Game changers

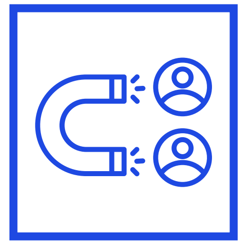
The dynamic people and social sustainability trends driving deal evaluations

2024

People are a valuable resource to any business

Demographics, digitization, decarbonization and deglobalization present disruptive headwinds and tailwinds to workplaces and the people who lead them. As a result, private equity investors – from large multinationals to small and mid-sized firms – need to enhance their approaches to transaction due diligence, which includes widening the lens of HR risks and opportunities. Activities that were traditionally left to asset onboarding or portfolio management are being pulled forward into the due diligence period – if not earlier into deal origination strategies.

Traditional HR due diligence topics scrutinized during M&A transactions typically include some combination of executive compensation, workforce diversity, union relations and HR compliance. However, several sustainability trends have begun to converge, with important implications for deals and HR strategy. These disruptive trends include:



Attracting and retaining top talent

During a prolonged period of inflation, low unemployment and labour mobility, minimizing turnover is central to corporate performance. Investors understand that talent attraction, retention and development area key success factors and value drivers. Yet these critical areas are often insufficiently explored or in some cases, even overlooked during the due diligence process.

Instead, investment committees and deal teams favour asking questions about the overall skills strategy for the asset and the talent required to see the transaction through. This is important because operating expenses for investing in talent and skills enhancement require explicit budgeting. In addition, deal teams and new boards will need to clearly identify the individuals who are pivotal to running the business going forward as well as the skill gaps that need to be filled to ensure the transaction can be deemed a success. Investors should prioritize securing these critical individuals with rewarding retention plans so they remain with the company.

According to KPMG in Canada's annual CEO Outlook

77%

of CEOs said labour shortages and the lack of skilled workers pose a threat to Canadian organizations.

Ensuring compliance with labour and human rights regulations

Some of the fastest moving developments in HR and ESG are market expectations for living wages, forced labour and human dignity – including the introduction of Canada's Fighting Against Forced Labour and Child Labour in Supply Chains Act. For too long, corporate leaders have considered these risks as they relate to their supply chains but not their own contingent labour force, such as temporary employees or 'temps', contractors, and student workers. Investment committees and deal teams can no longer avoid confronting these complex topics, as the reputational damage alone is enough to have long-lasting impacts on valuations. Even worse, miscalculations regarding contingent labour can directly affect performance and lead to the exit of talent from the business.

Consequently, deal teams should be poised to complete diligence across all workforce demographics and cohorts, dig into third-party staffing contracts and assess compliance against legislative requirements and asset-level HR policies. Deal teams should also ask their advisors to conduct deep dives into any management decisions that drove a material increase in contingent labour. This includes taking a full exploration of the reasons, which could include risky cost avoidance workarounds to salary, benefits and training and development. Co-employment risks associated with contingent labour also need to be assessed — and mitigations defined — to ensure such issues don't surface post-transaction.

Decarbonizing business operations

Organizations across all sectors are increasingly susceptible to two cost pressures tied to the speed of their organizations' decarbonization journey (or lack thereof):

1. The price of hydrocarbons is increasing due to a variety of factors, including carbon taxes, government regulations, net zero commitments and geopolitics. Those who are slow to progress on their decarbonization journeys will increase their exposure to the associated costs.

2. The costs associated with both electrifying their assets to reduce their carbon footprints, and sourcing renewable energy to operate those assets. Both early adopters and laggards will need to navigate the increased volatility in electricity markets due to rising energy demands in the wider economy.

Unfortunately, many C-suite executives and management teams lack the skills or urgency necessary to assess the implications of energy transition and climate risks on capital and operating expense planning.

These skill sets are already in short supply and can take years to build. As private equity investors exit current holdings, we anticipate more buy-side scrutiny of C-suites' sustainability attitudes and maturity.

Harness artificial intelligence (AI)

When used to strategically enable business models, AI has the potential to unleash improved productivity. Many investors don't yet fully grasp the implications for underwriting because they haven't dedicated the time during diligence to explore the impacts that AI has on long-term resource allocation and capital planning.

According to KPMG in Canada's Generative AI Adoption Index Report

90%

of GenAI users say the tools have enhanced the quality of their professional work.

In the near term, data is scarce, and professional judgement may suffice. Over time, we will see deal teams and their advisors develop more sophisticated tools and methodologies to appropriately assess the required skills of the future and implications of AI on Human Resources.

Enhancing cultural compatibility

Culture refers to the shared values, attitudes, standards, and beliefs that characterize members of an organization and define its nature. The impact of overlooking culture can significantly affect the success of a deal. Through our experience we have found that deal teams identified that they should have focused more on culture during due diligence. Cultural due diligence is a process of assessing the cultural compatibility between entities. It identifies potential clashes, non-negotiables aligned to the existing culture and fit-for-purpose strategies. These strategies typically include proactive communications, engagement, training and integration. Ignoring culture will impact employee morale, productivity and retention. No investor gets excited about dealing with time-consuming (and costly) cultural compatibility issues after a deal close.

People and social sustainability considerations for investors during the deal process

Do we understand this company's sustainability competencies at all levels?

What specific skill sets does your target company currently possess for implementing decarbonization strategies – including transitioning to lower carbon energy sources?

How are you currently utilizing AI technologies to enhance the accuracy and efficiency of your due diligence processes?

What strategies do you find most effective in retaining key talent during and after the M&A transaction?

What specific steps do you take to manage and integrate cultural differences post-acquisition?

Key takeaways

Before acquiring the next new business, investors need to bring the same rigour and consistency to their evaluation of Human Resources as they would to any other commercial consideration:

1. Retaining key talent during and after the M&A transaction is crucial for ensuring business continuity, innovation, and value creation.

2. Effective retention strategies include identifying and engaging high-potential employees, offering attractive incentives and recognition, communicating clearly and transparently, and providing opportunities for career development and learning.

3. Managing and integrating cultural differences post-acquisition is a complex and ongoing process that requires sensitivity, respect, and alignment of vision and values.

4. Successful cultural integration involves assessing and bridging the gaps between the two organizations, fostering collaboration and trust, leveraging the strengths and best practices of both sides, and creating a shared identity and culture.

Taken together, these diligence methodologies reveal potential liabilities that affect deal pricing, or surface often unobserved value levers.

KPMG in Canada's Deal Advisory practice offers comprehensive support to private equity firms, including HR and ESG due diligence. Our multidisciplinary team, including sustainability, technology, business consulting, engineering, and legal professionals, provides a holistic view of non-financial risks and opportunities in target companies. We deliver insights into potential challenges and benefits that could impact valuation and post-acquisition integration, prioritizing opportunities for value creation and retention.

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