Impact of the Supply Chain Act on the M&A process

Global supply chains are facing environmental concerns and geopolitical difficulties. With the new Supply Chain Law set to take effect in 2023, companies must prioritize sustainability and resilience in their supplier structure. Good ESG performance is now a crucial factor in attracting future collaborations and M&A opportunities. It's time to reassess the importance of supply chain analysis in corporate valuation.

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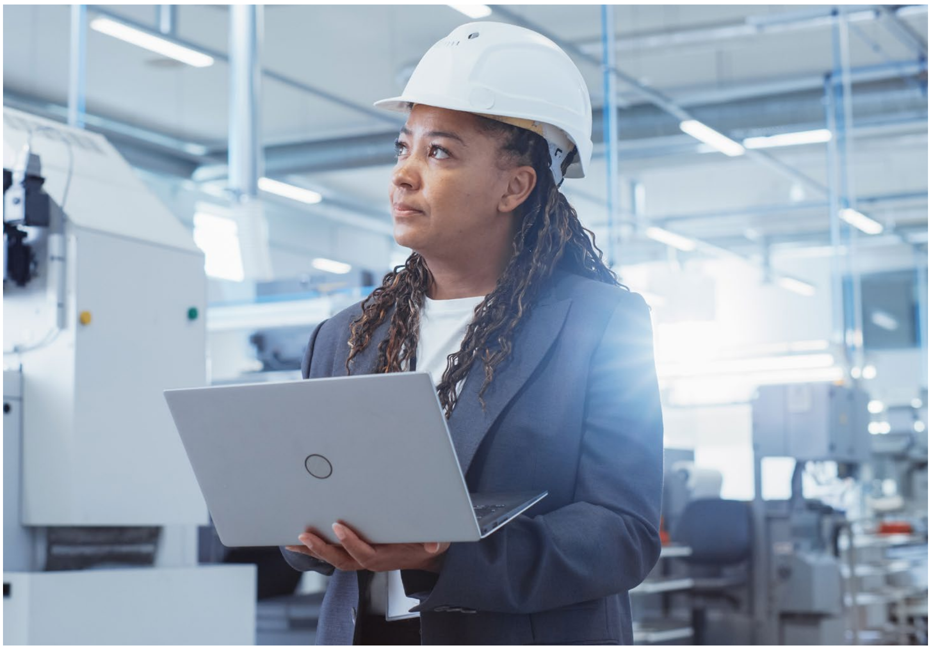
Abstract

The worldwide supply of goods and services has long been perceived as a catalyst for expansion, with the transnational delegation of manufacturing processes evolving into a determinant of competitiveness. But with the rise of environmental concerns and geopolitical issues, this trend has stagnated and there is a growing call for deglobalization and regionalization of value chains. Protocols implemented in response to unforeseen events (such as the coronavirus pandemic and the conflict in Ukraine) are designed to mitigate impact on supply chains.

Lockdowns and economic sanctions have caused shortages that make global supply chains a risk factor for businesses and entire nations. What's more, the Supply Chain Law, which goes into effect in 2023, further increases requirements. Large companies will be required to conduct risk analyses, report on conditions, and establish a complaint mechanism for work and environmental protection conditions along their supply chain. In February 2022, the EU Commission presented a first draft to make international transport more sustainable within Europe and to enforce minimum human rights standards at remote production sites.

Resilience and sustainability in supplier structure are thus becoming valuable attributes for successful expansion strategies. Both in terms of location and supplier selection, as well as in planned M&A activities. Analysis of supply security and local production conditions has become essential because good ESG performance makes potential suppliers and transaction targets more attractive for future collaboration with good ESG performance. In light of new economic and regulatory conditions, supply chains connected to a transaction object are becoming critical to corporate valuation, falling under entrepreneurial responsibility.



Importance of supply chains

“Made in Germany”, “Designed in California” and similar references to supposed origin appears on many products and are meant to signal high-quality workmanship and Western production standards. The truth is more complicated. From mining in the Congo of the rare earths essential to batteries, to the complex production of semiconductor chips in Taiwan and the composition of components in China, the production paths of modern technologies, as well as of conventional mass products, are today as global as their sales markets.

