ESG Materiality

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

Federated Hermes
International

www.hermes-investment.com

Introduction

Welcome to our 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.

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

At a glance

- 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 very **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.

For more insights into the rationale of our vision for responsible long-term investing, use the following link: https://www.hermes-investment.com/ukw/wp-content/uploads/2019/12/gems-responsible-investing-vision-2019.pdf

Portfolio snapshot, Q1 2020

As of end of March 2020, we engaged with companies representing

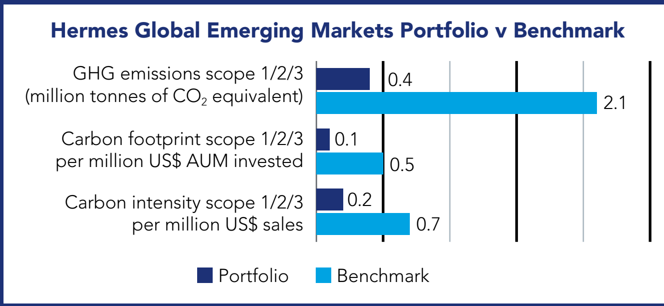
75% of our AUM making progress in **46%** of these engagements.

Percentage of AUM engaged by theme

29%	63%	44%	61%
Environmental	Social & ethical	Governance	Strategy and communication

Source: Federated Hermes as at 31 December 2019.

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



Source: Federated Hermes, as at 31 March 2020. The benchmark is the MSCI Emerging Markets Index.

[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

Samsung Electronics (Samsung)

Samsung is a global leader in consumer electronics, chipmakers and information technology.

Engagement themes

We are engaging Samsung on a number of themes including but not limited to:

- Governance
- Labour issues
- Capital allocation

In Q1 2020, we engaged Samsung predominantly on governance matters. Indeed, as one of the most controversial companies in our portfolio from an ESG perspective[2], we have been engaging with the company on a plethora of issues for a number of years.

The genesis of the position and engagement

In 2016, we initiated our position in Samsung and, in doing so, we made a commitment to actively engage in constructive dialogue with the company on material ESG issues. At the time, our investment team assessed the ESG concerns and took the view that Samsung demonstrated positive momentum in this regard. In addition, we were encouraged by the positive outlook on the company's fundamentals, namely the cycle for its memory business and a recovery following the recall of its Galaxy Note 7 tablets. We believed that Samsung's ESG risks – governance and corruption, labour issues and human rights, among others – were more than offset by its ESG opportunities and improving fundamentals.

The ESG opportunities that we were particularly encouraged by included references to improving Samsung's capital allocation and talks about chaebol reforms in South Korea. Our expectations about the company's capital allocation were rewarded when it committed to allocating half of its 2016-17 free cash flow to higher dividends and share buybacks. Furthermore, in 2017, the company announced a shareholder return programme for 2018-20.[3]

We believe a strong and independent board is necessary to tackle ESG issues

Alongside our colleagues at EOS at Federated Hermes, we have successfully engaged on a myriad of issues including capital allocation, board structure and gender diversity, workers' safety, product safety and supply chain management for cobalt. Indeed, the company has demonstrated a positive approach toward participating in the circular economy, CO_2 emissions and remuneration matters.

What's new

We believe that a strong and independent board is necessary to tackle ESG issues – and Samsung's board has been strengthened over time: the roles of the Chairman and CEO have been separated, additional independent directors were appointed in 2018, bringing greater diversity to the board, and some controversial directors left the company over the past 18 months.[4]

In February 2020, Samsung appointed Jae-wan Bahk, a former finance and labour minister, as its board chairman, breaking the tradition of having a family representative or executive at the helm. Bahk, who joined the board in 2016, has proven to take institutional shareholders' views into account. Last year we expressed concerns over his potential conflict of interest because he was also a professor and dean of the Graduate School of Governance at the University of Sungkyunkwan, which has received significant funding from Samsung.[5] During our last engagement call, management reassured us that Bahk terminated his relationship with Sungkyunkwan University in the first quarter of 2020 so as to resolve the potential conflict that we had raised.

In Q1, Samsung also announced the creation of an anti-corruption panel, which will be comprised of external legal experts and civic groups. The committee is still in its formation phase and, although many questions remain about how it will hold the company to account, it is an encouraging development.

[2] For instance, Mr Jae-Yong Lee (J Y Lee), an executive Vice-chairman and heir of the founding family, has been found guilty of corruption (his sentence was suspended in 2018 and he is now awaiting a retrial). In December 2019, three executives were sentenced for destroying evidence regarding Samsung BioLogics' accounting fraud. The same month Samsung Group's former Chairman, Lee Sang-hoon, and Vice-President Kang Kyung-hoon were sentenced to jail for sabotaging an employee union. Source: Reuters and Financial Times as at 2019.

