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Impact of ESG (Environmental, Social, Governance) Performance on Firm Valuation and Cost of Capital

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Abstract

In modern capital markets, environmental, social, and governance (ESG) performance has emerged as an essential indicator of business financing and valuation. With cost of capital performing as a key transmission mechanism, this study creates a conceptual framework for analysing how ESG performance influences corporate valuation. Good ESG policies cut the cost of debt, the cost of equity, and the overall weighted average cost of capital (WACC) by improving the company's reputation, reducing information asymmetry, and mitigating operational and regulatory risks. Market-based valuation criteria are then improved by better financing conditions. The central idea also emphasises how the governance, social, and environmental pillars play distinct roles in influencing financial results.

Keywords: *Environmental, Social, and Governance (ESG), Firm Valuation, Cost of Capital, Cost of Equity, Cost of Debt*

Introduction

Environmental, Social, and Governance (ESG) factors have emerged as critical determinants of corporate financial performance and investor decision-making in contemporary capital markets. The integration of ESG considerations into corporate strategy and investment portfolios reflects a fundamental shift in how stakeholders evaluate firm risk, value creation, and long-term sustainability. The relationship between ESG performance and firm valuation operates through multiple financial channels, with cost of capital serving as a crucial transmission mechanism linking sustainability practices to shareholder value. Understanding these interconnections is essential for corporate managers, investors, and policymakers navigating an increasingly complex financial landscape shaped by environmental pressures, social expectations, and governance reforms.

Literature review

Previous research emphasises how Environmental, Social, and Governance (ESG) performance is becoming more and more important financially. The quick development of ESG research and its incorporation into risk management and business strategy frameworks are highlighted by Tao Li et al. (2021). Global evidence of a favourable correlation between ESG performance and business financial returns is presented by M. Bolla et al. (2025). Jay P. Shimshack and Michael Kitzmueller (2012) provide economic perspectives on corporate social responsibility as a behaviour that enhances value. Additionally, K. R. Bhandari et al. (2022) indicate that sustainability promotes long-term competitive advantage by connecting ESG to the resource-based approach.

ESG Performance and Firm Valuation: Empirical Evidence

The analysis of ESG performance relative to firm valuation presents generally positive relationships, although these effects vary across different pathways and regions. A study of 24,500 firm-year observations from European companies (2015-2024) indicates that ESG performance positively correlates with firm value based on market metrics. Long-term effects are favorable, while short-term accounting returns, particularly in non-Nordic countries, reveal negative impacts on Return on Assets (ROA) and Return on Equity (ROE), due to transitional adjustment costs from sustainability initiatives.

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Non-linear dynamics often characterize the relationship; notably, certain industries, like pharmaceuticals and Chinese markets, exhibit U-shaped relationships, where extreme ESG scores outperform moderate ones. For instance, in China, firms with very high or very low ESG scores yield better market performance, driven by financing constraints and green innovation. In emerging markets, such as Indonesia and Malaysia, positive correlations between ESG scores and market value are reported, indicating significant valuation premiums for firms with robust sustainability practices. Conversely, in the Malaysian real estate sector, governance and social aspects are found to have a stronger influence on firm value than environmental performance, underscoring the need for industry-specific considerations in ESG evaluations.

Cost of Capital as a Transmission Mechanism

The cost of capital represents a critical channel through which ESG performance influences firm valuation and financial outcomes. Across multiple studies and geographic contexts, firms with superior ESG performance experience measurable reductions in both the cost of debt and cost of equity, though the magnitude and consistency of these effects vary substantially. Research on emerging market firms demonstrates that stronger ESG reporting practices lower a firm's overall cost of capital, with this reduction serving as a significant mediator between ESG practices and improved financial performance. This mediating relationship highlights that capital providers respond to ESG signals by adjusting the risk premiums they demand, effectively rewarding sustainable corporate practices with more favorable financing terms.

