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Competitive Advantage in Moderating the Three Pillars of ESG on Firm Value

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ABSTRACT

The increasing interest of international and domestic investors in recent years has driven investment in environmental, social, and governance (ESG) to become highly attractive The purpose of this research is to examine the performance of environmental, social, and governance (ESG) on the value of companies listed in Indonesia Stock Exchange which competitive advantage as moderating variables. This study employs a quantitative approach using combined time series and cross-sectional data (panel data). The population of this study comprises companies listed on the Indonesia Stock Exchange that have an ESG disclosure score on Bloomberg for the period 2018-2022. The sampling technique used in this research is purposive sampling. The result showed that the implementation of ESG by companies listed on the Indonesia Stock Exchange is still low for environmental and social aspects, whereas corporate governance aspects have been well-implemented, as reflected in relatively high governance scores. Empirically, there is no significant evidence that ESG affects firm value. The low environmental and social performance causes investors to pay less attention, so these factors are not considered in investment decision-making. Competitive advantage can moderate the influence of environmental performance on firm value, indicating that only companies with competitive advantage can enhance the role of environmental performance on firm value

Keywords: Competitive Advantage, Corporate Finance and Governance, Environmental, Social, and Governance, Value of Firms
JEL Classifications: G32, 016

1. INTRODUCTION

The term ESG first appeared in the "Who Cares Wins: Connecting Financial Markets to a Changing World" report by the UN Global Compact in 2004 (The Global Compact 2004). The purpose of the report was to integrate ESG criteria into the financial sector, providing recommendations and guidelines for incorporating ESG-related risks and opportunities into investment analysis and financial markets. Therefore, it is important for the government to support the implementation of ESG so that companies can engage in providing benefits to their business value chain and shareholders.

The Quality of ESG is considered a risk indicator, previous research shows that investors value companies that report ESG well. According to Mohammad and Wasiuzzaman (2021) stated that if a company does not disclose ESG, it can lead to poor investments in high-risk sectors that have the potential to harm the environment or discriminate against employees. However, if ESG is integrated into a company's investment decisions, investors will be better able to make choices based on overall performance, not just financial performance. Nelson (2017) found that integrating ESG as one of the investment decision-making factors for companies with competitive advantages will result in lower investment risks, better governance, and the ability to increase company engagement in good social and environmental practices. However, on the other hand, Porterm et al. (2019) argues that ESG disclosure is only intended to enhance the company's acceptance and reputation among investors. Additionally, some companies use ESG disclosure as a means to reduce regulatory restrictions on their investment portfolios.

Studies in developed countries have found that ESG disclosure and performance correlate well due to lower information risks associated with greater ESG disclosure Wu et al. (2022). Several previous studies state that the market reacts positively to positive ESG news; in this case, ESG investment can improve managed portfolio performance, reduce portfolio risk, and increase stock returns (Serafeim and Yoon, 2022); (Li et al., 2022). Furthermore, ESG practices can be used as a risk management tool to enhance stock price resilience, especially in turbulent times. Research results Luo (2022) mention that ESG is only significant for low-liquidity stocks but not significant for high-liquidity stocks, indicating that the effect of ESG on stock returns is related to liquidity. Thus, ESG has practical implications for investor decision-making.

Additionally, Eliwa et al. (2021) found that based on a sample of companies from 15 EU countries, lending institutions appreciate companies' efforts in disclosing ESG and reward them with lower debt costs. To gain long-term competitive advantage, Cai and He (2014) found a positive correlation between corporate environmental responsibility and long-term stock returns. ESG disclosure will encourage companies to actively engage in and enhance their credibility and ability to achieve superior performance compared to their competitors in highly competitive developed markets. These findings are confirmed by Lubis and Rokhim (2021), stating that when competitive advantage is linked to ESG disclosure, competitive advantage has a positive relationship with ESG disclosure, although the results are not significant.

Several studies state that after integrating ESG factors into company valuation and investment decisions, there is a significant increase in premiums and equity value (Nelson, 2017; Schramade, 2016; Jasni et al., 2020). If companies do not realize the synergy of ESG efforts and how these efforts create value for the company, ESG implementation aimed solely at lowering borrowing costs may not be sustainable. This is because ESG disclosure activities heavily depend on the company's resources, so the company's competitive advantage can influence ESG disclosure to reduce information asymmetry, which in turn reduces investment decisions made by investors (Mohammad and Wasiuzzaman, 2021).

