

ESG AND VALUATION : CONCEPT, APPROACH, CHALLENGES AND WAY FORWARD

Dr. S K Gupta

Managing Director

ICMAI Registered Valuers Organization

Abstract

Environmental, Social, and Corporate Governance (ESG) refers to the three central factors in measuring the sustainability and societal impact of an investment in a company or business. It's not just regulators that are driving this trend. It is being driven by investors themselves – both institutions and private individuals. – The companies that demonstrate their awareness of ESG principles are more likely to have higher valuation.

The Perspective

In the last decade, companies have come under pressure to be socially conscious and environmentally responsible, with the pressure coming sometimes from politicians, regulators, and interest groups, and sometimes from investors. The argument that corporate managers should replace their singular focus on shareholders with a broader vision, where they also serve other stakeholders, including customers, employees, and society, has found a receptive audience with corporate CEOs and institutional investors. The pitch that companies should focus on doing good is sweetened with the promise that it will also be good for their bottom line and for shareholders.

These changes have caused many to participate in an evolving conversation on the impact of ESG factors on corporate value. Understanding these impacts allows a finer understanding of the effects on share price, but

perhaps more importantly, how corporate decisions that impact these factors (and require resources to deal with), can be weighed with more conventional concerns like those that directly impact on customers, cost structure, and competition.

The global move towards better environmental standards is another theme that has been accelerated by the Covid-19 pandemic. Most of the world's major economies are now implementing massive investment programmes in green energy, to create jobs and futureproof their infrastructure. The investment opportunities created by the acceleration of the energy transition away from carbon should also provide many more opportunities for investors considering ESG factors

The ESG Phenomenon

Every business, is deeply intertwined with environmental, social, and governance (ESG)

concerns Environmental, Social and Governance (ESG) metrics are the three central themes for measuring the sustainability and positive impact of an investment or business. While these criteria help to better determine the future performance of companies.

- ⊙ The E in ESG, environmental criteria, is the energy your company takes in and the waste it discharges, the resources it needs, and the consequences for living beings as a result. Not least, *E* encompasses carbon emissions and climate change. Every company uses energy and resources; every company affects, and is affected by, the environment.
- ⊙ The S in , social criteria, addresses the relationships your company has and the reputation it fosters with people and institutions in the communities where you do business. *S* includes labor

relations and diversity and inclusion. Every company operates within a broader, diverse society.

- ⊙ *The G* in, governance, is the internal system of practices, controls, and procedures your company adopts in order to govern itself, make effective decisions, comply with the law, and meet the needs of external stakeholders. Every company, which is itself a legal creation, requires governance.

Just as ESG is an inextricable part of how you do business, its individual elements are themselves intertwined. For example, social criteria overlaps with environmental criteria and governance when companies seek to comply with environmental laws and broader concerns about sustainability. Our focus is mostly on environmental and social criteria, but, as every leader knows, governance can never be hermetically separate. Indeed, excelling in governance calls for mastering not just the letter of laws but also their spirit—such as getting in front of violations before they occur, or ensuring transparency and dialogue with regulators instead of formalistically submitting a report and letting the results speak for themselves.

Integrating ESG into valuation model

ESG factors are integral to assessing the quality of a company and thus are a vital part of valuation process. Three key questions to determine the sustainability of competitive advantage and how it can be monetized through growth:

- ⊙ Is the company a disruptor or is it insulated from disruptive change?
- ⊙ Does the company demonstrate financial strength with high returns on invested capital, high margins, strong cash conversion, low capital

intensity and low leverage?

- ⊙ Are there environmental or social externalities not borne by the company, or governance and accounting risks that may alter the investment thesis

When integrating ESG factors into investment analysis, they are examined alongside other valuation drivers. It has been more common to process ESG factors through qualitative analysis, but investors are increasingly also quantifying and integrating ESG factors into financial forecasting and company valuation models, in alignment with other financial factors.

There is a current imbalance in supply and demand of ESG targets which is driving higher multiples, two of the bankers said, noting that well-managed companies which market themselves in a sustainable fashion gain a premium. In particular, targets in some specific sectors, such as renewable energy or biotechnology, are in high demand, therefore multiples of these kind of companies have jumped

For instance, there have been about 30 deals announced where the target was in the renewables sector over the past five years, according to *Acuris* data. Of these, 16 were undertaken over 2019, 2020 and YTD 2021. These deals were carried out at an average EV/sales and EV/EBITDA multiple of 14.1x and 15.2x respectively. This is higher than the average multiple over 2018 and 2017 in which deals were done at an average sales and EBITDA multiple of 5.4x and 13.1x each, *Acuris* analytics show.

