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The Impact of ESG Factors on the Firm Valuation

Yingxuan He[1,a,*]

[1]Chengdu Shishi High School, Chengdu, 610015, China
a. heyingxuan@shishialevel.com
**corresponding author*

Abstract: ESG has gradually become a concern for firms, shareholders and stakeholder groups. ESG considerations have become increasingly important for firms, shareholders, and stakeholder groups. This article explores the impact of environmental, social, and governance (ESG) factors on a company's valuation, by first highlighting the growing importance of sustainability reporting and ESG considerations for investors. Four main points are concluded throughout the article. Studies conducted in various countries, such as Korea, Malaysia, and China, have consistently demonstrated a positive correlation between ESG ratings and a company's value and profitability. By prioritizing ESG performance, companies can reduce their exposure to compliance risks, thereby improving risk management and consistency. Long-term ESG investment can enhance shareholder value by boosting financial performance and mitigating risks associated with climate change and social responsibility. Additionally, ESG strategies can help companies build a strong reputation and foster consumer loyalty, as they address risks related to climate change and societal expectations regarding social responsibility.

Keywords: Investor Expectation, Risk Management, Brand Reputation

1. Introduction

Sixty four percent of the N100 companies reported sustainability ten years prior, sustainability was reported by 79% of N100 enterprises in 2022. The percentage of N100 corporations that report on global sustainability has been steadily rising, and nearly all of the top 250 firms in the world currently report on sustainability [1].

An increasing number of public companies are now publishing annual sustainability reports due to the growing interest of institutional investors in a firm's environmental risks, social practices, and governance before making investment decisions. This is crucial as institutional investors now play a significant role in modern capital markets. According to a report by the OECD (2019), institutional money managers controlled over 40% of the global public equity market capitalization by the end of 2017 [2].

Another reason appears to be the suggestion by corporate CEOs to prioritize maximizing stakeholder value rather than solely focusing on shareholder value [3]. Freeman's stakeholder theory, introduced in 1984, argues that successful companies should not only be accountable to their shareholders, but also to the wider community, employees, and customers, in order to ensure long-term sustainability. These stakeholder groups both influence and are influenced by the actions of the company. The actions taken to address the needs of these stakeholder groups are commonly referred to as corporate social responsibility (CSR), which McWilliams and Siegel’s study defined as "actions that go beyond what is legally required and appear to benefit society as a whole".

Whatever the cause, the rising rates of sustainability reporting indicated that businesses were becoming more conscious of the notion of sustainability. Rating agencies have employed Environmental, Social, and Governance (ESG) since the mid-1900s. The letter "E," which stands for "environmental," indicates how the company affects the natural ecosystem. This includes emissions, waste and pollution, efficient use of natural resources, and creative product design that takes the environment into consideration. S stands for social, and it gauges how businesses relate to their employees, clients, and society at large. This includes initiatives to guarantee employee well-being, safety, and diversity, as well as customer satisfaction and good community behavior. Lastly, G stands for governance, which covers bribery and fraud, administration of compensation policies, shareholder rights, and board composition [3]. The idea of ESG was initially introduced in the United Nations Principles for Responsible Investment report, which suggests that investors should prioritize ESG scores when making investment choices.

Given that investors are increasingly valuing a company's social responsibility, ESG assesses companies based on three criteria, providing a somewhat comprehensive picture of the company that investors want. A growing body of recent research indicates that strong ESG performance may contribute to increased business value. After matching and filtering, the final panel data comprised 14043 firm year observations. Aydoğmuş, et al. picked the largest 5000 publicly listed corporations in the world from the Bloomberg database spanning 9 years. With a coefficient of 0.008 and 0.049, respectively, the results demonstrate a positive and highly significant association with company value and profitability [4]. Comparable research also shows that ESG benefits businesses in a variety of ways; therefore, businesses should prioritize how ESG affects their long-term viability, profitability, and valuation.

