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2021 Use of Environmental, Social, and Governance Metrics in Incentive Plans

FW COOK

2021 USE OF ENVIRONMENTAL, SOCIAL, AND GOVERNANCE (ESG) METRICS IN INCENTIVE PLANS

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INTRODUCTION

Increased investor and stakeholder interest in Environmental, Social, and Governance (ESG) topics has led to increased focus on ESG among public companies. One approach for signaling the importance of ESG externally is to incorporate ESG metrics and goals into executive incentive plans. Against this backdrop, FW Cook studied current practices among the largest U.S. public companies with a focus on:

1. Prevalence of ESG metrics within executive incentive plans in the broader industry and amongst industry sectors
2. Types of ESG metrics
3. Approaches to incorporating ESG into incentive plans

Summary of Key Findings
64% of large companies disclose ESG metrics in incentive plans (up from 56% in 2020). The vast majority of these companies incorporate ESG metrics in the annual incentive plan, but a few also incorporate ESG in a long-term incentive plan
ESG use in incentive plans varies significantly by industry and is most prevalent among companies in the Energy, Utilities, Financials and Health Care sectors (>70% prevalence) and least prevalent among companies in the Communication Services and Industrials sectors (50% prevalence). In the past year, there was significant growth of ESG prevalence in the Consumer Discretionary sector
The types of ESG metrics employed vary by industry. Environment & Sustainability metrics are most common among the Energy and Utilities sectors while Human Capital & Culture and Diversity & Inclusion metrics are most common among the broader industry
Similar to last year's findings, most companies use an ESG metric as one of many factors considered in evaluating individual or team-wide performance; however, this year we also observed an increase in the number of companies using ESG metrics as stand-alone, formulaic metrics/modifiers (34% in 2021 compared to 22% in 2020)
Companies continue to disclose performance against the ESG incentive metrics qualitatively, with less than one-fourth of companies that use ESG incentive metrics disclosing quantitative performance achievement

FW COOK COMMENTARY

Our clients are actively discussing how best to signal to investors and other stakeholders the importance of ESG objectives. As companies develop their ESG objectives, they strive to demonstrate alignment among execution and progress against articulated goals, business strategy and management accountability.

While companies recognize that there is wide-spread external interest in ESG, there is significant concern about the most appropriate way to introduce ESG metrics into incentive plans and avoid unintended consequences, which may include:

- Pressure to set highly aspirational and potentially unachievable goals to demonstrate commitment,
- Embarrassment and criticism in the event of underachievement,
- Criticism from the proxy advisory firms and governance professionals for subjective measurement,
- Suboptimal short-term reaction to longer-term challenges, and
- Questions from investors and other stakeholders about the importance (or lack thereof) of excluded metrics.

As companies begin planning for 2022, it is appropriate to evaluate some key questions and factors regarding ESG and its inclusion in incentive plans:

1. **Status of Current Processes.** Does the company have a measurement system to accurately track ESG metrics? Does the governance structure assign ESG responsibilities to a specific board committee or multiple committees?
2. **Signaling of Importance.** Does the importance of ESG require its formal inclusion in the incentive plans, or can ESG be effectively measured and disclosed outside of the incentive plans?
3. **Balancing Multiple Stakeholder Perspectives.** What are the business implications of including an ESG metric, recognizing that not all stakeholders embrace the same investment strategy, social agenda, or time horizon? What ESG metrics are most important to investors? If an ESG metric is included, which financial metric is de-emphasized (i.e., weighting reduced)? Is there willingness to disclose the specifics of ESG incentive metrics? Does inclusion of certain ESG metrics unintentionally imply that others are unimportant? Once in the incentive plan, can an ESG metric be removed without internal and external criticism?
4. **Goal Setting Period.** Because progress on many ESG metrics will evolve over long periods (e.g., a decade or more, especially for climate change initiatives), it is natural to want to measure in long-term plans. But does the company have forecasting precision over periods as short as three years? If discretion in measurement is retained on an equity-based, multi-year incentive plan, is the company willing to accept variable accounting on the award? To reduce the impact of variable accounting, should ESG metrics apply exclusively to top level executives in a long-term plan? If lower-level executives are excluded, does it raise questions about the importance of the metric and/or accountability across the organization?
5. **Unintended Consequences.** If one ESG metric is chosen over others, does it miscommunicate the degree of importance placed on the metrics not chosen? If qualitatively assessed, does this create the potential for criticism from proxy advisors? Does underachievement or setting a target goal below investor aspirations create possible public relations challenges or inconsistency with the company's Corporate Sustainability Report? Might possible underachievement attract moral criticism to the company, and could this risk encourage suboptimal decision making?

