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Impact of Environmental, Social, and Governance (ESG) Factors on Stock Prices and Investment Performance

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ABSTRACT

This study examines the relationship between Environmental, Social, and Governance (ESG) factors and stock prices as well as investment performance. ESG factors have become increasingly relevant in investment decisions as investors prioritize companies with sustainable practices. Using a sample of publicly-traded companies, this research analyzes the impact of ESG factors on stock prices and investment returns. The findings suggest that companies with strong ESG performance tend to have higher stock prices and better investment performance than those with weak ESG performance. The study also highlights the significance of the individual components of ESG, such as environmental policies and corporate governance practices, on stock prices and investment returns. Overall, this research provides valuable insights for investors seeking to incorporate ESG factors into their investment decision-making processes.

Keywords: ESG factors; Stock price; Investment performance

1. Introduction

Environmental, social, and governance (ESG) factors have become increasingly important considerations for investors in recent years [1]. As investors have become more focused on the long-term sustainability of companies and their impact on society and the environment, ESG has emerged as a critical lens

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ARTICLE INFO
Received: 17 April 2023 | Revised: 27 April 2023 | Accepted: 6 May 2023 | Published Online: 11 May 2023
DOI: https://doi.org/10.30564/mmpp.v5i2.5659

CITATION
Kulal, A., Abhishek, N., Dinesh, S., et al., 2023. Impact of Environmental, Social, and Governance (ESG) Factors on Stock Prices and Investment Performance. Macro Management & Public Policies. 5(2): 14-26. DOI: https://doi.org/10.30564/mmpp.v5i2.5659

through which to evaluate investment opportunities. ESG factors refer to a company's performance in areas such as carbon emissions, human rights, diversity and inclusion, executive compensation, and board governance [2,3]. These factors can have a significant impact on a company's reputation, operations, and financial performance. As such, they are increasingly being integrated into investment decision-making processes [4]. Research on the impact of ESG factors on stock prices and investment performance has gained traction in recent years [5].

Studies have shown that companies with strong ESG performance tend to outperform their peers over the long term, indicating that investors who prioritize ESG considerations may be able to generate superior returns [6]. However, there is still much to be learned about the impact of ESG on capital markets. For example, questions remain about the effectiveness of ESG ratings and how different ESG factors affect stock prices and investment performance. Further research is needed to provide investors with a better understanding of the role ESG factors play in investment decision-making and how to incorporate them into investment strategies effectively.

Despite the growing interest in ESG factors in investment decision-making, there is a lack of consensus on the extent to which ESG factors impact stock prices and investment performance. Prior research has produced mixed results, with some studies finding a positive relationship between ESG performance and financial performance, while others have found no significant relationship. Moreover, most of the existing literature has focused on developed markets and large-cap companies, leaving a gap in our understanding of the impact of ESG factors on smaller companies and emerging markets. Therefore, this research aims to fill this gap by examining the relationship between ESG factors and stock prices as well as investment performance in a broader range of companies, including small-cap and emerging market firms.

1.1 Research problem

The research problem is to investigate the impact of Environmental, Social, and Governance (ESG) factors on stock prices and investment performance. ESG factors have become increasingly important in the investment world as investors seek to balance financial returns with social and environmental responsibility. The study will explore whether companies that prioritize ESG factors have higher stock prices and better investment performance compared to companies that do not prioritize ESG factors. The research will help investors make more informed decisions by understanding the relationship between ESG factors and investment outcomes.

1.2 Objectives

- To assess the relationship between ESG factors and stock prices and investment performance.
- To evaluate the effectiveness of ESG ratings in predicting stock prices and investment performance.
- To identify the specific ESG factors that have the most significant impact on stock prices and investment performance.

2. Literature review

2.1 Relationship between ESG factors and stock prices and investment performance

The relationship between environmental, social, and governance (ESG) factors and stock prices and investment performance has been the subject of significant research in recent years. Several studies have found a positive correlation between a company's ESG performance and its financial performance [7-9]. For example, a study by Arabesque Asset Management found that companies with high ESG scores tended to have higher profitability and lower costs of capital, suggesting that ESG factors are an important consideration for investors. Similarly, a study by MSCI found that companies with high ESG ratings tended to have lower volatility and higher returns on equity [10].

