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THE SOCIAL ASPECTS OF ESG INVESTING: INSIGHTS ON DIVERSITY IN ENERGY FINANCE

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As pressure mounts on energy companies to address environmental, social, and governance (ESG) concerns, now front and center for many large investors, the "social" aspects of ESG are coming to the fore. "Social" considerations gained attention during the 2020 shareholder proxy season, as witnessed by an intensification of focus on human capital and talent management in generating long-term value.[1]

The COVID-19 pandemic has brought worker well-being, safety, and fair compensation across the economy directly into the public eye. Similar to the 2009 financial crisis, the current economic downturn has disproportionately impacted women and people of color. McKinsey's *Women in the Workplace 2020* report calculated that overall, women's jobs are 1.8 times more vulnerable in this current crisis than men's jobs.[2] The immediacy of COVID's disparate impacts has been accentuated by the increased attention to racial justice and gender equality in wider public discourse in the United States and beyond. As downsizing has taken place in energy companies during COVID, workforce diversity and inclusion policies have come under greater investor scrutiny.[3]

Given these trends, energy companies are under pressure to take bolder ESG initiatives to ensure continued access to investment by institutional investors.[4] For example, one new area within the "S" dimension of ESG that is being incorporated into portfolio strategies is searching for opportunities based on workplace gender equality. Coined in the late 2000s as "gender-lens investing," a new class of impact investors is considering gender issues in financial analysis to better inform investment decision-making.[5]

This commentary discusses the approaches ESG-oriented institutional investors and engaged impact investors are taking to make apparent the gender and broader diversity standards that companies, including energy companies, will need to meet to maintain access to their capital. This commentary also considers the role a diverse workforce and leadership can play in promoting other ESG goals, such as environmental performance. It then takes a step back to examine early investing through venture capital. This is important because many energy companies begin as smaller ventures backed by risk finance. The role of venture capital in energy start-ups means that the onus is not just on the energy companies themselves to consider gender issues in long-term sustainability and profitability but also on early-stage investors of the energy industry to recognize the potential in women-owned and women-run start-ups and the biases holding them back.

Gender Lens and Diversity as an Investment Screen

Several diversity factors have been shown to positively impact investment outcomes. Early studies show that companies commended for diversity have had an initial positive stock price move in the aftermath of such announcements.[6] Also, Quantamental Research, a unit of Standard & Poor's Global Market Intelligence, found that Russell 3000 companies with female chief financial officers generated $1.8 trillion more in gross profit between 2002 and 2019 than the average for sector competitors, as well as generated more share value appreciation.[7] And the Institutional Shareholder Services Group (ISS) 2020 report *The Five Tenets of Diversity: Values Create Value* found that firms whose corporate boards have at least two women board members outperform the average Russell 3000 companies' returns over three, four, and five year periods.[8] A study by Diversity also links diverse collaborations that include women and underrepresented minorities (as opposed to heterogenous teams) with higher overall fund returns for venture capital firms.[9]

In recent years, as racial and gender inequality have stood out in US public discourse, ESG investors have become increasingly concerned that poor performance on diversity will have a negative impact on long-term corporate performance.[10] Shareholders filed proposals for corporate engagement on over 400 environmental, social, and sustainability issues during the 2020 proxy season, including on gender and racial diversity.[11] Last year, 77 percent of Fortune 100 companies voluntarily highlighted human capital initiatives, up from 32 percent in 2017. Now 69 percent of those companies have explicitly assigned diversity, corporate culture, and workforce issues to board or management committee oversight, up from just 28 percent in 2017. [12]

