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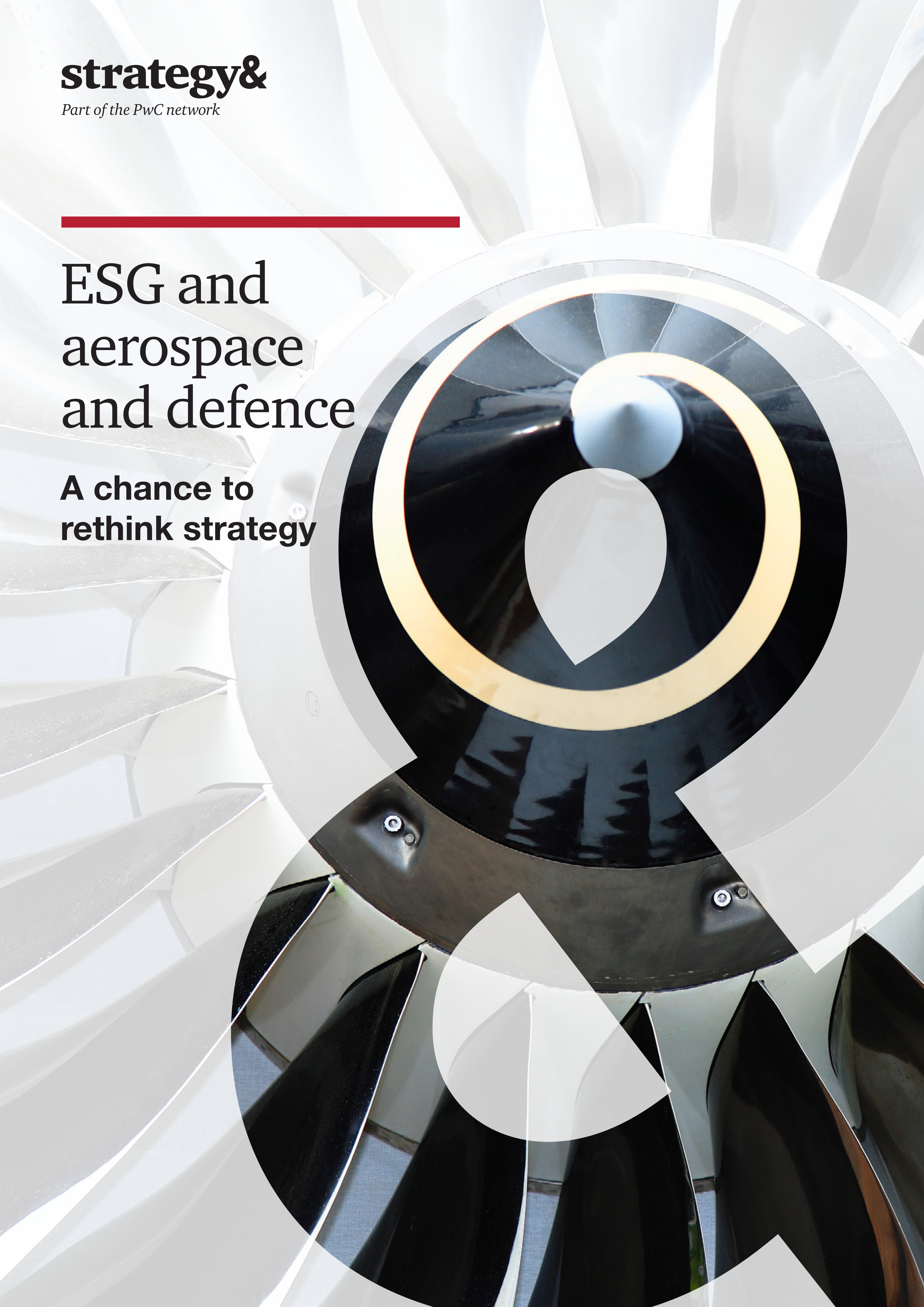
ESG and aerospace and defence

A chance to rethink strategy



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ESG and aerospace and defence: A chance to rethink strategy

Corporates must assess their strategies in the context of ESG, to transform themselves and reaffirm their purpose in society.

