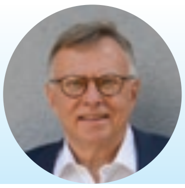
ESG Investing and its Impact on Middle-market M&A Across the Globe

Following keynote speaker, José Manuel Barroso's kick-off of IMAP's Environmental, Social, and Governance (ESG) initiative, IMAP held the first in what will be a series of panels dedicated to ESG investing. With IMAP Chairman, Jurgis Oniunas, leading the discussion, IMAP partners Pedro Benites, Brent Walker, and Vijay Balasubramanian, alongside Federico Gandino Masetti, General Manager at Rekeep World S.r.l., shared their experiences and deliberated on what is clearly no longer a voluntary activity and has serious implications for mid-cap transactions.



Setting the Scene

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You will have heard me mention on previous occasions that we should always be building for growth and preparing for the next wave. ESG investing is a wave that is already a major factor with debt providers and private equity funds, and its influence on mid-cap transactions will continue to grow.

In March 2021, the EU Sustainable Finance Disclosure Regulation (SFDR) came into effect and is designed to drive capital towards sustainable orientated investments. It's being followed by US and European firms, so it's clear that part of the move towards ESG we are currently experiencing is regulatory motivated.

Furthermore, at the recent COP26 conference, $130 trillion of capital was committed to net zero by the Glasgow Financial alliance for Net Zero, or GFANZ, a group of banks, fund managers and issuers led by Mark Carney, the Canadian former head of the Bank of England. To put things in perspective, that number is six times the GDP of the US, and larger than the market cap of all the world's stock markets. Whether or not that number is hype is beside the point. A huge amount of capital is being committed to net zero – estimates are that $2.5 trillion of annual investment will be required over the next five years alone.

So, the question is, how should we approach this? I see there being two different paths; first, the reactive approach, what we must do to meet ESG regulatory requirements, the other is what I consider a more pro-active point of view, i.e., where do the opportunities lie because of this new form of investing? How can we find the opportunities to drive these transactions? If we want to look on a sector basis, it's important that we understand the carbon footprint of each sector in turn, to evaluate the trends and subsequently find the opportunities. If we take the Healthcare sector as an example, there's telemedicine, life extension, new materials for health equipment and so on.

Ultimately, we need to find ways both to guide our clients through this new regulatory and financial wonderland, and more relevantly, to find opportunities that will drive these transactions. ESG is no longer a matter of personal choice - it's business.

Canada

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I'd like to start by echoing what José Manuel Durão Barroso has said, that ESG is now mainstream, as this has certainly been our firm's experience. Approximately half of our revenues over the last 10 years are due to ESG investing or advisory activities, which begs the question, what is happening in our market to create this situation? My observation would be that in our market we have been doing ESG for years before it became popular.

If you take the province of Ontario as an example, 20 years ago, the decision was made to close all the coal-powered fire plants, which led to a building spree, refurbishing our nuclear plants, and building wind and solar, along with transition fuel for natural gas power plants and we've been right there in the middle of this activity, be it financing or advisory on buying and selling.

Also in Canada, we're very open to immigration and we bring in approximately 400,000 new Canadians a year, and of course, they require somewhere to live. We are currently experiencing a massive housing affordability crisis so affordable housing investment is an economic imperative and we've been a leader in social housing finance for the last 10 years or so. About 10 years ago, we did a $250 million bond issue for the Regent Park project in Toronto, designed to redevelop the neighbourhood. Nowadays, this would be classed as a sustainable bond, which brings me back to the point that in Canada we have been doing this sort of activity for a long time.

Interestingly, we also have a large resource base in Canada, with lots of mining activities, some of which are for ESG minerals such as those for batteries. Most of these resources are located on indigenous land, and over the years we have advised many First Nation communities on how to earn money from their land, primarily from the mining companies.

We have also been doing a lot of work in the impact investing space. Family offices are an important part of this dynamic and there is high demand from them for sustainable investments. However, it is challenging to find direct investments in real projects that will make a real difference. We are seeing some investors unwilling to receive sub-market returns on this type of investment. At the end of the day, investment funds are looking to achieve alpha returns on their investments, though we are seeing some willing to accept beta on their investments, as long as in other areas of their portfolio, their alpha returns are in the form of social benefits.

Finally, though as a rule the "G" in ESG has less visibility, I would say that Canada has a very active governance business and we ourselves have advised on many governance issues. I would also add that ESG creates volatility, which in turn creates opportunity for investment bankers.

