

ESG+ INCENTIVES

2020 REPORT

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FINAL REPORT

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The strategic drivers of the business model for each industry appear to shape which ESG metrics are incorporated into incentives

Over the course of 2020 this report series has delved into the current state of ESG in executive incentives in the Fortune 200. We've parsed questions around which types of metrics are most prevalent and prominent in pay outcomes. Though over 60% of the Fortune 200 incorporate stakeholder metrics in executive incentives, many current metrics measure the health of business operations rather than social or environmental sustainability.

This final report for 2020 drills down into how these approaches manifest across different industries, pointing towards design considerations for companies considering integrating more stakeholder metrics in the future.

One of the most fundamental principles of effective compensation design is that pay should align with a company's strategy, mission, and values – and this is true for ESG incentives as well. This issue's findings on the prevalence of metrics by industry sector generally aligns with this principle. The strategic drivers of the business model for each industry appear to shape which ESG metrics are incorporated into incentives – though several less obvious findings are also noted throughout. These findings reinforce the idea that that ESG metrics do not “lead” strategy and are most effective at supporting efforts already in motion.

Going forward, we expect the current efforts to broaden and standardize ESG reporting will expand the range of metrics found in incentive programs. The efforts of the Big Four accounting firms to develop a set of core metrics for reporting on ESG, along with the recent SEC guidelines for increased disclosure around human capital management, will lead companies to focus on identifying which ESG issues are most material to their business and how they might measure and disclose progress.

2020 has been a watermark year in the ESG space in many ways and it remains to be seen how quickly these macro-level trends will impact incentive design. Next year's reports will capture a broader set of companies and year-over-year changes, providing an in-depth analysis of the evolution of these trends over time.

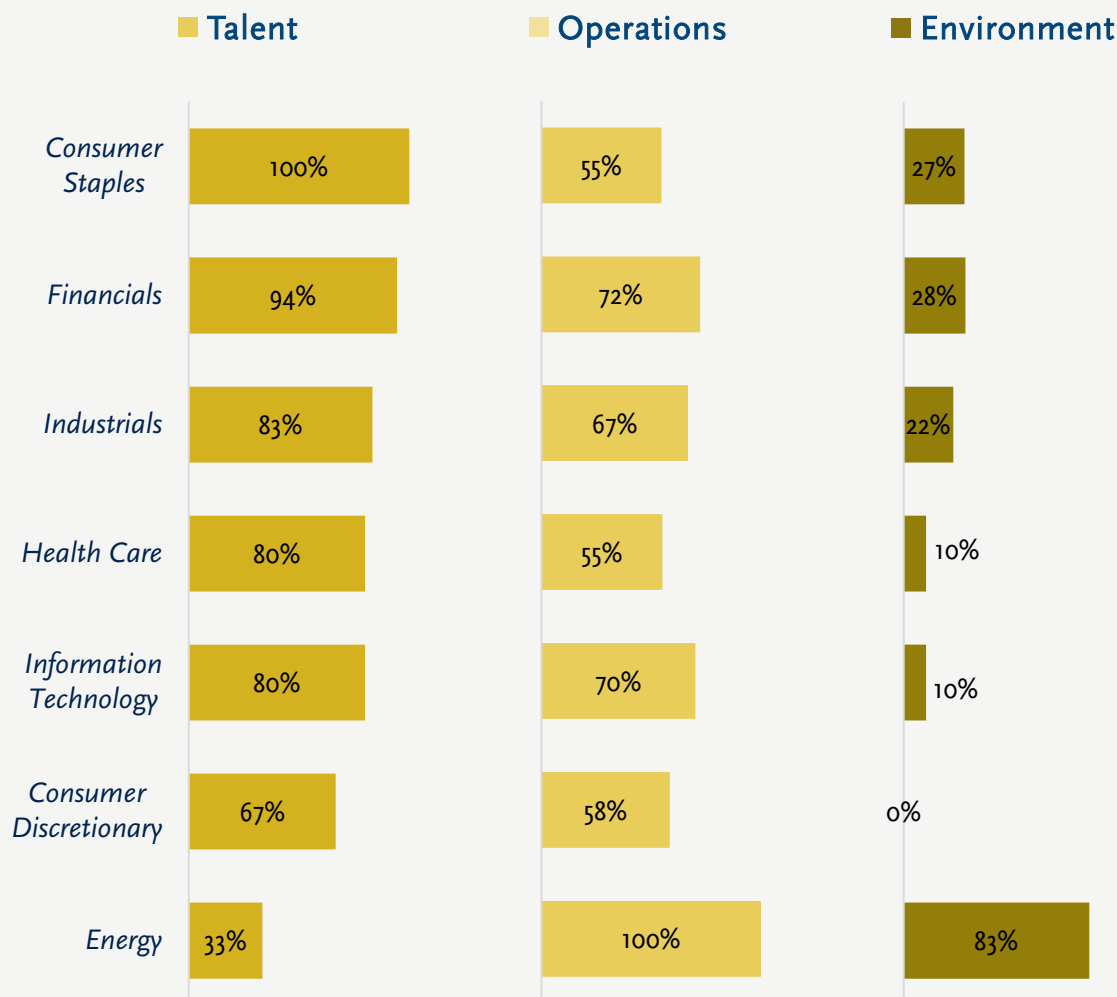
For the most part we see clear drivers behind the types of metrics that are used most frequently by each sector, with some interesting exceptions

