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PARTNERSHIP SINCE 1590

A BERENBERG ESG OFFICE STUDY

ESG RATINGS: THE SMALL AND MID CAP CONUNDRUM

May 2020

Acknowledgements

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Berenberg would like to express our appreciation to all organisations that completed our survey and took part in our dialogues.

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Introduction

The rising importance of Environmental, Social and Governance (ESG) considerations has had a significant impact on the asset management industry. Along with this trend, we have observed the proliferation of ESG rating providers. Increasingly they offer third-party solutions to investment managers that are under intensifying pressure to demonstrate how they integrate ESG considerations into their investment processes. We hope to demonstrate that the standardised frameworks of rating providers – while significantly improved – continue to struggle to account for the complexities and nuances of a real world business. With regards to smaller companies in particular, overreliance on such frameworks can easily result in significant risks being overlooked or attractive opportunities being missed. Ultimately, ESG integration must not be outsourced. Instead it should be an inherent part of fund managers' day-to-day work.

Fund managers need to demonstrate how they use ESG in their investment processes

ESG is raising the standards of the investment industry. It is safe to say that in the past, ESG considerations played little to no part in most industry participants' investment processes. Today, however, the pressure to demonstrate ESG integration is immense and continues to grow. Such demands call for fund managers to rethink their investment process and expand or enhance it to include ESG integration as an integral part of their approach.

We welcome the increased attention that ESG considerations receive. Firstly, it is encouraging to see that companies are, more than ever, held accountable to its many stakeholders. Secondly, we also commend companies that put themselves under more public scrutiny by providing greater insights into previously less transparent parts of their businesses (for example by providing data on fuel consumption, water usage and employee retention). Lastly, we believe it plays to our strengths. As quality investors that seek to invest in companies that can deliver durable long-term growth, we have always been interested in the sustainability of their business models.

ESG Rating providers are playing an important role in this process and we, too, make use of them. ESG scores provide us with a helpful starting point, highlighting potential strengths and weaknesses among the companies we consider. Moreover, well curated data helps us to be more efficient in our subsequent analysis.

Rating providers cannot replace all the work we do ourselves to assess the ESG risks and opportunities

Rating providers cannot, however, replace internal analysis to assess the ESG risks and opportunities of the companies we invest in. As the need to demonstrate ESG 'compliance' grows, we warn against overreliance on ESG rating providers and stress the importance of integrating ESG with in-house research. This applies to companies of all sizes though it is most important with regards to small and mid-cap companies.

To make our case we present an analysis of three of the most widely used rating providers. We find that all three providers have very good coverage of Mega and Large Cap companies. However, coverage rapidly declines as we move into the Mid, Small and Micro Cap equity universe. Further, we are led to conclude that all three providers have inherent biases towards more mature businesses that grow more slowly. Smaller, faster growing companies, which incidentally are the ones we are often most interested in, on average score less well or are not rated at all.

These inherent biases are at least in part explained by weaker disclosure of ESG data from smaller and less mature companies. To better understand the companies' perspective and their struggle with regards to the rating process, we have conducted a survey. There appears to be common agreement that the process of working with the many existing ESG rating providers continues to be time consuming. Despite a willingness to improve their ESG ratings, companies flagged a lack of resources as a prime obstacle to disclose more.

It is important to stress that disclosure by itself is not necessarily a sign of good behaviour. Equally, companies that are not disclosing their ESG performance do not necessarily behave irresponsibly. In two case studies we show how ratings, which are dependent on disclosure, sometimes, do not adequately capture what is really going on in a business. In one example a company that has 100% of its revenues tied to reducing emissions, was given a low environmental score. To our understanding the reason was that the rating provider's static framework had failed to identify the company's innovative technologies as environmentally friendly. The consequences of overreliance are clear: if we had relied on the scores provided, we would have missed a great investment opportunity that also helps to mitigate the exacerbation of climate change.

ESG analysis is necessary to be conducted in-house

Along with the rise of ESG, rating providers have grown in importance. As the pressure to demonstrate ESG integration increases, they are a valuable resource and we, too, make good use of them. However, they are far from perfect, especially when it comes to small and mid-cap companies, and with this paper we seek to demonstrate the limitations of their use. Ultimately, **ESG analysis has to be conducted in-house and by portfolio managers** that make the final investment decision. We hope this paper provides a useful insight into our thinking as well as our investment process.

