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# ESG-Sensitive Real Estate and Business Valuation

– and the Recent Updates in IVS –

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The integration of ESG factors into valuation decision-making is still at an early stage of development. This presents a significant challenge, particularly when it comes to projecting future cash flows and determining the cost of capital. In this paper, I will first provide an overview of the origin, role, and significance of ESG. This discussion also clarifies the linkage between ESG and Sustainable Development Goals (SDG), as well as the connection between corporate social performance (CSP) and corporate financial performance (CFP). Second, I explore the integration of ESG considerations into business and real estate valuation, highlighting ongoing challenges in ESG-sensitive valuation. Finally, I review the recently updated IVS ESG rules, evaluating their potential gaps and impacts.

## I. Introduction

Like football is never just a game, ESG (Environmental, Social, and Governance) considerations in business and real estate valuation transcend mere financial or performance metrics. In an era where societal and environmental issues increasingly shape corporate landscapes, integrating ESG criteria into corporations has become both pivotal and controversial. Striking a balance between profit-driven motives and sustainable, socially responsible practices has become a defining challenge for businesses and real estate stakeholders. This introduces a provocative discourse on the controversial intersections between profit and purpose, risk and responsibility, shaping the landscape where ESG is not merely an acronym but a transformative force in re-defining how we assess value in modern business. From the perspective of company value, it is perceived that sustainability and ESG may have a positive impact. However, mixed evidence in empirical literature implies that ESG investing may not necessarily be good for financial performance.<sup>1</sup> This puzzling picture increases tension regarding the value impact of ESG investing.

Almost all agree that ESG is important for intangible asset and business value creation, but no one is sure how to adjust existing valuation approaches and methods based on ESG impact. Data, measurement and valuation problems of ESG result in a shadow for its benefits. As an answer to this concern, newly emerging regulatory rule-making and local/global industry initiatives attempt to clarify the value impact of ESG. In this respect, one of the aims of the recently updated IVS is also to clarify ESG-sensitive real estate and business valuation.

In this paper, we first briefly review the origin, role and importance of ESG from the perspective of Sustainable Development Goals (SDG) and the linkage between corporate social performance (CSP; ESG) and corporate financial performance (CFP). As an answer to recently evolving anti-ESG rhetoric, this discussion will show the *raison d'être* of ESG integration for the new corporate value. Second, we will review how ESG consideration will integrate into business and real estate valuation by also presenting ongoing problems of ESG and ESG-sensitive valuation. Finally, we review the recently updated IVS ESG rules and assess their possible gaps and impacts.

## II. ESG: Global Trend and the Tool of SDG Integration

The United Nations' 2015 Sustainable Development Goals (SDG) encompass 17 interconnected objectives, targeting issues like poverty, inequality, climate change, and environmental degradation. They serve as a roadmap for global sustainability efforts, aiming for progress by 2030. ESG develops a bridge between firm-level activities and their societal and environmental impact in line with the SDG. Like other tools helping to achieve SDG, ESG is also special and the world needs great ESG companies which will make a difference.<sup>2</sup> However, ESG may not be set up to actively push for progress towards the SDG or pave the way for a truly sustainable world, the original goal of the ESG integration is to minimize the negative consequences of the ongoing multi-dimensional sustainability crisis.

1 Cornell/Damodaran, Valuing ESG: Doing good or sounding good?, NYU Stern School of Business, 20.03.2020, [» Link](#) (last access 20.02.2024).

2 An opposite view, Edmans, The end of ESG, Financial Management, vol. 52, no. 1 (2023): 3-17.

Fund managers are increasingly looking for ways to integrate ESG goals into their investment strategies<sup>3</sup> possibly to get higher fees for trading ESG assets.<sup>4</sup> Investors' broad support for ESG initiatives is the main factor for this push. According to the Conference Board's Shareholder Voting Trends (2018-2022) issued September 2022, there is a sharp increase in the number of shareholder proposals filed and voted in 2022 among Russell 3000 and S&P 500 companies, driven by a growth in environmental and social proposals, suggesting that investor focus on ESG is accelerating.<sup>5</sup> In 2023, with an increase of 47 shareholder proposals, environmental and social (E&S) policy saw the sharpest rise in volume.<sup>6</sup>

