Sustainability Report: The electric transition

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Federated Hermes Limited

www.hermes-investment.com
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Introduction

Together in electric dreams

In this interim update from the European Equities team, we take a closer look at the growth behind the electric vehicle (EV) market. As the energy transition gathers momentum, the opportunities are varied and compelling.

As the EV market nears an inflection point, we think exposure through to established suppliers of key components may be the best way to play the EV theme, rather than investing directly in the automakers themselves.

As our strategies are high-conviction and sustainability-focused, the team seek out companies with the potential for long-term outperformance both in terms of financial returns and driving sustainable change. From an investment standpoint, therefore, we believe the EV market has the potential to deliver strong growth and outperformance.

That said, we prefer companies with **strong market share**. 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.

That's where auto suppliers come in. Companies that provide key parts to the automotive industry are an excellent way of gaining indirect exposure to the market. We prefer to focus on those suppliers developing products essential for the electrically-powered, self-driving vehicles of the future.

What better way to illustrate this than to look at three portfolio holdings that highlight our 'indirect play' on the EV theme: **Epiroc**, an industry-leading mining and infrastructure manufacturer, **Sika Group**, a specialty chemicals company, and **Soitec**, a manufacturer of semiconductor materials.

Elsewhere in this report, we provide an update on the strategies' carbon and environmental footprints, the portfolio exposures to various environmental and social themes, and alignment to the UNSDGs.

Federated Hermes Sustainable European Equities

We categorise our approach as being sustainability driven, but investment led. In other words, it's not enough to just be good, we must have conviction in the long-term investment prospects.

To find out more about our Sustainable Europe and Europe ex-UK strategies, please visit our website.

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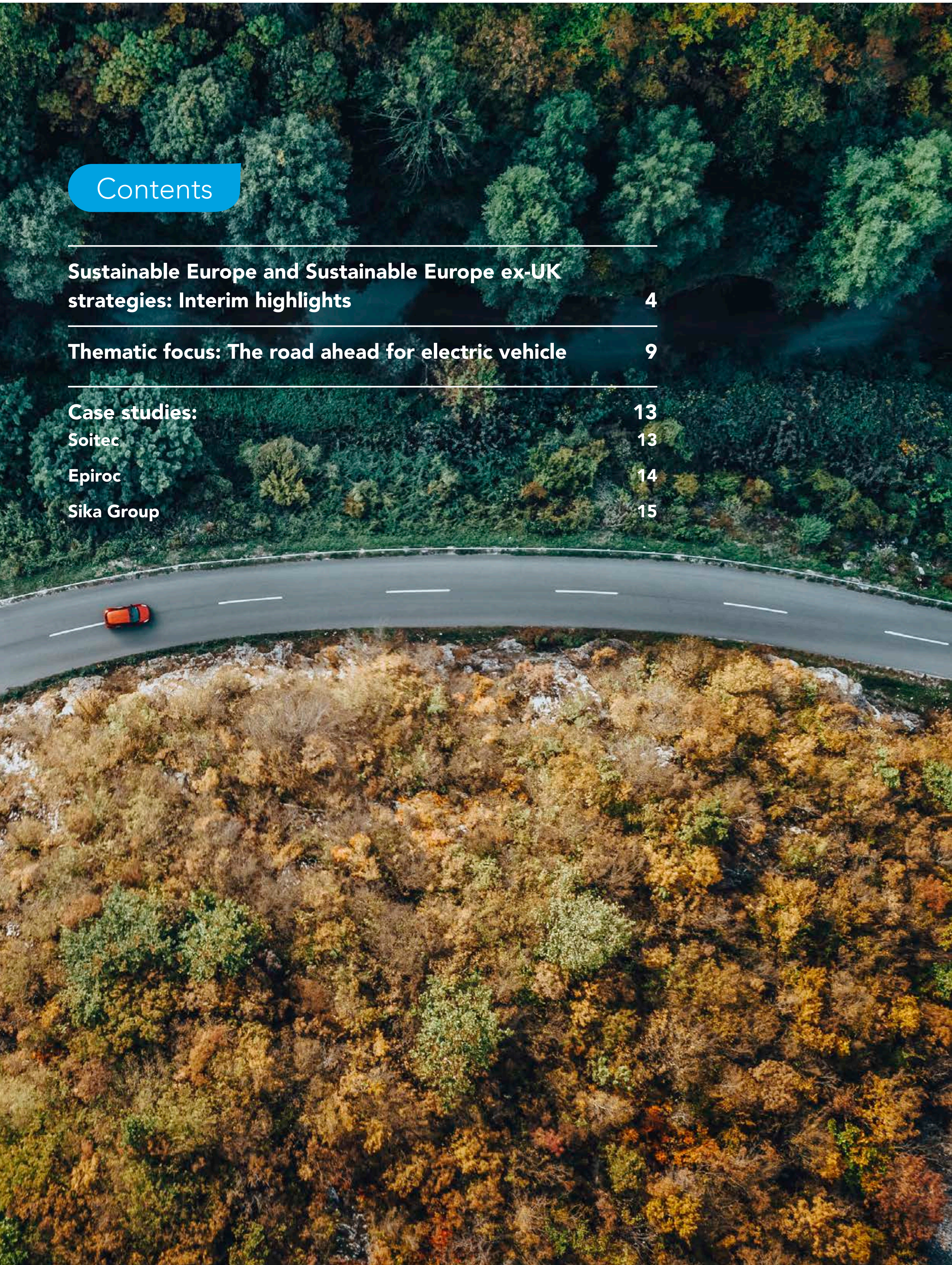


