ARIMAA NOKKU
ISSN: 2320 - 4842 (P)
ISSN: 3049-2688 (O)
International Conference on Indian Knowledge Systems (ICIKS 2026)

Shareholder Activism, ESG Initiatives and Cost of Capital in the Indian Market

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Abstract

Shareholder activism has become a critical force for change in organizations, as the world increasingly focuses on sustainability. This study aims at finding out the effect of ESG related activism on the ESG performance of a firm, Cost of Capital (CoC) and the market value. Using a linear mixed-effects model in Jamovi, the research analyzes shareholder dissent targeted longitudinal data sets.

The study also finds that activism has a significant negative impact on the following ESG disclosure score ($\beta = -3.3$, $p = 0.027$) while the following ESG disclosure score has a significant positive association with firm value ($\beta = 0.0195$, $p = 0.001$). On the other hand, there was no statistically significant impact of activism and ESG scores on the Cost of Capital, meaning that the market does not immediately depress interest rates or risk premiums. In theory, activism can have no direct short-term impact on lowering financial risk, but it can achieve value for firms for other reasons, including improved brand reputation or investor perceptions. The key managerial take-away should be that companies should focus on disclosing ESG comprehensively as the primary instrument of interest rate negotiation – regardless of whether it is directly correlated to a near-term interest rate impact. From the social aspect, the findings are as follows: Although the activists can help identify under-performers, transparency is the key principle to win long-term investors' trust.

This paper therefore concludes that activism is an effective “diagnostic tool” (H1) and ESG is a valid “value driver” (H3). It also concludes that H2 (direct linkage to cheaper financing) will take more time and/or different market circumstances to reveal itself. Long term results of activism beyond the immediate outcomes of activism should be investigated in future research.

Keywords: Shareholder Activism, ESG, Governance, Cost of Capital, Firm Value, Firm Performance, Indian Companies, NSE 100, Proxy Advisory, Stakeholder Empowerment Services, SEBI BRSR, Promoter Ownership, Panel Data Regression Analysis, Weighted Average Cost of Capital, Tobin’s Q, Agency Theory, Signaling Theory

Introduction

Shareholder value maximisation was the core mandate of corporate management, but has now been challenged by the introduction of Environmental, Social and Governance (ESG) principles. The Indian context has many nuances of concentrated ownership. Recently, however, regulatory changes have given more power to minority shareholders, including the Companies Act 2013 and the Business Responsibility and Sustainability Reporting (BRSR) norms by SEBI. This dissertation examines the effect of such changes on the financial performance and market valuation of the Indian companies.

Research Gap and Hypotheses

The impact of Shareholder Activism (ShA), ESG and CoC on different companies has been explored separately in the existing literature. Most of all, there is scant literature discussing the industry specific research on these factors in the Indian market. The area that has the most distinct scope for future research in India is the 3-way linkage between ShA, ESG initiatives and CoC (as presented in the main topic). The literature in India does not provide any direct evidence on the effect of specific ShA on the CoC and the ultimate on Firm Value. This research aims to reconcile the grouped effect of these three factors on Indian companies, from 2020 to 2024 (NSE 100). It will test this integrated model empirically, which is lacking in Indian literature, focusing on single factors analysis.

Based on the synthesis of the literature, the following hypotheses are proposed for the study:

Hypothesis 1 (Activism and ESG):
H1 : Shareholder Activism on ESG issues is negatively correlated with the target firm's subsequent overall ESG score. (Drawing from Qian, 2022: low ESG firms are targets).

Hypothesis 2 (ESG and Cost of Capital):
H2 : Higher ESG scores are negatively correlated with a firm's CoC, reflecting lower risk perception by investors and lenders.

Hypothesis 3 (Integrated Impact on Firm Value):
H3 : The combined positive impact of strong ESG performance and reduced Cost of Capital, potentially triggered by successful shareholder activism, is positively correlated with an increase in Firm Value.

Conceptual Framework

The conceptual model we identify in which it is possible to expect shareholder activism, environmental, social and governance (ESG) performance and firm value to interact, is the conceptual model. Consider this framework to be a roadmap that assists us to comprehend the reasons and the process by which companies transform when they fall under the pressure of external forces. It outlines an interesting tale of corporate transformation, showing the relationship between ethical practice and money and gives us a good overview of the dynamics between different forces in the market.

The first in this direction is the Targeting Path (supports Hypothesis 1) indicating that the activist investors are not more inclined to interfere in companies at random, but rather, are more inclined to interfere in companies when it is evident that the ESG scores of the company are lower than they should be. The wake-up call for the management to make necessary improvements is these activists ($\beta = -3.3$, $p = 0.027$). The lower the score, the more targeting that happens, which are external forces of corporate change. At the point when the company starts to implement these changes, the journey shifts to the Valuation Path which proves Hypothesis 3. The disclosure of ESG becomes more transparent as companies and there is a substantial gain in the

overall value of the firm ($\beta = 0.0195$, $p = 0.001$). This is an indication that the market is keen to reward those companies not only compliant, but also willing to be transparent on their sustainability efforts. It demonstrates that investors believe they are in a safe place when they witness transparency and ethical commitment and that they also embody that transparency directly into the market valuation.

