Progressing Forward 2021

SquareWell Partners

ESG INTELLIGENCE | SHAREHOLDER ENGAGEMENT | ACTIVISM DEFENSE

What's on Investors' Mind? Well, Everything!

When the 200 Chief Executive Officers (CEOs) of the US Business Roundtable published in August 2019 their Statement on the Purpose of Corporations, with a commitment to defend stakeholders' interest, little did they know that this commitment would be put to the test so rapidly. The pandemic pushed corporate leaders to decide how to protect their employees, while satisfying their customers and suppliers and reassuring shareholders of their capacity to navigate the crisis and deliver financial returns. Investors demonstrated restraint in 2020, however, **2021 is looking to be a critical year** where investors will give their verdict on the actions (or inactions) taken by companies to navigate the crisis.

While COVID-19 is continuing to have devastating impacts on human lives and economies, the crisis revealed the resiliency of sustainable (or ESG) funds. According to Morningstar's Global Sustainable Fund Flows report, inflows in ESG funds rose by 72% in Q2 2020 only, with Europe receiving 86% of these inflows, to reach a record of USD 1 trillion in global assets. Without opining on the loose definitions as to what qualifies as an ESG fund, which we will cover in a separate memo, the numbers evidence that investing with an ESG-lens is not a fad and that a massive reallocation of capital is well underway. This evolution is mirroring a larger societal movement calling to "**build back better**" after COVID-19. This reshaping of finance constitutes a rare opportunity for companies who understand societal changes to attract and retain engaged investors, which would in turn allow them to focus on the long-term.

Shareholder Engagement Does Not Take a Break

Pushed by client demand as well as regulatory initiatives (Stewardship Codes, Shareholder Rights Directive II), institutional investors keep increasing the pressure on listed companies. 2020 **did not show any decline in number of engagements undertaken by investors** or stopped their participation at shareholder meetings. On the contrary, COVID-19 brought ESG issues to the fore with an even stronger feeling of urgency.

The number of engagements undertaken by institutional investors have remained steady or even increased based on data already available (for example, BlackRock's engagements increased by 48% in 2020 when compared to 2019[2]), in line with what the stewardship representatives, representing USD 7.2 trillion in assets under management, had shared with SquareWell in March 2020. As the investor demand for engagements is increasing, the range of issues covered during

[1] BlackRock, Sustainable Investing: Resilience Amid Uncertainty, 2020

[2] BlackRock, Investment Stewardship Annual Reports, 2019 and 2020.

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these meetings is also expanding and covering more environmental and social topics. Companies should make sure to invite additional team members, including their Heads of Human Resources and Corporate Social Responsibility, to meet with shareholders.

Despite most companies having been forced to hold their shareholder meetings virtually in 2020, the average voter turnout has been rather stable in 2020 versus 2019[3] given the advances in technology and the ease of shareholders to exercise their votes electronically, especially for the institutional shareholders. Investors have re-affirmed their **preference for hybrid meetings**, i.e. providing the choice to shareholders to attend the meeting in person or virtually. The critical factor for institutional shareholders remains that the switch in meeting formats should offer the same rights to shareholders as physical meetings, including the right to ask live questions (especially for proponents of shareholders proposals being provided the opportunity to defend their concerns).

Shareholder Activism from Different Players

The first three quarters of 2020 saw a **24% decline in activist campaigns globally,** according to Lazard[4], though the share of activism in Asia and Europe increasing compared to the US. Nonetheless, this year still witnessed some major activist campaigns at Twitter (US – Media & Entertainment), Commerzbank (Germany – Banks), Toshiba (Japan – Capital Goods), Lagardère (France - Media & Entertainment), and Pearson (UK – Media & Entertainment). Activists' success rate did not appear to be impacted by COVID-19, with **293 board seats won by activists globally YTD 2020** (versus 378 in YTD 2019) despite the fall in the number of campaigns (data from Activist Insight[5]). We do not believe this to be a long-term trend. Some activists have decided to postpone their campaigns to not appear as "tone deaf" to the current market dynamics whilst others have used the drop in share prices to increase their stake in a company, waiting to launch a campaign in 2021. We may also see activists shifting their focus to M&A, whether it be pushing for a sale of the company or opposing announced deals.

