Short-run and long-run effects of ESG policies on value creation and the cost of equity of firms

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Abstract

Despite the general trend to include ESG indicators to evaluate firm performance and value creation, the effect of such policies on the market value of companies is currently the subject debate. In this paper we propose a dynamic version of Ohlson's model under time-varying discount rates consistent with the Campbell-Shiller present value identity, in order to differentiate between short term and long term implications of ESG performance on value creation, as well as income and substitution effects. Our results suggest that, although ESG policies imply almost no effects in the short-run, at longer horizons, better ESG performance results in a smaller difference between market value and book value, mainly due to substitution effects channeled to market value via higher long-term discount rates. Our results are consistent with ESG strategies implying transitory effects on the cost of equity and the market value of firms, which may result from time-varying investor preferences, long-term reputational penalties, or short-term market misvaluation, among other factors.

Keywords: ESG; CSR; Corporate governance; Value creation; Cost of equity; Dynamic Ohlson Model