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ESG ACTIVISTS EXERTING GREATER INFLUENCE ON CORPORATE MANAGEMENT

— PURSUING SOCIAL INTERESTS FOR THEIR SELF-INTEREST —

Masaru Ohnishi
Industrial Research Dept. I, Industrial Studies Div.
Mitsui & Co. Global Strategic Studies Institute

SUMMARY

- Activist funds, as actively engaging shareholders, are increasingly demanding changes from companies involved in business that harms the public interest, with social issues such as the environment as the matter of contention, and they are noticeably exerting their influence on corporate management.
- Behind the rise of such "ESG activists[1]" is the fact that it is becoming easier to obtain the support of institutional investors as a result of the growing environmental awareness at the individual level, and the accompanying increase in the inflow of money to ESG funds.
- Companies need to keep in mind the importance of initiatives that contribute to the public interest, such as the environment and society, yet also with the recognition that such interests are not necessarily the primary focus of ESG activists, but they are ultimately pursuing their own interests.

In December 2020, US oil giant ExxonMobil was presented with a proposal by the emerging activist hedge fund Engine No. 1, which is seeking stronger environmental measures, on the appointment of four candidates to the company's board of directors (composed of 12 members). However, the company did not accept the nominations, and the proposal came to a vote at the annual general meeting (AGM) of shareholders held in May 2021. Although the hedge fund holds a mere 0.02% of ExxonMobil's stock, it managed to get three of the four proposed nominees approved, with the endorsement of major US asset management firm BlackRock, which has a 6.6% equity stake in the oil company, and other shareholders. This illustrates that activist funds that make proposals to management regarding highly public issues, such as the environment, are exerting their influence on corporate activities by mobilizing institutional investors and other stakeholders to their side.

ESG ACTIVISTS GAINING PROMINENCE

Activist funds are institutional investors that aim to realize their shareholder proposals through active dialogue with a company's management and by waging proxy battles at the AGMs. In most cases, the essence of the discussions and proposals is related to the improvement of business performance, capital efficiency, shareholder returns, etc. In order to realize those objectives, the activist investor often seeks a seat on the board of directors, but the chief aim is to improve the profitability of the fund itself. That said, in recent years, the number of funds filing proposals with companies in areas related to the environment and society has been

[1] Activist funds have long focused on corporate governance as one of the areas where they have sought management's response. Adding "ESG" to the activist funds whose primal concerns are environmental and social issues is not therefore entirely appropriate. However, in order to clearly differentiate those activists from environmental NPOs, and since "ESG" is a generally accepted term today that brings together the concepts of the "environment, society, and corporate governance", for the purposes of this report, the term "ESG activists" is used to refer to activist funds that primarily focus on environmental and societal issues.

increasing. Those funds are referred to as ESG activists and the like. Their activities are especially prominent in the environmental issues, such as climate change. Traditionally, that role has been played by environmental NPOs, but such activities are limited to protests in front of the head office of the target company and the filing of proposals as minority shareholders, and they are not always able to obtain the endorsement of major shareholders. As such, their influence on corporate management has also been limited.

However, as awareness of the societal impact of environmental problems has spread, institutional investors have become more supportive of the proposals of environmental NPOs in recent years. Furthermore, activist funds, who believe that putting pressure on companies to tackle environmental problems will lead to profit opportunities for themselves, are more strongly involved in the pursuit of the environmental agenda, and such developments are manifesting themselves as a major trend. Institutional investors had previously maintained a certain distance from activists. Since a large amount of funds has started to flow into ESG funds as a result of the heightened environmental awareness at the individual level, an increasing number of the institutional investors who manage those funds are becoming signatories to the Principles for Responsible Investment (PRI),[2] which requires them to disclose information on their own actions, including the content of exercising voting rights, in order to fulfill those principles. This is feeding the motivation for institutional investors to endorse activists' proposals.

These pressures have spread not only to companies having business operations that significantly impact the environment, but also to financial institutions that provide loans to them. There have been cases, for instance, where new loans to related business operators have not been granted. Such heightened attention to environmental issues by institutional investors and banks is serving as a tailwind for ESG activists.

