Federated Hermes Impact Opportunities

Quarterly Impact Report
Q1 2023

Federated Hermes
Limited

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The Federated Hermes Impact Opportunities Strategy is a high-conviction global equity strategy with a bold objective. It aims to generate long-term outperformance by investing in companies succeeding in their core purpose: to generate value by creating positive and sustainable change that addresses the underserved needs of society and the environment. In this way, it focuses on tomorrow's leading companies – today.

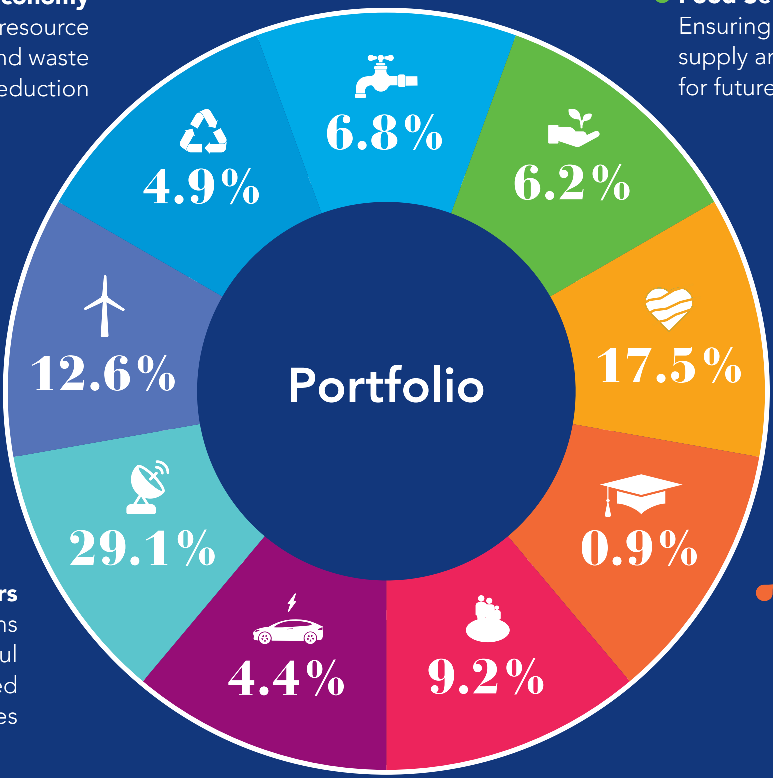
Exposure by impact theme

We take a thematic approach: our holdings fit into one or more of nine impact themes that are aligned with the Sustainable Development Goals (SDGs) of the United Nations (UN).

Water
Improving access to quality water supply and preservation of the resource

Circular Economy
Enhancing resource efficiency and waste reduction

Food Security
Ensuring a sustainable food supply and productive farmlands for future generations



Energy Transition
Transforming the energy system to power a low-carbon economy

Health & Wellbeing
Improving life expectancy and quality

Impact Enablers
Providing crucial solutions and services to impactful companies directly involved in the various themes

Education
Providing opportunities for all – irrespective of wealth, geographical location or ability

Future Mobility
Improving vehicle efficiency to increase low-carbon transportation

Financial Inclusion
Providing financial services to underserved populations

Source: Federated Hermes Limited, as at 31 December 2022.

THEMATIC FOCUS:

Future Mobility: Navigating the road ahead for electric vehicles

The poster children of the energy transition, electric vehicles (EVs), are reaching adolescence. While some short-term growing pains are inevitable, the future of electric transportation looks healthy. By ensuring exposure to suppliers involved in the electric revolution, we aim to deliver maximum impact and return at minimum risk.

Fast reading:

- Short-term challenges including the energy crisis in Europe, the end of Chinese subsidies and global recession fears may slow the momentum behind electric vehicle sales in 2023. However, we expect the EV market to experience huge growth over the long term.
- Currently, EV start-ups are battling to scale, capture market share and reach profitability, while legacy automakers are largely cannibalising their own traditional internal combustion engine vehicle sales . We therefore see exposure through suppliers as the best way to invest in this theme.

