Eurofi Initiative - ESG Report on Small & Mid-Cap[1]

I. Introduction of the report

This report stems from the growing awareness by the French stock market ecosystem of the considerable delay by French small- and medium-sized listed companies (hereafter, Small & Mid-Caps / SMIDs) in developing an ESG transition strategy with sufficient backing to ensure compliance with the requirements set out by public decision-makers at both national and European level. These requirements are already imposed on investors and financial intermediaries, who consequently fear that they will be unable to provide the level of financing required by these listed companies.

This unpreparedness is all the more critical as these companies make up a key portion of the national and European economy. Promoting the emergence of these ESG transition strategies, and facilitating their monitoring and transparency, thus represent an important challenge for competitiveness in both France and the European Union (EU), which has stated its ambition to be among the top Green Powers of the twenty-first century. Likewise, it plans to effectively reduce the various risks arising from negative externalities resulting in particular from European economies' poorly thought-out exploitation of natural resources. These risks are increasingly visible when it comes to climate change. They have also been seen recently in the emergence and spread of the SARS-CoV-2 virus, illustrating in real terms the potential impact on economies of these phenomena.

In this context a multidisciplinary group of Paris market players met under the umbrella of the Eurofi Think Tank in early 2019. Their aim was to analyse the French situation, formulate recommendations, and generate a Europe-wide momentum.

The working group met in particular with:

- Specialised rating agencies, brokers, lenders, market operators, investors, etc.)

- Mr de La Martinière Chair of the Task Force on Long Term Investment of Paris Europlace

- Patrick de Cambourg Rapport on non-financial information to the minister of Finance, now in charge of the the European lab project task force on preparatory work for the elaboration of possible eu non-financial reporting standards, within the EFRAG; former Chair of the French Autorité des Normes Comptables (Accounting Standards Authority)

- Mr Gauzes Efrag Chair

- SMIDS: SMC Bonduelle; ALBIOMA.

The report endeavours to assess the challenges posed to listed SMEs, for whom the ESG approach simultaneously represents a source of heavy and costly adaptation constraints, as well as opportunities for differentiation, resilience and, ultimately, development. This necessary migration must start immediately and be firmly in line with the European Green Deal strategy adopted last year by the new European Commission. It involves differentiated public support, mobilising significant technical and financial resources as part of a robust, coordinated effort between the EU and the Member States.

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

II. Executive Summary

- **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-Cap**

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-Cap 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 Covid19 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-Cap**

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-Cap, 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-Cap' 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-Cap 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 fewer 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-Cap are significant. Small & Mid-Cap 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-Cap 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-Cap. 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-Cap 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.

III. Small & Mid-Caps represent a key part of the European economy that must be fully integrated into the ESG ecosystem

The quantitative and qualitative importance of the EU SMIDs sector justifies their full and immediate integration into an ESG approach. This presents a considerable adaptation challenge to the vast majority of companies concerned, both in terms of the development model and financing.

III.1 – A major economic sphere including 2,000 active companies, with 13 million jobs in Europe and 1.8 million jobs in France, mostly in sectors exposed to specific ESG risks

There is still no consensus on the precise definition of Small & Mid-Cap. The concept is not consistent among the different European countries and stock markets. In this study, we have taken an approach based on stock market indices and a capitalisation threshold of €5 billion. This solution is not intended to produce an exhaustive record of Small & Mid-Cap, but rather to identify a scope of listed companies for which a significant volume of transactions is observed[2][3].

In France, the stock market index representing all the companies listed on Euronext Paris has 281 stocks, 40 of which are part of the CAC40 index and not considered to be Small & Mid-Cap.

Table 1: Features of Large Caps and Small & Mid-Cap indices in France

	Large Cap	*Small & Mid Cap*
Number of companies	40	241
Average market cap (in € million)	43,239.29	1,304.84
Total market cap (in € million)	1,729,571.41	314,465.75
Total average assets (in € million)	196,237.27	4,295.98
Average no. of employees	121,624.45	7,814.99
Total no. of employees	4,864,978	1,857,385

Source: PwC, Bloomberg, Reuters

Table 2: Features of Large Caps and Small & Mid-Cap indices in Europe

(Threshold of € 5 billion)	*Large Cap*	*Mid & Small Cap*
Number of companies	522	2,034
Average market cap (in € million)	27,133	906
Total market cap (in € million)	14,163,327	1,842,482
Total average assets (in € million)	100,022	2,650
Average no. of employees	52,336	5,789
Total no. of employees (K)	27,576	13,013

Source: PwC, Bloomberg, Reuters

[2] The volume of transactions is a criterion set by stock exchanges to be part of a stock market index.

[3] The exact scope of Small & Mid-Cap is potentially much wider – Euronext (including Euronext Access and Euronext Growth) lists 849 companies. Of these, 746 have a market capitalisation threshold of less than €5 billion. However, a large proportion of these companies have a very low transaction volume.

