ESG Materiality Newsletter

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Introduction

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

In this issue, we reflect on the 2023 corporate governance trends across emerging markets and then put the spotlight on India, examining key environmental, social and governance (ESG) risks and opportunities in one of the world's most exciting emerging countries. We also profile Malaysian aluminium producer **Press Metal** – a recent addition to the portfolio and a company that is making a vital contribution to the carbon transition.

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.
- We engage on strategic and ESG matters, including issues which are relevant to achieving the UN Sustainable Development Goals (SDGs); our engagements seek positive impact across value chains.
- Management teams must be willing to confront sustainability challenges and engage on future ESG strategy.
- We maintain a low carbon footprint and prioritise engagements with holdings with higher levels of emissions and/or climate related risks.

Portfolio snapshot

As at the end of April 2023, we engaged with companies representing **84%** of our AUM, making progress in **39%** of these engagements [1].

Percentage of AUM engaged by theme

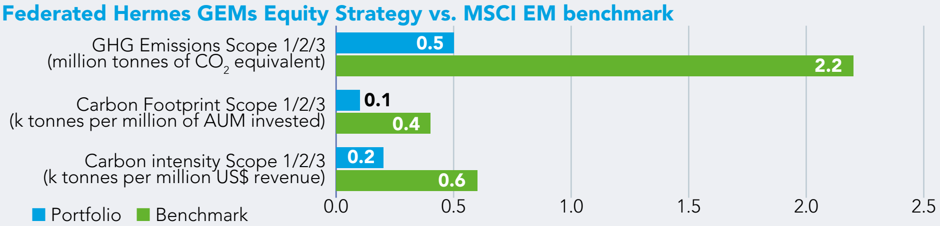
Environmental	Social and ethical	Governance	Strategy and communication
70%	63%	76%	49%

Source: Federated Hermes as at 30 April 2023.

Our portfolio's carbon footprint, Q2 2023

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 [2].

Federated Hermes GEMs Equity Strategy vs. MSCI EM benchmark



Source: Federated Hermes as at 30 April 2023. The benchmark is the MSCI Emerging Markets index

[1] Progress in engagement objectives is calculated from January 1st and so it typically higher in Q3/4 after more engagements have progressed

[2] **Scope emissions:** Scope 1, Scope 2, and Scope 3 is a classification system for greenhouse gas (GHG) emissions a firm creates through its operations, energy usage, and the wider value chain.
- Scope 1 emissions – All direct emissions from the activities of an organisation or under their control. Including fuel combustion on site such as gas boilers, fleet vehicles and air-conditioning leaks.
- Scope 2 emissions – Indirect emissions from electricity purchased and used by the organisation. Emissions are created during the production of the energy and eventually used by the organisation.
- Scope 3 emissions – All other indirect emissions from activities of the organisation, occurring from sources that they do not own or control. These are usually the greatest share of the carbon footprint, covering emissions associated with business travel, procurement, waste and water.

Corporate governance and voting

In the first half of 2023, regulators in **China** took positive steps, with new rules and guidance on key corporate governance topics announced by the State Council[3] (see Box 1). While the timeframe for implementation has not yet been announced, we are already seeing companies paying more attention to this agenda in our engagement discussions. For example, we discussed the criteria for independent directors with Chinese SOE[4], **NARI Technology**, and gave guidance on our expectations for overall board composition.

China – corporate governance reforms[5]

Key changes (timing of implementation TBC) include:

- Independent board members should be 'more than one-third' (instead of 'equal to one-third')
- SOE boards should have a majority of independent board members
- Audit committees to consist of 100% non-executive directors with majority independent
- Remuneration and nomination committees to be majority independent
- Exclusive process for independent board members to make decisions on material issues such as approving related-party transactions and accounting firm selection

Meanwhile, in **Taiwan**, the Financial Supervisory Commission (FSC) moved to translate existing guidance on corporate governance into actual requirements[6] including: boards to be at least one-third independent; maximum tenure to be nine years; and boards to have at least one-third female representation on a 'comply or explain' basis. The plan also requires companies to disclose emissions-reduction targets for the following financial year, including a strategy to achieve this.

