# Meeting Investor Expectations

## Through Corporate ESG Reporting, Planning and AGMs

MORNINGSTAR | SUSTAINALYTICS

# Contents

# Shareholders Want More ESG Accountability

Investors are increasingly influenced by environmental, social and governance (ESG) ratings and their portfolio companies' approaches to managing ESG risk. They want to know what companies are doing to address ESG issues and how they will do it. They want organizations to be responsible global citizens, while still offering good returns. It's a shift that's impacting businesses around the globe and those who don't make the shift will come under fire.

So how do you ensure you are meeting those expectations? You need to have an ongoing dialogue with your investors and stakeholders. That means being transparent about your goals, milestones, successes and failures; engaging with them regularly to understand their concerns; and reporting clearly and communicating adequately to ensure those concerns are being addressed.

Building that kind of dialogue takes time, and it goes well beyond proxy season or a single annual general meeting (AGM). But it's worth the effort. Because if you do it right, it will help customers and investors see that their money is supporting a company with values that align with theirs. Linking financial performance to ESG risk isn't easy. However, more and more board members and investors are realizing that ESG is about more than just risk management and is directly linked to profitability and a company's reputation.

This ebook outlines how incorporating ESG into your reporting and communication strategy can increase director and investor confidence and provide measurable value. It explains the increasing importance of accountability, lists best practices, and offers actionable tips for addressing potential anti-ESG sentiment.

# Impact, Risk and Opportunity

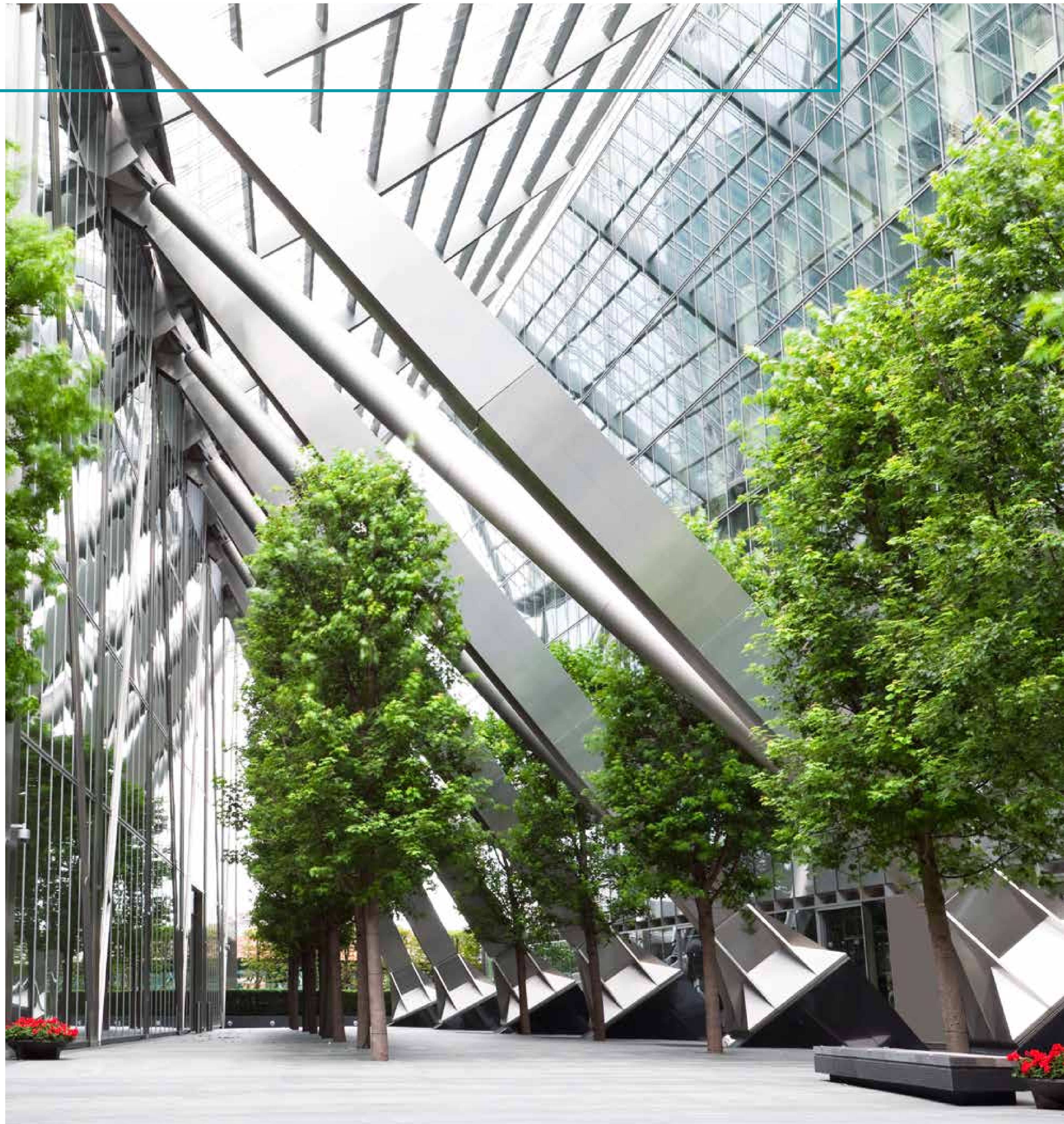
When it comes to the impact of ESG-related decisions, there's one maxim to keep in mind: where there is risk, there is also opportunity. Making ESG commitments can mean:

