Perspectives Paper:

ESG and Business Valuation

March 2021
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The IVSC issues Perspectives Papers from time to time, which focus on pertinent valuation topics and emerging issues. Perspectives Papers serve a number of purposes: they initiate and foster debate on valuation topics as they relate to the International Valuation Standards (IVS); they provide contextual information on a topic from the perspective of the standard setter; and they support the valuation community in their application of IVS through guidance and case studies.

Perspectives Papers are complementary to the IVS and do not replace or supersede the standards. Valuers have a responsibility to read and follow the standards when carrying out valuations.

By: Kevin Prall, IVSC Business Valuation Technical Director with contributions from the Business Valuation Standards Board and the ESG Working Group

The IVSC has issued this Perspectives Paper to initiate discussion and debate on the topic of ESG in business valuation. Share your thoughts and perspectives with us through LinkedIn

The ESG Landscape

Environmental, Social, and Governance (ESG) factors have become central tenets in the capital allocation process for both the providers of capital (e.g., investors) and the users of capital (e.g., corporations).

Many institutional investors leverage ESG filters to guide their investment strategies and improve returns. A recent study by Morningstar discovered a majority of sustainable funds have outperformed their traditional peers over multiple time horizons. Over the 10-year period ending
in 2019, 59% of sustainable funds across the categories considered beat their traditional counterpart.\(^1\)

Additionally, C-Suite management has begun incorporating ESG considerations into their capital budgeting processes to gain a fuller understanding of their ability to drive sustainable financial performance. In fact, 9 out of 10 companies in the S&P 500 produced sustainability reports in 2019\(^2\). For those that don’t yet produce sustainability reports, political and investor pressures are only expected to mount.\(^3\)

The events of 2020 have only acted to accelerate the broader adoption of ESG frameworks.

- **E** - Environmental disasters have become too prevalent and destructive to ignore.
- **S** - Social unrest has obligated enterprises to take a point of view on issues important to their workforce and broader stakeholders.
- **G** - The pandemic has challenged the governance structures of every industry and forced management to continuously pivot as they guide a path to recovery.

Though fewer people today debate the importance of ESG and its impact on value creation, most struggle to make sense of the web of interconnected standards, disclosure requirements, and ESG ratings. The lack of uniformity results in wildly varying disclosures, and in effect, a hesitancy from the valuation profession to wholeheartedly embrace the value creation impact of ESG. Like other market participants, for valuers to successfully incorporate ESG into valuations they will need reliable ESG metric reporting that is consistent between companies, across geographies, and over time.

The IFRS Foundation has begun a project on ESG by seeking input on the need for a global set of internationally recognised ESG standards, and gauging support for its role in developing such standards, through the issuance of a recent Consultation Paper\(^4\). While some believe that the inclusion of ESG in financial reporting is untenable, Nick Anderson’s 2019 article “IFRS Standards and climate-related disclosures” demonstrates the linkages between ESG and value creation.\(^5\) Specifically, Anderson notes

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\(^1\) [https://www.morningstar.com/content/dam/marketing/emea/shared/guides/ESG_Fund_Performance_2020.pdf](https://www.morningstar.com/content/dam/marketing/emea/shared/guides/ESG_Fund_Performance_2020.pdf)
\(^2\) ESG: a trend we can’t afford to ignore | Financial Times (ft.com)
\(^3\) Companies Could Face Pressure to Disclose More ESG Data - WSJ
\(^4\) [https://cdn.ifrs.org/~/media/project/sustainability-reporting/consultation-paper-on-sustainability-reporting.pdf](https://cdn.ifrs.org/~/media/project/sustainability-reporting/consultation-paper-on-sustainability-reporting.pdf)
the potential financial implications arising from climate-related and other emerging risks, all of which likely having direct valuation implications, may include, but are not limited to:

- **asset impairment, including goodwill**;
- **changes in the useful life of assets**;
- **changes in the fair valuation of assets**;
- **effects on impairment calculations because of increased costs or reduced demand**;
- **changes in provisions for onerous contracts because of increased costs or reduced demand**;
- **changes in provisions and contingent liabilities arising from fines and penalties**; and
- **changes in expected credit losses for loans and other financial assets**.

