ESG on the Rise: Making an Impact in M&A

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Foreword

The buzz surrounding environmental, social and governance (ESG) factors in investment and M&A decisions is stronger than ever. But how exactly are M&A dealmakers and fund managers taking these factors into account when considering potential investments? In this report, “ESG on the Rise: Making an Impact in M&A,” we surveyed private equity, asset management, and corporate executives to better understand the extent to which ESG impacts M&A and investment in today’s market environment.

The results of our survey confirm the importance of ESG to investment professionals in no uncertain terms. Respondents believe ESG will become increasingly critical to M&A decision-making in the next 12 to 24 months, and most already conduct ESG due diligence when assessing new investment opportunities. When it comes to the specific ESG issues respondents are most concerned about, climate change and greenhouse gas emissions top the list, with human rights and labor standards close behind.

Evidence in the market reflects this rising priority of ESG – and the challenges that come with it. For instance, the January 2019 bankruptcy filing by California utility PG&E Corp., a company known for sustainable practices that was later thought to be complicit in the state’s wildfires, highlighted the financial consequences of miscalculating ESG risk.[1] Meanwhile, global mining giant Glencore’s increased focus on sustainability – advertised in detail in its latest earnings announcement – confirms that the largest corporate players are keen to address investors’ ESG concerns.[2]

Given the vulnerabilities that a poor ESG profile can create, it is unsurprising that companies and investment funds are mostly on the defensive when it comes to these issues, seeking to mitigate potential business risk and respond to investor pressure. Indeed, many institutional investors now actively avoid assets with poor ESG profiles, instead increasing their total assets invested using ESG principles by 38% from 2016 to 2018, according to a study by the Forum for Sustainable and Responsible Investment. At the same time, our survey participants indicated there may be merit to the idea that investing for “good” can improve investment[3] returns as well.

The ESG investment landscape is evolving quickly, and we hope you find this study helpful in understanding the specific ESG factors dealmakers are most concerned about and the challenges they expect to face in the months and years ahead.

1 *PG&E’s Bankruptcy Shows Blindspots in Green Investing* (WSJ.com; February 2019)

2 *In Mining, Can Bad Boys Still Be Good?* (WSJ.com; February 2019)

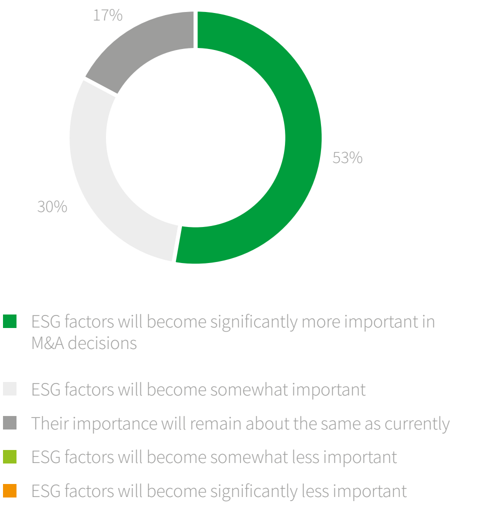
3 *More Institutional Investors Say No to Tobacco, Weapons* (WSJ.com; November 2018)

Methodology

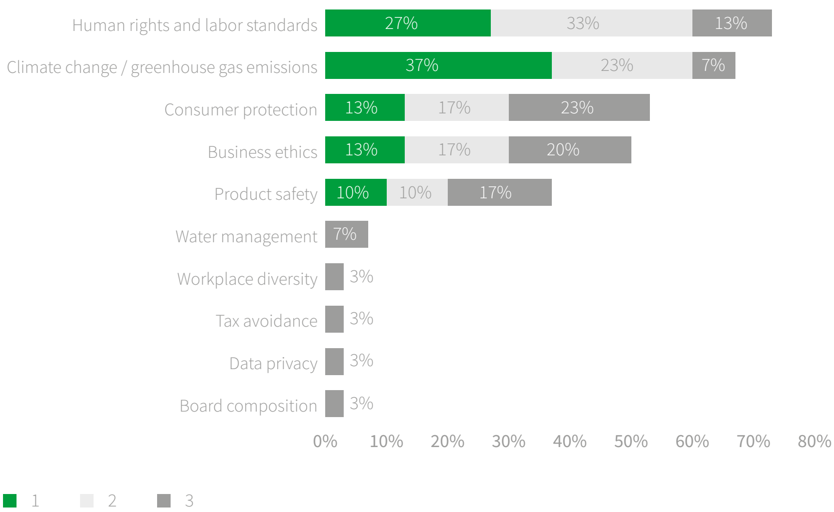
IHS Markit commissioned Mergermarket to interview 30 senior executives in Q1 2019 to better understand their approach to decision-making related to ESG issues at investment targets. The respondents were split between private equity (33%), corporate entities (33%), and asset management firms (33%). All responses are anonymous and the results are presented in aggregate.

