International
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Perspectives Paper:

A Framework to Assess ESG Value Creation

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The IVSC issues Perspectives Papers from time to time, which focus on pertinent valuation topics and emerging issues. Perspectives Papers serve a number of purposes: they initiate and foster debate on valuation topics as they relate to the International Valuation Standards (IVS); they provide contextual information on a topic from the perspective of the standard setter; and they support the valuation community in their application of IVS through guidance and case studies.

Perspectives Papers are complementary to the IVS and do not replace or supersede the standards. Valuers have a responsibility to read and follow the standards when carrying out valuations.

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The IVSC has issued this Perspectives Paper to initiate discussion and debate on the topic of ESG in business valuation. Share your thoughts and perspectives with us through LinkedIn.

Financial Discipline and ESG Investments

Environmental, Social, and Governance (ESG) factors have become a central tenet in many enterprises' corporate strategy. While companies track and measure how certain investments impact their overall ESG ratings or performance, many often fail to effectively take the further step to estimate and then capture how such investments translate to return on investment. Corporate finance principles to measure return on investment are most easily applied for discrete projects in which the output from such activities is financial information (e.g. profits, cash flows, capital formation, etc.) that can be identified, tracked, and quantified. Core finance principles used to measure ROI struggle to translate the non-financial outputs of ESG investments, to the impact on financial information. Initial rounds of ESG investment have largely been greeted with undiscerning praise by stockholders and stakeholders alike. However, to ensure appropriate financial discipline and the most efficient allocation of capital, a more analytical framework is necessary to articulate the value proposition of ESG investments and assess if and how such investments have resulted in value creation.

In our first article on ESG, *ESG and Business Valuation*, we began to explore how ESG characteristics are, or can be, incorporated into the value measurement process. In this second article, we analyse the impact of ESG on value creation and explore how such a framework may be incorporated into the capital allocation process and bring much needed financial discipline to ESG investments. In the below we:

I. Discuss why earnings-based measures for ESG investments can be difficult to apply;

II. Examine the close link between ESG investments and intangible asset value creation and/or maintenance, and the resulting implication that ESG returns may be better assessed by reference to intangible asset value creation; and

III. Leverage such insights to develop an example framework to assess and measure ESG value creation opportunities at the enterprise level. We discuss a framework that refers to both direct and indirect intangible asset creation, including recognition that intangible value creation via ESG investments can be scalable due to the interconnection between assets.

I. Measuring ESG Returns: Expense vs. Investment

Expenses typically provide an identifiable and quantifiable link between the cost incurred and the benefit received. For investments on the other hand, the connection between cost incurred and the measurement of benefits received is often more ambiguous. As the world continues to be increasingly driven by intangible value, the inability of "earnings" to capture value creation via investments becomes more evident. For example, in *The End of Accounting and the Path Forward for Investors and Managers* the authors, Baruch Lev and Feng Gu, found that the explanatory power of reported earnings and book value for market value between 1950 and 2013 substantially declined. The R^2 dropped from approximately 90% to 50% over the period.[1] More recent evidence suggests that the global pandemic has accelerated this trend.[2]

Like other *investments*, the connection between ESG cost incurred and the measurement of benefits received (e.g., profits) can be difficult to identify, track, and measure. While significant progress has been made to incorporate discrete climate related risks into valuation and forecasting processes (e.g., the recent A4S Essential Guide to Valuations and Climate Change[3]) many ESG investments share unique characteristics that challenge the ROI analyses, including:

1) ESG benefits often accrue to the enterprise as a whole and even outside the enterprise, rather than a specific product, business line, or geography. Additionally, for those benefits that accrue outside the enterprise (i.e., externalities), a warranted debate exists regarding if and how such benefits should be included in return considerations. The debate is separate from that of principal agent (stockholders versus stakeholders), but rather to how positive externalities may create a benefit for the enterprise (i.e., doing good is good for business).

2) ESG investments are often made over a number of years, and the benefits are often long-term. Such investments may even result in ongoing value

[1] The End of Accounting and the Path Forward for Investors and Managers

[2] Recovery Curves Take Shape and The Path Ahead... Recovery Curves Take Shape, 21-22.

