Compensating for ESG: You Get What You Pay For

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ESG, or Environmental/Social/Governance criteria, are growing increasingly important among socially responsible investors, shareholders, and a company's other stakeholders, e.g., customers, employees, and local communities. This trend was accelerated by recent social and cultural events such as Black Lives Matter and #MeToo, as well as growing concerns over environmental impact, wealth inequality, and other issues often discussed in the mainstream media.

It has also quickly become a growing priority for many of our clients. Forward momentum on ESG initiatives creates lasting value for shareholders and stakeholders. If an organization and its leadership team believe ESG is important, it should result in enterprise value creation through diversity of thought, improvement in how we do business, and the positive impact corporate America can have on the environment and the world.

Companies know this. Many are undertaking large efforts to release new and improved sustainability reports and are talking to their investors clearly and directly about where they stand on various ESG topics. There is growing pressure to start including ESG in executive compensation arrangements, but there is no roadmap for aligning compensation to ESG metrics. The types of metrics discussed in ESG disclosures are so unique to each organization as to make it nearly impossible to create reliable benchmarks.

The challenge lies in the tension between the expectation that organizations should undertake ESG efforts simply because it is the right thing to do, regardless of the money, and the reality that most leaders will neither believe in nor prioritize ESG work if it is not compensated accordingly. At Meridian, we believe that ESG work should be compensated appropriately. A company can make a highly effective public statement about its goals and priorities by including ESG in executive compensation disclosures.

Should ESG metrics be tied to annual or long-term incentive programs?

Many companies are inclined to start out by including these metrics in annual incentive or cash-based incentive programs. Annual performance is measured across a variety of metrics including financial, operational, and strategic goals. Some ESG metrics seem to fit naturally in that bucket, and until recently, many companies focused on the "E" (with metrics like safety and carbon emissions). Because annual incentives are cash-based, there is also more flexibility in how companies can set and measure meaningful goals, track metrics along the way, and assess performance. There is more room for some level of subjectivity, which is necessary for compensating more nebulous but popular "S" goals.

The problem with including ESG performance compensation in annual plans is that it is unlikely for any company to make meaningful progress on complex social issues like diversity and inclusion in a short twelve-month period. It could take months of internal surveys, business process analyses, and other data collection just to identify root causes of diversity issues. While a project like this would certainly represent significant progress to investors, there is no straightforward way to tie this progress to performance.

Addressing social and cultural issues in the workplace takes time. These types of changes are not about short-term profitability or cost reduction. ESG initiatives reflect how companies make meaningful changes to how the organization functions; how its employees feel about working there; and the policies and procedures that make the organization safe, inclusive, and sustainable.

With that in mind, long-term incentive plans are likely the more appropriate place for compensating ESG performance. The problem is that most publicly traded companies grant long-term incentives in the form of

equity. With equity, there is a different set of constraints in terms of the specificity necessary for goals to be considered true equity-based instruments.

In a typical three-year LTI cycle, metrics do not change often but goals are reset every year based on past performance; such is the annual nature of our overlapping PSU designs. ESG initiatives are better suited to multi-year objectives that can only be measured by progress over that period. For example, companies could focus on an “S” goal this year, with a three-year plan in mind. Next year, while maintaining the “S” goal a priority, companies could set a new “E” or “G” goal with a three-year plan. This approach would allow organizations to focus on three critical areas over a multi-year period without having different, moving goals for the same metric. Further, there are countless ESG metrics to choose from and most companies want to limit the focus to just one to three items (inclusive of financial and stock price goals that likely will not be replaced). ESG as a broad category could represent a defined percentage of the LTI. This allows for ESG to be a fixture of compensation programs while maintaining flexibility in goal setting and performance measurement.

Which metrics should our company choose?

Companies are under pressure to change everything as quickly as possible. This approach is not sustainable or realistic, so they are forced to prioritize which ESG programs and metrics will drive meaningful change. The list of possibilities is long, and there is no right answer.

Companies must look inward and try to identify specific problems they want to fix. What specific outcomes are they seeking? What behaviors need to change? They must also ask whether fixing this problem will create meaningful stakeholder (not just shareholder) value. Companies must evaluate processes and strategies for social issues like diversity and inclusion for potential legal considerations or unintended consequences. If a company can take the time to identify what meaningful changes will result in enterprise value creation, they have found the right metrics. Every metric should align with the larger initiative of creating value.

Yet, as mentioned above, there are no agreed-upon benchmarks. If an organization identifies an opportunity for change, does that mean it was done poorly beforehand? Do companies put themselves at risk by disclosing possibly unfavorable current states? Do the improvement goals keep up with industry and peer standards? There are no easy answers to these questions.

Conclusion

The compensation professionals at Meridian have seen it again and again: you get what you pay for, and you do not get what you do not pay for.

When companies include ESG in their executive compensation programs, they are making a public statement about where the company stands on critical issues in our society today. They are “proving” their belief in these initiatives by compensating executives who are responsible for their execution. By compensating these executives accordingly, organizations ensure that these important issues are top of mind.

When building annual and long-term incentive programs, a clear understanding of the business strategy is critical. Compensation programs must align with strategic priorities, and ESG is no exception.