In line with these trends, several US states have passed board diversity standards, with California requiring all publicly traded companies with principal executive offices in the state to have two to three women board members by 2021, depending on the size of the board. Similar bills have been introduced in Illinois, New Jersey, and Massachusetts.[13] Nasdaq, the US electronic stock exchange known for growth-oriented, innovative companies, has also weighed in with proposed new rulemaking that would require companies listed on its exchange to have at least one woman and one person who identifies as an underrepresented minority on their board of directors.[14] Nasdaq is also tightening rules for required disclosure of diversity information. As encouraging as these recent movements are for ESG investors, the United States still lags other developed countries/regions, such as Europe and Canada, when it comes to diversity on corporate boards. For example, while 13.4 percent of Russell 3000 companies still don't have a single woman on their boards, Norway has been mandating a 40 percent minimum female representation on public corporate boards since 2008.[15]

Research also has demonstrated a link between gender diversity on corporate boards and environmental performance, broadening the relevance of diverse boards to a wider aspect of corporate performance. A 2017 evidence-based study by Central China Normal University, using S&P Compustat data on publicly listed companies on the New York Stock Exchange and corporate databases from MSCI (boards), ISS (board diversity), and KLD (environmental policy), found that "the more likely firms in a given industry are to cause environmental pollution, the more salient will be the beneficial effect of gender diversity on boards on firms' environmental policy in the industry."[16]

In some cases, ESG investors are beginning to screen out companies or industries with poor records on gender equality from their equity portfolios, fearing that diversity issues are an indication of a deficit in management oversight as well as a potential disadvantage for firms in competing for workforce talent. This could have direct bearing on energy companies who have lagged other industries in recruiting and retaining women and promoting them to senior ranks. Women's share of the energy workforce ranges from 23 percent to 32 percent.[17] Women represent less than one-fifth of senior executive positions at energy companies. Minorities are even less represented in energy company leadership.

The investment decision of divesting (selling one's ownership stake) versus engaging with companies is a critical one. There is no right answer. However, it is worth noting that constructive engagement by institutional investors has brought positive change to energy companies in other areas, such as environmental practices, in recent years.[18] The advocacy group Ceres reported that shareholder engagements spurred company commitments to address specific climate-change-related issues such as greater disclosure, higher greenhouse gas emissions reduction targets, and improved strategic planning related to the energy transition.[19]

Investor Engagement on Transparency of Gender Roles and Pay

Some investors are engaging companies by issuing shareholder initiatives to advance gender parity. Some efforts are focused around disclosure and reporting, with shareholders asking companies to disclose compensation data to reveal whether a gender pay gap exists across the firm. In a famous case in 2019, Citigroup Inc. responded to shareholder engagement initiatives by improving the transparency of its reporting on compensation issues.[20] The bank disclosed that women were receiving 29 percent less in compensation than men on a global median basis corporate-wide, based on underrepresentation in the bank's top ranks. Women account for 37 percent of senior positions at Citi, compared to 50 percent of the total workforce. When adjusting for job function, level, and geography, women earn 99 percent of men, the bank added. Currently, 27 percent of Fortune 100 companies report a measure of workforce diversity data, including the percentage of women and minorities across the workforce and in certain leadership and management categories.[21] Only 10 percent of firms have announced concrete forward-looking targets for senior level roles, and only a few firms disclose specific pay ratios related to diversity.

A new law in Canada (C-25) enacts an important change for public companies in that country. Stopping short of imposing quotas, which are highly debated across industries, the new law requires companies to report various diversity metrics for both their boards and senior management.[22]

Shareholder Activism on Corporate Culture Accountability in the C-Suite and on Boards

Research shows that firms with highly satisfied employees outperform in terms of shareholder return.[23] Positive culture is promoted when there is a well-articulated alignment between a company's purpose and its core values and daily operations.

Accountability for corporate culture extends to the C-suite and board of directors, which set an example for the larger entity. The National Association of Corporate Directors 2017 report on corporate culture notes that directors should review board culture on a regular basis and make culture an explicit criterion in the selection and evaluation of the chief executive officer. In particular, it recommends that compensation committees review recognition and reward systems to ensure they are promoting company values, including diversity and pay equality.[24] Increasingly, public company shareholders are considering "say-on-pay" resolutions, which assert shareholders' rights to vote on the remuneration of corporate leaders. Higher scrutiny and engagement on executive salaries is a building block to consider pay inequity and to monitor and promote improved corporate performance on culture, equity, and inclusion. For the energy industry, where corporate performance on diversity and inclusion culture is lagging and there is scope for improvement in corporate culture, shareholder action on executive pay and social factors could intensify moving forward.

