

ESG as the new paradigm in business valuations



October 2022

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.



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 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 is 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.

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 a 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.



How can ESG factors be incorporated into business valuations?

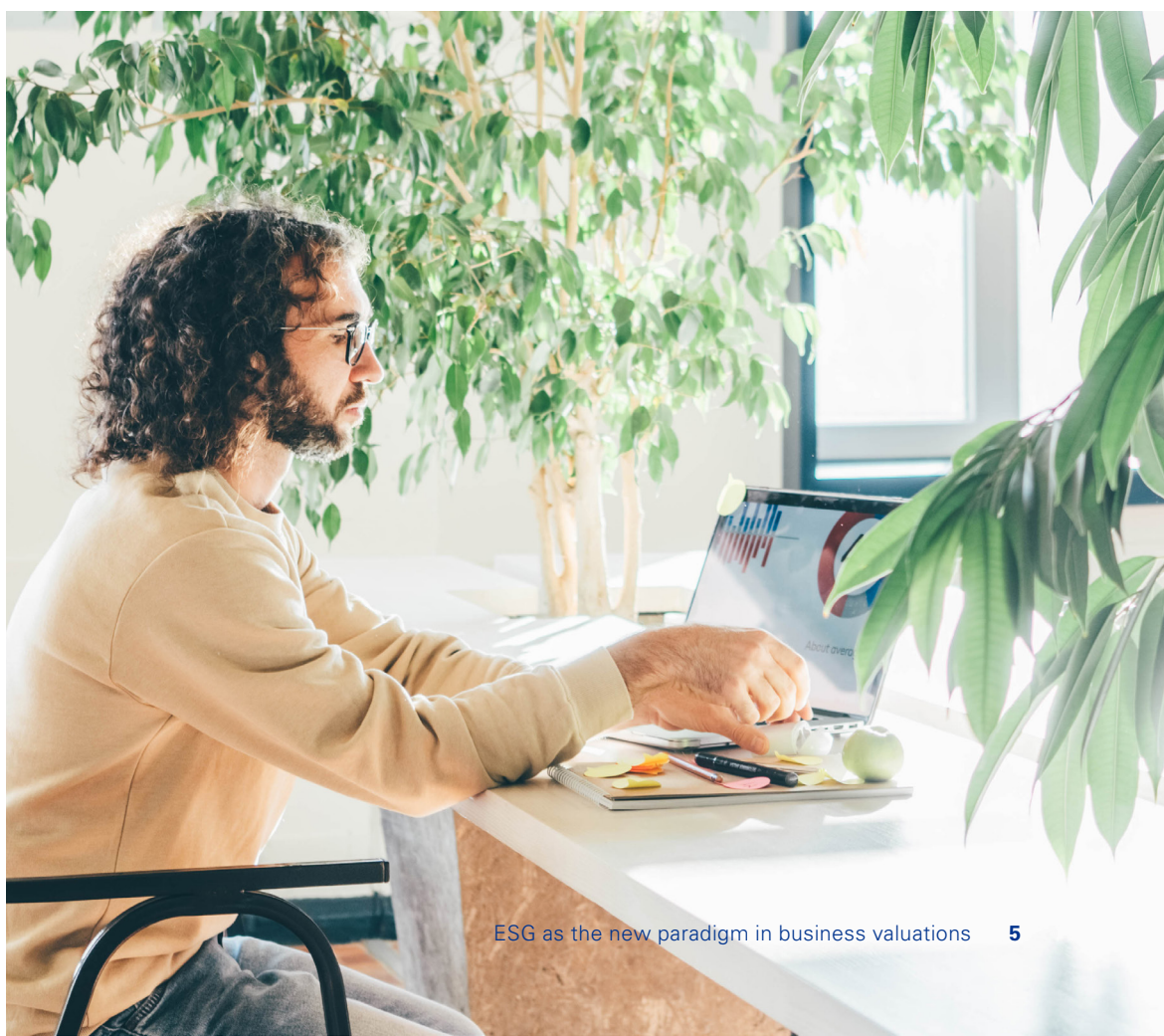
KPMG has developed a valuation framework for the incorporation of ESG factors in business valuations. This framework is based on the discounted cash flow (DCF) method in which the expected impact of ESG factors on the forecasted cash flows of a company is explicitly incorporated.

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.

