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Theoretical Insights on ESG advantages: Connexion to Corporate Financial Performance

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Abstract
In India, Nowadays the companies are moving from short term goals of profit maximization to long term sustainable ESG (environmental, social and governance) goal. ESG has become an dominant source of the corporate risk and profit and may affect the company's financial performance. Recent studies show that effective ESG performance could improve the financial performance of companies in some countries. The research set up the broaden pattern of corporate disclosure in the top companies. Now, the question of "how does ESG affect financial performance" will be thoroughly discussed in this paper. we take a holistic view of past research, looking at all material information of Environmental, social and governance (ESG) analysis which have impact on a company's returns over the long term. Our goal is to better understand why corporates adopt strong ESG policies and to what extent they are benefited to corporates performance. In this paper we explain the value of corporate sustainability for businesses, investors and wider society by case study. We find that operating performance, efficiency, and firm's value tend to increase with efficient ESG performance. This paper render a genuine contribution by providing a review on the relationship between ESG performance and corporate financial performance.

Keywords: ESG, Corporate risk, Financial Performance, Explore, Sustainable

Introduction

In the recent years' various research have tried to find performance of corporate in respect of ESG. In this paper analyse the linkage between corporate strengths and weaknesses with respect to ESG-related disclosure, its environmental, social, and governance (ESG) factors and its valuation. A flow of literature has also shows the factor of the corporate ESG disclosure and the possible valuation which effects the disclosure. The ESG have become crucial in decision making of businesses from last decade. Nowadays corporates always try to increase their reporting processes because investors are expecting from companies to disclose every information of environmental, social and governance (ESG) so they can trust and understand. As per PWC (2016), ESG is defined as a standardized set of a company's activities that investments are screened by investors. Environmental express as how a corporate performs as a fiduciary of the natural environment. Social factor analyse how in corporate sector, manages relationships with its employees, customers, suppliers and the rest communities. Governance Factors dealing with a corporates leadership position, executive positions, auditing and internal controls, and stakeholder rights.

The Environmental factor: First thing with sustainability is comes in our mind environment factor of ESG. The E factor in the ESG are concern with the effect of the company's operations on the environment. Environmental impact is varying with companies to companies that is depend on the type of operations. E.g. services companies have less impact on the environment than the manufacturing companies.

Thomson Reuters rating to companies based on the E factor, they used main criteria: emissions, resource use and innovation. When he rates companies on emission based he looked the effectiveness and commitment of companies in decreasing the emission in their business. When he rates companies in resource based he focus in company's capacity to reduce the use of the water, material and the energy. And for innovation he looks the company's capacity to decrease the environmental cost to the customers by producing eco-friendly products. (Thomson Reuters, 2017).

The Social factor: businesses have a great impact on the society in many ways. The S (social) factor find that how the companies effect their shareholders from social prospective. As per UNGC social sustainability is to find and arrange the effect of the companies on the society. The main class of the S factor of ESG in Thomson Reuters methodology are Human rights, Product responsibility, Workforce, and Community (Thomson Reuters, 2017), which all moving around the effect which companies can have on society issues.

The Governance factor: Corporate governance is the system of guidelines set by companies on how the company is managed. The Governance factor of ESG includes factors like CSR strategy, tax strategy, corruption, and wages. effective corporate governance strategies help to reduce the cost of equity, information asymmetries an d risk by being more transparent (Clark et al. 2015), There are also varies studies which show that companies with poor corporate governance strategies are valuated lower operational and financial performance (Clark et al., 2015).

Since ESG consists of different subgroups with underlying drivers this study uses a different stage approach to determine which factors of ESG have a positive or negative effect on the corporate financial performance of a firm. In the first stage the effect of an increase in a firm's ESG score on corporate will be determined. In the next stage the effect of the subgroups E, S and G performance on corporate financial performance will be studied. The next stage examines the effect of the drivers of the subgroups on the corporate financial performance. In this way this study contributes to the literature in many ways.

