CBV Institute

CBV INSIGHTS

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UNDERSTANDING VALUE IMPACTS ON PRIVATE COMPANIES THROUGH AN ESG LENS

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About Chartered Business Valuators Institute (CBV Institute)

CBV Institute leads the Chartered Business Valuator (CBV) profession – Canada's only designation dedicated to business valuation since 1971. With CBVs and Students across Canada and around the world, we uphold the highest standards of business valuation practice through education, accreditation and governance of the CBV, for the benefit of the public interest. The integrity of the CBV accreditation is grounded in the rigorous CBV Program of Studies and upheld by the Membership Qualification Examination and Code of Ethics.

CBV Insights

CBV Insights is a thought leadership periodical published throughout the year, sharing relevant insights on emerging topics of interest to our network and the general public. The opinions expressed by contributing authors in *CBV Insights* periodicals do not necessarily carry the endorsement of CBV Institute.

INTRODUCTION

In April 2023, the Bank of Canada released its first annual climate risk disclosure report as a supplement to its annual financial statements.[1] The Bank of Canada provided two reasons for enhancing its financial disclosure with climate-risk information – to be accountable to Canadians, and because it wants others to do the same so that we can all make better decisions.

What lesson can private company owners and executives learn from the Bank of Canada's message? The short answer is that it signals a shift in stakeholder and shareholder expectations. There's now an increased demand for high quality information about sustainability-related business risks, as well as the financial impact of those risks.

But the Bank of Canada is not the driving force in this shift. For example,

- asset owners and asset managers have been reporting on climate-related matters as recommended by the Task Force on Climate-related Financial Disclosures (TCFD) since 2017; and
- larger publicly listed corporations have been issuing sustainability reports listing their UN Sustainable Development Goals (SDGs) since 2015.

Building from these efforts, international regulatory and accounting bodies have progressed from climate-focused disclosures to a broader definition of sustainability, an umbrella term that includes ESG (Environmental, Social and Governance). **IFRS Sustainability Disclosure Standards** (ISSB Standards) will come into effect in January 2024 for public companies and large private companies in several jurisdictions. In the first year of implementation, only climate-related disclosures will be mandatory; sustainability-related disclosures will become mandatory in the second year. We note that while ISSB Standards are not currently mandated in Canada, the Canadian Securities Administrators (CSA), who determine the reporting requirements for Canadian public companies, is considering ISSB and U.S. developments and is expected to align with international requirements.

Canada's family-owned and private companies are not presently the target of these disclosure requirements, but there is no doubt that ESG considerations are set to impact every player in the Canadian economy. For one, the ripple effects of ESG practices and disclosures will be felt throughout the supply chain, flowing from larger public companies down to private enterprises.

Understanding the financial impact of ESG factors is key to appropriately quantifying and understanding the risks, making better business decisions, and turning them into opportunities for value creation.

WHAT DO BUSINESS OWNERS AND EXECUTIVES NEED TO KNOW ABOUT ESG?

ESG stands for environmental, social, and (corporate) governance. Investors, lenders and other stakeholders are increasingly considering ESG factors in their analysis to understand the impact and sustainability of a company's action. ESG factors may impact business valuations both from a qualitative and quantitative perspective.

Chartered Business Valuators (CBVs) seek to identify which ESG factors pose material risks and growth opportunities to businesses, and which may drive and create business performance and value.

ESG includes a broad array of topics and issues, and there is no definitive list. It can be challenging to classify an ESG issue as only an environmental, social or governance issue because they are often interrelated. Some key ESG factors (posing risks and opportunities) are included in the below table.

