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HOW TO INCENTIVE ESG PERFORMANCE? GLOBAL AND REGIONAL TRENDS 2024

On February 8, 2024, Southlea participated in a webinar with other firms within the Global Governance and Executive Compensation (GECN) Group. In this webinar, we shared our latest research on the inclusion of ESG measures within executive compensation plans (2024 Global Trends in ESG Incentives) and discussed the latest trends in each of our regions, including Canada, U.S., U.K., South Africa and Europe (including Switzerland, France and Germany). The following summarizes the key highlights of the discussion.

Overview of Key Findings

- Important to consider the context under which companies are considering how to embed ESG measures within their incentive plans, including addressing challenges associated with the long-term orientation of many ESG strategies, differing perspectives on the degree, speed, and type of ESG initiatives and expectations for companies to show real progress
- As we go forward, we expect greater standardization in ESG disclosures which will improve comparability and the refinement of ESG incentive measures, akin to the use of financial incentive measures
- The adoption of ESG measures within executive compensation continues to increase to 87% of large global companies (up from 78% last year)
- Companies continues to support employee measures in incentive plans (76% of companies) while environmental measures have seen the biggest increase in prevalence (61% of companies). Diversity, Equity & Inclusion (DEI) is the most common employee measure and GHG Emissions is the most common environmental measure
- Companies continue to use a mix of quantitative and qualitative ESG measures (65% of companies). The use of only quantitative ESG measures remains a minority practice (14% of companies) with little change over the past four years
- ESG incentives are increasingly being incorporated into long-term incentives (LTIs) (34% of companies), although there are large regional differences ranging from 12% in Australia and the U.S. to ~50% in Europe, the U.K. and South Africa
- The average weighting of ESG incentives remains 25% in short-term incentives (STIs) and 20% in LTIs with little change over the past four years
- The weighting of ESG incentives as a share of total CEO compensation continues to increase to 11% with regional variability as a result of differences in the proportion of pay in short and long-term incentives and the average weighting of ESG within the incentives

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Regional Observations

The following summarizes the key points raised throughout the discussion by the representatives in each region. Although Guerdon Associates in Australia did not participate in the webinar due to time zone differences, we have provided insights into the Australian market for completeness.

Canada

In Canada, the economy is heavily weighted to natural resources which tend to have the biggest impact on the environment. This creates unique challenges in balancing the need to reduce the environmental footprint overtime with growing the economy in the short-term. There is a general realization that we need to do both in the balanced way that will take time, significant investments, and a clear regulatory framework. Canadian companies continue to advance their ESG journeys, but the degree of sophistication varies by company size and sector. As Canadian companies develop more specific ESG targets over the short- and longer-terms, we expect to see greater adoption of environmental incentive measures that are more quantifiable, reflective of broader pressures from investors and other stakeholders.

U.S.

In the U.S., ESG has in some cases become politicized, and backlash to corporate ESG efforts has intensified. In particular, numerous U.S. states have enacted regulations that curb business activities with firms and vendors identified as receptive to addressing ESG issues such as climate change or DEI. Despite this, most companies continue to incorporate ESG strategies, expand disclosures, and use incentives tied to ESG measures. Some other companies are changing their terminology away from ESG to use terms like “sustainability,” or they are applying greater specificity to focus on emissions reduction or specific workforce metrics. We are also seeing some companies working to refine their ESG measures to focus on those with a more direct link to financial returns and shareholder value. ESG strategies are a bit newer in the U.S. than other markets, so there is still some learning occurring across management teams and directors. Nevertheless, we see continued adoption of ESG incentives across company sizes – usually used in the STI plan rather than the LTI plan. Going forward, we expect companies will continue to refine their ESG measures and goals to be more specific, more material to their business, and better support shareholder expectations.

U.K.

Regulatory requirements differ significantly based on company size and type of listing. Recent updates were made to U.K. Corporate Governance Code for premium listed companies and the Quoted Companies Alliance (QCA) code which has been adopted by about 90% of AIM-traded companies. It is important to note that U.K. corporate governance is based on principle of ‘comply or explain,’ which allows companies to present to stakeholders cogent reasons for non-compliance. Neither code is a rigid set of rules. The largest U.K. companies’ annual reports must also include non-financial and sustainability information complying

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with FCA Sustainability Disclosure Requirements designed to crack down on misleading sustainability-related claims and promote consistent disclosures. There is an observable prevalence of ESG metrics in STI plans; with a typical weighting around 20%.