Purpose of the Study

The purpose of the study is to find the effect of ESG factors on corporate performance. The study aims to add some contribution to the existing literature on sustainable investments of firm by studying the effect of ESG on corporate performance. To be more specific, the main objectives of the study are: 1) To study ESG and its impact on corporate financial performance. 2) To dwell upon E, S AND G disclosure practices on companies by case study method.

Literature Review

ESG and corporate financial performance: In the last decades the capitalization of ESG has been an important research topic. The main question was of studies is whether or not ESG factors affect the corporate performance. Previous research describing a wide variety in the linkages between ESG factors and corporate financial performance.

According to the traditional neoclassical approach, firm investing in socially responsible aspects faced additional costs for a firm (Palmer, Oates and Portey 1995). In a competitive market additional costs decrease the profits of a company (Baumol 1991). On the next hand, different theories state that a good CSR policy could also make additional benefits for a firm. Like Godfrey, Merrill and Hansen (2009) stated that investing in environmental, social and governance can be seen as an 'insurance factor' against risks of firm. A positive reputation has positive impact on corporate economic value. They argue that consumers consider products of companies with reputation. Like good reputation means high quality (McWilliams and Siegel 2006). A positive support from stakeholders can advantageous to hike the capital and create more craft to provide resources to a company. A positive reputation influences the employee's satisfaction and they want to work more and for the long time in the same firm (Rindova and Fombrun 1991). Some studies are provides mixed positive or negative result between CSR and corporate performance. An Empirical work that finds evidence for the difference in attention for stakeholder's relationship in their learning hypothesis The learning effect, the inverted 'U'-relationship and the discounted cash flow are all reasons for the lack of consensus in recent literature regarding the impact of ESG on corporate financial performance (Borgers & Derwall 2013). There is clear proof when studying the effect of governance factors over time. The two portfolios of firms were constructed with either high or low governance scores and on the basis of those score test corporate performance in periods of high and low care towards governance. Then they find that in a period of low governance attention there is positive alpha, disappears in g period when the market pays more attention towards the corporate governance factors of corporates. (Bebchuk, Cohen and Wang 2013). Some studies argue that ESG results in a firm's better relationship with consumers, and thus it is competitive advantage for firm on the consumer market. The better relationship derives from a better reputation among consumer which improved firm image (Porter and Kramer, 2011) Furthermore, a competitive firm attracts the best employees, which have a positive effect on financial results of firm, thus employee retention could also affect the financial performance in a positive way. (Sprinkle and Maines, 2010).

The Impact of ESG on Corporate Financial Performance

The impact of ESG performance of a firm is based on the performance of a company on the sub factors ESG (environmental, social and governance). The impact of each sub factor of the ESG on corporate financial performance is another thing of interest in literature. (Friede et al. 2005) conduct a meta-analysis to find the dominant sub factor in the relation of ESG on corporate financial performance. Their outcome is important as a starting point in the discussion of the impact of each E, S and G factor on corporate financial performance.

The Effect of Environmental performance on corporate Financial Performance

Out of all studies to find the positive relationship between ESG and corporate financial performance, the sub factor of E performance stands out as a highest number of the positive relations. (Friede et al. 2005). Since 1980s the effect of environmental performance on the firm's value is a topic which is widely discussed in literature. The study that give an overview of the theoretical arguments for a relation between E performances and firm's value. In their study different theoretical concepts are given which argues all different relationship. First, firm faced a trade-off between environmental and financial performance. Management improve their environmental performance are at an economic loss. Second, the cost to improve environmental performance are not substantial and are help to generate other managerial benefits like an increase in productivity and higher morale. (McGuire, Sundgren and Schneeweis, 1988). The cost of increasing environmental performance will offset by a reduction of cost and increase revenues of firm. In the recent studies this become the basis of hypothesis the methodology used in these studies is the long term regression analysis or the event study. Many studies focussed on the abnormal returns linked to the environmental performance. (McGuire et al. ,1988). the influence of E factors on stock market performance Is like that stocks react in an asymmetric way to environmental factor. They analysed that a hike in stock price as a result of positive environmental information is less than the decrease in price when a firm is facing negative news (Klassen and McLaughlin, 1996). In a more recent study the impact of the publication of Newsweek's 'Green Rankings' on profitability is studied. Based on data of 394 large US firms Yadav, Han and Rho (2016) investigate evidence for the hypothesis that investors take environmental performance positively and are willing to pay some cost for this. Dowell, Hart and Yeung (2000) in their study they find an evidence for a positive relation between environmental performance and firm's value. Evidence is based on data of 98 listed mining and manufacturing companies over the period 1994 -1997 they find that companies with a more market value, measured by Tobin's q, appear to be less polluted The effect of greenhouse gas emission disclosure on firm's value is the next study. He conducts a difference in different analysis, they analysis that compares the results before and after the new regulation. For this 419 listed firms on the London stock exchange (LSE), he finds a positive relation for firms that are most affected by new regulation. The deep relation is found for firms in the oil and gas sector. (Kruger,2015)

