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ESG – a Value Adding Driver

Impact on the Mergers and Acquisitions Market

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Thesis abstract

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This bachelor thesis deals with the topics ESG and M&A. The purpose of the empirical analysis is to support and underline the theoretical part of this work and grant new insights from the real economy. The goal is to identify what impact ESG has on the M&A market and how ESG can create value for companies. To do so, research, on the basis of current literature, is conducted.

The research and empirical analysis have shown, that ESG impacts the M&A market in three core areas. Decision-making-, due diligence- and valuation process. Also, multiple factors how ESG can create value have been identified throughout the thesis, illustrating the significance of the topic for a company's valuation.

[1] Keywords: ESG, M&A, Value Adding, Impact.

ESG – a Value Adding Driver

Impact on the Mergers & Acquisitions Market

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Abstract

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1. Introduction

The world is in a state of flux, resources are becoming scarcer, the climate is changing, and environmental hazards are on the rise. Thus, sustainability has become immensely important to preserve the world for future generations. This is where the term ESG comes into play. The acronym is being used more and more as a synonym for sustainable practices in business. These three letters describe three sustainability-related areas of corporate responsibility - Environmental, Social, and Governance.[2] In other words, the voluntary contribution of the economy to sustainable development that goes beyond already existing legal requirements.

ESG has had a huge impact on the economy and individual market players lately. Not only did ESG-products spike in the asset-management sector, but also the demand for ESG-consulting/advisory, as the regulatory environment became increasingly complex and cluttered (EU-Taxonomy, EU Green Deal, Corporate Sustainability Reporting Directive). Observations of the past years show that the topic of ESG has taken a massive influence on the M&A market and already captured a key success position in M&A transactions today. Financial investors no longer buy a target that has a weak sustainability positioning.[3] There is particular ESG-due diligence that is now routinely performed by almost every investor as standard. According to polls, 94 percent of all institutional investors undertake analyses of sustainability aspects during pre-transaction reviews. After doing their due diligence, 30 percent decide to change their investment decision. It is also interesting that 54 percent of institutional participants lower their target price offers depending on the findings of their sustainability evaluations.[4] ESG, therefore, becomes a value driver as a result and those who are not yet well-positioned in this area are delighted to purchase a target with higher sustainability standards in order to strengthen the balance sheet of their own group.[5]

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[2] cf. Erchinger, R., Koch, R., Schlemminger, R., 2022, p. 8.
[3] cf. Mellert, C., 2022.
[4] cf. Wendt, K., 2016, p. 116.
[5] cf. Dr. Tucher, M., 2022.

This thesis intends to get a better understanding of the topics ESG and M&A, followed by a theoretical and empirical analysis on how ESG influences the M&A market and in what way ESG can create value for companies.

2. Theoretical Background to the Megatrend ESG

For more than ten years, sustainability has grown into something called a megatrend.[6] Supported by a growing sense of environmental awareness and responsibility among people, a new ethic has developed over the years based on the pillars of economy, ecology, and ethics, that now influences our entire everyday lives.[7]

The aim of this chapter is to develop a fundamental understanding of ESG.

2.1 Terminology & Key Concept of ESG

2.1.1 Terminology

From a literature point of view, ESG represents sustainable corporate actions, which have been the subject of numerous publications since the early 2000s. Accordingly, the landscape of definitions and conceptualizations has become very broad. This thesis will stick to the definition made by Deloitte Global. "ESG stands for Environmental, Social, and Governance. These are called pillars in ESG-frameworks and represent the 3 main topic areas that companies are expected to report in. The goal of ESG is to capture all the non-financial risks and opportunities inherent to a company's day-to-day activities."[8] To be precise, Environmental metrics instantiate to what degree a company is sustainable, Social criteria ascertain the level of equality, treatment of employees, customers, and suppliers, and Governance pertains corporate areas in the manner of bribery, terrorism financing, corruption, and pay-gap.[9] At this point, it is important to distinguish between ESG and sustainability. ESG refers to the review of Environmental, Social, and Governance factors of companies to assess the risk and return opportunities of investment decisions. Sustainability, on the other hand, refers to the ability to meet the needs of the present without compromising the ability of future generations to meet their own needs.[10]

[6] Megatrend: trend leading to major changes.
[7] cf. McKinsey Global Institute, 2020.
[8] cf. Deloitte (1), 2021.
[9] cf. Yonghyup, O., 2019, p. 17.
[10] cf. Courtnell, J., 2022.

2.1.2 Key Concept

Since the market for ESG is still nascent and in constant upheaval, there are many derivations and not yet enough significant long-term studies to be able to conceptualize ESG once and for all. A commonly used visualization of the ESG-factors can be seen in Table 1.

Table 1 - ESG-conceptualization[11]

Environment	Social	Governance
- Climate Change	- Working Conditions	- Fair Tax Strategy
- Greenhouse Gas	- Health & Safety	- Executive pay
- Waste & Pollution	- Local Communities	- Bribery & Corruption
- Deforestation	- Diversity	- Employee Pay
- Resource Depletion	- Employee Relations	- Board Diversity

The Environment pillar serves as an indicator of a company's resource use, such as whether a company uses virgin or recycled materials in its production processes and how a company ensures that as many of the materials in its product as possible are returned to the economic cycle from cradle to grave instead of ending up as waste. Companies are also required to be sparing with water. Land use issues such as deforestation and biodiversity disclosure also fall under the environmental pillar, forcing enterprises to drive sustainable innovation and the use of renewable resources. Companies also report positive sustainability impacts that can translate into long-term business benefits (e.g., Apple managed to innovate their operations to carbon dioxide neutrality[12]).[13] In the Social pillar, companies report on how they rule employee development and labor practices, with regard to diversity and working conditions. In relation to the safety and quality of the company's products, they are obliged to report on product liability. Additionally, they provide information on labor, health, and safety standards in their supply chain, as well as controversial procurement

[11] cf. Reformis, 2022.
[12] cf. Apple, 2021.
[13] cf. Deloitte (1), 2021.

practices. Whenever possible, companies are also expected to report on how they provide their products and services to underprivileged social groups.[14] A few of the main topics covered under the Governance pillar include shareholder rights, diversity in the board of directors, and executive compensation in relation to sustainability performance. This also includes corporate conduct issues such as anti-competitive practices and corruption.[15]

2.2 Development & Drivers of ESG

Sustainable and social development is becoming more and more important in response to the increasing depletion of the earth's natural resources, environmental degradation, and climate change. Environmental awareness is turning from an individual lifestyle into a social movement. Sustainability from a consumer trend to an economic factor. And the climate crisis will become the basis for a new global identity.[16] Many investment companies, banks, insurance companies, and private individuals now increasingly use products that take into account Environmental, Social, and Governance (ESG) criteria in addition to financial ratio analyses. The development of sustainable products can also be seen in Figure 1 below.[17]

Five drivers chiefly in the risk landscape of companies are putting them under increased pressure to systematically address environmental and social risks:

a) Increasing relevance of environmental and social risks
b) Changing perceptions and expectations
c) Increasing transparency
d) New and stricter minimum regulations
e) Advances in business practices

ESG will shape the coming decade more than any other megatrend. A new-age spirit that has spent many years making its way from the niche into the mainstream is now anchored in the collective consciousness. It is giving rise

[14] cf. Yonghyup, O., 2019, p. 17.
[15] cf. Taticchi, P., Carbone, P., Albino, V., 2013, p. 20.
[16] cf. Erchinger, R., Koch, R., Schlemminger, R., 2022, p. 1.
[17] cf. Wendt, K., 2016, p. 118.

to new market logics and new customer needs, disrupting business models and transforming the economic system.[18]

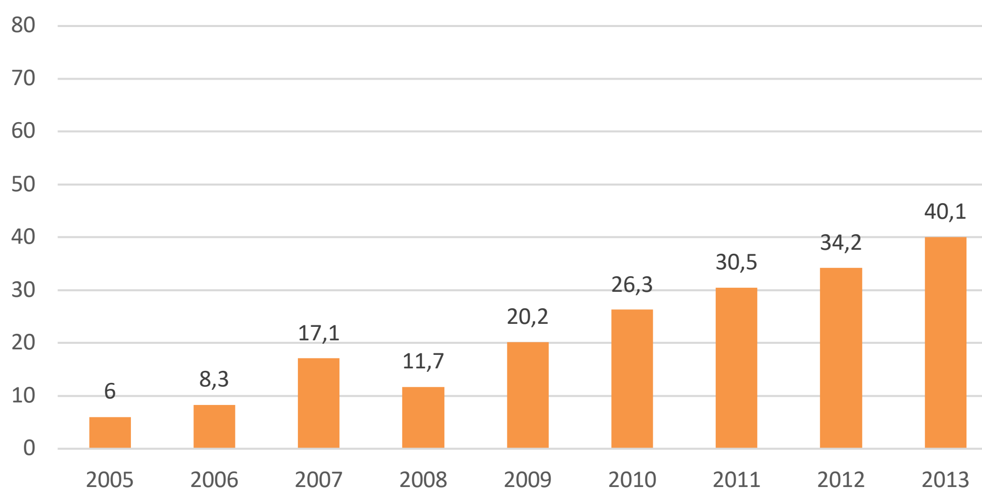

Figure 1 – ESG-investment fonds in billion EUR[19]

2.3 ESG-Reporting

Proper and thorough ESG-reporting has become a major task and challenge for companies. This is not only due to new regulatory requirements (e.g. EU-Taxonomy or Corporate Sustainability Reporting Directive), but mainly due to the (as in the previous chapter discussed) increased demands of customers and the capital market for ESG-compliance.[20]

To help companies report on their ESG-performance in a consistent and accurate set of data, frameworks that help them manage their ESG-commitments have been created and launched by various stakeholders, such as non-governmental organizations (NGOs), stock exchanges, think tanks, and governments. These organizations serve as a bridge between businesses and other ESG-stakeholders like investors and the general public, by representing the ecosystem's creators and regulators. The most eminent frameworks are Sustainalytics, Climate Disclosure Standards Board (CDSB), Dow Jones Sustainability Indices (DJSI), GRESB, International Organization for Standards (ISO),

[18] cf. Wendt, K., 2016, p. 450.
[19] cf. Wendt, K., 2016, p. 118.
[20] cf. Deloitte (2), 2022.

