



# Operationalizing the Stakeholder Preferences of Shareholders

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December 15, 2022: ICVG Conference, Monash Business School

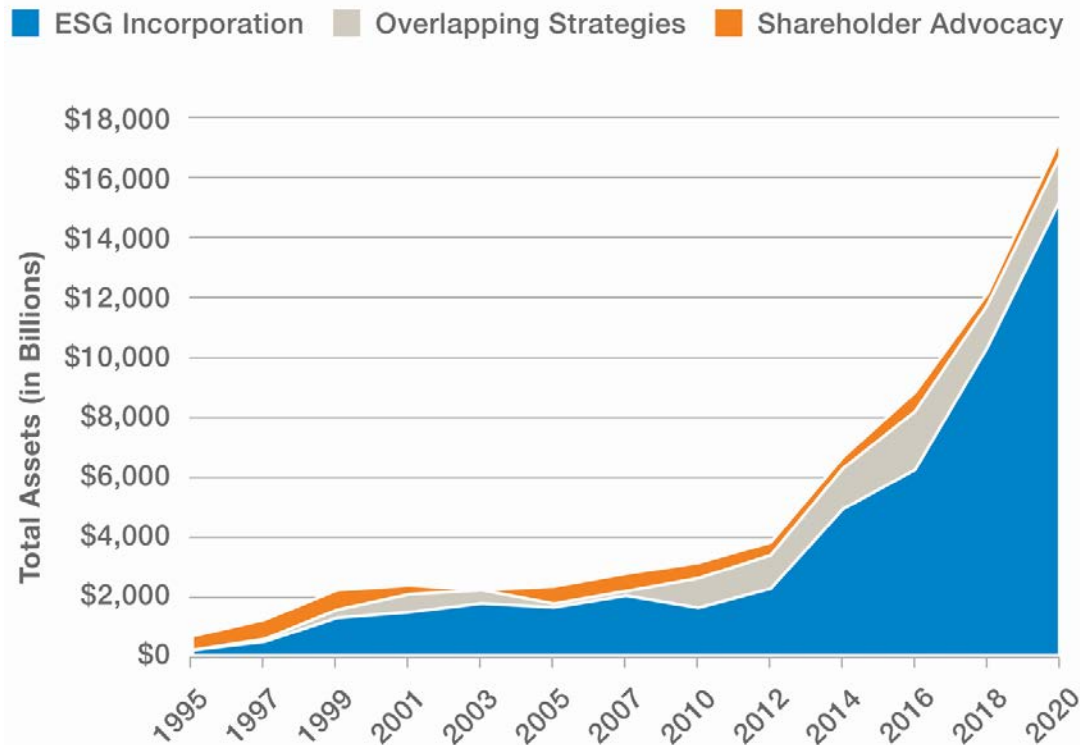
# Governance: General Principles

- In many corporations, shareholders delegate decision rights to a board of directors, that then delegates to the CEO
- The reality of this system is that a CEO serves at the discretion of the board, which in turn, serves at the discretion of shareholders
- Traditionally, this delegation structure has been examined through a straight-forward lens:
  - Shareholders desire management to increase the present value of expected cash flows, and thereby maximize stock price
- But, the world may be changing, with the possibility that a non-trivial fraction of shareholders are more willing to trade-off cash flow and non-cash flow preferences...

# Do Shareholders Have Preferences Beyond Cash Flows?

- Investors increasingly interested in the environmental and social (E&S) agendas of firms

Sustainable Investing in the United States 1995–2020



SOURCE: US SIF Foundation.

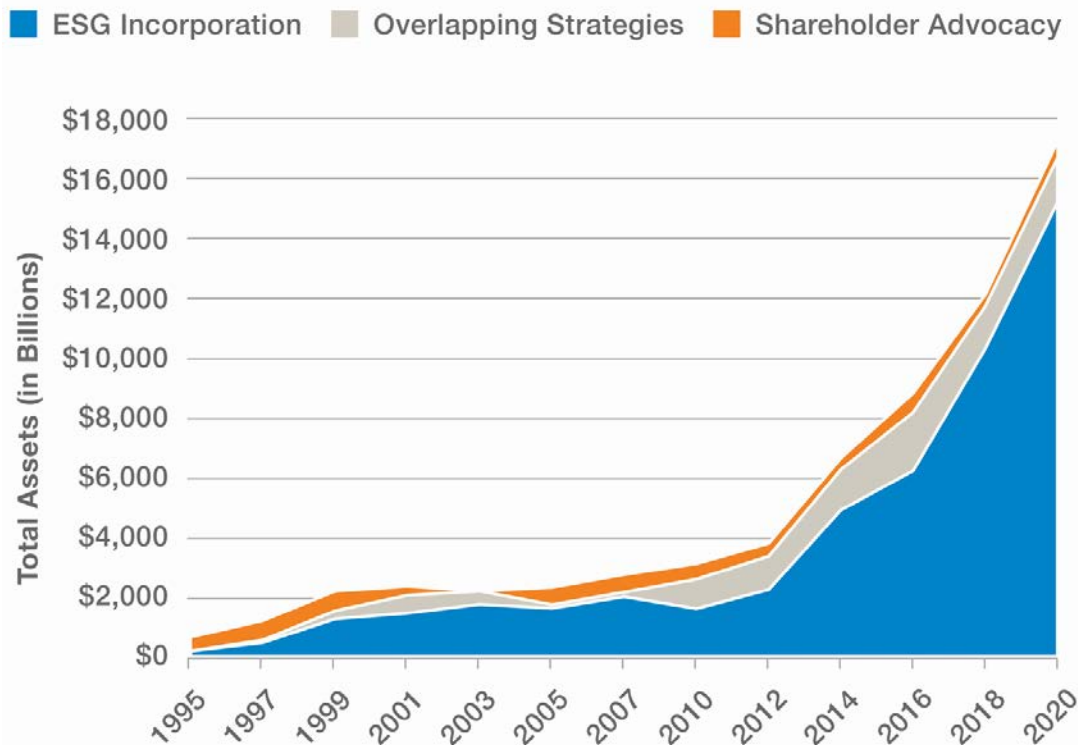
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Does this mean investors have preferences beyond cash flows?