[3] Essential Guide to Valuations and Climate Change

creation into perpetuity.

3) ESG benefits are often risk-reducing and may only maintain existing cash flows rather than generate incremental discrete cash flows. Risk reduction of ESG investments is often reflected in an enterprise's ability to recover from an adverse shock or adjust to changing dynamics (i.e. resiliency). An enterprise's ESG strategy and implementation may even determine the viability of the enterprise itself.

Given that ESG investments often generate non-financial (or pre-financial) information, a strategic financial framework should consider not only the impact on return metrics (e.g., profits, earnings, cash flows), but also value created. Such a framework should outline the value proposition of ESG investments, assess whether such investments have created value, and if possible, connect any value creation to the resulting financial information. A focus on value creation can help provide the critical linkage between investments in ESG and return.

II. The Link Between ESG and Intangible Assets

Our view is that potential ESG value creation would manifest in the formation and/or maintenance of intangible asset value. Certain characteristics of intangible value creation can help us assess how ESG investments may create value.

First, value creation or degradation for intangible assets, and therefore ESG investments, is not linear. For instance, many ESG investments will likely show a small return in the initial years after investment as value is created, and then exponential growth thereafter. Additionally, if not maintained, the value will also likely decline in a rapid fashion. However, if ESG investment continues to support and enhance the value created, the asset value and resulting benefit may be maintained indefinitely.

Secondly, the ability to create intangible value, and thus the ESG value creation opportunities, varies by industry. To generate economic value from ESG investments, or any investment, an enterprise must generate returns above those required by the value of tangible assets and financial capital employed. ESG value creation opportunities should be higher for companies with a differentiated, value-added, and high-margin business model than for companies with a commoditized, tangible asset intensive, low-margin business model.

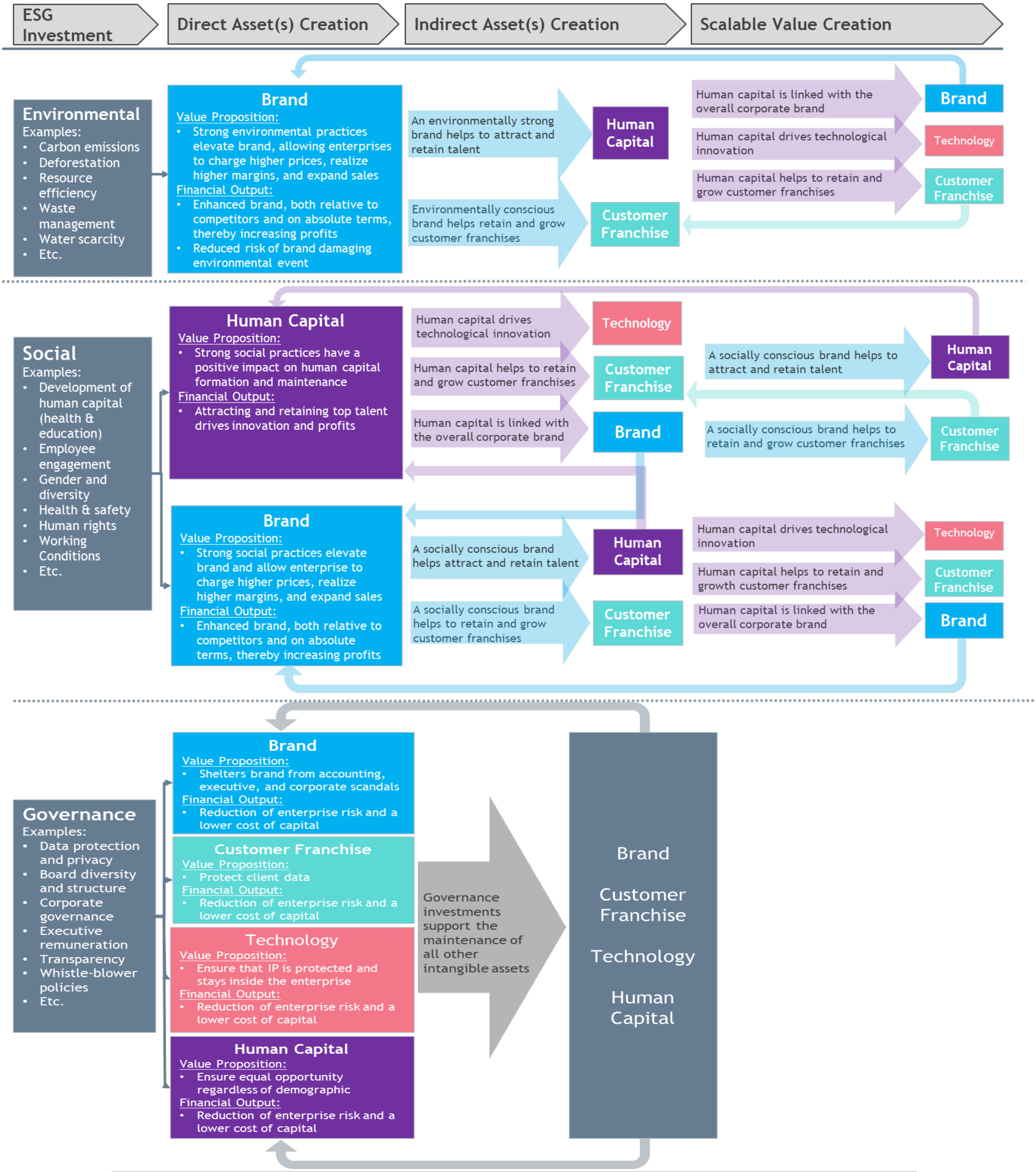
Finally, the business model and industry often also dictate which intangible assets will be created and which will offer the highest return. Similarly, the same is true for ESG, but which of E, S, and G investments will generate which intangible assets? Answering this question is necessary for enterprises to articulate the value proposition of ESG investments.