## The Concerns of the Benefits of ESG Investing

Despite its growing importance, ESG seems far from being a perfect tool. The ESG has its weaknesses such as measurement problems of (SDG-)ESG data points, lack of transparency for the ESG rating methodologies, and the lack of regulation.<sup>7</sup> *Boffo* and *Patalano* indicate that ESG ratings vary strongly depending on the provider chosen thanks to different frameworks, measures, key indicators and metrics, data use, qualitative judgement, and weighting of subcategories.<sup>8</sup> The variations in ESG scores among different ESG rating providers imply potential problems involving the reliability problem of the current ESG scores. The recent regulation attempts for the ESG rating agencies in the EU and the UK have both targeted to solve this problematic outlook. Moreover, ESG investing also attracts suspicions from the performance perspective of some (institutional) investors and public companies. Suggesting some mixed theories and evidence sets, the theoretical and empirical literature does not involve a consensus on the positive value effect of ESG investing.<sup>9</sup> Although the majority of the empirical evidence suggests a potentially positive link between CSP (ESG) and CFP, companies are aware that this relation may be sensitive to sample, period, and modelling selection strategies.

## Growing Demand for ESG Products

Despite these concerns, strong investor demand for ESG products and newly emerging ESG-related regulation attempts imply that ESG has become a new centre of intangible value creation and non-financial risk management practices in corporations. These trends result in a booming ESG-related asset volume. According to PwC's Asset and Wealth Management Revolution 2022 report,<sup>10</sup> asset managers globally are expected to increase their ESG-related assets under management (AuM)

3 Lindsey/Pruitt/Schiller, The cost of ESG Investing, Arizona State University, 05.07.2023, [» Link](#) (last access 20.02.2024).

4 Pucker/King, ESG Investing Isn't Designed to Save the Planet, Harvard Business Review, 01.08.2022, [» Link](#) (last access 20.02.2024).

5 Rousseau, ESG Overview and Trends, LSU Journal of Energy Law and Resources Symposium, 27.01.2023, [» Link](#) (last access 20.02.2024).

6 The Conference Board, 2023 Proxy Season Review: Navigating ESG Backlash & Shareholder Proposal Fatigue, 2023, [» Link](#) (last access 20.02.2024).

7 IOSCO, Environmental, Social and Governance (ESG) Ratings and Data Products Providers, Final Report, 2021, [» Link](#) (last access 20.02.2024).

8 Boffo/Patalano, ESG Investing: Practices, Progress and Challenges, OECD Paris, 2020, [» Link](#) (last access 20.02.2024).

9 Lindsey et al. indicate that despite extensive research, there is widespread disagreement in the literature on the return predictability of ESG characteristics, see: Lindsey/Pruitt/Schiller, op. cit. (footnote no. 2).

10 PwC, Asset and Wealth Management Revolution 2022 report, [» Link](#) (last access 20.02.2024).

to \$33.9tn by 2026, from \$18.4tn in 2021. With a projected compound annual growth rate (CAGR) of 12.9%, ESG assets are on pace to constitute 21.5% of total global AuM in less than 5 years. It is also indicated in the Russell Investments' 2023 Manager ESG Survey<sup>11</sup> that only 7% of the global survey respondents said that ESG factors do not drive investment decisions. Moreover, ECI Partners in their Growth Characteristics 2022 report shows that 74% of 500 U.K. CEOs sampled now hold ESG as equally important as financial performance.

This continued attention should come as no surprise. 2023 has been marked by some of the biggest disruptions to both people and the planet, with extreme climate change-related events causing widespread destruction and disruption. Now more than ever, companies are navigating a Volatile, Uncertain, Complex, and Ambiguous (VUCA) world.<sup>12</sup> More than ever ESG risk management and value transmission mechanisms seem a new normal for local and global companies.

### III. ESG and Company Valuation

The rise of ESG has started in the early 2000s. However post-Global Financial Crisis period and the COVID-19 era have played a catalyzing role. The changing investment landscape towards a more sustainable way brings into consideration several practical problems. Developing an ESG-sensitive valuation framework is one of the ongoing concerns in this process.

