22 April 2013

ESG Factors and Equity Valuation

Professional investors, financial analysts and valuation practitioners are increasingly addressing environmental, social and governance (ESG) factors in fundamental analysis and equity valuation. These are broad categories of factors that determine a company's sustainability over the years and therefore it has become critical to incorporate them when calculating corporate value. Sustainability in theory and increasingly in practice is becoming a fundamental long-term target for every company. It can stabilize cash flows and shareholders' value creation and at the same time assist analysts in performing credible projections with regard to cash flows or earnings which are the basis of valuation.

Valuators and equity analysts may consider the following questions when attempting to integrate environmental, social and governance (ESG) factors in the calculation of corporate value:

-- Are the projected trends of the subject company's revenues and earnings sustainable?

-- To what degree they reflect ESG constraints?

-- What ESG factors will affect demand trends?

-- Are the subject company's key markets sustainable in terms of consumer preference and social trends?

-- What are the specific environmental, social and governance risks as well as opportunities faced by the industry which the subject company operates in?

-- How can rapidly changing customer preferences be monitored and incorporated into forecasts?

-- Is the subject company's management aware of ESG factors in the market and the broader economy which it operates in?

-- How dynamic and committed towards value creation, without jeopardizing the company's commitment to ESG issues, is executive management?

-- What regulatory or legislative change is anticipated?

-- Which are the most updated information sources that can be used by analysts and valuators?

Such questions shed additional light to the numerous considerations and assumptions that must be made when performing fundamental analysis and corporate valuation. At the same time, they facilitate debate on the key issues that can enable investors and analysts to build and benchmark their own financial analysis and valuation techniques. With the ESG factors attracting significant attention within investment community, an increasing number of professional investors and equity analysts are now applying more analytical approaches when valuing companies exposed to environmental, social and governance (ESG) factors. Furthermore, these professionals tend to incorporate some of the ESG implications in the assumptions drawn in their valuation models.

Of course most ESG issues and factors tend to impact companies over the long-term whereas traditional financial analysis and valuation is known t have a shorter time frame. However short-term prediction is credible only as part of the bigger long-term picture which can be substantiated via a thorough analysis of ESG aspects.

The inclusion of ESG factors in fundamental analysis and equity valuation has led to the adoption of a more integrated approach in analyzing and valuing companies. In the past such approach may have been followed intuitively but now is well structured and based on a wide range of information sources. This new approach requires listed companies to enrich and integrate their financial and ESG reporting as all factors are now of vital interest for analysts and valuators to address risk and return.

In conclusion, following the recent credit and financial crisis in Americas and Europe, the full understanding of risk and return issues in addressing the real value of an investment has become even more compelling as a task. During the past few years, some of the world's largest financial institutions have started performing integrated financial and valuation analysis and an increasing number of institutional investors have been recognizing the importance of an integrated approach, based on financial as well as ESG factors, as part of their investment decision making process.

Nicholas Georgiadis, Director of Equity Research
VALUATION & RESEARCH SPECIALISTS (VRS)

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