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An Instructive Case Study On ESG Integration Within Tech

How A Leading Canadian Investor Incorporates ESG

Sector:
Information Technology

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This year, ESG-related shareholder proposals increased 37% Y/Y among ~100 of the largest North American tech companies we reviewed. To aid investors as they consider their own approach to ESG, this blog discusses insights into how a prominent Canadian investment firm integrates ESG into its investment process. These findings come from our wide-ranging interview with Jennifer Coulson, BCI's Senior Managing Director of ESG, and should be a helpful case study for investors as they reflect on their own treatment of ESG factors.

All figures in Canadian dollars unless otherwise stated.

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A Leading Investor's ESG Strategy For Tech Investments

BCI's ESG strategy provides a valuable case study of how a prominent investor folds environmental, social and governance factors into its investment decisions. In this blog we share key insights from our interview with Ms. Coulson, Senior Managing Director at BCI and a leading figure in the Canadian ESG space. Victoria-based BCI provides investment services to 11 of BC's public sector pension plans, benefitting over 715,000 pension plan members. As of F2021, it has $211 billion of assets under management (AUM), ~$164 billion of which fall within the public equities department and are part of the focus of Ms. Coulson's team.

The two most actionable pillars of BCI's ESG strategy are integration and influence. These refer to: (1) the integration of ESG factors into the investment process, and (2) the influence of investee companies on ESG issues BCI views as problematic. The conclusions of its integration process provide a layer of risk mitigation to BCI's investments and help prioritize the engagement efforts it pursues with investee companies. These engagement efforts are collaborative with a company's management team and seek to help improve their approach to the ESG issues in focus.

Our discussion revealed that while ESG factors alone won't prevent BCI from investing in a company – unless required by law – industry-specific ESG assessments and active engagement strategies are staples of its public markets investment process. It is noteworthy that many of the themes we discussed also appeared in our proxy analysis of the entire tech industry from November 1. Encouraging companies to reach 30% female representation on boards, including stock-based compensation in employee compensation packages, and encouraging companies to effectively manage their social impact – whether related to misinformation, content moderation or other areas – are examples of some of the best practises we discussed and which investors are encouraged to consider. We conclude this blog with a summary table of these topics, including relevant standardized metrics from the Sustainability Accounting Standards Board (SASB).

Four Central ESG Issues Specific To The Tech Industry

This section discusses what BCI considers to be key ESG risk areas specific to the tech industry. We explore the firm's view on these, and also provide additional context on each topic from SASB's Materiality Map. Our findings are summarized in Exhibit 1, which investors can use as a checklist to guide them on the important tech-related ESG metrics. We have categorized these by topic, along with information on their potential financial and operational impacts.

Integration

Integration at BCI occurs at the pre-investment stage when company-specific ESG assessments are conducted. These comprise metrics that largely align with (although can certainly vary from) those of the SASB Materiality Map, which identifies measurable and industry-specific metrics with potential to impact a company's operating performance or financial condition. SASB does not address traditional corporate governance issues (denoted with red x's in Exhibit 1).

The four key topics BCI focuses on are: Governance (which we consider a two-part issue comprising board composition and voting structure); Social Issues (human capital management, data privacy & security, growing societal influence); and Energy Management & Emissions. Worth noting is that many of these topics also appear in shareholder-backed proposals and proxy voting results.

1 & 2 – Governance: BCI considers board composition a key governance concern for tech companies and seeks 30% female representation on the board. Voting power is another key issue it looks at across all industries, and seeks voting power that is commensurate with economic ownership.

3 – Social Issues: Human capital management, data privacy & security, and tech's growing societal impact are key social issues that BCI examines.