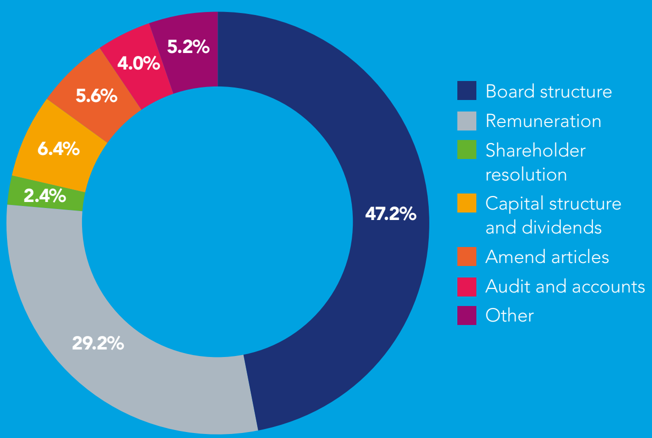
Across markets, the GEMs team has continued efforts to improve **board diversity** and **independence** through engagement and voting at company meetings, while also putting the spotlight on **remuneration**. This reflects our focus on board effectiveness as a key driver of long-term value and our expectation that remuneration schemes are aligned to company performance and the creation of value for all stakeholders.

In the Global Emerging Markets (GEMs) Equity Strategy we voted against management on board composition proposals at **47%** of companies in the portfolio (see Figure 1) over the last 12 months including at **AIA Group** and **Samsung Electronics**, both of which do not fully meet our expectations on independence and diversity (albeit heading in the right direction). While there is room for improvement at **Banco de Chile**, a new holding for the GEMs Strategy, we voted for the proposed board candidates 'by exception' in recognition of the positive momentum and openness to engagement. We also voted against 29% of remuneration proposals including at **Tencent**[7].

Tencent – shareholder meetings 2023

We voted against the 2023 share option and share award schemes due to concerns over potentially excessive dilution and the lack of disclosed performance conditions as well the potential conflict of interests in the administration of the schemes. Unlike in 2022, we supported both directors standing for election, in recognition of the positive momentum demonstrated by the company in increasing board diversity to 25%, increasing board independence to 63% and offering shareholders opportunities for direct conversation with board members

Figure 1: GEMs Strategy votes against (or abstentions) May 2022 – April 2023



[3] The State Council is the chief administrative authority of the People's Republic of China. It is chaired by the premier and includes the heads of each of the constituent departments.
[4] A state-owned enterprise (SEO) is a large organisation created by a country's government to carry out commercial activities.
[5] 国办重磅发文！上市公司独董制度改革！国有控股上市公司董事会中，外部董事应当占多数| 每经网(nbd.com.cn). China to reform independent director system (www.gov.cn)
[6] TWSE 公司治理中心
[7] Votes at Tencent and AIA Group AGMs are not included in Figure 1 since they took place in May 2023.

Spotlight on India

Overview

- India's rapid economic growth over the last two decades has **lifted millions out of poverty** and contributed phenomenally to global human development.
- India is now the **fifth largest economy in the world** and will likely be the third largest in the next seven years, with its GDP more than doubling from the current US$3.3tn. According to our analysis, India is forecast to add more than US$400bn to its GDP annually, a scale that only the US and China surpass[8]. India is poised to drive about a fifth of global growth in the coming decade[9].
- While growth has moderated slightly in recent months, the **outlook remains strong**, driven by many factors including India's 'demographic dividend' (more than half of India's population is under 30), an expanding middle class and rapid digitalisation.
- Meanwhile, from an ESG perspective, the Indian government's policy commitments around **renewables, healthcare, financial inclusion** and other sectors, give cause for optimism and present ample opportunities for companies to align with the SDGs.
- However, India's economic success has not yet resulted in an improved quality of life for everyone, and gender inequality and labour rights are ongoing areas of concern. Further economic expansion is needed to provide better education and improved healthcare, as well as access to banking services and the internet, to many more millions of people.
- Companies face high exposure to **climate change** risks, both physical and transition, despite very low per capita energy consumption, and **governance** standards are sometimes lagging SEBI guidelines.
- Against this backdrop, while the government of Prime Minister Narendra Modi is continuing to push ahead with reforms, it has set a delayed timeframe to achieve **net zero of 2070**.

