ESG Weighs-In on Executive Pay

Adopting standards to
report **ESG FACTORS**

ESG Doesn't Get Enough Love in Say-On-Pay in the U.S.

The notion of linking executive compensation to important governance issues has been a constant subject of tug-of-war between the buy-side and issuers for decades, giving rise to shareholder activism. One of the topics that has crystallized over the last three years is tying C-suite salaries to matters other than financial performance, such as adding key performance indicators that are directly tied to Environmental, Social and Governance (ESG) metrics.

Years ago, a Harvard Business Review paper published in 2015 cited evidence that corporate and social responsibility (CSR), today a component of ESG, "is likely to be financially beneficial for firms, and for shareholders. Firms with more shareholder-friendly governance are more likely to incentivize their managers to engage in CSR. Also, firms that provided compensation linked to CSR had greater levels of social performance on average, consistent with the notion that the provision of incentives for CSR leads to more CSR activities. If CSR provides sufficient financial returns to shareholders, firms with stronger corporate governance should incentivize their managers to invest in social performance."[1]

We randomly reviewed over two dozen proxies from 2019 and 2020, from small to mega cap companies worldwide, and found scarce support from C-suite executives for the idea of tying ESG metric performance to their paychecks. We found it interesting that the voting recommendations by boards of U.S. companies on proposals made by their very own shareholders was AGAINST tying any sustainability metrics to executive pay. European companies are more accommodating to ESG issues, likely because impact investing has been in focus for longer in countries including the Nordics and Germany.

It is sufficiently established that companies who have a solid oversight over ESG generate superior bottom line performance and usually appreciate faster than its peers in terms of market capitalization. It has also been corroborated, and we cited data in our previous white papers on the subject, that ESG / CSR performance addresses numerous risk factors. These allows issuers to be more prepared due to enhanced monitoring practices and actionable mitigation plans. Consequently, over the last several years we've seen a surge in demand from the buyside for ESG reporting, as well an eagerness from corporate issuers to communicate consistently with the street on ESG practices.

As standards and reporting practices evolve, many companies have started to embed ESG more deeply within their performance assessment. Some issuers took it to the next level two to three years ago by tying executive pay to specific ESG and CSR targets. In a study of 2019 proxy filings of the 52 executive compensation proposals received by S&P Composite 1500 companies, 18 sought to link executive pay to ESG metrics, representing a 50% increase to the number of such proposals received in 2017 and slight decline against 2018 figures.[2]

Activist investors and powerful supporters of ethical and sustainable business practices have been lobbying to add the ESG angle into executive compensation discussions, proposing a YES vote in recent proxies. In Mercer's surveys, at least half of approximately 200 participating companies are currently using ESG metrics in their incentive plans, or are considering to use them in the near future. European companies are more inclined to implement ESG metrics today than their North American counterparts, with over half of participants in Europe already using them compared to 30% in the U.S. and Canada. Sectors where there is a strong focus on ESG include energy, life sciences and mining & metals.[3]

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1) Harvard Business Review, Working Paper 16-014, "[Corporate Governance & Executive Compensation for Corporate Social Responsibility]"
2) Sullivan & Cromwell LLP, 2019 Proxy Season Review, Pari I (Rule 14a-8 Shareholder Proposals)
3) Mercer Study: "ESG metrics in incentive plans: Europe and North America compared" (December 4, 2019)

Most Recent Say-on-Pay Dynamic

Back in late December 2018 **Royal Dutch Shell,** responding to pressure from investors, unveiled plans to tie executive pay to a net carbon footprint from 2020 forward.

A global science-based company **DSM North America** has its executive pay tied by a massive 50% of short and long-term compensation. Compensation is attached to clear goals focused on sustainability, human factors of diversity and inclusion, and reduction of energy usage.

In its most recent earnings call and investor presentation (Q4FY20), **Clorox Company** fully committed to pursuing "Bold" 2030 environmental and sustainability goals. Clorox promotes accountability for ESG strategy in its leadership circles, making it a must to tie ESG goals to executive compensation. The Company's "Integrated Ignite ESG Goals" state that the Board of Directors must oversee ESG efforts and thus, its "*Executive compensation awards [are] tied to elements of ESG goals for members of the Clorox executive committee, including for the chair and CEO".*[4]

One of the largest utilities companies in the U.S. is **American Electric Power (AEP)**. Its leadership team considers the quality of their ESG performance to be a legitimate and material business risk. They have multiple layers of oversight built into the governance structure including a cross-functional ESG team that monitors potential and existing issues and immediately develops response strategies. AEP also has an Enterprise Sustainability Council (ESC), to which members of the Board of Directors present. This dual ESG oversight structure ensures ongoing measurement, validation, and timely action on all sustainability goals. As a testament to their utmost focus to their ESG issues, AEP also has ESG-led incentives incorporated into its executive compensation structure.

