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Soft power: The new importance of corporate culture and ESG

Companies are finding that positive values make good business sense

Dealmakers are starting to look closer at what companies preach in their corporate cultures, including their commitments to ethics and sustainability.

Corporate culture, or the set of values and behaviors that help define a company, are more important now than ever. Firms are facing a crisis over how to retain and recruit talented workers, and having an appealing culture is one way to do both. Meanwhile, the recent scandals involving employee harassment, which led to the “Me Too” movement, point to the risks of having a toxic culture.

The subject of corporate culture is increasingly relevant to dealmakers as well. After all, whether a potential acquisition has a healthy one in place could affect the amount of risk surrounding the target. Dealmakers need to know whether the current management team will conduct itself responsibly. Business experts have also recognized a connection between strong corporate cultures and better performance metrics.

Lately, a new wrinkle has been sustainability and environmental, social, and governance (ESG) principles, which more companies have been adopting as part of their respective cultures. Taking up these priorities presents new challenges for dealmakers, especially private equity buyers.

We wanted to learn just how challenging it is to implement a healthy corporate culture; how ESG and sustainability relate to a company’s culture; and how much both issues matter to bidders in M&A deals. In order to find out, we spoke with a half-dozen dealmakers who are experts in the field.

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Mergermarket **What are the biggest challenges in establishing and maintaining a positive corporate culture?**

Andrea Bonime-Blanc, GEC Risk Advisory The biggest challenge is when leadership—i.e., the CEO—doesn't have a clue or interest in culture as an asset, and doesn't understand that for better or worse, he or she is the pinnacle of that culture. Leadership and culture are inextricably linked, one influencing the other consciously or unconsciously. That's how you end up with, on the one hand, the toxic cultures of The Weinstein Company under Harvey Weinstein, and Uber under Travis Kalanick. But it also explains the great cultures of Starbucks and Microsoft under Howard Schultz and Satya Nadella, respectively.

Institutionalizing a great culture after the CEO who oversaw its growth and implementation is one of the toughest nuts for any organization to crack. It's something boards and executive teams need to work on consciously and proactively, and may include embedding performance management criteria that are not only financially-driven but that take into account environmental, social, and governance (ESG) issues, as well as culture. But the institutionalization effort must start at the very top of the organization, and work its way down into every nook and cranny.

"The lack of authenticity and consistency by management often means values are a bit of a bolt-on for big corporations."

Simon Propper, Context America

Stephen Pike, Gowling WLG The first challenge is recognizing that there already is a culture, and that no business starts out with a blank slate. The next is appreciating what that culture is and understanding it at all levels of the organization. Many businesses declare success when they have articulated corporate culture at the board level, but it's more than just the tone at the top.

Another challenge is understanding that culture change is a long and complicated process. Many organizations don't have the capability or appetite for change, evolution, or innovation, or they lack confidence in management's ability to create a positive corporate culture.

Melissa Sawyer, Sullivan & Cromwell The biggest challenge is striking the right balance between strategic planning and risk mitigation. If you left it up to the lawyers, the temptation would be to focus a lot of energy on avoiding worst-case scenarios, and dedicating a lot of resources towards compliance and policy-making functions. But at the same time, a vision of corporate culture that is only risk mitigation could negatively impact financial performance, as companies must engage in a certain measure of risk-taking in order to be profitable. What companies should focus on, and try to build their culture around, is being thoughtful and ethical about what risks they're willing to take.

Simon Propper, Context America Larger companies have the tallest obstacle when it comes to corporate culture, as it's often hard to get 10,000, 20,000, or as many as 100,000 people all feeling and thinking the same thing. It's particularly difficult when they see a lack of authenticity amongst management, who might be saying, "Here are our values and policy; it's all in our DNA." But at the same time, the employees see executive pay packages completely out of line with anything they can relate to. There is also all kinds of pressure to perform in sales or other ways, which make it extremely difficult to uphold softer values such as fairness and compassion.

