

Sustainability

## Make Sustainability a Financial Variable

Rodrigo Tavares and Catalina Stefanescu-Cuntze



Image Credit | EKKAPON

*Stop treating ESG as a parallel reporting track and instead manage it as a finance and operating system.*

For nearly two decades, the corporate case for ESG has been built on a confident proposition that virtue reliably produces value. From Davos panels to CEO letters and sustainability indices, the refrain has been consistent. Firms that reduce environmental harm, improve labor practices, and strengthen governance should face fewer disruptions, earn greater stakeholder trust, and build more durable competitive advantage. If that logic holds, markets should gradually reward companies whose ESG performance improves in ways that are economically material, through higher expected cash flows, lower downside risk, or a lower cost of capital.

#### RELATED ARTICLES

Han Smit, "Sustainability Real Options," *California Management Review* 67, no. 3 (Spring 2025): 5–23, <https://doi.org/10.1177/00081256251331264>.

Muhammad Asif and Cory Searcy, "ESG's Complicated Story," *California Management Review Insights*, July 29, 2024, <https://cmr.berkeley.edu/2024/07/esg-s-complicated-story/>.

#### RELATED TOPICS

[Corporate Social Responsibility](#)

[ESG](#)

[Disclosure & Accountability](#)

[Finance](#)

Yet a persistent puzzle remains. The volume of ESG activity has expanded rapidly, but the link between measured ESG progress and equity pricing is often weak. In our [recent statistical study](#) of publicly listed firms in the Gulf region over 15 years and more than 4,400 firm month observations, changes in sustainability scores had almost no

measurable association with stock returns, either contemporaneously or with lags up to two years. In the full sample, a 10 point increase on a 0 to 100 ESG scale corresponds to roughly a 0.005 percentage point change in monthly returns.

This result does not prove that sustainability fails to create value. It suggests something narrower and more operational. The ESG ecosystem frequently generates information that is not decision useful for valuation. Markets do not price intentions, narratives, or broad score improvements. They price expected cash flows and the distribution of those cash flows, including tail risk, as well as the discount rates applied to them. Much ESG work never reaches that level of translation.

A useful way to frame the problem is to separate measurement from valuation. The last decade has produced more measurement, more disclosure, and more frameworks. But measurement alone does not move prices. Prices move when new information changes forecasts of unit economics, growth durability, capital intensity, regulatory costs, disruption probabilities, litigation exposure, or the risk premium investors demand. Our Gulf region evidence is consistent with the view that many ESG score changes are not being interpreted by markets as updates to those fundamentals, or at least not with enough clarity and credibility to change pricing.

## Four frictions keep that conversion from happening reliably.

**First is a translation friction.** Companies disclose large quantities of ESG data, often because reporting itself has become a compliance and legitimacy function. But most disclosures, and notably the European Sustainability Reporting Standards (ESRS), are not organized around the question a finance committee or investor would ask. Investors receive large volumes of sustainability information, but most of it is disconnected from the metrics that shape valuation. Currently, companies report what they do (e.g., “we reduced emissions by 10%”), but they rarely quantify how it alters value (e.g., “this reduction lowers our systematic risk and reduces our cost of capital by X basis points”). Which operational variable changes, by how much, with what time profile, and through what channel into cash flows and risk? Without this rigorous financial translation, ESG remains merely an administrative burden—a cost to be managed rather than a value driver to be leveraged.

The Gulf region offers a revealing natural experiment. Governments are pursuing ambitious sustainability agendas, from Saudi Arabia's Vision 2030 to the United Arab Emirates' Net Zero 2050 strategy, and regulators have made ESG reporting mandatory across key sectors. If ESG fails to translate into valuation and returns in a region with strong regulation and disclosure, that is a warning sign for everyone. Our [study](#)'s conclusion is straightforward. Policy and reporting have moved faster than market understanding. Governments can accelerate sustainability goals, but only investors can turn them into capital allocation when the link to value creation is clear. When that link is missing and sustainability is perceived as primarily top down or moralized, markets tend to respond with indifference.

**Second, many ESG disclosures rely on annual and backward-looking data.** This reinforces the short-term orientation of the market. The most important benefits of sustainability unfold gradually and are therefore generally difficult to detect through yearly snapshots. Improvements in operational efficiency, lower exposure to shocks, stronger supply chain resilience and greater innovation capacity accumulate over long periods of time. Traditional valuation tools are not designed to capture this slow maturation of value. Investors then conclude that sustainability has limited financial impact, not because the impact is absent, but because the way it is reported prevents it from being visible.

