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Strategy and Sustainability

Stages of Integrated ESG Assessment Within Investment Processes: Valuation & Company Integrated Assessment

ESG & Sustainability Transformation

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After the research stage and any relevant risk and materiality mapping, investment analysts assess the impact of material financial and ESG factors on the corporate and investment performance of a company.

This can lead to adjustments to the following:

- Forecasted financials
- Valuation-model variables, such as cost of capital or terminal growth rates in discounted cash flow analysis;
- Valuation multiples
- Forecasted financial ratios
- Internal credit assessments
- Assumptions in qualitative or quantitative models

Regardless of whether a hurdle process is used, adjustments in models can be made - positively or negatively - on assessment.

Model Adjustments Based on ESG Assessment:

Discounted cash flow input adjustments:

A company's environmental management processes and policies are judged strong or weak. After this judgment, the cost of capital used to discount cash flows in a DCF analysis is adjusted down or up by 1% to account for this. This can also be on a country or sector basis, where a country or sector ESG risk factor can contribute to a change in a cost of capital or terminal value growth assumption. For example, the coal sector might be judged to have a negative environmental impact.

Note how the judgment on the E factor leads to a change in the financial model assumption. This is a complement. A higher cost of capital would lead - all other factors being equal - to a lower intrinsic value estimate from the model. This is an example of how the E factor then affects a valuation model.

Also note that the sizing of the adjustment is typically at the discretion of the analyst, though the analyst might use certain guidelines.

Explicit Profit and Loss Sales, Balance Sheet and Margin Adjustments from ESG Assessment:

Rather than changing model discount assumptions, explicit sales or margin assumptions can be adjusted. For example, an analysis of a company's strong management of its employees (as assessed by employee engagement or satisfaction metrics) leads to an assessment of strong future customer satisfaction, which in turn leads to sales forecasts five years out being raised to above the industry average to account for this strong social factor score.

An adjustment can be a direct impact (e.g., an assessment of an environmental litigation fine being $400m) or the risk-adjusted impact of a carbon tax might be forecast to be an absolute dollar amount per year in a model.

Adjustments can be made directly to the balance sheet or capital expense lines. A practitioner might believe that ESG factors will lead a company to decrease or increase its future capital expenditure. A forecast ESG impairment event (e.g., a substandard factory) could result in an impairment charge being made to bring the company's book value down.

Valuation Ratio Adjustments with ESG Integration:

Adjustments can also be made to valuation ratios.

An investor might decide that a company is worth a certain P/E ratio premium or discount versus its peers because of ESG factors.

Alternatively, an investor might be prepared to invest in a company with, for example, a 50% discount on a P/E ratio versus an index benchmark simply because the company is judged to have a high ESG risk.

Conversely, an investor might be willing to invest in a company at a 50% premium on a P/E ratio because of strong ESG characteristics.

The adjustment might also be absolute. For instance, the investor might assign a "fair value P/E" of 16x to a strong ESG company versus 14x for an average ESG company and 12x for a weak ESG company.

How ESG Analysis Can Complement Traditional Financial Analysis:

A few theoretical examples can now be examined. (These examples might be useful for thinking about how ESG factors affect industry and company performance. They show how integrated many ESG techniques and thinking are.)

One theoretical concept in fundamental analysis might be weak or strong ESG factor:

- Weak or strong business driver or moat
- Up or down sales or margins
- Up or down long-term cash flow
- Up or down intrinsic value
- Up or down share price

This might be expressed as high employee engagement or satisfaction (proved by being number one versus the competition on surveys or having an X% higher score against a threshold):

- High customer satisfaction (judged by a high net promoter score)
- Higher sales growth than competition
- Higher valuation than competition

The judgment of an intangible ESG factor, such as employee relations, complements an analysis of customer satisfaction and the assumptions that lead into a model of sales growth (a traditional financial factor).

Alternatively, high carbon intensity (proved by scope 1 and 2 carbon intensity being both absolute and relative to the sector):

- Increased risk from carbon taxes

- Increased cost of debt for new project financing
- Higher taxes
- Increased balance sheet risk of default on debt
- Change in debt rating
- Lower value of corporate debt

Here, the judgment of an E factor, such as exposure to carbon, leads to an analysis on the risk to debt pricing. It complements a traditional take on default risk.

Alternatively, weak governance identified in a private company (proved by a board with poor skills, not independent, non-diversified thinking):

- Increased risk of negative capital allocation decisions
- Lower future cash flows or difficulty in IPO to capital markets
- Lower valuation or increased bankruptcy risk

Here, a judgment on a G factor in a private company affects both a valuation and possible exit for a private equity investor.

Active Ownership as an ESG Technique:

What is worth noting here is how integration with a stewardship function - whether outsourced or part of the same investment team - might work in an integrated ESG approach. For instance, a stewardship-led investment team might gain a commitment or an action to improve (e.g., weak governance by gaining a commitment to recruit independent board members and an independent chair, thereby influencing future cash flows and valuations). Such strategies could come under an active ownership or ESG activist approach. The information gained from an active engagement might also inform the ESG and traditional analysis; for instance, a management team's unwillingness to disclose carbon emissions and not commit to future disclosure could affect an investment team's ESG analysis.

To learn more about ESG and sustainability-related models, don't hesitate to contact **YTT Consulting**!