QUOTED COMPANIES ALLIANCE

Henley Business School
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Research Report

ESG in Small and Mid-Sized Quoted Companies: Perceptions, Myths and Realities

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Contents

The Quoted Companies Alliance is the independent membership organisation that champions the interests of small and mid-sized quoted companies. It is a company limited by guarantee registered in England under number 4025281.

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Communicating an effective ESG policy really shouldn't be a burden to small or mid-sized companies. It should be part of telling the story of how the company is run and become an extension of the improved corporate governance disclosure that has been visible with smaller companies on the UK's public markets over the past several years.

QCA and Downing LLP

Even in today's more sustainably-aware climate, some company directors remain unaware that ESG stands for 'Environmental, Social and Governance'.

Indeed, there are those who might see this report as not worth reading precisely because of its focus on these issues. However, as and when such individuals come around, they will discover that there is a powerful groundswell of feeling that effective and transparent ESG communication is quickly becoming something that can and does drive material competitive advantage.

Companies that address this now will remain relevant and become more popular with investors who, this report shows, expect more from the organisations than many boards feel able to provide. Ultimately, investors may even be forced to divest from those that are slow to catch-up, as they too come under greater pressure from their clients to invest in companies that understand and manage ESG risks and opportunities well.

In an ideal world there should no longer be room for a debate as to whether this is an optional activity or not. Small and mid-sized companies need to work with investors and understand the issues they face, and assess how to integrate ESG into their business models, cultures and strategies. The key consideration is how it can become part of what they are and do, rather than it being something tacked on as an afterthought.

This report has been commissioned to gain a measure of the state of ESG adoption in the small and mid-sized quoted company ecosystem. Following on from this, the intention is to help companies understand where opportunities and risks lie, and to see what the QCA can do to help them in adopting an appropriate approach to ESG.

Ultimately, this analysis is designed to close the gap between investor expectations and their view of which companies are on top of ESG issues, and which are not. This will help organisations improve stakeholder engagement and should give investors what they need on behalf of their own clients.

Communicating an effective ESG policy really shouldn't be a burden to small or mid-sized companies. It should be part of telling the story of how the company is run and become an extension of the improved corporate governance disclosure that has been visible with smaller companies on the UK's public markets over the past several years.

Looking ahead, the QCA will use the findings of this report to help develop guidance for smaller companies. However, at the present moment, we believe there are more important questions that growth companies and investors, as well as policymakers and regulators, should be asking themselves as they carry forward the ESG agenda:

Questions for companies

- Does your board have the necessary understanding and experience of ESG factors to make an informed decision about what you need to do? If not, how can this be addressed?
- Are you clear on what the material factors are for your geography, sector and individual business?
- Has someone been identified as responsible for ESG on your board? How do they report on this to investors and stakeholders?
- Are you aware of the opportunities that may arise from improved ESG communication for your company? How could active acceptance of ESG help you gain a competitive advantage?
- Have you examined the risks that may arise from not communicating ESG effectively with investors and other stakeholders?
- Have you asked what your investors and stakeholders want from you on ESG?
- How are similar companies and competitors communicating with investors and stakeholders on ESG?
- Recognising that this is a journey for us all, how do you explain what you are and will be doing on ESG in the coming years to meet the expectations of investors and stakeholders?

Questions for investors

- Have you articulated clearly to companies your investment mandate and what it is you want from them regarding ESG?
- Do you have priorities that you can share and have you set out a timeframe within which you expect investee companies to have moved in a positive direction on ESG?
- Have you set expectations as to the level and quality of disclosure expected from your investee companies and proxy voting advisers?
- Are your expectations proportionate to the level of risk or opportunity, and the capacity of the business?
- What tolerance has been allowed for on short-term performance by investee companies while they address key ESG issues and opportunities?

Question for government/regulators

- How do we create a positive environment for promoting good ESG adoption and performance without adding to the disproportionate regulatory burden that small and mid-sized companies currently face?

Tim Ward
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Introduction from Henley Business School

In the modern world there is little doubt that private enterprise – investors and firms – is at a turning point over how these actors can best define and deliver value.

In short, maximising shareholder value and short-termism are gradually giving way to sustainable and stakeholder value, and longer-term considerations.

The Covid-19 pandemic has brought into sharp focus how economic activity requires a well-functioning society and environment. ESG has derived a real-life meaning during 2020 through Covid-19[1]. In terms of the impact on private enterprise, the 'E' for environmental has been evident in reduced pollution levels and lower carbon emissions from negligible road and air travel. This unexpected reprieve has been startling in its effect, not least of all by encouraging the temporary return of wildlife into conurbations.

From a social perspective, there has been concern about employee wellbeing and productivity for home-based worker populations, a loss of customers and, for some, a ramping up of potential client demand and a reduction in emerging innovations reaching existing or new customers. The 'S' also represents the test of resilience to business supply chains, whether they be national, regional or global.

The demand on board governance to be agile and supportive of executive teams has crystallised priorities to ensure operational resilience. Risk management and mitigations have proved to be either adequate or lacking. Notwithstanding the disruption to businesses and people's lives, organisational learning has helped make the business case for ESG.

A growing number of institutions across the globe are advocating for a paradigm shift that recognises the importance of more sustainable investment and business models that deliver value to all stakeholders in the long-term.

In the UK, government-led initiatives are pushing this agenda by developing legislative and regulatory frameworks and incentives. In July 2019, the UK government published the UK Green Finance Strategy[2] to "align private sector financial flows with clean, environmentally-sustainable and resilient growth" and to "strengthen the competitiveness of the UK financial sector".

UK asset owners and asset managers now need to "comply or explain" with a new version of the Stewardship Code[3], which attempts to remedy the low levels of institutional investor engagement revealed in the first 10 years of code implementation.

The new version has a much greater emphasis on ESG factors. For example, principle 4 requires systemic risks – including climate change – to be addressed by institutional investors. Principle 7 requires "the systematic integration of ESG factors into institutional investors acquisition, monitoring and exit decisions." Consequently, there is growing pressure for private enterprise to not only take notice, but to act.

So, what about small and mid-cap companies? Is ESG something they should be considering, given their size, resource-base and rate of growth? Is the London Stock Exchange[4] correct when it states that companies "don't need to be big to report on ESG?" Do mid-caps consider ESG as more of a tool for managing risk and competitive advantage? Ultimately, how can small and mid-cap companies be best supported in advancing their ESG agenda?

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[1] For a recent study on how Covid-19 increased stakeholder-ism see The Sustainability Board Report (2020). COVID-19 Special Report: The Acceleration of Stakeholder Centricity. Available at: https://bit.ly/34UKdeu

[2] UK Green Finance Strategy (2019), available at: https://bit.ly/3oSQkrX

[3] UK Stewardship Code (2020). Available at: https://bit.ly/32gkLP4

[4] London Stock Exchange Group (2018). Your Guide to ESG reporting: Guidance for issuers on the integration of ESG into investor reporting and communication. Available at: https://bit.ly/3eyrs3W

To answer the issues raised by these and other questions, the QCA and Henley Business School joined forces to examine the state of affairs on the Environmental, Social, and Governance (ESG) agenda for both small and medium-sized quoted companies, and a sample of investors. The study began by conducting 30 exploratory, in-depth interviews with companies and investors, and was followed by a survey developed, tested and distributed online to QCA associate companies and to investors through the data company YouGov.

The survey returned 100 completed responses from companies and 50 from investors. Some 53% of companies had over 250 employees, and 47% had less than 250 employees. Among these, 47% had market capitalisations of £100 million or more, with 6% having over a billion pounds in market capitalisation. Just over half (52%) of the companies are located in London/the South East, and the remaining 48% in other UK regions. Some 17% traded on the London Main Market and 83% on the Alternative Investment Market (AIM).

The companies surveyed cover a wide range of sectors and respondents held various roles: 30% were Chairs/non-executives; 54% were CEOs, CFOs or other executives, and 16% were company secretaries. In terms of investors, 92% invest in European (including UK) markets, 66% on London AIM, 60% in North America, and 50% on the London Main Market.

Finally, 46% of investor respondents were fund or asset directors/managers/assistants, 16% were Chief Investment Officers, and 34% had other roles. These demographics and other sample information can be found in detail in **Appendices 1 to 3**.

The remainder of this report is structured in seven sections examining, comparing and contrasting company and investor views on: organisation's ESG awareness and knowledge (**Part 1**); internal accountability and external ESG drivers (**Part 2**); and ESG integration, purpose, strategy and constraints (**Part 3**); ESG disclosure, including communication, standards and information quality (**Part 4**), and the role of the QCA (**Part 5**). The report concludes and makes a series of recommendations (**Part 6**), and provides an extensive list of appendices with background data (**Part 7**).

Henley Business School would like to thank the QCA and Downing LLP for the support they have provided towards this study, and all of the interviewees and survey respondents who so generously gave up their time for this research. The project work and guidance of Mrs Jana Herbert, previously of the QCA, has also proved invaluable and is acknowledged within this document.

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Executive Summary

This new and extensive study conducted by Henley Business School for the QCA and Downing LLP, examines Environmental, Social and Governance (ESG) adoption and practice in small and mid-cap UK companies. The following key findings are based on 30 in-depth interviews supported by survey responses from 100 companies and 50 investors:

1. ESG is a familiar concept, but is narrowly defined and applied by the majority of companies. ESG is often viewed as an extension of voluntary Corporate Social Responsibility (CSR) and is not holistically-conceived or applied. This lack of in-depth understanding of the ESG approach is partly explained by the fact that over two-thirds of companies are at a very early stage of the journey (51%), or are only planning to start the journey over the next one to two years (16%).
2. Despite being early on in the journey, and the piecemeal approach being taken to ESG as evidenced by interviews and confirmed by many investors, 92% of survey participants confirm that they are moderately (69%) to very knowledgeable (23%) about ESG, with smaller companies tending to be less knowledgeable.
3. While companies see themselves as relatively knowledgeable about ESG, practice does not confirm this. The piecemeal approach and the fact that many companies appear to have initiatives ranging across the three E-S-G pillars may create a false sense of awareness and knowledge about ESG.
4. There is a diffused and varied accountability for, and ownership of, ESG. While investors prefer the board (led by the Chair) to own ESG, and view the CEO as being accountable for its execution, the reality is quite different. Only 44.2% cite the board as the key internal driver, and even fewer the CEO (28.3%), and Chair (12%). In smaller companies the CFO/Finance Director tends to assume particular relevance (29%).
5. Contrary to some views, investors are not the primary external driver of ESG. Most companies consider ESG to be very much driven by government policy and regulation (79%), and watchdog and industry regulators (27%). Investors are a key external driver for 70% of firms, while for 72% see market forces as a key driver (in other words, customers, clients, suppliers and competitors). Some companies may view ESG as a compliance exercise, or a risk management tool. However, for many others it's a way of accessing long-term finance, or even gaining a competitive advantage in the marketplace.
6. Integration of ESG with strategy and vision is piecemeal and possibly overstated, with 62% of firms reporting having ESG integrated with strategy and vision, while 77% report having a formal purpose statement in relation to ESG. This is interpreted as reinforcing a misconception by some companies as to what ESG actually is.

7. As a result of the aforementioned points made, there appears to be a significant gap between the conception that numerous companies have of ESG, and the capability they possess to meaningfully and consistently implement it within the business. There are also a number of significant gaps between companies and investor views of existing capabilities and constraints to implementing ESG. These are:

   - 73% of firms believe they understand the impact that ESG can have on their long-term financial performance, but only 50% of investors believe this to be the case;
   - Only 20% of companies, versus 50% of investors, recognise that companies are too short-term focused to understand the long-term impact of ESG;
   - Companies (48%) and investors (52%), agree that companies understand ESG, but don't know how to measure it;
   - 31% of companies are not sure how to communicate to their stakeholders about ESG, but 52% of investors consider this to be the case in all or the majority of their holdings;
   - For 52% of companies, ESG helps inform the development of their strategy and business model, but only 34% of investors consider this to be the case in all or the majority of their holdings;
   - Companies (31%) and investors (36%), agree that company stakeholders do not clearly understand ESG impact.

8. Annual reports (88%) and company websites (64%) are by far the dominant communication methods used by companies to highlight and share their ESG activities. Investor specific meetings or roadshows are used more by larger companies (40%) as a method of ESG communication, than smaller ones (32%).

9. The use of ESG standards, such as the United Nations Sustainable Development Goals (UN-SDG), Global Reporting Initiative (GRI), or Sustainability Accounting Standards Board (SASB), as examples, are only a reality for 18.5% of small and mid-caps, with larger companies having twice the chance of using a standard.

10. Companies appear to lack confidence in the quality of the ESG information disclosed, rating themselves lower than investors across five disclosure categories encompassing: environmental, social capital, human capital, business model and innovation, and leadership and governance. The difference seems to be particularly noticeable for smaller companies, with environmental data being perceived as the worst measurable, and corporate governance and leadership the best. However, the average scores across all categories can be summarised as 'average or worse.'

11. There are important sectorial differences in terms of ESG maturity, knowledge, drivers and the degree of integration and disclosure. The real estate, construction, retail, travel and leisure sectors are clearly ahead in most items (see **appendix 8** for detailed sectorial differences).

12. Investors would like companies to be less formulaic in their reporting, and to ensure that there is a coherent narrative, supported by evidence.

13. Companies and investors consider that the Quoted Companies Alliance (QCA) has an important role to play in helping to build capability through training and the production of guidance that is then adapted to meet the reality faced by fast-growing small and mid-caps.

1

Part 1: ESG awareness and knowledge

ESG appears to be a familiar concept to many small and mid-sized quoted companies but it tends to be narrowly defined and applied, if at all [5]. The interpretation for environmental measures is often sector-specific – for example, sugar and plastic in the food industry – but otherwise is likely to default to carbon emissions and recycling for a service, or intellectual capital business.

The most entrenched and familiar pillar of ESG is governance, helped by the QCA Corporate Governance Code [6]. Investors say that governance for smaller companies should cover a minimum of board composition, skills and experience, independence, board tenure, all types of diversity including cognitive, and board evaluation.

The social pillar of ESG tends to automatically go to regulated metrics, such as gender pay gap or diversity, with a minority of companies considering their customers, supply chain partners or other external stakeholder groups. Investors would like to see more evidence-based metrics with targets, initiatives and progress, so there is clearly a desire for more detail and background to be given to the numbers.

Social matters have been highlighted due to the Covid-19 pandemic, but both E and S do not currently show sufficient objective analysis for investors. **Figure 1** shows survey results on awareness and knowledge of ESG of companies and investors.

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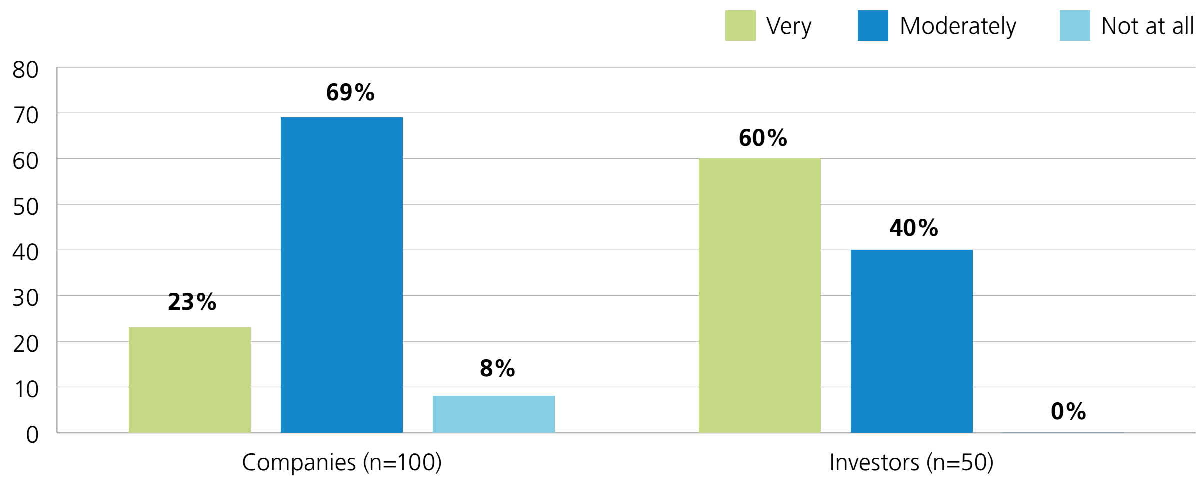
[5] Similar findings as to the level of understanding and commitment with ESG by company directors and senior management were obtained in an interview based study for the general market. See Zharikova, E., and Mitchell, P. (2020). The Corporate ESG Guide: A 360 View of the Current Landscape and Trends. Investor Update, Available from: https://bit.ly/3mTam3K

[6] The QCA Corporate Governance Code is available here: https://bit.ly/3oZTE4g

Figure 1: Knowledge of ESG (companies vs. investors) as a % of respondents

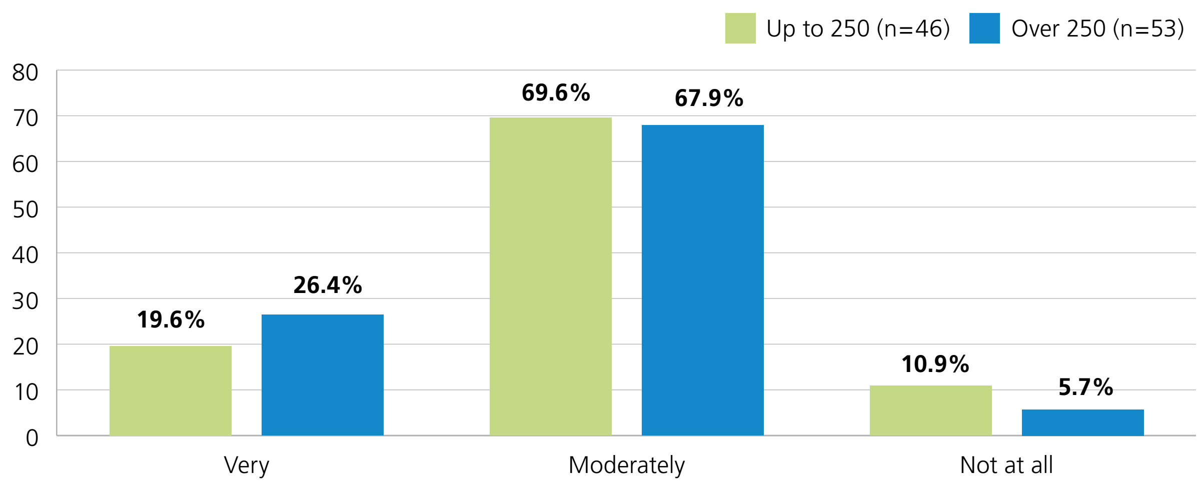


1.2 Small and mid-caps versus large caps

The worlds of small, mid and large caps are very different. Large-capitalisation companies, such as those in the FTSE 100, typically offer a lower risk profile for investors, due to revenue streams that are well diversified by product, service and location, and due to experienced, professional management teams and governance. These companies pay out attractive dividends. Mid-caps demonstrate similar characteristics but tend to produce dividends less frequently, while enjoying good growth potential and being likely acquisition targets for larger companies. Both classes of company typically have sufficient resources and differentiated structures of governance, with a clear separation between the executive and non-executive roles.

