ESG Materiality Newsletter

Q3 2022

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Federated Hermes
Limited

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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 impact of supply chain shocks on workers, particularly those most vulnerable to the impacts of Covid-19 and cost of living increases, and set out our expectations for companies in terms of ensuring the wellbeing of workers across their supply chains.

As we have done for 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 any 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, and our engagements seek positive impact across companies' value chains.

Portfolio snapshot, Q2 2022

As of end of June 2022, we engaged with companies representing **65%** of our AUM making progress in **49%** of these engagements.

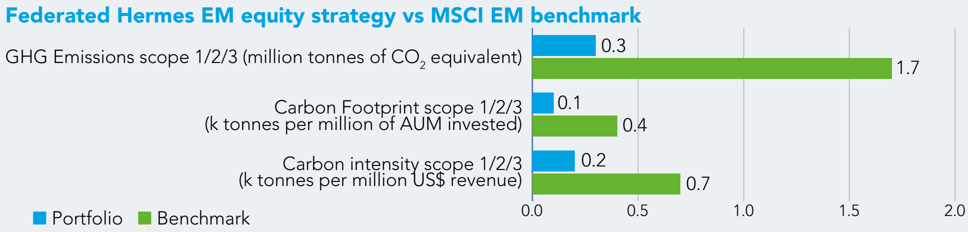
Percentage of AUM engaged by theme

Environmental	Social and ethical	Governance	Strategy and communication
49%	49%	62%	39%

Source: Federated Hermes as at 30 June 2022.

Our portfolio's carbon footprint, Q2 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]



Source: Federated Hermes as at 30 June 2022. 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.

IN FOCUS:

Supply chain scrutiny puts spotlight on workers' rights

Tough new US and EU regulations, and pressures related to the cost of living and the Covid-19 pandemic, are forcing companies to scrutinise their supply chains. How will this impact emerging markets?

- The UN Sustainable Development Goals (SDGs) include eradicating poverty and ensuring decent work for all – essential foundations for building thriving societies and economies. Decent work is recognised in the Universal Declaration of Human Rights, while poverty erodes access to fundamental human rights.
- Many of the problems targeted by these two SDGs – zero poverty and decent work – are disproportionately found in supply chains due to their complex and sprawling nature, especially in emerging markets.
- However, strict new US and EU regulations, as well as greater scrutiny from stakeholders, is putting companies under pressure to re-examine their supply chains and address human rights abuses.

Runaway fuel and food prices and the Covid-19 pandemic have pushed many people closer to poverty over the last two years. The climate crisis has also negatively impacted working conditions, particularly in emerging markets; low-income outdoor workers, such as people employed in agriculture or construction, are particularly vulnerable to heat stress, making working conditions intolerable and squeezing productivity[1]. While emerging markets are arguably more resilient to heat stress, India and Pakistan have endured temperatures near 50 degrees Celsius this year, a foretaste of what is to come[2].

Against this backdrop, the business case for corporate action is compelling. Social inequality is a systemic risk that undermines political and economic stability. A commitment to wider stakeholders and economic sustainability must include helping to lift communities out of poverty and finding ways to reach the vulnerable and disenfranchised. Beyond the ethical case for respecting human dignity and the fact that forced and child labour are illegal, being able to articulate human rights risks and implement effective human rights strategies is indicative of robust risk management.

Working conditions and fair treatment have been enshrined in international standards for many years – via the International Labour Organisation (ILO) Conventions, the UN Guiding Principles on Business and Human Rights (UNGPs) and corporate codes of conduct – and these soft law expectations combined with greater regulatory scrutiny could pose significant challenges to businesses globally that may be unwittingly connected to human rights abuses in their operations and supply chains (see box below).

Key regulatory developments

New regulations are coming into force to tackle human rights issues, adding to existing Modern Slavery Acts in the UK and Australia, the French Duty of Vigilance and Brazil's 'Slave Labour Dirty List'[3]. Investors and companies must get ahead of these or run the risk of fines, lawsuits, or reputational damage.