For some reason, we tend to think executives and boards (and customer, employees, etc.) may have a proclivity for E&S action, but that shareholders will never forgo cash flows to improve E&S

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**But, shareholders are people too!**

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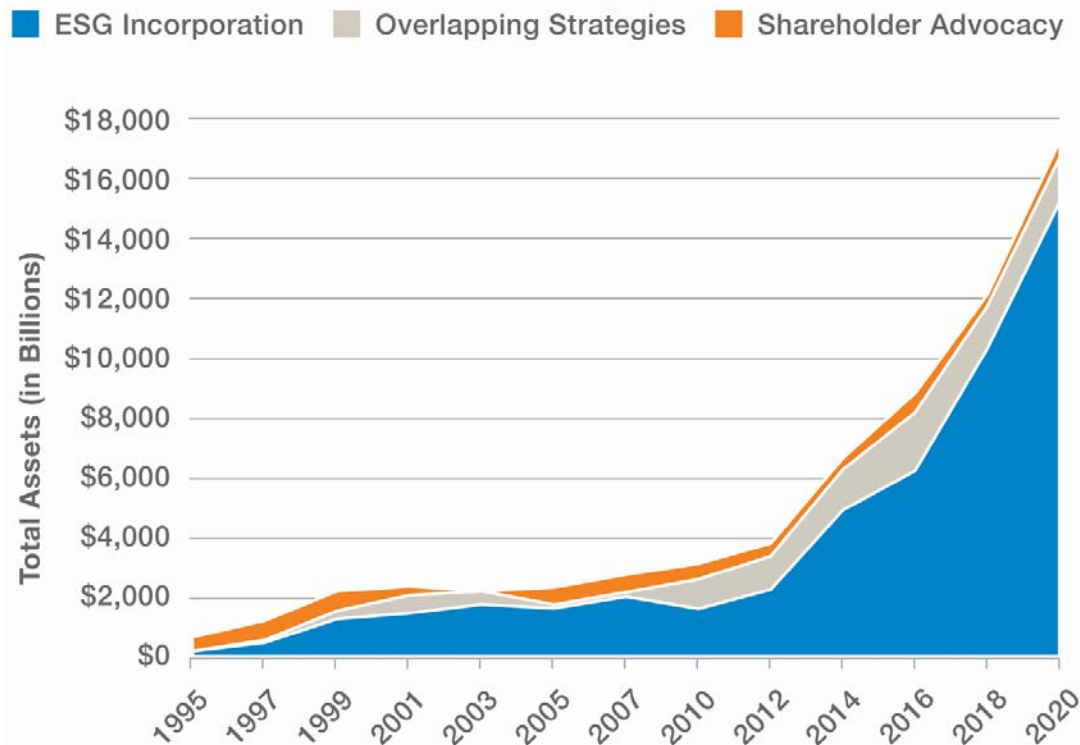


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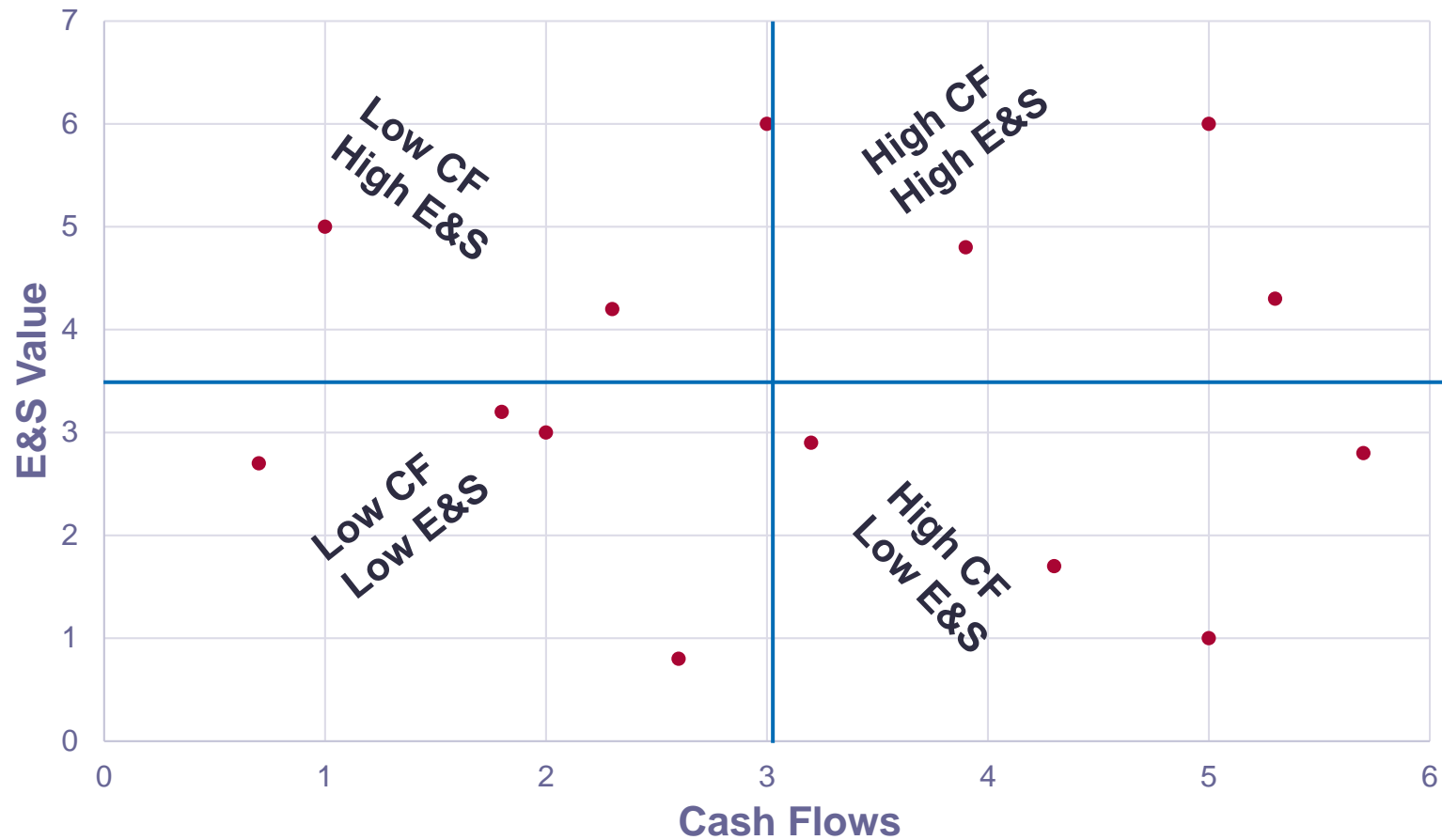
Alternatively, perhaps E&S investing simply means shareholders believe E&S is a key driver of long-term cash flows?