In its most recent proxy statement, **Regeneron** discussed how they maintain active dialogue with their shareholders with respect to say-on-pay matters, which now also includes ESG factors, and admit they are open to making changes based on their stakeholder inputs.[5]

FedEx recently filed a proxy statement pursuant to Section 14(a) of SEC Act (1934) asking its shareholders to vote on their proposal to integrate ESG metrics into its executive compensation. The votes are expected by September 21st, and we look forward to the final tally to see in which camp the company will end up.

AXA Investment Management, on the of the largest global money managers with AUM close to $1 trillion, follows its own set of ESG standards and screening policies to minimize investment exposure to firms with low ESG scores. In its July 2020 proxy season review the firm stated that it enhanced its voting policies on key sustainability topics and those include integration of non-financial ESG metrics into executive compensation.[6] BlackRock portfolio managers have been speaking out on the importance of having hefty executive compensation be subject to sustainable operations and examples of best corporate governance practice. However, most companies, from small to mega caps, still do not share ESG-based remuneration passion to the same extent.

XPO Logistics, Inc. (XPO), a leading global provider of supply chain solutions, ranking No. 1 in the Fortune 500 category of transportation and logistics for the fourth straight year, posted its Board recommendation to vote AGAINST having management's executive compensation weighted by ESG metrics.

4) https://www.thecloroxcompany.com/who-we-are/ignite-strategy/about-ignite-esg
5) Regeneron's Proxy Statement Filed with the SEC
6) AXA IM 2020 Corporate Governance and Voting Policy Updates

Apple, Inc. invited a long-time sustainability advocate Al Gore to be a part of its Board of Directors in 2003. In their 2020 Proxy Statement, for the first time ever since its public listing 40 years ago stated:

"RESOLVED: Shareholders request the Board Compensation Committee prepare a report assessing the feasibility of integrating sustainability metrics into performance measures, performance goals or vesting conditions that may apply to senior executives under the Company's compensation incentive plans. Sustainability is defined as how environmental and social considerations, and related financial impacts, are integrated into corporate strategy over the long term."[7]

While the report is being prepared, Apple's Board's recommendation was to vote AGAINST the shareholders' proposal of incorporating ESG metrics into the compensation of its C-Suite to drive accountability across key standards and related risks. Apple's explanation for the recommendation is that the company has already established itself as a leader in the space with multiple rewards, recognitions, and sustainability policies in place. At the same time, management compensation should be straight-forward and be based on financial performance to the extent to which shareholder value creation is being achieved. Apple's view implies that this will not be possible without proper ESG strategy embedded into its business conduct and culture. Since its core values already reflect ESG aspirations, there is basically no need to incorporate those redundant KPIs into say-on-pay matters.

Playing "devil's advocate" – if those values are already incorporated, our question is: why not just go for it and make your shareholders, including your largest ones, (i.e. BlackRock) happy?

What's the Hold-Up?

Perhaps the most significant challenge is that directors and management teams remain personally reluctant to base incentives on sustainability results that are arbitrarily evaluated, which may or may not eventually show up in the corporate financials.

The argument is that if ESG provides more insight and vigilance with respect to financials, at the end of the day more focus on ESG is going to boost the same returns or profits that are already measured in the compensation plans. Thus, what is the point of introducing these arbitrary measures that may open room for debate in terms of optimal performance, measurement, relevance and bottom line impact?

Many executives, much like those at Apple, argue that if part of the pay is already tied to the financial metric, this KPI might drag-out the assessment horizon and prompt much longer-term payouts. To make matters more complex, the payout will be based not just on carbon-emission reductions but on many other factors, including pace of technology advances, pilot programs, political climate affecting resource distribution, and progress of market penetration for new products and services - factors over which they may have little to no control.

7) Link executive pay to sustainability metrics (AAPL, 2020 Resolution)

Factoring ESG Into Say-On-Pay is a Great Idea, if Properly Executed

There are numerous positives for including ESG / CSR metrics into the executive compensation process:

- Aligning interests of all stakeholders and aligning these interests on ESG factors signal a strong commitment to ethical standards
- Enhanced transparency into business priorities with a 360-degree view of how today's actions impact the environment, the business and its people will in turn affect the business's performance in the future
- Vigilance and ongoing monitoring of business practices, risk mitigation and quality of corporate oversight

What are the Challenges?

