

The Rise of ESG and the Impact on Business Valuations and Economic Damages

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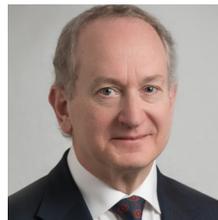
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Introduction

ESG has been a topic of increasing focus in corporate, legal and regulatory spaces in the past few years, expected to have an important impact on international arbitration and the types of disputes that tribunals will see going forward. One question that commonly arises in both investor-state and commercial disputes in international arbitration is with regard to business value, or the present value of lost cash flows: a common example of investor-state disputes relates to lawful or unlawful expropriation of commercial assets or projects, requiring a damages expert to assess the value of the subject assets or project(s). Similarly, a commercial arbitration relating to a breach of contract by one party requires an assessment of the impact to the harmed party in terms of the value of its future expected cash flows, determined as of the date on which the breach occurred.

In determining business value or the value of future earnings, our study seeks to determine whether the emerging ESG trend has an impact on business value or the value of future earnings, and if so, how the impact may be assessed and quantified. In this introductory article, we explore the topic of ESG, why it matters more today than before, how market participants view the emerging focus on ESG, and what possible impacts ESG has or will have on the valuation of businesses and business operations.

What is ESG?

ESG—or environmental, social and governance issues—appears to be one of the most ubiquitous terms in corporate affairs today and one of the fastest growing trends in investment, management and regulation topics globally. It is first important to attempt to define what the term “ESG” refers to, or perhaps more simply, what issues it comprises.

ESG includes a broad array of topics and issues, as demonstrated in Figure 1.

The figure below only begins to attempt to list the possible issues considered under an ESG “umbrella,” covering what organizations and their stakeholders consider to be relevant issues in the environmental, social and governance areas relating to businesses. Equally important is the notion that what may be relevant to an organization in one industry (such as the extractive industry of oil and gas) may bear little relevance for an organization operating in an entirely different industry (such as technology).

There are also other terms used in different jurisdictions, locations, or industries, that have similar meanings to the broader ESG themes, such as corporate social responsibility (“CSR”) and sustainability being the more

Figure 1. ESG Components



commonly encountered terms. ESG would appear to encapsulate these terms, although no standardized definitions or differentiation between the various terms exist.

In order to better understand the current landscape, we surveyed senior professionals involved in business operations and strategy as well as investment professionals, and we further interviewed certain of these professionals. Our focus was on whether ESG issues impact their day-to-day operations, how, if at all, they incorporate ESG factors into their analysis of business value, what issues they face in doing so and what they'd like to see in the future in the ever-changing ESG landscape.

When asked to what extent, if at all, ESG is factored into their organization's decision making, all survey respondents noted that they consider or directly factor ESG issues into their business or investment decisions. Half of respondents noted that ESG had first factored into their decision making process over five years ago, and the remainder noted more recent incorporation of ESG within the last five years. Governance—the “G” of ESG—was the topic of strongest focus among respondents, with 80% assigning the highest rating in terms of their organizational focus to governance, followed by Environmental issues at around 60% and social issues at 40%.¹

A senior executive we interviewed with over 25 years of experience in the mining industry confirmed this perspective, stating that the rise in ESG issues factored into decision-making by investors has intensified in the last two to three years to a point that was unanticipated. He noted that in his conversations with investors 10 years ago, ESG as a topic would arise around half an hour

into or near the end of a meeting, whereas today, ESG issues start and sometimes even dominate meetings, with other matters being discussed after ESG.

The increased adoption of and focus on ESG begs the question: why does ESG matter more so today than ever before to business operators and valuers? We examine recent trends in ESG adoption below.

Why does it matter?

As ESG continues to become more prevalent in corporate affairs, it is self-evident that a practitioner must, at the least, consider its impact on their organization. There are evident drivers of the increasing role ESG is playing in the day-to-day affairs of businesses, including the following:

1. In 2022, Bloomberg estimated that \$41 trillion was invested in ESG-related assets globally, which is expected to grow to \$50 trillion by 2025. Currently, ESG investment funds make up about a third of all investment dollars managed globally, as shown in Figure 2 below.² An increase in funds available for and restricted to investment in companies that are “ESG-compliant” signals a shift in investment behaviour—and a follow-on effect for capital-seeking companies towards the implementation of ESG strategies relevant to their industry.

2. High-profile ESG-related corporate scandals impacting firm value, such as Facebook's data privacy scandal in 2018, Volkswagen's emissions test cheating scandal in 2015, BP's Deepwater Horizon oil spill in 2010, and the Enron accounting fraud in 2001, all received widespread public attention, caused observable losses in the companies' stock value (and in Enron's case, bankrupted the company entirely) and increased the market's perception of risk related to these companies.

¹ Participants could rank ESG issues with equal importance, if applicable.

