ESG and Active Ownership Report

Q3 2023

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Foreword

Welcome to our ESG & Active Ownership Report for Q3 2023. A relatively quiet Summer period quickly gave way to a jam-packed September, with investment research and engagement trips to Hong Kong, Japan, and Sri Lanka.

Our lead article picks up where we left off last quarter – in China – this time focusing on the country's sprawling solar industry. While solar power is undoubtedly an exciting energy transition technology, in China we find that state-sponsored polysilicon overcapacity and allegations of forced labour weigh on the investment case. We discuss how we think about such issues, as well as how our supply-focused approach highlights alternative ideas which play to the same overarching theme.

Elsewhere, Chris Beaven discusses the investment team's recent engagement and research trip to Japan, where corporate governance reforms – bolstered by activists – are setting the stage for improving shareholder returns.

In July and August we were pleased to be joined by Girls Are INvestors ('GAIN') intern Sophia Ground, who joined the investment team, learnt about the capital cycle approach, and undertook a project studying the portfolio's materials exposure. An extract from her report is published on pages 11-12. The team at Hosking Partners would like to thank Sophia and wish her all the best as she embarks on a Master's degree at Imperial.

As ever, please do be in touch if you have any questions.

Roman Cassini
Head of ESG

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VOTING SUMMARY	Q3	2023
Meetings Voted	40	405
Proposals Voted	374	5,684

ENGAGEMENT SUMMARY	Q3	2023
ESG	44	177
Total Direct (1-on-1)	101	347
Total Indirect (Group)	29	109
Conference	8	42

Dark Side of the Sun: A closer look at the Chinese solar industry

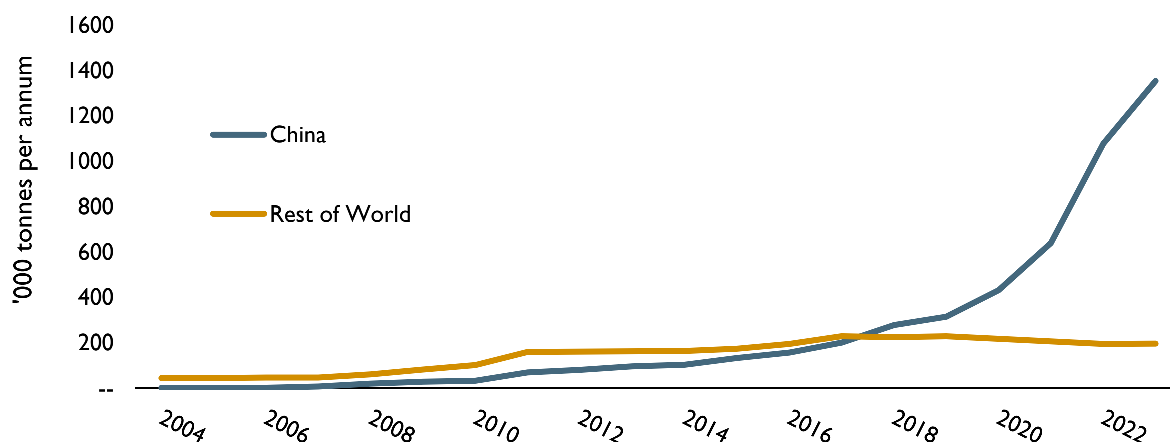
- The global solar industry is overwhelmingly reliant on Chinese manufacturing scale, which has been responsible for much of solar's broader cost deflation over the past decade.
- This scale has been delivered with the support of extensive government hand-outs, including use of the cheapest energy source in the world, subsidised Chinese coal power.
- Significant capacity overbuilds amidst continuing allegations of Uyghur forced labour mean we prefer opportunities elsewhere.

"Keep your face always towards the sunshine, and the shadows will fall behind you." Walt Whitman

Over the last two years we have used the Active Ownership Report to explore some of the debates implicit within the energy transition. For us as long-term investors, understanding conflicting views is important, not only to help position the portfolio to outperform as the transition progresses, but also to help inform our engagement efforts with the companies we own. A common theme has been the complex relationship between the set of risks covered by the 'E' in ESG – the environment – and those covered by 'S' – social issues. In this context, we have discussed how developed world approaches to decarbonisation could impact the emerging world ('A diverse world'), how the route to net zero cannot be extricated from the broader role of energy in society ('The maze to net zero'), and how recent Russian geopolitics may have been influenced by the energy transition ('The Gambler'). These are big ideas, spanning sectors and regions through time.

In this report, we turn our attention to a more specific example of this E-S tension – the Chinese solar industry. The solar industry is, at its heart, a mining industry. The basic building block of a solar panel is quartz sand, which is dug out of the ground and smelted into silicon metal, purified into polysilicon, upgraded to mono-crystalline polysilicon, and finally upgraded again to photo-voltaic ('PV') silicon. Around 10kg of quartz sand produces 1kg of PV silicon. The PV silicon is then processed into wafers, the wafers aggregated into solar cells, the cells into modules, and the modules connected to a variety of ancillary devices such as inverters to produce the final solar panel product. China currently dominates this value chain. If you have solar panels on the roof of your house, the overwhelming likelihood is that at least a part of them was manufactured in China, which produces 90% of the world's polysilicon, 96% of its

Figure 1: Global annual polysilicon production over time



wafers, 83% of its cells and 75% of its modules. There are several reasons for this dominance, but the underlying driver is government subsidies, which come in several forms.

The most obvious of these is subsidised energy. About 80% of the cash cost of PV silicon is energy. The cheapest energy in the world is subsidised Chinese coal power, at around 2-3¢/kWh, almost half the price of the next cheapest source, domestic US gas, and about five times cheaper than long-run European power prices. This application of cheap coal power to polysilicon production allowed China to build out manufacturing scale, monopolise the lower end of the solar cost curve and rapidly gain market share (see Figure 1, previous). In 2012, about half of the cost of a solar project was manufacturing compared to just one fifth today. This manufacturing scale, facilitated by subsidised coal power, has been the largest driver of the remarkable deflation in solar costs witnessed in the past decade, and have allowed China to price PV silicon at about $8-10/kg. Bottom-up analysis suggests that even with subsidies, a minimum price of $12.50/kg is required to generate a narrow 5% IRR. At such prices it is hard to see how producers are earning an economic return, and one study has estimated that without any subsides at all Chinese PV silicon could cost as much as $70/kg. An even more controversial source of subsidy than coal power, however, is the alleged use of forced labour – specifically from Xinjiang's Uyghur population – in the solar value chain.

