ESG in business valuations

Does ESG play a role in valuing a business?

KPMG Cyprus

Environmental Social and Governance ("**ESG**") principles are becoming essential for successful business. Progressively, more and more stakeholders as well as providers and users of capital, seek transparency on how ESG is affecting their investments and the value of a company.

ESG standing

Opportunities for sustainable investments used to be scarce. However, today in most developed countries it is hard to find a company that does not have some degree of ESG considerations integrated in its operations. This is mainly due to the fact that during the past few years, there has been a rising pressure on companies to embrace ESG norms.

The reason behind this pressure is the increasing demand by investors for more disclosure on environmental issues like carbon emissions, as well as the ESG ratings of companies calculated, which measure a company's resilience to long-term, financially relevant ESG risks and opportunities.

Regardless of the industry, ESG ratings impact profitability as investors and the general public nowadays like to know that the companies they interact with are environmentally and socially responsible.

Investors are increasingly excluding ethically unproven companies from their considerations. The generational shift of managing family wealth also enhanced the switch to more sustainable business as younger generations are more progressive and environmentally responsible. Even during turbulent times like the recent geopolitical crisis and economic upheaval, investors are not abandoning their ESG commitments for a greener future.

"Businesses designed to create value for the society are also good businesses that manage to sustain themselves during crises."

Sarah Gillard
CEO, A Blueprint for Better Business

The Paris Agreement

In December 2015, 196 parties adopted the Paris Agreement, a legally binding international treaty setting out a global framework for limiting global warming. The agreement envisions a climate neutral world by mid-century and therefore requires all parties to start reducing their emissions the soonest possible.

The Paris Agreement works on a 5-year cycle of increasingly ambitious climate actions carried out by all countries with the target to limit global warming to well below 2 degrees Celsius, ideally to 1,5 degrees Celsius.

The Treaty has been in force since 4 November 2016 and it marks the beginning of a shift towards a net-zero emissions world.

E Environmental disasters are becoming more prevalent and damaging to ignore

S Social unrest is compelling businesses to take seriously issues important to their personnel and other stakeholders

G Governance structures of every industry are remarkably challenged by the Covid-19 outbreak incurred in 2019

Investors concerns regarding ESG

ESG has become a framework for investors in assessing the following fundamental demands which can be leading indicators of financial performance:

1. Does the company have a resilient business model which can overcome threats in regards to climate changes and regulations?
2. Are the social practices and policies of the company optimised to appeal and retain customers and human capital?
3. Is the governance in place capable of sustaining any emerging risks or unforeseen challenges that undoubtedly exist beyond near term line of sight?

A provider of capital, an investor, would like to know how to include ESG in their investment decisions, and a user of capital (e.g. a corporation) would like to know how the value of the company is affected if they are more socially and environmentally responsible.

Recently, there has been a wider adoption of ESG frameworks by several organisations including the CFA Institute, the Royal Institution of Chartered Surveyors, the International Valuation Standards Council and the European Financial Reporting Advisory Group.

The main purpose is to provide investors with a greater transparency and comparability and to assist asset managers in communicating clearly the ESG-related features of their investment products. In addition, the ESG framework adoption aims to enhance the relevance, reliability and comparability of non-financial information disclosed.

Despite the fact that there are currently no consistent rating measures for ESG, there are several rating providers such as the MSCI and Sustainalytics which measure businesses against various ESG criteria in aim to promote environmental accountability and encourage the development of sustainable business practices and technologies. Furthermore, big credit rating agencies such as Moody's, Fitch, Standard & Poor's as well as Bloomberg have also incorporated ESG into their credit rating methodologies signifying the importance of ESG in business valuations.

ESG in business valuation frameworks

It is widely supported that a relationship between ESG and financial performance indeed exists. When assessing value, especially the long-term financial viability and sustainability of a business, ESG represents a multitude of factors. Considering the importance of the role of valuers in the efficient capital allocation process, it is advisable for ESG frameworks to be adopted in the valuation profession in aim to reflect investors' considerations more prudently.

To account for ESG factors in business valuations based on market methods like the relative approach, in other words "comparable companies" and "transactions" approaches, valuers need to firstly identify and asses the applicable ESG criteria of the comparable companies and industry. Then, they should assess the performance of the company under valuation in relation to those criteria and finally adjust the market multiples used for the valuation such as EBITDA multiples, to reflect the performance, as compared to the comparable companies in the market.

Regarding the economic methods used in business valuations such as the income approach, it is also deemed necessary to carry out similar adjustments when comparing the characteristics and the performance of the company under valuation with other comparable companies in the industry. For example, when including a risk premium in the discount rate to account for size, volatility of revenue and earning of the company under valuation, an additional risk premium may be supported to account for the risk of elaboration of ESG factors from larger public companies. Another example is the sufficient identification of comparable companies to reliably estimate the CAPM (e.g. beta). ESG characteristics may need to be added for comparable company identification and screening. Last but not least, when projecting cashflows, it is essential to recognise the ESG factors affecting business and operational factors as not all companies have the necessary structure to overcome or limit future risks and drive long-term sustainable growth. It is suggested that for low-performing ESG companies, a long-term rate of decline, instead of growth, may be more appropriate.

In overall, many studies support that companies' ESG position has a positive impact on their valuation and performance. This is through both the systematic risk inputs used for the valuation, like higher valuation multiples and lower cost of capital and through their unsystematic risk profile, like higher profitability and lower exposure to risk. On the contrary, the ignorance of ESG when valuing a business may have significant financial implications.

Potential valuation implications

1. Asset impairment, including goodwill
2. Changes in the useful life of assets
3. Changes in the fair valuation of assets
4. Effects on impairment calculations due to increased costs or reduced demand
5. Changes in onerous contracts provisions due to increased costs or reduced demand
6. Changes in provisions and contingent liabilities arising from fines and penalties
7. Changes in expected credit losses for loans and other financial assets
8. Impact on real estate valuations, for example green certificates for buildings

Final thoughts

Being an affiliate member of an organisation which is a global signatory to the United Nations Global Compact and adoptee of the Global Goals for Sustainable Development, I believe it is essential for leaders to reframe purpose as an indispensable way of enhancing business resilience and value. This was witnessed during the pandemic by altruistic businesses and eventually proven effective.

The implementation of a comprehensive ESG approach in business through sustainable principles in addition to the reduction of carbon emissions is becoming paramount as it does not only add value for businesses but also reflects the values, ethics and integrity of a business and its associated personnel.

To conclude and as evidence suggests, ESG represent fundamental considerations to inform valuation analysis as ESG factors are positively affecting long-term growth rates and are highly interrelated to long-term survivorship likelihoods. Consequently, it is critical to incorporate ESG considerations into valuation practice and enhance the relevance and sustainability of the profession.

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Sources:

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