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ESG IN THE MID-MARKET:

Where do dealmakers stand?

Part of the Monitoring Mid-market M&A in the UK series

Contents

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Foreword

In the latest instalment of our multi-year research into UK mid-market M&A, we focus on environmental, social and governance (ESG) issues. ESG considerations continue to rise across all sectors and industries as disclosure and reporting obligations increase and companies map out their credentials in ever more detail. For a number of years a point of difference, ESG is increasingly becoming a vital hygiene factor for large corporates in particular. But how is this manifesting itself in mid-market M&A? We spoke with expert voices from the corporate, private equity and advisory worlds to find out.

Corporate ESG strategies vary from organisation-to-organisation, dependent upon size, sector, growth stage, leadership and other stakeholder priorities. Beyond the obvious arguments around being a good corporate citizen for the planet, for society and for members of the organisation, the increase in reporting metrics shows the financial benefits that can be achieved, too.

McKinsey and others talk about the value of ESG in preserving an organisation's 'social license'. The role of ESG as a value-creator is not lost on the investment community, but in dealmaking the focus for investors and PE houses remains predominantly on the numbers. Large corporates value ESG in the round, but the journey to ESG prioritisation is inevitably slower for other groups.

This is not to say that it is overlooked or marginalised. Indeed, PE has for a long time been at the forefront of identifying or implementing good governance (the 'G') processes for its acquisition targets and portfolio companies. But there are myriad other factors that must be considered before investment decisions can be executed.

Dealmakers are also more detail-oriented and accustomed to thorough due diligence processes. They have a high threshold for scrutiny satisfaction and a low threshold for swallowing surface-level charades. The integrity of ESG claims is therefore closely examined and will not wash if found to be lacking.

The results of our annual sentiment survey have shown that ESG continues to play a role in decision-making, but for many in the market this remains as part of an overall consideration and not a critical or dominant factor in its own right (the exception obviously being those specialised social impact funds and investors who are leading the way in putting ESG considerations at the front and centre of their fundraising processes and investment decisions). Assessing a target for merger or acquisition activity requires a bespoke approach for every deal, and this bespoke approach will determine how important ESG issues are.

The insights our sources have shared provide a valuable window into how the role of ESG is impacting on M&A dealmaking in the mid-market and, on behalf of the Trowers & Hamlins Corporate team, I would like to formally thank those contributors. To those reading, we hope you find the contents insightful and informative.

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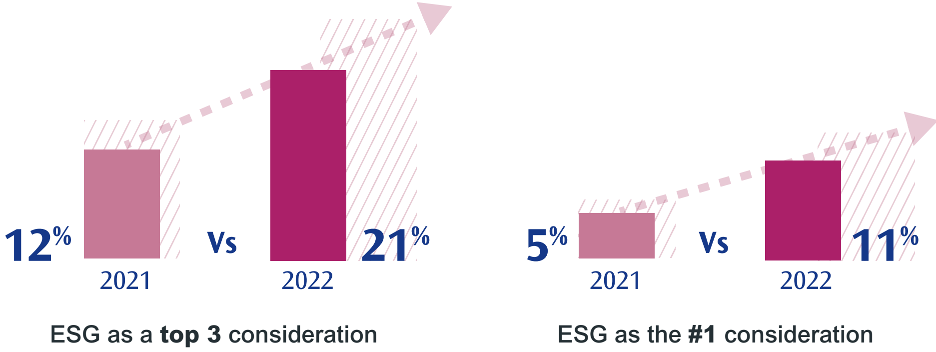
ESG making an impact on dealmaking

ESG impacting acquirer decision-making



Respondents were asked to identify their top considerations when weighing the attractiveness of an M&A target

One thing is clear from our data: ESG is now a much more valued part of that overall bespoke approach than it ever has been before. Our research shows that 21% of dealmakers now identify ESG credentials as a top three consideration when weighing the attractiveness of an M&A target, with 11% ranking it as the most important. A year ago, only 5% ranked it as the most important factor, and only 12% ranked it as a top three consideration.