Need to better understand this phenomenon, because the distinction is important for governance choices...

SOURCE: US SIF Foundation.

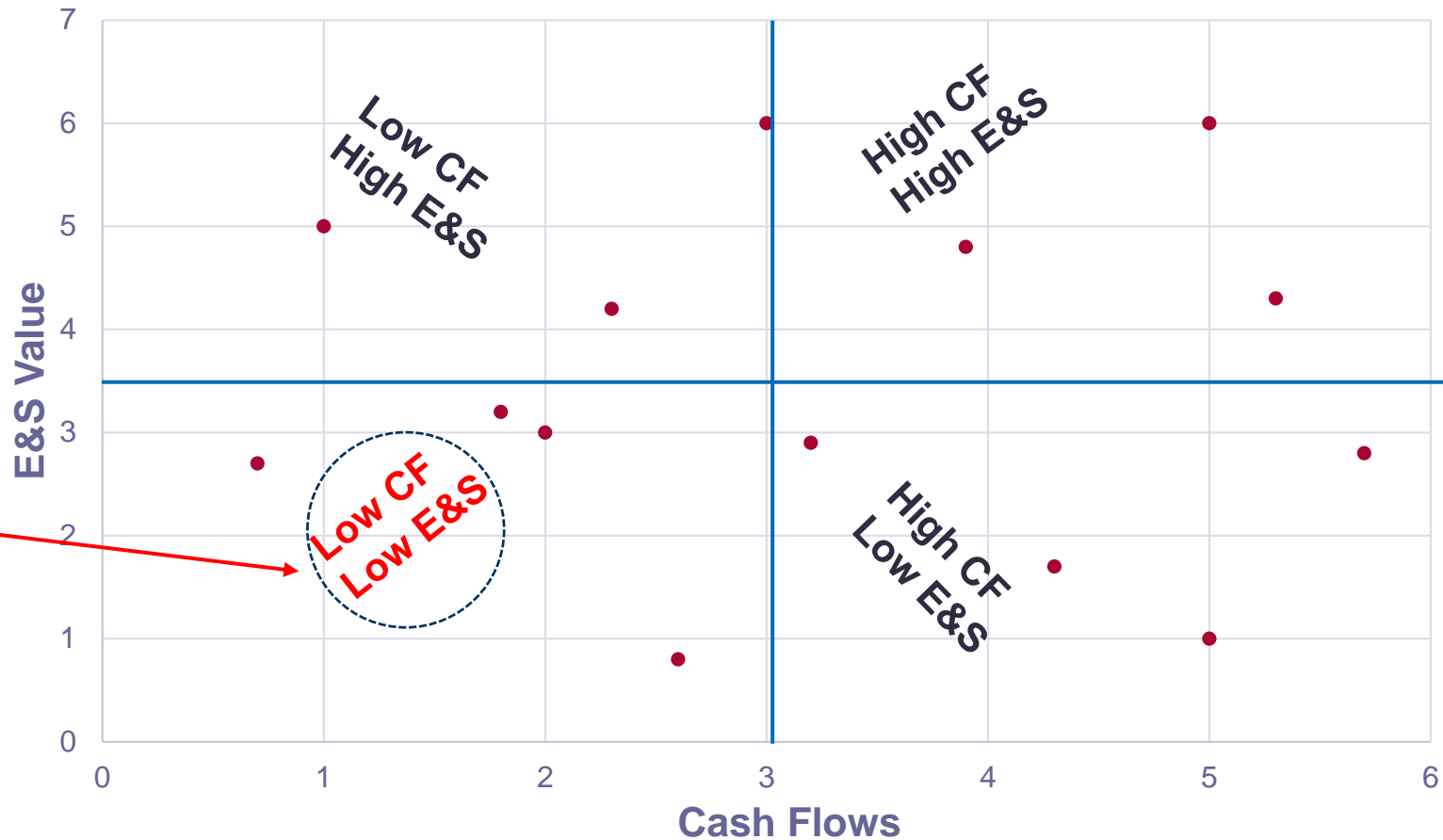
# Project Types

Projects along the E&S and Cash Flow Spectrum



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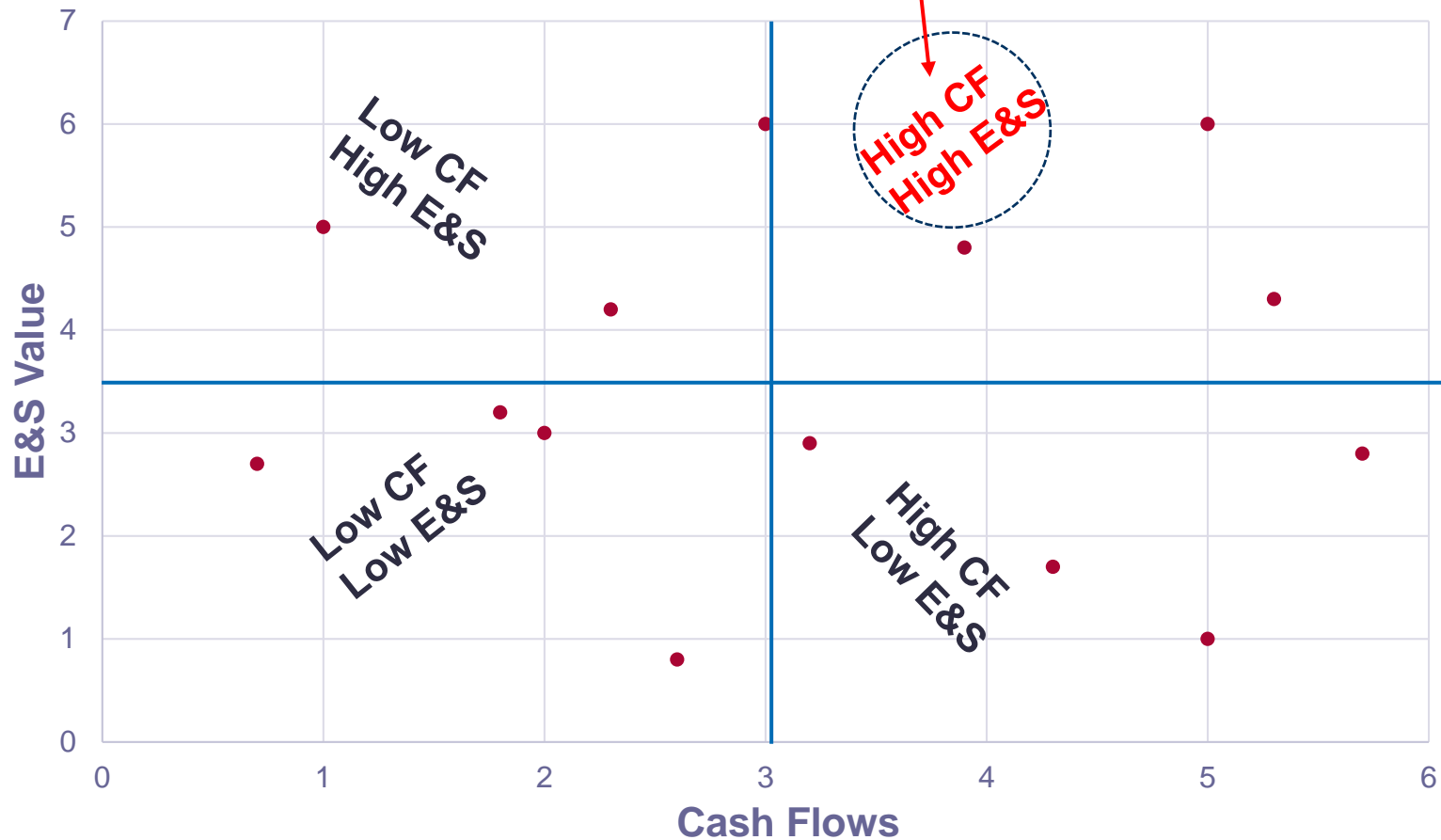
These cases should mainly be nefarious: discrimination, perverse workplace culture, etc.

