Department of Business and Management

Master's Degree Thesis in Corporate Finance

Chair of M&A and Investment Banking

ESG: from a nice to have to a must have in M&A Transactions.

Case Study: Ekaterra's Acquisition by CVC Capital Partners

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Table of contents

Table of contents 2

Introduction 4

1. Understanding ESG 6

1.1 Introduction to ESG 6

1.1.1 What does ESG stand for? 6

1.1.1.1 From Shareholders' Value Creation theory to ESG core role: a historical digression. 7

1.1.2 The European ESG Regulatory Framework 10

1.2 How do ESG factors impact corporate behavior? 13

2. ESG impact on firms' financials 18

2.1 Introduction 18

2.2 Positive Correlation between ESG performance and financial returns 20

2.3 Results and implications for investors 25

3. ESG Considerations in M&A deals 28

3.1 The current state of M&A 28

3.2 The ESG Due Diligence 32

3.2.1 ESG Risk and risks with ESG 32

3.2.2 The ESG Due Diligence process 35

3.3 The ESG premium 37

3.4 Private Equity Funds and ESG 39

4 Case study: CVC Capital's acquisition of Unilever's Ekaterra 42

4.1 Background and Deal rationale 42

4.1.1 The seller: Unilever 43

4.1.2 The Buyer: CVC Capital Partners 46

4.1.3 Ekaterra 49

4.2 Deal structure and timeline 59

4.2.1 Deal process ... 59

4.2.2 ESG – related issues ... 60

4.2.3 Closing the Deal ... 63

4.3. Ekaterra Company Valuation: Was it sold at a discount? ... 64

4.3.1 Choice of the Valuation Methods ... 64

4.3.2 Valuation through the Stock Market Multiples Method ... 65

4.3.3 Control method: the Comparable Transactions Multiples Method ... 70

4.3.4 Results and limitations ... 71

4.4 Ekaterra's future ... 73

5. Conclusion ... 74

6. Bibliography ... 81

Introduction

This Master's Thesis marks the completion of my two-year Master's Degree in Corporate Finance at LUISS University, by examining an emergent area of increased significance: the consideration of Environmental, Social, and Governance (ESG) factors in the execution of Mergers and Acquisitions (M&A) transactions.

The past decade has seen an ascension of ESG considerations from the periphery of business decision-making to its core. Such a shift is particularly noticeable in the realm of Mergers and Acquisitions, where ESG factors are increasingly influencing the dynamics of Deals. While businesses, investors, and regulatory bodies continue to place a high degree of emphasis on ESG compliance, it is becoming clear that M&A transactions cannot remain untouched by this development. To delineate this transformation, this Thesis delves into the intersecting realms of ESG and Corporate Finance, examining how ESG considerations are redefining the landscape of M&A transactions. In particular, this paper aims at answering the following questions:

i. Why did ESG consideration gain a relevant spot in M&A Transactions?
ii. How do ESG considerations influence the M&A process and the Deal outcome?
iii. In the context of Ekaterra's acquisition by CVC Capital Partners, what role did ESG considerations play? Was the company sold at a discount due to ESG - related issues?

In order to answer to the aforementioned questions, the Thesis is structured into four elaborate chapters, each serving as a stepping-stone to understand the multifaceted relationship between ESG considerations and M&A transactions.

Chapter 1, *"Understanding ESG"*, sets the stage for the discourse. It explores the concept of ESG from its very foundations, starting with a comprehensive explanation of what ESG factors entail. Recognizing that these factors do not operate in a vacuum, this chapter further investigates the regulatory framework in the European Union that oversees ESG compliance and standards. A deep understanding of this regulatory framework is critical, as it forms the backdrop against which companies, investors, and governments operate. Subsequently, the chapter discusses the implications of ESG considerations on corporate behavior, shedding light on the multiple ways in which ESG factors can affect operational strategies, stakeholder relations, risk management, and corporate reputation, among others.

Chapter 2, *"ESG impact on Firm's financials"*, takes the analysis a step further, examining the intersection of ESG considerations and financial performance. A comprehensive literature review is conducted, scrutinizing empirical and theoretical studies that seek to link ESG performance with firms' financial outcomes. The intention here is to go beyond the surface-level correlation and dissect the mechanisms through which ESG performance might drive financial outcomes. This analysis of existing scholarly works provides a holistic understanding of the

implications of ESG factors on firm financials, laying the foundation for subsequent discussions on their influence in M&A transactions.

Chapter 3, *"ESG Considerations in M&A Deals"*, shifts the focus to the very heart of this research: the relationship between ESG and M&A. This chapter seeks to paint a vivid picture of the current state of the M&A market, infused with the new dynamics introduced by ESG considerations. The complexity of this landscape is unraveled through a detailed description of the ESG Due Diligence process, illustrating how potential acquirers assess the ESG risks and opportunities tied to a Target Firm. Moreover, the chapter delves into risks associated with ESG considerations, such as greenwashing, which refers to deceptive practices by firms to appear more environmentally friendly than they are, and describes the ESG premium, an additional cost associated with high ESG compliance. It further explores the growing affiliation between private equity funds and ESG-linked investments, which has significantly influenced the M&A ecosystem.

Chapter 4, *"Case Study: CVC Capital Partners' Acquisition of Unilever's Ekaterra"*, provides a focused examination of an M&A Transaction where ESG issues influenced the outcome of the Deal. This chapter offers an in-depth analysis of the Transaction, focusing on the role played by ESG-related issues, particularly human rights concerns in the tea plantations, in shaping the deal's dynamics. Ekaterra (formerly Unilever's tea business) is the leading company in the tea industry, with a portfolio of 34 renowned brands. Unilever decided to dispose of its tea business in 2021, in order to focus its strategy on high-growth sectors, while the black – tea market reported stagnant growth. When it put its tea business, collected under the company Ekaterra, up for sale, many investors (primarily private equity funds) showed interest. However, in the final stages of the transaction, two out of the three final bidders withdrew from the deal. Sources close to these potential buyers confirmed that their motivation for the withdrawal was related to human rights concerns in the tea plantations, especially in Kenya. This left CVC Capital Partners with the opportunity to secure the company for € 4,5 billion, without *price competition* from its adversaries (i.e., Advent International and Carlyle). After providing a company overview of all the Parties involved in the Deal (i.e., the Seller, the Buyer, and the Target Company), as well as a market analysis focused on the tea market, a comprehensive valuation of the company is conducted to ascertain whether the ESG issues led to a discounted price for the sale of the Company, due to the lack of competition among the Bidders. The chapter unravels the implications of ESG considerations on this specific M&A deal and attempts to draw broader inferences about their role in the M&A landscape.

Through this extensive investigation, the thesis aims to contribute a meaningful understanding of ESG's rising impact on M&A deals. By weaving together theory, empirical research, and a real-world case study, this Master's Thesis provides a comprehensive exploration at the intersection of ESG and M&A, a nexus that is set to redefine the contours of Corporate Finance in the years to come.

1. Understanding ESG

1.1 Introduction to ESG

In recent years, *Environmental, Social, and Governance* (ESG) issues have gained significant attention from companies' stakeholders, such as investors, regulators, and Society as a whole. As this thesis aims to analyze the impact of ESG considerations in M&A deals, it is fundamental to first understand what ESG refers to: this section, in particular, focuses on what ESG factors are, what their regulatory framework is in Europe, and how they influence corporate behavior.

1.1.1 What does ESG stand for?

ESG, namely *Environmental, Social,* and *Governance*, is an umbrella term referring to the criteria used by stakeholders to assess a company's sustainable and ethical impact. The term was first introduced in 2004 by the UN Global Compact, through the *who cares wins* initiative (*UN, 2004*), and since then ESG relevance has grown sharply, reaching a core spot in investment decisions and company strategies' definition. Although there is no clear academic definition of the subject, according to *EBA (2018)*, this framework relies on three main pillars:

- Environmental factors: Under this pillar, they fall these metrics through which it is possible to measure the impact of a company's operation on the environment, such as *(i)* GHG emissions, *(ii)* Energy consumption and efficiency, *(iii)* Air pollutants, *(iv)* Water usage and recycling, *(v)* Waste production and management, *(vi)* Impact and dependence on biodiversity, *(vii)* Impact and dependence on ecosystems, *(viii)* Innovation in environmentally friendly products and services.
- Social factors: This pillar involves a company's impact on society, and the metrics focus on *(i)* Workforce freedom of association, *(ii)* Child labor, *(iii)* Forced and compulsory labor, *(iv)* Workplace health and safety, *(v)* Customer health and safety, *(vi)* Discrimination, diversity, and equal opportunity, *(vii)* Poverty and community impact, *(viii)* Supply chain management, *(ix)* Training and education, *(x)* Customer privacy, and *(xi)* Community impacts.
- Governance factors: The last pillar comprises metrics concerning the sustainability of a Firm's structure and management, such as *(i)* Codes of conduct and business principles, *(ii)* Accountability, *(iii)* Transparency and disclosure, *(iv)* Executives' pay, *(v)* Board diversity and structure, *(vi)* Bribery and corruption, *(vii)* Stakeholder engagement, and *(viii)* Shareholder rights.

Thus, the ESG framework aims to capture all non-financial risks and opportunities implied in a company's day-to-day operations.

1.1.1.1 From Shareholders' Value Creation theory to ESG core role: a historical digression.

Agency theory (Eisenhardt 1989) is used to comprehend the interactions between agents and principals. In a specific business arrangement, the agent is supposed to represent the principal's best interests without regard for self-interest. Conflicts of interest between the two parties may arise because certain agents may not always behave in the best interests of the principal. Corporate Governance literature underlines that companies may be affected by three different types of agency problems: (i) between shareholders and top managers (this is more common in Large Anglo – Saxon listed companies, characterized by a dispersed shareholding structure), (ii) between controlling and minority shareholders (more common in large, listed companies with a concentrated ownership structure, e.g. Italian family – held conglomerates), and (iii) between the firm (or its shareholders) and the other stakeholders.

To solve agency problems, or at least mitigate their effect on a Firm's long–term success, it is fundamental to understand what the purpose of a Company is, and thus allocate the so-called *residual ownership rights* (Zattoni, 2020) to those who will maximize the Company's overall value. In this context, it is possible to highlight two dominant theories: the *Shareholders' Value Creation Theory*, and the *Stakeholders' Value Creation Theory*. One or the other exists whether the residual ownership rights are entrusted to shareholders or a larger group of stakeholders.

According to the Shareholders' Value Creation Theory, the residual ownership rights have to be assigned to shareholders, since those (i) are the only group of stakeholders that is remunerated on a residual basis, since they perceive their income from the company as a dividend that is paid, eventually, with the residual cash flow that exists after repaying all the other stakeholders (such as suppliers, or debt – holders), and (ii) are the most likely to be expropriated by the Firm's top management which, according to the first agency problem, are used to pursue their own interest (i.e., *private benefits of control,* Zattoni 2020) and have direct control over the Company's operations. According to this Theory, the maximization of a Company's value overlaps with the maximization of Shareholders' value, because the relationship between Shareholders and the Firm cannot be regulated through complete contracts, as opposed to that between the Firm and other Stakeholders. Among the most relevant proponents of this Theory, there is the Nobel Prize winner Milton Friedman: in fact, in the article *"The social responsibility of business is to increase its profits"*[1] he argued that the primary objective of a Company has to be that of maximizing its profits for the benefit of its shareholders, staying in the bounds of law and ethical norms. According to the Article, Friedman thought that businesses should only focus on maximizing shareholders' returns, leaving social issues to competent organizations, like Governments, because pursuing environmental

[1] Friedman, M., "The social responsibility of business is to increase its profits", The New York Times Magazine, September 13, 1970.

sustainability or employees' welfare would reduce the Firm's profitability and the market's overall efficiency. Although Friedman's ideas shaped the way many businesses operate in the modern world, his theories have been subject to criticism from those who think that it is fundamental for a company to address other issues, pursuing the maximization of the Company's value for Society at large.

Those who criticize Friedman and, in general, the Shareholders' Value Creation Theory, foster the Stakeholders' Value Creation Theory, according to which Companies should meet their social responsibility toward all stakeholders and society. One of the main approaches through which this Theory is implemented on a real–world basis is CSR (i.e., *Corporate Social Responsibility*), which was first theorized by Howard R. Bowen in the book "*Social responsibilities of the Businessman*", that was published in 1953 and then republished, in 2013, by his eldest son. According to *Bowen* (*2013*), Businesses don't have to focus their strategies on just profits, instead, they have the duty to assess the social and environmental impacts of their actions, acting in a way that enriches society as a whole. One of the main suggestions of his work is that Companies should be accountable to society, and they should consider the *social cost* (i.e., the sum of private and external costs: the former is the direct cost sustained by the company to produce a good or to provide a service, while the latter is identified with negative externalities and is not reflected in a Company's income statement. The latter must be taken into account to ensure the generation of a socially efficient rate of output, which doesn't harm society) of their activity to the same extent as they consider financial costs. The publication doesn't leave all of the responsibility to Companies, instead, it suggests that Governments ensure that Companies act in the best interest of society, by regulating and limiting harmful activities, as well as incentivizing Companies that perform well under a CSR perspective.

Following Bowen's theories, *Elkington and Rowlands* (*1999*) suggest that those firms who seek long–term value creation should shift their focus towards a holistic approach, considering their social and environmental impact, alongside their financial returns. In particular, it introduced a sustainable development framework based on the so-called *triple bottom line*, which is composed of three dimensions: People, Planet, and Profit (also known as *the three P's*). By adopting such framework (i.e., improving the bottom lines, for example by investing in employees' welfare and development, reducing pollution, and reducing costs to increase profitability) Companies should be able to reduce the risks they are subject to when carrying out their activities and improve their reputation, thus gaining and retaining those customers who value sustainability.

According to *Wan et al.* (*2023*), ESG is the enrichment and extension of CSR, and, despite Friedman's work relevance, it is clear that nowadays the business ecosystem (made not only of Firms, but of a complex balance of stakeholders' interests), is converging toward what Bowen and Elkington theorized.

McKinsey (2020) proves this statement by comparing two surveys conducted among Executive Managers and Investment Professionals 10 years apart (2009 vs. 2019), where the interviewees were asked whether they thought that Environmental, Social, and Governance programs create long-term, short-term, or no value for companies. In particular, in 2019, almost 100% of the surveyed subjects believed that environmental programs create long-term value, while almost 60% thought that they can create short-term value. Moreover, 93% of the interviewees thought that social factors are able to create long-term value, and two-thirds of them believed that such programs could also bring value in the short run. Lastly, concerning Governance programs, it is shown that 93% of the respondents thought they provide long-term value, while 75% of them considered Governance to be able to generate short-term value. The table below (Table 1.1) shows the comparison between the 2009 and the 2019 answers.

Table 1.1 – Share of respondents to the survey who say given program creates value.

***Source**: McKinsey and Co., 2020. The ESG premium: New perspectives on value and performance*

By comparing the results, it is possible to highlight a steep increase in all the parameters examined, particularly those concerning the short-term and long-term value of environmental and social programs. Governance programs showed the smallest increase between 2009 and 2019, along with the long-term value of environmental programs, but this is justified by the fact that in 2009 their value already registered a high recognition among Investors and Executives.

Moreover, the hypothesis according to which the business ecosystem is converging toward a real-world application of Bowen and Elkington's theories on a wide scale can also be enforced by analyzing the most recent observable trends in both Companies' and Governments' decisions, as it will be done in the following paragraphs.

1.1.2 The European ESG Regulatory Framework

In this section, an overview of the ESG Regulatory Framework established within the European Union's bounds is presented.

Governments from all over the world decided to take a more sustainable route for the environment and the economy in 2015 by approving the UN 2030 Agenda for Sustainable Development and the Paris Agreement on Climate Change. The 17 Sustainable Development Goals (SDGs) are the cornerstone of the UN 2030 Agenda. The European Union served as a pioneer in the creation of an ESG regulatory framework and is a worldwide leader in promoting sustainable finance. As stated, one of the main factors pushing the EU toward such a change can be found in the Paris Agreement, signed on December 12th, 2015, which represents a legally binding international treaty signed by a total of 194 parties (193 States plus the EU as a whole) whose main goal is to keep "*the increase in the global average temperature to well below 2°C above pre-industrial levels*" and pursue efforts "*to limit the temperature increase to 1.5°C above pre-industrial levels*"[2]. Such a threshold was set since, according to the UN's Intergovernmental Panel on Climate Change, passing the 1.5°C barrier would cause far greater climate change impacts, such as more frequent and intense heatwaves, droughts, and rainfall. To avoid such consequences, and achieve what is set in the aforementioned Treaty, Greenhouse gas (GHG) emissions must reach their peak before 2025 at the very latest and then drop by at least 43% by 2030. To comply with the latter, in 2018, the United Nations Framework Convention on Climate Change (UNFCCC) launched the so-called *Race to Zero* campaign, which aims at mobilizing leadership in gaining support from businesses, cities, regions, Governments, and investors to achieve *Net Zero* emissions by 2050.

From a financial perspective, the EU's commitment to the cause is shown through the issuing of several key pieces of legislation, such as (i) the Corporate Sustainability Reporting Directive (CSRD), (ii) the Sustainable Finance Disclosure Regulation (SFDR), and (iii) the EU Taxonomy for sustainable activities. Such laws have as their ultimate goal that to promote transparency, accountability, and the integration of ESG factors into investment decision-making processes.

The CSRD (Directive (EU) 2022/2464) is an EU Directive that entered into force on January 5th, 2023, as an update to the formerly adopted Non-Financial Reporting Directive (NFRD) and aims to address the increasing

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[2] Agreement, P. (2015, December). Paris agreement. In Report of the Conference of the Parties to the United Nations Framework Convention on Climate Change (21st Session, 2015: Paris).

demand for companies to report on their ESG performance, by establishing a more comprehensive and standardized reporting framework. The new Directive applies to a larger set of Companies (compared to the previous), as many as 50.000, between large firms and listed SMEs. In particular, under the CSRD, Companies are required to report on a large range of sustainability matters, including their impact on climate change and biodiversity, and social issues like diversity or gender inequality, through the use of specific reporting standards set by European Financial Reporting Advisory Group (EFRAG). Moreover, further highlighting the relevance of ESG, the EU Commission set the obligation for Companies to undergo external assurance for their sustainability reports, just as it is required for their Financials which have to be audited by an independent assessor.

The SFDR (Regulation (EU) 2019/2088) is a Regulation that, as the aforementioned Directive, seeks to improve transparency and comparability of sustainable investments, by requiring the participants to the financial markets (i.e., Asset Managers, Insurance Companies, and Investment Funds) and financial advisors to disclose information on the sustainability characteristics of their financial products, including to which extent Environmental, Social, and Governance factors are considered in their investment-decision-making process, as well as to which degree their financial products promote sustainable finance. In Articles 6,8, and 9 of the aforementioned Regulation, the SFDR distinguishes between three different kinds of funds (classifying them on the basis of their sustainability) in order to require assessment and disclosure of sustainability–related metrics to different extents, thus providing a useful investment perimeter, and in particular Articles 8 and 9 provide a definition for the so-called *light green funds* and *dark green funds* respectively.

Specifically, the sixth Article "*Transparency of the integration of sustainability risks"* applies to all funds, regardless of their sustainable scope, and it requires financial market participants to include, in a fund's prospectus, descriptions of the way sustainability risks are integrated in their investment decisions, and the results of the assessment of the impact of such risks on the returns of the offered financial product, if relevant. If they don't deem such a risk to be relevant, they should provide a clear explanation of the reasons underlying the decision.

Article 8, *"Transparency of the promotion of environmental or social characteristics in pre-contractual disclosures",* regulates the so-called *light-green funds* (i.e., those funds that promote environmental or social characteristics), states that when a financial product also promotes environmental or social characteristics, or a combination of them, given that the businesses in which the investments are made follow good governance practices, the information required to be disclosed in accordance with article 6 must be increased to include (i) information on how such characteristics are met, and (ii) if it has been designated an index as a reference benchmark, information on whether and to which extent the index is consistent with the environmental and/or

social characteristics. Thus, this Article targets those specific funds which consider more characteristics than the sole sustainability risks as provided by Article 6, but, unlike *dark-green funds* (Article 9), Article 8 funds don't have ESG objectives or core objectives.

Lastly, Article 9, *"Transparency of sustainable investments in pre-contractual disclosures"* regulates the *dark-green funds* (i.e., those funds that have sustainable investment as their objective), and it requires an index to be designated as a reference benchmark, and the disclosure obligations provided by Article 6 to be accompanied by (i) information on how the designated index is aligned with the sustainable investment objective, and (ii) an explanation of why and how such index, aligned with that specific objective, differs from a broad market index.

Article 9 funds, in contrast to article 8 funds, should make a positive impact on society or the environment through sustainable investment and have a non-financial objective at the core of their offering. Article 8 funds should promote environmental or social characteristics and have good governance practices, but they have a financial objective as their main offer. Nevertheless, both article 8 and article 9 funds are recognized as ESG aligned. It is the responsibility of the entity producing and/or advising on the financial product to define its classification. Since the SFDR refers to disclosure, not prescription, the intention is, for market participants and advisors, to compare the sustainability characteristics of various products with the characteristics defined in the Regulation, and to disclose their classification based on these criteria. Since the implementation of SFDR Level 2 regulatory technical standards, or RTS, in January 2023, Asset managers have been required to increase their disclosure on the funds' ESG approaches, sustainability risks, and impact, through precontractual papers and periodic assessment and reports. The adoption of this higher level of standards, according to *Morningstar*, (*2023*), brought to a huge wave of downgrades of formerly Article 9 funds to Article 8 funds: the amount of the former shrunk by 40%, causing a loss of € 175 bn in value of total Article 9 Funds.

Just like the SFDR, the EU Taxonomy (Regulation (EU) 2020/852) was introduced to enhance transparency in sustainable investments, and most Companies falling within the SFDR are also required to report according to this framework. The EU Taxonomy is a classification system that has been created to give a uniform method of identifying economically sustainable environmental practices, and it is based on six environmental objectives, namely: (i) climate change mitigation, (ii) climate change adaptation, (iii) sustainable use and protection of water and marine resources, (iv) transition to a circular economy, (v) pollution prevention and control, and (vi) protection and restoration of biodiversity and ecosystems. Within the Taxonomy, economic activities are assessed against a set of technical screening criteria to determine if it complies with the following: (i) it makes a substantial contribution to at least one of the six objectives, (ii) it does not significant harm (DNSH) to the other objectives, and (iii) it respects the minimum necessary social lifeguards. The criteria take into account both qualitative and

quantitative aspects of an economic activity, such as its effect on ecosystems, its use of natural resources, and its ability to reduce GHG emissions.

1.2 How do ESG factors impact corporate behavior?

In this section it is provided an analysis of the main impacts of ESG implementation on corporate strategies and behavior, and are presented some real-life examples of ESG-focused strategies implemented by some of the largest Firms in the world. In particular, they will be analyzed (i) the effect of Divestment campaigns that have occurred since the 1980s, (ii) Executives remuneration policies linked to ESG-related KPIs, and (iii) some ESG-focused strategies implemented by Firms like Apple, Unilever, Patagonia, and others. What will be presented in this paragraph will be helpful in understanding the sustainability assessment (ESG Due Diligence) carried out during an M&A process, whose structure will be deeply investigated in Chapter 3.

By definition, divestment is the opposite of an investment, and it is carried out when a subsidiary asset or division is not performing up to expectations. Usually, Companies were used to deploy this strategy to satisfy financial goals, but then, since the 1980s, something changed and, according to *MacAskill* (*2015*) the apartheid government of South Africa, tobacco businesses, and the Israeli government's occupation of the West Bank were the targets of significant divestment efforts, that were aimed at using financial pressure to make a change and hold companies accountable for their actions. In particular, *divestment movements* are a form of activism, aimed at pressuring individuals, organizations (such as Universities), Companies, and institutions to divest from those companies that are deemed to be unethical or harmful to the environment or society. Although divestment movements have been able to successfully reduce the money flowing toward such industries and companies, as stated by Robert K. Massie[3], "*the key to divestment's power is not that it robs companies of phantom pennies, but that it forces individuals and institutions to confront the moral dilemma of accepting cash from truly destructive firms. And, when sustained, it can jolt a paralyzed political system back to life*", thus, to be effective in aiming its goals, it cannot be implemented as a stand-alone strategy, instead it should be complementary to other policies, such as engagement, so that it can help reshaping the future operations of the targeted companies and industries.

In recent years the divestment movement targeted the fossil fuel industry, since the latter is considered to be contributing to climate change, aiming at pressuring investors to divest from companies that produce and use fossil fuels, in order to move towards a cleaner, and more sustainable energy future, deeming morally and financially irresponsible to invest in the aforementioned companies. With multiple institutions, organizations and communities pledging to withdraw from fossil fuels, the movement has seen considerable success, however,

[3] Massie, R. K. (2014). Even the bricks cry out: It's time for Harvard to divest. Opinion: The Harvard crimson.

divestment campaigns alone are not sufficient to address the pressing issue of climate change, and the movement itself acknowledges the need for structural change and the creation of alternative energy sources, as stated by Connor Chung, Organizer at Fossil Fuel Divest Harvard, during a lecture held in 2022 at Copenhagen Business School.

Among the main direct and indirect consequences for target companies of a divestment campaign there are: (i) reputational damage, which can lead to loss of trust among customers and the general public, as well as the loss of business opportunities, (ii) negative financial impacts, since when large institutional investors decide to divest, share prices may fall, there might be difficulty in accessing capital, and Companies may even experience credit downgrades, and (iii) increased regulatory scrutiny from Regulators, particularly following the latest sustainability Regulations and Directives. In order to survive, when a Company is targeted by divestment campaigns it has to reshape its way of doing business, by engaging with stakeholders and being ready to accept the change. To sum up, divestment is a useful strategy for investors, which can be effective in reducing investors' exposure to certain industries or companies that do not align with their values or long-term goals. However, for those who wish to go beyond divestment and actively promote positive change, there are other options to consider.

Another option, for example, is represented by the integration of ESG- related KPIs in the design of executive compensation plans. This strategy can encourage business executives to place a high priority on sustainability and social responsibility, thus benefiting investors, as well as society at large. The rationale behind such remuneration programs can be found in the already mentioned Agency Theory, because Academics and Corporate Governance experts agree on the fac that such Theory suggests that executive compensation should be tied to performance metrics that align with the interests of shareholders and other stakeholders, and, as said before, shareholders and stakeholders are increasingly interested in a Company's sustainable performance, both for ethical and financial reasons (the latter will be later explained more in depth in Chapter 2). According to *Donaldson and Preston* (*1995*) and *Jones and Wicks* (*1999*), when financial incentives are based on the accomplishment of social and environmental goals, compensation is a possible instrument for directing business activity towards sustainability.

