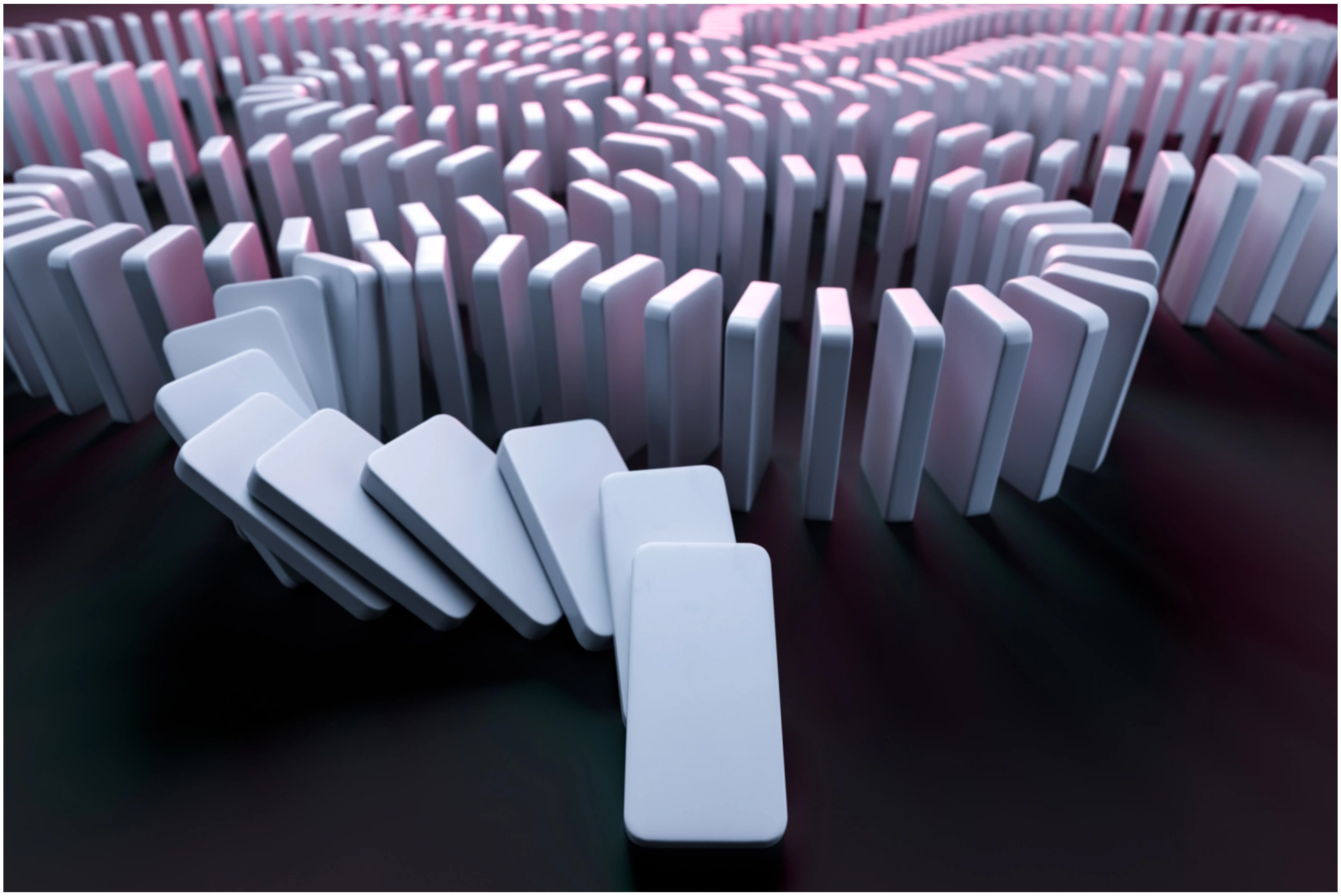
ESG and shareholder activism: A tsunami is coming to Silicon Valley

Derek ZabaContributor 1:40 PM PDT•October 21, 2021



With the increase in attention on environmental, social and governance (ESG) issues over the past few years, it's easy for companies to assume that we've reached the crest of the ESG wave. However, we are only at the early stages — an ESG tsunami is headed toward Silicon Valley.

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The increased attention on ESG issues has been across a much broader spectrum than just companies in the technology sector. This has largely been driven by broader societal trends, such as the focus on climate change. However, the ESG wave at companies, particularly public companies, is being accelerated by demands by various investor classes (including pension funds as well as a younger generation of individual investors) to focus more attention on such issues.

As a result, institutions that are trying to attract capital from these investors, such as mutual funds, venture capital funds and hedge funds, must increase their focus on the ESG dimension to stay competitive.

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While the increase in focus on ESG has been gradual over the past few years, the level of investor influence on ESG issues took a step function forward with successful campaigns by shareholder activists at energy companies during the spring of 2021, most prominently a prominent proxy contest led by Engine No. 1.

For the first time, investor pressure related to an ESG issue (in this case, climate change), directly led to substantial turnover in the board of a public company. Activist shareholders are tapping into new and powerful ESG themes as leverage in their activist campaigns to change control and strategy at public companies.

Is the technology sector next?