Beyond standard theory of economic incentives

# Project Types

Here E&S is like many other value drivers. Educate shareholders to avoid myopia (e.g., similar to long-term R&D activities) but shouldn't otherwise require novel incentive mechanisms. Will return to this later.

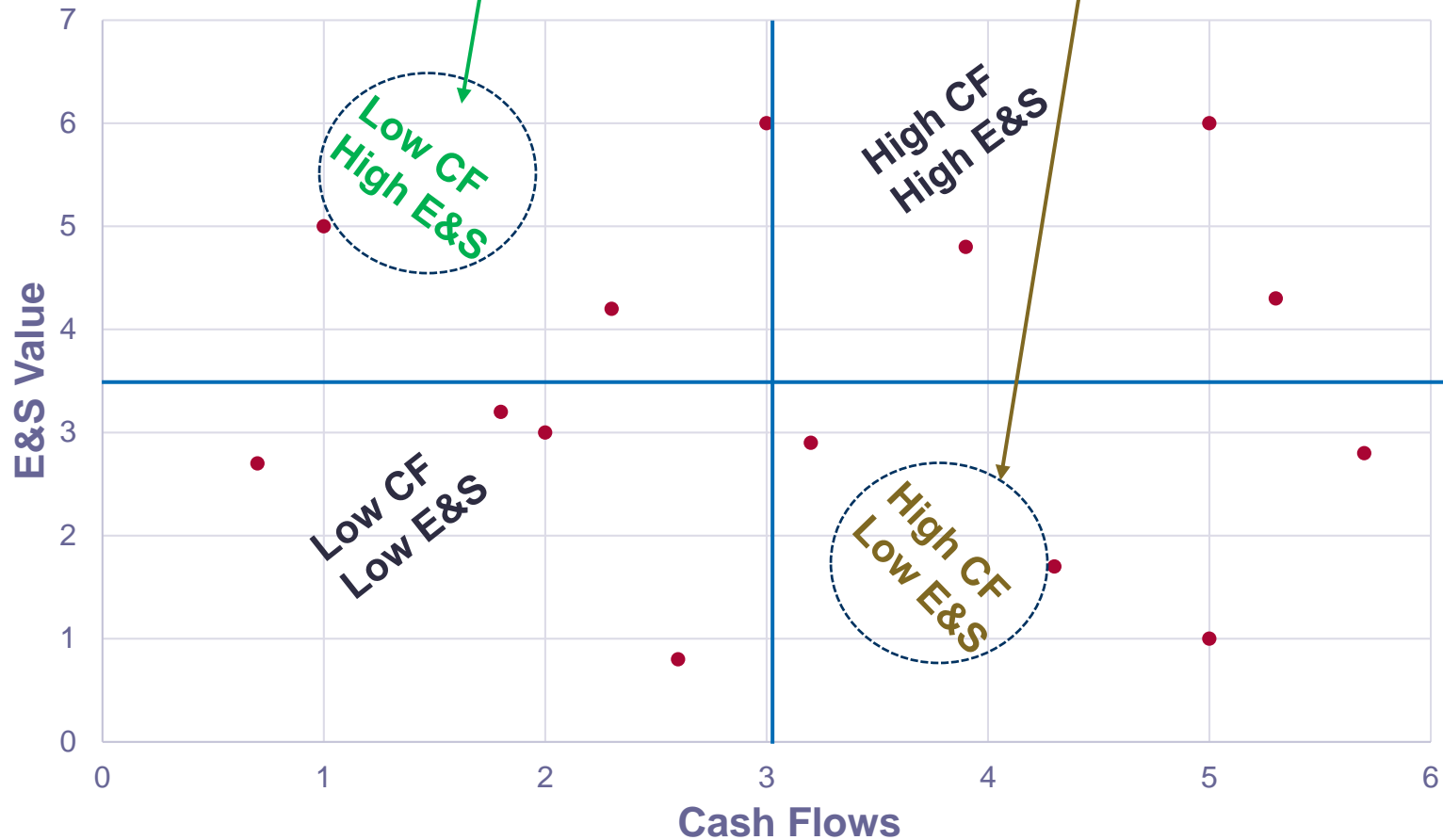
Projects along the E&S and Cash Flow Spectrum



