OUTCOMES BEYOND PERFORMANCE

PUBLIC ENGAGEMENT REPORT

Turning the tide on plastic pollution

Q1 2019

www.hermes-investment.com

This report contains a summary of the stewardship activities undertaken by Hermes EOS on behalf of its clients. It covers significant themes that have informed some of our intensive engagements with companies in Q1 2019. The report also provides information on voting recommendations and the steps we have taken to promote global best practices, improvements in public policy and collaborative work with other long-term shareholders.

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This report has been written and edited by Claire Milhench, Communications & Content Manager, Hermes EOS

ENGAGEMENT BY REGION

Over the last quarter we engaged with 350 companies on 777 environmental, social, governance and business strategy issues and objectives. Our holistic approach to engagement means that we typically engage with companies on more than one topic simultaneously.

ENGAGEMENT BY THEME

A summary of the 777 issues and objectives on which we engaged with companies over the last quarter is shown below.

Environmental topics featured in 28% of our engagements over the last quarter.

- Climate Change **77.7%**
- Forestry and Land Use **2.3%**
- Pollution and Waste Management **12.7%**
- Supply Chain Management **4.1%**
- Water **3.2%**

Social topics featured in 20% of our engagements over the last quarter.

- Bribery and Corruption **3.9%**
- Conduct and Culture **15.5%**
- Diversity **10.3%**
- Human Capital Management **32.9%**
- Human Rights **25.8%**
- Labour Rights **8.4%**
- Tax **3.2%**

Governance topics featured in 35% of our engagements over the last quarter.

- Board Diversity, Skills and Experience **35.7%**
- Board Independence **16.7%**
- Executive Remuneration **32%**
- Shareholder Protection and Rights **11.9%**
- Succession Planning **3.7%**

Strategy and risk topics featured in 17% of our engagements over the last quarter.

- Audit and Accounting **4.5%**
- Business Strategy **33.8%**
- Cyber Security **4.5%**
- Integrated Reporting and Other Disclosure **33.1%**
- Risk Management **24.1%**

WASTE NOT, WANT NOT

Reinventing the plastics economy

Companies are under pressure to address profligate plastics use as environmental degradation mounts, public sentiment shifts, and policymakers respond to calls for action. How can investors spur change in sectors such as consumer goods, retail and chemicals?

Setting the scene

Plastic is a durable and versatile material that has transformed industries, offers substantial social benefits, and is essential to the low carbon transition. Yet the benefits associated with plastic are challenged by increasing public awareness of the resources consumed. There is also mounting scientific evidence of the damaging ecological and human health consequences of the 'take-make-waste' model. As of 2015, on a cumulative basis, approximately 8.3 billion tonnes of virgin plastics had been produced, with 6.3 billion tonnes ending up as waste[1]. Of this, only 9% was recycled and another 12% incinerated. The current plastics consumption model is inherently unsustainable.

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Virgin plastics as of 2015:

8.3BLN T had been produced

6.3BLN T ended up as waste[1]

9% was recycled

12% incinerated

1 Geyer, Jambeck, Law Sci. Adv. 2017; 3: Production, use, and fate of all plastics ever made

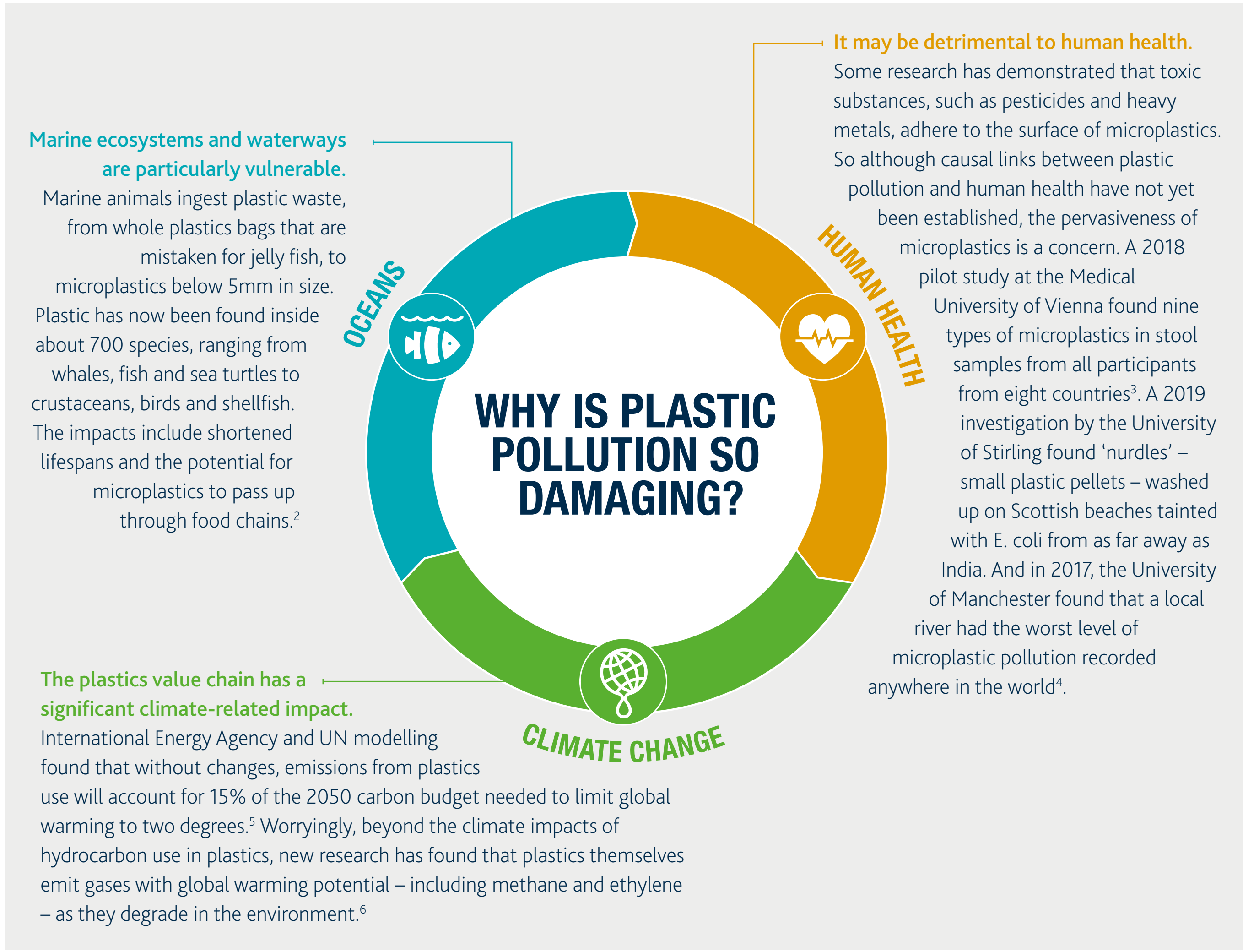
A whale that washed ashore in the Philippines in March 2018 was found to have died after eating 40kg of plastic bags, a shocking discovery that once again spotlighted plastic's damaging impact on the marine environment.

Headlines like this, underpinned by scientific research on the wider harms, are raising public awareness of the scale of the plastics problem and triggering progressive responses from policymakers. This will expose plastics value chains to unanticipated costs and disruptions.

For example, in January, the European Parliament voted to ban 10 single-use plastics that make up half of marine litter. Other markets have already moved. Last December, the United Nations (UN) found that 127 countries had adopted some form of regulation on plastic bags, while 27 had either banned or restricted single-use plastics. This includes Kenya, which in 2017 introduced jail terms of up to four years to combat rampant plastic pollution from bags and other sources.

But investor concerns go beyond the regulatory, physical and legal risks of business-as-usual plastics consumption. Reputational risk stemming from high-profile exposures of corporate behaviour, and the corresponding loss of consumer goodwill, also endanger shareholder value. For companies reliant on plastics value chains, these interrelated flashpoints may adversely affect financial performance. Meanwhile, finding alternatives to single-use plastic may present a commercial opportunity.

The United Nations found that 127 countries had adopted some form of regulation on plastic bags, while 27 had either banned or restricted single-use plastics.



Marine ecosystems and waterways are particularly vulnerable. Marine animals ingest plastic waste, from whole plastics bags that are mistaken for jelly fish, to microplastics below 5mm in size. Plastic has now been found inside about 700 species, ranging from whales, fish and sea turtles to crustaceans, birds and shellfish. The impacts include shortened lifespans and the potential for microplastics to pass up through food chains.[2]

It may be detrimental to human health. Some research has demonstrated that toxic substances, such as pesticides and heavy metals, adhere to the surface of microplastics. So although causal links between plastic pollution and human health have not yet been established, the pervasiveness of microplastics is a concern. A 2018 pilot study at the Medical University of Vienna found nine types of microplastics in stool samples from all participants from eight countries[3]. A 2019 investigation by the University of Stirling found 'nurdles' – small plastic pellets – washed up on Scottish beaches tainted with E. coli from as far away as India. And in 2017, the University of Manchester found that a local river had the worst level of microplastic pollution recorded anywhere in the world[4].

The plastics value chain has a significant climate-related impact. International Energy Agency and UN modelling found that without changes, emissions from plastics use will account for 15% of the 2050 carbon budget needed to limit global warming to two degrees.[5] Worryingly, beyond the climate impacts of hydrocarbon use in plastics, new research has found that plastics themselves emit gases with global warming potential – including methane and ethylene – as they degrade in the environment.[6]

2 https://ocean.si.edu/conservation/pollution/marine-plastics and peer reviewed journals
3 https://www.meduniwien.ac.at/web/en/about-us/news/detailsite/2018/news-october-2018/microplastics-detected-in-humans-for-the-first-time/
4 https://www.manchester.ac.uk/discover/news/uk-rivers-microplastics/
5 http://www3.weforum.org/docs/WEF_The_New_Plastics_Economy.pdf
6 https://www.hawaii.edu/news/2018/08/01/greenhouse-gases-linked-to-degrading-plastic/)

Rethinking plastics

It's important to recognise that plastics can play an essential role in low carbon transitions, fulfilling needs as diverse as lightweight components for electric vehicles and reducing food waste through protective packaging.

We cannot underestimate the role of plastics in critical services, such as healthcare, hazardous waste control and early-life nutrition. But negative environmental and social impacts have not been fully considered in plastics design, value chains, and use. We believe it is essential for companies and society to fundamentally rethink plastics use, whilst avoiding unintended consequences from potential solutions, which may be detrimental.

We believe it is essential for companies and society to fundamentally rethink plastics use.

Within our thematic approach to pollution, waste and the circular economy, Hermes EOS is intensifying its engagement with companies along the plastics value chain. We expect companies to move from the treatment of plastic as an externalised risk, to developing strategies that consider it as a resource requiring responsible management throughout its lifecycle – in partnership with suppliers, customers, recyclers and regulators. These strategies could include recycling, resource recovery, the consideration of reduction, substitution and recyclability in design, and working across value chains to develop and scale sustainable consumption models based on circular economy principles.

For the priority sectors, our objectives will focus on the need for companies to articulate and disclose their ambitions and strategies for reducing the negative impacts of plastic and generating solutions with meaningful and scalable outcomes, to move beyond 'take-make-waste'.

