ESG Materiality

Q4 2020

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Federated Hermes
International

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Introduction

Responsible investing in practice

Over the past decade, we have sought to act as responsible investors in emerging markets by focusing on companies that can tackle sustainability challenges as they arise. To explore our vision for responsible long-term investing in emerging-market equities, please read our commentary.

In our ESG Materiality Newsletter, Q4 2020, we seek to demonstrate our engagement activity with portfolio companies and showcase holdings that create positive impact aligned to the Sustainable Development Goals (SDGs). We also explore an environmental, social and governance (ESG) theme and its implications for the asset class.

Engagement overview

Engagement is a key part of our process. We believe it helps us gain a deeper insight into companies' past and future opportunities and it can contribute to unlocking shareholder value and/or limiting downside risks. We engage alongside our colleagues at EOS at Federated Hermes ('EOS'), who are leading experts in stewardship and advocacy. Our engagement approach is systematic and transparent. To measure our progress and the achievement of engagement objectives, we use a four-stage milestone strategy.

When we set an objective at the start of an engagement programme with a portfolio company, we will also identify recognisable milestones that need to be achieved. Progress against these objectives is assessed regularly and evaluated against the original engagement proposal.

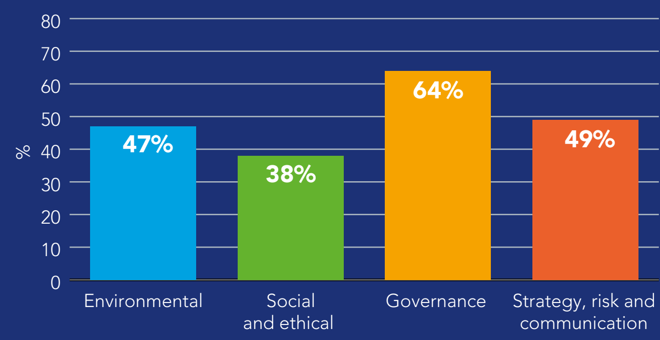
Engagement highlights, Q3 2020

As of the end of September 2020, we engaged:

76%

of our holdings in terms of AUM

% of AUM engaged by theme



Source: Federated Hermes, as at 30 September 2020.

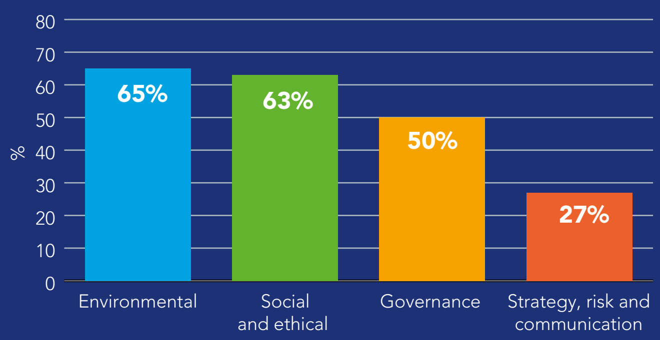
Engagement progress over the last 12 months

Actual: **49%**

Internal target: **40%**

Source: Federated Hermes, as at 30 September 2020.

Engagement progress by theme

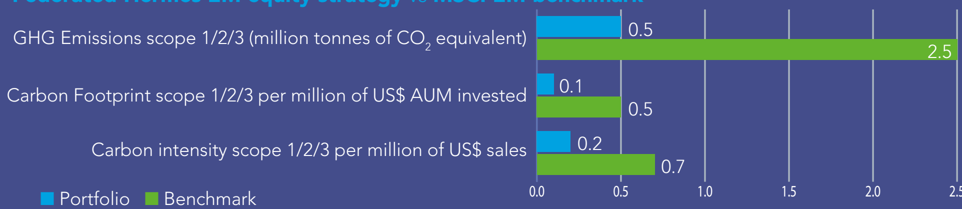


Source: Federated Hermes, as at 30 September 2020.

Our portfolio's carbon footprint, Q3 2020

Our portfolio is considerably greener than the MSCI emerging-market benchmark in terms of scope 1, scope 2 and scope 3 greenhouse gas (GHG) emissions[1].

Federated Hermes EM equity strategy vs **MSCI EM benchmark**



Source: Federated Hermes as at 30 September 2020. The benchmark is the MSCI Emerging Markets Index.