# Project Types

These two are the most interesting from a governance/incentives perspective - requires a tradeoff not often contemplated by existing governance paradigm...

Projects along the E&S and Cash Flow Spectrum



# Shareholder Preferences and Governance

- If some shareholders do have preferences beyond cash flows, how do we operationalize those preferences?
- First, how does the board learn about shareholder preferences?
  - Difficult to have a mandate for trading off cash flow and non-cash flow preferences unless the board understands those preferences
  - Without harnessing some form of mandate, E&S movement faces a steep uphill climb
- Second, how does the board incentivize managers to operationalize shareholders' non-cash flow preferences
  - Do we need to move away from current focus on stock incentives?
  - How/whether to incorporate E&S performance incentives?

# Understanding Shareholder Preferences

- Considerable recent focus on firm-level disclosures regarding their E&S activities
  - Voluntary disclosure (sustainability reports issued by more than 80% of large public companies worldwide\*)
  - Mandatory disclosure (in the U.S., SEC considering now)
  - Firm disclosure is helpful as shareholders must understand firms' E&S activities if they are to communicate whether they would like to see more or less done
  - But, information needs to flow in the other direction as well...

\*The KPMG Survey of Sustainability Reporting 2020

# Understanding Shareholder Preferences

- Critical for boards/executives to understand shareholders' E&S preferences to make tradeoff choices with cash flows
- Otherwise, Board/CEO must come up with more traditional or ad hoc decision rules:
  - Revert back to focusing solely on cash flows? (doesn't seem good for the E&S movement)
  - Make choices based on board/CEO personal preferences? (seems dangerous from a governance perspective and untethered from any defensible mandate)
  - Make choices based on preferences of customers, employees, society at large? (also seems dangerous and untethered – and, keep in mind that our emphasis here is on E&S activities incremental to their cash flow implications)

# Understanding Shareholder Preferences

- Gleaning information from shareholders
  - Observe characteristics of institutional investors (e.g., green funds, stated investment policies of institutions)
  - Direct communication with large investors (very common)
  - Voting outcomes of shareholder-initiated E&S proposals (e.g., Hart and Zingales, 2022)
    - However, most proposals are initiated by shareholders, and are opposed by the board, with little spirit of collaboration
    - In 2021, Fortune 250 firms saw 221 E&S shareholder proposals
    - Of those, only 21 passed...and, of the 21 that passed, 17 were opposed by the board of directors\*

\*Orrick Insights: ESG-Related Shareholder Proposals – Takeaways from the First Half of 2022

# Understanding Shareholder Preferences

- Another approach
  - No reason that board can't use proposals proactively to gauge E&S preferences from shareholders
  - Board could ask shareholders for (non-binding) votes on any number of existing or proposed E&S projects
  - As an example, this has been done for 10+ years with executive compensation (Say-on-Pay)

# Understanding Shareholder Preferences

- Perhaps a lack of such proposals reflects firms concerns that shareholders might either support expensive progressive initiatives, or vote down current E&S initiatives
  - However, not wanting to hear the answer doesn't seem like a compelling reason to avoid gathering the data
  - Further, shareholder voting would provide a defensible mandate for the firm's E&S activities
    - And, if shareholders do vote down managers' E&S initiatives, it should give them pause regarding whether they actually understand shareholder preferences
  - E&S agendas in conflict with shareholders' preferences likely need to be accomplished via regulation rather than through traditional governance

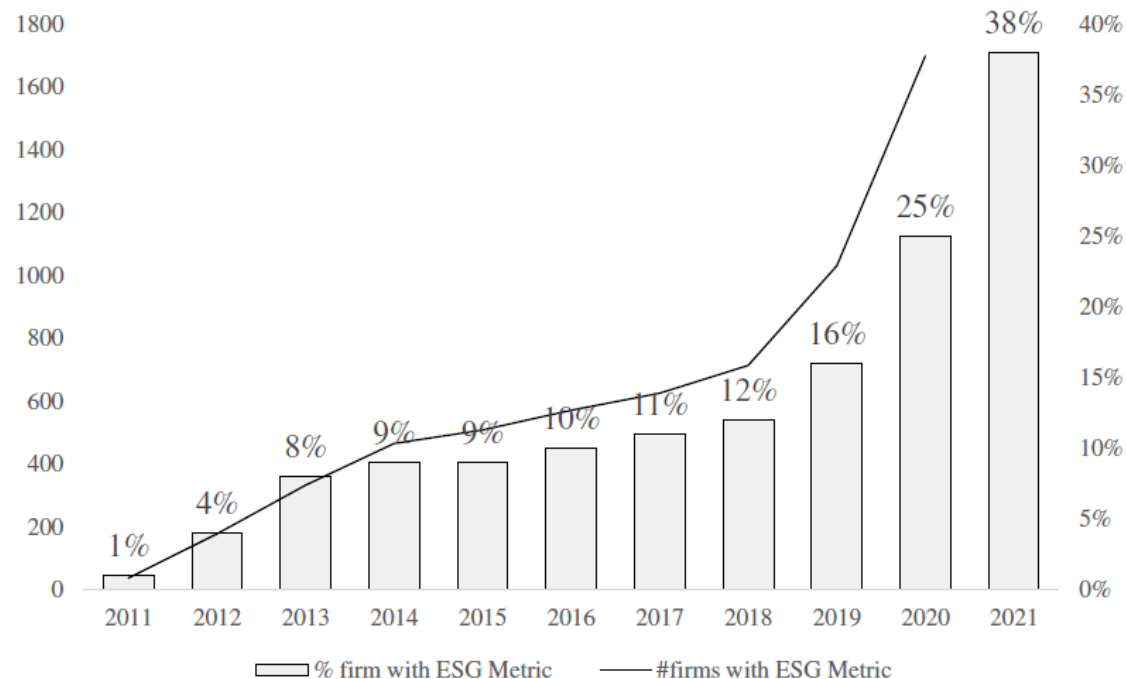
# Operationalizing Shareholder Preferences

