# AB SUSTAINABLE GLOBAL THEMATIC PORTFOLIO

## ENGAGEMENT REPORT: 2018

During 2018, AB Portfolio Managers and analysts engaged with the senior management and/or boards of directors of 31 companies in the Sustainable Global Thematic portfolio, for a total number of engagements of 43.

Summary reports of a selection of our engagements with companies during the year follow below.

## EXAMPLE ENGAGEMENTS ON ENVIRONMENTAL ISSUES

During the period, we had a conversation with Kingspan.

+ **Kingspan** (building materials company). We spoke with Kingspan's CEO to learn more about key material ESG issues at the company, including environmental impact, health & safety and labor relations.

Insulated panel and board manufacturing is inherently an energy-intensive process and can therefore result in significant carbon emissions. Kingspan pursues a number of initiatives to reduce its energy use and to reduce the carbon intensity of its energy consumption. Most notable is the company's decision to shift toward the use of 100% renewable, zero-carbon energy by 2020. Kingspan is on track, having reached 80% zero-carbon energy in 2018, up from 69% in 2017.

Insulation manufacturing involves the use of toxic materials, including formaldehyde, which can pose a health risk to both the employees involved in the manufacturing process as well as the end consumer without proper management of these materials. The company is conducting research and development in an effort to produce formaldehyde-free insulation panels and boards, which, if successful, could reduce the toxic material risk exposure and create a differentiated, superior product compared with that of competitors, potentially driving market share gains and stronger organic revenue growth.

Kingspan's team of chemical engineers and scientists is critical to developing superior-performing products. This team is a critical competitive advantage for Kingspan. Since highly skilled people are very important to the future success of the company, we spoke with the CEO about human capital development issues, specifically what the company does to attract and retain talented employees. One important thing that Kingspan put in place to manage risk of poor retention is to provide deep employee stock ownership, which helps align employee incentives with those of shareholders. Since its initial public offering in 1989, Kingspan has included every employee in its employee stock ownership program.

## EXAMPLE ENGAGEMENTS ON SOCIAL ISSUES

We discussed social issues with management of ICON and Medidata. In some cases we discussed governance issues such as compensation.

+ **ICON** (clinical-trial-related services provider). We engaged with the vice president of finance and investor relations of ICON during the period. ICON is a Dublin-based provider of clinical-trial-related services for the pharmaceutical industry. Despite going public two decades ago and having a market capitalization of over US$7 billion, ICON is not covered by MSCI and does not have an ESG rating from any major third-party ESG research provider. According to investor relations, ESG-related issues are not a significant focus at ICON's investor meetings but have slowly become more pertinent over time. Management noted that the company is doing a lot of what needs to be done to get a rating and expects ICON's engagement with third-party research firms to continue to increase over time. We explained to management that while we don't rely exclusively on MSCI's ratings, we find them to be helpful aggregators of ESG-related metrics and performance, which are helpful inputs to our investment process. We expect ICON's engagement with ESG research firms to lead to an eventual rating.

ICON operates a consulting business, and clinical expertise and experience and strong relationships with trial sponsors and trial sites are the company's primary asset. Not surprisingly, personnel costs are the company's largest expense. Given how competitive the industry is and how the number of drugs in pharmaceutical companies' pipelines continues to grow while trial recruitment timelines continue to stretch longer, we would consider the cost-effective retention of high-quality staff to be a key social risk and the largest ESG risk for ICON. ICON has extensive internal training programs that are designed to enhance career development for employees. ICON has over 3,000 training programs, including a partnership with University College Dublin for executive leadership courses in areas such as financial management and business operations. Out of ICON's 13,250 total full-time employee base, approximately 2,000 managers, directors and vice presidents would be entitled to these management training programs. Many of ICON's clinical research associates (CRAs)—who are actively involved in clinical trial management—are highly educated single women in their 20s and 30s. As the job of a CRA requires an extensive amount of travel time, ICON's internal training programs provide a valuable conduit for talented CRAs that wish to transition to a management role. The benefit to ICON is two-fold: the company can retain expertise, and employees receive valuable training that contributes to the retention of those managers' direct reports. Overall employee attrition at ICON is in the 13%-14% range, which has come down from 15%-16% in recent years. Management believes that the company is well positioned to retain and attract talent relative to industry peers, many of which are experiencing disruptions caused by large-scale M&A activity as the contract research organization industry has consolidated in recent years.