Chemicals

As suppliers of plastics inputs, chemicals companies play a crucial role in finding materials solutions for customers. Objectives may focus on how companies are delivering solutions for prominent plastics challenges, resource allocation to research and development (R&D), and capital investment in recycled and circular production. For example, chemicals companies could commit to increasing production of high-quality, consumer-grade plastics made from recovered materials, with the potential to scale and alter the take-make-waste cycle.

Consumer Goods

The consumer goods sector is instrumental in product and packaging design, recyclability and handling. Objectives may focus on R&D and design for sustainable plastics use and recovery, educating consumers, and greater leadership with value chains and regulators on scalable solutions. For example, consumer goods companies could commit to sourcing recycled plastics inputs for packaging, or collaborating with plastics value chains, including retailers and governments responsible for waste, to increase recovery rates in markets where their products are dominant.

Retail

Objectives may focus on how companies are making sustainable plastics choices easier for consumers, working with suppliers and value chains to offer products with sustainable materials use, and partnering with regional and national stakeholders on effective materials recycling infrastructures.

Beyond our individual company engagements, we participate in the Plastic Solutions Investor Alliance led by As You Sow, a collaborative initiative to engage with consumer goods companies such as PepsiCo and Nestle on the lifecycle of plastic packaging. We are also participants in the Investor Forum's plastic pellet management initiative. This aims to reduce ocean plastic pollution by encouraging national and international standard-setting bodies to include plastic pellet management. We are active members of the PRI Plastics Investor Working Group to advise on plastic strategy and engagement. And Hermes is a signatory of the New Plastics Economy Global Commitment led by the Ellen MacArthur Foundation with UN Environment.

Company Engagement: Amplify engagement in the priority sectors of **consumer goods, chemicals** and **retail** by setting objectives for high-risk companies and targeting outcomes that meaningfully confront opportunities and risks. We are targeting 10-15 companies for objectives this year, increasing up to 25 throughout 2020.

Thought Leadership: Communicate our viewpoint and objectives for change with companies, investors and broader audiences. Work with alliances, NGOs, policymakers and key stakeholders to amplify wider investor expectations for companies, plastics value chains and markets.

Investor Expectations: Over the course of this year, following further engagement experience on plastics, we aim to develop the Hermes EOS Investor Expectations on plastics, which will communicate the gravity of the key issues and expectations for change to companies in our engagement programme, providing a strong engagement tool for the investor community.

Sustainable Plastic Value Chains

Market Trailblazers

Corporate responses in the UK

In early 2019, the UK government launched consultations on cutting plastic waste and overhauling its waste management system, including taxation of non-recycled content, producer-pays laws, and material bans. Grocery retailers **Co-op** and **Iceland** backed a mandatory deposit return scheme on plastic bottles and have trialled this in some locations. **Tesco** is also trialling in-store deposit return machines for plastic bottles, and a pilot scheme allowing customers to bring their own reusable containers when buying meat, fish and cheese from counters.

Public-private co-operation in Canada

Ontario, Canada's most populous province of 14 million, introduced a deposit return scheme in 2007. This requires beverage companies and alcohol retailers to collect deposits of plastic and glass containers from customers in a system jointly funded by industry and government. As of 2016, 78% recovery was achieved, rising to 97% for refillable beer bottles. The system is one of several often cited as a model of corporate and public sector cooperation to achieve positive outcomes in materials management, avoid costs and reduce emissions and environmental impact.

78%
beverage container recovery achieved

97%
recovery for refillable beer bottles

Materials design to eliminate plastic packaging at Dell and Ikea

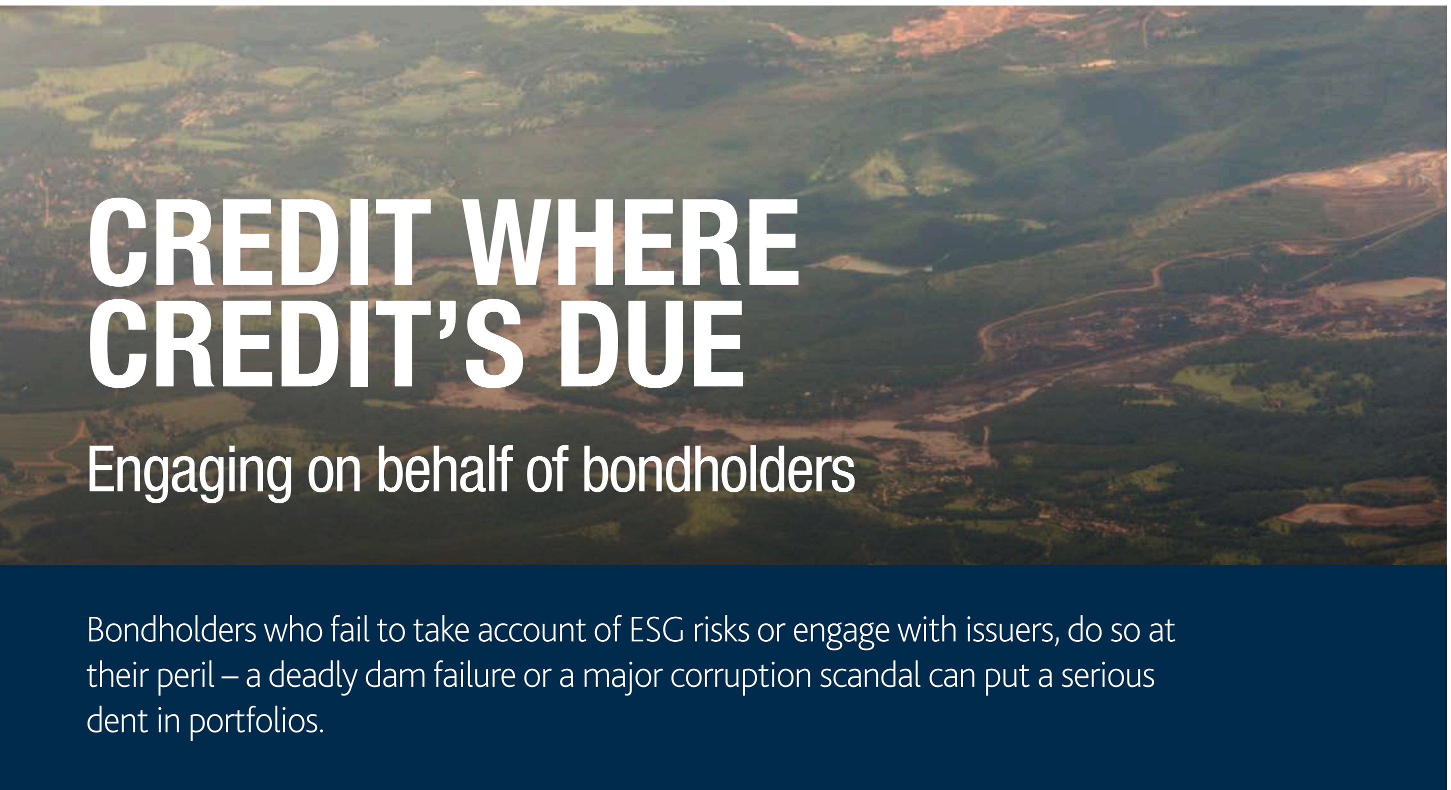
Nearly 50% of packaging materials are made of plastic. As part of their ambitions to deliver zero-waste packaging, **Dell** and **Ikea** have replaced oil-based foams and polystyrene with mushroom-based cushioning in some product shipments. This is grown from agricultural waste to provide the same functionality and is completely compostable. Dell says the packaging requires 98% less energy to make. Ikea has committed to replacing 100% of its Styrofoam packaging with an eco-friendly mushroom-based alternative.

50%
of packaging materials are made of plastic

98%
less energy to make mushroom-based compostable packaging

Sustainable growth through the circular economy

To respond to demand for recycled and reused plastics, **LyondellBasell**, a global plastics and chemicals company, entered a joint venture with **SUEZ**, a water and waste management company, to purchase **Quality Circular Polymers**, a Dutch plastics recycler. The aim is to combine manufacturing expertise with waste recovery capabilities to deliver recyclable, high-quality plastics for consumer goods.



CREDIT WHERE CREDIT'S DUE

Engaging on behalf of bondholders

Bondholders who fail to take account of ESG risks or engage with issuers, do so at their peril – a deadly dam failure or a major corruption scandal can put a serious dent in portfolios.

Setting the scene

Investors are increasingly exploring stewardship for their credit holdings as well as equities. In markets with concentrated ownership, or unequal voting rights structures, bondholders can have more influence than shareholders. This is particularly the case where companies regularly rely on debt capital markets to fund their expansion or have no listed equity.

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The collapse of an iron ore tailings dam at a Vale mine near Brumadinho in Brazil in January, which killed over 200 people, highlighted the importance of engaging companies on environmental, social and governance (ESG) risks for shareholders and bondholders alike.

The disaster, which followed a similar dam failure at Vale's joint venture Samarco in 2015, wiped billions of dollars off Vale's share price, while bond spreads blew out. Ratings agencies Fitch and Moody's downgraded the company's credit rating, with Moody's citing the "significant overhang of litigation exposure and financial liability" that is likely to persist for years to come.

The devastating impact of the dam's collapse on local communities is still being assessed. But the financial impact for Vale is likely to be high as a result of reparations, fines and lawsuits.

Avoiding such terrible outcomes is one of the key goals of engagement – and that doesn't stop with shareholders. In fact, bondholders may be able to bring more influence to bear on companies than equity investors in some cases.

For many years, Hermes EOS has represented both credit and equity investors on the basis that their long-term interests are aligned. Both bond and equity holders are interested in the sustainability of a company and the long-term growth of its value, and many of our engagements are thematic rather than equity specific – such as climate change or business ethics.

Poor corporate governance, low labour safety standards and a lax approach to environmental risk management can lead to major accidents or corruption scandals, which ultimately incur financial penalties. This impacts a company's balance sheet and its creditworthiness. The financial performance of a corporate bond is therefore linked to that of the company itself.

Moreover, the financial stakes held in companies give bondholders the legitimacy to engage – and arguably an obligation to do so under stewardship codes and the Principles for Responsible Investment.

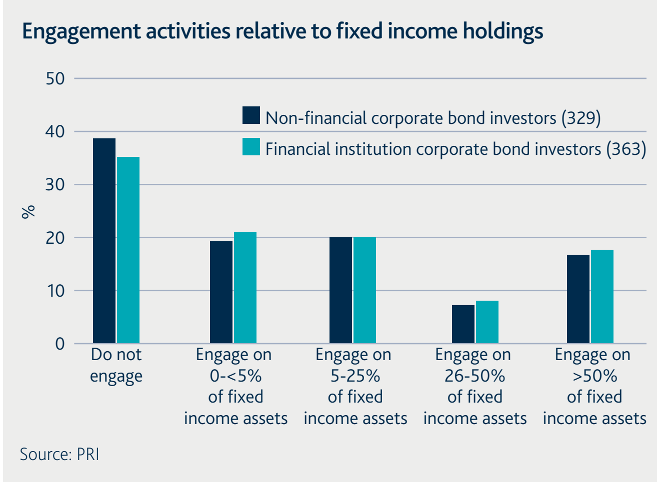
40+%
of the assets under advice from seven of our clients are bonds

30+%
of the assets under advice for Tier 1 engagement companies are in bonds

Growing appetite

Meanwhile, demand for credit stewardship services is growing. A 2018 PRI report "ESG Engagement for Fixed Income Investors" noted that 66% of its signatories engaged in relation to at least some of their bond holdings.

