Impact of ESG on Business Valuation

What is ESG?

ESG is an acronym that stands for environmental, social, and governance. It is a framework for assessing a company's sustainability and ethical issues.

The growing popularity of Socially Responsible Investing ("SRI") in recent years has led investors, business valuation specialists, and other stakeholders to place a higher emphasis on ESG factors. ESG factors are a set of metrics that can help one understand how a company manages its risks and opportunities associated with a changing environmental, social and governance landscape.

By focusing on ESG factors, a company can build a sustainable future and create long-term value for all stakeholders. The ESG factors are described below:

ESG

ENVIRONMENTAL

A company's impact on the environment, including its carbon footprint, direct and indirect greenhouse gas emissions, and waste management.

SOCIAL

A company's social responsibility relating to health and safety, engagement with communities, employee engagement, commitment to ethical labour practices, human rights, gender, and diversity.

GOVERNANCE

A company's governance framework encompasses internal controls, executive remuneration, board composition, bribery and corruption, and oversight responsibilities.

Explore How ESG Impacts Business Value

With the growing significance of ESG awareness and considerations and its pronounced impact on business valuation, namely International Valuation Standards (exposure draft in 2023 issued by the International Valuation Standards Council) which now requires the consideration of ESG factors in the business valuation process.[1]
This article delves into four key areas:

- How do ESG initiatives create value?
- Integrating ESG factors in the Income Approach.
- Integrating ESG factors in the Market Approach.
- Challenges in incorporating ESG in business valuations and difficulty in ESG data collection.

[1] International Valuation Standards | Exposure Draft April 2023

How do ESG Initiatives Create Value?

This section dives into various ESG factors and initiatives that businesses can adopt. We will explore how these initiatives contribute to a positive environmental and social impact, and also enhance a company's valuation. From environmental sustainability and social responsibility to robust governance practices, businesses can actively participate in building a better and more sustainable future.

Environmental

Climate Mitigation, a widely recognised environmental factor, focuses on reducing or preventing greenhouse gas (GHG) emissions. Companies play a crucial role in this effort by developing alternative fuels and green technologies, optimising energy use, leveraging automation and implementing smart technologies to reduce their emissions footprint.

Singapore's carbon pricing scheme, implemented in 2019 as the first in Southeast Asia, incentivises companies to actively contribute to this goal. The steadily increasing carbon tax, will reach S$50 to S$80 per tCO_2e by 2030 (Exhibit 1). To help put things in perspective, Singapore's largest public transport provider, i.e. Singapore Mass Rapid Transit (SMRT), produced 419,455 tCO_2e in 2023. At the current tax rate of S$5 per tCO_2e, it would amount to approximately S$2.1 million in carbon tax in comparison with SMRT reported net profit of S$42.5 million in 2023.[2] Assuming $50 per tCO_2e this would amount to c.S$21 million – wiping out almost half of the profits reported in 2023. With the potentially significant impact of carbon tax on profits, carbon tax will put significant pressure on companies to place a higher emphasis on lowering their greenhouse gas emissions. [3]

The below graph illustrates the carbon tax prices from 2022 to 2030.

Exhibit 1: Carbon Tax (nccs.gov.sg)

Another ESG factor that companies are strongly encouraged to focus on is Waste Management. In 2007, the National Environment Agency (NEA) launched the first Singapore Packaging Agreement (SPA) to reduce packaging waste. This led to a reduction of approximately 62,000 tonnes of packaging waste and total estimated savings of S$150 million over a 13-year period. [4]

According to "McKinsey 2020 Global Consumer Sentiment Survey", 79% of all consumers say that they include sustainable packaging in their purchasing decisions – always, usually or at least sometimes. This figure is even higher among millennials (83%). Millennials are also prepared to pay more for products that have the least negative impact on the environment and to get products from companies that share their values (Exhibit 2).[5]

How often do you include sustainable packaging in your purchasing decision?