International Sustainability Standards Board (ISSB), and United Nations Sustainable Development Goals (UN SDGs). It is important to note here that depending on the sector, type of business, and location, ESG-reporting's legal position varies, which leads to big discrepancies in ESG-reporting between industries, furthering the issue’s complexity. The GRESB-framework for example, focuses on ESG-criteria within the Real-Estate market only.[21]

Since it is very time-consuming and difficult for investors to analyze a company according to ESG-standards, rating-agencies have specialized in creating ESG-scores for companies. They use their own criteria to assess an organization's ESG-performance and may differ from provider to provider. The most prominent rating-agencies are Bloomberg, Thomson Reuters, Sustainalytics, MSCI, S&P Global, and FTSE Russell’s.[22]

[21] cf. Quantive, 2022.
[22] cf. Moro-Visconti, R., 2022, p. 309 f.

3. Theoretical Background to Mergers & Acquisitions

In this chapter, the theoretical foundations of M&A will be exemplified. To start with, the term M&A is defined, and the various forms of M&A are distinguished from one another. The schematic representation of the course of an M&A transaction and the subsequent presentation of possible motives make a significant contribution to understanding.

3.1 Terminology and Different Types of M&A

In the following subchapter, the basic terminology is first distinguished from each other, and then the different forms of M&A are presented.

3.1.1 Terminology of M&A

The Anglo-American term "Mergers and Acquisitions" has not yet been defined in the literature.[23] Essentially, the term M&A covers the acquisition, merger, or sale of ownership interests in a company, or parts of a company, on the basis of a strategic motivation that involves a change in the ownership structure of the companies concerned, as well as a transfer of performance, control, and disposal rights.[24] Other authors also include alliances, co-operations, joint ventures, corporate successions, management buy-outs and buy-ins, and transformations of the ownership structure as M&A activities.[25] In this thesis, however, we follow the narrower definition of Meckl and Weusthoff, according to which M&A, as opposed to other forms of cooperation, always involves a fundamental change in ownership.[26]

3.1.2 Different Types of M&A

As for their form, M&A projects can be divided into share and asset deals. In a share deal, the shareholder transfers his interest in the corporation to a purchaser who becomes the new shareholder of the corporation (see Figure 2).[27] A distinction within a share deal can also be made between friendly and hostile

[23] cf. Wirtz, B., 2012, p. 10.
[24] cf. Lucks, K., Meckl, R., 2015, p. 5.
[25] cf. Haarman, W., Wildberger, J., 2006, p. 200.
[26] cf. Meckl, R., Weusthoff, 2008, p. 578 f.
[27] cf. Brealey, R., Myers, S., Allen, F., 2008.

takeovers based on the target's management's attitude toward the takeover. A friendly takeover is one in which there is agreement between the buyer and seller. A hostile takeover on the other hand is one in which the buyer acquires a majority through share purchases without the consent of the target company to be acquired. A friendly takeover thus means the acquisition of a company with the consent of its board of directors and employees. Such a friendly takeover can bring advantages for investors, as in this case the management and supervisory boards can often negotiate a significantly better price than the current share price would bring in the event of a possible sale.[28]

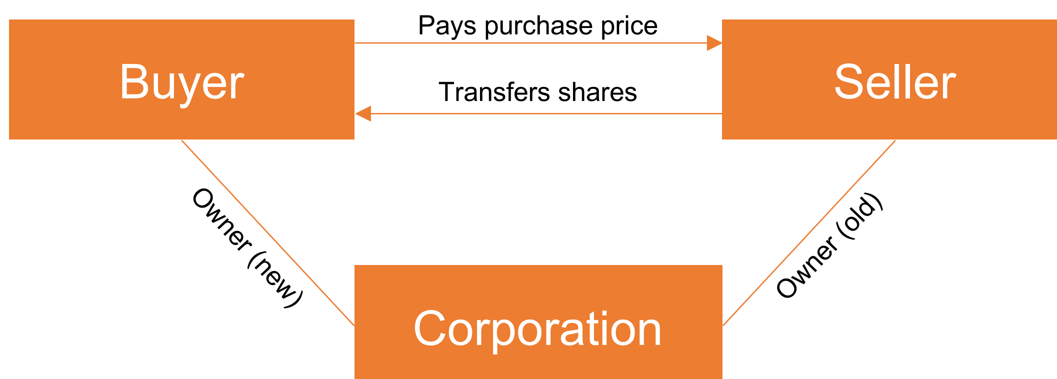

Figure 2 - Share deal[29]

Often, a transfer of the business shares is not desired or not possible due to the legal form of the company. This may be the case, for example, if a dependent business unit is to be sold or the company operates as a sole proprietorship. In these cases, for obvious reasons, no business shares are for sale, but only the tangible and intangible assets of the company. The sale in the context of an asset deal, therefore, concerns the assets and intangible assets of the target company such as the customer base, goodwill, know-how and others (see Figure 3).[30]

[28] cf. Wässa, G., 2017.
[29] cf. Wässa, G., 2017.
[30] cf. Brealey, R., Myers, S., Allen, F., 2008.

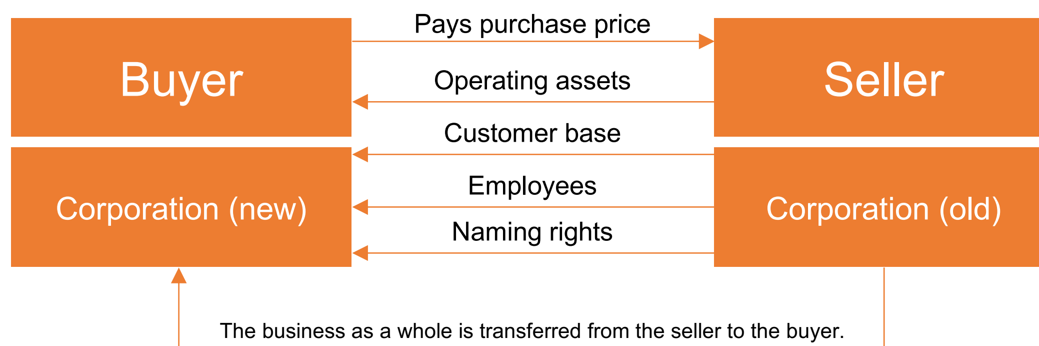

Figure 3 - Asset deal[31]

Furthermore, acquisitions can be classified according to their direction in the value chain (see Figure 4). In horizontal M&A, the acquiring and target companies are on the same production or trading level. Consequently, they are in the same industry, manufacture very similar products or are represented in the same markets and in direct competition with each other.[32] Horizontal acquisitions, therefore, lead to an increase in market concentration, which can change the competitive situation (monopoly formation). Due to the similarities in the product range, it is in many cases easier for the acquiring companies to realize synergy effects in the instance of a horizontal acquisition. Economies of scale and scope can be tapped by expanding the production or supply volume and sharing facilities and distribution sites as well as integrating procurement and distribution channels in the target country[33]. However, differentiated strategic coordination between the new parts of the company is necessary to avoid a competitive situation with regard to products and to create a coherent joint portfolio.[34]

A vertical M&A project is when companies at different levels of the value chain merge, for example, a manufacturing company and a sales company. In some cases, this results in a link between the seller and the customer at adjacent stages of the value chain.[35] This creates new procurement, production, or sales channels. Due to the renouncement of a profit markup with the exchange of

[31] cf. Wässa, G., 2017.
[32] cf. Papprottka, S., 1996, p. 11.
[33] cf. Berk, J., DeMarzo, P., 2013.
[34] cf. Lucks, K., Meckl, R., 2022, p. 25.
[35] cf. Kenton, W., 2022.

preliminary and final products between the integrated enterprise parts cost savings and thus competitive advantages can be realized. By linking up with distribution companies, manufacturing companies open up new sales opportunities and a new distribution infrastructure. Sales companies, on the other hand, gain access to low-priced intermediate products via new procurement channels. Nevertheless, due to the coverage of several stages of the value chain, vertical co-operations may result in additional transaction and organizational costs.[36]

A merger as a conglomerate is about the bundling of different products into one single hand. Companies merge that are neither in the same industry nor use the same distribution channels. This would be the case, for example, if a car manufacturer merged with a construction company. Sales channels and products are not comparable[37]. The result is a conglomerate. Merging the two companies increases the variety of products and overhead costs can be spread across more products. Despite that, the development of a symbiotic relationship between the business units is made more difficult due to the different natures of the partners.[38]