SECTION 1:

Highlights

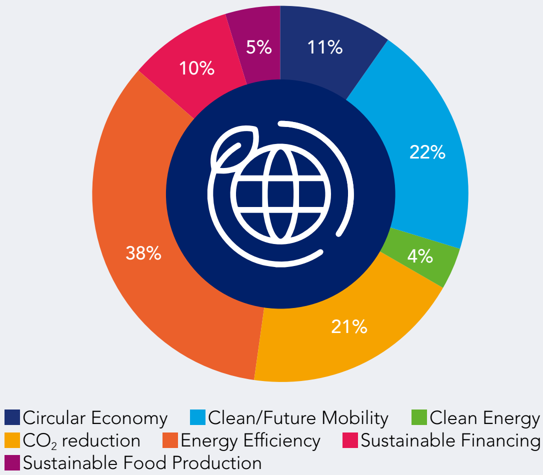
All portfolio holdings are exposed to one or more of the following environmental and social themes.

The portfolio's exposure is outlined below:

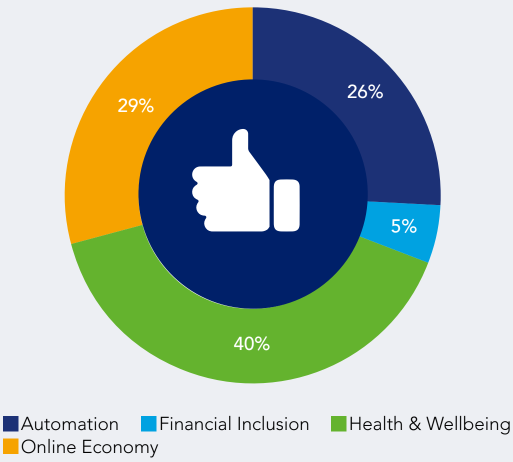
Thematic exposures

Sustainable European Equity

Environmental



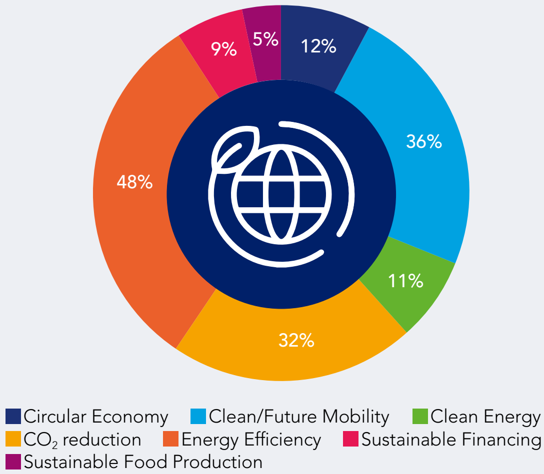
Social



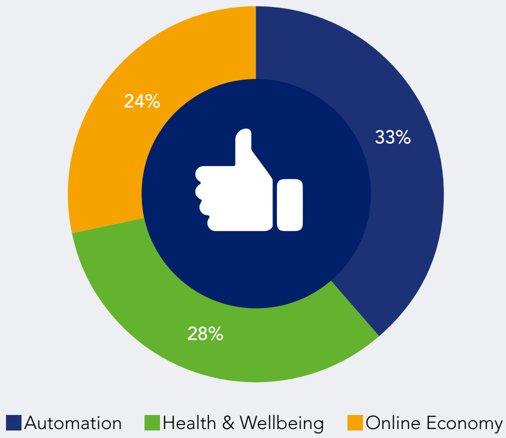
Source: Federated Hermes research, as at March 2023.

