

Exploring the Multi-Dimensional Effects of ESG on Corporate Valuation: Insights into Investor Expectations, Risk Mitigation, and Long-Term Value Creation

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Abstract: This paper investigates the multifaceted mechanisms through which Environmental, Social, and Governance (ESG) factors influence corporate value. ESG performance, reflecting a company's adherence to sustainable practices, has become increasingly significant in contemporary business strategy due to its potential impact on firm profitability and market perception. While ESG initiatives are known to enhance corporate transparency and stakeholder trust, contributing positively to a company's reputation and operational efficiencies, they also present financial challenges by potentially elevating operational costs and impacting short-term financial performance. Utilizing a comprehensive review of existing literature and theoretical frameworks such as stakeholder theory, agency theory, and signaling theory, this study delineates the balance firms must achieve between fostering long-term strategic advantages and managing immediate financial implications. By analyzing empirical evidence and case studies across diverse industries, the paper elucidates how robust ESG practices can attract better investment, improve risk management, and secure sustained economic benefits. This research contributes to academic discussions on ESG's role in corporate value creation and offers practical insights for companies aiming to integrate these practices into their core strategies effectively. The findings highlight the importance of strategic ESG implementation and the necessity for firms to align these initiatives with broader corporate objectives to optimize both societal impact and shareholder value.

Keywords: Environmental, Social, and Governance (ESG) Factors, Financial Performance, Corporate Valuation

1. Introduction

Environmental, Social, and Governance (ESG) performance refers to a corporation's actions and accomplishments in three key areas: environmental protection, social responsibility, and governance practices. These indicators are critical for assessing a company's commitment to environmental stewardship, social responsibility, and effective governance.

Globally, an increasing number of countries and regions have implemented policies mandating enhanced disclosure of ESG practices to promote sustainable development and fulfill social responsibilities. Regulations such as the European Union's Non-Financial Reporting Directive, the

United States' Global Reporting Initiative, and China's Guidelines for Corporate Social Responsibility Reporting specify requirements for corporate ESG disclosures.

The emphasis on ESG disclosure is driven partly by public and social pressure. As societal awareness and expectations for sustainable development and social responsibility grow, corporations face increased scrutiny from consumers, employees, and social organizations. Responding to these concerns through ESG disclosures is essential for maintaining corporate reputation and brand image. Moreover, global issues like climate change accelerate this process. From an internal perspective, ESG disclosure plays a crucial role in identifying, assessing, and managing environmental, social, and governance-related risks, thereby enhancing operational efficiency and better equipping companies to handle the complex and diversified risks in a post-pandemic world, ensuring sustainable and stable long-term growth. Furthermore, evidence suggests that corporations adhering to ESG standards are more favored by investors, consumers, and other stakeholders, enhancing their market competitiveness [1].

Increasing academic research supports the positive impact of ESG scores on corporate value, aligning with Freeman's Stakeholder Theory [2]. This theory posits that a company operates not only for its own benefit but also has an obligation to maximize the value for its stakeholders, including shareholders, employees, customers, suppliers, governments, and social organizations. ESG disclosures can be seen as a practical application of the Stakeholder Theory. By making these disclosures, companies communicate their environmental, social, and governance practices and performance to their stakeholders, thereby enhancing transparency and trust. In this way, ESG reporting can improve company reputation, gain employee loyalty, and benefit from customer support [3].

However, some critiques focus on the direct costs and potential profit declines associated with ESG activities, which could deter companies from undertaking such initiatives due to existing cost-efficiency policies [4]. In such cases, companies need to balance improving financial performance with sustaining environmental benefits.

This paper will analyze the mechanisms by which ESG factors influence corporate value from multiple research perspectives, including investor expectations, risk management, long-term strategic management, and cost efficiency. By examining the impact mechanisms of ESG factors, it aims to better understand their role in enhancing corporate value, thereby providing theoretical support and practical guidance for corporate management and investment decisions.

2. Investor Expectation

From an external perspective, investors' expectations regarding a company's future performance are a primary determinant of its current market value. If investors believe that a company will generate strong future cash flows and has significant growth potential, offering substantial potential returns, they are likely to attribute a higher valuation to the company. This enhanced valuation is reflected in higher stock prices, thereby increasing the company's market value, Tobin's Q, Price-to-Earnings (P/E) ratio, and other financial metrics. Conversely, if expectations are negative or uncertain, it may result in a lower valuation.