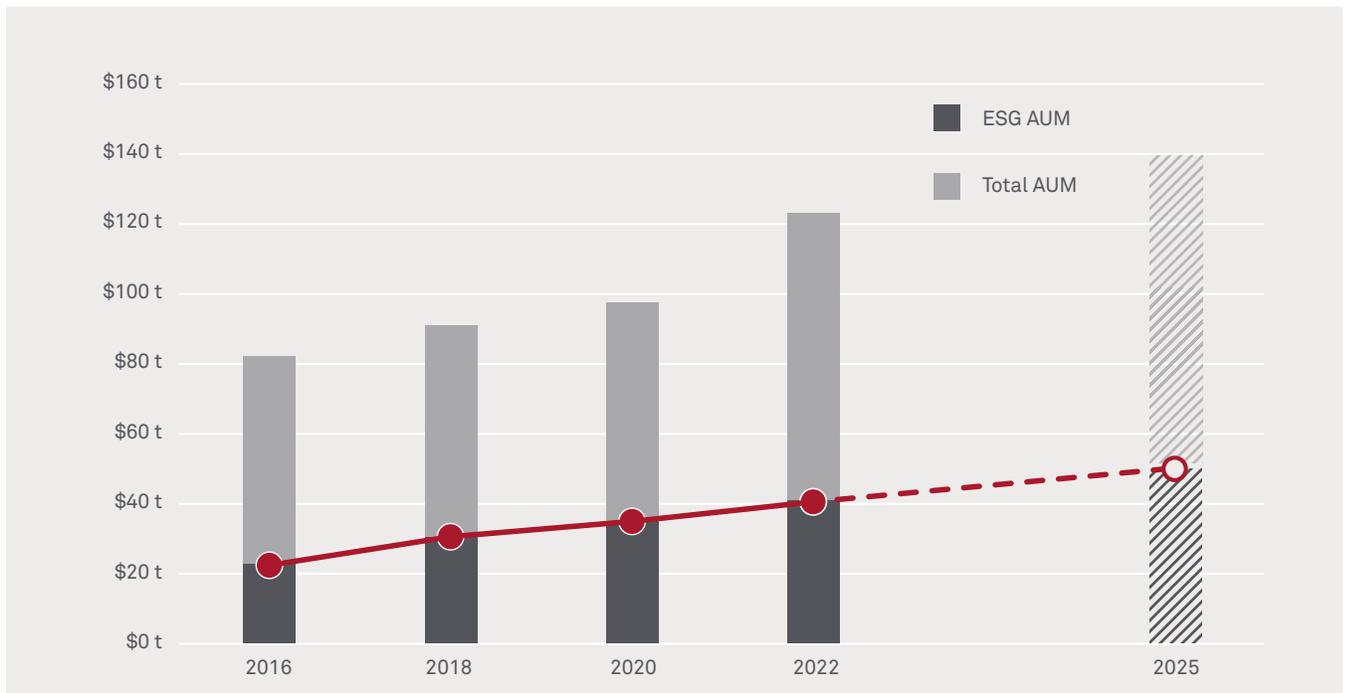
² Bloomberg Intelligence, “ESG Assets Under Management: 2022 Outlook” dated January 24, 2022.

3. There has been a noticeable increase in regulatory standards and requirements surrounding ESG and ESG reporting; for example, the European Union’s Corporate Sustainability Reporting Directive (CSRD), adopted in November 2022;⁴ the US Securities and Exchange Commission’s (SEC’s) proposed climate-related disclosure rules, issued in March 2022 and expected to be effective early 2023;⁵ and the International Financial Reporting Standards (IFRS) Foundation’s International Sustainability Standards Board (ISSB) which was launched in November 2021 and released the first exposure drafts for its global standards for sustainability and climate-related reporting—i.e., the

IFRS Sustainability Disclosure Standards—in March 2022, expected to be finalized in June 2023.⁶ A full discussion of the impact of these regulations in the various jurisdictions is beyond the scope of this article, however, the result is an increase in pressure on companies globally to monitor their impact and adjust behaviours as required.

4. Increasing consumer demand for “sustainable” products, from clothing to vehicles. In 2022, Forbes reported that Generation X consumers’ preference to shop sustainable brands had increased by almost 25% from two years prior, and their willingness to pay more for sustainable products had increased in 42%.⁷

Figure 2. ESG Assets Under Management (AUM), 2016-2022 and Forecasted 2025 (in trillions of dollars)³



³ Global Sustainable Investment Alliance, Global Sustainable Investment Review 2020, Figure 1, page 9; Bloomberg Intelligence, “ESG Assets Under Management: 2022 Outlook” dated January 24, 2022.

⁴ European Parliament press release, “Sustainable economy: Parliament adopts new reporting rules for multinationals” dated November 10, 2022.

⁵ Financial Times, “Climate risks gain corporate acknowledgement after SEC prodding” dated December 30, 2022.

⁶ ESG Today, “IFRS Chair: Global Sustainability and Climate Reporting Standards to be Released in June” dated January 19, 2023.

⁷ Forbes, “Consumers Demand Sustainable Products And Shopping Formats” dated March 11, 2022.

Similarly, electric-vehicle sales achieved a milestone in 2022, achieving around 10% of global market share, representing an increase of 68% from the previous year.⁸ These examples indicate an increased consumer demand for sustainable products and services.

5. In 2022, the Harvard Law School Forum on Corporate Governance reported that a vast majority of S&P 500 companies are now tying executive compensation to some form of ESG performance. The article reported growth to 73% of companies tying ESG to compensation in 2021, having increased from 66% in 2020,⁹ signaling an increased focus on ESG at the top corporate level of organizations.

It is therefore undoubtable that ESG matters—more so today than ever before. For some, especially those in the mining industry, however, ESG has long been a part of day-to-day business operations. A senior law partner and board member of a public mining company that we interviewed emphasized that ESG is, and has been, vitally important to the mining industry, in that it factors into decision-making at the Board and operational management level and plays a part in the economics and value assessment of mining projects. He cited an example of a decision to convert the transportation fleet for an underground mining project from diesel to electric, which impacts direct costs (for example, the cost of installing charging stations), offset by energy cost savings from a reduction in the ventilation of diesel and fumes underground—in short, major decisions valued at hundreds of millions of dollars which are being made and to an extent, have always been made, by companies incorporating ESG factors into their decision-making.

