SUMMARY VERSION

Why investors should engage automotive companies on the impacts of their supply chains: Risks and Opportunities

Lead the Charge

October 1, 2024

Executive Summary

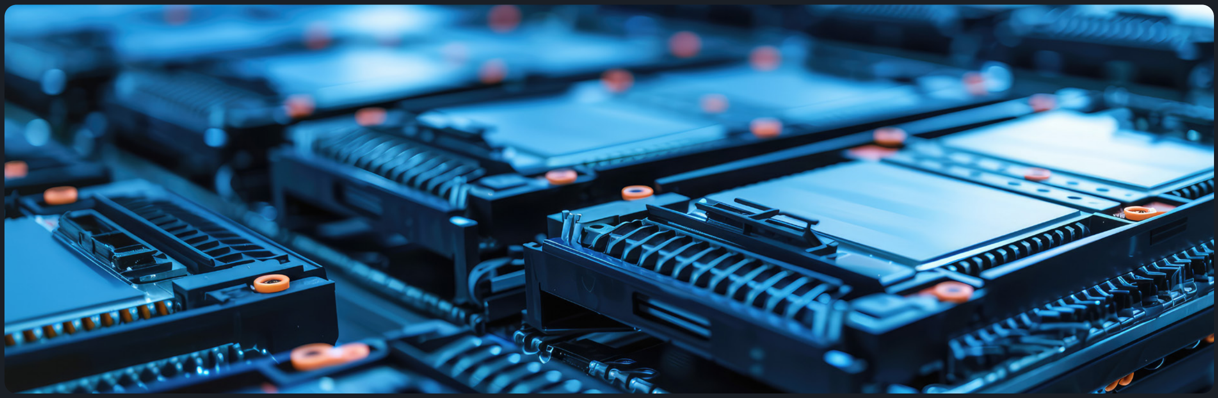
The global automotive industry is undergoing a profound transformation as it shifts from internal combustion engine (ICE) to electric vehicles (EVs). This transition is not only transforming the cars we drive, but is also propelling a far-reaching overhaul of automotive supply chains. As automakers work to build out new supply chains for EVs, they face a range of ESG risks and opportunities that will have significant implications for these companies and the value they create for shareholders.

The supply chains of automotive companies can significantly influence their financial and ESG performance. **Supply chains are a significant source of material risk**, which is "typically driven by ESG factors, such as natural resource depletion, human rights abuses and corruption" that can harm the reputations, operations and financial performance of investee companies. Conversely, **effective management of supply chain ESG can bring both short-term and long-term financial benefits**, such as increased revenue, better regulatory compliance, and enhanced stakeholder confidence (UN PRI, 2017). A study of US firms has provided evidence of these benefits, demonstrating that firms that "better manage supply chain ESG exhibit higher future stock returns," which persist "for at least three years."

Automotive supply chains also represent a **strategic lever for advancing the ESG goals of investor stewardship strategies**. A study by Trucost estimates that 95-96% of the automotive sector's environmental impacts are located in the supply chain, when compared to its direct operations. When automotive companies take action to address these impacts, they can not only reduce their own environmental footprint but can drive improved sustainability standards and practices across multiple industries, showcasing the potential of automaker supply chain action to catalyze positive environmental and social outcomes.

As the EV transition accelerates, the focus on automakers' ESG impacts will increasingly turn to their supply chains, providing investors with an important role to play in ensuring that automakers can more effectively manage the ESG risks and opportunities within their supply chains.

By constructively engaging with automotive companies on these issues, setting expectations for ESG risk management and disclosure, and allocating capital in ways that drive the industry towards greater sustainability, investors can mitigate financial risks and drive long-term value, as well as positive social and environmental outcomes, across their portfolios.



EXECUTIVE SUMMARY

Automotive supply chain risks and opportunities for investors

AUTOMOTIVE SUPPLY CHAIN DECARBONIZATION AND SUSTAINABILITY	
RISKS FOR INVESTORS	**OPPORTUNITIES FOR INVESTORS**
Failure to meet 1.5 °C-aligned climate goals: A Polestar and Rivian commissioned report has shown that, even when making rapid progress towards a fully electrified global vehicle fleet, automakers will exceed their 1.5 °C carbon budget unless they also aggressively reduce upstream scope 3 emissions. To stay within the emissions budget, the transition to EVs “must be accompanied with an 81 percent reduction in supply chain emissions by 2032.” Investors in the automotive industry that have committed to align their portfolios with the goals of the Paris Agreement therefore risk missing these targets unless automakers intensify their efforts to reduce their supply chain emissions.	**Driving progress on decarbonization goals across multiple industries:** As a leading source of demand for steel, aluminum and batteries globally, the automotive industry presents a unique opportunity for climate-conscious investors to advance their climate commitments. By leveraging their substantial purchasing power, automakers can unlock critical investments in green steel and aluminum, catalyzing the decarbonization of these hard-to-abate sectors, currently responsible for approximately 13% of the world’s CO2 emissions. Automotive supply chains therefore represent a strategic lever for investors to accelerate progress towards their emissions reductions targets across multiple industries in their portfolios.
Growing regulatory risks: New regulations, especially in the EU, are imposing increasingly stringent requirements on supply chain sustainability. Regulations such as the EU Batteries Regulation and the Corporate Sustainability Directive (CSDDD) impose risks of hefty financial penalties and market access restrictions for non-compliance. Others, such as the Carbon Border Adjustment Mechanism and France’s EV Subsidy regime, portend to put laggards on supply chain decarbonization at a competitive disadvantage. Automakers that fail to get ahead of these regulatory trends and demonstrate meaningful improvements on supply chain sustainability face severe transition risks that can adversely impact profits and shareholder value.	**Competitive advantage opportunities:** As consumers increasingly look to minimize their impact on the environment, ESG-related claims are driving higher product growth. These dynamics are becoming particularly salient in the EV market, as competition between OEMs for environmentally-minded EV consumers intensifies. Investors can capitalize on these trends by supporting EV manufacturers to strengthen their supply chain sustainability performance as a key strategy to differentiate their brands from competitors, capture market share and gain consumer loyalty.

