Quarterly Brief

Building an ESG lens into business valuations

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Dear reader

Not only has COVID-19 exposed the fragility of our global economic and social systems while the global climate crisis escalates, it has also accelerated existing trends in various areas in an unexpected and, in many cases, constructive way. An illustration of this is the remarkable increase in awareness of ESG (environmental, social and governance) in recent months in the public forum, private sector, and finance.

A new peak has been reached through a combination of progressive change in consumer behavior towards sustainable products and services, investor demand for financial assets with positive ESG factors, and actions by governments to support sustainable businesses and finance, in particular in light of pandemic-related stimulus programs. These factors positively reinforce each other to create exponential growth in momentum.

While the introduction of ESG to portfolio and investment decision-making has been accelerating, the challenge of how to properly reflect ESG in financial valuations remains a largely unexplored area in academia and practice. This edition of our newsletter suggests an approach to viewing business valuations through an ESG lens.

We undoubtedly recognize that ESG-related questions do not solely address the long-term value creation for companies' shareholders but rather the holistic value impact beyond the bounds of financial considerations, for all stakeholders, i.e. the global society. However, in the pages that follow, we focus on business value as a core decision indicator for management.

We are grateful to our colleagues from KPMG in the Netherlands, Sander Mulder, Deeptha Venkatanarayanan and Rudolf Stegink who contributed significantly to co-authoring this newsletter.

In addition to sharing our insights into the above topic, we will as usual summarize recent key capital market data such as index performance, sector multiples, risk free rates, as well as country risk premiums and growth rates for selected markets. This analysis can be found in the final section of this Quarterly Brief.

We wish you health and happiness in the year ahead and look forward to discussing your questions regarding valuation trends and practices in 2021.

Yours faithfully

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ESG takes center stage

ESG is no longer the distant and far-off topic that it was once thought to be. On the contrary, ESG is now having immediate effects on the world that are costly to ignore.

«Google's parent company, Alphabet, Inc., noted that rising temperatures could increase the cost of cooling its energy-hungry data centers»

«Banco Santander Brazil, said increasingly severe droughts in the region might hurt the ability of borrowers to repay loans»

«Online retail giant Boohoo found itself embroiled in scandal after a Sunday Times investigation claimed that the company had links to modern slavery. Boohoo faced a backlash from both consumers and investors following the controversy, with shares in the company dropping 46%»

«Barry Callebaut, global cocoa manufacturer, is concerned that if the industry does not commit to reducing its carbon footprint and achieve zero net deforestation in its supply chain, the ecosystem that provides chocolate ingredients will rapidly erode»

«Patagonia, global sportswear producer, ran a provocative Black Friday campaign asking customers not to buy anything in an attempt to sensitize customers to a more sustainable approach to purchasing»

«Danone, global fast-moving consumer goods (FMGC) leader, started reporting a 'carbon-adjusted' EPS evolution, an important step to start measuring carbon externalities and enable shareholders to make more informed and long-term oriented decisions»

«Shares of Beyond Meat, the plant-based burger company, skyrocketed as high as 836% just some months after its IPO as populations globally become increasingly aware of the environmental damage of meat production»

«In just a single quarter, Tesla sold regulatory credits to other less carbon-virtuous automakers for as much as USD 428 million as automakers need to comply with emission regulations»

Although sustainability or ESG are not newcomers to attention and exposure, interest in the topic has gained tremendous momentum recently. It would not surprise us if ESG emerges as the new dominant but long-term force in the economy and business decision-making, just as digitalization has become. It is apparent that stakeholders must work together to rebalance the world for the benefit of all – and to recognize that ESG is not only a question of risk, but also opportunity.

Growing awareness of ESG

The following examples are just a handful of the many that signal the skyrocketing development of ESG financing.

In 1972's 'The Limits to Growth', the Club of Rome already asserted that resource depletion meant that assumed perpetual economic growth, which until today was rarely challenged, could not continue indefinitely.[1]

Fast-forward to 2015 and the UN's Sustainable Development Goals (SDGs) combined 17 interlinked global goals around ESG topics. They are designed to achieve a better and more sustainable future for all and with the ambition to be accomplished by 2030.[2]

In his 2020 annual open letters to CEOs and clients Larry Fink, CEO of BlackRock, the world's largest asset manager, postulated "A Fundamental Reshaping of Finance" and "Sustainability as BlackRock's New Standard for Investing".[3]

In September 2020, the European Commission announced the establishment of an EU Green Bond Standard and will set a target of 30% of the 'Next Generation EU' recovery fund of EUR 750 billion to be raised through green bonds.[4] Johannes Hahn, commissioner for the EU budget, told the Financial Times that *"the commission is exploring the possibility to issue part of its bonds in formats that demonstrate its commitment to sustainable finance – including social and or green bonds."*[5]

The price of EU carbon credits/ European Union Allowance (EUA) futures rose 335% over the past five years.[6]

Moody's forecast in November 2020 that total sustainable bond issuance globally could approach USD 425 billion in 2020, up from less than USD 1 billion a decade ago. Sustainable bonds accounted for 6% of global debt issuance in the third quarter of 2020, also a new quarterly record. Sustainable bond issuance amounted to USD 288 billion for the first nine months of the year, 24% higher than the same period of 2019.[7]

'If you cannot measure it, you cannot improve it'

This famous quote by Peter Drucker, who is often described as the founder of modern management, also rings true for ESG. While the examples described demonstrate a genuine and expanding global financial impact, we suspect the quantification of ESG's impact is not yet properly measured. For example, the low likelihood that corporate balance sheets fully reflect physical climate risks or climate transition risks (see box for more explanations) cannot be ignored, but how should this be captured?