- Being an employer of choice and attracting the best talent.
- Lowering the cost of capital.
- Attracting long-term shareholders.
- Becoming a business that is more resilient to the impacts of extreme weather events and climate change.

ESG and profitability can coexist. In fact, an appropriate commitment to ESG can help companies succeed. But it's a fine line: no matter how important ESG issues are to investors, focusing on them should not come at the cost of financial performance. Because even the most vocal ESG advocates/activists don't want to see an ESG focus negatively impact a company's financials or their competitiveness.

On the other hand, not enough focus on ESG issues presents risks to growth, decreased market share and profits, and can end up costing you the support of investors, customers, and employees. A strong ESG strategy will help you find that balance.

According to a recent paper from the Harvard Law School Forum on Corporate Governance, investors are not ready to accept extensive ESG commitments as the supposed reason for performance dips, and have punished companies they think are prioritizing 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, to generate long-term sustainable returns for investors.[1]



# Investors: A Force for Change

Investor appetite for ESG is growing fast and shareholders are increasingly holding boards directly accountable. Their concerns about failure to adequately meet net-zero targets and other key ESG goals are having a huge impact on how companies operate, and on the topics they address in their reporting, communications and annual meetings.[2]

Since 2019, the number of shareholder-proposed resolutions focused on ESG factors has risen steadily.[3] In 2022, the number of ESG-related resolutions filed by investors and proxies in the U.S. hit an all-time high of 567, up significantly from 499 the previous year (which was also a record). That number includes 68 resolutions specifically addressing emissions, double the number filed in 2021.[4]

In January 2023, the EU finalized the Corporate Sustainability Reporting Directive (CSRD), introducing more detailed sustainability reporting requirements for EU companies, non-EU companies meeting certain thresholds for net turnover in the EU, and companies with securities listed in a regulated EU market.[5]

The U.S. Securities and Exchange Commission (SEC) also recently made it harder for companies to block proposals around climate targets and specific social issues such as paid sick leave, which is certainly a contributing factor to the increased number of proposals being submitted. And in a recent statement, the SEC also expanded the kinds of issues of broad social or ethical concern that shareholders can raise at AGMs.[6]

We aren't just seeing more ESG-focused proposals. We're also seeing much stronger support for those proposals from investors and shareholders. According to Edelman's 2022 Trust Barometer, 88% of institutional investors see ESG issues as being of equal importance to operational and financial considerations.[7] In 2022, the SEC approved about 16% of companies' bids to remove ESG-focused proposals, compared with about 50% in the previous year.[8]

The number of ESG-related proposals with 25% or more support rose by 48% over the last two years.[9] This is something boards should be paying close attention to.

Investor activism is also at an all-time high, and tactics like shareholder proposals, media campaigns and protests at AGMs are on the rise.[10] Asset managers have started engaging publicly as shareholders.[11] This higher level of involvement is poised to make a difference. According to the Principles for Responsible Investment (PRI), the increasing likelihood that investors will take such action at AGMs may incentivize board members to improve their consideration of ESG factors in decision making.[12]

# Support From Investor Advisory Companies

Recently, one proxy advisory company has recommended that investors vote against boards that don't adequately disclose their role in ESG oversight.[13] This sends a clear message to companies that they need to do more, and indicates that the demand for better and more quantifiable ESG accountability will gain even greater momentum in 2023. In 2022 alone, Morningstar Sustainalytics made 982 vote recommendations around sustainability-focused ballot items and shareholder and corporate resolutions.