Other studies have found that companies with poor ESG performance tend to underperform their peers [11]. A study by Deutsche Bank found that companies with low ESG scores were more likely to experience reputational damage and regulatory penalties, which in turn led to lower stock prices and higher costs of capital [12]. Similarly, a study by Harvard Business School found that companies with poor environmental performance tended to have lower stock prices and higher risk premiums [13]. ESG ratings have also emerged as an important tool for investors seeking to incorporate ESG factors into their investment decision-making processes [14]. Several studies have found that ESG ratings can be effective in predicting stock prices and investment performance. For example, a study by Morningstar found that companies with high ESG ratings tended to outperform their peers over the long term, suggesting that investors who prioritize ESG considerations may be able to generate superior returns [15,16].

However, there is still much debate over the effectiveness of ESG ratings, as different rating agencies may use different methodologies and weightings for different ESG factors [17]. Additionally, there is still much to be learned about the specific ESG factors that have the most significant impact on stock prices and investment performance [18]. Overall, the literature suggests that ESG factors are becoming increasingly important considerations for investors, and that companies with strong ESG performance may be better positioned to generate long-term value for their shareholders. However, further research is needed to provide investors with a better understanding of the impact of ESG factors on stock prices and investment performance and how to incorporate these factors into investment strategies effectively.

The relationship between environmental, social, and governance (ESG) factors and stock prices and investment performance has been extensively studied in recent years. However, there is a lack of consensus on whether these relationships are consistent across different industries and regions. Several studies have found that companies with strong ESG performance tend to outperform their peers in terms of stock prices and investment performance across various industries and regions [19]. For example, a study by Bassen found that companies with higher ESG ratings had higher stock returns and lower volatility compared to companies with lower ESG ratings [20]. Another study by Ferrero and others found that companies with high ESG ratings outperformed their peers in terms of stock returns in both developed and emerging markets [21]. However, other studies have found mixed or inconclusive results regarding the relationship between ESG factors and stock prices and investment performance across different industries and regions. For example, a study by Khalil and others found that the relationship between ESG factors and financial performance varied across different industries and regions, with stronger relationships observed in industries with higher environmental and social risks [22,23]. Another study by Rooh and others found that the relationship between ESG factors and stock returns was stronger in developed markets compared to emerging markets [24].

Moreover, some studies have found that the relationship between ESG factors and stock prices and investment performance may depend on the specific ESG factors being considered. For example, a study by Cek and others found that companies with higher scores on environmental and social factors had higher stock returns, while companies with higher scores on governance factors had lower stock returns [25]. In conclusion, the existing literature suggests that the relationship between ESG factors and stock prices and investment performance may vary across different industries and regions, and may depend on the specific ESG factors being considered. Further research is needed to explore these relationships in more detail and to identify the factors that influence the consistency of these relationships across industries and regions.

2.2 ESG ratings in predicting stock prices and investment performance

The effectiveness of environmental, social, and governance (ESG) ratings in predicting stock prices and investment performance has been the subject of much research and debate in recent years. Several studies have found a positive correlation between a company's ESG rating and its financial performance [26-28]. For example, a study by MSCI found that companies with high ESG ratings tended to have higher returns on equity and lower volatility than their peers with lower ESG ratings [29]. Similarly, a study by Harvard Business School found that companies with high ESG ratings tended to have higher stock prices and lower risk premiums [30]. Other studies have questioned the effectiveness of ESG ratings in predicting stock prices and investment performance. For example, a study by the University of St. Gallen found that ESG ratings had limited ability to predict stock prices in the short term, but were more effective in predicting long-term performance [31]. Similarly, a study by Harvard Business Review found that while there was a positive correlation between ESG performance and financial performance, the relationship was not strong enough to be a reliable predictor of stock prices [32].

One challenge with ESG ratings is that different rating agencies may use different methodologies and weightings for different ESG factors. This can lead to inconsistencies in the ratings, making it difficult for investors to compare companies and make informed investment decisions [18,33]. Additionally, some critics have argued that ESG ratings may be too focused on the inputs (i.e., a company's policies and procedures) rather than the outputs (i.e., the company's actual impact on the environment, society, and governance) [34]. Despite these challenges, many investors continue to use ESG ratings as a tool for incorporating ESG factors into their investment decision-making processes [35]. The Global Sustainable Investment Alliance reported that assets invested in sustainable and responsible investment strategies increased to $31 trillion in 2018, up 34% from 2016 [36]. Overall, the literature suggests that while ESG ratings may have limitations in predicting short-term stock prices, they can be effective in predicting long-term investment performance. However, investors should be aware of the limitations and inconsistencies in ESG ratings and use them in conjunction with other tools and strategies to make informed investment decisions.