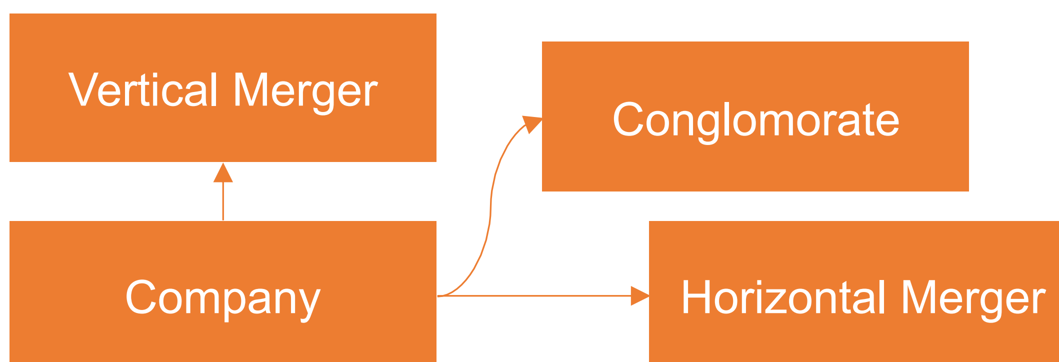

Figure 4 - Types of mergers[39]

3.2 The M&A Process Flow

The M&A transaction process is a complicated procedure with many miscellaneous stages and various factors that must be considered. As a result, efficient

[36] cf. Amadeo, K., 2022.
[37] cf. Berk, J., DeMarzo, P., 2013.
[38] cf. Lucks, K., Meckl, R., 2022, p. 25.
[39] Adapted from: Wässa, G., 2017.

and professional deal management is a decisive factor in the success or failure of a transaction. Efficient deal management helps to shorten transaction times, optimize workflows, and save transaction costs. Accordingly, for prosperous M&A it is vital to have a strategy for each acquisition stage.[40]

As for ESG and M&A, there is no clear definition in the literature of how a standardized M&A transaction process should look like. Depending on the interpretation the process can be divided into five sections. Analysis, Search, Assessment, Decision, and Integration phase[41]. This subdivision focuses strongly on the acquisition process and less on the integration after the purchase. A more commonly used interpretation can be seen in Figure 4. This model assumes three phases of the M&A process. Planning, Transaction, and Integration phase.[42] In this classification, which is usual in practice, the integration process in the integration phase (also known as the post-merger phase) is given significantly more weight.[43] It will also be adopted in this thesis.

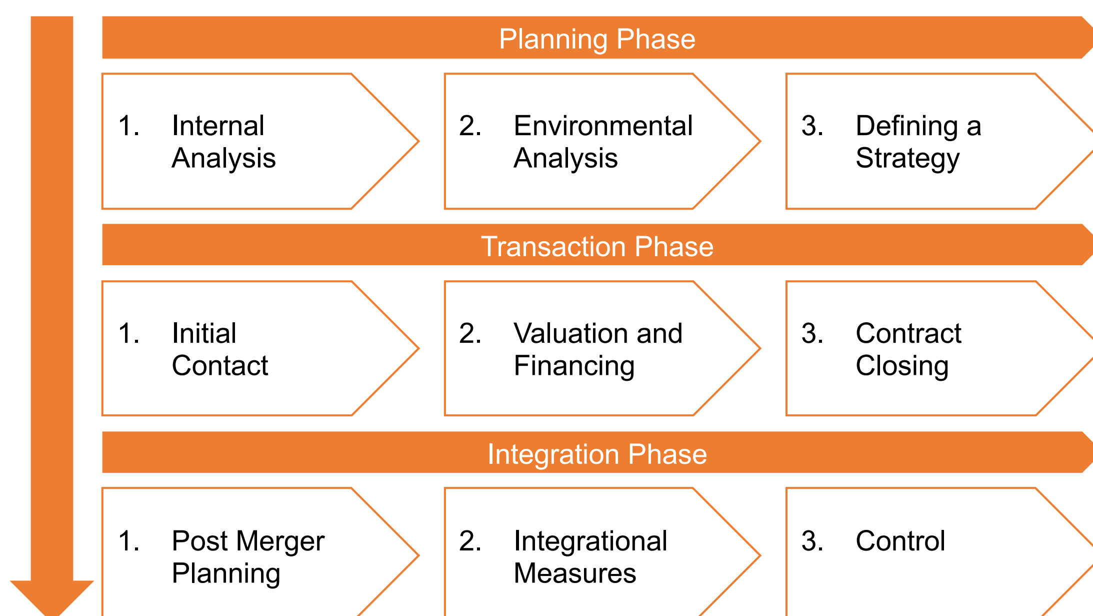

Figure 5 - Transaction process[44]

[40] cf. Schalast, C., Raettig, L., 2013, p. 89.
[41] cf. Hase, S., 1996, p. 22.
[42] cf. Jansen, S., 2008, p. 269 f.
[43] cf. DePamphilis, D., 2012.
[44] Adapted from: Jansen, S., 2016, p. 293.

3.2.1 Planning Phase

The aim of the planning phase (also called pre-merger phase) is to obtain a thorough overview of one's own business activities and to determine the general industry situation. Based on this, "strategic gaps" can be identified, and a targeted strategy developed to solve them. This can be done for a specific department or the entire company.

The first step is the internal analysis. This requires a rigorous so-called "self-due diligence"[45]. Here a company analyzes its position with regard to its economic, legal, tax, and financial circumstances. In this scenario, one widely used approach is to conduct a strengths and weaknesses analysis for each stage of the value chain. During this process, each function is considered individually and evaluated using a standardized scale. This method can be used to identify the company's core competencies as well as opportunities for development. Additional analysis methods and tests can also be used to confirm and expand on the results.[46]

In the subsequent step, a company would conduct an external analysis. The goal of the external analysis is to gather an overview of the industry and identify possible developments or trends, while at the same time screening the market environment for potential competitors who are or could become a threat to the company. A possibility to determine the opportunities and threats of a company is by undergoing a so-called "SWOT-analysis". The strengths-weaknesses-opportunities-risk analysis represents a positioning analysis of one's own activities in comparison to the competition. In the work procedure, the results of the external business environment analysis are first compiled in the form of an opportunity/risk catalog and then compared with the strengths/weaknesses profile of the internal business analysis.[47]

The final step in the planning phase is the strategic analysis. This includes the formulation of the expansion strategy and a "gap analysis" for the identified strategic and operational weaknesses. If the managers then decide that the

[45] cf. DePamphilis, D., 2012.
[46] cf. Schalast, C., Raettig, L., 2013, p. 91 f.
[47] cf. DePamphilis, D., 2012.

best way to close the previously detected weaknesses is by performing a transaction, they will define an acquisition strategy for the company, which entails information about motives, goals, and requirements for potential targets.[48]

3.2.2 Transaction Phase

In the transaction phase (also known as the merger phase), contact is made with the target company, due diligence is carried out, the company is valued, negotiations are conducted, and the contract is finalized. Here, selected candidates are evaluated according to uniform criteria, whereby key figures and the position in the competition are decisive criteria.[49]

The transaction phase usually starts with the initial contact. Here the company screens the market for suitable target candidates and decides which quantitative and qualitative criteria are relevant for the selection process. Key-performance-Indicators (KPIs) that acquirer might consider relevant are earnings before interest and tax (EBIT), net income, market share, and other key financial indicators such as compound annual growth rate (CAGR).[50] Other aspects such as strategic fit or organizational and cultural fit are also very important for a transaction. A high degree of compatibility in this respect is crucial for the realization of expected synergies later. Since the market is not always transparent, it is not always easy to find the necessary information that is needed. Hence, companies then seek help from investment banks and or specialized consulting firms that support the acquiring company to find potential targets by developing long- and then short-lists of promising candidates. With this information, the buyer then will approach the companies.[51] All interim results will be documented in letters of intent and if the target is interested in the deal a non-disclosure agreement between the two parties will be signed.[52]

The next and most extensive sub-step in the transaction phase is the due diligence process, followed by valuing the target company and establishing a financing strategy before closing the deal. M&A in most cases involves a great

[48] cf. DePamphilis, D., 2012.
[49] cf. Jansen, S., 2008, p. 269 f.
[50] cf. Berk, J., DeMarzo, P., 2013.
[51] cf. Jansen, S., 2008, p. 269 f.
[52] cf. Jansen, S, 2008, p. 265 f.

number of resources and with it risks. Consequently, a detailed investigation of the target company is required to examine the financial statements, the strategic opportunities, and the advantages of the transaction (due diligence). Latter is usually accompanied by advisors to enable the most objective assessment possible.[53] Figure 6 illustrates what the key focus areas of a strategic due diligence are.

Area	Focus	Area	Focus
Financial Due Diligence	• Accounting system and organization • Financial statements • Analysis of managerial accounting	Legal & Tax Due Diligence	• Internal and external legal structures • Current lawsuits • Tax risks
Marketing Due Diligence	• Marketing machinery • Pricing Strategy • Industry analysis including competitors	Environmental Due Diligence	• Environmental regulations • Products and production
HR Due Diligence	• Management • Staff and possible implications • Evaluations	Organizational & IT Due Diligence	• General organization • IT systems

Figure 6 - Strategic due diligence[54]

If the meticulous due diligence leads to a favorable result, the next step is to negotiate a purchasing price and the details of the deal. Finding a common denominator for the transaction price is not always easy. A conflict of interest occurs as one side wants to achieve the highest (seller) and the other side the lowest (buyer) possible purchase price. The most commonly used evaluation methods are the enterprise discounted cash flow (DCF) and multiples method[55]. The enterprise DCF model discounts future income streams at the weighted average cost of capital (WACC). When a company maintains a relatively stable debt-to-value ratio WACC based models work best. DCF based calculations can vary and are subject to a company's use case.[56]

DCF analyses are the most accurate and reliable when it comes to valuing projects, companies, or divisions, but it is only as accurate as the forecast it depends on. Therefore, a thorough multiples analysis where you compare your own multiples with peers can help make DCF calculations even more accurate. When computing and comparing industry multiples, analyzing enterprise value

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[53] cf. Berk, J., DeMarzo, P., 2013.
[54] Adapted from: Guserl, R., Pernsteiner, H., 2015, p. 576.
[55] Multiples refer to enterprise value as debt plus the market value of equity minus cash.
[56] cf. Koller, T., Goedhart, M., Wessels, D., 2010, p. 101 f.

to EBITA is important, by virtue of having the highest informative power about a target's value than any other multiple.[57] The following figure showcases how an appropriate value for the target company can be examined.

