DOES ESG SCORE IMPACT SHARE PERFORMANCE IN ROMANIAN STOCK MARKET?

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Abstract

Environmental, social and governance corporate policies (ESG) will remodel the overall economy in the next years, respectively will influence the success of investment. ESG factors will drive change fundamentally in the economy that will raise some risks and opportunities for the financial sector. Therefore, it is crucial that they include responsible investment and ESG criteria in their overall business strategy. ESG policies have passed so from the early stage, in which they represented a specialized product for a restricted group of investors, to the actual stage, in which these actions have transformed into a general framework that influences the strategic thinking of the whole entity. ESG thus has an influence on growing business strategy throughout the transaction life cycle and in their portfolios. This paper explores the impact of the ESG notch on the share performance of the Romanian entities listed on the Bucharest Stock Exchange. In conclusion, incorporation of ESG factors in investment strategy may influence stock performance and attract investors interested in sustainability.

Keywords
ESG, stock price, performance

JEL Classification
O16, G12, M21

Introduction

There was a moment when the environmental, social and governance topics remained the niche concern for a certain group of ethical and socially responsible investors. But now, that moment is long gone.

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During the last period, the increasing consideration rewarded to issues of 'sustainability' has directed a boom in the entities' information disclosure regarding the environmental, social and governance different performs. The outcomes of different studies indicate that market attention to the transparency of entities' ESG performance and practice tends to be large and on a growing trend (Eccles, Serafeim, & Krzus, 2011).
Entities may take advantage of implementing the ESG policies because they might lead to better economic performance, respectively may increase investor interest.
Considering the ESG factors, it becomes attractive as a fundamental part of investment management. Also, the asset owners and investment managers are starting to develop different ways to integrate ESG criteria in the investment analysis, respectively the decision-making processes.
The notion regarding Environmental, Social, and Governance (ESG) was proposed for the first time in 2004 during the UN Global Compact. According to the definition, ESG is considered an evaluation standard regarding the non-financial performance of companies in relation to environment, society and governance.
Examples regarding the definition, respectively the scope of ESG topics are illustrated in Figure 1.

Figure no. 1: The scope of ESG topics
Source: FTSE Russel (2018)

Business ESG performance tends to have a clear purpose which is the attraction of more investors. The practices of ESG are more appropriate for financial markets, because

ESG originally tends to emphasize ESG responsible investment, and this is logically closely correlated with the financial markets and all investors. Also, the politics of ESG are believed to be a clear standard to promote corporate sustainability. Moreover, ESG scores are considered to be a more normative guide for entities, rating agencies, respective all investors. This involves firms integrating the factors of governance, environmental and social in their corporate models, respectively to penetrate into the entities' core approaches (Gillan et al., 2021). In other words, entities' ESG performance may convey real information which is related to the capital market.

1. Review of the scientific literature

Whelan et al. (2021) studied several over 1,000 papers which were published during the period 2015 – 2020. To measure the financial performance of the entities, the papers used ratios such as return on assets, return on equity, respectively stock price. There was found a positive relationship between ESG ratio and financial performance in the case of 58% of the business's studies, respectively a percent of 13% which showed a neutral impact, furthermore 8% of researches presented a negative relationship, while 21% of the studies indicated mixed results.
Makridou et al. (2023) analyzed a panel data sample of 85 European entities from energy-sector for the period 1995–2020. Their results show a marginally negative relationship between financial performance and ESG, while environmental responsibility presents a significant negative effect. Moreover, governance and social responsibilities have a positive but insignificantly related with financial performance.
Kulal et al. (2023) investigated publicly-traded companies from India across several industries during the period 2018-2022. The independent variables were share prices and investment returns. They explored the impact of ESG score on independent variables, but also the effect of individual components of ESG on investment returns and share price. The results recommend that entities with strong ESG performance have a tendency to take higher share prices, respectively better investment performance in comparison with entities that show weak ESG performance.
Nițescu and Cristea (2020) analyzed the impact of ESG on Romanian financial banks performance. Their sample contains several top 12 commercial banks during the period 2007 – 2016. The independent variables used in their analyses were microeconomic variables (the number of members of management board, return on assets, loan-deposit ratio and leverage multiplier), but also macroeconomic variables to highlight the implementation of some principles regarding sustainability by banks (the growth rate of GDP, the inflation rate, respectively the unemployment rate). Furthermore, the authors consider the adoption of ESG strategy in the banking system as a dummy variable, that take the values zero for the years when there were any actions of ESG strategy adoption, otherwise it has the value one. The obtained results show a negative and significant impact of ESG adoption on return on assets and leverage ratio, while for the rest of the independent variables, the impact was insignificant. This means that if the value of these two indicators increases then the probability of implementing a
management strategy of ESG risks for the commercial bank decreases. Meanwhile, the impact of management board members has a positive, but insignificant effect on ESG

