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EQUITIES

ESG in Smaller Companies: An Overlooked Opportunity?

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BARINGS INSIGHTS

When it comes to ESG, smaller companies have their own unique challenges—which can also provide opportunities for active managers to identify unrecognized growth and undervalued companies.

Following the turbulent events of 2020, smaller capitalization equity markets have rebounded markedly. There are indeed a range of reasons for this recovery, from optimism around progress in vaccination programs to economic re-openings to ongoing support from governments. In particular, highly cyclical sectors that were heavily impacted by the lockdowns—such as commodities, mining and energy—have led the recovery. While quality companies with good growth prospects have more recently regained momentum, fundamental factors, including environmental, social and governance (ESG) considerations, have in some cases taken a back seat to cyclical growth as the economy has re-opened.

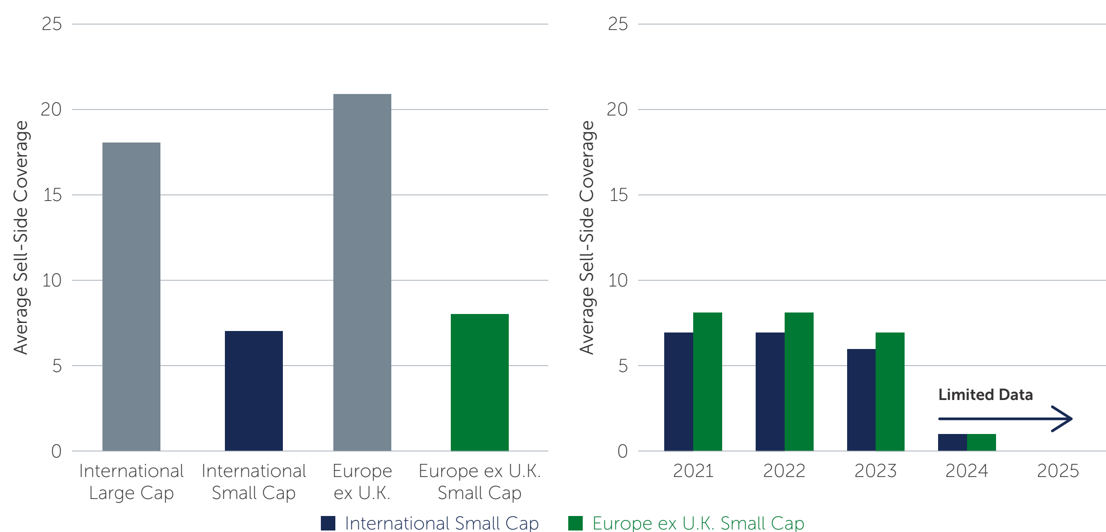
In our view, this set of circumstances has created a compelling opportunity for long-term, fundamental investors to uncover unrecognized growth and undervalued companies in the smaller company equity universe. And we believe ESG factors will play a significant role in this—particularly given the increasing regulation and investment focused on climate change mitigation around the world, from the Paris Climate Accord to the EU Green Deal.

The Challenge

A LARGE UNIVERSE OF UNDER-RESEARCHED COMPANIES

With roughly 1,000 companies in the European small-cap index and around 2,300 in the international small-cap index—and many more not included within these standardized benchmarks—there is an abundance of potential investment opportunities. But the size of the investment universe also presents a challenge in terms of coverage—indeed, there tend to be far fewer sell-side analysts covering each stock, and the information and earnings forecasts that are published often focus solely on the shorter term **(FIGURE 1)**. While this lack of coverage speaks to the challenge of investing in smaller companies more broadly, it also translates into less comprehensive coverage of ESG factors.

FIGURE 1: Smaller Companies Have Lower Sell-Side Coverage and a Short-Term Focus



SOURCE: Barings, MSCI, Factset. As of June 2021.

Compounding this, ESG data from third-party providers can vary widely. While there is a greater amount of information on governance and environmental factors, data on social issues, while improving, remains relatively scarce. Even so, because ESG is not a straightforward topic, a one-size-fits-all approach rarely works—meaning third party data, even when it does exist, is often more helpful as an input for consideration than as a comprehensive measure of a company's ESG profile. Again, this is more of an industry-wide issue than specific to smaller companies, but can nonetheless make it challenging to quantify and score ESG factors and compare them from company to company.

FEWER RESOURCES DEDICATED TO ESG

Smaller companies may also face challenges when communicating and addressing ESG issues. After all, smaller companies will tend to have more limited resources available to assess, disclose and report on ESG and sustainability issues, compared to their large cap counterparts. When the required disclosures and ESG regulations are rapidly developing and being enhanced, for all companies irrespective of size, smaller companies may face disproportionate burdens. As a consequence, smaller companies, particularly those without a large or dedicated team covering sustainability issues, may struggle to produce supplemental or more in-depth ESG data, and may report fewer disclosures. The EU Taxonomy[1] declaration, a proposed classification aimed at helping to identify sustainable investments, is an example. While this will have the positive impact of helping to prevent greenwashing, and should assist investors in making more sustainable or ESG-oriented investment decisions, the time and resources required of companies to provide the appropriate data, and the more limited access to policymakers and regulators, may adversely affect smaller companies' positioning under the developing Taxonomy rules. As a result, some smaller companies may end up having apparently weaker ESG profiles than are warranted.

