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Challenges for M&A in Developing Sustainable Finance Initiatives

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Abstract
Sustainable finance integrates environmental, social, and governance (ESG) factors into investment decisions to support projects that contribute to long term prosperity and eco-friendly practices. It focuses on mitigating climate change, conserve natural resources, uphold human rights, encourage ethical business practices, promote social inclusion, ensure economic stability, and foster long-term growth. Mergers and acquisitions (M&A) are increasingly influenced by sustainable finance, as companies focus on long term increase in market share, finding new market opportunities while simultaneously achieving economies of scale. However, incorporating sustainability into M&A presents additional unique challenges, especially in developing economies. Understanding these challenges ensures that M&A transactions align with ESG principles, mitigating risks and enhancing long-term value creation. This paper explores the challenges for M&A in sustainable finance and recommendations for overcoming these challenges while also focusing on G20 initiatives for driving sustainable practices.

1. Introduction
Sustainable finance involves making investment decisions that consider (i) environmental, (ii) social, and (iii) governance (ESG) factors to support projects that contribute to a sustainable and equitable future. It focuses on promoting climate change mitigation, conserving natural resources, upholding human rights, and encouraging ethical business practices.
The importance of sustainable finance lies in its ability to combat climate change, promote social inclusion, ensure economic stability, and foster long-term growth. By directing funds towards green and socially responsible projects, sustainable finance helps achieve global sustainability goals and supports balanced economic development that benefits both people and the planet.
Mergers and acquisitions (M&A), a critical component of business growth and expansion, are increasingly influenced by sustainable finance considerations. Mergers and acquisitions (M&A) involve the consolidation of companies or their assets. A **merger** combines two companies into a new entity, while an **acquisition** occurs when one company purchases another. M&A plays a crucial role in corporate strategy by enabling companies to expand market share, enter new markets, acquire new technologies, and achieve economies of scale. However, incorporating sustainability into M&A presents unique challenges, particularly in developing economies.
Studying the challenges of mergers and acquisitions (M&A) in the context of sustainable finance is crucial because it ensures that these transactions align with environmental, social, and governance (ESG) principles. M&A activities can significantly impact a company's sustainability goals, either positively or negatively. By understanding these challenges, companies can better integrate ESG considerations into their M&A strategies, ensuring that the combined entity supports sustainable practices. This approach helps mitigate risks,

enhances long-term value creation, and ensures that the benefits of M&A extend beyond financial gains to include positive environmental and social outcomes.
This paper explores the challenges for M&A in the context of sustainable finance, focusing on G20 initiatives, regulatory, financial, and operational obstacles, along with recommendations for overcoming these challenges.

2. The Growing Importance of Sustainable Finance in M&A

Sustainable finance has gained attention due to rising environmental concerns, regulatory pressures, and investor demand for responsible investment. In Emerging Market Debt (EMD) the need to conform also comes from Development Finance Institutions (DFIs), and other investors or sources of financing, though it may not appear to be important for domestic shareholders. In India, the incorporation of ESG factors into M&A decisions is driven by varied regulatory compliance requirements, long-term value creation, and stakeholder expectations.
In M&A, ESG factors affect target valuation, due diligence, and post-acquisition integration. Companies are more inclined to acquire businesses that align with sustainability goals, as these targets offer long-term value through reduced operational risks and access to sustainability-focused markets. However, this integration is not without its hurdles, particularly in the developing world.
As per World Economic Forum annual meeting 2022, high income countries dominate sustainability funds acquisition while the developing countries are constrained due to their debt situation and more reliance on hydrocarbon for their energy needs. Thus, developing countries have unintended consequences due to sustainability financing requirements.

