The structured integration of ESG issues in transaction processes – potential for minimizing risks and creating value

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1. Introduction

Besides international enterprises, investment companies are increasingly becoming aware of the benefit of incorporating sustainability concerns into their business processes. With regard to transactions and investments, this is referred to as the Environmental, Social and Governance (ESG) perspective. By now, many companies in the M&A sector have committed themselves through internal or external policies to complying with certain ESG standards. In this context, the consideration of ESG factors in transaction or investment process stands primarily for improved risk management geared to new market conditions.

Moreover, some investors now see the chance of not only using the ESG perspective for managing risks in a better way, but also to exploit specific potential of optimization and thus to directly enhance the company value. The foundation for this should be a structured and effective ESG management. Practical experience has shown, however, that difficulties may already arise when implementing the commitment to the ESG perspective in operative risk assessment processes.

After a brief introductory chapter on the ESG issue, this article will show that the relevance of the consideration of ESG aspects for investors has significantly increased, especially in recent years. Based on these explanations, we will make suggestions for implementing an effective management approach relating to different scenarios by showing examples of how risks can be reduced and optimisation potential be exploited in a targeted way by implementing ESG management instruments.

2. A tangible concept of ESG

While many players in the M&A market have meanwhile a general idea of what ‘ESG’ stands for, this concept is to a certain extent not quite tangible. In this article, ESG is used as a general term for non-financial aspects which may however have a substantial impact on the company value.¹

The ‘E’ for Environmental relates to environmental pollution or hazards (for soil, air, water, humans), greenhouse gas emissions, energy efficiency issues, water and resources management and natural hazards.

Social (‘S’) comprises aspects like occupational health and safety, internal working conditions and those within the supply chain, diversity, corporate citizenship as well as activities in areas of political or religious conflicts.

The ‘G’ in the acronym ESG stands for Governance, i.e. sustainable corporate management. This includes, amongst others, issues like corporate values, business ethics, relevant management and control processes, reporting transparency and the management of stakeholders.

A key aspect of the ESG perspective is the fact that not only a single company or location is studied, but that all influences on the individual environment are taken into account as well. This environment encompasses both the natural and the social environment of a company, as well as the economic relations along the value-added chain, i.e. suppliers and customers (cf. Figure 1).

¹ For detailed explanations on the ESG concept, also refer to Göbbels/Stubenrauch: Von der Environmental Due Diligence zu einem ganzheitlichen ESG Due Diligence Ansatz. In: M&A REVIEW, Vol. 25, no. 2, 2014, p. 55-60
It is evident that not all ESG aspects have the same relevance for the specific characteristics of different companies. Therefore it is indispensable to identify those company-specific ESG aspects which may have a significant impact on the company value.

2.1 Drivers of an increasing ESG relevance

The relevance of the consideration of ESG aspects results from new social and economic circumstances bringing about a change of risks, but also of potential. Among the important drivers are new market situations with increasing raw material prices and complex supply chains, as well as stricter legislation in all ESG areas. Another trend significantly enhancing the importance of ESG aspects is a changed awareness of stakeholders meanwhile established in the market, such as investors, employees, NGOs and customers placing more stringent demands on companies in terms of environment and social issues, as well as new demands in terms of sustainable governance. Figure 2 shows a synopsis of exemplary drivers of the increasing ESG relevance.

The risks entailed mainly result from the increasing internalisation of external effects (e.g. emissions) which may now have a direct impact on the company value owing to new market situations (EU Directive on industrial emissions).²
2.2 The development of ESG in the investment market

The increased importance of the ESG relevance for investors can be exemplified by the development of the network of Principles of Responsible Investments (PRI). The idea behind this initiative launched by the United Nations in 2006 is a voluntary commitment to integrate ESG factors in investment-related decisions and the management of assets by the signatories of these Principles. Currently, 1,380 investment companies and their contractors representing assets of some EUR51 trillion, have signed the six Principles of Responsible Investments as at April 2015. Especially in the recent past, there is an increasing interest in this initiative. In the past two years alone, the assets under management by PRI signatories have increased by almost 100% (as at April 2013: about EUR25.7 trillion).³ Figure 3 shows an overview of the development of the PRI since 2006 related to the number of signatories and their assets (in USD).