Sustainable Europe ex-UK Equity

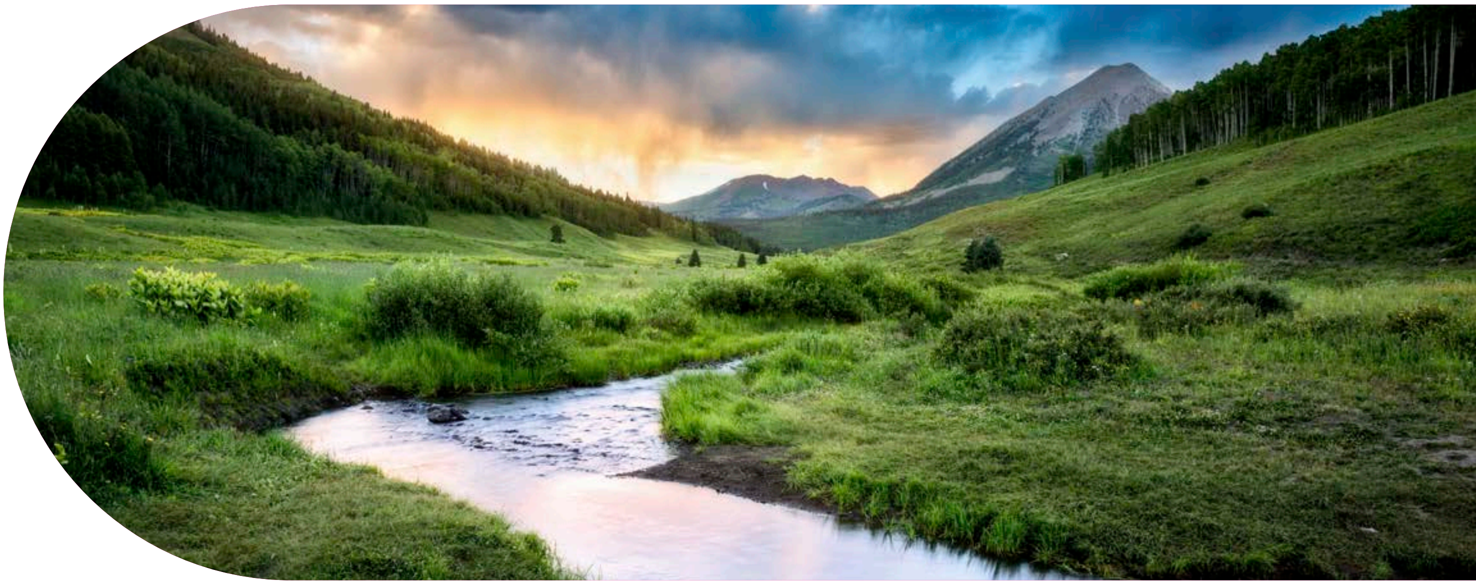
Environmental



Social



Source: Federated Hermes research, as at March 2023.



UN Sustainable Development Goals alignment

Through its products, services or activities, each company in the portfolio is aligned to at least one of the UN Sustainable Development Goals.

Sustainable European Equity

Sustainable Europe ex-UK Equity

Carbon footprint

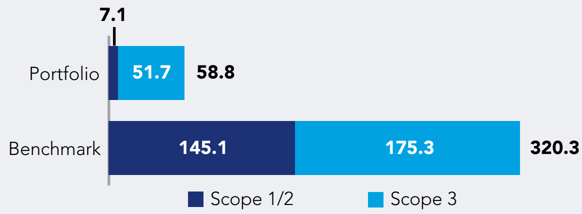
The Sustainable European Equity strategy's carbon footprint is 82% lower than the benchmark index (MSCI Europe), while the Sustainable Europe ex-UK strategy is 44% lower than the benchmark (MSCI Europe ex-UK).

Sustainable European Equity

	Fund	MSCI Europe
Carbon footprint (Scope 1 & 2: tonnes/$m invested)	7.1	145.1
Water footprint (Direct: m3/$m invested)	100.0	4.1
Waste footprint (Direct: tonnes/$m invested)	1.3	6.3

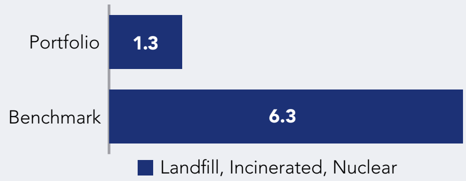
Carbon footprint

tonnes/$m invested in portfolio currency



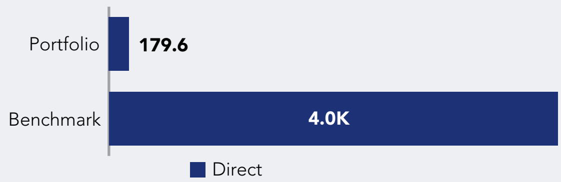
Waste footprint

tonnes/$m invested in portfolio currency



Water footprint

m^3/$m invested in portfolio currency



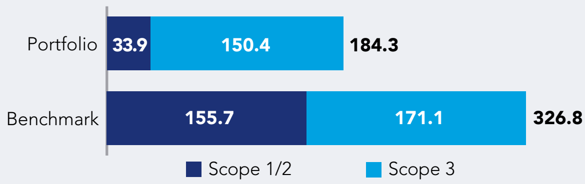
Source: TruCost, Federated Hermes Limited, as at March 2023.

Sustainable Europe ex-UK Equity

	Fund	MSCI Europe ex-UK
Carbon footprint (Scope 1 & 2: tonnes/$m invested)	33.9	155.7
Water footprint (Direct: m3/$m invested)	313.4	4.1
Waste footprint (Direct: tonnes/$m invested)	2.4	7.3

