KPMG

2022 EMA ESG Due Diligence Study

How leading M&A teams are managing ESG DD

home.kpmg/esg-dd
November 2022

Foreword

Dear readers,

Sustainability has become one of the defining megatrends affecting businesses worldwide. And the M&A world is no exception to the rule.

Across sectors and around the world, more and more deals are starting to be influenced by sustainability criteria. Targets with strong sustainability stories (and the data to back it up) are enjoying price premiums. And M&A teams are increasingly conducting Environmental, Social and Governance (ESG) due diligence (DD) on targets at an early stage.

To find out what this means for dealmakers across Europe, the Middle East and Africa, we surveyed more than 150 active dealmakers across the region. We asked them what works, what doesn't work and what challenges they face going forward. We discussed various models for embedding ESG into DD. And we asked them to share their advice and insights based on their experience.

What we found was little consensus around what ESG DD actually means. Dealmakers are divided about how best to incorporate ESG DD into their existing due diligence frameworks. ESG DD work is often underfunded. And ESG DD is not always aligned to the organization's overall ESG strategy.

Yet the data also suggests that dealmakers have made this area a key priority. And they are determined to see how ESG DD can not only help identify and manage potential risks, but also identify significant financial upside driven by ESG transformation. The importance of getting ESG DD right has never been clearer.

In this report, we explore the findings of our survey and one-on-one interviews with dealmakers. Leveraging insights gained from KPMG firms' experience in ESG and due diligence, the authors offer some tips and advice to help dealmakers evolve and mature their ESG DD capabilities. And we share some practical examples from KPMG firms' work in the area.

We hope this report provides EMA dealmakers and strategy leaders with new ideas and motivation to drive forward their ESG DD capabilities. To learn more about the topics raised in this report – or to discuss your organization's unique ESG DD situation – we encourage you to contact any of the KPMG professionals listed at the back of this report.

"To find out what ESG DD means for dealmakers across Europe, the Middle East and Africa, we surveyed more than 150 active dealmakers across the region.

Summary of key findings

Something exciting is happening at the nexus of M&A and ESG. Dealmakers are actively integrating ESG considerations into their deal activities. Investors across the board are ramping up their ESG due diligence efforts. And premiums are being paid for targets that meet ESG priorities. Dealmakers see the financial value and potential uplift opportunities that can be achieved by understanding a target's ESG-related performance at an early stage of the transaction process. Read Chapter 1 to learn more.

However, there are still major challenges faced by ESG DD practitioners. Specifically, there appears to be no market consensus around what a standard ESG DD scope would include, as practitioners struggle with the breadth of the term "ESG". And targets aren't always able to provide quality data or documentation. As such, practitioners can often struggle to quantify their findings and related financial impacts or value creation opportunities. Read Chapter 2 to learn more.

Nonetheless, there are clear indications of "what good looks like". Mature ESG DD practitioners are making a strong link between their overarching corporate sustainability strategy and their ESG DD procedures. They are connecting their ESG DD findings to post-closing actions. And they are focused on value creation opportunities (i.e. "upsides") rather than just mitigation of risks. They are also more likely to mandate a dedicated ESG DD workstream, as opposed to a "fragmented" model where "E", "S", and "G" topics are handled by separate workstreams. Financial investors appear to be somewhat ahead of the curve in terms of ESG DD maturity. Read Chapter 3 to learn more.

The immediate priorities for dealmakers are becoming clear. First, dealmakers need to understand their company's ESG strategy and identify the areas that are truly material. This can help them break through the complexity caused by the breadth of the term 'ESG'. Second, they need to develop a "blueprint" for their ESG DD approach, both in terms of intellectual framework as well as in terms of organization (dedicated workstream vs. fragmented workstream model). This will require ensuring proper budgets and resources are in place to deliver on these objectives. Read Chapter 4 to learn more.

Help is at hand. While the field of ESG DD continues to evolve, practitioners should look to leaders and other relatively more mature sectors to uncover new ideas and approaches to ESG DD. Dealmakers may also want to consider leveraging the experience of outside advisors and practitioners to not only ensure a robust DD process, but also to help share insights and knowledge as the ESG DD framework evolves. Read Chapter 5 to discover how KPMG firms can help.

Content

01
Something exciting is happening

Sustainability is changing the strategic environment
Sustainability has become a defining megatrend affecting businesses worldwide. This is particularly true of the EMA region, where the EU's Green Deal and other regulatory initiatives are pushing ESG to the top of the corporate strategy agenda.

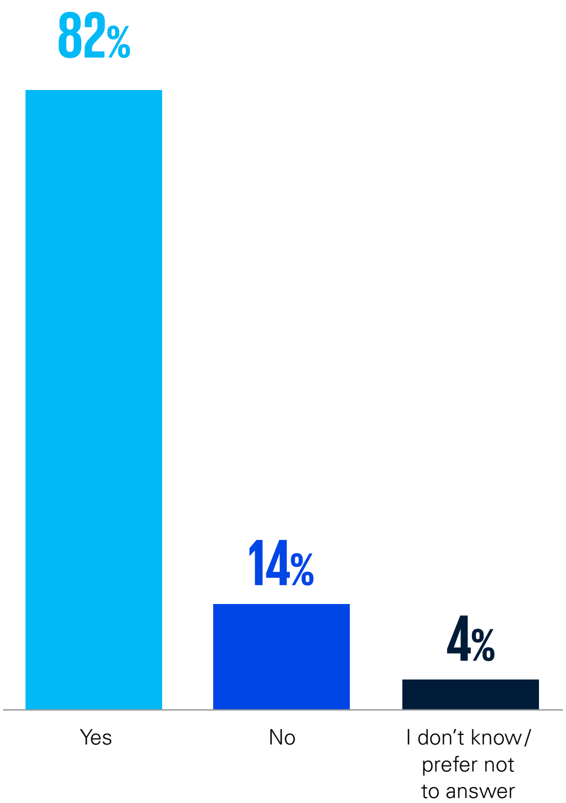
At the same time, companies face pressure from their employees and customers who want to work for, and purchase from, organizations that reflect their expectations around sustainability. And they are hearing from their investors who are starting to ask increasingly tough questions as they seek to understand and quantify risks and opportunities of their portfolios in a fast-changing business environment.

In sum, these developments amount to a significant change in the strategic environment companies in the EMA region operate in, driving corporate leaders to recalibrate their strategy.

The M&A world is clearly not immune from these pressures. M&A has long been a vital strategic tool in the corporate strategist's toolbox, used in times of disruptive change – be it to accelerate entry into emerging markets, to diversify away from markets with diminishing attractiveness or to close key capability gaps. Historically, M&A waves often occurred during times of fundamental regulatory or technological changes, as companies scrambled to capitalize on new market opportunities or to mitigate emerging risks. Our view suggests that the rise of sustainability as a disruptive factor in a company's strategic environment could have a similar catalytic impact on M&A activity going forward.

In this context, KPMG professionals surveyed over 150 active dealmakers across Europe, the Middle East and Africa ("EMA") to understand how environmental, social and governance (ESG) factors affect their deal-making activities. In addition, they held in-depth conversations with senior dealmakers in eight countries in the region. The results of these interactions clearly show that, indeed, something exciting is happening at the nexus of M&A and ESG.

Figure 1:
Are ESG considerations currently on your M&A agenda?

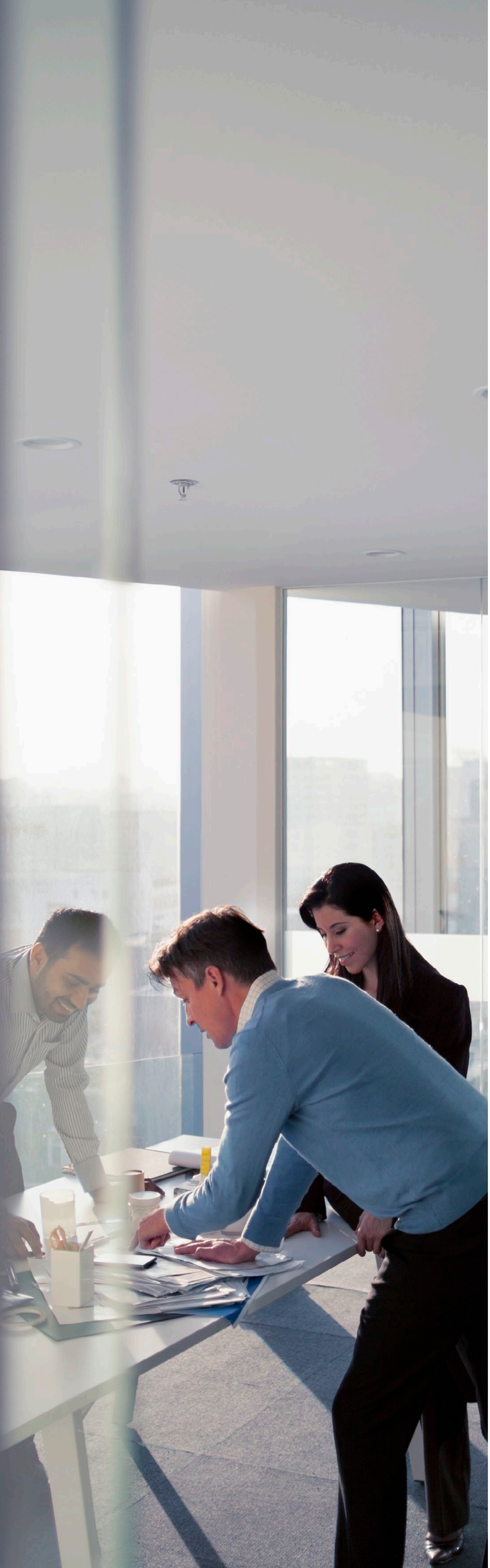


Source: KPMG EMA ESG Due Diligence Study (2022)

ESG is on the agenda of most dealmakers
Dealmakers recognize the importance of ESG. In fact, **four out of five dealmakers in our survey say that ESG considerations are now on their M&A agenda** (see Figure 1).

