

Success in cross-border M&A deals: can ESG performance be a countervailing force against political risk?

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Received: 11 June 2024

Revised: 27 November 2024

Accepted: 10 February 2025

Abstract

This paper explores how acquiring firms from emerging markets can mitigate political-risk concerns from host countries in Cross-Border Mergers & Acquisitions (CBM&As) deals by leveraging their Environmental, Social, and Governance (ESG) practices. Utilizing data from Chinese CBM&As activities from 2010 to 2018, we find that while relative political risk concerns deter deal completion rate, higher ESG standards of acquirer firms reduce this deterrence effect. The results remain robust to considering ‘duration of deal completion’ as an alternative variable and when splitting the target sample countries into developed and emerging economies. The key conclusion is that emerging market multinational companies can effectively employ ESG as a strategic tool for internationalisation, enabling them to overcome some of the inherent ‘liabilities of origin’.

Keywords: mergers & acquisitions, deal completion, political risk, ESG

JEL Classification Codes: G34, G38, F51

1. Introduction

In recent decades, developing countries have become a significant driving force of cross-border mergers and acquisitions (CBM&A), contributing 18% to the total global deal values in 2020 (UNCTAD 2022). Throughout this internationalization process, multinational enterprises (MNEs) must tailor their optimal investment strategy to local conditions worldwide. MNEs from emerging economies face a critical task of navigating diverse market environments, each

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Citation: Xu, B. and A. Mulatu (2025) Success in cross-border M&A deals: can ESG performance be a countervailing force against political risk?, *Economics and Business Letters*, 14(3), 146-155. DOI: 10.17811/eb1.14.3.2025.146-155.

with its own concerns about the acquirer firms' home-country economic or political risks (Julio and Yook, 2016; Li et al., 2023; Rao et al., 2023). This challenge is compounded by the negative stereotypes often attached to MNEs' home countries, commonly referred to as 'liabilities of origin,' which can constrain these firms' capacity to act legitimately when expanding abroad (Li et al., 2023; Marano et al., 2017). For example, China, as the second largest acquirer, witnesses approximately 50% failure rate in its CBM&A, a phenomenon predominantly attributable to political concerns about the home country (Zhang et al., 2020).

To address host country concerns regarding heightened asymmetric information, limited legal protection, weaker corporate governance frameworks, and a less stable legislative and regulatory environment for business operations (La Porta et al., 2000), merging market MNEs are increasingly adopting Environmental, Social, and Governance (ESG) reporting. This strategic approach, considering "the objective and the ability of the (acquiring) firm in protecting rights and fulfilling contracts" (Cuervo-Cazurra and Ramamurti, 2014: 292), aims to reduce barriers arising from political uncertainty during internationalization efforts (Marano et al., 2017; Tashman et al., 2019). For firms, this is essentially a legitimization strategy, recognizing, as North pointed out, that institutions vary when conducting transactions in different countries (North 1990: 4). The strategic approach in this context aims to align with the elevated ESG benchmarks prevailing in the target countries, thereby mitigating the levels of political uncertainty.

Given these conjectures, in this paper we aim to examine the effects of political risk and ESG on the completion of cross-border M&A deals originating from China, and how ESG practices of acquirer firms can mitigate the effects of political risk or uncertainty.

While several papers have studied the role of political risk or uncertainty, and ESG or CSR in M&As deal outcomes, separately, the literature examining the joint roles of these macro political factors and firm-level strategies is rather limited. For example, Rao et al. (2023) explore the impact of geopolitical risk on M&A deal size and its mitigation through national governance quality. Li et al. (2023) focus on how home country CSR mitigates the 'outsider disadvantage' in CBM&A, noting its positive impact may be diminished by discrepancies in institutional qualities between the acquirer and target firms. Cardillo and Harasheh (2023) analyze the role of differences in ESG standards of acquirer and target firms on M&A deal timing using European data.

