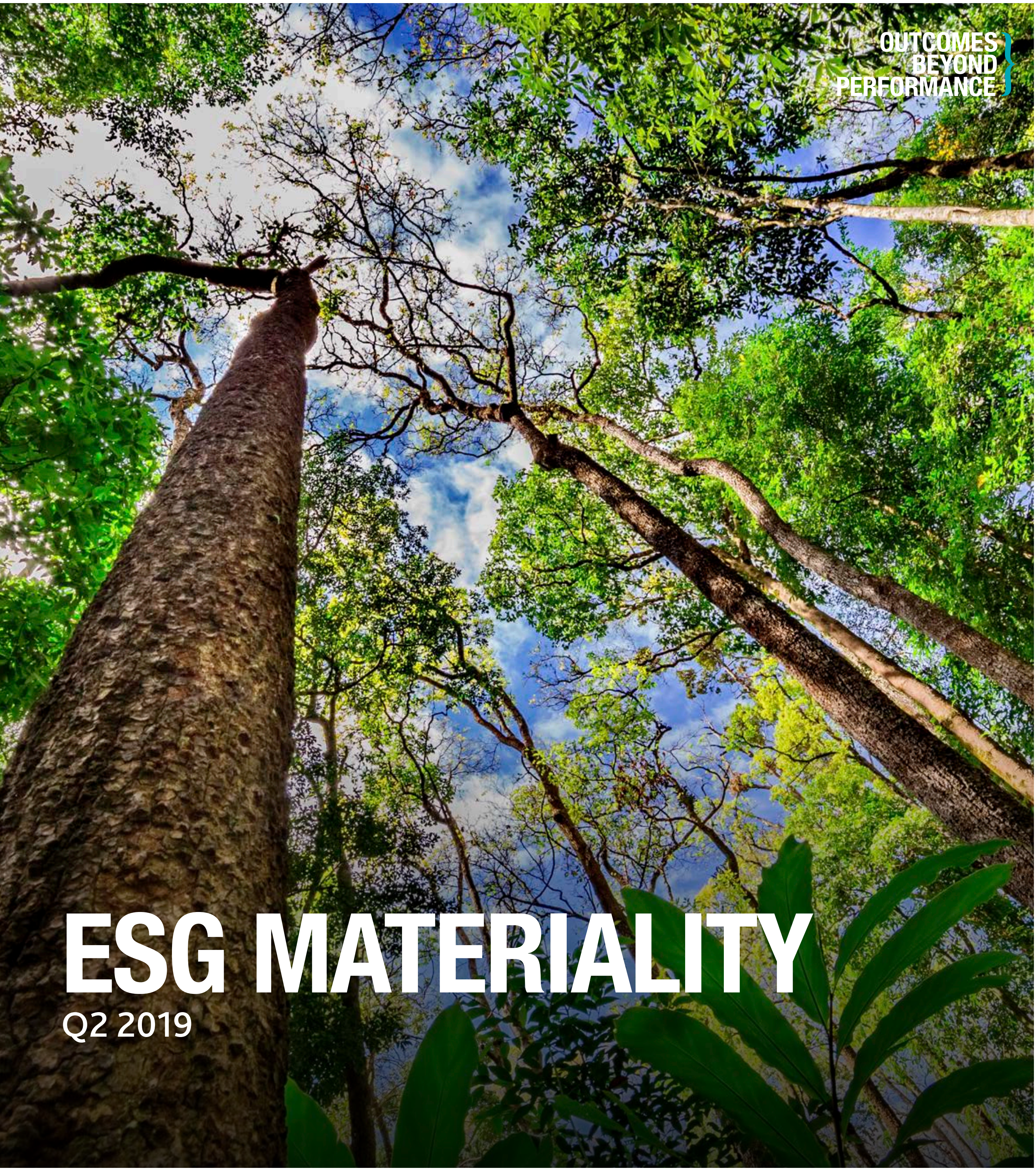

ESG MATERIALITY

Q2 2019

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HERMES
INVESTMENT MANAGEMENT

INTRODUCTION

Welcome to the inaugural edition of the Hermes Global Emerging Markets' *ESG Materiality* commentary – a quarterly publication that will demonstrate our engagement activity with portfolio companies and showcase holdings that are creating positive impact aligned to the Sustainable Development Goals (SDGs). In addition, we will 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 the emerging-market equity space by focusing on companies that can tackle sustainability challenges as they arise. We recognise that developing markets 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.
- These companies' management teams must be willing to confront **sustainability challenges** and enter the transformative process of engagement on material ESG issues.
- 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 ESG issues** – many of which are relevant to achieve the SDGs – as well as strategic issues; these engagements seek positive impact across companies' value chains.

Portfolio snapshot, Q2 2019

The carbon footprint of our portfolio is

437,296TN

of scope 1, scope 2, and scope 3 emissions compared to

2,544,918TN for the benchmark

We engaged **70%** of our holdings making progress in **69%** of these engagements.

Source: Hermes as at 30 June 2019.