INITIATIVES OF ESG ACTIVISTS AND THE RESPONSES OF COMPANIES AND FINANCIAL INSTITUTIONS

In addition to Engine No. 1, which has been in the limelight for its shareholder proposal with ExxonMobil, there are other activists who have a great influence in the ESG field (Figure 1). Of particular note is The Children's Investment Fund Management (TCI), which runs the "Say on Climate" campaign. The fund is well known in Japan as an activist shareholder, and in this campaign, it is calling on companies to: (1) disclose information on greenhouse gas (GHG) emissions on an annual basis, (2) present emissions reduction plans, and (3) reach resolutions on shareholder proposals regarding such plans at their AGMs. And an increasing number of companies, especially European companies, are voluntarily complying with the demands. In Japan, Strategic Capital has become one of the few activist funds in Japan to become a PRI signatory, and it is urging investee companies to include specific GHG reduction targets in their medium-term management plans and proposing withdrawal from coal-fired power generation-related business.

With respect to the oil majors, except for the case involving Engine No. 1, the push toward an environmental agenda is mainly led by the environmental NPOs, such as Follow This and Market Forces (Figure 2). These NPOs have called on BP, Royal Dutch Shell, ExxonMobil, and others to stipulate in their articles of incorporation the requirement to include their business strategies aligned with the GHG emissions reduction goals of the Paris Agreement in their annual report disclosures. The companies, for their part, have been accommodating and are proceeding with measures to comply. As for Japanese companies, Market Forces filed a shareholder proposal with Sumitomo Corporation, which has not detailed a concrete action plan to achieve GHG emissions reduction targets and continues to be involved in the construction of coal-fired power plants. Market Forces called on the company to formulate a business strategy that ensures Sumitomo's management will align with the goals of the Paris Agreement. Only around 20% approval was obtained for the proposal at the AGM, and the proposal therefore did not pass. It nevertheless resulted in a certain achievement, such as gaining concessions from Sumitomo Corporation.

[2] A set of investment principles for ESG issues. It consists of six principles, including one for institutional investors to incorporate ESG issues into their investment analysis and decision-making processes. It was formulated in 2005 by the efforts of then-UN Secretary-General Kofi Annan, who requested the participation of major institutional investors around the world. Although the PRI is not legally binding, the concept is widely supported, with 3,038 signatories and US$103 trillion in assets under management as of 2020.

Figure 1: Major achievements of activist funds in the ESG domain

Fund	Country	Year established	Overview and achievements
Bluebell Capital Partners	UK	2019	Called on **Danone** and **Hugo Boss,** both of which have been highly praised for their ESG initiatives, to replace their respective CEOs due to poor corporate performance, and with the support of other institutional investors for the call, both companies dismissed their CEOs.
The Children's Investment Fund (TCI)	UK	2003	In 2020, the fund donated a portion of its profits and launched the "**Say on Climate**" campaign with the Children's Investment Fund Foundation (CIFF), which operates integrally with the fund.
Cevian Capital	Sweden	2002	Called on investees, such as **ABB**, **Ericsson**, and **Thyssenkrupp**, to develop proposals to incorporate ESG goals into executive compensation plans by their 2022 AGMs.
Canyon Capital Advisors	US	1990	Called on US chemical maker **Berry** to work more aggressively on ESG issues to dispel misunderstandings about the destructive impact of plastics.
Engine No.1	US	2020	Proposed to **ExxonMobil** to appoint four fund-nominated personnel to the company's board of directors, citing the company's insufficient efforts in tackling environmental problems. Succeeded in appointing three of the candidates through voting by investors.
Inclusive Capital Partners	US	2021	A fund focusing on ESG founded by Jeffrey Ubben, the founder of ValueAct Capital (US). At the request of ExxonMobil, which became a target of Engine No. 1's activist proposal, Ubben became a director of the oil giant.
JANA Partners	US	2001	Although it is not an ESG-focused fund, it called on **Apple** to redesign its iPhone by taking into account how iPhone usage can impact children.
Trian Partners	US	2005	Called on **GE**, **DuPont**, **Danone** and others not only to reduce emissions and waste, but also to promote workplace diversity, and adopt supplier codes of conduct.
Strategic Capital	Japan	2012	Became a PRI signatory and proposed to investee companies that they clearly state GHG emissions reduction targets in their medium-term management plans and withdraw from coal-fired power generation-related business activities.