According to the German Federal Ministry for Economic Cooperation and Development, for instance, a T-shirt has travelled about 18,000 kilometers by the time it is offered to end consumers in the European Union. For reasons of cost, the first stages of raw material extraction and production are often outsourced to countries where wages are comparatively low and there are few if any environmental and labor regulations. Legal regulations tend to be stricter in Germany, but of course do not apply beyond national borders. By outsourcing to regional subcontractors, any discrepancies along the supply chain are – according to the current legal situation – generally not attributed to manufacturers, who retreat to the 'none-of-my-business' position when it comes to undignified working conditions and environmental pollution.

Sustainability has become a hot-button issue and ignited public discourse on the social, economic, and environmental due diligence of global supply chains, and there is mounting pressure on legislators to take action. The EU Parliament's Sustainable Corporate Governance Initiative has brought the state of global supply networks into sharp focus in Europe. A study by the EU Commission published in 2021 revealed that a mere one-third of the 334 companies surveyed scrutinize their suppliers for risks like child labor and non-conformity with waste disposal regulations. This reluctance can be attributed to concerns of being put at a competitive disadvantage from the additional workload involved in screening and the potential exclusion of crucial suppliers. Nevertheless, there seems to be a desire for greater accountability, as more than two-thirds of the companies surveyed believe there are benefits in a universally-applied due diligence requirement. The keys to ameliorating the situation, by averting regulatory asymmetries and ensuring compliance with human rights, seems to lie at the European level.

Member states of the European Union lead the way

In 2021, laws mandating due diligence were implemented in Germany and Norway, and similar concepts are under discussion in the Netherlands and Finland. The Supply Chain Due Diligence Law (LkSG), passed by the German Bundestag in June and currently applying to about 900 companies, will take effect for companies with more than 3,000 employees starting in reporting year 2023. A one-year grace period will be granted for 4,800 smaller companies with more than 1,000 employees[1]. The scope of the law will then be reviewed, with any developments at the European level reflected in national legislation. Thresholds will be calculated at the corporate level, and the presence of a branch in Germany will trigger the LkSG for foreign companies.

The law has the ambitious goal of extending the radius of social and ecological responsibility beyond one's own company. The explicit aim is not to establish German social standards worldwide, but rather to safeguard human rights in global supply chains. In its definition the LkSG refers in §2 to international law, listing specific cases in which human rights violations are likely to occur. These include child labor, discrimination against the workforce (for example on ethnic grounds) and withholding of fair wages. There are furthermore environmental obligations such as the avoidance of air, water, and soil pollution, excessive water consumption, and the use of prohibited substances and chemicals such as mercury.

[1]Deloitte, Coming Soon: The German Supply Chain Due Diligence Act, https://www2.deloitte.com/ch/en/pages/operations/articles/coming-soon-the-german-supply-chain-due-diligence-act.html.

Supply chains no longer end at borders

The concept of the supply chain in implementation of the new law is broadly defined and applies to all stages, both domestic and international, required for production of products and provision of services. The requirements for affected companies, however, are graduated based on their ability to influence the perpetrator of a legal violation and the depth of their supply chain. Utmost care is required within one's own business sphere and with immediate business partners, but action must also be taken on a case-by-case basis with indirect suppliers.

The Supply Chain Law initially calls for a statement of principles, which must not only be adopted by company management but also required of immediate suppliers. The statement should transparently lay out, for stakeholders and the public, company strategy for upholding human rights. It must then be implemented through an appropriate risk management system to prevent negative impacts on human rights within company operations.

It does not work without risk analysis

Risk analysis is the fundamental component, providing for the identification and evaluation of potential violations of the law. It is the starting point for prevention measures in procurement practices, training in relevant business areas, and risk-based control systems. Prevention also includes a critical analysis of the human-rights and environmental-risk factors of suppliers, as well as of their contractual commitment to respect human rights.

The requirements of the new Supply Chain Act provide legal certainty while also calling for action, since the law threatens exclusion from consideration in public tenders in the event of serious violations, with stiff fines of up to 2% of company turnover for gross negligence or intent. Affected parties can assert violations with the competent authority and seek legal assistance from abroad through German unions and non-governmental organizations.

If a company finds that a duty violation exists or is imminent in one of its business areas or with a supplier, appropriate measures must be taken. What is considered “appropriate” and thereby liability-limiting remains open to interpretation and public discussion. To ensure an efficient compliance system and rapid procedures, clear responsibilities must be defined in all relevant business processes and a systematic complaint mechanism for whistle-blowers must be established, as required by the Supply Chain Act.

