Germany: Looking Ahead to the 2021 AGM Season Through an ESG Lens

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Executive Summary

The phrase 'expect the unexpected' accurately describes the happenings of the 2020 Annual General Meeting season. This year has seen companies trying to navigate their way through a global pandemic, with workforces being forced to abandon their offices and work from home, large organisations suffering unexpected losses, and national lockdowns that have impacted not just balance sheets but also the way companies and stakeholders communicate.

Alongside the pandemic, we witnessed the tragic events in the USA with the murder of George Floyd in May, which gave rise to the Black Lives Matter (BLM) movement.

In light of these global events, the International Corporate Governance Network (ICGN) published its Statement of Shared Governance Responsibilities in April, and a statement on racial discrimination in May, highlighting: "the Covid-19 pandemic has ignited an acute recognition of social failures and deep gender, income and racial inequality worldwide. The murderous death of George Floyd and the ensuing protests in cities across the United States and around the globe provide a stark demonstration of what it means to ignore inequality, human rights and the fundamental lack of justice and fairness in society. Investment institutions and companies cannot divorce themselves from this social and historical context."[1]

Consequently, though the market had already anticipated that Environmental, Social and Governance (ESG) factors would become increasingly important for investors in 2020, what became apparent during the pandemic and through the BLM movement is that the discussion of the 'E' and the 'S' would take centre stage in 2021.

As a result, IHS Markit has reviewed the 2020 AGM season in Germany through an ESG lens, to give an insight into how this year's events have refocused the way investors view ESG measures, and how this will impact engagements between companies and their shareholders, and ultimately voting decisions at AGMs in 2021.

1 https://www.icgn.org/sites/default/files/4.%2003_June%20ICGN%20Press%20Release_%20Racial%20Discrimination.pdf

Key Takeaways

- Items on German AGM agendas that received a significant amount of dissent in 2020 were Supervisory Board elections and Capital Increase items
- Changes to the Shareholder Rights Directive II will make the vote on the remuneration policy and the remuneration report mandatory in 2021
- Investors will expect companies to switch to a hybrid AGM format once it is safe to do so
- Institutional investors are expected to focus on environmental and social topics during engagements in 2021
- Key institutional investors plan to take voting action against climate inaction in 2021
- German companies will be expected to increase gender diversity on boards in order to comply with the new mandatory female boardroom quota
- Investors will expect German companies to make efforts to increase racial diversity on boards.

Key Governance Developments

Implementation of the Shareholder Rights Directive II

The revised Shareholder Rights Directive II (SRD II) seeks to reinforce effective and long-term shareholder engagement and monitoring of company performance.

There are three notable changes introduced by the SRD II:

Related Party Transactions

Companies will need to establish an effective process for the identification and correct treatment of related party transactions, as well as ensuring that relevant transactions are approved by the independent board members and announced to the public. If an issuer or its subsidiary enters into a related party transaction, an announcement must be made at the time the terms are agreed and the board must approve the transaction before it is entered into. There are exemptions for transactions which are in the ordinary course of business and on normal market terms.

Directors' Pay Rules

The SRD II introduces new say-on-pay votes, one on the remuneration policy and one on the remuneration report. These votes will become mandatory in 2021. Additionally, the vote on the remuneration policy will be held at least every four years, rather than only upon the implementation of amendments.

During the 2020 proxy season, investors were critical of companies which did not have votes on the remuneration report as advised by the SRD II.

Companies such as Deutsche Börse and Rheinmetall, which saw dissent rates of 34%[2] and 56%[3]

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2 https://www.deutsche-boerse.com/resource/blob/2011042/d79953ad55a29f95c0826ef970ebf245/data/agm2020-results_en.pdf

3 https://ir.rheinmetall.com/rheinmetall/pdf/hv2020/Abstimmungspraesentation_virtuelle_HV2020_200520_EN.pdf

respectively on their 2020 Executive remuneration proposals, will likely be expected to put a revised proposal to the vote at their 2021 AGMs.

Additionally, in 2021, companies will be expected to comply with new miscellaneous requirements, such as increased website disclosure of remuneration reports.

Transparency on Shareholder Engagement

The SRD II requires much greater transparency on shareholder engagement activities, asset management mandates and investment strategies for asset managers and institutional investors investing in listed companies. Companies now also have the right to identify their shareholders. This creates an obligation on intermediaries to transmit the necessary information to determine shareholder identity.