How to Include ESG in Valuation

Every valuer considers political, environmental, social and technological factors that might have an impact on the growth of an industry, businesses within that industry or the profitability of those that operate within the industry.

Accordingly, valuers consider each of these factors and the potential impact of them on revenue, costs, tax, working capital and capital expenditures, risk and market sentiment, even today. For some businesses, these factors may either be very distant, or idiosyncratic in their effect (and therefore eliminated by an investor diversifying their portfolio). In either of these cases, value impacts are unlikely to be large. However, in markets where there are substantial externalities or a stigma attached to the ownership of particular stocks or particular sectors, valuers will take these issues into account.

Environmental factors

Every valuer considers political, environmental, social and technological factors that might have an impact on the growth of an industry, businesses within that industry or the profitability of those that operate within the industry. Accordingly, valuers consider each of these factors and the potential impact of them on revenue, costs, tax, working capital and capital expenditures, risk and market sentiment, even today.

For some businesses, these factors may either be very distant, or idiosyncratic in their effect (and therefore eliminated by an investor diversifying their portfolio). In either of these cases, value impacts are unlikely to be large. However, in markets where there are substantial externalities or a stigma attached to the ownership of particular stocks or particular sectors, valuers will take these issues into account. For example, in recent days, when looking at the value of carbon intensive industries, the impacts of potential carbon taxes is often considered in terms of price forecasts and cost structure forecasts for major miners and oil and gas operators.

In addition, a number of investors have decided to remove some of these asset classes from their portfolios, particularly thermal coal related

assets. This reluctance to invest has already led to a demonstrable increase in the funding costs for those assets in the credit markets, which is increasingly translating to higher costs of equity. These changes have had an adverse effect on the pricing of thermal coal assets beyond the effect suggested by changes in commodity prices and exchange rates, which historically have been the most significant drivers of changes in prices for those sort of assets.

Social factors

Social factors represent where a business may be acting in a way outside current social mores. For valuers, the effect of these social issues is felt most profoundly on an organization's brand in the markets in which it operates. The most common markets for a company where brand plays a role are consumer, supplier, employment and capital.

The effect of brand is most significant when the identity of the counterparty is affected by association with the brand. For example, an expensive car purchase might seem eminently reasonable if the purchaser sees themselves in a better light because they own that car. Similarly, employee identity is often inextricably linked with their profession and their employer, so the choice of role is highly influenced by the brand associations of their employer and industry. Accordingly, where an organizations brand in any market is associated with the identity of the other side of the deal, social factors that impact the identity of that other party will significantly impact the price at which they would be willing to do business – or sometimes make them refuse to do business at all.

An example might help illustrate. Take a distinctive fashion brand that is exposed as a proponent of unfair labour practices in developing countries. Assuming that the situation is not remedied, those that continue to wear that brand are effectively saying

“I am OK with that” - many people wouldn't be, so demand may ebb considerably for that brand, affecting cash flow and value in a very direct and straightforward way

Governance

The final aspect of governance has interesting valuation considerations.

For example, when valuers value 100% of the business, the governance question becomes almost moot, because the buyer of the entire business can change current governance practices. Of course, the costs of resolving previous governance issues may need to be allowed for, but prospectively they can almost be assumed away.

For minority interest (effectively share prices), such a convenient assumption cannot be made. When compared to valuing 100% or otherwise controlling interests, valuers will apply a discount to these minority interests. These discounts take into account a multiplicity of factors, including the propensity for the company to act in a way that is not aligned with the interests of a minority shareholder (ie issues of trust), and the propensity for poor (or perhaps just more risky) future decisions to be made. Therefore, this element of the minority discount is effectively a governance discount.

⊙ **Market Approach:** Valuers may take a greater initiative to integrate ESG factors into current market approach procedures by identifying the relevant ESG criteria for the comparable companies. Instead of focusing on assessing different financial factors, ESG criteria may need to be included. Valuers may need to compare the performance on ESG of the subject company with that of the comparable companies.

⊙ **Income Approach:** Valuers may need to carefully assess

if they have already counted ESG factors implicitly when considering different pre-financial characteristics of a company to prevent double counting. For example, the size premium, which represent a higher rate of return for smaller companies, might have considered certain ESG factors. For Beta, similar with market approach, ESG factors may need to be considered when selecting comparable companies.

