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ESG ratings often inadequate

- **Tendency to favour large companies**
- **Gaps in coverage of range of equities**
- **Low comparability of scores**

Hamburg/Frankfurt. When assessing a company's sustainability in terms of ESG (environmental, social and governance standards), many asset managers rely heavily on scores by external rating agencies. However, a study by Berenberg's ESG Office has shown that many of these ratings are inadequate and only partially reflect real-life circumstances. Particularly smaller companies tend to receive a poorer rating, often preventing investors from recognising investment opportunities. Consequently, ratings should only be used as an indicator in an ESG analysis and cannot replace the need for the investor's own analysis.

The significance of ESG standards in asset management has increased substantially in recent years. This development has created pressure on investors to integrate these standards in their investment decisions, as is now a legal requirement in many cases. Ratings prepared by specialised agencies aim to make a company's ESG approach measurable and comparable and therefore to help guide the investment decision. However, an analysis carried out by Berenberg on three of the most prominent rating providers has shown the providers and their ratings to be considerably lacking. For example, there are major gaps in the coverage of the range of equities, with small and very small companies often not even receiving a rating. Furthermore, Berenberg case studies have also shown that ratings for large companies are generally better, while companies that are still small and are growing quickly on average are given lower ESG ratings even if they are operating very sustainably.

The study shows in this regard that, for all three providers, highly rated companies grow more slowly on average in terms of sales, profit and capital expenditure than the companies that get lower ratings. According to the study, these differences in ratings also mean that investors fail to see significant risks and miss out on attractive opportunities in relation to smaller companies in particular. In addition, a low ESG rating may prevent the share price from reflecting the actual value of the company. Matthias Born, Head of Investment at Berenberg, says: "There is no standard for assessing ESG and scarcely any comparability across ratings. This is why we as investors must assess ESG risks and opportunities for ourselves as part of our investment decisions. A proactive fund manager can recognise these gaps in information and use detailed analysis to close the gaps. This is even more decisive in the case of smaller companies, because it's not possible to see ESG opportunities on the basis of the ratings." This is another reason, namely to recognise and take advantage of opportunities, why Berenberg's fund management is in close contact with the companies and also gives them advice on how to improve their ratings.

The disparity is due at least in part to the fact that smaller companies disclose less ESG data. A survey by Berenberg has shown that working together with the many providers of ESG ratings requires a high level of resources that many small companies cannot afford. As a consequence, these companies get a poorer rating or no rating at all from the agencies in many cases. Smaller firms publish much less sustainability information compared to larger enterprises. And publication alone is not necessarily a sign of good conduct. Likewise, firms that do not publish their ESG performance are not necessarily conducting business irresponsibly, as Berenberg case studies prove.

The study also demonstrates that there are still significant differences between the rating providers. In the analysis of the three most-used ESG providers, there was no strong correlation between the different ratings for one and the same company. For example, the average correlation of the three ratings ranges between 0.53 and 0.71 and is thus in sharp contrast to the high correlations of the rating agencies on the credit side. Ratings from Moody's and Standard & Poor's have a correlation of almost 0.99, which indicates very strong similarities between their methods.

Rupini Deepa Rajagopalan, Head of ESG at Berenberg, has this to say: "ESG analysis cannot be completely outsourced to rating agencies. Instead, it must be incorporated into a fund manager's work. The case studies used in the study show that smaller companies are often ahead of the curve and have integrated ESG very well, but this frequently goes unnoticed and unappreciated by the rating agencies. Understanding the complexity of a company takes expert knowledge, time and resources. This is why we have come to the conclusion that ESG analyses must be done internally and by the portfolio managers who ultimately take the final investment decision and that ratings are just one of many tools which can be used."

Contacts:

Karsten Wehmeier
Director of Corporate Communication
Telephone +49 (40) 350 60-481
karsten.wehmeier@berenberg.de

Frank Bremser
Press Officer
Phone +49 69 91 30 90-515
frank.bremser@berenberg.de

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