Despite a growing and significant body of thought leadership on Environmental, Social and Governance (ESG), it remains an area many aerospace and defence executives are grappling with. This article aims to help resolve that challenge, bridging the gap between high-level ESG thinking and more technical literature. It offers a framework to think through and put in place business initiatives to address ESG and identify growth opportunities.

There are many drivers of the ESG agenda for aerospace and defence companies, depending on where they sit in the value chain and whether they are public or private organisations. Regardless, those that lead on ESG are most likely to find competitive advantage and create better value for stakeholders.

Authors: Diane Shaw, Harry Malins and Alison Hollingsworth.

Why is ESG important?

At its simplest, ESG provides an umbrella framework to assess a company's impact on the environment and society, as well as its system of rules, practices and processes. But while everyone talks about 'ESG' and 'green', there are no official, comprehensive definitions other than those being developed by the European Commission and the generally accepted definitions used by green bonds issuers.

Figure 1 – Environmental, Social and Governance (ESG) definition

ESG is an umbrella framework that refers to the impact of a company on the **natural environment**, social **equality and fairness** and to the **quality of its corporate governance**

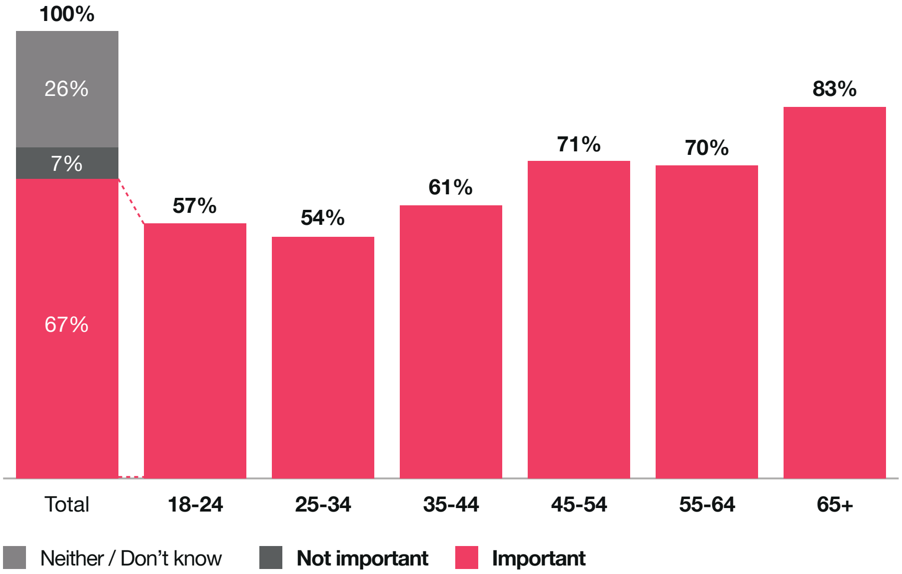
Environmental The impact of a company on the environment	• Respect for the **natural environment**, including contribution to **climate change**, consumption of **natural resources**, production of **pollution and waste** products and support for **environmental improvement**
Social The contribution of a company to fairness in society	• **Contribution to equality, fairness and trust in society**, including responses to social trends by improving **inclusion, diversity, mobility** and **welfare**
Governance Processes for decision making, reporting and ethical behaviours	• The quality and scope of **reporting**, nature and type of **accountability**, level of **independent oversight** and **ethical behaviours** in a firm – on both ESG and non-ESG matters • Considers elements such as **board structure**, director and audit **independence** and **Executive compensation**

Source: Strategy& analysis

Companies can no longer ignore ESG

Driven by factors such as climate change, social inequality and the impact of COVID-19, and amplified through social media platforms, ESG has become front of mind for most organisations. PwC UK's 24th Annual CEO Survey shows organisations are increasingly focusing on purpose and sustainability. This year, 70% of UK CEOs told us they are concerned about climate change, compared to just 44% in 2019. And there are already positive signs of change, with 60% of UK CEOs planning to increase their investment in sustainability and other ESG initiatives over the next three years. Around a third also noted they should be doing more to report on their purpose and values, and their organisation's impact on its wider communities.

Figure 2 – Views on the importance of business operating in a sustainable way, by age group



Source: Nationally representative survey of UK consumers, PwC UK, February 2021

70%

of UK CEOs told us they are concerned about climate change, compared to just 44% in 2019

Source: PwC UK's 24th Annual CEO Survey

More stakeholders to manage

Companies are no longer answerable just to shareholders, but to a far broader set of stakeholders: customers, employees, suppliers, communities, the press and regulators. Below, we summarise the breadth of stakeholders that companies now need to consider when addressing ESG.

