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The Impact of Sustainability Performance on Financial Outcomes of Listed Indian Firms

Mukundan Ramakrishnan
DBA, SP Jain Global

Abstract
There is a growing importance of sustainability, that is, 'environmental, social and governance' (ESG) as a key expectation of firms' stakeholders. This study aims to examine the impact of sustainability on financial outcomes in terms of returns to shareholders and credit ratings for Indian firms. The study will analyse the top 1000 listed firms' ESG performance and its correlation with financial outcomes. This quantitative study primarily relies on publicly available data on ESG and financial performance relating to the listed firms. While the understanding of ESG and its importance among Indian investors and shareholders is still evolving, foreign institutional investors are increasingly paying attention to ESG performance in their investment decisions. The evidence-based approach can provide improved understanding of the link between ESG performance and financial outcomes, leading to better investment decisions. As a first step, this working paper limits its focus to the top 100 listed firms, in order of market capitalisation, and the impact of their ESG performance on their financial performance; however, this study shows a low correlation between ESG performance and financial performance. No variance between the firms was observed – the low correlation between ESG performance and financial performance, is irrespective of the industry sector. This could imply that the link between ESG performance and financial performance is still evolving in India.
Keywords: *Sustainability, Stakeholders, Financial performance, ESG, Investors, Emerging markets, shareholder, SDGs*

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I. INTRODUCTION

Sustainability has evolved over the years, initially starting as socially responsible investing (SRI), dating back to 1758, when the Quaker Philadelphia Society prohibited its members from participating in slave trade. In the mid-1900s, SRI gained further significance when American investors began to avoid 'sin' stocks – companies that dealt in alcohol, tobacco or gambling. Furthermore, civil rights movements as well as environmental and labour movements highlighted the importance of sustainability issues. The advent and adoption of the United Nations sustainable development goals (SDG)[1] in the 2000s and their direct link to businesses ensured the mainstreaming of sustainability and the importance of environmental, social and governance (ESG) performance. This forced businesses to look holistically beyond financial performance, as well as at ESG.

Recent developments include the big three credit rating agencies such as Moody's, S&P, and Fitch making ESG evaluation[2] a key part of their ratings exercise, thus making ESG performance critical not only for equity capital but also to raise debt.

It is in this context that a study of the correlation of financial outcomes to the adoption of ESG and performance on ESG parameters by Indian firms can provide useful input to Indian shareholders and investors. This will also aid foreign institutional investors (FIIs) who increasingly use ESG metrics in their investment decisions when they consider investing in Indian firms. More importantly, evidence-based research on the impact of sustainability on firms' financial performance and credit ratings will aid the increased adoption of these ESG frameworks in the entire ecosystem of Indian firms and their investors.

A. *The ESG Performance and Indian Context*

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[1] *UN SDG Goals- The 2030 Agenda for Sustainable Development, provides a shared blueprint through 17 Sustainable Development Goals (SDGs), for peace and prosperity for people and the planet, now and into the future.*

[2] https://www.spglobal.com/esg/csa/csa-timeline -Corporate Sustainability Assessment (S&P Global)

The ESG performance itself is an evolving subject and there is a proposed standard for uniform reporting by the International Sustainability Standards Board which was created by the IFRS Foundation consolidating the Climate Disclosure Standards Board and the Value Reporting Foundation. Despite the challenges of reporting, the focus on ESG has grown over the years. This is further evidenced by the fact that ESG issues are increasingly influencing the financial viability of firms. This is borne out by the impact on BP of the oil spill in the Gulf of Mexico, the 737 Max failures' impact on Boeing, etc., wherein the firms suffered a huge collapse in market value. Given the large impact of ESG on the very viability of firms as illustrated by these examples, the amount of research in this field has grown exponentially, with over 2000 studies looking into the impact of ESG performance on financial performance, focussed mainly on more mature and developed markets. There have been differing results in terms of the impact of ESG performance on financial performance across various geographies and sectors.

While the overall adoption of the ESG framework is evolving, India has experienced several firsts including the mandating of 2% of profits as corporate social responsibility (CSR) by legislation, which came into force in April 2014, through Section 135 of the Indian Companies Act, 2013. Business responsibility and sustainability reporting (BRSR)[3] was applicable voluntarily for the top 1000 listed firms as per the Securities and Exchange Board of India. This will be mandatory from the Financial Year 2022–23. For this study, existing ESG performance as reported by CRISIL (an S&P Company)will be used. Since this framework is applied globally, it allows for comparisons across the markets. This study is important as it will provide insights into the impact of ESG on Indian listed firms' financial performance. With an increasing inflow of capital into Indian stock markets, from both domestic and foreign investors, this study will be an aid to an investment thesis.

