

CHAPTER I

INTRODUCTION

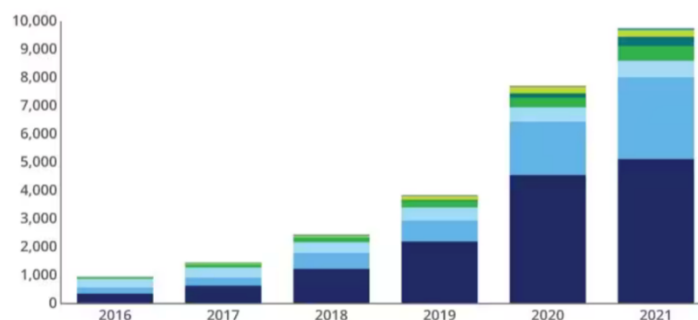
1.1 Background

Sustainability was once a topic seen as a project meant for only a group of people, such as environmentalists and development specialists, but has now grown to be a board-level priority topic in business, as investors tend to prioritize companies that seem to act sustainably (Beatty, 2022). The trend, as seen in Figure 1.1, is happening due to a large amount of environmental and social issues in the global community, such as social injustice, unfair wealth distribution, failing economies, war and hostilities, gender inequality, a lack of education, widespread poverty, changing climate, habitat loss, extinction of species, ecological degradation, and a host of other issues which are just a few, that can be reduced if companies began to do business sustainably (Chungyalpa, 2021).

ESG-aligned funds have seen strong growth across all 13F filings since 2016

Total number of ESG funds in 13F filings

■ General ESG ■ Renewables ■ Water ■ Climate-focused ■ Electric vehicles
■ Religious values ■ Gender equity ■ Empowerment ■ Impact



Note: 2021 as of September 30, all other years as of December 31.

Figure 1.1 Sustainability trend in investment (Taylor & Collins, 2022)

According to Bergquist (2017), the problem of sustainability started centuries ago, during the Industrial Revolution era, when companies already discovered technology that uses natural resources for energy and raw materials. In the nineteenth century, a group of entrepreneurs began to do green business practices, challenging the conventional way, which has become the foundation for sustainable business in the next era. However, the twentieth century has the most significant rise in energy use (Figure 1.2), depletion of natural resources, and global environmental sustainability problems in general compared to the previous centuries (Soluri, 2002). In 1989, the first sustainable report from the company was published, leading to more companies disclosing their sustainable business practices despite having no guidelines for the writing (Kolk, 2004).

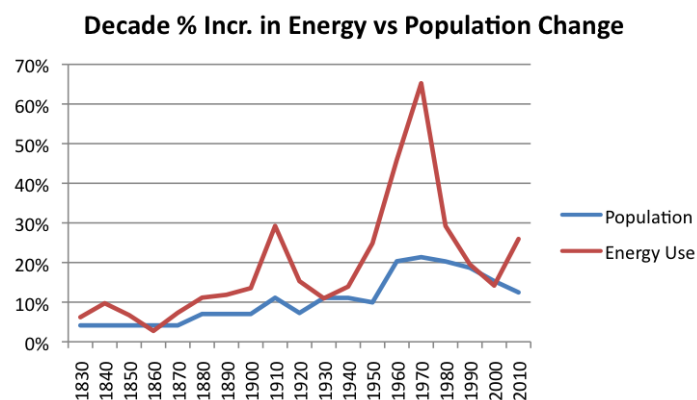


Figure 1.2 The rise of energy use in the 20th century (Tveberg, 2012)

Continuing the trend, Elkington (1997) introduced the term “Triple Bottom Line ” as a new way of doing business. It refers to the understanding that a business can only sustain itself when it takes into account three main drivers: profit, people, and planet. The factors are also known as economic, social, and environmental aspects in the current era. In 1997, a project department called the Global Reporting Initiative (GRI) was created by the Coalition for Environmentally Responsible

Economies (CERES) with the main purpose of creating a sustainability reporting framework for companies. The Triple Bottom Line as a basis is still used up to this day, and is continued to be redefined and made detailed, as seen in Figure 1.3.