The EU creates comparable conditions

To avoid further national solo efforts, the European Commission presented a draft for an EU Supply Chain Directive (EU-LkRL-E) on February 23, 2022. Since European directives must be transposed into national legislation, Germany will have to adapt in the medium term. Uniform standards prevent a regulatory race to the bottom for location attractiveness between the individual countries and thus create a level playing field for companies active in the EU.

The movement has become increasingly public, with European industry leaders spearheading it and publishing a statement by over 100 companies from different industries and countries in February. The collective around well-known brands such as IKEA, Danone and Hapag Lloyd demands, among other things, effective regulations against irresponsible purchasing practices for all companies operating on the domestic market.[2]

From a German perspective, deviations of the draft from the German LkGS are particularly interesting. If the EU rules are adopted in their current version, the circle of addressees could expand, as a lowering of the employee threshold from 1,000 to as few as 250 is in the offing - albeit linked to turnover requirements for number and attributability to classified risk sectors, which include the textile industry, food production, and certain commodities.

The scope of the risk analysis in the Commission's draft moreover extends to the entire supply chain. Should the gradation of due diligence for indirect suppliers integrated into national law be abolished by the EU regulation, a far greater audit effort would be required. Affected companies would then have to proactively investigate their supply chains all the way to their origin for human rights and environmental violations, instead of just reacting to indications. In addition to due diligence along these two dimensions, Article 15 of the draft obliges companies to develop a transition plan towards a business model that is in line with the Paris Climate Agreement.

The Commission's published draft legislation requires the approval of Parliament and all 27 member states of the European Union. In its current form, the regulations are precisely worded and addressed in greater detail. To avoid expenditure when the EU regulation comes into force, the stricter test criteria of the Commission draft should be anticipated in upcoming due diligence processes. In particular, the broader scope of application must be considered for the entire supply chain to minimize risk in any subsequent audit of indirect suppliers to the company purchased.

[2]Business & Human Rights Resource Centre, More than 100 companies and investors call for effective EU corporate accountability legislation, https://www.business-humanrights.org/en/latest-news/eu-mandatory-due-diligence-2022/.

Impact of the Supply Chain Act and its significance in transactions

The Supply Chain Act will have an organizational and accounting impact on companies, since compliance with the described requirements ties up considerable resources. Starting implementation in good time will ensure that sufficient qualified staff is available. The impact will be even greater within companies that purchase large parts of their value creation because they must ensure compliance with more suppliers.

Particularly in the initial transition phase, we expect the law to have a disruptive effect on existing trade relationships. If companies cannot ensure that a supplier complies with human rights and environmental standards, they can no longer purchase goods from that supplier. Only suppliers whose risk profile is acceptable will be considered candidates for compliance with due diligence requirements. Depending on the product, this may lead to a significant reduction in the number of suppliers that can be approached after the legally required risk analysis.

While suppliers who do not meet the regulatory requirements will soon fall through the cracks, compliant suppliers will in turn face a significant increase in demand. In any case, suppliers in critical sectors will not be able to avoid meeting regulatory requirements and adjusting supply capacities. Depending on sector and the risk exposure of its (pre-) products, this may entail far-reaching changes in supplier structure for some companies.

Even if the size thresholds in both the German law and the European draft directive exclude small and medium-sized enterprises, as suppliers they will be indirectly affected. Industry giants will up the pressure on their contractual partners to enforce the due diligence obligations imposed on them within their supply chain.

By transferring previously voluntary standards into national legislation, breaches will have consequences that go beyond any reputational damage. An inadequately established supplier structure is not just an indirect risk for delivery failures and poor product quality. Especially when it comes to corporate acquisitions, it is worthwhile for buyers to develop scenarios and understand potential weak points in the supply chain. The LkSG significantly increases the need to include sustainability risks in the supply chain in due diligence processes.

The supply chain as a strategic competitive factor

Semiconductors have become essential to the electronic networking of modern technologies. They are core components of smartphones, computers, and cars, and thereby crucial to end products. Lockdown measures stranded hundreds of cargo ships at Chinese ports last year, causing delays within international delivery networks. Interruptions in the supply chain bring production lines in the automotive industry to a standstill, leading to increased costs for manufacturers and up to two years waiting time for new car customers. In contrast semiconductors, as a supplier industry, recorded worldwide revenue of 556 billion US dollars in 2021, a robust increase of 26 percent over the previous year.[3]

From a competitive perspective, the resilience of a company's supply chain can be gleaned from its delivery capability. Diversification and flexibility are crucial to avoiding production bottlenecks. Various global economic upheavals have shown that prioritized delivery contracts, secure transport routes, and quality standards are decisive in competitive markets.