It is remarkable that – comparing the three biggest economies in Europe – the number of PRI signatories in Germany (54 companies) is considerably lower than that in the United Kingdom (194 companies) and in France (134 companies) as at August 2015.⁴

The fact that the consideration of ESG issues is regarded as essential not only by small specialised investors, is revealed by examples of recent date, like the introduction of new investment criteria by the government pension fund of Norway, one of the largest Government funds in the world. They announced in April 2015 that besides the already existing ESG–relevant investment criteria, a so-called climate criterion would be introduced to exclude investments in companies considered as especially large greenhouse gas producers.⁵ This means basically the investor’s exit from the coal industry.⁶

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2 Cf. also KMPG: A New Vision of Value – connecting corporate and societal value creation. KMPG International Cooperative, 2014
4 Cf. www.unpri.org/signatories/signatories/
5 www.regjeringen.no/en/aktuelt/nytt-klimakriterium-for-utelukkelse-av-selskaper/id2405205/
6 www.nytimes.com/2015/06/10/opinion/norway-divests-from-coal.html
It can be stated that the importance of ESG issues respectively their relevance for investors has seen a very dynamic development in the recent past. The assumption on which this development is based, namely that ESG issues have a substantial influence on the company value, is consistent with recent scientific findings. The Harvard Business School has recently published a study saying that there is a positive relationship between a good ESG performance with regard to the material impacts of an investment object and its economic performance.\(^7\)

3. Implementation of a structured ESG management

The foundation of a comprehensive and effective risk assessment and the identification of optimisation potential in transaction and investment processes in terms of ESG issues is a structured management approach. However, a standard tool for implementing ESG risk assessment processes, such as a standard checklist or the like, has not been established so far, which is due to the multitude of aspects contained in ESG, as well as to the variety of industries and their multiple activities.

The key aspect should be in any case a commitment by the management.

3.1 Development of strategic ESG guidelines

In general, a materiality assessment at a strategic level is conducted in a first step to identify the ESG factors which are important for the investor. This should basically be guided by the requirements of stakeholders or by generally applicable characteristics of present or planned investment objects. Therefore, stakeholders like investors and investment staff respectively investees, should be involved in this process. Guidelines like the PRI or the Global Reporting Initiative (GRI) can provide guidance to identify key ESG issues.\(^8\)

The identification of key factors is followed by the determination of ESG-related investment criteria or targets.

3.2 Implementation of ESG guidelines in transaction or investment processes

Practical experience has shown that the implementation of an ESG-relevant commitment may initially involve some difficulties. This is often due to an insufficient awareness at the operative level, missing interdisciplinary expertise on certain non-financial issues as well as allegedly hardly measurable ESG factors. However, there is a number of investors who have already established an extensive ESG management in their investment strategy thereby taking on the role of trailblazers in this issue. It is therefore possible to distinguish different degrees of maturity in the market which are explained in the following scenarios (cf. Fig. 4).

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\(^8\) www.globalreporting.org/standards/g4/Pages/default.aspx
(1) Scenario 1: ESG guideline has been implemented, but has not yet been effectively implemented

This scenario reflects a relatively low degree of maturity with regard to structured ESG management. The relevance of the consideration of ESG issues has been recognised at strategic level and the pertaining commitments have been declared.

The implementation of such strategic guidelines, i.e. the development and application of certain identification and assessment mechanisms requires primarily awareness for the relevance of ESG also at operative level. Hence, it is necessary to impart this awareness down to analyst level by means of communication and training and to underline the benefit of ESG management.

The implementation as such should take part in a defined process. This process can comprise a further detailed materiality analysis to identify the material ESG aspects for individual investment or transaction objects in order to determine the main risk areas. A useful tool for this purpose are the KPIs for ESG 3.0\(^9\) published by the European Federation of Financial Analysts Societies (EFFAS) containing sector-specific ESG indicators for 114 sectors, subdivided into ten categories according to Stoxx Industry Classification Benchmarks\(^{10}\), or ESG-related company ratings.\(^{11}\) Even if the investment object as such is not listed in the respective rating, the information on other companies can be used to judge which ESG aspects are to be considered in a specific sector.

The materiality analysis should be aimed at determining the specific ESG-relevant investment criteria applicable to the object in question in order to conduct a targeted and efficient risk assessment. The information on and KPI’s of the individual investment objects needed to this end are already available in many cases. Examples for such information and ratios are shown in Figure 5.

It goes without saying that empirical expertise and specific knowledge play a major part in selecting and assessing the individual ESG issues which are essential for an investment object. Some – mainly large – investment companies have made internal resources and teams available to provide the required interdisciplinary expertise. In case of insufficient internal know-how, lack of resources or particular issues, external consultants can be involved in the ESG assessment process.

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\(^{9}\) Cf. www.effas-esg.com/

\(^{10}\) The Stoxx Industry Classification Benchmark divides companies into 10 ‘industries’, 19 so-called ‘supersectors’ and 114 ‘subsectors’. The ten ‘industries’ are Oil&Gas, Basic Materials, Industrials, Consumer Goods, Health Care, Consumer Services, Telecommunication, Utilities, Financials and Technology

\(^{11}\) Cf. www.oekom-research.com or www.sustainability.com/
Some transaction advising firms have adapted themselves to the changed needs of investors and extended their classic business areas by relevant ESG issues.