Note: Includes not only ESG-focused funds, but also funds that partially appropriate capital for ESG investments.
Source: Compiled by MGSSI based on materials of Activist Insight, Institutional Investor, Lazard, Daiwa Institute of Research, and others

Figure 2: Major shareholder proposals related to climate change (filed against oil majors and trading companies)

Year	Target company	Proposer	Proposal details	Outcome
2018	Royal Dutch Shell	Church of England / Follow This	Establish and disclose goals aligned with the goals of the Paris Agreement, and link the results to management compensation	The proposal failed to pass, with only 5% of shareholders voting in favor of it.
2019	Royal Dutch Shell	Church of England / Follow This	Establish and disclose goals aligned with the goals of the Paris Agreement	The proposal was withdrawn in response to changes in the company's attitude.
2020	Royal Dutch Shell	Follow This	Establish and disclose goals aligned with the goals of the Paris Agreement	The proposal failed to pass with only 14% of shareholders voting in favor of it.
	Chevron	Follow This	Publish a report assessing the risks of conducting business in regions susceptible to natural disasters due to climate change	The proposal failed to pass with only 46% of shareholders voting in favor of it.
	ExxonMobil	Follow This	Publish a report assessing the risks of conducting business in regions susceptible to natural disasters due to climate change	The proposal failed to pass with only 24.5% of shareholders voting in favor of it.
2021	BP	Follow This	Set higher reduction targets than the conventional GHG emissions reduction targets to achieve the goals of the Paris Agreement	The proposal failed due to lack of support from major institutional investors, such as CalPERS (however, BlackRock and some other institutional investors voted in favor of it).
	Sumitomo Corporation	Market Forces	Formulate and disclose a plan showing a business strategy that aligns business activities with the goals of the Paris Agreement	Market Forces felt Sumitomo Corporation's policy revision was still insufficient and the proposal came to a vote at the AGM, but it failed to pass.
	Chevron	Follow This	Significantly cut GHG emissions over the medium to long term	The proposal passed with 61% of shareholders voting in favor of it.
	ExxonMobil	Engine No.1	Replace four directors to promote business activities that will contribute towards a low-carbon society, and other demands	With the support of BlackRock and others, three out of the four fund-nominated candidates were appointed as directors.
	Royal Dutch Shell	Follow This	Establish more stringent policies to reduce GHG emissions	The proposal was withdrawn because a broad agreement was reached between the two parties.

Source: Compiled by MGSSI based on materials published by As You Sow, Bloomberg, etc.

Many of the shareholder proposals filed with financial institutions are also initiated by environmental NPOs and often involve institutional investors, and they have achieved remarkable results (Figure 3). For instance, the US financial group JPMorgan announced that it will compile a report on its borrowers' measurements of GHG emissions volume and disclosures and will no longer provide new loans to coal-related business operators. In Japan as well, the Mitsubishi UFJ Financial Group and Mizuho Financial Group have taken similar actions. To introduce another example, when asset management companies, such as BlackRock, have chosen not to support environmental NPOs on their proposals submitted to the AGMs of investee companies urging them to alter their engagement in projects with a high environmental burden, and exercised voting rights in the interests of the companies, such asset management companies were harshly criticized, which forced them to change policies.

