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When sustainability becomes a factor in valuation

Sustainability efforts are material to investors only to the extent they affect cash flows. What matters depends on the industry.

Investors and other stakeholders seeking to understand companies' risks and opportunities increasingly demand to know more about their performance related to sustainability concerns—or more specifically, environmental, social, and governance issues. Companies generally disclose variables that have a material effect on their value, according to financial accounting standards. But a one-size-fits-all approach to disclosure misses meaningful differences among industries.

In this December 2016 interview, excerpted from a conversation at the inaugural symposium of the Sustainability Accounting Standards Board (SASB), McKinsey's Tim Koller joined alumnus Jonathan Bailey to discuss how accepted principles of valuation apply. Koller, an author of *Valuation: Measuring and Managing the Value of Companies*,[1] has argued that "creating shareholder value is not the same as maximizing short-term profits—and companies that confuse the two often put both shareholder value and stakeholder interests at risk."[2] In this conversation, Bailey and Koller dig into the issues related to how sustainability affects value, the asymmetry of information between companies and their investors, and how companies communicate about that information.

Jonathan Bailey: How does your thinking about valuation reflect today's focus by many stake-holders on sustainability and how it's changed over time?

Tim Koller: I think we have to separate the mechanics of valuation from what managers should be doing to maximize a company's value and how investors react to the whole thing. For hundreds of years, the value of a company has ultimately come down to the cash flows it generated. That's what you can spend as an owner, whether you're a private owner or whether you're a shareholder in a large company.

Now, there have been periods of time when people said, "Oh, the rules are changing." For example, during the dot-com bubble, all of a sudden, people said, "Traditional methods of valuation don't make sense anymore—look at all these companies with high valuations that have nothing to do with cash flow." Well, ultimately, it was the lack of cash flow that brought those companies' valuations back down.

Sustainability issues aren't any different from other things management has to worry about. If the forces in the world that relate to sustainability are going to be material to a business, it's management's job to take a longer view and figure out what to do about them. Because eventually, these things will affect cash flows. And what's good about SASB's approach is its focus on how different sustainability factors might materially affect the cash flows of companies in 79 different industries.

From the perspective of how investors react, one thing we find is that managers have a lot more information than investors—and long before investors have it. So sometimes the markets lag behind in their valuations because some important factor is too vague or unclear for investors to see how it might affect a company's cash flows. When it does become clear, the markets do react. If you look at the way oil and gas companies are valued, for example, people say, "There will be all these stranded assets out there. Some oil reserves won't be produced because of the growth of alternative energy sources." When you look closely, the market's already discounting those concerns. Investors are assuming that there's not much value beyond a certain period of time, which isn't too far into the future.

Jonathan Bailey: That requires managers to be able to think about the long-term horizon, internal budget processes, and capital-allocation decisions with materiality in mind. In my experience with corporate clients, there are often dynamics in the way that people think about creating value within a business that seem to be a little less than efficient.

From your perspective, thinking about it more in terms of corporate finance, what would you say are some of the things we need to overcome in order to help managers do a better job of integrating these longer-term goals, like sustainability?

Tim Koller: When managers make decisions, they always work off some baseline of performance. One trap they fall into is ignoring what really would happen, relative to the baseline, if they *didn't* do something. For example, what are the consequences of not doing an acquisition? Maybe they won't be able to achieve their base case. Or, for another example, if they don't invest in safety, the effect on the baseline isn't that safety would increase their cash flow—but rather that it reduces the probability of having lower cash flows.

So one thing managers need to be more thoughtful about is which things actually create value in and of themselves. With regard to sustainability, if a company can do things that make customers more likely to buy from it than from a competitor, because it has better credentials, those things are all going to be positive. But what are the consequences, relative to the baseline, of not doing

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something? What if a company doesn't invest in safety, for example? Or if it doesn't invest in environmental mitigation? Or if it builds a plant in such a way that it can't be operated under future regulations as opposed to today's? That's really the challenge for managers. If they don't do these things, what's likely to happen? And it's not going to be business as usual.

