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SEMLER BROSSY

ESG+INCENTIVES

2020 REPORT

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PRELIMINARY FINDINGS

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As we entered the new decade, corporate engagement with environmental, social, governance ("ESG") factors was on a major upswing, part and parcel of growing focus on corporate social responsibility to a broad group of stakeholders. Shareholders have become increasingly focused on ESG, as highlighted by BlackRock's 2020 Letter to CEOs calling for a "Fundamental Reshaping of Finance," and corporations are responding, as articulated in the Business Roundtable's new definition of Corporate Purpose. Consideration of corporate responsibility has taken on heightened relevance as COVID-19 has further increased the scrutiny of corporate behavior and companies weigh broad social impacts in deliberations about how to respond.

"Companies and countries that champion transparency and demonstrate their responsiveness to stakeholders...will attract investment more effectively, including higher-quality, more patient capital."

— LARRY FINK
2020 LETTER TO CEOs

As companies engage with this growing focus on ESG, incentive compensation – both short-term and long-term – will likely play a natural role in demonstrating corporate commitment to ESG and in focusing behavior.

To help companies navigate this evolving landscape, Semler Brossy has started an initiative to track integration of ESG in executive compensation plans over time. Our initial review focuses on Fortune 200 companies, as we've often found the largest and highest-profile companies to be early adopters of new governance trends. Well over half of these companies already report using some form of ESG in deciding compensation outcomes, and studying where they are in the process of integrating strategically-meaningful objectives will provide insights for others looking to include ESG in their incentive compensation plans.

Although the majority of the largest public companies already include ESG as part of their incentive plans, the distribution of ESG incentives is not consistent across industries

This first report delves into the types of companies including ESG in their incentive plans, and critically, how these incentives are designed and incorporated. Future reports will delve further into the specific incentive metrics used to measure ESG and their evolution over time.

ESG INCENTIVES BY INDUSTRY

While well over half of the Fortune 200 use ESG in their incentive plans in one form or another, the distribution of ESG incentive integration varies significantly across industries. These variations are likely driven by differences in external pressures and the levels of strategic/ competitive importance of ESG within sectors:

– Healthcare, Financials, and Industrial sector companies have the highest prevalence of ESG incentives among Fortune 200 sectors
– Relative to their representation in the Fortune 200, a high proportion of both Energy and Consumer Staples companies also incorporate ESG incentives
– The sectors with the least prevalence of ESG in incentives relative to their representation in the Fortune 200 include Consumer Discretionary and Information Technology companies

The Utilities, Communications Services, and Real Estate sectors also appear to have a high concentration of companies with ESG incentives, but the sample sizes are too small to draw firm conclusions.

