EURODEV MERGERS & ACQUISITIONS

GOING GREEN: AN UNTAPPED OPPORTUNITY FOR PRIVATE EQUITY GROUPS

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EXECUTIVE SUMMARY

- Environment, Social & Governance criteria are playing an increasingly important role in company valuations.
- Europe is striving to become the leader of sustainable finance, planning to mobilize at least $1 trillion of sustainable investment in the next decade.
- M&A is not immune to the public pressure to be sustainable anymore.
- ESG compatibility brings value to M&A transactions, being associated with higher profitability and lower volatility.

INTRODUCTION

The discussion around climate change is not whether it exists or if humans are exacerbating it, it is around how severe the damages will be and what could we do to slow it down. While many governments have set ambitious climate plans, businesses regularly remain reluctant to implement changes, unless so instructed. Furthermore, the topic is still surrounded by scepticism and faces some challenges before it will get incorporated into the corporate strategies of businesses across all industries.

In the Private Investment space, pursuing green deals represents an untapped opportunity for PEGs. Sustainable finance, which includes green bonds, sustainable bonds and sustainability-linked loans, offers PEGs a chance to put capital to work in investments that meet sustainability criteria. Moreover, recent M&A activity in environmental, social, and governance (‘ESG’) ratings demonstrates an increasing demand for metrics from regulators, presenting new investment opportunities. Regarding the latter, properly evaluating the impact of ESG practices is the best way to be prepared for this decade and reap positive results in the long term.

WHAT ARE ESG CRITERIA?

Environmental, Society & Governance criteria are becoming more and more important for investors when evaluating a company. The evaluation of ESG covers a broad range of factors. The **Environmental** might include things like energy consumption, waste, pollution, whether the company does something to offset its carbon footprint and most importantly how well a company is prepared to manage and mitigate the risks associated with those factors. The **Social** criteria mostly look at the relationships the business has with the local community, its suppliers, its employees, and basically all stakeholders, which are directly or indirectly involved. Finally, the **Governance** criteria are mostly focused on transparency, fairness and staying away from illegal practices.

It is important to note that no company is doing perfectly on all criteria, that is just unrealistic. However, when it is clear that a company is taking proactive steps to address those issues, investors are likely to see the business as more valuable. There are several reasons why they do so. Firstly, younger investors and younger people in general are keen on putting their money where their values are. Secondly, it is observed that complying

with the ESG factors mitigates future risks for the business and ensures the longevity of the enterprise, thus making it more attractive for investors. Thirdly, the governance factor is becoming more and more important, as businesses in all industries are faced with increased regulations regarding their operations and stricter rules requiring them to be more transparent when disclosing information.

As for the benefits of it, there are various examples of companies already benefiting from ESG. For example, Marks and Spencer reaped similar benefits when they introduced 'Plan A' to source responsibly, decrease waste, and help communities, leading the firm to save $200 million annually. Additionally, Coca-Cola successfully improved their ESG quality and produced superior performance as a direct result when the company reduced the water intensity of their production process by 20% over the last decade.

GREEN DEALS IN EUROPE

Europe has ambitions to become the leader in sustainable finance and this can be clearly seen in the European Commission's 2018 *Action Plan: Financing Sustainable Growth*. The plan has three main objectives:

- reorient capital flows towards sustainable investment, in order to achieve sustainable and inclusive growth;
- manage financial risks stemming from climate change, environmental degradation and social issues;
- foster transparency and long-termism in financial and economic activity.

Most notably, an essential step would be the establishment of taxonomy for sustainable investments and products, that would gradually create a classification system. This system will be unified and companies with well-developed sustainable investment processes are likely to get a competitive advantage over their peers with less-developed processes, that are not aligned with the preferences of responsible asset owners. Disclosure obligations are also introduced, so a clearer picture on how ESG practices are integrated into companies' risk processes is provided.

In 2019, the European Parliament endorsed the legislation setting the building blocks of a capital markets union, including the regulation on disclosures relating to sustainable investments and sustainability risks. Later the same year, the Commission presented the European Green Deal, a growth strategy aiming to make Europe the first climate neutral continent by 2050, which was followed by the presentation of the European Green Deal Investment Plan on 14 January 2020, which will mobilise at least €1 trillion of sustainable investments over the next decade. Its goal is to enable a framework to facilitate public and private investments needed for the transition to a climate-neutral, green, competitive and inclusive economy.

DOES SUSTAINABILITY MATTER IN M&A?

There is no doubt that both in Europe and globally, the public pressure for companies to be sustainable has seen tremendous growth and is expected to only grow further. People are more aware and conscious about their environmental and social impact and expect companies to be too. In the past, however, the M&A industry appears to have been unaffected by those trends, at least for the most part. Certain industries have seen some questions raised about their sustainability related practices or more about the lack of them, but in general little to no attention was paid to sustainability when deals were evaluated.

Recently however, there have been some changes, most prevalent in the energy and retail industries, which have demonstrated how a company's outlook on sustainability can affect both the attractiveness of the said company and its value. It comes as no surprise that

those two industries are the first to be held accountable by the general public and investors for their environmental impact. Arguably, it is the easiest for people to correlate climate change with their business practices. At the same time, it would be a lot harder to evaluate the impact on the environment, a service business has, for example, especially by the public, thus their ability to fly under the radar and exclude the sustainability topic from value calculations. However, this does not mean that those businesses should not be held accountable for their impact. Sustainable practices can and should be incorporated in all aspects of business, across all industries.

HOW CAN ESG COMPATIBILITY BRING VALUE TO M&A DEALS?

ESG is not only beneficial for external stakeholders, it is beneficial for the companies as well and can bring their attractiveness and value up. Both things are vital if a company is to be sold, after all every buyer is looking to acquire the best possible target. But how exactly does the ESG compatibility bring this value?

According to a publication from The Harvard Law School Forum on Corporate Governance, higher ESG is associated with higher profitability and lower volatility. The research found that better ESG performance is associated with firms that create economic value and have higher return on capital. As all of the above mentioned are good news for any investor, the added value from a good ESG compatibility is becoming increasingly harder to ignore. The reduced volatility to the mix, and the M&A industry, which has a huge detest for uncertainty, will most definitely be intrigued. Environmental matters are not entirely new to M&A, but today’s world is faced with new challenges, which companies need to address accordingly.

With Europe positioning itself ahead of other continents with its regulations and initiatives, companies on the continent are naturally ahead of their peers in their ESG practices. This makes the acquisition of a European company a well-motivated, strategic move, which would allow the buyer to quickly adopt the ESG practices and incorporate them into their own company.

CONCLUSION

The corporate interest in ESG is growing and is expected to continue to grow. Two decades ago, environmental performance was disclosed by very few, whilst nowadays 93% of the world’s largest companies by revenue report their ESG information. Notably, S&P 500 companies have started citing ESG on earnings calls as well. There is more and more emerging evidence of the positive impact of ESG incorporation into business. Investors, policymakers, and the public are all pressuring companies to be more responsible and while it is not up to the companies to save the world, it is up to them to create a sustainable place for themselves in this world. Focusing on the strategic value that ESG brings can be crucial to the longevity and success of businesses globally and with M&A being the fastest way to acquire new capabilities and incorporate them into the business practices, looking into the ESG compatibility when evaluating a company would benefit all sides.

REFERENCES

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