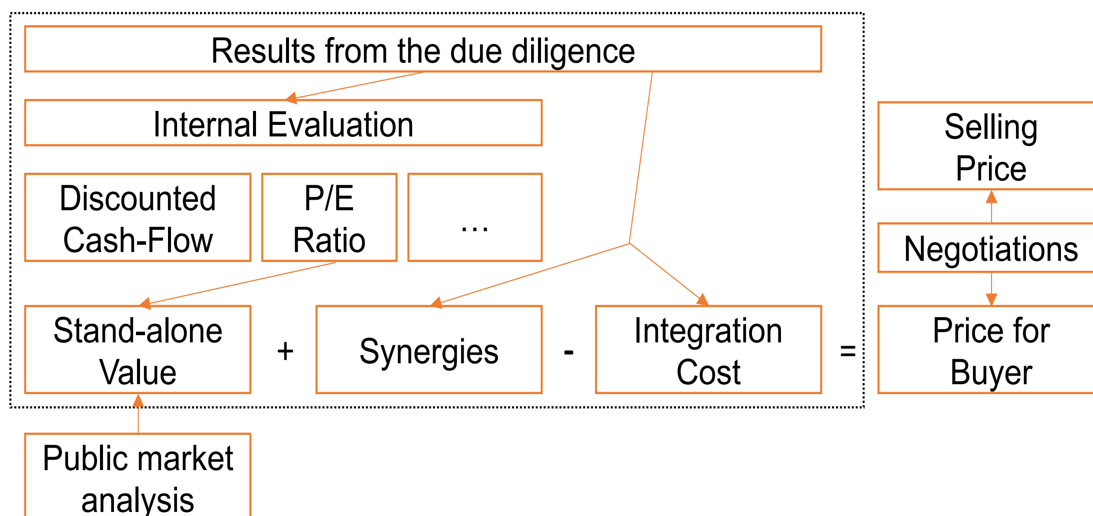

Figure 7 - Valuation process formula[58]

The penultimate step is to decide on a financing strategy. The buyer usually has four options to do so. The purchase price can be put on the table by using a company's cash flows from operating activities, undergoing a leveraged buy-out, or combining both options. A fourth option can be the exchange of stocks if both companies are publicly listed on a stock exchange.[59]

Once this is completed and both parties have agreed on the purchase price and transaction terms, lawyers are approached to draft the final contract, which then is signed after contractual and antitrust issues are resolved.[60]

3.2.3 Integration Phase

The integration phase (also known as post-merger) is the last step in a M&A process. This phase is characterized by harmonization and structuring of the "new" business into the established organizational structure of the acquirer, followed by monitoring and controlling progress.

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[57] cf. Koller, T., Goedhart, M., Wessels, D., 2010, p. 303 f.
[58] Adapted from: Stahlke, N., 2007, p. 211.
[59] cf. Schön, B., 2013, p. 34.
[60] cf. Berk, J., DeMarzo, P., 2013.

Developing an integration strategy should be a priority from the outset. In best practice it is the most convenient to delegate integration planning to a team of specialists, often including external ones such as restructuring or post-merger M&A consultants. Furthermore, the results of the previous phases, in particular all analyses and due diligence, can be utilized as a foundation for the subsequent steps. The aim is to maximize the value of the transaction possibilities and to materialize synergies.[61]

After coming up with an integration plan the actual integration process begins. Before defining measures for the latter, it is important to choose the optimal type of integration in advance to set the measures for integration. For this, four types can be pinned down:

a. **Holding structure**: Acquirer holds the ownership of the target, but they don't integrate with each other. Focus lies on the exchange of expertise.
b. **Absorption**: Acquirer completely absorbs the target, including all processes, procedures, and organizations. The goal is to standardize the processes and get the most out of the transaction. This is the most demanding and intricate kind of integration.
c. **Stand-alone position**: In this form of integration, the acquired company is managed in a completely independent legal form. This type is preferred in cases where corporate objectives diverge.
d. **Partial integration**: Here an attempt is made to combine the advantages of the stand-alone position with the consistent realization of synergy potential. In particular, the divisions and functional areas of the acquired company that are clearly related to the acquiring company are integrated with the aim of realizing economies of scale.[62]

After choosing a type of integration, the actual integration begins, which essentially touches the following six areas:[63]

a. **Strategic integration**: strategy complementarity, business unit integration, definition of joint strategic realignment, agreement on customer, management, innovation, future, and competitive orientation.

[61] cf. Berk, J., DeMarzo, P., 2013.
[62] cf. Jansen, J., 2008, p. 367 f.
[63] cf. Jansen, J., 2008, p. 371.

b. **Organizational integration**: clarification of interfaces, setting up standard processes, migration, and alignment of financials, defining reporting and control instruments, system integration, legal and taxation.
c. **Personnel integration**: agree on one management/leadership style, conceptualize incentive and compensation systems, corporate benefits, escalation, and conflict management, develop decision-making process, and socialization of new employees.
d. **Cultural integration**: protection of national and company-specific values, assimilation of an independent culture and identity, guidelines, defining corporate conduct.
e. **Operational integration**: consolidation of product lines, materialization of synergies, exchange of know-how, perform economies of scale/scope.
f. **External integration**: involvement and communication with all relevant stakeholders.[64]

Continuous control and monitoring are the last steps in the transaction process, where you assess how well the transaction went and figure out how to make the integration process better. Consequently, it is helpful to keep track of the transaction's costs and contrast them with the increased profits from the realized synergies. The accomplishment of strategic objectives should also be considered. The study can be carried out with the aid of well-known management tools like the balanced scorecard or the Jansen “7K-model”[65] and should take place at the longest a couple of years after completion of the transaction.[66]

3.3 Motives for M&A

There are multiple varieties of motives for an M&A transaction. However, certain motives and objectives are frequently found. A distinction between the buyer’s and the seller’s perspective must be made.[67]

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64 cf. Jansen, J., 2008, p. 371.
65 cf. Jansen, J., 2008, p. 374.
66 cf. DePamphilis, D., 2012.
67 cf. Schön, B., 2013, p. 63.

3.3.1 Buyer's Perspective

An acquirer must develop a clear vision of its competitive position, the growth it seeks, and the goals it intends to achieve through organic growth or acquisitions as part of its overall M&A strategy.

One of the most common motives is the aim to realize synergies between two companies. The goal here is to increase profits and reduce costs in financial, operational, and managerial areas. This can be achieved by either economies of scale (a larger output results in a cost reduction per produced unit), or economies of scope (the capacity of a business to use a single set of inputs to offer a wider range of goods and services).[68]

The target of internationalization, growth, and increase in market power can be seen as strategic motives for a company to undergo a transaction. The aim of this is to eliminate competition, set up market entry barriers (monopoly), tap into new markets, as well as expand on a geographical level. Other motives can be opportunistic financial acquisitions to increase market capitalization or realize hidden reserves.[69]

Refinance and tax benefits can be seen as financial motives. The reduction of financing costs and the tax burden can be achieved by realizing write-offs on "hidden reserves" and "loss carry-forwards" of the purchased business..[70]

Financial investors (private equity), on the other hand, primarily aim to leverage hidden or untapped potential in the target company. Motives can be an undervaluation of the target company, high hidden reserves, a high equity ratio, and weak management. Business models that are characterized by a high and constant cash flow are particularly attractive for financial investors. In contrast, target companies in certain regulated industries, such as the financial sector with its strict equity requirements, are often less interesting.[71]

Another but often misleading motive for M&A is management hubris. Latter refers to the event in which the arrogance of the management of a corporation

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[68] cf. DePamphilis, D., 2012.
[69] cf. Schön, B., 2013, p. 63 f.
[70] cf. Berk, J., DeMarzo, P., 2013.
[71] cf. Schalast, C., Raettig, L., 2013, p. 24 f.

is responsible for the takeover. Managerial hubris is connected to overconfidence because managers believe they have the necessary skill set to minimize risks and successfully complete transactions, but they actually underestimate the likelihood of failure. The results are unsuccessful deals and overprized transactions.[72]

3.3.2 Seller's Perspective

The seller's decision to discontinue engaging in specific entrepreneurial activity may be motivated by a number of factors. The following list of causes is particularly typical:

a. Unresolved succession issues. A problem that affects smaller and medium-sized businesses.
b. Lack of capital to finance the required expansion of the business.
c. Regulatory requirements (in particular antitrust law) that require the sale of a portion of a company.
d. In the case of private equity sales, the perception of an exit opportunity following an increase in the company's value by private equity sellers.
e. Concentration on the core business by divesting non-core competencies.[73]

The seller will primarily strive to achieve the highest possible purchase price for the company activities to be sold. This interest conflicts with the interest in offering the company long-term development prospects and securing jobs.[74]

[72] cf. DePamphilis, D., 2012.
[73] cf. Schalast, C., Raettig, L., 2013, p. 31 f.
[74] cf. DePamphilis, D., 2012.

