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Do financial markets care about SRI? Evidence from mergers and acquisitions

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ABSTRACT

Mergers and acquisitions offer a framework for shedding new light on the stock market performance of socially responsible investments (SRI). We use Innovest's Intangible Value Assessment (IVA) ratings as a measure of firms' ability to cope with social and environmental risks. The IVA ratings allow us to uncover a positive relation between acquirer gains and the level of the target's social and environmental risk management practices. Our findings suggest that the stock market rewards the acquirer for making socially and environmentally responsible investments. We also document that the environmental and social performance of the acquirer increases following the acquisition of a SRI aware target. These results are consistent with acquirer learning from the target's SRI practices and experiences.

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1. Introduction

Socially responsible investing (SRI)¹ has developed to a remarkable extent worldwide. According to the *Social Investment Forum* (2007), assets in SRI portfolios have increased by more than 324% (from \$639 billion in 1995 to \$2.71 trillion in 2007), while in the same period, total assets under professional management increased by less than 260% (\$7–25.1 trillion). The same trend appears in Europe.

The rapid development of the SRI market has attracted interest from the academic community, yet debate still rages regarding whether financial markets care about social and environmental dimensions. Empirical research results are mixed. *Derwall et al.* (2005) argue that SRI improves portfolio performance, according to the eco-efficiency scores they use to rank US companies and construct mutually exclusive portfolios. The portfolio that features stocks with the highest scores outperforms the portfolio of stocks with lower scores by 6% per annum during 1997–2003. *Bauer et al.* (2005) instead report that SRI funds in the United States and United Kingdom yield the same risk-adjusted return, on average, as traditional funds. In a more recent international study,

Renneboog et al. (2008) indicate that SRI funds in the United States, United Kingdom, and many continental European and Asia–Pacific countries underperform their domestic benchmarks by –2.2% to –6.5% per annum. This result seems consistent with the proposition that investors pay a price for their ethics. *Fisher-Vanden and Thorburn* (2008) reveal that voluntary corporate environmental initiatives yield negative stock performance, according to a sample of 58 US firms that joined Climate Leaders, a program related to climate change, and that suffered significantly negative abnormal returns around the date of their announcement. This result suggests that corporate commitments to reduce greenhouse gas emissions may conflict with shareholder value maximization goals.

In view of these contradictory results, the question of whether SRI provides value creation or destruction for shareholders remains largely open. We therefore conduct an analysis based on mergers and acquisitions (M&A) to shed a new light on this question. To the best of our knowledge, the finance literature has paid little attention to social and environmental dimensions in M&A decisions. Yet M&A markets offer interesting frameworks for complementary insights on the ability of SRI to generate financial performance.

We focus on a sample of listed acquirers and measure wealth effects according to stock market reactions (i.e., abnormal returns,² from event study methodology) to the announcement. Thus, we can analyze the impact of targets' social and environmental performance

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E-mail addresses: aktas@em-lyon.com (N. Aktas), eric.debodt@univ-lille2.fr (E. de Bodt), jgcousin@univ-lille2.fr (J.-G. Cousin).¹ According to the definition provided by the *Social Investment Forum* (2007), SRI is "an investment process that considers the social and environmental consequences of investments, both positive and negative, within the context of rigorous financial analysis".² In an efficient market, abnormal returns around an announcement date measures the wealth creation for shareholders.

on acquirer gains. Our measure of the target firm's environmental and social performance comes from the Innovest group's social and environmental performance ratings.

An important benefit of this framework is that it avoids endogeneity issues between environmental (and/or social) performance and financial performance. The direction of causation is not well established in the literature. It is unclear whether SRI improves performance of the firm or if well-performing companies are more willing to make SRI because they have the necessary financial resources to do so (see Fisher-Vanden and Thorburn, 2008). Endogeneity is an issue in the current literature because it is almost always the environmental performance and concurrent financial performance of the same firm that are related. In the M&A framework, we relate the financial performance of the acquirer to the environmental performance of the target; these are two different firms.

Our results confirm that SRI is value creating for shareholders within the context of M&A announcements. Acquirer abnormal returns are positively associated with targets' social and environmental performance. This result indicates that the better the target is in terms of environmental and social performance, the higher the gain for acquirer shareholders. The gain is economically substantial. An increase in the target rating by one unit (over a seven-unit scale), leads to an abnormal gain of 0.9% for acquirer shareholders. For an acquirer worth \$100 million in equity, this represents a dollar gain of \$0.9 million. We document also that the acquirer's environmental and social performance increases on average following the acquisition of an SRI aware target. This result provides some indication that the acquirer learns from the target's SRI practices and experiences. Overall, our results provide further evidence that SRIs are value enhancing for shareholders in general.