Some 60% of investors report high levels of knowledge and awareness of ESG, and 40% report moderate levels. With regards to companies, 23% say they are very knowledgeable on ESG, 69% moderately so, and 8% not at all. The effect of company size on awareness and knowledge of ESG (**Figure 2**) is not very significant, with the largest differences concentrated at the extremes, while smaller companies are more likely to know nothing about the topic (10.9%), compared to larger companies (5.7%). Conversely, larger companies tend to report higher levels of awareness (26.4%) when compared to smaller firms (19.6%).

Figure 2: Knowledge of ESG by company size as a % of respondents

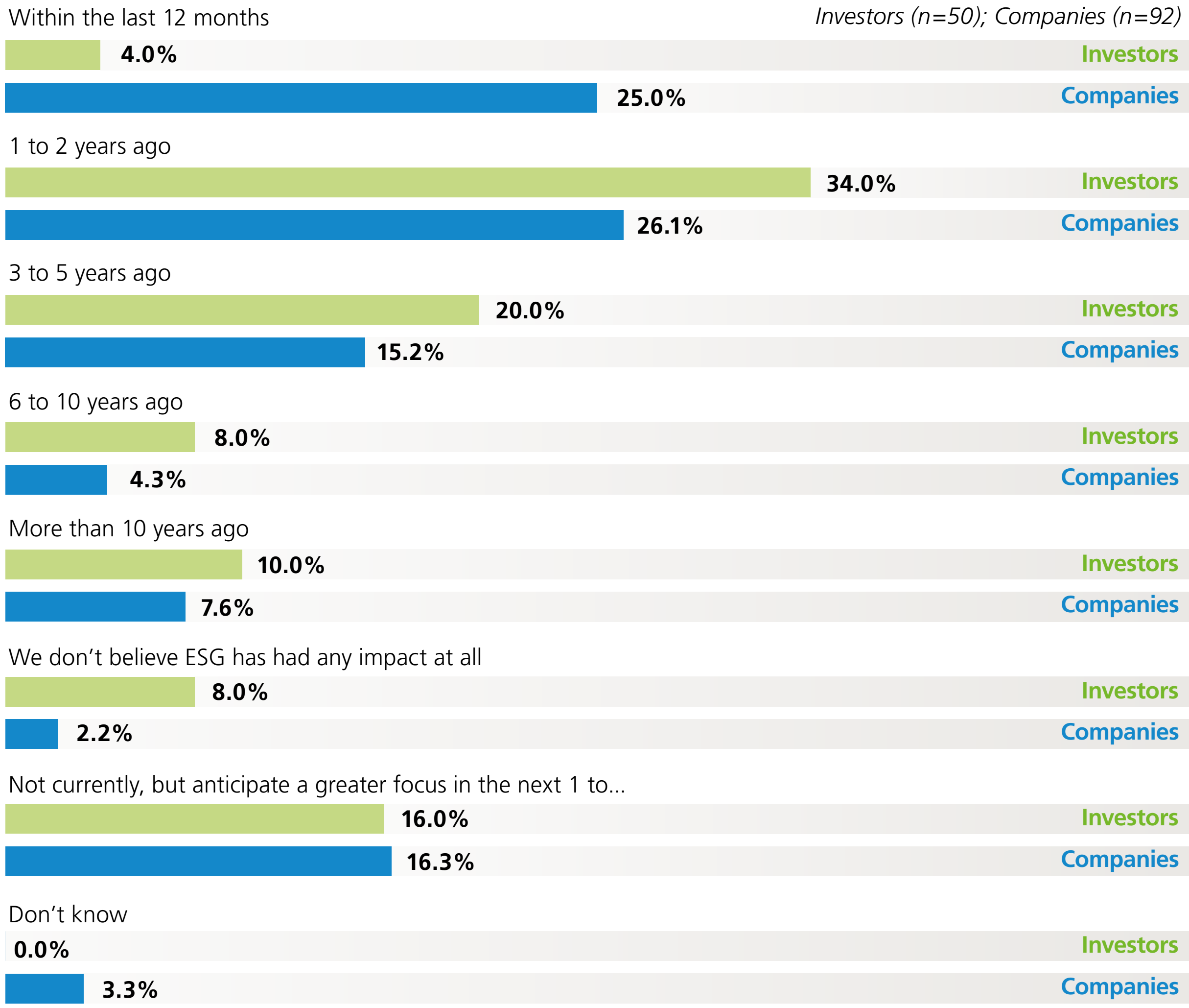


It appears that the real estate and construction sector feels most knowledgeable about ESG impact on performance in their promotion to investors, followed closely by the aerospace and engineering sector. The least confident sector appears to be banking and financial services.

However, all sectors rate themselves over 90% knowledgeable, except banking and financial services, which may be overstating reality, or indicating that the question has been interpreted purely on one of the pillars (see **appendix 8**).

Figure 3 shows how recently companies and investors have begun to recognise the value of ESG adoption. One in every four companies (25%) only started to recognise the value of ESG adoption in the last 12 months, possibly fuelled by Covid-19 pandemic, which has made the issue more salient for investors and specialised media.

Figure 3: Determination of the value of ESG for long-term financial performance (companies) and as a criterion to invest (investors), as a % of respondents



Many investors are beginning to understand ESG as an indication of quality and sophistication of the company, its board and management:

> *"We would view ESG as almost another proxy for quality."* (Investor)
>
> *"It's a lack of sophistication, and I think that lack of sophistication is mirrored on the investor side."* (Investor)

A sizeable percentage of companies (16.3%) and investors (16%) anticipate they will be increasing their focus on ESG over the next 1-2 years. The survey finds 51.1% of companies only started to recognise the value of ESG adoption to long-term financial performance in the last two years or less, clearly indicating that most companies are at an early stage of the journey.

Interestingly, 8% of investors don't see any impact or value in ESG. There is certainly an informality and piecemeal approach to how ESG is perceived and how engagement happens:

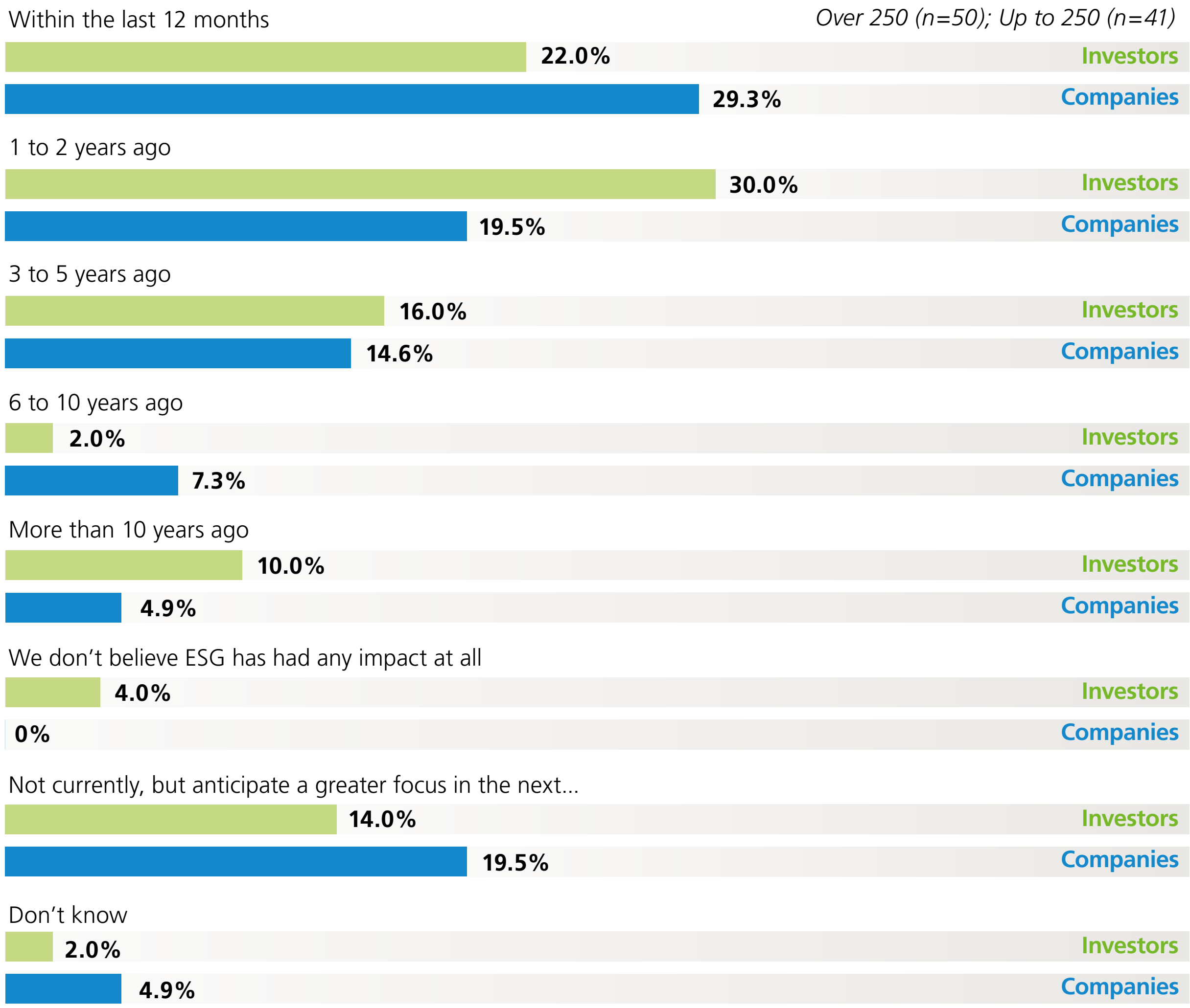
> *"About 18 months ago I hadn't even heard of ESG. I'd heard of the component parts but not as a collective phrase. Now it's definitely something which we're being asked about by our shareholders on a regular basis. And I think our employees are so much more conscious of it now. I think ESG is probably not as far up the agenda as it will be in a year… two years' time."* (CFO)

> *"So I don't say the words ESG in that context. I talk about climate change a lot more. And I talk about governance, I talk about social impact, I talk about the internal stakeholders as well as external stakeholders. So all of that stuff is there."* (Investor)

> *"Do we really understand the business case, the true business case of being sustainable?"* (Chair)

Figure 4 shows the effect of company size on the recognition of ESG value for long-term financial performance. Overall, company size shows mixed effects.

Figure 4: Determination of the value of ESG for long-term financial performance by company size, as a % of respondents



The least amount of awareness of the link between ESG and financial performance seems to be within the aerospace and engineering sector, with over a third of responses indicating that they either don't know, or don't recognise any correlation. The technology and communications sector closely follows this, with almost a third of respondents feeling the same way.

The most recently enlightened sectors appear to be real estate and construction, with over 70% of respondents answering in the affirmative on the link between ESG and financial performance. Utilities, oil and gas, chemicals are similarly inclined, with two-thirds of respondents saying that they have begun to link ESG and financial performance over the past two years.

Laggards over the same period appear to be the technology and communications sector, while 'early adopters' are seen in the retail, food, travel and leisure industries, where almost a quarter of respondents say they started effective management of ESG over 10 years ago (see **appendix 8**).

> *"We are aware that it's becoming higher and higher up on investors' agendas."* (Company Secretary)

> *"At the moment we've got probably still a patchwork quilt of adoption in this area."* (CFO)

> *"I think there's quite a lot of reframing of how to look at results and reward where the ESG conversation is starting to happen."* (NED)

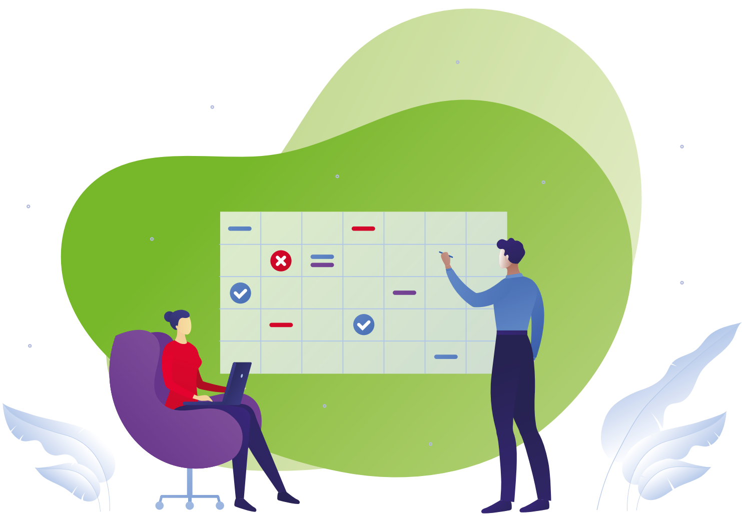
The following key messages and questions summarise the key insights from this section and outline what boards should ask of themselves with regards ESG awareness and knowledge.

Key Messages – ESG Awareness and Knowledge

- ESG is a familiar concept but narrowly defined and poorly applied
- E is the pillar most customised to sector
- G is the most entrenched pillar, while S is largely focussed on diversity, gender pay gap and KPIs
- Investors would like to see more evidence-based metrics
- A quarter of companies began to recognise the value of ESG over the last one to two years

Questions for the Board

- How far do you understand a comprehensive definition of ESG?
- Have you discussed and quantified the value of ESG to your company?
- What does ESG mean to all your stakeholder groups?
- How does ESG affect your long-term financial performance?
- Are you discussing ESG with board and executive colleagues?