Murphy and McGrath (2013) also argues that companies, especially those in "sensitive" industries, are motivated to make corporate ESG reports to avoid civil lawsuits rather than to genuinely improve ESG adoption. In fact, Dhaliwal et al. (2011) found that companies with high equity capital costs in the previous year tend to disclose social activities in the current year to obtain lower funding in the following year.

Based on the above background, ESG has shown promising results, but there is not much research focusing on the relationship between ESG and a company's competitive advantage. This is because ESG disclosure activities heavily depend on the company's resources, so the company's competitive advantage can influence ESG disclosure to reduce information asymmetry, which in turn support investment decisions made by investors. This research aims to confirm the results of previous research which has not provided strong evidence regarding competitive advantage as a variable that plays a role in improving company performance. This study offers originality by measuring the performance of the three ESG pillars environmental, social, and governance performance-on firm value, with competitive as moderating variables. This study refers to the stakeholder theory, legitimation theory and resource-based view. Resource based view (RBV), which posits that a company must have valuable, rare, and tricky resources to substitute. The RBV views ESG disclosure as a company resource that can create a competitive advantage.

2. LITERATURE REVIEW

2.1. The Environmental Performance on Firm Value

In the context of agency theory (Jensen and Meckling, 1976), there is a potential conflict of interest between company owners and managers. Owners aim to maximize firm value, while managers may focus more on personal or short-term goals. Strong environmental performance can indicate that managers are wisely managing the company's resources, thereby increasing owners' trust. Companies committed to good environmental performance tend to be more transparent in their reporting (Wu et al., 2022). Clear and accountable reporting can reduce information asymmetry between owners and managers, aligning with agency theory.

2.2. The Social Performance on Firm Value

Good social performance, such as corporate social responsibility (CSR), can enhance trust among stakeholders, including customers, employees, and society (Kalia and Aggarwal, 2022). In the context of agency theory, increased trust can reduce conflicts of interest and strengthen the relationship between owners and managers, ultimately leading to an increase in firm value (Aryonanto and Dewayanto, 2022). Companies committed to strong social performance tend to be more resilient to social and reputational risks. According to agency theory, mitigating these risks benefits owners by protecting firm value from potential crises caused by poor or controversial social actions.

2.3. The Governance Performance on Firm Value

Good governance performance helps reduce conflicts of interest between owners and managers. With a clear governance structure and effective oversight mechanisms, managers are more likely to act in the owners' best interests, which can enhance firm value (Melinda and Wardhani, 2020). Good governance increases transparency in decision-making and managerial accountability. Agency theory suggests that transparency reduces information asymmetry between owners and managers, ensuring that decisions align with the owners' interests, ultimately enhancing firm value (Seker and Sengür, 2021).

2.4. Competitive Advantage Mediating the Relationship between Environmental Performance and Firm Value

Strong environmental performance often enhances a company's reputation among stakeholders, including customers, investors, and society. According to agency theory, a positive reputation can reduce conflicts of interest and improve trust between owners and managers (Donaldson and Davis, 1991; Jensen and Meckling, 1976). With a strong reputation, companies can establish a competitive advantage, leading to increased firm value. Moreover, strong environmental performance attracts investors who prioritize sustainability in their investment decisions (Yu et al., 2024). By securing investor support, companies can gain access to additional capital and resources for innovation and development, further strengthening their competitive advantage and enhancing firm value (Setiany et al., 2023).

2.5. Competitive Advantage Mediating the Relationship between Social Performance and Firm Value

Good social performance, such as CSR, enhances the company's reputation among stakeholders. Agency theory suggests that a strong reputation can reduce conflicts of interest and improve trust between owners and managers. A positive reputation creates a competitive advantage, ultimately increasing firm value (Gatzert, 2015; Setiany et al., 2023). Additionally, good social performance fosters positive relationships with stakeholders, including local communities and non-governmental organizations (NGOs). These relationships can create synergies that strengthen the company's competitive position in the market and risk management reporting depend not only on the amount of information provided but also on the quality of disclosure (Hidayah et al., 2024; Yawika and Handayani, 2019). Agency theory supports the idea that effective collaboration reduces conflicts and benefits the owners (Liu and Song, 2007).

2.6. Competitive Advantage Mediating the Relationship between Governance Performance and Firm Value

Good governance performance includes effective risk management, covering legal, reputational, and operational risks (Alam and Ali Shah, 2013). Well-managed risks help the company avoid losses that could negatively impact firm value. Agency theory emphasizes that efficient risk management by managers creates value for owners and provides a competitive advantage (Mahmod et al., 2018).