Traditional financial reporting, which focuses primarily on financial indicators such as revenue, profit, and assets and liabilities, does not fully capture a company's performance in non-financial areas, such as efforts in ESG. Many large corporations have adopted integrated reporting and sustainability reporting to disclose non-financial information about how they address sustainability challenges. This type of disclosure can help companies better manage external expectations through the lens of agency theory and signaling theory, enhancing investors' confidence in the company's governance structure and future growth potential.

Agency theory focuses on the relationship between the company management (agents) and shareholders (principals), particularly in an environment of information asymmetry where management may not always act in the best interest of shareholders. By publicly disclosing information about their ESG activities and outcomes, companies can reduce information asymmetry, allowing investors to have a more comprehensive understanding of the company's operations and its potential risks and opportunities. This enhanced transparency helps build investor trust in management. A thorough and transparent ESG report also enables investors to more effectively monitor management's actions, ensuring that decisions in environmental protection, social responsibility, and good governance align with long-term value creation goals, thus reducing agency costs. Clearly defined ESG goals and strategies can serve as a basis for evaluating management performance, thereby strengthening management's accountability to shareholders and other stakeholders.

Signaling theory explains how companies can influence market perceptions through information transmission, particularly in markets characterized by information asymmetry. Proactive ESG disclosure can be seen as a significant indicator of a company's operational quality and future potential. By publicly displaying their performance in ESG aspects, companies send a clear signal to potential investors about their commitment to high-standard operational practices and sustainable development, potentially attracting investors who seek responsible investments [5]. Among many companies, effective ESG disclosure can help a company stand out in the market as a differentiating strategy. Investors are often more inclined to invest in companies that demonstrate a high level of responsibility and transparency.

Integrating these two theoretical frameworks, it becomes evident that ESG disclosure is not only about fulfilling corporate social responsibilities but also a crucial tool for corporate management to communicate with and build trust among a broad investor base. This communication strategy helps enhance the company's market evaluation, thereby attracting and retaining investor interest and capital investment.

Recent empirical research has demonstrated that ESG factors significantly influence corporate market value by shaping investor attitudes and behaviors, both in emerging and developed economies. Park et al.'s study, utilizing the Analytic Hierarchy Process (AHP) focused on the South Korean market, highlighted the critical impact of ESG management on investment decisions, especially regarding future profitability and risk management [6]. They underscored that companies with exemplary ESG performance garner higher credibility and trust among investors, thereby enhancing their market value. Similarly, Bai et al. analyzed panel data from 3,400 listed companies in China from 2013 to 2020, finding that companies with robust ESG disclosures could send positive signals to the market, attract more holdings by institutional investors, and alleviate financing constraints, thus boosting their value [7]. Additionally, Nazarova et al. study on companies listed on the S&P 500 in the United States and the S&P 350 in Europe showed that firms with ESG performances above the median had significantly better investment attractiveness indicators, such as higher Tobin's Q values and a greater ROE compared to their counterparts below the median [8]. This further confirms the positive global impact of ESG factors on corporate value.

In summary, ESG factors play a crucial role in shaping investor expectations and market behaviors across both emerging and mature markets. This provides new perspectives and challenges for corporate management in strategic and operational decision-making.

3. Risk Management

Beyond the shift in investor expectations in the external environment, ESG disclosure enhances corporate internal risk management in several ways, thereby increasing corporate value. Firstly, during the process of ESG disclosure, companies are required to set clear accountability goals and

metrics. This necessitates the establishment of corresponding internal accountability mechanisms and oversight systems. Defined ESG objectives and accountability mechanisms further guide the behavior of employees and managers, ensuring that corporate activities align with social responsibilities and environmental objectives. This alignment reduces the risk of violations and unethical behaviors, thereby decreasing fines, litigations, and compliance costs, which in turn lowers unnecessary expenditures and enhances cost-efficiency.

Secondly, ESG disclosure mandates that companies report on their environmental impacts, social responsibilities, and governance structures. This requirement prompts companies to optimize decision-making processes and increase transparency in decision-making, which includes enhancing the independence and diversity of the board of directors. This reduces trust crises and agency problems caused by information asymmetry, and decreases the risks of management abuse and corruption. ESG disclosure enables companies to have a clearer understanding of their performance in environmental and social responsibilities, allowing for timely identification and response to potential risks, as well as the development of corresponding risk mitigation and management strategies.

Moreover, public ESG disclosure showcases a company's adherence to national and international standards, facilitating business relationships with partners who have high compliance requirements and reducing collaboration risks. Excellent ESG performance and transparent disclosure can attract more responsible investments and green funding, which are often associated with lower capital costs and more stable investment relationships.