These figures show that a rapidly increasing number of dealmakers are prioritising ESG above all else, though the majority still do not see it as crucial to transacting. More 'traditional' transacting values such as financial performance, business ownership structure, data and IP assets, existing relationship and brand reputation still carry more weight for buyers and investors. However, the fact that our data reveals a doubling of the number of dealmakers that highly value ESG factors cannot be ignored, particularly if this trajectory continues.

"Financials ultimately determine the deal. But the importance of ESG strategy is more apparent and can certainly be a value-driver. It is on the agenda of investment committees much more than it was," says Neil McManus, Partner and Head of Business Services M&A at KPMG.

"We ask clients what their ESG agenda is and how we present it. It's not quite a hygiene factor yet but strategy and delivery will become one as we move forward. It won't be long before funds start to baulk at those without an agenda," adds McManus.

Every transaction will be screened for ESG 'red flags' as part of an overall assessment and investors may look elsewhere if they are not satisfied with what they unearth.

"We consider ESG throughout the investment process, right from the point a potential investment is identified. During these initial conversations, we often choose not to progress a company because of concerns around its ESG positioning, as well as for many other reasons," says Ben Long, Partner at leading mid-market PE firm Inflexion.

However, if there are compelling (non-ESG related) reasons to invest, workaround solutions will be sought out to address ESG shortcomings.

"At the point we are conducting third-party ESG diligence, because of the type of businesses we tend to invest in, it would be unusual to see any surprises in ESG due diligence that would prevent a deal going ahead. Instead, the ESG DD is used to identify gaps in ESG management and performance that need to be corrected in the 100 Day Plan and to identify value creation opportunities to be incorporated in the value creation plan," adds Long, whose firm is one of a number that has moved to employ an ESG lead specifically to monitor and implement ESG progress in their portfolio companies, in recognition of how important this will be as a value-driver going forward.

It may be rare for ESG issues to prevent a deal from going ahead because the majority of ESG challenges can be overcome. Outside of agreed 'no-go' industries for certain investors or acquirers, ESG as a 'problem' is rarely insurmountable.

"I haven't seen a deal blocked because of ESG. The issues that come up can be resolved. Financials are still key, and if there are ESG risk factors you would address and overcome them rather than let them kill a deal," says Timothy Buckeridge, Partner at RPL Mergers.

Of course, size and scale is another determinant of attention. This comes down to resource, impact, footprint and stakeholder expectations.

At the smaller end of the mid-market spectrum, the views and values of individual founders will hold more sway and determine the approach.

"At the moment, this seems to be more of a focus for larger corporates," say Mark Neath, Corporate Finance Partner at Old Mill. "For the majority of owner-managed businesses, it comes down to the ethos of the owner."

Size and scale aside, the other determinant is sector. The raison d'etre of a business, and the demographic it serves, will influence the weighting of ESG and its constituent parts.

For some sectors, customers can vote with their feet – and wallets – given the range of choice available. This is where ESG's impact on brand value and reputation comes into focus.

"Consumers want to consume brands doing something environmentally sustainable," says Chris Bates, Director, Corporate Finance at Alantra.

Well-functioning, high-growth businesses will probably be thinking about these issues as part of the natural course of good organisational governance, not just because they are thinking of transacting.

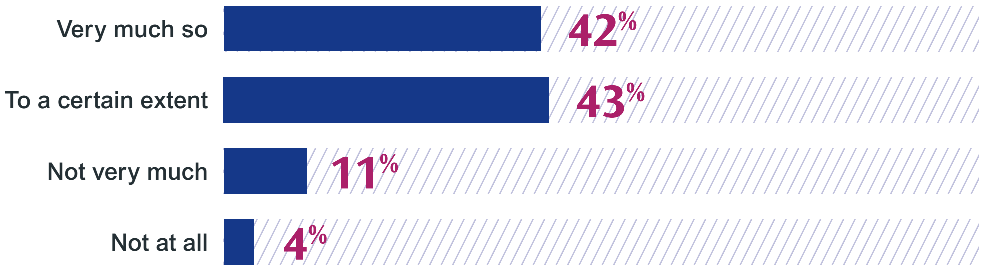
Aside from the merits of having an ESG strategy in itself, the absence of one can be an indicator of a poor management team, if they are not on top of business-critical issues.