How are these ESG risks and opportunities reflected in our analysis and engagement?

While issues vary by company, at a country level, we consider climate change, water scarcity, labour rights, gender equality and access to basic services to be the most material ESG risks and opportunity areas, linking closely to the SDGs

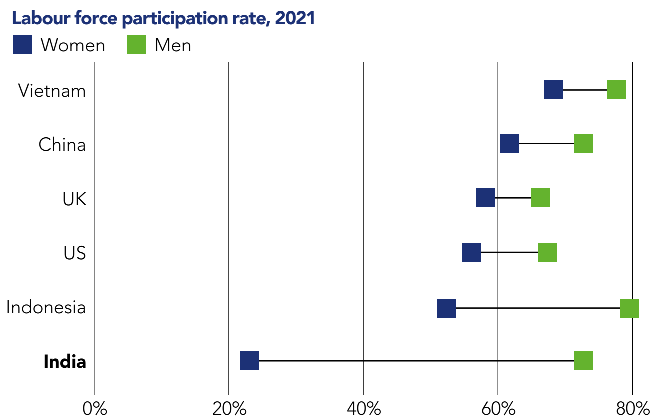
Social Issues

- **Gender diversity in the workplace (SDG 5)** – According to the World Bank and the UN's International Labour Organization, overall female participation in the workplace is one of lowest in the world (less than 30% in 2021) and declining. India was ranked 140 out of 156 countries by the World Economic Forum (Gender Gap Report 2021) and is now one of the worst performers in South Asia, despite some improvements at senior and executive levels[10].

Engagement

We see quite a mixed picture in the GEMs portfolio with some examples of very low participation (**Dabur**, for example, with approx. 250 women out of a workforce of more than 5,000) but more progressive approaches at **Hero Motocorps** (target of 30% by 2030) and **Bharat Forge** (target of 20% women in leadership positions by 2030). Gender diversity at board level typically meets the Securities and Exchange Board of India (SEBI)[11] requirement of minimum one female independent director but does not go further. Exceptions include **Hero** which now has three female directors. Our engagement focuses on asking companies to set improvement targets and to articulate their strategy for creating a more inclusive workplace.

Figure 2: India's female participation rate lags behind



Source: ILO/Financial Times

[8] Global Emerging Markets Outlook (hermes-investment.com)
[9] India takes off? | Financial Times (ft.com)
[10] Labor force participation rate, female (% of female population ages 15+) (modeled ILO estimate) - India | Data (worldbank.org). Explained: Why Indian Women's Workforce Participation Is Still Considerably Low (indiatimes.com).
[11] The Securities and Exchange Board of India is the regulatory body for securities and commodity market in India under the ownership of Ministry of Finance within the Government of India

- **Labour rights and human capital management (SDG 8)** – while labour disputes are still an issue to watch (and much flagged by ratings agencies), enlightened companies have a vested interest in ensuring good working conditions and positive employee relations. This was borne out by our site visits in Q1 (eg **Hero** and **Samvardhana Motherson**). There is a trend in India towards increasing flexibility in favour of the employer; amended labour laws seek to reduce the administrative burdens on employers and bring more workers into the formal sector. A recent example being Karnataka's new labour laws that allow 12-hour day and night shifts and an increase in allowable overtime. Companies typically employ a mix of contract labour and permanent employees depending on the skill level required, with lower skill jobs often given to contract workers.