The lack of authenticity and consistency by management often means values are a bit of a bolt-on for big corporations. The policy and value statements don't necessarily ring true to employees who feel, to some degree, exploited by their employers, and therefore not part of the big family that management would like to think their companies are.

Nick Martin, Antea Group It's relatively easy to introduce a positive culture, because corporate leaders can set ambitious goals. They can make statements about how much positive change their company is going to make, but at the end of the day, they've got to be able to deliver. I think that's where a lot of companies struggle, especially when the goals involve sustainability. Those goals can be extremely difficult to achieve. You must have the full support of your organization, as well as functional leaders, middle management, etc., in order to come through.

It's great for organizations to talk, but another thing entirely to actually walk that talk. That's where you see companies really try to differentiate themselves. Some are able to embed ideals of sustainability in everything they do, from the markets they want to play in to the products they want to offer, as well as their research and development. It becomes part of their genetic fabric.

Mergermarket **In your view, what are some of the most important benefits of a positive corporate culture, including upsides that might not be so obvious?**

Melissa Sawyer, Sullivan & Cromwell Better investor, community, and governmental relations are an important byproduct of having a good corporate culture. Meanwhile, on the employee front alone, companies historically viewed as having supportive and respectful environments for their employees tend to have better employee retention, and accordingly, lower costs associated with their human resources functions. We've also seen positive corporate cultures lead to the instilling of creative habits in employees, and a space within the company environment for innovation to bloom.

On the opposite side of things, we've seen the negative impact of a bad corporate culture through the "Me Too" issues of the past year, as those companies with instances of workplace misconduct—and particularly misconduct targeted at women—have been the first to admit an inability to attract and retain talented women. It certainly does not count as a benefit when 50% of your potential workforce is unable or unwilling to work for you.

Simon Propper, Context America I agree with Melissa about the benefit to employee retention. If you're in a field where there's a talent shortage, workers know they have their choice of employer and are essentially being courted all the time. In that scenario, once they've looked at location and remuneration packages, they're thinking, "Now what kind of company is this? Does it do good things and look after

people, and make things in a responsible and considerate way? Or is it sort of lacking?" As a differentiator between the types of companies someone would like to devote themselves to, and ones they would feel ambivalent or have concerns about, culture and, specifically, social and environmental sustainability are significant tools. Of course, that plays into the hands of smaller companies, because it's easier to establish a founder culture from day zero-forward.

A second benefit is in sales, particularly in many B2B markets, where there is the need to provide brand customers with confidence that you're not going to embarrass them through behavior. They don’t want to find out about missteps in the supply chain of a product that ends up with their brand on it. They need to know you can be relied upon to conform to social and environmental requirements, and that only a sensible amount of checking and auditing is needed to ensure you do. That's all about culture, trust, and reputation.

There is also a benefit to investors, which is especially applicable in an acquisition situation, in which culture is essentially a risk management tool. After all, you can have all the ethical codes in the world, but if the culture turns a blind eye to them in order to get ahead in the short term, the company will be exposed to bigger risks, whether that's bribery and corruption, cutting corners in regulations, etc. There's an increased risk profile to a company with a poor culture. Two recent and very prominent examples—shocking ones, really—were Volkswagen in Europe, and Wells Fargo in the US. Both featured appalling missteps in corporate behavior, which pointed to rotten cultures in their organizations. They're still dealing with the fines and liabilities from those missteps many years afterwards.

Andrea Bonime-Blanc, GEC Risk Advisory

The biggest upside is a focused, purposeful workforce that is not wasting its time—and indirectly, corporate resources and money—back-biting and complaining about the bad culture. Instead, they’re focused on teamwork, hitting targets, and camaraderie. Once a positive cultural attitude becomes the norm for employees, it, in turn, benefits important stakeholders such as shareholders and customers.

The hardest thing to prove with a qualitative matter such as culture is quantitative impact. The intrinsic value of a good culture cannot always be proven via strictly financial or quantifiable measurements. The well-known business adage that you only manage what you can measure works against the generally intangible, qualitative ways in which most businesspeople think about culture. However, there are measurements that boards and C-suites can deploy in order to get a sense of organizational climate, as well as a feel for how employees and other third parties consider their workplaces.