ENVIRONMENT

- air & water pollution
- biodiversity
- climate change (current and future risks)
- clean water & sanitation
- carbon & other gas emissions
- deforestation
- natural disaster
- resource efficiency (i.e., energy, water, raw materials)
- waste management

SOCIAL

- human rights in the supply chain
- community relations
- conflict
- customer satisfaction
- labour relations
- employee health, safety & well-being
- development of human capital (health & education)
- employee engagement
- equity, diversity & inclusion (EDI)

GOVERNANCE

- corporate governance
- board diversity & structure
- audit committee structure
- business ethics
- bribery & corruption
- data security & privacy
- ESG integration with financials
- executive remuneration
- management succession planning
- transparency & communication

Further complicating things, ESG is often used interchangeably with sustainability, despite having distinct meanings and implications. One distinction is that ESG is used as a structured framework for evaluating specific business performance criteria, while sustainability takes a broader, holistic view, connected to a company's ability to deliver long term value for its investors. For example, a business may have a sustainability program that addresses specific ESG factors over the short, medium and long term.

WHY SHOULD PRIVATE BUSINESS OWNERS CARE?

Strong ESG practices mitigate risks, open doors to new opportunities, drive innovation, attract top talent and strengthen our communities.

— Export Development Canada[2]

Few small and midsize business owners in North America feel they have the bandwidth to create a strategic climate plan for their business, while they remain preoccupied with the challenges posed by inflation, supply chain and labour issues.[3]

And for now, sustainability disclosure requirements mostly affect publicly listed companies and large international corporations.

But Chartered Business Valuators (CBVs), Canada's leading finance professionals with extensive knowledge and expertise in the specialized field of business valuation, are witnessing a trickle-down effect impacting private companies. Investors, lenders, and customers are increasingly asking companies of all sizes for their sustainability goals, management succession plans, disaster preparedness, ESG regulatory costs, etc. The following pages feature some lessons learned from CBVs who have been successfully guiding their private company clients through this "new normal."

Ultimately, however, this "new normal" is about more than just satisfying information requests. Investors are no longer looking at ESG initiatives as a sunk cost or trade-off – some specifically use money to influence ESG efforts, such as investing in sustainability-linked loans. There is now an expectation that companies tackling sustainability issues will deliver better commercial returns over the long term. But with limited time and resources, which ESG initiatives are worth tackling first? This is where CBVs enter the picture. CBVs understand value-drivers. They work with management to create shareholder value, the primary objective of any enterprise. CBVs also understand business risk. They employ a variety of analytical approaches to address how risk affects cash flows and corporate values, including ESG considerations. A CBV can help translate the impacts of specific risks on financial performance and offer valuable advice to maximize the value of your business.

WHAT HELP CAN CBVs OFFER PRIVATE BUSINESSES?

CBVs play a critical role in providing independent analysis and advice to private companies. On the following pages, CBVs share insights from their experiences advising private companies on ESG issues that have arisen in ownership disputes and buyouts, deals, transaction due diligence, private investments, and even ESG-related legal claims. Read on to learn more about how considering ESG factors may drive long-term corporate value at your company, enhance operations, and boost confidence when interacting with stakeholders.

ESG ISSUES ARE BUSINESS ISSUES, AND THEY ARE HERE TO STAY

Should having a sustainability strategy in place matter to private companies? For those of you looking for the quick answer – it should. If you'd like to know why, read on.

IT'S HERE TO STAY

Sustainability issues are business issues, and they matter. As a Chartered Business Valuator, I see value through a lens of risk and future benefit. All other things being equal, a decrease in risk will result in an increase in value, provided of course the cost of decreasing the risk doesn't offset the benefit. Having a sustainability strategy in place will give you a better understanding of the risks that your stakeholders view as material and ways to mitigate them.

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— Mark Weston, CPA, CA, CBV

STAKEHOLDERS AND RISK

For private companies, stakeholders can be shareholders, lenders, customers, suppliers, employees or even the community you operate in. Risks can be environmental, relating to how you're sourcing and using natural resources, disposing of waste or dealing with the impact of floods or fires on supply chains or distribution networks. Risks can also be social in nature, relating to the health and wellbeing of your employees or the potential of losing favour with customers or the support of the community at large.

THE IMMEDIATE BENEFITS

At some point most private companies will be asked whether they have a sustainability strategy in place. The question might be asked by a banker, potential investor, an individual customer who cares about sustainably sourced products or a large corporate customer. Remember small companies sell to bigger companies, and bigger companies often have mandates to ensure they are sourcing from companies that are sustainable and have sustainability strategies in place.