4. ESG – a Value Adding Driver. Impact on the M&A Market

ESG factors are gaining strategic importance in Merger and Acquisition decisions. They are increasingly being considered throughout the M&A lifecycle, but they are also becoming more important as a catalyst for transactions themselves. From an ESG-standpoint, the reasons for an M&A transaction can range from adjusting the corporate strategy to risk mitigation to increasing the overall value of the corporate portfolio. These motivations also have an impact on the transaction's operational implementation.[75]

This chapter takes a closer look at the emerging causal links between ESG and the Mergers & Acquisitions market and identifies how ESG can create value for companies.

4.1 The Impact of ESG on the M&A Process

ESG has disrupted the traditional M&A process in many ways. The areas of planning and transaction from chapter 3.2 are particularly affected. Not only do the motives for transactions change, but also the due diligence and valuation process of a company.

4.1.1 ESG Influence on the Planning and Decision-Making Process

At the planning level, the focus is on portfolio planning and thus on corporate strategy, the origin of any buy or sell decision. Consequently, the first level begins even before the actual M&A transaction process. In concrete terms, companies must develop their portfolio, business unit, or product strategy and decide on growth or reduction.[76] At this point, the motives as we know them from Chapter 3.3 begin to diverge. ESG has become an integral part of today's business and financial world. Therefore, the portfolio is the starting point for a company's ESG strategy and becomes a driver for deals.[77]

First, a company must assess its ESG conformity and then decide what conformity they aim for. Furthermore, it must be clarified how realistic this target is and how it can be achieved in concrete terms. There are several options

[75] cf. Dr. Tucher, M., 2022.
[76] cf. Jansen, S., 2008, p. 269 f.
[77] cf. Moro-Visconti, R., 2022, p. 289 f.

available to companies in this regard. For example, ESG conformity can be bought in, but lacking ESG conformity can also be sold with an entity or a product area (divestment). In addition, the ESG portfolio valuation can be increased through a so-called ESG arbitrage. Here, a largely ESG-compliant company acquires a less ESG-compliant one or its assets. The ESG compliance of the purchased asset is now directly increased by integrating it into the buyer company, for example by replacing the less ESG-compliant manufacturing and production processes of the purchased asset with its own, more ESG-compliant ones.[78]

In short, ESG influences the management's perspective on M&A transactions, as tax benefits and other motives become secondary.

4.1.2 ESG Influence on the Due Diligence Process

During the classic M&A due diligence, a company is carefully analyzed for economic, legal, tax, and financial circumstances. This includes, for example, sales figures, shareholder structures, or possible links to white-collar crime such as corruption and tax evasion.[79] The goal is to identify hidden risks and avoid unforeseen events that could damage the acquirer financially or in terms of reputation.[80] Typical topics of strategic due diligence are discussed in chapter 3.2.2 and can be seen in Figure 6 from above.

With the growing impact of ESG on companies, the due diligence of key facts and figures of a potential target in the context of a transaction by corporates or private equity firms is now extended to ESG aspects. This is a crucial measure because if ESG-related risks of the target are not identified in time, there is a risk of costly errors in valuation and pricing, subsequent expenses in remedying grievances, and reputational damage for the buyer.[81]

[78] cf. Moro-Visconti, R., 2022, p. 235 f.
[79] cf. Schalast, C., 2019, p. 107 f.
[80] cf. Berk, J., DeMarzo, P., 2013.
[81] cf. Dr. Tucher, M., 2022.

An ESG-due diligence does not differ from a regular due diligence approach. The difference lies in the new areas that need to be examined and the importance these areas have developed recently for a successful acquisition in the long-term perspective. Topics of an ESG-due diligence are split into the 3 pillars Environment, Social, and Governance, and can be found in Figure 8.[82]

Environment	Social	Governance
• Environmental Management Systems • Pollution and Emissions • Impacts on ecosystems-climate change resilience-resource efficiency (energy, water, waste).	• Stakeholder management systems • Occupational health and safety and working conditions • Diversity and equal opportunities • Human rights • Product safety	• Risk management systems • Accounting and reporting standards • Cyber security / data protection • Competition law conduct • Board structure and compensation

Figure 8 - Typical topics for ESG-due diligence[83]

The experts derive an ESG Risk & Opportunity Assessment from the evaluation of these aspects, which also determines the potential impact on the company's valuation. The result is an ESG-score for the target company. Furthermore, as part of an ESG-due diligence, they provide recommendations for future value creation and enhancement, which can be used as the foundation for an ESG-action plan.[84]

Studies conducted by KPMG[85] show that ESG-due diligence is not only performed because it is mandatory (regulatory requirements or stakeholder pressure), but also because investors believe in “the monetary value of identifying

[82] cf. Feng, X., 2021, p. 288.
[83] Adapted from: Dr. Tucher, M., 2022.
[84] cf. Dr. Tucher, M., 2022.
[85] KPMG is a global network of legally autonomous and independent companies in the fields of auditing, tax consulting, legal consulting and business and management consulting.

risks and upsides related to sustainability at the pre-signing stage".[86] As mentioned earlier, 94 percent of all institutional investors undertake an ESG-due diligence. After doing so, 30 percent decide to change their investment decision, and 54 percent lower their target price offers depending on the findings of their sustainability evaluations.[87]

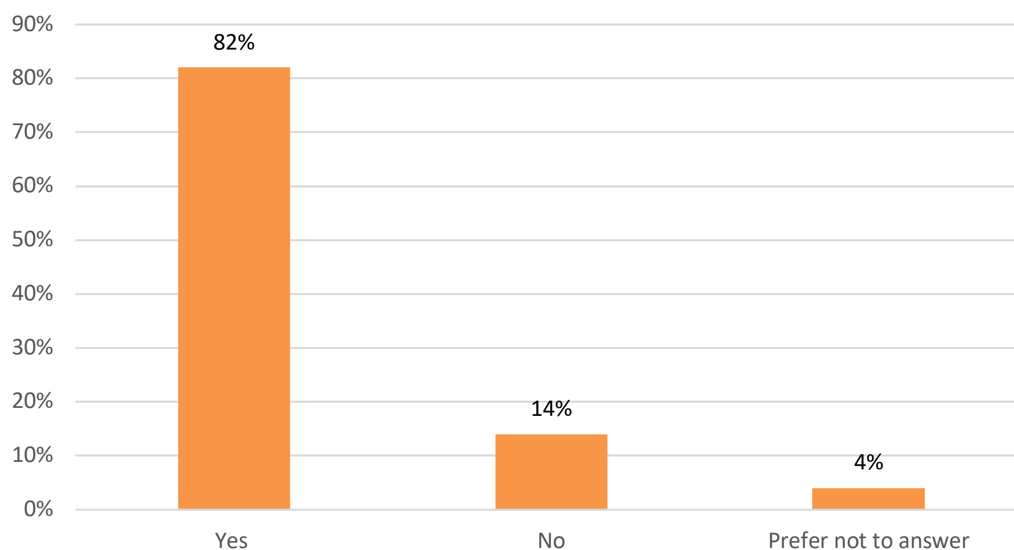

Figure 9 - Are ESG considerations currently on your M&A agenda?[88]

The current trends show that ESG is on the plan of most transaction makers, as it becomes more vital to link a corporate's ESG-strategy to their M&A strategy and processes (see Figure 9). As a result, the focus of classic due diligence has expanded to include ESG-aspects and has become one of the most important factors in the success of a transaction.

4.1.3 ESG Influence on the Pricing

A target's price tag is traditionally determined by using the discounted cash flow or multiples method (chapter 3.2.2).[89] However, with the exponential rise of ESG, this factor now must be considered as well when negotiating a purchase price. Ignoring ESG-aspects is not only bad for a company's reputation, but also for its valuation and later acquiring price. Just recently, a whole series

[86] cf. KPMG, 2022, p. 8.
[87] cf. Wendt, K., 2016, p. 116.
[88] Adapted from: KPMG, 2022, p. 5.
[89] cf. Koller, T., Goedhart, M., Wessels, D., 2010, p. 303 f.

of cases came to light in which disregard for the aforementioned had negatively impacted corporate values, whereby the image increasingly influences the company valuation. For many investors, analyzing ESG issues has long been a variable in their forecasting models and thus has a direct influence on the selection of their investments.[90]

The challenge in incorporating ESG in the valuation of a company is to translate the previously ascertained ESG-due diligence results into a reasonable monetary value that will be added to the purchase price. Using a valuation factor (multiple methods) derived from the calculated ESG-score (see previous chapter) an expected purchase price adjustment can be added.[91] Finally, the assessment of the M&A target also leads to a revaluation of the overall portfolio. Thus, the issue of ESG in the context of M&A transactions has a significant impact on the strategic valuation and the return of investors. The following chapter (4.2) explains in more detail how ESG drives value and influences the valuation of a company.[92]