**Third, ESG aggregation creates more confusion than clarity.** ESG scores typically bring together hundreds of indicators. A handful of these variables capture genuine business risks or opportunities (what is good for the firm), such as carbon cost exposure for energy intensive firms, water stress for certain industrial and agricultural value chains, safety incidents in high-risk operations, or supply chain concentration in politically exposed geographies. But many other indicators have weak or ambiguous financial relevance; they often assess whether a company behaves responsibly rather than whether it performs efficiently or creates value. Most ESG ratings are statistical composites that merge indicators of external social or environmental impact with measures of internal corporate social responsibility practices (what is good for the world). Aggregation dilutes what is economically material, and differences across rating methodologies further erode comparability. When a key metric is unstable or not comparable, investors discount it.

**Fourth is an incentives friction.** Inside many firms, ESG performance is still managed as a communications product, a reporting calendar, a target narrative, and a reputation buffer. That orientation encourages breadth rather than materiality, and it rewards disclosure volume rather than capital discipline. Markets, however, tend to penalize uncertainty and reward credible commitments only when they are embedded in operating decisions, investment criteria, and accountability mechanisms.

These frictions appear across markets. In Europe, regulatory disclosure has outpaced the analytical capacity to convert ESG data into valuation models, and the recent softening of the CSRD and the Corporate Sustainability Due Diligence Directive (CSDDD) reflects a growing skepticism about the financial validity of ESG compliance. As markets fail to see its impact on valuation, rules risk becoming an exercise in bureaucracy rather than a driver of capital efficiency. In the United States, political polarization has clouded the financial rationale of sustainability, turning an analytical framework into an ideological battleground. In Asia, state-led sustainability initiatives have expanded more rapidly than private-sector mechanisms for risk pricing and capital allocation.

If those are the frictions, the remedy is not to abandon ESG. The remedy is to make it legible to finance. ESG needs to be expressed in a small number of economically material variables that can be debated, quantified, and embedded in decision making. Leaders who want ESG to matter financially should treat it like any other performance system. The model below breaks the task into five steps that can be embedded in planning, budgeting, investment approval, and investor communication.

**One, identify three to five financially material ESG variables that are specific to the business model** – the “super-metrics”. Do not start with a ratings template. Start with the profit model and the balance sheet. Where is margin earned and lost. Which inputs are scarce, volatile, or politically exposed. What can shut the business down, including permits, labor constraints, supply chain fragility, safety incidents, cyber events, corruption enforcement, or acute resource scarcity such as water. Which externalities are likely to be priced through regulation, litigation, or customer requirements. These questions naturally produce a short list of ESG variables with plausible economic pathways. If a variable cannot be linked to a line item or a risk distribution, it may still be valuable to pursue, but it should not be marketed internally as value creation. Executives should therefore stop

chasing higher aggregate ESG scores. For most companies, improving ESG performance has become an exercise in score optimization rather than risk management, a costly distraction that rarely changes how the firm is valued, as our study showed.

**Two, specify the valuation channel for each variable.** Every selected ESG variable should be mapped to one or more of three valuation levers. Cash flows, through revenue growth, price realization, unit cost, capex, working capital, or terminal value assumptions. Downside risk, through cash flow at risk, disruption probability, or loss severity in adverse states. Discount rate, through financing access, insurance pricing, covenant constraints, or changes in risk premia. The point is to make the model explicit enough that it can be challenged, audited, and improved. If a metric does not have a plausible causal link to the P&L or balance sheet, it belongs in a corporate philanthropy report, not an investor presentation. Until ESG affects valuation outputs, it will remain reputational rather than financial.

**Three, quantify ranges rather than slogans.** Most ESG targets are stated as endpoints, such as net zero by a certain year. That is not decision useful unless it is converted into an investment path, operating cost impacts, and residual exposure. Finance needs ranges and scenarios, not aspirations. A credible ESG variable should have a base case, an adverse case, and an upside case, with a timeline for when impacts emerge. Uncertainty is not a reason to avoid numbers. It is a reason to use distributions.