A similar viewpoint was shared by an executive and investor in a group of mining projects based in Europe, North and South America. He noted that while mining has always been a heavily regulated industry as it relates to environmental and social issues, ESG is becoming a much more relevant focal point compared with the last 10-15 years in his experience. While he cited examples of long needing to have two years of environmental baseline studies documenting the environmental impact of a mining project on a particular site, the requirement to set funds aside for site rehabilitation—often leaving sites in better condition at the end of a mining project—and studies and licenses required around the social impact on indigenous communities, he noted a recent shift in the focus by markets on carbon emissions, whereby companies are having to measure and report on their carbon footprint. This is causing his companies to take real action: transitioning to renewable sources of power including solar power in project locations such as countries in South America, and switching to electric vehicles for use in operations. He noted that while these decisions at the corporate level are resulting in minor capital cost increases in the near-term, the expectation is that these costs will be offset by lower energy costs in the long-term.

Thus, not only does ESG matter, but it is impacting the decisions and therefore the value of businesses—an impact which may need to be explicitly considered in performing an assessment of value if it is not already, and which may or may not result in significant differences to the outcome of a business valuation. In this article,

⁸ Wall Street Journal, “EVs Made Up 10% of All New Cars Sold Last Year” dated January 16, 2023.

⁹ Harvard Law School Forum on Corporate Governance, “Linking Executive Compensation to ESG Performance” dated November 27, 2022.

we first set out the various schools of thought on ESG as it relates to business value. We then discuss current guidance provided the various finance and accounting institutions, and our views as to how ESG may be incorporated into valuing businesses in a more disciplined way. We end with our outlook on what the future holds with respect to ESG in corporate affairs, and what practitioners, business owners and operators, and market participants hope to see with respect to the emerging ESG landscape.

2

ESG Schools of Thought

As set out above, it is hardly debatable that ESG is a burgeoning trend demanding increased attention from the investment industry and regulators alike. Nevertheless, its impact on business operations, prospective business value and stakeholder returns remains a topic of debate.

The term “ESG” was first coined in a 2004 United Nations (UN) report prepared as part of a joint initiative with the financial industry (including some of the world’s largest banks such as Goldman Sachs, Morgan Stanley, UBS, Credit Suisse Group, Deutsche Bank, HSBC, BNP Paribas, etc.; insurance companies; and investment advisors).¹⁰ The purpose of the initiative was *“to develop guidelines and recommendations on how to better integrate environmental, social and corporate governance issues in asset management, securities brokerage services and associated research functions.”*¹¹ The report postulated that *“[c]ompanies that perform better with regard to [ESG] issues can increase shareholder value by, for example, properly managing risks, anticipating regulatory action or accessing new markets, while at the same time contributing to the sustainable development of the societies in which they operate.”*¹²

¹⁰ Elizabeth Pollman, University of Pennsylvania Carey Law School, “The Origins and Consequences of the ESG Moniker,” pages 11-12.

¹¹ The United Nations Global Compact, “Who Cares Wins: Connecting Financial Markets to a Changing World”, dated December 2004, page i.

¹² The United Nations Global Compact, “Who Cares Wins: Connecting Financial Markets to a Changing World”, dated December 2004, page i.

In the almost 20 years since, not much has changed with respect to the perceived benefits of implementing ESG-related strategies. What has evolved is our ability to measure the value of these perceived benefits. And the results are, interestingly, mixed, as we discuss further below.

Drivers of Firm Value

First, it is important to establish the items that drive firm value in order to understand the way in which ESG might impact value.

Value is prospective, meaning that for an economically viable business, it is mainly a function of future discretionary cash flows. The value of these future cash flows at a current date—i.e., the present value of the future cash flows—is determined by discounting them at a risk-adjusted discount rate. Thus, the drivers of value of a business can be distilled down to two main components:

- 1. Prospective future cash flows:** Based on the best estimate of future earnings and cash flows for a business as of a point in time; and,
- 2. Discount rate:** The risk associated with the cash flows being discounted, driven by market factors impacting the business, such as industry factors, macroeconomic conditions, geographical location, and other influences on the risk perceived with a business. The discount rate of a company is equivalent to its cost of capital – i.e., the rate of return on its debt capital (or interest cost of debt) and its equity capital. Generally speaking, the higher the cost of capital for a company, the lower its firm value as the bigger the discount that is levied against its prospective future cash flows.

The increased focus on ESG issues in the corporate world may thus impact value in two ways: by affecting a business' expected future cash flows, or by altering

its cost of capital (discount rate). Herein, we explore ESG's potential impacts on value, and how it may be factored in when valuing businesses and claims related to business value.

ESG and Positive Returns on Capital

As mentioned above, proponents of ESG have long suggested that companies that incorporate ESG practices can increase shareholder value while also positively impacting the surroundings in which they operate—a proposition commonly referred to in forms of “doing well while doing good.”

In March 2020, Professor Aswath Damodaran, a well-known and widely cited academic in the fields of finance and business valuations along with Professor Bradford Cornell of the University of California's Anderson Graduate School of Management published a research paper titled “Valuing ESG: Doing Good or Sounding Good?” in which they examined “*how being socially responsible can manifest in the tangible ingredients of value and [...] evidence for whether being socially responsible is creating value for companies and for investors.*”¹³ The authors postulated that “being good” could converge with “doing well” in the following ways:¹⁴

- 1. Revenue growth:** customers buy more from “good” companies, resulting in higher revenue growth;
- 2. Operating margins:** operating expenses are higher in the short term, but go back down in the long term, leading to unchanged or even higher margins;
- 3. Growth/Investment efficiency:** capital invested in good businesses deliver higher returns, resulting in higher sales per capital and returns on capital spent;
- 4. Cost of capital (equity and debt):** investors and lenders prefer to invest in “good” companies, pushing up stock prices (lowering cost of equity) and lending at lower rates (lowering cost of debt); and

¹³ Aswath Damodaran and Bradford Cornell, “Valuing ESG: Doing Good or Sounding Good?” dated March 20, 2020, page 2.

