ESG: the key to unlocking opportunities in Small Caps

INSIGHT

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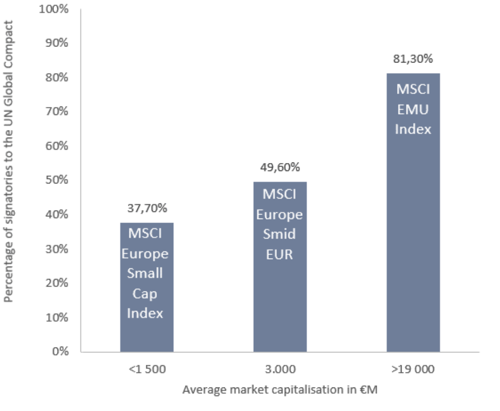
While ESG rating coverage differs among traditional third-party ESG rating providers, small and mid-cap companies generally have lower ESG ratings than larger market capitalization companies. In this paper, we explain why, given the specificities of the small cap segment, a combination of "best-in-universe " and "best effort " approaches with an internal rating scale based on ESG analysis may be beneficial. We believe that such an approach eliminates size and information bias, which is essential for risk mitigation and value creation in the small cap segment. This text is based on many years of ESG research at ODDO BHF Asset Management.

1. Traditionally, small cap companies tend to allocate fewer resources to ESG topics, primarily because they are in a different financial maturity cycle than larger companies.

Our analysis shows, that the higher the market capitalization of a company, the greater the likelihood that it will be a signatory to the United Nations Global Compact (UNGC). UNGC is a voluntary initiative based on CEOs committing to implement universal sustainability principles and take action to support the UN's goals. While 81.3% of companies with an average market capitalization of more than €19 billion (MSCI EMU Index) are signatories to the UNGC, only 37.7% of companies, with an average market capitalization of less than €1.5 billion (MSCI Europe Small Cap Index), are signatories. Companies that have joined the UNGC are required to submit an annual Communication on Progress (COP), which is an environmental, social and governance report. This accountability and reporting commitment can be a barrier to membership for small caps, even though the ten principles of the UNGC that focus on human rights, labor, environment and anti-corruption are often incorporated into national practices and European laws in which small caps operate.

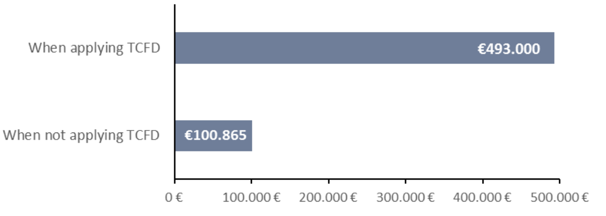
Figure 1: UN Global Compact signatories by company market capitalization



Source: ODDO BHF AM SAS, Sustainable Investment Reports, Data as of 31/03/2021

A public consultation from the European Parliamentary Research Service based on 80 responses shows that the average cost of fully applying a non-financial reporting standard or framework is EUR 100’865 per year, with the highest cost being at EUR 493’000 per year when applying the Task Force on Climate-related Financial Disclosures (TCFD) to improve and increase reporting of climate-related financial information. This shows how challenging it can be for small caps to disclose efficiently on ESG topics as their annual revenue levels is traditionally around EUR1bn and they need to hold a balance between growth opportunities, R&D investments, profitability improvements and publications. The EU Non-financial Reporting Directive from 2014 (Directive 2014/95/EU) is being reviewed. There is strong support for the use of a simplified version of the standard for SMEs, but it remains to be seen whether this will solve the problems of comparability, reliability and relevance for the small cap segment, which is by definition difficult to standardize because it is so vast and diverse in terms of sectors, themes and countries.

Figure 2: Average cost per year of fully applying a non-financial reporting standard or framework



Source: ODDO BHF AM SAS, European Parliamentary Research Service, January 2021

Sustainability budgets offer much more room for manoeuvre for large companies. This is traditionally due to their greater financial flexibility. In December 2020, Nestlé published a detailed, time-bound plan to halve greenhouse gas (GHG) emissions by 2030 and achieve net zero emissions by 2050. The plan calls for a total investment of 3.2 billion Swiss francs over the next five years. As the company explains, these investments will be profit-neutral as they will be financed mainly through operational and structural efficiencies. It is hard to imagine such a non-dilutive investment in the small cap segment.