The Introduction of Virtual AGMs

As a response to the pandemic, many jurisdictions including Germany passed emergency legislation that allowed corporations to switch to a virtual format in order to conduct their shareholder meetings. For many issuers and investors, this was seen as a positive change, as even prior to the pandemic it was not possible for all investors to attend AGMs in person.

Common reasons that make it difficult for institutional investors to attend physical meetings are the sheer volume of meetings being voted by their teams on a daily basis during proxy season, coupled with the fact that, with global portfolios, it is not always possible or feasible to travel to the country where the meeting is taking place.

On the contrary, virtual AGMs allow institutional and retail investors all over the world to participate via a webcast, making the meetings accessible to a wider pool of investors by removing the geographical barriers, travel costs and other requirements related to physical participation.

At the same time, some investors have criticised the virtual format for general meetings, on the basis that such a format poses restrictions on essential shareholder rights such as the right to question and challenge the board and management.

Nevertheless, it is important to note that virtual general meetings held by German companies have been successful in terms of quorum levels. Henkel's AGM held in June had a capital presence with voting rights of 90%,[4] whilst SAP and Bayer were also able to reach a quorum similar to that of previous years, indicating that the change of format did not have an impact on shareholder participation at AGMs.

As we prepare for 2021 proxy season, one thing is for sure: virtual general meetings are here to stay. However, many shareholders expect companies to revert to a hybrid format when it is safe to do so, as this would allow for meaningful engagement between investors and boards at the physical meeting, whilst also accommodating participation via webcast.

As a short-term solution, and to address the criticism regarding lack of issuer-investor interaction at virtual meetings, companies should explore the possibility of holding virtual Q&A sessions, to give shareholders the opportunity to voice their opinions at the meeting.

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4 https://personal-financial.com/2020/08/19/the-virtual-general-meeting-needs-to-be-improved/

Environmental Focus for 2021: Climate Change

Due to increased investor expectations on companies and asset managers to do the right thing when it comes to the environment, climate change has become a key priority for many major institutions, such as BlackRock and Vanguard.

Earlier this year, BlackRock announced that it would crack down on companies that were not doing enough regarding climate change. In his letter to company CEOs, Larry Fink (CEO of BlackRock) highlighted: "Climate change has become a defining factor in companies' long-term prospects. Last September, when millions of people took to the streets to demand action on climate change, many of them emphasized the significant and lasting impact that it will have on economic growth and prosperity – a risk that markets to date have been slower to reflect. But awareness is rapidly changing, and I believe we are on the edge of a fundamental reshaping of finance".[5]

Furthermore, Glenn Booraem, Head of Investment Stewardship at Vanguard, recently said that climate change "is getting increasing attention at every level of the market" and confirmed that Vanguard's views on climate and its proxy votes reflect the dominant voice among investors and companies that issuers need to be held accountable for their inaction regarding climate change.[6] Vanguard also acknowledges that some companies play a larger role in the climate crisis than others.

Thus, in 2019, Vanguard engaged with more than 250 companies in carbon-intensive industries.[7] Companies for which climate risk is a direct material risk, Vanguard expects boards to be climate competent and to maintain oversight and informed perspectives that are independent of management. Vanguard also expects effective disclosure of climate risks using investor-oriented frameworks such as those promoted by the Task Force on Climate-related Financial Disclosures.

Companies should therefore be prepared to disclose details of their climate change efforts during investor engagements in 2021.

5 https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter

6 https://uk.reuters.com/article/uk-climatechange-vanguard-exclusive/exclusive-vanguard-names-names-and-backs-some-calls-for-climate-steps-idUKKBN23P1T7

7 https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/ISHVAC_062020.pdf

Social Focus for 2021: Racial and Gender Diversity

This year, it has become apparent that social aspects are as common as environmental and governance factors in contributing to business risk and, in turn, causing lasting damage to a company's reputation. Companies that had already implemented ESG considerations within their pre-Covid business strategy have done better at surviving during these times than those companies which had previously overlooked ESG.

Since the start of the pandemic, investors have been questioning companies regarding the measures they have put in place to protect their employees and their supply chains. What's more, with the rise of the Black Lives Matter movement, investors are increasingly interested in learning about the efforts companies are making to ensure racial diversity within their organisation.