More than likely the question will come from the new engineer, scientist, or marketing intern that you're eager to hire. By the way, Gen Z's – those enthusiastic and innovative employees that everyone is trying to hire and retain – care about sustainability. Companies have reported that securing and retaining talent is one of the key benefits of having a sustainability strategy in place.

Understanding sustainability and having a strategy in place won't guarantee you that financing, get that extra dollar of revenue or land that recruit. However, for those customers, potential investors or employees that care, having a strategy in place could possibly be the difference between them doing business with you, or turning to a competitor.

Sustainability. There's never been a better time to start thinking about it.

Mark Weston *is the leader of Davidson & Company's ESG Advisory Services practice.*

ESG IS MAINSTREAM IN DEALS AND CAPITAL ALLOCATION

ESG has transitioned from a risk mitigation strategy to a key driver of sustainable value creation. While ESG was once relegated to activist stakeholders, embedding sustainability via identifying and then incorporating industry specific ESG value levers into core strategic, operational, and financial decisions is now far more mainstream.

Dealmakers should be aware that intangible ESG attributes – such as employee morale and a reputation as a green company – are affecting value in SME deals and capital allocation decisions. Value levers are modernizing; we can now quantify many of these elements.

— Miriam Pozza, FCPA, MBA, CBV

Dealmakers and capital providers are expanding their due diligence to evaluate risks and opportunities related to ESG issues, like unethical marketing, reputational risks, supply chain vulnerabilities, workforce engagement, measurement of sustainability goals, and disclosure transparency. More specifically, decision makers seek to avoid regulatory penalties and loss of revenue from unethical behavior, identify deeper company issues, build resilience into supply chains, and boost retention through a strong company culture. Post-transaction, they are monitoring companies to **ensure deals truly deliver on ESG promises,** and fully leverage value creation opportunities.

These value levers are maturing into a set of ESG due diligence criteria with important implications across the M&A landscape, from raising financing, to capital allocation, to carrying out acquisitions and divestitures. This ongoing transition will require evolving capital allocation decision frameworks, to take fuller account of intangible attributes that matter to value. For example, what is the value of high employee morale, or diversity of thinking in an innovation process, or an enhanced reputational brand value as a greener company? These sorts of attributes can be quantified, and linked directly to cash flow forecasts that drive enterprise value.

In summary, understanding the broader ecosystem of risks and opportunities at work in every company - which is not a new concept to valuations - is truly fundamental to navigating the complexity of these ESG factors. There is a need for more **discipline when assessing the impact, both tangible and intangible, on enterprise value.** We are no longer focused on improving shareholder value but focused on considering all elements that can influence stakeholder value.

Miriam Pozza *leads the Deals ESG practice globally and in Canada at PwC. She also leads the Transaction Services teams in Quebec.*

INSTITUTIONAL INVESTORS EXPLICITLY CONSIDER SUSTAINABILITY-RELATED FACTORS

There is a growing view that companies with leading sustainability practices attract premium valuations, as they are better equipped to manage the related risks and capitalize on opportunities, leading to improved financial performance in the long run. At CPP Investments, we allocate capital with a long-term horizon and we view sustainability-related considerations as business critical. We partner with portfolio companies to create long-term value by integrating material sustainability-related risks and opportunities in all phases of the investment life cycle.

CPP Investments is proactively monitoring and tracking sustainability-related factors that are material to long-term success, with a current focus on climate change and the transition to net zero by 2050.

— Emily Tse, CFA, CBV, FRM

In light of this, CPP Investments recognizes the importance of incorporating sustainability into our valuation practices. We have implemented frameworks and policies to proactively monitor and track sustainability-related factors that are material to the long-term success of our portfolio companies, with a current focus on climate change and the **transition to net zero by 2050**. Today, where sustainability-related factors are material to the investment, we are starting to explicitly consider these factors to the extent that decarbonization plans exist. We also qualitatively incorporate other sustainability-related risk factors in determining discount rates and multiples.

