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ESG and Valuation

The initials ESG seem to be everywhere. ESG stands for Environmental, Social and Governance. It is a framework that people use to analyze a company's performance on principally non-financial measures. The way it's presented in the press it sounds like the new, new thing, but ESG concepts have been around for many years and have had different names (such as triple-bottom line reporting).

Having another framework to analyze businesses is nothing new. There are many frameworks that can be used to analyze a business, such as the Boston Consulting Group's 4-cornered matrix, or Michael Porter's 5-forces analysis. Frameworks are useful because they help us to organize our thoughts.

How Does it Work?

The ESG framework views a business from three different perspectives:

Environmental: pollution, waste, energy usage and use of natural resources.

Social: employee health and wellness, vendor viability, product quality/safety, privacy/data security, and diversity/inclusion efforts.

Governance: board oversight of management, executive compensation, fraud controls, ability to respond to critical events (such as a data breach, or natural disaster).

At a high level, every single business uses ESG principles in one way or another. They just don't call it that. As an example, if a company has a bad reputation or its employees treat other people poorly, pretty soon customers will find somewhere else to do business. That is why many companies stress the importance of relationships and being people oriented.

"We interrupt sounds of the ocean for this special news bulletin: Back at the office, everyone is getting along just fine without you!"

When ESG is viewed as a framework for analysis it doesn't seem to be controversial, because a smart focus on ESG principles can enhance the value of a company. The key issues to remember from a valuation perspective are the cost versus the benefits, and to whom those benefits accrue. As long as the costs are not greater than the benefits, and the benefits ultimately accrue to the shareholders, then the action being taken is likely to enhance shareholder value (all else equal).

The Rub

But ESG has generated a good deal of controversy, which seems to come from defining stakeholders broadly to include employees, the community, suppliers and the environment. Some interpretations of ESG effectively place them on the same level of priority as shareholders, which would lead to a dramatic widening of management's ultimate responsibility.

Earlier in our history, the business, financial and legal communities struggled to define a management team's ultimate responsibility. These communities seemed to come upon a workable answer about 100 years ago in a court case that defined the doctrine of shareholder primacy, which states that a company's management team is ultimately responsible to its shareholders. In a related development, an area of academic research known as agency theory grew in importance by studying ways to ensure that agents (or managers, who are generally not shareholders) act in the best

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interests of principals (or shareholders). Dissenting shareholder laws reinforce the notion that the management team serves all shareholders, not a select few. Laws that expand management's fiduciary duty to include creditors when a company is insolvent emphasize the importance of all providers of "risk capital."

Shareholder primacy, agency theory, dissenting shareholder laws, and expanded fiduciary duties during insolvency are among the foundational elements in the growth and development of US capital markets. They are at the core of the effective "contract" between companies and their primary provider of risk capital, their shareholders.

A serious concern is that if we start broadening management's ultimate responsibility by placing other stakeholders on the same level as shareholders, we risk returning to the dysfunction that existed prior to the doctrine of shareholder primacy. It would bring up serious questions about management's fiduciary duty. It would also severely complicate capital formation (the foundation of our economy) and how investors balance risks and rewards in an investment (a central element of our capital markets).

A framework that encourages managers to be more aware of the broader impact of their decisions can be useful, but we have to be very careful with it. Anything that alters the effective contract between companies and shareholders should be viewed with great caution, because what we had without the contract did not promote sustainable business practices. It promoted the opposite.