ESG Materiality Newsletter

Q4 2022

Olivia Lankester
Director, Responsible Investing & Sustainability – Global Emerging Markets

Federated Hermes Limited

www.hermes-investment.com
For professional investors only

Introduction

Welcome to our Global Emerging Markets' ESG Materiality commentary – a quarterly publication that demonstrates our engagement activity with portfolio companies and showcases holdings helping to create positive impacts in line with the UN's Sustainable Development Goals (SDGs).

In this issue, we reflect on the 2022 voting seasons and key trends, including the continued push for greater board independence and diversity across emerging markets. We also profile two names – AIA Group and Landmark Optoelectronics, that have shown positive progress on environmental, social, and governance (ESG) topics, following our engagement.

As we have done the past decade, we remain committed to acting as responsible investors by focusing on companies best placed to tackle sustainability challenges as they arise.

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 low carbon footprint and prioritise engagements with holdings in the extractive industries or those with higher levels of emissions.
- We engage on strategic and/or ESG matters, including issues which are relevant to achieving the UN's Sustainable Development Goals; our engagements seek positive impact across value chains.

Portfolio snapshot, Q3 2022

As of the end of September 2022, we engaged with companies representing **80%** of our AUM, making progress in **53%** of these engagements.

Percentage of AUM engaged by theme

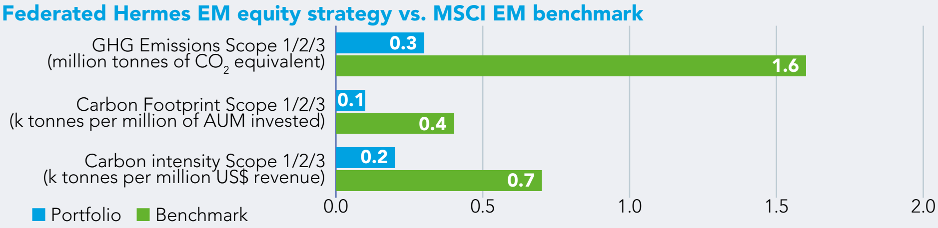
Environmental	Social and ethical	Governance	Strategy and communication
61%	57%	76%	43%

Source: Federated Hermes as at 30 September 2022.

Our portfolio's carbon footprint, Q3 2022

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]

Federated Hermes EM equity strategy vs. MSCI EM benchmark



Source: Federated Hermes as at 30 September 2022. The benchmark is the MSCI Emerging Markets Index.[2]

[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. Companies' greenhouse gas emissions are categorised into three groups or 'Scopes' by the most widely-used international accounting tool, the Greenhouse Gas (GHG) Protocol. Scope 1 covers direct emissions from owned or controlled sources. Scope 2 covers indirect emissions from the generation of purchased electricity, steam, heating and cooling consumed by the reporting company. Scope 3 includes all other indirect emissions that occur in a company's value chain.

[2] Benchmark source: MSCI. The MSCI data is for internal use only and may not be redistributed or used in connection with creating or offering any securities, financial products or indices. Neither MSCI nor any other third party involved in or related to compiling, computing or creating the MSCI data (the "MSCI Parties') makes any express or implied warranties or representations with respect to such data (or the results to be obtained by the use thereof), and the MSCI Parties hereby expressly disclaim all warranties of originality, accuracy, completeness, merchantability or fitness for a particular purpose with respect to such data. Without limiting any of the foregoing, in no event shall any of the MSCI Parties have any liability for any direct, indirect, special, punitive, consequential or any other damages (including lost profits) even if notified of the possibility of such damages.