Known unknowns

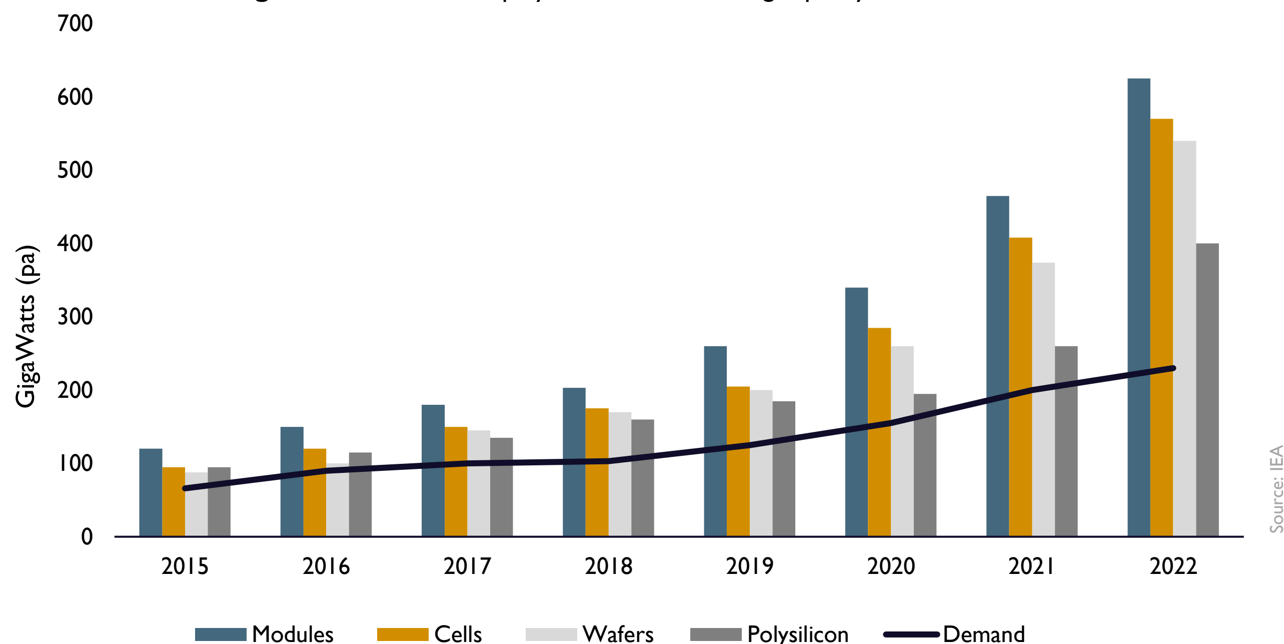
Of the 90% of the world's solar-grade polysilicon that is manufactured in China, over half originates in Xinjiang province. This vast region in Western China is home to the majority Muslim Uyghur ethnic group who, over past years, have been subject to a state-sponsored "labour transfer" programme. The Chinese government claims these initiatives are voluntary, but evidence suggests such transfers are carried out coercively, with up to 2.6 million transferees unable to refuse or walk away once relocated. Such activity is defined as forced labour by the UN's International Labour Organisation, as it constitutes "work or service which is exacted from any person under the threat of a penalty and for which the person has not offered himself or herself voluntarily." Since these programmes came to light, much work has been done to examine which goods and products they affect, and which companies may be complicit. While the cotton and tomato picking industries are likely the largest recipients of "labour transfers", serious allegations have also been made about the solar industry. Upstream quartz-mining and silicon smelting are the most clearly implicated due to their reliance on manual and low-skilled labour. However, due to the highly integrated nature of the industry, it is difficult to establish the extent to which different companies across the supply chain are involved.

Despite these concerns, Chinese solar was nevertheless heralded by many Western analysts in 2020-21 as a realm of value and opportunity. Margins and market shares were strong, China was a cost-leader, and a moat was emerging in technology R&D. Compared with wind, solar has clear scope to continue getting more efficient – and therefore potentially cheaper – without running into engineering problems where further gains are capped by hard physical laws. As in semiconductors, the intangible value of technological leadership – and the barrier to competitive forces it exerts – is magnified by the rapid pace of change. Comparisons with Taiwan's burgeoning semiconductor industry in the early 2000s did not appear unreasonable. To gain some exposure to this seemingly exciting theme, Hosking Partners initiated a small position in LONGi Green Energy in July 2021. LONGi has a particular focus on manufacturing solar modules, where it is a technology leader. The company has no manufacturing sites in Xinjiang and claimed to have taken the unusual step of requesting 150 of its suppliers make a written commitment against forced labour. Nevertheless, in September 2021 we began an engagement with the company to encourage greater transparency over the issue.

The engagement spanned background research, 1-on-1 calls with management, and a series of formal letters. We worked to gain a more complete understanding of the regulatory and reputational risks facing LONGi due to forced labour allegations. We asked the company how they managed the risk of forced labour, and how their revenues could be affected by related US sanctions. We encouraged them to offer more transparency through their supply chain, citing examples of good practice drawn from elsewhere in our portfolio. For example, we highlighted how **Associated British Foods**' subsidiary Primark has published a supply chain map and associated human rights audit data. Concurrently, we conducted an in-depth assessment of the broader Chinese solar market. The outcome of this work would help our investment team assess whether to expand our exposure to the sector beyond a single position or reduce it.

Despite our efforts, we made relatively little progress determining the scope of LONGi's exposure to forced labour. It was difficult to ascertain the true nature of the problem in general, let alone attribute involvement at the company-level. LONGi itself made some limited efforts to address our concerns, but

Figure 2: Global annual polysilicon manufacturing capacity versus demand



ultimately seemed unable to fully engage on the issue as the Chinese government effectively prohibits companies from accepting in the first place the proposition that Uyghur forced labour exists at all. This makes it difficult for companies to be open about the extent of their involvement, restricting them to general statements about being opposed to forced labour in principle. Furthermore, LONGi was unwilling to call into question the activities of their major suppliers – most notably Daqo and Hoshine – many of whom form long-term 'strategic partnerships' as part of the industry's complex JV network. Our inability to encourage greater transparency on the materiality of the forced labour risk – combined with a deteriorating and related supply-side picture described in more detail below – led us to sell the portfolio's position in LONGi in August 2023.

Capacity at all costs

Our engagement with LONGi on forced labour ran alongside an in-depth examination of the broader Chinese solar market. Despite the rosy outlook posited by sell-side analysts that stimulated our initial interest, since mid-2021 Chinese solar equities have proved to be a disappointment for investors. Our analysis provides some insight into the reasons for this outcome and offers some pointers to the future.

As described above, China's dominant global market share was built by cornering the upstream production of polysilicon. Aside from a 2022 spike, subsidised Chinese polysilicon prices have remained near or even below cost. Meanwhile, upstream capacity continues to be added despite poor returns, leading to a permanent state of oversupply. To keep the upstream producers alive, the government encourages joint ventures with midstream and downstream companies who help fund the capex. IEA data reveals manufacturing capacity running ahead of demand from polysilicon to modules, with the oversupply growing over time. In 2022, capacity was over double demand (see Figure 2, above). Combined with increasing polysilicon efficiency on a per wafer basis, this has caused polysilicon capacity utilisation to fall from 85% in 2004 to just 60% today.