Finally, ESG disclosure encourages companies not only to focus on short-term profits but also to prioritize long-term sustainable development. This approach helps companies better manage long-term operational risks, strengthen investor confidence, and attract more responsible and long-term investments.

Zhang et al. emphasize that effective ESG performance reduces litigation risk by strengthening internal control mechanisms within firms [9]. They argue that high ESG standards compel firms to enhance their risk identification and management processes, which in turn fortify internal controls and reduce the likelihood of engaging in activities that could result in legal disputes. Similarly, Do and Vo examine the impact of mandatory ESG disclosures on default risks in emerging markets [10]. Their findings suggest that compulsory ESG disclosure decreases firms' default risks by enhancing transparency and serving as a surrogate for strong governance practices. This transparency allows firms to manage their risks better, ultimately reducing the likelihood of default. Moreover, in the study by Choy, the focus is on the broader spectrum of corporate risks, including operational and strategic risks [11]. The research suggests that strong ESG performance correlates with robust risk management practices that address both immediate and long-term risks. Effective ESG practices lead to improved sustainability, which helps firms manage and even anticipate various business uncertainties. Overall, these studies demonstrate that ESG factors not only enhance a firm's internal controls and compliance with legal standards but also bolster financial stability and reduce exposure to adverse outcomes, which collectively improve a firm's market valuation and investor appeal. These benefits highlight the importance of ESG factors in contemporary corporate risk management strategies.

4. Long-Term Strategy

ESG disclosures not only play a pivotal role in corporate risk management but also propel long-term sustainable development and enhance market value from a strategic perspective. Firstly, ESG disclosures advance sustainable corporate development by enhancing brand value. By increasing transparency, these disclosures allow shareholders, investors, consumers, and other stakeholders to gain a comprehensive understanding of a company's operational status and values. Such transparency

fosters public trust, facilitates the cultivation of a positive image among potential investors and customers, and strengthens brand value and corporate reputation—crucial factors for long-term success. According to Maaloul et al.'s research, using Structural Equation Modeling (SEM) to analyze data from U.S. S&P 500 firms between 2013 and 2016, there is a documented positive impact of ESG performance on corporate reputation, which subsequently lowers the cost of debt financing, underscoring the strategic value of ESG initiatives in reducing financial costs and enhancing corporate worth [12].

Furthermore, ESG disclosures contribute to corporate resilience in the face of global economic instability by enhancing adaptability and flexibility. With increasing global focus on environmental protection and social responsibility, many regions have begun implementing stringent ESG-related regulations. Regular ESG disclosures enable companies to track and adapt to these regulatory changes, avoiding potential compliance risks. In volatile international economies, where resource prices may fluctuate significantly and supply chains could be disrupted, attention to ESG can also promote effective resource management, reducing dependence on external environmental changes and enhancing adaptability to economic instability. Zhang and Liu hypothesize that high ESG performance bolsters a firm's financial adaptability to unpredictable market environments by alleviating financing constraints, thus allowing firms to better manage resources and respond to external shocks [13].

Moreover, ESG disclosures drive sustainable development through the enhancement of corporate innovation capabilities. By reducing information asymmetry between the company and investors, these disclosures lower agency costs, garner stakeholder support for corporate innovation activities, and alleviate investors' concerns about market uncertainties. This reduction in informational drawbacks lowers the costs and barriers in financing processes, eases financing constraints, and ensures stability in the capital chain for numerous innovative activities. These factors enable firms to increase their investment in innovation projects, maintain a competitive edge in fierce market competition, and achieve sustainable commercial success and market share expansion through technological innovation. Liu finds that ESG performance significantly impacts corporate innovation strategies, positively affecting both substantive innovation—related to technological advancement and competitive edge—and strategic innovation, which often aligns with policy or regulatory demands [14].

Lastly, robust ESG disclosures that reflect a company's attention to internal employees can enhance their sense of belonging and loyalty, thereby reducing turnover rates, attracting, and retaining talent, and promoting sustainable development. Zhang et al. conclude that corporate ESG behaviors significantly enhance employee satisfaction, a relationship that is strengthened by effective internal controls and high environmental awareness among executives [15].

5. Cost-Efficiency

ESG disclosures significantly enhance corporate transparency and reputation, yet they may also impose additional cost burdens that could adversely affect financial and operational performance. According to Buallay's study, while ESG investments can enhance market performance and drive value creation, they may increase capital costs and reduce financial and operational efficiency in the short term, with particularly noticeable impacts within financial institutions due to stringent regulatory expectations and market demands [16].