More recently, numerous recommendations have been put forward at both international and national levels, emphasizing the significance of connecting non-economic, long-term objectives with the remuneration of executives. *The United Nations' Principles for Responsible Investment* (*2016*) advised that linking environmental, social, and governance (ESG) performance with compensation could hold executive management accountable for sustainable business achievements. The document also called for the linking of appropriate ESG metrics to reward systems in a manner that forms a significant element of the overall remuneration framework. In a similar vein, the *World Business Council for Sustainable Development (WBCSD)* (*2010*) suggested that compensation could be a potent instrument in fostering a culture of sustainability. The *Italian Corporate Governance Code* (*2020*) urges

boards of directors to align a firm's remuneration policy with sustainability goals, with the variable component primarily based on long-term objectives and connected to non-financial variables.

Despite the fact that, as mentioned, Corporate Governance best – practices codes started to recommend Firms to implement remuneration schemes for top managers that include incentives whose magnitude depends on ESG – related KPIs, *The Conference Board Global Compensation & Benefits Watch webcast* (*2021*) pointed out that one of the major challenges is represented by the definition of appropriate metrics that are relevant and meaningful to the company's business goals: there is, in fact, a need to carefully select ESG metrics that align with a company's core values, culture, and strategic priorities, because metrics that are not relevant to the business can lead to misalignment and disincentivize executives. Another serious challenge is measuring ESG performance accurately and transparently, since there is no universally accepted method for measuring ESG performance, and companies often face difficulties in gathering and verifying data. This can lead to inconsistencies and inaccuracies in reporting ESG performance, making it difficult to evaluate the success of executive compensation plans that incorporate these metrics. Nonetheless, the constantly updating Regulatory Framework is helping Companies through the standardization of reporting and sustainability – assessing activities.

From an analysis conducted on the executive compensation structure of some of the largest Companies in the S&P500, including Apple, Microsoft, BlackRock, Coca Cola, JPMorgan Chase, and Intel, it emerged that the most common KPIs that are used to determine sustainability – linked Executives remuneration incentives are: (i) GHG emissions, (ii) Diversity and inclusion of the Firm’s workforce and leadership, (iii) Supply chain sustainability, (iv) workplace Health and safety, and (v) Board diversity and independence.

Moreover, *Cook et Al.* (*2023*) suggest that in order to effectively incentivize sustainability, the selected KPIs must be measurable and set in reference to external standards or international treaties, such as the Paris Agreement. As regulations and standards surrounding sustainability continue to evolve, Boards of Directors, and, in particular, Remuneration Committees, must ensure that the selected KPIs are relevant and allow for discretionary adjustments where necessary. Once the metrics have been selected, it is crucial to quantify and calibrate target performance levels for each KPI. For instance, KPIs related to reducing GHG emissions may set a target of reducing emissions by a certain percentage over a specific period of time, and relative targets may be used to enable sector comparison, or metrics may be adjusted based on levels of sales or production to assess internal efficiency. Effective incentives must be given for achieving results beyond what would have been accomplished without executive intervention. To drive meaningful change, targets must be sufficiently ambitious and not trivial. A strong level of credibility is provided by linking remuneration to targets established in accordance with the Science Based Targets initiative (SBTi). By setting measurable and relevant sustainability KPIs, calibrating target

performance levels, and establishing credible incentives, Boards can drive sustainability and make meaningful progress towards ESG goals.

By looking at their websites and searching for press releases, as well as retrieving online articles, it has been possible to gather information on the sustainable strategies implemented by the following selected companies: (i) Apple, (ii) Patagonia, (iii) Unilever, (iv) Coca Cola, (v) Nestlé, and (vi) Ikea.

This section allows to examine some of the most relevant ESG strategies used by big Corporations to increase their sustainability score (that is a rating or assessment system used to evaluate the environmental, social and economic performance of organizations, with the aim of providing a comprehensive evaluation of their impact on sustainability. Such scores are published by specialized Companies or Organizations, such as Sustainalytics, Corporate Knights, and MSCI).

In the following, the results of the analysis described above:

With respect to its Environmental sustainability policy, Apple has set the goal to become carbon neutral by 2030. This means reducing its carbon footprint across its entire supply chain, including manufacturing, transportation, and product use[4].

Moreover, since 2016, the Company started raising capital through Sustainable Finance (SF) instruments. In particular, through three Green Bonds issuances (in 2016, 2017, and 2019) Apple raised $ 4.7 Billion, whose proceeds are used for (i) clean energy investments, (ii) direct carbon - free aluminum purchase, and (iii) recycling technologies[5].

From a Social perspective, Patagonia has let employees work flexible hours so they can go surfing, attend educational courses, or pick their kids up from school[6].

Moreover, the Company actively engages its customers, with campaigns aimed at reducing waste and promoting sustainability, like for example the “Don’t buy this Jacket” campaign: through such a marketing campaign, Patagonia published an Advertisement on the New York Times on the Black Friday encouraging its customers not to buy a new product, but instead to reduce consumes, repair old garment, reuse and recycle[7].

[4] https://www.apple.com/newsroom/2020/07/apple-commits-to-be-100-percent-carbon-neutral-for-its-supply-chain-and-products-by-2030/
[5] https://www.apple.com/newsroom/2022/03/apples-four-point-seven-billion-in-green-bonds-support-innovative-green-technology/
[6] https://entrepreneurshandbook.co/patagonia-has-provided-a-business-blueprint-in-how-to-avoid-the-great-resignation-6dcd6ea6f668
[7] https://eu.patagonia.com/it/it/stories/dont-buy-this-jacket-black-friday-and-the-new-york-times/story-18615.html

Following the Corporate Governance best practices issued around the world, Unilever has established a sustainability framework that includes responsible sourcing, reducing waste, and promoting ethical business practices, which is overseen by a dedicated board committee, the Corporate Responsibility committee. The Company's vision is to "*deliver winning performance by being the global leader in sustainable business"*[8]. Another strategy, provided by Unilever's Compass for sustainable growth, is its commitment to make all of its packaging plastic – free by 2025, and the establishment of responsible marketing guidelines to protect its customers.

Being a beverage – producing Company, Coca Cola makes a really extensive usage of the most precious resource on Earth, water ("*The Coca-Cola system uses about 300 billion liters of water across approximately 900 bottling facilities annually"*, according to *CDP, 2022*). To reduce its negative impact on such a resource, the Company has implemented a comprehensive water stewardship program, which includes water conservation initiatives, community engagement, and partnerships with local organizations to protect water resources[9].

When assessing a product's sustainability, it is fundamental to check the sustainability of its whole value chain, since the product's impact is not limited to its direct impact on the environment or on the society. Given the stakeholders' rising increased attention to such matter, Companies began establishing sustainable supply chains. Nestlé, for example, through the establishment of its *responsible sourcing standards*[10], requires its suppliers to meet certain standards concerning environmental sustainability, human rights, and responsible animal welfare practices.

The Swedish furniture producer, Ikea, adopts a business model that promotes circular economy, in order to reduce waste and to promote the recycling of resources. Ikea's circular economy strategy[11] aims at making the Company circular and climate positive by 2030, by producing goods that can be reused, refurbished, remanufactured and eventually recycled. To do so, Ikea developed some circular product design principles that guide the all the production stages.

[8] https://www.unilever.com/planet-and-society/
[9] https://www.coca-colacompany.com/sustainability/water-stewardship
[10] https://www.nestle.com/sites/default/files/asset-library/documents/library/documents/suppliers/nestle-responsible-sourcing-standard-english.pdf
[11] https://about.ikea.com/en/sustainability/a-world-without-waste

2. ESG impact on firms’ financials

The majority of Academics and experts argue that ESG factors have a positive impact on companies' performance, value, and investments. This paragraph presents a literature review focused on the analysis of some evidence and theories that support the notion that ESG factors can lead to better financial outcomes for Firms.

2.1 Introduction

According to *Bloomberg* (*2021*), Global ESG assets are expected to exceed $53 trillion by 2025, accounting for more than a third of the forecasted total assets under management (AUM), which should reach a total value of $140.5 trillion. The assumption behind such a positive forecast is a prudentially assumed annual growth rate equal to 15%, which is half the pace recorded by ESG assets between 2015 and 2020. As of 2021, Europe accounted for half of global ESG assets, thanks to the dedication that the European Regulatory system showed toward this matter, while the US had the largest expansion in the same year, and its domination on Asset category was expected to start since 2022 (*ibidem*).

ESG Assets fall into two different investment categories: (i) Sustainable Investments, and (ii) Responsible Investments. Those are usually deemed to be the interchangeable terms but, as specified by the Principles for Responsible Investment (i.e., the United Nations-supported global network of financial institutions whose purpose is to help its signatories understanding the value of sustainability for investors, and helping them to incorporate such issues into their investment decision-making and ownership practices, contributing to the development of a more sustainable global financial system), they are different. In particular: (i) Sustainable Investments typically refer to investments that aim to achieve positive ESG outcomes while generating financial returns, while (ii) Responsible Investments are those taking into account the ESG factors of a company or organization and aim to invest in companies that align with ethical values and principles, with the intention of influencing corporate behavior towards more responsible and sustainable practices, thus involving a larger component of shareholders’ activism. Whether Sustainable Investing or Responsible Investing is taken into account, it is important to acknowledge that, as mentioned before, the number (and value) of funds, as well as their AUM are growing sharply, and this growth is forecasted to continue the future. One of the main beliefs that have been fostering this growth is the idea that there is a positive correlation between ESG performance and financial performance.

Among the main methods used to track a correlation among the two metrics, there are: (i) linear regression analysis, (ii) event studies, which analyze the impact of specific ESG events on Companies’ stock price, and (iii) surveys and interviews with managers and investors.

In terms of investment strategies, *UNPRI,* (*2023*) provides a standardized, five – step process that has to be followed to integrate ESG in listed equity, but its analysis is beyond the scope of this thesis. Nonetheless, it is important to understand what the main strategies used by investors to build sustainable portfolios are. In particular, among the main approaches suggested by *Fulton et Al.* (*2012*) there are:

- **Environmental/social negative screening,** that the process of finding and excluding companies whose operations are seen as unsustainable from an environmental or social standpoint, thus it is used to exclude Firms that engage in environmentally or socially harmful practices from consideration for investment.
- **Positive screening,** as opposed to the above - mentioned method, is the practice of picking stocks or assets that fulfill particular predetermined criteria, such as ethical standards, social responsibilities, environmental commitment, and also economic performance.
- **Community investing,** which is the practice of allocating capital to low-income communities, and it aims to earn returns for investors while contributing to noble causes such as providing secure and affordable housing, employment opportunities, education, healthcare, childcare, and other critical community services.
- **Best – in – class,** which is the strategy focused on finding these Firms that are leaders in their sector in terms of meeting ESG criteria. This technique is commonly used in positive screening as a means of finding those companies with superior pre-defined ESG characteristics, regardless of their industry.
- **Shareholder activism**, which is a form of investing through which investors aim at influencing a Company's behavior by exercising their ownership rights. Shareholder activists are shareholders of companies who bring about change within or for a corporation, and they can do that by dialoguing with the Companies' management, filing shareholder resolutions, and voting on ESG-related issues at annual general meetings.
- **Norm – based screening,** which is an approach to responsible investment where investments are screened based on compliance with relevant international norms and standards such as those issued by, among the others, the United Nations. This approach may include exclusions of investments that are not in compliance with norms or standards, or over and underweighting in accordance with the degree of compliance evidenced.

This section is fundamental to understand why ESG considerations are growing sharply in relevance in the context of M&A transactions.

2.2 Positive Correlation between ESG performance and financial returns

In this paragraph it is provided a literature review focusing on five academic papers that show a positive correlation between Companies' ESG performances and their financial performance. This means that the Authors, through their analysis, agree on the assumption that when a company has a strong sustainability performance, then it will have stronger financial performance, if compared to non – sustainable peers.

Among the main areas that can be positively impacted by ESG implementation there are:

- **Risk management**: according to *Gorley* (*2022*) integrating ESG factors into the existing risk management framework is fundamental since negative ESG incidents are becoming more disruptive and expensive. For example, *Bank of America Merrill Linch* (*2019*) analyzed 24 ESG scandals concerning S&P 500 Firms between 2014 and 2019, stating that such controversies led to a loss of $ 534 bn. Thus, implementing ESG into a Companies' structure may help mitigating risks, avoiding huge losses deriving from sustainability – related scandals or controversies, and thus improving a Firm's performance.

- **Access to capital**: according to *Lodh* (*2020*), that analyzed the relationship between Firms' MSCI ESG Rating and their cost of capital, those companied with a higher ESG score have, on average, a lower cost of capital (with a spread of 0,39% between the highest ESG – scored quintile and the lowest one). This research, together with older studies promoted by MSCI, shows that high-ESG-rated Firms are less vulnerable to systematic risks (i.e., the risk that affects the overall stock market or comparable sectors and industries), than low-ESG-rated companies. This result is consistent with the capital asset pricing model (CAPM), according to which reduced systematic risk (β) implies a lower cost of equity. Similarly, the average debt cost of high-ESG-rated enterprises has been found to be lower than the average debt cost of low-ESG-rated companies. The reduction in the cost of debt can be correlated with Corporate Governance that, as one of the pillars of ESG, is known to minimize a firm's default risk, directly reducing the cost of debt financing.

- **Costs:** Although implementing ESG in a Company is deemed an expensive practice, *Piatek* (*2023*) states that ESG implementation is able to support cost reduction. For example, a sustainable supply chain can contribute to a cost advantage in the long run and also help achieving larger revenues, but ESG is often margin-enhancing over a long-time horizon, so when comparing ESG and cost reduction, leaders should abandon the quarter-to-quarter performance view, focusing on longer time horizons. Moreover, it is fundamental to consider that ignoring ESG may lead to costs, as already shown when describing the impact on risk management and the cost of capital, and how has been confirmed by *Rapier* (*2021*).

- **Revenues and margins:** *Moore Intelligence* (*2022*) surveyed 1.262 large firms, coming to the conclusion that Businesses who have placed a stronger emphasis on ESG have seen their revenues improve by 9,7% between 2019 and 2022. This figure is higher than the one recorded by organizations with a lower level of commitment to ESG, who experienced a revenue growth of only 4,5%. In particular, the regional differentiation for organizations that value ESG was very minimal, ranging from 10,4% in the United States to 9,3% in Europe and 9,1% in Australia. The discrepancies were more pronounced among individuals who did not value ESG. It fell from 4,9% revenue growth in the US and Europe to 2,6% in Australia. Those Companies that have engaged in ESG considerations have seen their revenues increase by $3,1 trillion at an aggregate level. The United States tops the way with $2,1 trillion, followed by Europe ($930,5 billion) and Australia ($58,8 billion). The total sample of companies that did not engage in ESG had revenues increased by $402.4 billion. In terms of profitability, Businesses publicly prioritizing ESG witnessed an average 9,1% boost in such a metric.

- **Attracting investments from external sources:** the same analysis (Ibidem) found out that, according to 84% of respondents, raising financing has gotten slightly or much easier since when Companies started implementing ESG considerations in their operations. Companies in the United States identified ESG as the most beneficial in raising funding, in fact, the 48,1% indicated that ESG has greatly increased their ability to obtain external investment, however the sort of finance was not mentioned. Italy 41,8% and Germany 37,5% followed. In terms of sector, 92,9% of companies in the Information Technology (IT) sector worldwide reported that a commitment to ESG had greatly or slightly helped their ability to raise capital. Accounting and finance followed closely behind IT, with a 92,3% of respondents stating that ESG have had a positive impact on their capital raising activities. It is clear that energy-intensive industries find it more difficult to change their operations to comply with ESG principles, whereas service sectors such as IT would probably find that transition a lot smoother, being those office – based working environments, and not heavy industry.

Now that some of the main areas that can be positively impacted by ESG implementation have been identified, it is possible to analyze some studies that found such a positive correlation between ESG performance (usually measured through the ESG score) and financial performances, in terms of stock price or some KPIs like Return On Equity (ROE), Return On Assets (ROA), Earnings per share (EPS), and Tobin's Q (i.e., the ratio between a physical asset's market value and its replacement value).

Ahmad et al. (*2021*) analyzed the correlation of ESG performance and financial performance by conducting their research on a sample of 351 firms, operating in 10 different industries, from FTSE350 for the time period between

2002 and 2018. The study is based on both static and dynamic panel data techniques: the former is used to estimate the relationship between variables in a panel data set at a specific point in time, and assumes that the relationship between the variables is constant over time, (its focus is on estimating the average effects of the independent variables on the dependent variable over time), while the latter takes into account the fact that the relationship between the variables may change over time, and focuses on estimating the short-run and long-run effects of the independent variables on the dependent variable, as well as the speed of adjustment towards the long-run equilibrium. In terms of variables, the Company's market value (MV) and earnings per share (EPS) are the dependent variables. while the independent variables are represented by ESG scores, ECO scores, ENV scores, SOC scores, CG scores, ESGH scores, ESGL scores, and business size. Lastly, the control variables, which are introduced in a model to isolate the effect of the independent variable on the dependent variable from the effect of other variables that might be related to both the independent and dependent variables, are financial leverage, total revenues, capital expenditure as a percentage of sales, and effective tax rate. The study also includes economic performance among the ESG metrics, and that is because the data used is retrieved from Thomson Reuters' ASSET4 Database, which scores companies on four pillars: Economic, Environmental, Social, and Corporate Governance. In the analysis, the ESG factors are considered together as a composite measure and also separately as individual Environmental, Social, and Governance factors. The study's static and dynamic results show that, at an aggregated level, ESG considerations have a positive and considerable impact on firm's MV and EPS. Single ESG attributes have a beneficial effect on business financial performance, but, when analyzing the individual elements of ESG and their impact on firm financial performance, the results are mixed. The dynamic study, in particular, shows that economic, social, and corporate governance performances have a beneficial impact on the MV and EPS of the investigated companies. Meanwhile, environmental performance has a negligible and statistically insignificant impact on financial performance since such impact is less than zero. Regarding the distinct components' positive significant impact, it is indicated that economic performance has a positive and significant effect on market value, while a company's EPS is positively impacted by its social and governance performance. According to the research, the connection between ESG and corporate financial success is also influenced by firm size.

Alareeni & Hamdan, (*2020*) analyzed, through panel regression analysis, the relationship between ESG disclosure and operational, financial, and market performance, by studying the correlation between ESG and ROA, ROE, and Tobin's Q for S&P 500 Firms on the period between 2009 and 2018. In the study, Environmental Score, CSR Score and Corporate Governance Score were used as independent variables, while ROA, ROE, and Tobin's Q were taken as dependent variables. Moreover, financial leverage, assets turnovers and assets growth were set as control variables.

The conducted regression analysis showed that, at an aggregate level, ESG disclosure has a favorable impact on all the considered dependent variables. However, considering the disclosure variables as stand – alone, for US S&P 500 Firms, Environmental disclosure has a significantly negative impact on the firm's operational and financial performance, respectively measured by ROA and ROE. Nonetheless, the authors explain that Environmental disclosure standards lead to higher costs, which explains such a negative impact on business operational and financial performance. On the other hand, Environmental disclosure is positively correlated to company market performance as measured by Tobin's Q. This suggests that Environmental considerations and disclosure are important for Firms, even though they can be expensive. Likewise, from a Social perspective, it is highlighted a negative correlation between Social (CSR) disclosure and both ROA and ROE but again, this can be caused by the higher financial costs linked with the participation in socially responsible practices. However, the findings revealed a substantial positive correlation between Social disclosure and market performances, through the Tobin's Q analysis. Thus, Social initiatives have should be undertaken by Companies to enhance their market performances. Lastly, CG disclosure was found to improve ROA and Tobin's Q, thus improving assets efficiency and a Firm's Market Value, mainly because implementing good Governance practices lowers agency costs by providing relevant information to investors and assisting firms in improving operations. Once again, the study found a negative correlation with ROE, which can be attributed to the high expense of practicing and publishing Governance transparency. The main recommendations provided by the writers are that Companies should be aware that ESG serves the interests of shareholders in long-term planning, and significant resources should be allocated in this direction, given that ESG expenditure does not pay off immediately, but only when a certain level of ESG has been reached. Furthermore, the authors suggest that authorities such as central banks, auditors, and stock exchange organizers should consider ESG to give credible financial information. Lastly, stakeholders such as investors were advised to increase their understanding of the term ESG and its role in business in order to make better, and more inf investment decisions.

Bajic & Yurtoglu, (*2018*) analyzed the relationship between the level of ESG integration and Firms' value (measured through the natural logarithm of Tobin's Q, to reduce the impact of outliers) on a sample of 23.803 Companies from 35 countries (with data ranging between 2003 and 2016) through a linear regression. The authors underline the importance of the correlation among the three different ESG variables, highlighting the presence of an OVB bias (i.e., Omitted Variable Bias) when performing the regression analysis on Environmental, Social, and Governance Scores taken individually. To address this issue, the authors used a two – step method: (i) first they divided the coefficients on the ESG indices, and then (ii) they combined all subindices in a single regression. When regressing the Environmental, Social, and Governance indices separately on Tobin's Q, they emerge highly relevant correlation coefficients, but when they included all the three metrics in a single regression, the Environmental factor lost its relevance, and the coefficients on the Social and Governance indices decreased in

magnitude and importance. Thus, when regressed on company value in isolation from other indices, all three indices capture statistically and economically significant coefficients, but, with the exception of the social aspect, fail to do so when other indices are taken into account. The main take aways of this research are: (i) ignoring relevant aspects of ESG and CSR can cause severe OVB bias and falsely suggest that a specific aspect is important for company value, and (ii) the only part of the entire ESG measure that matters for business value is the Social component, while the other indicators, Environmental and Governance, have little consistent predictive value when used to determine a Firm’s value.

Since ESG are believed to provide for long – term value, *DasGupta* (*2022*) investigated if financial performance shortfalls lead organizations to enhance their ESG practices in order to maintain future legitimacy, as a strategic response to poor financial performances. Moreover, the study also looks into whether ESG controversies influence firms' ESG decisions in such cases. The panel consists of 24.390 firm-year observations from 27 countries between 2010 and 2019, and the study finds a strong positive correlation between financial performance shortfall and ESG performance. It also finds that Firms do not engage in higher ESG practices when they are additionally restricted by high ESG controversies, even though such controversies would positively moderate the impact of financial performance deficits on their ESG performance, demonstrating the negative impact of high ESG controversy on such managerial actions, which may further erode financial performance shortfalls, Company credibility, and survival chances. The findings of such research have fascinating implications for managers as well, because they propose an alternate strategic action of enhancing ESG performance to Firms that experience financial performance shortfalls, rather than the more common recourse to R&D investment. However, the negative impact of ESG controversies on these Firms may limit such managerial action and potentially further erode corporate legitimacy, as well as increasing the possibility of future operational failures. The main recommendation to managers is to show greater flexibility in handling these ESG – related controversies in order to avoid future bankruptcy threats.

Velte, (*2017*) provided an analysis of the correlation between ESG performance and both accounting and market – based metrics of performance. The sample included 412 firm – year observations from 2010 to 2014, concerning Firms listed on the German Prime Standard (i.e., DAX30, Tec DAX, MDAX). The ESG scores were retrieved from the Asset4 database, and the analysis was conducted on the overall ESG score (equally – weighted average of the Environmental, Social, and Governance scores), as well as on the single pillars. As far as the dependent variables are concerned, the ROA and Tobin’s Q were selected as proxies of Firms’ profitability and Market performance. Lastly, the chosen control variables were (i) R&D, obtained as the R&D expense retrieved from the Firms’ statements, (ii) Risk, measured both through beta and the total debt to total assets ratio (to include both systematic and unsystematic risk), and (iii) Firm size. Analyzing the results, the global ESG performance and its

three pillars, Environmental, Social, and Governance Scores, were all found to be strongly positively correlated to the ROA, thus to the Firm's financial performance from an accounting point of view. Moreover, the Governance component has a greater impact on profitability than the Social and Environmental. The research found a neutral impact between ESG as a whole (and the three pillars singularly) and the Firm's financial performance measured in market – related terms, so through Tobin's Q. Lastly, regarding control variables, risk has been found to be negatively correlated with ESG performance, both on a systematic and on a non – systematic level, while the Size of a company is positively correlated to ESG performance and its pillars.

2.3 Results and implications for investors

The results of the performed literature review are summarized in the table below, where the green dot identifies a positive correlation, the red one a negative correlation, while the yellow dot visually symbolizes a non – significant relationship (i.e., correlation equal, or really close to zero).

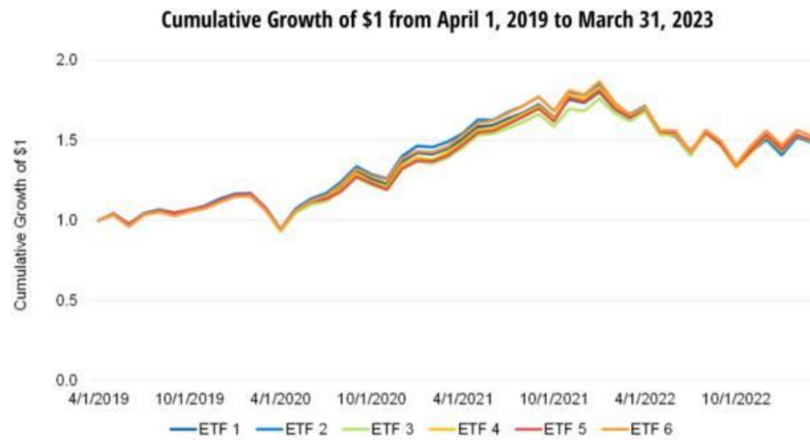
Table 2.1 – Results of the literature review.

Author(s)	Year	ESG		Environmental		Social		Governance	
		Accounting	Market	Accounting	Market	Accounting	Market	Accounting	Market
Ahmad et al.	2021		Green		Yellow		Green		Green
Alareeni & Hamdan	2020	Green	Green	Red	Green	Red	Green	Green	Green
Bajic & Yurtoglu	2018		Yellow		Green		Green		Yellow
DasGupta	2022	Green	Green						
Velte	2017	Yellow	Yellow	Green	Green	Green	Green	Green	Green

Source: *own elaboration.*

It has to be noted that not all the Academics and experts agree on the existence of such a positive correlation. For example, *Hickey*, (*2023*) described an analysis conducted by Research Affiliates that tracked, over a four – years period, the five largest US ESG ETFs by AUM, and compared their returns to a non – ESG ETF, in particular it has been used the SPDR S&P 500 ETF as a reference. The chart below shows the analysis' results, with *ETF 3* being the non – ESG one: as it is observable, the six tracked ETFs almost overlap in terms of returns during the period of analysis, so there is no clear evidence of an underperformance of the non – ESG ETF when compared to the ESG – focused ones.

Figure 2.1 – Results from Research Affiliate analysis.