Figure 3: Summary of Nestlé’s key ESG investment initiatives/budget

Amount (mn)		Timeframe	Description
CHF	3,200	2020-2025	Net Zero Roadmap to achieve carbon neutrality by 2050
CHF	1,500	2020-2025	Create a market for food-grade recycled plastic, i.e. by paying a premium for food-grade recycled plastics NESN intends to create a market and to ensure that there is enough supply
CHF	250	2020-2025	Sustainable packaging venture fund to invest in 1) companies which provide innovative technologies for packaging and recycling; 2) larger enterprises which will help to build better supply of food-grade plastics and materials
CHF	78	2019	Sourcing coffee responsibly: Nescafé Plan and Nespresso AAA Sustainable Quality Program invest to improve coffee economics for farmers by helping them increase productivity, optimize costs, and promote alternative sources of income. Nestlé invested CHF350mn in Nescafé Plan since its inception.

Source: UBS European Food & HPC. What do consumers think of ESG? 26 April 2021

2. Private founders or management tend to hold a significant stake in small and medium-sized companies.

Stakeholder alignment traditionally leads to strong and sustainable returns and keeps companies on a growth path. This key characteristic of the small cap segment often penalizes governance ratings that favor board independence and minority shareholder rights. We explain below that the "agency problem" is less decisive in the small-cap segment and that stable insider shareholders can be an advantage, according to our analysis.

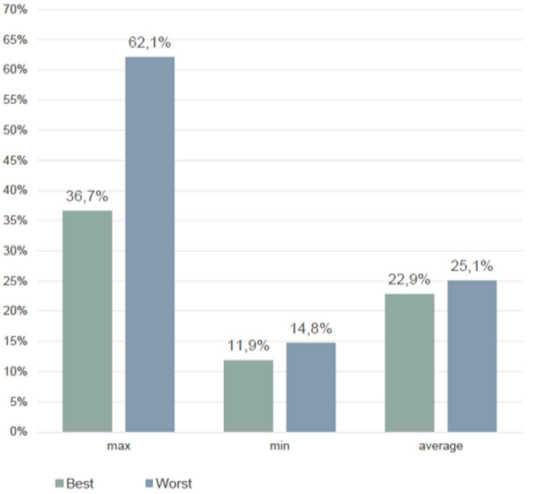
Using ESG data from third-party rating providers alone gives an incomplete and distorted picture with a bias toward large companies in general. We believe it is particularly beneficial for an asset manager to develop an internal ESG research analysis, and active ownership model in addition to data from third-party ESG rating providers. One way around this ESG issue is to combine 2 approaches: "best-in-universe", where the management team favors the highest rated issuers, regardless of size or industry, and "best effort", where the management team values the progress made by issuers over time, through direct dialogue with them. In addition, it is essential for an asset manager, through a stringent process of dialogue and engagement, to regularly encourage companies to disclose more information on the key E, S and G factors in order to better track progress.

Based on numerous years of research, we believe that a focus on corporate governance and human capital has the potential to bring long-term value to all stakeholders, particularly in the case of small caps. In the following, we outline our approach on human capital, corporate governance as well as active ownership and explain why these three pillars are so important when investing in small caps.

3. Corporate Governance may be a key source of risk mitigation.

We believe that a company with good governance is more likely to deal effectively with the most important risks, including environmental and social issues. In a study from September 2019, we demonstrated that the 3-year volatility of the highest rated STOXX Europe 600 stocks in terms of corporate governance is lower than that of the lowest rated stocks in different market regimes, when measured with our proprietary research model. This compares with the 3-year average volatility of the Stoxx 600 of 24.9%.