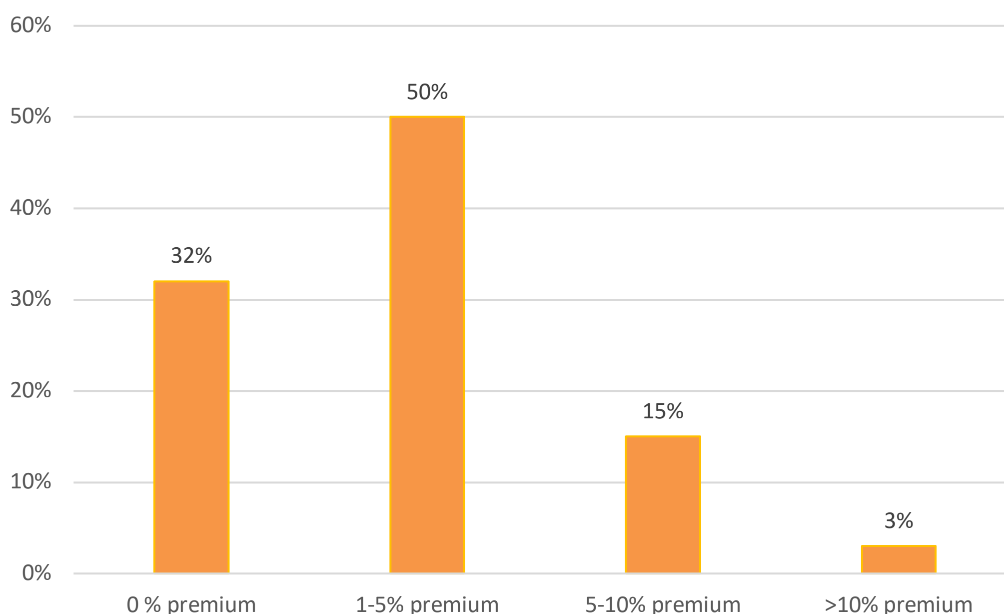

Figure 10 - As a buyer, how much would you be willing to pay more for a target with a high level of ESG maturity?[93]

[90] cf. KPMG, 2022, p. 5.
[91] cf. Moro-Visconti, R., 2022, p. 241 f.
[92] cf. Dr. Tucher, M., 2022.
[93] Adapted from: KPMG, 2022, p. 6.

KPMG research shows that more than two-thirds of respondents would be willing to pay a premium for a target company with a high level of ESG maturity in areas aligned with the acquirer's ESG objectives (see Figure 10). 50 percent would be willing to pay a premium of between 1 and 5 percent and almost one in five would pay a premium of more than 5 percent.[94]

4.2 ESG – a Value Adding Driver

Recent research shows that organizations that address Environmental, Social, and Governance issues do not damage value creation, rather quite the contrary experiencing positive reverberations and higher financial return (Figure 11).[95] In terms of inclination and momentum, strapping equity returns are correlated with ESG-commitment. Lower credit and credit default swap spreads, as well as higher credit ratings, are a few examples of how better ESG performance is linked to lower downside risk.[96]

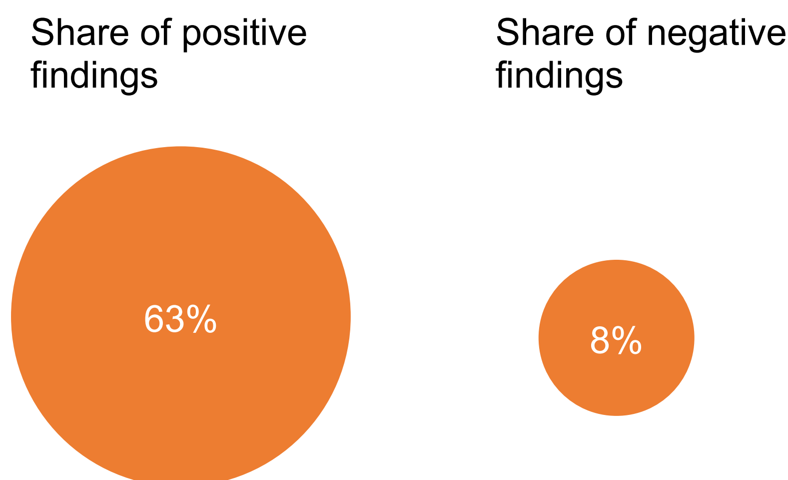

Figure 11 - Results of >2000 studies on the impact of ESG propositions on equity returns[97]

An ESG-strategy integration drives long-term sustainable performance and stakeholder value through 5 major areas (Table 2), which will be discussed in more detail in the subsequent chapters below.

[94] cf. KPMG, 2022, p. 6.
[95] cf. Mozaffar, K., Serafeim, G., Yoon, A., 2016, p. 4.
[96] cf. Henisz,W., Koller, T., Nuttall, R., 2019, p. 5.
[97] Adapted from: Henisz, W., Koller, T., Nuttall, R., 2019, p. 3.

Table 2 - Value creation links to a strong ESG proposition[98]

	Strong ESG proposition (examples)	Weak ESG proposition (examples)
Top-line growth	Attract more customers through sustainable products Better community & government relations lead to better access to resources	Poor sustainability practices lead to loss of customers Poor social relations lose access to resources
Cost reductions	Lower energy demand Fewer water intake	Unnecessary waste & with that higher waste-disposal costs
Regulatory and legal interventions	Freedom through deregulation Gain subsidies/governmental aid	Restrictions & barriers through regulations (fines, penalties)
Productivity uplift	Better employee environment Social credibility strengthens talent attraction	Deal with “bad” reputation and stigma Lose talent due to weak purpose
Investment and asset optimization	Investment returns are enhanced by more sustainable allocation of capital (long run)	Fall behind competitors as they have invested in less energy-consuming assets

4.2.1 Top-line Growth

Sustainability creates up to 13 percent explanatory share of sales. This is confirmed by a study compiled by the communications agency Serviceplan Corporate Reputation (SCR) together with the management consultancy Biesalski & Company.[99]

[98] Adapted from: Henisz, W., Koller, T., Nuttall, R., 2019, p. 4.
[99] cf. Biesalski & Company, Serviceplan, 2016, p. 11.

Brands can increase their value by making a visible contribution to fulfilling their customers' needs for sustainability. A compelling ESG-offering does not only help companies to open up new markets or break into existing ones, through having better relationships with governing authorities who are more likely to grant them the access, approvals, and licenses that imply opportunities and growth, but also to ameliorate a company's image.[100] McKinsey research shows that more than 70 percent of consumers in the automotive, construction, and electronics industries are willing to pay up to 5 percent more for a sustainable product that performs as well as a non-sustainable alternative.[101] For instance, Unilever. Releasing a dishwashing detergent that consumes much less water than the competition, led to a 20 percent revenue growth within a water-scarce market.[102] However, the study performed by SCR also illustrates that sustainability-driven sales are dependent on the industry and whether the market has already engaged with sustainability or not (Figure 12).

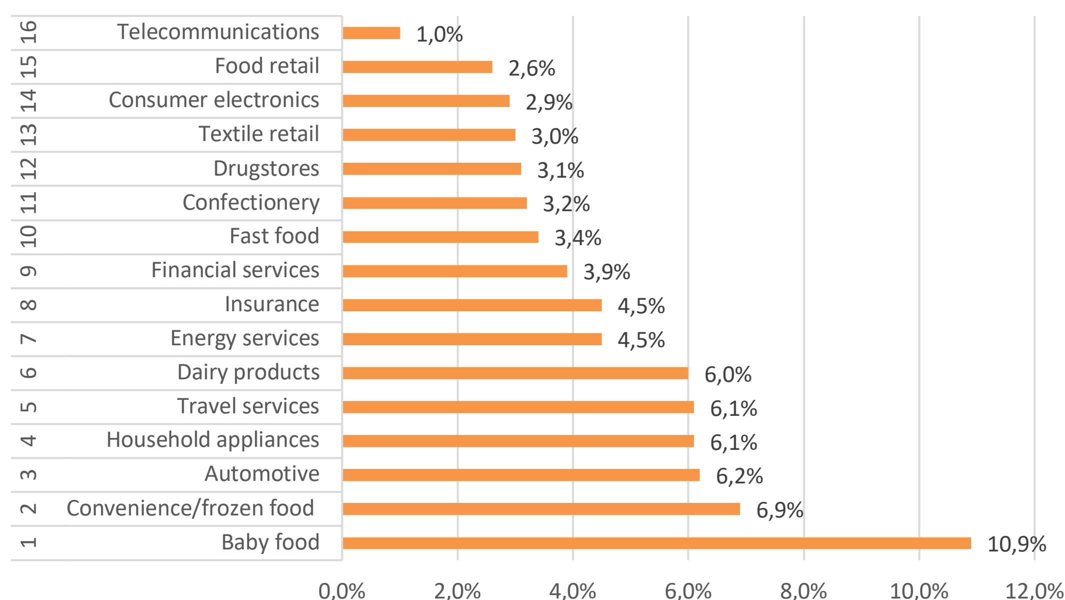

Figure 12 - ESG-driven sales, which range from highly relevant (baby food) to negligible (telecommunications), depending on the sector[103]

[100] cf. Flustix, 2018.
[101] cf. Miremadi, M., Musso, C., Weihe, U., 2012.
[102] cf. Unilever, 2022.
[103] Adapted from: Biesalski & Company, Serviceplan, 2016, p. 14.

Not too long ago, the German economy provided dramatic negative examples of how reputation damage can impact sales and monetary performance. The reputational losses of Volkswagen and Deutsche Bank alone calculate billions in lost sales and destroyed stock market value.[104] A company's reputation, therefore, becomes one of its most valuable assets.

