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## Industry Directions™

# Hidden Benefits of ESG compliance will help developing IMM Firm structure for resilience

(Part-II)

## Does ESG Improve Export Performance and vice-versa

Sustainable social responsibility reshapes firms' business philosophies. Today's progressive firms must focus on and participate in solving these problems and incorporate environmental, social, and governance (ESG) factors into their business philosophies. On the one hand, firms cannot operate without a supportive and appreciative external environment. By implementing ESG concepts, firms can establish new competitive advantages, such as green technology and brand reputation.

ESG practices can help firms innovate and improve their relationships with employees, suppliers, and other stakeholders. China is the largest trading country in the world, and Chinese firms experience frequent social responsibility crises in international trade. Often, hidden barriers, such as prior safety checks, ongoing environmental protection, and consumer rights protection, hinder firms' export performance. Therefore, it is of great practical significance to explore whether the new competitive advantages established by ESG practices can promote export performance.

## Likely Adoption Benefits of ESG

ESG performance affects a firm's risk, which can affect the cost of capital. ESG, through multiple channels, can affect many types of risks, including systemic, regulatory, supply chain, product and technology, litigation, reputation, and physical risks. During the 2008–2009 financial crisis, firms with high ESG performance outperformed low-ESG firms. ESG enhances firms' resilience to shock. These are the typical benefits.

There is a negative correlation between environmental and governance performance and the cost of equity capital, but that social performance is independent of

### Benefits of ESG Adoption

1. **Due to product differentiation strategies, firms with high ESG performance face relatively low price elasticity of demand, thereby reducing systemic risks.**
2. **Firms with poor environmental performance tended to have relatively low credit ratings. ESG activism could reduce a firm's downside risk.**
3. **Good ESG performance reduces the cost of capital, including equity and debt.**
4. **The asset advantage and reputational value created by ESG practices provide firms with a significant competitive advantage, as investors and consumers take ESG more seriously. Even green bonds are issued at a negative premium, suggesting that issuing bonds associated with environmental projects lower capital costs.**
5. **ESG preferences exist in an investor's utility function and the financial and practical effects of ESG preferences. Good ESG performance have lower capital costs.**

