How to accelerate your green value creation

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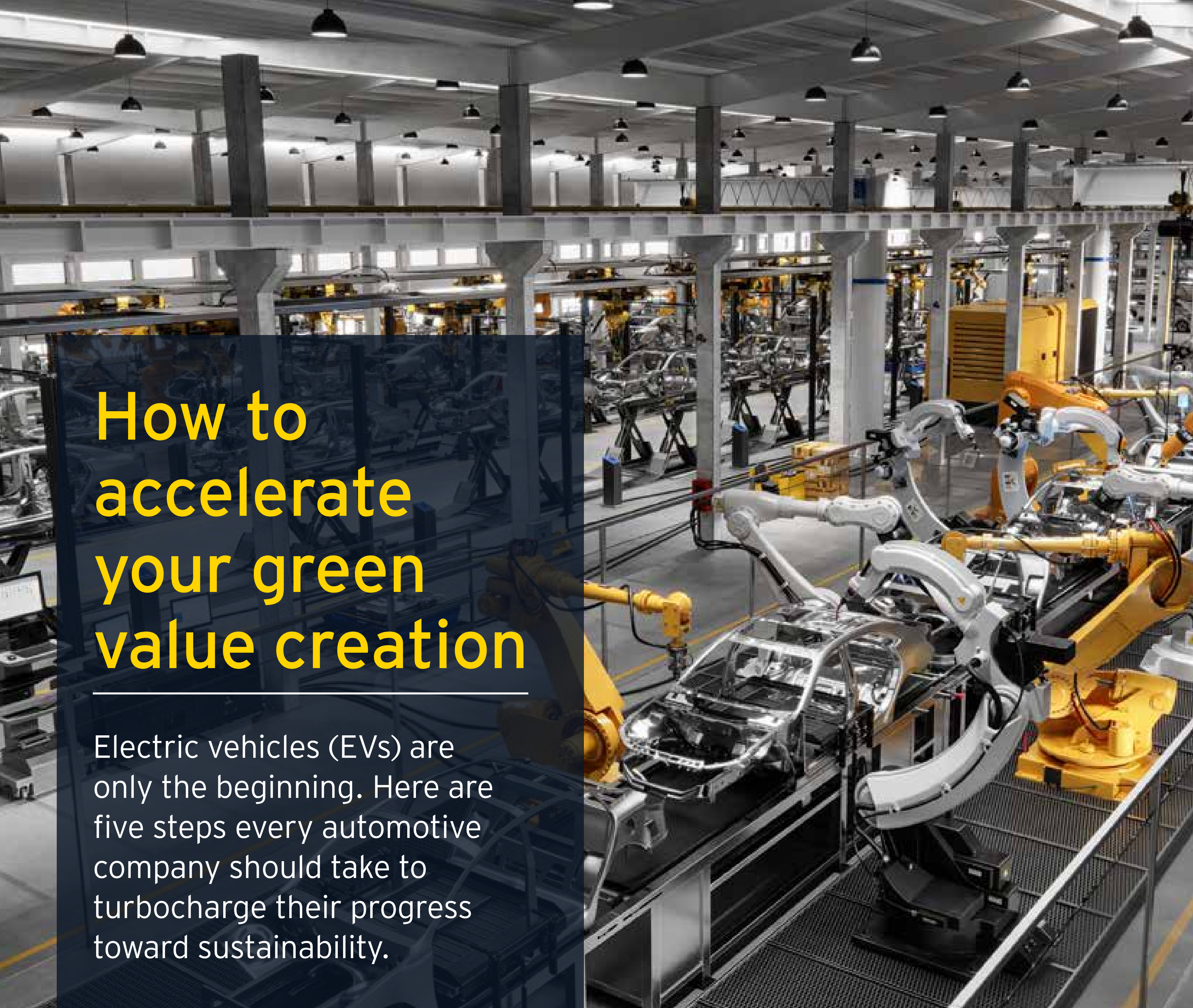

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Electric vehicles (EVs) are only the beginning. Here are five steps every automotive company should take to turbocharge their progress toward sustainability.

The internal combustion engine is on its way out. This marks the first step into a more sustainable future for mobility. Most industry insiders agree that the only question for original equipment manufacturers (OEMs) and their suppliers is whether they want to be a follower or a leader in the sustainability transformation.

A gradual transition to automotive's second century may look tempting. After all, selling to a new market alongside an old one might be profitable in the short run and less wrenching to your company's culture. But given the rapidity with which this shift is happening, your company may not have that luxury. An array of powerful political, social and economic trends may drive it even faster than the nearly 20% annual growth already forecast for EVs between now and 2027.

The speed of change may be so rapid, that some automotive industry leaders see EVs as table stakes in an even bigger environmental, social and governance (ESG) transformation. A few are beginning to ask – and answer – a host of important ESG-related questions: Should maximizing the number of cars sold still be our aim? What other ecosystems will develop as EVs flourish? How sustainable is our sourcing and how can we improve it? How can we benefit from improved diversity and inclusion? Are we designing all of our product's components with "end of life" in mind?

Integrating ESG into your business model

Of course, you could wait and see how your peers respond to this challenge, but given the speed with which technologies now advance, a bold offense may ultimately be a less risky strategy.

Here are **five steps** to get you started:

1 Start at the end

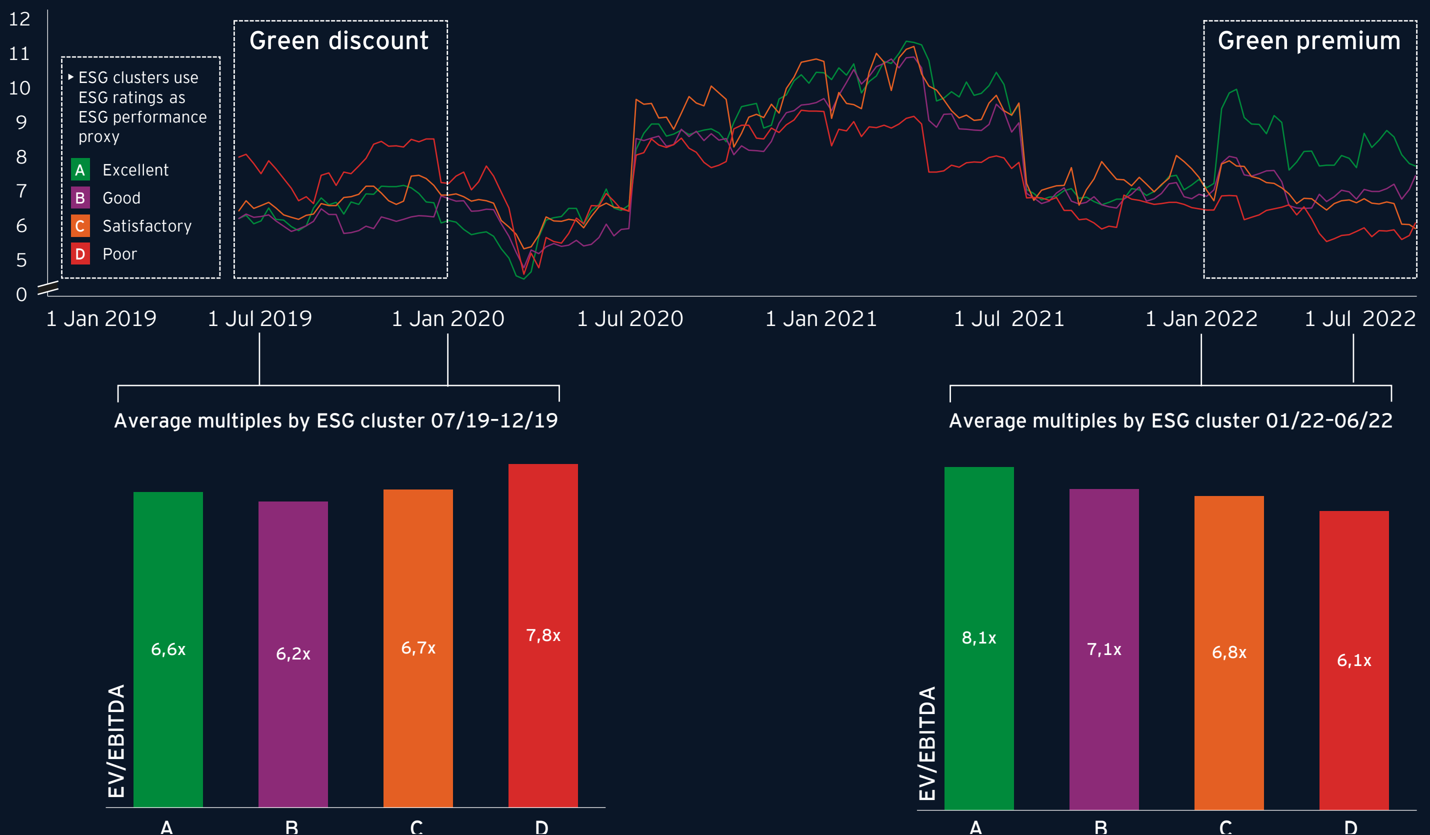
ESG can no longer be just another box-checking exercise. Your ESG program must be fully integrated into your C-suite agenda, at a level detailed enough to reverberate through your strategy, capital allocation and target operating model. The strategies you choose will depend on the nature of your ESG ambitions — your envisioned end scenario. They will also have to be integrated with existing business targets and KPIs, particularly those related to growth (e.g., sales growth) or profitability (e.g., earnings before interest and taxes (EBIT) margin). These decisions will influence where you place your bets (e.g., internal combustion engine parts vs. battery electric modules), and how you organize your capital allocation, your ways to operate, including sourcing criteria, and talent recruitment and retention.