2. Investor Expectation

Recent studies conducted in different parts of the world, such as Asia, have consistently demonstrated a significant and positive relationship between ESG ratings and the value and profitability of leading companies worldwide.

Korean scholars proposed a positive relationship between CSR and valuation in the Korean financial market. CSR, as defined by McWilliams and Siegel, refers to actions that exceed legal requirements and benefits the community. The scholars have utilized the total ESG score as the primary factor in assessing the comprehensive CSR performance of Korean companies. In particular, they have employed Ohlson's valuation model, which incorporates non-accounting factors that hold value, in conjunction with Barth and Clinch's adjusted model for testing purposes [5]. Barth and Clinch's valuation model relies on two key variables, equity book value and earnings, and also adjusts Ohlson's financial factors to effectively mitigate scale effects [5]. The hypothesis was confirmed by the final result, however, it was found that the impact on share price can differ depending on the characteristics of the firm [5].

Motivated by the concern that the ESG index will affect market values of Malaysian listed companies, researchers conducted a study to explore how ESG practices influence firm value and the dual function of ESG disclosures in mitigating negative impacts and boosting positive impacts on firm value [6]. The data is extracted from 122 firms listed on Bursa Malaysia from 2011 to 2019 [6]. In order to determine the endogeneity of ESG performance, three instrumental variables are considered: the presence of a CSR committee on the Board of Directors, dispersion of forecasted earnings, and ownership concentration of the firm [6]. The researchers employed three first stage regression models to analyze the relationship between ESG disclosure and the interaction between the strength, concern, and disclosure of ESG [6]. Additionally, a second stage regression was

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conducted to examine the impact of ESG activities and disclosure on firm value [6]. The results indicate that a strong ESG performance enhances firm value, whereas ESG disclosure and concern have a negative effect on firm value.

A separate study conducted in China also confirmed that there is a positive correlation between ESG performance and firm valuation. Additionally, this research further supports the stakeholder theory proposed by Freeman, which advocates for maximizing stakeholder value. This study used data of disclosed ESG-related quantitative data of Chinese A-share listed companies from 2010 to 2019. Scholars utilized a hierarchical ESG scoring system to assess firms' overall ESG performance and the three individual dimensions: E, S, and G [7]. Then, using unbalanced panel data from 2010 to 2019, consisting of 3069 observations, the study examined the influence of ESG performance on firm value, with Tobin’s Q (TQ) and Return on Assets (ROA) serving as indicators of firm value [7]. Beside the result of positive relationship between ESG performance an firm value, the research also concluded that the effect of ESG composite performance on firm value is different for state-owned companies compared to non-state-owned companies [7]. For state-owned-enterprises, the relationship between overall ESG performance and company value is stronger, while for non-state-owned-enterprises, the relationship is weaker [7]. State-owned enterprises have a more significant relationship between comprehensive ESG performance and corporate value, with a clear positive relationship regardless of the proxy variable used for corporate value [7]. On the other hand, non-state-owned enterprises only show a statistically significant relationship between ESG performance and company value when market value (TQ or MB) is used as a measure of company value [7].

All of the three research above show the same conclusion of ESG rating positively affects one firm’s corporate valuation. The following article will discuss the importance of ESG performance on corporate valuation from another perspective–how ESG performance can reduce exposure to compliance risks, thereby achieving risk management consistency.

3. Risk Management

With the introduction of the ESG concept, ESG risk has emerged as a significant concern for both investors and companies. This has led investors to reassess their portfolios and companies to potentially revise their operational plans in response to climate risks.

Gil Cohen's research on the influence of ESG risks on corporate value highlights two significant aspects of sustainability's impact on financial markets as a whole and portfolio construction [8]. Firstly, investors are increasingly prioritizing ESG issues and favoring companies that demonstrate awareness of these concerns and actively work towards mitigating sustainability risks. Secondly, a growing number of investment firms are publicly declaring their refusal to invest in companies that contribute to environmental harm [8]. In fact, as ESG performance is often used to measure corporate social responsibility (CSR). Conclusion from recent studies conducted by Menz in 2010, Albuquerque et in 2019 and Shih et in 2021 indicate that socially responsible firms generally experience lower costs of equity. Additionally, investing in stocks with higher CSR ratings can contribute to reducing the overall risk of a portfolio [9].