Figure 3: Major shareholder proposals related to climate change (filed against financial institutions)

Year	Target company	Proposer	Proposal details	Outcome
2020	Mizuho Financial Group	Kiko Network	Disclose a plan in the annual report describing management strategies for investment and financing, including indicators and targets, aligned with the goals of the Paris Agreement	In response to the proposal, Mizuho promised to stop investment and financing for newly built coal-fired power plants and set targets for lowering the credit balance, etc. However, Kiko Network did not withdraw its proposal and it came to a vote for resolution, but failed to pass with the support of only 34.5% of shareholders.
	JPMorgan	As You Sow	Formulate and publish financing strategies consistent with the goals of the Paris Agreement	The proposal failed to pass with 49.6% of shareholders voting in favor of it.
2021	JPMorgan, Wells Fargo, Citibank, Goldman Sachs, Bank of America	Follow This	Release a report on whether borrowers have the intention to cut GHG emissions towards achieving a net-zero emission, and how they aim to achieve reductions	The proposal was withdrawn as agreements were reached between the proposer and each of the financial institutions.
	Mitsubishi UFJ Financial Group	Kiko Network	Include a provision in the Articles of Incorporation stipulating the requirement to disclose in the annual report the indicators for conducting investing and lending aligned with the goals of the Paris Agreement and management strategies that include short-, medium- and long-term goals	Although Mitsubishi UFJ announced a revision to its financing policies for the coal-fired power generation sector as well as forestry and palm oil sectors, it failed to obtain Kiko Network's approval and Kiko Network filed a shareholder proposal.
	HSBC	15 institutional investors, including Amundi/ShareAction	Strengthen efforts towards decarbonization	The HSBC side presented an action plan for ceasing financing for coal-fired power plants and electricity-use coal development in stages by 2040, and the proposal was withdrawn.
2022	Standard Chartered	Market Forces	Withdraw from the US$400 million co-financing plan for Indonesia's Adaro Energy	Market Forces gave a warning to file a shareholder proposal in 2022 if the bank does not respond within 2021.

Source: Compiled by MGSSI based on materials published by As You Sow, Bloomberg, etc.

To date, ESG activists have not played a leading role in demanding changes from financial institutions. However, it does not mean signs of change are non-existent. TCI Fund Management's founder Christopher Hohn has called on central banks, such as the Bank of England (BoE, the UK's central bank) and the European Central Bank (ECB), to increase the risk weight of financing fossil fuel-related business by banks, with the aim of putting pressure on the banks that provide fossil fuel-related lending and eventually getting them to stop lending to companies that engage in coal-related operations.[3]

POINTS FOR COMPANIES TO CONSIDER

Soaring cost of capital

In December 2020, the US announced its participation in the Network for Greening the Financial System (NGFS), a network of central banks and financial supervisors established to formulate financial supervisory responses to climate change risks. Until then, the US had been the only major country that had not pledged its participation in the network. In addition, the ECB has announced that it will investigate the impact of climate change on management at banks in the eurozone in a stress test scheduled to be conducted in 2022. As such, with central banks increasingly paying close attention to this issue, it is also possible that regulations on bank loans for related business operations will be tightened. For companies engaged in business activities with a large environmental impact, it may become increasingly difficult for them to ensure business continuity as they suffer from the rising cost of shareholders' equity accompanying declining demand (deterioration of business performance) because of heightened environmental awareness, and rising debt costs as a consequence of the suspension of bank loans and downgrading in credit ratings, among other reasons.

[3] As risk-weighted assets increase, the minimum capital adequacy ratio expressed as a percentage of a bank's risk-weighted credit exposures will decrease, and there is a possibility of it falling below the capital adequacy regulation level required under Basel and other standards. In order for banks to avoid this, it will be necessary for them to reduce or stop financing related business operations, resulting in pressure on companies engaging in those activities.

Global initiatives by institutional investor groups and the limitations of their efforts

There are also moves led by institutional investor groups aimed at motivating certain companies to tackle climate change issues. A good example is the global initiative Climate Action 100+ (CA100+), which brings together the climate change initiatives of institutional investors in various regions of the world (Figure 4). Through the CA100+, institutional investors encourage companies that emit large volumes of GHG emissions to take action to meet the goals of the Paris Agreement. In addition, a group of 15 institutional investors, including the major French asset management firm Amundi, has asked major financial institution HSBC to reduce its loans to fossil fuels-related business operators, and HSBC is responding accordingly.