> **"ESG is now, without a question, a mainstream lens through which companies are viewed and assessed by investors."** [14]
>
> \- The Harvard Law School Forum on Corporate Governance

# For ESG Reporting, the Stakes Are Higher

Focusing on traditional determinants of a company's value is no longer enough. Today, value is also defined by how well they meet ESG standards. This has a big impact when raising capital or looking to attract investment, and is increasingly considered by debt rating agencies.

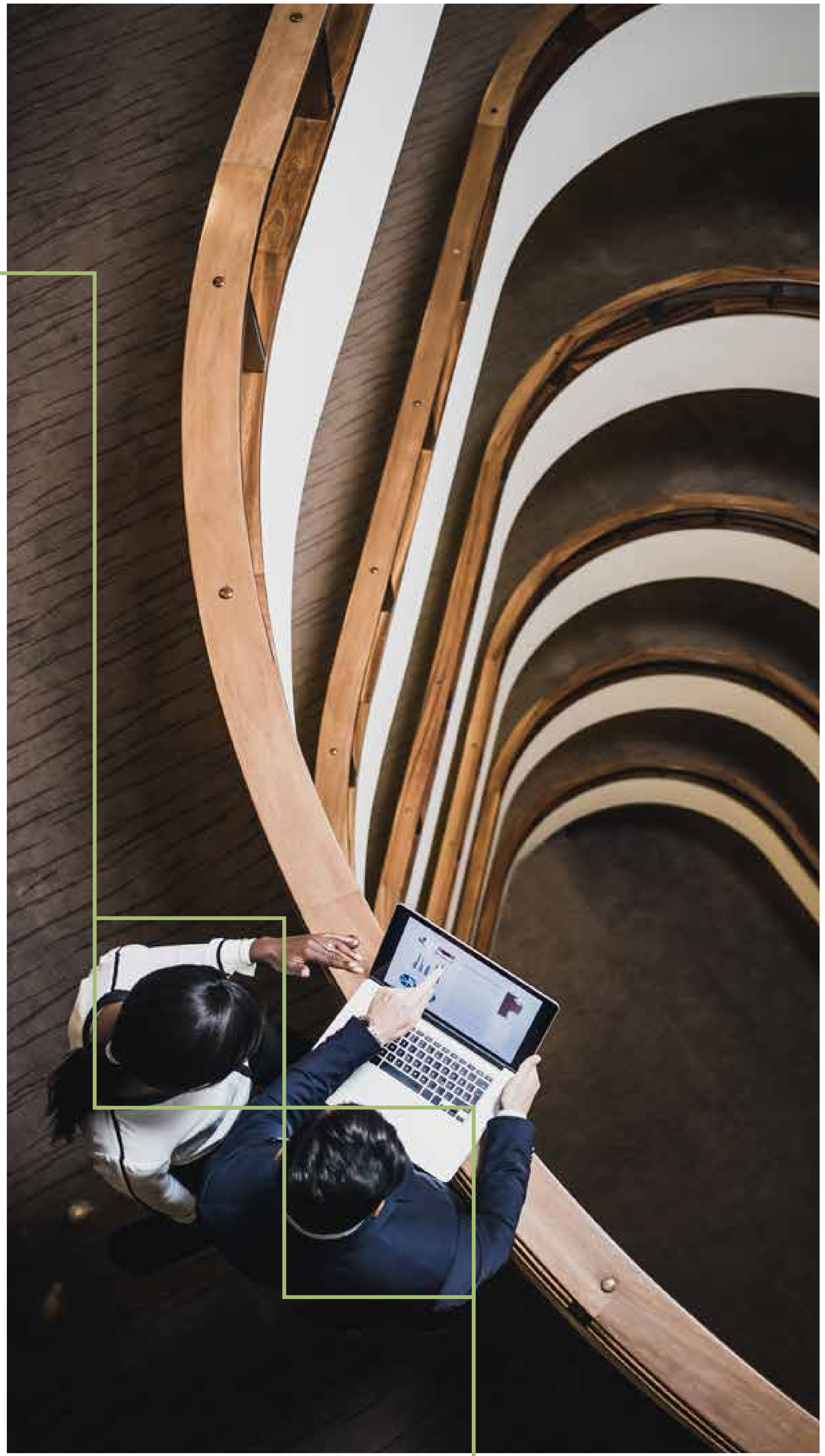
In Europe, EU-listed entities and large public and private companies with activities in the EU (including U.S. entities) now have to report on how their business model affects sustainability, and how external sustainability factors (e.g., climate change or human rights issues) influence their activities. This ESG reporting must be independently audited and based on EU standards to combat greenwashing, to better inform investors, and to facilitate the transition to a net-zero economy.[15]