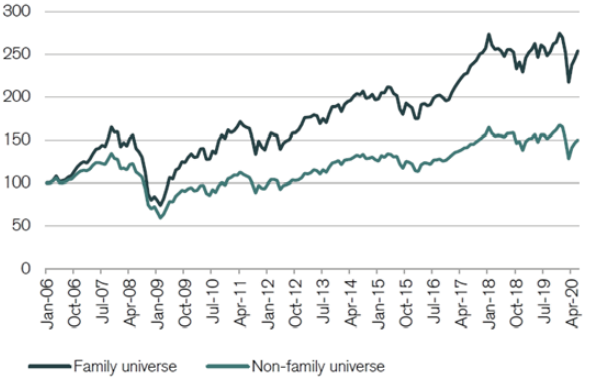
Figure 4: Corporate Governance may be a key source of risk mitigation



Source: ODDO BHF AM SAS, Best = 129 companies | Worst = 79 companies based on our proprietary research model. Factset as of 30/09/2019

Stakeholder alignment traditionally leads to strong and sustainable returns and keeps companies on a growth path. Private founders or management traditionally hold a significant stake in many small and medium-sized companies. For the sake of simplification, we focus thereafter on so-called family companies. According to KPMG International, family businesses represent, throughout Europe anywhere from 55–90 percent of businesses, depending on the country. The number is the highest in the small cap segment. The CS Family 1000 report focuses on the performance of family-owned companies (companies with a minimum threshold of 20% "founders or descendants “) on a sector-adjusted and market-capitalization-weighted basis – labeling their outperformance “family-owned alpha.” According to the September 2020 report, family-owned companies have outperformed their non-family-owned counterparts by an average of 370 basis points per year since 2006, highlighting the positive impact of stakeholder alignment.

Figure 5: Family returns relative to non-family companies overall since 2006.
The ‘family owned alpha’ shows a performance of 370 basis points per year.



Source: The CS Family 1000: Post the pandemic, Credit Suisse Research, September 2020

The ‘agency problem’ is less of an issue at small businesses. High insider participation can be a double-edged sword. The ‘agency problem’ arises when the interest of the management (agent) may not be wholly aligned with the shareholders. Critics focus on the risk that corporate insiders will take advantage of powerless shareholders for their own financial gain. This challenge is magnified at larger companies. In the case of small caps, independent analysis shows that a significant equity stake by a private founder or by management may be conducive especially in the expansion phase of the business cycle. We believe that at smaller companies there is greater scope for individuals at the top to have direct knowledge across a business. According to the CS Family 1000 report of September 2020 the ‘family owned alpha’ since 2006 has been overall the greatest for smaller companies with a market capitalization of less than USD 3 billion. In Europe, small family-owned companies showed over the period an annual average return of 6,2% outperforming by more than 3% large family-owned companies according to the CS report. Based on these figures, we conclude that high insider participation in the small cap segment can be a source of performance. Traditionally, it brings stability, allows long-term vision and may even enhance financial discipline if surrounded by solid governance measures.

Figure 6: Family returns relative to non-family companies by market cap and region since 2006.
The ‘family owned alpha’ has been overall the greatest for smaller companies.

	Annual average since 2006			
	Overall	**Small**	**MId**	**Large**
Global	3.7%	6.5%	3.9%	3.1%
Europe	4.7%	6.2%	3.9%	3.0%
North America	2.6%	2.3%	3.0%	1.5%
APxJ	5.0%	4.3%	2.9%	4.5%
Japan	9.2%	13.8%	1.6%	11.8%
EMEA	3.5%	–0.5%	11.9%	2.5%
Latam	3.7%	6.5%	3.9%	3.1%

Source: The CS Family 1000: Post the pandemic, Credit Suisse Research, September 2020

To ensure that stewardship is always in focus, a small cap asset manager must pay particular scrutiny to the governance objectives of each company. This means understanding in detail its ownership and control structure, the composition and diversity of its board of directors, and how succession planning is managed. The analysis should be extensive and include details on the composition of governance subcommittees such as audit, compensation, and nominating committees, as well as any oversight mechanisms.

Figure 7: ODDO BHF Asset Management's rating grid of Corporate Governance:

1 Minority Shareholder Rights

- One share / One vote
- Poison pill

2 Top Management

- Separation of functions
- Organization of the succession
- Remuneration policy

3 Board of Directors

- % of independence
- Composition & experience
- Committees

4 Internal Audit & Financial Communication

- Accounting debates / irregularities
- % of non-audit fees
- Access to top management
- Track-record & profit warning history

Source: ODDO BHF AM SAS, 30/09/2019

Examples of investee companies in the small cap segment whose stable ownership structure has provided resilience and long-term value for all stakeholders over the cycle:

CEWE Stiftung & Co. KGaA , a German photographic prints processing firm, famous for its successful transformation into a digital company, and its accretive takeover of customer friendly apps, is a good example for an investee company that scores high on innovation, positive human capital and value creation over the long term. Its shareholding structure includes the 27.4% participation of the heirs of the founder, the largest shareholders since 2007 which provided stability during the growth and acquisition phase as well as during the recent pandemic crisis.

