# Climate-related Financial Disclosures Report 2022



www.hermes-investment.com For professional investors only Climate change has become a key defining factor in the long-term prospects of the global economy and the companies within it.

As an investment manager, we have a duty to our clients and their investors to take action to address systemic risks and opportunities – and the Task Force on Climate-related Financial Disclosures' focus and guidance on the financial impact of climate change are of particular importance as we collectively strive to keep 1.5°C within reach.

## Foreword

With US scientists confirming the arrival of El Niño, the natural weather event, earlier this year and the continuing human-induced climate breakdown, breaching the 1.5°C Paris Agreement climate threshold by 2027 is exceedingly likely according to the World Meteorological Organisation (WMO).<sup>1</sup> The world is running out of time to avoid a climate catastrophe and new green solutions have never been in greater demand to facilitate the transition to a low-carbon economy. As part of the transition, it will be crucial for the Global South to play a leading role and the implications on job security, reskilling and energy affordability considered.

Positively, clean energy investment has seen a significant boost in recent times, as corroborated by research from the International Energy Agency that found the estimated annual clean energy investment had risen faster than investments in fossil fuels since 2021.<sup>2</sup> Further positives that can be drawn such as the prospect of investment from countries in the Middle East, and the passing of the Inflation Reduction Act last year in the United States, which provides significant incentives for green investments in North America. Development of the necessary green solutions, however, comes with huge capital expenditure requirements, which is a big ask when effectiveness has not always been proven and there is a lack of government investment or subsidies to support. The increased focus on nature during 2022 has also been encouraging, particularly the agreement of the Kunming-Montreal Global Biodiversity Framework (GBF) at COP15. However, the scale of the challenge means that swift action must be taken by governments, companies, investors and civil society to achieve the targets contained within the GBF.

Federated Hermes Limited, as a financial institution, has a critical role in enabling companies to meet the demand for solutions and we fulfil this through various means, including: primary investment through our upcoming UK Nature Impact Strategy; our infrastructure portfolio, such as Scandlines; our real estate solutions, such as placemaking at our large regeneration schemes in Paradise, Birmingham<sup>3</sup> and Wellington Place, Leeds<sup>4</sup> among others; and stewardship to influence investee companies' capital allocations. We are also advocating for governments to create an enabling environment that drives corporate action and engaging with asset owners to use their influence to mitigate these systemic risks.

This document outlines how we are assessing, monitoring and mitigating our exposure to climate risk and identifying opportunities to support the transition in recognition of rising expectations of our clients and the urgent need to assess these systemic risks. The disclosures in this document are aligned with the recommendations of the Task Force on Climate-related Financial Disclosures. For the first time, we also include reporting on our approach to nature-related risks and opportunities.



Saker Nusseibeh, CBE Chief Executive

World Meteorological Organization, 'WMO update', (May 2023)
 International Energy Agency, 'World Energy Investment 2023'. (May 2023)
 FHL, 'Real estate case study - Paradise: a development without the divide', (March 2023)
 FHL, 'Real estate case study - 11& 12 Wellington Place, Leeds: a bridge between two revolutions', (May 2023)

## Background



Scientists are increasingly concerned by the outlook for 2023. As the current El Niño continues to develop there is good reason to expect periods in the coming twelve months during which the global-mean air temperature again exceeds pre-industrial levels by more than 1.5°C.<sup>5</sup> Meteorologists expect that this El Niño, coupled with excess warming from climate change, will see the world grapple with recordhigh temperatures. Some 80% of cities face climate risks ranging from extreme heat and heavy rainfall to drought and flooding.<sup>6</sup>

As the effects of human-caused global warming are already having widespread effects on the environment in the form of extreme weather events, countries and governments urgently need to double down on efforts to mitigate the impacts of this two-pronged temperature crisis. From Pakistan to Europe, Australia and the US, extreme weather events are already becoming common place, with an estimated 70% of events being "made more likely or more severe" by human-caused climate change.<sup>7</sup> There are also more gradual ongoing chronic impacts such as rising and warming sea levels, loss of biodiversity, food and water insecurity, and increased vulnerability to poverty.<sup>8</sup> Climate change has caused substantial damage, and increasingly irreversible losses, in terrestrial, freshwater and marine ecosystems, and people least able to cope are being hardest hit.<sup>9</sup> According to the Natural History Museum's Biodiversity Intactness Index, which measures the change in ecological communities in response to human pressures, the proportion of the original number of species in an area that remain and their abundance is measured at 75% - significantly below the 90% average set as the 'safe limit'.<sup>10</sup> Additionally, more than 1 million species are now threatened by extinction, vanishing at a rate not seen in 10 million years, and with freshwater species populations having seen the greatest overall global decline (83%).<sup>11</sup>

These physical changes along with the urgent action needed to reduce and, in time, eliminate new greenhouse gas (GHG) emissions will require significant structural transformation of the economy, both at a global level and locally. To avert irreversible catastrophe for our economies and the natural world, the global economy must change its course. It has to rapidly shift from business as usual and embrace risks and opportunities surrounding today's climate crisis.

From Pakistan to Europe, Australia and the US, extreme weather events are already becoming common place, with an estimated 70% of events being "made more likely or more severe" by human-caused climate change.

<sup>&</sup>lt;sup>5</sup> Copernicus, 'Tracking breaches of the 1.5°C global warming threshold', (June 2023)

<sup>&</sup>lt;sup>6</sup> World Economic Forum, 'The Global Risks Report 2023', (January 2023)

<sup>&</sup>lt;sup>7</sup> Carbon Brief, 'Mapped: How climate change affects extreme weather around the world', (August 2022)

<sup>&</sup>lt;sup>8</sup> United Nations, 'Causes and Effects of Climate Change', (June 2023)

<sup>&</sup>lt;sup>9</sup> IPCC, 'Climate Change 2022: Impacts, Adaptation and Vulnerability', (2022)

<sup>&</sup>lt;sup>10</sup> Natural History Museum, 'Analysis warns global biodiversity is below 'safe limit' ahead of COP 15', (October 2021)

<sup>&</sup>lt;sup>11</sup> United Nations Conservation to Combat Desertification, ' Land Degradation Neutrality for Biodiversity Conservation', (2019)

<sup>&</sup>lt;sup>12</sup> International Energy Agency, 'World Energy Investment 2023', (May 2023)

<sup>&</sup>lt;sup>13</sup> FHL, 'Climate Action Plan', (November 2022)

These changes, if unchecked, will fundamentally affect our economies, our way of life and the value of investments we make on behalf of our clients. This also presents an unprecedented growth opportunity as achieving a net-zero emissions scenario will require clean energy spending to rise nearly threefold by 2030, with an estimated 65% of this needing to come from the private sector.<sup>12</sup>

To help do our part to change this course, in 2022, Federated Hermes Limited ("FHL") set interim net zero targets across all of our asset classes.<sup>13</sup>

Our enhanced focus on climate action aligns with the accelerating global momentum towards the low carbon transition. FHL intends to lend the full support of its stewardship and advocacy capabilities to help mobilise that transition.

This document sets out how FHL incorporates climate-related risks and opportunities into our governance, strategy, risk management, and metrics and targets, in line with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), and how we are responding to rising expectations of our clients and updated regulatory requirements. We have also enhanced our scenario analysis across some of our investments in partnership with a third party. In addition, we have also considered and incorporated nature in all areas of the report, particularly in the Governance, Strategy and Risk Management sections, following the recommendations from the Taskforce on Naturerelated Financial Disclosures (TNFD).

#### We have also enhanced our scenario analysis across some of our investments in partnership with a third party.

#### Key Terms

**Climate:** refers to the long-term regional or global average of temperature, humidity and rainfall patterns over seasons, years or decades.<sup>14</sup>

**Climate change:** the significant variation of average weather conditions becoming, for example, warmer, wetter, or drier—over several decades or longer. It is the longer-term trend that differentiates climate change from natural weather variability.<sup>15</sup>

**Nature:** the natural world, with an emphasis on the diversity of living organisms (including people) and their interactions among themselves and with their environment.<sup>16</sup>

**Biodiversity:** the variability among living organisms from all sources, including, inter alia, terrestrial, marine and other aquatic ecosystems and the ecological complexes of which they are part; this includes diversity within species, between species and of ecosystems.<sup>17</sup>

#### **Status of TCFD implementation**

In terms of our own implementation of TCFD, we have identified several areas in the TCFD recommendations where we are fully implementing recommendations (those coloured green in the diagram below) and some where we are partially implementing recommendations (those coloured amber in the diagram below).

Since our last report, we have enhanced our approach to scenario analysis with expanded disclosure in this report. We have also enhanced the Metrics and Targets section of this report with a wider range of metrics and reporting against our net zero interim targets. Going into 2023, we will be focusing on enhancing our assessment of nature-related risks, opportunities, impacts and dependencies across our portfolios.

In this report we have also included information on nature in line with recommendations from the Task Force on Nature related Financial Disclosures.

<sup>14</sup> World Bank Group, 'What is Climate Change?', (2021)
 <sup>15</sup> World Bank Group, 'What is Climate Change?', (2021)
 <sup>16</sup> S. Diaz, et al., 'The IPBES Conceptual Framework - connecting nature a
 <sup>17</sup> United Nations, 'Convention on Biological Diversity', (1992)

Go	vernance	Stra	ategy	Ris	k Management	Me	trics and Targets
Disclose the organisation's governance around climate-related risks and opportunities.		Disclose the actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning where such information is material.		Disclose how the organisation identifies, assesses, and manages climate-related risks.		Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material.	
Recommended Disclosures		Recommended Disclosures		Recommended Disclosures		Recommended Disclosures	
a)	Describe the board's oversight of climate- related risks and opportunities.	a)	Describe the climate- related risks and opportunities the organisation has identified over the short, medium, and long term.	a)	Describe the organisation's processes for identifying and assessing climate- related risks.	a)	Disclose the metrics used by the organisation to assess climate-related risks and opportunities in line with its strategy and risk management process.
b)	Describe management's role in assessing and managing climate-related risks and opportunities.	b)	Describe the impact of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning.	b)	Describe the organisation's processes for managing climate- related risks.	b)	Disclose Scope 1, Scope 2, and, if appropriate, Scope 3 greenhouse gas (GHG) emissions, and the related risks.
		c)	Describe the resilience of the organisation's strategy, taking into consideration different climate-related scenarios, including a 2°C or lower scenario.	c)	Describe how processes for identifying, assessing, and managing climate-related risks are integrated into the organisation's overall risk management.	c)	Describe the targets used by the organisation to manage climate-related risks and opportunities and performance against targets.

#### Figure 1. FHL performance against TCFD recommended disclosures

#### Good disclosure – good coverage to date

Limited disclosure – coverage to be increased, quality to be improved

No disclosure – Limited disclosure, methodologies in experimental phase

Source: TCFD and FHL as at 30 June 2023.



## Governance



The responsibility for implementing our approach to climate and nature-related risks resides with all personnel in our business, but we also have a number of structures and teams in place to ensure that we effectively discharge our stewardship responsibilities, including those regarding climate change and nature-related risks and opportunities. Key governance functions include:

**Board.** FHL has a well-established governance structure that is led by the FHL Board. Among the Board's responsibilities is approving and implementing the strategy set by our parent company, Federated Hermes, Inc.. The Board is responsible for approving updates (where applicable) to FHL's climate and nature-related targets and accompanying strategy – which applies mainly to our investment practice but also to management of risk as a corporate entity – on an annual basis. The Board is kept up to date on the progress of implementation through annual updates from the Head of Policy & Integration and Head of Responsibility.

**Governance Committee.** The Governance Committee is a formal oversight committee responsible for the annual approval of updates to FHL's climate and nature-related targets and accompanying strategy on an annual basis and the climate- and nature- related financial disclosure reporting. The committee is accountable to and reports to our CEO. The members include the Head of Responsibility, Head of Investment, Head of International Client Group, Managing Legal Counsel, Chief Regulatory Officer & Head of Government Affairs and Managing Director, Private Markets.

**Responsibility Working Group ("RWG").** Meeting every quarter, the RWG is made up of senior representatives from across the business and is chaired by our Head of Responsibility. This group discusses a comprehensive range of topics that relate to the delivery of sustainable wealth creation for our clients and beneficiaries and shares best practice across the organisation, including on climate change and nature.

#### Climate Change and Nature Working Group ("CNWG").

Our CNWG is a cross-business initiative, including staff from investment management in public and private markets and representatives from the engagement, strategic and investment risk and business development teams. The group reports to the RWG and is responsible for idea generation and advancing our climate and nature-related strategy, meeting at least four times per year to continually review and strengthen our approach.

In 2022, the CNWG focused its work on finalising and publishing our enhanced business-wide climate change approach, set out in the FHL <u>Climate Action Plan</u>. This document includes interim targets validated by the Institutional Investors Group on Climate Change (IIGCC). This fulfilled our commitment to publish interim 2030 targets as a member of the Net Zero Asset Manager Initiative (NZAMI). During 2022, we also expanded the focus of this group to also consider the impacts of deforestation and biodiversity loss on climate change.



**Steering Committee.** The Steering Committee oversees the work of the Climate and Nature Working Group (CNWG). The purpose of the group is to provide regular oversight of progress towards our targets and to act as an escalation forum to deal with any challenges in meeting these targets. This ensures effective co-ordination on climate- and nature-related work across the business. The Committee meet after each CNWG meeting and includes the Head of Responsibility, Head of Investment, Head of Policy & Integration, Chief Regulatory Officer & Head of Government Affairs and Managing Director, Private Markets.

**Real Estate ESG oversight.** The real estate team has working groups for ESG and Net Zero which include representatives from various areas of the business including developments, investment management and fund management. These open forums ensure best practice, innovation, and challenges to be discussed to enable improvements to be made in an inclusive and transparent manner. External experts are also included in these forums and as advisors as appropriate to ensure project decisions are made with the help of investment managers, delivery counterparts and the real estate ESG team.

**Infrastructure oversight.** The Head of Infrastructure and Infrastructure Investment Committee (IIC) are ultimately accountable for all sustainability matters related to infrastructure.

**Private Equity oversight.** In the private equity team, the Private Equity Investment Committee (IC) is responsible for all investment risks, including climate change risk. The Portfolio Review Committee, which is a subcommittee of the IC, assesses portfolio-level ESG risks including climate change risks quarterly to inform GP engagement. These Committees are ultimately accountable for all sustainability matters related to private equity investments.

In addition to the governance structures outlined above, the following key business functions are particularly involved in delivering our climate and nature approach:

**Responsibility Office.** Our Head of Policy & Integration chairs the Climate and Nature Working Group (CNWG) and is the climate change and nature coordinator for FHL, leading on implementation and delivery of our respective climate change and nature strategies, and reporting progress to the FHL Board, the RWG and the Governance Committee. Our ESG integration team supports investment teams across the business by coordinating access to tools and data relating to climate change and wider ESG risks including nature-related risks and provide a link through to EOS our stewardship team in public markets. Our Policy and Advocacy team engages with regulators and policymakers to advocate for an enabling environment that supports and incentivises the achievement of the goals of the Paris Agreement and the Global Biodiversity Framework.

Portfolio Managers and Investment Analysts. Each of our investment teams across all asset classes is responsible for integrating climate change and nature considerations into their investment decisions. Each team undertakes their own fundamental ESG research, including assessing climate and nature risks and opportunities, and is accountable through the performance appraisal system for their part in delivering the FHL mission to generate wealth sustainably. Their work is supported by both the Responsibility Office and EOS.

**Stewardship Team.** Our stewardship team for public markets, EOS, boasts one of the largest stewardship resources of its kind in the world, representing approximately £1.1tn of assets under advice (AUA as at 31 December 2022) and engaging with 575 companies in 2022. EOS also has a Client Advisory Board (CAB) which contains client representatives who provide insight, advice and guidance on EOS' business strategy and service offering to ensure that the EOS service is and remains a client-focused offering. The team is composed of individuals with a diverse mix of backgrounds, skills and perspectives and has been at the forefront of the development and evolution of responsible investment practices globally. The EOS team leads our public-markets engagement activity.

**Risk.** Throughout 2022, the Risk team has continued to integrate ESG risks within the existing risk management framework, including the risk taxonomy, risk policies and in setting risk appetite. The Risk team provides independent oversight and challenge to our approach to corporate sustainability and responsible business management – and provides regular reports to the Risk, Compliance and Financial Crime Committee on ESG risk issues. The team also works closely with the Responsibility Office to oversee work to ensure that our business continues to authentically and accurately, report on our ESG objectives and activities via a documented delineation of climate risk-related responsibilities for both first and second lines of defence.



## Strategy



# Describing climate – and nature – related risks and opportunities

FHL recognises that climate change and nature loss present serious risks to the world at large and to our business – both as a corporate entity and as an investment manager – and that action is needed by governments, companies and investors to mitigate these risks. Our assessment of and response to the risks posed by climate change and nature spans our asset and portfolio level analysis; our corporate and public policy engagement activities; and our operational risk management.

As a corporate entity, we rely on the services of a range of suppliers including information and communication technology (ICT) and data providers as well as the utility services that power our offices and, all importantly following the introduction of hybrid working, our homes. These are all potentially exposed to acute physical climate – and nature – related risks.

As an investment manager, understanding and responding to the range of potential risks and opportunities and generating performance for clients is fundamental for our business and so has been the major focus of our efforts to date. We understand these climate and nature risks, both physical and transition, do not exist in isolation. They interact with other changes happening at the same time, such as technological innovation; changing consumer behaviour and demand; and the effect of local regulation versus geopolitical dynamics on infrastructure and supply chains.

As a result, our assessments do not sit in a standalone box, they are part of our fundamental view of sustainable wealth creation. As part of our integration of E, S and G issues into our investment processes and our wider business strategy, we assess and model future climate change and wider sustainability policy and regulatory changes and their impact on our investment strategies. This is based on our internal expert knowledge and insights from third party studies and data providers. More information is available under the Risk Management section of this report. As part of our integration of E, S and G issues into our investment processes and our wider business strategy, we assess and model future climate change and wider sustainability policy and regulatory changes and their impact on our investment strategies.

#### **Climate-related risks and opportunities**

As part of this process, we assess the transition (including regulatory) and physical risks from climate change across all our investment products through qualitative analysis of market and regulatory framework and future trends.

Transition risks are assessed on a qualitative and quantitative basis using a pragmatic approach that acknowledges that there are issues with the amount and quality of data that is available.

In terms of how we use data, we assess climate risks based on how they will affect us in the short (0-2 years), medium (2-5 years) and long term (5 years and beyond), as set out in the table (Figure 2). Acute locational physical risk is an everpresent consideration. Beyond this in the near term, legal and regulatory change are the biggest risks. As time goes on and new markets and technology opportunities continue to open up, the risk of stranded assets increases. Acute and also chronic physical risks are also highly likely to increase – and affect all asset classes, as well as our own operations.