[1] We adopt the methodology set by the Task Force on Climate-related Financial Disclosures (TCFD) to measure our portfolio's emissions, carbon footprint and emission intensity. See Implementing the recommendations of the Task Force on Climate-related Financial Disclosures for further information.

ENGAGEMENT CASE STUDY

Taiwanese contract chipmaker

As the world's largest semiconductor foundry, the company's products are used in a wide range of applications in the computer, communications, consumer and industrial sectors, and are used in end markets such as mobile devices, high-performance computing, automotive electronics and the internet of things (IoT).

Engagement theme

- Environment: Climate change, water

As a core holding in our Global Emerging Markets strategies, we have had exposure to the world's largest semiconductor foundry for more than a decade. During this time, it has greatly outperformed the MSCI Emerging Markets IMI benchmark index[2] thanks to its ability to innovate, sound management team and corporate culture, and clear long-term vision.

Towards sustainable semiconductor manufacturing

The group's operations consume lots of electricity and water. It must be commended for its water-management framework, which include reducing water consumption and increasing water recycling. However, tackling electricity consumption has historically been challenging due to the shortage of sizeable green electricity suppliers in Taiwan. Yet there is pressure from responsible investors who see the business case for climate-change mitigation and adaptation strategies, and who recognise that meeting ambitious climate goals is increasingly important to the company's clients.

In 2019 its overseas sites achieved the goal of zero carbon emissions from power consumption, thanks to the purchase of Renewable Energy Certificates (RECs) and carbon credits[3] . This demonstrates the group's awareness of climate-change risks. However, RECs are often considered to be only the first step for a company seeking to achieve its environmental goals, and are ideally coupled with a plan to increase renewable sources at the expense of non-renewables in its energy mix. To this end, the company has set the following sustainability targets: it aims for 25% of the power consumed by its fabrication operations to be supplied by renewables and to procure 100% of its energy for the rest of the business from renewable sources by the end of 2030[4].

Despite these goals, the group's use of renewable energy is currently low. We recently engaged the senior management team to encourage the company to make progress on this front despite the constraints in the local power market[5]. They understood our views and highlighted the company's efforts to work with the Taiwanese government to overcome some of the obstacles.

Powering on: contract chipmaker takes green action

Following our engagement, the company signed a landmark 20-year deal to buy the entire power production – 920 megawatts – of a Danish power company's third offshore windfarm in Taiwan[6]. The Danish power company obtained permits for the wind farm in November 2019 and is expected to start commercial operations in 2025-2026, subject to grid availability and its final investment decision. The Taiwanese group has agreed to pay the power company a high price for this contract so as to purchase both the power and the underlying Taiwan RECs.

For the semiconductor foundry, this deal is strategically important: the company's power-purchasing agreements (PPA) for renewable energy will now total 1.2 gigawatts[7] – a significant increase over the current level. What's more, it should enable the group to eliminate more than 2m metric tonnes of carbon emissions per year[8].

The deal gave the group the confidence to join RE100[9] in the third quarter of 2020. In doing so, it became the first semiconductor company worldwide to join the alliance of businesses committed to 100% renewable-electricity use – the company has pledged that all of the power consumed in its manufacturing plants and offices worldwide will be sourced from renewables by 2050[10].

[2] Between 21/7/2009 and 30/09/2020, the company outperformed the MSCI Emerging Markets IMI benchmark index by 1114% in USD terms. Source: Bloomberg.
[3] "2019 Corporate Social Responsibility Report," published by the company.
[4] In the third quarter the targets were expanded to include also a long-term goal of sourcing 100% of the company's power from renewable energy (or buying RECs to meet this goal in the instances where direct purchases of renewable energy supply are not possible due to respective government regulations in the countries where the group operates manufacturing facilities - Taiwan, China and the US).
[5] The Taiwanese renewable energy market is constrained by a lack of sizeable green suppliers, regulations (the power market was liberalised in 2017, but it is still undergoing reforms) and limited space for solar and wind farms in the island.
[6] Source: Danish power company, as at August 2020.
[7] This represents 9% of electricity consumed in 2019 and is a clear step toward achieving the goals set for 2030. In 2019, the company consumed a total of 14,327 GWh in energy; with electricity making up 94.8%. Source: "2019 Corporate Social Responsibility Report," published by the company.
[8] Company press release published in July 2020.
[9] See RE100 members: https://www.there100.org/re100-members.
[10] Other meaningful 2030 environmental targets include reducing the greenhouse gas emissions per unit of production (metric ton of carbon dioxide equivalents (MTCO2e)/ 8-inch equivalent wafer mask layers) by 40% (Base year: 2010); and for renewable energy to account for 20% of energy consumption of new fabs starting from 3nm. Source: 2019 Corporate Social Responsibility Report," published by the company.