- The US Tariff Act dates from 1930, but in recent years there has been a significant increase in enforcement actions on items where modern slavery is suspected in production, including fish, palm oil, and rubber gloves.
- The US Uyghur Forced Labour Prevention Act (UFLPA) was passed in December 2021, effective from June 2022. This works on the assumption that goods mined, produced, or manufactured (wholly or in part) in China's Xinjiang Uyghur Autonomous Region are made with forced labour and, therefore, will be subject to a US import ban[4].
- The EU's proposed Corporate Sustainability Due Diligence Directive[5] will mandate companies to carry out due diligence and annual reporting on environmental and human rights issues throughout their supply chains. Under the proposal, companies falling within the directive's scope will be required to identify and, where necessary, prevent, end or mitigate the adverse impacts of their activities. Fines may be imposed in the event of non-compliance, and victims may be able to sue for damages. This directive will apply to EU companies of a certain size threshold, or operating in high-impact sectors, and non-EU companies operating in the EU being captured by the other criteria.
- The Japanese government has set up a panel on human rights in business supply chains. It aims to publish guidelines for companies in mid-2022, and will consider passing a law.

Meanwhile, China's Anti-Foreign Sanctions Law adopted in June 2021 provides legal grounds for the Chinese government to take countermeasures against 'discriminatory restrictive' foreign sanctions, including asset freezing and prohibition of PRC persons from conducting business with designated parties. This places companies operating in China in a very difficult position, where they seek to meet regulatory requirements on both sides of the geo-political divide.

[1] ILO: Occupational Heat Strain and Mitigation Strategies in Qatar wcms_723545.pdf (ilo.org)
[2] "We are living in hell': Pakistan and India suffer extreme spring heatwaves | the Guardian (theguardian.com)
[3] This was introduced by the Ministry of Labour and Employment in 2004 to name and shame companies found to be profiting from slave labour, with potential criminal and commercial sanctions. After temporary suspension of the list in 2014, it was re-instated in 2017.
[4] Text - H.R.1155 - 117th Congress (2021-2022): Uyghur Forced Labor Prevention Act | Congress.gov | Library of Congress
[5] Corporate sustainability due diligence (europa.eu)

The crunch issues

By decent work, we mean that employees should be safe, treated with respect and compensated fairly. Yet long supply chains may involve forced labour (see box below), child labour, poverty wages, abuse, and even workplace deaths because of negligence. The non-payment of minimum wages and insecure work can place vulnerable people in a spiral of poverty and dependency. While these abuses are increasingly also found in developed markets, workers in emerging markets are disproportionately affected, particularly migrants, women, children and ethnic minorities. Such abuses are most common in manufacturing, agriculture, construction and mining, but can also be found in less manual sectors, such as the technology supply chain.

ILO Forced labour indicators

Almost 25 million people around the world are in a condition of forced labour, according to the International Labour Organisation (ILO) and research conducted with leading UK brands found that 77% of companies, when interviewed anonymously, thought it likely that modern slavery occurred in their global supply chains[6].

ILO indicators of forced labour include:

- restriction of movement
- retention of identity documents
- withholding of wages
- abusive working conditions
- intimidation and threats
- excessive overtime
- and debt bondage

Debt bondage is widespread, accounting for an estimated 50% of cases of forced labour. This situation arises when workers are exploited because they must repay a debt. Migrant workers are highly vulnerable to the payment of recruitment fees, a predominant practice in emerging markets to access employment.

These issues have been exacerbated by Covid-19, which has put additional pressures on supply chains, as orders were cancelled and also resumed with short lead times, leading to the loss of livelihoods for some workers and excessive overtime for others[7]. Working hours well above legal thresholds, and in excess of 72 hours a week, have been prevalent in China and other countries, even before the pandemic. This continues to be a challenge with ongoing supply chain disruptions. Diversification of supply chains as a means of spreading risk and accessing lower cost manufacturing, has also led to companies shifting manufacturing to countries with weaker enforcement of labour laws.

