Integrating ESG Risks and Opportunities in Business Valuations

A Fresh Perspective

As governments and regulators in Australia and globally continue to drive an array of ESG-related policies, corporates need to adapt to remain resilient to the headwind of changes. A company's actions (or inactions) will have an impact on its future performance and relatedly, on its underlying value and sustainability. In this article, we attempt to take a fresh perspective on ESG considerations in business valuations.

ESG reporting and disclosures will help incorporate ESG risk and opportunities in business valuations, as ESG-related disclosures become more standardised.

ESG risks and opportunities are best reflected in the projected cashflows than in the discount rate.

ESG-based benchmarking can add additional insights in a market multiples-based valuations.

ESG and Sustainability

ESG: an acronym coined in 2004. It is a reflection of the growing attention and focus on environmental, social and governance issues leading to sustainable development of the business and social needs and is now used interchangeably with sustainability. As sustainability concerns have evolved, it has become more apparent that businesses can no longer operate in a way that does not meet the social, governance and environmental needs of the present or compromises the ability of future generations to meet these needs.

ESG encompasses environment factors, such as climate change, resource depletion, waste, pollution and deforestation; social factors such as human rights, modern slavery, child labour, impact on communities, working conditions and employee relations and governance factors such as bribery and corruption, executive pay, board diversity and structure, amongst others. Addressing all these important areas in a meaningful way can be challenging, and it would require strategic thinking and decisive actions on behalf of companies and alignment of reporting guidelines on behalf of the sustainability reporting bodies, to generate tangible results over time.

Investors are beginning to pay more attention to companies' strategies regarding ESG risks and opportunities as these become key to protecting and creating value. However, there is still a long way to driving an awareness of the long-term impact of current business decisions and how these would translate into sustainability and subsequently impact business value. As disclosures related to climate risks will become mandatory in Australia, investors will

be compelled to take climate and other ESG risks into consideration.

Regulatory Framework

The International Sustainability Standards Board (ISSB) issued in June 2023 inaugural standards IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information* (IFRS S1) and IFRS S2 *Climate-related Disclosures* (IFRS S2).[1] The standards aim to introduce an alignment internationally in financial information disclosure related to sustainability and thus help improve trust and confidence in companies' disclosures assisting investment decisions.

The standards will take effect globally in January 2024. They will not be immediately mandatory across markets, with each jurisdiction needing to define the extent to which they will be implemented. However, with the global community seeking a consistent sustainability disclosure baseline, the ISSB Standards are likely to be widely adopted across the globe.

In Australia, the development of mandatory climate-related financial disclosures is part of the Australian Government's commitment to ensure greater transparency and accountability regarding climate-related plans, to ultimately deliver on the country's net zero commitments.

As such, the Treasury is leading the policy design of the new mandatory requirements, with the Australian Accounting Standards Board (AASB) responsible for the draft, consultation and issuance of the standards.

The Treasury has signalled that mandatory climate-related financial disclosures for Australian listed and unlisted companies and financial institutions will follow the ISSB Standards. The Treasury's mandatory climate-related financial disclosure rules would apply to the largest Australian companies for the reporting period commencing 1 July 2024 and then expand to smaller companies over the following three years.

The AASB is consulting on proposals for the disclosure design and is expected to issue Australian climate-related disclosure standards in Q2 2024. These are to follow the ISSB IFRS S2, with some aspects of IFRS S1, for example, materiality definition, implemented to give effect to IFRS S2.

Beyond climate disclosures, AASB is developing sustainability disclosure standards for the Australian market, likely to be closely aligned with the ISSB Standards. There is currently no indication these standards will become mandatory in Australia in the near future.

It is worthwhile noting that there is divergence in the interpretation of materiality across regulatory bodies. Internationally, the European Union is adopting a double materiality definition vs. ISSB's financial materiality definition. This will be an additional factor that may impact valuations once this aspect gets resolved and firmed up globally and in Australia, in particular.

ESG Implications on Valuations

The impact of sustainability-related risks and opportunities not traditionally reflected in the company's financial reporting, would need to be considered when assessing its value. Companies' decisions relating to sustainability will potentially have an impact on the natural and social environment, on one hand, (some impossible to quantify), and on the companies' market positioning, reputation, resilience (all hard to measure), on the other. To assess the "tangible" financial impact, positive or negative, on the future cashflows, it is critical that there is a culture of assessing the nature of the impact, quantifying and ultimately reporting it in a consistent way. The newly developed standards and legislation on sustainability aim to facilitate this.

For example, an Australian 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 to keep greenhouse gas emissions below the baseline imposed by the Safeguard Mechanism (Crediting) Amendment Act 2023 (Cth) (Safeguard Act). This would result in a significant capital expenditure required by the company. Several questions arise:

- How is this decision going to affect the current (and future) value of the company?
- How is it best benchmarked to its peers?
- How is the external impact going to be measured and could it be reflected in the company's value?

Different valuation bodies such a IPEV and 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 at a high-level, ways to adjust for and reflect ESG risks and opportunities in valuations.

Factoring in ESG Risks and Opportunities in Valuations

Given that finding a uniform solution for sustainability reporting is still evolving, it is difficult to predict how the valuation aspect of ESG will evolve over time. It is feasible to anticipate a range of scenarios that can be practical for implementation and meaningful to investors for comparison and interpretation.