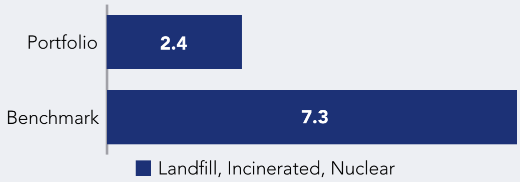
Carbon footprint

tonnes/$m invested in portfolio currency



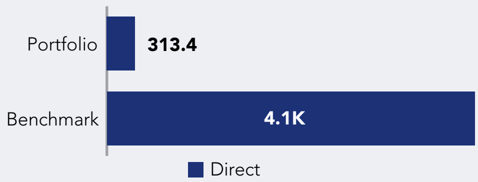
Waste footprint

tonnes/$m invested in portfolio currency

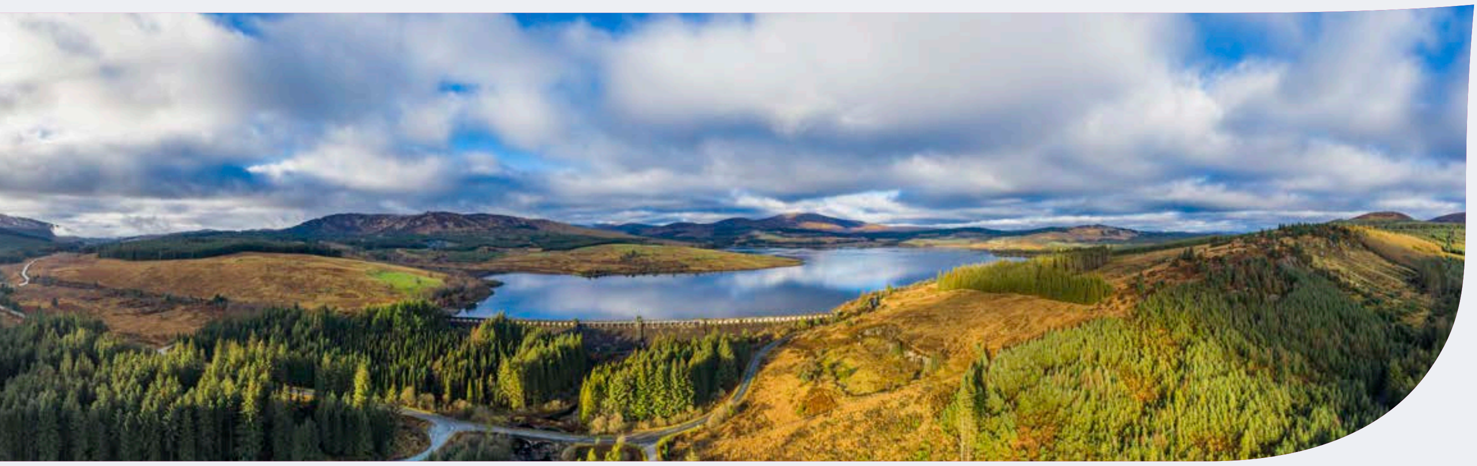


Water footprint

m^3/$m invested in portfolio currency



Source: TruCost, Federated Hermes Limited, as at March 2023.



Environmental footprint

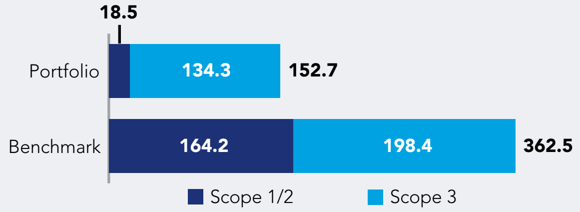
The strategies aim to have a smaller environmental footprint than the benchmarks (MSCI Europe and MSCI Europe ex-UK). As at March 2023, the strategies' CO_2, water intensity, and waste intensity was measured as follows:

Sustainable European Equity

	Fund	MSCI Europe
Carbon intensity (Scope 1 & 2: tonnes/$m sales)	18.5	164.2
Water intensity (Direct: m3/$m sales)	487.9	4414.0
Waste intensity (Direct: tonnes/$m sales)	3.4	7.0

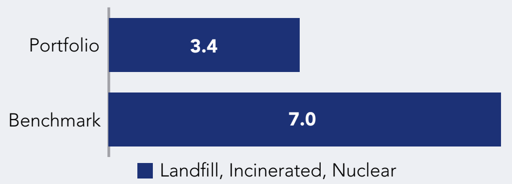
Carbon intensity

tonnes/$m revenue



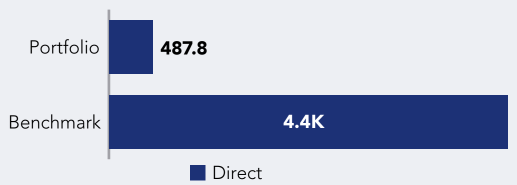
Waste intensity

tonnes/$m revenue



Water intensity

m³/$m revenue



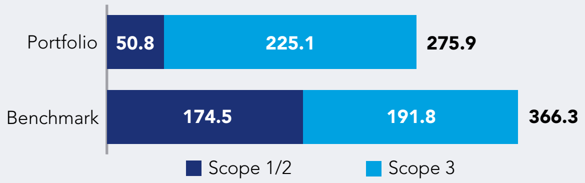
Source: TruCost, Federated Hermes, as at March 2023.

Sustainable Europe ex-UK Equity

	Fund	MSCI Europe ex-UK
Carbon intensity (Scope 1 & 2: tonnes/$m sales)	50.8	174.5
Water intensity (Direct: m3/$m sales)	471.3	4491.2
Waste intensity (Direct: tonnes/$m sales)	3.6	7.9

