We can all get along

Part II: How bondholders can engage companies for the benefit of all stakeholders

Mitch Reznick, CFA
Head of Research and Sustainable Fixed Income

Dr Hans-Christoph Hirt
Head of EOS at Federated Hermes

Federated Hermes Credit and EOS at Federated Hermes
Q2 2019

www.hermes-investment.com
For professional investors only

This is the second part of a two-part paper asserting that the shared interests of bondholders and shareholders provide incentives to jointly engage companies – and generate positive outcomes by doing so. In part one, we disproved the claim that the imperatives of bond and shareholders typically diverge and argued that both financial stakeholders have the legitimacy to engage. In this paper, we explain how bondholders can play their part in promoting the interests of all financial stakeholders.

In the first instalment of this paper, our challenge to the traditional idea that bondholders and shareholders have diverging interests that prevents them from jointly engaging companies was based primarily, though not exclusively, on two principles:

01 **The financial stakes** held by bond and long-term shareholders gives them the legitimacy to engage and, arguably, an obligation to do so; and

02 **The interests of financial stakeholders** in the responsible growth and long-term health of businesses are substantially aligned, because stable and sustainable value creation is positive for all stakeholders.

If a company is performing well and focused on a sustainable growth trajectory, the volatility in the performance of its securities should ease over the long term. Therefore, the risk premia should decline for all financial stakeholders in the business, and valuations are more likely to remain stable or rise. This relationship between volatility and risk premia connects all financial stakeholders, and explains why we engage with companies themselves, not just on the instruments through which our clients invest in them.

Figure 1. How value generated by fundamental and ESG factors accrues to bond and shareholders

Source: Federated Hermes. For illustrative purposes only.

In this instalment, we progress from our philosophy of engagement on environmental, social and governance (ESG) factors to the practice of it. The foundation for corporate engagement, which we see as inexorably linked to investment itself, is grounded in the belief that stakeholders have the legitimacy to do so. We believe that when we speak to a company on this basis, our voice is louder, more credible and more influential.

What do we engage on?

Our engagements are focused on providing both improved long-term financial returns from companies and fostering better, more sustainable outcomes for society and the environment – what we call holistic returns. In our view, these objectives are more than simply compatible: mutually reinforcing, they are essential for each other's success.

But on which issues should we engage? To answer this question, we have to go back to our belief that engagement is inseparable from successful investment. As fund managers and stewards of capital respectively, our Credit team and EOS at Federated Hermes (EOS) must consider ESG factors due to their influence on cash flows, and therefore enterprise value. This, of course, affects the valuations of a company's securities. It follows that ESG factors feature among operating strategy and financial policy as engagement topics.

Going further, we must seek a deeper understanding of the materiality, probability and timing of ESG risks. This enables us to attempt to price them alongside traditional operating and financial risks, and provides opportunities to encourage better behaviours.

The positive feedback loop

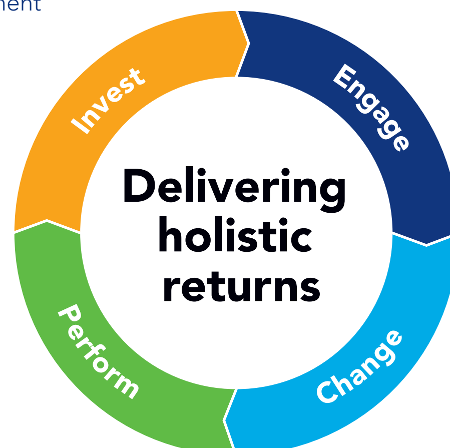
Engagement is not a linear fact-finding exercise but a purposeful dialogue promoting activities that can improve a company's ESG behaviours. In doing so, we believe that over time there is potential for all stakeholders to prosper from successful engagement in three ways:

- **First,** investors can profit from improving valuations;
- **Second,** engaged companies may benefit from lower costs of capital; and
- **Third,** society and the environment should benefit from better ESG practices through outcomes including reduced pollution, safer working conditions, and trustworthy products and services.

In essence, we see engagement as being intrinsic in the delivery of holistic returns.

Throughout engagements, we also continually assess a company's earnestness in seeking change. This influences the probability and timing of ESG factors manifesting as material financial risks.

Figure 2. Paying it forward: engagement's role in seeking positive outcomes for investors, companies, society and the environment



Source: Federated Hermes. For illustrative purposes only.