Attracting and retaining tech talent is a challenge for most Canadian tech companies we speak with, and underscores the importance of a sound approach to **human capital management**. It begins with the recognition that employees contribute the intellectual capital that drives a tech company's value creation. With a shortage of technical domestic employees, intense competition and high turnover are rampant factors in the industry. Tech companies that provide employees with significant monetary and non-monetary benefits improve their ability to attract and retain their talent pool. BCI views stock-based compensation (SBC) as integral to ensuring employees at all levels of a company are aligned ("from employees to the executive team") and ensuring they are able to benefit beyond simply collecting a paycheck. Ultimately, providing employees with SBC is beneficial to investors as well, since doing so aligns employee contributions to the firm with shareholder interests, although we recognize that a fine balance must be struck in order to avoid dilution issues. Finally, SASB states that an effective approach to human capital management includes strategies for effectively managing a globally dispersed workforce and for counteracting the low representation of women and minority groups in the industry. Both factors are key because, as SASB states, "a diverse workforce is important for innovation, and helps companies understand the needs of their diverse and global customer base."

Rising systemic risks of data breaches and cyber-attacks lead BCI to encourage companies to adopt best **data privacy & security** practices for managing the risk of financial losses, disruption, and reputational damage that result from failures of IT systems, or failures of data collection, handling and storage. SASB adds that addressing these threats with best practices can also minimize customer churn, remediation expenses, and compliance costs, and limit harm to a firm's brand value. Ignoring these risks could result in heightened regulatory scrutiny of companies with an insufficiently thoughtful approach to user data and security. Additionally, providing user data to governments is another source of reputational risk, since doing so raises concerns that data could be used for censorship and curbing citizens' freedom.

A final social priority for BCI relates to tech companies' **growing influence on social discourse**. This is a rising concern for the investment community and has featured heavily in recent shareholder proposals. Our proxy analysis found numerous proposals, particularly among Big Tech companies, ranging in topic from content moderation to misinformation & disinformation and freedom of expression, among others. SASB found in a recent research project that the mental health of content moderators is an area that presents rising ESG risk to social media platforms, given their reliance on user-generated content. It noted that investor interest in the topic is rising, especially as its social and financial impacts are increasingly revealed, such as in the 2020 $52MM settlement between Facebook and a group of former moderators, its $500MM annual content moderation contract with Accenture, and a suit filed against TikTok by a former moderator.

This growing societal impact has started to extend beyond the confines of social media companies and now includes other tech industries, such as online marketplaces like Shopify. Indeed, early last year, the company cut its ties with Donald Trump (to whom it had provided services for his campaign website) in the aftermath of the US Capitol riot. Other examples include Apple and Google, which in response to the same event pulled the Parler app from their app stores, and Amazon AWS, which suspended its hosting services. SASB concluded that "occasionally, one-off controversies or societal outcries lead to a broader array of tech companies making business decisions akin to content moderation," underscoring the growing importance of a coherent social strategy tech companies must have for managing their social impact.

Exhibit 1 lists a number of metrics investors could use to track a company's approach to managing their social impact, but for added context, we provide a few examples here:

- **Human Capital Management**: Level of employee engagement, as a percentage
- **Data Privacy:** (1) Number of law enforcement requests for user information; (2) number of users whose information was requested; (3) percentage resulting in disclosure
- **Data Security:** (1) Number of data breaches; (2) percentage involving personally identifiable information; (3) number of users affected
- **Techs' Growing Influence:** Description of policies and practices relating to behavioural advertising and user privacy

4 – Energy Management & Emissions represent another ESG-related risk that BCI includes in both its integration and engagement efforts. In fact, on the engagement side, BCI makes an exception for prescriptive shareholder proposals related to climate change, which it will usually support; something it does not do for proposals covering other topics. In particular, BCI will often support proposals that ask companies to align their emission reduction targets with best practices, and proposals that encourage companies to report their climate-related risks using frameworks like those of the Task Force on Climate Related Financial Disclosures (TCFD), SASB, and the CDP Climate Change program. BCI tracks the impact of its engagement efforts through ~40 KPIs. Within emissions, this includes the number of companies with GHG emission reduction targets, that use an internal price on carbon, and that have adopted water usage targets.