In addition to the usual performance, strategy and portfolio overviews, companies need to clearly showcase actions and outcomes around how they're addressing ESG risk now – and how they plan to do so in the future.

# Being Better Prepared: Issues That Matter Most to Investors

Responsible investors are focused on encouraging companies to make better ESG decisions. Companies that are greenwashing or not acting adequately on ESG issues will face investor opposition. There's a disconnect between what board members think their responsibility is with respect to ESG oversight, versus what investors expect, and that is becoming an increasing investor focus as well.

Being well-prepared for your annual reporting season means knowing what issues are important to your investors. From climate concerns to equity issues to executive compensation structures, here are some areas that deserve attention as part of your investor engagement efforts.



# Environmental Issues

## 1. CLIMATE

Investors want to know what companies are doing to improve their climate performance, exactly how they're doing it, and they want measurable details on how those goals are being met. Driven by the Paris Agreement, they are pushing companies to be transparent about how they will transition to net-zero through reduced emissions and climate resilient development.[16]

Until recently, it may have been enough just to announce a net-zero commitment. But today, good intentions aren't enough: investors want detail, credibility, and ambitious goals. They are scrutinizing general climate performance, seeking detailed disclosures about climate risks, looking at how robust climate strategies actually are in terms of mitigating those risks, and focusing on what progress they're making against those goals – expressed not in broad statements but with real, measurable metrics.

Investors are also increasingly critical of net-zero plans that lack ambition and are alert to new projects or financing (e.g., fossil fuels) that contradict the Paris Agreement. They are also calling on the United States' largest lenders to stop financing new fossil fuel projects.[17]

**What your investors want to know about your ESG efforts:**

- Are you doing what you've committed to?
- Are you doing enough – or could you do more?
- How are you achieving what you say you're going to do?

**What does a strong climate transition plan look like?**

In 2022, Sustainalytics evaluated a number of climate transition plans. The ones that were most widely accepted by investors had the following characteristics:[18]

- They took widely recognized decarbonization pathways into account.
- They set independently verified, science-based emission targets.
- They set targets for scope 3 emissions reductions (where applicable).
- They included supporting governance measures to analyze physical, financial and transition risks.
- They reported in line with Task Force on Climate-Related Financial Disclosures (TCFD) framework.

# Environmental Issues

## 2. BIODIVERSITY LOSS, DEFORESTATION AND CHANGING LAND USE

The Kunming-Montreal Global Biodiversity Framework for addressing biodiversity loss was ratified at the UN Biodiversity Conference (COP 15), held in December 2022. In it, 196 nations agreed to protect and restore at least 30% of global lands, inland waters, oceans, and coastal areas.[19] The framework puts pressure on companies to green their operations and supply chains. Based on COP 15, the International Corporate Governance Network has recommended that companies put science-based targets in place to:

- Stabilize biodiversity loss by 2030.
- Restore ecosystems by 2050.
- Align executive pay with, "quantifiable, financial, human and nature capital-related performance metrics." [20]

For example, Home Depot investors requested that the company report on its efforts to eliminate deforestations in its supply chain – a resolution that passed with over 60% of the vote despite company opposition.[21]

## 3. PLASTICS

Plastic waste and plastic pollution is increasingly a topic of investor proposals. PRI, the world's leading proponent of responsible investment, anticipates a higher demand for circular economy-based business models that prevent waste by reducing plastic use, make it easier to repair products, and address other factors that contribute to pollution.[22]

## 4. WATER STRESS AND RISK

In 2022, proposals around water stress and stewardship came from a wide range of industries, including IT, automotive, and food sectors. With the increasing number of heat waves and droughts, PRI expects to see more shareholder proposals targeting companies either causing or exacerbating water risk.[23]

# Social Issues

### 1. DIVERSITY, EQUITY AND INCLUSION

How companies treat people is a fast-growing area of concern for investors. From 2021 to 2022, the number of diversity and civil rights-related proposals more than tripled.[24] Investors are also increasingly focused on transparency around gender and racial equity, both in the workforce and at the executive and board levels.