IVSC and RICS underline that in the ESG-sensitive valuation of private companies, considerations include the impact on cash flows, cost-benefit balance, and long-term implications on the cost of capital.<sup>13</sup> The ESG characteristics affect company value in two main interconnected transmission channels: the cash flow and risk.<sup>14</sup> The optimistic perception of the long-term value impact of ESG is pictured in Figure 1. Although theoretical and empirical literature does not necessarily support this, one may expect that ESG investing may have a positive value impact based on the increasing cash inflow and declining cost of capital. Both channels may eventually result in increasing predictability in future cash flows with declining risk perception. Below we briefly review the value impact of each transmission channel.

**Figure 1. An Optimistic ESG Value Transmission Channels**



- 11 Russell Investment, 2023 Manager ESG Survey: Climate risk dominates, » [Link](#) (last access 20.02.2024).
- 12 Thomson Reuters Institute, The 2023 State of Corporate ESG: At the crossroads of data, regulations, and digital solutions, 2023, » [Link](#) (last access 20.02.2024).
- 13 IVSC/RICS, Future Of Valuations: The Impact of ESG, 2023, » [Link](#) (last access 20.02.2024).
- 14 El Ghoul/Guedhami/Kwok/Mishra, Does Corporate Social Responsibility Affect the Cost of Capital?, *Journal of Banking and Finance*, vol. 35, no. 9 (2011): 2388-2406, » [Link](#) (last access 20.02.2024); Gregory/Tharyan/Whittaker, Corporate Social Responsibility and Firm Value: Disaggregating the Effects on Cash Flow, Risk and Growth, *Journal of Business Ethics*, vol. 124, no. 4 (2014): 633-657, » [Link](#) (last access 20.02.2024).

### 1. Cash-Flow Transmission Channel

ESG factors can affect a company's cash in/out flow by influencing the investment costs, consumer preferences, investor decisions, and regulatory requirements. These factors may collectively contribute to ESG-related income flows and intangible asset formation. In the short term, ESG investing requires cash outflows besides its organizational and cultural impacts. The survey of the Sustainability Institute by ERM found that on average corporate issuers are spending \$533,000 annually only on climate-related disclosure, while institutional investors are spending an average of \$1,372,000 annually to collect, analyze, and report climate data to inform their investment decisions.<sup>15</sup>

Companies with strong ESG performance may attract more loyal customers and talents, secure investments from socially responsible investors, or benefit from government incentives, leading to increased cash flow with lower risk perception. This positive scenario can help create additional long-term value. Supposedly positive perception in investors may also create some behavioral impact on the value. IVSC and RICS discuss that "valuation professionals categorise the impact of ESG on valuation into 'hard' and 'soft' impacts.<sup>16</sup> Hard impacts directly influence cash flows through identifiable risks or opportunities. Soft impacts, involve the subtler task of appraising investor sentiment towards ESG-positive businesses, which might not be directly reflected in valuations." Although there is no consensus on stock/accounting performance benefits of ESG, the majority of the studies suggest a positive relation.<sup>17</sup> For example, *Eccles et al.* discuss that high-sustainability companies significantly outperform their counterparts in both stock market and accounting performance over the long term.<sup>18</sup> *Caldecott et al.* argue that "sustainable firms or projects would need to have greater or easier access to capital than their unsustainable peers.<sup>19</sup> Firms with easier access to liquidity from a wide pool of investors are also more likely to face a lower cost of capital and to have corporate practices acceptable to the market. From an industry perspective, it is indicated in the U.S. Securities and Exchange Commission's (SEC) proposed "Rules on Enhancement and Standardization of Climate-Related Disclosures for Investors" that climate-related risks are linked to negative impacts on financial performance. However, climate-related disclosures may reduce investors' uncertainty about estimated future cash flows and lower the risk premium and cost of capital by reducing information asymmetry, and adverse selection problems and improving liquidity. This may make it easier to raise equity and debt or to obtain loan financing.<sup>20</sup> This positive informational signal may contribute to long-term value creation and may be related

15 ERM Sustainability Institute, Survey reveals costs and benefits of climate-related disclosure for companies and investors, 2022, » [Link](#) (last access 20.02.2024).

16 IVSC/RICS, op. cit. (footnote no. 12).

17 Friede/Busch/Bassen, ESG and financial performance: aggregated evidence from more than 2,000 empirical studies, *Journal of sustainable finance & investment*, vol. 5, no. 4 (2015): 210-233.

