KPMG

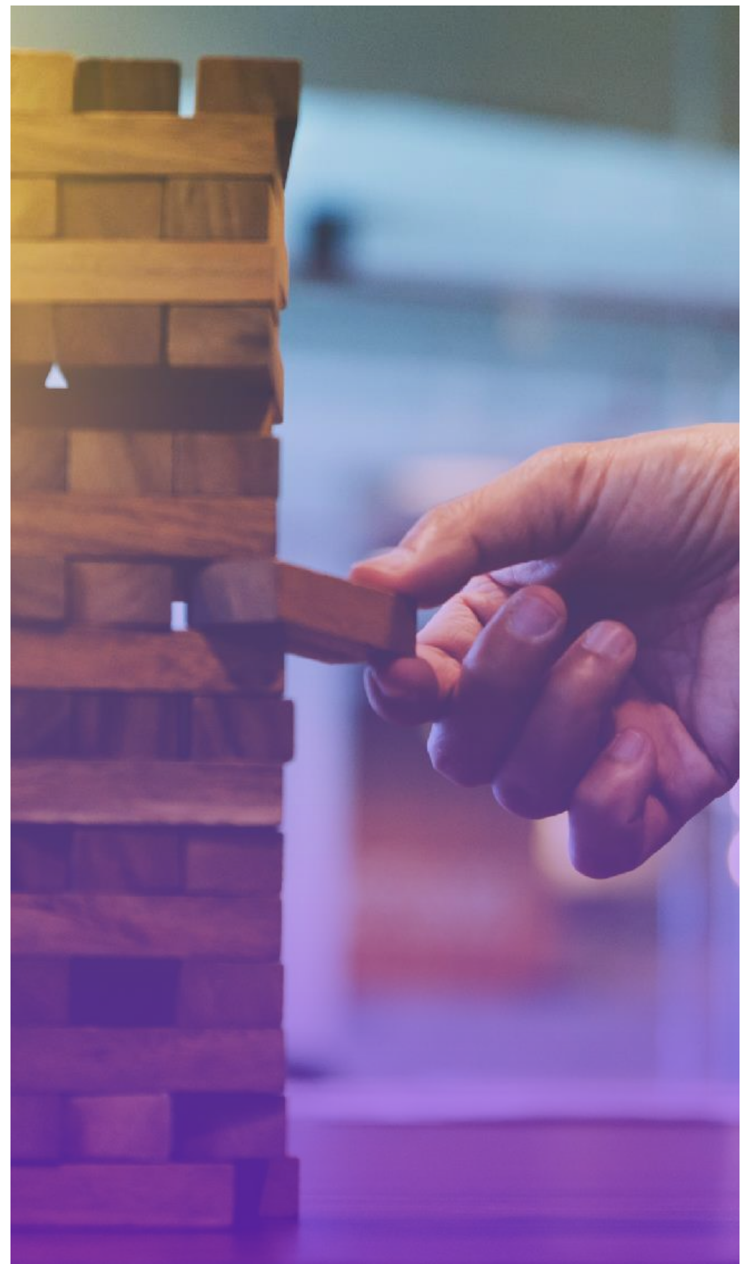
ESG as the new paradigm in business valuations

Why is ESG consideration important in businesses valuations?

The incorporation of environmental, social, and governance (ESG) factors in companies' business models, partially because of the growing pressure from stakeholders and partially driven by looming regulatory initiatives, is profoundly changing the perspectives of companies.

Depending on the industry sector, it implies major strategic inflections and structuring evolutions of the business models. It is also prompting a more integrated approach to measure the value creation by considering both the financial and nonfinancial performance impact of ESG. Regulatory initiatives are also driving a change by calling on companies to integrate the principle of "sustainability" more widely into their activities so that they are more respectful of the environment, concerned about social well-being, and operate with the best standards of governance.

This new paradigm requires a different perspective on the value drivers of companies and, consequently, on their long-term value creation potential. Executives are therefore encouraged to broaden their vision of risks and opportunities by taking ESG factors more explicitly into account in their business planning.