In addition to the IFRS foundation, there are other international organisations that have begun to drive convergence and standardisation. The CFA Institute has recently begun work to develop a voluntary, global industry standard to provide greater transparency and comparability for investors by enabling asset managers to clearly communicate the ESG-related features of their investment products⁶. Similarly, the European Financial Reporting Advisory Group (EFRAG), has established a task force to proceed with the development of non-financial reporting standards to increase comparability, relevance and reliability of such non-financial information.⁷

Whether an ESG framework ultimately sits within the financial reporting framework, or separately, market participants are not waiting for a more universal framework when making investment decisions. Given that the role of valuers in the efficient capital allocation process is to reflect the considerations made by investors of capital, it's advisable for the valuation profession to do the same.

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This article, along with our recent panel discussion *Unlocking the Value of ESG* and our recent Agenda Consultation*, represent IVSC’s first steps on the path toward a more systematic approach to the incorporation of ESG into business valuation practice and standards.*

## Seeing ESG as ‘Pre-Financial’ and not ‘Non-Financial’ Information

There is a perception by some that because ESG disclosures are typically non-financial in nature, that they therefore do not have a financial impact. This view fails to recognise that ESG represents a multitude of factors to assess the long-term financial viability and sustainability of an enterprise. When assessing lasting value, analysis must naturally move away from detailed price x quantity considerations and examine the structures that allow an enterprise to create value in the medium and long-term. ESG has become a framework for investors of capital to assess this fundamental question. Does the enterprise have a business model that faces threats from climate change and regulation? Are its social practices and policies optimised to attract and retain customers and human capital? And finally, is its governance environment such that it can sustain unforeseen challenges that undoubtedly exist beyond near term line of sight? Although the answers to these questions may not impact the current period financial statements, they can be a leading indicator of financial performance.  

In this respect, ESG is better characterised as *pre-financial information*. Given the exceptional rate of technological change exacerbated by the pandemic, in many ways ESG factors resemble the considerations investors have long made around safe haven assets. This results in many equities now trading with more consideration towards the store of value qualities, rather than near term cash flow. Failure to thoroughly account for such in the valuation process fails to account for much of the market value. A recent study examining ESG’s impact on the fundamentals of equity valuation, supports a relationship between ESG and financial performance. In *Foundations of ESG Investing: How ESG Affects Equity*

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10 The IVSC Social Value Working Group recently published the Perspectives Paper: *Defining and Estimating ‘Social Value’*. As outlined on page 5 of that article, Social Value encompasses the broader externalities that accrue to stakeholders outside of just the asset owner. While in the context of this article, ESG factors specifically focus on the commercial value that accrues to the asset owner.
11 [The Future of ESG Is ... Accounting? (hbr.org)](https://hbr.org)
Valuation, Risk, and Performance, the authors conclude that companies’ ESG information positively impacted their valuation and performance, both through the systematic risk inputs (e.g. a lower cost of capital and higher valuation multiples), and their unsystematic risk profile (e.g. higher profitability and lower exposures to tail risk).12

Occurring in tandem to the ESG debate, is one on how to better disclose and report on the value creation through investments in unrecorded intangible assets. Like ESG, value creation through investment in intangible assets is disproportionally focused on long-term prospects. In that light, consideration of unrecorded intangible assets in the ESG framework, may represent a more complete framework to uncover the true nature of an enterprises’ financial sustainability.

The Decline of Interest Rates and The Rise of ESG

While the events of 2020 have placed additional emphasis on the importance of ESG, there is another factor that helps to explain the meteoric rise of ESG in the capital allocation process. As valuers well know, a decline in interest rates increases the present value of future benefits. The further in the future the benefit, the greater the relative increase in present value from any decrease in interest rates. Low short-term interest rates are nothing new, but the 2020 economic crisis has brought about an unprecedented expectation for a prolonged period of low interest rates. If one assumes the lower interest rates result in a lower cost of capital for businesses, the relative value of lasting cash flows has increased at the expense of those in the near term. Given that a greater percent of the present value of cash flows for organisations now resides in the distant future, it should come as no surprise that the ESG framework has taken on greater importance.

