Eurofi Initiative - ESG Report on Small & Mid-Caps

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-Caps

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-Caps 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 Covid 19 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-Caps

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-Caps, 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-Caps' 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-Caps 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 less 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-Caps are significant. Small & Mid-Caps 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-Caps 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-Caps. 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-Caps 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.

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.

REPORT

Introduction

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.

A multidisciplinary group of Paris market players (rating agencies, brokers, lenders, market operators, investors, etc.) 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.

We will endeavour 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.

A) Small & Mid-Caps are 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.

A.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-Caps. 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-Caps, but rather to identify a scope of listed companies for which a significant volume of transactions is observed[1,2].

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-Caps.

Table 1: Features of Large Caps and Small & Mid-Caps 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-Caps 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

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

[2] The exact scope of Small & Mid-Caps 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-Caps 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-Caps

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-Caps 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[3].

Table4: Breakdown of Small & Mid-Caps by business sector

Sector	% *(Threshold of € 5 billion)*
Manufacturing	28.16%
Financial and insurance	17.85%
Information and communication	11.05%
Wholesale and retail trade, repair and motor vehicles and motorcycles	7.30%
Real estate	6.51%
Professional, scientific and technical	5.03%
Construction	4.04%
Mining and quarrying	2.81%
Transportation and storage	2.56%
Administrative and support service	2.37%
Electricity, gas, steam and air conditioning supply	1.58%
Arts, entertainment and recreation	1.13%
Accommodation and food service activities	1.28%
Health and social work	0.99%
Agriculture, forestry & fishing	0.79%
Water supply, sewerage, waste management and remediation activities	0.49%
Education	0.20%
Other service	0.15%
Missing	5.72%

Source: PwC, Bloomberg, Reuters

A large portion of Small & Mid-Caps 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 ago-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-Caps. 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.

[3] 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.

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-Caps 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[4]. It has thus been able to identify more than 60 Small & Mid-Caps 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-Caps. 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

A.2) Example of ESG risks threatening Small & Mid-Caps operating in the agro-industry, plastics, mining and chemicals sectors

The following sections illustrate the specific risks to which Small & Mid-Caps 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

[4] Companies involved in Green-Fin-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.

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-Caps, 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-Caps 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.

B) The challenges of integrating Small & Mid-Caps into the ESG approach: ensuring industrial and financial performance – or even survival – in a rapidly changing environment

B.1) Anticipate risks and opportunities associated with the business model

There has been a notable rise in the perception of ESG risks. The direct impacts of climate change are starting to become apparent, even in Western European countries (increased temperatures, water stress, etc.).

At the same time, the acceptance of ESG risks by civil society – whether these be environmental, public health, social or governance risks – is decreasing significantly. **The regulations and behaviour of the various stakeholders, including the companies' end-customers, are tightening in response to these changes.**

These transformations are happening at pace. While once they could be thought of as uncertain and distant, they are getting dangerously close, with much of this uncertainty remaining.

These changes are a source of both risks and opportunities for SMIDs.

Threats are mainly to companies that are poorly diversified and embedded in a value chain that brings both ESG constraints and risks. Some of these are still not very visible. But they are potentially fatal for companies whose resilience can be less than that of large companies. The rapid decline of diesel, the planned end to the combustion engine, and the impact of this on subcontractors specialising in the manufacture of parts that will no longer have an outlet, is an example of risks that may arise in other sectors due to the combined effect of regulations and changing end-customer preferences. These changes in end-customers' preferences and tolerance create a reputational risk for which Small & Mid-Caps are poorly prepared.

Small & Mid-Caps also seem particularly vulnerable to stakeholder-related risks. This is particularly the case for key clients' growing concerns about responsibility throughout the value chain, which may lead Smalls & Mid-Caps to deploy control processes that are essential for their survival, as well as capital to gain access to major institutional investor markets. Finally, the issue of business ethics in environments that are increasingly subject to international regulation is another potential source of threat, as Small & Mid-Caps are in principle far less equipped to handle these issues than large groups, in particular when faced with Anglo-Saxon players.

