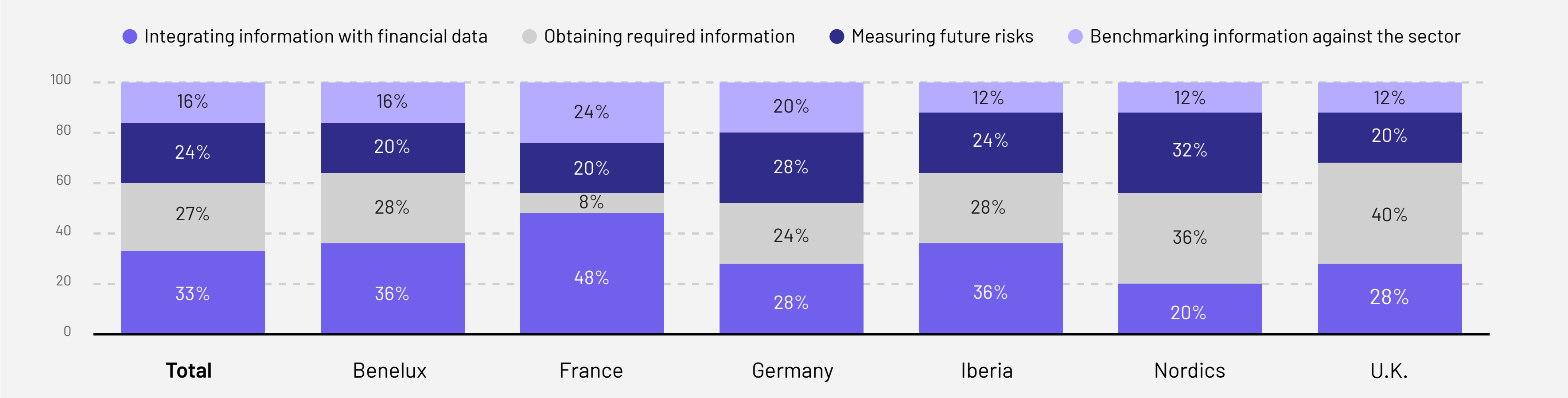
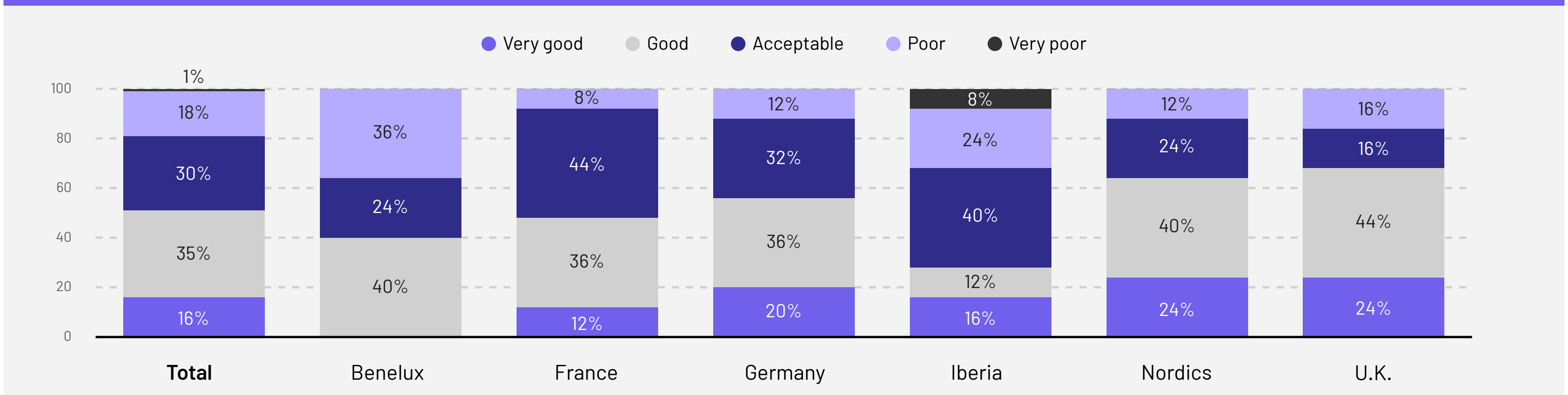


Chart 13. How would you assess the quality and comprehensiveness of ESG due diligence data available to you in your last deal?



Legal and Regulatory Environment

Last year saw the EC introduce the Sustainable Finance Disclosure Regulation (SFDR) for asset managers. PE fund managers regulated under the AIFM Directive fell within the scope of the new rules. The directive calls on general partners to publish the potential adverse ESG impacts their investments make and requires them to disclose how they adhere to responsible business conduct codes and internationally recognized standards for due diligence and reporting.

It's a major shift for GPs and will require heavy lifting to adapt compliance processes and operational norms. As always, the devil is in the details. A major point of contention is the confusion surrounding the proposed Regulatory Technical Standards (RTS), the practical and detailed disclosures fund managers will need to make and which are expected to come into effect on January 1, 2023.

Nearly half (47 percent) of GPs surveyed have one or more funds that "promote environmental or social characteristics" and which "has a sustainable investment objective," as defined by Articles 8 and 9, respectively, of the SFDR.

And those who fall within the purview of the directive are already feeling the pressure. Over three-quarters (77 percent) of PE firms think the administrative burden of complying with the SFDR to date is a challenge, including 13 percent who say it is very burdensome. This is not only a case of establishing new processes and procedures to follow, but it is expected the new rules will impact deal terms and structures. According to the managing partner of a PE firm based in France, "Compliance with the SFDR will mean [the] inclusion of ESG warranties in particular. Apart from the financial terms and agreements, ESG risks and remedies have to be discussed in detail."

