Pearl Meyer

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Incentivizing ESG Progress in Private Companies

Ed Steinhoff

MANAGING DIRECTOR

Over the past several years, there has been heightened focus on corporate initiatives and performance in the environmental, social, and governance (ESG) areas. Some of the increased emphasis has been driven by employees who want to know that their company is not only a good place to work from culture, profitability, and rewards perspectives, but also that their employer is proactively advancing broader social missions and objectives in the areas covered by ESG. This employee emphasis on ESG spans nonprofit, private, and public organizations alike.

However, for publicly traded companies, institutional shareholders and proxy advisors are also focused on corporate performance in ESG-related areas. This has led to the development of corporate scorecards that boards use to evaluate ESG performance. Additionally, about half of publicly traded companies use ESG metrics in their annual or long-term executive incentive plans (though it is most common in the annual plan) to reinforce the importance of strong and continuously improving performance in these areas.

Categories of ESG metrics that may be used in corporate scorecards or in incentive plans include the following:

Environmental

- Carbon and climate
- Use of natural resources
- Waste and toxicity
- Sustainability

Social

- Human rights
- Diversity, equity, and inclusion
- Labor, health, and safety
- Employee satisfaction and engagement
- Stakeholders and society
- Product safety and quality
- Customer satisfaction

Governance

- Board structure
- Compensation processes
- Shareholder rights
- Audit and risk oversight

While private companies are not subject to the same external shareholder scrutiny, they, too, have their sights on ESG and are considering if and how to increase focus in these areas. Most commonly, a process is initiated through senior executive and board-level conversations around the importance of ESG at the private company and how to develop a scorecard of performance measurement in these areas. The board and senior management typically will review current company initiatives to identify those that are most critical for continuous monitoring and improvement. Industry considerations often factor heavily into this process as some ESG-based metrics are more critical to companies in certain industries than others, such as wastewater or emissions levels for a manufacturing plant.

Signaling a maturity in their ESG journeys, many private companies are also beginning to take the next step by identifying key ESG metrics where improvement is desired and incorporating those metrics into the company's annual incentive plan design. Generally, private company incentive plans are less formulaic or less structured than those in publicly traded companies. They also incorporate much greater use of discretion in determining the size of awards to be paid. For companies with a heavily discretionary approach to annual incentives, ESG-focused performance considerations may be incorporated into the discretionary assessments of performance to determine the appropriate resulting incentive awards. This can be a fairly simple process, compared with the complexity of a public company incentive plan, which is complete with numerous disclosures. However, boards of private companies are increasingly implementing more structured annual incentive plans with several financial and operational performance measures, each with its own weighting, and incorporating ESG into the portfolio of operational performance measures in the plan.

One important learning from the experience of public companies is the need to balance the interest in focusing on ESG-based metrics in incentive plans with the desire for an incentive plan that is easy to communicate and administer, and therefore does not have an overwhelming number of performance metrics in the overall plan design. A good rule of thumb is that an incentive plan should not have a performance measure weighted at less than 10 percent of the total award opportunity to ensure that there is sufficient focus on performance in each of the metric areas.

In the coming years, we are sure to see an increased prevalence of ESG-based metrics in private company incentive plans, most likely in the annual award. Like many executive compensation practices, changes began with the largest publicly traded companies and have now begun to cascade to mid-sized and smaller publicly traded companies as well as private companies.

Given the broad scope of factors that can be reasonably considered ESG-related, there is plenty of opportunity for every organization to identify and prioritize a reasonable number of measures that directly relate to the organization's business and talent management strategies. If the board moves to tie incentives to the ESG goals, a clear communication strategy to the executive team is warranted, especially if the ESG metrics add some complexity to formulaic plans. Finally, while private companies enjoy a relative reprieve from the growing list of required compensation disclosures for public companies, broader communication about the organization's focus on ESG is absolutely warranted. The movement itself largely originated from a broad set of stakeholders and when it comes to attracting and retaining talent, an environmental, social, or governance differentiator could tip the scale.

About the Author

Ed Steinhoff is a managing director and consulting team leader at Pearl Meyer. In his management role, he oversees a team of senior compensation consultants in the execution of the firm's growth strategy and in the development of consultants at various stages in their careers. With more than 25 years' experience in executive compensation, Ed works with the boards of directors and senior management teams of public and private companies, ranging from small and middle-market firms to multibillion-dollar corporations, to design pay programs that drive business performance and value creation, secure high-performing executive talent, and meet both regulatory standards and stakeholder expectations.

About Pearl Meyer

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