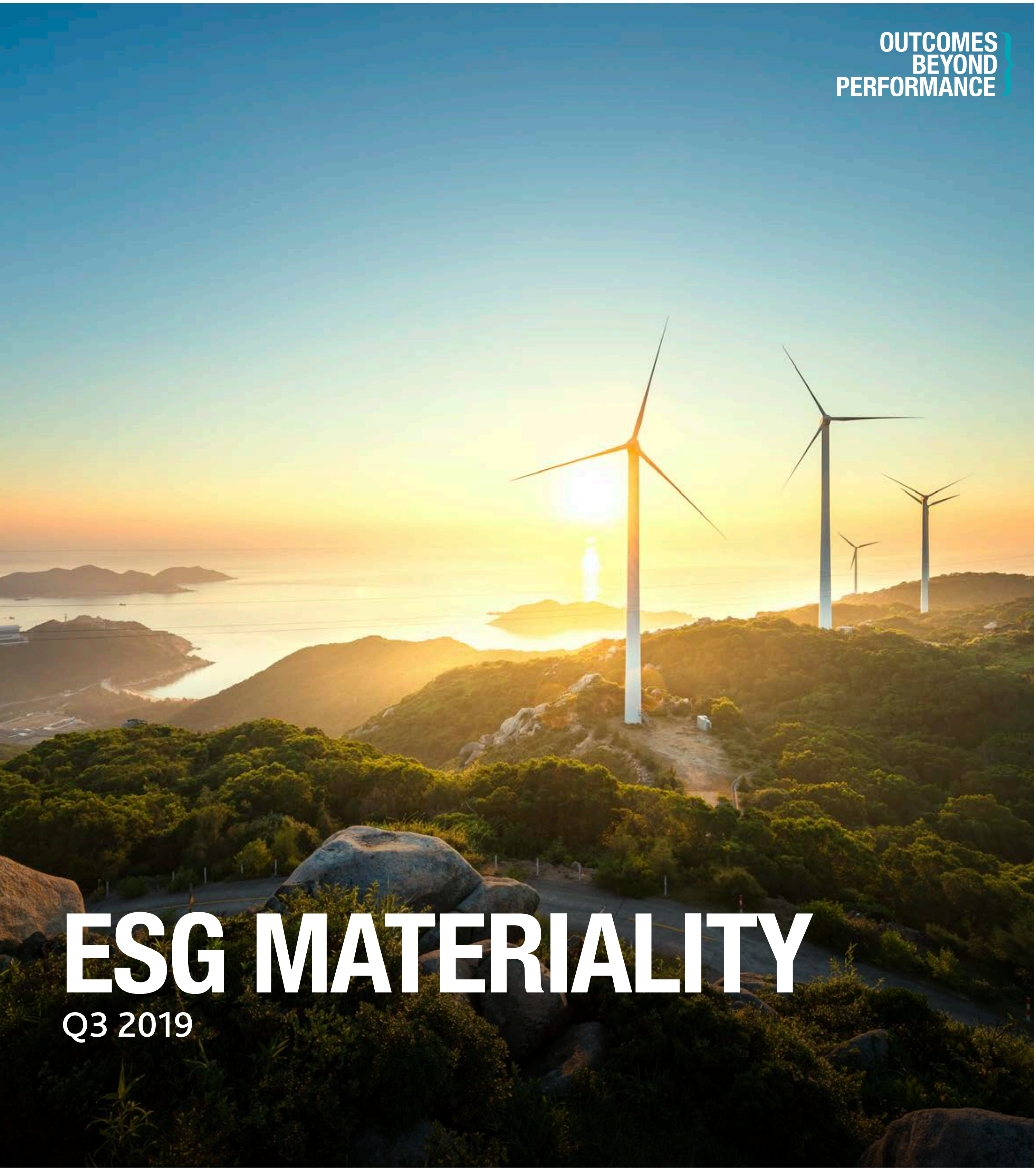


ESG MATERIALITY

Q3 2019

Elena Tedesco, CFA
Co-Portfolio Manager – ESG Strategies
Hermes Global Emerging Markets

For professional investors only

www.hermes-investment.com

HERMES INVESTMENT MANAGEMENT

INTRODUCTION

Welcome to the Hermes Global Emerging Markets' *ESG Materiality* commentary – a quarterly publication that demonstrates our engagement activity with portfolio companies and showcases holdings that are creating positive impact aligned to the UN Sustainable Development Goals (SDGs). In addition, we explore an environmental, social and governance (ESG) theme and its implications for the asset class.

