Key Private Bank

Key Questions

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How Did a Tiny Investor Take On an Energy Giant?

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A case study in how ESG is altering shareholder engagement.

Engine No. 1, a small and previously little-known hedge fund with no history of shareholder activism in oil and gas, held a small 0.02% stake in Exxon Mobil.

But last month, three current Exxon directors lost their board seats to Engine No 1's nominees after a six-month proxy fight. As a result, Engine No. 1 now has one-quarter of the seats on the 12-member board, a significant step in its goal to reenergize Exxon, diversify its portfolio, and better position it for an energy transition. A real-life David versus Goliath story, it is the first time a director has lost a board seat due to climate issues.

How did Engine No. 1 do it? It certainly leveraged the discontent of investors, those focused on climate and broad ESG issues; a discontent fueled by Exxon's historical lack of meaningful engagement with shareholders; and some talk but little decisive action. No doubt, the consistent underperformance of Exxon stock compared with peers tapped into investor frustration as well.

Until very recently, Exxon had not put much emphasis on what some investors see as a material risk: the transition to a low-carbon economy. It has been unresponsive to previous shareholder proposals, and one institutional investor noted that it has been like pulling teeth to get Exxon directors to talk to investors at all.

Even as Exxon took steps earlier this year to address concerns raised by Engine No. 1, including launching a new low-carbon solutions business and adding new board members, many institutional shareholders thought it wasn't enough. Exxon's board lacked directors with energy experience when Engine No. 1's campaign started in December. And the energy giant's last-minute efforts at placating investors fell short — too little too late — which set the stage for its defeat.

But the bottom line is that Engine No. 1 made a strong case for change, highlighting the long-term value destruction at Exxon if that didn't happen. And it was able to convince several of Exxon's biggest shareholders to support its position and director nominees. This group included the California Teachers' Retirement System (CalSTRS), the second largest US pension fund; the New York Common Retirement Fund; and BlackRock, Exxon's second-biggest shareholder with a 6.7% stake.

Engine No. 1's case for change was based on Exxon's poor capital allocation decisions, dismal stock underperformance, and lack of preparation for a decarbonizing world. Its argument was that current Exxon directors did not have the experience needed to press for or oversee a transition to a less carbon-focused business. The new nominees would bring the necessary skills and experience to set strategic plans for long-term growth.

Engine No. 1's actions forced big investors to take a side. It was no surprise that CalSTRS and other large pension funds, which have been promoting climate-friendly corporate policies and ESG principles for years, were supportive of Engine No.1's nominees. But BlackRock was a different story. While BlackRock has been outspoken on climate risk, its approach to working with companies in the oil and gas sector has been more diplomatic.

It has relied on long-term comprehensive engagement with companies instead of supporting environment-related shareholder resolutions or proxy contests.

Over the past twelve months, BlackRock engaged with Exxon twelve times. This time was different as it voted with the dissidents. Institutional Shareholder Services, a leading institutional proxy research firm, also supported Engine No. 1, noting that it made a compelling case for change based on operating performance alone.

Ultimately, the former CEOs of IBM, MetLife, and Petronas were replaced with directors having diverse and relevant private sector energy experience and who were not beholden to management. The new directors include an investor in an energy infrastructure start-up, the former CEO of a petroleum refining company, and a former executive credited with boosting her company's renewable offerings.

Many ESG investors cheered the coup over management as a historic decision and significant victory for investors demanding sweeping action to address climate change, a sign that it is going to be easier for investors who are pushing companies on sustainability issues. Others differed and saw the vote as a reflection of the leverage and power of large pension funds and institutional asset managers with progressive agendas. Regardless, enough investors agreed that fresh voices and more independent industry experience were needed to help improve performance for shareholders and guide Exxon forward.

As you look past the headlines and dig into the details, a primary takeaway of Engine No. 1's case is that Exxon was not earnestly addressing climate risk and protecting value in an energy transition. The argument is not that fossil fuels are going away any time soon. But as societies and governments around the world adopt more stringent climate and carbon-reduction targets, Exxon and other companies will be affected. It is strategically smarter for Exxon to address the risk and gradually diversify for success in the long term. Competitors are re-imagining their business plans, and Exxon will fall short if it doesn't.

The shocking vote against management at Exxon, historically one of the largest public companies in the world, conjures up images of David beating Goliath.

It may also offer other companies a signal of what the future holds. While outlooks on the long-term trajectory away from fossil fuels vary, most acknowledge it as inevitable as society moves to decarbonize. Many view the need for change not through the eyes of an environmentalist but through a core business lens. We submit that companies that don't take climate issues seriously may find themselves being forced to reconsider.

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