Transition risks are assessed on a qualitative and quantitative basis using a pragmatic approach that acknowledges that there are issues with the amount and quality of data that is available.

Timeframe	Climate risk definition	Description of material climate-related issues		
Short term	Risks that could cause impacts in 0-2 years from now, notably but not exclusively legal and regulatory risks and acute short-term physical risks.	Legal and regulatory change affecting licence to operate, supply chains or management practices in certain highly exposed sectors (e.g., fossil fuel extractive industries) or geographies (e.g., EU).		
		Extreme weather events, including flood, drought, heat waves and storms that cause business and labour market disruption and mass migration.		
Medium term	Risks that could cause impacts in 2-5 years from now, notably continued legal and regulatory but also technology and consumer demand-based market transformation risks and acute short-term physical risks.	In addition to the above the following are a consideration: Legal and regulatory change affecting licence to operate, supply chains o management practices in certain sectors or geographies.		
		Technology and consumer demand-based market transformation risks and opportunities, obsolescence of certain products and services affecting certain sectors.		
		Increased risk of stranded assets.		
		Extreme weather events, including flood, drought and storms that cause business and labour market disruption and mass migration.		
Long term	Risks that could cause impacts in 5 years and beyond; includes legal and regulatory risks, technology and consumer-led market transformation risks and increasingly extreme weather events (acute risk) but also rising sea levels, rising sea-levels and associated floods, shifts in regional weather-related events (chronic risk).	In addition to the above the following are a consideration: Obsolescence and stranded assets across a range of assets, sectors and geographies due to regulatory changes and/or market transformation.		
		Increasingly frequent extreme weather events impacting specific geographical locations and supply chain disruption affecting large number of sectors and regions.		
		Impact to infrastructure and real assets, ranging from business discontinuity costs, refurbishments and rebuilding costs to obsolescence and destruction.		
		Impact to insurance premiums or ability to insure assets in certain locations faced with chronic risk.		

#### Figure 2: How we think about climate-related risks across different timeframes

This analysis highlights the significant legal and regulatory risks we need to consider as investors in the short term. Chiefly, this relates to regulatory changes and legislation that may affect an asset's licence to operate, supply chains and/or management practices in certain sectors that are highly exposed or geographies in which climate policy is tightening faster than in other jurisdictions (e.g., the European versus Asian markets).

In the medium term, there are also considerable risks associated with market transformation, which will occur as new opportunities emerge during the transition to a resilient and net zero carbon economy requiring a significant amount of capital to be reallocated towards new growth markets. There are also clear risks associated with the fact that companies will face higher operating costs from carbon pricing or taxes, or the costs of implementing new regulatory standards.

Also in the medium term, companies may increasingly have to pay higher insurance premiums or struggle to insure assets in certain locations at risk. Changes in market demand mean some products and services in certain sectors may become obsolete and, as the pressure to do so becomes unstoppable, some companies may even be regulated out of existence as they lose their social licence to operate.

In the long term, as extreme climatic events become more frequent, they may also cause assets to become stranded across a whole range of industries, assets and geographies. Extreme weather events could affect defined geographical locations or, in some cases, whole regions, and significantly disrupt the supply chains of a large number of sectors in the economy.

Our investment and stewardship teams look at these issues in detail as the implications of climate change for investor decisions will differ industry by industry. The automotive and power sectors, for example, both have significant value at risk from the transition to a more sustainable economy, but also significant opportunities – from electric vehicles and renewable energy, respectively. By contrast, the oil and gas sector will be one of the hardest hit, with little upside. Even if an oil company can achieve an economic return, it might reach a point where this is not in beneficiaries' interests to own its shares if the emissions from the production and use of its products continues to accelerate climate change as this creates a growing pressure on policymakers to ultimately regulate the industry out of existence.

Increasingly, we are seeing many companies providing or transitioning into providing solutions to the climate challenges we are facing. One such example is STMicroelectronics (ST), who produces analogue semiconductors for the global market. ST'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 in a single EV

sedan is approx. 690kg  $CO_2e$  over its nearest alternative. 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.

We also recognise the relevance of physical risks to our own operations and those of our suppliers, which we discuss further under the Risk Management section.

# Nature-related impacts, dependencies, risks and opportunities

Companies' relationship with nature can be characterised by impacts and dependencies. Our engagement with companies seeks to understand the ways in which biodiversity and ecosystem services are relevant to companies, be this through their sourcing practices and supply chains, through their products and services, in the construction of new sites on land, especially if this is an ecologically important habitat, or through the way their operations interact with surrounding ecosystems.

#### Figure 3. Key impacts and dependencies on biodiversity and ecosystem services across sectors

Sector	Key impacts and dependencies on biodiversity and ecosystem services		
Consumer goods and retail (including food, beverages, tobacco, household products, cosmetics and fashion)	High dependence on ecosystem services such as pollination, soil quality and water flow to maintain a reliable supply of agricultural products and other nature-based inputs		
<i>,</i>	High impact on biodiversity through significant land footprint, greenhouse gas emissions and the overall business model (including sourcing activities and agricultural practices)		
Utilities	Operational dependence on ecosystem services such as water quality and flow, climate regulation and others		
	High impact on biodiversity through significant greenhouse gas emissions and contributions to climate change, pollution of air, soil and water, land use (including potentially higher land use requirements for renewables), and disturbances to species		
Mining & materials	Operational dependence on ecosystem services such as water quality and flow, climate regulation and others		
	High operational impact on land and ecosystems, significant greenhouse gas emissions and contributions to climate change, pollution of air, soil and water (including one-off events such as tailings dam collapses), and disturbances to species		
Oil & gas	Operational dependence on ecosystem services such as water quality and flow, climate regulation and others		
	High operational impact on land and ecosystems, significant greenhouse gas emissions and contributions to climate change, pollution of air, soil and water (including through high-risk events such as oil spills), land use (including operations in fragile ecosystems) and disturbances to species		
Agrochemicals and pharmaceuticals	Dependencies on genetic materials, water quality and flow, climate regulation and others		
	High direct impact on biodiversity and ecosystem services through pollution of soil, air and water, and greenhouse gas emissions and contributions to climate change		
Real estate and construction	Dependence on ecosystem services such as raw material input (e.g., timber), water quality and flow, protection from floods and storms, and others		
	High impacts on biodiversity and ecosystem services through significant land use, greenhouse gas emissions, and pollution of air, soil and water		
Financial services	High potential impact on unsustainable land use and the loss of biodiversity through financing of, and investment in, all other sectors		

Source: ENCORE tool, Natural Capital Finance Initiative



Companies with impacts and dependencies on biodiversity are exposed to numerous physical and transition risks across the short, medium and long-term.

These include operational risks, which can become acute and occur when companies face direct challenges in sourcing raw materials due to disruptions to ecosystem services. For example, farmers may be unable to supply raw ingredients due to a lack of water availability or unhealthy soils. Physical climate change may exacerbate these risks.

Companies may fail to take account of changing consumer preferences and miss opportunities by not effectively taking nature into account in their decision making. For instance, food and beverage companies may not respond to the growing consumer demand for healthy, plant-based or organic foods. In more extreme cases, companies may face reputational risks and lose their social licence to operate if they are found to be responsible for having negative impacts on biodiversity. These risks have become material for some companies linked to deforestation in the Amazon, for example.

Another short to medium-term risk on the horizon is the regulatory and litigation risk that companies may face relating to biodiversity. This is likely to continue to increase in line with the increasing regulatory focus on nature-related issues. The UK Environment Act introduced mandatory due diligence for companies to ensure that commodities have been sourced without links to illegal deforestation, whilst in the EU equivalent regulation covers both legal and illegal deforestation. Mandatory disclosures are also on the increase, for example in France where large companies and financial institutions are required to disclose their biodiversity risks and impacts.

There are, however, investment opportunities for companies to tackle and provide solutions to biodiversity loss and in developing products to meet consumer demand for sustainable products. For example, companies meeting the market demand for healthy, organic or sustainable products or sustainable protein products. These companies may gain market share and have reputational benefits due to their management of their natural capital/biodiversity risks. Companies that better manage nature-related risks and identify opportunities could be most successful in the long-term.

#### The impact of climate- and nature-related risks and opportunities on our business, strategy, and financial planning

Board and Senior Management Team (SMT) members are aware of and are engaged with the growing importance of climate change and nature loss to our business, strategy, and financial planning. As a business we understand that, unchecked, climate change and nature loss represent systemic risks to financial markets, the global economy, and our ability to create sustainable wealth for our clients and their investors. Of particular concern to us is the fact that even if transition risk is managed within our portfolios of investments, unmanaged physical risk could still destroy value through business operation or supply chain interruption caused by factors outside the control of our investee companies.

# The impact of climate-related risks and opportunities

For this reason, we understand we must look at first and second order effects of climate change risk. We take the view that it is our fiduciary duty to contribute to the conditions in which global efforts to limit warming to 1.5°C are successful and in which public and private investment to create resilient infrastructure and societies is delivered. Another driving factor is our policy and regulatory environment. In particular, FHL is headquartered in the UK where the government has made a legally binding net zero commitment and has committed to have the world's first net zero financial centre. For these reasons, we made our own net zero commitment as part of the Net Zero Asset Managers initiative in 2021.

In thinking about our business risks, as a corporate entity, these notably relate to investment performance, changing client expectations, business reputation and operational risks.

In terms of physical risk, we have mitigation and emergency action plans for our real estate assets, in addition to our own buildings to ensure business continuity, and our key suppliers.

As investors, on a day-to-day basis the management of climate risk and opportunities that arise from the transition to a resilient and net zero economy is led by our investment, engagement and advocacy teams with this work supported and coordinated by the Responsibility Office and the CNWG. As described further under the Risk Management section, all of our investment strategies incorporate consideration of climate-related risks and opportunities.

Within our <u>Climate Action Plan</u>, published in November 2022, we set out our engagement driven approach to driving decarbonisation in the real economy by way of our interim targets within our net zero commitment.





Source: FHL, Climate Action Plan, November 2022.

More detail on our plans for supporting the transition to a low-carbon economy are available in our <u>Climate Action Plan</u>.

# The impact of nature-related risks and opportunities

We have identified nature-related opportunities in our product development. As such, 2022 saw the launch of our Biodiversity Equity Fund. The team at FHL has extensively researched the major regional and global threats to biodiversity and has defined six themes for the Fund: land pollution, marine pollution and exploitation, unsustainable living, climate change, unsustainable farming, and deforestation. These themes help to identify businesses which help mitigate the loss of, or provide solutions to, the specific biodiversity risks to which they are related. Each of these themes has multiple sub-verticals that are aligned to specific UN SDGs. The two themes which, as of Q4 2022, make up the greatest proportion of our investments are those tackling deforestation and unsustainable farming.

In addition, FHL is collaborating with Finance Earth, the UK's leading environmental impact investment advisory firm, on the development of the UK's first fully diversified UK Nature Impact Fund. This private markets-based, blended finance strategy has received seed investment from the Department for Environment, Food and Rural Affairs (Defra) and is designed to help address the climate and biodiversity crises in the UK.

We are continuing to work on ways in which we can incorporate nature-related risks into our business.

# Assessing the resilience of our strategy under different scenarios

The most material climate and nature-related risks and opportunities to our business are related to our investments. This is therefore the focus of our scenario analysis. To date, we have undertaken scenario analysis for our public equity and credit, and infrastructure investments. We hope to in the future also include our real estate, real estate debt, private equity and direct lending investments. In partnership with a third party, Planetrics, we have been exploring scenario analysis across some of our investments. The tool allows us to assess transition and physical risks and opportunities related to climate change across different regions and sectors. Forward-looking data, such as that from scenario analysis, is becoming increasingly important to integrate into our investment decisions. The below analysis outlines the expected impact of different climate scenarios on our investments, split by asset classes. We will continue exploring options on building climate resilience in our portfolios as we develop better tools to help us understand impacts and dependencies.

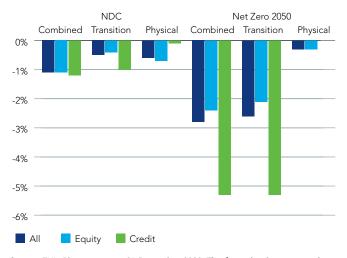
#### Public equity and credit

We have assessed our public market strategies using the following two Network for Greening the Financial System (NGFS) scenarios. It is worth noting that the scenarios forecast outcomes until 2050 hence some of the more severe physical risk impacts are not evident in the below analysis as these are set to occur post 2050.

- Impacts based on achieving 1.5°C alignment This scenario limits global warming to 1.4 degrees through stringent climate policies and innovation, reaching global net zero CO<sub>2</sub> emissions around 2050. Some jurisdictions such as the US, EU and Japan reach net zero for all GHGs. This assumes an orderly transition.
- Impacts based on the current Nationally Determined Contributions (NDCs) – This scenario includes all pledged policies even if not yet implemented. This assumes a hot house world scenario, in which global efforts are insufficient to halt significant global warming.

Figure 5 below shows the change in net present value (NPV) using two different scenarios for our public equity and credit funds. However, it currently does not contain valuation risk that accounts for any climate targets set by investee companies. Through this analysis, we have identified names that have the largest valuation risk, and we find that Hero Motocorp is our top detractor in our equity funds, with the negative change in NPV being driven by demand destruction. Occidental Petroleum is our top detractor in our credit funds, with the negative change in NPV being driven by demand destruction. Both names have set climate targets however, not enough to reduce the transition risk and in the case of Occidental, the demand destruction is driven by lack of diversity in their business activity. We will continue to engage on our high risk names to ensure they set appropriate targets.



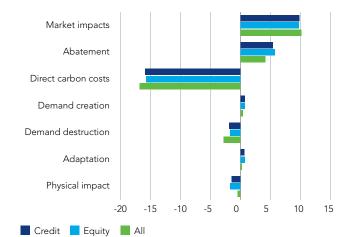


Source: FHL, Planetrics, as at 31 December 2022. This figure has been created by Federated Hermes Limited ("FHL") drawing on selected data provided by Planetrics, a McKinsey & Company solution (which does not include investment advice). This figure represents FHL's own selection of applicable scenarios selection and/or and its own portfolio data. FHL is solely responsible for, and this figure represents, such scenario selection, all assumptions underlying such selection, and all resulting findings, and conclusions and decisions. McKinsey & Company is not an investment advice. Figure 6 below further breaks down the change in NPV by different impact channels. These impact channels can be split into four categories which are:

- Physical impacts (physical impacts and adaptation)
- Changes in revenues (demand destruction and creation)
- Changes in costs (direct carbon costs and abatement)
- Market impacts (competition and cost pass through)

The main driver of valuation risk is direct carbon cost for both public equity and credit, responsible for a valuation impact of 16% in a  $1.5^{\circ}$ C scenario.



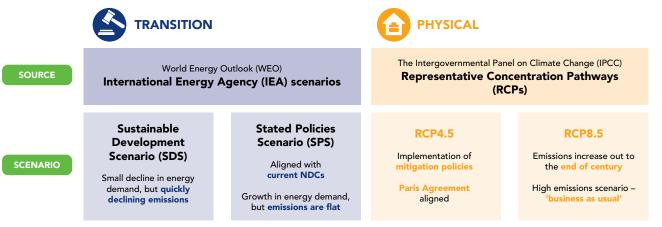


Source: FHL, Planetrics, as at 31 December 2022. This figure has been created by Federated Hermes Limited ("FHL") drawing on selected data provided by Planetrics, a McKinsey & Company solution (which does not include investment advice). This figure represents FHL's own selection of applicable scenarios selection and/or and its own portfolio data. FHL is solely responsible for, and this figure represents, such scenario selection, all assumptions underlying such selection, and all resulting findings, and conclusions and decisions. McKinsey & Company is not an investment adviser and has not provided any investment advice.

#### Infrastructure

With support from a leading consultancy, Environmental Resources Management ("ERM"), our infrastructure team undertook 5 months of deep dive work in 2021 focused on scenario analysis for individual assets and risk management. Using two physical and two transition scenarios, the team initially created a portfolio risk heat map, which informed further analysis and stewardship priorities for individual companies where material potential risk was identified. All analysis was undertaken in collaboration with the investee companies using actual operational and financial data.

#### Figure 7. Infrastructure scenario analysis



Source: Environmental Resources Management, FHL

As anticipated, transition risks are more prevalent and quantifiable in the short term, in particular carbon pricing and revenue exposure to highly carbon intensive industries. The most prominent physical risks being increased storms and fluvial flooding in the medium term and increases in heat in the longer term. Several material transition opportunities were also identified, including increased demand for sustainable products and services, e.g., green transport and potential participation in a future market for negative emissions.

Using the outputs of the deep dive analysis, the team have reviewed their stewardship approach with the relevant businesses to date and set priority focus areas and objectives. The team expect to continue to update their climate stewardship objectives annually, as risks and mitigation evolve over the duration of the holding periods, including refreshing the scenario analysis periodically to reflect the most up to date net zero scenarios.

Despite this research being undertaken in 2021, the exercise was in-depth and the portfolio attribution remains similar therefore we deem these results to be broadly representative of current holdings.



## Risk management

Our assessment of, and response to, the systemic risk of climate change spans our top-down investment risk and asset-level analysis, our engagement activities and our operational and strategic risk management.

In this section we describe how we identify, assess, monitor and manage climate-related risks, and how this is integrated into our overall risk management processes.

We integrate consideration of climate-related risks across all of our investment strategies. Through our advocacy and engagement work we seek to play our part in mitigating climate risk at both a systemic and asset level.

We aim to understand both a company's contribution to climate change and its exposure to related risks and opportunities, which should allow us to play a positive role in encouraging firms to generate lower emissions and reduce the risks arising from climate change.

#### Through our advocacy and engagement work we seek to play our part in mitigating climate risk at both a systemic and asset level.

In this section we also describe how we are developing our approach to identifying, assessing, monitoring and managing nature-related risks. We are enhancing our approach to assessing the impacts and dependencies of our investments on nature and associated risks and opportunities. Our advocacy and engagement activities already incorporate nature-related issues, including biodiversity loss and land use change.

Our integrated approach to managing climate and nature risk and opportunities is based on our belief that we can create positive feedback loops between investment and stewardship. This should help reduce climate - and naturerelated risks and maximise the opportunities for the companies and assets in which we invest.

