Federated Hermes International

ESG in private debt

Understanding and managing the risks

Presented to

DB Strategic Investment Forum

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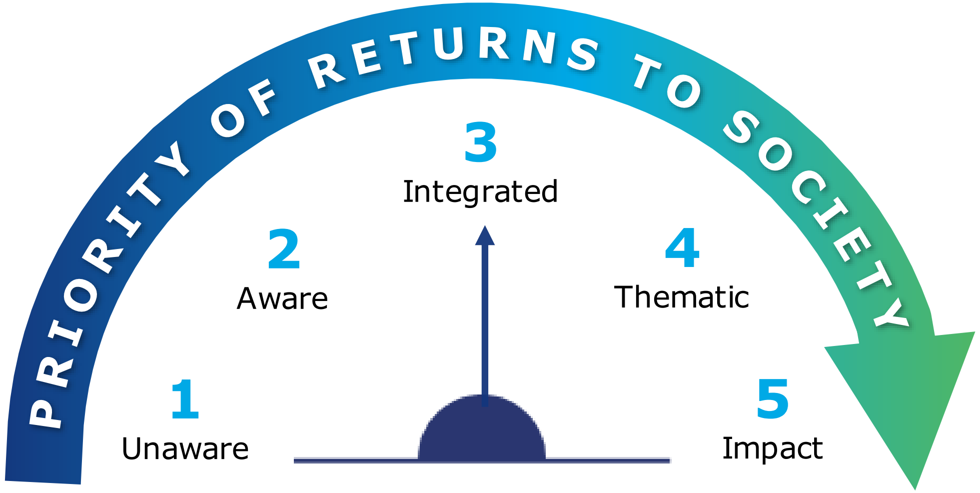
Types of responsible investment solutions

The different degrees of sustainable investing: Where do ESG integrated funds sit ?



3 = Integrated	4 = Thematic	5 = Impact

• Conviction in the belief that ESG factors can have a material impact on financial performance
• Integrate ESG factors in the investment process/decisions
• Engage on ESG factors that, in particular, could impact financial performance and company valuations
	• Increasing priority on 'returns to society'
	• Non-financial objectives
	• Themes
	  • Low Carbon (Exclusions and/or Leaders)
	  • Laggards-to-leaders
	  • Values-based exclusions
	• Reporting on both financial objectives and thematic objectives
		• Alignment with EU Article 9 forms its taxonomy
		• Must have a sustainable objective
		• "Do no significant harm"
		• Sustainability is core driver of allocation
		• Not exclusively, but more commonly financed with private capital
		• Significant reporting requirements
		• Financial benefits are longer-term

ESG integration: an investment imperative

ESG factors impact enterprise value and valuations – benefitting lender security

Investment imperative

- Fiduciary duty compels us to consider and minimise ESG risks
- As ESG risks arise – these should be managed through engagement

Improving risk-adjusted returns

- Companies with poor ESG behaviours are at greater risk of underperformance – and hence have higher credit risks
- Reducing ESG risk improves EVs of borrowers – on which lenders are secured

ESG integration informs borrower selection

- Much more than exclusions and/or 'avoid bad companies' – although these have a key role to play in illiquid private market strategies
- ESG loan 'conditions' can be tailored to manage certain risks

Invest and engage

- Federated Hermes actively engages with companies where ESG risks arise
- Outcomes include greater transparency, improved behaviours, reduced uncertainty and risk

Creditors as financial stakeholders justifies engagement

- Securities valuations synced to the health of companies
- Companies are dependent on loan markets – and are increasingly understanding the value of reducing ESG risks
- Private Equity shareholders are equally motivated to reduce ESG risks

Fundamental and ESG factors → **Cash flows** → **Enterprise or asset value** → **Credit risk**

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ESG – Liquid Markets v Private Markets

SME Private Markets funds have particular challenges in meeting their ESG fiduciary obligations

Difficulty in accessing the right information when undertaking due diligence

- Lack of detailed information – usually SME are less sophisticated and information may be less transparent
  - No ESG database available for SMEs
  - Need for lender to make judgement calls on limited information
- Interpretation of the information required can be different from borrower to borrower

Competition to deploy

- ESG due diligence adds to the workload for potential borrowers – meaning that non ESG focused lenders may seem more attractive to these borrowers

Illiquidity of the investment means divestment is not an option

- Once a loan has been provided – if ESG risks arise, divestment is not an option
- Exclusions remain the best protection against future risks
  - Engagement is a reaction to a new ESG risk rather than a strategy on investment to change a behaviour

ESG – Carrot and Stick approach

Two broad approaches to ESG are developing in Private Debt

The Carrot approach

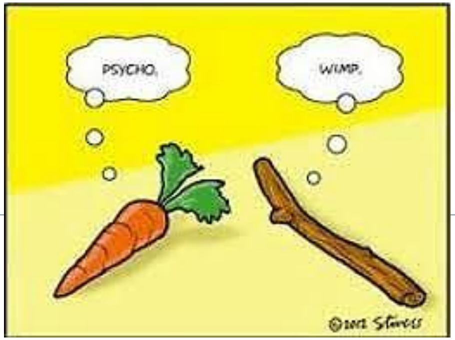
- Incentivise good ESG behaviour through reduced interest costs
- Ratchets reduced interest margin paid by borrowers if certain ESG targets are met
- Usually between 5bps – 15bps in interest margin reductions

