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TRANSACTION & VALUATION SERVICES

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ESG Integration in Valuation

In recent years, corporates and private companies have been widely impacted by environmental, social and governance ("ESG") factors operationally and financially. The HKEX, among other exchanges and regulators across the globe, has set out ESG-related disclosure standards [1] for corporates based on the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), a global leader in developing consistent climate-related financial risk disclosures.

The International Financial Reporting Standards (IFRS) sustainability disclosure standards were recently published for public consultation, and further integration of ESG disclosures in financial reporting is expected very soon. By then, shareholders and potential investors would be able to make their investment decisions based on the widely-available ESG disclosures.

This article explores how the valuation of public and private companies may be impacted by the evolution of ESG considerations.

Major global ESG regulatory milestones

2015
TCFD was established by the **Financial Stability Board (FSB)** to improve and increase reporting of climate-related financial information

2015
196 parties adopted the **Paris Agreement**, legally binding international treaty on climate change with the goal to limit global warming

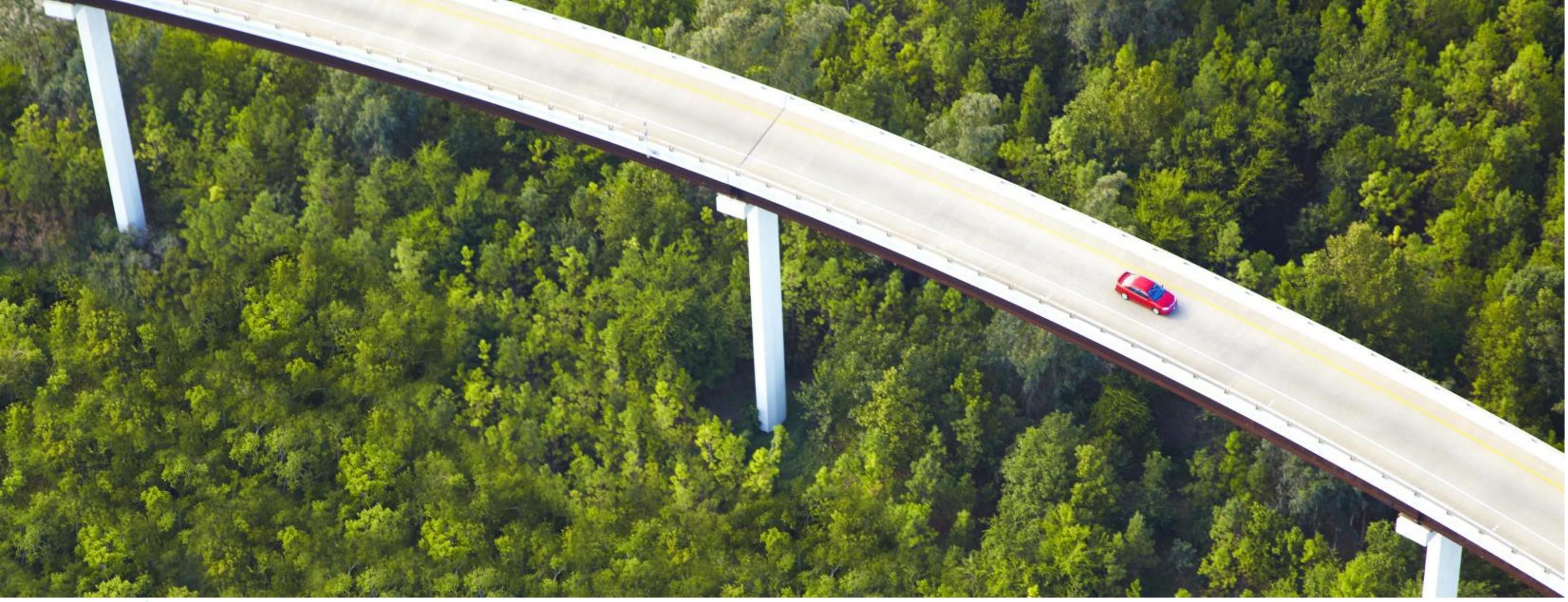
2020
IFRS published consultation paper to consult the market on the formation of a new **International Sustainability Standards Board (ISSB)** – a single set of globally accepted sustainability standards

2021
IFRS announced the formation of the new **ISSB**

2022
ISSB published two **IFRS Sustainability Disclosure Standards (ISDS)** for public consultation, of which the Securities and Futures Commission (SFC) and the HKEX indicated their support towards adoption

2025
The Hong Kong **Green and Sustainable Finance Cross-Agency Steering Group**, co-chaired by HKEX and SFC, announced that climate-related disclosures aligned with the TCFD recommendations will be mandatory across relevant sectors no later than 2025

Note:
1. With effect from July 2020, HKEX's ESG Reporting Guide has been amended to incorporate elements of the TCFD recommendations: https://en-rules.hkex.com.hk/sites/default/files/net_file_store/HKEX4476_3841_VER18584.pdf



ESG: How valuation practices are evolving?