#### Investment risk management

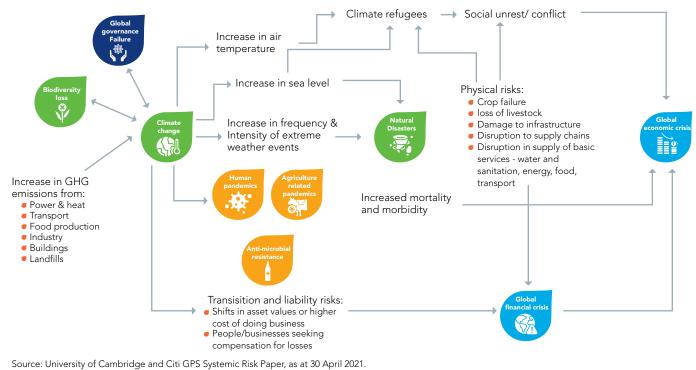
#### **Awareness**

We continue to monitor the evolving landscape of climaterelated risks and opportunities. Keeping teams abreast of developments is an ongoing task. It is achieved through internal information sharing, discussion and debate across and between teams but also through more formal initiatives such as our Sustainability Investment Centre (SIC). The SIC supports the development of our firm's responsible investment capabilities. It facilitates monthly conversations between teams across the business to pool the best ideas in the sustainable space and supports our focus on longterm sustainable wealth creation.

The ESG Integration team within the Responsibility Office also works closely with the investment teams to help identify material ESG issues, including relating to climate and nature, that are specific to the investment manager's strategy. The ESG Integration team organises sector-level knowledge-share sessions between EOS and the investment teams and also works with the investment teams to develop frameworks which assess the materiality of ESG risks at the company level. Finally, the ESG Integration team obtains data from third-party providers, which is overlaid in our proprietary tools by insights gleaned from our engagement with the company and is also used by analysts and engagers in their company research and portfolio analysis.

#### **Risk Identification**

The systemic nature of the risks posed by climate change and nature loss require a tailored approach to risk identification and mitigation. To truly address such a systemic risk, collective and coordinated action will be required to provide systemic solutions. Asset managers, working in conjunction with other stakeholders, must join forces to mitigate these systemic risks and to ensure a well- functioning financial system. We seek to take an integrated systems-based approach and prioritise and respond to the risks that are most likely, impactful and interconnected in nature. The key systemic risks we take into consideration across our investment risk, engagement and advocacy work are informed by the latest academic research from the World Economic Forum Global Risks Report and the Centre for Risk Studies at Cambridge University.<sup>18</sup> The figure below illustrates the interconnectedness of climate change action, one of our top engagement and advocacy theme, with a range of other issues.



#### Figure 8. Cambridge University diagram of the cascading effects between systemic risks

This systems-based approach informs all three elements of our strategy – ESG-integrated investments, engagement and advocacy. Part of our horizon scanning exercise in 2022 included a review of recent academic reports to ascertain the key systemic risks to take into consideration across our engagement work.

The Investment Office is responsible for the daily oversight of market risk across FHL, as well as the oversight of the underlying portfolio managers' adherence to their predefined/client-agreed investment processes.

The Risk team has also been highly effective in providing a second line of risk management as new issues emerge.

#### **Risk prioritisation**

Taking an active approach is a central part of our investment proposition. We consider all material investment factors, including those relating to material ESG issues such as climate change.

While the most pressing material risks are those that will crystallise in the short term, we are long-term investors that strive to deliver sustainable wealth creation for our end investors. This means that our definition of materiality is necessarily wider. We believe that a wider range of risks will ultimately become material over a longer timeframe and that we need to engage proactively to mitigate them.

#### **Climate-related risks**

Climate change is one of the key medium to long-term risks that we factor into our investment analysis and engagements, and we also recognise that it poses risks over shorter timelines. Across our assets, both in the public and private space, we pledge to engage with the most material emitters that are misaligned or exposed to significant transition risk, to help them reach the 1.5°C target.

Given our net zero commitment, we will be monitoring the progress at fund level towards increasing the proportion of Paris-aligned investments through engagement to understand implications for our firm level targets. The information we gather through stewardship enables us to develop a more comprehensive view of both the climate risk and opportunities a company is exposed to and to factor this into valuations and investment decisions. Such assessments are not a one-off but rather form an ongoing feedback loop.

#### **Nature-related risks**

During 2022, nature-related issues were increasingly a priority in our engagement and advocacy activities. In our investment activities, all of our investment strategies integrate consideration of material E, S and G issues. We have also started to explore impacts and dependencies on biodiversity with the investment teams primarily using the ENCORE tool, which provides information on how the different GICS (Global Industry Classification Standard) subindustries both impact and depend on nature. In 2022, building on our climate approach, we developed a detailed approach to assessing and mitigating deforestation risk in recognition that deforestation and land use change is a key driver of climate change and biodiversity loss. We published our Policy Statement on Deforestation in December 2022, which sets out how we assess our deforestation risk across asset classes and how we will prioritise engagement with our investees. For example, our real estate team have identified that the most material forest-risk commodity exposure in this asset class is to pulp & paper and timber as it is widely used in construction and fixtures/fittings. Our real estate developments and major refurbishment projects are at the highest risk of exposure to deforestation due to the amount of timber sources. This assessment has informed our deforestation policy for real estate, which includes a commitment that by 2023, for all new projects tendered we will mandate that all timber and wood products used for structural work and fittings in our new developments and major refurbishments must only come from legal and sustainable sources, which must be verified by certification.

During 2023 and 2024, we will continue to enhance our approach to other nature-related issues, with a focus on biodiversity in line with our commitments as a signatory of the Finance for Biodiversity pledge.



#### All our investment activity is supported by our dedicated Investment Office and Responsibility Office, both of which report directly to our CEO.

Monitoring this information informs our engagements, while engagement insights inform our investment decisions. Our fundamental research benefits from our ongoing dialogue with investees, as well as that between our public-markets investment teams and stewardship arm. We invest time and resources to encourage companies to strengthen their governance of climate change related issues, give our views on strategy to implement business models that are aligned with the Paris agreement and encourage companies to take a long-term view on identifying and mitigating transition risk. The insights we glean from these interactions help us to better understand a company's complex strategic challenges – something that ultimately helps us serve our clients.

All our investment activity is supported by our dedicated Investment Office and Responsibility Office, both of which report directly to our CEO. Regular meetings are held between the two offices and with the investment teams to ensure proper coordination and integration of ESG factors and engagement insights. However, it is the responsibility of our investment teams to effectively integrate ESG and engagement information into their investment processes and ultimately our fund managers have discretion on investment decisions. This ensures that ESG factors including climate considerations are fully integrated into investment analysis and decision making.

#### **Public markets – Integration**

Our experience suggests that a systematic engagement approach, combined with tried and tested methods of escalation such as collaboration or shareholder meeting interventions, is needed to accelerate change at companies, such as those failing to prepare for the low-carbon transition. Driving change through engagement is one side of the coin – effective integration of stewardship insights into investment decisions is the other.

All of our strategies at FHL integrate climate considerations and engagement insights into their investment processes and decision making. We believe in developing processes that are relevant to the investment strategy, and therefore, the method of this integration can vary by investment team. Climaterelated data and engagement insights can be a component of a screen, a source of ideas, an input into fundamental analysis or an adjustment to valuation drivers and/or a portfolio construction factor.

To support all our investment teams, we continue to add tools and datasets and participate in research to better understand and continue to refine our process of integrating climate risk management into every stage of the investment process from inception of new strategies through to day-to-day portfolio management. Integration is facilitated by a range of tools (proprietary and third party) and information, including from our own engagement activities.

The primary means through which we monitor and measure the climate-change exposure of our investment portfolios is through our proprietary Carbon Tool, which measures a fund's carbon footprint relative to its benchmark and calculates its carbon efficiency/intensity. As well as providing a carbon heatmap, the tool enables portfolio managers to stress-test the resilience of our portfolios to a range of carbon prices, identify whether highemitting companies in the portfolio are being engaged with or whether engagement needs to be initiated, and understand the progress on any climate or wider environmental engagements already underway.

The information also helps increase our investment team's awareness of carbon-related risks, which can lead to updated valuations and potentially change investment decisions.



Figure 9: Carbon footprint – portfolio dashboard

Source: FHL, as at 30 June 2023. For illustrative purposes only.

Launched in 2021, our Environmental Tool assesses both portfolios and companies on their carbon, water and waste performance. It also looks to quantify the environmental cost of the impact via the following six lenses; carbon, water, waste, air pollutants, land/ water pollutants and natural resource use. In addition, we have incorporated the temperature alignment of portfolios and companies alongside exposures to carbon intensive sectors; namely fossil fuels, mining and thermal coal.

We are also expanding our analysis in the next year to look at our exposure to deforestation risk and the impact of our investments on biodiversity.



Source: FHL, as at 30 June 2023. For illustrative purposes only.

Through these tools, along with additional EOS engagement information, the public equities and fixed income teams have access to third-party ESG data, as well as insights on engagement carried out by EOS with investee companies and the broader investable universe. These sources are a valuable input to the investment process, as well as to the ongoing monitoring of and engagement with companies. We also use other external tools, including Planetrics which allows us to explore transition and physical risk across various scenarios. We are also expanding our analysis in the next year to look at our exposure to deforestation risk and the impact of our investments on biodiversity.

Beyond the tools that have been made available to all of the investment teams systematically at the firm level, our investment teams are responsible for conducting the appropriate due diligence when they have identified material ESG risks, this includes any climate- and nature-related risks. The due diligence includes sourcing relevant data including through communication with the investee company.



Figure 10: Environmental Tool – Portfolio dashboards

To further enhance and provide support to the investment teams, the Responsibility Office meets with each of the investment teams, on a quarterly basis, on various sustainability topics including an analysis on the portfolio's exposure and understanding the progress on mitigating these risks and/or how they have been integrated into the investment process and decision-making. To date, we have had conversations with the teams on their carbon exposure as well as the transition targets and progress of their investee companies. Over the last year, we have started to explore with the investment team's exposure to commodity-driven deforestation, focusing on palm oil, soy, cattle products and timber, pulp and paper. This has been primarily through Forest 500, SPOTT, Trase Finance and looking at sectors at risk defined by Global Canopy. We have also started to explore impacts and dependencies on biodiversity with the investment teams primarily using the ENCORE dataset, which provides information on how the different GICS sub-industries both impact and depend on nature. Over the course of 2023, we hope to deepen this work. These are also important lenses through which we identify companies for engagement.

We believe that sustainability-aware investors should not rely on quantitative ESG data alone. The information provided by companies may not be comparable with peers. In addition, it is often backward looking, updated infrequently and with a time lag. As such, engagement activities and voting information can be used by our teams to provide a forward-looking view of a company's performance on climate and nature issues. As well as accessing EOS' engagement portal – which includes the engagement history and progress against live objectives - and discussing specific companies with the relevant engager, portfolio managers can, and are encouraged to, attend engagement meetings with the engagers. The benefit of these joint meetings is substantial and results in more robust engagement that focuses on the relevant and material E, S and G risks and opportunities. Our investment teams also regularly discuss salient sustainability issues with company management directly.

Our Responsibility Office is tasked with monitoring and overseeing every investment team's integration approach. To that end, the Responsibility Office meets with every investment team on a quarterly basis to review the portfolio holdings from a sustainability point of view and flag, if necessary, particular holdings which our third-party ESG data vendors might have highlighted as controversial. As such, the Responsibility Office and the investment teams regularly use our proprietary sustainability and stewardship tools to review the sustainability performance and engagement coverage of our holdings.



Whilst many of the tools and data providers we use are shared across our public market strategies, some of our strategies layer additional approaches on top of this:

- Biodiversity Equity Strategy: The strategy aims to achieve long-term capital appreciation by investing in a concentrated portfolio of companies that are best in class and are providing solutions to avert loss of and support restoration of biodiversity. The team have extensively researched the major regional and global threats to biodiversity and have defined six investable themes: land pollution, marine pollution and exploitation, unsustainable living, climate change, unsustainable farming, and deforestation. Each of these themes has multiple subverticals that are aligned to specific UN Sustainable Development Goals (SDGs).
- Impact Opportunities Equity Strategy: The strategy aims to generate long-term outperformance by investing in companies succeeding in their core purpose: to generate value by creating a positive and sustainable impact that addresses the underserved needs of society and the environment. It is driven by thematic research focused on megatrends and the team's nine impact themes,<sup>19</sup> as well as bottom-up fundamental analysis. Our thorough analysis of impact and financials ensure a high bar for positive impact database quantifies company impact to ensure traceability and accountability, allowing us to monitor progress and report to clients.



- Climate Change High Yield Credit Strategy: The strategy aims to outperform the global high-yield market through high-conviction investment in companies with strong fundamentals that also demonstrate the potential to decarbonise and transition to a low-carbon world. The team seek companies that have the willingness and ability to make a positive impact on the planet, whilst excluding companies involved in activities believed to be unsustainable or unethical. To determine a company's progress towards decarbonisation and the materiality of its impact, the team begin by analysing an aggregate of historical climate change data and scores. They then supplement the forward-looking perspectives of our credit analysts and engagers, including engagement insights. This enables them to assess each company's climate-related risks and its progress towards decarbonisation and potential impact. Designed by the Sustainable Fixed Income team, our bespoke framework - the Climate Change Impact (CCI) Score – conveys a company's willingness to decarbonise, the potential to reduce its carbon footprint and the materiality of that decarbonisation path. These scores are key to issuer selection and sizing within the strategy. Dedicated engagers in the Fixed Income team, supported by EOS, seek positive action on climate change. The strategy will not hold a company's credit where engagement on climate change transition has failed.
- SDG Engagement Equity Fund and SDG Engagement Credit Fund: Our SDG Engagement Equity strategy and SDG Engagement High Yield Credit strategy seek to achieve a meaningful social and/or environmental impact as well as a compelling return through investing in and engaging with companies to drive positive change in line with relevant SDGs. The SDGs provide an ideal framework to identify ex-ante potential for creating positive societal and environmental change through engagement to create more impactful and sustainably profitable companies. Given the added focus on engagement for these strategies, we have dedicated engagers based in the relevant investment teams who focus solely on these strategies and work closely with EOS to ensure a consistent approach. All investments are formally reviewed by the lead manager and lead engager, while the relevant analysts and team members also provide input every six months. These meetings investigate whether the original engagement thesis is still valid and also measure progress towards any specific objectives.
- Nature-based Solutions (NbS): FHL is collaborating with Finance Earth, the UK's leading environmental impact investment advisory firm, on the development of the UK's first fully diversified Nature and Biodiversity Impact Investment strategy (detailed above), a private markets, blended finance strategy which will receive seed investment from the Department for Environment, Food and Rural Affairs (Defra) and which is designed to help address the climate and biodiversity crises in the UK. The strategy will seek to invest into high-integrity NbS across land, coasts, rivers and sea in the UK. It will be directly informed by the UK's leading capabilities across climate science and ecology, and will invest into both NbS real assets (nature restoration projects) and impactful businesses operating across the nature restoration value chain. It aims to produce attractive risk adjusted returns through direct investment into the recovery of nature in the UK and support key targets and objectives set out by the UK government, such as protecting 30% of UK land by 2030, unlocking infrastructure and housing developments and "levelling up" by creating skilled green jobs across rural areas and coastal communities.

#### Public markets – Engagement

Our approach to engagement is driven by our purpose and investment beliefs. We believe that the purpose of investment is to create wealth sustainably over the long term and that investing responsibly is the best way to sustain long-term outperformance and contribute to beneficial outcomes for investors, and where possible, society and the environment. We aim to generate sustainable wealth creation for the end beneficiary investors, encompassing investment returns and their social and environmental impact. As a result, our engagement is outcomes-driven and focused on ensuring that the companies we invest in are creating wealth sustainably. We are able to engage on particular issues over multiple years to encourage fundamental change within our investee companies. We believe that this approach delivers the best results for our clients and end beneficiaries. We adopt a systematic approach to identifying companies for engagement. We select companies and tailor the intensity of engagement based on the size of our investment, materiality of the risks and issues and feasibility of achieving change through engagement. As part of this process, we use our own proprietary carbon and environmental tools to systematically assess which of our holdings are exposed to material carbon and water-related risks, therefore material climate and naturerelated transition risks. This informs the selection of companies for our engagement programme.

Our public markets dialogue with investee companies is primarily conducted through in-person meetings, calls, letters or emails, either directly or as part of a collaborative group. We see value in both direct and collaborative engagement, and it is the combination of both which helps us to influence issuers and borrowers and to carry out effective stewardship. Any collaboration is done in line with applicable rules on antitrust, conflicts of interest and acting in concert. Indeed, each party will exercise unilateral decision-making principles in deciding how to act while engaging in any collaboration. More information on how we prioritise and conduct our engagements is available in our <u>Stewardship Report 2022</u>.

Engagement is a crucial element of our approach to managing both climate change and nature-related risks and opportunities.

#### **Engaging on climate change**

Climate remains as one of four engagement priority themes in EOS' public-markets engagement programme (alongside human and labour rights, human capital management, and board effectiveness and ethical culture). In 2022, we intensified engagement on aligning corporate targets to the goals of the Paris Agreement to limit climate change to 1.5°C.

Part of our horizon scanning exercise in 2022 included a review of recent academic reports to ascertain the key systemic risks to take into consideration across our engagement work. We also consider how our engagement can support companies to play their part in achieving the SDGs.

Climate change continues to be the biggest single issue of concern for long-term investors as a systemic risk, and we tailor our engagements accordingly. Our engagement remains focused on companies having a strategy and greenhouse gas reduction targets aligned with the Paris Agreement, seeking to limit climate change to 1.5°C, together with aligned financial accounts and political lobbying. Under the broader Glasgow Financial Alliance for Net Zero and our own engagement-driven targets, we have intensified our engagement with banks on ensuring that their net-zero ambitions are aligned with those of asset managers.

Over the past year we have also stepped up our engagements with companies to highlight the issue of appropriate accounting for the impacts of climate change, outlining our concerns and challenging companies through the board chair and audit chair. The aim is to challenge the disconnect



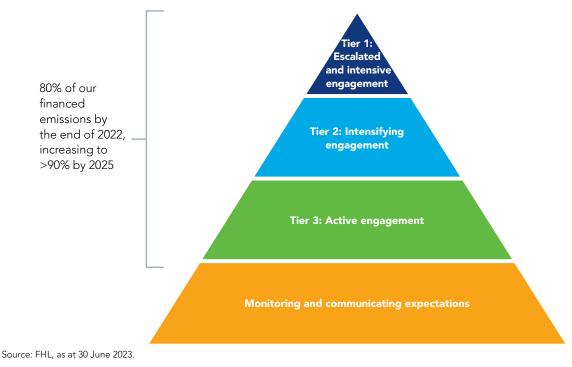
<sup>19</sup> The team's nine themes are: Energy Transition; Circular Economy; Water; Health and Wellbeing; Education; Financial Inclusions; Future Mobility; Food Security; Impact Enablers. between a company making bold net-zero pledges and the business-as-usual reporting still found in some company accounts. We seek clarity on what the critical accounting assumptions are, how climate risks are factored in, and the sensitivity analysis used for a 1.5°C pathway. In the auditors' report, we want to see details about how climate risks were examined. It is our contention that existing accounting standards allow for a greater consideration of the financial liabilities companies will incur due to climate change than has been evident to date.