METHODOLOGY

FW Cook conducted a study of the use of ESG metrics in annual and long-term incentive plans among the largest U.S. public companies, consisting of 250 U.S.-listed companies in the S&P 500 with the largest market capitalizations as of March 31, 2021 (excluding Foreign Private Issuers that do not have the same disclosure requirements). The industry breakdown of our 250-company sample is as follows:

Sector	Cos.
Communication Services	12
Consumer Discretionary	26
Consumer Staples	21
Energy	10
Financials	31
Health Care	39
Industrials	36
Information Technology	41
Materials	12
Real Estate	10
Utilities	12
Total	250

Data was sourced from the latest proxy filings (as of September 15, 2021) and represents annual and long-term incentive programs in place during fiscal year 2020/21.

METHODOLOGY

For purposes of this report, we grouped ESG metrics into the seven broad categories below:

	Environmental	Social			Governance		Broad ESG
Category	**Environment & Sustainability**	**Human Capital & Culture**	**Diversity & Inclusion**	**Health & Safety**	**Governance**	**Cyber Security & Data Protection**	**Overarching ESG**
Example of Metrics	Reduction in carbon emissions Waste reduction Environmental stewardship	Employee engagement Succession planning Recruitment and retention Employee training and development Transforming culture	Gender representation Racial minority representation Inclusion survey	Fatalities Lost workdays Accident prevention Food or product safety	Regulatory compliance and internal controls Risk management processes Stakeholder engagement All-encompassing governance enhancements	Cybersecurity Fraud prevention Data governance	Implement overarching ESG or corporate responsibility strategy Recognition for ESG initiatives High ESG scores from external ratings agencies

Note - Our study excludes any metrics that are not intended to be ongoing. For example, metrics in place as a response to COVID-19 or any other one-time event are interpreted as one-off and are therefore not included in this study capturing ongoing changes to incentive plans.

METHODOLOGY

The various methods of ESG incorporation and degree of disclosure were categorized as follows:

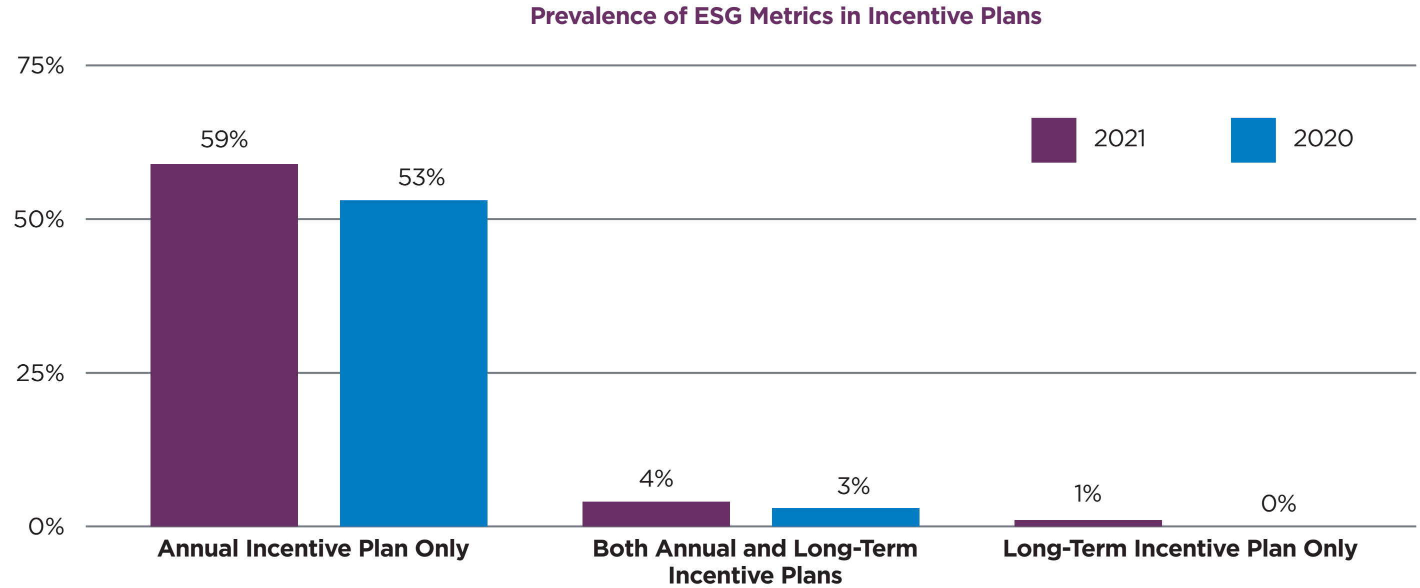
ESG Measurement Approach		
Individual Performance Consideration	**Team-Wide Scorecard**	**Formulaic Metric of Modifier**
ESG metrics are incorporated into a broader assessment of individual performance. The particular ESG metrics and/or achievement against the ESG objective may vary by Named Executive Officer	ESG metrics are incorporated into a scorecard of objectives by which all Named Executive Officers are evaluated. The ESG metrics are not a formally-weighted component of the scorecard, and instead are typically considered as part of a holistic evaluation of performance used to determine payouts	ESG metrics are formally weighted and achievement is considered as part of a formulaic determination of the incentive payout