This slack in manufacturing capacity may take years to unwind. Although there are some signs that financing conditions for capacity addition are tightening – producer Tongwei was recently forced to cancel a proposed equity raise to fund further growth – the top eight Chinese producers still have enough cash fully to fund all stated expansion plans through 2026. Meanwhile, marginal demand growth for solar both in China and internationally is showing some signs of levelling off as bottlenecked power grids struggle to adjust to the rapidly rising share of intermittent generation. A recent IEA report suggests around 3,000 GW of global renewable power generation capacity sits idle, unconnected to national grids which have not been sufficiently built-out. That is five times the total amount of solar capacity added to the energy mix in 2022. Globally, electricity grids require annual investment to double by 2030 to accommodate the growth of renewables, a significant step-up in the long-run trend (see Figure 3, next page), and a real constraint on the pace of solar demand growth. If we were to adapt the adage 'to put the cart before the horse' for 2023, we might say 'to put the solar panel before the grid'!

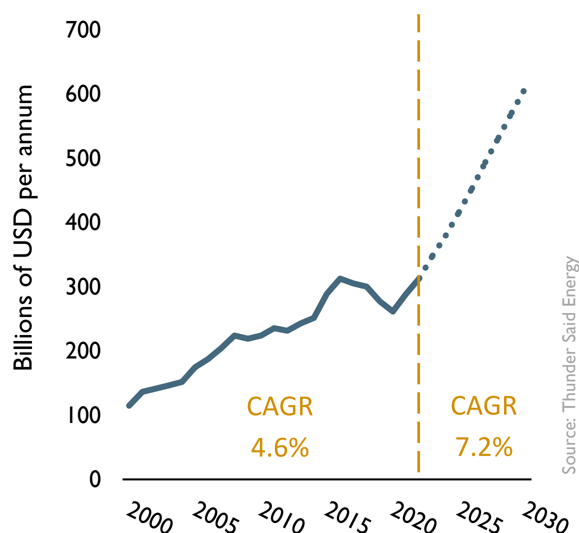


Figure 3: Required annual global power grid investment

Meanwhile, some of the costs associated with solar production may be beginning to re-inflate. The Chinese manufacturing scale that has delivered such remarkable cost deflation has been catalysed by the web of subsidies discussed above, whether in the form of cheap coal energy, forced labour, or low-cost government funding. These are ultimately unsustainable (in several senses of the word), and as such the profits of each industry player need to be discounted heavily in any valuation analysis. Furthermore, if much of the cost reduction achievable via scale is already behind us, then the focus for future deflation switches to materials, cell efficiency, and cost of capital. Promisingly, cell efficiency may eventually double to 50% or more. But such opportunity is tempered by research which suggests a 1% rise in the discount rate implies a 6% rise in the cost of delivered solar power, while materials bottlenecks across the solar value chain continue to tighten. Geopolitics also has an impact. US import bans on Xinjiang-manufactured modules have led to the equivalent of an entire year of European demand (50 GW) being held up in warehouses near Rotterdam. Return on capital suffers a double whammy from inflated assets and lower future profits as this inventory eventually floods the market. This effect is magnified by the impact of the further 3,000 GW of unconnected spare capacity discussed above.

None of this is to say that solar will not form a critical part of the energy transition. Or that efficiencies will not continue to improve, or that costs will suddenly rise precipitously, or that demand will disappear. However, when we consider the impact of years of Chinese oversupply, such issues are worth considering when we ask ourselves how long such a situation might last, and what impact it might have on the returns of the leading Chinese producers.

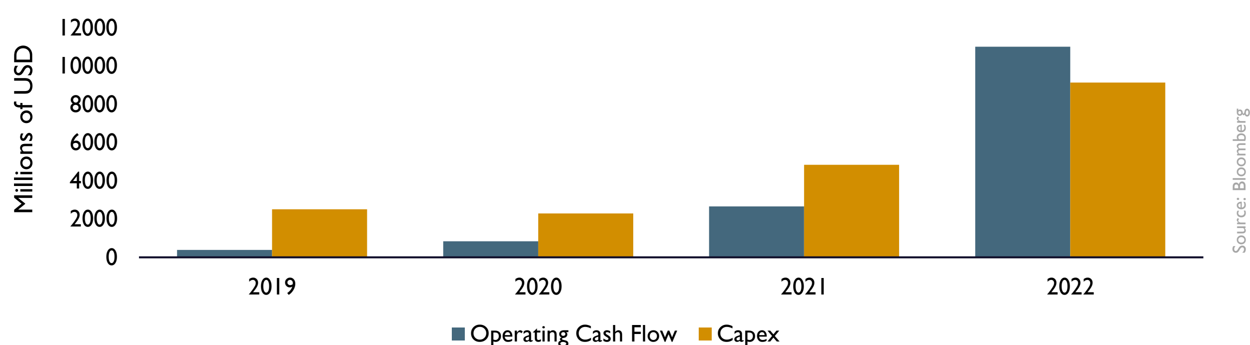
We still seem some way from a meaningful cycle of consolidation or capital discipline among the Chinese players. Analysts have been predicting such a cycle since 2012, when the Chinese government suggested it would incentivise industry M&A, but instead the number of large Chinese manufacturers has increased. The Silicon Module Super League – a group of the world's largest solar module manufacturers – has grown from five founder members in 2015 to seven today, six of whom are Chinese. The story is similar for polysilicon, where Chinese market share is divided relatively equally between six large firms. This oligopolistic set-up could be attractive if capital discipline was maintained and supply tight, but as we have seen that is not the case. In fact, firms are still frequently spending as much on capex than they earn in operating cashflow (see Figure 4, next page).

On the other side of the Pacific, the US was slow to wake up to the fact that an entire industry had been stolen from under its nose. In response, the Inflation Reduction Act ('IRA') now promises to deliver the kind of fiscally supercharged investment cycle for US solar that China implemented back in 2011. Furthermore, from August 2024 the US will expand tariffs on Chinese modules to include those assembled elsewhere in Southeast Asia, which to date has been an easy workaround. These policies are undoubtedly politically as well as economically motivated, but nevertheless the prospect of this new avenue of supply has contributed to a derating of Chinese solar equities over the past year. Average P/Es for the top five producers have halved from 31x in 2022 to an expected 16x in 2023 – cheaper, but still not cheap. And while subsidised coal remains a significant cost advantage for Chinese producers, US natural gas is a worthy alternative and is less exposed to the potentially re-inflationary impacts of rising carbon prices (or taxes) in Western markets.

Opportunities elsewhere?

Despite our scepticism regarding the Chinese solar market – for the financial and non-financial reasons we have described – we remain interested in the opportunities posed by increasing solar adoption. However, as we discussed in a recent podcast with Thunder Said Energy's Rob West ('Energy Transition: Active Duty?'), it is measurable supply bottlenecks rather than conjectured demand forecasts which most pique our interest. One company in the Hosking Partners portfolio whose investment case expresses this idea is **Ferroglobe**. One of the largest

Figure 4: Cumulative capex versus OCF of the six largest Chinese polysilicon manufacturers



producers of silicon metal and related alloys worldwide, it primarily supplies sub-solar grade silicon to the chemicals and aluminium industries, and ferro-silicon and manganese to the steel industry. It is vertically integrated from coal and quartz through to the production of silicon metal, and it has a global production footprint of scale which should advantage it in terms of cost, raw material prices and tariffs. It is generally market leader (ex-China) in all its markets. As the West challenges China's dominance of the solar value chain by means of the IRA, companies like Ferroglobe are well-placed to leverage their existing assets towards the growing market in non-Chinese PV silicon by supplying silicon metal to Western upgraders. Clearly, continued Chinese overcapacity is a risk to Ferroglobe's pricing power, and we see only early signs that capacity growth may be moderating in China. However, over the longer-term, broader economic pain and over-indebtedness may place pressure on subsidies. This, in turn, could prove more accretive to Western competitors than Chinese incumbents. After all, the former has already been through a cycle of consolidation amidst the last 10 years of Chinese cost-leadership, and Ferroglobe's healthy balance sheet sets the stage for future returns.