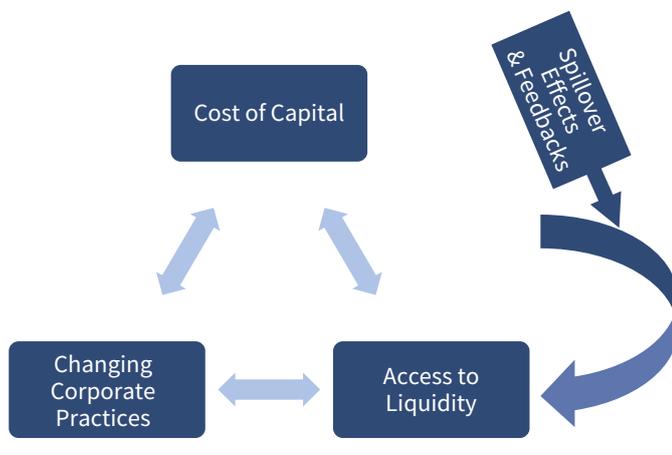
18 Eccles/Ioannou/Serafeim, The Impact of Corporate Sustainability on Organizational Processes and Performance, *Management Science*, vol. 60, no. 11 (2014): 2835-2857.

19 Caldecott/Harnett/Koskelo/Wilson/Liu, Sustainable Finance and Transmission Mechanisms to the Real Economy, University of Oxford Smith School of Enterprise and the Environment, Working Paper, 19.04.2022, » [Link](#) (last access 20.02.2024).

20 SEC, The Enhancement and Standardization of Climate-Related Disclosures for Investors, 2022, » [Link](#) (last access 20.02.2024).

to interconnected factors of cost of capital, access to liquidity and changing corporate practices more sustainably (see, Figure 2).

**Figure 2. ESG Transmission Mechanism Interdependencies**



Source: Caldecott et al.<sup>21</sup>

## 2. Risk Transmission Channel

The second transmission channel of ESG value is related to firm-level risks. The integration of ESG may have a positive impact on risk management and corporate governance quality and hence may result in a lower cost of capital (WACC). Within a DCF model, systematic risk is typically captured through the cost of capital (i.e., the denominator in the DCF model). In contrast, firm-specific risk is linked to the numerator of the DCF model, that is, future cash flows.<sup>22</sup> In this respect, ESG integration may contribute to corporate value by better risk management practices for firm-wide risks. Increases in risk management quality by integrating non-financial risk management practices may play a pivotal role in the declining cost of capital. *Cornell and Damodaran* also argue that the evidence that socially responsible firms have lower discount rates, and thereby investors have lower expected returns, is stronger than the evidence that socially responsible firms deliver higher profits or growth.<sup>23</sup>

However, composed of the weighted average of the cost of equity and cost of debt, the cost of capital varies depending on a broad set of macroeconomic and financial variables besides firm-specific factors including ESG impact. These factors also look highly volatile due to the cyclical nature of the general economy and firm/industry-specific factors. The life cycle stage (i.e. startup, growth, mature) and the nature (i.e. public/private, developed/emerging market or asset class of the firm) of the firm have also affected the external financing costs and hence the cost of capital. Although the cost of capital impacts of the social dimension of ESG is still in an emerging debate in the literature, the strong corporate governance, representing the G-investing in ESG framework, may be regarded as a lower cost of equity

and cost of debt.<sup>24</sup> Some empirical evidence also supports that E-investing and ESG investing may result in a decline in financing costs.<sup>25</sup> From an E-investing perspective, using data for 13,114 firms for the period 1992–2007, *Chava* finds that lending institutions charge a significantly lower interest rate on bank loans for environmentally responsible firms.<sup>26</sup> *Kling et al.* provide evidence that companies in countries with greater exposure to climate risks exhibit higher financing costs and are financially more constrained.<sup>27</sup> From the aggregated ESG perspective, *Ng and Rezaee* suggest that non-financial sustainability performance is also negatively related to the cost of equity.<sup>28</sup> *Eliwa et al.* find that firms with stronger ESG performance have a lower cost of debt, and ESG disclosure has an equal impact on the cost of debt as ESG performance.<sup>29</sup> Practitioners typically adjust the discount rate and the long-term growth rate in ESG-sensitive valuation implying the long-term impact of ESG factors on company cash flows.<sup>30</sup> However, this impact may depend on several factors such as age, size, industry, firm-specific ESG material factors,<sup>31</sup> the volume of ESG disclosure, and even some unethical corporate actions (i.e. carbon washing, greenwashing).

