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How Top M&A Professionals Are Embracing ESG in the Deal Process

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Introduction

For the mergers and acquisitions (M&A) community, the goal of creating enduring and sustainable value has always been about finding the right balance between risk and return.

Now it is getting more complex. The transformational move to embrace environmental, social and corporate governance (ESG) is having a dramatic impact on how M&A is conducted.

Drawing on insights and knowledge from a diverse group of M&A professionals and thought leaders, this white paper seeks to improve the literacy of the deal community and advance the M&A practice as ESG practices take hold.

This report is based on interviews with: **Ray Cameron**, head of investment stewardship, BlackRock; **Paul Davies**, partner, co-chair of ESG task force, Latham & Watkins; **Dr. Zhenyi Huang**, M&A Research Centre, at The Business School (formerly Cass), City, University of London; **Kamran Khan**, managing director, head of ESG for Asia Pacific, Deutsche Bank; **Sonalee Parekh**, senior vice president of corporate development and investor relations, Hewlett Packard Enterprise and **Pat Tucker**, managing director, Abernathy MacGregor. Our sincere thanks for their collective insights.

Where is the money flowing?

Let's start with the world's largest asset manager, BlackRock. With USD 8.7 trillion in assets under management at the start of 2021, BlackRock's voice during proxy season is massive, having had a role in over 16,000 meetings last year. The firm voted on more than 150,000 ballot items and had more than 3,000 "engagements," meaning specific conversations with management teams and their boards on their business practices and role as fiduciaries. This activity is associated with more than 60 percent of the assets under management on the equity side of BlackRock.

Leading BlackRock's voice on ESG in the Americas is Ray Cameron, head of investment stewardship. BlackRock has mandated that all investment teams incorporate an ESG lens into their process and Cameron's 50-person team is leading the charge.

At BlackRock, it's now standard practice to price climate risk into the value of securities. This approach was outlined in a recent investor letter from BlackRock's CEO Larry Fink, which arguably

changed the conversation on ESG by drawing attention to the fundamental reallocation of capital to sustainability-focused investments.

From January through November 2020, sustainability-focused mutual funds and ETFs attracted USD 288 billion globally, a 96 percent increase over the whole of 2019.

Over time, capital allocation will shift at an accelerating pace, to lower risk and higher return investments, according to Fink. In the past year, Cameron points out that 81 percent of BlackRock's ESG-focused funds outperformed their parent benchmarks.

Boards are starting to understand the lift from good stewardship

"Our most senior leaders view long-term sustainability as a duty of care," says Sonalee Parekh, senior vice president of corporate development and investor relations at Hewlett Packard Enterprise. "It's simply an imperative for the deals we pursue. We have to do this for our shareholders because they expect it, but it will also yield a positive IRR," she says. ESG, like M&A,

is an investment proposition that should be measured over the long term.

