

Sustainability transition challenges for Small and Mid-Caps

See the Eurofi Policy note “ESG Report on Small & Mid Caps - April 2020”:

https://www.eurofi.net/wp-content/uploads/2020/04/esg-report-on-small-mid-caps_zagreb_april2020.pdf

Key role of Small & Mid-Caps in the ecological transition economy

Small & Mid-Caps play a key role in the European economy and account for 80% of the listed companies in this region. However, they have been largely absent from the development of an ESG rating system (based on environmental, social and governance criteria) to assist the ecological transition. The measurement models for ESG ratings and Climate change issues that emerged in the 2000s primarily targeted Large Caps, as these feature heavily in the portfolios of institutional investors, who were the first to adopt a responsible investment approach under pressure from their customers, regulations and the weight of public opinion.

The adoption of the Paris Agreement aimed at limiting global warming to two degrees Celsius by the end of the century in 2015 has changed the face of the ESG rating system. It has become an essential tool for analysing the different risks and opportunities that each sector faces according to **the nature of its activities and products. The most documented risk analysis models** are those concerning energy models' urgent transition from fossil fuels to renewables.

A lack of relevant ESG data for many Small & Mid-Caps

ESG data emerged in the 2000s with the first regulations requiring companies – only the largest, initially – to publish information on their greenhouse gas emissions or the gender breakdown of their boards of directors. These requirements led to the creation of a new business: corporate ESG ratings. Initially, data providers and specialised rating agencies assessed companies based on a large number of criteria from the data they provided. This remained largely confined to very large companies, which then deployed resources targeting this type of reporting, for which they identified strategic marketing opportunities. Small & Mid-Caps remained largely outside this ESG data structuring effort. While they have nevertheless provided data at the instigation of their shareholders and clients, the heterogeneity and lack of relevant information linked to the ecological transition demanded by the Green Deal and the Covid 19 crisis are regrettable. This is all the more problematic given their significant economic weight in the European economy in terms of jobs and development.

New obligations linked to Europe's prioritisation of sustainable finance will have a significant impact on Small & Mid-Caps

Since 2018, Europe has actively implemented an offensive strategy aimed at making Sustainable Finance the core of its financial activity. It has already adopted binding measures that affect Small & Mid-Caps, especially as 40% of these operate in the sectors with the highest greenhouse gas emissions and are exposed to increasingly stringent regulations.

By 2021, the taxonomy of green activities will lead companies of all sizes to publish the green portion of their turnover and/or capex. They will have to communicate the portion of their products and services corresponding to the activities listed in this taxonomy. Similarly, from next year, investors who want to launch products claiming to be Sustainable Finance will have new obligations to inform their customers about these products' features. They will have to assess the financial cost of the environmental and social risks to their portfolios, and set up environmental and social performance indicators accordingly.

Mobilise Small & Mid-Caps' high capacity for innovation and adaptation to create more resilient models

In the current times of health and ecological crisis, there are increasing calls for the emergence of a more sustainable European economic model. Small & Mid-Caps are hence faced with new expectations from their shareholders, who will demand to understand how their transition to more sustainable, more local, circular models that consume less natural resources is organised, and how this provides data for the risk and opportunity analysis models used in ESG.

All companies will have to mobilise their full range of adaptation capacities, which in the case of Small & Mid-Caps are significant. Small & Mid-Caps represent an excellent solution to these challenges, as they have real strengths in terms of adaptation, innovation and responsiveness that can be brought to this critical process. Their ability to rapidly develop their products and services due to shorter processes can make them very attractive to responsible investors. This is provided, however, that they can produce data explaining these strategic directions based on appropriate and comparable indicators.

Small & Mid-Caps require strong support for their ESG initiatives

This report thus puts forward a series of recommendations likely to help the intensive deployment of a dedicated and relevant ESG approach among European Small & Mid-Caps. Solutions tailored to the current needs of this group of companies include the development of specific support systems, improved access to ESG data within a harmonised framework, and the promotion of access to financing for Small & Mid-Caps involved in ESG initiatives. This requires differentiated support that combines measures at both European and domestic level in a coordinated manner, and which makes full use of the principle of subsidiarity. It must be based on specific expertise, financial support from European bodies, and greater investor involvement, in particular regarding the demand for high-quality ESG data. This is a crucial challenge for European sovereignty in an increasingly less regulated world.

This ESG SMID initiative aims to propose an industry-wide approach to promote the adoption of ESG approaches in the Small and Mid-Cap sector.

Today we are presenting the report related to the initial phase of the initiative, that focused on:

- The analysis of the entities concerned, the investment potential for each business sector and the ESG issues associated with these sectors;
- The identification of the drivers and obstacles for the development of ESG for Small and Mid-Caps;
- The identification of possible proposal for industry-wide initiatives to promote the adoption of possible ESG approaches for Small and Mid-Caps.

In the Eurofi context, the initial phase of the initiative focused on the French financial market ecosystem. This phase has been driven by a working group with representatives from CDC Croissance, Ethifinance, Eurofi, Euronext, Novethic, and PwC, as well as Tradition.

The initiative will now be extended at the European level.

Summary of the recommendations to promote the application of the ESG approach for Small & Mid-Caps

Improve the accessibility and quality of ESG data at national and European levels

1. Coordinate long-term national investors to **standardise the ESG analysis grids** based on their ESG expertise.
2. Coordinate the National Promotional Banks and Institutions (NPBIs) and the European Investment Bank (EIB) Group at the European level to develop a **minimum European base of standardised ESG indicators** for the public sector.
3. Bring together national public opinion leaders (auditors, national central banks, accounting and financial association, etc.) and European public opinion leaders (EBA, EFRAG, ESMA, Eurostat, European Central Bank, etc.) as part of a **common normative approach for the production of ESG indicators**.
4. **Consider the specific features of SMIDs and SMEs** in view of the forthcoming revision of the Extra Financial Reporting Directive and promote the emergence of **extra-financial reporting of a similar comparability and quality to that of financial reporting**.
5. Promote **the automation of ESG data collection and the provision of data input, display and transmission tools for ESG indicators**.
6. Assess the **advantages and disadvantages of organising the collection and provision of ESG data as part of a public process** to facilitate data entry and data access.

Develop a support system for listed SMEs in implementing their ESG approach

7. Develop **awareness-raising and methodological materials** to facilitate the implementation of ESG approaches by SMIDs.
8. Identify, mobilise and strengthen **structures offering support for SMIDs**.
9. Set up a **transition support fund** to provide financial resources at the various stages of SMIDs' **implementation of an ESG approach**.

Preserve and develop intermediaries able to monitor the extra-financial performance of European SMIDs

10. Ensure the **sustainability and development of agencies specialised in the ESG assessment** of European SMIDs.
11. **Restore research capacities** for SMIDs and **promote the integration of ESG assessment in this research**.

Promote access to financing for Small & Mid-Caps undertaking an ESG approach

12. Create **an index, fund of funds or an ESG market fund** to support the development of Small & Mid-Caps by prioritising a **Best Effort approach** in addition to the Best In Class approach. Encourage a pan-European approach in conjunction with the EIB group (including the EIF) and the European Commission.
13. Promote the creation of a **dedicated ESG European stock market section** to provide benchmarking and visibility for investors.
14. **Promote "impact" financing that combines financing with support** (performance improvement, support services), for instance via tax or regulatory incentives.