Figure 1.3 Triple Bottom Line framework (Dalibozhko & Krakovetskaya, 2018)

A Memorandum of Understanding (MoU) between GRI and UN Global Compact was signed in 2010, marking the recognition of GRI guidelines as a basis for sustainability reporting. Along with the growth of business scene, numerous social and environmental issues still occurring, leading to the birth of the Millennium Development Goals (MDGs) in 2000, which consisted of a series of targets to tackle both issues in a span of 15 years. The success of MDGs leads to United Nations' Sustainable Development Goals (SDGs), a more comprehensive and global target to be achieved by 2030. These goals have become the reputable and practical foundation for companies to do Corporate Social Responsibility (CSR) and categorize it in their sustainability report.

Numerous reporting standards and frameworks other than GRI have also been developed in the current century, such as: Task Force on Climate-related

Financial Disclosures (TFCD), Carbon Disclosure Project (CDP), International Integrated Reporting Council (IIRC), Sustainability Accounting Standards Board (SASB), International Organization for Standardization 26000 (ISO26000) which all will complements and consolidated in the International Sustainability Standard Board (ISSB) (H. Liang, Sustainable Finance class, 2023), that is expected to be the global baseline for Sustainability Reporting.

However, the wide variety of reporting styles from a non-financial perspective of the company would increase the possibility of anchoring biased judgment to happen, and a non-apple-to-apple comparison of companies within the same industries. To tackle the issue, the International Integrated Reporting Council released an Integrated Reporting (<IR>) Framework, where sustainability reports and financial reports of a company are not standalone anymore, but consolidated into one single report, with the hope of avoiding biased and distorted valuations.

In 2020, over 40 stock exchanges around the world have referred to <IR> as guidance for public-listed companies. Although not all countries adopt the framework, a handful of countries have obliged the companies listed in their stock exchange to do Environmental, Social, and Governance (ESG) or Sustainability Reporting to catalyze the transformation to be a greener company and help investors make informed and sustainable investment decisions. The way to reduce biases and subjectivity in analyzing a sustainability report is by creating an ESG Scoring procedure, which is made by various rating agencies and perceived differently by different investors. Some of the most well-known scorings are Refinitiv ESG

Scores, Sustainalytics ESG Score, and Morgan Stanley Capital International ESG

Scores, which each have their criteria to measure company performance on ESG.

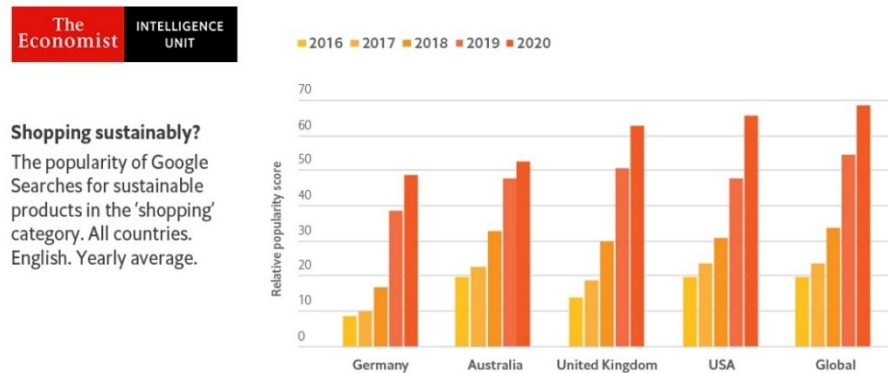


Figure 1.4 Growing demand for sustainable products (Bonini, 2021)

The COVID-19 pandemic has transformed a lot of things in the world, and in terms of sustainability, the event raises people's awareness towards sustainability, specifically in terms of production and consumption. Due to the growing demand from customers that choose products manufactured sustainably (Figure 1.4), more companies are paying attention to its practices to drive higher sales, which leads more investors to choose companies with good ESG practices, proven by the fact that 79% of APAC investors increased their ESG investments by Q3 2020 (PwC, 2021). Moreover, some investors are not going to invest in companies with bad ESG practices. This type of investment is often called Sustainable and Responsible Investment (SRI), and as of today, numerous stock exchanges around the world have an SRI index, like Dow Jones Sustainability World Index, Ethical Europe Equity Index, and S&P ESG India Index, for instance. Moreover, a survey from Mambu has found that more than 50% of customers, especially Millennials and Gen Z, are willing to boycott a non-sustainable brand, with 60% of them preferring to use sustainable brand products.