II. RESEARCH PROBLEM AND QUESTIONS

The research problems involve the research gap that has been reflected in the research questions, which is an outcome of a systematic literature review of the impact of sustainability performance on financial outcomes. The following questions are asked:

a) Is there an impact of sustainability performance on financial outcomes in the Indian context?

b) Does the impact of sustainability performance on financial outcomes vary by industry sector?

III. RESEARCH OBJECTIVES

To address the above questions, the objectives of the study are:

a) The impact of environmental, social, and governance performance on the financial performance of the top 100 listed Indian firms.

b) The impact of environmental, social and governance performance on the financial performance of the industry sector.

IV. LITERATURE REVIEW

While it would be expected that good ESG performance should correlate with good financial performance, the evidence in respect of this is mixed. A study by Robb et al. (2021) on ESG performance of US companies, showed that it lowered financial performance and increased risk. In addition, a study of Australian firms by Balabat (2012), found weak positive between ESG scores and financial performance. In contrast, the study by Chelawat & Trivedi (2016), showed that good corporate ESG performance enhances financial performance, which was reaffirmed in a panel study of Indian companies that good corporate ESG performance enhances financial performance, evaluated through accounting as well as market-based measures. Similar was the conclusion by Bodhanwala (2018) highlighting that firms that practice remarkable sustainable development strategies report higher profitability and have substantially lower gearing ratios. According to Dalal & Thaker (2019), there are very interesting insights, contradictions and areas to explore further. This extends further to positive impact of ESG performance delivery by businesses on achieving SDG goals at national level, in a study by Hieu and Hai (2022). A comparative study by Buallay (2020) concluded that ESG positively impacts performance in the manufacturing sector while negatively impacting performance in the banking sector. However, in a paper Linda (2021) highlights that while with imperfect data and evolving measurements, the available evidence, spanning over a decade has supported ESG led investment thesis especially in US, it still needs more refinement and improvement. The varied impacts could also stem from a lack of commonality in ESG rating criteria used by prominent agencies in terms of characteristics, attributes and standards defining ESG components. This could lead to opposing opinions in the same companies. Macmohan (2020) eloquently highlights that ESG ratings is challenging work due to lack of uniform requirements for reporting ESG information and several of

[3]BRSR - https://www.sebi.gov.in/sebi_data/commondocs/may-2021

measures are hard to measure coupled with lack of rules and robust metrics. This makes it difficult to assess if financial performance is conditioned by chosen ESG benchmarks. In addition, even when there is agreement, ESG performance has no impact on financial performance according to a study by Billio et al. (2020). Another study by Jha & Rangarajan (2020) discovered that Indian firms do not obtain financial performance benefits with either higher or lower corporate sustainability performance. Another research by Garg (2015) revealed that the sustainability reporting practices of a firm impacts its performance negatively in the short term, while positively in the long term. A study by Sudha (2015) highlighted daily compounded returns of ESG India Index (index of stock portfolio of ESG Funds) and General Index CNX 500 was not statistically different, the annualised return of ESG India Index was better. Further a study by Goel & Misra (2017) found that the relationship between financial performance and sustainability scores was inconsistent across different financial measures. In another study by Kim and Li (2021) found that there is positive relationship between governance, social and ESG Score and credit rating, environmental score has negative impact on Credit rating. These divergences could also indicate that the focus on materiality needed improvement. A study by Eklund and Stern (2021) proposed a ESG based CEO compensation framework, this could help firms drive ESG performance while balancing it with financial performance. A study by Van Heijningen(2019) of firms in developed countries found that firms should preferably invest in material ESG issues over immaterial issues, as this has a great influence on firm value. Inaddition, a study of non-financial companies from five emerging economies for a five year period of 2014 to 2018 by Yilmaz (2021) showed there is positively significant relationship between sustainability performance and financial performance. Hence, a study of Indian-listed firms could yield further insights.

V.CONCEPTUAL FRAMEWORK

The proposed conceptual framework as detailed below seeks to examine the impact of independent variables composed of ESG performance as drawn from publicly available ratings and performance data from Sustainalytics. The relative improvement in the performance of independent variables is then correlated with the dependent variable of financial performance in terms of return on assets, price-to-book ratio and Tobin's Q. This analysis is done by industry sectors as a control variable to cull out variations in the industry sector. Therefore, this study relies on publicly available data and uses regression analysis to draw conclusions in terms of correlation and the impact of ESG performance on the financial outcomes of firms.