Figure 3 – ESG stakeholder environment – Aerospace and defence example

Customers

- Increasing demand for **ESG-compliant products** and related disclosures, particularly from public sector customers
- Demand is **likely to grow across all products and services**

Shareholders / investors

- Institutional investors are **putting pressure on companies to act on climate change** (e.g. shareholder resolutions)
- Investors are increasingly including **ESG** as a **consideration** for **investment decisions** (access to capital)

Value chain partners

- Strategic partnerships will increasingly assess ESG policies as part of **partnership due diligence checks**
- Organisations that do not respond to ESG adequately risk **narrower partnership opportunities** across the value chain

Senior Management

- Corporate **vision, mission** and **values**
- **Management decision** in response to ESG influences (e.g. climate change)
- **Proposition** and **business model** (e.g. ESG growth opportunities)

Communities / press

- Companies are increasingly **held to higher standards** in their interactions with the public
- Companies that do not meet standards risk **potential reputational** impacts, which may increase in frequency and severity

Employees / unions

- ESG will be a **significant lever** for **talent management** given **changing employee attitudes** towards the **purpose of work**
- Research shows that **employee satisfaction** drives **higher productivity** and is positively correlated with **shareholder returns**

Regulators

- Aerospace and defence has long been a **highly regulated industry** with an emphasis on health and safety
- We can expect regulators to place even **stronger requirements** on environmental standards in the near future

Internal stakeholders   External stakeholders

Source: Strategy& analysis

How should companies think about ESG?

Break it down and choose where to participate

ESG addresses the broadest of scopes and can have an impact on all components of a company’s strategy and operating model, especially if it chooses to embrace ESG fully. To make it easier to tackle ESG, executives should first think through the three elements of ESG separately and then do so at the next level down – considering Environmental elements including buildings and footprint, products and services, supply chain and distribution, for example. Figure 4 offers a framework for companies to break down ESG into more structured and manageable sub-elements.

> “Business leaders should consider their ESG ambitions against the expectations of the stakeholders who matter most to the business.”