Regardless of the pressure that PE firms are under to meet this challenge, they see the benefits of the rules. More than two-fifths (43 percent) say that SFDR compliance will bring with it improved planning to mitigate ESG risks after deal completion as a top-two impact, and 37 percent say it will help them to enhance their ESG due diligence. And as much as 44 percent of those surveyed believe that firms are likely already fully compliant with SFDR, with another 43 percent saying they think firms are somewhat compliant at this stage.

Chart 15. Under SFDR, does your firm have one or more funds which "promote environmental or social characteristics" (Article 8) or "has a sustainable investment objective" (Article 9)? (Select one) (Fund respondents only)

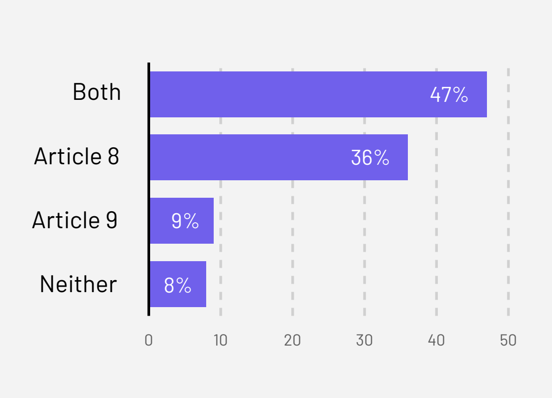


Chart 16. How would you assess the administrative burden of complying with the SFDR to date? (Fund respondents only)

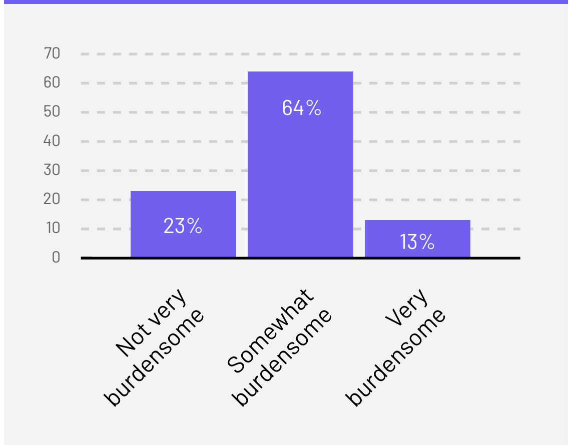


Chart 17. How would you assess the current state of compliance with the SFDR by financial market participants overall? (Fund respondents only)

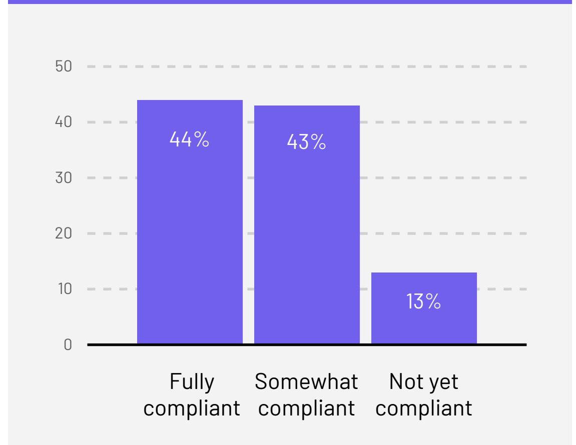
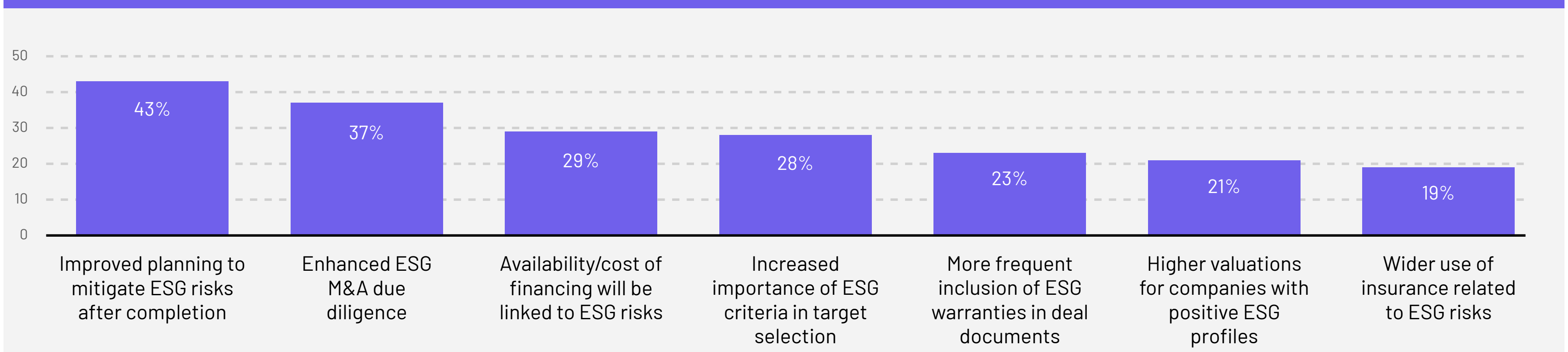


Chart 18. How do you expect compliance with the SFDR to impact your dealmaking in the future? (Select top two) (Fund respondents only)



