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Dr. S K Gupta is a highly experienced professional with over 42 years of corporate expertise in Finance, Costing, Internal Audit, Legal, and Company Secretarial functions. He holds a Ph.D. in Corporate Governance and is a Gold Medalist Post Graduate in Commerce. With a wide range of skills in areas like Mergers and Acquisitions, Corporate Restructuring, and Business Valuations, Dr. Gupta has played leadership roles in both public and private organizations. He is currently the Managing Director of ICMAI Registered Valuers organization and serves as an Independent Director on several company boards. Dr. Gupta has a strong academic background and has contributed significantly to various professional journals with over 275 research papers and articles. He is a sought-after mentor, speaker, and judge at esteemed business schools and conferences, focusing on Valuation, Finance, Corporate Governance, and Corporate Laws. Additionally, Dr. Gupta regularly conducts Management Development Programs for companies.

ESG AND VALUATION A STUDY OF INEXTRICABLE INTERRELATION

THE PERSPECTIVE

When nearly two-thirds of investors globally say they want sustainability reporting to describe the impact a company has on the environment and society, it's time to listen. There is a growing recognition that, over time, externalities will become internalised and directly affect a company's cash flows, its access to finance, and, therefore, its enterprise value. There is some concern that today's valuation models might not adequately capture sustainability factors, even if they have the potential to affect cash flows or the cost of capital. ESG factors represent one of the fundamental components in determining the long-term prospects and financial performance of a firm.

From a valuation perspective, traditional business valuation approaches are more inclined to financial indicators and metrics, neglecting the ESG impacts on long-term value creation or degradation. Hence, an ESG-integrated valuation model that can systematically value a company by considering different scenarios and outcomes may benefit investors by developing a rounded-out investment and optimizing the risk-return characteristics.

ESG FACTORS AND COMPANY VALUATION

A lot of people would describe ESG as an organization's capacity to do good. But that's really a vague and very subjective concept. I prefer to think of ESG as a concept in which an organization shifts its focus from short-term profit-making to longer-term sustainability of profits. Building business resilience: so very much anchored in financial metrics. ESG in truth is not one holistic topic. It's a concept that's made up of many different facets. ESG factors can have a significant impact on company valuation.

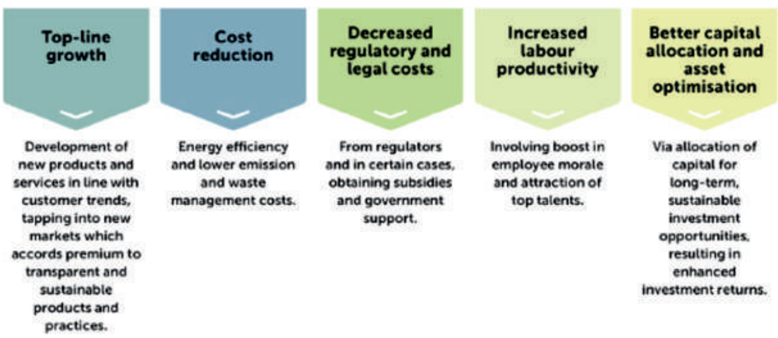
Environmental factors, for example, can affect a company's reputation and long-term viability. A company that has a poor environmental track record may face regulatory action or public backlash, which can result in lost revenue and a lower valuation. On the other hand, a company with a strong environmental record may attract socially responsible investors and receive positive media coverage, which can result in increased revenue and a higher valuation.

Social factors, such as labor practices and diversity, can also impact company valuation. Companies that treat their employees well and have diverse and inclusive workforces are likely to be more productive and innovative, which can lead to increased revenue and a higher valuation. Companies that have a poor track record in these areas may face negative publicity, which can result in lost revenue and a lower valuation.

Governance factors, such as board diversity and executive compensation, can also impact company valuation. Companies that have transparent and accountable governance structures are more likely to attract investors and have a higher valuation. Conversely, companies that have poor governance structures, such as excessive executive compensation or a lack of board diversity, may face regulatory action and negative publicity, which can result in lost revenue and a lower valuation.

ESG CAN ENHANCE CORPORATE VALUE

ESG can therefore be viewed as a set of intertwined, qualitative, and non-financial factors that are used by the markets to understand the impact and sustainability of a company's actions. Based on various publicly available sources, there are five (5) principal ways in which good ESG practices, in aggregate, affect economic performance and valuation: *Figure below (Left corner)*



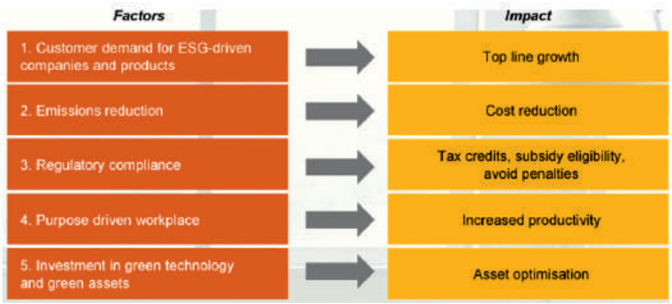
According to the IVSC, there is a common misconception that ESG disclosures are typically non-financial by nature and hence, do not have a financial impact. It added that this ignores the fact that ESG represents a myriad of factors that evaluate the long-term financial viability and sustainability of an enterprise. When assessing such factors, an analysis will therefore need to shift away from the traditional detailed "price x quantity" into an examination of how it allows enterprises to create value in the medium to long-term. In recognising ESG factors in valuation, the IVSC laid out that it should be a matter of embedding them into the current valuation methods and procedures.