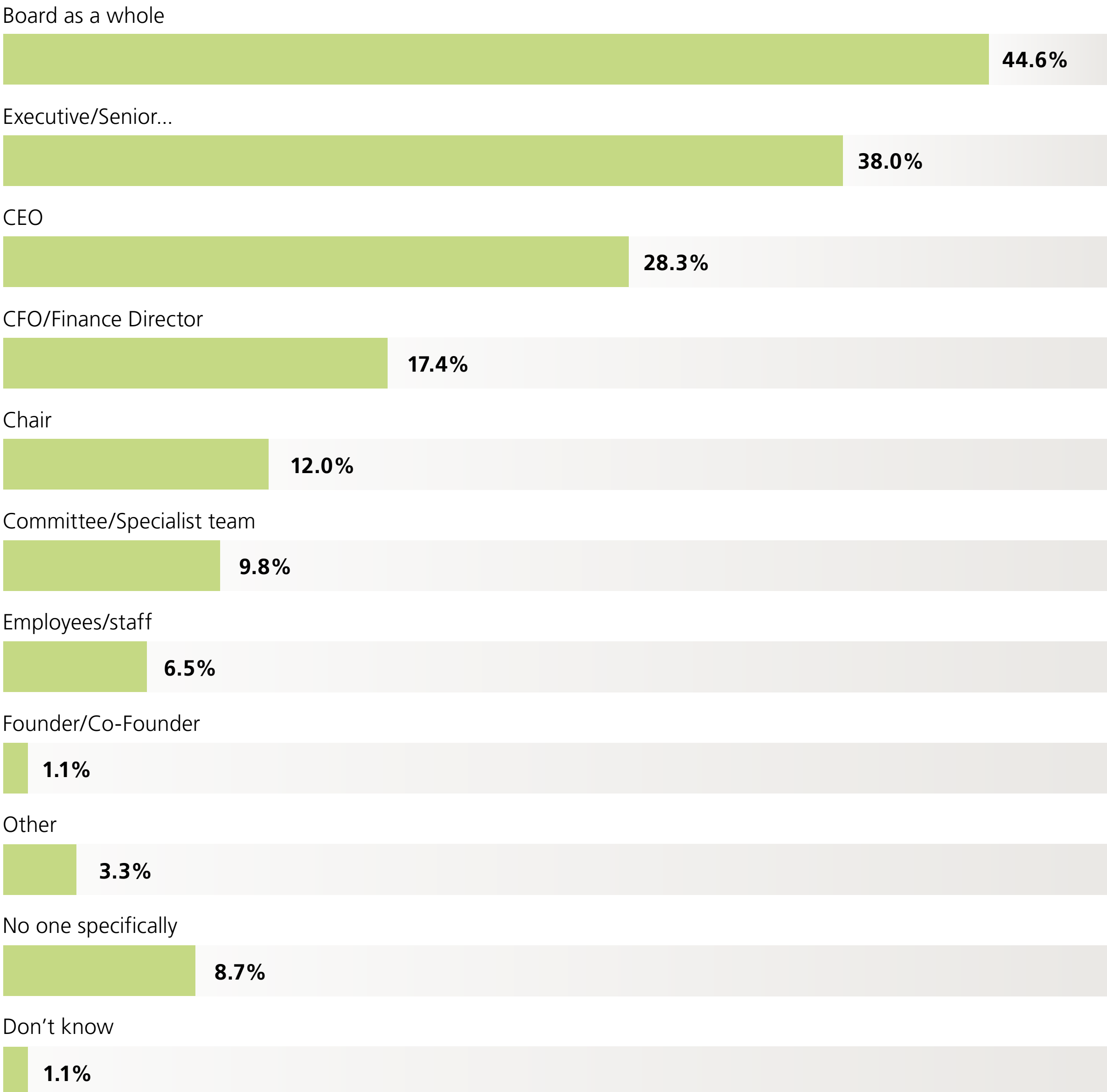
2

Part 2: Internal accountability and external drivers of ESG

2.1 Internal accountability

There is a lack of accountability and ownership within small and mid-sized quoted companies for ESG. For some companies, the board owns ESG, with the Chair setting the tone and driving the agenda. For other companies, ESG sits with the CEO or CFO.

Figure 5: Responsibility for driving ESG internally, as a % of respondents



There appears to be diffused responsibility and leadership on ESG, with a minority of companies claiming to be in the process of hiring a global or regional lead executive to coordinate ESG projects.

As shown in **Figure 5** collective bodies, such as the "Board as a whole" (44.6%), or "Executive/ Senior Management Team" (38%), tend to be responsible for ESG, with individual officers, such as Chairs, CEOs and CFOs exhibiting less direct accountability.

Unsurprisingly, most investors wish to see a clear and accountable director who is ideally well resourced, engaged and proactive in driving the ESG agenda in practical terms, and not just 'ticking the box.' An investor explained:

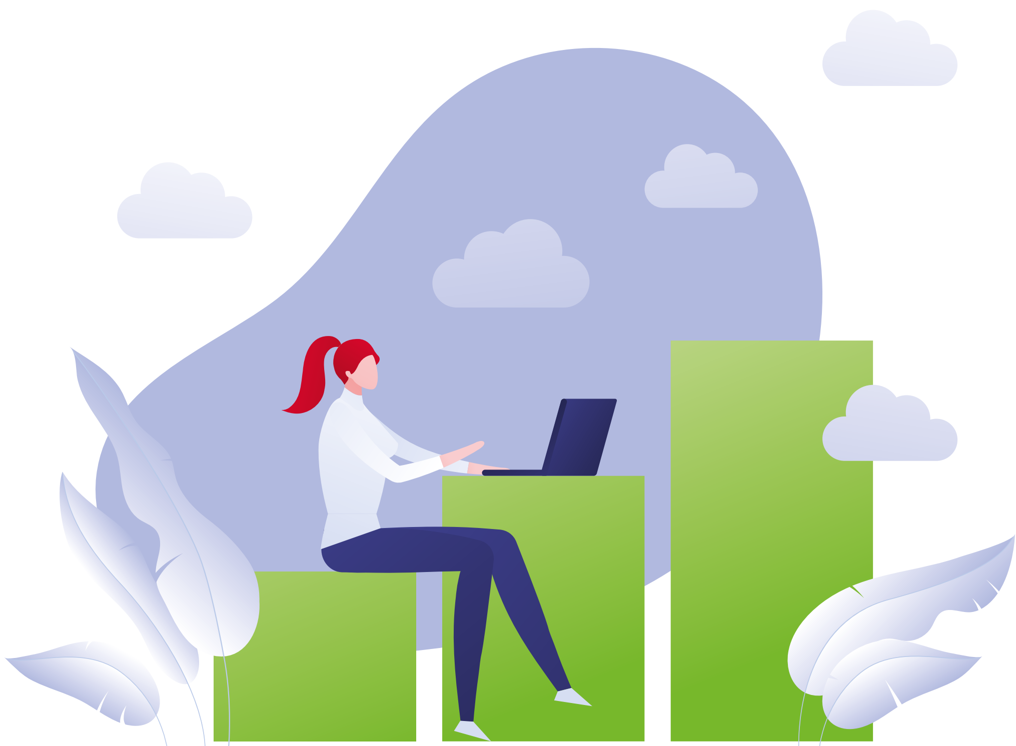
> *"If it comes across that the board isn't effective, or is particularly ineffective perhaps I should say, then I won't touch the company."* (Investor)

Many investors prefer the CEO to own ESG, with the board acting as the ultimate proprietor. They welcome proactive contact from an ESG-knowledgeable Chair, but as figures 5 and 6 show, that is not the practice in most companies.

In terms of sector, founders are least likely to be driving ESG within the organisation, except in the technology and communications sector where employees are also determinedly pushing ESG.

The board, as a whole, appears to be dominating ESG, with approximately half of respondents saying this is the case in real estate and construction, banking and financial services, and the technology and communications industries. In terms of the split between board, Chair and executive team and C-level roles, ESG is most markedly led by the executive team in the aerospace and engineering and utilities sectors.

There appears to be little or no internal driver in the retail, food, travel and leisure sectors, according to over 30% of respondents. However, this could be explained by ESG being more fully integrated into strategy, business operations and company culture (see **appendix 8**).



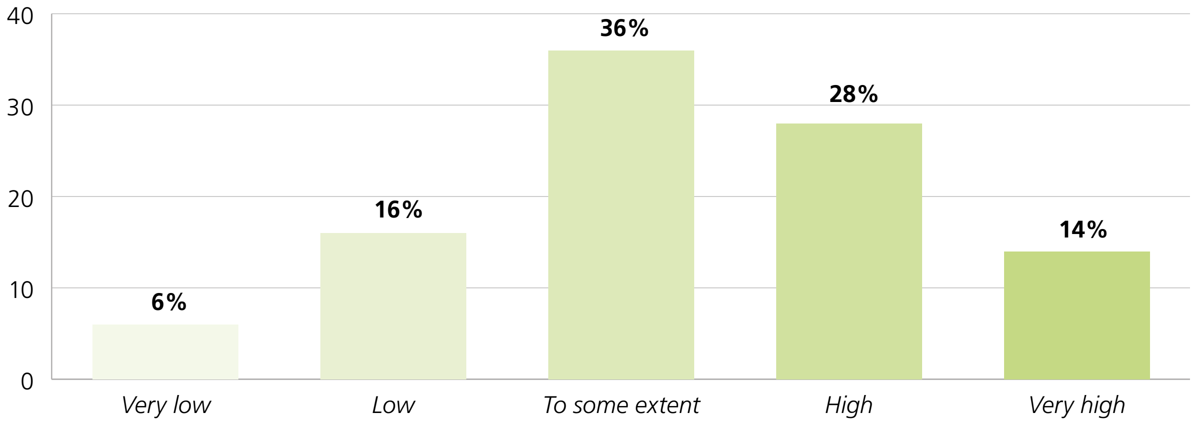
2.2 External ESG drivers

The drivers of ESG are government and regulation, not investors. In fact, as shown in **Figure 6**, 58% of investors have limited consideration of ESG factors in their decision to invest in a small to mid-sized company, while 42% say ESG factors have a high or very high influence on their decision to invest [7].

As a group investors approach ESG in very different ways. Some will focus only on material measures of success and financial performance, while others have a more fundamental stewardship and good citizenship-directed approach. Some investors will divest shares in a company which is not addressing an area of environmental risk, while other investors will engage in long-term dialogue and coach smaller companies to improve their practices. One investor, identified this as a growing trend:

> *"The whole institutional investor community is being compelled to think about these issues, if they weren't already. Don't feel put off that this is another very complicated reporting exercise with a niche or tiny proportion of the investor community."* (Investor)

Figure 6: ESG factors' influence on investors' decisions to invest in a small to mid-sized company (n=50), as a % of respondents



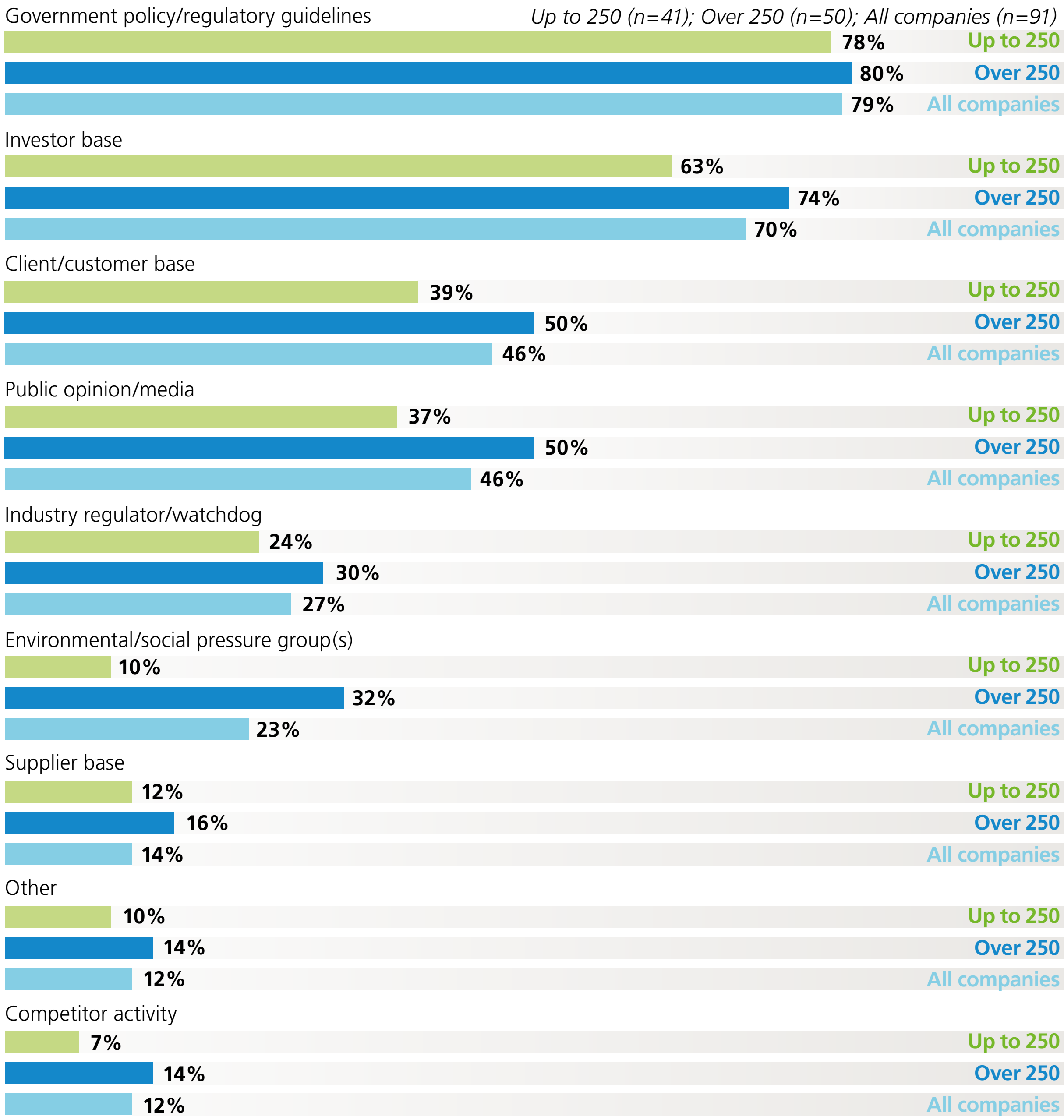
The drivers of ESG with smaller quoted companies are often their employees, customers or suppliers, but the emphasis may be on one pillar of ESG, rather than the whole concept.

ESG is perceived as a means to build and retain employee and consumer trust, confidence and loyalty. In fact, market forces – customers, clients, suppliers and competitor activity – have a combined score of 72%, versus 70% for investors as drivers of ESG.

This all points to the fact that, for many companies, ESG is seen as a competitive advantage in the marketplace, rather than simply a mechanism for attracting finance. **Figure 7**, shows the key external drivers of ESG adoption as reported by companies.

[7] The PWC (2019) Annual ESG pulse survey found that although as much of 80% of investors have an ESG component into their investment strategies, only 27% fully integrate ESG criteria into long-term investment decision-making. See: PWC (2019a). Mind the gap: the continued divide between investors and corporates on ESG. PWC ESG Pulse 2019, Corporate Governance Insights Centre. Available at: https://pwc.to/38fgi2K

Figure 7: External drivers of the management of ESG risks and opportunities (all companies / by company size), as a % of respondents



ESG in the banking, aerospace and technology sectors is largely perceived as being motivated by government policy or regulation and associated investor bases.

Banking and financial services have remained largely unaffected by environmental and social pressure groups, public opinion and media, while these factors do appear to influence ESG to an extent in the utilities sector. The supply chain appears to be the most powerful force for ESG responsiveness and take-up within the utilities and technology industries. Competitors also play a significant role in ESG activity across the real estate and construction industries (see **appendix 8**).

> *"I find it quite difficult to understand how any one person can be responsible for everything to do with the ESG."* (CFO/COO)

> *"The board are taking it very seriously. They haven't got much experience in it, but it is now a standing point on the agenda."* (CFO/COO)

> *"We're only as good as the people we employ, so actually, if it matters now to our employees then it absolutely matters to us."* (CFO)

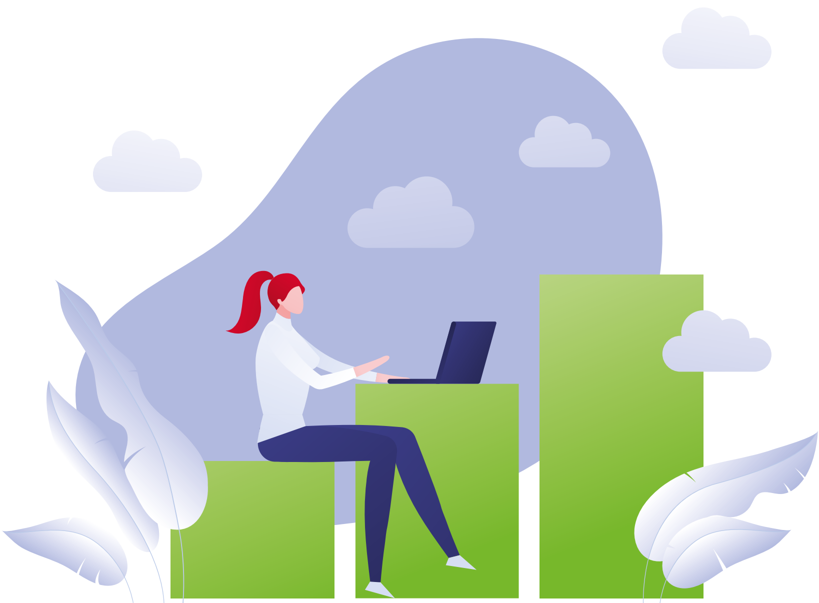
The following points outline the key insights from this section and essential questions that boards should ask themselves with regards internal accountability and external drivers of ESG.