The case for EVs

According to the International Energy Agency (IEA), transport has the highest reliance on fossil fuels of any sector, and accounted for 37% of global carbon dioxide emissions from end-use sectors in 2021.[1] Passenger cars produced 41% of CO_2 emissions from transportation; while vans, trucks, buses and motorcycles together made up a further 37%.[2]

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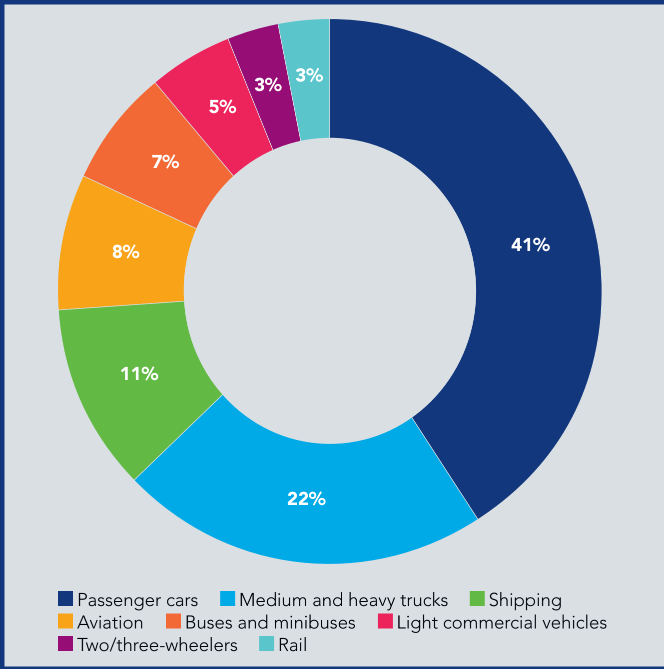
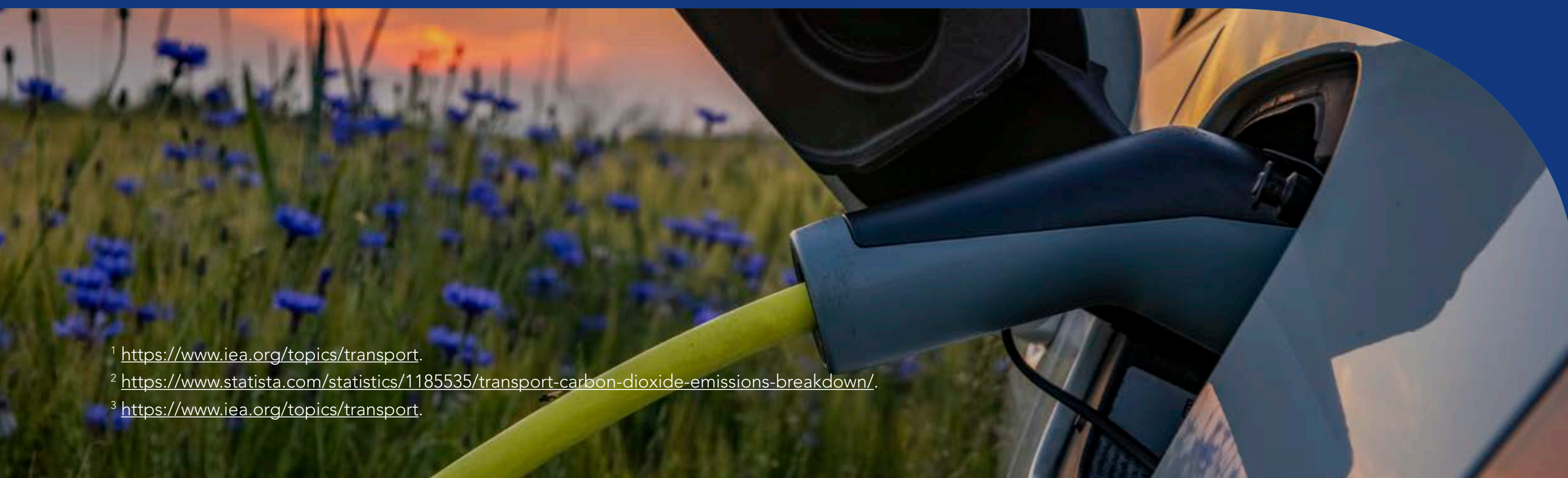
Figure 1: Carbon dioxide emissions produced by transportation worldwide in 2020, by subsector



Source: Statista, as at 2023.