Yet what this means in practice differs from investor to investor. Each company will look at ESG from a different context and at a different stage of maturity.

Some are at an early stage of assessing the issue. "I'm quite sure that the current ESG trends will impact our deal processes. But I'm not quite sure how yet," admitted one business development manager at a life sciences organization.



Others have started to seek alignment between their company's overarching ESG strategy and its DD procedures. "One of my tasks right now is to link our corporate ESG strategy to the M&A strategy and processes," said an industrial manufacturing M&A manager. "We are identifying the main pillars of our ESG strategy and determining what they mean for our deal process."

Many of those that are further ahead say they are focused on operationalizing this alignment. "We're developing a standard ESG due diligence questionnaire," noted an investment director at a European chemicals company. "Going forward, we want to enter into an annual dialogue with management about our targets, post-closing goals and milestones."

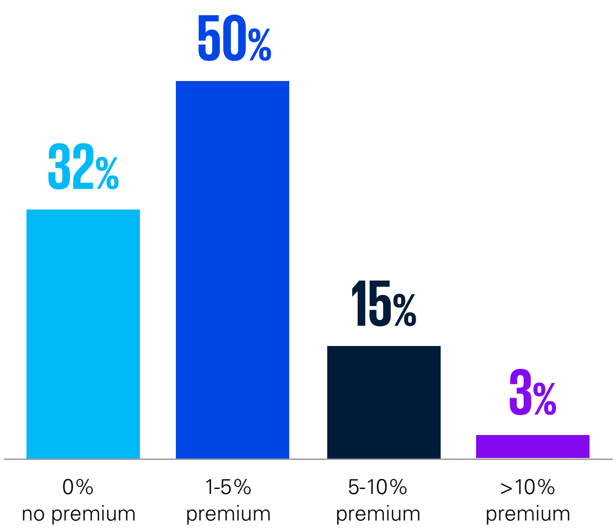
As the data suggests, dealmakers are highly focused on integrating ESG factors into dealmaking activities. And many are now working along a journey to achieve that.

Investors are willing to pay more for a sustainable target
And what's more: Dealmakers aren't just talking about wanting sustainable investments. They are ready to put extra money on the table to secure those investments.

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. Half of all respondents said that premium would be between 1% and 5% (see Figure 2). Almost one-in-five said they would pay a premium of 5 percent or more.

Figure 2:

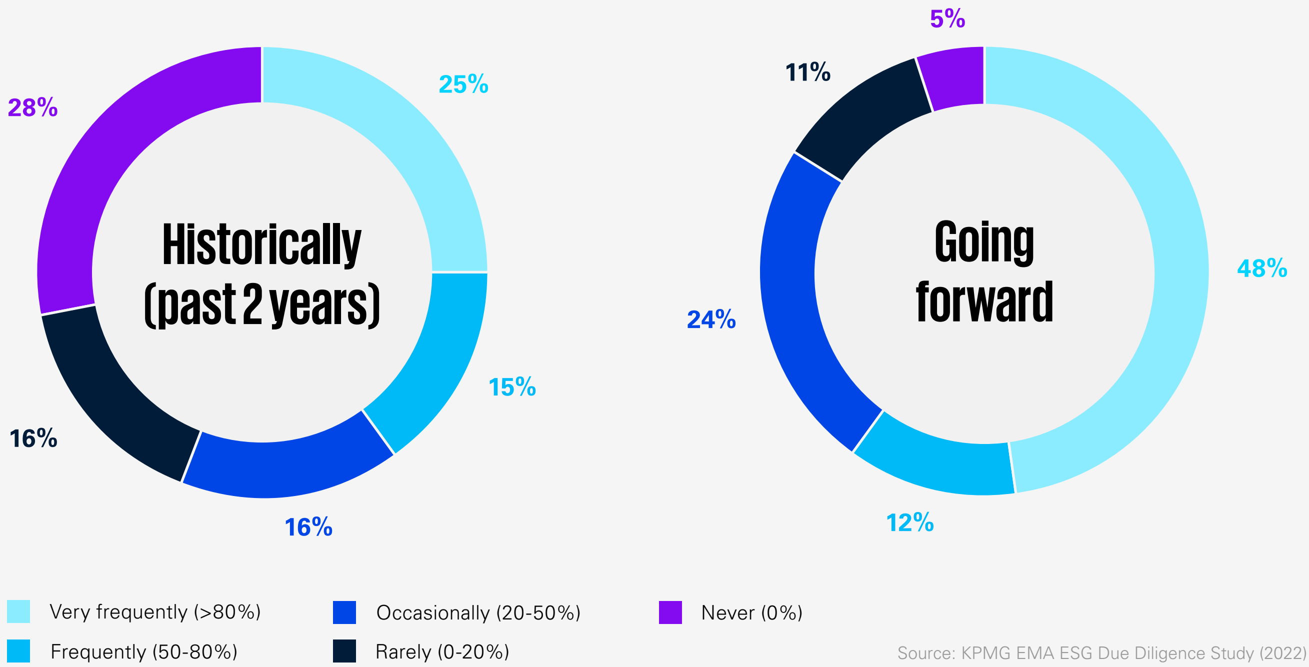
As a buyer, how much would you be willing to pay more for a target that demonstrates a high level of ESG maturity in line with your ESG priorities?



Source: KPMG EMA ESG Due Diligence Study (2022)

Figure 3:

How frequently did you / do you expect to involve an ESG DD on your deals?



Source: KPMG EMA ESG Due Diligence Study (2022)

Why are investors willing to pay more for a sustainable target? Most believe that there is a positive long-term correlation between sustainable business practices and financial returns. "We believe sustainability is good for business," noted the head of M&A at an industrial manufacturing company and added: "We see good performance on ESG as a proxy for good management. And we know that good management drives the financial value of a company." Or, in the words of a partner at a PE fund: "ESG helps us reduce the beta risk – the systemic risks – of our investments".

ESG DD is on the rise

Expect ESG due diligence to become much more commonplace in dealmaking. The survey results indicate that **investors are looking to significantly increase their use of ESG DD**. The number who expect to conduct ESG DD 'very frequently' is set to nearly double. The share of dealmakers who don't plan to conduct any ESG DD will fall from 28 percent to 5 percent going forward (see Figure 3).

This means that the pool of ESG DD practitioners will grow, which in turn will drive market maturity.

For buyers, this is good news, as ESG DD procedures are likely to mature quickly over the coming months and years.

For sellers, it means that increasing levels of scrutiny from buyers must be expected – even for assets and dealmakers that may historically *not* have been subject to stringent ESG DD enquiries.

Investors believe in the value of ESG DD

And finally, ESG DD isn't just performed because dealmakers *have to* (e.g. due to regulation or stakeholder pressure). The top reason mentioned by the survey respondents was that **they believe in the monetary value of identifying risks and upsides related to sustainability at the pre-signing stage** (see Figure 4).

"I have not seen one single company that is poor on ESG matters and has been sustainable over time," argued one PE fund partner. "We are convinced that ESG is a key operational performance indicator," he added. A head of M&A of an industrial manufacturing company explained that they had "learned in practice that ESG-related problems will come around to impose a cost on the business at a later stage."

