CANDRIAM
A NEW YORK LIFE INVESTMENTS COMPANY

Human Capital in Small and Mid-Sized Firms: Part II

Active Engagement

MARCH 2024

Marketing communication

The topic.

Human Capital is a key asset for smaller, rapidly-growing companies. Most of these companies are keenly aware of the importance of Human Capital Management (HCM) to their continued profitable growth. In the second phase of our Engagement campaign on HCM in European Small- and Mid-Sized companies (SMIDs), we broadened our target sample, updated our data collected in the first phase, and used the results to understand the realities on the ground, especially post-Covid. The direction of these companies is generally positive and improving in their HCM. We also evaluated the preparedness of these companies for the new European disclosure requirements.

8 DECENT WORK AND ECONOMIC GROWTH

Human Capital Management is both a strategic issue as well as a Sustainability issue. Investors have engaged over time with larger companies, in particular through the collaborative Workforce Disclosure Initiative (WDI). Beginning with fiscal year 2024 reporting, EU regulations will require larger firms to report a wide range of HCM metrics, to be followed soon after by reporting from all firms. The larger firms do not seem prepared.[1] Will the SMIDs be ready?[2]

To maintain the rapid growth which attracts investors to this segment, SMID companies must both retain talent and attract new talent, while competing with larger companies for the same employees. These challenges are made even more difficult because the rapid growth strains workers. We believe that Human Capital is a key asset and a key risk – both a financial risk, and a sustainability risk. Our goal is both to gather information and to accompany the companies along their Sustainable journey.

In January 2022, we shared our Case Study on the first phase, outlining our goals and methodology. Our database and questionnaires included four categories of Key Performance Indicators (KPIs) -- Workforce Stability, Workforce Demographics, Workforce Development, and Employee Engagement. Among the twelve[3] KPIs, some of the most important include employee turnover and retention, training (which might help to retain and motivate employees), and diversity. We filled in our database with published information from each of the target companies and shared the compilation with all of the companies. Most companies offered additional information which they had collected but not published.

1 Les Echos, 2 Jan 2024. Directive CSRD : un immense défi des entreprises pour 2024 | Les Echos. Accessed 20 February, 2024.
2 The ESRS, or European Sustainability Reporting Standards, is a set of 12 standards which are part of the CSRD, or EU Corporate Sustainability Reporting Directive. Larger firms will be required to report their 2024 data in 2025, while smaller firms will be phased in from 2025 onwards.
3 We adjusted our KPIs after the first stage, originally 13, settling on 12. In the first phase, we also examined companies' Management of the Covid-19 crisis.

The choice of relevant and meaningful KPIs is critical to extra-financial measurement and progress reporting, and critical to a successful Engagement. The KPIs must provide insight not only in themselves, but also to guide the qualitative questions and the dialogues with issuers. They should offer realistic comparison against peers, and for each company over time.

