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Leading or Lacking?

ESG at AGMs

Insights from Brunswick's Global ESG Practice

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Collective Intelligence

Leading or Lacking?
ESG during the 2022 AGM season

While the eyes of the world are on the Russia-Ukraine war, and while companies the world over are grappling with the fallout, the 2022 AGM and proxy season is quietly getting underway.

ESG is now, without question, a mainstream lens through which companies are viewed and assessed by investors. AGMs have become firmly established as a platform for shareholders to bring key ESG issues to the attention of boards and the public.

Global ESG assets are projected to surpass $41 trillion by 2022 and $50 trillion by 2025, one-third of the projected total assets under management globally, according to Bloomberg Intelligence. ESG funds represent the fastest-growing part of the global fund market.

We expect ESG issues to rank high on this year's AGM discussions between investors and managements, continuing a strong trend we saw in 2021, when we observed the following:

- A higher percentage of shareholder proposals on environmental issues are winning majority support. Shareholders across Europe, the US and Australia sent a clear message through their voting that they expect companies to establish robust decarbonization strategies and plans. Around 30% of shareholder resolutions on environmental issues received majority support from investors in 2021, with resolutions on specific aspects of climate action, such as lobbying, receiving more support than resolutions on corporate climate strategy.[i]
- The "Say on Climate" campaign is gathering pace, although it received mixed reviews depending on regional investor perspectives. Say on Climate votes that were backed by company management have received high levels of investor support, often with upwards of 90% "for" votes.[ii]
- Diversity as the key social issue, with many disclosure-related diversity resolutions receiving good support. Overall, however, most shareholder resolutions on other social issues failed to get significant or received considerably lower support than environmental resolutions.[iii]

Since last year's AGMs, we have seen significant political and regulatory changes across the world, such as broad endorsement around the globe of TCFD as a standard for climate disclosures; the merger of SASB with the IIRC and the establishment of the International Sustainability Standards Board; incoming supply chain regulation in a number of Western countries; and the EU's detailing of its Taxonomy which stipulates which corporate activities are to be regarded as sustainable and which ones are not.

Add to that landmark climate change litigation against Shell in the Netherlands, increasing activist investor activity on ESG and the recent intense pressure many companies are facing to abandon their operations in Russia, and it is clear there is potential for heated ESG debates and close votes in the run-up to AGMs this year.

So, what's mere hype and what's real? Will ESG top the AGM agendas, or will we see a lack of meaningful action between companies and investors around the world?

Company commitments under increasing scrutiny

More and more investors are focused on ESG risks and demanding accountability on these issues by the board through swift, determined and strategic actions.

The days of management carrying on regardless are over. Companies that cannot demonstrate how they have engaged on, committed to improving, or made real progress on ESG issues that are deemed critical to their industry's licence to operate should expect to come under fire during this AGM season.

For the energy, industrial and infrastructure industries, that means decarbonization. For banks, it means fossil fuel financing. For everyone, it means diversity, equity and inclusion, or DEI.

But even companies that have made substantial ESG commitments and are well on their way to putting them into practice should expect more intense scrutiny and corresponding criticism of their efforts as the bar for disclosure and demonstrated accountability by the board and senior leadership team continues to rise.

This is particularly true regarding climate action and decarbonization. Many institutional investors are asking for proof of companies' transition plans, actions and business progress towards their net-zero commitments.

Whereas one or two years ago it was enough to have a net zero commitment in place, a growing number of investors now demand detailed, credible and ambitious decarbonization plans aligned with corporate strategies including

- full disclosure of climate change-related risks in line with TCFD reporting;
- details about relative and absolute reductions of greenhouse gas emissions across scopes 1, 2 and 3;
- decarbonization plans with milestones that are detailed, science-based, Paris-aligned and certified by a reputable organisation like the SBTI;
- alignment of capex to and P&L impact of climate targets;
- disclosure of corporate lobbying practices to ascertain whether they are Paris-aligned;
- details on exactly how decarbonization is to be achieved and how related issues, like biodiversity loss and deforestation, are addressed as part of decarbonization plans; and
- recognizing and mitigating the social impact of decarbonization strategies on affected employees and communities (so-called "Just Transition" plans).