At Hermes EOS, bonds account for 40% or more of the assets under advice from seven of our clients. And for some of our Tier 1 engagement companies, over 30% of the assets under advice are in bonds, with some evenly split between bonds and equity.



Source: PRI

A 2019 ShareAction report examining the views of 22 corporate bond market participants, found that a consideration of ESG factors was generally already part of their investment processes. "Almost universally, bond investors see ESG as a manifestation of downside risk," the paper noted, with investors acknowledging that the refusal to refinance or roll over corporate debt could influence issuers.

The bondholder's ability to "vote with their feet" can be just as powerful as the shareholder's vote at an annual general meeting – potentially more so. Companies who need to tap the market on a regular basis will have to placate fund managers if they want to refinance at a nice price. If the company fails to reassure, they may have to pay a premium to investors to sweeten the deal.

Over the longer term, a company that does not mend its ways despite warnings from disgruntled bondholders, could find itself paying ever higher coupons to a dwindling pool of creditors. Meanwhile, bondholders who actively engage with companies on ESG issues raise the bar for sector peers, putting more pressure on the laggards to clean up their act.

This growing interest in credit engagement is partly driven by the secular trend for pension funds to invest more in bonds as schemes mature – income-generating assets are needed so commitments to retirees can be met.

This growing interest in credit engagement is partly driven by the secular trend for pension funds to invest more in bonds as schemes mature

This desire for a predictable income stream means that bond investors won't necessarily be short-term holders of company debt, even though individual issues will mature. Some pension funds and insurance companies may be restricted to holding investment grade issues or quasi-sovereign names, and may look to replenish their portfolios with new issues from favoured names. So even if the bonds are short-term in nature, an investor's exposure to a company may be long-term.

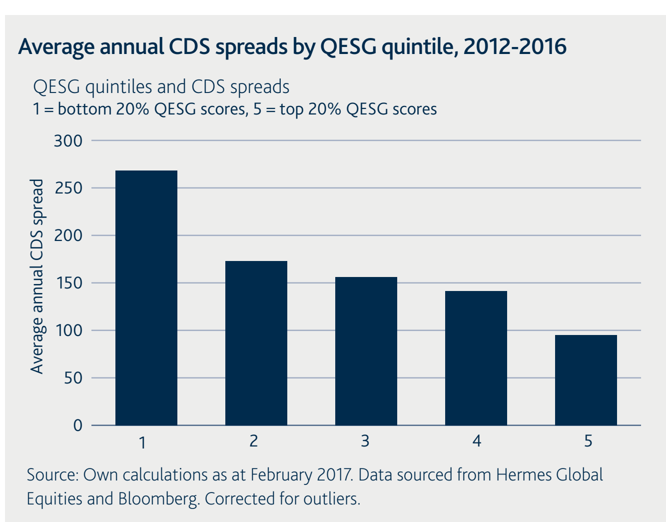
Downside risk

Badly-managed ESG factors destroy value for both equity and bond investors, as illustrated by the collapse of UK outsourcer Carillion in 2018. Similarly, retailer Steinhoff asked creditors to allow it to restructure its debt after it was hit by South Africa's biggest ever accounting scandal, which wiped over 90% off the company's market value.

Even in cases where a company avoids defaulting on its debt, ratings downgrades and widening spreads can put a significant dent in bondholder portfolios. And investors who can only hold investment grade securities may have to sell if an issuer is downgraded to junk in a crisis, crystallising their losses.

All this suggests that integrating ESG into credit analysis and engaging with companies can help to insulate bond portfolios against downside risk.

Technical analysis supports this assertion. In a 2017 Hermes research paper[1] we demonstrated the correlation between QESG scores – our proprietary measure of ESG risk - and credit risk. Issuers with the lowest QESG scores tended to have the highest median credit default swap spreads and vice versa.



Source: Own calculations as at February 2017. Data sourced from Hermes Global Equities and Bloomberg. Corrected for outliers.

[1] https://www.hermes-investment.com/ukw/wp-content/uploads/sites/80/2017/04/Hermes-Credit-ESG-Paper-April-2017.pdf

Effective bondholder engagement

Bondholder engagement can be especially effective in emerging markets, where bonds offer investors a juicy yield but issuers are often lower-rated and riskier than their developed market peers.

Raising standards here can make a big difference. And bondholders can have more sway with companies, as shareholders may have to contend with complex share class structures designed to limit their influence. Moreover, through engagement the bondholder gains greater insight into the credibility of the management team and the board – it also offers a way to communicate how important ESG factors are, and to test the earnestness with which companies are seeking to change. The following engagement examples are typical of our work.

CASE STUDY
Petroleos Mexicanos (Pemex)

Oil company Pemex is a pure bondholder engagement – it is not publicly listed as the Mexican state is the sole shareholder. Instead it relies on international debt capital markets to help finance its operations. This provides bond investors with an excellent opportunity to hold the company to account.

We have engaged with Pemex since 2013, pressing for the adoption of best practice on environmental risk management and labour safety, given our concerns about the frequency of oil spills, gas leaks and fatal accidents. Early on, we made it clear there was a direct link between how the company managed ESG risks and a bondholder's decision to invest. We currently act on behalf of some $90 million in bonds under advice.

Throughout our engagement, the company understood that a strong sustainability performance, particularly on labour and environmental safety, was essential to gaining access to international debt capital markets under favourable conditions. Pemex published its first ever labour safety targets in its 2017-2021 business plan and committed to reducing its carbon emissions by 25% during the execution of its 2017-2021 plan.

However, an explosion at one of the company's ruptured pipelines in January killed at least 89 people and injured over 50 more. This was likely caused by fuel theft - a serious public security issue in Mexico. Although Pemex is not responsible for policing the pipelines, we argued that its reputation is damaged when an accident occurs. Therefore, we expect the company to have best-in-class response procedures and resources.

We continue to engage with Pemex on climate change, and labour safety, where it has promised to have its safety procedures certified according to ISO standards by a specialist independent consultant.

Also, as Mexico's new government has signalled its intention to be more "hands-on" with the day-to-day management of Pemex, we are arguing for strong board independence to ensure proper checks and balances are in place.

CASE STUDY
The steel and mining company

This European steel and mining company is very active in the debt capital markets, but there is little equity free float – just over 20% is listed, as the rest is held by the controlling shareholder. In this regard, bondholder engagement can reinforce that of equity investors.

This company has only recently entered our engagement programme. In the near term we will focus on labour safety given the risk of major mining accidents, including a series of deadly methane gas explosions at a coal mine owned by the company in 2016. We have pressed the company for greater and better disclosure of its safety and environmental performance and the implementation of ISO occupational safety standards.

In an encouraging sign, following Vale's Brumadinho tailings dam failure, the steel company's board challenged management on dam safety. Management assured the board that the company had no dams with the same scale and risk as Vale. It uses dry stacking and underground tailings storage, which reduces the risk of accidents.

CASE STUDY
The telecoms company

This emerging markets telecoms company has a triple-class share structure, but the AA shares control around 97% of the voting rights while accounting for just over 30% of the capital.

This means little voting power for overseas investors. However, bondholders have more clout, and this is primarily a bondholder engagement for us with some $258.2 million in bonds under advice compared with $185.7 million in equities.

We have focused on data privacy, conduct and corporate governance in our engagement. A breach of data privacy could have serious financial implications due to fines by regulators, so proper internal governance is key. This is challenging as the company operates in multiple jurisdictions and must comply with different local laws. However, following our engagement, it has introduced a code of ethics and a digital privacy policy.

Engaging on corporate governance is more difficult as the company's board is oversized, and the controlling family has the power to nominate 14 out of 16 members. There are six family members on the board, alongside long-tenured directors.

MIND THE GAP

Seeking a step change on diversity

Regulators are pushing companies for greater board diversity, and a failure to comply could be costly. Meanwhile, improved reporting on gender pay gaps in the UK, and the global drive towards greater disclosure, will help investors hold companies to account.

Setting the scene

The business case for diversity has been made but change has been glacial. Now more legislators are introducing quotas to force companies to pick up the pace. In California, a law passed in 2018 requires companies to have at least one female board member by the end of 2019. In the UK, yawning gender pay gaps exposed by mandatory reporting have encouraged employees and investors to question companies about hiring policies and practices. In this article, we focus on the value and extent of gender and ethnic diversity, for which reasonable data are available in different markets. When we engage with individual companies, we also look for other aspects of diversity including skills, international experience and tenure on the board.

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Despite plenty of evidence that diversity improves company performance, progress has been slower than hoped in many parts of the world and at different organisational levels. Instead of building a pipeline of talent or looking beyond their traditional networks for people who can bring a different perspective, companies still make excuses – there are no qualified candidates, or they don't want to "disrupt board chemistry". But legislators are losing patience.

15.5% of board members of California's publicly traded companies are women

26% of the Russell 3000 companies based in California had no women on their boards

Companies must have at least one woman on the board by the end of 2019, and a minimum of two or three by 2021, depending on board size.

California's introduction of gender quotas to improve board diversity was a wake-up call for the technology sector in particular, which has been at the centre of controversies about discrimination and sexual harassment in recent years. The new law applies to publicly-listed companies whose principal executive offices are in the state – this includes global names such as Google's Alphabet and Facebook. Companies must have at least one woman on the board by the end of 2019, and a minimum of two or three by 2021, depending on board size. Failure to comply will incur fines and may be reputationally damaging.

30-40% female representation on boards is already mandatory

30.2% female representation on boards in top 100 UK listed companies

But it isn't just the technology sector that will have to change – the problem is broad-based. In June 2017, only 15.5% of the board seats in California's publicly traded companies were held by women, while 26% of the Russell 3000 companies based in California had no women directors serving on their boards[1]. And some believe the new law could have a ripple effect – New Jersey is also considering adopting quotas for women, and a bill has been introduced in Congress to boost diversity by requiring companies to disclose demographic information.

In European countries such as France, Italy and Norway, quotas are already mandatory, targeting 30-40% female representation on boards. Initial opposition to these laws has largely subsided as companies have reaped the benefits. Meanwhile, in the UK, 'soft law' voluntary targets set by the government have helped to improve gender board diversity among the largest companies. The proportion of women on the boards of the top 100 UK listed companies has risen from 12.5% in 2010 to 30.2%[2] in 2018. While this is good progress towards the Hampton-Alexander Review target of 33% women by 2020, there remains much more to do to improve diversity across smaller companies, among executive and senior management teams, and on ethnicity.

Voting guidelines

UK

We are toughening our voting guidelines on diversity in line with the Hampton-Alexander Review, which has a 33% target for women on boards and in the leadership teams of FTSE 350 companies by 2020. In 2019 we will consider recommending voting against the chair of a FTSE 100 company where women are materially less than 30% of the board, or less than 25% at FTSE 250 companies. For the first time, we will also consider recommending voting against the chair at a FTSE 100 company that has an all-male executive committee. This is part of a concerted push to improve gender diversity more broadly.

US

We will consider recommending voting against the chair of the nomination or governance committee of a company where women are less than 20% of the board or where board-level gender and ethnic diversity is less than 30%. For companies where poor diversity persists or there is outright discrimination, we will consider tougher tactics such as shareholder resolutions. In 2018, women accounted for 22.5% of Fortune 500 board seats, but African-American women only accounted for 2.7% and Latinas 0.8%, according to data cited by the Latino Corporate Directors Association[3].