In addition to chips, another core component currently lacking in the automotive industry is wiring harnesses, whose production in western Ukraine has failed overnight due to the war. Their manufacture is hardly automated because it depends on individual vehicle configuration. According to the government in Kiev 38 plants, in which 22 international auto suppliers have invested a total of more than 600 million dollars, have been affected.[4] Various manufacturers have announced that plants in Ukraine will have to be shut down again due to the production stop. This pause will also be used to logistically replenish the supply chain and reinforce supply stability[5], to be guaranteed in the short term through replacement production in neighboring countries like Romania.[6]

In the long term, fundamental questions of supply chain management are arising across all industries in an uncertain world economic situation. Since essential production capacities and entire markets can nosedive without warning due to geopolitical tensions and natural disasters, it is wise to perform a risk analysis of one's own production sites and trade routes, not only from a legal but from an entrepreneurial perspective. As to mergers and acquisitions, a focus on supplier routes and a resilient supply chain sharpens the competitive edge in times of lockdowns and sanctions.

[3] Statista, Umsatz in der Halbleiterindustrie weltweit in den Jahren 1988 bis 2021, https://de.statista.com/statistik/daten/studie/150901/umfrage/umsatz-in-der-halbleiterindustrie-seit-1988-weltweit/.
[4,6] Statista, Umsatz in der Halbleiterindustrie weltweit in den Jahren 1988 bis 2021, https://de.statista.com/statistik/daten/studie/150901/umfrage/umsatz-in-der-halbleiterindustrie-seit-1988-weltweit/.
[5] The Wall Street Journal, Volkswagen Faces Production Stoppages Due to Ukraine Supply Issues, https://www.wsj.com/livecoverage/russia-ukraine-latest-news-2022-03-01/card/volkswagen-faces-production-stoppages-due-to-ukraine-supply-issues-OMeXyXL5w4F5J6bNcg9G .

Aspects of supplier due diligence

To assess the risks of a supplier, various factors must be examined. But structure and geography can make just the identification and evaluation of information a challenge. Many supply chains depend on Eastern European or Asian companies. Language and cultural factors make it difficult to assess risk exposure. External support from international networks and practical experience in the respective regions can help meet these challenges.

The Supply Chain Act focuses primarily on human rights and environmental protection. But it makes sense to go beyond these legally prescribed topics, not only to anticipate the expected tightening by the European Supply Chain Directive, but to benefit from the positive effects. Preventive consideration of other aspects of corporate governance - such as business practices and corruption - helps with preparation. In the case of deep and complex supply chains, constant review of supplier management and the suppliers selected is essential.

The original goal of supplier due diligence is identification of risks. Below we describe what should be assessed.

Production sites

The country in which the company is located significantly influences risk exposure. There are considerable differences in standards between European and Asian countries in terms of compliance with human and labor rights and environmental protection. Priorities for supplier due diligence can be selected on this basis.

Certifications and Commitments

Existing certifications must be checked. These can be classic ISO certifications for environmental management (ISO14001), energy management (ISO 50001), and for occupational health and safety management systems (ISO45001). Commitments to internationally recognized standards and norms should also be checked. These include the UN Global Compact, the International Labour Organisation (ILO) and the UN Convention on Human Rights.

As well as external concessions, internal commitments such as generally applicable regulations and codes of conduct should be examined. Their availability and coverage of human and labor rights, environmental protection, and good business practices point to cultural and internal expectations.

Companies that do a lot of business with European and American clients may also be subject to more frequent external audits or auditing by external organizations. Audit protocols can be an important source for identifying risks and gaining an impression of how a company deals with the identified weaknesses.

