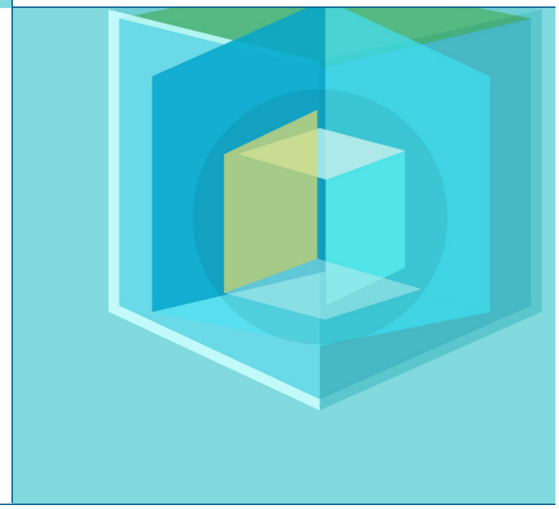
SEMLER BROSSY

SEMLER INSIGHT

ESG & Human Capital Management



The Real Opportunity for Long-Term Resiliency: Strategic Stakeholder Investment

MAY 2021

Seymour Burchman

Blair Jones

There's a new perspective for the debate over corporate short-termism. In the past, we focused on shareholder value, specifically whether firms were cutting R&D and physical plant in order to make quarterly numbers or buy back stock. The pandemic, social unrest, and climate change have now intensified concerns about other areas of long-term commitment. Are companies investing enough in other stakeholders—customers, employees, supply chains, and local communities? Ambitious companies now have an opportunity to build strong relationships with these vital contributors and create competitive resilience for future success.

Moving to Stakeholder-Focused Investments

Concerns about investment have moved to new areas, especially human capital and environmental and social sustainability, including climate change and racial inequities. Commentors also cite the need for greater investment in robust, sustainable, and transparent supply chains, and in stickier and deeper customer relationships.

These areas are not just nice-to-have or an expression of social responsibility; they're existential. Companies are increasingly realizing that stronger human capital will help them improve the customer experience and respond to the vicissitudes of the marketplace. Supportive communities and loyal customers will give them a solid base upon which to build future success. End-to-end, agile supply chains will enable them to handle disruptions such as pandemics.

Meanwhile, companies that fail to adjust to climate change will likely pay the price in higher costs (including carbon taxes) and penalties, both regulatory and reputational. Some industries have already made sweeping changes, such as

Detroit embracing electric vehicles, that shine a bright light on climate change. Companies are also recognizing the value of better brand images and reputations, especially among younger customers, employees, and investors. Stronger relationships with these stakeholders will generally benefit investors over time—there's no trade-off.

Yet a variety of constraints discourage executives from embracing these long-term investments. Many executives believe they still need to make the numbers, and shortened tenures (5-7 years for CEOs and 5 years or fewer for the rest of the C-Suite) push them toward quicker paybacks. In many industries, the pandemic has reduced the resources available for strengthening these relationships. These investments are also complex and distinct for each industry or organization, and the high stakes make executives leery of getting them wrong.

Meanwhile, most companies emphasize short-term financial metrics in their reporting and in their executive pay programs. Many of them still give quarterly earnings guidance, which further discourages long-term investment. Translating long-term stakeholder goals into accountable metrics requires a fundamental rethinking of executive pay.

Getting Started

Executives can't make this shift alone; they need the support and guidance of boards. Especially through the work of the Finance, ESG and Compensation/Human Resources Committees, directors can collaborate with management to focus on the stakeholder priorities that make the most difference—both directly and with new compensation incentives. Boards and management teams can move boldly here by keeping the goals front and center on the agenda.

For example, a food services company invested in its suppliers with the goal of increasing the sources of sustainable food. Management, with the support of the board's ESG committee, brought this goal to life by refining the priorities and providing the resources needed to achieve these goals. With the ESG's committee's prodding, management translated the need for sustainably sourced foods into new packaging, delivery and storage requirements, along with sourcing from more sustainable suppliers. The Finance committee worked with management to evaluate sustainable funding vehicles with better rates for delivering on sustainability achievements. The Compensation committee is now considering how to reward management for these investments.

Likewise, a durable products manufacturer is now withdrawing from underperforming regions and product lines to better invest in the environmentally friendly products that society and consumers increasingly want. Directors have helped by engaging with executives about the types of talent needed to develop these products, and how the corporate culture might have to change to embrace both existing and new employees. Separately, management with board support developed plans to reskill current workers and retool U.S. factories for these future products. The Finance committee worked with management on the capital allocations and targeted investments to acquire the talent and technologies for shortening the development cycle.

Everyone benefits from these long-term investments. The companies gain stronger relationships with customers (and employees), who might otherwise look elsewhere for these products. These investments should also pay off in stronger brands and greater shareholder value overall. Society as a whole benefits too. By contrast, more short-term oriented investments in reputation through marketing, for example, might yield a similar short-term payback, but leave a company weaker in the long run.

A Framework for Action

Companies can promote these long-term goals in three ways:

1. *Put a priority on investments in stakeholder relationships*—in human capital, local communities, customers, and suppliers. Each company will want a different mix of plans, with varying levels of investment; some will focus on just one or two for now. The main thing, as the food company did, is to keep those

discussions going and align with the company's mission and core competencies. Management must take the initiative here, with support from the relevant board committees.

2. *Increase engagement with investors to communicate the company's overall mission and strategies for addressing key stakeholders and how these strategies support long-term sustainability.* With expansive, regular communications, companies can get valuable input and eventually buy in. They can also attract and retain investors who share their focus on the company's intrinsic value and long-term success.

3. *Design compensation programs to support these long-term plans.* Because most goals will extend beyond the three years of the usual long-term incentive programs, boards will need to work with management on milestones that demonstrate progress. Ideally, annual (and possibly three-year incentive) payouts would depend on meeting these milestones as well as the usual financial goals. Companies risk getting behind the curve if they stick with the usual long-term incentives, which emphasize financial measures and look ahead only three years.

To get the appropriate focus, boards will want to design long-term incentives for outcomes tied to the company's mission and strategy. Energy companies, for example, are adding metrics to reduce carbon emissions in supply chains. They might also invest in increasing the resiliency of their networks and grids, to overcome crises such as the recent freezes in Texas and wildfires in California.

Healthcare companies might include metrics tied to better patient care, improved healthcare outcomes, and overall cost containment (such as through greater prevention, early intervention, and shift toward home care). Retail apparel companies might focus on sustainable sourcing, product reuse and recycling, and respecting workers' rights.

Concerns about corporate short-termism haven't gone away, and they've acquired new saliency with the pandemic. It isn't enough for companies to invest in R&D and production capacity; they also need strong long-term relationships with stakeholders—for reasons of strategic survival as well as social responsibility. Board and management teams working together can advance the agenda and reorient their incentives toward the long-term. ■

Seymour Burchman is a senior advisor at Semler Brossy Consulting Group. He has been an executive compensation consultant for over 30 years and has consulted on executive pay and leadership performance for over 40 S&P 500 companies. Blair Jones is a managing director at Semler Brossy and has been named for the last seven years to the NACD Directorship 100 as one of the hundred most influential leaders in boardrooms and corporate governance. She has been an executive compensation consultant for over 25 years.

For more information, visit us at SEMLERBROSSY.COM, *or reach us at 310.481.0180.*

Seymour Burchman, Managing Director
sburchman@semlerbrossy.com

Blair Jones, Managing Director
bjones@semlerbrossy.com

SEMLER BROSSY

LOS ANGELES | NEW YORK