[3] Chaebol reforms were high on the agenda of Moon Jae-in during his presidential campaign in 2016. Following his election in 2017, he failed to deliver on his campaign promises and our hopes of meaningful chaebol reforms have since cooled.

[4] J Y Lee's board membership expired on 26 October 2019 and he did not seek re-election to Samsung's board. Former Chairman Lee Sang-hoon resigned in February 2020.

[5] At the company's AGM in 2019, we were among the 29% who voted against (or abstained) Bahk's re-election.

POSITIVE IMPACT CASE STUDY

China Communications Services Corporation Ltd

Theory of Change

China Communication Services (CCS) provides services to customers in the telecommunication sector to build 3G, 4G and 5G infrastructure networks, which are key for achieving the goal of universal and affordable access to the internet. It also supports a number of other industries in their digital transformation journey.

SDG9: access to affordable internet

Significantly increase access to information and communications technology and strive to provide universal and affordable access to the internet in the least developed countries by 2020.

9 INDUSTRY, INNOVATION AND INFRASTRUCTURE

Why universal and affordable internet access matters

Despite improvements in broadband and smartphone penetration, internet usage remains low in the poorest emerging-market countries. For example, only 40-50% of the population in Indonesia, Egypt or Peru use the internet[6]. This can in part be explained by the considerable difference in infrastructure, data package prices and average internet speeds across the world[7].

According to the World Bank, broadband or high-speed internet access is "not a luxury, but a basic necessity for economic and human development in both developed and developing countries"[8]. Internet access fosters knowledge sharing and micro-entrepreneurial opportunities, enables financial inclusion, helps to reduce poverty, enhances government transparency and accountability, and provides access to further education and health services. In turn, establishing infrastructure to increase the reach and affordability of the internet can also translate into efficiency, innovation, and new business and employment opportunities.

The advent of 5G infrastructure should accelerate internet speed and enable new technologies. Last year, South Korea and China were among the first to begin the deployment of this infrastructure, and their experience will no doubt inform other countries in the adoption of 5G.

Enabling the roll out of "quality, reliable, sustainable and resilient infrastructure"

China has set its 5G target high: 500,000 5G base stations are expected to be in place by the end of 2020[9]. This build-up of 5G infrastructure is the main growth driver for current holding CCS, which counts China Telecom, Unicom and China Mobile as its main clients.

In March, as part of the country's stimulus plan to offset the economic impact of the coronavirus, China's government ordered the acceleration of new infrastructure construction, including 5G networks and data centres[10].

For background, it is worth noting that CCS is controlled by China Telecom Group. As such, from a governance perspective, reforms of State Owned Enterprises (SOEs) and related party transactions are key. On environmental issues, our engagements focus on Scope 3 emissions caused by clients' data centres.

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Acting responsibly in a time of crisis

So far, the immediate impact of the coronavirus has been mixed for CCS. In just three days, CCS managed to complete the 4G and 5G wireless network planning and construction for two hospitals in Wuhan[11]. Moreover, the group provided a number of Chinese hospitals with emergency communication construction and support to ensure smooth communication at the frontline in the fight against the outbreak. CCS also swiftly developed several applications for epidemic prevention. That said, business was interrupted in Q1 and, as a result, additional resources were needed to ensure local governments and hospitals had secure and stable wireless connections.

[6] Source: World Bank, as at March 2020.

[7] For example, in South Africa, it costs an average of $87 per month for fast internet with a speed of 100Mbps or higher, while in Russia it costs $7.68 every month. Source: "Countries with the cheapest and fastest Internet: price comparison," published by AIN in December 2019. According to the OECD, the monthly package for a medium mobile broadband user ranges from $6 in Turkey to $62 in Greece. This compares to the OECD average of $26. Source: OECD Broadband statistics. In terms of broadband speeds, Korea tops the global charts, with an average of 29 Mbps (and 121 Mbps at peak). Colombia and the Philippines are the laggards in emerging markets, with 5.5Mbps each. Source: "State of the internet report," published by Akamai in Q1 2017.

[8] "Connecting for inclusion: broadband access for all," published by the World Bank.

[9] "China expects 5G to reach all prefecture-level cities by the end of 2020," published by RCRWireless in December 2019.

[10] "China Mobile picks Huawei and ZTE to build its 5G network," published by the Financial Times in April 2020.

[11] "CCS Annual Report," published by CCS.

IN FOCUS:

How will the coronavirus impact workers in emerging markets?