"To grow and be in position to exit, you need to play to those themes anyway. On the transactional side, most investors expect there to be a strategy," says Bates.

The overall steady progress around ESG within dealmaking is consistent with our previous findings, with a majority positioning it as a mid-level priority. Previously, a combined 61% said they value ESG factors when making M&A decisions, but within that figure the majority (47%) answered 'to a certain extent' versus 14% 'very much so'. Only a small proportion (8%) said it is 'not at all' factored into their decision-making.

Due diligence processes

ESG as a focus for due diligence



Respondents were asked to what extent has ESG due diligence now become its own area of expertise

One area of tangible progress around ESG is in the formalisation of (ESG) due diligence processes.

Of our dealmaking respondents, 42% say ESG due diligence has 'very much so' become its own area of expertise – characterised in some cases, for example, by the existence of separate, specialist consultants advising on transactions.

Investors will often have criteria to distinguish the type of business they look to work with, in terms of culture and approach to sustainability, for example. They will also interrogate the process of getting to certain ESG outcomes, rather than being solely focused on goals and outputs. This is particularly important if target or portfolio companies are early-stage businesses.

"It's not just about asking what the overall sustainability outcome is for the business, but also how they are getting to that outcome. From an ESG perspective, what are the secondary benefits and externalities, whether risks or benefits? That's the sort of risk assessment we go through, before creating an action plan to incorporate into the equity documentation," says Stevie Ingamells, Associate Director at Gresham House, an asset manager specialising in alternative investments with a positive sustainable impact.

"We also put in place ESG policies for each of the companies we buy or invest in to make sure we are completely aligned on outcomes and objectives. We handle it all in-house, and only hire external advisers for a very specialised topic like carbon footprint analysis. But that's not the diligence process, that's part of the ongoing portfolio value-creation process," says Ingamells.

Other investors with less of a specialist focus than Gresham House may hire consultants to look at value-add and assess where improvements can be made. Depending on the business, this might range from wholesale change through to small tweaks around the edges to improve sustainability outcomes.

Despite this range of approaches, only 4% of our respondents believe ESG due diligence is 'not at all' its own area at this stage, with 11% answering 'not very much'. The remaining 43% say 'to a certain extent'.

"Historically, ESG DD may have been a box-ticking exercise and quite anodyne. It has become more detailed and focused on value-add, and it happens much earlier in the process and is more focused on value creation than purely risk management," says Long.