Environmental due diligence advisors who are traditionally dealing with issues like soil and groundwater contamination, EHS compliance or building contaminants observe an increasing demand for extended individual services in the market. In other words, apart from these rather traditional topics, other issues are now coming into focus associated, for instance, with the perspective dependence of companies on fossil fuels, the ability to adapt to environment-related management and reporting systems or energy efficiency aspects as well as biodiversity. Experience has also shown that the interdisciplinary expertise is increasingly asked for already in the phase of identifying key ESG aspects as described above.

(2) Scenario 2: Existing ESG assessment mechanisms are not optimally used

This scenario refers to companies where the management of ESG issues in investment and transaction processes is already in place. They use a process for the risk assessment of ESG factors in form of an ESG due diligence which is considered when taking decisions on certain transactions.

Looking at the lifecycle of an investment, the ESG factors are considered as an adapted risk management geared to new market conditions. This takes place mainly in the ‘pre-deal’ phase, respectively during the acquisition of a target.

If the relevant mechanisms for assessing ESG issues and the pertaining know-how have already been implemented, however, it may be considered to use them also in the following phases of the lifecycle of an investment object, and to use a structured ESG management at investor respectively management level also for exploiting potential of value enhancement during the holding phase.

The individual value enhancement potential varies, yet it depends both on the characteristics of the investment object and the investment strategy. It is advisable to focus on the key ESG aspects having a material influence on the company value so as to achieve an optimum value enhancement effect.
Figure 6 shows selected examples for ESG-related value drivers and the potential cost-relevant benefit resulting from them.

Among the benefits which may have an indirect positive impact on costs, are, amongst others, improved employee motivation, good relations to certain stakeholders like authorities or non-government organisations as well as long-term customer retention.

In some investment companies, implemented structured ESG management tools can also be used to introduce selected ESG benchmarking processes in their respective investment portfolio. That way, best practices of individual investment objects can be identified, for instance, concerning issues like energy efficiency, the organisation of hazardous substances and supplier management, but also employee retention or corporate citizenship, internal control mechanisms or reporting systems. This may bring about substantial synergy effects for other assets, which in its turn leads to a more efficient use of value levers.

Practical experience shows that especially small and medium-sized companies hold optimisation potential in terms of their ESG performance.

(3) Scenario 3: Complete integration of ESG into the business model

An especially high degree of maturity with regard to the consideration of the ESG perspective is reflected by the complete integration of ESG management into the business model. Such investment model takes the correlation between a good ESG performance and a rising company value as given and regards this as the primary basis for an individual investment strategy. The comprehensive consideration of ESG issues also holds potential competitive advantages because information is utilized which competitors do not or only insufficiently include in their M&A processes when taking decisions.12

There are various possibilities to incorporate a mature ESG management system into the investment strategy. On the one hand, investors and investment companies can invest in selected companies where essential ESG issues are not yet implemented in an optimum way and this fact is reflected in the purchasing or price negotiations. By focussing on the improvement of ESG aspects in the holding phase, business-relevant risks can be reduced and – as described in the preceding passage – further value drivers can be activated, thus enhancing the company value.

Where a long-term investment is intended, it is advisable to focus on those companies which – compared with competitors – have an especially good performance in terms of their key ESG aspects and keep them on a high level.

In any case it is essential with a high degree of maturity to apply a structured ESG management along the entire lifecycle of an investment, from the pre-deal phase down to the exit phase.

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4. Summary and conclusion

Overall it can be said that the relevance of the consideration of ESG issues by investors has markedly increased in the recent past. However, Germany seems to have a certain need to catch up with the other European countries when it comes to the strategic implementation of ESG aspects. Yet the awareness of the benefit of considering the ESG perspective with a view to improved risk management keeps spreading in the M&A sector so that this area is in for a dynamic development in future.

Practical experience has shown that the effective implementation and application of a structured ESG management approach may involve difficulties, e.g. due to insufficient awareness or missing interdisciplinary expertise. A standardised generally applicable ESG assessment concept has not yet been established. However, there is a number of instruments, guidelines and service providers offering good assistance with the operationalisation of ESG management.

Moreover, there are already some investment companies in the market which have recognised the relevance of ESG aspects for investments early on and which already have an effective ESG management system in place. In the next step, these companies endeavour to derive targeted optimization potential from this perspective and to enhance the investment value by applying the ESG perspective along the entire lifecycle of the investment objects.

In specialised companies, the degree of maturity of the ESG management approach has advanced to the point that it provides the primary orientation for the investment strategy. This extent of integration of the ESG approach is certainly not convincing or feasible for every company in the M&A market.

It must be stated, though, that any company may well use existing instruments and guidelines, as well as established approaches and empirical values provided by ‘ESG forerunners’ to attain its individually appropriate degree of maturity of a structured ESG management approach, thus living up to changed market conditions. In this context, a risk management system geared to ESG issues should be the minimum standard.

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