Jonathan Bailey: I know some of the work you've been doing recently has been around communication between managers and investors. Given the information asymmetry you mentioned, what do the best companies do to communicate how they'll create value in a way that investors should care about—in the context of sustainability issues?

Tim Koller: I think we're still in a very infant stage with regard to this. Some of the reporting by companies is still boilerplate. But there are some good examples. For example, some of the consumer-apparel companies have become very conscious about their overseas sourcing. They're becoming more proactive about describing what they do to make sure that suppliers are upholding certain standards. You can also see it in extraction or energy-related industries, where they're worried about sustainability issues. You can see it in healthcare where they're ultimately concerned about product safety.

Unfortunately, communication often doesn't happen until after there's been a blowup somewhere in the industry—situations where, all of a sudden, something happens that gets everyone's attention, and people start to worry about it.

Jonathan Bailey: Another trend we've seen is in the growth of information available to investors. Whether it's from what they learn from company disclosures, from data providers (which may not be from disclosure), from trawling news media, or from building input-output models that compile a view of what's happening inside a business on sustainability characteristics.

From an investor perspective, do you feel that this is really just a trend toward more data or is it really important to focus on better data?

Tim Koller: I think it's about the better data. There are investors who look at a Bloomberg screen to make investment decisions, and having sustainability factors available there provides a lot of visibility to the issues. But the investors who drive the market are typically much deeper than that. They're going to spend a month doing their research before they decide to make an investment in a company. They're going to follow it for a long period of time. They're going to be more interested in what material factors may drive the company's value.

What ultimately matters, we've learned from sophisticated long-term investors, is the importance of management credibility.[3] It's not so much about the amount of data. It's that managers, when facing those investors one on one, are able to talk about what's really going to matter, what's going drive the cash flows, and what's being done about it.

So the disclosures are good because they get the conversation going. But whether or not they're mandated or audited, what really matters to those investors is, when they're face to face with management, whether they have a sense of what management really knows what they're talking about and what they're doing about it.

Jonathan Bailey: That's an interesting point, because you'll often hear CEOs say, "Look, I never get questions from sell-side analysts around these sorts of topics." But it's probably the case that those conversations are happening in a different forum. They're not happening on a quarterly earnings call—they're happening in those one-on-one meetings with a value-based investor who has a much more active focus.

So if you're sitting there as a CEO trying proactively to have that conversation, do you think that management teams are doing the best thing they can to structure the right conversations? Or do you think, on the whole, managers are basically waiting for people to come to them and the loudest voices will be the ones that shape the discussion?

Tim Koller: It's a combination of the two, because there are two worlds going on. There are the quarterly earnings and the sell-side analysts, and then there are the actual investors who tend to have private conversations with managers. And those worlds don't intersect for the most part.

When executives sit down with what we call intrinsic investors, the conversation is much deeper and it does focus on what's material, whether it's sustainability or other things that are affecting the industry. They talk about, "What's going on there? How is management reacting?"—getting a sense of whether management knows what they're doing. That's a sharp contrast from the quarterly calls where usually only the sell-side asks questions.

I was talking to one investor-relations professional who's been in the business for decades who said that only once did a buy-side investor actually ask to join a quarterly call. There are ways to improve that. When we talk to long-term investors, they would like management to be more proactive in those quarterly calls. They say, "Tell us what you really think is important. Don't try to guess what the sell-side analysts want to know. Tell us about the results in the context of what you're doing longer term. And then find a way to make sure that the most important questions about the long term get raised. Take more charge of investor communications and focus on what's really important." ■

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[1] Marc Goedhart, Tim Koller, and David Wessels, *Valuation: Measuring and Managing the Value of Companies*, sixth edition, Hoboken, NJ: John Wiley & Sons, 2015.
[2] Marc Goedhart, Tim Koller, and David Wessels, "The real business of business," March 2015, McKinsey.com.
[3] Rebecca Darr and Tim Koller, "How to build an alliance against corporate short-termism," January 2017, McKinsey.com.

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