Representation on Fortune 500 board seats in 2018:

22.5% women

But only:

2.7% African-American women

0.8% Latina women

Asia

In Hong Kong and Japan, where levels of diversity are at a lower base level, we will consider voting against the chair of the nomination committee of a company with no female board directors, no credible plans to rectify this in the near future and with whom we have given ample time to engage on the topic.

1 http://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=201720180SB826
2 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/764520/hampton-alexander-review-report-nov18.pdf
3 http://latinocorporatedirectors.org/news/

Board effectiveness and diversity

Boards should be composed of directors with technical skills aligned with the strategic needs and direction of the company and a diversity of perspectives, including across gender, age, ethnicity, nationality, background, skills and experience to improve decision-making.

Board diversity is only one part of the equation, with several studies showing that gender and ethnic diversity at other levels leads to better financial performance. According to a McKinsey report published in January 2018, "Delivering Through Diversity"[4], companies in the top quartile for gender diversity of executive teams were 21% more likely to outperform on profitability and 27% more likely to have superior value creation. And companies in the top quartile for ethnic/cultural diversity on executive teams were 33% more likely to have industry-leading profitability.

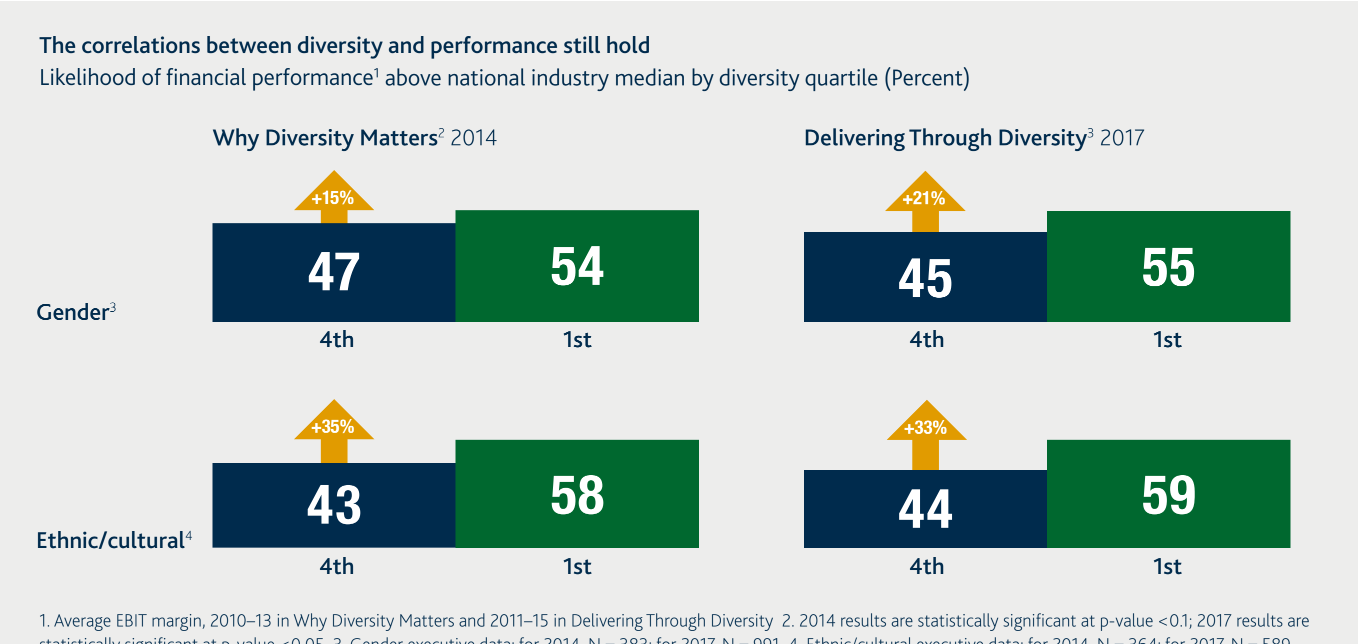
More diverse companies were able to attract the top talent and improve their customer orientation, employee satisfaction and decision-making.

McKinsey said this was probably because more diverse companies were able to attract the top talent and improve their customer orientation, employee satisfaction and decision-making. Diverse boards were also less likely to avoid falling prey to groupthink. However, McKinsey noted that progress was slow, with the 346 companies in its earlier 2015 study – mostly based in the UK and US – increasing the average gender representation on their executive teams by only 2 percentage points over three years to 14%, and ethnic and cultural diversity by 1 percentage point to 13%.

In the UK, the Parker Review[5] on ethnic diversity published in 2017 also painted a dispiriting picture. As of end-July 2017, people of colour who are UK citizens held only 2% of director positions, despite accounting for 14% of the UK population, while 51% of FTSE 100 companies had no ethnic minorities on their boards.

21% more likely to outperform on profitability with high gender diversity

33% more likely to have industry-leading profitability with high ethnic/cultural diversity



4 https://www.mckinsey.com/~/media/mckinsey/business%20functions/organization/our%20insights/delivering%20through%20diversity/delivering-through-diversity_full-report.ashx
5 https://www.ey.com/Publication/vwLUAssets/The_Parker_Review/$FILE/EY-Parker-Review-2017-FINAL%20REPORT.pdf

In early 2017, international mining company Rio Tinto had just two female directors on the board out of 12. Gender diversity has also been a concern at Glencore, an Anglo-Swiss company, which was the last in the FTSE 100 to appoint a female director to its board, in 2014. By 2017, no further progress had been made, with one lone woman out of eight directors.

Rio Tinto, 2017

2 out of 12 directors on the board are female

Glencore, 2017

1 out of 8 directors on the board are female

We raised our concerns about board diversity with both companies and recommended voting against the re-election of the chairs of the nomination committees at Glencore and Rio Tinto in 2017. Each company subsequently made progress.

In December 2017, Glencore appointed a second female non-executive director, which enabled us to be supportive in 2018. In February 2018, Rio Tinto announced the appointment of a new female non-executive director. Although her appointment took effect after the company's 2018 AGM, this was a step towards the 33% female representation targeted by Hampton-Alexander and we were pleased to be able to support the new chair. While we welcomed this development, we continue to engage with each company on their plans to reach 33% female representation by 2020.

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Legal intervention: quotas and pay gap reporting

This lack of progress shows why more prescriptive legislation is necessary. Swiss lawmakers are discussing proposals to introduce a non-binding quota, given the under-representation of women on Swiss boards. However, non-binding quotas are unlikely to deliver the step-change that is needed.

In 2015, Germany introduced a mandatory gender quota of 30% for the supervisory board level but left it to companies to set voluntary targets for gender diversity on management boards. Disappointingly, many listed companies set themselves 0% targets for women[6], and according to the Allbright Foundation, the proportion of women in executive management is only 12.1% in Germany, putting it behind Sweden, France and Poland[7].

In the UK, the lack of female representation at senior levels was highlighted by the first round of mandatory gender pay gap reporting from companies with over 250 UK employees. This showed a median pay gap of around 9.7% based on companies' own reporting looking back on 2017[8]. Perhaps not surprisingly, banks filed some of the biggest gaps, with Barclays Bank reporting one of 43.5%[9], but fashion brands also did poorly with Karen Millen[10] paying women 49% less on a median hourly basis. Initial figures for 2018, released in April 2019, suggested little change[11].

18.4% median pay gap across the UK workforce in 2017

17.9% median pay gap across the UK workforce in 2018

31% median pay gap in asset management

The Office for National Statistics' Annual Survey of Hours and Earnings, which looks at the whole UK workforce, showed a median pay gap of around 18.4% in 2017 and 17.9% in 2018[12].

The asset management industry also demonstrated a broad median pay gap of 31%[13]. This has been a wake-up call for firms to act, including at Hermes, where we have reduced the mean pay gap from 30% to 27% in the last year[14] and taken a number of steps to further promote a culture of inclusion and diversity. However, the median pay gap is effectively unchanged at around 24.5%.[15]

6 Allbright, September 2018, Die Macht der Monokultur: Erst wenigen Börsenunternehmen gelingt Vielfalt in der Führung.
7 Analysis of 30 largest corporations on the stock exchange in Germany, France, Great Britain, Poland, Sweden and the USA, which were listed as of April 1, 2018, on their respective national benchmark index, found in Allbright, May 2018, Germany in Last Place: Corporations across the world get more women into top management.
8 https://www.theguardian.com/money/2018/apr/04/gender-pay-gap-figures-reveal-eight-in-10-uk-firms-pay-men-more
9 https://www.home.barclays/content/dam/home-barclays/documents/who-we-are/our-strategy/Barclays-GPG-2017.pdf
10 https://gender-pay-gap.service.gov.uk/Employer/kGdzdrX1/2017
11 https://www.theguardian.com/world/2019/apr/04/gender-pay-gap-figures-show-eight-in-10-uk-firms-pay-men-more-than-women
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15 https://www.hermes-investment.com/ukw/wp-content/uploads/2019/03/hermes-gender-pay-report-01.03.19.pdf

Hermes EOS is also pressing companies to produce action plans setting out concrete steps showing how they are responding.

The UK reporting exercise was intended to provide a basis for each company to question its culture and adopt measures to address the problem. But according to the UK's Equalities and Human Rights Commission only a fifth of the companies it sampled produced an action plan to close the gender pay gap. It has called on the government to make the publication of action plans mandatory, so that reporting can drive meaningful change.

Hermes EOS is also pressing companies to produce action plans setting out concrete steps showing how they are responding. For example, with one Swiss company that disclosed a significant gender pay gap in its UK subsidiary, we suggested looking into the performance of diverse teams versus non-diverse teams to showcase the benefits, and encouraged more outcome-driven programmes. The company agreed that the tone from the top could be strengthened, and that its culture and aversion to hard targets may be hindering progress.

We are aware that there is no single solution or quick fix to a problem that has evolved over centuries and is reflective of broader societal and cultural issues. That is why we also engage on a range of elements including flexible working, unconscious bias training, paternity leave and recruitment. Our initial focus on improving board diversity is broadening out to include executive teams and forms part of our wider engagement efforts to challenge the status quo, with positive outcomes for companies, their employees and investors, and society as a whole.

CASE STUDY

Tullow Oil

We engaged with Tullow Oil about the low level of diversity on its board although the company's oil production, drilling and exploration operations are in Sub-Saharan Africa. In addition to the under-representation of women and African nationals at the board and executive committee level, there appeared to be a substantial gender pay gap with the top and upper middle quartiles consisting of 90% and 91% men, respectively.

Encouragingly, in February 2019 the company announced the appointment of two women of colour as non-executive directors, with effect from April. Both have extensive experience and knowledge of Africa and the resources sector. Tullow's board chair Dorothy Thompson participated in a roundtable at our March Client Advisory Council, which touched on how companies can attract diverse board level talent when this is prioritised. Panellists emphasised that diversity comes in a variety of forms – it can be helpful to look for people of different backgrounds and nationalities, as well as recruiting people from outside the company's own sector.