Historically, the pattern of investor pressure on governance issues (the "G" in ESG) in public companies is to successively tackle issue after issue, winning on one issue and then moving on to the next. One good example of this is the migration of public companies to have annual elections for all directors for a one-year term rather than staggered elections of a portion of the directors for a three-year term — a so-called “classified board.”

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In 2007, 55% of the U.S. incorporated public companies in the S&P 1500 had a classified board. By 2021, after years of governance campaigns by shareholders, this was reduced to 26% of S&P 1500 companies, with the classified board almost extinct at the largest public companies that comprise a larger percentage of investors’ portfolio. Thus, from an investor perspective, the push to achieve annually elected boards is almost entirely resolved and the glare of the investor spotlight moves to focus on other issues.

We expect the same scenario to play out here. At a recent conference, Aeisha Mastagni, a portfolio manager at CalSTRS and one of the architects of Engine No. 1’s proxy contest this spring, stated that she hopes the contest would serve as a wake-up call for all companies across all industries, not just for energy companies. So if targeting climate change in the energy sector was an obvious first choice, the question now becomes “Who’s next?”

There are several reasons to believe that the technology sector is next on the agenda. First, the technology sector, as a whole, is now by far the largest sector in the economy when weighted by market cap, comprising roughly a third of the S&P 500. Furthermore, the six largest companies in the S&P 500 are all technology companies.

At large companies, small percentage increases in business improvement can translate to a greater amount of aggregate dollars created than larger percentage increases at smaller companies. Additionally, the behavior of technology companies tends to have greater influence on companies in other industries and society more broadly.

This has already resulted in increased Congressional focus on the industry, which itself may create some momentum for investor support for campaigns targeting technology companies. Lastly, we have already witnessed such a campaign: In 2008, Charlie Penner of Engine No. 1 attempted an ESG-oriented campaign at Apple at Penner's prior firm, JANA Partners.

ESG and shareholder activism at public technology companies

Targeting ESG issues to gain investor support in shareholder activist campaigns that seek to change board composition is no longer a theoretical construct. While it is not yet clear to what degree activists will use ESG themes as a core pillar of their campaigns, activist investors recognize that ESG themes are likely to resonate with a wide array of institutional investors.

An institutional investor that overlooks an ESG-themed activism campaign may risk criticism for disregarding client priorities and even lose out on future investment from ESG-focused investors.

The most common challenges facing tech sector industries, and potential areas of focus for activists, relate to societal influence, diversity and inclusion, customer privacy, data security, product design and lifecycle management, energy management, supply chain management, competition practices and employee engagement. The relevance of any of these factors differs by subsector. For example, semiconductors and electronics manufacturing have pronounced ESG risks related to emissions, water and waste management, and employee health and safety.

IT and telecommunications face particular challenges related to systemic risk management. And many technology companies face challenges with respect to diversity in both the employee and senior management ranks.

The wide variety of potential ESG issues in the technology sector creates multiple opportunities for activists. Some of technology's most pronounced ESG challenges have been essential business issues for many years, long before they became widely recognized as being associated with ESG. Prominent examples are the protection of customer privacy and data security.

Tech companies that have to contend with customer privacy and data security issues are in no way surprised that investors consider these issues important to the business. Nevertheless, the emergence of the ESG movement has made it all the more important for tech companies to perform well and provide transparency in these areas.

Five years ago, if a tech company experienced a significant event or controversy related to customer privacy, data security or its competition practices, the issue could have been treated as a business challenge comparable to any other. Today, the same event can be cast by an activist as an ESG problem that the activist can treat as an indicator of major "governance failure" that presents "systemic risk to long-term value" of the business.

An activist investor can also cast ESG-related problems at a company as a moral failure needing reform in order to "do the right thing" for moral reasons but also to protect the reputation of the business and its social license to operate. As the public becomes more receptive to ESG-themed arguments, it may become harder for institutional investors to overlook activism campaigns that feature these kinds of moral themes in campaign rhetoric.

Recommended actions to take

Tech companies have many reasons to take ESG seriously, including a desire to address moral priorities and to attract investors. For public companies, a weak ESG profile may also be exploited by shareholder activists. As a result, companies in the tech sector should take heed of the following recommendations:

- Work ESG concepts and talking points into the company's overall story. Public companies also need to be prepared to defend their records if challenged by a shareholder activist. Do not underestimate shareholders (activist or not) that approach the company with interest or concerns about ESG. Today's passive engagement could become tomorrow's activist campaign. A company should be ready to speak at a high level about material areas of its ESG program in order to respond to public criticism quickly.
- Understand the behavior and disclosure of peers. Companies are judged on a relative basis. Being a leader is helpful, but it's important to at least be within the pack. Take advantage of existing disclosure regimes such as the Sustainability Accounting Standards Board (SASB) and the Global Reporting Initiative (GRI), which can be used as roadmaps for disclosure practices in a given industry.
- For smaller and growing companies, it's helpful to take a gradual, calculated approach to ESG program implementation and disclosures. In fact, in many cases it's more impactful to demonstrate that you have a thoughtful plan to integrate ESG measures at appropriate times in the evolution of the company rather than expending precious resources on

implementation too early in the company's lifecycle. Start by focusing on the most impactful goals and build up your program over time.

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