> **Critique on ESG and export performance**
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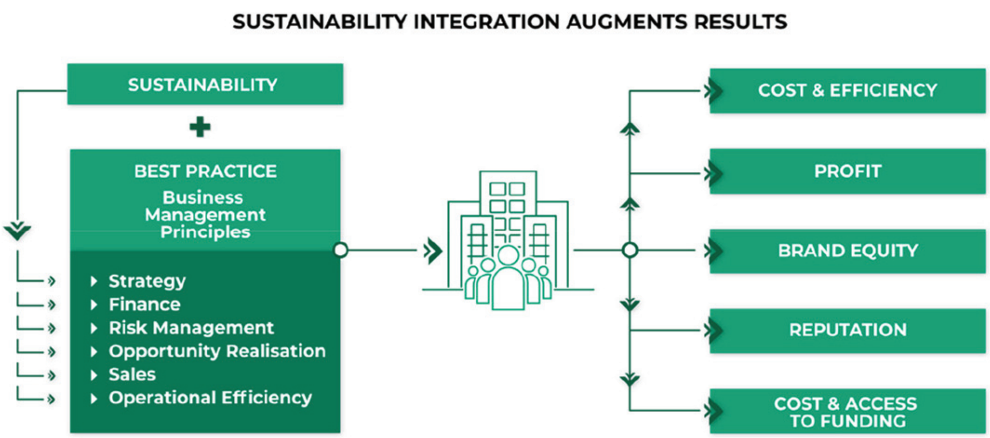
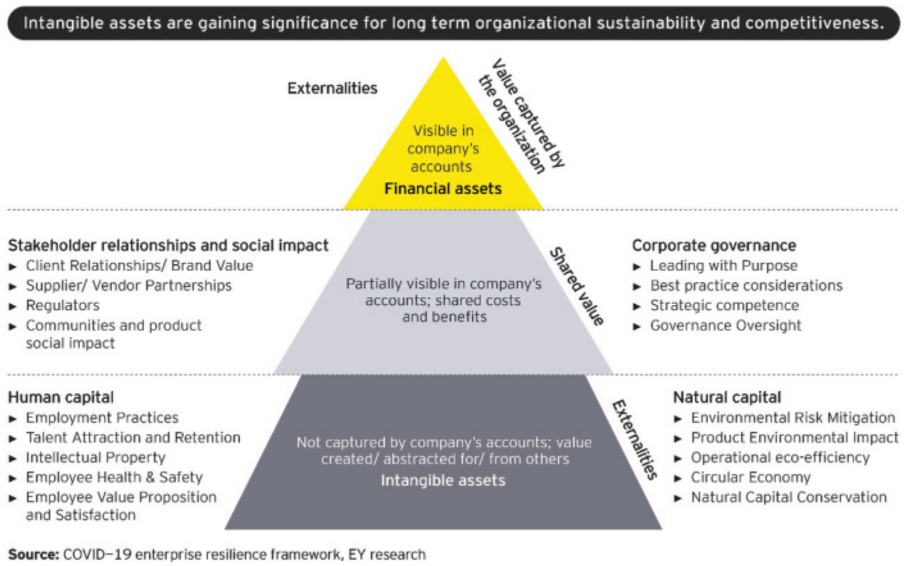
> **Sustainable development reshapes firms' business philosophy. ESG practices create new competitive advantages and profoundly impact the export trade.**
>
> **a. First, ESG performance can have a strong and significantly positive impact on enhancing export intensity.**
>
> **b. Second, the mechanism analysis shows that good ESG performance enhances firms' export intensity by promoting innovation and alleviating financing constraints.**
>
> **c. Third, the results of the heterogeneity analysis show that the effect of ESG performance on firms' export intensity mainly originates from large firms and SOEs in the sample.**
>
> **As a result, policymakers should pay attention to ESG, improve ESG information disclosure and give financial support to encourage non ESG complaint firms to develop ESG**

equity capital costs. The relationship depends on investor protection laws in the firm's home country. In countries with strong investor protection, higher ESG performance lowers capital costs. Some studies focusing on the relationship between ESG performance and firm value argue that better ESG performance can increase a firm's market value. Influencing mechanisms can be divided into two categories. First, increasing cash flow (e.g., consumers buying goods from firms with a reputation for social responsibility; more productive employees working for such firms) or lowering the discount rate (the lower cost of capital mentioned above) achieves ESG value creation. Second, ESG increases firm value through the shareholder utility maximization channel. For example, shareholders can value environmental or social products while valuing cash flows. Under this valuation method, shareholders of firms with good ESG performance gain more utility. Some studies have reached similar conclusions, using evidence that ESG performance is positively related to stock returns. Other studies focus on the relationship between ESG performance and disclosure. Firms with higher pollution levels are more likely to disclose conventional environmental information and firms' environmental performance and voluntary environmental disclosure are related.

## ESG and Export Performance

Before we begin to understand the effects of ESG adoption on exports, let us understand the factors that influence exports. Many scholars have studied the factors influencing export behaviour at different dimensions and levels. As micro-entities of trade, the export intensity of a firm is related to its size, age, foreign capital share, capital stock, product quality, and the sunk cost of exports. productivity is also considered as the most critical factor affecting a firm's export growth. When a firm faces a financing constraint dilemma, the financing constraint potentially determines whether the firm can afford the sunk cost of exports and then







determines the firm's export intensity. Financing constraints restrict firms' export behaviour.

Therefore, the impact of non-economic factors such as environmental regulations and social responsibility on firms' export performance is not yet completely understood. The traditional view holds that strict environmental regulations increase compliance costs and reduce firms' basic productive investment, thus reducing their competitiveness in the international market but some studies argue that environmental regulation can force firms to innovate to increase productivity and help them develop a comparative advantage in trade.

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