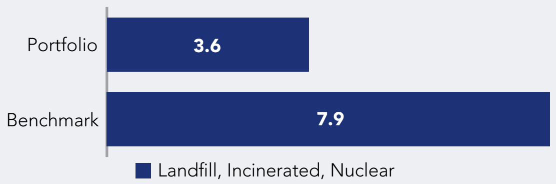
Carbon intensity

tonnes/$m revenue



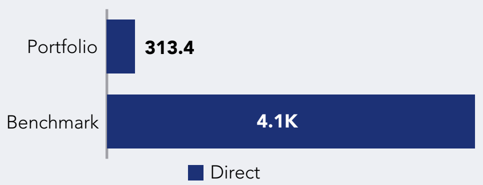
Waste intensity

tonnes/$m revenue



Water intensity

m³/$m revenue



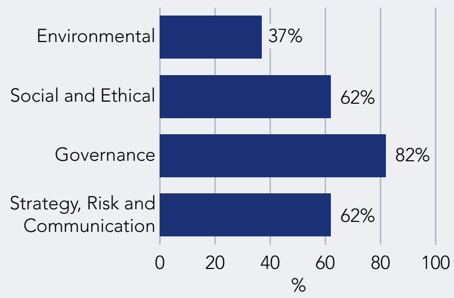
Source: TruCost, Federated Hermes, as at March 2023

Engagement

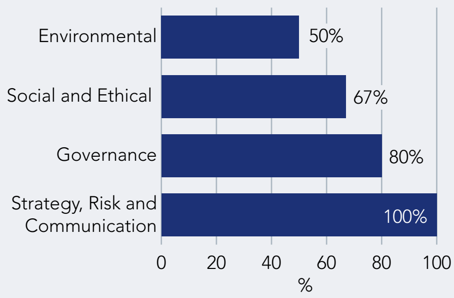
Company engagement is a crucial part of our approach. It enables the team to hold companies to account, encourage positive change, and ensure senior management take their responsibilities to the environment and society seriously.

Sustainable European Equity

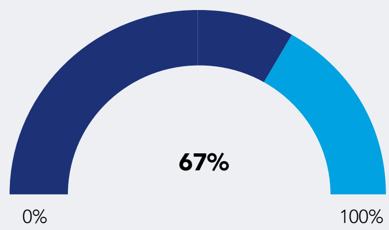
% AUM Engaged by Theme



Engagement Objectives Progress by Theme



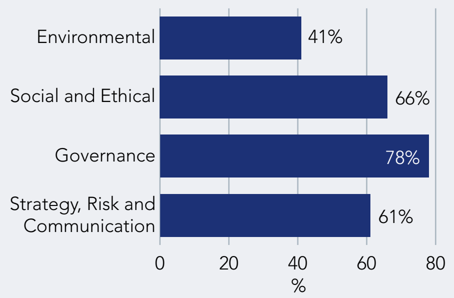
Engagement Objectives Progress



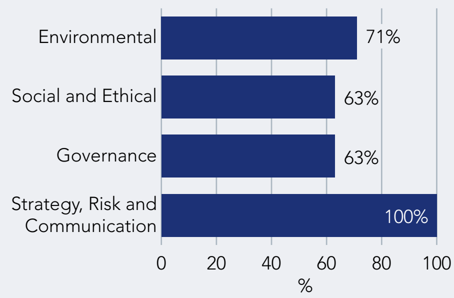
Source: Federated Hermes Limited, as at March 2023.

Sustainable Europe ex-UK Equity

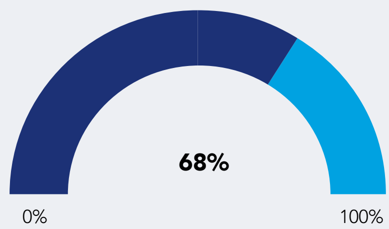
% AUM Engaged by Theme



Engagement Objectives Progress by Theme



Engagement Objectives Progress



Source: Federated Hermes Limited, as at March 2023.

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SECTION TWO:

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.

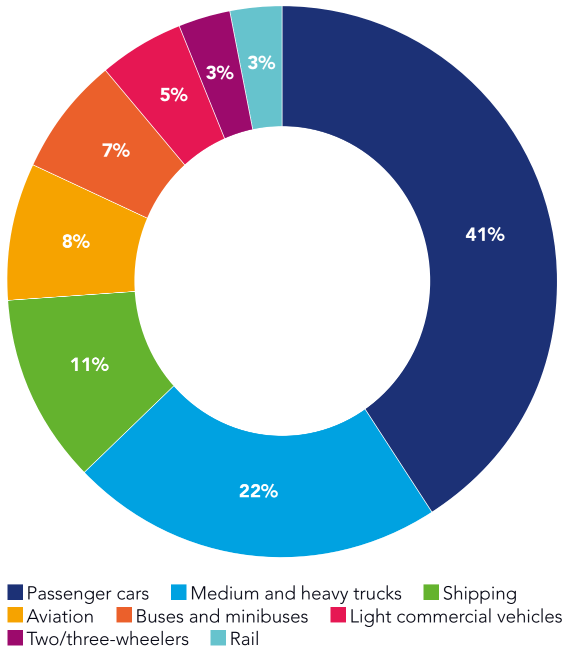
The case for EVs

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]

