LKQ:

engagement commentary

Federated Hermes SDG Engagement Equity
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ENGAGEMENT COMMENTARY:

LKQ

In a nutshell

LKQ is a global distributor of vehicle products, including replacement parts, used in the repair and maintenance of vehicles.

US$14.3bn

Market capitalisation (Aug 2023)

US$12.7bn

Revenue (FY22)

45,000

employees (FY22) of which 19.5% are female

Carbon intensity:

27.8 MT

Scope 1 and 2 greenhouse gas emissions per US$m of revenue (FY22)

Most pertinently for this note, LKQ is the largest recycler of automobiles in the world. Circularity is at the heart of its business model. In North America, its salvage operations recycle more than 90% of the materials from end-of-life vehicles.

LKQ's recycling activities intrinsically generate a positive environmental impact; and it is well positioned to sustain its commitment to automotive circularity as the proportion of electric vehicles (EVs) around the world increases.

Furthermore, the company has made meaningful steps to reduce its operational emissions footprint and enhance the livelihoods of the 45,000 people it employs.

Investment case

- Secular trend favouring alternative collision parts, in North America in particular.
- Long track record of execution by experienced management team.
- Scale enables superior part availability, ensuring improved reliability for customers.
- European alternative part utilisation under 10% suggests opportunity for LKQ to grow and penetrate the market through partnerships with key European insurers.

Theory of change

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Enterprise impact

In 2023, LKQ celebrated its 25th anniversary. The company has, through its salvage and recycling operations, generated significant positive environmental impacts over the course of its history to date.

The next 25 years, however, will see a fundamental change in the automobile market and vehicle population. EVs will slowly replace traditional internal combustion engine (ICE) vehicles and technology should further reduce the frequency of collisions.

As the total number of vehicles in operation shifts towards EVs, recycling and remanufacturing priorities will change. The battery is – by some distance – the most expensive component of an EV vehicle. This shift presents challenges.

Lithium-ion batteries, for example, need careful end-of-life management to avoid leaching of dangerous chemicals. Furthermore, the mining of the various metals needed for such batteries requires vast resources. So while EVs can reduce CO_2 emissions over a vehicle's lifetime (depending on the electricity used to power them); the batteries they require mean they start life with a large environmental footprint.

As the world's largest vehicle recycler, LKQ has shown a commitment to the circularity of materials for ICE engines. It is well positioned to expand these capabilities to cover EVs as well.

Operational impact

LKQ is a large operation, spanning 26 countries and about 45,000 employees. A large proportion of workers are paid by the hour and on modest incomes; many doing dangerous work.

As a result, there is significant scope for the company to reduce its own operational emissions footprint, and to address social inequalities by investing in its employees.

Practice of change

Since investing in LKQ we have had multiple interactions with management, including site visits, and have discussed a range of sustainability topics.

While the company has a track record of positive environmental impact, it is only recently that it has begun to formalise its sustainability strategy.

To that end, we welcomed the appointment in 2021 of the company's first Sustainability Director. Since this appointment, along with the appointment of a new Senior Vice President of Human Resources, the company has accelerated its commitments towards both its people and its operational impacts.

EV circularity

The average life span of an automobile today is in the region of 12 years, suggesting the transition to EVs will take decades. ICE vehicles are still forecast to hold about two-thirds of total global auto market share in 2030[22]. The emergence of EVs as a mass-market product is a recent phenomenon. One reason recycling capacity has lagged battery production is because an EV can run for years before its battery pack requires disposal. As a result, a non-closed battery loop is commonplace, leading to material waste and costly disposal. Nonetheless, 1.3 million batteries are expected to need repair or replacement in Europe by 2030 – and this figure is forecast to increase by 30% annually[23].

