

Environmental, Social and Governance (ESG) in Long-Term Incentive Plans

Say-on-Sustainability puts pressure on companies

Stakeholders increasingly demand higher commitment from companies to make meaningful progress on sustainability. At the same time, regulatory pressure rises. For example, with the counterproposal to the corporate responsibility initiative, as of the annual general meeting 2024, i.e., for the financial year 2023, Swiss listed companies will be obliged to hold a shareholder vote on their sustainability report. While some companies are starting to act, stakeholders including investors and proxy advisors have already expressed dissent over corporate ambition levels at companies' say-on-sustainability votes in the 2021 and 2022 proxy seasons.

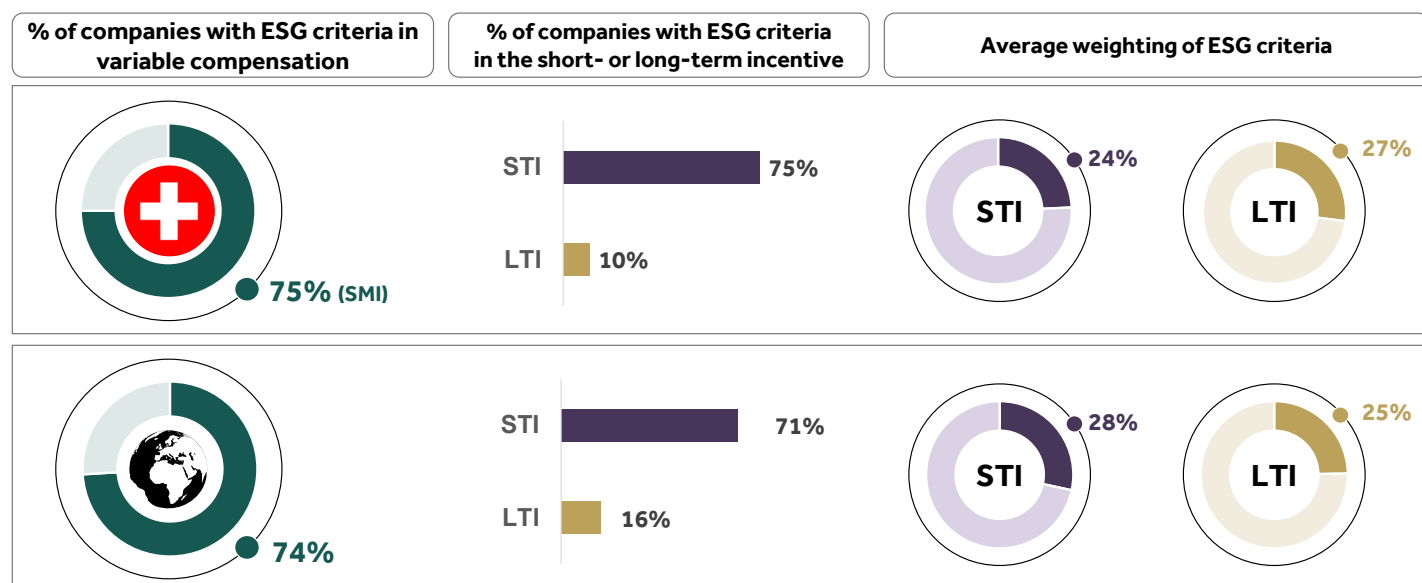
ESG in compensation: A growing trend

One way to show commitment to internal and external stakeholders and avoid criticism regarding "greenwashing" and low credibility is to reflect environmental, social, and governance (ESG) performance in executive pay decisions. In fact, companies are increasingly integrating ESG topics in short-term incentive plans (STI).

A 2021 study conducted by the HCM presided Global Governance and Executive Compensation Group (GECN) found that among over 500 international companies, 71% use ESG in their STI (2020: 66%).

In comparison, listed companies in Switzerland are still lagging with only 42% of the 100 largest companies in the Swiss Performance Index (SPI) reflecting ESG in pay decisions. At the same time, 75% of companies in the Swiss Market Index (SMI), comprising the largest and most liquid 20 Swiss stocks, integrated ESG in their STI in 2021. The average weighting of these criteria within the respective STI makes up for 28% on a global level and 24% for SMI companies.

However, the prevalence of integrating ESG in incentive plans can vary significantly by industry. For example, while in the materials, financial, utilities and energy sectors, ESG can be observed in most incentive plans (approx. 90%), companies active in consumer discretionary and information technology do not integrate them as often yet (only approx. 55%).



Also, given the different ESG focuses and challenges of companies and respective industries, ESG metrics vary quite significantly. Globally, among the most common topics are social criteria (64%) such as diversity & inclusion or employee engagement, governance criteria (39%) such as risk management or compliance, and customer focused criteria (31%) such as customer satisfaction or product quality and safety.

ESG in LTI to anchor the sustainability strategy

While the integration of ESG in STI frameworks has almost become a “must” for modern compensation designs, the integration in long-term incentive plans (LTI) is still less common. Currently, on a global scale only 16% of companies do so with an average weighting of 25%. In Switzerland, only 4 SPI companies reflected ESG in their LTI plans during the 2021 cycle. At the same time, leaders are increasingly realizing that sustainability is a long-term commitment. To align with long-term strategic plans, more and more companies are therefore considering ways to reflect ESG performance in LTI plans.

For example, Holcim is one of the first Swiss listed companies to not only integrate ESG in their STI but also in their three-year performance share plan. Within the LTI, environmental criteria are weighted at 33%. Specifically, targets regarding CO2 emissions, the quantity of recycled waste, and freshwater withdrawal are included. All three are aligned with Holcim’s sustainability strategy and its commitment to build a net-zero future by taking a rigorous science-driven approach, with its industry’s first net-zero 2030 and 2050 targets, validated by the Science Based Targets initiative (SBTi).

Natascha Haegy, Group Head of Compensation and Benefits at Holcim, emphasizes that: “As the first global building materials company to sign the UNGC’s “Business Ambition for 1.5°C” initiative, it was crucial to hold management accountable by linking objective and measurable sustainability targets to their long-term compensation”.

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ESG in incentives: How to deal with trade-offs?

Such a link is important as including ESG in pay decisions can entail trade-offs because certain ESG and financial objectives are sometimes diametrically opposed - at least in the short term. For example, additional costs for a production plant with lower CO2 emissions reduce profits in the medium term. While several approaches exist, two alternatives come closest to solving this challenge.

Qualitative assessment: In this approach, ESG factors are incorporated into the compensation model in the form of an overall assessment. To this end, strategically relevant ESG topics are defined, which are underpinned by concrete criteria. These should be measurable but are not subject to a weighting and mathematical formula. Rather, an overall assessment of ESG performance is made by the board of directors. In Switzerland, listed companies are increasingly adopting this approach, as it reduces the pressure on the discussion about «true» performance and better accounts for trade-offs.

Framework conditions: Here, ESG criteria are defined as a minimum requirement or threshold. For example, a CO2 reduction of x% or a safety improvement of y% per year would need to be fulfilled. This increases the robustness of the compensation model and shifts the discussion about trade-offs between ESG and financial performance to the strategic level - or rather to the periodic discussion about how ambitious these thresholds should be set.

Based on our experience, those two approaches solve the sometimes tricky question of potential trade-offs most adequately. In addition, they allow for a comprehensive reflection of the perceived performance by owners, board members and managers. With this, integrating ESG in compensation can help companies to make significant progress on their ESG strategies also in the long-term.

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