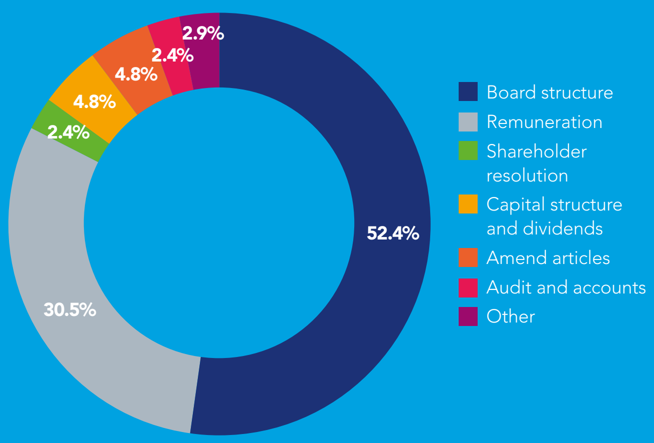
IN FOCUS:

Key voting season trends in emerging markets

The annual general meeting (AGM) voting season in 2022 saw renewed attempts to improve board diversity and independence – underlining our focus on board effectiveness as a key driver of long-term shareholder value.

In the Global Emerging Markets (GEMs) Equity fund we voted against management on grounds of board composition at 52.4% of companies in the portfolio (see Figure 1).

Figure 1: GEMs fund votes against (or abstentions) in 2022.



Independence

We continued to push for improved board independence both through our voting and engagement discussions. In some markets, we now seek higher proportions of independent directors, such as 40% in Mexico and 50% in Brazil for the Novo Mercado listing segment, where corporate governance requirements are more stringent.

Through our engagements, we are able to consider not just the proportion of independent members but also how they function in practice. Some boards fulfil the independence criteria at a technical level, but this does not always result in sufficient genuinely independent thought on the board.

We opposed directors at companies in India, China and Hong Kong where their long tenure weakened board independence or where non-independent directors sat on audit committees. For example, we voted against management at **Bajaj Finserv, Wuxi Biologics, Silergy Corps** and **Sungrow** on independence grounds.

However, there are times when engagement remains the best way forward, even if there are some concerns on independence. For example, at **Samsung Electronics**, we have been concerned that nearly half the board are executives, reducing the proportion of independent directors. However, we ultimately supported the election of proposed executive board members, given a range of recent positive governance developments, including implementation of a new compliance framework. Meanwhile, we will continue to engage to seek an increase in the proportion of independent directors.

Separation of CEO/Chair

Our corporate governance principles set out a clear expectation for the separation of chief executive officer (CEO) and chair roles as the best way to ensure the effectiveness and independence of the board. We recognise that the transition to separate roles can take time and requires careful succession planning but nevertheless see this as a priority. In the absence of an independent chair, the overall independence of the board takes on extra significance and we also recommend the appointment of a lead independent director (see box) as a counterweight to a combined CEO/chair. As an example, we are engaging **Alibaba** on this topic and are pleased to hear that it is under consideration by the board.

Role of lead independent director (as set out in Federated Hermes Corporate Governance principles)

- Leading the group of non-executive directors and functioning as a link between them and the executive directors
- Consolidating the views of other board directors and acting as the main, constructive counter-weight to the chair, executives and major shareholders on the board
- Chairing meetings of non-executive directors
- Playing a key role in board evaluation and shareholder engagement
- Representing the interests and views of minority shareholders at board meetings
- Ensuring that all directors are sufficiently well-informed to perform their duties
- Managing government investigations (if any) as a non-executive but informed director of the company.

Gender diversity

The slow progress in board and senior management gender diversity in Brazil led B3, the Brazilian Stock Exchange, to propose the introduction of a new listing rule, on a 'comply or explain' basis. This requires companies to have at least one woman and one ethnically diverse member on the board or the executive committee from 2025. This remains below our expectations of a minimum threshold of 20% female representation, which is based on the premise that a diverse board is the best way to ensure robust challenge and protection against 'group think'.