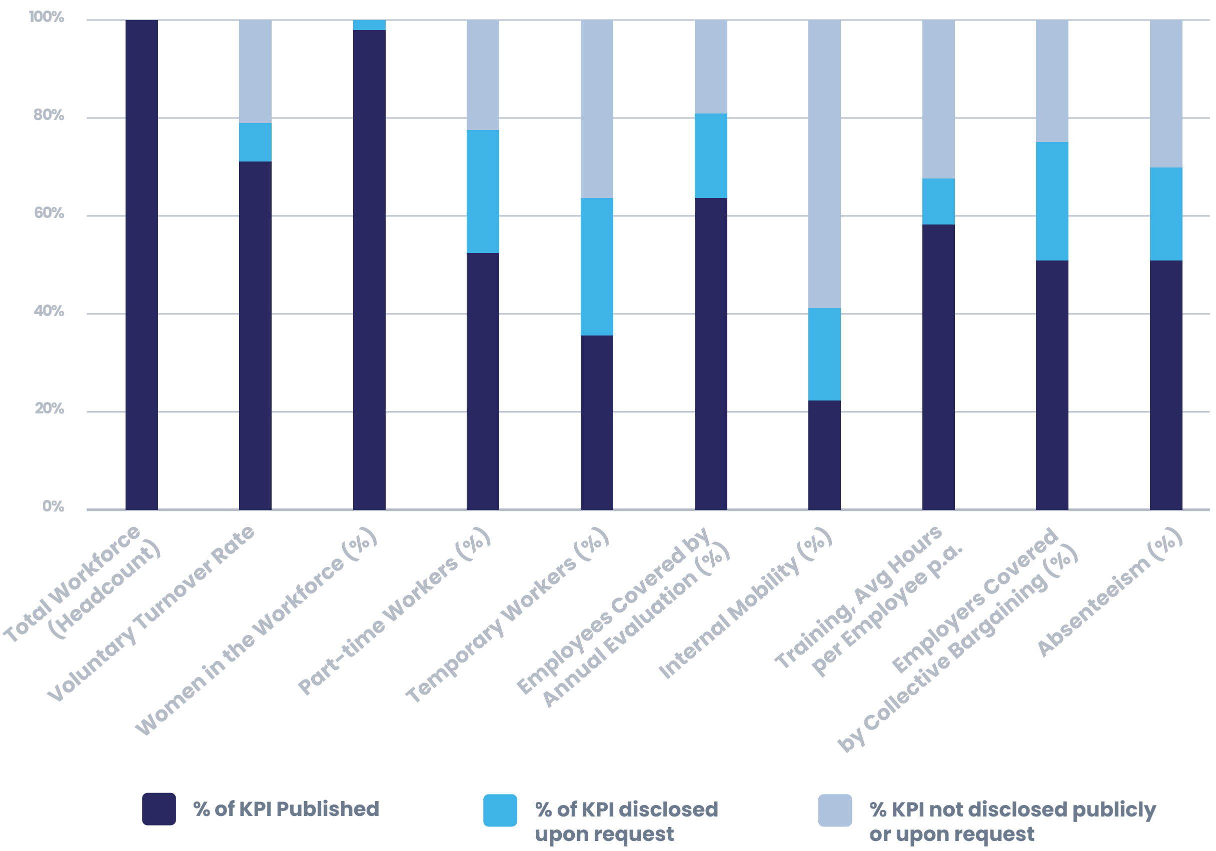
> **"These rapidly-growing European companies take their need for human capital seriously.**

The story thus far.

In 2022, we explained the logic behind our KPIs, and the insights we hoped to gain. With the two-phase broad campaign now complete, we can begin to draw some conclusions. Begin, that is, as Engagement is an ongoing part of our investing, not an end in itself.

The response rate was strong, underscoring that SMID companies consider HCM important to profitable and sustainable growth. In the first phase, we reached out to more than 60 companies, with a 72% response rate. During the second phase, we reached out to 67 companies, with an 84% response rate. This is a high response rate for an Engagement campaign, perhaps in part because most of these companies felt that HCM is important to their future success. Another reason for the high response is presumably because we are long-term shareholders in most of the target companies, and we have strong relationships with some of them. Our collaboration with the WDI showed that few large companies are transparent and informative about their workforces, so we were particularly gratified to have such a response

Figure 1:
Potential for further disclosure



Source: Candriam

We made some adjustments to our target list between the two phases, mostly reflecting changes in the composition of our investee companies, but we had 49 responding companies who participated in both phases, allowing for some comparison over the two phases.

The Engagement Team, the ESG Team, the Investment Team, and Candriam's internal Human Resources Team worked together to determine and revise both the KPIs and the qualitative questions. We aligned our views to speak with one voice in our dialogues with the companies.

The workforce growth rate was enormous, at 24.8% over the two years. Clearly with this type of increase, it is crucial to understand how each company is managing their hiring, training, motivation, and efficiency. It must be noted that the two data phases of our study correspond to the low of the Covid-19 crisis, and the high of the Post-Covid-19 hiring growth.