To answer this question, we postulate how E, S, and G investments may generate value (i.e. enhance cash flows) and/or maintain value (i.e. reduce risk) for specific groups of intangible assets, including Brands, Human Capital, Customer Franchises, and Technology. We examine the potential value creation lifecycle in the figure below through three separate stages:

- Direct Assets – Those intangible assets which may be directly impacted by the E, S, or G investment.

- Indirect Assets – Those intangible assets which could benefit from the value accretion of the direct intangible asset(s) which was targeted with the E, S, or G investment.

- Scalable Value Creation – The final phase of the lifecycle recognizes that intangible asset value creation via ESG investments can achieve scalable returns as a result of the interconnection with other intangible assets.


ESG Investment
Direct Asset(s) Creation
Indirect Asset(s) Creation
Scalable Value Creation
Environmental
Examples:
• Carbon emissions
• Deforestation
• Resource efficiency
• Waste management
• Water scarcity
• Etc.
Brand
Value Proposition:
• Strong environmental practices elevate brand, allowing enterprises to charge higher prices, realize higher margins, and expand sales
Financial Output:
• Enhanced brand, both relative to competitors and on absolute terms, thereby increasing profits
• Reduced risk of brand damaging environmental event
An environmentally strong brand helps to attract and retain talent
Human Capital
Environmentally conscious brand helps retain and grow customer franchises
Customer Franchise
Human capital is linked with the overall corporate brand
Brand
Human capital drives technological innovation
Technology
Human capital helps to retain and grow customer franchises
Customer Franchise
Social
Examples:
• Development of human capital (health & education)
• Employee engagement
• Gender and diversity
• Health & safety
• Human rights
• Working Conditions
• Etc.
Human Capital
Value Proposition:
• Strong social practices have a positive impact on human capital formation and maintenance
Financial Output:
• Attracting and retaining top talent drives innovation and profits
Human capital drives technological innovation
Technology
Human capital helps to retain and grow customer franchises
Customer Franchise
Human capital is linked with the overall corporate brand
Brand
A socially conscious brand helps to attract and retain talent
Human Capital
A socially conscious brand helps to retain and grow customer franchises
Customer Franchise
Brand
Value Proposition:
• Strong social practices elevate brand and allow enterprise to charge higher prices, realize higher margins and expand sales
Financial Output:
• Enhanced brand, both relative to competitors and on absolute terms, thereby increasing profits
A socially conscious brand helps attract and retain talent
Human Capital
A socially conscious brand helps to retain and grow customer franchises
Customer Franchise
Human capital drives technological innovation
Technology
Human capital helps to retain and growth customer franchises
Customer Franchise
Human capital is linked with the overall corporate brand
Brand
Governance
Examples:
• Data protection and privacy
• Board diversity and structure
• Corporate governance
• Executive remuneration
• Transparency
• Whistle-blower policies
• Etc.
Brand
Value Proposition:
• Shelters brand from accounting, executive, and corporate scandals
Financial Output:
• Reduction of enterprise risk and a lower cost of capital
Customer Franchise
Value Proposition:
• Protect client data
Financial Output:
• Reduction of enterprise risk and a lower cost of capital
Technology
Value Proposition:
• Ensure that IP is protected and stays inside the enterprise
Financial Output:
• Reduction of enterprise risk and a lower cost of capital
Human Capital
Value Proposition:
• Ensure equal opportunity regardless of demographic
Financial Output:
• Reduction of enterprise risk and a lower cost of capital
Governance investments support the maintenance of all other intangible assets
Brand
Customer Franchise
Technology
Human Capital