Every employee at ICON is eligible for a bonus plan. Furthermore, restricted stock units—which vest over a three-year period—are part of the compensation plan for managers and above. Equity grants for senior executives are based on hitting earnings-per-share target ranges over rolling three-year performance-measurement periods, with flexibility to alter the payout midway through the period. We asked the company for more disclosures around these plans and the metrics, and whether it would consider adding/using a metric that would incorporate returns ICON generates relative to its balance sheet. Management seemed receptive. On a positive note, ICON does have share ownership guidelines for senior executives, which are approximately 50%-100% of salary. The senior leadership team and succession at ICON have been unusually steady in recent years.

ICON has taken steps to bolster its IT security to mitigate the risk of unauthorized data access/theft. The company has employed a data protection officer since 2009, maintains an IT security council that provides direct updates to the company's board on a quarterly basis and has had its information security management system certified under ISO 27001. Unlike other repositories of healthcare records, much of ICON's data is anonymized, given the blinded aspect of clinical trials.

In the absence of external ESG research on the company, our conversation with management provided helpful insight into ICON's strategy to mitigate ESG risks, particularly those related to attracting and retaining human capital. We assign the company a relatively low risk score.

+ **Medidata** (software-as-a-service solution provider for clinical trials). During the period, we met with management of Medidata, including the CEO/co-founder, the president/co-founder and the CFO. We discussed the topic of diversity and inclusion, highlighting at the time that the company had no women on its board of directors. The CEO agreed with us about the importance of diversity and inclusion at all levels of the company and commented that Medidata's executive team planned to make improvements in the near future.

Since then, the company made some significant announcements, including its increased focus on corporate responsibility. It signed a number of pledges related to diversity and inclusion, such as the 2020 Pledge, through which the company aims to have at least 20% of its board be female by 2020. Toward that effort, the company appointed a new female member, Dr. Maria Rivas, to its board in the fall.

We believe that Dr. Rivas's experience and perspective should make her a valuable contributor to Medidata's board. She has built and led global teams of 2,000 medical, research, safety, communications and compliance professionals in over 90 countries. She has experience launching new products. Additionally, she has served as a senior executive in S&P 500 Index companies for nearly two decades.

## EXAMPLE ENGAGEMENTS ON GOVERNANCE ISSUES

We engaged with the leadership of Bruker and Xylem on governance issues.

+ **Bruker** (scientific instrument manufacturer). We met with the new head of investor relations at Bruker. Bruker has an A rating from MSCI and is still run by a member of the founding family, which owns approximately 34% of the company. We believe that this provides some alignment of interests between management and long-term external shareholders. The company is considered a leading provider of high-quality instruments in niche areas of particle analysis, and per the MSCI report, has issued just one product recall in the past six years. Although MSCI notes that Bruker lags its peers in terms of its effort to reduce its carbon footprint, the report acknowledges that "exposure to risks of rising costs associated with carbon regulation is low" and Bruker "faces limited exposure to risks of compliance costs stemming from new or more stringent carbon regulations." The specific ESG risk that we instead focused on during our conversation with investor relations was human capital development.

Over the past few years, Bruker has gone through a significant restructuring of its business. Since 2014—when we initiated our position in the stock—adjusted operating margins have risen by over 400 basis points. However, there has been a high degree of turnover, particularly in more senior positions at the company. Bruker's CFO, who was previously at Millipore and seen as a driving force behind the initial restructuring efforts, resigned abruptly in 2015, three years after joining the company and just when Bruker was beginning to see improvements in its business. He was replaced internally. The company's head of investor relations resigned shortly after that. More recently, the head of Bruker's BioSpin business, which accounts for 35% of group revenues, announced his resignation shortly after joining the company in late 2015. A replacement has not been named, but the company is hinting at internal candidates.

In recent years, Bruker has recruited new board members with relevant experience that bring valuable expertise to the organization. With a bulk of the restructuring now behind it, Bruker's focus is on shifting to ongoing efficiency programs and reaccelerating top-line growth. We discussed the issue of management turnover with investor relations and expressed our interest in seeing the company continue to add talent to senior management positions.

Bruker recently completed its first share repurchase program in the amount of US$225 million. Investor relations explained to us that the board was pleased with how the stock buyback went and may consider another program in the future as the company continues to generate higher levels of free cash flow. We asked if the company would consider, at the margin, reinvesting the cash into the company's management, given that Bruker is at the low end of peers in terms of share-based compensation as a percentage of revenues. Share buybacks are used by peers to offset the new share issuance from stock-based compensation. Such a program would also help align management—beyond just the CEO—with external shareholders and may help retain/attract talent to the company. Given the stage of the firm's development and the execution challenges ahead, we consider management talent to be an attractive area of reinvestment.

