At an Inflection Point: ESG in Small and Mid Cap Equities

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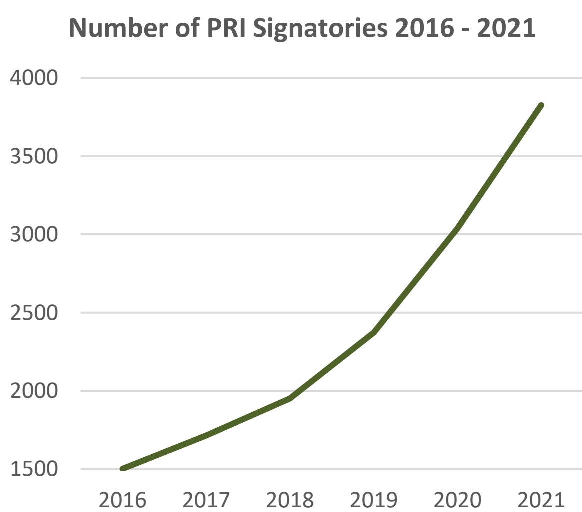
The Opportunity

Small and mid cap equities provide uniquely positioned Environmental, Social, and Governance (ESG) opportunities for investors. ESG disclosures are often lacking or incomplete at small and mid-sized companies, and many of them are not covered by ESG rating providers. The resulting ESG "information gap" requires an approach that goes beyond data-driven strategies. And as the market increasingly focuses on the legitimacy of sustainability claims and plans, knowledge of management quality and delivery track records- especially in under-followed small and mid cap names- becomes essential. Incorporating ESG analysis with stock-by-stock fundamental analysis can therefore be a powerful approach to uncover opportunities for value and improvement.

ESG in Small and Mid-Cap Equities: The Inflection Point is Here

Investor considerations of ESG factors continues to grow at a rapid pace. According to the Global Sustainable Investor Alliance (GSIA), approximately $35 trillion in AUM worldwide- or 36% of all professionally managed assets- employed some form of ESG strategy as of 2020. This global penetration rate shows a strong deepening trend: in 2016, 28% of global AUM employed an ESG strategy. The number of Principles for Responsible Investment (PRI) signatories- a representation of professional investors who commit to integrating ESG into their investment process- doubled during this same period. This increased global adoption of ESG is heightening attention on the topic at small and mid cap companies.



Source: Principles for Responsible Investment

Source: Global Sustainable Investment Review

While we see small and mid cap companies moving rapidly to try to accommodate investor demands for enhanced disclosures, the starting point is a relatively low base. In addition to providing overall ESG scores on companies, rating provider ISS ESG also scores the content, quality, and coverage of a company's public reporting on ESG issues. This sustainability[1] *reporting* score (distinct from sustainability *performance* score) is done on a 12-point A-D scale. Across the globe, we see significant differences in small and mid cap reporting scores in comparison to those of large cap companies. In the US, for example, the average sustainability reporting score for small caps (the Russell 2000 Index) was an uninspiring D+, with 93% of the constituents of that index receiving reporting scores of C- or lower. By contrast, large and mega caps (the Russell Top 200 Index) have an average reporting score that is three notches higher, and only 26.7% of its constituents received reporting scores of C- or lower.

We observe similar small cap versus large cap differences in non-US indices. When we move beyond ISS ESG's assessment of company sustainability reporting and look at one of the most commonly agreed upon ESG metrics- greenhouse gas emissions (GHG)- the dichotomy persists. Nearly 100% of the MSCI EAFE index constituents report GHG data; in the small cap version of this index, however, only 54% of constituents report emissions.