Engaging for the Sustainable Development Goals

The Sustainable Development Goals (SDGs), an ambitious set of objectives agreed by the 193 UN member states, seeking global prosperity and environmental preservation by 2030. They are a valuable resource in focusing both equity and credit investors' minds on crucial sustainability issues – and the investment and engagement opportunities they represent.

In our view, companies that are not currently supporting or planning for a world progressing towards the SDGs may ultimately face fines, sudden capital expenditure and unplanned operating costs. These outlays could be due to excessive carbon emissions, abusive labour practices, natural-resource depletion or, worse, fraudulent business practices. Failure to act on the SDGs is potentially a lost opportunity for companies.

With this in mind, bond and long-term equity investors should consider avoiding SDG laggards with no desire to change and identifying the leaders. It follows that they also have a shared interest in engaging on these issues.

In our view, companies that are not currently supporting or planning for a world progressing towards the SDGs may ultimately face fines, sudden capital expenditure and unplanned operating costs.

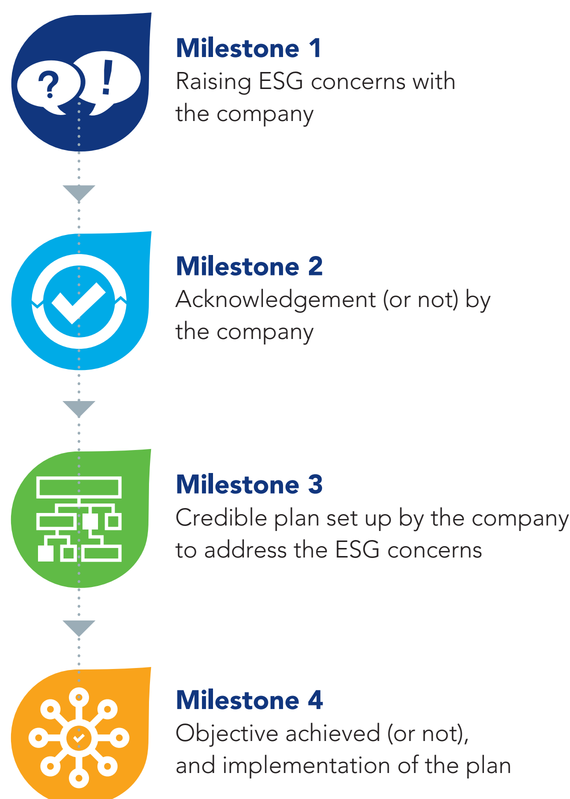
How does the engagement process work?

Our engagements are focused on issues that are most material to a company's ability to create long-term value. These generally address ESG factors, long-term strategy and the sustainability of business models.

We begin by identifying potential engagement objectives and outcomes at the sector level, based on our top-down understanding of relevant thematic risks. These are revisited at the company level to gauge their materiality and feasibility, together with our knowledge of how well the company appears to be managing the risks.

We then plan the engagement, considering how to best develop existing relationships with companies, and how to establish new ones. We aim to engage companies at the most senior levels, such as board directors and c-suite executives, because in our experience this results in the greatest impact on companies' activities. As a rule, most of our engagements are constructive and conducted behind closed doors in order to build trusting relationships with companies, though there are exceptions in which we feel that pressure should be applied publicly. We measure and monitor engagements by assessing progress towards objectives against four milestones, developed by engagement specialists in EOS (see figure 3).

Figure 3. EOS's milestone system for assessing engagement progress



Source: Federated Hermes. For illustrative purposes only.

This information does not constitute a solicitation or offer to any person to buy or sell any related securities or financial instruments.

CASE STUDY

Suzano: who's afraid of a big buyout?

We have engaged with Suzano, the Sao Paolo-based pulp and paper producer, on ESG issues including governance, greenhouse-gas emissions, energy efficiency, water consumption and sustainability disclosures since 2014.

Suzano, an issuer that our Credit team has exposure to, has generated strong cash flow in recent years due to a supportive pricing environment for its goods and low cash costs. It had used free cash flow to reduce debt, with bond and equity investors alike welcoming the decline in its net-debt-to-EBITDA ratio from 4.2x to 2.1x in the final quarter of 2017. But the business soon took a different path.

