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Modified objective functions – Purpose

Our guide has so far primarily dealt with how to adjust traditional valuation models to reflect the ESG dimensions, keeping the maximisation of shareholder wealth or contract values as the fundamental objective. Michael Jensen denotes this "Enlightened Shareholder Value", which recognises and serves stakeholders' demands and externalities, but only as a condition for furthering shareholder value.

(Hart & Zingales, 2017) addressed situations in which owners (or decisionmakers in general) do not maximise financial value but have a modified objective function. The classical example, which also is the basis for their model, is when a company could either use a costly and clean technology, or a cheaper, but dirty, technology. In a case where shareholders have sufficient concern for the environment and how the company impacts it, they may choose to accept a lower return on their investment by choosing a clean technology that reduces emissions. This is a direct trade-off between shareholder wealth and shareholder utility. In most situations it is challenging to implement such a modified objective function. Firstly, because the choices and trade-offs are difficult to measure and compare, secondly as an optimisation of several objectives at the same time is in principle impossible and may dilute responsibilities, and thirdly since shareholders may well have different views on what non-financial objectives they want to pursue through the company. Still, in cases where shareholders and stakeholders have a broad agreement on the material ESG issues, these may be recognised in an implementable way.

A related concept is the focus on company purpose, which is particularly advocated by Alex Edmans in his recent book "Grow the Pie" (Edmans, 2020). The argument being that if shareholders, management and stakeholders together focus on maximising value creation in a company, rather than a pure profit focus, then the overall value will grow, and even shareholders get a larger slice. This thinking obviously also relates to management style and focus. A purpose-driven perspective could be implemented as a scenario in a DCF analysis but is generally difficult to enter into a model due to the implicit assumptions regarding how a stated and acknowledged purpose impacts both the operating model and corporate culture. This is particularly challenging if the focus on purpose is new and has not been present during the past financial development of the company.