

Incorporating ESG in valuation: Impact to discount rates

As fundamental, bottom-up value investors, we incorporate material environmental, social and governance (ESG) issues into our valuation on a stock-by-stock basis, applying the same principles to these issues as we do to any other material factor. This may be presented as an adjustment to revenue, operating expenses, margin forecasts, assets, liabilities, capital expenditure, cost of capital or terminal multiple depending on if the factor is a risk or opportunity. Specific ESG risks and opportunities will vary between companies depending on their sector, individual circumstances, types of economic activity of their customer bases, regulatory regimes they are exposed to, emissions intensity and management of risks.

One way that we can incorporate an assessment of ESG risk is by adjusting the discount rate, or cost of capital used in our financial modelling. In a discounted cash flow (DCF) valuation model, expected future cash flows are forecasted and then discounted to the present value using a discount rate. A higher discount rate may be used to account for ESG related risk, which will reduce the present value of future cash flows leading to a lower expected valuation.

Analysts at Harris | Oakmark may use discount rate adjustments to incorporate ESG factors into valuation. For example, companies operating in emerging markets are assigned higher discount rates compared to developed markets to account for the additional governance and political risk in these regions. We use an even higher discount rate for Chinese headquartered companies given the risk associated with a government that has much greater power and control. Chinese companies must follow the policy direction of the government which can create uncertainty for investors as rules and regulations can change quickly. This is why it is appropriate to incorporate this governance risk into the intrinsic value through a significantly higher discount rate.

We also adjust company-specific discount rates. For example, we have increased the discount rate for a mining company, with cash flows coming from high ESG risk regions, such as in the Democratic Republic of Congo, which could be exposed to issues like child labor, dangerous working conditions, modern slavery and deforestation.

Another example is an energy company producing fossil fuels. We account for the risk of declining global demand for refined products, by using a higher risk category, and a higher discount rate to value its future cash flows, reflecting the uncertainty of how a low carbon transition will unfold.

In an oil and gas exploration and production company with operations in the United States, Egypt's Western Desert, the United Kingdom's North Sea, and Suriname, we account for the geopolitical risk associated with operating in Egypt through an elevated discount rate.

Analysts utilize adjustments to the discount rate to incorporate ESG issues where they are considered material to the company. We believe that adjustments to the cost of capital allows us to more accurately capture the true intrinsic value of a business by taking into considering ESG risks and opportunities.

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