For terminal growth rate, strong ESG criteria is likely to be positively correlated to the long-term growth rate. Valuers may need to consider adjusting the terminal growth rate by assessing the subject company's performance on ESG factors. With detailed consideration, valuers could also include a specific risk premium for ESG factors, or adjust on the projected cash flows. It would be complex and highly technical, which requires a more formal ESG framework.

Challenges in factoring ESG in Valuation

Unlike financial metrics, ESG or sustainability metrics have far more interpretation challenges due to non-standardization. That is also the reason sometimes for marked differences in ESG ratings for a company assessed by different agencies. Thus valuation benchmark remains a major challenge as the future cost and value of ESG issues are still difficult to calculate. ESG is increasingly affecting the fundamental value of a business and becoming core to what a target is worth

Key issues in linking ESG with Valuation are as under:

⊙ What are the best conditions for linking ESG issues to value

drivers?

- ⊙ What levels of analyst quality, reporting, and corporate integration of sustainability into strategy are needed?
- ⊙ And how do these factors interact?
- ⊙ And even when linking is successful, how does impact on corporate financial performance translate to the performance of investment funds?
- ⊙ Are better financial performers more likely to succeed at ESG integration?
- ⊙ Do weak performers have more/less incentives to start ESG integration
- ⊙ Another dimension is visibility, which means that if your consumer doesn't know about ESG it is unlikely to affect their behavior. .
- ⊙ Another complexity is competitor relativity. Essentially, if everyone in your industry is doing the same thing, it is less likely to affect your value because the alternatives for customers, employees and suppliers are restricted.

Clearly, there are still several challenges ahead of us and steps we can take. Challenges include getting stronger views on specific factors, better data from companies and sell side analysts, better measurement of our sustainability impact, and a clearer link to higher aggregation levels, so as to get an ESG macro view and an ESG asset allocation view. We are confident that we can take these steps, but wider adoption of true ESG integration by peers would be helpful, as an exchange of knowledge and experience in this area would likely speed up the learning process.

ESG Valuation in India

Indian firms are upping their game

on ESG—environmental, social and governance—factors. When Zomato Ltd kicked off its roadshows for its initial public offering, its ESG measures featured as a prominent slide in its presentation. India's largest company, Reliance Industries Ltd, said recently it will invest ₹75,000 crore in green energy projects. Analysts said this will help improve its ESG score, as it will partly offset the overhang of the oil business. Elsewhere, India's largest cement firm, Ultratech Cement Ltd, aims to cut its carbon emissions by 27% by 2032 and raise the share of green energy in its total power consumption. Even as companies have increased their thrust on ESG, experts say these are still early days, and investors will need to carefully evaluate how valuations will be impacted by ESG disclosures. The path ahead is not rosy on this front for firms in certain industries. Firms in the tobacco, coal and oil sectors, for instance, will inherently find it more challenging to meet expectations on the ESG front. ITC Ltd, for instance, has labored to improve its environmental and social engagements and offset the impact of its tobacco business on ESG scores and has even succeeded.

Although a few ESG indices have outperformed the market, the direct correlation with ESG-related factors is not easy to assess. It is one thing to make an ESG announcement but following up on changes in the business model to reap the benefits of the process takes time. Valuations will not change only on the basis of companies making statements on becoming more ESG-compliant; execution is the key.

In this backdrop, market regulator Securities and Exchange Board of India's (Sebi) Business Responsibility and Sustainability Report (BRSR) is expected to meaningfully improve ESG reporting standards. The BRSR is applicable to top 1,000 listed companies based on market capitalization and would be mandatory from FY23, although it

is voluntary in FY22. The BRSR is intended towards having quantitative and standardized disclosures on ESG parameters. This would facilitate comparability across companies and sectors, thereby enabling investors to make better investment decisions.

Conclusion

In the end, business valuation outcomes are a reflection of the story line of the financial figures that serve as input for these valuations. Given the new and expanding view on risks and opportunities associated with businesses, viewing the development of industry and market forces not just with a financial lens but also with an ESG-lens, and incorporating them in the cash flows and discount-rate analysis, is a need of the hour. The demand for better informed change is growing. Pressure from investors, employees and customers alike means that ESG ratings have become critical metrics for success. ESG is all about attracting capital flows given that ESG investment has seen a big spike in flows in recent years. While this might increase near-term costs for firms and weigh on profitability, note that more capital would eventually translate into higher valuations and lower cost of capital for corporates