**Four, embed the variables in capital allocation.** ESG becomes economically real when it changes investment choices. That means incorporating the valuation channel into project approval templates, hurdle rate adjustments, procurement criteria, and risk committee decision rules. Internal pricing is one of the clearest mechanisms. An internal carbon fee is a good illustration of translation because it converts an environmental externality into an internal cost that affects business unit choices and funding flows. The design matters less than the principle. When an externality becomes an internal decision variable, it starts to influence resource allocation.

**Five, attach governance and accountability.** A small set of material ESG variables should have clear owners, data controls, and escalation rules. Incentives can be used, but only where the variable has a demonstrable link to economics and where measurement is

robust. The objective is to ensure ESG performance is managed with the same seriousness as operating performance.

This model also changes the external conversation. Investors do not need another long sustainability report. They need a short, auditable reconciliation that shows how a few material variables translate into financial drivers. Metric, mechanism, quantitative range, governance. That is more decision useful than dozens of pages of narrative.

Several companies provide instructive pieces of this approach. A concrete example comes from Kering, the luxury group behind Gucci, Saint Laurent, and Bottega Veneta. Kering developed an Environmental Profit and Loss framework that translates environmental impacts across its operations and supply chain into a monetized measure. This forces management to confront tradeoffs in a common unit and makes environmental exposure easier to integrate into investment and sourcing decisions. Walmart's Project Gigaton is valuable because it recognizes that for many firms, material exposure sits in the value chain, and managing it requires supplier level levers, measurement, and operational change rather than corporate level rhetoric.

For investors, the implication is equally practical. Stop rewarding disclosure volume and demand valuation relevant translation. Ask for the implied capex path, margin sensitivity, and disruption risk reduction associated with ESG initiatives. Some investors are already moving in this direction. For example, in guidance posted for the 2026 proxy season and effective January 2026, BlackRock Investment Stewardship's climate and decarbonization stewardship guidelines push companies to connect climate strategy to forward looking capital allocation and procurement plans, because that is where commitments become finance. Investors should treat ESG analysis more like credit analysis, with probability weighted impacts on cash flow stability and downside risk, and focus engagement on governance and capital allocation rather than score movements. A metric without ownership, auditability, and decision integration is easy to market and hard to price.

ESG will not be consistently priced until it is consistently treated as finance. That requires materiality discipline, explicit mechanisms, quantified scenarios, integration into capital allocation, and accountability that holds when tradeoffs become real. For that to happen, ESG needs to give up on its roots. Ethical investing has a long lineage, from Quaker

prohibitions on financing slavery and weapons to campaigns that used capital to oppose apartheid and advance social objectives. Modern ESG entered mainstream markets in the 2010s for a different reason, to identify environmental, social, and governance exposures that could impair cash flows, increase downside risk, or raise the cost of capital. However, over time ESG drifted back toward moral identity and activism. As it did, it lost precision and became harder to model and price.

Therefore, the path forward is not to abandon sustainability and it is not to add yet another layer of disclosure. It is to build the missing translation layer between ESG performance and valuation. When that layer is in place, the market does not need to be convinced that ESG matters. The cash flows and risk premia will show it.

---



Rodrigo Tavares [Follow](#)

Rodrigo Tavares is an Adjunct Full Professor at NOVA School of Business and Economics (Nova SBE), where he teaches master's and executive education courses in sustainable finance, corporate sustainability, and artificial intelligence, in addition to conducting research in these fields. He is the Founder and CEO of the Granito Group, a financial firm headquartered in the United Kingdom dedicated to advancing the sustainable economy through strategic consulting, financial advisory, and policy & research services. He is the author of five books and dozens of academic articles on international relations, sustainability, finance, and economic development, published in journals such as the Journal of Sustainable Finance & Investment, Journal of Environmental Investing, and Sustainable Communities.



Catalina Stefanescu-Cuntze [Follow](#)

Catalina Stefanescu-Cuntze is Professor of Management Science, and the Faculty Lead of the Master of Analytics and Artificial Intelligence. She started her career as Assistant Professor of Decision Sciences at London Business School, then joined ESMT Berlin where she previously served as Director of Research and Dean of Faculty. She holds a PhD in Operations Research from Cornell University. Catalina's research and advisory work focus on the design, development, and application of analytical and artificial intelligence models and methods for managerial decision-making. Her expertise focus areas include customer analytics, corporate and consumer credit risk, and sustainability modeling.