Money Matters: Essays on Sustainable Finance and the Institutionalization of ESG

Jukka Honkaniemi
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Jukka Honkaniemi
Aalto Executive Doctor of Business Administration

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It seems to me that the natural world is the greatest source of excitement; the greatest source of visual beauty; the greatest source of intellectual interest. It is the greatest source of so much in life that makes life worth living.

David Attenborough (1926-)
Abstract

This thesis investigates the role of sustainable finance in supporting the institutionalization of environmental, social, and governance (ESG) practices and, consequently, sustainable development. The relationship between ESG performance and corporate financial performance has been researched extensively. This thesis aims to fill a research gap by investigating ESG integration into single-company financial analyses and extending the purview to small and medium-sized companies (SMEs). The thesis is organized around three standalone essays under a common theme.

Essay 1, “What’s valued by investors gets valued by analysts: Institutional motives of ESG integration into sell-side research”, investigates the status of ESG analysis practices among sell-side analysts and equity investors. This research combines a review of equity research reports integrating ESG into the valuation of shares of OMXS-30 businesses by a Swedish bank with interviews of the bank’s analysts as well as institutional investors from Sweden and Finland. Single-company financial analysis is the basis of capital pricing decisions and should incorporate financially material ESG factors. Our findings, however, suggest that few of the future effects of financially material ESG issues have been considered by sell-side analysts thus far when transparently assessing businesses. This research shows that investors fail to compensate sell-side research for ESG assessments or systematic examination of the non-financial factors that affect long-term value. This absence of crucial compensation input, together with homogeneous normative ESG evaluation techniques, seems to be the main obstacle to more rapid development in integrated ESG equity research. We suggest that asset owners are in a unique position to drive market development to new levels, and asset managers and intermediaries (brokers) would be able to answer this call, given the right incentives.

Essay 2, “Sustainable finance and SMEs: A systematic literature review,” contributes to the field of study of sustainable finance by shifting the focus from large corporates to small and medium-sized enterprises (SMEs). The ESG-corporate financial performance relationship has been extensively researched in the context of large corporates. SMEs, on the other hand, have received less attention. Cumulatively, SMEs make up the majority of corporations, and account for most of the GDP, employment, and
environmental impact in the European Union. The green and sustainable transition cannot be achieved without having SMEs on board. Using the Scopus database, we conducted a systematic literature search and found 36 scientific articles exploring the relationship between ESG performance and financial performance of SMEs. The results were coded and divided into nine clusters, highlighting the main ESG driver impacting financial performance. Existing research shows that ESG impacts both the financial performance and access to capital of SMEs. A corollary of essay two is that financially material ESG factors are more country- and culture-bound in SMEs than in large corporates, and as such, needs to be considered in future studies. Furthermore, SMEs financial success is also supported by their ability to dynamically respond to changed circumstances and adopt their ESG strategies accordingly.

Essay 3, “Sustainable finance and institutionalization of ESG: A case study of a Finnish SME,” examines how and why sustainable financial considerations impact the case company’s adoption of ESG, and how institutional drivers manifest in the case company’s adoption of ESG. The analysis draws on interviews and company materials and is carried out and drawn against the ESG framework derived from essay two. This research finds out that though some of the case company’s clients have sent sustainability questions to the case company, this is yet to impact the actual business negotiations. Furthermore, most clients, banks, and suppliers had not started engagement on ESG. However, the case company rationalizes institutionalizing ESG into its strategy and operations to retain legitimacy with its key stakeholders in anticipation of increased demands. Financial returns, access to capital, and the cost of capital are implicit key considerations in deciding which ESG factors to invest in while maintaining a focus on key stakeholders.

By investigating fresh and novel business situations through case studies, institutional theory, and sustainable finance perspectives, this thesis adds to the understanding of business management as well as the body of research on sustainable finance. We identify and suggest how banks and investors could accelerate the institutionalization of ESG practices and identify financially material ESG areas for SME owners and managers to explore. We, furthermore, expand the field of study on sustainable finance to the institutionalization of single-company financial analyses and ESG integration in SMEs and suggest several areas for further exploration.

**Keywords**: Sustainability, ESG, CSR, non-financial data, sustainable finance, company valuation, financial performance, access to capital, cost of capital, sell-side equity research, SME, institutionalization
Acknowledgements

This dissertation and the learning process would not have been possible without the support of many individuals to whom I owe my greatest gratitude. Sustainable finance and investment studies were new at Aalto at the time when I started, but I was fortunate to find Professor Hanna Silvola as my supervisor. Hanna had the foresight to build expertise in sustainable finance and accounting early on in her career. My thesis would never have finished were it not for her patient guidance and encouragement through the past years. Dr. Hedon Blakaj became my second supervisor at a later stage on methodologies and structured writing. His endless patience in guiding and sometimes pushing me through the last part of the journey was important in getting over the finish line. The examiners Professor Sami Vähämaa from the University of Vaasa and Professor Gunnar Rimmel from Aalborg University provided excellent ideas for improvement and comments of encouragement that helped me improve my work.

I first contacted Aalto EE in the spring of 2016 and went to see Professor Henrikki Tikkanen, the father of the DBA program. The Paris Agreement had just been adopted and signed. Climate change and sustainability were increasingly discussed in the finance sector, but sustainable finance had not yet been mainstreamed. At work, I was puzzled that business and sustainability discussions with banking clients continued to be separate, and was keen to research how sustainability relates to financial value and risk. I am grateful for Professor Tikkanen’s encouragement for me to start the program and his continued support throughout the journey. I am also grateful for the support and guidance from the staff at Aalto Executive Education along the way. Maarit Hursti, Dr. Ulla-Maija Uusitalo, and Dr. Patrick Furu as Program Directors provided continuous encouragement. Dr. Mikko Laukkanen, as the Academic Director of Aalto EE, Suvi Leinonen, Tinja Lindfors, and many others helped me along the way. Dr. Sami Kajalo gave valuable guidance on how to study, conduct academic research, and importantly use Mendeley! Thanks also to all co-DBA students for your support during seminars and in other discussions.

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as a leader, friend, and early instigator of sustainable banking that has supported me at different stages of my career. My friend and colleague Julian Beer, Head of ESG Research was an inspiration in his pursuit of financial materiality when the concept had not even landed in popular discourse. Countless colleagues in SEB’s sustainability and banking practices have been important discussion partners and sources of inspiration and I thank you all. I am also grateful to Paul Stucki for his friendship and foresight in being an early adopter of sustainability among medium sized companies and above all allowing his company to be the case study of my last essay.

I started as an entrepreneur in January 2020. When the coronavirus pandemic started in the winter, life came to a sudden disruption with heightened uncertainty about the future. I am grateful for having four bright students join our company to write a feasibility study during the summer on Sustainability Assessment Services for SME Market. Work which became the inspiration for my second and third essays. Finn Goodall, Nora Hildén, Sanna Honkaniemi, and Kiia Laukkanen- working with you was inspiring and fun. Finn and Sanna co-authored the second essay and I am thankful for your passion and dedication. I also thank Filip Kaila for joining me in developing our own sustainability assessment service for SMEs, and for our discussions on ESG and sustainable finance. In the pursuit of climate change and sustainability knowledge, I was lucky to get to work with exemplary leaders in the field and want to thank especially Jouni Keronen from Climate Leadership Coalition, Mari Pantsar, earlier from Sitra and now an entrepreneur, and PA Enkvist from Material Economics.

I am grateful for the support and encouragement of my family and friends - you are too numerous to mention all here but you know who you are and how much energy I get from our discussions and friendships. My mother Vuokko has been tirelessly interested in when I finish – and reminding me that I need to do so when she is still alive – thank you, Mom, I made it! I thank my brother Kari for his endless encouragement and belief in me - it means the world. Also, thank you to my brother’s son Mikael, who brightens the day by frequently visiting us at his home away from home. My good friend Kari Laukkanen has since my first day at Citibank in 1991 been an advisor and bouncing board in life, work, and in DBA studies. My cousin Samuli Kuusisto, childhood friends Seppo Rantala and Erkan Fere have been invaluable discussion partners in the pursuit of life and happiness.

Finally, I want to thank my wife and partner, Marja for being in my life. You have been the constant source of support throughout my career, studies, and our wonderful family journey. My children Sanna, Anni, and Sami- thank you for putting up with the student-dad and your encouragement for getting this done. You are my source of energy and joy – I am proud to be your father and spouse every day!

Espoo April 2023
Jukka Honkaniemi
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<th>Description</th>
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<tbody>
<tr>
<td>CFP</td>
<td>Corporate financial performance</td>
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<tr>
<td>CO2</td>
<td>Carbon dioxide</td>
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<tr>
<td>COP</td>
<td>Conference of Parties</td>
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<tr>
<td>CSR</td>
<td>Corporate social responsibility</td>
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<tr>
<td>CSRD</td>
<td>Corporate Sustainability Reporting Directive</td>
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<tr>
<td>ESG</td>
<td>Environmental, social, and governance</td>
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<td>ESRS</td>
<td>European Sustainability Reporting Standard</td>
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<tr>
<td>EUROSIF</td>
<td>European Sustainable Investment Forum</td>
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<tr>
<td>FINSIF</td>
<td>Finland’s Sustainable Investment Forum</td>
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<tr>
<td>IASB</td>
<td>International Accounting Standards Board</td>
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<td>ICMA</td>
<td>International Capital Markets Association</td>
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<tr>
<td>IPO</td>
<td>Initial Public Offering</td>
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<tr>
<td>ISO</td>
<td>International Organization for Standardization</td>
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<tr>
<td>ISSB</td>
<td>International Sustainability Standards Board</td>
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<tr>
<td>LMA</td>
<td>Loan Market Association</td>
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<tr>
<td>NGFS</td>
<td>Network for Greening the Financial System</td>
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<tr>
<td>NGO</td>
<td>Non-governmental organization</td>
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<tr>
<td>PRB</td>
<td>Principles for Responsible Banking</td>
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<tr>
<td>PRI</td>
<td>Principles for Responsible Investment</td>
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<tr>
<td>SASB</td>
<td>Sustainability Accounting Standards Board</td>
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<td>SBT</td>
<td>Science-based targets</td>
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<td>SDG</td>
<td>Sustainable development goals</td>
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<td>SME</td>
<td>Small and medium-sized enterprise</td>
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<td>SWESIF</td>
<td>Sweden’s Sustainable Investment Forum</td>
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<tr>
<td>TBL</td>
<td>Triple bottom line</td>
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<tr>
<td>TCFD</td>
<td>Taskforce on Climate-related Financial Disclosure</td>
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List of Essays

The front part of this doctoral dissertation consists of a summary of the following essays which are referred to in the text by their numerals. The essays are attached in full in the end.


2. Honkaniemi, Jukka; Goodall, Finn; Honkaniemi, Sanna. Sustainable finance and SMEs: A systematic literature review. September 2021.

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Climate change, biodiversity loss, and other environmental and social sustainability challenges have gained increased focus from businesses over the past few years. Reducing emissions in line with the Paris Agreement and meeting the 17 UN Sustainable development goals (SDG) is a strategic goal at the EU level, as well as at the member state, corporate, bank, and investor levels. The EU’s Green Deal drives systemic change by ensuring SDGs are considered in all policymaking including its Sustainable Finance Roadmap (European Commission, 2019b). Creating a more sustainable planetary system will require systemic changes, and call for large, incremental investments in clean energy systems and circular solutions (Stuchtey et al., 2016). At the EU level alone, the incremental investment needed for the energy system is estimated at over €3 trillion between 2021–2030 (European Commission, 2021). These and other sustainable development investments will need to be financed largely by the private sector.

Sustainable finance has emerged as a concept describing capital flows that support sustainable development. In addition to supporting green and sustainable investments, banks and investors need to incorporate environmental, social, and governance (ESG) factors into risk and return evaluation (European Commission, 2021). Hence, companies’ ESG performance has become much studied and followed. ESG performance impacts companies’ financial returns (Khan et al., 2016), and access to, and cost of, capital (Cheng et al., 2014; Hong et al., 2012; Ng & Rezaee, 2015). The financial sector is taking an increasingly active stance in demanding clarity and transparency in climate action and corporate governance (UN
SSE Initiative, 2016; UNEP Finance Initiative, 2019). For some, ESG is primarily a risk management exercise, for others, a business opportunity, and, for many, both (Crifo & Forget, 2013; Stockholm Environment Institute & Material Economics, 2016).

This thesis investigates how sustainable finance can support the institutionalization of ESG practices, and, consequently, sustainable development. I have focused on financially material ESG performance and access to, and cost of, capital, as opposed to companies’ impact on the planet and society specifically. Focusing on financially material ESG factors supports ESG resilience where investment by companies in sustainability is not dependent on economic cycles but on a competitive advantage generating financial success. This thesis is organized around three standalone essays. Essay 1, titled “What's valued by investors gets valued by analysts: Institutional motives of ESG integration into sell-side research”, investigates how and why analysts use ESG information in valuation processes, and what key drivers and barriers to the institutionalization of ESG data can be identified. Essay 2, titled “Sustainable finance and SMEs: A systematic literature review” expands the field of study of sustainable finance from large corporates to small and medium-sized enterprises (SMEs) by investigating how the ESG performance of SMEs relates to their financial performance, and what ESG drivers can be identified that improve the financial status of SMEs. Essay 3 is titled “Sustainable finance and institutionalization of ESG: A case study of a Finnish SME” and addresses a research gap identified in Essay 2 concerning how and why sustainable finance considerations impact the case company’s adoption of ESG, and how institutional drivers manifest in the case company’s adoption of ESG. The findings are analyzed through a novel framework set out in Figure 6.

This research contributes to existing literature and policy and business practice considerations. I elaborate on the institutional pillars and mechanisms supporting the integration of ESG practices into single-company financial analyses that support capital allocation decisions. I also investigate the research field and gaps in sustainable finance research on SMEs, and develop a novel model for analyzing the financial materiality of SMEs. I further develop the model through an examination of a Finnish case company’s ESG journey and suggest that the case company rationalizes its ESG investments by seeking to retain legitimacy with financially significant stakeholders and financially material ESG matters.

The following part of the thesis is organized so that Chapter 2 covers the background on sustainable finance through different perspectives, Chapter 3 describes the research approach including research methodologies and theory used, Chapter 4 summarizes the essays, and Chapter 5 provides contributions and conclusions. Each of the three essays is attached at the end of the thesis.
Sustainable finance is a term used to describe financing and investment practices that take environmental, social, and governance (ESG) factors into account in order to promote sustainable development. Large companies are increasingly reporting and managing their ESG performance, but small and medium-sized enterprises (SMEs) by and large do not do so. Studies on the relationship between ESG and financial performance have largely concentrated on large companies and equity price performance. However, single-company-level analyses on how ESG impacts a company’s financial performance, as well as the drivers and hindrances around the adoption of practices for individual companies are less studied: even among large companies. The relationship between financial performance and ESG for SMEs is much less researched. Specifically, how, and why SMEs consider the financial materiality of their sustainability practices, as well as their access to, and the cost of, capital in their pursuit of ESG strategies warrant further exploration.

Before we address our research gap and review the essays, I will review the key concepts in sustainable development and sustainable finance and the emergence of the field. These concepts are key drivers in the development of green and sustainable financial markets in which finance and capital are allocated to support sustainable development investments, and ESG risks are monitored and managed at a systemic level across banks and investors. These developments at the financial system level will have a fundamental impact on companies as their access to, and the price of, capital will increasingly be impacted by their ESG performance. This section is organized as follows. First, I will address the notion of sustainable development, then the field of sustainable finance, followed by the notion of the Task Force on Climate-related Financial Disclosure and the EU Sustainable Finance Roadmap. I will finish the section with a brief overview of the academic research on sustainability and financial performance.
2.1 Sustainable Development

There are many ways to define sustainability, but perhaps the most commonly used description comes from the Brundtland Report: “Sustainable development is development which meets the needs of the present population without compromising the ability of future generations to meet their own needs” (Brundtland, 1987, p. 54). The report was published in 1987 as a reaction against the perceived unsustainability of industrial society. The concept of sustainability became discussed widely already in 1972, after the Club of Rome’s report: The limits to growth (Meadows et al., 1972). This started a broader discourse about the dramatic consequences the world would face if no changes were made in the way nature was being overexploited and polluted (Meadows et al., 1972). Sustainable development involves both government and private sector intervention, as well as international agreements and cooperation. It is a strategy that manages all resources sustainably, increasing long-term wealth and well-being (Repetto, 1986). Elkington (1998) later coined the term triple bottom line (TBL) for his framework with three pillars of sustainability: environmental, economic, and social. Although these can be analyzed separately, all of them are tightly interlinked. The economic pillar includes appropriate development and, for example, employment; the environmental pillar takes account of the conservation of all living things, resources, and life support systems; whereas the social pillar is about peace, equality, and human rights (UNESCO, 1997).

In 2015, the United Nations (UN) member states adopted the sustainable development goals (SDGs) across 17 themes, such as climate change, reducing inequality, gender equality, peace, justice, and strong institutions. The SDG established multiple targets for each SDG to be reached by 2030. Although the SDGs represent complex global challenges, they are also opportunities for solutions to advance the SDG agenda for policymakers, businesses, and civil society (GRI et al., 2015; Pedersen, 2018). In 2015, the Paris Agreement became the first-ever legally binding global climate agreement and was adopted at the Paris Climate Conference of Parties (COP21). The Paris Agreement established by the United Nations Framework Convention on Climate Change (UNFCCC) covers climate change mitigation, adaptation, and finance with the overall aim of preventing the global average temperature from rising 2 degrees Celsius and striving to keep temperature rise below 1.5°C degrees. The Paris Agreement was adopted by 196 parties at COP21, and required signature countries to reduce emissions in line with nationally determined contributions (NDCs) to reach the agreed proposals of a net-zero emission world by 2050, as well as adapt to the impacts of climate change (UNFCCC, 2016).
2.2 The Emergence of Sustainable Finance

The use of sustainability in the corporate business and finance world is a recent phenomenon (see timeline in Figure 1). The UN Global Compact, established in 2000, became a widely adopted voluntary initiative for companies to adopt ten principles around human rights, labor rights, environmental rights, and anti-corruption (United Nations Global Compact, 2000). Signatory companies are committed to embedding these principles into the corporate strategy, culture, and day-to-day operations of the firm (United Nations Global Compact, 2000). The UN Global Compact acted as a catalyst for the alignment between the business community and sustainable development objectives. Initial development of implementation and disclosure around the principles laid the foundation for corporate sustainability work, as well as reporting on it (United Nations Global Compact, 2020).

![Figure 1. Sustainable finance timeline (own figure).](image)

The widely used acronym ESG (environmental, social, and governance) was first introduced in the Global Compact report ‘Who cares wins’ (The Global Compact, 2004), endorsed by 20 global financial institutions. The report laid the foundation for the integration of ESG into financial analyses and investment practices, and the establishment of the Principles of Responsible Investments (PRI) organization in April 2006. The PRI now has more than 4,900 signatories, representing $121 trillion in assets, all of which adhere to the six core PRI principles: 1) incorporate ESG in investment decisions; 2) be active owners and incorporate ESG into policies and practices; 3) seek ESG disclosure; 4) promote acceptance and implementation of the Principles; 5) work together to enhance effectiveness; and 6) report on the progress towards implementing the Principles (Principles for Responsible Investment, 2023). PRI has had a significant impact on institutionalizing ESG practices in the investment industry.
The sustainable finance landscape has further developed into banking and finance, beyond the initial focus on institutional investors. The emergence of sustainable financing has been attributed to green bonds that were initially launched by the European Investment Bank (European Investment Bank, n.d.) and the World Bank Group (The World Bank, n.d.) in 2007 and 2008 respectively. The green and sustainable bond market has subsequently grown beyond the initial green-only focus and is often governed by principles developed by the International Capital Markets Association (ICMA, n.d.). Similarly, the Loan Market Association has issued sustainable loan principles to govern and support the growth of the green and sustainability-linked loan markets (Loan Market Association, n.d.).

The development of the sustainable finance field is further evidenced by the landmark voluntary initiative set up by the UNEP FI organization's Principles of Responsible Banking (PRB). The PRB initially launched in 2019, and now has over 300 banks signed up to align their business strategies to the SDGs, the Paris Agreement, and regional frameworks. The PRB covers themes such as working responsibly with stakeholders and customers, impact and target setting, governance and culture, and transparency and accountability (UNEP Finance Initiative, 2019). The Principles are set broadly to meet the SDGs and to encourage banks to set their targets based on their own impact analysis of their portfolios, as well as accountability through reporting on the targets they set as signatories to the PRB. The PRB has triggered development within banks to further assess climate-related risk across strategy, decision-making, lending, and investments, which could have a significant long-term impact on the real economy and sustainable development (Marchant, 2020). In addition to UN-linked initiatives, there are several voluntary sustainability initiatives that companies and investors have signed up to. For example, Science Based Targets (SBT) had 2,253 companies commit to reducing their greenhouse gas emissions in line with the Paris Agreement, up from 918 companies a year earlier (SBT, n.d.). On the investor side, with the Climate Action 100+ initiative, investors engage collectively with the largest greenhouse gas emitters to ensure they commit to the Paris Agreement (Climate Action 100+, n.d.).

For corporations to support various sustainability objectives and financial institutions to facilitate the financing need for the sustainability transition, a plethora of sustainability/ESG reporting frameworks and standards has been developed. Within the last ten years, sustainability standards and frameworks have aimed to integrate sustainability practices and disclosure of sustainability information into corporate and financial intuitions practices. The two most used ESG accounting systems are 1) the Global Reporting Initiative (GRI), and 2) the Sustainability Accounting Sustainability Board (SASB) (GRI & SASB, 2021). Efforts by the IFRS Foundation, overseeing the International Accounting Standards Board (IASB) led to the creation of the International Sustainability Standards Board (ISSB) in November 2021 (IFRS Foundation, 2022). The ISSB has subsequently during 2022 amalgamated SASB and the Integrated Reporting
Framework (which had just merged to form the Value Reporting Foundation) and signed a cooperation agreement with the GRI (IFRS Foundation, 2022). Furthermore, the EU has adopted a mandatory ESG reporting law under the Corporate Sustainability Reporting Directive (CSRD). CSRD mandates large and listed corporates to report their ESG performance in accordance with the European Sustainability Reporting Standards (ESRS) (Baumuller & Sopp, 2022).

2.3 Task Force on Climate-Related Financial Disclosure

The Task Force on Climate-related Financial Disclosure (TCFD) was created in 2015 by the Basel-based Financial Stability Board (FSB). The FSB was established by G20 countries in the aftermath of the financial crisis in 2009 to promote international financial stability. The FSB identified climate change as a systemic risk for the stability of the global financial markets and considered the lack of unified and financial value-related disclosure as a root cause that needed to be addressed. The TCFD published its disclosure recommendations in 2017, calling for companies, investors, lenders, and insurance underwriters to appropriately assess and report risks associated with climate change (TCFD, 2017). Since then, the TCFD has been instrumental in embedding climate-related risks into corporate governance and strategy at the board and management level in large organizations. Increasingly, corporates are embedding TCFD disclosure and strategy relating to climate risk in their corporate net-zero plans, as transparency becomes increasingly critical for investors, lenders, and insurance underwriters to make informed economic decisions (TCFD, 2022). The TCFD’s core principle is that corporates should inform financial markets about how they consider climate-related risks and opportunities in their governance, strategy, risk management, and metrics and targets (TCFD, 2017). The rationale is that better information will enable more informed investment decisions and reduce systemic risk.
Background on sustainable finance

Figure 2. The TCFD model of climate-related risks, opportunities, and financial impacts, adopted from the recommendations of TCFD report (TCFD, 2017).

More simply, Figure 2, above, adopted from the TCFD (2017) report, conveys how climate change can impact a company’s financial value or risk. Climate change presents both risks and opportunities for companies. Risks can be either transitional or physical. Transitional risks represent swift or secular change in the business environment like regulatory requirements, technological changes, market changes in demand, supply or competitive landscape, or reputational risk. Physical risks represent acute or chronic changes brought about by changes in weather or climate patterns, like floods, droughts, storms, or changes in heat or cold patterns. Climate change also represents opportunities for firms. Opportunities derive from changing market trends and developing and offering products and services to climate mitigation and adaptation needs. Investments in energy efficiency, new energy sources, and climate resilience are all further areas of value. Future changes in transitional and physical risks as well as business opportunities have an impact on companies’ financial performance and cash flows. This impact transcends income statement or balance sheet, and acknowledging, preparing, and communicating the risks and opportunities is value enhancing not only for a single company, but for the financial market as a whole (TCFD, 2017).

2.4 The EU and Sustainable Finance

The EU has set upon greenifying the financial markets to meet its climate and other SDG targets. Transforming the EU economy towards carbon neutrality is estimated to require additional annual investments of €175 to €290 billion between 2020—2030, the majority of the funds coming from the private sector (Brühl, 2021; European Commission, 2019a). The aim of the EU sustainable finance action roadmap and plan is to ensure that
private financial markets support the green transition and identify and mitigate climate and other sustainability risks. The action plan includes 10 actions aimed at steering capital flows to support sustainable investments, integrate sustainability into risk management, and ensure financial markets incorporate transparency and long-term orientation (Principles for Responsible Investment, 2018).

According to the EU, “Sustainable finance refers to the process of taking environmental, social and governance (ESG) considerations into account when making investment decisions in the financial sector, leading to more long-term investments in sustainable economic activities and projects” (European Commission, 2021). In the EU’s estimation, sustainable finance includes:

1. The process of considering ESG factors when making investment and finance decisions in the financial sector.
2. Transparency about the financial impact of ESG risks impacting companies, financial institutions, and the financial system, and the mitigation of such risks through the appropriate governance of financial and corporate actors.
3. Transparency about the impact of companies and financial industries on the environment and society to direct private capital flows to support green transition (European Commission, 2021).

As such, sustainable finance considers the double materiality of, on one hand, companies’ impact on the environment and society, and, on the other hand, the impact of the changes in the environment and society on companies’ financial value and risks (Figure 3).
There are two central pieces of legislature at the center of the EU sustainable finance action plan. First, the sustainable finance taxonomy criteria, a first-of-its-kind harmonized environmental and sustainable set of criteria to guide policymakers, industry, and investors on how best to support the transition to a carbon-neutral, resource-efficient economy. Secondly, disclosure of sustainability-related information from corporates and financial institutions to incorporate sustainability impact and risks in a transparent and uniform manner to financial market participants and other stakeholders (SFRD, CSRD/NFRD) (KPMG, 2022).

Figure 3. EU Sustainable finance and materiality.¹

Figure 4. The EU’s sustainable finance taxonomy, disclosure, and tools landscape.

The EU taxonomy regulation (EU 2020/852) develops a classification system to define what is a sustainable or green economic activity. The initial taxonomy areas cover six economic activity areas around climate change mitigation, adaptation, water and marine resources, circular economy, pollution, and biodiversity criteria (European Commission, 2019a). The taxonomy regulation is pivotal as it supports the creation and criterion included in the financial and corporate disclosure regulations, the Sustainable Finance Disclosure Regulation (SFDR) (EU 2019/2088), and the Corporate Sustainability Reporting Directive (CSRD) which is set to amend the existing Non-Financial Reporting Directive (NFRD) (EU 2014/95). The CSRD will apply a more stringent and standardized approach to climate-related disclosures and cover more companies (but still leave out unlisted small and medium-sized enterprises) in comparison to the NFRD (Brühl, 2021).

Further, the three Europan Supervisory Authorities (ESAs), namely, the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), and the European Insurance and Occupational Pension Authority (EIOPA) all have sustainable finance in their scope. For example, the EBA will be requiring banks to report climate risks of their lending books (European Banking Authority, n.d.-b), which will mean all lending clients’ carbon emissions and taxonomy alignments need to be determined and reported on. The ESAs are coordinating their individual sustainable finance regulatory initiatives with the focus on financial institutions to map, manage and report on their climate and other ESG-related risks and impacts over the coming years (European Banking Authority, n.d.-a).