Key Messages – Internal Accountability and External Drivers of ESG

- There is diffused and varied accountability and ownership for ESG within small and mid-sized quoted companies
- Investors wish to see clear responsibility with the CEO and board ownership
- External drivers of ESG are government and regulation, followed by investors
- Customers, employees, suppliers and competitors are often drivers of ESG
- Market forces are more powerful drivers than investors are for competitive advantage

Questions for the Board

- Who has clearly defined responsibility and accountability internally for ESG?
- How are the CEO and Chair working together on ESG?
- Are your investors sufficiently interested in ESG and supporting you in developing it?
- Which of your stakeholder groups are driving ESG?



3

Part 3: ESG integration: purpose, strategy and constraints

This section considers ESG integration, comparing and contrasting the views of companies and investors.

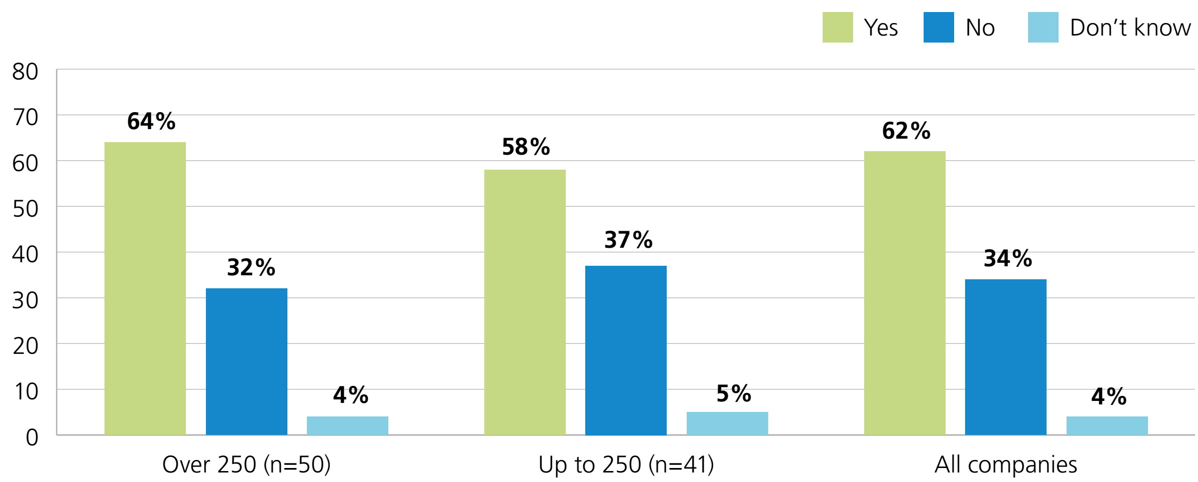
ESG integration is defined by Principles for Responsible Investment (PRI) [8] from the investor perspective as being "the explicit and systematic inclusion of ESG factors in investment analysis and decisions."

From the company perspective, the systematic integration of ESG factors occurs in strategy, the business model, executive remuneration, and ultimately every other aspect of the firm. It focuses on the extent to which companies have ESG embedded as part of their strategy and vision, a formal ESG purpose, and the constraints and capabilities that enable companies to achieve ESG maturity.

3.1 ESG and strategy and vision

Figure 8 shows that 62% of all companies surveyed consider ESG as an integral part of their strategy and vision, with smaller companies' integration reaching 58% and larger companies tending be slightly ahead at 64%.

Figure 8: ESG integration as part of company's strategy or vision (all companies/by size), as a % of respondents



[8] Principles for Responsible Investment – PRI (2018) – How ESG engagement creates value for investors and companies. UNEP Finance Initiative and UN Global Compact. Available at: https://bit.ly/32gzXvA

However, this does not necessarily translate into a holistic approach to ESG integration, and these relatively encouraging figures may be more a result of a limited understanding of ESG, or when just one ESG pillar is perceived as integrated.

In fact, the approach by companies is largely piecemeal so E, S and G are addressed as discrete topics or practices, with little reference to ESG as an umbrella term, or as any strategic or integrated approach. Investors feel strongly that education is critical to advancing this holistic interpretation of ESG.

A major frustration on the part of investors is the lack of understanding, sophistication and engagement by smaller quoted companies, which overwhelmingly perceive ESG as a compliance exercise evolved from corporate social responsibility (CSR), which they in turn deem as optional. Investors would like companies to interpret ESG more broadly, customise it to suit their businesses and take it as an opportunity to demonstrate quality, reputation and credibility. Investors explain:

> *"It starts with having the right people, with the right strategy, and the right incentive programs to support those value drivers, rather than having a one size fits all piece."* (Investor)

> *"If ESG and taking account of the ESG risks are really embedding, it should be through everything, from the strategy through to communication to investors, to give a sense of how big those risks are and how they are being managed."* (Investor)

> *"You can't drive a border between financial performance and ESG criteria. They're part of the same picture. It's really important and it's about sustaining, getting good products that empower the local community and looking after the workforce."* (Investor)

It appears from the survey data that 'integration' is interpreted very narrowly and if any aspects of ESG are integrated, then this has 'ticked the box.' This conclusion mirrors the low awareness of ESG and therefore adds to the call for further education.

ESG is beginning to be added to board agendas, often when it is championed by an executive director, shareholder, or board Chair. However, the business case for demonstrating competitive advantage through ESG remains poorly understood by small and mid-sized quoted companies. As a result, work on ESG is exploratory at best, but ultimately becomes relatively peripheral to the company's operations.

Investors would welcome small and mid-sized quoted companies embracing ESG as an opportunity to demonstrate resilience and good management, but for many smaller companies the focus inevitably falls on survival – short-term cash flow and sales growth. Investors believe there is prospective flexibility in contextualising ESG by company, sector, product and lifecycle, while little benchmarking exists within sectors that encourages learning about how listed companies are approaching ESG.

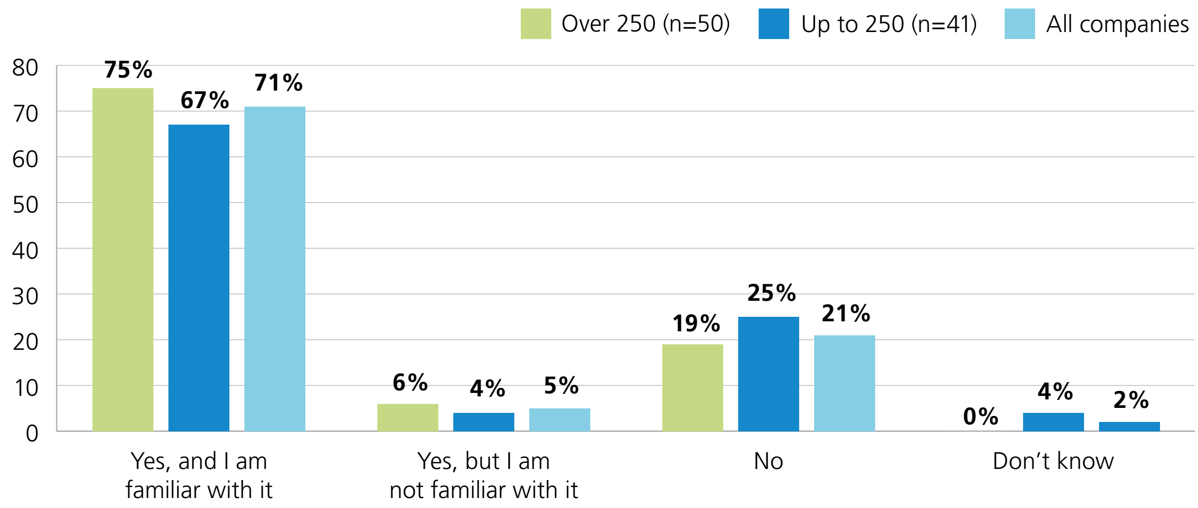
The best integration of ESG into company strategy and vision appears to be within the real estate and construction sector, followed by the banking and financial services sector. This finding aligns with ESG being led primarily by the board (see **table 2**).

It is surprising to note that two thirds of respondents feel ESG integration is evident in the retail, food, travel and leisure sector which is occupied by the highest percentage of executive, little or no internal drivers (see **table 2**), (see **appendix 8**).

3.2 ESG formal purpose statement

The survey asked companies to indicate whether they had a formal purpose statement in relation to ESG and the response was surprising, with over three in every four companies answering the question positively. No significant variation was found with regards to company size. Considering feedback from interviews, it is unlikely that this formal purpose statement is all-encompassing in terms of ESG, and more likely that it purely addresses one of the pillars.

Figure 9: Presence and familiarity with a formal purpose statement (or equivalent) in relation to ESG (all companies/ by size), as a % of respondents



The banking and financial services sector shows the highest percentage of companies with no formal purpose statement or equivalent in relation to ESG (45%). Interestingly the aerospace and engineering sector has the highest number of companies with a formal purpose (100%), followed by the real estate and construction industry (90.9%), (see **appendix 8**)

> *"Companies have to have a purpose above and beyond, which is that they have to be relevant in a social context, a community context, they have to make a difference, and incorporate that into the values of the business."* (Investor)

3.3 Constraints and capability to integrate, measure and communicate ESG

Companies exhibit a high level of agreement with statements about the value and impact of ESG on long-term financial performance, but they also share an apparent denial of being affected by short-termism. Again, the question has to be raised as to whether ESG is being misunderstood and interpreted in a piecemeal fashion? It appears that when some of the potential elements of ESG are being visibly managed in companies, they then feel an ability to agree with the statement.

The blame for any lack of understanding appears to be attributed to stakeholders who present a communication challenge in terms of explaining the potential impact of ESG (**Table 1**).

Smaller companies (up to 250 employees) tend to exhibit lower self-ratings across all of the statements featured, confirming that size matters for the adoption and maturity of ESG (see **appendix 8**). Furthermore, it appears that small and mid-sized quoted companies are adopting a short-term perspective at the moment, which is most likely explained by the demands of managing Covid-19.

The greatest challenge for small and mid-caps appears to be quantifying and communicating ESG to stakeholders. However, a quarter of larger companies also struggle with communicating their ESG initiatives and the resulting impacts.

Understanding of ESG is at its lowest levels in the technology and communications sector, with most short-termism demonstrated by the aerospace and engineering sector, again taking into account that these findings are likely to be swayed by Covid-19.

The biggest issue for the banking and financial services sector appears to be communicating ESG and integration with strategy and the business model to stakeholders. Companies cannot communicate what they do not fully comprehend so they avoid doing so (see **appendix 8**).

Table 1: Investors and Companies perceptions of "ESG maturity" within their portfolio/company, as a % of respondents

Statements	Investors: In almost all cases/in most cases (n=50)	Companies: Agree/ Strongly agree (n=100)	GAP
Companies understand the impact that ESG can have on their long-term financial performance	50	73	**-23**
Companies are too focused on the short-term to understand the long-term impact of ESG on performance	50	20	**30**
Companies understand how management of ESG issues can have an impact on performance, but they don't know how to quantify it	52	48	+4
Companies are not sure how to effectively communicate to their stakeholders the potential impact of ESG	52	31	**+21**
The companies' understanding of the impact of ESG helps inform the development of their strategy and business model with regard to their performance	34	52	**-18**
The companies' strategy and business model with regard to the impact of ESG is clearly understood by their stakeholders	36	31	+5
We would consider how ESG would impact on companies' performance before deciding whether to advise/invest in them	58	-	-
We would not advise/invest in companies if their ESG performance/ management was regarded as low or poor	52	-	-

Table 1 shows that there are important gaps in how companies see themselves and how investors view the companies in their portfolio in terms of ESG maturity. While only about half of investors say that all, or most, of the small and mid-caps in their portfolio "understand the impact that ESG can have on their long-term financial performance," 73% of companies feel they have this understanding – a 23 percentage gap.

As discussed, companies show some denial regarding short-termism as a problem to adopting ESG. 50% of investors feel this is the case for most or all companies in their portfolio, but only 20% of companies recognise this as an issue. Investors see it as a key constraint:

> *"They're so desperate in the very short term to keep generating a little bit of cash or not losing too much that they just don't have the bandwidth to take it (ESG) on. Other companies which have a little bit more headroom can engage and think ahead a bit more."* (Investor)

> *"In terms of the growth in the company it's the underpinning for sustainable growth for the company, rather than prioritisation of near term growth."* (Investor)

About half of the companies don't know how to quantify ESG and its impact on performance and so a tacit agreement forms between investors and companies. Of the investors, 52% feel all or most companies can effectively communicate to stakeholders about their management of ESG, while only 31% of companies feel effectively equipped to do so.

Finally, 52% of companies agree or strongly agree that their understanding of ESG helps inform the development of their business model and strategy, but only 34% feel the same way about the companies in their portfolio. Some companies do understand the need to integrate ESG with strategy, risk and remuneration, although the application of this does not always live up to expectations:

> *"We've got different reports, different leaflets or documentation that probably comprise an overall approach with policy."* (Company Secretary)

> *"ESG initiatives need to be embedded within the values of the company to be really effective."* (Finance Director)

> *"That is our statement of environmental responsibility and that pervades everything we do."* (Chair)

The highest agreement among investors is over whether ESG is a factor they consider before investing, or alternatively advising other investors to do so, with 58% and 52% agreement respectively. These numbers suggest that ESG is important for about half of investors, but also that ESG is not a required qualifier for a large part of the investment community.

The following outlines key insights from this section and highlights questions that boards should ask themselves regarding ESG integration.

Key Messages – ESG Integration: Purpose, Strategy and Constraints

- Integration of ESG with strategy or vision is piecemeal and possibly overstated
- Investors would like small and mid-caps to define ESG more broadly and customise it
- The greatest challenge for smaller quoted companies is quantifying and communicating ESG to stakeholders
- Small and mid-sized quoted companies tend to perceive ESG as a compliance exercise evolved from CSR
- Investors feel there is too much short-termism which prevents long-term planning

Questions for the Board

- Is ESG integrated and embedded in your company vision, mission, values and strategy?
- Do you have a comprehensive and customised ESG purpose statement?
- How does ESG help you demonstrate quality, reputation and credibility?
- Which companies in your sector are good benchmarks for ESG?
- To what extent is ESG a qualifier for your investors?

4

Part 4: ESG disclosure: communication, standards and information quality

This section discusses company and investor views of ESG communication, the use of standards and ratings, and information disclosure quality. The gaps between investors and companies with regards to information quality are identified and discussed. Standards are considered as a generic issue, although examples commonly used in UK and Europe are the United Nations Sustainable Development Goals (UNSDG) and Global Reporting Initiative (GRI) standards by sector. Other global standards include the Sustainability Accounting Standards Board (SASB), Climate Disclosure Standards Board (CDSB) and Taskforce on Climate-Related Financial Disclosures (TCFD).

4.1 Communicating ESG to investors/ shareholders

All companies communicate ESG mainly in written format as annual reports and on company websites. Greater levels of communication by larger companies with investors take place in meetings and at roadshows (**Table 2**).

Table 2: Main company communication methods with investors / shareholders about ESG (all companies / by size), as a % of respondents

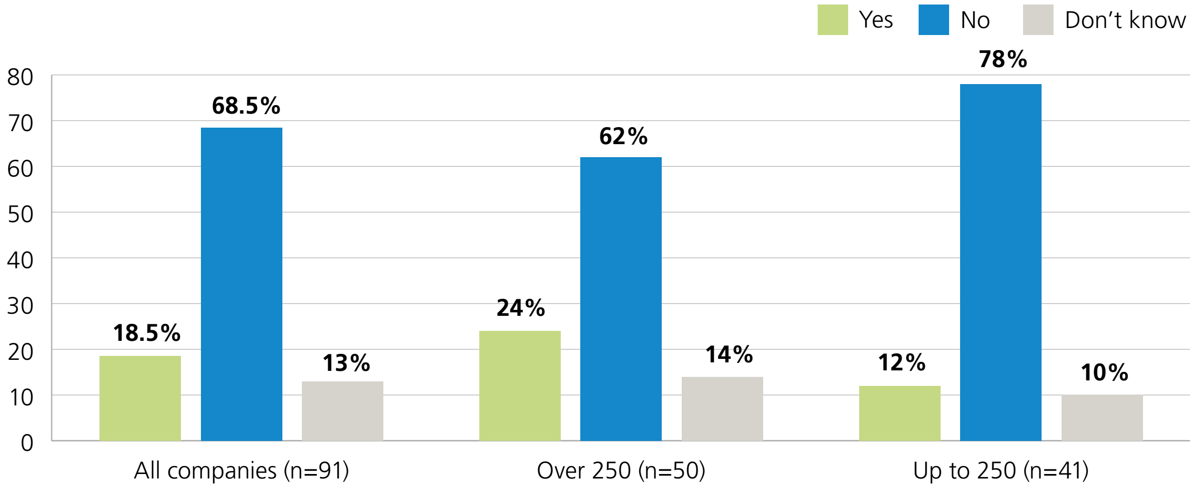
Top-4 Communication channels	Up to 250 (n=41)	Over 250 (n=50)	All companies (n=91)
In the annual report	82.9%	92%	88%
On our website	61%	66%	64%
At investor specific meetings / roadshows	31.7%	40%	37%
At annual meetings (e.g. AGM)	9.8%	12%	10.9%

In sectorial terms the aerospace and engineering (21.4%), and technology and communications (10.5%) sectors utilise the least amount of investor specific meetings or roadshows to communicate with investors (see **appendix 8**).