adoption. This can be explained that the introducing of ESG strategy in bank activity is influenced by the number of management boards. The macroeconomic variables had a negative and insignificant effect on ESG adoption; these results are not in line with that obtained in the American and Asian banks.
Sandberg et al. (2022) investigated the connection between the ESG ratings and financial performance during 2017 – 2020 on a sample of 83 entities from food sector. The employed financial performance measures were return on assets, respectively return on equity. The outcomes indicate a significant and positive but modest effect of ESG ratings on ROA and ROE ratio.
Alareeni and Hamdan (2020) studied the effect of ESG disclosure on entities' financial (ROE), operational (ROA) and market performance (Tobin's Q). The analysis contains a sample of 500 US listed entities from the S&P 500 in the period 2009 - 2018. The outcomes exposed that ESG disclosure affects positively an entities' performance measures. Moreover, when the ESG sub-components were separately analyzed, environmental and corporate social responsibility disclosure indicated a negative impact on ROA and ROE. While, there is a positive impact on Tobin's Q of environmental and corporate social responsibility. Furthermore, the ESG ratio and its components tend to be higher in the case of entities with a high level of financial leverage ratio, respectively big value of assets.
Maji and Lohia (2023) examine the effect of ESG sub-components performance on a sample of 222 Indian entities. The ESG ratios for Indian entities were chosen from the Credit Rating Information Services of India Limited (CRISIL) ESG score, respectively the economic data were selected from the ACE Equity database. The research showed that Indian entities were focused more on governance and social variables than on environmental ones. Furthermore, the outcomes indicated that between ESG performance, respectively its components was a positive relationship with firm performance.

2. Research methodology

There is a big question in the financial literature regarding the impact of ESG characteristics on stock performance. Therefore, many researchers are studying the relationship between firms and strong environmental, social and governance (ESG) features, respectively corporate financial performance. Furthermore, a major challenge consists in showing that the positive correlations — when they are produced — may explain the behaviour.
To analyze the impact of ESG scores on the performance of companies listed on the Bucharest Stock Exchange, we chose a sample of 21 companies for the year 2021, the data are annual and are taken from the Bucharest Stock Exchange and the Hub Research database. We analyzed the impact of ESG scores on economic return, financial return, earnings per share, respectively stock price return. To study the impact, we used simple regressions.

The regressions are presented below:

$$ROA = c_1 + c_2 * ESG + \varepsilon_t; \quad (1)$$
$$ROE = c_1 + c_2 * ESG + \varepsilon_t; \quad (2)$$
$$EPS = c_1 + c_2 * ESG + \varepsilon_t; \quad (3)$$
$$\text{PRICE} = c_1 + c_2 * ESG + \varepsilon_t \quad (4)$$

where:

ESG- Environmental, Social, and Governance score
ROA – return on assets
ROE – return on equity
EPS- earnings per share
Price-price share calculated as an annual increase
ε_t- residual value

3. Results and discussions

In general, ESG policy is a new topic for the business ecosystem, even for more developed economies than Romanian entities; these firms are still in a learning process, that is influenced by the degree of environment sophistication they are part of, which means investors.

Romania will need to align to the general dynamics, respectively the acceleration of the listing processes over the last four years does nothing but to grow the number of entities that want to integrate this new topic into the business process.

Environmental, social and governance aspects (ESG) may have a positive impact or a negative on households, and entities in general and on financial institutions - in particular.

Scientifically reports suggest that climate change and the environment degradation as well as the associated need for moving to a sustainable economy will lead to profound changes in the real economy which, in turn, will have an impact on the financial sector through new risks and opportunities.

In Figure 1, it is analyzed the impact of ESG on ROA, we found that the ESG score has a positive impact. This result is in line with that obtained in the financial literature, such as Sandberg et al. (2022).

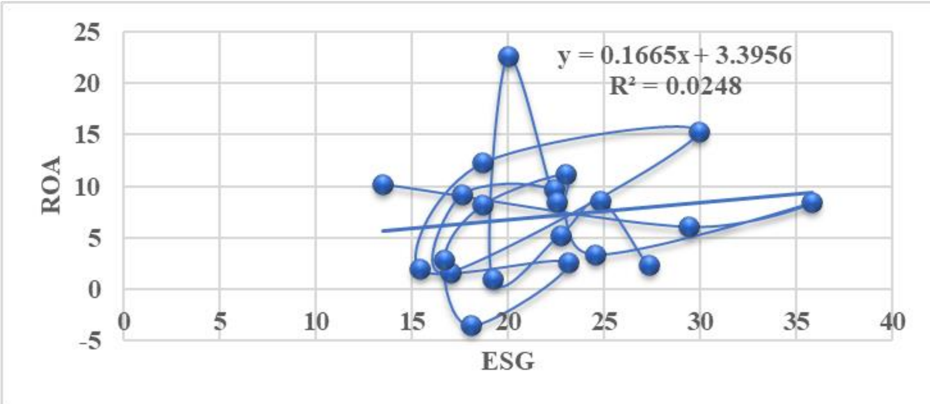

Figure no. 2 - Impact of ESG on ROA
Source: Own processing

In the second graph, we analyzed the impact of ESG on ROE, and here the impact is negative. In the financial literature, we also find researches with a negative impact, but in the case of the Romanian capital market, this result can be explained due to the fact that many entities have negative profits during the pandemic period. The same outcomes were obtained by Alareeni and Hamdan (2020), Makridou et al. (2023).

