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THE INFLUENCE OF ESG SCORES ON FIRM VALUE AND PROFITABILITY: EVIDENCE FROM THE FTSE BURSA MALAYSIA TOP 100 INDEX.

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ABSTRACT

The area of environmental, social, and governance (ESG) investing has experienced significant growth over the past decade. On a global front, the United Nations Principles for Responsible Investment (UN-PRI) encourage investors to incorporate ESG factors into their assessment of a company's performance. The growing interest in ESG factors among investors, including institutional and retail investors in Malaysia, may reflect that the decision could affect the long-term performance of a company. Nonetheless, the emergence of the COVID-19 pandemic has exacerbated other challenges in the development of the capital market. This study aims to investigate the influence of ESG scores assigned to the performance in terms of the value and profitability of companies in Malaysia. The study analyses the data of 33 companies under the FTSE Bursa Malaysia Top 100 index with complete ESG data from 2019 to 2021. Panel regression is employed to analyse the influence of the ESG score on firm profitability and value. The study concluded that aggregate ESG scores do not significantly influence firm value and profitability. In addition, only the social score is found to have a significant impact on firm value, and all individual ESG scores are found to have no significant impact on firm value or profitability.

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INTRODUCTION

There has been a notable surge in the level of emphasis placed on environmental, social, and governance (ESG) metrics within the corporate sector and capital markets in recent years. The term "environmental, social, and governance factors," also referred to as ESG factors, is commonly used within the realm of capital markets to indicate the performance of an organisation in non-financial metrics. The United Nations Principles for Responsible Investment (UN-PRI) were established in 2006 through a collaborative effort between the United Nations Environment Programme Finance Initiative (UNEP-FI), the United Nations Global Compact, various investment industry entities, and intergovernmental and governmental organizations. The primary objectives of the UN-PRI encompass comprehending the impact of ESG factors as well as providing assistance to investors in effectively incorporating these factors into their investment strategies. In today's world, there is an expectation for firms and entrepreneurs to not only effectively manage their daily business operations but also to demonstrate a conscientious awareness of the impact their businesses have on the surrounding environment. This effort is in line with the notion of sustainability. Companies and investors are continuously incorporating environmental, social, and governance (ESG) considerations into their investment decision.

On a global front, companies are presently electing to participate in ESG practices on a voluntary basis, suggesting the potential for economic benefits associated with these endeavours. Nevertheless, from the standpoint of a company, implementing the ESG process entails making an investment. An essential concern is the financial viability of the necessary investment and allocation of resources. International organisations, sector institutions, and governments are increasingly enhancing their efforts to promote and sustain a global economy that is environmentally, socially, and economically sustainable. The United Nations Sustainable Stock Exchange Initiative (SSE) collaborates with stock exchanges to promote and enhance the sustainability agenda. In Malaysia, there are several efforts available to assist Malaysian investors in incorporating ESG concepts into their investment practices. It is evident that notable institutional investment managers and asset owners, including Employees Provident Fund (EPF), Retirement Fund Incorporated (KWAP), and Khazanah Nasional, have engaged in and signed the UNPRI in 2019. These institutions have integrated the ESG mandate into their investments' funds.

Numerous scholars have conducted research on the association between ESG factors and the financial performance of companies. In recent times, most of the studies have yielded favourable outcomes, while a considerable number of studies have also reported unfavourable findings (Aydogmus et al., 2022). This study aims to examine the impact of ESG scores on firm value and profitability among the top 100 companies listed on Bursa Malaysia. This study has made several contributions. First and foremost, it is important to note that despite the substantial growth of responsible investing, there is a scarcity of academic research focused on the ESG practices of companies in Malaysia, particularly in the association between ESG performance and firm value along with profitability. In addition, the study analyses the contribution of each component of ESG to the financial performance of companies under the FTSE Bursa Malaysia Top 100 index.