To better understand metric selection by industry, we segmented metrics into those focused on talent management, operations, and the environment. We noted different emphasis by industry, as outlined below.

CATEGORY	METRICS INCLUDED	PREVALENT INDUSTRIES
Talent		
Part of a growing trend of incorporating Human Capital Management metrics in incentive plans. These metrics are often assessed on a subjective basis without formal weighting. D&I metrics, where used, stand out as more often having formal weightings, but weightings are small (i.e., <5% of annual incentives)	<ul style="list-style-type: none"> – Gender Pay – Community Engagement/ Charity – Company Culture – Diversity & Inclusion (“D&I”) – Employee Engagement/ Satisfaction – Talent Development – Turnover/ Retention 	<ul style="list-style-type: none"> Consumer Staples – Financials – Health Care – Information Technology – Real Estate
Operations		
As classic measures of “good business,” these metrics are often quantifiable and incorporated with a higher weighting than other ESG metrics	<ul style="list-style-type: none"> – Customer Satisfaction/ Net Promoter Score – Product Quality – Safety 	<ul style="list-style-type: none"> – Communication Services – Financials – Industrials – Materials – Utilities
Environment		
As explicit measures of environmental impact, these metrics are rare and are used primarily by Energy and Utilities companies. When used, they tend to have explicit weightings, though almost always weighted less than 10% of the program	<ul style="list-style-type: none"> – Carbon Footprint – Emissions/ Chemical Containment – Energy Efficiency/ Renewable Energy – Sustainable/ Responsible Sourcing – Waste Reduction/ Packaging – Water Consumption 	<ul style="list-style-type: none"> – Energy – Utilities