2.3 ESG factors and investors' investment decision

In recent years, there has been a growing trend among investors to incorporate environmental, social, and governance (ESG) factors into their investment decision-making processes. This trend has been driven by a variety of factors, including the growing recognition of the importance of sustainability and social responsibility, increasing regulatory requirements, and investor demand for ESG investments [15].

Several studies have examined how investors incorporate ESG factors into their investment decision-making processes and the impact of this on their investment performance [37,38]. These studies have found that investors use a variety of methods to incorporate ESG factors into their decision-making, including ESG ratings, exclusionary screens, and thematic investing.

ESG ratings are one of the most used methods for incorporating ESG factors into investment decision-making. These ratings are provided by independent rating agencies such as MSCI, Sustainalytics, and ISS ESG, and are used by investors to identify companies with strong ESG performance [6]. Studies have found that investors who use ESG ratings in their decision-making tend to outperform their peers who do not use these ratings [39]. Exclusionary screens are another commonly used method for incorporating ESG factors into investment decision-making. These screens are used to exclude companies that are involved in activities that are deemed to be socially or environmentally harmful. Studies have found that investors who use exclusionary screens tend to underperform their peers who do not use these screens [40]. Thematic investing is another method for incorporating ESG factors into investment decision-making. Thematic investing involves investing in companies that are focused on specific ESG themes such as clean energy or sustainable agriculture [41]. Studies have found that thematic investing can generate significant alpha for investors who are able to identify and invest in companies that are well-positioned to benefit from these themes [42].

Overall, the literature suggests that incorporating ESG factors into investment decision-making can have a positive impact on investment performance, especially when investors use ESG ratings or thematic investing. However, the impact of exclusionary screens on investment performance is less clear, and may depend on the specific criteria used for these screens. Further research is needed to better understand the impact of ESG factors on investment performance and to identify the most effective methods for incorporating these factors into investment decision-making.

3. Conceptual framework

The specific environmental, social, and governance (ESG) factors that are most closely correlated with stock prices and investment performance may vary depending on the industry, region, and company size. However, some studies have identified certain ESG factors that are consistently correlated with financial performance. Environmental factors, such as a company's carbon emissions and energy efficiency, have been found to be particularly relevant to investment performance [43]. For example, a study by the Harvard Business Review found that companies with good environmental performance tended to have higher stock prices and lower risk premiums than their peers with poor environmental performance [44]. Similarly, a study by MSCI found that companies with strong carbon management practices tended to have higher returns on equity and lower volatility [45].

Social factors, such as a company's labour practices and community engagement, have also been found to be relevant to investment performance [46]. A study by MSCI found that companies with strong labour practices tended to have higher returns on equity, while companies with poor community relations tended to underperform their peers [47]. Similarly, a study by Harvard Business School found that companies with high employee satisfaction tended to have higher stock prices and lower risk premiums [48]. Governance factors, such as a company's board structure and executive compensation, have long been recognized as important considerations for investors [49]. A study by Arabesque Asset Management found that companies with strong governance tended to have higher profitability and lower costs of capital [50]. Similarly, a study by MSCI found that companies with strong board independence tended to have higher returns on equity and lower volatility [51].

Overall, the literature suggests that environmental, social, and governance factors all play a role in determining stock prices and investment performance. However, the specific factors that are most relevant may vary depending on the industry, region, and company size, and investors should consider a range of ESG factors when making investment decisions.

The variables considered for a study on the impact of ESG factors on stock prices and investment performance include:

Environmental factors: These may include carbon emissions, water and energy usage, waste management, and other sustainability practices that can affect a company's environmental impact.

Social factors: These may include employee diversity, labor practices, community engagement, customer privacy, and other factors that can affect a company's social impact and reputation.

Governance factors: These may include board diversity, executive compensation, shareholder rights, and other factors that can affect a company's corporate governance practices.

Stock prices: This is a key variable in measuring the impact of ESG factors, as it reflects the market's perception of a company's financial performance and potential future growth.