Over the past decade, we have sought to act as responsible investors in emerging markets by focusing on companies that can tackle sustainability challenges as they arise. We recognise that developing nations have a long way to go in this respect, but as responsible investors, we can contribute to their evolution over time.

At a glance

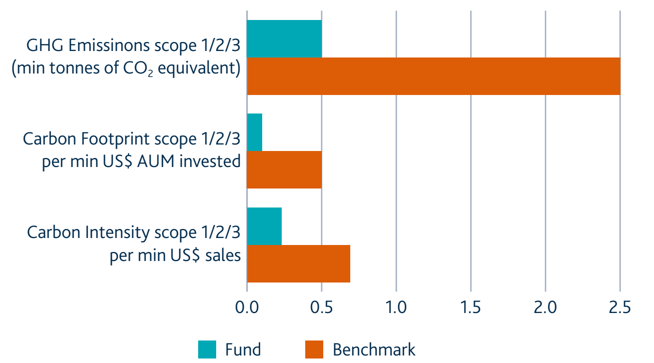
Our vision for responsible long-term investing in emerging-market equities

- We aim to select companies with **attractive business models** and, if we identify material ESG issues, we seek to improve them through engagement.
- In the case of companies with material ESG issues, management teams must be willing to confront **sustainability challenges** and enter the transformative process of engagement.
- We maintain a **low carbon footprint** and prioritise engagements with any holdings in the extractive industries or those with higher levels of emissions.
- **We may engage on strategic and/or ESG matters**, including issues which are relevant to achieve the SDGs, and our engagements may seek positive impact across companies' value chains.

Portfolio snapshot, Q3 2019

Our fund is considerably greener than the MSCI emerging-market benchmark in terms of scope 1, 2 and 3 greenhouse gas (GHG) emissions[1].

Hermes Global Emerging Markets Fund v Benchmark



Source: Hermes as at 30 September 2019. The benchmark is the MSCI Emerging Markets Index.

We engaged with 74% of our holdings making progress in 71% of these engagements.

Percentage of AUM engaged by theme

Environmental	Social & ethical	Governance
37%	57%	43%

Source: Hermes as at 30 September 2019.

[1] We adopt the methodology set by the Task Force on Climate-related Financial Disclosures (TCFD) to measure our portfolio's emissions, carbon footprint and emission intensity. See Implementing the recommendations of the Task Force on Climate-related Financial Disclosures for further information.

ENGAGEMENT CASE STUDY

ICICI BANK (ICICI)

ICICI is India's largest private bank, serving 52m customers across the country.

Engagement themes

- Governance – conflicts of interest
- Disclosure
- Sustainable banking

We started engaging with ICICI in 2018 after concerns were raised about the quality of loans in many Indian banks, and we therefore requested more information on ICICI's loan book and governance practices. Today we are proud to have contributed to the clean-up of its board and our engagement has extended to issues such as sustainable finance.

Governance

Initially our engagement with the company focused on a bad loan that had been issued to Videocon Group, a company linked to the husband of ICICI chief executive Chanda Kochhar, and his brother. We saw this as a potential conflict of interest and were disappointed that, despite pressure from the market, the board remained supportive of Kochhar. In May 2018, we wrote to the chairman to voice our concerns over these related party transactions, requesting an independent investigation. A month later the bank announced an independent, third-party review. In October 2018, the board asked Kochhar to take indefinite leave. The investigative report concluded that Kochhar was in violation of the bank's code of conduct, its framework for dealing with conflicts of interest and fiduciary duties, and the terms of applicable Indian laws, rules and regulations[2]. Subsequently, the board decided to treat former chief executive Kochhar's exit from the bank as a "termination for cause". The bank revoked all of her existing and future entitlements and said it would claw back all bonuses paid from April 2009 until March 2018.

Perhaps due to these improvements in governance – though also to the clean-up of the loan book – the stock contributed positively to the performance of our fund in 2018 and has continued to do so in the first nine months of 2019. Today we believe that ICICI has further room to strengthen its ESG culture and thus we continue to engage with management.

We believe that ICICI has further room to strengthen its ESG culture and thus we continue to engage with management.