Proposal for a Directive on Corporate Sustainability Due Diligence

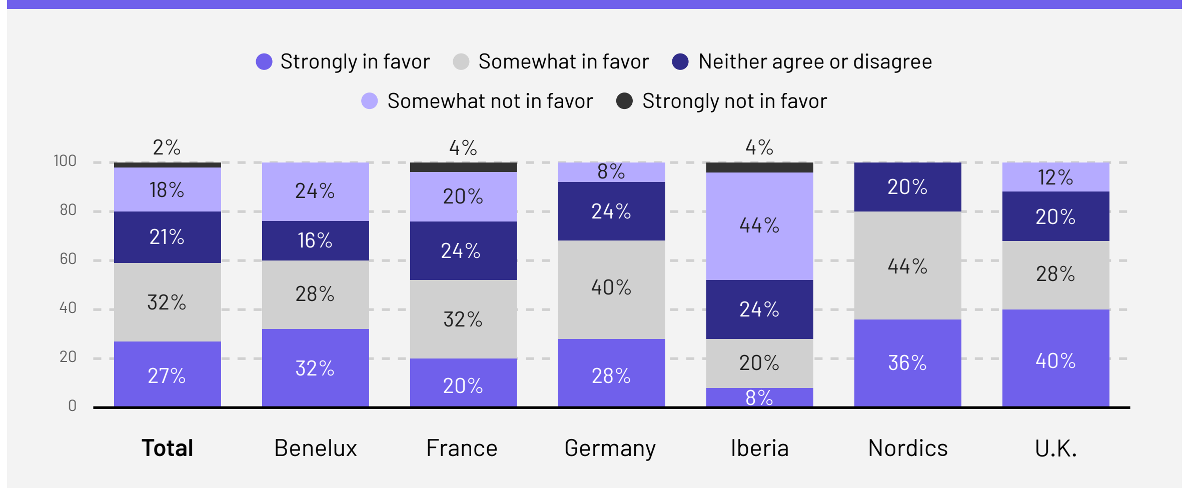
Additionally, the E.U. is proposing a Directive on Corporate Sustainability Due Diligence. The intention is to impose on companies a duty to identify, prevent and mitigate adverse human rights and environmental impacts. The proposal is wider-reaching than the SFDR, since it aims to foster sustainability and responsible corporate behavior throughout global supply chains, rather than applying to investment managers' reporting. Initially, the planned directive will apply to E.U.-domiciled companies with more than 500 employees and EUR 150 million in global annual net turnover, as well as non-European businesses that make upwards of EUR 150 million of their revenues from the region.

Our survey found that the proposal enjoys broad support. A majority of respondents (59 percent) overall are in favor of the directive, including 27 percent who strongly support it.

U.K.-based respondents were most likely to be strongly in favor (40 percent), followed by those in the Nordics (36 percent). As may be expected, Iberian respondents were least in favor of the proposed directive, with 48 percent saying they are not behind it, including four percent who say they're strongly against it.

Unquestionably, the rules will place a burden on those required to step up to meet them. A large 79 percent majority believes it will prove to be an administrative burden, including 16 percent who think it will be very burdensome. Unsurprisingly, given the level of opposition to the proposed directive in Iberia, respondents in the region were also most likely to say it

Chart 20. The European Commission has proposed a legal duty on companies to identify and take action on human rights and environmental adverse impacts resulting from their supply chains. What is your view on this?



would be very burdensome, with over half (52 percent) saying this. At the other end of the scale, only four percent of respondents in the U.K. say it will be very burdensome; an additional 60 percent say it would be somewhat burdensome.

"I feel that due diligence will be impacted the most because of this law," says the head of M&A at a French corporate. "Since we are talking about the entire supply chain here, the due diligence will also need to be extensive."

Nordics-based respondents were the most likely to say they believe complying with the proposed requirements would not be very onerous, 44 percent saying this compared with 36 percent in the U.K., the next highest.

This gap between forerunner markets like the U.K. and Nordics versus Iberia suggests that investors in the former have already made headway in hardwiring ESG considerations and assumptions into their investment strategies, making compliance relatively straightforward. However, there is no denying that understanding ESG risk throughout the supply chain is a daunting, if surmountable, challenge and will require thorough diligence before pulling the trigger on deals.

Chart 21. How would you assess the administrative burden on companies of complying with these proposed requirements?