Implications for GEMs holdings

Companies in emerging markets may face less regulatory and market pressure to respond to these concerns but are by no means insulated. Premiumisation – the shift to more expensive brands – has driven greater consumer awareness; and companies operating in, or exporting to, developed markets face greater scrutiny from new regulations.

A recent survey of **1,000** companies across **68** countries by the World Benchmarking Alliance found that only **4%** of firms are demonstrating 'decent work' fundamentals.

While there are pockets of leadership, a recent survey of 1,000 companies across 68 countries by the World Benchmarking Alliance found that only 4% of firms are demonstrating 'decent work' fundamentals[8]. Challenges exist across both emerging and developed markets, as highlighted by a recent *Financial Times* article documenting labour abuses at garment factories in the UK[9].

Examples of leadership in the GEMs portfolio include a leading South African food retailer, which has recently introduced a 'living Wage' for all its 149,000 employees, a move that is likely to have ripple effects on suppliers. Other companies in the portfolio have also made good progress, including a Taiwanese electronics manufacturing company (see case study). Yet, in common with the majority of DM and EM companies, much more needs to be done.

[6] CCLA. Find It, Fix It Prevent It. The problem | CCLA Modern Slavery (modernslaveryccla.co.uk)
[7] CHBR-Covid-Study_110221_FINAL.pdf (worldbenchmarkingalliance.org)
[8] 2022_Social_Transformation_Baseline_Assessment.pdf (worldbenchmarkingalliance.org). Page 11
[9] Leicester garment factories still exploiting staff, study finds | Financial Times (ft.com).

Our engagement approach

Our engagement with companies focuses on their responsibility to respect human rights as outlined by the UNGPs, including establishing adequate due diligence to identify and mitigate salient risks and provide a remedy. As a standard, this includes supply chain mapping (ideally beyond Tier 1 given heightened risks at lower tiers) and establishing robust responsible sourcing programmes (including regular audits and unannounced visits to suppliers).

As part of this, we engage on how a company can provide meaningful grievance mechanisms that allow affected workers to be heard and provide feedback for solutions. We also encourage companies to move beyond the relatively standard process of auditing supply chains – which may identify concerns but not provide remedies – to consider how their actions may exacerbate substandard working conditions and how to address this. Falling under the umbrella term of purchasing practices, this challenges the typical approach of pushing much of the burden for improving working conditions onto suppliers alone.

Where modern slavery or child labour is identified as a salient risk, we engage on how companies can implement tailored due diligence. This should focus on how to identify the ILO's forced labour indicators[10] or use the Children's Rights and Business Principles[11]. We believe that companies in high-risk sectors should "find it, fix it and prevent it"[12] given the prevalence of modern slavery and child labour in some industries[13].

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We also encourage companies to use their leverage and collaborate, recognising that transformative change requires collective action. Examples include the **Responsible Minerals Initiative**[14] which provides resources for companies seeking to address mineral sourcing issues in their supply chains. It has more than 400 corporate members, including GEMs holdings – a Taiwanese electronics manufacturing company, a South Korean multinational, a Hong Kong power tools manufacturer, and a Taiwanese semiconductor maker. Another example is the **Responsible Glove Alliance**[15] launched in 2022, following the imposition of several Withhold Release Orders by US Customs during the pandemic, highlighting labour rights concerns related to the medical supplies industry operating in **Malaysia**. While this initiative is not relevant to current GEMs holdings, it highlights increased regulatory risks and the positive trend for collaborative action.

