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ESG and Investing in Small Caps

Analysing and understanding ESG factors in smaller companies is very different to top-100 companies. For a start, there is less public information available and fewer groups doing external research. Smaller companies do not have the resources to produce a glossy annual sustainability report or have proxy advisors examining board structures and remuneration reports. Broker analysis of ESG issues largely relate to larger companies and mid-tier brokers tend to avoid the issues altogether. Bottom line; in smaller companies you do it yourself.

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Introduction

We were recently taken by surprise when during a conversation about the role of ESG in equity analysis one of those present dismissed it as "woke investing". That led to time pondering why someone would think of it in this way; not withstanding that the term 'woke' relates to social justice and racism. So given ESG's high, and rapidly growing profile, we thought it worthwhile putting our thoughts as to what it actually means (and what it doesn't), how it can be applied to small cap stocks and what benefits that application can mean to an investment portfolio.

The term ESG (Environmental, Social and Governance) has become a catchall for a number of non-financial investment approaches. These include Corporate Social Responsibility (CSR), Socially Responsible Investing (SRI) and several ethical and belief-based approaches to equity investing. ESG has a broad scope and with that, comes broad interpretation. In order to corral the concept, it is worth pointing out early that there should be a clear distinction between ESG and ethical investing. ESG is about addressing investment risk and ethical investing is based on belief.

Of course, there is overlap. An ethical investor will do analysis on ESG factors in addition to addressing the ethical factors that may lead to industry exclusions or biases in a portfolio. Ultimately, understanding how a company addresses ESG issues is an insight into its long-term risk profile. And at Flinders, that is why it is a core consideration and why we have always incorporated it into our research approach.

Analysing ESG Factors in Small Caps

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The added issue is that smaller companies are inherently higher risk than large companies. Which is why understanding ESG issues are fundamentally more important.

ESG – Flinders Approach

G (50% weighting)	Many small companies have Board structures that often do not appear as "best practice"
S (30% weighting)	Many small companies rely on Government expenditure (and/or) regulation for their revenue base
E (20% weighting)	There are few small cap industrial companies where environmental issues are likely to be a concern

In small caps, minor events can cause larger problems. It should be a core part of any risk assessment of a company.

Just as understanding a company's management of costs, margins, marketing, debt and working capital are all vital to their short-term prospects and risk profile, understanding a company's environmental impact, people & culture, industry regulation, board composition and competency are all related to longer term risk and need constant assessment.

The following points will give an indication as to how we think about each of the Environmental, Social and Governance factors, their relative importance and examples of why it is a necessary part of our research process.

1. ENVIRONMENTAL:

Contrary to expectation, environmental impact is the least important ESG investment criteria. Unlike the top 100 companies, there are few primary manufacturing, chemical or operating mining companies (no shortage of explorers) amongst small caps. The majority of companies in this part of the market are service focused ranging from retail, financial, technology, health, property and tourism. That is to say, lower environmental impact sectors of the economy.

However, there are companies that do require close assessment - particularly resource companies that are in production. Issues such as waste product disposal, ground contamination and mine rehabilitation are all significant issues and compliance on a consistent basis is a minimum.

^ Prior to establishing Flinders with partner Andrew Mouchacca, Richard ran socially responsible investment portfolios for over a decade and was one of the original members of ESG Research Australia which is now part of the Responsible Investment Association Australasia (RIAA).

> *"ESG factors impact the risk of a company, and ultimately its valuation. Our highest ESG weighting when we assess companies is Governance. In our experience, it is the single largest factor which can impact the long term performance of small companies.*
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Most small cap resource companies that are producers certainly have the internal capability to deal with the basic regulatory requirements (at a minimum). Areas of risk need to be understood and the best way to do that is through discussions with management, site visits and knowing the history and record of a company's compliance. Again, it is not something covered adequately in a sustainability report (most small companies don't have them). It has to be do-it-yourself.

The issue of carbon emissions and abatement is also captured in this category. This should not be an emotional, political or ethical issue as much as it has become so. Consequently, when it comes to investing in equities (and anything else related) there is plenty of mud in the water. As always, it's about longer term risk, so ignoring short term politics and polarised views is a good start.

Having just advised against listening to the politics, one way or another, both major Australian political parties are blushingly edging toward a net zero emissions target by 2050. That's important because there aren't too many ways of getting there. Technology is evolving quickly but not fast enough for some proposed pathways to make them part of the answer. Solar, wind and energy storage will be the final outcome – perhaps with help from hydrogen. But that neat package is still well over a decade away in scale and adoption. So where is the risk and where is the opportunity? Hopefully, you noticed the word *opportunity*. Unlike most ESG related factors that address risk, the carbon issue also provides opportunity because of the enormous economic change that it will bring to our future.

To be fair, the risk impact in listed smaller companies is modest. Outside of the relatively small coal sector (which includes miners and associated service providers) demand will fall as electricity generators close over time. The impact will be low and slowly felt but obviously it is an area to be avoided. The opportunity, however, is potentially rich. Battery materials, power grid contractors and software providers, specialty finance companies, engineering and fabrication companies, the list goes on. So, in a nutshell, understanding the environmental issues faced by smaller companies is vital for risk assessment but will also illuminate opportunities for companies in the future.

2. GOVERNANCE

Ok, back to risk. At Flinders, our highest ESG weighting when we assess companies is governance. That is because in our experience, it is the single largest risk factor which can impact the long term performance of small companies. A company's governance also has clear implications for environmental and social issues. So, when we assess a company on an ESG basis, governance has a 50% weight.