Engagement

We focus on how companies ensure worker well-being and retention, paying particular attention to companies that rely heavily on contract labour (which can signal higher risks of poor labour practices). It is notable that **Samvardhana Motherson** uses almost 100% permanent employees, in part reflecting higher skill requirements, but also a belief in investing in worker well-being and development.

- **Supply chain due diligence (SDG 8)** – While some sectors are further advanced on this topic (such as apparel), it is relatively new for others (such as the auto and consumer products industries). Risks of human rights abuses and poor working conditions increase at lower tiers of the supply chain, particularly when sourcing agricultural raw materials and metals. The **Global Slavery Index** flags that an estimated 8 in 1,000 people in India can be classified as being in the condition of modern slavery, compared to 4 in China, 6.4 in Indonesia and 6.3 in Malaysia[12]. According to the World Bank, 1.7% of children aged 7-14 are involved in child labour (2019)[13].

Engagement

We focus on whether companies have systems in place to risk assess and monitor supply compliance. **Hero, Bharat Forge** and **Dabur** are all rolling out a code of conduct across their suppliers, but it is still early days and the routine monitoring of suppliers varies.

- **Inclusion and access to products and services (SDGs 9 and 10)** – Despite huge growth that has lifted millions out of poverty, further economic expansion is required to deepen access to essential products and services. Notably, despite fast and widespread digital uptake, internet use in India hovers below 50% according to World Bank data with a marked gender gap (57% of men and 33% of women)[14,15]. This leads to both **opportunities** and **challenges**.

  – **Financial inclusion** (SDG 9) – 22% of Indians (aged over 15) are unbanked with women particularly affected[16]. Government schemes provide a supportive backdrop, such as an initiative to guarantee a bank account for all[17], and the Aadhar scheme, which provides unique identification numbers to every individual[18].

  – **Access to health care** (SDG 3) – Life expectancy at birth has increased from 62 years in 2000 to 70 years by 2020[19], yet many still lack access to services. All Indian citizens can get free outpatient and inpatient care at government facilities yet underfunding of the state system[20] leads many households to seek care from private providers and pay out-of-pocket.

  – **Access to clean water and sanitation** (SDG 6) – Latest World Bank data shows that 46% of the population is using 'safely managed sanitation services' and 71% are using at least basic sanitation services[21]; 90% of people use at least 'basic drinking water services'[22].

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Engagement

We focus on whether companies are addressing under-served population groups and how they are ensuring products are fit for purpose, simple to understand and accessible. **Bajaj Finserve** plays into the financial inclusion space with more than 15% of its revenues[23] from rural areas and a focus on providing credit to low-income consumers. In healthcare, **Max Healthcare** ensures 7% of beds[24] are set aside for low-income patients; there could be opportunities to address gaps in the 'missing middle' in the near future, in terms of healthcare provision and insurance – an area also addressed by **Bajaj Finserve** and **AIA Group**. **VA Tech Wabag** plays into the clean water theme by designing and building water and sewage treatment plants, and desalination units, for local governments and industries.

