

Financial and ESG Drivers of Profitability and Market Valuation: Emerging and Developed Markets Evidence

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INTRODUCTION

The relationship between traditional financial drivers and emerging sustainability factors has become a focal point of corporate performance research in recent years. The increasing integration of environmental, social, and governance (ESG) considerations into financial decision-making has challenged the long-standing dominance of classical performance determinants such as profitability, leverage, and firm size. This study, titled Traditional and Sustainable Drivers of Firm Performance, investigates how these traditional and sustainable dimensions interact to shape firm performance in both financial and sustainability contexts. Using a comprehensive dataset of listed companies across emerging Latin American markets, Chile, Peru, and Colombia, and the developed European market of Spain, the study provides empirical evidence on how financial fundamentals and corporate sustainability jointly influence profitability and firm value.

The research is grounded in a dual theoretical foundation that bridges classical corporate

finance and modern sustainability theories. The traditional perspective draws on the Modigliani & Miller (1958) and Modigliani & Miller (1963) propositions on capital structure neutrality, the Agency Theory (Jensen & Meckling, 1976), and Pecking Order Theory (Myers & Majluf, 1984), all of which emphasize firm behavior under information asymmetry and financial constraints. These models explain performance primarily through leverage, profitability, and firm size. The sustainable finance perspective, however, incorporates the Triple Bottom Line approach (Elkington, 1994), Stakeholder Theory (Freeman, 1984), and the Resource-Based View (Barney, 1991), recognizing sustainability as a strategic asset capable of reducing risk, improving efficiency, and fostering long-term competitiveness. By combining these frameworks, the study proposes an integrated model in which traditional financial and sustainable factors jointly determine firm performance.

The main objective of the research is to analyze the extent to which sustainability performance, measured through ESG scores, complements or modifies the effects of traditional financial

determinants on firm profitability. Specifically, the study examines whether firms with stronger sustainability performance achieve higher profitability and efficiency, and whether these effects differ between developed and emerging market contexts. The underlying hypothesis posits that sustainability-oriented firms experience superior financial outcomes due to enhanced stakeholder trust, improved risk management, and operational resilience. However, given the institutional heterogeneity between Europe and Latin America, the magnitude and significance of these relationships are expected to vary.

DATA AND METHODS

The empirical analysis employs a quantitative and explanatory research design based on secondary data from the Refinitiv® database, covering the period 2018–2023. The sample includes publicly listed companies from the Nuam Exchange (integrating the stock markets of Chile, Peru, and Colombia) and the Bolsa de Madrid in Spain. This cross-country sample enables a comparative analysis of firm performance in markets with differing levels of institutional maturity, regulatory enforcement, and investor orientation toward sustainability. Financial variables include profitability (Return on Assets, ROA), leverage (total debt ratio), firm size (logarithm of total assets), liabilities (logarithm of total liabilities), and interest coverage ratio (ICR). Sustainability performance is represented by the logarithm of the ESG score, which aggregates environmental, social, and governance indicators.

The methodological framework combines panel data econometric models and robust estimations to ensure reliability. Three baseline models were tested: Pooled OLS, Random Effects (RE), and Fixed Effects (FE). Model selection was guided by diagnostic tests, Breusch–Pagan, Honda, and Hausman, which confirmed the adequacy of the Fixed Effects specification. To correct for heteroskedasticity, serial correlation, and cross-sectional dependence, Driscoll–Kraay robust estimators were applied. These statistical procedures ensure the consistency and robustness of coefficient estimates in the presence of firm-specific heterogeneity. All

analyses were conducted using RStudio (v.4.4.0), employing the plm, lmtest, and sandwich packages for estimation and inference.

RESULTS

The results reveal that corporate sustainability has a positive and statistically significant effect on firm profitability. Firms with higher ESG scores tend to achieve stronger financial outcomes, confirming that sustainability-oriented strategies contribute to performance improvement. Specifically, a 1% increase in ESG performance is associated with an average 0.09% increase in ROA, indicating that sustainability contributes to operational efficiency and financial stability. This finding aligns with the growing body of literature asserting that sustainable firms enjoy lower capital costs, reduced risk exposure, and improved stakeholder relations, all of which translate into superior profitability. The result also reinforces the notion that sustainability has moved beyond ethical or reputational dimensions to become an economically material factor in firm performance.