2.5 Sustainability and Financial Performance

The relationship between sustainability, corporate social responsibility (CSR), or ESG, and financial value or corporate financial performance (CFP) has been researched extensively. An early study by van Beurden and Gössling (2008) looked at 34 research papers examining the relationship between corporate philanthropic and ethical conduct or reputation and financial performance and found that 23 exhibited a significant positive relationship with CSR and CFP, whilst only 2 had a significant negative relationship. Cantino et al. (2017) conducted a systematic literature review examining the cost of debt and equity end ESG. They found 31 relevant journal publications which pointed to a clear positive relationship between better ESG performance resulting in lower cost of equity whilst the results were more ambiguous on ESG lowering the cost of debt (Cantino et al., 2017). Gonçalves et al. (2022) got similar results examining European STOXX600 companies and finding that investors reward companies’ investment in ESG with a lower cost of equity, whilst lenders penalize companies overinvesting in CSR activities with a higher cost of debt (Gonçalves et al., 2022). Friede et al. (2015) found over 2,200 articles from 1970 to 2015 in their meta-analysis looking at the research on the relationship between ESG and CFP. The study found that although varying definitions of ESG and CFP were used in the articles, an overwhelming 90% concluded that ESG investing is not value-negative and that the relationship in most studies had a positive correlation (Friede et al., 2015).

The growing focus on ESG, and evidence that good performance on financially material ESG factors is positive for financial performance is not without its challenges. Auer and Schuhmacher (2016) found that using Sustainalytics rating company’s ESG scores solid performance in ESG produced no significant returns regardless of the industry and geography in focus. Christensen et al. (2022) found ESG ratings between rating agencies diverging more for companies with greater disclosure due to the subjective nature of ESG information and its interpretation. One explanation could be that ESG ratings or scorings are found to be biased, incomparable, and inconsistent between different ESG rating agencies (Berg et al., 2022; Doyle, 2018). Berg et al. (2022) identified 1) scope (which ESG factors are chosen), 2) weight (how their importance is weighted), and 3) measurement (how each factor is scored) as the main causes for divergence, with measurement accounting for over 50 percent. This is all the more reason to identify robust industry- and firm-specific financially material ESG factors (Eccles et al., 2012; Eccles & Youmans, 2016).

Khan et al. (2016) found that firms performing well on financially material ESG factors generate excess returns with the same risk profile. Khan et al. (2016) used industry-specific material sustainability issues developed by the Sustainability Accounting Standards Board (SASB). The SASB standard has developed financially material sustainability reporting standards for 77 industries to support companies to target sustainability topics that are
most relevant for financial stakeholders. Khan et al. (2016) analyzed 2,396 firms between 1991 and 2013 organized according to SASB standards and found that firms performing in material industry-specific topics had an excess share return of 5% p.a., and those investing in non-material aspects yielded no or negative returns. Further studies have also found that firms performing well on CSR also have improved access to finance (Cheng et al., 2014), face a lower cost of equity (Girerd-Potin et al., 2014), and have better credit ratings (Attig et al., 2013). Ali et al. (2022) studied if S&P 500 companies between 2005 and 2020 and found that pro-active climate action resulted in reduced cost of debt. Importantly, they discovered that this outcome holds for both environmentally sensitive and non-sensitive industries. Hoepner et al. (2022) looked at the impacts of EU Taxonomy’s non-climate environmental criteria, and found performance on especially biodiversity, water and pollution prevention impacting infrastructure firms cost of debt. Overall, the existing literature confirms the growing importance of ESG for companies and the financial industry. However, there is further room to investigate the methods, drivers, and motives of integrating ESG into corporate and financial industry practices.
This thesis is organized into three essays forming an overarching theme around sustainable finance and ESG. Essays 1 and 3 draw on institutional theory and case study methodology, and essay 2 is a systematic literature review. The following sections will provide an overview of the research approaches used in the essays.

### 3.1 Theory Informing Essays 1 and 3: Institutional Theory

Institutional theory provides a good framework to study the process of change and legitimization taking place within an institutional field. According to DiMaggio and Powell (1983), institutional fields comprise “those organizations that, in the aggregate, constitute a recognized area of life”(p. 148). Expanding on this definition, Lawrence and Philips (2004), define “an institutional field as a set of organizations that constitute a recognized area of life, are characterized by structured network relations, and share a set of institutions”(p. 691). A characteristic of this definition is that it implies that institutional fields are comprised of a set of actors who relate to one another and have a common set of institutions. The notion of legitimacy and institutions is central to institutional theory (Suchman, 1995). Institutions provide actors with meaning, rules, and practices by which they relate to each other. According to Scott (2008), “institutions consist of cognitive, normative, and regulative structures and activities that provide stability and meaning to social behavior”(p. 57). In other words, institutional legitimacy takes the form of regulative, normative, and cultural-cognitive legitimacy. Table 1 below summarizes the key concepts comprising the institutional theory framework. I underscore a few main points from the table below.
Table 1. Three pillars of institutions adopted from Scott (2008).

<table>
<thead>
<tr>
<th>Basis of compliance</th>
<th>Regulative</th>
<th>Normative</th>
<th>Cultural-Cognitive</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expendience</td>
<td>Social obligation</td>
<td>Taken-for-granted</td>
<td></td>
</tr>
<tr>
<td>Basis of order</td>
<td>Regulative rules</td>
<td>Binding expectations</td>
<td>Constitutive Schema</td>
</tr>
<tr>
<td>Mechanisms</td>
<td>Coercive</td>
<td>Normative</td>
<td>Mimetic</td>
</tr>
<tr>
<td>Logic</td>
<td>Instrumentality</td>
<td>Appropriateness</td>
<td>Orthodoxy</td>
</tr>
<tr>
<td>Indicators</td>
<td>Rules Laws Sanctions</td>
<td>Certification Accreditation</td>
<td>Common beliefs Shared logics of actions Isomorphism</td>
</tr>
<tr>
<td>Affect</td>
<td>Fear Guilt/ Innocence</td>
<td>Shame/ Honor</td>
<td>Certainty/ Confusion</td>
</tr>
<tr>
<td>Basis of legitimacy</td>
<td>Legally sanctioned</td>
<td>Morally governed</td>
<td>Comprehensible Recognizable Culturally Supported</td>
</tr>
</tbody>
</table>

Institutional theory and its concepts provide researchers with means by which to examine action in the context of macro-structures forming an institutional field. Scott (2008) maintains that the three pillars of institutions manifest differently depending on the context in which institutional processes unfold. In some fields, the regulative legitimacy may be more pronounced, whereas, in some other fields, it is the cultural cognitive and the normative legitimacy, or a combination of the three. For example, industries that have an environmental impact through air or water pollution are more prone to regulation, effectively impacting how normative and cultural legitimacy unfold for them.

Lawrence and Philips (2004) underscore this aspect by saying that macro-discourses always inform how an institutional field is organized. However, in line with new institutionalism, macro-discourses are not viewed as omnipotent categories as captured with the “iron cage” metaphor (DiMaggio & Powell, 1983). They do provide constraints, but, at the same time, they provide opportunities for actors in the institutional field to interpret and use them for their interests and desires. So, in other words, institutional theory underscores a dynamic relationship between macro-discourses and individuals’ or groups’ actions, making it suitable to study the responses and activities of individuals or groups in the context of institutional field dynamics, comparable to the field of sustainable finance.

In Essay 1, I explore the interplay between normative and mimetic mechanisms and how they impact legitimacy. In Essay 1, actors are shown to interpret the appropriateness of ESG integration into the financial valuation differently. Due to ESG being a novel phenomenon in the sustainable finance field, the mimetic tendency with investors was more pronounced. Specifically, we look at how and why analysts use ESG information in a valuation process, and what are the main drivers and barriers to the institutionalization of ESG data and practices.

In Essay 3, institutional theory is used to address how the field of sustainable finance and its dominant macro-discourses exemplified by the ESG criteria inform the actions of SMEs in institutionalizing ESG into their business activities. More specifically, it allows me to describe and
explain how and why an SME seeks to institutionalize ESG into its business activities, and how an SME seeks to retain legitimacy within the industry by adopting ESG into its business activities. This reflects Suddaby’s (2010) position that the role of institutional theory is “understanding how and why organizations attend, and attach meaning, to some elements of their institutional environments and not others” (p. 15).

Dacin, Goodstein, and Scott (2002) identify three drivers as major sources pushing an institutional field to change: the functional, the political, and the social. In both Essays 1 and 3, we can argue that the functional and social drivers are more prominent, however, in Essay 1, the political driver also plays a role. Within the broad field of finance, these drivers challenge the perceived utility of the dominant view on profit maximization, instead prioritizing sustainable profitability through adhering to ESG criteria.

There is a general assumption within institutional theory literature that institutions should be viewed as independent variables. However, Palthe (2014) “argue[s that] explanations for organizational change cannot simply be pared down to the relationships between independent and dependent variables but should be viewed as interactions between context and action” (p. 64). Institutions, in as much as they shape action, are also shaped by the action undertaken by institutional actors. As an example, sustainable investment started as an ethical investment driven by the church and other religious organizations, providing the initial discourses through which the institutionalization of sustainable finance commenced. Similarly, ESG as a term was broadly launched by the PRI upon its formation in 2006 and has only more recently been adopted in general business discourse. Over the recent past, regulative legitimization has entered the sustainable finance and sustainability field globally, especially in the EU. For example, the EU is implementing its “Green Deal”, whereby sustainability consideration gets incorporated into all EU regulations. The EU sustainable finance program is thus institutionalizing new terminology and practices within the finance industry, and, in the process, creating new instructional fields and logics. For example, in Essay 3, I examine how and why sustainable finance institutionalizes the ESG adoption practices of a Finnish SME. These short examples highlight the dynamic relationship between institutional pillars identified by Scott (2008), and the actions and interpretations of actions by institutional actors.

So, to this end, the process of institutionalization can be viewed both as comprising both stable and unstable institutional pillars, and as the evolving relative importance of each pillar in the idiosyncratic context and action in which institutionalization takes place (Dacin et al., 2002; Lawrence & Phillips, 2004; Suddaby, 2010). As Lawrence and Phillips (2004) argue, the sustainable development fields has also evolved at the macro-level towards increased concern over the breach of climatic and planetary boundaries. These discourses have entered corporate and financial institutions, effectively shaping their institutional fields and underscoring the increasing role of ESG and sustainable finance. What initially started as cultural-
cognitive concern has evolved into normative and increasingly regulative legitimacy. An outcome of the institutionalization of sustainable finance is accentuated by institutional actors seeking to retain legitimacy within their institutional field and among stakeholders. Overall, today there is a common agreement that all businesses should be sustainable and report on their ESG performance.

New-institutional theory seeks to explain the drivers and hindrances between organizations and within organizations that support change toward homogeneous practices and forms. The convergence of organizational strategies, designs, and processes towards homogeneity as institutional isomorphic processes was first defined by DiMaggio and Powell in their seminal paper “The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organizational Fields” (DiMaggio & Powell, 1983). DiMaggio and Powell identified three isomorphic forces: coercive, mimetic, and normative (see also Scott, 2008). Coercive isomorphism is a prevalent pressure from society and stakeholders that either tempts or forces behavioral change. Organizations might seek change to achieve benefits (competitive or otherwise) or feel pressured to do so. Mimetic isomorphism is especially prevalent in times of uncertainty, characterized as organizations seeking to copy what others are doing for lack of a better way of addressing the uncertainty. Normative isomorphism comes from the standardization of professionalism. This process implicates common education standards, job descriptions, career paths, and formal and informal networks that influence standards and behavior. However, as Lawrence and Philips (2004) and Suddaby (2010) argue, institutional forces are not solely top-down, as suggested in DiMaggio and Power (1983). Institutional actors are constrained by the macro-forces, but at the same time, macro-forces enable institutional actors to interpret and adapt them to fit their needs and objectives.

Institutional theory is well suited for qualitative study of sustainable finance as it is a field that has evolved and developed rapidly over the past decade. Institutional theory has been used in social science and management studies as well as in analyzing sustainable finance, investments, and accounting (Bhimani et al., 2016; Galbreath, 2013; Herold, 2018; Sjostrom, 2008). Investors have conformed to institutional expectations by adopting widely used exclusion strategies, where controversial sectors are excluded from the investment universe. This rather subjective and limited financial value and impact strategy has been largely a result of normative and mimetic isomorphic pressures (Sjostrom, 2008). Reliance on external ESG data providers’ tools and rankings, and on screening internal ESG teams provides conformity to expectations. However, a focus on ESG by investors would achieve longer-term, more permanent change in industry or company behavior if integrated into core investment processes and practices (Sakuma-Keck & Hensmans, 2013). An Australian study found that firms exhibit improved ESG performance over time, especially in the governance dimension (Galbreath, 2013). Isomorphic mimesis acts
as a driver motivating firms to follow each other. The first movers in CSR and CSR reporting identify with coercive and normative pressures from stakeholders. This regulatory or stakeholder pressure can be an impetus for some, while a drive for genuine strategic differentiation motivates others. In these contexts, external pressures might change over time and be impacted by firm-specific drivers (Bhimani et al., 2016). The convergence towards common practices has also been analyzed in management accounting practices, systems, and processes, and indicates that conformity rather the differentiation is the driving force (Granlund & Lukka, 1998). Bauckloh et al. (2023) examined PRI signatories’ commitment to the principles and found institutional theory providing explanations for increasing popularity and signatory number of PRI whils leaving open whether the signatories integrate ESG to their pratices (Bauckloh et al., 2023). Thus, institutional isomorphic pressures are likely both significant drivers and hindrance factors in the development of sustainable investment and finance practices. Therefore, institutional theory is well suited to examining why and how ESG is integrated into the assessment of financial value and risk at a company level, as well as why and how sustainable finance impacts the adoption of ESG in corporate strategies and practices.

3.2 Methodology Used in Essays 1 and 3: Case Study Methodology

Essays 1 and 3 draw on case study methodology around a single case (Yin, 2003). Both essays used an analytic method largely adopted from Kahkonen (2014) and Battistella et al. (2018).

Data collection
- interviews
- other data and documents

Data treatment
- transcription
- inter- and intratextual analyses

Data analysis
- constant comparative analyses
- open and axial coding of texts
- selective coding

Figure 5. This Data collection and analysis. Adopted from Battistella et al. (2018) and Kahkonen (2014).

First, we collected data through interviews and documentary searches relevant to the case at hand. When data was considered sufficient for covering the case, the data treatment phase started. The process was not rigid, and, if there was a need to obtain more data that surfaced during data treatment or analyses phases, more data was retrieved. Data treatment entailed transcription and inter- and intra-textual analyses. The treated data was then coded and analyzed using constant comparative analysis.
In Essay 1, we used Excel for coding, and in Essay 3, I used Nvivo software. We then triangulated and analyzed the data from multiple sources (Eriksson & Kovalainen, 2008).

3.3 Methodology Used in Essay 2: Systematic Literature Review

Essay 2 is based on a systematic literature review methodology. According to Snyder (2019), there are two types of literature review methodologies: 1) semi-systematic, and 2) systematic. The use of systematic methodology in business research has increased as it offers an unbiased perspective in a particular research field (Khan et al., 2020). Systematic literature reviews are used to find articles that address specific research questions or a given set of search strings in a population of journals. The method helps determine research gaps, commonalities in hypotheses and conclusions, as well as the volume of existing studies (Snyder, 2019). A semi-systemic literature review methodology is used where the volume of research is large and hence a systemic review of every article does not add value to the discovery of common theoretical methods or research principles (Snyder, 2019).

In Essay 2, we used a systematic review method to find the volume and type of research around sustainable finance and SMEs with selected keywords from Scopus database prior to our search date of end of October 2020. We used Johnson and Schaltegger’s (2016) methodological steps from (1) selection of search strings; (2) search of articles from Scopus; (3) selection of relevant articles based on criteria; (4) extraction of search and analytical data into a spreadsheet; and (5) analyses and summary of the findings. The chosen research method allowed us to identify and group research in relevant ESG areas with common drivers for financial performance and access to, and cost of, capital. We also identified areas with research gaps specifically around SMEs and ESG or sustainable finance.
4. Summaries of the Essays

This dissertation consists of three essays as shown in the table below, with each one investigating a different aspect of how sustainable finance can institutionalize ESG into corporate strategies.

Table 2. List of essays.

<table>
<thead>
<tr>
<th>Article 1</th>
<th>Article 2</th>
<th>Article 3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Title</strong></td>
<td><strong>Sustainable finance and SMEs: A systematic literature review</strong></td>
<td><strong>Sustainable finance and the institutionalization of ESG: A case study of a Finnish SME</strong></td>
</tr>
<tr>
<td>2) What key drivers and barriers to the institutionalization of ESG data can be identified?</td>
<td>2) What ESG drivers improving the financial status of SMEs can be identified?</td>
<td>2) How do institutional drivers manifest in the case company’s adoption of ESG?</td>
</tr>
<tr>
<td><strong>Research method</strong></td>
<td><strong>Systematic literature review</strong></td>
<td><strong>Case study; Open coding</strong></td>
</tr>
<tr>
<td><strong>Theoretical frame</strong></td>
<td><strong>Literature review</strong></td>
<td><strong>Institutional theory</strong></td>
</tr>
<tr>
<td><strong>Data</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interviews and documents</td>
<td>Research articles</td>
<td>Interviews and documents</td>
</tr>
</tbody>
</table>

4.1 Essay 1 – What’s Valued by Investors Gets Valued by Analysts: Institutional Motives on ESG Integration Into Sell-Side Research

Essay 1 examines sell-side equity analysts’ and institutional investors’ practices around environmental, social, and governance (ESG) analysis. The essay fills a gap in the existing research literature by examining two research questions: 1) How and why do analysts use ESG information in a valuation process? And 2) What key drivers and barriers of institutionalization of ESG data can be identified? To address these research questions, this essay draws on qualitative methods, namely, case study methodology, and
institutional theory. The empirical data consists of the case firm’s equity analysis report that integrated ESG into analyses of OMXS-30 companies, and a sample of other banks’ research. The data is further supplemented by four interviews with case firm equity analysts, and ten interviews with Swedish and Finnish institutional investors, resulting in some 220 pages of transcribed text. All data was analyzed inter- and intra-textually, coded, and synthesized for findings. The data was analyzed against institutional theory tenets with the aim of exploring the process of rationalizing the integration of ESG into equity valuation by analysts and investors, and identifying which drivers and hindrances institutionalize these new market practices.

The case firm’s integrated ESG valuation report was novel in the market and viewed positively by the analysts, asset managers, and asset owners. Transparent and explicit integration of ESG information into a company’s valuation increases the amount of information available to investors and companies. The same sell-side equity analysts perform analyses on the pricing of equity issues and assess the impact of mergers and acquisitions on a company’s value. The equity market’s view of a company’s value drivers impacts the companies’ boards and management strategy design and KPI selection. Hence, the impact of ESG on financial value enables better capital pricing and allocation, as well as driving the institutionalization of ESG into corporate strategies and practices.

Our results indicate that transparent and standardized ways of integrating ESG factors into share valuation are not common practices by sell-side analysts or investors. Our findings indicate that this is because 1) investors inadequately compensate the sell-side for ESG analysis efforts; 2) undeveloped ESG valuation practices increase the cost of implementation by analysts; and 3) commonly adopted exclusion and engagement strategies suffice for sustainable investor status by asset owners. Our findings suggest that investors, and in particular asset owners, could drive market development by ensuring analyses compensations include ESG considerations. The sell-side analyst community would be able to cater to increased demands on valuation practices that integrate ESG factors.

This essay provides an enriched view of the state of ESG integration with investors and sell-side analysts, and of how institutional isomorphism is influencing the conduct of these actors. However, this research only looked at a single case firm and its ESG integration efforts. As sustainable finance practices are rapidly evolving, new practices and methods could have been developed since the launch of the case firm’s report in late 2016.

Further studies into ESG integration around single-company financial analyses should be done. Are financially material ESG factors industry or company specific? Do they remain the same over time or change together with dynamic developments in societies and industries? How can we conduct sensitivity analyses around climate change or other disruptions in a standardized manner? The EU’s sustainable finance roadmap and associated regulations are creating new practices and raising investor awareness. The push for greenifying capital markets to tackle climate
change and other sustainability challenges is hopefully expediting ESG integration into valuation as well.

4.2 Essay 2 – Sustainable Finance and SMEs: A Systematic Literature Review

Essay 2 is a systematic literature review investigating how sustainable finance has been researched in the context of small and medium-sized enterprises (SMEs). The essay contributes to academic discussion by exploring two research questions: 1) How does the ESG performance of SMEs relate to financial performance? And 2) What ESG drivers improving the financial status of SMEs can be identified? This perspective is important as SMEs account for over 99% of firms in the EU and over 50% of employment, value added, and environmental impact. Climate and sustainability transition cannot take place without SMEs being onboard and yet much of green and sustainable finance practices evolve around large companies, investors, and banks.

We conducted a systematic literature review of the Scopus database using specific search words around SMEs, ESG performance, and financial performance or access to, and cost of, capital. According to the company website, Scopus “is the largest abstract and citation database of peer-reviewed literature – scientific journals, books and conference proceedings.” (Scopus, n.d.). All in all, we found 1,637 articles researching ESG and financial performance dimensions. Of these, 52 looked at SMEs, and, after further examination, 36 were selected as relevant for further analysis. The articles were first coded for identifiers and then reviewed against the research questions. The articles were then grouped into clusters under the ESG framework as in Table 3 below.

Table 3. Clusters organized under the ESG framework.

<table>
<thead>
<tr>
<th>Environment</th>
<th>Social</th>
<th>Governance</th>
</tr>
</thead>
<tbody>
<tr>
<td>7 articles</td>
<td>35 articles</td>
<td>24 articles</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Environment</th>
<th>Social engagements</th>
<th>Governance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brand reputation</td>
<td>Innovation</td>
<td>Financial materiality</td>
</tr>
<tr>
<td></td>
<td>Community and philanthropy</td>
<td></td>
</tr>
</tbody>
</table>

The findings shed new light on the status, method, and findings of existing research on SMEs and sustainable finance. SMEs are motivated by financial materiality and access to, and cost of, capital in their choice of ESG strategies. Seven articles identified performance in environmental factors as key drivers for the financial performance of SMEs. Similarly, 35 articles had one of four social clusters as a key area, and 24 explored one of four governance clusters as a key driver of financial performance. Local and cultural contexts were important for financial materiality, especially in
developing country contexts. The dynamic adoption of strategy in response to changing circumstances was found to be a sign of the strength of SME operating culture, as well as an important requirement for SME financial success.

The generally limited number of articles found suggests that further research into why and how SMEs adopt ESG strategies is required, for example by conducting case study analyses of SMEs. Studies of the role of ownership were largely absent from the literature and warrant exploration, especially as most SMEs are family-owned companies. The role of climate change and its impact on large companies, investors, and banks is under increased focus. The existing SME and sustainable finance literature does not explore how climate change impacts SMEs and their adoption of ESG strategies. The impact of a sustainable finance focus on the part of banks and investors in the EU, and how this influences the institutionalization of sustainability in SMEs should also be researched. Questions remain as to whether, or to what extent, the financially material ESG factors are the same or different between large companies and SMEs operating in the same industries. Further research should be done using qualitative research methods (exploring the how and why) as well as quantitative methods to explore causal hypotheses. We should especially do further research within the EU where sustainable finance trends and regulations are increasingly being implemented with little research-informed knowledge of their direct or indirect impact on SMEs.

4.3 Essay 3 – Sustainable Finance and the Institutionalization of ESG: A Case Study of a Finnish SME

Essay 3 is a case study of a Finnish family-owned SME, idiosyncratic in its stakeholder focus and long-term value-oriented family ownership. The case company was starting (as of 2020) to investigate ESG as a theme and our research explores 1) How and why do sustainable finance considerations impact the case company’s adoption of ESG? And 2) How do institutional drivers manifest in the case company’s adoption of ESG? Our empirical data consists of five semi-structured interviews of board and management members totaling 17,637 transcribed words and other documentary material including a company history book draft, annual reports, and marketing materials. The data were individually read, compared, and coded. After treating and mapping the data, it was analyzed against the existing ESG cluster identified in Essay 2, as well as institutional theory tenets.

The case company rationalizes institutionalizing ESG into its strategy and operations to retain legitimacy with its key stakeholders. Financial returns and access to, and cost of, capital are implicit key considerations in deciding which ESG factors to invest in while maintaining a focus on financially material stakeholders in the Finnish context. Value-driven corporate
culture derived from long-term family ownership creates a unique corporate disposition. In turn, such disposition translates to closeness and alignment with key stakeholder groups. From an institutional theory perspective, the case company reaction is geared towards retaining legitimacy in anticipation of increased ESG demands from financially material stakeholders.

The case company rationalizes institutionalizing ESG into its strategy through financial returns and access to, and cost of, capital considerations. The case firm’s leadership team is strongly impacted by corporate values linked to long-term family ownership and the normative and cultural-cognitive drivers inherent in this. The institutional field of sustainable finance is evolving, and new practices and regulations are impacting value chain stakeholders. The management implicitly identifies financially material ESG factors and key stakeholders. Management is focused on maintaining legitimacy through a focus on financially material value chain partners and ESG factors even before regulatory pressures appear. Even though lenders and other financial institutions, such as insurance companies as credit providers, are not yet engaging in ESG work, the case company’s leadership team foresees and plans for this to take place.

The clusters under the ESG framework exhibited in Table 3 are also mostly present as drivers in the analyses of the case company. The case company is seeking a competitive advantage and financial benefits from its strategic ESG focus. The case company’s ownership and values system act as a basis on which much of its activity is carried out. Significantly, the role of ownership and a value system as a catalyst for ESG change was not included in the ESG framework used. Also, a strong focus on retaining legitimacy on financially material stakeholders and ESG factors was new.

This essay contributes to the field of sustainable finance and SMEs by examining a single case company’s unique circumstances and considerations in adopting ESG more explicitly into its business. The findings have practical implications for policies and their implementation. Banks, and other financial institutions providing financial services to SMEs, are not engaging in ESG. Systemic requirements on ESG engagement on financially material ESG factors would expedite ESG adoption by SMEs and reduce systemic risks in the financial sector. SMEs need support in developing ESG capabilities and capacities to answer the call. However, the green and sustainable transition requires having SMEs on board, so this is an important focus area for the public sector, industry associations, and NGOs going forward.
The objective of sustainable finance is to direct capital to sustainable development investments whilst ensuring a resilient corporate and financial sector. This calls for an understanding of the impact of corporates on the planet and society, as well as managing the ESG factors that are financially material for companies and the financial sector. Solving climate change, biodiversity loss, and other sustainability challenges requires large investments in innovation, and scaling of new businesses. The physical and transition risks from the disruptions, together with the emerging demand for new products and services, require the identification and management of new types of risks, as well as offering large opportunities for growth. The role of sustainable finance will grow in importance as new regulations, commitments, and practices institutionalize in the financial sector and these impacts extend to the real economy.

The objective of this thesis is to examine the institutionalization of sustainable finance and ESG practices. In Essay 1, we explore the methods, and motives for the inclusion of financially material ESG in single-company analyses for equity valuation purposes. The role of financial data in explaining financial value and risk has declined from some 90% in the 1950s to 55% today (Lev & Gu, 2016). ESG data, particularly from an industry-specific financial materiality perspective, has gained importance (Eccles et al., 2012). Companies performing strongly on financially material ESG factors generate excess shareholder returns over time (Khan et al., 2016). ESG data, particularly from an industry-specific financial materiality perspective, has gained importance (Eccles et al., 2012). Companies performing strongly on financially material ESG factors generate excess shareholder returns over time (Khan et al., 2016).

Sell-side and buy-side analysts conduct a financial valuation on company shares, and, generally, there is a desire for more information on companies and their peers. This is the case for ESG data as well, though Krasodomska and Cho (2017) found that analysts seldom make use of ESG data. Similar to Krasodomska and Cho (2017), the case firm’s equity analysts did not make use of the ESG data of the companies they followed. However, the case firm’s sell-side analysts following OMXS-30 companies were required to identify and integrate material ESG factors in the valuation of their respective companies for the pilot exercise. The analysts, asset managers, and asset owners valued the ESG integration work, and the case firm intended to make this a standard practice. However, this integration did not materialize during the case period, and we found that, whilst normative pressures drive the sell-
Contributions and conclusions

side to integrate ESG into valuation analyses, the mimetic and regulatory tendencies at the investors’ side hinder these efforts (DiMaggio & Powell, 1983). For investors and, in particular, asset owners, systemic compensation for ESG-integrated research could significantly impact single-company analysis practices in the market. The institutionalization of improved analytical practices would impact companies, boards, and managements in their strategic consideration of ESG, thus supporting a more resilient financial system.