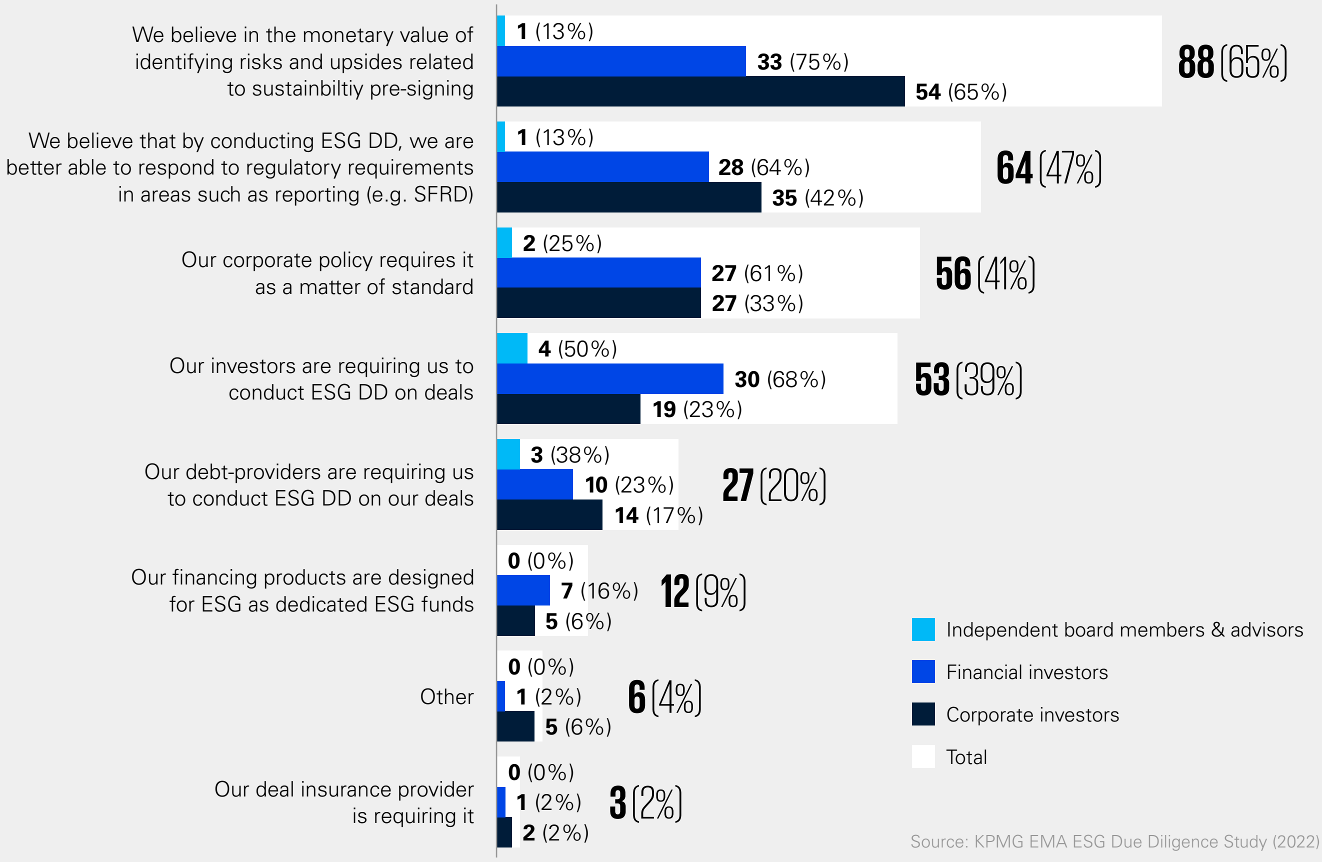
A range of other motivations also play a role in driving demand for ESG DD. Many suggest it can help them better respond to regulatory requirements in areas such as reporting (e.g. SFDR[1]). Others suggest it is a requirement of their internal corporate policies or from investors or debt providers.

Many fund managers also see ESG as a key differentiator with clients. "We see ESG as being of primary importance in fund raising. It helps us distinguish us from other organizations," explained an ESG leader at an infrastructure fund. Such ESG-funds then naturally need to ensure that its investments fall in line with the fund's ESG-related priorities – and ESG DD is a key tool to achieve that outcome.

[1] SFDR refers to the EU's "Sustainable Financial Disclosure Regulation," a landmark legislation related to ESG disclosures of asset managers and other financial market participants, effective since 10 March 2021. For more information, see: What is the SFDR? Sustainable Finance Disclosures - KPMG Ireland (home.kpmg)

Figure 4:

Why have you conducted / are you going to conduct ESG DD on your deals (multiple choice)?



Source: KPMG EMA ESG Due Diligence Study (2022)

02
There are still major challenges to be solved, however

As ESG DD is becoming more common and as dealmakers enhance their maturity around ESG-related issues, several challenges and complexities remain to be solved.

Challenge #1: Agreeing on terminology and scope
First and foremost, the term "ESG Due Diligence" suffers from a similar degree of confusion as the term "ESG" often does on a broader scale beyond just deals. "The term ESG is vast, complicated to define and to fulfill," noted one PE fund sustainability director. Or, as a chief sustainability officer of another PE fund noted: "I do not like the term 'ESG'. I do not discuss 'ESG' matters. I try to find key areas that will have an impact on the company, which naturally cover the 'E', the 'S' and the 'G' – but these are not necessarily labeled as 'ESG'."

In our view, the reason for this confusion lies in the inherent broadness of the term "ESG". The term co-mingles a multitude of distinct topics under each of the respective letters that are quite different in their nature. For example:

- "E" could include topics like greenhouse gas emissions, climate change, biodiversity, soil contamination, water contamination, air pollution, the protection of marine resources, etc.
- "S" brings together topics like living wages, child labor and human rights in the supply chain, diversity and inclusion, data security and privacy, social practices, product labelling, etc.
- "G" relates to topics like anticorruption, business ethics, anticompetitive behavior, responsible tax records, whistleblower mechanisms, etc.

Clearly, not all these topics are equally applicable to all targets and transactions.

To cut through this complexity, mindful upfront scoping is paramount. Yet, this is a step that many investors are struggling with. The survey results indicate that **selecting a meaningful, yet manageable scope is the number one challenge faced by ESG DD practitioners** (see Figure 5).

"The basic problem with ESG DD is understanding what to look at in the first place," admitted one industrial manufacturing M&A leader.

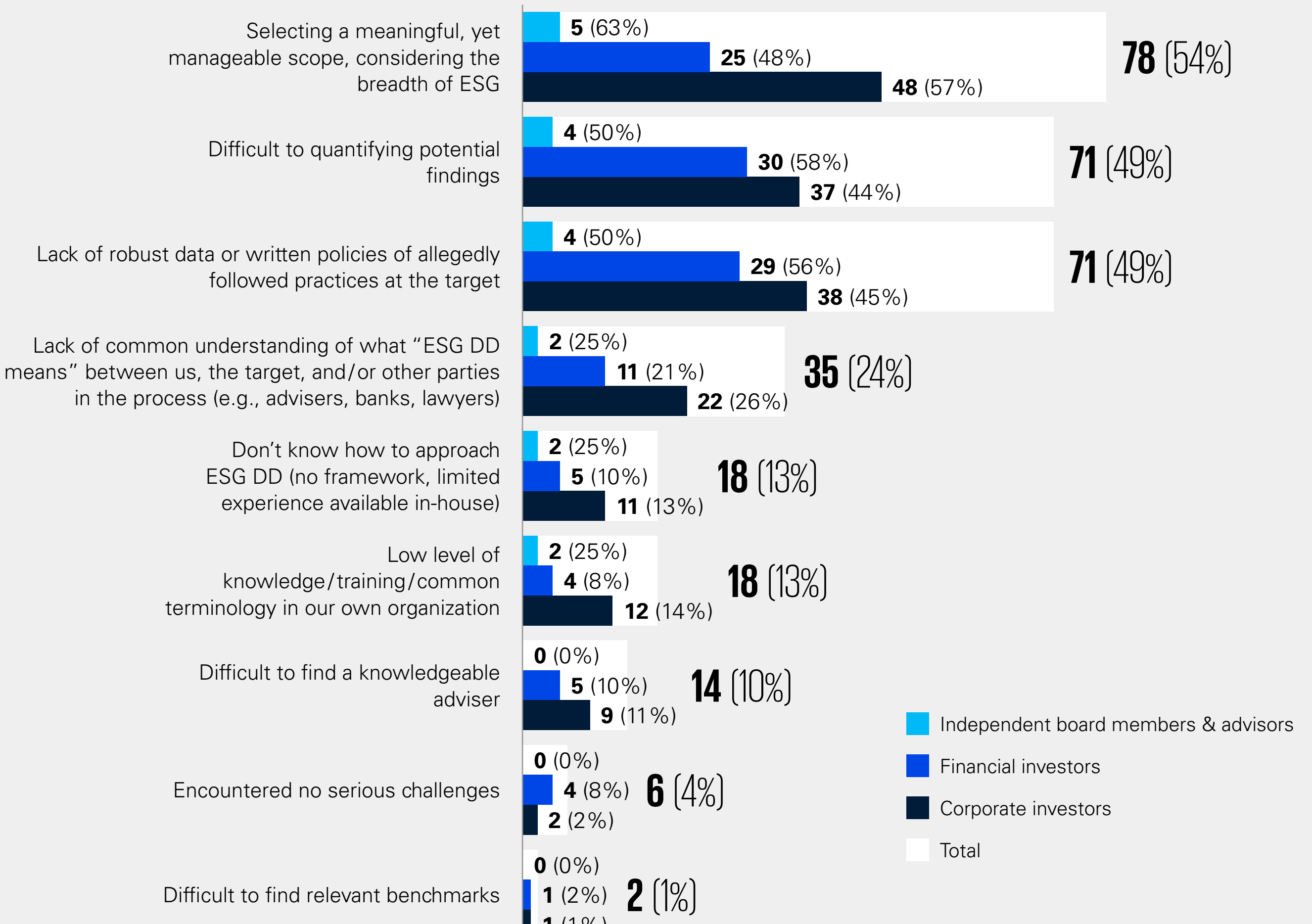
To better understand the depth of this challenge, survey participants were asked to rate a set of twenty potential ESG DD scope items according to: (a) Whether they are important at all and (b) if so, whether they should be included in an ESG DD workstream or in another workstream such as environmental DD, HR DD, tax DD, legal DD, etc. The results (shown in Figure 6) show that:

- While the respondents agreed that all 20 items are important to some degree, there is no clear market consensus on whether they should be part of an ESG DD or not. Specifically, for 16 of the 20 items, only 40-60% or respondents agreed that they should be part of an ESG DD product.
- Some degree of consensus (~70%) can be seen only on three topics:

  - Climate-related matters generally appear to be viewed as belonging in a ESG DD product (e.g. a target's understanding of its climate related-risks, as well as its own carbon footprint and the presence of a credible decarbonization plan)
  - There was similar consensus that issues such as tax transparency and cybersecurity may belong in other workstreams (presumably tax and IT, respectively).

