# ESG Overperformance? Assessing the Use of ESG Targets in Executive Compensation Plans

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# Introduction

- ESG-based compensation for executives is (was?) pervasive among large US firms and is especially prevalent in the EU.

- There is a substantial body of research on this practice, but we know little about how often executives hit these targets and receive this compensation.

- In this paper, we extract this information from the proxy statements of the S&P 500. We find that executives get these awards at remarkably high rates.

# The Theory of ESG-Linked Compensation

- There are two primary accounts of what this practice is trying to accomplish.

- The first is that it is incentivizing ESG performance to satisfy investor demand. The second is that this is a symptom of poor governance (greenwashing and/or padding pay).

- The optics of missing the target may put firms in a difficult place.

# Brief Background on ESG-Based Compensation

- Executive compensation usually has three components: annual salary, annual bonus, and long-term incentive plans (stock, options, or both).

- In our sample, the average mix for the CEOs of S&P 500 firms was 10% salary, 18% bonus, and 72% LTIP.

- To date, ESG-based compensation has largely been confined to being part of the annual bonus. As others have noted, this means it is only a small part of the comp package.

# Background on the Structure of Bonuses

- A typical bonus has multiple components (e.g., revenue and EBITDA for the financial component).

- Many components will have “threshold,” “target,” and “maximum” levels. To get any compensation for a given component, the executive must at least meet the threshold level.

- Each component has a target dollar amount. Executives who exactly hit the target receive 100% of that amount, while threshold performance receives less than that and maximum receives a capped multiple (e.g., 150%).

# Data

- We look at the proxies for the S&P 500 for the 2023 proxy season.

- These proxies report the compensation for the top 5 executives for the next year and they also report pay for the previous year.

- Using a combination of hand coding and GPT-assisted auditing we code a large number of variables including information on the financial and ESG components of both annual bonuses and LTIPs.

# Basic Statistics

- Of the S&P 500 firms, 315 (63%) use ESG performance measures for the CEO or other named executive officer.

- Of those 315, 304 of them incorporate the ESG targets into the annual bonus.

- On average, the ESG target accounts for 15% of the weights in the bonus and accounts for about 3% of the CEO’s overall potential compensation.

# Basic Statistics

- Forty-eight of the firms in the sample include ESG targets in LTIP.
- Those components account for about 14% of the overall LTIP amount.
- For the CEOs that received these ESG-linked LTIP incentives, those incentives accounted for about 7% of their overall target compensation.

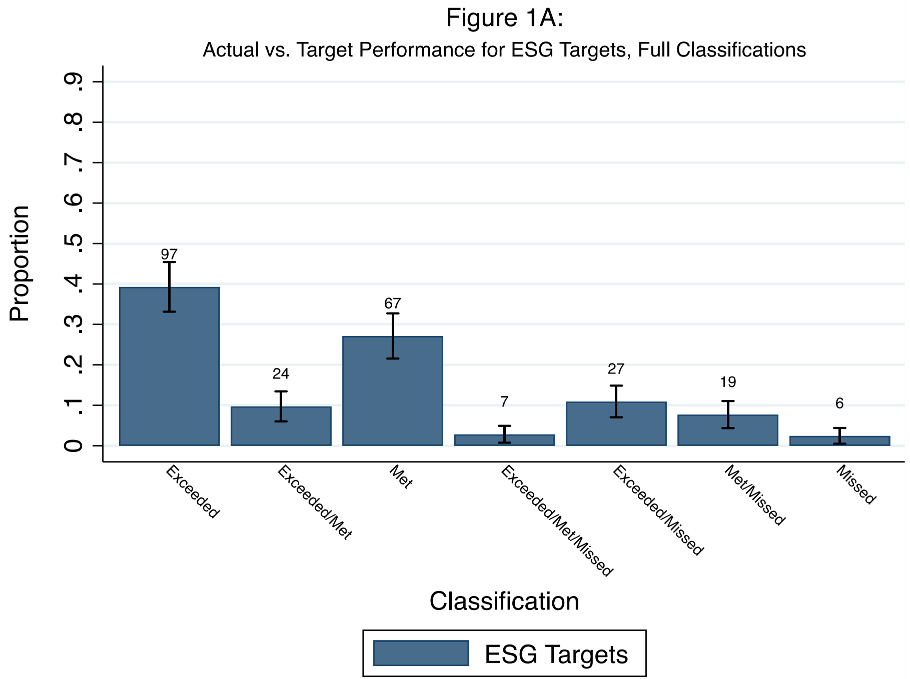
# Do Executives Hit Targets?