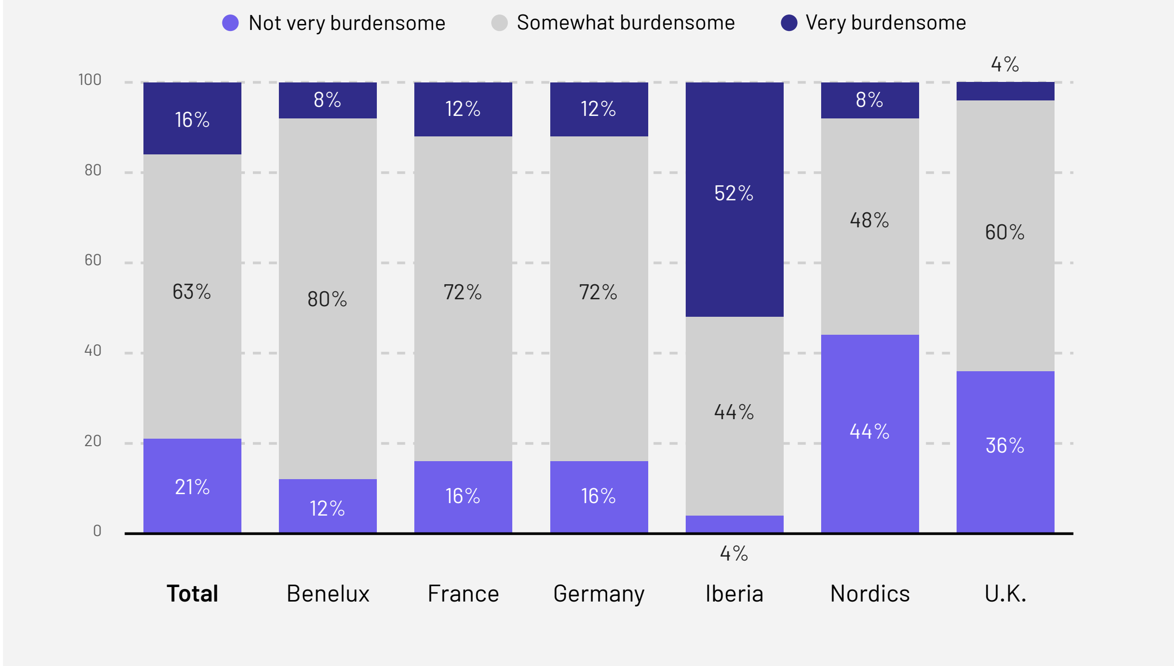
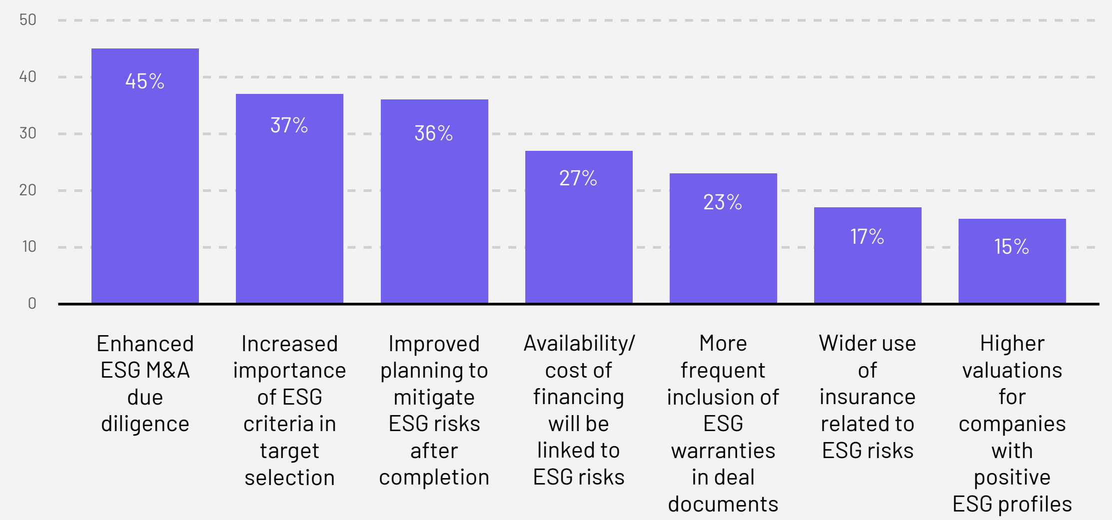


Chart 22. How would such a law impact your dealmaking in the future? (Select top two)



Competition law

Antitrust authorities across Europe have been stepping up their reviews of potentially anti-competitive deals and transactions that they believe may pose a threat to national security. These efforts were already increasing prior to the pandemic, but have since escalated over concerns parties may seek to exploit the market dislocation to acquire strategic assets. Many jurisdictions have taken steps to bolster their merger control regimes, the strengthening of foreign direct investment (FDI) controls being a major focus.

Almost half of the respondents (47 percent) believe that stricter antitrust and national security reviews will hinder M&A activity in EMEA in the next 12 months, including 22 percent who believe it will hinder activity to a great extent. Those in Iberia were most likely to think this (36 percent), followed by U.K.-based respondents (32 percent).

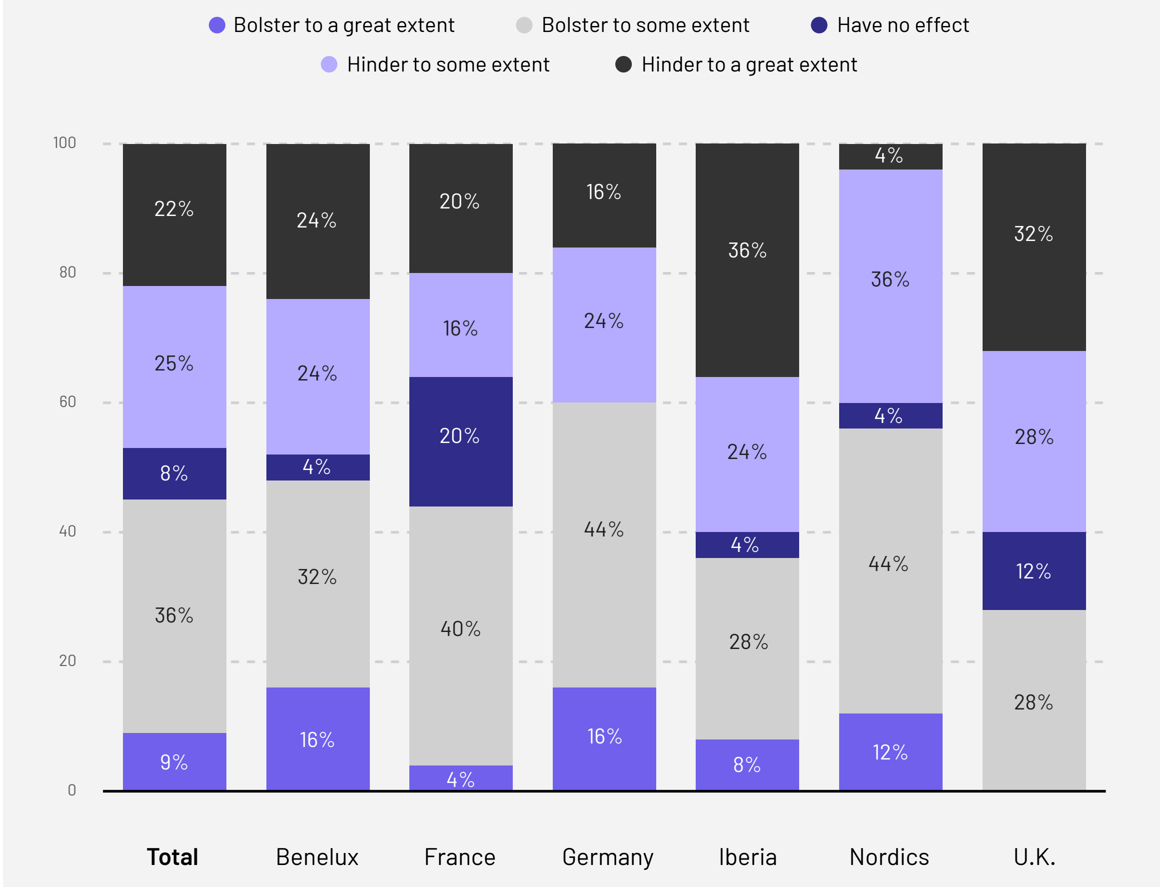
"There will be hindrances to dealmaking," says the partner of a Portuguese PE fund. "Dealmakers cannot make target selections based on their synergetic requirements. They have to see if the antitrust regulations are being adhered to."