We contribute to the literature in several ways. Firstly, we focus on deal completion and deal duration and more importantly, the key variables of interest are not two national or firm-level variables but the joint role of a macro factor and that of a firm level. This approach allows us to explore a different story from the existing literature. That is for a macro-level disadvantage, such as political risk, to be mitigated by a firm level strategy of higher ESG performance. This is a context that complements the existing literature significantly. The reason is as firms in emerging economies strive to overcome the 'outsider disadvantage' owing to their national environment, the question arises if firms have any other leverage at their disposal to strengthen their internationalisation strategy. Secondly, inspired by Starks (2023), who emphasized the distinction between ESG motivation driven by *value* versus *values*, we analyze whether the ESG preferences of firm leadership can facilitate a smoother internationalization process. Lastly, the Chinese CBM&A experience (approximately 50% deal failure) is particularly

pertinent for examining the ‘liability of origin’ and the potential negative stereotypes associated with emerging markets. This contrasts with similar analyses such as, for example, Cardillo and Harasheh (2023) which focuses on EU.

Our findings suggest that while relative political risk, as measured by political-risk-distance between China and the host-country, deters deal completion, higher firm ESG standards reduce this deterrence effect. In other words, a strategy of high ESG performance by acquirer firms can effectively dispel home country stereotypes. The remainder of the paper is organised as follows. Section 2 describes the data and introduces our empirical strategy. Section 3 presents the empirical results, and Section 4 concludes the paper.

2. Data and methods

2.1. Data

This research includes CBM&A carried out by Chinese firms from 2010 to 2018. Concluding the sample period in 2018 enabled us to monitor the completion status of deals and avoid potential impacts from the outbreak of Covid-19 on CBM&As.¹ Both CBM&A and ESG data are collected via LSEG (Refinitiv) Workspace.² We obtain a total of 1,093 observations consisting of 707 Chinese firms. The third key variable, political risk is represented by the Index of Economic Freedom developed by the Heritage Foundation (Baldacci et al., 2011; Liou et al., 2016). The index is derived by averaging the grades for each 12 factors on a scale of 0–100.³ We also consider several control variables, commonly used in the literature (e.g., Li et al., 2023). Table 1 presents the list of variables used together with their definitions and sources.

2.2. Methodology

We employ a probit model of the following equation:

$$Y_{i,t+1} = \alpha_0 + \alpha_1 PRD_{jt} + \alpha_2 ESG_{ht} + \alpha_3 ESG_{ht} * PRD_{jt} + \beta Age_{mt} + K_{it}\gamma + X_{ht}\delta + Z_{jt}\theta + \vartheta + \tau + \varepsilon_{it}, \quad (1)$$

where i , t , j , h and m index respectively deal, time (year), host-country, acquirer firm, and target firm. The dependent variable $Y_{i,t+1}$ is a binary outcome variable (0 and 1) of deal status. All explanatory variables are lagged one year to avoid potential simultaneity problems.

¹ The prevalence of Covid and the ensuing lockdowns and disruptions in China were particularly severe – so much so that it would seem unwise to take any economic data relating to that period as business as usual (McKibbin and Fernando, 2023; Zeng, 2024).

² While we recognize that ESG has been evolving over time, we argue that the essential nature and the relative standards across countries has arguably not changed significantly. For example, Al Amosh and Khatlb (2023) found that across the globe ESG scores showed no significant changes before and after COVID-19.

³ The 12 factors are grouped into four pillars of economic freedom: Rule of Law (property rights, government integrity, judicial effectiveness); government size (government spending, tax burden, fiscal health); regulatory efficiency (business freedom, labor freedom, monetary freedom); open markets (trade freedom, investment freedom, financial freedom).

