MFS® Case Study

Sustainability in Action: Volkswagen

August 2023

In brief

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In **2015**, Volkswagen was branded with a **scandal involving emissions** that led to a long period of oversight by US authorities.

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The events of the scandal initially resulted in our team taking a **negative view of the company** in addition to it being given the **lowest ESG rating** by a third-party agency.

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In this case study, we describe how, through fundamental analysis and engagement, we were able to look past the ESG rating to find **attractive fundamentals** and an **improving sustainability outlook**.

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This case study highlights **the power of active management**, and how a forward-looking, bottom-up, **ESG-rating agnostic approach** can unveil untapped investment opportunities for investors.

Dieselgate: Reputation and recovery

In 2015, Volkswagen was branded with a Clean Air Act violation after emissions violations and poor governance practices were unearthed.

The scandal initially progressed as follows:

- VW was the focus of widespread investor and consumer concern, along with impaired valuations compared to its original equipment manufacturer (OEM) peers.
- The company was given the lowest ESG rating by MSCI (CCC),[1] determining it uninvestable under third-party rating criteria.
- VW chose to leave the United Nations Global Compact (UNGC) — a UN pact to encourage businesses to adopt sustainable and socially responsible policies and practices — following “Dieselgate,” subjecting it to further exclusion.
- Our team took a negative view of the company, which is one reason we downgraded our rating.

Is it best to divest? The case against ex ante exclusion

While the Volkswagen case raised concerns for us, we also recognized that wider spreads caused by the scandal presented an opportunity to enhance returns for investors.

VW makes up a significant part of the automation sector and Euro Corporate Bond Index, and excluding it could constrain our ability to outperform the benchmark for our clients. We believe a combination of traditional credit analysis alongside sustainability considerations and thorough engagement reveals relative value opportunities. Critical to this analysis is a sound understanding of the company's strategic path forward. When seeking to drive returns and effectively manage risk, understanding whether VW would be able to remain relevant and generate cash flows over the long term was critical.

The road to recovery

After tracing the company's recovery efforts over the past few years, we have begun to take a more positive view.

Environmental leadership

- The company committed to a low-carbon transition and was early to set some of highest electrification targets in the industry.
- VW issued €3 billion in green bonds in 2021 to "refinance" existing projects related to its production of battery-electric vehicles.
- The company has planned for an ambitious 30% reduction in CO_2 by 2025, and carbon neutrality by 2050.
- Following the VW's departure from the UNGC, the compact's founder was hired by the company to lead its reformed ESG strategy.
- In February 2021, VW announced its reinstatement in the UNGC.

Over time, these observations have positively reinforced our investment thesis, and our view has now changed. Our fundamental analysis revealed that VW's environmental strategy is the most comprehensive within its sector. We believe its renewed commitment to sustainability potentially enhances its reputation and may increase its resilience in the marketplace over the long term.

Rethinking corporate governance

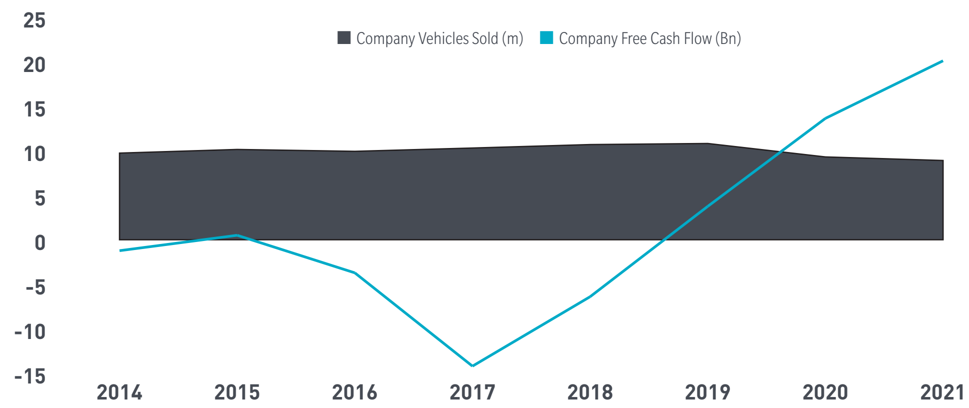
Some of VW's greatest conflicts have been internal and governance-related due to family and state ownership, lack of independence and the long-term nature of board membership. Our research has revealed that company leadership is aware of its governance issues and has recently introduced management changes across all divisions in 2020 as board members sought to shake off a reputation tarnished by Dieselgate. We expect to see governance concerns gradually easing as strategic reform based on sound principles gains traction.