However, private investors may have a contrasting perspective compared to institutional investors. They believe that avoiding investments in high ESG risk stocks could negatively impact their portfolio returns and potentially lead to a significant loss of customers for the investment firm [8]. And not all firms are willing to allocate resources towards mitigating sustainability risks. While prioritizing environmental, social, and governance (ESG) issues may enhance the overall value of a corporation, it may not be effective for every firm. A study conducted in China in 2020 by Li et al. revealed that when firms start to adopt environmental regulations, CER (corporate environmental responsibility) would have a negative effect on firm value [10]. The study was designed to investigate the correlation between CER engagement and firm value using a sample of 496 China's A-share listed

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companies from 2008 to 2016. CER(corporate environmental responsibility) is now understood as the integration of environmental concerns into business operations to minimize waste and emissions, and mitigate negative impacts on the country's natural resources [10].

Beside the result of negative effect on firm value, the study also suggested that once environmental regulations are implemented at a certain level, Corporate Environmental Responsibility (CER) can actually improve firm value [10]. Other studies and examples could also support the view of ESG would reduce overall risks and thus enhance corporate value.

An example during financial crisis would strongly emphasize the role of ESG performance reducing exposed risks. Prior to the financial crisis in 2020 caused by COVID-19, research about the specific role of ESG performance during times of crisis was limited. At the beginning of 2020, a sudden and widespread financial crisis emerged due to a growing global health crisis. This led to significant declines in global markets, with China's CSI300 members dropping to 4600 points.

The research, led by David C. Broadstock, focused on analyzing ESG data from China's CSI300 companies during the COVID-19 pandemic [11]. Trading activity for CSI300 companies increased significantly during the pandemic, with both high and low ESG firms experiencing heightened trade activity. However, low ESG firms saw a particularly significant increase in trading. This indicates that high ESG firms were more resilient during the pandemic, as investors were more patient and less likely to sell their shares to avoid losses in the volatile market [11]. Researchers use an empirical asset pricing model to analyze the impact of ESG factors during times of crisis compared to "normal" times. They incorporate information from the same period one year ago and introduce a dummy variable post to account for changes in both intercept and slope. The findings indicate that the COVID-19 pandemic had a significant and detrimental effect on the market. In all model specifications, there was a noticeable and negative shift in the intercept. According to the alternative hypothesis, during times of crisis, ESG investors place greater importance on a company's ESG performance. When a crisis event affects the entire market, investors have lower expectations for future earnings. However, they may have more confidence in companies with a stronger ESG profile. The overall findings showed that companies with strong ESG performance were better able to manage financial risks during the crisis [11].

4. Long-Term Strategy and Reputation

The preceding sections of the article have demonstrated that ESG performance improves corporate value and reduces overall risks within a company. In the following section, we will delve into the benefits of long-term ESG investment. The studies and examples mentioned earlier in this article all support the notion that long-term ESG investment yields greater value for shareholders. Furthermore, we will explore the significance of ESG strategies in establishing a strong reputation and fostering consumer loyalty.

ESG investment can be a powerful tool in maximizing long-term benefits for shareholders. The performance of a company in terms of environmental, social, and governance factors directly impacts its financial health, which in turn affects shareholder value. Historically, metrics like profitability have been recognized as key drivers of shareholder value, as noted by Rappaport A. in 1986 and Bistrova J. in 2014. In a study conducted by Zumente I. and Bistrova J. in 2021, it was found that high ESG performance has a significant impact on financial factors, leading to improved financial performance and stock returns. This ultimately results in higher value for shareholders [12].