As usual in an emerging literature context, some studies find no relation between ESG metrics and the cost of capital. *Bofinger et al.* show that an ESG engagement may result in misvaluation as it increases a firm's market valuation relative to its true value.<sup>32</sup> This may be related to reflecting the positive sentiment of external stakeholders on the value.<sup>33</sup> Moreover, although there is a consensus that quality information is associated with a low cost of capital and low financial constraints, noisy ESG information may result in a higher cost of capital and financial constraints.<sup>34</sup> Eventually, besides estimating higher cash inflows, the selection of the lower cost of capital may also play a catalysing role in over-estimation of ESG-sensitive value.

Therefore, considering the empirical literature reveals mixed evidence on the risk transmission channel of ESG investing, we may conclude that the lower risk and the lower cost of capital effects of ESG investing is not a rule but may depend on the firm-specific environment.

21 Caldecott/Harnett/Koskelo/Wilson/Liu, op. cit. (footnote no. 18).

22 Giese/Lee/Melas/Nagy/Nishikawa, Foundations of ESG investing: How ESG affects equity valuation, risk, and performance, *The Journal of Portfolio Management*, vol. 45, no. 5 (2019): 69-83, [Link](#) (last access 20.02.2024).

23 Cornell/Damodaran, op. cit. (footnote no. 1).

24 Bozec/Bozec, Corporate governance quality and the cost of capital, *International Journal of Corporate Governance*, vol. 2, no. 3/4 (2011): 217-236; Tran, Multiple corporate governance attributes and the cost of capital – Evidence from Germany, *The British Accounting Review*, vol. 46, no. 2 (2014): 179-197.

25 An opposite view, Goldstein/Kopytov/Shen/Xiang, On ESG investing: Heterogeneous preferences, information, and asset prices, *National Bureau of Economic Research*, April 2022, [Link](#) (last access 20.02.2024).

26 Chava, Environmental externalities and cost of capital, *Management Science*, vol. 60, no. 9 (2014): 2223-2247.

27 Kling/Volz/Murinde/Ayas, The impact of climate vulnerability on firms' cost of capital and access to finance, *World Development*, vol. 137 (2021), 105131.

28 Ng/Rezaee, Business sustainability performance and cost of equity capital, *Journal of Corporate Finance*, vol. 34 (2015): 128-149.

29 Eliwa/Aboud/Saleh, ESG practices and the cost of debt: Evidence from EU countries, *Critical Perspectives on Accounting*, vol. 79 (2021), article 102097.

30 Bancel/Glavas/Karolyi, Do ESG factors influence firm valuation? Evidence from the field. *Evidence from the Field*, 20.02.2023, [Link](#) (last access 20.02.2024).

31 Ahn/Patatoukas/Skiadopoulos, Material ESG Alpha: A Fundamentals-Based Perspective. *The Accounting Review* (2024): 1-27.

32 Bofinger/Heyden/Rock, Corporate social responsibility and market efficiency: Evidence from ESG and misvaluation measures, *Journal of Banking & Finance*, vol. 134, (2022), article 106322.

33 Bancel/Glavas/Karolyi, op. cit. (footnote no. 29).

34 García-Sánchez/Hussain/Khan/Martínez-Ferrero, Do markets punish or reward corporate social responsibility decoupling?, *Business & Society*, vol. 60, no. 6 (2021): 1431-1467.

### 3. The Challenges of Quantifying ESG

#### a) Valuation Approaches and ESG Integration: Role of Income Approach

Considering the value of a company entails accounting for sustainability-related risks and opportunities that often elude conventional financial reporting. With the ongoing evolution of sustainability reporting standards, forecasting the trajectory of ESG valuation proves to be a complex task. Nonetheless, envisioning a spectrum of plausible scenarios that are both actionable and insightful for investors to assess and analyze remains feasible. After the company has identified its ESG risks and opportunities based on its materiality map, it falls upon the valuation professional to determine how to integrate these factors into adjustments for projected financial performance.