Cost of Debt

The relationship between ESG performance and cost of debt exhibits more consistent negative associations across studies compared to cost of equity effects. Analysis of European publicly listed companies reveals that firms with strong ESG performance enjoy lower costs of debt, reflecting favorable borrowing conditions perceived by debt financiers. More specifically, research on Fortune 500 companies demonstrates that firms with stronger ESG performance have lower leverage ratios and weighted average cost of capital (WACC), indicating that good ESG outcomes result in better equity financing facilities and are perceived as less risky by credit markets. For large firms particularly, environmental and social factors exercise more significant influences on leverage and WACC than governance factors.

The magnitude of cost reduction varies meaningfully across institutional contexts. In Nordic markets, a 10-point increase in ESG score corresponds to an estimated 4.2-basis-point reduction in WACC, reflecting the benefits of mature disclosure systems and sophisticated investor bases. In contrast, non-Nordic countries show that governance emerges as the only ESG pillar capable of reducing financing costs, suggesting that institutional maturity and investor sophistication shape the financial materiality of different ESG dimensions. Research across G20 countries documents significant negative relationships between ESG practices and both costs of equity and debt capital, with ESG engagement reducing overall funding costs for firms.

The internal audit function moderates these cost-of-debt effects in important ways. Studies demonstrate that while high ESG performance uniformly reduces cost of debt, this negative relationship weakens when firms have independent and large internal audit organizations. This counterintuitive finding suggests that robust internal audit functions expose and highlight ESG-related risks to external credit rating agencies, potentially offsetting some cost-reduction benefits. Additionally, research on Indonesian firms shows that higher costs of debt can diminish the positive effect of ESG on a firm's financial condition, implying a trade-off between debt financing advantages and financial risks.

Cost of Equity

The relationship between ESG performance and cost of equity presents more complex and sometimes contradictory patterns compared to cost-of-debt effects. While research on European companies reveals a positive relationship between ESG performance and cost of equity, suggesting higher expected returns for equity investors due to perceived long-term risk and growth opportunities, other studies document negative associations. Research on Indian firms finds that ESG performance disclosure negatively impacts cost of equity capital, providing firms with equity financing at lower cost while reducing information asymmetry and building investor confidence. Similarly, studies in ASEAN-5 countries show that higher ESG scores significantly lower the cost of equity, indicating that strong ESG performance reduces perceived investment risks and boosts investor confidence.

The heterogeneity in these findings reflects important moderating factors. In countries with strong national governance quality, ESG-cost of equity relationships are more pronounced and consistently negative. ESG media coverage and information transparency play crucial roles:

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stronger ESG-related media coverage correlates significantly with lower cost of equity, with this relationship more pronounced in state-owned and large firms. Furthermore, tax risk moderates the ESG-cost of capital relationship; highly-rated ESG firms can reduce the positive association between tax risk and cost of capital, as these firms prefer stable tax positions and invest after-tax cash flows into sustainable management.

Regional and Institutional Heterogeneity

The impact of ESG performance on firm valuation and cost of capital exhibits substantial variation across geographic regions and institutional contexts. Nordic countries demonstrate the strongest and most consistent positive effects of ESG on firm value and cost reduction, reflecting mature ESG disclosure systems, sophisticated investor bases, and well-developed governance infrastructure. In contrast, emerging markets show more mixed and weaker effects, with regulatory gaps, market inefficiencies, and investor inexperience moderating the financial benefits of ESG practices.

Governance quality emerges as a critical moderating factor throughout the literature. In countries and sectors with higher governance quality, ESG practices demonstrate stronger influences on cost of capital and firm valuation. This pattern reflects the signalling function of ESG practices: in institutional environments where governance structures are robust and credible, ESG signals more effectively convey information about firm quality and risk to capital market participants. Conversely, in environments with weak governance institutions, ESG disclosures may face credibility challenges, with ESG rating divergence and inconsistency undermining their financial impact. Research specifically examining ESG rating divergence in the European Union demonstrates that inconsistent ESG scores across rating agencies increase uncertainty and potentially raise the cost of equity for firms.

Mechanisms and Value Creation Pathways

ESG performance significantly affects firm valuation and cost of capital through various interconnected mechanisms. Key pathways include operational efficiency, where environmental factors like carbon footprint reduction lead to cost savings and improved cash flow, justifying lower capital costs. Social dimensions enhance value via brand equity and workforce productivity, with labor practices and community engagement boosting corporate reputation. Governance quality, marked by board independence and ethical practices, correlates with risk mitigation and better capital allocation. Furthermore, technology investment complements ESG performance, with research indicating their combined impact positively influences firm value. High ESG performance also shapes financial decision-making, resulting in increased capital expenditures and lower cash flow sensitivities while fostering financial flexibility for sustainable development.