Part 1: The ESG Appeal

How do you think the role of ESG factors will change in acquirers' M&A decisions over the next 12-24 months, if at all? (Select one)



Which ESG issues are most important to your firm and your current investor base? (Rank from 1 to 3, where 1 = most important)



The topic of ESG has become a mainstream point of discussion among investment and M&A professionals. Our survey indicates that it will increasingly play a key role in actual deal decisions as well.

The majority of our respondents predict that ESG issues will become significantly (53%) or somewhat (30%) more important in M&A decision-making over the next 12 to 24 months . Less than a fifth believe the importance of ESG will remain the same, and no one thinks its importance will decline.

One asset management executive notes that many firms are already taking these issues into account: "The importance of ESG is already high. Most buyers, especially in the West, consider ESG factors when finalizing a target. They are already digging deep to find out whether the target's ESG standards meet the level that the current market demands."

A corporate respondent likewise describes ESG as an existing make-or-break issue for most acquirers: "Buyers already consider ESG in all of their M&A deals. After an ESG assessment, it is up to them whether they are willing to spend the money and time necessary to bring a target's ESG standards to their desired level."

Top priorities

When it comes to the specific ESG issues respondents are most concerned about, climate change and greenhouse gas emissions emerge as the top priority for over a third of respondents (37%), followed by human rights and labor standards for over a quarter (27%). These two areas outweigh others in terms of importance, including consumer protection, business ethics, product safety, and, perhaps surprisingly, data privacy. It is worth noting that human rights and labor standards are also favored as the second-highest priority for 33%.

For many respondents, public image is the unifying thread linking this spectrum of different ESG concerns together. One US-based corporate executive notes the influence of a more socially conscious public: “Social activism has increased significantly. We have seen many cases of prominent companies going down by ignoring the various ESG factors that such activism seeks to address.”

Also notable are the issues respondents are not prioritizing. Despite recent high-profile campaigns such as the #MeToo movement, aimed at exposing sexual harassment and gender inequality in the workplace, only 3% of respondents identify workplace diversity and board composition as high priority ESG issues.

Despite these results, there is evidence to suggest that firms will increasingly need to factor such issues into the legal fabric of their M&A deals. For example, so-called “Weinstein Clauses” requiring an investment target to disclose any misconduct allegations before the closing of an acquisition are increasingly being added to M&A agreements. Such clauses may also allow potential buyers to reduce the purchase price in response to any sexual harassments allegations that arise post-closing – emphasizing the tangible financial value of even the less-prioritized ESG concerns. [4]

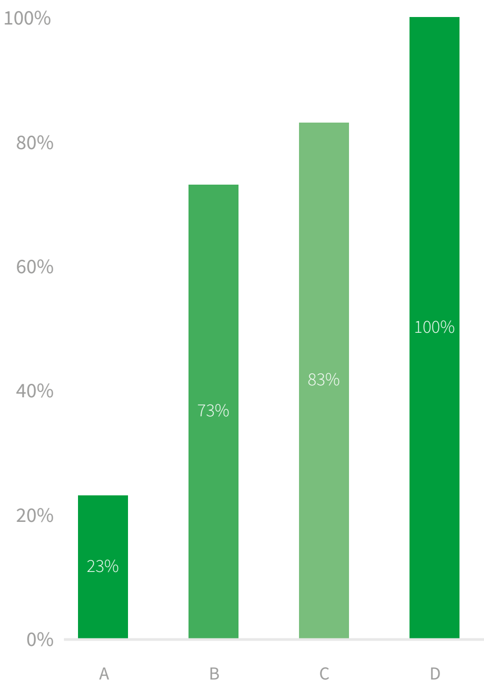
Risk vs. reward

Given the damage that poor ESG standards can do to a company’s image, it is logical that most respondents prioritize ESG issues primarily because of potential liability. Respondents unanimously cited business risk as a reason for taking ESG into account, followed by investor pressure (83%). When asked to narrow in on the single most important motivator, 67% again cited business risks, including potential litigation.

This is not to say that respondents do not value ESG for other reasons as well – rather, their current focus on ESG is a protective measure more than anything else.