3. METHODOLOGY

This study employs a quantitative approach, the data collection technique used being secondary data collection, and the research framework was presented in Figure 1.

Based on research framework and referencing the perspectives of stakeholder theory and legitimacy theory and RBV the hypotheses are formulated as follows:

H_1: Environmental performance has a positive effect on corporate value.

H_2: Social performance has a positive effect on corporate value.

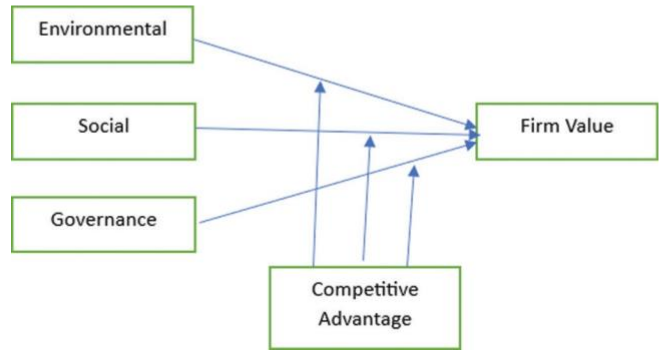
H_3: Governance performance has a positive effect on corporate value.

H_4: Competitive advantage positively moderates the effect of environmental performance on corporate value.

H_5: Competitive advantage positively moderates the effect of social performance on corporate value.

H_6: Competitive advantage positively moderates the effect of governance performance on corporate value

Figure 1: Research framework



3.1. Population and Sampling

The population of this research comprises companies that have ESG reports and are listed on the Indonesia Stock Exchange (IDX). The sample includes companies listed on the IDX that have ESG performance data for the period 2018-2022, obtained from Bloomberg data. The sampling technique used in this study is purposive sampling, where the samples are selected based on the suitability of characteristics with predetermined criteria to obtain a representative sample. Based on the number of samples, there are 64 companies which have ESG performance data, resulting in 320 observable data points. The sampling criteria used are:

1. Companies listed on the IDX during the observation period 2018-2022
2. Companies ESG element score was available in Bloomberg data source during the observation period 2018-2022.

3.2. Variables

The variables in this study consist of independent variable, which are environmental performance, social performance and governance performance; moderating variable was competitive advantage and dependent variable was firms value. The following Table 1 presents the measurement of variables.

Competitiveness is measured by the return on invested capital (ROIC) to the weighted average cost of capital (WACC) (Koller et al., 2015).

3.3. Data Analysis Method

Statistical data processing plays an important role in research because the conclusions of the research will be derived from the results of data processing. Before drawing conclusions, data analysis is necessary to ensure the accuracy of the research results. Therefore, this study is assisted by the EVIEWS 12 software program. The data analysis method in this study uses multiple regression model analysis with panel data and interaction testing, commonly known as moderated regression analysis (MRA). Panel data is a combination of time-series data and cross-sectional data.

4. RESULTS

4.1. Description Statistics

Based on the criteria and the completeness of the available data, a sample of 64 companies was obtained, with an observation period of 5 years, from 2018 to 2022.

Table 1: Measurement of variables

Variable type	Variable	Measurement
Dependent	Firm value	Tobin's Q=(MVS+D)/TA
Independent	Environmental performance	Environmental performance score
	Social performance	Social performance score
	Governance performance	Governance performance score
Moderating	Competitive advantage	ROIC/WACC

Table 2: Statistic descriptif

Variable	N	Minimum	Maximum	Mean	Standard deviation
ENV	320	0.48	78.07	29.157	19.031
SOC	320	9.40	58.62	32.439	11.151
GOV	320	42.81	98.62	75.231	10.269
CA	320	−0.829	9.432	1.027	1.296
FV	320	0.606	17.67	1.740	2.056

Based on Table 2, descriptive statistics of all estimated variables are shown. The average value of environmental performance is 29.157 with a standard deviation of 19.03, reflecting that environmental performance is still very low and quite varied. This variation may occur because the sample comes from various financial and non-financial industries.

Social performance has a higher value compared to environmental performance, with an average of 32.43 and a deviation of 11.15. Social performance is also still low because the maximum score is 100. Social performance tends not to vary much, meaning that the social activities of issuers have similar patterns of activity.

Governance performance shows the highest average score of 75.3 and a standard deviation of 10.26, indicating that the level of compliance with governance regulations issued by the Financial Services Authority (OJK) is good as regulated in several governance POJKs according to the company's business field.

