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TRANSCRIPT

ESG Now Podcast

“Sustainability and the Cost of Capital”

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Bentley Kaplan

Hello, and welcome to the weekly edition of ESG Now, the show that explores how the environment, our society, and corporate governance affects and are affected by our economy. I'm Bentley Kaplan, your host for this episode.

On today's show, we are going to take a look at the relationship between how well companies are managing sustainability risks and their financial performance. Specifically, we'll look at whether there's any correlation between a company's MSCI ESG rating and its cost of capital, a financial metric that really matters for both companies and their investors. So thanks for sticking around. Let's do this.

When it comes to sustainability, investors might be coming from a range of different angles. We've spoken a lot about regulations and how that's requiring better disclosure from both companies and investors about their sustainability-related activities. We've also spoken about the impacts, both positive and negative, that companies or by proxy investments are having on society and the environment. But today we are looking at how sustainability relates specifically to financial performance. And I've got the guests to do just that. Jakub Malich out of MSCI's Hong Kong office and Anett Husi out of our Budapest office, have taken a look at the relationship between how well companies are managing sustainability-related risks and their cost of capital.

And cost of capital is an interesting metric. From a company's point of view, it's about how cheaply they can finance themselves, the cost of accessing debt or equity. It sets the minimum profit that they need to make from a project or venture. Lower cost of capital turns down the pressure dial on profit. For investors, cost of capital is one way of understanding opportunity costs, figuring out where to invest. Basically, an investment made into a company or project with a high cost of capital really needs to knock the lights out and turn a healthy profit if it's going to compete with an equivalent company or project that has a lower cost of capital. And as Jakub plainly put it, assuming that a company with good sustainability practices, as measured by an MSCI ESG rating, would have a low cost of capital is not unreasonable.

Jakub Malich

MSCI ESG ratings are designed to measure a company's exposure to and management of financially relevant or material risks related to environmental, social, and governance issues. So if these risks are indeed relevant for a company's financial performance, they inform the company's overall risk profile. And if that's so, which we test frequently, over and over again in many of our studies, this should also reflect in the relative ease with which they can access capital in the market, whether it's debt capital or equity.

Bentley Kaplan

Right. So financial relevance underpins the assessment that we make in our MSCI ESG rating. And a brief service announcement here, because there are all shapes and sizes of ESG ratings out there in the world. They use different approaches and look to measure different things. Why that is and what should be done about it, if anything, is probably the most epic sidebar that I can think of, and one that we are going to leave well enough alone.

So from here on out, just know that when we talk about ESG ratings, we're talking specifically about the MSCI ESG rating, a measure of how well a company is managing its financially relevant sustainability risks. And as Jakub muses out loud, better management of sustainability risks should make it easier for companies to access capital. And it's a theory that he and co-author Anett put to the test in a piece of research that they recently published. And the headline result of that research was pretty short and pretty sweet.

Jakub Malich

So the very simple and short answer would be yes, we found a significant negative correlation between MSCI ESG ratings and company's cost of capital. Of course, we didn't just want to scratch the surface, and we also examined what determines the cost of capital, which is the cost of equity and cost of debt. And we also examined these components separately.

Finally, because these numbers are largely driven by factors outside of the company's control, such as the local interest rates, the local equity market, or the local tax regime, we wanted to go one step further and look into the components or proxies for cost of equity and debt that are directly related to company's risk profile. So in this case, it was the stock beta for the cost of equity and the credit spreads in the bond market for the cost of debt; because these two are indeed driven by the company's own profile and not where the company is based. In the end, we examined all of these in a matrix or these measures for cost of capital, and we did find a significant relationship with our ratings, or better yet, I would say the information that is contained in our ratings.

Bentley Kaplan

Okay. So I'm just going to underline that for a second. Anett and Jakub found a significant, yay, negative correlation between a company's MSCI ESG rating and cost of capital. "Negative correlation" sounds like bad news, but it's not. Basically, as ESG scores went up, so cost of capital went down. The better your ESG score, the lower your cost of capital, at least on average. And as Jakub said, an ESG rating is a way to assess how well a company is managing its sustainability risks, broadly classified into environmental, social, and governance issues. And living in an abstract world, it seems relatively straightforward that this ESG rating would correlate with financial metrics.

In simple terms, the theory goes something like this. A company that is more sustainably managing its workforce or quality controls or data security or carbon emissions might also benefit from higher productivity, lower recall costs, fewer data breaches, and less disruption from a carbon transition than their competitors that aren't doing so. And those attributes could then in theory translate to higher revenue, bigger margins, and more hashtags with that sweet cheddar and dope Benjamins. And anecdotal examples of this type of relationship are easy to find, say single companies that had a big governance risk and were then found to have been violating emissions tests, or ones that had recurring gaps in quality checks and then saw a large proportion of their aircraft grounded for safety reasons.

And these single stories can be convincing, but to make a truly strong case, it really helps to have these stories sitting on a foundation of objective analyses, ones that include a much bigger array of data. And 15 or 20 years ago, figuring out how sustainability does or doesn't relate to financial performance wasn't always possible. But as data sets have grown, not only in terms of the companies they cover, but also their duration, there has been a lot more to analyze.

In Anett and Jakub's analysis, they looked at nearly a decade of sustainability data between 2015 and 2024, covering more than 4,000 global companies, those that were part of the MSCI ACWI Index. This analysis is just part of a growing body of work that looks at the relationship between sustainability and financial performance.

