

Capital structure and speed of adjustment: the impact of environmental, social and governance (ESG) performance

ABSTRACT

Purpose This study aims to examine the impact of sustainable practices as proxied by the environmental, social and governance (ESG) score on capital structure. It also investigates whether ESG performance influences the speed of adjustment (SOA) to target leverage in firms. **Design/methodology/approach** the sample covers 116 non-financial firms listed on the main stock exchanges from five Southeast ASEAN countries (Bursa Malaysia, Indonesia Stock Exchange, Philippines Stock Exchange, Singapore Stock Exchange and Stock Exchange of Thailand) over the period 2012–2019. The study adopts the OLS regression and system-GMM estimators to perform the data analysis. **Findings** The authors show that the ESG score is positively associated with book leverage, suggesting that firms increase their debt capital through sustainable practices. However, they find that the ESG score is negatively associated with market leverage across our model estimations. The authors also reveal that environmental, social and governance pillar scores produce about 7.82%, 2.88% and 0.47% SOAs, respectively, higher than the SOA of the traditional SOA without the ESG factor. The aggregate ESG score has about 3.41% SOA higher than the baseline SOA without the ESG factor. **Practical implications** This study is of interest to investors, corporate firms and policymakers. The study demonstrates that the ESG score increases the firm's SOA to target leverage. By disaggregating the ESG score, the authors establish that ESG pillar scores produce higher SOAs than the traditional SOA (without ESG), with the environmental score inducing the fastest SOA. Practically, the study implies that environmentally sustainable activities reduce environmental transaction costs, benefit firms through better information transparency and enhance a trustful climate between the firm and suppliers of capital. Therefore, this study demonstrates that firms do not only incur the cost of disseminating ESG information but also benefit from lower information asymmetry and a higher SOA with better tax-deductible advantages. **Social implications** the findings have combined advantages for both stakeholders and directors who monitor and manage the firms' resources to improve the quality of ESG practices and initiatives. **Originality/value** to the best of the authors' knowledge, this study is among the first to establish that sustainable practices induce higher debt capital. Secondly, unlike prior research focusing on the cost of capital, the authors examine whether ESG performance affects capital structure patterns. Thirdly, it documents the extent to which sustainable practices influence the SOA towards target leverage in firms. The authors contribute to corporate finance literature that firms reach faster to their target leverage in the presence of ESG performance. Theoretically, through the notion of the stakeholder

proposition, the study establishes that the firms' pursuance of stakeholder goals further enhances the prediction of the trade-off theory.