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# The effects of social ratings on firm value

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ABSTRACT

This paper examines, in a short-term perspective, the effects of Vigeo social ratings announcements on the firm's shareholder value. From an event study on a large sample of European firms, we show that the announcement of ratings generates a strong positive stock market reaction regardless of whether the rating is good or bad. This finding underlines the relevance of ratings and reveals the value effects of corporate social responsibility (CSR). We also find that the overall rating has no impact on shareholders' wealth. We highlight that specific CSR dimensions drive the value effects. Some are value enhancing and others value destroying. Our study complements the literature on the complex links between socially responsible practices and firm value. It gives arguments to measure properly the benefits and risks associated with non-financial factors, and to integrate them into asset pricing models and allocation processes.



## 1. Introduction

The development of Socially Responsible Investment (SRI) suggests that investors increasingly care about Environmental, Social and Governance (ESG). According to Eurosif, by the end of 2009,

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SRI accounts for 10% of total assets under management[2] in Europe. Moreover, the Ernst & Young Business Risk Report, 2010[3] suggest that over the last decade new kinds of risks have emerged from CSR. Consequently CSR and social acceptance are nowdays, among the top 10 risks that firms face. At last, initiatives, such as the Principles for Responsible Investing (PRI) leading toward integration of ESG criteria into mainstream asset management perpetuate this growth.

These evolutions increase the need for non-financial information and induce a development of social rating agencies providing such information. The recent concentration of this sector confirms that the financial world is integrating these considerations. In the United States, MSCI gained a dominant position with the creation of MSCI ESG Research after merging with RiskMetrics in March 2010.[4] In Europe, the same trend operates. Vigeo became one of the European leaders in extra-financial analysis after several mergers and partnerships.

Despite this evolution, the question of whether and how CSR is priced by capital markets is still open, as concluded by Renneboog et al. (2008b). Moreover, the detailed effects of social ratings announcements on firm value are very few studied. In this paper, we examine the impacts of social ratings announcements on stock prices to better understand the relationship between social responsibility and firm value, in a shareholder perspective.[5] Even if some recent studies show that CSR is a way to reduce the cost of equity capital (El Ghoul et al., 2011), the results of papers exploring the relationship between social and stock market performances (among others Hall and Rieck, 1998; Derwall et al., 2005; Galema et al., 2008) are mixed. So, we aim to highlight the effects of non-financial factors on firm value. Our main research questions are: Do social ratings affect the firm's shareholder value, in a short term perspective? What kind of influence operates from socially responsible practices to shareholders' wealth?

To answer these questions, we focus on the European market and we use Vigeo ratings established from internationally recognized standards. These ratings are not initiated by firms; in contrast to credit ratings, they are private (sold to Vigeo's customers, mainly institutional investors). Our study assumes that Vigeo has the ability to extract, from the collected information, a relevant assessment[6] of the firm's CSR.

On the debated issue of the links between shareholders' wealth and stakeholders' satisfaction, two opposite views are available. On one side, many studies (e.g., Pagano and Volpin, 2005) view stakeholders (employees, customers, suppliers, communities, etc.) satisfaction as a cost for shareholders, and deem that interests are conflicting. On the other side, many studies (e.g., Zingales, 2000) consider stakeholder welfare as a way to increase firm value. For instance, Jiao (2010) establishes that the relationship between firm value and welfare varies across stakeholders. She finds a positive influence of employee relations and environmental issues.

Considering the scarcity of theories dealing with the relationship between social responsibility components and firm value, and the weakness of empirical results that may contradict themselves, this study comes within the broader frameworks of information asymmetry (Foster and Viswanathan, 1996; Wang, 1998) and information incompleteness (Merton, 1987). Since both theoretical arguments could explain a market reaction and considering that responsible investors need social ratings to achieve their strategies,[7] then the disclosure of these ratings can be considered as good news whatever the grade. Thus, we hypothesize that regardless of whether the rating is good or bad the announcement of social ratings induces a positive stock price reaction.

To investigate how social performance influences firm value, we refer to the theoretical literature on ethical demand of investors (Heinkel et al., 2001; Dupré et al., 2009), and to the empirical literature on

[2] A total of € 5 trillion of which € 3.8 (1.12) trillion for broad (core) SRI. "European SRI 2010": www.eurosif.org/research/eurosif-sri-study/2010.

[3] World Business Council for Sustainable Development (2010), "Translating environmental, social and governance factors into sustainable business value: Key insights for companies and investors" (www.wbcsd.org).

[4] RiskMetrics previously acquired in 2009 Innovest Strategic Value Advisors and KLD Research & Analytics.

[5] This paper uses stock prices to proxy firm value. Several studies (for instance Jiao, 2010) use alternate proxies such as Tobin's Q, book-to-market, or accounting data.

[6] Such an assertion may be questioned (among others Chatterji et al., 2009; Scalet and Kelly, 2009; Bessire and Onnée, 2010), but this is beyond the scope of this study.

[7] In Europe the "best in class" approach is predominant.