I outlined a few of these in a National Association of Corporate Directors article I recently wrote on the board's culture oversight responsibilities. In larger companies, these measurements can come from several sources, including talent management and human resources departments, as well as ethics, compliance and/or risk management teams, which as part of their remit are regularly collecting data on risks. They also draw from helpline and hotline statistics, workplace trends, training and communications activities, focus groups, and pulse surveys.

Mergermarket **Sustainability and ESG issues have become increasingly important priorities for many companies. Do you think prioritizing these principles helps reinforce a positive corporate culture? Or do you think sustainability and corporate culture are completely separate?**

Stephen Pike, Gowling WLG In terms of human capital management, prioritizing sustainability and ESG really helps to reinforce a positive corporate culture. Recently, Deloitte did a survey of millennials, and the results showed that they believe businesses should consider stakeholders' interests as well as profits. In fact, they feel very little sense of loyalty to employers who only prioritize the bottom line above workers, society, and the environment.

Harvard Business School professor Robert Eccles co-authored a working paper in 2012 entitled, "The Impact of Corporate Sustainability on Organizational Processes and Performance." In the authors' view, corporate policies reflecting principles of sustainability and ESG forge a stronger culture of sustainability, which, I believe, in turn, reinforces a stronger corporate culture overall. They definitely go together. In fact, I'm hard pressed to think of an example in which companies adopted policies and practices relating to sustainability and ESG and then had a weak corporate culture.

Sara Bernow, McKinsey & Company I agree with Stephen. Sustainability and ESG issues are seen as increasingly important for employees and customers, especially millennials. As companies align their values to those of their employees to a greater extent, it likely makes a positive contribution to corporate culture. In our work involving organizational health, what we've found to be a key motivator among employees is knowing that the company they work for shares the same values they find meaningful.

Simon Propper, Context America They're incredibly interconnected, because where else do you show your culture? At the end of the day, if you're a company with a strong, positive culture, you're going to treat your employees well. You're going to make sure the workers in your supply chain are not slave labor, and that they're reasonably well looked after. You're going to make sure your products and operations don't pollute the environment more than they absolutely need to. You're going to make sure to have very strong governance and ethics, and not behave badly by lying to consumers or investors, or by bribing people.

You really need to have a great culture in order to implement sustainability and ESG. If you try to more or less bolt ESG onto a company that has a cynical culture, or no culture at all, it's probably not going to be consistently implemented or necessarily believed by those employees asked to implement it. If you have a so-called fantastic culture, but then do very little in terms of intervention, environmental, social, and ethical performance, it's a great marketing effort and branding job, but you didn't actually walk the talk.

Andrea Bonime-Blanc, GEC Risk Advisory: These two concepts are absolutely and inextricably interconnected, and when combined in an organization setting, they reflect smart corporate leadership. For me, “sustainability” falls clearly within the environmental part of ESG, while culture falls squarely under governance. What I like about the ESG nomenclature is that it captures and encapsulates a broad, yet interconnected series of issues, which many might call soft, intangible, and not core to the business. However, at the end of the day, they are actually very impactful, both financially and to an organization’s reputation.

When a company that doesn’t understand ESG issues and related risks suffers an ESG-related crisis, it is unable to react properly, protect the interests of its shareholders and other key stakeholders, and can suffer serious and sometimes lasting consequences. But the reverse is also absolutely true: companies that understand their ESG issues and risks are able to manage them proactively, which is to their long-term benefit.

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>
> **Andrea Bonime-Blanc, GEC Risk Advisory**

Nick Martin, Antea Group With many of our clients, our sustainability consulting work has also been one of the first few times in which cross-functioning has taken place, with communications, marketing, and procurement teams interacting more with the supply chain than previously. By breaking down silos and bringing different functions together in this way, sustainability drives some positive cultural change.

