Small Caps and ESG Ratings

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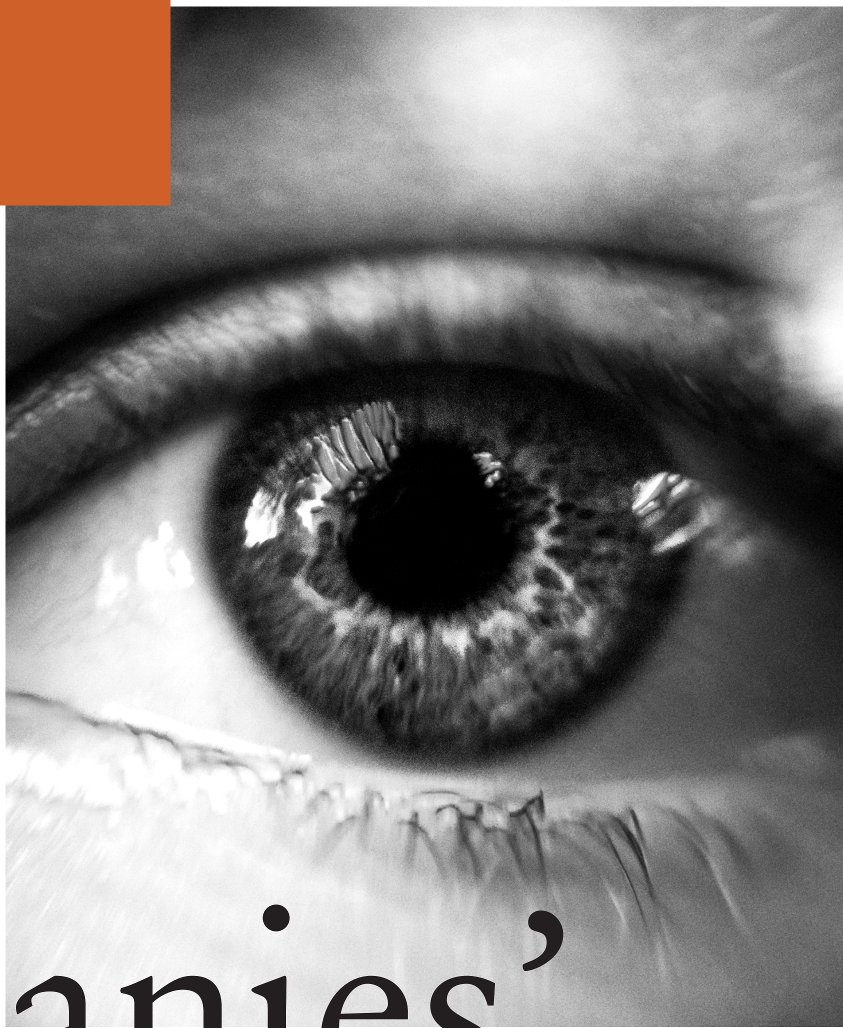

The Companies' Perspective

A Berenberg Wealth and Asset Management Study
May 2024

Berenberg

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Authors:

Katharina Raatz, Small/ Micro Cap Equity Portfolio Manager, Wealth and Asset Management
Dr. Rupini Deepa Rajagopalan, Head of ESG Office, Wealth and Asset Management
Till Schultis, ESG Investment Specialist, ESG Office, Wealth and Asset Management
Tabea Weber, ESG Investment Specialist, ESG Office, Wealth and Asset Management

Content

1 – Introduction

The subject of "ESG ratings" has been continuously debated in the investment world in recent years, in terms of methodology, usability, transparency and comparability, among other aspects. Since we published our study "ESG Ratings: The Small and Mid Cap Conundrum"[1] in 2020, much has changed and yet, at the same time, little. Niche data providers appeared while others were taken over by bigger providers, and rating coverage increased, while policy-makers became interested in the topic. Yet, dissatisfaction with providers and their ratings remains, both on the side of investors (the users) and companies (the rated). This study encountered one source of dissatisfaction at that time: a "small-cap bias" in ESG ratings, describing the phenomenon that companies with a lower market capitalisation achieve on average lower ESG ratings.

It has been four years since we published that study. Now we have revisited the subject, with updated data to understand if those results still hold and if there have been any changes since. For this, we reviewed the ESG ratings for 4,099 companies from the MSCI World Index, the STOXX Europe 600, the MSCI Europe Small Cap Index and the MSCI Europe Micro Cap Index. But more importantly, we wanted to understand what companies think about the ESG ratings they receive. For this, we gathered answers from 98 of our small- and micro-cap portfolio holdings through an online survey, covering topics such as the importance, opportunities and challenges they assign to external ESG ratings as well as how existing issues could be resolved.

We continue to be interested in the subject of "ESG ratings" because their significance cannot be denied. ESG screening and integration have increased significantly in importance for retail and institutional investors in recent years. Investment universes may be reduced significantly based on best-in-class approaches and minimum ESG ratings. Issuers with higher ratings may be preferred. ESG ratings by third-party providers have the potential to increase the accessibility, quantifiability and comparability of ESG assessments and more and more investors are utilising this data. However, a size bias to the detriment of smaller companies, or missing coverage of these companies, would steer investors with ESG-rating-based integration approaches towards larger-cap companies in a potentially unintended manner. On the flip side, a coverage gap of smaller companies and their respective omission by ESG-rating-focused investors may offer inefficiencies to exploit for active discretionary investors.

Our study is composed of two parts: the first focuses on the ESG ratings comparison in which we analyse the correlation and coverage of ratings from two providers. The second and main part of this study focuses on the perspective of our small and micro-cap companies concerning the importance, opportunities, challenges, and potential solutions with regards to ESG ratings. The final part summarises our main findings.

2 – ESG Ratings: Provider Comparison

In 2020, the ESG ratings of three of the most widely used providers formed the basis of our analysis. Over the past four years, all three providers have adjusted and further developed their methodologies:

- Provider A: in addition to an annual update to the material ESG issues per sector, this provider changed its methodology over time particularly with regards to sub-score calculation and weighting as well as industry benchmark values.
- Provider B: this provider has changed its rating to have an ESG risk focus and does not cover both risks and opportunities any more.
- Provider C: although it has not fundamentally changed its rating methodology, this provider has reduced the scope of data it requests from rated companies, and awards additional points for voluntary information.

For compatibility with our previous study, we have excluded Provider B from further analysis since its rating no longer focuses on sustainability/ESG performance but primarily on ESG-related risks. Thus, a comparison over time and to the other ratings would not add any meaningful value.

We conducted the same analysis as in 2020 based on the same representative indices[2] for two of the three providers, to revisit: (1) the extent to which their ratings correlate with each other; (2) their coverage by market cap; and (3) the divergence of ratings by market cap.

2.1 – Correlation between ESG Ratings

Correlation remains low and even decreased between providers A and C from 0.45[3] in 2020 to 0.40 in 2023.

We understand that our comparison of only two providers is limited; however, the low correlation has been confirmed in academic literature[4], which points to the prevailing concern that ESG rating frameworks significantly differ from each other in measuring the same overarching theme (i.e., ESG risks and opportunities).

Providers may differ with regards to the ESG aspects they assess, how they assess them, how they classify companies by sectors, how they weight ESG aspects' importance by sector, and how they subsequently aggregate these factors to arrive at their overall rating.