The overarching questions for investors are:

Are companies doing what they have committed to?

Are they doing enough, or could they be more ambitious?

Are they "greenwashing"? If so, this will be severely scrutinized and likely punished with votes against directors.

The same is true for companies' DEI commitments. Two of the three largest global asset managers have stated this year that DEI is a key concern for them and that corporate progress towards goals will be scrutinized.

Many other investors have highlighted the importance of progress on DEI in their voting policies for this year. For US and UK companies, that will include a growing focus on ethnic and racial diversity, reaching far beyond board diversity to racial equity audits and community impact.

Additionally, there will be industry-specific ESG issues that invite investor scrutiny, such as equitable access to healthcare and drug pricing in the pharma and healthcare sectors; the impact on biodiversity of agriculture and food companies; supply chain human rights issues across the automotive, technology, fashion and food sectors; and equitable pay and working conditions in many others.

In focus: the governance of ESG

Traditionally, for most investors, the G in ESG has come first. There is a widely held belief that a company that has strong governance will be managed well in every way.

Only in the past three years has the E in ESG gained more prominence as a result of the global push for more action on climate change. A recent Brunswick global survey of investors[iv] in energy & resources companies confirmed that 53% of investors identified governance as most important among ESG factors in making their investment decisions – closely followed by environmental factors with 43%.

But whereas investors tended to care mainly about the traditional corporate governance issues of board composition, skillset, tenure and executive remuneration, their focus is now turning to the governance or board oversight of companies' ESG efforts.

A growing number of investors and proxy advisors such as Glass Lewis are looking for clear disclosures on boards' oversight of and accountability for E and S issues. Unsatisfactory disclosures can lead to votes against directors, in particular the governance or risk committee chairs.

Similarly, the inclusion of E and S metrics into management incentive and C-suite compensation programmes needs to be fully aligned with companies' sustainable business strategies. Investors and proxy advisors demand detailed, quantifiable ESG metrics and hard performance targets as well as disclosure of the impact on pay-outs upfront rather than *ex post facto* subjective assessments by boards.

Many investors in Europe go beyond board oversight and executive compensation, expecting detailed disclosures on how companies identify, manage and mitigate their ESG risks. That includes how E and S issues are embedded in strategy and day-to-day decision-making processes, how they are integrated in management information and control systems, and how E and S risks are escalated and owned within companies.

The question of how companies are managing their Russian operations and investments is also assessed through a governance lens: How is social responsibility and a stance on human rights an active factor in decision-making beyond aligning to international sanctions? Does the company have a declared purpose, and what bearing does this have on operations? Is the corporate strategy on E and S aligned, or in conflict? How do the company and board manage ethical dilemmas?

Our picks: rising ESG issues for the 2022 season

From our interactions with investors and our review of proxy advisor guidance, the following top themes have emerged for 2022.

Environmental issues

- Say on Climate is applying intense pressure on banks and other financial institutions for votes at AGMs. Organisations like the UN's Principles for Responsible Investment (PRI) and some proxy advisors guide investors to review Say on Climate plans on their individual merit rather than supporting the idea outright, out of concern for unintended consequences. The PRI sees several drawbacks of Say on Climate plans developed and/or sponsored by companies, and advises investors to use more effective engagement and proven stewardship mechanisms than recurring Say on Climate votes.[v]
- More detailed and intense scrutiny of net-zero targets and climate action plans. As outlined earlier, investors want to understand how credible and detailed companies' decarbonization plans are; those that are not and/or lack ambition may result in votes against directors.
- Pressure to provide/include scope 3 data.
- Pressure to provide reporting in line with TCFD.
- Scrutiny of climate-aligned lobbying practices.
- Broadening the scope of E issues to industry-relevant issues closely related to climate change, such as:
  - biodiversity loss, deforestation and land use change;
  - water stewardship/water stress;
  - pesticides;
  - plastic waste.