Climate Change activism, on the other hand, has not slowed down in 2020. The number of climate-related proposals more than doubled in the US, receiving a higher level of shareholder support than in previous years (34% in 2020 versus 26% in 2019) (Glass Lewis data) and in certain cases receiving a majority support. Of particular interest is the shareholder proposal filed by BNP Paribas Asset Management, a traditional asset manager, at Chevron (US – Oil & Gas) requesting a report on climate lobbying aligned with Paris Agreement goals. A majority of shareholders, including BlackRock, approved a proposal requesting the publication of a report on Procter & Gamble's (US – Consumer Staples) effort to eliminate de-forestation at its October 2020 general meeting.

Climate change activism was also present in Europe. Total (France – Oil & Gas) received the first shareholder proposal in France by a consortium of traditional asset managers to have the Company set a worldwide net zero emissions target (Scope 3) and adopt a detailed action plan. Close to 30 percent of participating shareholders supported the proposal or abstained, despite the proxy advisors siding with the Company. More recently, Spanish airports operator, Aena,

[3] In Europe the average voter turnout was 70.5% in 2020 versus 70.7% in 2019 (ISS data). In the United States, the voter turnout decreased only by 2% to 77% (link).

[4] Lazard https://www.lazard.com/media/451406/lazards-q3-2020-review-of-shareholder-activism.pdf

[5] Activist Insight, Shareholder Activism – Q3 2020 YTD.

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submitted to shareholders for approval in October 2020 its efforts to tackle climate change, submitting to pressure from TCI Fund Management.

Capital Allocation Decisions under the Spotlight

Previously capital allocation decisions in most countries were considered "routine" by investors provided that companies allocated capital within established thresholds. However, with COVID-19, capital allocation decisions, whether to pay **dividends** (or not) or make **share repurchases**, came under the spotlight in 2020 with many **investors**, regulators, and governments asking companies to retain the cash in the business to navigate the crisis whilst protecting its stakeholders. The International Corporate Governance Network also published a guidance on the topic of Covid-19 and Capital Allocation calling for companies to "develop — and communicate - a sustainable capital allocation framework to support long-term company success".

As the impacts of COVID-19 will continue and the 'V'-shaped recovery looking less likely, capital allocation decisions will require a delicate balancing act for companies in 2021 to manage the diverging expectations of its stakeholders (especially within its shareholder base regarding the payment of dividends). Companies will be expected to **justify their capital allocation decisions**, whether it is to renumerate shareholders or not. Whilst investors like Schroders have communicated that they would be more flexible regarding capital raising requests, other investors (and proxy advisors) will scrutinize the management quality, urgency of the funds, and the long-term strategy before supporting any capital raise (as in the case at French mall operator, Unibail-Rodamco-Westfield).

Corporate Purpose: A Compass through COVID-19

Since Larry Fink, BlackRock's CEO, asked companies in a 2018 letter to define their sense of purpose, the concept has never been as popular. In 2019 the Business Roundtable in the US, followed by the World Economic Forum in its Davos Manifesto 2020, have also embraced the concept. There is **clear investor appetite as well for companies to define their purpose**. Based on a SquareWell survey of investors (managing USD 22.1 trillion of assets) at the beginning of 2020, 93% of shareholders believe a corporate purpose is needed to set a long-term business strategy that creates value and 75% expect the company to come up with KPIs to measure its progress on fulfilling its purpose.

Companies that have defined a corporate purpose will have to demonstrate to investors how this purpose is guiding their decisions through COVID-19. Inability to do so will evidence that the purpose definition process had not been carried out efficiently.

Directors Under Pressure

• Accountability on COVID-19

Shareholders will want to understand the lessons learned from the current crisis, such as any gaps identified in the company's risk and crisis management strategy and the board's preparedness to respond. Boards are also expected to emerge with a better view on the quality of the management bench, the resiliency of the business, and what skills and experience might be missing in the boardroom. Board members are likely to be held accountable at companies that are perceived to have not taken the necessary measures to manage the crisis, including the protection of its workforce.

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• Accountability on ESG Issues

Investors have toughened their stance on board accountability for ESG matters, with investors opposing the re-election of board members due to the absence or the lack of progress on ESG practices and disclosures. Some "trendsetter" investors, including Legal & General Investment Management or Aviva, are progressively **voting against companies due to their poor reporting practices on environmental risks**. BlackRock has publicly reported multiple votes against board members or board discharge due to inadequate reporting on climate risk, including the failure to follow the recommendations from the Task Force on Climate-Related Financial Disclosures (TCFD).