Transparency levels varied sharply by topic. The divergence is surprising, as ten of the twelve KPIs we chose will soon be required reporting figures under the European CSRD.[2] For example, although the percentage of temporary workers is part of the new reporting requirements coming soon, only 39% of respondents either publish it now, or provide it when asked. Towards the other end of the spectrum, 98% of the respondents published or provided the proportion of women in the workforce.

Among the ten KPIs collected in both phases, transparency improved in five but declined in the other five. Internal mobility and the proportion of temporary workers were among the least-transparent KPIs, and among those which suffered the greatest decline in disclosure.

Employee retention is competitive. Obviously the optimal level varies by industry. In the first phase, voluntary turnover for our target SMID companies averaged 7.6% versus large-company turnover of 11.3%.[4] During the second phase, using a somewhat different group of SMID companies, average voluntary turnover rose from 8.3% in 2020 to 11.2% in 2022. Of course, much of the increase is attributable to the post-Covid-19 changes.

SMID companies are investing to retain employees. Training hours and internal mobility rates are two KPIs which can help indicate whether companies are taking actions to reduce turnover and retain talent. We believe training is an important path to retaining and motivating employees. It is a sign of the SMIDs dedication to Human Capital that training hours are rising. While we would like to see more information on internal mobility, we do admit that it can difficult to define. These companies are also emphasising annual evaluations. On average, these surveyed SMID companies are providing feedback to an amazing 91.2% of employees, another path to retention.

Companies are not prepared for the new reporting requirements. Contrary to the general expectation of a gradual improvement in public disclosure practices over time, our findings indicate a lack of meaningful progress among the SMID companies in enhancing their data collection and disclosure practices. Of the 56 responding companies, only one publishes data for all twelve KPIs, with five providing all the data requested upon request. Some companies have made notable strides in enhancing their disclosure practices, while others have exhibited alarming declines.

This revelation underscores a critical juncture for these companies as they grapple with the impending CSRD requirements. The challenges extend beyond mere compliance; they encapsulate the essence of effective governance, transparency, and responsible business practices. As the regulatory landscape evolves, the preparedness of SMID companies becomes pivotal for compliance, for upholding their commitment to sustainability, and for investment risk.

4 The WDI performed a survey of large companies at roughly the same time as the first phase of our SMID company survey.

Determining diversity.

Diversity is a profitability issue, say McKinsey and others.[5] Yet even if companies wish to measure diversity, privacy laws can make it very difficult for them to collect data on their own workers. For example, Europe's Data Protection Directive prohibits the processing of ethnic data.[6] And of course what constitutes 'diversity' is, well.....diverse.

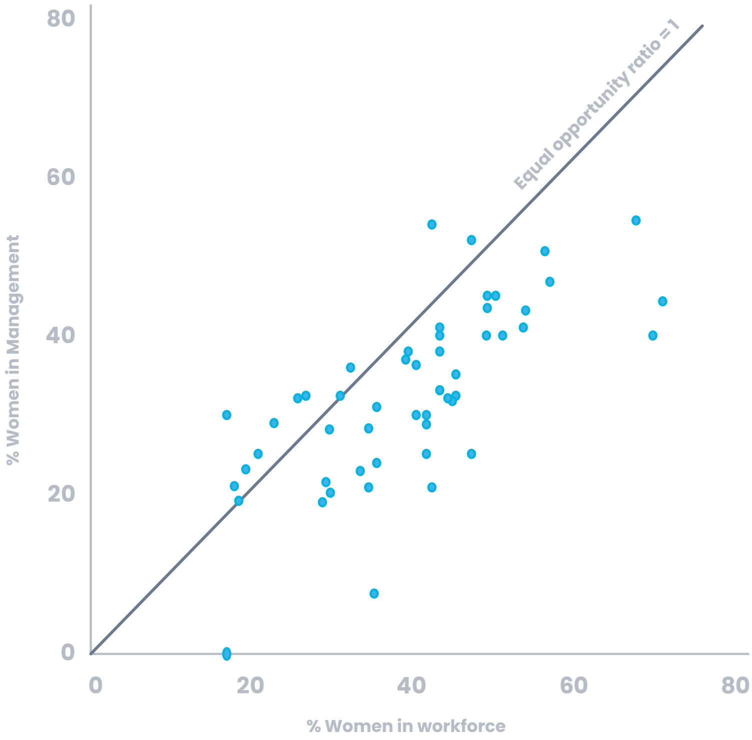
Women in the workplace was one of the metrics among our ten original KPIs. For our second round of data-gathering, we include the proportion of women in management. In contrast to the prohibition on many types of diversity data, gender diversity will be phased in as a required figure for reporting under the ESRS reporting rules. Fortunately, the SMID companies in our sample appear to be well-prepared to publish this data.