3. Challenges for M&A in Sustainable Finance Initiatives

3.1. Regulatory Challenges

Sustainable finance initiatives are often hampered by regulatory variability across jurisdictions. Different countries have diverse frameworks for ESG reporting, creating inconsistencies that complicate cross-border M&A transactions. In developing countries, the lack of robust regulations governing sustainable finance adds further complexity.
For instance, the evolving regulatory landscape in India presents a challenge. ESG (Environmental, Social, and Governance) regulatory compliance is governed by a combination of various laws and guidelines rather than a single comprehensive framework. The National Voluntary Guidelines (NGVs), 2011on environmental, social, and economic responsibilities, by India's Ministry of Corporate Affairs gives details for businesses to demonstrate responsible conduct. The Reserve Bank of India has social lending framework for Banks as per priority sector lending requirements. Recently it has introduced framework for acceptance of green deposits, to encourage banks to mobilise funds to promote green finance. The framework from market regulator, Securities and Exchanges Board of India (SEBI), Business Responsibility and Sustainability Reporting (BRSR) applies primarily to top companies, leaving smaller firms with little guidance on sustainability practices. This gap makes it difficult for acquirers to assess the ESG risks associated with potential M&A targets.
Separately, the Central and state governments have various laws governing environment protection, waste and pollution control, labour welfare, anti-bribery and corruption. Further, there are recently introduced various ESG related policies to meet the country's short and long-term emission reductions targets. These include the 2022 Energy Conservation Act and

mandatory trading for carbon credits in 2025 for energy intensive sectors like petrochemicals, iron, and steel.
Thus, investors need to transact a complex operating environment for investments to minimise operational and reputational risks.

3.2. Due Diligence Complexities

Conducting ESG-focused due diligence is critical for identifying risks and opportunities, yet it is a challenging process. The lack of standardized ESG metrics and reporting frameworks in many developing economies complicates due diligence efforts. Investors struggle to find reliable data on a target company's environmental impact, labour practices, and governance frameworks. Mostly in these economies the financial regulators are yet to develop regulatory measures and risk assessment frameworks. In other case there are challenges of obtaining consistent ESG data during due diligence, as many companies do not disclose sufficient information. Thus, private investment firms often build their own assessment and risk frameworks. This inconsistency in reporting makes it difficult to accurately assess the financial impact of ESG factors on M&A transactions.
Taxonomies and disclosure adapted in developing economies too have shortcomings in terms of transparency, governance, and auditability. There is a lack of clear link of its "green" or "sustainable" label to the intended goals with no third-party audit. Hence, one apprehends risk of "greenwashing," and credibility of the tools.

3.3. Financial Constraints

Sustainable finance requires significant investment, and access to capital is often limited in developing countries. Companies aiming to pursue M&A deals focused on sustainability, face financial barriers as traditional financing models may not accommodate the additional costs associated with meeting ESG standards. Furthermore, the absence of well-developed green financing markets in developing countries exacerbates these challenges. In India, for instance, ESG-related financing products such as green bonds are relatively new, and many companies lack the financial expertise to leverage these instruments for M&A transactions. This financial gap limits the ability of firms to pursue sustainable acquisitions.

3.4. Cultural and Organizational Barriers

Cultural integration is a common challenge in M&A, and when sustainability is factored in, it adds another layer of complexity. Merging organizations with differing ESG priorities and sustainability cultures can result in conflicts and disrupt post-acquisition integration. In developing countries, where sustainability may not yet be embedded in corporate culture, aligning the ESG practices of the acquiring and target companies can be difficult. For instance, many Indian firms may lack formalized sustainability strategies, making it challenging for foreign investors with stringent ESG criteria to integrate their sustainability goals.

3.5. Greenwashing Risks

Greenwashing, where companies falsely claim to meet sustainability standards, is a significant challenge in M&A involving sustainable finance. In developing economies, regulatory oversight of greenwashing is often weak, increasing the risk of acquiring companies that do not genuinely adhere to sustainable practices. During due diligence, acquirers may not have the tools to distinguish between genuinely sustainable practices and greenwashing. This lack of transparency can lead to poor investment decisions, where acquirers overvalue companies based on false ESG credentials.

3.6 Some other challenges to sustainable finance initiatives in M&A include:

- Reporting: There is a lack of experts with in-depth knowledge of sustainable finance reporting.
- Stakeholder expectations: Stakeholders have higher expectations for sustainability.
- Lack of knowledge: There is a lack of knowledge about sustainable finance.
- Complex frameworks: There are complex frameworks and increasing legislation and regulations.
- Company engagement: There is low engagement from the company itself.