Correlation analysis of ESG ratings

	2020 Study			2023 Study		
	Provider A	Provider B	Provider C	Provider A	Provider B	Provider C
Provider A	1.0	0.53	0.45	1.0	N/A	0.40
Provider B		1.0	0.71		N/A	N/A
Provider C			1.0		N/A	1.0

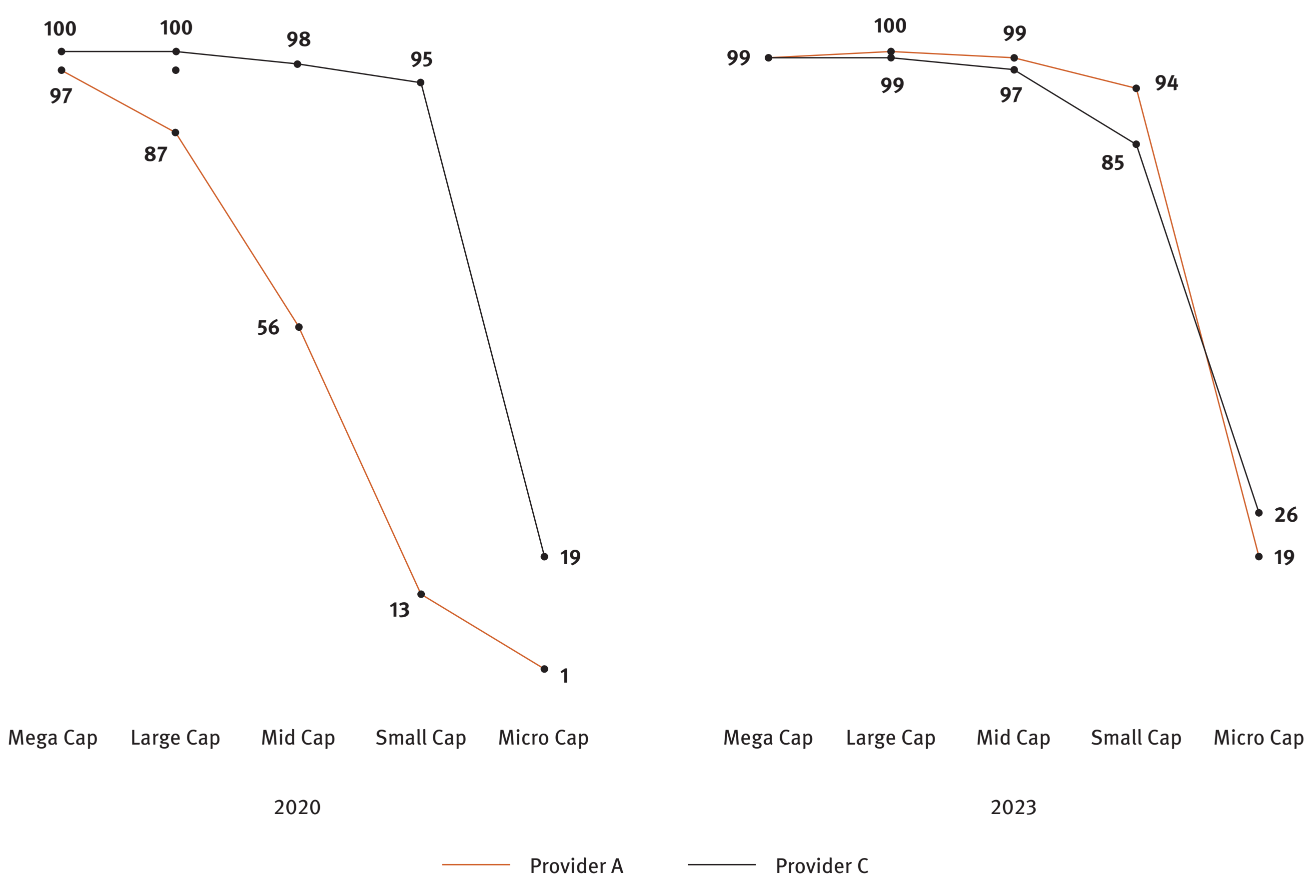
[1] Available at www.berenberg.de/en/esg-publications
[2] MSCI World, MSCI Europe Micro Cap, MSCI Europe Small Cap and STOXX 600
[3] Pearson's Rho
[4] E.g., Berg et al. (2022) find correlations ranging between 0.38 to 0.71 in their comparison of ESG ratings from six different providers. Gibson et al. (2021) study seven providers and find average pairwise correlation of 0.45.

2.2 – Coverage by Market Cap

Coverage of rating providers by market cap[5] has increased but shows a similar pattern – moving from (almost) complete coverage for large caps to a steep drop in coverage for micro caps.

Whereas Provider A already in 2020 had broad coverage (95-100%) of the small to mega caps in our study's universe, Provider C has significantly increased its relative coverage. In fact, it covered only 31% of companies in the small-cap segment in 2020 and now covers 85%. The coverage of micro caps has increased for both providers but remains at 26% and 19% coverage significantly below that for larger caps. However, it is reasonable to assume that also within the individual market-cap buckets coverage decreases with decreasing size. Furthermore, an increase in coverage does not necessarily imply an increase in quality or fit of the ratings.

ESG ratings coverage by market capitalization (in %)



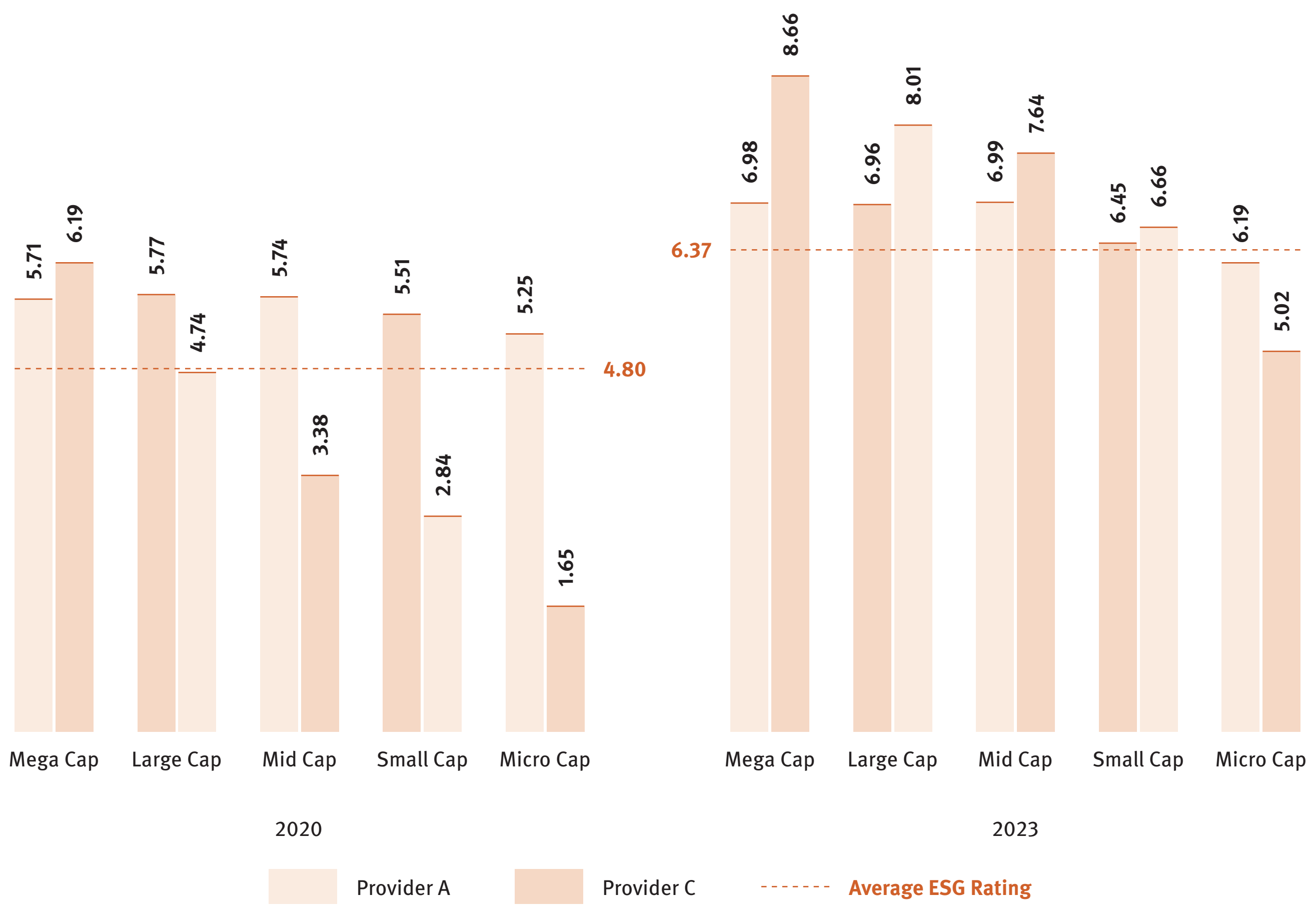
Source: Providers, Bloomberg, own calculations.

2.3 – ESG Ratings by Market Cap

There has been a strong rise in average ratings over the past three years across all market caps, but smaller caps still have on average lower ratings.

Ratings from both providers rose significantly across market caps, but smaller market caps still go along with lower ESG ratings. The rise in ratings may be attributable to increased disclosure efforts and requirements, as well as higher awareness of sustainability matters within companies. More disclosure may have positively influenced companies' sustainability transparency, which in turn resulted in more information to be analysed by providers and reflected within ESG ratings. In addition, increased transparency together with increased awareness of sustainability may have positively influenced companies' sustainability performance and, in turn, their ESG ratings. In particular, the connection between company disclosure and ratings will be further covered in the next section of this study.