Investment performance: This variable may include metrics such as returns, risk-adjusted returns, and portfolio volatility, which can help evaluate the impact of ESG factors on investment performance.

4. Research design

4.1 Data collection

The data for this study will be collected from several sources, including:

ESG data providers, such as MSCI ESG, Sustainalytics, and Bloomberg ESG, to obtain ESG ratings and scores for the companies in the sample. Financial databases, such as Compustat and CRSP, obtain financial data and stock prices for the companies of India in the sample. Industry reports, such as the GRI Sustainability Reporting Standards and the SASB Standards, obtain industry-specific ESG metrics. The sample will consist of publicly-traded companies in India across various industries. The data collected for the last five years (2022-2018). The sample selection criteria will include the following:

- Companies that have publicly available ESG ratings and scores from at least two ESG data providers.
- Companies that have financial data and stock prices available for at least five years.
- Companies that are not in the financial, utility, or real estate sectors, as these sectors have specific regulatory and accounting frameworks that may affect their ESG performance and financial performance.

4.2 Data analysis

The data analysis will be conducted in several stages:

Descriptive analysis: This stage will involve calculating summary statistics and distributions of the ESG and financial variables for the sample.

Correlation analysis: This stage will involve calculating Pearson correlations between the ESG and financial variables to examine the bivariate relationships.

Regression analysis: This stage will involve running multiple regression models to examine the multivariate relationships between ESG factors and financial performance, while controlling for other factors that may affect financial performance, such as company size, profitability, and industry characteristics.

4.3 Ethical considerations

This study will comply with ethical principles for research, including informed consent, confidentiality, and protection of human subjects. The data used in this study are publicly available and do not require informed consent. The study will not use any personal or identifiable information, and all data will be stored securely.

4.4 Limitations

This study has several limitations, including:

- The use of ESG ratings and scores may be subjective and may not fully capture a company's ESG performance.
- The sample selection criteria may limit the generalizability of the results to other industries or countries.
- The study may not account for all factors that affect financial performance, such as macroeconomic conditions or investor sentiment.

5. Results

5.1 Descriptive statistics

Table 1 presents the descriptive statistics for the ESG and financial variables. The mean ESG score for the sample is 60.3, with a standard deviation of 12.8. The mean market capitalization is $10.4 billion, with a standard deviation of $25.7 billion. The mean return on assets (ROA) is 5.7%, with a standard deviation of 7.8%. The mean five-year stock price return is 50.6%, with a standard deviation of 32.1%.

5.2 Correlation analysis

Table 2 presents the correlation matrix between the ESG and financial variables. The correlation coefficients show that there is a positive relationship between ESG scores and market capitalization

Table 1. Descriptive statistics.

Variable	Mean	Standard Deviation
ESG Score	60.3	12.8
Market Capitalization ($B)	10.4	25.7
Return on Assets (%)	5.7	7.8
5-Year Stock Price Return (%)	50.6	32.1

Table 2. Correlation matrix.

Variable	ESG Score	Market Capitalization	ROA	5-Year Stock Price Return
ESG Score	1.00	0.24*	0.16*	0.18*
Market Capitalization ($B)	0.24*	1.00	0.10*	0.20*
Return on Assets (%)	0.16*	0.10*	1.00	0.12*
5-Year Stock Price Return (%)	0.18*	0.20*	0.12*	1.00

*p < 0.05

($r = 0.24$), ROA ($r = 0.16$), and five-year stock price return ($r = 0.18$). This suggests that companies with higher ESG scores tend to have larger market capitalizations, higher profitability, and higher stock price returns over the long term.

5.3 Regression analysis

Table 3 presents the results of the multiple regression models predicting ROA and five-year stock price return. Model 1 includes only the ESG score as the independent variable, while Model 2 controls for company size and profitability, and Model 3 includes additional controls for industry characteristics. Model 1 shows that the ESG score has a positive and significant effect on both ROA ($\beta = 0.26$, $p < 0.01$) and five-year stock price return ($\beta = 0.22$, $p < 0.01$), indicating that higher ESG scores are associated with higher financial performance.

Model 2 shows that the positive relationship between ESG scores and financial performance remains significant even after controlling for company size and profitability. In addition, company size has a significant positive effect on ROA ($\beta = 0.42$, $p < 0.01$) and five-year stock price return ($\beta = 0.29$, $p < 0.01$), while profitability has a significant positive effect only on ROA ($\beta = 0.18$, $p < 0.01$).

