ESG Due Diligence in M&A

Clarity on Mergers & Acquisitions

January 2023

How leading teams manage ESG due diligence

Environmental, Social and Governance (ESG) criteria influence growing numbers of M&A transactions, with investors willing to pay premiums for targets with strong sustainability stories. Consequently, M&A teams increasingly conduct ESG due diligence (DD) on targets at an early stage. Yet, many dealmakers are not always clear about how to incorporate ESG DD into existing due diligence frameworks. KPMG's new international study[1] on this subject provides clarity and is highly relevant to Swiss dealmakers.

The KPMG study surveyed more than 150 active dealmakers across Europe, the Middle East and Africa (EMA) to find out what works, what does not work, and what challenges M&A practitioners face when incorporating ESG into transactions. This article summarizes the study's key findings and discusses their relevance to dealmakers in Switzerland.

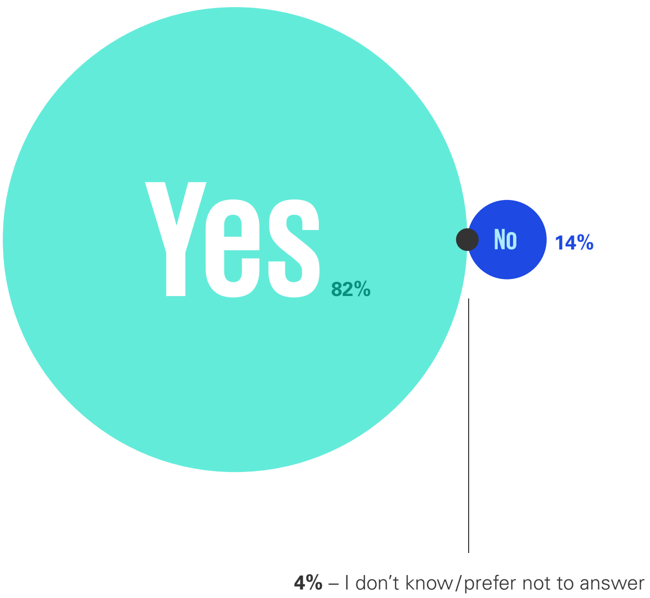
[1] 2022 EMA ESG Due Diligence Study – KPMG Global

What is happening at the nexus of M&A and ESG?

The past couple of years have brought significant changes to ESG regulation, spearheaded by the EU (e.g. Green Deal, CSRD, EU Taxonomy, CBAM) but also in other jurisdictions, including Switzerland. This has pushed ESG to the top of corporate agendas. At the same time, society at large has started to change – as seen in the changing behaviors of customers, employees and investors, who increasingly express preferences for sustainable products, employers and investments respectively. In sum, these changes constitute a disruptive force in the strategic environment of many firms; this is starting to impact M&A.

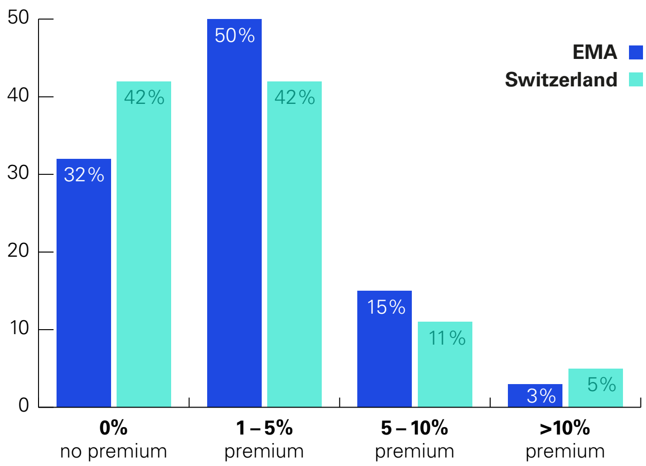
ESG is on the agenda of most dealmakers, though what this means precisely varies between companies depending on their stage of maturity: Some are at an early stage of assessing the issue, while others have conducted ESG DD for years and continue to fine-tune their approach.

Are ESG considerations currently on your M&A agenda?