ESG ratings by market cap (scales from 0-10)



Source: Providers, Bloomberg, own calculations.

[5] In this chapter we follow the size categorization by market capitalization of our 2020 study to be able to compare the results: i) mega cap › EUR 100bn; ii) large cap EUR 5 - 100bn; iii) mid cap EUR 2 - 5bn; iv) small cap EUR 0.5 - 2bn; and v) micro cap ‹ EUR 0.5bn.

3 – ESG Ratings: Companies' Perspective

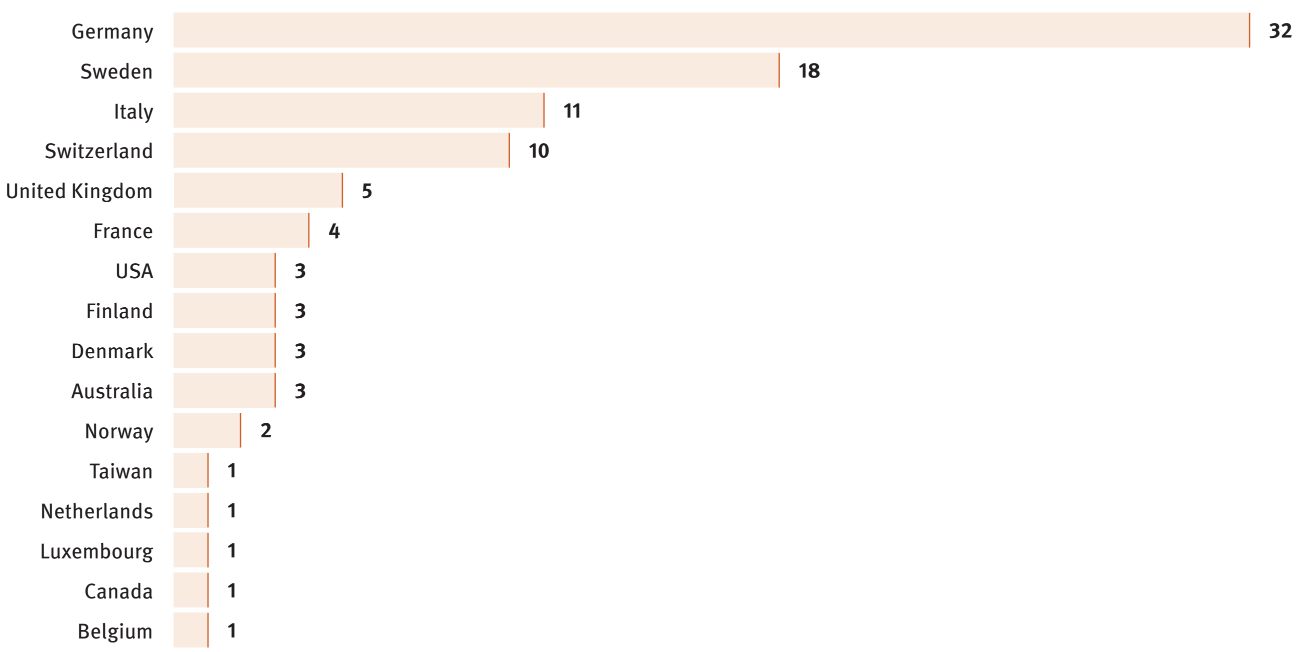
The degree to which investors incorporate external ESG ratings varies significantly: some focus only on a few or selected providers, others aggregate ratings from numerous providers into their own proprietary rating, and others do not use them at all. There seems to be no one-size-fits-all approach.

But what do the rated companies think: are ESG ratings relevant to them? Do they see themselves reflected well in ratings? What are the main opportunities and challenges? In this part of our study, we analyse the small- and micro-cap perception of ESG ratings. To do so, we sent a survey to the holdings of our four small- and micro-cap portfolios Berenberg European Small Cap, Berenberg European Micro Cap, Berenberg International Micro Cap and Berenberg Aktien Mittelstand, and received feedback from 98 companies.

3.1 – Survey Design

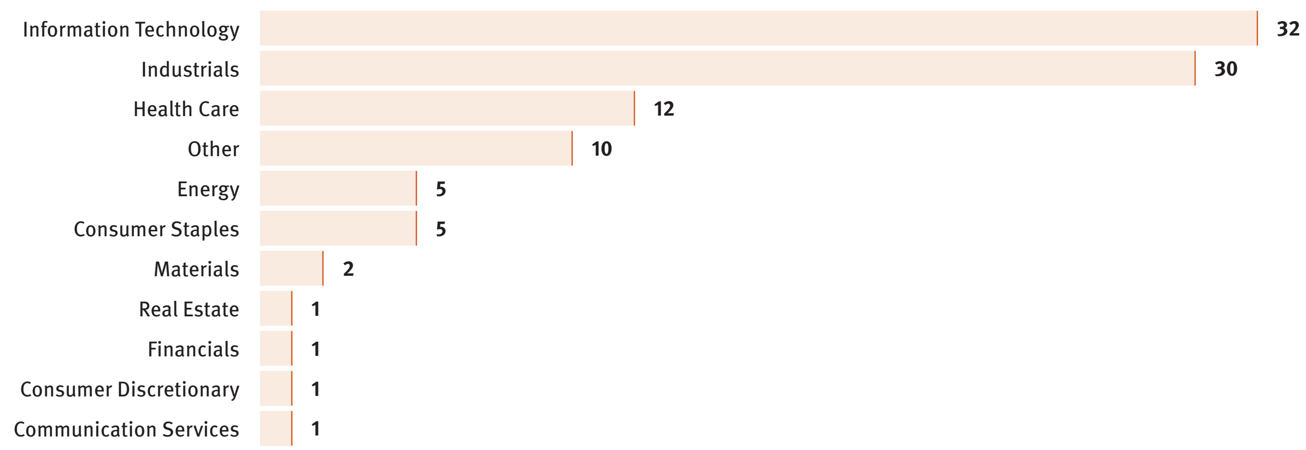
The survey was conducted online and on an anonymous basis. It contained 16 questions with single and multiple-choice answers, and some with a free text field. Our survey sample has the following characteristics:

Location of headquarters (in %) N=98



Source: Survey responses, own calculations.

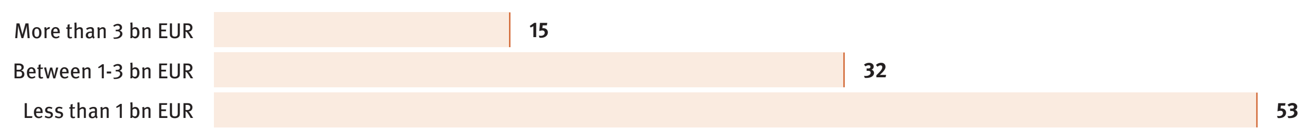
GICS sector (in %) N=98



Responses in "Other" included: mechanical engineering, mobility, software, semiconductors (2), technology, defence, production and sale of pet supplements and nutraceuticals, intralogistics solutions, automated storage solutions and material handling systems, and support services.

Source: Survey responses, own calculations.

Market capitalization (in %) N=98



Source: Survey responses, own calculations.