Environment

We encouraged the bank to improve their reporting practices, in line with the Taskforce for Climate-Related Financial Disclosures (TCFD) and to consider adopting the UN's Principles for Responsible Banking. We also highlighted the issue of water stress in India and its implications for the banking sector. A recent study found that 11 of India's 20 largest cities are at extreme risk of water stress.[3] India has witnessed widespread droughts in four of the past five years. This poses risks to the economy: according to India's environment ministry, desertification, land degradation and drought cost the country about 2.5% of GDP in 2014-15.[4] We provided information about the Climate Policy Initiative – a think tank that works to improve energy and land use policies around the world – and the work it is doing in this area.

In addition, during the third quarter our engagement focused on the growth of renewable energy and lending opportunities in this area. Despite the risks of providing finance for greenfield projects and local government ventures, we believe the transition to a low-carbon economy can offer opportunities to Indian banks.

[2] "Justice Srikrishna panel says Chanda Kochhar violated ICCI Bank's code of conduct," published by The Economic Times in January 2019.
[3] "Chennai is the tip of the iceberg for India's water stressed cities," published by Versik Maplecroft in August 2019.
[4] "India's worsening drought is forcing doctors to buy water for surgery," published by The Economic Times in July 2019.

IMPACT CASE STUDY

PT BANK RAKYAT INDONESIA (RAKYAT, BRI)

Theory of Change

Rakyat is a leading Indonesia-based microfinance institution. It provides financial services to low-income households in the country, and loans to small and medium-sized enterprises (SMEs), thereby promoting inclusive and sustainable economic growth. It also offers banking activities based on shariah principles which allow financial inclusion of Islamic people. It plays a role in halting deforestation: before it provides loans to palm oil businesses, it requires forests to be certified.

SDG alignment:

In 2006, Muhammad Yunus, the microcredit pioneer, was awarded the Nobel Peace Prize for helping to reduce poverty and inequality by lending money to the world's poor. According to a World Bank study[5], there is evidence that appropriate financial services can have substantial benefits for consumers, especially women and the poor. Yet, 31% of the global population remain unbanked.[6] While many low-income people rely on informal financial services, access to formal services would allow them to make transactions more efficiently and safely – and at a relatively cheaper cost. In addition, it could provide them with access to insurance products for their businesses – for example, crop insurance for farmers.

In Indonesia, banking credit penetration is below 50%.[7] To foster financial inclusion, President Joko Widodo introduced a national strategy plan in November 2016, committing to expand the share of the adult population with a bank account.[8] Rakyat expects its microloan portfolio to increase from 35% (as of H1 2019) to 40% of the total loan book by 2022.[9] Importantly, Rakyat's microloans have a lower bad loan ratio than the rest of its book[10] (its non-performing loans ratio for its microloan portfolio stood at 1.4% in H1 2019 compared to a ratio of 2.3% for the rest of its book) . In addition, they are highly profitable, with a return on equity of 35% (compared to 18% for the group as a whole).[11]

Agriculture loans related to palm oil account for about 2% of Rakyat's loan book. As a condition for loan approval, the bank checks to ensure its clients follow international labour laws and have environmental certification. We would like Rakyat to strengthen the enforcement of such policies and refer to robust certification standards such as those of the Roundtable on Sustainable Palm Oil (RSPO).[12] Furthermore, we would like the bank to report in line with the TCFD framework and commit to the UN Principles for Responsible Banking, particularly in the context of loans to coal mines and coal-powered utilities, which are significant in Indonesia. That said, we believe that overall Rakyat generates a strong net positive impact on Indonesian society.

[5] "Financial Inclusion and Inclusive Growth: A Review of Recent Empirical Evidence, " by Demirguc-Kunt et al, published by the World Bank Group in 2017.
[6] "2017 Findex Report" published by Findex in 2017.
[7] Note: In 2017, it is estimated that less than 49% of the adult population (aged 15 and above) has an account in a financial institution in Indonesia. Source: the World Bank in 2018.
[8] "Economic outlook for Southeast Asia, china and India 2019: towards smarter urban transportation," published by the OECD in 2018.
[9] https://ir-bri. com/
[10, 11] PT Bank Rakyat Indonesia as at H1 2019.
[12] Note: the UN PRI working group on palm oil is holding discussions aimed at strengthening the Indonesian Sustainable Palm Oil standard (ISPO).

ESG IN EMERGING MARKETS

In focus: the push for renewable energy

No plan B

The UN summit on climate change last September had a strong following from civil society asking for a 'Plan B' as opposed to a 'Planet B'.

To meet the Intergovernmental Panel on Climate Change's (IPCC's) target of limiting global warming to 1.5°C above pre-industrial levels all coal-fired power plants globally would need to close by 2050 – which is unlikely. In turn, this implies that the thirst for electricity will be increasingly met by renewable energy.