4. RBI Survey on Climate risk

The Reserve Bank of India (RBI) conducted a survey on climate risks among various financial institutions to assess the awareness, preparedness, and risk mitigation strategies related to climate risks. Below is a summary of key findings:

4.1. Perception of Climate Risks:

- Nearly 90% of respondents viewed climate risks as a material threat to their business. Among the identified risks, transition risk (due to the shift towards a low-carbon economy) was ranked as the most concerning for financial institutions.

4.2. Sectoral Exposure:

- Respondents identified energy and mining as the sectors most exposed to climate risks, followed by automobiles, agriculture, and infrastructure.

4.3. Risk Management:

- While 60% of the institutions incorporated climate risks into their risk management framework, a majority still lacked specific mechanisms to address these risks. Only 40% had mobilized capital for green lending, and 45% had introduced financial products leveraging green finance.

4.4. Challenges:

- The survey revealed significant challenges, including a lack of data and analytical tools. About 95% of respondents cited the absence of appropriate data as a major hurdle to assessing climate risks.

This survey highlights the rising awareness of climate risks but also underscores the need for enhanced data availability, better risk management frameworks, and policy support to manage these risks effectively.

5. Strategies for Overcoming M&A Challenges in Sustainable Finance

5.1. Strengthening Regulatory Frameworks

To overcome regulatory challenges, developing countries need to adopt comprehensive ESG frameworks that standardize reporting and provide clear guidelines for companies. This would enable more accurate ESG due diligence and reduce the inconsistencies currently faced in cross-border M&A transactions. Governments should also consider creating incentives for companies to adopt sustainable practices, such as tax breaks or subsidies for green investments.

5.2. Enhancing ESG Due Diligence

Companies can improve ESG due diligence by leveraging third-party assessments and industry benchmarks to evaluate potential M&A targets. Incorporating external audits and sustainability certifications into the due diligence process can help mitigate risks associated with greenwashing and inconsistent ESG reporting. Additionally, developing more sophisticated tools for ESG data collection and analysis can improve transparency and enable investors to make more informed decisions.

5.3. Building Financial Infrastructure for Green Finance

To address financial constraints, developing economies must invest in creating robust green finance markets. This includes promoting the issuance of green bonds, sustainability-linked loans, and other financial products tailored to sustainable investment. Financial institutions should also focus on building capacity in sustainable finance to enable companies to access the capital needed for M&A transactions.

5.4. Cultural Integration and Change Management

Successful M&A in the context of sustainable finance requires careful management of cultural integration. Acquirers should prioritize aligning the sustainability strategies of the merged entities by fostering open communication and providing cross-functional training. In cases where cultural misalignment poses significant risks, companies may consider appointing sustainability officers to oversee integration efforts and ensure the combined entity meets ESG goals.

5.5. Increasing Transparency and Accountability

Combatting greenwashing requires greater transparency and accountability. Acquirers should demand comprehensive ESG reporting from target companies and incorporate ESG-specific representations and warranties into transaction documents. Companies should also invest in post-acquisition monitoring to ensure ongoing compliance with ESG commitments.

6 G20 Initiatives on Sustainable Finance under India’s Presidency (2023) and Post-G20 Roadmap.

In 2023, India assumed the presidency of the G20, a critical platform for international economic cooperation, comprising the world's largest economies. The presidency marked a significant opportunity for India to influence global policy in areas like climate change, sustainable development, and financial resilience. Under the theme “One Earth, One Family, One Future”, India's G20 presidency placed substantial emphasis on sustainable finance, recognizing its pivotal role in addressing climate change and achieving sustainable development goals (SDGs).

6.1 Sustainable Finance Working Group (SFWG):

- India led the G20 Sustainable Finance Working Group (SFWG) to foster collaboration on developing frameworks that support green and sustainable investments. The group focused on improving the availability and quality of ESG (Environmental, Social, and Governance) data and reporting, as well as enhancing financial flows to developing countries for climate-related projects.
- The 2023 Sustainable Finance Report under India's leadership outlined strategic steps to scale up sustainable finance globally, focusing on mobilizing private capital, improving transparency, and reducing greenwashing risks.