Figure 5:

What are the key challenges you have encountered, or you expect to encounter in conducting ESG DD (multiple choice)?



Source: KPMG EMA ESG Due Diligence Study (2022)

Figure 6:

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

	Important and should be part of ESG DD	Important, but should be part of another DD work stream	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%

Source: KPMG EMA ESG Due Diligence Study (2022)

In KPMG firms' experience a meaningful scope of an ESG DD needs to be defined on a case-by-case basis, considering the sector, size and maturity of the target, as well as the investors' sustainable investment strategy. We will elaborate on this in Chapter 3.

Challenge #2: Securing the right data from the target

Dealmakers say they are **struggling to gather the relevant data and documentation** of allegedly followed ESG practices at a target, making it difficult to assess the relevant areas in a fact-oriented manner (see Figure 5 above).

On a positive note, this situation should be expected to gradually improve in the near future, as many companies are required by regulation to measure and report on many aspects of sustainability in a more standardized and transparent manner[2]. Indeed, as the recent KPMG global Survey of Sustainability Reporting 2022 has shown, sustainability reporting is adopted at fast rates across the globe[3].

However, in the meantime, dealmakers need to find solutions to this challenge. For many, the absence of sufficient data or documentation is a relevant finding in itself, suggesting the existence of potentially undiscoverable risks or an overall lack of ESG maturity of a target.

Additionally, KPMG firms are seeing buy-side practitioners start to become more creative in the way they find and assess target data. For example by:

- Making use of innovative data and analytics tools, such as internet scrapers, which can be used to screen large amounts of external data for ESG-related controversies in connection with a target
- Making use of some of the methods typically applied in other DD workstreams where reliable documentation is rare – for example, Commercial Due Diligence workstreams regularly speak to large numbers of customers, suppliers, or competitors to fact-check alleged characteristics of the target's product or service. The same could be done to sanity-check certain claims of management with regard to ESG; e.g. launching a survey or interview program with (ex-) employees, suppliers, or customers to fact-check whether indeed the target is perceived as having acted as described orally by management
- Where there are gaps in documentation, discuss with management about why these exist and what it would take to close them – in many cases, they exist because a target is still developing on a particular matter, and in certain cases such a gap can turn out to be a potential source of value creation post-closing

At the same time, sell-side advisors should take note. If buyers struggle with proper target documentation, this is an opportunity for sell-side advisors to create additional value by properly documenting (and ideally improving) a target's ESG-related performance in advance of a sales process – an activity that KPMG firms still do not see embedded into standard sell-side vendor assistance services frequently enough.

Challenge #3: Quantification of findings

Even in situations where the scope of the ESG DD is clear and reliable target data is available, **dealmakers often struggle to quantify their findings and assess the financial impact on the deal** (see Figure 5 above).

In large part, this reflects challenges in obtaining readily available, fit-for-purpose benchmarking data. Once again, such data should be expected to become more readily available in the near future due to the increase in public reporting described above. In fact, there is already a dynamic landscape of start-ups focused on addressing this need in the market.

However, in some instances, even if a relevant benchmark can be found and if a target turns out to be "below par" or "above par", it can still be difficult to quantify the potential financial deal impact of such performance on a specific ESG-related factor. As one senior ESG industry practitioner noted: "Let's say I find out that a target company has not been paying up for all its carbon certificates. I can probably quantify the financial risk this may cause. But if I find that the target's management team is somewhat lagging in its diversity and inclusion – what's the financial impact of that on a deal? How much less should you pay for a few percentage points of lower D&I?"

One workaround KPMG firms see applied in practice is to quantify such gaps by estimating the expected costs to bring a target up to the level expected by the investor. Taking the D&I example from above, the investor could consider which particular skills and profiles are missing in the target's management team and how much it would cost to re-shuffle the team accordingly in the post-closing phase.

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[2] For example, EU legislation such as the Corporate Social Responsibility Directive (CSRD) or the EU Taxonomy. For further information on these acts, see Corporate Sustainability Reporting Directive – The CSRD – KPMG Ireland (home.kpmg) and EU Taxonomy disclosures – setting a baseline - KPMG Ireland (home.kpmg)

[3] According to the KPMG Survey of Sustainability Reporting 2022, sustainability reporting rates among the Top 100 companies in terms of revenues across the 58 geographies worldwide have climbed from 64% to 79% in the past decade. For further information see: Big shifts, small steps – KPMG Global (home.kpmg)

03
What does best practice look like?

This survey and KPMG firms' experience highlight seven key actions that the more mature dealmaking teams are taking with the aim of achieving real value from their ESG DD processes.

Action #1: The leaders conduct ESG DD on every transaction

The first recommendation is as basic as it is important: If an investor indeed believes ESG-related factors are a source of either risk or value, then ESG DD should be performed on transactions as a matter of standard.

The survey shows that ESG DD is impactful. For example, consider the responses shown in Figure 7. It shows that **those investors who performed ESG DD more frequently were more likely to say they had unearthed material findings**. Conversely, investors who performed ESG DD less frequently were more likely to say that they hadn't uncovered any material findings – or, perhaps more worryingly – that they didn't know whether they had identified any material findings in the past.

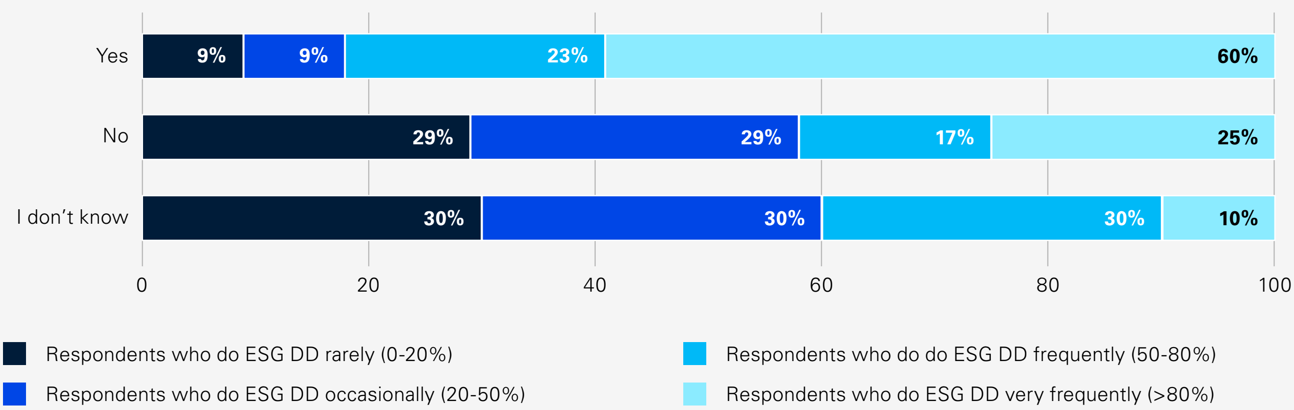
The consequences of these material findings can be significant (see Figure 8). More than half of the respondents suggested some material findings could be a 'deal stopper'. A similarly high share of respondents said that ESG DD findings can result in a need to request an additional representation, warranty or indemnity from the seller, a need to reduce the value of their bid, or a need to change the deal structure, timeline or closing conditions. In other words: ESG-related findings have the potential to derail a deal. Consider the sidebar for a real-life example of a deal derailed by an ESG-related issue.

A case in point...

Consider the example of an industrial manufacturing company in the Nordics where an ESG-related finding resulted in a deal stopper. This company had identified a target in the same industry for a bolt-on acquisition. Since the industry involves significant indirect sales, the investor wanted to put particular focus on the target's business ethics and bribery-related processes and practices as part of their ESG DD. During the DD phase, indications of kickback payments were discovered. Upon making this finding, the investor gave the target an opportunity to improve performance – but when meaningful changes were not effectively made over the next year, the investor walked away from the deal.