The Effect of Social Performance on Corporate Financial Performance

Less amount of positive relation is between subs factors of social performance is conclude from the meta analysis (Friede et al. 2005). A huge amount of literature studies the question if Social performance does affect the corporate financial performance. Among these studies the data is found that firm's human resources policies have a direct significant positive effect to the corporate financial performance (Huselid 1995). Most studies found evidence for the theory that human resource management have a competitive advantage if they are combined in the competitive strategy of a firm (Jackson and Schuler 1995). Molina and Ortega (2003) do study on 405 publicly traded firms in North-America.in their study they find that training and development cost are positively related with firm performance. Their results are evidence with the expectation that firm performance may improve through customer loyalty and employee satisfaction. Waddock and Graves (1997) find a strong relationship between a company's reputation and its ratings according to the list of most admired by Fortune magazine in social responsibility. The impact of ESG advertising is very high for firms whose clients are individuals other than other firms. Lubin and Esty (2010) in their study describing the increased 'sustainability imperative' that now a part in society as a megatrend which ultimately make the companies more competent. Similarly, in next study sustainability is find as one of the most significant trends in financial markets in last decades (Clark, Feiner and Viehs 2014).

The Effect of Corporate Governance on Corporate Financial Performance.

Various studies have also looked at governance Factor effect on firms' value. Good governance helps to increase investors' confidence in firms which results in enhancement of firm value (Lemmon & Lins, 2002; Bauer, Guenster, & Otten, 2004; Bebchuk, Gompers, Ishii, & Metrick, 2003; Bebchuk et al., 2010; Cohen, & Ferrell, 2010; Siagian, Siregar, & Rahadian, 2013). the study that focus on internal governance factor the impact of size of board, board independence and level of debt financing on firm's financial performance. The effect of board independence is in the favour of shareholders that helps to increase the earning per share. (MacAvoy and Millstein, 1999). Yermack (1995) in his study on 452 US large firm find negative relationship between size of board and corporate financial performance. He stated that mall size companies are able to work more effectively which enhance the market value. same relation is found by the (guest, 2009) who study 2746 listed companies of UK for a period of 1981-2002.he found that expanding the size of board result in reduction in Tobin's q. Corporate governance performance are considerably more important around the world in terms of their particular mix of factors. It include complex interaction that involves financial, legal systems and economic development, , history, politics, and culture (Doidge, Karolyi, & Stulz, 2007). The relationship between corporate governance and financial performance of firm depends on country-level and corporate-specific factors. Klapper and Love (2004) elaborate why country-level characteristics are important for effective corporate governance and its effect on firm performance. They showed that the good corporate governance system for a corporate depends on the economy's financial and legal development. their work also shows that strength of investor protection and legal system helps explain ownership structure for corporates. Low level of investor protection and Ownership concentration are main features in developing countries (Arun & Turner, 2003). In additional, effective governance provide better operational performance through better allocation of resources in business and better management. It decreases the risk of financial crises for business, which can have reducing economic and social costs. Furthermore, it tends to better relationships with all stakeholders, and help to improves labour relations as well as providing better platform for increasing social aspects like environmental protection (Bebchuk, Cohen, & Ferrell, 2009).