Global push for greater transparency

Improving the overall level of disclosure is another way to identify where biases persist, and we advocate for this through our public policy work across the globe:

- **We support the Workforce Disclosure Initiative** (WDI), which is backed by over 120 investors with over $13 trillion under management. The WDI's survey aims to elicit information from companies about how they manage workers – we ask companies to fill this in and publicly disclose the results.

- **The International Organization for Standardization's** new ISO standard for human capital reporting should also improve transparency and help investors to benchmark companies. This outlines an essential set of metrics with definitions, applicable to enterprises of all types and sizes. We will be suggesting that companies report along these lines, as appropriate for their sector.

- **We are members of the Human Capital Management Coalition**, a US investor group, which in 2017 petitioned the Securities and Exchange Commission (SEC) for increased workforce disclosure, given that US companies only have to disclose headcount.

  The SEC did not act, and now members of Congress have stepped in with their proposed Improving Corporate Governance Through Diversity Act. This was endorsed by the Council of Institutional Investors (CII), of which we are a member. With the US expected to become majority-minority in the 2040s, companies may come under increasing pressure to define ethnicity more precisely, and tailor their hiring processes accordingly.

- **At the CII's conference in Washington, DC in March we hosted a panel that addressed the widespread failure to make progress on diversity**, and whether there should be more focus on this issue from companies, investors and regulators. Moderated by Kimberley Lewis, a director at Hermes EOS, panellists included Esther Aguilera, president and chief executive of the Latino Corporate Directors Association and Geof Stapledon, vice president, governance at BHP. This multinational mining, metals and petroleum company has set a new precedent by agreeing targets for 2025 gender diversity across all levels of the organisation from the board down.

- **Through our work with Brazil's AMEC Stewardship Group** we helped establish a Brazil Chapter of the 30% Club. The Club aims to improve the gender balance on boards via a number of initiatives and chapters around the globe, to broaden the pipeline of women at all levels from "schoolroom to boardroom".

REVISING THE UK'S STEWARDSHIP CODE

A global blueprint?

Changes to the UK's Stewardship Code should make it more effective. And lessons learnt in the UK could be valuable for other markets.

Setting the scene

In January 2019, Britain's Financial Reporting Council (FRC) published an updated draft of the UK Stewardship Code. The new Code sets an expectation that stewardship – that is, the monitoring of assets and service providers, engaging companies and holding them to account on material issues, and publicly reporting the outcome of these activities – will be at the forefront of investor thinking. The Code broadens the definition of stewardship and explicitly places an obligation on signatories to consider how environmental, social and governance (ESG) issues impact on investments.

For further information, please contact:

Ingrid Holmes
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The UK Stewardship Code is being overhauled this year and the new definition of stewardship is very much aligned with our long-held belief that we must deliver holistic returns. Generating superior financial performance must go hand-in-hand with leaving the assets – and the world – in a better place than we found it.

If adopted, the new Code will serve as a resounding response to criticism from Sir John Kingman in his independent review of the Financial Reporting Council (FRC), published in December 2018. In this he took aim at the "well-intentioned but ineffective" Code and recommended that it be abolished if it could not be made more effective[1]. This may surprise some in overseas markets who thought the UK was the standard-bearer for stewardship.

1 https://www.gov.uk/government/news/independent-review-of-the-financial-reporting-council-frc-launches-report

Progressive investors such as Hermes are already embracing the Code – which has been streamlined to mirror the recently revised UK Corporate Governance Code – as a welcome step change. In a major innovation, the Code has been substantially rewritten to articulate the purpose of stewardship as a guiding principle for signatories. In effect, stewardship becomes a core driver of business purpose. In addition, if the Code is implemented effectively by signatories, it will have a much larger geographical impact as signatories' obligations will now apply globally. It will also apply across all asset classes and the expectation is that it will be implemented both at a firm and a fund level. This will help to identify and then eliminate conflicts of interests within firms, between their funds. Finally, and very importantly, it will introduce greater accountability for signatories by focusing on outcomes not processes.

Where the UK goes, we can expect other countries to follow. The 2010 UK Stewardship Code was one of the first to be introduced globally, after Germany's Corporate Governance Code for Asset Managers in 2005 and Belgium's Asset Managers Code of Conduct in 2009. The International Corporate Governance Network (ICGN) developed a Statement on Institutional Shareholder Responsibilities in 2003 and is widely considered to be the blueprint for other codes. Since 2010, codes have proliferated so that 24 are now in play across the globe at national and multinational level. So why is this change happening in the UK now and why is it needed, if the UK code is best in class?

Despite amendments made to the Code in 2016, when the FRC found it necessary to introduce tiering as a response to the highly variable quality of reporting, there is still a sense that there is too much focus on intent – scrutinising policies and aims of processes – and not enough on outcomes and impact – what stewardship has actually achieved. There is also a growing perception that stewardship is simply a tick-box exercise for many firms, rather than something that is worth resourcing and implementing in a way that will help improve ESG outcomes.

Amending the Code to make it clearer who is actively engaging companies with the aim of driving real change, and who is piggybacking on the efforts of others becomes a must.

Issues such as high executive pay, income inequality and job automation, as well as ongoing threats from climate change, air pollution and biodiversity loss, mean there is a growing consensus that investors cannot remain neutral and silent. At the same time, individuals must be able to differentiate between asset managers who are undertaking effective stewardship and those that only pay lip service to doing so. Against this backdrop, amending the Code to make it clearer who is actively engaging companies with the aim of driving real change, and who is piggybacking on the efforts of others becomes a must.

A further driver is the fact that the European Union is starting to catch up with the UK. The upcoming introduction of the Shareholder Rights Directive II (SRD II) in May 2019 will impose new obligations on shareholders and ensure that decisions are made for the long-term stability of a company.

These legal changes, which create the buildings blocks for a potential Stewardship Code for Europe, are an opportunity to introduce minimum legal obligations on stewardship in the UK, but they also ratchet up market expectations by introducing the new 'gold standard' Stewardship Code.

Stewardship in other markets

United States

Unlike in Europe, there is no drive from regulators and stock exchanges to improve stewardship in the US, but some institutional investors are leading by example with the establishment of the Investor Stewardship Group in 2018.

This laid out a framework comprised of a set of stewardship principles for institutional investors and corporate governance principles for US listed companies.

Members now number over 60 US and international investors, with combined assets in excess of $31 trillion in US equity markets. Hermes Investment Management has endorsed the initiative, although we have some reservations. The framework lacks a formal monitoring and review mechanism, and it could be more stretching. We also fear that without the impetus of regulatory action, any voluntary adoption will be limited.

Japan

Japan was the first country in Asia to introduce a stewardship code – the Principles for Responsible Institutional Investors in 2014.

Japan's Financial Services Agency committed to regularly reviewing the principles and we have largely welcomed their proposed amendments. However, substantial cross-shareholdings of companies remain an issue, limiting the effectiveness of stewardship activities. Companies appear to be more aware of the issue since the revision of the Corporate Governance Code in 2018.

Other countries in the region have followed suit, but Japan is in a unique position relative to other Asian markets as its government, regulator and biggest pension fund have all pushed for enhanced levels of investor stewardship. What Japan seems to lack are the experience and culture of constructive engagement between investors and companies and – crucially – clear rules around collaboration.

The gold standard

So what should that gold standard include versus what is being proposed? Our view is that the Code should:

1. **Comprehensively articulate the purpose** of stewardship as a guiding principle for signatories
2. **Apply globally and across all asset classes** to ensure no opportunity to improve companies for the long-term is missed
3. **Have a firm-level and a fund-level approach** and focus on outcomes not processes
4. **Have an easy to understand** binary signatory/non-signatory status
5. **Is voluntary to sign up** to but is monitored and enforced

Taking each of these elements in turn, the UK draft stewardship code is very strong.

1. The first test is met. The draft Code articulates the purpose of stewardship as being, "the responsible allocation and management of capital across the institutional investment community to create sustainable value for beneficiaries, the economy and society. Stewardship activities include monitoring assets and service providers, engaging issuers and holding them to account on material issues, and publicly reporting on the outcomes of these activities". The draft also explicitly recognises the importance of ESG factors. Finally, the draft Code sets out a requirement for signatories to establish an organisational purpose, strategy, values and culture to enable them to fulfil their stewardship objectives.

2. The second test appears to be met. The revised Code requires signatories to use the resources, rights and influence available to them in the UK and beyond, to exercise stewardship across asset classes and regardless of how capital is invested. The text indicates an application beyond UK borders. This is important because few firms potentially covered by the Code will only invest in the UK. So to have an impact, the Code should apply to investments in non-UK jurisdictions as well. For example, in 2017, £91 billion flowed out of the UK as foreign direct investment. In addition, enhanced stewardship efforts across all asset classes help promote the long-term success of companies and generate financially, economically and socially sustainable value for investors and other stakeholders.

3. The third test is met with further positive provisions that go beyond it. The draft Code applies to a wide range of stakeholders: asset owners, asset managers and entities providing services to the institutional investment community, such as investment consultants, proxy advisers and other service providers wishing to demonstrate their commitment to effective stewardship. All signatories are required to publicly disclose their stewardship Policy and Practice Statement and publish an annual Activities and Outcomes Report, setting out stewardship activities but also how these are integrated into investment processes, implying that fund level reporting will follow.

4. The fourth test is met. With the introduction of this new Code, there will be a two-tier system - a Stewardship Code of excellence and a Shareholder Rights Directive II-compliance code. For the updated Code the proposal is for applicants to only become signatories if they meet all the conditions set out.

5. The fifth test is partially met. The draft Code envisages more rigorous reporting obligations that would be subject to increased oversight by the FRC. Although asset owners will discern who are the stewardship leaders and allocate money accordingly, regulatory enforcement would complement this. At present there is no mention of any enforcement mechanism. This last matter needs to be resolved to ensure the Code has teeth.

Investors must step up and play their part in ending the short-termism that has blighted capital markets, and become responsible stewards to tackle the big issues facing society.

Not every member of the investment community will like what they see with the Code. This should not be a surprise. Much of the investment industry has yet to realise that it must move on from simply being an allocator of capital to becoming a steward of capital for the long term. This means that understanding investee companies and what they are doing is as, if not more, important than understanding what the company's shares or bonds are doing. That is a precondition of effective stewardship – and what becoming a signatory to the revised Code will imply.

While some with further to go on their journey will find embracing this concept requires a significant investment in resource and skills it is proportionate and necessary. Investors must step up and play their part in ending the short-termism that has blighted capital markets, and become responsible stewards to tackle the big issues facing society. This is not a 'nice to have', it is a 'must have' and a necessary evolution of the investment industry's business model.

SRD II – Ready to roll?

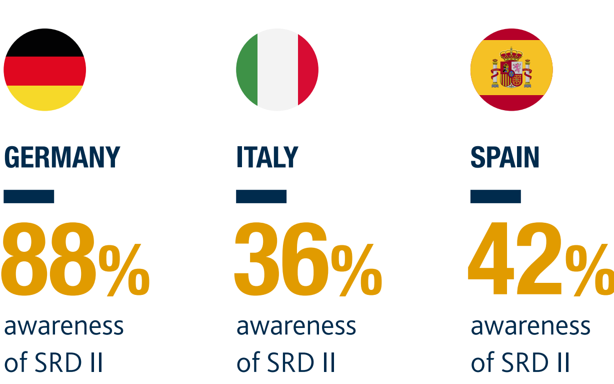
The amendment to the 2007 Shareholder Rights Directive (SRD II) is a watershed moment in the evolution of shareholder responsibility, encouraging investors to adopt more long-term thinking to support more sustainable capitalism. Investors will be required – on a comply-or-explain basis – to report publicly on their engagement activities and voting decisions. But not everyone is ready to meet the Directive's requirements, reflecting the lack of real progress on stewardship in many EU member states.