AUTOMOTIVE SUPPLY CHAIN DUE DILIGENCE AND RESPONSIBLE SOURCING	
RISKS FOR INVESTORS	**OPPORTUNITIES FOR INVESTORS**
Litigation and operational disruptions: Suppliers of automotive companies that fail to respect human rights and environmental standards are facing a rising tide of costly legal challenges, which can result in huge fines or the suspension of licenses. As mandatory human rights and environmental due diligence (HREDD) laws gain momentum across major markets, these legal risks will increasingly extend to downstream companies. Financial penalties for non-compliance with the CSDDD, for example, can reach 5% of the company's net worldwide turnover. Suppliers that violate human rights also expose automakers to social unrest that can cause operational disruptions and reputational damage, shutting down or delaying projects for months on end at a significant cost to downstream companies. **The financial risks of Indigenous Rights violations in automotive supply chains:** Over half of the energy transition mineral resource base is located on or nearby Indigenous lands, raising the risk of conflicts and legal disputes if these minerals are extracted without Indigenous Peoples' Free, Prior and Informed Consent (FPIC). Courts have increasingly ruled against projects lacking FPIC, causing costly delays and suspensions that negatively impact not only the implementing companies but also their downstream customers. Investors should therefore see due diligence on FPIC as a strategic investment to mitigate these risks. **Risks to shareholder value:** Human rights violations in automotive supply chains can not only depress the market capitalization of upstream companies and projects, but also negatively impact the share price of downstream companies, as evidenced by the impact of supply chain scandals on companies such as Boohoo and Top Glove.	**Driving improved environmental and social performance across investment portfolios:** Engaging with automotive companies to enhance their supply chain human rights and environmental due diligence offers investors a strategic lever to improve ESG performance across multiple portfolio companies and sectors. Global automotive companies sit at the top of a supply chain that spans multiple industries and thousands of suppliers. Through robust policies, due diligence and supplier engagement, automakers can use this leverage as a force for good, driving a race to the top on human rights, environmental and labor standards within the industries that depend on auto supply chains as a key source of revenue. **Business opportunities for automotive companies:** Automotive companies can achieve significant economic benefits by proactively driving improved human rights, environmental and labor standards in their supply chains. Effective supply chain ESG management can drive financial gains through increased productivity and reduced operational costs, compliance with regulations, enhanced stakeholder confidence, facilitating technology adoption, improved labor retention, and better management climate and social risks, ultimately creating value and innovation throughout the supply chain. **Creating enabling conditions to achieve climate commitments:** Strong supply chain HREDD is also a key enabling factor for ensuring a successful transition to EVs and renewable energy. For example, it is essential for unlocking reliable and diversified sources of transition minerals. Supporting automakers to strengthen their HREDD systems, Supply Chain Due Diligence and Responsible Sourci including on FPIC, is therefore complementary to investor efforts to advance the goals of the Paris Agreement.

Evaluating Automakers' Supply Chain Performance with the Lead the Charge Leaderboard

The Lead the Charge Leaderboard offers investors valuable insights and data into how effectively automakers are managing ESG risks and opportunities in their supply chains. By evaluating 18 leading automakers across more than 80 indicators related to climate, environmental sustainability and human rights, the Leaderboard highlights key industry leaders and laggards, best practices, and areas needing industry-wide improvement. The annual benchmark emphasizes practical implementation over policy commitments, providing investors with a useful tool to engage with automakers on the effectiveness of their supply chain ESG management.

The Leaderboard can help investors to identify:

- Which automakers are more effectively capitalizing on the business opportunities related to supply chain sustainability, and which automakers are falling behind.
- Supply chain risks that automakers are failing to address, collectively and/or individually.
- Current supply chain ESG management best practices at the industry-wide level.
- Industry trends that can provide valuable insights into opportunities for investors to use their leverage in ways that achieve the greatest impact.

Recommendations for investors

Investors in major automotive companies can drive the transition to cleaner, more equitable, and environmentally sustainable automotive supply chains through the following actions:

- **Policies, Targets and Governance:** Review and refine public commitments to align portfolios with the Paris Agreement and international human rights standards, ensuring that they adequately encompass supply chain impacts. Incorporate standards and metrics on HREDD, FPIC, and workers' rights into operational policies and decision-making processes.
- **Investor engagement:** Develop engagement strategies for the automotive sector to drive meaningful changes by automakers on supply chain ESG, using the Leaderboard as a tool for identifying priority engagement areas. Engage systemically and cross-sectorally to support an enabling environment for accelerating progress towards sustainable auto supply chains.
- **Response and Escalation:** When adverse supply chain impacts have been identified, escalate engagement to ensure that automakers take action to mitigate and remedy these impacts. Support shareholder resolutions for improved disclosures and practices, and file or co-file resolutions as needed to drive faster action by industry laggards.