Transport accounted for

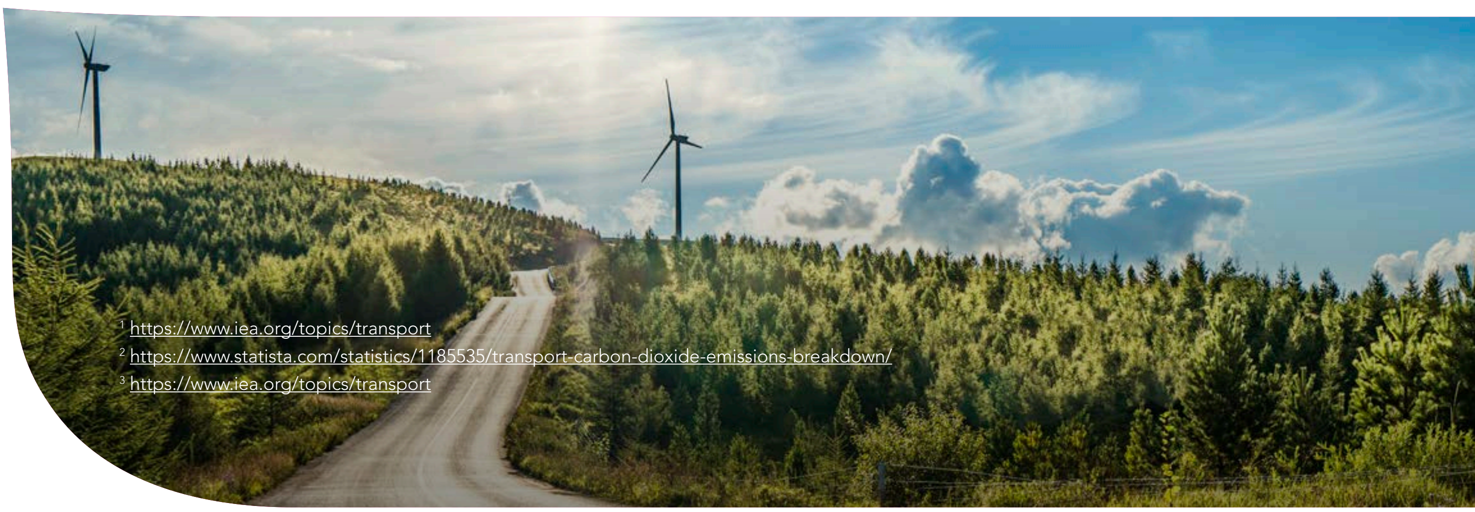
37% of global carbon dioxide emissions from end-use sectors in 2021.[3]

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

In our 2021 whitepaper, 'EV lover, she'll take your heart because it's greener', the European Equities team provided a comprehensive lifecycle comparison between electric and combustion-engine cars. The resulting analysis demonstrated that the broader decarbonisation picture is more nuanced than previously thought.

It is no secret that road transport is one of the largest contributors to global warming. With regulatory pressure mounting, the industry has turned to electric vehicles in recent years, both hybrid and fully electric, to get their average emissions down. But how much lower (if at all) is the lifetime CO_2 footprint for a battery electric vehicle (BEV) compared to an equivalent internal combustion engine (ICE) vehicle?

There is a natural tendency to want to reduce the argument to 'electric: good – petrol and diesel: bad'. However, proper analysis emphasises that the situation is more complicated, and in this report the team conduct a thorough interrogation of the production and operating processes underpinning the automaking industry.

There is still a long road ahead to make cars as green as they could be, but at least we are headed in the right direction. Follow the link to find out more.

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.

EV sales grew by about

36% year-on-year from 2021-2022.[5]

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]

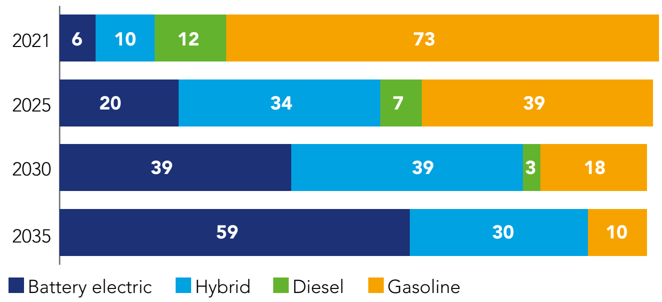
Our view is that EV uptake will reach a tipping point as better battery and charging technology improves useability and prices come down. As a result, despite some short-term headwinds, we expect the EV market to grow significantly in the medium-to-long term.

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]

[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

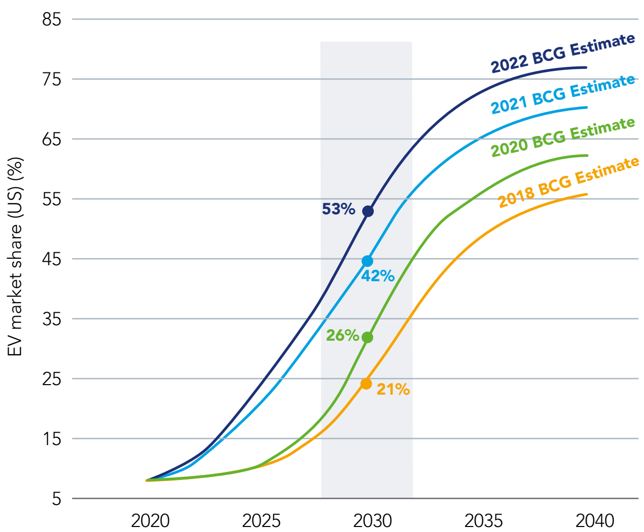
Overall, the bigger picture means that the industry will need to plan for significantly increased volumes. Eliminating supply chain bottlenecks and ensuring adequate growth in the production of the metals and minerals essential for EV powertrains – which takes energy stored in a vehicle's battery system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

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



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

Figure 3: Projected US EV adoption is accelerating



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

Sparks and transformers: A challenging environment for EV manufacturers

While there is plenty of open road ahead, it is 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 $25,000) 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, sustainability-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.