Prevalence of ESG Metric Type by Industry Sector – Fortune 200*

% of companies using each measurement type, of those with ESG metrics

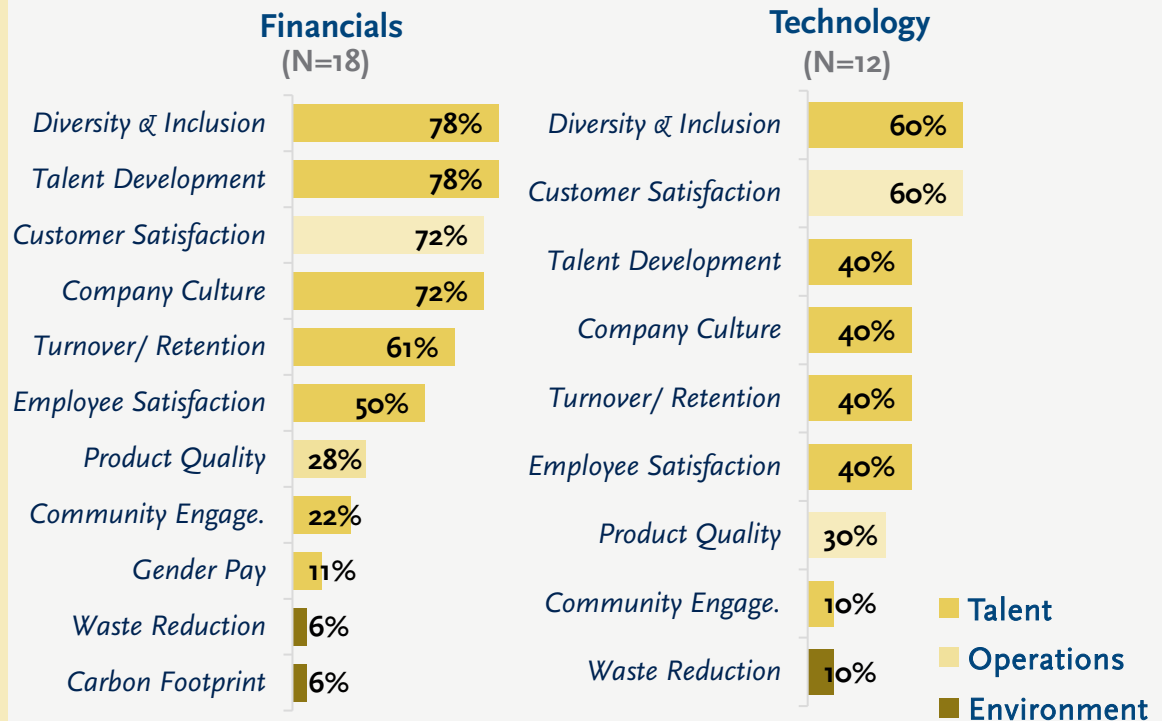


* Sample size is too small for meaningful comparisons in Communications Services, Materials, Real Estate, and Utilities industries

A common theme throughout this report is that many of the relationships above are intuitive. Many of the most innovation-driven industries, such as Financials, Information Technology, and Health Care, tend to have higher prevalence of people-related metrics, as talent is a key driver of business outcomes. Energy companies have the highest relative focus on environment metrics given their association with energy production and corresponding emissions.

However some relationships make less intuitive sense. Industrials' high focus on talent metrics and the distinction in metric prevalence between Consumer Staples and Consumer Discretionary are both interesting trends explored in more detail on the following pages.

Metric Prevalence Among Financials and Technology



FINANCIALS

- AIG
- American Express
- Bank of America
- Bank of New York Mellon
- Capital One Financial
- Citigroup
- Fannie Mae
- Freddie Mac
- Goldman Sachs
- Hartford Financial
- JPMorgan Chase
- MetLife
- Morgan Stanley
- PNC Financial
- Prudential Financial
- Synchrony Financial
- Travelers
- Wells Fargo