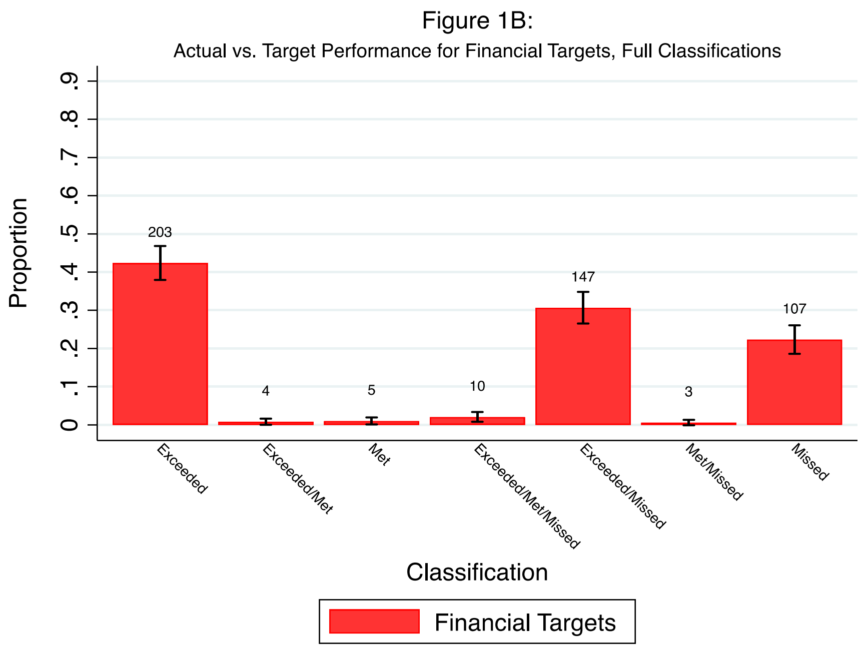
- Most firms disclose what the quantitative financial targets are. The are less likely to disclose non-financial, strategic, and safety targets, including ESG targets.

- Of the 304 firms with ESG-linked components in the bonus, we can classify performance for 247 of them and we can identify financial targets for 479 firms.

- We code whether each component was missed, met, or exceeded and then categorize each firm as some mixture of those categories (e.g. all met, all missed, met/missed, exceeded/met/missed, etc.)