In addition, some sellers of financial assets have become acutely aware that if they 'dress up' their sale with green labelling or ESG certificates, their assets may attract higher prices despite a lack of substantiation or transparent quantification of the expected higher returns. As we know, while price is a function of supply and demand, financial asset value is a function of expected cash flows, growth and risks (i.e. volatility).

For over a decade, a common debate within ESG investing revolves around the question of whether incorporating ESG factors into the investment process would hurt asset performance. Some studies suggest that companies with robust ESG practices exhibit a lower cost of capital, lower volatility, and fewer instances of bribery, corruption and fraud. Conversely, studies have shown that companies that perform poorly on ESG have a higher cost of capital, higher volatility due to controversies and other

Physical climate risks such as rising temperatures, flooding, drought, sea level rise and water scarcity – are already being felt globally, and the associated financial losses (both insured and uninsured) have significantly increased in recent years.[8]

Climate transition risk: A sudden and disorderly transition to a low carbon economy will financially impact investment portfolios. Transition risks include policy changes, carbon taxes, reputational impacts, and shifts in markets and technology. These will vary across geographies, sectors, time and according to commitments to limit global temperature rises.[9]

incidents such as labor strikes, fraud, environmental pollutions, and accounting or other governance irregularities.[10] Despite the age of these studies, we are not aware of any common approach regarding how to systematically factor ESG into financial valuations of specific target businesses.

A fundamental problem is the lack of commonly accepted uniform standards on how to measure the financial impact of certain ESG factors. Various scoring models have been developed in order to select companies with a positive ESG impact on a relative basis to its peers for respective investment portfolios, but further work is needed to achieve a uniform set of such criteria. To sensibly include ESG considerations into a business valuation analysis, is it necessary to stand by and wait for such globally accepted standards? We do not believe so.

In the following pages, we describe the ways in which the outside-in impact of ESG factors on the prospects of businesses could be reflected in the cash flows and discount rate estimations to perform business valuations, as it is imperative for investors and management to assess the value drivers of businesses through not just a financial lens but also an ESG lens.

Traditional Way

Business valuations based on market and industry forces with a financial lens **only**

New Way

Business valuations based on market and industry forces with a financial **and ESG** lens

Encouraged by the substantial momentum of ESG, we would like to motivate business leaders, investors and the corporate finance community to consider more sophisticated solutions to quantify the impacts of ESG on value.

Projecting the power of positive impact

Objectively quantifying the impact of ESG on value

In 2015, German car manufacturers came under fire for admitting that defective devices were installed in their vehicles and that they misguided emissions test authorities. 'Diesel gate' raised a number of questions about management practices of the companies involved. These companies faced recalls of hundreds of thousands of vehicles, leading to massive additional cost.[11] As a consequence, the market capitalizations of these car manufacturers declined significantly.[12]

The scandal highlighted the apparent failure of investors' and analysts' valuation models to capture the full range of risk posed by ESG factors. Valuation models are generally based on, or heavily consider, the most commonly used valuation method, the discounted cash flow (DCF) method. Under this method, the free cash flows of a business are often forecast into perpetuity. These cash flows are then discounted at a rate equivalent to the expected cost of capital of the business (reflecting the risks related to these cash flows) consisting of both the cost of debt financing to the company as well as the expected return of equity investors in the company, or the cost of equity, both weighted by a target capital structure.

Typical cash flow drivers are analyzed to perform business valuations; these are expected sales growth, development of profitability, and further capital investment, among others. Historically, these cash flow drivers have often been determined from a direct financial and economic point of view. For example, sales growth was typically assessed in relation to expected industry growth, development of product or services lines, market penetration, market share, etc. Profit margins were considered based on various factors such as the expected development of production costs, supply chain relations and exchange rate fluctuations. Investment levels were determined based on expected asset base level which would be required to grow and sustain future sales. Management prepare budgets and long-term forecasts based on such assessments.

Management is expanding its view of the periphery of risks and opportunities, especially those associated with ESG factors

ESG factors are generally considered to be relatively novel and were historically not explicitly analyzed. Due to the recent visible impacts of climate change, however, we observe management being keen to incorporate the impact of climate change in their budgeting process. In this context, the Task Force on Climate-related Financial Disclosures (TCFD) has provided recommendations for companies to conduct and include climate change related scenario analyses in their financial statement disclosures.[13]

The TCFD has recommended these measures to ensure that management considers risks and opportunities through an ESG lens with respect to climate change and its impact on market and industry forces. From our interactions with management, however, there seems to be considerable ambiguity exists regarding how to reflect risks and opportunities related not only to climate change but also to social and governance-related factors (ESG factors).

ESG factors in cash flows or the discount rate?