An assessment of the impact of ESG factors on the company's strategy and forecast financial performance should be carried out to quantify its possible impact on value, factoring in likelihood and materiality. Some ESG issues may be material for companies in certain industries (e.g., water stress can disrupt the operations of mining or beverages 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 or financial companies). In assessing material ESG factors for a company, frameworks such as SASB (Sustainability Accounting Standards Boards standards which are industry based and covers 70+ industry categories) are helpful resources. This assessment will require consistent disclosure standards across geographies, industries and over time, including materiality, which is still under development. The valuation professionals will need to apply fresh thinking and analytical techniques to incorporate their understanding of the potential financial and non-financial impact of the adopted ESG strategy on the company internally and its external environment, respectively, and hence its value.

Once the material ESG risks and opportunities have been identified and reported by the company, the valuation professional should decide how to incorporate these to adjust forecast financial performance, capital expenditure, terminal growth rates and/or cost of capital assumptions.

Income Approach

The Discounted Cash Flow method estimates the value of an entity based on expectations of future cash flows (including their quantum, timing and reasonable certainty of the cash flows), discounted at its cost of capital. In an ESG conscious business environment, one way of incorporating the value of sustainability efforts would be to develop a "business as usual" forecast cash flow scenario, i.e., no ESG impact and an alternative scenario(s) reflecting tangible ESG strategies with material impacts on the operations. Depending on the nature of these strategies, the forecast ESG cash flow implications can be presented as a separately identifiable set of forecast cash flows, possibly discounted to present value at a lower discount rate. This is similar to asset retirement obligations in mining companies, thus resulting in a clear ESG-driven liability. Any anticipated positive developments and opportunities should be evaluated and included in the "with" scenario, discounted at the business' cost of capital. This could include:

- increased market share
- improved client loyalty
- better human capital
- avoided taxation or other penalties
- better access to capital
- better business positioning based on perception
- potentially improved margins.

Adjustments may be made to revenue and growth assumptions, operating costs and capital expenditure. As different scenarios are developed to reflect the different likelihood and magnitude of ESG initiatives, a weighted average or the most likely "with" scenario can be adopted.

In circumstances where it is challenging to quantifying the impact of the ESG considerations on the forecast cash flows, an adjustment to the cost of capital may be made to reflect the incremental risk or opportunity. In such situations, the valuer will need to ensure there is no double counting of the identified risks. The discount rate is typically estimated based on a capital asset pricing model and may already reflect the industry risk in the beta estimate or the size premium may potentially capture less sophisticated ESG commitment. Therefore applying an additional risk premium/discount may lead to an undervaluation/overvaluation of the company.

The resulting "with" and "without" ESG impact scenarios can be compared thus understanding the net effect on value driven by the proposed by management ESG strategy reflecting a clear commitment and possibly evaluation scenarios.

Market Approach

Adjustments to a company's maintainable earnings and valuation multiples may also need to be made in a market multiples-based approach, possibly in a different way now, then at a point in time when ESG impact becomes "a way of life".

At present, to carry out meaningful analysis, any historical costs reported by listed companies as ESG related, need to be identified and normalised and the implied peer multiples calculated on a "with" and "without" ESG impact basis. These multiples can serve as a basis for

estimating the appropriate multiple to be applied to the reported or normalised for ESG earnings of the company, depending on the scenario being used.

In the interim, like the benchmarking exercise performed with respect to 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., GHG emissions, wastewater discharge, diversity, and inclusion statistics, etc.) performed in addition to the above. This exercise may, however, be more difficult given the lack of uniformity in reporting, discretionary nature of disclosures currently provided by companies, and the differing ESG-related disclosure requirements in various geographies. As disclosure requirements develop, 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) is a useful tool to arrive at a robust and justifiable valuation conclusion. The IFRS S1 and IFRS S2 for sustainability related disclosures, or the respective equivalents issued by AASB, may help to improve trust and confidence in company disclosures about sustainability to inform investment decisions.

In the end, there will be only one set of earnings and multiples, when an ESG-supportive approach has been adopted by the universe of companies, which could take years, or even decades.

In addition to the quantifiable effect on financial statements, which materially impacts the company's value, an assessment of the positive external impacts on society and the environment could be assessed using an appropriate scale or comparator of qualitative impact. This would highlight the relevant value contribution of the business both internally and externally. This aspect is still in debate and will take longer to embrace, measure and apply in a valuation context.

Conclusion

It is becoming increasingly important to act on how to best incorporate ESG considerations in valuations, as companies adapt to meet requirements of new regulations and polices driven by sustainability initiatives. The process will evolve over time, but uniformity in valuation approach and methodology can be achieved once reporting is embraced and applied consistently.

Companies that can evidence the incorporation of ESG risk and opportunities assessment in their strategies to mitigate and manage risks will likely benefit from greater access to capital and lower borrowing costs. As ESG disclosures and ratings become less opaque and disclosure discipline becomes more standardised, incorporating ESG factors in valuations will become less challenging.

Footnote

[1] How Australian Companies Can Prepare for the ISSB Standards and Mandatory Climate-Related Financial Disclosures FTI Consulting (24 August 2023).

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