Essay 2 is a systematic investigation of the status of sustainable finance research on SMEs in line with Snyder’s (2019). We found 1,637 articles investigating the corporate financial performance and corporate social responsibility (CFP-CSR) relationship, of which 36 relevant articles looked at this from an SME perspective. We grouped the articles into eight clusters under an ESG framework. Most of the articles were quantitative research studies investigating the CFP-CSR relationship in an emerging market context. Proactiveness and a focus on financially material ESG factors have a positive impact on SMEs’ financial performance (Panwar et al., 2015; Torugsa et al., 2013), and disclosure of ESG information lowers the cost of debt (Dunne & McBrayer, 2019). Employee engagement (Cantele & Zardini, 2018), supply chain relationships (Yang et al., 2020), and innovation capabilities linked to strong CSR (Bahta et al., 2020) are examples of ESG clusters impacting SMEs CFP. However, unlike large for companies, cultural context also plays a role in the financially material ESG of SMEs. For example, religious and other social philanthropic activities improve the legitimacy of SMEs with stakeholders and thus positively impacting CFP (Aziz et al., 2020; Basuony et al., 2014). The existing research highlights the importance of financial performance and access to, and cost of, capital for SMEs in their consideration of ESG strategies. It also highlighted the need for further research on SMEs, ESG, and sustainable finance. Cultural and social context was recognized to play a particularly important role in such relationships. We also identified the need for further studies in the EU context, using both qualitative and quantitative methods.

In response to Essay 2, we investigate a Finnish SME in Essay 3, with particular attention paid to how and why sustainable finance impacts SMEs’ integration of ESG into its strategy and practices. We draw on case study methodology (Yin, 2003), institutional theory (Scott, 2008), and the SME ESG framework created in Essay 2. The empirical data was based on interviews with the case company leadership team, as well as the company’s history book, annual reviews, and other documentary materials. The data collection and analytical processes were based on Kahkonen (2014) and Battistella et al. (2018). Institutional theory provided a framework to analyze the change process in SMEs, in particular the process of legitimization of ESG in the case company. According to Scott (2008), the regulative, normative, and cultural-cognitive pillars of institution contribute to legitimacy differently depending on context. Similar to Panwar et al. (2015), the case company’s environmental focus is motivated by financial
returns. The focus on employee well-being (Torugsa et al., 2012) and motivation (Choongo, 2017) were evident as financially material factors in the case company. This further supports, for example, strong relations and innovation with supply chain partners (Valdez-Juárez et al., 2019; Yang et al., 2020). Importantly, we found that the case company’s long-term family ownership played an important role in driving ESG institutionalization. The case company’s leadership team is seeking to retain legitimacy with its key stakeholder by proactively and implicitly working on financially material ESG factors.

Taken together, these three essays examine relationships between capital providers and capital users in the context of sustainable finance (see Figure 6). I have examined why and how ESG could be included in single-company financial analyses, as well as why and how sustainable finance considerations translate to SMEs’ considerations of ESG.

The financial materiality of ESG factors differs per industry (Eccles et al., 2012; SASB, 2016) and firms performing well on material ESG factors generate excess shareholder returns (Khan et al., 2016). Strong ESG performance can also result in better credit risk ratings (Attig et al., 2013), lowered cost of capital (El Ghoul et al., 2011; Ng & Rezaee, 2015), and improved access to finance (Cheng et al., 2014). For SMEs, the proactive and strategic approach to ESG, over and beyond what is demanded by laws and regulations, improves financial performance (Torugsa et al., 2012). Also, SMEs that perform on ESG and proactively engage with stakeholders have improved access to debt (Ansong, 2017), as well as lower costs of debt (Dunne & McBrayer, 2019). Sustainable finance regulations in the EU especially are acting as catalyst for institutionalization of ESG considerations in the financial sector and the real economy (European Commission, 2021). Companies and financial institutions are also committing to voluntary initiatives such as the Global Compact, PRI, and PRB. The positive relationship between CSR and CFP, together with regulatory and voluntary initiatives are increasing the importance that ESG has on companies’ financial success, and the cost of, and access to, capital.
Contributions and conclusions

Overall, this thesis contributes to the existing literature by examining new and novel business situations through case study, institutional theory, and sustainable finance lenses. It also contributes to existing sustainable finance literature by highlighting the greater need for researching the role of SMEs in the green and sustainable transition, and how policymakers, industry associations, and other actors could accelerate the ESG-resilient transition of SMEs. The role of banks and investors in driving the green transition could be even greater if ESG integration into single-company financial analyses were institutionalized. The EU CSRD requirements will increase the volume and standard of disclosure of large companies’ on their ESG performance. Policymakers should adopt workable standards for the SME sector as well, supported by resources to improve the capabilities and capacities of SMEs to work with and report on ESG. The tools, practices, and knowledge on the impact of ESG factors on a single company’s financial value and financial risks warrant further work between public, private, and academic interests. After all, disclosed ESG information is only useful if it supports achieving sustainable development goals and the ESG resilience of corporates and financial institutions.

5.1 Limitations and Future Research

This research is not without limitations. Essays 1 and 3 are single-company case studies based on case study methodology (Yin, 2003). The case companies might not be representative in their field, limiting the generalizability of findings. Essay 2 is a systematic literature review based on the Scopus database. The selected search words and database could limit the scope of articles found. Despite these limitations, our research provides interesting findings that add to the body of existing research around sustainable finance and ESG both from theoretical and practical perspectives. As such, our research also highlights further areas of research from theoretical and practical perspectives.

In terms of future research, the field of sustainable finance is evolving rapidly, with new regulations, practices, and norms being adopted by investors, banks, and companies. This is impacting the relationship between capital providers and capital users. However, much remains unexplored with respect to the impact of sustainable finance on the institutionalization of ESG in corporate strategies and practices, especially in SMEs. For example, what are the costs of sustainable finance regulations, norms, and practices and how well do they accelerating investments into sustainable development?

With the wider use and broader offering of green and sustainable loan products by banks, their role in the institutionalization of ESG practices in SMEs should be studied. Will green and sustainability-linked bonds and loans motivate large and small businesses to adopt ESG strategies or increase their investments in the green transition?
Similarly, within the EU, the new SFRD regulation is creating transparency on what is required from a fund in order for it to be called sustainable (so-called article 6, 8, 9 funds), in turn requiring transparency from companies wanting to be accounted for as sustainable. Will the new fund requirements around reporting and levels of sustainability impact listed companies’ business and ESG strategies? What is the cost of the SFRD regulation, and what benefits will it ultimately yield to sustainable development?

Companies will face increased requirements on ESG reporting with the adoption of the ESRS in the EU. The preceding developments raise many questions for research and industry. How will this new level of data be used in single-company financial analyses? What is the financial value or risk impact of ESG at a company level? Will companies have transparency on the cost and benefits of adopting or changing ESG strategies? Is the financial materiality of ESG the same or different for small and large businesses? Is industry-based financial materiality that is used by large companies transferable to SMEs as such? Are financially material factors static or dynamic over time? How should cultural and country context be accounted for especially for SMEs?

Our findings show that institutional drivers of the sustainable finance field can support the diffusion of a more ESG-resilient corporate sector and, hence, support financial stability. This is positive as the investment needs for climate and sustainability transition are huge and will only materialize if the private sector accelerates the green transition.
6. References


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Essay 1 - What’s Valued by Investors Gets Valued by Analysts: Institutional Motives on ESG Integration Into Sell-Side Research

Jukka Honkaniemi
June 24, 2020
Abstract

This paper investigates the status of environmental, social, and governance (ESG) analyses among sell-side analysts and equity investors. Using a case method research approach, we combine a review of equity research reports integrating ESG into the valuation of shares of OMXS-30 companies by a Swedish bank with interviews of the bank’s analysts, as well as Swedish and Finnish institutional investors. It is a prerequisite of correct capital pricing and allocation decisions that ESG information be priced into financial value and risk. However, our results indicate that sell-side analysts have thus far considered few of the forward-looking impacts of material ESG factors in valuing companies in a transparent and standardized way. Our findings indicate that this happens because investors inadequately compensate sell-side research analysts for ESG analyses or systematic considerations of the non-financial drivers that impact long-term value. This lack of essential compensation input, together with homogenous normative ESG assessment methods, appear to be key factors hindering a more rapid development in moving the market. We suggest that asset owners are in a unique position to drive market development to new levels, and asset managers and intermediaries (brokers) would be in a position to answer this call, given the right incentives.

**Keywords:** Sustainability performance, non-financial data, ESG performance, company valuation, sell-side equity research
1. Introduction

The annual and quarterly corporate financial disclosures are closely followed by sell-side analysts and investors (Barker & Imam, 2008; Gassen & Schwedler, 2010). Much time is used to analyze the information in income statements, balance sheets, and financial footnotes to construe a view of the current and future value, and the credit risk of a firm. However, the power of financial data in explaining the value of a firm has decreased over the past decades, increasing the importance of identifying both the strategic drivers that enable firms to create value in a sustainable manner, as well as the intangible assets or nonfinancial data that can help to analyze the performance (Lev & Gu, 2016). The academic research looking at the correlation and causality between non-financial sustainability (or ESG data¹) and corporate financial performance (CFP) has yielded varying results, although largely concluding that companies performing well in sustainability at least do not have a significantly negative CFP or equity performance tilt. In part, this is motivated by sustainability data catering to the needs of all stakeholders, rather than just to shareholders or financiers, as well as the often repeated research question: “Does doing well enable doing good” or vice versa (Adam & Shavit, 2008; Friede et al., 2015; Halbritter & Dorfleitner, 2015). To only consider material ESG data from a financial performance perspective, it is necessary to identify key strategic drivers and data parameters for different industries (Eccles et al., 2012). Companies that perform well in their material sustainability areas can generate excess returns with the same risk profile (Khan et al., 2016). In this work, the perspective is on looking at how ESG performance impacts financial value and risk rather than how companies impact the planet and society.

Institutional investors are rapidly implementing sustainable investment or ESG strategies across their portfolios. The UN Principles of Responsible Investments (PRI) were established in 2006, and, as of May 2020, had 3 038 institutions signing up.

¹ non-financial data, ESG data, CSR data and sustainability data are used interchangeably to describe same set of reported data.
signatories with assets of USD 103 trillion under management. According to the PRI “... responsible investment can and should be pursued even by the investor whose sole purpose is financial return because it argues that to ignore ESG factors is to ignore risks and opportunities that have a material effect on the returns delivered to [investors] clients and beneficiaries” (Principles for Responsible Investment, 2006). However, the ESG investment strategies deployed vary across investors with European investors often considered more proactive in integrating sustainability into investment strategies. Exclusion strategies based on normative breaches or ethical considerations seem to prevail due in part to client demand (for asset managers), and, importantly, due to the lack of available standardized data (Amir & Serafeim, 2018; Eurosif, 2016). Exclusions of sectors or companies based on ethical or other normative criteria is a common starting point, followed by active engagement and ESG integration (Eurosif, 2016). Strategies around ESG integration vary from using ESG scores as a threshold to be included in the investment universe to adjusting cashflows or cost of capital. PRI also encourages its investor signatories to influence their research service providers to integrate sustainability into their research (Principles for Responsible Investment, 2006). Despite the growing ESG literature, there is a gap in the existing knowledge about how and why analysts and investors use or rather do not use ESG data.

Motivated by the gap in the existing ESG literature, this study investigates how and why analysts and equity investors use ESG data. The primary data consists of interviews and report analyses from a single case firm, a Nordic bank, which is triangulated with interviews with institutional investors and publicly available broker reports. Our findings show that equity analysts strive to provide comprehensive assessments of the company’s valuation that are as accurate as possible. Yet, the case firm’s integrated ESG analyses appear to have broken new ground, showing that a systematic review of material ESG factors by seasoned equity analysts results in significant adjustment of recommended share prices. Effective internalization of material ESG externalities has the potential to alter capital allocations and drive development toward a more sustainable world. Even though equity markets are leading the way in developing the integration of sustainability within investment processes, much remains to be understood in terms of systematically translating the real value impacts of non-financial ESG data. Sell-side equity research has largely remained absent from this development, and consequently, M&A valuation and credit analyses are also underdeveloped in this regard. Hence, we suggest that, if the actors in capital markets systematically and explicitly identified material ESG factors and incorporated these into all financial analyses, capital pricing and allocations would better reflect externalities pricing.

Our research findings present an enriched view of the state of ESG integration with investors and sell-side analysts, and of how institutional isomorphism is influencing the conduct of these actors. Institutional isomorphism is a phenomenon whereby organizations become increasingly
homogeneous through coercive, mimetic, and normative processes. “Rational actors make organizations increasingly similar as they try to change them.” (DiMaggio & Powell, 1983; p.147). Coercive (cultural pressure), mimetic (imitating others in uncertainty), and normative (professional standardization) pressures have been used to study the developments in sustainability ratings (Chelli & Gendron, 2013), CSR reporting (Bhimani et al., 2016) and sector exclusion investment strategies (Sjostrom, 2008), amongst others. This research explores the question of how and why analysts use ESG information in a valuation process. We investigate this in the light of a new institutional theory and aim also to analyze drivers and barriers of the institutionalization of ESG data.

We show that coercive isomorphism influences asset owners to adopt sustainable investment policies and requires that asset managers sign-up to PRI, although the substantive requirements on what sustainable investment by asset managers need to encompass is varied. Also, ESG considerations are largely absent from sell-side compensation consideration by asset managers and asset owners with few exceptions. Mimetic isomorphic pressures result in a high degree of similarity in the adoption of exclusion and engagement strategies, which emerges as the base sustainable investment strategy, influenced by the ubiquity of service providers, and the ease of this approach. Clear valuation-based approaches are largely absent, although they are recognized by investors as key to integration into day-to-day investment decisions. Normative isomorphism is evident in the ubiquity of ESG tools, and in the approaches that data and scoring providers bring to bear on their choices of sustainable investment strategies. Sell-side research providers also seem to be influenced by the need to produce sustainability research, often captured by producing thematic sector analyses, their version of scoring, or commenting on one of the sustainability rating provider’s results with questionable value to investors. However, transparent, and explicit valuation-based analysis of material ESG factors is absent from the market despite this being recognized by the investors as the most value-adding to the investment process. More interestingly, a lack of compensation by investors, as well as of standardized language or a systemic method of implementation into analyses are also potentially significant hindrances. This research contributes to the field of sustainable finance and investment by analyzing the drivers and barriers of the institutionalization of ESG data, and by exposing levers that could advance further integration of ESG externalities into financial value and risk analyses, hence supporting the more efficient allocation of capital.

The paper is structured as follows: Section 2 provides a literature review of a cross-section of contemporary research looking into the relationship between sustainability or ESG performance and corporate financial performance, as well as providing an overview of institutional isomorphism as the theoretical framework for the research. Section 3 reviews the research methodology. Section 4 is an empirical review of a case firm, i.e., Nordic bank SEB’s project to integrate ESG into sell-side research, as well as a review of
the approach taken by select institutional investors in Sweden and Finland in considering ESG in their investment process. Section 5 summarizes the findings and includes a discussion of the theoretical and empirical research, ending with suggestions for further research.
2. Literature Review

2.1 ESG and Financial Performance

Financial statements, income statements, balance sheets, cash flow statements, and accompanying footnotes are prepared to provide investors with useful information to ascertain the financial value and risk of a company. Yet, as Figure 1 demonstrates, a multivariate regression analysis over a large set of US public company data shows that, while financial data explained some 90% of company value in the 1950s, this has now decreased to around 55%. The importance of innovation, strong client relationships, technological advantages, competitive business processes, and other strategic intangible assets has increased. The identification and analysis of material non-financial drivers are essential for assessing the financial value of a firm (Lev & Gu, 2016).

Figure 1. The declining power of financial data. Taken from Lev and Gu (2016), p.53.
Similarly, the recent literature shows that firms with strong ESG performance are viewed as transparent and trustworthy by the stakeholders and benefit from improved access to finance. Moreover, improved and predictable access to finance in turn enables such firms to maximize the number of investments with positive net present value, thus driving shareholder value (Cheng et al., 2014). Focusing on, and performing well in ESG improve earnings quality and capital market participants’ trust in earnings quality (Choi & Moon, 2016). Firms with strong ESG performance also enjoy lower costs of equity capital, driven by strong labor relations, environmental policies, and product strategies, as well as inducing a larger investor base and broader investor and analyst coverage (El Ghoul et al., 2011; Girerd-Potin et al., 2014). Good ESG performance can also result in reduced volatility and hence improved risk-return ratios (Ashwin Kumar et al., 2016). In addition to ESG performance, normative considerations can also impact the cost of capital. Companies involved in “sin” industries such as alcohol, tobacco, and gambling have higher capital costs, not due to their cash flow performance but due to their narrower investor base and lower analyst coverage (Hong & Kacperczyk, 2009).

No surprise, then, that the global investment community is adopting sustainability as an integral part of their investment process, from climate to broader environmental, social, and governance strategies (Amir & Serafeim, 2018; Principles for Responsible Investment, 2016). With significant evidence that ESG performance drives CFP, it should be possible to make a good case for ESG investment driving superior returns. Key to superior performance is the identification of material sustainability factors from a financial performance perspective, and the integration of these factors into the investment strategy (Khan et al., 2016). However, it appears that actively managed ESG funds are failing to show superior returns. ESG fund performance is impacted by negative and positive screens, as well as stock picking or selection criteria. On a risk-adjusted basis, the performance of ESG and non-ESG funds are not differentiated (Benson et al., 2006). ESG is used more to consider the impact of the investee company, including in terms of risk management, but “…ESG investors have an overwhelmingly strong belief as to their ability to generate positive risk-adjusted returns, despite their disappointing track record” in this regard (van Duuren et al., 2016; p. 532). Mainstream investors that are driving the market are not integrating ESG into their investment decisions because the operationalization of considering ESG is not standardized, for example in terms of which factors to consider and which data to use. Nor is ESG analysis considered in the service provided by the sell-side analysts (Nielsen & Noergaard, 2011).

Financial analysts aim to identify and consider relevant material matters when valuing a firm. Companies increasingly publish separate sustainability reports that include qualitative and quantitative ESG information, catering to the needs of the capital markets as well. However, sell-side and buy-side financial analysts seem to pay little attention to sustainability disclosures. There is a general desire for more information, but there remains a lack of
knowledge about what information is useful in decision-making, as well as how to use such information for valuation purposes (Krasodomska & Cho, 2017). Improved ESG performance can be due to good financial performance, i.e. doing good is enabled by doing well (Hong et al., 2012; Ioannou & Serafeim, 2015). This is also evident in bank analyses. Through their lending activities, banks are exposed to environmental risks that can incur liabilities or change the risk profile of the borrower. However, the sell-side largely ignores environmental aspects and disclosure when valuing banks, perhaps partly due to assumptions based on how analyses have been done previously (Campbell & Slack, 2011).

To navigate in the new landscape, where non-financial data plays an increasingly important role in valuations, several ESG rating firms have emerged to provide their own ranking or scoring of individual companies’ sustainability performance (Novethic, 2014). Despite this proliferation of sustainability indexes and ESG rating firms, the comparability of the ratings and rankings is poor due to the lack of standardization of methodologies and data application (Olmedo et al., 2010). Furthermore, as companies adapt their strategies to changes in external circumstances—issues ranging from labor laws to environmental regulation—ESG ratings commonly fail to provide a clear link to financial performance. With the volume of data serving multiple constituencies, understanding which data is material from a financial performance point of view in a particular industry sector has become of increasing interest (Eccles et al., 2012; Eccles & Youmans, 2016).

An aggregated analysis of 60 vote count and meta-analysis studies that covered over 2 200 unique underlying research papers from 1970 to 2015 found a positive relationship between ESG and CFP. The underlying studies use widely different data sets for E, S, and G, as well as for CFP, but over 90% of the cases conclude that investing in ESG is not value-negative, and, in a majority of the studies, ESG and CFP have a positive correlation. Noteworthy within these results is that ESG portfolios yield a significantly lower positive correlation compared to primary studies not linked to indexes or funds (16% compared to 57%). The authors identify the need for careful consideration when integrating ESG into the investment process and call for future research on “… the relevance of specific ESG sub-criteria for CFP.” (Friede et al., 2015; p. 227).

A recent study (Khan et al., 2016), looking at sustainability data from 2 396 firms between 1991–2013 organized following SASB\(^2\) standards, concluded that firms that invest in areas that are material in their specific industries achieve superior share performance to those that have either not invested in

\(^2\) The US base Sustainability Accounting Standard Board (SASB) has, in collaboration with investors, companies, academia, and sustainability specialists, created a materiality matrix that defines the most financially material sustainability factors for 79 industries (SASB, 2016)
these or have invested in non-material factors. The excess share return was 5% p.a. for sustainably performing firms, whilst investment or performance in non-material aspects yielded no or negative returns.

The existing literature leads to the interesting question of how analysts and equity investors use ESG data, given that the research findings appear to show somewhat contradictory results. One stream of quantitative literature shows that sell-side investors downplay the role of ESG (Campbell & Slack, 2011), whereas the responsible investing literature shows increasing rates of ESG adoption in investment strategies. For example, a survey by Serafeim and Ahmed-Zadeh (2018) shows that more than 80% of global asset managers have implemented some form of responsible investing strategy. Thus, a qualitative examination of what analysts and investors do, i.e., how they conduct their analyses and investment decisions, could bring a valuable piece to this puzzle.

2.2 Theoretical Framework

The convergence of organizational strategies, designs, and processes towards homogeneity as institutional isomorphic processes was first defined by DiMaggio and Powell in their 1983 seminal paper (DiMaggio & Powell, 1983). Coercive isomorphism is a prevalent pressure from society and stakeholders that either tempts or forces behavioral change. Organizations might seek change to achieve benefits (competitive or otherwise) or feel pressured to do so. Mimetic isomorphism is especially prevalent in times of uncertainty, characterized as organizations seeking to copy what others are doing for lack of a better way of addressing the uncertainty. Normative isomorphism comes from the standardization of professionalism. This process implicates common education standards, job descriptions, and career paths, as well as formal and informal networks that influence standards and behavior.

Institutional theory has been used in analyzing sustainable finance, investments, and accounting. This bodes well for a field that has evolved and developed rapidly over the past decade. Conformance to institutional expectations has been achieved by investors through the adoption of widely used exclusion strategies, where controversial sectors are excluded from the investment universe. This rather subjective and limited financial value and impact strategy have been largely a result of normative and mimetic isomorphic pressures (Sjostrom, 2008). Reliance on external ESG data providers’ tools and rankings, and screening internal ESG teams provide conformity to expectations. Investors’ ESG focus would, however, achieve longer-term, more permanent change in industry or company behavior if it were integrated into core investment processes and practices (Sakuma-Keck & Hensmans, 2013).

This institutional pressure has not, however, gone unnoticed over time, but it is failing to have a larger impact on companies in high-impact areas
(Galbreath, 2013). What this means is that coercive and normative pressures are seen as explanatory drivers of why some firms seek to be first movers in CSR reporting. Regulatory or stakeholder pressure can be an impetus for some, while a drive for genuine strategic differentiation motivates others. In these contexts, the pressures might change over time and be impacted by firm-specific drivers. (Bhimani et al., 2016). The convergence towards common practices has also been analyzed in management accounting practices, systems, and processes, indicating that conformity rather than differentiation is the driving force (Granlund & Lukka, 1998). Thus, institutional isomorphic pressures are likely both significant drivers and hindrance factors in the development of sustainable investment practices, and how ESG is integrated into the assessment of financial value and risk at a company level.
3. Methodology

3.1 Data and Research Design

This research was mainly conducted in a single case firm, the Nordic bank SEB³ (henceforth “the case firm”). However, our data were triangulated with interviews with institutional investors and publicly available broker reports, as well as the authors’ professional observations based on participation in the sustainable finance and investment field. The research consists of a total of 14 semi-structured interviews: four with sell-side equity analysts from the case firm, and ten with institutional investors. Four of the institutional investors represent pension funds (asset owners), and six were asset managers. Geographically, five of the institutional investors were from Sweden, and five were from Finland. Swedish investor interviews were conducted by an analyst from the case firm in the first half of 2017 and digitally recorded. Finnish investor interviews were conducted in the first half of 2019 by the author and digitally recorded. The interviewees include a combination of Chief Investment Officers, portfolio managers, heads of sustainable investments, and ESG analysts. All ten investors were provided the topic areas in advance, together with the information that digital recordings will only be used for academic purposes and anonymized unless otherwise agreed in writing. Three of the investors were represented by two participants and seven by one participant. In three cases, on the investor side, 2 representatives, and, in all, 13 investor

³ During the time of the interviews, the author worked at Skandinaviska Enskilda Banken Ab (publ) (SEB) as a Senior Banker and Head of Sustainability for Large Corporate and Financial Institution division. The equity analysts interviewed worked at SEB Securities Research, and the Institutional Investors interviewed were clients of SEB. All interview recordings and transcriptions were done solely for academic research purposes. All data is treated anonymously unless otherwise agreed in writing.
representatives, were interviewed, and the interviewees were The four sell-side analysts were all interviewed by the author in 2017, shortly after the case firm released a research report on ESG integration into valuation (SEB, 2016). All interviewed analysts were engaged in activities looking to integrate ESG into sell-side research. The analysts were also provided with the subject matter in advance, and responses have been anonymized. In all, the data include 10 hours and 23 minutes of recorded interviews, yielding some 220 pages of transcribed text that has been analyzed here.

Table 1. Investor interviewees.

<table>
<thead>
<tr>
<th>Interviewee</th>
<th>Organization</th>
<th>Duration, min</th>
<th>Pages</th>
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<tr>
<td>Investor 5</td>
<td>Asset manager</td>
<td>37</td>
<td>11</td>
</tr>
<tr>
<td>Investor 6</td>
<td>Asset manager</td>
<td>27</td>
<td>10</td>
</tr>
<tr>
<td>Investor 7</td>
<td>Asset manager</td>
<td>59</td>
<td>27</td>
</tr>
<tr>
<td>Investor 8</td>
<td>Asset manager</td>
<td>37</td>
<td>14</td>
</tr>
<tr>
<td>Investor 9</td>
<td>Asset manager</td>
<td>44</td>
<td>17</td>
</tr>
<tr>
<td>Investor 10</td>
<td>Asset manager</td>
<td>40</td>
<td>16</td>
</tr>
</tbody>
</table>

We triangulated the interview data with reports and other publicly available documents (Modell, 2005). In addition to the interviews, the research material consisted of a review and analysis of 1) an 85-page research paper “A SAFE approach to valuation - ESG evaluation of OMXS-30 companies” (SEB, 2016); 2) sell-side research reports published by the case firm and six other well-known brokers about the Swedish-based steel company SSAB with regards to ESG considerations, and 3) investors’ sustainable investment strategies and policies from public sources.

Encouraged by the rapid and accelerating interest in ESG matters from institutional investors, a case firm started to investigate how to incorporate ESG matters into its sell-side equity offering in 2015. In October 2016, the case firm published its inaugural ESG integration report (SEB, 2016). The report analyzed the valuation changes resulting from ESG impact for OMXS-30 companies, the 30 largest listed companies on the Stockholm stock exchange. The analysis in the report was conducted by 13 equity analysts at the bank. The report was presented to investors in late 2016 in various group and individual investor meetings. The anecdotal feedback from investor meetings was positive, iterating, amongst other things, that the approach was i) unique in the market, and ii) valued by the investors.

Actors in the research field
The interviewees in this study, including asset owners, asset managers, and sell-side broker research providers, have business relationships with each other with distinct roles in the capital markets (see Figure 2). To illustrate,
asset managers invest their clients' funds, with a duty of care responsibility including following the investment guidelines of a particular fund, as well as the investment principles of the fund management company. Asset managers create investment products or funds with different themes or focuses to attract capital and win mandates in competition with other asset managers. The performance of the fund, and hence of a portfolio/fund manager, is typically tracked against a predetermined index or set of criteria. Asset managers may be separate specialist boutique firms, sometimes very large, or they may be part of bank groups or insurance companies. As an example, all of the large Nordic banks, Nordea, SHB, Swedbank, SEB, Danske Bank, and DNB have separate asset management businesses.

