2023 Brooks Case Competition

Acquisition Target Evaluation

I. Recommendation

In order to improve Principal's ESG metrics, Footprint Asset Management should be acquired at a price of $345M. In doing so, Principal will experience positive progress towards their environmental-focused investing as well as their social metrics. Footprint Asset Management is currently dominating in the areas of ethics and compliance as well as marketing and labeling. As such, this purchase will enable Principle to continue to be a global leader in sustainable business practices and ESG investing, while also gaining the assets of a company that is a financial and cultural fit.

II. ESG Strategy

Principal intends to accelerate growth in ESG investing through market share capture. As such, it is necessary to evaluate the ESG metrics of the two acquisition targets to determine their potential value to Principal's ESG goals. Principal's ESG Vision is to "help people today by advocating for security and inclusion, creating opportunities for future generations"[1].Principal's formal approach to ESG is to "grow a sustainable and secure society through long-term, responsible actions". Their three pillars of achieving these goals are through people, practices, and products and services.

The potential acquisition of Footprint Asset Management has strengths in the areas of social and governance. The significant percentage of partners at Footprint planning their retirement from the industry could be an opportunity for not only current Principal employees to advance but to also implement their own strategy with a newer workforce. Since Principal's internal financial resources state that they strive to build up their employees and offer a variety of career development resources, these management openings are not necessarily a hinderance to the transition. Additionally, Footprint has not experienced recent turnover in key positions, which is indicative of a good company culture. With the presence of many partners planning to retire after being employed 2-3 years following the acquisition, they can be a huge advantage in training who will be replacing them. That being said, a social concern is that the managers who are retiring or seeking employment elsewhere will forfeit a portion of their equity-based compensation for not joining Principal. This could potentially mean that the managers who do stay may only be doing so for the compensation.

Next, in evaluating Quant it is clear that their strength lies in the fact that they are already concerned with ESG and are looking to use their capabilities within ESG to grow and diversify their customer base and distribution channels. This aligns directly with Principal's vision for ESG. However, in the last nine months, three fund managers have left the company, two of those departed without notice for similar roles at competing firms. This could be seen as a potential hole in Quant's Social ESG sector if managers are leaving for other companies. Principal is looking to grow a sustainable and secure society so they will have to be careful of fixing the risk within the fund managers.

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[1] https://topworkplaces.com/company/the-principal-financial/desmoinesregister/

When looking at the metrics of the two targets, it is necessary to evaluate Principal's current practices. In terms of sustainable finance, the company is falling behind. Principal's approach to ESG is focused on sustainability, especially in their long-term plans. By 2035, they hope for a 40% reduction in emissions and by 2050 a 100% reduction in Emissions. Their sustainability is an area to improve on and we can see this is a part of what they want for the future. With Footprint and Quant both doing well in the Sustainable Finance sector, merging with either one would be a great start to their long-term goals. Socially, Principal was the lowest scored compared to the targets. However, they are doing well in the areas of labor & employment practices, as well as marketing & labeling. In the area of governance, Principal is leading primarily due to their executive compensation and board composition scores.

In comparison, Footprint's sustainable finance score is used to describe the effect that their firm has on the environment. Footprint's score in this category is significantly higher than both Quant and Principal. Footprint is leading ahead of Principal and quant on average in the social metric. More specifically, Footprint is dominating Ethics & Compliance as well as Marketing and Labeling. Footprint was the lowest average scoring firm in governance, yet they are not far behind. However, their low score can be attributed to a few lower outliers within executive compensation and auditing. Quant's ESG scores, while generally high, are not sufficient to justify their poor cultural or financial alignment.

III. Cultural Fit

Principal's purpose is to "foster a world where financial security is accessible to all" and the company's mission is to "help more people save enough, protect enough, and have enough". The core values of Principal are to start with the customer, do what's right, own what's next, and invest in the future.

Considering these aspects, Footprint Asset Management would be more culturally cohesive with Principal. Footprint Asset Management prioritizes "investing for good", which has been demonstrated through their expansion of ESG-focused products and investment in greener technologies. The company's unwavering dedication to ESG-focused business demonstrates a forward-thinking attitude that will allow them to adapt quickly to the necessary adjustments accompanying the acquisition process. Their intention to further develop their international funds aligns with Principal's outlook of "owning what's next". While Footprint's governance metrics are below Principal's. This can likely be solved by restructuring their board of directors and implementing an improved auditing process. Footprint Asset Management makes an effort to retain fund managers, which likely is done through positive workplace culture. The main concern culturally with the acquisition of Footprint is the loss of key personnel's equity-based compensation as they are not within sight of retirement.

Quant will likely not be culturally compatible with Principal. Quant Impact Partners is a much newer, smaller company with only 28 employees. This alone may indicate that the transition could be very manageable because of the low number of employees. However, the company has extremely high turnover rates, which could be a result of poor workplace culture. QI utilizes a "Fossil Fuel Free" investment policy, which does follow Principal's desire to meet future standards head on. That being said, Quant Impact's non ESG-focused funds do not consider ESG data points, which could lead to those funds limiting the positive impact of the company's investment decisions.

IV. Financial Analysis

The valuation of the two acquisition targets was completed through the utilization of discounted cash flows based on two different required returns. One analysis was based on cost of equity while the other was based on cost of debt. Vertical analysis was also used to evaluate the financial feasibility of each target. Both firms can liquidation concerns with Footprint having 50% liquidation and Quant having 39% liquidation. Liquidation is a sign of lack of profitability and can also be a sign of assets being worth more sold than the operating value. It also may be reflected on unmotivated management, whether as a result of a desire to retire or to cease business operations.

The overall financial evaluation was limited due to a lack of significant historical data and with there being no past forecast to compare. The bid to be offered also had to be adjusted for synergies and erosion. There is a 10% compensation synergy, 30% general and administrative synergy, and 5% shock lapse to management and advisory fees (negative) synergy. There is also only a 75% expected capture of synergy benefits. The original offer ranges following this analysis is 300M-329M for Footprint and 259M-289M for Quant. That being said, the purpose of this transaction to make improvements upon Principal's ESG metrics. MSCI studies argue that higher ESG scores can reduce the cost of capital for companies by 1.14%-10%. To allow for relatively conservative estimates, a reduction of 5% is assumed as a result of higher ESG scores, which increases the ranges to 315M – 345.45M for Footprint and 271.95M – 303.45M for Quant. As such, it would be recommended to offer $345M to acquire Footprint Asset Management.