There is a different picture among private equity firms. Whilst listed firms include ESG targets into their incentives (and bigger firms produce Sustainability Reports), private firms are more reticent about including ESG targets in their incentive plans. That said, private equity firms are recruiting ESG or Sustainability-dedicated personnel, but the focus is on enhancing portfolio company performance not on the private equity firms themselves.

South Africa

South Africa is a developing country yet the prevalence of ESG factors in executive compensation design is the highest (tied with Europe). This high prevalence is only among the biggest companies in South Africa (JSE Top 40 that are global companies) and is not representative of the typical local companies. South African companies are reticent to adopt ESG strategies because of the associated cost. Instead, they create their own corporate social investment strategies (CSI) that tend to focus on their employees or communities in which they operate. For this reason, the social factor has the highest prevalence in South Africa and particularly DEI. This is dominant in South Africa because of legislation called Black Economic Empowerment (BEE) and Employment Equity (EE) that makes sure that there is pay equity as well as DEI in line with the demographic make-up of the South African population.

These issues are long term in nature because companies have to adopt a long term strategy to get the representative demographics across all levels within their companies (including gender targets) and therefore South Africa has one of the highest inclusions of ESG measures in LTIs (more than 50%) to incentivise executives to meet these targets. Although the prevalence of ESG in LTIs is high, the weighting is still low making up less than 12% of total CEO compensation which means that South African companies still have a long way to go to ensure these targets are taken more seriously.

EU and Switzerland

Europe is taking a leading role in the sustainability area and has one of the highest rates of ESG adoption. In particular, Europe has one of the highest levels of ESG measures in LTI plans (54%, with a global average of 34%). This is partly because countries such as Germany and France have adopted regulations and corporate governance codes that require ESG metrics to be part of compensation plans. In addition, companies are advancing in their “ESG journey,” e.g. they have gained some experience with ESG targets in STI plans and, at the same time, their confidence in setting long-term targets is growing. In contrast to this, Switzerland lags behind Europe, with only 28% of the largest listed companies linking ESG measures to their LTI plans.

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Despite these positive European ESG trends, there is still room for improvement. Not all companies are focusing on their material ESG topics in their compensation plans. This was the finding of a recent HCM study among Swiss listed companies, which compared material topics with ESG criteria that are tied to compensation.

Overall, the European ESG landscape will change over the next 3-5 years. New European regulations on reporting and due diligence such as the Corporate Sustainability Reporting Directive (CSRD) and the Corporate Sustainability Due Diligence Directive (CSDDD) will significantly impact companies' non-financial reporting. While these regulatory updates mainly concern European companies, they will also affect Swiss companies with ties to the European market above certain thresholds. As a result, even small and medium-sized companies will have to provide more transparency on their sustainability targets and progress.

Australia

Australia's executive incentive adoption of ESG is relatively high but is primarily limited to STIs. It lags Europe in incorporating these measures into LTI plans. Outside of prudentially regulated industries, this is probably because there are few compliance drivers compelling adoption. Despite this, there appears to be a trend in fossil fuel exposed industries to voluntarily adopt ESG contingent LTIs. In most cases, these companies have struggled with aligning longer return on capital time frames for environmental measures with the typical 3-to-4-year LTI performance period for capital returns.

The trend is expected to pick up pace from 2024 with the introduction of mandatory climate-related financial disclosures from July 1st. These disclosures will include information relating to governance, strategy, risk management and metrics, and targets (including Scope 1 and Scope 2 greenhouse gas emissions) in the first year of reporting. Information on Scope 3 emissions will be required from the second year of reporting. The likely introduction of an Australian version of the international sustainability reporting standards from about 2026 is also likely to accelerate the incorporation of measures in longer term incentives.

Key Takeaways

We believe that it is important for companies to take a planful approach when embedding ESG measures within their incentive plans. Our report articulates the steps for consideration in the design process, including:

- Fewer and more focused ESG measures that follow the priorities and material issues identified in the ESG strategy
- Greater focus on quantifiable measures that drive important changes and overall improvements in performance
- Incorporated in the incentive plan aligned with the time horizon to effect meaningful change
- Clear governance processes to establish, verify, and compare performance

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