The Hermes Shareholder Rights Directive survey was carried out in December 2018 to gauge levels of awareness and readiness for SRD II. Some 175 responses were collected from asset owners and asset managers in the UK, the Netherlands, Germany, Italy, Spain and the Nordics. Staggeringly, only 3% of respondents believed their organisation already met all the Directive's requirements, suggesting rapid strategic business changes will be required. Some 42% surveyed had not even heard of SRD II.

175 responses collected

42% surveyed had not even heard of SRD II

Only 3% believed their organisation already met all the requirements



Tellingly, the more that people were aware of SRD II and what was expected of them, the less they felt they complied or could do so within a reasonable time period. For example, German respondents showed the highest levels of awareness of SRD II at 88%, supported by the fact that the German government has already issued draft legislation. But 70% said they did not fully meet all the requirements. We believe that a supporting stewardship code is needed to clarify the requirements on engagement and reporting, as superficial implementation could simply encourage a box-ticking approach.

Conversely in Italy, only 36% of respondents were aware of SRD II, with another 68% saying they did not know if their organisation met the requirements or not. In Spain, awareness was at just 42%, with 93% saying they were unsure of the measures they needed to take to comply with SRD II. This suggests a risk of late implementation, and a potential lost opportunity as Spain does not currently have a stewardship code.

Investors will be required... to report publicly on their engagement activities and voting decisions.

ENGAGEMENT ON STRATEGY

Business strategy and structural governance issues are at the heart of many of our most successful engagements.

Overview

Our approach to engagement is holistic and wide-ranging. Discussions range across many key areas, including business strategy and risk management, which covers environmental, social and ethical risks. Structural governance issues are a priority too. We challenge and support management on the running of the company and management's approach to ensuring the company's long-term future. In many cases, there is minimal external pressure on the business to change. Much of our work, therefore, is focused on encouraging management to make necessary improvements. The majority of our successes stem from our ability to see things from the perspective of the business with which we are engaging. Presenting environmental, social and governance issues as risks to the company's strategic positioning puts things solidly into context for management. The issues may also present opportunities. For instance, businesses may benefit from fresh thinking at board level. Similarly, a change of chief executive can be the catalyst for enhanced business performance and the creation of long-term value for shareholders.

Examples of recent engagements

Corporate lobbying

Lead engager: Lisa Lange

We had concerns about the fact that certain industry associations, of which this European car manufacturer is a member, are not aligned with the Paris Agreement on climate change. In particular, we were concerned about the positions of the European Automobile Manufacturers Association and the German Association of the Automotive Industry. During a European Union (EU) consultation on emissions reductions for cars and vans, the industry associations lobbied for smaller reductions than those proposed by the European Council and European Parliament. The EU has now agreed a reduction in average fleet emissions for passenger vehicles of 37.5% by 2030, but we remain concerned about the positions held by these industry associations.

We had an intensive dialogue with the company about this and urged it to improve disclosure on how it assessed whether the industry association of which it is a member is aligned with the Paris Agreement, and if its own position differs from that of the association. Further, the company needs to communicate how it would address any misalignment. The statement that the company has shared with us to date is insufficient to allay our concerns, and we are continuing to engage with the company on this issue.

Board composition and effectiveness

Lead engager: Jaime Gornsztejn

In a meeting with the board secretary of this Latin American beverage and retail company, we reiterated our concerns about the composition and effectiveness of the oversized board. He acknowledged our concern but explained that the 20-strong board is a result of pressure from the seven founding families to be represented, and the requirement for independent members to make up 25%. He added that the board finance and strategy committee ensures that there is an adequate level of depth in the discussion of matters submitted to the full board.

We highlighted that the 2018 edition of the home market's corporate governance code recommends that companies implement board evaluation and asked about the board's plans to do so. Disappointingly, the board secretary informed us that the board has not looked into this issue and would not commit to it.

We explained our expectations in terms of board composition, particularly at a time when the company's growth is in its retail business rather than soft drinks production. Board composition should be aligned with the strategy, not just driven by the chair's network. The board secretary assured us that, as long-tenured board members retire they will not necessarily be replaced, and promised to take our concerns to the chair. We requested a meeting with the chair, which the head of investor relations promised to look into, but he added that this was not usual practice.

Integrating climate change risk management

Lead engager: Nick Spooner

We had a meeting with this North American bank about its preparations for the transition to a low-carbon economy. The company has included the high-level risks and opportunities that climate change presents in its annual report. However, we were unconvinced as to how the company is managing these risks and opportunities at the operational level. The company excels in its internal and external training programmes, where it educates bank employees on climate-related risks and provides a platform for retail investors to better understand ESG risks. Nevertheless, the bank seems to be somewhat behind its home market peers in terms of fully integrating risk throughout its systems to identify and track the physical and transitional risks of climate change. We will be following up on the development of more comprehensive reporting of climate-related risks in line with the recommendations of the Task Force on Climate-related Financial Disclosures.

Board skills matrix and succession planning

Lead engager: Natacha Dimitrijevic

The general counsel of this European oil and gas company sought our comments about the resolutions for the upcoming AGM. We were pleased to hear that a skills matrix will be published, along with the results of a board assessment, in the next corporate governance report. We raised some concerns regarding the non-independence of the chair. We explained that we would like further reassurance on succession planning and pushed for a strong lead independent director. On remuneration, we welcomed the reduction in the number of metrics but encouraged a higher shareholding requirement. We agreed to follow up on human rights after the publication of the company's new integrated report.

Dual-class share structure and related-party transaction

Lead engager: Jaime Gornsztejn

In a call with the chief financial officer (CFO) of this Latin American paper producer, we pressed for the nomination of a genuinely independent board candidate at the 2019 AGM. We expressed our disappointment with the lack of progress made in improving the company's corporate governance framework compared with some of its national peers, which have collapsed their dual-class share structures and increased board independence. We highlighted that the royalties contract, under which the company pays a percentage of its revenues to one of the founding families to use its name, to the detriment of minority shareholders, shows that there is no proper debate on the board and the voice of minority shareholders is not represented.

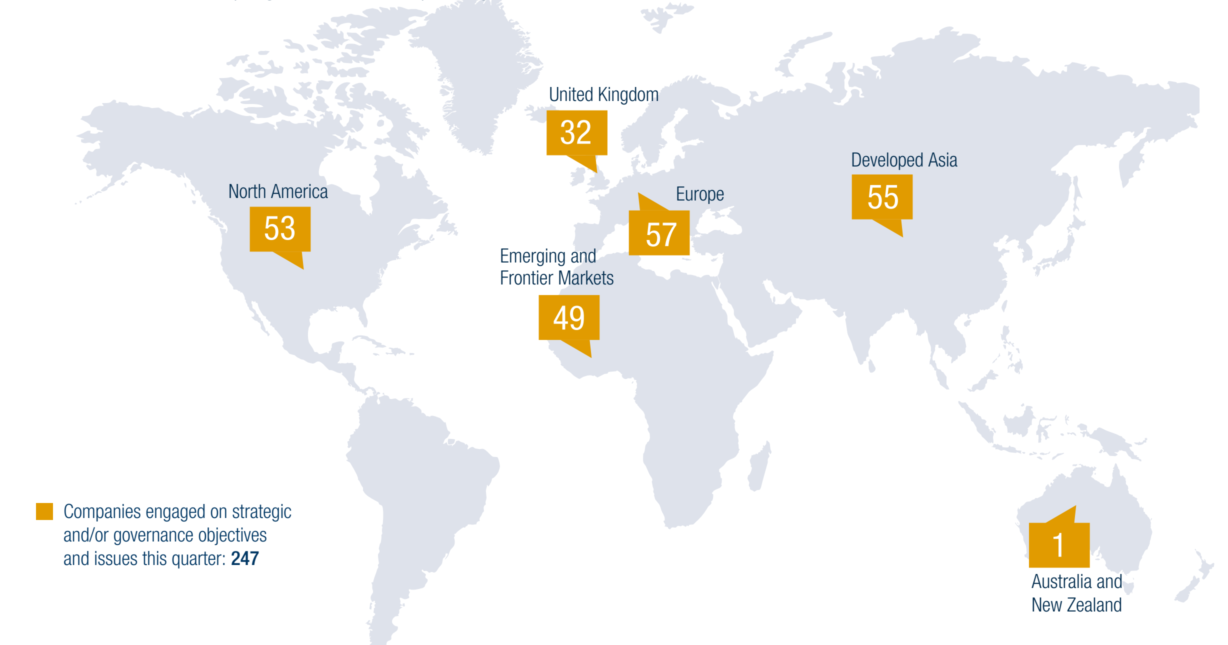
The CFO said the management team understands that the company's poor governance negatively impacts its share price and is supportive of our proposal to nominate an independent candidate to the board. We informed the company that we would discuss the issue with other investors, with a view to nominating a candidate for a separate election.