Figure 4: Investor-led climate change initiatives

Initiative	Overview	Operating entity	Supporters, target companies, achievements
Climate Action 100+ (established in 2017)	To ensure the world's biggest corporate GHG emitters take necessary actions to achieve the goals of the Paris Agreement, the following three demands are made to targeted companies: (1) Improve governance of climate change risks and opportunities (2) Reduce GHG emissions in alignment with the goals of the Paris Agreement (3) Strengthen information disclosure, in line with TCFD recommendations	・The Asia Investor Group on Climate Change ・Ceres ・Investor Group on Climate Change ・Institutional Investors Group on Climate Change ・Principles for Responsible Investment (PRI)	The initiative has 575 participating investors, responsible for US$52 trillion in assets under management. It targets 100 companies with large volumes of Scope 1, 2, and 3 emissions as reported through the CDP (collectively, the emissions represent more than 80% of global industrial emissions volume), and an additional 67 selected focus companies contributing to the transition to clean energy, having high financial risks associated with climate change, and considered to be important at the regional and national levels. 167 companies in total (as of June 2021)
Say on Climate (established in 2020)	To improve the transparency of corporate reports on climate change, companies are asked to: (1) Annually disclose information related to GHG emissions (2) Present a plan for controlling emissions (3) Reach resolutions on shareholder proposals regarding the above plan at the AGMs (non-binding advisory resolutions)	The Children's Investment Fund (TCI) / Children's Investment Fund Foundation (CIFF)	ISS and Glass Lewis, two of the world's leading proxy advisory firms, and asset managers BlackRock and Vanguard voted in favor of a TCI-led shareholder proposal related to Spanish airport operator Aena's decarbonization transition plan. In response, Unilever, Nestlé, Glencore, and others voluntarily adopted shareholder proposals on climate change countermeasures.

Source: Compiled by MGSSI based on information on the websites of Climate Action 100+ and Say on Climate

However, environmental NPOs and others have complained about the inadequate response of CA100+, showing that approaches by environmental NPOs and institutional investors are not necessarily aligned. This is a factor that could complicate environmental responses by businesses.

Activists campaigning in non-environmental areas

ESG activists are expanding their reach to not only environmental issues, but also to social challenges, such as human rights. For example, the US asset management firm Trian Partners is urging GE and DuPont to promote workplace diversity and adopt a supplier code of conduct, in addition to demanding to reduce emissions and waste. This trend will likely gain momentum going forward.

Chief objective of ESG activists is to improve corporate value

Engine No. 1's Charlie Penner, who effectively won the battle over board appointments with ExxonMobil, said the fund is not an NPO that is purely seeking a corporate response to environmental issues, and made it clear that the purpose of this action is premised on expectations of the impact on ExxonMobil's performance and stock price. He also expressed a negative view of British oil major BP, which focuses on renewable energy, but is showing markedly sluggish performance. This clearly reflects the nature of ESG activists: Their aim is to expand their own profits by increasing the value of investee companies, which is fundamentally different from environmental NPOs whose ultimate goal is to protect the global environment. Bluebell Capital Partners of the UK asked Danone and Hugo Boss, which have been evaluated highly for their ESG initiatives, to dismiss their CEOs because of poor corporate performance, and with the support of other institutional investors, it managed to succeed in effectuating that. This approach is much the same as the activism of Engine No. 1 in terms of its focus being primarily on corporate value. As a PRI signatory, Bluebell is in a position to call on investee companies to strengthen their ESG initiatives, and it does not mean to negate the attention given to ESG such as that shown by Danone. What is shown by the fund's move is that a commitment to ESG initiatives does not constitute an excuse for companies' poor performance.

As the presence of ESG activists is expected to increase further in the financial markets in the future, based on the notion that environmental and social issues are directly linked to business performance, companies will need to enhance their ability to identify the legitimacy and rationality of ESG activists' assertions, which are likely to become more diversified, and strategically tailor responses to them. As indicative of remarks by Engine No. 1's Penner, businesses should keep in mind that what ESG activists are ultimately pursuing is their own interests, through the improvement of corporate value, and this will hold true even as greater attention is given to ESG.

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