> **The slow progress in board and senior management gender diversity in Brazil led B3, the Brazilian Stock Exchange, to propose the introduction of a new listing rule, on a 'comply or explain' basis.**

In Asia, legal requirements are also tightening, for example, in South Korea, Malaysia and Hong Kong. At **AIA Group**, we recommended support for directors by exception to our policy to recognise its progress in reaching a level of diversity that is just below our minimum expectations (see case study on page 5). In China, we were pleased to see progress at companies such as **Alibaba**, which now has three female board directors after several years of engagement on this topic, and **NARI Technology** (albeit with small steps) where gender diversity increased from 8% to 17% in 2022[3]. However, we voted against other names where there were no such accentuating circumstances or progress such as **China Communications Services** and **Shenzhen International**. More focus is needed to raise female board membership far above our current 20% minimum threshold.

Progress report

We were pleased to see some companies performing well this year. The board of India's **Tech Mahindra**, for example, is now 60% independent and 40% female while **Magazine Luiza** is 64% independent and 38% female.

We were also pleased to see improved gender diversity at **Grupo Aeorporto del Pacifico** (up to 27% from 10% in 2018) although we noted that the group has zero female representation at executive management level and have raised this as an issue for the company to address.

However, there is still room for improvement on independence and diversity. At a national level there has been progress on gender diversity requirements, but some backsliding in other areas. For example, the Indian regulator has revoked a requirement to separate the roles of CEO and chair (downgraded to a recommendation), after pressure from major companies.

> **In combination with EOS, our stewardship team at Federated Hermes, we have recently tightened expectations on independence and diversity in some markets, such as Brazil.**

Meanwhile, we will continue to scrutinise board effectiveness and translate this into voting recommendations. In combination with EOS, our stewardship team at Federated Hermes, we have recently tightened expectations on independence and diversity in some markets, such as Brazil. We must now focus on enforcing these tighter expectations and continue to raise them in markets as relevant.

> **Through voting and engagement, we will continue to scrutinise board effectiveness and support companies with positive momentum on ESG issues.**

[3] At **China Merchants Bank**, we voted for a male candidate by exception, despite low gender diversity, since voting against him would have the unintended consequence of lowering the independence of the board.

ENGAGEMENT CASE STUDY

AIA Group

EOS[4], our stewardship team at Federated Hermes, has engaged extensively with AIA Group on a range of issues, including board gender diversity and is pleased to see improvements.

Company overview

AIA Group is a Hong Kong-based American multinational insurance and finance corporation, with a presence in 18 markets across Asia-Pacific.

Details of engagement

We have been engaging with AIA on a range of topics since 2013, including on governance, human capital management and its sustainability strategy. Since 2018, we have been communicating our expectation for the board to feature at least 20% female directors by 2020 due to the evidence that greater diversity results in improved debate and decision-making. Given limited progress, in 2020 we recommended voting against the election of the nomination committee chair, who is also the independent board chair. The company secretary acknowledged our concerns and followed through on some of our suggestions, such as refreshing the board diversity policy.

Since 2018, we have been communicating our expectation for the board to feature at least **20%** female directors by 2020 due to the evidence that greater diversity results in improved debate and decision-making.

We will continue our productive discussions with AIA about its board composition and effectiveness, as well as climate change and other sustainability matters.

We continued to reiterate our perspective and signalled our ongoing concerns at the 2021 AGM, with a further recommended vote against the longest-serving member of the nomination committee who was up for election.

Outcomes and next steps

We are pleased to see that the company has now appointed an additional female director to the board, which has resulted in board gender diversity rising to 18%, just below our current expectations. In a call with the head of investor relations and the sustainability team in early 2022, we welcomed this development and thanked the company for taking our feedback into account, whilst encouraging it to stay focused on further increasing board gender diversity. We learned that the new female director has brought valuable technology and accounting skills to the board. We will continue our productive discussions with AIA about its board composition and effectiveness, as well as climate change and other sustainability matters.