Patterns of potential value creation begin to emerge from the analysis above. While G largely reduces risk and maintains asset value, S investments tend to drive asset creation and cash flow generation. E investments tend to fall in between, with an expectation that the relative mix of risk reduction and asset creation will be highly dependent on the industry and related exposure to environmental risks.

III. A Framework to Assess ESG Value Creation Opportunities at the Enterprise Level

With a better understanding of how E, S, and G investments result in value creation via specific intangible assets, and given that intangible asset value drivers are well documented and understood[4], we can identify certain characteristics to help assess expected relative value creation of ESG investments between enterprises. Here are the six characteristics identified, along with brief descriptions:

- Criteria 1 – Reliance on Brand/Brand Strength.
    - As noted in the prior section, the enhancement and maintenance of ones' brand and reputation appears central to the value proposition of E, S, and G investments. Brand power can generate excess returns between identical products with no more than a name and reputation. As such, the ability to increase one's brand, or maintain an existing brand, is critical to ESG strategy. It would appear that, the greater the reliance on brand and reputation for an enterprise, the greater the ability to create or maintain value through ESG investments.
- Criteria 2 - Reliance on Human Capital and Workforce Skill Level.
    - As noted in the table above, Human Capital is central to intangible asset value creation. Much of the value, and the value generating capacity, in an

[4] See International Valuation Standards (IVS), Effective 31 January 2020, Section 210

intangible-driven enterprise resides in its human capital. The cost of failing to attract talent, or losing existing talent and knowhow, are high. It would appear that, the greater the reliance on human capital for an enterprise, the greater the ability to create or maintain value through ESG investments.

- Criteria 3 - Premium to Book Value and Value-added Business Model.
  - ESG investment value creation manifests in the formation and/or maintenance of intangible assets. The magnitude of ESG value creation as well as the optimal investment in ESG, are therefore dependent on an enterprise's ability to drive excess economic returns within its industry. It would appear that, the greater the enterprise valuation premium over tangible assets and capital, or the ability to generate enterprise valuation premium, the greater the ability to create or maintain value through ESG investments.

- Criteria 4 - Nature of Customer Relationships.
  - Per the table above, E, S, and G investments all have an impact on the formation and maintenance of customer franchise assets. However, assessing how much of an impact requires studying an enterprise's customer base, along with the respective ESG expectations or requirements of those customers. Such analysis is critical to understanding how ESG investments may or may not drive value creation. For enterprises which operate in business to consumer industries, ESG investments provide the opportunity to create value through brand recognition and differentiation as well as through investments in human capital. Alternatively, for enterprises which operate in business to business industries, ESG investments may be a requirement imposed by customers as ESG mandates are pushed through their supply chains. An early example of such requirements is Apple's goal to become carbon neutral across its

entire value chain by 2030.[5] It would appear that, the greater the connection to the end customer, the greater the ability to create or maintain value through ESG investments.