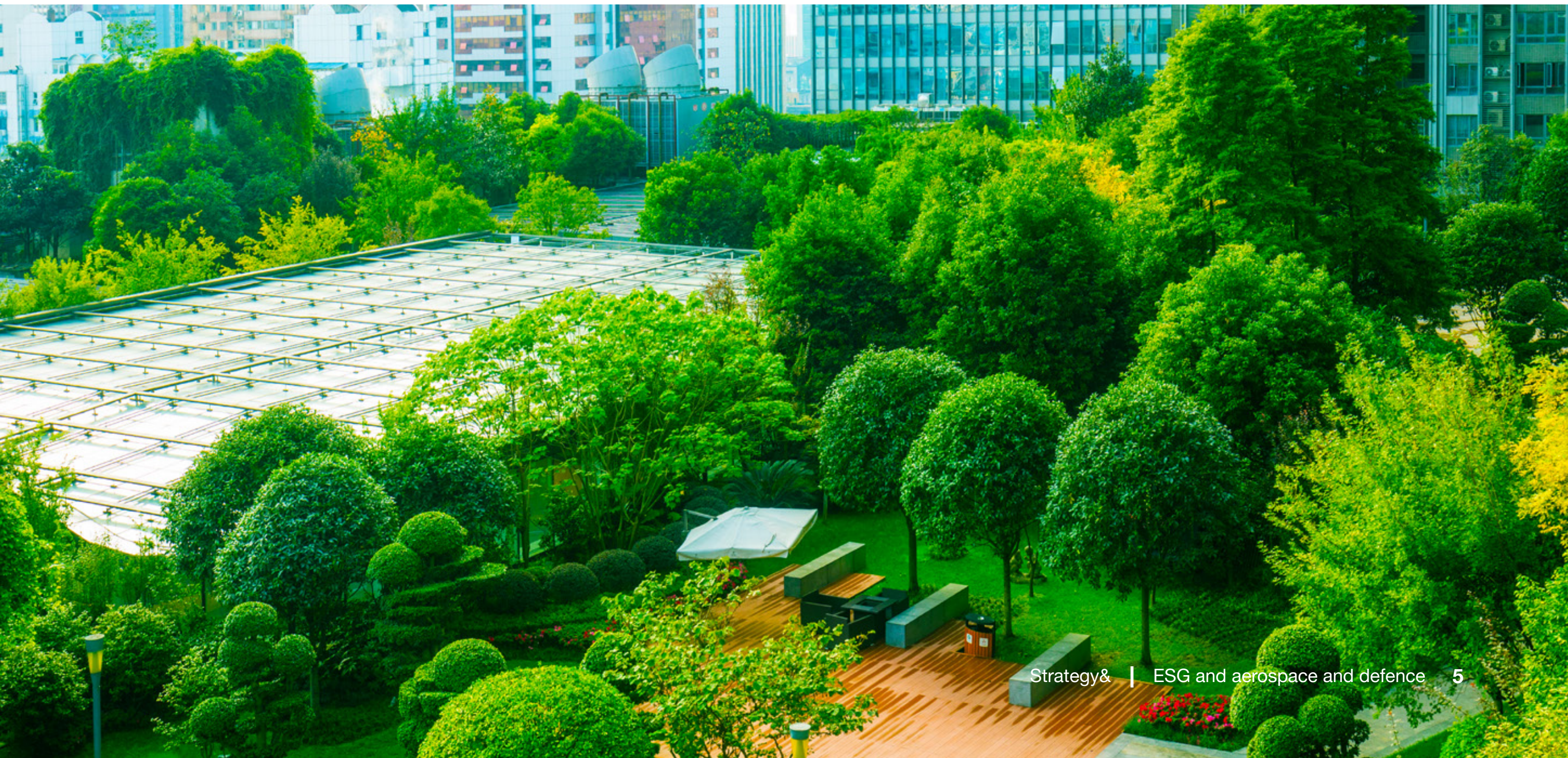


Figure 4 – ESG framework for companies

Dimensions		Examples
Environmental The impact of a company on the environment	**Buildings & footprint**	• **Carbon emissions from offices or data centres**, waste to landfill from facilities (e.g. non-recycled electronics) • Waste water from offices and facilities (e.g. localised pollution from factories)
	Products & services	• **Emissions from services**, such as emissions from aircraft and ships • Waste from products which go to **landfill** (e.g. non-recycled single use plastics)
	Supply chain & Distribution	• **Commiting to net zero** (i.e. having no net emissions) across entire supply chain and distribution • **Emissions from shipping** of inputs and components • **Waste from sourcing of raw materials** (e.g. bauxite waste from aluminium production for aircraft production)
	Organisations & community	• Emissions from **staff travel** (e.g. airline and vehicle emissions) • Providing staff on secondment to work in clean tech or investment (e.g. cross-sector research initiatives such as alternative fuels)
	Contributions	• **Philanthropy and investment in environmental improvement initiatives** (e.g. staff volunteering and green pension funds)
Social The contribution of a company to fairness in society	**Buildings & footprint**	• Providing **accessible buildings** for all employees and **diverse spaces** for all employees (e.g. prayer and meditation spaces)
	Products & services	• Developing **bespoke customer service propositions** (e.g. virtual reality flight simulations)
	Supply chain & Distribution	• Using **socially inclusive and minority friendly** providers and professional services, and ensuring **compliance with human rights and modern slavery standards** from suppliers and customers • Partnerships with supply chain partners to upskill and educate the next generation workforce
	Organisations & community	• Providing targeted **recruitment, retention and promotion** programmes (e.g. BAME, social mobility) • Ensuring diverse representations at **executive**, **board and management levels**
	Contributions	• Investing in **government supported ESG initiatives** and ESG schemes which **provide tax credits** • **Philanthropy and investments in diversity** initiatives (e.g., sponsorship of STEM students)
Governance Processes for decision making, reporting and ethical behaviours	**Reporting**	• **Providing accurate and timely reports to stakeholders** – across ESG and corporate metrics; assumes level of ethical choices
	Accountability	• Ensuring leaders are **accountable for performance**, across both ESG and other decisions, and pay is aligned to outcomes
	Independence	• **Ensuring appropriate independent oversight**, incl. Board membership, auditing and reporting across a company and limiting controlling shareholders and concentrated voting rights
	Ethical behaviour	• **Corporate governance:** undertaking business in an ethical manner (e.g. avoiding bribery and corruption, tax transparency)

Source: Strategy& analysis

Business leaders should then address the crucial question of their level of ESG ambition, both overall and for each chosen sub-element, against the expectations of those stakeholders who matter most to the long-term viability of their businesses.

