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Around THE Curve

Aligning Incentives Matters: ESG in Executive Compensation

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With proxy season upon us, "say on pay" is a common issue on which we vote and have discussions with management teams. Historically, we have requested for executive compensation to be tied to financial metrics, such as return on invested capital and earnings per share growth. However, companies are now increasing the resources spent on measuring, disclosing, and setting targets around various ESG initiatives that have operational implications. We believe corporate focus on material ESG issues helps mitigate risk and take advantage of opportunities to enhance long-term value. For example, we previously noted Alcoa's efforts to produce lower-carbon aluminum, which may help open new markets to the company and reduce costs. These heightened focus areas run the gamut from worker safety to decarbonization to gender pay equity. According to a recent IBM study that surveyed 2,500 executives across 22 industries and 34 countries, 76% believe ESG is central to their business strategy.[1] Consistent with these findings, we have observed management teams increasingly discussing their ESG efforts on corporate earnings calls and in conference presentations, along with allocating space within proxies and annual reports to dig deeper into their ESG initiatives.

While ESG information is proliferating across many industries, I often find myself asking whether CEOs and other key decisionmakers have any "skin in the game" to help make their ESG ambitions a reality. Target setting is futile if you do not incentivize the achievement of those targets. While operational performance can be clearly evaluated, quantifying success in terms of ESG factors remains subjective and nebulous. According to the IBM study, *"95% of surveyed executives say their organizations have developed ESG propositions; however, only 10% say that their organizations have made significant progress against them."*[1] Furthermore, many ESG projects span multiple years, if not decades, while the average CEO tenure may be far shorter. Linking ESG goals to executive performance and compensation helps promote accountability and continuity across tenures while advancing progress toward multi-year initiatives. Executive compensation metrics help confirm which key performance indicators (KPIs) a CEO is or is not focused on, including ESG-related goals.

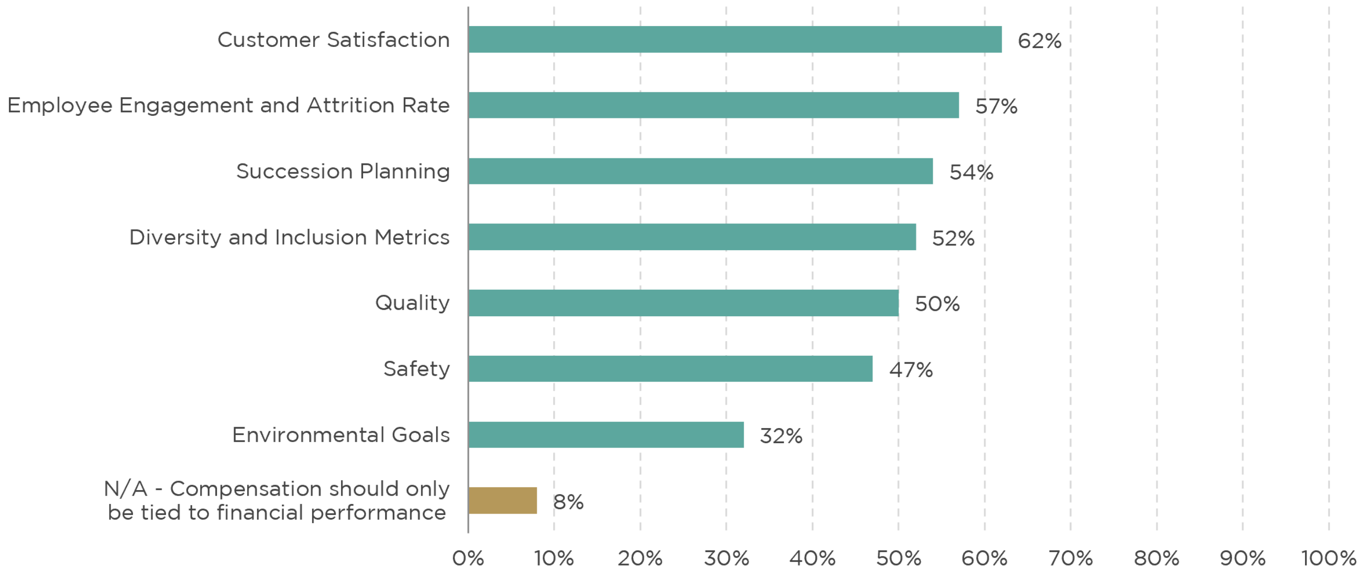
Said simply, what is the point of spending significant resources to gather data, set goals, and improve disclosure without aligning executive accountability?