Growth opportunities for these companies also exist. They can embrace this new environment to develop new products, new processes, access new financing and attract new customers. For example, the public sphere is well acquainted with issues relating to climate change due to their exposure among citizens and voters. Some listed companies address this market segment, providing solutions or products with a positive impact. This gives them a competitive advantage over their competitors in public tenders.

However, managing risks and taking advantage of opportunities requires the resources to understand fast-changing issues, to analyse all risks across the full range of upstream and downstream channels, and to communicate. Investing in solutions with uncertain profitability timeframes is a risk that can be tough for an entrepreneur to take on. Thus, integrating the constraints of a circular economy into a business model involves an investment that can only be made profitable when the circular economy is fully recognised by both the regulations and end-customers.

The scenario-based analysis of climate transition risk (for example, the impact of a 2°C trajectory) thus seems a good example of a risk analysis structured around business performance and a business model that is both requested by external stakeholders (TCFD recommendation, investor demand to comply with disclosure regulations) and that requires investment and resources which are not readily available to Small & Mid-Caps.

B.2) Increase the ESG commitment of Small & Mid-Caps teams and make their actions more visible among external stakeholders

Integrating ESG challenges helps companies respond to growing aspirations on the part of both society and employees, in particular in their search for meaning that extends beyond financial performance targets. In the same spirit, the Pacte Act in France introduces the concept of corporate social interest into law. It allows companies to set out a raison d'être, and establishes the formal status of a mission-oriented company.

By explaining how their activity, strategy and purpose are part of a broader sustainability goal, Small & Mid-Caps can thus differentiate themselves among stakeholders. This can increase their attractiveness to job applicants, particularly young graduates. Since 2018, more than 30,000 students have signed the Student Manifesto calling for an "Ecological Awakening" of society. This is an expression of their deep desire to integrate environmental issues into their day-to-day lives and jobs, in particular by refusing to work for employers who do not respect their environmental beliefs. **ESG is also more generally a lever for team involvement and can potentially improve motivation, productivity and employee retention, and reduce absenteeism.**

B.3) Improve financial performance and ensure access to new sources of funding

A growing number of studies link extra-financial performance with financial performance. A 2015 meta-study carried out by Deutsche Asset Management and the University of Hamburg found that 90% of the 2,000 empirical analyses they examined confirmed a link between ESG performance and financial performance. Another led by Oxford University in 2015 had similar findings: **80% of the empirical studies analysed**

showed a positive correlation between stock market performance and the adoption of good sustainable development practices.

In the SMIDs segment, specifically, a 2019 study of listed French SMEs/Mid-Caps by EthiFinancce ("The level of ESG transparency of listed French SMEs/mid-caps and the relationship between ESG performance and financial performance") shows the positive impact of a good ESG rating on stock market performance, particularly in the form of a lower risk premium. The GAÏA index (French SRI stock market index for Mid-Caps), produced by this same agency, has outperformed the CAC Mid & Small index each year since its creation in 2009. Its companies show significant resilience during times of market slowdown. Analyses of OFI AM[5] and a study of Morningstar indices[6] largely confirm these trends.

An increasing number of financial institutions are recognising this link by offering financial instruments whose price is directly connected to the company's ESG performance. A report by the Corporate Social Responsibility Observatory (ORSE) mentions a reduction in the cost of insurance for this type of company, and banks offer them loans whose preferential interest rate is linked to changes in their ESG rating or other extra-financial performance indicators. Several[7] French companies (Danone, EDF, Les Fromageries Bel, Séché Environnement, etc.) have already taken out so-called "sustainability linked loans". Issuance volumes for this product, which is barely two years old, have doubled, particularly in Europe, which accounts for 80% of total outstanding loans.

Since they have integrated ESG issues into their management, these lenders are recognised by financial institutions as having an increased resilience that justifies tiered pricing.