As ever, capex is something to which we pay close attention. On average, it still costs US polysilicon manufacturers over four times more than their Chinese counterparts to add one unit of incremental capacity. Encouragingly, instead of splashing the cash on new assets, Ferroglobe are focusing on deleveraging and delivering returns to shareholders, while exploring strategic partnerships with specialist producers including REC Silicon as the means by which to explore the solar opportunity. Looking forward, incremental silicon metal consumption in North America relating to solar could amount to one third of existing consumption by 2030, implying EBITDA for Ferroglobe of $300m from this sub-segment alone. That compares materially to a 2022 adjusted EBITDA of $795m for the entire business. The company also has exposure to developing technology for silicon cathodes in electric batteries, which could prove an exciting source of future profits. Meanwhile, Ferroglobe is free from the regulatory and reputational discount associated with the issue of forced labour in China, which shows no sign of abating in the near to medium term.

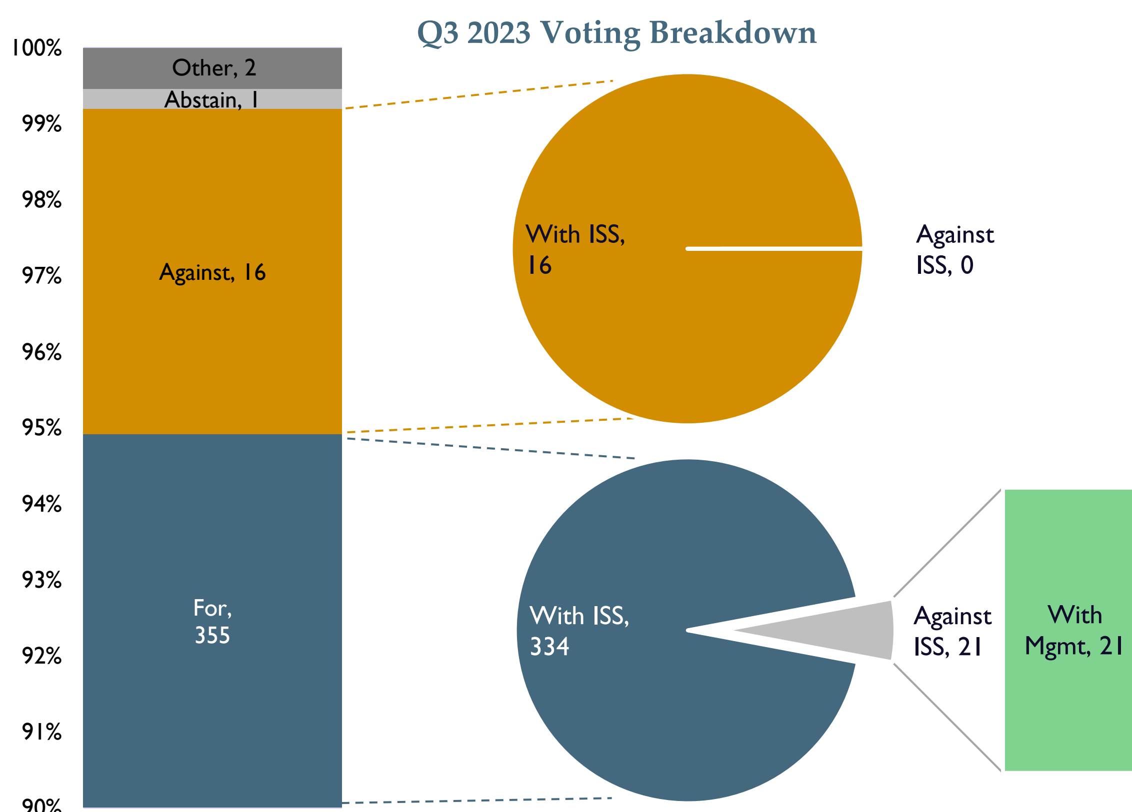
Our experience over the past two years investigating – and briefly investing in – the Chinese solar market demonstrates how supply-side analysis, consideration of ESG factors, and active engagement combine in our long-term investment process. As at October 2023, almost 30% of the Hosking Partners portfolio is in sectors closely related to the unfolding energy transition, with a larger percentage indirectly exposed. Currently, much of this is in unloved areas of the market where there has been recent underinvestment and valuations are low. Our confidence in many of these ideas – mining, long-lived conventional energy assets, tanker shipping – is supported by the careful consideration of ESG factors as outlined in this report. Meanwhile, nowhere is the tension between 'E' and 'S' that is implicit in much of the energy transition more clearly illustrated than in the Chinese solar industry. Over the past decade valuations of renewable energy companies have spiked and are now slowly deflating. This is a bubble we largely avoided, built as it was on unrealistic financing predicated on cheap energy and even cheaper money. Looking forward, we will continue to search for opportunities in emerging energy technologies, where we like companies such as Ferroglobe. These are companies that combine a strong asset-base, regulatory tailwinds and compelling valuation, with a smart capital allocation strategy and improving governance regime.

References

References for any data or quotations included in this article and articles elsewhere in this report are available on request and on our website.

Voting Summary

Proxy voting is a fundamental part of active ownership and our procedures are designed to ensure we instruct the voting of proxies in line with our long-term investment perspective and client investment objectives. We use the proxy voting research coverage of Institutional Shareholder Services Inc (ISS). Recommendations are provided for review internally, and where the portfolio manager wishes to override the recommendation they give instructions to vote in a manner which they believe is in the best interests of our clients.



2023 YEAR-TO-DATE THEMATIC BREAKDOWN	FOR		AGAINST		ABSTAIN		AGAINST ISS	
	Total	% share-holder	Total	% share-holder	Total	% share-holder	Total	% share-holder
Director related, elections etc	2,802	1%	233	6%	23	-	56	11%
Routine/Business	915	<1%	43	16%	-	-	2	-
Capitalisation incl. share issuances	448	-	40	-	-	-	7	-
Remuneration & Non-Salary Comp	566	2%	99	4%	-	-	12	-
Takeover Related	56	-	8	-	-	-	-	-
Environmental, Social, and Corporate Governance	76	45%	72	92%	1	100%	16	94%
Other	56	20%	21	33%	1	-	1	100%
Total	**4,919**	2%	**516**	19%	**25**	4%	**94**	23%

Not displayed in the graph above are 8 non-votable proposals.