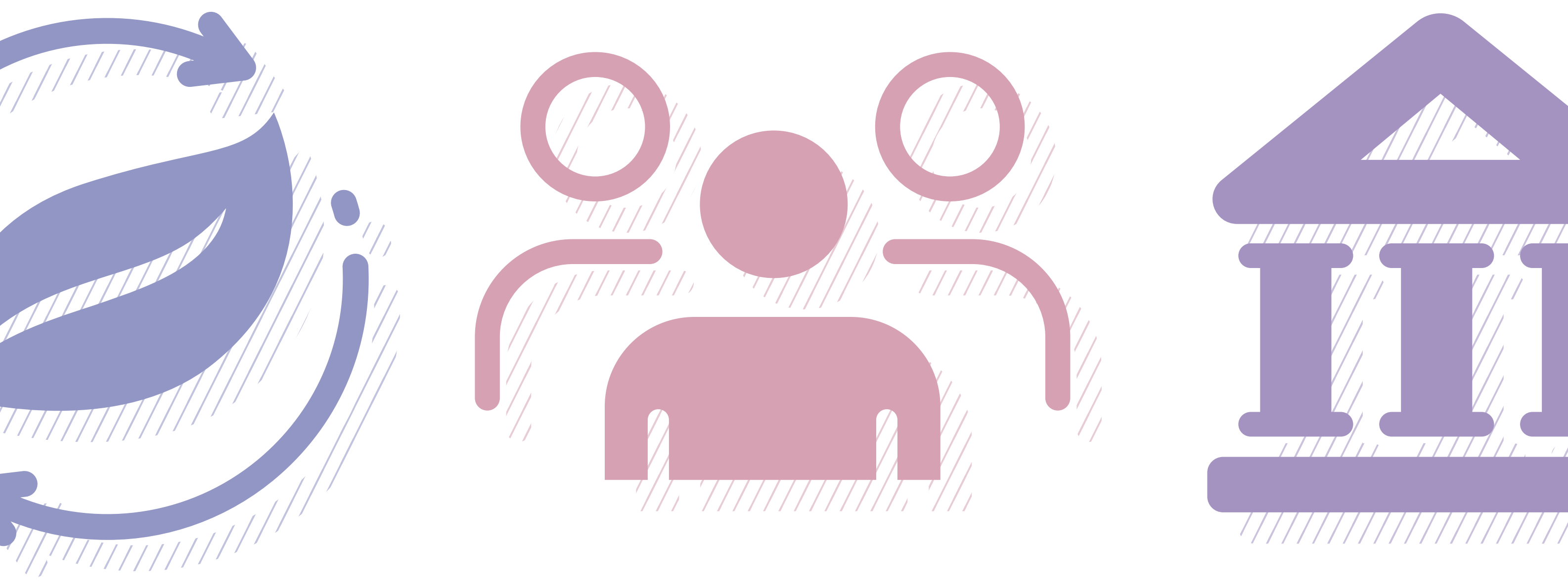
"It's an increasing area of focus in the DD process, but it's still early days in the mid-market. Larger cap funds are more advanced in having specific ESG DD providers," says Richard Chapman, Partner at PE investor group ECI Partners.

While it remains early days for the mid-market, the progression of ESG can be seen in its increased prominence in Investment Committee papers.

"Since 2022 we have had an investment prompt list as part of our IC paper to evaluate businesses' ESG credentials, rather than just a one-liner within the paper. Sell-side, we are factoring it into our exit processes now.

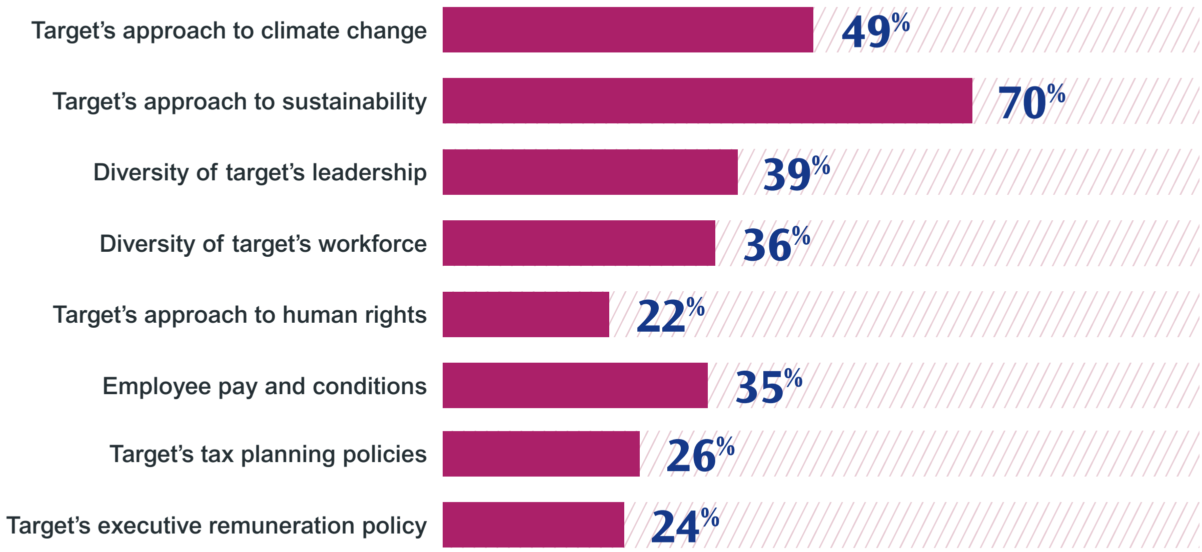
"It's a key metric when deciding on a deal – we won't engage in certain sectors on ESG grounds and if we felt a business was counter to any macro ESG trend.