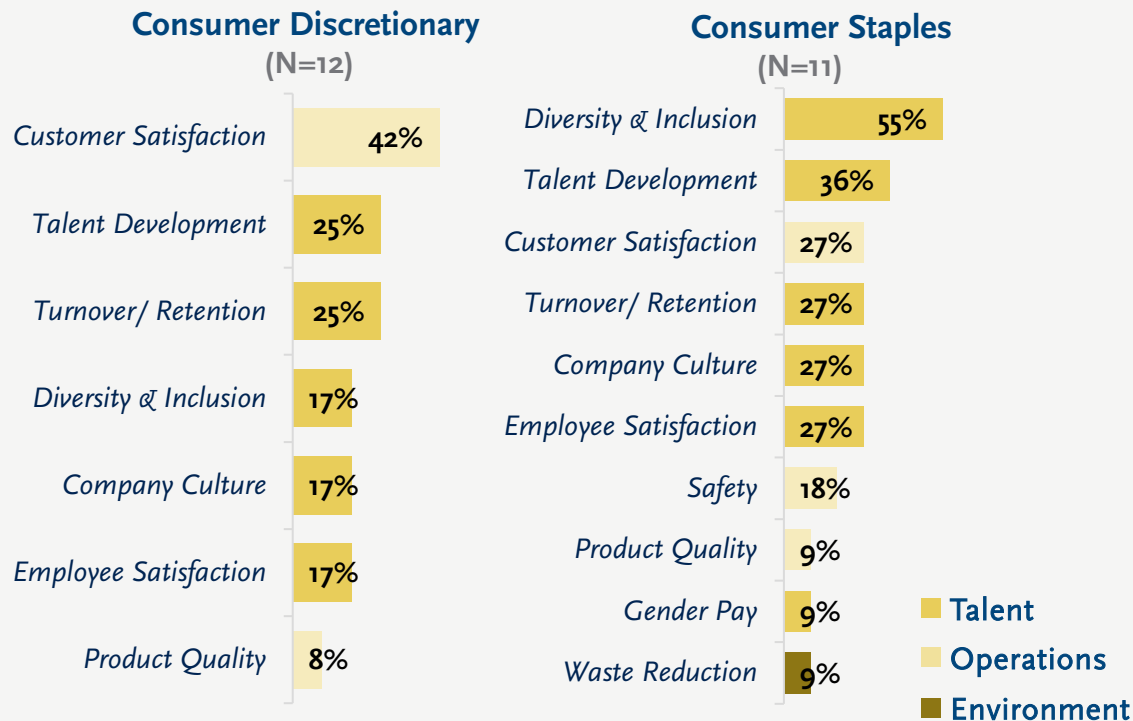
TECHNOLOGY

- Applied Materials
- Cisco
- DXC Tech.
- Hewlett Packard
- HP
- IBM
- Intel
- Micron Tech.
- Microsoft
- Visa

One notable finding is that Financials and Information Technology companies' most prevalent ESG metrics are focused on people. D&I and Talent Development are two of the top three metrics for both industries. Company culture, turnover, and employee satisfaction also fall in the top seven. These measures are most often assessed subjectively and do not carry a formal weighting, likely to manage challenges around quantitatively measuring and publicly disclosing performance related to people.

This finding is explained by the fact that both industries heavily rely on talent as a key strategic input. Incorporating people-related ESG measures – particularly newer metrics of sustainable human capital management like D&I – helps companies gain a competitive advantage in attracting top talent. Furthermore, these metrics help protect companies from being “in the headlines” for lagging performance on these measures, as well as responding to increased shareholder activism around the issues. We expect talent metrics to grow in prevalence and weight, particularly as COVID-19 and recent social movements around racial inequality have put a spotlight on companies' treatment of employees. Technology and Financial companies will likely continue to emphasize talent management as it is one of these sectors' most strategically-material issues.

Metric Prevalence Among Consumer Discretionary and Consumer Staples



CONSUMER DISCRETIONARY

- Aramark
- AutoNation
- CHS
- Ford Motor
- Gap
- GM
- Kohl's
- Lennar Corp.
- Marriott
- Penske
- Starbucks
- Whirlpool

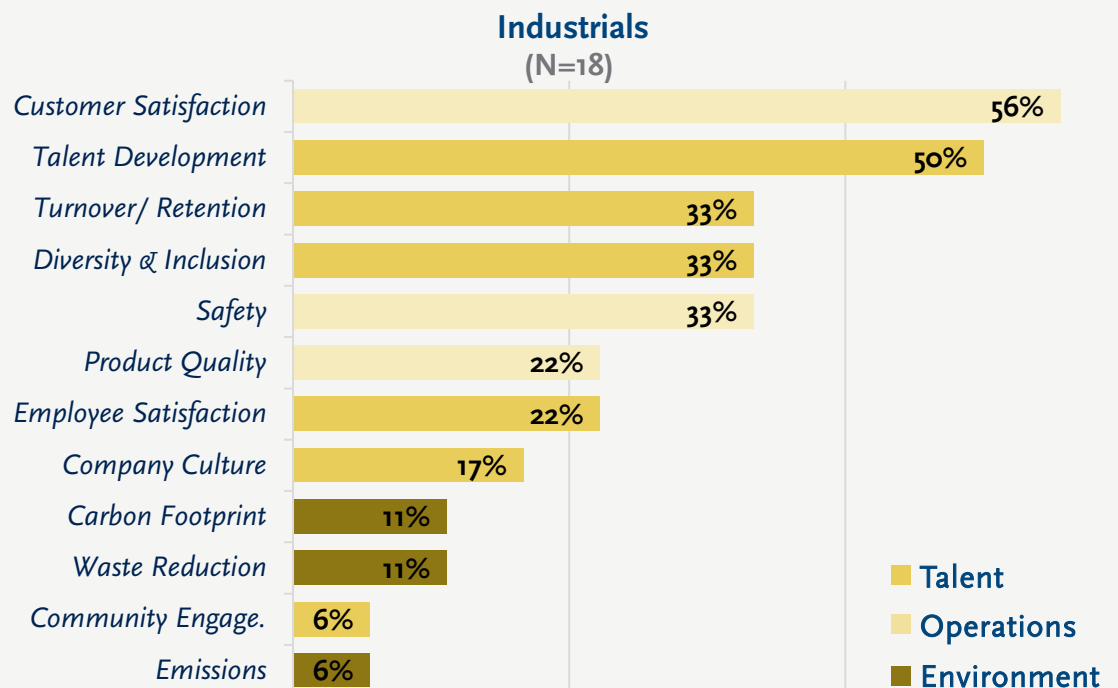
CONSUMER STAPLES

- Altria Group
- Archer Daniels
- Coca-Cola
- General Mills
- Kimberly-Clark
- Kraft Heinz
- Mondelez
- PepsiCo
- Performance Food
- Philip Morris
- Sysco

At first blush, the differences in ESG metric prevalence between Fortune 200 Consumer Discretionary and Consumer Staples companies seem surprising. Talent development, turnover, and customer-focused measures are top ESG metrics for both, but the overall prevalence of companies using D&I and company culture is lower for Consumer Discretionary than it is for Staples.