How ambitious a company is on ESG will determine whether they develop an ESG strategy that sits on the side of their existing corporate strategy; or whether they develop a new, ESG-aligned corporate strategy.

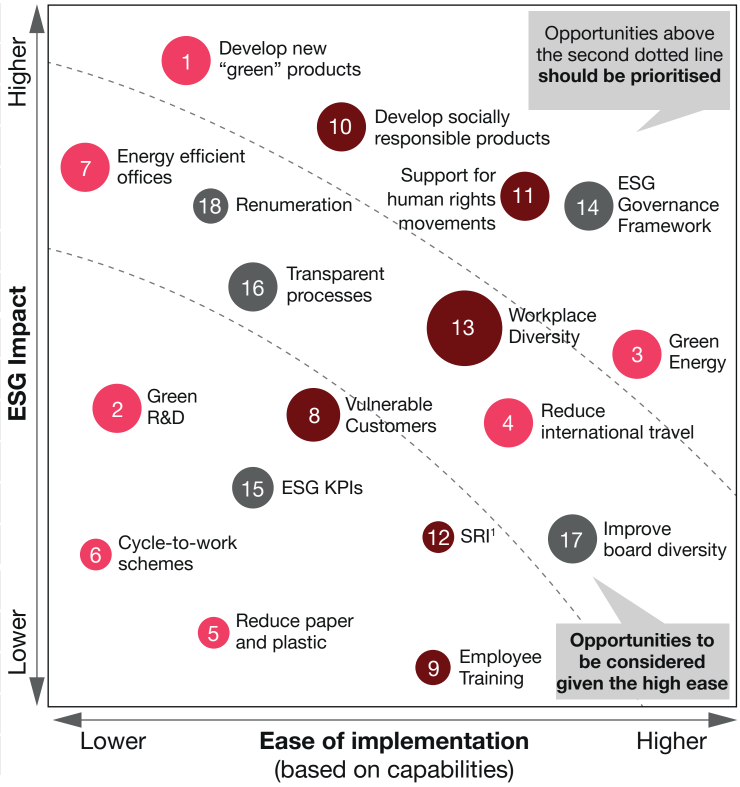
Taking action on ESG

To avoid ending up with a long list of disjointed initiatives, executives should assess how impactful potential ESG actions are, and how easy they are to implement. The illustration below provides an example of such a prioritisation exercise.

Figure 5 – Strategic ESG opportunities assessment framework

Example ESG opportunity set for a potential aerospace company (illustrative)

Environmental The impact of a company on the environment	1 Develop new "green" products
	2 Invest in "green" R&D projects
	3 Switch to "green" energy providers
	4 Reduce employee international travel
	5 Reduce use of paper and single-use plastic
	6 Walk / cycle to work scheme
	7 Create energy efficient offices
Social The contribution of a company to fairness in society	8 Support vulnerable customers
	9 Offer best in class employee training
	10 Develop socially responsible products
	11 Support for human rights movements
	12 Socially responsible investments
	13 Improve workplace diversity
Governance Processes for decision making, reporting and ethical behaviours	14 Incorporate ESG into governance
	15 Implement ESG KPIs
	16 Adopt transparent financial processes
	17 Improve board diversity
	18 Align remuneration approach to ESG



Environmental Social Governance **Bubble size indicates ROI**

Source: Strategy& analysis

A call to action

Having considered the multiple ESG dimensions, companies should decide how to integrate ESG into their strategies and operating models. To do so effectively, there are a number of steps to take.

