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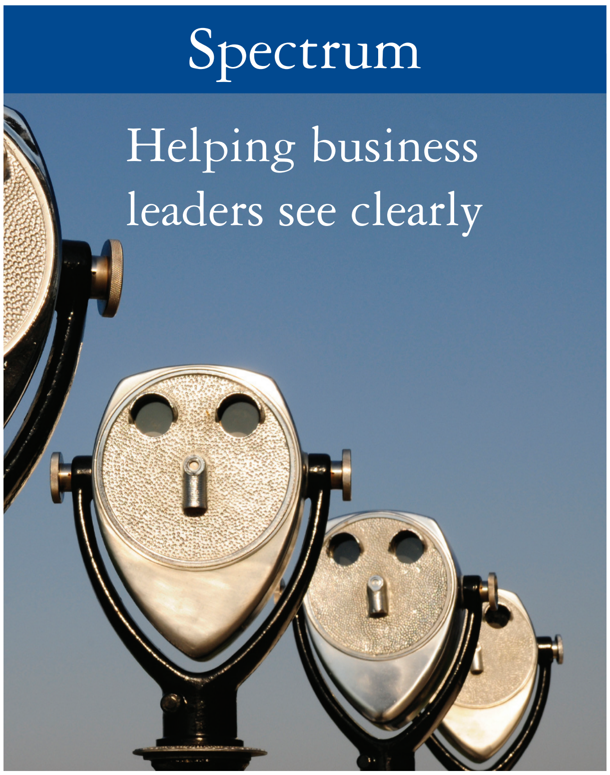
Merger & Acquisition Services

How Green is the Deal? The Growing Role of Sustainability in M&A



The "greening" of products and business operations has become a central theme in virtually every industry. Companies increasingly recognize they can be better positioned to achieve strategic and financial goals by addressing sustainability issues and requirements.

Mergers and acquisitions (M&A) and divestitures have been — for the most part — unaffected by the green trend. However, recent deals in industries as disparate as energy and retailing have demonstrated that sustainability can affect both the viability and the ultimate value of deals. Companies are seeking to gain support for acquisitions by committing to actions that will help address issues which affect the environment. Others are willing to pay a premium earnings multiple for companies because of their sustainability leadership.

In today's environment, companies that have strong corporate responsibility and sustainability (CR&S) programs in place are likely to be rewarded for their efforts. Those that don't have such programs can expect to face increasing regulatory and marketplace demands for change. It is clear that greater consideration of sustainability related issues when evaluating potential M&A transactions will help improve the likelihood of the success of the deal.

A changing landscape

The trend toward considering CR&S in M&A continues to gather momentum, fueled by an array of factors.

Regulatory changes at the federal, state, and local levels are aimed at more aggressively combating issues that impact the environment and protecting the soil, water, and air. As environmental regulations become more stringent, companies face increasing demand for information about their environmental liabilities. Legislative initiatives and lawsuits are likewise addressing these concerns. These issues have historically impacted only certain sectors but future regulations are likely to have much broader reach.

Sustainability has become a financial disclosure issue as well. Investors are calling on the Securities and Exchange Commission (SEC) to issue guidance for publicly traded companies to assess and fully disclose their financial risks from environmental issues. Responding to the clamor, the U.S. Senate Appropriations Committee has approved language in the Financial Services Appropriations bill for the next federal fiscal year directing the SEC to take such action.

Environmental matters are not new to M&A. Assessing the scope and cost of remediating soil and water contamination, for example, has long been part of the deal calculus. But today the requirements are increasingly far reaching, both in the industries affected and the types of exposures that companies face. In light of this, it's important for both M&A buyers and sellers to understand the scope and impact of sustainability issues on the structure, execution, and value of deals. The deal parties can then take steps to address these issues appropriately.

New requirements flourish

New and proposed changes to regulations are causing dealmakers to think more carefully about the implications of upcoming deals and — if necessary — alter their approach, as a recent energy industry deal highlights.

The deal broke ground in terms of assessing potential future environmental liabilities. The acquirers recognized that the growing call for some form of national carbon legislation in the United States could lead to huge expenses for coal-fired power plants. Because of this, they made the decision not to build plants the acquired company had previously planned. In the process, they demonstrated that responsibility can be good for business by substantively addressing the environmental issues and engaging investors and activists in the process.

Energy isn't the only industry affected by sustainability issues such as carbon trading and environmental protection. Deals in virtually all sectors are likely to involve a variety of sustainability challenges and opportunities. The key is to recognize them early.