Companies cannot progress toward their sustainability goals in isolation. They must collaborate with their suppliers and even competitors to achieve these ambitious targets, staving off the looming climate and biodiversity crisis using sustainability cooperation agreements. However, this is often seen as at odds with existing antitrust enforcement. Last year, the U.K. Competition and Markets Authority (CMA) acknowledged that businesses tend to abandon sustainability initiatives that may be seen as incompatible with competition concerns.

This is playing on the minds of investors. We find that 46 percent of respondents are concerned about the possibility of sustainability cooperation agreements between companies falling foul of European competition authorities. At one extreme, 44 percent of Iberia-based respondents report that they are worried about this to a great extent. At the other end of the spectrum, 76 percent of Nordics-based respondents say they are not at all concerned about this possibility.

There is also a notable split between corporates and financial investors here. Close to two-thirds (63 percent) of strategic acquirers say they are not at all apprehensive compared with 45 percent of PE and multi-

Chart 23. Do you think stricter antitrust/national security reviews would hinder, bolster or have no effect on M&A activity in EMEA in the next 12 months?



Regulators are increasingly paying attention to the vertical links between companies in a PE fund's portfolios.

Chart 24A. Are you concerned about the possibility of sustainability cooperation agreements between companies falling foul of European competition authorities?

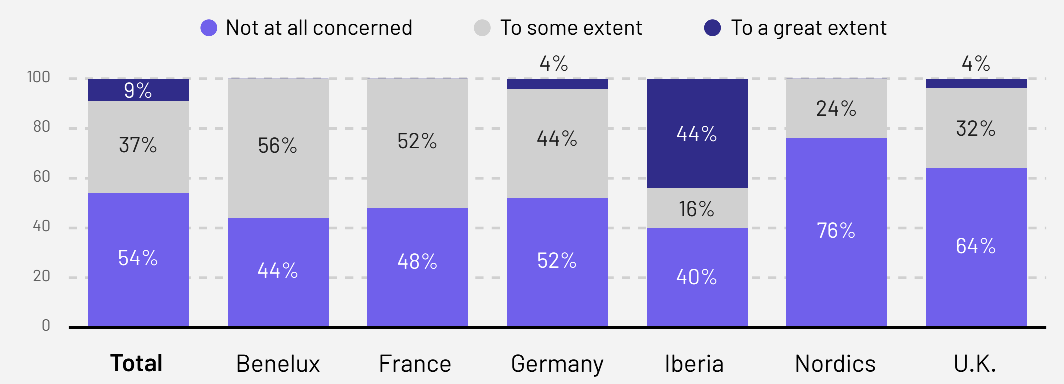
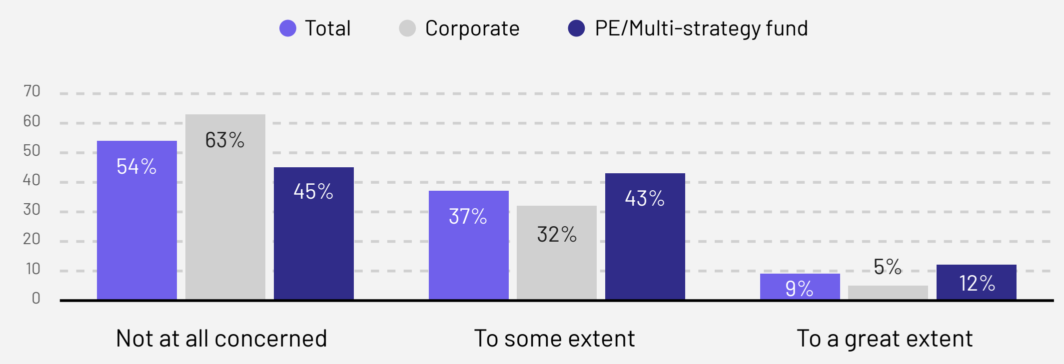


Chart 24B. Are you concerned about the possibility of sustainability cooperation agreements between companies falling foul of European competition authorities?



strategy funds. There is no clear reason why fund managers should be warier of antitrust authorities standing in the way of sustainability cooperation agreements, though it is worth noting that regulators are increasingly paying attention to the vertical links between companies in a PE fund's portfolios. This should be less of a concern for smaller managers, but large-cap GPs may find greater interference from authorities given the size of their assets.