### 2. HUMAN RIGHTS

Investors want companies to ensure people across operations and the entire supply chain have safe working conditions and fair treatment. That includes access to healthcare, medicines and vaccines, and, increasingly in the West, reproductive healthcare.

# Governance Issues

### 1. BOARD MEMBERSHIP

Information about board members and their backgrounds has always been important to investors. But today, there is increased focus on diversity, on individuals with a history of poor management of ESG issues, and on whether members have what it takes to lead a company to net-zero and other ESG goals.

Many investors want at least one minority gender member. Companies are looking for diversity of gender, gender identity, ethnicity, expertise, background, and perspective. They also want board members to have specific ESG competency. As a result, more boards are engaging with investors to understand how to adapt governance to an ESG-focused landscape.[25]

### 2. LOBBYING

Any lobbying, political contributions, trade association memberships and other political engagement at odds with corporate ESG ambitions is an increased point of scrutiny. Research shows that many companies are actually lobbying against their stated policies, both directly and indirectly.[26]

According to a PRI report, negative lobbying against climate policies from companies and industry associations remains a persistent problem. It undermines the ability of the world to meaningfully address climate change and reduce climate-related risks in investor portfolios.[27]

### 3. TYING EXECUTIVE PAY TO PERFORMANCE

In 2022, 87% of Americans expressed concern about the growing gap between what CEOs make and what average workers bring home.[28] C-suite remuneration is getting more attention as investors demand that pay be based on performance (including ESG performance), and that it be peer-adjusted and proportional to direct reports and what an average employee makes.[29] There is also a push to link payouts to ESG targets: a recent poll shows investors agree that tying ESG metrics into compensation is an effective way to increase appreciation of these issues and drive change.[30]

In 2020, 42 of the largest 100 European companies included ESG as a metric in compensation plans.[31] In 2021, 57% of S&P 500 companies did the same, and a poll of global governance professionals shows 44% compliance with the strategy, with 60% in Europe.[32]