Beyond establishing a link between executive pay and performance related to corporate culture and diversity, shareholders can take, and are taking, a more proactive role in ensuring gender balance in the selection of independent board members. The Council on Institutional Investors, an influential governance group of important asset owners and asset managers, has begun tracking independent directors who receive less than majority support but still remain on boards.[25] This is significant because shareholders vote each year to renew each independent board member serving on the board of directors of public companies. Concerns about diversity and performance are now leading activist investors to use this annual vote to express dissatisfaction with board composition that lacks female representation.[26] Specifically, these activist shareholders vote against the renewal of directors who are members of board nominating committees who are failing to propose a diverse slate of independent board members for the board where they serve. It is the job of nominating committee members to propose new appointments when there is a vacancy for new independent board members. Average opposition to nominating chairs at all-male S&P 1500 boards was about 30 percent in 2019.[27] Proxy advisory firm Glass Lewis & Co. is now recommending against reelecting directors who chair nominating committees at Russell 3000 companies with all-male boards.[28] Two of the largest asset management firms, BlackRock and State Street, have begun to vote against all-male boards with no plans to add women.[29] BlackRock sent out warning letters in 2020 to companies with fewer than two women directors on their boards. And Goldman Sachs announced last year that it will not take companies public and work with them as IPO underwriters if the companies have all-male boards of directors.[30]

The prevalence of all-male boards or boards with few women and underrepresented minorities raises questions about the energy industry's ability to attract investment dollars from ESG-oriented institutional investors managed by firms like BlackRock and State Street. That's a problem for an industry that is already reeling from falling stock valuations amid lower prices, flagging cash flows, and high debt. In 2019, women represented just over 12 percent of board seats for energy companies in the Russell 3000 Index, where almost a third of energy companies still had all-male boards.[31] Only 6 percent of energy board seats could be characterized as ethnically diverse.

Women-Owned Companies and Access to Venture Capital

In a 2019 report, the International Energy Agency (IEA) found that more energy investment funding than ever is going to energy venture capital deals. The IEA noted that risk-taking capital like venture capital (VC) is an essential complement to government and corporate spending.[32] The IEA study observed that large energy companies and large technology companies are increasingly buying up or taking an equity stake in energy start-up firms to expand their investment portfolios in clean energy and energy innovation. Because energy infrastructure tends to be expensive and long-lasting, access to risk funding is all the more critical to energy entrepreneurs.[33]

The importance of venture finance in energy innovation raises questions about whether there are disparities in access to VC funding for women-owned start-ups. To the extent that many energy company strategies for the future include acquisition of interesting energy start-up firms, a lack of funding for women-owned and minority-owned energy start-ups can perpetuate the lack of diversity inside existing energy companies. Disparities in women's access to venture funding also discourages the development of diverse talent pipelines, which are linked in large measure to visibility of opportunity.

In 2020, 2.1 percent of overall US venture capital[34] and 1.8 percent of European VC went to companies whose CEO was a woman, despite a sizable increase in the number of women-owned businesses.[35] Studies have shown that gender bias can be present during the pitch process to VC firms. Research on the TechCrunch competition found that women were asked different questions than their male counterparts, with men more often given the opportunity to discuss upside potential for their ventures, while women were asked questions of a more preventive nature (e.g., how they would avoid potential losses and mitigate risk).[36] Entrepreneurs asked questions about upside received six times more money than those asked about risk mitigation. By contrast, Boston Consulting Group found, in a recent survey of MassChallenge[37]-accelerated businesses, that start-ups founded or cofounded by women generated 10 percent more in cumulative revenue over a five-year period than male-founded firms.[38] Meanwhile, less than half of US startups had at least one woman in an executive position in 2020, according to Silicon Valley Bank's annual survey.[39]

While venture capital is not the only asset class with significant female underrepresentation, it is receiving increased attention because reform in this sector could directly help fix the "pipeline issue" of a lack of female- or diverse-owned companies, including in the energy industry. Having more women-owned or women-started ventures supported by the VC industry would increase the number of firms that could grow over time to become medium- and large-sized women-owned or women-run companies.