"We get excited for things like 'tech for good'. It does go through to appetite and valuation," says Chapman.



The marathon continues

Ranking specific ESG factors



Respondents were asked which specific ESG factors are the most important when assessing a potential M&A target

It is clear that the spotlight on sustainability and related issues is not just a passing trend. Economic downturn will be a key period in the ongoing assessment of where ESG truly ranks. The resolve and commitment of corporates, consumers and investors will be tested by the challenging times upon us and no doubt still to come. Lip service will likely be exposed and the gap between rhetoric and action will become harder to hide.

"It's not a novelty. It has shown itself to be a mainstream topic and part of the day-to-day conversation in deal-doing circles. Whether corporate buyer or financial investor, ESG best practice is now firmly on the agenda and is often a condition of any acquisition or investment," says Ali Aneizi, Founder at consumer-focused M&A and PE advisory business Tamweel, itself a certified BCorp

However, after the explosion of the ESG term into corporate vocabulary over the past decade or so, replacing – and going beyond – the concept of corporate social responsibility, a slowdown has taken hold thanks to greater scrutiny and 'integrity-testing' of claims and credentials. More sophisticated data tracking and measurement options have also played a role.

As reporting requirements continue to rise and key milestones for achieving ESG-related goals and commitments draw nearer, dealmakers may be on the lookout for deals with an ESG angle, as strategic acquisition could be an impactful way of taking big strides towards meeting those goals. This impact may be reflected in larger multiples for those businesses with demonstrable credentials that stand up to scrutiny.

ESG's disruptive impact on dealmaking is still a work-in-progress, but will surely continue to increase. Greater scrutiny of these concepts during due diligence, VDR and IC approval is one area of focus, while financing may also become increasingly tied to ESG covenants. ESG-linked performance metrics will generally become more widely used alongside financial targets for management teams and departing shareholders.

There is a limit to the disruption ESG will cause in M&A terms. But there is no doubt its role is on the up, with sustainability ranked as a top three ESG consideration for 70% of investors and acquirers assessing a potential target, while its approach to climate change was highlighted by 49%. A year ago, sustainability was identified as a top three factor by 65%, with climate change picked by 31%, again highlighting the heightened value placed specifically on environmental and sustainability issues in light of net zero targets. Other factors such as diversity, human rights approach, tax planning policies and executive remuneration scored much lower.

Ultimately, the ESG approach businesses, investors and buyers follow will be determined by what makes most commercial sense for their current growth plan and where they are in their business lifecycle.

> *"It needs to be looked at in the round. There's little point being ESG-focused if you're not profitable," says Aneizi.*

The sweet spot for difference-making comes where ESG and financial performance collide.

"UN Sustainability Goals are on the horizon and are a factor we try to ask portfolio companies to go after, but Nirvana is where you're using them to create value in the company," says Long.