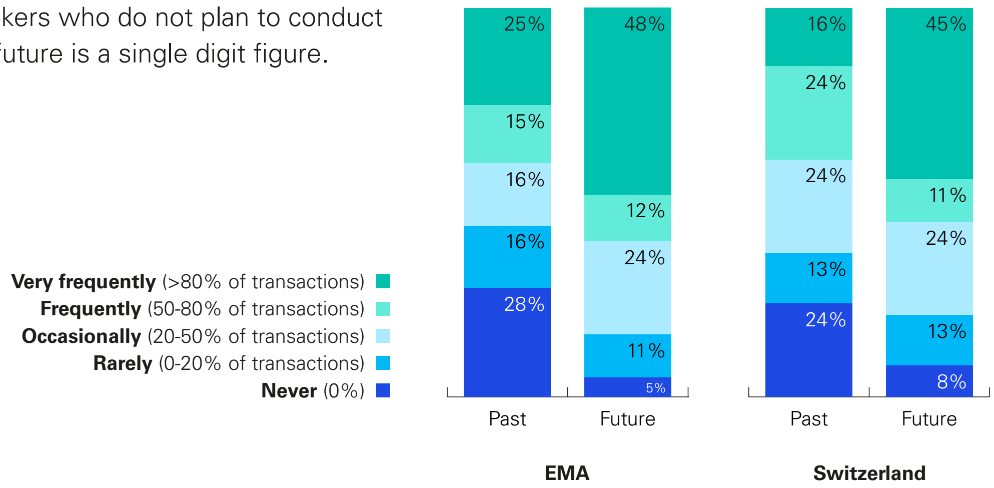
Investors are willing to pay more for a sustainable target. Across EMA, more than two thirds of respondents said that they would be willing to pay a premium for a target that demonstrates a high level of ESG maturity in areas that align to their ESG priorities. The same is true among Swiss respondents, though to a slightly lower degree.

As a buyer, how much more would you be willing to pay for a target that demonstrates a high level of ESG maturity in line with your ESG priorities?



As a consequence, ESG DD is becoming much more frequent. Investors are looking to significantly step up their ESG DD efforts. The number who expect to conduct ESG DD very frequently is set to nearly double in EMA and nearly triple in Switzerland, while the share of dealmakers who do not plan to conduct any ESG DD in the future is a single digit figure.

How frequently did you conduct ESG DD in the past and how frequently will you conduct ESG DD going forward?



What are the challenges for investors trying to integrate ESG into DD?

The study reveals several challenges for investors. The three primary challenges were selecting a meaningful but manageable ESG DD scope, getting access to robust data, and quantifying the findings.

Agreeing terminology and scope. Most importantly, there appears to be no market consensus around what a standard ESG DD scope should include. ESG is a very broad term that covers a multitude of distinct topics. Survey respondents indicated that selecting a meaningful, yet manageable scope is their number one challenge in the context of ESG DD. As a consequence, there is little consensus about which areas should be investigated in the context of ESG DD.

In your view, which are the key sub-areas of sustainability that an ESG DD workstream should make enquiries about?

- 70–79%
- 60–69%
- 50–59%
- 40–49%
- 30–39%
- 20–29%
- 10–19%
- 0–9%

	Important and should be part of ESG DD	Important, but should be part of another DD workstream	Unimportant in the context of my deals	Don't know
Climate – a target's understanding of its carbon footprint, science-based decarbonization targets and a credible decarbonization plan	69%	15%	12%	4%
Climate – a target's understanding of its exposure to climate change related risks	68%	14%	14%	5%
Contamination – risks from soil or groundwater contamination	59%	27%	13%	1%
Waste & resource efficiency – maturity of a target's waste & resource management practices	58%	21%	18%	3%
ESG controversy screening – whether the target has had any controversy that may impact their ESG performance and wider reputation	58%	23%	10%	9%
Link to business strategy – degree to which ESG considerations are embedded in a target's strategy and business model (e.g., whether to play in a certain product category, geography, etc.)	54%	30%	11%	5%
Regulation - a target's understanding of existing or emerging sustainability-related regulation relevant to its business	53%	34%	11%	2%
Certifications & ratings – degree to which the target has obtained well-recognized sustainability certifications & ratings	52%	27%	18%	3%
Governance – a target's sustainability-related governance structures (e.g., management roles & responsibilities, link to executive pay, etc.)	51%	33%	12%	4%
EHS – strength of a target's employee health & safety records and policies	50%	39%	8%	3%
Labor practices – strength of a target's labor policies and practices (e.g., human rights, living wages, modern slavery, child labor)	47%	41%	11%	1%
Diversity & inclusion – strength of a target's Diversity & Inclusion policies and performance	44%	30%	23%	3%
Product safety – strength of a target's product safety records and policies	44%	47%	7%	3%
Biodiversity – a target's understanding of its impact and dependency on biodiversity, related targets and action plans	43%	17%	30%	10%
Corruption – strength of a target's anti-corruption policies and processes	42%	49%	7%	2%
Materiality – whether a target has a robust understanding of its material areas	41%	39%	11%	9%
Data & systems – maturity of a target's ESG data, systems, and processes	41%	34%	21%	4%
Compliance – degree to which a target has mature compliance processes and a strong compliance record	40%	55%	3%	2%
Tax transparency – degree to which company makes use of aggressive tax planning; risks of tax avoidance/evasion; non-regulatory disclosure of tax-related information	24%	71%	3%	2%
Cybersecurity – strength of a target's cybersecurity policies and track record	23%	70%	3%	4%