	US Equity			Non-US Equity	
	Small Cap (Russell 2000)	**Mid Cap (Russell Midcap)**	**Large & Mega Cap (Russell Top 200)**	**Small Cap (MSCI EAFE Small Cap)**	**Large & Mid Cap (MSCI EAFE)**
Average ISS ESG Sustainability Reporting Score	D+	C-	C+	C	C+
% constituents with bottom third Sustainability Reporting Scores	93.0%	72.6%	26.7%	54.9%	26.4%
% constituents disclosing GHG data	15.6%	54.9%	88.3%	54%	90.3%

Sources: ISS ESG, Russell, MSCI

Assessing What Matters

Inadequate sustainability disclosures do not always equal poor sustainability practices, in the same way that extensive disclosures do not always portend favorable ESG practices. That said, limited or poor disclosures place a greater onus on investors to develop a qualitative understanding of corporate sustainability practices. While the ESG rating industry has blossomed in recent years, that purely data-driven approach limits the value brought to the small and mid cap space; it is challenging to generate quality ratings based on little to no data. We therefore advocate for an active fundamental approach to evaluate how aspects of ESG can affect the investment case for a given stock. We see four main areas where this approach can generate superior insights, especially in comparison to passive, data-driven strategies:

[1] The definition of "sustainability" used in this paper follows the convention from the United National Global Compact, which covers a range of sustainable corporate practices for environment, social, and governance business activities. Hence the term can be used interchangeably with "ESG."

1. **A more nuanced and comprehensive understanding of business models, which helps better identify areas of ESG risk and opportunity**. While data-driven approaches (such as ratings) look at ESG risks and opportunities formulaically through GICS and SICS classifications[2], growth-oriented small and mid cap companies often have business models that cut across these classifications. As such, the identification of their true ESG-related risks and opportunities requires a greater understanding of the underlying businesses. A mid cap company like Copart, for example, is classified as a "Professional and Commercial Services" firm under the SICS system used by the Sustainability Accounting Standards Board (SASB); this classification focuses on the company's online auction and vehicle remarketing businesses. Yet Copart also provides end-of-life vehicle processing services that give it a larger physical footprint than most online auctioneers. Ignoring that element of the business in an ESG analysis would disregard related risks and opportunities.

2. **Better understanding of management track records of delivering on commitments**. Sustainability plans are only as good as the management teams responsible for implementing them; corporate leaders with a more disciplined and long-term value building approach are more likely to deliver on sustainability promises. Understanding management's commitment to sustainability initiatives (beyond what is stated on web sites, sustainability reports, etc.), and their ability to deliver on these, is key to cutting through greenwashing and developing a forward view on ESG performance and how it may affect valuation.

   In a recent engagement with board members of UK-based Bodycote plc (BOY), for example, our analysts gained insights regarding the company's challenges setting and disclosing emission targets. At the same time, we also learned about business tailwinds based on the company's ability to help clients achieve their own emission reduction targets—an aggregate decrease in GHG that more than offsets the company's own environmental footprint. These greater environmental benefits stem from BOY's thermal processing services, which significantly extend the lifespan of the metal components it treats, thereby reducing replacements and waste. Given the financial, regulatory, and other stakeholder imperatives benefiting the business, we believe this company is potentially more likely than other firms to invest in sustainability improvements. This qualitative understanding of management and the company's business model is especially relevant in the sustainability field, where goals and targets typically have longer timeframes than mainstream financial metrics, and where a quarterly reporting cadence to assess progress is lacking.

3. **Multidimensional views of emerging sustainability standards through practices like channel checks.** Fundamental analysts gain important insights into emerging industry trends through their contacts across corporate value chains. These insights are also valuable in a sustainability context. An understanding of how sustainability practices are broadly being adopted across corporate suppliers, clients, and competitors can inform a view on the veracity of sustainability claims. For example, channel check conversations can help shape a view on how emissions reductions are driving external supplier decisions (especially for companies with net zero pledges).

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[2] Global Industry Classification Standard (GICS) and Sustainable Industry Classification System (SICS) are commonly used sector and industry categorizations from MSCI and SASB, respectively. They are also widely used by third-party ESG research providers.

4. **Greater influence with management teams to effect change**. Through years of frequent qualitative interactions, long-term fundamental shareholders often develop strong rapports with management teams. Across TimesSquare's strategies, for example, it is not unusual that our largest positions have been held for a decade or longer. As such, long-term, active, fundamental investors are structured to have a higher level of influence than a passive investor. Passive investor influence in this space can be further limited by the more restrictive corporate governance structures (e.g., classified boards, supermajority voting requirements, dual class share structures) that are found in the asset class, leaving a weakened proxy vote as the only tool for influence.