During a subsequent engagement, we further discussed the company's human capital risks with the CEO and the head of investor relations after the CFO resigned in the middle of an SEC investigation into the company's accounting practices. The CEO stressed the attractiveness of the compensation package that the CFO received from the private equity firm Carlyle to serve as CFO of one of its recently acquired portfolio holdings. The equity incentives were worth multiple times what the CFO could have earned at Bruker. While he was unable to comment beyond the company's disclosures in regulatory filings, the CEO stressed that the CFO's departure had nothing to do with the ongoing SEC investigation.

The CEO also described the progression of talent in the finance organization at Bruker in the context of the company's substantial transformation in recent years. Given that much of the restructuring has been completed, the focus of the company is on ongoing lean process improvements, including enterprise resource planning harmonization. Familiarity with Bruker and its systems will be highly valued in the next CFO. We again stressed that management must focus on improving employee retention and that the company can afford to provide higher compensation packages relative to its life science tool peers.

Bruker's next phase of transformation will focus on products and market niches that will boost the company's organic growth and margin profile. The CEO believes that the group presidents will play a key role in this phase.

We also discussed Bruker's board of directors. While the CEO is happy with the current size of the board, he commented that he would be on the lookout for another member with diagnostics/microbiology experience as the company makes further headway in those markets. He also highlighted the recent addition of Adelene Perkins, who brings experience from the pharmaceutical sector as the current CEO of Infinity Pharmaceuticals and who adds more diversity to the board. We mentioned that our proxy policy would be, all else equal, opposed to plurality voting for directors and a staggered board. Management appreciated the feedback and pointed out that Bruker does not have an entrenched board, with normal turnover falling in the range of every six to nine years. The CEO explained that Bruker has greater opportunities to create shareholder value outside of a takeover, which would face other obstacles aside from the board voting policy, such as restrictions around calling special shareholder meetings and proxy access. Even incorporating the CEO's pledged shares, his substantial stock ownership provides alignment of interest with other shareholders. Going forward, his stock pledging warrants monitoring and a discussion with the company if it gets excessive.

+ **Xylem** (water technology provider). We spoke with Xylem management, including the head of the compliance, environmental and health & safety functions and the head of employee compensation and benefits. We asked for a description of how ESG performance is tied to the company's executive compensation plan. Management explained that 25% of executives' annual incentives is tied to individual performance objectives, which include performance on ESG issues such as employee health & safety, environmental protection and ethical behavior/compliance. The weight of the ESG metrics is not set or formulaic. It is both subjective and quantitative. Every single manager and senior executive has health & safety goals. The company has targets for reducing greenhouse gas emissions, water use and waste generation, and these are included in individual performance objectives for some managers and senior executives. Xylem set ESG performance targets beginning in 2014. It is clear that sustainability is an important priority for Xylem, as it is fully integrated into the company's business strategy at all levels. While the company has strong ESG practices and performance and includes ESG metrics in executive compensation, the weight in compensation is not specific. We asked the company to move toward more explicit weight settings for ESG metrics in executive compensation and to better disclose what targets are linked to executive compensation. We expressed our view that linking the ESG targets to executive compensation more explicitly and concretely would be an opportunity for Xylem to demonstrate its ESG leadership and drive faster-paced improvement on environmental and social targets. Management said that it understood our argument for more concrete linkage, appreciated the feedback and would consider this issue.

We also conveyed to management our belief that the company should reduce the threshold for the right to call a special meeting from 25% of share ownership to 10%, a shareholder proposal that we supported—but that a majority of shareholders did not support—at the most recent shareholder meeting. Given 43% support for the proposal, we asked how management and the board are discussing the issue. Management indicated that it had engaged with the company's 30 largest shareholders and that, in aggregate, these shareholders were not pushing for a change in the level, although management mentioned that some of the shareholders supported a change to a lower threshold. We expressed our view that we preferred the lower threshold, as it would then become a mechanism that could be used by numerous shareholders. Given the ownership profile of Xylem, we expressed our view that at a 25% threshold, the top four investors, who collectively hold 27% of the company, effectively have veto power over any special meeting requests that may be invoked by smaller investors. Management pushed back and said that it did not think there needed to be a change.