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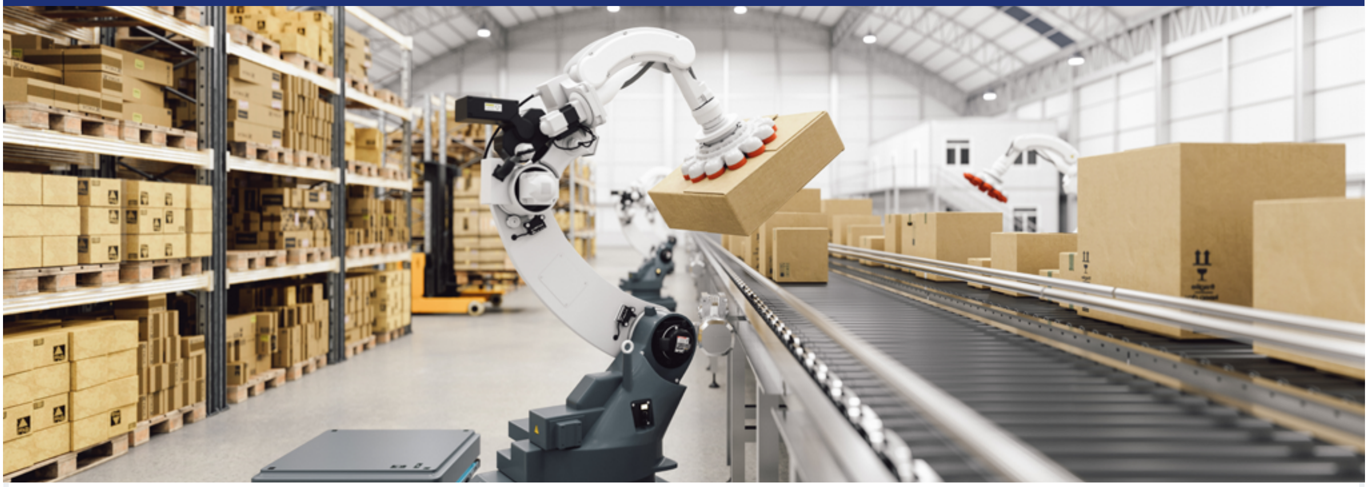
[10] ILO indicators of Forced Labour
[11] https://www.unglobalcompact.org/docs/issues_doc/human_rights/CRBP/Childrens_Rights_and_Business_Principles.pdf
[12] Find It, Fix It, Prevent It. Annual Report | CCLA Modern Slavery (modernslaveryccla.co.uk)
[13] Forced labour, modern slavery and human trafficking (Forced labour, modern slavery and human trafficking) (ilo.org)
[14] Responsible Minerals Initiative
[15] Responsible Glove Alliance (responsiblebusiness.org)

ENGAGEMENT CASE STUDY

Taiwanese electronics manufacturing company

The company committed to net zero by 2050, improved its gender diversity on the board from 0% to 25% and set up a zero-placement policy for foreign migrant workers to prevent modern slavery.

Sustainable development goals:



2020

- Our stewardship team, EOS at Federated Hermes, began engagement on climate, migrant workers, and board gender diversity.
- EOS suggested joining RE100, a group of businesses committed to getting 100% of their energy from renewable sources.
- The company stated that foreign migrant workers will not pay any placement fees in Taiwan.

2021

- The company signed up to RE100 and committed to becoming carbon neutral by 2030.
- The company set an internal carbon price of US$300/tonne.
- The company added its first female director to the board.

2022

- The company outlined further measures to care for foreign migrant workers in Taiwan.
- The company added two more female directors to the board.
- The company committed to net zero by 2050.

Company overview

Our holding, a Taiwanese electronics manufacturing company, is one of the main global power and thermal management solution providers, and is expanding rapidly in the electric vehicle charging and power solution market. When EOS, our stewardship team at Federated Hermes, first engaged with the company in 2020, it had not yet committed to a longer-term net-zero target. It also had a significant proportion of migrant workers from Southeast Asian countries working in Taiwan and we had human rights concerns about the foreign migrant workers' recruitment process. Foreign migrant workers are sometimes required to pay large fees or take on debt in exchange for job opportunities in other countries, which is a form of modern slavery. The company also had an all-male board which we were opposed to.