4.2 Evaluating and reporting on ESG

The use of ESG standards among small and mid-caps is still low, in part because they are seen as unsuitable for this segment and its specific needs in terms of growth and innovation. **Figure 10** shows figures for the full sample of companies and by size.

Figure 10: Company's use of standards to evaluate and report on ESG (all companies/ by size), as a % of respondents



The use of ESG standards appear to be fully embraced within the real estate and construction, and retail, food, travel and leisure sectors. The lowest level of standards application is seen in the aerospace and engineering, and technology and communications sectors. A lack of standard usage can also be explained by low awareness and understanding. Companies commented:

> *"We are doing a lot of very good things, it's how we bring all of that together, and make it more alive in terms of our communications."* (Company Secretary)

> *"What's the point in having a document that doesn't represent you as a responsible, proper, well conducted business?"* (Chair)

> *"We don't see ESG as something separate, it's woven into the way that the business works."* (NED)

In terms of size, 12.2% of larger companies (250 employees or more) report using ESG standards, whereas for smaller companies this number drops to 6%. The sectors reporting some adoption of ESG standards are real estate and construction (23.1%), utilities, oil, gas and chemicals (16.7%), followed by the banking and financial services (6.7%), and technology and communications (5.3%) sectors.

There is even less awareness or reference to ESG ratings (8.7%) than the standards by companies. Investors say that small and mid-caps shouldn't seek to be rated as it is premature and less relevant for them. However ratings and rating agencies can be used as part of the process to educate smaller quoted companies about ESG (see **appendix 8**).

4.3 Quality of information disclosure

A 2019 study by Hermes [9] stated that ESG analysis is more complicated in small businesses given the typically lower quantity and quality of information disclosure, and the rapid degradation of the relevance and materiality of individual metrics when these businesses exhibit high rates of growth. Similar findings were found in Europe by the Eurofi Initiative [10].

The present study arrives at similar conclusions. According to investors, disclosure is low-level and formulaic, even when some metrics are within a companies operational gift, such as CO_2, water and energy consumption.

> *"I think management teams and boards are finding it's a bit of a pain to have to even think about how they answer it. So it goes into that ESG category as well as the tick in the too difficult box."* (Investor)

Investors would like to see more disclosure grounded by a narrative within annual reports and on websites, with progress against targets clarified, rather than just the reporting of KPIs. This narrative should ideally feature growth history, risk mitigation, succession planning, director remuneration, customer service and outcomes, sustainable competitive advantage, reputation management, visibility of crisis management, climate (where relevant), independence and board diversity.

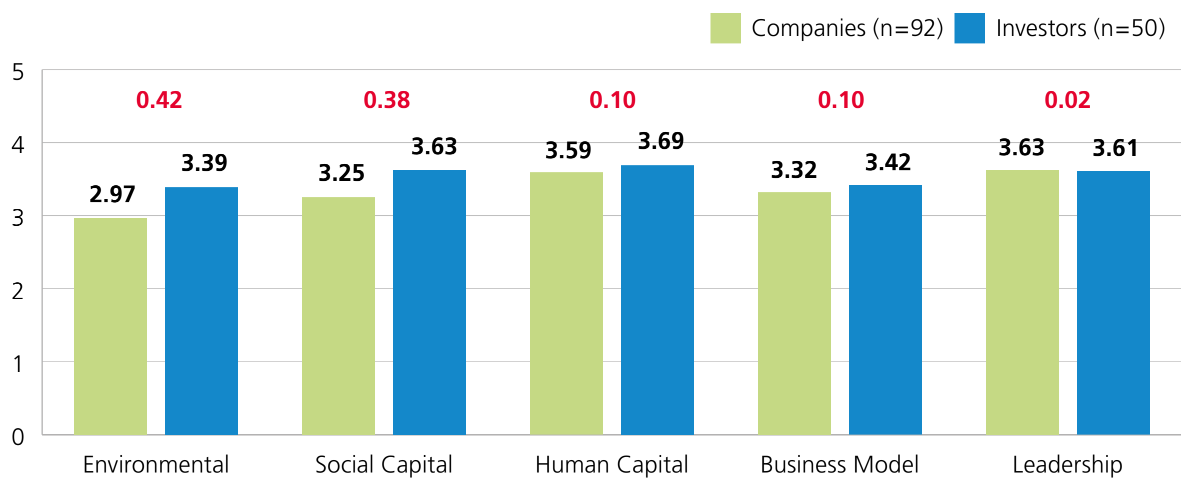
Investors are especially interested in employee engagement surveys, and insights into how small and mid-caps lead and motivate their staff. As one investor explained:

> *"The small companies, they'll say, we care about our employees, but they'll give no data about what that means."* (Investor)

In addition, disclosure needs to be consistent year-on-year, cost-focused, and show an awareness of the business landscape. Context is critical.

Investors are better placed to make a comparison and benchmark across companies so they can rate the quality of information more accurately, whereas the companies self-rating suggests that they are primarily concerned that their quality of disclosure is not meeting the required standard for investors (**Figure 11**).

Figure 11: Companies vs. investors views of company quality of information disclosed in five categories (Scales reversed: 1=Very poor to 5=Very good), average scores



[9] Hermes Investment Management (2019). Go to the source: ESG Integration in small- and mid-cap equity investing. Available at: https://bit.ly/3es2Zgt

[10] Eurofi Initiative (2020). Sustainability transition: SMIDs Challenges, ESG Report on Small & Mid-Caps. Available at: https://bit.ly/34WfJIZ

Integration is crucial to impactful ESG disclosure. For example, telling an integrated story if a company invests in environmental initiatives to obtain returns in social areas such as customer attraction, staff retention and investor engagement. Investors emphasise material ESG risks and mitigation, which should be explicit in the company strategy.

Companies should show evidence for improvement over the past financial year, alongside the implications of any major decisions taken in the business. Investors said:

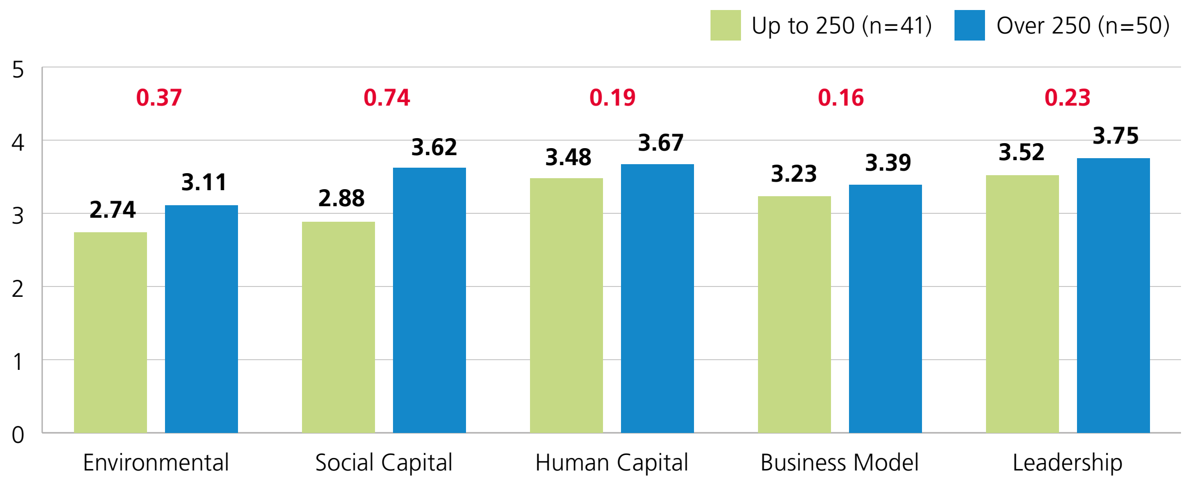
> *"If you have got a story to tell and if it is going to give you commercial advantage, for God's sake don't hide it under a bushel."* (Investor*)*

> *"So tell that story and evidence it. And I think it's the evidencing piece that's too often missing. If that can be brought into a coherent narrative that's told to the investor community, and not just told to the ESG part of the investor community, they'd get a pretty receptive audience and I'm sure would both attract new investors, but also make their current investors much more confident and stickier and therefore have a win-win for all parties."* (Investor)

The ESG wrapper surrounding the company story will help further articulate it. Companies should integrate their ESG purpose statement into their vision, mission and values, together with aspirations, successes, failures and learning, all positioned within the commercial reality of the company.

Investors are interested in answers to the big question: 'Is this business making the world a better place?' **Figure 12** shows the variation of quality of information disclosed by company size.

Figure 12: Companies' views, by company size, of company quality of information disclosure in five categories (Scales reversed: 1=Very poor to 5=Very good), average scores



The most familiar and well-rehearsed areas of business, namely leadership and governance, and the business model and innovation, are perhaps unsurprisingly perceived as being accurate and complete in terms of the information they help disclose to investors. With scores not reaching the top of the scale (5), it seems as though companies are lacking confidence in the quality of their disclosures, with this effect being more pronounced for small companies.

The environmental agenda is relatively new for many companies and the greatest difference between small and larger organisations is reporting on social capital. Companies also report very different approaches and levels of ESG maturity from the investor community:

> *"Where there's more public scrutiny it's probably higher up on investors' agendas, therefore more pressure on companies to do it, report on it."* (Company Secretary)

> *"We have fantastic investors and they are asking us about our active engagement on ESG."* (Chair)

> *"We've had a very clear steer from our investors over the last couple of years, probably, that we needed to be more upfront on ESG matters."* (Executive Director)

> *"It's really interesting as you go around the different fund managers, the different levels of understanding around ESG, what they really mean by it."* (CEO)

The following details show the key insights from this section and highlight the questions boards should be asking themselves with regards to ESG disclosure.

Key Messages – ESG Disclosure: Communication, Standards and Information Quality

- Companies appear to lack confidence in their disclosure of quality ESG information
- Companies communicate ESG mainly in their annual reports and on their websites
- ESG standards and ratings are not utilised by companies and are not seen as relevant
- Investors perceive small and mid-cap disclosures on ESG as low level and formulaic
- Investors would like to see disclosure based on a narrative with targets and actions

Questions for the Board

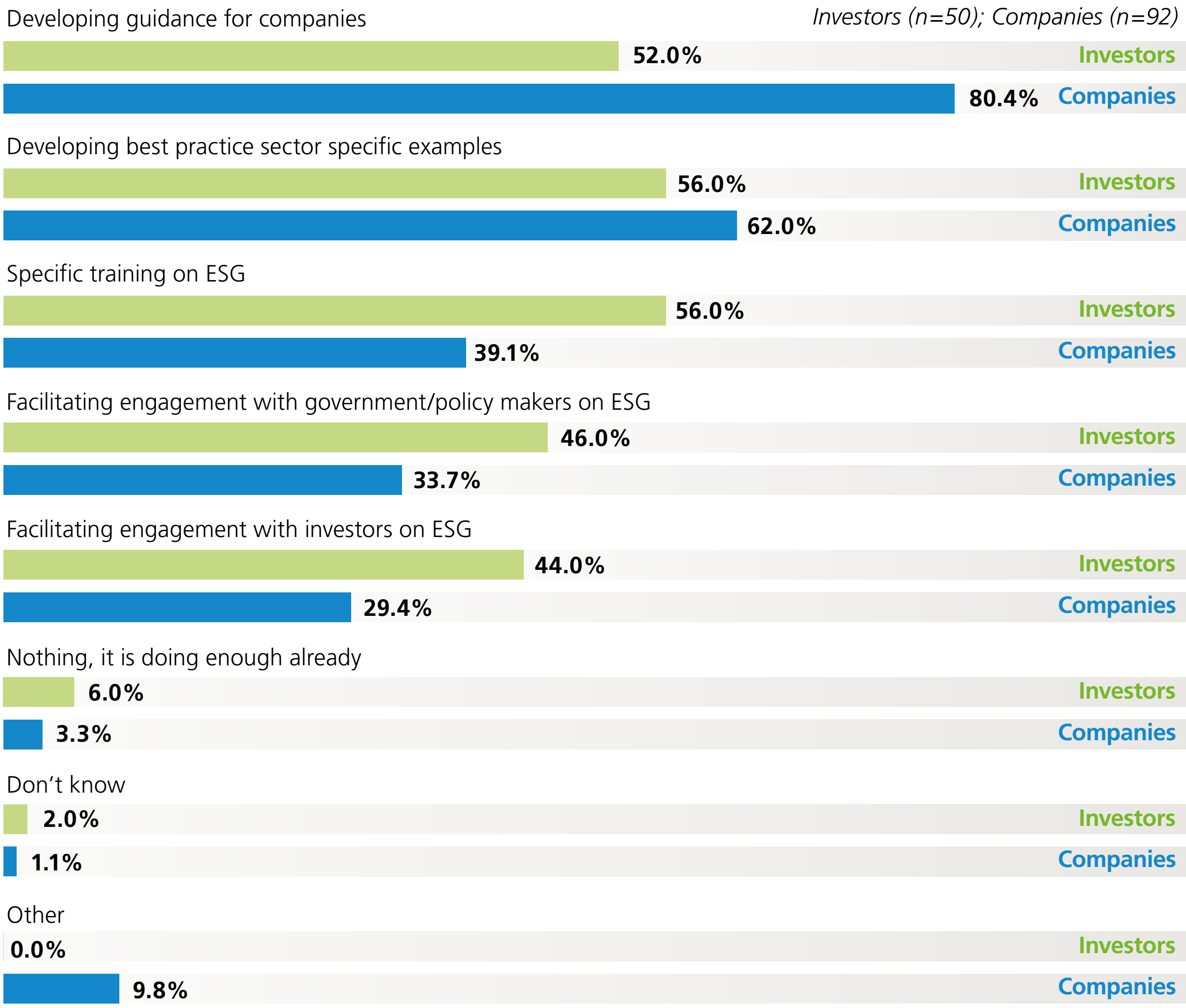
- What do investors feedback about your ESG disclosure and information quality?
- Are you aware of standards and ratings which exist in Europe and the UK?
- When have you reached out to investors for private meetings and roadshows?
- What expertise could you secure to help improve your quality of disclosure?
- How is your business making the world a better place?

5

Part 5: The role of the Quoted Companies Alliance

There is now an extreme demand from companies to develop guidance on ESG, whereas investors feel that specific ESG training would be a more helpful solution. These findings can be seen as an endorsement of the lack of awareness and understanding by companies. Investors appear to want the QCA to facilitate more engagement with them and policymakers on ESG.

Figure 13: Investors and Companies views on the role of the QCA, as a % of respondents



There is fear on the part of small and mid-sized quoted companies that ESG is just the 'latest fad,' and they will become over-burdened with new reporting requirements at a time when resources are already overstretched. There is little awareness of ESG standards and rating agencies, and virtually no engagement with this aspect of ESG. Guidance must be adaptable and enable smaller quoted companies to tell their story in narrative form, and also provide evidence-based metrics within a strategic wrapper.

Many companies gave their qualitative suggestions, offering a wide range of perspectives. Some feel that there should be one standard for all companies, others that standards should recognise the size and business development stage, while a remainder believe ESG is an expensive and overreaching reporting requirement. Typical comments on the role and direction QCA should take with regards to ESG include:

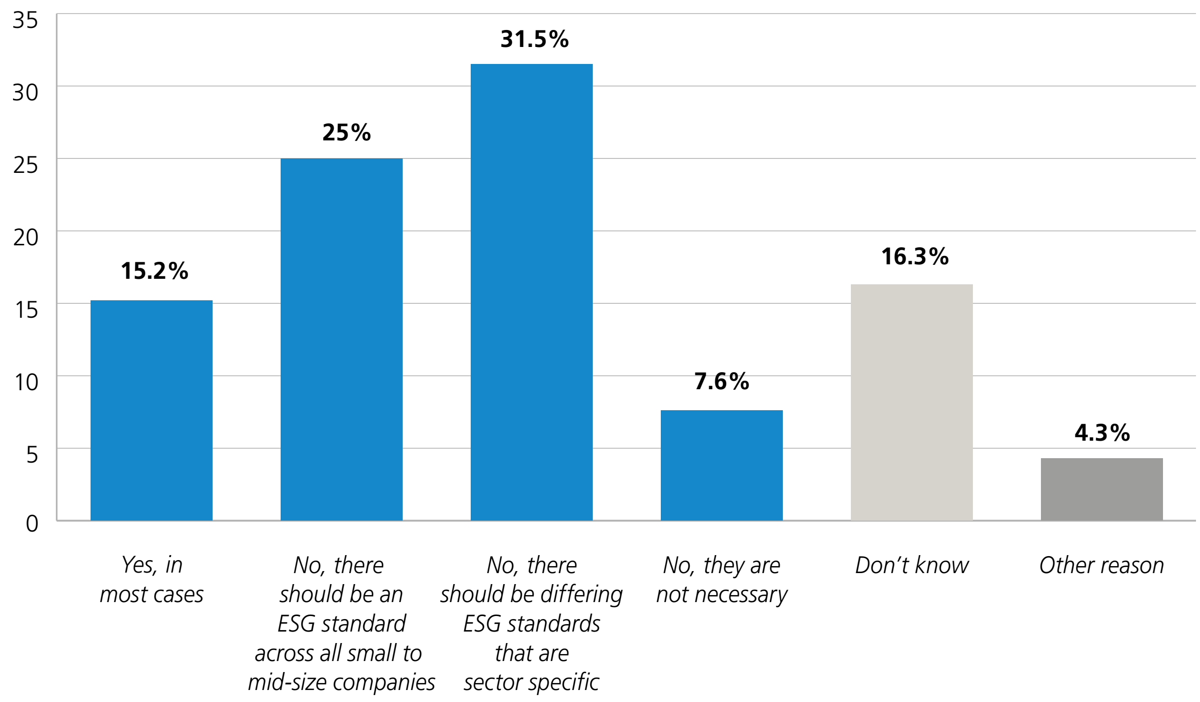
> *"Working with regulators to remove unnecessary, time-consuming and expensive reporting requirements such as ESG."* (CEO)

> *"Enable companies to judge for themselves – so avoid the implementation of further reporting burdens."* (Audit Committee NED)

> *"Any guidance needs to be proportionate to the size of the company and where it is in its development cycle."* (NED)

In fact, when we asked the question about the effectiveness of current ESG standards in meeting the requirements of small to mid-sized companies (Figure 14), only 15.2% of companies consider that they are appropriate and helpful.