4.2.2 Cost Reductions

The management of a company can reduce capital costs by focusing on ESG. This is due to the increased amount of capital that will be made accessible to businesses with better ESG-performance. More investors and PEs seek to engage rather in them, than a company with moderate efforts towards ESG.[105] Not only do equity markets lay more value to the topic, but banks in the loan market also started linking interest rates on loans based on a corporation's ESG score and results. Last year, such ESG-linked loans reached a volume of 428 billion dollars worldwide, surpassing the classic green loans, which are granted exclusively for green projects.[106]

In addition to the latter, a company that has implemented a sophisticated ESG-strategy, can reduce its operating costs (material prices, energy, water) by redesigning products, improving assembling processes, and implementing a circular economy. FedEx serves as a great example here. The logistics company seeks to transform its entire 35,000-vehicle fleet to electric or hybrid motors by 2050. As of today, 20 percent have been transformed and approximately 190 million liters of fuel have been saved.[107]

4.2.3 Regulatory and Legal Relieve

De Giuli and Kostovetsky (2014) find that sustainable investments out of political intentions or beliefs are value-destroying for shareholders.[108] This belief is outdated. Being compliant with regulatory requirements on federal level entails several advantages that a company can use to mitigate risks and avoid legal actions against it.

[104] cf. Süddeutsche Zeitung, 2018.
[105] cf. Harvard Business Review, 2020.
[106] cf. Handelszeitung, 2022.
[107] cf. FedEx, 2022.
[108] cf. Di Giuli, A., Kostovetsky, L., 2014, p. 158-180.

With a stronger ESG-proposition your organization gains greater strategic freedom, reducing regulatory pressure. According to a McKinsey statistic, government action might threaten one-third of a company's net profitability. In industries where subsidies play an important role, such as automotive or aerospace, even up to 60% of the profits are at stake.[109] Authorities can view businesses that have provable ESG-objectives as being more responsible. Regulators may therefore investigate your business less, be more forgiving when non-compliance is found, and may support sustainable development.

The merger of Fiat Chrysler Automobiles (FCA) and Peugeot serves as a great example. Through the merger, the two companies will save billions of dollars' worth of carbon emissions-related fines from the European Union, as Peugeot will improve FCA's overall ESG-compliance.[110]

4.2.4 Productivity Upheaval

In recent years, with increased awareness, the importance of ESG-challenges has spread beyond the boardroom to also include employees. Employees want to know what principles their firm upholds, what initiatives are being taken, and how they may participate. The Corona-epidemic was a major motivator in this scenario[111]. It provided time for employees to reflect, determine what is important to them, and think about how this can improve their day-to-day work.

Alex Edmans revealed that corporations that were ranked among the "100 Best Companies to Work For" made 2.3 up to 3.8 percent greater equity returns than their competition.[112] A higher sense of purpose set up by the company can spur employees to perform better, a weaker ESG-offering can hurt productivity. Typical examples would be strikes, work stoppages, and other workforce actions within the company.[113] Hence, the responsibilities of the corporates are to combine the corporate philosophy with authentic measures and

[109] cf. Henisz, W., Koller, T., Nuttall, R., 2019, p. 5.
[110] cf. The New York Times, 2019.
[111] cf. Pew Research Center, 2020.
[112] cf. Edmans, A., 2012, p. 9.
[113] cf. PwC Indonesia, 2022, p. 10.

a value-oriented approaches in order to strengthen social credibility, retain employees in the long term, get access and attract valuable talent.

Another critical aspect is the supply chain. It is also vital to scan a company's suppliers and subcontractors, as they are frequently mismanaged and have poor working conditions under minimum wage.[114] Farsighted organizations take that into consideration. Think about Deutsche Bank, as of July 2022 the bank requires its suppliers to provide an assessment according to ESG-criteria for larger contracts. For each new or extended contract of more than 500,000 euros per year, suppliers will then have to submit a sustainability rating from external rating agencies.[115]

4.2.5 Investment and Asset Optimization

Sustainable investments and optimization of property, plant, and equipment become more crucial, as the regulatory field becomes more complex and cluttered. Energy costs are more likely to rise due to regulatory response to climate change and emissions.[116] This could hurt companies, especially in energy-intensive markets. Companies should switch to more sustainable solutions that consume less energy and scarce resources (water, oil, sand, gold, titanium). By allocating money to more attractive and sustainable alternatives, a strong ESG-proposition can improve investment returns (for example, renewables, waste reduction, circular economy). Additionally, it can assist businesses in avoiding stranded investments that would not be profitable due to long-term environmental problems (such as massive write-downs of oil plantations). A simple but meaningful example is when paper-based processes are digitized, whereas the primary goal is process optimization, the environment benefits as well. And it does so very directly and precisely when the consumption of paper in offices is reduced to the point where a significant contribution is made to reducing the associated resource consumption. In the long-term run, this will not only help the environment but also lead to better financial returns in the future.[117]

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[114] cf. Henisz, W., Koller, T., Nuttall, R., 2019, p. 7.
[115] cf. Deutsche Bank, 2022.
[116] cf. Bundesregierung, 2022.
[117] cf. Henisz, W., Koller, T., Nuttall, R., 2019, p. 8.

Long-term financial and non-financial value creation can be achieved by implementing a thorough ESG plan that is incorporated deep into an organization's strategy.

4.3 Critical View

With all the positive aspects that ESG brings to value creation, there are also negative connotations. Investors, especially in the Private Equity branch heavily rely on benchmarks and ESG-scores made by rating agencies and public institutions, which often, depending on the rater's approach, differ from each other significantly. The lack of unity in terms of a standardized ESG-framework can result in misleading investment decisions and costly errors for investors.

A company that commits to ESG must undertake expensive investments to compensate areas with non-compliance in the long-term. That is becoming more and more of a problem for small and medium-sized companies (SMEs), which don't have the necessary capital to allocate to ESG topics and thus become the target of authorities and associated fees. ESG-investments make a positive return in the long-run but influence a company's budget in the short-term and harm especially SMEs in their competitiveness.

Another crucial downside of the ESG-movement is the possible innovation-brake. Investors tend to neglect innovative transactions due to the lack of a sufficient ESG-proposition of the target and thus miss out on innovative growth. This can influence and lower a company's innovation system's ability to create wealth for the shareholders and attain social benefits.

5. Empirical Part

5.1 Interview with Experts

To illustrate the core topic of this thesis, the expert interview method was chosen. For this purpose, a questionnaire was created to be able to evaluate and structure the data. However, the wording and sequence of the questions in an interview are not fixed from the outset so the interview appears more like a natural conversation. In addition, this type of interview does not have any predetermined answers so the interview partners can freely express their views.[118]

5.2 Interview Partner and Goal

To better understand the links between ESG and M&A it is necessary to gain insights from the industry and real economy to get a sense of scale. Therefore, three Deloitte Subject-Matter Experts (SMEs), who have practical experience in the field of M&A and ESG, were interviewed:

Table 3 - Interview Partner

SME	Name	Company	Field	Position
1	Sarah Schmidt	Deloitte	ESG/M&A	Manager
2	Alexis Kehrbach	Deloitte	Valuation	Senior Manager
3	Dr. Maximilian Tucher	Deloitte	ESG/M&A	Director

For simplicity only, in the following the interview partner will be referred to as SME-1, SME-2, and SME-3.

The goal is to highlight the fundamental understanding from the theory section above, with evidence and practical experience from the real economy, as well as to enlighten further issues and insights on the topic.

[118] Bortz, J., Döring, N., 2003, p. 315.

5.3 Contents of the Questionnaire

The questionnaire for the expert interview contained a total of nine specific questions and one open-ended concluding question (outlook). The interview questionnaire targeted the following key areas:

a. ESG and it's meaning for our economy
b. Challenging aspects of ESG
c. ESG impact on decision-making
d. Due diligence
e. Valuation
f. ESG as a value adding driver
g. Outlook

5.4 Evaluation Method

Philipp Mayring's qualitative content analysis was chosen as the evaluation method. The goal of such a content analysis is the processing of material that was obtained from one or more communication situations. The advantage is that the material is analyzed step by step or divided into units that can be processed one after the other.[119]

5.5 Data Evaluation

After the interviews were conducted, they were analyzed using Mayring's qualitative content analysis. This reduces the statements to the most important ones and ultimately divides them into three categories. Here, the statements of the interviewees (SME-1, SME-2, SME-3) were included as paraphrases and direct quotes.