Our engagement

We started engaging with the company on the issues of migrant workers, board gender diversity and long-term climate targets in May 2020. We asked the company to conduct due diligence on indirect labour and the recruitment of direct employees, and how it ensured that workers were not being charged for jobs. We emphasised that the recruitment process for blue-collar workers could pose risks to labour and human rights. We also asked the company to disclose the composition of its migrant workers and asked it to elaborate on the recruitment process such as the involvement of labour agencies; we provided an example from Apple on the zero-tolerance policy for any supplier employee paying fees.

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The company had already set science-based targets by 2025 but had yet to commit to a longer-term net-zero target. Its 2025 target aims to reduce carbon intensity by 56.6% from Scope 1 and 2 activities and increase product power efficiency by 1.6% before 2025, as more than 70% of Scope 3 emissions stem from server power supplies. We were concerned that existing targets were still not Paris-aligned and that there was a lack of long-term climate targets. We encouraged the company to commit to a long-term net-zero target for its operations and value chain, and asked if there were any obstacles that stopped it from this commitment. We also recommended the company join the RE100 initiative to commit to sourcing 100% renewable electricity. We suggested managing supply chain emissions as part of the Scope 3 emissions reduction targets. We commended the company's ambitious carbon pricing of US$300 and requested further disclosure on the use of internal carbon funds. We also made several suggestions on the Task Force on Climate-related Financial Disclosures (TCFD) report to further improve its disclosure.

We also recommended the company join the RE100 initiative to commit to sourcing **100%** renewable electricity.

In May 2020, we sent a letter to the chair stating our principles on corporate governance in Taiwan, stressing our concerns about gender diversity on the all-male board. We also asked the company to disclose nominated directors' gender in the proxy materials, even though it is not yet a requirement in Taiwan, to further promote board gender diversity. In 2022, we emphasised that we increased the gender diversity requirement on the board to at least 20%, expecting the company to improve before the next election.

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Changes at the company

After our first engagement, the company stated in its Corporate Social Responsibility report, published in August 2020, that foreign migrant workers in Taiwan are not required to pay fees incurred for agents, passports, visas or transportation. In the next report, published in August 2021, the company further disclosed the care it provides to foreign migrant workers, such as training workers in their own language, providing religious venues or information, and hosting foreign worker forums and social events.

On climate, the company thanked us for our suggestion and joined the RE100 initiative in March 2021 by committing to sourcing 100% renewable energy and carbon neutrality by 2030. In June this year, the company formally announced its commitment to net zero by 2050.

The chair/CEO of the board responded to our letter sent in May 2020. The chair acknowledged the benefits of a diverse board and confirmed that from 2021, the board planned to include woman candidates. The company subsequently added its first female director to the board in 2021 and a further two female directors in 2022. The gender diversity on the board increased from 0% to 25% since we first engaged on this issue.

> **The chair acknowledged the benefits of a diverse board and confirmed that from 2021, the board planned to include woman candidates. The company subsequently added its first female director to the board in 2021 and a further two female directors in 2022.**

