

# Comparative Analysis of ESG Ratings and Their Impact on Equity Valuation

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**Abstract.** In accordance with studies on 2,000 large-cap corporations headquartered in nearly 50 countries, significant differences exist in ESG disclosure quality and transparency. This article aims to conduct a comparative analysis of ESG ratings and their impact on equity valuation. By analyzing factors influencing enterprise valuation and theoretical frameworks explaining the potential links between ESG and corporate valuation, addressing a critical blank space in existing papers. It contributes to redefine how ESG factors influence corporate performance and equity valuation, providing valuable perspectives for policymakers, investors and managers navigating the evolving landscape of sustainability. Furthermore, this article proposes some targeted policy recommendations. For instance, incentivizing sustainable practices can promote the importance and accuracy of ESG indicators in equity valuation. Governments can develop fiscal incentives for corporations adopting robust ESG practices. Tax breaks or subsidies can be typical examples. This would encourage more enterprises of various ownership types to prioritize sustainability in their operations and reporting.

**Keywords:** ESG ratings, corporate disclosure, financial performance, sustainability, equity valuation.

## 1. Introduction

In recent years, ESG factors have a growing significance in investment decision-making. However, there exist significant differences in ESG disclosure quality and transparency in different regions. There are exist few policies encouraging ESG disclosure, such as the safe harbor rule, minimizing the litigation risk due to ESG disclosures. This article aims to conduct a comparative analysis of ESG ratings and their impact on equity valuation.

By analyzing the current status of corporate ESG disclosure, factors influencing enterprise valuation, and the linkage between corporate valuation and ESG, addressing a critical gap in the existing field. It contributes to the reconsidering of how ESG factors influence corporate performance and equity valuation, providing informed viewpoints for senior managers, policymakers, investors and navigating the evolving landscape of sustainability.

## 2. Literature review

Previous research shows that ESG ratings of power generation companies do have a positive impact on their financial results in India and China, while from the viewpoint of developed countries, the results are contradictory to this study [1]. However, from the overall perspective of European companies, ESG performance is positively correlated with company's financial performance [2].

ESG consideration has a growing importance in investment decision-making. It is said that combining ESG factors with traditional "fundamental" financial statement analysis can always lead to successful ESG investment [3]. Some of the world's best value investors, including Warren Buffett, take governance, social, environmental and into long-term consideration. In the fundamental analysis, ESG problems can be considered as risk factors which means lower values with higher costs of capital. And even mature institutional investors who have heavily indexed portfolios, have become more active in involving their portfolio corporations in ESG issues [3].

Numerous past studies have explored linkage between the ESG rating and stock prices or equity valuations. Giese et al. find that with the transmission mechanism to a financial value which is one

dimensional, ESG factors are a multi-channel process and are more complex [4]. But overall, ESG indicators impact stock prices and valuations positively. Idiosyncratic risk channels, better risk management practices, and lower risk of severe incidents can all be the reasons.

Previous studies have drawn conclusions about linkage between the ESG rating and company's financial performance or equity valuation, and growing significance of ESG consideration. However, little research discussed about what and how ESG factors exert influences.

Based on this, this article will comprehensively evaluate the comprehensive impact of ESG within the framework of traditional enterprise market value research.

### **3. Basic Factual Analysis**

#### **3.1. Current Status of Corporate ESG Disclosure**

The safe harbor rule, minimizing the litigation risk due to ESG disclosures, is established to encourage voluntary disclosures [5]. As a result, listed companies are expected to increase the trend of ESG indicator disclosure. Studies have shown that the emergence of sustainable development frameworks such as UNGC, GRI, SASB, TCFD and accounting firms has reinforced the significance of companies' accountability to their stakeholders beyond shareholders. Moreover, the evolution of corporate disclosures has changed from financial to environmental, and to ESG disclosures nowadays. Since 2000, the demand for discrete key performance indicators on environmental and social performance has changed from regulators to financial stakeholders such as asset managers and investors, driving a market-driven method in the development of reporting frameworks and corporate strategies [6].

Yu et al. led a study to examine the variations in ESG disclosure quality and transparency across different industries and regions [7]. The study finds out the diversity in the quantity of ESG disclosure across close to 2,000 large-cap corporations headquartered in nearly 50 countries. Choosing Bloomberg ESG disclosure score as a standard, Yu et al. found that the characteristics of companies clarify the majority of the changes in its ESG disclosure, while there is less explanation for changes in national factors such as political power or corruption [7].

The key finding is that cross-listed firms provide more ESG data compared to those listed solely in their domestic market. This supports opinions that cross-listed firms disclose more to mitigate foreign liabilities when accessing external capital environments. However, a higher percentage of foreign ownership does not necessarily result in greater ESG disclosure. Corporations increasing foreign equity ownership domestically won't encounter same challenges of foreignness.

The results indicate cross-listing status can presumably reduce the significance of national elements on changes in the quantity of ESG disclosure. This implies that to determine the extent of ESG disclosure, firm-level factors play a more crucial part than country-level elements, especially for companies that achieve global business through cross-listings.

#### **3.2. Analysis of Factors Influencing Enterprise Valuation**

Key factors affecting a company's valuation are financial and non-financial factors. Kotane proposed to use 17 indicators for evaluating corporations' performance and modeling corporations' net revenue. Including 10 financial indicators: cash-flow report, total debt ratio in the balance, accounts receivable turnover (days/times), gross profitability, return on equity (ROE), return on assets (ROA), return on investments (ROI), return on sales (ROS), EBITDA profitability, and 7 non-financial indicators: quality of the services or products, consumers loyalty, loyal employees, motivated employees, development of new services or products, company's reputation, and training of employees [8].