In manufacturing, growing risks and uncertainties related to the price and availability of natural resources are challenging companies to reduce their resource footprint. Manufacturers are seeking ways to reduce emissions and control the use

How to tackle sustainability issues during a deal

How can you address sustainability questions that will increasingly arise in M&A situations? Here are a few suggestions to consider:

- **Know your own backyard**. Sellers and buyers alike should understand how well their organization is addressing sustainability issues. Acquirers should assess the strengths and deficiencies of the target company's sustainability efforts within the context of what's being done in its own organization.
- **Begin to incorporate CR&S metrics, goals, and targets into the deal valuation process**. Along with the pure economics of the deal, evaluate potential acquisition targets in terms of energy and water consumption, carbon footprint, solid waste and wastewater disposal, and other environmental concerns. Know and understand the potential costs associated with these factors.
- **Consider the potential economic impact of changes on consumer preferences, legislative changes, significant variations in energy prices, and other supplier prices**. Identify potential future costs (including potential branding impacts) associated with carbon emissions generated by the acquired operation. Explore the economics of using offsets. Evaluate how different fuel supply conditions could affect an acquired operation's ongoing profitability.
- **Plan for evolving regulatory conditions**. Conduct planning exercises under different future regulatory scenarios. How would a stricter or more lenient regime affect the value of the deal?
- **Engage in a formal alternative future/risk assessment scenario planning exercise**. Think about the potential impact of environmental developments on the target company. Does the company have operations in geographic locations that could be especially vulnerable?
- **Consider the people aspects**. Determine whether target-company management can effectively address sustainability requirements and whether the people responsible for sustainability initiatives are capable and receiving necessary organizational support. Assess the potential impact of sustainability initiatives on talent recruitment and retention. Consider what change management and communication efforts will be needed to instill the importance of sustainability in the organization.

of power and water in their supply chains, production operations, and distribution systems. Measures such as shrinking packaging size can yield multiple benefits including reduced resource and transportation costs.

Retailers, meanwhile, are developing "green" store templates. They are incorporating resource-conserving features, environmentally conscious branding, and alternative energy sources into their store layouts and operations. In one recent deal, a grocery retailer paid a premium for a target company because of its advanced sustainability approach and capabilities in such functions as procurement, store operations, distribution, and community involvement programs.

Product disposal is another sustainability issue with potential ramifications across the supply chain. There are growing calls for some manufacturers to take responsibility for retrieving items from customers and disposing of them. This is an expensive process involving storage, transportation, and disposal costs. It could also create a retirement obligation on a company's books.

The impact on M&A

CR&S issues have traveled from their roots in community and environmental activism into the forefront of regulatory action and, ultimately, the valuation of deals.

M&A is frequently used strategically to attain a competitive advantage in the marketplace. As government regulation and consumers embrace the principles of sustainability, the need for companies to develop enterprise sustainability capabilities becomes increasingly imperative. M&A can be used strategically to identify competitors with existing skill sets that can be incorporated into the existing organization.

In a merger or acquisition, a buyer should learn exactly how advanced the target company's assessment of sustainability issues is. This involves understanding their philosophy, how it has impacted operations, and whether management is capable of addressing upcoming issues in the right framework. A seller should understand its position relative to CR&S activity and be able to accurately convey that to a buyer and ultimately help achieve higher value for the sale.

Some acquisition targets may be rewarded for their sustainability excellence. In other instances, however, companies may not be as far along the sustainability continuum, lacking the processes, metrics, and leadership focus and support required to effectively address the issues involved. These companies may be valued differently as a result.

Evaluation of a target company's CR&S activities must go beyond the seller's public claims regarding carbon output reduction, lowering of energy use, or other sustainability successes. The metrics associated with such claims are evolving and so far subject to little agreement. Often, companies don't consider what is technically, operationally, or financially feasible from a sustainability standpoint. At the same time, they may lack appropriate controls for review of external communications regarding sustainability claims. A company that is either too aggressive or conservative in its representations could end up having to account for this down the road, potentially impacting brand value.

A buyer should examine the seller's processes and controls underpinning such claims and get comfortable that it can in fact meet the commitments it has made to shareholders, stakeholders, and the communities in which it operates. This may involve the use of public domain searches and business intelligence tools to assess and compare assertions in news releases, on a Web site, and in financial statements. Often, such information doesn't align.

Preparing for a sustainable future

As CR&S wields growing influence on the strategy and operations of companies, so will it become an increasingly important aspect of M&A. Acquiring companies will want to know whether they are taking on sustainability problems or opportunities. Divesting organizations will want to know whether their sustainability profile will contribute to a premium or discount price.

Making such determinations won't be easy. Evolving regulations, fluctuating but relentlessly growing demand for energy and natural resources, and potentially game-changing technological advances may all play a role in shaping an unpredictable future.

Regardless of what's in store, companies involved in M&A should be better prepared by addressing CR&S issues early in the process. As recent deals demonstrate, protecting the environment and treasuring the earth's resources can benefit both the planet and the bottom line.

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