Over 75% of executive respondents in the IBM study agree that "their organization focuses on achieving ESG outcomes, not just reporting requirements."[1] Shareholders and boards have realized that it is not enough to set and disclose targets; CEOs need to be incentivized to work toward achieving these goals. This realization has resulted in a big push toward adding ESG as a component of executive compensation.

Board members—the decisionmakers on executive compensation—are largely in agreement. The 2022 PwC Annual Corporate Directors Survey showed that 92% of directors agree that non-financial metrics are appropriate (see Figure 1). Some of the most supported areas include customer satisfaction (62%), employee engagement/attrition (57%), and diversity and inclusion metrics (52%).[2]

1

Corporate Directors Indicate Non-financial Metrics Should Be Included in Executive Compensation Plans %, As of October 2022



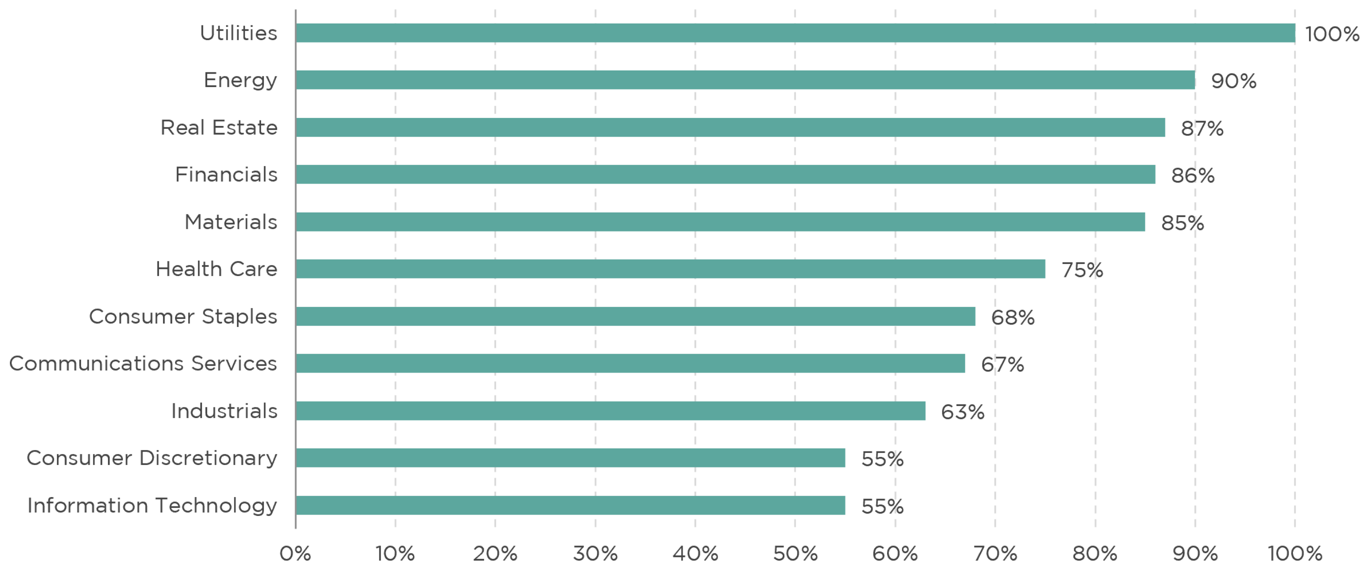
Base: 646
Source: PwC, *2022 Annual Corporate Directors Survey*