LITERATURE REVIEW

Theories

STAKEHOLDER THEORY

According to the stakeholder theory, the long-term success of a company is contingent upon its effective management of relationships with all stakeholders. The company aims to cultivate a favourable relationship with stakeholders by addressing both financial and non-financial aspects of performance. This will help establish a strong foundation of trust, ultimately serving the long-term interests of the company. The stakeholders encompass individuals or organisations who derive benefits from or are adversely affected by the conduct of enterprises (Freeman, 1994). The stakeholder theory is applicable to companies that actively support environmental conservation, strive to enhance social well-being and community ties, and consistently adhere to governance practices that prioritise value maximisation. As stated by Dahlberg & Wiklund (2018), prioritising stakeholder well-being in relation to ESG aspects will lead to certain outcomes in optimising the financial well-being of both the company and its stockholders. In accordance with stakeholder theory, the integration of ESG activities can be transferred or integrated into a firm's market performance. For instance, employees who experience satisfaction and happiness in their work are likely to exhibit higher levels of motivation. Similarly, customers who are delighted with a company's products or services tend to develop a sense of loyalty. Furthermore, suppliers who express satisfaction with their existing relationship with a firm may be inclined to provide discounts or other benefits. These factors collectively contribute to the enhancement of a company's reputation, ultimately resulting in improved financial performance and long-term sustainability (Pen & Isa, 2020).

LEGITIMACY THEORY

Legitimacy is an important consideration in determining a company's ability to sustain itself, as it pertains to the company's endeavours to conduct its operational activities in line with the prevailing standards within the community (Syafrullah & Muharam, 2017). The company will engage in social and environmental responsibility endeavours in order to cultivate trust and garner support from the community, hence reaping advantages in the form of enhanced market potential. Additionally, in order to mitigate the risks inherent in their operations, it is imperative for companies to adopt a transparent approach and enhance the quality of information disclosure, hence establishing legitimacy for their business (Fatima et al., 2015).

IMPACT OF ESG INVESTING ON FIRM VALUE AND PROFITABILITY

The area of finance has generated a substantial body of literature that presents differing ideas and empirical findings regarding the value implications of environmental, social, and governance (ESG) factors. First, advocates of ESG contend that a company can perform better through ethical and responsible practices (Edmans, 2011; Dimson, Karakaş and Li, 2015; Flammer, 2015; Dowell, Hart and Yeung, 2000; Ferrel, Liang and Renneboog, 2016). On the other hand, opponents perceive the allocation of resources towards ESG as a form of agency cost that is borne by the shareholder. (Tirole, 1999; Benabou and Tirole, 2010; Cheng, et al, 2013; Masulis and Reza, 2015; Kruger, 2015). Based on this perspective, managers utilise the resources of the firm to invest in environmental, social, and governance (ESG) initiatives for their own personal gain, disregarding the interests of shareholders. With regards to crisis events, the proposition that engagement in ESG activities can enhance the stability of stock prices during times of crisis is based on the premise that corporate social responsibility initiatives foster the development of social capital and trust in the organisation. These connections, in turn, are expected to incentivize various stakeholders of the company, such as employees, customers, suppliers, financiers, the government, and society at large, to maintain their loyalty. Consequently, this loyalty is anticipated to assist the company in overcoming the difficulties posed by a crisis (Demers et al., 2021).

According to Garg (2015), it was determined that the sustainability reporting practices of organisations have a favourable long-term influence on corporate performance while having a negative impact in the short term. Velte (2017) provides evidence that the incorporation of ESG factors has a favourable impact on both company value, as measured by Tobin's Q, and profitability, as measured by Return on Assets (ROA), among companies in Germany. Similarly, Yoon et al. (2018) investigate the relationship between ESG ratings and market value within the context of Korea. The findings demonstrate that corporate social responsibility (CSR) activities have a positive and significant impact on the market value of a corporation. Nonetheless, the extent of this impact varies depending on the specific characteristics of the firm. In another study, Zhao et al. (2018) examine China's publicly traded energy companies and discover that better ESG performance may have positively influenced their financial performance. This is in line with Dalal and Thaker (2018), who concluded that Indian firms with better ESG tend to perform better financially. More recently, Aydogmus et al. (2022) concluded that the ESG combined score has a positive and highly significant relationship firm value. Specifically, there exists a significant positive association between social and governance attributes and company value.