Voting Discussion

Company	Country	Meeting Date	Meeting Type	% of Voting Shares
CHAMPION IRON	Australia	31st August 2023	Annual	0.2% (as at the end of Q3)

Proposal(s)	Management Recommendation	ISS Recommendation	Our Vote
Several related to remuneration	FOR	AGAINST	FOR

Our proxy research provider, ISS, has developed several voting policies to automate their recommendations, based on pre-determined measures, generally benchmarked against relevant peer groups. This allows ISS to deliver research and recommendations more quickly than they could otherwise, as well as ensuring consistency in their judgement of ESG standards. Although efficient, this approach has its limitations. For example, it does not always have the flexibility to fairly assess the appropriateness of practices within a company subject to atypical circumstances. One victim of this in the past quarter was **Champion Iron Ltd**, an iron ore exploration company operating out of Canada, but incorporated in Australia. This geographic dislocation was the key source of a disconnect between ISS and the company. ISS recommended voting AGAINST the company's remuneration report, citing misalignment between the pay for performance model and shareholder outcomes, which ISS state are inconsistent with accepted market practice. Specifically, ISS raised concerns such as the upper discretion exercised on the Short Term Incentive Plan (STIP), inconsistencies between the company's Long Term Incentive (LTI) programme compared with those of other ASX200 listed companies, and excessive termination benefits awarded to the former CFO. These concerns have been flagged by ISS repeatedly and as a result ISS also recommended voting AGAINST the re-election of the company's Head of Remuneration for bearing ultimate responsibility for these practices. Finally, ISS recommended voting AGAINST the re-election of the Executive Chair, due primarily to their classification as an overboarded director given he also serves as Chair of Burgundy Diamond Mines Ltd.

Hosking Partners consulted with Champion Iron Ore to discuss ISS' concerns. The company highlighted several factors not reflected in ISS' judgement, including the sensitivity of financial performance to market conditions outside of management's control, for which the STIP parameters were sympathetically adjusted. Further, in response to ISS' comparison of standard market practices, the company highlighted that, although incorporated in Australia where the ASX200 might be a relevant comparator, the company's workforce and operations are all based in Canada, where the LTI programme is in line with local market practices. On a similar note, the termination benefits paid to the former CFO were required by local Quebec law, further highlighting the inappropriate application of ISS' rules-based approach. Finally, although the company recognised that the Executive Chair is overboarded by ISS standards, they evidenced his clear commitment to the company by his perfect attendance record, and his position as the company's founder and largest shareholder. Champion Iron Ore has appealed persistently to ISS to recognize the relevant policy differences between their country of incorporation and their country of operation, but thus far have had no such success.

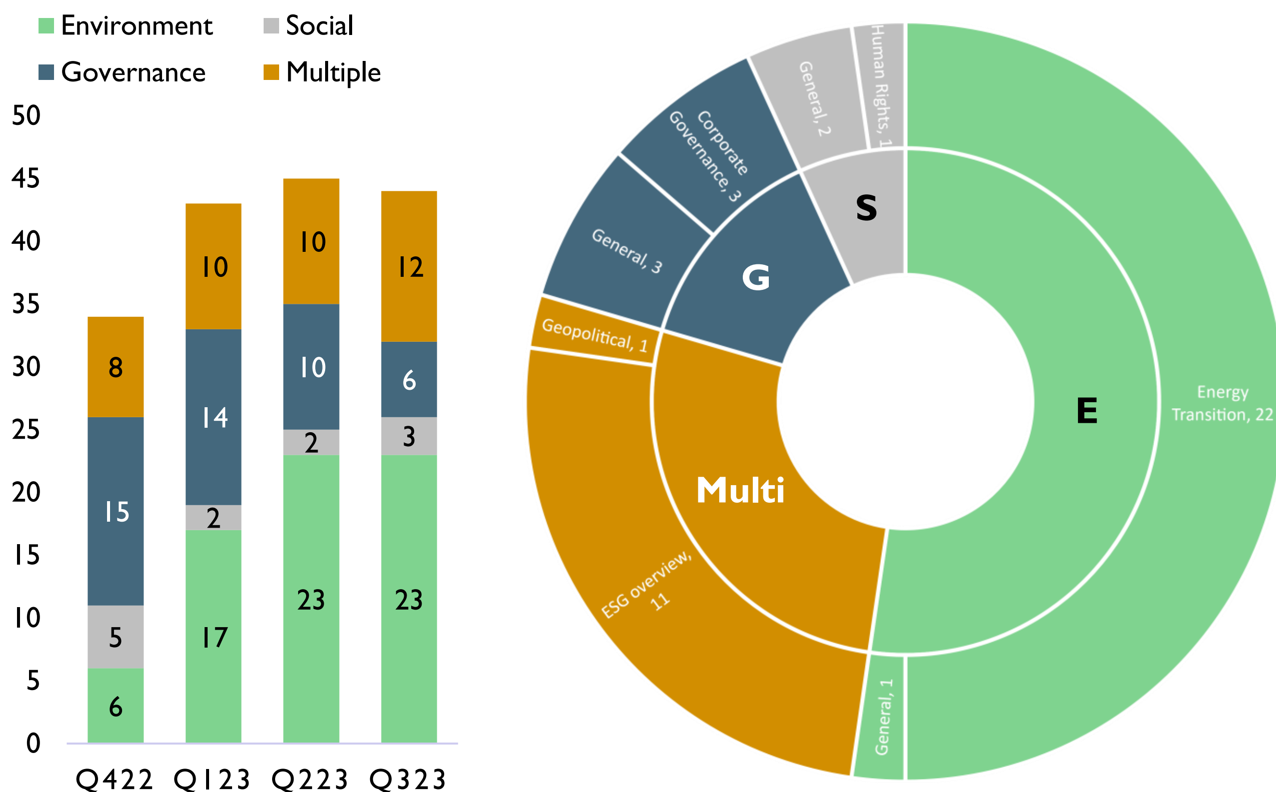
This meeting highlights the importance of independent review and the need for managers to play an active role in proxy voting, even whilst proxy research providers like ISS become increasingly efficient and adaptive. Fund managers should remain cognizant to the limitations of a low-touch, rules-based application for providing subjective judgement. Simultaneously, this encourages healthy communication with management, which improves mutual understanding between management and shareholders, and furthers alignment of interests accordingly.

Source: UnSplash

Engagement Summary

Corporate engagement is a core component of Hosking Partners' process. As well as engaging in specific situations, we focus on company management, and careful consideration is undertaken by the portfolio managers to assess whether the management teams' time horizons and incentive frameworks are aligned with the long-term interests of our clients. We also look to confirm management's understanding of capital allocation and believe part of getting capital allocation right is to consider environmental and social risks, along with other factors that might affect a company's long-term valuation.

Q3 2023 Engagement Breakdown



Hosking Partners' Q3 2023 Postcards

Jeremy and Chris meet with representatives from the Tokyo Stock Exchange during their September research trip to Japan.

Steve and Roman with Professor Russell Napier having attended his 'Practical History of Financial Markets' course.