Disclosure of ESG Performance		
No ESG-Specific Performance Disclosure	**Qualitative Performance Disclosure**	**Quantitative Performance Disclosure**
ESG metrics are listed among the factors that are considered in arriving at an incentive payout, but specific performance achievements are not described. Most common among companies using ESG qualitatively as an individual performance consideration	ESG performance is described qualitatively without any quantitative performance results disclosed. Includes companies that disclose a payout score for ESG without disclosing the underlying quantitative performance that was used to calculate the payout	ESG performance that was considered in arriving at a payout is disclosed quantitatively. Most common among companies using a formulaic ESG metric or modifier
Note – it is possible to evaluate ESG performance quantitatively using pre-established goals but disclose the performance achievement qualitatively or not specifically describe achievement at all		

KEY FINDINGS

Prevalence of ESG Metrics

In this year's study, 64% of companies use one or more ESG metrics in the annual or long-term incentive plan compared to 56% of companies in 2020. Most companies incorporate ESG metrics in the annual incentive plan, with low prevalence in long-term incentive plans.

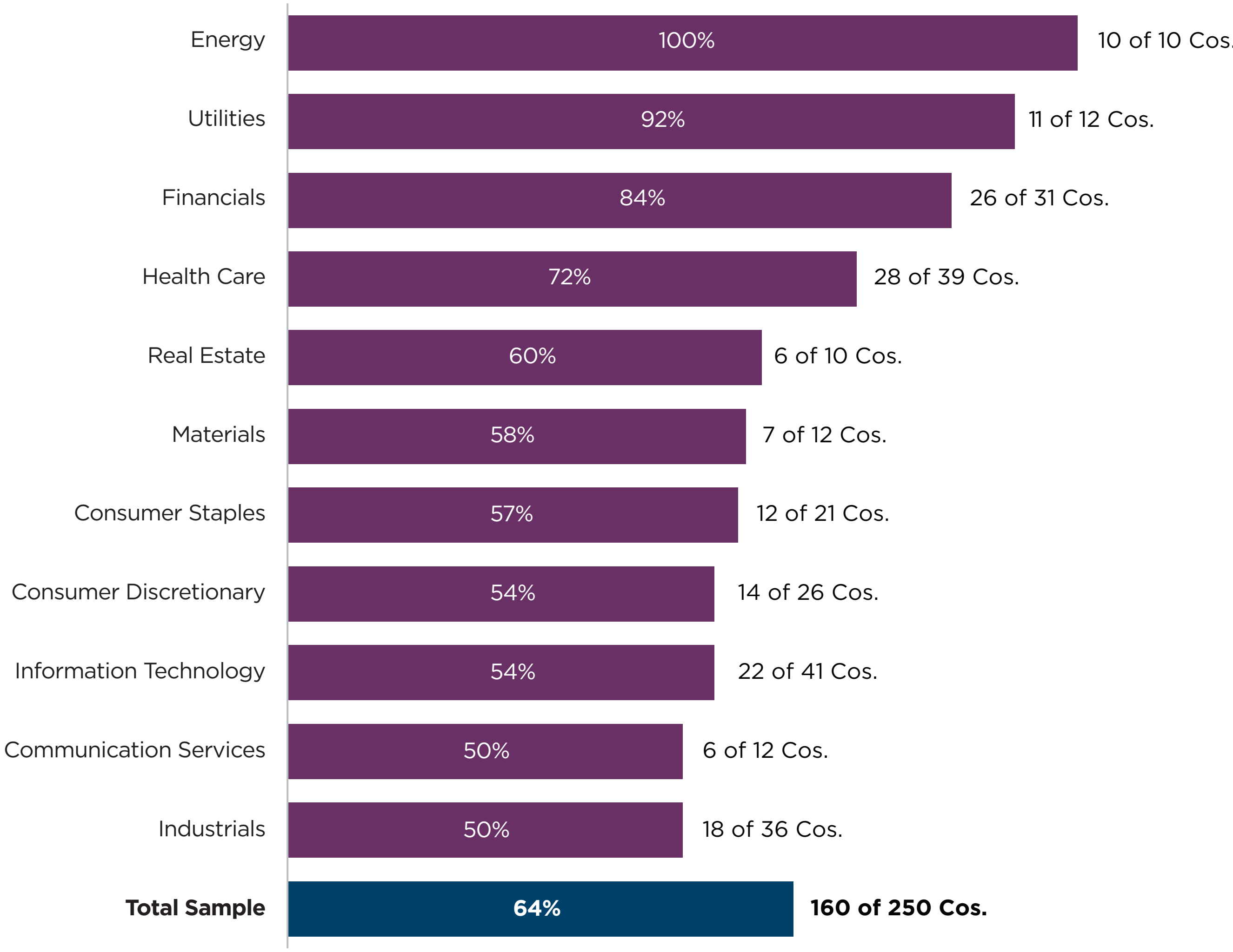


KEY FINDINGS

The prevalence of metrics varies among sectors; however, at least 50% of companies in each sector incorporated ESG metrics

- ESG metrics are most prevalent among Energy and Utilities companies (consistent with last year's analysis)
- The Consumer Discretionary sector saw the largest increase in the prevalence of ESG metrics (increased from 27% to 54% of companies)

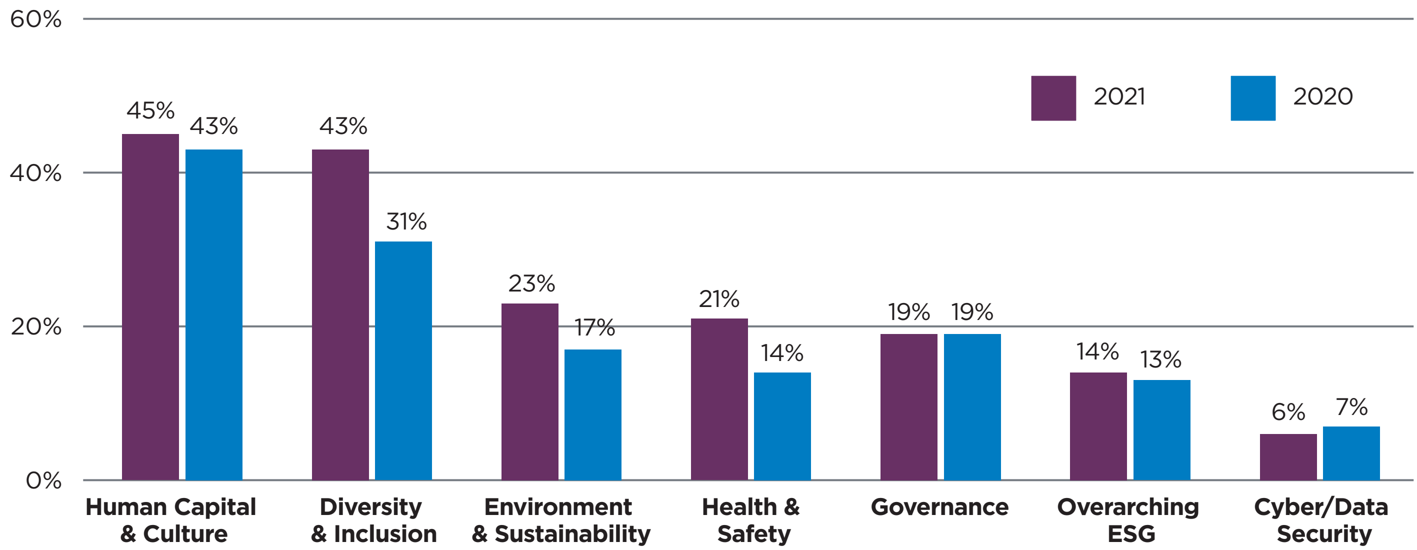
Prevalence of ESG Metrics in Incentive Plans by GICS Sector