# Coping With Anti-ESG Sentiment

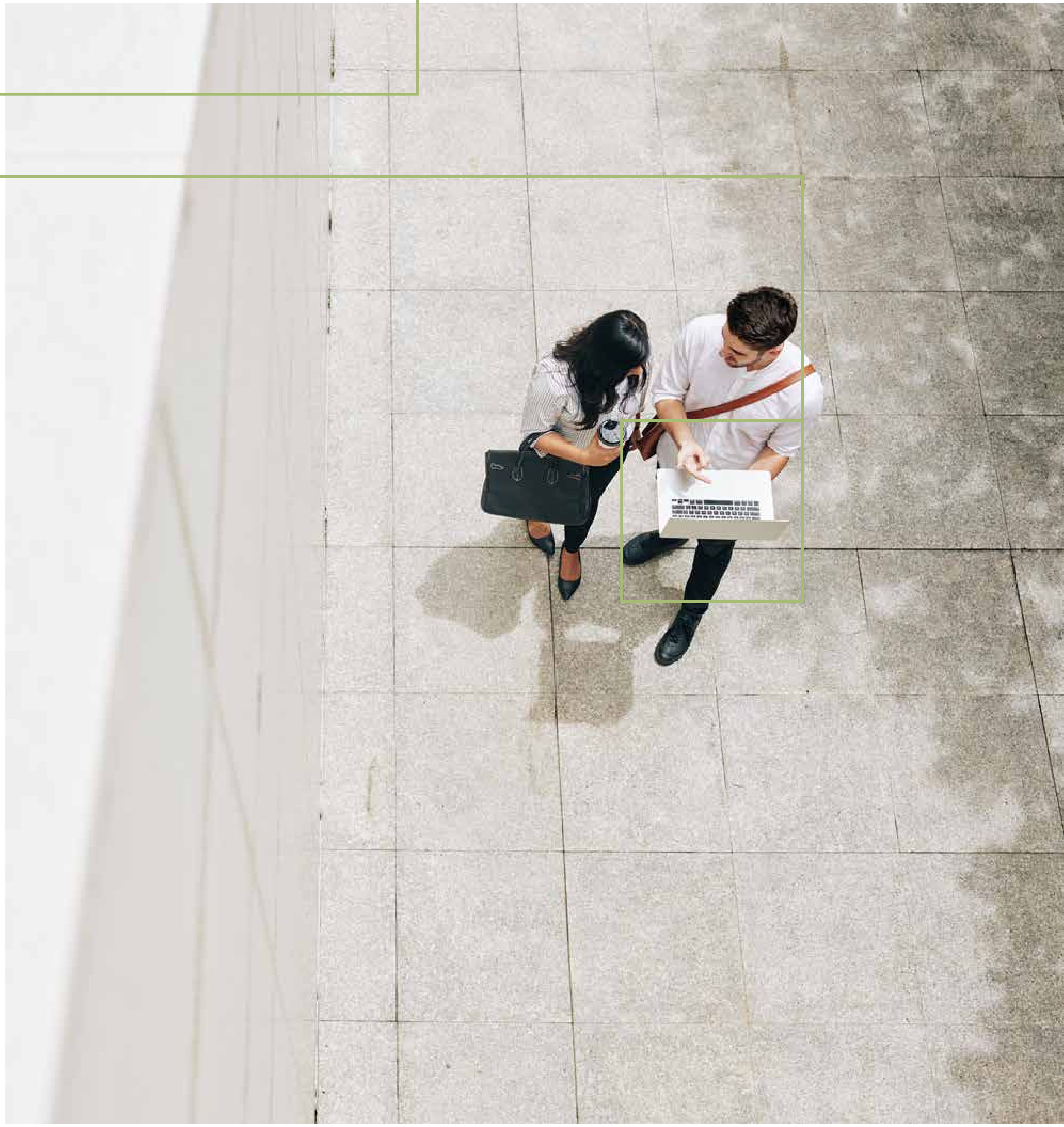
In 2022, Morningstar's database tracked 43 anti-ESG proposals. ESG isn't on every investor's radar, and there is a vocal minority that is actively opposed to the emphasis being placed on it. The U.S., for example, is seeing efforts to discredit the importance of climate change with the rise of anti-ESG shareholder proposals.[33]

However, despite making a lot of noise, these proposals have received very little support because they weren't relevant to shareholders.[34]

"Our recent research shows that large asset managers have come out strongly in favor of measures that seek to improve diversity, equity, and inclusion at the board level, senior management and in the wider workforce," said Lindsey Stewart, Director of Investment Stewardship Research at Morningstar. "That includes those that haven't so far taken a particularly strong line on environmental issues like climate or biodiversity. As one top five U.S. asset manager puts it: 'our view is that diversity of perspective and thought in the boardroom, in the management team, and throughout the company, leads to better long-term economic outcomes for companies.' "[35]