According to data from The Conference Board and analytics provider ESGAUGE, 73% of S&P 500 companies in 2021 tied executive compensation to some form of ESG performance, up from 66% in 2020. Interestingly, the sectors with the largest percentage of compensation tied to ESG are utilities (100%), followed by energy (90%), sectors where the energy transition is a core part of strategic planning and long-term financial viability (see Figure 2). For the utilities we own, we have found their executive compensation includes ESG goals and metrics that are relevant and rigorous. Consumer discretionary and information technology sectors both come in last at around 55%.[3]

2

Most Companies in Each Business Sector Tie Executive Pay to ESG Performance

%, ESG Goals, Prevalence by Business Sector, As of 9/7/2022



NOTE: Based on disclosures made by 455 S&P 500 companies between January 1 and September 7, 2022

Source: The Conference Board/ESGAUGE, 2022

While aligning executive incentives is good in theory, there are both common pitfalls and best practices.

ESG Goals Should Be Material to the Business and Sector

First, it is important that companies focus on metrics that are material to their business. For example, a pharmaceutical company that outsources manufacturing likely has a negligible carbon footprint. Therefore, tying its executive compensation to decarbonization is missing the point. Rather, it should focus on incentivizing management in material areas such as drug affordability and patient access. On the other side, we would expect to see an energy company or utility tying executive compensation to lowering the financial risk of future emissions.

ESG Goals Should Be Rigorous

Second, it is important that ESG goals are challenging enough, which is similar to how we evaluate financial metrics. We think Alaska Air has outlined rigorous ESG-related metrics around their worker and guest safety record, reducing aircraft carbon dioxide emissions per revenue ton mile (which may generate fuel savings and

other financial benefits), and improving BIPOC representation in leadership to 23%+ by 2024 (currently at 17.5%). We would argue these are all materially relevant areas for improvement. Conversely, a company that has already achieved gender parity but then sets a goal on gender diversity is not prioritizing an area that needs focus.

ESG Goals Should Be Quantifiable

Third, goals must be clear and quantifiable. Saying a company is focused on culture, safety, or cybersecurity is not enough—how will improvements and goals be measured and reflected in data? For example, do they have a goal around improving employee safety toward the industry average, or reducing safety incidents by a certain percentage in absolute terms? Is the company working toward a specific greenhouse gas (GHG) emissions reduction target? By when?

At its best, compensation will include clear, quantifiable goals with a set time horizon, target threshold, and the percentage of compensation tied to the realization of that goal. Generally, goals can be multi-year or multi-decade. While short-term compensation metrics can incentivize immediate-term decisions, embedding ESG-related metrics within long-term compensation—where appropriate—ensures objectives are met and endure as management teams experience turnover.

Here are the relevant questions when evaluating ESG in executive compensation:

1. What are the most material and important metrics to the business? Sustainability Accounting Standards Board (SASB) Materiality Maps are a great reference for identifying issues deemed most material to an industry, according to a third-party analysis.
2. How long will it take to achieve short- or long-term goals? Should they be included in annual incentive or long-term compensation? Interestingly, in 2021, 88% of companies included ESG objectives solely within their annual incentive plans and not within their long-term incentives.[3]
3. What is the right metric or KPI to use so that it is clear, transparent, and measurable?
4. How does the ESG portion of compensation impact overall compensation? If it is just an upward modifier, that may not successfully incentivize behavior.
5. Who else has compensation tied to ESG metrics beyond the C-suite? To ensure alignment of a strategic vision, employees at various levels of an organization should also be motivated to achieve these shared goals.

Companies should thoughtfully incorporate ESG metrics into executive compensation, as these factors are relevant to the risks and opportunities every business faces. As companies continue to integrate facets of ESG into their daily operations and strategic planning, these related objectives should be treated with importance, and investors should seek transparency and accountability. We believe incorporating ESG within compensation is the next logical step to align incentives and help make a company's ESG goals a reality.

Sources

[1] *New IBM Study Reveals Inadequate Data Hinders Progress Against Environmental, Social and Governance Goals*

[2] *2022 Annual Corporate Directors Survey*

[3] *Linking Executive Compensation to ESG Performance (harvard.edu)*

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