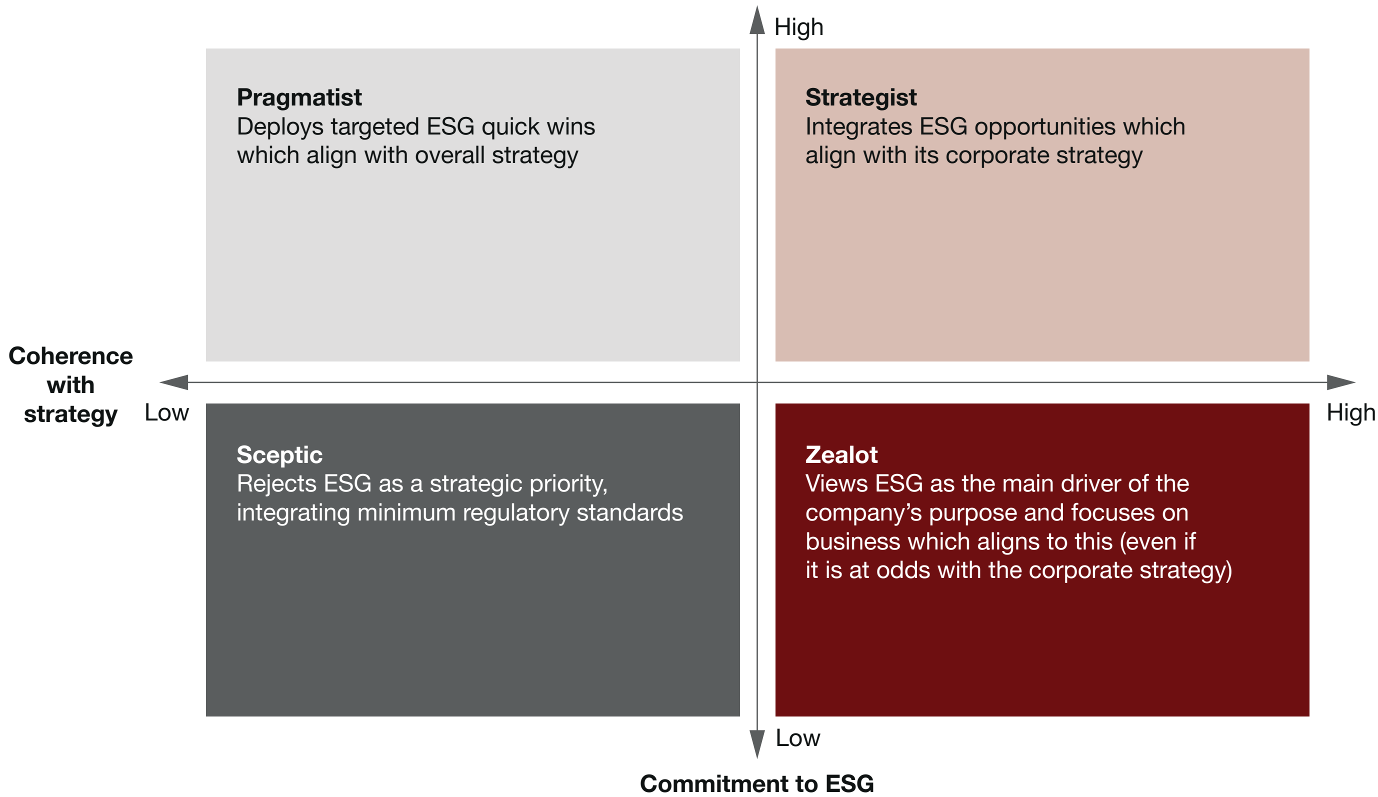
First, organisations should confirm their ESG ambition, assess strategic options and align with their corporate strategy or create a new, ESG-coherent strategy, adopting purpose-led approaches to creating value for itself and its stakeholders. Realising this may require a redesign of the business or operating model (for example, if new resources, assets and capabilities are needed).

Next, they must execute these changes and transform, rolling out the chosen initiatives backed by the support of strong senior sponsorship.

Finally, they should tell their stories to stakeholders, including by sharing and reporting on targets. Organisations must rise to the challenge of giving their stakeholders confidence, not only in relation to sustainability and profitability, but also that they think, behave and operate with integrity and transparency across the extended enterprise.

These last two factors are critical. Success in execution will be influenced by the tone at the top of organisations. It is hard for executives to divorce their own, personal attitudes to ESG from their corporate roles. As such, executives should decide on the most appropriate 'corporate persona' for their organisation.

Figure 5 – Spectrum of corporate personas



Source: Strategy& analysis

What does ESG mean for aerospace and defence?