Figure 7:

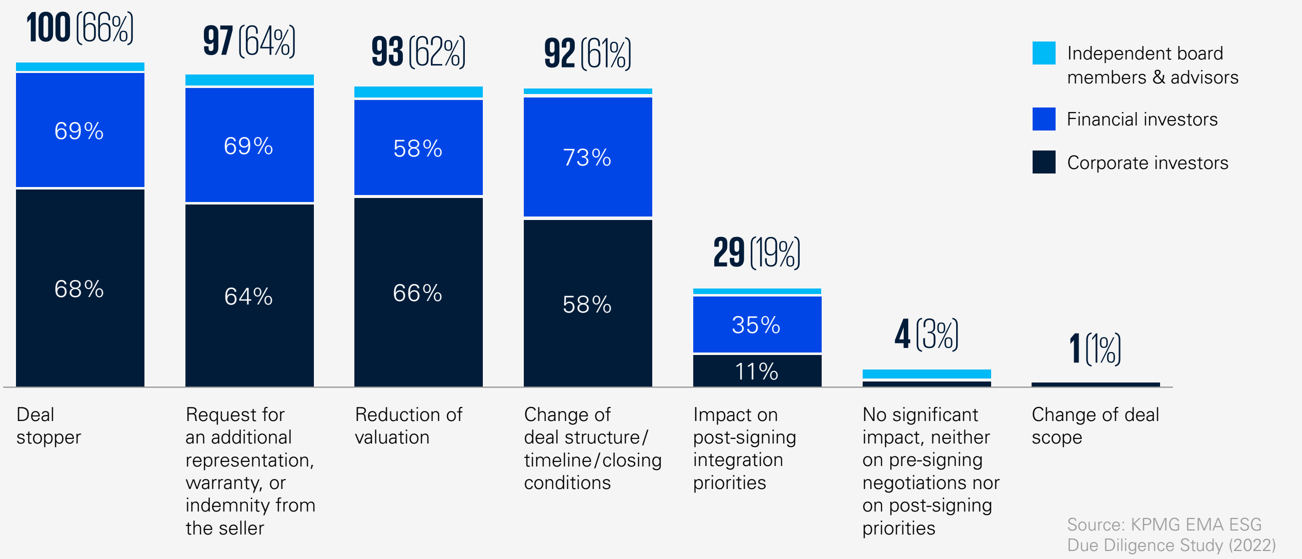
Have you ever had a material finding in an ESG DD that has had a significant deal implication (by frequency of conducting ESG DD)?



Source: KPMG EMA ESG Due Diligence Study (2022)

Figure 8:

What consequences did those material findings have / could such material findings have for you (multiple choice)?



Source: KPMG EMA ESG Due Diligence Study (2022)

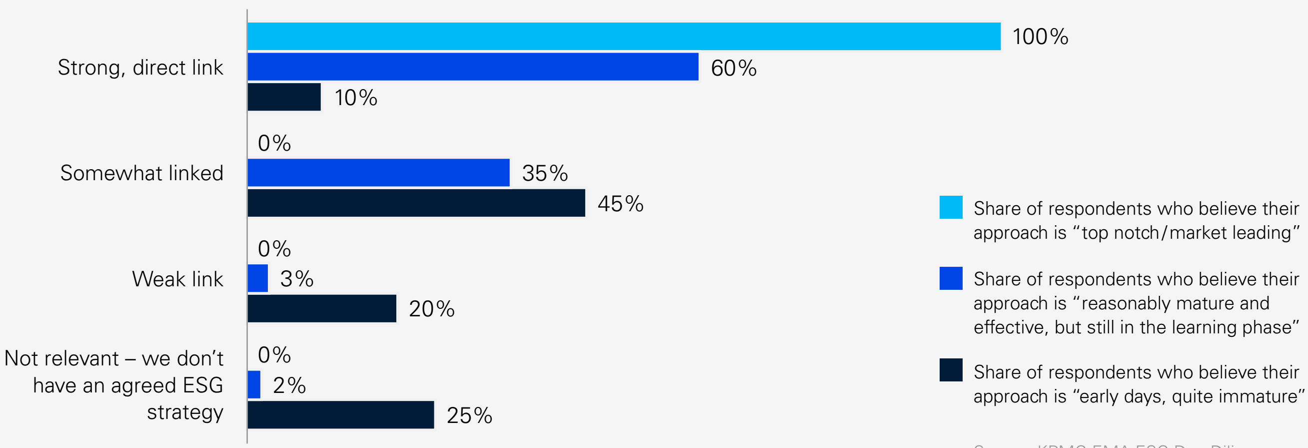
Clearly, the only way to make these consequences actionable is by uncovering ESG-related issues during the pre-signing phase. And this can only happen if systematic ESG DD is performed. Those investors who forego ESG DD processes do so at their own peril.

Action #2: The leaders link their ESG DD approach to the overall corporate ESG strategy

As part of the survey, dealmakers were asked how mature their ESG DD approach is overall. Additionally, they were asked to comment on the strength of the link between their company's overall ESG strategy and their ESG DD approach in deals. The combination of these questions revealed an interesting pattern shown in Figure 9: There is a clear link between the maturity of an organization's ESG DD approach and its alignment to the corporate ESG strategy. **The most mature unanimously say they have strong and direct alignment with the corporate ESG strategy**. Many of the least mature suggest that there is only a weak link or that their organizations don't even have a formal ESG strategy (see Figure 9).

Figure 9:

In your view, how well connected is your pre-signing ESG DD approach to your ESG strategy?



Source: KPMG EMA ESG Due Diligence Study (2022)

This finding is strongly supported by the work of KPMG firms' deal practitioners across the EMA region. If there is no agreed ESG strategy at the corporate level, or if the corporate ESG strategy is not sharp enough – for example, by not clearly differentiating the material sustainability areas, or by not setting a clear ambition – then scoping a meaningful ESG DD is difficult for the responsible M&A departments.

The more mature organizations – financial investors in particular – tend to have a clear view of how their ESG DD aligns to their overall ESG strategy. They assess sectors and subsectors for unique risks and opportunities. "We systematically look at ESG topics based on a checklist. Before the non-binding offer, we cover around 10 different topics that help us scope what needs to be addressed in terms of ESG issues during due diligence," one ESG leader at an infrastructure fund explained.

Corporate investors tend to face a less complex process, as most of them are only active in a small number of adjacent sectors. Nonetheless, going "back to basics" and understanding their overarching ESG strategy and ambition first is equally applicable to corporate investors, as the example in the adjacent sidebar illustrates.

A case in point...

Consider the example of a food & beverage company, whose M&A department was tasked with incorporating ESG considerations into their due diligence procedures. Initially, the team struggled. The topic seemed broad. The number of potential KPIs to be requested from targets was overwhelming. The inability of targets to provide the relevant information was frustrating. So, the M&A team took a step back, sat down with senior leadership and worked with them to identify which areas of sustainability were material to their company overall, and to set their ambition. Today, the team has an agreed, short list of non-negotiable topics that are successfully incorporated into every deal process.

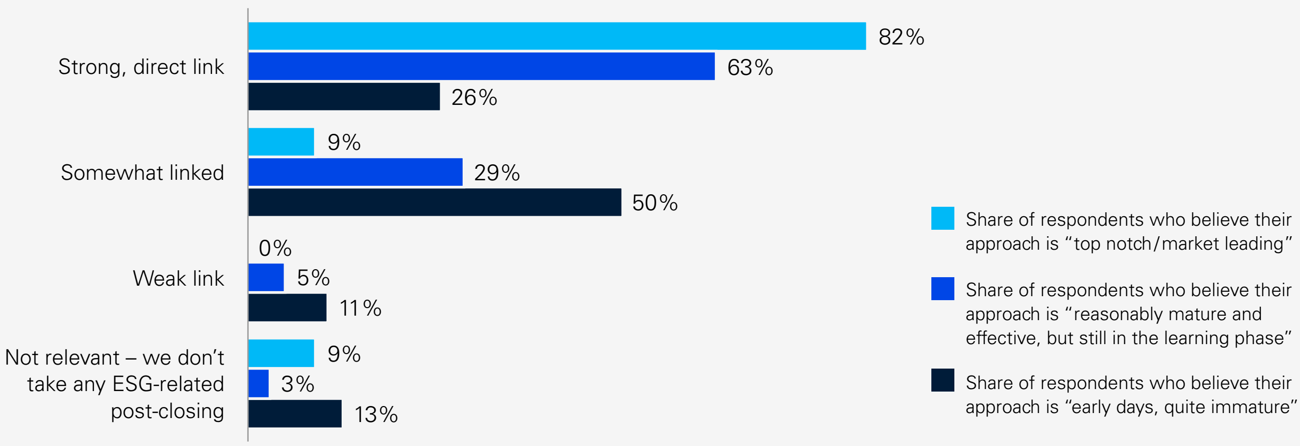
Action #3: The leaders link their ESG DD to clear post-closing actions

Uncovering ESG risks and opportunities during the due diligence process is not the same as managing those risks and opportunities. **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** (see Figure 10).