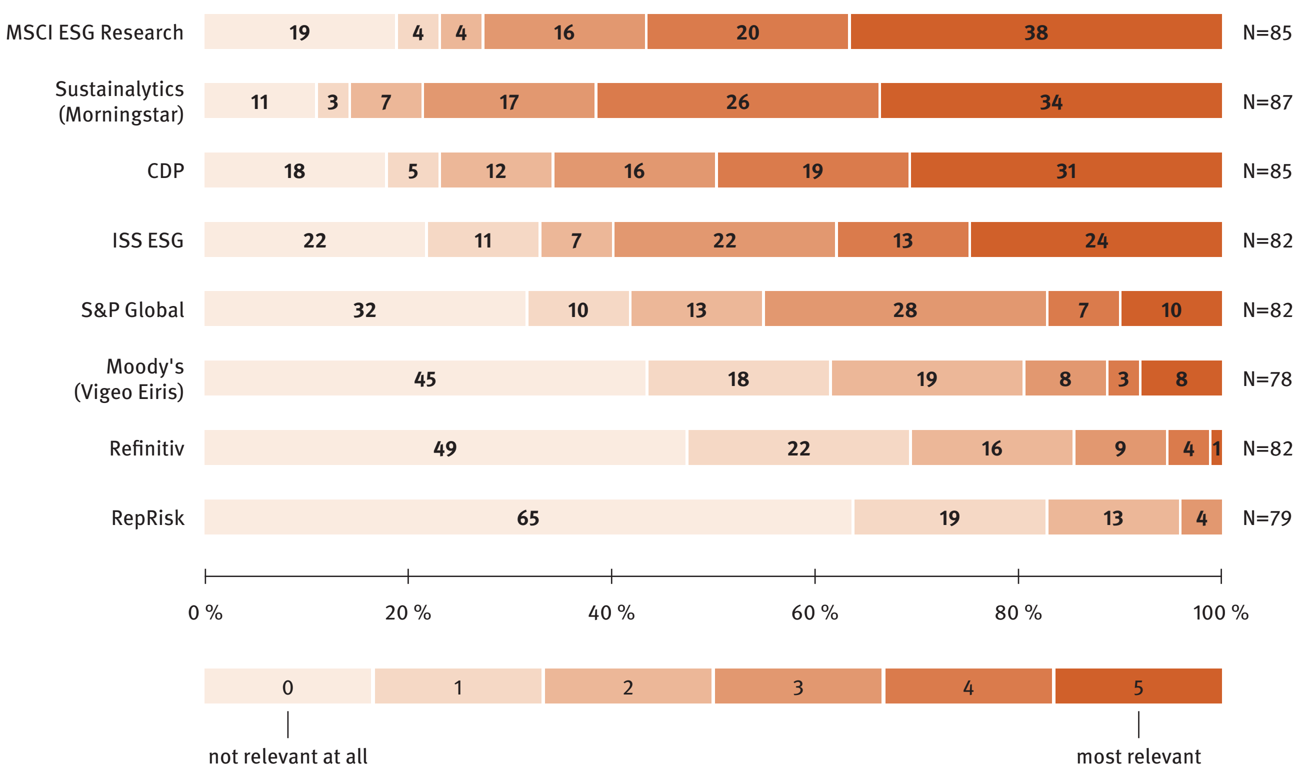
3.2 – Most Relevant ESG Rating Providers

As the landscape of ESG rating providers is broad and continuously expanding, we only included a selection of providers in our survey. We asked respondents to rank different providers from 0 (not relevant) to 5 (most relevant) and it is no surprise that **the most relevant providers for the companies are the household names of the industry:** MSCI ESG (38% selecting as most relevant) and Sustainalytics (34%), followed by CDP (31%) and ISS ESG (24%). The credit rating providers, which entered the sphere of ESG ratings through acquisitions (S&P Global via RobecoSAM, Moody's via Vigeo Eiris) in recent years, are instead of medium relevance from our respondents' perspective. RepRisk, as a specialised provider of news-based ESG controversy data, is assessed as not relevant by almost 65% of the companies in our sample, which is understandable as this provider does not contact companies with questionnaires to feed into its rating.

Besides an impression regarding the most and least relevant providers we observe that:

- Respondents mentioned further ratings that are relevant to them, particularly EcoVadis, which was mentioned by 11 respondents as well as the following providers: EthiFinance (4), Gaia Research (2), "Nasdaq ESG Reporting" (1), Inrate (1) and Glass Lewis (1). This gives a glimpse of the plethora of providers active in the market.
- The relevance of rating providers does not seem to be majorly influenced by regional preferences. MSCI ESG and Sustainalytics appear to be particularly relevant for companies with a market cap above €1bn, and the relevance of CDP appears to increase with market cap.

Which ESG/sustainability rating providers are relevant for your company? (in %)



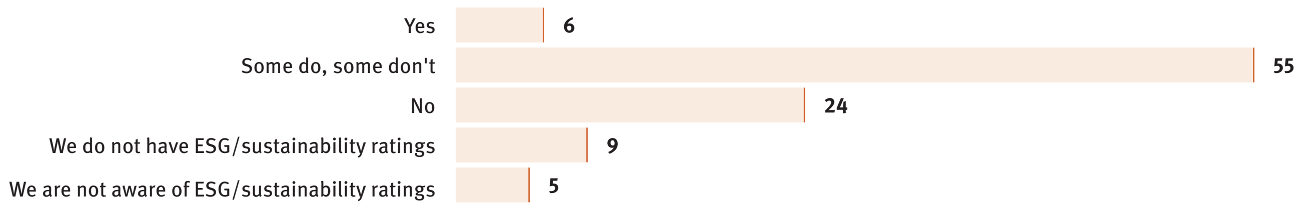
Source: Survey responses, own calculations.

There may have been some variation in how our respondents defined the "relevance" of an ESG rating provider when answering this question. Assessing one provider as more relevant than another might imply that a respondent is of the opinion that the former's rating better reflects the company's sustainability, or that they prioritise this rating when, for example, allocating resources to answering rating questionnaires, or purely that the company or its investors are more aware of that provider than another.

3.3 – Suitability of ESG Ratings

Almost 80% of our respondents **view their business as not correctly assessed by ESG ratings.** More than half indicate that only some ratings correctly reflect their actual sustainability performance. Almost a quarter believe that generally ESG ratings do not reflect the reality within their companies. And only 6% believe that generally ESG ratings correctly reflect their sustainability performance. The remainder of respondents indicate that they either do not have or are not aware of an ESG rating for their company. On top, we noticed differences between market-cap ranges: whereas no respondent from companies with a market cap below €1bn feels generally correctly assessed, 13% of respondents (six) from companies with a market cap above €1bn do so (i.e., answering "Yes").

Do you believe that ESG/sustainability ratings for your company correctly reflect your actual sustainability performance? (in %)[6] (Single Choice) N=98

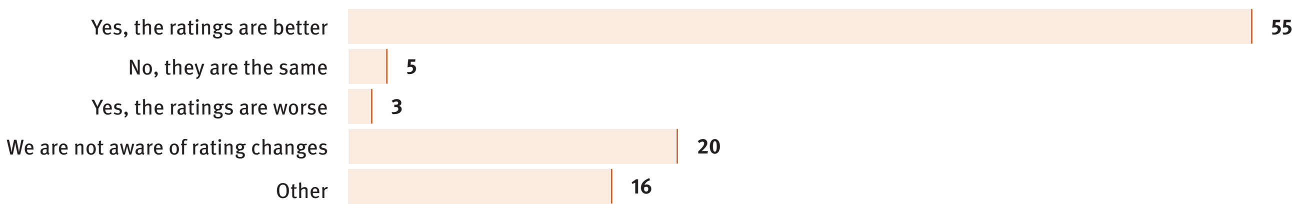


Source: Survey responses, own calculations.

Despite the general dissatisfaction as external ESG ratings are not seen as fully reflective of actual sustainability performance, **more than half of our respondents recognise an improvement in their company's ratings compared to three years ago.** This ties in with the results of the first section of our study in which we noticed a general improvement in ESG ratings across market caps.

[6] Percentage figures for single choice questions may not add up to 100% due to rounding.

Are you aware of a change of your company's ESG/sustainability ratings in comparison to three years ago? (in %) (Single Choice) N=98



Responses in "Other" included: "First ratings this year", "Not following ESG ratings three years ago", "Not listed nor rated three years ago", "Company is only one year old", "No ESG/sustainability ratings available" (3), "Not rated three years ago" (4), "Some improved, some are worse", "Some better, some unchanged", "Requirements are getting stricter and stricter, so it is hard to improve the rating even if you do take corrective measures".

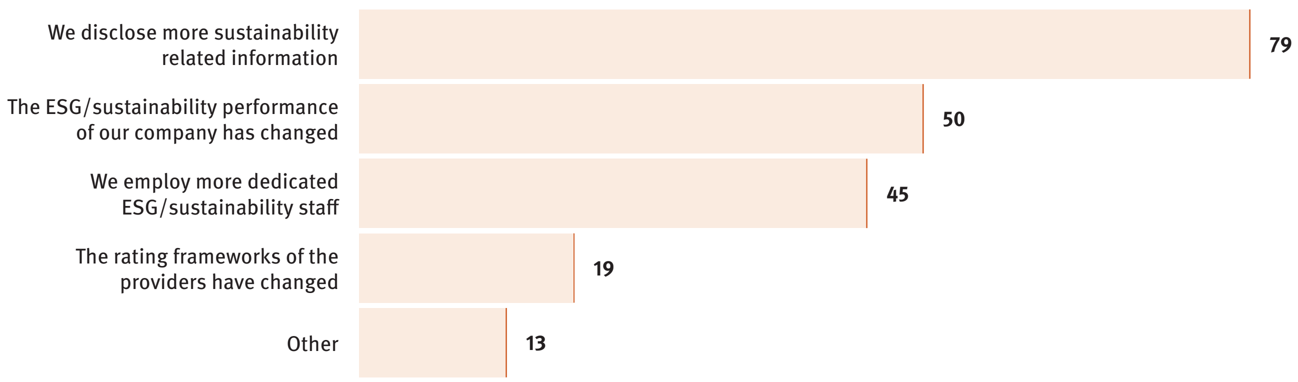
Source: Survey responses, own calculations.