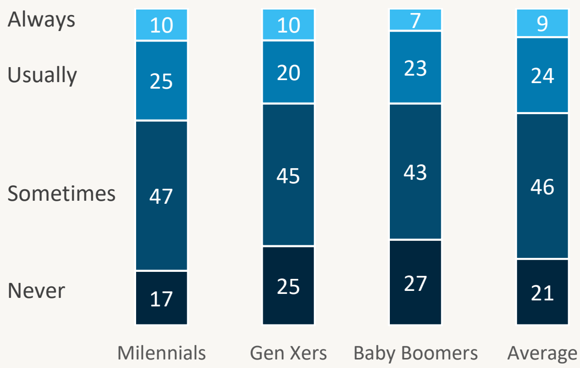


Exhibit 2: McKinsey-2020-Global-Consumer-Sentiment

[2] The Straits Times & SMRT SR 2023
[3] Carbon Tax (National Climate Change Secretariat)

[4] NEA | Singapore Packaging Agreement and Packaging Partnership Programme
[5] McKinsey-2020-Global-Consumer-Sentiment-Survey.ashx

An increasing number of consumers are actively purchasing more eco-friendly products and are willing to pay more for them. [6] Likewise, an increasing number of companies are producing more eco-friendly products. Patagonia (an American retailer of outdoor recreation clothing) for example, has fully embraced being sustainable by using a high proportion of recycled materials in their products and encouraging customers to repair and reuse their clothing through their "repair and reuse" program. [7] With greater emphasis on prioritising environmental responsibility, companies are actively lowering their carbon footprint to remain competitive. Implementing effective waste management practices represents a strategic opportunity to achieve this goal, leading to increased revenue and a larger customer base.

Sustainability Practices and Policies are crucial for every company making sure its internal practices and policies align with its environmental claims.

Greenwashing occurs when companies falsely market their products as more environmentally friendly or sustainable than it really is. It can mislead consumers who want to make eco-conscious choices. According to Control Risks' article published on 24 Feb 2023, the principles to minimise greenwashing risk include ensuring internal policies align with environmental claims, staying up to date with the latest sustainability best practices and be prepared to adjust the environment claims as necessary. [8]

Implementing effective sustainability practices and policies not only enhances a company's profitability through improved operational efficiency but also boosts its public image among stakeholders and results in greater employee satisfaction. This demonstrates the company's commitment to environmental protection, social justice and good governance.[9]

Social

Employee Well-Being has risen to the forefront of company priorities, with many companies implementing flexible work arrangements as a key strategy for improvement. This approach has proven successful, as evidenced by Google's recent recognition as Singapore's best employer for the third consecutive year, largely attributed to their popular flexible work options.[10]

Prioritising employee well-being leads to increased productivity and positive employer branding. This enhances the organisation's reputation as the employer of choice, attracting top talent and ultimately lowering hiring costs.[11]

Furthermore, ManpowerGroup Singapore reported that a staggering 83% of employers in Singapore are facing talent shortages and difficulty in hiring.[12] To attract and retain employees in this competitive landscape, companies are increasingly prioritising and enhancing employees' well-being through various benefits and initiatives.

Diversity, Equity, and Inclusion (DEI), represents a set of principles and practices that cultivate a workplace valuing and leveraging the unique perspectives, backgrounds, and abilities of all individuals, irrespective of their diverse characteristics such as race, gender, age, religion, or disability.

Adopting inclusive and diverse recruitment practices enable companies to navigate cultural nuances in global markets more effectively.[13] This empowers companies to tailor their products, services and strategies to meet the needs and expectations of diverse consumer groups across

[6] Most Consumers Want Sustainable Products and Packaging (Business News Daily)
[7] How Ethical is Patagonia? (good on you)
[8] How companies can protect themselves from greenwashing (Control Risks)
[9] Top Five Benefits of Sustainable Business Practices | Eliot Partnership
[10] Singapore's Best Employers 2023 (The Straits Times)
[11] What Is Employee Wellbeing and Why Is It Important (Gallup)
[12] The Talent Shortage (ManpowerGroup Singapore)
[13] 13 Statistical Benefits of Diversity Within the Workplace

different regions, ultimately lowering barriers to entry and expediting market penetration.

By embracing DEI, companies gain a significant advantage in understanding diverse customer segments, potentially securing their customer base before competitors enter the market.

Community Engagement refers to a company's active involvement and interaction with the community in which it operates. This can be achieved through volunteering for or partnering with non-profit organisations, like the Singapore Cancer Society. A company can differentiate itself from larger, impersonal competitors by demonstrating its commitment to social responsibility and building trust with the community.[14]

Governance

Navigating the rapidly evolving ESG reporting landscape requires scalable and effective internal controls tailored to ESG performance.

The recent guidance from Committee of Sponsoring Organisations (COSO) emphasises the broader value of internal controls beyond compliance and financial reporting. Organisations that align their sustainable business objectives with their business strategies are better able to design effective controls, achieve sustainable growth, and contribute to value creation and preservation. [16]

Companies can consider leveraging the COSO Internal Control – Integrated Framework for establishing and integrating internal controls over decision-useful sustainability information. This enhances the likelihood of achieving the company's goals and effectively adjusting to changes in the business environment.