The director of corporate strategy at a US-based firm sheds light on this, describing the market’s heightened sensitivity to all things ESG by noting that in a world where “social media, regulators and activists are always on

For which reasons does your firm take ESG factors into account when making investment and M&A decisions? (Select all that apply)



A Seeking higher investment returns
B Part of our firm’s philosophy
C Investor pressure
D Concerns about business risk (e.g., potential litigation, reputational risk, etc.)

[4] *The ‘Weinstein Clause’: M&A deals in the #MeToo era* (Compliance week; October 12, 2018)

the lookout for possible ESG neglect, there is no question of whether these issues hold relevance to a deal or not."

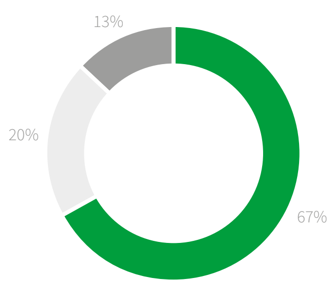
While returns may not be the primary driver of respondents' increased ESG focus, a stronger emphasis on ESG has nevertheless had a positive impact on returns for 57% of our respondents. It is noteworthy that so many respondents are seeing this positive and perhaps unintended effect, as this could signal a greater focus on ESG-driven M&A opportunities down the road.

"ESG is more about the culture and social responsibility of a firm. It is difficult to determine at what point these things will have a positive impact on returns – but neglecting ESG will certainly cause lower returns."

Managing director at a Canada-based private equity firm

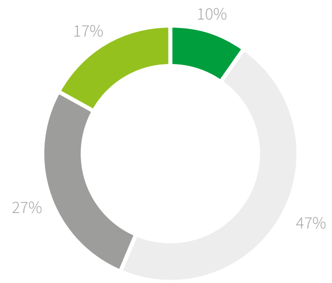
All the same, the nature of ESG can make it easier to gauge losses due to ESG factors than it is to measure gains, as one respondent explained: "ESG is more about the culture and social responsibility of a firm. It is difficult to determine at what point these things will have a positive impact on returns – but neglecting ESG will certainly cause lower returns. It can lead to a bad reputation, and a bad reputation will always hurt growth, as customers may abandon you and regulators can penalize the company. We cannot always expect higher returns for higher ESG standards, but we will certainly lose if ESG standards are not maintained." This perspective is consistent with respondents' tendency to equate ESG more with vulnerability as opposed to opportunity.

For which reasons does your firm take ESG factors into account when making investment and M&A decisions? (Select one most important)



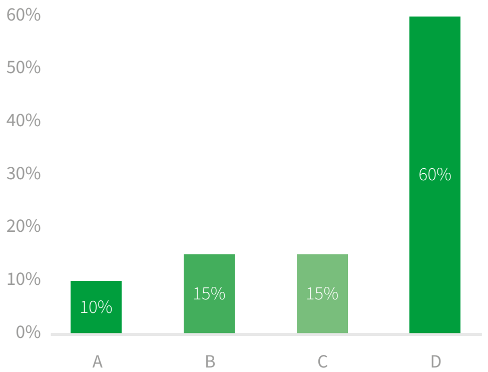
- Concerns about business risk (e.g., potential litigation, reputational risk, etc.)
- Investor pressure
- Part of our firm's philosophy
- Seeking higher investment returns

What effect has your ESG investment strategy had on overall investment and M&A returns? (Select one)



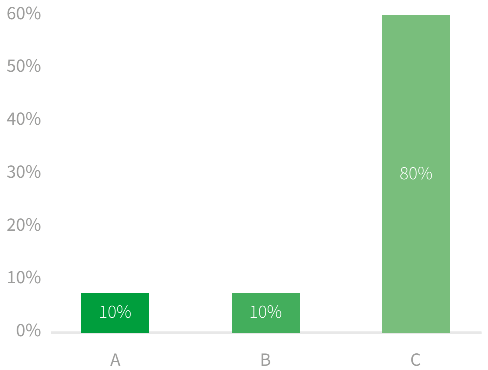
- Highly positive effect on returns
- Somewhat positive effect
- Neutral effect
- Too early to tell

(For PE and asset manager respondents only) Among your institutional investor base, which type of investor places the highest emphasis on ESG issues, if any? (Select one)



A HNWI
B Pension funds
C Sovereign wealth funds
D Endowments / trusts

(For corporate respondents only) Among your investor base, which type of investor places the highest emphasis on ESG issues, if any? (Select one)



A HNWI
B Pension funds
C Mutual funds

Mounting pressure

When asked to identify which investor groups are most focused on ESG, a majority of private equity and asset management respondents (60%) say endowments and trusts put the most pressure on them, while 80% of corporate respondents identify mutual funds as most emphatic. Both respondent groups say sovereign wealth funds, pension funds, and high net-worth individuals (HNWIs) place less emphasis on ESG.