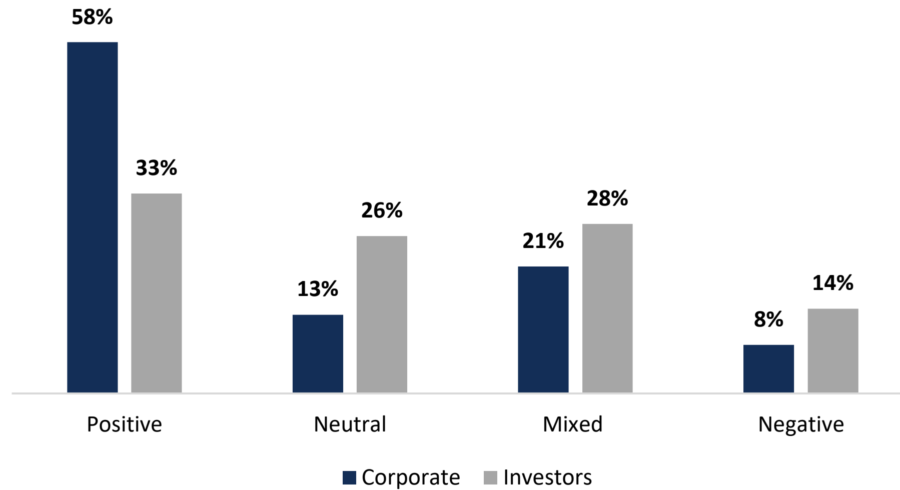
***Source**: Hickey, S. (2023). The impact of ESG on performance is non-existent. FT Adviser.*

Overall, the existing literature agrees on the assumption that there is a positive correlation between Companies' ESG performance and their financial performance, even though, in the short – run, they may negatively affect a Firm's financials due to the higher costs associated with a higher level of compliance to ESG best practices.

For the sake of brevity, the literature review was only conducted on five papers, but to be more precise and take into account a larger number of studies, it is useful to analyze the findings of *Whelan et al.* (*2020*), which conducted a meta – analysis on more than 1.000 research studying the relationship between ESG and financial performance between 2015 and 2020. The researchers divided the articles into those focused on corporate financial performance, so those taking into operating metrics such as ROE or ROA or stock performance, and those focused on investment performance seen from the perspective of an investor, generally measures of α or other metrics such as the Sharpe ratio on stock portfolios.

Analyzing their findings, it has been observed a positive relationship between ESG and financial performance for 58% of the studies focused on operational metrics (ROE, ROA, or stock price), while 13% showed neutral impact, 21% mixed results (i.e., positive, neutral or negative results found by the same research, so not significant) and only 8% was showing a negative relationship. For those studies that were focused on risk-adjusted metrics from an investor point of view, 59% of the analyzed studies showed positive or neutral performance relative to conventional investment strategies, and only 14% of them demonstrated a negative correlation. The results are graphically presented, for better understanding, in the figure below.

Figure 2.2 – Results from meta – analysis.



Source*: own elaboration on Whelan et al. (2020), ESG AND FINANCIAL PERFORMANCE: Uncovering the Relationship by Aggregating Evidence from 1,000 Plus Studies Published between 2015 – 2020. NYU Stern Center for Sutainable Business, Rockefeller Asset Management.*

The main consequences for investors and managers of the above – mentioned findings about the positive correlation between ESG performance and financial performance (measured in terms of Market Value, or profitability of both Equity and Assets) can be summarized as follows: (i) improved financial performance coming from the implementation of ESG – related strategies is more noticeable over longer time horizons, thus both investors and managers should not focus on short – term returns when implementing ESG strategies; (ii) from a historical standpoint, ESG investments have been able to provide downside protection, particularly in times of social or economic crises; and (iii) Corporate sustainability programs appear to produce higher financial performance due to mediation factors such as enhanced risk management and increased innovation.

It is worth to mention that despite the proven long – run beneficial effect of ESG strategies on Corporate value, there has been a rise in the so – called Anti – ESG (or *Anti – woke*) proposals within shareholders assemblies (*Saldanha, 2022*), whose main rationale appears to be destabilizing the growing sustainable movement, rather than offering a constructive route to change and value creation. The anti-ESG wave resulted in about 50 proposals during the 2022 AGM (Annual General Meeting) season, nonetheless, most of these resolutions did not garner much support from shareholders. In fact, the 43 anti-ESG proposals submitted during the 2022 assembly season that were monitored by Morningstar between January and June 2022, received an average of 7% support and only 12 received more than 5% support. In contrast, resolutions submitted by the other shareholders averaged a support equal to more than 30%. The majority of these proposals aimed at requiring further reporting on the impact of

Social – related measures on those groups (ethnicity or gender) that are not directly affected by the positive impact of the measures themselves.

3. ESG Considerations in M&A deals

The rising relevance of ESG topics in the modern financial world has been shown in the previous chapters. Thus, it is clear why ESG have become a critical consideration in the field of Mergers and Acquisitions: for dealmakers, the mitigation of ESG risk and the maximization of ESG – related synergies have become key points in the M&A agenda, due to the positive impact that such goals can have on the Buyer's performance and reputation.

Acquisitions are being promoted by a Companies to achieve certain ESG goals, by benefitting from the incorporation of Target Firms' ESG performance and by exploiting synergies. On the other hand, ESG scandals can delay, or even jeopardize, M&A deals, leading to a discount on the price paid by the buyer or even the cancellation of the transaction itself. Given the great focus on ESG compliance, the number of transactions that explicitly refer to sustainability as one of the primary drivers behind the execution of the transaction itself is on the rise.

This chapter aims at deeply analyzing the rising impact of ESG Considerations in the context of M&A transactions, and, in particular, they will be provided: (i) an introduction to M&A and an analysis of the current state of the M&A market, (ii), a thorough description of the ESG Due Diligence process, and what its goals are, (iii) a description of the so – called ESG Premium, and (iv) a description of the increasing relevance of ESG considerations for Private Equity Funds.

3.1 The current state of M&A

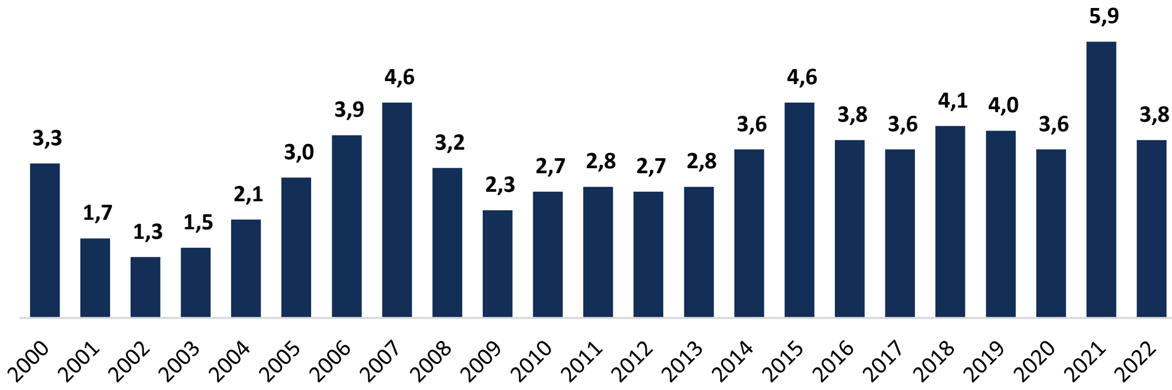
The terms Mergers and Acquisitions refer to those events related to takeovers, restructuring of Companies, or variations in corporate control in the context of Firms' ownership structure, as defined by *Durga et Al.* (*2013*). Although the two terms are often used interchangeably, Mergers and Acquisitions are substantially different: (i) in an Acquisition, a Company (the Buyer) purchases, in whole or in part, another Firm (the Target), while (ii) a Merger is defined as the legal activity in which two or more Companies give rise to one Organization (*Horne and Wachowicz, 2004*).

Companies engage in M&A transactions for several reasons, and these deals can represent a core strategy for those Firms pursuing growth and expansion. In fact, as provided by *Attolico & Donzelli* (*2022*), M&A are used as a means to pursue, and achieve, strategic objectives such as:

(i) Economies of Scales, when the acquisition results in lower average costs or by elimination of redundancies in the Organization, (ii) Time to market, that is a variant on economies of scale, that consists in extending a product line and/or enhancing a particular business function, (iii) Combination of customer supplier, that is vertical integration, which is achieved to reduce the risk of dependance from a supplier, or to mitigate the fluctuation of costs, (iv) Product line diversification, which is pursued to change its risk profile, (v) Defensive Acquisitions, that are pursued when the Buyer may be facing a severe downturn in its business, and the transaction may alleviate the causes of such downturn, (vi) New and Better management, when, after the transaction has happened, the Buyer replaces the Management of the Target to enhance its value, and (vii) Acquisition of a Control Premium, whose rationale is that public trading markets misprice publicly owned stocks since the market value of the stock is that of the individual holder who does not have control. Bidders may bid on firms only to acquire the inherent control premium in the shares, which they can subsequently cash off by selling the control premium to another buyer. Being the core of this Thesis, another strategic rationale behind M&A transactions will be later extensively described: that is pursuing Environmental, Social, or Governance objectives when acquiring (or merging with) another entity.

Having defined what M&A is and what the main reasons why Firms undertake this kind of extraordinary transactions are, this paragraph will continue by providing an analysis of the current state of the M&A market, in particular by highlighting the recent key trends and showing future outlook of such a market.

Figure 3.1 – M&A Transactions Value between 2000 and 2022 (Data in $ Trillions)



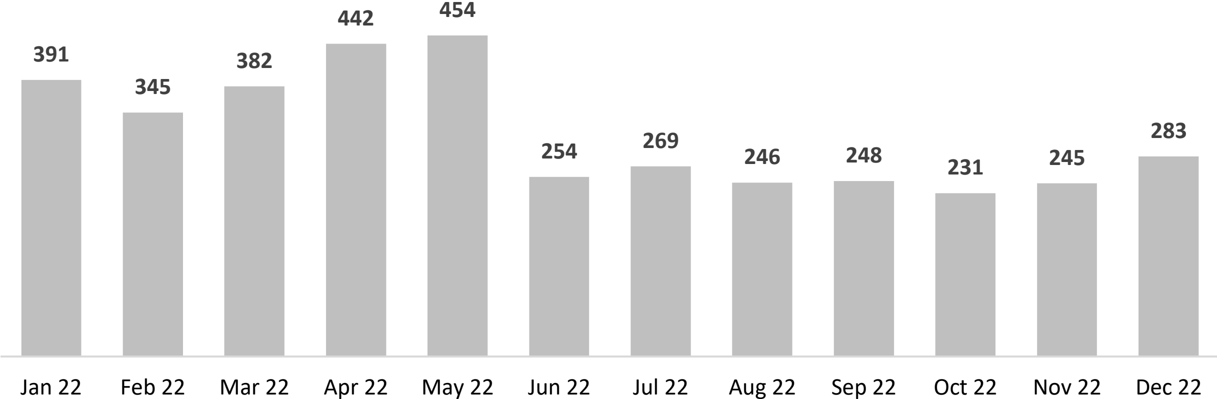
Source*: own elaboration on Bain & Company, Global M&A Report 2023.*

The bar chart (retrieved from *Bain & Company, Global M&A Report 2023*) presented above shows the total value, per year, of M&A transactions that took place globally between 2000 and 2022 (in $ trillions). Through its analysis, it is possible to observe that the average and median transaction value is equal to $ 3,3 Trillion, thus, during the period 2014 – 2022, in all of the years it has been recorded an above – average result in terms of

transactions value. In the considered time span, the lowest amount was recorded in 2001 ($ 1,3 trillion), following the dot – com bubble crisis, while the highest result was reached in 2021 ($ 5,9 trillion), when M&A transactions value reached an all – time high. According to the 2022 issue of the aforementioned Bain's report, the 2021 positive result (+ 64%) was fueled by strategic operations put in place by Companies in order to stay up with the developments that are reshaping their businesses (that were accelerated by the Covid – 19 pandemic), despite higher multiples and, thus, deal prices.

After the all – time high results from 2021, the following year ended with a YoY change equal to – 35,6%, reaching a total deal value of approximately $ 3,8 trillion. Although the result is above average, it is still surprising to observe such a severe drop in deal value ($ - 2,1 trillion), and to better understand the slowdown, the chart below presents a breakdown of the 2022 result on a monthly basis.

Figure 3.2 – 2022 M&A Transactions monthly Value (Data in $ Billions)



Source*: own elaboration on Bain & Company, Global M&A Report 2023.*

As observable in the monthly breakdown, 2022 can be clearly divided into two halves: after the 2021 all – time high result, the first five months of 2022 kept showing a strong dealmaking activity but, approaching Summer 2022, the US Federal Reserve Bank (on June 16th), the European Central Bank (July 21st), and other major Central Banks around the world raised interest rates in order to slow down the inflation that was mainly caused by the steep increase in energy prices due to the Russian invasion of Ukraine. Higher interest rates have a direct consequence on the M&A market, since they increase borrowing costs, and thus it is observable a – 44% drop in transactions value between May and June 2022, and the following months saw the monthly transactions value stabilized around that result, never exceeding the $ 300 billion ceiling, due to even further rises in interest rates by the major global players in the area of monetary policy. The spikes in interest rates had a harder impact on *Megadeals* (i.e., the Deals whose value exceeds $ 10 billion), that were put on hold (*ibidem*).

Despite the rough YoY decrease in transaction value, the number of transactions only experienced a – 12% decrease, thus demonstrating dealmakers' perseverance and determination. Such a positive attitude shown by dealmakers bodes well for the M&A market: according to PwC's. Global M&A 2023 outlook, "*2023 will be an exciting time for M&A with transformation and transactions at the forefront of CEOs' value creation strategies.*"[12] This because, since company executives strive to overcome the many obstacles, M&A will be a critical instrument to help them reposition their organizations, boost growth, and achieve long-term results. In fact, as highlighted by *Bain & Company* (*2023*) during previous market downturns, M&A was a winning response: by analyzing the acquisition activity of 2.845 firms during the global financial crisis of 2008-2009, they discovered that, in the long run, those companies that put in place at least one M&A transaction per year, earned, on average, 120 basis points more in returns for their shareholders than their peers that didn't pursue Deals.

Nonetheless, M&A market's cyclicality must be taken into account in forecasts, and the core variable is when Central Banks will signal an end to their pursue of a contractionary monetary policy, since there is a clear correlation between general market conditions and M&A activity: in fact, *Gaughan,* (2002), formulated the concept of "Merger waves" to describe the waves of M&A linked with technical, economic, and institutional shocks that started in the Anglo-Saxon world due to its unique market structure, kind of capitalism, and institutional set-up, and subsequently spread globally. Since 1900, there have been 7 distinct merger waves (*Attolico & Donzelli, 2022*), each with unique characteristics, but their explanation is beyond the scope of this thesis. The important takeaway is that, during economic crisis, M&A activity is expected to shrink: deal valuations and multiples usually decline, since dealmakers hold back. Due to the effect of uncertainty on both acquirers' and targets' core businesses, deal decisions are harder to make, thus many Executives abandon M&A deals, despite the proven positive effect that they can have, in the long – run, on Firms' returns.

Deal values and deal multiples decline as sellers hold back and acquirers lose conviction. As uncertainty impacts both the base business of acquirers and targets, it becomes harder to make decisions about deals. It is no wonder why many executives lose their appetites for the deal process during turbulent times. Due to all of the aforementioned reasons, uncertainty surrounds the M&A Outlook for 2023, but analysists are optimist, and we can expect the majority of deals to be valued at less than $ 500 million, since smaller to medium transactions are simpler to complete, compared to megadeals thanks to their lesser risk, the lower requirement of reliance on finance, and lower regulatory scrutiny.

[12] PricewaterhouseCoopers, (2023), Global M&A Industry trends: 2023 outlook. PwC.

3.2 The ESG Due Diligence

When pursuing an acquisition, the acquiring Company cannot assume that third parties adhere to the same ESG standards as it does, and it is critical to remember that the Buyer will inherit any ESG risk carried by the Target. For example, if the target company is later discovered to have violated labor or environmental laws, it can seriously harm the Buyer's public image, and in some cases (for example, in the context of serious accusations, such as human trafficking), the Buyer may be held legally or civilly liable for the Target's actions. Thus, in the context of M&A transactions, it is critical to assess and evaluate the extent of the additional ESG risk which is acquired as a result of the acquisition operation, in order to avoid bearing higher, unanticipated, costs in the future, or even worse, legal actions which may jeopardize the Buyer's operations and public image. To do so, it is fundamental to put in place an ESG Due Diligence, that should be at least as deep and thorough as the more commonly conducted Due Diligence (i.e., financial, legal, and operational) that is carried on in the preliminary phases of every M&A deal.

This paragraph will first introduce the ESG risk, as well as the risks that are hidden behind ESG practices, and then it will provide an overview on the ESG Due Diligence process that is usually followed by Buyers in the context of an M&A deal.

3.2.1 ESG Risk and risks with ESG

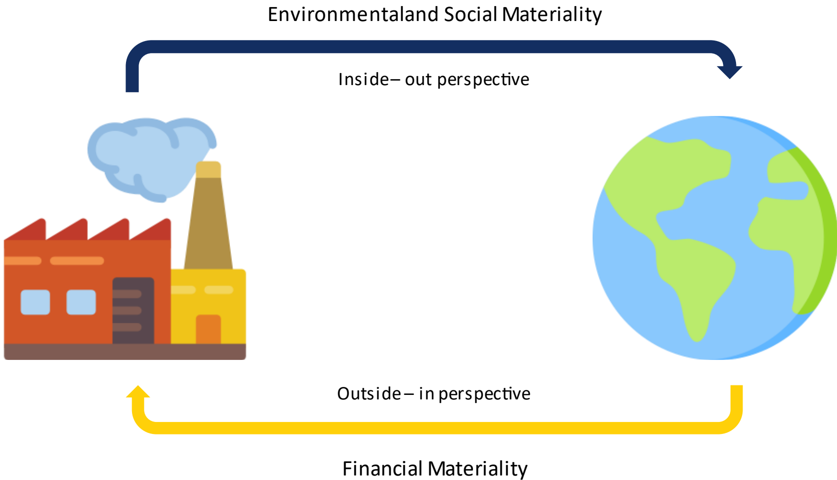
ESG risk refers to the potential negative impacts that Environmental, Social, or Governance factors may have on a Company's financial performance and reputation. Since Firms may be influenced by (from the outside-in) or have an impact on (from the inside-out) ESG variables, a double – materiality approach (incorporated by the CSRD) should be used in order to assess this class of risk: (i) financial materiality (outside-in perspective) refers to the effect of ESG factors on a Firm's operations, including economic and financial ones, that affect the returns of those operations across the entire value chain, and (ii) environmental or social materiality (inside-out perspective), which, the other way round, results from the impact that a company's economic and financial activities may have on ESG issues, which could become financially material themselves if they impact the returns of the Firm's operations. Thus, both the impact of external ESG factors on a Company and the Company's impact on ESG issues need to be considered to assess ESG risk fully, and to better understand such a definition, an example may be useful. (*EBA,2021*)

Let us assume that Company A, a leading player in the manufacturing industry, is considering the acquisition of Company B, a smaller competitor with a similar business model, for strategic reasons. To assess the ESG risks and opportunities associated with the acquisition, Company A should adopt a double materiality approach that considers both financial materiality (that is the impact of ESG factors on Company the Target's financial

performance) and ESG materiality (that is the impact of the Target's activities on the environment, society, and governance). From an environmental standpoint, Company A should evaluate the potential impact of Company B's environmental performance, including compliance with environmental regulations, potential liabilities arising from pollution incidents, and the costs associated with transitioning to more sustainable production processes, as well as the potential impact of climate change on the Target's operations, such as disruptions to the supply chain or the need for increased investments in energy efficiency. All of the above is part of the financial materiality screening, since it deals with how the company itself may be affected by ESG – related issues while carrying out its operations. On the other hand, through an environmental materiality lens, the Buyer should assess Company B's environmental footprint, including GHG emissions, energy and water consumption, waste generation, and resource usage, as well as the Target's commitment to environmental sustainability through its policies, targets, and initiatives aimed at reducing its environmental impact and promoting sustainable production practice, in order to understand if Company B is aligned with the Buyer's standards and what is the Target's impact on the environment. The same is true for Social and Governance factors.

In the figure below, there is a graphical representation of how double materiality works.

Figure 3.4 – Double materiality explained



Source*: own representation*

In order to implement the double materiality approach, a Buyer should carry an ESG Due Diligence, whose process is described in Chapter 3.3.2. Identifying, assessing, and managing the potential ESG – related risks (and opportunities) is fundamental, since those could heavily impact the valuation, reputation, and long-term success of the Target. Companies may proactively manage risks, unleash new value drivers, and align their strategic objectives with the growing expectations of investors, regulators, and stakeholders by incorporating ESG Considerations into their existing Due Diligence strategy. Failing to do so is increasingly considered as a

substantial danger to Firms' long-term value, and as already mentioned, can lead to substantial liabilities (see Chapter 2.2).

Having described what ESG risks are, it is useful to understand which risks can arise when dealing with ESG matters, and in particular, it is fundamental to become aware of the concept of *Greenwashing*, that appears to be the major downside aspect of the recent ESG uprise.

SEC (*2021*) provides a definition of greenwashing as "[…] *the act of exaggerating the extent to which products or services take into account environmental and sustainability factors*"[13], and, following such a definition, it is possible to conclude that it refers to a deceptive practice of companies portraying themselves as environmentally responsible or exaggerating their sustainability efforts in order to appeal to both consumers and investors, given the uprise of ESG considerations from stakeholders. Moreover, greenwashing can amplify the effect of ESG scandals, and a practical example is provided by the so – called *Dieselgate* experienced by Volkswagen AG. On September18th, the United States Protection Agency (EPA) issued a notice of violation to the German car manufacturer (that at the time had been just proclaimed the world's largest in its industry, with 5,04 million units sold in the first semester of FY2015[14]) after Researchers discovered the installation of a software in their Diesel vehicles, that was able to detect when cars were undergoing emission testing, leading to a temporary reduction of nitrogen oxide (NOx) emission for the sole purpose of passing the test, while in normal conditions, the cars were producing up to 40 times more NOx than the threshold set by Regulations. This is a perfect example of greenwashing since the Company was promoting its Diesel – fueled vehicles as environmentally friendly and fuel-efficient, while they were actually causing high levels of air pollution. As said, ESG scandals do not come at zero cost: according to Reuters, the company faced fines of € 31,3 billion, as well as substantial costs related to vehicle recalls, buybacks, compensation for dealers and customers globally. Moreover, during September 2015, Volkswagen's stock price experienced a significant drop: the Company's share price fell by over 30% (*Yahoo Finance*) within a few days of the EPA announcement, wiping out billions of dollars in market value, because Investors were concerned about the financial and legal repercussions of the scandal, as well as the potential damage to the Firm's reputation, due to the loss of trust from customers.

This scandal demonstrates the detrimental consequences of ESG scandals and greenwashing and, despite the Regulatory efforts trying to lower the number of companies that rely on false sustainability claims, (e.g., The EU Taxonomy Regulation and the SFDR, in the EU) Companies have the duty, when pursuing an M&A deal, to detect greenwashing activities, in order to avoid not – forecasted costs coming from unexpected ESG – related

[13] US. Securities and Exchange Commission (SEC). (2021, February 26). Environmental, Social and Governance (ESG) Funds – Investor Bulletin. Retrieved from https://www.sec.gov/oiea/investor-alerts-and-bulletins/environmental-social-and-governance-esg-funds-investor-bulletin.
[14] https://eu.usatoday.com/story/money/2015/07/28/volkswagen-surpasses-toyota-worlds-largest-automaker-first-half-2015/30772509/.

scandals. To do so, it is fundamental to carry an ESG Due Diligence, focused on the examination of the Target's environmental policies, its ESG disclosures, and on the comparison of the Target's sustainability claims against industry benchmarks or third-party certifications. New technologies are rising their relevance in greenwashing detection: Artificial Intelligence (AI) tools are able to analyze vast amounts of data, including news articles, social media posts, and Firm's disclosed documents (such as ESG reports), to detect patterns and discrepancies that may indicate greenwashing, for example by using Natural Language Processing (NLP) algorithms to perform a *sentiment analysis*.

3.2.2 The ESG Due Diligence process

ESG Due Diligence can be defined as that process that leads to "*identifying risks and upsides related to sustainability at the pre-signing stage*" (*KPMG, 2022*). There are two main operational models that are used when carrying an ESG Due Diligence (*ibidem*): (i) the *Fragmented Model* through which, without a dedicated ESG Due Diligence workstream, dealmakers identify the specific Environmental, Social, and Governance themes important to their transaction and embed these within their already existing Due Diligences workstreams (e.g., Financial, Tax, Legal etc.), and results flow together to the Deal Leader not being bundled or labeled as ESG Due Diligence findings; and (ii) the *Dedicated workstream model*, that, as the name suggests, implies the appointment of a dedicated workstream, that identifies the relevant ESG topics and analyzes them separately. Through the latter, ESG Due Diligence is treated at the same level as other workstreams, but the *Fragmented Model* has been used more frequently in past M&A transactions.

According to Ashley Bleeker, Director of ESG & Sustainability at BDO Australia, "*In conducting a Due Diligence exercise, […] the ESG becomes another component of the exercise that you cannot afford to ignore anymore.*"

In order to understand the ESG Due Diligence process, it is useful to analyze the dedicated workstream model, since it is easier to look at this process from a stand – alone perspective, without mixing the results and the scopes with other Due Diligence processes. In particular, the ESG Due Diligence process is articulated into four main steps: (i) definition of the scope, (ii) data analysis, (iii) validation, (iv) Reporting (*BDO Australia, 2023*).

The first step is focused on *drawing the materiality line*: that means determining the threshold at which ESG issues become significant enough to require further investigation or action from the Buyer, and the choice of where such a line is drawn, is based on the likely impact of these issues on the future value of the Business. Thus, this step of the process involves identifying the ESG – related issues that are most relevant to the Company, and then assessing their relevance based on their potential impact on the Company's operations, financial performance, and stakeholders. During the first step, the Buyer divides the ESG issued into those that are likely to be material, and so worthy of further analysis, and those that might be secondary for the determination of the Target's

Enterprise Value. The relevance of ESG issues for a Company depends on a variety of factors, including its sector, size, geography, value chain, corporate strategy and values, and more (ibidem).

