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The price of environmental, social and governance practice disclosure: An experiment with professional private equity investors

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ABSTRACT

This paper sheds light on the impact that environmental, social and governance (ESG) corporate practice disclosure has on equity financing. We present a unique framed field experiment in which professional private equity investors competed in closed auctions to acquire fictive firms. We hence observe that corporate non-financial (ESG) performance disclosure impacts firm valuation and investment decision and we quantify to which extent. Main result is an asymmetric effect, investors reacting more to bad ESG practice disclosure than to good ESG ones. Our findings are discussed in terms of practical implications for both investors and firm managers.

1. Introduction

The academic community has acknowledged that the past half-century wide gains in global economic development and human wealth creation have been achieved at the cost of environmental degradation, jeopardizing the sustainability of our economic systems (Dean and McMullen, 2007; Millenium Ecosystem Assessment, 2005). In search for green growth foundations, an expanding body of literature investigates the role that sustainable entrepreneurship can play. To understand how firms may find capital for undertaking socially responsible entrepreneurial activities, Cumming and Johan (2007) consider for instance the factors that influence institutional investors to allocate capital to socially responsible Private Equity investments. Our paper contributes to this literature by shedding light on the impact socially responsible and irresponsible corporate practice disclosure has on private equity financing. We indeed

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ask whether investors support good environmental, social and governance (ESG) practices by preferentially providing them with the equity needed to ensure their growth and/or potentially divest bad ESG ones. Throughout the paper, we use the wording "socially responsible" and "good" practices for corporate practices above legal and/or community standards, and "socially irresponsible" and "bad" for below legal and/or community standards.[1]

The impact of corporate social performance on economic performance has been largely studied in the business and economic literature (e.g. Humphrey et al., 2012; Margolis and Walsh, 2003; Orlitzky et al., 2003). In the most extensive literature meta-analysis up-to-date, Margolis et al. (2009) conclude on the existence of a small, positive and significant relationship between firm financial and social performance. However, drivers and causality of this relationship are ambiguous and not well understood (Horváthová, 2010; Surroca et al., 2010). This paper argues that the equity market reaction to corporate socially responsible orientation disclosure is likely to be profit-oriented. Therefore, understanding how corporate social performance is perceived by investors in terms of value creation is crucial. As emphasized by Humphrey et al. (2012), the question from the investor's perspective is whether environmental, social and governance analysis helps with identifying firms that are good investments.

It is now conventional wisdom in the literature to identify corporate social responsibility with good ESG practices and corporate social irresponsibility with bad ESG practices. This identification is reflected for instance by the United Nations Principles for Responsible Investing (UNPRI) which defines "responsible investment" as "an approach to investment that explicitly acknowledges the relevance to the investor of ESG factors, and the long-term health and stability of the market as a whole".[2] Hereby we take the standpoint of focusing specifically on how good (or socially responsible) and bad (or socially irresponsible) ESG practice disclosure can respectively create and destroy firm value, that is create or destroy profits for the firm shareholders. More specifically, we aim at providing a quantified measure of whether social responsibility disclosure is rewarded by investors in terms of firm value and investment attractiveness. The literature highlights that socially responsible investors may pursue two types of goals: the economic rational goal of wealth-maximization and social, i.e. ethical, responsibility (see e.g. Renneboog et al., 2008b). Here, whatever their original motivations, we explore how investors may have a strong rationale for wanting to know whether engaging their firm on a responsible path will create or destroy its market value and whether it will ease or not their access to equity.

Firm value aggregates a large quantity of information on the company's past, current and future cash flows and assets, both tangible and intangible. Many factors, often not directly available to researchers,[3] interweave in real life to build firm value, making it difficult to isolate the sole contribution of extra-financial performance in standard empirical analysis. A first research path consists in analyzing listed firms, whose values publicly result from stock market consensus. In this line, the socially responsible investment literature (see Renneboog et al., 2008a for a review) provides interesting insights using event studies (Takeda and Tomozawa, 2008) and empirical comparisons of socially responsible to conventional portfolio performance (Galema et al., 2008; Van de Velde et al., 2005). However, the backbone of our economies consists in non-listed firms, for which no public price is available. The novelty of our approach is to provide an original analysis based on experimental economics (see Plott and Smith, 2008), which allows us to quantify the contribution of ESG practice disclosure to the value of non-listed firms. The experimental setting we rely on enables us to simplify the investing environment and control the information that grounds firm value to focus on ESG information impact. Hence, this methodology guarantees the estimation of the impact of ESG practice disclosure on firm valuation. Because the objective of our study is to provide experimental results with high external validity, the robustness of our methodology is grounded in the firm valuation expertise of the participants in our experiment and in the realism of the firm cases provided to them.

Indeed, our experiment involves professional Private Equity investors (including both venture capital and buyouts specialists). Our motivation to recruit these specific investors was threefold. First, their business is to value and invest in unlisted firms, in particular small and medium size enterprises. On a theoretical level, they have been identified as highly efficient at maximizing shareholders' value by reducing information asymmetry (Jensen, 1986, 1989), monitoring the companies they select (Holmstrom and Tirole, 1997) and evaluating them better than a standard financial institution would (Ueda, 2004). Second, several authors pointed out that they already include in their valuation and investment decision non-financial criteria identified as core for business in the long run, such as the quality of management or governance (Kaplan and Strömberg, 2009; Wright et al., 2009). Third, many entrepreneurs turn to Private Equity investors to get access to capital. Analyzing whether responsible and irresponsible ESG practices matter for those key investors in terms of firm valuation and investment decision is therefore a core issue when analyzing returns to private equity (for a very comprehensive review of the literature on private equity see Cumming et al., 2007).

We present a framed field experiment with Private Equity investors and infer from their expertise explicit measures of over and underperformance in terms of corporate social responsibility practice disclosure, formalized as ESG factors. Along each *factor*, we consider that the firm can implement either responsible or irresponsible practices (*sign*, either positive or negative). Finally, we distinguish policies that are core for the business and mobilize resources (*hard*) from policies which are peripheral (*soft*), following a dichotomy suggested by Hannan and Freeman (1984). Our experimental design thus enables a focus on these

[1] We hence follow the widely acknowledged definition of the European Commission (2011): "Corporate social responsibility concerns actions by companies over and above their legal obligations toward society and the environment".

[2] See http://www.unpri.org/introducing-responsible-investment/.

[3] Examples of such factors include expected cash flows, management quality and intangible assets.