# This Paper in One Slide



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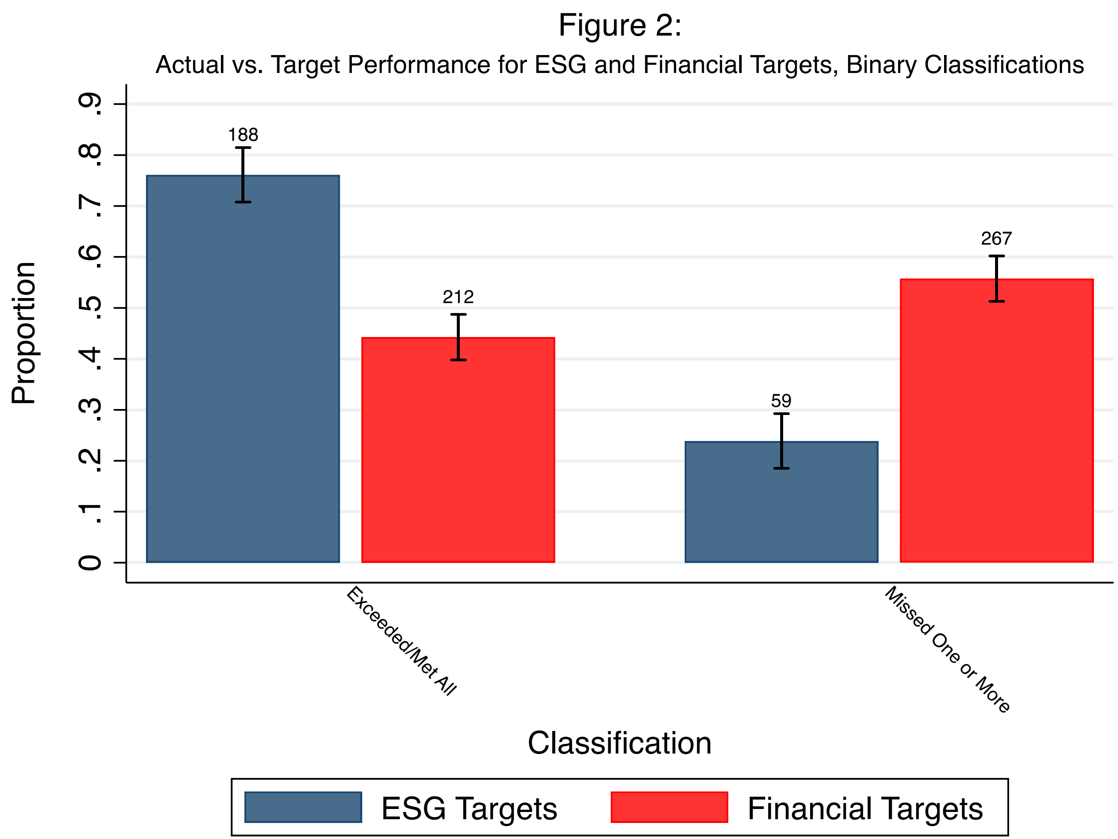


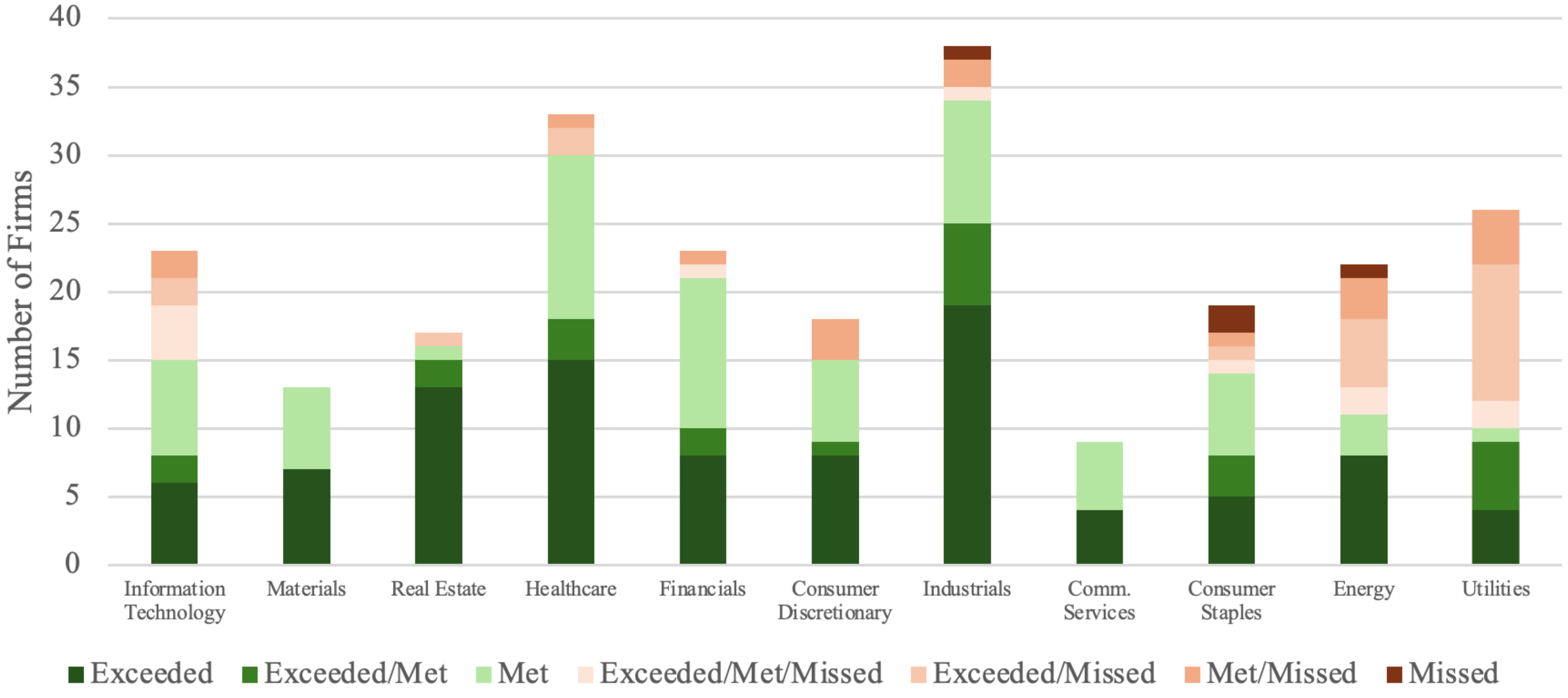
# Do Executives Hit Targets?