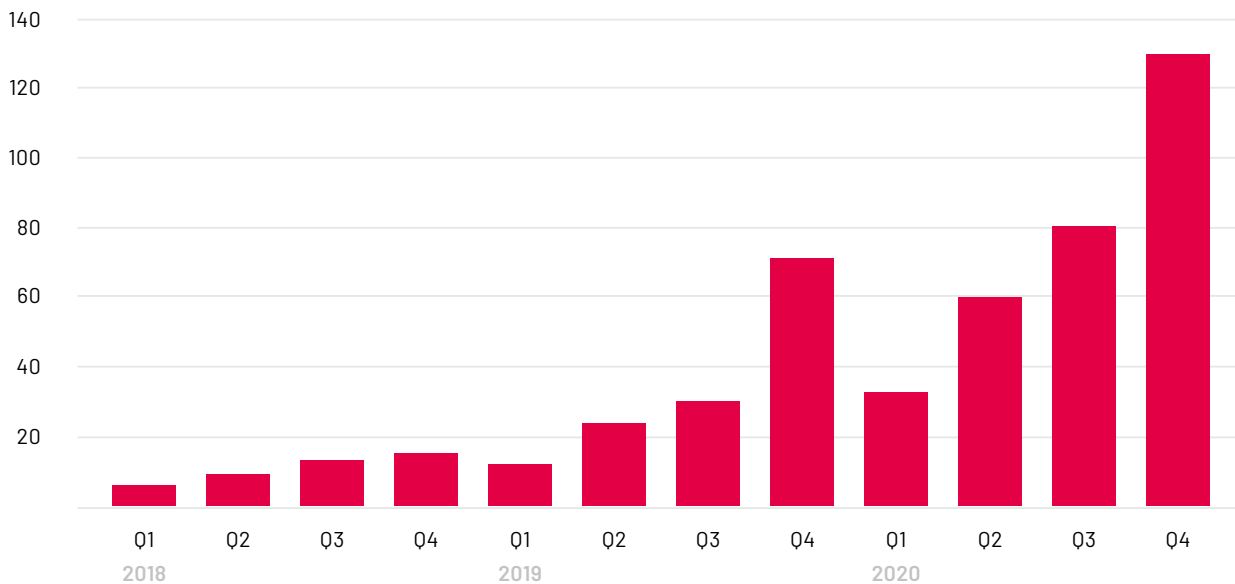
But not all boards are comfortable with the near-term trade-offs that may be required. In some cases, there may be an “awakening” underway, Cameron explains.

“We may need younger and more diverse boards. We certainly need more accountability,” he offers.

Although turnover in directors has not been as robust as BlackRock would like, the key question is whether the board is “fit for purpose.” The investment community will require that, Cameron says, because it leads to better returns.

In a study of its portfolio companies, leading private equity firm Carlyle found that firms with two or more diverse board members recorded annual earnings growth 12 percent higher than those with fewer diverse directors.

S&P 500 companies mentioning ESG on earnings calls



Through March 5, 2021, categorized by quarter of earnings not date of call
Source: FactSet

ESG infiltrates M&A and accelerates

Investors and corporate directors are also challenging their M&A teams to consider targets that advance the organization's pursuit of sustainability.

Paul Davies, partner and co-chair of the ESG Task Force at Latham & Watkins says, "The direction of travel is clear: ESG issues are taking a more prominent place in the boardroom as a rule, including in the context of acquisitions. The ESG literacy at various levels of companies has undoubtedly increased."

The influence of millennials

The next generation wants to work for companies, buy from companies, and invest in companies that embrace ESG. This is not a "fad." This is where the economic demand is going and M&A needs to align with this reality, BlackRock's Cameron explains.

At Hewlett Packard Enterprise, the recent acquisition of Cray has been a point of ESG pride, as the company's supercomputers are helping healthcare providers with pharmaceutical

research and scientists study the recent wildfires with massive simulations of climate change.

Building ESG into the M&A playbook

The pressure from institutional investors is significant and well known, but there are also pressures dealmakers need to consider.

To truly understand the ESG characteristics of a transaction, Deutsche Bank's Kamran Khan, managing director, head of ESG for Asia Pacific, generally looks at a deal's impact on profit and positioning within the supply chain, an area where he thinks more scientific analysis is needed.

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Partner, co-chair of ESG task force, Latham & Watkins

ESG screening

Better technology and data are enabling dealmakers to narrow their M&A targeting lens to sustainability-focused companies.

In terms of modeling ESG risks and opportunities, Davies says, “We are finding deal teams increasingly using financial metrics to assign values to ESG factors. For example, teams will apply implied prices on (1) greenhouse gas emissions (2) increased insurance costs from operations in climate-sensitive areas (3) enhanced demand for goods with positive environmental or social characteristics; and (4) the value of enhanced employee retention and productivity.”

A growing market of providers of ESG data services, facilitated by technological innovations such as AI and machine learning, presents a host of benefits that go beyond ethical or reputational concerns. Analyzing ESG data and information through the M&A process allows for better comparability across companies, improved identification of opportunities and increased transparency

between the companies and other stakeholders, Davies explains.

