Insight Paper

ESG Share Buybacks

Summary for Financial Departments

Benedicte Thibord, 29 June 2021

"*Michelle, ma belle, these are words that go together well*." However, share buybacks and ESG, these are words that do not traditionally go together very well…

How can share buybacks integrate an ESG component and allow companies to adopt a more inclusive approach by meeting the needs of all of their various stakeholders? The recent examples of BIC, CAMPARI and ENEL, which have launched ESG share buybacks, invite us to reconsider the role of this financial instrument.

The objective of this article is to explain the ESG share buyback, to position it in the context of strong growth in ESG assets under management, and address the main success factors. We also surveyed a panel of institutional investors for this article and asked them their views of this initiative.

1. What is an ESG Share Buyback?

The concept of the ESG share buyback is that a company allocates part of the outperformance of its share buyback to the funding of an ESG project, in line with its ESG values and commitments.

What do we mean by outperformance? To put it simply, there are two main types of share buybacks: i) a "**best efforts**" share buyback ii) a so-called "**optimized agency**" share buyback, usually with a guaranteed discount and / or outperformance sharing arrangement. An ESG share buy-back only works in the second case.

In the **"best efforts"** case, the bank buys the company's shares at market price, within the volume limits provided for by regulation and according to the authorizations of the Shareholder's Meeting. This type of structure does not generally allow outperformance.

In an "**optimized agency**" buyback, the bank guarantees to the company, up front, a fixed discount in the price of shares acquired versus the average VWAP (Volume Weighted Average Price) over the period. Therefore, at the end of the period, the company will have purchased its own shares at a price which is equal to the average VWAP over the period minus this guaranteed discount.

Let's take a practical example:
Company A wishes to launch a share buyback program for EUR200m.
Under a "Best Efforts" structure, the cost of the share buyback for the company will be the amount of its program (EUR200m) plus the bank's fixed brokerage rate.
In an "Optimized Agency" structure, let's assume that the guaranteed discount is 100bps. The guaranteed outperformance will amount to EUR2m. The maximum net cost for the company will therefore be EUR198m.

Ordinarily, this outperformance is returned to the company. In the context of an ESG share buyback, this outperformance is allocated in whole or in part to the funding of an ESG project.

Thus far we have observed two types of ESG share buybacks:

"Non KPI linked": in this case, the allocation of the outperformance to the funding of the ESG project can be unconditionally determined in advance.

Take the case of the **BIC** ESG share buyback launched in March 2021: the outperformance of the share buyback is unconditionally allocated on the one hand to the funding of an educational research project led by J-Pal, and on the other hand to that of projects led by the BIC foundation.

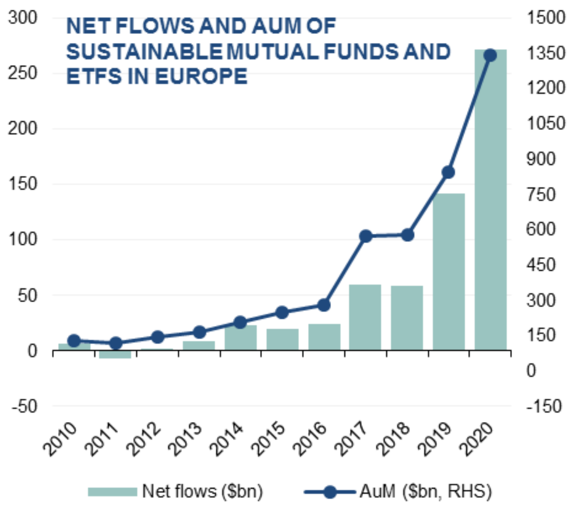
It's also the case for **Campari** in May 2021: *"An amount deriving from the outperformance in the purchase cost of the shares during the Programme will be allocated by Campari to an energy efficiency project, namely the installation of photovoltaic panels in Campari's main plant located in Italy (Novi Ligure). This will allow the Company to insource the production of renewable electricity and reduce emissions, in line with Campari Group's energy efficiency and decarbonisation agenda. By introducing this additional initiative, Campari reaffirmed its strong commitment to the responsible use of resources and the reduction of the environmental impact of its production activities, one of the four pillars of Campari Group's sustainability roadmap."*