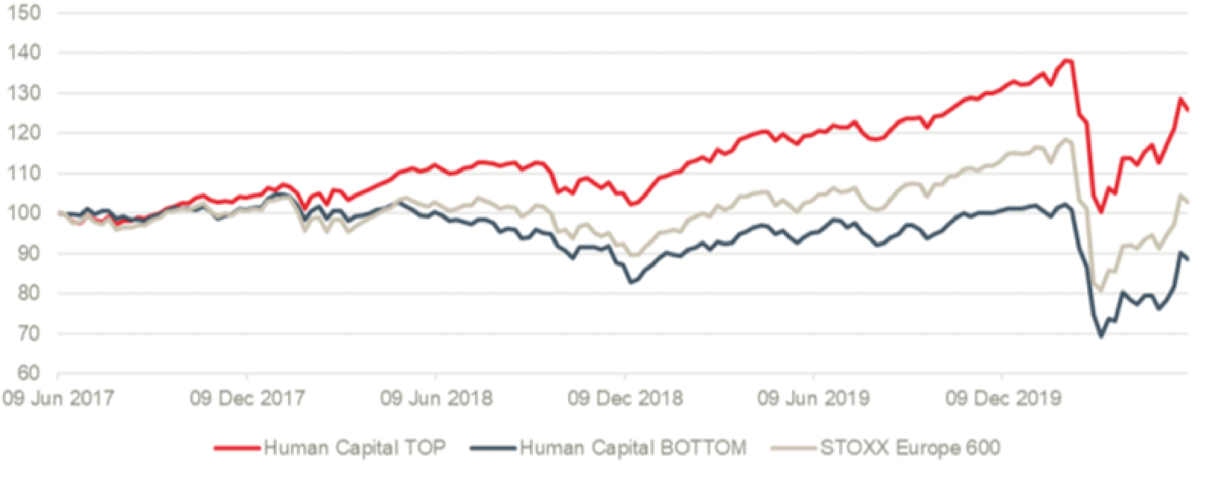
Plastic Omnium SA was founded by the Burelle family, which still holds 59.4% of the innovative French automotive supplier. The family plays a key role in its long-term stability, including the recent succession settlement of its CEO.

4. Human Capital (part of the Social factor) may be a driver of innovation and long-term performance, particularly in the small cap segment, according to our analysis.

Human capital is defined by the OECD as the knowledge, skills, competencies and attributes embodied in individuals that facilitate the creation of personal, social and economic well-being. At ODDO BHF Asset Management, human capital has been a key source of companies' sustainable growth since the start of our research work and its analysis is at the heart of our proprietary ESG research method. Human capital is a key factor in determining the building of sustainable competitive advantages and thus the ability of a company to create value for its shareholders and all its stakeholders.

Of the 700 companies covered by our proprietary research model as of June 2020, we identified those that are the top rated (4/5 or 5/5) in the "human capital" pillar and that also have a good overall ESG score (4/5 or 5/5). The 101 companies meeting these criteria are in the "TOP" basket. We also looked at the performances of companies rated the lowest in our model (1/5 or 2/5 in the "human capital" pillar, as well as the overall ESG score): 49 companies meet these criteria and comprise the "BOTTOM" basket. As our research focuses mainly on European mid and large caps, it makes sense to compare the performances of these two baskets with the DJ Stoxx Europe 600. We found a very significant outperformance by the "TOP" basket in the past three years (+25.8%), vs. both the Stoxx Europe 600 (2.9%) and the "BOTTOM" basket (-11.5%). This would tend to confirm that good human capital management is a source of performance and superior value creation in the medium and long terms, while, conversely, a subpar strategy in human capital management could have a harmful effect on companies' financial performances.

Figure 8: Compared performances of "TOP" and "BOTTOM" baskets of the 'human capital' pillar over three years.