Political risk distance, PRD_{jt} , is an index calculated as the economic freedom score difference between the host-country and acquiring firm's home-country, China (e.g., Liou et al., 2016). Positive values indicate that the target market has greater economic freedom than China, while negative values indicate the opposite. Therefore, PRD_{jt} reflects China's political risk relative to that of the respective host country. ESG_{ht} refers to the acquirer firm's ESG score in year t . Age_{mt} is target firm's age. K_{it} represents a vector of deal characteristics (Value of deal and industry Matching). X_{ht} and Z_{jt} represent, respectively, vectors of other acquirer firm characteristics (Total Assets, Firm Age, and Revenue), and other target country characteristics (GDP per capita, CPI, Governance Effectiveness, Natural Resource Endowment, FDI, Patent level, Geographic distance). ϑ and τ represent, respectively, industry and year specific effects.

Table 1. Description of variables

Variables	Definition	Source
STATUS_DEAL	Dummy variable, which equals 1 if the deal is completed and 0 otherwise	LSEG Workspace
PRD	The economic freedom score difference between the host-country and China	Heritage Foundation
ESG_ACQ	ESG score of acquirer firm	LSEG Workspace
TA_ACQ	Firm size of the acquirer firm (in Millions of 2015 PPP\$)	LSEG Workspace
AGE_ACQ	Firm age of the acquirer firm	LSEG Workspace
REV_ACQ	Profitability of the acquirer firm (in Millions of 2015 PPP\$)	LSEG Workspace
AGE_TAR	Firm age of the target firm	LSEG Workspace
VALUE_DEAL	Deal value at announcement (in Millions of 2015 PPP\$)	LSEG Workspace
MATCH	dummy variable, which equals 1 if the acquirer and target are from the same industry	LSEG Workspace
GDP_TA	GDP per capita of the target country (in Billions of 2015 PPP\$)	WB WDI
CPI_TA	Corruption Perception Index of the target country	Transparency International
GOV_TA	Governance effectiveness of target country	WGI
NATURAL_TA	Natural resource endowments of target country (in Millions of 2015 PPP\$)	WB WDI
FDI_TA	FDI reserves in the target country (in Millions of 2015 PPP\$)	WB
PATENT_TA	Total patent applications of the target country	WIPO
GEO	The great circle distance between two countries	Berry et al. (2010)

3. Estimation results⁴

Table 2 shows the descriptive statistics of the variables used in this study, as defined in Table 1. We have considered the potential multicollinearity problem. The majority of the correlation coefficients are below 0.20. We have also assessed the Variance Inflation Factor (VIF) values in the regression results, which show that the average VIF is less than 5. Based on these

⁴ We use Stata 16.

statistics, it is unlikely that our empirical results suffer from serious multicollinearity problems.

Table 2. Descriptive statistics

	N	Mean	Std. Dev.	p25	Median	p75
STATUS_DEAL	1093	0.538	0.499	0	1	1
PRD	1093	34.699	10.248	30.725	36.212	41.888
ESG_ACQ	1093	0.151	0.358	0	0	0
TA_ACQ	902	6.991	2.185	5.627	6.58	7.905
AGE_ACQ	1093	2.85	0.568	2.603	2.875	3.137
REV_ACQ	899	6.178	2.259	4.796	5.852	7.406
AGE_TAR	1093	1.762	1.104	1	1	2.581
VALUE_DEAL	1093	2.594	1.881	1	1.973	3.897
MATCH	1093	0.543	0.498	0	1	1
GDP_TA	1093	28.311	1.442	26.854	28.219	29.113
CPI_TA	1093	70.868	15.54	73	76	80.461
GOV_TA	1093	4.469	0.215	4.51	4.536	4.567
NATURAL_TA	1093	1.715	0.785	1.236	1.463	2.312
FDI_TA	1092	24.924	1.422	24.218	24.969	25.922
PATENT_TA	1093	10.5	1.844	9.381	10.072	12.256
GEO	1093	8.614	0.738	7.999	8.923	9.313

Source: own elaboration

The probit estimation results are reported in Table 3. The differences across the columns have to do with how the key variables of interest are included such that the effects under investigation can be traced and the stability of the estimates assessed. In each of the specifications, the overall fitness of the model is satisfactory judging by the respective Wald statistic and *p*-value.