¹⁴ Aswath Damodaran and Bradford Cornell, “Valuing ESG: Doing Good or Sounding Good?” dated March 20, 2020, Figure 2, pages 8-9.

5. Failure risk: by operating as a good corporate citizen, the company minimizes the chance of a scandal or catastrophic event that could put its business model at risk, making it a more “sustainable” business.

Based on their research, the authors first noted a significant issue that arises when attempting to link ESG-compliance with financial performance, which is the lack of a universal metric by which to measure ESG-

compliance. Research conducted in 2019 identified 70 different firms that provided some sort of ESG ratings data,¹⁵ including, for example, Refinitiv (formerly, Thomson Reuters), Bloomberg, MSCI, Sustainalytics, Carbon Disclosure Project (CDP), to name a few.¹⁶ The ratings systems adopted by these firms were also found to vary, leading to different ratings for the same company produced by different firms, shown in the figure below:

Figure 3. Differences in ESG Scores by Company, by Ratings Provider¹⁷

The 20 Largest Market-Cap Companies in the United States as of December 31, 2017

COMPANY	SECTOR	WEIGHT	ESG score		E score		S score		G score	
			PROVIDER 1	PROVIDER 2						
Apple	Technology	3.52%	0.41	0.43	0.69	0.96	0.10	0.42	0.54	0.19
Amazon	Cyclical	2.82%	0.23	0.07	0.25	0.13	0.15	0.20	0.51	0.06
Microsoft	Technology	2.78%	0.88	0.94	0.89	0.92	0.90	0.83	0.74	0.84
Alphabet	Technology	2.76%	0.33	0.48	0.54	0.67	0.50	0.75	0.10	0.10
Facebook	Technology	2.00%	0.29	0.20	0.77	0.23	0.32	0.63	0.07	0.01
Berkshire Hathaway	Financial	1.97%	0.04	0.04	0.06	0.07	0.04	0.24	0.04	0.04
JPMorgan Chase	Financial	1.53%	0.79	0.76	0.97	0.75	0.88	0.82	0.45	0.45
Johnson & Johnson	Health Care	1.34%	0.95	0.87	0.95	0.90	0.97	0.45	0.78	0.92
Bank of America	Financial	1.27%	0.59	0.81	0.86	0.79	0.58	0.88	0.29	0.54
Exxon Mobil	Energy	1.24%	0.70	0.53	0.45	0.35	0.65	0.91	0.86	0.37
Wells Fargo	Financial	1.10%	0.84	0.31	0.82	0.87	0.80	0.30	0.70	0.03
Visa	Financial	1.07%	0.75	0.65	0.67	0.63	0.53	0.37	0.98	0.71
Walmart	Cyclical	1.03%	0.72	0.35	0.64	0.77	0.61	0.10	0.73	0.42
Intel	Technology	0.89%	0.75	0.99	0.81	0.84	0.99	0.99	0.37	0.99
Cisco	Technology	0.86%	0.98	0.98	0.88	0.86	0.95	0.98	0.93	0.78
AT&T	Telecomm	0.86%	0.94	0.86	0.98	0.82	0.84	0.50	0.80	0.87
UnitedHealth Group	Health Care	0.84%	0.18	0.51	0.16	0.60	0.20	0.16	0.40	0.67
Pfizer	Health Care	0.84%	0.68	0.67	0.65	0.59	0.85	0.66	0.39	0.57
Chevron	Energy	0.82%	0.32	0.30	0.32	0.21	0.41	0.87	0.35	0.25
Boeing	Industrial	0.82%	0.51	0.24	0.48	0.42	0.38	0.08	0.63	0.47

¹⁵ Feifei Li and Ari Polychronopoulos, “What a Difference an ESG Ratings Provider Makes!” dated January 2020, page 3.

¹⁶ Feifei Li and Ari Polychronopoulos, “What a Difference an ESG Ratings Provider Makes!” dated January 2020, pages 4-5.

¹⁷ Feifei Li and Ari Polychronopoulos, “What a Difference an ESG Ratings Provider Makes!” dated January 2020, page 10.

These differences were driven by the types of metrics used to assess different ESG attributes, differences in scope of what attributes were assessed and the weighting or level of materiality assigned to each attribute by the ratings provider.¹⁸ For example, while virtually all ratings include the most highly publicized ESG indicators in their ratings (carbon emissions, climate change effect, pollution, waste disposal, renewable energy, discrimination, diversity, community relations, human rights, and independent directors), ratings agencies failed to agree on how these indicators are to be measured, and included or excluded other indicators in different ways when calculating ESG scores.¹⁹

Notwithstanding the issues noted with reporting consistency, Professors Damodaran and Cornell found that the overall evidence on how “good” companies perform on growth/profitability measures relative to “bad” companies was mixed—some research showed a small positive link between ESG and operating profitability depending on the time period selected, while other research found a negative relationship between ESG and return on capital, and still other research found no link between profitability and social responsibility.²⁰

In ESG research updates published by Professor Damodaran in 2021 and 2022, he reported finding no link between “good” ESG companies and increases in revenues or operating margins, stating specifically that there is *“little evidence that ‘good’ companies are able to grow faster [than] ‘bad’ companies, but there is some evidence,*

albeit anecdotal, that it is more difficult for good companies, in some sectors, to scale up” or grow its revenues.²¹ Professor Damodaran also found that while some studies found that “good” companies are more profitable than “bad” companies, these studies are unable to show causality, meaning that it could be the simple case that more profitable companies find it easier to look good²² (by way of, for example, more embellished or fulsome ESG disclosures).