Many of the directions won't respond to the traditional financial theory norm. An Non-Significant Path denoted by the whether a high ESG scores automatically lower the Cost of Capital (WACC). The results showed that the relationship between them was not statistically significant ($p = 0.456$). This is an eye opener to us that the transparency of ESG emerges as trust and market value but in the short run, it does not mean cheaper debt or equity. Hence this framework provides a comprehensive view of the interaction between governance, financial efficiency and activism in the market and that value creation is a balancing equation.

Contributions of the Study

Theoretically, this research is a landmark in developing a theory on the link between Agency theory and Signaling theory because it illustrates that activism serves as a "trigger" which sets off signaling (ESG disclosures) valued by the market. The study is empirical and offers one of the first integrated analysis of activism and ESG from the context of 'promoter-heavy' market structure in India. In reality, the board members saw ESG as a major value-enhancing tool for corporations. For regulators, it also shows that activism is an effective way to uncover problems, but not an effective way to reduce the cost of capital, meaning there is a need for more ESG to be incorporated into the credit and debt markets. This could include creating a new debt indices focused on ESG performance.

Research Design

7.1 Data Collection & Sources : The research methodology is quantitative with the design of data collection being a longitudinal panel data. The research follows 100 companies listed on the NSE over 5 years (2020-2024) to show how corporate actions change after times of shareholder dissent.

7.2 Variables & Methodology : Linear Mixed-Effects Models (LMM) are used in the analysis. The method is better than standard regression because it takes both fixed effects (the variables that are of interest) and random effects (natural differences between individual firms).

Sample Selection : National Stock Exchange top 100 market capitalisation companies. The analysis is completed using the Jamovi application version 2.7.6 that includes the GAMj module.

Key Variables : Dissent Rate $\geq$ 15% on shareholder resolutions is considered Activism. ESG Score was determined based on a key analysis of the corporate sustainability report, annual report and governance disclosures, across 18 individual factors. The measures of Firm Value are Tobin's Q and the measure of Cost of Capital is WACC.

7.3 The 18-Factor ESG Index : A comprehensive disclosure index was developed based on transparency and disclosure of the companies' performance, The 18-Factor ESG Index was developed for an accurate measure of corporate performance.

Environmental (E) : Net Zero targets, disclosures of GHGs and transition to renewables. **Social (S)** : Assesses CSR expenditure compliance, occupational health and safety level and formal human rights policy.

Governance (G) : Tracks the diversity of the board (including gender) and the presence of dedicated ESG committees; and assesses the strength of ethics and anti-corruption policies.

This index is used as the key indicator to assess whether activist engagement actually results in increased transparency in sustainability-related reporting and improved internal management of sustainability-related risks.

Data Analysis and Findings - The statistical results gave some important findings:

The negative coefficient is a significant coefficient (β = -3.3) that suggests that activism is targeting firms with lower ESG scores. This is in support of H1, which suggests that activism can be used as a means to identify laggards. The results of this hypothesis testing showed that there is a significant positive correlation between ESG scores and Firm Value (β = 0.0195), which is in line with the hypothesis. This means that it is paying premium prices for the transparency of companies. In contrast to H2, the data indicated that there was no connection between ESG and/or activism and the Cost of Capital. This indicates that ESG performance has a stronger effect on investor appetite and on their reputation than on the technical risk premiums of debt or equity in India.

Conclusion

This study reveals a fascinating two-step story of the corporate scene in India. The Selective Monitor is the first stage. The study successfully demonstrates that shareholder activism is a novel monitoring system. We find a strong negative correlation between activism and ESG scores (p=0.019), which suggests that activists are indeed 'policing' the NSE 100 and are concentrating their efforts on companies with poor governance and disclosure records. Stage 2: Market Lag. There is a disconnect between governance improvements and rewards in the research. Activists get others to do their work by making the right calls and in the short-term, the markets (as represented by WACC) don't care. This indicates that the 'ESG Premium' in India is still in the nascent stage.

Limitations

The limitations include that in India, the gains of "symbolic" activism are often disproportionate because of concentrated ownership of the promoters of dissent, potentially dampening the impact of dissent on measurable outcomes. In addition, external macro-economic conditions (interest rates) that are not part of the firm's ESG have a major impact on the Cost of Capital.

Recommendations for Future Research

Long-term Lag Analysis : The observation period needs to be extended into the future years to determine if the Cost of Capital does change over the years as a result of the ESG improvements.

Qualitative Dissent Analysis : Dissent Analysis using a qualitative approach that investigates the nature of the activism (environmental vs. governance) that could inform the identification of the type of dissent that is most likely to affect the market value.

Macro-Financial Interaction : The rationale behind the low R2 values in risk models could be explored by looking into the exogenous interest rate cycles and their effects on the ESG-CoC nexus.