

Correlation Between Financial Performance and ESG Performance

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Abstract

This paper investigates the relationship between ESG scores and financial performance metrics such as Return on Equity (ROE), Return on Assets (ROA), and Return on Investment (ROI). By leveraging a quantitative approach, the study explores the potential synergies and trade-offs between achieving high ESG scores and financial success. The analysis aims to uncover insights into whether superior ESG performance translates into enhanced financial outcomes across diverse industries.

Keywords: Correlation, Financial Performance, ESG Performance

1. Introduction

Over the past ten years, there has been a significant increase in the incorporation of Environmental, Social, and Governance (ESG) factors into company plans. Customers, regulators, and investors are among the stakeholders who are highlighting the significance of sustainable practices more and more. ESG performance has become a crucial indicator of a business's dedication to sustainability and moral behavior. A crucial query still needs to be answered, though: Is there a relationship between financial and ESG performance? For investors, legislators, and business executives looking to match environmental and financial objectives, the answer to this issue is crucial. This study examines the connection between financial performance indicators like return on equity (ROE), return on assets (ROA), and return on investment

(ROI) and ESG scores. Using a quantitative methodology, the paper investigates the possible trade-offs and synergies between reaching high.

2. Literature Review

Research on the relationship between ESG measures and financial performance has yielded conflicting results throughout the years. Variable connections between ESG performance and financial measures have been found in studies like those by Xiong et al. (2023); certain industries have a high positive association, while others show a neutral or even negative relationship. Through increased operational efficiencies, higher brand equity, and risk reduction, ESG elements have the potential to promote long-term value creation, according to a study published in *Frontiers in Environmental Science*.

In a similar vein, Bloomberg research emphasizes that firms with strong ESG profiles frequently draw higher investor valuations because of their perceived stability and forward-thinking tactics. ESG-aware businesses are becoming more and more regarded as safer investments, especially in uncertain economic times.

The sector-specific nature of the correlation is further highlighted by other studies, including those that have been published in ScienceDirect. For example, because they prioritize innovation, energy efficiency, and sustainability, technology companies with high ESG scores frequently exhibit higher ROE and ROI. On the other hand, because of their significant transition costs and operational limitations, resource-intensive industries like manufacturing and energy might find it difficult to match ESG performance with financial indicators. The literature also highlights how ESG reporting standards and measurement issues are dynamic. Comparisons between industries are frequently challenging due to the heterogeneity of ESG measures. However, future studies should become clearer due to the increased focus on sustainability reporting.

3. Hypothesis

Null Hypothesis (H0): There is no significant correlation between ESG performance and financial performance.

Alternative Hypothesis (H1): There is a significant correlation between ESG performance and financial performance.

This hypothesis serves as the foundation for examining whether higher ESG scores are associated with better financial outcomes.

4. Data Analysis

The analysis leverages ESG scores and financial performance metrics of 10 companies across diverse industries, including technology, consumer goods, and automotive sectors. The dataset includes key metrics such as ESG scores, ROE, ROA, and ROI for firms like Reliance Industrie, Tata Consultancy, HDFC Bank. Correlation coefficients were calculated to measure the strength and direction of relationships between ESG scores and financial metrics

Company Name	Sector Classification	ESG Score	RONW (%)	Debt Equity Ratio	EV/EBITDA
Reliance Industries	Oil & Gas	65	8.1	0.5	12.5
Tata Consultancy	Information Tech.	75	35.6	0.3	15.2
HDFC Bank	Financial Services	70	16.5	0.4	14.8
Maruti Suzuki	Automotive	60	12.3	0.6	10.3
Hindustan Unilever	Consumer Goods	72	80	0.2	18.1
Infosys	Information Tech.	74	25	0.8	11.7

ITC Limited	Consumer Goods	68	25	0.7	13.4
Larsen & Toubro	Construction	65	15	0.6	14
Mahindra & Mahindra	Automotive	63	14	0.4	9.6
Wipro	Information Tech.	70	17	0.3	12

The Return on Net Worth (RONW) has an average of 24.85%, with a median value of 16.75%. The highest RONW is 80.00%, while the lowest is 8.10%.

The Debt Equity Ratio averages at 0.48, with a median of 0.45. The maximum recorded ratio is 0.80, and the minimum is 0.20.

The EV/EBITDA ratio shows an average of 13.16, with a median of 12.95. The highest value is 18.10, while the lowest is 9.60. Overall Findings:

1. RONW (%):

The average Return on Net Worth (RONW) across companies is 24.85%, indicating healthy profitability relative to shareholders' equity.

However, the wide range (8.10% to 80.00%) suggests significant variation in financial performance among the companies analysed.

2. Debt Equity Ratio:

An average of 0.48 and a range from 0.20 to 0.80, the companies maintain relatively low leverage levels, which indicates controlled borrowing and financial stability.

The variability highlights differing risk appetites and capital structures among the firms.

3. EV/ EBITDA:

The average EV/EBITDA ratio of 13.16 reflects a fair valuation of companies, with most falling between 9.60 and 18.10.

The relatively narrow range suggests that companies are valued consistently based on their earnings before interest, taxes, depreciation, and amortization.

Conclusion

Financial Performance: Most companies demonstrate strong profitability, reasonable leverage, and stable valuations. However, the high variability in RONW highlights the need for sector-specific analysis to better understand performance differences.

Leverage: The debt levels are generally conservative, which is a positive indicator for long-term sustainability, though some companies might benefit from more optimal capital structuring.

Valuation: The consistent EV/EBITDA range indicates market confidence in these companies, with no extreme outliers or undervaluation.

Recommendations

1. For High RONW Companies:

Leverage their strong profitability to expand operations or reinvest in high-growth areas, ensuring continued shareholder value creation.

2. For Low RONW Companies:

Conduct a deep dive to identify inefficiencies and improve profitability through cost-cutting measures or revenue diversification.

3. Debt Management:

Companies with higher debt-equity ratios should focus on debt reduction strategies, such as improving operational efficiency or equity infusions, to lower financial risk.

4. Valuation Optimization:

Companies with lower EV/EBITDA should highlight their growth potential

and earnings stability to attract better market valuations.

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