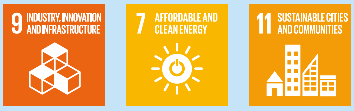
POSITIVE IMPACT CASE STUDY

Global leader in IoT intelligent systems and embedded platforms

Theory of Change

The company offers technology that supports and enables sustainable industrialisation, green transportation and renewable power generation.

SDG alignment:



One of our holdings offers its clients differentiated IT solutions, spanning sustainable industrialisation, green transportation and renewable energy. It is a global leader in Internet of Things (IoT) intelligent systems and embedded platforms.

The group's Industrial IoT (IIoT) business benefits from a strong position in the industrial PC market. It develops technologies that improve efficiency in industrial plants by facilitating enhanced data management and communication. In doing so, it is, among other things, establishing traceability along supply chains, predictive maintenance and automation as well as achieving workforce safety. For example, it helped a Taiwanese state-owned power company to build a smart-grid intelligence facility[11] and Beijing International Airport to adopt system management measures for energy conservation and environmental protection[12], thereby increasing their efficiency and helping them become more sustainable[13]. These examples serve to demonstrate that IIoT is a key enabler of sustainable industrialisation and innovation (that is, SDG 9) – and for the company, IIoT accounts for about a third of its sales[14].

One of the IIoT vertical industries the company targets is energy and environment – and this includes renewable energy (thereby serving SDG 7). For example, the company offers technology solutions to manage solar power plants, which in turn improve their operational efficiency through data accuracy and optimise the management of the assets. It also plans to devolve resources to develop more software and artificial intelligence (AI) products for the solar and wind sector in recognition of the fact that the global appetite for a greener economic system presents new opportunities for its business.

Within the group's Service IoT business, a number of vertical markets also contribute to the attainment of the SDGs – and, in our view, we believe this segment has strong potential to grow (it currently accounts for approximately 8% of the group's revenues). Its intelligent transportation systems unit sells products and solutions for railway transportation, traffic management and road/ railway safety. In doing so, it serves SDG 11 (sustainable cities and communities) because railway transportation can play a key role in sustainable mobility as the electrification of transportation reduces the consumption of carbon and increases safety[15]. What's more, traffic management reduces congestion, which in turn reduces greenhouse gas emissions.

The Taiwanese company is also a leading player in the global healthcare market. It's iHealthcare Service IoT division assists hospitals with advancing patient-centred healthcare.
By connecting various departments and exchanging data on integrated platforms, it provides monitoring solutions, information centres and other products that help create 'smart' hospitals.

Connecting our way to a sustainable future

Many of the group's technologies are cloud enabled, which means they do not require clients to have in-house server rooms or data centres. Indeed, outsourcing data centres to specialists has many benefits: it allows for better capacity utilisation, fewer idle resources, more efficient cooling systems and increased energy savings, which in turn translate to more environmentally friendly business practices.

The company's vision is to enable 'an intelligent planet' – and by offering IoT architecture to various sectors, it assists its clients in connecting their value chains. In turn, this enables them to communicate, run smoothly and improve results. The company has also added energy star labels, the US government-backed symbol for energy efficiency, to many of its products – a strategy that can help its clients become more sustainable.

[11] Company press release published in August 2019.
[12] Company press release published in May 2020.
[13] The company publishes a rich list of case studies to highlight how its technologies support a vast range of activities, including wastewater treatment, product safety and traceability in the food industry, eco-friendly dyeing and printing for the textile industry, or tracking healthy beehive population.
[14] Company's analyst meeting, in August 2020.
[15] According to the International Energy Agency (IEA), rail is among the most energy efficient modes of transport for freight and passengers. And with three-quarters of passenger rail transport activity taking place on electric trains today, the rail sector is the only mode of transport that is widely electrified.