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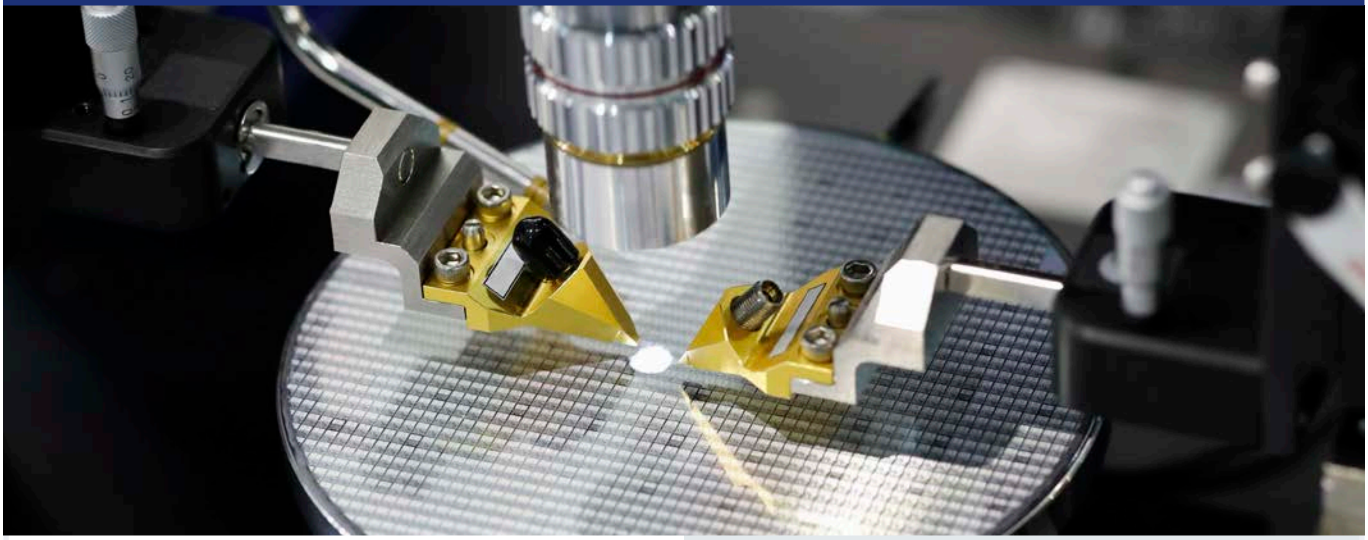
[4] EOS is a leading stewardship service provider at Federated Hermes and its engagement activities enable long-term institutional investors to be more active owners of their assets, through dialogue with companies on environmental, social and governance issues.

ENGAGEMENT CASE STUDY

LandMark Optoelectronics

Since our engagement, the company produced its first Corporate Social Responsibility (CSR) report and started to report against the key pillars of the Task Force on Climate-related Financial Disclosures (TCFD) recommendations. The company set short-, medium-, and long-term emission targets and committed to carbon neutrality by 2050.



Engagement timeline

Feb 2018
- EOS' first engagement on setting climate and renewable energy targets.

Oct 2019
- The company issued its first Corporate Social Responsibility report.

Dec 2019
- The company established the Corporate Sustainability Committee at the board.

Jun 2021
- The company started to report against the TCFD key pillars and announced its short-term climate targets by 2025.

Jun 2022
- The company set short-, medium- and long-term climate targets and committed to carbon neutrality by 2050.

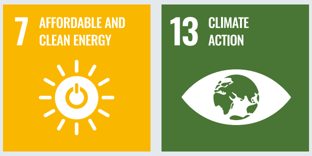
Company overview

LandMark Optoelectronics engages in the research, design, manufacture, and sale of laser epitaxial wafers and optoelectronics wafers. It specialises in the manufacture of wired communications machinery and equipment, and electronic components. When we first engaged with this company in 2018, the company did not yet publish a sustainability report, disclose any ESG data or set any climate-related targets

Engagement objectives:

Environmental:
TCFD reporting, Emissions reductions

Sustainable Development Goals:



Top three successes:

The company produced its first Corporate Social Responsibility (CSR) report

The company started to report against the key pillars of the Task Force on Climate-Related Financial Disclosures (TCFD) recommendations

The company set short-, medium-, and long-term emission targets and committed to carbon neutrality

Our engagement

We started our engagement with LandMark Optoelectronics on climate data disclosure and target-setting in 2018 by regularly meeting with the chief financial officer (CFO). We requested the company to start collecting and reporting ESG progress annually and suggested it refer to the CDP climate change survey framework for disclosure.