As can be seen readily, the estimated coefficients of the *PRD* are consistently negative and significant across all columns in Table 3. That is as expected given the hypothesis that all else equal, home country political risk is associated with a lower likelihood of deal completion. It is also consistent with common findings of a negative association between foreign investment and political risk or uncertainty (e.g., Busse and Hefeker, 2007; Julio and Yook, 2016) and with a more general conclusion on the crucial role of geopolitics on firm investment decisions (e.g., Caldara and Iacoviello, 2022).

The estimated coefficient of -0.019 for *PRD* implies a marginal effect of relative political risk of -0.008 (at the average value of all explanatory variables). The standard deviation in the sample being 10.2; this marginal effect represents a one standard deviation rise in relative political risk leads to a 7.8% decrease in the probability of deal completion. This suggests a considerable economic significance of political risk for M&A deal outcome. Moreover, the higher ESG standards (*ESG_ACQ*) enhance the likelihood of deal completion, as shown in Column (2) of Table 3. The results in Column (3) show the interaction between the variables *PRD* and *ESG_ACQ* represented by *INT*. The positive and significant estimated coefficient of *INT* indicates that, the *PRD*'s negative influence on deal completion is moderated by acquirer ESG performance.

The signs of the coefficients of most of our control variables are consistent with the exiting literature. Specifically, target firm age, value of deal (Grinstein & Hribar, 2004), GDP per capita

(Cardillo and Harasheh, 2023) and government effectiveness (Kaufmann et al., 2011) of the target country are positive and significant. The level of FDI (Mulatu, 2017) and patent intensity within the target country are found to be negative and significant (Maskus et al, 2019).

Table 3. The effects of relative political risk and ESG on M&A deal completion

	(1)	(2)	(3)
PRD	-0.019** (0.009)	-0.019** (0.009)	-0.023** (0.009)
ESG_ACQ		0.503*** (0.166)	
INT			0.013*** (.004)
TA_ACQ	-0.062 (0.062)	-0.124* (0.065)	-0.111* (0.064)
AGE_ACQ	0.100 (0.09)	0.099 (0.09)	0.100 (0.09)
REV_ACQ	0.063 (0.056)	0.071 (0.057)	0.067 (0.056)
AGE_TAR	0.120*** (0.042)	0.123*** (0.042)	0.124*** (0.042)
VALUE_DEAL	0.081*** (0.025)	0.082*** (0.025)	0.084*** (0.025)
MATCH	0.026 (0.094)	0.005 (0.094)	0.003 (0.094)
GDP_TA	0.29** (0.132)	0.273** (0.133)	0.288** (0.132)
CPI_TA	0.011 (0.009)	0.01 (0.009)	0.01 (0.009)
GOV_TA	10.199*** (0.448)	10.278*** (0.455)	10.251*** (0.451)
NATURAL_TA	0.049 (0.076)	0.04 (0.077)	0.056 (0.076)
FDI_TA	-0.094** (0.04)	-0.097** (0.039)	-0.093** (0.039)
PATENT_TA	-0.232*** (0.08)	-0.224*** (0.08)	-0.232*** (0.08)
CPFER_TA	-0.001 (0.019)	-0.003 (0.019)	-0.001 (0.019)
GEO	0.095 (0.109)	0.106 (0.11)	0.085 (0.109)
Constant	-10.334*** (3.658)	-9.868*** (3.679)	-10.085*** (3.654)
Industry FE	YES	YES	YES
Year FE	YES	YES	YES
Observations	898	898	898
Pseudo R^2	0.088	0.095	0.094
Wald statistics	101.24***	110.55***	107.86***

Notes: Standard errors are in parentheses. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$

Source: own elaboration

Our robustness analysis explored ‘duration of deal completion’ as the dependent variable in Eq. 1. The results are shown in Table 4. While *PRD* is no longer significant at conventional levels of significance, the moderator variable, *ESG_ACQ* is shown to play a significant role of reducing the duration of deal completion, hence these results as a whole don’t contradict the main results.

We conducted a further sensitivity analysis where we split the sample target countries into two groups: developed countries (DE) and emerging markets (EM). The results are presented in Table 5.