The Opportunity

While these challenges should not be underestimated, they can also present opportunities to identify unrecognized growth and undervalued companies. Due to the information gaps that exist across the smaller companies universe, for instance, there are often opportunities to identify good companies—with strong management teams, good long-term prospects and positive ESG outlooks—that are undervalued in the market. In our view, active managers that have the resources and breadth to take a deep dive into this large and diverse universe are particularly well-positioned.

Opportunity in Action

A Finnish packaging company has revolutionized its sustainability strategy in recent years. While it still has some exposure to single-use plastic, the company has set clear sustainability targets, introduced innovative packaging products using sustainable materials, and become very thoughtful in how it recycles. In our opinion, the company has solid fundamentals and significantly improving ESG credentials—and looks poised for strong long-term growth—but its share price today does not yet reflect this story.

1. According to the European Commission, EU rules on non-financial reporting currently apply to large public-interest companies with more than 500 employees. Businesses of any size, including small companies, can use the EU Taxonomy to explain to investors or stakeholders in general whether they carry out or plan to carry out Taxonomy-aligned green activities. Disclosures are only mandatory for large companies within the scope of the CSRD, but many small companies and businesses could find it useful to disclose the Taxonomy alignment of their activities on a voluntary basis.

Given the challenges that smaller companies face when it comes to dedicating significant resources to sustainability efforts, there is a perception that they have been slower to adopt ESG relative to their larger counterparts. But in reality, many smaller companies are doing much more when it comes to sustainability and ESG than meets the eye. And again, we believe these unrecognized or overlooked efforts often create strong potential for longer-term growth—setting the stage for upgrades to company quality profiles and significant improvement in share prices.

Opportunity in Action

We are seeing ambitious targets being set across the globe by governments and corporates alike aiming at reducing emissions. Buildings—both existing and those under construction—are one of the largest consumers of energy in Europe and are responsible for over one third of EU emissions. In fact, the majority of buildings in the EU are not energy efficient. In our view, this is creating a huge opportunity for smaller companies that are supporting this requisite renovation wave. Companies that we are particularly excited about in this space include a Dutch company offering energy efficient underfloor heating systems, a Danish company that is a leader in environmentally-friendly insulation technology, and an Austrian business that offers energy efficient wall systems and insulated panels. We believe that the market opportunity in these new construction and renovation businesses is currently underestimated. Moreover, the strength of these companies' competitive advantage—and therefore the potential share of the market they can win—is being overlooked.

Due to these companies' smaller size, there is also, often, a more meaningful opportunity for engagement. In our view, engaging in frequent, in-depth conversations with management teams—rather than simply excluding companies that do not 'tick the box' on paper—not only offers a better sense of whether a company is moving in the right direction (or not), but also presents opportunities for value creation. The smaller capitalization equity markets is prime for engagement, for a few reasons. For one, investors tend to have better access to management teams than is sometimes the case with larger companies, meaning there is often greater ability to engage with key decision-makers to drive positive, long-term change. Additionally, because of their smaller size, these companies tend to be more nimble when it comes to making changes.

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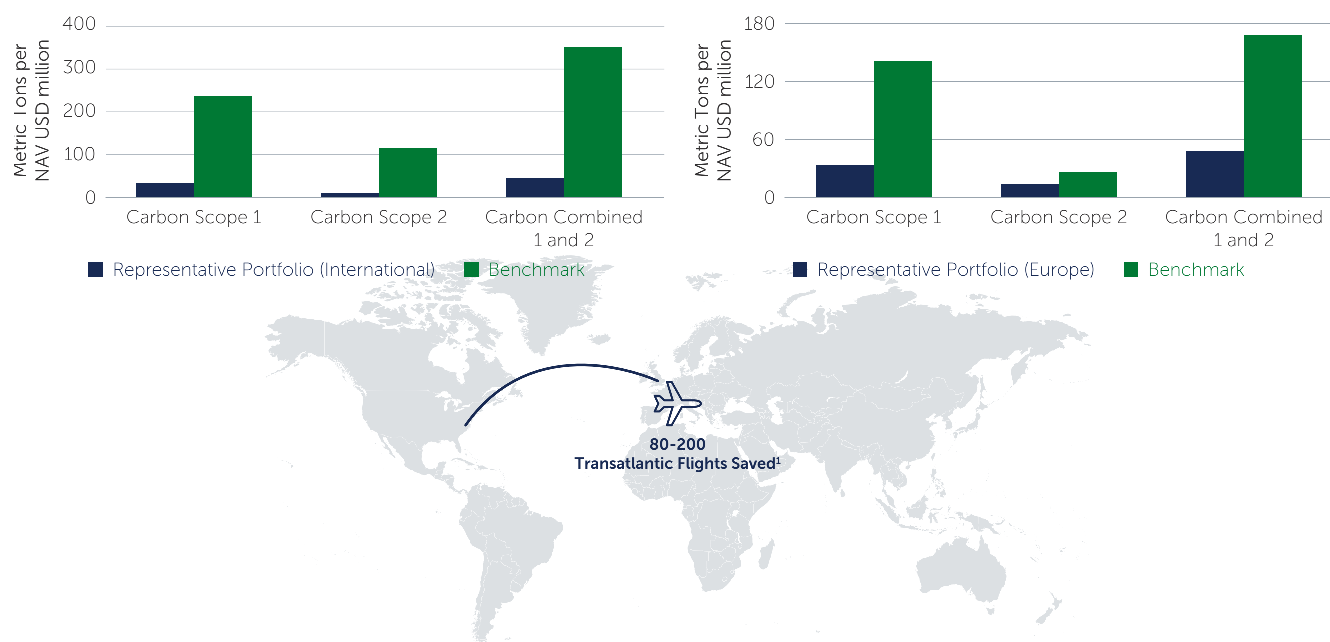
Barings' Approach: Seeking Superior Risk-Adjusted Returns & Better ESG Practices