Small & Mid-Cap account for nearly 80% of companies listed on European stock exchanges. They have a significant footprint in the French and European economies in terms of employment, number and market capitalisation.

Our analyses in the remainder of the document are focussed on Europe. However, the findings remain generally valid for the situation in France.

The significance of Small & Mid-Caps differs from one European country to another and reflects the disparity of local ecosystems

Table 3: Geographical breakdown of Small & Mid-Cap

Country	Number of companies	Average market cap (in € million)	Total market cap (in € million)
Germany	95	1,818	172,675
France	221	648	143,141
Sweden	241	324	78,123
Spain	58	1,255	72,802
United Kingdom	522	1,100	574,152
The Netherlands	51	1,504	76,704
Italy	86	1,559	134,036

Source: PwC, Bloomberg, Reuters

The two countries with the highest number of Small & Mid-Cap are the United Kingdom and Sweden. These markets have favourable structural conditions, such as a large base of institutional investors, in particular pension funds, or direct access to individual investors with a strong equity culture based on numerous intermediaries with expertise in analysing these securities (brokers, analysts, rating agencies, etc.).

The SMIDS listed in this report belong to a wide variety of business sectors. Under the NACE classification system, Manufacturing is the most represented sector, with more than a quarter of companies. By its very nature, however, the industry spans many different activities.[4].

Table: *Breakdown of Small & Mid-Cap by business sector*

Sector	***%***	
	(Outside the Threshold)	***(Threshold of € 5 billion)***
Manufacturing	27.41%	28.16%
Financial and insurance	18.74%	17.85%
Information and communication	10.63%	11.05%
Wholesale and retail trade, repair and motor vehicles and motorcycles	7.03%	7.30%
Real estate	6.47%	6.51%

[4] This discrepancy between the NACE classifications, which are used in the European Taxonomy framework and for the accurate identification of sectors with specific ESG challenges, appears to be an initial difficulty in promoting ESG to stakeholders.

Professional, scientific and technical	5.18%	5.03%
Construction	3.70%	4.04%
Mining and quarrying	2.57%	2.81%
Transportation and storage	2.46%	2.56%
Administrative and support service	2.21%	2.37%
Electricity, gas, steam and air conditioning supply	1.54%	1.58%
Arts, entertainment and recreation	1.28%	1.13%
Accommodation and food service activities	1.08%	1.28%
Health and social work	0.98%	0.99%
Agriculture, forestry & fishing	0.72%	0.79%
Water supply, sewerage, waste management and remediation activities	0.51%	0.49%
Education	0.15%	0.20%
Other service	0.15%	0.15%
Missing	7.19%	5.72%

Source: PwC, Bloomberg, Reuters

A large portion of Small & Mid-Cap operates in sectors exposed to material ESG risks and opportunities

At least 40% of SMIDs operate in sectors with Europe's highest greenhouse gas emissions (Agriculture, Manufacturing, Transport, Construction, Electricity and Energy). These companies are therefore exposed to climate change risks – either risks related to the transition or physical risks.
Some of these activities also involve broader environmental issues (pollution, public health, water use, etc.), which place them at high risk over relatively short timeframes.
This is the case for the ag0-industry plastics, the mining sector and, more generally, chemicals. The next chapter will examine these risks in more detail.
The Finance and Insurance sector also accounts for a significant portion of Small & Mid-Cap. These are mainly fund management companies (particularly those listed in the United Kingdom) whose ESG issues are indirect and linked to those of the companies in which they invest.

More generally, the challenges faced by all these companies extend beyond the environment to social and governance issues. They are also exposed to indirect and complex risks linked to their supply chain, distribution system, and use of subcontractors.
There is an demand for new environmental and social rules among their stakeholders (customers, shareholders, etc.), making the ESG approach a real source of opportunity for companies that choose to embrace it.

Small and medium-sized enterprises operate as close as possible to the ground. They can take advantage of their size to demonstrate flexibility and a capacity for innovation. For example, they could develop activities identified as helping with climate change adaptation or mitigation based on the European Taxonomy framework (some have already committed to this type of approach. See the box: focus on companies involved in ESG and the possible valuation of their efforts)

The challenge for these companies is to attain financing and development resources via a dynamic European Small & Mid-Cap market, thus turning it into an asset

An in-depth look at companies involved in ESG and the possible valuation of their efforts

1/ GreenFin Label

Created by the French Ministry for the Ecological and Inclusive Transition, the Greenfin label guarantees the green quality of investment funds. It is awarded to funds that invest in companies in the green economy without ESG controversies. It is used by financial players who demand transparent and sustainable practices.