• Director Over-Boarding

COVID-19 increased the attention that investors put on the issue of over-boarding, **as the crisis increased the time required for directors to carry out their oversight responsibilities**. Some asset managers like BlackRock, Amundi Asset Management or Aviva Investors had already set stricter limits pre-COVID-19 of four total board mandates for a non-executive board member, with J.P. Morgan Asset Management even setting a lower limit of three directorships. Likewise, investors are limiting the outside commitments of executive directors to ensure they remain dedicated and focused to the company they are leading. Nine of the largest asset managers, including the Top 3 – BlackRock, Vanguard, and State Street Global Advisors – expect an executive to sit only on one external board (other than the board on which they sit as an executive).

It should be noted that eight of the 20 largest asset managers have stricter guidelines on over-boarding than the two global proxy advisors (i.e. ISS and Glass Lewis). We expect these two proxy advisors to catch-up with this trend in the coming years.

• Board Diversity

Nomination committee members will face increasing shareholder pressure whenever the board composition does not **reflect the diversity of the society** (more specifically, its consumers and employees), and we expect investors to start looking more closely at the executive committee gender and racial makeup as well. Viewpoints from Institutional Investors on these topics have mushroomed (see the ones from Vanguard or Aberdeen Standard Investments) in parallel with higher voting dissent targeting nomination committee members. AXA Investment Managers announced a 33% board gender diversity target for companies in developed markets from 2021 (excluding France, where the expectation is 40%), following other European investors including Legal & General Investment Management, Ostrum Asset Management and BNP Paribas Management. As part of its "Fearless Girl Campaign", State Street Global Advisors recorded more than 230 oppositions to nomination committee members due to the lack of board gender diversity during the second quarter of 2020 alone.

Although diversity in terms of gender, ethnicity, age etc. remains important and is the first step towards improving board diversity, we caution that it may not be sufficient to achieve the desired outcome of "**cognitive diversity**" and representing different perspectives and expertise on the board that is critical for the long-term success of the business. It is therefore imperative for the nomination committees to disclose a board skills matrix to evidence the diversity of thoughts and ideas.

• Board Responsiveness

Investors are also assessing the board's responsiveness to shareholders. This is particularly the case on the topic of executive pay. Some investors like Norges, but also the proxy advisors ISS and

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Glass Lewis, indicate in their guidelines they will oppose the election of pay committee members whenever a pay-related proposal received a **low support level (more than 10% dissent) and the board failed to address the issue(s)**. This is not limited to the remuneration topic, however, as experienced by Netflix (US – Media) whose three board members on the ballot, including the CEO, received 33% to 55% opposition at their 2020 general meeting due to their ongoing failure to address majority-supported shareholder proposals on a range of governance topics.

Executive Pay: A Question of Alignment

Regardless of the company's performance/sector, the general expectation is that **2021 should be a year of restraint** with limited to no increases in pay and investors will carefully examine decisions made by pay committees in 2020 and 2021. SquareWell expects that the analysis by investors and proxy advisors will rely principally on these three principles:

- **Pay-for-Performance:** Any decision by the board to amend performance measures or targets should not shield management from the consequences of the crisis that has impacted all the other stakeholders. **Discretion will have to be used cautiously** to not validate investors' belief that it applies only in one direction (i.e. to increase an executive's pay, and never to reduce it) as well as the use of one-off/special awards. There is also an increasing expectation ESG criteria be considered in incentive plans, whether it be for the short- or long-term incentives.
- **Alignment with Shareholders:** Companies that have decided to reduce or cancel dividend payments, or experienced a share price decline (especially when compared to peers), would be in a challenging position to defend the decision that the management needs to be rewarded for their performance. Also, companies need to be sensitive to **equity dilution** when granting shares, especially if the share price decreased significantly over the past year.
- **Alignment with the Wider Workforce:** COVID-19 has only intensified, in the investors' minds, the need for **internal pay equity and fairness**. If employees had to be furloughed, experienced pay cuts, or if there had been mass layoffs, investors may consider that the decision to pay a bonus to management as "tone-deaf".

Overall, investors will make **case-by-case** decisions that will mostly rely on the quality of the explanations, both in written format as well as during engagements, provided by remuneration committees.

Social Factors Step to the Fore

If there was a silver lining in COVID-19, it may have been the sudden focus on the Social pillar of ESG. From the start of the crisis, many investors have publicly called on companies to protect all their stakeholders: in priority their workforce but also their clients and suppliers (see for example the letters from Schroders or from BMO Global Asset Management).