For example, we have been engaging with one of the world's biggest emitters, cement company CRH, challenging it to provide more transparency. While the management team has made good commitments to reduce the company's carbon impact, and CRH aspires to reach net zero by 2050, these commitments are not yet supported by details.

Our <u>Climate Change Expectations for investee companies</u> set out very clearly our rationale for believing climate change is a material issue – and six key expectations of companies that range from setting science-based targets to having a positive public policy position on the issue and committing to disclosing in line with the TCFD. As we set out in our <u>Climate Action Plan</u>, engagement to support our interim targets will be prioritised based on the materiality of financed emissions and the degree of misalignment to the goals of the Paris Agreement. We have developed an in-house Paris Alignment methodology to assess the extent to which a company's climate change ambitions are aligned to the 1.5°C goal of the Paris Agreement. The methodology primarily assesses alignment of a company's GHG targets and associated emissions trajectory to a 1.5°C-aligned decarbonisation pathway, applicable to the relevant sector and geography where possible. Companies will be placed into different categories of alignment: Not aligned; Committed to net zero; Aligning to 1.5°C; and Unscored.

We have developed an in-house Paris Alignment methodology to assess the extent to which a company's climate change ambitions are aligned to the

 $1.5^{\circ}C$  goal of the Paris Agreement.



#### Figure 11. Structuring climate change engagement

For instance, companies that are categorised as "Not Aligned" or "Unscored" will receive the highest intensity of engagement over the next few years, with engagement focused on asking companies to commit to net zero by 2050 at the latest and set supporting interim emission reduction targets. Meanwhile, companies that are already categorised as "Aligned" will receive less intensive engagement but will be monitored to ensure that they are not underdelivering. In general, we will allow approximately up to 2-3 years for companies to move from one level to the next level, depending on specific regional or sectoral challenges. If the pace of change is slower than expected, we will consider using a range of escalation tactics, such as voting against responsible directors.

#### **Engaging on nature & biodiversity**

Material issues for engagement include regenerative agriculture, deforestation, sustainable proteins, water use, animal welfare, antimicrobial resistance, chemicals and pollution, and ocean health. The key topic for us is deforestation, as it has the most related metrics and certification schemes across the industry.

Following FHL's signing of Finance for Biodiversity Pledge in 2020, we continued to recognise biodiversity as a critical stewardship topic and pursued further engagement in 2022. EOS developed a dedicated biodiversity engagement programme to accelerate and deepen the focus on biodiversity protection and restoration. The programme includes 15 companies from the food and beverage sector from around the globe.<sup>20</sup>



The selection process for the target companies was based on multiple factors, including laggard companies on the Forest 500 or Farm Animal Investment Risk and Return (FAIRR) benchmarks, companies with low ratings on the World Benchmark Alliance Seafood Index, or those selected as having poor water-related performance as part of the Ceres Valuing Water Finance Initiative. We also looked at companies with controversies related to biodiversity, such as inappropriate antibiotic use and animal welfare concerns. More information on our biodiversity engagements is available in the <u>EOS Annual Review 2022</u>.

We engage with companies on their impacts and dependencies on biodiversity and encourage them to develop strategies to avoid and mitigate their impacts on nature, whilst aiming for an overall net-positive impact.

#### Following FHL's signing of Finance for Biodiversity Pledge in 2020, we continued to recognise biodiversity as a critical stewardship topic and pursued further engagement in 2022.

To begin the engagement, we sent a letter to each company outlining the risks of not addressing biodiversity loss. We also held individual and collaborative engagement meetings to highlight our expectations and discuss how each company could contribute to halting and reversing nature loss.

Other sectors for which biodiversity loss is material include infrastructure, banking and financial services, fast fashion, chemicals and extractives, due to their operational and supply chain impacts on biodiversity. In our engagements, we are integrating more biodiversity discussions for these sectors to progress cross-industry action on biodiversity. In 2024, where we deem nature is a material risk we will ask our investees to start reporting in line with TNFD recommendations from 2025.

#### **Tracking progress**

We track the progress and the achievement of our public market engagements using our four-stage milestone strategy.

**Milestone 1:** Our concern is raised with the company at the appropriate level

**Milestone 2:** The company acknowledges the issue as a serious investor concern, worthy of a response

**Milestone 3:** The company develops a credible strategy to achieve the objective, or stretching targets are set to address the concern

**Milestone 4:** The company implements a strategy or measures to address the concern

Our milestones are specific and measurable, which helps us identify progress towards achieving the objective. An engagement objective can take up to three years to complete, depending on factors that include the nature of the issue and how receptive the company is to engagement.

In 2022, 30% of all EOS engagements – on behalf of both third-party clients and FHL – were related to environmental topics. For FHL investments specifically this was 28%. The bar charts below show completed milestones during 2022.<sup>21</sup>

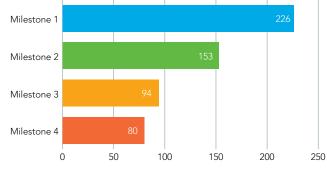
**Figure 12:** EOS Engagements on environmental topics on behalf of all clients (including FHL)

## Environmental topics comprised 30% of our engagements in 2022



Climate change 75.4%
Forestry and land use 6.8%
Pollution and waste management 12.6%
Supply chain management 2.1%
Water 3.2%

#### **Progress against environmental objectives**

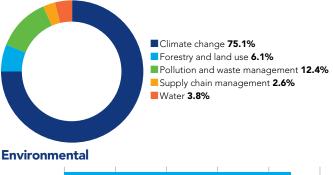


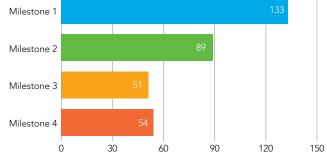
Source: FHL, as at 31 December 2022.

So, for example, 226 environmental objectives (or 133 for FHL investments only) saw Milestone 1 completed during 2022. 80 environmental objectives (or 54 for FHL investments only) were fully achieved during 2022.

Figure 13. EOS Engagements on environmental topics on behalf of FHL only  $% \mathcal{F}(\mathcal{A})$ 

# Environmental topics comprised 28% of our engagements in 2022





Source: FHL, as at 31 December 2022.





SDG Engagement High Yield Credit Strategy - EQT Corporation



EQT Corporation (EQT) engages in natural gas production and commercial sales from the Appalachian Basin, predominantly within Pennsylvania, West Virginia and Ohio, and is the largest independent natural gas producer in the United States.<sup>22</sup> EQT's shale basins benefit from an environmentally advantaged geology for natural gas extraction, providing an operational carbon and methane emissions intensity for its produced gases and liquids which is amongst the lowest of comparable natural gas peers in the US and globally, per unit of energy.<sup>23</sup>

As EQT's emissions per unit of production is among the lowest in the US, it can continue to decrease Scope 1 and 2 emissions, before offsetting or sequestering remaining emissions. Of particular importance is methane, given that this potent global-warming potential gas drives substantial CO<sub>2</sub>equivalent emissions. On setting the objective, we felt the company should set a net-zero target to be achieved within a matter of years, given its advantaged profile and history of intensity reductions. We wanted EQT to articulate, in particular, how methane management contributes to the effort.

In 2021, we were therefore pleased that EQT announced its intent to achieve operational net zero prior to 2025, with specific detail on emissions reductions efforts. This includes Scope 1 carbon intensity of below 160 MT  $CO_2e/Bcfe$  (~70% reduction vs. 2018) and Scope 1 methane intensity below 0.02% (~65% reduction vs. 2018).

EQT's 2021 remuneration policy integrated emissions intensity, safety performance and employee incident rates as ESG incentives in short-term remuneration. However, in line with net-zero aspirations and nearer-term commitments to carbon and methane emissions reductions targets, we felt it should consider expanding these to long-term incentive plans (LTIPs) alongside financial performance drivers. This allows EQT to align decarbonisation incentives with medium term emissions reductions pathways.

This objective was completed in 2022 when the company introduced an innovative emissions reduction and net zero incentive. This incentive limits the amount of carbon credits the management team can use in reaching net zero by 2025. A penalty is applied to the LTIP award result if the company purchases credits for more than 350,000 tonnes of  $CO_2$  per annum, and a positive modifier if it is able to purchase credits to offset less than 100,000 tonnes, in arriving at net zero by 2025. This should help focus management on investing in genuine, additionality-based offsetting solutions while decreasing the actual emissions intensity of operations simultaneously.

When we commenced engagement, only Scope 1 emissions had been disclosed and, as of 2019, environmental metrics were disclosed inconsistently. The new management team, in place since July 2019, set out to create an efficient, lowest-cost operational model driven by technological innovation and workforce capabilities and collaboration. It sought to reach leadership among peers on ESG disclosure and strategy. We felt EQT should use its sustainability strategy to set targets that decrease environmental impacts of operations. We wanted to see short and medium-term targets which drive meaningful improvements in environmental performance, including on water management. Moreover, the company needed to disclose material environmental impact drivers in a year-over-year fashion, including water use and emissions and energy footprints in Scope 1 and 2.

We reviewed the latest disclosures in line with a 2022 engagement. EQT delivered reporting which includes Scope 1 and 2 historic emissions, emissions reduction targets at or ahead of 2025, a net zero target to be achieved before 2025, and consistent, comparable social and environmental indicator reporting. We will engage it on climate risk scenario analyses and key assumptions within TCFD-based components, which have already evolved to a degree in recent ESG disclosures.

Future objectives will focus on execution of net zero to ensure this is delivered by 2025, and how the company may be able to commercialise future energy innovations which address the challenges of climate change, including biomethane and potential for regional hydrogen and carbon capture hubs. EQT's ambitious orientation towards responsible fuels and best-in-class operations can be influential in the US.

For listed equities, our voting and engagement are cointegrated as part of our overarching approach to stewardship. As such, our voting decisions - as well as EOS' recommendations to third-party clients on voting decisions are informed by the insights and experience of engagement with the investee company. More information on our approach to voting is available in our <u>Stewardship Report 2022</u>. EOS has had a formal climate change voting policy in place since 2019 targeting climate-change laggards. We continued to use the Transition Pathway Initiative (TPI) assessment, setting a threshold of Level 4 for all European companies, coal mining companies or oil and gas companies, or Level 3 for all other companies. We also identified several other areas where we believed a company's actions were materially misaligned with the goals of the Paris Agreement, including companies contributing to coal expansion and deforestation.

While we can be robust in our dealings with companies, the aim is to deliver value for clients, not to seek headlines which could undermine the trust that we believe should otherwise exist between a company and its owners. As a result, we generally prefer to conduct engagement privately, rather than taking a public route when seeking change at companies. In our experience, working constructively with boards and management in private is the most effective way to achieve positive change, as it allows us to build trusted relationships with companies, which results in more open and frank discussions.

However, on the occasion that we should not be able to achieve success by our usual methods of conversations behind closed doors, we may escalate our engagement by choosing to speak publicly at the company's annual general meeting (AGM) to garner additional investor support and add further pressure. When doing so, we would normally notify a company in advance. We may also vote against (or EOS may recommend voting services clients vote against) a resolution or board directors at a company's AGM - we consider this choice carefully as we only want to use this approach if our usual engagement has consistently stalled, and we are not confident that the company is taking any action to address our concerns. Similarly, we have demonstrated a willingness to use the full range of rights that we have at our disposal, including the tabling of resolutions at shareholder meetings when necessary or collaborating with others to co-file shareholder resolutions.





We collaborate with other investors in our engagement with companies when this may be beneficial for the engagement and could influence the actions and governance of investee companies. We seek collaboration where interests are aligned, and the objectives are based on material issues. Any collaboration is done in line with applicable rules on antitrust, conflicts of interest and acting in concert.

#### EOS is leading or co-leading engagement with over

#### 24 companies as part of the Climate Action 100+ Initiative

Since 2017, the collaborative engagement initiative Climate Action 100+ (CA100+) has grown to include 700 signatories representing over \$68tn in assets under management – more than 50% of the global total. Since the initiative's inception, EOS has advised on high-level governance and engagement strategy, as well as leading or supporting a significant portion of company engagement dialogues.<sup>24</sup> In 2022 we acted as lead or colead engager for 24 companies, although EOS and CA100+ paused engagement at three Russian companies after the start of the Russia-Ukraine conflict.

In October 2022, the CA100+ Net Zero Benchmark revealed the impressive progress to date with 75% of focus companies committing to achieving net-zero emissions by 2050 or sooner. Some 92% have disclosed that there is board oversight of climate change, and 91% have aligned their climate disclosures with the TCFD recommendations. Also, the electricity utility Enel became the first company to score positively on all nine currently assessed benchmark indicators.

However, companies still need to match their long-term ambitions with comprehensive 1.5°C-aligned short- and medium-term targets, and disclose credible strategies to achieve these. For example, only half of the CA100+ focus companies have net-zero targets that include material Scope 3 emissions, only half have disclosed

<sup>24</sup> Any collaboration is done in line with applicable rules on antitrust, conflicts of interest and acting in concert. Indeed, each party will exercise unilateral decisionmaking principles in deciding how to act while engaging in any collaboration. decarbonisation strategies, and just 20% have mediumterm targets that were assessed by CA100+ as aligned with 1.5°C. Also, only 23% of companies have committed to aligning their lobbying activities with the Paris Agreement, despite the importance of policy support for achieving company decarbonisation.

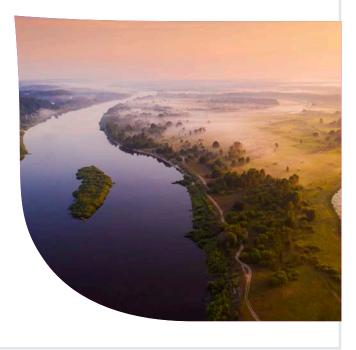
Tackling methane emissions through engagement is not a new focus for us, but we have been able to leverage the greater awareness post-COP26 to help galvanise industry efforts. EOS helped to set up a collaborative CA100+ midstream roundtable on methane attended by midstream companies and investors, alongside the Energy Infrastructure Council and the GPA Midstream Association. Investors reiterated the importance of energy transition plans with timelines and targets, aligning with the OGMP 2.0 reporting framework, and supporting methane regulations. Companies described their key initiatives to cut methane emissions. For example, Kinder Morgan said that it focused on reducing venting from pipeline repair or testing activities and leaks at compressor stations.

We believe that escalation of engagement will be increasingly important to ensure that companies make the necessary changes at the pace required. EOS have been at the forefront in using escalated engagement methods, including:

- Supporting the process by which one of our clients and others filed a shareholder resolution asking for an explanation of how its lobbying activities help to address climate risk, when automobile company Volkswagen<sup>25</sup> remained reluctant to provide lobbying reports after we had specifically requested transparency on climate-related lobbying activities.
- Supporting climate-related shareholder proposals at US and Canadian banks asking for banks to align financing with the International Energy Agency's Net Zero by 2050 scenario where they were not overly prescriptive and aligned with an energy transition in line with 1.5°C, for example at Toronto-Dominion Bank and JPMorgan Chase.

 Pressuring technology company Hon Hai Precision Industry (better known internationally as Foxconn), as CA100+ co-lead for the company, to improve its climate risk disclosure and align these with the TCFD recommendations to give investors better visibility of its exposure to climate-related risk.

These examples relate to EOS' entire AUA, which includes third-party assets, as well as FHL's assets. EOS will continue to play an active role in CA100+ and other collaborative climate engagements, leveraging the power of collaborative engagement as an escalation tool, and a way to signal investor consensus on the need for rapid climate action from the world's largest emitters. We will continue to shape efforts to expand collaborative engagement on climate change to additional sectors and companies not covered by CA100+. More information on EOS' 2022 CA100+ engagement activities is available in the <u>EOS 2022</u> <u>Annual Review</u>.



#### **Collaborative Engagement: Nature**

Collaborative engagement will be key to halting and reversing biodiversity loss. We currently co-chair the Engagement and Public Policy working groups within the Finance for Biodiversity Foundation. The engagement working group has focused on sharing knowledge and collaborative engagement opportunities on topics including deforestation, plastics, chemicals and regenerative agriculture. We are part of the Finance Sector Deforestation Action collaborative engagement on deforestation (see case study below). We are also part of the Launching Investor Group of Nature Action 100 initiative, which will facilitate collaborative engagement with companies that have the greatest impact on biodiversity.

After joining the Natural Capital Investment Alliance (NCIA) in 2021, we contributed towards its goal of mobilising more than \$10bn in aggregate for natural capital investment opportunities by the end of 2022 through the launch of our Biodiversity Equity Fund.

#### 

#### **Engaging on Deforestation**



Investors have a critical role to play in halting and reversing deforestation, especially through engagement with companies and capital allocation.

A collaborative initiative called Finance Sector Deforestation Action (FSDA) has been launched to support investors in delivering against this commitment. It uses data from Forest 500 and Global Canopy to help identify those companies at risk of having links to deforestation. EOS and FHL are supporting these efforts through collaborative engagements with over 30 focus companies.

For example, following the FSDA letter that we sent to Yum! Brands, which operates fast food chains such as KFC and Pizza Hut, we met the company's chief sustainability officer together with other FSDA coalition members. We pushed for Yum! Brands to increase commodity traceability in its supply chain.

The company said that all its beef was sourced locally for its restaurants and that less than 2% was sourced from Brazil, which supplies Brazilian restaurants. It underlined the challenge of achieving traceability in its soy supply chain but said it had made efforts to map this and had joined the UK Soy Roundtable. It was good to hear that the company was conscious of emerging deforestationrelated regulatory risks, especially in European markets.

We expect companies that source or produce soy, beef and leather, which are commonly linked to deforestation in the Amazon rainforest, to commit to deforestation-free and conversion-free production and sourcing by 2025. The commitment should cover all commodities, regions and suppliers, including indirect suppliers. We also encourage a commitment to achieving full traceability of commodities to source, across all tiers of the supply chain, in order to demonstrate that the company's value chain is deforestation and conversion-free. There should also be an explicit commitment to respect human rights. Companies should focus on the implementation of the commitment by articulating a clear strategy for how their operations and supply chain will become deforestation and conversion-free. This includes setting clear expectations for suppliers and creating mechanisms to enforce them. Ongoing due diligence and monitoring of suppliers and operations will be critical for effective implementation. Equally, ongoing collaboration will be necessary to tackle this complex issue.

For example, in an October 2022 call with the head of sustainability at JBS, we reiterated our concern about controversies related to the acquisition of cattle raised on deforested land.<sup>26</sup> JBS confirmed the company's target of achieving 100% full traceability of the supply chain by 2025. Currently, 36% of all cattle acquired by JBS can be fully traced.