- Criteria 5 - Tangible Asset Intensity.
    - As noted above, tangible assets have a relatively capped rate of return. On the other hand, ESG investments largely drive additional returns through the formation and maintenance of intangible assets which are scalable. It would appear that, the more a business model relies on tangible assets, the less the potential to create value through ESG investments. However, while tangible assets have relatively fixed returns on the high end, there are significant ESG risks (especially environmental) which could reduce return and degrade value. As such, ESG's role in maintaining value should be considered for both tangible and intangible driven enterprises.

- Criteria 6 - Market Dominant Technology.
    - While there is a positive correlation between intangible asset intensity and ESG returns, there are exceptions. For example, propriety technology, especially patented technology, can create consumer demand that is less elastic to the value of other intangible assets. As such, ESG investments may have a lower impact on value creation in these instances. Note that Human Capital is critical to developing technology, but this impact is addressed in Criteria 2. It would appear that, the more a business model relies on proprietary technology, the less the potential to create or maintain value through ESG investments.

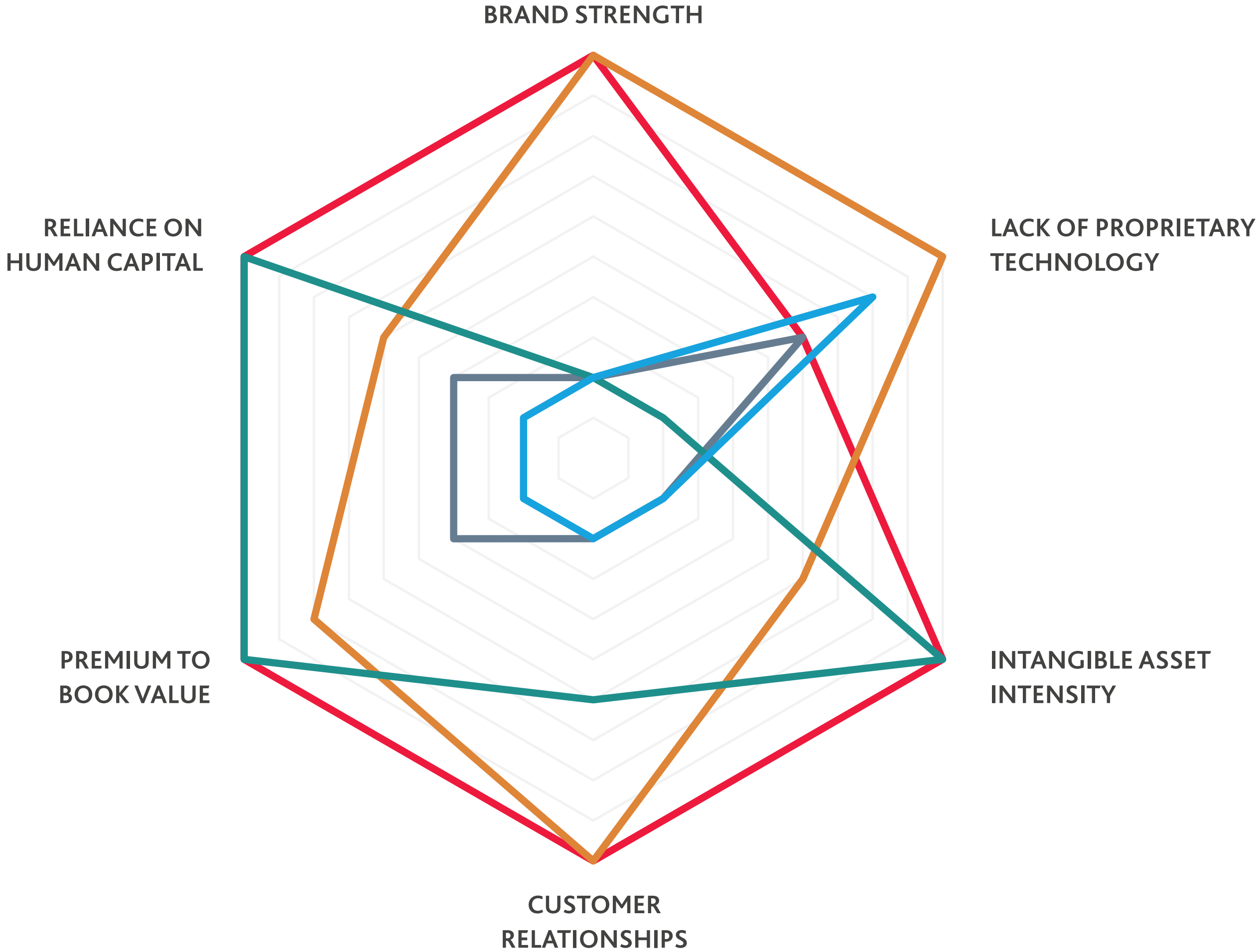
The below interactive graph analyses these six criteria for five enterprises from different industries, on a scale from 1 to 5. The further away from the centre (e.g., 5), and greater area covered, the greater the expected value creation of ESG investments.