According to International Energy Agency, coal and oil-fired power generation as a share of the global fuel mix is expected to fall from 37% in 2016 to 16% by 2030. Meanwhile, wind and solar energy are expected to grow globally from 6% to 29% over the same period.

Clean power in emerging markets

China's 13th five-year plan established targets for renewable energy: by 2020, non-fossil fuels should represent 15% of energy use (with solar and wind reaching a minimum of 10% and coal capped at a maximum of 58%). An updated draft plan released by the National Development Reform Commission in September 2018 states that renewables should account for at least 35% of electricity consumption by 2030 – up from the 20% targeted in 2016.

Efforts have been made elsewhere too: in April 2019, the Korean government announced that it will boost the contribution of renewable energy in the country's power generation mix to 30%-35% by 2040. Meanwhile, India plans to increase its solar and wind energy capacity to 40% by 2030, up from 21% in 2018. At present, however, India is one of the most coal-intensive countries in emerging markets: according to CLSA, coal accounted for 76% of the country's power generation in 2018. The same research showed that coal reached 57% of the installed capacity in India in 2018, up from 52% in 2010, with capacity growth of 142% (a 12% CAGR[13]). However, India has also invested in solar and wind, and installed capacity has grown a remarkable 364% from 2010 to 2018 (21% CAGR). The country has set a target of achieving 100GW of solar power and 75GW of other renewable energy sources under its 2018-2022 national plan, which will require the CAGR of solar and wind installed capacity to accelerate to 25%.

The economics

Government incentives have largely driven the growth of renewable generation capacity worldwide. In turn, scale economies have brought down costs globally. In the US, the levelized cost of energy (LCOE) – a measure of lifetime costs divided by energy production – has dropped so significantly that unsubsidised renewable energy is now cheaper than legacy sources of electric power generation, such as coal[14]. The same is true for the UK, Brazil, China and India. Furthermore, according to a study by the International Renewable Energy Agency, electricity generated by onshore wind and solar panels across the world will be consistently cheaper than any fossil fuel source in the next year.

Renewable energy has become an increasingly competitive way to meet new power generation needs. As such, incentives to switch to renewables are no longer necessary. For example, last year China announced plans to end subsidies for renewable energy projects, shocking markets. Share prices for major solar and wind companies fell by 31%-39% compared to 17% decline for the CSI300 index between June and October 2018. In its wake, solar capacity additions have started to moderate in China.

Despite the shift from a subsidised regime, China will continue to support the renewable energy industry strongly. The State Council's energy administrative department will set annual minimum renewable energy-use targets for each province. Similarly, India should also enjoy strong capacity additions despite the decline in subsidies. According to research by Wood Mackenzie, China, India, and the US will account for more than half of total solar PV installations by 2024.

The growth of renewables poses challenges to companies with assets that are at risk of becoming stranded – such as coal-fired utilities and thermal coal miners – while it also offers investment opportunities in emerging markets.

How are we positioned to benefit from the shift to renewable energy?

We have exposure to LandMark Optoelectronics, a Taiwanese manufacturer of gallium arsenide (GaAs) epitaxial wafers (epi) for double junction solar cells. Landmark also manufactures LED products which improve energy efficiency.

In China we own NARI Technology, which manufactures products that are used to improve the energy efficiency of China's electricity grid network, thereby connecting renewable energy projects. NARI also produces solar and wind power control equipment as well as charging infrastructure for electric vehicles.

In addition, we have a position in Bharat Forge, an Indian metal component manufacturer, which manufactures and sells components for wind turbines; it also sells electricity generated from its own windmills.

We have no exposure to thermal coal miners or coal-fired utilities.

[13] CAGR – Compound Annual Growth Rate.

[14] "Plunging prices mean building new renewable energy is cheaper than running existing coal," published by Forbes in December 2018.

HERMES
INVESTMENT MANAGEMENT

OUTCOMES BEYOND PERFORMANCE

Hermes Investment Management

We are an asset manager with a difference. We believe that, while our primary purpose is to help savers and beneficiaries by providing world class active investment management and stewardship services, our role goes further. We believe we have a duty to deliver holistic returns – outcomes for our clients that go far beyond the financial – and consider the impact our decisions have on society, the environment and the wider world.

Our goal is to help people invest better, retire better and create a better society for all.

Our investment solutions include:

High active share equities, private markets, credit and responsible investment advisory services.

For more information, visit www.hermes-investment.com or connect with us on social media: