

Clarios, LLC

- World's largest manufacturer and supplier of low-voltage batteries
- A subsidiary of Brookfield Business Partners
- Acquired from Johnson Controls in 2019



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How the Federated Hermes high-yield team incorporates ESG

Understanding, evaluating and incorporating material environmental, social and governance (ESG) factors is a valuable component of our credit research, providing our investment teams with a complementary stream of information to identify long-term risks and opportunities. We use this analysis to generate a proprietary ESG score for every company owned, a process based on direct engagement with companies.

About Clarios

Clarios is the world's largest manufacturer and supplier of low-voltage batteries. The company primarily serves the passenger vehicle end market and is roughly four times the size of its largest competitor in the space. Federated Hermes has been involved with the name since the business was spun out of Johnson Controls and sold to Brookfield Business Partners in 2019. In 2020, Clarios published a blueprint for sustainability, the company's unifying framework and integrated ESG approach. During our engagement at this time, we asked Clarios to increase its transparency on ESG topics, metrics and goals in appropriate areas as the company continues to evolve its strategy.

Investment thesis

The management team estimates that one in three passenger vehicles worldwide are powered by a Clarios low-voltage battery, with 150 million annual unit sales in over 100 countries. We believe many elements of the business have made it an attractive investment. First, with an estimated 5 times the sales of its next largest competitor, it is a clear market leader with significant scale. Earnings and cash flows appear to be highly stable and predictable, given the largely nondiscretionary nature of low-voltage battery replacements in passenger cars. The company's sponsor, Brookfield, pledged significant cash equity and told a compelling story about streamlining the business's domestic operations to provide a sustainable earnings boost over the medium term. Additionally, we viewed the company as an attractive ESG investment candidate given the closed-loop nature of its primary product and the opportunity it had to continue to grow in a world where all passenger vehicles are ultimately pure BEVs (battery electric vehicles). From a high-yield investment

perspective, governance has been strong, and management has proven to be debtholder-friendly, having dedicated nearly all of its free cash flow after investing in growth to paying down debt and deleveraging the balance sheet.

ESG factors specific to the sector and the firm: Digging deeper into the "E"

Electric vehicle transition

The high-yield group at Federated Hermes believes keenly that investors can apply ESG principles to credit issues that threaten certain businesses' long-term viability. An automotive supplier focusing exclusively on supplying its customers with components only relevant to internal combustion engines (ICE) faces a potential reality of lower secular demand as the global fleet of passenger vehicles transitions to BEVs. Lower demand typically leads to lower earnings and cash flows, which could obstruct a business's ability to service its debt in the future. Clarios's principal product, the low-voltage battery, is powertrain-agnostic — it provides power to the growing energy demand across the low-voltage network, regardless of whether it is in a traditional ICE, hybrid or fully BEV. Regardless of its propulsion mechanism, every vehicle needs a low-voltage power source to get it started, power various electrical functions (i.e., lights, infotainment, autonomous features) and support key safety functionality within the vehicle.

The management team at Clarios follows a chemistry-agnostic approach. The company offers a range of low-voltage solutions capable of meeting the needs of its original equipment manufacturer customer, regardless of the vehicle's powertrain. Clarios supports this with ongoing investment into and development of emerging chemistries like sodium-ion and the complementary use of supercapacitors. These initiatives are supported by 350 engineers across the company's research, advanced development, materials and manufacturing efforts, and its more than 2,000 patent assets, including active patents and pending patent applications.

Circular economy

All of the batteries that Clarios manufactures are recyclable. The company recycles 8,000 batteries per hour, 24 hours a day, seven days a week and 365 days a year within its network. The result is that 76% of the lead and 54% of the plastic used within its batteries comes from recycled or remanufactured content. In utilizing recycled materials, Clarios's batteries require approximately 90% less energy to process and generate approximately 90% fewer life-cycle greenhouse gas (GHG) emissions than virgin materials (Clarios, LLC 2023 Sustainability Report). The company has a long history of operating a closed-loop system using its in-house recycling and collection capabilities and third-party recyclers. This approach provides a stable supply of cost-advantaged local recycled materials for new battery production.