Social issues

- DEI: gender is still the most prevalent issue, but race and ethnicity are gaining more prominence, particularly in the US and UK, reaching far beyond board diversity to racial equity audits and community impact.
- Pay equity.
- Working conditions.
- Support for employees and communities facing hardship, such as the pandemic and the Russia-Ukraine war.
- Human rights in the supply chain.
- For Pharma:
  - access to medicine and vaccines;
  - patent protection for vital vaccines;
  - antibiotic resistance.
- For Tech:
  - data privacy and protection;
  - hate speech and impact on influencing public opinion;
  - youth addiction to gaming and social media.

Governance issues

- DEI on boards: many investors now demand a minimum of one minority gender board member and for US companies, some are calling for more racially diverse representation on boards.
- Continued focus on remuneration, aligning executive pay with employee and investor experiences during the pandemic.
- ESG KPIs for remuneration: credibly aligned to corporate and sustainability strategy, measurable, audited, and detailed description provided for KPI target setting up front.
- ESG competencies on boards.
- ESG governance processes and accountability at executive and board levels.
- Decision-making on exiting/not exiting Russia as a result of the Russia-Ukraine war.

Investors turning activist on ESG

Where many long-only investors have addressed ESG issues with companies as part of their ESG engagement strategies – in private meetings or via written correspondence – some of those institutional investors increasingly make their disapproval of corporate ESG practices public. Especially in the US and UK, activist-style tactics are being deployed to get companies to move faster on ESG, via shareholder proposals and media campaigns.

In the 2021 AGM season, a number of ESG shareholder proposals were fairly closely voted and would have only needed the support of one or two of the largest asset managers to secure a majority. As these large asset managers ramp up their ESG voting, they can easily tip the balance in favour of ESG shareholder resolutions. Not surprisingly, some companies seem more willing than in the past to settle shareholder proposals rather than take the reputational risk of having an ESG proposal go to a vote at AGMs. This suggests that ESG activism could become more successful.[vi]

Many more investors are aligning through alliances for greater impact. Investors told us that on many ESG topics, they now coordinate with each other as there are simply too many important issues and too many AGMs for investors, especially smaller ones, to cover to the same extent.

Some investor alliances, such as Climate Action 100+, are integrating year-round ESG engagement strategies, and flagging shareholder proposals at AGMs. These alliances come with an inherent expectation for the proxy voting of their members, which is drawing large, passive and more conservative investors closer to more activist tactics.[vii]

Resolutions flagged by Climate Action 100+ received a higher-than-average level of investor support in 2021, although around half of those still failed to reach majority - which could change in coming years.

Investment strategies determine votes

Active and passive investors tend to vote differently. Passive investors have a fiduciary duty to protect pension funds or private pension savings for decades to come, leading them to take a very long-term view. As passive investors follow indices, they also cannot sell out of a stock, so engagement and voting strategies become key in achieving progress on ESG issues. Many of these funds are therefore anything but passive on ESG stewardship.[viii]

Large passive investors with stewardship teams generally have their own voting guidelines and use the services of proxy advisors as inputs into their voting processes. Company engagement also influences the voting decisions of passive investors.

Active investors often pursue a more hands-on ESG approach. It is up to the fund manager to decide to buy, hold or sell a stock, and more often, it is the fund manager who votes the proxies for the fund. If companies don't make the demanded progress on ESG, there is always the option to sell, potentially putting pressure on the share price. However, many active investors also opt for longer-term ESG engagement strategies, as they can only influence the companies of which they hold or are planning to hold stock. Selling stock due to ESG and other concerns is a matter of last resort.

Increasingly, the ultimate asset owners are taking back their voting power. Asset owners such as pension fund owners or life insurance companies are long-term owners of stock. Instead of letting their respective asset managers (active or passive) do the voting for them, they want to have a consistent voting impact across all their holdings.