The Role of ESG Dimensions: Environmental, Social, and Governance

The three ESG pillars impact firm valuation and cost of capital distinctively, with their significance varying by context. Environmental performance generally correlates positively with firm value by promoting regulatory compliance, resource efficiency, and resilience, especially in developed markets with strong ESG disclosure and investor activism. Social factors enhance firm value through human capital development and stakeholder engagement, with mixed effects on profitability in emerging markets. Governance quality consistently influences cost of capital and valuation, characterized by board independence and transparent reporting, reducing information asymmetry and enhancing investor confidence. In non-Nordic Europe, governance is key to lowering financing costs, although some studies indicate negative effects on profitability in emerging markets due to compliance costs.

Sector and Firm-Size Heterogeneity

The impact of ESG performance on firm valuation varies significantly across industrial sectors and firm size categories. Tourism and hospitality sectors demonstrate particularly complex ESG-performance relationships, with food service firms experiencing predominantly negative relationships where compliance costs exceed stakeholder benefits due to thin profit margins. Hotel firms demonstrate positive correlations at performance extremes through operational efficiency gains and brand differentiation, while service sector firms exhibit volatile mixed patterns.

Firm size significantly moderates ESG effects across multiple dimensions. Larger firms generally experience more pronounced financial benefits from ESG practices, with stronger ESG-cost of capital relationships in firms with greater market visibility and institutional investor participation. State-owned enterprises and private firms show different ESG-performance patterns, with state-owned firms demonstrating stronger market-based valuation benefits but potentially weaker cost-of-capital reductions.

Crisis Resilience and Dynamic Effects

The COVID-19 pandemic provided a natural experiment examining ESG performance's role in crisis resilience. Research on Indonesian firms reveals that while ESG companies generally have higher cost of capital compared to non-ESG

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companies in normal periods, the relationship reverses during significant crises. ESG firms' stronger stakeholder relationships, superior operational flexibility, and enhanced credibility enabled better performance during the pandemic, though these benefits emerged only after substantial periods of commitment to sustainability practices.

Practical Implications and Strategic Insights

The evidence shows that ESG performance positively impacts firm valuation and cost of capital, although benefits vary by institutional context, governance quality, and sector. Managers must commit to ESG investments for long-term value, particularly in mature markets where they can lower costs of capital through better information and resilience perceptions. Investors should use context-sensitive frameworks for ESG assessment, adapting to varying materiality across sectors. In weak governance environments, improving governance is crucial for leveraging ESG advantages. Policymakers should work towards ESG rating standardization and regulatory harmonization to reduce investor uncertainty, especially in developing economies where tailored support can help small and medium-sized enterprises.

Research Gaps and Future Directions

Despite substantial empirical progress, important research gaps remain. The heterogeneous effects of ESG on firm valuation and cost of capital warrant deeper investigation into the specific mechanisms driving these relationships across different institutional contexts and time horizons. The role of ESG rating divergence and its implications for market efficiency requires continued attention, particularly as regulatory bodies work toward standardized disclosure frameworks. Additionally, the long-term sustainability of ESG-driven cost reductions and whether these represent permanent shifts or cyclical phenomena merit longitudinal investigation extending beyond current datasets.

Conclusion

Environmental, Social, and Governance (ESG) performance has emerged as a financially material determinant of firm valuation through its influence on the cost of capital. Strong ESG practices reduce information asymmetry, enhance corporate reputation, and mitigate operational and regulatory risks, leading to lower cost of debt, cost of equity, and overall WACC. However, these effects vary across institutional environments, industries, and governance structures. While short-term adjustment costs may arise, long-term valuation benefits remain evident. Therefore, ESG integration should be viewed not merely as ethical compliance, but as a strategic financial decision that strengthens competitive advantage and sustainable value creation.

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Conflicts of interest

The authors declare that there are no conflicts of interest regarding the publication of this paper

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