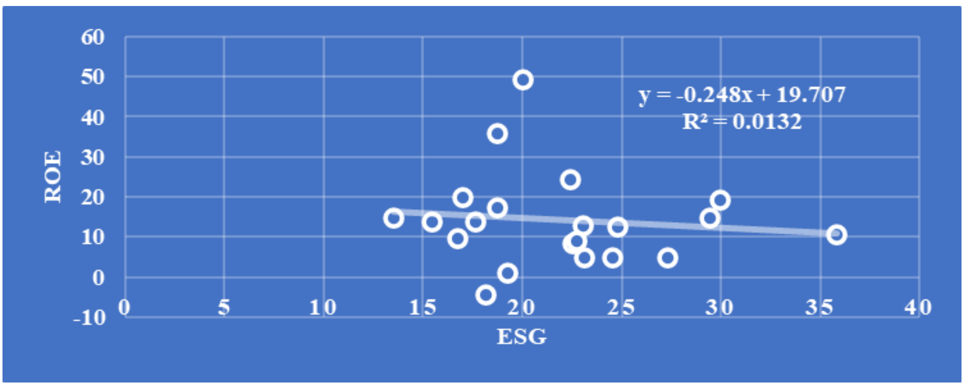

Figure no. 3 -Impact of ESG on ROE
Source: Own processing

In the third graph, we analyzed the impact of ESG on EPS and found that the impact is positive. This positive relationship means that the adoption of ESG regulations raises the shares' value.

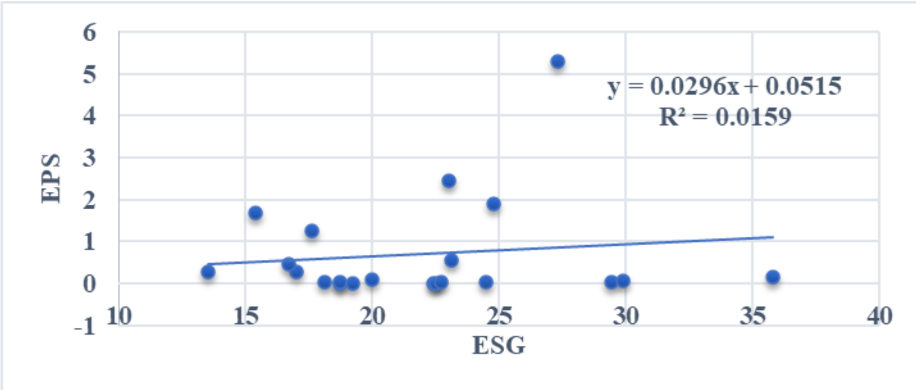

Figure no. 4 - Impact of ESG on EPS
Source: Own processing

In the fourth graph we analyzed the impact of ESG on PRICE and found that the impact is negative. This result is surprising us, because the entities that adopt ESG policies tend to be more attractive to investors. Maybe in our further research, when we include more periods, the impact will be different.

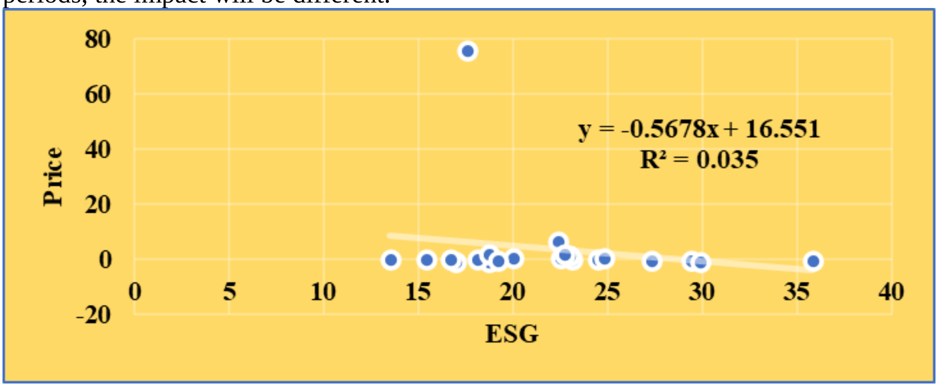

Figure no. 5 - Impact of ESG on price share
Source: Own processing

Conclusions

The applied implications of implementing ESG policies are important for policymakers, entities, respectively investors. Policymakers can have a significant role in encouraging the implementation of ESG practices over regulation and incentives.

The firms that have high levels of ESG performance can offer the best investment opportunities related to those entities with low levels of ESG performance. Furthermore, entities may take advantage of accepting ESG practices as they can lead to better financial performance, respectively increase the interest of investors. It is important for investors to consider ESG factors when they make investment decisions.

Future study may examine the effect of ESG factors on other features of entity performance, such as customer satisfaction, employee engagement, respectively innovation. Moreover, forthcoming research may analyze the impact of the ESG factors on the performance of different categories of investors, for example retail investors, institutional investors, or socially responsible investors.

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