Why ESG Is a Business Opportunity

We spoke with Tanja Gihr, managing director and head of ESG Advisory EMEA, sustainable & impact banking at Barclays Investment Bank, about regulatory harmonization, the rising tide of social issues in ESG and what she sees on the horizon.

Tanja Gihr
Managing Director & Head of ESG Advisory EMEA, Sustainable & Impact Banking, Barclays Investment Bank

Our survey found a wide regional difference within Europe when it comes to implementing ESG in M&A. Are you seeing any variance between regions across Europe?

Tanja Gihr: I've worked for a long time with clients in the Nordics and the Netherlands, and they have always been leaders in this field. However, that will rapidly change, with other countries playing catch-up. We are working with many companies in Iberia and the stakeholder pressure is becoming consistent everywhere. It's right across the board now.

Incoming regulations are E.U.-wide which will bring with it a harmonization in the quality and the level of disclosure. From an M&A perspective, it's inevitable that acquirers will continue to narrow down their universe of investable targets. If you don't get ahead of this, then you risk being left behind. Investors are now looking for best-in-class, and financial sponsors in particular are happy to walk away from a deal if they feel that the ESG credentials of a target do not meet their minimum standards. Otherwise, they will push especially hard on price to accept that risk and to cover the work required to make the necessary adjustments in that company.

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> There is always room for improvement in ESG! It's so fast-moving that if you stand still, you get left behind.

While 65 percent of those polled in our survey said they undertook enhanced due diligence on all their deals, this was still far from standard across the market. How seriously do you see dealmakers taking ESG-specific due diligence in their M&A processes?

 We are seeing this come up on a consistent basis, especially on the sponsor side. In some cases, they will seek enhanced ESG due diligence from their usual providers, but in many instances, they are looking for a specialist to give potential buyers a far more granular picture of the ESG credentials of the company they are selling. In two years, this won't even be a question anymore. ESG will be an integral part of any and every due diligence process. It is heading in that direction very quickly and moving from simple risk management to being a tool for understanding value creation opportunities that are available in a deal.

One challenge that investors are coming up against is integrating ESG information with fundamental financial data. Is that something you're seeing at all?

 That is still the biggest challenge right now. Companies struggle to measure and track their ESG metrics in absolute terms. So, when you look to integrate that on a line-by-line basis with the financial data that becomes especially challenging. There's such a range of possible metrics, whether it's physical risks or the impact of carbon prices. However, I'm hopeful that in the medium term with more and more regulation, harmonization on disclosures and guidance on which KPIs to report that this will be solved. The build-up of more consistent and comparable data will help. In the U.S., the Securities and Exchange Commission (S.E.C.) recently published its proposed new rules and has made a big step forward on this. That could have a global impact on which data fast-moving points need to be incorporated and integrated into corporations' financial data — subject to its final outcome. It won't be an overnight change, but progress is being made.

Greenwashing is a major topic and there are some signs of pushback from investors who see their firms placing too much emphasis on ESG. What do you make of that?

 Greenwashing is definitely a risk, and it seems to be increasing as companies come under greater commercial pressure. Everyone wants more sustainability and there is a risk of businesses taking shortcuts to achieve that. That said, you have seen the S.E.C. bringing greenwashing enforcements in the U.S. and that has created shockwaves through the market and raised awareness among companies to be more thoughtful and take the appropriate actions. I think we will see more and more interventions coming.

In terms of pushback, that's something you saw in the wake of the global financial crisis. Many asked whether regulations had gone too far or were appropriate. This situation is different in my opinion. Rather than simply following rules, it's more about integrating ESG into M&A thought processes and adopting a mindset that considers how this can be applied to positively develop and future-proof companies to seize upon this long-term opportunity. That's the task of everyone involved in this area, to raise that awareness and help make this an integral part of the equity story.

Europe has been taking the lead on ESG. Do you think there is still room for improvement despite this head start?

There is always room for improvement in ESG! It's so fast-moving that if you stand still, you get left behind. You might have been the best performer last year, but that may not be the case next year. There needs to be a constant focus on what are the KPIs, the targets and how they can be improved.

There is always a better way to approach these issues and stakeholders continue to increase pressure. If you want to be an ESG leader, you really have to be on the front foot. ESG-linked pay is definitely an area that is growing as well as the focus on the supply chain. Then you have considerations around CapEx allocation for R&D compared with how that was allocated in the past, which is most notably playing out in Oil and Gas, but other sectors will follow. I always say to our clients that if you want to take action on ESG then now is the time to start, rather than waiting until it hits you. Ultimately, it's a business opportunity.

What's next for ESG? What do you have your eye on?

In previous years much of the focus has been on the "E" in ESG and that's a little easier to measure. Biodiversity will come more into focus depending on the transaction that you're looking at. More than that, the social element is quickly becoming more prominent. The current backdrop is putting more emphasis on the "S" in ESG. That will become more emphasized in the due diligence processes when buyers are looking at companies. We've even seen that from our clients in their requests for proposals (RFPs) asking about the diversity of our deal team.

Last, but not least, the S.E.C. proposal is really important. That's in the consultation phase so it hasn't concluded and obviously applies to the U.S. But if you are in Europe and want to keep your exit options as wide open as possible, which you should, and you want to achieve the best valuation possible, then that will be highly influential. Investors will need to rethink what they disclose and how they disclose it when those regulatory details are finalized. That's definitely one to watch.