With key targets like these approaching, the corporate and investor focus on ESG continues to increase, particularly when it comes to environmental impact. Dealmakers are naturally keeping a close watch on this, and our data shows the upwards trajectory which ESG issues are on. This is clearly reflected in the fact that twice as many respondents listed ESG considerations as a major influence on weighing the attractiveness of a target compared with just a year ago.

Looking ahead, it will always be one of a number of factors that dealmakers assess, but the momentum is undoubtedly shifting away from ESG being viewed as a risk factor that must be mitigated, and towards the merits of ESG as a growth factor and value-driver. This change in perspective is already breeding positive results and we expect this pattern to continue throughout 2023 and beyond.

About Trowers & Hamlins' corporate team

Businesses today face a range of challenges as well as opportunities when looking to grow – our role is to help you navigate complexity, prepare for change and adapt to a shifting political and economic landscape. Our corporate lawyers will help you assess and make decisions on your growth strategies – recognising that this involves balancing risk and legal considerations with your commercial business objectives. Simply put – we're here to help your business operate, grow and succeed.

From acquisition activity, partnering in joint venture arrangements, raising finance in the public or private investment arena or seeking to overlay corporate governance arrangements on your business – our specialists understand what you need.

Whether you are adopting a buy and build approach, engaging in a strategic acquisitions programme, seeking to establish a stronger capital base whether through entering the public market or raising investment by partnering with private equity, we can assist. We know investments and we know acquisitions. From structuring the transaction to undertaking core due diligence, to drafting and negotiating investment agreements, shareholder agreements, sale and purchase agreements, we know how to kick off, execute and deliver transactions. Our experts will advise and guide you throughout the whole transactional lifecycle, and post deal support.

We make it our business to understand how your business operates – knowing what's important, what's current and what's coming next – investing time and commitment into building collaborative partnerships and on-going dialogue with you. Many of our client relationships have lasted decades – so businesses benefit from our knowledge of company history, mutual expectations and establishing working relationships.

So whatever stage you are in your growth strategy – you can be sure you are working with a team who understand the transactional lifecycle, what your business needs and how to partner with you to execute your strategy.

In brief

- Passionate about helping businesses operate, grow and succeed
- Dedicated middle-market specialists
- Market expertise combined with sector knowledge
- Dedicated experts in mergers and acquisitions, private equity, capital markets, corporate finance, corporate governance, corporate restructuring, cross-border investment, fund formation, financial services and joint ventures
- Bridging private and public sector collaboration