On a more granular basis we observe that:

- Of companies with a market cap above €1bn, 74% of respondents noticed improved ratings. This stands in contrast to companies with a market cap below €1bn, of which only 39% saw better ratings compared to three years ago.
- A comparably large share of companies with a market cap below €1bn (61% versus 13% with a market cap above €1bn) are not aware of a change or indicated that they were not rated/not following ratings three years ago which may be due to the younger age of the companies and the lower coverage of this market-cap segment by rating providers.

Companies view the reason for changes in their ESG ratings as largely lying in their own (reporting) efforts. A large majority of our respondents (79%) ascribe the change in ratings to their increased disclosure of sustainability-related information. Further, 50% of our respondents see an actual change in their sustainability performance as reflected in their rating, and 45% attribute the change to an increase in dedicated sustainability resources within their company. On the other side, only 19% of respondents chose adjustments of providers' rating frameworks as a reason for the change.

If you have noticed a change in your ESG/sustainability ratings over the last three years, what reasons do you see for this? (in %) (Multiple answers possible) N=78



"Other" particularly includes responses by those respondents which do not yet have an ESG rating or just recently have been rated.

Source: Survey responses, own calculations.

Many of our respondents seem to believe that three years ago they were already operating more sustainably than the ESG ratings showed but that providers did not sufficiently reflect their efforts in ratings and/or that they did not disclose enough of these efforts – a conclusion that we had also drawn in our 2020 paper. The build-up of more dedicated sustainability resources may work through different channels to influence sustainability ratings: additional resources may both support an increase in sustainability-related disclosure, as well as improving sustainability performance, and also help to respond to the different provider frameworks and questionnaires.

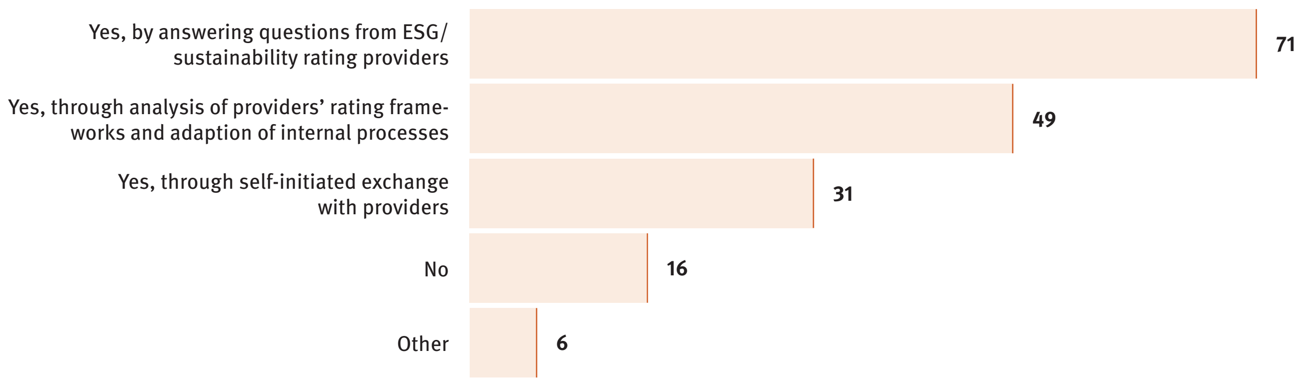
Almost no company with a market cap below €1bn (4% compared to 28% for companies with market cap above €1bn) attributed rating changes to changed frameworks, which may point, on one hand, to a persistent inflexibility in these frameworks to account for the smallest-cap companies but, on the other hand, may also be due to the limited awareness of ratings and their frameworks in this market-cap segment.

3.4 – Interaction with ESG Rating Providers

Of our respondents, 82% seek to influence their ESG ratings through one or more of the answer options we offered, whereas the remainder currently do not take action in this regard.

- 71% of our respondents seek to have a positive influence on their ESG ratings by answering questions from rating providers, often in form of questionnaires.
- Active engagement with rating providers is attempted by about a third of our respondents, through initiating exchanges to inquire about and actively influence their ratings.
- Approximately half of our respondents indicate that they analyse rating providers' underlying frameworks and adapt internal processes.

Does your company actively seek to influence its ESG/sustainability ratings? (in %)
(Multiple answers possible) N=96



"Other" includes remarks that preparations for external ratings are ongoing, that no ESG/sustainability ratings are available, or that the focus is on internal developments.

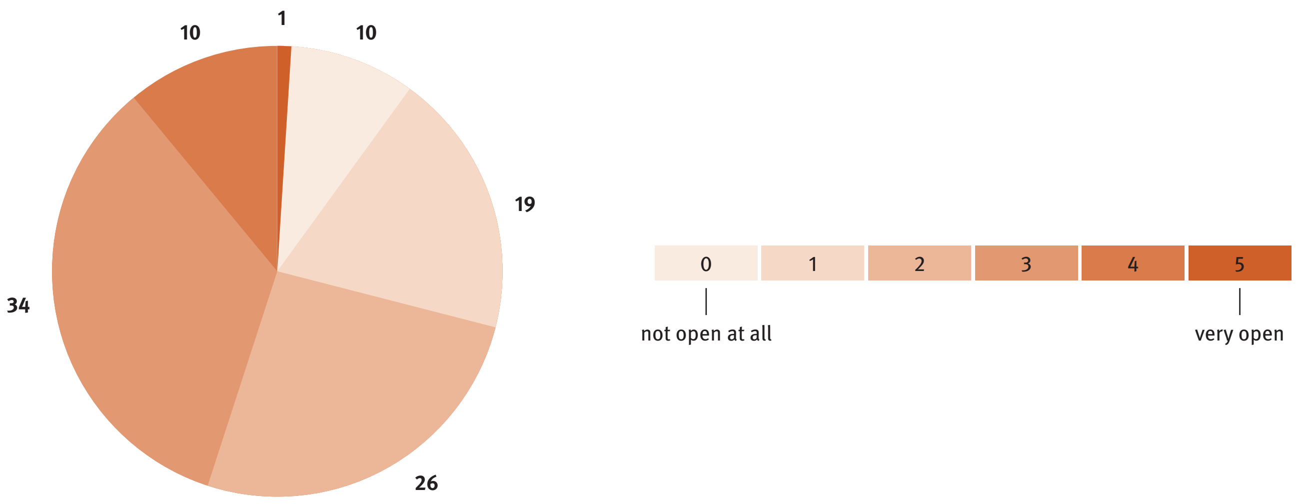
Source: Survey responses, own calculations.

Our answer option leaves it open as to whether internal operational processes are adapted based on the rating providers' frameworks or if framework analysis and process adaptation are carried out separately. Nevertheless, this highlights a potential impact of rating providers on companies' internal sustainability management choices. On one hand, ESG rating frameworks could be used as a guideline by companies, but on the other hand they also might put pressure on companies to adhere to potentially irrelevant standards set by a third party. Upcoming EU regulation of ESG ratings and their providers aims to avoid, among other things, undue influence by providers and potential conflicts of interest (e.g., through overlapping consulting services) and may address this issue.

If companies choose to attempt to actively influence their ESG ratings, how open are the rating providers to these attempts? This is how our respondents judge the openness of providers:

- The largest part of our sample **assesses providers as neither very open nor not open at all to exchanges** (60% choosing answer option 2 or 3).
- Only one respondent assesses providers as very open to exchange and incorporation of company input (choosing answer option 5), whereas 10% of respondents perceive the rating providers as not open at all (answer option 0).
- A higher proportion of respondents from companies with market cap below €1bn perceive providers as not open at all: 14% chose “not open at all” compared to 7% for respondents from companies with market cap above €1bn. This could mean that the smaller a company, the less influence it has on its external sustainability narrative presented through ESG ratings.