Investors and management often attempt to include ESG-related risks in the discount rate by including a premium in the case of high ESG risk. Although this approach is regarded as more expedient, we favor including ESG risks in a more explicit manner as cash flow adjustments. This approach makes the impact of a material ESG factor or factors on cash flow both transparent and measurable.

How to incorporate ESG in cash flows

Below are examples of how cash flow drivers could be determined through an ESG lens:

– The 'E' of the ESG lens: One TCFD recommendation is to incorporate the '2 degree' scenario[14] (a scenario under which the earth's temperature has risen more than 2 degrees Celsius above pre-industrial levels) analysis. This would be a way of reflecting additional risk associated with climate change or severe weather events in the future. For example, beverage companies could assess the impact on cost and investment in water utilization under a '2 degree' scenario. Another example could be for companies across industries to consider the impact on their business of the introduction of carbon pricing, i.e. embodied energy.
– The 'S' of the ESG lens: An example of capturing the impact of poor social measures is the impact on revenue and cost-related contributors to cash flow due to employee unrest in industries such as the garment industry[15], known for poor labor conditions and health

   and safety issues. In such cases, unexpected costs could be incurred to satisfy the workforce's compensation or safety-related demands, where not addressing them could result in a huge reduction in product sales in light of reputational issues.
- The 'G' of the ESG lens: Weak corporate governance policies could impact cash flows in the form of fines/increased taxation imposed by regulatory authorities. Higher taxes were imposed on Google by the European Commission due to perceived unethical business practices, for example.[16] The imposition of fines or higher taxes could therefore have a negative cash flow impact where it is concluded that insufficient measures have been put in place by tech companies to mitigate regulatory authorities' concerns.

Materiality of individual ESG factors would be industry and company-specific, assessed on a case-by-case basis

Corporate management has raised concerns with us regarding how to carry out ESG-related adjustments given ambiguities in determining future cash flows. Our view is that ambiguity could be avoided by showing explicit ESG adjustments associated with individual value drivers. The table below provides a simplified example, purely for illustrative purposes, on how ESG factors could be translated into cash flow adjustments:

	Cash flow items	Values	ESG adjustments	ESG factors
	Operational revenues	**1,000**		
Less:	Decrease in operational revenues	(200)	Reduced sales due to social backlash associated with bad reputation caused by poor employee work conditions	S – Social
	ESG revenues	**800**		
Less:	Operational costs	(300)		
	Operational EBIT	**500**		
Less:	Operational taxes	(100)		
	Operational NOPLAT	**400**		
Less:	Additional taxes	(40)	Additional tax payments due to fines imposed by regulatory authorities	G – Governance
	ESG NOPLAT	**360**		
Add:	Depreciation and amortization	100		
Less:	Regular Capex and NWC	(150)		
Less:	Additional Capex	(50)	Additional investments to mitigate the impact of the '2 degree' scenario	E – Environmental
	ESG free cash flow	**260**		

EBIT = Earnings before interest and taxes, NOPLAT = Net operating profit less adjusted taxes, Capex = Capital expenditures, NWC = Net working capital

Presenting adjustments in this manner could help management and investors avoid ambiguity surrounding the positive or negative impact of ESG-related issues on the company's future cash flows. This would help focus attention on the company's relevant material ESG issues.

How to incorporate ESG in discount rates

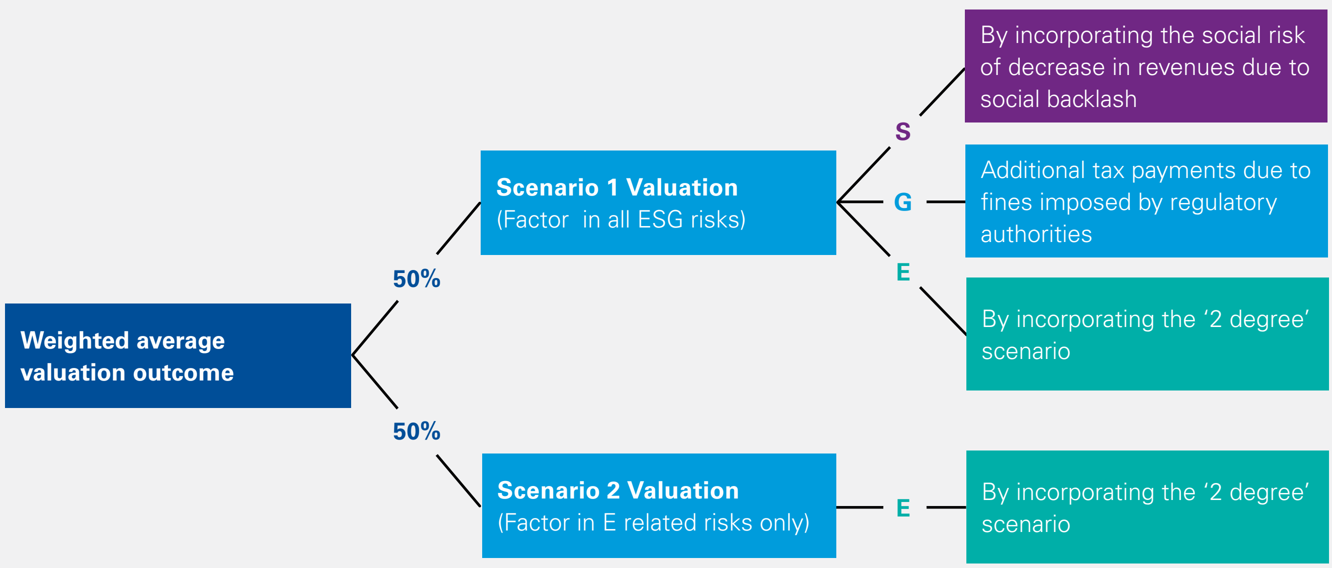
Care should be taken to avoid double-counting risk (and opportunities) in the discount rate. This is especially the case in industries that are generally impacted by ESG factors, such as the automotive industry such as due to the emergence of hybrid and electric vehicle competitors. In these cases, it could be argued that the industry beta (a measure of risk) partly includes this E(SG) risk. One should therefore be alert when applying additional downward adjustments to cash flows due to the negative 'E' impact, as such a risk may already be partially imbedded in the industry beta.