Looking ahead, we endeavor to capture the sustainability-related impact on valuations in a more systematic and data-driven way, in conjunction with more robust and consistent sustainability disclosure which we expect will be facilitated with the broad adoption of the recently released **International Sustainability Standards Board standards**. Specifically, enhanced disclosures by companies will allow investors to better assess and value the impact of sustainability-related factors on company performance. This ultimately helps valuators assess comparability of companies from a sustainability perspective and calibrate valuation assumptions accordingly.

Emily Tse *is the private investments valuations team leader at CPP Investments and a member of the* ***Business Valuation Board*** *at International Valuation Standards Council (IVSC).*

PREPARE TODAY FOR ENHANCED M&A ESG DUE DILIGENCE

ESG factors are **redefining value and risk** in business. Organizations that build ESG into the M&A process, from establishing strategy, to due diligence, post-acquisition and exit strategy, are best positioned to maximize shareholder returns and safeguard from value erosion.

CBVs in M&A advisory are seeing growing investor interest around ESG, leading to a notable increase in ESG due diligence. As a result, it is critical that SMEs are prepared to answer ESG-related questions.

— Anne-Julie Souchereau-Renaud, CPA, CBV

No matter what step of the M&A process you need to tackle, we recommend taking a pragmatic approach and determining the material ESG considerations relevant for your industry, jurisdictions, and operations. You can leverage frameworks such as Sustainability Accounting Standards Board (SASB), which focuses on financially material **considerations by industry**. For example, a professional service firm would mostly focus on DEI, business ethics and data security, while an industrial machinery company would focus on energy management, health & safety and material sourcing.

In a buy-side context, we recommend following a similar approach; identify the material ESG risks and opportunities for the target company, discuss with management and review documentation to understand how material considerations are managed and integrated into their business. This will help determine the impacts on the transaction value and the appropriate post-closing strategy to protect value and/or generate incremental revenues and cost synergies.

In a sell-side context, it is critical to recognize the material ESG considerations impacting your business and to have a strategy in place for mitigating risks and capitalizing on opportunities. You should also reflect your approach to ESG governance as well as ESG key value drivers in the deal story.

Organizations that are not ready to answer ESG questions in a sell-side process could potentially drive away prospective buyers, ultimately reducing competition and lowering the sale price. As an example, through ESG diligence on a renewable energy business, we identified that several solar energy assets were exposed to an increase in the frequency of extreme heat waves. This posed the risk of degradation of solar equipment, shortening capital replacement cycles and increasing operational costs. The seller was unable to provide their view on these risks or a mitigation strategy and our client ultimately did not proceed with the transaction.

In summary, our advice is to get started on your ESG journey now. This will ensure you do not overlook material risks and opportunities for new acquisitions and can maximize value in the sell-side process by being prepared to answer questions on ESG. The biggest mistake you can make today isn't getting ESG wrong - it's overlooking it completely.

***Anne-Julie Souchereau-Renaud** is a lead for Deloitte Canada's ESG Mergers & Acquisitions practice.*

THOUGHTFUL GOVERNANCE POLICIES HELP PRESERVE AND CREATE VALUE

There is a trend towards private companies implementing stronger governance to preserve and create value. In simple terms, governance refers to the process enabling decision-making. In a public company or institutional setting, governance is often regulated or legislated. In a private setting, governance is frequently informal, inconsistent, and sometimes non-existent.

Potential buyers value indicators of strong governance – a clearly defined strategy, objective decision making and predictable cash flow, to name a few. In contrast, poor governance can result in undesirable conditions including dysfunctional management, poor quality reporting, and lack of dividends. Having supported many business owners through ownership succession, disputes and buyouts, I have witnessed the profound impact of governance. Additionally, lacking governance may result in the breakdown of familial or business relationships, resulting in a loss beyond financial value.

Thoughtful governance policies should consider all stakeholder perspectives and be revisited often.

— Alana Geller, CPA, CBV, CFF

The loss of value often stems from poor communication. Consider a family with two children who inherited a family business. One sibling runs the business, and the other works outside of the business. Under the management of the first generation, the family lived modestly, reinvesting most profit.