In Clarios's aftermarket channel, the company pioneered an incentive structure to encourage the return of spent batteries to the point of sale, minimizing the leakage of materials from the company's circular system. This point-of-sale exchange allows the company to reduce transportation costs and GHG emissions by pairing the delivery of new batteries with the reverse logistics of collecting spent batteries.

In 2021, we questioned the company's ESG reporting progress since it released its sustainability blueprint. We reiterated our desire for a more formal ESG report from the company. The company stated it was planning Sustainability Accounting Standards Board (SASB)-aligned disclosure later in 2021 and was working on Task Force on Climate-related Financial Disclosures (TCFD)-aligned reporting, which we welcomed.

Moving forward

Clarios's 2020 ESG report included performance metrics on the appropriate ESG matters identified in the company's sustainability blueprint to establish baseline measurements. In our subsequent engagement, we discussed the report as a positive step towards greater transparency. We reiterated our request for the company to set and disclose forward-looking goals and targets. The company published its SASB-aligned disclosure index in its 2022 Sustainability Report released in 2023. We wrote to Clarios, continuing to encourage the setting of ESG goals, particularly given the two years of reported data.

In early 2023, the company confirmed that it intends its published ESG data to have the same discipline as its financial data, and for its ESG disclosures to be governed by a senior management ESG Council and overseen by the board's ESG and risk sub-committee. The company also committed to the Science-Based Target initiative (SBTi) and will submit its climate targets to the SBTi in 2025. We welcomed the opportunity to contribute to the company's materiality assessment and engaged again with the company in July 2023, providing positive feedback on its third ESG report.

The company's reporting continues to evolve, with the latest report providing metrics and targets aligned to material matters. We consider that Clarios has made sufficient progress on its ESG disclosures. We will continue to engage with the company on climate risks and further enhancements to its ESG reporting.

Bottom line

We believe Clarios is an excellent example of how the high-yield team at Federated Hermes marries ESG analysis and traditional fundamental research to create an investment hypothesis. We view the company's focus on ESG issues as credit-enhancing and appreciate the resulting risk mitigation. We see the potential for the company to continue to generate strong financial results while furthering its ESG journey, eventually readying itself to achieve its stated desire to operate as a public company.

The case study is shown to demonstrate engagement. EOS does not make any investment recommendations, and the information is not an offer to buy or sell securities.

ESG investments may be viewed as "sustainable," "responsible" or "socially conscious," among other names. ESG factors may be utilized and evaluated differently by different investment managers and may mean different things to different people. Investing based in part on ESG factors carries the risk that, under certain market conditions, the investment strategy may underperform strategies that do not utilize such factors. The application of responsible investment criteria may affect exposure to certain sectors or types of investments and may impact relative investment performance depending on whether such sectors or investments are in or out of favor in the market. An investment's ESG performance or an investment manager's assessment of such performance may change over time. The successful application of ESG factors is dependent on an investment manager's skill in properly identifying and analyzing material ESG issues, and the suitability of ESG investments may change over time.

The ESG ratings assigned are one consideration among others as part of the security selection process. The qualitative analysis described does not automatically result in including or excluding specific securities but is used as an additional input to improve portfolio risk/return characteristics.

Bond prices are sensitive to changes in interest rates and a rise in interest rates can cause a decline in their prices.

High-yield, lower-rated securities generally entail greater market, credit/default and liquidity risks, and may be more volatile than investment grade securities.

There is no guarantee that any specific investment approach will be successful. **Past performance is no guarantee of future results.**

The Federated Hermes high-yield team may consider the EOS engagement information in managing certain products and strategies that incorporate ESG factors. Not all Federated Hermes products and strategies incorporate ESG factors in the same way.

This information has been obtained from sources deemed to be reliable, but neither the completeness nor accuracy can be guaranteed.