In 2019, we further stressed the importance of setting targets on energy efficiency and emissions. We met with the company's sustainability adviser and agreed that one of the main targets for the company is to report against the Task Force on Climate-Related Financial Disclosures (TCFD)[5] recommendations. We urged that the process of determining a long-term target should start as soon as possible and be given sufficient resources, instead of its current approach of only setting yearly incremental emissions reduction targets. We explained the benefit of a more forward-looking approach and target-setting informed by risk mitigation and long-term planning. We also suggested it further examine peer companies' disclosure and explore purchasing green energy to reduce its Scope 2 emissions[6]. In 2021, we encouraged more detailed disclosure about risk and financial impact and how this links to strategy. We shared information about science-based targets, as well as several TCFD examples.

> **We started our engagement with LandMark Optoelectronics on climate data disclosure and target-setting in 2018 by regularly meeting with the chief financial officer (CFO).**

Changes at the company

In 2018, the CFO shared with us that the board has approved allocating dedicated resources for corporate sustainability purposes and that the company will disclose greenhouse gas emissions information in its next annual report. In October 2019, the company issued its first CSR report. In December 2019, it established the Corporate Sustainability Committee at the board which is comprised of three independent board directors, the board chair, and an execution team led by the general manager that reports quarterly to the board. Despite the scarcity of renewable energy in Taiwan, the company took steps to install solar panels on its newly built factory's rooftop. The company disclosed its first short-term climate target in June 2021 by committing to reduce greenhouse gas emissions intensity by 6% by 2025. We were also pleased to learn that the company started reporting against the TCFD key pillars.

The company disclosed its first short-term climate target in June 2021 by committing to reduce greenhouse gas emissions intensity by **6%** by 2025.

At a meeting in June 2022, the chair and CFO shared that the board had decided to commit to carbon neutrality by 2050. In its latest sustainability report published in the same month, it further disclosed its medium- and long-term climate targets. This set of targets aims to source 100% renewables for non-manufacturing facilities, and 20% for manufacturing facilities by 2030. It also aims to achieve no carbon emission growth by 2040 and reach carbon neutrality by 2050. The company confirmed that its carbon footprint verification and a carbon management plan will be finalised by the end of 2022. In addition it will further improve its TCFD reporting in the 2023 sustainability report. The CFO also confirmed that a submission to the Science Based Targets initiative (SBTi)[7] is also part of the next three-to-five-year plan.

Next steps

We welcomed the company's new climate commitment and will continue to engage on board gender diversity, alignment to the Paris goals (or further 1.5°C alignment), improvement of TCFD reporting and supply-chain climate readiness.

[5] The Task Force on Climate-Related Financial Disclosures (TCFD) was created in 2015 by the Financial Stability Board (FSB) to develop consistent climate-related financial risk disclosures for use by companies, banks, and investors in providing information to stakeholders.

[6] Companies' greenhouse gas emissions are categorised into three groups or 'Scopes' by the most widely-used international accounting tool, the Greenhouse Gas (GHG) Protocol. Scope 1 covers direct emissions from owned or controlled sources. Scope 2 covers indirect emissions from the generation of purchased electricity, steam, heating and cooling consumed by the reporting company. Scope 3 includes all other indirect emissions that occur in a company's value chain.

[7] The Science Based Targets initiative (SBTI) provides companies with a clearly defined pathway to future-proof growth by specifying how much and how quickly they need to reduce their greenhouse gas emissions.

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Investments in emerging markets tend to be more volatile than those in mature markets and the value of an investment can move sharply down or up.

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