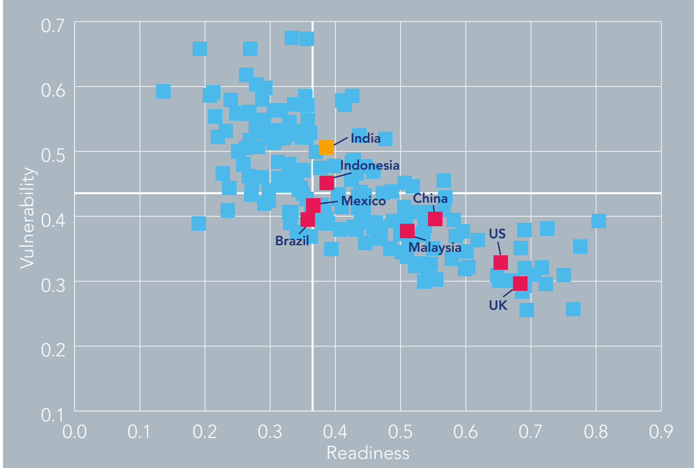
[12] India | Global Slavery Index. These figures include people subject to 'forced marriage'.
[13] India.pdf (worldbank.org)
[14] Based on use of internet in last 3 months. India | Data (worldbank.org)
[15] Exploring India's Digital Divide | ORF (orfonline.org). National Health Survey 2019-21
[16] As per the World Bank's Findex report 2021. This compares to 11% in China and 48% in Indonesia.
[17] India's Narendra Modi launches bank accounts for all - BBC News
[18] How Digital Payments Drive Financial Inclusion in India (microsave.net) The India Stack is Revolutionizing Access to Finance - IMF F&D
[19] World Bank
[20] A country of 1.3 billion people but India spends barely 1.5% of its GDP on healthcare, which is among the lowest in the world. 5 reasons India's 'Missing Middle' is struggling to access quality healthcare (indiatimes.com)
[21] India | Data (worldbank.org)
[22] Defined as drinking water from an improved source, provided collection time is not more than 30 minutes for a round trip (World Bank).
[23] Company disclosures.
[24] Company disclosures.

Enviroment

Climate change (SDG 13)

Despite very low per capita energy consumption, India is the world's third-largest greenhouse gas emitter[25]. India's economy is closely tied to natural resources such as agriculture, water and forests and is therefore highly vulnerable to increases in temperature. Research shows that with a 2°C to 3.5°C rise in temperature[26], India's farmers may lose 9% to 25% of their net revenues, which may decrease the country's GDP by 1.8% to 3.4%[27,28]. The **Notre Dame GAIN Index** ranks India as more vulnerable and less ready than some of its peers (for example China and Malaysia)[29].

Figure 3: India is more vulnerable to rises in temperature than peers



Source: The Notre Dame GAIN Index

It has set a net-zero-by-2070 target as well as a target to reduce carbon intensity by 45% below 2005 levels by **2030**

The government response has been mixed. It has set a **net-zero-by-2070** target as well as a target to reduce carbon intensity by 45% below 2005 levels by 2030. It also aims to create 500 gigawatts (GW) of renewable energy capacity by 2030. While India missed its 2022 renewable energy target, it continues to expand its renewable capacity, and has one of the fastest rates of uptake in the world.

However, despite policies to encourage the transition from coal to gas in various industries (such as the ceramics sector in Gujaret), the government continues to support the use of coal to ensure energy security and meet the fast-growing demand for power as India's population rapidly increases. India has the **second-largest coal pipeline** globally and the draft National Electricity Plan[30] projects another 26 GW of coal capacity will be installed by 2026-27[31]. (Such priorities need to be seen in the context of a country where millions of people still do not have access to reliable electricity.)

Engagement

There are examples of leadership with companies setting nearer-term carbon neutrality targets for their own operations (Scopes 1 and 2) – for example **Hero** and **Bharat Forge**. However, in common with many global peers, companies are just beginning to engage with suppliers and to map their Scope 3 emissions (emissions that the organisation is indirectly responsible for, up and down its value chain). Few have committed to the Science Based Targets initiative (SBTi)[32] as yet and there is a tendency to rely on offsets above 10% which is the SBTi maximum. Our engagement focuses on urging companies to evaluate climate-related risks and opportunities, set interim and long-term net-zero targets and work towards SBTi verification.