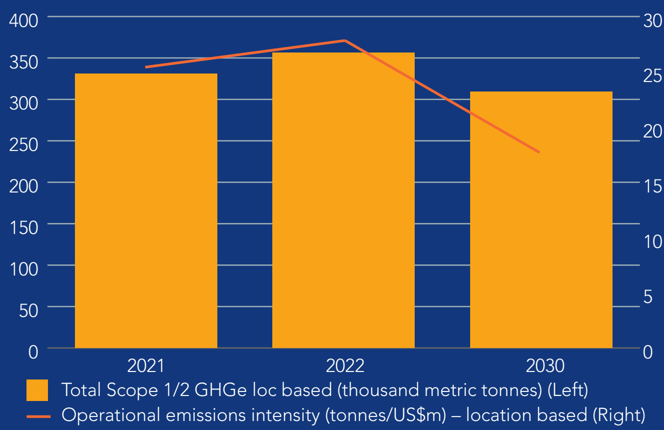
LKQ has made a number of strategic acquisitions in anticipation of this shift. The company has acquired hybrid battery remanufacturers GreenBean and Bumblebee, both of which specialise in repairing faulty battery cells and extending a battery's useful life. Over the longer-term, the company has signed a memorandum of understanding (MoU) with Korea Zinc to pursue the recycling of lithium-ion batteries in the US.

An EV battery's life span is typically seven to nine years. Replacement costs can be between US$8,000 and US$20,000, which poses a significant challenge to developing a second-hand EV market. However, LKQ's investment in remanufacturing hybrid batteries should help reduce this cost barrier – and there is potential to develop similar solutions to remanufacture EV batteries.

Operational carbon footprint

Despite a year-on-year increase in reported emissions in FY22, the company is making strides forward. LKQ has committed to a 30% emissions intensity reduction by 2030 vs. 2021 and a roadmap towards this target will be established by 2025. The company has set a target to become net zero by 2050. LKQ began measuring its Scope 3 emissions in 2023 (in addition to Scopes 1 and 2)[24].

Figure 10: 30% operational emissions intensity reduction by 2030 (vs. 2021)



Source: Company reports.

A large contributor to the company's operational emissions is its 14,000 vehicle fleet. It has begun to procure electric and bio-fuel vehicles – for example, 100 electric vans and 30 compressed biomethane trucks in the UK – which should help address this. However, we believe the company has the capacity to accelerate this transition. With current emissions reduction targets only set to modestly reduce absolute emissions by the end of the decade, we believe the company should heighten its ambition.

Workforce

The CEO has described the workforce as 'the heart and soul' of the company, and we have been struck by the vocal commitment of management towards its workforce.

[22] 'Explosive' growth means one in three new cars will be electric by 2030, IEA says - Carbon Brief

[23] LKQ Expects Major Savings in Cost and CO_2 from Traction Battery Repair and Remanufacturing - LKQ Corp

[24] **Scope emissions:** Scope 1, Scope 2, and Scope 3 is a classification system for greenhouse gas (GHG) emissions a firm creates through its operations, energy usage, and the wider value chain.

- Scope 1 emissions – All direct emissions from the activities of an organisation or under their control. Including fuel combustion on site such as gas boilers, fleet vehicles and air-conditioning leaks.
- Scope 2 emissions – Indirect emissions from electricity purchased and used by the organisation. Emissions are created during the production of the energy and eventually used by the organisation.
- Scope 3 emissions – All other indirect emissions from activities of the organisation, occurring from sources that they do not own or control. These are usually the greatest share of the carbon footprint, covering emissions associated with business travel, procurement, waste and water.

Of course, these words need to be supported by actions. **Reassuringly LKQ has raised its wage floor the last few years**, to US$14 in early 2021 and US$15 by the end of 2021. Its **average hourly starting wage in early 2023 was above US$18.** Wage increases for its hourly employees have outpaced the wider workforce in each of the last two years and US$1,000 was deposited in every United States employee's 401k pension plan during 2022.

Beyond basic pay, the company has introduced a number of meaningful benefits to help address any financial insecurities its employees may face. For example, it began to rollout an income advance scheme in the United States during 2023 – a benefit which evidence suggests has a meaningfully positive impact on reducing financial stress.

