ESG AND BUSINESS VALUATION: RESEARCH NEEDS

Patrick Ulrich *, Felix Stockert **

* Aalen University, Aalen, Germany; University of Bamberg, Bamberg, Germany
** Aalen University, Aalen, Germany

How to cite: Ulrich, P., & Stockert, F. (2023). ESG and business valuation: Research needs. In M. Tutino, V. Santolamazza, & A. Kostyuk (Eds.), *New outlooks for the scholarly research in corporate governance* (pp. 73–75). Virtus Interpress. https://doi.org/10.22495/nosrcgp14

Copyright © 2023 The Authors

Received: 16.05.2023
Accepted: 29.05.2023
Keywords: ESG, Valuation, Mergers and Acquisitions
JEL Classification: M00, M15, M40
DOI: 10.22495/nosrcgp14

Abstract

In the context of mergers and acquisitions (M&A), the environmental, social, and corporate governance (ESG) score is becoming increasingly important. According to a study, 73% of the companies surveyed take the ESG score into account during due diligence and 91% say non-financial performance has played a key role in their investment decisions over the past 12 months (Rogl & Gehmayr, 2020). According to another study, companies with higher ESG scores achieve a higher enterprise value in a transaction (KPMG, 2022, p. 6) or a higher announcement yield (Rehm et al., 2012). The enterprise value in dependence on the ESG score represents a relevant field of investigation.

In principle, a firm valuation or price determination for a transaction can be carried out using various methods. The most common method is the discounted cash flow method, whereby future cash flows of the company are discounted with its weighted capital costs (WACC) (Hasler, 2011, p. 213).

$$Enterprise\ Value\ EV = \sum_{t=0}^{n} \frac{Free\ cash\ flow\ to\ firm_t}{(1 + WACC)^t} + \frac{Terminal\ value_n}{(1 + WACC)^n} \quad (1)$$

Thus, the future cash flows of the company are discounted with its weighted cost of capital. When considering dividend (cash flows) and divisor (weighted cost of capital), the following findings on the influence of the ESG score are known:

Dividend (cash flows): A survey has presented that companies with a higher ESG score achieve higher financial performance (Khan et al., 2015, p. 1). In addition, companies with higher ESG scores would be less likely to face lawsuits, which also has a positive impact on cash flows (Morgan Stanley, 2019, p. 9). Meeting ESG factors enables better management of operational, strategic and reputational risks (Drescher, 2017, p. 42).

Divisor (weighted cost of capital): To meet social responsibility requirements, companies have a higher cost of capital in the long term. As a result, the above cash flows would be discounted at a higher discount factor, which would ultimately translate into a lower company valuation (Cornell & Damodaran, 2020, p. 9).

The explanations show that the ESG score can undoubtedly have an influence on the enterprise value. However, the studies are scarce and, in some cases, not up to date. The studies also do not distinguish between family and non-family businesses. Since family businesses have a fundamentally different set of values than non-family businesses (Becker & Ulrich, 2008, p. 265), it is conceivable that sustainability is assigned a different relevance, which may ultimately also be reflected in the value of the business. It is still largely unclear from theory and practice whether the different natures of family businesses and non-family businesses can have an influence on the possible effects of ESG on enterprise value. It is conceivable, for example, that the market per se assumes greater sustainability in the case of family businesses and that these, therefore, need to pay less attention to ESG factors. From a theoretical point of view, there should, therefore, be a stronger effect of taking ESG factors into account in the case of family businesses. A need for research especially with the differentiation between family businesses and non-family businesses can, therefore, undoubtedly be identified. The following research questions could be investigated:

RQ1: To what extent does the relevance of sustainability differ between family businesses and non-family businesses?

RQ2: What risks are family businesses and non-family businesses willing to take in order to implement a consistent sustainability strategy?

RQ3: How do ESG factors find practical application in business valuation?

RQ4: Does a potential buyer imply different sustainability expectations for family businesses vs. non-family businesses?

RQ5: Is a lack of fulfillment of sustainability aspects sanctioned by the market in a differentiated manner depending on the type of company?

REFERENCES

1. Becker, W., & Ulrich, P. (2008). Corporate Governance in mittelständischen Unternehmen — Ein Bezugsrahmen. *Zeitschrift für Corporate Governance, 6,* 261–267. https://doi.org/10.37307/j.1868-7792.2008.06.06

2. Cornell, B., & Damodaran, A. (2020). *Valuing ESG: Doing good or sounding good?* NYU Stern School of Business. https://doi.org/10.2139/ssrn.3557432
3. Drescher, A. (2017). CSR-orientiertes Risikomanagement in M&A. In *Corporate Social Responsibility als Erfolgsfaktor bei Mergers & Acquisitions* (pp. 29–54). https://doi.org/10.1007/978-3-658-15963-4_3
4. Hasler, P. T. (2011). *Aktien richtig bewerten: Theoretische Grundlagen praktisch erklärt*. Springer. https://doi.org/10.1007/978-3-642-21170-6
5. Khan, M., Serafeim, G., & Yoon, A. (2015). *Corporate sustainability: First evidence on materiality* (Harvard Business School Working Paper No. 15-073). https://dash.harvard.edu/bitstream/handle/1/14369106/15-073.pdf
6. KPMG. (2022). *2022 EMA ESG due diligence study*. https://kpmg.com/xx/en/home/insights/2022/11/esg-due-diligence-in-deals.html
7. Morgan Stanley. (2019). *Sustainable reality: Analyzing risk and returns of sustainable funds*. https://www.morganstanley.com/content/dam/msdotcom/ideas/sustainable-investing-offers-financial-performance-lowered-risk/Sustainable_Reality_Analyzing_Risk_and_Returns_of_Sustainable_Funds.pdf
8. Rehm, W., Uhlaner, R., & West, A. (2012). Langfristige Wertschaffung durch M&A. *M&A Review, 10*(23), 404–412.
9. Rogl, G., & Gehmayr, B. (2020, September 10). *Wie wird die ESG-Performance Ihre Zukunft gestalten?* Ernst & Young. https://www.ey.com/de_at/assurance/wie-wird-die-esg-performance-ihre-zukunft-gestalten