Advantage

- Borrowers like it – makes the loan proposition attractive (even if financial benefits are limited)
- The cost to lenders is negligeable

Disadvantage

- How do you monitor if improvement is real?
- Would it have happened anyway?
- No guarantee improvement will happen
- Investors have less visibility on what the final yield of the loan will be



The Stick approach

- Require good ESG behaviour and punish if not forthcoming
- Events of default in loan documentation if certain targets are not met
- Usually give 6 months to a year to reach target
- Target improvement is audited to ensure compliance

Advantage

- Will guarantee ESG issues will be rectified
- Requirement to improve is part of loan contract
- No impact on loan yield

Disadvantage

- Borrowers may not like it and hence could make your loan proposal uncompetitive

Three Pillars of ESG

With ESG in Private Debt – the key is understanding the risks and managing them...

Exclusions

- Certain industries are excluded as the risks outweigh the rewards for investors:
  - Gambling, Tobacco, Distilled Alcohol, Pornography, Weapons & Munitions, GMO, Fur Trade, Ship Breaking, Shark Finning, Cosmetics tested on Animals, Palm Oil, Thermal Coal
- Other Industries are subject to enhanced due diligence (external and internal):
  - Energy – Oil, Gas and Power Generation, Chemicals, Manufacturing, Forestry & Agriculture, Mining & Metals

Awareness

- Investment team undertakes analysis of the ESG risks and provides an ESG rating for the borrower, as well as aligning with SDGs
- Investment team evaluates if investors are adequately remunerated for ESG risk
- Investment team seeks to incorporate ESG undertakings in the loan documentation
- ESG ratings are discussed at Investment Committee and a decision is made on whether they are acceptable to the investment case
- ESG ratings, which continue to be monitored throughout the life of the loan, are reported to investors on a quarterly basis

Engagement

- Should ESG issues arise during the life of the loan – these issues will be reported to investors
- Federated Hermes will seek to engage with sponsor and the management team of the borrower to rectify or improve any ESG issues throughout the life of the loan
  - Improving ESG risks has been shown to increase the EV of a company – which in turn:
    - Makes Federated Hermes investors' loan to the borrower more secure
    - Benefits the shareholders of the company as the EV is improved
    - Benefits society because bad ESG practices have been stopped

Deciding not to participate…

ESG case study – hosting provider

Governance issues

- Federated Hermes reviewed the opportunity to lend to a privately owned UK Hosting and Cloud service provider, benefitting from strong financial fundamentals, including stable cashflows and recurring revenues in excess of 95%. The company also benefited from a conservative balance sheet and proposed capital structure
- Federated Hermes independent ESG analysis uncovered a number of corporate governance and management behavioural issues which shareholder/CEO was unwilling to discuss with Federated Hermes
- Federated Hermes turned down the loan on ESG issues but other lenders funded a loan based on the strong credit fundamentals of the business
- In October 2019 – the Financial Times reported on a number of allegations of inappropriate behaviour by the company's CEO, leading to his resignation
  - Resignation led to issues within the management team (the CEO's wife was a major shareholder and CFO), put in jeopardy a number of critical contracts – negatively impacting the company
  - Erosion of the value of the company on which the lenders were secured
  - Loss of critical contracts, as a result of bad publicity, had a significant negative impact on company's cashflow used to service the loan

Opportunity to lend to UK Hosting and Cloud service provider → **Governance and behavioural issues uncovered** → **FH turned down the loan, others funded the loan** → **Press allegations led to devaluation and issues servicing the loan**

Engaging for change…

ESG case study – manufacturer of road marking materials

Environmental issues

- Federated Hermes reviewed the opportunity to lend to a Nordic-based manufacturer of road marking materials who was seeking to acquire a business to expand its geographic footprint and manufacturing capabilities
- As part of the due diligence process, environmental reports were commissioned that identified some deficiencies with respect to ESG practices of the Target business
- To mitigate these risks, Federated Hermes incorporated specific undertakings into the loan documentation, ensuring the borrower maintained compliance with an agreed remediation plan that was measurable and timebound. Failure by the borrower to deliver on the remediation plan would trigger an Event of Default and mandatory prepayment of the loan
- Examples of agreed actions included investment in health & safety equipment, improvement in environmental reporting standards, and the introduction of health & safety practises and programs for workers
- Federated Hermes' in-house ESG knowledge and experience, coupled with detailed discussions with management and shareholders, allowed in-depth analysis to understand the standards and practices appropriate for this type of business which would mitigate the environmental risks identified during the due diligence phase
- This benefitted:
  - The company and Lenders by minimising environmental risk and subsequent erosion of the borrower value on which lenders are secured by establishing better standards of market practice and reducing risk of environmental litigation or fines

1. **Opportunity to lend to Nordic-based manufacturer to acquire a business**
2. **Poor ESG practices at target company**
3. **Clauses in the loan agreement to mitigate ESG risks of purchase**
4. **Our expertise helped minimise environmental risk and erosion of borrower value**

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Guided by our conviction that responsible investing is the best way to create long-term wealth, we provide specialised capabilities across equity, fixed income and private markets, multi-asset and liquidity management strategies, and world-leading stewardship.

Our goals are to help people invest and retire better, to help clients achieve better risk-adjusted returns, and to contribute to positive outcomes that benefit the wider world.

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

Our investment and stewardship capabilities:

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

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