In general, there is a growing demand for environmental or social financial instruments (SRI labels/green benchmarks, green/social bonds, etc.). These products can offer new sources of financing for Small & Mid-Caps.

The impact loans market, for example, is extremely open to SMEs/Mid-Caps, which account for 55% of volumes in terms of credit lines.

Conversely, investors' constraints in terms of ESG, for example those of public entities that have made climate commitments and that adhere to ESG reporting requirements, will increase. These constraints will increasingly apply to lenders, who find themselves under growing pressure. Access to financing could be interrupted or made very difficult for companies that are unable to communicate positively about their ESG performance, or even about the compatibility of their business model with a 2°C global warming trajectory. Thus, according to Black Rock CEO Larry Fink, companies that do not communicate about ESG face a increased risk of crowding out. Eligibility for ESG is expected to become the norm by 2030, according to AUM growth forecasts with international ESG mandates: from $30 trillion to $45 trillion in 2021, and $125 trillion in 2020, i.e. 95% of AUM.

Sustainable finance obligations will increase, with a significant impact on SMIDs. By 2021, companies will have to communicate the portion of their turnover and investments that is compatible with the European taxonomy. Transparency regulations will also gradually force investors to communicate the impact of their investments on sustainability.

At the same time, the smaller a company is, the more limited its resources and the less it communicates about ESG. There is a real risk for Small & Mid-Caps, and more broadly for SMEs, of losing their access to medium-term financing if this state of unpreparedness persists.

C) Obstacles to integrating Small & Mid-Caps into an ESG approach: a general lack of resources at all levels (companies, intermediaries, regulations) that can be difficult to resolve without powerful and rapid intervention by the state

C.1) A necessary trade-off between an immediate cost and the perception of risks or benefits considered more distant and uncertain

The analysis of risks and opportunities by managers and the definition of an appropriate strategy are a prerequisite for implementing an ESG approach.

This step corresponds to the first two reporting sections of companies recommended by the TCFD[8]. It is true that good reporting practices or the financial sector may encourage managers to initiate such an approach. However, the analysts and investors specialising in the ESG sector interviewed as part of this working group insist that **the need to engage in direct dialogue with investors is a key requirement for both the company and managers embracing ESG**.

At first glance, they may observe a discrepancy between the human and financial costs and the perceived benefits. **These costs are tangible: investments required in terms of time, data collection and reliability, communication and team training. All of these require expertise on a range of technical topics, the implementation of dedicated procedures, and significant investment with improved structuring in the event of a change in business model**.

Conversely, the perceived benefits may seem less certain and more distant. The intensity and manifestation of risks and opportunities over time still frequently entail a large amount of uncertainty. When the investment capacities of these companies are limited, this may lead to inaction, either ahead of time or even when the risk becomes clear. Sometimes, it can be when the challenge facing these companies is primarily their short-term financial survival.

The production of standardised data and reporting would set in motion a virtuous circle enabling SMIDs to optimise their costs and investments. This could be achieved by harmonising the data required, improving and systematising analyses, harmonisation, simplifying the basis for dialogue with investors, etc. And more fundamentally, by the company structuring its ESG approach in the same way as that of the income statement, assets, liabilities, EBITDA, etc.

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5 In its ESG rating system, OFI AM classifies companies according to their level of ESG involvement in their business sector. These classifications are on a scale ranging from "leader" to "under monitoring". According to a 2017 study, OFI AM found that "leader" companies display 60% better performance than companies "under monitoring" over 10 years https://www.mutavie.fr/portal/rpm/conseils-epargne-patrimoine/isr-et-performance-est-ce-compatible

6 Of Morningstar's 20 sustainable indices, 16 outperformed their non-sustainable peers during their lifetime, such as the Morningstar Europe Sustainability Index with an average annual performance of 9.1% compared to an average annual return of 8.7% for the Morningstar Europe Large-Mid Cap Index, from which it is derived. https://www.morningstar.fr/fr/news/164273/lapproche-esg-am%C3%A9liore-les-performances-sur-le-long-terme.aspx