THIS PAPER IS ORGANISED IN THREE PARTS

- The first part presents our understanding of this topic with the analysis of three ESG data providers coverage on ratings.
- The second part is the survey conducted to understand companies' views on the ESG rating process.
- The third part aims to understand how Berenberg´s approach would help to mitigate this dilemma.

Part 1: Our View and Analysis

ESG disclosure and its shortcomings

The proliferation of rating providers is fuelled by the increased data disclosure from corporates. As a result of rising pressure from investors as well as successful initiatives, company disclosure has accelerated in recent years. For example, the Global Reporting Initiative (GRI) introduced a global best practice for reporting publicly on a range of economic, environmental and social impacts[1]. In a relatively short period of time, such initiatives have come a long way. In a recent survey it was found that 93% of the world's largest 250 corporations report on their sustainability credentials[2].

While the quantity of available data has grown in recent years, the quality of that data remains, in many cases, unsatisfactory. A study by Goldman Sachs demonstrated, large parts of the data being reported are vague and hard to assess. For example, 85% of all companies that are part of the MSCI ACWI index disclose a "community involvement policy".[3] While this by itself is not negative, it can neither give us assurance that a business is engaging productively with its wider community. The mere presence of such a policy is likely to raise a company's ESG score despite no assessment of how such a policy is executed on. Quantifiable metrics that can be tracked over time are significantly less reported, even among larger corporates, making it difficult to use them at all as an input for scoring frameworks.

Smaller-sized companies publish a relatively low volume of CSR related information compared to larger caps

A further limitation in the data is the ongoing lack of disclosure by smaller companies. A study by Demerents et al (2014) shows that smaller-sized companies publish relatively low volumes of Corporate Social Responsibility (CSR) related information compared to large caps. Very few mid-cap firms apply the GRI framework, and the CSR-related information that they do publish is unclear to stakeholders. Large caps' CSR communication strategies are far more advanced than that of smaller sized companies. In 2011, 68% of larger companies applied GRI norms compared to only 4% of mid-caps, with 79% of large caps publishing a separate CSR report compared to 9% for mid-caps. The depth of these reports also differs, with larger companies publishing an average of 57 pages of CSR-related information and mid-caps publishing around 3 pages[4].

ESG disclosure has significantly improved over time, but there remain limitations. Smaller companies are yet to catch up to larger corporates' disclosure efforts. Further, the overall quality of the disclosure needs to improve to have a meaningful

[1] GRI Standards, Available at https://www.globalreporting.org/standards/gri-standards-download-center

[2] KPMG Survey of Corporate Responsibility Reporting 2017

[3] GS Sustain, The PMs Guide to ESG Revolution, April 2017

[4] Demerens Frédéric, Géraud Bénédicte, Paré Jean-Louis et al., « Do European Mid-cap firms disclose enough non-financial, specifically CSR-related information to their stakeholders? », Gestion 2000, 2014/1 (Volume 31), p. 179-198. DOI : 10.3917/g2000.311.0179. URL : https://www.cairn.info/revue-gestion-2000-2014-1-page-179.htm

contribution to scoring frameworks. We now turn from the disclosure to ESG ratings and assess three of the most widely used ESG ratings providers.

Three rating providers and their biases

Scoring methodologies ultimately determine the output rating agencies provide. We therefore conducted an analysis of three of the most widely used ESG scoring frameworks and ratings to understand: (1) the extent to which their ratings correlate; (2) their overall coverage; and (3) potential inherent biases.[5] Our analysis suggests that there continues to be significant differences between rating providers. Further, we find that all three providers have very good coverage of Mega and Large Cap companies; however, coverage rapidly declines as we move into the Mid, Small and Micro Cap equity universe. Lastly, we are led to conclude that all three providers have inherent biases towards European companies, companies with large market capitalisations and companies that are more mature and thus grow revenues, profits and capex more slowly.