The data analysis heavily relies on the available data and might include interviews and structured questionnaires aimed at addressing relevant performance data and procedures, as well as the review of relevant documentation, including company reports (e.g., ESG Reports), public databases, and news articles. It is obvious that data verification process must be put in place, in order to assure that the data is verified, accurate, and complete: to do so, the Buyer can cross – check data from multiple sources, as well as conduct site visits or interviews with key stakeholders to confirm the information that it gathered. In this step, it is also important to assess the Audit protocols of the so – called *Tier 1 suppliers* (i.e., those partners the Target company directly conducts business with, such as contracted manufacturing facilities or production partners.[15]), in order to assess that the ESG commitments are being respected throughout the value chain.

The third step involves the assessment of ESG – related risks and opportunities and marks the turning point from qualitative identification of issues to the assessment of the quantitative impact these issues may have on a Business, and on its future value. This step is the most complex, but it is critical to conduct an effective ESG Due Diligence, as it allows Buyers to quantify the potential financial impact of ESG risks and opportunities: to do so, the Buyer may use financial modeling, such as scenario analysis or stress testing, to analyze the possible impact of ESG risks on the company's financial performance, as well as assess the financial effect of ESG opportunities such as energy efficiency or sustainable sourcing practices by analyzing metrics such as return on investment (ROI) or forecasting cost savings. This step is also fundamental to analyze, from a risk management perspective, Target's risk management system, and the extent to which ESG – related risks might impact on intangible assets like reputation, brand, or market confidence, endangering the Deal and its future outcomes.

The last step is represented by reporting, and it involves packaging all the findings of the previous steps in a report, from which a clear set of conclusions should come out. The contents of the ESG Due Diligence report can be used for the purposes of further discussion with the Target or any related parties that may be involved, such as investors, financiers, future customers, employees, and other stakeholders.

In conclusion, ESG Due Diligence is a critical process for Buyers to identify and manage sustainability risks and opportunities. This process involves a comprehensive and iterative approach aimed at leading investors to better understand the potential impact of sustainability issues on the Target company and develop strategies to create long-term value for all stakeholders.

[15] https://www.sustain.life/blog/tier-suppliers

3.3 The ESG premium

When an acquisition is carried out, the Buyer pays a certain amount (purchase price) to the Seller to acquire the Target. The amount of the consideration is usually equal to the Equity Value of the Company, that is the market value of the shareholders' equity, as displayed in the formula below.

$$Equity\ Value = Enterprise\ Value - NFP$$

Where:

Enterprise Value = Value of the company calculated by using methods such as the Multiples Method, or the Discounted Cash Flow Method

NFP: Net Financial Position (Debt – Cash)

Moreover, in the context of M&A transactions, when the Buyer acquires a *controlling stake* (i.e., according to different legal frameworks around the world, that is the ownership of a significant percentage of a company's outstanding voting shares, granting the owner the power to influence or control the company's overall direction. Although it is typically achieved by holding more than 50% of a company's voting shares, in some cases, a controlling stake can be obtained by holding a lower percentage, especially when the remaining shares are widely dispersed among numerous smaller shareholders who are unlikely to coordinate their voting power) it is usually considered the payment of a *control premium*, that is the extra – amount that an investor is willing to pay to obtain the rights to determine the management of corporate resources (*Namethy & Glekov, 2019*).

In recent years, the relevance of a premium linked to other metrics has been rising within the M&A field: the *ESG premium*. In fact, according to *KPMG* (*2023*), ESG factors are influencing an increasing number of Mergers and Acquisitions, with investors inclined to pay premiums for targets with compelling sustainability stories. If it is true that investors are likely to pay more than the Target's fair value to acquire a Firm that holds a high ESG score, it is true that, on the opposite side, investors may require a discount when purchasing a Company that does not meet their sustainability standards, the so – called *Brown Discount* (*PwC, 2012*).

In recent years, given the rise of ESG's relevance in M&A transactions, many studies have been conducted to analyze the ESG premium phenomenon: these range from Top Managers and Investors'

McKinsey (2020) highlighted that 83% of the interviewed C – suite managers and investment professionals, have been found to be willing to pay a median premium of about 10% to acquire a Firm with a solid ESG performance over one with negative records of ESG issues. 25% of the interviewees stated that they were willing to pay a premium in the range of 20% to 50%, while 7% of the respondents were found ready to pay an ESG premium

equal to more than 50% of the Company's Equity Value. Surprisingly, among the respondents who are willing to pay an ESG premium, there are also some of those who don't believe in the effect of ESG programs on shareholders' value.

Deloitte (*2022*) used a sample of over 300 listed companies operating in four industries (i.e., Basic materials & Energy, Consumer goods, Industrial, and Services) to study, through a regression analysis, the impact of ESG performance (measured through the ESG score provided by Refinitiv) on Firms' Market Value. To do so, Researchers observed the simple correlation (that is the measure of the intensity of the correlation among two variables) between the ESG score and the EV/EBITDA multiple. The study was able to prove the existence of the ESG Value Premium, as it is summarized in the graph below, since, in all the considered industries, the Companies with a higher ESG score were also found to have a higher EV/EBITDA multiple. However, other than ESG ratings, there could be other factors influencing a Firm's EV/EBITDA multiple that are not taken into consideration in the simple correlation, such as revenue growth or profitability, and to isolate the effect of ESG factors on the EV/EBITDA multiple, the Researchers performed a multiple linear regression analysis. The findings of the latter once again confirmed the existence of the ESG premium: in particular, even after accounting for the influence of other variables often regarded as corporate value drivers, the study has shown that a 10-point difference in an ESG score is related with a higher EV/EBITDA multiple (1.2x) on average across the data sample. Moreover, a 10-point increase in the ESG score for the same Firm generates a 1.8x higher EV/EBITDA multiple.

Kengelbach et Al., 2023 shows that *Green deals* generate greater value than the non - green peers both at the time of announcement and over the following two years. Although at a more granular level, the industry, area, deal aggressiveness, and qualities of the parties are all key determinants, the outcome of the Research shows that Firms who pursue green dealmaking are able to generate greater profits.

Moreover, in the survey proposed by *Bakertilly International* targeting dealmakers, it has been highlighted that 60% of the interviewees had already walked away from an M&A transaction due to negative assessment on ESG issues regarding the Target. Thus, in the current state of the economy, ESG issues have become a make – or – break factor in M&A Deals. This represents a significant departure from the traditional M&A process, since in the past Deals were pursued for merely financial and commercial reasons. Nonetheless, among those who answered negatively to the question, there were practitioners who stated that despite the ESG issues, they decided to go on with the transactions while thinking about how to solve the issues, in order to enhance the value of the Target on a post – deal basis.

Thus, the Green Premium is increasingly playing a significant role in M&A transactions. Businesses that demonstrate strong ESG practices are attracting higher valuations, reflecting a shift in investor attitudes towards sustainable and responsible business operations. These premiums are not only indicative of the market's growing

commitment to sustainability, but also underscore the potential financial benefits for companies investing in green initiatives. While the Green Premium may vary across sectors and regions, the trend is clear: sustainability is no longer a peripheral consideration in M&A, but a crucial factor influencing deal values and long-term corporate strategy. This evolution places a premium on future-proofing businesses through sustainable practices, positioning them to thrive in an increasingly ESG-conscious global market. Alongside this concept, another notable phenomenon in the M&A landscape is the emergence of the Brown Discount. As stated, this term refers to the decreased valuation or potential financial penalties faced by companies with poor ESG practices like, for example, those heavily involved in pollution-intensive industries. The 'brown discount' reflects the growing risk aversion among investors and financiers to harmful business models, and the rise of both the Green Premium and the Brown Discount underscores the financial implications of ESG factors in M&A transactions. They serve as financial incentives and deterrents that push companies to align their strategies with a more sustainable business model.

Although one may expect that investing in firms with exceptional ESG performance would be the most beneficial from a return standpoint, *Cappucci* (*2018*) argues that it can be most beneficial for Buyers to invest in those Firms that have average ESG performance, since those can experience an improvement in their worth over the investment period. This is due to the fact that Firms that are already experiencing a strong ESG performance have less room to increase their risk-adjusted financial performance than those companies that, instead, are not top – performers in ESG terms. Since a Firm's extraordinary ESG performance is already included in the acquisition price, there are fewer potential returns at an eventual exit stage. Thus, for example, Private Equity firms should invest in those companies that have an average ESG performance, while those who seek strategic M&A transactions, may find convenient to pay the higher premium in order to benefit from the already increased value of the Target Company.

3.4 Private Equity Funds and ESG

It is worth focusing on the activity of Private Equity funds since those are the most active players in the M&A market.

The expansion of ESG focused private equity funds has been a notable trend in recent years, particularly in response to changing societal attitudes and expectations. While there has been skepticism in the industry, especially in the U.S., initiative-taking firms are incorporating sustainability and social responsibility into their investment and operational strategies without waiting for ROI studies to pan out. This expansion is mainly due to the fact that ESG is becoming a critical element in gaining market share, engaging employees, and raising capital. There is, however, a wide gap in ESG adoption between the private equity industry in North America and that in Europe. While 80% of the top 20 EU-based institutional investors have committed to either the Principles for

Responsible Investment (PRI), the UN's Net-Zero Asset Owner Alliance, or the Task Force on Climate-related Financial Disclosures, only around 45% of the top 20 North American institutions have done so, and many of these are based in Canada. Analysis of ESG performance among PE firms shows that portfolio companies owned by US-based firms trail those owned by EU-based firms. Even in Europe, there is ample room to grow, as many EU-owned portfolio companies haven't launched meaningful sustainability initiatives. (*Bain, 2021*).

In the year of 2022, there was a noticeable trend towards increased sector specificity among funds, driven by Limited Partners (LPs) exhibiting more discernment, thematic focus, and an aim to surpass performance through strategic allocation within the asset class. In Europe, funds dedicated to addressing climate change and promoting sustainable investments became prominent, exemplified by the likes of Generation IM's Sustainable Solutions Fund, which accumulated €1.6 billion in the second quarter. Other noteworthy instances include Lightrock's successful closing of their first Climate Impact fund with €860 million in the fourth quarter, and Algebris Investments, which secured €200 million for its Green Transition fund in the third quarter. The expectation for the year 2023 is a continued escalation in fundraising for sustainable and climate investments, largely precipitated by the ongoing oil and gas crisis in Europe, which has emphasized the urgency for a greener energy infrastructure. Another sector that garnered significant interest was healthcare, with Glide accumulating €517 million for their fourth healthcare fund, and Apposite Capital securing €229 million for its third. (*Moura, 2022*).

In terms of integrating ESG into their strategies, private equity firms are beginning to move away from viewing ESG as a separate initiative and are instead integrating it into their core business strategies. They are focusing on governance risk and increasingly seeing the value in cutting costs through sustainability. There is also a growing awareness that environmental, social, and governance issues are highly interrelated and that the biggest benefits over time accrue to companies that balance efforts between all three. (*Bain,2021*).

In order to understand how ESG – focused PE funds develop a sustainability – oriented strategy, it can be useful to analyze the methodology developed by Ambienta SGR, a leading European asset manager with a core focus on environmental sustainability trends in investment. The firm, established in 2007, is a pioneer in the domain of sustainability investing, operating from offices in Milan, London, Paris, and Munich. Ambienta concentrates its investments on private and public companies that are driven by environmental megatrends. It sees a vast investment opportunity in the European sustainability-driven sector, propelled by irrefutable long-term drivers. The firm believes that companies whose products and services tackle global environmental challenges pertaining to resource efficiency and pollution control solidify their long-term competitive edge, as sustainability drives value. Ambienta developed an Environmental Impact Analysis that is a comprehensive tool used to measure the environmental footprint of businesses, focusing on Resource Efficiency and Pollution Control. This requires a method that goes beyond a single indicator like CO_2 emissions and can be applied uniformly across companies

with different business models, sectors, and stages in the value chain. This approach uses 11 Environmental Metrics to assess all businesses encountered, conducted concurrently with due diligence for potential investments. Companies' impacts are evaluated across their entire value chain and against viable technological alternatives, not competitor products. If a positive environmental impact is certain but difficult to quantify, it is acknowledged without measurement. Companies presenting both significant positive and negative environmental impacts may be excluded from investment. In complex cases, an independent expert may be consulted.[16]

Firms are also recognizing that consumers, regulators, employees, and sources of capital are energized by the notion that investors can and should use their economic clout to address societal and environmental crises. These groups are ramping up demands for change and, in many cases, rewarding it. This business rationale is driving more private equity firms to prioritize ESG initiatives. In some instances, ESG initiatives are formalized through sustainability-linked loans (SLLs), which tie the company's financial performance to its ESG goals. The interest rate on such loans can fluctuate depending on the company's success in achieving its ESG targets. These loans are often used to incentivize companies to improve their sustainability performance metrics, which in turn can lead to a lower interest rate on their debt. This is one of the innovative ways in which private equity firms are integrating ESG into their strategies, not just as a peripheral concern, but as a central part of their business model (*PwC, 2021*). In the coming years, as the ESG landscape continues to evolve and as societal pressures mount, private equity firms will likely have to make more substantial efforts to integrate ESG into their strategies. This will entail not only focusing on environmental initiatives but also giving equal weight to social and governance issues. This integrated approach could potentially lead to better long-term outcomes for the firms, their investors, and society at large.

[16] Ambienta 2021 Environmental Impact Analysis

4 Case study: CVC Capital's acquisition of Unilever's Ekaterra

After providing a comprehensive overview of the increasing importance of ESG considerations in M&A transactions, this thesis will conclude with the analysis of a relevant case study (i.e., a recent M&A transaction in which certain ESG issues concerning the target company were relevant to the outcome of the transaction).

Specifically, the case under analysis is the acquisition of Ekaterra, a company that held most of Unilever's tea business, by CVC Capital, a private equity firm. The ESG issues that emerged were on the S side (i.e., Social) and led to the withdrawal of some potential buyers from the transaction, effectively leaving CVC Capital Partners as the sole buyer.

After describing the companies that participated in the transaction and the market in which the target company operates, a valuation of the target company is carried out, using the stock market multiples method as the primary method and the transaction multiples method as the control method, to show that the ESG issues that emerged had a negative effect on the potential return for the Seller, which had to settle for a discounted price, paid by the Buyer.

4.1 Background and Deal rationale

In January 2019, Unilever appointed Alan Jope as its new CEO, replacing former CEO Paul Polman after ten years of tenure. During its first earnings presentation, Mr. Jope pledged to prioritize growth in Unilever's strategy, given the slow – growth trend that had been characterizing the Group's Revenues during the previous years and he argued "[…] *with so many of our brands enjoying leadership positions, we have significant opportunities to develop our markets, as well as benefit from our deep global reach and purpose-led brands*". (*Abboud, 2019*).

Table 4.1 – Unilever Turnover and YoY growth rate (2012-2022)

€/mln	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Revenues	55.548	49.797	48.436	53.300	52.700	53.700	50.982	51.980	50.724	52.444	60.073
YoY Growth	-	*-10,4%*	*-2,7%*	*10,0%*	*-1,1%*	*1,9%*	*-5,1%*	*2,0%*	*-2,4%*	*3,4%*	*14,5%*

Source*: own elaboration on Unilever Annual Reports (2012-2022) Data*

Since 2015, Unilever focused its M&A program on cosmetic and skincare Companies: almost 75% of the € 11 bn spent for acquiring 30 Companies were invested by the beauty and personal care division (a further detail on the Firm's divisions will be presented in Chapter 4.1.1). While acquisitions were focused on the beauty markets, the disposals mainly concerned the food industry, where the Group sold € 8 bn in assets, due to the slower growing rate of the products sold. In its first interview after taking office, the newly appointed CEO confirmed the trend,

stating that the Group's focus would further shift away from food, moving toward the beauty and personal care market, which could grant higher margins and growth. (*ibidem*)

Seen all of the above, the Market wasn’t shocked when Unilever’s CEO announced that a strategic review of its global tea business was taking place, in an attempt to deal with the division’s poor growth after the black tea lost its appeal among consumers: according to Jope itself, the black tea market customers were getting older, while young consumers were seeking forth new experiences. Due to this change in customers’ habits, the Group’s tea business, that was focused on black tea, was far from those areas were growth resides (fruit and herbal, according to Matthew Barry, drinks and tobacco consultant at Euromonitor), thus leaving Unilever’s tea division experiencing declining volumes for years, in fact, Mr. Jope stated “*Two-thirds of our [tea] business is in black tea, and most of that is in the developed world . . . and for a decade it’s been a drag on Unilever’s growth*”. More insights on the tea market and on Unilever’s tea business will be provided in Chapter 4.1.3. (*Evans, 2020*)

Thus, the rationale behind the operation (i.e., the disposal of Unilever’s tea business) was that of reshaping the business portfolio in order to abandon the slow – growth markets, while focusing on the high – growth ones, seeking confidence from investors after years of slow Sales growth for the diversified Giant.

In particular, as it will be described in Chapter 4.2, the disposal was pursued through the creation of a new company, Ekaterra BV, which gathered under one entity Unilever's tea business (including 34 brands, among which there are Lipton, Red Label, PG Tips, T2, Pucca, and Tazo), excluding Unilever's tea businesses in India, Indonesia, Nepal, and the so-called ready-to-drink (RTD) tea business (except in Japan, where the chilled RTD business is in Ekaterra's scope).

In the following subsections, the Seller, the Acquirer, and the Target will be presented, providing a thorough company overview of the main actors in the transaction. The information is retrieved from the Firm’s websites.

4.1.1 The seller: Unilever

Unilever is a multinational consumer goods Corporation that has established itself as one of the leading brands worldwide. The company's extensive product portfolio spans across five main Business Groups: Beauty and Wellbeing, Personal Care, Home Care, Nutrition and Ice Cream. These products touch the lives of more than 2.5 billion people around the globe every day, underscoring Unilever's significant role in the global market. The roots of Unilever go back over a century, and its core mission of enhancing people's lives through sustainable living has remained consistent throughout its evolution, and as provided by the Company’s website, its vision is “*to deliver winning performance by being the global leader in sustainable business.*”

Unilever's history dates back to the 19th century with the founding of several companies that eventually merged to form the present-day Unilever. The most significant of these mergers took place in 1929, between *Margarine Unie*, a Dutch margarine producer, and *Lever Brothers*, a British soap maker. The alliance was based on the mutual need for palm oil, a critical ingredient in both margarine and soap, and this strategic consolidation allowed Unilever to economize on the supply chain and create a strong foundation for the expansive enterprise it would eventually become.

Over the years, Unilever has diversified its portfolio, made strategic acquisitions, and penetrated various markets around the globe. This expansion was often achieved by identifying and leveraging local consumer habits, preferences, and needs. The company's history is marked by constant innovation, adaptation, and a forward-thinking approach that has kept it at the forefront of the consumer goods industry.

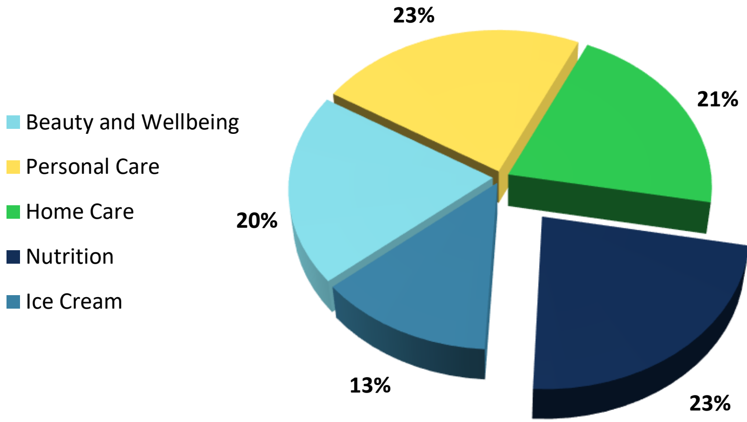
Unilever's operations are vast and encompass more than 400 brands that are renowned globally. The company's product range is comprehensive, including food and beverages, cleaning agents, personal care products, and beauty products. Some of Unilever's most recognized brands include Dove, Cif, Ben & Jerry's, Hellmann's, Knorr, and Vaseline. The company's products are grouped into five principal categories:

- **Beauty and Wellbeing**: This division represents a € 12,3 bn business, including skin care brands such as Dove, Sunsilk, Clear and Vaseline, as well as luxury brands such as Dermalogica and Hourglass. The Health and Wellbeing subdivision is focused on the production of vitamins, minerals and supplements, with brands including Liquid I.V. and OLLY. Recently, the company has become the spokesperson for a new beauty movement, promoting inclusive, equitable and regenerative Beauty and Wellbeing.
- **Personal Care**: This division represents a € 13,6 bn business, including skin cleansing and oral care brands such as Dove, Rexona, LUX, Axe, Lifebuoy and Pepsodent. The Personal Care unit holds a leading position in skin cleansing and deodorant markets, standing at either 1st or 2nd position in the served geographical areas.
- **Home Care:** This division represents a € 12,4 bn business, including home cleansing brands such as Cif, Comfort, Domestos and OMO. This Business Group is responsible for the biggest share of GHG emissions of the whole Unilever Group, and its strategy is now focused on transforming some of the most popular cleaning and laundry brands in the world to produce lower carbon and lower waste, keeping the same or achieving even better performance.
- **Ice Cream**: This division represents a € 7,9 bn business, including brands such as Ben & Jerry’s Ice Cream, and the “Heartbrand”. Unilever’s Ice Cream Business Unit is the largest ice cream producer in the world, and this goal has been achieved through a 100 – years long journey of strategic geographical

acquisitions, to unify under one brand (i.e., the Heartbrand), many of the most important ice cream – making companies in the world (see, for example, Algida in Italy).

- **Nutrition**: This division represents a € 13,9 bn business, including food and beverage brands such as Knoor, Hellmann's, Horlicks, and The Vegetarian Butcher. Until July 1st, 2022, this Business Group also included a portfolio of tea businesses, which included brands such as Lipton and PG Tips. In recent years, the Division, in order to comply with the Group's sustainability objectives, started initiatives of regenerative agriculture, plant – based production of meat and food, focus on nutrients, and food waste reduction. Ekaterra belongs to this Unit.

Figure 4.1 – Unilever Turnover by Business Group



***Source**: own elaboration on Unilever Annual Report 2022 Data*

As it can be seen above, the "Nutrition" Business Group generates the higher share of Turnover of the Unilever Group, nonetheless, as stated before, the Management wants to focus its strategy on the expansion of the other Business Units, due to the lower growth rate that characterizes the food industry.

Unilever's global footprint is extensive: the company operates in over 70 countries, and its products are available in around 190 countries, making it a truly international entity. Unilever's largest markets are the United States, China, India, Brazil, and Indonesia, but the company also enjoys a strong presence in Europe, Africa, the Middle East, and other parts of Asia and the Americas. This global reach has been achieved through a robust distribution network that extends to both urban and rural areas, ensuring the availability of Unilever products across diverse retail landscapes, from supermarkets and hypermarkets to local convenience stores and e-commerce platforms.

This broad geographical spread allows Unilever to serve a diverse range of consumer markets and demographics and mitigates risks associated with over-reliance on a single market.

Looking forward, Unilever is dedicated to a strategy of sustainable and responsible growth. The company plans to further integrate sustainability into its business operations and strategy, driven by its belief that businesses that prioritize sustainability will experience better long-term growth. Moreover, Unilever recognizes the growing importance of digital transformation and e-commerce in today's consumer goods landscape, and so it is investing in these areas to adapt to changing consumer behavior and market trends. Unilever aims to leverage technology and data to enhance its consumer understanding, improve its products and services, and drive operational efficiency. With regards to its product portfolio, Unilever is likely to continue innovating and diversifying its offerings to meet evolving consumer preferences and needs. The company has identified several key areas for growth, such as plant-based foods and sustainable personal care products, as consumer awareness and demand for sustainable and ethical products continue to grow.

Unilever’s decision to dispose of the tea business has been described in the previous subsection.

4.1.2 The Buyer: CVC Capital Partners

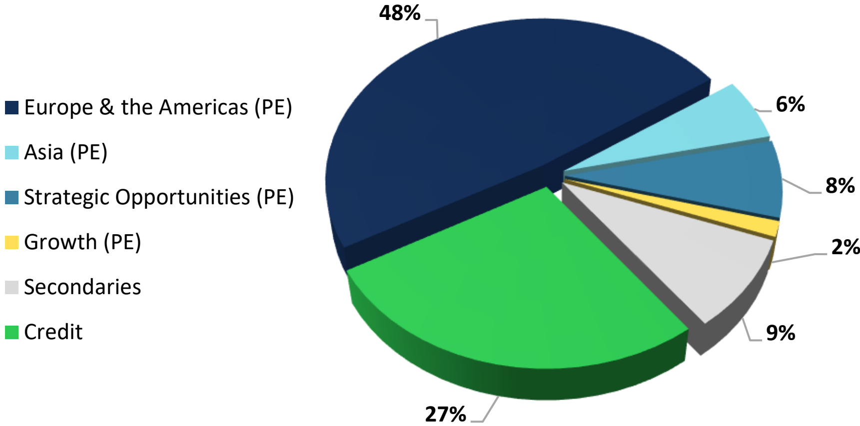
CVC Capital Partners is a leading global alternative investment manager focused on private equity, secondaries and credit founded in 1981, with a global network of 25 local offices across the Americas, Asia, and Europe, and € 133 bn of AUM. Thanks to its global footprint, CVC has been able to tap into lucrative investment opportunities across various markets, demonstrating its strategic ability to leverage international business dynamics. At the core of CVC's investment strategy there is a focus on acquiring either controlling or significant minority interests in high-potential companies, and once these acquisitions are made, the Firm works diligently with the Management teams of these Targets to enhance performance and build long-term sustainable value.

The firm's investment philosophy is generalist in nature, meaning it does not restrict itself to specific sectors. Instead, it displays a diverse investment portfolio, spanning sectors such as consumer goods, financial services, healthcare, industrials, media, technology, and telecommunications. This broad approach enables CVC to remain flexible and adapt to changing market conditions, thus maximizing the potential for high returns.

CVC's investments are typically large-scale. The firm generally invests between $100 million and $1 billion in its portfolio companies, and although its typical holding period ranges between four to six years, CVC maintains the flexibility to adjust these timelines and value ranges depending on individual investment circumstances and market conditions. For example, the “Strategic Opportunities” strategy is focused on Companies with an EV between € 1 bn and € 5 bn, and the holding period is around six to fifteen years.

In particular, CVC has six complementary strategies across private equity, secondaries and credit, through which they invest on behalf of pension funds and other leading institutions. In the chart below, it is provided a recap of the allocation of AUM among the six strategies: (i) Private Equity (PE) Europe & the Americas, (ii) PE Asia, (iii) PE Strategic Opportunities, (iv) PE growth, (v) Secondaries, and (vi) Credit.