Suzano's net leverage target of 2x to 3x takes priority over dividends

In early 2018 Suzano confirmed its long-rumoured acquisition of Brazilian pulp producer Fibria, in a cash and shares transaction requiring it to take on an additional $9.2bn in debt. This led to a rise in its estimated net leverage to range between 3.1x and 4.1x at end of the year, with this projection dependent on pulp prices at the close of the deal.[2]

Such metrics alone suggest that this would have favoured equity investors and could have been received negatively by bond markets, as such a large acquisition would likely increase financial risk. However, looking at the transaction in a broader sense revealed clear benefits to Suzano's business profile.

They included:

- Increased scale, enabling the combined entity to become the largest pulp producer globally;
- Ongoing top-quartile positioning on the cost curve, as both companies operated with high margins and potential synergies further enhanced the profile of the merged business; and
- Greater supply discipline for market pulp, which is significant given the company's market-leading position.

Good communication is key

Suzano's management team has issued a bondholder-friendly financial policy, reiterating that the company's net leverage target of 2x to 3x takes priority over dividends and investments.[1]

Therefore, although the acquisition may have initially seemed like a growth story involving greater financial risk, we saw the situation differently. The real potential for Suzano's business profile to improve, combined with strong cash flows, well-signposted financial policy and potential benefits through synergies, meant that we took a positive view on the company's credit profile.

Credit-rating agencies agreed. Standard & Poor's (S&P), for instance, upgraded Suzano to investment-grade status immediately after the merger. S&P noted that the revision reflected its commitment to financial policy instead of the merger. This shows how a strongly communicated financial policy can help bond investors view a leveraging event positively.

We also were encouraged that Suzano's listing on the Novo Mercado, a segment of the Brazilian stock market requiring companies to adopt stronger corporate governance principles than those required by law, would remain in the incumbent company. This cemented the governance improvements that the company had already achieved.

Diverging interests? Mind the (extremely narrow) gap

As discussed in part one of this paper, even though both credit and equity investors share common interests in almost all areas, conflict can arise on rare occasions – especially concerning near-term changes. We also described why engagement can, extremely infrequently, cause conflict between equity investors and bondholders.

As rare as these conflicts of interest may be, they cannot simply be ignored or wished away. The most obvious clash would be caused by situations in which one financial stakeholder benefits strictly at the expense of another, such as in a leveraged buyout, debt-financed dividend payment, secondary equity offering made simply to repay debt, or a dividend cut to protect cash flow.

Managing conflicts

Flashpoints typically involve corporate governance: priorities for capital allocation, financial policy or the development of an operating profile that supports business success.

We have established a Stewardship Conflicts of Interest Policy to follow in these rare situations. If a potential conflict of interest is identified, the issue is escalated first to a line manager, then an escalation group reporting to an independent sub-committee of the Board of Directors. The escalation group is comprised of the heads of EOS and our Investment, Responsibility, Client Relations and Compliance teams.

If a potential conflict materialises, the joint credit-equity engagement is restricted to those objectives that are not affected, and we alert our clients to the matter, so that their respective fund managers can take the necessary actions.

[1] Source: Company presentation as at 15 March 2018.

[2] "Suzano and Fibria. From dream to paper, from paper to reality." Corporate presentation issued on 16 March 2018.

Conflict-free zones

In our experience, there is negligible risk of a conflict of interest between long-term shareholders and bondholders on environmental and social concerns.

The ramifications of this are significant. In important areas – such as climate change, resource efficiency and the transition to a low-carbon economy; and workplace health, safety and equality – all financial stakeholders are aligned. That long-term equity and bondholders can have a united voice in encouraging companies to seek positive change on these fronts bodes well, as businesses that future-proof their operations against sustainability risks are more likely to benefit a wide range of stakeholders.

CASE STUDY

HSBC: 2030 vision

In a September 2017 meeting with Mark Tucker, the incoming Chairman of HSBC, our engagers said the bank could be more explicit in disclosing its exposure to climate-change risks, encouraging it to demonstrate its commitment to best practice by reporting in accordance with the recommendations of the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD). We also made the case for HSBC to develop long-term, sustainable-finance objectives and to update its sustainability-risk policies.

Following this meeting, the bank's sustainability director asked our engagers to provide further input into a review of HSBC's policy for financing energy companies. The team then commented on its scope and prohibitions, and suggested specific actions related to lending to coal-fired power plants. To support the global transition to a low-carbon economy, EOS reiterated the need to commit to renewable-energy financing.

Capital for the low-carbon transition

HSBC, which our Credit team has exposure to, has made significant progress. In November 2017, the board updated the bank's sustainability strategy with five new commitments to support the transition to a low-carbon economy. It has agreed to intensify its support for clean-energy and low-carbon technologies, as well as for projects that support the implementation of the SDGs.

