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Climate Capitalists

Based on BFI Working Paper No. 2024-116, "Climate Capitalists," by Niels Joachim Gormsen, University of Chicago; Kilian Huber, University of Chicago; and Sangmin Simon Oh, Columbia University

Firms' perceived cost of green capital has decreased since the rise of sustainable investing. Sustainable investing has surged since 2016, with green firms' perceived cost of capital on average 1 percentage point lower than brown firms.

Over the past decade, **sustainable investing** has surged, with trillions of dollars now allocated to green assets and significant support from major institutions like BlackRock and the European Central Bank. A common argument is that sustainable investing reduces the cost of capital for firms' green investments, encouraging them to pursue more sustainable practices. However, measuring firms' actual cost of capital has been challenging, and existing studies have produced mixed results.

This study addresses these challenges by analyzing firms' perceptions of their cost of capital through data from corporate conference calls, which provides insights directly tied to firms' investment decisions. The authors employ a theoretical model along with an empirical analysis mined from those conference calls. The theoretical model outlines two channels through which a decrease in the cost of green capital encourages a shift in capital allocation toward greener investments:

1. The *cross-firm* channel reallocates capital from brown to green firms, as green firms—being more efficient in utilizing green capital—lower their prices and expand, while brown firms shrink. This effect depends on the substitutability of products between green and brown firms.
2. The *within-firm* channel involves individual firms increasing their use of green capital as its cost declines, favoring climate-friendly projects that are cheaper to finance.

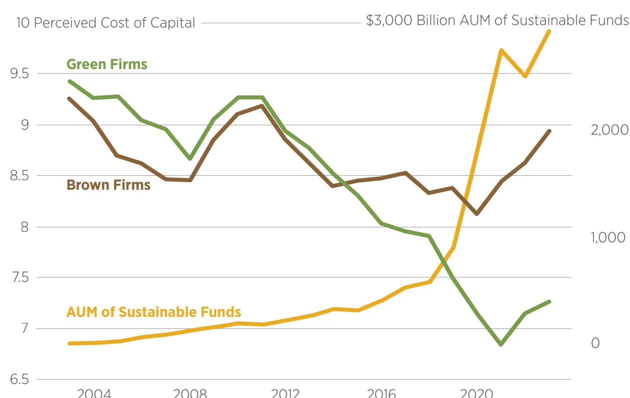
The authors' empirical analysis combines data on firms' perceived cost of capital from corporate conference calls with "greenness" scores from

Sustainable investing: Sustainable investing is an investment strategy that considers environmental, social, and governance (ESG) factors in addition to financial returns. The goal is to achieve financial returns while also creating positive environmental and societal impacts.

Morgan Stanley Capital International (MSCI), an investment research firm that provides **environmental, social, and governance (ESG)** ratings. Firms in the sample are large enough to matter for aggregate emissions.

The authors' main findings are illustrated in the accompanying figure:

Figure 1 · The Perceived Cost of Capital of Green and Brown Firms



Note: This figure plots the average perceived cost of capital for green and brown firms in different years. In each year, the authors split all firms into two groups at the median of the Morgan Stanley Capital International (MSCI) environment score and calculate the average firm-level perceived cost of capital in both groups. They then plot the three-year moving averages. They use firm-level data collected from conference calls to measure the perceived cost of capital. The assets under management (AUM) of sustainable funds from 2010 to 2023 are in billions of USD. Please see the working paper for more details.

- Since the rise of sustainable investing post-2016, the perceived cost of capital for **green firms** has significantly decreased compared to **brown firms**. This trend exists among US and European firms.
- Specifically, from 2016 to 2023, green firms' perceived cost of capital has been, on average, 1 percentage point lower than that of brown firms. Thus, some major energy and utility firms (like BP, Shell, and TotalEnergies) have begun applying lower costs of capital and discount rates to their renewable energy divisions.
- Further, firms in sectors with a larger spread between green and brown capital costs have committed to greater emission reductions, suggesting that changes in the cost of capital due to sustainable investing do have real-world impacts.

Bottom line: This novel research supports the idea that sustainable investing has influenced firms' perceived cost of capital and shifted capital allocation towards greener investments. Both cross-firm and within-firm channels can operate when sustainable investment surges and can thereby stimulate green investments.

Environmental, social, and governance (ESG): ESG is a framework that measures a company's performance in these three areas and is often used to evaluate the sustainability and ethical impact of a business or investment.

Green firms: A green firm, also known as a sustainable business, is a company that prioritizes the health of the planet while still earning a profit. Green firms aim to reduce their negative environmental impact by incorporating sustainable practices into their business decisions.

Brown firms: Less sustainable than a green firm, that is, less inclined to consider such factors as carbon emission when weighing effects on earnings.

READ THE WORKING PAPER

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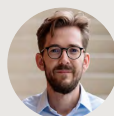

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