- While we still have a lot of work to understand shareholder' E&S preferences, let's turn now to operationalizing preferences once we know them
- Key issue: ensure board/managers have E&S related incentives aligned with shareholders
- Firms are increasingly incorporating E&S performance metrics directly into executive compensation plans
  - Let's start by giving that some thought...

# E&S Performance in Executive Compensation

**Figure 1. Use of ESG Metrics in Executive Compensation**

This figure shows the evolution of ESG pay (i.e., the inclusion of ESG metrics in executive compensation contracts) over our sample period. The data includes all firms covered by ISS Executive Compensation Analytics (ECA) from 2011 to 2021 (10,061 firms). The bars represent the percentage of firms that include ESG performance metrics in their executive compensation contracts in a given sample year (right axis). The solid line represent the number of firms that include ESG performance metrics in their executive compensation contracts in a given sample year (left axis).



\*Cohen et al. (2022): Executive compensation tied to ESG performance: International evidence

# E&S Performance in Executive Compensation

**Table 3. Contract Characteristics**

This table describes variation in the characteristics of the compensation contracts that include ESG metrics. Panel A focuses on the types of ESG metrics used in the contracts. Panel B focuses on the types of compensation vehicles in which ESG metrics are included. Panel C presents the median values of the weights assigned to ESG metrics in short-term and long-term compensation vehicles.

<b>Panel A. Types of ESG metrics:</b>	<b><u># firms</u></b>
a) Specific indicators <sup>(1)</sup> :	
Carbon emissions	172
Other environmental variables	651
Safety and security	824
Diversity and inclusion	285
Employee satisfaction and development	1,167
Governance and corporate culture	1,323
b) Scores <sup>(2)</sup> :	
Self evaluation (i.e., combination of metrics defined and measured by the firm)	884
External evaluation (i.e., scores defined and measured by external parties)	97
<b>Panel B. Compensation vehicles with ESG metrics:</b>	<b><u># firms</u></b>
Short-term compensation (annual variable compensation)	1,321
Long-term compensation (long term incentive plans)	327
Both short-term and long-term compensation	233
<b>Panel C. Weights</b>	<b><u>% of comp.</u></b>
Short-term compensation	13.2%
Long-term compensation	15.9%

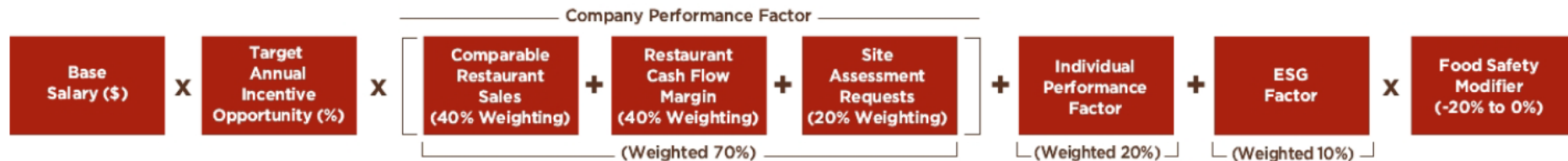
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# Example: Chipotle Mexican Grill, Inc.

## Annual Incentive Plan (AIP)

The AIP is our annual cash incentive program for certain bonus eligible employees, including our executive officers, which is based on the achievement of three factors: a company performance factor (“CPF”), an individual performance factor (“IPF”) and an environmental, social, and governance (“ESG”) factor. The Committee added an ESG factor to the 2021 AIP, with components aligned around our food & animals (organic, local grown), people (pay equity and diversity) and environmental (carbon footprint) goals. For 2021, the Committee also rebalanced the weightings of the performance factors so that 70% of the target value is based on CPF achievement, 20% is based on IPF achievement, and 10% is based on the new ESG factor. The total bonus is then subject to a food safety modifier that can reduce the bonus by as much as -20%. Chipotle is committed to food safety and strong food safety performance is an expectation. Therefore, our executive officers cannot earn a higher bonus for strong food safety performance.

The graphic below illustrates the AIP calculation, including the weighting of the CPF, IPF and the new ESG factor, with potential food safety negative modification:



10% weighting in annual bonus plan

Payout for each of the factors and for total AIP can range from 0% up to a maximum of 275%. Any payout above 200% of the target level will be paid in the form of RSUs that vest in two equal installments on the 2nd and 3rd anniversaries of the grant date, subject to the executive officer's continued service through the applicable vesting date.

## Environmental, Social and Governance (ESG) Factor

In 2021, the Committee added an ESG performance factor to the 2021 AIP, which accounted for 10% of the overall payout. The ESG factor has three components, which align with the three pillars of our sustainability strategy and reporting, with four specific metrics for the ESG factor. Based on the Committee's evaluation of the achievement of these ESG metrics, a payout of up to 275% could be assigned for the ESG factor.