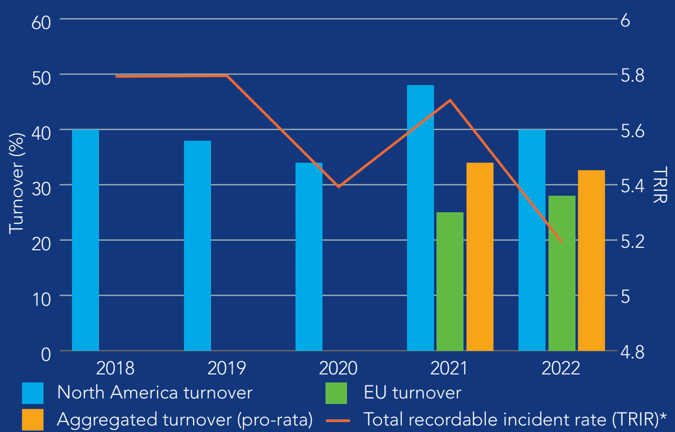
We believe LKQ's management team is genuinely committed to directing workforce investments in a such a way as to break inter-generational poverty – a common feature in many of the communities in which its sites are located.

The company's Joseph M. Holsten Scholarship fund for children of employees has been around for a number of years. In the past, however, the scholarship fund's outreach was modest. In 2023, the fund grew to US$1m and should support 400 beneficiaries per year (1% of the total employee population). The company has also reinforced its commitment towards US employees who wish to further enhance their own educational and career advancement journeys by increasing annual tuition reimbursement to US$5,000 per employee.

We were further heartened by the CEO publicly noting on a February 2023 earnings call that "positive employee engagement is critical, but importantly, it's the right thing to do for our most important asset, our people". We very much agree with this view and are sympathetic to the fact that cultural change takes time and results longer still.

Nonetheless, we observe that the company does operate with very high levels of staff turnover and accident rates – the two are typically highly correlated. Our view is that there remains much scope for improvement here: both as the management team continues to develop its genuine commitment in this regard and with substantive actions and investments. The results should be beneficial for staff but also for business: unnecessary turnover is costly; stressed employees are unproductive, and accidents incur insurance claims.

Figure 11: Turnover and accident rates



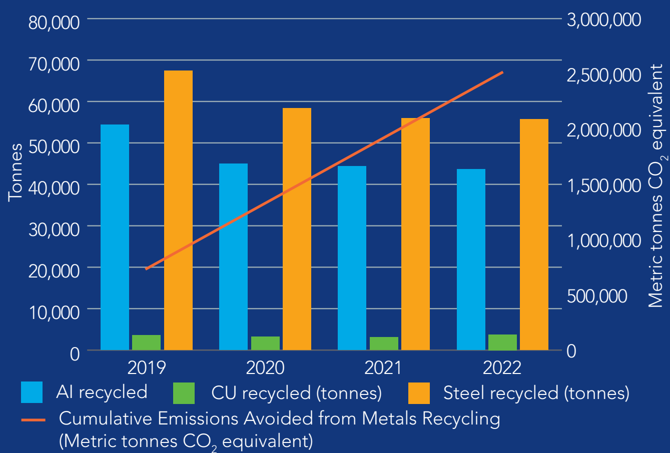
***incidents per 200,000 hours worked**

Source: Company reports.

Enterprise impact – avoided emissions

As the world's largest recycler of vehicles, the company's positive environmental impact is central to its business. LKQ procured 768,000 vehicles in 2022. From these vehicles it salvaged 90% or more of the materials. In terms of the metals alone, this process results in significant avoided emissions – displacing demand for primary production. But this reduction is only part of the story as fluids (fuel, motor oil to windshield washer) from the salvaged vehicles are reused, including in its own vehicles, and tyres are similarly sold or repurposed.

Figure 12: Emissions avoided from metal recycling (metric tonnes CO_2 equivalent)



Source: Company reports and Federated Hermes estimations.

Next steps

We have been pleased by LKQ management's commitment towards expanding its positive impact in emissions reduction, not least as the automotive industry evolves from ICEs to EVs. Nonetheless, **we wish to see additional change:**

- **Accelerated fleet transition with heightened (absolute) operational emissions-reduction goals.**
- **Ongoing investment in people (including pay) to aim for a Living Wage Plus employment model with expanded internal career development paths and an ongoing commitment to breaking the cycle of intergenerational poverty.**
- **A further concerted focus on health and safety with senior management accountability to drive down accident rates.**

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