[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/

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.

Given the difficulties in predicting clear winners, we think there are better ways to play the EV theme than investing directly in vehicle manufacturers.

> **The significant expected growth in the EV market is a major potential driver for the Silicon Carbide (SiC) wafer market.**

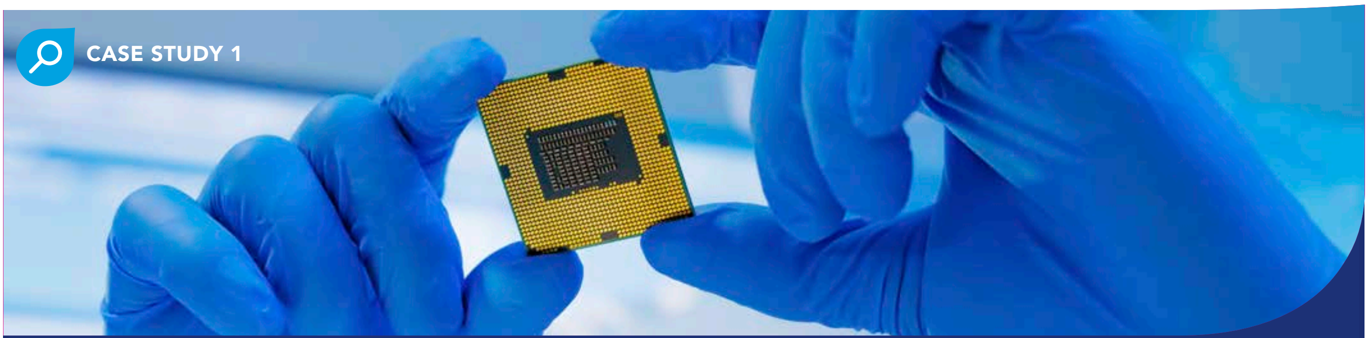
Auto suppliers that provide key parts to the automotive industry are an excellent way of gaining indirect exposure to the market. We prefer to focus on those suppliers developing products essential for the electrically powered, self-driving vehicles of the future.

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.

The Europe and Europe ex-UK strategies have exposure to SiC and other leading edge automotive technologies through holdings, including leading manufacturer of high-performance substrates, Soitec. To learn more, a comprehensive case study for Soitec (and two other portfolio holdings) can be found at the end of this report.

SECTION THREE:

Case Studies



Soitec

Themes: Future Mobility; Energy Transition

Soitec is a leading manufacturer of high-performance substrates used in the manufacture of semiconductors. Since its creation in 1992, the company has launched various environmental programmes, indicating its commitment to positive environmental practices.

Why we're invested

The company has a competitive advantage over its peers through the development of its innovative **SmartSiC™ technology** – a new-generation substrate driving the electrification, autonomy, sustainability power, and cost-efficiency of electric vehicles and industrial applications.

This technology significantly contributes – in both its long-term programs and engagements as well as in its production and products – to improve sustainability and lower emissions in microelectronics.

This technology uses **Silicon Carbide (SiC)**, a hard, crystalline compound able to withstand higher electrical fields. Its application enables new levels of ultra-high conductivity and performance, improved manufacturing yields, and reduced environmental footprints in eMobility, industrial and smart grids applications (for more information on SiC, please refer to the information box on page 12 of this report).

Wolfspeed, an American developer and manufacturer of wide-bandgap semiconductors, estimates that the lifetime GHG emissions reduced by using SiC in a single EV sedan is approx. 690kg CO_2 eq over its nearest alternative.

> **Wolfspeed estimates that the lifetime GHG emissions reduced by using SiC in a single EV sedan is approx. 690kg CO_2 eq over its nearest alternative.**

As the electric vehicle market grows, so too will the SiC market as demand for these materials increases. Soitec has a very strong market position in silicon-on-insulator (SOI) wafers due to its leading-edge technology, so the business has longevity as long as SOI wafers remain high in demand from the semiconductor industry. The company works closely with its customers to develop materials that have desired characteristics for future generations of electronics.

How is the company doing?

Soitec has a positive approach towards ESG consideration, and the company appears particularly strong on the social aspect with many initiatives promoting employee wellbeing and community relations. However, while we believe the company's narrative and disclosure of environmental factors is strong, we think it would benefit further from the introduction of clear future targets.

The above does not represent all of the securities held in the portfolio and it should not be assumed that the above securities were or will be profitable. This information does not constitute a solicitation or offer to any person to buy or sell any related securities or financial instruments.

Epiroc

Themes: Future Mobility; Energy Transition; Health and Wellbeing

Epiroc is a leading global manufacturer of mining and infrastructure equipment, based in Stockholm, Sweden. The company develops innovative, sustainable construction products, drill rigs and rock excavation tools.

Epiroc is a market leader in battery-powered and automated mining equipment. The company therefore plays a critical role in enabling the mining industry to reduce its emissions by facilitating the transition to battery-powered equipment. It also plays an important role in improving the health and safety record of the mining industry with its intelligent mining equipment.