© 2022 KPMG Caricom, a St. Lucia company limited by shares and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee.

ESG: what does it mean?

ESG means using Environmental, Social and Governance factors to evaluate companies on how far advanced they are with sustainability.

Environmental factors include the contribution that a company or government makes to climate change through greenhouse gas emissions, along with waste management and energy efficiency. Given renewed efforts to combat global warming, cutting emissions and decarbonizing are becoming more important.

Social factors include human rights, labor standards in the supply chain, any exposure to illegal child labor, and more routine issues such as adherence to workplace health and safety. A company's performance on social factors also rises if a company is well integrated with its local community and therefore has a 'social license' to operate with consent.

Governance refers to a set of rules or principles defining rights, responsibilities and expectations between different stakeholders in the governance of corporations. A well-defined corporate governance system can be used to balance or align interests between stakeholders and can work as a tool to support a company's long-term strategy.

The E of ESG, specifically, climate change, has become the most pressing factors, surpassing other ESG factors. Climate change is expected to influence the course of businesses, forcing changes in behavior and implementation of regulatory standards over time. From an organization's point of view, climate change will impact value from many directions:

Investor and lender behavior: Companies that are highly exposed to climate-related risks may face higher financing costs or greater financial constraints, as investors or lenders integrate climate-related risks into their investment or lending decisions.

Government policies and legislation: the introduction of new climate-related policies or legislation may affect a company's revenues or operating costs.

Customer and supplier behavior: customer preferences may shift more intensively towards "green" products and services. A company's cost structure may also change as a result of the impact of climate change on its suppliers; for example, suppliers may pass on increased costs to the supply chain.

Technological developments: Emerging green technologies can significantly affect a company's competitiveness and lead to higher capital expenditure to develop or acquire equivalent technology.

Physical impacts: the physical impacts of climate change, such as rising temperatures and an increase in the frequency and severity of extreme weather events, may lead to increased insurance or maintenance costs, or even limit the suitability of current operating locations.

© 2022 KPMG Caricom, a St. Lucia company limited by shares and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee.

Regulatory developments are giving a big push to the incorporation of ESG in business valuations

A variety of regulatory and nonregulatory bodies release guidance and standards on ESG reporting. These initiatives promote the transparency and consistency of corporate disclosures. It aims to set up common frameworks and to provide better information to assess the risks and opportunities related to ESG factors.

In the meantime, companies are adapting their disclosures and, in some instances, developing their own tools in order to meet the regulatory requirements and stakeholders' expectations. These disclosures help investors make informed decisions and encourage the incorporation of ESG factors in company valuations.

Global Reporting Initiative
Founded in Boston in 1997 to create the first accountability mechanism to ensure companies adhere to responsible environmental conduct principles.

1997

Sustainability Accounting Standards Board
Independent nonprofit organization that sets standards to guide the disclosure of financially material sustainability information by companies to their investors.

Jul 2011

Integrated Reporting Framework
Created by the International Integrated Reporting Council (IIRC) to bring together material information about an organization's strategy, governance, performance and prospects in a way that reflects the commercial, social and environmental context within which it operates.

Apr 2013

Non-Financial Reporting Directive (NFRD)
EU Regulation that requires large (500+ employees) listed companies to report on their key impacts and risks from ESG.

Oct 2014

Task Force on Climate-Related Financial Disclosure (TCFD)
The TCFD released climate-related financial disclosure recommendations designed to help companies provide better information to support informed capital allocation.

Jun 2017

EU Taxonomy for Sustainable Activities
Classification system establishing a list of environmentally sustainable economic activities to create a clear definition of what is considered "sustainable".

Jul 2020

Mar 2021

Sustainable Finance Disclosure Regulation (SFDR)
Imposes mandatory ESG disclosure obligations for asset managers and other financial markets participants with substantive provisions of the regulation.