7 EthiFinance Impact Credit study and Novethic article https://www.novethic.fr/actualite/finance-durable/isr-rse/l-emprunt-a-impact-nouveau-chouchou-des-entreprises-et-de-leurs-banques-146969.html

8 A TCFD Task Force was set up by the Financial Stability Board (FSB). The FSB Task Force on Climate-related Financial Disclosures (TCFD) will develop voluntary, consistent climate-related financial risk disclosures for use by companies in providing information to investors, lenders, insurers, and other stakeholders. The Task Force will consider the physical, liability and transition risks associated with climate change and what constitutes effective financial disclosures across industries.

Acculturation and support on ESG issues for companies and their managers are therefore necessary. This presents a specific problem for SMIDs and, more broadly, SMEs: the need to accommodate a bilateral approach, as is the case for Private Equity and mass processing.

This requires **a favourable ecosystem**, including: the development of dialogue and the provision of expertise via intermediaries (analysts, rating agencies, Banque de France through its rating process, the accounting function, professional organisations, chambers of commerce, banks, insurers, etc.); the standardisation of information and methodologies; training and communication; the creation of transition support funds; the development of new funding sources linked to the adoption of an ESG approach (SMIDs ESG market fund index, dedicated sections on the stock exchanges, or the promotion of "impact" financing), etc.

C.2) A considerable shortfall of standardised data

A large majority of investors cite the lack of standardised, comparable and certified ESG data as the limiting factor for the development of Sustainable Finance, and more generally ESG.

Almost all the investors interviewed as part of this working group mentioned limitations in terms of the coverage, transparency, quality and cost of available data, with a specific concern about climate data.

These limitations concern both unit indicators (each of which measure a specific ESG dimension, for example "carbon" emissions or the workplace accident frequency rate) and the aggregated ratings provided by intermediaries. They are also highlighted by analyses such as the GPIF study[10] that show significant disparities or weak correlations between ESG ratings from one rating agency to another. This observation also applies to unit indicators such as Scope 3 emissions (companies' "indirect carbon" emissions). The availability of unit quality indicators enables investors to directly reflect their appetite for ESG risk by constructing their own rating (by giving greater or lesser weight to the individual components (E, S or G) of the ESG indicator or dimension) and to compare these ratings with those provided by intermediaries.

The subjective and cultural nature of the choice of indicators, as well as that of their weighting, was touched on in our interviews. For example, a company's mass firing of employees will not be viewed in the same way in France as in the United States. In recent years, however, almost all data and ratings providers have been purchased by US companies. This also raises questions as to the long-term relevance of these data in a European context, and, more broadly, the control of and access to this data. The EthiFinance rating agency, which specialises in rating SMIDs in France and Europe, plays a unique role in providing this data and analysis. It enjoys an exceptional status in Europe due to both the scope of its coverage and its European shareholding.

ESG and Sustainable Finance cannot develop sustainably in the EU without reliable and transparent data pertaining to risk assessment, stock selection, index construction, implementation of the European taxonomy, etc. The importance of data for developing Sustainable Finance is so great that the question of its potential status as a public good was raised in our interviews, as well as the possible establishment of a public data production service. **This issue undeniably raises the question of the instruments needed to ensure European sovereignty, in order to become a credible Green Power in the medium term.**

Currently, these data are collected either via bilateral exchanges or questionnaires, or on the basis of existing reporting and public information, which generally provide incomplete and non-comparable information.