Regional Deviation in the Relationship of ESG and Corporate Financial Performance

Another interesting point of study is the difference in the ESG and corporate financial performance relationship across various regions. Most of the research that deliver the deviation in the ESG and corporate financial performance among regions in term of development of regions. Asia, South-America and Africa are regions which less coverage of ESG.

Friede et al. (2005) find two forms regarding the ESG and corporate financial performance relation across various regions. First, among the developed countries other than US, showed less positive relations as compared to the US. Second, investigation that discusses the linkage of ESG and corporate financial performance in emerging markets do find more positive relations compared to studies in developed countries. Despite these practices, controversies are still existing. Like, Dixon et al. (2013) identified that the ESG and corporate financial performance relation in the region North-America is more than in the rest of the countries. In opposite to this, when the sub-factor 'environmental' is reasoning on corporate financial performance the result showed highest positive relation on corporate financial performance is in non-American countries (Albertini, 2013).

Miras-Rodríguez, Carrasco-Gallego and Escobar-Pérez. (2015) define these deviation across regions link to a difference in regional culture. They test the hypothesis that regional culture acts as a mediator in the relation ESG and corporate financial performance of companies. Their findings show that in a regional culture with higher institutional collectivism, future orientation and human orientation there is more positive relation in ESG scores and financial performance.

Despite the fact that all studies show is hard to find, the conclusion can be made that the less amount of positive relations is found in Europe (Friede et al. 2005). Beside less positive relations, more negative relations are found. In a recent investigation, based on ESG ratings of Sustainalytics, Auer and Schuhmacher (2015) find that investors even ready to pay a price for social responsible investing in Europe

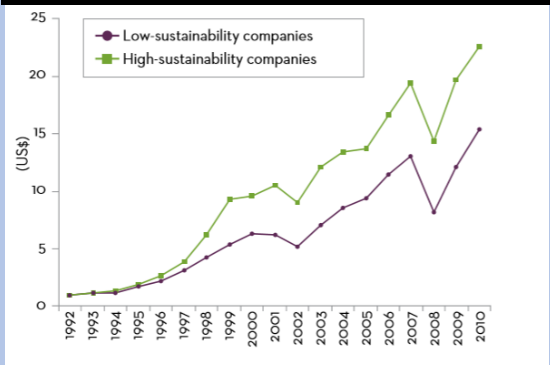
In recent literature the controversies found makes the region difference in ESG and corporate performance make it an interesting region for further research. According to the study of Miras-Rodiguez et al. (2015) in the region Europe cultural aspects results in least impact of ESG on corporate financial performance. Financial performance will be relatively less across Europe as compared to other countries.

Advantages of ESG Efficiency

There is a many studies showing that companies which follow efficient sustainable business practices, specifically considering of environmental, social and governance (ESG) factors, raise the competitive advantage and increase their long run financial performance.

- The corporates can product meaningful cost and efficiency benefits through sustainability initiatives such as technology innovation, waste reduction, and resource efficiency is consistent (Eccles, Ioannou, and Serafeim, 2011).
- Corporates with an efficient ESG focus also incline to show innovative processes in tems of cost reduction. The number of case studies in this area is increasing. Cheng, Ioannou & Serafeim, 2014) in their investigation highlights the examples of Dow Chemicals, which reported that over 16 years' period of energy efficiency improvement firm save US$9.4 billion and General Motors, reported saving of US$2.5 billion from recycling and reuse initiatives used by company.
- The default risk of a firm is directly link with the corporates sustainable ESG measures.in their study they showed that positive perception of effective governance result in the reduction in firms default risk and reduce its cost of capital. (Bhojraj and Sengupta,2003)
- There is a relationship between the environmental factor of a firm and its cost of capital, the investors take account of a company's environmental risks, which then lay down to higher cost of equity and debt capital. (Chava, 2014)
- Verwijmeren and Derwall (2010) recognised that corporates having good track records in employee wellbeing lead to reduce the probability of bankruptcy by lower debt ratios and also enjoy benefit of credit ratings.
- A company taking a focusing on stakeholder interests including employee and community relations, imparting an important non-financial messages to ratings agencies, thus indirectly reducing its financing costs. (Ghoul, Guedhami and Suh, 2013).
- ESG information enclosed within companies is transmitted to the share markets. The study showed that 'high-rated' ESG companies tended to show higher profitably, higher dividend payments and lower market risks (based on MSCI ESG Ratings data and financial variables)
- Historically the long-term strategic advantages of ESG have also been evidenced. Study of more than 2000 studies They conclude that there is a positive relationship exists between ESG and corporate financial performance and that therefore the case for ESG investing is empirically very common founded. In general, they noted that 'the orientation toward long-term responsible investing should be more important for all type of rational investors in order to accomplish their fiduciary duties and may better adjust investors' interests with the objectives of society. (Friede, Busch and Bassen, 2015)
- The corporate sustainability practices have positive impact on share prices having clearly evidenced by the study of Eccles et al. (2011). Their research by analyzing 180 companies for a period of 1993-2009, showed that approx. half of the sample companies (those which had implemented a substantial ESG policies for a significant number of years'), significantly better than lower sustainability firms, both in business activities as well as stock market performance.

