YTT. Consulting
Strategy and Sustainability

ESG Integration Assessment Stages in the Investment Process: Valuation & Integrated Company Assessment

ESG & Sustainability Transformation

Hung NINH 12/2023 ESG Transformation

ESG Integration Assessment Stages in the Investment Process: Valuation & Integrated Company Assessment

Following the research phase as well as mapping the materiality and associated risks, investment analysts will assess the impact of material financial and ESG factors on a company's investment performance and corporate performance.

This may result in 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, model adjustments can be made - either positive or negative - during evaluation.

Adjusting the Model Based on ESG Assessment:

Adjusting Discounted Cash Flow Inputs:

The company's environmental management policies and processes are assessed as strong or weak. Following this judgment, the cost of capital used to discount cash flows in the DCF analysis is adjusted downwards or upwards by 1% to take this into account. This can also be on a country or industry basis, where country or industry ESG risk factors may contribute to changes in the cost of capital or terminal value growth assumptions. For example, the coal industry may be assessed as having a negative environmental impact.

Note that the E-factor judgment results in a change in the financial model assumptions. This is an addition. A higher cost of capital will result in – all else being equal – a lower intrinsic value estimate from the model. This is an example of how the E-factor affects the valuation model.

Also note that the size of the adjustment is often at the discretion of the analyst, although the analyst may use certain guidelines.

Clear Balance Sheet Adjustments, Profit Margins, Revenue Gains and Losses, From ESG Assessment:

Instead of changing the discounting assumptions in the model, explicit assumptions about revenue or profits can be adjusted. For example, an analysis of a company's ability to effectively manage its employees (as measured by employee engagement or satisfaction metrics) leads to an assessment of strong future customer satisfaction, which in turn leads to a forecast of sales over the next five years that will be higher than the industry average, to account for the strength of this social factor.

The adjustment can be a direct impact (e.g., an assessment of a $400 million fine from environmental litigation) or a risk-adjusted impact of a carbon tax that can be forecast as an absolute amount per year in a model.

The adjustment can be made directly on the balance sheet or capital expenditure line. The assessor may believe that ESG factors will cause the company to reduce or increase capital expenditures in the future. An anticipated ESG impairment event (e.g. a non-conforming plant) could result in an impairment charge being taken to reduce the company's book value.

Adjusting Valuation Ratios with ESG Integration:

Adjustments can also be made to valuation ratios. An investor may decide that a company has a higher P/E or should be discounted by a certain amount relative to its industry peers because of ESG factors. Additionally, an investor may be willing to invest in a company with, say, a 50% discount to its benchmark P/E simply because the company is perceived to have a high ESG risk.

Conversely, an investor may be willing to invest in a company with a 50% higher P/E ratio because of strong ESG characteristics. Adjustments can also be absolute. For example, an investor might assign a “fair value P/E” of 16x to a company with strong ESG versus 14x for a company with average ESG and 12x for a company with weak ESG.

How ESG Analysis Complements Traditional Financial Analysis:

Let us consider a few theoretical examples. (These examples can be useful when thinking about how ESG factors affect the performance of certain industries and companies. They show how many ESG thoughts and techniques are integrated.) A theoretical concept in fundamental analysis might be a weak or strong ESG factor:

- Weak or strong business momentum or moat
- Increasing or decreasing revenue or profit
- Increasing or decreasing long-term cash flow
- Increasing or decreasing intrinsic value
- Increasing or decreasing stock price

This can be demonstrated by high levels of employee engagement or satisfaction (as evidenced by ranking number one above competitors in surveys or scoring X% above the threshold):

- High customer satisfaction (as measured by a high net promoter score)
- Higher revenue growth than competitors
- Higher pricing than competitors

Assessing intangible ESG factors, such as employee relations, can complement analysis of customer satisfaction and the assumptions that drive sales growth models (a traditional financial factor).

In addition, high carbon intensity (as evidenced by both absolute and relative scope 1 and 2 carbon intensity relative to the industry):

- Increased risk from carbon taxes

- Increased cost of debt to finance new projects
- Higher tax rates
- Increased risk of default on the balance sheet
- Changes in debt ratings
- Decreases in the value of corporate debt

Here, the assessment of the E factor, such as exposure to carbon risk, leads to a risk analysis of the valuation of debt. It complements the traditional view of default risk.

In addition, poor governance identified in a private company (evidenced by a board that is poorly skilled, un-independent, and not diverse):

- Increased risk of negative capital allocation decisions
- Lower future cash flows or difficulty in IPOing in the capital markets
- Lower valuation or increased risk of bankruptcy Here, the assessment of the G factor in a private company affects both the valuation and the exit potential of a private equity investor.

Active Ownership as an ESG Technique:

It is worth noting here how integration with the asset management function (stewardship) – whether outsourced or within the same investment group – can work within an integrated ESG approach. For example, an asset management investment group may seek to improve or take action to improve (e.g. governance weaknesses by seeking to recruit independent directors and an independent chairman, thereby impacting future cash flows and valuation). Such strategies may fall under active ownership or an active ESG approach. The information gained from active engagement can also inform ESG analysis and traditional analysis; for example, a company's management team's unwillingness to disclose its carbon emissions and failure to commit to future disclosures may impact the investment analysis team's ESG analysis.

To learn more about ESG and sustainability-related models, please contact **YTT Consulting**!