Incorporating additional premia or discounts in the discount rate should be considered thoughtfully and meticulously in conjunction with industry and company-specific characteristics and ESG adjustments in cash flows.

Seeking to circumvent ESG's subjectivity

Considering the inherent subjectivity of ESG adjustments as well as the assessment of their materiality and proper application in the cash flows and/or discount rate, such adjustments could be applied considering 1) the varying degree of significance of the adjustment, 2) under varying scenarios wherein each scenario reflects the impact of a particular ESG factor on the business. The final valuation result could be a probability-weighted scenario where probabilities and weightings are attached to the various ESG scenarios based on materiality. Although internal assessment can yield meaningful materiality considerations, the materiality of ESG factors can also be demonstrated within a company's social media feeds, driven by market sentiment of ESG risks and opportunities associated with the company. Alternatively, many standard guidelines can be considered in relation to the materiality assessment of ESG factors for a specific company or industry. Assessment of the weighted average valuation results could be further enhanced by the use of innovations such as big data, artificial intelligence and predictive forecasting tools using smart algorithms.

Here is an overview of an illustrative derivation of a weighted average outcome:



Note: For simplified illustrative purposes. In reality, multiple scenarios could be constructed with varying degrees of probability. Probabilities will be subjective in nature based on materiality assessment of the various ESG factors.

Business valuation outcomes not only reflect their quantitative financial figure inputs but, with comparable emphasis, also the valuation story which is the glue connecting the numbers in a cohesive and symbiotic manner. Considering novel and expanding views with respect to risk and opportunity, looking at industry developments and market forces through an ESG lens as well as a financial lens is key to avoiding the pitfalls of risk assessment for valuations.

Engaging the right experts to deal with such complexity

KPMG Valuation Services helps a large number of clients assess the ESG impact on cash flows and the discount rate (including ensuring there is no double-counting) and assign probabilities to various ESG impact scenarios to arrive at a weighted-scenario outcome. Our services are provided in conjunction with those of KPMG Sustainability. See also KPMG IMPACT – KPMG Global (home.kpmg) for our expertise in building a more sustainable and resilient future.

Together, we support you in complex valuation issues to facilitate strategic decision-making. We work closely with you while remaining objective and independent in our approach. Our valuation experts have deep sector knowledge, with colleagues fully dedicated to a number of specific sectors such as Energy & Natural Resources, Real Estate and Financial Services.

Capital market data

In this section, we provide a selection of key financial market data covering:

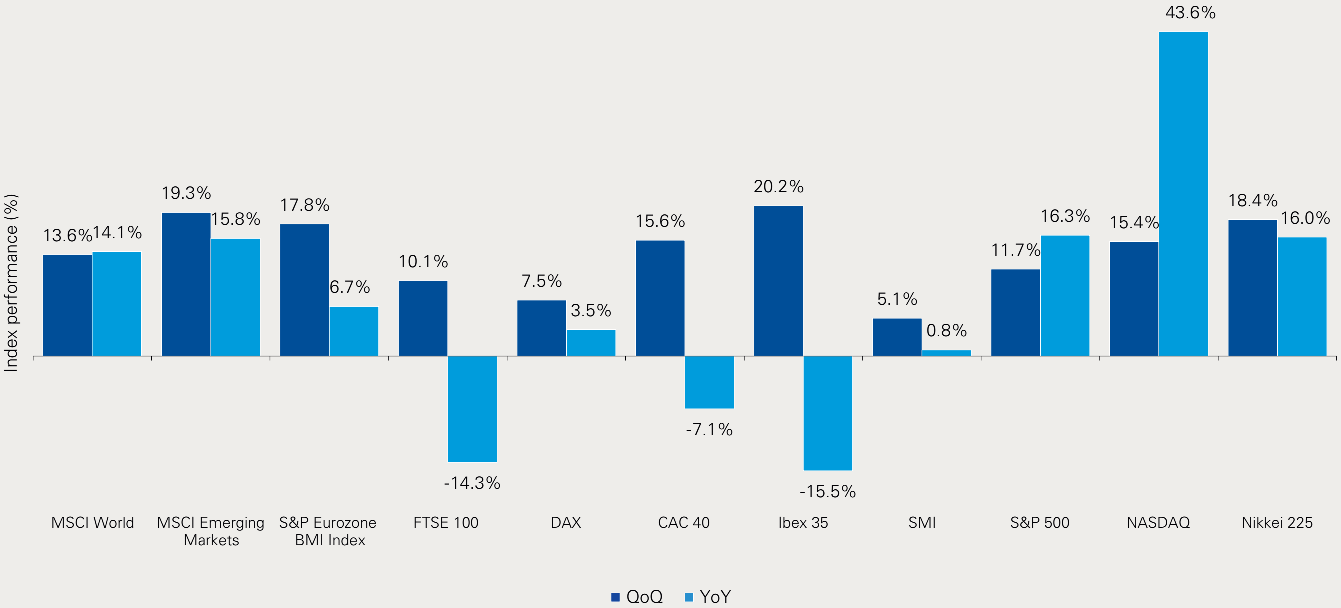
- Comparison of major stock market performance for the 12 months ending 31 December 2020
- S&P Eurozone BMI Index sector multiples
- Risk-free rates for major currencies
- Country risk premiums and inflation forecasts for the BRIC countries