Low correlation between ESG ratings from data providers

In our analysis of three of the most widely used ESG providers we found no strong correlation between the different ratings for the same company. The results presented in Table 1 show that the average correlation between the three ratings lie at 0.56 and range between 0.53 and 0.71. Similar findings of correlations have also been found by Berg, Koelnel & Rigobon (2019) who have used five different ESG rating providers (KLD, Sustainalytics, Vigeo-Eiris, Asset4 and RobecoSAM).

Table 1: Correlation Analysis of ESG Ratings

	Provider A	Provider B	Provider C
Provider A	1.0	0.53	0.45
Provider B		1.00	0.71
Provider C			1.00

Source: Berenberg

The correlation stands in stark contrast to the high correlations of credit rating agencies. Ratings from Moody's and Standard & Poor's have a correlation of nearly 0.99[6], which is suggests very strong similarities between their methodologies.

The relatively weak correlation between the three ESG providers is, in our view, indicative of the evolving nature of ESG analysis. We are still at the beginning when it comes to quantifying ESG risks. Contrasting opinions remain on how risks are best captured in one overall score. There is further progress to be made. However, it is also clear that ESG assessments will always remain subjective. This

5 There are of course many more ESG rating providers. One study recently identified as many as 125 providers. For the purpose of this study, we have decided to keep the three rating providers anonymous.

6 Berg, Florian and Kölbel, Julian and Rigobon, Roberto, Aggregate Confusion: The Divergence of ESG Ratings (August 17, 2019). MIT Sloan Research Paper No. 5822-19. Available at SSRN: https://ssrn.com/abstract=3438533 or http://dx.doi.org/10.2139/ssrn.3438533

is partly why we only consult ratings and always rely on our own analysis and company engagement to make a final investment decision.

The scope of rating providers' coverage remains limited. We conducted an analysis of rating providers' coverage of the equity universe by market cap. Figure 1 shows the coverage by market cap of a number of representative indices[7]. In Figure 2 we show the coverage relative to the absolute number of index participants. As representative indices we selected the MSCI World, MSCI Europe Micro Cap, MSCI Europe Small Cap and Stoxx 600. The analysis presented below demonstrates that although coverage of the Mega to Large Caps is generally good, we observe a steep drop as we move into the lower market cap bands.

Figure 1:
Ratings coverage between Providers

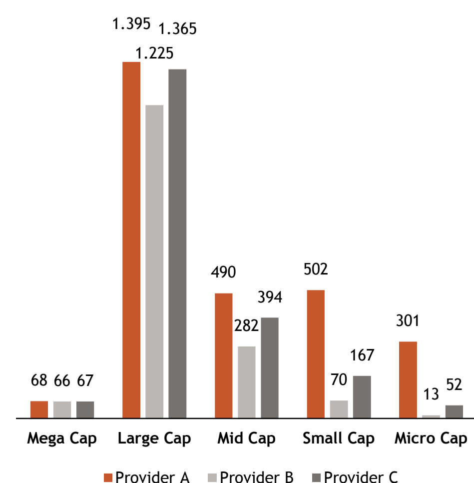
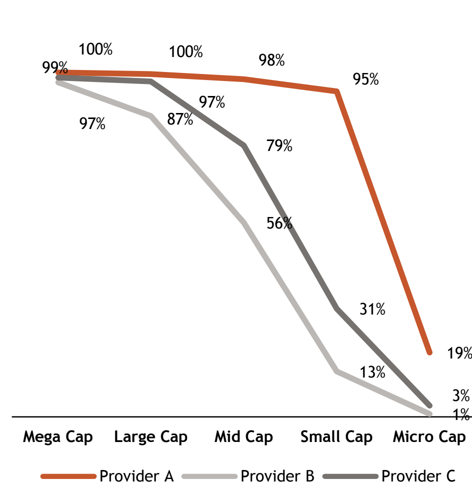


Figure 2:
Ratings coverage based on Indices



Source: Data Providers/Berenberg

We examined the rating providers for potential inherent biases. Here, we looked at the importance of size (measured by market cap). In Figure 3, we show the average ratings of the different providers by market cap bucket. For all three of them we found that ratings correlate positively with size. In other words, the larger a company is, the more likely is a better rating. Geographically the coverage also shows limitations. In Figure 4 below, we looked at the percentage of companies covered from different regions. For the purposes of this analysis we used the MSCI ACWI as a basis. The chart clearly shows that coverage is highest in Europe and North America and rapidly drops off as we move beyond. In Figure 5 to 7, we analysed the ratings for potential biases towards certain financial characteristics.