Figure 14: ESG standards' effectiveness in meeting the requirements of small to mid-sized companies, as a % of respondents



Smaller companies (up to 250 employees) favour "sector specific ESG standards" (36.6%), followed by 19.5% who say one "standard across all small to mid-sized companies" should be the way forward. Larger companies are more divided with 30% asking for a common standard across all firms, and 26.6% arguing for sectorial standards.

By sector, utilities, oil and gas and chemicals (44.4%), along with banking and financial services (46.7%), prefer the development of sector specific standards. Conversely, the technology and communications (31.6%) sector tends to favour a one-size-fits-all approach. Across all sectors there are many respondents who do not have an opinion, a particularly notable point for the aerospace and engineering sector (35.7%).

> *"We and investors know ESG is of increasing importance, but no investor has ever asked a standards question."* (Chair)

Investors are calling on policymakers to be more responsive to the needs of small and mid-caps given concerns that a reporting burden will prevent them from doing what they do best – being innovative and disruptive businesses.

It also appears that investors would like ESG standards to gain more traction with smaller quoted companies, but are less concerned with ESG ratings. Any guidance needs to be pragmatic and based on open questions so that companies can clarify their value proposition. There is still a substantive gap that needs to be closed between policy and reality, where appropriate guidance founded on a pillared approach could prove hugely beneficial. One size most definitely does not fit all, so variability in scope, size and sector needs to be accommodated within any emerging guidance. Typical comments from investors include:

> *"As I said repeatedly, I am more interested in companies talking about how they do things than I am about ticking boxes."* (Investor)

> *"I think ESG is moving rapidly in the right direction but a broad range of maturity is still yet to come in the market related to this topic. The companies that we are speaking to are focused on it to some degree so I think it is positive as of now."* (Investor)

> *"I would like to say that it is still inconsistent. I am not sure if companies really know how to invest in it, or represent or measure it. Companies still are working on how to prioritise it. The investors on the other hand are still learning and finding it difficult to articulate or manage it."* (Investor)

> *"It feels a lot like people want to be seen doing the right thing, but they are not really doing the right thing, there's a lot of green washing, which is a shame and very few companies are taking it seriously."* (Investor)

> *"Make it mandatory by law if you really want to see some action."* (Investor)

Overall, there is a clear mandate for the QCA to help raise companies' awareness and knowledge of ESG through training, as one example, but also by acting as an ambassador that advocates for proportionate regulation for small and mid-caps.

There remains some debate as to whether standards should be generic or sector specific. The idea that there should be a minimum common reporting requirement, with some sectorial variation allowing companies to tell their own story, has emerged from the data and should accommodate most of the expressed concerns.

> *"You can do this very heavily or you can do it lightly, but irrespective, you should be doing something."* (Chair)

> *"Most of it has been tick box type stuff and it's quite difficult to deal with, because there isn't a common framework."* (NED)

> *"We have to implement ESG in the company in the way in which we feel is best, because there is no helpful guidance out there yet."* (CFO/COO)

> *"I'm personally of a view that tick lists don't work, well, they work as a tick list, but so what, who wants a tick list?"* (NED)

The following outlines the key insights from this section and highlights the questions boards should be asking themselves regarding the role the QCA should play in supporting companies on their ESG journey.

Key Messages – The Role of the Quoted Companies Alliance

- Companies and investors are calling for guidance and training for small and mid-sized quoted companies on ESG
- Investors would like the QCA to facilitate more engagement between them and policymakers on ESG
- Companies fear that ESG brings a risk of excessively burdensome reporting
- Companies feel that there should be distinct and customised ESG standards for smaller companies
- The QCA could help with guidance on ESG to help small and mid-sized quoted companies better tell their own story

Questions for the Board

- Who in your company should be earmarked for new ESG guidance and training?
- In what creative ways could your company tell their own ESG story?
- Have you asked your investors what ESG guidance and training they consider beneficial?
- As a board, have you reviewed the available ESG standards?
- What ESG guidance do other larger companies in your sector use?

6

Part 6: Conclusions and recommendations

The emergent picture from this research report is that ESG investing in small and mid-caps is often misunderstood and misapplied by companies, investors, regulators and other third parties.

While the findings largely agree with global investors who state that "the heterogeneity of ESG data users – investors, stakeholders and companies – will remain and is not inherently negative" [11], in small and mid-caps there is a basic need to ensure greater clarity on what ESG is. The question also remains as to how ESG can be meaningfully implemented in companies that are relatively small, less resourced and for which ESG application looks very different from large and very large caps.

A few things are clear. Firstly, as one investor said: "ESG is not going away." The pressures and demands for businesses to play a hugely important role in the sustainability agenda are set to grow, and small and mid-sized quoted companies will need to play a part in this.

For some sectors these pressures will come in the form of government policy and regulation. For others, consumers, suppliers and even competitors will push them into considering ESG as a tangible advantage. In the case of specific sectors, such as oil and gas, pressure groups and public opinion will continue to act as key drivers for change.

The investor community did not emerge as a significant agent of ESG and this report proposes that they step up their efforts in this respect. The 'talk is cheap' mantra does not only apply to companies.

Secondly, although smaller companies have fewer resources and space to consider long-term objectives and opportunities, they can use ESG strategically for competitive advantage and as a mechanism to attract finance from like-minded investors.

Thirdly – small and mid-cap organisations cannot do all of this alone. There needs to be a much more concerted effort from all stakeholders – government, regulators, companies and investors – to create the conditions and clarity for ESG to work for smaller companies.

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[11] Douma, K., and Dallas, G. (2018). Investor agenda for corporate ESG reporting: a discussion paper by global investor organisations on corporate ESG reporting, PRI and ICGN, October, available at: https://bit.ly/3mVlwn8

Here follow three recommendations on what can be done to improve this state of affairs with regards ESG in the small and mid-cap market:

1. The creation of general ESG guidance, frameworks and a roadmap from which small and mid-caps can voluntarily consider how best to organise for ESG, and how to move their journeys forward accordingly. It is clear there is a lack of understanding about what ESG really means, and how it can be effectively developed, implemented, measured and reported.
2. An ESG education programme for small and mid-caps. There is a need to establish a common language and minimum platform of understanding for companies and investors, in order for them to meaningfully engage on ESG topics. The guidance and framework suggested in point 1 could be used to start embedding ESG thinking, and creating a mind-set and skills that enables better engagement between different actors.
3. Government policy and regulation must work with the industry and investor community to acknowledge the specificities of small and mid-cap companies. Any intervention must be based on principles, education and support, rather than being linked to extensive compliance with attempted 'one-size-fits all' solutions.

In conclusion, much of the success of the sustainability agenda rests in the recognition, by both companies and investors, that sustainability is here to stay and, in the not too distant future, will become a critical capability for most firms wanting to successfully compete and prosper. Company boards need to become less reactive and take the sustainability agenda seriously – in all that it has to offer – competitive advantage, risk management and the attraction of long-term financial gain.

7

Part 7: Appendices

Appendix 1: Interview sample

A total of 30 interviews (20 companies and 10 investors) were carried out over June and July 2020.

Table 3: No. Interviewees by gender and role for companies and investors

	Total	Male	Female	NED	Executive
Companies	20	14	7	13*	11*
Investors	10	7	3	n/a	n/a

*Three participants with both Exec and NED roles / one company had 2 interviewees simultaneously

Table 4: Distribution of company interviews per sector

Sector	No.
Technology/computer hardware	1
Software/computer services	1
Telecoms	2
Pharma	1
Electronic/electrical components	1
Leisure/entertainment	1
Insurance	1
Construction/building materials	2
Food and beverage	1
Medical equipment	1
Media	2
Professional services	1
Personal goods	1
Oil/gas	1
Chemicals	1
Industrial support/security	1
Household goods	1
Total	**20**

Appendix 2: List of interviewees

Table 5: List of Interviewees*

Name	Company	Role
Sangita Shah	Bilby PLC & RA International Group PLC	Chair
Tim Jones	Treat PLC	Chair
Neil Crabb	Frontier Group IP PLC	CEO
Ross McDonald	Breedon Group PLC	Group Services Director
Susan Bolton	Breedon Group PLC	Assistant Company Secretary
Clive Gartson	Warpaint London PLC/ DAC Beachcroft LLP	Chair/Consultant
Richard Bungay	Diurnal Group PLC	CFO
Neil Platt	Hurricane Energy PLC	COO
Beverley Smith	Hurricane Energy PLC	NED
Mary Dowd	Crossword Cyber Security PLC	Finance Director
David Tilston	SDI Group PLC	Audit Committee Chair
Marnie Millard	Nichols PLC/Finsbury Food Group PLC	CEO/NED
Martin Warner	Michelmersh Brick Holdings	Chair
Steven Webb	Sumo Group PLC	Gen. Counsel & Company Secretary
Mark Carlisle	Amino Technologies PLC	CFO & COO
Peter Pollock	LPA Group	Chair
Malcolm Diamond	DiscoverIE Group PLC	Chair
Annette Nabavi	Maintel Holdings	NED
Peter Harris	Next 15 Communications	CFO (& NED of QCA)
Maria Darby-Walker	Personal Group Holdings PLC	NED
Moira MacDonald	Portmeirion Group PLC	Group Company Secretary
Alan Newman	Ebiquity PLC	CFO/COO of Ebiquity PLC & NED/Chair of Audit Committee of Future PLC
Sinead Lennon	Liontrust Asset Management PLC	Governance & Stewardship Manager
Gervais Williams	Premier Miton Group PLC	Head of Equities
Fraser Elms	Herald Investment Trust	Investment Manager
Derren Nathan	Hybridan LLP	Director, Head of Research
Georgina Brittain	JP Morgan Asset Management	Fund Manager, SMIDs
Andrew Ninian	The Investment Association	Director, Stewardship & Corporate Governance
Judith McKenzie	Downing LLP	Partner & Head of Downing Fund Managers
Will Pomroy	Federated Hermes	Director, Engagement
Sacha Sadan	Legal & General Investment Management	Director of Investment Stewardship
Adam McConkey	Lombard Odier Asset Management	Investment Fund Manager/ Chair of QCA

* A small number of interviewees preferred to remain anonymous

Appendix 3: Sample characteristics – companies' survey

Figure 15: Companies by sector, in percentage (n=100)

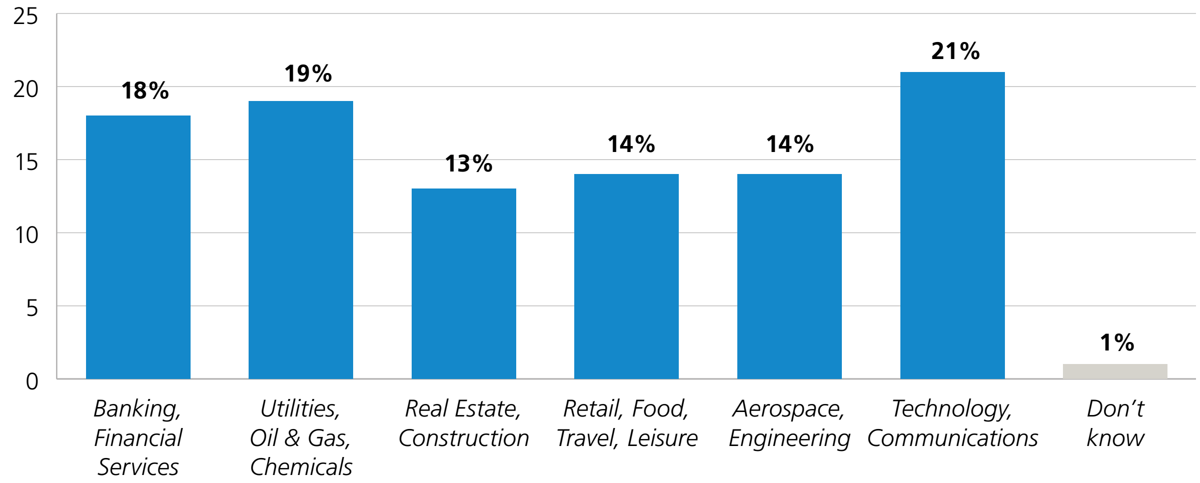


Figure 16: Companies size (No. employees), in percentage (n=100)

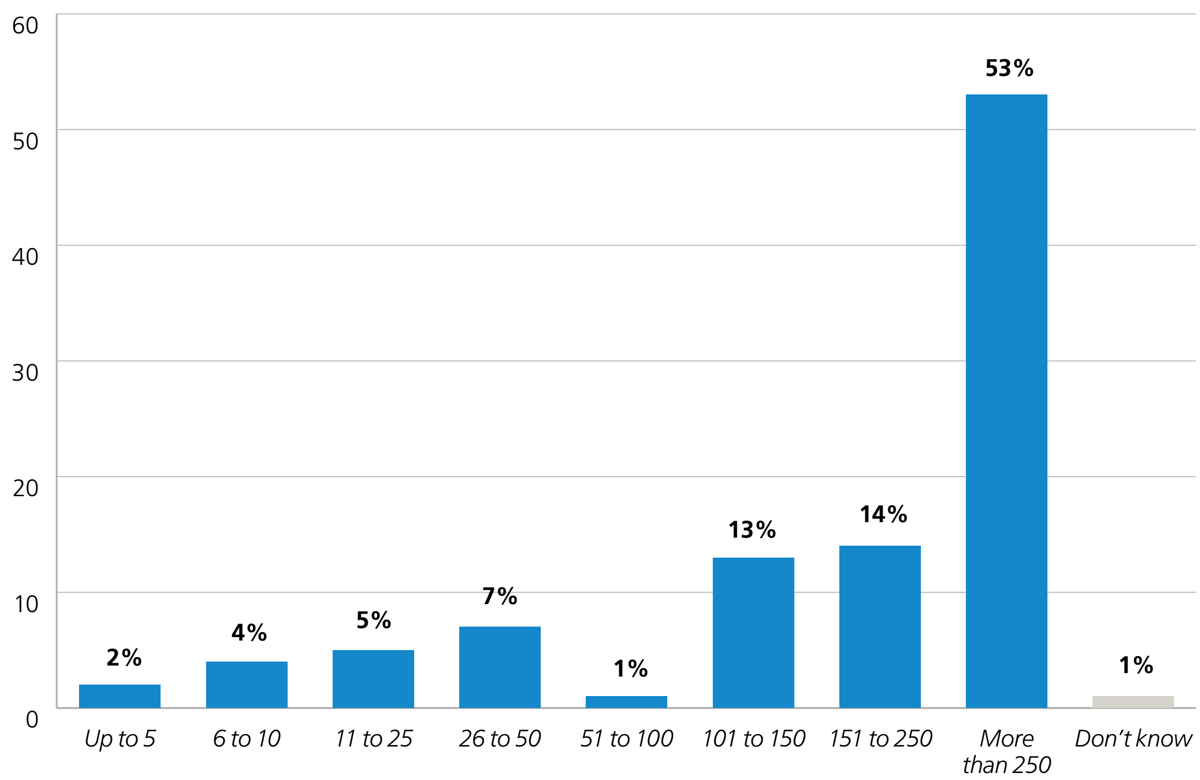


Figure 17: Companies size (Market Cap.), in percentage (n=100)