However, the individual companies included in the Fortune 200 sample may explain these differences. In this size category, the Staples sample includes many consumer packaged goods (“CPG”) businesses, which have both an innovative bend and a clear brand image that must be upheld. The Discretionary sample, on the other hand, includes many services-oriented companies, with arguably less need for skilled labor. Instead Consumer Discretionary companies rely on operational efficiency to drive competitive advantage – and high employee turnover rates are more deeply incorporated into the business model. As consumers have pushed for more environmental and social consciousness among corporations, it’s more than possible that these pressures will be felt more significantly among products rather than services companies going forward.

Metric Prevalence Among Industrials

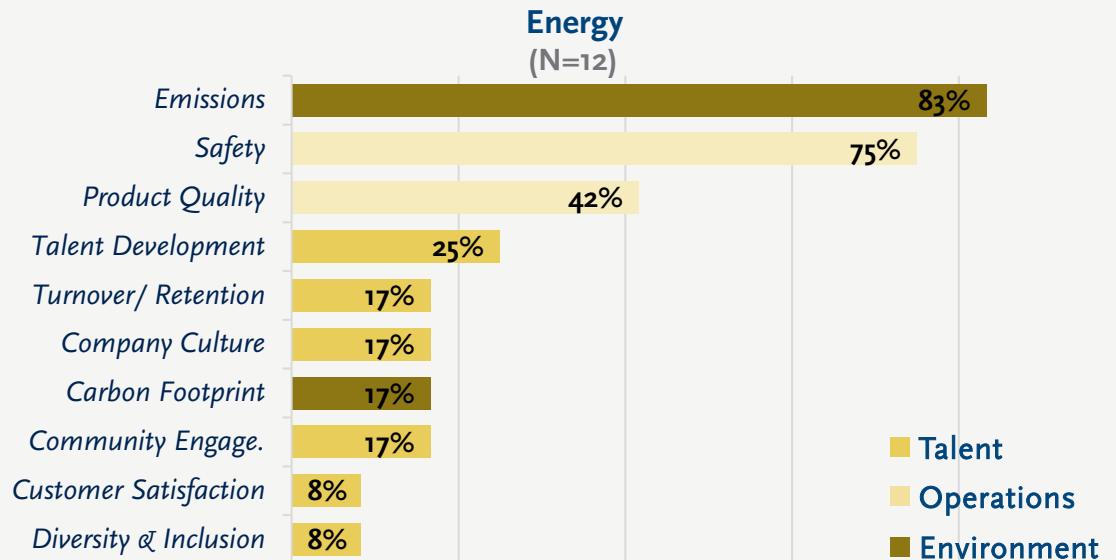


INDUSTRIALS

- AECOM
- Delta
- Emerson Electric
- FedEx
- Fluor
- General Dynamics
- General Electric
- Honeywell
- Lockheed Martin
- Manpower Group
- Northrop Grumman
- Raytheon
- Southwest Airlines
- Union Pacific
- United Continental Holdings
- United Parcel Service
- United Technologies
- XPO Logistics

The relative prevalence of ESG metrics among Industrials companies is perhaps unexpected. Though operations-focused ESG metrics like customer satisfaction, safety, and product quality are relatively common compared to other industries, many of the top slots are also occupied by people-related metrics. Fully half of Industrials companies in the sample measure Talent Development in executive incentives and a third measure D&I and/or turnover.

As with Consumer Discretionary and Consumer Staples, the drivers of these relationships may be explained by the individual companies in the sample. Many of the companies at left require a broad and stable pool of relatively skilled labor. Those companies with manufacturing operations likely compete for engineering talent, with a clear innovation component to their businesses. Even the distribution companies with a large hourly workforce likely compete for talent and seek to minimize turnover; access to a trained, reliable and stable workforce is similarly a key component of their business. Talent metrics are matched in prevalence by ESG metrics around customer satisfaction and workforce safety, showing a sector that is defined by both operational and talent needs.