Novethic has listed 193 companies in its GreenFin-labelled funds.[5] *It has thus been able to identify more than 60 Small & Mid-Cap already selected in this type of fund, and nearly 30 from the green economy itself, as shown in the following table:*

No. Companies in a "Greenfin" fund			
Total	Study scope	Small & Mid cap	
		Index approach	Threshold approach
193	126	62	61

No. Companies in a "Greenfin" fund - Pure Player			
Total	Study scope	Small & Mid cap	
		Index approach	Threshold approach
84	45	27	26

2/ Companies identified by environmentally themed funds

In addition to the companies identified by the GreenFin label, Novethic has identified 361 companies that are most present in a sample of 100 European "environmentally themed funds" or "sustainable funds".
Within this sample, less than one-third (110 companies) fall under the scope of the study as Small & Mid-Cap. This is explained by a high proportion of non-European companies (66% of counterparties) in this type of fund – a warning sign for the weak European momentum in these growth sectors (see table below).

	No. Companies in a "green" fund		
	Total	ISIN code absent	ISIN code present
Total	361	140	221
% Euro zone	33%	6%	49%

No. Companies in a "green" fund			
Total	Study scope	Small & Mid cap	
		Index approach	Threshold approach
361	110	32	25

[5] Companies involved in GreenFin-labelled funds may be considered (i) "pure players" relative to the maturity of their ESG approach, (ii) drivers of ESG solutions or (iii) neutral in their ESG approach.

III.2 – Example of ESG risks threatening Small & Mid-Cap operating in the agro-industry, plastics, mining and chemicals sectors.

The following sections illustrate the specific risks to which Small & Mid-Cap operating in each of the selected business sectors are exposed. Certain themes are common to all these sectors, including pollution risks, risks related to the use of hazardous/toxic products, risks related to working conditions, reputational risks, etc.

Agro-Industry

The agro-industry includes various companies in the same value chain (agro-chemical production (fertilisers/pesticides), seed production, food processing, trading, distribution and catering, etc.).

The sector is exposed to three main categories of ESG risk that question the sustainability of "industrial" agricultural business models:

- ***Environmental***: global warming (nearly a quarter of greenhouse gas emissions), degradation of natural resources (70 to 85% of freshwater consumption, soils, biodiversity, 70% of the causes of deforestation), etc.
- ***Sanitary and nutritional***: presence of harmful products (pesticides, endocrine disruptors, toxic nanoparticles, antibiotics, etc.), impact on overweightness and obesity, undernutrition, etc.
- ***Social and societal***: agricultural land grabbing and impact on local populations, working conditions, child labour, concentration within the agro-industrial chain (seed production, production of fertilisers and pesticides, traders, etc.).

SMIDs operating in the European Agro-Industry

	SMIDs
Number of companies	102
Market capitalisation	€91 billion
Number of employees	766,000

Plastics

ESG risks linked to plastics are widespread throughout the economy. More than one-third (in volume) of plastics outlets serve the packaging sector, with impacts on numerous sectors including the agro-industry (PET (polyethylene terephthalate) bottles, polypropylene microwaveable dishes, fast food packaging, etc.). Other major plastics-intensive industries include construction, textiles, electronics and transport.

The ***risks of pollution and bans on single-use plastic, as well as reputational risks***, are the most visible for companies in direct contact with consumers (e.g. Coca-Cola). However, the entire production chain is affected (oil companies, petrochemical companies, plastics manufacturers, producers using plastic directly or for packaging, etc.).

It is difficult to trace all the companies affected by plastics. The table below shows only plastic-producing Small & Mid-Cap, the extent of the impacts, and risks associated with plastic that could affect all sectors in the long term:

SMIDs operating in Plastics in Europe

	SMIDs
Number of companies	24
Market capitalisation	€22 billion
Number of employees	98,000

Mining

Historically, the mining industry has faced three main categories of ESG risks:

- ***Environmental***: pollution and toxic discharges into the environment, degradation of natural resources (fresh water, soils, biodiversity, deforestation), global warming (e.g. phasing out of coal power), etc.
- ***Social and societal***: land grabbing and impact on local populations, expropriation and forced displacement that can even lead to deadly conflicts, working conditions, health and safety of employees, child labour, etc.
- ***Legal and ethical***: human rights violations, fraud, corruption, aggressive tax optimisation, etc.

These high risks have already led some investors to exclude companies with the worst practices from their portfolios. This jeopardises their financial situation and more generally the reputation of the sector's productive entities, as well as that of their shareholders.