A related but more focused study was performed by Professor Elizabeth Demers (University of Waterloo), Jurian Hendrikse (Tilburg University), Professor Philip Joos (Tilburg School of Economics and Management) and Professor Baruch Lev (New York University Stern School of Business), in which they sought to understand whether ESG provided an insulation for stocks’ performance during the COVID-19 market crash.²³ The researchers found, using a multiple regression model which provided robust evidence, that ESG was not significantly associated with stock market performance during the first quarter of 2020. For the researchers, this was *“a sobering finding considering all the hype.”*²⁴

ESG and Risk Measurement

Nonetheless, while evidence linking ESG to positive operating performance or stock performance is weak or unsubstantiated, Professors Damodaran and Cornell did report more evidence linking ESG with a company’s cost of capital. Specifically, they found that evidence supported the fact that the cost of capital (or discount rate) of “bad” companies was higher than for “good” companies. For example, “sin stocks”—companies involved in businesses such as alcohol,

¹⁸ Feifei Li and Ari Polychronopoulos, “What a Difference an ESG Ratings Provider Makes!” dated January 2020, pages 5-6.

¹⁹ Aswath Damodaran and Bradford Cornell, “Valuing ESG: Doing Good or Sounding Good?” dated March 20, 2020, page 3.

²⁰ Aswath Damodaran and Bradford Cornell, “Valuing ESG: Doing Good or Sounding Good?” dated March 20, 2020, pages 1, 15-16.

²¹ Aswath Damodaran, “The ESG Movement: The Goodness Gravy Train Rolls On!” dated 2022, page 15.

²² Aswath Damodaran, “The ESG Movement: The Goodness Gravy Train Rolls On!” dated 2022, page 15.

²³ Harvard Law School Forum on Corporate Governance, “ESG Didn’t Immunize Stocks Against the Covid-19 Market Crash” dated September 8, 2020.

²⁴ Harvard Law School Forum on Corporate Governance, “ESG Didn’t Immunize Stocks Against the Covid-19 Market Crash” dated September 8, 2020.

tobacco and gaming—have been less commonly held by institutions, resulting in those companies having to pay investors a higher return for the reputational cost associated with holding sin stocks. Similarly, the authors cited a report from 2011 that showed that companies facing concerns regarding social responsibility paid higher interest rates on their loans, relative to companies without those concerns, leading to a higher discount rate for those firms.²⁵ As stated above, a higher discount rate, or cost of capital, translates to a lower firm value.

Professor Damodaran's updated research in 2021 and 2022 indicated similar results. He stated that “[t]he strongest evidence that is supportive of ESG comes on the risk front, with evidence that it does not pay to be a ‘bad’ company, with some [sic] a higher cost of funding and greater risk of catastrophes[...].” Specifically, Professor Damodaran cited evidence that investor aversion to buying shares in “bad” companies can lead to higher costs of equity for these firms.²⁶ Professor Damodaran's 2021 and 2022 research updates also reported that “good” companies are able to borrow money at lower rates (again caveating that the studies indicating as such are in a specific industry—the “green energy” space).²⁷

This was consistent with results from our survey asking respondents whether they foresaw any impacts (benefits such as cost savings and efficiency or risks such as reputational and financial risks) with not having an ESG policy in place. The majority of respondents—almost 90%—cited increased reputational, financial and other risks as an impact, with the remainder citing no impact.

The above finding manifests beyond “sin stocks” in the recent environment as the market's view of problematic industries expands beyond alcohol, tobacco and gaming.

A recent example of this observation linking ESG practices with the discount rate is HSBC's decision in late 2021 to phase out thermal coal-related financing in the European Union (EU) and Organization for Economic Cooperation and Development (OECD) markets by 2030, and worldwide by 2040.²⁸ We discussed this with an investment director specializing in responsible investing at an asset management firm with over a trillion dollars in assets under management. He noted that HSBC's decision was the culmination of several factors, mainly the result of an increase in lending rates to thermal coal companies with existing debt, where the renewal of that debt is as at higher interest rates today, given the lack of lending appetite for thermal coal-related businesses.

“The ESG trend [is] *“the greatest thing that has happened to consultancy since Y2K.”* [...] In the mining sector, ESG has long been a key part of doing business in the form of having a social license to operate and obtaining environmental studies for which approval can take years. Yet [...] there seems to have been the creation of an entire industry around companies attempting to demonstrate that they are doing the right thing.”

²⁵ Aswath Damodaran and Bradford Cornell, “Valuing ESG: Doing Good or Sounding Good?” dated March 20, 2020, page 12.

²⁶ Albeit noting that the evidence comes primarily from fossil fuel firms, as the following recent example confirms. Aswath Damodaran, “Musings on Markets.” “The ESG Movement: The ‘Goodness’ Gravy Train Rolls On!” dated September 14, 2021, page 3 of the PDF.

²⁷ Aswath Damodaran, “Musings on Markets,” “The ESG Movement: The ‘Goodness’ Gravy Train Rolls On!” dated September 14, 2021, page 3 of the PDF. Aswath Damodaran, “The ESG Movement: The Goodness Gravy Train Rolls On!” dated 2022, page 15.