As one PE fund Sustainability Director noted, "There is a direct link between our findings and the action plan that is put in place right after the closing. We use our findings to drive an 18-month post-closing program in which we assess ESG issues together with the management and create a roadmap around the ESG priorities."

Figure 10:

How well do you make use of the findings of your ESG DD reports to establish a post-closing action plan?



Source: KPMG EMA ESG Due Diligence Study (2022)

Others indicate that their strong link between their ESG DD and their post-closing action plan often allows the team to move forward on deals that might otherwise be seen as too risky. "We recognize that our targets won't be as mature as us on the ESG agenda," said the head of M&A at an industrial manufacturing company. "But we then focus on bringing them up to that level post-closing."

Action #4: The leaders look beyond risks to find value
Avoiding risks is important – but in addition to avoiding risks, **the most mature ESG DD practitioners put significant focus into helping investees tap into ESG-related value creation opportunities** during the post-closing stage (see Figure 11). More than nine-in-ten of the most mature say they focus on the opportunities they uncover during their ESG DD process. Perhaps not surprisingly, more than a quarter of the least mature see no link between their ESG DD and their plans to enhance the value of their investments.

Among some of the more mature investors, ESG-related transformation is a core investment theme, as one Private Equity practitioner explained: "Our main objective is to transform our portfolio companies. Thus, sustainability is approached from a strategic point of view and not from a "tick-the-box" compliance point of view. We work hand-in-hand with the CEOs of our portfolio companies to integrate sustainability in their vision, mission, purpose, DNA and strategy."

Interestingly, the approach taken by the target also says a lot to some investors about the quality of the target's management. As one Private Equity fund leader noted, "If the president or CEO of a company responds to ESG questions from a pure compliance point of view and with conformism, this is a clear red flag for us as investors."

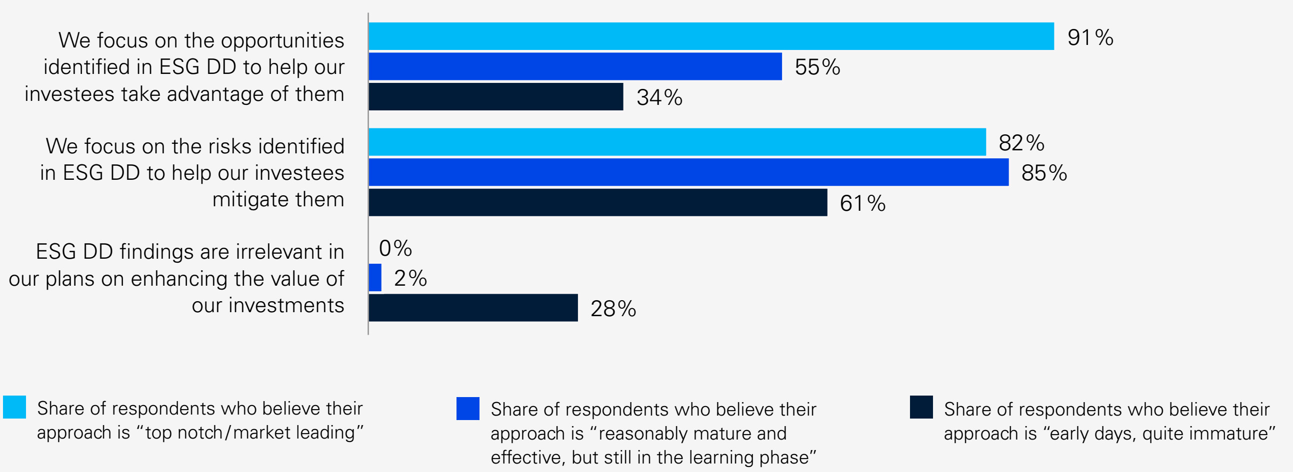
KPMG firms' experience suggests that risk mitigation is clearly important. However, risk mitigation alone tends to be viewed as an immediate cost item. To achieve more financial value from sustainability-related interventions, dealmakers need to follow the lead of the most mature practitioners and embrace the focus on commercial and operational improvement levers related to sustainability.

A case in point...

Consider the example of a Private Equity fund that conducted an ESG DD on a company in the oil and gas sector. As part of the process, they talked with the owner about what it means to be present in the oil and gas sector today, and how the target could potentially reduce their carbon footprint. A few months later, the owner of the company called the fund manager to say that he had signed a partnership with a well-established company to develop their decarbonization plan – a direct result of the ESG DD that the PE fund conducted.

Figure 11:

To what extent are the findings of ESG DD relevant in the value creation plans of your investments?



Source: KPMG EMA ESG Due Diligence Study (2022)

Action #5: The leaders are clearly defining their DD workstreams

Based on the survey data, **there appear to be two distinct operational models of running ESG DD** in the market – the "fragmented" model and the "dedicated workstream" model (see sidebar for a deeper look at both models).

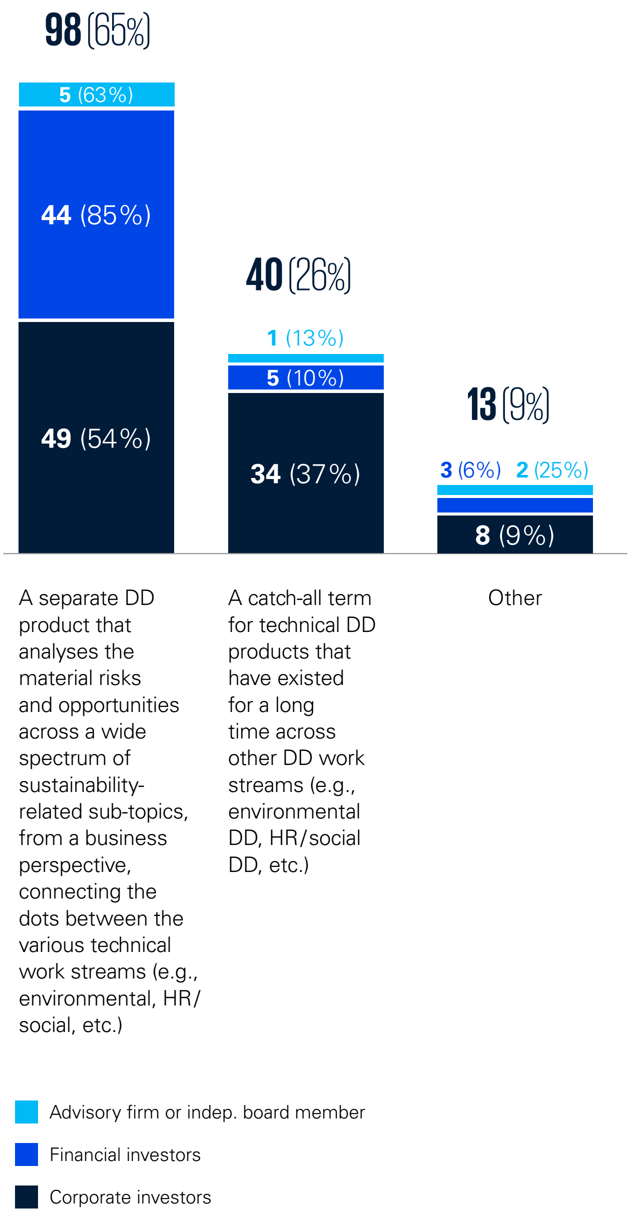
A closer look at ESG DD operational models

Fragmented model: In this model, practitioners define the individual "E", "S" and "G" topics relevant to their transaction and embed these into existing workstreams (such as environmental, legal, HR, etc.), without an overarching ESG DD workstream. Findings flow together at the level of the M&A deal leader but are not necessarily grouped or labelled as ESG DD findings.

Dedicated workstream model: In this model a dedicated workstream is appointed, which defines the relevant "E", "S" and "G" topics and owns them. ESG DD is therefore treated at the same level as other, pre-existing workstreams streams. In some instances, expert inquiries into selected "E", "S", and "G" topics are left with previously existing workstreams if they already were a functioning part of the investors' historical M&A playbook (e.g. soil pollution risks may stay with environmental DD, bribery may stay with legal DD, labor practices may stay with HR DD, etc.), but all ESG-related findings on pre-defined material topics are at least pulled together centrally by the ESG DD workstream in order to create a particular focus on them.

Figure 12:

Which of the following descriptions best fits your understanding of "ESG Due Diligence" in deals?



Source: KPMG EMA ESG Due Diligence Study (2022)

The **dedicated workstream model was most popular among respondents** (see Figure 12). However, there was also a significant minority of proponents of the "fragmented model". Interestingly, the difference between these responses is almost entirely driven by the difference between financial and corporate investors. Among financial investor respondents, the dedicated workstream model was hugely popular, with 85 percent saying they maintain a separate workstream for ESG DD, while amongst corporate investors both models are prevalent.

And dealmakers have good arguments for both of these approaches.