High-sustainability firms outperform over the long term



Source: Eccles R.G, Ioannou I., and Serafeim G. *Management Science, Volume 60, Issue 11 (2011).*

- It is also important that companies with a strong ESG performance tend to enjoy a number of benefits both short-term and long-term. An effective sustainability strategy can give significant benefits in the long run, in terms of economic returns & operational performance. In contrast, poor ESG performance of companies can lead to damage to a company in immediate financial terms, and strategic risks that could harm its long-term position. Some other examples of long-term benefits created by ESG activities on corporates include:
- Developing business models to reduce the impact of interruption from technology or regulation.
- The adoption of renewable energy infrastructure and technology to minimize carbon emissions and costs rise from environmental tax or payments for starting carbon emissions.
- Technological advancements in sharing economy that promotes innovation and improves efficiency.
- Adopt sustainable supply chains that support local businesses while ensuring supply chain resilience and maintaining competitiveness in the market.

How ESG Integrate into the Business

With effective ESG governance structure, a company can have a stronger foundation to favour the integration of ESG issues into their business process. ESG is a relatively new field for corporate, so need learning curve. Mostly corporates are still at an early stage in adoption process of ESG, they will have required time to integrate ESG into their core business. The following actions are required for this:

Governance

- Companies should set clear roles and responsibilities for the board, governance committee and ESG committee accountable for ESG issues.
- Establish policies regarding ESG issues, that address and govern that how business should be conducted in a sustainable manner

Strategy

- Formulate proper strategy for communications and engagement to improve stakeholder knowledge of ESG and sustainability issues. This can be happened by imparting ESG strategies, performance, initiatives, and progress to shareholders on a daily basis by the mode effective communication methods.
- Companies should Utilize new ESG knowledge, tool and techniques to develop the business performance.
- Build new capacity building programmers and strategies for key stakeholders to increase knowledge of ESG or related sustainability issues.

Risk management

- Identify and manage ESG risks, including environment-related risks associated with a specific business initiative, specific investment.
- Integrate ESG risks into an enterprise risk management (ERM) process and describe its incorporation process as part of the ESG disclosure.

Conclusion

This paper has demonstrated evidence of the increasing the value of ESG (Environmental, Social, Governance) factors for corporates for their financial performance, investors and society. In my view there is a fundamental shift of corporate towards society or sustainability. The neoclassical view that a company's objective as being solely engaged in 'activities designed to improve its profits. But now the concept of a company moves to view 'doing well by doing good'. They very well determined long-term business performance by adopting ESG measures. The results show that companies that follow with good ESG practices can expect to attain higher financial performance and decrease firm costs. The ESG issues can actually impact the performance of our stakeholders. From my perspective, fully integrating ESG in the in our core business process is therefore inherently accordant with our fiduciary responsibilities to act in the long-term interests of our society. A significant emphasis on active ownership as a key element of ESG by building strong relationships with companies and integrating with them in a constructive manner. Our focus will always be on ESG issues that are most material to long-term shareholder value, such as governance, wider sustainability matter & social issues. This allows us to improve our understanding of corporates and ESG performance, it builds conviction so we work with companies towards better ESG practice.

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