How do you rate the openness of rating providers to exchange and incorporate company input into final ESG/sustainability ratings? (in %) N=89



Source: Survey responses, own calculations.

Although we did not provide the option to differentiate between different providers in this assessment, it is reasonable to assume that providers may very well differ in this respect. Varying openness and quality of exchange, including the technical abilities and resources to engage in critical conversations on the provider side, are frequently raised as concerns in our engagement dialogues with portfolio companies.

3.5 – Opportunities and Challenges of ESG Ratings

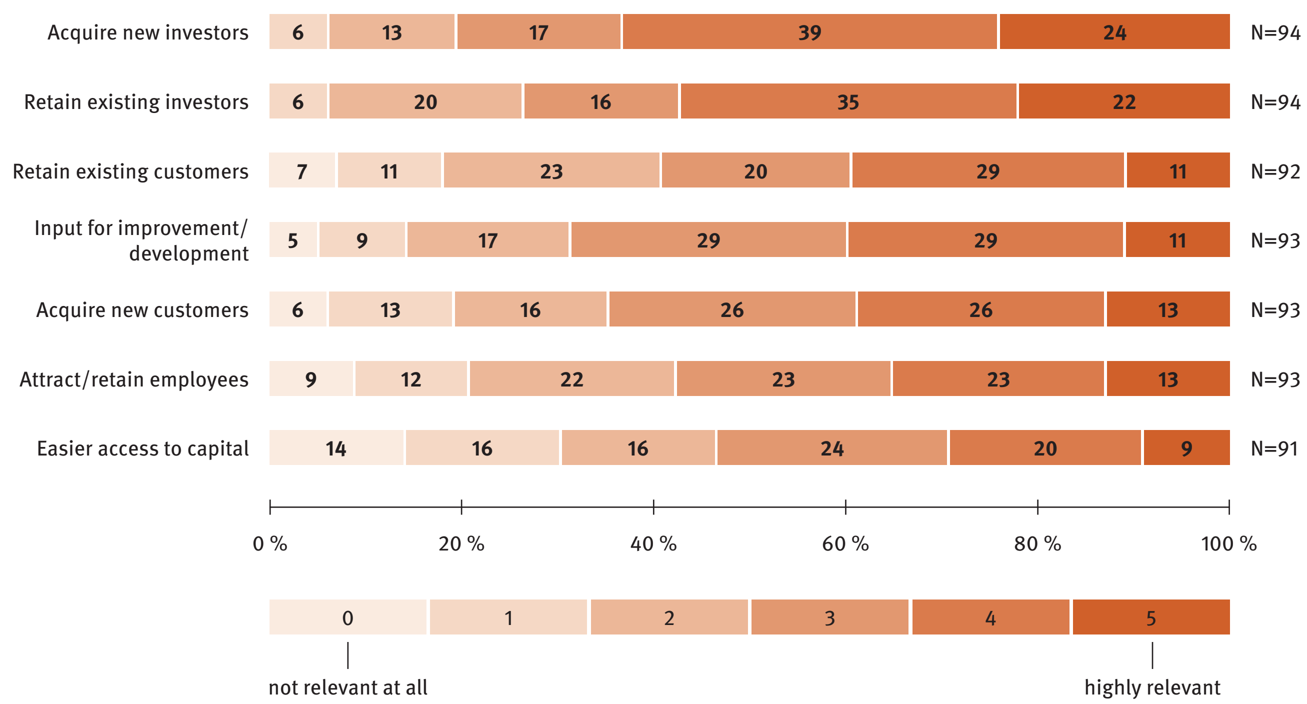
If small- and micro-cap companies often do not see their sustainability performance correctly reflected in their ESG ratings and rating providers are assessed as not very open to exchanges, why do companies consider ESG ratings relevant? We gave our respondents multiple answer options and asked them to rate each from 0 (not relevant at all) to 5 (highly relevant). **The main driving force behind ratings appears to be the investor community:**

- Acquiring new and retaining existing investors are the most relevant opportunities related to ESG ratings for our respondents. They were rated at 4 or 5 by 63% and 57% of our respondents, respectively.
- Other potential opportunities, which we provided as answer options, were less often rated as highly relevant. These include using the external input for internal process improvements and developments (40% at 4 or 5); using the external accreditation to gain new (39%) or retain existing customers (40%); and recruiting new/retaining existing employees (36%).

A respondent highlighted in the free-text field that ESG ratings can help with the *“motivation of employees as sustainability efforts get visible and more trustworthy”*, while another stressed that *“for employees, [the] general ESG strategy & performance is more relevant than the ESG ratings”*.

- Easier access to capital was least often assessed as relevant (29%); however, respondents might have subsumed this under the wider opportunity of investor acquisition and retention.

What are the opportunities of ESG/sustainability ratings for your company? (in %)

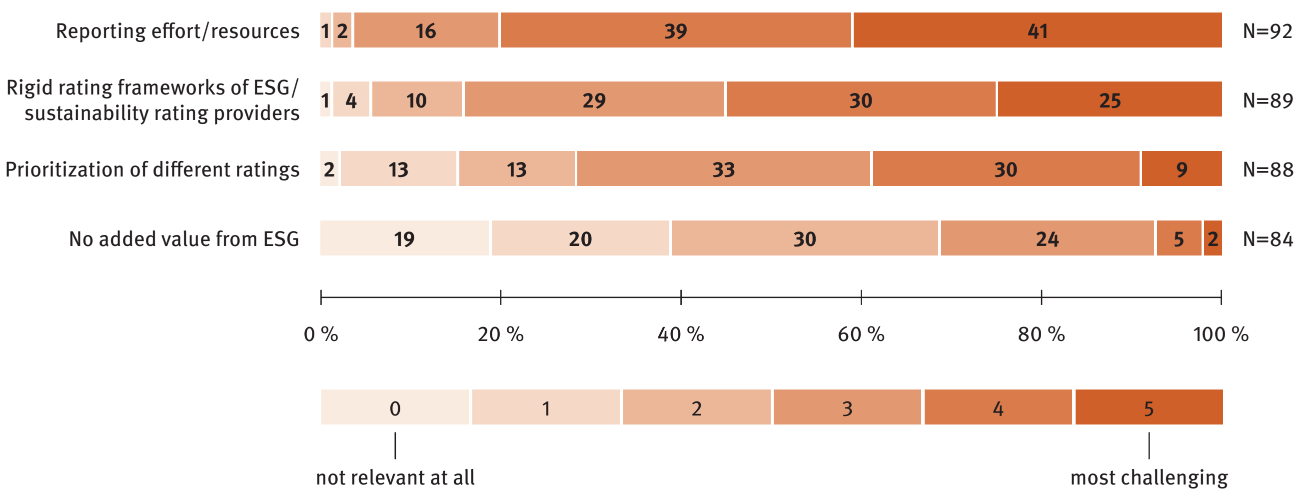


Source: Survey responses, own calculations.

Besides the opportunities, ESG ratings also come with challenges for companies. We asked respondents to rate different challenges from 0 (not relevant at all) to 5 (most challenging) and **the biggest challenge for our respondents lies in the associated reporting efforts and resources:**

- Reporting efforts and resources were rated by 41% of our respondents at 5, and by 80% at 4 or 5.
- The rigidity of rating frameworks, rated by 55% at 4 or 5, means it is a challenge for companies to correctly position themselves within these frameworks.
- The prioritisation of different ratings is less often perceived as challenging (39% at 4 or 5), but the option to prioritise may have an ambiguous impact on other challenges. On one hand, a higher number of ratings potentially increases reporting efforts; on the other hand, a variety of different frameworks from the providers may in turn allow companies to choose ratings that most appropriately account for their specific circumstances.
- The fewest respondents chose “no added value” as a challenge (7% at 4 or 5), meaning conversely that respondents put some importance on ESG ratings.