Asset owners may be, for example, pension companies, foundations, or insurance firms. Asset owners have a liability side to their business, within which they need to meet expected future payments arising from pension obligations, projected insurance claims, or desired foundation grant levels. Asset owners typically have an absolute return target for their assets under management, which enables them to safely meet current and future claims and retain sufficient capital buffers. Asset owners, such as pension funds, invest either through asset managers or directly into the market. Examples of pension companies are the Swedish AP funds and Alecta, and the Finnish funds Varma, Ilmarinen, and VER.

Brokerage firms are intermediaries providing equity research and equity transaction execution services to asset managers and asset owners. These are typically part of investment banks' markets or research business units, part of specialist broker-dealer boutiques, or, increasingly, standalone pure-play research companies. In each case, the research unit needs to justify its existence with direct income from asset managers or asset owners.
or indirect income from transaction flows. High-quality equity research is also essential for banks’ investment banking businesses, in particular for winning mandates for equity capital market transactions (listing of companies or selling shares).
4. Empirical Analyses

In this section, we first look at the case firm’s ESG integration process (4.1) followed by a review of institutional investors’ ESG strategies (4.2).

4.1 Case Firm ESG Integration Process

4.1.1 Investigation Phase

The initial impulse for the sell-side equity research department to investigate ESG analyses came from an in-house asset management unit as early as late 2014. The management of equity research initiated an investigation process in 2015 to look into ESG and financial analyses. At the outset, and long into the process there was outright skepticism among the analysts towards this ESG work; it was considered an additional burden with no clear appreciation or payback from investors. Some of the analysts warmed up during the process of meeting with investors or companies; while some retained their skepticism on investors’ willingness to pay for the added service.

Hence, the focus of the investigation was to determine whether there was real investor demand and willingness to pay for sustainability analytic services, and what these added value services could be. But, initially, much work was put into mapping and understanding what the available ESG research market offered, and what investors used.

... we learned an awful lot about exactly what they're doing. ... That was a big learning curve for us to realize how simplistic the bridge was. Exclusions and norm-based. It’s an ethical judgment ... Yeah and reputation (risk) to the fund managers themselves. (Analyst 1)

The management of research and sales units was actively involved in the discovery process with a clear focus on seeing if the added investment would be worth it:
... their involvement was not only to listen to the proposals that we were coming up with from an action point of view, or the options but also to think about the cost-benefit of going forward with such work as well - Given the resource constraint and downsizing process going on in Equities Research at that time. (Analyst 1)

The feedback from investors proved critical. Much of the research available was scorecard-based ranking or scoring. None of the service providers seemed to take a view on which of the non-financial factors were most material for a given company, nor how these would impact the valuation of a firm. In other words, ESG tools were there to exclude companies rather than attach a value to material non-financial parameters. At the same time, the analysts noticed that investors started to hire more ESG specialists. Initially, they had no votes or say over how fees were allocated, but that was expected to gradually change.

*Then you could actually say that the ESG people had a real bullet that they could allocate some payment to banks that they felt are good at ESG and maybe then at the expense of those banks or counterparties that were not good.* (Analyst 2)

Meetings with industrial companies started in June 2015. Companies were very grateful for the attention given to matters that they had been working hard on, but which had largely gone unnoticed by sell-side analysts. Company meetings also proved critical, not only for the understanding of sustainability matters for a given company but for understanding the company’s strategy and strategy execution from a broader perspective.

*We learned then the sort of question lists that we needed to ask any company, which were ... Some were very generic, organizational and there the key issues for us were, having established what codes companies had - to try to answer how integrated those policies and codes were in the operations of the companies themselves. A second very important part was to understand just how committed top management, operational and strategic management was to codes and stated strategies regarding ESG, to really understand how much of the ... What the companies were saying was commitment versus greenwashing.* (Analyst 1)

Whilst the investigation work was ongoing, two incidents happened on the corporate side that further increased the focus on ESG analysis. First, in the early part of 2015, the Finnish-Swedish paper company Stora Enso was blacklisted by several investors for having used child labor in its supply chain. Second, in the latter part of 2015, Volkswagen’s emission scandal came into public view.
... then many portfolio managers at the client side, not only the ESG people but portfolio managers said that “Well, if there had been some way we had known about this beforehand, it would have been great,” and what do we need to do in order to identify these matters? Obviously, they started to influence share prices more and more. (Analyst 2)

A key question had been whether the ESG analyses needed to be prioritized:

*If it’s nice-to-have, then it will be very hard for us to prioritize it, and if it’s need-to-have, then we of course need to do something about it. I think many of us thought initially that it’s more in the nice-to-have camp than in the need-to-have. Then gradually, the, how do I say, opinions evolved and developed. (Analyst 2)*

*That was also, there were people who had internal interests. There was the external push, and it was still a fairly virgin market, or virgin territory, in terms of our business. (Analyst 2)*

By the end of 2015, the investigation into sustainability research providers, investor needs and attitudes, and company views came to an end. The global and local head of research decided to buy a set of ESG data and conduct a pilot research analysis in 2016. The feedback from the corporate and investor sides was key, but also the fact that this could be done with existing resources weighed heavily in the decision-making.

### 4.2 Research Launch and Learnings

The ESG integration report was launched by the case company on October 24, 2016, by hosting three separate investor meetings in Stockholm, later followed by investor meetings in Denmark, Finland, and Norway. According to the interviewees, the overall level of interest came as a positive surprise, and the report was presented to some 100 investors and 20 companies in seminars and one-to-one meetings during the proceeding two months. The fact that a leading research broker had identified and valued material non-financial factors for OMXS-30 companies, and shown what the impact on recommended share prices would be, was itself interesting. Furthermore, that two-thirds of the companies would have a reduction in recommended share price, and one-third an increase was also striking. Given the strong investor interest and all-around positive feedback from the clients, another surprise was the lack of substantive questions about the methodology and conclusions drawn about individual companies.
Figure 3. Results of the ESG integration report.

There were some very specific issues that we raised with some of the companies, and they were quite severe issues. The fact that they weren’t drilled down into, how did you do that? How did you get to that sort of level of analysis? Was to some extent I think reflecting that they … If we did come to … if they did agree to the approach we take them, their systems wouldn’t allow them to incorporate those results into their portfolio structures at the moment. (Analyst 1)

Positive feedback from clients alleviated some of the skepticism in the analyst community. There was an increased appreciation that systematically incorporating material non-financial factors into the analyses makes the analyses better. Though a potential challenge remained on how the investor clients would integrate the research findings into their systems and processes.

I think that the most, how do you say it, from our perspective, it’s obvious that we’re just moving forward. These issues are not there just because they are some dumb soft factors. I mean, they are, of course, it’s kind of hard facts. If you want to build value and you want to build a sustainable company or a business, then you need to be very conscious about environmental impact. Even more so about the social and governance issues. (Analyst 2)

In December 2016, the case firm’s securities research management group decided to develop the SAFE methodology further and roll it out to cover all securities covered. However, hesitation over the cost-benefits of the exercise remained among some of the research and equity sales managers outside Sweden.
A year later, little progress had been made as organizational and personnel changes, regulatory matters, and other priorities had been in focus. Newly listed companies for which the case firm had a lead role in the IPO occasionally incorporated the ESG adjustment into their equity analysis reports, but otherwise the roll-out had stagnated. There remained an expectation that the integration of ESG requires a substantial amount of incremental work with no clear knowledge that the hours invested would be compensated by the investors.

*I think my key take was really the fact that the whole topic is very, very complicated, especially putting some values around different factors, and what topics you should be looking at, and to be analyzed. So, it’s actually more clearly complex compared to doing, let’s say, traditional equity research, or it is quite a substantial addition to it. If you want to do it properly so it requires quite a lot of hours and resources to get it, so let’s say, right, or get a good grip on it. (Analyst 3)*

The lack of norms and standards around ESG investment raises the costs and barriers to further ESG integration into financial analyses. Also, the analysts lacked regular access to some of the same tools, services, and training that sustainable investment professionals had, and, hence, were not exposed to the same terminology and information flow regularly.

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4 SEB (2016) A SAFE approach to valuation
4.2.1 SSAB Analyses

One of the few fully integrated ESG analyses carried out by a case firm analyst was a report on the Nordic steel company SSAB dated February 6, 2017. This was the first report incorporating ESG analyses into the actual share price recommendation explicitly and transparently. In short, the case firm was seeking to differentiate its research product and gain a competitive advantage by being a first mover in the field.

Figure 5. Case firm SSAB share valuation waterfall.\(^5\)

The overall ESG adjustment at the time was SEK 7 per share, resulting in a share price recommendation of SEK 43 at the time. Making the ESG components explicit in the valuation was as much an art as a science, depending on which component or data point was evaluated. The analyst writes:

“The most significant ESG issue for SSAB is increasing CO2 emissions due to the current EU emissions trading system (ETS) with declining allowances and SSAB’s coke-based steel manufacturing in the Nordic region. We estimate the discounted value of the CO2 deficit to be some SEK 8.2bn or SEK 8 per share. This is offset by high-strength steel products that, by definition, reduce lifetime CO2 emissions of the products through less material and lower fuel consumption. Nevertheless, benefits from this are largely shifted to clients and end users.

Aside from the above, we believe that SSAB’s ESG ambitions and governance is in good shape and we have not identified any other substantial risks. We believe that SSAB is in a position to react to adverse ESG events swiftly and accordingly.”

\(^5\)SEB Equity Research Report, February 6, 2017.
The overall net impact of SEK 7 per share, or 14% of pre-ESG value, is significant. The impact of emissions accounted for SEK 8 per share according to the analyst’s calculation and judgment, leading to the conclusion that SSAB’s strategy concerning the carbon intensity of its steel production is a major driver of its future success and valuation. Subsequently, we reviewed the sell-side analyses from six well-known equity research providers to see if they identified or commented on CO2 emissions vis-à-vis SSAB.

### Table 2. List of SSAB equity research reports.

<table>
<thead>
<tr>
<th>Broker</th>
<th>Report details</th>
<th>CO2 analyses</th>
</tr>
</thead>
<tbody>
<tr>
<td>SEB (re-initiation of coverage)</td>
<td>60 pages, February 6, 2017</td>
<td>Valuation impact of CO2 explicit</td>
</tr>
<tr>
<td>Firm 1</td>
<td>7 pages, September 15, 2017</td>
<td>No mention</td>
</tr>
<tr>
<td>Firm 2</td>
<td>12 pages, July 20, 2017</td>
<td>No mention</td>
</tr>
<tr>
<td>Firm 3</td>
<td>17 pages, July 21, 2017</td>
<td>No mention</td>
</tr>
<tr>
<td>Firm 4</td>
<td>7 pages, July 20, 2017</td>
<td>No mention</td>
</tr>
<tr>
<td>Firm 5</td>
<td>8 pages, July 21, 2017</td>
<td>No mention</td>
</tr>
<tr>
<td>Firm 6</td>
<td>8 pages, July 21, 2017</td>
<td>No mention</td>
</tr>
</tbody>
</table>

None of the broker reports reviewed mentioned emissions or considered the future price of CO2 to be material in the context of their analyses. This is somewhat surprising given that SSAB is the largest emitter of CO2 in the Nordics and publishes its emission data regularly. Also, the current and potential future price of CO2 is a much researched and published area, making this one of the least complex areas of the non-financial data spectrum to identify and analyze.

### 4.3 ESG Strategies of the Interviewed Institutional Investors

In addition to the analysis of the case company, we interviewed a total of 10 institutional investors from Finland and Sweden. The combined assets under management of the interviewed institutional investors were over 500 billion euros, of which over 300 billion was with asset managers and the balance of over 200 billion with asset owners. In total, these ten investors employed some 1,500 people in their investment businesses. They all are signatories of the United Nations Principle for Responsible Investments, albeit at very different times. The two distinct types, asset owners and asset managers, seem to have many similarities, but also some clear differences. All interviewed investors state that they have ESG integrated into their investment processes and describe that they are sustainable investors. Both asset owners and asset managers are using the same type of tools, data, and services providers. For sources of individual company analyses, and, sometimes, ESG data, five of the investors used only MSCI, one used only Sustainalytics, and four used both MSCI and Sustainalytics.
All investors also used a third-party service provider for screening and scoring controversies. Five used GES (subsequently bought by Sustainalytics), three MSCI, one ISS Ethics, and one investor did not disclose the service provider. The concentration of service providers was noticed by investors with some concern for the lack of competition.

Table 3. Investor’s ESG attributes.

<table>
<thead>
<tr>
<th>Respondent</th>
<th>Actor</th>
<th>ESG Remuneration</th>
<th>Controversy screening</th>
<th>Source of analyses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor 1</td>
<td>Asset owner</td>
<td>No distribution and no plans</td>
<td>GES</td>
<td>Sustainalytics, MSCI</td>
</tr>
<tr>
<td>Investor 2</td>
<td>Asset owner</td>
<td>No distribution and no plans</td>
<td>GES</td>
<td>Sustainalytics, MSCI</td>
</tr>
<tr>
<td>Investor 3</td>
<td>Asset owner</td>
<td>ESG considered in broker review</td>
<td>GES</td>
<td>Sustainalytics, MSCI</td>
</tr>
<tr>
<td>Investor 4</td>
<td>Asset owner</td>
<td>ESG can be input in broker review</td>
<td>GES</td>
<td>Sustainalytics, MSCI</td>
</tr>
<tr>
<td>Investor 5</td>
<td>Asset owner</td>
<td>Explicit 9% of total fees</td>
<td>n/a</td>
<td>Sustainalytics, MSCI</td>
</tr>
<tr>
<td>Investor 6</td>
<td>Asset owner</td>
<td>Not explicit now but see a need</td>
<td>GES</td>
<td>Sustainalytics</td>
</tr>
<tr>
<td>Investor 7</td>
<td>Asset owner</td>
<td>PM’s decide who added value and get rewarded as part of normal process</td>
<td>ISS Ethics</td>
<td>Sustainalytics, MSCI</td>
</tr>
<tr>
<td>Investor 8</td>
<td>Asset owner</td>
<td>not known by interviewee</td>
<td>GES</td>
<td>MSCI</td>
</tr>
<tr>
<td>Investor 9</td>
<td>Asset Manager</td>
<td>no distribution and no plans</td>
<td>MSCI</td>
<td>MSCI</td>
</tr>
<tr>
<td>Investor 10</td>
<td>Asset Manager</td>
<td>no distribution and no plans</td>
<td>MSCI</td>
<td>MSCI</td>
</tr>
</tbody>
</table>

Methods for sustainable investing vary a little between the groups of institutional investors. Asset managers, more than the asset owners, divest companies “blacklisted” by the service providers. Furthermore, asset managers are more prone to divestment without engagement and dialogue with the companies. This type of negative screening is driven by the product strategies of asset managers, or by investors’ ethical considerations, rather than their valuation considerations (Amir & Serafeim, 2018). Asset owners have more long-term influence through a dialogue approach in events where controversies arise.

*Our basing in responsible investing is norm-based, so we screen our companies. We use GES, just like everybody else I would say. We are very keen on having a dialogue with all companies that get caught in that net, and that they’re not that many to be honest since we’re quite picky when it comes to choosing companies in the first place. (Investor 2)*
The investors interviewed used one or more of the most common responsible investment strategies:

1) Exclusion of controversial sectors. For example, not investing in companies involved in tobacco, alcohol, weapons, or coal industries.

2) Norm-based or ESG-based screening and exclusions. For example, not investing or divesting companies found to be violating norm-based criteria based on the ESG service provider screening or not investing in companies with low ESG scores.

3) Engagement. For example, actively engaging with the investee company in order to impact company direction management either through a consortium or directly with a set of questions.

4) Positive thematic tilt. For example, allocating a portion of the funds to companies that are particularly focused on a sustainability theme such as electrification of mobility system, clean water, or food system solutions.

5) ESG integration. This involves explicit consideration by portfolio managers of selected ESG criteria in their investment process.

These align with Eurosif’s studies of Socially Responsible Investment strategies in Europe (Amir & Serafeim, 2018; Eurosif, 2016). However, all investors interviewed were interested in forward-looking value-based analyses but had not seen any in the market and had few tools to work on this themselves. Asset managers had better resourced ESG teams but were more focused on exclusions and normative screening. Asset owners appeared more focused on engagement and ensuring that asset managers were focused on sustainability, however, this might be manifested. This could be explained by asset managers being more sensitive to reputational risk impacting their brands and client attrition, whereas asset owners are more inclined to impact their companies through active engagement.

*It’s the same language (between sell-side analysts and portfolio managers) because that’s one of the problems I think with ESG is why do we talk about sustainability when we should talk about long-term value for each. That’s what they’ve always been talking about. The P&L and balance sheet. It affects the balance sheet. That’s their language. If you can then relate that to us and update... Look at water stress or carbon emissions. How would that affect P&L? Now I’m listening. I’m not going to listen to that closely if you talk about our emissions decreasing by 5%. I don’t really know how to take that into account in my DCF. (Investor 2) (Note: DCF= discounted cashflow analyses.)*

For most investors, it is up to the portfolio manager to ensure proper consideration of ESG factors. Some asset owners are implicitly adjusting their risk factor or required rates of return, but more based on judgment by portfolio managers rather than explicitly and systematically. On the other hand, one of the asset managers interviewed had a proprietary approach requiring portfolio managers to systematically document a four-step ESG
risk assessment process that included identifying: 1) material risks; 2) what is the company doing with these risks; 3) where and at what level in the organization is the responsibility; and 4) what is my assessment of the situation. In this case, the portfolio manager had the right to invest even if controversy existed, as long as they were able to defend and mitigate their standing/position against the identified key risks.

Interpreting non-financial data for the benefit of regular financial analyses is the ultimate goal for all; do it explicitly, and systematically, and link it to values and risks.

*My long-term mission is that it’s not separated, it’s the same people doing ESG analysis and financial analysis. Then it’s the topics ... To have a close eye on the different topics, being climate change, tax, whatever, business ethics, that I think we’re going to need specialists going forward to really know the topic in depth. I think that’s where we’re going. (Investor 5)*

The sustainable investment market has developed rapidly over the past few years, but investors still lack a clear “bridge” between material ESG factors and valuation, and it appears this is not being provided by the sell-side brokers either:

*Because what creates a lot of frustration in our organization, is when the quality of the ESG work is poor. Because they don’t know the company. And I mean integrated work, in an essence is when you can connect your view on a company’s target price, or something similar. Or view of financial development, and survival, and so to draw it further away, in relation to relevant ESG issues. So, I think maturity-wise, it's still a very open playing field for someone who wants to do it properly. (Investor 7)*

Investors are asking for improved norms, standards, and tools to have a valuation based ESG approach. Based on the author’s observations, the circle of sustainable investment professionals is still rather small and limited, with mainstream portfolio managers absent from the discourse. Whilst, for example, the national sustainable investment forums SWESIF and FINSIF organize regular sustainable investment seminars, these are largely attended by the same sustainable investment professionals and lack frontline investors and sell-side equity analysts.
5. Discussion and Conclusions

To fill the existing gap in the ESG literature, this study explores the questions of how and why analysts use ESG information in valuation processes. Utilizing the framework of institutional isomorphism, we explore the drivers of, and barriers to, the institutionalization of ESG integration into valuation analyses.

Table 4. Forces at play in ESG integration.

<table>
<thead>
<tr>
<th>Forces</th>
<th>Drivers</th>
<th>Barriers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Coercive</td>
<td>Sustainable investment becoming the industry standard. Investors in PRI. Compensation for ESG integration by some asset managers.</td>
<td>ESG data service providers lack an integrated valuation focus. Investors not tool ed/ resourced for ESG integration. Investors, esp. asset owners, not paying for ESG integration considerations in valuation.</td>
</tr>
<tr>
<td>Mimetic</td>
<td>Being a “sustainable investor”; important for asset owners (license to operate) and asset managers (sales).</td>
<td>Ethical and normative exclusions enough for “sustainable investor” status.</td>
</tr>
<tr>
<td>Normative</td>
<td>New professional category in sustainable investment heads/analysts. FINSIF / SWESIF etc. organizations supporting networked developments. Data, standards, tools.</td>
<td>The professional sell-side is largely absent from networks and lacks similar data/ tools and professionals.</td>
</tr>
</tbody>
</table>

Market actors recognize the need to develop analytical approaches further, and they welcome investment into new methodologies in the area. The field of sustainable investment is developing, and the interplay between asset owners, asset managers, and intermediaries may play a key role in this development going forward. The PRI signature has become a convenient way to obtain “sustainable investor” status, often with sector-based exclusion and normative breach monitoring as a starting point. The continuous development of the sustainable investment profession and networks have the potential to support the development of methods driving ESG integration. New standards in investment research practices and the investors’ compensation of broker research also on ESG merits would be key in accelerating integrated ESG analytic practices. Recent research has demonstrated that, in most cases, performing well in sustainability generates positive financial returns, and performing well on material ESG factors generates positive shareholder value over the long term (Friede et
al., 2015; Khan et al., 2016). However, based on our findings, integrating ESG considerations into single company valuations in a standardized and transparent manner has not been done, and the market has not been researched to a significant extent. Re-tooling the sell-side analysts from skills, data, systems, and methods perspective is costly, and sustainable investors should create mechanisms for paying for the added service to drive the market.

The case firm went through a two-year process from the initiation of the investigation to the launching of the initial integrated ESG research report. Positive feedback from investors and companies, as well as internal resourcing, were key enablers in moving forward. The analysts interviewed seemed convinced that integrating non-financial factors resulted in a more robust analysis product. Further development of the methodology and roll-out across all securities research has been decided on, but hesitation prevailed as no one else was doing this type of research, and it remained unclear whether investors would pay for the extra work. Asset managers seem to be moving toward more transparent compensation models, although this practice is still marginal. Asset owners are the ultimate buyers of services from both asset managers and intermediary research providers, and, hence, could yield coercive pressure if tooled and resourced correctly. However, our findings indicate that asset owners are not valuing ESG integration in their asset manager and broker compensation consideration. In fact, asset owners appear less willing to transparently pay for added services. Our findings indicate that the lack of transparent compensation models for integrating ESG perspectives into analysts’ compensation is the greatest barrier to the institutionalization of the use of ESG data in investment analysis.

The asset managers interviewed appeared more active and visible in the sustainable investment arena. This may partly be driven by their implicit need to productize their sustainable investment offering but may also act as a hindrance to more fundamental forward-looking value-based research. The current ethical, normative, and qualitative scoring-based approaches serve asset managers’ thematic and norm-based strategies well. Asset owners are also focusing on sustainable investments but seem partly to outsource the chosen implementation method to asset managers. Additional coercive pressure from asset owners over asset managers’ research compensation principles could help drive the market further. Overall, normative pressure from all institutional investors for the creation of transparent and explicit ESG integration valuation methods would have the power to drive the development of sell-side research. Integration of positive and negative material externalities into equity valuation will improve information value to investors, alter capital pricing and allocations, and ultimately help drive the development of a more sustainable world. It is therefore important that market actors jointly drive the improvement of the pricing mechanism of non-financial factors transparently and explicitly. Paying for added-value services will go a long way in motivating change. However, sell-side research providers also need to go the extra mile and invest in developing analysts’
tools and skill set-sets, and in allowing the development to take place.

Further studies into single-company financial analyses with ESG integration should be done. Questions remain, for example, around the selection of material sustainability factors. How much are these generic vs company- or industry-specific? Are they static or dynamic over time if the disruptions facing an industry or company change? What are the standardized ways of quantifying non-financial data parameters into cash flow or financial value or risk terms? How can we sensitize non-financial factors in a standardized manner? Another area to explore would be the normative pressure that investor engagement networks are having on companies, and how these directly or indirectly impact share analyses or share prices.

This research was limited in its scope by looking only at the case firm and its ESG integration efforts, together with a select universe of investors. The sustainable investment field is evolving rapidly, and new standards, tools, and methods have been created since the launch of the case firm’s report in late 2016. Furthermore, the EU’s sustainable finance roadmap and associated regulations are creating new practices and raising investor awareness. The push for greenifying capital markets to tackle climate and other sustainability challenges is hopefully expediting ESG integration into valuation as well.
Appendix

Interview questions for case firm equity analysts

1) Background for the interview
   The target group for the interviews consists of the case firm equity analysts that participated in the initial ESG equity research launched in October 2016 under the heading “A SAFE approach to valuation – ESG evaluation of the OMXS-30 companies”. The purpose of the interview is to 1) review the road to the case firm ESG analyses report; and 2) get reflections and conclusions now that the analyses has been reviewed with the investors and companies as well.

   The interviews constitute empirical material for doctoral dissertation work at Aalto Executive Education. Interviews are confidential: interviewees’ personal data or identifiable feedback shall not be published without the prior explicit approval of the interviewee, and they will be used only for research purposes. Interviews will be recorded.

   1) Could you tell about your background?
   2) Road to case firm SAFE Analyses
      a) When did you get involved and what were your initial feelings / thoughts about the project?
      b) Which companies did you meet and how did these meetings go?
      c) Did you consult investors during this time? If so, whom, and what was the feedback?
      d) What did you do, and what were your key findings or learnings during the work?
      e) How do you see the final SAFE outcome in relation to conventional analyses?
      f) What would you do differently if you had the opportunity to redo the analyses?
3) Launch and investor feedback?
   a) What did you think of the final results of the analyses? What surprised you?
   b) Which investors did you discuss the report with, and what was their feedback?
   c) What were your thoughts about the investor feedback?
   d) How do you see the role of this type of analysis in the future in the market in general?
4) Do you have any additional comments or observations?

**Interview questions for institutional investor**

ESG research priorities

1. Do you incorporate non-financial or ESG factors into your investment decision making process in your actively managed funds? If so, do you have a formal or systematic approach?
2. How do you expect this to develop over the next two years?
3. Do you use the sell-side for input on ESG insight, events or evaluation?
4. If so, how do you reimburse that service? Do you expect that reimbursement model to change in the next two years?
5. Do you have any feedback on case firm ESG Equity Research on “SAFE” ESG analysis of OMXS-30 companies, launched in Q4 2016 (note: SAFE = SEB's Adjustment for ESG)?
6. What kind of research or service would your PM’s and analysts find most useful going forward (e.g. full integration of ESG issues into share analysis, thematic pieces, focus on ESG analysis of mid-cap shares not covered by specialist qualitative ESG researchers like Sustainalytics, MSCI ESG, etc)?


Abstract

We investigate the status of research on sustainable finance in small and medium-sized enterprises (SMEs). Sustainable finance is a key focus for regulators, large companies, and financial institutions. The impact of environmental, social, and governance (ESG) performance on financial value and risks, and of corporate sustainability strategies on the cost and availability of capital is much researched in large corporations. SMEs make up the majority of corporations, and therefore have a large impact on GDP, employment, and the environment. Rapid institutionalization of sustainability into SME strategies is paramount for solving global sustainability challenges. We performed a systematic literature search on the Scopus database and found 36 scientific articles that were grouped into nine clusters that categorized the most significant impacts on the financial performance and capital cost/access of SMEs. The results demonstrate that ESG impacts both the financial performance and access to capital of SMEs, but also that ESG is more country and culture-bound in SMEs than in large corporates. Lack of research on topics such as climate change and biodiversity and scarcity of research on European SMEs call for increased research in an EU context, as well as increased qualitative research to investigate how and why SMEs could more speedily and profitably implement sustainability in their business strategies.