The evolution of ESG considerations is rapidly taking place in valuation practices.

The International Valuation Standards Council (IVSC) is proactively preparing for setting ESG-related valuation standards. In 2021, it issued an agenda consultation and three perspective papers on ESG and further launched a survey in February 2022 to explore the progress of ESG quantification among valuation analysts as well as valuation users.

If directors and senior management of public and private companies are better informed of how their companies' valuation could be impacted by ESG considerations, risk management and ESG strategy can be streamlined to increase shareholder value.

ESG valuation: where to start?

Step 1	Step 2	Step 3	Step 4
Identify financial and material ESG issues	Assess the impact of material ESG factors	Quantify the impacts in the financial statements	Incorporate the identified financial impacts into the financial forecasting and valuation exercise

Step 1: Identify financial and material ESG issues

- Implemented by a stakeholder-assisted business and industry review, with reference to the **common ESG KPIs**
- Both internal and external stakeholders should be included
- Goal: to identify all ESG-related risks for the company and identify the relevant causes, links and consequences

Common ESG KPIs

Environment	Social	Governance
• Energy efficiency	• Diversity	• Litigation risk
• Greenhouse gas (GHG) emission	• Maturity of workforce	• Corruption
• Deployment of renewable energy	• Staff turnover	
	• Training and qualification	

Step 2: Assess the impact of material ESG factors

- Identify the relevant metrics and indicators for the identified ESG issues
- Goal: to measure the level and impact of the company's ESG-related risks
- Climate-related metrics are quantities measured to assess climate-related risks in a company
- Climate-related indicators are specific constructs of metrics designed to reflect the level of business impact of particular climate-related risks
- Below shows some common ESG-related metrics and indicators for reference [2]:

	Indicators (by industries)			
Metrics	**Manufacturing**	**Real Estate**	**Construction**	**Finance**
Amount of expenditure or capital investment deployed towards climate-related risks and opportunities	Capital investment in renewable energy	Expenditure on green building investment	Expenditure on sustainable materials or capital investment in the development of energy efficiency technology	Capital investment of portfolio of projects focused primarily on physical climate risks mitigation
Proportion of assets and/or business activities materially exposed to physical and transition risks	Proportion of factories and equipment materially exposed to flooding	Proportion of new developments that are subject to tightened standards on carbon emissions	Proportion of construction materials that are subject to cross-border carbon tax	Proportion of investment funds that are subject to tightened ESG standards
Carbon prices	Carbon costs due to assumed carbon tax on GHG emissions	Carbon credit costs due to offsetting GHG emissions	Carbon costs generated from projected carbon prices such as carbon tax	Carbon price range per tonne of carbon dioxide (CO2) to evaluate the resilience of potential investment

Step 3: Quantify the impacts in the financial statements

- To identify the affected components of financial statements corresponding to the identified ESG-related metrics and indicators
- Common affected components of financial statements:

Income Statement (Financial Performance)	Balance Sheet (Financial Position)	Cash Flow Statement
• Sales revenue • Cost of goods sold • SG&A expenses • Depreciation & amortization • Interest expenses • Income taxes	• Assets • Liabilities	• Capital expenditures • Changes in working capital

Note:
2. EFFAS/DVFA (2021). KPIs for ESG: https://effas.com/wp-content/uploads/2021/09/KPIs_for_ESG_3_0_Final.pdf

Step 4: Incorporate into financial forecasting & valuation

- Determine the timing of occurrence of the ESG factors, which is especially crucial for the financial forecast period
- Where applicable, discount rates applied in valuation exercises should be adjusted for ESG considerations
- That is, both cost of debt and cost of equity should be adjusted taking into account of ESG risks, such as regulatory risks, innovation risks and other non-quantifiable ESG risks
- The governance pillar of ESG is usually non-quantifiable, common metrics include lack of board independence, lack of appropriate board expertise, inappropriate remuneration systems, fraud and accounting risks
- For such ESG risks, adjustments could be made to the applicable discount rates, risk premiums and/or perpetuity growth rates

Conclusion

A company's ESG risks and opportunities should be well reflected in a valuation exercise to help stakeholders, including management, shareholders, potential investors, and business partners, to assess the company's historical and forecasted ESG performance. Therefore, other than for the mere purpose of regulatory compliance, corporates could take account of their estimated ESG-related impacts when devising their business strategies for increasing shareholder value.

How we can help?

Our valuation and transaction advisory specialists include European Federation of Financial Analysts Societies Certified ESG Analyst (CESGA). We can provide relevant and valuable insights and opportunities based on our experience and extensive knowledge to deliver value beyond the deal. Should you wish to obtain more information on ESG valuation and other transaction advisory matters, please contact us.

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