Research repeatedly shows that companies with diversity in senior leadership has a positive impact on the company's performance, with companies significantly outperforming their all-white, all-male counterparts. Such companies generate better financial performance and stronger innovation.

It therefore comes as no surprise that institutional investors are putting pressure on companies to do more with regard to racial diversity. State Street Global Advisors (SSGA) recently published an open letter, in which its Global Chief Investment Officer Richard F. Lacaille called on the companies it invests in to become more racially and ethnically diverse, and to disclose their strategies for doing so. Effective 2021, SSGA "will ask companies in (its) investment portfolio to articulate their risks, goals and strategy as related to racial and ethnic diversity, and to make relevant disclosure available to shareholders".[8]

In Germany, there is an evident lack of racial diversity within the senior management of organisations. In fact, Germany has only had one prominent Black executive in recent times: Janina Kugel, former Chief Human Resources Officer at Siemens.[9]

Furthermore, when it comes to gender diversity, whilst globally, more and more executive teams are increasing their female representation, none of Germany's DAX 30 companies have a female CEO or reach a proportion of 30% women on their executive boards[10]. In fact, women make up just 12.8%[11] of the management boards of the DAX 30 companies.

Additionally, Germany is one of the only major economies which has seen a decline in female representation on boards, with personal and professional lives merging during the pandemic, as well as historical issues of females having to break the glass ceiling, being named as contributing factors for the decline.

The new mandatory female boardroom quota agreed in November 2020 by the German government therefore comes as a much-needed breakthrough. The female quota requires listed companies with more than three members on their management boards to have at least one woman on the board. For companies in which the German government owns a majority stake, a minimum 30% of supervisory board positions will be required to be filled by women.[12]

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8 https://execcomp.org/News/NewsStories/state-street-new-policies-focused-on-racial-and-ethnic-diversity-improvements

9 https://fortune.com/2020/06/19/corporate-germany-race-diversity-data/

10 https://static1.squarespace.com/static/5c7e8528f4755a0bedc3f8f1/t/5f85ac5ec02756262f2b0f9f/1602595950169/Allbrightbericht-Nr.9-Abstract.pdf

11 Ibid

12 https://www.theguardian.com/business/2020/nov/22/germany-agrees-historic-mandatory-boardroom-quota-for-women

The new mandatory female quota, coupled with the fact that an increasing number of institutional investors have amended their proxy voting guidelines to highlight their stance regarding board diversity, will require German corporates to rapidly address and make efforts to reverse the negative diversity trends in 2021.

Consequently, next year, German companies should be prepared to enter into engagements with investors where they may be questioned regarding the company's strategy to improve racial and gender diversity, and the efforts being made to ensure diverse talent is not only secured but also successfully retained.

Governance Focus: Significant Dissent in 2020

Supervisory Board Elections

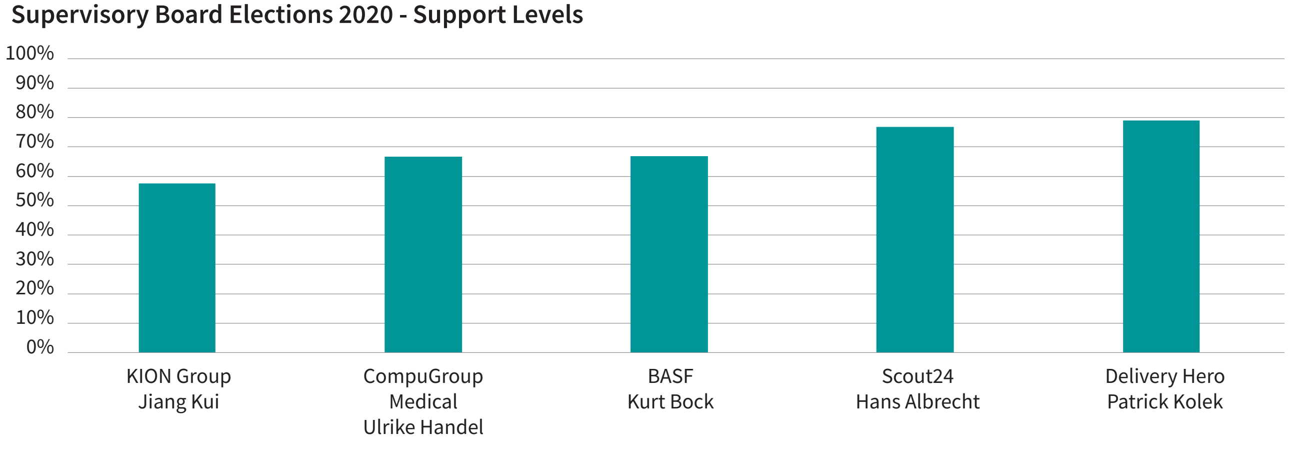
During the 2020 proxy season, one of the key areas for dissent were board elections. Proxy advisors like ISS and Glass Lewis recommended against many board election items, mainly due to concerns regarding board independence and director overboarding.