From a real estate valuation perspective, *Aronsohn* argues that “discounted cash flow (DCF) analysis is very well suited to quantifying ESG factors within a real estate valuation because a DCF can explicitly reflect specific assumptions which relate to income, expense, capital expenditures and exit yields and vacancies over years.”<sup>35</sup> This argument specifically seems valid for quantifying the financial impact of E-investing in the built environment due to its well-established measurement procedures. However, quantifying the financial impact of G-investing specifically S-investing in real estate is still evolving in industry and academic circles. For example, Cambridge Centre for Housing and Planning Research and Womble Bond Dickinson indicate despite the evidence that ESG practices are impacting the built environment sector in the UK, there are gaps in the evidence regarding the social and governance elements of ESG requiring further definition and consistent measurement practices, as found with environmental commitments.<sup>36</sup>

From a business valuation perspective, there is no one-size-fits-all approach to integrating ESG but taking into account that the cost approach is used in valuation only in special circumstances and the challenge to employ the market approach due to the lack of comparable ESG-sensitive market transactions, it seems that the income approach is also the best option among the traditional valuation approaches for integrating ESG factors into business value.

#### b) Possible Financial Impacts of ESG Integration

In today's ESG-conscious landscape, incorporating the value of sustainability initiatives often means creating two scenarios: one baseline scenario without ESG effects and another with ESG strategies impacting operations (see Box 1).

#### Box 1. With or Without You: ESG Impact Scenarios for Companies

##### Baseline Scenario

In the baseline scenario, the firm operates without specific ESG strategies influencing its active operations. Traditional business practices are followed, focusing primarily on accounting performance metrics such as revenue growth, cost reduction, and profit maximization. In this traditional case, ESG considerations are not explicitly integrated into deci-

sion-making processes. The firm's valuation is based solely on financial factors, with no adjustment for potential ESG-related impacts on future cash flows or risk.

##### ESG Impact Scenario

In the ESG impact scenario, the firm actively incorporates ESG strategies into its operations, such as reducing carbon emissions, improving workplace diversity, and enhancing business ethics practices. These initiatives are expected to yield various benefits, including cost savings from energy efficiency measures, enhanced brand reputation leading to increased customer loyalty, and reduced regulatory risks. Consequently, the firm's financial performance may be influenced by these ESG-related factors, leading to adjustments in revenue forecasts, cost projections, and risk assessments. Investors and analysts may utilize ESG-specific metrics and frameworks to evaluate the firm's performance and assign a positive/negative premium to its valuation based on its sustainable practices and long-term resilience to ESG-related challenges.

The financial impacts of ESG strategies on fundamental valuation variables should be initially estimated by the management. This work should also reflect intangible costs and benefits of ESG policies on critical value-effective items such as market share, sales, product/service pricing, profitability, financing cost, corporate governance quality, and customer and employee loyalty. As indicated by KPMG, among others, the final output of this ESG-sensitive forecasting is mainly to determine ESG-sensitive free cash flow, discount rate, and hence enterprise value.<sup>37</sup> However, the process of adjusting cash flow and discount rates to account for ESG risks and opportunities currently resembles more of a skilled craft than an exact science or an art.

#### c) The Challenges of ESG Integration in Valuation

Despite the supposedly positive value contribution of ESG, existing valuation literature does not provide a clear answer for integrating ESG factors into valuation. From the accounting and financial reporting perspectives, the standards of ESG impacts on financial tables are also not fully clear. From the literature perspective, for example, *Schramade* indicates that the value impact of ESG integration is still challenging.<sup>38</sup> The following questions asked by the author mostly remain unanswered: “How should an analyst take into account issues like management quality, tail risks, and the timing of the impact? That is, how long does it take specific sustainability factors (i.e. materiality framework, KPI) to impact corporate financial performance? And how long does that impact last? How does it differ per type of ESG issues?”

In this emerging framework, each solution attempt usually comes with its possible limitations. For example, *Huang* discusses that ESG activity may affect firm valuation through prospective capital and operational expenditure, and the financial benefits that such expenditure may bring.<sup>39</sup> However, the practical incorporation of ESG factors in cash flow and discount rate

35 Aronsohn, Unlocking the Value of ESG, *The European Valuation Magazine*, vol. 1, no. 1 (2022): 26-36.

36 Cambridge Centre for Housing and Planning Research/Womble Bond Dickinson, ESG: Investing in the built environment, 2023, [Link](#) (last access 20.02.2024).

37 KPMG, Incorporating an ESG lens in business valuations, 2020, [Link](#) (last access 20.02.2024).

38 Schramade, Integrating ESG into valuation models and investment decisions: the value-driver adjustment approach, *Journal of Sustainable Finance & Investment*, vol. 6, no. 2 (2016): 95-111.