In early 2022, the Committee reviewed the achievement of the ESG metrics and determined that performance on each had exceeded expectations defined at the start of the year:

Pillar	Metric	Achievement
Food & Animals	<ul style="list-style-type: none"><li>Year-over-year increase in pounds purchased of organic, local and/or regeneratively grown/raised food</li></ul>	<ul style="list-style-type: none"><li>17.8% year-over-year increase in pounds purchased of organic, transitional and/or locally grown food over the prior two years.</li></ul>
People	<ul style="list-style-type: none"><li>Maintain racial and gender pay equity</li><li>Implement a program that improves and accelerates the development of our diverse field organization and support centers for promotion to above restaurant and next level roles</li></ul>	<ul style="list-style-type: none"><li>2021 pay equity analysis of our U.S. workforce did not identify preferential treatment to any class of employee</li><li>Leadership Evolution and Development (LEAD) program launched in 2021, resulting in internal diversity pipeline of 60% and increased pipeline of females to top field leadership positions to 50%</li></ul>
Environmental	<ul style="list-style-type: none"><li>Publish our Scope 3 emissions by December 31, 2021</li></ul>	<ul style="list-style-type: none"><li>In November 2021, published scope 3 emissions and announced Science Based Targets initiatives (SBTi) to reduce absolute Scope 1, 2 and 3 greenhouse gas (GHG) emissions by 50% by 2030 from a 2019 base year</li></ul>

As a result, the Committee approved an ESG factor of 200% of target. For 2022, the Committee has refined the ESG component of the AIP design and approved quantitative ESG performance goals for each of these three pillars.

ESG payout at 200% of target

## 2021 Bonus Payouts

The 2021 AIP payouts for each of our NEOs are set forth below.

Name	Target 2021 AIP Payout		Actual 2021 AIP Payout				
	% of Base Salary	Dollar Value	CPF	IPF	ESG Factor	Dollar Value <sup>(1)</sup>	% of Target
Brian Niccol <b>CEO</b>	180%	\$2,250,000	190.0%	200.0%	200.0%	\$4,342,500	193%
Jack Hartung <b>CFO</b>	100%	\$ 850,000	190.0%	175.0%	200.0%	\$1,598,000	188%
Curt Garner	95%	\$ 688,750	190.0%	200.0%	200.0%	\$1,329,288	193%
Christopher Brandt	85%	\$ 573,750	190.0%	200.0%	200.0%	\$1,107,338	193%
Scott Boatwright	85%	\$ 467,500	190.0%	200.0%	200.0%	\$ 902,275	193%

CEO's ESG Bonus Payout = \$450,000

= 10% ESG weight x 200% ESG Performance x \$2,250,000

If performance had been at "Target", payout = \$225,000

# But, Here's the Wrinkle...

## 2021 SUMMARY COMPENSATION TABLE

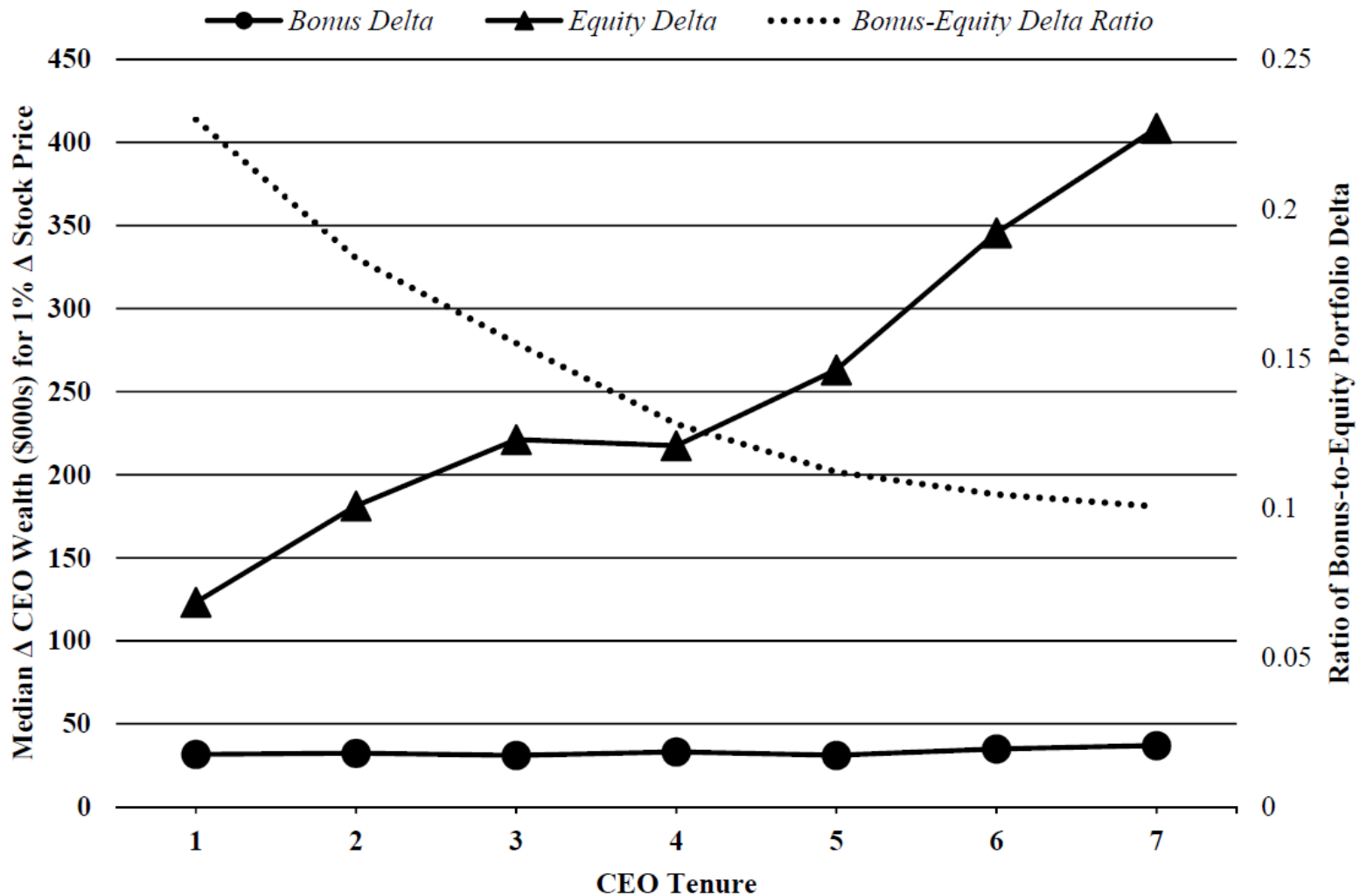
Name and Principal Position	Year	Salary(\$)	Bonus(\$)	Stock Awards\$(1)	Option Awards\$(2)	Non-Equity Incentive Plan Compensation\$(3)	All Other Compensation\$(4)	Total\$(5)
<b>Brian Niccol</b> <i>Chairman and Chief Executive Officer</i>	2021	\$1,250,000	\$ —	\$ 7,200,970	\$ 4,800,102	\$4,342,500	\$ 287,008	\$17,880,580
	2020	\$1,242,307	\$ —	\$29,222,813	\$4,000,219	\$3,150,000	\$ 420,529	\$ 38,035,868
	2019	\$ 1,200,000	\$ —	\$ 5,700,073	\$2,731,683	\$ 3,870,000	\$ 2,566,388	\$16,068,144
<b>Jack Hartung</b> <i>Chief Financial Officer</i>	2021	\$ 844,615	\$ —	\$ 2,100,961	\$1,400,358	\$1,598,000	\$ 224,739	\$ 6,168,673
	2020	\$ 812,692	\$ —	\$15,733,267	\$1,200,156	\$1,035,559	\$ 220,678	\$19,002,352
	2019	\$ 800,000	\$ 1,000,000	\$ 2,800,210	\$1,170,844	\$1,462,000	\$ 293,547	\$ 7,526,601

