TIME TO THINK:

ESG

ESG is a focus on the non-financial performance of a company, taking into account the experience of other stakeholders rather than just shareholders, and can be used in incentives to reinforce the delivery of sustainable value creation.

The Ellason team has significant experience in supporting companies in the selection of performance measures and setting targets around them – please do not hesitate to contact us if you would like to discuss further.

Why should we consider using ESG measures?

In recent years, investors have taken a growing interest in companies' ESG performance. ESG is increasingly considered to be a lead measure of financial returns, and can have a significant impact on company valuations (especially if material negative ESG events occur).

ESG might be considered to be more relevant to some 'high impact' sectors than others, but this reasoning fails to appreciate the breadth of ESG and its relevance to capturing the experience of stakeholder groups that are common to all companies, including employees, customers, suppliers, communities, and governmental bodies (e.g. regulators, tax authorities).

Which measures should we use?

There is no single ESG measure which will be relevant to all companies as the selection will depend on which issues are a priority to address, or are a particular risk/concern.

Many companies have traditionally used safety (a 'Social' measure) in the bonus, and now complement this with 'E' and, albeit to a much lesser extent, 'G' measures.

Other 'Social' measures commonly used include employee satisfaction, workforce diversity and inclusion statistics, and customer satisfaction.

'Environmental' measures are many and varied, and increasing are linked to decarbonisation, but may also include specific risks (e.g. incidents such as chemicals spills) or measures of environmental impact (e.g. waste reduction).

'Governance' measures include corporate reputation, individual and collective conduct, and data security.

In the Bonus or in the LTIP?

There is no single appropriate answer – it depends on the type of measure, the urgency with which improvement is required, the length of time required for any revisions to be made etc.

Whilst most companies may find it easier to use ESG (and other non-financial measures) in the Annual Bonus, as companies progress through their ESG roadmap and can set robust, quantifiable targets, a preference is evolving to incorporate such measures in the LTIP.

As standalone objectives or as an Index?

ESG potentially captures a significant number of different measures which can make it challenging to select how to reinforce ESG through pay without diluting the focus on any one measure.

The most common approach is to use 1-3 of the most important ESG measures, and reward these separately in the incentive. However, if ESG is particularly important, and organisational, or geographic, diversity is significant, then the use of an ESG 'index' (i.e. capturing ESG outcomes as a single number) or a third-party rating may be appropriate.

In the scorecard or as a multiplier?

There are arguments for both: using ESG performance as a multiplier to the regular bonus or LTIP would help ensure there is no dilution to the focus on the existing measures, but would risk a lack of focus on the ESG component if other measures are 'underwater'. Measuring, and rewarding, ESG as a separate category in the incentive scorecard helps ensure the ESG component is not ignored, but with the risk of diluting other measures.

A common design is for a modest weighting to be allocated to 'BAU' ESG measures in the incentive scorecard, with Remuneration Committee discretion applied as an override to the overall bonus to reflect material ESG events (similar to the approach used by many for health & safety).

How much weighting should we assign to ESG in our incentives?

Investors continue to prefer variable pay is weighted heavily to financial measures and/or quantifiable targets. In this context, ESG metrics typically account for 15-25% of the total incentive opportunity, with often a higher focus in the 'high impact' sectors.

What are shareholder views?

Whilst some shareholders have come out strongly in favour of the use of environmental metrics in incentives, others remain concerned around perceptions of greenwashing, poor disclosure and weak targets. Focus has now largely moved on from whether or not a company has included ESG to a more nuanced evaluation of the relevance of the measures to the company's strategy, and how the targets align with a company's stated long-term ambition.

Increasingly, shareholders are pushing for the use of 'science-based' targets and a number of companies now incorporate the use of SBTi certified targets. However, some ESG measures, in common with many other non-financial measures, may not currently be audited, requiring some other validation mechanism.