Figure 4.2 – CVC Capital Partners: the six investment strategies (Data in € billion)



***Source**: Own elaborations on CVC Capital Partners Data*

As can be seen above, the Europe & Americas focused Private Equity Funds are those with the higher amount of AUM, totalizing € 64 bn out of the total Assets managed by CVC (ca. 48%). In particular, these Funds employ 171 investment professionals, and as of May 2023 they have 77 active investments, in very different sectors, including, among the others, consumer retail, energy, infrastructure, media and financial services, among which there are LaLiga, Breitling, Douglas, and Ekaterra, the subject of this analysis.

CVC has the most geographically diverse and long-established pan-regional office network of any private equity firm in Europe. 16 of CVC's 25 offices are located in EMEA and the Americas, providing a deep and local knowledge of the markets in which it operates. In particular, the Europe & Americas PE Funds invest in businesses operating in stable, non-cyclical markets with several characteristics, such as: (i) a defendable market position, (ii) predictable cash flows, (iii) competitive leadership, (iv) well diversified consumer bases, diversification of products and geography, and (v) providing products and services that are needed in both good and bad times.

CVC’s funds, as of May 2023, are summarized in the table below.

Table 4.2 – CVC Capital Partners' active Funds (size in currency mln)

Fund	Year	Region	Size (mln)
CVC European Equity Partners I	1996	Europe	$ 840
CVC European Equity Partners II	1998	Europe	$ 3.333
CVC Asia Fund I	2000	Asia	$ 750
CVC European Equity Partners III	2001	Europe	$ 3.971
CVC European Equity Partners IV	2005	Europe	€ 6.000
CVC Capital Partners Asia Pacific II	2005	Asia	$ 1.975
CVC European Equity Partners Tandem Fund	2007	Europe	€ 4.123
CVC European Equity Partners V	2008	Europe	€ 10.750
CVC Capital Partners Asia Pacific III	2008	Asia	$ 4.120
CVC Capital Partners Asia IV	2014	Asia	$ 3.495
CVC Capital Partners VI	2014	Global	€ 10.907
CVC Growth Partners	2015	US & Europe	$ 1.000
CVC Capital Partners VII	2017	Global	$ 18.000
CVC Growth Partners II	2019	US & Europe	$ 1.600
CVC Capital Partners Asia V	2020	Asia	$ 4.500
CVC Capital Partners VIII	2020	US & Europe	€ 21.300

Source*: Own elaborations on CVC Capital Partners Data*

CVC Capital Partners has an exceptional track record that demonstrates its investment expertise. Since its establishment, the business has undertaken over 300 investments in a variety of industries and geographies. One of the reasons CVC has a high reputation in the financial sector is its long history of successful investments. Each investment demonstrates CVC's ability to identify high-potential prospects in a variety of industries and regions and then add considerable value to its portfolio businesses.

As far as the Firm's sustainability is concerned, CVC claims that it is deeply committed to responsible investing and conscientiously integrates ESG considerations into its investment process, performing a dedicated ESG Due Diligence, and evaluating investments considering a double materiality approach. To ensure adherence to these principles, CVC has a clearly defined Responsible Investment Policy that guides its approach to managing ESG issues. Further demonstrating its commitment to sustainable and ethical investment practices, CVC has been a signatory to the United Nations-supported Principles for Responsible Investment (PRI) since 2012.

Considering CVC Capital Partners' remuneration for their services, the management fee on the Company's latest private equity fund is 1.5% but discounts are provided for these institutions that commit large sums. (*Wiggins, 2022*). Other than the management fee, CVC services are remunerated through a 20% share of profits on successful deals, making this income stream the main source of income for the Firm (*ibidem*).

4.1.3 Ekaterra

Ekaterra Company Overview

Ekaterra B.V. is the world's leading tea business, holding its market leader position through a portfolio of 34 world-class brands. Before Ekaterra's inception, the brands were owned by Unilever, and they formed the Group's tea business. Among the brands there are:

- **Lipton**: that is the world's largest tea brand, which is available in 110 countries wor1dwide. The brand offers an array of tea and herbal supplement drinks, including black and green teas, benefit-led herbal teas, flavorful powdered mixes, bottled drinks, and more.
- **Pukka**: the brand is defined by Ekaterra as its "well – being champion", and its products are based on ancient ayurvedic wisdom and herbal medical knowledge. Since 2017, Pukka has planted one million trees, and all of its goods are created with sustainable energy, since the brand has pledged to become carbon-neutral by 2030. It is a B Corp Certified company and an active member of 1% for the Planet, that donates 1% of its annual revenue to environmental initiatives.
- **TAZO:** That is a brand focused on the younger generations, and it is mainly sold in the US. Hot and iced teas, concentrates, tea bags, and ready-to-drink bottled teas are among the brand's offerings.
- **T2:** it is Ekaterra's premium retail brand from Australia and it is expanding, from New Zealand and the United Kingdom to more countries, such as the United States of America and Singapore. The brand gained B Corp accreditation in 2020, highlighting its dedication to sustainability and its innovative approach to establishing an inclusive workplace.
- More brands are local icons that are deeply ingrained in their own marketplaces and top the market in their respective geographies, such as JOKO in South Africa, Brooke Bond in Pakistan, and several others.

The Company owns tea estates in three countries (i.e., Kenya, Tanzania and Rwanda), and eleven production facilities across four continents, ranging from China and Sri Lanka to Argentina and Australia. As the world's market leader, it buys 5% of the world's tea leaf supply, and serves circa 385 million consumers every day with its products. Ekaterra's mission is to create a wor1d of well-being through the regenerative power of plants. 90% of Ekaterra's products fall within the black and green tea categories and are obtained from the leaves of the *Camellia Sinensis* plant. The Company is also engaged in the production of plant based herbal teas, infusions and non-teas made from flowers, herbs and plants other than *Camellia Sinensis* (such as chamomile, peppermint and rooibos).

As of December 31st, 2021, the Ekaterra Group consisted of 60 entities. The Group, controlled by Ekaterra B.V., is made up of holding companies based in the Netherlands, the United Kingdom, and the United States of America, as well as operational businesses with responsibilities in sales and marketing, production, and group services. The Company emp1oyes c1ose to 20.000 peop1e, including the deferred entities, temporary and seasonal staff working in the tea estates, and below there is a summary of the workforce, not including the deferred entities, as of December 31st, 2021.

Table 4.3 – Ekaterra workforce (not including the deferred entities)

Employees (n.)	31.12.2021
Africa, Middle East and Turkey	10.894
Americas	23
Australasia	1.051
Bangladesh, Sri Lanka and Pakistan	377
Europe	1.214
Total	**13.559**

Source*: Own elaborations on Ekaterra's 2021 annual statement*

From a phone interview carried with Mrs. Eleonora Pitaro, Temporary Finance Manager at Ekaterra Italy, I understood that, following the sale of Ekaterra to CVC Capital Partners, to facilitate the transition, Unilever and the Ekaterra Group entered into different Transitional Services Agreements (TSAs), under which Unilever provides Ekaterra with a variety of corporate and operational services, such as IT infrastructure and support services, financial services, operations management services, distribution services, office and facilities use, manufacturing services, and logistics and supply chain management. Furthermore, Unilever sells goods for the Group and obtains proceeds from these sales, with a contractual duty to remit such revenue to the Group (minus any expenses paid by Unilever).

The table below shows the Income Statement of Ekaterra as of December 31st, 2021. It has to be noted that, since the Company had no business prior to October 1st, 2021, the Profit and Loss Statement only refers to the period between October 1st, 2021, and December 31st, 2021.

Table 4.5 – Ekaterra Income Statement between October 1st, 2021, and December 31st, 2021 (Data in €/mln)

€/mln	31.12.2021
Revenue	476,6
Cost of Sales	(338,3)
Gross Profit	**138,3**
Other Income	18,9
Selling and Administrative Expenses	(129,8)
Operating Profit	**27,4**
Net Finance Cost	(8,3)
Finance Income	0,6
Finance Expenses	(8,9)
EBT	**19,1**
Taxes	(1,6)
Net Profit	**17,5**

Source*: Own elaborations on Ekaterra 2021 annual statement*

In the reference period, which accounts for just a quarter of a Financial Year, Ekaterra generated € 476,6 mln in sales. The Company's marginality, is equal to 5,75% and it was calculated through the following formula:

$$Margin = \frac{Operating\ Profit}{Revenues}$$

This data is higher than that of Ekaterra's group of peers, as summed up in the table below. Information on such a group will be provided in Chapter 4.3.

Table 4.5 – Ekaterra's Group of Peers margin (Operating profit/Revenues) as of December 31st, 2021

	31.12.2021
Tata Consumer Products Ltd.	12,1%
McLeod Russel India Ltd.	3,4%
Goodricke Group Ltd.	1,8%
ITO EN Ltd.	3,7%
Camellia Plc	3,4%
Average	**4,9%**

Source*: Own elaborations on Companies' Annual Reports*

In terms of Net profit, the Company generated € 17,5 mln, due to a combined negative impact of ca. € 10 mln of Financial Expenses and Taxes.

The table below shows a detail of Ekaterra's Revenues in the last quarter of 2021. In particular, it is provided the breakdown of Revenue:

- By Geographical Area: Considering five different areas, those are (i) Americas, (ii) AMET, that is Africa, Middle East and Turkey, (iii) Australasia, (iv) BSPAN, that is Bangladesh, Sri Lanka, and Pakistan, and (v) Europe (Including Russia).
- By Sales Channel: (i) Retail, and (ii) OOH, that is Out – of – Home.

Table 4.6 – Ekaterra Revenues Detail (Data in €/mln)

€/mln	Retail	OOH	Total
Americas	86,9	1,7	88,6
AMET	99,2	9	108,2
Australasia	48,5	43,8	92,3
BSPAN	48,7	1,3	50
Europe	127,9	9,6	137,5
Total Revenues	**411,2**	**65,4**	**476,6**

Source*: Own elaborations on Ekaterra 2021 annual statement*

As it can be seen above, for the period between October 1st, 2021, and December 31st, 2021, the majority of Revenues were generated through Sales in Europe (€ 137,5 mln), followed by AMET (€ 108,2 mln), Australasia (€ 92,3 mln), the Americas (€ 88,6 mln), and BSPAN (€ 50 mln). In terms of Sales Channel, the retail one accounted for 86% of the revenues, while the remaining 14% was generated by exploiting OOH Channels. While in the Americas, AMET, BSPAN, and Europe the average Retail share of total turnover is 95,0%, in Australasia the Retail and OOH channels are almost equally relevant, whit the former accounting for 52,5% of total Sales, and the latter accounting for the remaining 47,5%.

To assess the company's profitability, solidity, and liquidity, I calculated some of the most relevant Ratios that are commonly used by Managers and Analysts to analyze Companies. The results, as well as the relevant formulas, are summed up in the table below. Since many of these Ratios are obtained through the comparison of some Balance Sheet items, please refer to Appendix 1 for Ekaterra's Balance Sheet. Moreover, it has to be noted that I had to estimate the value of Income Statement items due to the fact that the Statement only refers to Q4 2021, to do so, the Income Statement items were multiplied by 4: the assumption underlying this estimate is that Ekaterra's (or Unilever's tea business) Q4 trends were constant throughout the whole year.

Table 4.7 – Ekaterra's Key Ratios[17]

Ratio	Value	Formula	Definition	Comment
Return On Equity (ROE)	**3,9%**	$\frac{Net\ profit}{Net\ Equity}$	It is a measure of the Company's profitability	Comparing this measure with the *average ROE in the industry*[18], it appears lower
Current Ratio	**0,19**	$\frac{Current\ Assets}{Current\ Liabiilties}$	It is a measure a company's ability to pay short-term obligations.	The ratio should be higher than 1.5, thus Ekaterra's Current Ratio is low.
Quick Ratio	**0,12**	$\frac{Current\ Assets - Inventories}{Current\ Liabilities}$	It is a measure of the Firm's capability to instantly use its near cash means to pay current obligations.	The ratio should be higher than 1, thus Ekaterra's Current Ratio is low.
Cash Ratio	**0,01**	$\frac{Liquidity}{Current\ Liabilities}$	It is a measure of a Firm's capability to cover its short-term obligations using only cash and cash equivalents.	Ekaterra's ability to pay its liabilities is really low, comparing its liquidity to the obligations.
Equity to Fixed Assets Ratio	**1,85**	$\frac{Equity}{Non - Current\ Assets}$	It is a measure of the relative exposure of shareholders to the fixed assets owned by the Company.	The Company shows a good solidity, all the assets are financed through equity

Source: *Own elaborations on Ekaterra 2021 annual statement*

Although the Liquidity Ratios are low, it has to be noted that the main negative impact on liquidity ratios comes from the short - term financial liabilities, which consist of € 2,4 bn of related party loans with Unilever, with maturity date September 30th, 2022. As explained later in the deal structure, the financial liabilities are bore by Unilever, and therefore should have no impact on Ekaterra's performance post-acquisition.

Ekaterra market analysis

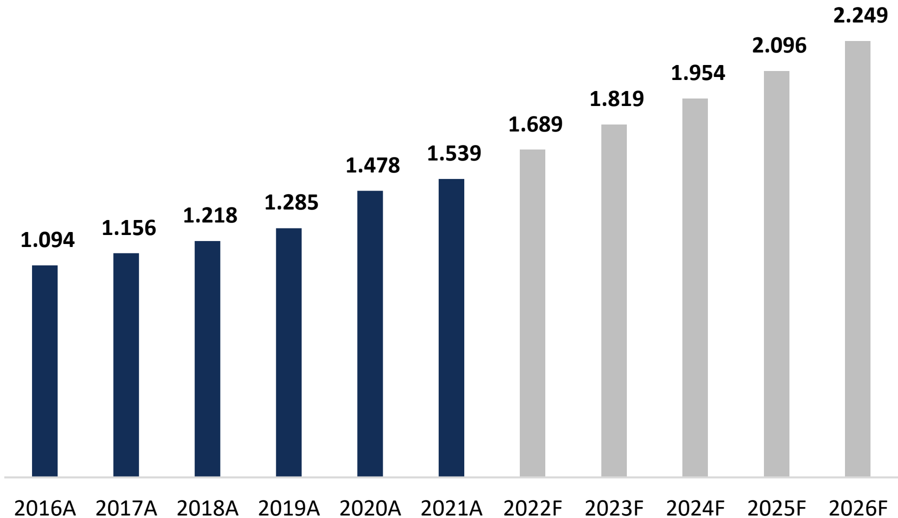
Ekaterra is the leader in the tea market, thanks to its portfolio of brands. Such a market is a subsegment of the hot drinks market, that consists of the retail sale of coffee, tea and other hot drinks (such as hot chocolate), and, in particular, the tea segment consists of black specialty tea, fruit and herbal tea, green tea, instant tea and tea pods.

[17] Definitions and formulas are retrieved from *Penman (2018)*

[18] It has been chosen, as a comparable measure, the average ROE of the industry (soft beverages) provided by Prof. Aswath Damodaran as of January 2021. This figure is equal to 28,86%.

The whole industry grew with a CAGR (i.e., Compound Annual Growth Rate) of 7,1% between 2016 and 2021, and is forecasted to grow at a 7,9% CAGR till 2026, when it should reach, according to MarketLine estimates, € 224.9 bn.

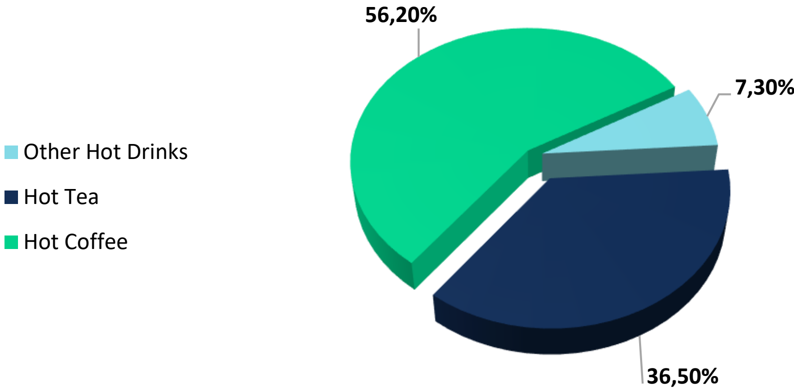
Figure 4.3 – Hot Drinks Market Value 2016A-2026F (Data in €/bn)



Source*: Own elaborations on MarketLine, Industry Profile Global Hot Drinks (2022)*

In 2021, Hot tea accounted for the 36,5% of the hot drinks market, reaching € 56,2 bn in revenues (*MarketLine, 2022*). In particular, in terms of products, the market is segmented as summarized in the following graph:

Figure 4.4 – Hot Drinks Market Segmentation as of 31.12.2021



Source*: Own elaborations on MarketLine, Industry Profile Global Hot Drinks (2022)*

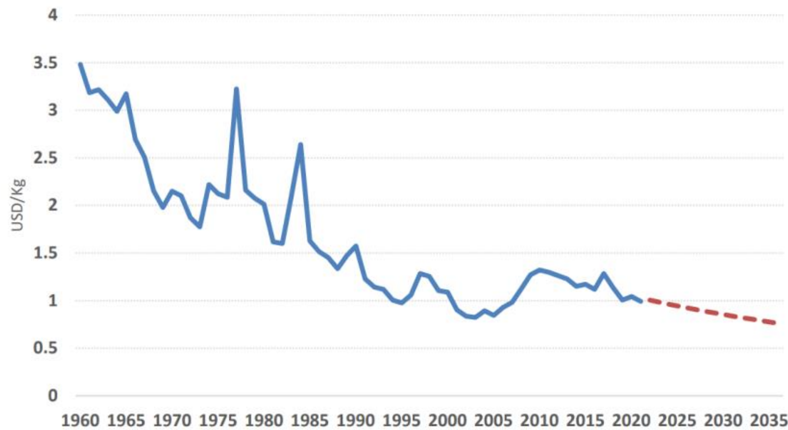
Focusing on the tea sector, Global per capita tea consumption has seen a rise of 2,5% between 2010 and 2020, with significant growth observed in those countries responsible for the production of tea. The surge in demand has been predominantly driven by developing and emerging economies, with regions such as East Asia, Africa, Latin America, the Caribbean, and the Near East at the forefront of this increase. Conversely, in the well-established markets of Europe and other advanced economies, the quantities of tea consumed have been on a downward trend. (*FAO, 2022*).

As for the latest trends, the conflict between Russia and Ukraine is expected to have a negative impact on tea prices and trade. This is due to the significant role of the Russian Federation in the tea market, being the top importer of tea from India, the third-largest importer from Sri Lanka, and the fifth largest from Kenya. Moreover, Russia plays a crucial role in supplying fertilizers, so a potential scarcity or increased cost could result in lower tea yields and compromised quality. In 2021, global tea production saw a rise, reaching an approximate 6.5 million tons, up from 6,3 mln tons in 2020. This increase can be attributed to the recovery of black tea production in key producing countries like India and Sri Lanka, following a shortfall in 2020. China continues to dominate as the largest tea producer, contributing 47 percent of the global production with 3.1 million tons in 2021, up from 2,9 mln tons in 2020. India, the second-largest producer, saw a rebound in output in 2021, producing 1,33 mln tons compared to 1,26 mln tons in 2020. After the dip in 2020 due to COVID-19, tea exports experienced a modest recovery in 2021, reaching 1,8 mln tons. This was due to an increase in exports from Kenya and China and resumed shipments from Sri Lanka, the world's second-largest black tea exporter. (*ibidem*)

Global tea consumption has been growing annually by 3,5 % over the past decade, reaching 6,4 mln in 2021. This growth is largely driven by robust demand in major producing countries like China and India, as well as other Asian and emerging economies.

In terms of prices, the price of tea (in real terms) has been declining by 2% per year since 1960, and 2,4% annually since 2011. The main underlying factors underpinning such decline are expansions of the largest players, productivity, and both internal and external economies of scale, according to El Mamoun Amrouk, Senior Economist, Markets and Trade Division at FAO. In the figure below it is shown the downward trend of the tea price, expressed in USD/kg, between 1960 and 2022.

Figure 4.5 – Tea historical price and estimate (1960 – 2035)



Source*: 24th Session of the Intergovernmental Group on Tea, FAO (February 23rd, 2022)*

Although the movements in tea prices have been found to be mainly caused by specific shocks to production and consumption of the tea market, there are some external factors that may drive up the price of the commodity, which is currently expected to become cheaper as time passes, getting close to $ 0,75/Kg by 2035. These external factors are: (i) inflation, since producers may experience a price – cost squeeze, (ii) higher interest rates, which will make investments more expensive, and (iii) changes in the perspectives of consumers and governments regarding the value chains of commodities. (*El Mamoun, 2022*)

Having analyzed the key trends and figures of the industry, it is useful, to better understand the reference market, to conduct a PESTLE analysis (*Aguilar, 1967)*, that is a strategic framework that can be used identify and evaluate the macro-environmental factors that can impact a market or a Firm's operations. Through this analysis it is possible to understand the broader market conditions, potential opportunities, and risks. In particular, he acronym PESTLE stands for: Political, Economic, Sociocultural, Technological, Legal, and Environmental. The results are summed up in the table below.

Table 4.8 – PESTLE Analysis

Area	Key Factors
Political	Trade Policies Labor Laws Political Stability
Economic	Economic Growth Inflation rates Interest rates Exchange rates
Sociocultural	Health Consciousness Ethical Sourcing Demographics Cultural Preferences
Technological	Innovation in production E - commerce Sustainable technologies
Legal	Food Safety Regulations
Environmental	Climate Change Water Usage Waste Management

***Source**: Own Elaborations*

- **Political** factors that may impact on the tea industry are:
    - Trade Policies: The tea industry is significantly influenced by trade regulations and agreements, as tea is produced and consumed globally. Changes in trade policies, tariffs, or quotas can impact costs and pricing.
    - Labor Laws: Tea production often involves manual labor, making labor laws and regulations important. Changes in these laws, such as minimum wage legislation or worker safety regulations, can affect the industry.
    - Political Stability: Political unrest in tea-producing countries can disrupt supply chains, impacting the availability and cost of tea.
- **Economic** factors that may impact on the tea industry are:

- Economic Growth: The economic environment in key consumer markets influences demand for tea. Higher disposable income often correlates with increased demand for premium tea products.
- Inflation rates: High inflation can lead to increased production and operational costs.
- Interest rates: These can affect the cost of capital for companies in the tea industry and influence investment decisions.
- Exchange rates: As tea is often exported and imported, fluctuations in exchange rates can affect pricing and profitability.

- **Sociocultural** factors that may impact on the tea industry are:
  - Health Consciousness: The growing trend of health consciousness can drive demand for tea due to its health benefits. (*Evans, 2020*)
  - Ethical Sourcing: An increased focus on ethically sourced products can influence consumer preference towards companies that ensure fair trade and responsible sourcing.
  - Demographic: Age, lifestyle, and income levels can influence tea consumption patterns. As has been highlighted, older people consume more black tea than the younger consumers, which, in turn, prefer to drink other beverages.
  - Cultural preferences: Different cultures have varied tea-drinking habits and preferences, affecting demand patterns.
- **Technological** factors that may impact on the tea industry are:
  - Innovation in production: Technological advancements can improve efficiencies in tea farming, processing, and packaging, affecting product quality and cost.
  - E – commerce: The growth of online shopping impacts how consumers purchase tea, necessitating effective digital marketing and distribution strategies for tea companies.
  - Sustainable technologies: New technologies that promote sustainability in farming or packaging can impact the tea industry.
- **Legal** factors that may impact on the tea industry are:
  - Food Safety Regulations: Compliance with food safety standards and regulations is crucial in the tea industry. Changes in these regulations can affect the production process and costs. For example, tea producers should comply with the *Codex Alimentarius* (issued by FAO and the WHO), or, in Europe, with the standards set by the EFSA (European Food Safety Authority)
- **Environmental** factors that may impact on the tea industry are:
  - Climate change: The tea industry is heavily dependent on specific climate conditions. Changes in weather patterns, temperature, and rainfall due to climate change can influence tea production.

- Water usage: Tea farming is water-intensive, so water scarcity or policies related to water usage can impact tea production.
- Waste Management: Environmental regulations regarding waste disposal can affect the cost and methods of waste management in tea production.

4.2 Deal structure and timeline

In this section it is described the Deal process that led to the acquisition of Ekaterra by CVC Capital Partners, as well as the ESG issues that arose during such a process, that led to the withdrawal from the Transaction of two of the three final bidders.

4.2.1 Deal process

The talks about the sale of Unilever's tea business started in November 2019, but Unilever was quick to respond that no sale was in the Company's plan. A couple of months later, following a strategic business review, which, as mentioned, was pursued due to the slow growth of the black tea business, it was confirmed that Unilever's tea division was "*a promising business that could best achieve its potential as a separate entity*"[19], and thus the division was on sale.

In February 2021, right after the strategic review of the tea business was confirmed, it was rumored that the business would've been separated through an IPO of the newco, since Unilever's CEO, in an interview with Bloomberg stated: "*You could easily see the Unilever Tea Co becoming a standalone business on a listed stock exchange with its own IPO, that is a highly likely outcome [...]"*. In the context of the same interview, the CEO also added that the Seller was open to talks with Private Equity firms (*Cavale, 2021*), thus carrying on the so – called Dual – Track process: that is a strategy that involves preparing for an Initial Public Offering (IPO) while, at the same time, also exploring a possible trade sale, in order to maintain flexibility and to be able to choose the path that maximizes the outcome of the exit strategy for the Seller. It is important to highlight that pursuing such a strategy can be a complex, expensive and time-consuming process, since it involves preparing for two very significant and different transactions at the same time. Nonetheless, in some cases, the benefits of having multiple exit options and potentially increasing competition for the company (and thus the final price) can outweigh the costs. While preparing the IPO, the talks with Private Equity firms began and, as of June 23rd, 2021, according to *Nair et Al.* (*2021*), some of the Globe's most successful buyout Firms were among the possible bidders for Unilever's tea division: in particular, Carlyle, Advent International, Bain Capital, KKR & Co., Clayton Dubilier & Rice, Jacobs Holding AG, and Blackstone Group Inc. were deemed to be among those considering making

[19] Ekaterra 2021 Annual Report

offers for the tea business, while Cinven was reported in talks about the possibility of a collaborative proposal for the tea business, in partnership with the Abu Dhabi Investment Authority. At this stage, the Tea Business was valued at € 5,4 bn. In July 2021, it was also reported that Advent and GIC Special Investments Pte Ltd (Singapore's wealth fund) could be making a joint bid for the tea business.

Although the competition seemed fierce (Unilever could've benefitted from this, since competition among potential buyers drives the sale price up), the Seller was left, in the end, with just one final offer on the table: CVC Capital Partner's € 4.5 bn offer. How has that been possible? The next section answers this question by analyzing the ESG – related issues that may have emerged during the ESG Due Diligence of some of the aforementioned potential buyers.