The fact that pension funds are perceived as having less concern for ESG may come as some surprise, given that many pensions have become prominent public backers of ESG investing.[5] Canada Pension Plan Investment Board[6] and Ontario Teachers' Pension Plan[7] are just two examples of funds that have voiced their commitment to responsible investing in recent years, while increased regulatory pressure abroad suggests a push for greater ESG transparency among pensions going forward. In September 2018, for example, the UK's Department for Work and Pensions introduced new regulations aimed at holding large pension funds accountable for ESG risks; these regulations followed closely on the heels of a probe by the Environmental Audit Committee into the country's largest pension funds, which sought to determine the true environmental impact of their investments.[8]

The pressure being brought to bear on corporate respondents by mutual funds likely reflects the proliferation of socially conscious funds in recent years[9], as well as a broader discussion about the importance of ESG among high-profile fund managers including Vanguard, Fidelity, and BlackRock.

5
Sustainable investing grows on pensions, millennials (Bloomberg.com; April 2018); European pension funds ramp up responsible investments (FT.com; November 2017)

6
Investing Responsibly for CPP Contributors and Beneficiaries (CPPIB.com; 2018)

7
Responsible Investing is Central to Making Sound Decisions (OTPP.com; 2017)

8
ESG wake-up call for pension laggards (FT.com; October 14th, 2018)

9
Socially Conscious Funds List (Schwab.com; December 2018)

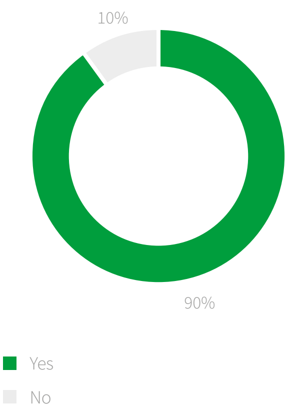
Part 2: Diligence, Valuation and Integration

It is clear that acquirers are placing a growing emphasis on ESG in their investment decisions. The next logical question becomes how dealmakers are integrating these new priorities into their day-to-day work, and what challenges they face in doing so.

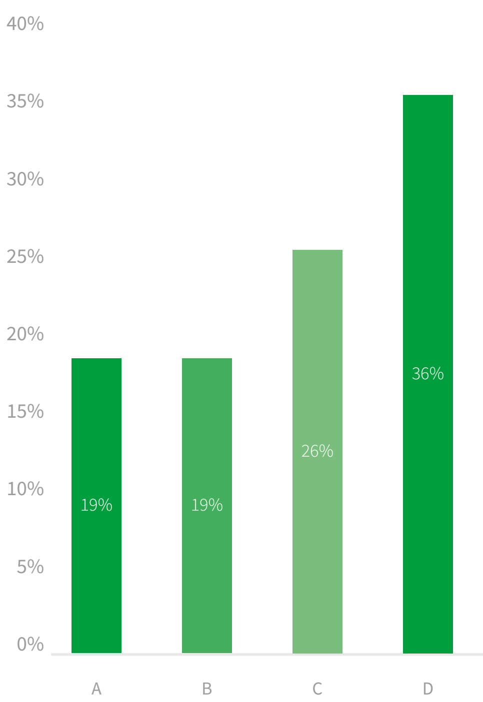
As companies take next steps after identifying a promising target, nearly all our respondents (90%) said they conduct ESG due diligence – once again confirming that it has become a core element of the M&A process despite its relative newness. When asked to identify the greatest due diligence challenges, respondents cited comparing a company's ESG metrics to the broader market (36%) and analyzing future ESG risks at target companies (26%).

Because ESG due diligence is still in its infancy, many respondents emphasize the need for ongoing study and experimentation. A managing director at a US-based private equity firm provides insight into the somewhat fraught process as it stands today: "ESG due diligence is still a niche area and there are no screening criteria or defined processes to properly judge the ESG risks associated with a target. The fact is, it is very difficult to decide what to prioritize or evaluate, and with insufficient information, it is impossible to identify potential non-compliance issues that could crop up in the future. This is a big concern for investors like us."

Does your firm conduct due diligence on ESG issues at investment and M&A targets?



