Demystifying the Integration of ESG Risks and Opportunities in Business Valuations

Summary

— Environmental, social, and corporate governance ("ESG") considerations can have a meaningful impact on valuations.

— To the extent quantifiable, it is arguably preferable to reflect ESG risks and opportunities in the cashflows used in discounted cash flow analysis, rather than adjusting the discount rate.

— As ESG-related disclosures become more standardised, and sustainability standards better embraced by corporates, an ESG-related benchmarking exercise would become possible, which may be helpful in a market multiples-based valuation approach.

Introduction

The current climate crisis and ongoing geopolitical events have precipitated the need to react and respond to ESG-related challenges and threats. As governments and regulators continue to drive an array of ESG-related policies, corporations need to adapt to remain resilient to the headwinds of change. A company's actions (or inactions) will have an impact on its future performance and, relatedly, its valuation. In this article, we demystify incorporating ESG considerations in company valuations.

ESG and Sustainability

The term ESG was coined in 2004 in a landmark paper from the World Bank Group's International Finance Corporation,[1] and was originally a framework oriented toward the risks of ESG factors to a company's business model. Today, the term is used interchangeably with sustainability, which is the practice of operating a business in a way that meets the economic, social, and environmental needs of the present without compromising the ability of future generations to meet their own needs.

ESG encompasses (i) environmental factors such as climate change, resource depletion, waste, pollution, and deforestation; (ii) social factors such as human rights, modern slavery, child labor, impact on communities, working conditions, and employee relations; and (iii) governance factors such as bribery and corruption, executive pay, and board diversity and structure, among others. Investors are beginning to pay more attention to a company's consideration of ESG factors, as these are a lens for identifying risks and opportunities that traditional financial methods do not. Increasing awareness of long-termism, rather than focusing solely on short-term financial performance, supports ESG consideration.

ESG Implications on Business Valuations

The impact of sustainability-related risks and opportunities that are not necessarily reflected in an entity's financial reporting need to be considered when assessing its value. Such sustainability-related decisions could result in incremental costs or capex, or the expansion or winding down of certain business lines, which would have an impact on future cashflows of the entity.

For example, a European Union ("EU")-based steel producer's plan to change its production process from highly polluting blast furnace-based production to a less carbon-intensive method, such as electric arc furnaces or electrolysis, in response to tighter annual caps on emissions imposed by the EU via the emission-trading system ("ETS") would result in a significant amount of capital expenditure required by the company. However, this may also open new markets for the company's products, as the property sector's demand for low-carbon building materials is growing rapidly.

Different valuation bodies such as International Private Equity and Venture Capital Valuation ("IPEV") and International Valuation Standards Council ("IVSC") have recognised the need to consider ESG-related factors in the valuation of companies. While integrating ESG considerations into valuations is still at a nascent stage and there is no comprehensive guidance at present, we discuss methods to adjust for and reflect ESG risks and opportunities in valuations.

Adjusting for ESG Risks and Opportunities in Business Valuations

An assessment of the material ESG factors regarding a company's performance should be carried out. Materiality is typically measured in terms of both the likelihood and magnitude of impact. Some ESG issues may be material for companies in a specific industry (e.g., water stress can disrupt the operations of mining or beverage companies, which rely heavily on clean water in their production processes) but not for those in other sectors (e.g., water stress has little effect on software and financial companies). In assessing material ESG factors for a company, frameworks such as SASB ("Sustainability Accounting Standards Board"), which are industry-based and cover 70+ industry categories are helpful resources. While the SASB provides industry-specific materiality, companies would need to adjust for geography, size, and stakeholders — a process that advisors can often help with.

The identified material ESG risks and opportunities may be reflected via adjustments to forecasted financials, terminal growth rates, and/or cost of capital assumptions. Adjustments to valuation multiples may also be made in a market multiples-based approach.

- Discounted cash flow – The value of an entity is essentially the current expectations of future cash flows (including the quantum, timing, and certainty of the cash flows) generated by an entity discounted at its cost of capital. Cash flows may be adjusted with overlays representing the additional risks/opportunities to the extent that these are not already reflected in the forecasts. Such adjustments could be made to revenue and growth assumptions, costs, and capex. As different scenarios are developed to reflect the likelihood and magnitude of ESG initiatives, a weighted average or the most likely scenario can be adopted.

  In circumstances where it is challenging to quantify the impact of the ESG consideration on the cash flows, an adjustment to the cost of capital may be required to reflect the incremental risk or opportunity.

- Quoted comparator multiples – Similar to a benchmarking exercise performed concerning the financial performance of a company versus its peers, a company's performance on ESG metrics may be assessed relative to its peers (e.g., Greenhouse gas emissions, wastewater discharge, diversity, and inclusion statistics, etc.). This exercise may, however, be more difficult given the lack of uniformity in reporting, the discretionary nature of disclosures currently provided by companies, and the differing ESG-related disclosure requirements in various geographies. As disclosure requirements develop and become more standardised and mandatory, an ESG benchmarking exercise that feeds into the determination of an appropriate valuation multiple (discount or premium to the quoted peer set/sector multiples) could be a useful tool to arrive at a robust and justifiable valuation conclusion. In June of this year, the International Sustainability Standards Board ("ISSB") issued inaugural standards,[2] General Requirements for Disclosure of Sustainability-related Financial Information ("IFRS S1") and Climate-related Disclosures ("IFRS S2") for sustainability-related disclosures, which will help improve trust and confidence in company disclosures about sustainability to inform investment decisions.

- Precedent transactions – Buyers may likely be willing to offer a higher price for companies that perform well on ESG metrics. Again, as ESG and sustainability-related disclosures improve, benchmarking companies against targets in relevant precedent transactions in the sector will provide a useful indication of whether the subject company should be valued at a premium or discount to recent deal multiples.

Conclusion

It is increasingly important to incorporate ESG considerations in valuations, as companies adapt to meet the requirements of new regulations and policies driven by sustainability initiatives. Companies that can evidence the incorporation of ESG risk assessment and their strategy to mitigate and manage risks will likely benefit from greater access to capital and lower borrowing costs. As ESG ratings become less opaque and disclosure requirements become more standardised, incorporating ESG factors in valuations will become less challenging.

Endnotes

1 Who Cares Wins, 2004-08 https://documents1.worldbank.org/curated/en/444801491483640669/pdf/113850-BRI-IFC-Breif-whocares-PUBLIC.pdf

2 https://www.ifrs.org/news-and-events/news/2023/06/issb-issues-ifrs-s1-ifrs-s2/

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