Keywords: SME, ESG, CSR, sustainable finance, financial performance, access to capital, cost of capital
1. Introduction

Sustainable finance concepts have mainstreamed into financial markets and are starting to impact corporate behavior, investments, and capital allocations. Principles of Responsible Investments (PRI) and Principles of Responsible Banking (PRB) have become market standards to which investors and banks should sign-up and adhere (Principles for Responsible Investment, 2006; UNEP Finance Initiative, 2019). A plethora of academic research examines the relationship between environmental, social, and governance (ESG), or sustainability performance, and accounting or market-based finance performance. Whilst research has produced mixed results depending on timing and method of analyses, increasing evidence points to more positive results (Friede et al., 2015; van Beurden & Gössling, 2008). Academic research has shown that good performance in environmental, social, and governance (ESG), or aspects of sustainability, leads to improvement in financial performance or share price development. Private and institutional investors are allocating more capital to sustainability, with sustainable assets investments standing at USD 35 trillion in 2020, representing a growth of 55% since 2016 (Global Sustainable Investment Alliance, 2021). The Network of Central Banks and Supervisors for Greening the Financial System (NGFS) is investigating how to integrate climate matters into monetary policy consideration. Similarly, The Coalition of Finance Ministers for Climate Action is sharing best practice standards on how to integrate climate change into monetary and fiscal policies. The European Union (EU) has laid out a comprehensive sustainable finance strategy and thereby integrated climate change mitigation and other sustainability considerations into financial market regulations.

Since the 1990s, ESG, or corporate social responsibility (CSR), as it is more commonly called in SME research, has become prevalent within the business community due to a change in stakeholder attitudes and an increase in sustainability regulations (Malesios et al., 2018). Global financial crises and numerous corporate scandals in the 21st century have eroded the public’s trust in the integrity of firms, leading to an increase in media attention on company ethics (Rezaee & Homayoun, 2019). The understanding of value creation in business has changed, such that a company’s value is no
longer measured only in terms of economic gains (Sarango-Lalangui et al., 2018). If a breach of ethics comes into public awareness, it can have dire consequences for a company’s financial value. Around 50–70% of the value of large public companies comes from their goodwill, reputation, and brand name (Stubbs & Rogers, 2013). Loss of reputation due to ESG issues can have a major negative financial impact on companies. The contribution of companies towards sustainable development as well as the impact that climate change has on the financial performance of companies has become evident. Companies are increasingly being required to do their part on the path toward sustainable development (United Nations Global Compact, 2000, 2020).

All this points to sustainable finance considerations being material, and under considerable momentum when it comes to investors, banks, large corporates, regulators, and supervisors. Despite such advancements, small and medium-sized enterprises (SMEs) fall outside of the focus of sustainable finance trends. Corporate social responsibility performance is important for securing shareholder value, but also for satisfying the demands of stakeholders, which is becoming increasingly important to companies. CSR is growing to be an integral part of company strategy as its long-term financial benefits become increasingly clear (Malesios et al., 2018). Investment decision-making is also increasingly influenced by the quality of ESG data and practices as finance professionals assess the impact of ESG on financial risks and returns. This knowledge led to the launch of the United Nations (UN)-backed Principles for Responsible Investment (PRI) in 2006, as awareness of the impact of ESG issues on portfolio performance grew and it, therefore, became imperative to factor ESG issues into investment decisions (Stubbs and Rogers, 2013.)

Outside the scope of institutional investors and listed corporations, Masocha, (2018) found that SMEs tend to think they are too small to have to think about their environmental footprint or broader societal impact compared to larger companies. Additionally, Dey et al. (2020) found that SMEs are not just little big companies but often have unique characteristics of simpler management schemes and limited financial resources reducing the capabilities and resources to undertake effective sustainable management. Yet, collectively SMEs make up 99.8% of companies within the EU and make up the majority of companies globally (Battistella et al., 2018). This means their social and environmental impact is likely to be significant. Still, SMEs lag behind in their commitment to sustainability compared with their larger counterparts (Battistella et al., 2018).

It is rational to assume that SME owners/managers would invest in and excel in matters that improve financial performance as well as access to or cost of capital. Therefore, aspects of sustainability or ESG investments that lead to improved financial performance or access to capital should be central for SME owners/managers to invest in. Considering the under-researched status of SMEs vis-à-vis sustainable finance, this study seeks to review the status of academic research on the relationships between ESG and financial
performance within SMEs. We conducted a systematic literature review following the methodologies of Johnson and Schaltegger (2016) and Snyder (2019) by selecting keywords, searching articles from selected databases, selecting articles using inclusion and exclusion criteria, and extracting relevant data to Excel. The search resulted in the final pool of 36 relevant articles to be carefully analyzed for content and findings. In particular, we investigate academic discussions with the help of the following research questions:

1) How does the ESG performance of SMEs relate to financial performance?
2) What ESG drivers improving the financial status of SMEs can be identified?

Based on the literature review, we identify and suggest further research areas to enrich the field of sustainable finance and SMEs.

The rest of the study is organized into the following sections: first, we introduce a short definition of SMEs and review the sustainable finance research findings and key trends that motivated the research questions above. In Section 2, we introduce the methodology and define the criteria for the literature reviews and database query results. This is followed by an analysis of the findings in Section 3. Section 4 offers discussions of and conclusions to the research, and Section 5 examines the limitations and possible future directions of this research.
2. An Overview of SMEs, Sustainable Development, and Sustainable Finance

This section will begin with a definition of SMEs and their current impact on the economy in Europe. The chapter will explain why SMEs are essential if sustainable development is to be achieved. This will be done by going through the topics of sustainable development and sustainable finance, as well as sustainability reporting, ESG performance, and financial performance in relation to SMEs. It is important for the reader to understand these topics to appreciate the purpose and outcomes of this literature review article.

2.1 Small and Medium-Sized Enterprises

Small and medium-sized enterprises (SMEs) are often referred to as the backbone of the European economy, providing jobs and economic growth. According to a 2019 European Commission report, SMEs account for 99.8% of the enterprises in the EU and the UK, which is about 25 million firms. Micro-firms, which employ less than 10 people, are the most common size of enterprise, and their share of the total enterprises varies between member countries from 80–95% (European Commission, 2019). A further 1.47 million enterprises are classified as small firms, with between 10 and 49 employees, and approximately 236 thousand more are medium-sized firms, with 50 to 249 employees (European Commission, 2019). Only 0.2% of EU firms are large, employing more than 250 people (European Commission, 2019). The average number of people employed in EU SMEs is 3.9. Companies with 250–3000 employees are often referred to as the mid-cap sector, making a divide between SMEs and large companies, although this mid-cap sector is not part of the official statistics (European Commission, 2019).
Table 1. SME categorization. 

<table>
<thead>
<tr>
<th>Company Category</th>
<th>Staff headcount</th>
<th>Turnover/ €</th>
<th>Balance sheet Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medium-sized</td>
<td>&lt; 250</td>
<td>≤ 50 m</td>
<td>≤ 43 m</td>
</tr>
<tr>
<td>Small</td>
<td>&lt; 50</td>
<td>≤ 10 m</td>
<td>≤ 10 m x</td>
</tr>
<tr>
<td>Micro</td>
<td>&lt; 10</td>
<td>≤ 2 m</td>
<td>≤ 2 m</td>
</tr>
</tbody>
</table>

Further, the European Commission (2019) reports that 98 million people were employed by SMEs in the EU, which was a 66.6% share of the workforce in the private sector at the time (European Commission, 2019). The share of total value added by SMEs in the non-financial business economy was 56%, amounting to €4.357 billion (European Commission, 2019). The largest industries by added value are wholesale and retail trade, and manufacturing, together accounting for just more than 40% of both SME employment and total SME value added (European Commission, 2019). In the Nordic countries and the Netherlands, the proportion of the SME sector by value added is larger than the EU average and especially larger compared to Germany (European Commission, 2019).

Approximately 40% of SMEs are companies with a high impact on the environment. Overall, SMEs account for 60–70% of environmental impact (Constantinos et al., 2010). For many SMEs, reducing their environmental impact is challenging. SMEs will face increased pressure for more environmentally friendly production methods and processes from the marketplace and environmental legislation in the coming years. A quarter of SMEs are actively involved in actions to reduce their environmental impact, and 0.4% of SMEs use a certified Environmental Management System. Industries that are especially damaging from an environmental perspective include the production of chemicals and base metals; mining and quarrying; paper and pulp; construction; and energy production (Constantinos et al., 2010). Therefore, whilst individual SMEs have a small impact on climate change or other aspects of sustainable development, in the aggregate, SME companies have a large impact and must implement ESG into their business strategies; climate change mitigation and other sustainability transformations cannot be met without having SMEs on board.

2.2 Sustainable Development

There are many ways to define sustainable development. However, the most used description is from the Brundtland Report (1987): “Sustainable development is development which meets the needs of the present

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1 The main factors determining whether an enterprise is an SME are: 1) staff headcount, and 2) either turnover or balance sheet total. Adopted from (EUR-Lex., 2019)
population without compromising the ability of future generations to meet their own needs” (p. 54). The report was published as a reaction against the perceived lack of sustainability in industrial society (Brundtland, 1987). The concept of sustainability became discussed widely as early as 1972, after the Club of Rome’s report ‘The limits to growth’ (Meadows et al., 1972). This report set out the dramatic consequences the world would face if no changes were made in the way that nature was being overexploited and polluted; it will sooner or later collapse (Meadows et al., 1972). Sustainable development involves both government and private sector intervention, as well as international agreements and cooperation. It is a strategy that manages all resources sustainably, increasing long-term wealth accumulation and well-being (Repetto, 1986).

### 2.3 Sustainable Finance

The EU is integrating the UN Sustainable Development Goals (SDGs) into financial policy as part of the European Green Deal (European Commission, 2019). As part of this initiative, the EU has defined sustainable finance to encompass both the considerations of environmental, social, and governance (ESG) performance into companies’ financial value and risk, as well as assessing the environmental, social, and governance impact of companies being financed or invested in. This so-called double materiality consideration is already being adopted by the finance sector to mitigate risks, maximize long-term returns, and ensure sustainable development through meeting the SDGs. Consequently, large companies relying on equity and debt capital markets are well advanced in implementing ESG strategies to ensure meeting shareholder and financier demands.

Even before the EU’s sustainable finance focus, theoretical construction of corporate sustainability strategy, and management control had become necessary, and several initiatives had already been put in place. The UN Global Compact was launched in 2000 to promote sustainable business practices (United Nations Global Compact, 2020). In 2015, the United Nations member states adopted the 2030 Agenda for Sustainable Development and the Sustainable Development Goals (SDGs), which set targets for sustainable development to be reached by 2030 (Pedersen, 2018). In the next year, the Paris Agreement, the first-ever legally binding global climate agreement, was adopted at the Paris climate conference (Conference of Parties number 21 or COP21). Consequently, climate change mitigation and adaptation, as well as the impact of climate change on financial risks, have become central focus areas for regulators and financial market participants. In 2017, the Financial Stability Board’s Task Force on Climate-Related Financial Disclosures (TCFD) launched its recommendation for a climate risk disclosure standard framework for businesses (TCFD, 2017).

After this, the need for relevant and reliable environmental, social, and governance (ESG) data increased. ESG issues and opportunities have
been discussed for many years by large corporates and policymakers, but recently the interest of stakeholders, and especially investors, has increased. This puts pressure on companies to act accordingly in order to maintain their good reputation and image (Tarmuji et al., 2016). However, more importantly, companies that invest and perform well in their material ESG factors provide superior shareholder returns (Khan et al., 2016). ESG disclosure also improves the relations companies have with their stakeholders and improves their access to capital (Cheng et al., 2014). Companies with good ESG performance are prone to make the necessary long-term decisions to ensure the success of their business over longer time periods in order to remain sustainable (Greenwald, 2010). Stronger environmental performance can improve the value of the firm and attract new stakeholders. Good environmental practice in terms of operational activities can also generate reasonable cost savings and separate the business effect from reputational issues such as contamination (Jasch & Savage, 2008). Furthermore, companies that are performing well attract eligible employees (Jasch & Savage, 2008).

However, the lack of readily available and reliable ESG data remains a limiting factor in furthering sustainable finance. ESG disclosure can reduce information asymmetry between companies and their stakeholders (Stubbs & Rogers, 2013). Specialized ESG rating agencies have emerged in response to the need for ESG information by the financial investment community (Stubbs & Rogers, 2013). The results of the ESG ratings may differ widely due to the different methods used and, as a result, investors might have little confidence in basing investment decisions on these ratings (Berg et al., 2022).

What this implies for businesses is that, as climate-related financial disclosure is a quickly growing field, failure to meet expected reporting requirements can increase a company’s risk of missing evolving regulatory requirements (Fellow, 2013). As mandatory disclosure requirements increase, early evidence points to its positive operational and financial benefits for reporting companies (Ioannou & Serafeim, 2014). At the same time, while all this can be said in the context of large corporations, SMEs fall outside of sustainability reporting requirements within the EU (European Commission, 2023).

2.4 Sustainability Reporting

The rise of engagement with ESG and sustainability has led to an increase in the quantity and quality of sustainability reporting (Rezaee & Homayoun, 2019). Companies increasingly wish to disclose not just for their shareholders but for their wider set of stakeholders (Ioannou & Serafeim, 2014). Sustainability reporting has increased rapidly in the past two decades, with many companies using it to identify their sustainability challenges and make improvements, as well as to disclose to stakeholders.
The motivation for sustainability reporting has come to include many strategic benefits such as; “market (improving competitive position), social (warding off stakeholder challenges), political (reducing political pressure and regulation), and accountability (the company is playing its part in sustainability) outcomes.” (Higgins & Coffey, 2016, p. 18). Sustainability reporting has generated benefits for firms who take part in it, whilst simultaneously aligning firms more closely with the UN SDGs (Rezaee & Homayoun, 2019).

The effectiveness of sustainability reporting depends on communication with stakeholders and the community, and also on communication between managers and leadership teams (Higgins & Coffey, 2016). The economic effect of corporate sustainability reporting regulations appears to be positive. While complying with the regulation might be costly for some firms, the outcome for firms on average can be seen to be financially beneficial (Ioannou & Serafeim, 2014). Big companies report more because they are under societal pressure to disclose sustainability information in order to gain legitimacy (Drempetic et al., 2019). Drempetic et al. (2019) found a correlation between data availability and ESG scores. Bigger companies have more data available, which gives them an advantage in sustainability reporting. Whereas SMEs do not fall under sustainability reporting requirements, they do adhere to a few sustainability requirements, such as ISO certifications or employee satisfaction measures, although they do so on a voluntary basis and do not have the same degree of investor or financier pressure as large companies.

### 2.5 ESG Performance

The increase in sustainability reporting has led to the emergence of what are called ESG rating agencies. ESG rating agencies are providers of information for investors, as well as the broader scope of stakeholders, about the level of the social responsibility of firms (Stubbs and Rogers, 2013). They can also be used as tools for investors to shape the behavior of companies (Clementino & Perkins, 2021). ESG performance contributes towards financial performance and investment returns but reporting on ESG factors is not included in a company’s profit and loss statements. Therefore, investors may look for this missing information from ESG rating agencies. The world’s first sustainable index was the Domini 400 Social Index, now called FTSE KLD 400 Social Index, which was launched by KLD in 1990. Since then, numerous rating agencies and sustainability indices have been launched as the desire for reliable data and uniform measurement has appeared (Stubbs & Rogers, 2013). ESG rating agencies have contributed to the institutionalization of sustainability management in large companies (Escrig-Olmedo et al., 2019)

Developing tools that measure sustainability performance remains difficult because the definitions of sustainability are so multifaceted. There
is still no single agreed-upon definition for sustainability or the contents of ESG (Ahi et al., 2018). A big challenge for indices and ratings is to combine all aspects of sustainability within the environmental, social, and governance factors, whilst also considering the economic aspect. Often, more importance is given to one over others (Singh et al., 2009). Scholars say combining all aspects is what makes up sustainability, meaning that sustainability is the combination of all of these factors, and a practice cannot be said to be sustainable if all aspects are not accounted for (Singh et al., 2009). There is an inherent uncertainty in how to prioritize sustainability requirements (Ahi et al., 2018). Rajesh and Rajendran (Rajesh & Rajendran, 2020) suggest assigning priorities when implementing ESG-related strategies or policies into practice. Their research shows that good ESG performance also has financial benefits for firms in the long run. Sustainability models should also incorporate the fact that organizational priorities and sustainability requirements can change over time (Ahi et al., 2018).

The growing concern for ethical corporate practices from stakeholders calls for more accurate measuring of ethical performance. The three main issues identified by scholars within ESG rating methods are a lack of objectivity, uniformity, and transparency (Stubbs & Rogers, 2013). Scholars have accused rating agencies of being biased for several reasons. Rating methods make assumptions and assign different weightings to the factors in various indices. Different rating agencies have different methods for calculating their scores and favor different aspects. The ratings themselves are rarely evaluated and differ extremely between different agencies. Transparency can be a challenge for ESG rating agencies. They must strive to be transparent enough to satisfy stakeholder demands without giving away the whole of their methods for competitors to copy. Full transparency is therefore not commercially viable (Stubbs & Rogers, 2013). Only a handful of rating tools disclose specific information about what criteria and methodology they use to make their ratings. One of the biggest critiques of ESG rating agencies is the lack of standardization in sustainability criteria and methodology. Many use different measures, making it difficult to make comparisons (Siew, 2015). Rating agencies respond to their customers’ demands, so uniformity amongst different agencies is also not seen as viable (Stubbs & Rogers, 2013). ESG rating agencies can evoke criticism from companies due to the number of their surveys and requests for information, and this can even lead to a negative outlook on the issue of corporate sustainability and ethics (Clementino & Perkins, 2021). “Greenwashing” is also a major critique of ESG rating agencies, as this kind of service, if not made with the right intent, can help companies appear to be sustainable without doing the actual work (Siew, 2015).

Stubbs and Rogers (2013) believe that ESG rating will become increasingly important with the mainstreaming of ESG that can be seen in investment markets. Reasons for companies conforming to or resisting ESG values are largely commercial, rather than ethical (Clementino & Perkins, 2021). Corporate responses often lie with managers’ perceptions of the business
value of responding to ESG ratings and their alignment with current corporate strategy and objectives. The impact of ESG ratings at its best can “contribute to the incorporation of new CSR issues into a firms’ policy, practice, and strategy; provoke internal organizational change required to more effectively operationalize business ethics and sustainability; and elevate the strategic importance of addressing ESG issues” (Clementino & Perkins, 2021, p. 393). The results of translating ESG ratings into improvements in a company’s sustainability performance remain mixed. Clementino and Perkins (2020) found that, most often, ESG ratings do not translate into substantial improvements in a company’s sustainability performance. However, Rajesh and Rajendran (2020) found that ESG ratings can be seen to correlate positively with an organization’s sustainability performance. SMEs are not impacted by SME ratings because most ratings serve investors and financiers, and hence cover large, listed companies. Those rating service providers that cover supply chain companies typically cover the most significant suppliers to large corporates, while SMEs, due to their size, are not included in most material supplier lists.

2.6 Financial Performance

In the context of reviewing how ESG, or aspects of sustainability, impact a company’s financial performance, several different measures are used. A common measure is total shareholder returns, factoring in share price development and dividends (Lev & Gu, 2016). The shareholder-value-based assessment of ESG is prevalent in studies that utilize, for example, the long and deep US data sets. Other common measures look at profitability (Torugsa et al., 2012), financial ratios such as return on assets, and return on equity (Fatemi et al., 2018). Yet other studies look at financial riskiness through credit ratings or the cost of debt or equity (Attig et al., 2013; Chava, 2014). Whether looking at market-based or accounting-based measures, the objective is the same: assessment of external factors on companies’ financial value or financial risk. The sustainable finance literature on large corporates has studied access to and cost of capital, as well as the relationship of sustainability and financially material ESG factors on either stock market or accounting-based financial performance. Similar studies on SMEs are of interest in our literature review.
We use a literature review methodology to gauge the status of existing research on sustainable finance and SMEs. According to Snyder (2019), a literature review can help investigate areas where the focus is interdisciplinary and less established. Snyder (2019) describes two types of literature reviews: 1) semi-systematic, and 2) systematic. A semi-systemic review is used to detect commonalities in theoretical approaches and research premises (Snyder, 2019). A semi-systemic review is also pragmatic in fields where the volume of published research renders a systemic review of every article impossible. Systematic reviews were originally mostly used in medical fields, yet their prevalence in business research has grown (Khan et al., 2020). The purpose of a systematic review is to search for articles in all scientific journals that fit keywords chosen to help answer the research questions. This is also useful in assessing the quantity of research, and for identifying commonalities in theories and findings, as well as research gaps.

We used a systematic review method to gauge the amount and type of research conducted on SMEs and sustainable finance, as well as to find the drivers for financial performance and access to, and cost of capital. We also identified sustainable finance areas that have not been investigated when it comes to SMEs. We followed the five-step methodology used by Johnson and Schaltegger (2016) in their research: (1) identification of search words; (2) search for articles from the chosen database(s); (3) selection of articles based on inclusion and exclusion criteria; (4) extraction of relevant data into a spreadsheet; and (5) synthesis of findings and reporting.

To identify a relevant research base, we tested several search strings such as “sustainable finance” and “sustainable investments” but found that these related to large companies and were not useful in searching SMEs. We also tested combinations such as “sustainable*” and “performance”, but these generated very large and irrelevant outcomes; for example, “sustainable performance” relates to many fields outside the intended scope. Through trial and improvement, we settled on the following three search strings:
1) “SME” OR “small and medium-sized enterprise” OR “small and medium enterprise” OR “small business”, AND
2) “ESG” OR “environmental, social and governance” OR “corporate social responsibility” OR “corporate sustainability” OR “CSR”, AND
3) “financial performance” OR profitability” OR “cost of capital” OR access to capital”.

We used the Scopus database for the search to look at all published peer-reviewed English language articles only (conference papers are excluded). The search included all articles before October 24, 2020. Scopus is Elsevier’s database for journal articles, and, according to the company, it “is the largest abstract and citation database of peer-reviewed literature – scientific journals, books, and conference proceedings.” (Scopus, 2021). We did not limit the search to top-ranked journals or pure business or finance journals. The field of ESG research, especially when it comes to SMEs, is still an emerging and developing field, and such limitations might have led to critical findings being omitted from the search.

Table 2. Search strings and hits.

<table>
<thead>
<tr>
<th>Search string one</th>
<th>Search string two</th>
<th>Search string three</th>
<th>Search hits</th>
<th>Excluded articles</th>
<th>Included articles</th>
</tr>
</thead>
<tbody>
<tr>
<td>“SME” OR “small and medium-sized company” OR “small and medium enterprise” OR “small business”</td>
<td>“ESG” OR “environmental, social and governance” OR “corporate social responsibility” OR “CSR”</td>
<td>“financial performance” OR “profitability” OR “cost of capital” OR “access to capital”</td>
<td>52</td>
<td>16</td>
<td>36</td>
</tr>
<tr>
<td>“SME” OR “small and medium-sized company” OR “small and medium enterprise” OR “small business”</td>
<td>“ESG” OR “environmental, social and governance” OR “corporate social responsibility” OR “CSR”</td>
<td>financial performance only</td>
<td>38</td>
<td></td>
<td></td>
</tr>
<tr>
<td>“SME” OR “small and medium-sized company” OR “small and medium enterprise” OR “small business”</td>
<td>n/a</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>n/a</td>
<td>“ESG” OR “environmental, social and governance” OR “corporate social responsibility” OR “CSR”</td>
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<td></td>
<td></td>
<td>35,999</td>
</tr>
<tr>
<td>n/a</td>
<td>“environmental, social and governance” OR “corporate social responsibility” OR “CSR”</td>
<td></td>
<td></td>
<td></td>
<td>26,603</td>
</tr>
<tr>
<td>n/a</td>
<td>“ESG” OR “environmental, social and governance” OR “corporate social responsibility” OR “CSR”</td>
<td>“financial performance” OR “profitability” OR “cost of capital” OR “access to capital”</td>
<td></td>
<td></td>
<td>1,637</td>
</tr>
</tbody>
</table>

Table 2 shows our search strings in various combinations. The top row shows the actual search with matches and excluded and included articles.
The second row shows how the main search is split between four different permutations of search string three. The three bottom rows depict for reference the volume of research with varied combinations of search strings.

From the search string in the top row, 52 articles were a match. We carefully reviewed the 52 articles and excluded a total of 16 articles: 12 for not matching the intended research area, and 4 as full copies of these articles could not be located in the database. This left us with 36 articles. For reference, strings 2 and 3 together (CSR and financial performance), covering all companies and not merely SMEs, yielded 1,637 articles, over 30 times more than the number published on SMEs alone. Overall, CSR (string 2) yielded 26,603 articles, and SMEs (string 1) yielded 35,999. The volume of research indicates that ESG performance in large companies, and the relationship between ESG and financial performance, have been amply researched. The readily available data on large companies’ ESG performance, as well as the greater impact of a single large company, are but some of the explanatory factors. Similarly, SMEs have been amply researched from various societal and economic perspectives, but not from the perspective of ESG and financial performance. Suffice it to say that the low volume of published research on the topic area calls for more attention from the research community.

After selecting articles for inclusion in our review, we analyzed the results on two levels (Johnson & Schaltegger, 2016). First, we coded the relevant identifiers of the articles, such as the research method used, geographical source of data, journal of publication, and year of publication. Second, we reviewed each article for findings against the two research questions repeated here: 1) How does the ESG performance of SMEs relate to financial performance? and 2) What ESG drivers improving the financial status of SMEs can be identified? The quantitative method articles included in the research were analyzed based on mediating and moderating factors that contributed to financial performance. The qualitative and literature review articles were analyzed concerning the methods and theories used as well as outlined findings.
The number of published scientific articles has increased significantly over the last few years. Of the 36 articles, 28 (or 78%) were published between the years 2016 to 2020, and only 2 were published before 2012. Of the results of the “ESG and financial performance for all companies” search (strings 2 and 3), some 56% were published between 2016–20. Seven journals had published more than one article amounting to a total of 19 articles. Sustainability Switzerland was the journal with the most articles meeting the search strings with 5 of those 19 articles. Another 17 journals covered the remainder of the research.

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**Figure 1.** Search result articles by year of publication.²

**Table 3.** Search result articles by journal of publication.³

<table>
<thead>
<tr>
<th>Journal</th>
<th>Article count</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sustainability (Switzerland)</td>
<td>5</td>
</tr>
<tr>
<td>Journal of Business Ethics</td>
<td>3</td>
</tr>
<tr>
<td>Business Strategy and The Environment</td>
<td>3</td>
</tr>
<tr>
<td>Corporate Social Responsibility and Environmental Management</td>
<td>2</td>
</tr>
<tr>
<td>Journal of Indian Business Research</td>
<td>2</td>
</tr>
<tr>
<td>Journal of Small Business Management</td>
<td>2</td>
</tr>
<tr>
<td>Social Responsibility Journal</td>
<td>2</td>
</tr>
</tbody>
</table>

² Data gathered from Scopus (2020).
³ Data gathered from Scopus (2020).
Figure 2. Search result articles by author.\(^4\)

Table 4. Search result articles by research method and country of context.\(^5\)

<table>
<thead>
<tr>
<th>Analysis’s method</th>
<th>Number of articles</th>
<th>Developing country</th>
<th>Developed country</th>
</tr>
</thead>
<tbody>
<tr>
<td>Qualitative method</td>
<td>2</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Quantitative method</td>
<td>31</td>
<td>20</td>
<td>11</td>
</tr>
<tr>
<td>Literature review</td>
<td>3</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Four authors had published three articles, and, of these, Das and Rangarajan co-authored three, and Jain and Vyas another three articles. 33 of the articles used quantitative research methods, and, of these, 21 used data from developing economies, with the most coming from India, four articles, and Mexico, three articles. Only the USA featured in more quantitative research as the geographical focus – five articles in total. The large number of quantitative method articles is striking due to the lack of readily available data on the CSR performance of SME companies. The lack of data was mostly overcome by surveys – either purpose-built or generic industry surveys. On the other hand, the three literature review articles included here found that most articles in their population used qualitative research methods.

The definitions for developed and developing economies utilized in this paper are based on the United Nations’ World Economic Situation and Prospects report 2021. These two groups are classified based on “basic economic country conditions” (Department of Economic and Social Affairs, 2021).

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\(^4\) Data gathered from Scopus (2020).

\(^5\) Data gathered from Scopus (2020).
4. Findings

After the selection of the relevant articles, we coded each article into one or more clusters based on their content. Each cluster (see Table 5) signifies a driver resulting in improvement in SME financial performance or access to, or cost of, capital, i.e., sustainable finance drivers. We triangulated the article coding process with three different authors reading and coding each article. Each author read and coded the articles separately, after which the results were compared. The analytic similarities were high, with few key differences.