IN FOCUS:

ESG implications for emerging markets and our portfolio in a post-Trump world

The election of Democrat Joe Biden as US President has buoyed the spirits of ESG investors everywhere on the strength of his progressive agenda that could roll back much of the Trump era policies.

But while Biden will be restrained by a Senate that, as at the time of writing, remains in Republican control and other political machinery left in situ by the previous administration (such as a conservative-leaning Supreme Court), the new US leader could still push through significant changes in line with sustainable investment themes.

For example, Biden has vowed to re-join the Paris Accord within days of taking office next year, bringing the US back inside the global climate change tent. Returning to the Paris Agreement should be a relatively easy step, given it simply requires an executive order from the new President. Other ESG-friendly policy efforts may be harder for Biden to implement under legislative changes that could be blocked in a Republican-controlled Senate. Nonetheless, the potential for progress on vehicle emission standards under the Clean Air Act augur well for sustainability focused investors.

The President-elect may also take a harder line against regimes known for causing geopolitical tensions or human rights abuses – such as Turkey[16] or Russia – and seal a *'freeze-for-freeze'* deal with Iran.

Of course, much could happen in the remaining weeks before Biden's inauguration in January 2021 let alone the next four years, but we have sketched out several scenarios that could flow on from new US policies to our asset class and our portfolio.

Why clean energy will trump dirty politics

The Biden administration will take a tougher stance on fossil fuel use and fracking – to what extent will depend on Senate support. However, the President-elect is pushing for a US$2tn spending program, including US$400bn earmarked for renewable energy infrastructure to establish a 100% carbon-free electric market by 2035 (compared to 37% as at 2019).

The Biden-Sanders Unity Task Force released a plan calling for 60,000 made-in-America wind turbines alongside 500m solar panels in five years. The US already has 60,000 operational wind turbines and around 105 gigawatts (GW) of installed capacity, which makes it the second-largest country in terms of cumulative installed capacity of wind power worldwide after China (237GW in 2019)[17].

However, the global wind industry is concentrated and polarised: the top five wind original equipment manufacturers (OEMs) control over two-thirds of the market globally[18]. Of the top five wind OEMs two are Chinese companies with little or no presence in the US, and the other three are Western multinationals with plants in the US (as well the rest of the globe).

Clearly, the multi-national wind firms are better-positioned to directly benefit from Biden's '*Buy American*' agenda but there will be spill-over effects for the whole wind industry, including for companies whose products help connect renewables to the grid and/or store the energy produced.

In our portfolio, for instance, a Brazilian company could see sales of power transformers to the US market rise as the group grows its share from the current level of 4% in a US$2.7 billion market in North America. The group's energy storage division should likewise benefit from the acquisition of the battery business of Vermont-based Northern Power Systems in 2019. In the first nine months of 2020, North America accounted for 46% of the company's total sales, with the US being 82% of that.

Meanwhile, the global solar panel market is solidly in the hands of Asian suppliers, some of which have plants in the US, potentially ticking the Biden made-in-USA box if needed.

To meet the proposed green energy ambitions of the President-elect the US would need to significantly boost solar power generation from the 2019 level of 76 GW.

Energy consultancy firm, Wood Mackenzie (WoodMac), expects that the US solar power industry is already on track to add more than 18GW in 2020, rising to more than 20GW by 2022. The data suggests that even if the Democrats' grand plan fails to materialise[19] the US solar market is headed for significant growth.

[16]The Trump administration has recently imposed sanctions on Turkey in relation to its purchase of a Russian missile defence system and EU leaders are preparing sanctions against Turkey in relation to the dispute over natural gas resources in the Mediterranean Sea. See https://www.ft.com/content/9423f6a8-a096-4907-b62f-668b559f187f for more information.

[17]"Democrats' Platform Draft: Near-Term Renewables Surge, Net-Zero by 2050," published by Green Tech Media in July 2020.

[18]"Wind turbine sizes keep growing as industry consolidation continues," published by GWEC in May 2020. Source: Statista, as at 2019.