Board diversity is essential for good governance as it demonstrates a company's commitment to strategic leadership and strong oversight. This ensures effective identification and management of ESG risks and opportunities, compliance with regulations and standards, and enhancement of transparency and accountability.

To uphold this commitment and ensure the board's effectiveness in navigating the ESG landscape, regular evaluations are crucial. This will help ensure that the board composition remains competent and diverse, with members possessing the necessary skills, experience, independence, and diverse perspectives to guide the company's ESG journey towards its set goals.

According to a Journal of Accounting Research study, the adoption of ESG-linked Executive Compensation (ESG Pay) has grown rapidly from 3% in 2010 to over 30% in 2021. The research found improvements in key ESG outcomes for companies with ESG Pay, but not necessarily in financial performance.[17]

This suggests that integrating ESG metrics into executive compensation schemes is most effective when aligned with a company's broader strategy. By using pay incentives as a motivator, companies can mobilise their executives towards achieving their ESG goals and ensuring that sustainability becomes a core priority, not just a side hustle.

The table below provides examples of various ESG metrics used in the compensation contracts:

Type of ESG Metric	Examples
Carbon emissions	Greenhouse gas emission intensity at gold producing operations measured in kg CO_2e/tonne
Safety and security	Days Away/ Restricted or Transfer (DART) incident rate per 100 full-time employees
Diversity and inclusion	Percentage of women among the senior management position

[14] Community involvement: Why it's good for business (America's Small Business Network)
[16] Committee of Sponsoring Organisations (coso.org)

[17] Executive Compensation Tied to ESG Performance: International Evidence - COHEN - 2023

Employee satisfaction and development	Internal promotion rate in global leadership
Corporate culture	Colleague culture & engagement survey
Compliance	FY2021 actions and targets (continue to assess human rights, bribery and corruption and other related risks)
Governance	Establish standalone corporate governance and risk procedures at the company following internalisation that build trust, create long-term securityholder value and align with company values

Source: Journal of Accounting Research - Wiley Online Library

Integrating ESG Factors into Business Valuation

The surge in interest in ESG has highlighted the need to integrate ESG factors into valuation, providing investors with a more holistic perspective. Neglecting ESG's impact can lead to a gap between financial performance and market value, potentially obscuring valuable intangible assets and hindering a company's true long-term potential.

Income Approach

ESG and DCF Model

The widely used Income Approach, specifically the discounted cash flow (DCF) model, values a business by determining the present value of its projected future cash flows. The core element of the DCF model is projecting future cash flows, while the applied discount rate reflects the company's long-term cost of capital. This dependency on future expectations entails the need for integrating ESG calibrations to refine the company's performance assessment.

When incorporating ESG factors into DCF's financial forecasting, quantifying their financial impacts becomes crucial, ensuring coherence with other valuation drivers.

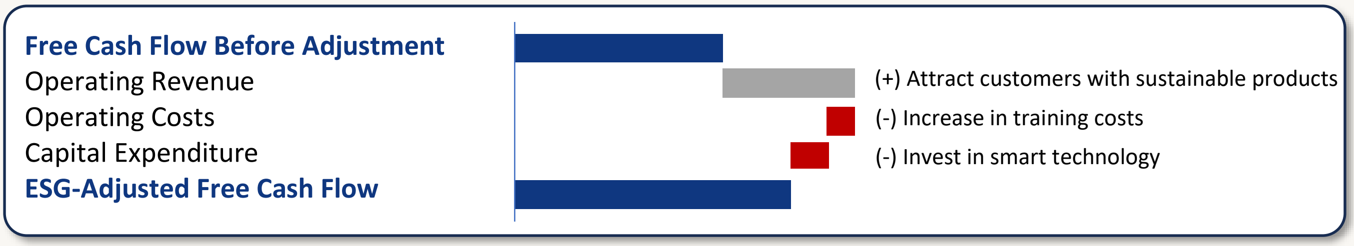
McKinsey outlines five essential ways in which ESG factors can boost the company's cash flows, offering a framework for assessing ESG's impact. While their applicability may vary by company and situation, all five deserve careful consideration.