Key Concerns

BlackRock voted against Director Elections at several German meetings, as it held directors sitting on or chairing committees accountable for issues such as the lack of independence on the board, lack of diversity, and poor board composition.

Norges also voted against a few Director Elections at German meetings due to concerns regarding independence. Most notably, Norges voted against several Director Elections at the CompuGroup AGM, giving the rationale that "the board should guide company strategy and monitor management performance without conflicts of interest. A majority of shareholder-elected board members in a non-controlled company should be independent of management, dominant shareholders, and related third parties. In a majority-controlled company, at least a third of board members should be independent."

The below graph shows key Supervisory Board election items this year with support levels that imply significant dissent among key investors:



- **Delivery Hero**
  The Election of Patrick Kolek to the Supervisory Board achieved 78.91% support. ISS recommended a vote against Kolek, as he was considered to be non-independent and was also the Chair of the Audit Committee. Glass Lewis also recommended a vote against Kolek, highlighting that he was the Chief Operating Officer of Naspers Limited (which beneficially owns 22.17% of Delivery Hero's share capital) and also serving as the Chair of the company's Audit Committee. The German Corporate Governance Code recommends that the Audit Committee Chair should be independent and should not have been a former member of the Management Board within the past two years.
- **BASF**
  At the BASF AGM, Kurt Bock received 66.81% overall support from investors which indicates significant dissent among shareholders. Although ISS and Glass Lewis were in favour of Bock's election, key investors did not support this item, largely due to their internal policies. BlackRock was one such investor which voted against Bock, due to him serving on an excessive number of public company boards which they believed raised substantial concerns about the director's ability to exercise sufficient oversight on the board.

Capital Increase

In April 2020, the ICGN issued a statement[13] regarding capital allocation, encouraging its members to "share the pain" of the pandemic with their investee companies, as companies were forced to make important and difficult capital-related decisions. ICGN members were advised to deviate from stringent internal guidelines relating to capital allocation as needed, in order to allow investee companies to make decisions that would enable them to weather the storm.

Whilst this viewpoint was shared with some of the largest institutional investors, IHS Markit observed little leniency when it came to voting, resulting in capital increase items on the AGM agendas of many German companies receiving significant dissent.