<table>
<thead>
<tr>
<th>Clusters</th>
<th>Number of articles</th>
<th>Geographical focus or articles</th>
</tr>
</thead>
<tbody>
<tr>
<td>Literature review</td>
<td>3</td>
<td>Authors in Europe</td>
</tr>
<tr>
<td>Environment</td>
<td>7</td>
<td>USA, Europe</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Zambia, India, Mexico, Pakistan, Sri Lanka, Thailand</td>
</tr>
<tr>
<td>Stakeholder engagement</td>
<td>5</td>
<td>Greece, Australia</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Ghana, India, Pakistan</td>
</tr>
<tr>
<td>Supply chains</td>
<td>10</td>
<td>Italy, USA</td>
</tr>
<tr>
<td></td>
<td></td>
<td>China, Egypt, India, Mexico, Pakistan, Sri Lanka, Thailand, Vietnam</td>
</tr>
<tr>
<td>Employee engagement</td>
<td>12</td>
<td>Australia, Italy, Romania</td>
</tr>
<tr>
<td></td>
<td></td>
<td>China, Egypt, India, Malaysia, Mexico, Vietnam, Zambia</td>
</tr>
<tr>
<td>Community and philanthropy</td>
<td>8</td>
<td>Europe, Romania, USA</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Egypt, Korea, Mexico, Pakistan, Zambia</td>
</tr>
<tr>
<td>Brand reputation</td>
<td>5</td>
<td>Italy</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Eritrea, India, Vietnam</td>
</tr>
<tr>
<td>Innovation</td>
<td>10</td>
<td>Australia, Romania, USA</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Eritrea, India, Mexico</td>
</tr>
<tr>
<td>Access to capital</td>
<td>4</td>
<td>Europe, Italy, USA</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Eritrea, India, Mexico</td>
</tr>
<tr>
<td>Financial materiality</td>
<td>5</td>
<td>Australia, Greece, USA</td>
</tr>
<tr>
<td></td>
<td></td>
<td>India</td>
</tr>
</tbody>
</table>

Table 5. Summary table of clustered articles.\(^6\)

\(^6\) Data gathered from Scopus (2020). Please see appendix for more detailed breakdown by article.
Table 5 above lists the results of the literature survey coded into keywords (clusters). After the comparison of the codes, we reviewed the code words and agreed on adding new sections on stakeholder engagement, environment, and financial materiality. Although supply chain, community, employees, and environment can be considered stakeholders, a sufficient number of articles considered stakeholder engagement as a mediating factor for financial performance without specifying which stakeholder was the primary driver. Environment was added after a review of more considered evaluation revealed that environmental measures were the underlying drivers of financial success. The financial materiality of ESG was added after consideration of managerial and strategic implications that SMEs undertake to achieve their strategic and financial objectives, as well as due to interesting linkages to large corporate research and sustainable finance discourse. The articles were further listed by country domains into developing and developed countries, with specific countries listed in the rightmost columns of Table 5. The country listing enriches the analyses of identifiable differences in research focus areas between developing and developed countries. The sections below review key findings under each of the clusters.

### 4.1 Analyses of Literature Review Articles

Three of the articles were systematic literature reviews using the same methods as this essay, examining dimensions of sustainability and financial performance in SMEs (Johnson & Schaltegger, 2016). The first of the articles, by Bartolacci, Caputo, and Soverchia (2020), found an initial dataset of 136 articles which was then narrowed to a final dataset of 62 articles published between 1998–2018; 35 of which were published after 2016. The journals of publication were largely the same as those that came up in our research, with one notable difference being that Sustainability in Switzerland featured at the top of our search, with six articles but did not feature in the top ten publications there. The Journal of Business Ethics featured high in both searches. The geographical location was based on the corresponding author’s country which in two-thirds of the cases was in developed markets. However, this is a different basis of analysis than in our article where we looked at the geographical location of the SMEs being analyzed. The articles were then assembled into three groups by analyzing the interconnectedness of the articles: 1) innovation and entrepreneurship and their role in sustainability (30 articles); 2) CSR practices in SMEs (22 articles); and 3) green management and environmental issues for SMEs (10 articles).

Articles in group one (innovation and entrepreneurship) draw on resource-based theory and illustrate improved financial performance from investments in environmental and social activities. Investments in innovation and intangible assets, such as knowledge base and human
resources, had positive correlations with performance. Social responsibility investments, on the other hand, were highlighted as beneficial for long-term success. Group two articles largely confirm that CSR practices generate intangible benefits through motivated personnel and stakeholder relationship improvement, which in turn improves SME competitiveness, resulting in improved financial performance. The third and final group, looking at green management and environmental issues, consisted of the fewest articles (10), using mostly quantitative methods of analysis. The articles highlighted the relevance of firm-specific characteristics, such as owner influence, innovation orientation, company sector, and size, and perceived direct financial benefits as key propositions motivating green orientation. Environmental practices were often found to be part of a broader CSR agenda, sometimes supported by specific energy or waste monitoring tools.

Most of the articles confirmed a positive relationship between sustainability and financial results. The authors had a method of assembling the articles into three groups which enabled drawing some general conclusions but also resulted in overlaps and gaps in findings. Further analysis is suggested in fields like comparative country and sector reviews to highlight the most impactful CSR activities, as well as the financial benefit from the implementation of circular business strategies, where products are designed to maximize reuse and recycling.

The second and third literature review articles (Das et al., 2019, 2020) are from the same authors, but they apply different research questions and search criteria. In the first of the articles (Das et al., 2019), the authors used only two search string categories, one denoting sustainability and another denoting SME, resulting in 104 hits between the years 2010–2016. Financial performance was not a search string, though it was a mode of study in the articles. After applying for screening criteria, 66 papers were selected for further analysis concluding in a proposed model relating to the analysis of SME sustainability and business performance. The model proposed three levels of influence (government intervention, collaborative approach of operation, supportive organization culture) impacting environmental or social sustainability performance, which in turn impacts business performance. Furthermore, the authors developed an initial set of questions that could form a basis for further analysis.

The second article (Das et al., 2020) identified 100 articles between 2010–17 for analysis and coding. The authors used the selected literature to build a model that developed their earlier construct. The model looked at policy level (government policy and external facilitation), industry level (partnership collaboration and communication), and firm level (supporting organizational structure) impact on sustainability performance (environmental and social), and how this, in turn, impacts business performance. Further, a questionnaire supporting the model was composed and tested with 30 SMEs from the Indian leather and chemical sectors. The model and questionnaire were further refined and applied through
structured interviews of 225 Indian SMEs (Das & Rangarajan, 2020), and are included in the analysis below.

4.2 Environment

An environmental focus was found to impact financial performance in seven articles: five from developing countries, and two from the USA. Profit motives driven by energy savings, waste recycling, and water preservation were most prevalent in the US surveys. SMEs that had implemented green strategies focusing on environmentally friendly products or services benefitted from improved sales. Clearly identified profit benefits were key drivers enabling the implementation of sustainability-focused environmental strategies (Depken & Zeman, 2018). Similarly, when the investments were yielding financial benefits, firms retained their ability to maintain an environmental sustainability focus when faced with reduced financial performance, especially in dynamic business conditions (Panwar et al., 2015).

Similarly, small family-run tourism businesses in the EU and Chile had intentions to invest in environmental improvement initiatives provided they had the financial capability to fund them. The motive for investments was the owners’ altruistic values, though environmental investments were perceived to result in financial benefits through lower costs and improved competitiveness (Tamajón & Aulet, 2013). Many SMEs in developing countries target multinational companies as a source of growth and economic success. Retention and growing existing buyer relationships is a key concern, and therefore meeting the sustainability requirements of multinational corporates is of primary importance. This supply chain induced investment in triple-bottom-line (economic, environmental, social) aspects resulted in SMEs adopting sustainability strategies to adhere to multinational company requirements. The financial gains from savings generated from environmental strategies supported the continuation of these investments in the absence of multinational pressure also, and further supported the potential for the development of a strategic approach to sustainability (Luken & Stares, 2005).

4.3 Stakeholder Engagement

Stakeholder engagement was a key mediating factor in five of the articles. Three of these were surveys conducted in a developing country context. Ansong (2017) surveyed 423 SMEs in Ghana to test the effect of CSR on financial performance directly or with stakeholder engagement as a mediating factor. Ansong found that CSR does not lead to improved financial performance, except through the mediating variable of stakeholder engagement. The stakeholder engagement questions solicited data on the
extent to which the firm engages with stakeholders who are directly affected by the organization’s operations; those who have an interest in, or influence over the organization’s operations; stakeholders who have knowledge about the impact of the operations of the firm; and authorities or regulators who exercise control over an industry and several other types of stakeholders. Vyas and Jain (2020) found similar results using a panel of experts to investigate the relationship between CSR and financial performance in Indian SMEs. They found that market orientation (customer focus) and entrepreneurial orientation (innovation) led to improved financial performance, whilst CSR (employee, customer, environment, community) only results in an improvement in financial performance if stakeholder management is well taken care of through effective communication. Conversely, Islamic work ethics, social finance, and religiosity drive financial performance if mediated by CSR, here defined as engagement with community, employees, customers, and environment, according to a study of 241 Pakistani SMEs (Aziz et al., 2020). Employee and stakeholder engagement, combined with firms’ innovation capabilities, impacted proactive CSR, which resulted in improved financial performance in a survey of 171 Australian machinery and equipment manufacturing SMEs (Torugsa et al., 2012). Magrizos et al. (2021) found that, during economic crises in Greece, the management of the most financially vital stakeholders was key for financial survival and success. Common to all five articles was that the stakeholder concept was broad, and no single stakeholder group could be identified as the most important.

4.4 Supply Chain

The link between the CSR practices and the financial performance of SMEs often has a mediating variable of improved supply chain management. Through the articles reviewed, 10 demonstrated themes such as improved supply chain relations through transparent marketing to consumers; improved long-term and strategic relationships across supply chain actors; and improved ability for collaborative innovation.

The academic literature suggests that for SMEs selling products or services directly to environmentally and socially conscious consumers, the importance of environmental and social issues when meeting the demands of customers creates an ability to enter new markets with environmentally and socially conscious buyers. To credibly undertake CSR initiatives, consumers are often aware of firms’ supply chain CSR or sustainability performance (Depken & Zeman, 2018). Here, financial performance can be improved through communicating transparently and providing accurate information about positive environmental or social practices using eco-labels or various marketing strategies (Depken & Zeman, 2018). Cantele and Zardini’s (2018) findings support the idea of communicating environmental and social practices from supply chains to consumers, as this helps consumers to make
sound purchasing decisions based on their beliefs and morals. This ability to integrate sustainability through the supply chains allows SMEs to not only communicate this through labels and marketing but it was also found to help to penetrate new markets with eco-conscious consumers (Depken and Zeman, 2018). In addition, research shows it helps instill trust within the consumer, which studies here suggest generates loyal customer bases for these SMEs (Vyas and Jain, 2020).

Another option for CSR and supply chains to gain a significant ability to improve financial performance within SMEs suggested by this research is that they can establish superior supplier-buyer relations. A study by Yang et al. (2020) looked at small and medium supplier firms and found that CSR is naturally taken up when their buyers prefer or require CSR practices to avoid bargaining costs and to improve client relations. In addition, the study found that, if suppliers have good CSR practices, this can build moral capital and trust attached to the SME within their supply chains, therefore positively influencing the image of that SME (Yang et al., 2020).

Cantele and Zardini's (2018) study analyzed how improved sustainability could lead to a competitive advantage by looking at the drivers of organizational commitment, customer satisfaction, and reputation. They found that to gain a sustainable competitive advantage, the economic dimensions of sustainability in customers and suppliers were the second most important factor after engaging internal employees. Informing suppliers, getting them on board for organizational change for sustainable production, and developing a joint ability to communicate sustainability to customers supports the firm competitive advantage. This can enhance company reputation and customer satisfaction, as well as generate capacity for organizational commitment along supply chains, in turn enabling greater innovation and efficiencies and thus improved financial performance (Cantele and Zardini, 2018).

Sustainability or CSR practices and innovation within supply chains are also mentioned by Valdez-Juárez, Gallardo-Vázquez, and Ramos-Escobar (2019), and Yang et al. (2020). Valdez-Juárez et al. (2019) emphasized the importance of educating and training internal employees in CSR practices. They stress that CSR training practices equip employees to further drive CSR supply chain innovation and collaborative innovation through better engaging with supply chain partners to create and promote new products and services (Valdez-Juárez et al., 2019).

### 4.5 Employee Engagement

Fifteen articles focused on employee engagement as one of the central mediating factors between CSR and financial performance. A handful of studies within the ‘employee engagement’ cluster focused on how CSR strategies can motivate and create a more committed workforce. A study by Cantele and Zardini (2018) found significant results that ‘employee
organizational commitment’ was the most significant mediating factor between CSR and financial performance for manufacturing SMEs in Italy. They found that SMEs that have CSR activities that ensured the well-being of employees were making a worthwhile financial investment as their employees would go above and beyond work expectations and be proud of the company they work for (Cantele & Zardini, 2018). Similar results were found by Vyas and Jain (2020) in India as CSR activities increased employee skills, and improved competence led to increased productivity. In addition, they found that fewer employees would leave the company, which reduced the cost which would have been spent on new recruitment (Vyas & Jain, 2020).

An Australian study by Torugsa et al. (2012) found comparable results to the Italian findings reported by Cantele and Zardini (2018). The study focused on ‘proactive CSR’, meaning firms that are proactive rather than reactive in the adoption of activities that ensure social cohesion and integrity, environmental protection, and economic growth, and went beyond what is required by law and regulations. They found that a central factor for proactive CSR to increase financial performance was its ability to create a shared vision within the firm. They found CSR activities helped enable this shared vision as they created employee enthusiasm and engagement with SMEs and the development of their CSR practices (Torugsa et al., 2012). These findings can also be seen in a study by Nejati et al. (2017) in Malaysia that found that responsible practices with respect to employees led to a motivated workforce that was driven to see the betterment of the SME they worked for, which translated to better financial performance.

A study by Choongo (2017) in Zambia interviewed several SMEs on employee commitment, employee relationships, and employee work ethics with regard to the SME, and how they correlated with an SME’s environmental and social CSR policies, as well as their impact on financial performance. They found that environmental CSR policies significantly enhanced employees’ commitment to the firm, thereby improving financial performance. However, they found social CSR, including training and development of employees, motivated employees highly, although this was the only study to show a negative correlation with financial performance due to the costs associated with the training and development.

CSR activities that included employee training and development were found by many studies to improve skills, expertise, knowledge, and experience which were all essential for improved internal capacity and a strong competitive advantage position for improved financial performance (Jain et al., 2017). Building on the resource-based theory, Burlea-Schiopoiu and Mihai (2019) study from Romania found that owner-managers who invested in budgets for CSR activities such as employee training had a positive impact on overall profit, profit per employee, and total expenditure, and that they negatively affected debt ratio. Burlea-Schiopoiu and Mihai (2019, p. 8) state that “employees [are] the most significant asset of an SME and a source of potential competitive advantage”, and SMEs need to
continually develop the skills and knowledge of employees in order to grow and become more profitable.

As demonstrated from the articles above employee engagement with CSR, activities can enable a motivated and highly skilled workforce for an SME. In addition, a greater awareness of CSR means that developing employees’ skills and expertise creates an innovative culture where employees are in a better position to capitalize on their CSR practices (Burlea-Schiopoiu & Mihai, 2019). A Malaysian study demonstrated that investment by owners or managers into the wellbeing and training of employees was worthwhile, as it created the conditions for employees to be innovative with the SMEs’ CSR strategies for the betterment of the company. They also found this resulted in a more strategic position for employees to innovate for social and environmental development with supply chain actors (Nejati et al., 2017).

Furthermore, Valdez-Juárez et al. (2019) stressed that organizational learning within an SME was the mediating factor for CSR and financial performance. Central to this finding was that improved internal capabilities created great innovative capability, adding great value (Valdez-Juárez et al., 2019).

4.6 Community and Philanthropy

Eight of the articles considered community and philanthropic activities to drive financial performance. These included engagements in local projects by employees or managers, and charitable donations to local causes. Community and philanthropy CSR was frequently motivated by religious values, especially in religious states. Due to the selection of our search terms, these articles focused on the relationship between community engagement and philanthropy and the financial performance of the firm. These findings highlight the significance of cultural differences regarding community and philanthropy and SMEs’ financial performance; often this depends on how socially embedded SMEs are within their community and religious groups.

Basuony et al. (2014) analyzed CSR and financial performance in SMEs in Egypt. Their study comprised CSR within the four categories of economic, legal, ethical, and discretionary categories. The discretionary categories included indicators such as employee involvement and employee-led philanthropic activities, energy programs for communities, and direct involvement in community projects. Their results had a strong positive correlation with return on assets, return on sales, return on equity, competitive position, and sales growth. This study stressed the importance of cultural and religious associations and the significance of understanding how the concepts of CSR unfold and relate to financial performance. Based on the findings of the study, the authors state that management philosophy was the central mediating factor between CSR and improved financial performance, which, in Egypt, were closely related to the religious values
held by the managers. Philosophy and religious values held by managers and the community in this study provide insights into how philanthropy and community engagement for SMEs enable improved financial performance for SMEs in this particular regional context (Basuony et al., 2014).

A study by Aziz et al. (2020) in Pakistan adds insight beyond the previous articles concerning the implications of religion, community, and philanthropic donations and their relation to CSR and financial performance. Their research questions addressed the impacts of Islamic religious values on CSR and financial performance, as well as conducting additional research into religious philanthropy and its impact on CSR and financial performance. Aziz et al. (2020) found that the religious values of doing good in the name of Allah, living life based on religion, and religious attendance and practice, positively impacted financial performance. In contrast to the previous study, Aziz et al. (2020) found that the acts of ‘Zakat’, ‘Waqf’, and ‘Sadaqah’, which are all expressions of charitable donations motivated by the religion of Islam in the form of liquid assets or fixed assets, had no positive correlation with improved financial performance. These findings go beyond the previous papers, as the research questions look directly at philanthropic donations and their impact on financial performance (Aziz et al., 2020). The previous studies had a more general focus on analyzing a range of community engagement and philanthropic activities together without resolving the results independently into philanthropic or charitable donations.

Similarly to Aziz et al. (2020), a Korean study by Choi et al. (2018) analyzed charitable donations to evaluate their correlation with financial performance in Korean firms. Choi et al. (2018) had a narrow perspective on CSR, focusing solely on charitable donations. Similarly, they found no positive correlation between financial performance and charitable donations for SMEs in Korea. However, their study also analyzed larger corporations, in which they found charitable donations began to have a positive correlation with financial performance, specifically for large technology firms. Choi et al. (2018) argued that this was due to the greater visibility and media presence of larger firms, enabling better stakeholder relations from charitable donations.

Context plays a big role in the philanthropy-financial performance relationship. Research conducted in geographical contexts which had strong community relations, religious values, and traditions, frequently found positive correlations between philanthropy and financial returns. These results suggest that in a given context philanthropy can result in greater engagement with the community, which acts as a key to improved financial performance in SMEs through improved stakeholder relations. The studies that found philanthropic work to positively impact financial performance were often found in societies considered to be highly collectivist and would likely not yield the same results in more individualistic societies.
4.7 Brand Reputation

The largest cluster of articles was found on brand image and reputation and the impact they had on increasing the financial performance of SMEs. Here, many articles focused their attention on how CSR activities in SMEs could enhance stakeholder relations as the SME could be perceived as having a better brand image and greater legitimacy. The studies found that this could achieve greater competitive advantage because an improved brand image has been found to relate to increased loyalty from customers, a motivated workforce, better collaboration with supply chain actors, and enhanced network building with NGOs, regulators, and the community. All these stakeholder relations resulting from increased brand image secure an SME’s position within the market and maintain the longevity of their business success.

The articles found that CSR strategies provide an appropriate position for the SME to engage with a range of stakeholders. CSR strategies usually involve a range of actors from employees, community, local authorities, NGO organizations, customers, supply chain actors, and more. For example, Bahta, Yun, Islam and Bikanyi (2020) found that SMEs that actively engage their business practices with positive societal impact more easily navigate and mediate a positive relationship with many. Das and Rangarajan (2019) found greater CSR activities improve brand image which has a positive correlation with improved financial performance through the mediating factors of customer loyalty and employee satisfaction.

A study in Italy highlighted the importance of brand image and reputation when it comes to environmentally and socially conscious products. They found that brand image can help to achieve a competitive advantage, as many Italian consumer markets pay great attention to the environmental and social attributes of products; therefore, an SME which successfully integrates social and environmental product development can be rewarded financially (Cantele & Zardini, 2018). Cantele and Zardini’s (2018) study explained that this was due to products being associated with higher quality by the consumer, and, thus, conferring a superior image on the SME in comparison to its competitors.

In contrast to the previous studies, three papers found that promoting CSR activities could be correlated to a negative brand image or be a costly procedure that does not yield financial returns. A study looking at SMEs in China found that some CSR activities gain increased financial performance through the mediating factor of improved corporate reputation. Internal CSR activities related to improved welfare of employees, environmental efficiencies in production, and training of employees correlated with positive financial performance. However, they found that external CSR activities in China do not enable improved financial performance as the “costs of reputation are high because of the interference of uncontrollable information dissemination via social media in the circumstance of Internet” L.Yang et al. (2017, p. 348). They found that the management of external CSR
was very costly and burdensome, and the returns were not remunerated (L. Yang et al., 2017).

Similarly, a study in Vietnam found that promoting CSR as a marketing strategy was not financially beneficial due to a lack of customer and market awareness. The study found no correlation between CSR and financial performance as it failed to improve brand reputation and image for SMEs in Vietnam (Tien et al., 2020). A study in Italy found CSR could hamper the SMEs’ brand image as it conflicts with traditional family identity and the transgenerational identity of the small family business (Gjergji et al., 2021). In addition, the study found that CSR disclosure could negatively impact the competitive advantage of the firm as CSR disclosure could leak sensitive information to competitors (Gjergji et al., 2021).

### 4.8 Innovation

The aforementioned articles by Valdez-Juárez et al. (2019) and (Y. Yang et al., 2020) found innovation amongst supply chain actors to be a mediating factor for improved financial performance from CSR activities. Additional articles also focused on innovation within the firm for improved financial performance from CSR strategies (Arend, 2014; Bahta, Yun, Islam, & Ashfaq, 2020; Jain et al., 2017). Building on the resource-based view, these articles focused on increased training, employee capabilities, and intellectual capacity within the workforce. Commitment to CSR increased employees’ innovation abilities and improved firms’ competitive advantage (Arend, 2014; Bahta, Yun, Islam, & Ashfaq, 2020; Jain et al., 2017).

A study by Bahta, Yun, Islam, and Ashfaq (2020) analyzed the relationship between CSR and financial performance in Eritrea, specifically looking at the role that innovation capabilities play in mediating improved financial performance. They found that in the developing context of Eritrea, an SME which embedded CSR within the firm’s strategy helped bring profits as it caused the firm to think in new and innovative ways of working (Bahta, Yun, Islam, & Ashfaq, 2020). Engaging in socially responsible behaviors and environmental activities promoted employee training and creativeness, correlating with innovation, and constituting a competitive advantage for the firm (Bahta, Yun, Islam, & Ashfaq, 2020). The study also found that improved innovation from CSR activities helped alleviate difficulties suffered by SMEs, such as “financing, innovating, and attracting employees”, all of which help reinforce an SME’s competitiveness (Bahta, Yun, Islam and Ashfaq, 2020, p. 4). A study by Arend (2014) supplements these findings and found that SMEs with genuine CSR commitments usually attribute greater training and capability development for employees, positively relating to innovation and better firm performance.

The improved intellectual capital of a firm through CSR strategies was found to be the key mediating factor between CSR and financial performance in an Indian study (Jain et al., 2017). In this study, intellectual capital was
understood as the value-creating amalgamation of the SME’s innovation and learning, expertise, skills, and competence, as well as its relation capital with established stakeholders. Jain et al. (2017) study found that CSR strategies in firms often could lead to intellectual property rights in the forms of patents as a direct consequence of CSR innovation. They also found there was much more product innovation improving the quality of products with social and environmental attributes. In addition, CSR strategy improved financial performance as it developed a space for a creative and innovative workforce, which helps SMEs hold onto their talented employees who were satisfied due to their continual development (Jain et al., 2017).

A study by Torugsa et al. (2013) focused on SMEs’ ‘proactive’ CSR strategies which actively involve key stakeholders and a shared vision throughout the workforce, as well as on the strategic proactivity of CSR activities they engage in. Their study found that proactive CSR activities create the conditions to innovate products and services attached to environmental and social attributes, which can add value. With a proactive approach, they found the SME could better forecast opportunities and threats to innovate products to take advantage of new niche markets from changing consumer demands (Torugsa et al., 2013). An earlier study also by Torugsa et al. (2012) shows further support for the idea that CSR strategies help to enable forward-looking innovation by making the most of new opportunities. The study found that having stronger stakeholder relations with their community improved the ability of SMEs to capitalize on opportunities for innovation because communities were a key source of motivation to engage with CSR. It is also important to note here that local NGO organizations also fell into this community category (Torugsa et al., 2012).

A study by Burlea-Schiopoiu and Mihai (2019) provides a different approach to understanding the relationship between CSR and financial performance. They focused their study on a sample of 200 SMEs in southwest Romania, looking strictly at their CSR budgets, innovation budgets, and training budgets, and how they correlate with profit, profit per employee, total expenditure, and debt ratio. Interestingly, they found a strong positive correlation with profit, profit per employee, and total expenditure, but a negative correlation with debt ratio. They believe from these findings that CSR practices in SMEs help promote innovation and creativity, leading to a large competitive advantage and investments into CSR, which have strong financial returns (Burlea-Schiopoiu & Mihai, 2019).

4.9 Access to Capital

The impact of ESG performance on the access of SMEs to capital or the cost of capital was studied in four articles. Dunne and McBrayer (2019) reviewed the impact of ESG disclosure and the cost of debt for US-based SMEs over the ten years 2005–15. The authors used publicly available data
and found that ESG disclosure and transparency had a positive impact on reducing debt costs. Furthermore, they demonstrated that debt costs were reduced more for smaller SMEs than for larger SMEs. The authors posited that voluntary disclosure of ESG data signals transparency on the part of the companies and reduces uncertainty on the part of financiers. Another study looked at publicly available ESG and cost-of-capital data from Italian listed SMEs (Gjergji et al., 2021), including examining whether family ownership had an impact on the results. The study found no impact from social or governance disclosure on the cost of capital on the SMEs included. However, the cost of capital of non-family companies increased with environmental disclosure, whilst SMEs with family ownership status benefited from lower capital costs in environmental disclosure. Gjergji et al. (2021) posit that this could be due to the desire of family firms to retain intangible value features such as family company control and identity, influence, and status through the company, and public image.

Another US study looked at how the race of the entrepreneur impacts the access of SMEs to bank financing and found that racial minorities were treated worse than their white counterparts (Williams et al., 2020). Williams et al. (2020) used mystery shopping as the method of study. Mystery shoppers posing as SME owners visited bank branches with solid business cases backed with credible and credit-worthy financials. The shoppers had either Caucasian, Hispanic, or African American ethnic profiles. Overall, SMEs received poor reception and customer service at US banks, and this impaired their access to loans to a degree not warranted by their credit scores (Williams et al., 2020). However, this reception was accentuated greatly when the SME owner-manager was from an African American or Hispanic background. The authors posit that bank profitability would improve if banks implemented socially conscious customer service principles (Williams et al., 2020).

The last of the articles analyzed the hospitality and tourism industries in Chile, Catalonia, and Europe to see the main motivations for undertaking CSR, and how CSR can affect business performance (Tamajón & Aulet, 2013). The article reported the proportion of SMEs that undertook CSR in these three regions as 10.5% in Chile, 4.4% in Europe, and 12% in Catalonia; the authors explained that CSR helped, or the firms believed that it would help, them to apply for and get more subsidies and grants from the government (Tamajón & Aulet, 2013).