Now, fight me on this if you want, but the fountainhead of this work is a paper written in 2019 by my colleagues Guido Giese, Linda-Eling Lee, Dimitris Melas, and Laura Nishikawa, called The Foundations of ESG Investing. In addition to showing that higher ESG ratings correlated with better financial performance, the authors also laid

out a theoretical framework for the transmission channels of company valuation and performance in a standard discounted cashflow model. Basically how sustainability fits into financial performance.

Since then, work has been ongoing to understand not only whether these ESG scores correlated with financial performance, but how. Now in addition to using large samples, Anett told me that a key part of this type of work, this research of analyzing correlations in this case between the cost of capital and ESG scores, is about controlling for variables.

Anett Husi

This was a crucial step to prove that the results we saw were not caused by any noise in the data or any unrevealed relationships. It can happen that when we are examining two factors we see very high correlation, but it is caused by a third factor which we didn't even include in the analysis. Imagine for example, trying to prove that eating ice cream causes sunburns without controlling for any other variables. There, we would probably conclude that ice cream is a huge risk, when in reality people just eat more ice cream on sunny days. And well, exposure to sun is the real risk here.

So to avoid such false results, we control for potential influential factors revealed in previous research, for example, economic sector, which can be a key risk and return driver and mean different financing habits, or a home market to see whether results hold even when accessing same source of capital and the basic conditions like interest rates, for example. And for the debt space, credit quality might be the most influential characteristic as well as the currency the bonds were denominated in. And while we saw that even after controlling for all these variables, higher rated companies seemed to enjoy lower cost of capital with very few exceptions detailed in the paper.

Bentley Kaplan

Right. So even when Anett and Jakub controlled for the sector a company is in, or whether it was in a developed or emerging market, or if its bonds were classified as investment grade or high-yield, the relationship held. Companies with a higher ESG rating tended to have a lower cost of capital.

In the final part of this episode, I wanted to look at the MSCI ESG rating itself. We've already touched on its intent to signal financially relevant sustainability risks. It's also worth mentioning that it's an aggregate score, built up by three distinct pillars: environmental, social, and governance.

But we can go even further, because each of these three pillars is made up of individual Key Issues that signal very specific risk areas within each pillar. And investors that see correlation between cost of capital and an aggregate ESG score might want to look a little deeper to see if individual pillars or even individual Key Issues showed a stronger relationship to the cost of capital than the ESG score in aggregate. Put more simply, maybe the links between cost of capital and the way a company manages say its environmental risks is stronger than the way it collectively manages its environmental, social, and governance risks. And it's a question that Jakub and Anett were also interested in answering.

Jakub Malich

I think it's reasonable to expect that perhaps investors or capital providers may focus on some of the say, most prominent risk profile drivers in the different industry. And we would therefore expect also to see a higher correlation perhaps between these most relevant risk drivers and the company's cost of capital.
So to give you an example, what to imagine under this, perhaps for some of the companies whose business may be more taxing on the environment, you can intuitively think about the energy sector, perhaps material sectors, utilities, and on. We would perhaps expect to see the highest correlation with the environmental pillar, right? So the better the companies are doing there, perhaps the lower their cost of capital. Same for industries that have

maybe big social impact. You can imagine perhaps healthcare, media companies, and so on. We would again, perhaps expect to see the highest correlation with our social pillar assessment.

So this is indeed what we tested. And we also looked at a few examples from different industries which are relatively homogeneous, so we would really expect this key risk to drive their cost of capital. So to maybe name a few, we looked at the oil and gas industry, and we saw that indeed the highest correlation was between the cost of capital and their Carbon Emissions Key Issue.

And of course, there were also some industries where perhaps this intuitive relationship didn't hold, or at least not as expected. Maybe for it I would mention the utilities sector. So for utilities, we actually saw the highest correlation with our cost of capital with our governance pillar assessment, not the environmental pillar assessment. So of course, at least for me, that would be surprising on the first glance. On the second, and of course we need to dig much deeper and do a proper analysis on this, but I would say that perhaps for utilities, this industry is very tightly regulated, right? There is a relatively strong government influence in this sector. So perhaps also investors may be paying more attention to the governance pillar and the risks contained within the governance assessment. So I think it's always important, as you mentioned, not look at maybe just one score and not know what is the score really measuring, but to maybe dig a little deeper or look under the hood and see the individual risk drivers within the assessment and see which are the most or least related to the results that we have seen.

Bentley Kaplan

Right. So in a few cases, yes, the specific areas where a sector or an industry faced the most risk, say the Carbon Emissions Key Issue for integrated oil and gas companies, were better correlated with their cost of capital than their overall ESG score. But these cases were actually the exceptions. For the most part, these components were not better correlated with the cost of capital than an aggregate ESG score. As Jakub stressed in a longer conversation, the MSCI ESG ratings model is very carefully constructed to include only financially relevant Key Issues, weighted differently depending on the industry. And it's this careful selection that might be the reason why the overall ESG score shows a better relationship with cost of capital than individual components.

Anett and Jakub are not nearly done, they told me. Their results are interesting and compelling, but this is just another chapter in a longer story as more data becomes available and company disclosure improves and investor interest grows. And for researchers like these two, getting under the hood to better understand the relationship between sustainability and financial performance is what gets them out of bed in the morning. Well, that, and eating ice cream in the sunshine.

And that is it for the week. A massive thanks to Jakub and Anett for spending time with me and explaining, with patience, a lot more of their work than we were able to share here. Thank you very much for tuning in. If you like what we're doing, then let us know. Drop us a review, rate the show on your platform of choice, and tell a friend or a colleague about this episode. Thanks again, and until next time, take care of yourself and those around you.

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