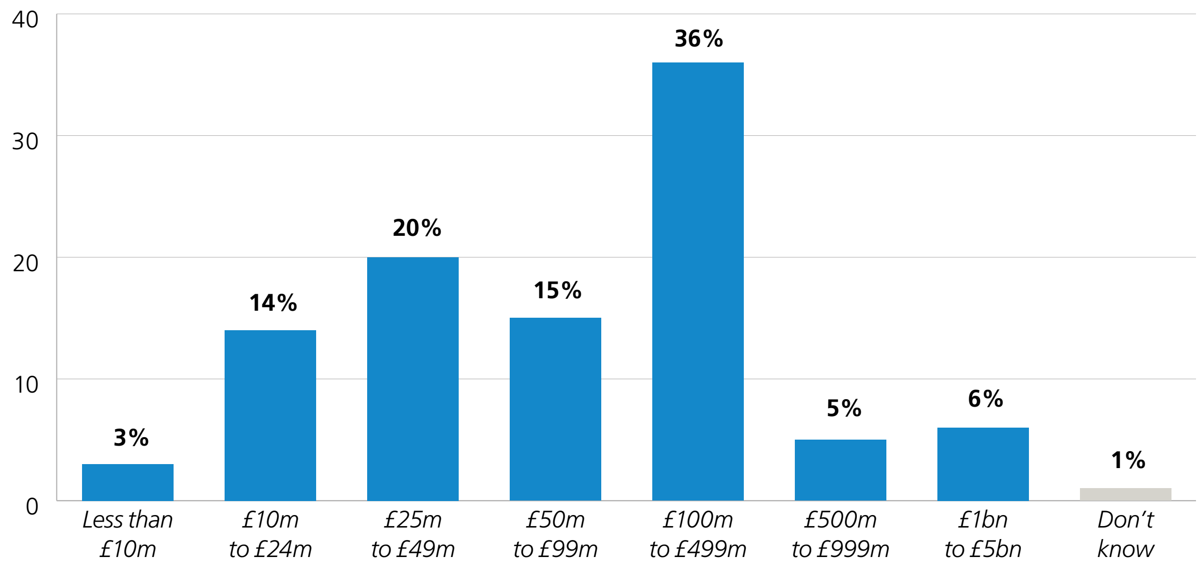


Figure 18: Companies by location, in percentage (n=100)

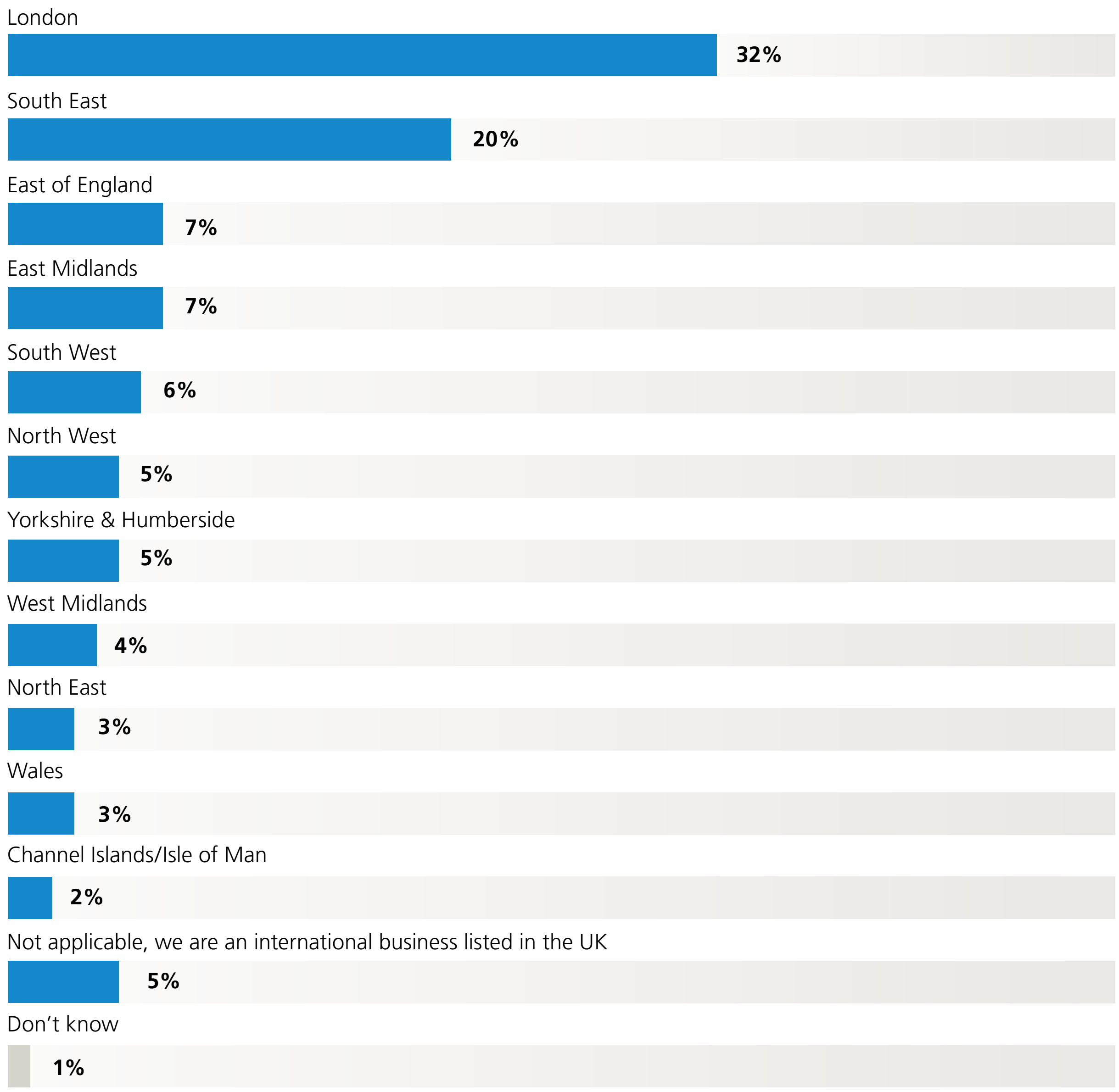
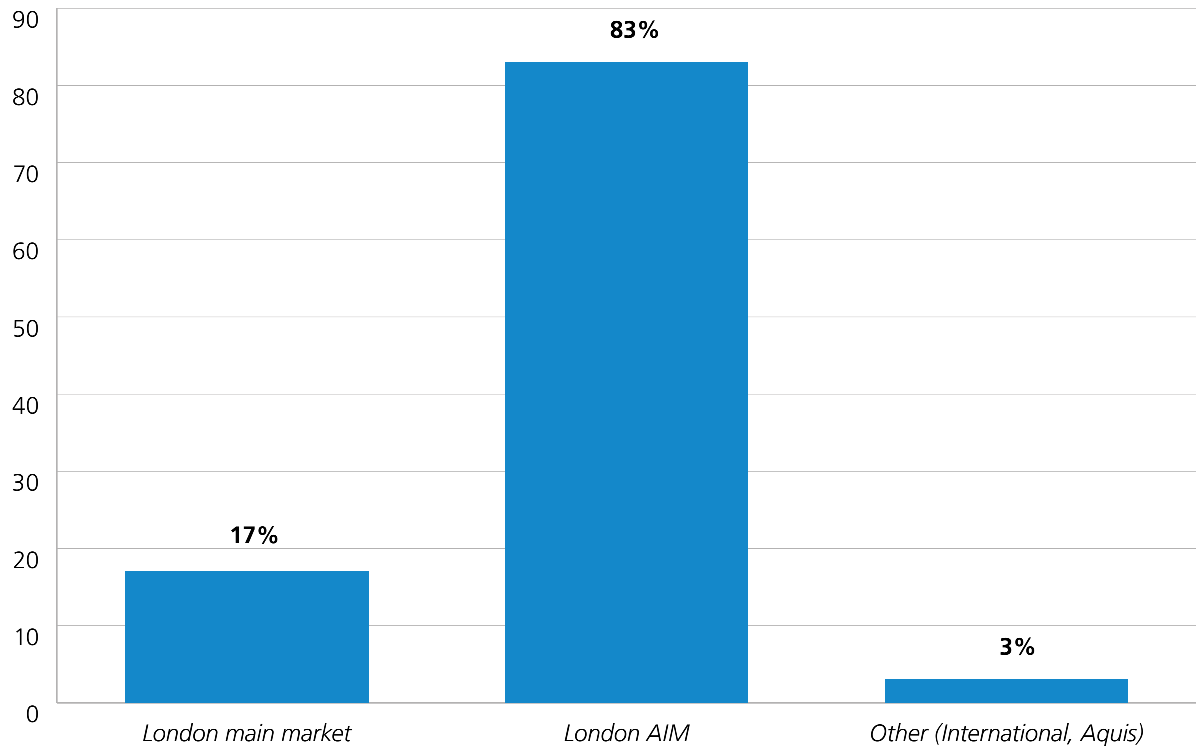
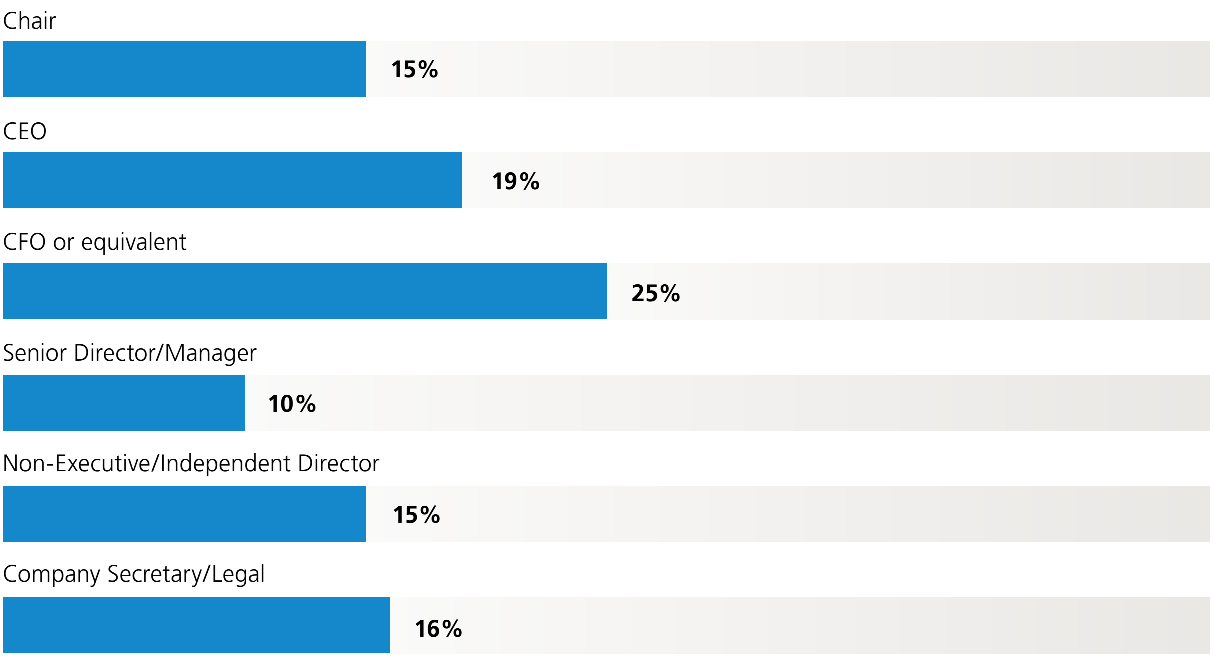


Figure 19: Companies by exchanges business shares traded, in percentage (n=100)



Note: More than one option may have been selected

Figure 20: Job title of respondents (companies, n=100)



Appendix 4: Sample characteristics – investors survey

Figure 21: Markets Invested (investors, n=50)

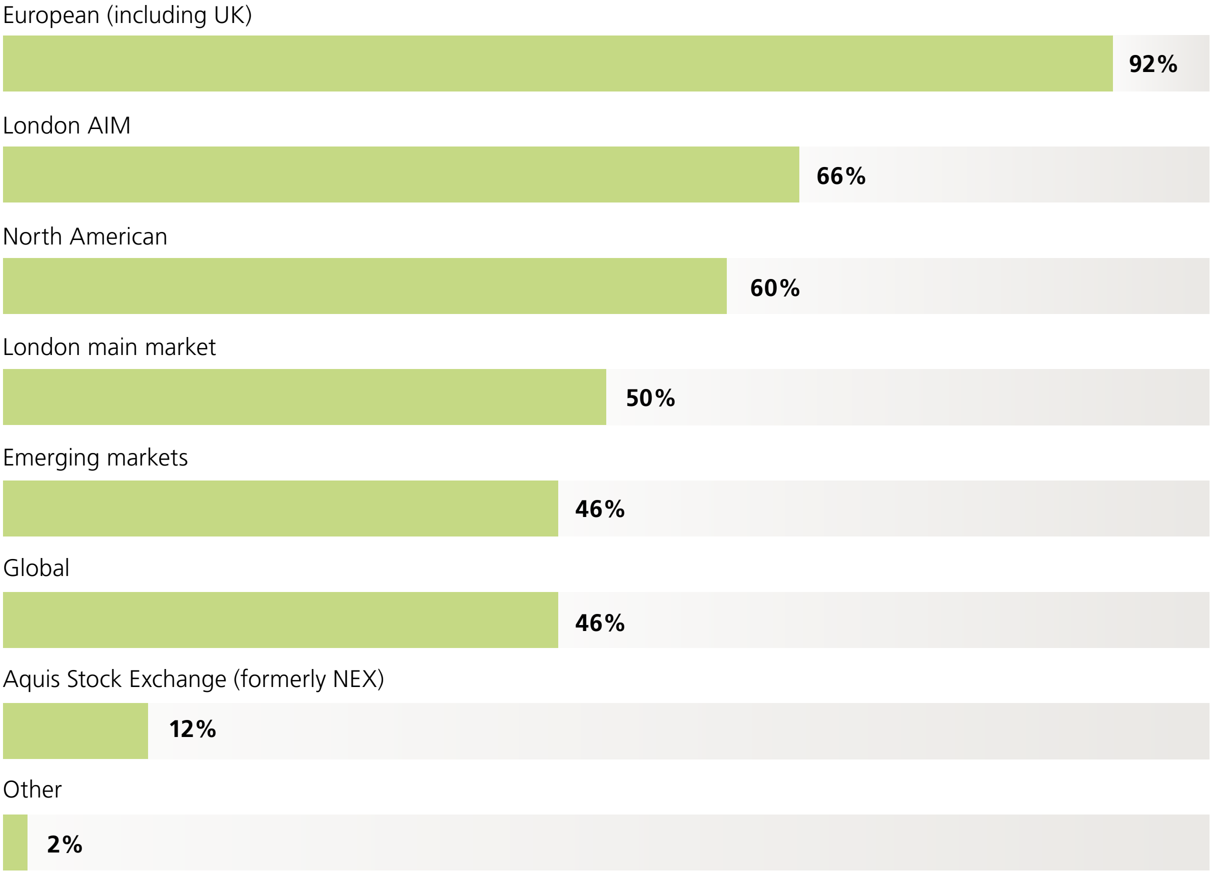
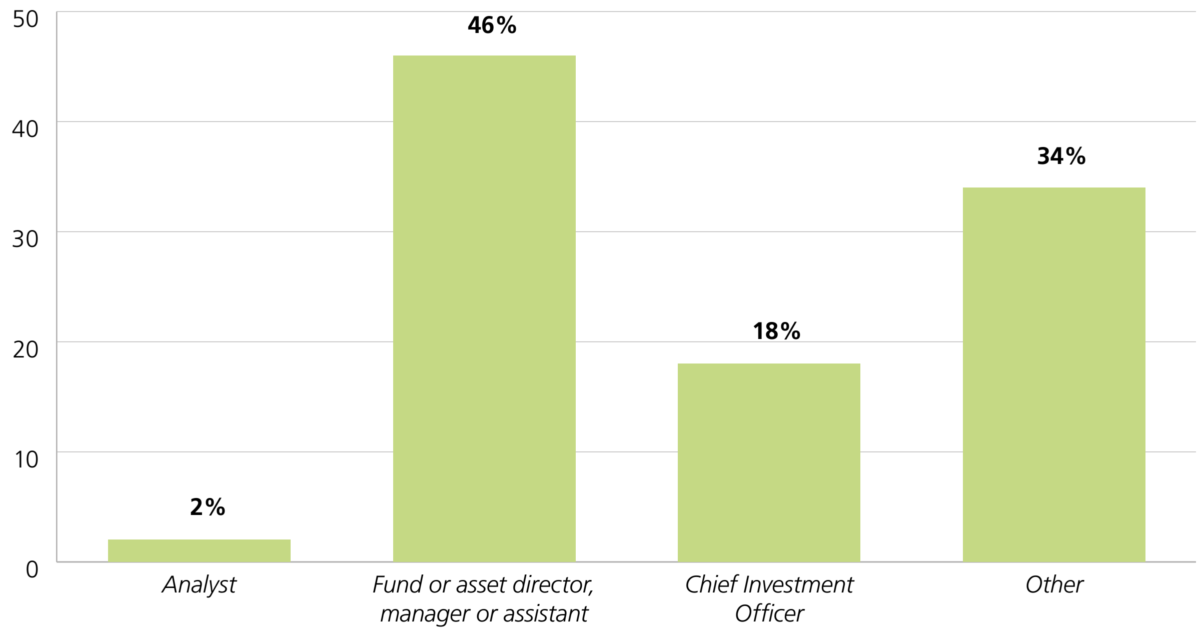