- For financial targets, executives miss all of their financial targets at 107 firms (22%).

- For ESG targets, executives miss all targets in only 6 firms (2%).

- For ESG targets, firms meet or exceed all of them 76% of the time while that only happened 44% of the time for financial targets.

Figure 3A: Actual vs. Target for ESG Metrics by Industry



# Outperformance or Underachievement?

- This is difficult to measure, but we can at least look at some correlates.
- The first question we ask is whether there is an association between ESG-linked compensation and ESG score (as measured by S&P Global).
- We then ask whether meeting those goals has any association with ESG score with controls for CEO vote share, E-index, SoP votes against, and size.
- $Y_i = \alpha_i + \beta_1 ESGScore_i + \beta_2 CEO_i + \beta_3 Eindex_i + \beta_4 Against_i + \beta_1 Size_i + \delta_i + \varphi_i + \varepsilon_i$

| | (1) | (2) | (3) |
|---|---|---|---|
| | ESG AIA Target | All ESG Targets Met/Exceeded | All Financial Targets Met/Exceeded |
| ESG Score | 0.00662*** | 0.0000173 | -0.00336** |
| | [0.00143] | [0.00159] | [0.00154] |
| CEO | -0.932*** | -0.329 | -0.72 |
| | [0.355] | [0.539] | [0.537] |
| Eindex | -0.0314 | -0.0336 | -0.0222 |
| | [0.0377] | [0.0595] | [0.0431] |
| Against | -0.340* | 0.441** | -0.22 |
| | [0.177] | [0.219] | [0.186] |
| Size | 0.0459** | 0.00961 | 0.0661*** |
| | [0.0218] | [0.0310] | [0.0242] |
| Constant | -0.208 | 0.513 | -0.803 |
| | [0.456] | [0.665] | [0.519] |
| Observations | 495 | 244 | 474 |
| R-squared | 0.229 | 0.278 | 0.164 |
| Industry FE | YES | YES | YES |
| Consultant FE | YES | YES | YES |

Robust standard errors in brackets

*** p<0.01, ** p<0.05, * p<0.1

# Outperformance or Underachievement?

- We also do an analysis that uses different ESG scores.
- We collect the 2021 and 2023 scores from LSEG and Sustainalytics in addition to S&P Global.
- We want to estimate the following, where $Y_i$ is the 2023 ESG scores for firm $i$:

$$Y_i = \alpha_i + \beta_1 2021Score_i + \beta_2 AIA_i' + \delta_i + \varepsilon_i$$

| | S&P Global | | | LSEG | | | Sustainalytics | | |
|---|---|---|---|---|---|---|---|---|---|
| | (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) | (9) |
| | 2023 Score | 2023 Score | 2023 Score | 2023 Score | 2023 Score | 2023 Score | 2023 Score | 2023 Score | 2023 Score |
| 2021Score | 0.721*** | 0.699*** | 0.731*** | 0.706*** | 0.716*** | 0.715** | 0.806*** | 0.794*** | 0.806*** |
| | [0.0182] | [0.0247] | [0.0177] | [0.0261] | [0.0370] | [0.0253] | [0.021] | [0.030] | [0.021] |
| $AIA_i^{ESG}$ | 1.844*** | | | 2.092*** | | | -0.28 | | |
| | [0.563] | | | [0.651] | | | [0.285] | | |
| $AIA_i^{Met}$ | | -0.753 | 0.87 | | 0.207 | 1.744** | | -0.699 | -0.187 |
| | | [0.932] | [0.532] | | [0.864] | [0.598] | | [0.492] | [0.277] |
| N | 498 | 246 | 498 | 484 | 237 | 484 | 486 | 241 | 486 |
| R-squared | 0.828 | 0.805 | 0.825 | 0.752 | 0.699 | 0.752 | .843 | .870 | .843 |
| Industry FE | YES | YES | YES | YES | YES | YES | YES | YES | YES |