Competitive advantage (CA) has an average value of 1.027 with a standard deviation of 1.296, indicating that companies in Indonesia tend to build competitive advantage, especially by considering the gap between benefits and costs, in this case, ROI and WACC. Meanwhile, the value of the company proxied by Tobin's Q has an average value of 1.740, reflecting that companies in Indonesia with ESG performance reports tend to manage their resources effectively and efficiently. According to Kaijser (2014), when the firm's value projected by Tobin's Q exceeds one, it means that the company is good because its market value is higher than its replacement cost; Therefore, the company can benefit from its investments.

4.2. Model Selection

The best regression model selection is done with the Chow Test, Hausman Test, and Lagrange Multiplier Test. The test results are presented in Tables 3-5.

The Chow test results show that the probability value of the cross-section is 0.5516 or sig > 0.05, so it can be concluded that the CEM model is better. Next, the Hausman test is performed.

Table 3: Chow test results

Redundant fixed effects tests			
Equation: Untitled			
Test cross-section fixed effects			
Effects test	**Statistic**	**d.f.**	**Probability**
Cross-section F	0.966617	63.252	0.5516
Cross-section Chi-square	69.262246	63	0.2745

Table 4: Hausman test results

Correlated random effects-hausman test			
Equation: Untitled			
Test cross-section random effects			
Test summary	**Chi-square statistic**	**Chi-square d.f.**	**Probability**
Cross-section random	6.891858	4	0.1417

Table 5: Lagrange multiplier test results

Lagrange multiplier tests for random effects			
Null hypotheses: No effects			
Alternative hypotheses: Two-sided (Breusch-Pagan) and one-sided (All others) alternatives			
Test hypothesis			
Measurement	**Cross-section**	**Time**	**Both**
Breusch-Pagan	0.124319 (0.7244)	1.909063 (0.1671)	2.033382 (0.1539)

The Hausman test results show that the probability value of the cross-section is 0.1417 or sig > 0.05, so it can be concluded that the REM model is better. Next, the LM test is performed.

The LM test results show that the probability value of the cross-section is 0.7244 or sig > 0.05, so it can be concluded that the CEM model is better.

4.3. Hypothesis Testing

The regression results with the common effect model are presented in Table 6.

The evaluation of the structural model is carried out to provide an overview of the causal relationships between the variables developed based on theory. This is done by assessing collinearity issues and R-squared values. The adjusted R-squared value indicates that the disclosure of the three ESG pillars, CA, contributes to the firm value by 52.1%, while the remaining 43.9% is influenced by other factors.

As shown in Table 6 of the hypothesis test results, environmental performance has a negative impact on firm value. This is evident from the coefficient of −0.022 with a P = 0.001 < 0.05. This figure indicates that H_1 is rejected because it has a negative coefficient. Furthermore, social performance does not affect firm value. This is evident from the coefficient of 0.003 with a P = 0.7801 > 0.05, indicating that H_2 is rejected. Additionally, governance performance does not affect firm value. This is evident from the coefficient of 1.278 with a P = 0.341 > 0.05, indicating that H3 is rejected.

Table 6: Regression coefficients, t-statistics, and probabilities

Variable	Coefficient	Standard error	t-Statistic	Probability
C	0.498838	0.668025	0.746737	0.4558
ENVIN	−0.022214	0.006972	−3.186266	0.0016
SOCIAL	0.003749	0.013419	0.279401	0.7801
GOV	0.009242	0.009703	0.952497	0.3416
CA	1.278762	0.270892	4.720557	0.0000
CA*ENVIN	0.017947	0.004156	4.317857	0.0000
CA*SOCIAL	−0.010555	0.010592	−0.996418	0.3198
CA*GOV	−0.006029	0.003615	−1.667647	0.0964

R-squared: 0.532
Adjusted R-squared: 0.521
Prob (F-statistic): 0.000
Dependent variable: Firm Value

4.4. Testing Moderation Effects

The results of the moderation effect tests are shown in Table 6 of the hypothesis test results, indicating that the coefficient of CA*ENVIN on firm value is 0.017 and significant with a P = 0.000 < 0.05, thus H_4 is accepted, meaning the influence of environmental performance on firm value is moderated by competitive advantage. Furthermore, the coefficient of CA*SOCIAL on firm value is −0.010 and not significant with a P = 0.319 > 0.05, thus H_5 is rejected. The coefficient of CA*GOV on firm value is −0.006 and not significant with a P = 0.09 > 0.05, thus H_6 is rejected.