Nonetheless, several studies conducted found negative relationship between ESG performance and firm financial performance. Han et al. (2016) investigated the associations between the social, governance, and environment scores of listed firms on the Korea Stock Exchange. The study covered the period from 2008 to 2014. The findings of the study indicate that there is no significant association between social scores and the performance of the companies. However, a positive relationship was seen between governance scores and company performance. Conversely, a negative relationship was found between environment scores and company performance. Atan et al. (2019) revealed that no statistically significant correlation exists between the individual and combined elements of ESG considerations and the profitability of firms in Malaysia, as measured by return on equity (ROE). Landi and Sciarelli (2019) examine a sample of 54 publicly traded Italian firms during the period of 2007 to 2015. The authors find evidence of a negative relationship between the companies' environmental, social, and governance (ESG) rankings and their financial performance. The study posited that investors tend not to factor in corporate social responsibility (CSR) when valuing stocks on the stock exchange. In turn, listed companies are not compensated a premium price as a result of their strong focus on stakeholder-oriented practices. The study conducted by Giannopoulos et al. (2022) investigates the influence of environmental, social, and governance (ESG) scores on the financial performance of companies listed in Norway during the period spanning from 2010 to 2019. The findings provide a mix of outcomes, suggesting a positive relationship between ESG scores and company value (as measured by Tobin's Q) and a negative relationship between ESG scores and profitability (as measured by ROA).

HYPOTHESIS

This study is grounded in the stakeholder theory approach, which serves as the research framework. The stakeholder theory asserts that it is necessary for a corporation to fulfil the demands of both internal and external stakeholders. ESG initiatives are perceived as a strategic approach by management to address stakeholders' demands and enhance overall firm performance. Based on the aforementioned literature study, taking into account the heightened attention from investors and the public image, it is anticipated that achieving strong ESG ratings would likely result in a favorable effect on both the value and profitability of the firm. The subsequent hypotheses are subjected to testing.

Hypothesis 1: There is a significant positive relationship between ESG score and value of firms under the FTSE Bursa Malaysia Top 100 index.

Hypothesis 2: There is a significant positive relationship between ESG score and profitability under the FTSE Bursa Malaysia Top 100 index.

METHODOLOGY

In order to accomplish the research objectives, a quantitative methodology was utilized in this study. In this study, ESG and firm performance data are collected from the Bloomberg database. Bloomberg publishes thorough ESG data (for example, board composition, board independence, employee turnover percentage, and biodiversity policy), which is updated on a yearly basis. ESG scores calculated by Bloomberg are based on financially material, transparent, and quantitative data that are available across the Bloomberg database. The study adopted data from companies listed under the FTSE Bursa Malaysia Top 100 index. The index is a capitalization-weighted index that is comprised of the top 100 large and medium-cap companies on the Bursa Malaysia Main Board by market capitalization. Based on the latest list of companies under the index, 33 companies with a complete Bloomberg ESG score from 2019 to 2021 were selected for analysis purposes.

MEASUREMENT OF VARIABLES

In this study, four independent variables were used including the total ESG score, Environmental score, Social score and Governance score of the companies. The firm value as the dependent variable was measured by Tobin's Q while the firm profitability was measured by Return on Equity (ROE).

Tobin's Q

Tobin's Q is widely regarded as the preferred method for evaluating business value by a significant number of researchers. (Atan et al., 2019; Dalal & Thaker, 2019; Saygili et al., 2021; Giannopoulos et al., 2022; Naeem et al., 2022). Tobin's Q is a term used to describe an accounting variable that represents the value generated by management of a company. Tobin's Q is defined as the ratio of the market value of the company to the book value of total assets, where the market value of the company is measured by the sum of the market value of equity and the book value of total liabilities. The measurement aids in ascertaining if a company is overvalued or undervalued. It is used to assess the value of a firm, which is calculated by dividing the market value of the firm by the value of its physical assets (Kim et al., 2013). This implies that companies with greater value will demonstrate higher Tobin's Q values in comparison to companies with lower values. The study derived the Tobin's Q values from Bloomberg based on the following formula:

Tobin's Q = (Market Capitalisation + Total Liabilities + Preferred Equity +Minority Interest) /Total Assets

Return on Equity (ROE)

The selection of utilising Return on Equity (ROE) as the accounting-based assessment in this study is justified due to its widespread usage as a measurement tool for assessing financial performance (Gryphon & Mahon, 1997). Additionally, ROE is considered the primary indicator for investors to evaluate a firm's management performance (Scott, 2003). ROE refers to the amount of net income that is distributed as a percentage of shareholders' equity. The following formula was used by Bloomberg for the calculation of ROE:

ROE = Net Income Available for Common Shareholders / Average Total Common Equity) * 100

ESG score

The independent variables used in the study include the total ESG score, environmental score, social score, and governance score, which were obtained from the Bloomberg database. The ESG scores provided by

Bloomberg incorporate an assessment of both the present level of exposure and the performance of management. Bloomberg evaluates risk management exclusively through the analysis of publicly available data. The Bloomberg scores are used to assess performance relative to peers, with a numerical scale ranging from 0 to 10. Higher scores on this scale signify more effective handling of material concerns. Bloomberg's methodology for evaluating ESG performance is characterised by a bottom-up, model-driven approach that relies predominantly on self-reported, publicly accessible data. This approach yields a scoring structure that is fully transparent, parametric, and rule-based.