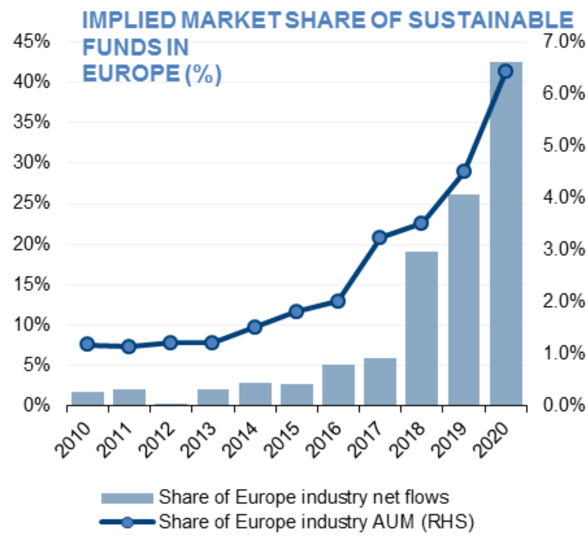
"KPI linked": in this case, the allocation of the outperformance to the funding of the ESG project is conditional on the achievement of ESG criteria at a timeframe fixed in advance by the company.

Take the example of the **ENEL** share buyback launched in June 2020. ENEL set itself an ESG related KPI to meet within a predetermined time frame. The discount on its ESG SBB was put in place as a failsafe in the event this KPI was not met. The discount monies would finance a reforestation project, thereby ensuring good ESG governance was observed in all outcomes.

2. Why is this initiative so well suited to the current market context?

A number of market trends are combining to push companies to make ESG a strategic priority. These include i) the strong rise of ESG asset management (as illustrated by the graphs below), ii) the increasingly systematic integration of ESG into the investment criteria and brokers' research methodologies iii) the development of ESG rating agencies and iv) growing regulatory pressures. Gone are the days when ESG was covered superficially in sustainability reports.





source : Exane BNP Paribas

In this context, integrating an ESG component into the share buyback program can make a lot of sense for companies particularly those committed to the implementation of a comprehensive ESG strategy, as illustrated by the quotes from investors below:

“For a company, I understand the symbolic value of the proposal: optimizing the share buyback and considering this optimization as a gain that can be allocated to others than the shareholders, it is a good way to feel useful and share."
Family Office, France

"The ESG Share Buyback is an excellent initiative"
Long Only, USA

"This can allow a lot of responsible projects to become a reality and allow companies to really integrate CSR into everything they do. The share buybacks will continue no matter what, as will the discount; so it is not illogical for this discount to be allocated to one or more responsible projects. "
Private Bank, France

3. What ESG plan for the ESG share buyback?

One of the key questions that must be addressed by companies wishing to implement an ESG share buyback program is the choice of the ESG project.

In general, the launch of an ESG share buyback should be part of the company's overall ESG strategy, depending on the relative importance of "**E**nvironment" or "**S**ocial" topics in its priority commitments.

BIC's press release on the launch of its ESG share buyback program illustrates this well.
“This program is consistent with BIC's vision and mission to create and share value with all stakeholders. The outperformance in purchasing the share over the program's execution will be allocated to the Abdul Latif Jameel Poverty Action Lab (J-PAL), the global research center led by professors Abhijit Banerjee, Esther Duflo, and Ben Olken, and the BIC Corporation Foundation for Education.”

For a presentation of **J-Pal** and the diversity of its ESG research projects by Cillian Nolan, Director of Policy, J-Pal Europe, watch this video **(17’)**

On the basis of the survey carried out among investors, one of their main observations is that the ESG project should be defined **precisely** in order to generate the greatest positive market impact**.**

“I think this is a good and promising initiative. I think that the ESG discount should in this case be allocated to a specific project (and not to various projects of a foundation). The question increasingly arises as to whether it is better to contribute to various causes directly by choosing projects or indirectly by supporting multiple biases like this one. A specific and identified ESG project is therefore preferable."
Private Bank, France

Two investors also mentioned that the ESG share buyback was a good opportunity to **focus on social engagement** or their **philanthropic initiatives.** The reference to social commitment makes sense, in particular, in the context of the ‘Devoir de vigilance’, implemented in France in 2017, currently under discussion at European level.

"It is an excellent approach because it emphasizes social engagement. Everyone only looks at CO2. The process must be more inclusive. It has to be very well explained so that the company is not accused of Greenwashing. "

Long Only, France

“The initiative is original and undoubtedly something that companies can promote in their philanthropic initiatives."

Long Only, UK

4. In practice, is the ESG share buyback more difficult to implement than a traditional share buyback? What are the key success factors for a company wishing to launch an ESG share buyback?