4.2.2 ESG – related issues

The Deal rose serious ESG concerns about alleged human rights violations on tea estates held by Unilever. I was able to identify three main issues that may have been considered by some of the bidders during the Due Diligence they performed: (i) potential backlash from the workers (and their families) that were involved in a violence outbreak in Kericho plantations in 2007, and concerns about the new elections, (ii) concerns about the living conditions and wages of plantation workers, and (iii) sex – for – work scandals that were reported through the years by different sources.

During the period following the disputed election in Kenya in 2007, a significant human rights violation took place involving Unilever and its workers, and the tragic events occurred in Kericho, where a Unilever subsidiary (i.e., Unilever Tea Kenya Limited) operated an 8.900-hectare tea plantation, hosting over 10% of the company's global workforce at the time, primarily belonging to the Kisii tribe. After the presidential election, violence erupted across the country, leading to more than 1.300 deaths nationwide, and, in Kericho, attackers invaded the plantation owned by Unilever, assaulting hundreds of workers and their families, leading to seven deaths, numerous injuries and 56 reported rapes. This event was described as "*the most serious known case of human rights abuse suffered by the largest concentration of Unilever workers anywhere in the world*" (*The Guardian, 2020*)

In August 2020, a group of 218 tea plantation workers from Kericho filed a complaint with the United Nations Working Group on Business and Human Rights and the UN Special Rapporteur on Extreme Poverty and Human Rights, arguing that Unilever breached its obligation to remediate any human rights abuses to which it had contributed, a principle that Unilever had previously endorsed. Unilever, however, "*strongly rejected any allegation*" that it violated the principles in the case of the tea workers, but the victims' complaint alleges

otherwise: the workers, in fact, stated that Unilever violated international human rights standards by inadequately assisting its employees during and after these attacks. (*Ibidem*)

In particular, the complaint is focused on three core allegations[20] against Unilever:

- Unilever exposed the victims to a considerable risk of attack on their plantation while refusing to give proper reparation or help. Unilever has failed to make necessary efforts to address and mitigate the consequences.
- Following the violent events, Unilever neglected to give adequate support to the victims and instead unilaterally stopped paying them for six months, aggravating their position.
- When confronted with a particular request for remedies from the 218 victims of racial violence in 2016 in the form of a legal lawsuit for damages against Unilever in England, the firm denied any remediation and attempted to obstruct any possibility of access to remedy by hiding behind its corporate structure. Unilever argued that it could not be held legally accountable for any faults of its Kenyan business despite knowing that these claims could not be filed in Kenya in order to prevent the allegations from advancing in England.

Thus, the workers claimed that Unilever did not provide adequate support in the aftermath of the incident: Unilever temporarily closed the plantation and sent workers at home, and some victims report that they were left unpaid for six months, further aggravating their condition, while those who returned to the plantation got financial compensation equal to one month's wage. The workers initially sought legal redress in the UK, but the case was denied jurisdiction by the Supreme Court in 2018, which ruled that Unilever's Kenyan subsidiary was responsible for risk management of any crises and as such, any case should be heard in Kenya. This case is considered one of the first instances where an African community has brought a complaint to the UN working group on business and human rights, signifying a substantial challenge to corporate impunity in the region.

Nonetheless, Unilever argued that it "*can't be held responsible for what happened"* following the Court's decision. Critics argue that Unilever used its corporate structure to avoid liability for the human rights abuses: in fact, a lawyer involved in the case stated that Unilever "*relentlessly hid behind its corporate structure*" to prevent the case from proceeding in the UK. This raises further questions about corporate responsibility and accountability for human rights abuses occurring within their subsidiaries. (*The Guardian,* 2020).

Due to the unique nature of the tea industry, the provision of housing and other facilities for the plantation workers is common for employers, such as Unilever. This is due to the fact that tea plantations are often located in remote,

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[20] Allegation against Unilever plc to the United Nations working group on human rights and transnational corporations and the UN Special Rapporteur on extreme poverty and human rights submitted by SOMO, REDRESS, KITUO CHA SHARIA, CORE Coalition, The African Coalition for Corporate Accountability (acca) and LEIGH DAY on behalf of 218 current and former Unilever employees. 28 July 2020

rural areas where there is a lack of infrastructure, including housing, and workers are typically required to live on or near the plantation due to the nature of the work, which involves early morning starts and can extend into the evening during harvest periods. By providing housing and other facilities, tea companies can attract and retain workers, ensuring a consistent labor supply. This is critical in an industry where the quality of the product is heavily dependent on the skills and knowledge of the workers. Despite the relevance of the provided services, the estates often suffer from overcrowding, especially during peak season, and it is not uncommon for them to be in a state of disrepair. Furthermore, the process of assigning these homes is plagued by accusations of corruption, favoritism based on tribal affiliations, and instances of sexual harassment (*Van der Wal, 2011*).

Since 2019, by visiting the Kericho tea estates, some reporters documented the living conditions of those working as tea pickers in the estates owned by Unilever, coming to the conclusion that Unilever's acclaimed "responsible sourcing policy" actually lacks substance. Assertions regarding "*fair wages*," "*fair procedures and remedies*," and "*equal treatment with respect and dignity*" that are presented on the Company's website seem to be misleading. The WSWS reporters asserted that Unilever, along with other prominent tea corporations, appears to be capitalizing on the critical unemployment situation and the deficiency of educational opportunities in Kenya, and this enables them to secure inexpensive labor and enforce challenging living and working conditions. By visiting some of the houses, they found bundles of firewood laying next to the workers' beds, and that "*there was hardly space to even turn around*". Moreover, FTM reporters, in another visit, found out that the houses were filled with holes, both in the walls and in the tin roofs overlooking the houses, leading to huge water leaks when it rains, and they also discovered that workers in Kericho lacked a water system that could provide them with a supply of water, and thus, in the absence of rainfall, the nearby stream ceases to flow, depriving the families of drinking water as well as water for cooking and washing. (*Van Heugten, 2023* and *WSWS, 2019*)

These exact circumstances were described by Tomoya Obokata, Special Rapporteur on contemporary forms of slavery at the UN since Merch 2020, in a report dated July 2022 covering Sri Lanka tea plantations. The UN Representative wrote *"These substandard living conditions, combined with the harsh working conditions, represent clear indicators of forced labour and may also amount to serfdom in some instances"* [21].

Lastly, women in the tea estates face discrimination in the shape of sexual harassment and compelled pregnancy examinations. Female pluckers who decline the unwelcome advances of their supervisors, who are always male, are occasionally burdened with excessive workload or assigned isolated and hazardous plucking areas. Prior to employment, all workers undergo medical tests, and women who are discovered to be pregnant during this assessment are not hired. Ethnicity predominantly influences promotions and employment opportunities within

[21] Report of the Special Rapporteur on contemporary forms of slavery, including its causes and consequences, Tomoya Obokata on his visit to Sri Lanka (A/HRC/51/26/Add.1)

the companies. Moreover, some supervisors ask for sex in exchange for the possibility to work on the plantations (*Van der Wal, 2011*). Although these claims appear to be old, they have been confirmed in a 2023 *reportage* published by BBC, which will be described later in Chapter 4.4, since it is not relevant for the analysis of pre – acquisition ESG issues.

In conclusion, the sale of Unilever's tea business raised significant ESG-related issues, primarily centered on alleged human rights abuses.

4.2.3 Closing the Deal

The process described in Chapter 4.2.1 ended in November 2021, leaving three final bidders for Ekaterra: CVC Capital Partners, Advent International, and Carlyle.

Right before the final term for submitting the final offer, two out of the three final bidders pulled out of the transaction, due to the substantial ESG risks. In particular, Advent International decided to exclude the tea estates from its final offer, resulting in a € 750 million lower than CVC's one, while Carlyle completely withdrew from the bidding process just a few days prior to the deadline.

Advent International became increasingly apprehensive about taking on the responsibility of ensuring the health, welfare, and security of the vast number of plantation workers. This concern stemmed from the fact that not only did supervisors have control over the workers' employment, but they also held power over crucial aspects of their lives such as housing and access to medical care. Furthermore, given that these plantations were often situated in remote areas, workers were often brought in from different regions, adding to the complexities Advent International had to consider. The primary source of worry for Advent International was the potential eruption of violence at their Kericho plantation in Kenya following the upcoming general elections slated for August of the following year. The painful memory of the violent assault that occurred at the plantation in the aftermath of disputed elections in 2007 loomed large. In a bid to conduct a comprehensive evaluation, Advent International commissioned a report that delved into the prevailing conditions on the plantations. Unfortunately, the findings of the report were far from encouraging, according to individuals familiar with the matter. Consequently, the buyout group made a strategic decision to exclude the plantations from their final offer and instead focused solely on acquiring the associated brands. This decision reflected their concerns about the challenging circumstances faced by the workers on the plantations. Moreover, the reports of sexual harassment directed towards female workers by certain managers further contributed to this decision, together with the presence of pending compensation claims from workers, which could have posed substantial challenges for any potential buyer of the plantation. Carlyle as well dropped out of the transaction due to the same concerns, as confirmed by persons

familiar with the Transactions, while Blackstone avoided bidding in the early stages of the Deal, describing the Ekaterra acquisition "*a massive ESG issue*" (*Schipani et Al. 2021*).

So, given the circumstances, potential investors opted to avoid assuming liability for the individuals dependent on the plantations, as it was deemed both expensive and intricate. The potential risks associated with any ESG incidents occurring on the plantations posed a significant threat to the investors' reputation.

It is worth to mention that, although many of the Bidders left the transaction due to the results of their ESG Due Diligence, prior to making any investment, CVC promised to conduct due diligence on the human rights, environmental, and corporate governance issues. If they encountered manageable or immediately remediable risks, CVC committed to addressing them within the first one hundred days after investing. However, if they concluded that the ESG risks were too substantial and could not be appropriately mitigated within a reasonable timeframe, CVC vowed not to proceed with the investment. (*ibidem*)

Thus, being left as the only Bidder, CVC Capital Partners secured the Deal, with a cash consideration of € 4,5 bn on November 18th, 2021. In particular, the corporate Carve – Out was pursued by Puccini Bidco B.V, a special purpose vehicle (SPV) established for the purposes of the Merger, ultimately controlled by CVC through CVC Capital Partners Fund VIII. The Deal took place on a on a cash – free, debt – free basis, that means that the transaction was structured such that the buyer took the business without any cash or debt, thereby ensuring the acquisition of the operating business alone, free of financial obligations or additional financial assets.

The acquisition of Ekaterra by CVC Capital Partners exemplifies the intricate challenges associated with navigating ESG considerations within the contemporary global business landscape.

4.3. Ekaterra Company Valuation: Was it sold at a discount?

Since CVC Capital Partners was left without competition in the final stages of the transaction, as described in the previous Chapter, it is reasonable to assume that the bid that was accepted by Unilever for the sale of Ekaterra hasn't been the best possible outcome for the Seller, in terms of purchase price. In order to understand whether Ekaterra was sold at a fair price or at a discount, in this Chapter it is provided a valuation of Unilever's tea business (Ekaterra) using the data that was available at the Deal announcement date.

4.3.1 Choice of the Valuation Methods

Ekaterra was established as a separate company in August 2021, and it became an independent group in October of the same year. Thus, as of May 2023, there is little – to – none historical data on the Company itself, also given

that Unilever doesn't publish separate Financial Statements for its Business Units, but only shares consolidated annual statements.

So, with respect to the financial valuation of Ekaterra, there has been a significant challenge concerning the suitability and efficacy of the Discounted Cash Flow (DCF) analysis as a valuation method due to the lack of detailed historical data on the company which. In fact, although the DCF method, is widely regarded as one of the most comprehensive and rigorous ways of valuing a company, in a perfect scenario, the DCF method would necessitate a rich history of revenue, expense, capital expenditure, and working capital data in order to forecast future financial performance and cash flows accurately. In Ekaterra's case, this level of historical financial data is lacking, rendering it highly challenging, if not impossible, to develop accurate future cash flow projections. Consequently, any DCF valuation undertaken with such sparse data would invariably be suspect and unreliable, thereby undermining its relevance and usability for decision-making purposes. Given these fundamental limitations, the alternative valuation method that better suits Ekaterra's circumstances is the Market Multiples approach, which involves comparing the company to similar companies or transactions within its industry. This method does not require detailed historical data or future cash flow projections. Instead, it requires identifying comparable companies or transactions, deriving relevant multiples (such as Price/Earnings, Price/Sales, or EV/EBITDA), and applying these multiples to Ekaterra's financial metrics. The rationale behind this method is grounded in the law of one price, which assumes that two identical assets should sell for the same price, therefore it allows to sidestep the challenge presented by a lack of detailed historical financial data. Despite potential criticisms regarding the oversimplification of complex realities or the assumption that markets are always efficiently pricing comparable firms, research has suggested that the Market Multiples method can provide valuations that are as accurate, if not more so, than DCF valuations (*Liu, Nissim & Thomas, 2002*). In addition, it is worth noting that the choice of a valuation method should be determined by the context and data availability rather than any intrinsic superiority of one method over another.

Thus, in the present case, the valuation was carried out by applying the Stock Market Multiple Method given all of the reasons highlighted above. Moreover, it is standard practice, where possible, to subject the result of the chosen method to verification through a different valuation method. A comparison with the result of the alternative, so-called control method confirms the results obtained. Accordingly, in the present case, the control method was applied, and the choice fell on the Comparable Transactions Multiples Method.

4.3.2 Valuation through the Stock Market Multiples Method

The Stock Market Multiples Method is a relative valuation approach that compares the subject company with similar companies currently traded on the stock market. This technique bases its value estimates on key financial performance metrics, presenting a dynamic view of a company's value as it directly relates to current market

perceptions. Multiples employed in multiples analysis can be categorized as either enterprise value multiples or equity multiples. The asset side multiple EV/EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) was deemed appropriate for determining the economic value of Ekaterra because it is the most widely used multiple in valuation practice and is unaffected by accounting policies, being calculated before non-cash costs (depreciation, amortization, provision, and impairment). Thus, EV/EBITDA is a reasonably neutral multiple since it allows Companies operating in the same industry to be easily compared and is also favored for its broad applicability and effectiveness in reflecting a company's operational profitability.

The formula using the EV/EBITDA multiple is as follows:

$$\frac{EV}{EBITDA}\ Multiple = \frac{Market\ Enterprise\ Value\ of\ Comparable\ Comapny}{\text{EBITDA of Comparable Company}}$$

Where the Market Value of Comparable Companies is as follows:

$$Market\ Enterprise\ Value = Market\ Capitalization + Debt - Cash\ and\ Cash\ Equivalents$$

The first step to perform a valuation using such a method is to identify a panel of comparable listed companies that can be deemed similar to the Target company in terms of Business, Geography, Size, and general structure. To valuate Ekaterra, the following panel of seven comparable companies was identified:

- **Tata Consumer Products Ltd:** Tata Consumer Products Ltd., a subsidiary of the Tata Group, is a leading player in the fast-moving consumer goods (FMCG) industry. The company has a robust presence in the beverages and food sector, with tea being one of its principal products. Tata Tea, one of their flagship brands, is a market leader in India's branded tea segment. Tetley, another brand under its umbrella, is a globally recognized tea brand with a strong presence in Canada, the UK, and the USA. Tata Consumer Products' tea portfolio includes black, green, and herbal teas, catering to a wide array of consumer tastes. With an expansive distribution network spanning over 40 countries, the company has a significant influence on the global tea market.
- **McLeod Russel India Ltd:** Based in Kolkata, India, McLeod Russel is one of the world's most prominent tea producers. Its operations span across the fertile tea-growing regions of Assam and Darjeeling in India, as well as in Vietnam, making it a key player in these high-quality tea markets. The company manages over 30 tea estates, producing a significant volume of tea annually, with a sizable share in the global tea

market. McLeod Russel's primary focus is on the cultivation, production, and marketing of bulk tea, catering to both domestic and international markets.

- **Goodricke Group Ltd:** Goodricke Group is a historic tea company, part of the UK-based Camellia Plc. The company manages 17 tea estates in India, mainly in Assam and West Bengal, producing a diverse range of teas such as black, green, and specialty teas. With decades of tea-producing expertise, Goodricke is recognized for its unique blends and distinct flavors. The company also has a retail presence with a line of packaged teas, and it owns and operates several tea lounges across India where customers can experience Goodricke's tea products firsthand.
- **ITO EN Ltd:** ITO EN is Japan's leading purveyor of green tea, offering a wide assortment of tea-based products ranging from loose tea leaves to ready-to-drink beverages. It is the largest distributor of green tea in Japan and enjoys a strong international presence. The company emphasizes natural, healthy, and high-quality products, which align with global consumer trends towards health and wellness. Notably, ITO EN is known for its innovative methods in cultivating tea and its commitment to sustainability, making it a front-runner in environmentally friendly tea production practices.
- **Camellia Plc:** Camellia Plc, a UK-based multinational, operates in various sectors, with agriculture being one of its core businesses. The company owns over 30 tea estates across India, Bangladesh, Kenya, and Malawi, making it one of the largest tea producers globally. Camellia's tea production includes black, green, and specialty teas, meeting a wide range of consumer preferences. The company is recognized for its sustainable farming practices, ethical business conduct, and significant contributions to local communities where its tea estates are located.
- **PepsiCo Inc:** PepsiCo is a global leader in the food and beverage industry with a diverse product portfolio. Although best known for its carbonated soft drinks, the company has strategically diversified into healthier beverage options, including tea, through a partnership with Unilever to form the Pepsi Lipton Tea partnership. This joint venture has resulted in an impressive assortment of ready-to-drink teas, under the brand Lipton, that are distributed globally. PepsiCo's vast distribution network and marketing expertise enable the Lipton RTD partnership to maintain a strong presence in the global tea market.
- **The Coca Cola Company:** Known worldwide for its namesake cola drink, The Coca Cola Company has diversified its product portfolio to include a variety of other beverages, including tea. The company owns Honest Tea, a top-selling organic bottled tea brand in the U.S., and Fuze Tea, an iced tea brand available in various flavors and sold in over 40 countries. The Coca Cola Company's extensive global distribution network and powerful brand recognition make its tea products widely available and popular with consumers seeking alternative beverage options.

In this research, the 2020 multiples provided by the Refinitiv database (previously Thomson Reuters) were considered, in accordance with the time period in which the actual Transaction occurred and are summed up in the table below.

Table 4.9 – Comparable Companies' EV/EBITDA multiples (2020 – 2022)

EV/EBITDA				
Company	**Geography**	**2020**	**2021**	**2022**
Tata Consumer Products Ltd.	India	38,3x	42,1x	35,3x
McLeod Russel India Ltd.	India	44,9x	12,3x	32,5x
Goodricke Group Ltd.	India	9,3x	11,6x	17,6x
ITO EN Ltd.	Japan	20,9x	23,8x	20,2x
Camellia Plc	UK	23,2x	12,9x	7,2x
PepsiCo Inc.	USA	16,9x	18,9x	18,4x
The Coca Cola Company	USA	23,7x	22,9x	22,7x

***Source**: Own Elaboration on Thompson Reuters Refinitiv Data*

Furthermore, because the comparable firms under examination are listed on stock exchanges, their multiples reflect the higher liquidity on which they may rely, having far better access to the capital market than an unlisted company like Ekaterra. Valuation techniques may involve the application of a discount on the multiples that considers the lower liquidity that exists due to the fact that these shares are not traded on regulated markets. Given the Structure of the Company, its reliance on fixed assets such as the plantations, and the aforementioned ESG issues, it has been applied a 30% liquidity discount to the median multiple, such a value is coherent with several studies focused on the impact that low liquidity has on the value of a Company: in particular, it has been demonstrated an average discount of 31,6% with a minimum of about 14% and a maximum around 42%. (*National Association of Certified Valuation Analysts. 1988*).

To obtain Ekaterra's Enterprise Value, the 2020 median multiple has been prudentially chosen, since it is the lowest one among the computed ones (i.e., median, average, and Adjusted average excluding the extremes), and subsequently such a multiple has been multiplied by the 2020 EBITDA retrieved from an equity report covering Unilever and the sale of its tea Business (*Deutsche, 2021*). Ekaterra's financials, retrieved from the aforementioned source, are summarized in the table below:

Table 4.10 – Ekaterra's Key financials as of 31.12.2020

€/000	**2020**
Sales	1.900.000
EBITDA	310.000
EBITDA Margin	*16,32%*
Operating Profit	230.000

***Source**: Own Elaboration on Deutsche Bank Data*

In the Following table, the valuation process is summed up:

Table 4.11 – Ekaterra's Valuation as of 31.12.2020 using the stock Market Multiples Method

EV/EBITDA		
Company	**Geography**	**2020**
Tata Consumer Products Ltd.	India	38,3x
McLeod Russel India Ltd.	India	44,9x
Goodricke Group Ltd.	India	9,3x
ITO EN Ltd.	Japan	20,9x
Camellia Plc	UK	23,2x
PepsiCo Inc.	USA	16,9x
The Coca Cola Company	USA	23,7x
Average		*25,3x*
Adjusted Average		*24,6x*
Median		***23,2x***

€/000	31.12.2020
EBITDA	**310.000**
Median Comparable EBITDA Multiple	23,24x
Liquidity Discount	30%
Discounted EBITDA Multiple	**16,27x**
EV	**5.043.437**
Net Financial Position	-
Equity Value	**5.043.437**

Source: *Own Elaboration*

Since, as stated in the previous Chapter, the transaction has been conducted on a Cash – free, Debt – free basis, the Net Financial Position was considered equal to zero, thus, in this valuation, the Equity Value is equal to the Enterprise value, due to the fact that the Buyer, CVC Capital Partners, didn't acquire any Liability nor Liquidity of Ekaterra from Unilever.

Moreover, it was deemed necessary to conduct a sensitivity analysis on the obtained Equity Value, considering a +/- 0,5x change in the EBITDA Multiple, ranging between 15,77x and 16,77x.

Table 4.12 – Sensitivity Analysis on the EV/EBITDA Multiple

		Enterprise Value (€/000)
EV/EBITDA	16,77x	5.198.437
	16,52x	5.120.937
	16,27x	**5.043.437**
	16,02x	4.965.937
	15,77x	4.888.437

Source: *Own Elaboration*

Thus, through the Stock Market Multiples Method it has been obtained an Equity Value of € 5.043.437.000, and, through the performed sensitivity analysis, it has been individuated a valuation range between € 4,81 bn and € 5,27 bn.

4.3.3 Control method: the Comparable Transactions Multiples Method

The Comparable Transactions Multiples Method is often used in M&A transactions, and it is a valuation technique that gauges a company's value by assessing similar companies that have recently been sold or acquired within the same industry. The underlying assumption of this approach is that businesses in similar sectors, of comparable size, and with analogous financial and operational characteristics should have comparable valuations. In practical terms, this method necessitates the identification of recent transactions that involve companies comparable to the Target company. In order for this control method to be comparable with the main valuation method, it was deemed appropriate to use the EV/EBITDA multiple.

The process of retrieving multiples from comparable transactions for the valuation of Ekaterra was conducted methodically. Relevant data was sourced from the Mergermarket database, a widely recognized platform for M&A information. The focus was on transactions conducted between 2018 and 2021 within the food and beverage sector. Specifically, companies that were involved in the production and sale of soft drinks, with a particular emphasis on tea, were considered, and it is important to note that not all selected companies exclusively produced tea, but they all had a business operation within the broader soft drinks category. This selection criteria ensured a level of comparability in terms of industry dynamics, while also acknowledging the inherent diversity within the food and beverage sector. The gathered data served to establish a set of relevant multiples for the targeted tea company valuation.

The comparable transactions panel used for the valuation can be retrieved in Appendix 2.

To obtain Ekaterra's Enterprise Value, Adjusted Average Multiple (i.e., the average excluding the extremes) has been multiplied by the 2020 EBITDA, and the results are in the table below:

Table 4.13 – Comparable Transactions valuation results

€/000	2020
EBITDA	**310.000**
Median Comparable Transactions EBITDA Multiple	16,1x
EV	**5.004.801**
NFP	-
Equity Value	**5.004.801**

***Source**: Own Elaboration*

Again, the NFP was deemed equal to zero, due to the nature of the Deal, and a sensitivity analysis was performed, considering a +/- 0,50x change in the EBITDA Multiple, ranging between 15,6x and 16,6x.

Table 4.14 – Sensitivity Analysis

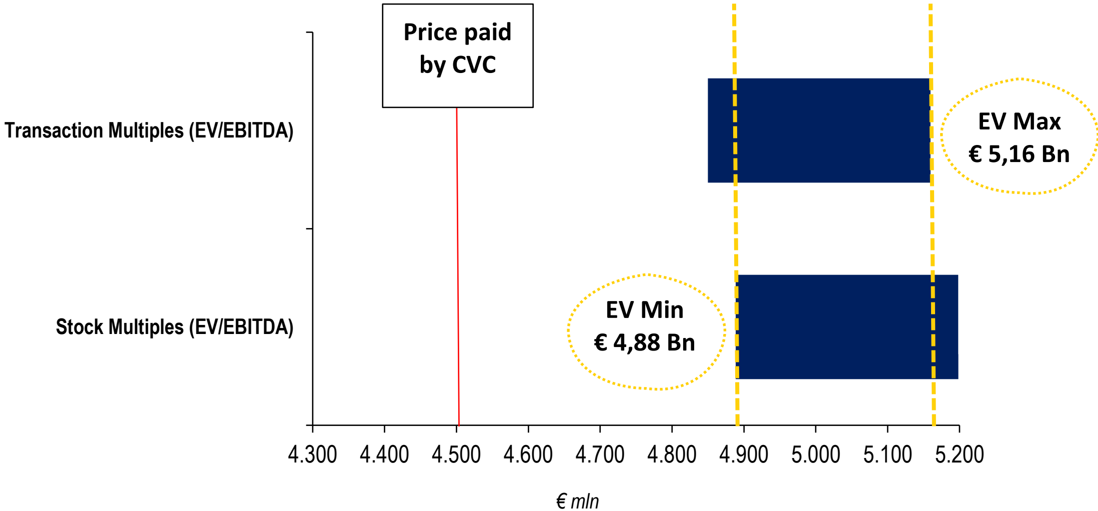
		Enterprise Value (€/000)
EV/EBITDA	16,6x	5.159.801
	16,4x	5.082.301
	16,1x	**5.004.801**
	15,9x	4.927.301
	15,6x	4.849.801

Source: *Own Elaboration*

Thus, through the Comparable Transactions Multiples Method it has been obtained an Equity Value of € 5.004.801.000, and, through the performed sensitivity analysis, it has been individuated a valuation range between € 4,85 bn and € 5,16 bn.

4.3.4 Results and limitations

Figure 4.6 – Football Field Graph



Source: *Own Elaboration*

The valuation results, presented visually via a *football field graph*, delineate the range of potential values of the company. Specifically, the final range related to Ekaterra's EV is the following:

- The “lower bound” is equal to the minimum value resulting from the application of the Stock Multiples Method, i.e., a value of € 4,888 bn.
- The “upper bound” is equal to the maximum value resulting from the application of Transaction multiples, i.e., a value of € 5,160 bn.