12 https://www.msci.com/documents/10199/03d6faef-2394-44e9-a119-4ca130909226
While much of the ESG framework emphasises the creation of sustainable financial performance, it also focuses investors and organisations on the mitigation of future risks and liabilities. As the decline in cost of capital makes future cash inflows more valuable, it has the same effect on cash outflows (i.e. liabilities related to ESG considerations). ESG provides a structure to identify and quantify potential future liabilities through explicit forecast adjustments or scenario analysis, rather than assume such tail risks reside implicitly in the terminal assumptions.

The fundamental degradation in near term profits resulting from the pandemic has also placed additional value on the lasting prospects of an enterprise. Specifically, an analysis of 24 broad industries shows that 21 of the industries are expected to experience a reduction in expected 2020 profits as compared to pre-COVID expectations. Furthermore, the expected recovery curve is relatively flat and prolonged, as 20 of the 24 industries are projected to still be below their pre-COVID expectations in the furthest forecasted out year (e.g. 2022 to 2024 depending on industry). This broad decline in discrete period expected cash flows, much like the decline in interest rates, also acts to shift focus toward the long-term prospects of enterprises. The combination of these phenomena has manifested in the equity markets as “falling earnings coincided with much higher valuations of future earnings, as lower interest rates and bond yields made stocks look more attractive.”

A simplistic example shows the impact of these two changes. In the pre-COVID example, the discrete period represents 36% of the total value.

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14 Thank the Fed for the Stock Market’s Run—and the Plodding Pace to Come - WSJ
However, a hypothetical decrease in the cost of capital of 200 bps\textsuperscript{15}, combined with a decrease in discrete period cash flows consistent with the expected recovery curve for many industries,\textsuperscript{16} results in a post-COVID scenario where approximately 13% of the aggregate value has shifted from the discrete period to the terminal period.

<table>
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<tr>
<th>Free Cash Flow</th>
<th>Terminal Value</th>
<th>Discount Factor</th>
<th>Discounted Cash Flow</th>
<th>$’s</th>
<th>% of Total</th>
<th>Discount Rate</th>
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<td>$12.4</td>
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Given the ever-increasing adoption of ESG by market participants, as well the current market conditions that have placed additional weight on lasting value, valuers should begin incorporating ESG considerations into the business valuation framework.

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<th>Discounted Cash Flow</th>
<th>$’s</th>
<th>% of Total</th>
<th>Discount Rate</th>
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Incorporation into the Business Valuation Framework

The novelty of the ESG framework may cause some to assume a fundamental change to valuation methods and procedures is necessary. However, consideration of ESG should be a matter of incorporation rather than assimilation.

\textsuperscript{15} In 2020 the 10-year Treasury yield has fallen from 1.9% to 0.9% see Thank the Fed for the Stock Market’s Run—and the Plodding Pace to Come - WSJ

\textsuperscript{16} ADV_CFS_VBA_Forecast-Engine-Industry-Impact-Study_Issue-2_Web.pdf (bdo.com). For example purposes, we have not adjusted the long term growth rate.
The Market Approach - While ESG data and disclosures are becoming more standardised for public companies, most companies that are the subject of valuation exercises are private. As such, to account for ESG factors a valuer will be required to:

1) Identify and assess the relevant ESG criteria for the comparable companies and industry, then
2) Assess the performance of the subject company for such criteria, and
3) Calibrate the market inputs (e.g., EBITDA multiple, etc.) to the subject entity to take into account the relevant performance as compared to the comparable companies.

At first impression, this process appears daunting. However, such a process has direct parallels to existing procedures in which a valuer must:

1) Understand the size, risk, future growth, business comparability, etc. of the comparable companies, then
2) Assess the performance and characteristics for the subject company, and
3) Calibrate the market inputs to the subject entity to take into account the relevant performance as compared to the comparable companies.