5. DISCUSSION

5.1. The Influence of Environmental Performance on Firm Value

The primary goal of sustainable development is to ensure that all economic activities do not disrupt the availability of resources for future generations. Global warming has resulted in climate changes caused by greenhouse gases (CO_2). Therefore, a company's environmental performance is of primary concern to stakeholders. Based on the descriptive data in Table 1, the average environmental performance score is 29.157, which is very low. This low score is due to the sample coming from various service and non-service industries. Environmental performance has a negative and significant effect on firm value, which does not support stakeholder theory and legitimacy theory. The value of environmental performance has not yet attracted investors, resulting in the firm's value remaining low despite historical improvements in performance. If the company's performance continues to improve to a certain level, the confidence of stakeholders and investors can increase, leading to an increase in firm value, as expressed by Smith et al. (2020) and Wang et al. (2022) that proactive environmental management strategies can enhance the company's reputation and operational efficiency, thereby increasing performance and firm value.

5.2. The Influence of Social Performance on Firm Value

Companies have a social responsibility, meaning that the community should benefit from the existence of the company, and management policies should always consider their impact on the community. The social performance score of issuers in Indonesia is still relatively low, with an average value of 32.439. Social performance does not affect firm value; the low social performance has not been able to enhance the company's performance and value. This result does not support legitimacy theory, which posits that management's compliance with regulations and social values can enhance the company's existence and stakeholder loyalty. The impact of social performance on firm value varies because its effects are long-term through the reputation built by management (Wu et al., 2022). Although social performance is important, management prioritizes environmental aspects and company efficiency, which do not directly impact firm value (Firdaus et al., 2021).

5.3. The Influence of Governance Performance on Firm Value

Good governance can provide transparent information, thereby reducing information asymmetry and business risks, increasing investor confidence, and subsequently raising firm value, as explained in agency theory. The research results do not prove that governance performance significantly affects firm value. The governance performance score is the highest compared to environmental and social performance, with an average score of 75.23. Despite being high, it does not impact firm value. Governance is mostly driven by regulatory compliance motivation, which, although important, does not directly affect firm value (Garcia et al., (2020); Martinez et al. (2021). The ability to implement regulations varies among companies, making the results questionable or debatable (Thompson et al., 2022). Governance regulations for issuers in Indonesia are detailed by the Financial Services Authority (OJK), which imposes significant penalties for violations. The fact that governance does not affect firm value indicates that governance implementation does not reflect management's ability to efficiently manage company operations; instead, governance mechanisms become an additional burden for management.

5.4. The Moderating Role of Competitive Advantage on the Relationship between ESG Performance and Firm Value

Based on Table 6, it can be seen that competitive advantage (CA) has a significant positive effect on firm value, reflecting that the strong driver of firm value increase is competitive advantage proxied by the ROIC/WACC ratio. The higher this ratio, the more efficient the company is, and it will be able to compete, increasing market share followed by financial performance improvement. According to the resource-based view (RBV) approach, one source of competitive advantage comes from the organization's strategic resources to generate innovation (Johnson et al., 2021). Therefore, if a company has competitiveness, it can strengthen the influence of ESG performance on firm value.

The results of the moderation effect tests presented in Table 6 conclude that competitive advantage significantly strengthens the influence of environmental performance on firm value (CA*ENVIN). However, competitive advantage cannot moderate the influence of social performance (CA*SOC) and governance (CA*GOV) on firm value.

Environmental performance and competitiveness can synergize to improve operational performance. For example, good waste management practices and the use of renewable energy can reduce operational costs, allowing companies to sell their products at lower prices and remain competitive (Chen et al., 2021).

6. CONCLUSION

A company's ESG performance reflects management's commitment to participating in achieving sustainable development goals. The implementation of ESG by companies listed on the Indonesia Stock Exchange is still low for environmental and social aspects, whereas corporate governance aspects have been well-implemented, as reflected in relatively high governance scores. Empirically, there is no significant evidence that ESG affects firm value. The low environmental and social performance causes investors to pay less attention, so these factors are not considered in investment decision-making. Competitive advantage can moderate the influence of environmental performance on firm value, indicating that only companies with competitive advantage can enhance the role of environmental performance on firm value. The research implications provide evidence that ESG performance needs to be improved to enhance its role in achieving sustainable development, especially in Indonesia. To motivate management, regulators can provide an incentive system for well-performing companies and support companies that have not yet optimized their performance.

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