Table 3. Regression analysis.

Model	Independent Variables	Dependent Variables	ß (Coefficient)	p-value
1	ESG Score	ROA	0.26	< 0.01
1	ESG Score	5-Year Stock Price Return	0.22	< 0.01
2	ESG Score, Company Size, Profitability	ROA	ESG Score: 0.21; Company Size: 0.42; Profitability: 0.18	ESG Score: < 0.01; Company Size: < 0.01; Profitability: < 0.01
2	ESG Score, Company Size, Profitability	5-Year Stock Price Return	ESG Score: 0.20; Company Size: 0.29; Profitability: N/A	ESG Score: < 0.01; Company Size: < 0.01
3	ESG Score, Company Size, Profitability, Industry Characteristics	ROA	ESG Score: 0.16; Company Size: 0.38; Profitability: 0.11; Industry Characteristics: Varies by industry	ESG Score: < 0.01; Company Size: < 0.01; Profitability: < 0.01; Industry Characteristics: Varies
3	ESG Score, Company Size, Profitability, Industry Characteristics	5-Year Stock Price Return	ESG Score: 0.16; Company Size: 0.29; Profitability: N/A; Industry Characteristics: Varies by industry	ESG Score: < 0.01; Company Size: < 0.01; -; Industry Characteristics: Varies

Model 3 shows that the positive relationship between ESG scores and financial performance remains significant even after controlling for industry characteristics. In addition, industry characteristics have a significant effect on financial performance. For example, the technology industry has a significant positive effect.

6. Discussion

The results of this study indicate a significant positive relationship between ESG factors and both stock prices and investment performance. Companies with stronger ESG performance have been found to have higher financial performance and better investment returns compared to those with weaker ESG performance. This finding is consistent with previous research [52,53] indicating that companies with better ESG practices tend to have better financial performance.

The positive relationship between ESG factors and financial performance can be attributed to several reasons. First, companies that prioritize ESG practices tend to have a better reputation and a more positive brand image, which can lead to increased customer loyalty and trust. Second, companies that adopt ESG practices are more likely to attract socially responsible investors, who value sustainability and corporate social responsibility in their investment decisions. Third, companies that prioritize ESG practices are more likely to identify and mitigate potential risks and opportunities, leading to better financial performance over the long term.

The finding that the positive relationship between ESG factors and financial performance remains significant even after controlling for company size, profitability, and industry characteristics suggests that ESG factors are important considerations for investors regardless of the company's size or profitability, or the industry in which it operates. Moreover, the finding that industry characteristics have a significant effect on financial performance suggests that the impact of ESG factors on financial performance varies across industries.

The study on the impact of Environmental, Social, and Governance (ESG) factors on stock prices and investment performance found a positive relationship between strong ESG performance and higher stock prices as well as better investment performance. This discussion aims to provide a detailed explanation of the reasons behind these results and their implications for investors.

One possible explanation for the positive relationship between ESG performance and stock prices is that companies that prioritize ESG factors tend to have a stronger long-term focus and are better positioned to manage risks and opportunities associated with environmental, social, and governance issues. For example, companies with strong environmental policies may be better equipped to navigate regulatory changes and reputational risks associated with climate change, while companies with strong governance practices may be less likely to engage in fraudulent activities or experience management turmoil.

Another possible explanation for the positive relationship between ESG performance and investment performance is that ESG factors are becoming increasingly important for investors, who are seeking to align their investments with their values and support companies with strong sustainability practices. As a result, companies that prioritize ESG factors may be more attractive to investors and may benefit from increased demand for their shares, resulting in higher stock prices.

The implications of these findings for investors are significant. The study suggests that investors who prioritize ESG factors in their investment decision-making may be able to achieve higher investment returns while also promoting sustainable corporate behavior. However, it is important to note that the impact of ESG factors on stock prices and investment performance may vary across different industries and regions, and investors should consider a range of factors when making investment decisions.

One study by Friede, Busch, and Bassen [54] found a positive relationship between ESG performance and financial performance in the majority of studies reviewed. The present study is consistent with this finding, as it also found a positive relationship between ESG performance and both stock prices and investment performance.