Securing the right data from the target. Dealmakers struggle to gather relevant data and documentation of a target's ESG practices, making it difficult to assess the relevant areas. We expect this situation to improve as regulations require companies to measure and report on many aspects of sustainability in a more standardized and transparent manner.

Quantifying findings. Even where the scope of the ESG DD is clear and reliable target data is available, dealmakers often struggle to quantify findings and assess the financial impact on the deal. In large part, this reflects challenges in obtaining readily available, fit-for-purpose benchmarking data. We expect such data to become more readily available in the near future due to the increase in public reporting.

What does good look like?

7
best practices

Our study investigated best practices of those investors who believe their approach to ESG DD is market leading. Many of these respondents are international financial investors who have actively worked to develop and improve their ESG DD approach in recent years in preparation of the introduction of the Sustainable Finance Disclosure Regulation (SFDR).

Our insights into seven distinct best practices are:

1. **Conducting ESG DD on every transaction.** Our survey shows that investors who performed ESG DD more frequently were more likely to say they had unearthed material findings – and that such material findings could have significant deal implications. The most mature investors therefore tend to conduct ESG DD on their transactions as a matter of standard.

2. **Linking the ESG DD approach to the overall corporate ESG strategy.** The most mature investors say they have strong and direct alignment with the corporate ESG strategy.

3. **Linking findings of the ESG DD to clear post-closing actions.** The more mature ESG DD teams put significant effort into making sure the findings of their ESG DD reports are used to drive a clear post-closing action plan.

4. **Looking beyond risks for value creation potential.** More than nine-in-ten of the most mature investors say they do not just focus on the risks, but on the opportunities they uncover during ESG DD. Our experience suggests that to achieve more financial value, dealmakers need to embrace the focus on commercial and operational improvement levers related to sustainability.

5. **Clearly defining their DD workstreams.** There are two distinct operational models for ESG DD – the fragmented model and the dedicated workstream model. The dedicated workstream model was most popular among our respondents internationally, especially among financial investors.

6. **Securing appropriate resources.** ESG DD budgets appear to lag behind those of other workstreams such as commercial, financial or legal. Budgets have not yet caught up with the emerging importance of the topic.

7. **Continuously improving.** The more mature deal-making teams look to other leaders and external advisors to help them capture best practices. Financial investors appear to be ahead, perhaps because the EU's SFDR has caused them to think early about their positioning as sustainability becomes increasingly important.

Immediate priorities for Swiss dealmakers

To a large extent, the study results of Swiss respondents were similar to those of their international peers. Our four recommendations for next steps apply as presented in the original study – with slight regional nuances for Swiss circumstances, which are reflected below:

Step 1

Establish a clear link to your corporate sustainability strategy

Establishing a direct link between your ESG DD approach and your company's overall sustainability strategy is key.

Ask yourself:

a] Do we have clarity on our overall corporate sustainability strategy?

b] Does it articulate which E, S and G areas we consider material?

c] Does it say anything about our company's overall sustainability ambition? E.g. is our objective simply to be compliant with regulation? Or are we seeking to use sustainability as a competitive advantage, perhaps even looking to become an industry benchmark?

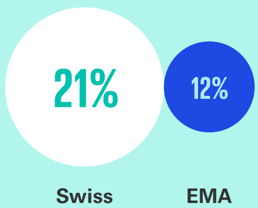
d] Does our corporate strategy aim to capture the commercial upside potential unlocked by sustainability? E.g. through the creation of new products or services for consumer segments that particularly value sustainability? If so, what does this mean for our M&A strategy?

Once that link is established, scoping an ESG DD will become much easier.

