

How to Integrate ESG into Valuation... Or Not...

The debate over how we should be valuing superior ESG scores in the process of stock selection is becoming keener. Having incorporated ESG principles within our process for several years we are delighted about this development. However, whilst there is consensus about the necessity to scrutinise the ESG credentials of investee companies there is still no common ESG standard for the industry. A lack of consistent corporate reporting adds to the challenge. Given these issues how can fund managers attach a value to an ESG score and use it in their valuation analysis?

Chartered Financial Analyst (CFA) Society UK suggest firms adjust forecasted financials, valuation-model variables such as terminal growth rates and cost of capital in a discounted cash flow model (DCF) to reflect these nuances. Intellectually, this approach may seem reasonable. There is a body of opinion backed by various academic studies that suggests companies with high ESG scores will enjoy a lower cost of capital in their financing arrangements and hence a higher price-to-earnings ratio. For example, an academic study from Koelbel and Busch (2017) on the 'Link between ESG, alpha and the cost of capital' supports this proposition.

At Aubrey, we are often left wondering how exactly we monetise a superior ESG rating. What is it worth and when will this value be enjoyed by the company and its investors? For example, we forecast earnings two years ahead and that is difficult enough to formulate. Estimating benefits from improving ESG scores 2 years forward is likely to be even more difficult. Consequently, attributing a precise value to an ESG score is fraught. Equally, adjusting a discount rate is not only subjective, it is an extremely sensitive input in a DCF model and can cause valuations to become distorted. No matter how rigorous the ESG process, it will also remain subjective to a certain extent.

Thus, our approach to ESG is built on common sense. Whilst we are never complacent, this year it has helped us avoid a couple of corporate scandals, despite these companies being scored highly by third party ESG providers.

While the companies in our portfolio display strong ESG credentials, we have engaged with smaller companies in order to enhance the disclosure. An example is MIPS, a Swedish company that has developed a helmet safety and brain protection system based on brain trauma research carried out by doctors at the Royal Institute of Technology in Sweden. This helps protect the brain from shock or concussion on impact by allowing for a very slight 10-15mm spin inside the helmet when the head hits the ground at an angle.



This company is making a serious contribution to the safety of individuals, particularly cyclists, construction workers, police and armed forces and those engaged in sport. However, some might point out that ESG disclosure is not as comprehensive as it could be, and therefore the company's

cost of capital should be higher (and PE lower) because there is less information transparency resulting in higher risk.

In this case, we spoke with management and have been reassured. They do not want to create an ESG report simply to keep investors happy, rather the plan is to integrate sustainability into all their products. The current sustainability section in the 2019 annual report is a short-term compromise while the longer-term strategy is being developed. This will be published in March 2021 and will focus on four key areas: Employees, Products, Supply Chain and MIPS' own environmental impact.

We have not performed a complex valuation adjustment in this case, rather we preferred to have frequent dialogue with management about the progress. This has allowed us to prioritise long-term value creation in accordance with our investment philosophy as opposed to making speculative model adjustments.

Another example is TAL Education. A Chinese company that has developed a leading education platform that integrates technologies and the internet into education, to deliver a better study experience for children.



This company helps students achieve better grades through a more efficient learning process. However, some might argue that because of the lack of ESG disclosure, the company should trade at a discount to its current valuation. We believe this is not at all pragmatic. Simply because a company does not disclose relevant ESG data does not mean it is not managing its ESG risks appropriately.

In general, smaller companies do not place a large emphasis on ESG disclosure because they have fewer resources. In this case, we have engaged with management on how the company integrates sustainability into the group's operations and have been reassured that a longer term sustainability strategy is being developed. In addition, we derive confidence from the fact that one of the co-founders is still the CEO of the company. This demonstrates that TAL Education is less likely to be managed for the benefit of short term profitability, but rather for long term value creation.

These characteristics of corporate governance, accountability and alignment, are variables that a discount rate cannot capture.

As such, we believe integrating ESG is not about tweaking financial models. It is about engagement, monitoring and constant dialogue with companies in order to create long term value.

We appreciate consultants in this industry need to see evidence of process which is why these complex valuation methods are proposed. However, these can overcomplicate and distract our focus away from what is more important. We believe regular dialogue with management is sufficient to satisfy the demands for ESG reporting and the longer-term goal of value creation. Aubrey's ESG process has always been built on common sense and will continue to be.

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