If yes, what is the biggest challenge you face when conducting ESG diligence? (Select one)



A Determining how to find the relevant information at the target

B Gaining permission to access the relevant information at the target

C Analyzing the potential future ESG risks carried by the target

D Comparing the target's performance on ESG metrics to the broader market (i.e., fitting their data to comparable metrics)

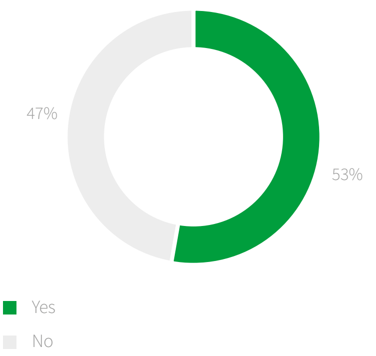
Gaining buy-in

After the challenging work of closing a deal is complete, more than eight in ten respondents (83%) said they work with their portfolio companies in order to address ESG issues. And while respondents largely concur about the importance of ESG, they also note the difficulties involved in monitoring data related to these issues on a consistent, ongoing basis after a deal has closed. The top challenge asset owners said they face when conducting this work with companies is balancing a long-term vision with short-term goals (44%), followed by gaining buy-in from company management to track and report data consistently (40%). Such issues reflect the broader struggle of balancing short-term and long-term objectives – an especially tall task for private equity firms, given their typical hold period of five to seven years.

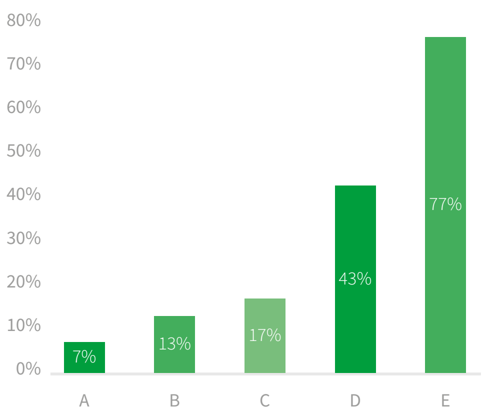
Given that many ESG benchmarks are still being established – and, perhaps more importantly, that it is often hard to measure the concrete impact of ESG on returns – it

> *"ESG due diligence is still a niche area and there are no screening criteria or defined processes to properly judge the ESG risks associated with a target."*
>
> ***Managing director at a US-based private equity firm***

Has your firm ever walked away from an investment or M&A target due to a negative assessment of ESG issues at the company?



When it comes to valuation of potential investment and M&A targets, what role do ESG factors typically play, if any? (Select all that apply)



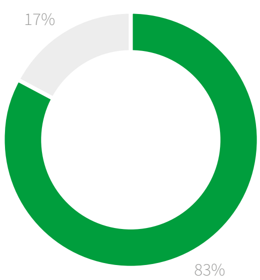
- **A** ESG factors rarely affect valuation one way or the other
- **B** A positive assessment of ESG factors increases valuation significantly
- **C** A negative assessment of ESG factors lowers valuation somewhat
- **D** A positive assessment of ESG factors increases valuation somewhat
- **E** A negative assessment of ESG factors lowers valuation significantly

comes as little surprise that gaining buy-in from company management can prove difficult.

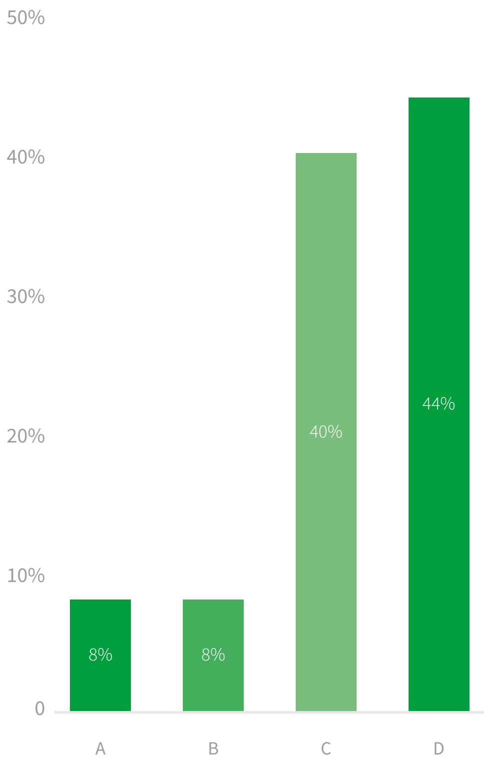
The data imperative

When asked to identify the greatest challenges of tracking ESG data at portfolio investments or target companies, 43% of respondents cited the collection of consistent, reliable data, while 27% cited gaining buy-in from company management. The buy-in challenge reflects the various technical and personnel issues previously identified by respondents.