Major stock market performance: Tech outperforms all

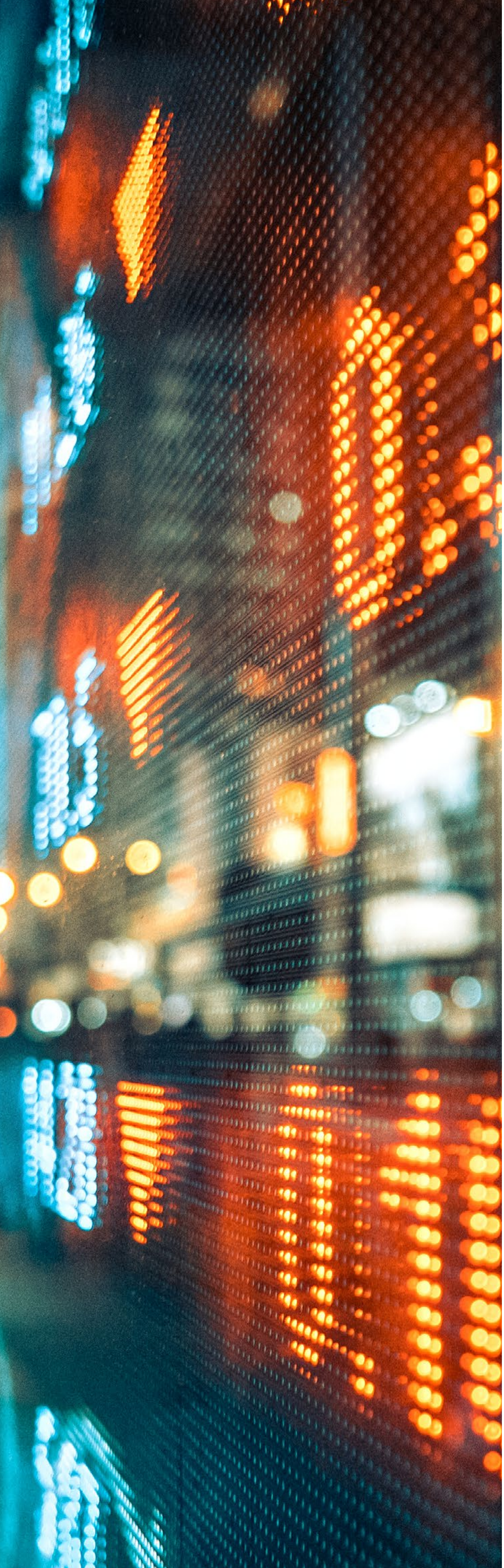
Investing in 2020 has been extremely challenging. We saw negative returns for some European indices, e.g. the FTSE 100 at -14.3% and the IBEX 35 at -15.5%. The S&P Eurozone BMI and the DAX achieved small positive returns (+6.7% and +3.5% respectively). However, the stock market showed a clear winner for 2020: NASDAQ gained more than 43%. Unequally distributed returns around the world lead to one question: Are European stocks currently undervalued and will be the winners of 2021? Or do they better reflect the risks ahead of us?