Engagement Discussion

Company	Country	Engagement Type	% of Voting Shares
PENDRAGON	United Kingdom	Collaborative	1.5% (as at the end of Q3 2023)

Source: Pendragon

Over the course of 2023, Hosking Partners carried out an extensive engagement exercise with British automotive firm **Pendragon** to untangle a shareholder deadlock that has weighed on the company over the past 18 months. The saga started in Spring 2022, when the company's largest single shareholder – Hedin Group with 29% of the float – approached the company with an offer valued at 28p per share. This was rejected by the board without wider shareholder consideration. A few months later, Hedin blocked a rival approach at 29p by US firm Lithia. Hedin then made a second approach, also at 29p, but failed to turn this into a firm offer amidst rumoured financing difficulty. Meanwhile, Pendragon's share price languished around 18p. Throughout, the situation was complicated by an indecisive board and competing interests among management, board, and different groups of shareholders.

In February 2023, activist investor Palliser Capital emerged on the scene. It sought support from other shareholders for a letter to the Pendragon board urging a more proactive approach to resolving the shareholder deadlock, as well as for the company to carry out a thorough strategic review. Following discussions with the C-suite, board members, and other shareholders, we gave our support to the letter, subject to conditions. We made clear that our preferred solution would be one whereby Pendragon sold its legacy automotive business but retained ownership of its promising software enterprise, Pinewood. We valued the business at around 30p per share on a look-through basis, around a 50% premium to its share price at the time. At the AGM we supported the company, on the understanding that changes to the board would be announced subsequently, and the strategic review carried out.

In September, we were pleased to see our faith rewarded when Lithia announced a fresh approach worth a total of 27.4p per share. The offer was structured as a Class I transaction, requiring a simple majority (50%) of supporting votes to pass. This prevented Hedin from unilaterally blocking the deal, and so broke the shareholder deadlock. As we saw this as an attractive outcome for shareholders, we agreed to sign an irrevocable undertaking to accept the offer subject to the condition that this would fall away if a subsequent rival offer at a higher price received a board recommendation. Days later a bidding war broke out. Hedin and another US auto-retailer, Autonation, both launched all-cash offers at 32p per share. Our support for the Lithia approach, which had left the door open for other bidders, was rewarded when Lithia then responded with a raised offer, similarly structured to the first but priced at the higher level of 35.4p. At this point, Hedin and Autonation dropped out of the running, and the Lithia proposal was overwhelmingly approved by shareholders at a general meeting held on 26th October 2023.

This successful outcome demonstrates the value of persistent and wide-ranging engagement. It further demonstrates the importance of careful collaboration with others, as well as the value of prudence and caution when agreeing to commit voting shares, particularly to a course of action that is strongly supported by management. We plan to retain our holding in the new listed entity – Pinewood Technologies – and look forward to continuing to work closely with the company in the interests of our clients.

Investigating… Glencore Plc

*Over Summer 2023 we were pleased to welcome Girls Are INvestors ('GAIN') intern **Sophia Ground** to join our investment team and learn about life at HP. During her time with us, we gave Sophia the open-ended task of assessing the ESG-related risks associated with our materials exposure. As supply-focused investors, this is an area to which we are attracted due to long-run underinvestment, as recently discussed in the Hosking Post 'Where's a copper when you need one?'. However, the extractive industries are also exposed to a range of non-financial risks that may be material to long-term performance. Sophia focused on the question of how to incorporate the matter of corruption-related fines into a forward-looking valuation of the company. With our thanks to Sophia, an abbreviated version of her report is published below.*

In May 2022, Glencore Plc admitted to several charges of bribery and market manipulation. The allegations related to activity which took place in the early 2010s linked to West African oil trading and copper mining in the Democratic Republic of Congo. They resulted in penalties exceeding $1.5 billion, and raised questions about management ethics versus industry norms, and the extent to which such allegations pose a risk to the company in the future.

Originally a Swiss-based trading entity, Glencore has evolved into a multinational commodities firm. It divides its operations into industrial (exploration, development, extraction) and marketing (processing, refinement, distribution). These segments encompass energy products (coal, oil, natural gas) and metals and minerals, including metal recycling. The extractive sector divides into metals and minerals, and energy extraction due to differing extraction and refining methods, distribution, and usage. Glencore's vertical integration and diversification helps manage risk and has protected Glencore's margins from volatility. However, their corresponding lack of specialization may have been a weakness when it came to analysing and controlling compliance risks.

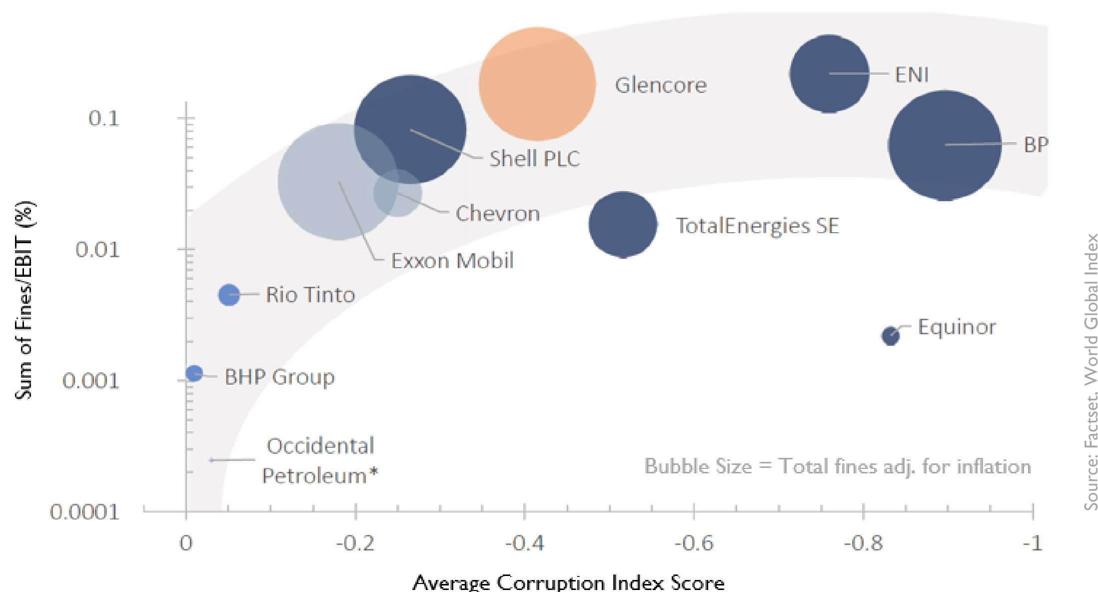
In general, fines relating to corruption tend to be heavily concentrated around energy extraction in emerging markets. They often relate to charges of market-fixing, fraud, and bribery. Many oil and mineral-rich countries have higher rates of conflict, corruption, and authoritarianism. This is a phenomenon known as the 'resource curse'. An extraction company for which government fees and royalties make up an increased proportion of production costs are more exposed to potential corruption, either to take advantage of lower costs, or to settle threatened disruption. Using data from the World Global Index on corruption level per country alongside published company reports on payments to governments, average corruption weighted by non-income tax payments to each country can be used to give a comparable figure of exposure to corruption by company. Analysing fines as a ratio of a company's EBIT at the time – the ability of a company to pay a fine when issued – versus the exposure to corruption yields notable results (see Figure 1, next page).