Specifically, ESG disclosures enhance the transparency of company operations, allowing investors, consumers, and other stakeholders to gain a comprehensive understanding of the company's business practices and values. However, establishing and maintaining this level of transparency requires significant financial and human resource investments in environmental protection, social responsibility, and corporate governance. These efforts necessitate the development and maintenance

of data collection and reporting systems, including investments in information technology systems, employee training, and the establishment of monitoring and reporting processes. The initial setup and ongoing operational costs associated with these activities can be substantially high. To ensure the accuracy and reliability of ESG reports, companies often need to hire external experts for audits and certifications. These services, which may include environmental impact assessments, social responsibility audits, and governance structure evaluations, can be costly, especially for companies seeking international certification standards.

As global attention to ESG standards increases, compliance costs also rise. Companies must adhere to an expanding array of environmental regulations, social responsibility norms, and governance standards. This includes not only direct financial outlays, such as investments in environmental improvements and social responsibility projects but also adjustments and enhancements made to avoid non-compliance penalties. The preparation and publication of ESG reports require expertise, potentially involving significant time from internal staff or fees for external consultants. Additionally, companies might need to invest in platforms and tools for communication with investors and other stakeholders to ensure effective disclosure. Improving ESG performance may require changes to business models or operational processes, such as switching to more environmentally friendly materials or adopting new production technologies, often necessitating upfront investments that can increase costs in the short term.

These investments, while beneficial in the long term, can adversely affect the company's financial performance in the short term, such as increasing operational costs and reducing net profits. To ensure the sustainability and effectiveness of ESG activities, companies need to find a suitable balance between cost efficiency and performance. This requires corporate leaders to conduct thorough cost-benefit analyses when formulating ESG policies and implementation plans, strategically planning ESG investments, and optimizing resource allocation to ensure that ESG activities maximize social and environmental benefits without compromising the overall financial health of the company. Moreover, by adopting innovative technologies and management strategies, companies can reduce the costs of implementing ESG initiatives, offsetting initial expenditures with enhanced operational efficiency and improved corporate reputation.

Furthermore, companies should continuously track and evaluate ESG performance, adjusting and optimizing ESG strategies to align these initiatives with the company's long-term business goals and strategic development. In this way, companies can not only effectively manage ESG-related costs but also enhance their market performance and shareholder value through strengthened social responsibility and environmental stewardship.

In conclusion, although ESG disclosures may increase business costs and impact short-term financial performance, through careful planning and management, companies can leverage ESG to enhance long-term market performance and value creation. This achieves a balance between cost efficiency and firm performance, ensuring sustainability while safeguarding the company's financial stability and growth.

6. Conclusion

This study systematically examines the multifaceted impact of Environmental, Social, and Governance (ESG) factors on corporate value, encompassing investor expectations, risk management, long-term strategic planning, and cost-efficiency. The findings corroborate that ESG practices bolster corporate transparency and stakeholder trust, thereby positively influencing investor expectations and enhancing market competitiveness. However, the dynamics between ESG initiatives and corporate value are intricate and multi-layered, underscoring the imperative for firms to judiciously balance short-term financial repercussions with aspirations for sustainable long-term growth.

ESG performance markedly shapes investor expectations, supported by agency and signaling theories. Strong ESG scores are consistently associated with increased market valuations and heightened investor confidence. In the sphere of risk management, effective ESG practices are instrumental in establishing robust accountability mechanisms and oversight systems, significantly mitigating operational and legal risks, reducing potential financial and reputational damages, and augmenting overall corporate stability. Strategically, ESG factors promote sustainable development by positively influencing corporate innovation, employee satisfaction, and operational methodologies—elements critical for sustained long-term competitiveness.

Nevertheless, the adoption of ESG measures presents considerable challenges. While ESG initiatives can yield substantial long-term advantages, they necessitate significant initial and continuous investments, which may adversely affect short-term financial outcomes. This demands a strategic alignment of ESG objectives not only with environmental and social imperatives but also with financial viability to ensure that ESG integration substantively benefits the corporate bottom line.

In summary, although the advantageous impact of ESG on corporate value is evident, companies face complex challenges in embedding these practices within their core strategies. This process involves not merely enhancing ESG practices but also tackling the associated rise in operational costs. Companies are thus encouraged to embrace a proactive and integrative approach to ESG management, viewing cost-efficiency and performance enhancement as synergistic rather than antagonistic goals. Through such a strategy, firms can effectively utilize ESG as a powerful tool for sustainable growth, concurrently amplifying societal impact and shareholder value. This research makes a significant contribution to the ongoing dialogue on sustainable business practices by providing both theoretical insights and practical guidelines for firms aiming to maximize the impact of their ESG endeavors on corporate value.

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