Performance of leading indices

31 December 2020 - 31 December 2020



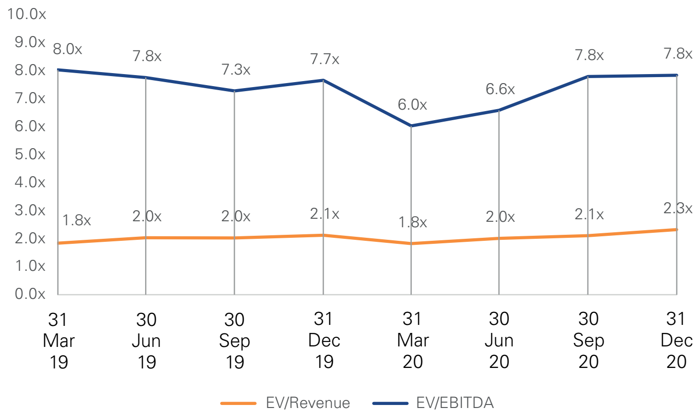
Source: Capital IQ, KPMG analysis



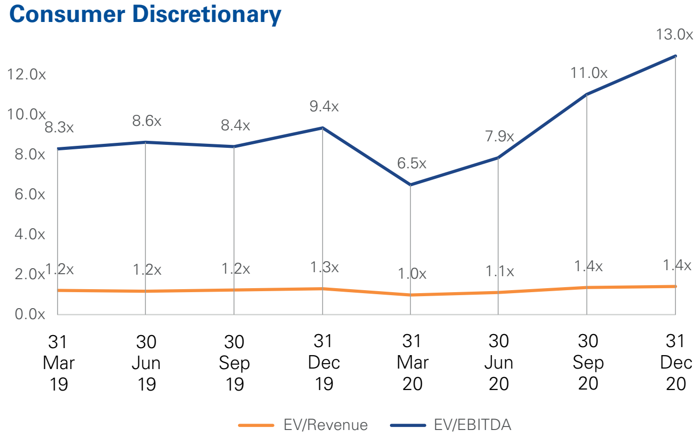
S&P Eurozone BMI Index sector multiples: Surprising underperformer over past 12 month

Over the past three months, EV/EBITDA multiples increased for 10 out of 11 sectors. Only the sector multiple for Communication Service remained stable at 7.8x compared to the previous quarter. The largest increases in EV/EBITDA multiples in absolute terms was seen in Industrials (+2.2x) and Consumer Discretionary (+3.6x). Only two EV/EBITDA sector multiples have fallen since December 2019: Consumer Staples (- 1.3x), and, which might come as a surprise, Health Care (- 0.9x).