   We see the potential of this influence in several instances among our holdings. In early 2021, TimesSquare began engaging with ALK-Abello (ALK.B), a small cap Danish pharmaceutical company. We had some corporate governance concerns, and other investors may have also expressed similar concerns. Since that time, there have been improvements in ALK's audit committee independence, a reduction in the number of other boards its directors serve on, and additional disclosures regarding board-level cyber security practices and breach experiences. We believe those changes fundamentally benefit all shareholders by advancing board supervision and focus on key risk areas. Those ESG improvements also have been noted by others, and at least one ESG data service cited that when it raised its corporate governance score for ALK[3]. The collaborative influence approach used by TimesSquare stands in contrast to the strategy of an activist investor, who may strike a combative stance with management teams. Hence, we believe an investor with broader views can help guide management teams who have less experience with the newer nuances of ESG best practices and disclosures.

Smaller Footprints, but Bigger Potential Impact

Structurally, small and mid cap companies are often asset-light, which limits (but does not eliminate) investor exposure to areas like climate risk. On average, TimesSquare's main strategies have carbon footprints that are 35% lower than their respective benchmarks. We look at corporate emission trends where our analysts deem it to be financially material; strategies are not managed toward a specific emission goal. Lower carbon footprints are therefore an outcome from the growth orientation of our investment strategies. Nonetheless, the solutions offered by these companies in which we invest, can, in select instances, give investors exposure to both growth and sustainability opportunities across several themes like energy transition, climate adaptation, data privacy and protection, and human capital management. Some examples of TimesSquare investments include:

Developers of climate resilience and adaptation solutions:

- Tetra Tech (TTEK, $8.5 billion market cap) is a US-based consulting and engineering firm focusing on water, environment, sustainable infrastructure, renewable energy, and international development work. As commercial and government needs around these areas escalate, TTEK leverages its 21,000 global associates to help societies implement essential climate resilience, biodiversity, sustainable energy, and high-efficiency building programs. Our analysts are bullish on the company's improving business mix, strong funding backdrop, and the upside from a steady stream of acquisitions at attractive multiples that should continue to deliver value over time.

[3] ISS Governance Quality Score update on March 1, 2022.

Energy transition enablers:

- Nexans (NEX-FR, $3.3 billion market cap) is the #2 global leader in the cable manufacturing industry. Based in France, the company's solutions underpin the electrification that is essential to the clean energy transition. For example, NEX is a contributor to the development of the European "Super Grid", and to the rapid expansion of the global offshore wind market. Our analysts see benefits from the company's transition from being a cable generalist to a high-value pure-play electrification solutions provider.

Unique human capital management solutions:

- APM Human Services (APM-AU, $2.5 billion market cap) is an Australia-based international human services provider with more than 1,000 locations worldwide. Founded by an occupational therapist, APM supports people with disadvantages or disabilities by providing them rehabilitation, job training, and placement services. APM's ability to provide those services efficiently gives it an advantage over competitors, and long-term government contracts provide earnings visibility and a moat around the business. An accretive M&A strategy further adds to its appeal.

Sustainability accelerators:

- Workiva (WK, $4.9 billion market cap) delivers a leading cloud platform for regulatory, financial, and ESG reporting. WK enhances corporate transparency with an enabling solution that brings together corporate data from enterprise resource planning, governance risk and compliance, human capital management and customer relationship management systems, among other services. WK's significant top line growth potential- which in part stems from investors, stakeholders, and regulators push for more ESG data- provides key drivers for long-term growth, in our analysts' view.

Conclusion

The influence of ESG on small and mid cap stocks globally is generally underappreciated, in our view. Smaller companies offer the advantage of often having lighter asset footprints, which limits (but does not eliminate) their exposure to some risk areas, particularly in the environmental sphere. Nonetheless, in some instances, these companies offer solutions that enable advances in key areas of sustainability. Most small and mid cap companies are in the early stages of their ESG reporting journeys; investors with in-depth knowledge of business models and management track records are best positioned to see through greenwashing and understand the impact that ESG performance can have on corporate risks and opportunities.

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