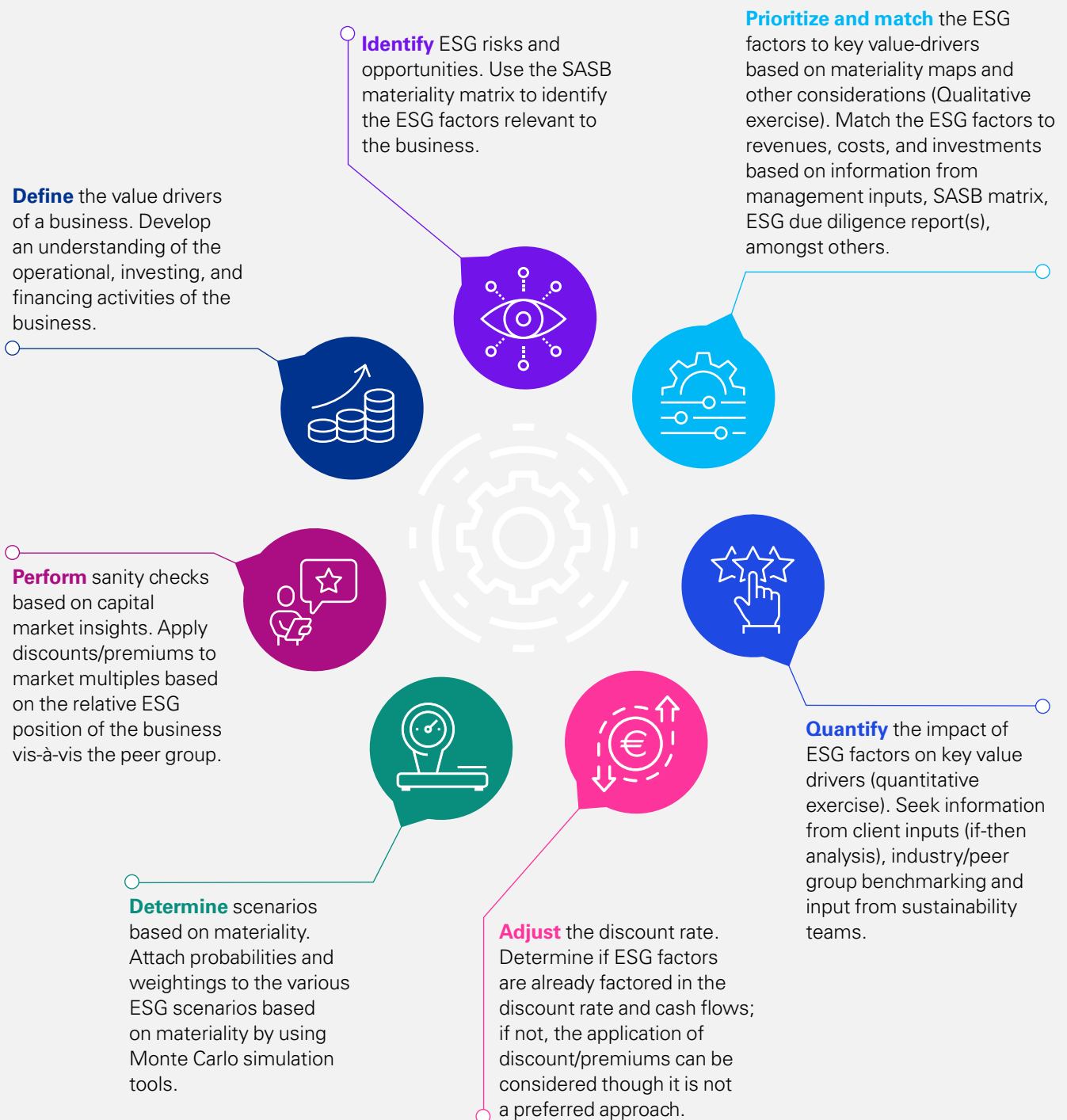
The materiality of certain ESG factors is specific to the company and the industry it operates in. The ESG risks and opportunities must therefore be assessed on a case-by-case basis and may require adjustments either to cash flows or the discount rate.

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 scenario's 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



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.

Some or all of the services described herein may not be permissible for KPMG audit clients and their affiliates or related entities.

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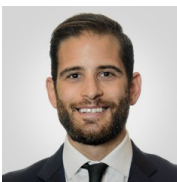
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