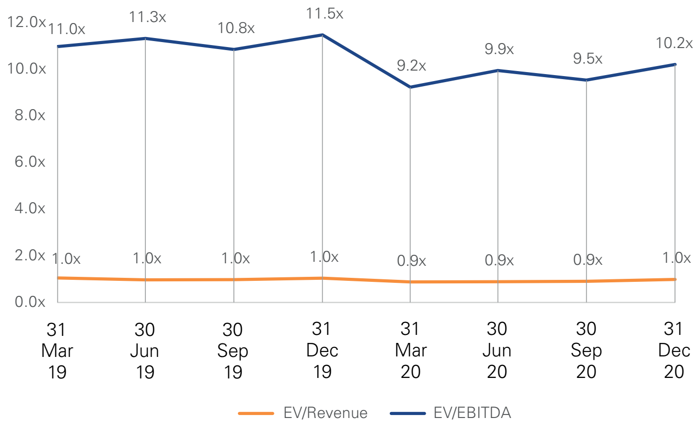
Communication Services



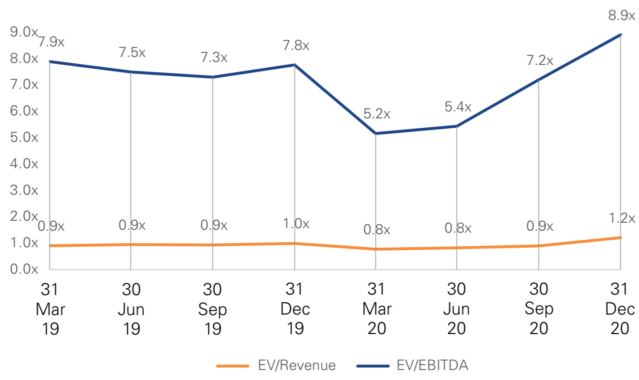
Consumer Discretionary



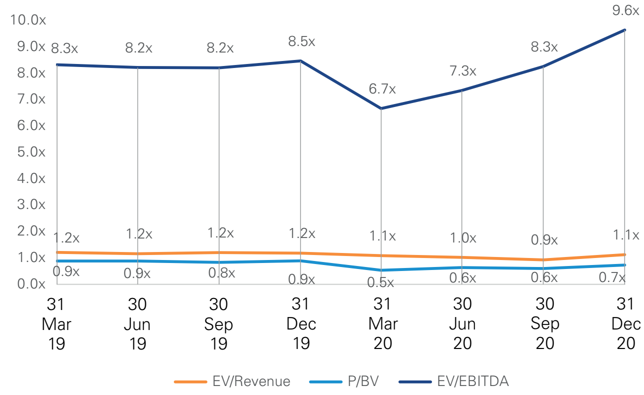
Consumer Staples



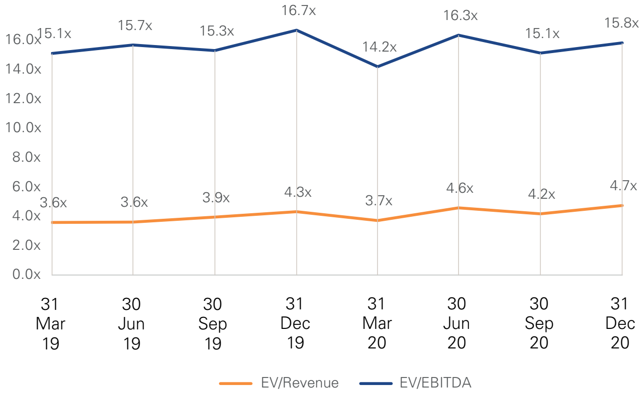
Energy



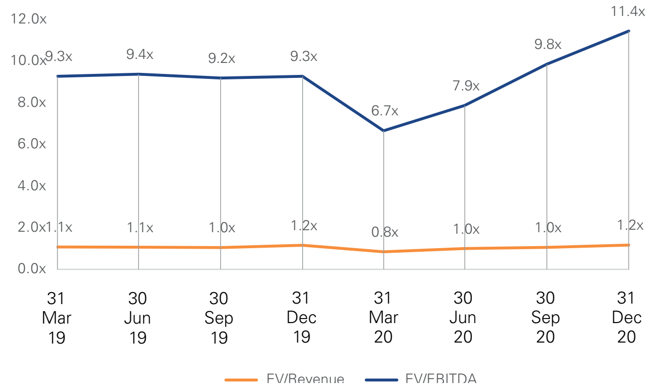
Financials



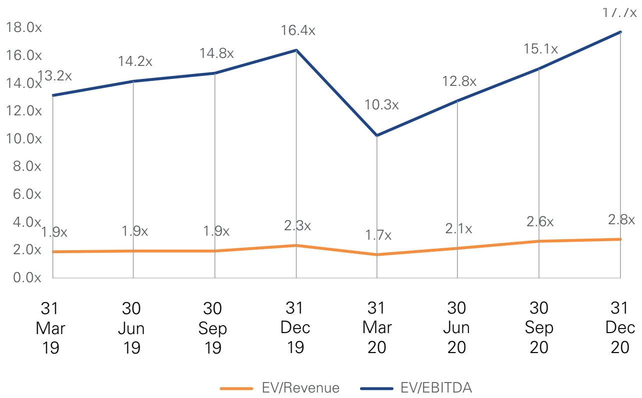
Health Care



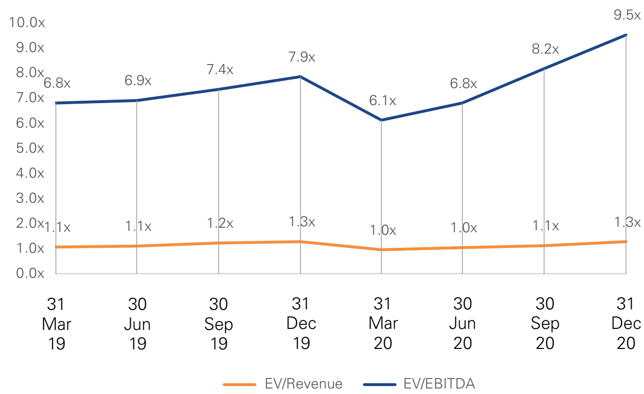
Industrials



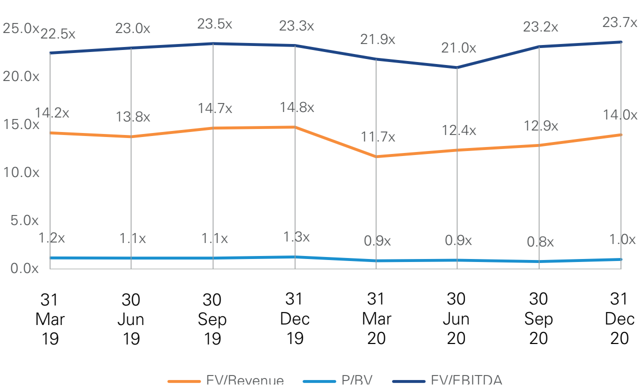
Information Technology



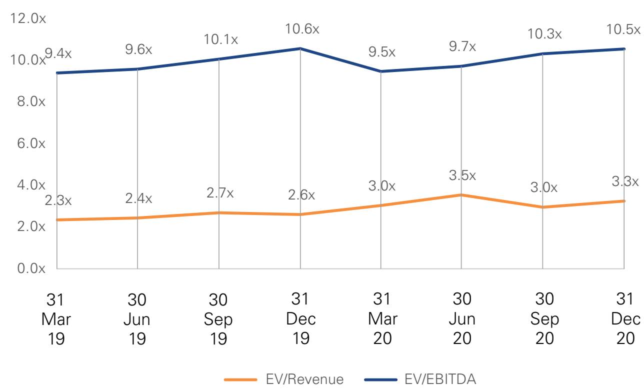
Materials



Real Estate



Utilities



Source: Capital IQ, KPMG analysis
Note: Multiples are analyzed based on the latest information available as of the assessment date for the respective edition of the Quarterly Brief. Changes in index composition, revised financial information and newly available information as of the respective assessment date may cause multiples to change.

Risk-free rates: The US is an exception as risk-free rates of other currencies fall

Investors who were waiting for interest rates to increase in 2020 were disappointed. Compared to 31 December 2019, the risk-free rates of all considered currencies decreased. The outbreak of COVID-19 caused central banks to again loosen their monetary policy, sending risk-free rates down further. For the UK and the US, the lowest interest rates in 2020 were observed as of 31 March and have rebounded since then to 0.70% and 1.78% respectively as of 31 December. For the Eurozone, Germany and Switzerland, rates experienced only one direction: downwards. As of 31 December 2020, the risk-free rate of Switzerland reached its all-time low of -0.36%, the same as at the end of September 2019.