These asset owners, like the large passive funds, often have their own AGM voting guidelines and use the services of proxy advisors to inform their decisions.

ESG vs. the bottom line

Will all be well at the AGMs of those companies that are considered ESG champions? Not necessarily.

Investors are not ready to accept extensive ESG commitments as the supposed reason for performance dips and have punished companies they perceive to be putting ESG over profit. They do not want to choose between ESG and the bottom line, but would rather see a sound ESG approach integrated into strategy as a means of generating long-term sustainable returns for investors.

Corporate options for AGM season

For companies that haven't engaged intensively throughout the year with their investors on ESG, time has effectively run out to do anything meaningful ahead of AGMs. Institutional investors are voting at thousands of companies' AGMs and need to digest countless shareholder proposals, while proxy advisors are busy filing their research and proxy advice, with some known to have "black-out periods" for corporate engagement during this season.

So, what can companies do if confronted with a significant new ESG issue or shareholder proposal without enough time for a substantial policy response?

We recommend five key actions:

1

Engage with your top 20 investors, recognizing who the ultimate asset owners are and whether they will be voting themselves or via their asset managers.

2

Where appropriate, engage with ESG activists to try to establish some common ground, such as a shared goal or commitment, and a mutually agreeable way of getting there. This may result in shareholder proposals being withdrawn or planned voting against company directors to change.

3

Provide as much clarity as you can on your stance on the ESG issue in question, including your longer-term ambition, your challenges, your strategy and your journey/milestones to reach your targets, as well as your current metrics.

4

Don't rely on your annual or sustainability report alone to tell your story, as relevant data, ambitions and proof points may be buried deep within, making it hard for investors and the financial media to find. Enable them to access your latest information easily: ensure you use proxy advisors' corporate data tools to ensure their advice is based in your up-to-date statements, use your AGM website or other direct investor communications channels to provide a succinct overview of the salient points, and explain your ESG strategy to the media in the run-up to the AGM.

5

Ensure all key information is public. Proxy advisors as well as ESG ratings agencies rely on up-to-date, robust disclosures. Some of the large passive funds will only accept public information for their voting decisions, dismissing non-public data.

Brunswick's Global ESG Practice

Brunswick is trusted advisor to the world's leading companies on ESG critical issues and critical stakeholders. Our unique offering recognizes the importance of social value and financial risk, leverages deep sectoral and regional knowledge and is fully integrated across our practice groups and sectors. We enable clients to understand the global ESG conversation and emerging trends, to define their ESG ambition, and to communicate and engage effectively with ESG stakeholders.

From financial situations through to capital markets, regulatory and public affairs, climate and environmental action, social issues, crisis, cyber, litigation and employee engagement, clients rely on Brunswick for ESG insight, advice, preparedness and campaigns.

Covering all regions, our ESG experts are based in major offices across the globe.

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Notes

[i] ShareAction: Voting Matters 2021, December 2021, and Insightia: The Proxy Voting Annual Review 2021

[ii] ShareAction: Voting Matters 2021, December 2021, and Insightia: The Proxy Voting Annual Review 2021

[iii] ShareAction: Voting Matters 2021, December 2021, and Insightia: The Proxy Voting Annual Review 2021

[iv] Brunswick Energy & Resources global investor survey, 2021-2022

[v] Principles for Responsible Investment: Climate transition plan votes: investor briefing, February 10, 2022 at https://www.unpri.org/stewardship/climate-transition-plan-votes-investor-briefing/9096.article

[vi] Patrick Temple-West in FT Moral Money, Feb 18, 2022

[vii] Claudia de Meulemeester in Mergermarket, Feb 7, 2022: ESG campaigns set to reach more sectors in 2022 as engagement and proxy voting further intertwine

[viii] Claudia de Meulemeester in Mergermarket, Feb 7, 2022: ESG campaigns set to reach more sectors in 2022 as engagement and proxy voting further intertwine