The replacement of traditional internal combustion engine (ICE) powered vehicles with electric vehicles is therefore a core component of the transition to a more sustainable future. EV rollout aligns closely with a number of United Nations Sustainable Development Goals, most obviously SDG 7 (Affordable and Clean Energy) and SDG13 (Climate Action). EV uptake can also influence SDG 3 (Good Health and Wellbeing) and SDG 11 (Sustainable Cities and Communities).



[1] https://www.iea.org/topics/transport.
[2] https://www.statista.com/statistics/1185535/transport-carbon-dioxide-emissions-breakdown/.
[3] https://www.iea.org/topics/transport.

NAVIGATING THE ROAD AHEAD FOR ELECTRIC VEHICLES

Changing gear: Is the EV market at an inflection point?

According to S&P Global Mobility, EV sales grew by about 36% year-on-year from 2021-2022.[4] There are, however, some short-term challenges for the market to negotiate, as a result of which many industry observers expect sales growth to slow down in 2023:

- The energy crisis in Europe has driven up electricity prices, making EVs temporarily less attractive to buyers in this key region.
- China is withdrawing longstanding subsidies for EVs, while European countries are also looking to scale back financial incentives as EVs become more established.
- Fears of a global recession are driving down new vehicle sales generally.

Beyond this short-term friction, however, the evidence indicates that future demand is likely to be high:

- The direction of travel of policy and regulation globally is highly positive for the energy transition in general and EVs in particular.
- The US Inflation Reduction Act and Europe's REPowerEU initiative will provide an economic boost that will help scale the necessary infrastructure and develop key technology.
- The scaling of battery production in 'gigafactories' will result in a rapid fall in costs (while EVs are currently more expensive than ICE vehicles, this is because the lithium-ion batteries they use are expensive to produce – they are otherwise simpler and therefore cheaper to build).
- Better battery technology will reduce charging times and improve vehicle range, while the charging network will grow; this will resolve the issue of 'range anxiety'.[6]

Our view is that EV uptake will reach a 'tipping point' as better battery and charging technology improves useability and prices come down. As a result, despite some short-term headwinds, we expect the EV market to grow significantly in the medium-to-long term.

This expectation is supported by research by BloombergNEF, which predicts that in the wake of the Inflation Reduction Act (IRA) more than half of car sales in the US – a market where EV uptake has been relatively slow – are now expected to be electric by 2030.[7]

Overall, the bigger picture means that the industry will need to plan for significantly increased volumes. Eliminating supply chain bottlenecks and ensuring adequate growth in the production of the metals and minerals essential for EV power trains – which take energy stored n a vehicle's battery system and supply it to the motors – will be critical.