The company highlighted its engagement with smaller farmers in its supply chain and its provision of technical assistance. Approximately 3,000 small farmers that had been excluded from its list of approved suppliers were reinstated after engaging with JBS and implementing the recommendations made by the company's technical assistance team.

We continue to engage with companies that are exposed to deforestation risks. Our vote policy also includes a deforestation dimension, which targets companies that are lagging on disclosure and risk management. In 2022, we expanded the policy to look at poor performing financial institutions, as well as companies. In 2022 we recommended opposing directors on the Archer-Daniels Midland board due to concerns that the company had not taken adequate climate and deforestation risk mitigation measures. The company is one of the world's largest agribusiness traders in soft commodities including soy.

#### **Private markets**

In private markets, ESG data is often less readily available. As such, the teams are heavily reliant on their due-diligence process and have developed their own frameworks for assessing E, S and G risks within their investments.

#### **Private debt**

The private debt teams consider sustainability behaviours when carrying out credit analysis for each potential investment. Sustainability considerations are a fundamental part of the research presented, and discussed, for all new transactions tabled at the Investment Committee. Material sustainability issues will often form part of engagement with the company prior to investment and once invested.

For our direct lending team, the key is to identify meaningful sustainability risks (both current and potential) before investing. Due to the difficulty of divesting and the capped upside, it is important to manage the downside and engage where possible ex-ante. The direct lending team undertakes enhanced due diligence on industries that are deemed controversial, such as energy, chemicals, forestry and agricultural commodities, manufacturing and mining and metals. They also undertake transaction-specific sustainability analysis by carrying out an assessment on sustainability risks for every investment opportunity. In addition, the team focuses acutely on the sensitivity of the company's cashflows to the identified potential sustainability risks. With that in mind, the direct lending team will evaluate if investors are adequately remunerated for the sustainability risk(s) of the transaction. We have recently developed a modelling tool to help us estimate Scope 1 and 2 carbon emissions for companies that do not disclose their carbon emissions. The team have been using this to estimate carbon emissions for their holdings to form part of their investment analysis as well as use it as a tool for engagement to improve disclosures by the company.

#### **Real Estate**

Our real estate business has embedded climate risk management throughout their asset management and investment processes since 2006. The focus has been primarily on mitigating the environmental impact of our operations and developments.

This includes an initial screening, where the team assesses the risks and opportunities for value-add from sustainability characteristics. This is then followed by a responsible investment due diligence for any new acquisitions, where surveyors and environmental consultants collect relevant data on the buildings to identify risks and opportunities. As part of our due diligence process, we inquire to understand the level of community and occupier engagement in the assets being considered. The findings from this then inform the assetmanagement plans and processes.

The team has developed internal tools and standards, the Responsible Property Management Standard and the Design Innovation Standard which sets out a series of sustainable guidelines and principles for our project and development



**Direct Lending** 



Our direct lending team reviewed the opportunity to lend to a Nordic-based provider of biodegradable consumer and industrial packaging, and insulation materials. The company's broad product portfolio as well as the underlying market drivers to move away from plasticbased products and towards more sustainable packaging and building solutions presented a compelling prospect. The proposed debt financing was to support the continued expansion of the company's product offering, manufacturing facilities and geographic footprint. To ensure the borrower continued on its journey to improve sustainability practices, several conditions were included in the loan documentation. These included a requirement for sustainability reporting, annual disclosure of the CSR report and the reporting of 3 KPIs relative to targets: (i) usage of bio-based and recycled raw materials as a % of total raw material; (ii) the % of CO<sub>2</sub> neutral energy and (iii) the use of Certified Paper. By building this into the documentation, we have agreed mandatory measurable and time bound targets to continue to drive progress.

managers to follow. This ensures a consistent, start-to-finish approach to sustainable refurbishment and development, making use of key RIBA Stages.<sup>27</sup> The approach also follows BREEAM principles,<sup>28</sup> which adopt sustainable methods of construction to deliver an operationally efficient and sustainable building or refurbishment.

To better understand the climate change risk, the team carried out a climate risk assessment across all their assets using the MSCI Climate Value at Risk (CVaR) tool. The tool models both the physical and transition risk for all the assets in the real estate portfolio. As the majority of the portfolio is in the UK, the most material physical risk is flooding. Therefore, the team has been developing flood prevention plans for the assets with high risk of flooding in the portfolio.

The real estate team reports portfolios' exposure to climate risk on the surveys submitted to the Global Real Estate Sustainability Benchmark (GRESB) portal every year. Specifically, we disclose details on the resilience of strategy to climaterelated risks, transition and physical risk identification.

<sup>&</sup>lt;sup>27</sup> The Royal Institute of British Architects (RIBA) Plan of Work organises the process of briefing, designing, constructing and operating building projects into eight stages and explains the stage outcomes, core tasks and information exchanges required at each stage.

<sup>&</sup>lt;sup>28</sup> BREEAM is the Building Research Establishment (BRE) Environmental Assessment Method, first launched in the UK in 1990. It sets best practice standards for the environmental performance of buildings through design, specification, construction and operation.

In 2019, we joined the <u>Better Building Partnership Climate</u> <u>Change Commitment</u> (along with 22 other signatories) with the aim of achieving net-zero emissions across our real estate portfolios by 2050.

As part of this commitment, on behalf of our clients, during 2021, the real estate team issued the <u>Net-Zero Pathway</u> <u>document</u> which sets out both the targets and approach to reaching net zero emissions by 2035 across the managed assets included within our UK real estate portfolio. Since then, we have published pathways for our <u>residential</u>, <u>International</u> and real estate debt portfolios, which are available on our <u>website</u>.

By taking a proactive approach in developing and operating net zero buildings, we intend to reduce the risks of having stranded assets, asset value declines and potential so-called 'brown penalties' (a higher cost of capital for carbon-intensive buildings). Net zero also presents opportunities for market leadership: to generate income resilience for our clients; support and retain our occupiers; and provide long-term value to our stakeholders.

## O CASE STUDY

#### Real estate – Fully integrating ESG into decisions at Fleets Corner Business Park



Located in Poole, FHL's Fleets Corner Business Park is one of the most significant assets of its type in Southern England and is home to many recognised names such as Lush, Starbucks, Travelodge and CityFibre, alongside local businesses.

Spanning 560,000 sq. ft., Fleets Corner offers a range of new and comprehensively refurbished industrial accommodation, accounting for 320,000 sq. ft. of the site, the largest amount in Dorset. Alongside industrial units, the business park offers 40,000 sq. ft. of refurbished office space, and has a range of amenities onsite, including the newly built Starbucks drive-thru and the brand new 81-bed Travelodge hotel.

Fleets Corner Business Park is managed in accordance with the Responsible Property Investment programme, which seeks to deliver holistic outcomes by generating positive societal and environmental impacts in addition to meeting financial return targets. Federated Hermes is committed to reducing its environmental impact, creating carbon savings, and supporting the climate transition by seeking to meet highperformance criteria for both new-build and existing projects.

FHL has sought to meet the highest sustainability performance at Fleets Corner, and all new builds include the following accreditation and specification: BREEAM Excellent, EPC A, solar PV panels, PIR lighting sensors, external cycle racks, shower facilities, external biodiversity and tree-planting programmes, and an attractive built environment to promote the end-user experience. Refurbishment projects at Fleets Corner have sought to improve energy performance as well as promote the end users' overall experience, and includes the following features:

- HVLS destratification fans saving up to 20% energy used in heating refurbished industrial units
- New thermal rated fenestration (where appropriate)
- Toilet refurbishments
- Enhanced building management systems and boiler sequencing
- External cycle racks
- New shower facilities
- Automatic electric water heaters
- Rainwater harvesting to supply WCs
- Flow restrictors on water outlets to reduce water usage
- Leak detection

Health and safety are front of mind, ensuring building standards are kept up to date. Working collaboratively with CBRE, its property management partner, FHL has sought to reduce energy consumption and carbon emissions and promote a more sustainable basis to service provision on site:

- The landlord's electricity is 100% renewable
- BREEAM In Use rating for existing office accommodation
- No communal waste is sent to landfill
- LED estate lighting energy consumption reduction of 90%
- PIR sensor lighting in building communal places
- Green travel plan for occupiers
- Access to bike share scheme

The real estate team are currently developing a robust and ambitious biodiversity strategy to deliver a targeted quantifiable increase in biodiversity and ecosystem service provision (BNG and ENG). Furthermore, measuring biodiversity and environmental performance will be crucial and asset level biodiversity plans will underpin targeted improvements in line with our overall strategy.

#### Infrastructure

Our infrastructure team engages actively with our portfolio companies in our capacity as shareholder, board director and committee member on their approach to climate change. We see significant opportunity in the transition to a net zero economy, including both 'greening' our existing infrastructure and allocating capital to transition solutions, such as renewable energy generation and storage.

As a primarily minority shareholder, we see the integration of sustainability considerations into governance and strategy from the top down as the most effective means by which to catalyse whole business efforts. At a number of our portfolio companies, our roles at board and committee level have enabled us to successfully collaborate and influence sustainability strategy.

During Q4 2022, we recorded 50 sustainability-related engagement with our portfolio companies, with 42% of our ESG-related interactions related to climate change. As part of our annual strategic portfolio and investment reviews, we aim to identify emerging systemic ESG risks which will likely affect, or are already affecting, every asset in our portfolio and, where necessary, undertake further work on such matters, which help us gather comprehensive risk management information.

In 2021, we undertook 5 months of deep dive work in partnership with climate adviser ERM, focused on scenario analysis for individual assets and risk management of identified risks. Our portfolio is unchanged from 2021, when the work was undertaken, this combined with the depth of underlying work in this engagement provides results we deem to continue to be representative of current holdings.

The table below illustrates the primary risks identified across our Core and Value Added strategies and different sectors. As anticipated, transition risks are more prevalent and quantifiable in the short term, in particular carbon pricing and revenue exposure to highly carbon intensive industries. The most prominent physical risks being increased storms and fluvial flooding in the medium term and increases in heat in the longer term. Several material transition opportunities were also identified, including increased demand for sustainable products and services, e.g., green transport and potential participation in a future market for negative emissions.



Figure 14: Primary risks and opportunities identified across Core and Value Added strategies and different sectors

Using the outputs of our deep dive analysis, we reviewed our stewardship approach with the relevant businesses and set priority focus areas and objectives. We continue to update our climate stewardship objectives annually, as risks and

mitigation evolve over the duration of our holding periods,

including refreshing our scenario analysis periodically to reflect the most up to date net zero scenarios. We expect to update this in 2024.

As a follow on to the 2021 work, in 2022, we asked ERM to focus on analysing the potential risks to eight of our largest assets from current and future carbon pricing mechanisms.

The work involved reviewing carbon price mechanisms relevant to each asset to better understand the direct and indirect impacts, the asset emissions that would be captured by each mechanism, and how this could be reflected within asset models. The outcome of this work was a clearer view on which assets are at risk to carbon pricing mechanisms. An example of this was the proposed inclusion of the maritime sector within the European Union Emissions Trading System and the direct impact to Scandlines from this. This has facilitated discussions with Scandlines management on potential mitigation strategies, and the inclusion of carbon pricing in capital expenditure decision making and financial analysis.



#### Scandlines



#### **Overview:**

In 2018 we acquired a shareholding in Scandlines, a ferry operator between Denmark and Germany, in consortium with an aligned co-shareholder. We have participated in extensive discussions on sustainability (and climate change in particular) at board and committee level since acquisition, building on Scandlines' track record of investing in green technology to reduce its environmental footprint and CO<sub>2</sub> emissions.

These have most recently resulted in the approval in September 2021 of the acquisition of a new €80m investment (inclusive of works in the harbour) in a new zero-emission freight ferry and in Scandlines setting in 2022 ambitious net zero direct emissions targets by 2040 (and 2030 for its main Denmark to Germany route), which it aims to meet through further electrification of its fleet, providing one of the greenest links between Sweden/Denmark and Germany.

#### **Our rationale:**

The new zero-emission freight ferry will allow Scandlines to expand its cargo capacity whilst retiring older vessels from the fleet. Its impact (described further below) is consistent with our engagement thesis that Scandlines can continue to improve its commercial offering and grow revenues (with low carbon transportation being seen as increasingly desirable by freight customers) while also decarbonising its operations and thereby minimising impact of operations on the planet and potentially reducing cost.

#### **Our engagements:**

The approval of the investment required board votes to be exercised at Scandlines in September 2021, the exercise of which was escalated to the Infrastructure Investment Committee due to the materiality of the proposal.

#### The outcomes:

The vessel is currently being built and expected to be deployed in 2024. Deployment of the new vessel from 2024 is expected to reduce Scandlines' emissions by c.170k tons of  $CO_2$  to 2035, or the equivalent of one full year of operations pre-Covid 2019. Given this and the replacement of older vessels, it is also expected to result in much lower Opex (including likelihood of carbon taxes). Monitoring of the project's progress is taking place via the Safety and Sustainability Committee (chaired by FHL Infrastructure's Board representative) as well as at Board level.

Deployment of the new vessel from 2024 is expected to reduce Scandlines' emissions by

## **c.170k**

tons of  $CO_2$  to 2035, or the equivalent of one full year of operations pre-Covid 2019.

#### **Private Equity**

Our private equity team assesses sustainability risks and opportunities, including climate change ahead of each investment. For direct co-investments, the investment team review the ESG materials provided by the lead investor and complement them with in-house research or expert call where relevant. The investment team scores each deal for ESG risks and opportunities and report their findings to the Private Equity Investment Committee (IC). Investments with significant and financially material climate change risks are declined (typically ahead of IC) and investment with relevant risks that could materialise during the investment hold are included in an ESG watchlist.

Portfolio monitoring has a quarterly cadence, the investment team report to the Private Equity Portfolio Review Committee any changes in the ESG watchlist, both companies which need to be included given that a sustainability risk or issue materialised or companies that are removed from the watchlist once a risk has been significantly mitigated.

In addition to reviewing risks and opportunities for individual investments, the private equity team also aims to leverage the transition to net zero as a key investment theme. The private equity investment strategy is guided by a thematic investment framework that identifies structural long-term trends we expect to shape the landscape of global economic activity over the next decades. This framework is naturally aligned to the UN's Sustainable Development Goals. 'Net Zero Economy', one of the target megatrends, underwent significant expansion in scope and materiality in 2021 to reflect a more purpose-driven goal of investing in the cross-sector foundations of a carbon neutral economy.

The 'Net Zero Economy' focuses on investments relating to sustainability and the energy transition. This megatrend will capture opportunities that are arising from the convergence of technological progress and demand for new solutions to reduce the impact of human activity on the planet. We summarise our current thematic thinking below:

- Given the extraordinary significance of climate change across business, consumers and government since our original introduction of the sustainability theme in the early 2010's, we have holistically reviewed our target sectors in light of the required transformation of the economic system to achieve carbon neutrality;
- The transformation to achieve net zero outcomes cuts across traditional sectors to encompass companies within 'next generation' energy, the future of food and mobility sectors to the broader production and consumption cycle, including ESG metrics measurement and technology;
- We expect the increasing demand for net zero-aligned products coupled with the competitive advantages of more sustainable supply chains, will create a rich vein of opportunities to be addressed by the private equity market, which this megatrend intends to capture.



In October 2022, the private equity team completed an investment in Evora, a sustainability consulting and software vendor to the real estate industry, selling services to both asset owners and investment managers. The investment was completed alongside Bridges Fund Management, a specialist impact investor.

The business provides bundled consulting, managed services, and software to customers who are looking to develop and implement their net zero carbon pathways for their assets, as well as improve sustainability monitoring and reporting. The services provided by Evora are mostly recurring in nature, such as multi-year net zero implementation, quarterly GRESB reporting, data collection and validation and various other stakeholder reporting.

The services provided by Evora are mostly recurring in nature, such as multi-year net zero implementation, quarterly GRESB reporting, data collection and validation and various other stakeholder reporting.

The company benefits from regulatory and transition risk tailwinds, the real estate market as it relates to sustainability is undergoing rapid development driven by regulatory, LP and societal pressure. Buildings are estimated to be responsible for up to 40% of global greenhouse gas ("GHG") emissions and will require \$2-3tn of spend to half emissions by 2030<sup>29</sup>.

Buildings are estimated to be responsible for up to 40% of global greenhouse gas ("GHG") emissions and will require \$2-3tn of spend to half emissions by 2030.

#### Advocacy: delivering positive industry-wide change

We believe that policymakers have a key role to play in determining the investment risks and opportunities relating to climate change and nature. We engage constructively with regulators and policymakers globally to address environmental, social and other market failures that may prevent the financial system from operating in the best interests of its ultimate asset owners.

EOS also has a comprehensive programme of engagement with legislators, regulators, industry bodies and other standardsetters to help shape capital markets. Our investment teams contribute their expertise through collaboration with the Responsibility Office and EOS, as well as direct involvement in external industry initiatives. The result is an advocacy policy that aims to lead rather than follow the policy debate. Given the global nature of our investments, this work spans asset classes and geographies.

We often engage directly with regulators and policymakers and aim to be a progressive and constructive voice in the debate. We engage on regulation relating to the investment industry and the assets in which we invest. We contribute to policy discussions both directly and in collaborative fora and initiatives. We are a member of many industry bodies and initiatives around the world and are co-founders of a number of them. Through these initiatives we engage with others both within and beyond the investment industry to promote responsible investment, including ways that the industry and our investees can respond to market-wide and systemic issues such as climate change. Colleagues from across the business – including the Responsibility Office, EOS, Risk and the investment teams – take on advisory roles in many of these organisations to share our practical expertise.

#### Climate

In 2022 we carried out extensive advocacy work on climaterelated issues.

Throughout 2022, we have participated in public consultations and meetings with government officials, financial regulators, stock exchanges, industry associations, and other key parties to contribute to the development of policy and best practice to facilitate the transition to a net zero carbon economy.

We have advocated for a number of changes to public policy and market best practice, including asking governments to commit to more ambitious climate targets with aligned domestic policies and deployment of required technologies. In the UK, we called for an ambitious Green Finance Strategy, in particular:

- For the UK to take a principles-based approach with a strong disclosure framework across the economy that allows for innovation;
- To create clear sectoral roadmaps with financing frameworks and aligned incentives to encourage investment in the transition and in green solutions;



- To work with the financial industry on public/private hybrid financing to crowd in private investors, as well as the use of public funding to support the development of early technologies to a point that they become credible investment opportunities;
- To increase incentives for financing both green solutions and the transition; and
- To ensure that stewardship is enabled and incentivised through recognition of outcomes-focused stewardship as a means of investor impact

We also joined a number of our peers in supporting calls for a UK Net Zero Investment Plan, as well as the need to address the energy security, cost of living and climate crises through accelerated action to meet UK climate commitments. We are supportive of strong disclosure frameworks to ensure comparability and transparency. For example, we have voiced our support for the development of international sustainabilityrelated reporting standards by the International Sustainability Standards Board (ISSB). We responded to the ISSB's consultation on climate exposure draft supporting their efforts to drive reliable and consistent climate disclosures, with suggested areas for enhancement such as the inclusion of impacts to communities and workers, and the just transition.

