



ESG

SUSTAINABILITY: A MADE-TO-MEASURE  
RATING SYSTEM FOR SMEs

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## RESEARCH TEAM

Italy



## ESG STRATEGY

### SUSTAINABILITY: A MADE-TO-MEASURE RATING SYSTEM FOR SMEs

*While awareness of environmental sustainability issues is becoming increasingly relevant in the world of finance, efforts to apply investment strategies that incorporate sustainability criteria are being hindered by inadequate disclosure practices and analyses, particularly when it comes to SMEs. Equita aims to help both investors to fill this "information gap" and companies to fully exploit the value of their ESG performances.*

#### ■ ESG: growing relevance for companies and investors

Awareness of ESG (Environmental, Social, Governance) issues is becoming increasingly relevant, including in the world of finance. As a result, **investment strategies that factor in ESG criteria are rapidly gaining ground** - not just for large caps but **also for small and mid-cap companies**.

On the back of this growing awareness, **Equita and ALTIS** (Università Cattolica's Graduate School of Business and Society in Milan) formed a partnership that led us to conduct our **research into the problems with the ESG rating process for small and medium enterprises**. Indeed, it is becoming more and more apparent that assessing a company's ability to create value, generate opportunities and reduce risk exposure must take both economic-financial factors as well as ESG performance into account.

#### ■ Key findings of Equita-Altis report: significant problems within the process and with SME ESG rating analysis models

Our research report, "Sustainability: a made-to-measure rating system for SMEs" presented at Cattolica University, **aimed to show how ESG rating methodology could be better adapted to small and medium-sized companies** and help these same companies better **exploit their strengths in terms of ESG performance**.

The report highlights a number of **problems with the ESG rating process for small and medium enterprises, e.g.: lack of proper communication** between companies and rating agencies (essential for any analysis), **companies' difficulties in fully exploiting the value of their efforts on the ESG front** (for example, failure to publish their ESG policies), and an excessively **rigid valuation approach**, which is more suited to larger companies than to SMEs.

#### ■ Equita's commitments for investors and issuers

In light of our research findings, **Equita has decided to undertake a number of initiatives:**

- We plan to send the companies covered by our Research team the same survey used in our ESG study, enabling us to **create a database on the ESG efforts of the companies we cover and include this information in our fundamental research reports;**
- We also intend to provide the survey as a **tool to be used by all companies** (particularly small and mid-caps), which, by answering our questionnaire will be able to identify the **best practices to follow when implementing their ESG strategies.**

## ESG (ENVIRONMENT, SOCIAL, GOVERNANCE): GROWING RELEVANCE FOR COMPANIES AND INVESTORS

Awareness of ESG (Environmental, Social, Governance) issues is becoming increasingly relevant, including in the world of finance. As a result, **investment strategies that factor in ESG criteria are rapidly gaining ground** - not just for large caps but **also for small and mid-cap companies**.



According to Global Sustainable Investment Alliance (GSIA) estimates, by the end of 2018 assets invested according to strategies that factor in ESG criteria stood at USD 31 trn, of which 46% (over USD 14 trn) in Europe.

Even when we apply a stricter definition of "sustainable funds", such as that proposed by Morningstar<sup>1</sup>, the **amount of assets under management held in investment products based on ESG strategies exceeded € 1,000 bn in Europe at the end of June 2019**. The main asset class at the end of 1H19 was Equity (almost € 600 bn, or nearly 60% of the total).

**Moreover, sustainable funds showed much higher growth rates than non-sustainable funds** (+7% YoY vs. +2% for all asset classes and +5% YoY vs. -1% specifically in the Equity asset class).

### TOTAL SUSTAINABLE VS. NON-SUSTAINABLE AUM IN EUROPE BY ASSET CLASS (€ bn)

Asset Class	Sustainable (EUR Bil)			Non-Sustainable (EUR Bil)		
	July 2018	June 2019	% Growth	July 2018	June 2019	% Growth
Equity	566	595	5	3,802	3,774	-1
Fixed Income	191	216	12	2,626	2,797	6
Allocation	128	141	9	1,394	1,412	1
Money Market	76	81	6	1,142	1,201	5
Other	31	31	-1	856	787	-9
<b>Total</b>	<b>993</b>	<b>1,064</b>	<b>7</b>	<b>9,819</b>	<b>9,972</b>	<b>2</b>

Source: Morningstar Direct. Data as of June 30, 2019.

The amount of AuM and inflow growth trends shown have led to more widespread use of sustainable investment strategies - **not just for funds focused on large caps but also on mid-small cap companies**.

On the back of this growing awareness, **Equita and ALTIS** (Università Cattolica's Graduate School of Business and Society in Milan) formed a partnership that led us to conduct our **research into the problems with the ESG rating process for small and medium enterprises**.

Indeed, it is becoming more and more apparent that assessing a company's ability to create value, generate opportunities and reduce risk exposure must **take both economic-financial factors as well as ESG performance into account**.

<sup>1</sup> Open-ended funds (including ETFs) which, according to their prospectus, consider ESG criteria as part of their investment strategies, indicate that they pursue objectives based on the issue of sustainability (environmental, social or governance), or which seek a measurable sustainable impact in addition to financial returns.