Next steps

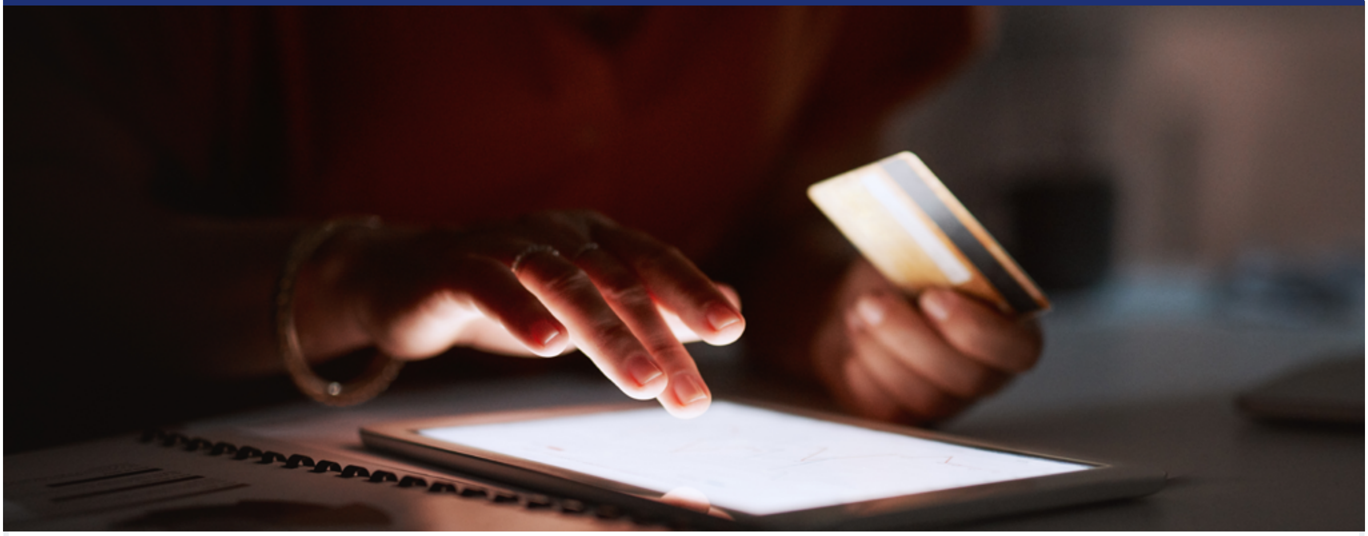
We will continue to engage with the company on supply chain human rights issues, such as sourcing of cobalt and the risks of connections to forced labour in the supply chain, as well as further improving its disclosure on the use of internal carbon payment funds, TCFD and supply chain emissions reductions.

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

ENGAGEMENT CASE STUDY

Chinese multinational technology company

EOS, our stewardship team at Federated Hermes, has engaged extensively with the company on a range of key sustainability issues and are pleased to see various improvements.



Company overview

The Chinese multinational specialises in e-commerce and technology. The group employs more than 250,000 people and has approximately 1.31 billion active consumers.

Background

The company is dual listed in the US and Hong Kong, with foreign investors accessing the stock via a variable interest entity structure (VIE)[16]. However, there was initially little information about governance, appointed directors and oversight of this entity and how it interacted with the Hong Kong-listed company.

The company has a partnership structure that raised concerns about board and committee independence and transparency about how the partnership interacts with the board. A combined chair/CEO and lack of lead independent director were also of concern. Its significant employee base and use of contractors and 'gig' workers, requires effective management of people and their wellbeing, therefore development of a human capital management strategy has also been a significant objective for our engagement. In addition, the company's varied business segments for online and offline retail, consumer and digital sectors creates an ecosystem of billions of consumers and suppliers, introducing a range of ESG risks and opportunities which require more detailed reporting and shareholder engagement. Particular concerns included the lack of climate change targets and the company's approach to ethical data governance and the use of artificial intelligence.

The group employs more than **250,000** people and has approximately **1.31** billion active consumers.

Governance concerns

We first raised our concerns about lack of shareholder communications in 2015 and insufficient board and committee independence in 2016, which the company acknowledged, although we were unable to arrange a follow up discussion. At an investor day in 2017, we raised our concerns about governance, board independence and data privacy directly with the founder/chair. Based on these concerns, at the 2017 AGM, we recommended voting against the re-election of the founder, chair/CEO.

Ahead of the 2018 AGM, we issued a public statement to urge clarification on the company's board governance structure including the VIE structure, improved board independence (at least 50%), appointment of a lead independent director and independent chairs for the nominating and governance committee and the compensation committee.

[16] An offshore entity allowing foreign investors to buy the offshore entity's stock.