Apr 2021

Corporate Sustainability Reporting Directive (CSRD)
Enhances the scope of NFRD to cover all large undertakings (250+ employees), as well as all SMEs listed on EU regulated markets, and further clarifying the nonfinancial information that entities should report under European Sustainability Reporting Standards (ESRS).

Jun 2021

Value Reporting Foundation (VRF)
The IIRC and the SASB officially merge to form the VRF.

Nov 2021

International Sustainability Standards Board
Formed to deliver a comprehensive global baseline of sustainability-related disclosure standards.

May 2022

The US SEC's Enhancement and Standardization of Climate-Related Disclosures for Investors
Requires registrants to include certain climate-related disclosures in their registration statements and periodic reports and certain climate-related financial statement metrics in a note to their audited financial statements.

International Frameworks | European Regulation

© 2022 KPMG Caricom, a St. Lucia company limited by shares and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee.

How can ESG factors be incorporated into business valuations?

KPMG has developed a valuation framework for the incorporation of ESG factors in business valuations. This framework is based on the discounted cash flow (DCF) method in which the expected impact of ESG factors on the forecasted cash flows of a company is explicitly incorporated.

The incorporation of ESG factors into business plans, and therefore into free cash flow projections, should be based on reasonable and supportable assumptions. These assumptions represent management's best estimate of future economic conditions and regulatory developments, and may affect revenues, costs, investments or other cash flow items.

The materiality of certain ESG factors is specific to the company and the industry it operates in. The ESG risks and opportunities must therefore be assessed on a case-by-case basis and may require adjustments either to cash flows or the discount rate.

Given the potentially subjective nature of the size and likelihood of the ESG-related adjustments to the 'base case' cash flows, the preferred approach is to determine scenarios based on materiality and i) determine ranges for the ESG adjustments, ii) set probabilities, and iii) run a Monte-Carlo simulation.

In line with our common valuation approach, trading (and transaction) multiples will be applied as a sanity check on the valuation outcome based on the DCF method. In the application of market multiples, leveraging ESG ratings provided by rating agencies, we will incorporate premiums/discounts in order to reflect the relative ESG position of the business vis-à-vis the peer group.

Valuation Approach

Value

Define the value drivers of a business
Develop an understanding of the operational, investing, and financing activities of the business.

Identify

Identify ESG risks and opportunities
Use the SASB materiality matrix to identify the ESG factors relevant to the business.

Prioritize

Prioritize and match the ESG factors to key value-drivers based on materiality maps and other considerations (qualitative exercise)
Match the ESG factors to revenues, costs, and investments based on information from management inputs, SASB matrix, ESG due diligence report(s), amongst others.

Quality

Quantify the impact of ESG factors on key value drivers (quantitative exercise)
Seek information from client inputs (if-then analysis), industry/peer group benchmarking and input from sustainability teams.

Adjust

Adjust the discount rate
Determine if ESG factors are already factored in the discount rate and cash flows; if not, the application of discount/premiums can be considered though it is not a preferred approach.

Determine

Determine scenarios based on materiality
Attach probabilities and weightings to the various ESG scenarios based on materiality by using Monte Carlo simulation tools.

Perform

Perform sanity checks based on capital market insights
Apply discounts/premiums to market multiples based on the relative ESG position of the business vis-à-vis the peer group.

© 2022 KPMG Caricom, a St. Lucia company limited by shares and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee.

How KPMG can support you

KPMG firms know the power of ESG to transform your business. KPMG ESG Advisory can show you how to enhance trust, mitigate risk and unlock new value as you build a sustainable future.

KPMG ESG Advisory's solutions are both holistic and practical. They can guide your teams to drive sustainable innovation across your business and help you gain a competitive edge. With deep experience across critical issues—including climate change, decarbonization, ethical supply chain, circular economy, DEI (diversity, equity and inclusion), governance, ESG reporting and measurement—KPMG professionals help you create the right blueprint for your ESG journey. A blueprint that simplifies your strategy, guides its full implementation, and enables you to manage and report on your ESG journey.