Our research report, "**Sustainability: a made-to-measure rating system for SMEs**" presented at Cattolica University, **aimed to show how ESG rating methodology could be better adapted to small and medium-sized companies** and help these same companies better **exploit their strengths in terms of ESG performance**.

We used the following methods to conduct our research:

1. **We interviewed company managers** in charge of Social Responsibility at medium-small cap companies already **subject to ESG ratings**;
2. **We prepared and distributed a survey on ESG issues** to a panel of medium-small cap companies;
3. **We performed a critical analysis** of the survey results;
4. **We found the practical implications** based on an analysis of survey results;
5. We drew up **proposals** to help investors analyse the ESG credentials of SMEs and help companies to better promote their ESG efforts.

## 1. INTERVIEWS WITH ESG-RATED SMEs

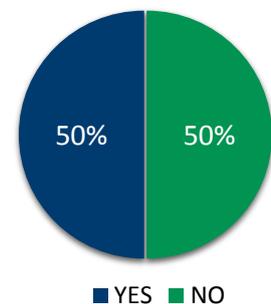
We started our research by interviewing the managers of listed mid-small cap companies (excl. FTSE-MIB) that have already been awarded ESG ratings, in order to discover:

- **How rating agencies and companies interact** during the valuation process;
- **If the ratings awarded match how each company perceives themselves**.

Our interviews shed light on some of the problems that arise during the ESG valuation process.

The ESG rating process is based on the use of **publicly available documents** and engagement between the rating agencies and the companies under examination. However, we discovered some **issues in the process** (e.g. problems with language, with finding the right contact to speak to at each company, or in understanding the questions) and found that:

### DOES YOUR COMPANY HAVE AN ESG RATING?



**50% of the companies interviewed did not even know they had an ESG rating!**

Source: Equita-Altis report

 **Communication problems between companies and rating agencies**

 **Failure to exploit company ESG performances in full**

**Companies are failing to fully exploit the value of their ESG efforts** (e.g. lack of ESG disclosure, which therefore does not count towards the scores awarded by rating agencies).

 **Excessively rigid valuation models**

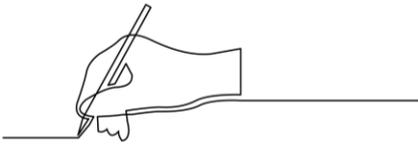
**Excessively rigid valuation approach that is more suitable to larger companies than to SMEs** (e.g. binary responses with no room to elaborate, limited focus on issues with important social impacts in the local areas of the various SMEs).

## 2. SURVEY PREPARATION AND DISTRIBUTION

Based on the problems that came to light during the interviews, we drew up a **questionnaire** which was sent to a sample of **20 listed companies with market capitalisations of under € 4 bn** in various different sectors (financials, utilities, industrials).

The survey was drawn up with the aim of:

- Putting together most of the ESG information usually collected by rating agencies and **finding the areas that appear to be under-represented**, particularly on the Social side;
- Helping companies to fully exploit their strengths, by providing a **check-list to understand the main sustainability issues**.



## 3. CRITICAL ANALYSIS OF SURVEY RESULTS: COMMUNICATION ISSUES AND SUITABILITY OF RATING MODELS

In our view, a critical analysis of the survey results highlights that:

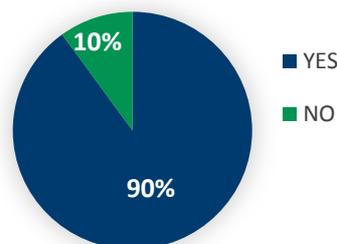
1. Respondent companies are paying close attention to **environmental issues**, partly thanks to established regulations and quantifiable metrics, as shown in the following table and charts.



ENVIRONMENTAL POLICIES (SAMPLE OF 20 RESPONDENTS)				
Entire sample (#20)	Impact Reduction	Impact Monitoring	Final Report	Improving Trends
Water usage	10	16	16	12
Energy usage	13	18	18	13
Greenhouse gas emissions	11	18	18	14
Raw material usage	7	11	11	9
Waste production	11	16	16	14

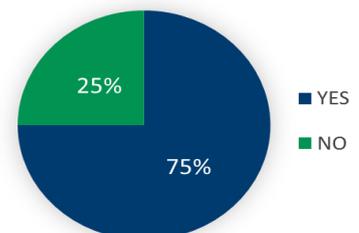
Source: Equita-Altis report

### ENERGY SYSTEMS



Source: Equita-Altis report

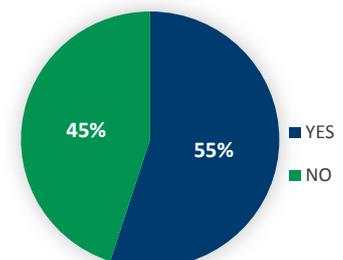
### ISO 14001 CERTIFICATION (ENVIRONMENTAL MANAGEMENT)



Source: Equita-Altis report

However, there is a **communication gap** as companies often fail to publish their policies, as shown in the chart.

