Bhutan Conference on Green Bond Issuance

Session 3: Desirable Policy Framework to Facilitate the Development of Capital Markets

Topic: Valuation Effect of Sustainability and Environmental Disclosure

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The Lesson

- ✓ The purpose of this research presentation is to introduce academic research evidence on the valuation effect of sustainability and environmental disclosure.
- ✓ Based on research papers examining US and other international data, we conclude that there is obvious ***financial benefit*** in terms of ***higher stock price, lower risk, and suffering less stock price decline from negative news*** when companies and institutions ***disclose more sustainability and environmental information*** to the public and investors.

Story

- We explore the value enhancement or strategic benefits of better sustainability and environmental disclosure.
- Growing awareness of ESG has led to increased demands by investors for firms to provide additional information about their strategy or performance in ESG.
- On one hand, when outside shareholders' information availability is low, a new disclosure about company ESG activities should elicit more price response as traders look to benefit from the heretofore private information.
- Increased voluntary disclosures in ESG can reduce information asymmetry, increased awareness of a firm's existence and enlarging the investor base, or increased liquidity, which at last can decrease cost of equity.
- Besides, firms with 'good news' concerning ESG would have more incentives to disclose ESG than firms with "bad news'. Therefore, investors may interpret such disclosure as a positive signal concerning the firm's exposure to ESG, which can reduce firm's regulatory costs.

Story-Cont.

- On the other hand, These disclosures provide information about practices related to protecting the environment that could reduce government regulation and the resulting compliance costs, potential litigation, and/or pollution remediation costs.
- Disclosures related to these issues inform stakeholders (beyond investors) who opt to partner with, patronize, or work for environmentally responsible firms, which leads to superior sales and financial performance.
- Furthermore, sustainability reporting can generate other strategic benefits including protecting and enhancing firm's reputation, attraction and retention of high-caliber employees, etc., which shareholders would interpret as leading to increased long-term value for the firm.

Research Evidence 1: Value enhancement of better sustainability and environmental disclosure

- Anderson and Frankle (1980) examine market reactions at the time of annual report issuance controlling for differences in firm-specific market risk based on a sample of 201 disclosing firms and 113 non-disclosing firms in 1972 drawn from the Ernst & Whinney surveys. They find:
  - ✓ significant positive market reactions for CSR disclosing companies vis-à-vis non-disclosing counterparts.
  - ✓ disclosure of social information can increase the firm's stock price, suggesting that such disclosures have information content.
- Guidry and Patten (2010) examines reactions at the time of 37 press releases announcing the first-time issuance of stand-alone CSR reports from the Academic Universe Lexis-Nexis database over the years 2001-2008. They find:
  - ✓ positive market reactions over a three-day event period centered on the press release date, but only for firms with higher quality reports.

Research Evidence 1: Value enhancement of better sustainability and environmental disclosure

- Griffin and Sun (2013) examine shareholders' response to a unique set of 575 release about climate change made by US companies through the Corporate Social Responsibility newswire service (CSRwire) over 2000 through 2010. They find:
  - ✓ Managers' disclosure decisions involving greenhouse gas emissions produce positive returns to shareholders.
  - ✓ The sample of disclosing companies received an aggregate market value boost from their CSR news releases of approximately ten billion dollars, independent of differences in public information availability.
- Plumlee et al. (2015) examine the relationship between the quality of a firm's voluntary environmental disclosures and firm value using US listed firms drawn from five industries (oil & gas, chemical, food/beverage, pharmaceutical, and electric utilities) over 2000 to 2005. They find:
  - ✓ positive disclosure quality is significantly positively associated with firm value.

Research Evidence 1: Value enhancement of better sustainability and environmental disclosure

- Cahan et al. (2016) examines the valuation implications of CSR disclosures and the relation between CSR disclosures and firm value varies across 22 countries (2170 firms) assessed by KPMG in 2008 for CSR disclosures. They find:
  - ✓ a positive relation between unexpected CSR disclosure and firm value (Tobin's Q).
  - ✓ while countries with strong nation-level institutions promote more CSR disclosures, the valuation of a unit increase in unexpected CSR disclosures is higher when nation-level institutions are weak.
- Du et al. (2017) examine the short- and long-term investor reactions to sustainability reporting of Fortune 500 companies in the period 2005-2011. They find:
  - ✓ the impact of such sustainability reporting on stock prices occurs not just in the short run but also in the longer run, producing higher value relevance (i.e., the extent to which stock prices are associated with sustainability performance) of sustainability performance for firms that release sustainability reports.

Research Evidence 2: Other strategic benefits of better sustainability and environmental disclosure

- Blacconiere and Pattern (1994) examine the five-day window market reaction of 47 chemical firms other than Union Carbide to Union Carbide’s chemical leak in Bhopal, India during December 1984 which resulted in approximately 4,000 deaths and 200,000 injuries. They find:
  - ✓ a significant negative intra-industry reaction occurred.
  - ✓ however, firms with more extensive environmental disclosures in their financial report prior to the chemical leak experienced a less negative reaction than firms with less extensive disclosures.
  - ✓ investors interpreted such disclosures as a positive sign of the firm managing its exposure to future regulatory costs.

Research Evidence 2: Other strategic benefits of better sustainability and environmental disclosure

- Cormier, Ledoux and Magnan (2011) investigate how social and environmental disclosure affects information asymmetry on stock markets using 137 non-financial firms with web disclosure on the Toronto Stock Exchange S&P/TSX Index in 2005. They find:
  - ✓ Social disclosure and environmental disclosure substitute each other in reducing stock market asymmetry, as proxied by share price volatility and bid-ask spread.
  - ✓ Stakeholders must assess and retain an increasing flow of information: a more efficient disclosure strategy becomes critical if firms want to convey the right picture of their CSR performance.

Research Evidence 2: Other strategic benefits of better sustainability and environmental disclosure

- Plumlee et al. (2015) examine the relationship between the quality of a firm's voluntary environmental disclosures and components of firm value (expected future cash flows and cost of equity) using US listed firms drawn from five industries (oil & gas, chemical, food/beverage, pharmaceutical, and electric utilities) over 2000 to 2005. They find:
  - ✓ higher quality disclosures that are classified as soft and positive are positively associated with expected future cash flows.
  - ✓ higher quality disclosures that are classified as soft/positive are negatively associated with cost of equity.

Conclusion

- ✓ Sustainability and Environmental Disclosure can enhance firm's value and provide firm strategic benefits, including reduction in information asymmetry and cost of equity.
- ✓ Therefore if Bhutan will encourage voluntary disclosure on sustainability and environmental, capital market will become more efficient.

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