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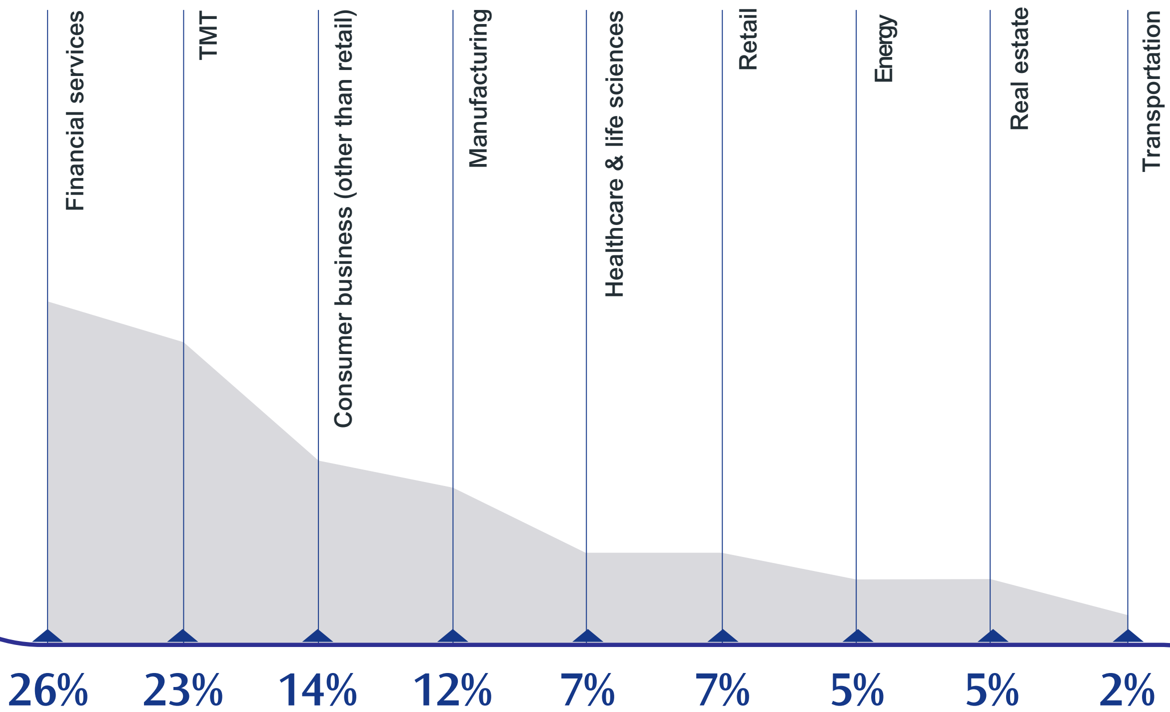
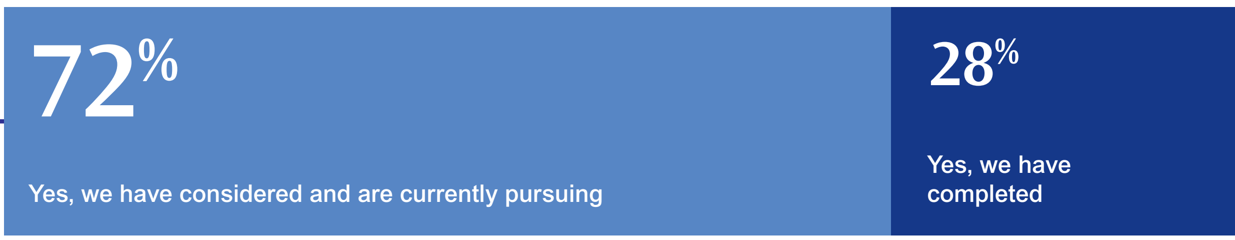
Appendix 1: About our respondents*

Respondent type

Which of the following industries best describes your primary business?



Has your business considered or completed an M&A transaction in the past 18 months?



* All respondents were primary decision-makers or part of a team that shares decision-making responsibility. Respondents all have one of the following job titles: CEO, CFO, MD, Director, President, VP, AVP, Partner, Unit Head.

Appendix 2: Methodology – our research

Trowers & Hamlins' research into the UK mid-market dealmaking landscape is designed to provide timely insight into, and understanding of, the role of transactional activity in business transformation and corporate growth.

Following our most recent report in the 'Monitoring Mid-Market M&A' series, which analysed the M&A landscape in light of recent economic conditions, this report focuses on the increasingly important role of ESG in mid-market dealmaking