	Strong ESG proposition (examples)	Weak ESG proposition (examples)
Top-line growth	• Attract B2B and B2C customers with more sustainable products. • Achieve better access to resources through stronger community and government relations.	• Lose customers through poor sustainability practices (e.g., human rights, supply chain) or a perception of unsustainable/ unsafe products. • Lose access to resources (including from operational shutdowns) as a result of poor community and labour relations.
Cost reductions	• Lower energy consumption. • Reduce water intake.	• Generate unnecessary waste and pay correspondingly higher waste-disposal costs. • Expend more in packaging costs.
Regulatory and legal interventions	• Achieve greater strategic freedom through deregulation. • Earn subsidies and government support.	• Suffer restrictions on advertising and point of sale. • Incur fines, penalties, and enforcement actions.
Productivity uplift	• Boost employee motivation. • Attract talent through greater social credibility.	• Deal with "social stigma", which restricts talent pool. • Lose talent as a result of weak purpose.
Investment and asset optimisation	• Enhance investment returns by better allocating capital for the long term	• Suffer stranded assets as a result of premature write-downs.

	(e.g., More sustainable plant and equipment). • Avoid investments that may not pay off because of longer-term environmental issues.	• Fall behind competitors that have invested to be less "energy hungry".

Exhibit 3: Five ways that ESG creates value (mckinsey.com)

Illustration on ESG impacts on free cash flow:



ESG and Discount Rate

Another popular method to capture ESG factors in income approach is to adjust the discount rate itself. The discount rate reflects the uncertainties inherent in future market conditions and are typically higher for riskier investments.

One may consider incorporating ESG factors into the discount rate where an addition of a risk premium can be made for companies with poor ESG performance, effectively lowering their present value and overall valuation. Conversely, a downward adjustment is applied to the discount rate for companies with strong ESG scores, reflecting their lower perceived risk.

According to an article by Business Valuation Resources dated 23 August 2023, a quote taken from one of the chapters on Valuation and Sustainability written by Frédéric Le Meaux, the WACC adjustment should not exceed ±100 basis points (bp). The size of the adjustment should be based on the importance of the ESG issue being considered. For instance, a significant ESG issue could justify a ±50 bp adjustment, whereas a minor or less relevant one might only warrant a ±10 bp adjustment.[18]

Double Counting Issue

Integrating ESG factors into a valuation through discount rate requires careful consideration to avoid double-counting and preserve accuracy. It is important to assess whether the risks or opportunities are already priced into the industry-wide discount rate by the market.[19]

For example, if a company operates in an industry heavily impacted by ESG factors, its beta may already capture some of these risks, potentially leading to redundant adjustments in the cash flow analysis and discount rate. Therefore, any adjustments made to the discount rate for ESG should be carefully evaluated in conjunction with the industry-specific considerations, and existing ESG adjustments in the cash flow analysis.[20]

Market Approach

The Market Approach determines a company's fair value by comparing it to similar publicly traded companies or recent transactions. The most commonly used price multiples are enterprise value to EBITDA, enterprise value to revenue, price-to-earnings and price-to-book.

[18] Adjusting WACC for ESG: ±100 basis points proposed | Business Valuation Resources (bvresources.com)

[19] Essential Guide to Valuations and Climate Change

[20] Incorporating an ESG Lens in Business Valuations

Selecting the right comparable companies is crucial for a successful market valuation. This requires careful assessment of relevant ESG metrics alongside traditional financial indicators. There are several platforms on the market to collate ESG data such as Bloomberg, Refinitiv and MCSI.[21] They have also developed their own ESG scoring system, providing valuable insights and a reference point for market comparison.

Companies with higher ESG risks tend to have lower enterprise values. As a result, when assessing comparable companies through an ESG lens, the pricing multiple will be adjusted to reflect the discrepancies in risks and opportunities. However, before applying adjustments, the crucial first step is identifying and evaluating industry specific ESG criteria[22].

By comparing these ESG criteria to the target company's ESG performance, we can determine the appropriate adjustments to pricing multiples, ensuring a valuation that accurately reflects the company's sustainability profile and inherent risks.