This range arises from the lower and upper bounds established in the sensitivity analysis, showcasing the inherent uncertainty encapsulated within the valuation process. This approach is comprehensive, yet it presents the typical constraints linked to the application of the Multiples Method for Company valuation. Such a method relies on the comparability of companies within the same sector, presuming that they share similar financial metrics, business models, growth trajectories, and risk profiles. However, the idiosyncrasies of individual firms can yield divergences, potentially impacting the accuracy of the multiples-based valuation. Thus, the presented valuation is an indicative approximation of the company's worth and should not be considered as an absolute figure. In particular, the differences in valuation can stem significantly from the computation of EBITDA, which serves as a proxy for the firm's operational profitability and cash generating ability, thereby influencing its perceived value. It is not uncommon for the seller and buyer to agree on certain adjustments to the reported EBITDA which account for non-recurring items or extraordinary expenses that are not representative of the company's ongoing operational performance, resulting in the so-called "Adjusted EBITDA." These modifications aim to represent a more accurate picture of the firm's sustainable profitability, providing a more reliable base for valuation. The adjusted EBITDA, agreed upon by both parties, could substantially deviate from the reported EBITDA and, consequently, result in a markedly different enterprise value. This variability underlines the potential divergence in valuation outcomes that can arise from access to differing financial information and the application of distinct valuation models. Hence, the potential acquirers of the company, which had access to more financial details, might have arrived at a valuation that diverges from the one presented herein. Therefore, while my valuation provides a meaningful ballpark estimate of the company's worth, it should be understood within the context of these inherent limitations.

The valuation analysis yields a valuation interval that is higher than the acquisition price paid by CVC Capital Partners. This discrepancy could potentially be traced back to several factors, such as the specific calculation of Adjusted EBITDA or the use of different valuation models, as previously discussed in this analysis. However, a crucial aspect to consider is the competitive dynamics of the transaction process, specifically, the presence or lack thereof of competition in the final stages of the transaction: academic research supports the notion that competition among potential buyers during a sale process can significantly influence the final purchase price. *Bulow and Klemperer* (*1996*) state that the price achieved by a seller in a competitive auction environment is often higher than in a negotiated sale, even if the seller has the option to negotiate with the highest bidder post-auction. They argue that the increase in competition drives up the bidding prices, thus benefiting the seller. The presence of multiple interested parties can lead to a bidding war, resulting in higher acquisition prices. Conversely, the lack

of competition can decrease the pressure on potential acquirers to offer a premium, leading to a lower transaction price (*Boone and Mulherin, 2007*).

In the case of Ekaterra, the fact that the final stage of the transaction was characterized by a lack of competition might have given CVC Capital Partners an advantage, allowing them to secure the acquisition at a lower price. Furthermore, the lower price paid by CVC could also be a reflection of the market's perception of Ekaterra's ESG issues. As indicated by the studies shown in Chapter 3, firms with high-quality ESG standards can command a valuation premium, and conversely, ESG issues might lead to a discount.

Thus, it is possible to conclude that ESG issues played a relevant role in the sale of Ekaterra, and it has been demonstrated that CVC Capital Partners could have benefitted from the lack of competition caused by the ESG issues that arose during the Due Diligence, being able to pay a discounted price to purchase the Firm.

4.4 Ekaterra's future

In this section they are presented several key happenings involving Ekaterra that took place after the transaction was completed.

In February 2023, The BBC documentary "The True Cost of Our Tea" aired, that is a joint investigation by BBC Africa Eye and Panorama, uncovering widespread sexual abuse in the tea industry. The documentary revealed that some of the world's largest tea companies, including Ekaterra, were implicated in these abuses. The investigation focuses on farms in Kenya, where women report being forced into sex by their managers while working on plantations. The documentary highlights the systemic issues within the tea sector, including labor exploitation, low wages, and poor working conditions. Unilever expressed profound shock and sadness upon learning of the allegations. During the BBC's covert filming, the company had already divested its operation in Kenya, while Ekaterra responded by suspending the two implicated managers and initiating a comprehensive and impartial investigation into the matter. The outbreak of this scandal represents the realization of the fears that led major bidders to pull out of the transaction, proving that including ESG considerations in the M&A process can avoid losses and reputational damage.

In January, Ekaterra CEO Nathalie Roos made an announcement regarding the company's rebranding as Lipton Teas and Infusions, set to take effect in 2023. The rebranding initiative aims, according to the CEO, to reinforce the Company's position while reaffirming its commitment to sustainability, environmental consciousness, and a consumer-centric approach.[22] The appointment of a woman CEO seems to be the right direction for the Company, due to what appears to be her commitment to pursuing real sustainability, instead of greenwashing and false

[22] https://www.linkedin.com/feed/update/urn:li:activity:7018541373452607488/

claims. For example, Ekaterra has now 46% of women managers in its tea estates, while the Company states that full gender equality in management will be reached by 2024.

It is important to note that CVC Capital Partners Fund VIII provided a sum of € 2,4 bn, and additionally, it secured a loan of € 2,55 bn, burdening Ekaterra with this substantial debt. As estimated by Moody's rating agency in late 2022, Ekaterra's debt stands at approximately nine times its annual income. Moody's assigned Ekaterra a B3 rating, placing it on the higher end of the risk spectrum, even for private equity investors. According to David Birchall, a senior lecturer at the London South Bank University and a private equity researcher, "*Incurring such high levels of debt for portfolio companies forces them to resort to extreme cost reduction measures*,", and he emphasized that the tea pickers could be facing a significant risk of CVC cutting back on efforts to protect human rights due to the substantial debt burden placed on Ekaterra. (*Van Heugten, 2023*).

The future of Ekaterra appears uncertain, primarily due to (i) its low credit rating and (ii) the lingering potential for ESG scandals. With its B3 rating assigned by Moody's, Ekaterra faces challenges in securing favorable financial terms and maintaining stakeholders' confidence. Despite the new management's apparent commitment to ESG principles, there remains a lingering concern about the company's ability to address potential ESG issues effectively. Given the heightened scrutiny surrounding ESG practices and the consequences of reputational damage, any missteps or failures in upholding sustainable and responsible practices could lead to significant setbacks for Ekaterra.

Nonetheless, given CVC Capital Partners' notable reputation in the field of Private Equity and its demonstrated commitment to sustainable investments, it is highly plausible that the fund will instigate significant measures to enhance Ekaterra's ESG compliance. This initiative would not only be aimed at mitigating the risk of further scandals but also at unlocking greater value upon exit. Even with the almost $400 million discount factored in, it would be uncharacteristic of a prominent firm like CVC to leave itself vulnerable to considerable losses arising from ESG-related controversies. Instead, it is much more likely that CVC recognized the potential value uplift achievable through rigorous improvements in ESG compliance, thereby turning a challenging situation into a strategic opportunity for value creation. This strategy aligns with the expectations of CVC's financiers, who are increasingly conscious of sustainable and ethical considerations in their investment portfolios.

5. Conclusion

In this Thesis, an analysis was carried out regarding the rising impact of Environmental, Social and Governance (ESG) criteria in Mergers and Acquisitions (M&A) transactions, both through the review of theoretical and empirical studies, and the analysis of a recent real – world example: the acquisition of Ekaterra NV by CVC Capital Partners, that was agreed on November 18th, 2021, for a cash consideration of € 4,5 bn, on a cash – free, debt – free basis. As stated in the Introduction to this work, the paper aimed at answering the following questions:

i. Why did ESG consideration gain a relevant spot in M&A Transactions?
ii. How do ESG considerations influence the M&A process and the Deal outcome?
iii. In the context of the acquisition of Ekaterra by CVC Capital Partners, what role did ESG considerations play? Was the company sold at a discount due to ESG - related issues?

With respect to the first question, it was found that the increased relevance of ESG considerations in M&A transactions was a direct consequence of the increased implementation of ESG in Companies' strategies, that is mainly due to pressures from Regulators and other stakeholders on the one hand, and to the financial benefits coming from the implementation of ESG – focused strategies on the other. Given the fact that CSR has been gaining ground in the international business landscape, investors, Regulators, and stakeholders in general have begun to demand more and more compliance with ESG standards from Companies, in order to protect the environment and society as a whole from the potential side – effects of their operations. From a regulatory point of view, in order to comply with the UN 2030 Agenda and the Paris Climate Agreement, the EU has enforced several sustainability directives such as the CSRD, SFDR, and the EU Taxonomy, which pose new obligations for transparency and ESG compliance for Firms in Europe, but also offer the chance for Companies to distinguish themselves through robust ESG practices. Additionally, pressure from activist movements has encouraged companies to further adhere to sustainability standards, resulting in strategies that promote the circular economy, renewable energy use, human rights, water management, and waste reduction. Another fundamental factor driving companies to adopt these standards is the positive correlation between the implementation of ESG strategies and financial performance from which shareholders benefit as well. This Thesis emphasized several notable advantages, including (i) enhanced risk management practices, (ii) affordable capital acquisition, (iii) long-term cost minimization, (iv) augmented revenue and increased profit margins, and (v) simplified process of attracting external investments. Such a positive correlation is also observable through correlation studies which compared the ESG performance with both accounting and market-related parameters, resulting in positive results for shareholders and, in turn, for society at large. Since ESG factors are increasingly critical for Businesses, and M&A is a fundamental strategy for pursuing company expansion and growth (in 2021 the M&A market reached a peak value of $ 5,9 trillion), ESG influence on such a strategy is inevitable. ESG considerations are now heavily shaping

the M&A process, from the selection of target companies to the successful completion of the transaction. This growing prominence underscores how these considerations are no longer optional extras, but rather integral components shaping successful M&A outcomes. The spotlight is thus shifting towards ethical, environmental, social, and governance, cementing their role in the dynamics of modern business transactions.

The second question led to an analysis of the M&A process, and the way in which ESG factors are considered and analyzed in the context of a Deal, particularly from a buy – side perspective. Among the main "tools" that can be used to pursue the ESG integration in the M&A process, it was analyzed the ESG Due Diligence, which in the last years has gained a place of relevance comparable to that of the "traditional" Due Diligence. This particular kind of Due Diligence aims at identifying and managing sustainability risks and opportunities concerning the Target company, and its outcome can have a significant impact on the outcome of an M&A Transaction. By following a four – steps process, potential Buyers are able to implement the so – called double materiality approach when considering their investments, in order to avoid bearing the risk of reputational damages caused by ESG – related issues. The ESG Due Diligence is not only focused on the impact that the Target company has on the environment and on society, but also on the detection of possible greenwashing practices put in place by the Target which could lead to significant losses if only discovered post – acquisition. In terms of Deals' outcomes, the central role that ESG considerations gained was confirmed by managers and investors who are willing to pay a premium (i.e., the ESG premium) in order to acquire companies that have a positive ESG record. The existence of this premium, which stands in contrast to the so-called brown discount, stems from several factors, that include the previously mentioned positive correlation between ESG performance and financial outcomes, the potential high costs arising from sustainability scandals, and the possible expenses incurred in aligning the acquired company with the buyer's sustainability framework. Additionally, an increasing number of companies are undertaking M&A transactions primarily to improve their ESG standings, since from a *make or buy* perspective, it can be more cost-effective to acquire a company at a premium than to adapt existing operations to meet sustainability standards, and in some Transactions, poor ESG performance from the Target may lead to the abandonment of the transaction by some potential buyers. Lastly, the review of Ambienta SGR's investment strategy, helped to further understand the process followed by ESG – focused Private Equity funds to integrate ESG in their investments, and the considerations which could determine a successful or an unsuccessful outcome for M&A Transactions.

The answer to the third question was found through a thorough analysis of the case, which consisted of reviewing the whole process and culminated with a financial valuation of the Target Company, Ekaterra, to determine its fair value at the time of the acquisition, using publicly available data at the time of writing.

In particular, when Unilever announced the disposal of its tea business (under the form of a Newco, Ekaterra) to focus on higher growth sectors, many Private Equity funds manifested interest in pursuing the acquisition, given Ekaterra's position of leader in the black tea market. At the last stage of the M&A process, three main potential Buyers were competing to acquire the Company: Advent International, Carlyle, and CVC Capital Partners. While performing their ESG Due Diligence, many issues concerning the *S* side of ESG were found, mainly concerning human rights violations in the Company's tea estates. These ESG issues had a detrimental effect on the transaction outcome, leading to Carlyle's exit from the transaction and an offer which didn't include the tea estates (lowered by € 750 mln) from Advent, effectively leaving CVC Capital without price competition in the final stage of the transaction, which secured the Target for € 4,5 billion, since those who left the Deal didn't want to bear the risk of post – transaction reputational damage (also other potential Acquirers left before the final stages for the same issues). Thus, in the context of this transaction, ESG issues played a central role in determining the Deal Outcome, decreasing the panel of potential buyers, and leading to one single comprehensive final offer: CVC's one, which was accepted by the Seller.

Considering the empirical analysis, this was conducted to assess whether the Company was sold at a discount given the lack of competition resulting from the ESG issues. The result from the valuation, which was based on publicly available data, confirmed the existence of such a discount since, through the application of two distinct valuation methods (i.e., the Stock Multiples Method and the Transaction Multiples Method), the floor value was higher than the price paid by CVC Capital Partners to acquire Ekaterra. In particular, the valuation range, which was identified between the minimum value resulting from the application of the Stock Multiples Method, and the maximum value resulting from the application of the Transaction Multiples Method (after performing a +/- 0,50x sensitivity analysis on both the considered EV/EBITDA multiples), laid between € 4,88 bn and € 5,16 bn, thus identifying a discount of at least almost € 400 mln.

It should be noted that this valuation may differ from the valuation made by CVC Capital Partners and by other participants to the Deal process, since the valuation provided in this Thesis is based on publicly available data, whereas those who actively participated to the transaction may have had access to more information (e.g., a Business Plan provided by the Company's management, or more historical data on Unilever's tea business before the creation of Ekaterra), and that their valuation could have been based on different financials, like an Adjusted EBITDA agreed between the Purchaser and the Seller, thus resulting in different outcomes. However, by comparing Ekaterra both with its publicly listed competitors and with comparable transactions that took place within a significant period of time with respect to the analyzed transaction, the valuation yielded a higher fair value, and it is therefore possible to conclude that, in the absence of ESG issues, price competition between potential buyers could have resulted in a higher cash consideration for the Seller. The analysis of the Ekaterra

case was coherent with the answers given to the previous research questions, since in this recent transaction, ESG consideration played a fundamental role in determining the outcome of the Deal itself.

One could argue that CVC's acquisition of Ekaterra, despite its poor ESG performance, was not a decision taken lightly. Instead, it could be seen as a strategic move, where CVC identified an opportunity to enhance the company's value. By working to improve Ekaterra's ESG performance, the acquirer stands a chance to greatly increase its value upon exit. This transaction could potentially pave the way for a new trend in M&A transactions, similar to the concept of Distressed M&A. Companies with subpar ESG performance could be purchased at a discount, then restructured to align more closely with sustainability frameworks. Such improvements would ultimately boost their value, providing a profitable exit for the acquirer. This approach presents a novel way for firms to turn poor ESG performance into an opportunity for value creation.

In conclusion, nowadays ESG considerations are not just an addendum to the M&A process, but a critical element that can determine its success. Companies are increasingly recognizing the importance of ESG in M&A transactions, not only as a response to regulatory and societal pressures, but as a strategic tool for value creation and risk mitigation. The findings of this study underscore the need for companies to integrate ESG considerations into their M&A strategies, as a means of driving sustainable growth and as a response to the evolving expectations of their stakeholders, and to avoid reputational damage. As ESG continues to gain prominence, its impact on M&A transactions will undoubtedly become even more profound, shaping the future landscape of business practices and strategies.

Appendix 1 – Ekaterra Balance Sheet (Data in €/mln)

€/mln	31.12.2021
Assets	
Non-current assets	
Goodwill	102,1
Intangible assets	16,9
Property, plant, and equipment	272,1
Biological assets	11,9
Pension asset for funded schemes in surplus	6,4
Deferred tax assets	299,3
Financial assets	290,9
Non - Current Assets	**999,6**
Current assets	
Inventories	247,5
Biological assets	1,2
Trade and other current receivables	356,8
Current tax assets	7,6
Cash and cash equivalents	34,5
Derivatives	1,8
Current Assets	**649,4**
Total assets	**1.649**
Liabilities	
Non-current liabilities	
Financial liabilities	**112,3**
Pensions and post-retirement healthcare liabilities	9,8
Funded schemes	*0,4*
Unfunded schemes	*9,4*
Deferred tax liabilities	9,0
Non - Current Liabilities	**131,1**
Current liabilities	
Financial liabilities	2.508
Derivatives	12,6
Trade payables and other current liabilities	836,8
Current tax liabilities	6,7
Provisions	3
Current Liabilities	**3.367,1**
Total liabilities	**3.498,2**
Equity	
Shareholders' equity	(1.850)
Non-controlling interests	0,8
Total Equity	**(1.849,2)**
Total liabilities and Equity	**1.649**

Source*: Own elaborations on Ekaterra 2021 annual statement*

Appendix 2 – Comparable Transactions Panel

Target	Target Description	Announced Date	EBITDA Multiple
PT Garudafood Putra Putri Jaya Tbk (29.19% Stake)	Indonesia-based company that produces and markets snacks, biscuits, confectionary, fruit-flavored tea, and jelly drinks	15/12/2021	19,4x
Bryggeriet Vestfyen A/S (60.88% Stake)	Denmark-based producer of beer and soft drinks	12/05/2021	21,2x
GTNFoods JSC	Listed Vietnam-based company engaged in trading agricultural products, producing tea, wine & industrial bamboo, biomass energy development, and infrastructure construction	09/04/2021	16,0x
Everton SpA	Tea manufacturer.	03/12/2020	9,0x
Caffè Bonomi S.p.A.	Italy-based company engaged in the production and processing of coffee.	01/12/2020	10,7x
Hangzhou Haomusi Food Co., Ltd.	China-based company engaged in manufacturing and wholesale of snacks and tea leaf	24/02/2020	19,2x
International Coffee & Tea, LLC	US-based owner and operator of coffee and tea shop chain	24/07/2019	31,4x
Pioneer Food Group Limited	South Africa-based company engaged in the manufacturing of food, beverages and related products	19/07/2019	14,0x
Hatton Plantations PLC	Sri Lanka-based company that engages in the cultivation, manufacture, and sale of tea	28/05/2019	14,3x
Premium Brands Holdings Corporation (7.08% Stake)	Canada-based manufacturer and distributor of consumer food products	21/05/2019	16,2x
Woongjin Foods Co.Ltd (74.75% Stake)	South Korea-based producer and seller of beverages, food and health products	20/12/2018	12,4x
Keurig Dr Pepper Inc	US-based producer of soft drinks and beverages	29/01/2018	18,0x
Average			**16,8x**
Adjusted Average			**16,1x**
Median			**16,1x**

***Source**: Own Elaboration on Mergermarket Data*

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Executive Summary

This Master's Thesis marks the completion of my two-year Master's Degree in Corporate Finance at LUISS University, and it explores the rise of Environmental, Social, and Governance (ESG) considerations in Mergers and Acquisitions (M&A). In particular, it particular, it aims at understanding why ESG considerations have become important in M&A, how these affect the processes and outcomes of deals, and it investigates ESG's role in a relevant case study: the acquisition of Ekaterra NV by CVC Capital Partners.

Thus, the goal of this work is to answer the following research questions:

i. Why did ESG consideration gain a relevant spot in M&A Transactions?
ii. How do ESG considerations influence the M&A process and the Deal outcome?
iii. In the context of Ekaterra's acquisition by CVC Capital Partners, what role did ESG considerations play? Was the company sold at a discount due to ESG - related issues?

In order to answer to the aforementioned questions, the Thesis has been structured into four chapters, each serving as a stepping-stone to understand the multifaceted relationship between ESG considerations and M&A Deals.

Chapter 1 examined the fundamentals of ESG, the underlying regulatory framework applied in the EU, and its implications on corporate behaviors.

Chapter 2 investigated the link between ESG and financial performance through a comprehensive review of existing literature.

Chapter 3 focused on how ESG considerations have reshaped the M&A landscape, diving into topics like the ESG due diligence process, the risks of greenwashing, and the rising relevance of ESG-related investments for Private Equity funds.

The final chapter, Chapter 4, by means of a case study analyzed how ESG issues are able to influence the outcome of a deal, specifically the CVC Capital Partners' Acquisition of Unilever's Ekaterra. The Target, leading company in the tea industry, was sold by Unilever in 2021. This study examines whether human rights concerns in the company's tea plantations led to a discounted sale price due to the lack of competition among potential buyers. The case study combines company overviews, market analysis, and company valuation to assess the implications of ESG considerations on the M&A deal.

Overall, this thesis offers a comprehensive understanding of the increasing relevance which ESG considerations cover in M&A transactions, through theoretical exploration, empirical research, and a practical case study to elucidate this emerging dynamic in Corporate Finance.

ESG, namely *Environmental, Social,* and *Governance*, is an umbrella term referring to the criteria used by stakeholders to assess a company's sustainable and ethical impact. As the acronym may infer, the ESG framework relies on three main pillars: (i) the "*E"* represents the Environment, encompassing energy consumption and efficiency, water usage and recycling, and it addresses concerns such as, but not limited to, carbon footprint, deforestation, greenhouse gas (GHG) emissions, biodiversity preservation, and pollution control; (ii) the "*S"* signifies the Social aspect, focusing on the Company's commitment to human rights, adherence to labor standards, equitable compensation or benefits for employees covering comparable positions, and fostering an inclusive workplace that respects diversity in terms of race and gender, while the (iii) the "*G"* denotes Governance, which pertains to of a Firm's structure and management, comprising metrics such as Codes of conduct and business principles, Board diversity and structure, transparency and disclosure, as well as Executives' pay.

ESG may be considered as the enrichment and extension of Corporate Social Responsibility (CSR) and, despite the relevance of the Shareholders' Value Creation Theory, it is clear that nowadays the business ecosystem (made not only of Firms, but of a complex balance of stakeholders' interests), is converging toward the theory according to which those firms who seek long–term value creation should shift their focus towards a holistic approach, considering their social and environmental impact, alongside their financial returns, using a *triple bottom line* (i.e., People, Planet, and Profit) in defining their strategies.

Nowadays, the majority of Executives is fostering the implementation of ESG strategies in Firms' day – to day operations, it is possible to identify three main determinants for such a trend: (i) the pressure coming from Regulators, who, particularly in the European Union (EU), are increasingly promoting Directives and Regulations aimed at enhancing companies' compliance with ESG best practices, (ii) the influence of other stakeholders, such as customers and the society as a whole, driven by new emerging needs, and (iii) the financial benefits deriving from the implementation of ESG strategies.

Each of these drivers is concretely declined as follows:

- From a Regulatory standpoint, in the EU, the approval of the UN 2030 Agenda for Sustainable Development and the Paris Agreement on Climate Change led to a new wave of Regulations aimed at creating an integrated ESG regulatory framework. In this view, the EU served as a pioneer in defining such a framework, also given its position as a worldwide leader in promoting sustainable finance. To mention a few, some of the key sustainability Directives and Regulations issued by the EU are: (i) the Corporate Sustainability Reporting Directive (CSRD), (ii) the Sustainable Finance Disclosure Regulation (SFDR), and (iii) the EU Taxonomy. In detail, the CSRD has been drafted to improve the consistency and comparability of sustainability information provided by companies, by requiring businesses to deliver

comprehensive disclosure on their social and environmental impacts, the SFDR requires financial market participants and financial advisors to provide disclosures on the level of sustainability related to their investments, while the EU Taxonomy, a classification system establishing a list of environmentally sustainable economic activities, sets a perimeter for what can be considered as "sustainable". The ultimate goal of these and many other ESG – focused regulatory efforts promoted by the EU is to align Companies' operations and strategies with the so-called green activities, through the introduction of disclosure and transparency obligations. Those measures push to a transition in which Firms move towards sustainable operations behavior which, in turn, contributes to global sustainability goals, enhances their appeal to investors, and enables a more sustainable future for business.

- With respect to the pressure coming from other stakeholders, it must be observed that the share of customers requesting for sustainable products is sharply increasing while Companies operating in specific industries (e.g., fossil fuels, tobacco, weapons etc.) have been targeted by *Divestment movements*, namely a form of activism aimed at pressuring individuals, organizations (such as Universities), Companies and institutions to divest those interests held in companies that are deemed to be unethical or harmful to either the environment or the society. Among the main direct and indirect consequences for companies targeted from a divestment campaign there are: (i) reputational damage, which can lead to a loss of trust among customers and the general public as well as a leakage of business opportunities, (ii) negative financial impacts, deriving from the fact that when large institutional investors decide to divest, share prices are deemed to fall, access to capital may be restricted, and Companies may experience credit downgrades, and (iii) increased regulatory scrutiny (which is also more true following the latest sustainability Regulations and Directives).
- Lastly, the proven positive correlation between ESG performance and financial performance has been able to link stakeholders' and shareholders' interests, further reinforcing the importance and implementation of ESG strategies in Companies. The table below summarizes the key findings of the literature focused on empirical studies regarding the correlation between ESG scores and financial performance, both in terms of market measures (stock price) or accounting KPIs such as Return On Equity (ROE), Return On Assets (ROA), Earnings per share (EPS), and Tobin's Q (i.e., the ratio between a physical asset's market value and its replacement value).

The results may be interpreted as follows: a green dot identifies a positive correlation, a red dot a negative correlation, while the yellow dot represents a non – significant relationship (i.e., correlation equal, or really close to zero).

Executive Summary Table 1 – Results of the literature review.

Author(s)	Year	ESG		Environmental		Social		Governance	
		Accounting	Market	Accounting	Market	Accounting	Market	Accounting	Market
Ahmad et al.	2021		🟢		🟡		🟢		🟢
Alareeni & Hamdan	2020	🟢	🟢	🔴	🟢	🔴	🟢	🟢	🟢
Bajic & Yurtoglu	2018		🟡		🟢		🟢		🟡
DasGupta	2022	🟢	🟢						
Velte	2017	🟡	🟡	🟢	🟢	🟢	🟢	🟢	🟢

***Source**: own elaboration.*

From the above it can be derived that a positive correlation has been statistically demonstrated by Academics, and the reasons why ESG have such a positive effect can be traced back to the fact that the implementation of ESG strategies can result in (i) enhanced risk management practices, since integrating ESG factors into the existing risk management framework allows to avoid negative ESG scandals, which are becoming always more disruptive and expensive for Companies, (ii) affordable capital acquisition, since high – ESG – rated Firms benefit from (*a*) a lower systematic risk (β factor in the CAPM), which lowers the cost of equity, and (b)from a minimized default risk, which in turn lowers the cost of debt (iii) long-term cost minimization, since ignoring ESG topics may lead to high costs in terms of reputational damage, as well as, on the contrary, in the long – run a sustainable supply chain can contribute to a cost advantage, leading to higher margins, (iv) augmented revenue and increased profit margins, due to the aforementioned increased demand for sustainable products, and (v) simplified process in the attraction of external investments due to the lower cost of capital, and the increased willingness of investors to fund ESG – compliant firms.

