

ENGAGING WITH A STATE-OWNED ENTERPRISE ISSUER

SIGNATORY TYPE	Investment manager
OPERATING REGION	Europe
ASSETS UNDER MANAGEMENT (AUM)	\$39.1 billion*
FIXED INCOME AUM	\$2.6 billion*
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WHY ENGAGE WITH ISSUERS?

A plethora of academic and financial studies show a relationship between ESG risk and financial outcomes¹. Well-governed companies with minimal or positive impacts on society and the environment tend to have lower costs of capital than their less-sustainable peers². This has an important implication for credit investors: companies with poor ESG characteristics tend to have a higher cost of capital because they are exposed to more risks stemming from externalities that undermine corporate financial performance – fines for not complying with environmental and safety regulations, for example.

By engaging with issuers, we can influence them to adopt ESG best practice. As companies shift to stronger governance and better management of their environmental and social responsibilities, such as emission control and labour safety, externalities are reduced. Consequently, better societal and environmental outcomes, lower cost of capital for issuers, and enhanced returns for bondholders may follow.

* As at 30 September 2017

- 1 See, for example, Rob Bauer and Daniel Hann. (2010). Corporate Environmental Management and Credit Risk. ECCE Working Paper. University Maastricht, The European Centre for Corporate Engagement; Allen Goss and Gordon S. Roberts. (2011). The Impact of Corporate Social Responsibility on the Cost of Bank Loans. Journal of Banking and Finance, 35, 1794-1810; Najah Attig, Sadok El Ghoul, Omrane Guedhami and Jungwon Suh. (2013). Corporate Social Responsibility and Credit Ratings. Journal of Business Ethics, 117, 679-694; Sudheer Chava. (2014). Environmental Externalities and Cost of Capital. Management Science, 60(9), 2223-2247; Pornsit Jiraporn, Napatsorn Jiraporn, Adisak Boeprasert and Kiyoung Chang. (2014). Does Corporate Social Responsibility (CSR) Improve Credit Ratings? Evidence from Geographic Identification. Financial Management, 43(3), 505-531.
- 2 Gordon L. Clark, Andreas Feiner, and Michael Viehs. "From the Stockholder to the Stakeholder." Research Paper: University of Oxford and Arabesque Partners, 2015.

ENGAGEMENT PROCESS

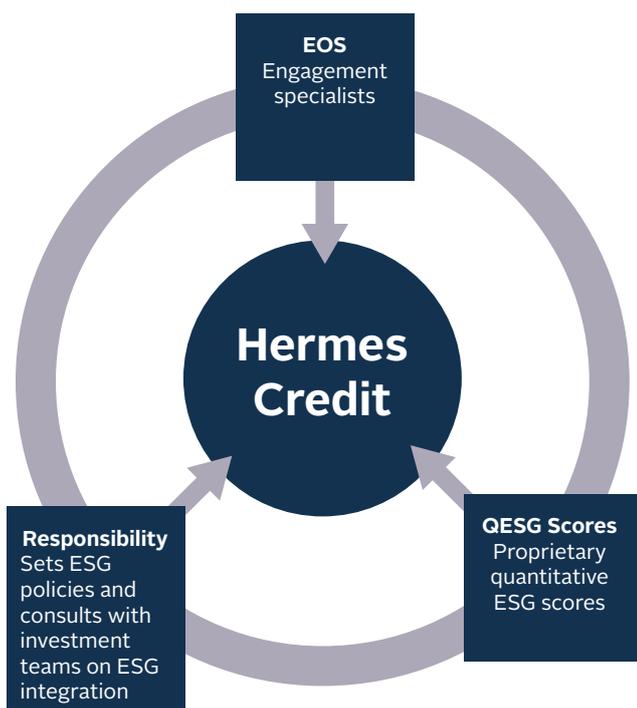
In addition to analysing and pricing operating and financial risks, the Hermes Credit team also considers ESG factors when making investment decisions. To make the best-informed ESG decisions, Hermes Credit relies on several inputs.

- First, from a more general perspective, along with the rest of Hermes, the credit team relies on the responsibility team for firm policies, approach, and investment tools.
- When focusing on a company-specific level, the team reviews Hermes' proprietary measures of ESG risk – the QESG scores. These scores represent a good snapshot of the company's overall ESG performance.
- This score is supported by the company information provided by Hermes' engagement team, Hermes EOS, because the dialogue with the company provides the context of the QESG score. For example, is the company on the right trajectory, or is it more on a negative path?

With all this information, the ESG contribution to the investment decision is more real-time and more dynamic than, for example, simply relying on scores alone. And, more importantly, because we engage as an investor, companies are more likely to be responsive.

When engaging, Hermes EOS usually follows the below

Figure 1: Engagement as an integral part of Hermes Credit's investment approach. Source: Hermes Credit



process, which encompasses a proprietary four-step milestone system. This allows EOS to track progress of its engagements relative to the objectives specified at the beginning of an engagement. Though the specific milestones can vary by engagement, they can broadly be defined as follows:

Figure 2: Hermes EOS' proprietary four-step milestone system for ESG engagement. Source: Hermes EOS

- Milestone 1: Raising ESG concerns with the company.
- Milestone 2: Acknowledgment (or not) by the company.
- Milestone 3: Credible plan set up by the company to address the ESG concerns.
- Milestone 4: Objective achieved (or not), and implementation of the plan.

