Please consider the environment: Why decarbonization belongs in capital allocation conversations

As the planet grows warmer, extreme heat events that used to occur once every 50 years are now likely to happen nearly five times in the same period.[1] Recent—and unprecedented—wildfires in Maui and Canada would appear to underscore the point. Indeed, climate change—something that may have felt somewhat conceptual 20 years ago—now exhibits tangible impacts.

The upshot for CFOs and other leaders? The future may belong to resilient, sustainable businesses. But building resilience requires a long-term perspective, one that anticipates evolving legal and regulatory requirements and possible disruptions to business triggered by severe weather threats. Likewise, CFOs will need to accurately assess, among a lengthy list of items, what it will cost their companies to transition to low-carbon operating models.

Like climate change, this growing attention to business sustainability is not likely to abate any time soon. As climate change considerations draw increasing scrutiny from investors and regulators—and as consumers and employees seek more information about corporations' climate impacts—a sustainability filter will likely need to be applied to business decisions. Factoring in the cost of climate risk will almost certainly challenge assumptions about ROI, portfolio strategy, and resource allocation. Forecasting, capital expenditures, external investments—all will probably eventually require some sort of sustainability component.

As stewards of shareholder capital, chief financial officers will likely be asked to include decarbonization in capital allocation models. In time, decarbonization and, more broadly, ESG assessments, may become a routine consideration when conducting FP&A. The not-so-subtle message for CFOs: Get ready for a new environment for assessing investments and strategy.

In this edition of *CFO Insights*, we look at the role of the finance function in assessing climate change impacts on capital allocation. What investment decisions may benefit the most from sustainability analysis? Could a commitment to sustainability provide a competitive advantage that separates winners and losers in a number of industries? And, ultimately, how do CFOs square societal obligation with the pressure to produce quarterly earnings?

Materials risk

Management teams that give short shrift to sustainability and resilience in investment decisions may have to defend those choices in years to come. Worse, they could lose out to sustainable competitors in attracting talent, capital, and customers. In a Deloitte survey of business leaders across the globe from a wide range of industry sectors (including mining, manufacturing, real estate, construction, and pharmaceuticals), 27% of respondents said they consider ESG issues in every capital allocation decision (see Figure 1).[2]

Stricter—and more burdensome—regulatory requirements in Europe and in the US[3] will likely garner increasing attention from the C-suite. But at the moment, corporate directors seem to be the most vocal champions of sustainability inside a company. In the Deloitte survey, 81% of businesses reported that their company's board is a significant or very significant influence on ESG initiatives.[4] This makes sense. Boards are entrusted to protect, among other assets, a company's brand.[5] Crafting decarbonization policies that satisfy customers and other stakeholders fits the brief. Moreover, as part of their fiduciary duty of care, directors must look to protect a company's long-term value and viability (see Figure 2).[6]

Existential threats like climate change could threaten such viability. Shorter term, weather events can pose a material risk to the day-to-day operations of a business. Disastrous weather can have a disastrous impact on supply chains. Obviously, businesses do not want to depend on links in supply chains that are increasingly interrupted by extreme weather events.

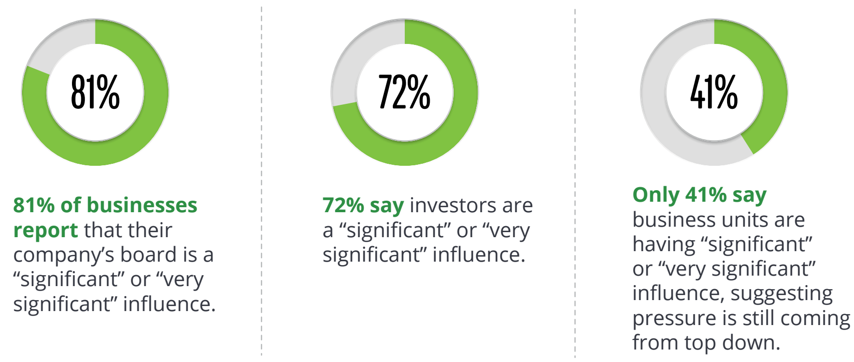
Figure 1. Developing an ESG mindset

The way organizations think about ESG is evolving

Source: "Capital allocation and resilient portfolios," Deloitte Global, 2023.