Robust standard errors in brackets
*** p<0.01, ** p<0.05, * p<0.1

# Transparent vs. Non-Transparent Targets

- Some of the existing exec comp literature discusses the transparency of targets (GAAP vs. non-GAAP measures)
- This literature generally finds that non-transparent targets are hit more often than transparent, verifiable targets.
- We find a mix of these approaches for ESG targets. Some of the quantitative measures are also linked to mandatory reporting requirements, which makes them more transparent.

# Salesforce Has Hard, Verifiable DEI Targets

| ESG Measures (and Weighting) | | Performance Targets | Achievement |
|---|---|---|---|
| **Equality (50%)** | **U.S. Underrepresented Minorities & Women (25%)** | **47.5% of our U.S. Employees** will identify as Underrepresented Minorities[1] (Black, Latinx, Indigenous, or Multiracial) and/or Women as of the end of fiscal 2023 | **Exceeded** Target |
| | **Global Women (25%)** | **36.5% of our Global Employees** will identify as Women as of the end of fiscal 2023 | **Below** Target |
| **Sustainability (50%)** | **Air Travel (25%)** | **50% Reduction** in air travel emissions intensity[2] (GHG emissions / Revenue) for fiscal 2023 relative to fiscal 2020 levels | **Exceeded** Target |
| | **Supplier Engagement (25%)** | **10% of Spend** in fiscal 2023 with suppliers who have signed an agreement with a Salesforce Supplier Sustainability Exhibit[3] | **Exceeded** Target |
| **Total Attainment** | | | **75%** |

# Mondelez Uses Non-Transparent DEI Targets

| SPI Goals | | Assessment[1] | Annual Progress |
|---|---|---|---|
| **Snack Leadership** (50% of SPI) Drive global leadership in snacking by accelerating growth in multiple snacking categories | | ↑ | • **Priority & Total Snacks Share change:** Strong market share driven by (1) Pricing execution and volume growth across developed and emerging markets and (2) Strengthened portfolio through strategic high-growth acquisitions (Chipita, CLIF Bar and Ricolino) |
| **ESG** (50% of SPI) | **Sustainability:** Drive towards net zero environmental impact with sustainably sourced cocoa and wheat and reduction in packaging waste and $CO_2$ | → | • **Sustainably Sourced Cocoa:** ~80% sustainably sourced cocoa and on track to deliver on our long-term goals via expansion of Cocoa Life Program<br>• **End-to-end $CO_2$ Reduction:** Continued $CO_2$ reductions driven primarily by renewable energy expansions in key markets<br>• **Recyclable Packaging:** Conversion to recycling packaging in line with annual expectations and long-term goals |
| | **Mindful Snacking:** Evolve our products and portfolio to help consumers snack mindfully | → | • **Mindful Portions:** Progress made year-over-year but limited relative to long-term goals<br>• **Nutrients:** Progress was in line with annual expectations and long-term goals |
| | **Colleagues:** Build a winning growth and ownership culture that invests in local talent and champions diversity, equity and inclusion | ↑ | • **Diversity and Inclusion:** Sustained progress year-over-year for Women in Leadership roles. Continued improvement in Black Representation in Management in the U.S. in line with long-term goal<br>• **Employee Engagement:** Flat results to prior year with key focus area improvements; Maintained scores > 2019 and benchmark companies<br>• **Depth of Talent:** Continued significant improvement in our bench strength allowing greater internal talent sufficiency for leader roles |
| **SPI Rating** | | | **125%** |

(1) Arrow up = above expected progress; sideways arrow = at expected progress; arrow down = limited progress

| Area(s) of Missed Target(s) | Number | Percent of Total |
|---|---|---|
| DEI | 19 | 32.2% |
| Environmental | 8 | 13.6% |
| Safety | 20 | 33.9% |
| Safety + Environmental | 3 | 5.1% |
| Safety + DEI | 7 | 11.9% |
| Not Specified | 2 | 3.4% |
| Total | 59 | 100.0% |

# Conclusion and Takeaways

- The extensive use of ESG targets suggests a demonstrated public commitment to those values.