Data Analysis

It is customary to employ a cross-sectional technique, or a pooled ordinary least square (OLS), to determine the direct impact of ESG on financial performance when examining the relationship between sustainability and financial prosperity. The pooled regression model is a specific form of model that assumes constant coefficients for both intercepts and slopes. In this particular model, researchers have the ability to aggregate all available data and do an ordinary least squares regression analysis. The study ran the following models to estimate the results:

$$TQ_{it} = \beta_0 + \beta_1 ESGTS_{it} + \mathcal{E}$$

$$TQ_{it} = \beta_0 + \beta_1 ENVS_{it} + \beta_2 SOCS_{it} + \beta_3 GOVS_{it} + \mathcal{E}$$

$$ROE_{it} = \beta_0 + \beta_1 ESGTS_{it} + \mathcal{E}$$

$$ROE_{it} = \beta_0 + \beta_1 ENV_{it} + \beta_2 SOCS_{it} + \beta_3 GOVS_{it} + \mathcal{E}$$

Where:

TQ_{it} = Tobin's Q for firm i in period t
$ESGTS_{it}$ = ESG Score for firm i in period t
$ENVS_{it}$ = Environmental Score for firm i in period t
$SOCS_{it}$ = Social Score for firm i in period t
$GOVS_{it}$ = Governance score for firm i in period t
ROE_{it} = Return on Equity for firm i in period t

FINDINGS AND DISCUSSION

Descriptive Statistics

The dataset comprises 33 firms spanning the years 2019 to 2021, resulting in a total of 99 observations. The data represents both independent variables (ESG total score, environmental score, social score, and governance score) and dependent variables (Tobin's Q and return on equity) obtained from Bloomberg. Table 1 illustrates descriptive statistics. It can be observed that, on average, the Tobin's Q value is 2.3679, while the values of Tobin's Q vary around the mean by approximately 2.306. When Tobin's Q exceeds one, it indicates that the stock is potentially overvalued. Hence, it can be deduced that a significant proportion of the firms included in our dataset are overvalued. In general, a higher ROE indicates a greater level of profitability for the firm. As the mean for ROE is recorded at 17.16, firms are, on average, performing well in terms of profitability. In relation to the independent variables, the mean score for the ESG score is 3.3981, followed by the environmental score at 2.3725, the social score at 3.2855, and the governance score at 5.2706. Upon closer examination, it is evident that the governance score exhibits a comparatively higher rating in relation to the other components of ESG factors.

Table 1: Descriptive statistics

	N	Mean	St Deviation	Min	Max
Dependent variables					
Tobin's Q	99	2.3679	2.3060	0.6058	13.3991
Return on Equity	99	17.1616	34.5429	-12.338	214.9677
Independent variables					
ESGTS		3.3981	1.0165	1.54	6.62
ENVS		2.3725	1.4575	0.0	7.02
SOCS		3.2855	1.7232	0.6	7.16
GOVS		5.2706	0.7078	3.72	6.8