The Indonesia Stock Exchange (IDX) is currently partnering with Morningstar Sustainalytics to disclose the ESG ratings of listed companies, and with Keanekaragaman Hayati Indonesia Foundation (KEHATI) to release the SRI-KEHATI Index, consisting of the top twenty-five companies with the best environmental, community, corporate governance, human rights, business behavior, labor practices and decent work aside from financial aspects like total assets, price to earnings ratio, and free float ratio. The index indicates that the listed companies obtain higher ESG scores than those not included, based on the Kehati Foundation assessment.

Companies listed in the SRI-KEHATI Index must have capital of at least IDR 1 trillion and have a competitive advantage due to their ESG practices. However, with the significant change of trend in the business and investment scene, where sustainable business and investment are becoming more conventional, and just “the standard way of doing business”, would companies with higher ESG scores still perform better? This study will do research on the comparison between the impact of ESG score on company performance, before and during the COVID-19 pandemic.

1.2 Problem Identification

Ideally, companies with higher ESG ratings, such as those included in the SRI-KEHATI Index list, are deemed to be more sustainable and resilient, hence resulting in higher company performance in normal conditions. But in reality, companies that did not comply with some sustainability points, like those in the tobacco industry,

for instance, were still performing just as well. A study by Bansal et al. (2021) has shown that there have been inconsistent results on the impact of ESG ratings on company performance, creating confusion and uncertainty for both companies and investors. Additionally, it could weaken the drive of companies, including banks with higher ESG ratings to keep on doing business sustainably due to the lack of benefits they received, which is a serious issue that hampers Indonesia's transformation toward a greener economy and its contribution for SDGs.

As the COVID-19 pandemic hit, people started to pay more attention to ESG and sustainability, which should have strengthened the impact of ESG rating on company performance. However, there is a lack of empirical evidence on the significance of the impact before and during the COVID-19 pandemic period. Therefore, this study aims to assess the impact of ESG ratings on company performance of SRI-KEHATI Index-listed companies, for the period of before and during the COVID-19 pandemic.

1.3 Research Questions

This research aims to answer the following questions:

1. Does ESG score affect the fundamental performance of SRI-KEHATI Index-listed companies before and during the COVID-19 pandemic?
2. Does ESG score affect the market performance of SRI-KEHATI Index-listed companies before and during the COVID-19 pandemic?

1.4 Research Objectives

The purpose of this research is to compare the impact of ESG scores on company performance on SRI-KEHATI Index-listed companies before and during the COVID-19 pandemic, to be used as an evaluation tool for companies for future ESG implementation planning and strategy without sacrificing the fundamental and market performance. The objectives of this research are as follows:

1. To examine the impact of ESG score on the fundamental performance of SRI-KEHATI Index-listed companies before and during the COVID-19 pandemic.
2. To examine the impact of ESG score on the market performance of SRI-KEHATI Index-listed companies before and during the COVID-19 pandemic.

1.5 Benefit of the Research

1. For companies: This research helps companies to identify the impact of ESG scores on company performance, so companies can develop better ESG strategies to improve their company performance in the future.
2. For investors: This research can be used as a consideration of whether to invest in companies with higher ESG scores or not based on its company performance.
3. For readers: This research gives insights about the comparison of the impact of ESG score on company performance before and during the COVID-19 pandemic as a reference for future study or investment.

1.6 Scope and Limitations of the Research

The scope of this study will focus on the impact of ESG score on company performance of SRI-KEHATI Index-listed companies before and during the COVID-19 pandemic. The study will specifically observe companies that have at least listed in the Index four times during the pre-pandemic era (2017-2019) and pandemic era (2020-2022).

1.7 Writing Framework

This paper is structured as follows: Chapter 1 provides an introduction that consists of background, problem identification, research questions, purpose and objectives, benefit, contribution, scope and limitations, and writing framework. Chapter 2 gives information about theory, literature review, and hypothesis development. Chapter 3 provides the research design, operational definition of variables, population and samples, research instruments, data collection, and analysis methods. Chapter 4 discusses the data description, hypothesis testing, and research results. In the end, Chapter 5 gives conclusions, limitations, and implications of the research.