Table 4. Robustness analysis: deal duration (deal completion date minus deal announcement date) as outcome variable

	(1)	(2)	(3)
PRD	-1.307 (1.899)	-1.188 (1.928)	-.925 (1.872)
ESG_ACQ		-64.211*** (23.896)	
INT			-2.238*** (.614)
Controls	YES	YES	YES
Industry FE	YES	YES	YES
Year FE	YES	YES	YES
Observations	445	445	445

Notes: Standard errors are in parentheses. *** p<0.01, ** p<0.05, * p<0.1
Source: own elaboration

Table 5. Robustness analysis: separate target country sample, developed countries (DE) and emerging economies (EM)

	(1) DE	(2) EM	(3) DE	(4) EM	(5) DE	(6) EM
PRD	-.036* (.019)	-.039 (.024)	-.038** (.019)	-.035 (.023)	-.039** (.019)	-.042* (.023)
ESG_ACQ			.468*** (.178)	.855 (.723)		
INT					.012*** (.005)	.055 (.05)
Controls	YES	YES	YES	YES	YES	YES
Industry FE	YES	YES	YES	YES	YES	YES
Year FE	YES	YES	YES	YES	YES	YES
Observations	784	105	784	105	784	105
R-squared	.083	.333	.089	.34	.09	.34

Notes: Standard errors are in parentheses. *** p<0.01, ** p<0.05, * p<0.1
Source: own elaboration

The intuition is that to the extent there is a difference in the effects of political risk on M&A deal success across countries, it should be more pronounced in the case of developed countries

because the relative political risk is stronger. The results in Table 5 support this hypothesis. A negative and significant estimated coefficient of *PRD* is born much more for the developed countries sample than for that of the emerging markets. Comparison of the last two columns reveals that the positive moderating effect of *ESG_ACQ* is significant only for the DE sample.

4. Concluding remarks

The increased number of cross-border mergers and acquisitions (CBM&A) deals, along with a notably high failure rate of such announced deals originating from emerging markets, underscores the significance of CBM&A deal outcomes as a crucial phenomenon. In light of the global emphasis on ESG considerations, the question arises: Can an emerging market firm's ESG performance enhance its internationalization efforts?

Our study aimed to shed light on the widely documented phenomenon of the very high withdrawal rate of announced CBM&A deals originating from China. We investigated the effects of political risk on such deals and how these effects might be moderated by acquirer firms' ESG performance. The novelty of this line of enquiry is the evaluation of the joint effects of a national environment variable and a firm-level strategy.

Analyzing CBM&A data from Chinese firms from 2010 to 2018, our findings reveal that while relative political risk, as measured by political-risk-distance between China and the host country, impedes deal completion, higher ESG standards of acquirer firms mitigate this deterrent effect. This suggests that while firms may have limited control over their national environment, elevating their ESG standards can serve as an effective tool in their internationalization endeavors. This study is the first to address ESG's role in mitigating host countries' concerns about political risks of acquirer firm's home countries in CBM&A deals.

Our findings carry significant policy implications. Policymakers should recognize the deterrent effect of political risk on deal completion and explore measures to mitigate these risks. Encouraging firms to adopt higher ESG standards could effectively counteract the negative impact of home country political risks as perceived by host countries. Additionally, investment in robust risk assessment mechanisms tailored to the needs of firms from emerging markets is crucial for accurately evaluating and managing political risk factors affecting CBM&A deals. By addressing political risk and promoting ESG standards, policymakers can foster an environment conducive to successful CBM&A efforts and thus promote sustainable development. Furthermore, our research provides valuable insights for firms seeking to understand the role of ESG in creating value in the internationalization process. This is particularly relevant for MNEs in other emerging markets, who can draw lessons from the Chinese case.

Data availability statement: The data that support the findings of this study are available upon request.

Acknowledgements. We are grateful for the helpful comments and suggestions of the anonymous referees whose constructive comments and suggestions have greatly improved the

paper. The usual disclaimer applies.

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