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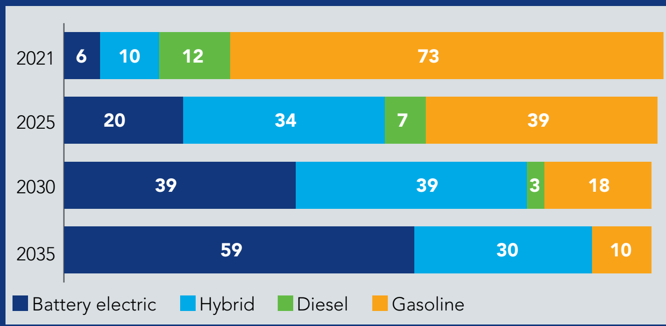
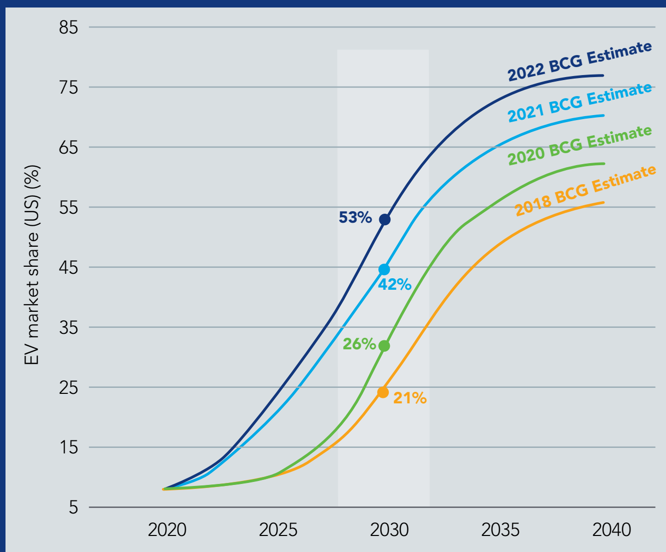
Figure 2: Battery electric vehicles (BEVs) could make up majority of new cars sold globally by 2035



Note: Less than 1% of vehicles sold are projected to be fuel cell electric.

Source: Boston Consulting Group (BCG), as at 2022.

Figure 3: Projected US EV adoption is accelerating



Source: Boston Consulting Group (BCG), as at 2022.

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[4] https://www.spglobal.com/commodityinsights/en/market-insights/blogs/metals/013123-ev-sales-momentum-to-face-challenges-in-2023-but-long-term-expectations-unaffected.

[5] https://www.spglobal.com/commodityinsights/en/market-insights/blogs/metals/013123-ev-sales-momentum-to-face-challenges-in-2023-but-long-term-expectations-unaffected.

[6] 'Range anxiety' describes the issue of consumers not wanting to buy an EV because of the lower distance between refuelling and slower refuelling times compared to ICE vehicles.

[7] https://www.bloomberg.com/news/articles/2022-09-20/more-than-half-of-us-car-sales-will-be-electric-by-2030.

Sparks and transformers: A challenging environment for EV manufacturers

While there's plenty of open road ahead, it's still early in the race to be predicting individual winners. As a relatively new, high growth market with excellent long-term prospects, the EV industry is full of young, dynamic companies. However, vehicle research and development is extremely costly, and production at scale even more so – most pure EV manufacturers have therefore yet to turn a profit, and their success in a highly competitive market is far from assured.

Major legacy automakers such as Ford and Toyota (which recently revamped its strategy towards an 'EV-first mindset') are also focusing on an electric future. However, so far, they are mainly cannibalising their own sales rather than seeing dramatic growth.

Even Tesla, whose first truly affordable car (expected to cost less than £20,000) is due by the end of the year, has its problems. As well as a recent major recall[8], the company has been hit by labour shortages[9], particularly in Europe, and has dropped the price of its models in China to stimulate demand.[10]

As such, although the long-term prospects for the overall market are excellent, the investment potential of any single manufacturer is difficult to guarantee.

Indirect current: Why suppliers are the most interesting EV market play right now

As a high-conviction, impact-focused strategy, we are looking for companies with the potential for long-term outperformance both in terms of financial returns and driving sustainable change. From an investment standpoint, the EV market has the potential to deliver strong growth and outperformance. It also aligns well with our Future Mobility and Energy Transition impact themes.

However, we prefer companies with strong market share. As already noted, unlike many tech subsectors, the existence of incumbents and the brand-led nature of the automotive industry makes it highly competitive and hard to dominate. Given the difficulties in predicting clear winners, we think there are better ways to play the EV theme than investing directly in vehicle manufacturers.

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Auto suppliers that provide key parts to the automotive industry are an excellent way of gaining indirect exposure to the market. In particular, we prefer to focus on those suppliers developing products essential for the electrically powered, self-driving vehicles of the future.