KPMG professionals can go beyond strategy, working with you side-by-side at each step of your ESG transformation. With our industry-leading experience, data-driven technology and global alliances, you can turn insight into opportunity for your business, your people and our planet. Because how you grow matters.

The ESG team comprises transformation, measurement, and reporting specialists. They can help you:

Assess and design your ESG strategy.

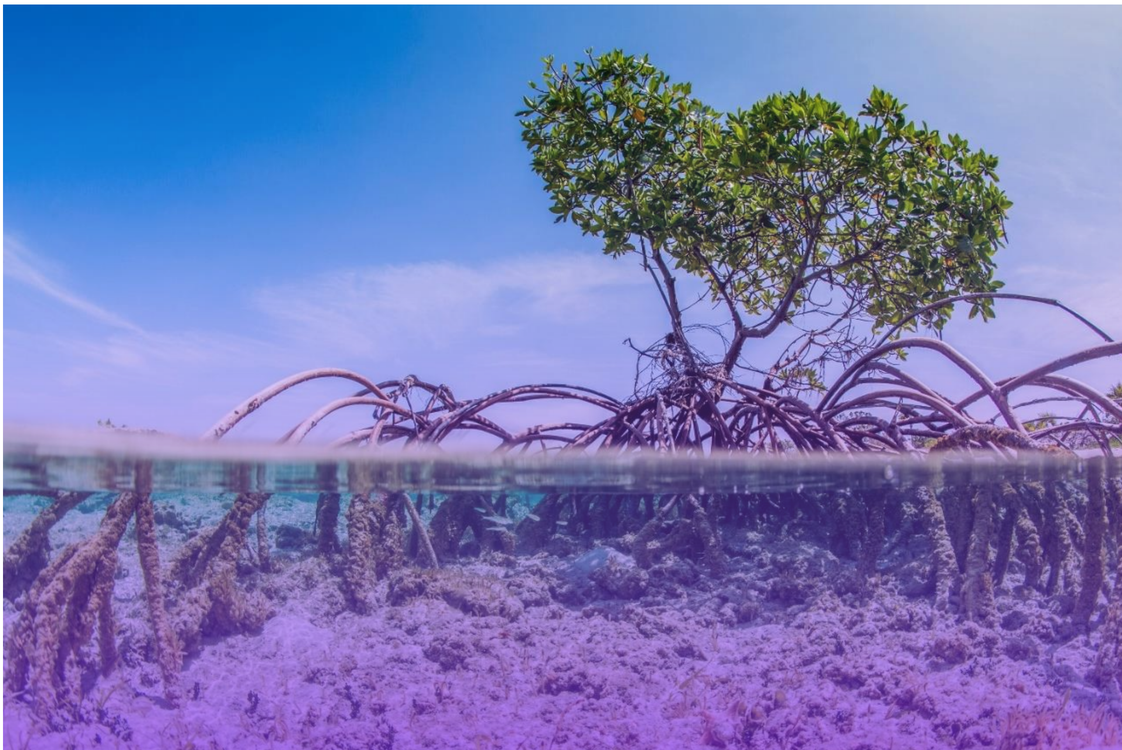
Measure progress and tell your ESG story.

Embed ESG across your operations.

Make future steps transformational.

KPMG firms have designed their services to put ESG at the core of your operations—where it should be.

Our valuations specialists can support you with the valuation of your business through an ESG lens. Together we can help you solve complex valuation problems to facilitate strategic decision-making. We will work closely with you, while remaining objective and independent in our approach.



© 2022 KPMG Caricom, a St. Lucia company limited by shares and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee.

Contact us

Christopher Brome

Head of Deal Advisory

Hastings, Barbados

E cbrome@kpmg.bb

kpmg.com/socialmedia

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

© 2022 KPMG Caricom, a St. Lucia company limited by shares and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee.

The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

KPMG