The aerospace and defence sector is a highly complex system with organisations spread across the public and private sectors. There are many drivers of the ESG agenda, depending on where in the value chain an organisation sits. The Ministry of Defence (MOD), for example, is accountable to taxpayers and driven by government targets, whereas a civil aerospace manufacturer must respond to investor or customer expectations.

While these organisations face challenges across the range of ESG considerations, three areas present the most difficulty: net zero, diversity, and supply chains.

Net zero remains a challenge

The scale of change required combined with the lack of commercially viable solutions to technical challenges means net zero is arguably the industry's biggest challenge.

Take the MOD as an example. It currently accounts for over half of the UK Government's Greenhouse Gas (GHG) emissions, and faces greater scrutiny as the UK positions itself as a global leader on climate change.

But with aviation accounting for two-thirds of the MOD's fuel consumption, and limited low carbon alternatives, the solution is unclear. While research continues into developing and maturing synthetic fuels that deliver 25% – 100% emissions reductions, adoption is limited by cost, availability and supporting infrastructure.

The MOD will increasingly place greater expectations on suppliers to comply with higher sustainability requirements as part of the procurement process.

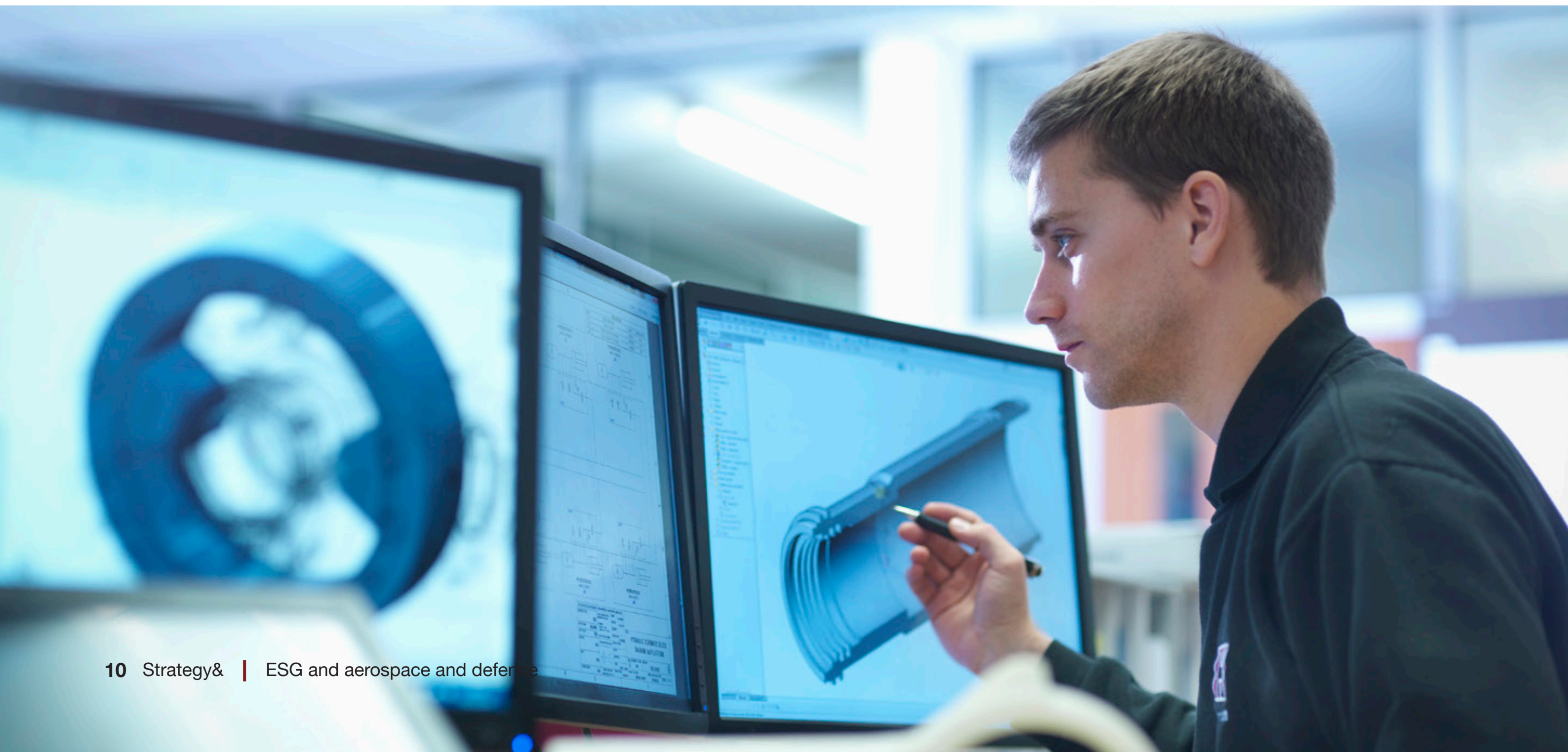
> "While aerospace and defence organisations face challenges across the range of ESG considerations, three areas present the most difficulty: net zero, diversity, and supply chains."