Companies receive multiple ESG questionnaires from investors. These documents have common goals. However, they require different data to be provided in detail, and this data is not always fungible. SMIDs do not necessarily have the capacity to provide data on an ad hoc basis. They generally communicate much less on ESG than Large Caps. In the case of Small Caps, this communication can be very little. **The bilateral handling of the ESG data recovery process is proving very difficult to implement for SMIDs. More generally, it appears to be totally unsuitable for the population of SMEs and VSEs, which may find themselves excluded from Sustainable Finance. Standardised reporting including a standardised and comparable ESG data framework could be a valuable complement to the collection of bilateral data.**

Changes in ESG reporting requirements are on the agendas of both European authorities (in particular EBA, EIOPA, EFRAG and the European Commission) and national authorities (in France, the AMF, in particular, and via the Cambourg mission). The consistency and convergence of ESG reporting requirements for banks, investors and companies funded by these players will be highly desirable in this context. **A review of the Extra-Financial Reporting Directive is scheduled for late 2020/early 2021.**

The directive and its transpositions into national law have limitations in their current form. Their coverage can be improved, as they do not guarantee comparable and unambiguous data. In short, they do not meet the needs of end-users in their present state.

These obligations do not apply to all companies (in France, they only apply to listed companies with a balance sheet of more than €20 million, €40 million in turnover and 500 employees). They are not prescriptive in terms of indicators or reporting format, and they require external controls of limited and variable scope across Europe. Generally speaking, the transposition of the directive in Europe reveals constraints and varying levels of ambition, depending on the country.

The data issue seems absolutely central to developing Sustainable Finance and ESG in small companies. However, an extra-financial reporting objective of an equivalent standard to long-standing financial reporting can take a long time to achieve.

There are many obstacles to achieving a high level of ESG standardisation, including: a very broad and multi-faceted scope of information to be standardised; the need for small companies to accommodate standardisation, taking into account their specific features and the material nature of the risks; the multitude of existing standards; the difficulty of bringing diverse stakeholders together for standards that will involve an amount of compromise

[9] GPIF, the world largest pension fund, searched for a correlation between MSCI and FTSE on ESG ratings among 430 Japanese companies and reached a conclusion of a strong disconnect between the scores provided by the two players.

[10] GPIF, the world largest pension fund, searched for a correlation between MSCI and FTSE on ESG ratings among 430 Japanese companies and reached a conclusion of a strong disconnect between the scores provided by the two players https://www.gpif.go.jp/en/investment/pdf/ESG_indices_selected.pdf – GPIF ESG Selected Indices - Jul.

and forfeiture; and, finally, an immediate and potentially significant cost for small companies including, first and foremost, a need for new skills.

This objective is undoubtedly a critical aspect of integrating ESG into small companies, and more generally of the development of Sustainable Finance. **A gradual, voluntary approach, taking into account the specific features of SMEs, carried out by the European Union to give it the required legitimacy, should be implemented as soon as possible under the Green Deal Strategy initiated by the Von der Leyen Commission.**

C.3) Regulations that are sometimes ambitious, lacking in clarity, and largely inappropriate for Small & Mid-Caps

The regulatory constraints relating to ESG are marked by their extreme complexity and a lack of clarity. They are expressed at various levels (international, European, national or local) and in various forms (recommendations, regulations, laws or technical standards). They are not harmonised at the different international levels and are subject to rapid change. **This complexity makes it all the more difficult for small players who do not have the monitoring and research resources of large companies to take on board, monitor and anticipate regulations**. Increasing the visibility, homogeneity and certainty of regulations would undeniably encourage small companies to integrate ESG.

Generally, regulations are also poorly tailored or completely unsuitable for Small & Mid-Caps, and more broadly for SMEs and VSEs. Each regulatory mechanism relating to ESG includes a minimum application threshold (e.g., for extra-financial reporting; for the obligation to carry out an energy audit or a carbon audit; for the implementation of an alert system; or for due diligence obligations concerning social factors in supply chains). **A change in approach seems highly desirable.** Rather than excluding these companies from the regulations, which has the effect of excluding them from the associated transition dynamic, it would be better to adapt these regulations to the specific features of small companies and to provide financial and human support mechanisms to help them comply.