Does your firm work with portfolio companies or target companies after investment or acquisition in order to address ESG issues?



If yes, what is the biggest challenge in conducting this work with companies? (Select one)



A Allocating investment to address ESG issues

B Meeting deadlines for conducting necessary improvements

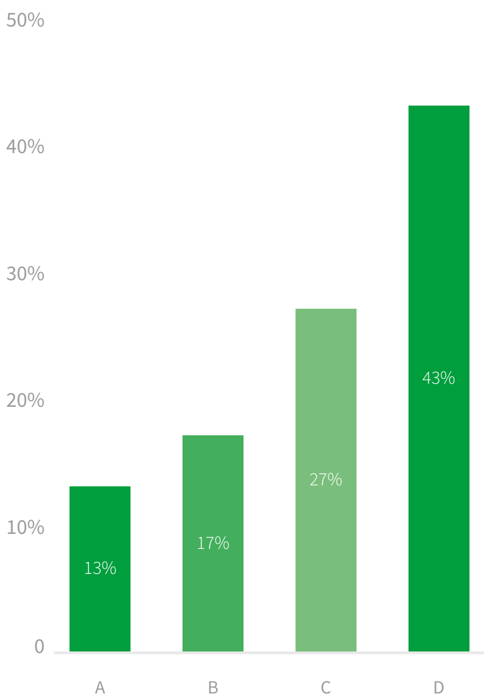
C Gaining buy-in from company management to track and report data consistently

D Balancing a long-term vision with shorter-term goals

Indeed, an entire new market is emerging to help address some of these thorny tasks. IHS Markit provides a range of reporting and analytics tools to facilitate the efficient use of ESG data in capital markets. In both public and private markets, IHS Markit helps capture corporate sustainability reports, diversity in employment, climate impact reports, independence of board members and other metrics that enable asset managers to apply non-financial data to their value creation and risk management processes.

As the technology for gathering ESG data improves, companies are more likely to be motivated to collect and report it.
Even more enthusiastic buy-in may become easier to achieve as tangible financial benefits of ESG continue to be studied and publicized – studies by the likes of BCG, Bank of America Merrill Lynch, and Deutsche Bank have been released in recent years to showcase the concrete impact of ESG on corporate performance. [10] More of such studies are likely to be published as investors seek a more thorough understanding of ESG's role across sectors and regions.

What is the biggest challenge you face in tracking ESG data at your portfolio investments or acquired companies? (Select one)



A Managing data storage and analysis
B Selecting which data points to track
C Gaining buy-in from company management to track ESG data
D Collecting reliable data on a consistent basis

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ESG: Impact on Companies Doing Business in America and Why They Must Care (BOFAML.com; March 2018); *ESG & Corporate Financial Performance: Mapping the global landscape* (institutional.dws.com; December 2015)

Looking Ahead

Two key themes have emerged from our survey: first, the rising importance of ESG to M&A dealmakers, and second, the difficulty of assessing ESG factors at acquisition targets through a standard due diligence process. Our results also consistently showed a tendency on the part of buyers to link ESG more with risk than with opportunity – at least for now. Voicing this sentiment, a corporate respondent called ESG a "major risk factor" that acquirers are increasingly trying to understand: "No buyer wants to take a hit on reputation by ignoring ESG. Buyers will continue to evaluate targets based on their ESG standards and compliance before finalizing deals."

Yet there are also signs that investors will increasingly seek upside as the positive impact of ESG on performance and returns is studied in greater detail. As one respondent predicts: "Buyers with low ESG standards will increasingly look for targets with high ESG standards to enhance their reputation and learn from the target about how to build a better image."

Our results serve as strong evidence that ESG is no longer just a buzz word – it is becoming critical to M&A dealmakers and asset managers alike. And as market participants develop a more sophisticated understanding of the role ESG plays in investment processes, the methods they use to evaluate it are likely to become more fine-tuned – both to combat potential risks and to reap potential rewards.

"Buyers with low ESG standards will increasingly look for targets with high ESG standards to enhance their reputation and learn from the target about how to build a better image."

Vice president for corporate development at a Fortune 500 company

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Please contact:
Alissa Rozen
Head of Sales, Acuris Studios
Tel: +1 212 500 1394