²⁸ HSBC News Release, “HSBC Announces Thermal Coal Phase-Out Policy” dated December 14, 2021.

The Potentially Dark Side of ESG

Still, Professor Damodaran and others are generally cynical when it comes to ESG, especially with regards to the proposition that investing in companies with higher ESG scores generates higher returns. He believes that this suggestion is fueling the creation of a new industry with certain beneficiaries—ESG ratings or score measurement agencies, accounting firms that push for additional ESG disclosures, investment funds that charge additional fees for ESG investment and ESG consulting firms that charge fees for advising companies on how to implement and improve on ESG criteria.²⁹

This general viewpoint was supported in our discussions with the mining industry law partner and board member, who called the ESG trend “*the greatest thing that has happened to consultancy since Y2K.*” He noted that, in the mining sector, ESG has long been a key part of doing business in the form of having a social license to operate and obtaining environmental studies for which approval can take years. Yet, he noted, there seems to have been the creation of an entire industry around companies attempting to demonstrate that they are doing the right thing, citing examples such as hiring consultants to rate carbon emissions and ESG performance, rating agencies competing to be the scorecard of choice, and accounting firms competing over work around disclosures and standards. He observed that this translates into the production of large annual reports on ESG at a huge cost to companies, whereas, in his view, companies ought to stop talking about ESG at length—a few paragraphs in his view would be equally as effective since more disclosure does not mean better disclosure.

A related and even bigger issue with respect to inflated ESG disclosure by companies is the emergence of false or misleading reporting and branding about their products or practices being ESG-compliant. Given the lack of consensus about what the term ESG actually entails, the current deficiencies in standardized reporting—both general and industry-specific—around the topic of ESG and the absence of standardized regulations and guidance, it is hardly surprising that some firms take advantage of such lack of clarity to disseminate false claims about their ESG practices.

The SEC in the US has started to monitor and act on such misinformation—in 2022, the SEC charged Goldman Sachs Asset Management, L.P. and BNY Mellon Investment Adviser, Inc. for missteps related to their ESG considerations and practices—Goldman Sachs’ investment arm was charged for not having and following ESG policies and procedures, and BNY Mellon’s investment arm for misstatements and omissions related to their incorporation of ESG factors. The two companies paid a \$4.0 million and \$1.5 million penalty, respectively.³⁰ The SEC’s actions highlight an increasing role being taken by regulators in monitoring and policing ESG-related reporting and behaviour, a step in the right direction to providing additional clarity to fund managers on the required reporting and procedural requirements when incorporating ESG.

The lack of regulation was cited as a key issue to implementing proper ESG practices and disclosure in our discussions with the mining executive and investor. Despite the positive actions that his various projects are assessing and implementing in response to the increased

²⁹ Aswath Damodaran, “The ESG Movement: The Goodness Gravy Train Rolls On!” dated 2022, page 29.

³⁰ Securities and Exchange Commission press release, “SEC Charges Goldman Sachs Asset Management for Failing to Follow its Policies and Procedures Involving ESG Investments” dated November 22, 2022.

Securities and Exchange Commission press release, “SEC Charges BNY Mellon Investment Adviser for Misstatements and Omissions Concerning ESG Considerations” dated May 23, 2022.

focus on carbon emissions, he noted that his biggest challenge is being able to communicate ESG actions effectively and efficiently with stakeholders, including investors. To do this, he emphasized the need for standardized reporting, which he stated needs to come from the industry and investors, and which will set requirements and a framework for junior mining companies to be able to effectively convey information that investors and stakeholders at large are able to compare across firms in the industry.

ESG, Beyond Financial Returns

Given the current landscape, even taking into account skepticism around the link between ESG and simple shareholder returns and despite the issues around implementation of standardized ESG compliance, it is indisputable that the ESG “trend” has not only gained momentum in recent years but that it is a trend that is likely to persist – at least for the foreseeable future. The majority of respondents to our survey (86%) believes that ESG is a permanent consideration that most or all businesses will be required to incorporate.³¹

Even Professor Damodaran accepts this, providing “a roadmap for being good and doing good”³² in which he advises readers that in the long term they may have to accept lower returns if investing in ESG-compliant businesses, stating that “[t]elling companies that being good will always make them more valuable, investors that they can add morality constraints to their investments

and earn higher returns at the same time, and young job seekers that they can be paid like bankers, while doing peace corps work, is delusional.”³³

The notion that investors and stakeholders continue to support the adoption of ESG despite lower financial returns was supported by a recent study³⁴ performed by Malcolm Baker, Mark Egan and Suproteem K. Sarkar at Harvard University, in which they found that not only are investors willing to pay additional fees (around 20 basis points, or 0.2%) to invest in an ESG-compliant fund, but that they accept lower financial returns (by over 60 basis points, or 0.6%) for the psychic and societal benefits of ESG.³⁵ This

The message appears to be that while ESG may not directly correlate with higher market returns on investment, it is still an increasingly prevalent factor in corporate affairs that has an impact on value—whether that is positive or negative will depend on the specific issues and industry involved.

³¹ With the remainder preferring not to answer; no respondents believe that ESG is a temporary trend in the market that will go out of fashion.

³² Aswath Damodaran, “The ESG Movement: The Goodness Gravy Train Rolls On!” dated 2022, page 32.

³³ Aswath Damodaran, “The ESG Movement: The Goodness Gravy Train Rolls On!” dated 2022, page 33.