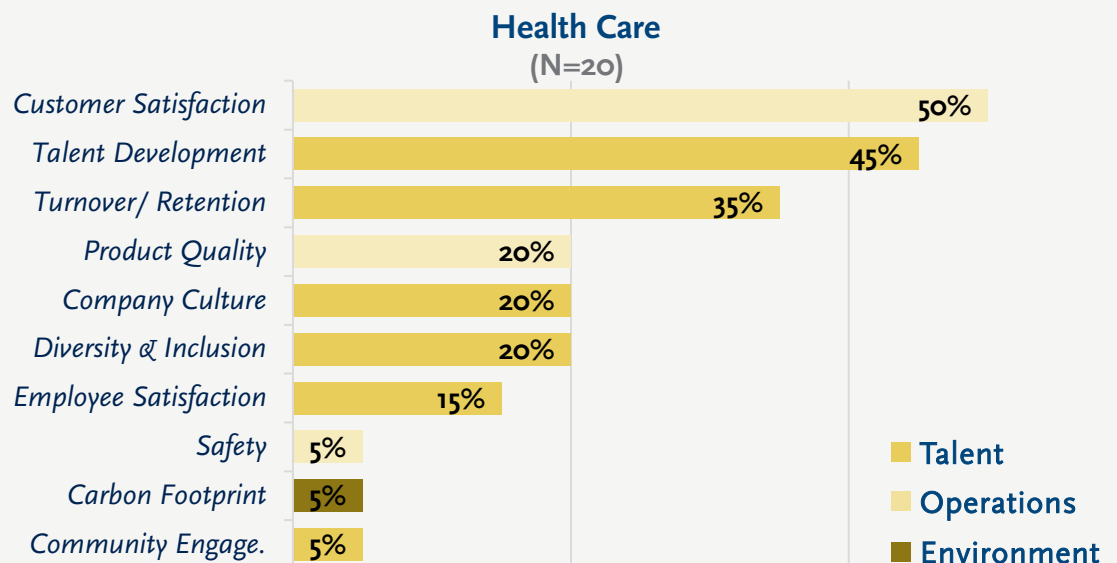
Metric Prevalence
Among Energy**ENERGY**

- Chevron
- ConocoPhillips
- Enterprise Products Partners
- EOG Resources
- Exxon Mobil
- HollyFrontier
- Marathon Petroleum
- Occidental Petroleum
- Phillips 66
- Plains GP Holdings
- Valero Energy
- World Fuel Services

Energy leads the Fortune 200 in the use of environment metrics. 10 of the 12 largest Energy companies include an emissions or chemical containment goal. Three of those 10 include additional carbon footprint or renewable energy goals. As with other industries, adoption of the metrics seems to address both risk mitigation and strategic opportunity. Energy companies have a higher profile when it comes to environmental impact and are more subject to public scrutiny, particularly during crises and spills. These companies also have a strategic imperative to move towards cleaner operations and energy sources as investors and customers look for long-term sustainability of the business model.

While the sample is small, Utilities also bear mention for high prevalence of environment metrics. Though there are only six Fortune 200 Utility companies, four of them have environment metrics, with half of those including multiple metrics. This sector is highly regulated, treated almost as quasi-governmental, and thus is likely on the leading edge of responsibility towards a wider group of stakeholders (i.e., customers and the broader public). Similar to Energy, Utilities companies have a strategic interest in moving towards sustainable energy sources.

Though environmental metrics are rare among other industries, we expect to see a proliferation of these measures over the long-term as the environmental focus continues to gain momentum among all stakeholders.

Metric Prevalence
Among Health Care

HEALTH CARE

- Abbott Laboratories
- AbbVie
- Anthem
- Becton Dickinson
- Bristol-Myers Squibb
- Cardinal Health
- Centene
- Cigna
- CVS Health
- Danaher
- DaVita
- Gilead Sciences
- HCA Healthcare
- Humana
- Johnson & Johnson
- Merck
- Molina Healthcare
- Tenet Healthcare
- Thermo Fisher Scientific
- UnitedHealth Group

The Health Care sector is an interesting case study. The business models of the constituent companies vary widely by subindustry, making it difficult to explain macro-level trends by considering the sector as a whole.