What about consumers?

Dieselgate appears to have impacted investors more than consumers, with VW's reputational risk having less impact on unit sales and free cash flow. In our view, free cash flow is one of the strongest indicators of the health of a company. Exhibit 1 shows how despite the scandal, VW's sales remained steady and its free cash flow generation reverted to strong positive flows after the company paid billions in fines.

Exhibit 1: Reputational risk

'Greenwashing' to Green Bonds



Source: Company data.

Despite a serious breach from an ESG perspective, ongoing engagement with VW unveiled insights on multiple fronts, helping to both inform our clients and support our investment thesis.

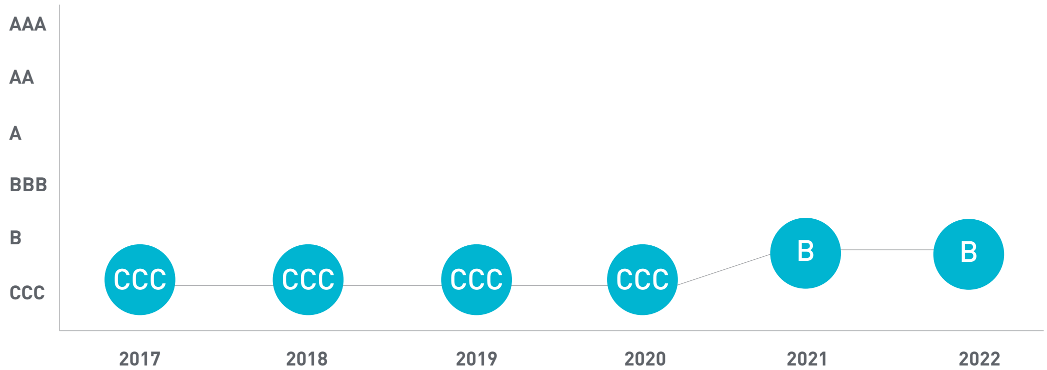
Looking through the rearview mirror? The role of third-party ratings

Despite VW's downgrade to a CCC ESG rating by a third-party following Dieselgate, the case highlights key limitations of overrelying on third-party ratings in investment decision making. We believe that ratings can be backward-looking and may not be refreshed often enough to reflect recent progress a company has achieved to improve its ESG profile:

- We felt that the third-party ratings provider focused too much on the emissions scandal and did not account for the environmental strides the company has made.
- The company is currently positioned as Europe's largest electric vehicle producer.
- VW has also demonstrated a clear strategy to meet progressively stringent regulation and political-driven climate targets through efforts such as increasing production of battery- manufacturing plants.

In our view, these decarbonization plans and sector initiatives render the company undervalued. This was reinforced following discussions between MFS analysts and the rating agency. After discussing the company's sound sustainability strategies and the massive changes made over the years to recover from Dieselgate, VW's MSCI ESG rating was upgraded to B from uninvestable CCC, as of November 2022. This highlights how, in our opinion, third-party ESG ratings are often inadequate when it comes capturing the complexities of sustainability analysis, which is why they are just one component of our broader materiality analysis across companies and sectors.

Company third-party ESG rating



Source: MSCI ESG ratings as of November 2022.

Where do we go from here?

Bottom-up fundamental analysis and thoughtful issuer engagement are at the heart of our long-term ownership philosophy, and VW presented a strong case. That said, wide spreads, poor ESG ratings and Europe's move toward electrification showed the need for robust analysis and engagement. Engaging in it allowed for clearer insights into the company's strategic direction and a reevaluation of its third-party ratings. Volkswagen's recovery will be a long-term pursuit, and we believe active management will be key. Going forward, fundamental analysis and engagement with the company will remain a vital part of our investment thesis.

Endnotes

[1] As of August 2017. MSCI ESG Ratings aim to measure a company's resilience to long-term ESG risks. Companies are scored on an industry-relative AAA-CCC scale across the most relevant Key Issues based on a company's business model.