> “To address net zero, organisations must fundamentally rethink what they do – that means understanding current GHG emissions, setting aspirational targets and pulling on the levers they need to achieve that target.”

Elsewhere, civil aerospace businesses have the dual challenge of COVID-19 recovery and net zero. A solution will require cross-industry collaboration such as the Fly Zero initiative led by the Aerospace Technology Institute, which brings together experts from industry and academia to enable zero carbon aviation. Organisations that bring more sustainable offerings to the market will have an advantage in their recovery.

In aerospace, targeted R&D will be key to longer-term survival. Recognising whether an organisation is an innovator or ‘fast follower’ will be important in identifying and building the right set of capabilities.

All organisations must ensure any long-term strategy is compatible with a low carbon future. To address net zero, minor adjustments will no longer be sufficient: organisations must fundamentally rethink what they do and how they do it. That means understanding current GHG emissions and forecasting how that will look in the future, setting aspirational targets and pulling on the levers they need to achieve the target. The earlier this journey begins, the more likely it is that an organisation will hit its goals and achieve a commercial advantage.



Diversity must improve

Historically, the aerospace and defence industry has failed to attract a diverse range of employees, largely due to entrenched societal issues such as fewer females studying engineering or limitations on women serving in the armed forces. However, the scale of the problem must not prevent organisations from tackling this challenge.

While current diversity and inclusion efforts tend to focus on gender, such as the Women in Defence Charter and Women in Aviation & Aerospace Charter, organisations should think broadly about diversity. They need to address other characteristics that are under-represented, particularly related to ethnicity and disability, and promote fairness. But PwC's Harnessing Innovation in Aerospace and Defence Survey 2020 found that over a fifth of respondents do not plan to introduce a Diversity and Inclusion strategy.

Leaders must set the 'tone from the top' by demonstrating that they are genuinely committed to diversity. Taking visible action on diversity – for example, by linking it to executive remuneration or monitoring diversity with the same rigour as financial metrics – shows that diversity is high up on the agenda and empowers teams and individuals to take action at a local level.

20%

of respondents do not plan to introduce a Diversity and Inclusion strategy

Source: PwC's Harnessing Innovation in Aerospace and Defence Survey 2020

Sustainable and ethical supply chains

Ensuring sustainable and ethical supply chains is another complicated challenge for the aerospace and defence sector. As with GHG emissions, the impact of an organisation on the environment and society is multiplied along its supply chain. Placing stricter requirements on suppliers must not be seen as a way to pass on the burden but as an opportunity to reinforce purpose. But the global nature of supply chains makes it difficult to hold suppliers to account, for example, where labour is used in countries with few employee protection laws.

The use of rare-earth metals in applications such as satellite communications and missile guidance systems not only creates risks of exploitation and forced labour in mining operations but can damage the environment through its method of extraction. Organisations must strive for full transparency to protect the people at risk, and their own business reputation. One option is to take a risk-based approach, concentrating on the areas of the supply chain where there is the greatest risk of unsustainable or unethical practices. For example, countries that score highly on the Corruption Perception Index should be areas of focus.

A final word

Our defence sector exists to protect our people and promote prosperity, but this can only be achieved with a clear focus on all aspects of ESG. Without that, it is failing in its purpose. Elsewhere, while the aerospace sector is facing a challenge unparalleled in its history, it still has a historic opportunity to effect change.

Whatever the industry, those organisations that take a lead in ESG, and closely align decisions to net zero ambitions, will position themselves as market drivers, perform better than competitors, and create new value for stakeholders.

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