One example of a key technology is the silicon carbide (SiC) wafer. SiC has great potential in the automotive industry – in fact it's likely that all electric vehicles will eventually use SiC chips. The significant expected growth in the EV market is therefore a major potential driver for the SiC market.

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The strategy has exposure to SiC and other leading edge automotive technologies through holdings including multinational semiconductor producer STMicroelectronics; read the case study that follows to learn more.

What is SiC and what are its advantages?

- Silicon carbide (SiC) is a hard, crystalline compound of silicone and carbide, also referred to as 'carborundum'; it is the world's third-hardest composite material, and, crucially, is able to withstand higher electrical fields.
- Using SiC wafers in EV power electronics means chips can run at higher voltages and higher temperatures, improving power density. This also improves the power losses in the inverter, meaning better overall system efficiency of around 99% can be achieved vs. ~95% with silicon insulated-gate bipolar transistors (IGBTs). This translates to increased vehicle range of up to 10%.
- Improved battery efficiency enables the use of smaller, lighter battery packs and cooling systems; this also means the weight of the vehicle's supporting structure can be reduced. SiC also allows a simplified circuit design, resulting in a reduction in the size, weight and cost of the control system. Overall weight savings per car can be 150-200kg.
- As a result, SiC devices are increasingly preferred in high-voltage power converters over traditional silicon-based designs; however, SiC wafers are tricky, time-consuming and costly to make, creating high barriers to entry and giving sector leaders a strong advantage.

[8] https://www.forbes.com/sites/qai/2023/02/20/tesla-recall-hits-nearly-363000-cars-with-full-self-driving-software/.

[9] https://www.wired.com/story/tesla-vacancies-staff-shortage-berlin/.

[10] https://insideevs.com/news/630106/tesla-model3-modely-prices-china-january2023/.=

CASE STUDY

STMicroelectronics

STMicroelectronics is a global Integrated Device Manufacturer (IDM) that provides proprietary technologies for industrial, consumer electronics, communications, computer equipment and automotive applications, including EVs.

Impact themes:
Future Mobility
Energy Transition

French-Italian multinational STMicroelectronics ('ST') produces analogue semiconductors for the global market. With annual revenues of over $13bn, it is one of the top five players in this space. The company has 14 manufacturing sites globally, including both wafer processing and assembly.

ST is attractively valued and is a leader in several areas of high structural growth. It is directly exposed to the electrification of our world and is leading innovation in fields that promise to significantly reduce global emissions. The firm's products are sold predominantly into the Asian electronics value chain, but in terms of end use are employed across a balanced regional profile (41% Americas, 34% APAC, 25% EMEA).

Why we're invested

Sustainability has been integral to ST's business model for over a quarter of a century. The company first established an environmental policy in 1993 and published its first environmental report in 1997.

Arguably the firm's products have always been a 'net good' for society, enabling wider technological innovations and helping improve energy efficiency. Today, ST is leading the charge on silicon carbide (SiC) power electronics, a technology that promises to save millions of tonnes of CO_2. Wolfspeed estimate that the lifetime GHG emissions reduced by using SiC is a single EV sedan is approx. 690kg CO_2 eq over its nearest alternative.

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SiC has enormous potential for use in electric vehicles (EVs) to drive improved efficiency and enhance vehicle performance. These improvements are helping to accelerate EV adoption by overcoming hurdles such as range anxiety, resulting in a growing positive downstream impact.

ST also has a class-leading portfolio of products in Advanced Driver Assistance Systems (ADAS). These are an increasingly common set of automotive technologies that include blind spot detection, lane departure warning, collision warning, adaptive cruise control and park assist.

Given its strong position in these leading-edge technologies, ST is well-placed to benefit strongly from the evolution of the automotive sector, even if the overall market is flat in terms of sales growth. We estimate the company could reach around $2bn in revenues from SiC alone by 2025.

Goals and targets

25 years ST started sustainability reporting in 1997.

20% Reduction of energy consumption per wafer by 2025 vs. 2016.

2027 ST is committed to being carbon neutral by 2027.

100% All the company's direct energy needs will be met by renewable energy by 2027.

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