Figure 22: Job title of respondents (investors, n=50)



Appendix 5: Detailed company-investors self-ratings gaps in information disclosure quality by sector

Environmental	Companies (n=92)	Investors (n=50)	GAP
Carbon emissions	3.13	**3.35**	- 0.22
Air quality	**2.54**	**3.35**	**- 0.81**
Energy management	3.05	3.47	- 0.42
Waste and wastewater management	3.05	3.39	- 0.34
Waste and hazardous substance management	3.19	3.39	- 0.20
Ecological impacts	2.96	3.39	- 0.43

Human Capital	Companies (n=92)	Investors (n=50)	GAP
Human rights and community relations	3.35	3.72	- 0.37
Customer privacy	3.12	3.74	**- 0.62**
Data security	3.28	3.70	- 0.42
Access and affordability	**2.93**	3.54	**- 0.61**
Product quality and safety	3.56	3.71	- 0.15
Customer welfare	3.45	**3.51**	- 0.06
Selling practices and product labelling	3.35	3.55	- 0.20

Social Capital	Companies (n=92)	Investors (n=50)	GAP
Labour practices	3.52	3.72	- 0.20
Employee health and safety	3.79	**3.56**	**+0.23**
Employee engagement, diversity and inclusion	**3.47**	3.78	-0.31

Business Model and Innovation	Companies (n=92)	Investors (n=50)	GAP
Product design and lifecycle management	3.34	**3.33**	+0.01
Business model resilience	3.78	3.38	**+0.40**
Supply chain management	3.23	3.54	-0.31
Materials sourcing and efficiency	**3.03**	3.46	-0.43
Physical impacts of climate change	**3.03**	3.37	-0.34

Leadership and Governance	Companies (n=92)	Investors (n=50)	GAP
Business ethics	3.82	3.62	**+0.20**
Board effectiveness	3.78	3.53	**+0.25**
Competitor behaviour	3.08	3.52	-0.44
Succession planning	**3.06**	**3.45**	**-0.39**
Management of the legal and regulatory environment	3.67	3.68	-0.01
Board oversight	4.00	3.58	**+0.42**
Critical incident risk management	3.47	3.66	-0.19
Director compensation / incentives	4.13	3.54	**+0.59**
Systemic risk management	3.48	3.68	-0.20

Appendix 6: ESG survey results summary by company size

ESG Theme	Up to 250 employees	>250 employees
1. Accountability for ESG	**Board:** 34% **CFO:** 29% **Senior Management Team:** 29% **CEO:** 20% **Chair:** 15% **Employees/staff:** 7% **Committee/Specialist Team:** 1.2%	**Board:** 54% **Senior Management Team:** 44% **CEO:** 36% **Chair:** 10% **CFO:** 8% **Committee/Specialist Team:** 8% **Employees/staff:** 7%
2. Knowledge of ESG	**Very:** 19.6% **Moderately:** 69.6% **Not at all:** 10.9%	**Very:** 26.4% **Moderately:** 67.9% **Not at all:** 5.7%
3. Determination of value of ESG for long-term financial performance	**Within last 12 months:** 29.3% **1-2 years ago:** 19.5% **3-5 years ago:**14.6% **6-10 years ago:** 7.3% **>10 years ago:** 4.9% **Don't believe ESG has any impact:** 0% **Not currently, anticipate greater focus in future 1-2 years:** 19.5% **Don't know:** 4.9%	**Within last 12 months:** 22% **1-2 years ago:** 30% **3-5 years ago:**16% **6-10 years ago:**2 % **>10 years ago:** 10% **Don't believe ESG has any impact:** 4% **Not currently, anticipate greater focus in future 1-2 years:** 14% **Don't know:** 2%
4. External drivers of management of ESG risks and opportunities*	**Gov./Reg:** 102% **Investor base:** 63% **Marketplace:** 59% **PO/PG:**47% **Other:** 10%	**Gov./Reg:** 110% **PO/PG:** 82% **Marketplace:** 80% **Investor base:** 74% **Other:** 14%
5. ESG integration as part of company strategy or vision	**Yes:** 58%	**Yes:** 64%
6. Presence and familiarity with formal ESG purpose statement	**Yes:** 67%	**Yes:** 75%
7. Use of investor specific meetings/ roadshows to communicate ESG	31.7%	40%
8. Companies' use of standards to evaluate and report on ESG	**Yes:** 12%	**Yes:** 24%
9. Quality of ESG "Environmental" disclosure**	**2.74**	3.11
10. Quality of ESG "Social Capital" disclosure**	**2.88**	3.62
11. Quality of ESG "Human Capital" disclosure**	**3.48**	3.67
12. Quality of ESG "Business Model & Innovation" disclosure**	**3.23**	3.39
13. Quality of ESG "Leadership/Governance" disclosure**	**3.52**	3.75
14. We understand the positive impact that ESG can have on our long-term financial performance	68%	78%
15. We are too focused on the short-term to understand the long-term impact of ESG on performance	29%	12%
16. We understand how managing ESG issues can have an impact on performance, but we don't know how to quantify it	**54%**	**44%**
17. We are not sure how to effectively communicate to our stakeholders the potential impact of ESG	37%	26%
18. Our understanding of the impact of ESG helps inform the development of our strategy and business model with regard to our performance	**39%**	**62%**
19. Our strategy and business model with regard to the impact of ESG is clearly understood by our stakeholders	32%	30%

* Gov./Reg. = government/regulator/watchdog ; Marketplace = customers/clients/suppliers/competitors; PO/PG = public opinion/ environmental and social pressure groups. Respondents could give multiple responses.

** Scales reversed: 1=Very poor to 5=Very good

Appendix 7: Detailed company self-ratings in information disclosure quality by sector

Environmental	**Banking, Financial Services** (n=15)	**Utilities, Oil & Gas, Chemicals** (n=18)	**Real Estate, Construction** (n=13)	**Retail, Food, Travel & Leisure** (n=13)	**Aerospace, Engineering** (n=14)	**Technology & Communications** (n=19)
Carbon emissions	3.36	3.07	4.00	3.33	2.64	**2.43**
Air quality	3.29	2.85	3.25	2.00	**1.89**	2.25
Energy management	3.25	3.29	3.64	3.00	**2.55**	2.79
Waste and wastewater management	3.57	3.21	3.18	3.09	3.00	**2.80**
Waste and hazardous substance management	3.13	3.57	**2.91**	3.36	3.08	3.00
Ecological impacts	3.17	3.12	3.33	2.82	**2.50**	2.69

Human Capital	**Banking, Financial Services** (n=15)	**Utilities, Oil & Gas, Chemicals** (n=18)	**Real Estate, Construction** (n=13)	**Retail, Food, Travel & Leisure** (n=13)	**Aerospace, Engineering** (n=14)	**Technology & Communications** (n=19)
Human rights and community relations	3.54	3.44	3.40	4.08	3.08	**2.81**
Customer privacy	3.83	2.93	3.30	2.83	**2.58**	2.94
Data security	4.07	3.06	**3.00**	**3.00**	3.15	3.37
Access and affordability	3.50	2.88	3.10	3.13	**2.38**	2.91
Product quality and safety	4.17	3.65	3.63	3.55	3.45	**3.15**
Customer welfare	4.18	3.40	4.00	3.22	3.09	**3.00**
Selling practices and product labelling	3.83	**3.00**	3.86	3.70	3.13	3.10

Social Capital	**Banking, Financial Services** (n=15)	**Utilities, Oil & Gas, Chemicals** (n=18)	**Real Estate, Construction** (n=13)	**Retail, Food, Travel & Leisure** (n=13)	**Aerospace, Engineering** (n=14)	**Technology & Communications** (n=19)
Labour practices	3.79	3.47	3.90	4.08	**3.00**	3.25
Employee health and safety	4.40	3.67	3.92	4.08	3.50	**3.39**
Employee engagement, diversity and inclusion	4.00	3.44	3.42	3.92	**2.93**	3.33

Appendix 7: Detailed company self-ratings in information disclosure quality by sector *(continued from page 41)*

Business Model & Innovation	**Banking, Financial Services** (n=15)	**Utilities, Oil & Gas, Chemicals** (n=18)	**Real Estate, Construction** (n=13)	**Retail, Food, Travel & Leisure** (n=13)	**Aerospace, Engineering** (n=14)	**Technology & Communications** (n=19)
Product design and lifecycle management	3.57	**3.29**	3.75	3.30	3.36	3.31
Business model resilience	3.87	3.83	4.08	3.62	**3.36**	3.68
Supply chain management	3.82	3.19	3.25	3.38	**3.00**	3.13
Materials sourcing and efficiency	3.67	3.07	3.17	3.20	**2.50**	3.00
Physical impacts of climate change	3.38	**2.80**	3.50	2.89	2.82	3.00

Leadership and Governance	**Banking, Financial Services** (n=15)	**Utilities, Oil & Gas, Chemicals** (n=18)	**Real Estate, Construction** (n=13)	**Retail, Food, Travel & Leisure** (n=13)	**Aerospace, Engineering** (n=14)	**Technology & Communications** (n=19)
Business ethics	4.07	3.72	4.00	4.08	**3.57**	3.74
Board effectiveness	4.20	3.83	3.77	4.00	**3.21**	3.58
Competitor behaviour	3.25	3.08	3.60	3.36	**2.57**	2.88
Succession planning	3.60	2.94	3.08	3.25	2.79	**2.76**
Management of the legal and regulatory environment	4.20	3.53	3.54	4.15	**3.21**	3.42
Board oversight	4.40	3.89	3.92	4.15	**3.50**	3.95
Critical incident risk management	4.27	3.24	3.69	3.50	**3.08**	3.18
Director compensation / incentives	4.21	4.00	**3.85**	4.62	3.86	4.11
Systemic risk management	3.93	3.35	3.50	3.42	3.36	**3.24**

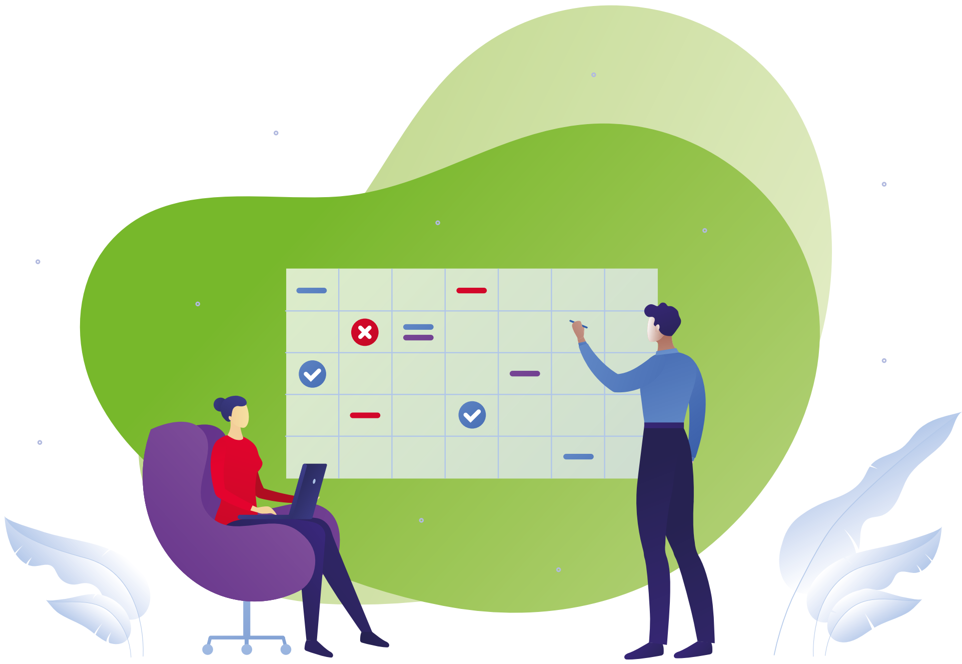
Appendix 8: ESG survey results summary by sector

ESG Themes	Banking, Financial Services (n=15)	Utilities, Oil & Gas, Chemicals (n=18)	Real Estate, Construction (n=13)	Retail, Food, Travel & Leisure (n=13)	Aerospace, Engineering (n=14)	Technology & Communications (n=19)
1. Accountability for ESG (top 2)	Board: 53% Exec Team: 47%	CEO: 39% CFO: 39%	Board: 46% Exec Team: 39%	Exec Team: 46% Board: 39%	Exec Team: 43% CFO: 36%	Board: 53% Exec Team: 32%
2. ESG focus starts next 1-2 years	27%	22%	15%	8%	14%	21%
3. ESG focus started last 12 months	20%	28%	31%	23%	21%	16%
4. ESG external drivers*	**Gov./Reg: 113%** **Investors:** 68% **Marketplace:** 47% **PO/PG:** 27%	**Gov./Reg: 94%** **Investors:** 89% **Marketplace:** 78% **PO/PG:** 78%	**Gov./Reg: 92%** **Marketplace:** 92% **PO/PG:** 62% **Investors:** 61.5%	**Gov./Reg: 108%** **PO/PG:** 92% **Marketplace:** 69% **Investors:** 62%	**Gov./Reg: 114%** **Marketplace:** 79% **Investors:** 57% **PO/PG:** 36%	**Gov./Reg: 126%** **PO/PG:** 84% **Marketplace:** 79% **Investors:** 63%
5. ESG integral part of vision strategy	73%	56%	**85%**	62%	**50%**	53%
6. Investor specific meetings/ roadshows to communicate ESG	40%	44%	**46%**	**46%**	21%	**11%**
7. Formal purpose in relation to ESG	**36%**	70%	91%	75%	**100%**	70%
8. Use of standards to evaluate/report on ESG	20%	22%	**31%**	**31%**	**7%**	11%
9. Quality of ESG "Environmental" disclosure**	**2.9**	3.2	3.5	**2.6**	**2.7**	**2.8**
10. Quality of ESG "Social Capital" disclosure**	3.9	**3.1**	3.9	3.4	**2.9**	3.1
11. Quality of ESG "Human Capital" disclosure**	4.0	3.5	3.7	4.1	**3.2**	3.3
12. Quality of ESG "Business Model & Innovation" disclosure**	3.9	3.4	3.6	3.4	**2.9**	3.3
13.Quality of ESG "Leadership/ Governance" disclosure**	4.0	3.5	3.8	3.8	**3.3**	3.4
14. We understand the positive impact that ESG can have on our long-term financial performance	**86.7%**	72.2%	76.9%	84.6%	64.3%	**57.9%**
15. We are too focused on the short-term to understand the long-term impact of ESG on performance	**13.3%**	27.8%	23.1%	15.4%	**28.6%**	21.1%

ESG Themes *(continued from p43)*	Banking, Financial Services (n=15)	Utilities, Oil & Gas, Chemicals (n=18)	Real Estate, Construction (n=13)	Retail, Food, Travel & Leisure (n=13)	Aerospace, Engineering (n=14)	Technology & Communications (n=19)
16. We understand how managing ESG issues can have an impact on performance, but we don't know how to quantify it	53.3%	50.0%	**53.8%**	46.2%	42.9%	**31.6%**
17. We are not sure how to effectively communicate to our stakeholders the potential impact of ESG	**40.0%**	22.2%	23.1%	23.1%	35.7%	**42.1%**
18. Our understanding of the impact of ESG helps inform the development of our strategy and business model with regard to our performance	60.0%	55.6%	**69.2%**	61.5%	35.7%	36.8%
19. Our strategy and business model with regard to the impact of ESG is clearly understood by our stakeholders	26.7%	27.8%	**53.8%**	30.8%	**21.4%**	36.8%

* Gov./Reg. = government/regulator/watchdog ; Marketplace = customers/clients/suppliers/competitors; PO/PG = public opinion/ environmental and social pressure groups. Respondents could give multiple responses.

** Scales reversed: 1=Very poor to 5=Very good



About the QCA

We are the Quoted Companies Alliance, the independent membership organisation that champions the interests of small and mid-sized quoted companies.

The value of our members to the UK economy is vast – as is their potential. There are around 1,250 small and mid-sized quoted companies in the UK, representing 93% of all quoted companies. They employ approximately 3 million people, representing 11% of private sector employment in the UK, and contribute over £26bn in annual taxes.

Our goal is to create an environment where that potential is fulfilled. We identify the issues that matter to our members. We keep them informed. And we interact to build the understanding and connections that help our members stay ahead. The influence we have, the influence we use, and the influence we grow ensures that our members always benefit from the impact of our initiatives.

theqca.com

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