What are the challenges of ESG/sustainability ratings for your company? (in %)

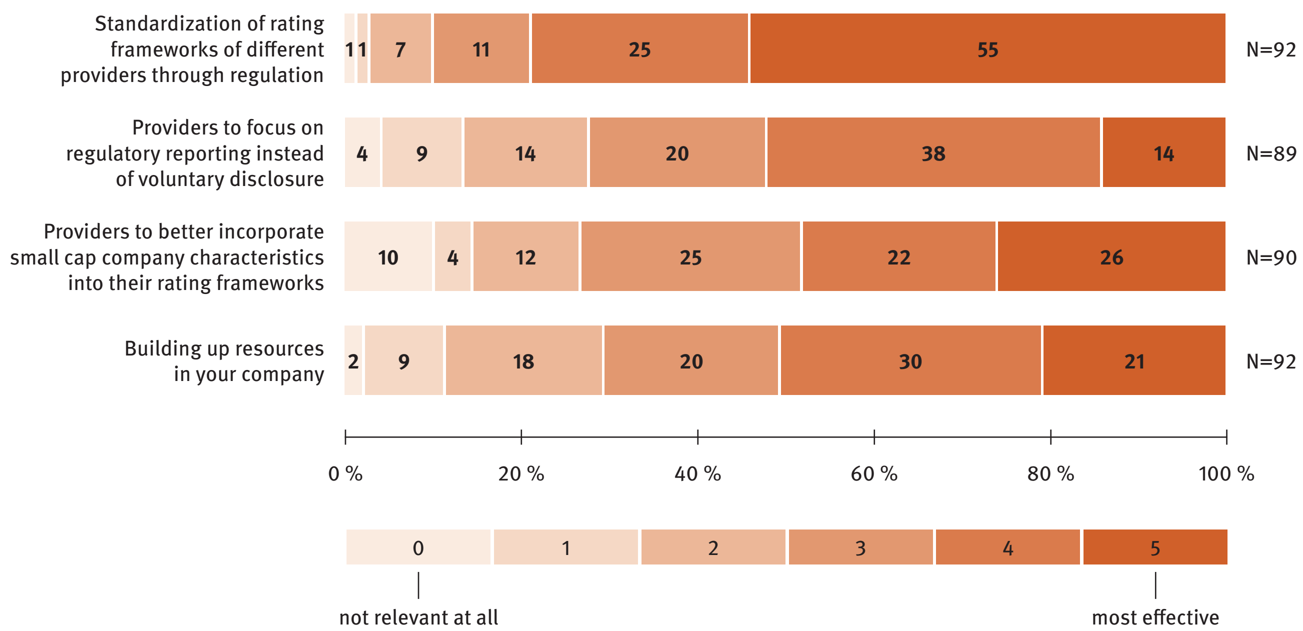


Source: Survey responses, own calculations.

How can these challenges be overcome? We provided different solutions for our respondents, to rate each from 0 (not relevant at all) to 5 (most effective). Our respondents attribute their improved ESG ratings largely to their own efforts – in terms of reporting, hiring and improving their own sustainability performance as described above. In turn, they see **rating providers and regulators as having a responsibility to reduce existing challenges:**

- The standardisation of the rating frameworks of different providers through regulation was rated by 80% of our respondents at 4 or 5 as the most effective solution. Such standardisation could lead to a decrease in reporting efforts. A respondent emphasized that ESG ratings *“need a single governance framework that is broadly consistent globally, similar to IFRS accounting standards”*.
- 52% of our respondents would find it most effective (rated 4 or 5) if providers would focus their frameworks and assessments on information that needs to be disclosed anyway as part of regulatory reporting, instead of voluntary disclosure by companies. This could potentially decrease reporting efforts.
- 48% of our respondents believe it would be most effective if providers better incorporated smaller-company characteristics into their rating frameworks, which could potentially decrease framework rigidity.
- However, besides the perceived effectiveness of external solutions, our respondents still see the need to build up internal resources, which was rated by 51% at 4 or 5 and by only 11% at 0 or 1.

What are possible solutions to reduce the challenges? (in %)



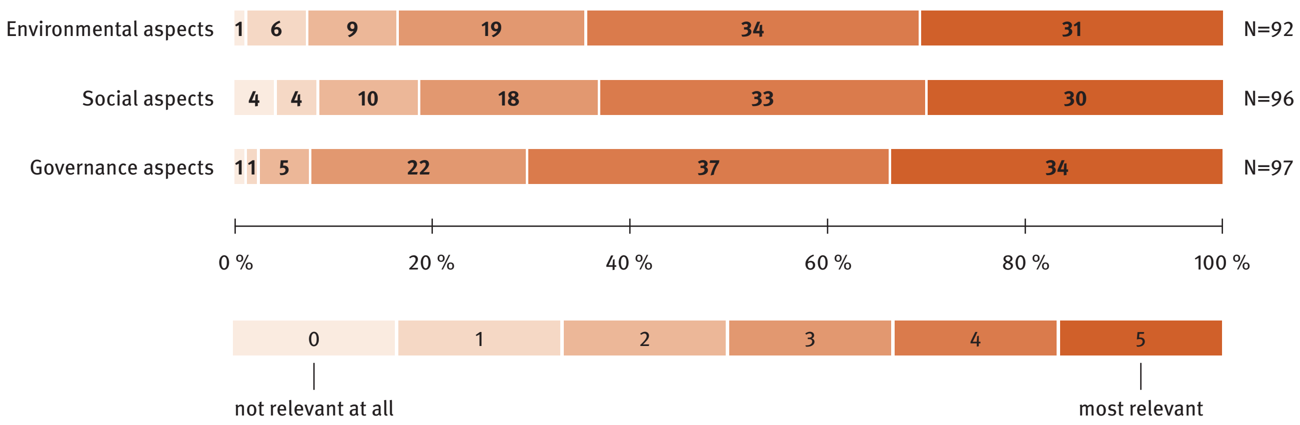
Source: Survey responses, own calculations.

3.6 – Relevance of ESG Aspects

ESG ratings assess companies on several different environmental, social and governance aspects and aggregate these assessments into an overall rating, often specifically weighted by industry. The selection and weighting of these aspects vary with each framework, reflecting the importance a provider attributes to specific topics. In this context, we wanted to understand the relative importance of the three pillars for our small- and micro-cap companies. We asked our respondents to rate the relevance to their company's operations from 0 (not relevant at all) to 5 (most relevant):

- Governance aspects have the highest relevance among our respondents. 71% rate the G pillar at 4 or 5, whereas only 2% rate it at 0 or 1.
- However, environmental and social closely follow in relevance – for each between 63-65% of respondents chose answer options 4 or 5 and only 7-8% 0 or 1.

What are the most relevant ESG aspects for your company's operation? (in %)



Source: Survey responses, own calculations.

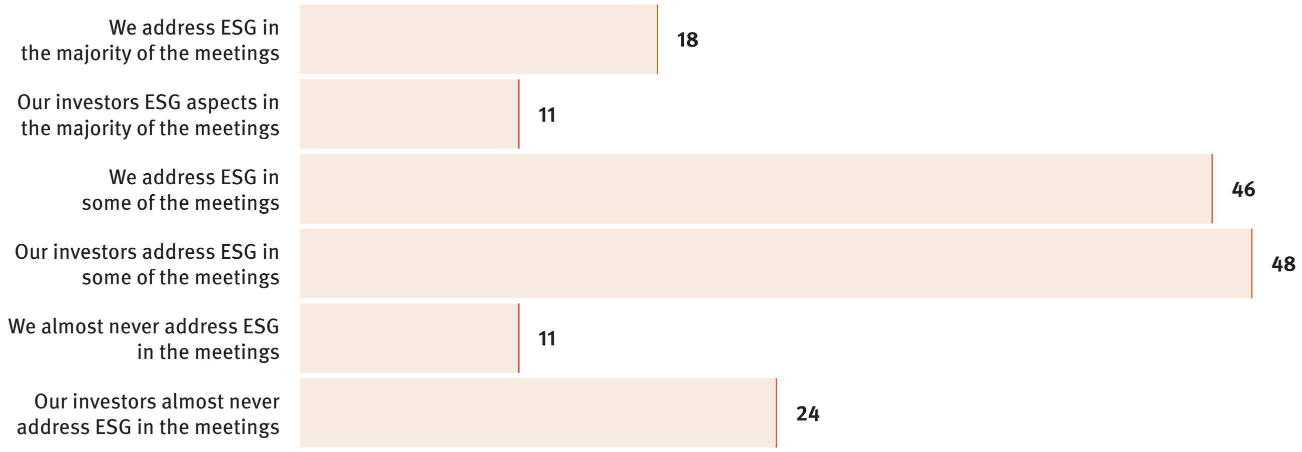
ESG aspects are incorporated in our respondents' meetings with investors:

- For 48% of our respondents ESG aspects are addressed by investors in some of their meetings and 46% themselves address ESG aspects in some of their meetings.
- For fewer respondents ESG aspects come up in most meetings – more because the companies themselves address these aspects proactively (18%) and less because investors do so (11%).
- Almost a quarter of respondents (24%) indicate that investors almost never address ESG aspects in meetings. A smaller proportion of our respondents (11%) almost never raise these aspects proactively.