We have also contributed to policy group of GFANZ (Glasgow Financial Alliance for Net Zero), which published a report in 2022 that reflected on the progress that had been achieved around the world this year on policies supporting the transition. The Call to Action: One Year On Report also offers recommendations to support governments in developing their own economy-wide transition plans, building on the policy levers identified in Glasgow the year prior.<sup>30</sup>



#### **UK Climate Financial Risk Forum**



A key focus of our advocacy work over the past three years has been as a member of the UK Climate Financial Risk Forum (CFRF). The CFRF, co-chaired by the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA), builds capacity and shares best practice across financial regulators and industry, to advance our sector's responses to the financial risks from climate change. The CFRF plays a critical role in supporting firms as they get to grips with some of the more challenging aspects of climate change mitigation and adaptation by providing guidance by industry, for industry. Our CEO chaired the Disclosures Working Group (DWG) of the CFRF for two years during 2020 and 2021. We led the development of practical guidance on disclosures for financial institutions. The outputs of these two sessions have already been used widely both within and beyond the UK and referenced by the FCA as a useful guide for firms wishing to go beyond minimum regulatory disclosure standards.

#### During 2022, we were members of the Disclosure, Data and Metrics Working Group and the Transition to Net Zero Working Group.

During 2022, we were members of the Disclosure, Data and Metrics Working Group and the Transition to Net Zero Working Group. In the Transition to Net Zero Group, we co-led the development of <u>Mobilising</u> <u>Investment into Climate Solutions</u> report which provides recommendations for financial institutions to consider in how to most effectively finance climate solutions, with sector specific scoping notes on carbon capture usage and storage (CCUS), electric vehicle infrastructure and retrofitting commercial real estate. We will continue to work as part of the CFRF in 2023 to advance industry best practice in responding to the need for climate change mitigation and adaptation.

#### Nature

With COP 15 finally going ahead in Montreal in December 2022 after multiple postponements, the threat to wildlife and natural habitats remained in focus for investors last year. The World Economic Forum has identified biodiversity loss as one of the three most severe global risks over the next 10 years. Through the year we continued to advocate for best practice and industry standards, including calling for an ambitious Global Biodiversity Framework at COP 15.

As co-chair of the Finance for Biodiversity Foundation's public policy and advocacy working group, we advocated for an ambitious Global Biodiversity Framework (GBF) to be agreed at COP 15. We focused on the need for the GBF to require public and private financial flows to be aligned with global biodiversity goals and targets. We also contributed to three position papers outlining text suggestions for the GBF36. We attended international biodiversity negotiations virtually in August 2021, in Geneva in March 2022, and in Montreal in December 2022. At COP 15 the Kunming-Montreal Global Biodiversity Framework was adopted by almost 200 countries. This features a target to protect at least 30% of land and seas by 2030, and addresses key issues related to biodiversity loss, such as subsidies and the financing gap. There is a requirement for financial flows to be aligned with both the 2030 targets and the 2050 vision, which should stimulate action over the short, medium and long term. In addition, governments will be required to ensure that large companies and financial institutions assess and disclose their risks, impacts and dependencies on biodiversity throughout operations, value chains and portfolios.

#### **Corporate risk management**

#### **Risk Function Activities**

The Risk team plays a critical role in providing independent oversight of sustainability risks across the firm. It ensures that ESG risks are systematically identified, assessed, managed, and reported on, to safeguard our sustainability and reputation. Key activities include:

- Risk identification: The Risk team actively identifies and assesses sustainability risks that we may be exposed to. This involves analysing a number of different factors, such as changes in sustainability regulation, climate change impacts, emerging sustainability developments, scenarios that could adversely impact our social licence to operate, alignment of our third parties to the values of our firm and broad stakeholder expectations. Through regular assessments, the risk team helps prioritize sustainability risk assurance based on their potential impact on our firm and clients and the probability of occurrence.
- Risk mitigation: Following appropriate risk assessments, the Risk team collaborates with relevant business stakeholders to ensure that risk mitigation and controls are implemented and that mitigation efforts are aligned to our sustainability objectives.
- ESG integration in the Risk Management Framework: The Risk team continues to integrate sustainability considerations within the risk management framework, risk polices and processes. In doing so, the Risk team ensures ESG risks are adequately identified, measured, managed

and reported on in the same manner as other business risks. During 2022 we advanced our corporate level risk management framework by integrating sustainability risks further into our risk taxonomy as principal risks setting qualitative risk appetite statements and metrics to monitor reputation, sustainability risks more broadly. In particular, updates to the risk management framework included changes to our non-financial risk appetite statements to consider drivers of reputation, sustainability risks through a stakeholder lens.

- **Risk Monitoring and Reporting:** The Risk team has established mechanisms to monitor sustainability risks on an ongoing basis. This is primarily done through established risk appetite statement and metrics – for instance, tracking relevant key risk indicators and monitoring internal and external emerging sustainability risks and trends. The Risk team regularly reports risk issues to senior management and risk governance forums. Furthermore, the Risk team continues to provide independent oversight on the progress made delivering both internal and external sustainability commitments and that the processes implemented to comply with sustainability regulation remain effective.
- Stakeholder engagement: The Risk team actively engages with internal and external stakeholders to understand and monitor changing sustainability expectations, trends and concerns. This includes close collaboration with the Responsibility Office, Investment teams, data governance, and external parties to gather insights on best practice, emerging sustainability issues and evolving industry standards. The Risk team participates in a number of sustainability-related industry forums (for example, the Central Bank of Ireland Climate Forum) in order to learn, share and help develop industry best practice with peers.

#### Sustainability-related standards and regulation

Horizon scanning for developing sustainability regulation and maintenance of pipeline of sustainable regulation has been established to augment the existing Compliance team regulatory horizon scanning process. This ensures that activities to comply with requirements are implemented and coordinated across the business. The Compliance team determines whether a new sustainability regulation or external standards requires the support and expertise of our Business Change team in order to implement it.

## **Development over 2022 and beyond**

To ensure the business continues to measure, monitor, manage and mitigate the risks from climate change in line with risk appetite statements, key risk indictors at the corporate entity level were set in 2022, as part of risk appetite development. Furthermore, as part of our transition to the Investment Firm Prudential Regime, sustainability and reputational risk formed a key risk and harm scenario in our calculation for regulatory capital adequacy assessments.

Looking ahead to 2023, Risk will continue to assess the physical risks of climate change as part of our continued enhancement of our business continuity programme and wider work on operational resilience. With smaller operations in jurisdictions such as Singapore, Japan and Australia we are cognisant of the growing threat of climate physical risks in these regions. As such, we are increasingly integrating measures into our business continuity plans to mitigate potential disruption from extreme climate events. This is a key are of focus in 2023, that will ensure we maintain the resilience and sustainability of our operations in these regions.

# Identification, assessment and management of corporate GHG emissions

Addressing our environmental responsibilities as a firm, EMS works with a specialist third party consultant to set and deliver our environmental goals and improve our sustainability. EMS actively promotes sustainability in the office by educating and encouraging staff to reduce our environmental impact.

The system we use to measure and manage our impact is ISO14001: an internationally accepted standard demonstrating an organisation's commitment to continual improvement of their environmental management system. We first achieved this certification in 2010 and retain it to this day – in recognition of the rigour of our on-site environmental management programme.

# Under the EMS we had three strategic objectives in 2022:

	Strategic Objectives for 2022	Measure of Success	Result
1	Achieve a successful ISO14001 surveillance audit for the EMS at 150 Cheapside.	Upheld certification to ISO14001 following surveillance audit in May 2022.	Achieved –Re-certification maintained until August 2023.
2	Work with the building management team to better understand the building's and FHL's own impacts and contribute to efforts to reduce these where possible.	Evidence of meetings with building manager.	Achieved –FHL holds regular meetings with the building management team and a quarterly data sharing programme has been put in place for the reporting of its utilities and waste data. Recommendations are also made to the building manager where improvements could be made to common areas and shared services, e.g., fan coil units in tenants' demise and power quality investigations.
3	The EMS Group is tasked with developing initiatives with a specific focus on environmental benefits.	Evidence of implementation of initiatives with a specific focus on environmental benefits	Achieved – Proposals from the EMS group are discussed at the quarterly EMS meetings where decisions on whether / how to implement them are made.

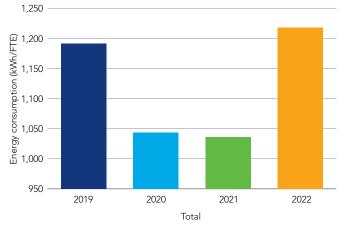
# In addition, the EMS had eight management objectives in 2022:

	Tactical and Operational Objectives for 2022	Measure of Success	Result
1	Reduce FHL's operational electricity consumption for its occupied space at 150 Cheapside by 5% per full time employee in 2022 compared to 2019.	Reduced electricity consumption at 150 Cheapside.	Achieved – Electricity consumption has reduced by 16% compared 2019 with regard to intensity, although there has been a slight increase in consumption when comparing 2022 & 2021's absolute consumption due to increased headcount. Absolute consumption still remains below 2019 levels.
	(2019 selected due to atypical consumption year in 2020)		consumption still remains below 2019 levels.
2	Compliance with Streamlined Energy and Carbon Reporting (SECR).	Make a public disclosure within their annual directors' report of energy use and carbon emissions.	Achieved – disclosure of compliance will feature within the 2023 financial report. The statement has been provided, with disclosure adjusted to fall in line with wider company policy.
		Report using a relative intensity metric	
		e.g., tCO <sub>2</sub> /annual revenue.	
		Provide a narrative on energy efficiency actions taken during the reporting period.	
3	Maintain reduction in waste at <400kg per full time employee.	Improved recycling rates and decreasing total waste amounts.	Achieved – Waste has significantly reduced since 2019. A trend of reduction was seen in the months leading up to the first UK Covid-19 lockdown. The lockdown then caused a dramatic drop of almost 90%. Waste consumption has not reverted back to pre-pandemic levels yet, but shows signs of increasing to half of normal consumption.
4	Maintain recycling rate >70%.	Reduction in the number of reprints and absolute paper usage.	Not achieved – This has been consistently achieved throughout the previous few years, however with a return to the office, and new restrictions around single use items following the pandemic, waste rates have suffered slightly. In the future, FHL are working with the Landlord to implement new food disposal procedures as an additional waste stream, which should correct the shortfall.
5	Continue to monitor business travel across all departments and modes of transport where possible. Work with the new travel provider to receive more detailed information on each department's travel with a view to reducing it in future.	Continual monitoring and reporting of business travel activities and emissions.	Achieved – We are working with the travel provider Reed & Mackay on monitoring and providing more detail on the types of journeys and breaking the data down by department to help focus potential reduction opportunities in the future.
6	Socialise the travel policy and drive engagement.	Robust travel policy which minimises unnecessary travel.	Achieved – The travel policy has been socialised, however the impact of Covid on travel restriction from 2020 to 2022 has meant that the impact of the travel policy engagement is uncertain in the immediate future.
7	Continued promotion of the work being undertaken by the business to manage its environmental risks and the firm's EMS performance in key areas.	Communications to stakeholders.	Achieved – The Federated Hermes Environmental Management System has been uploaded to the corporate SharePoint. This allows for greater transparency and engagement with the wider business.
8	Ensure that continued involvement in and support for the EMS Group is included in all Group members' annual personal objectives.	Evidence of EMS Group within objectives of members.	Achieved

We are proud to have met the vast majority of our objectives and retained our ISO14001 EMS standard for another year. As the charts below show we have also exceeded the targets we set for ourselves on reducing electricity consumption and waste production.<sup>32</sup> We have consistently achieved our recycling objective, however with a return to the office, and new restrictions around single use items following the pandemic, waste rates have suffered slightly. To help rectify this, FHL are working with the Landlord to implement new food disposal procedures as an additional waste stream, which should correct the shortfall. It should also be noted that non-recycled waste from within the City of London is taken to an Energy-From-Waste Facility where it is processed to produce electricity.

As we had anticipated, our travel emissions increased over 2022 as the company entered a period of growth and travel increased after the impacts of Covid-19 in 2021, a trend which is likely to continue in 2023. However, we remain positive that with the assistance of our travel provider Reed & Mackay we can help identify potential per capita travel reduction opportunities in the future.

Figure 15: Energy consumption (kWh) per full time employee at 150 Cheapside offices in 2022



Source: FHL, Cushman and Wakefield as at 31 December 2022.

Energy consumption in 2022 was 1,218 kWh per full time equivalent (FTE))<sup>33</sup> at 150 Cheapside.

For the first time, we are also reporting energy consumption across all of our offices. Our Scopes 1 and 2 energy consumption from our offices in 2022 was 1,589 kWh per FTE. 8% of this figure is based on estimated data. It does not include serviced offices. These figures are calculated using a location-based methodology. This means that any use of renewable energy is not represented in these metrics, as they are based on the average emissions intensity of the grid, although our Landlord sources 100% renewable electricity for our head office (150 Cheapside).

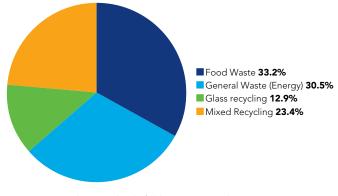
<sup>32</sup> Figures 15-17 capture data from our London office (150 Cheapside) only and do not include our other offices or Hermes GPE.

- <sup>33</sup> Full time equivalent figures include temporary staff. Part time employee headcount is pro-rated based on the number of days worked. Employees on parental leave and long term sick leave are not included. Consultants, non-executive directors and visitors such as auditors are not included. The figures are based on a two point average (based on headcount at the start and end of the calendar year).
- <sup>34</sup> In Figure 18, the building emissions data is for our London office (150 Cheapside) only and does not include our other offices or Hermes GPE. The travel emissions data in Figures 18 and 19 includes colleagues from both 150 Cheapside and our other offices outside the UK, but does not include Hermes GPE.



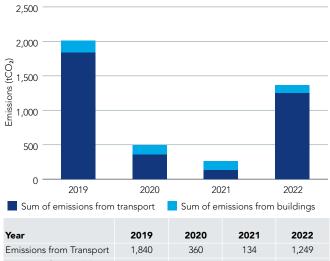
Source: FHL, Cushman and Wakefield as at 31 December 2022.





Source: FHL, Cushman and Wakefield as at 31 December 2022.

#### Figure 18. Travel and Building (150 Cheapside) emissions in 2022<sup>34</sup>



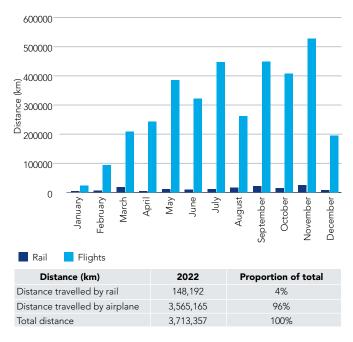
Year	2019	2020	2021	2022
Emissions from Transport	1,840	360	134	1,249
Emissions from Buildings	168	136	124	115
Total Emissions	2,008	496	258	1,364

Source: FHL, Reed & Mackay as at 31 December 2022.

Figure 16. Recycled vs non-recycled waste (kg) (150 Cheapside) in 2022

The above chart includes building emissions data for 150 Cheapside only. For the first time, we are also reporting the total Scope 1 and 2 building emissions across all of our offices. The Scopes 1 and 2 building emissions from all of our offices in 2022 was 243 tCO<sub>2</sub>e. 8% of this figure is based on estimated data. These figures are calculated using a locationbased methodology. This means that any use of renewable energy is not represented in these metrics, as they are based on the average emissions intensity of the grid, although our Landlord sources 100% renewable electricity for our head office (150 Cheapside).

#### Figure 19: Total distance of corporate travel in 2022



Source: FHL, Reed and Mackay as at 31 December 2022.

As well as measuring its GHG emissions, FHL offsets its Scope 1 and Scope 2 emissions and corporate air and rail travel emissions. Due to an internal change in responsibility for managing our offsets, we have not yet offset our 2021 operational and travel emissions. We will be offsetting 258 tonnes of  $CO_2$  e emissions as soon as possible for 2021, as well as offsetting 1,669 tonnes of  $CO_2$  e emissions relating to our 2022 operational and travel emissions.

# FHL continues to target a

50% reduction of our 2019 per FTE baseline through travel up to 2030.

In calculating our 2022 offsets, we have included reported or estimated emissions for all of our offices, including those outside of the UK. As with the reporting of our operational emissions, we use a location-based methodology to calculate the Scopes 1 and 2 operational emissions for our offsetting, meaning that we calculate the total using grid intensity and do not factor in that our Landlord purchases renewable data for our head office. We have also included estimated travel emissions based on a per capita average for those colleagues for whom we do not have travel data. We have also included estimated travel emissions based on a per capita average for those colleagues for whom we do not have travel data.

As an additional charitable donation, we have continued our commitment to Treedom, a collaboration that works with a small collective of farmers, local community, and NGO across different countries, with a second-year donation of £20,000. With our support Treedom have assigned 3,240 trees to be planted across the world, including Cameroon, Kenya, Madagascar, Haiti, Colombia and Nepal.

#### **Travel Policy**

As part of FHL's travel policy, we continue to request that our employees considering business travel on behalf of the firm should undertake the avoid-reduce-mitigate hierarchy assessment. A global consolidated travel policy is currently being developed and will be rolled-out in early 2024.

FHL continues to target a 50% reduction of our 2019 per FTE baseline through travel up to 2030. More information is included in the Metrics and Targets section of this report.<sup>35</sup>

We will also be monitoring the mileage of our travel. While we will continue to work with partners to offset our operational carbon emissions, we will not use offsets to meet our carbon reduction target.

This builds on existing guidance to employees to consider carbon efficiency, prioritise essential travel only and consider alternatives to air travel and to multiple trips where possible. We continue to request that our employees considering business travel on behalf of the firm should undertake the following assessment, based on an avoid-reduce-mitigate hierarchy:

- Avoid: Consider whether the objective the journey seeks to fulfil can be achieved through other means, for example using audio-visual conferencing facilities, telephone or email.
- Reduce: If the journey is necessary, can it be combined with other upcoming meetings or site visits perhaps.
- Mitigate: Where travel cannot be avoided, we will mitigate through offsetting our carbon emissions, as we currently do.

# Metrics and Targets



In November 2022 we published our corporate <u>Climate Action</u> <u>Plan</u>, with new interim targets and metrics to help us manage climate-related risks and opportunities over the near, medium and long term.