Figure 2. Pressure cookers: Boards and investors leading the way

The pressure to do more on ESG is coming from investors and boards



Source: "Capital allocation and resilient portfolios," Deloitte Global, 2023.

Concerns about threats to supply chains due to climate change appear to be a point of discussion for C-suite leaders. In the Deloitte survey, respondents were asked to name the ESG factors that get the greatest focus in their capital allocation process. Sustainable supply chains and materials were at the top of the list (75%).[7]

In terms of their own supply chains, CFOs may want to consider:

- **What methods are we deploying to gauge the risks to suppliers of severe weather events and rising sea levels?**
- **Do we have a cohesive business continuity strategy that takes into account increasing weather-related disruptions to our supply chain?**
- **Do we have a firm grip on the steps our suppliers are taking to minimize shutdowns?**
- **What scenarios are most likely to disrupt suppliers—and how long will it take for them to come back on line?**

This corporate concern about the resilience of supply chains can be seen in recent M&A activity. In the first half of 2023, companies paid around $4 billion to acquire stakes in electricity and raw materials suppliers.[8] Such purchases typically serve two purposes. For one, allocating capital to purchase a stake in a supplier may enable buyers to exert greater control over the vendor's production processes and risk mitigation strategies. That, in turn, could help boost the resilience of the supplier's operations, safeguarding a more reliable flow of vital inputs. (For a look at ESG's role in other M&A decisions, see accompanying story, "Fixer-uppers: How sustainability data might factor in M&A deals.")

Beyond business continuity, deploying a greener operating model at a supplier might lower the supplier's greenhouse gas emissions. While a noble social pursuit, acquirers can also experience a more practical benefit: Lowering a supply-chain vendor's emissions will help a company reduce its own footprint. CFOs will likely be involved in both assessing vendors' emissions and reporting on them in regulatory filings (see "Environmental impact: How finance leaders can add value to sustainability efforts," *Deloitte Insights*, June 8, 2023). But this will require that CFOs have access to the appropriate data to make such assessments, which is no small thing.

Blowing smoke

Compliance is a base-level aspiration, however. In many industries (energy, transportation, and consumer packaging, to name a few), sustainability could prove to be a competitive advantage. As such, CFOs may need to think bigger, modeling ESG scenarios across a wide range of capital allocation proposals. Finance chiefs will likely need to address a number of challenges along the way, including the following:

- **Are we comfortable with the trade-offs involved in factoring in sustainability?** Some climate change outlays may not yield the short-term financial returns generated by more traditional investments. The question: Will long-term gains in competitiveness and market position make up the difference? The answer could impact hurdle rates for pure-play decarbonization investments or capital investments in non-ESG projects that offer some sustainability gains.
- **Are we informing our investment approach with a clear understanding of the opportunities that are arising from sustainability?** Does reducing our carbon footprint play a prominent role in our value creation strategy? Do we have a plan in place that will help us hit our sustainability goals and create value for shareholders and stakeholders?
- **Perhaps, most important for CFOs: What is the impact of not investing in decarbonization?** Can we ignore it and create shareholder value? Can we even preserve value?

A logical place for CFOs to begin the process is incorporating sustainability into a company's formal capital allocation framework. The snag? Some companies don't have a formal capital allocation framework. Even for those that do, the frameworks are not always sufficiently robust, particularly when it comes to decarbonization analysis.[9] Beyond that, CFOs may lack the tools to accurately measure the decarbonization outcome of investments and therefore might be unable to hold business leaders accountable for reaching milestones and hitting targets.

Other hurdles may be less technical. For example, in C-suites with competing agendas, sustainability may be low on the list of priorities. Not surprisingly, financial returns often eclipse social concerns. With the rising cost of capital, investments must deliver clear results—not always possible in less-tangible, long-term pursuits like decarbonization. Indeed, senior leaders may see sustainability efforts more as a cost center. This perception ignores, among other things, the potential hit to reputation and brand that could come from an outsized corporate carbon footprint. This is particularly true as regulators require filers to disclose more information about the impacts of their operations on the environment.

Of course, some CFOs and senior executives might simply be more comfortable relying on familiar allocation methods, methods that typically ignore climate change. And in some cases, sustainability may be added in at the end of the review process simply to check a box, long after decisions have been made. This sort of after-the-fact analysis may serve marketing purposes. But when it comes to mitigating risks to operations from climate change—and tending to the long-term sustainability of a company—it may amount to little more than window dressing.