Percentage of AUM engaged by theme

Environmental	Social & ethical	Governance	Strategy and communication
32%	59%	48%	70%

Source: Hermes as at 30 June 2019.

ENGAGEMENT CASE STUDY

THE FOSCHINI GROUP

The Foschini Group is a South African fashion retailer comprising 22 brands.

Engagement themes

- Sustainable consumption and production
- Board committees and succession planning
- Labour and human rights
- Water management and climate change

From a financial and an ESG perspective, Foschini is a strong performer. However, we believe that there is still potential for further improvement. In the three months to 30 June, we have engaged with its management and chairman on ESG issues.

Environment

Foschini has a strong presence in the Western Cape area – a region with significant water stress. Between 2013 and 2018, the group invested over 5m South African Rand in water-conservation initiatives. By doing so, it reduced its water consumption by more than 25% between 2017 and 2018. We had an introductory discussion with the chair and the management team on sustainability, and we aim to resume our engagement with a water-focused discussion.

5M
Rand invested in water-conservation initiatives

25%
reduction in water consumption between 2017-2018

Social

Within a South African context, Foschini is a leader in both labour and supply chain issues: some of its manufacturing facilities are based in South Africa and so, unlike its main competitors, which import fashion goods from third parties in Asia, it creates employment locally. We urged the company to update its human rights policy to include local minimum-wage standards and other key labour rights – and management have agreed to do so. Meanwhile, Foschini's international suppliers are monitored using Sedex – a platform for sharing responsible sourcing data on supply chains – while in Asia, factory audits are outsourced to supply-chain-inspection specialist QIMA, formerly Asian Inspection. In addition, new suppliers must sign the company's human-rights policy and pass an initial audit.

Governance

We expressed concerns about the composition of the company's audit committee and the long tenures of some directors: its chair is 80 years old and has served on the board since 1998. The chairman assured us that succession plans have been established, with preparations underway for changes in 2020. We believe that independence, experience and leadership are key elements for this role. As such, we will consider opposing the re-election of the existing chairman of the audit committee and/or of the chair of nomination committee if succession is not addressed in a satisfactory manner at the 2020 AGM.

IMPACT CASE STUDY

DELTA ELECTRONICS

Theory of Change

Delta Electronics manufactures products that help reduce energy consumption and enable the transition to a low-carbon economy.

SDG alignment

7 AFFORDABLE AND CLEAN ENERGY

SDG target 7.2: By 2030, increase substantially the share of renewable energy in the global energy mix.

SDG target 7.3 By 2030, double the global rate of improvement in energy efficiency.

Taiwanese IT company Delta Electronics derives a significant portion of its revenues from products that create positive impact: they help to reduce energy consumption and enable the transition to a low-carbon economy. As such, the Taiwanese IT company can make a significant contribution to SDG target 7.2 (renewable energy) and SDG target 7.3 (energy efficiency).

As the largest power-supply vendor worldwide, Delta offers some of the most energy-efficient power products in the electronic equipment industry, including switching power supplies with efficiency of over 90%; telecom power with up to 98% efficiency; and photovoltaic solar (PV) inverters with up to 98.8% efficiency.

In addition, the group manufactures LED lighting as well as other automation solutions that improve buildings' energy efficiency while also reducing their carbon footprint, thereby enabling solutions for sustainable (green) buildings.

As the largest power-supply vendor worldwide, Delta offers some of the most energy-efficient power products in the electronic equipment industry

More recently, the company has focused on another area of growth: electric vehicles (EVs). It manufactures products including on-board chargers, EV charging stations, and energy storage systems (battery management system, BMS).

The company is committed to sustainability: last year, it was recognised by Dow Jones Sustainability Indices (DJSI) as an industry leader within the electronic equipment, instruments and components sector for the fourth time. Furthermore, the company has been included in the DJSI Emerging Markets index for the seventh consecutive year.

ESG IN EMERGING MARKETS

In focus: will the new Mercosur-EU trade deal raise the risks of deforestation?

Mercosur 'cows for cars' accord

In June 2019, the European Union (EU) and the Mercosur – the South American bloc of Argentina, Brazil, Uruguay and Paraguay – reached a landmark trade agreement, concluding two decades of negotiations in the face of rising protectionism.

The EU is Mercosur's second-biggest trade partner: a total of 20.1% of the bloc's exports in 2018 went to the EU. Meanwhile, the EU exported €45bn-worth of goods to the four South American countries.

Described by the media as the 'cows for cars' accord[2], the deal, if ratified, includes the prospect of greater competition for Mercosur's car manufacturers (it will slowly end the 35% tariff on imported European cars) and EU farmers (it grants the South American bloc increased access to the European market for beef, soya and other soft commodities).

Rising resistance

Already, the trade pact has faced opposition – environmental groups are concerned it could worsen deforestation in the region, while French President Emmanuel Macron cautioned that a deal could not go ahead if Brazilian President Jair Bolsonaro wavered on the country's environmental commitments.

Indeed, from an environmental perspective, the idea of more cars in Latin America is concerning, but the adoption of electric vehicles may go some way to alleviating these concerns. As for the cows, one must wonder: does Europe really need more beef or does the pact merely facilitate a production shift to low-cost countries?