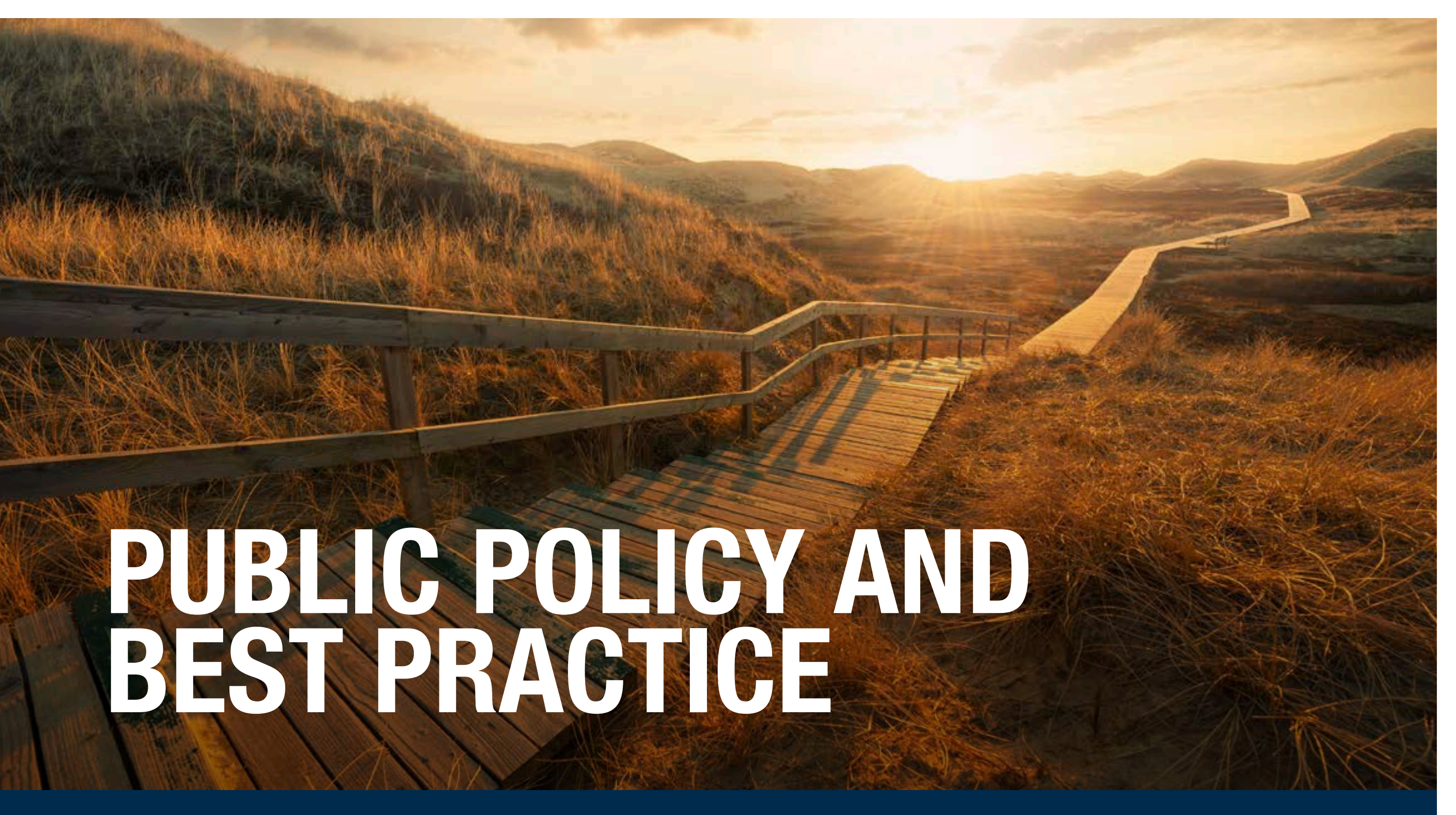
In a subsequent correspondence with the company, we expressed our opposition to the related party transaction proposed at an EGM. The company has proposed acquiring the trademark rights owned by the controlling shareholders, to whom the company pays royalties. We are concerned about the lack of disclosure regarding the underlying royalties contract signed by the company and its controlling shareholder. We also have concerns about a potential conflict of interest in the negotiation of the terms of the related-party transaction, and the lack of safeguards to guarantee the independence of the process. Finally, the sole independent board member abstained from supporting the terms of the proposal citing doubts regarding the valuation, which do not appear to have been addressed by the company.

Remuneration report

Lead engager: Amy Wilson

Ahead of the AGM, we wrote to this UK home improvement retailer to express our concerns about its remuneration report, including the fact that the long-term incentive plan (LTIP) is based solely on an earnings metric and vests after three years with no holding period, which is against our policy. We also had concerns about the number of shares awarded to executives under the LTIP, which remained at 100% of salary despite the share price falling for a second consecutive year, resulting in material increases in the awards to executives. Finally, the dilution limits appear to exceed UK best practice guidelines.





PUBLIC POLICY AND BEST PRACTICE

Hermes EOS contributes to the development of policy and best practice on corporate governance, sustainability and shareholder rights to protect and enhance the value of the shareholdings of its clients over the long term.

Overview

We participate in debates on public policy matters to protect and enhance value for our clients by improving shareholder rights and boosting protection for minority shareholders.

This work extends across company law, which in many markets sets a basic foundation for shareholder rights; securities laws, which frame the operation of the markets and ensure that value creation is reflected for shareholders; and codes of best practice for governance and the management of key risks, as well as disclosure. In addition to this work on a country specific basis, we address regulations with a global remit. Investment institutions are typically absent from public policy debates, even though they can have a profound impact on shareholder value. Hermes EOS seeks to fill this gap. By playing a full role in shaping these standards, we can ensure that they work in the interests of shareholders instead of being moulded to the narrow interests of other market participants whose interests may be markedly different – particularly those of companies, lawyers and accounting firms, which tend to be more active than investors in these debates.

Highlights

German Corporate Governance Code

Lead engager: Lisa Lange

We had a constructive call with the German Investment Funds Association (BVI) to discuss the new German Corporate Governance Code, which is undergoing a consultation process. We stressed the need for a stewardship code, a less rigid approach to remuneration, and the need to focus more explicitly on a holistic understanding of diversity.

Subsequently we commended the German Corporate Governance Commission on the proposed revisions to the code, specifically the Commission's attempt to address important topics such as executive remuneration and supervisory board independence. However, we communicated that Hermes EOS is very disappointed that the Commission has failed to tackle the issue of gender diversity on management boards. Also, we are concerned that the proposed one-size-fits-all approach to executive remuneration may not be suitable for all companies. Moreover, Hermes EOS believes that without the introduction of a stewardship code for institutional investors, the German Code may continue to exist in a vacuum and fail to have a real impact. We will continue to engage with the Commission on the revision of the Code.

30% Club – Brazil Chapter

Lead engager: Jaime Gornzstejn

At the launch event for the 30% Club – Brazil Chapter, we chaired a panel exploring the role of various stakeholders in promoting greater board gender diversity in Brazil. The event was attended by chairs, board members, investors, consultants and regulators. In our panel, we presented our corporate governance principles for Brazil and our voting policy, highlighting our expectations on board gender diversity. Panellists included the biggest local pension fund, a major international asset manager, the head of the Brazilian Institute of Corporate Governance, a female non-executive director and a board recruitment consultant. We also set next steps for the investor group. These included giving feedback to companies on the 2019 AGM board elections, and engagement on the development of nomination policies by Brazilian companies, taking diversity into account.

We chaired a panel exploring the role of various stakeholders in promoting greater board gender diversity in Brazil.

International Energy Agency

Lead engager: Nick Spooner

We signed a letter to the International Energy Agency (IEA) requesting a meeting with investors, led by the Institutional Investors Group on Climate Change (IIGCC). The aim was to discuss the current scenarios being produced by the organisation and the broader implications of these. During the consultation on the letter we emphasised the importance of taking a conservative approach to carbon capture, utilisation and storage technologies within modelling. The letter also called for a 1.5-degree global warming scenario. We stressed how important it was that all the scenarios take a more realistic and representative approach to low-carbon technology improvements, where previously the IEA has been particularly conservative. This is critical, as even if a 1.5-degree scenario is produced, it is unlikely this will be used as a base case by many organisations.

The IEA was forthcoming about meeting the IIGCC's members to discuss the current scenarios being produced. It noted that the Sustainable Development Scenario (SDS) is aligned with the goals of the Paris Agreement, as the temperature outcome of the scenario is between 1.7 and 1.8-degrees.

1.5°

global warming scenario was called for

1.7°-1.8°

temperature outcome of the SDS

US Securities and Exchange Commission

Lead engager: Tim Goodman

We participated in a meeting with a commissioner of the US Securities and Exchange Commission (SEC) organised by the PRI. The commissioner was very positive on the agenda that concerns long-term shareholders but is currently in a minority on that body. In response to our question about how to defend the proxy voting process in the US from attack, he encouraged those present to actively use their rights. This could include filing shareholder proposals, as this will make it harder for the SEC to argue that they are not important. In response to our question about how to successfully achieve SEC rule changes, specifically the one that we have supported to improve human capital management reporting by US companies, the commissioner suggested that those present write in to support such initiatives. In particular, large institutions, including those from outside the US, should show they believe that ESG issues are important. Following the meeting we sent the human capital management petition for rule-making to the PRI, suggesting that it circulate the petition for those present to write in to support it if they had not done so already.

European Union's sustainable finance plan

Lead engager: Hans-Christoph Hirt

We gave the headline presentation at a conference on the European Union's sustainable finance plan hosted by the initiative's Technical Expert Group (TEG) in Brussels. This was a high-profile event and a great platform to develop TEG's understanding about stewardship practices and explain how it could and should supplement the various sustainable finance initiatives. We welcomed the EU's overall agenda and ongoing projects on the topic but explained why getting the taxonomy right may be difficult.

Moreover, we argued that while identifying sustainable investments was very important – thus addressing the "what" question – investors should also have a clear understanding of what is expected after an investment is made. In other words, addressing "how" to invest and how to behave as an owner of the underlying asset. The latter aspect will be particularly important with regard to investments classified as not sustainable. Our presentation was very well received judging by the number and quality of questions and remarks during the Q&A session and in the follow up. We will continue our close dialogue with all relevant European institutions and key stakeholders in order to shape the implementation of the EU sustainable finance plan.

Other work this quarter included:

Transition Pathway Initiative

The Transition Pathway Initiative (TPI) scores companies based on the quality of their management of **climate change risks** and the extent to which they are transitioning their business model. At the TPI's Technical Advisory Committee meeting we received an update on the academic analysis of the results of the TPI's scoring methodologies. Notable insights included that companies generally divide into those that are 'well managed' and those that are 'less well managed' with not much in between. Most companies that have set targets have made these Paris Agreement-aligned, but many more have unfortunately not set any targets at all.

We discussed a number of proposed changes to the measurement methodology for the management score under TPI. We expressed our enthusiasm for adding a score for having a link between executive remuneration and action on climate change and also including alignment of lobbying activity. We also discussed some of the methodological challenges in measuring carbon intensity targets. For the coal industry, it could be better to look at intensity per unit revenue rather than per unit energy, otherwise little reduction in emissions is possible. We agreed to meet again in around six months to review progress against the new scores.

Asset Management Association of China

We delivered the first full-day **ESG education seminar** to over 200 members of the Asset Management Association of China in Beijing. This focused on the importance of ESG investment analysis pre-investment and stewardship post-investment across a number of asset classes, including equities, bonds, real estate and private equity, with case study examples. We discussed the practical challenges in responsible investment, ranging from integration and data availability to transparency issues. We encouraged the audience to think 'outside the box', focusing not only on disclosure-based research analysis to embrace innovative, forward-looking approaches to ESG but also on proactive actions when identifying material ESG issues, and supporting the policy framework development as it emerges.

Responsible Business Alliance

On a call with the Responsible Business Alliance (RBA) we discussed its newly launched Responsible Minerals Initiative (RMI) **blockchain guidelines.** The RBA has three key areas of focus: forced labour; factories and capacity building; and running the RMI. The RBA engages with mining companies across the industry, including steel, aluminium and cobalt, and focuses on human rights. It developed the blockchain guidelines after seeing more interest in this technology, but no clear standards or practical understanding of how to use it. It has discussed blockchain with many practitioners such as Minespider, Better Chain and the London Bullion Market Association.

The RBA/RMI see the potential benefits of blockchain relating to traceability and chain of custody work. It does not force smelters to share all their supplier information, as many claim this is confidential - getting to the mine is the key. As a result, the RBA is compiling an aggregated list of mines used by smelters and assigning levels of risk.

Asian Corporate Governance Association

In a group meeting with the Asian Corporate Governance Association (ACGA) and other investors, we discussed **governance issues in Japan, China, South Korea and India**. We shared our concerns regarding the lack of clarification from Japan's Financial Services Agency about collective engagement, which is deemed to be deterring investors from working collaboratively. In discussing the role of the board at Japanese companies, we pointed out that most companies do not even explicitly name the chair, who plays a key role in improving board effectiveness. As the ACGA asked whether UK boards explicitly support initiatives to tackle climate change, we mentioned how some companies in the extractive sector have supported shareholder proposals for a clear roadmap to address climate change in line with the Paris Agreement, sending a clear message from the top.

