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ESG Valuation

As the global investment community increasingly prioritises environmental, social, and governance (ESG) factors, valuation practitioners face a critical juncture. While the awareness of ESG's significance has grown in recent years, translating these principles into robust and transparent valuation practices remains challenging.

Traditionally, the integration of ESG into valuations has been hampered by a lack of clear guidelines and reporting standards, leading to inconsistent and sometimes ambiguous adjustments by valuers. Consequently, the basis for ESG-related adjustments often lacked transparency and wide recognition.

However, the landscape is shifting. Recent revisions to the International Valuation Standards and International Financial Reporting Standards now explicitly require consideration of ESG factors in valuations, underscoring the growing importance of ESG due diligence (ESG DD) in capturing both the risks and opportunities presented by ESG factors.

This shift necessitates enhanced due diligence processes that can effectively assess the impact of ESG factors, leading to more robust and reliable valuations - a practice that we call “ESG Valuation”. By embracing ESG Valuation, practitioners can ensure their services are aligned with the evolving expectations of investors and regulators, providing greater transparency and soundness during the valuation process.

Professionals engaged in ESG due diligence

A range of practitioners, including ESG rating agencies, ESG advisors, valuers, and compliance advisors, play a vital role in conducting ESG DD. Their objective is to gain a comprehensive understanding of their clients' ESG performance through various methods including those listed below.

Questionnaires	To gather detailed information about client's ESG policies, practices, and performance.
Site visits	To observe target's operations at first hand and assess their ESG practices in real-world settings.
Regulatory checks	To verify target’s compliance with relevant ESG regulations and standards.
Expert opinions	To gain specialised insights from subject-matter experts on specific ESG issues.

While the specific approach to ESG DD varies depending on the objectives of the engagement, these exercises generally adhere to well-recognised ESG frameworks, including:

- **Global Reporting Initiative (GRI)**
- **Sustainability Accounting Standards Board Standards**
- **Task Force on Climate-related Financial Disclosures (TCFD)**
- **International Financial Reporting (IFRS) Sustainability Disclosure Standards**
- **Green Loan Principles**

Motivations for conducting ESG due diligence

Investment decisions

Assessing ESG risks and opportunities
ESG DD helps investors evaluate the potential financial impacts of ESG factors on a company's performance. By considering factors like greenhouse gas emissions, labour practices, and corporate governance, investors can gain a more complete picture of a company's risk profile and identify potential opportunities for value creation.

Supporting investment decisions
ESG DD enables investors to make more informed decisions by providing them with a comprehensive understanding of a company's ESG performance. This includes information on the company's ESG policies, practices, and track records.

Meeting investor demand
Growing investor interest in ESG issues is driving demand for ESG DD. Investors are increasingly seeking investments that align with their values and contribute to a sustainable future. ESG DD helps investors identify companies that are effectively managing their ESG risks and capitalising on ESG opportunities.

Compliance with regulations
A growing number of regulations, particularly in the EU, require investors to consider ESG factors in their investment decisions and due diligence processes. For example, the EU Sustainable Finance Disclosure Regulation (SFDR) requires financial market participants to disclose how they integrate ESG risks and opportunities into their investment processes.

Corporate governance and risk management

Identifying and managing ESG risks
Companies use ESG DD to identify and manage ESG risks that could have a negative impact on their business, such as environmental liabilities, human rights violations, or corruption.

Improving business performance
ESG DD can help companies improve their overall business performance by identifying opportunities to reduce costs, improve efficiency, and enhance their reputation.

Mitigating supply chain risks
ESG DD is increasingly used to assess and mitigate ESG risks in supply chains. This can include identifying suppliers that engage in unsustainable practices or have poor human rights records.

Enhancing brand reputation
Companies can enhance their brand reputation by ensuring that their supply chains are sustainable and ethical. ESG DD can help companies identify and address potential risks to their reputation.

Significant business benefits

- Improved financial performance
- Strengthened stakeholder relationship
- Increased transparency and accountability

Key considerations for conducting an effective ESG due diligence

Materiality	Focus on ESG issues that are most material to the specific company or industry.
Framework selection	Choose an ESG framework that aligns with the objectives of the due diligence exercise and the reporting needs of the stakeholders.
Data quality	Ensure the accuracy and reliability of ESG data collected.
Engagement	Engage with key stakeholders, including suppliers, employees, and communities, to gather insights and build trust.
Integration	Integrate various ESG DD findings for a comprehensive understanding of ESG risks and opportunities.

ESG valuation in practice

While the importance of ESG is increasingly recognised, its application in valuation methodologies is still evolving. To enhance the integration of ESG into valuations, we suggest focusing on several key aspects crucial for effective ESG Valuation in practice. The following recommendations can provide guidance on how to integrate ESG considerations more systematically and accurately within valuation processes.

1. Define materiality

Material ESG issues are those that are likely to significantly affect enterprise value within a specific subindustry. ESG Valuation should mostly focus on the impacts of the relevant material ESG issues. Poorly defined materiality levels of ESG factors may lead to inaccurate estimation of the financial impacts. Using a materiality framework like the Sustainability Accounting Standards Board (SASB) standards can help prioritise issues.

2. Identifying and assessing ESG risks and opportunities

ESG DD is critical to uncovering and evaluating how ESG factors could impact a company's future performance. After identifying the key ESG issues, ESG Valuation then assesses the respective financial impacts. The material ESG issues are quantified through management estimation, expert opinions, industry benchmarking, etc. Reasonableness of such estimation is critical to sound ESG valuation.