Profitability is also significantly influenced by traditional financial determinants. Leverage shows a negative and significant relationship with ROA, supporting the Pecking Order Theory's prediction that more profitable firms rely on internal financing rather than debt. High leverage levels increase financial risk and interest burden, which in turn reduce net profitability. Conversely, liabilities exert a positive and significant effect on profitability, suggesting that, up to a point, debt commitments can discipline managerial decisions and enhance efficiency, consistent with Agency Theory. The interest coverage ratio (ICR) displays a negative association with profitability, indicating that firms with higher debt service capacity may operate more conservatively, limiting opportunities for aggressive reinvestment or growth. Firm size is negatively related to profitability, contrary to traditional expectations. Larger firms may face bureaucratic inefficiencies or lower marginal returns on assets, especially in Latin American markets characterized by concentrated ownership structures and limited competition.

The results also confirm the robustness of the sustainability-performance nexus across alternative model specifications. The positive effect of ESG persists after controlling for firm-specific heterogeneity, time effects, and potential endogeneity biases. Importantly, the impact of sustainability is stronger in Spain than in Latin America, reflecting differences in market maturity and regulatory enforcement. In Spain, where sustainability disclosure is mandatory under the European Union's Non-Financial Reporting Directive and Sustainable Finance Disclosure Regulation, ESG practices have become integral to financial strategy and investor decision-making. In contrast, Latin American firms operate in environments where sustainability disclosure is still voluntary, inconsistent, and less valued by investors. As a result, ESG integration in these markets functions primarily as a signaling mechanism rather than a fully material financial determinant.

DISCUSSION

The comparative analysis thus reveals an institutional gap between developed and emerging markets. In Spain, the integration of ESG factors into corporate strategy and reporting has matured, making sustainability a measurable and priced component of firm value. The relationship between ESG performance and profitability is both stronger and more stable, reflecting higher investor confidence in sustainability metrics. In Chile, Peru, and Colombia, however, sustainability adoption remains uneven. While Chile shows moderate ESG influence on profitability, Peru and Colombia exhibit weaker effects, constrained by regulatory fragmentation and limited investor awareness. This heterogeneity underscores the need for regionally harmonized sustainability standards and stronger enforcement mechanisms to ensure that ESG performance becomes financially relevant across Latin America.

The study's findings have important theoretical and practical implications. From a theoretical standpoint, they challenge the traditional dichotomy between financial and non-financial performance, demonstrating that sustainability has become a complementary driver of firm

outcomes. Integrating ESG factors into the analysis of profitability and capital structure extends classical financial models, offering a more comprehensive understanding of firm behavior in contemporary markets. The results support the emerging sustainable finance paradigm, which views environmental and social responsibility as sources of competitive advantage rather than costs.

From a managerial perspective, the evidence suggests that integrating sustainability into business strategy enhances profitability and long-term value creation. Managers should view ESG initiatives not as external impositions but as strategic tools for improving efficiency, innovation, and reputation. Firms with high ESG scores tend to attract patient capital, improve stakeholder relations, and enjoy greater resilience during market downturns. In contrast, neglecting sustainability can expose firms to reputational, regulatory, and financial risks, particularly as global investors increasingly screen portfolios for ESG compliance.

For policymakers, the results underscore the urgency of strengthening sustainability disclosure frameworks and integrating ESG criteria into capital market regulation. Governments and financial authorities in Latin America should adopt mandatory reporting standards aligned with the Global Reporting Initiative (GRI), the International Sustainability Standards Board (ISSB), and the EU's Corporate Sustainability Reporting Directive (CSRD). Additionally, policy instruments such as tax incentives, green bonds, and sustainability-linked loans could accelerate the adoption of sustainable business practices. Regional cooperation through the Nuam Exchange could also enhance cross-border ESG standardization and attract foreign investment committed to responsible finance.

The limitations of the study include its reliance on secondary ESG data, which may vary in methodological rigor across countries, and its focus on listed firms, which limits the generalizability of findings to smaller or privately held companies. Future research could expand the analysis by incorporating firm-level qualitative assessments, longitudinal data, or industry-specific breakdowns. Structural Equation Modeling (SEM) and mediation analysis could also be applied to disentangle the

indirect pathways through which sustainability affects performance, such as innovation capacity, reputation, or cost of capital.

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