Today, the business is worth many hundreds of millions of dollars. The owners should be celebrating, but instead, there is a lack of trust among stakeholders. Why?

1) Lack of independent board members to provide objectivity.
2) No forum to resolve conflict or conflicts of interest.
3) No formal reporting aside from financial statements and tax returns.
4) Lack of alignment on vision, values, and strategy.
5) Management team includes family members with perceived limited experience and unfair compensation.
6) No dividend policy, cash distributions are unpredictable.
7) Outdated shareholders' agreement.

Having only a few of the above characteristics is a recipe for value erosion. How can you protect your business and your relationships?

1) Enact a board (advisory or fiduciary) with independent members to provide objectivity, address conflict directly, and hold management accountable.
2) Communication and regular reporting are paramount, especially when conflictual.
3) Align on a vision, values, and strategy and revisit often.
4) Enact a family employment policy.
5) Enact a dividend policy.
6) Negotiate a shareholders' agreement, including exit mechanisms.

Private businesses require thoughtful governance policies to preserve and create value. I have outlined some best practices, but a tailor-made solution will be most impactful. Governance policies should be revisited often and consider all stakeholder perspectives. Consider obtaining support from professionals with deep governance expertise to help your business sustain and create value over time.

__Alana Geller__ is a partner at Richter advising clients and the legal community on valuation, ownership and dispute matters.

ESG LITIGATION IS ON THE RISE

KPMG in Canada's recent **Future of Litigation** survey of litigation lawyers in Canada found that more than half of respondents expected the following types of ESG-related legal matters to increase:

- ESG-related securities and other class actions (e.g., allegations of "greenwashing" or other unsubstantiated or misleading ESG claims).
- Investor and consumer protection claims (e.g., claims related to the environmental impacts of an organization's products).
- Property remediation and environmental impact (e.g., a landowner facing civil claims brought by tenants, neighbours or future owners, for contamination on or sourced in its property).
- Insurance matters triggered by ESG-related claims (e.g., Director & Officer insurance claims related to the above matters).
- General ESG-related breaches (e.g., liability for human rights issues at foreign operations).

To prepare for increased ESG litigation, identify the greatest risks (financial and non-financial), and strategically implement the relevant internal controls and monitoring strategies.

— Becky Seidler, CPA, CA, CFF, CBV, MFAcc
— Ana Rusu, CPA, MAcc, MFAcc

ESG litigation is both costly and time consuming for an organization and is exacerbated through the associated reputational damage. To effectively mitigate the risks and potential impacts, organizations should:

1. **Perform a risk assessment –** This entails understanding the types of ESG litigation to which the business may be most susceptible, the likelihood, and the impact. Organizations also need to be cognizant of ESG impacts and risks both up and downstream their value chain. This risk assessment should involve the appropriate perspectives, including from legal counsel and other subject matter experts. CBVs can assist in estimating the potential impact of identified risks in terms of possible financial damage exposure, cash flow, and business valuation.

2. **Implement internal controls and monitoring strategies –** This may involve gathering data from and implementing internal controls in areas of the business that have not historically had a rigorous internal control structure, compared to finance/accounting where strong internal controls are more commonplace. A data driven approach to monitoring (including compliance with ESG expectations of relevant parties) can be effective in detecting anomalies early, enabling an organization to remediate and possibly avoid litigation.

3. **Be prepared to respond strategically to claims should they arise –** ESG litigation may differ from claims organizations could have faced in the past. Often, multiple experts are required to assess both liability and potential damages. Depending on the claim, a satisfactory outcome may be a monetary award, or a simple agreement that the organization will act more in line with stakeholder ESG expectations - another reason to ensure you have the right expertise at the table to assist in determining financial and non-financial impacts.

In summary, a well-balanced approach to ESG practices, disclosures and related litigation risks can help to preserve and create shareholder value.