In Khan’s view, we are entering an era where companies will not want to do business with a firm that does not have high ESG standards. He expects we will start to see more ‘stranded assets’ that can’t be sold because of their negative ESG standing. “Some companies will be left behind, in a cycle of declining valuation with strained capital availability,” he explains.

Picking the right targets

Hewlett Packard Enterprise’s Parekh considers ESG in a tailored fashion as she is looking at targets, depending on the type of deal that’s being pursued.

If the transaction is transformative (merger of equals, a consolidation play, etc.), the initial screening would include critical ESG calculations at the earliest stages and mitigation of any concerns would be considered. For smaller transactions, including acqui-hire deals, ESG may be a less critical element that can be solved after the deal is done.

Dr. Zhenyi Huang, from the M&A Research Centre, at The Business School (formerly Cass), City, University of London, finds acquirors are now typically screening targets based on ESG filters and looking for deals where the buyer can improve their ESG profile through the acquisition.

Dr. Huang also points to research that showed deal pursuits for companies with high levels of corporate social responsibility can be attractive because they tend to take less time to complete and are less likely to fail.¹ The research pointed to Krupp-Hoesch, a German steel producer that ran into regional political pressure when it attempted to take over Thyssen, among other transactions.

ESG diligence gets creative

Diligence on the integrity of the target's management team is standard practice, but often the in-house M&A team lacks the breadth of expertise that is required to properly study the full range of additional ESG considerations, Parekh observes.

Unlike a quality of earnings study or other traditional due diligence activity that easily flows into the data room and the deal model, dealmakers will need to improve their ability to identify risk factors and apply those to the valuation and synergy calculations.

It's an adjustment

Looking at environmental concerns, dealmakers will be increasingly challenged to assess post-close risks associated with potential litigation, damages and remediation as well as reputational concerns. This may extend to long-term operational burdens that could flow through to lost capacity that hits the top line.

But again, there may be benefits from the additional analysis. An ESG view may help an M&A team streamline the supply chain or move to resource-light production methods, which could lower regulatory burdens.

For the M&A community, it is often difficult to understand the science behind environmental

[1] Xin Deng (Nanyang Technological University), Jun-Koo Kang (Nanyang Technological University) and Buen Sin Low (Nanyang Technological University), *Journal of Financial Economics* (2013), Vol. 110, p. 87-109.

risks during diligence. At Deutsche Bank, Khan's first external hire after assuming his current role was a Ph.D. economist with expertise in measuring, monitoring and reporting the impact of ESG in a deal.

Khan explains that "ESG due diligence can identify key technical issues (e.g., unflattering baseline of CO2 emissions); health-related effects of a product; operational mistakes made by the target which will have lasting effects (e.g., worker safety record; questionable pricing practices; facilities built on inappropriately acquired land, etc.). This information can not only affect company valuation but also the structure of the deal, i.e., the need to legally distance the parent acquirer from the target in the post-transaction legal/accounting structure."

It's all about the people

Cultural "fit" has always been an important consideration for M&A professionals. Today, the focus on social issues and environmental track record has made assessing culture all the more critical.

Latham & Watkins now see due diligence covering a variety of social issues, such as human rights, diversity, equity and inclusion, human capital management and whistleblowing measures.

"A disconnect on ESG could be lethal for your deal."

— Kamran Khan

Managing director, head of ESG for Asia Pacific,
Deutsche Bank

Examining harassment claims and workplace complaints is one way to identify certain social risks. Deal teams may also examine a company's approach to global supply chains and its alertness to modern slavery/human rights risks.

Do target companies incorporate these issues into their procurement process, and do companies then undertake the necessary steps to check their suppliers? M&A professionals will need to ask these questions.

Latham's Davies also pointed to the evaluation of third-party signals, such as social media postings and news stories that indicate how a company is perceived by its customers, employees and other key stakeholders.

"Critically, we assess whether what the company reports about its values and mission lines up with what the company is actually doing," he says. Using third-party solutions, especially those supported by advanced technologies, allows M&A teams to interrogate the ESG data sets and consider how the company is keeping pace with transition risks, Davies suggests.