Finally, **the European Commission's new Action Plan for Sustainable Finance is a comprehensive, ambitious system. The first of its kind at international level, it clearly sets the EU on the path to Sustainable Finance.** As such, along with changes in the way that ESG risks are accepted by civil society, the plan is a key factor in changing the approach of financial institutions. **However, it omits two essential aspects that make both listed and unlisted SMEs a blind spot for this regulation, with an associated risk of stalled progress: the requisite support for companies in their ESG transition; and the plan being tailored to the specific features of SMEs.**

At this stage, many of the action plan's components are aimed at defining a desirable target (taxonomy in its initial version, green bond, etc.) and rewarding players who have achieved this target for all or part of their activity. However, it does not address transition issues directly, such as supporting companies in improving their sustainability, or providing assistance for companies and their employees whose activities are not sustainable. Small & Mid-Caps that do not have the resources and resilience of large companies are particularly vulnerable to these issues. Finally, the different components of the action plan have not been broken down and assessed in regard to their impact on SMIDs. This risks creating a two-tier finance industry, leading to a slowdown in the sector.

C.4) The necessary intermediation of ESG analysis is negatively affected by weak research on Small & Mid-Caps

For Large Caps, ESG is gradually becoming a complement to financial analysis in assessing medium- to long-term risks and opportunities that are poorly identified by traditional financial analysis. With this in mind, the research industry is gradually acquiring the means to provide ESG data for traditional investment universes. Large Caps also have the means to respond to requests for information and data from investors and analysts.

ESG has also gained importance for investing in unlisted securities. It is grounded in qualitative analysis based on the various ESG criteria for a given company, and carried out directly by managers in companies in which they have an interest. As these companies publish relatively little ESG information, they report the data directly to their investors via dialogue or due diligence.

The listed Mid Cap segment, on the other hand, has significant potential for improvement, whether in terms of the reporting capacities of these companies or analysis by financial intermediaries. **For ESG analysis, it is particularly dependent on the presence of intermediaries likely to engage in dialogue with the company, to pool data collection, and to provide expertise and ESG analysis on behalf of investors.** This is all the more important in the absence of standardised ESG reporting. As mentioned above, the rating agency EthiFinance currently plays a unique role in providing these data and analyses for the European SMIDs segment.

Moreover, while the regulators' intentions were commendable with regard to adopting the MiFID2 directive (better channelling of savings towards financing the economy, improved transparency, etc.), the results, in the end, seem especially counter-productive for research into actions taken by SMIDs. The SFAF's (explain in a footnote) current view is that 40% of European Small & Mid-Caps are not monitored by a financial analyst. In the current environment, traditional research on Small & Mid-Caps is unlikely to meet the needs of pooled ESG analysis, **which calls for the implementation of new schemes to strengthen a fragile European ecosystem.**

D) Recommendations to promote the application of the ESG approach for Small & Mid-Caps

D.1) Improve the accessibility and quality of ESG data at European and national level

1. *Ensure coordination between national long-term investors (in France, for example, Bpifrance, the Caisse des Dépôts et Consignations, the Pension Reserve Fund, ERAFP, etc.) to pool their ESG expertise with the aim of standardising the ESG analysis grids and promoting ad hoc investment vehicles to leverage the SMIDs sector for their migration. Expand this dynamic at the European level between the NPBIs and the EIB Group (see how to link this development with point 1)*

