How ESG due diligence can help PE firms create value

Like other investors, private equity (PE) firms have come to recognize that companies can create value with thoughtful environmental, social, and governance (ESG) programs.[1] They also see that there is an opportunity to add value by improving a weak ESG program. This is why PE firms should understand how ESG is contributing to value in companies that they are buying—and how ESG can enhance the value of portfolio companies.

In this brief paper, we show how PE firms are making ESG diligence part of their process for assessing M&A targets and preparing assets for sale. We also look at how buyers calculate ESG value during the deal and plan value capture after close. By focusing on ESG value creation early in diligence, investors improve the odds of improving EBITDA and hitting other financial performance metrics. Without robust ESG diligence, investors are leaving money on the table.

ESG diligence is becoming standard

It is increasingly common practice to embed ESG assessments into the overall diligence process. In a recent KPMG LLP survey,[2] 33 percent of U.S. respondents had conducted ESG due diligence in more than half of their deals in the past two years. However, 43 percent noted that they plan to conduct ESG due diligence in the majority of their deals going forward. Among respondents who consider their ESG due diligence approach to be top-notch, 90 percent say they use their findings in post-closing action plans, including identifying specific sources of value creation.

Sell-side ESG diligence can also be used to increase value and attract more bidders. In the U.S., 63 percent of investors say they would pay a premium for a target demonstrating high ESG maturity. And more than half of buyers said that a material ESG finding or weakness—such as high exposure to future carbon taxes from operational inefficiencies tied to legacy capital assets —had led to deal cancellation.

[1] Source: See "How to determine where ESG can create value," KPMG LLP, 2022

[2] Source: See "2023 US ESG Due Diligence Study" KPMG LLP, 2023

Where to look for ESG value during diligence

Effective ESG diligence should focus on tangible sources of value creation from ESG programs, performance, and business strategies. For example, acquirers can calculate the financial value of a target's decarbonization plans. Increasing energy efficiency in buildings, equipment, and transportation fleets is often a KPI in a company's ESG program. These initiatives reduce operating costs while helping the company make progress toward its decarbonization goals (See "Putting a price on decarbonization"). In addition to installing LED lighting and energy-efficient windows and HVAC systems, companies can reduce energy costs by using Power Purchase Agreements (PPAs), which can also provide tax credits and potential brand enhancement.[3]

Environmental, health, and safety (EHS) management offers another opportunity for tangible cost savings by limiting use of dangerous materials such as chemicals, cutting water use and discharge, and reducing waste. EHS programs also help avoid fines and reputational damage caused by pollution violations and exposing employees to dangerous substances. Proactive management of employee health and safety programs and training can avoid costly penalties for OSHA or other regulatory violations, workers' compensation, and legal costs.

Companies that demonstrate progress on climate action can also create value by winning more customers. A growing number of consumers say that sustainability is a purchasing consideration. Also, companies can win supply contracts with companies that are trying to hit Scope 3 (supply chain) emissions targets by showing that they are adopting sustainability practices.

Finally, sustainable practices can increase value in an asset sale. For example, during a recent sell-side diligence, KPMG helped a private equity-owned packaging company present a sustainability value story based on the client's use of recycled materials in its cardboard and plastic products.

In cases like these, ESG can be a powerful driver of financial performance, as well as a means of aligning company goals with broader societal outcomes. With so much potential value at stake, ESG considerations should be a central focus for investors throughout the investment cycle.

Putting a price on decarbonization

During due diligence for a PE buyer, KPMG helped identify energy and operational efficiencies that would reduce a portfolio company's carbon footprint and lead to cost savings. These included new logistics analytics to provide dynamic scheduling, route optimization, and other improvements, which amounted to an estimated $8 million a year in OpEx savings. KPMG also demonstrated that the company could save $1 million a year by switching to LED light fixtures across its facilities. Further, KPMG calculated a savings between $9 and $40 per MWH (megawatt hour) in the U.S. and $10 to $20 per MWH in the EU by using Power Purchase Agreements (PPAs) for renewable energy contributing to more savings.