[25] WRI India | World Resources Institute
[26] Policy Series 12 (icrier.org)
[27] Achieving Sustainable Development and Promoting Development Cooperation, Department of Economic and Social Affairs Office for ECOSOC Support and Coordination
[28] Climate | WRI INDIA (wri-india.org)
[29] Matrix // Notre Dame Global Adaptation Initiative // University of Notre Dame (nd.edu)
[30] DRAFT_NATIONAL_ELECTRICITY_PLAN_9_SEP_2022_2-1.pdf (cea.nic.in)
[31] India | Climate Action Tracker
[32] **The Science Based Targets initiative (SBTi):** Established in 2015, the SBTi is designed to help companies to set greenhouse gas (GHG) emission reduction targets in line with climate science. The initiative defines and promotes best practices in emissions reductions and includes a team of experts to provide companies with independent assessment and validation of their targets.

- **Water** – water scarcity is a crucial issue and will impact rural demand as well as creating operational risks for many companies dependent on water. The World Resources Institute Aquaduct tool[33], which tracks water-related risk (water scarcity, drought, flooding) evaluates India as 'extremely high risk' (with a score of 4 out of 5).

Engagement

Companies are making 'water neutrality' pledges (for example, **Dabur**, **Samvardhana Motherson** and **Bharat Forge**) which is encouraging, but some pledges rely too much on offsetting the impact of their own operations by investing in water projects elsewhere (ie in different communities). Given that water is a local issue, local communities will not feel the benefits of water projects in another district or state. We engage on this and broader water management issues.

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- **Circularity** – India has one of the most developed informal recycling industries in the world. In terms of circularity[34], however, many companies are in the early stages of establishing strategies. This is in part due to lower consumer demand and a less stringent regulatory framework. While there are initiatives (and some targets) around recycling and waste at factory level, most companies are yet to set targets around reduction of virgin materials (particularly plastic) in their products. For example, **Dabur** has a 'plastics neutrality' pledge but no targets on reduction of virgin plastic use. There could be future opportunities for companies that offer solutions around sustainable materials (eg recycled plastics, bio-plastics) and recycling.

Engagement

We are engaging on setting a circularity strategy and targets for reduction of virgin materials used, particularly plastics.

The World Resources Institute Aquaduct tool, which tracks water-related risk (water scarcity, drought, flooding) evaluates India as 'extremely high risk' with a score of

4 out of 5

Governance

India was the **first country globally to make Corporate Social Responsibility (CSR)[35] mandatory by law** with the 2014 amendment to the **2013 Companies Act**, requiring companies with a net worth of more than 5bn rupees (US$70m) to spend 2% of their three-year annual net profit on CSR initiatives. This has led to increased spending on CSR, in addition to improved visibility and governance of these investments. Companies are required to set up **board level CSR committees** with at least three directors (one of whom must be independent).

- In terms of wider corporate governance, while the **SEBI guidelines** have driven some improvements, few companies go beyond the minimum requirements. As well as a lack of diversity on boards, overall **independence** can be compromised by long tenures (more than nine years) and over-boarding. Other issues include **related-party transactions** (RTPs)[36] without clear processes for seeking shareholder approval and escalating executive pay without appropriately stretching long-term incentives.

Engagement

There are of course areas of leadership. As previously mentioned, **Hero Motocorps** has appointed three female directors. We focus on encouraging companies to move beyond minimum requirements and to adopt the SEBI best practice recommendations (such as the separation of Chairman and CEO).

India was the first country globally to make Corporate Social Responsibility (CSR) mandatory by law with the 2014 amendment to the **2023** Companies Act

[33] Aqueduct | World Resources Institute (wri.org)
[34] Circularity means using plastics (or any resource) more efficiently by keeping the material in use for as long as possible, getting the most we can from the material during its use, and then recovering it to make new products.
[35] In the Indian context, the term Corporate Social Responsibility (CSR) broadly refers to the work undertaken by corporates towards social and environmental causes.
[36] A related-party transaction (RPT) describes arrangements and transactions between a publicly traded company and parties the company already has a pre-existing business relationship with.