### HAVE COMPANY POLICIES BEEN MADE PUBLIC?



Source: Equita-Altis report

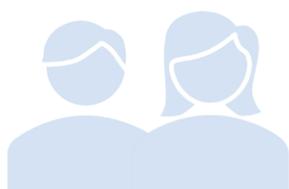


2. SMEs are involved in a **large number of social initiatives**, which often have positive effects on the local area, as shown in the table. The value of these initiatives is **not always adequately reflected** in light of the unsuitable rating models and the gaps in terms of communication and disclosure.

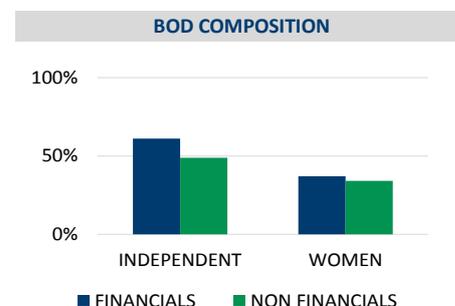
**LOCAL COMMUNITY INITIATIVES (BASED ON SAMPLE OF 20 RESPONDENTS)**

	All	Financials	Non-financials
Consult with stakeholders on strategic initiatives (new branches, delocalisation, etc.)	5	0	5
Pricing policies for disadvantaged groups (e.g. migrants, pensioners, disabled people, etc.)	3	1	2
Donations to charitable organisations	18	4	14
Sponsorship of cultural-sports-social events	18	4	14
Work-experience projects	13	1	12
Training days at schools on business or social issues	11	1	10
Long term partnership projects with local non-profit organisations	8	4	4
Company voluntary work initiatives	7	1	6
Infrastructure design and construction projects for local communities	1	0	0
None of the above	1	0	0

Source: Equita-Altis report

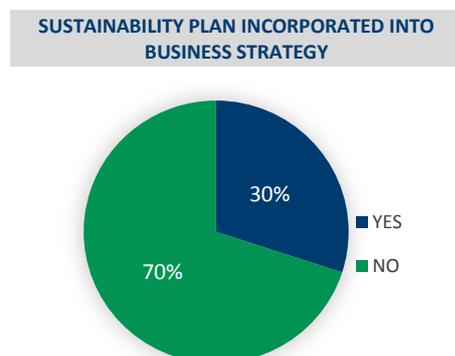


3. As for **corporate governance**, our sample of companies appears to **pay close attention to the most common issues** (e.g. Board composition, alignment of management interests, integrating ESG issues into executive pay).



Source: Equita-Altis report

Companies are **not as focused on the governance aspect of ESG criteria** (e.g. appointment of a manager in charge of all ESG issues, incorporating sustainability into business strategy).



Source: Equita-Altis report

#### 4. SUGGESTIONS FOR SMEs AND RATING AGENCIES



**Companies: let investors know what you do!**

##### ■ SMEs: Disclosure is as important as monitoring ESG issues

An analysis of our survey results shows that as many as 8 companies have an ESG rating but have **not published their social and environmental policies**.

We performed a rating simulation in which we replaced (where possible) any zero scores awarded by rating agencies (due to inadequate disclosure practices) with the average scores within the relevant sector.

**Our simulation shows an improvement in the average ESG score of 5.6%**

##### ■ Rating agencies: adjust the "S" pillar for a fair rating for SMEs

**SMEs are very active on the Social front** but struggle to highlight the value of their efforts for local communities for the purpose of ESG ratings.

We suggest awarding a **social premium** to reflect any efforts made regarding the *key issues* shown in the table, which we believe rating agencies do not take into adequate consideration. Our suggestion would be to improve the average ESG score of the panel of companies by 5.7%.



**Rating agencies: readjust the "S" parameter when analysing SMEs**

#### THE "SOCIAL PREMIUM" HYPOTHESIS

Key Issues	Premium
Local suppliers	1,5%
Integration policies in the event of M&A	1,0%
Absence of de-localised production	1,25%
Local community initiatives	1,5%
People development	1,0%
Flexible working arrangements	1,0%
Corporate welfare initiatives	1,0%
<b>Total</b>	<b>8,25%</b>

Source: Equita.Altis report

#### 5. EQUITA'S COMMITMENTS FOR INVESTORS AND ISSUERS

In light of our research findings, **Equita has decided to undertake a number of initiatives:**

- We plan to send the companies covered by our Research team the same survey used in our ESG study, enabling us to **create a database on the ESG efforts of the companies we cover and include this information in our fundamental research reports.**
- We also intend to provide the survey as a **tool to be used by all our companies** (particularly small and mid-caps), which, by answering our questionnaire will be able to identify the **best practices to follow when implementing their ESG strategies.**

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**EXPECTED TOTAL RETURN FOR THE VARIOUS CATEGORIES OF RECOMMENDATION AND RISK PROFILE**

RECOMMENDATION/RATING	Low Risk	Medium Risk	High Risk
BUY	ETR >= 10%	ETR >= 15%	ETR >= 20%
HOLD	-5% <ETR< 10%	-5% <ETR< 15%	0% <ETR< 20%
REDUCE	ETR <= -5%	ETR <= -5%	ETR <= 0%

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