TYPES OF ESG METRICS

Human Capital & Culture and Diversity & Inclusion continue to be the two most common ESG categories used in incentive plans. Diversity & Inclusion saw the biggest year-over-year increase in prevalence (increasing from 31% to 43%).

Prevalence of ESG Metrics by Category



The types of metrics used vary by industry sector:

- The Energy and Utilities sectors are more likely to incorporate metrics tied to Environment & Sustainability and Health & Safety, which has been a long standing metric in these sectors
- The most prevalent metrics in all other industry sectors are Human Capital & Culture and Diversity & Inclusion

Industry	Human Capital & Culture	Diversity & Inclusion	Environment & Sustainability	Health & Safety	Governance	Overarching ESG	Cyber/Data Security
Communication Services	42%	50%	17%	17%	0%	8%	0%
Consumer Discretionary	31%	38%	19%	12%	8%	0%	0%
Consumer Staples	38%	33%	24%	0%	14%	0%	5%
Energy	30%	40%	100%	90%	20%	0%	0%
Financials	71%	71%	23%	3%	58%	16%	16%
Health Care	56%	46%	13%	15%	36%	31%	8%
Industrials	39%	33%	17%	19%	8%	11%	6%
Information Technology	44%	37%	7%	12%	10%	22%	5%
Materials	25%	33%	42%	58%	0%	8%	0%
Real Estate	60%	30%	20%	10%	10%	10%	0%
Utilities	25%	58%	67%	92%	8%	17%	8%

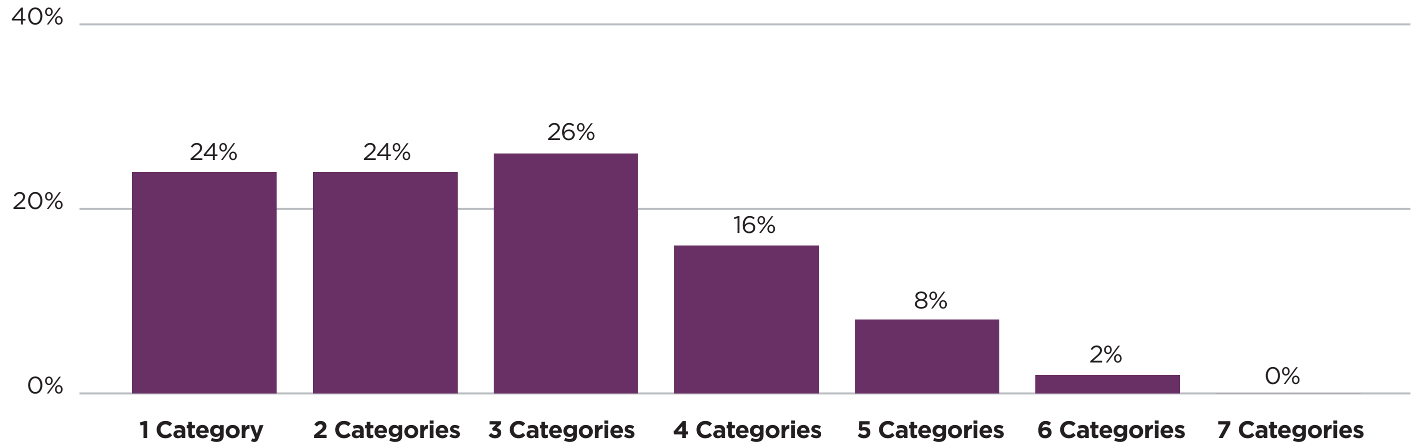
HOW ESG METRICS ARE INCORPORATED INTO INCENTIVE PLANS

The majority of companies incorporate metrics from one to three ESG categories within their incentive plans (typically in the individual performance component or a team-wide strategic component) and measure performance on a qualitative basis.