ENGAGEMENT CASE STUDY

Press Metal

Headlines:

- Press Metal is a Malaysian aluminium smelter producing **'low carbon' aluminium** from renewable electricity (hydropower).
- Aluminium is vital to the clean energy transition, for use in areas such as transmission lines and electric vehicles (EVs), and demand is forecast to surge in the coming years.
- Press Metal is working to mitigate its environmental and social risks throughout its supply chain, and is preparing for **Aluminium Sustainability Institute** (ASI) Chain of Custody certification[37] to demonstrate its commitment across its product life cycle.
- The company has set a **net-zero-by-2050** target. However, it faces some structural constraints including a raw materials supply chain (for alumina) that is currently dependent on coal (when refining alumina from bauxite).
- We are engaging to ensure risks and environmental impacts are managed effectively.

Context:

Aluminium is an energy intensive material to produce yet it is critical for a net-zero world. The smelting process (which turns alumina into aluminium) requires vast quantities of electricity (not heat), which must also be applied consistently in order to ensure that the 'cells' do not 'freeze.' Looking at the overall aluminium industry, more than 50% produces aluminium using coal-fired electricity plants, roughly 25% from gas-fired electricity plants, and only 25% from renewable electricity (hydropower)[38]. A hydro-powered aluminium smelter (such as those operated by Press Metal) will typically produce aluminium with around 2 to 5 tonnes of CO_2 emissions per tonne of aluminium, whereas a coal-fired smelter will produce aluminium with about 15 tonnes of CO_2 emissions per tonne of aluminium. So there is a massive difference between the first quartile and the bottom two quartiles of producers. Press Metal is firmly established in that first quartile.

There is currently no existing model for a net-zero aluminium smelter globally and it is unlikely that existing smelters can be retrofitted for a net-zero outcome. New technologies under exploration would likely involve the construction of entirely new smelters – both time and capital intensive. This further demonstrates the significance of the real-time ability to produce 'low carbon' aluminium.

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

Sustainable Development Goals:

7 AFFORDABLE AND CLEAN ENERGY

13 CLIMATE ACTION

So what is the problem?

We concentrate on the aluminium smelting process because it accounts for 77% of the industry's emissions[39]. But the smelting process is not the only part of the aluminium supply chain. Alumina is the key raw material (you need about 2 tonnes of it to produce 1 tonne of aluminium). Alumina itself is 'refined' from bauxite. The process by which bauxite is turned into alumina is a 'heat process' which today almost exclusively involves burning gas, fuel oil or coal. While geothermal, biofuels or hydrogen might one day take over, there are currently no economically viable carbon-free alternatives. So 'dirty' *alumina* is still the reality for the industry overall. Press Metal has two associate companies (JVs) which supply 60-80% of its alumina (with the remainder bought in the open market). Both currently use coal in their processes which has understandably led to concern from activist investors.

Our view

- Although Press Metal's alumina supply chain is dependent on coal, the most significant industry emissions (77%) occur at the aluminium smelting stage.
- The potential carbon savings from Press Metal aluminium versus its non-hydro powered peers are therefore significant (in the region of 75%). *To give a theoretical example, the aluminium in a North American vehicle would be associated with approx. 0.9 tonnes of carbon emissions if made with Press Metal aluminium versus approx. 3.45 tonnes of carbon emissions if made using aluminium from a coal fired smelter.*
- While we expect Press Metal to seek to influence its joint ventures (JVs), it does not have full control and the timing of Indonesia's transition away from coal is unfortunately uncertain.
- The fact that Press Metal is working on ASI **(Aluminium Sustainability Institute)** Chain of Custody certification, covering its whole supply chain, is a clear signal that they are taking this issue seriously. ASI certification validates the sustainability credentials of the whole supply chain, including alignment with the Science-Based Targets initiative (SBTi) expectations.
- We continue to engage and monitor progress.

[37] ASI Chain of Custody Standard | Aluminium Stewardship Initiative (aluminium-stewardship.org)
[38] www3.weforum.org/docs/WEF_Aluminium_for_Climate_2020.pdf
[39] www3.weforum.org/docs/WEF_Aluminium_for_Climate_2020.pdf

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