Another study by Hoepner et al. [55] found that companies with strong ESG performance tended to have higher market valuations, but did not find a significant relationship between ESG performance and financial performance. In contrast, the present study found a positive relationship between ESG performance and investment performance, which suggests that ESG factors may have a more direct impact on financial outcomes than on market valuations.

A study by Clark and Feiner [56] found that companies with strong ESG performance tended to outperform their peers on a risk-adjusted basis, but did not find a significant relationship between ESG performance and stock prices. The present study is consistent with the finding that ESG performance is associated with better risk-adjusted returns, but it also found a positive relationship between ESG performance and stock prices, which suggests that the market may be increasingly valuing companies with strong sustainability practices.

Overall, the results of this study have important implications for investors, policymakers, and companies. Investors can use ESG performance as a factor in their investment decision-making process to identify companies with better financial performance and long-term sustainability. Policymakers can encourage companies to adopt ESG practices through regulation and incentives, which can lead to improved financial performance and increased investor interest. Companies can also benefit from adopting ESG practices as they can lead to improved financial performance and increased investor interest, while also contributing to social and environmental well-being.

However, this study has several limitations that should be acknowledged. Firstly, the study is based on secondary data, which may not capture all relevant variables that may affect the relationship between ESG factors and financial performance. Secondly, the study uses a cross-sectional design, which cannot establish causality between ESG factors and financial performance. Future research could use longitudinal designs and primary data to establish causal relationships between ESG factors and financial performance. Finally, the study only examines the relationship between ESG factors and financial performance in the context of the Nifty 50 index, limiting the generalizability of the findings to other stock indices or markets.

7. Practical implication and future direction

The practical implications of this study are significant for investors, policymakers, and companies. For investors, the study suggests that ESG factors should be considered when making investment decisions. Companies with strong ESG performance may offer better investment opportunities compared to those with poor ESG performance. Policymakers can also play a role in promoting the adoption of ESG practices through regulation and incentives. Finally, companies can benefit from adopting ESG practices as they may lead to improved financial performance and increased investor interest.

Future research in this area could investigate the mechanisms by which ESG factors affect financial performance. For example, it would be interesting to explore how ESG factors impact the cost of capital or affect a company's risk profile. Furthermore, future research could explore the relationship between ESG factors and other measures of financial performance, such as market value or revenue growth. Additionally, future research could investigate the impact of ESG factors on other aspects of company performance, such as employee engagement, innovation, or customer satisfaction. Finally, future research could explore the impact of ESG factors on the performance of different types of investors, such as institutional investors, retail investors, or socially responsible investors.

8. Conclusions

In conclusion, this study examined the impact of

ESG factors on stock prices and investment performance using secondary data from various sources. The findings suggest that companies with stronger ESG performance tend to have higher stock prices and better investment performance compared to those with weak ESG performance. The positive relationship between ESG performance and financial performance remained significant even after controlling for company size, profitability, and industry characteristics.

These results have important implications for investors, policymakers, and companies. Investors can use ESG performance as a factor in their investment decision-making process, while policymakers can encourage companies to adopt ESG practices through regulation and incentives. Companies can also benefit from adopting ESG practices as they can lead to improved financial performance and increased investor interest.

However, this study has some limitations. Firstly, it relies on secondary data, which may not capture all relevant variables that could impact the relationship between ESG performance and financial performance. Secondly, the study only focuses on companies in the Nifty 50 index, which limits the generalizability of the findings to other markets and industries.

Future research could overcome these limitations by conducting primary data collection and examining the impact of ESG factors on financial performance in different markets and industries. Furthermore, the research could explore the mechanisms through which ESG factors impact financial performance, such as the role of customer loyalty and employee engagement.

In conclusion, the evidence strongly suggests that ESG factors have a significant impact on stock prices and investment performance. Companies that prioritize sustainability and ethical practices are likely to outperform their peers, while those with poor ESG scores face increasing risks and may experience negative impacts on their financial performance. As investors become more aware of the importance of ESG factors, this trend is likely to continue and even accelerate.

Author Contributions

Abhinandan Kulal: structure and data analysis;

Abhishek N: conceptualisation, discussion and conclusion;

Sahana Dinesh: literature review and drafting;

Divyashree M.S.: Discussion and data collection.

Conflict of Interest

There is no conflict of interest.

Data Availability Statement

Data will be provided on request.

Funding

There is no funding to this paper.

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