All-Party Parliamentary Corporate Governance Group, UK

We attended the annual lunch of the All-Party Parliamentary Corporate Governance Group, held in the House of Lords. The event featured a debate on whether corporate governance generates value for shareholders, with speakers representing a range of views. One area of general agreement was that the push for **greater disclosure** has produced unintended consequences, with reporting becoming unwieldy and difficult to understand and companies facing high reporting and compliance burdens.

Companies face legal and reputational risks as a result of their products being misused for executions, and most have a public policy opposing such use.

Reprieve

We met with Reprieve, a non-profit organisation, for an update on its engagement work with pharmaceutical manufacturers and distributors to prevent the **diversion and misuse of drugs** for lethal injections in capital punishment. Companies face legal and reputational risks as a result of their products being misused for executions, and most have a public policy opposing such use. The importance of controlling the supply chain to prevent misuse of medicines in executions has been recognised by the Organisation for Economic Co-operation and Development Guidelines for Multinational Enterprises and the United Nations Global Compact. Despite measures taken by industry, including tighter distribution controls and restricted sales channels, drugs continue to be misused. There is an overlap with the opioid epidemic, which is also a drugs misuse/supply chain oversight issue, while some drugs used for lethal injections are opioids. This compounds the legal and reputational risks.

VOTING

Hermes EOS makes voting recommendations at general meetings wherever practicable. We base our recommendations on annual report disclosures, discussions with the company and independent analyses. At larger companies and those where clients have a significant interest, we seek a dialogue before recommending a vote against or an abstention on any resolution.

In most cases where we recommend a vote against at a company in which our clients have a significant holding or interest, we follow up with a letter explaining the concerns of our clients. We maintain records of voting and contact with companies, and we include the company in our main engagement programme if we believe further intervention is merited.

VOTING OVERVIEW

Over the last quarter we made voting recommendations at 1,428 meetings (12,536 resolutions). At 677 of those meetings, we recommended opposing one or more resolutions. We recommended voting with management by exception at seven meetings and abstaining at 15. We supported management on all resolutions at the remaining 729 meetings.

We made voting recommendations at **1,428** meetings (**12,536** resolutions) over the last quarter.

- Total meetings in favour **51.1%**
- Meetings against (or against AND abstain) **47.4%**
- Meetings abstained **1.1%**
- Meetings with management by exception **0.5%**

We made voting recommendations at **4** meetings (**13** resolutions) over the last quarter.

- Total meetings in favour **25%**
- Meetings against (or against AND abstain) **75%**

We made voting recommendations at **514** meetings (**3,896** resolutions) over the last quarter.

- Total meetings in favour **57%**
- Meetings against (or against AND abstain) **42.4%**
- Meetings abstained **0.4%**
- Meetings with management by exception **0.2%**

We made voting recommendations at **456** meetings (**3,152** resolutions) over the last quarter.

- Total meetings in favour **50%**
- Meetings against (or against AND abstain) **49.8%**
- Meetings abstained **0.2%**

We made voting recommendations at **184** meetings (**2,893** resolutions) over the last quarter.

- Total meetings in favour **42.4%**
- Meetings against (or against AND abstain) **50.5%**
- Meetings abstained **5.4%**
- Meetings with management by exception **1.6%**

We made voting recommendations at **169** meetings (**1,464** resolutions) over the last quarter.

- Total meetings in favour **33.7%**
- Meetings against (or against AND abstain) **64.5%**
- Meetings abstained **0.6%**
- Meetings with management by exception **1.2%**

We made voting recommendations at **101** meetings (**1,118** resolutions) over the last quarter.

- Total meetings in favour **71.3%**
- Meetings against (or against AND abstain) **26.7%**
- Meetings abstained **1%**
- Meetings with management by exception **1%**

The themes of the resolutions on which we recommended voting against management or abstaining are shown below.

We recommended voting against or abstaining on **1,652** resolutions over the last quarter.

- Board structure **46.2%**
- Remuneration **24.8%**
- Shareholder resolution **3.8%**
- Capital structure and dividends **4.4%**
- Amendment of articles **5.9%**
- Audit and accounts **6.9%**
- Investment/M&A **0.1%**
- Poison pill/Anti-takeover device **0.1%**
- Other **7.8%**

We recommended voting against or abstaining on **5** resolutions over the last quarter.

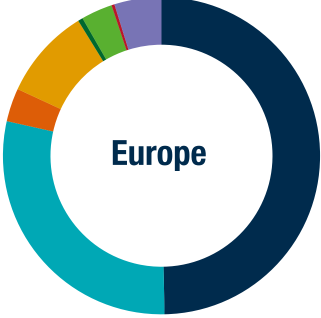
- Board structure **20%**
- Remuneration **80%**

We recommended voting against or abstaining on **416** resolutions over the last quarter.

- Board structure **55.0%**
- Remuneration **14.7%**
- Shareholder resolution **2.6%**
- Capital structure and dividends **1%**
- Amendment of articles **7.7%**
- Audit and accounts **16.1%**
- Poison pill/Anti-takeover device **0.2%**
- Other **2.6%**

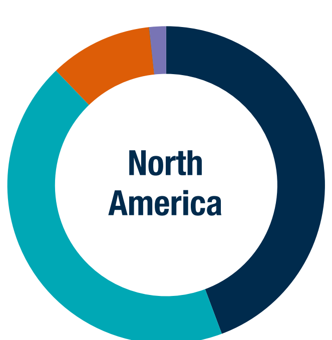
We recommended voting against or abstaining on **562** resolutions over the last quarter.

- Board structure **38.8%**
- Remuneration **18.5%**
- Shareholder resolution **2.5%**
- Capital structure and dividends **5.5%**
- Amendment of articles **11.2%**
- Audit and accounts **6.2%**
- Investment/M&A **0.4%**
- Other **16.9%**



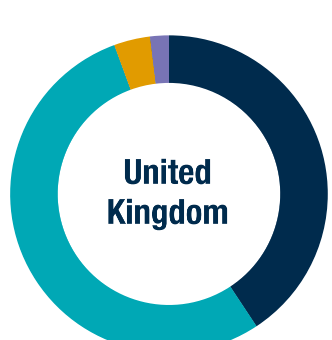
We recommended voting against or abstaining on **378** resolutions over the last quarter.

- Board structure **49.7%**
- Remuneration **28.8%**
- Shareholder resolution **3.4%**
- Capital structure and dividends **9.3%**
- Amendment of articles **0.5%**
- Audit and accounts **3.2%**
- Poison pill/Anti-takeover device **0.3%**
- Other **4.8%**



We recommended voting against or abstaining on **237** resolutions over the last quarter.

- Board structure **44.3%**
- Remuneration **43.5%**
- Shareholder resolution **10.5%**
- Other **1.7%**



We recommended voting against or abstaining on **54** resolutions over the last quarter.

- Board structure **40.7%**
- Remuneration **53.7%**
- Capital structure and dividends **3.7%**
- Other **1.9%**

What is Hermes EOS?

Hermes EOS helps long-term institutional investors around the world to meet their fiduciary responsibilities and become active owners of public companies. Our team of engagement and voting specialists monitors the investments of our clients in companies and intervenes where necessary with the aim of improving their performance and sustainability. Our activities are based on the premise that companies with informed and involved shareholders are more likely to achieve superior long-term performance than those without.

Pooling the resources of other like-minded funds creates a strong and representative shareholder voice and makes our company engagements more effective. We currently have £450.5/€522.9/$587.1 billion* in assets under advice.

Hermes has one of the largest stewardship resources of any fund manager in the world. Our 32-person team includes industry executives, senior strategists, corporate governance and climate change experts, accountants, ex-fund managers, former bankers and lawyers.

The depth and breadth of this resource reflects our philosophy that stewardship activities require an integrated and skilled approach.

Intervention at senior management and board director level should be carried out by individuals with the right skills, experience and credibility. Making realistic and realisable demands of companies, informed by significant hands-on experience of business management and strategy-setting is critical to the success of our engagements.

We have extensive experience of implementing the Principles for Responsible Investment (PRI) and various stewardship codes. Our former CEO led the committee that drew up the original principles, and we are engaged in a variety of workstreams through the PRI Collaboration Platform. This insight enables us to help signatories in meeting the challenges of effective PRI implementation.

How does Hermes EOS work?

Our company, public policy and best practice engagement programmes aim to enhance and protect the value of the investments of our clients and safeguard their reputation. We measure and monitor progress on all engagements, setting clear objectives and specific milestones for our most intensive engagements. In selecting companies for engagement, we take account of their environmental, social and governance risks, their ability to create long-term shareholder value and the prospects for engagement success.

The Hermes Responsible Ownership Principles[1] set out our fundamental expectations of companies in which our clients invest. These cover business strategy, communications, financial structure, governance and management of environmental and social risks. The engagement programme we have agreed with our clients, as well as the Principles and their regional iterations, guide our intervention with companies throughout the world. Our approach is pragmatic, as well as company- and market-specific, taking into account the circumstances of each company.

We escalate the intensity of our engagement with companies over time, depending on the nature of the challenges they face and the attitude of the board towards our dialogue. Some engagements involve one or two meetings over a period of months, others are more complex and entail multiple meetings with different board members over several years.

At any one time around 400 companies are included in our core engagement programme. All of our engagements are undertaken subject to a rigorous initial assessment and ongoing review process to ensure that we focus our efforts where they can add most value for our clients.

While we can be robust in our dealings with companies, the aim is to deliver value for clients, not to seek headlines through campaigns which could undermine the trust that would otherwise exist between a company and its owners. We are honest and open with companies about the nature of our discussions and aim to keep these private. Not only has this proven to be the most effective way to bring about change, it also acts as a protection to our clients so that their positions will not be misrepresented in the media.

For these reasons, this public report contains few specific details of our interactions with companies. Instead, it explains some of the most important issues relevant to responsible owners and outlines our activities in these areas.

We would be delighted to discuss Hermes EOS with you in greater detail.

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*As of 31 March 2019
1 https://www.hermes-investment.com/ukw/wp-content/uploads/sites/80/2018/03/final-responsible-ownership-principles-2018.pdf

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Sector lead: Consumer & Retail

Janet Wong
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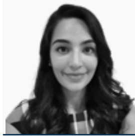
Charlotte Judge
Communications & Marketing



Marwa Maan
Client Service

Alice Musto
Client Service

HERMES INVESTMENT MANAGEMENT

We are an asset manager with a difference. We believe that, while our primary purpose is to help savers and beneficiaries by providing world class active investment management and stewardship services, our role goes further. We believe we have a duty to deliver holistic returns – outcomes for our clients that go far beyond the financial – and consider the impact our decisions have on society, the environment and the wider world.

Our goal is to help people invest better, retire better and create a better society for all.

Our investment solutions include:

Private markets
Infrastructure, private debt, private equity, commercial and residential real estate

High active share equities
Asia, global emerging markets, Europe, US, global, small and mid-cap and impact

Credit
Absolute return, global high yield, multi strategy, global investment grade, unconstrained, real estate debt and direct lending

Stewardship
Active engagement, advocacy, intelligent voting and sustainable development

Offices

London | Denmark | Dublin | Frankfurt | New York | Singapore

Why Hermes EOS?

Hermes EOS enables institutional shareholders around the world to meet their fiduciary responsibilities and become active owners of public companies. Hermes EOS is based on the premise that companies with informed and involved shareholders are more likely to achieve superior long-term performance than those without.

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

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EOS00387 0006082 04/19