How often is ESG addressed in your meetings/exchanges with investors? (in %)

(Multiple answers possible)

N=96



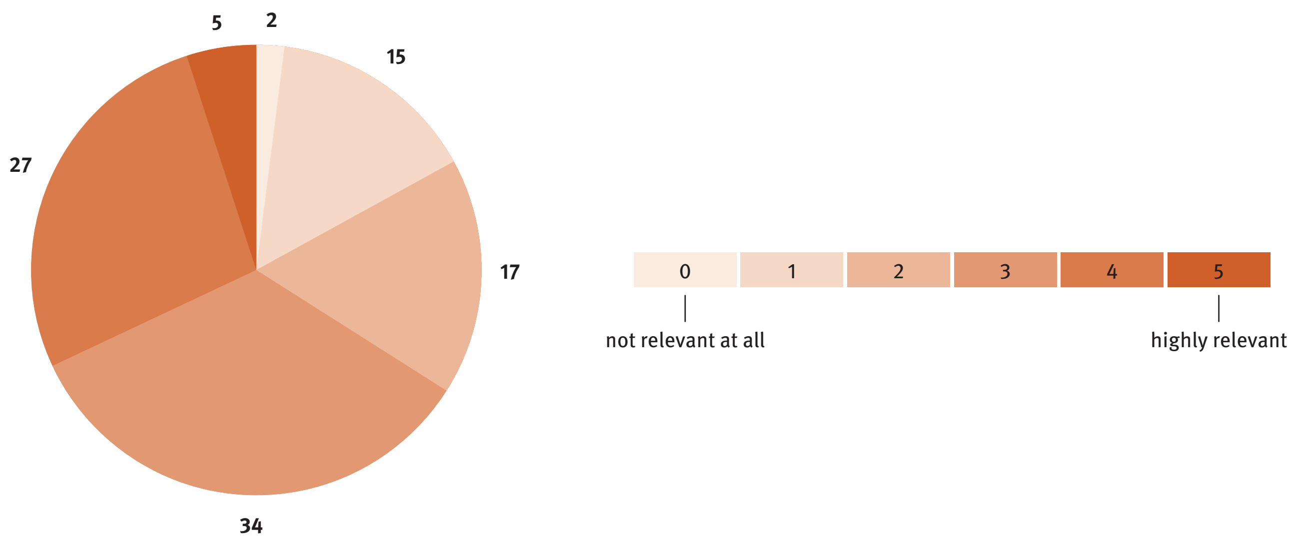
Source: Survey responses, own calculations.

But, if ESG aspects are generally relevant for companies and if they are discussed at least by some companies in some of their investor meetings, are the aspects raised in those meetings actually relevant for companies' business operations? Our respondents cannot agree on this.

- For 32% of our respondents, ESG aspects discussed in their meetings with investors are very relevant for their business operations, rated at 4 or 5. Only 17% of respondents rated the relevance at 0 or 1.
- However, 51% of our respondents assess the ESG aspects discussed with investors as neither highly relevant nor not relevant at all and chose answer options 2 or 3.

How relevant are the ESG aspects that are discussed in your meetings with investors for your business operations? (in %)

N=96



Source: Survey responses, own calculations.

The latter results may either mean that in general ESG aspects discussed are of only medium relevance or that some aspects are relevant whereas others are not. In terms of the relationship between companies and investors and the exchanges they have, this raises the question of whether, on the one hand, investors ask the right questions, and, on the other hand, companies prioritise the right topics during these meetings. Nevertheless, looking at the former results, more investors raise the most relevant ESG topics for specific companies than do not, and this is despite a perceived lack of rating quality and coverage and thus a limited degree of informational benefit from ESG ratings. It seems, though, that not only the relations between companies and rating providers but also between companies and investors can be further developed when it comes to ESG aspects.

4 – Berenberg Approach

ESG is an integral part of our investment philosophy. To identify quality and structural growth investment opportunities, it is crucial to analyse and assess environmental, social and governance topics. The importance of individual environmental and social aspects varies with the sector and the company itself. E.g., for capital-light business models like software or diagnostics companies, social aspects such as employee development, salary and staff turnover rates tend to be more important in terms of sustainability (i.e., to continue past success) than environmental aspects. Analysing corporate governance topics like incentivisation schemes for management teams sheds light on a company's culture and is thus of general importance irrespective of the sector.

External ESG ratings may facilitate easier access to information than gathering the information on our own. However, they are just an input factor for our own internal ESG analysis. In many cases, our portfolio holdings, particularly in our small- and micro-cap portfolios, do not have an ESG rating – just as they lack a research recommendation. The lack of ESG ratings or the low quality of existing ESG ratings is one explanation of small- and micro-cap inefficiency, which we exploit for our clients.

5 – Conclusion

Investors and companies seem ambivalent about ESG ratings. On the one hand, ratings and rating providers are exposed to criticism regarding, among other factors, the transparency of their methodologies, the accuracy of their ratings, and their openness to engage. On the other hand, investors use these ratings for investment and reporting processes and companies to gain credibility with stakeholders, mostly investors. Ideally, ESG ratings will support investors in assessing individual and portfolio investment opportunities and risks and companies in communicating the sustainability of their operations.

The market of ESG ratings has grown and changed over recent years and can be expected to do so further. Despite notable improvements, this market remains inefficient in terms of coverage and suitability, and ratings do not fully meet the expectations either of investors or companies. However, that said, regulators aim to improve the market such that ratings “enable users, investors and rated entities to take informed decisions as regards ESG-related risks, impacts and opportunities”[7].

Four years after our first study on ESG ratings and small-cap companies, we took the opportunity to revisit our analysis and, more importantly, to give our portfolio companies the opportunity to share their views on ESG ratings.

In the first part of this study, we conducted an analysis of ESG ratings by two providers and compared them to our 2020 study. We concluded that ratings remain skewed towards large and more mature companies both in terms of coverage and average ESG rating, and that different providers may paint very different pictures of companies’ sustainability, which is demonstrated by a low correlation between the two different providers’ ratings on the same companies – even though rating providers’ coverage has increased. In our opinion, the apparent connection between ESG rating and market capitalisation of companies indicates that the ESG market remains inefficient, in particular for small- and micro-cap companies.

In the second part of this study, we conducted an analysis of 98 small- and micro-cap portfolio companies’ responses to our ESG survey. Our main conclusions on the opinions of companies about rating providers are that (1) ratings often do not correctly mirror companies’ sustainability, even though they have improved over recent years, (2) ratings have improved due to companies’ own efforts to increase disclosure accompanied by increases in internal resources and that (3) companies place importance on their ESG ratings because they are used for investor attraction and communications, whereas their relevance for employees and customers is assessed as smaller.

Our main conclusions on the opinions of companies about ESG discussions with investors are that (1) ESG aspects are not part of every meeting, despite the general rise in sustainability awareness over recent years and (2) the ESG aspects that are discussed during meetings are not always the ones most relevant to the companies.

We believe that there is still room for improvement when it comes to ESG research and the exchanges between companies and investors, companies and ESG rating providers, and – not to forget – investors and ESG rating providers. Amid the plethora of regulation requirements, data disclosures and rating providers, there still seems to be a lack of a common understanding about what is useful ESG information to provide or ask for.

The conclusion from our 2020 study still holds true: given the significant degree of complexity and company specifics involved in an ESG analysis, standardised and disclosure-reliant rating frameworks will not suffice to replace the detailed analysis and engagement that investors can conduct. Understanding these complexities requires expertise, time and resources. This is why we believe ESG ratings can be a useful input in a detailed analysis of investment ideas’ opportunities and risks but should not be used on a standalone basis.

6 – Key Takeaways

1 Provider comparison reveals that ESG rating correlation remains low, whereas average ratings have increased

2 Also companies have noticed an improvement in their ESG ratings, albeit they are dissatisfied with the assessments

3 Companies attribute the improvement in their ESG ratings to their own increased disclosure

4 The lack of openness of ESG data providers is a concern for companies

5 ESG ratings are a strong driver of investor retention and attraction

6 Material ESG aspects are not often raised in company meetings with investors

[7] European Commission “Proposal for a Regulation of the European Parliament and of the Council on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities”, https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52023PC0314

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Joh. Berenberg, Gossler & Co. KG
Neuer Jungfernstieg 20
20354 Hamburg
Telefon: +49 40 35060-0
info@berenberg.de
www.berenberg.de

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