The term governance covers a broad field. Simplistically, it refers to the board of directors and how they govern the strategy and management of a company on behalf of its shareholders. In reality, it involves much more. Compliance, legal, audit, culture, systems, strategy, human resources (people) and use of shareholder funds are just some aspects of governance.

Small companies have to be looked at differently (and more closely) in this regard. Sadly there is no cookie-cutter approach that will fit into a proxy advisors tick sheet. The key reason is the evolution of a company from when it is first listed and then how (and if) it grows and matures as a listed company.

When companies first list, it is either to access growth capital or to provide a sales mechanism for existing shareholders to divest some or part of their holding – or a combination of both. Consequently, it is not unusual to have board and management with significant or controlling holdings in smaller companies (and occasionally in large ones). From one angle, that looks like alignment of interest with minority shareholders. From another angle, risk that minorities get a nasty surprise from an event not in their interest. That is where an assessment of the board and their relationship with the management team is vital.

Independent directors that are truly independent are essential for the protection of all shareholders. In fact, it is a legal requirement. Sadly, not always properly adhered to. Independence is one thing, but non-executive directors (NEDs) also need to bring skills that will help the company develop and carry out its strategy and importantly, make sure that their management team adhere to the strategy to the best of their ability. As a fund manager, it is our job to assess if those skills exist, if the NEDs have the voice to be independent when needed and to understand what is expected of both board and management by shareholders.

We often see outcry and anguish from listed company boards and management about the role of proxy advisors. They should stop. While the advisors can be systematic and miss nuance at times, they still perform a role in the protection of minority shareholders – and deciphering over-complicated remuneration reports. Perhaps the corporates (and the board members in particular) could spend more time communicating with their shareholders (large and small).

Smaller companies are generally not covered by proxy advisors, so again we need to make the assessments and judgements ourselves. We look for companies that communicate their strategy and have consistency in adhering to it. If there are changes (and there naturally are), why and what are the expected outcomes.

We respect companies that can also articulate and put in honest context bad news. Consistent, transparent, and detailed financial accounts are very important, as is a company's history of capital management – especially their use of working capital, which is ultimately the shareholder funds we are looking for a return on.

We watch senior staff turnover closely, as well as CEO and board tenure. Succession planning at both board and management level is also important. And then for smaller companies, their corporate evolution as they grow. How they deal with their capital structure, increased stakeholders, the greater demands and responsibilities of both management and board need to be monitored because when things go wrong in small companies, they tend to go seriously wrong.

There is no simple approach, it's about engaging with the companies, understanding their history and keeping close to the way they currently go about their business. Governance will always largely be a subjective assessment, but it is always going to be based on risk.

3. SOCIAL

Ok, they were not in regular order – alphabetical instead. The social aspect of ESG can get confusing but it shouldn't. The way we look at 'social' is the behaviour, and impact of that behaviour, by a company on its broader operating environment. By that we mean everything from its customers, suppliers, employees, contractors, landlords, tenants plus a host of others; but most importantly, regulators.

Ultimately, regulators exist to provide an operating environment in which businesses must adhere to a set of rules that protect stakeholders (those that may be impacted by a company) from poor corporate behaviour. Well known bodies such as the ACCC, ASIC, APRA, various Ombudsmen and any number of Government departments provide a regulatory framework for companies to operate. Step out of line and there are usually consequences and consequences with a regulator equals risk.

A good example is that a large number of smaller listed companies rely on the Government for a significant proportion of their revenue. They may be involved in healthcare, education or aged care - all socially (and politically) sensitive sectors. We have seen poor behaviour in all of the above sectors at various times and it has led to stricter regulation, licences being pulled, and even Royal Commissions. This can also impact companies complying with regulation. So, understanding those industries, spotting unsustainable profitability or companies working against (rather than with) the spirit of the regulation are reasons for concern – and engagement with management, competitors and industry bodies helps evaluate those risks.

As mentioned earlier, governance overlaps with social. A well-run company that provides a good professional work environment will have more consistent regulatory compliance. When staff are well trained and incentivised, they will be more responsive to how they deal with customers, peers and others they deal with at work.

These are often the hardest aspects to evaluate by an investor, but it is often easier to get an insight with a small company than a top 100 company that have public relations and investor relations departments controlling information to shareholders.

We also do not underestimate the potential negative impact of social media on a company if there is poor corporate behaviour (no matter how serious). Deterioration of a corporate image can have a rapid and significant impact on any company, but it is amplified in smaller ones. Another reason companies must address the potential risks associated with its social responsibilities.

The emphasis is again on assessing things that could go wrong. Social considerations are about a company's interaction with its human surroundings and most of us have worked for companies that do it well and in ones that don't. Now think of which ones would be more likely to strike problems…

In summary, there are some simple points we have attempted to flesh out in this paper. It is a topic that is getting an increasing profile but is often over complicated and at times, confused. At Flinders, ESG has always been a part of our investment process and approach to portfolio construction. Not every investment manager will look at it the same way but for us it is natural to incorporate it into the way we look at any company in any sector.

We leave you with five points:

- ESG should be seen through a lens of longer-term risk assessment.
- Keep a clear view of what each of Environment, Social and Governance means to a particular company.
- Smaller companies are higher risk and have higher volatility than large companies – therefore, ESG issues have a greater potential impact on their performance.
- A small companies fund manager must do the ESG research themselves and in our view direct engagement with companies is the only way to do it.
- Reducing investment risk, of which ESG is an important part, leads to better returns. And at Flinders, that's what we strive to do.

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