3. Incorporating ESG into valuation models

Adjusting financial forecasts

ESG factors can be integrated into valuation models by adjusting key financial metrics like revenue, costs, and capital expenditures. For example, a company facing regulatory risks related to carbon emissions could lead to higher compliance costs, impacting future profitability.

Scenario analysis can be used to model the potential impact of different ESG-related events on a company's financial performance.

Adjusting discount rates

ESG factors can also influence discount rates, which are crucial parameters used in valuations.

Companies with strong ESG performance may be perceived as lower risk, leading to a lower cost of capital.

Conversely, companies with significant ESG risks may face higher financing costs due to concerns about their long-term sustainability.

4. ESG integration in different asset classes

Equities

Increased integration of ESG factors into equity valuation assessments of a company's financial performance, growth prospects, and risk profile. This can involve adjusting financial forecasts to reflect the impact of ESG risks and opportunities or adjusting the discount rate to account for ESG-related risks.

Fixed income

ESG integration in fixed income valuations focuses on assessing a company's ability to repay its debt obligations over time. ESG factors can signal potential credit risks that may not be captured by traditional financial metrics.

Sovereign debt

ESG Valuation of sovereign debt focuses on a government's ability and willingness to repay its debt obligations, considering factors such as environmental risks, social stability, and governance quality.

Infrastructure

Infrastructure projects often involve long time horizons, significant environmental and social impacts, and complex stakeholder relationships. Detailed ESG DD is needed for accurate quantification of the material ESG issues.

Real estate

Environmental impact of the real estate to the surroundings, as well as climate risk impact are increasingly important in real estate valuations, influencing factors such as operating costs, tenant demand, and property values.

Challenges and opportunities

1. **Data availability and quality**:
   Reliable and comparable ESG data remains a challenge, particularly for non-public companies.
2. **Lack of standardised metrics**:
   The absence of universally accepted ESG metrics for aspects such as social evaluations.
3. **Subjectivity in valuation adjustments**:
   Integrating ESG into valuations often involves subjective judgments about the financial materiality of ESG factors.
4. **Transparency and disclosure**:
   Enhanced transparency and disclosure of ESG-related valuation adjustments are needed to ensure credibility and comparability.

Despite these challenges, ESG valuation represents a significant opportunity for practitioners to enhance their services and meet the evolving needs of investors and regulators. By adopting robust ESG DD processes and integrating ESG factors into their valuation models, practitioners can contribute to a more sustainable and resilient financial system.

Comparable company analysis with ESG factors

Comparable company analysis is a critical part of ESG valuation, a range of techniques for integrating ESG considerations into the analysis can be adopted. One prominent method is adjusting the beta or discount rate to reflect the impacts of ESG factors. Such adjustments relate to the selection of comparable companies, and the capital structure and costs of capital of the comparable companies and the valuation target itself.

We suggest the following approach for incorporating ESG factors into a comparable company analysis:

Identify comparable companies

1. Start by identifying a set of comparable companies within the same industry as the target company. This involves considering factors such as business model, size, geographic location, and financial performance.

Collect ESG data

2. Gather ESG data on each company from various sources, including ESG ratings providers, company disclosures, industry reports, and news articles.

Assess ESG performance

3. Analyse the collected data to evaluate each company's performance on relevant ESG factors. This may involve considering industry-specific ESG risks and opportunities.

Ranking

4. Rank the comparable companies based on their overall ESG performance.
- This step often involves subjective judgment, as different investors may prioritise certain ESG factors over others.
- A classified approach can be utilised to select companies classified to have similar ESG practices and performances within the industry.

Adjust beta / discount rate

5. Once the companies are ranked, adjust the beta or discount rate for each company based on its relative ESG performance.
- Companies with stronger ESG performance may be assigned a lower beta or discount rate, reflecting lower perceived risk.
- Conversely, companies with weaker ESG performances may warrant a higher betas or discount rates.

Incorporate adjustments into valuation

6. Finally, incorporate these adjusted betas or discount rates into the valuation model, these adjustments will impact the applicable cost of capital and ultimately the valuation result.

A practical example on beta β: ESG Valuation for an apparel company

- Three comparable companies are identified and their ESG performances are assessed.
- Company A is a leader in ethical sourcing and labour practices, while Company C has faced criticism for its environmental record and poor working conditions. Company B falls somewhere in between.
- Based on this analysis, a lower beta may be assigned to Company A, a higher beta to Company C, reflecting their relative ESG risks.
- These adjusted betas will then be used in the valuation model, ultimately impacting the valuation result.

Conclusion

Enhanced ESG DD is necessary for valuation practitioners to better identify the ESG risks and opportunities of individual companies, which can then be quantified more reasonably in ESG valuations. Detailed consideration on relevant adjustments of valuation parameters and the selection of comparable companies is conducive to robust ESG valuation.

How we can help

Moore Hong Kong has been actively providing transaction and valuation advisory services to its clients. We are eager to share our insights on the subject matters in this regard, with our team of valuation specialists and transaction advisory experts, who are holders of professional qualifications including the Certified ESG Analyst (CESGA) designation granted by the European Federation of Financial Analysts Societies (EFFAS), Chartered Financial Analyst (CFA), Financial Risk Manager (FRM), Certified Public Accountant (CPA), member of the Royal Institution of Chartered Surveyors (MRICS) and Chartered Alternative Investment Analyst (CAIA).

To find out more on ESG DD and ESG Valuation, or other transaction advisory matters, please contact one of our experts below:

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