39 Huang, Environmental, social and governance factors and assessing firm value, *Accounting & Finance*, vol. 62 (2022): 1983-2010.

forecasts is not obvious. As a solution to integrate ESG factors into discount rate calculation, the equity discount rate may be adjusted based on an ESG-adjusted capital asset pricing model (CAPM). For example, as a rare study in the literature, Pedersen et al. derive an ESG-adjusted CAPM.<sup>40</sup> But, like other measurement problems of ESG valuation, the theoretical and empirical literature is also still emerging in this specific discussion.

Inard discusses that due to materiality, valuation practitioners do not systematically address the ESG topic in valuations.<sup>41</sup> CFA Institute suggests that to determine the materiality of ESG information, analysts might rely on a materiality framework developed by a third party, a firm's proprietary framework, or their judgment and they consider sector/industry, company-specific factors, location, governance, climate change and investment horizon as the fundamental components.<sup>42</sup> However using qualitative considerations in firm valuation inevitably results in additional subjectivity problems in valuation.<sup>43</sup>

#### IV. IVS and ESG-Sensitive Valuation

Besides emerging literature, industry practices, accounting and reporting standards, the rule-making on ESG valuation is also evolving. Recently, IVS has broadened its scope to incorporate ESG considerations into valuations for all assets and liabilities. IVS suggests that valuers should be knowledgeable about pertinent legislation and frameworks concerning the ESG factors that influence valuation outcomes.<sup>44</sup> It is also indicated in the IVS' public announcement that "impact on valuation is still in development and additional requirements may be needed".<sup>45</sup>

Effective 31.01.2025, the updated IVS involves several measures to address ESG consideration in the following sections: Glossary, IVS 103 Valuation Approaches, Appendix, IVS 104 Data and Inputs Appendix, IVS 300 Plant, Equipment, and Infrastructure, IVS 400 Real Property Interest, and IVS 410 Development Property. Among these updates, the IVS 104 involves a detailed rule-making for the ESG integration into the valuation process. As seen in the below Box 2, the IVS explicitly indicates that ESG is the very fundamental variable in valuation.

#### Box 2. Selected ESG Rules in IVS Effective 31.01.2025

##### Glossary

10.08. Environmental, Social and Governance (ESG)

The criteria that together establish the framework for assessing the impact of sustainability and ethical practices, financial performance or operational of a company, asset, or liability. ESG comprises three pillars: Environmental, Social and Governance, all of which may collectively impact performance, the wider markets and society.

40 Pedersen/Fitzgibbons/Pomorski, Responsible investing: The ESG-efficient frontier, *Journal of Financial Economics*, vol. 142, no. 2 (2021): 572-597.

41 Inard, in: Glavas (editor), *Valuation and Sustainability: A Guide to Include Environmental, Social, and Governance Data in Business Valuation*, (2023): 99-128.

42 CFA Institute, *Guidance For Integrating ESG Information Into Equity Analysis and Research Reports*, Nov. 2022, » [Link](#) (last access 20.02.2024).

43 Huang, op. cit. (footnote no. 37).

44 IVSC, *IVS Exposure Draft (2023)*, » [Link](#) (last access 20.02.2024).

45 IVSC, *New edition of the International Valuation Standards (IVS)* published, » [Link](#) (last access 20.02.2024).

#### IVS 103 Valuation Approaches: Appendix

A10.08. The valuer should analyze and make adjustments for any significant differences between the comparable transactions and the subject asset. Examples of common differences that could warrant adjustments may include but are not limited to:

- (a) material characteristics (age, size, specifications, etc),
- (b) size adjustments,

...

- (l) differences in ESG considerations,

#### IVS 104 Data and Input: Appendix

A10.01. The impact of significant ESG factors should be considered in determining value of a company, asset, or liability.

A10.02. ESG factors may impact valuations both from a qualitative and quantitative perspective and may pose risks or opportunities that should be considered.

A10.06. ESG factors and the ESG regulatory environment should be considered in valuations to the extent that they are measurable and would be considered reasonable by the valuer applying professional judgement.

#### IVS 300 Plant, Equipment, and Infrastructure & IVS 400 Real Property Interest

100.06. Significant ESG factors associated with the value of an asset should be considered as part of the data and input selection process.