In this section we set our firm-level and asset class-level targets used to manage climate-related risk within our investment management activities. We also detail our carbon foot print coverage and present a range of metrics which we use in order to understand the company's exposure to climate- and naturerelated risks and opportunities. These metrics have been selected on the basis of what is most appropriate to our business and to the asset classes we manage.

## **Targets**

# Scopes 1 & 2 operational emissions reduction targets:

We offset our Scope 1 and 2 operational emissions as well as our corporate travel emissions by air and rail.

Our operational emissions targets are reviewed annually and are based on data captured in the Federated Hermes Environmental Management System (EMS) and Streamlined Energy and Carbon Reporting (SECR) methodologies. Our 2019 baseline was:

- Absolute total emissions: Scope 1 1.13 tCO<sub>2</sub>e; Scope 2 202.1 tCO<sub>2</sub>e
- Emissions Intensity (Scope 1 & 2): 0.44 tCO<sub>2</sub>e/FTE<sup>36,37</sup>

#### We are targeting a further reduction in our energy intensity (based on our Scope 1 & 2 operational emissions per FTE) of 25% by 2030 relative to the 2019 baseline.

Using an intensity metric as the basis of our operational emissions target allows us to track progress whilst allowing for changing office space and FTE numbers, which in turn will have a direct impact on office size, energy consumption and emissions. As the organisation's size evolves, we will work with our external environmental consultants combined with the internal knowledge base via our EMS to maximise efficiency gains and ensure that the targets remain fit for purpose.

The 2019 emissions intensity baseline was based on the electricity and gas consumption and FTEs for 150 Cheapside (London), Gutter Lane (the London offices of HGPE) and estimates for MEPC offices only. We have used location-based emissions factors – in line with SECR methodologies – to calculate the emissions associated with our energy consumption on site and corresponding energy intensity. This means that any use of renewable energy is not represented in these metrics, as they are based on the average emissions intensity of the grid, although our Landlord sources 100% renewable electricity for our head office (150 Cheapside). Reductions in our energy intensity will therefore result from energy efficiency measures and grid decarbonisation.

We committed to track progress against our targets including FTEs from our other offices and estimations for gas and electricity consumption in these additional offices.<sup>38</sup> Therefore, our reporting on progress towards our target now includes reported or estimated emissions and headcount data for all of our offices. In 2022, our Scopes 1 and 2 operational emissions intensity was 0.40 tCO<sub>2</sub>e/FTE, which represents an 8.9% reduction from our 2019 baseline.

<sup>&</sup>lt;sup>36</sup> Energy intensity for our offices is calculated by dividing energy consumption by the number of FTEs. This is calculated on a monthly basis and averaged over the year. <sup>37</sup> We have recalculated our 2019 baseline, based on a refinement of our headcount methodology to represent full time equivalent (FTE) across all UK offices. Previously we had reported a baseline of 0.39 tCO<sub>2</sub>e/FTE.

<sup>&</sup>lt;sup>38</sup> FHL has used the main requirements of the GHG Protocol Corporate Standard (revised edition) as a basis to report operational emissions. Data was gathered at site level to compile the carbon footprint. The International Energy Agency (IEA) and DEFRA UK Government Conversion Factors for GHG Company Reporting have been used to convert activity data into tCO<sub>2</sub>e emissions. For measuring progress against our targets, actual data will be prioritised, however in instances where this is not available, consumption data will be estimated using the following methods: Average daily consumption for any unknown period within the same reporting year, substituting actual consumption for known periods in place of those missing, apportioning building level consumption data based on the company's leased floor area, or the 2021 CIBSE Guide F Benchmarks where no data was available (using the associated asset type's benchmark and multiplying this by the occupied floor area of the assets).

#### Scope 3 operational emissions reduction targets:

One of the key risks identified by EMS and the CNWG in relation to climate is reputational risk from operational emissions, notably travel emissions. As a result, in 2021 we established ambitious reduction targets for employee travel. We have committed to reducing our emissions from business-related travel by 50% from a 2019 baseline by 2030, whilst establishing internal mechanisms to monitor annual progress including monthly emissions tracking and updated guidance within our Travel Policy. As we have implemented monitoring against our targets during 2022, we have found that a per capita target is more relevant and meaningful than an absolute target. A per capita target allows for us to expand the scope of which colleagues are included in our target, as well as allowing for the growth of the business.

From 2022, enhancements to our responsible supplier management process have been embedded, including a revised Supplier Code of Conduct which better considers the ESG credentials of our third-party suppliers and integration of environmental and social considerations within the supplier due diligence process.

## We have committed to reducing our per capita emissions from business-related travel by

**50%** from a 2019 baseline (by 2030)

Our 2019 baseline was 4.33 tCO<sub>2</sub>/FTE. In 2022, our per capita emissions from business-related travel were 2.33 tCO<sub>2</sub>/FTE.<sup>39,40</sup> This represents a 46% reduction from the 2019 baseline. However, we note that the levels of travel in 2022 were notably depressed as the economy emerged from the pandemic.

#### **Our Investments**

In addition to our operational emissions, our targets also cover Scopes 1 and 2 of our financed emissions and, where possible, Scope 3, either where it is reported by the company or where we deem it a priority for estimation because it is material to the sector or accounts for 40% or more of total emissions. The approach we have adopted requires that our investments include an increasing proportion of companies that are planning decarbonisation in line with 1.5°C pathways. These pathways will use science-based methodologies for the distribution of emissions reductions between sectors and geographies and therefore account for the fair share of emissions reductions required from different companies.

Our approach to achieving our commitment to the Net Zero Asset Managers (NZAM) initiative – through which we have committed to net zero by 2050 at the latest – is focused on ensuring its achievement delivers decarbonisation in the real economy. We have therefore set portfolio-coverage type targets that will drive engagement with portfolio companies to achieve decarbonisation at the company level and not just the portfoliolevel, as an inseparable part of our fiduciary responsibility.

We also aspire to develop a tailored methodology for the holistic assessment of positive climate impacts from our portfolios and will look to set a target for increasing such impacts in the future. We will in the meantime continue engaging with investees to increase green revenue and investment into climate and nature-based solutions between now and 2030.

<sup>39</sup> These figures are based largely on reported data, with estimated data based on average emissions per FTE for 12% and 13% of employees in 2019 and 2022 respectively.

<sup>40</sup> We have recalculated our 2019 baseline, based on a refinement of our headcount methodology to represent full time equivalent (FTE) across all UK offices. Previously we had reported a baseline of 0.39 tCO<sub>2</sub>e/FTE.

# The path to net zero

## Turning commitment into action

As the climate crisis accelerates, the question remains: what can we do to remain on track?

Achieving net zero is the only way forward and, unfortunately, time is not on our side. That's why, as stewards of our clients' capital, the global financial community must act - and we must act now. We believe we have a responsibility as an industry, and indeed as a business, to allocate capital in a way that mitigates exposure to climate risk and helps deliver the goals of the Paris Agreement<sup>41</sup>.

# Taking the first step

So, how do we get there?

# **Our climate goals**

We need to start planning for this future now, even if we do not have all the answers today.

Federated Hermes Limited has committed to achieving net zero by

As we strive to reduce our portfolio emissions, we have set the following

interim milestones<sup>42</sup>:

In public markets, we are aiming to align...

In Real Estate, we are working toward a...

but we will try our best

to get there sooner.

25%

to 1.5°C by 2025



by 2025

... And achieving **net zero** in terms of development and operations and debt by 2035.

# Engagement roadmap

# Helping companies along the journey

engage with the most material emitters that are misaligned or exposed to significant transition risk, to help them reach the 1.5°C target.

<sup>41</sup> Article 2.1c of the Paris Agreement, sets out the objective of "(c) Making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development."

42 While we hope to cover all asset classes over time, our interim target currently applies to all our assets under management except for private equity, direct lending, sovereign debt, FX, cash, indices and, ABS, CLOs and CDOs issued by companies.

## **Public Markets**

#### Our public market interim targets:

25% of in-scope AUM and financed emissions to be 1.5°C aligned by 2025: 50% by 2027 and 80% by 2030.

We are targeting that over 90% of financed emissions across public markets will be subject to direct or collective engagement and stewardship actions by 2030 (from 80% at the end of 2022).

By targeting 80% of the assets within portfolios to be aligned to these pathways by 2030, the vast majority of portfolio emissions will be decreasing in line with  $1.5^{\circ}$ C pathways that substantially incorporate the IPCC's requirement for a 50% global reduction in CO<sub>2</sub> emissions by 2030. We have targeted 80% to allow for 20% portfolio rotation into new companies which require further engagement to achieve this.

To achieve these ambitious targets, in-depth engagement will be focused on the top emitters. We will prioritise the following sectors: forest; land and agriculture; buildings; iron and steel; cement; chemicals; transport; oil and gas; and power generation. We will also seek to raise awareness regarding our climate expectations with all investee companies where climate change is considered a material risk, and no credible target has been set by the company. During 2022, we engaged with 80% of our financed emissions.

Figure 20 below shows the current state of alignment of our public markets as a percentage of our AUM and as a percentage of financed emissions as at the end of 2022. We currently assess the alignment of our holdings by assessing the GHG reduction targets that the company has set. Further information on our Paris Alignment methodology can be found in our Climate Action Plan.

#### Figure 21: Real Estate approach to net zero for UK managed assets

**Figure 20.** Alignment according to FHL methodology of public markets exposure (% of AUM and financed emissions) in FHL shareholder and participating funds (credit and equity).

Category	% of AUM	% of financed emissions
Not Aligned	25.2%	21.7%
Unscored	3.6%	4.1%
Committed to net zero	28.9%	31.9%
Aligning	21.6%	26.9%
Aligned	20.8%	15.4%

Source: FHL, Trucost, MSCI, Bloomberg, SBTI, as at 31 December 2022.

## **Real Estate**

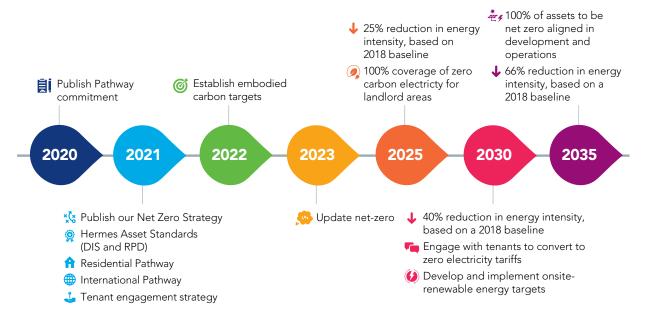
#### Our real estate interim targets:

25% reduction in energy intensity by 2025, 40% by 2030 and 66% by 2035.

Net Zero commitment for real estate development and managed assets operations and for real estate debt by 2035.

In 2019, we joined the <u>Better Building Partnership Climate</u> <u>Change Commitment</u> (along with 22 other signatories) with the aim of achieving net-zero emissions across our real estate portfolios by 2050.

As part of this commitment, on behalf of our clients, during 2021, the real estate team issued the Net-Zero Pathway document which sets out both the targets and approach to reaching net zero emissions by 2035 across the managed assets included within our UK real estate portfolio. Since then, we have published pathways for our <u>residential</u>, <u>International</u> and real estate debt portfolios.



Source: FHL, as at 31 December 2022.

By taking a proactive approach in developing and operating net zero buildings, we intend to reduce the risks of having stranded assets, asset value declines and potential so-called 'brown penalties' (a higher cost of capital for carbonintensive buildings). Net zero also presents opportunities for market leadership: to generate income resilience for our clients; support and retain our occupiers; and provide longterm value to our stakeholders.

We aim to deliver on this aspiration in four specific areas:

- 1 **Decarbonisation.** Remove the use of fossil fuels, increase energy efficiency, use green tariffs and reduce embodied carbon in our new development and major refurbishments. This should support improvements in local infrastructure and emphasise best-practice innovation.
- 2 **Deliver energy efficiency.** Reduce energy use intensity by 66% in the years to 2035 against a 2018 baseline.<sup>43</sup>
- 3 **Stakeholder engagement.** Work with occupiers, suppliers and other stakeholders to successfully transition to net-zero alignment.
- 4 **Utilise offset opportunities.** Use credible, permanent carbon-removal methodologies for residual carbon utilising schemes, such as natural-capital solutions for carbon sequestration to address embodied carbon

We continue to develop and implement initiatives across our real-estate portfolio that are designed to reduce carbon emissions and to improve efficiencies in our built environment portfolio, making use of new technology and best practice gleaned from our active engagement in peergroup benchmarking.



#### Infrastructure

# **Our Infrastructure interim target:**

#### 100% Paris-alignment of assets by 2025.

We are focussed on ensuring companies have short, medium and long-term Net Zero targets accredited under recognised standards (such as the SBTi) and that these targets are aligned with the Paris protocol to meet the 1.5°C international warming target. In 2022, the infrastructure team used a Paris Alignment test developed by FHL in which companies were scored and classified as Aligned, Aligning, Committed to Net Zero and Not Aligned.

We have supported the development of sustainability strategies and their integration into broader long term business plans at a number of assets in the reporting year 2022 with further work ongoing in 2023, particularly at our transport assets.

# Of our four Special Purpose Vehicle portfolio companies, three are renewables which we consider climate solutions and thus out of scope of our Paris alignment assessment.

All eight of our large operating portfolio companies (across regulated utilities, transport and energy transition) have public net zero targets. Of our four Special Purpose Vehicle portfolio companies, three are renewables which we consider climate solutions and thus out of scope of our Paris alignment assessment. The remaining one is a portfolio of toll roads in Spain to which we are providing support and guidance to develop targets. We also have investments in two social infrastructure funds with an external manager. We consider these out of scope of our target and captured by the external manager's sustainability programme.

While we see a reduction in emissions as a necessary part of transition risk management, we also see the central role infrastructure investments can play in the decarbonisation of the broader economy and, in doing so, support jobs and local growth.

In some cases, it is clear that the path to net zero is highly policy dependent. In such instances, our stewardship includes supporting such companies in their advocacy where their positions align with our broader expectations and climate change committee recommendations.

#### **Metrics**

We undertake carbon footprinting for the following asset classes:

- Listed Equities and Fixed Income
- Real Estate
- Infrastructure
- Real Estate Debt
- Private Equity
- Direct Lending

#### **Carbon Footprinting Coverage**

Across all our strategies we aim for high carbon data coverage. During 2021 we developed our own internal issuer hierarchy to improve data coverage in the public credit space. We also developed our own internal baseline methodology which excludes certain securities to which we will not apply ESG data (cash, FX, long CDS, index or pooled product, sovereign, derivative where underlying is a government entity). This makes up 3.1% of our total public equity and credit AUM (excluding cash and FX exposure). Figure 22 below does not take these securities into account. We are also not yet able to measure the carbon footprint of our sovereign and structured credit. This is an area of focus for us and are evaluating estimation methodology to fill in the gaps.

In 2022, we further enhanced our methodology for calculating carbon metrics. In addition to those exclusions described above, securities for which we have no data (reported or estimated), primarily due to lack of coverage by third-party data providers, are excluded from the calculation. This includes removal of these names from the AUM figures used in our carbon metric calculations. This ensures that we are not understating our carbon exposure by excluding companies with no data from the numerator but including them in the AUM denominator. This has not been applied to historical data shown in this report.

For public equities, credit and real estate debt we use estimated data where there are gaps in reported data from the company (apart from the exceptions described above). For private equity, we only use estimated data. We rely on third-party data providers for our estimated data. Due to the way our real estate debt emissions data is collected, we do not have the breakdown of the data split by scope; scope 1 and 2 data that the real estate debt team receive is combined. 61% of the real estate debt AUM is reported data and 39% is estimated. Real estate debt receives meter readings and the amount of renewables produced and used onsite from their borrowers which are then used in the

Looking beyond carbon footprinting, we use data, metrics and targets from various sources in order to understand the company's exposure to climate- and nature-related risks and opportunities. These have been selected on the basis of what is most appropriate to our business and to the asset classes we manage. A selection is disclosed here. FHL invests across a number of different asset classes and there is no single carbon metric that can be reliably aggregated across asset classes to give a view on our carbon intensity. We adapt the methodology for our carbon calculation for some of the asset classes where we believe revenue is not a useful indicator of intensity. For our real estate and real estate debt portfolios, the standard practice within the industry including INREV (European Investors in Non-Listed Real Estate) and EPRA (European Public Real Estate) reporting, as well as the definition of reporting under GRESB (Global ESG Benchmark for Real Assets) uses the complete buildings in the footprint rather than the return on the amount of equity invested, as the revenue can differ widely depending on the type of occupier

CRREM model. Where the team do not get direct emissions data from their borrowers, they use a third-party to estimate emissions data to fill in the gaps.

Our real estate, infrastructure and direct lending funds only use reported data from the portfolio companies or assets in this report.

Figure 22 below shows the breakdown of reported and estimated data by each asset class used in this report. Our real estate and infrastructure teams do also collect scope 3 data; however, this has not been included in this report. This is due to inconsistency of the scope 3 data.

**Figure 22:** Breakdown of reported, estimated and non-disclosure of carbon emissions data across scopes 1, 2 and 3 across all asset classes where we undertake carbon footprinting (public equity and credit, infrastructure, real estate, direct lending and private equity).



Source: FHL, as at 31 December 2022. Please note, real estate debt has been omitted from this chart as the split between reported and estimated data is unknown.

and the nature of the assets usage (such as industrial versus office). For our private equity portfolios, we look at the carbon footprint, rather than the weighted average carbon intensity due to lack of revenue data. We have calculated the weighted average carbon intensity across our asset classes where data is available and used the below metrics to account for size:

- Public equity and credit, infrastructure and direct lending per million revenue
- Real estate and real estate debt per square meter
- Private equity per million invested

Figure 23 below shows the weighted average carbon intensity (WACI) of all asset classes where we undertake carbon footprinting, including changes from 2021. 2022 is the first year that we have included direct lending and private equity.

2022 WACI Asset Class Unit Scope included 2021 WACI Public Equity and Credit tCO<sub>2</sub>e / \$mn revenue 112.4 115.0 1.2 1,2,3 228.6 251.2 Infrastructure tCO<sub>2</sub>e / £mn revenue 1,2 478.2 465.7 23.0 Real Estate kgCO<sub>2</sub>e / m² / year 22.0 1,2 Real Estate Debt kgCO<sub>2</sub>e / m<sup>2</sup> 1,2 58.1 42.2 Not included in 2021 Direct Lending tCO<sub>2</sub>e / \$mn revenue 1,2 15.1 123 Not included in 2021 31.4 17.6 Not included in 2021 Private Equity tCO<sub>2</sub>e / £mn invested 1,2

Figure 23: Weighted average carbon intensity (WACI) of all asset classes where we undertake carbon footprinting (public equity and credit, infrastructure, real estate, real estate debt, direct lending and private equity)

Source: FHL, Trucost, Carbon Intelligence, Verco, MJ Hudson as at 31 December 2022.