2 Think of ESG as a new value driver

It's easy to dismiss ESG as a new name for corporate social responsibility, but it would be a mistake to take such a narrow view. Just three years ago, ESG leaders[1] (as defined by the EY organization) traded at a discount to laggards (a 6.6-times enterprise value to EBITDA [EV/EBITDA] multiple against the laggards' 7.8 times). Today, however (year-to-date 2022), they have almost two times the advantage (8.1 times to 6.2 times). Companies that are incorporating sustainability into their strategies credibly command a substantial premium in today's market.

[1] ESG leaders are from companies with ESG ratings, as per Refinitiv, in the top quartile.

EV/EBITDA trading multiples of automotive companies by ESG cluster



This is true in the debt markets as well, where companies with strong sustainability value propositions have long enjoyed a lower cost of capital. Companies that earned a top-quartile Sustainalytics ESG rating between FY2018 and 2020 could borrow at 2.9% compared with 3.9% for companies scoring in the two bottom ESG quartiles. Sustainable companies have a lower beta as well, suggesting that investors believe better ESG performance correlates with lower systemic risk.

In the automotive sector (as well as most others), the positive relation between ESG performance and value holds even when controlling for different aspects such as profitability, growth or size. When we look at the EY proprietary ESG impact model, which treats ESG ratings as proxies for sustainability performance and plots them together with key financial KPIs against total shareholder return, we find that ESG performance is an important value driver for automotive companies and one of the top indicators of total shareholder return.

ESG offers some of today's lowest-hanging fruit for operational improvement. A 1% bump in ESG performance can do more for total shareholder value than a 1% gain in your EBIT margin. It's easier and cheaper to raise your ESG score from 70 to 70.7 than taking your 10% EBIT margin to 11% – and it can do more for your total shareholder value.

In other words, traditional value maximization frameworks should consider adopting ESG performance:

$$\sum_{BU=1}^{n} \frac{(\text{Multiple} \pm \text{ESG Adj})_{BU}}{} \times (\text{EBITDA} \pm \text{ESG Adj})_{BU}$$

KPI	Factor	Exemplary impact/total shareholder return
EBIT margin	0.28	Improvement of EBIT margin from 10% to 11% improves excess **TSR by 0.28%**
Net income margin	0.23	Improvement of NI margin from 6% to 7% improves excess **TSR by 0.23%**
ESG score change	0.200	Improvement of ESG score from 70 to 70.7 improves excess **TSR by 0.20%**
Gross profit growth	2.330	Improvement of GP growth rate from 4% to 5% improves excess **TSR by 2.33%**

3 Find your own path

Sustainability frameworks, such as SASB, MSCI and TCFD, can be a good starting point for understanding the most relevant ESG topics for your company based on your sector specifics. But you will need to adapt them to your own situation, using them to determine material topics and then benchmark your own performance against your peers.

Material topics for automotive companies according to selected sources[2]

	MSCI	SASB	Sustainability reports
GHG emissions		●	●
Energy management		●	●
Waste and hazardous materials management	●	●	●
Labor practices	●		●
Product quality and safety	●	●	
Product design and lifecycle management		●	●
Materials sourcing and efficiency		●	
Competitive behavior		●	●
Clean technology	●		●
Governance	●		●
Supplier involvement and monitoring			

When you consider the relevant topics, it is clear that an exclusive focus on the decarbonization of your products' use phase is not enough. An EY study[3] of 200 companies shows that when it comes to environmental impact, product use ranks fourth, and own production (excluding energy) in fifth, behind supplier footprint, logistics and energy byproducts. That's why, despite being an electric pioneer, Tesla was kicked off the S&P 500 ESG Index. "While Tesla may be playing its part in taking fuel-powered cars off the road, it has fallen behind its peers when examined through a wider ESG lens," S&P concluded in a corresponding blog post.