The ESG share buyback is no more complicated to implement than a traditional share buyback. However, two elements must be taken into account:

First, the ESG share buyback involves an "Optimized Agency" structure with (generally) guaranteed discount and / or outperformance sharing. The important thing to keep in mind is that the longer the duration of the share buyback, the greater the guaranteed discount or possible outperformance of the share buyback.
Starting an ESG share buyback program therefore involves **allocating time to the program**. For a company for which the speed of execution of its buyback program would be the number one priority, a guaranteed discount structure is probably not the most optimal.

The other important element to take into account is the **human factor**. The completion of a traditional share buyback is generally carried out by the treasury and investor relations departments in conjunction with the legal department. In the context of an ESG share buyback, this should be considered as more of a group wide project in nature. Firstly it will generally supported by the Board of Directors. However, it will also involve the ESG department as well as the corporate / press / internal communication teams and Human Resources. Each team will be able to leverage the initiative with its various target audiences, in particular employees (especially if the ESG project includes a social component), the press, ESG rating agencies, investors & analysts.

The testimony of **Sophie Palliez,** VP Corporate Stakeholder of BIC, is particularly enlightening on the subject: Watch video **(10’)**

The last point to highlight is the flexibility of the ESG share buyback at two levels:

1) **The choice of the ESG project:** Some companies chose to finance an ESG project led by their foundation (like BIC for example), while others choose to finance an ESG research project led by J -Pal (like BIC also) or a different project led by an association external to the company (like ENEL for example);

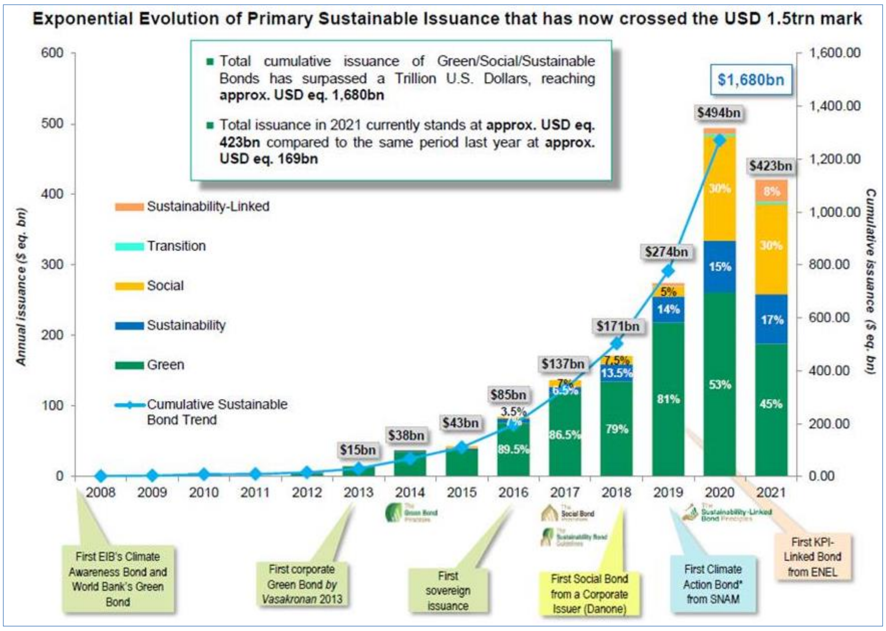
2) **The share of the outperformance allocated to financing the ESG project:** Some companies choose to allocate 100% of the outperformance, others only a part. It may depend on the size of the share buyback program, as well as a company’s priorities over capital allocation.

Legally, the ESG component can be mentioned in the share buyback mandate, it being specified that the agreement between the company and the foundation and / or association that carries the ESG project is addressed in separate documentation.

From an accounting perspective, the ESG share buyback does not involve a sophisticated IFRS entry. The allocation of the outperformance of the share buyback to the ESG project is simply recorded as an expense which in turn becomes the source of financing of the ESG project, provided directly by the company.

In terms of ESG financing it would be remiss not to mention the growth in Sustainable Bonds. According to Bloomberg, the total cumulative issuance of Green/Social/Sustainable Bonds has surpassed 1trillion US Dollars, reaching approximatively $1.68tn. The ESG share buyback projects launched by BNP Paribas and Exane BNP Paribas in 2021 are ground-breaking in Europe. We believe ESG share buybacks could be an important additional vehicle through which corporates work to balance wealth sharing between its different stakeholders.

Will ESG share buybacks take off in the way that Sustainable Bonds have? It is far too early to make any clear predictions. On the other hand, the comments of a Corporate Treasurer who recently shared his feedback on ESG share buybacks suggest they have a promising future: *"The ESG share buyback is simple to implement and easy to explain internally and externally. It fits perfectly into an overall ESG policy."*



Source: Bloomberg/BNP Paribas

EXANE BNP PARIBAS