Risk-free rates

	EUR	EUR	GBP	CHF	USD
31/3/2016	1.03%	0.90%	2.39%	0.25%	2.81%
30/6/2016	0.46%	0.49%	1.85%	(0.03)%	2.50%
30/9/2016	0.53%	0.47%	1.61%	(0.06)%	2.48%
31/12/2016	0.97%	0.95%	2.03%	0.35%	3.06%
31/03/2017	1.25%	1.24%	1.88%	0.32%	3.27%
30/06/2017	1.39%	1.33%	2.02%	0.39%	3.04%
30/09/2017	1.40%	1.38%	2.05%	0.45%	3.04%
31/12/2017	1.34%	1.34%	1.89%	0.36%	2.89%
31/03/2018	1.25%	1.24%	1.79%	0.56%	3.08%
30/06/2018	1.09%	1.12%	1.83%	0.51%	3.00%
30/09/2018	1.13%	1.15%	1.87%	0.61%	3.10%
31/12/2018	0.90%	0.94%	1.91%	0.37%	3.17%
31/03/2019	0.67%	0.65%	1.65%	0.17%	2.96%
30/06/2019	0.35%	0.33%	1.56%	0.02%	2.71%
30/09/2019	(0.03)%	(0.03)%	0.88%	(0.36)%	2.25%
31/12/2019	0.37%	0.34%	1.25%	(0.16)%	2.46%
31.03.2020	0.06%	0.01%	0.68%	(0.20)%	1.54%
30.06.2020	0.01%	(0.02)%	0.56%	(0.29)%	1.60%
30.09.2020	(0.08)%	(0.11)%	0.72%	(0.32)%	1.61%
31.12.2020	(0.13)%	(0.14)%	0.70%	(0.36)%	1.78%

Source: KPMG analysis
Note: Risk-free rates are determined as a present value-equivalent uniform interest rate based on the yield curve of the respective central bank (Svensson model)

Country risk premium: No major changes despite COVID-19

Most country risk premiums remained stable compared to Q3 2020. Only for Russia did the country risk premium decrease by 10 basis points to 1.9% – the same as of 31 March 2020. Since Q1 2020, the country risk premiums for the other BRIC countries have increased, with Brazil experiencing the highest increase in absolute terms (+0.3%), and China the highest increase in relative terms (+40%).

Country risk premium

	31 Mar 20	30 Jun 20	30 Sep 20	31 Dec 20
	2.8%	3.0%	3.1%	3.1%
	1.9%	1.9%	2.0%	1.9%
	1.9%	2.0%	2.0%	2.0%
	0.5%	0.6%	0.7%	0.7%

Based on two-year analysis
Source: KPMG CRP study

Growth rates: Long-term growth expectations for China and India revised downwards

Inflation forecasts are one of the typical indicators that can be used to assess the long-term growth rate for the terminal value calculation. The inflation rates for Brazil, Russia, India and China are based on the Economist Intelligence Unit's inflation forecast for the years 2021 to 2025. The expected inflation can be measured through several parameters. For our presentation, we consider the Consumer Price Index ('CPI') and the GDP deflator. The CPI is a measure that examines the weighted average of prices of a basket of consumer goods and services, while the GDP deflator, calculated as the difference between nominal and real GDP, measures the change in prices for all the goods and services produced in an economy.

Based on the latest available long-term forecasts for 2025, at 3.9% Russia has the highest inflation forecast among the BRIC countries measured through the GDP Deflator. In terms of consumer prices, Russia and India are forecast to have the highest growth rate, at 4.1%. The GDP deflator and CPI forecast for China are the lowest among these countries at 1.4% and 2.2%, respectively.

Inflation forecast

Country		2021	2022	2023	2024	2025
	CPI	5.1%	3.3%	3.3%	3.2%	3.2%
	GDP Deflator	3.6%	2.7%	2.6%	2.8%	2.9%
	CPI	3.9%	4.2%	3.9%	4.0%	4.1%
	GDP Deflator	5.7%	5.7%	5.6%	4.4%	3.9%
	CPI	4.2%	4.7%	4.3%	3.9%	4.1%
	GDP Deflator	1.8%	4.2%	4.1%	3.7%	3.2%
	CPI	1.5%	1.6%	2.5%	2.4%	2.2%
	GDP Deflator	1.9%	2.1%	1.9%	1.7%	1.4%

Source: Economist Intelligence Unit

References

1 The Limits to Growth – Club of Rome

2 THE 17 GOALS | Sustainable Development (un.org)

3 BlackRock has USD$7.8 trillion in assets under management as of end-Q4 2020; Larry Fink›s Letter to CEOs | BlackRock; BlackRock Client Letter | Sustainability

4 EU Green Bond Standard | Legislative train schedule | European Parliament (europa.eu)

5 EU explores green bonds as part of €750bn borrowing spree | Financial Times (ft.com)

6 https://www.capitaliq.com/ciqdotnet/Estimates/Commodities/Tearsheet.aspx?CompanyId=59490654

7 Research: Moody›s – Sustainable bond issuance hits record high in Q3 as green bonds recover – Moody's

8 Physical risk framework: Understanding the impact of climate change on real estate lending and investment portfolios – Cambridge Institute for Sustainability Leadership

9 ClimateWise transition risk framework: Managing the impacts of the low carbon transition on infrastructure investments – Cambridge Institute for Sustainability Leadership

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