Ambition Versus Conscience, Does an Environmental, Social and Governance Strategy Pay off? Application of Matching Methods

by

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Abstract

Introduction: ESG strategies have gained interest recently. The study of ESG strategies is based on both moral and competitive aspects. This paper focuses on the business case of developing a mature ESG strategy. The authors attempt to answer the question whether corporate ambition and social conscience are mutually exclusive goals. To do this we develop the business case for and against ESG strategies and test the two on 27 ESG and 95 non-ESG companies listed on the Johannesburg Stock Exchange.

Methods: Matching methods are used to avoid the selection bias problem. Propensity Score methods are used to reduce multi-dimensionality problem and allow us to develop a sample of non-ESG firms similar to ESG.

Results: We conclusively find that there are no negative financial implications for firms engaged in an ESG strategy. This discredits the *shift of focus hypothesis.* Furthermore, we find that ROA and ROE are significantly amplified when a company has a developed ESG strategy. The exact channels by which ESG affects financial performance are still inconclusive nonetheless, our findings are in line with *agency theory, resource dependence theory* and *signal theory*.

INTRODUCTION

A well-performing firm is not only judged by its current profitability, but by its risk-management strategy to ensure long-term profitability. This is the concept of an Environmental, Social and Governance (ESG) strategy.

Environmental, Social and Governance (ESG) is a multi-disciplinary subject and therefore various studies define it in different ways. Commission of the European Communities (2001) defines it as a company's integration of social and environmental concerns in their operations and how the company interacts with its stakeholders. The ethical aspect has been at the forefront, but as research has been conducted the business case for ESG has gained attention. A plethora of theories have been used to argue in favor of developing ESG strategies. These include *resource dependence theory*, *agency theory*, *signaling theory (*Li, Wang & Sueyoshi, 2021). On the contrary, the *shift of focus hypothesis* argues that due to increased costs associated with ESG strategies, firms under-perform their non-ESG counterparts (Shen and Chang, 2009). This paper tests whether financial performance is increased or whether ESG is a burden.

ESG has no single global standard, this is borne of how a good ESG strategy is formed. A material analysis of a firm's risks is conducted. This entails an understanding of the connectedness between a business and its operating environment. Encompassing but not non-exhaustive of; human resource risk management, supply chain risk management, brand/image risks, and any tail-risk hedges implemented by a firm's management team. *Signal theory* (Adib and Zhang, 2019) asserts that mature ESG strategies signal to the market that a firm is embarking on a path to maintaining long-term competitive advantage (Guido Giese, 2019). Many companies around the world have incorporated and implemented ESG in their decision-making strategies and that has sparked increasing interest in the research field.

The concept of ESG was first introduced in the 1970s period in the United States with intentions of building a company's image and improve employee's satisfaction and morale but with progression of time, more reasons behind the importance of ESG became apparent. In the 1980's Environmental Health and Safety (EHS) - human resource management- became the focal management strategy. In the 1990's this evolved into Sustainability – which was focused on environmental factors not necessarily obligated by law. In the 2000's Corporate Social Responsibility (CSR) became the focal management decision making process. This encouraged corporate philanthropy and alignment with social issues. In the 2010's ESG gained prominence. The ethos being that firms with compelling ESG strategies better ensure long-term competitive advantage and hedge tail-risk. However, the debate on whether there is a positive or negative relation between ESG and financial performance is still inconclusive and ongoing. The discrepancies in the findings of this debate are mostly attributed to the differing methodologies used to measure ESG since there is no definite and consistent way used to measure ESG.

Fauzi and Idris (2010) found a positive relationship between ESG and financial performance of Indonesian firms and their findings were congruent with those of Ahamed, Almsafir and Al-smadi (2013) who conducted a study on the impact of ESG on financial performance for Malaysian firms. The positive relation can be explained by multiple factors such as companies that put an effort in their ESG strategy tend to have a good reputation in the community and reputable companies attract investors. Building a positive relationship with a community can help in reducing operating costs for companies and increase profits. Through these channels companies that employ ESG strategies have a better long-term competitive advantage due to loyal customers. Though many studies support the positive relationship between ESG and financial performance, some are contrary to those findings. Chin, Chen, Hu, et.al