Number of ESG Metrics

Most companies in our sample cover between one and three different ESG categories in their incentive plans. This indicates companies are focusing on select ESG categories rather than ensuring all categories are covered.

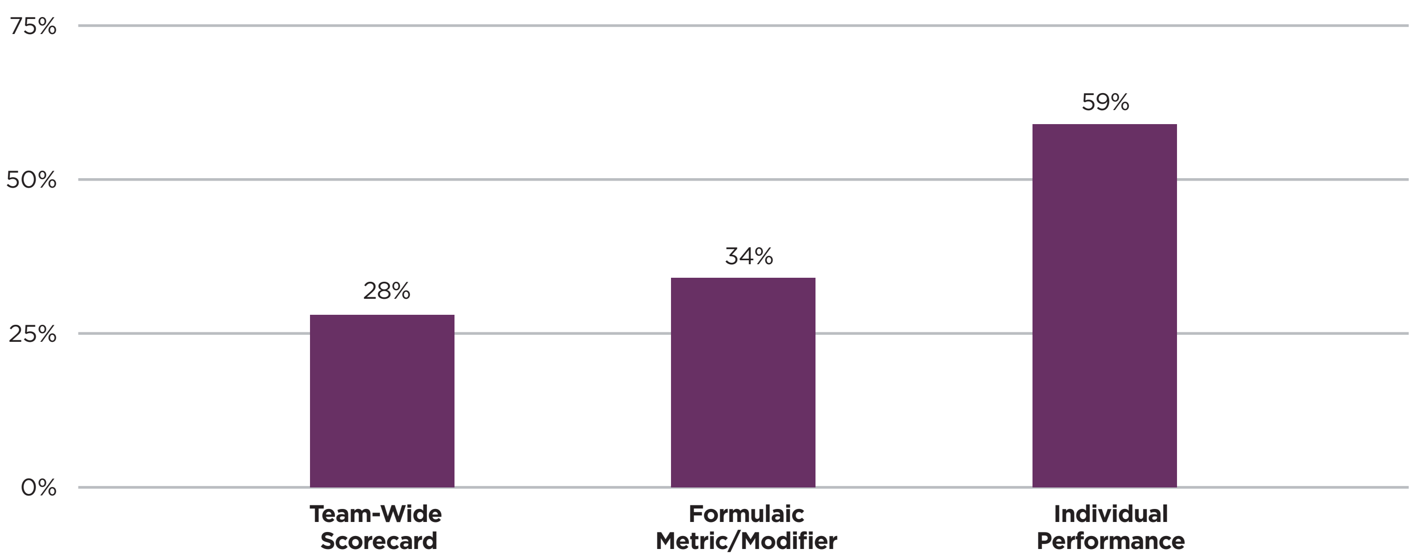
Amount of ESG Metrics by Category
(Among Companies using ESG Metrics)



ESG Measurement Approach

The majority of companies continue to measure ESG performance as one of many factors considered in the evaluation of individual or team-wide strategic performance; however, we did see an increase in the number of companies using ESG metrics as stand-alone, formulaic metrics or modifiers (increased from 22% of companies in 2020 to 34% of companies in 2021).

Prevalence of ESG Incorporation
(Among Companies using ESG Metrics)

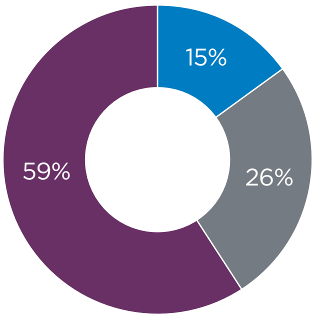


Note - prevalence sums to greater than 100% because some companies incorporate ESG into incentive plans in more than one way (e.g., use one metric formulaically and another as part of an individual performance assessment)

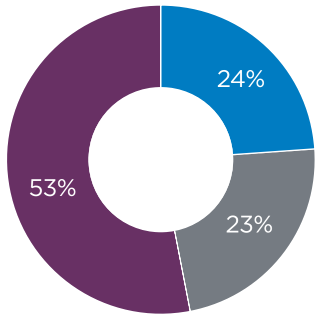
HOW ESG METRICS ARE INCORPORATED INTO INCENTIVE PLANS

The following exhibit is a breakdown of ESG metric inclusion in incentive plans by category. The most notable increases from the prior year include an increase in formulaic metrics/modifiers based on Environment & Sustainability and Overarching ESG goals:

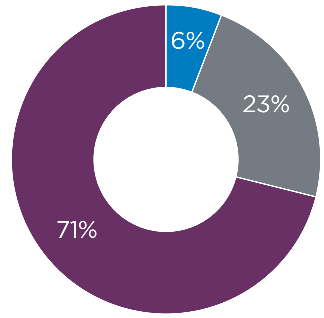
Human Capital & Culture



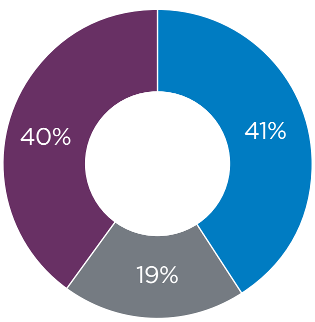
Diversity & Inclusion



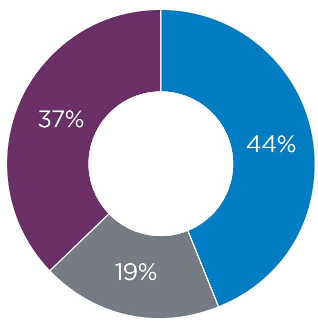
Governance



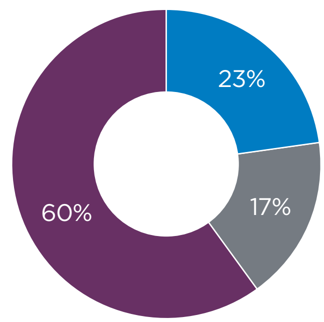
Environment & Sust.



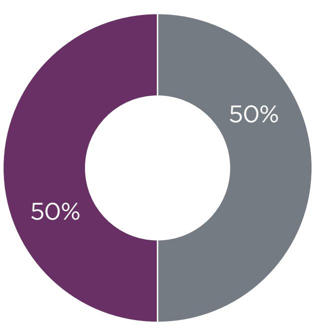
Health & Safety



Overarching ESG



Cyber/Data Security



Legend

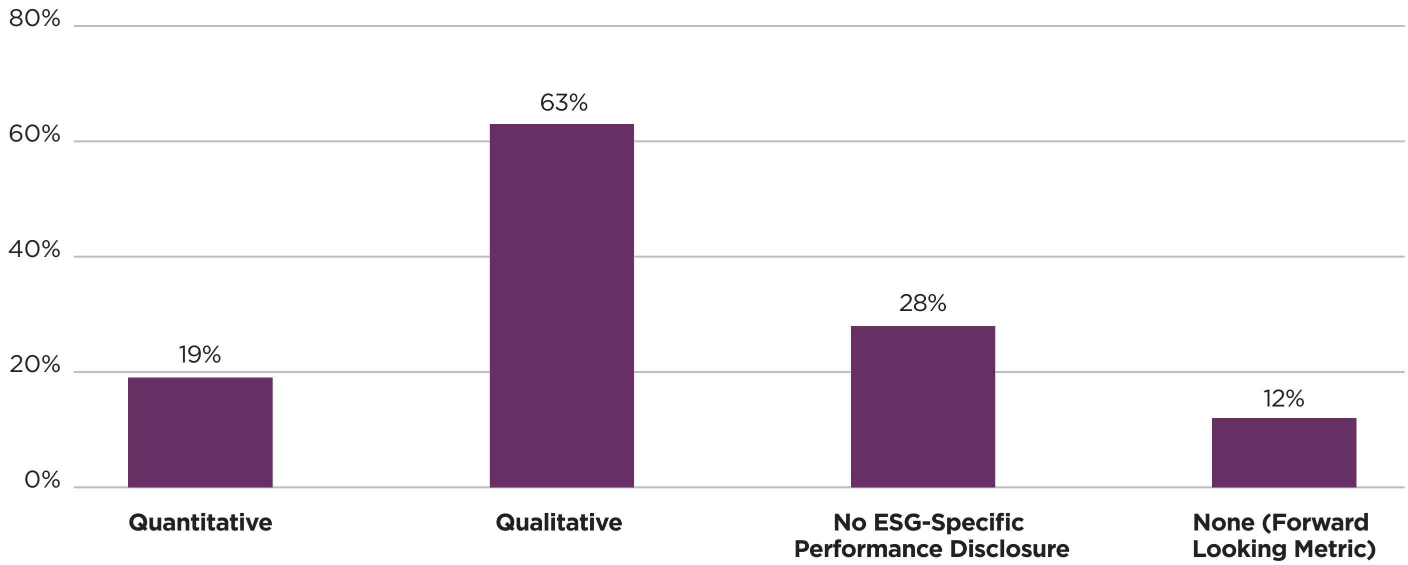
- Formulaic Metric/Modifier
- Team-Wide Scorecard
- Individual Performance