4.10 Financial Materiality

The financial materiality of ESG is a significant research topic in the context of large corporates. ESG materiality is different for different industries, but, in general, companies investing in and performing well in their material ESG aspects will gain financially. Five of the articles in the sample discussed financial materiality from different perspectives: 3 from developing
markets, and 2 based on the same survey from India. Financial materiality was identified to be significant from 1) stakeholder, 2) activity, and 3) strategic orientation perspectives. SMEs should concentrate on financially material stakeholders, especially during economic downturns. Stakeholder salience, as well as physical proximity, was found to be impactful for SME performance during the Greek economic crises between 2010–15 (Magrizos et al., 2021). Similarly, a US study found that financial performance motives resulted in SMEs continuing to invest in core CSR activities and cut from peripheral activities in a post-financial-crisis period, especially when operating in a dynamic and competitive environment (Panwar et al., 2015). The economic dimension of proactive CSR was found to have a positive impact on financial performance (FP) (Panwar et al., 2015). However, economic, social, and environmental dimensions were found to have a large positive impact on FP in a study of Australian SMEs, provided that firms identify the elements of social and environmental items for which they are best equipped (Torugsa et al., 2013). Similarly, two Indian studies found that CSR does not enhance financial performance when it is a religiously motivated, philanthropy-focused activity. Financially material strategic intellectual capital and employee-focused activity would, however, support economically sustainable sustainability work (Jain et al., 2016, 2017).
5. Discussions and Conclusions

The objective of this study was to review the status of academic research concerning sustainable finance and SMEs by applying a systematic literature review method. We investigated the status of published research on which ESG drivers impact the financial performance of, and access to and cost of capital for, SMEs. Sustainable finance covers both the financing of sustainable companies and projects, as well as the analysis of the impacts of ESG performance on companies’ financial value and risk. We identified nine clusters of primary impact on SMEs’ financial performance and capital cost and access in our literature review. Table 6 lists the nine clusters around environmental, social, and governance factors as per our analytical deduction: environment was placed under E; clusters that dealt with engagement with different SME stakeholder groups were placed under S; and clusters where impact depended on managerial activity under G. The limited amount of research, of which most was quantitative survey-based analysis from a developing country context, was a surprising finding, as was some of the subject areas not covered by any of the research. These findings are elaborated below.

<table>
<thead>
<tr>
<th>Environment 7 articles</th>
<th>Social 35 articles</th>
<th>Governance 24 articles</th>
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<tr>
<td>Environment</td>
<td>Stakeholder engagements</td>
<td>Brand reputation</td>
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<td>Supply chain</td>
<td>Innovation</td>
<td></td>
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<tr>
<td>Employee engagement</td>
<td>Access to capital</td>
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<tr>
<td>Community and philanthropy</td>
<td>Financial materiality</td>
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</table>

Investment in environmental performance factors were the drivers of financial performance in seven articles, compared to 35 under social and 24 under governance grouping. In the two US-focused articles, environmentally-focused customer and product strategies were at least partially identified as profit drivers (Depken & Zeman, 2018; Panwar et al., 2015). On the other hand, the developing country studies were more focused on the financial impact of energy, water, and waste-saving measures (Choongo, 2017; Luken & Stares, 2005). Importantly, none of the
articles examined the resilience of SME business strategies and financial performance against climate change. Climate change mitigation and adaptation requires significant annual investments, offering opportunities for large-scale innovation for start-ups, as well as for scaling-up new firms into larger firms. Studies on SMEs focusing on strategic environmentally focused growth strategies and the impact of these on financial performance were absent as a research focus, both from family as well as from venture capital owned SMEs perspectives.

Performance in social factors was found to impact financial performance in 35 articles, of which 25 focused on developing markets, ad 10 on developed markets. The strong linkage of SMEs to their local communities and cultural context was highlighted in several of the studies. For example, relationships with stakeholders ranging from local customers, suppliers, and employees to local and regional regulators were especially important in developing countries (Ansong, 2017; Choongo, 2017; Das et al., 2019). Choongo (2017), for example, replaced an employee satisfaction question with one asking whether the SME sponsored orphaned or underprivileged students in school, a factor deemed critical for community relations in a local Zambian context. Ansong (2017) showed that in a Ghanaian context, engagement with local stakeholders led to improved financial performance even to the degree that CSR performance in the absence of stakeholder engagement does not improve financial performance. Neither Ansong nor any of the other articles considered owners as stakeholders, though this is perhaps the most powerful stakeholder driving the actions of a company. Bartolacci et al. (2020) literature review identified one article that explored how the personal values of entrepreneurs impact the sustainability focus of SMEs, whilst for Das et al. (2020), this was one of the key drivers identified, with six articles supporting the finding.

The four clusters grouped under governance were each related to managerial action. The four clusters included 24 articles altogether, of which 13 were from developed countries and 11 from developing countries. All the articles about access to capital, and most of those related to financial materiality, were studies done in developed countries. Whilst we discovered articles that explored financial materiality from the perspective of SMEs choosing financially material stakeholders, activities, or strategies, the review also highlighted that SME questionnaires were the same for all survey targets without adjusted financially material ESG factors for different industries. On the other hand, Torugsa et al. (2012, 2013) discovered that a key success factor for SMEs was their ability to dynamically adapt to changing conditions, although large corporate-style process orientation can be a hindrance not only to financial success but also to environmental and social impact. This strategic agility enabled successful SMEs to reap the financial benefits of Proactive CSR by focusing on innovation through stakeholder engagement as well as the other ESG elements they were best equipped for.
Our research had some limitations through the method adopted. We used only a single database, Scopus. Whilst multiple databases could have yielded further articles, Scopus is the largest database of its kind providing a good overview of published articles. We used fixed keywords to limit our search. More adaptive search criteria could have yielded additional relevant results that did not use the chosen keywords in their abstracts, keyword lists, or titles.

Despite these limitations, this literature review provides an explication of the current state of academic debate on the relationship between sustainable finance and the financial performance of SMEs. Future research should investigate the impact of a sustainable finance focus by banks and investors in the EU, and how this influences the institutionalization of sustainability in SMEs.

Second, an exploration of financially material sustainability strategies and ESG factors should be investigated in single and multi-country contexts. Financial materiality is of key importance in large corporate research. The distinctive features of SMEs, such as their smaller size, lower capital intensity, strategic agility, the higher relative importance of local cultural context, and a more limited amount of human and financial resources could play a role here. Would an SME and a large company operating in the same industry have the same financially material ESG factors?

Third, the need for an exploration of the role of SME owners in driving or initiating sustainability change in the organization is indicated. Existing sustainable finance studies recognize the role of institutional investors in influencing both the board and management. Furthermore, existing management studies underscore the role of CEOs as key actors driving change processes in large corporates. By and large, change processes tend to be more successful when they are clearly mandated by endogenous factors.

Further research should cover both quantitative and qualitative research methods. We should expand our understanding of the relationship between sustainable finance and SMEs by studying individual case companies. We should also study larger populations, especially in the EU where sustainable finance is being rapidly integrated into the regulation of financial systems, putting climate change under increasing focus by the business community. Appendix
Table 7. Clustered articles by author.\(^7\)

<table>
<thead>
<tr>
<th>Clusters (No.)</th>
<th>Authors</th>
<th>Geographical focus</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Literature review</strong> ((3))</td>
<td>(Bartolacci et al., 2020) (Das et al., 2019) (Das et al., 2020)</td>
<td>A in Europe Authors based in India Authors based in India</td>
</tr>
<tr>
<td><strong>Environment</strong> ((7))</td>
<td>(Choongo, 2017) (Das &amp; Rangarajan, 2020) (Depken &amp; Zeman, 2018) (Luken &amp; Stares, 2005)</td>
<td>USA Zambia India India, Pakistan, Sri Lanka, Thailand Mexico</td>
</tr>
<tr>
<td></td>
<td>(Panwar et al., 2015) (Tamaçoj &amp; Aulet, 2013) (Valdez-Juárez et al., 2019)</td>
<td>USA Europe Mexico</td>
</tr>
<tr>
<td><strong>Stakeholder engagement</strong> ((5))</td>
<td>(Ansong, 2017) (Aziz et al., 2020) (Magrizos et al., 2021) (Torugsa et al., 2012) (Vyas &amp; Jain, 2020)</td>
<td>Greece Australia Ghana Pakistan India</td>
</tr>
<tr>
<td><strong>Supply chains</strong> ((10))</td>
<td>(Basuony et al., 2014) (Cantele &amp; Zardini, 2018) (Das &amp; Rangarajan, 2020) (Depken &amp; Zeman, 2018) (Luken &amp; Stares, 2005)</td>
<td>Italy USA Egypt India India, Pakistan, Sri Lanka, Thailand Vietnam Mexico Mexico India China</td>
</tr>
<tr>
<td></td>
<td>(Nguyen et al., 2020) (Valdez-Juárez et al., 2018) (Valdez-Juárez et al., 2019) (Vyas &amp; Jain, 2020) (Y. Yang et al., 2020)</td>
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<tr>
<td><strong>Community and philanthropy</strong> ((8))</td>
<td>(Aziz et al., 2020) (Basuony et al., 2014) (Burlesa-Schiopoiu &amp; Mihai, 2019) (Choi et al., 2018) (Choongo, 2017) (Niehm et al., 2008) (Tamaçoj &amp; Aulet, 2013) (Valdez-Juárez et al., 2018)</td>
<td>Romania USA Europe USA Pakistan Egypt Korea Zambia Mexico</td>
</tr>
<tr>
<td><strong>Brand reputation</strong> ((5))</td>
<td>(Bahta, Yun, Islam, &amp; Bikanyi, 2020) (Cantele &amp; Zardini, 2018) (Das &amp; Rangarajan, 2020) (Gjergji et al., 2021) (Nguyen et al., 2020)</td>
<td>Italy Italy Eritrea India Vietnam</td>
</tr>
<tr>
<td><strong>Access to capital</strong> ((4))</td>
<td>(Dunne &amp; McBrayer, 2019) (Gjergji et al., 2021) (Tamaçoj &amp; Aulet, 2013) (Williams et al., 2020)</td>
<td>USA Italy Europe USA</td>
</tr>
<tr>
<td><strong>Financial materiality</strong> ((5))</td>
<td>(Jain et al., 2016) (Jain et al., 2017) (Magrizos et al., 2021) (Panwar et al., 2015) (Torugsa et al., 2013)</td>
<td>Greece USA Australia India India</td>
</tr>
</tbody>
</table>

\(^7\) Data gathered from Scopus (2020).
References


Essay 3 - Sustainable Finance and the Institutionalization of ESG: A Case Study of a Finnish SME

Jukka Honkaniemi
December 5, 2022
Abstract

This essay investigates how and why small and medium-sized enterprises (SMEs) adopt environmental, social, and governance (ESG) considerations in their business and strategy. We look at what role sustainable finance plays in institutionalizing ESG. The empirical section of the study uses a single-company case study methodology of an idiosyncratic Finnish SME. We analyze the empirical findings against an ESG framework from existing literature around sustainable finance and SMEs. The case company rationalizes institutionalizing ESG into its strategy and operations as a way of retaining legitimacy with its key stakeholders. Financial returns and access to and cost of capital are implicit key considerations in deciding which ESG factors to invest in while maintaining a focus on key stakeholders in the Finnish context. At the same time, value-driven corporate culture derived from long-term family ownership creates a unique corporate disposition. In turn, such a disposition translates to closeness and alignment with key stakeholder groups. From an institutional theory perspective, the case company's ESG orientation is motivated by legitimacy retention in anticipation of increased demands on financially material ESG factors and stakeholders.

Keywords: SME, ESG, sustainable finance, financial performance, access to capital, cost of capital, value chain, institutionalization
1. Introduction

Sustainable finance is a term popularized by the EU’s Sustainable Finance Roadmap 2022–2024 (European Commission, 2021). Sustainable finance is used to describe practices in finance and investment that consider environmental, social, and governance (ESG) factors to promote sustainable development. This means that banks and investors consider these factors when making decisions on lending and investments. Under the EU’s Corporate Sustainability Directive, each company must report on ESG factors that impact the company’s financial value and risk as well as on the impact of the company on the planet and society, which is also referred to as “double materiality” (European Commission, 2022). In this essay, when we refer to sustainable finance, we consider the financial materiality of ESG as well as companies’ access to and cost of capital.

The impact of ESG and corporate social responsibility (CSR) on corporate financial performance (CFP) has been studied extensively in large companies (Friede et al., 2015). Friede et al. (2015) reviewed over 2,000 academic studies to investigate the relationship between financial performance and ESG performance and found that over 90% of the studies had a nonnegative correlation and that a majority were positive. For the CSR-CFP relationship to be positive, companies need to perform in financially material ESG factors (Eccles et al., 2012; Khan et al., 2016). Strong performance in material sustainability factors combined with transparency will increase companies’ access to capital (Cheng et al., 2014), lead to better credit ratings (Attig et al., 2013), and ultimately result in lower systematic risks and higher value (Albuquerque et al., 2019). However, most of the academic literature on the CSR-CFP relationship concentrates on investigating large companies. This raises the question of whether the same holds for small and medium-sized enterprises (SMEs).

Small and medium-sized enterprises account for over 99% of companies in the European Union (EU) and over 50% of economic value added, employment, and environmental impact (Constantinos et al., 2010; European Commission, 2019a). In order to achieve climate and other environmental objectives, the EU is implementing a green deal, a policy initiative that incorporates sustainability in all regulatory work (European Commission, 2019b). The EU’s green deal is estimated to require an additional over €3
trillion in investments to achieve the targeted 55% emission reduction goals over the ten years to 2030 and, as such, has been called both ambitious and insufficient (European Commission, 2021; Storm, 2020) Regardless of one’s stance, the green transition cannot be achieved without having SMEs on board, and hence understanding the drivers impacting the adoption of ESG by SMEs into their strategy and business operations is of societal importance.

Honkaniemi et al. (2021), based on a systematic literature review, developed an ESG framework to investigate the relationship between sustainable finance and financial performance in SMEs. The literature review found 1,637 articles investigating the CSR-CFP relationship, of which 36 were on SMEs (Honkaniemi et al., 2021). They found that the consideration of ESGs by SMEs is driven primarily by financial performance and the cost of and access to capital and idiosyncratic cultural and national context also receive attention in these considerations (Honkaniemi et al., 2021). Honkaniemi et al. (2021) mapped the 36 SME articles onto nine clusters organized under an ESG cluster framework which is used in the analysis of the SME case in this essay.

Following a similar logic identified in the abovementioned studies, this essay is a case study analysis of a Finnish SME with some €15 million in sales and 100 employees operating in the secondary packaging space and utilizing advanced robotics. Secondary packaging refers to the packaging of already manufactured and packaged goods for storage and transportation. The company is in its second generation of private ownership, and it is a unique SME case in that its owners have been ahead of the times in terms of governance by starting to move to independent board members already in the mid-1990s. They now wanted to ensure that sustainability was more explicitly embedded into the company’s strategy and operations, starting with a joint board and management sustainability workshop held in late 2020 (led by the author). In terms of methods, this essay is a case study triangulating empirical material obtained through pre-workshop interviews of the members of the board and management with a review of the company’s annual reviews, history book, and other available materials (Yin, 2003). After the interviews and data collection, the author designed and facilitated the management sustainability workshop with the company’s management and board. The author also has a prior prolonged engagement with the case company, having been the first external board member from 1996 until 2002.

In this essay, we use institutional theory and the ESG cluster framework identified through the literature review as a theoretical lens to analyze the drivers for change. Specifically, we map our findings to the nine clusters of the ESG cluster framework juxtaposed against the regulative, normative, and cultural-cognitive analytical pillars of institutional theory which we link respectively, to coercive, normative, and mimetic mechanisms (DiMaggio & Powell, 1983; Scott, 2008) in the case analysis. Scott (2008) argues that the three pillars of institutions manifest and rank differently depending on the context and case exemplar. We found that the case company’s leadership
team is driven by normative and cultural-cognitive pillars, strongly linked to corporate values derived from a long-term family ownership foundation. The institutional field of sustainable finance is new and rapidly emerging, including its regulatory aspects. The management of the case company implicitly identified financially material stakeholders and ESG aspects to focus on. Management was driven to maintain legitimacy with value chain partners before regulatory pressures appeared. All in all, we explore how sustainable finance considerations, specifically financial performance and access to and cost of capital, impact the adoption of ESG, as well as how institutional drivers support the adoption of ESG. This research contributes to the field of sustainable finance and SMEs by examining a company’s adoption of ESG in its business practices. Methodologically, this study follows a single-case research design (Yin, 2003).

The essay is structured as follows: Section 2 reviews the background on sustainable finance and ESG in the SME context. Specifically, we review an analytic framework (Honkaniemi et al., 2021) used to structure the case company findings. Section 3 reviews institutional theory pillars (regulative, normative, and cultural-cognitive) and mechanisms in the context of this research. Section 4 reviews the case company method and data. Section 5 analyzes the case company findings against the ESG cluster framework and institutional theory. Section 6 includes a summary and discussion of the case, as well as its limitations, and suggestions for further research.
2. Background

Sustainable development is often defined as “development that meets the needs of the present without compromising the ability of future generations to meet their own needs” (Brundtland, 1987, p. 54). Elkington (1998) later introduced the so-called triple bottom line (TBL) concept whereby companies should focus on a bottom line that balances people, planet, and profits. Sustainable finance is any financing and investment activity that supports sustainable development goals. The European Union (EU) has defined sustainable finance in a policy context (European Commission, 2021) as covering both investment and finance into environmentally and socially beneficial activities on one hand, and incorporating ESG considerations into financial value and risk considerations that drive capital allocation and cost decisions on the other. EU has further defined the so-called double materiality conception of impact whereby companies need to define and report how they impact the environment and society (E and S), as well as which ESG factors are financially material to them. In this essay, we concentrate on the latter part of the EU’s sustainable finance definition, i.e., ESG factors that impact financial performance as well as the cost of and access to capital.

The impact of environmental, social, and governance (ESG) factors on the financial value of large, listed companies has been studied extensively (Friede et al., 2015). Industry and sector-specific financial materiality and good performance on these material ESG factors have a positive impact on financial value, and the cost of capital in large companies (Cheng et al., 2014). In contrast, investing in non-material factors can impact a company by lowering its financial value as financial and managerial resources are devoted to activities with little or no financial returns (Eccles et al., 2012; Khan et al., 2016). Sustainable investing has become more of a norm than an exception (Global Sustainable Investment Alliance, 2021), and banks are aligning their operations with climate and sustainable development goals by signing up for the Principles for Responsible Banking (Franklin, 2019). Regulators are demanding increasing disclosure of corporate climate and sustainability action and performance, especially in the EU, where the forthcoming Corporate Sustainability Disclosure Regulation (European Commission, 2023) will impact the depth and breadth of ESG disclosure requirements.
However, in much of the sustainable finance discourse, small and medium-sized enterprises are absent, in part due to the small size and hence small impact of each SME, and due to limited understanding of the drivers and hindrances at the level of individual SMEs. The subject of this essay is an examination of a single SME. Although considered small as single firms, collectively, SMEs are a significant part of the EU economy, employment, and environmental footprint. SMEs account for 99.8% of the enterprises in the EU, 64.4% of employment, and 52.4% of economic value added (Eurostat, 2020). Further, SMEs collectively contribute significantly to environmental impact, accounting for 63 percent of Europe’s carbon footprint (ITU, 2022).

To create a framework of analysis, Honkaniemi et al. (2021) conducted a systematic literature review of the Scopus database before October 2020 with selected keywords. We followed Snyder’s method of systematic review (2019), which is useful in finding commonalities in the research field, as well as identifying research gaps. We searched for articles that matched ‘SME’ and ‘ESG’ and ‘financial performance’ or ‘access to capital’ with a specifically selected search string. The 36 articles thus selected were first coded with relevant identifiers, such as research method used, geographical source of data, journal of publication, and year of publication. Secondly, we reviewed each article for findings against our research question(s), including 1) how the ESG performance of SMEs relates to financial performance; and 2) what specific ESG drivers contribute to improving the financial status of SMEs.

The findings in the literature review were then mapped onto nine clusters previously identified as key drivers of financial performance (Honkaniemi et al., 2021). Table 1 below shows these clusters broken down according to their major areas of ESG. Following Snyder’s methodology, the literature review identified gaps for further areas of research (Snyder, 2019), including conducting case studies to further explore and understand the relationship between sustainable finance and SMEs. Existing studies underscore how financially material ESG factors are specific to national and cultural contexts. The Nordic context is considered idiosyncratic with specific cultures and norms (“Nordic Consumer Culture: State, Market and Consumers,” 2019). None of the papers identified examine sustainable finance and SMEs from the Nordic perspective, and hence this essay adds to the field of study around sustainable finance.

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<td></td>
<td>Community and philanthropy</td>
<td>Financial materiality</td>
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</table>

Several topical drivers were identified and grouped in clusters among the articles dealing with sustainable finance and SMEs. The clusters were
further grouped under environmental, social, and governance themes as shown in Table 1. Profit motives in the environmental theme mostly related to resource conservation and consequent financial savings when it came to energy, water, and waste (Depken & Zeman, 2018; Panwar et al., 2015). Developing country SMEs also felt supply chain pressure from their supply chain to conform to multinational clients’ requirements (Luken & Stares, 2005). Financial benefits from strategic positioning with respect to climate or other environmental benefits were not identified as profit drivers in the analyses of these papers.

The clusters under the social theme had the largest number of articles. Most of these were related to the stakeholder (without specifying which stakeholder), supply chain, and employees. In general, the focus of SMEs on social aspects of ESG created tighter relationships with clients, employees, and other stakeholders, resulting in stronger loyalty, commitments, and subsequent financial benefits (Ansong, 2017; Torugsa et al., 2012). The focus of SMEs on charitable donations or other types of community and philanthropy activities was found to be an important driver of legitimacy and of resulting financial performance in specific national and cultural and religious contexts (Basuony et al., 2014). This was especially true in the Islamic religious context (Aziz et al., 2020).

The clusters we grouped under the governance theme according to companies’ management activities outside of environmental and social contexts. Brand image and reputation had most articles but not all positive. Mostly, but not exclusively, developing country SMEs found brand reputation to be a driver of financial performance through employee and customer impact. However, brand reputation was also found to be costly and burdensome, with insufficient returns especially in developing country contexts (Choi et al., 2018; Tien et al., 2020). Innovation was an important driver of financial performance via closer supply chain collaboration and improved innovation capabilities through employee and client interactions (Bahta, Yun, Islam, & Ashfaq, 2020; Valdez-Juárez et al., 2019; Yang et al., 2020). ESG performance was found to lower the cost of debt (Dunne & McBrayer, 2019) and improve access to public grants (Tamajón & Aulet, 2013). Identifying and staying close to financially material stakeholders (Magrizos et al., 2021) and identifying and investing in financially core CSR, as well as cutting peripheral activities were important financial performance drivers in developing country contexts (Panwar et al., 2015; Torugsa et al., 2013).

The fact that only 36 articles studied the relationship between ESG and the financial performance of SMEs was remarkable compared to the 1,637 articles that studied ESG and the financial performance of all companies. Most of the 36 articles were based on quantitative survey analyses from a developing country context. Studies in the EU context were lacking. Honkaniemi et al. (2021) concluded by suggesting areas of further research including conducting case company studies to further our understanding of the relationship between sustainable finance and SMEs, especially in the EU.
As a follow-up, in this essay we therefore explore 1) How and why sustainable finance considerations impact our case company’s adoption of ESG; and 2) How institutional drivers manifest in the case company’s adoption of ESG. To answer these research questions, we draw on a case study methodology (Yin, 2003), institutional theory (Scott, 2008), and our previous theorizations on ESG (Honkaniemi et al., 2021).
3. Institutional Theory

Institutional theory provides a useful framework to study processes of change, whether within an organization or between organizations. The primary concept of institutional theory is to examine how a change process is legitimized. In this essay, we study a case company’s adoption of ESG by examining the leadership team’s decision-making in its unique historical and organizational context. According to Scott (2008), institutional theory underscores the role of organizations and institutions in shaping their environment as a means of seeking legitimacy with respect to the very environment in which they operate. Institutions are defined through legitimacy pillars (see Table 2). Scott (2008) maintains that institutions are comprised of regulative legitimacy and cultural cognitive legitimacy. Depending on the context, legitimacy pillars can contribute equally to reinforcing institutional processes. However, in some cases, it may be that one pillar is more prominent, while the others are less important.

Table 2. Three pillars of institutions adopted from Scott (2008).

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<tr>
<th></th>
<th>Regulative</th>
<th>Normative</th>
<th>Cultural-Cognitive</th>
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</thead>
<tbody>
<tr>
<td><strong>Basis of compliance</strong></td>
<td>Expedience</td>
<td>Social obligations</td>
<td>Taken-for-granted; Shared understanding</td>
</tr>
<tr>
<td><strong>Basis of order</strong></td>
<td>Regulative rules</td>
<td>Binding expectations</td>
<td>Constitutive Schemata</td>
</tr>
<tr>
<td><strong>Mechanisms</strong></td>
<td>Coercive</td>
<td>Normative</td>
<td>Mimetic</td>
</tr>
<tr>
<td><strong>Logic</strong></td>
<td>Instrumentality</td>
<td>Appropriateness</td>
<td>Orthodoxy</td>
</tr>
<tr>
<td><strong>Indicators</strong></td>
<td>Rules; Laws; Sanctions</td>
<td>Certification; Accreditation</td>
<td>Common beliefs; Shared logics of actions; Isomorphism</td>
</tr>
<tr>
<td><strong>Affect</strong></td>
<td>Fear Guilt/ Innocence</td>
<td>Shame/ Honor</td>
<td>Certainty/ Confusion</td>
</tr>
<tr>
<td><strong>Basis of legitimacy</strong></td>
<td>Legally sanctioned</td>
<td>Morally governed</td>
<td>Comprehensible; Recognizable; Culturally Supported</td>
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</table>

According to DiMaggio and Powell (1983), the mechanisms by which institutional actors seek legitimacy are either coercive, normative, or mimetic-isomorphic. Isomorphic processes drive actors toward homogeneity. However, these processes also reflect the context and the macro-discourses informing how an institutional field is organized (Lawrence & Phillips, 2004). This is to say that institutional actors’
isomorphic processes reflect a negotiation with respect to both the basis of compliance (expedience, obligation, and shared understanding) and the macro-discourses informing and institutional field (Dacin et al., 2002; Lawrence & Phillips, 2004; Suddaby, 2010).

Against this backdrop, institution theoretic concepts can help to address how the field of sustainable finance and its dominant macro-discourses, as exemplified by the ESG criteria, inform the actions of SMEs to institutionalize ESG into their business activities. More specifically, these concepts allow me to describe and explain how and why an SME seeks to institutionalize ESG into its business activities, as well as how an SME seeks to retain legitimacy within the industry by adopting ESG into its business activities. The latter part reflects Suddaby (2010, p. 15), who posits that the role of institutional theory consists of “understanding how and why organizations attend, and attach meaning, to some elements of their institutional environments and not others.” Reflecting on other studies in the field of sustainable finance, institutional theory has, for example, been used to study sustainable finance and ESG, exploring the drivers that impact institutional investors (Sjostrom, 2008), investment practices (Sakuma-Keck & Hensmans, 2013), and sustainability reporting (Bhimani et al., 2016). Dacin et al. (2002) identify three major categories of drivers that push an institutional field to change: functional, political, and social. The abovementioned drivers qualify as functional and social drivers, as identified by Dacin et al. (2002).
4. Method and Data

4.1 Case Study Methodology

Our case analysis follows Creswell et al. (2007) in their definition of a case study as “a qualitative approach in which the investigator explores a bounded system (a case) or multiple bounded systems (cases) over time through detailed, in-depth data collection involving multiple sources of information (e.g., observations, interviews, audiovisual material, and documents and reports) and reports a case description and case-based themes.” (p. 245).