At Barings, we strongly believe in integrating ESG factors into fundamental, bottom-up investment analysis and decision-making, taking a dynamic and forward-looking approach to analyzing a company's ESG practices and actively engaging with management teams to improve ESG outcomes. We have also found that integrating ESG into our investment process is imperative to delivering better risk-adjusted returns over the long-term—and for each opportunity we consider, our large team of equity analysts includes ESG analysis alongside the rigorous, bottom-up analysis of other fundamental factors.

As part of our ESG integration process, we have developed processes and tools that enable us to look at our portfolios in a holistic way—not only across smaller companies, but also across our broader equity platform. For instance, we have the ability to generate an ESG profile for a particular strategy that looks across a range of environmental, social and governance factors—from emission reduction targets, to child labor bans, to the percentage of female directors on a company's board—and compares them to the relevant benchmark. In addition to helping us ensure we're investing in the right companies from an ESG perspective, this also allows us to identify gaps in our data and focus our engagement on the areas where we believe it will be most impactful.

We have also developed a tool that allows us to look at carbon emissions specifically, not only in our own portfolios but also relative to the benchmark. And because we are active managers, we have the flexibility to carve out of our portfolios some of the higher-polluting, carbon-emitting companies in the space. For this reason, the carbon footprint from our smaller capitalization equity strategies are significantly lower than that of their relevant benchmarks. This means that there is a lower carbon intensity per unit of dollar, for every dollar invested—and that investing in our active strategies vs. a passive ETF is equivalent to saving between 80–200 one-way flights across the Atlantic **(FIGURE 2)**.

FIGURE 2: Carbon Footprint (& Savings) vs. the Benchmark



SOURCE: Barings, Sustainalytics. As of June 30, 2021.

1. 80–200 flights are saved per $1 million invested in the strategy. Calculation is based on Carbon Independent's estimate of 1.5 metric tons of CO2 for a one-way flight from London to New York. We perform carbon analysis to compare the portfolio vs. the benchmark based on scope 1 and 2 emissions. This analysis uses carbon emissions data from 3rd party data providers, as well as Barings' own estimates based on the company's sector, geography, and size. To calculate the portfolio carbon footprint, we compute the carbon emissions per share for each held company, multiply by the number of shares the portfolio holds, and then sum across all held positions. The carbon footprint shown is scaled to a NAV of $1 million. We apply the same methodology to the benchmark.

As things stand, ESG risks do not appear on a company's balance sheet and therefore may not be evident or quantified through traditional fundamental financial analysis. However, using our ESG framework, we incorporate the insights and data we collect on a company both into our qualitative assessment of a company and into our proprietary cost of equity model, which can result in a higher or lower required cost of equity—and by extension, a more or less attractive valuation. In allowing us to quantify ESG risks and giving us a more holistic view of a company's current state and outlook, this approach positions us to deliver potentially superior risk-adjusted returns over time, as we also strive to create a better long-term outcome for people and the planet.

Key Takeaway

Smaller companies often operate in niche/specialist areas that are too small to attract significant interest from new entrants. But these exciting niches are precisely what make the small-cap asset class so compelling, particularly when considering the strides many companies are taking when it comes to ESG. Moreover, because small businesses by nature tend to be more nimble than their larger counterparts, they typically have the flexibility to quickly respond to changing market conditions and regulations, whether ESG-related or otherwise. For these reasons, and considering the diversity of this vast universe, we believe small-caps continue to provide a wide range of stock selection and growth opportunities—and active managers with significant breadth and resources are particularly well-positioned to uncover overlooked opportunities.

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