[19]According to WoodMac, the options for radical progress will be limited if Mitch McConnell from coal-loving Kentucky remains Senate Majority Leader. Biden has promised to extend the Investment Tax Credit (ITC) to encourage new solar installations. The solar ITC is one of the most important federal policy mechanisms to support the growth of solar energy in the US. Since the ITC was enacted in 2006, the US solar industry has grown by more than 10,000% (52% per annum) as it offered a 26% tax credit for solar systems on residential (under Section 25D) and commercial (under Section 48) properties. This mechanism is due to lapse and the incentive started to phase out in 2019: after 2021, the residential credit drops to zero while the commercial credit drops to a permanent 10%, safe for a bipartisan extension that is.

We own a Taiwanese electronics manufacturing company, which booked over 25% of its total sales in the US during 2019. The group's infrastructure division includes renewable energy, energy storage systems and electric vehicles (EV) charging.

Since 2008 the company has also sold photovoltaic (PV) on-grid/off-grid solutions for residential, commercial and utilities clients. It already has a solid presence in the US with clients in Arizona and California for its commercial rooftop solutions. As well, the group offers modular solar system blocks that exhibit a payback period of three to six years (depending on the incentive and tax benefit).

Energy storage and charging are key elements of the green revolution. Generally, renewable technologies need batteries to store and release the energy as needed. The company's energy storage systems are based on Li-ion technology with a portfolio ranging from small cells to large battery cabinets or containers. In the EV charging field, it has worked with the US Department of Energy to develop next-generation smart-grid-capable EV chargers and the site management system, enabling comprehensive management of EV charging.

Aside from the Taiwanese electronics manufacturing company, we have indirect exposure to the energy storage market via our holding of one of the leaders in the battery market for EV globally.

The Korean-based company has strongly expanded its capacity to reach 3.4 GWh (up 52.6% from 2.2 GWh), North America represents about 10% of this company's total sales.

The new US administration could amp up subsidies for electric, hybrid or hydrogen fuel-cell cars vehicles by offering rebates and/or tax incentives. Biden said his plan for dealing with climate change also includes building 500,000 electric vehicle charging stations on US highways as well as investing in clean energy public transportation systems such as electric buses.

As cautioned earlier, Democrats might not be able to come good on all their green energy promises given they probably won't control both houses of the US government. But regardless of the political outcomes, energy transformation is a global structural trend driven by more than sustainability considerations. Fossil-free fuels are becoming increasingly competitive versus legacy ones thanks to a colossal drop in the levelised cost of energy per megawatt hour (LCOE)[20] and EV battery costs.

In other words, the green revolution is also about economics rather than just climate ethics, which should encourage Republicans to support the trend. For stock-pickers, though, the devil, as usual, will be in the detail with issues such as incentives (and who gets them) likely to favour some companies over others.

And, as a reminder that stock markets focus on details, it's worth noting that in spite of Trump's unabashed support for the US fossil fuel industries, the sector has lagged amid the structural transformation: oil companies have underperformed the S&P 500 for years as investors embraced the idea that (loosely regulated) data is the new oil.

During Trump's tenure numerous US states set green energy targets. In a statistic little noted by the almost former President, from 2016 to 2019 coal-fired electricity generation declined by 22% in the US as solar and wind energy production grew 40%.

Protecting the rights of Dreamers

Along with a clean energy agenda, Biden will likely adopt a more conciliatory immigration policy than his predecessor. The Democrat is also expected to seek long-term solutions targeting the causes of migration, which could include increased US engagement and aid towards Central America.

Biden said during his campaign that protecting 'Dreamers' will be a priority. While the Deferred Action on Childhood Arrivals (DACA) programme started by former President Obama in 2012 affects less than 650,000 young people, the vast majority of them were born in Central and South America: Mexican-born children represent over 80% of the DACA cohort[21]. Hence, protecting the rights of Dreamers will send a positive message to America's southern neighbours, in contrast with the Trump militarisation of the frontier and his infamous 'wall'.

The next step – although very unlikely in the event of a split Congress – might see Biden seek deeper reforms including a pathway to citizenship for the millions of undocumented immigrants in the US from emerging market countries.

Evidence suggests that official citizenship papers help immigrants get better jobs at a higher salary[22]. If the Biden administration can turn millions of undocumented immigrants into citizens, the value of remittances sent to Mexico and the rest of Latin America could increase by billions of dollars[23].

In addition, a softer stance on immigration could have a small positive effect for Indian IT companies in our portfolio.