Portugal

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In terms of our activities, ESG is going to make an impact, namely with regards to the investor base and their availability to invest in equity and debt through ESG available funds. It also affects the diversity of the investor base, as in some cases, investors are no longer interested unless they see the target is ESG compliant. Further down the line, during the due diligence process, ESG will also be an important factor in determining the company valuation, which must be taken into consideration and factored into the transaction process.

Just recently, the International Financial Reporting Standards (IRFS) issued a notice advising of their plans to put in place international sustainability financial reporting. We are currently seeing a big issue in being able to properly compare companies. Therefore, this new regulation will ensure that all companies can be compared on an equal basis and measured across the sectors to understand how they will impact ESG. Investors and businesses will have the necessary information to understand the full range of environmental risks they face and create.

We are already working on a sustainable-linked bond, which we hope will soon be coming to the market. In parallel, we are also working on and providing advisory on the format and structure of several green bonds and see lots of potential in this area.

Due to its increased importance, our firm is taking great steps to understanding the implications and determining our approach to ESG investing.

USA

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For the last 15 years or so, I have focused on the Chemicals and Special Materials industry and as you can imagine, the "E" in ESG has been extremely important for deals in the space. One of the first deals I worked on in the industry was for a large acquisition financing. Whilst presenting to the credit officer, I realized his negative preconceived notions of the industry (pollution and hazardous materials) just about sums up the way the general public feels about chemicals. Most of the press the industry receives is bad (spills, leaks, explosions etc.), so the "E" in ESG has always been very central to dealmaking - investors don't want to spend millions on an asset and then have to spend billions cleaning up environmental or safety issues. Historically however, the "S" and "G" have been very low touchpoints.

Over the last few years, we have seen an explosion of interest in ESG in the Chemicals sector. I was looking through the earning call transcripts of the 10 largest chemical companies and found that eight of them mention "ESG" and "sustainability" multiple times in their most recent earning calls – go back to their 2015 year end call, and you find that none of the ten mentioned either term during the call. ESG is now front and center for the industry.

This has led to many interesting developments and there are five in particular I want to share:

1. Everyone is now looking to build ESG credibility. At least for the "E" and the "S" parts, the easiest way to achieve this is through acquisition. However, there is not a lot available to buy on the market and prices are high – should you find something, you will have a long list of potential buyers.

2. Due to difficulties in buying, chemicals companies are spending significant money on building capabilities (e.g., recycling, R&D on renewable feedstocks etc.). However, this will take time to scale/ make a difference.

3. The changes we are seeing appear very abrupt and may cause unintended disruptions. For example, it's become increasingly difficult to raise funds to dig new oil & gas wells. I believe a greener future is better for all of us, yet the transition must be managed well, or the short-term disruptions could be severe.

4. There remains much confusion as to what contributes to ESG so this needs better definitions and a better understanding of objectives which will allow us and our clients to focus on solutions that work.

5. There are a lot of new opportunities and technologies emerging (e.g., carbon capture) that are nascent and not profitable today but will require capital and support in the near term.

We see lots of changes ahead, not just for the Chemicals industry, but across the broader economy as well and as with all change and volatility, this brings opportunities.

Italy

FEDERICO GANDINO MASETTI
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For Rekeep, and from a corporate standpoint, ESG is becoming more and more crucial. It forms an integral part of our critical mission and core business. Indeed, almost 50% of our activities are devoted to helping our clients to go greener, for example in areas such as waste management and energy efficiency, etc.

Rekeep is a management company, and we have over 300 owners of the company. We have had a corporate social responsibility (CSR) report since 1992, meaning we have been talking on a stakeholder level as opposed to shareholder level for 20 years now.

One important point is that Rekeep is already on the market. We issued a bond for almost €400 million in January 2021, which received a high level of demand (multiple times the book). Whilst there were approximately 50 core institutional players that purchased the bond, we also saw that some players were hesitant as they felt Rekeep was not ESG compliant. Considering that in January 2023 we will have the opportunity to refinance the entire bond, we realized that it was crucial for us to turn our CSR report into an ESG compliant report. We subsequently gave a mandate to a strategic consultancy company to help us achieve this and are very close to being able to being labelled ESG compliant.

At the end of the day, for our company, because of the industry we are in, and our core business, ESG is already a big part of our culture.