ENGAGEMENT IN PRACTICE

PRIORITISING PEMEX FOR ENGAGEMENT

Petróleos Mexicanos (Pemex) is the Mexican state-owned petroleum company. Founded in 1938, it is the eighth largest oil producer in the world, with production of approximately two million barrels of oil a day and revenue of about \$62 billion. Although Pemex is wholly-owned by the Mexican state, the company has a strong presence in international debt capital markets, on which the company relies to finance its operations, with around \$87 billion of debt outstanding.

In strategic, governance and sustainability terms, a set of wide-ranging energy reforms enacted in Mexico at the end of 2013 is having a significant impact. Competition will gradually increase as the government auctions new oil fields, but this also opens up new partnership opportunities for Pemex. Furthermore, an oil and gas safety regulator has been set up to bring best international practice to Mexico and enforce its application.

We have had concerns about Pemex's track record on environmental management and labour safety compared with its international peers. We expect Mexico's new regulatory framework, along with the independent external health and safety regulations, to have a positive impact on the company as it will be more exposed to best practice by competitors and partners.

What makes an engagement more significant is that Pemex is not a public company. However, the company's willingness to engage and its initiatives to improve labour safety indicates that it recognises the importance of managing ESG risks to its debt investors. A holistic outcome was therefore likely to be the result of our engagement – lower cost of capital for the company, a good relative performance of the debt securities, and improved sustainability alongside a better performance on health and safety.

In February 2017, Hermes Credit invested in Pemex's new issue to increase exposure to the energy sector at an attractive relative value for a higher quality investment grade energy credit. A deeper analysis of the company's credit profile gave us a better understanding of the company's oil reserves, production levels and recent operational and financial efficiency initiatives. We also believe we have a firm grip on Mexico's energy reform programme, the ownership of Pemex, and tax policies. Throughout this analysis, ESG factors, such as labour safety and historical oil spills and leaks emerged as a recurring theme to the credit discussion.

Before we could add to the initial position we received in primary, we wanted clarification on the company's labour safety track record, which was below the industry average, and insight into the company's environmental management programmes, given the frequency of spills and leaks in the past. Because of this, we characterised Pemex's ESG risks as higher than average, indicating that ESG factors could potentially have a negative impact on the credit. As a result, we were reluctant to increase our position in Pemex until we could speak to the company about our ESG concerns, despite relatively attractive bond valuations.

ENGAGEMENT MEETING

We initiated an engagement to address our investment concerns. When Hermes EOS engages, we try to be present with at least two team members, especially when we are meeting senior management or the chair. Depending on the engagement issues, we speak with the sustainability team, investor relations, or the board. We always aim to speak with the board (in particular the chair) as this has been proven the most effective way to conduct successful engagements.

The company were keen to speak to us. As we had engaged with the company in the past, there was no resistance from them and they were open to discuss our concerns with them and re-engage. In a discussion with the Pemex sustainability and investor relations teams in May 2017, our associate director of engagement, co-head of Hermes Credit, and senior credit analyst covering energy were encouraged by the company's commitment to improve labour safety and environmental management. We were assured that the company views a strong sustainability performance, particularly on labour and environmental safety, as essential

to gaining access to international debt capital markets in favourable conditions.

We also took the opportunity to speak to Pemex about the introduction of Mexico's new regulatory framework to accelerate the adoption of best practice. Pemex highlighted that the oil and gas safety agency has tried to bring best international practice (such as adoption and compliance of international technical standards) to the market and enforce its adoption. We discussed the company's performance in labour safety and the gap between the average industry performance and Pemex, as reported by the International Association of Oil and Gas Producers. The company sought to reassure us that its overall performance for the last three years was above average for Europe and South and Central America. The sustainability team highlighted that the Pemex performance compared to peers is improving because of the various actions it is implementing. In particular, among others, the company cited a recent campaign aimed at developing a culture of zero tolerance to health and safety risk in the workplace.

We were pleased with the publication of labour safety targets in the company's 2017-2021 business plan. If the 2021 target is achieved, it will equal a reduction of 36% in lost time injury frequency compared with 2015, bringing Pemex's indicator in line with that of its peers. Equally positive was the company's commitment to reduce carbon emissions by 25% during the execution of the 2017-2021 plan. We discussed how the company plans to achieve the target. The company described initiatives to reduce flaring, co-generation in various industrial facilities and energy efficiency improvements in refineries. We were satisfied with Pemex's public sustainability targets and the actions underway to achieve them.

NEXT STEPS

We will continue to engage with the company to monitor its progress against the established targets. If Pemex demonstrates improvement against its goals in labour safety and follows through on its environmental and sustainability objectives, we will view ESG risks as reduced and will consider increasing our position in the credit, becoming overweight versus the index, assuming the credit profile remains stable and valuations adequate.