We organize the remainder of this article as follows: in Section 2, we lay out our two testable hypotheses. Then, we consider the sample of M&As, Innovest ratings, and empirical methods in Section 3. Section 4 is devoted to the empirical analysis. Section 5 concludes.

2. Research question

A significant corporate finance literature investigates the determinants of an acquirer's abnormal returns around M&A decision announcements and identifies the most important ones to be the payment means, the target's status, the relative size of the deal, and uncertainty about the target's valuation (for a review, see Betton et al., 2008). We propose adding a novel determinant to this list, namely, the target's ability to cope with social and environmental risks (i.e., social and environmental performance of the target).

If buying a target that satisfies SRI is a value creating decision, acquirer abnormal returns should have a positive relationship with the level of social and environmental performance of the target. One potential explanation of this positive relationship between announcement returns and the target's SRI performance is the acquirer's learning from the target's SRI practices and experiences. Learning from the target's SRI practices will add value to the acquirer shareholders only if SRI practices are value enhancing investment strategies. Several arguments support the value creation stemming from SRI activities. Some authors argue that increased social and environmental performance can enhance a firm's input–output efficiency, improve employee and customer satisfaction, generate new market opportunities, or signal management quality (see, e.g., Fombrun and Shanley, 1990). Socially and environmentally responsible activities may also enhance a firm's standing with financial market participants (such as bankers, financial intermediaries and investors) and governments. This

reputation effect may improve a firm's access to financing sources (see, e.g., McGuire et al., 1988). In this context, acquiring a socially responsible firm could be a signal, sent by the acquirer, about willingness to learn from the target on how to increase or maintain social and environmental screening and manage social and environmental risks. This leads to the following learning hypothesis. *SRI is value enhancing: positive announcement returns imply that the acquirer learns from the target's SRI practices.*

Besides the authors who suggest that SRI is value creating, there are other scholars who argue that social and environmental responsibility might be achieved only to the detriment of the firm's financial performance, therefore viewing SRI as value destroying decisions for shareholders. Walley and Whitehead (1994) argue, for example, that adopting ethical or higher social and environmental standards will translate into higher costs, which negatively affects the competitiveness and profitability of the firm. In fact, a positive relationship between acquirer announcement returns and the target's SRI performance could also be compatible with SRI being value destroying for shareholders. Consequently, if social and environmental responsibility cannot be achieved without destroying shareholder value, socially responsible companies should be more frequent targets of disciplinary takeover bids according to the theory of the market for corporate control (Manne, 1965; Jensen and Ruback, 1983).

The disciplinary view of M&A decisions leads us to formulate our alternative hypothesis. *SRI is value destroying: positive announcement returns imply that the acquirer may reverse the value destroying SRI activities of the target.*

In the remainder of the paper, our aim is to disentangle these two alternative explanations (learning versus discipline) of positive acquirer announcement returns following the acquisition of SRI aware targets.

3. Data and methods

3.1. Environmental and social performance

To measure the firm's ability to cope with social and environmental risks, we use data obtained from Innovest Strategic Value Advisors (hereafter, Innovest). The Innovest group provides several ratings of firms' environmental, social, and governance performance. We use the Intangible Value Assessment (IVA), which is a composite measure of 120 performance factors, including innovation capacity, product liability, governance, human capital, emerging markets, and environmental opportunities and risk. We also employ two specific components of the IVA score: environmental (ENV) and social (SOC) ratings. Several recent articles use these ratings as well (see, e.g., Derwall et al., 2005). However, to the best of our knowledge, ours is the first study to use Innovest ratings as potential determinants of wealth effects associated with M&A transactions.

Companies earn high IVA, ENV, and SOC scores by exhibiting low environmental or social risks and a strong strategic position that enables them to capture environmentally or socially based profit opportunities. Innovest's methodology not only reflects historical environmental and social performance but also identifies future environmental and social risks and opportunities. Another strength is that the Innovest method rates firms relative to other firms in their industry.

The Innovest database provides IVA ratings for 1108 different firms during the period 2000–2007. Because social and environmental performance ratings have low variability (Derwall et al., 2005), we extrapolate this notation three years backward, to 1997. Table 1 describes the Innovest ratings, which go from AAA (best) to CCC (worst).

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