³⁴ Malcolm Baker, Mark Egan and Suproteem K. Sarkar, “How Do Investors Value ESG?” dated November 2022. Note: Study is in working paper form, finalized version to be released at a future date.

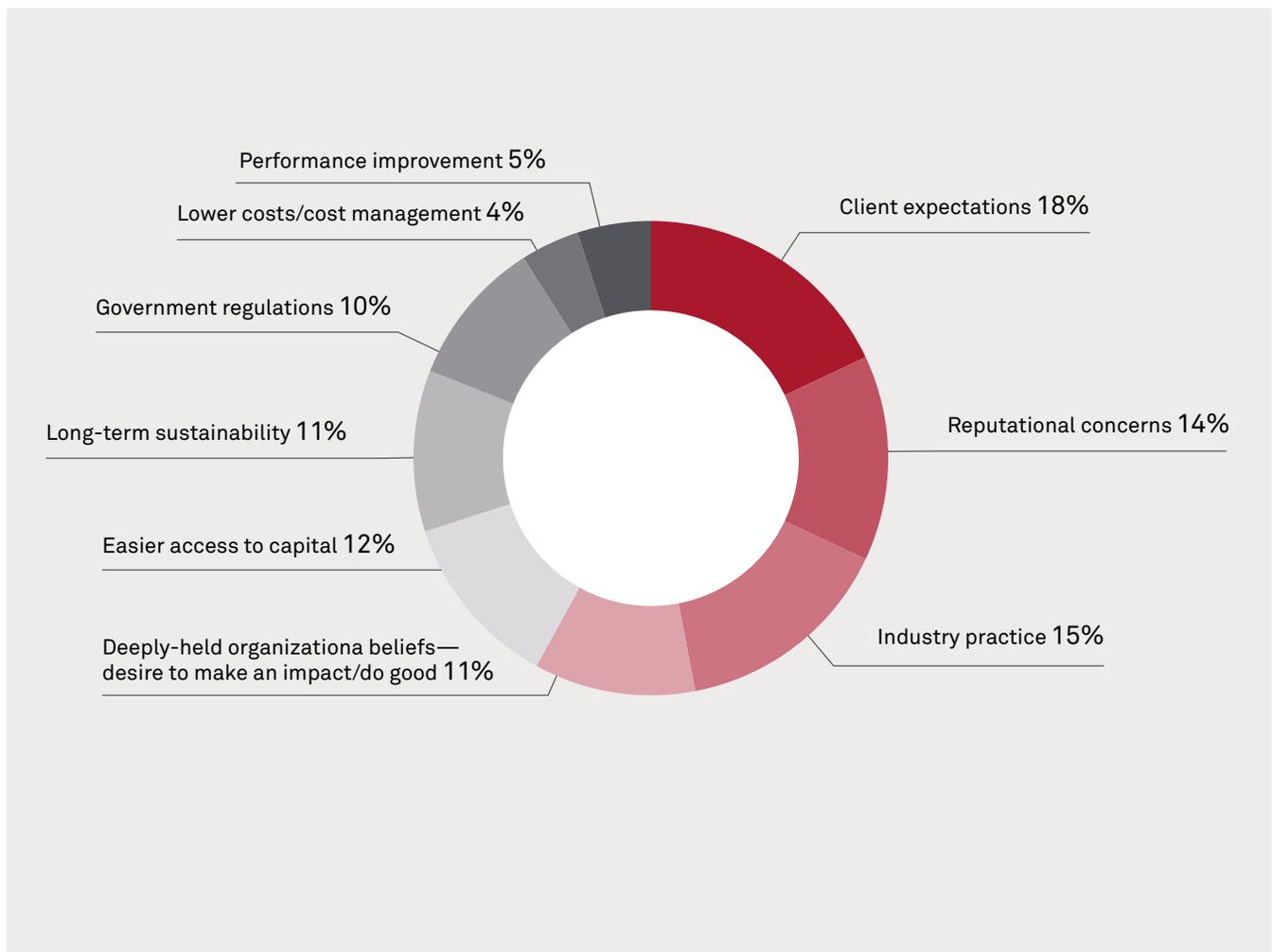
³⁵ Malcolm Baker, Mark Egan and Suproteem K. Sarkar, “How Do Investors Value ESG?” dated November 2022, pages 1, 4 and 26.

is consistent with conclusions by other researchers in the space, who have noted that “citizens looking for solutions from any quarter to cure society’s pressing ills ought not appeal to financial returns alone to mobilize corporate involvement.”³⁶

The reasons cited by survey respondents for the adoption of ESG policies or practices is summarized in Figure 4.

The message appears to be that while ESG may not directly correlate with higher market returns on investment, it is still an increasingly prevalent factor in corporate affairs that has an impact on value—whether that is positive or negative will depend on the specific issues and industry involved.

Figure 4. Survey Respondents’ Reasons for ESG Adoption



³⁶ Aswath Damodaran and Bradford Cornell, “Valuing ESG: Doing Good or Sounding Good?” dated March 20, 2020, page 15.

3

How ESG May Be Incorporated into Business Valuations

Thus, as ESG issues become increasingly more prevalent in corporate affairs, it is incumbent upon those assessing value to consider the ESG issues relevant to a business in a more disciplined manner. It is clear from the above that ESG topics impact business value—and in some cases, may be already incorporated into existing valuations.

In the example provided by the mining executives where a project's fleet is being converted from diesel to electric, this would be factored into the upfront capex costs and ongoing operating costs of the mine plan, therefore impacting the mine's projected future cash flows directly.