The drawbacks of weighing executive compensation by ESG metrics are complex. We understand where Boards and senior management are coming from, especially for companies like Apple, whose market cap is larger than most countries. These include:

- Given ESG reporting is not formalized, there is no right or wrong way of reporting.
- There are no developed assurance standards that can validate the reporting in accordance with accepted standards and principals. Therefore, scores, metrics and methodologies can be up for debate.
- There are a many variables going into ESG scores, various reporting topics, and a myriad of reporting formats that are quite subjective. All of those might ultimately put management into the "opening Pandora's Box" of deliberations on methodology and proper KPI levels.
- ESG promotes a higher level of corporate governance and for companies that have already achieved high levels, adding more metrics can be overburdensome and distracting.

That said, there is always a middle road. There is always a metric or two that should be most crucial for the issuer. Again, let's take Apple.

Leaning on SASB's Materiality Map for the Technology and Communications sector, whether we chose Hardware or Software, Data Security is most certainly a very material item. One of Apple's top risks in its latest 10K filed with the SEC states:

"*There may be losses or unauthorized access to or releases of confidential information, including personally identifiable information, that could subject the Company to significant reputational, financial, legal and operational consequences.*"[8]

In our opinion tying an ESG metric to this particular material risk in Apple's business model would be an impactful metric to be tied to management's compensation, given the degree of importance of information security factor for the corporate business model, as well as immediate impact on Apple's bottom line, reputation, and legal risk, should a major issue occur.

8) Apple Inc. | 2019 Form 10-K | 28

What Is The Best Way To Effectively Motivate Management Accountability?

ESG strategy must be tightly aligned with corporate purpose and strategy. The challenge of different time horizons across ESG metrics that may distort the compensation calculations can be mitigated by focusing on just one issue. For instance, some companies in natural resources and energy only include the GHG component into their compensation weights if that is the most impactful, risky and financially critical item on the ESG spectrum. Xcel Energy (XEL), for example, reflects only the pace of achievement of its carbon footprint reduction goals in annual executive compensation review. On the other hand, VEREIT (VER), being a "people's business", includes into its management compensation assessment factors only concerning human capital assessment demographics, such as diversity and inclusion initiatives, employee retention and employee compensation practices.

Therefore, even for the companies with superb corporate governance, it is possible to find at least one subject that should be aligned with C-suite pay as a further mitigator to the top risk for the issuer. We conclude that companies should:

- Focus on 1-2 most material factors that, if mismanaged, will immediately trigger key risk(s) described in the SEC filings, and if managed timely will increase capitalization and shareholders' ROI.
- Understand the difference and realistic time horizon for each metric. It is possible to find balance between short-term ambition that is likely unachievable and demotivating, and mid-term achievable goals.
- Embrace that an all-or-nothing approach is unnecessary. There is no need to weight in the entire gamut of sustainability issues to executive compensation. It would be enough for a company to focus on one or two aspects and tie those to the executive pay, making them focused and accountable for the promises and aspirations for the sake of risk mitigation and better financial performance.
- Select key ESG KPIs that influence the pay and thereby signal to stakeholders that a particular issue is a major focal point. Management then ensures that related risk exposure is the same for C-suite pockets and for those of its shareholders. Just focusing on one factor, such as diversity and inclusion, can strengthen a firm's external reputation, internal culture and lead to increased sales, customer satisfaction, employee retention and brand loyalty.

We believe that addressing the most important stakeholder risks within corporate ESG policy and building immediate response and prevention strategies are a must for any business. The larger the business, the more vigilant it should be, knowing that at current scale it should be one of the most responsible corporate citizens. A company can lead by example with at least one top ESG factor being weighted in the executive compensation package.

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ESGiQ

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Environmental, Social & Governance (ESG) metrics are rapidly ascending in importance for all capital market participants. Companies monitoring ESG factors tend to be more vigilant on improving overall corporate governance, while increasing profitability and mitigating risk.

Focusing on risk oversight and mitigation strategies, advocating for cultural diversity and inclusion, and being a responsible corporate citizen creates a positive environment for employees and aligns the interests of all stakeholders.

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Combining MZ Group's consulting expertise with proprietary software capabilities helps crystallize each of these important components into one complete ESG solution that enables issuers to report ESG metrics in ways that resonate with capital markets participants.

ESG iQ is a user-friendly and interactive software platform designed specifically to customize ESG reporting for private and public companies, as well as ESG focused funds. ESG iQ is the only solution that generates a cross-sectional analysis incorporating Environmental, Social & Governance protocols, with the flexibility to adopt multiple standards.

ESG Consult empowers private and public clients to obtain greater insight into ESG best practices,while preparing them to track, monitor and properly report their material ESG factors to various stakeholders, rating agencies and financial media.

Please visit www.mzgroup.us/esg-iq-platform or email esg@mzgroup.us
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