Sustainability turning into investment yardstick

Sustainability is fast turning into an investment criterion for asset managers, banks, private equity firms, development finance institutions and individual investors - with net gains reflected in better managed risks, improved returns and more accurately priced assets.


Donald Gibson

As an aid in value creation, sustainability is now so well accepted internationally that ESG (environmental, social and governance) has become a catch-all term in capital markets for corporate behaviour likely to influence company valuations and share prices. Its impact is felt across the investment cycle – pre-investment, acquisition of a targeted asset, on-going operations, pre-disposal and exit.

Accurate picture

Within the asset management industry, ESG is evolving into an investment style known for volatility mitigation while delivering acceptable portfolio returns.

"Investors hate uncertainty and unforeseen risks. ESG measurement addresses these issues while enabling investors or business buyers and sellers to develop an accurate picture of risks and obstacles to the realisation of optimum value," says Donald Gibson, a partner at ERM.

Determining cost of capital

ESG focuses on areas such as energy and water efficiency, carbon emissions, occupational and community health and safety, jobs, absenteeism and staff turnover, compliance risks, ethics and governance and potential revenue from product innovation. Measurement of these areas permits the development of metrics in financial analysis. In addition, ESG scores have an increasing role in determining the cost of capital.

Poor ESG management tends to increase risk exposure. Elevated levels of risk clearly affect a corporate borrower's ability to manage debt. One result is higher interest rate charges for poor management while lower rates reward better outcomes.

“A growing number of local businesses see the benefits. ESG enables informed decisions and risk assessments. This can be monetised. Results are seen in the purchase or disposal price during M&A activity or through long-term improvements in corporate earnings that ultimately make it into a company's share price," he explains.

Metrics spreading cross-border

This explains why this model has been adopted by local companies, and, of course, many South African corporates are striving to widen their African footprints; which means that businesses deploy these same metrics when cross-border acquisitions or partnerships are contemplated.

Thorough due diligence assessments rely increasingly on ESG, and importantly link associated liabilities and opportunities to the drivers of business value. In one recent acquisition, the measurement alerted the deal team to potential risk factors, resulting in a discount of $400m on the envisaged purchase price.

“When the ESG difference runs into six figures in just one deal, the value of sustainability as a criterion for investment becomes clear enough," Gibson says.