A CORPORATE M&A SERIES:

Your Next Deal Will Be Different

Part 3: The Expanding Influence of ESG on M&A

Do environmental, social and governance (ESG) factors represent a propeller or an anchor in the M&A process? The answer depends on the acquiring company and the steps taken early on in the deal-making process. Active deal makers have learned that a compelling ESG story is essential to both inorganic growth and divestiture actions, significantly impacting how much and how fast value can be realized. But more importantly, leading companies are realizing that a proactive approach to the full range of ESG considerations can add tangible value – improving the risk posture, influencing the price paid for assets, shaping capital market access and costs for the acquirer, boosting valuations and increasingly factoring into portfolio management decisions.

ESG as a Value Lever in M&A

- Company A is in the final stages of signing a definitive agreement for a meaningful acquisition, but the ESG due diligence nets a surprising result: four out of five ESG ratings services rank the target as an ESG laggard. Given growing ESG pressures, Company A quickly assesses the difficulty in improving the target's profile and decides to advance the deal, but negotiates a discount to the purchase price given the damaging report.
- Company B is raising $700 million to buy copper and lithium mining assets. It has prioritized strong ESG practices for multiple years and recognizes the growing role of their products as energy transition minerals helpful in meeting Paris Treaty goals. The company conducts a convincing roadshow and is able to use sustainably linked bonds to reduce its coupon rate by 25 basis points, saving more than $10 million over the life of the loan.

With ESG rapidly evolving from a nicety several years ago to what is now a must-have part of any M&A transaction, organizations can, and should, leverage ESG tactics to mitigate risks and add value in the following seven ways:

Pre-Acquisition Diligence: ESG is fast becoming a foundational part of any pre-acquisition diligence. It can reveal key risks and identify elements that can impact valuation for the buyer's protection and potential advantage. Best-practice ESG diligence includes risk and opportunity assessment, peer benchmarking, identification of possible early-wins and evaluation of industry-specific ESG materiality issues.

Acquisition Financing: Companies that were once able to go to the market for equity or debt funding without uttering the phrase ESG now find that having a well-considered view on multiple dimensions of ESG is essential to successful fundraisings. For instance, savvy companies are issuing sustainability-linked debt products and/or earning a quarter-point less on their coupon rate for every year they meet certain thresholds on diversity, safety or emissions. And research shows that ESG leaders can reduce their cost of debt up to 200 basis points below ESG laggards[i].

Merger Integration: Folding one company into another is fraught with challenges, but there is also no better time to critically view the parent and target ESG profiles. The "best-of" list can include good systems for tracking and improving energy use and emissions, strong governance practices, solid safety programs and an enhanced employee value proposition. Consider opportunities to tackle legacy controversies for both target and parent companies, and rebrand the combined entity. Keep in mind, too, that this may be a rare opportunity to take a step-function improvement in diversity for go-forward staffing considerations.

[1] Research by Bank of America Merrill Lynch

Telling Your Story: Stakeholder communication is always about defining yourselves when a number of others may be framing your position in a less favorable way. These dynamics are all the more present during the fast-changing time of a transaction when regulators, labor unions, analysts and media are likely to have a point of view. Now is the time to control your narrative, rebrand around the new business attributes, build your employee value proposition and engage all stakeholders in the journey.

Divesting Through an ESG Lens: Buy well. Improve. Sell at a profit. For companies that are also active portfolio managers, using the ownership period to enhance the ESG aspects of the subsidiary not only boosts reputational advantages but has real valuation benefits. This approach also aids companies in "skating to where the puck is going," as Wayne Gretzky notably said. By selling off a subsidiary in a difficult ESG space, companies can garner strong cash flows that can be oriented toward neutral to positive ESG industries, and earn a higher multiple in the process.

Activist Investor Mitigation: Activists are using ESG components as an additional tool in their arsenals. Funds are seeing increased inflows for ESG-related investments. Some fund managers have mandates or growing pressure from their own investors to increase ESG-related activity. Public support and reputational consideration increasingly incentivize responsible investing causes. And, opportunistically, ratings and disclosures are public and provide easy fodder as activists seek all available weapons to achieve their goals, while perhaps putting themselves "on the side of the angels." Managing ESG risks and enhancing disclosures helps to mitigate activist investor opportunities.

Corporate Valuation Uplift: Yes, ESG is about reducing long-term risk and serving stakeholder needs. But shrewd corporate executives recognize that ESG results in tangible valuation uplift for the ongoing company – through active portfolio management of subsidiaries along the way. Jefferies finds that "A" Class ESG performers nearly doubled the annualized return over "CCC" ESG performers. BAML notes that "Good" ESG companies enjoy up to a 20 percent premium valuation over "Poor" companies. And Goldman Sachs observes a materially higher performance for best-quintile ESG companies versus worst-quintile performers, based on returns on invested capital net of cost of capital.

Conclusion

IHS Markit notes that 90 percent of acquirers conduct ESG diligence after a good target is identified.[ii] Your next deal will be laser-focused on value creation, synergies, strategic fit and long-term growth. Higher valuations, lower debt costs, improved stakeholder support and tempered investor activism all suggest that a thoughtful filter on ESG considerations could pay major dividends in making your next deal not only different, but better.

[2] *IHS Markit*

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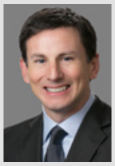

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