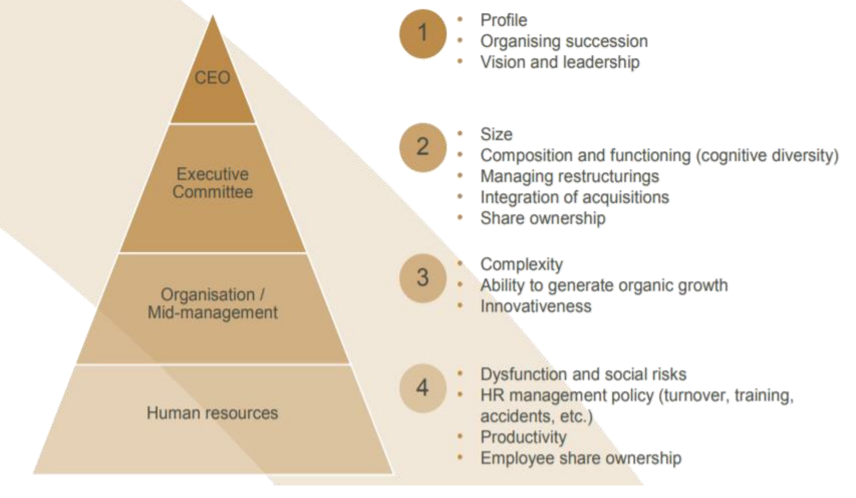


Source: ODDO BHF AM SAS, Human Capital a key factor in resilience and differentiation, November 2020

Past performance is not a reliable indication of future return and is not constant over time

We believe that a successful human capital model should include both quantitative and qualitative data and review the most important criteria across the organization along 4 axes: the CEO, the executive committee, the middle organization and human resources.

Figure 9: The four Human Capital research avenues according to our analysis



Source: ODDO BHF AM SAS, Human Capital a key factor in resilience and differentiation, November 2020

Innovation makes the difference between a leader and a follower said Steve Job. Some small companies are among the world's most innovative and often the driving force behind disruptions. It is often by investing in small companies that investors can gain exposure to a new technology or a new market driven by innovation. Innovation is the creation, development and implementation of a new product, process or service in order to achieve strategic objectives, improve competitiveness and create value. Small caps are traditionally more nimble, less encumbered by layers of management and less concerned about losing sales volumes or market share by introducing new products, a major problem for larger, established companies.

The most difficult part of innovation is creating value propositions that resonate with customers and finding the right business models for profitability. Independent analysis shows that having great technology and new products doesn't guarantee return. A study by the consulting firm Simon Kucher & Partners shows that 72% of all new products fail to meet their revenue targets. Therefore, the asset manager needs to look at many additional factors beyond the usual measure of R&D spent as a percentage of revenue. The manager should focus on criteria such as the possession of adequate professional skills, the number of innovation projects launched, new ideas in progress, good staff relations, adequate organizational technology, the ability to attract and retain the best professionals, etc... Finally, after assessing the commercial potential of innovations, it is key to evaluate the company's ability to monetize innovations and maintain high barriers to entry to protect the development against competitive peers. To this end, portfolio managers should meet regularly with companies, monitor their progress, and audit management teams to assess how they are executing their plans as they grow.

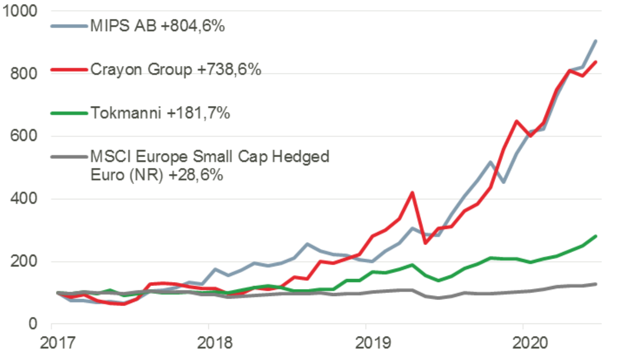
Examples of highly innovative, value-creating companies with real human capital strengths according to our analysis:

MIPS AB is a leading Swedish developer of patented safety technologies that can be integrated into all types of helmets to protect the head and brain in case of a fall. Its technology is disruptive and its management scores very high thanks to its capacity to protect the brand, its health and safety policy and the very transparent supply management system in place.