Some VC firms have shifted to a digitally mediated process to reduce gender bias in early stage screening. Also, some newer VC firms are emerging that specifically focus on companies with female founders. One such example is the Vinetta Project, which recently launched an initiative with JPMorgan to help close the gender funding gap.[40]

Since barriers to female founders accessing capital in the venture space are well understood and documented, there have been encouraging signs of mitigating this issue. For example, Caisse de dépôt et placement du Québec (CDPQ), one of the largest Canadian pension funds, launched a new initiative in 2020 called Equity 25[3], an investment fund aimed at increasing diversity and inclusion in the SME space (small and medium enterprises).[41] Specifically, companies eligible for this program will be required to have 25 percent of their board of directors, management teams, and shareholders comprised of diverse people.[42]

The venture space is not the only part of the investment chain lacking in women leadership. The dearth of women-leading companies further along in their life cycle, such as in the growth equity and private equity businesses, is equally perplexing.

To address the disparities in early finance, some investors are specifically seeking out investment opportunities in women-owned companies or companies known to advance women through their internal governance structures. Several large Wall Street firms have launched gender-lens investing products or initiatives, and experts believe the market could expand to over $30 billion in products by 2025, especially as more women become leaders in family offices (investment firms focused on the portfolios of ultrahigh-net-worth families) or as asset owners.[43]

One way to reduce bias across energy funding ecosystems is to ensure there is sufficient diversity among the officers in pension funds and family offices whose capital is allocated to be deployed by venture capitalists, private equity managers, and large asset management firms. By promoting a diverse composition of investment professionals making investment decisions, it would likely reduce bias and result in allocation of capital to companies, including energy companies, with better long-term prospects—which, as discussed, are companies that have sustainable business models and are led by diverse management teams and boards.

Recommendations

Energy companies seeking broad investor support, including from the ESG community, will need to increase transparency and improve disclosure regarding human capital, including publishing data on workforce diversity and compensation. Companies should also assign board-level oversight responsibilities for promoting an inclusive corporate culture, workforce diversity, and equal pay. Boards should tie executive compensation to diversity performance and should issue explicit statements on the company's philosophy and aims for corporate culture. Executive leadership should ensure diversity objectives are part of management's annual performance reviews. Companies should consider using annual employee surveys or other means to study and track improvement of business culture.

Venture capital firms should consider incorporating gender-lens investing strategies when funding start-ups. To combat bias early in the decision-making phase, they can employ a "blind" application process by removing names from proposals and not requiring the founder, male or female, to pitch the product. Instead, VC firms can review proposals solely on the numbers and results, or have a third-party partner deliver the pitch.

Conclusion

2020 was a remarkable year in terms of bringing diversity, inclusion, and equity to the forefront of ESG investor priorities. However, the implementation and measurement of tangible results is key to establishing success.

The energy industry faces unique challenges from the increased scrutiny of ESG factors in investment decision-making. As ESG-oriented investors turn their attention to social factors, many energy companies are not well positioned to make the case that their corporate culture and governance structures reach the level of diversity needed to promote higher returns known to be associated with a well-run, diverse workforce and C-suite. The ability to change this limiting situation rests not only with energy companies but also with venture capital firms, which can remove social bias from financial elements of the energy innovation process. Meanwhile, shareholders are playing an important role in spotlighting the benefits of diversity, and firms that need to access capital markets will increasingly have to focus on cultivating a corporate culture that promotes a diverse executive leadership and workforce.

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