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ESG requirements overburden SMEs

- **EFFAS warns of regulatory overload for listed SMEs in meeting sustainability standards**
- **ESG baseline strategy called for as a transitional solution**

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EFFAS - the European Federation of Financial Analyst Societies – discussed at its annual CESG Conference in Frankfurt various sustainability subjects. One important topic has been the ESG regulation and its influence on SMEs (small to medium-sized companies).

Under the Sustainable Finance Disclosure Regulation (SFDR, which regulates disclosure obligations in the financial services sector), investment funds and asset managers are continuously called upon to classify all portfolio investments in order to enable an ESG classification of the respective fund.

In this context, investment funds are classified into three categories analogous to the SFDR: Article-9 funds, so-called impact investment funds, Article-8 funds, which invest mainly in companies that already fulfil ESG criteria, and so-called Article-6 funds, which have no or only a low ESG affinity.

"The continuous and recently strongly increasing inflows of funds for ESG-compliant investments, clearly underpins how important it is for listed companies to fulfil ESG criteria. Otherwise, companies run the risk of no longer being investable for ESG funds," says Frank Klein, Co-chair of the EFFAS ESG Commission and client coverage officer at DWS International in Frankfurt.

Not only blue-chip companies across Europe (including the CAC 40 in France, the DAX 40 in Germany or the FTSE MIB in Italy) but also companies with a market cap as small as € 1bn have taken action and have set up their own ESG teams to establish ESG data pools. Further on they mandated external sustainability specialists and finally were evaluated by ESG rating agencies.

"However, in the context of the Disclosure Regulation, it has become apparent that funds classified under Article-8 or Article-9 that invest in SMEs (small and medium-sized enterprises) generally have no access to ESG ratings or corresponding ESG company data of SMEs. Thus, the methodology of the fund providers assumes that SME companies are automatically classified as unsustainable or do not have an ESG impact. Thus, investments in SMEs have become more difficult. Due to the fund specific implementation of the Disclosure Regulation investments in SMEs are often systematically outmanaged." says Thorsten Müller, co-head of the EFFAS Capital Markets Commission and Managing Director at Lighthouse Corporate Finance GmbH in Frankfurt.

In addition to the low trading liquidity, which has already made it difficult for institutional investors to invest in SMEs for some time, there is now a further hurdle in the form of ESG requirements. “The ongoing trend towards passive fund management also in the context of ESG products increases this hurdle” adds Stefan Maxian, member of the EFFAS Capital Markets Commission and ECM director at Raiffeisen Bank International in Vienna.

“In the SME primary bond market we are witnessing an increasing number of institutional investors demanding ESG standards and thus reducing funding cost for ESG compliant companies. While non ESG compliant SME issuers may face increased funding costs or completely drop out of the investment universe of institutional investors” says Angelo Dipasquale, member of the EFFAS Capital Markets Committee and co-head of fixed income desk at equity SIM Spa in Milan.

There is the danger of a further dry up of capital market financing for SMEs. This would have disastrous consequences for growth companies, for their IPOs, capital increases, bond issues and the listed SME sector as a whole. Numerous studies prove the high importance of the SME sector for innovation and employment. In its guidelines on the further development of the Capital Markets Union, the EU Commission also points out the great importance of efficient capital market access for the SME segment. "However, by introducing ESG requirements in an undifferentiated manner according to size classes, SMEs are now threatened to become victims of the ESG regulation and its implementation," adds Thorsten Müller.

Many listed SMEs across Europe are currently unable to deliver comprehensive ESG reporting. There is a lack of trained ESG specialists, ESG data pools have not been set up yet and external consultants who can guide companies towards an ESG strategy are not available in sufficient numbers. IT- and possibly AI-based automated rating procedures for SMEs are also not yet available in Europe. According to Barbara Cohen, Co-head of EFFAS Capital Markets Commission and Executive Director of SCOPE Ratings in Paris, “currently many listed European SMEs seem simply overwhelmed with the implementation of ESG requirements”.

EFFAS therefore resolutely calls for a transitional solution for capital market-oriented SMEs in Europe to be included in the EU taxonomy or in the Corporate Sustainability Reporting Directive (CSRD), which is currently in consultation. Institutional investors should be able to classify an SME as Article-8 compliant, provided that the respective company has developed a basic ESG strategy. This basic strategy should indicate ways in which the SME will develop further in the direction of sustainability in the future, corresponding data pools should be built up and which key performance indicators should be introduced. The future development of a best practice guide for an ESG baseline strategy for SMEs would be beneficial. The financial community could proactively support this process. According to EFFAS, a three year transition period would be adequate. Afterwards, the planned CSRD should come into force for capital market-oriented SMEs.

As already stated by ESMA (European Securities and Markets Authority) on the subject of the reintroduction of bundling within the framework of MiFID II, a size limit of up to € 1 billion market capitalization is a suitable definition for a listed SME. If only bonds are listed, a total issue volume of up to € 250 million would be an appropriate definition from the EFFAS's point of view.

By establishing an ESG Baseline Strategy listed SMEs have a feasible workable tool to qualify for Article-8 funds during the transition period. While institutional investors receive an operable "tick the box" solution (ESG Baseline Strategy is available: yes/no) for ESG compliant SME investments. In this way, SMEs could participate in the growing ESG financial flows instead of being systematically cut off from them.

EFFAS – European Federation of Financial Analysts in Europe:
EFFAS was established in 1962 as an association for nationally based investment professionals in Europe. Headquartered in Frankfurt am Main, EFFAS comprises 15-member organizations representing more than 16,000 investment professionals.