Case methodology is particularly suited for new phenomena that are not yet fully developed, are complex, and where the researcher asks why and how questions (Yin, 2003). In this essay, I examine why and how the case company’s leadership team respond to sustainable finance as a new megatrend. Sustainable finance is a relatively recent megatrend impacting financial markets across the globe. Investors, banks, regulators, and legislators are working to ensure that a green and sustainable transition receives adequate finance without jeopardizing the stability of the financial markets. So far, academic research has studied if and how SMEs have implemented CSR, but little is known about how and why the drivers of sustainable finance manifest themselves in SME management, and, generally, SMEs fall outside of the scope of sustainable finance discourse due to their size. We aim to explore these drivers within the unique settings of a case company. The aim is not to find generalizations in the traditional sense, but, rather, to examine the unique settings of the case company (Eriksson & Kovalainen, 2008) going through the contemporary phenomenon of adopting ESG in an SME strategy, and, further, to understand how and why sustainable finance impacts this adoption. The drivers and motives influencing the case company’s leadership team shed light on more generalized perspectives of ESG adoption in SMEs (Flyvbjerg, 2006). Yin (2003) also suggests that case study methodology is suitable when the researcher has little control over the events being studied. A prolonged company engagement, first as a board member, and later as a consultant, has instilled in me a unique and
detailed knowledge of the case company background and decision-making. However, at the time of the study, I had not been an active participant and in this regard, I can claim that I as a researcher had “little control” over the events at the company during the case study period.

Following the case study research methodological procedures and identifying the type of case study, i.e., explanatory (Yin, 2003), this research is about SMEs’ response to Sustainable Finance. Specifically, it seeks to answer the question of how and why sustainable finance impacts the case company’s ESG implementation. Once the type of case study is argued for and the research questions are in place, the next step is to argue for the type of case study design. Yin (2003) breaks down research strategy and design into single and multiple case studies. We follow a single-case study design as our unit of analysis is group decision-making in the case company’s leadership team. The logic of data interpretation or analysis, and the criteria according to which the findings will be evaluated are suited for studying the research question.

This study adopts a single-case study following the line of argumentation above and based on Yin (2003). Yin (2003) identifies several rationales as to why this approach may be fruitful. In this study, the rationale for a single case is based on the uniqueness of the case. SMEs, by and large, fall outside the remit of sustainable finance regulations, and, because of that and their small individual size, they fall outside the focus and discourse on sustainable finance. This case is unique and interesting because it examines a family-owned company without an explicit ESG agenda. However, the management and owner are attuned to sustainability and sustainable finance as megatrends without explicitly rationalizing them or formulating their knowledge about them.

4.2 Case Company

The case company, a Finnish family business, started as a business producing parts as a subcontractor and building machines for the sawmill industry. The case company was founded by two people in a rural town in Finland in 1970, where their primary facilities and headquarters remain to this day. In order to abide by anonymity criteria, one of the founders, called X here, came from an entrepreneurial family of X’s, and the other, Y, had strong experience in metal and engineering. The 1990s were the decade of automation applications for the case company; most of its revenue came from equipment manufacturing, and material handling and secondary packaging systems became its main business focus. In 1995, the case company started importing robots from the company Kawasaki, and, in 2004, from Toshiba Scara. Today, tailored solutions based on advanced robotics play a major part in the case company’s customer offering as well as servicing its installed base.

From its beginning, the case company needed close and trusted relationships with key stakeholders including the local municipality, the local
bank, the then-operating SME guarantee center, an industrial investment institute, and a machinery manufacturer. These close relationships with key stakeholders contributed to getting the factory off the ground with the required space, equipment, employees, and capital. As an example, the municipality set up designated training programs for initial employees in metalwork, and the local cooperative bank manager traveled personally to Helsinki to negotiate much-needed guarantees for start-up loans from the SME guarantee center. The case company is currently owned by a second-generation member of Family X who also actively works in the business as deputy CEO. The case company CEO and board are independent of family.

The case company’s turnover in the financial year ending April 2021 was some 16 million euros, an increase of 17% from the previous year. The company’s operating profit was approximately 600,000 euros, and it employed 100 people.

4.3 Data Collection and Analyses

Following the identification of the case company through personal work engagement, we embarked on a data collection and analysis process based on the process identified in Kahkonen (2014) and Battistella et al (2018) and summarized in Figure 1.

![Figure 1. Data collection and analysis adopted from Battistella et al. (2018) and Kahkonen (2014).](image)

The data we identified and collected from the company is outlined in Table 3. In the first phase, I collected data through interviews and documentary searches. The data was then transcribed and read individually and compared to one another as depicted in the data treatment box. The next phase involved open coding of each data followed by axial coding in which themes started to emerge as described in Eriksson and Kovalainen (2008). All texts were then treated, mapped, and analyzed using Nvivo software. During this stage, the emergent themes were grouped against ESG criteria and analyzed against existing ESG clusters and the institutional theory tenets.
Our data included transcribed semi-structured interviews with five members of the case company leadership team. The interviews aimed to investigate the managers’ and board members’ views on the strategic drivers and strengths of the company, as well as their personal value preferences when it comes to ESG (see interview protocol in Appendix 1). We also used personal notes and presentation materials prepared for the case company consulting engagement as well as publicly available company materials such as annual reviews. Through data search through Google and Google Scholar, we found seven academic works and research reports where the case company was involved. These were also studied for relevant findings. The case company was in the process of compiling a comprehensive book of its history at the time of data collection and a draft of the book was used in the data collection and analysis process.

The data collection process started in August 2020 with a review of company reports, websites, and related material, culminating in the semi-structured interviews in October 2020 (see Table 4). The consulting work that came after the data collection increased our proximity to the case company, creating an active role that could have an impact on our interpretation of the studied phenomenon. To counter this potential subjectivity, data was collected from multiple sources, as set out in Table 3, enabling triangulation in the treatment and analysis phase.
5. Case Company Findings

In this section, we seek to answer the research questions. This will be done against the ESG framework and clusters identified in Table 1 and institutional theory tenets described in Chapter 3.

5.1 Environmental Topic

The abovementioned literature review of Honkaniemi et al. (2021) identified seven articles where different aspects of environmental performance were important for the financial success of SMEs. Thus, the ESG framework only had one cluster under the “Environment” heading. The analyses of the case company data uncovered two financially material “Environment cluster” themes that related to energy and waste management, and climate and environmental pressures from clients.

Table 4. Environmental clusters.

<table>
<thead>
<tr>
<th>Cluster</th>
<th>Themes in the case company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Environment</td>
<td>Energy and waste management</td>
</tr>
<tr>
<td></td>
<td>Climate/environmental pressure from clients</td>
</tr>
</tbody>
</table>

The case company’s primary environmental focus is on investments in energy savings. These investments were not motivated or driven by environmental considerations per se, but rather due to their financial benefits. Consider, for example, the quote below from a manager:

Energy, heat recovery, and all these things have been in focus because that’s where the big money has been, and as I said, it was a little more like a personal dream to get geothermal heat here and we got it, and if anything, 350 to 360 000 liters have been saved today. (Manager 1)

Similarly, a company’s business success with its clients is increasingly tied to environmental performance. This is manifested by clients demanding more from the case company in terms of the way it manages its environmental impact, as described in the next quote:
Also, at [case company], we were awakened to the investigation of environmental impacts. The company’s big customers such as [large firms 1, 2, and 3] were interested in their subcontractors’ way of handling environmental issues, and, increasingly, managing environmental issues was a prerequisite for the creation of deals. (Case company history book)

The environmental driver also manifests as a business differentiator in capturing new business. When the case company’s large clients operate in a climate of other environmental targets, offering more products and services to enable clients to meet those targets becomes a business differentiator driving sales.

Several of our large clients are coming out with new [climate] commitments, like [large firm 1] [...] committing to, was it 2035 [climate neutrality], ... there are several of these, and we are in close dialogue with different parts of [large firm 1] organization [...] that [it raises the question] how can we progress development on these together. Of course, there will be cost pressures for suppliers, but also [possibility for] different operating models that can be done more sensibly, and... they are now really driving the carbon neutrality work, which will then be visible through various things... but this is a good example. (Manager 5)

Similarly to the case company in Panwar et al. (2015), our case company views financial benefits from energy saving investment first and foremost as a financial investment not primarily driven by environmental consideration. Similarly, supply chain pressures were affecting the case company, and it was positioning its offering to meet clients’ climate targets to develop a more strategic approach to sustainability to improve sales generation (Depken & Zeman, 2018; Luken & Stares, 2005).

From an institutional theory point of view, the drivers that most affect the case company come from dominant actors within the value chain (Dacin et al., 2002). These can encourage the case company to proactively think about the potential impact they may have at the level of industrial competition, as well as the resources necessary to stay relevant within an industry (Dacin et al., 2002). The case company’s reflective process in the face of such pressures can be best viewed as cultural-cognitive indicators (Scott, 2008) since the management of the case company shares a common belief about what needs to be done to maintain legitimacy and relevance within the value chain. These form what Scott (2008) refers to as a shared logic of action. The case company engages in isomorphic behavior so that it maintains certainty against value chain actors but also expected regulatory changes such as carbon neutrality targets of its large clients.
5.2 Social Topic

The social performance topic had four different clusters, according to Honkaniemi et al. (2021). The case company had financially material seven themes under two of the clusters; employee engagement and supply chain.

### Table 5. Social clusters.

<table>
<thead>
<tr>
<th>Cluster</th>
<th>Themes in the case company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Community &amp; Philanthropy</td>
<td>No observations</td>
</tr>
<tr>
<td>Employee engagement</td>
<td>Investment in employee well-being&lt;br&gt;New generation of employees increasingly interested in ESG strategy of case company</td>
</tr>
<tr>
<td>Stakeholder engagement</td>
<td>No observations</td>
</tr>
<tr>
<td>Supply chain</td>
<td>Long-term trusted client and supplier relationships&lt;br&gt;Strategic focus on client relations and service, and life cycle of products&lt;br&gt;Collaborations supported by shared values&lt;br&gt;Anticipate requirements from the supply chain</td>
</tr>
</tbody>
</table>

The **community and philanthropy** cluster featured prominently in Honkaniemi et al. (2021) as it was a driver for the business success of SMEs in a cultural context where clients, suppliers, and employees rather do business with firms supporting local communities (Aziz et al., 2020; Basuony et al., 2014). The case company operates in a Nordic, and, more specifically, a Finnish, context, and Finnish culture does not give the same prominence to philanthropy because the national welfare state ideology downplays the role of philanthropy (e.g., due to universal access to free healthcare and education). The **Stakeholder engagement** cluster refers to studies where stakeholders as mediating factors were considered in general, without analyzing effects for different types of stakeholders (Magrizos et al., 2021; Torugsa et al., 2012). With regards to our case company, the empirical material highlighted specifically identified stakeholder groups (e.g. employees, suppliers, clients) and not stakeholders generally. Hence we had no findings within this cluster specifically.

However, **employee engagement**, as identified in Cantele and Zardini (2018), featured prominently in the case company. Consider for example the quote below:

_In my opinion, [case company’s] … characteristic is that the owner has a strong value base, a commitment to the company and a desire to take care of the personnel, and indeed a very positive perception of and approach to people._ (Manager 4)

The case company owner’s commitment to employee well-being reflects proactive ESG practices similar to the proactive CSR practices found in Torugsa et al. (2012). The outcomes of such practices contribute to workforce motivation and retention and, ultimately, financial performance (Choongo, 2017; Nejati et al., 2017).
And now to communicate [ESG strategy] in a way that, for example, if you think about the young generation of employees who are looking for a job, if they don’t like us as a company, if these [ESG] things are not on our agenda, then it can lead to us not being the chosen workplace. In other words, this young person can go to another workplace where he/she feels that these [ESG] issues are better taken into account, or that the other company contributes to saving the world. (Manager 2)

In Honkaniemi et al. (2021), employee retention and motivation were identified as key benefits of CSR investments (Cantele & Zardini, 2018; Jain et al., 2017; Vyas & Jain, 2020). The case company underlined the additional benefit of attracting new talent. Today’s job market discourses in Europe heavily emphasize sustainability. Attracting, retaining, and motivating employees are important financial value drivers. Attracting new employees is not only a matter of salary but, increasingly, a matter of value system alignment.

Rather than employee engagement in general, the case company’s supply chain relationships were found to be important drivers of business success. Yang et al. (2020) looked at small and medium supplier firms and found that CSR is naturally taken up when their buyers prefer or require CSR practices to avoid bargaining costs and to improve client relations. In addition, the study found that, if suppliers have good CSR practices, this can build moral capital and trust attached to an SME within their supply chains, therefore positively influencing the image of the SME (Yang et al., 2020). Anticipation of supply chain pressure was also observed in the case company:

...that of course if ecology or this topic [ESG] is increasingly on the agenda for investors too, then those [larger] firms have to think about them and then they will expect us to address them too with for example [ESG] question lists about how you deal with these topics, and I believe this starts a kind of chain reaction. (Manager 1)

The case company manager saw the investors’ ESG focus as the ultimate driver impacting the focus of large companies on ESG, and viewed supply chain channels as distributing this investor pressure to non-listed supply chain partners as well. This phenomenon was not prevalent at the time of the interviews, but, rather, anticipated to intensify in the future.

At the social level, the legitimacy of the case company for its stakeholders was anticipatory. The management of the case company recognized that future employees are more value-driven when choosing companies to work for. Such a view reflects the normative expectations through which the case company anticipates its future. Similarly, with regard to clients, the management anticipates the pressure for expected ESG performance to increase in the future. This anticipatory isomorphism is driven by changes in normative expectations largely emanating from the institutional field and dominant stakeholder actors.
5.3 Governance

The governance topic had four clusters identified by Honkaniemi et al. (2021) each relating to themes from the case company. After reviewing the case company’s empirical data, we identified an additional cluster, namely, ownership, elaborated below.

Table 6. Governance clusters.

<table>
<thead>
<tr>
<th>Cluster</th>
<th>Themes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Access to Capital</td>
<td>Anticipation of ESG demands from banks and insurance companies (as financiers)</td>
</tr>
<tr>
<td>Brand reputation</td>
<td>Trustworthy, reliable, and client-oriented partner</td>
</tr>
<tr>
<td>Financial materiality</td>
<td>Investment into financially material ESG factors and stakeholders</td>
</tr>
<tr>
<td>Innovation</td>
<td>Co-innovation with the supply chain partners</td>
</tr>
<tr>
<td>New governance cluster finding</td>
<td>Corporate values emanating from long-term family owner</td>
</tr>
<tr>
<td>Ownership</td>
<td>Owner as an active promoter of sustainability</td>
</tr>
<tr>
<td></td>
<td>Corporate values align with supply chain partners</td>
</tr>
</tbody>
</table>

Access to capital and cost of capital was found to be impacted by the company’s ESG performance and disclosure. SMEs that disclose their ESG performance have a lower cost of debt, and this discount becomes larger the smaller the SME (Dunne & McBrayer, 2019). The case company was no exception in this regard, as exemplified in the quote below:

Yes, maybe I’m more in the direction of financiers, so that, in terms of communication in general, we stand out from the rest of the crowd in this way and that way as a progressive company. (Manager 2)

The case company noted that banks and insurance companies (as credit providers) had not yet discussed sustainability with them, but they anticipated that this would happen in the future. They perceived that the price of loans, and even access to loans, will increasingly be linked to the sustainability performance of companies and that investing in ESG and reporting it to financiers will become important activities that help the case company to differentiate itself.

Brand reputation is important to the case company, so great efforts are put into maintaining its image. As Bahta, Yun, Islam, and Bikanyi (2020) recognize, brand reputation and image impact the quality of the relationships with many stakeholders.

Yes, specifically trust equity, it’s actually like that in a certain way, [the owner] and his father have built the company in such a long-term way that all things are handled in that customer base until the end, even if there are more difficult projects, and even if there are occasional losses in a project, it’s handled that way, and, when you have a reputation like that, it does help
to move things forward, so I think it’s a really big strength that maybe isn’t always remembered in everyday life. (Manager 2)

What is striking from this quote is the focus of the case company on specific brand equity dimensions (awareness, perceived quality, associations, and loyalty) of its brand. Aaker and Joachimsthaler (2000) posit that the perceived quality of a product or service correlates with loyalty, contributing to strong brand equity. Echoing Aaker and Joachimsthaler (Aaker & Joachimsthaler, 2000), Das et al. (2019) maintain that CSR activities help improve brand image and are positively correlated with financial performance. In our case company example, these relationships are playing out differently. The case company’s focus on quality control, in some cases, is affecting short-term financial performance, but it is nonetheless considered critical for its brand image and long-term success.

Financial materiality was found to be significant from 1) stakeholder, 2) activity, and 3) strategic orientation perspectives in Honkaniemi et al. (2021). A proactive approach to ESG, and, in particular, most material ESG aspects, was underscored as important from a financial performance perspective, as well as from a resilience perspective, in retaining continuous investments even in economic downturns. (Panwar et al., 2015; Torugsa et al., 2013).

This is perhaps a little bit the same thing, that this kind of sustainable development must not be something like a sticker that is pasted on top of other activities, but it must start from the very strategy and thinking about it, not what it means for us internally in our activities. But specifically, to the question of how this can be utilized on the customer side so that we can not only promote sustainable development as a whole but also produce added value for customers that they might even be willing to pay for. (Manager 4)

Similar to Torugsa et al. (2013) and Panwar et al. (2015), the case company also embodies a strategic orientation to sustainable development, arguing that it must not be a “sticker” but a strategic endeavor, reflecting business activities and ultimately delivering value to the value chain and stakeholders. In other words, this reflects a proactive ESG approach from a business performance perspective.

The case company has, throughout its history, demonstrated its client orientation in its business management and strategy with close collaboration and innovation with supply chain partners. This has allowed the company to engage closely with partners in the supply chain. Innovation amongst supply chain actors contribute to financial performance (Russo & Schena, 2020; Valdez-Juárez et al., 2018, 2019; Yang et al., 2020). The following excerpt from the history book exemplifies this:

Even though [case company] had its product development process, the planning of new products and services was always based on the identified
needs of the customer. For example, if the customer wanted to increase the capacity of the planing mill machine, [case company] delivered, in addition to the feeding devices, the unloading devices for the saw package, and the receiving conveyors with pinning stations that come after the planing. If the wish was to make operations more efficient, [case company] put together a package suitable for this need. Oftentimes, the design work took several hundred hours before the total plan was ready. (Case company history book)

This quote illustrates the idiosyncratic innovation capabilities of the case company. Specifically, it highlights the capacities and intellectual capabilities of employees. The case company’s capacity and capability not just to sell a product to a client, but to identify the holistic need and offer value-added solutions to it, characterizing a cultural feature of the firm qua supply chain partners. As an outcome of this co-innovation capability with supply chain partners, the case company further embeds itself as an indispensable partner within the value chain.

In the governance clusters, the prevalent common theme is cultural-cognitive legitimacy. This is driven by the case company’s strong value base which reflects the owner’s values. The strong value base fosters mimetic behavior among organizational members which translates into co-innovation with value chain partners, further manifesting in trusted stakeholder relationships. Furthermore, such behavior does not reflect the logic of orthodoxy but of proactive differentiation. The case company is positioning itself through a balance of structural isomorphism, and service differentiation, that enables it to bring added value to its stakeholders.

As a new finding that goes beyond the findings in Honkaniemi et al. (2021), long-term family ownership and the personal values of the owner play an important role in the case company’s conduct and business success. By and large, they reflect the social element of ESG, and, as such, build a strong foundation against which the business is run, and its relationships with stakeholders are maintained. One clear manifestation is reflected in the organizational identification of the case company:

Family entrepreneurship has been evident at [case company] throughout its existence as taking care of the staff and being transparent. The company has been honest about the state of the company and its possible effects on its personnel. This has strengthened the we-spirit, and, during the recession, the staff in the company have united and even been flexible in their salaries [...]. When the crisis was over and times were better, the salary reductions were paid back to the staff with interest. (Case company history book)

In the quote above the organizational culture and identity of the case company are vividly expressed with the “we-spirit” reflecting the cultural-cognitive and normative pillars of institutional theory. These case company specific themes are further expressed at the cultural-cognitive level where individual managers are in alignment with the normative values of the case company:
That’s right, I don’t know anything more important than trying to get things going so that we live sustainably here and in harmony with the environment. And there is more to [ESG] than an ecological point of view: [like] a kind of comprehensive well-being. Economic and social equality. Yes, I would see that. It is probably the finest... the noblest goals of mankind but also one of the greatest challenges considering how a short-sighted focus on money drives the world. (Manager 3)

These kinds of values bind the stakeholders and foster structural isomorphism that supports long-term value creation. Similar to philanthropic actions driving financial performance through stronger stakeholder relationships (Basuony et al., 2014) impacting the legitimization of SMEs, the case company achieves the legitimization through its embedded value base linked to its long-term ownership and the stakeholder relationships and conduct the values drive.
6. Discussion and Conclusions

The relationship between sustainable finance, ESG, and financial performance has been extensively researched in the context of large companies (Friede et al., 2015). However, when it comes to SMEs, research is rather scant. Honkaniemi et al. (2021) identified 36 academic journal papers that analyzed the relationship between sustainable finance and financial performance in SMEs. In this essay, we complement this prior work by examining a Finnish SME against sustainable finance and financially material ESG drivers. This is done via case study methodology and institutional theory tenets. The results highlight how the case company institutionalizes ESG into its business activities to maintain relevance and legitimacy with stakeholders.

To understand how and why the case company institutionalizes ESG into its business and organizational activities, we looked at the case company in the context of the key stakeholder groups as identified by the company’s leadership team. As part of the value chain, the case company is a less dominant actor; rather, its stakeholders dominate and dictate the dialogues about sustainability and ESG. The case company retained legitimacy by focusing on financially material stakeholders and ESG factors with available resources. The case company’s closeness to its employees, clients, and suppliers, supported by a strongly value-driven culture emanating from long-term stable family ownership, provided its unique strategic capabilities. The case company implicitly rationalizes its choices through financial returns, as well as access to and cost of capital considerations. Even though banks and insurance companies as capital and credit providers are yet to engage with them on the topic of ESG, the case company anticipates that this will happen in the future and acts accordingly.

The findings from this essay contribute to the existing sustainable finance literature. Our findings highlight quests for legitimacy and forms of isomorphism as sharing similarities with and differences from existing works (Bhimani et al., 2016; Sakuma-Keck & Hensmans, 2013; Sjostrom, 2008; Torugsa et al., 2012). For example, our findings resonate with Sjostrom’s (2008) findings on sustainable finance and quests for legitimacy. However, unlike Sjostrom (2008), the case company’s quest for legitimacy is not normative or based on cultural expectations, but, rather, on cultural-cognitive expectations.
The case company’s endeavors in adopting ESG are proactive, and they are projected to help the case company carve out a competitive advantage (Bhimani et al., 2016). The case company may well be characterized as an early adopter of ESG amongst SMEs of its type in Finland. In contrast to normative and coercive mechanisms identified as key drivers for CSR reporting in Bhimani et al. (2016), the case company’s adoption of ESG as a sustainable strategy is not normative per se, but, rather, instrumental, and it is geared primarily towards added value as a means of retaining legitimacy within the value chain and stakeholders.

Such endeavors among SMEs are identified by Torusga et al. (2012) as proactive corporate social responsibility (CSR) strategies. They found that proactive CSR mediates between company capabilities and company firm performance. Among the key capabilities identified by Torusga et al. (2012) were shared vision, stakeholder management, and strategic proactivity. In our case company, we found ownership to be an antecedent to the abovementioned capabilities. The role of the owner was instrumental in creating and fostering a strongly value-based corporate culture capable of enabling strategic proximity to financially critical stakeholders. Similar to the proactive CSR investments impacting SMEs’ financial success as in Torugo sa et al. (2012), our case company sought to retain legitimacy with its key stakeholders by implicitly but proactively identifying (financially) material ESG factors to focus on.

The role of ownership, in the case company, was critical in driving the integration of sustainability in a long-term return-focused manner. When asset managers (as owners) conform to ESG integration pressures without financial materiality focus, they tend not to create a genuine impact on the strategies and businesses of the companies they own (Sakuma-Keck & Hensmans, 2013).

Sakuma-Keck and Hensmans (2013) demonstrate that in a large company context, the asset managers as owners are unlikely to create a long-lasting impact on companies’ ESG performance if they as owners are only motivated and concerned about conforming to external institutional expectations. This is at the heart of the argument that focusing on financially material ESG generates long-term ESG resilience. The case company’s focus on financially material ESG factors and stakeholders stems from the owners’ values and focus on sustainability and are thus likely to generate a lasting impact.

Cultural-cognitive legitimacy, by and large, drives the case company’s meaningful conduct and activities within the company itself, with stakeholders, and within the value chain. The company’s ownership and value system serve as the bedrock against which much of its organizational activity is carried out. The cultivation of a strong value system reflects the mimetic character of the organization’s members and their strong identification with the case company. Consequently, the case company value system disposes the case company to engage in proactive and anticipatory isomorphism. Proactive and anticipatory isomorphism manifests a prominent characteristic of the case company and its relationships with
stakeholders. The case company’s decisions are not based on orthodoxy but are, rather, instrumental.

The case company’s value system supports a response to the ESG pressures coming from the institutional field and supply chain. In turn, the case company’s response enables it to adapt, through structurally isomorphism, within the value chain, while simultaneously maintaining its distinction as a value-adding actor within the value chain.

Finally, this essay extends existing research on sustainable finance and ESG by examining an SME as a case study. The case company understands its size and role within the value chain. They have limited capabilities and resources to invest in ESG and new ventures and are therefore very focused on adding value to dominant stakeholders and retaining their legitimacy. As such, their adoption of ESG may manifest in ESG areas that are financially most material. Financial materiality is identified through business strategy and operations towards employees, clients, strategic suppliers, and financiers. Whilst the management of our case company was aware that ESG demands from stakeholders had not yet manifested fully, they anticipated changes ahead and planned accordingly.

The case company in this essay had clear expectations that their key capital providers will place demands on ESG performance, though the actual implementation remains unclear. The case company recognizes that their banks and insurance companies must, at some stage, come to talk about ESG or climate change, and that these will have an impact on their access to, and the cost of, loans.

The interviewees anticipated normative and regulatory changes from banks and insurance companies that will act as drivers for ESG legitimization even before they materialize. This finding has practical implications that can contribute to policy changes. As mentioned, SMEs account for most companies in the EU and over half of its economic value added, employment, and environmental impact. A green transition cannot happen without having SMEs on board. If banks, insurance companies, and other capital providers to SMEs had a systemic requirement on financially material ESG aligned with the capacities and capabilities of SMEs, we would start to see speedy uptake of ESG adoption and a more resilient SME sector. In terms of capacities, SMEs don’t have the same personnel resources as large companies. Similarly, the capabilities of SMEs with respect to ESG knowledge and tools are more externally dependent than in large companies. Support from industry associations, NGOs, and governmental agencies in these matters will be important.

### 6.1 Limitations and Future Research

We followed a single case study methodology and design based on Yin (2003). We coded and analyzed the data against institutional theory tenets, and a sustainable finance framework to enhance validity. However, this
essay is exploratory and focused on a single-company case study from Finland. As such, the case company might not be representative of SMEs in other industries or cultural or national contexts, and, therefore, our findings may not be generalizable. However, transferability may be claimed through comparison with other cases with compatible SMEs and similar contexts identified in the sustainable finance literature.

The case company’s focus on retaining legitimacy and investing in financially material ESG factors was evident in this qualitative research. However, it would be important for future research to shed light on financial materiality from a multi-industry and general SME perspective by testing the correlative and causal relationships between ESG and financial performance and access to, and the cost of, capital through quantitative research, especially in the EU context. Also, ownership was found to play a key role in supporting the proactive adoption of ESG by the case company. Future research could specifically investigate the mediating role of ownership against financial performance. These would be especially important as more SMEs consider the implementation of ESG strategies. Lastly, as the EU develops and implements further sustainable finance regulations, their impacts on SMEs should be studied and understood. For example, banks will in the future be required to measure and report climate risks on their lending portfolios, relying on reported data from large companies, but needing new actual or estimated data from SMEs as well. The impact of these regulations on SMEs’ ESG adoption should be studied.
Appendix

Synopsis of the semi-structured interview questionnaire provided to the interviewees:

1. What are the key strengths and challenges of your company?
2. What are the most significant growth opportunities for your company?
3. What does sustainable development mean to you personally?
4. How do sustainable development and responsibility relate to your company’s growth and success?
5. Has the relevance of sustainability changed in your business, or do you see it changing in the future?
References


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