In accordance with Rehman et al.'s research, the emotions of the investors play a crucial part in the returns of the Karachi Stock Exchange [9]. Therefore, even in weakly efficient market conditions, the impact of investor emotions on stock market returns is observed. They used trials on Karachi Stock Exchange data to confirm whether investors' sentiments can affect stock market returns.

In addition, emotional factors are not the only factors that cause fluctuations in stock returns, as a result low volatility caused by regression factors also confirms the importance of investors' fundamental analysis of listed companies in deciding to purchase stocks. Even in the Efficient Market Hypothesis, it's impossible to persuade all investors that securities prices fully reflect all information available, as even correlations between past and present securities returns can be examined in weak and semi-strong efficient forms. Therefore, even if technical or fundamental analysis is conducted on a company, calculating the intrinsic or true value of stocks based on existing information isn't enough to justify the fluctuation of returns. However, investor emotions also play a crucial part in the volatility on returns [9].

## **4. The Relationship between ESG and Corporate Valuation**

### **4.1. Overview of Relevant Theories**

There are some important theoretical frameworks that explain the potential links between ESG and corporate valuation.

Stakeholder theory argues that organizations have a responsibility to a larger set of stakeholders, including workers, customers, purveyors, and the community. It suggests considering needs of all stakeholders to create long-term sustainable value, not just maximize profits.

That view is a framework for strategic management theory focusing on the inward resources and competence of a company as the main sources of competitive superiority. This indicates that firms can outperform their competitors by utilizing their valuable, rare, unique, and irreplaceable resources and capabilities. The RBV emphasizes that a company's unique bundle of resources and how their deployments are crucial for sustainable competitive advantage, rather than just the external industry environment.

Signaling theory explains how parties in a transaction can use information asymmetry to their advantage. It suggests that parties can send signals such as product quality, and financial health to other parties to convey private information and influence their beliefs and decisions. Effective signaling can help reduce information asymmetry and uncertainty.

The research conducted by Khanchel examined the dynamic linkage between the cost of capital and CSR disclosure over time. Key findings indicate that the influence of CSR disclosure on costs of capital varies across its different ESG dimensions and changes over time. While environmental disclosure initially had a significant effect, this impact diminished over the later years. In contrast, the impact of social disclosure became more pronounced over time. An impact of governance disclosure was initially negative but turned positive in the later windows [10].

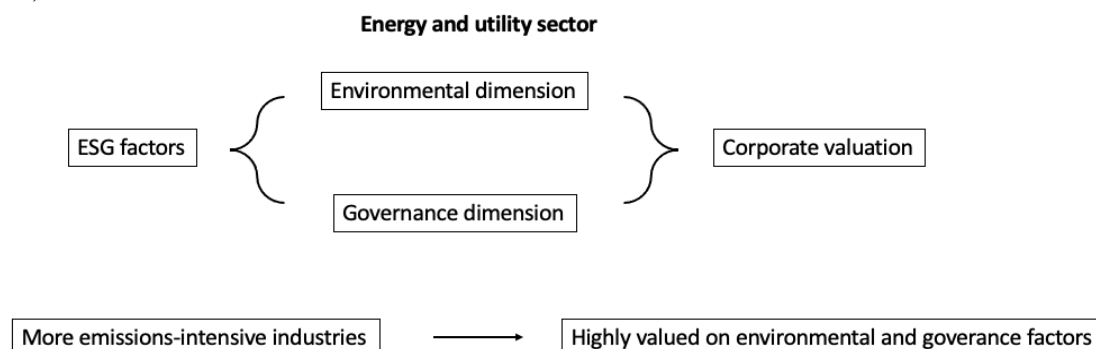
These results suggest that the strategic value of CSR disclosure is not static, but evolves dynamically. Companies must thoughtfully evaluate the trade-offs between benefits and costs of CSR disclosure, and tailor their approach based on the changing preferences of key stakeholders like equity providers and debtholders [10]. The paper calls for further research to validate these findings in different settings and explore the underlying mechanisms driving the dynamic CSR disclosure-cost of capital relationship. Ultimately, a more nuanced understanding of this relationship can help firms make informed decisions about their CSR disclosure strategies.

### **4.2. Mechanism Analysis of ESG on Corporate Valuation**

ESG impacts on company valuation metrics varied significantly across sectors and market capitalization levels. While the overall ESG scores had a positive but limited impact on market capitalization, Şerban et al. found differences exist when analyzing the individual dimensions.

In the utilities and energy industries, the governance and environmental dimensions of ESG had a stronger positive influence on market capitalization of smaller corporations. This suggests that for companies in more emissions-intensive industries, environmental and governance factors are particularly valued by investors in the smaller cap space [11].

In contrast, the social dimension of ESG did not show a consistent impact across sectors or market cap levels. This stands out the demand on a more detailed understanding of how the different ESG pillars interact with company valuation, as the relationships appear to be highly context-dependent. Further longitudinal research is warranted to better understand these dynamics over time (Figure 1).



**Fig. 1** Linkage between ESG factors and corporate valuation

## 5. Conclusion

In conclusion, firm-level factors play a more important role than country-level factors for the extent of ESG disclosure, especially for companies that achieve global business through cross-listings. Some famous theoretical frameworks imply that taking on more social responsibility is beneficial for the development of enterprises. Therefore, ESG factors have a positive effect on corporate valuation.

And some practicable policies are suggested. For instance, standardizing ESG reporting can significantly enhance clarity and comparability across industries. It is suggested to collaborate with global accounting or regulatory bodies to establish reporting frameworks. In addition, facilitating ESG education and training can also have a positive influence. Governments and organizations can invest in workshops or educational programs for corporate executives and investors to improve their understanding of ESG factors and their impact on financial performance.

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