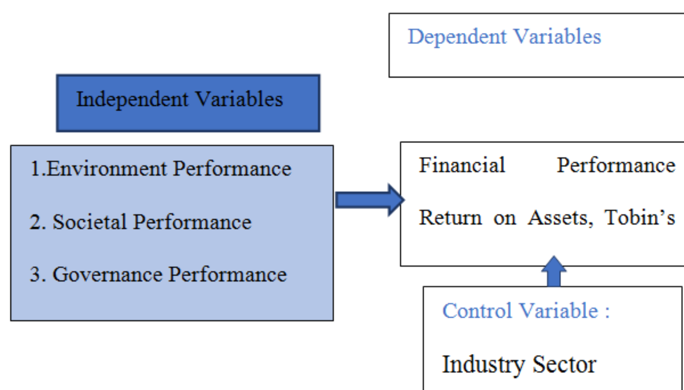

Figure 1:
The proposed conceptual framework

A. Sample Selection

For this research paper, the sample is from the top 100 listed firms in the National Stock Exchange, Mumbai. The ESG data and financial data were available for approximately 89 of these firms (the rest either did not have ESG data or did not have full financial data due to the recency of listing of these firms). The study further segments these firms into seven sectors. These are industrials, IT & technology, banking and financial services, auto and consumer durables, consumer staples and Fast MovingConsumer Goods, pharmaceuticals and infrastructure.

B. The ESG Performance

For this research paper, the rating framework of CRISIL (an S&P company) is used. It is a multi-dimensional measurement of ESG.The ESG performance score is based on publicly available information released by the companies through their websites, exchange filings, annual reports, investor presentations, sustainability reports, CDP filings, etc. It also factors in other material ESG information available in the public domain through reliable sources, such as data reported by industry associations, regulators and various government agencies. The assessment is based on quantitative as well as qualitative disclosures. Each company is monitored for ESG material events that could potentially lead to a change in scores. Scores are measured on a scale of 100 points.

C. Research Hypotheses

This paper fills a research gap on the impact of ESG on financial performance among Indian firms in various sectors. This leads to the following three hypotheses:

Hypothesis 1: Environment performance measured through environment scores impact the financial performance of the top 100 Indian listed entities.

Hypothesis 2: Social performance measured through social scores impacts the financial performance of the top 100 listed entities.

Hypothesis 3: Governance performance measured through governance scores impact the financial performance of the top 100 listed entities.

Hypothesis 4: Industry sector performance measured through ESG scores impact the financial performance of the top 100 listed entities.

D. Methodology

Research hypotheses 1, 2, 3 and 4 are examined through correlation analysis between various financial metrics and ESG scores. The study used regression analysis and an examination of the ESG score and financial performance. The strength of the correlation between the ESG score and financial performance is then tested for the overall sample set and also for a sample set broken into seven sectors. For this study, two financial metrics are examined, i.e. operational performance in terms of return on assets and market performance in terms of Tobin's Q equals total market value/total asset value. The study ensured all data and analysis conformed to consistent ethical standards as these were publicly available data from websites of CRISIL for ESG performance and Equitymaster for financial performance.

VI. RESULTS AND DISCUSSIONS

A. The Impact of ESG Performance on Financial Performance

The overall conclusion is that ESG performance has no major impact on financial outcomes. The R-squared value of ESG performance on financial performance is below 0.01. Hence there are factors other than ESG that influence financial performance. The stock market performance of these listed companies also failed to show any correlation with ESG performance, and this may be an indication of the fact that ESG as a factor is still in the early stages of investors' perspectives on valuing a company.

B.Impact of ESG Performance on Financial Performance by Industry Sector

The analysis of the impact of ESG performance on financial performance by the industry sector, additionally, did not yield a high correlation in any of the sectors. Thus, it can be concluded that ESG performance has no major impact on financial outcomes irrespective of the sector of industry. Therefore, across various sectors there could be other factors that influence the
financial performance of firms, irrespective of the industry sector. Moreover, companies across different sectors have varying ownership by FIIs, which did not influence the impact of ESG performance, thus highlighting that even FIIs are probably in the early stages of applying differential value for ESG performance.

VII. LIMITATIONS OF STUDY

As can be observed from the study, there was a low impact of ESG performance on financial performance; however, it was not conclusive whether these differences had remained constant over the years. In addition, it was unclear whether these differences were due to the small set of samples, as the study was limited to the top 100 listed companies. Overall, it can be noted that there could be several other factors that may have a higher impact on financial performance than ESG performance. Further, this may also be a reflection of the early stages of the adoption of ESG frameworks in terms of arriving at an ESG score. As this process matures through the adoption of BRSR reporting, there could be an increasing influence of these factors as ESG becomes increasingly mainstream in India.

VIII. CONCLUSIONS

The reporting and performance rating of ESG has gathered momentum in India, especially for listed companies. However, its correlation to financial performance is still evolving. In addition, investors are yet to value ESG performance; this is irrespective of FII holdings in companies, i.e. it probably is still evolving even with international investors. The ESG performance rating itself is also evolving, and as the ESG performance

rating elements become more granular and precise, it could lead to a greater appreciation of the importance of ESG performance by investors, thus impacting stock performance. The same could also lead to greater recognition by other stakeholders of the company including customers, employees and suppliers, further enabling better organisational performance, which could then reflect in better financial performance.

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