6.2. Green Taxonomy Development:

- One of the flagship achievements of the G20 under India’s presidency was the advancement of discussions on a common global green taxonomy. The aim was to develop harmonized standards for what qualifies as green and sustainable investments, ensuring comparability and consistency across markets. This will help reduce fragmentation in global markets, making it easier for investors to identify sustainable projects.

6.3 Climate Resilient Infrastructure:
- The G20 under India's leadership prioritized investments in climate-resilient infrastructure, essential for building resilience to climate impacts in vulnerable regions. The Coalition for Disaster Resilient Infrastructure (CDRI), spearheaded by India, continued to gain momentum during its G20 presidency, with several new countries committing to join and invest in resilient infrastructure.

6.4. Financing for Climate Adaptation:
- A significant emphasis was placed on mobilizing climate finance for adaptation, recognizing that developing nations often bear the brunt of climate impacts. India pushed for stronger commitments from developed nations on the $100 billion annual climate finance goal and encouraged private-sector involvement in funding adaptation efforts in vulnerable countries.

6.5. Transition Finance:
- Another critical focus was on transition finance, supporting countries and industries in shifting from high-carbon to low-carbon pathways. The G20 promoted mechanisms to provide financial support to sectors in transition, such as the coal industry, ensuring that workers and communities dependent on fossil fuels are not left behind in the global shift towards decarbonization.

6.6. Blended Finance and MDB Reforms:
- India advocated for blended finance mechanisms to unlock private capital by using public and philanthropic funds to reduce investment risks. Reforms to multilateral development banks (MDBs) were also discussed to better align their operations with sustainable development goals, ensuring more financing for green projects in developing countries.

6. 7 Sovereign Green Bonds:
- During its presidency, India highlighted the role of sovereign green bonds as tools for governments to raise capital for green projects. India's own issuance of sovereign green bonds in 2023 was presented as a model for other G20 countries to follow, demonstrating the potential for governments to finance their climate and sustainability commitments through the bond market.

7. Some Case studies in India – a brief

7.1 Tata Power and Welspun Energy:

Tata Power acquired Welspun Energy's renewable energy assets for approximately $1.4 billion in 2016. This acquisition included 1,140 MW of renewable energy projects, primarily in solar power. It boosted Tata Power's renewal energy portfolio for transition to sustainable energy.

7.2 Adani Green Energy and SB Energy:

In 2021, Adani Green Energy acquired SB Energy India from SoftBank Group and Bharti Enterprises for $3.5 billion adding 4,954 MW of renewable energy projects to Adani's portfolio, becoming one of the largest renewal energy companies in India.

7.3 Kotak Mahindra Bank and Sonata Finance:

In 2023, Kotak Mahindra Bank acquired Sonata Finance, a microfinance institution, for INR 537 crore to expand its financial inclusion and reach in MFI sector and rural entrepreneurs.

These M&A deals have been successful as they align with the acquiring company's long-term strategy, in sectors like renewable energy and financial inclusion.

8. Conclusion

For companies, M&A presents significant opportunities for advancing sustainable finance, but the challenges involved, particularly in developing countries, cannot be overlooked. Addressing regulatory gaps, improving ESG due diligence, and building the financial infrastructure necessary to support green investments are critical to overcoming these obstacles. By fostering a culture of transparency and aligning corporate practices with sustainability goals, companies can navigate these challenges and unlock the long-term value creation potential of sustainable finance in M&A transactions.

India's presidency of the G20 in 2023 gave shape to global agenda on sustainable finance. Development of a global green taxonomy to promoting climate-resilient infrastructure and transition finance, would help create sustainable finance ecosystem that supports global climate goals. The post-G20 roadmap emphasis should be on scaling up private sector involvement, implementing global standards, and ensuring that financial systems are resilient to the risks posed by climate change.

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