'Greeniums'

CXOs may be missing a trick here. The perception that sustainability can help burnish a company's image but does little to generate tangible value may actually be off the mark.

Indeed, a Deloitte AG analysis of 306 publicly traded global companies across four industries measured the effect of a corporation's ESG score (determined by a third-party vendor) on enterprise value. Impact was gauged by changes in the ratio of enterprise value (market capitalization + market value of debt—cash and equivalents) to EBITDA. The results of the analysis showed that, on average, a 10-point difference in a company's existing ESG score, when compared to the other companies in the analysis, is associated with an approximate 1.2x higher EV/EBITDA multiple. The research also showed that a company that improves its ESG score by 10 points experiences an increase of approximately 1.8x in its EV/EBITDA multiple.[10]

A commitment to sustainability brings other measurable gains. Companies with sufficiently high ESG scores may be able to attract institutional funds earmarked specifically for investments in sustainable companies or projects. Those investors are typically willing to accept lower short-term gains in exchange for societal benefits or to meet fund mandates. So-called "greeniums" also extend to the debt market. Some banks offer lower-rate loans to companies that meet decarbonization targets. Such debt instruments can a go a long way in signaling to the market that a company is serious about sustainability. For CFOs, it can help shave some basis points off the cost of capital—a definite win in the current high-rate environment.[11]

Moreover, assessing the long-term impact of an investment in sustainability can help a finance chief and other C-suite leaders future-proof the business. How? For one, by ensuring that a company's carbon profile is in line with regulations in years to come. Allocating capital for sustainability efforts now may ensure a company isn't playing catch up down the road. For many companies, the time to act is now.

On a more basic, existential level, CFOs and risk managers are charged with the vital task of mitigating both short-term and long-term risks to a company's operations and assets. If climate change worsens, those threats may become more constant, more severe. Given that scenario, CFOs may increasingly be asked to analyze and identify climate change strategies and capital investments that will best help businesses ride out the storm.

Here again, the message for CFOs seems clear: While the phrase 'please consider the environment' is a familiar suggestion in an email footer, it soon may be elevated to a marching order.

Fixer-uppers: How sustainability data might factor in M&A deals

Generally speaking, C-suite discussions on climate change tend to revolve around one topic: risk management. The usual talking points? Business continuity, decarbonization mandates, and the rise of ESG-conscious consumers. But increasingly, C-suite leaders are widening the lens. Specifically, some discussions now include climate change factors when analyzing potential mergers and acquisitions.

Indeed, in a Deloitte Global survey of leaders at global companies, 57% of respondents said ESG would be considered in acquisitions.[12] Climate impact assessments of potential targets is not hard to come by. A host of third-party vendors market ESG ratings systems. In addition, interested buyers can glean sustainability information from regulatory filings—or, in some cases, voluntary disclosures.

Such data can be used to inform a number of M&A strategies (see Figure 3). Businesses looking to improve their carbon intensity (that is, the amount of greenhouse gas emissions per unit of an activity or output) might look to unload units that are carbon inefficient. In the Deloitte survey, 27% of respondents would consider divesting assets for ESG reasons.[13] Or, a company's management could decide to buy a business, in part, because it's carbon efficient. The acquisition could improve the acquirer's overall carbon intensity and help it meet climate goals. Indeed, ESG benefits can give C-suite leaders more ammunition to convince board members of the merits of a deal. Similarly, a company might make a pure-play purchase—that is, buying a company that sells technology that reduces GHG emissions, then deploying the technology in its operations.

Figure 3. Part of the deal

ESG is a growing factor in mergers, acquisitions, and divestments

Source: "Capital allocation and resilient portfolios," Deloitte Global, 2023.

Sustainability data can also play a role in negotiating a deal. The increase in extreme weather events, for example, could eventually pose a threat to a target's future cash flow. CFOs of potential acquirers might look to calculate the costs of de-carbonizing that target's operations. The number can then be baked into deal pricing. Likewise, acquirers might consider lowballing companies with extremely low ESG scores.

Businesses with many 'dirty assets' present a similar opportunity. Organizations with expertise in turnarounds (private equity firms, perhaps) and plenty of cash on hand (again, private equity firms) could purchase a company with low decarbonization scores, clean up or modernize the assets, and turn them into money-makers.

End notes

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