ESG value creation opportunities

Cost saving opportunities

- Reduce transition risks related to climate transition such as exposure to energy price increases and carbon taxes
- On-site Renewable energy/PPA procurement
- Fleet electrification/optimization
- Raw materials cost savings by designing out waste and reuse/recycling
- Manufacturing efficiencies and material efficient operations
- Heating/HVAC/Energy efficiencies
- Reduce water consumption and discharge costs
- Reducing EHS violations that result in fines and penalties through waste, water, and chemical management
- Reduce legal and reputation risks and employee turnover costs from failure to provide a safe workplace

Revenue uplift opportunities

- Meet customer demand for green products with sustainable product sales growth
- Sales increase opportunities by meeting customer goals and targets
- Compete effectively and expand market share through new business models or green products
- Build a strong brand for providing safe and responsible products
- Improve employee engagement, satisfaction and productivity which supports revenue growth

[3] Source: See "Decarbonizing with virtual power purchase agreements," KPMG LLP, 2023

Integrating ESG diligence into the deal process

Identifying and sizing ESG value creation opportunities and risks during the diligence phase can help PE buyers and sellers across the investment lifecycle. The analysis can document value-creation opportunities that affect deal economics and by presenting the ESG analysis and projections during the underwriting process, can align funding with the true value of the target. The same analysis can help the PE buyer prioritize the most valuable ESG activities to pursue during the first 100 days post-close (Exhibits 2 and 3). Additionally, by presenting the ESG value story, investors can also demonstrate their commitment to sustainable practices to limited partners and other stakeholders.

During due diligence, deal teams can use industry datasets and analyses of company data to estimate the potential financial impact of a target's ESG and decarbonization efforts. This analysis includes evaluating the financial impacts of climate-related transition risks along with physical risks. To get to the net financial impact, the team must then deduct the estimated investment for energy efficiency upgrades or training employees on new processes, for example.

Integrating Climate Considerations into Target's 100 day plan

	Step 1 **Level setting**	Step 2 **Climate risk assessment**	Step 3 **Validation of DD findings**	Step 4 **Business plan adjustment**	Step 5 **Mapping of next steps**
Overview	**Understand current position and identify strategy to fill data gaps**	**Understand current position and identify strategy to fill data gaps**	**Understand current position and identify strategy to fill data gaps**	**Understand current position and identify strategy to fill data gaps**	**Understand current position and identify strategy to fill data gaps**
Key activities	• Verify current baseline • Fill any key data gaps identified during the DD needed for the following steps	Physical risk assessment: • Analyze potential physical climate risk on key sites and assets Regulatory assessment: • Assessment of key regulations impacting the target in their key geographies and financial implications and mitigation strategies of those regulations	Technical assessment: • Detailed individual site review • Validate and Identify decarbonization projects for short-, medium- and long-term Economic assessment: • Update and refine CapEx and OpEx profile • Identify potential government incentives to support decarbonization actions	• Identify key recommendations and map synergies between climate and technical and commercial analysis, particularly across key CapEx projects • Work with Deal Teams to embed findings from step 2 and 3 into Target's existing business strategy consider key strategic changes	• Design foundation to implement the outcomes of the previous four steps • Analyze Target's internal programs and governance • Develop an end to end decarbonization strategy with a strategic roadmap to realize value creation opportunities
Outcome	**Enhanced understanding to form basis of following steps**	**Financial impacts of key risks and mitigation recommendations to embed in the business plan**	**Refined technical and economic analysis**	**Updated business plan aligned across DD areas**	**Strategic plan to embed climate into Target's future business strategy and realize value creation opportunities**

ESG Program Development Roadmap Illustrative Example

Short-Term (<6 months)

1. Formalize and document ESG program elements
2. Enhance public reporting on ESG metrics and program
3. Close open environmental, health and safety non-compliances/violations

Medium-Term (6-18 months)

4. Develop roadmap for each ESG program pillar
5. Develop a decarbonization plan to meet stated goals
6. Focus on product sustainability
7. Establish / further develop social programs

Long-Term (18+ months)

8. Perform a climate risk assessment
9. Design product and production process to reduce waste
10. Prepare to report under CSRD regulations

Conclusion

By identifying ESG value creation opportunities early in the diligence phase, investors can align resources and focus on the opportunities with the most impact throughout the deal, resulting in improved financial results, as well as the progress against ESG goals. Leading firms view ESG due diligence as a way to identify value creation opportunities that can drive financial performance while aligning the portfolio company and the PE firm with broader societal outcomes. The incorporation of ESG opportunities into the deal economics and post-close playbook ensure a focused approach to ESG value creation and early action planning.

How KPMG can help

KPMG offers a proven standardized approach to ESG M&A due diligence that is tailored to individual private equity clients. Our process can help you assess the risks, liabilities, and opportunities in your M&A investments. KPMG offers decarbonization services across industries and sectors for companies of all sizes. Let us help you find the right ESG solutions.

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