Corporate behavior, term in which both the strategies and operations are included, must appropriately take into account ESG considerations. One way in which firms are incorporating ESG elements into their strategies is by considering ESG-related Key Performance Indicators (KPIs) in their Executives' compensation plans. This is based on the idea that financial incentives tied to social and environmental goals can steer business activity towards sustainability. Other means by which companies embed ESG topics in their strategies include (i) issuing green bonds to finance their activities, (ii) auditing their supply chains to evaluate the sustainability of their entire value chain, (iii) promoting waste reduction and recycling initiatives and (iv) creating sustainability frameworks to oversee all operations. The combination of the mentioned efforts reflects the growing importance of ESG considerations in shaping corporate behavior and strategic decisions.

Also Mergers and Acquisitions, which represent a core strategy pursued by those Companies who seek expansion and have been heavily impacted by ESG considerations in recent years, surging to the forefront of strategic planning. These considerations have emerged as pivotal components that can no longer be sidelined or treated as secondary concerns, morphing from being a **nice-to-have, to a must-have** in the M&A playbook. ESG

considerations have garnered such an attention due to their profound influence on the comprehensive success (or, alternatively, the failure) of the Deal. These now play a central role in similar business undertakings, factoring into the formulation of a transactional strategy, as well as its execution. For the Dealmakers, namely those who orchestrate and negotiate these intricate transactions, ESG factors have surfaced as elements that need to be carefully examined and effectively integrated into any broader M&A plan. Two key aspects have specifically accentuated the prominence of ESG considerations in the M&A realm: (i) the strongly perceived need to mitigate the risks associated with ESG factors (which can range from environmental hazards, such as pollution or unsustainable business practices, to governance issues like poor management structures or lack of accountability) is high, since these may have significant implications and may negatively affect the Transaction's financial outcomes if not adequately addressed, and (ii) the opportunity to maximize ESG-related synergies, which entails aligning the respective ESG practices of the merging and acquiring entities, at first, through the identification of common grounds and, then, leveraging these shared values or strategies to create a stronger, more sustainable, combined entity. These synergies are able to provide numerous benefits, such as cost savings, improved operational efficiency, and increased market competitiveness; therefore, companies that excel in these areas are seen as more attractive acquisition targets due to their potential for creating long-term, sustainable value.

As said, the commitment to these dual objectives is driven by the recognition of the potential benefits which may be derived. When managed effectively, in fact, these efforts can significantly boost the financial performance of the Buyer, not just in terms of direct monetary returns but also by fostering long-term sustainability. In addition, these may determine a positive impact on the buyer's reputation itself.

As a consequence of the increasing relevance of ESG considerations in M&A Deals, the processes of ESG Due Diligence and the concept of an ESG premium have become prominent in the M&A landscape. Hence, these have been thoroughly analyzed in this Thesis. In particular, ESG Due Diligence can be defined as the process that leads to the identification of risks and upsides related to sustainability at the pre-signing stage, and it involves the assessment of items as for example, but not limited to, the company's environmental impact, its relationships with stakeholders, its governance structure and its ability to adhere to relevant laws and regulations, in order to uncover any potential ESG risk that may impact the Deal's viability or the post-merger integration dynamics, hence providing crucial insights for Dealmakers.

There are two main operational reference models when carrying out an ESG Due Diligence: (i) the “Fragmented Model” through which, without a dedicated ESG Due Diligence workstream, dealmakers identify the specific Environmental, Social, and Governance themes crucial to their transaction and embed these within their already existing Due Diligences workstreams (e.g., Financial, Tax, Legal etc.), and (ii) the “Dedicated workstream Model”, that, on the contrary implies the appointment of a dedicated workstream, whose goal is to identify the

relevant ESG topics and to analyze each of these on a standalone basis. In particular, said workstream entails a four – step process which starts with the so-called drawing of the materiality line, which means determining the threshold at which ESG issues become significant enough to require further investigation or action from the Buyer. The choice of where such a line is drawn is based on the likely impact of these issues on the future value of the Business. Following in step two, the Buyer carries a data analysis, which heavily relies on the available data and might include interviews and structured questionnaires aimed at addressing historical performance track records and procedures, as well as the review of relevant documentation, (e.g., company reports, public databases, and news articles). The third step involves the assessment of ESG – related risks and opportunities and marks the turning point from a qualitative identification of issues to the assessment of the quantitative impact these may have on a Business (and on its future value) and it entails financial modelling and other quantitative assessments of the identified risks and opportunities. Although this step is deemed to be the most complex, it is critical to conduct an effective ESG Due Diligence, as it allows Buyers to quantify the potential financial impact of ESG risks and opportunities. The last step is represented by reporting, and it involves packaging all the findings of the previous steps into a report, with the aim of providing a clear set of conclusions. The ESG Due Diligence report contents will then be used for further discussion with the Target, or any related parties potentially involved (such as investors, financiers, future customers, employees, and other stakeholders).

It is important to remember that the assessment of ESG risks and opportunities derived through the ESG Due Diligence could have an impact on the Target's financial valuation and, thus, could positively or negatively impact the price offered by potential buyers, resulting in a premium, namely the ESG or Green premium, or in a discount also known as the Brown discount. With respect to the ESG premium, ESG factors' influence in M&A led to an increasing number of investors willing to pay premiums (as high as 50% of the Company's fair value) for targets with compelling sustainability performance. If it is true that investors are likely to pay more than the Target's fair value to acquire a Firm that holds a high ESG score, it is true that, on the opposite side, investors may require a discount when purchasing a Company that does not meet their sustainability standards, the so – called Brown Discount. Businesses that demonstrate a strong attitude towards ESG practices attract higher valuations, reflecting a shift in investors' preferences for sustainable and responsible business operations. The ESG Premium is not only indicative of the market's growing commitment to sustainability, but it also underscores the potential financial benefits for companies investing in "green" initiatives. On the other hand, the Brown discount reflects the growing risk aversion among investors and financiers to harmful business models. Thus, the existence of both the Green Premium and the Brown Discount highlights the financial implications of ESG factors in M&A transactions: these considerations act as financial incentives and deterrents that push companies to align their strategies with a more sustainable business model.

To provide a complete and coherent analysis, a focus on the activity of Private Equity funds has been provided, as those are conceived to be the most active players in the M&A market. In 2022, the financial landscape saw a pronounced trend towards an increased sector specificity among funds. Europe, in particular, saw a rise in those funds dedicated to addressing climate change and promoting sustainable investments. In terms of ESG integration, private equity firms are undergoing a paradigm shift: instead of treating ESG as a separate initiative, these Firms are beginning to weave it into their core business strategies. Governance risk and sustainability-driven cost reduction are emerging as key focus areas. In some cases, ESG initiatives have been formalized through Sustainability-Linked Loans (SLLs), those being innovative financial instruments tying the company's financial performance to its ESG performance by varying the interest rate according to the company's success in achieving its ESG goals. Thus, companies are incentivized to improve their sustainability performance metrics, leading to lower interest rates on their debt. As the market changes, social pressures and the evolving ESG landscape will likely prompt private equity firms to make more significant efforts to incorporate ESG into their strategies. This will not only entail focusing on environmental initiatives but also prioritizing social and governance issues equally. This integrated approach could potentially lead to better long-term outcomes for the firms, their investors, and society as a whole. In other terms it may be stated that it represents an evolution in business strategy, where ESG considerations are not just supplementary, but central to the business model and its long-term success.

In the context of this Thesis, seeking to explore the role of ESG considerations in M&A Deals, a relevant case study has been analyzed: the acquisition of Ekaterra NV by CVC Capital Partners, transaction which took place on November 18th, 2021.

The Ekaterra case provides a unique opportunity to explore how ESG factors influence the M&A process and the Deal's outcome, especially given its relatively recent establishment and subsequent operations in a period where ESG considerations have gained significant prominence in corporate strategic planning. The case study provides evidence to delve into the effect of ESG performance on a company valuation and the related M&A process, as it allows to understand how a poor ESG performance may potentially determine a discount on the transaction price. Moreover, the case is useful to understand how some Buyers may view the scarce ESG performance as an opportunity to maximize their exit value by improving the Target's ESG compliance overtime, while others are more adverse investors aim to bear the potential reputational damage coming from potential ESG scandals. The relevance of the case is evident since, during the final stages of the M&A process, two out of the three final Bidders pulled out of the Transaction due to ESG issues, mainly concerning the tea plantations owned by Ekaterra.

In February 2021, Unilever's CEO announced that a strategic review of the Company's global tea business was taking place, in an attempt to deal with the division's poor growth after the black tea lost its appeal among

consumers. In fact, the traditional target customers of this market segment were getting older, while young consumers were seeking new experiences.

The outcome of the review was that Unilever's tea division was a promising business that could best achieve its potential as a separate entity and, thus, it was decided that, in order to pursue the disposal, a Newco, Ekaterra BV, should be created. The latter gathered under a sole entity Unilever's tea business (including 34 brands, among which there are Lipton, Red Label, PG Tips, T2, Pucca, and Tazo), with the exclusion of Unilever's tea businesses held in India, Indonesia, Nepal as well as the so-called ready-to-drink (RTD) tea business (except the one held in Japan, where the chilled RTD business is in Ekaterra's scope).

At a first stage, Unilever pursued the so – called Dual Track process, a strategy that involves preparing for an Initial Public Offering (IPO) while, at the same time, also exploring a possible trade sale, in order to maintain flexibility and guaranteeing the possibility to choose at a later stage the path that would maximize the outcome of the exit strategy for the Seller. In the context of the IPO preparation, talks with Private Equity firms began and some of the Globe's most successful buyout Firms showed among the possible bidders, including CVC Capital Partners, Carlyle, Advent International, Bain Capital, and KKR & Co., among the others. At this stage, the Tea Business was valued at € 5,4 bn.

While the process was ongoing, serious ESG concerns about alleged human rights violations on tea estates owned by Ekaterra rose and, by means of consequence, among the assets object of the purchase.

In particular, the main ESG issues were:

- Violence and Human Rights violations: during the disputed 2007 election in Kenya, a wave of violence broke out across the Country, leading to more than 1.300 deaths. In Kericho, where Unilever Tea Kenya Limited operates a tea plantation, attackers invaded and assaulted hundreds of workers and their families, leading to seven deaths, numerous injuries, and 56 reported rapes. The workers deemed Unilever to be responsible for poor management of the situation, but the Company dismissed the allegations. The workers initially sought legal redress in the U.K., but in 2018 the case was denied jurisdiction by the Supreme Court, which ruled that Unilever's Kenyan subsidiary was responsible for risk management of crises and, as such, any case should be heard in Kenya. Subsequently, the workers filed a complaint with the United Nations, accusing Unilever of violating international human rights standards by not providing adequate support during and after these attacks.
- Concerns about the living conditions and wages of plantation workers: the tea industry, which for its operations involves early morning starts and late evening work during harvest periods, often requires workers to live on, or near to, the plantation; therefore, usually the plantations' owners provide housing

and other facilities to the workers. However, the living conditions at Unilever's Kericho tea estates have been described as substandard with overcrowded and damaged housing and allegations of corruption and favoritism in housing assignments. Furthermore, investigations have questioned the validity of Unilever's "responsible sourcing policy," citing that the company seemed to exploit the high unemployment and lack of educational opportunities in Kenya to secure inexpensive labor and impose challenging living and working conditions.

- Sex – for – work scandals: such events were reported through the years by different sources. The tea estates have been criticized for gender-based discrimination, specifically sexual harassment and forced pregnancy examinations. Female tea pickers who rejected the unwanted advances of their male supervisors faced excessive workloads or assignment to isolated and risky plucking areas. Also, women found to be pregnant during pre-employment medical checks were not hired. Moreover, some supervisors were accused of offering employment opportunities in exchange for sex.

In the light of all the above, just before the final term for submitting the final offer, two out of the three final bidders pulled out of the transaction, due to the substantial ESG risks. In particular, Advent International decided to exclude the tea estates from its final offer, resulting in a € 750 million lower than CVC's one, while Carlyle completely withdrew from the bidding process just a few days prior to the deadline.

In particular, as confirmed by sources close to the Firms involved, Advent International became increasingly apprehensive about taking on the responsibility of ensuring the health, welfare, and security of the vast number of plantation workers. This concern stemmed from the fact that not only did the owners have control over the workers' employment, but also, they held power over crucial aspects of their lives such as housing and access to medical care. In a bid to conduct a comprehensive evaluation, Advent International commissioned an in – depth report focused on the conditions on the plantations, and its results were alarming. This negative revelation led Advent to strategically withdraw from acquiring the plantations, instead targeting the associated brands. The decisions were further influenced by the reported cases of sexual harassment against female workers and outstanding compensation claims. Similarly, Carlyle exited the deal due to the mentioned issues, while Blackstone abstained from early bidding, referring to the Ekaterra acquisition as "a massive ESG issue". Therefore, given the circumstances, potential investors opted to avoid assuming liability for the individuals dependent on the owned plantations, as it was deemed both expensive and intricate. As it may be noticed the potential risks associated with any ESG incidents occurring on the plantations posed a significant threat to the investors' reputation.

Being left as the only Bidder, CVC Capital Partners secured the Deal on November 18th, 2021, with a cash consideration of € 4,5 bn provided by its Fund VIII. The Deal took place on a on a cash – free, debt – free basis,

that means that the transaction was structured without any cash or debt transfer to the buyer, thereby ensuring the acquisition of the operating business alone, free of financial obligations or additional financial assets.

Given the concerns of the other Bidders, prior to making any investment, CVC promised to conduct Due Diligence process on human rights, environmental, and corporate governance issues, in the context of which if the Buyer would have encountered any manageable or immediately remediable risk it committed to addressing these within the first 100 days after the investment. However, if the DD procedures would bring to the conclusion that the ESG risks were too substantial and could not be appropriately mitigated within a reasonable timeframe, CVC vowed not to proceed with the investment. Apparently, the ESG risks identified by CVC were less dramatic and more easily manageable than what found by the other potential Acquirers, leading to the subsequent acquisition of the Target Company by the Private Equity Firm.

Since CVC Capital Partners was left without competition in the final stages of the transaction it is reasonable to assume that the bid that was accepted by Unilever for the sale of Ekaterra hasn't been the best possible outcome for the Seller in terms of purchase price. In order to understand whether Ekaterra was sold at a fair price or at a discount, a valuation of the Company has been conducted, using publicly available data.

Ekaterra was established as an independent company in August 2021 and, thus, has a very limited pool of historical data since its former parent company, Unilever, only published consolidated annual statements rather than individual financial statements for its business units. This presents a significant challenge for the financial valuation of Ekaterra, particularly when considering the application of the Discounted Cash Flow (DCF) method, which necessitates a substantial history of financial data in order to forecast future financial performance and cash flows. In Ekaterra's case, the absence of detailed historical financial data makes it extremely challenging, if not impossible, to derive accurate future cash flow projections. As such, any DCF valuation performed on this sparse data would likely be questionable and unreliable, rendering it unsuitable for decision-making purposes.

Given these significant constraints, the alternative Market Multiples approach was deemed more suitable to determine a valuation of Ekaterra. This method involves comparing the Target to similar companies within its industry using relevant multiples and, in the case under analysis, the EV/EBITDA multiple was chosen since this is the most widely used multiple in valuation practice being less affected by accounting policies as it is calculated before non-cash costs (depreciation, amortization, provision, and impairment). This valuation method bypasses the need for detailed historical data or future cash flow predictions, relying instead on identifying comparable entities and applying derived multiples to Ekaterra's financial metrics. The logic behind this approach lies in the "law of one price", which assumes identical assets should sell for the same price. Therefore, it allows for a valuation even under a scenario of a lack of detailed historical financial data. Despite potential criticisms of oversimplification or diverging assumptions about efficient market pricing, research suggests that the Market

Multiples method can offer valuations as accurate as DCF valuations. It's important to note that the choice of valuation method should be driven by the context and data availability rather than the inherent superiority of one method over another.

Given these considerations, Ekaterra's valuation was carried out using the Stock Market Multiples Method. Furthermore, it is common practice to validate the results of the chosen method through a different valuation method, known as the control method. In this case, the Comparable Transactions Multiples Method served as the control method and confirmed the results of the primary method.

Relatively to the valuation carried through the Stock Market Multiples Method, 7 comparable listed companies have been considered (i.e., Tata Consumer Products Ltd, McLeod Russel India Ltd, Goodricke Group Ltd, ITO EN Ltd, Camellia Plc, PepsiCo Inc., and The Coca Cola Company), and the respective EV/EBITDA multiple as of December 31st, 2020 was retrieved from Refinitiv database. Since the considered comparable firms are publicly traded on different stock exchanges, their multiples reflect higher liquidity and better access to the capital market. However, Ekaterra, being unlisted, has lower liquidity as its shares aren't traded on regulated markets, thus it was deemed appropriate to apply a liquidity discount in valuation techniques. Given Ekaterra's structure, dependency on fixed assets like plantations, and the ESG issues arose during the Deal, a 30% liquidity discount was applied to the median multiple, resulting in a discounted EBITDA multiple equal to 16,27x. Such a multiple was then applied to the 2020 reported EBITDA (€ 310 Mln), resulting in a valuation of € 5.043.437.000.

Considering all the above, Table 2 shows the analysis of multiples performed as described:

Executive Summary Table 2 – Ekaterra's Valuation as of 31.12.2020 using the stock Market Multiples Method

EV/EBITDA		
Company	**Geography**	**2020**
Tata Consumer Products Ltd.	India	38,3x
McLeod Russel India Ltd.	India	44,9x
Goodricke Group Ltd.	India	9,3x
ITO EN Ltd.	Japan	20,9x
Camellia Plc	UK	23,2x
PepsiCo Inc.	USA	16,9x
The Coca Cola Company	USA	23,7x
Average		*25,3x*
Adjusted Average		*24,6x*
Median		***23,2x***

€/000	31.12.2020
EBITDA	**310.000**
Median Comparable EBITDA Multiple	23,24x
Liquidity Discount	30%
Discounted EBITDA Multiple	**16,27x**
EV	**5.043.437**
Net Financial Position	-
Equity Value	**5.043.437**

Source*: Own Elaboration*

Since the transaction has been conducted on a Cash – free, Debt – free basis, which implies that the Buyer didn't acquire any Liability nor Liquidity of Ekaterra from Unilever, the Net Financial Position of the Target was assumed to be equal to zero. Moreover, it was deemed necessary to conduct a sensitivity analysis on the obtained Equity Value, considering a +/- 0,5x change in the EBITDA Multiple, ranging between 15,77x and 16,77x, which led to a valuation range between € 4.888.437.000 and € 5.198.437.000.

Considering the control method, the Comparable Transactions Multiples Method was applied. To align this control method with the main valuation approach, the EV/EBITDA multiple was chosen. To obtain relevant multiples for Ekaterra's valuation, data was methodically sourced from the Mergermarket database, focusing on transactions within the food and beverage sector from 2018 to 2021. Specifically, companies involved in producing and selling soft drinks, with specific focus on tea, were considered, resulting in a transaction panel comprising 12 Deals. Despite not all the chosen companies are engaged in the sole production of tea, the Targets all operated within the broader soft drinks category, ensuring comparability while acknowledging industry diversity.

The data retrieved from Mergermarket resulted in a median EBITDA Multiple equal to 16,1x which, when applied to the 2020 reported EBITDA, resulted in a valuation of € 5.004.801.000. The table below summarizes the above, while the transaction panel can be retrieved in the Appendix to this summary.

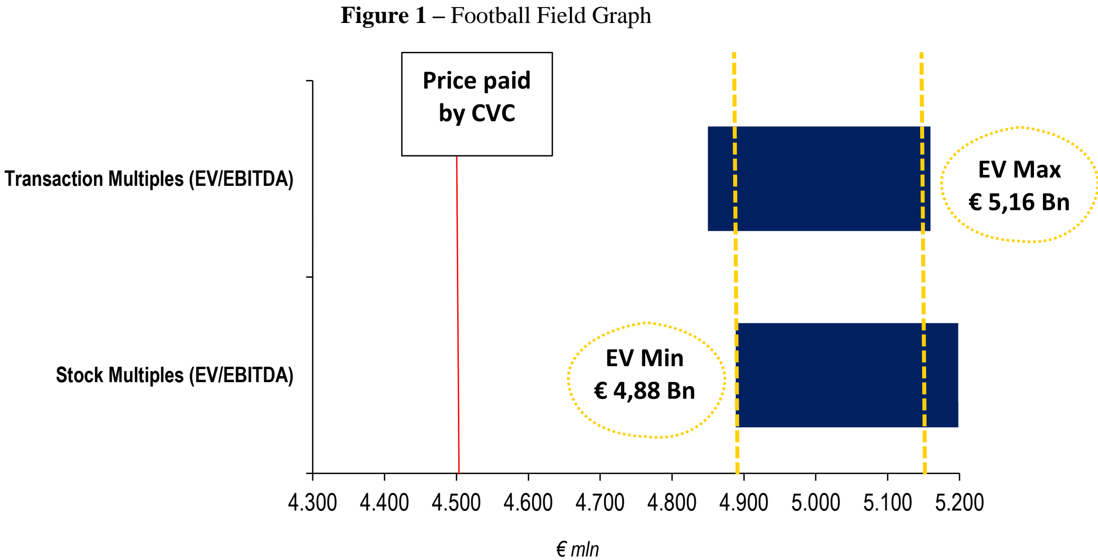
Executive Summary Table 3 – Comparable Transactions valuation results

€/000	2020
EBITDA	**310.000**
Median Comparable Transactions EBITDA Multiple	16,1x
EV	**5.004.801**
NFP	-
Equity Value	**5.004.801**

Source*: Own Elaboration*

It was again conducted a sensitivity analysis on the obtained Equity Value, considering a +/- 0,5x change in the EBITDA Multiple, ranging between 15,6x and 16,6x, which led to a valuation interval ranging between € 4.849.801.000 and € 5.159.801.000.

Figure 1 – Football Field Graph



Source*: Own Elaboration*

The valuation results, presented graphically in the above football field graph, delineate the range of potential values of the company. Specifically, the final range related to Ekaterra's EV is the following:

- The "lower bound" is equal to the minimum value resulting from the application of the Stock Multiples Method, i.e., a value of € 4,888 billion.

- The “upper bound” is equal to the maximum value resulting from the application of Transaction multiples, i.e., a value of € 5,160 billion.

Ultimately, this valuation resulted in the identification of Ekaterra’s Value in a range between € 4,88 billion and € 5,16 billion, which, compared with the price paid by CVC for the acquisition of the Firm, leads to the conclusion that the company has been underpriced, with a discount of at least almost € 400 mln. The underlying reason may be found in the fact that the final stage of the transaction was characterized by a lack of competition might have given CVC Capital Partners an advantage, allowing it to secure the acquisition at a discount with respect to the Company’s fair value.

Nonetheless, this valuation might differ from that conducted by CVC Capital Partners and other deal participants as it is based on publicly available data, while they might have had access to relevant historical data from the seller, or to confidential information, such as a business plan. Furthermore, it is possible that an Adjusted EBITDA may have been agreed between the Purchaser and the Seller, therefore leading to different outcomes.

Yet, the comparison of Ekaterra with publicly listed competitors and similar M&A transactions led to the individuation of a higher fair value. This suggests that without ESG issues, competitive bidding could have raised the sale price. In conclusion, it may be stated that ESG considerations were crucial in the Transaction object of the present study.

Given CVC Capital Partners' notable reputation in the field of Private Equity and its demonstrated commitment to sustainable investments, it is possible to argue that CVC's decision of acquiring Ekaterra despite its poor ESG performance was not taken lightly. Instead, it could be seen as a strategic move, where CVC identified an opportunity to enhance the company's value. By working to improve Ekaterra's ESG performance, the acquirer stands a chance to greatly increase its value upon exit. This transaction could potentially pave the way for a new trend in M&A transactions, similar to the concept of Distressed M&A. As said, companies with subpar ESG performance could be purchased at a discount, then restructured to align more closely with sustainability frameworks; such improvements would ultimately boost their value, providing a profitable exit for the acquirer. This approach presents a novel way for firms to turn poor ESG performance into an opportunity for value creation.

The findings of this study underscore the need for companies to integrate ESG considerations into their M&A strategies, as a means of driving sustainable growth and as an effective response to the evolving expectations of their stakeholders, as well as to avoid reputational damage.

To conclude, as ESG continues to gain prominence in financial markets, its impact on M&A transactions is likely to become even more profound, shaping the future landscape of business practices and strategies.

Executive Summary Appendix 1 – Comparable Transactions Panel

Target	Target Description	Announced Date	EBITDA Multiple
PT Garudafood Putra Putri Jaya Tbk (29.19% Stake)	Indonesia-based company that produces and markets snacks, biscuits, confectionary, fruit-flavored tea, and jelly drinks	15/12/2021	19,4x
Bryggeriet Vestfyen A/S (60.88% Stake)	Denmark-based producer of beer and soft drinks	12/05/2021	21,2x
GTNFoods JSC	Listed Vietnam-based company engaged in trading agricultural products, producing tea, wine & industrial bamboo, biomass energy development, and infrastructure construction	09/04/2021	16,0x
Everton SpA	Tea manufacturer.	03/12/2020	9,0x
Caffè Bonomi S.p.A.	Italy-based company engaged in the production and processing of coffee.	01/12/2020	10,7x
Hangzhou Haomusi Food Co., Ltd.	China-based company engaged in manufacturing and wholesale of snacks and tea leaf	24/02/2020	19,2x
International Coffee & Tea, LLC	US-based owner and operator of coffee and tea shop chain	24/07/2019	31,4x
Pioneer Food Group Limited	South Africa-based company engaged in the manufacturing of food, beverages and related products	19/07/2019	14,0x
Hatton Plantations PLC	Sri Lanka-based company that engages in the cultivation, manufacture, and sale of tea	28/05/2019	14,3x
Premium Brands Holdings Corporation (7.08% Stake)	Canada-based manufacturer and distributor of consumer food products	21/05/2019	16,2x
Woongjin Foods Co.Ltd (74.75% Stake)	South Korea-based producer and seller of beverages, food and health products	20/12/2018	12,4x
Keurig Dr Pepper Inc	US-based producer of soft drinks and beverages	29/01/2018	18,0x
Average			**16,8x**
Adjusted Average			**16,1x**
Median			**16,1x**

***Source**: Own Elaboration on Mergermarket Data*