I also agree that sustainability and corporate culture are increasingly linked together, especially when it comes to talent management and retention. If you look at the younger generations, they seem to be more environment- and sustainability-conscious. As a result, companies need to have sustainability as a major component of their culture or reputation.

Cultural assessment

The experts

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Mergermarket **How difficult is it to evaluate a company's corporate culture during the due diligence process? How do you think corporate culture affects a company's attractiveness as an acquisition target or IPO investment?**

Sara Bernow, McKinsey & Company Corporate culture is a critical dimension of any organization's health, which in turn drives its performance. In fact, we've found that the healthiest companies generate total returns to shareholders that are three times higher than those in the bottom quartile. Evaluating corporate culture, however, can be complex, although structured approaches are available for assessing key markers—for example, transparency and operational discipline.

Melissa Sawyer, Sullivan & Cromwell The evaluation is extremely difficult from the outside looking in, but I think there are techniques for getting at it. I think first and foremost that casual interactions with employees and people who work for the company are useful—they are usually the proverbial canary in the coal mine when it comes to those types of issues. I think the same approach has been used for years in assessing whether UK companies have a good culture of compliance around the 2010 Bribery Act, the environment, and similar issues. This is just a natural extension.

For the second part of the question, evaluating corporate culture is probably harder for private equity buyers than strategic buyers, as the former likely interact less with targets on a day-to-day basis. Strategic buyers, on the other hand, may have commercial interactions with targets over the ordinary course of business, and therefore more insight into how they actually function and what their cultures are really like.

Nick Martin, Antea Group I agree that it's difficult. A problem is that oftentimes, due diligence is driven by the need to have operations in a certain market, or to grow market share or production-to-market efficiency. The buyer isn't thinking about a lot of the social and environmental aspects fundamental to the location; they're just looking at it from a traditional business viewpoint.

It's also hard to spend a lot of time on due diligence, so a company picks what it really wants to focus on. Our hope is that sustainability can become more embedded in the process, but it's currently a bit of an anomaly. It doesn't happen as much as it should.

Stephen Pike, Gowling WLG I'll start off on the negative side, by saying that a company without an ethical, "compliance-aware" corporate culture will be less attractive in many ways, and present a very different risk profile to a potential investor or acquirer. Thinking of businesses in which the focus is not compliance or ethics—in which there are groups, for example, working on projects that are clearly unethical and skirting or avoiding compliance issues—that culture is not going to be enticing.

In terms of how difficult it is to evaluate a company's culture during due diligence, it's challenging but doable. As I said earlier, a huge part of culture is the doing, not the saying. It may be challenging for an outsider to get into the insides of a business, and see how people are living the culture and acting in accordance with it every day. I'm reminded of when I was still in law school and went for what we called "articling interviews," in which you visited various law firms. I was told, "Look for lawyers walking in the hallways without their jackets," because that was an indicator of a firm with a more casual approach. Meanwhile, there were law firms in which people did not walk around without their jackets.

The point is, there are many indicators of culture, but during due diligence, the focus has to be on what people are doing, and not so much on what they're saying.

Mergermarket **What effect do you think a company's emphasis on sustainability and ESG issues has on its attractiveness to acquirers, if any?**

Nick Martin, Antea Group Through our practice and work with various clients, we see sustainability driving value in three different ways. The first, and most critical, is reducing risk and avoiding costs, as a company or facility focused on sustainability has likely reached a certain level of maturity and has proactively managed risks, liabilities, and baseline compliance responsibilities. That kind of facility has its house in order more so than one that has never considered sustainability.

The second way is monetary and natural-resource savings, as these facilities or companies are likely to be more efficient. We've found that sustainable companies

start out optimizing their own operations because they fully control them. They tend to focus on reducing their energy consumption, saving water, managing their waste water, minimizing waste, etc., which adds up to a leaner company.

The last bucket is about growing revenue and reputation. For example, by acquiring an up-and-coming sustainability brand, the buyer might get a reputational enhancement. Or if they acquire a more sustainable product within a certain category, they may be well-positioned for the long run.