In the Perspective Paper: ESG and Business Valuation, IVSC highlighted the importance of recognizing ESG as "Pre-financial" information rather than "Non-financial" information. Given the intertwined linkage between ESG factors and enterprises' long-term financial resiliency, the analysis shall be set aside from the traditional valuation metrics, such as typical cash flows, price-to-earnings, and EBITDA measurements, but comprising a multitude of factors instead.

APPLICATION OF ESG CONSIDERATIONS IN VALUATION

Generally, when performing a business valuation regarding ESG, it is important to identify the relevant risks and opportunities for the business model of the company to be valued. ESG ratings, corporate and sustainability reports as well and analyst evaluations can be used as sources. The impact of the identified factors on the operating business, financing, and cash flow should then be assessed and quantified for each company on a case-by-case basis.

The increasing relevance of ESG implies that ESG factors should be included in the valuation process from the very beginning. As part of a DCF or income approach, it should first be assessed to what extent the ESG risks and opportunities identified by the valuation specialist have already been considered in the company's business plan. This is often difficult, but essential in order to avoid double counting. If ESG factors are not included yet, the planned cash flows should be adjusted accordingly. For example, a reduction in sales revenue due to poor reputation, an increase in taxes due to legal requirements, or increased CAPEX to reduce ESG risks could be taken into account.



In addition, it is possible to add risk premiums to the discount rate applied. The first step is to identify the drivers of the business model and their risks in connection with ESG factors. An analysis of the comparable companies (peer group analysis), which includes the relevant ESG criteria, can be used to derive a company-specific risk factor, which in turn is incorporated into the appropriate discount rate. This risk factor is intended to reflect fluctuations in returns due to ESG opportunities and risks. For example, companies with a poor ESG score have, on average, a higher risk profile and thus a higher discount rate, which again leads to a lower enterprise value in the DCF analysis.

THE INCOME APPROACH

The Income approach, best known as the discounted cash flow (DCF) model, values a business by determining the present value of its expected future cash flows. To account for ESG considerations, valuation under the income approach should consider its impact on the discount rate or cash flows itself.

INCORPORATION INTO THE DISCOUNT RATE

This entails the screening and analysis of comparable companies, incorporating into the screening process to account for specific ESG considerations relevant to the industry in which the subject entity is operating. Therefore, a company that scores poorly in terms of ESG practices by comparison to its peers operating in the same industry would be accorded a higher discount rate, and vice versa. When integrating ESG-related risks into the discount rate, extra attention is needed to prevent the issue of double counting. Due to the possibility of overlapping ESG factors with other pre-financial information, valuers might have already addressed some ESG-related risks implicitly in calculating the risk-adjusted discount rate.

For Beta, similar to the market approach, ESG factors may need to be considered when selecting comparable companies. For terminal growth rate, strong ESG criteria are 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.

THE MARKET APPROACH

To account for ESG considerations, valuation under the market approach should: Identify and assess ESG practices for comparable companies and industries, Assess the performance of the subject company for such criteria, Calibrate the market inputs to the subject entity to take into account the relevant performance as compared to the comparable companies.

VALUATION MULTIPLE

Based on assessing the company's exposure to ESG issues and strategic plan and governance related to managing the issues, the analyst can adjust (Premium or discount) price multiples in valuing a company compared to peer companies. For example, an ESG risk may depress the company's bottom line by 10% compared to peers (assuming all the other factors are unchanged); the analyst can adjust 10% in market multiple. Similarly, an FMCG company is spending heavily on developing a packaging waste collection system while its peers are not doing anything significant, demanding a premium on valuation multiple.

HOW TO CIRCUMVENT THE SUBJECTIVITY OF ESG?

Given the potentially subjective nature of the assessment of the materiality and application of ESG-related adjustments on the cash flows and the discount rate, these adjustments could also be applied in varying degrees under different scenarios, wherein each scenario would reflect the impact of a particular material ESG factor on the business. The final valuation outcome could be a weighted-scenario outcome wherein probabilities and weightings (based on materiality) are attached to the various ESG scenarios based on materiality.

CONCLUSION

Given the implications of ESG factors on the long-term sustainability and financial viability of a company, there should be a paradigm shift among practitioners to take into account the long-term benefits of having businesses operate in a sustainable manner, while simultaneously balancing the need to achieve short-term financial goals. Valuation has a pivotal role to play in quantifying and realizing the benefits of sustainable practices. However, due to the lack of standardisation, insufficient data, and an unclear correlation between ESG factors and a company's returns the findings currently still involve a lot of uncertainty. Nonetheless, taking into account ESG factors, both for the operational planning of companies and for company valuations, should not be overlooked as it will become increasingly important in the future. Business valuation outcomes are a reflection of the storyline 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. ESG is likely to have increasing significance in the years to come. Continuous efforts are required to achieve consensus on a standardised approach to incorporate ESG into the valuation. Valuation has a pivotal role to play in quantifying and realising the benefits of sustainable practices.

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