Where ESG may not yet be incorporated is with respect to emerging issues relevant to a particular industry or risks related to ESG factors that are not being factored into a company's decision-making, but should be.

The Chartered Professional Accountants (CPA) of Canada institution, along with the Accounting for Sustainability (A4S) project and other institutions, published a guide in

2021 for practitioners to incorporate climate change—one of the issues of top focus among the various ESG areas—into business valuations.³⁷ The A4S “*CFO Leadership Network's Essential Guide To Valuations And Climate Change*” provides a framework to assess the impact of climate change on business valuations. This framework is outlined below:

Step 1: Identify the value drivers of the subject company. This will help identify areas in which climate-related risks and opportunities are likely to be found.³⁸

Step 2: Assess sources of climate change risks and opportunities. These include, but are not limited to, transition risks due to changing regulations which may increase compliance costs, physical risks due to temperature increases which may increase raw material costs, and resource efficiency opportunities which may reduce operational costs.³⁹ These risks and opportunities can be found through the following:⁴⁰

- a. Discussions with management;
- b. Review of corporate reporting (i.e., annual reports and sustainability reports of subject and comparable companies);
- c. Review of the Sustainability Accounting Standards Board (SASB) materiality map, which identifies sustainability issues likely to affect the financial condition or operating performance of an industry/sector;
- d. Review of analyst reports;
- e. Review of risks reported by external data providers; and
- f. Review of asset-level data.

³⁷ Chartered Professional Accountants Canada and Accounting for Sustainability (A4S) CFO Leadership Network, “Essential Guide to Valuations and Climate Change” (the “**A4S Guide**”).

³⁸ A4S Guide, page 21.

³⁹ A4S Guide, pages 25-29.

⁴⁰ A4S Guide, page 23.

Step 3: Filter the assessed sources of climate change risks and opportunities for those that should be evaluated more closely for incorporation into the valuation. This can be done by considering the likelihood and level of impact of each risk/opportunity and using professional judgement to decide which should be considered in the valuation.⁴¹

Step 4: Integrate the risks and opportunities into the valuation models, where appropriate. For the discounted cash flow model (DCF), it is preferable to reflect the climate change risks and opportunities directly into cash flows; however, this should only be done if the cash flows can be estimated reliably. If the cash flow impact is highly uncertain and is challenging to quantify, then the risk/opportunity should be reflected in the discount rate instead. For the market approach, the subject company's climate risks and opportunities should be compared to the risks and opportunities of peer companies, and the valuation multiple adjusted accordingly. Specifically, we should compare the climate risk rating of the companies' sector and geography, industry-specific climate change metrics, and the current and prior period overall climate assessment.⁴²

Step 5: Triangulate the risks and opportunities and their related impacts on the subject company versus its peers. This assists in confirming the reasonability of the valuation adjustments in Step 4. Triangulation should also be repeated over time as information develops and improves, which solidifies the certainty and quantifiability of the risks and opportunities.⁴³

We spoke to an academic and researcher with a focus on ESG, who also recommended the use of the SASB materiality map which can be used to apply the A4S valuation framework to any ESG issue in a similar way as the topic of climate change. SASB's materiality map

visually reveals how 26 general sustainability issues manifest across 77 industries—which the professor informed us will form the backbone of the upcoming ISSB standards when reporting on material issues to a company based on the industry in which it operates. She also believes that as new research continues to emerge and the data availability on ESG issues evolves over time—when companies perform well on ESG issues material to their industry (as mapped by the SASB materiality tool)—evidence will show that those companies outperform the market, thus stressing the importance of material, relevant ESG issues being addressed.

Conclusion

Regardless of whether ESG can be correlated with higher returns or more profitable operations, it is a factor at play in corporate affairs more so today than ever. ESG is driving investment demand and impacting investors' risk assessment of companies, which in turn is driving corporate behaviour, and which undoubtedly will have an impact on company values and future outlook. For those companies that are not currently taking action, regulatory changes could force changes to certain areas of operating businesses based on the industries in which they operate.

While ESG appears to be an important consideration for the foreseeable future, much improvement in the space is required before any of the anticipated benefits can manifest themselves or be measured reliably. As stressed by several of our interviewees, standardized reporting regulations and convergent ESG assessment ratings are the next step in achieving a common basis for business operators, market participants and all stakeholders to have a starting point to navigate the complex and evolving ESG

⁴¹ A4S Guide, pages 32-33.

⁴² A4S Guide, pages 35 and 38.

⁴³ A4S Guide, page 40.

landscape globally. Concerns around the relative benefits provided by nascent consultancies and ratings agencies versus their costs should be addressed in-house by decision-makers, as well as by investment funds and other users, prior to their retention.

Ultimately, however, it is becoming clearer that the main drivers of ESG policies, actions and behaviour are the increasing demand from stakeholders (investors, customers, market observers, and others) with an inherent desire to “do good” as well as companies’ desire to reduce risk while maintaining a hope to achieve longer-term sustainability and value.

We plan to update our research on a regular basis, tracking updated ESG issues, adoption and implementation, and the corresponding effects on business value. Our hope is that as regulations continue to emerge and ESG reporting becomes more convergent across jurisdictions and industries, and as additional, more streamlined data continues to become available with the passage of time, the impact of ESG factors on the risk-adjusted rates of return quantified for businesses may be more easily and empirically determined. Our aim is to determine if an “ESG premium” to be included in the discount rate for non-compliant organizations can be reasonably determined, and if this might be incorporated in the Capital Asset Pricing Model used to determine the Weighted Average Cost of Capital (similar to a Country Risk Premium). Stay tuned for more in the ESG space in the future.

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