So yes, I would think an emphasis on ESG and sustainability would make a target more attractive, although that is not the case across the board. There are still investors who do not fully appreciate sustainability, or do not feel it's critical. It really depends on the investor who's trying to make the acquisition, what they are trying to do with it, and their investment horizon.

Andrea Bonime-Blanc, GEC Risk Advisory The answer depends on how enlightened and emotionally intelligent the leaders involved in M&A activity are. Sadly, many private equity firms and venture capitalists, as well as other acquirers of companies, focus almost exclusively on the financial aspects of an acquisition, failing to understand the importance of culture in post-acquisition value creation and destruction. As such, they don’t do nearly enough due diligence around a target’s culture.

Sara Bernow, McKinsey & Company There are two aspects to this. First, academic research shows that in more than 90% of cases, there is a positive or neutral link between ESG performance and financial performance. This means

that to the extent the emphasis on sustainability issues translates to real positive impact on sustainability performance, it may result in stronger financial performance. Secondly, we are seeing investors increasingly believing that ESG factors contribute to long-term performance. As such, companies' decisions to emphasize these issues may resonate well with those investors. In addition, providing investors and other potential acquirers with transparency on sustainability efforts and performance could have a positive impact.

Melissa Sawyer, Sullivan & Cromwell It doesn't have a big impact on attractiveness from an M&A perspective, but could have more of one for a company planning to go public. The largest passive institutional investors have been very clear that they are looking for their portfolio companies to raise the flag on ESG-type issues. However, when it comes to an acquisition target, many buyers have their own ESG practices, which they will impose on the target once they've completed the acquisition.

Mergermarket **On average, the holding period for private equity is around five years. How does this affect the way in which PE firms view companies that emphasize sustainability issues, since they often require strategizing for the long term?**

Melissa Sawyer, Sullivan & Cromwell First of all, there are two different kinds of PE buyers. Many have five-to-seven-year holding periods, but there are also many that are longer-term capital investors. A good example would be any of the Canadian pension funds that tend to buy into investments and stay in them for a longer period of time.

In any event, for the PE shops with a five-to-seven-year investment horizon, I suspect they are largely indifferent to public characterizations of their targets' ESG positioning. However, at the same time, they are probably interested in targets that have demonstrated some forward-thinking behaviors around ESG-type issues, such as adapting business models to be more sustainable, as that is evidence of a good management team. After all, PE investors are not just buying companies; they're also essentially buying management they believe can be successful. When they see a management team planning ahead like that, they probably find that appealing.

"For many [longer-term investors], I would imagine that companies with sustainability emphases would fit in fine with their strategies."
Stephen Pike, Gowling WLG

Nick Martin, Antea Group It depends on which dimension of sustainability you're thinking about, because if you hold onto a company or asset for five years, there's a lot you can do to optimize that operation. As I mentioned before, you can reduce costs, avoid costs, save money, and make it a very lean operation. That will, in turn, make it more attractive if you try to turn around and sell it, because you've reduced operational costs and increased the profit potential.

The one thing you wouldn't get with a five-year timeline is that really aspirational culture—the leadership that says, "We're in this for very long run. We're thinking decades down the line to where everything is headed; revamping the products we want to sell, as well as our research and development process." There aren't many buyers that say that, because of the focus on quarterly earnings, as well as the leadership not being guaranteed to be in place beyond the next five years.

On the other hand, sustainability is starting to push some companies into considering science-based targets, which may not be profitable until the year 2040-2050. But that requires real ambition, and those buyers aren't the norm.

Stephen Pike, Gowling WLG There are many different kinds of investors involved in private equity, and on a global level, we are definitely seeing more whose focus is longer-term. For many of them, I would imagine that companies with sustainability emphases would fit in fine with their strategies. For example, BlackRock Chairman and CEO Larry Fink is an avid proponent of long-term investing. In his annual letter to CEOs sent earlier this year, he wrote that "a company's ability to manage ESG issues demonstrates the leadership and good governance that is so essential to sustainable growth," which is why BlackRock integrates those issues into its investment process.

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