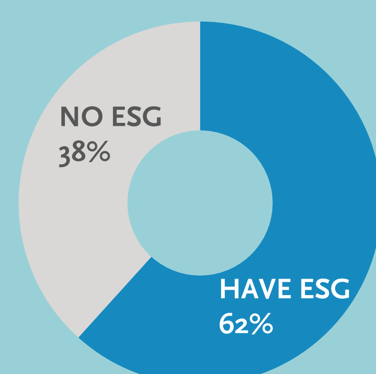
SUMMARY OF SAMPLE

188

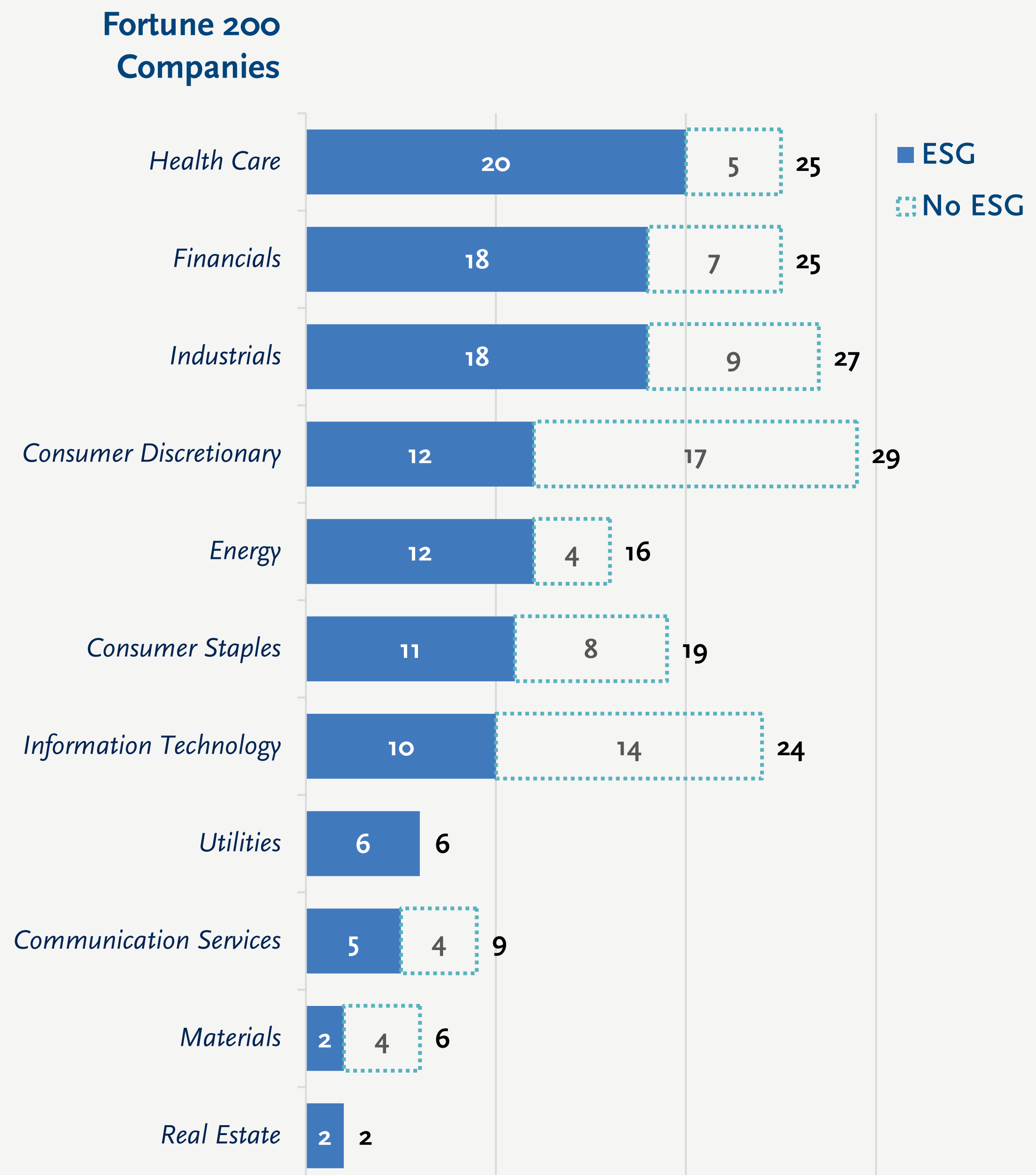
FORTUNE 200 COMPANIES INCLUDED IN SAMPLE

36B

MEDIAN MARKET CAP



Breakdown of ESG Metric Prevalence by Industry



Healthcare, Financials and Industrials have the highest proportion of companies with ESG incentives

This uneven distribution across sectors seems to be driven by a few key trends. Energy, Financial Services, and Healthcare companies have frequently been ‘in the spotlight’ for failures of social responsibility over the past decade, increasing scrutiny of their governance practices. Industrial companies likewise have had a broad social footprint. Climate change, the financial crisis, and the opioid epidemic all epitomize crises that have led to more focus on the role of the corporation.

Positive drivers related to competitive advantages also help explain adoption of ESG across these sectors. For example, Energy firms in particular face a clear social and strategic rationale to move toward more sustainable energy sources as the world seeks to reduce carbon emissions. ESG becomes a win-win in contexts where there is a strong business rationale to ‘do the right thing.’