- COVID-19 has disrupted the workplace and its longer-term impact remains largely unknown. Companies will have to demonstrate they have in mind issues surrounding **work-life balance, burn out, women employment, mental health, and well-being**.
- Investors will also be scrutinizing the **resiliency and sustainability of the supply chain** of their portfolio companies on the full ESG spectrum, from their respect of workers' rights to the protection of biodiversity. Failure to ensure proper oversight and management of supply

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chains can result in significant reputational and economic losses, as well as regulatory scrutiny. Companies that invest in this area also benefit from competitive advantages, faster recovery from disruptions and, for those who wish to demonstrate leadership, broader impact.

- Investors are also monitoring how companies are ensuring the **safety of workers**, including in the supply chain. Front-line workers, who cannot work remotely, are facing a higher risk of contamination which reinforces demographic inequalities. The UK "fast-fashion" retailer, boohoo, lost close to half of its value when allegations appeared, later confirmed, that the suppliers' factories were not respecting workers' rights and forcing employees to work while sick or on furlough.
- **Cybersecurity** risks should also be re-assessed by companies as most of their employees and managers are spending more time remote working, not always with company issued computers or through secured Internet connections.
- The **Black Lives Matter movement** in the US has led companies and investors globally to reflect about the topics of social inequalities, racial injustice and how minorities are effectively represented within companies. Companies, and investors themselves, will be pressed to disclose more information on its efforts to address social and racial inequality. State Street Global Advisor sent a letter to their portfolio companies to ask for more disclosure on diversity & inclusion, as did the proxy advisor ISS focusing on the Board members' ethnicity information. Legal & General Investment Management (LGIM) is leading the movement in Europe, cautioning in a recently published viewpoint that the asset manager is ready to vote against management and may even divest from companies with all-white boards in 2022 (starting with the FTSE 100 and S&P 500). Others will surely follow. While local regulations do not always allow the recording of ethnicity statistics, companies should still be ready to explain how they make sure their diversity policy and practices allow them to recruit and retain diverse talents, who appropriately reflect their customers and local communities.

New Letters in the "Alphabet Soup" of ESG Reporting & Initiatives

As the integration of ESG data into investment decisions is becoming mainstream, investors have been asking for standardized ESG reporting from companies. Initiatives to create new reporting frameworks have mushroomed. In addition to older frameworks that companies may already be familiar with, including the Global Reporting Initiative (GRI) or the Integrated Reporting (<IR>) framework, two recent initiatives have gained strong support from investors and should therefore be considered by companies:

- The **Task Force on Climate-Related Financial Disclosure (TCFD)**, created by the Financial Stability Board, issued a set of recommendations to provide a reporting framework on climate risk. The recommendations are championed by Climate Action 100+, one of the most important investors initiative. The initiative seeks to enhance corporate disclosure from the largest carbon emitters, in line with the recommendations of the TCFD. More than 500 investors managing USD 47 trillion of assets are signatories, with BlackRock being one of the most recent significant supporters.

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- The **Sustainability Accounting Standards Board (SASB)** developed a short list of financially material sector specific ESG metrics. Although originating in the US, it has been endorsed by investors globally (representing more than USD 40 trillion in AUM) and will be a key standard for companies.

These different reporting frameworks are moving rapidly from the “nice to have” to the “must have” category for listed companies as non-complying reporting will have a **direct impact on their assessment by investors and/or ESG ratings and research houses**. In the European Union, though TCFD reporting is not mandatory, the European Commission has recognized it as the authoritative guidance on the disclosure of financially material climate information.

Companies should also be aware of the **Science Based Targets initiative (SBTi)**, which validates companies' greenhouse gas emissions reduction targets if they are consistent with keeping warming to well below 2°C or 1.5°C above pre-industrial temperatures. On 13 October 2020, CDP announced a new initiative supported by a total of 137 investors (USD 20 trillion in AUM) who are asking over 1,800 companies globally to take action on climate and for their for emission targets to be science-based.

The main standard setters (CDP, Climate Disclosure Standards Board (CDSB), Global Reporting Initiative (GRI), International Integrated Reporting Council (IIRC) and SASB) are working together with the goal of **creating a new comprehensive framework**, which should be welcomed by companies. A joined statement was recently published laying the groundwork for a future framework. A competing initiative to develop a common framework has been launched by the World Economic Forum's International Business Council at the 2020 Annual Meeting in Davos. In September 2020 a report was published, with the help of the “Big Four” audit firms, including a proposed framework and metrics, based on four pillars (Governance, Planet, People, Prosperity). Adding to the mix, the International Financial Reporting Standards (IFRS) Foundation has launched in September a consultation, including a proposal to create an International Sustainability Standards Board in order to become an official global standards-setter that would work with the existing initiatives. This proposal received an official endorsement from BlackRock.

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It's always a good time to speak with SquareWell.

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