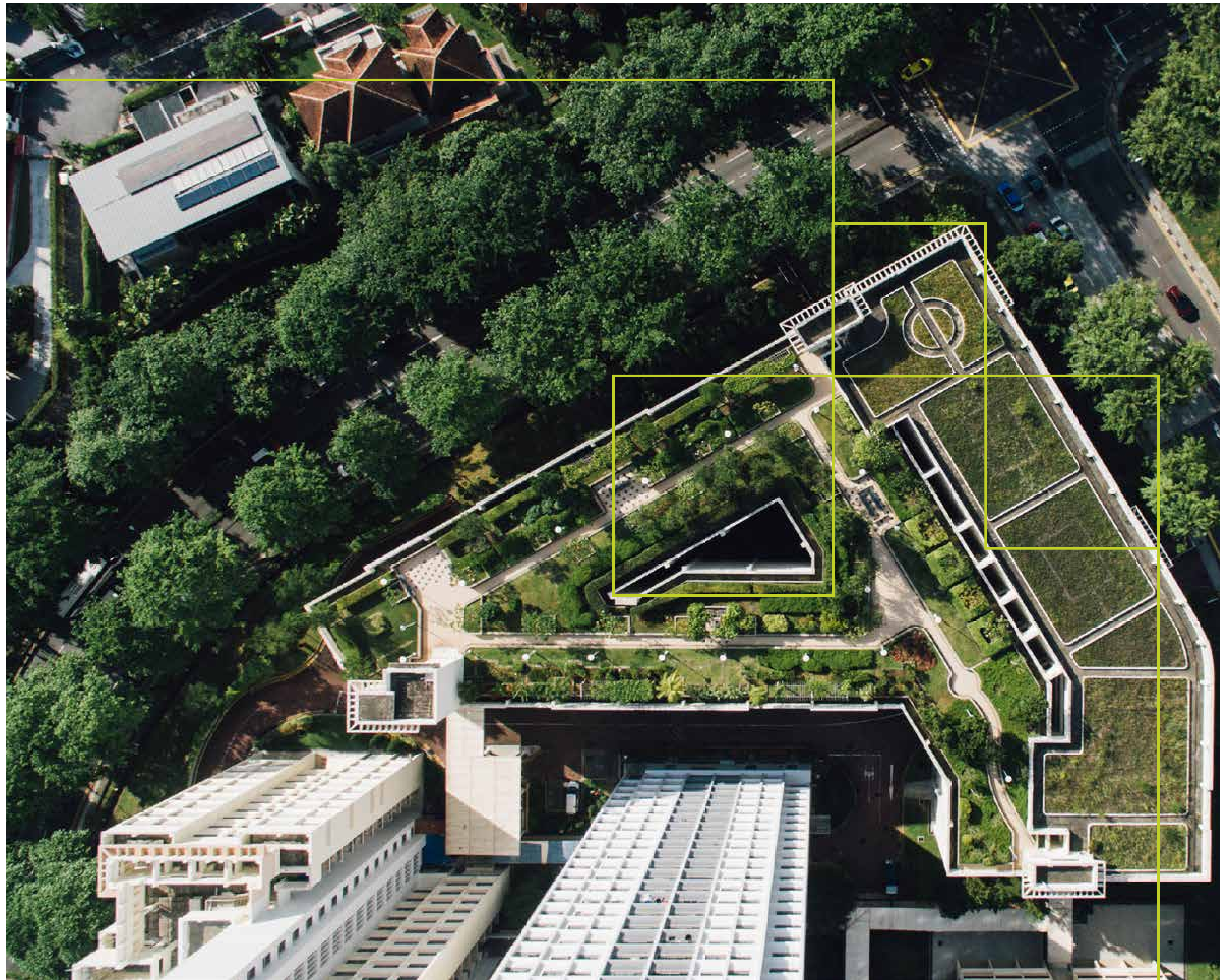
What should you do if your company is the target of anti-ESG sentiment?

Being prepared is your best defense – with quantifiable, verified data around the real financial, legal and reputational benefits of an ESG-focused approach.



# Why You Need an Effective ESG Strategy

A solid ESG strategy will address shareholder concerns and bring the board into better alignment with investor expectations. And it will protect your company from risk: poor management of ESG issues can lead to fines, litigation, alienated investors, poor financial returns, or damage to a company's reputation.



# Five Ways to Address Investors’ ESG Concerns

### 1. INCREASE BOARD MEMBERS’ ESG COMPETENCY

Investors want to know that boards have what it takes to meaningfully advance towards ESG goals. Currently, however, many boards are out of touch with investor expectations, with only 11% of directors agreeing that a board’s ESG expertise is important.[36]

The solution here is to proactively build their knowledge and competency so they genuinely understand the financial impact of ESG risk, and can speak authentically about ESG-related progress, performance and plans. They should be able to meaningfully answer questions that go beyond scripted remarks, tackle potentially thorny questions, and speak to how ESG is integrated into strategy.

This is the level of knowledge that will build investor confidence: according to Ernst & Young's 2022 Proxy Season Review, investors appreciate disclosure that boards are getting ongoing training on ESG-related issues.[37]

### 2. PROACTIVELY PREPARE FOR QUESTIONS

Concerns shouldn't come as a surprise. To avoid facing stakeholder proposals, review investors’ publicly disclosed views well in advance and engage with them consistently to better understand their needs. Share agendas and pre-reads before any meeting, ensure the right subject matter experts are available, and create clear briefing docs that give directors and other speakers an in-depth understanding of the company's ESG platform.