Note - in cases where companies incorporate the same ESG category in more than one way (e.g., formulaic and individual), they are counted according to their most impactful incorporation of ESG (i.e., formulaic > scorecard > individual)

ESG PERFORMANCE DISCLOSURE

Only 19% of companies using ESG metrics disclosed the performance achievement used to arrive at an incentive payout in a quantitative manner, consistent with our findings last year. Companies are still most commonly describing the performance achievement qualitatively (e.g., met/exceeded expectations, improved relative to last year, etc.). Twenty-eight percent of companies did not specifically describe how they performed on a given ESG metric, only noting that the metric was considered in arriving at the payout (most common for companies that use ESG metrics as part of individual performance assessments). Twelve percent of companies had no disclosure because the company disclosed the metric will be in their plan for the following year, and achievement disclosure will be available in next year's proxy statement.

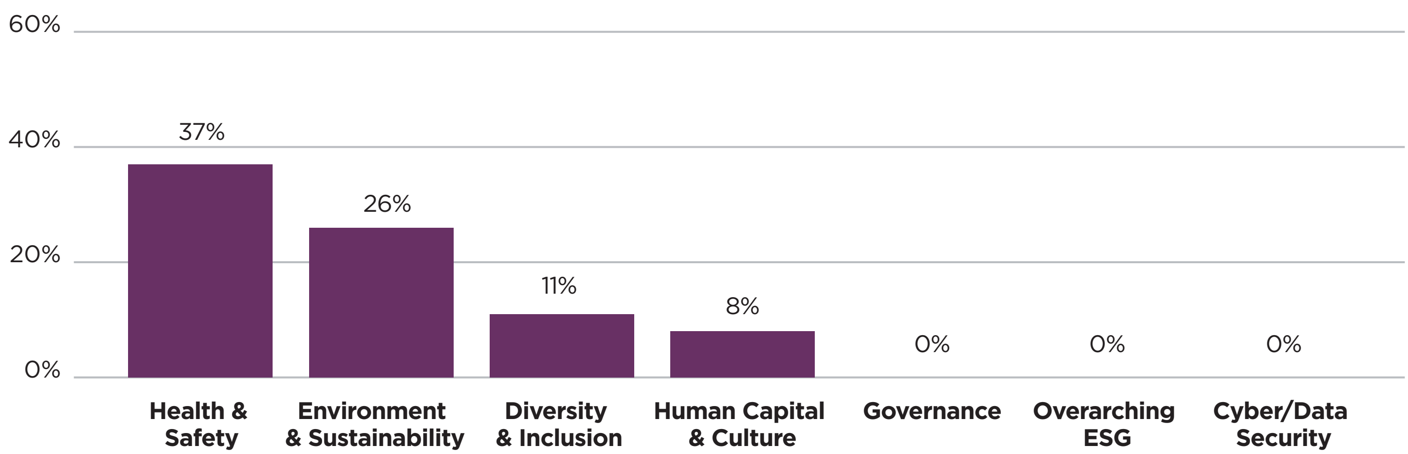
Disclosure of ESG Performance Achievement
(Among Companies using ESG Metrics)



Note - prevalence sums to greater than 100% because some companies disclose performance in different ways for different ESG metrics (e.g., quantitative disclosure for one metric and qualitative disclosure for another)

As expected, the ESG categories most used in a formulaic manner are also the categories that most often have quantitative performance disclosure.

Quantitative Performance Disclosure by ESG Category
(Among Companies using ESG Metrics)



FW COOK PROFILE

FW Cook is an independent consulting firm specializing in executive and director compensation and related corporate governance matters. Formed in 1973, our firm has served more than 4,000 companies of divergent size and business focus from our offices in New York, Chicago, Los Angeles, San Francisco, Atlanta, Houston, and Boston. We currently serve as the independent advisor to the compensation committees at a substantial number of the most prominent companies in the U.S.

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