***Becky Seidler* and Ana Rusu** *are forensic and dispute advisors at KPMG LLP.*

THE PRIVATE LOAN MARKET IS OFFERING INCENTIVES FOR SUSTAINABILITY ACHIEVEMENTS

Sustainability-linked loans (SLLs)—where a loan's economics are tied to the borrower's achievement of certain ESG key performance indicators (KPIs)—are becoming popular in the private loan market. **Debtwire** reported that one-fourth of privately negotiated loans in Europe contained ESG triggers in the first three quarters of last year.[4] With their growing prevalence, private debt valuation teams are refining their approach to assessing fair value for less liquid SLLs.

SLLs can incentivize borrowers to achieve meaningful ESG objectives in a transparent and measurable way, offering the opportunity to enhance both reputation and value.

— Cheryl Cheng, CPA, CA, CFA, CBV

In most SLLs, the lender(s) and borrower establish KPIs and sustainability performance targets (SPTs) tied to those indicators. If the borrower achieves the SPTs, it is rewarded with lower interest, and if it falls short, it pays higher interest.

For SLLs, valuation methodologies and processes are essentially the same as for loan agreements with performance-based pricing grids tied to credit quality. The pricing grid will account for meeting or not meeting the KPIs. However, valuations will require comparing the SPT-driven pricing grid to the current market. As the SLL market for private loans continues to develop, pricing services and valuation agents will begin to better track pricing for SLL loans to have adequate benchmarks.

VRC views the SPT and margin adjustments as part of the underwriting calibration, like other pricing grids. All else equal, if an issuer moves within the pricing bands, VRC would generally apply a similar margin adjustment in line with the pricing grid. As a result of the offsetting adjustment, changes would be value-neutral.

VRC may view the pricing grid as value-impacting if the pricing for market clearing SLLs, margin ratchets, or SPTs materially changes from the calibration. A more common example would be for a leverage-based pricing grid where the market reduces allowable leverage limits after issuance and, therefore, the original leverage limits are not representative of market terms. In that case, we would adjust the credit spread to reflect the higher relative risk of the existing pricing grid versus the "market" pricing grid.

SLLs are becoming increasingly common in the private credit market as borrowers and end investors look to leverage their ESG credibility. A CBV with expertise in the concepts of performance pricing with respect to leverage ratios can help guide your understanding of these new private debt instruments.

Cheryl Cheng *is a leader in portfolio valuation at VRC.*

ESG TOPS THE AGENDA FOR MINING AND METALS LEADERS

By some accounts, the term ESG was coined in 2003. And yet the term social licence to operate (SLO), which addresses many elements of ESG, was first used by the mining industry in 1997. SLO must be earned — and maintained — on the basis of delivering profits and value to shareholders, establishing trust and maintaining effective communication with all stakeholders. The SLO roadmap provides a working understanding of how to approach ESG.

Learning from the mining industry, a strong focus on stakeholder relations can help to address many elements of ESG while creating or preserving value over the long term.

— Jay Patel, CPA, CA, CBV, ACCA (UK)

It's important to note that mining's SLO focus remains true to Milton Friedman's thesis that companies should focus on delivering profits and value to their shareholders. Such focus improves sustainability of mining operations by lowering risk as the following examples reveal:

- **Environmental –** Deploying technologies to reduce or reuse scarce resources, such as water, leads to improved process plant availability and processing volumes.
- **Social –** Building hospitals and schools leads to improved employee welfare, which enhances attendance and engagement.
- **Governance –** Growing local managerial talent leads to better community and country relations over the longer term.

The above are great examples of how a long-term, sustained ESG focus can deliver true performance improvements, enhance credibility with stakeholders, reduce risk and ultimately drive long-term value creation or preservation. While value drivers in other sectors will differ from mining, the focus on the relevant ESG initiatives to either improve cash flow or mitigate risk will always be a prudent measure to enhance a company's performance over the long term.

Today, ESG issues are regarded as the mining industry's **number-one** source of risk and opportunity. Considered integral to corporate strategy and almost every aspect of operations, ESG's foothold in the mining industry is firm, and it is broadening in scope.

My advice to SMEs? Look to mining for lessons on how to build trust with stakeholders and achieve sustainable profitable growth, and adapt these lessons to your respective industry.

Jay Patel *is a Partner and the Mining & Metals Transactions and Valuation Leader at EY Canada.*

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