It is not enough to employ a diverse workforce, there should be equal opportunities for career development. That does not mean half of managers should be women -- but perhaps the proportion of women in management should be the same as the proportion of women across the company?

We illustrate the relative access to career development for women in our target companies, and show all the companies against the 'Equal Opportunity Ratio'. This EOR is simply that the percentage of women in management should equate to the percentage of women in the company's overall workforce (**the blue line**).

Figure 2:
Equal Opportunity Ratio

Women in Management (%) vs Women in the Overall Workforce (%)



Source: Candriam

5 McKinsey & Company. Diversity wins: How inclusion matters. May, 2020. Accessed 2 February, 2023. 2021_01_diversity_en_web.pdf (candriam.com)
6 For more on this, see Candriam's White Paper, Ethnic Diversity: Why Investors Cannot Afford to Remain Silent, January 2021

A caution for this type of data – simply comparing the overall representation within the workforce to representation on the Board of Directors, or senior management, can offer a misleading picture. A broader definition of management, to include department heads, etc, offers a more accurate picture of the development path available within the company – and a more accurate picture of the diversity of skills and background brought to decision-making and ultimately, growth and profitability.

Next steps?

Our most important discovery is that these rapidly-growing European companies take their need for human capital seriously. Companies definitely appreciate when we make the effort to deliver reports describing industry practices.

More details are available in our full white paper on the data. But averages can be misleading in any analytical effort. Stakeholders need to look at figures for each company, and look 'behind' the figures. While we have 'completed' our three-year Engagement campaign, our Engagement is not over. We will use what we have learned in all our future investment decisions for European SMID companies, and build on our data collection and our insights.

We have identified three investee companies with exceptional performance. We are evaluating these for potential upgrades of our internal ESG ratings, and identifying best practices for sharing. Twelve companies showed enough areas of concern to warrant close inspection and we are engaging with them individually on specific challenges. The are often instances of red flags thrown up by a combination of factors – for example, a combination of high workforce growth and a simultaneously high turnover rate. Or the combination of a rising proportion of part-time workers along with rising absenteeism.

Support, rather than Exclusion. We are committed to accompanying the 12 companies on the watchlist. Our aim is to facilitate a productive two-way exchange of information and insights. If we remain invested, it is because we believe in their capacity to achieve Sustainable performance. At Candriam we are active owners and debtholders. We exercise our rights when we believe actions are needed to create long-term value for our clients and ultimate beneficiaries. We will divest when necessary, but we prefer to identify companies with potential to generate Sustainable benefits and to accompany them in their growth.

€144 B

AUM at end June 2023*

+600

Experienced and committed professionals

+ 25 years

Leading the way in sustainable investing

*As of 31/12/2022, Candriam changed the Assets Under Management (AUM) calculation methodology, and AUM now includes certain assets, such as non-discretionary AUM, external fund selection, overlay services, including ESG screening services, [advisory consulting] services, white labeling services, and model portfolio delivery services that do not qualify as Regulatory Assets Under Management, as defined in the SEC's Form ADV. AUM is reported in USD. AUM not denominated in USD is converted at the spot rate as of 31/12/2022.

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