With regard to question b], there appear to be differences in the areas that are considered important among EMA-based and Swiss investors. In particular, our survey results showed that a higher share of Swiss investors considered the following topics "unimportant in the context of deals" than their EMA-based peers:

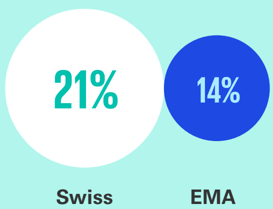
"Climate: A Target's understanding of its carbon footprint, science-based decarbonization targets and a credible decarbonization plan"

Considered unimportant
in the context of transactions



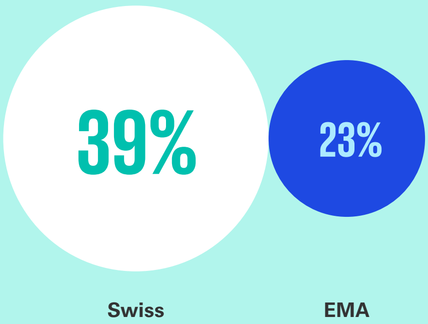
"Climate: A Target's understanding of its exposure to climate change-related risks"

Considered unimportant



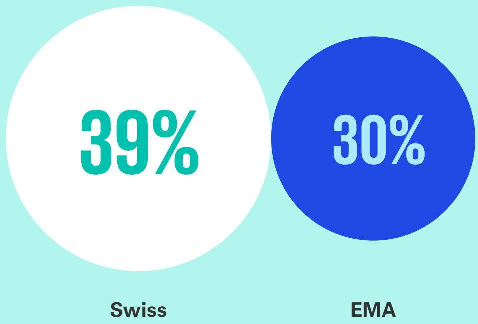
"Diversity & Inclusion (D&I): Strength of target's Diversity & Inclusion policies and performance"

Considered unimportant



"Biodiversity: A Target's understanding of its impact and dependency on biodiversity, related targets and action plans"

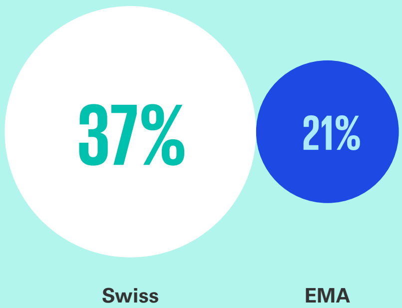
Considered unimportant



We believe these differences will shrink over time as Swiss investors are increasingly pushed to the same disclosure standards that have already been on the horizon for their EU-based counterparts in recent years. For Swiss dealmakers who do not have these topics on their radar yet, this may warrant revisiting their ESG DD approach.

"ESG Data & Systems: Maturity of a target's ESG-related data, systems and processes"

Considered unimportant



Step 2

Develop your framework

The next step is to develop your blueprint for ESG DD.

Ask yourself:

a] Have we explicitly defined which areas of ESG we will consider material in the context of transactions? Which ones will we monitor in every transaction versus on a case-by-case basis?

b] Do we know what we will measure our targets against (e.g. industry peers' relative performance)? Are there any levels of performance we would consider red lines?

c] Should our ESG DD approach focus on risks only? Or do we have an appetite to explore potential sources of financial value creation connected to ESG?

d] Would a fragmented or a dedicated workstream model be most appropriate? In this context, have we properly demarcated the scope of ESG DD and where it interfaces with other existing workstreams?

With regard to question d], we would encourage Swiss dealmakers to take a step back and consider a dedicated workstream model with an open mind. In our study, the dedicated workstream model was significantly more popular among EMA respondents (65 percent) than Swiss (45 percent). This difference is in part due to the difference in survey sample (lower share of financial investors among the Swiss sample, with the dedicated workstream model being most popular among this group). However, we would point out that it was these international financial investors that generally displayed the highest maturity in terms of ESG DD procedures. Swiss investors who still apply a fragmented workstream model may therefore wish to consider whether any of the benefits of the dedicated model (e.g. increased focus on truly material ESG areas) could warrant experimentation with the dedicated workstream model.

Step 3

Secure appropriate resources

Ensure you have the appropriate resources, budget and capabilities. Where needed, look for additional support that can also help enhance your own in-house capabilities.

Ask yourself:

- Who should run the ESG DD workstream?
- Do we have sufficient budget for the additional workstreams and expertise required?
- What capability gaps might we experience as we evolve our ESG DD approach and how can we fill them?
- Are we securing the right level of budget for deals and are we using the budget efficiently?
- What resources are our competitors putting in their ESG DD approach and are we lagging?

Step 4

Implement and improve

Many of the most mature dealmakers have reached maturity through trial and error, refining and adapting their approach as they went along. Many continue to develop their approach.

Ask yourself:

- How can we capture best practices, lessons and material findings to ensure we continuously improve?
- What organizations and peers should we be watching as industry benchmarks?
- Could external advisors help bring best practices to the table?
- How might those topics we deem material evolve over the medium term and how are we monitoring those shifts?

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For further discussion on all of these areas, we recommend you read the full study at:

2022 EMA ESG Due Diligence Study – KPMG Global