Crayon Group Holding ASA is a very innovative software asset manager from Norway that selects, advises and manages software for its customers. The company is a preferred partner of Amazon and Microsoft for cloud computing solutions and stands out in terms of quality of management and corporate governance.

Tokmanni Group Oyj is Finland's largest low-cost retailer, which offers very attractive consumer products in all its channels. The company attaches great importance to responsible sourcing and has a clear roadmap to increase the transparency and traceability of its supply chain, including increased certification and regular audits of its suppliers.

Figure 10: Innovation as a key performance driver illustrated with 3 companies compared to the index MSCI Europe Small Cap



Source: Source: ODDO BHF AM SAS, Bloomberg as of 23/04/21

5. In the small cap segment in particular, dialogue and shareholder engagement can have a substantial impact on company strategy and ESG commitment.

Active ownership is the active exercise of shareholder rights in a company, including active engagement with management and discussion of financial and non-financial ESG factors. An asset manager has regular active discussions with various investee companies, which may include dialogue with concrete ESG improvement targets. It determines the growth potential of companies and also seeks to understand whether management has identified potential ESG gaps and how these can be addressed to create long-term sustainable value and a positive transition trajectory. It should engage with company management and boards, and also visit company sites to observe the production process, talk to employees, observe interactions and the company culture.

Furthermore, an asset manager should regularly encourage companies to disclose more information on key E, S and G factors in order to better track progress. This includes, for example, ODDO BHF's participation in the CDP disclosure campaign, which encourages companies to disclose information on their climate strategy and to report on their emissions footprint. Controversy analysis (industrial accidents, pollution, corruption convictions, anti-competitive practices, product safety, supply chain management, etc.), should also be integrated into a proprietary ESG model and directly influence the ESG rating of each company. Collaborative engagement can be an effective way to achieve concrete and measurable results within a reasonable timeframe. There are several collaborative initiatives that an asset manager may join, both locally and internationally.

Figure 11: ODDO BHF AM's Active Ownership & Dialogue policy

ENGAGEMENT FOCUS

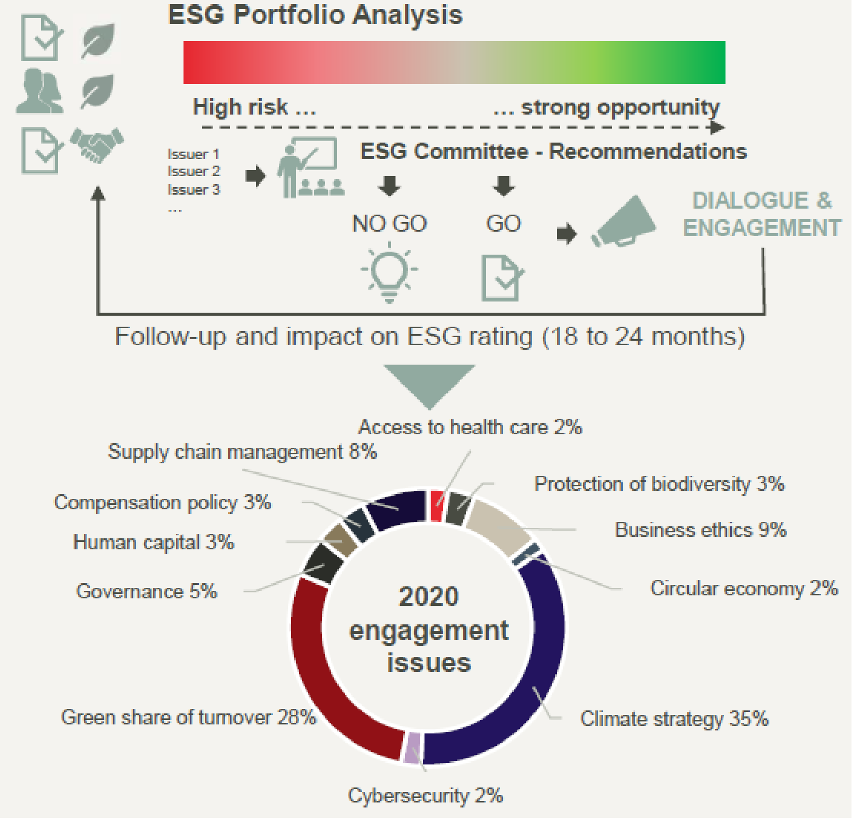
1. Identification of Key Engagement Issues	2. Preparation of Company Meeting	3. Company and Stakeholder Dialogue	4. Monitoring & Reporting of Meeting
• **Identify companies** in which we have invested with a long-term perspective and within a multi-strategy context • **Define engagement KPIs** in line with: o portfolio manager priorities for long term value creation o events at a specific company and/or sector level o (time)-sensitive issues for the sector	• **Define and communicate approach** for company interaction including level and expertise of contacts • **Establish process for individual and collaborative engagement and dialogue:** o approach and inform about ESG issues o communicate engagement objectives o align on desired outcomes	• **Provide regular updates on ESG progress:** o discuss key issues o communicate expectations and desired outcomes on vs a reliable timeline o agree on next steps / targets and potentially future meetings • **Participate in stakeholder dialogue** with other investors and through membership organizations	• **Document and monitor next engagement steps** as agreed with the company and other stakeholders • **Include engagement outcomes in regular reporting** to ensure transparency on active ownership and stewardship dialogue • **Share best practices in** collaborative engagement groups and incorporate learning from other engagement experts
ESG TEAM + PORTFOLIO MANAGERS	ESG TEAM	ESG TEAM	ESG TEAM + PORTFOLIO MANAGERS