#### IVS 410 Development Property

120.06 Significant ESG factors associated with the value of an asset should be considered as part of the data and input selection process.

#### V. Conclusion

As an answer to the growing need for ESG-sensitive valuation, the recently updated IVS involves several ESG-sensitive valuation rules. This new rule set shows the recognition of the importance of ESG-based intangible value formation by the IVS besides other valuation initiatives such as the RICS Red Book and The International Private Equity and Venture Capital Valuation (IPEV) Valuation Guidelines. However, despite some technical improvements in defining ESG-sensitive value, newly issued rules do not provide specific solutions to the ongoing ESG valuation problems such as measurement problems in S-investing. Moreover, it has also no specific ESG considerations for some critical valuation variables such as (terminal) capitalisation rate, discount rate, and useful life. IVS provides broad discretion and responsibility for the valuation professional to estimate ESG-sensitive value. As indicated in the new rules professional judgement of the valuer and qualitative perspective matters in ESG sensitive value search.

ESG-sensitive valuation is still in its infancy. Integrating ESG factors into valuation decision-making implies a challenge specifically in terms of future cash flow and cost of capital projections. The scarcity of comprehensive ESG information, measurement problems and skills gap in valuation professionals may exacerbate the valuation challenge. But, in such an early stage of development, the more explicit rules may not properly address ongoing problems and newly evolving market dynamics in ESG valuation. Taking into account that emerging ESG valuation literature also does not help much in solving ESG valuation problems, we believe that the new IVS rules may play a significant role in improving ESG awareness in the valuation industry despite its gaps. ♦

## Articles

<i>Harri Seppänen</i> Judicial Business Valuation in Finland	4
<i>Yener Coşkun</i> ESG-Sensitive Real Estate and Business Valuation – and the Recent Updates in IVS –	10
<i>Stefan Schöniger / Heike Snellen / Andreas Tschöpel</i> Cost of Capital Study 2023: Unpredictability on the Rise! – Interest Rates Too? What Are the Drivers, What Are the Consequences?	16
<i>EACVA</i> EACVA's Annual International Business Valuation Conference 2023 – Detailed Review	22

## Data

<i>Martin Schmidt / Andreas Tschöpel</i> Industry Betas and Multiples (for Eurozone Companies)	26
<i>Stefan O. Grbenic</i> Discounts for Lack of Marketability (Europe)	30

## News

News from EACVA	39
News from IVSC	40

## IVSC Members Introduce Themselves

Luxembourg Valuation Professionals Association (LVPA)	42
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## In this issue



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### Judicial Business Valuation in Finland

This article on country specific valuation topics briefly reviews the key issues regarding judicial valuation in three main areas in Finland: minority shareholder squeeze-outs, estate and gift taxation, and marital dissolution. The degree and detail of guidance provided for judicial valuations varies significantly depending on the applied law.

### ESG-Sensitive Real Estate and Business Valuation – and the Recent Updates in IVS –

The integration of ESG factors into valuation decision-making is still at an early stage of development. This presents a significant challenge, particularly when it comes to projecting future cash flows and determining the cost of capital. This paper first provides an overview of the origin, role, and significance of ESG. This discussion also clarifies the linkage between ESG and Sustainable Development Goals (SDG), as well as the connection between corporate social performance (CSP) and corporate financial performance (CFP). Second, it examines the integration of ESG considerations into business and real estate valuation, highlighting ongoing challenges in ESG-sensitive valuation. Finally, the author reviews recently updated IVS ESG rules, evaluating their potential gaps and impacts.



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### Cost of Capital Study 2023: Unpredictability on the Rise! – Interest Rates Too? What Are the Drivers, What Are the Consequences?

Recently the 18th edition of KPMG's Cost of Capital Study was published. As in previous editions, the study presents current developments regarding

the preparation of business plans and the derivation of cost of capital, as well as its relevance for company values and company value developments. The study examines the impact of increased uncertainties and accompanying interest rate and inflation developments on business models, corporate development and long-term return expectations (cost of capital), based on sector-specific analyses. 2023 response rate demonstrates once again the high practical relevance of the annual Cost of Capital Study. In total, 322 companies participated in this year's Cost of Capital Study. Of the participating companies, 240 are based in Germany, including 65 percent of the DAX-40 companies.