5.5.1 ESG a Megatrend

"ESG is an exciting topic for companies, especially for the buy-side, from an M&A-perspective, as ESG increases the transparency with which a target can be analyzed." said SME-1 with regards to how ESG influences corporates and the global economy. In SME-1's opinion this presents a "big challenge"[120] for

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[119] Mayring, P., 2010, p. 37.
[120] SME-1, 2022.

organizations because companies now must figure out how to answer the ESG-related questions asked by the financial markets or buy-side. SME-3 added that the topic is one of the major megatrends currently, especially regarding the M&A-, corporate- and Private Equity (PE) side. Thus, PEs now more frequently deal with the question of how ESG impacts their portfolio negatively or positively, and in case of bad findings separate from the respective companies (for example, the plastic industry).[121] When it comes to the scope of application, SME-2 said, that the aspects (requirements, regulations) of ESG are still uncertain and highly dependent on the business model or industry, as for instance, ESG impacts the automotive industry (high carbon-dioxide emissions industry) more than the banking-industry. Additionally, all three SMEs agreed on the challenging aspects of ESG, such as the fact that there is currently no uniform framework that allows comparison in a cross-industry dimension and that the different ESG-assessments by rating agencies, each with its own definition of sustainability, create confusion for investors and companies. Hence, ESG has become "a curse and a blessing"[122] at the same time. It is important to standardize and structure the topic properly in the next coming years to overcome these problems.[123]

5.5.2 ESG Impact on the M&A Market

The impact on the M&A market is rising. This is the opinion of all three SMEs. "The influence on the decision-making process increased drastically over the past years, […]. The topic has an impact on the investment strategy of a company making companies ask themselves, how can I invest sustainably, add on new technologies, sell old ones, or where does it make sense to sell parts of the company, or to buy new ones? The impact of ESG, […], is clearly felt in the strategic direction of a company, wherein the field of M&A, not only financials are now on the decision-criteria agenda, but also sustainability issues and strategies." said SME-3.[124] In addition to that SME-2 thinks that sustainability

[121] SME-3, 2022.
[122] SME-1, 2022.
[123] SME-2, 2022.
[124] SME-3, 2022.

and ESG has become a leverage in company's M&A strategies to satisfy the demand of customers and other market participants.[125]

“ESG-due diligence is gradually becoming a standard process.” SME-2 regarding the change of M&A processes. This is mainly due to the “risk-glasses”[126] perspective. If you do not deal with the topic intensively, the risk of overvaluation and hidden costs is very high. For this reason, acquirers need to perform detailed ESG-due diligence to avoid misguided decisions and governance confrontations.[127] “Technologies that negatively influence the sustainability trend decrease the valuation of a company, […] and are sold with significantly more markdowns. Latter can be seen in the automotive industry, where technology for conventional internal combustion engines was sold in part at negative selling prices.” SME-3 on why you should perform ESG-due diligence.[128]

SME-2 explained how ESG influences the valuation of a company. The classic valuation process is to forecast the cash flow of a target and deduct risk adequately, based on a 3-year plan plus perpetual annuity (terminal value) that is inflated. However, this is changing partially as the factor ESG is influencing a target’s valuation and becomes more and more a reason for price discussions.[129] Nonetheless, SME-2 added, as practice shows, it is enormously difficult to convert ESG-proposition into a concrete monetary value. Deloitte has examined this in detail in the “ESG-quantification project”, as it is still a very "sore subject" for the company.[130] Six exemplary KPIs were tried to bring into a causal relationship with company performance. A peer group from the industrial sector was created and it was tried to derive an insight into how a KPI was influenced by ESG. In doing so, Deloitte has massively reached its limits. The topic has "too many factors and is statistically highly complex" and was therefore put on hold.[131] “The solution currently used is individual and dependent on the case. There is yet no computational model that allows investors, companies, or consultants to just type in figures and get a valuation for the ESG-

[125] SME-2, 2022.
[126] SME-1, 2022.
[127] SME-2, 2022.
[128] SME-3, 2022.
[129] SME-2, 2022.
[130] SME-1, 2022.
[131] SME-1, 2022.

aspects. Right now, acquirer perform peer-to-peer evaluations and compare the respective target to its competition or use the multiple method from an earlier derived ESG-score. Depending on the results companies then decide on a markup or markdown on the overall valuation. For example, if a company has higher energy consumption for the same process as its competition, the company would be valued less through markdowns, as further investments in that area will be needed." said SME-2 on the correlation between ESG and valuation.

SME-1 thinks that the non-integration of an ESG-strategy leads to a loss of value. Also, in her opinion the G part of ESG (Governance) is the basis, so the rest can work. Governance-compliance is needed to not destroy value in the first place, through getting fines and penalties by authorities.[132] Studies by Deloitte Switzerland have shown that E and S in ESG have a greater leverage effect on the company's value creation than G, which acts as a value preserver rather than a driver.[133] ESG is in fact a value adding driver. "Depending on how you define value, […], ESG can create value across the whole value chain of a company." said SME-3. Beginning with sales, green products can have a positive impact on demand and hence revenue, whereas a positive ESG-commitment can increase employee satisfaction and productivity. From the perspective of a supplier, you gain attractiveness and thus awareness.[134]

5.5.3 Outlook

In the end, all three SMEs agreed on the fact that ESG is not just a movement that will fade away with time, but that this trend is a development instead and is here to stay.[135] SME-1 even compared the ESG-trend to digitization: "The last trend that was so hyped was digitization, and it's far from over. ESG will become established as the expectations are rising". SME-2 also added the importance of this development and why it will grow in his opinion "The new generations have understood the issue, who are massively affected by it, for whom it has a different impact than for the older generations between 60-80

[132] SME-1, 2022.
[133] SME-2, 2022.
[134] SME-3, 2022.
[135] SME-1, SME-2, SME-3, 2022.

years, […], who know that if nothing happens now, it will have drastic effects on our world”.

5.6 Discussion

The interview provided practical evidence for the above-stated information from the theory section regarding ESG, M&A, and its correlation.

Regarding ESG as a megatrend, all three experts agree. ESG is changing the business environment and is massively driven by the changing expectations of different stakeholders, such as customers, institutions, and governments. The interviewees also agree on the complications of ESG. The lack of a broadly used unified standard framework creates confusion and thus prevents a clear “apple-to-apple” comparison methodology between company's ESG-assessment. The complexity of ESG further complicates the topic, as ESG-analysis are time-consuming and require specialized knowledge.

All three SME’s say that ESG is having a major impact on the M&A market and thus decision-making. Companies and investors now have other goals and motives on their agenda and are increasingly making ESG-based purchasing decisions, as ESG-factors can influence a company's valuation by affecting its risk profile, reputation, and future growth prospects.

On ESG-due diligence, SME-2 said it is becoming more standard in the M&A industry, as downside risk increases. ESG-due diligence identifies potential risks and opportunities related to a company's ESG-performance and assesses how those risks and opportunities could impact the company's financial performance over time. Therefore, it is imperative for companies and investors to conduct ESG-due diligence during Mergers and Acquisitions.

According to SME-1 and SME-2, the standard valuation process is clearly influenced by ESG. Buyers increasingly have to convert the results of the preceding ESG-due diligence into a monetary premium or discount. In practice, there is not yet a uniform solution to this problem due to the complexity of the issue and the fact that standardization is not yet possible. In reality, an individual approach is taken, depending on the case. This confirms the assumptions

made in the theory section and shows that ESG is still a vague and constantly changing topic.

When it comes to ESG as a value driver, all SMEs are on the same page. ESG creates value. Companies with strong ESG-practices are less susceptible to reputational, regulatory, and operational risks, which can lead to an improved risk profile and potentially lower cost of capital. In addition, companies with strong ESG-offerings can be more attractive to customers, employees, and partners, which can improve sales performance and operational efficiency, and sustainability leaders can better adapt to new business opportunities in areas such as renewable energy, electric vehicles, and sustainable agriculture.

The outlook according to the experts is clear. ESG is here to stay. The issue affects the whole world and has an impact on many aspects of our lives. The topic will become an integral part of M&A in the future and will influence and change many purchasing decisions. For the younger generation, it is important to act now, as it is their future that is at stake. To summarize, ESG is no longer a trend, it is a development that will change the world.

6. Conclusion and Outlook

6.1 Conclusion

The purpose of this thesis was to identify how ESG influences the M&A market and creates value for companies. For that reason, literature research about the relevant theoretical background as well as the influence of ESG on the M&A market and an empirical subject-matter expert analysis was conducted.

The results show that ESG is more than just a megatrend and will consolidate in the long-term run, as the economy starts seeing the topic as a development rather than a trend. Its influence has grown exponentially in recent years and is increasingly shaping how deal makers approach and value transactions. ESG has not only changed the classic motives and thus the decision-making process of a deal, but also how a due diligence process is carried out and how a target is valued. Investors are now inclined to change their purchasing decisions based on ESG-due diligence and adjust the price up or down predicated on a target's ESG-compliance. In addition to that, ESG functions as a value adding driver. If a company has a strong ESG-proposition it can enhance its shareholder value through top-line growth, productivity upheaval, cost reduction, regulatory relief, and asset optimization, which in the long-run lead to an increase in the overall valuation of a company.

The empirical evidence collected from the interviews supports the current thinking that adopting a strategic focus on ESG-issues can lead to a value adding effect and has a major influence on the M&A market. The topic is still evolving, and many things still need to improve (lack of unity, transparency, quantification, and many more). However, ESG has become a necessity for companies, if only because of stricter regulations. From transparency requirements in financing to packaging rules to the carbon footprint of the supply chain, ESG influences organizations and the M&A market.

6.2 Outlook

In the future, the topic of ESG will accelerate further and establish itself as a standard in the capital and especially the M&A market. The demand for sustainable investment opportunities continues to grow and more and more investors are recognizing the long-term benefits of making investment decisions based on ESG-criteria.

In addition to that, the regulations for ESG-reporting and transparency are expected to continue to increase. This can help improve the comparability and quality of ESG-data and improve the integrity of ESG-investments. Technology and Artificial Intelligence (AI) will play a major role in the collection, analysis, and processing of ESG-data, improving the efficiency and accuracy of ESG-scores.

Overall, it is inevitable for a company these days, to have an ESG-strategy implemented in the core of its philosophy.

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Declaration of Originality

I hereby declare that I have written this bachelor's thesis independently, not submitted it elsewhere for examination purposes, used no sources or resources other than those indicated and marked any verbatim quotes and paraphrases as such.

Würzburg, 27.01.2023

Place, date

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