As the Tesla example suggests, it's important to think about the entire value chain, not just the product. There are so many variables in terms of product, production and sourcing, that it's not always easy to see where your company's sustainability needs have the most substantial impact on the environment and society, or present the greatest risks to your business model. However, the fact that it's difficult doesn't mean you don't need a clear understanding of all your ESG weaknesses – and begin to design a program to address them.

[2] SASB, MSCI, automotive companies' nonfinancial reports, EY analysis.

4 Reimagine your structure

Obvious moves, such as redesigning sourcing strategies and implementing new ESG-friendly KPIs, will not be enough. You will need to optimize and maybe even reinvent your target operating model. This will entail a holistic view of multiple dimensions of your operation, taking the end goal as your starting point, both for your group and the individual business units.

On the one hand, this may require taking a fresh look at particular functions:

- **HR:** Adopt hiring criteria and campaigns to bolster diversity and inclusion.
- **IT:** Amend the IT and system landscape, and design "open" interfaces to collaboratively determine scope 3 emissions together with business partners.
- **Procurement**: Consider human rights aspects in sourcing criteria.
- **Learning and development**: Implement dedicated trainings and awareness trainings for compliance and integrity.

On the other hand, redesigning entire business units may be the best option. For instance, considering sustainability in the design phase may lead you to want to separate "green" (good bank) from "gray" (bad bank) assets, making it easier for your company to react opportunistically to market opportunities and monetize any green dividends that accrue. Also, aspects such as tax transparency and fairness play a central role when structuring tax groups and starkly influence the perception as that of a good corporate citizen.

You should also consider nonorganic growth options. One recent study of AM&M companies found that 75% expect to see more M&A activities driving their sustainability performance. M&A activities need to be proactive, incorporating ESG in perimeter designs in divestment cases, thoughtful integration of ESG as screening criteria for target selection. There may well be other kinds of heavy lifting involved, such as a wind-down or a divestiture, taking a minority stake in a company, signing on to a joint venture, or even undertaking a merger or acquisition where the synergies include enhanced sustainability or a better social outcome.

Many companies are already finding new financial and ESG value in such moves. In 2016, E.ON spun off Uniper, its portfolio of fossil fuel assets. STEAG, a German power giant, is also in the process of separating its fossil assets from its green energy production. Ford Motor Company, meanwhile, is cleaving its EV business from internal combustion engine (ICE) vehicle production as a way to boost its e-profits. Sometimes, even more courage is required: Shell, for example, is simply shutting down several refineries to speed up its transition to net zero.

This hard work may also lead to new opportunities, even early in the process. For example, it's worth reminding your team that a commitment to ESG makes for easier recruiting. Being a sustainability leader can give you a powerful advantage in attracting younger talent, as many young people want to work for an organization that shares their values.

[3] Sustainable portfolio study, November 2022.

5 Lead with "no regret" moves

Of course, it won't be possible to do everything at once. As with traditional business plans, the actions in an ESG-driven strategy need to be carefully prioritized.

To build momentum, it's a good idea to start with ESG-friendly measures that also have a positive financial impact. Such no-regret moves improve at least one dimension (e.g., ESG performance or strategic fit) without risking capital.

For automotive companies, this may mean taking advantage of public funding schemes for ESG initiatives, such as the US$3b earmarked by the US Postal Service to purchase a new generation of zero-emission delivery vehicles, and tax credits for clean fuels and reduced emissions, or the €9.7b European Regional Development Fund.

Conclusion:
ESG is your business

A company can become a high-performing ESG leader only after it begins to understand the full range of ESG risks and opportunities ahead, and insights that cannot be gained unless sustainability metrics are deeply integrated into its larger, long-term strategic financial plan. In the automotive industry, in particular, success will depend increasingly on the degree to which the company makes sure that ESG is no longer a side project. From here on out, ESG must be everyone's business.

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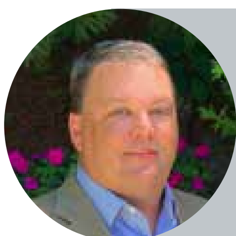

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