Some proponents of the "fragmented" model argue that it is difficult to put all "E", "S" and "G" topics under one roof. "To us, having a dedicated 'ESG' ad-hoc workstream does not make sense. The topics are just too broad to be covered by one workstream", said one sustainability director of a Private Equity fund. Others argue that for historical reasons, the relevant ESG topics are already well addressed through existing workstreams, as this business development professional at a chemicals company explained: "Our material areas mostly relate to environmental and health & safety topics. They have always been important to us and they have always been covered by an EHS workstream."

While this may be true in many cases, those who follow the fragmented model will need to ensure they aren't missing out on the strategic layer of sustainability. An EHS workstream may, for example, be well versed in assessing a target's compliance with, say, carbon trading schemes. But it may not have the capabilities to assess the viability of and the value creation opportunities in a target's decarbonization plan. A fragmented model also runs the risk of allowing some material ESG issues to fall into obscurity.

Not surprisingly then, proponents of the dedicated workstream model, tend to argue that their approach enhances the focus on the material ESG-related topics. As one deal practitioner at an industrial manufacturer said in our interviews, "In my view, the ESG DD team should be a separate one because otherwise the relevant information would be too scattered. A separate stream allows the relevant dimensions to be investigated with the required focus."

There are also some more nuanced views that suggest a dedicated ESG DD workstream can be complimentary to existing DD workstreams: "We run a separate ESG DD workstream. But there is typically some overlap, particularly between the legal DD and ESG DD workstreams. The legal team is usually focused on gathering documentation to compile a checklist of policies and documentation. They do a "tick-the-box" type of exercise – but they don't really investigate whether such policies are actually implemented," noted a healthcare sector investor. "This is where the ESG DD workstream adds value for us in combination with the existing legal workstream."

In KPMG's view, neither of these approaches is necessarily right or wrong. Ultimately, the right operational set-up will likely depend on multiple factors, including a dealmakers' historically established processes, potential resource constraints and the importance of ESG-related factors in the context of its wider business strategy. The key lesson for investors is to **think explicitly about which of these models suit them best and to manage the potential downsides of either approach accordingly**.

Action #6: The leaders are securing appropriate resources to be effective

The survey suggests the majority of dealmakers are underinvesting in ESG DD relative to other DD workstreams. Indeed, when respondents were asked what they considered an appropriate external advisor budget for ESG DD, the majority returned a figure below EUR50,000 – even on large transactions worth more than EUR1 billion in value.

Given that ESG DD is central to assessing a company's actual value and the broad variety of topics covered under the workstream, it seems that **ESG DD budgets are lagging behind those of other workstreams such as commercial, financial or legal**.

One area where many dealmaking teams often hope to cut costs is in site visits. Site visits tend to require significant time investments from senior experts, as well as travel costs and other costs. However, KPMG firms' experience suggests that site visits can be crucial in the context of ESG DD and are often the only tool available to help dealmakers ensure what they are seeing in the data is borne out in the reality on the ground (see sidebar for an illustrative example).

A case in point…

Consider the example of a member firm client who was looking to acquire a datacenter operator in the US. For this investor, the target's greenhouse gas footprint was a material area they wanted to understand better during ESG DD. Desktop analysis revealed no critical findings – the target seemed to understand its as-is carbon footprint and appeared to be in compliance with the local "cap & trade" carbon credit trading system, which requires companies to own certificates for their carbon emissions. However, upon visiting its site, the investors' ESG DD team did a walkaround of the exterior of the building and noted the presence of diesel generators placed behind the facility, used by the target to bridge the occasional local power outages. These generators had not been mentioned in the documents provided by the target through the virtual data room. Upon enquiry, the ESG DD team noted that the emissions for the generators were not reported, which were significant given their size and that the company had failed to secure the required air permits for the generators, essentially rendering the target non-compliant with local carbon trading regulations and thereby creating a financial risk to the deal. This issue would not have been uncovered without a site visit.

Earlier sections described that ESG DD is a potentially very broad workstream. In addition, its findings can be as significant as de-railing a deal or supporting an investors' ability to pay a significant price premium for a compliant target. In this context, it appears to the authors that ESG DD budgets have not yet caught up with the emerging importance of the topic.

To put it in the words of one Private Equity partner: "ESG is an investment. An investment may or may not have a return. Thus, as any investment, ESG must be managed as such. You have to put in energy, be engaged, allocate experts on the subject (for ESG DD for example) and budget. I am convinced that ESG increases the value of a company."

Action #7: The leaders are continuously improving their approach

KPMG firms' experience shows that the more mature dealmaking teams are constantly seeking to improve their approach to ESG DD. They recognize that the ESG agenda continues to shift and that approaches continue to improve. And **they are looking to other leaders – and outside advisors – to help them identify and capture best practices**.

Interestingly, the data indicates that financial investors tend to be somewhat ahead on the ESG DD maturity curve. For example, financial investors were more likely to say ESG considerations are on their agenda (see

Figure 13), more likely to rate themselves as 'top notch/ market leading' in their approach (see Figure 14), and they reported having performed more ESG DD in the past than corporate investors (see Figure 15).

KPMG professionals asked a number of senior dealmakers – both corporate and financial – why financial investors might be ahead. Many suggest that the EU's Sustainable Finance Disclosure Regulation (SFDR) may

Figure 13:

Are ESG considerations currently on your M&A agenda?

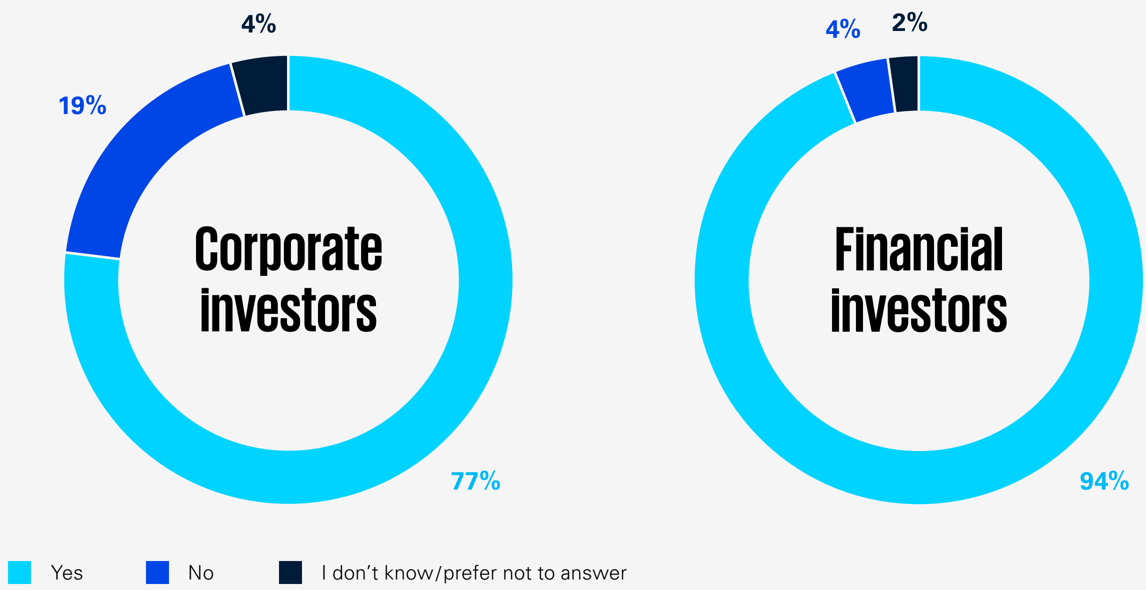
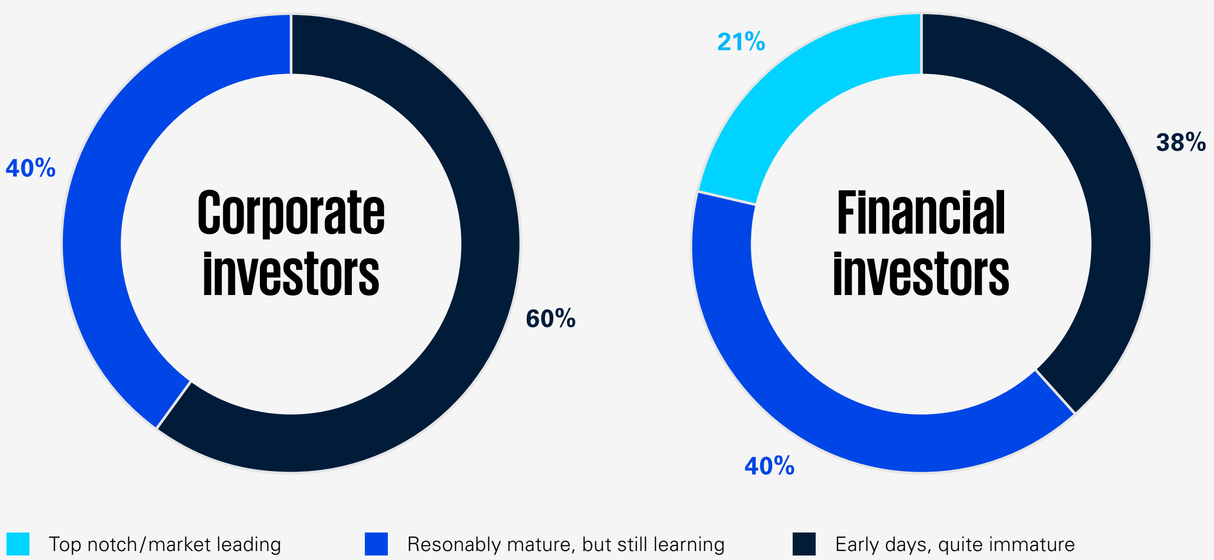