PROMINENCE OF ESG IN PAY PROGRAMS

In addition to difference by industry, we also noted a difference in *how* ESG metrics are incorporated into incentive plans. We have categorized incorporation into three main approaches:

– Individual/Subjective

– Shared/Qualitative

– Weighted/Quantitative

For many companies, ESG is evaluated as part of an individual performance assessment, which generally includes at least several other considerations and is subjectively assessed at year end. For others, explicit ESG objectives are formally included in the incentive plan, but their assessment includes substantial discretion and the metrics are often part of a larger scorecard. Finally, some companies include ESG metrics as independent incentive plan components, with clear goals and weights that flow directly to pay outcomes. Though weightings for these quantitative ESG goals may be comparatively small, the impact on pay results is clearer than when assessed subjectively.

Each of these approaches have different degrees of impact on pay outcomes, which for this study we refer to as "ESG Prominence." To help segment the data we categorized each company's ESG incentives as Low, Medium, or High Prominence based on the following criteria:

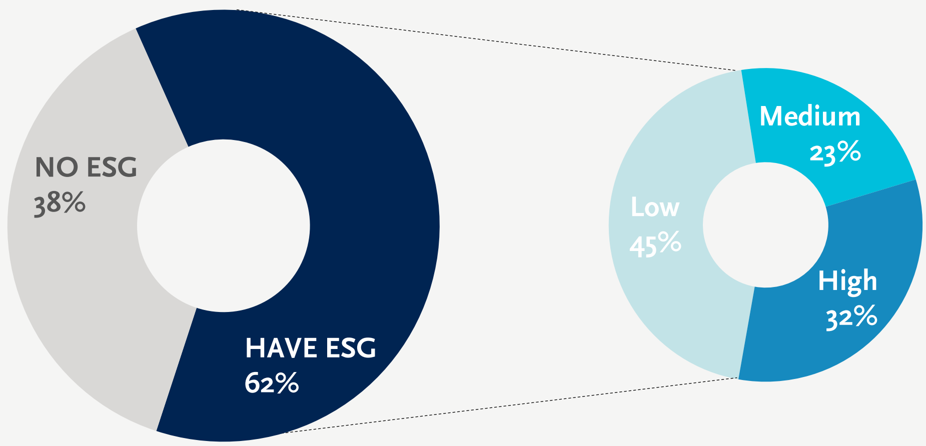
ESG PROMINENCE	INDICATORS		DESCRIPTION
	WEIGHTING	ASSESSMENT	
Low	**None**	**Subjective**	ESG is not fully quantified or included as a standalone/weighted component but considered in a broad discretionary assessment of senior leaders, generally in an individual component.
Medium	**Part of a Scorecard**	**Qualitative**	ESG objective(s)/categories are formally identified and included in incentives for senior leadership focus. ESG metrics are not separately weighted and are generally assessed as part of a broader scorecard of key non-financial business priorities.
High	**Separately Weighted**	**Quantitative**	ESG is incorporated in incentive plans through a discrete, weighted component with specific metrics. In many, but not all plans, each specific metric is also assigned its own discrete weighting within the overall ESG component.

While most Fortune 200 companies include some assessment of ESG in their incentives, the most common approach – used by 45% of companies with ESG – is to incorporate ESG in a discretionary evaluation of individual performance (i.e., have a "Low Prominence"), rather than as a formal component of the annual or long-term incentive plans. The second most common approach – used by 32% of companies – is to formally include ESG as a separately weighted metric in the incentive plan (i.e., "High Prominence"), with the remainder using a "Medium Prominence," scorecard approach.

That many companies only include ESG objectives in incentives as part of an individual performance modifier is not surprising given difficulties of measuring many ESG initiatives. But the incentive and signaling effect of individual performance modifiers are often muted. While a good starting point, investors and other stakeholders are likely to continue to demand greater levels of prominence over time.

ESG Metric Prevalence in Annual and Long-Term Plans

(N=188)



The use of ESG in annual plans is much more common than in long-term plans, although where incorporated in long-term plans, the measures are almost always explicit and quantitative (i.e., "High Prominence"). However, only 9 companies in the Fortune 200 have incorporated ESG into long-term plans to date.