The coronavirus knows no borders: since it first emerged in the Chinese city of Wuhan late last year, it has aggressively spread across the world, with the US now the epicentre of the global pandemic. With many countries in lockdown, governments have conjured up fiscal packages to support their economies, while central banks have pulled on their monetary levers to reassure financial markets. But despite these efforts, we expect the pandemic will have lasting effects on many workers in emerging markets (EM).

Safety net or a small spider's web?

According to the International Labour Organization, the pandemic could lead to well over 25m jobs losses worldwide, compared to 22m lost during the 2008-9 global financial crisis[12]. Those most at risk work in sectors such as accommodation and food services, wholesale and retail trade, manufacturing, and business and administrative activities. Many of these workers are in low-paid, low-skilled jobs, where a sudden loss of income is devastating.

But with social distancing measures impacting 92% of global GDP and more than four out of five people in the global workforce, many adults have already lost their jobs with no safety net in Q1.[13] Meanwhile, some employees have been asked to self-isolate without paid sick leave and are struggling to get by. Others however have been more fortunate: some employees (mainly in high-skilled jobs) can work remotely, thanks to farsighted investments in digital infrastructure by their companies and countries.

A study by the International Trade Union Congress, which surveyed its members in 86 countries to gauge government and employer responses to the pandemic[14], highlights the stark reality facing families in need during this challenging time. It found that sick leave is only provided in 21% of respondent countries. Only 29% of respondents pay sick leave to employees that miss work to comply with self-isolation rules, while 34% of countries guarantee employment protection for those self-isolating[15]. Worst still, only half of the countries surveyed provide free health care.

However, in the informal sector – which accounts for about two-thirds of the labour force in developing countries – there is no safety net and no shelter from the virus. Informal workers are more likely to catch the virus as they cannot afford to skip work and self-isolate. Even if they could, social distancing is practically impossible for those living in crowded favelas or shanty towns, and with no clean running water, handwashing is hard.

Some demographic groups are also more vulnerable to the virus because of their weak immune systems. For example, the high incidence of HIV and tuberculosis in South Africa could make it difficult for miners and their communities. Meanwhile, remittances – usually a safety-net for the poorest in emerging countries – will tumble by about 20% globally as relatives working as migrants in rich cities and countries will lose their jobs[16]. Equally, seasonal pickers will be stuck at home, unable to reach their workplace because of travel bans and food will be left to rot on many fields.

Governments inject support to save jobs, but automation threatens workers

During the first quarter, many emerging countries announced support measures for employers to avoid layoffs because retaining the workforce is believed to be the best way to ensure a swift(er) return to "business as usual" once the pandemic is over. Aid packages from some governments also included support to defer social security payments, retrain staff, offer childcare subsidies for parents that juggle work with childcare amid the closure of schools and nurseries, delay utility bills and taxes, and assist people with accessing their severance funds. In February, Hong Kong became the first region to announce handouts to help its population, offering HK$10,000 (US$1,280) to each permanent adult resident[17]. Since then, from South Korea to Chile and Poland, a raft of measures have been announced combining lockdowns with fiscal packages, liquidity boosts and monetary measures such as helicopter money or quantitative easing.[18]

[12,13] "COVID-19 causes devastating losses in working hours and employment," published by the International Labor Organisation in April 2020.
[14] The countries polled represent some of the world's most powerful economies, including 28 out of 36 OECD countries and 15 G20 countries. The survey included MSCI EM member countries such as Argentina, Brazil, India, Indonesia, Mexico, the Russian Federation, South Africa, Turkey, Chile, Greece, Hungary, Poland, as well as some non-OECD countries.
[15] "Only a fifth of countries provide sick pay - The big challenges for work in a pandemic," published by the World Economic Forum in March 2020.
[16] "Migration and Development Brief 32: COVID-19 Crisis through a Migration Lens," published by the World Bank in March 2020.
[17] "Hong Kong to give cash gift of $1,200 to residents," published by the BBC News in February 200.
[18] For more information see: "Global economic policy response to coronavirus crisis," published by Reuters in April 2020.

For instance, in the first quarter India cut interest rates and revealed a fiscal stimulus in parallel with its lockdown. This package included free food and cash transfers to the country's poorest as well as support for farmers. Some state governments announced that they would pay pensions in advance, while others would pay a month's wage to all migrant construction workers. With the informal sector accounting for over 70% of the workforce in India, President Modi asked employers to be supportive of these workers, suggesting that each wealthy family should take care of nine less fortunate ones during the lockdown.

The pandemic could lead to well over 25m jobs losses worldwide.

Overall, in Q1 markets received strong financial support in response to the pandemic. Although government measures aim to save jobs, this might prove difficult in the medium-to-long term given the structural trend in favour of automation.