According to Forbes, US tech companies will be relieved if a Biden administration returns to Obama-era immigration policies because Trump made it difficult to attract and retain talent in a globally competitive world.

Indeed, this year the US tightened the issuance of work visas, including those issued under the H-1B programme, which is often used by big tech companies to bring in high-skilled immigrants from China and India to the Silicon Valley.

[20]According to Lazard (2020), the LCOE for unsubsidised wind dropped by 71% in 2009-2020 (-11% CAGR) and solar dropped by -90% (-19% CAGR).
[21]Source: U.S. Citizenship and Immigration Services, as at December 2019.
[22]A survey released by the Center for American Progress, the National Immigration Law Center, and United We Dream in 2018, indicates that the average hourly wage respondents increased by 78% since receiving DACA, from $10.32 per hour to $18.42 per hour.
[23]According to BBVA (Yearbook of Migration and Remittances Mexico 2020), 39 million Mexicans lived in the US in 2019 and remittances to Mexico reached US$ 36.4 billion in 2019, or 2.9% of Mexican GDP. Despite the COVID-19 crisis, the remittances to Mexico are expected to reach US$ 39.5 billion in 2020 (remittances to Latin America and the Caribbean will reach US$ 70.4bn. According to a Pew Research Center analysis of the U.S. Census Bureau's American Community Survey, 69% of the Mexican origin population living in the US was born in the US. This is the portion of the population with highest hopes of naturalisation one day.

A more benevolent immigration policy could allow emerging market IT companies to send their high-skilled workers to work on projects in the US and save costs. Admittedly, such a move would not be a game-changer – the US is already a core market for some of the Indian IT companies in our portfolio and two of those companies have established a strong local presence in the country. But a more open attitude to allowing high-skilled workers into to the US would still help, especially if coupled with Biden's promised plan for US$300bn support to breakthrough technologies including research and development (R&D) in fields ranging from EV to 5G and artificial intelligence (AI)[24].

Trees climb the agenda

As discussed previously, Biden promised to re-join the Paris climate agreement within days of taking office in a move that will give a significant boost to global climate policy efforts.

Potentially, the imminent Democrat administration may pressure the Brazilian government to act against deforestation in the Amazon, including by dangling the carrot of Article 6 in the Paris Accord (assuming that the US re-joins it). Article 6 covers international carbon markets and other forms of cooperation, but the clause has remained unresolved since the rest of the Paris accord was introduced. If adopted under US support, Article 6 could set a way to reward Brazil financially for the vast carbon storage abilities of the Amazon[25].

Naturally, any Amazon-saving powers of Article 6 would depend on the carbon price and other technical details, but Brazil could theoretically benefit from a more constructive stance in international climate negotiations under Biden leadership. The Brazilian Environment Minister Riccardo Salles has signalled an opening to negotiations by saying that Brazil could pledge to carbon neutrality by 2060 (or earlier) if other nations and investors sponsor the conservation of the Amazon forest with US$10bn per year.[26]

The Democrat administration may also have responsible investment implications in emerging markets for geopolitics, the fight against COVID, mandatory ESG disclosures for US-listed companies, rules that may make it easier for US pension funds to invest in ESG vehicles among other developments: time will tell; for Biden the clock starts ticking soon.

[24] "Tech after Trump: what a Biden win will mean for Asia," published by the FT in November 2020.

[25] According to the International Emissions Trading Association (IETA), a non-profit business organisation, article 6 has the potential to reduce the total cost of implementing nationally determined contributions (NDCs) by more than half (approximately $250 billion cost reduction per year in 2030), or alternatively facilitate the removal of 50% more emissions (approximately 5 gigatonnes of carbon dioxide per year [$GtCO_2$/year] in 2030), at no additional cost. And Brazil could become one of the largest sellers of international carbon credits before 2050.

[26] "Brazil Puts a $10 Billion-a-Year Price Tag on Carbon Neutrality," published Bloomberg in December 2020.

The value of investments and income from them may go down as well as up, and you may not get back the original amount invested. Any investments overseas may be affected by currency exchange rates.

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Federated Hermes
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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 to contribute to positive outcomes that benefit the wider world.

All activities previously carried out by Hermes now form the international business of Federated Hermes. Our brand has evolved, but we still offer the same distinct investment propositions and pioneering responsible investment and stewardship services for which we are renowned – in addition to important new 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

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