

# Chapter 6

## The Effect of ESG Practices on Firms' Financial Performance of Environmentally Sensitive Industries

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### ABSTRACT

*This study aims to verify whether the adoption of sustainable practices favors firms' profitability. Furthermore, we investigate the possible differences in this relationship between companies that operate in environmentally sensitive industries (ESI) or not. These objectives are examined through a panel data regression, whose data are obtained from 2011 to 2022. The analysis considers 2,095 non-financial public companies from 57 countries, being 1,070 of ESI and 1,025 of non-ESI ones. As a result, both hypotheses were supported - H1: ESG scores positively affect firms' profitability and H2: ESG scores affect firms' profitability differently from that of (non) environmentally sensitive industries. This study contributes to confirming stakeholder and legitimacy theories, as well as mitigating non-consensual results on the topic. Furthermore, investors are encouraged to stake money in companies that actually implement sustainable practices. Finally, these results encourage reg-*

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*ulators to continue evolving with global standards for registration and disclosure of these practices*

## **1. INTRODUCTION**

In 2015, the United Nations General Assembly (UNGA, 2015) established a sustainable development agenda for 2030. It contains 17 sustainable development goals (SDG) and 169 targets to be achieved. The proposed action plan is of interest to regulators, investors, companies and consumers, as it promotes balance in serving all stakeholders. Furthermore, the plan contributes to the sustainable growth of the economy. The disclosure of non-financial information by companies is a market demand that is being regulated by the Securities and Exchange Commissions – e.g.: ISEC (2012), BSEC (2021) – as well as by other entities – e.g.: Sustainability Accounting Standards Board (SASB) and Global Reporting Initiative (GRI) (Chen *et al.*, 2023).

The concept of sustainability refers to the balance between the environment, society and economy. Corporate sustainability is related to the environmental, social and governance (ESG) pillars. The impact of these practices on companies' financial performance has been the subject of empirical studies for many years. Researchers are interested in understanding the effect of ESG scores on the results and value of companies. Among the corporate finance theories that support these analyses, there is that of the stakeholder, which is opposed to that of the shareholders. Serving the interests of groups other than shareholders is fundamental to the company's success (Friedman, 2007; Jyoti & Khanna, 2021).

Furthermore, this balance of interests contributes to the company's long-term continuity and mitigates the pressure that managers have on very short-term results. Thus, by implementing and publicizing their sustainable practices, companies alleviate the conflict of interests between managers and owners. These actions also signal positively to the market about its commitments to customers, suppliers, employees, the community and regulators (Bilyay-Erdogan & Öztürkkal, 2023; Rao *et al.*, 2023). In fact, the topic of sustainability matters to all types of companies. However, for those operating in environmentally sensitive industries (ESI) it is especially relevant.

Due to the nature of their production chain and commercial operations, ESI industries face a high degree of exposure to environmental factors, competition and greater political risk. The environment is modified or tends to be significantly modified by its economic activities. Furthermore, they are also targets of moral debates and social criticism. Typically, these industries are identified by the following GICS codes: (10) energy, (15) materials, (20) industrials and (55) utilities (Gracia & Siregar, 2021; Liu, 2024). Therefore, they face more challenges and are

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