ESG Metric Prevalence by Plan Type

(N=116)

107 HAVE ESG IN ANNUAL PLAN ONLY

6 HAVE ESG IN BOTH PLANS

3 HAVE ESG IN LONG-TERM PLAN ONLY

Nearly half of the ESG measures in executive incentives today are part of an individual performance assessment resulting in Low prominence

There are several reasons why a company might choose to structure their ESG incentives with a different degree of prominence within executive incentive plans:

Low: Incorporation of ESG within individual goals can allow flexibility to tailor goals and payouts to the executives most responsible for their achievement. It may also be an appropriate approach when a company's ESG objectives are hard to measure effectively and/or may be less clearly linked to a well-defined business need but are still considered important objectives to be recognized within the incentive framework.

Medium: Inclusion within a broader scorecard allows the flexibility to include multiple ESG metrics, often without requiring judgement around their relative weighting. Similarly, it can allow important qualitative metrics to be integrated into the plan without requiring quantitative goals, which may not be appropriate for all ESG objectives, particularly those without clear annual milestones. For example, companies have understandably been wary of setting targets, or "quotas," around diversity and inclusion initiatives.

High: Quantitative goals with discrete weightings provide an objective measure of success and having a quantitative target can help focus a management team – or company – on the same goal. This approach is likely most common when the ESG objectives are clearly aligned with well-defined strategic needs.

Subsequent ESG + Incentives reports will address the types of ESG metrics used and how they vary across industries in greater detail

CONCLUSION

ESG objectives are already a prevalent component of executive compensation plans for a significant majority of large public companies in the United States. Unsurprisingly, this prevalence is led by companies that have a significant and well-defined social impact beyond their economic contribution, as well as those that have identified ESG objectives as a critical component of their long-term strategy and the sustainability of their business model.

While many of those companies that have ESG incentives today use a subjective approach and include ESG as an indirect component of compensation, the absolute prevalence of ESG in compensation plans is an important indicator of corporate commitment, and we expect that both the prevalence of ESG incentives and the prominence of ESG in determining pay outcomes will increase over time.

CASE STUDY Chevron Corporation

Chevron provides a great example of these trends converging in a program with "high prominence" ESG metrics. As a company in the Energy sector, Chevron recognizes that environmental stewardship is a critical part of their social 'license to operate.' With a large workforce operating in often difficult or hazardous conditions, Chevron also takes the safety and wellbeing of their employees seriously. These factors are reflected in their annual incentive plan, where "Health, Environmental and Safety" goals have a discrete weighting, and each have objective metrics of success:

ESG OBJECTIVES	METRICS
Personal Safety	– Days away from work rate – Serious injury count
Process Safety and Environmental	– Loss of containment incidences – Spill volume
Greenhouse Gas Management	– Flaring and methane intensity reductions

(cont'd)

These metrics combined represent 15% of the overall corporate assessment component of the Company's annual incentives, which has a material impact on pay results:

CATEGORY	WEIGHT	PERFORMANCE MEASURES	
Financials	40%	Earnings	
		Cash flow	
		Divestiture proceeds	
Capital management	30%	Return on capital employed	
		Organic capital and exploratory expenditures	
		Major milestones	Gorgon
			FGP/WPMP
			Permian
			Asia Petrochemicals
Operating performance	15%	Net production	
		Operating expense	
		Refining utilization	
Health, environmental and safety	15%	Personal safety	
		Process safety and environmental	
		Greenhouse gas management	

NEW YORK OFFICE

350 Fifth Avenue, Suite 4700
New York, NY 10118

212.393.4000

Olivia Voorhis, Senior Associate
646.969.2308
ovoorhis@semlerbrossy.com

LOS ANGELES OFFICE

11755 Wilshire Blvd, 10th Floor
Los Angeles, CA 90025

310.481.0180

John Borneman, Managing Director
310.943.8366
jborneman@semlerbrossy.com

Tatyana Day, Consultant
310.943.8392
tday@semlerbrossy.com

Kevin Masini, Senior Associate
310.295.3615
kmasini@semlerbrossy.com

For more information,
visit us at **SEMLERBROSSY.COM**