In 2019, having had little success in arranging a follow-up discussion, we sent a letter to the board of directors seeking dialogue about our concerns.

At the 2020 AGM, we recommended voting against the election of the CFO to the board in order to support more independent directors.

In a call with the company in June 2021, we highlighted the company's opportunity to improve its board independence by replacing a non-independent non-executive director with an independent director, who would ideally be female. The investor relations director said this was a useful suggestion and would relay it to the board.

ESG strategy and reporting

Given the range of ESG concerns, in 2017 we requested improved ESG strategy and reporting, sharing best practice examples. We therefore welcomed publication of the company's first ESG report in 2019, which focused on seven priorities. We provided feedback on this reporting, proposing improvements including more information on ESG governance, aligning to the UN Sustainable Development Goals, further disclosure on cyber security, carbon emissions, the inclusion of science-based targets and reporting based on the taskforce for climate-related financial disclosures. We also requested inclusion of more strategic social aspects such as human capital management strategy and metrics to align with the company's six core values. During a meeting at the company's Hong Kong offices in 2019, we responded to questions about our feedback on governance and structuring the team, which demonstrated the company was thinking carefully about further improvements. We also urged the company to report annually, rather than every other year, as planned.

In light of allegations of a '996' culture – working 9am to 9pm, six days a week – we enquired how the company ensures employees are engaged and deliver high performance while maintaining their wellbeing and work-life balance. The company took us through a variety of examples of how the company seeks to engage with employees, monitor their 'happiness score', and provide training and dialogue with senior leadership. We encouraged the company to develop this into a clear strategy with disclosure.

Outcomes

At the 2021 AGM we were pleased that the company did not propose to re-elect one of the non-independent non-executive directors, as we had also suggested, meeting the goal of 50% board independence. In addition, the company made the audit, nomination, and governance committees 100% independent and appointed an independent chair to the compensation committee. The 2019 and 2020 20-F reports[17] provided more information on the VIE structures, including information about the governance and the holding structures as well as the names of the individuals who form the limited liability companies as part of the VIE structure.

As part of establishing a credible plan to improve minority shareholder engagement, 2021 the company appointed a director responsible for engaging with shareholders on all aspects of ESG, leading to significantly improved shareholder engagement.

At the end of 2021 we were pleased to receive more information about the company's ESG strategy, and confirmation that it would issue a 2022 ESG report and subsequently report annually. The company announced a new sustainability development committee reporting into the board, committed to carbon neutrality by 2030 including halving Scope 3 emissions by 2030 and net zero by 2030 on the company's Cloud's Scope 3 emissions. The company announced a new Scope 3+ ecosystem commitment – to reduce 1.5 gigatons of emissions by 2035. On commitments to social considerations, the company joined the United Nations Global Compact in 2021 and in early 2022 it published a status update (currently only in Chinese). During the chair and CEO's update to investors at the end of 2021, he talked about the company's social responsibility and launched 10 initiatives aligned with the UN Sustainable Development Goals which includes high-quality employment and training as well as improving the welfare of some of its more vulnerable workers, such as gig workers.

Next steps

We have been pleased to see the company make significant progress in many aspects of ESG activities and commitments, as well as an established and ongoing dialogue with the company. It has also assured us that their upcoming ESG report will include enhanced disclosure on key topics. Nevertheless, there remain important areas of further engagement, including on governance: separation of the chair and CEO, appointment of a lead independent director and improved board director engagement with minority shareholders.

On the environment, we would like to see the company commit to accredited science-based targets and then deliver on its ambitious Scope 3+ emissions. On social impacts, we want to see more granularity on its UN Global Compact commitments, together with a clearer overview of human capital management strategy and accompanying disclosures on performance against its existing commitments. Finally, we continue to request more information from the company on digital rights, including the ethical use of artificial intelligence.

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

[17] SEC Form 20-F is an annual report filing for non-U.S. and non-Canadian companies that have securities trading in the U.S.

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Federated Hermes

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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.

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