- But the low amounts of related compensation, the very high rates of hitting those targets, and the lack of association with improved ESG performance suggests governance and greenwashing concerns.



- It will be interesting to observe these trends going forward given the ESG backlash. There is also an argument for standardizing disclosure of targets and process.

# Follow-On Analysis

- We have started an additional analysis of firms that are outside the S&P 500 and have had a market cap of >$500M. This produces a sample of 1,719 firms.

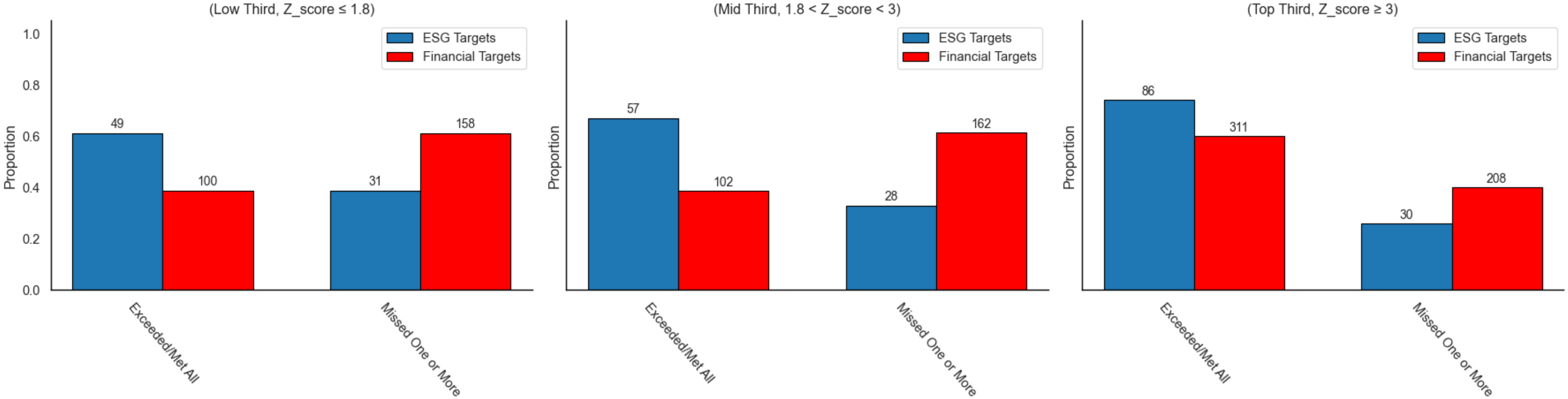
- With the caveat that these proxies have been coded by the Chat-GPT API, we have some preliminary findings.

- In contrast to the 63% of S&P 500 firms that use ESG-linked compensation, only about 24% of these other firms do so. We also find lower realization rates, with some interesting patterns with respect to firm financial distress.

# Financial Distress

| | Yes | Percentage | No | Percentage | Total |
|---|---|---|---|---|---|
| *ESG Targets* | | | | | |
| Distressed (Z<3) | 165 | 27.5% | 434 | 72.5% | 599 |
| Healthy (Z>=3) | 116 | 19.7% | 473 | 80.3% | 589 |
| | | | | | |
| Note: Using a chi-square test, the t-stat is 9.7 with a p-value of 0.002. | | | | | |

# Financial Distress



# Takeaways

- Smaller firms are *much* less likely to incorporate ESG-linked compensation and *much* less likely to award it.
- Evidence for a U-shaped curve, or at least a fishhook. That is, more distressed firms are more likely to use ESG-linked compensation.
- More distressed firms are also less likely to award this compensation. This provides tentative evidence against the greenwashing these, but more investigation is needed.