$100bn **pledged to sustainable businesses by 2025**

100% **of electricity from renewable sources by 2030**

The bank pledges to provide $100bn in financing and investment to sustainable businesses by 2025, source 100% of its electricity from renewable sources by 2030 and reduce its exposure to thermal coal, while also helping enable the transition path for other high-carbon sectors. In addition, HSBC has adopted the recommendations of the TCFD – with the first disclosures reported in its 2017 annual report. It also continues to lead and shape the debate about sustainable finance and investment.[3]

In addition to this progress, we are also encouraged by the changes in HSBC's energy policy, particularly its decision to stop financing new coal-fired power stations in all countries apart from Bangladesh, Indonesia and Vietnam. In addition, the bank has pledged not to provide financial services for new offshore oil and gas projects in the Arctic and a new greenfield oil-sands project.

We will continue to engage HSBC to monitor progress against its sustainable-finance commitments.

Getting along, for the good of all

Given their financial stakes in companies, bondholders have a legitimacy to engage – for the benefit of investors and all financial stakeholders. To engage companies, we must have a deep understanding of the materiality, probability and timing of the ESG and strategic risks that companies face, and be able to address these in realistic objectives with buy-in from the company. Engagement is more time-intensive than ESG analysis, and more constructive than divestment. Its rewards are clear: investors can benefit from potential improvements in business practices and therefore valuations; engaged companies can experience lower costs of capital; and society and the environment are likely to benefit from better ESG practices through outcomes including reduced pollution, safer working conditions, and trustworthy products and services.

With their mutual interest in the long-term financial success and sustainability of businesses, bond and equity investors can engage holdings, thereby getting along for the good of all.

> **Investors can benefit from potential improvements in business practices and therefore valuations; engaged companies can experience lower costs of capital; and society and the environment benefit from better ESG practices.**

[3] Source: "Sustainable finance," published on the HSBC website. Accessed May 2019.

This was published in June 2019 before Hermes Investment Management rebranded as the international business of Federated Hermes

Federated Hermes
International

Federated Hermes

Federated Hermes is a global leader in active, responsible investing.

Guided by our conviction that responsible investing is the best way to create long-term wealth, we provide specialised capabilities across equity, fixed income and private markets, multi-asset and liquidity management strategies, and world-leading stewardship.

Our goals are to help people invest and retire better, to help clients achieve better risk-adjusted returns, and to contribute to positive outcomes that benefit the wider world.

All activities previously carried out by Hermes now form the international business of Federated Hermes. Our brand has evolved, but we still offer the same distinct investment propositions and pioneering responsible investment and stewardship services for which we are renowned – in addition to important new strategies from the entire group.

Our investment and stewardship capabilities:

- **Active equities:** global and regional
- **Fixed income:** across regions, sectors and the yield curve
- **Liquidity:** solutions driven by four decades of experience
- **Private markets:** real estate, infrastructure, private equity and debt
- **Stewardship:** corporate engagement, proxy voting, policy advocacy

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

The value of investments and income from them may go down as well as up, and you may not get back the original amount invested. Past performance is not a reliable indicator of future results.

For professional investors only. This is a marketing communication. The views and opinions contained herein are those of Mitch Reznick, Head of Research and Sustainable Fixed Income, and Dr Hans-Christoph Hirt, Head of EOS at Federated Hermes, and may not necessarily represent views expressed or reflected in other communications, strategies or products. The information herein is believed to be reliable, but Federated Hermes does not warrant its completeness or accuracy. No responsibility can be accepted for errors of fact or opinion. This material is not intended to provide and should not be relied on for accounting, legal or tax advice, or investment recommendations. This document has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient. This document is published solely for informational purposes and is not to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. Figures, unless otherwise indicated, are sourced from Federated Hermes. This document is not investment research and is available to any investment firm wishing to receive it. The distribution of the information contained in this document in certain jurisdictions may be restricted and, accordingly, persons into whose possession this document comes are required to make themselves aware of and to observe such restrictions.

Issued and approved by Hermes Investment Management Limited ("HIML") which is authorised and regulated by the Financial Conduct Authority. Registered address: Sixth Floor, 150 Cheapside, London EC2V 6ET. HIML is a registered investment adviser with the United States Securities and Exchange Commission ("SEC").

BD006237 0009497 09/20

SAI GLOBAL
ISO 14001
Environmental