[7] We define the sizes based on market capitalization: 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.

Indeed, we found that for all three providers well rated companies (defined as scoring in the top quartile of the overall universe) on average grow Sales, EPS and Capex more slowly than those companies that fall into the bottom quartile.

ESG ratings in the small and mid cap segment differs quite significantly in comparison to large caps

Figure 3: Average ESG Ratings between Providers

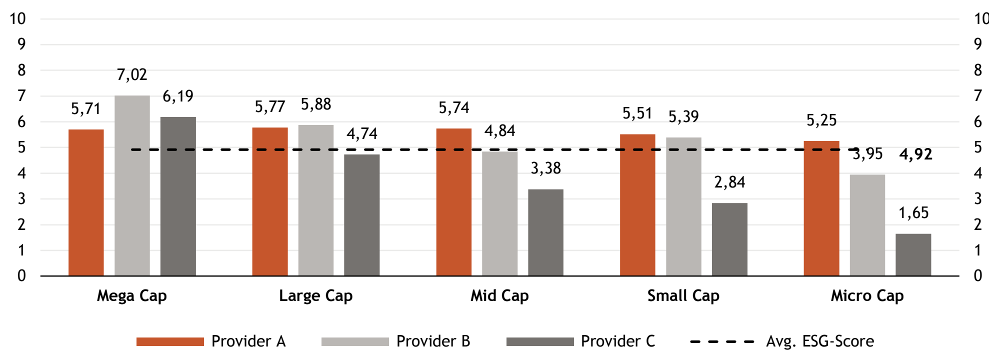


Figure 4: Coverage based on Geographical Locations

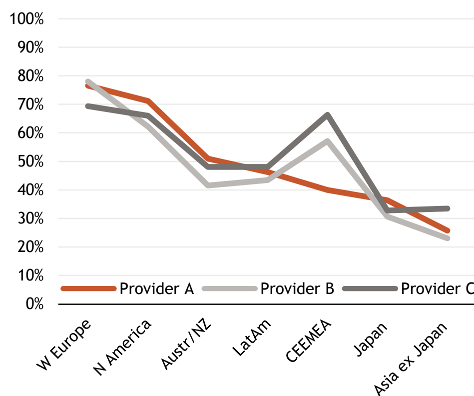


Figure 5: 5 Year Historic Revenue Growth (CAGR)

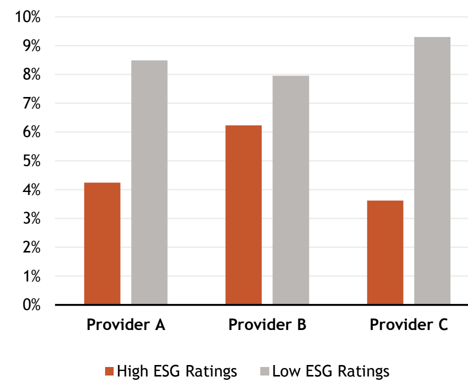


Figure 6: 5 Year EPS Growth Rate (CAGR)

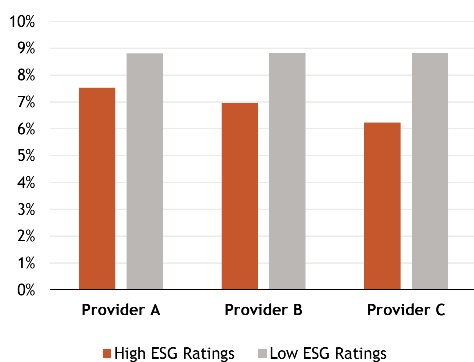
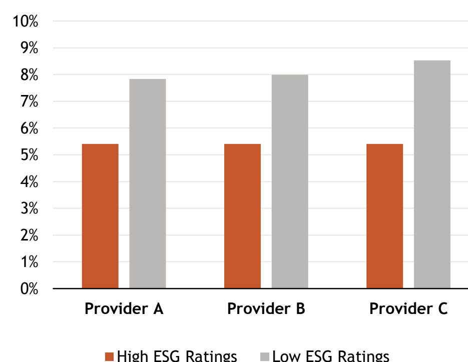


Figure 7: 5 Year Capital Expenditure Growth



Source: Data Providers/Berenberg

Part 2:
The rating process from a company perspective

Part 1 discussed the inherent biases of the scores of three ESG rating providers and identified weaker disclosure from non-European, smaller and faster growing companies as a likely cause. In addition to this analysis, we prepared a survey to better understand what is potentially holding back better disclosure. Although we understand that the companies that have responded to our questions might not be a representative sample[8], we believe their feedback provides us with a useful insight into a company's perspective.

From the results of the survey, we can observe that companies are generally interested in a productive dialogue. Ratings are generally perceived as helpful in promoting changes and raising awareness internally. However there seems to be common agreement that the processes of working with ESG rating providers are too time consuming, partly because they are not standardised. One further obstacle is the collection of the data, which rating agencies want disclosed. For smaller companies, there are limited resources available for this process. Finally and particularly striking is that most companies agree a lack of disclosure is the key driver behind a low ESG rating. That may also be why all companies expressed a willingness to improve disclosure.

Most of the companies agree that it is because of their lack of disclosure that results in lower ESG ratings

Result 1: What are their views on the ESG rating process?

Strengths of the ESG rating process

- Opportunity to positively influence the rating before being rated
- The ratings are helpful for promoting changes and raising awareness within the company
- Interested in a successful cooperation with the rating agencies and support their initiatives to create transparency, comparability and standardisation

ESG ratings are helpful for promoting changes and raising awareness within the company

Drawbacks of the ESG rating process

- Process of feedback is not standardized and differs according to rating provider
- Not all rating providers are transparent in their process
- Poor communications with companies and feedback is not taken into account
- Increasing number of agencies offering ESG ratings and all have different criteria. Questionnaires are all different and require different data and information.
- Does not reflect up to date information

Poor communications between companies and ESG rating providers

8 We received feedback from six companies and thank them for their contributions.

Result 2: What are their views and reason for the low ESG rating?

Views of a Low Rating

- If investors make decisions solely on the basis of the rating and not the broader picture then this will be a concern
- A low rating in ESG can prevent the share price to reflect the real value of the company

A low rating in ESG can prevent the share price to reflect the real value of the company

Reasons for a Low Rating

- Up to date information/sustainability report not taken into account
- Limited resources dedicated to ESG activities in smaller companies
- Lack of public disclosure
- Larger companies in the industry are ahead when it comes to implementing ESG measures.
- Reporting is not yet geared to the ESG requirements
- Difficult to implement group wide ESG measures for all rated areas immediately, thus ratings will not reflect the full picture

Limited resources dedicated to ESG activities in smaller companies

Result 3: Can they increase their disclosure?

Views and Strategy on Disclosure

- Disclosure is dependent on strategy, processes and data collection. The latter is the biggest challenge
- Improving the effectiveness of ESG disclosure is expensive both in terms of cash and resources especially for smaller firms
- Limited available resources compared to larger companies
- Take ESG ratings seriously, as far as possible, to provide the required information. At one point or another, some requirements can be implemented more quickly, but unfortunately only at a slower rate elsewhere

Improving ESG profile and disclosure is dependent on strategy but is expensive for smaller firms

Part 3: The Berenberg Approach

Going beyond ESG ratings

ESG ratings and their underlying research reports are useful, but not perfect. In most cases, they are a good tool that give us a broad overview and set us up well to conduct our own analysis. However, they can also get it wrong. This is particularly the case when looking at companies with a market capitalisation of $5bn or lower. In this section, we present two case studies that illustrate how overreliance can result in missed opportunities. To mitigate those risks we go far beyond ratings.

In-depth research and engagement with companies is necessary to examine the rationale of ESG ratings

Our investment approach incorporates a more thorough integration of ESG considerations. As quality growth investors, we seek to invest in companies for relatively concentrated portfolios, and aim to hold them over a long period of time. With this time horizon, we have the capability and resources to build expertise in the sectors we invest in. We develop a deep understanding of each individual company and engage with corporate management to assess and potentially shape how ESG risks and opportunities are taken into account.[9]

For two small sized companies[10] we show our analysis step-by-step. We demonstrate that although their ESG ratings do not present them as compelling investments, they are two quality growth companies that can deliver sustainable growth while effectively managing ESG risks and opportunities.

[9] For these case studies we also engaged with the rating provider.
[10] Our definition of small sized companies is based on the market capitalisation of between €0.5 and €2bn.

CASE STUDY: ELECTRONIC COMPONENTS COMPANY FOR APPLICATIONS IN AIR-CONDITIONING/ HEATING/VENTILATION (HVAC) AND REFRIGERATION

The company received a low ESG rating due to its supposedly unclear strategy to capitalise on 'clean-tech' opportunities and thus demonstrates limited potential to benefit from the structural growth of the underlying market it operates in. Additionally, the rating provider names risks concerning controversial sourcing and corporate governance. However, following in-depth research and direct engagement with the company as well as the rating provider, we find that:

Environmental Issues (Low clean tech opportunities):

- The rating provider identified that only 1.8% of the company's revenue is classified as "clean tech" opportunity. Our understanding is that the company's sales exposure is considered low because its end markets do not fit into the rating provider's static set of "clean tech markets".
- In our opinion the company derives all its sales from "clean tech markets". By focusing on components and solutions in the control and regulation of HVAC and refrigeration applications, it in the company´s DNA to improve energy efficiency and cut back on the use of natural refrigerator gases, thus minimizing the environmental impact. In fact, its components and solutions facilitate c.30% of energy savings and c.95% less of refrigerant leaks. The importance of the former is demonstrated by highlighting that the HVAC/R market makes up of c.17% of global electricity consumption.
- Further, the rating provider indicates that the company lacks a clear strategy to capitalise on 'clean-tech' opportunities in the future. It derives its opinion from three factors. The most tangible of these factors, is the comparison of its R&D investments/sales to the industry average. The fact the company has spent on average 6% of its sales on R&D in the last five years, both expensed and capitalised, and thus less than the industry average of c.7.5% gives reason for a low rating on the company's strategy.
- In our opinion, this methodology is not comprehensive because it does not consider the investments' efficiency. Instead of assessing the absolute R&D amount spent, we recommend assessing the return of the R&D investments. We do so by analysing the company's incremental market share, profitability and cash flow. The fact that the company has organically grown its sales twice as fast as the industry's growth rate, improved its EBITDA margin by 2ppts to 20% and almost doubled its operating cash flow while investing on average 6% of its sales on R&D in the last five years demonstrates, in our opinion, a successful strategy to capitalise on 'clean-tech' opportunities.

Social Issues (Controversial Sourcing):

- The rating provider cites the need to extend the effort to ensure compliance with controversial materials sourcing in order to reduce the risks of human rights and labour abuses. It states that the company has neither a policy to address controversial raw materials nor a policy to collaborate with suppliers to address potential impacts of raw materials sourcing.
- Through our engagement with the company, we learned that the company is, on a voluntary basis, compliant with Section 1502 of the Dodd Frank Act, which governs the use of conflict minerals. The rule requires US listed companies to (1) disclose the use of minerals sourced from countries affected by conflicts or extensive violations of human rights, i.e. the Democratic Republic of Congo or an adjoining country; (2) take steps to address associated risks; and (3) report the yearly efforts to the U.S. Securities and Exchange Commission. The rule does not encourage stopping sourcing from this region, but requires that companies operate and source with appropriate care. In fact, in 2019 the electronic equipment company sourced 85% of its procurement value from component manufacturers which in turn source conflict-free 3TG minerals, and of this, 74% declare to be committed to upstream supply chain monitoring. The company aims to increase its conflict-free 3TG mineral sourcing to 100%.
- On top of its Dodd Frank Act compliance, the electronic equipment company works on its compliance with international best practice, the Responsible Minerals Assurance Process. This would guarantee that its component suppliers source only from smelters and refiners, which are validated by an independent third-party assessment.
- We appreciate the company's target to become compliant with the most stringent rules, the Responsible Minerals Assurance Process of the Responsible Business Alliance Code of Conduct.

Corporate Governance Issues (Ownership Structures):

- The rating provider highlights the risk that the company's decision-making may not be in interest of its minority shareholders, given that its two controlling shareholders have effective control of the board, owning 36.2% and 23.6% of share capital and 45.3% and 29.5% of voting rights, respectively.
- Also it points to the lack of disclosure on compensation components for individual members of the board of directors, namely fixed salary, short/ long-term incentives, pensions, benefits and other one-off payments.
- We do not agree on the rating provider's main points of criticism, but rather highlight improvement potential of the board of directors' composition.
- The company's chairman, as co-founder of the company, still owns 45.3% of voting rights and 36.2% of share capital. Due to the nationally established double voting right which is eligible for all shareholders owning shares for more than two years, a discrepancy between share capital and voting right ownership is common in the country. However, even with 45.3% of voting rights we do not consider the chairman to be in control of the company.

- In its comprehensive remuneration report, the company details the remuneration components of its board of directors and management.
- Even though the company's corporate governance is aligned with national best practice, in line with a continuation of strong earnings and stakeholder number growth, we recommend adapting international corporate governance standards. We recommended three changes to the company: (1) establishing a majority of independent board members, (2) being led by a non-executive director as chairman and (3) excluding the two controlling shareholders from the long-term share-based incentive plan.

Recent development through Engagement:

- As a long-term shareholder of this company, we have an active dialogue with its management. Through our engagement we became convinced that sustainability is an integral part of the company's DNA, and learned that the company contacted the ESG data provider to discuss how it is potentially misperceived.
- Also, the company continuously strives for further improvements like:
  - Sourcing: The company's goal is to increase its conflict-free 3TG mineral sourcing to 100%. It will publish more information about its current progress in its upcoming sustainability report.
  - Corporate governance: The company will implement the new local Code of Conduct which defines the pursuit of sustainable success as the primary task of the board of directors.

  In addition, we identified areas of improvement on corporate governance measures, i.e. the recommended structure of the board of directors, which we shared with the company's management. This is part of our continuous dialogue as an active shareholder.

Conclusion: We are invested in the electronic equipment company due to its strong market position in niche HVAC and refrigeration applications, aimed at reducing the environmental impact of such applications, benefiting from both structural growth of the underlying demand for clean technologies and its ability to gain market share. It is a highly efficient company that successfully transforms strong sales growth into strong earnings and cash flow growth. Having a long-term oriented and incentivized management team with controlling shareholders makes us confident that their interests will remain aligned with those of long-term shareholders.

CASE STUDY: SOFTWARE AND SERVICES COMPANY

Though the company has a strong governance score, it has received very low social and environmental scores, thus reducing its overall score. The company's low social score was given due to a supposed difficulty in attracting and retaining talent which is indicated because of recent mergers and acquisitions (M&A). Also the company faced criticism against its limited exposure to 'clean-tech' product lines compared to peers (thus affecting its environment score). However, after further research and direct engagement with the company as well as the rating provider, we found that:

Environment Issues (Clean tech products)

- Learning and educational software falls in the category of industrial software hence the corporation is compared to business models that have a strong exposure to highly energy intensive applications and operations. As the company is only active in education and personnel management software, we see the opportunities to save energy and reduce waste with learning products as very limited. This comparison is therefore not made on a fair basis, which has consequently led to a much lower score. This was also confirmed by the rating agency when we discussed the matter with them. The ratings agency promised to review the opportunity-scoring which we find very encouraging.
- Although the potential is limited, we have found that the company is moving clients from legacy desktop solutions to more efficient cloud-based solutions. The company is already reducing business travel and increasing the usage of video conferencing. We have encouraged the company to take more effort in disclosing emissions and also providing specific targets, which was well received by the company.

Social Issues (Talent Management):

- The ratings agency concludes that for the software sector, a material risk is to retain human capital and talent. Through the M&A activity, the company adds additional potential risk which needs to be managed. We agree on this conclusion and think this needs to be monitored very closely.
- The company has a long history of buying poorly managed companies which often have negative growth rates, very low profitability and poor corporate culture but good product offering. The company therefore aims to change the business structure and organisation while investing in innovation/products. Such restructuring would require, initially, a change of management which would implement a fresh culture and long-term plan. The track record on these initiatives and the integration process is strong, as it has enhanced the product offering for the clients and the long term financial strength of the company.

- In the process of transformation and integration, a business turnover is usually higher. We have found that the retention rate has increased from 73% to 85% in the last 12 months (after big acquisition) and the companies expect this to increase to 90% in the next two years. The positive effects of this are illustrated by the fact that very talented people are already returning to the company because of the progress made.
- We have also found that this specific rating category is largely disclosure based and the rating agencies check if documents for specific trainings, surveys or other programs are provided. This small cap company does not have the resources to put a large amount of documentation on their website. In our discussion with the executive and middle management, we found that extensive training, onboarding, talent and management solutions for new and existing employees is provided. The company also has regular group communications, staff-surveys and feedback. Further all staff can participate in bonus schemes and the share save plan has seen a high uptake (2019: >50% take-up by staff) and was recently opened for US-based employees (following a significant acquisition in the US).
- Overall, we would agree that the nature of the business has a higher risk than other companies through its dependency on a skilled workforce, but we have found that its management is taking steps to overcome these challenges. Consequently, we can conclude that the very low score is not justified.

Recent development through Engagement:

- We are a long-term shareholder in the company and we have a very active dialogue with the management. It is encouraging that the company has taken steps to increase transparency and demonstrated progress to become more sustainable. We are assured that this is not solely based on our engagement, as other shareholders have been active as well and the management understands the long-term correlation of sustainability and financial strength. A few examples are stated below:
  - Accounting: The transparency on accounting has increased significantly regarding critical metrics.
  - Focus on ESG overall: The focus on ESG has increased as the company has appointed a board member to take a strategic role on ESG considerations. In addition the company has hired a new Head of Legal with a focus on ESG in order to strengthen their ESG capabilities.

  In addition, we have found new areas of improvement on the corporate governance and the environmental side which is being shared by management. This is part of our constant dialogue as an active shareholder.

Conclusion: We are invested in the company as it is targeting the structural growing market of adult education and learning, which is critical to support employment and lift standard of living. In addition its management has a very strong track record, especially on M&A, and is doing a great job to widen their offering further.

Conclusion

The rise of ESG continues to gather traction. Along with it comes the pressure on investors to integrate ESG. ESG rating providers fulfil a relevant function here to help the financial industry to meet these increased demands. They provide a useful first review and good overview that assists us in our subsequent analysis. However that being said, the providers do have several shortcomings. In an analysis of three of the most prominent rating providers we found remaining gaps in the coverage of the equity universe. This is particularly applicable in the small to micro-cap universe. Further, we found inherent skews in the ratings towards large and more mature companies. Companies that are still small and are growing rapidly on average have lower ESG ratings. A lack of disclosure from the less mature companies explains in large measure theses biases and is also acknowledged by the companies we surveyed in this paper.

However, it is important to recognise that smaller, growth-oriented businesses often struggle with the rating process. Non-standardised processes make it a time-consuming task for companies to engage with the rapidly increasing number of rating providers. Most importantly, non-disclosure is not necessarily a reflection of poor ESG behaviour. As we demonstrated with the two case studies, smaller companies are at times often well ahead of the curve and integrate ESG very well. These case studies also demonstrate, that given the endless complexities and nuances involved in an ESG analysis, standardised and disclosure-reliant scoring frameworks will always struggle to replace the detailed analysis and engagement that we conduct. Understanding these complexities requires expertise, time and resources. This is why we believe ESG analysis has to be done in-house and by the portfolio managers that make the final investment decision.

Below we have outlined key takeaways from this paper:

5 KEY TAKEAWAYS	
	ESG ratings coverage differ across providers
	Small and Mid caps have in general lower ESG ratings
	Disclosure based frameworks penalize smaller and resource constrained companies
	ESG ratings are skewed towards larger and more mature companies
	In-depth research and direct engagement allows for deeper understanding of ESG risks and opportunities

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