The financial impacts are reflected in heavy fines imposed by governments, and in legal sanctions. They can even go as far as to partially interrupt operations, and adversely affect the reputation of mining companies, or even the reputations of those using the mined products. This may lead to the loss of the "license to operate" that is essential to the sustainability of these activities:

SMIDs operating in the European Mining Industry

	SMIDs
Number of companies	33
Market capitalisation	€26 billion
Number of employees	173,000

Chemicals

Chemicals is a complex value chain that can be grouped into five families:

1. Production of industrial gases (nitrogen, hydrogen, etc.)
2. Petrochemicals (production of plastic and fertilizer bases, synthetic rubber, fibres, etc.)
3. Agro-chemicals (production of fertilisers, pesticides, potash, etc.)
4. Speciality chemicals (low volume of high value-added products)
5. Miscellaneous chemical products

There are two main types of ESG risks facing the chemicals industry:

- ***Environmental***: pollution and toxic discharges into the environment, management of resources and products (water, air, soil, waste, etc.), hazardous and controversial products (e.g. pesticides), direct threats to the product portfolio, loss of competitiveness or business, reputational consequences up to and including the disappearance of the company (e.g. Union Carbide and Bhopal) etc.

- ***Social and Health***: working conditions, health and safety of employees including exposure to toxic substances, exposure of consumers to toxic/polluting products, disaster and incident management, etc.

The sector is subject to European REACH regulations aimed at finding substitutes for the most toxic chemicals. However, these are still very poorly applied. The table below shows only those SMIDs that are producers in the chemicals industry. The risk impacts can, if necessary, be extended to other sectors (agro-industry, textiles, mass distribution, etc.).

SMIDs operating in the European chemicals industry

	SMIDs
Number of companies	30
Market capitalisation	€24 billion
Number of employees	75,000

This brief outline makes it possible to introduce both the range of risks to which European Small & Mid-Cap are currently exposed, as well as opportunities such as an ESG approach, particularly in the context of a major crisis such as Covid 19.

These risks and opportunities will increase as time goes on. In the following section, we will examine the future issues that SMIDs will have to face.

IV. 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.

V. REPONSES of the Working Group to the consultation of the EU Commission on sustainable finance - 10/7/2020

Question 13:

In your opinion, which, if any, further actions would you like to see at international, EU, or Member State level to enable ***the financing of the sustainability transition****? Please identify actions aside from the areas for future work identified in the targeted questions below (remainder of Section II), as well as the existing actions implemented as part of the European Commission's 2018 Action Plan on Financing Sustainable Growth.*

REPONSE

Actions should be taken to help Small & Midcaps (SMIDs) to implement an ESG approach.

SMIDs play a key role in the EU economy and represent 80% of its listed companies. Yet, although 40% of SMIDs operate in sectors having substantial greenhouse gas emission levels and are exposed to ever growing ESG expectations from their shareholders and regulators, their ability to provide the information required by analysts and investors on their ESG strategy, risks and impact is limited, notably regarding climate change adaptation. Assisting them is therefore key to achieve EU sustainability ambitions.

A multidisciplinary group of Paris market players is gathered under the umbrella of the Eurofi Think Tank. It aims at analysing the challenges posed in France to listed SMEs, for whom the ESG approach represents significant cost, as well as differentiation, development and resilience opportunities. This analysis will be discussed with colleagues from other European countries. For more details see https://www.eurofi.net/wp-content/uploads/2020/04/esg-report-on-small-mid-caps_zagreb_april2020.pdf

Question 14:

In your opinion, ***should the EU take action to support the development of a common, publicly accessible, free-of-cost environmental data space*** *for companies' ESG information, including data reported under the NFRD and other relevant ESG data?*

REPONSE

YES

Small & Midcaps (SMIDs) play a key role in the EU economy and represent 80% of its listed companies. Yet, although 40% of SMIDs operate in sectors having substantial greenhouse gas emission levels and are exposed to ever growing ESG expectations from their shareholders and regulators, their ability to provide the information required by analysts and investors is limited, notably regarding climate change adaptation. Assisting them is therefore key to achieve EU sustainability ambitions.

The development of an EU ESG Database would support sustainability financing. This is especially needed by Small & Midcaps for which the creation of both a standardized reporting framework and a dedicated database are essential steps forwards.

This would help them to structure their ESG strategy, ESG risks and impact assessments, to ease the supply of related information to investors and analysts and thus secure access to financing. In this end standardization is essential to reduce the cost of processing data and should be considered as a pivotal component of the NFRD project and the EU taxonomy implementation.

To build this database, the private sector could act fast, but the public sector is needed to control the quality of data, provide its own data (governments, ECB, EIB, central banks etc) and maintain free access, especially to smaller players.

An ESG database is also needed to make available S and G data in addition to E ones. Here we stress the need to favour 1) methodologies taking into account the specificities of EU ethics, culture and approach to sustainability, 2) the diversity and transparency of rating and analysis providers (the benefits of which are illustrated by the Wirecard case).This database should also remain under European control and the Commission, ECB, ESMA, EIB should be part of the Management Committee governing this ESG database, in addition to representatives of the private sector and experts (TEG).