#### **Public markets**

Over the course of 2022 we have continued to monitor the carbon intensity of our public market investments. We have seen a slight increase in our carbon footprint (more information on this described below) and our WACI has stayed relatively stable. We have increased our climate change engagement in 2022 compared to 2021, bringing this up to engaging with 80% of our public markets financed emissions. Finally, we have started to explore nature-related metrics and included these in the report below for the first time.

We have increased our climate change engagement in 2022 compared to 2021, bringing this up to engaging with

80% of our public markets financed emissions

Within public markets - listed equities and credit - we have seen aggregate carbon footprint decline by circa 32% since a peak at the end of 2018 to year end 2022. 2018 is the year we introduced the carbon tool, and this improvement seems to indicate its impact in helping our investment managers integrate, respond to, and manage transition risk within their portfolios. We use the enterprise value including cash (EVIC) method for calculating the carbon footprint of equity and credit assets. We have seen a slight increase in our carbon footprint between 2021 and 2022. This looks to be driven by an increase in market value in several of our top emitters. The top three contributors are Norsk Hydro, Press Metal Aluminium Holdings and Shoprite Holdings. All three have been engaged on climate change in the last year. Although Norsk Hydro is a high emitter, it is a leading company in the renewable energy space as well as working towards providing net-zero aluminium by 2050. Press Metal Aluminium is an aluminium smelter producing low carbon aluminium from renewable electricity and it has also set a target to be net-zero by 2050. Finally, Shoprite Holdings has been engaged on setting a science-based target and has made the commitment to setting science-based targets. The company has also committed to halving its scopes 1 and 2 emissions by 2030.

Figure 24: Carbon footprint  $(tCO_2e)$  invested) of corporate credit and equity in FHL shareholder and participating funds (scopes 1 and 2, and scopes 1, 2 and 3)



In addition to tracking our carbon footprint, we also track the WACI of our public equity and credit portfolios as shown in Figure 25. The analysis includes scope 1, 2 and 3 emissions. Between 2021 and 2022, the WACI has stayed relatively stable, with a slight increase when including scope 3.

**Figure 25.** Weighted average carbon intensity (tCO<sub>2</sub>e/\$m revenue, weighted by the proportion of each holding in the portfolio) of corporate credit and equity in FHL shareholder and participating funds.

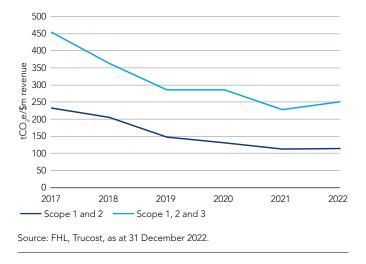
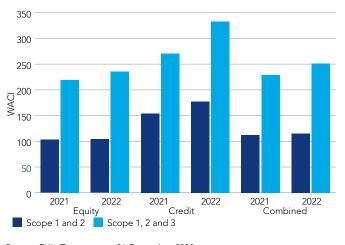


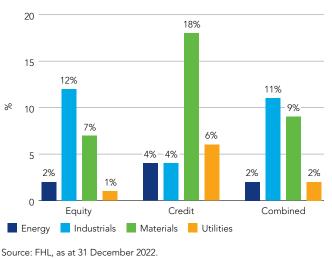
Figure 26 splits out the WACI by equity and credit. The WACI of public equity for scope 1 and 2 has stayed stable year-onyear, however when including scope 3 there has been a slight increase. The WACI of public credit has had an increase across scope 1 and 2, and particularly across scope 3. Having investigated this increase with the third-party data provider, Trucost, this looks to be driven by an increase in both Cemex and Cleveland Cliffs respective revenues, which resulted in an increase in their respective carbon emissions. **Figure 26:** Weighted average carbon intensity (tCO<sub>2</sub>e/\$m revenue, weighted by the proportion of each holding in the portfolio) of corporate credit and equity in FHL shareholder and participating funds.



Source: FHL, Trucost, as at 31 December 2022

In Figure 27 we look at our exposure to carbon intensive sectors (energy, industrials, materials and utilities) in shareholder and participating funds (both equity and credit). Out of the four carbon intensity sectors, our equity funds have most exposure to industrials whereas our credit funds have most exposure to materials.

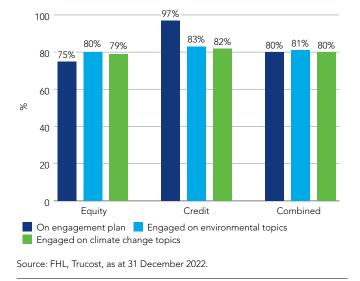
Figure 27. Public markets exposure (% of AUM) to carbon intensive sectors in FHL shareholder and participating funds (credit and equity).



We believe that climate is a material risk across a variety of sectors, and therefore climate change is an important topic for our engagement. We will aim to engage with our top emitters, with a first focus on the top 100 emitters across our public equity and credit funds which makes up c. 80% of our public equity and credit carbon footprint. Issuers that are not added to our formal engagement plan will be engaged by our investment teams who will continue their dialogue with companies to better understand their transition plans. In our private market asset classes, our dialogues with companies are directly via our investment teams given the nature of the relationships in these asset classes. Climate change will

continue to be a main point of conversation to ensure we have a good understanding of the climate risks of the asset and appropriate actions are being undertaken to minimise the transition risk and ensure we remain on track to meet our net zero target. Figure 28 shows the proportion of the carbon footprint of our corporate credit and equity investments that was covered in 2022 by our engagement both on all environmental topics and specifically on climate topics. Over the last year we have increased our engagement on climate change. In 2021, 54% of our public markets carbon footprint was engaged on climate change and we have increased this to 80% in 2022.

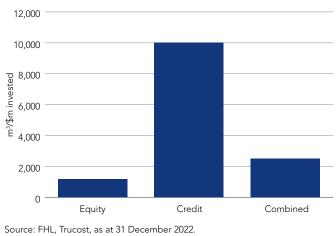
**Figure 28.** Percentage of public markets carbon footprint (scope 1, 2 and 3) on the engagement plan and engaged on environmental and climate change topics by EOS in FHL shareholder and participating funds (credit and equity).



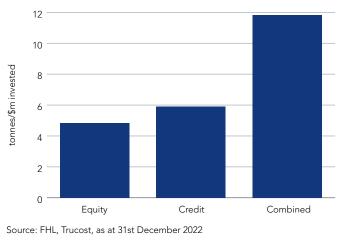
As well as identifying climate risks across our portfolios, we also recognise the importance of identifying climate opportunities, and companies who provide products and services which lead to avoided emissions. Due to the complexity of calculating this type of metric, we currently only assess avoided emissions for our impact and sustainable strategies. As at 31 December 2022, the total avoided emissions of our impact and sustainable strategies in public markets was 2.16bn tCO<sub>2</sub>e and the total apportioned (based on the proportion of our ownership of the company) avoided emissions of our impact and sustainable strategies in public markets was 343,389 tonnes CO<sub>2</sub>e.<sup>44</sup>

Through our environmental tool, we also assess the water and waste footprint of our portfolios. This is the first time we have reported these metrics, and the below charts show the water footprint (direct cooling, direct processing and purchased water) and waste footprint (landfill, incinerated and nuclear) of our public market funds.





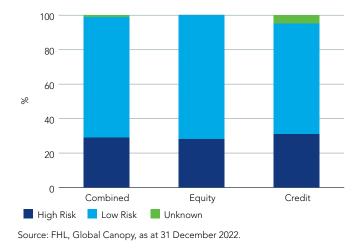
**Figure 29b.** Waste footprint (tonnes/\$m invested) of corporate credit and equity in FHL shareholder and participating funds.



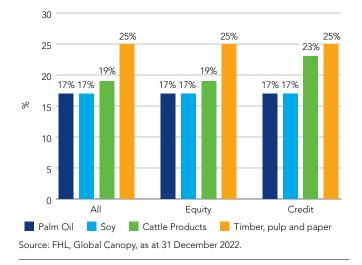
In line with our commitment on deforestation, we are working on assessing our potential exposure to commodity-driven deforestation. In line with the recommendations of Global Canopy, our first step has been to identify which of our investments are in high-risk sectors for exposure to commodity-driven deforestation. We have used Global Canopy's list of high-risk sectors to conduct this analysis. Throughout the course of 2023, we will continue to develop our risk assessment for deforestation.

Figure 30a below shows the proportion of our AUM in public markets which is at high-risk of exposure to commodity-driven deforestation based on sector analysis. Figure 30b further splits this data out into the key forest-risk commodities and shows that timber, pulp and paper is the most common commodity for those investments in sectors at high risk of exposure to forest-risk commodities. This analysis is based only on sectors and does not assess whether companies have actual exposure to these commodities.

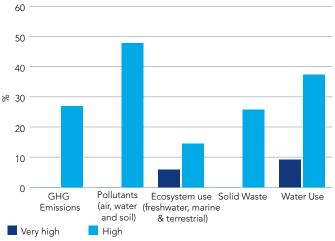
**Figure 30a.** Public markets exposure (% of AUM) to sectors at high risk of exposure to commodity-driven deforestation in FHL shareholder and participating funds (credit and equity)



**Figure 30b.** Public markets exposure (% of AUM) to potential forestrisk commodities, identified through sector at risk analysis in FHL shareholder and participating funds (credit and equity)

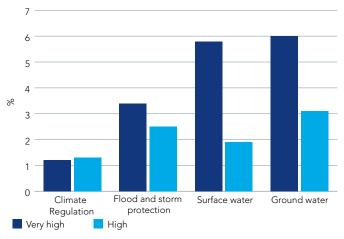


As a first step towards assessing our impacts and dependencies on biodiversity, we have looked at our exposure to sub-industries that have potential high and very high impacts and dependencies. Figure 31a and b show that through our sub-industry exposure, we have the greatest exposure to sub-sectors with potential impact on biodiversity through pollutants, and potential dependency on water (both surface and ground water). We will continue to develop our approach to assessing our exposures during 2023. **Figure 31a.** Public markets exposure (% of AUM) to potential impacts on biodiversity (very high and high materiality) in FHL shareholder and participating funds (credit and equity)



Source: FHL, ENCORE, as at 31 December 2022.

**Figure 31b.** Public markets exposure (% of AUM) to potential dependencies on biodiversity (very high and high materiality) in FHL shareholder and participating funds (credit and equity)



Source: FHL, ENCORE, as at 31 December 2022.



## **Private markets**

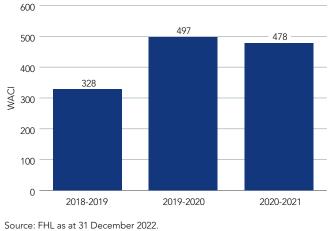
#### Infrastructure

Our infrastructure team has been collating Scopes 1 and 2 carbon emissions data from its portfolio companies since 2017. All companies, except the two fund investments and one renewables Special Purpose Vehicle, report on their Scope 1 and 2 emissions (representing over 94% coverage overall by NAV) and we use this data to monitor the emissions of our infrastructure portfolio. When calculating the emissions of our portfolio, we use gross figures and do not include any 'avoided' emissions from renewable energy generation. Gross scope 1 & 2 emissions across the portfolio companies we are invested in decreased by 6.2% in 2022 versus 2021. The largest emitters, Cadent (the UK's largest gas distribution network) and Viridor (a leading UK recycling, resource and waste management company) together make up 81% of gross emissions in the infrastructure portfolio (38% and 43% respectively). Cadent's gas leakages, comprising c.95% of its overall greenhouse gas emissions, continue to decrease as a result of an ongoing mains replacement programme, which is overhauling largely iron pipes with modern alternatives.

The infrastructure team also engages with portfolio companies to report scope 3 emissions, and 73% of companies by NAV now report on these.

Despite absolute emissions reducing, as shown in Figure 32, the WACI has modestly increased 3% between 2021 and 2022. This is largely a result of Cadent's increasing Net Asset Value relative to the rest of the portfolio, meaning it has a higher weighting. We continue to engage with all portfolio companies to establish targets and further reduce their emissions in line with the needs of the Paris Agreement and UK carbon budgets.<sup>45</sup>

**Figure 32.** The weighted average carbon intensity of our infrastructure portfolio (tCO<sub>2</sub>e/fm revenue, weighted by the proportion of each investment in the portfolio)



#### **Real Estate**

In 2019 we set a target to reach net zero by 2035 this includes all scopes of carbon emissions from both landlord and occupier use. We continue to make progress on this target through the construction of a pathway for all asset types in 2021 and the roll out of net zero audits across multiple funds. The effects of lockdown and post lockdown operations has had an effect on the emissions we have seen from all asset types. During lockdown all assets remained open and operational with increased use of ventilation in order to maintain clean air flow within the properties.

Figure 33a shows the long-term performance of our portfolio. It depicts the annual emissions from energy usage for areas we manage in our real estate portfolio. The chart includes only the properties within our real estate portfolio for which we supply energy. There may be areas within these properties for which we do not supply energy as they are managed by our tenants, and which are therefore not captured in the chart below. Due to variation in the size and energy needs of individual assets, it is not feasible to normalise the carbon footprint for the whole portfolio by floor area. However, the chart below shows that in 2010  $66,939 \text{ tCO}_2$ e were emitted by 152 properties.

Over the course of 2022, proactive property management helped to ensure that absolute carbon emissions continued to fall. This was also supplemented by the continued decarbonisation of the UK grid and a move to 100% green electricity for all assets where we have freedom to negotiate supply contracts.

The infrastructure team also engages with portfolio companies to report scope 3 emissions, and

73% of companies by NAV now report on these.

<sup>45</sup> Weighted average carbon intensity for assets managed by the Infrastructure Team of Federated Hermes. A change in reporting methodology, which has been applied to all three years, means that outputs for each portfolio company are based on the December valuation and the annual emissions for the financial year ending in the same calendar year. Figures exclude Scope 3 and avoided emissions. 2019 figures exclude: Iridium Hermes Roads (asset was acquired in January and April 2020), Energy Assets Group (realised in April 2020 which lead to a lack of available data), Ventus (lack of available data), and Viridor (acquired in July 2020). 2020 figures exclude Braes of Doune (realised in February 2021 which lead to a lack of available data). Indirect investment holdings are excluded.

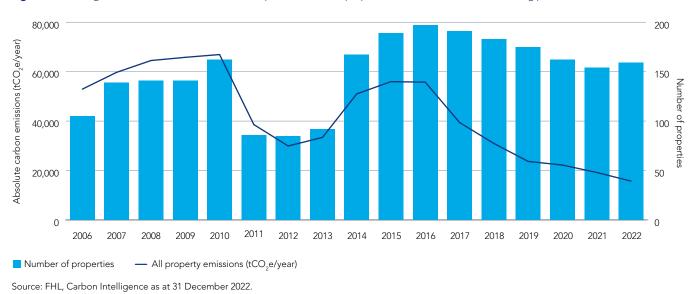
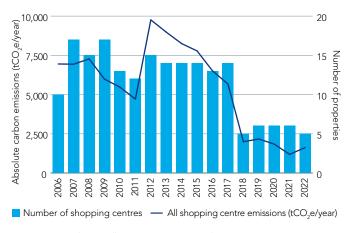


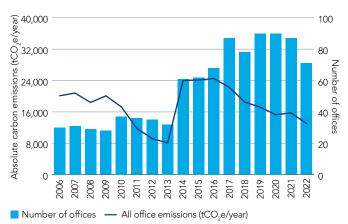
Figure 33a. Changes in absolute carbon emissions (Scope 1 and 2) for all properties in landlord-controlled standing portfolio between 2006 and 2022

**Figure 33b.** Changes in absolute carbon emissions (Scope 1 and 2) for shopping centres in landlord-controlled standing portfolio between 2006 and 2022



Source: FHL, Carbon Intelligence, as at 31 December 2022.

Figure 33c: Changes in absolute carbon emissions (Scope 1 and 2) for offices in landlord-controlled standing portfolio between 2006 and 2022



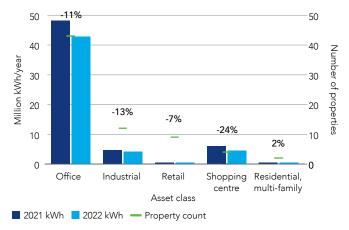
Source: FHL, Carbon Intelligence, as at 31 December 2022.



As of 31 December 2021, offices account for 75% of overall portfolio emissions, compared with 9% for shopping centres. Other retail and industrial buildings account for 15%.

Figure 34 shows the annual change in  $CO_2$  emissions on a like-for-like basis for each real-estate asset class over a period of 24 months, adjusted for heating degree days. We have only included assets where there was consistency over the 24-month period in terms of void rates, occupancy rates and major refurbishment. In all asset classes we have seen a mixed picture on energy consumption. The main cause of this is the rebound from covid lockdown as office use has increased. In retail and industrial asset types, the reduction shows that there is an underlying efficiency where asset types are operating at similar use rates across both years. Residential increase has remained the same across the 24-month period.





Source: FHL, Carbon Intelligence as at 31 December 2022.

## The path ahead

We recognise there is still significant work needed to be done to limit temperature warming to less than 1.5°C above preindustrial levels. We will continue to leverage our engagement and proxy voting capabilities to elevate the ambition and action of our portfolio companies, and we will continue to support a focused range of advocacy initiatives in an effort to encourage a transformation of the whole industry. FHL has sought to report on a wide range of environmental metrics, in an effort to understand the climate-related risks, and where possible nature-related risks, our portfolios are exposed to. We continue to further incorporate nature into our approach and explore metrics to better identify the positive opportunities offered by the transition. The TCFD and CFRF recommendations on metrics formed the basis for ongoing dialogue across our firm on how to provide robust, best-inclass disclosure. At the same time, we are aware that the methods and data required to evaluate climate and nature exposure are still advancing and maturing, and as such we will continue to focus our efforts on incorporating the most robust and forward-looking approaches over time.

#### Offices account for







# **Federated Hermes**

Federated Hermes is a global leader in active, responsible investing.

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, where possible, to contribute to positive outcomes that benefit the wider world.

All activities previously carried out by Hermes Investment Management are now undertaken by Federated Hermes Limited (or one of its subsidiaries). We still offer the same distinct investment propositions and pioneering responsible investment and stewardship services for which we are renowned – in addition to important strategies from the entire group.

# Our investment and stewardship capabilities:

- Active equities: global and regional
- Fixed income: across regions, sectors and the yield curve
- Liquidity: solutions driven by four decades of experience
- Private markets: real estate, infrastructure, private equity and debt
- Stewardship: corporate engagement, proxy voting, policy advocacy

For more information, visit **www.hermes-investment.com** or connect with us on social media:



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