Glencore's corruption exposure is generally higher than its mining peers, but lower than several of the oil majors. Nevertheless, it has paid higher fines relative to the overall trend. The corruption allegations made against Shell, BP, and ENI in recent years dealt with tens of billions in bribes paid, with instances suggesting similar or higher corruption levels than Glencore. However, unlike Glencore all three were acquitted after years of trial. A cynic might conclude that this suggests the highly experienced oil majors have more effective legal departments rather than a genuinely lower degree of corrupt practices.

Years of high capex and negative EBIT in the run up to the period of increased corruption may have encouraged Glencore's oil trading department to adopt an increased risk appetite. Glencore's stake in oil extraction began as offshore development in Equatorial Guinea, with the project commencing production at the end of 2011. Following poor initial returns on capital, Glencore doubled down with further developments in Chad and Cameroon in 2013 for a considerable additional outlay of capex. The resulting debt, coupled with the contingent nature of Cameroon's reserves and a significant decline in oil prices from 2014 to 2016, culminated in negative EBIT margins within the oil segment despite achieving peak production levels.

According to the company, the culture at Glencore in the 2010s lacked transparency, and encouraged competition between internal departments rather than cooperation in pursuit of a shared aim. While not necessarily bad in and of itself, without the requisite oversight in place a

Figure 1: Fines/EBIT versus exposure to corruption



department faced with the axe (or simply bonus cuts) for underperformance may have been incentivised to take short-term risks. The concentration of compliance issues stemming from the London-based oil desk suggests that claims of endemic corruption within the whole company may be inaccurate, with the issues in fact localised to a select group of now ex-employees within a single errant department.

Glencore's compliance department has grown significantly in recent years. The employee count is now over 150 after being in single digits for many years. There has also been a management overhaul, with increased integration and interaction between departments as well as more active involvement of senior leadership. This has relieved the pressure on short-term performance competition between departments, allowing the adoption of a longer-term approach. Several multi-stakeholder groups which aim to promote transparency and anti-corruption legislation within the extractive industries (e.g. EITI and NRGI) monitor companies' commitments to transparency legislation and create diagnostic frameworks to identify red flags in advance. In recent years, Glencore has consistently met or exceeded the expectations of these entities, with its new compliance regulations adapted directly from US Department of Justice guidance.

Meanwhile, Glencore is a market leader in mining technologies that maximise efficiency. Efficiency is an important lever in all carbon-intensive industries' paths to net zero. Glencore has also developed a recycling business alongside its metal refining operations. By adapting existing metallurgy plants instead of constructing on greenfield sites, it has a lower footprint, reduced capex, and avoids issues with planning permission or building new distribution infrastructure. It has also partnered with several small battery recycling startups, which specialise in closed-loop recycling methods for electric vehicle batteries. Glencore has also started selling recycled material alongside primary production on the secondary market. These initiatives put Glencore in an advantageous position in the extraction and distribution market, as well as in the growing recycling market.

Glencore's journey from trading desk to vertically integrated global commodities firm has involved a compliance overhaul. Recent fines are largely representative of a historic lack of transparency and weak inter-departmental oversight, as well as relative inexperience in emerging oil markets. However, the shift in compliance culture that Glencore has since undergone means the company is now operating in line with industry standards. Nevertheless, continued exposure to geographies with a high corruption index is a risk that must be actively managed by the company and interrogated by active investors. With good management, the company's strong competitive position, improved compliance regime, and the relative protection offered by geographic and product diversification means Glencore remains an attractive prospect over the long term.

A focus on… Engagement in Japan

- A recent trip to Japan for two members of the investment team provided an opportunity to engage with representatives from the Tokyo Stock Exchange ('TSE').
- Our conversation shed light on the TSE's involvement in the 'quiet revolution' currently underway in Japanese corporate governance.
- These reforms are designed to unlock a significant amount of value in the Japanese market, and diligent active ownership by engaged shareholders is playing a vital supporting role.

The Tokyo Stock Exchange has been at the heart of an apparent renaissance in the Japanese stock market in 2023. We recently discussed this in our Capital Cyclists podcast 'Japan: Land of the Rising Shareholder'. Specifically, focus has been rightly paid to the TSE's edict, published in the Spring, imploring Japanese corporates to increase their focus on capital efficiency, improve returns on capital, and thus tackle the significant undervaluation of domestic shares versus global counterparts. A price-to-book ratio ('PBR') below 1x is no longer tolerable. Yet, while the TSE's initiatives since March this year appear to herald a watershed moment in Japan, the origins of this reform date to the Corporate Governance Code introduced back in 2015. As the saying goes, good things come to those who wait.

Three clear messages shone through in our conversation with members of the TSE's Listing Department. Firstly, the TSE's decision to focus corporates and investors alike on a PBR ratio greater than 1x reflects the importance of simplicity and universality. Secondly, the ambition of reforms is clearly long-lived, with their full scope reaching beyond these initial measures. Lastly, the TSE is coordinating its efforts alongside those of The Ministry of Economy, Trade and Industry ('METI'), the regulator, the government, and to a lesser degree global proxy voting agencies (most notably ISS and Glass Lewis). Together, this alliance is a force to be reckoned with.

Corporate governance reform in Japan was first championed by Shinzo Abe in 2013. Codified in 2015, the Corporate Governance Code sought to raise and equalise standards for domestic companies with those of their global peers. With limited independent board representation (less than 5% in 2014), strong bank and crossholding influence on company strategy, and de minimis shareholder involvement in capital allocation decisions, the reforms seemed a promising development for one of the world's major economic superpowers. And yet in 2023, over 50% of Japanese shares still trade at less than 1x PBR, cross-holding ownership remains high (the average Japanese corporate owns 20% of net assets in equities excluding treasury stock), and despite near 40% of listed Japanese companies boasting net cash balance sheets worth over 20% of equity, dividend payout ratios remain stubbornly low.

Despite the diversity of sectors, companies, and business models, the concepts of PBR ratio and return on equity ('ROE') are universal. While around 70% of Japanese corporates have fewer than two sell-side brokers covering the company (and half have none at all!), all are now obliged to share whether they meet the newly introduced minimum PBR requirements. Indeed, the pervasive coverage of the Japanese reforms by the domestic press – particularly Nikkei Asia, a staple broadsheet in every Japanese boardroom – has served to further popularise usage of these terms (a development about which the TSE Listing Department members were proud and impressed in equal measure).

Importantly, trading at over 1x PBR is not the final destination, but rather the first stop on a longer journey. The Japanese market boasts global market leaders, innovative niche disruptors, and dominant monopolistic businesses. Contrary to popular opinion, it is also a market that grows. Through 2010-2023 the growth rate for Topix-listed corporates' earnings per share was over 11% in US dollar terms, only 1% shy of the Nasdaq equivalent. Why the TSE was understandably reluctant to share what an ideal end destination looks like, it acknowledges that the journey ahead – and opportunity therein – is long-lived. Of this longer list of objectives, arguably the simplest to achieve is encouraging increased usage of English in reporting and disclosure. Perhaps more challenging is the stated objective to improve female Board representation – a target has been set of at least 30% of executive members by 2030 from only 11% in 2022 – but nevertheless the direction of travel is constructive.