Inside the Critical Role of an ESG Manager

Bridgepoint Credit is a private credit fund manager that provides debt financing to private equity sponsors. We spoke to Katie Cotterell, ESG manager at the firm, to understand how Bridgepoint is integrating sustainability considerations into its due diligence processes, the progress that private equity (PE) fund managers are making and what the biggest challenges are to ESG investing within the private equity industry.

Katie Cotterell
ESG Manager at Bridgepoint Credit

What does your role as ESG manager at Bridgepoint Credit entail, and how do you work with PE managers on these issues?

As the ESG manager at Bridgepoint Credit, I am fully dedicated to ESG, ensuring we continue to drive positive impact through best practice implementation. My role essentially is to support all our investment teams to integrate ESG across the investment cycle. This involves enabling them with the tools that we already have and continue to develop such as our ESG due diligence questionnaires and proprietary ESG scoring, and everything across the equity sponsor side. Being a credit fund means that we have to work as closely as possible with equity sponsors to drive the ESG initiative through to exit.

I also work closely with the other ESG team members at Bridgepoint who are more equity-focused. Although I am fully on the credit side of the business, we have overarching strategies and toolkits that we can use to achieve positive outcomes.

How are ESG considerations integrated into the dealmaking process?

We have our first stage of screening and making sure that nothing is on our blacklist, which is frequently updated. The credit deal teams only work with sponsors who are able to meet those exclusion criteria and deals that do not cause social or environmental harm.

A large piece of work that is done is around our ESG due diligence questionnaire, which looks at both the company's and the sponsor's practices. This is really important because the sponsor is the big change agent in each investment. We need to look at how they conduct their own ESG diligence and what kind of commitments they have made, including whether they are a signatory of the U.N.'s Principles for Responsible Investment (UNPRI). We also look closely at the company and what they have achieved with their ESG strategy, then the specifics — for example, how far they have progressed towards a net-zero strategy and whether they have measurements in place to track progress.

We are trying to push as much as possible on ESG margin ratchets, both to have them in place in as many deals as possible and to ensure the targets in place are ambitious. At Bridgepoint Credit, that is something we are held accountable for because we have an ESG-linked fund facility ourselves and one of our tests is to increase the number of deals we do that feature ESG margin ratchets.

GPs in our research also report that it can be challenging to access ESG data during their due diligence processes. Is that something you have observed?

Clearly, the markets do not have the same standardization around ESG data for financial data yet. Therefore, the quality and access to this are not at the same level. ESG requests from various stakeholders are different, and there is not yet harmonization across ESG data requests and requirements. That makes it challenging for companies to consistently provide information that's required by their various stakeholders. We see better quality data from companies when they are supported by their investors, who push for improved and expanded coverage of that data. That's an area we are driving more on, to supporting investees on developing sustainability strategies, measurability and data governance.

It's important to be patient and not dismiss incomplete and imperfect data. Where there are gaps, we have to be resourceful in using that to get closer to better quality, actionable data. For example, conducting greenhouse gas footprinting within an alternative assets portfolio, it is unlikely to find full coverage of the greenhouse gas footprints of all of the companies. Where there are gaps, it is possible to run science-based estimates and those are usually based on the sector, geography and the economic activities of the companies, rather than any specific sustainability initiatives of the company in question. These act as a starting point for engagement and a driver for the company to conduct an actual assessment and develop an emission reduction strategy from there.

What's the significance of ESG regulation in prompting financial sponsors to act on improving their sustainability profile and those of their portfolio companies?

 The Sustainable Finance Disclosure Regulation (SFDR) is a huge topic right now and everyone is deciding how to position themselves within Article 8 or Article 9, so whether they are "light green" or "dark green." That's helpful for the industry — increasing transparency around sustainability objectives and measurement, and aiding the uncovering of greenwashing. There is still a lot of inconsistency around ESG. Impact definitions and SFDR helps to promote clarity, making it easier to hold managers accountable for what they claim they are going to deliver.

With the proposed Corporate Sustainability Reporting Directive, that's a reflection of the demands on asset managers to dig a level down by assessing companies and asking them questions. That would be useful for us in terms of data disclosures that would need to be made at the company level.

What do you see as the biggest challenge to ESG investing within private equity?

 Data is the biggest challenge — understanding how to use that in decision-making throughout the investment cycle. You don't want to get caught up in requesting data that doesn't end up being used. It's all about keeping the focus on actionable data and not being afraid to use proxies and data that isn't yet perfect. This is a journey after all.

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Data is the biggest challenge — understanding how to use that in decisionmaking throughout the investment cycle. You don't want to get caught up in requesting data that doesn't end up being used.

Balancing Energy Security and Costs With Sustainability

Tim Marahrens, co-head of investments at Energy Infrastructure Partners, discusses the challenge of balancing various ESG considerations and how net-zero can only be achieved whilst taking energy security and affordability into account.

Tim Marahrens
Co-Head of Investments at
Energy Infrastructure Partners

ESG is central to energy investing, considering the impact of carbon emissions from fossil fuels. As a firm, how do you approach this strategically?

 Tim Marahrens: We invest exclusively in energy infrastructure on behalf of our clients and aim to contribute to the energy transition while ensuring [the] security of supply. Our hands-on investment approach targets long-term, direct investments into high-quality, large-scale renewables and system-critical energy infrastructure with sustainable/long-term cash flows.

We believe that in order to master the challenges brought by net-zero targets, we must be present not only where we can actively transform the energy sector — which is through investment in renewables — but also in associated sectors. Transportation infrastructure, for example, will require modernization to be able to carry hydrogen or CO2.

A majority (60 percent) of survey respondents in Germany said their company placed too much importance on ESG in the dealmaking process. Do you think it is possible to overemphasize the importance of ESG in dealmaking?