### 3. BE TRANSPARENT ABOUT CHALLENGES

Investors know that transitioning to net-zero and hitting ambitious diversity targets aren't easy achievements. Don't be afraid to share those challenges – and the steps you're taking to solve them. They want to see a candid overview of progress, how companies are innovating, and a sense that the board understands the urgency and importance of ESG matters.

### 4. LEVERAGE THE Q AND A SESSION

The question and answer period in AGMs and other meetings should be used as a learning tool and a jumping off point for making stakeholder engagement a year-round conversation.

### 5. EXPLAIN CONTRADICTORY ACTIVITIES

If your company is doing something that is contrary to your ESG targets, you must be able to tell investors why. If a mistake has been made, address it, and move to fix it as soon as possible to ensure investor confidence isn’t eroded.

# Best Practices For the Way Forward

### 1. LOOK TO COMPANIES THAT ARE DOING IT RIGHT

Take your cue from highly respected companies and award winners. Review their proxy disclosures to see how they approach ESG reporting. The Corporate Governance Awards are a good place to find companies to model.

### 2. KEEP THE CONVERSATION GOING

ESG reporting is an ongoing exercise that shouldn't be restricted to your AGM or to proxy season, but should be an ongoing dialogue with investors and shareholders. Approach investors as partners with shared interests: they want companies to actively listen to them and hear their perspectives.[38]

### 3. CREATE BETTER COMMUNICATION TOOLS

A proxy statement is a valuable tool for disclosing your ESG agenda: it helps to clearly define your ESG priorities and hard performance targets throughout the year. You can also share your goals, successes and meaningful metrics with timely newsletters or press releases.

### 4. STRIVE FOR TRANSPARENCY

Build trust with honest communication about your goals, short and long-term ambitions, strategy, metrics, milestones and how oversight is carried out. Don't be afraid to share challenges. Make it easy for shareholders and the media to access information by making everything publicly available.

Share your ESG strategy via your website, investor communication channels, media outreach, and at your AGM. Be open about how the board keeps up with ESG trends and developments: investors want to know the board is aware of the full scope of ESG risks affecting the business.[39]

Don't forget to be transparent about your successes. According to some leaders, because a lot of traditional stewardship takes place privately, it's often difficult to see what the results of that stewardship have been.[40]

### 5. LEVERAGE YOUR MATERIALITY ASSESSMENT

An ESG materiality assessment identifies the most critical ESG issues and risks for your company and shows your plan for managing them. It prioritizes topics based on impact (both positive and negative) and importance to stakeholders, and highlights opportunities for the business. It simplifies reporting on progress, speaking to future plans, and shows stakeholders you are taking their perspectives into account.

# Next Steps: Building a Better Dialogue With Investors

More and more companies are initiating effective ESG reporting and communications, and taking steps to engage investors around ESG topics. The most successful ones are engaging investors by:

### 1. EMBRACING INVESTOR ACTIVISM

As activism becomes more successful, more companies are avoiding reputational risk and settling proposals rather than letting them go to a vote. Investors are getting more comfortable holding companies to account, which adds incentive for board members to factor ESG into their decision making.

2023 and beyond could be significant for investor activism, given the introduction of universal proxy cards (listing the names of all duly nominated director candidates for election at upcoming shareholder meetings, regardless of whether they were nominated by management or shareholders) and continued scrutiny of ESG issues.[41] Organizations that listen to their investors and shareholders are the ones that will come out ahead. Prioritizing ESG reporting is a key part of that commitment.

### 2. THINKING AHEAD

Companies are wrapping their heads around key issues and seeking out shareholder concerns well ahead of time. They're paying attention to trends in their industry to understand investor perspectives.

### 3. COMMUNICATING BETTER

Companies are increasingly disclosing meaningful ESG targets and metrics. Investor skepticism is high: sharing quantifiable, achievable goals demonstrates authenticity and builds trust.

### 4. USING BENCHMARKS

Companies are doing more than just reporting on ESG progress. They are setting benchmarks and responding to ESG rating providers like Sustainalytics to put third-party validation behind their achievement, track progress, and compare performance across industries.

Evolving trends around ESG show one thing very clearly, companies will increasingly be held accountable for their ESG policies and practices. Shareholder involvement will only increase, and to anticipate scrutiny and criticism, companies must have a clear strategy in place to demonstrate oversight of ESG issues. Those who can't demonstrate how they have engaged with, committed to, improving, or made real progress on issues critical to their industry's operation should expect to face consequences.

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