Influence of ESG score on firm value

Table 2 demonstrates the relationship between both individual and aggregate ESG scores and the value and profitability of the firms. The coefficient of determination, denoted as R-squared, is calculated to be 0.1212. This value signifies the proportion of the total variability observed in Tobin's Q that can be accounted for by the independent variables. In this particular instance, it can be observed that the model accounts for approximately 12.12% of the variability in Tobin's Q. The analysis reveals that the aggregate score of the firms ESG does not have a significant impact on Tobin's Q. This finding is consistent with Haryono and Iskandar (2015), Han et al. (2016), and Atan et al. (2019). A firm's higher ESG score does not boost its value, as investors may be cautious about the firm's plan to invest heavily in non-financial aspects during hard times such as the pandemic. It is also noted that the environment and governance scores are also statistically insignificant in influencing Tobin's Q, while the social score is significant in influencing Tobin's Q. The social score is found to have a negative and highly significant relationship with the value of a firm. The coefficient of -0.6689 indicates that a one-unit increase in social score is associated with a -0.6689 unit decrease in Tobin's Q. This aligns with the study conducted by Brammer et al. (2006), which examines the influence of corporate social performance on enterprises in the UK by analysing market returns. The findings indicate that firms with low social scores outperform the market. In a similar case, Nollet et al. (2016) utilised accounting and market metrics and found evidence of a negative relationship between social performance and the financial performance of S&P 500 companies from 2007 to 2011. This reaffirms that the impact of social initiatives conducted by the firms in Malaysia during the period of 2019 to 2021 did not translate into financial advantages. This may be due to the shift of attention among investors to focus on other considerations during the pandemic period.

Influence of ESG score on firm profitability

Based on the analysis in Table 2, the coefficient of determination (R-squared) is 0.0234, denoting the proportion of the variability in the ROE that can be accounted for by the independent variables. It is found that the aggregate ESG score and the individual ESG score are statistically insignificant in influencing firm profitability. These findings indicate that firms with higher ESG scores do not exhibit superior performance compared to those with lower ESG scores. The response to financial performance from environmental, social, and governance initiatives is inadequate. The firm's environmental performance is not translated into financial performance, which may be due to the fact that the firm does not address the environmental impact generated by operations and fails to achieve sustainable management, which could result in a long-term cost reduction. This contradicts the legitimacy theory, which asserts that effective implementation of operation management should help minimise the cost of production. In addition, the governance score was also found to be insignificant to firm profitability. This result contradicts the stakeholder theory, which asserts that a strong governance body in a corporation can enhance the firm's reputation and hence lead to greater financial success. The absence of any association between social performance and financial performance can be attributed to the presence of a highly volatile market environment. As a result, management's focus is primarily directed towards addressing market conditions that have a direct impact on profits and sales, rather than non-financial aspects such as employee development. The result is consistent with Zhang (2010), Barnett and Salomon (2011), Yawika and Handayani (2019), and Atan et al. (2019).

Table 2: Panel regression results

	Model 1 Y = Tobin's Q		**Model 2 Y= ROE**	
	Coefficient	**t**	**Coefficient**	**t**
Constant	1.5749	1.92	3.3769	3.69
ESGTS	1.3255	2.07	0.1078	0.15
ENVS	-0.1360	-0.87	0.0107	0.06
SOCS	-0.6689*	-2.97	-0.2341	-0.93
GOVS	-1.0705	-1.81	-0.100	-0.15
Observations	99		99	
R-squared	0.1212		0.0234	
No of company	33		33	

*Indicate the value is significant at 5% level

CONCLUSION AND RECOMMENDATION

This study aims to examine the potential association between a firm's ESG score and its performance, as indicated by its firm valuation and profitability. The investigation will focus on the top 100 enterprises in Malaysia during the COVID-19 pandemic. The analysis signifies that firms under the FTSE Bursa Malaysia Top 100 index with higher ESG scores do not necessarily have superior financial performance. This pertains specifically to the period during which the COVID-19 pandemic adversely affected the economy from multiple perspectives. Firms must develop strategies that effectively reconcile the pursuit of both financial and non-financial goals, with the aim of optimising value for stakeholders. The overemphasis and investment in non-financial metrics could result in an expense to the financial performance. Excessive focus and allocation of resources on non-financial measures may have a negative impact on financial performance. There is a lack of comprehensive research on the effects of ESG factors on firms in Malaysia, especially during challenging periods. This study presents empirical evidence that could potentially be valuable to firms, as well as both the capital market and policymakers, in their endeavours to encourage responsible investment in Malaysian public firms and strategize investment decisions to maximise the advantages of sustainable investment.

The study examines the influence of ESG scores on the value and profitability of the leading 100 companies in Malaysia, based on their market capitalization. The study employs scores obtained from the Bloomberg database. It is suggested to conduct further studies in order to incorporate ESG scores obtained from various third-party sources such as Refinitiv, MSCI, and Sustainalytics. Furthermore, using the findings from a study encompassing all companies listed on Bursa Malaysia would enhance the empirical insights related to the research area.

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