 In my view, there is no such thing as "overemphasizing the importance of ESG." ESG considerations form an integral part of our investment process. We have a dedicated ESG investment committee, and its reviews and approvals are a pre-condition before any deal makes it to the final conventional investment committee. This ESG committee ensures

we have performed a full ESG due diligence process that lives up to our strict standards and industry regulations. We also have ESG experts embedded in the investment team, who work on deals and ensure that all relevant ESG parameters are embedded within our investment process. Not having a focus on ESG is a risky approach.

Energy security has become a top concern, especially in Europe. With increased regulation on ESG, do you still see greenwashing in the market? Is there a trade-off between energy security and sustainability?

 Within the energy industry, avoiding trade-offs means that a balance must be struck across the trilemma of cost competitiveness, security of supply and sustainability. Those have been the three pillars of energy and the backbone of any economy. In the European market today, we see that many countries have neglected to invest in system-critical energy infrastructure over the last decades. This opens a huge opportunity for specialized investment managers like us, who invest on behalf of institutional investors such as pension funds and insurance companies. So, ultimately, we enable the beneficiaries of our investors to invest in their own energy infrastructure and security of supply.

What is it that you look for on the environmental side specifically when weighing up a deal?

 That is a central topic for us. First of all, we only consider investment-grade countries, trusted counterparties that have been carefully screened through our due diligence process and high-quality assets. When considering an investment, we look carefully at how environmental and social issues are managed. Naturally, we also carry out a comprehensive ESG due diligence process when evaluating any potential deal. The ultimate goal is to identify any relevant ESG topics or implications that may affect investment performance, society and the environment from a long-term perspective. We are clearly mandated by our investors to achieve long-term returns from energy infrastructure investments, which are often renewables. This results in a strong alignment of incentives as our objective is that the capital that we invest delivers financial returns while having a long-term positive impact on the environment and the security of supply.

There appears to be some regional variation in how seriously our survey respondents are taking ESG issues. Is that something you see among target companies from one country to another?

 In my view, companies across Europe are prioritizing these issues as they have come

to the forefront of the public consciousness. We see a lot of standardization being forced into the system due to the ongoing EU taxonomy legislation, which recently broadened its scope in light of the current energy market crisis.

Energy security and cost competitiveness are absolutely fundamental. Without those two pillars, there cannot be support for the third pillar: sustainability. The energy transition requires buy-in from the public, and while some countries may be willing to sacrifice higher costs to bring down emissions, that same level of support might be different in other countries.

Do you find accessing ESG-specific data and KPIs in your due diligence processes challenging, or is this also becoming more harmonized?

This is still a challenge because it's not black and white. There is no standard ESG scorecard or checklist for approving a deal in today's market. It's all still in flux. Even the EU taxonomy has not yet been finalized. A lot of questions are unanswered at this stage.

It will take a few more years to establish a template approach similar to standards in the financial sector. The global financial crisis was the catalyst for a lot of financial regulation you see today, and it took five to ten years to establish a global framework. I think it will be similar for ESG.

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There is no standard ESG scorecard or checklist for approving a deal in today's market. It's all still in flux. Even the EU taxonomy has not yet been finalized. A lot of questions are unanswered at this stage.

Conclusion

Corporate and PE dealmakers have their work cut out for them. As the regulatory burden mounts and society raises its expectations, companies will have to rise to the occasion. Given the urgency and gravity of the climate emergency, ESG mustn't be viewed as a passing fad, but instead as vital to the M&A process as any commercial aspect of a deal. Drawing upon our research, we sum up what to expect moving ahead and leave you with some considerations that you may find applicable as you prepare for your next M&A transaction.

ESG's importance is set to grow further

There's no turning back. ESG is set to continue to grow in importance. A winning majority of our respondents (96 percent) agree that ESG regulation in Europe will increase in the coming 12 months, while 73 percent of dealmakers expect the importance of ESG in their organization to rise.

How is this likely to change behavior? As much as 59 percent of respondents say they have never turned down an M&A deal due to ESG concerns. As regulations mount and attitudes change, expect this number to drop. Already, more than half (60 percent) of those based in the U.K. and Germany say that they have turned down one or more deals due to such issues.

Regional catch-up

Although our survey found that European dealmakers have, broadly speaking, embraced ESG, there is considerable regional variation. Respondents in Germany, the U.K. and the Nordics tend to lead the field, while responses from Iberia indicate that that region has some catching up to do, something they are already aware of: 36 percent of respondents from this market say their organization does not place enough importance on ESG — the highest of any country or region within Europe.

As regulations tighten, companies will be expected to demonstrate their commitments with results. And greenwashing will not be tolerated.

Genuine change, not greenwashing

For a significant number of respondents who believe ESG creates value for companies, it is seen to do so by strengthening brands (52 percent). Certainly, a poor ESG reputation can be bad for business and 38 percent say reputational matters are one of the top two drivers of ESG engagement in their organization. Firms must be careful not to virtue signal and posture but to live and breathe these values. As regulations tighten, companies will be expected to demonstrate their commitments with results. And greenwashing will not be tolerated.

Room for improvement

As always, there remains room for improvement, and not just in regions like Iberia that are lagging behind their neighbors. Although a majority of respondents (65 percent) say they always carry out enhanced ESG due diligence, this number could increase, especially as regulations become more stringent. Similarly, a slim majority of respondents (54 percent) presently do not undertake due diligence on their targets' supply chains, which may soon be required by the EC. If firms have yet to adopt a methodical ESG-centric approach, they should do so promptly. For those that have, their strategy can always be enhanced further.

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