The key to employing an ESG data service is to use a technology platform that can screen and analyze a large volume of information, helping to focus the deal team's reviews. Combining third-party data with sensitive target information is another critical step that needs to be managed on a secure platform.

Protections beyond diligence

Deutsche Bank's Khan expects to see increasing use of contingent consideration structures that include requirements to improve performance around ESG characteristics. This is "not a minor shift, as a disconnect on ESG could be lethal for your deal," he offers.

The use of transactional insurance was raised as an additional method for protecting acquirors from various ESG risks that could damage the business after closing.

The sophistication of risk pricing in this area is increasing as the market for third-party allocations becomes more active, explained Dr. Huang, who recently authored the [research study](#), *Green Business: The Environmental Impact of M&A*. Although AIG and other transactional insurance underwriters may take the hit in the short term if management fails to provide proper controls, the public relations hit may be even more impactful on the buyer over the long term, Khan notes.

Is there any financial gain in the near term?

The question of the “ESG trade-off” is of particular interest to Dr. Huang. She points to research on the cost of capital, which tends to be higher for companies that are viewed as “bad actors” on the ESG front. This flows through into both higher debt pricing and more restrictive covenants. On the other hand, firms with superior levels of corporate social responsibility tend to benefit from a lower cost of bank loans².

Better credit terms

The Carlyle Group recently announced a USD 4.1 billion credit facility for its portfolio companies that ties the price of debt to the diversity of a company’s board. The facility, which the firm says is the largest of its kind in the U.S., is part of an “integrated approach to building better businesses,” according to the firm’s CEO Kewsong Lee. The three-year credit facility will tie the price of the debt it offers to interim targets on diversity. Carlyle has

arranged more than USD 6 billion in ESG-linked financing, which saved the firm more than USD 15 million, according to the *New York Times*.

So it’s all about the money?

Although ESG is in the popular consciousness, there may be a disconnect between the investment landscape and management on how to measure the qualitative and quantitative benefits.

BlackRock is looking to lead on the acceptance of common terminology and standards including the Task Force on Climate-Related Financial Disclosures (TCFD) and the Sustainability Accounting Standards Board (SASB), which are increasingly the accepted framework. But confusion on disclosures and measurement standards should not prevent dealmakers from stating their aims for a transaction.

The deal announcement gain

The perception of a “good quality firm” provides a level of assurance to the market, which can include more favorable gains when deals are

[2] Goss, A., Roberts, G.S., 2011. “The Impact of Corporate Social Responsibility on the Cost of Bank Loans.” *Journal of Banking & Finance*.

announced, according to research in the *Journal of Financial Economics*³.

“Your sources of capital do care about this, and therefore you should too,” says Pat Tucker, managing director at strategic communication firm Abernathy MacGregor, where he heads the M&A and Activism practice.

Securing the sustainability premium

It can also be good for recruiting. The next generation will expect a culture with ESG commitments, Parekh says. “Plus, I feel very strongly about it, because I have children and we need to leave the planet a better place for them.”

It is clear ESG is here to stay. For dealmakers, the M&A process will need to incorporate more data and a more sophisticated review. Technology will play an increasingly important role in the analysis of ESG data, from reviewing sensitive personal information in a secure environment during diligence to the application of AI to analyze troves of data.

Given the speed in which deals are now being pursued and the pressure to secure strategic acquisitions, the addition of ESG-related analysis will need to be tackled smartly. The adoption of digital platforms for deal management will be a critical factor for the successful embrace of ESG as M&A professionals direct their attention to the key value drivers and risk factors associated with the deal.

The adoption of digital platforms for deal management will be a critical factor for the successful embrace of ESG.

Amid the vast embrace of ESG principles in the capital markets and throughout the economy, dealmakers will find they are now faced with a charter that requires best practices.

[3] “Corporate Goodness and Shareholder Wealth.” Philipp Krüger (Université de Genève), *Journal of Financial Economics* (2015), Vol. 115, p. 304–329.

The critics that view ESG with a cynical lens are finding waning support, as the economics are often the more powerful force.

For the M&A community, it's clear these are not issues that can be left to be considered after the deal is closed.

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