European consumer preferences are changing: for example, annual meat consumption in Germany has dropped to an average of 64 kilos per person in 2016 from 69 in 2010 owing to the growing emphasis on health, ethical and environmental considerations[3]. In addition, Germany has one of the largest populations of vegans, vegetarians or flexitarians – and numbers are growing steadily. Indeed, similar trends are being observed across Europe, and the European Commission expects beef consumption to gradually decline across the bloc to 10.4kg per capita by 2030 (down from its current level of 11kg)[4]. Such trends suggest that the deal has little to do with increased demand – and so, it may come down to the competitive advantage that South America has in the beef industry – which may exacerbate the deforestation problem (many experts believe that cattle ranching is responsible for the growing levels of deforestation in the Amazon rainforest[5]). Further concerns are based on a study by Oxford University, showing that on average, beef produced in South America results in three times the amount of greenhouse gases as beef produced in Europe[6].

Bolsonaro policies

Since Bolsonaro was elected last year, he has cut the budget of the ministry's environmental protection agency, the Brazilian Institute of Environment and Renewable Natural Resources (IBAMA), thereby weakening its ability to identify – and penalise – illegal deforestation.

Indeed, Bolsonaro has made his intentions clear when it comes to the country's environmental policy: he plans to open the Amazon rainforest to development and agribusiness. In addition, he has undermined the country's reputation as a responsible food producer and threatened to withdraw from the Paris climate accord.

Cynical investors may view the benign political landscape as an opportunity to buy shares in Latin American meat or soybean producers. But now, more than ever, we believe that investors must act responsibly: they must assess the ESG impact of their investment decisions. Especially those that may accelerate deforestation in the region or have a detrimental impact on the environment – and they must engage with companies to track the implementation of their supply-chain policies.

What does it mean for emerging-market investors?

Food companies: it is important to audit the supply chain of meat producers and other food companies to ensure that their cattle do not graze on land where forests have been felled illegally and monitor the impact that farming is having on climate change. This sector – to which we have no exposure to at present – has a key role to play in cutting emissions: it can improve manure management, change cattle feed, use energy-efficient tractors and equipment, reduce the use of chemical fertilisers, adopt renewable sources of energy and limit the use of antibiotics in livestock management.

Financial institutions: We have exposure to financial institutions and therefore check whether and to what extent the assessment of ESG issues forms part of their credit scoring or insurance risk underwriting policies and practices. We engage with companies to strengthen their approach and address material issues. The IBAMA established an electronic system, the Forest Origin Document, which tracks timber harvests in legal areas. Some Brazilian financial institutions use it to check the activities of their clients before issuing new credit. International banks may also request internationally recognised certification (such as those from the Forest Stewardship Council, FSC, or the Programme for the Endorsement of Forest Certification) for soft commodities and proof of timber legality as pre-conditions for financing. Furthermore, some banks actively support the beef and soya moratoria adopted in Brazil in 2006 and 2009, respectively. Any company that signed up to the moratoria committed to monitor its supply chain and agreed to stop the purchase of soya and cattle from deforested areas in the Amazon biome. According to the World Wide Fund for Nature, both the beef and the soya moratoria have yielded positive results for the Amazon[7].

Building materials: We also have exposure to the forestry products industry, and we are aware that the logging of natural forests can disrupt growth cycles and wildlife habitats, which can in turn affect regional ecosystems. In this sector, it is therefore important to select companies whose forest and/or suppliers have obtained FSC certification and whose operations have obtained international accreditations for their environmental management system and occupational health and safety practices.

At risk of rejection?

The Mercosur-EU trade deal still needs to be ratified by Mercosur, the European Parliament and constituent countries – and Brazil's government has conceded that this could take years.

In addition, French farmers are concerned about the risk of a surge in beef import volumes. Meanwhile, environmentalists, whose influence is stronger in the new European Parliament, argue that the agreement could pose challenges to the aim of SDG target 15: to protect, restore and promote sustainable use of terrestrial ecosystems. As responsible investors, we will follow these developments, hoping that ESG considerations will go hand in hand with economic ones at the negotiation table.

Sources

[1] Scope 1 emissions are direct emissions from company-owned or controlled sources; Scope 2 emissions are indirect emissions caused by the generation of purchased energy; and Scope 3 emissions are all other indirect emissions that occur throughout the value chain of the reporting company, including from both upstream and downstream entities.
[2] "Environmental criticism mounts over EU-South America trade deal," published by the Financial Times in July 2019.
[3] "Germany's eating habits die hard," published by Handelsblatt in January 2018.
[4] "EU agricultural outlook: for markets and income 2018-2030," published by the European Commission in December 2018.
[5] "Brazil's rainforest warriors ready to battle Bolsonaro," published by the Financial Times in April 2018.
[6] "Climate change food calculator," published by the BBC in August 2019.
[7] "Soy moratorium: the main global zero deforestation benchmark," published by the World Wide Fund for Nature in October 2016.