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How does ESG drive value?

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Investors are increasingly applying non-financial factors such as Environmental, Social and Governance (ESG) as part of their process to identify material risk and growth opportunities.

What is ESG Investment

A set of standards measuring a business's impact on society, the environment, and how transparent and accountable it is.

Environmental

Focuses on how a business can minimise its impact on the environment. Covers a businesses' products/services, its supply chain and operations:

- Reducing energy and using renewable energy sources
- Move towards net zero
- Developing greener products and services
- Use of sustainable packaging and/or using biodegradable materials
- Reducing carbon emissions
- Increased recycling and reducing landfill waste

Social

Focuses on various social aspects on how a business impacts wider society and workplace culture. Ways in which businesses can contribute to equality and fairness in society, by investing in fair and equal opportunities and conditions for employees, people in the supply chain, and local communities:

- Ensuring products are safe
- Ensuring customer data is secure
- Labour rights and modern slavery in supply chain
- Training, health & safety and wellbeing
- Equality in the workforce with diversity & inclusivity policies
- Investment in local community projects

Governance

Relates to processes of decision-making, reporting and the way in which businesses should be run.

Also relates to a business's ethical behaviours and its transparency with stakeholders about its activities.

ESG can be applied to all businesses, which will be increasingly important:

- Accurate reporting to stakeholders
- Accountability of risk and performance management
- Undertake business ethically
- Diversity in a leadership team
- Openness about executive pay

Benefits of having a strong ESG Proposition

A strong ESG proposition will enable companies to:

- tap into new markets and expand into existing ones with governing authorities more likely to approve and licensed based on the prior performance in sustainability.
- enhance the investment returns by having more sustainable plant and equipment for the long term as well as avoid investments that may not pay off because of longer-term environmental issues.
- access resources through stronger community and government relations that will boost employee motivation and attract talent through greater social credibility.
- Attract quality employees, enhance employee motivation by instilling a sense of purpose, and increase productivity overall.
- allocating capital to more promising and more sustainable opportunities, such as renewables and waste reduction.
- avoid investments that may not pay off because of longer-term environmental issues

Trends in ESG funds

ESG funds seek to make investments in equities or bonds whereby the companies being invested in meet certain ESG criteria.

- ESG-related assets under management (AuM) are expected to increase 84% by 2026 compared to 2021
- ESG assets are anticipated to constitute 21.5% of total global AuM in less than 5 years.
- There is an active investment community which lobby and raise awareness on ESG investment
- Demand from retail investors increasing as awareness increases and demographic shift

What investors look for:

To fulfil their ESG criteria assessed through a combination of independent ESG consultants and their own in-house ESG team.

An Environmental Social Action Plan (ESAP) is used to set out the environmental and social mitigation risk factors, objectives and how this will be measured through KPIs, including:

- Energy consumption and efficiency
- Greenhous Gas Emissions
- Renewable energy use
- Water usage
- Staff turnover
- Training
- Absenteeism
- Litigation
- Corruption

According to Blackrock, during the peak of the Covid-19 pandemic in 2020, over 80% of ESG funds outperformed non-ESG based funds.

Proven track record of financial returns and therefore due diligence pre-investment is as important as for any investor.

Integrating ESG into Valuation and Investment

Investors want to integrate ESG risks and opportunities, and their financial impact, on any investment decision.

Recently, there has been a larger adoption of ESG frameworks by several organizations. The main purpose is to provide investors with a greater transparency and comparability and to assist asset managers in communicating clearly the ESG-related features of their investment products. In addition, the ESG framework adoption aims to enhance the relevance, reliability and comparability of non-financial information disclosed.

Market based approach

A private company is usually benchmarked against comparable public companies in terms of business activities, target markets, revenue contribution and profitability.

As ESG rating systems are still early stage and share prices are typically too volatile to draw out the impact of individual ESG issues, relying on a quoted company share price and multiple to illustrate the impact of ESG actions on value is currently difficult in practice.

In order to perform such an exercise, there needs to be better data and better reporting standards around ESG data for investors and valuers to make the comparison.

Therefore, with sustainability reporting becoming more dominant and obligatory under IFRS, investors will be able to differentiate companies based on their disclosures of ESG strategy and more standardised performance metrics, and thus make informed investment decisions.

Income approach

Valuation models may include an assessment of the most significant ESG demands for key stakeholders, quantify the costs to meet or exceed them and the financial implications of doing so.

Taking this into account, companies need to consider price elasticity of different customers to estimate whether this will enhance or destroy brand value through changes in demand or discounted/premium pricing.

Revenue

The company's sales growth rate my increase or decrease by an amount that reflects the level of ESG opportunities or ESG risks.

Operating costs and operating margin

The influence of ESG factors on future operating costs may need to estimated, by either adjusting costs directly or adjusting the operating profit margin. For instance, the operating costs of a chemical company may increase with the additional costs associated with new legislation on toxic waste.

Terminal cashflows

The long term prospects of a company need to be considered. Certain ESG risks may also trigger doubt of sustainability of business model and foreseeable closure, hence resulting in terminal value of zero.

Adjustment to discount rate

The beta or discount rate can be increased or decreased for companies considered to possess high or low ESG risk, thus in turn reducing or increasing the overall value of the company.

Given the significant demand from investors and lenders for ESG investment opportunities, ESG performance metrics are increasingly linked to the cost of debt through the inclusion of ESG linked debt margin ratchets. The cost of debt may increase or decrease in line with the borrower's performance on pre-agreed ESG targets.

Why is ESG important for your business

Although, climate change is core of ESG, but ESG is wider than climate change alone and takes account of sustainable finance, business and human rights and governance.

Accountants and auditors have an expanding role to play in determining the integrity of their company's or their clients' disclosure of ESG topics.

Increasingly, organisations are integrating ESG criteria into their corporate strategies, operating models and management incentive plans.

This has been driven by many factors, including regulatory requirements, consumer sentiment, competitive pressures and the aim of being an attractive employer.

A well-defined and well-executed ESG strategy can help a company stand out within the investment community, and drive value throughout the fund lifecycle.

Companies need to assess their current environmental, social, and governance capabilities so as to develop an actionable and flexible guide for moving forward.

This will empower them with a clear understanding of how to execute to achieve desired ESG goals and objectives and deliver necessary outputs (including increased value) to all stakeholders.

1. **Increased revenue**
2. **Reduced risk**
3. **Improved brand and reputation**
4. **Reduced cost**
5. **Increased investments**

How we can help:

The best place to start is with a thorough assessment of your ESG goals and objectives, what has been implemented and achieved so far, and what the next steps should be on your ESG journey to best drive positive impact and deliver outstanding value.

Our services include:

- Strategy and policy
- Operations and implementations
- Risk and disclosure
- ESG Assurance
- Investment impact

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