## Executive Stock Ownership Guidelines

Stock ownership guidelines are intended to ensure that our executive officers retain ownership of a sufficient amount of Chipotle stock to align their interests in a meaningful way with those of our long-term shareholders. Alignment of our employees' interests with those of our shareholders is a principal purpose of the equity component of our compensation program. The Committee believes that our stock ownership guidelines for our NEOs are robust and in the case of the CEO and CFO among the highest requirements in our compensation peer group. The table below reflects our guidelines and compliance by our NEOs with the guidelines as of March 1, 2022.

	Ownership Requirement (multiple of base salary)	Value of Share Ownership Towards Requirement(1)	Actual Share Ownership as Multiple of Base Salary(2)
Brian Niccol	7 times	\$46.6 million	37x
Jack Hartung	4 times	\$97.2 million	112x

# Figure 1: Bonus vs Equity Incentives



Guay, Kepler, Tsui (JFE, 2019)

# E&S Incentives Puzzle

- Prevalence of E&S bonus compensation growing rapidly
  - In 2021, 73% of S&P500 firms had some form of E&S incentive pay (The Conference Board, Inc.)
- Yet, it comprises a very small fraction CEO incentives
  - E.g., a 20% ESG weight in an annual bonus that comprises 10% of the CEO's total incentives, implies a 2% weight on ESG
- Lion's share of incentives provided by stock price (at least in the U.S. and many other countries)
- Seems unlikely E&S pay will provide meaningful economic incentives for most executives without massive overhaul in the executive compensation landscape

## E&S Incentives – Working Within the System

- So, does that mean operationalizing E&S incentives is doomed to failure (at least in the near term)?
- Not necessarily...
  - Stock price expected to impound the stakeholder preferences of shareholders
  - E&S performance measures allow for coordination and teamwork among senior executives
  - E&S performance measures help communicate the firm's E&S commitments to shareholders

# E&S Incentives – Stock Price

- Stock price
  - Friedman and Heinle (2016), and Pastor et al. (2021) show theoretically and empirically that stock price is expected to weight shareholders' cashflow and non-cashflow preferences
  - In other words, taking projects that exclusively focus on cash flows WILL NOT maximize stock price
    - Also note if E&S activities are value enhancing to begin with, then no need to adjust existing incentive structures (Edmans, 2022)
  - Implies executives' equity holdings should not be an impediment to E&S activities, but rather should motivate managers to consider shareholders' E&S preferences
  - However, requires managers know shareholders' preferences, AND that shareholders understand firms' E&S activities

# E&S Incentives – Coordination and Teamwork

- E&S performance measures can foster coordination and teamwork
  - Guay, Kepler and Tsui (2019) document that firms use common performance measures across executives to promote mutual monitoring and cooperation
  - Particularly true for firms with stable management teams, young firms, and firms with growth opportunities
  - Further, adding E&S to a compensation plan requires the board to identify important E&S performance measures, to set targets for these measures, and to disclose performance outcomes relative to target
  - All critical for manager-shareholder E&S communication

# E&S Incentives – Communication to Shareholders

- E&S communication to shareholders
- Three most common reasons firms give for including E&S measures in compensation plans\*
  1. Signal E&S as a priority
  2. Respond to investor expectations
  3. Achieve firm's E&S commitments
- Signals a strong commitment to assessing specific E&S objectives, even if the weights on these measures are not economically large

# Concluding Remarks

- Two-way communication essential regarding firms' E&S activities and shareholders' E&S preferences
  - Hard to see how E&S agenda can be operationalized and incentivized if shareholders don't understand or agree with the direction
  - E&S agendas in conflict with shareholders' preferences likely need to be accomplished via regulation rather than through traditional governance
- Important to understand how E&S fits into the existing executive compensation and incentives structure
  - Overhaul of existing system unlikely to happen, but doesn't seem necessary to move the ball forward
  - Incentives via stock price need not be in conflict with E&S objectives
  - Think about E&S compensation through a disclosure and commitment lens rather than direct monetary incentives