Innovation falls along a wide spectrum for companies included in the Health Care sector, from biotechnology and pharmaceutical development companies at one end, to facilities and distribution companies at the other. These companies might be broadly classified as having a technology- or service-orientation. Service-oriented companies (i.e., managed healthcare and healthcare distributors/services/facilities) contain almost every instance of operational ESG metrics in the sector's sample, with customer satisfaction and product quality among the most prevalent. This finding makes sense: operations and customer satisfaction are a core part of service-oriented business models. Talent metrics, like turnover, retention and talent development, are relatively evenly spread among both the technology and service companies, as the next two most prevalent ESG metrics behind customer satisfaction. Technology-focused companies (i.e., biotech, pharmaceuticals, life sciences tools, and medical technology) contain all the sector's examples of D&I metrics, as well as two examples of environment metrics. Competition for top talent is a key driver of these companies' business models, and a focus on social sustainability likely provides a competitive edge in drawing and retaining talent.

The most prevalent ESG metrics are generally related to drivers of success or risk factors within each industry

The other industries within the Fortune 200 generally contained too few companies to draw firm conclusions, but largely supported the themes drawn out on the preceding pages. Those with a heavy reliance on talent and innovation to drive the business – like Real Estate and Communication Services – tend to include talent-oriented metrics. Though only two Materials companies are included in the sample, both include safety metrics as an intuitive area of focus for the sector.

CONCLUSION

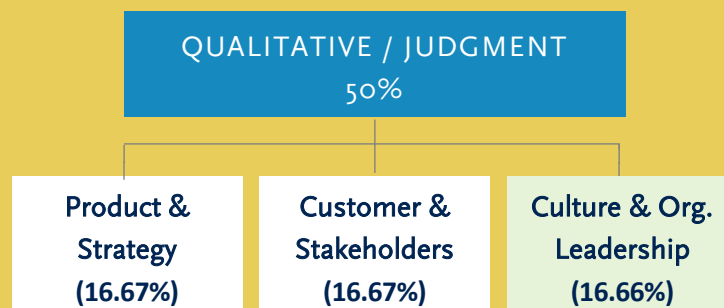
Digging into ESG metrics by industry demonstrates that Boards are giving thought to relevance when deciding which metrics to incorporate. Existing metrics are generally related to drivers of success or risk factors within each industry. Though these early trends are encouraging, we expect to see increased use and diversification of ESG metrics across sectors in the future. In particular, D&I, while already prevalent, is likely to further expand in incentives driven by this year's social movements around racial injustice. Likewise environmental sustainability affects every sector, not just Energy and Utility companies, creating both internal and external pressure to incorporate sustainability in a meaningful way. Not only will these metrics broadly grow in prevalence, but the types of metrics will evolve as companies across sectors develop increased sophistication around defining, setting goals for, working towards, measuring, and disclosing progress on their material ESG issues. Current designs will pave the way for companies looking to tailor incentive metrics to best suit their own strategy, mission, and values.

We will expand on these trends and look at broader developments as they evolve over the next year when we continue this series in 2021. In the meantime visit the Semler Brossy website to read more about ESG metric design best practices:

<https://www.semlerbrossy.com/corporate-purpose-guidance/>

CASE STUDY Microsoft Corporation (Technology)

Technology companies are highly focused on people. A great example is Microsoft, where 17% of the annual incentive is based on a “culture & organizational leadership” category that includes D&I metrics. These measures are a part of the qualitative assessment, which makes up 50% of the overall bonus.



CASE STUDY General Mills, Inc. (Consumer Staples)

Similar to the Tech sector, Consumer Staples companies are also highly oriented around people and talent. Nearly all CPG examples in the Fortune 200 assess these metrics subjectively as a part of the individual component. General Mills is a good illustration. 20% of the company’s annual performance is based on an individual

performance rating, which may be scored between “Exceptional” and “Unsatisfactory”. The ratings are based on specific objectives, which include *“organizational development progress in important areas such as diversity and employee development and fulfillment of leadership expectations”*.

CASE STUDY Marathon Petroleum Corporation (Energy)

In contrast, Energy companies have the highest focus on environment metrics. For instance, 20% of Marathon Petroleum’s annual cash bonus program for 2020 is based on reducing greenhouse gas emissions, releases of other hazardous substances, along with other environment and safety measures.

METRIC	WEIGHT
GHG Intensity	5%
Designated Environmental Incidents	5%
Marathon Safety Performance Index	5%
Process Safety Events Rate	5%

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