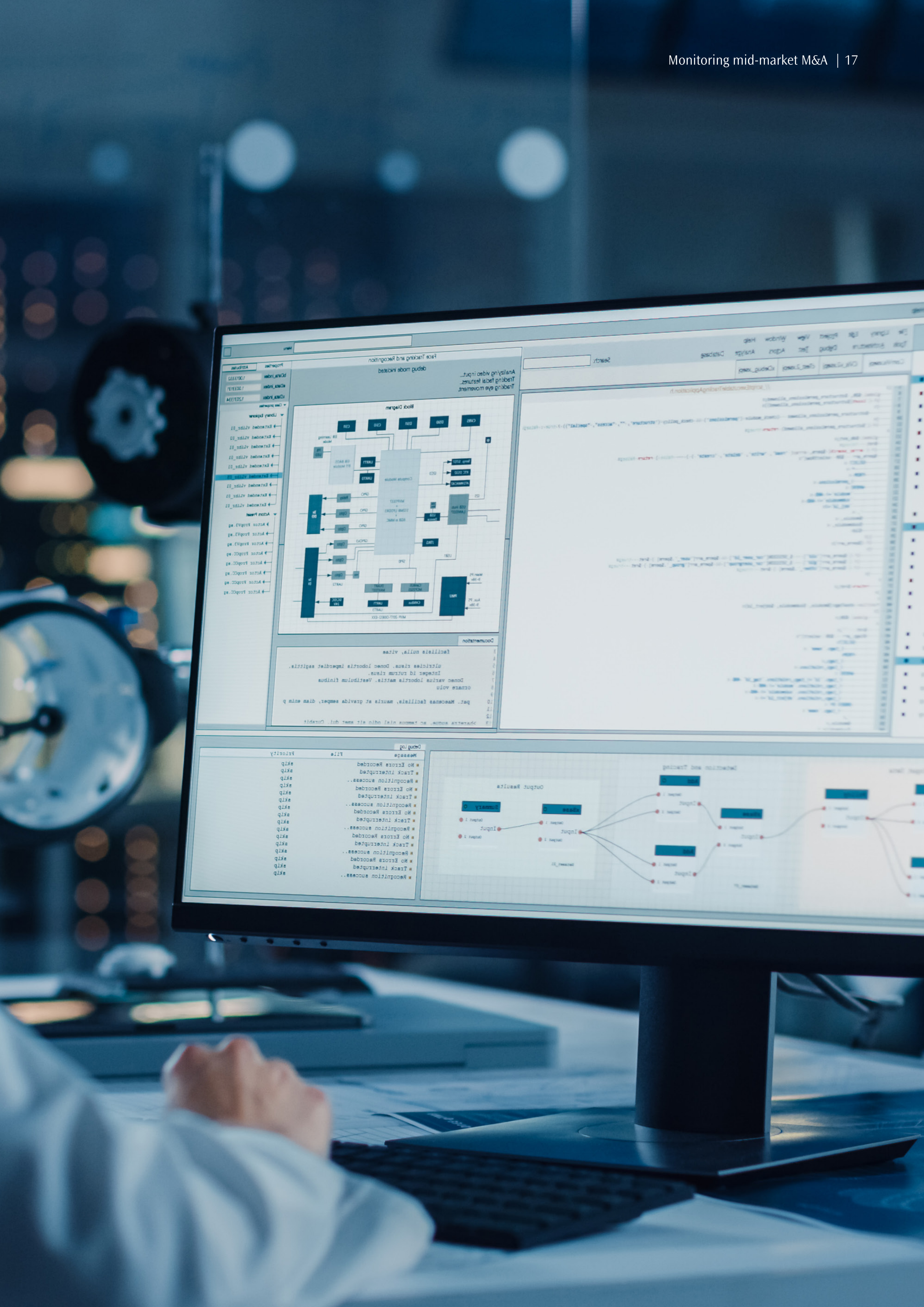
For the purposes of this research, 'mid-market deals' were identified as deals valued between £25 million and £150 million. Given Trowers' particular expertise in the mid-market, we have applied this magnifying glass to our research in order to more closely analyse qualifying M&A activity.

Our research presents a survey of dealmakers including insight from private equity investors and views from across the corporate finance world.

These sources represent a range of industries, including Consumer, Financial Services, Healthcare and Life Sciences, Manufacturing, Retail, Technology, Media and Telecommunications, and Transport. All respondents had recently completed, or were currently pursuing, a deal.

Our research team also conducted a series of qualitative interviews with representatives of the corporate c-suite, their professional services advisers and the investment community, to hear first-hand how the trends unearthed by our data tools are playing out in practice.

This is the second instalment of a research set which will be repeated annually to provide year-on-year comparison of dealmaking activity and trends, focused on how corporate growth and economic health are impacting – and being impacted by – the M&A mid-market.



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