SASB also recognizes the importance of energy management, and in particular for cloud companies, the reliance of their rapid scaling abilities on expandable access to data centers. On this topic, SASB recommends that, to minimize any potential disruption to their services, companies ensure they have access to reliable sources of energy and water for cooling purposes. It also notes the importance of having a data center management plan in light of the increased regulatory focus on climate change, and the rising threat that droughts inflict on a company's access to significant local water resources. Example metrics from SASB include:

- **Energy:** Total energy consumed, percentage grid electricity, percentage renewable
- **Water:** Total water withdrawn, total water consumed, percentage of each in regions with *high* or *extremely high* baseline water stress
- **Data Centers:** Discussion of the integration of environmental considerations into strategic planning for data center needs

Exhibit 1: Tech Investor ESG Checklist – Key Issues And Metrics From BCI And SASB, 2022

Metric	BCI's View	SASB Metrics & Commentary On Operational Impact
Governance		
1 – Board Composition	✔ **At least 30%** female board representation	X
2 – Voting Power	✔ Should be **proportional** to economic ownership	X
Social		
3 – Social Issues: Human capital management	✔ **SBC compensation that aligns with shareholder interests** Inclusion of SBC in employee compensation package helpful for recruitment, retention, and aligning employee contributions with shareholder interests	**Example Metrics:** - Level of employee engagement (as %) - % of gender and racial/ethnic group representation for 1) management, 2) technical staff, 3) all other employees **Operational Impact:** 1. Improving employee engagement may influence the recruitment & retention of a diverse workforce, which in turn can help address the current talent shortage in tech and enhance innovation
3 – Social Issues: Data security & privacy	✔ Adoption of best practices to manage risks of financial losses, disruption, and reputational damage resulting from failures of IT systems or failures in data collection, handling and storage.	**Example Metrics:** - # of data breaches, % involving personally identifiable information, # of users affected - Description of approach to identify/address data security risks, including use of third-party cybersecurity standards - Monetary losses from privacy-related legal proceedings due to user privacy issues - List of countries where core products or services are subject to government-required monitoring, blocking, content filtering, or censoring - Number of government requests to remove content; percentage compliance with requests **Operational Impact:** 1. Inadequate prevention, detection & remediation of data security threats can influence customer acquisition and retention, and result in market share erosion and lower demand for company's products. 2. Timely response to data security threats can help protect brand value, and prevent customer turnover. 3. New and emerging data security standards and regulations likely to increase costs of compliance.
3 – Social Issues: Growing influence of tech	✔ **Strategies** for managing their social impact, especially as technology companies provide a central service	**Example Metrics:** - Description of policies/practices related to behavioral advertising & user privacy - Existence of a thoughtful content moderation policy and strategy for supporting workers' mental health[1] **Operational Impact:** 1. Increased costs of compliance associated with varying local laws or government demands related to censorship, with the potential to impact a company's profitability through the loss of users 2. Influence on a company's decision to enter or operate in certain markets 3. A company positions itself to outperform as well as attract and retain top talent through a thoughtful approach to human capital management, including in areas of compensation and workplace safety policies (especially related to the area of content moderation)[1]
Environmental		
4 – Energy Management & Emissions	✔ **# of companies with:** GHG emission reduction targets, using an internal price of carbon, and adoption of water usage targets.	**Example Metrics:** - Total energy consumed, % grid electricity, % renewable energy - Total water withdrawn, consumed, % of regions with *high* or *extremely high* baseline water stress - Discussion of integration of environmental considerations into strategic plan for data center needs **Operational Impact:** 1. Data center management decisions help lower costs, reputational risks, and identify opportunities to increase energy efficiency and use of renewable energy.

[1] Metrics related to content moderation do not come from SASB (the company does not yet provide metrics on this topic), but were created by the authors of this report.

Source: BCI, SASB and CIBC World Markets Inc.