RESPONSIBILITY

Source: ODDO BHF AM SAS, Sustainable Investing, April 2021

Our approach focuses on improving business practices and transparency on environmental, social and governance issues of the companies. To this end, we hold over 500 meetings a year, engage in dialogue with concrete ESG improvement targets with various investee companies and exercise our voting rights aligned with the investment thesis and any stewardship agenda.

Figure 12: Individual engagement at ODDO BHF AM



Source: ODDO BHF AM SAS, Sustainable Investing, April 2021

It is not about shareholder activism, but about engaging in dialogue with companies when necessary and dealing with issues on an individual basis. We are convinced that efforts to make progress on non-financial issues can create long-term value for all stakeholders. Our engagement process consists of systematically identifying and establishing explicit areas where we expect progress, allowing us to monitor and evaluate the results achieved. It is considered successful if dialogue with an issuer leads to greater ESG transparency and/or improved ESG practices within 18 to 24 months. If the engagement is not successful (the dialogue proves to be non-existent or unsatisfactory), our fund management teams may decide to exclude the issuer from the investment universe or, if an active position is already held, to dispose of it. Our engagement policy is implemented by our ESG Integration Committee, which meets quarterly. Its members include the head of ESG research, the chief investment officer (CIO), heads of portfolio management expertise, and the chief risk and compliance officer.

Examples of our growing company engagement at ODDO BHF Asset Management in the small cap segment:

Aluflexpack is a Swiss company that produces flexible packaging solutions primarily for the coffee/tea and pharmaceutical end markets. ODDO BHF Asset Management has been in regular dialogue in order to motivate the company to further increase its transparency regarding its end-market exposure and social disclosures. The management's efforts and progress were well received by the stock market.

A similar dialogue was initiated with **Almirall S.A.**, a Spanish company in the pharmaceutical sector where according to our analysis, transparency is lacking on the control, audit and selection procedures of its suppliers with the objective to see an increase of sustainable factors. Almirall is in the process of reviewing and finalizing these issues with the recent nomination of the new CEO.

One form of escalation of engagement is disinvestment. This was recently the case with the Belgian/Dutch company **Fagron NV**, a healthcare products and services supplier who was not able to show progress in the transparency of its supply chain in South America, raising questions on possible social issues according to us.

The small cap segment is unique and therefore requires, in our view, a combination of a "best-in-universe" and "best effort " approaches with an internal rating scale based on ESG analysis, in addition to traditional third-party ESG rating providers, to be fully exploited. Such an approach eliminates size and information bias in the stock selection process. Our extensive analysis over the past 15 years shows that the two pillars of corporate governance and human capital are critical to risk mitigation and value creation in the small cap segment. In the small cap segment in particular, shareholder engagement can have a substantial impact on company strategy and ESG commitment.

None of the aforementioned companies constitutes an investment recommendation.