Why we're invested

The mining industry is in the midst of a technology transformation. The shift towards automation, as part of the emergence of intelligence mining, is focused on cost reductions, improved efficiencies, and the removal of human labour from the mining process.

Battery-powered equipment – with zero emissions – is increasingly replacing diesel-powered machines. This is beneficial both to working conditions and removes the need for costly ventilation.

For Epiroc, this trend provides a long-term growth tailwind, owing to the positive implications from both a sustainability perspective as well as on the company's financials.

How is the company doing?

Epiroc has set 2030 sustainability targets in line with the 2015 Paris Agreement and the United Nation Sustainable Development Goals (UN SDGs). These targets are comprised of two major elements: 'people' and 'planet'.

The overarching goal of the 'planet' target is to halve the company's CO_2 emissions by 2030, and is made up of four sub-targets focusing on reduced emissions within the wider business framework: operations, transport, products and suppliers.

> **In 2019, 63% of the company's energy came from renewable sources – exceeding its target of 60%.[11]**

The 'people' targets include doubling the number of women in operational roles and improving employee safety.

Epiroc has identified eight of the 17 UN SDG's that it can contribute most towards: SDG 5 (Gender Equality), SDG 6 (Clean Water and Sanitation), SDG 7 (Affordable and Clean Energy), SDG 8 (Decent Work and Economic Growth), SDG 9 (Industry, Innovation and Infrastructure), SDG 12 (Responsible Consumption and Production), SDG 15 (Life on Land), and SDG 16 (Peace, Justice and Strong Institutions). All the company's 2030 targets work towards achieving at least one of the UN SDG's.

Under the UNSDG framework, and specifically SDG 6, Epiroc's global community engagement initiative, founded in 1984, aims to empower people through access to clean drinking water, sanitation and hygiene. This initiative, financed through employee donations that are tripled by Epiroc, has reached millions of people worldwide since its inception.

[11] https://www.epiroc.com/

Sika Group

Themes: Future Mobility; Energy Transition

Sika Group is a multinational speciality chemicals manufacturer, headquartered in Switzerland, that supplies to the construction sector and motor vehicle industry. The company is considered one of the largest players in a highly fragmented market (construction chemicals) and is strongly associated with sustainability and environmental impact reduction.

Why we're invested

Sika is one of the biggest players in a very fragmented market. We believe there is a long runway for the company to continue its existing roll-up strategy of consolidating the market. Furthermore, in response to the Covid-19 pandemic and the imperative to address climate change, many major economies plan to issue green stimulus infrastructure projects, and we believe Sika will benefit from these initiatives.

How is the company doing?

A large part of the company's value proposition to customers is the positive sustainability impact of its products – over 70% emphasise positive sustainability attributes.

> **Sustainability is not just important to the company from an internal standpoint; it is seen as a key competitive advantage.**

However, the nature of the business means Sika's operations result in a heavy CO_2 footprint. In recognition of this, the company launched its '**Sustainability Strategy**' in 2019 which encompasses both its financial and non-financial targets. As part of this strategy, Sika pursues six strategic target areas, focusing on: climate performance, energy, waste and water, community engagement, occupational safety, and sustainable solutions.

The company is also committed to the United Nation's Sustainable Development Goals (UN SDGs) and has identified eight of the 17 goals as areas to contribute towards: SDG 3 (Good Health and Wellbeing), SDG 4 (Quality Education), SDG 6 (Clean Water & Sanitation), SDG 8 (Decent work and Economic Growth), SDG 9 (Industry, Innovation and Infrastructure), SDG 11 (Sustainable Cities and Communities), SDG 12 (Responsible Consumption), and SDG 13 (Climate Action).

> **The European Union (EU) estimates construction and demolition waste (CDW) accounts for more than a third of all waste generated in the EU.[12]**

Sustainability is not just important to the company from an internal standpoint; it is seen as a key competitive advantage. As well as appealing to a key consumer trend, environmental sustainability is an increasing pre-requisite in public infrastructure contracts and local authority works.

For example, large-scale infrastructure projects initiated by government agencies are increasingly incorporating green requirements in the procurement process that will benefit Sika. The European Union (EU) estimates construction and demolition waste (CDW) accounts for more than a third of all waste generated in the EU.[12]

Sika scores very highly on the sustainability front and this is considered a key competitive advantage. They have set clear environmental targets on a path to a net-zero position.

[12] Construction and demolition waste (europa.eu)

The company also stands to benefit from a growing electric vehicle market through the production of automotive adhesives (a duopoly with American multinational chemical company, DuPont). These products are used to bond different materials, making vehicles lighter which means they can be driven further on full battery.

Furthermore, Sika's products are seen by customers as offering high value-add to their cost, meaning there is more willingness to pay, and the focus on sustainability further enhances this as it allows its customers to reduce their environmental impact. For example, the company's additives can allow builders to use less cement (a very high CO_2-emitting product) while achieving the same strength, and the company's roofing products can reflect heat allowing buildings to use less energy for cooling, for example.

Goals and targets

Sika is committed to being carbon neutral by 2050. As part of this, the company looks to reduce its negative impact with the following targets:

15% less energy consumption per ton sold.

15% less waste generated per ton sold.

15% higher recycling rate of total waste.

15% less water consumption per ton sold.

50% fewer accidents (and zero fatalities).

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