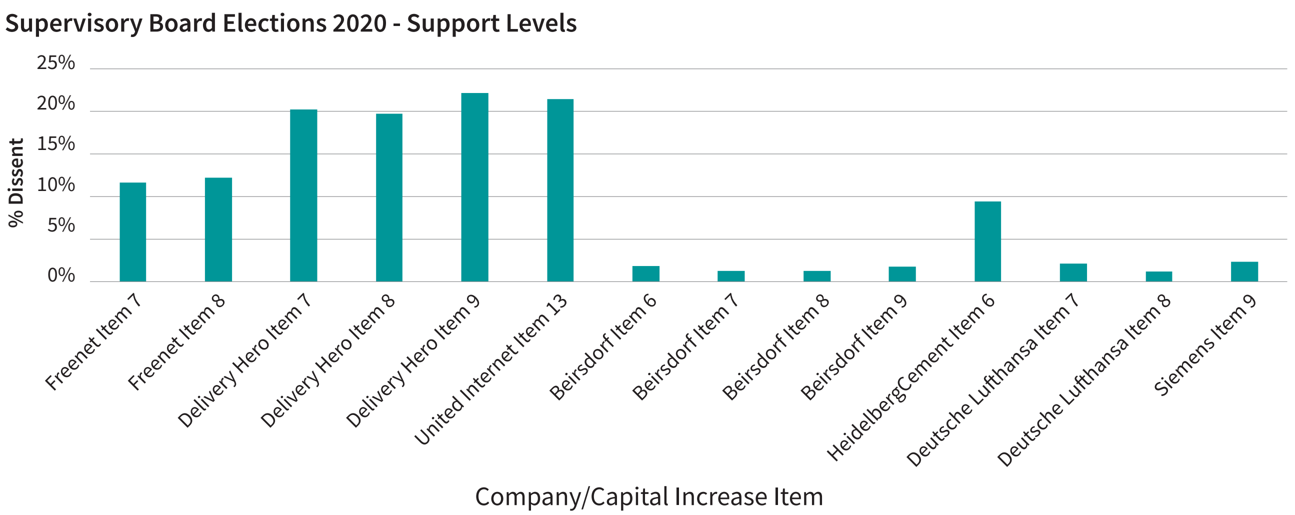
Key Concerns

BlackRock did not support the proposal to create capital with partial exclusion of pre-emptive rights at Zalando's 2020 AGM, on the basis that the proposal would result in excessive dilution. In general, in Germany BlackRock may vote against resolutions seeking authority to issue capital if the amount requested is above 10% of the issued capital without pre-emptive rights.

13 https://www.icgn.org/covid-19-and-capital-allocation

Furthermore, DWS also expressed their concerns prior to Zalando's AGM in the form of a letter[14] sent to the company, asking: "What is the capital strategy behind [the capital increase] proposals?", adding that a 69.5% increase of the share capital seemed too high and would therefore warrant a vote against the proposal.

The below graph shows the level of dissent received for key capital increase items this year at the AGMs of German companies:



- **Delivery Hero**
  As per the above graph, Delivery Hero received a high level of dissent for all three capital increase items at its 2020 AGM, particularly Item 9, which received 22.19% dissent, with proxy advisors ISS and Glass Lewis also recommending against the company's capital increase.

A key investor, Norges Bank, voted against all three capital increase items on the company's agenda, highlighting that "existing shareholders should have the right to approve share issuances in order to prevent the dilution of ownership without their prior consent. Existing shareholders should have the right to participate pro rata to maintain their voting share and benefit from any discount offered. The approval for a general authority should be reasonably close in time to the intended capital allocation to allow for an informed voting decision."[15]

14 https://www.dws.com/AssetDownload/Index?assetGuid=8005568d-d967-455c-ba6a-980a59ae3f8a&consumer=E-Library

15 https://www.nbim.no/en/the-fund/responsible-investment/our-voting-records/meeting/?s=DE000A2E4K43&m=1398614&c=5643915

Recommendations to Companies for 2021

The after-effects of the global pandemic are expected to be felt by companies in 2021, with German issuers needing the continued support of their shareholders in order to make decisions that will help them stay afloat.

With the rise of the ‘S’ in ESG, German companies must be prepared to address social topics, such as racial and gender diversity. It is clear that Germany is lagging behind when it comes to matters concerning racial and gender diversity, and companies should be prepared to discuss their diversity strategy to ensure they are actively making efforts to increase female representation at senior management level.

In addition, during the last months of 2020, IHS Markit has observed that investors are actively reaching out to companies to address concerns and understand the company perspective on the following topics:

Board Accountability:

- What lessons has the board learnt from the pandemic and what changes might be implemented going forward?
- What efforts has the board made to minimise the impact of the pandemic on the company’s workforce and supply chain?

Human Capital Management:

- What measures have been taken during the pandemic to facilitate the work from home transition?
- What is the long-term strategy in relation to human capital?

Long-Term Value Creation

- How is the company planning for long-term resilience in terms of the company’s capital allocation?
- How is the company contributing to the UN’s Sustainable Development Goals?

In order to mitigate key concerns that may result in dissent at the next AGM, companies need to engage with their investors ahead of time, keeping in mind that key institutions are often unavailable for engagements during proxy season. Thus, organising a roadshow at the beginning of the year and conducting an agenda analysis to identify potential against votes ahead of the AGM can be effective ways of addressing shareholder concerns and securing support for 2021.

IHS Markit believes in working with clients to assist them in building stronger and better relationships with their investors. We understand the needs of key institutional investors and can in turn help German issuers to better understand how to effectively communicate key messages to their investor base, in order to win shareholder support. We expect 2021 to be an exciting year and look forward to working with our clients, both old and new, to build better relationships and win shareholder support for the 2021 proxy season.

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