Figure 14

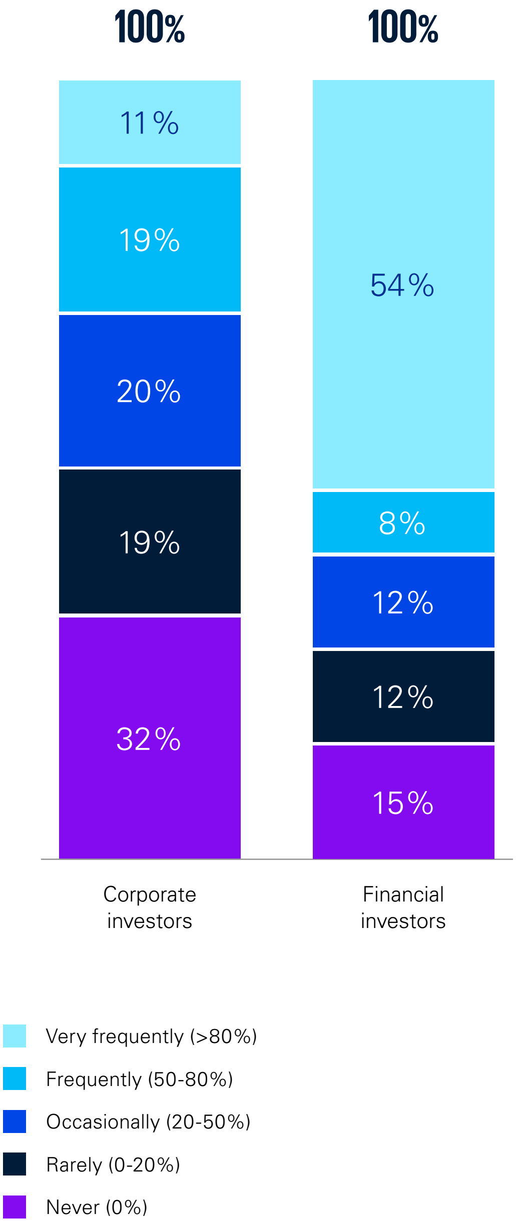
Overall, as how mature would you describe your ESG DD approach?



Source: KPMG EMA ESG Due Diligence Study (2022)

Figure 15:

Historically, for what share of deals did you involve ESG DD?



Source: KPMG EMA ESG Due Diligence Study (2022)

have catalyzed financial investors to start thinking early about how they might position themselves in a world where sustainability is becoming increasingly important. "We really formalized our ESG best practices after 2018 when we saw how ESG was rising up the agenda for German, Nordic and European funds at the time," noted an infrastructure fund leader. "Today, we have gone even further, offering specific SFDR Article 9-branded funds."

Privately, some corporate M&A practitioners acknowledge that their financial peers may currently be more mature in terms of ESG DD. "Although in-house corporate M&A teams don't like to hear it, financial investors are probably ahead of the curve on this," admitted one. "They are professional dealmakers, after all".

04
What should dealmakers do?

Based on the findings described in the preceding sections and KPMG firms' experience in working with leading investors in the market, here are four recommended steps for dealmakers who wish to embed ESG into their due diligence procedures more thoroughly.

Step #1: Establish link to corporate sustainability strategy

As discussed in the preceding chapters, establishing a direct link between your ESG DD approach and your company's overall sustainability strategy is a key step to cut through the complexity of the broad term of "ESG".

If you have not already done so, ask yourself.

- Do we have clarity on our overall corporate sustainability strategy?
- Does it articulate which "E", "S" and "G" areas we consider material?
- Does it say anything about our company's overall sustainability ambition? For example, 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?
- Does our corporate strategy aim to capture the commercial upside potential unlocked by the sustainability revolution? For example, by mandating the creation of new products or services for consumer segments that particularly value sustainability? If so, what does this mean for your M&A approach (e.g. target search, due diligence, integration)?

If your existing corporate sustainability strategy does not answer these questions, insist on that conversation being initiated with your company's leadership.

Once you have answered fundamental questions such as the above together with your leadership team, articulating the most relevant areas for ESG DD will become easier.

Step #2: Develop your framework

Having created alignment with your corporate sustainability strategy, the next step is to develop your blueprint for ESG DD, both in terms of its intellectual framework, as well as from an organizational perspective.

If you have not already done so, ask yourself.

- Have we explicitly defined which sub-areas of ESG we will consider material in the context of transactions? Which ones will we need to monitor in every transaction versus on a case-by-case basis?
- Do we know what we will measure our targets against (e.g. industry peers? Relative level of performance compared to us?). Are there any levels of performance we would consider red lines?
- 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?
- 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?

Step #3: Secure appropriate resources

Make sure you have the appropriate resources, budget and capabilities to ensure your ESG DD delivers on your corporate ESG strategy. Where needed, look for additional support that can also help enhance your own in-house capabilities.

If you have not already done so, ask yourself:

- Who should run an ESG DD workstream?
- Do we have sufficient budget for the additional workstreams and expertise required for ESG DD?
- 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 towards their ESG DD approach and are we lagging?

Step #4: Implement & improve

With a basic framework in place and resources earmarked, the best advice is to just get started. Rather than waiting until you achieve a high level of ESG DD maturity, work with what you have and focus on improving as you learn – even if you still feel the pain of the challenges described in Chapter 2.

Many of the most mature dealmakers in the market have reached their level of maturity through trial and error, by refining and adopting their approach as they went along. Many of them continue to develop their approach further.

If you have not already done so, 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?
- Are there external advisors that can 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?

05
How KPMG can help

As some of the world's leading deal advisory and sustainability service providers, KPMG member firms are at the nexus of the intersection between M&A and ESG. Through their daily work, KPMG professionals are at the forefront of the developments taking place in this rapidly evolving field. They are working with many of the leading corporate and financial investors to identify and develop ESG-related deal strategies and processes that meet their unique needs and objectives.

Leading investors and dealmakers around the world look to KPMG firms to help them:

1

Develop the corporate sustainability strategy:
For investors who do not have a sufficiently sharp corporate sustainability strategy in place, KPMG professionals can help review, develop and sharpen your corporate sustainability strategy. They can help identify which areas should be considered material. They can help align ambition with the strategic context of your sector and overall business strategy. And they can help articulate pathways towards achieving your ambition.

2

Link the M&A strategy to corporate strategy:
For investors who have a sharp corporate sustainability strategy in place but who have not yet explicitly linked it to their M&A strategy, KPMG professionals can help ensure your M&A strategy reflects and aligns to your corporate sustainability strategy. They can help make the linkage stronger. They can help assess acquisitions or divestitures based on sustainability-related criteria. And they can assist investors to articulate the material areas that should be reflected in the deal process.

3

Develop an ESG DD framework:
KPMG professionals can help investors develop their ESG DD framework. For those seeking to include standard ESG DD approaches going forward, KPMG professionals can help identify areas that should be considered material in all transactions and those that will be material on a case-by-case basis. And they can help you consider what operational approach would be most effective for your organization.

4

Perform ESG DD procedures:
KPMG professionals can help investors execute against their framework on live transactions. They can help perform not only ESG DD procedures, but a wide range of different DD workstreams. And they can help enable a seamless integration across the DD environment to maximize value.

How can KPMG help your organization? To find out, please contact your local member firm or any of the authors listed at the back of this publication.

About the study

This report is based on a survey conducted across the EMA region using a two-step process. In the first step, dealmakers completed a standardized online survey. The second step involved additional interviews with selected respondents to dig deeper into the survey results.

A total of 151 valid and complete responses were received in the first step. Ninety-three percent of respondents reported conducting at least one transaction per year ranging from less than EUR10 million to more than EUR1 billion in size. Respondents were split across sub-regions, ownership status and investor type as follows:

By sub-region	No. of responses
DACH	71 (47%)
Benelux	25 (17%)
Southern and Western Europe (Italy, France, Spain)	24 (16%)
U.K. & Ireland	18 (12%)
Middle East, Africa & India[4]	8 (5%)
Nordics	5 (3%)
Total	**151 (100%)**

By ownership status	No. (and share) of responses
Privately held	98 (65% of respondents)
Publicly traded	45 (30% of respondents)
Government owned	8 (5% of respondents)
Total	**151**

By investor type	No. (and share) of responses
Corporate investor	91 (60% of respondents)
Financial investor	52 (34% of respondents)
Independent board members and advisors	8 (5% of respondents)
Total	**151**

To find out more about the survey sample – or to view further breakdowns of the results – please view the interactive dashboard online.

[4] For the purpose of this study, India was a part of the EMA perimeter

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