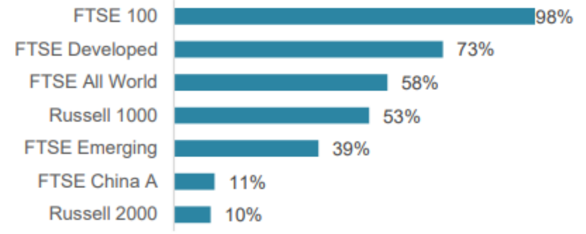
Challenges in Incorporating ESG in BVs and difficulty in ESG data collection

Reliable ESG data is the cornerstone of incorporating sustainability factors into valuation, collecting it presents its own set of challenges. Valuers often encounter issues like data availability, quality concerns, and lack of comparability across sources. These hurdles can compromise the entire valuation process as unreliable, irrelevant or incomplete ESG data leads to misleading and inaccurate valuation results.

Availability of Data

Insufficient data stands as a major hurdle incorporating ESG factors into valuation.

Many companies, especially private ones, lack the resources or incentives to actively collect and report ESG data. They operate under less pressure to disclose their sustainability practices. Even among public companies, comprehensive ESG data disclosure remains elusive. For example, a recent study by FTSE Russell and Refinitiv found that 42% of large and mid-caps globally still do not disclose both Scope 1 and 2 emissions, including high-profile firms like Berkshire Hathaway and Moderna.[23]



Source: FTSE Russell and Refinitiv.

Moreover, the absence of robust ESG regulations leaves companies free to pick and choose what data they disclose, resulting in incomplete and inconsistent information. This lack of standardisation makes it challenging for valuers to compare data across companies, further exacerbating the already limited availability of reliable ESG data.

Quality of Data

Even if ESG data is available, assessing its quality becomes another hurdle. According to a benchmarking study by the International Federation of Accountants (IFAC), an analysis of 50 Singapore companies was conducted in 2021 and one of its key findings showed that of the 48 companies that report sustainability information, 21% received some level of assurance on it.[24] Therefore, valuers must navigate concerns over data accuracy and reliability.

Selective reporting practice is often attributed to the voluntary nature of ESG disclosure and weak regulations. This paints an incomplete and potentially misleading portrait. Second, an increase

[21] Top 10: ESG Platforms | Sustainability Magazine
[22] Impact of ESG Factors on Business
[23] Mind the gaps: Clarifying corporate carbon (FTSE Russell)
[24] The State of Play in Sustainability Assurance l Benchmarking Global Practice

in the risk of greenwashing, wherein certain companies may inflate or misrepresent their sustainability efforts to appear more virtuous, further muddying the data waters. Lastly, companies with lower ESG maturity often lack a robust data governance framework. Outdated, inconsistent, or even manipulated data can arise from inadequate systems and controls, further diminishing the value of available information.

Comparability of Data

When conducting a valuation, data comparison is necessary between a company and its peers or against its historical data. However, comparing ESG data can be a complex and challenging task influenced by various factors.

One major hurdle is the scarcity of historical data, making it difficult to track trends and progress in sustainability practices. This is evidenced by a study of 50 large Danish companies' sustainability reports, revealing that only 60% provided data from prior years for comparison.[25]

Another challenge arises from the lack of a single and standardised framework. A multitude of frameworks exist, such as the Global Reporting Initiative (GRI) Standards, the Sustainability Accounting Standards Board (SASB) Standards, and the Task Force on Climate-related Financial Disclosures (TCFD) Recommendations. This inconsistency in measurement and reporting enables companies to choose different frameworks and methodologies to measure and report their ESG performance. Consequently, comparing the ESG performance of two companies becomes complex when they adopt different reporting frameworks.

Lastly, the use of various data sources, such as self-reporting, third-party assessments, or publicly available information, further hinders ESG data comparability. Each company's reliance on different sources introduces potential variations in the data, pose challenges to make consistent assessments.

Even if these hurdles are overcome and high-quality, relevant, and comparable data is found, the valuer may still face challenges in incorporating these data into the valuation model.

Conclusion

While the need to integrate ESG factors into valuation is undeniable, translating them into concrete value remains a nascent challenge. Without standardised approaches and robust regulations, navigating this landscape can be complex. However, this is a space in constant evolution, and progress is being made.

For companies, embracing ESG principles and integrating ESG risks and opportunities assessment into their strategies offers multiple benefits. From securing lower borrowing costs, wider access to capital to fostering stronger stakeholder confidence, the advantages of responsible practices are clear.

This article is written by Jimmy Lim (Partner), co-authored by Abbie Phang (Assistant Manager), Xiong Jia Yi (Senior Associate) and Sam Gan Sen (Experienced Associate), of PKF-CAP Advisory Partners Pte Ltd, and published on 31 January 2024. The author is contactable at **jimmy.lim@pkf.com**.

[25] WBCSD-Internal-Control-Guidance

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