Furthermore, our conversation with the TSE made clear that the exchange is not operating alone. When we praised our hosts for "leading the

charge,' the response was characteristically humble and retiring, with the efforts of METI, the FSA, and the Japanese government duly highlighted. Examples of such coordination include METI's updated guidance promoting M&A activity in Japan. Over 600,000 privately held small and midsize enterprises across Japan have an owner over 70 years old, as do a further 3,800 publicly listed companies. The opportunity for consolidation and value-accretive M&A is ripe. In sectors like oil refining, Japan has started to demonstrate what is possible. Today just three players account for the entire domestic market capacity. Meanwhile, the government is taking aim at Japanese households' investment balances, where today just 10% of liquid assets are exposed to equities – in the US the figure is 45% – while almost half is held in cash. The announced expansion of tax-advantaged N-ISA investment accounts is designed not only to re-address this imbalance, but also to provide a marginal source of buyers for Japanese shares.

These reforms are already gaining traction. The potential is clear, and a snowball effect is building. Companies' investor updates are now making frequent reference to initiatives designed to improve ROE, sharing progress on the shedding of cross holdings, and highlighting the strategic importance of raising PBRs. Total shareholder returns are at all-time highs for the post-War era. We are even starting to see a spattering of hostile takeovers and management buyouts; all signs of a healthy capital market oriented towards value creation. While typically capital cycle investors are wary of initial public offerings – given the resultant flow of capital into industries – the recent news that KKR has successfully launched the IPO of Kokusai Electric is another indicator of the rude health of the broader Japanese stock market.

Furthermore, investors themselves are playing an important role in establishing and sustaining this momentum. In recent years the approval ratings for Japanese management teams and boards of directors have reached the lowest levels in reported history. Even domestic investor voting practises – which have traditionally been passive – are increasingly reflecting a renewed challenge towards corporate Japan. Bloated balance sheets, poor returns on capital, and miserly shareholder returns are now being voted accordingly. Activist investors are also playing an important role in encouraging progress. Today over 70 activists are present in Japan – a number that has grown 10x over the past decade – with each pursuing a handful of campaigns on average. Whether public or private, shareholder proposals at general meetings are increasing, and the number of successful campaigns is testament to the largely thoughtful and respectful way they are being pursued. Over the past year, Hosking Partners has 'piggy-backed' on the work of a number of these activists. This strategy allows us to leverage their influence without the need to build concentrated – and therefore potentially risky – single-stock positions.

For all the reasons expressed above, we returned from Japan encouraged by what we had heard and excited by the opportunity that is rapidly developing. But there remains a considerable way to go. Not only do over 50% of Japanese shares still trade below 1x PBR, but the TSE estimates that only one third of corporates have formally submitted a plan for improved capital efficiency and rising returns on capital. Undeterred, the TSE has recently announced that from January 2024 it will be publishing a monthly list of those that are meeting requirements, and therefore implicitly highlighting those that are not. The snowball may still be small, but it is gathering pace. At the time of writing – as of the end of Q3 2023 – the Hosking Partners portfolio has approximately 12% of client assets invested in Japan across a basket of over 50 holdings.

Source: UnSplash

VOTING PROCESS

Hosking Partners has subscribed to the 'Implied Consent' service feature under the ISS Agreement to determine when and how ISS executes ballots on behalf of the funds and segregated clients. This service allows ISS to execute ballots on the funds' and segregated clients' behalf in accordance with ISS recommendations. Hosking Partners retains the right to override the vote if it disagrees with the ISS recommendation. In practice, ISS notifies Hosking Partners of upcoming proxy voting and makes available the research material produced by ISS in relation to the proxies. Hosking Partners then decides whether or not to override any of ISS's recommendations. A range of factors are routinely considered in relation to voting, including but not limited to:

- **Board of Directors and Corporate Governance**. E.g. the directors' track records, the issuer's performance, qualifications of directors and the strategic plans of the candidates.
- **Appointment / re-appointment of auditors**. E.g. the independence and standing of the audit firm, which may include a consideration of non-audit services provided by the audit firm and whether there is periodic rotation of auditors after a number of years' service.
- **Management Compensation**. E.g. whether compensation is equity-based and/or aligned to the long-term interests of the issuer's shareholders and levels of disclosure regarding remuneration policies and practices.
- **Takeovers, mergers, corporate restructuring and related issues**. These will be considered on a case by case basis.

In certain circumstances, instructions regarding the exercise of voting rights may not be implemented in full, including where the underlying issuer imposes share blocking restrictions on the securities, the underlying beneficiary has not arranged the appropriate power of attorney documentation, or the relevant custodian or ISS do not process a proxy or provide insufficient notice of a vote. The exercise of voting rights may be constrained by certain country or company specific issues such as voting caps, votes on a show of hands (rather than a poll) and other procedures or requirements under the constitution of the relevant company or applicable law.

The decision as to whether to follow or to override an ISS recommendation or what action to take in respect of other shareholder rights is taken by the individual portfolio manager(s) who hold the position. In circumstances where more than one portfolio manager holds the stock in question, it is feasible, under the multi-counsellor approach, that the portfolio managers may have divergent views on the proxy vote in question and may vote their portion of the total holding differently.

ENGAGEMENT PROCESS

Hosking Partners recognises that ESG considerations are important factors which affect the long-term performance of client portfolios. ESG issues are treated as an integral part of the investment process, alongside other relevant factors, such as strategy, financial risk, capital structure, competitive intensity and capital allocation. The relevance and weighting given to ESG and these other issues depends on the circumstances relevant to the particular investee company and will vary from one investee company to another. Whilst Hosking Partners may consult third-party ESG research, ratings or screens, Hosking Partners does not exclude any geographies, sectors or stocks from its analysis based on ESG profile alone. The multi-counsellor approach, which is deliberately structured so as to give each autonomous portfolio manager the widest possible opportunity set and minimal constraints to making investment decisions, means that ESG issues and other issues relevant to the investment process are evaluated by each portfolio manager separately, with the support of the Head of ESG.

Interaction with management and ongoing monitoring of investee companies is an important element of Hosking Partners' investment process. Hosking Partners does however recognise that its broad portfolio of global companies means that the levels of interaction are necessarily constrained and interaction will generally be directed to those investee companies where Hosking Partners expects such involvement to add the most value. Monitoring includes meeting with senior management of the investee companies, analysing annual reports and financial statements, using independent third party and broker research and attending company meetings and road shows.

Hosking Partners looks to engage with companies generally, and in particular where there is a benefit in communicating its views in order to influence the behaviour or decision-making of management. Engagement will normally be conducted through periodic meetings and calls with company management. It may include further contact with executives, meeting or otherwise communicating with non-executive directors, voting, communicating via the company's advisers, submitting resolutions at general meetings or requisitioning extraordinary general meetings. Hosking Partners may conduct these additional engagements in connection with specific issues or as part of the general, regular contact with companies.

Some engagements highlighted in this publication are part of an ongoing two-way dialogue, and as such Hosking Partners may not always publish the specific details of engaged firms. Where this is the case, further information about the engagements is available to clients upon request.

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