[5] Apple launches $200 million forestry fund it says will bring financial return for investors

All Enterprises | Professional Services | Contract Manufacturer | Branded Consumer Products | Biotechnology | Distributor

ESG VALUE CREATION FRAMEWORK

Click on each tab above to see select insights for each enterprise.



While the above is what we believe to be six key criteria for ESG value creation, such a framework is not limited to just six criteria, nor does it require the utilization of these specific criteria.

Visuals courtesy of BDO USA, LLP

Next Steps

In the short term, a focus on intangible valuation creation can bring more financial discipline to ESG investments and bolster sustainability reports to go beyond lists of statistics and overtly qualitative narratives. Longer term, a focus on intangible value creation can facilitate a move toward a financial reporting system that captures intangible value creation. While the current accounting framework often lacks relevant information on value creation, there are examples in which it is also actively constraining efforts to fully implement value creating ESG priorities.

In a recent article, *Examining How Current Accounting Practice is Constraining the Net Zero Transition*, the authors analyse an oil company's commitment to become carbon neutral by 2050 in the context of ESG and the current accounting model for intangible assets and liabilities. They argue that the current accounting model unduly penalizes and demotivates companies as they attempt to make such investments.[6] This need is no more succinctly articulated than in the author's analysis of both technology and brand intangibles, the latter of which is discussed below:

"A further clue is provided by the IASB Conceptual Framework which defines an 'Asset' as 'a resource controlled by the entity........ from which there is potential for future economic benefits.' We postulate that while an organization does not control the environment, its employees, or other stakeholders, it has control of its relationship with those entities, intertwined with its reputation, through the alignment of its decisions with social norms. It follows that the definition of an asset should be applied to an entity's reputation or its social license to operate, resulting in capitalization and fair valuation of these assets. This treatment balances the requirement to recognize social obligations as liabilities and reduces the punishing treatment of costs related to complying with social norms. Such costs could be viewed as investment in reputation and the potential benefit to the organization from such investment would be capitalized."

Such constraints within the current accounting model are not limited to brand and technology, but also exist for human capital. In *Two Sigma Impact: Finding Untapped Value in the Workforce*, the authors note how current accounting

[6] Constrained by Accounting: Examining How Current Accounting Practice is Constraining the Net Zero Transition

drives behaviour that limits the value creation opportunities for human capital. They state that *"private equity has tended to view labour as a line-item to be reduced rather than a place to invest, resulting in a large blind spot for the industry. What if there were another, more fruitful way of looking at workforce issues?"*.[7]

Such insights are not meant to argue that ESG is a fad that will soon go out of style. To the contrary, ESG is inextricably linked to ongoing efforts by accounting standard setters and investors to further explore opportunities to systematically address internally generated intangible assets. Additionally, the best ideas, concepts, and frameworks that emanate from ESG, will undoubtedly help inform the accounting process.

In our next article series, we plan to further explore opportunities for considering intangible value creation by 1) Reviewing the goals and opportunities for an enhanced framework, 2) Performing an analysis to map the types of costs that give rise to intangible assets in order to identify intangibles that could be subject to an enhanced intangible asset framework, and 3) Exploring whether an enhanced framework should be based on enhanced disclosures, capitalization, or value creation concepts.

The IVSC would be interested to hear your views on this paper and on ESG as it relates to valuation. Share your feedback in IVSC Group Page on LinkedIn or by emailing contact@ivsc.org.

[7] Two Sigma Impact: Finding Untapped Value in the Workforce