Besides financial considerations, sustainable investing offers strong incentives for risk reduction. Research has shown that as climate change and growing societal expectations around social responsibility pose significant risks for companies in the future, it is crucial for businesses to prioritize sustainability in order to mitigate these risks, and thus protect shareholder value over the long term. Additionally, capital allocation is the crucial for investors, banks, and other capital providers support

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the development and growth of sustainable companies. Companies with lower ESG scores facing pressure from capital providers indirectly benefit their higher-scoring counterparts. Top ESG companies are more likely to attract capital and are more efficient in allocation, leading to lower costs of equity and debt and ultimately increasing long-term shareholder value [12].

Another study the article discussed earlier about the role of ESG performance during financial crisis also supports that long-term ESG investment will be beneficial. Efforts including environmental management system certification, water conservation, energy efficiency, waste gas emission reductions, and reducing accidental waste and spills help mitigate long-term environmental risks, Broadstock et al. [11]. Consequently, This supports the idea that ESG investments should be viewed as long-term strategies.

To provide further evidence of the effectiveness of long-term ESG investment, this article will examine a study that highlights the positive impact of ESG strategies on stakeholder relationships [13]. The study underscores the significance of incorporating ESG practices to establish trust with stakeholders and maintain customer loyalty. It delves into the various facets of ESG and their effects on corporate reputation, brand image, and consumer behavior. Additionally, the study provides compelling arguments for companies to integrate ESG strategies into their long-term business plans: To begin with, risk management. In order to effectively manage their reputation, companies should focus on building a positive brand image through ESG activities. This will help create a favorable perception among the public, ultimately enhancing the firm's reputation. Furthermore, investors often rely on ESG ratings to make investment decisions. Therefore, it is crucial for companies to prioritize long-term ESG investment in order to mitigate risks and ensure sustainability. By doing so, companies can attract more investors and strengthen their ability to secure funding. Lastly, companies that demonstrate satisfactory ESG performance are more likely to meet consumer preferences and expectations. This leads to increased customer loyalty, as consumers are more inclined to support socially responsible firms. Ultimately, the more socially responsible a company is, the larger its market share is likely to be.

The authors also proposed that organizations should take certain steps to develop and incorporate a comprehensive ESG strategy into their operations. These steps include creating a strategic road map and ensuring its thorough implementation, as well as establishing a strong communication strategy [13].

5. Conclusion

The paper proves that ESG has an overall benefit on firms, shareholders, and the stakeholder group. Specifically, strong ESG performance strengthens corporate value, and mitigates overall risks. Long-term investment in ESG also shows the potential to enhance shareholder value, establish better firm reputation, and foster consumer loyalty. It is valuable to refer to this article when one is doubting the effectiveness of the role of ESG on firm’s overall growth: While initial investments in ESG may not immediately show positive effects on corporate value, the long-term benefits far outweigh any initial challenges. Companies with good ESG performance demonstrate resilience during financial crisis, which build up consumer loyalty in the existing investors, thus the low risks would eventually enhance shareholder value and gain a good reputation for the firm. The overall ESG performance is very likely to attractive more investors in the long term and build up consumer loyalty. In fact, long-term ESG investment is cost-efficiency, which brings countless benefits.

The article shows some space for improvement. The conclusions drawn are based on general concepts, while the referenced articles focus on specific types of firms and their ESG effects. For example, the impact of CSR on share price in Korean firms varies depending on the firm's characteristics. Companies in environmentally sensitive industries tend to have a lower value creation from CSR compared to those in non-sensitive industries. Specifically, corporate governance practices

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negatively affect the firm value of environmentally sensitive companies. Furthermore, the studies cited in the article come from different time periods, regions, and types of firms, making it less effective for comparing similar companies in different areas. According to the possible limitation, there are expectations toward future studies. More research should be done on identical types of firms across various areas and time periods, and do the same thing on other types of firms. This will help industries gain confidence in ESG investment and achieve long-term cost efficiency.

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