Communication of sustainability

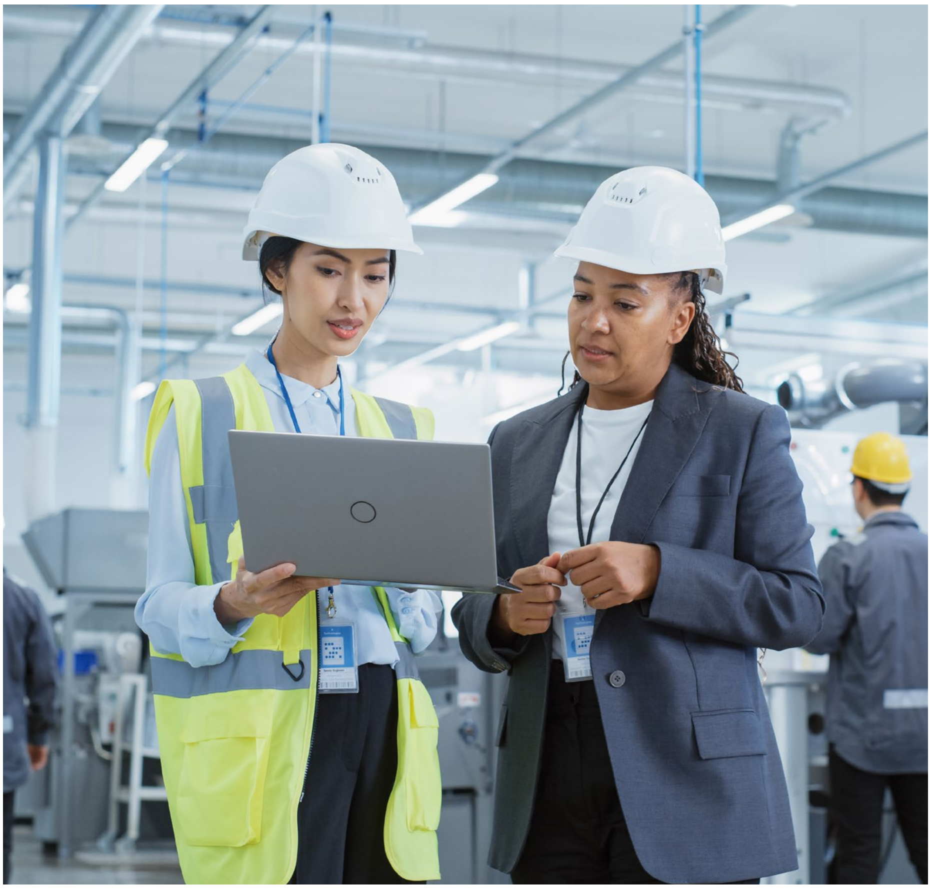
Structured sustainability reporting and otherwise communicating sustainability information, for example on the homepage, suggests that the company is already addressing these issues. While detailed sustainability reporting does not indicate the absence of risk, it provides insight into supplier priorities and current issues.

Sustainability in purchasing

As described, direct suppliers also have a significant influence on supplier structure. If Tier 1 companies have supplier codes of conduct and are compliant with environmental and social standards, taking them into account when selecting suppliers and even conducting supplier audits, for instance, the likelihood of ESG risks occurring along the supply chain are minimized. This criterion is specifically relevant to the Due Diligence Act. While the original due diligence obligations refer to direct suppliers, they can also apply to the downstream supply chain.

Previous incidents and the community

Past fines, lawsuits, and publicly documented conflicts with stakeholders can also point to how a company handles environmental, social, and governance risks. Such a track record can indicate that ESG aspects are not sufficiently considered in the corporate culture and that the company may be predisposed to similar incidents in the future.



Conclusion and outlook

In European industrial policy, transitioning to a sustainable economy places greater emphasis on the global network of supply chains. The introduction of supra-regional corporate responsibility, which includes suppliers and one's own business unit, represents a significant shift in economic policy with significant implications for companies and investors. To meet regulatory requirements, many companies will have to restructure their operations and include ESG factors in their decision-making. The Supply Chain Act, already passed in Germany, will require companies to exercise due diligence in their supply chain as early as next year. Companies that use this legal risk analysis as a competitive opportunity will have a leg up. Innovative tech and automotive companies are leading the way in showing that strategic supply chain management is essential to strong market position in uncertain times. Investment in procurement rights and secure transport routes can reduce the risk of supply bottlenecks and production stoppages. It remains to be seen whether the upcoming legal reforms will contribute to more socially- and environmentally-compatible value creation worldwide. Companies looking to take advantage of disruptive economic conditions should examine supply chains linked to transaction target for resilience and flexibility, investing in the necessary competences and resources.

Contact

Dr. Maximilian Tucher
Director
M&A Transaction Services
Tel: +49 211 8772 3066
mtucher@deloitte.de

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