2. *Consider coordinating National Promotional Banks and Institutions (NPBIs) and the European Investment Bank (EIB) Group at the European level to create a minimum base and standardised ESG indicators.* The aim would be to encourage the systematic production of these data by SMIDs in which Long-Term Public Investors and the EIB Group invest. The purpose of creating this minimum base would be to provide an initial common basis for ESG information. It would also seek to promote dialogue with SMIDs on ESG issues and their specific features. The work of the FranceInvest's ESG commission could be considered from this perspective[11]. These indicators and their specifications would be in the public domain and could be taken up voluntarily by all stakeholders.
3. *Bring together national (auditors, national central banks, accounting and financial associations, etc.) and European (EBA, EFRAG, ESMA, Eurostat, European Central Bank, etc.) public opinion leaders as part of a common normative process* for the production of ESG indicators.
4. *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.
5. *Promote the emergence of extra-financial reporting with similar levels of comparability and quality to financial reporting.* Include the forthcoming revision of the Extra-Financial Reporting Directive in this goal and take the specific features of SMIDs into consideration in these developments. This framework would provide ESG data from which the various stakeholders can build their analyses. It must be able to combine comparability and relevance by taking into account the specific features of the companies' sectors, the size of the companies, and the material nature of the risks. SMIDs and SMEs that are not generally listed should not be excluded from this framework. Rather, they should benefit from a system based on proportionality.
6. *Promote the automation of ESG data collection and the provision to SMIDs of input, display and transmission tools for ESG indicators.*

D.2) 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: communication media, methodological materials (general approach, challenges by sector, reporting), regulatory oversight, training materials.
8. *Identify, mobilise and strengthen structures offering support for SMIDs:* consular chambers, professional branches, local authorities, accounting and financial professions, financial intermediaries, grants, etc.
9. *Set up a transition support fund* that can provide financial resources at the various stages of the implementation of an ESG approach: assistance in constructing an ESG approach (strategy, training, methodology, reporting, etc.); assistance in ensuring compliance with specific regulations; assistance in the transition of operations and in improving ESG performance.

D.3) 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;* e.g. by setting up a market round table or involving public players. In general, ensure that the rating agencies take into account economic, cultural or regulatory elements that are specific to the European context.
11. *Restore research capacities for SMIDs and promote the integration of ESG assessment in this research.* This can be achieved as part of the MIF2 review and, for example, through public funding in the form of a tax or regulatory incentive associated with the need to integrate ESG findings into this research.

D.4) 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 European stock market section* to provide benchmarking and visibility for investors.
14. *Promote "impact" financing that combines financing and support* (performance improvement, support services), for instance via tax or regulatory incentives.

Next Steps

This report provides an initial analysis of the heterogeneity of the French Small & Mid -Caps sector's preparation for the major ESG transition. If this heterogeneity continues, it could threaten the existence of many companies facing insurmountable difficulties in adapting their investment model due to lack of information and resources. Ultimately, these companies could face massive funding problems as investors and bankers turn their backs.

The European desire to become one of the main Green Powers justifies the fact that this key component of its economy receives special treatment and extensive support to ensure a successful migration. This is a key element of its future growth that requires competitive SMEs and compatible ESG.

Based on this initial observation concerning a Member State (France) that the group wishes to share, it would be useful to create a European-level ESG/SMIDs forum to enable, in particular, an exchange of good practices (survey of experiences and reproduction) as well as the harmonisation of methodologies and instruments

[11] France Invest, Commission ESG: Recommandation pour faciliter le dialogue entre GPs et LPs – October2019.

to support the development and communication of transition strategies. The Eurofi conference in Berlin in September 2020 will be an opportunity to discuss this topic and to mobilise both its public (primarily European institutions, opinion leaders, regulators, etc.) and private players (rating agencies, brokers, investors, lenders, market companies, etc.) at both the domestic and EU levels.

This ESG SMID initiative aims to propose an industry-wide approach to promote the adoption of ESG approaches in the Small and Mid-Cap sector.

Today we are presenting the report related to the initial phase of the initiative, that focused on:

The analysis of the entities concerned, the investment potential for each business sector and the ESG issues associated with these sectors;

The identification of the drivers and obstacles for the development of ESG for Small and Mid-Caps;

The identification of possible proposal for industry-wide initiatives to promote the adoption of possible ESG approaches for Small and Mid-Caps.

In the Eurofi context, the initial phase of the initiative focused on the French financial market ecosystem. This phase has been driven by a working group with representatives from CDC Croissance, Ethifinance, Eurofi, Euronext, Novethic, and PwC, as well as Tradition.

The initiative will now be extended at the European level. ●