Influence

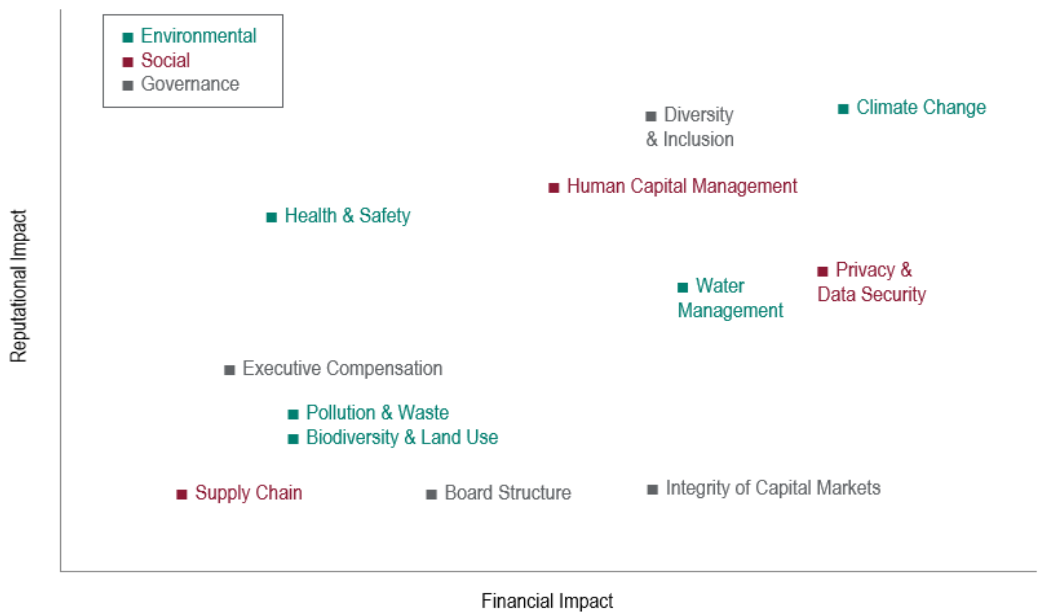
SASB metrics are also used by investors to communicate with and track the performance of investee companies on areas of ESG concern. These engagement efforts – by BCI and other institutional investors – have produced tangible results. In 2021 for example, Amazon released its first Health & Safety report. This followed coordinated engagement activities between BCI and a number of its peers that began in 2019 and included the issue of workforce safety. These efforts represent a portion of the millions of proxy votes that influence key ESG issues within companies.

In particular, BCI prioritizes its engagement activities around a few key topics, including: Diversity & Inclusion, Data Security & Privacy, Climate Change, Human Capital Management and Water Management, although these are not specific to the tech industry. BCI tracks ~40 KPIs to help measure the long-term outcome of its engagement efforts. A few examples where it has seen success include:

- **Say on Pay:** S&P/TSX Composite Index companies that have adopted Say on Pay votes: from 76 (2012) to 163 (2020)
- **Board Diversity:** S&P/TSX Composite Index companies with at least 30% female board representation: from three (2011) to 69 (2021)
- **Emissions:** Companies with GHG emissions reduction targets:
  - **64** (2012) to **78** (2021) of U.S. companies
  - **45** (2012) to **60** (2021) of Canadian companies

We have summarized BCI's priority engagement areas in the chart in Exhibit 2.

Exhibit 2: BCI ESG Materiality Assessment – Focus Engagement Areas, 2020



Source: BCI and CIBC World Markets Inc.

Conclusion

We recommend that investors who would like to integrate ESG factors into their investment decisions consider the four topics we discussed above. Following best practises, by incorporating SBC into employee compensation packages and striving for a diverse workforce, for example, can help companies improve talent attraction and retention. Additionally, having well thought-out policies on data security & privacy, social issues, and data center management are also beneficial for companies and may reduce expenses that might arise from cyber attacks, a disruption in cloud-based services, and reputational risk events, among others.

For further reading on the rising wave of ESG within the tech industry, please refer to our report "Ignore ESG Within Tech At Your Own Peril" published on November 1.

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