By integrating ESG considerations into the current market approach procedures, the task becomes more manageable (see IVS Section 105, paragraphs 20 and 30).

The Income Approach – While the income approach requires similar calibrations to compare the performance and characteristics of the subject entity to that of the comparable companies, the greater reliance on future expectations and the explicit consideration in the forecast does add an additional layer of complexity.

The bifurcation of responsibility over forecast assumptions between management and the valuer is a complex and evolving area. As noted by the IVSC, practice has been trending toward additional onus on valuers to consider the risks inherent in the forecast (see IVS Section 105, paragraphs 50.36 through 50.40). However, management is typically still responsible for derivation of the
forecast. The ESG framework presents a new set of factors for valuers to consider, but also for management consideration. Additionally, management will be best equipped to identify, consider, and quantify many of the considerations noted in the framework. As such, incorporation of an ESG framework into business valuation procedures will require education of both management and valuers.

Fortunately, work is underway to develop best practices and frameworks for explicitly incorporating such risks into forecasts. For example, the Canadian Chapter of the A4S CFO Leadership Network has formed a Valuation & Climate Change Task Force which has developed a draft framework for climate change and valuation.

While the systematic and explicit consideration of ESG factors by valuers is in its infancy, many ESG factors are likely already incorporated into valuations implicitly. Due to the overlap and correlation between ESG factors and certain pre-financial characteristics already considered by valuers, care must be taken to not double count such characteristics as “new ESG risks”.

For example, it’s common in practice to include a risk premium to the discount rate (or discount to the comparable company multiples) to account for the relatively smaller size of the subject company. These risk premiums are supported by historical analysis that shows a statistically higher rate of return for smaller companies as compared to larger. However, an examination of criteria often cited as the rationale for the existence and magnitude of size premiums used in the discount rate derivation, shows overlap with what many would consider to be “ESG” factors. As such, current practice may partially account implicitly for some of the risk calibration of ESG factors from large public companies, to that of the subject. This represents just one example of potential overlap, as multiple other aspects of the income approach will require specific consideration, including:

- **Beta** – Reliable output from the
CAPM requires the identification of sufficiently comparable public companies. As with the market approach, ESG characteristics may need to be added to the current framework for comparable company screening and identification.

- **Long-term Growth** – A core concept of ESG investing is to acknowledge that not all companies have the same structures in place to drive long-term sustainable growth. As such, a blanket reliance on standard long-term growth rates, with only minor consideration of industry and/or geographic growth rates, is likely to be insufficient. In fact, evidence suggests that ESG criteria is strongly correlated to long-term survivorship likelihoods, with a positive impact on the long-term growth rate. As displayed above, given the low interest rate environment, valuations have become extremely sensitive to the long-term growth rate assumption. Furthermore, for low-performing ESG companies, many may argue that a long-term rate of decline, rather than growth, may be more appropriate.

- **Alpha** – Adjustments for additional risk in the cash flow projections requires detailed consideration (see IVS Section 105, paragraphs 50.36 through 50.40). Understanding the ESG profile of the subject, comparison to the comparable public companies used to derive other inputs to the analysis (e.g., Beta), and interplay with projected cash flows, are all potential areas for investigation.

These considerations are highly technical and complex issues that likely requires additional deliberation for any ESG framework.

## Next Steps

ESG solutions require collaboration between stakeholders throughout the capital markets. Currently there is no shortage of opinions when it comes to how, and even if, to proceed with the standardisation of ESG disclosures and reporting. However, regardless of the path taken by standard setters, including the IVSC, ESG factors represent fundamental considerations to inform valuation analysis. As such, these first

17 [https://www.ft.com/content/5430ff68-2a73-4e1b-bf40-8de6a76389a2](https://www.ft.com/content/5430ff68-2a73-4e1b-bf40-8de6a76389a2)
steps to begin incorporating ESG considerations into valuation practice are critical for the relevance, and therefore the sustainability, of the profession.

The IVSC would be interested to hear your views on this paper and on ESG as it relates to valuation. Share your feedback through the IVSC Group page on LinkedIn or by emailing contact@ivsc.org