According to media reports, a total of 36m jobs could in theory be replaced by machines globally using existing technologies. A survey by auditing firm EY found that 41% of respondent employers in 45 countries are investing in accelerating automation as businesses prepare for a post-crisis world. The pandemic will probably reinforce these views as companies with a high degree of automation can continue to work even if their employees are forced to stay home.

According to the International Federation of Robotics (IFR), the industries with the highest installations of robots are automotive, electronics, and metals, but the food industry is the area exhibiting the strongest percent increase (from a low base)[19]. As we know, the food sector is labour intensive, and it is one of the industries whose workers are being hit the hardest by the pandemic.

How has the virus impacted the asset class and our companies?

As of 31 March 2020, the number of infected cases in MSCI EM countries accounted for 18% of the total worldwide and 12% of deaths.[20] If we assume that these figures are not under-reported, this compares very well with the percentage of population that EM countries represent worldwide (China and India alone represent 36% of the world population). Yet, in a risk-off move, foreign investors pulled billions of dollars from emerging markets since the start of the crisis. The outflows diminished the value of EM currencies and forced people to pay more for imported goods. The collapse of oil and other commodities further exacerbated the problem in EMEA and Latin America's key markets, which have seen their currencies plunge by 19-22% in Q1.[21]

Many companies have reacted to the lower demand and lower liquidity by accessing existing credit lines, lowering capacity utilisation, laying off staff, starting furloughs, withdrawing their guidance, cutting dividends and/or postponing expansions. Analysts have cut their 2020 earnings per share estimates for the MSCI Emerging Markets Index by 5% over the quarter (the index dropped by 24% in Q1)[22].

Across our portfolio, companies have been adversely impacted by travel bans (e.g. Samsonite International), forced closures (e.g. Galaxy Entertainment) and value chain disruption in the car industry (e.g. Motherson Sumi).

The government orders to stay at home led to stockpiling, a behaviour which has favoured grocery stores (e.g. BIM Birlesik Magazalar A.S.) and resulted in a surge in home entertainment. In addition to gaming giant Tencent, we hold NC Soft, a Korean on-line gaming software developer, which benefited from users staying at home more in Q1. These two stocks were the main contributors to our outperformance in Q1.

Similarly, China Communication Services (please refer to the case study on page 4) and TSMC benefitted from a revived urgency for deploying 5G infrastructure, with fast digital networks now considered a vital staple. Ecommerce titan Alibaba was another top contributor to our outperformance in the first quarter. Its all-in-one mobile workplace app, DingTalk, enjoyed a surge in downloads, mirroring the trajectory of ecommerce and online streaming. Data compiled by JP Morgan, using Apptopia records from 30 January to 22 March, showed that DingTalk was the most downloaded video-conferencing app worldwide with over 22m downloads. This compared to 20m downloads for Zoom Cloud Meetings, 9m for Microsoft Teams and 2m for Skype for Business. DingTalk enables quality video conferences and other forms of remote collaboration – and it may serve as an example of how the coronavirus will change the way people work in the post-pandemic world.

In terms of the benefits of automation, the temporary shut-down of Samsung Electronics' Korean handset plant due to the virus demonstrated the vulnerability of its worker-heavy phone plants compared to the resilience of more automated chip-making plants which have not incurred a shut-down thus far. Worldwide, South Korea has one of the highest robot densities in the manufacturing industry[23]. Data from the IFR shows that Taiwan is very tech-savvy too: we own Delta Electronics Inc, a maker of automation solutions that improve buildings' energy efficiency, and Advantech Co Ltd, a maker of automation products and solutions (interestingly, its technology has been used in robots measuring the temperature of people in public places during the pandemic). Meanwhile, China ranks 20th worldwide with a robot density of 140 compared to the global average of 99 and the remaining emerging markets countries lag the global average. The automotive industry remains the largest customer industry, with 30% of total installations globally, but Mexico, whose industrial sector is key for US car manufacturers, is a laggard. And with a narrow safety net, high dependency on energy prices, no additional aid from the government to save jobs and low use of robotics, its workers might be among those that suffer the most from this crisis.

[19] Note: the food sector increased by 32% in 2016-18. Source: International Federation of Robotics, as at September 2019.
[20] Source: World Health Organisation, as at 31 March 2020.
[21] According to Bloomberg data, the Brazilian reai and the South African rand dropped 22%, the Russian ruble and the Mexican peso lost 21% and the Colombian peso declined by 19%.
[22] Source: Bloomberg, as at 31 March 2020.
[23] Robot density is defined as the number of installed industrial robots per 10,000 employees. Source: World Robot Statistics issued by the International Federation of Robotics.

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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
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- **Liquidity:** solutions driven by four decades of experience
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