

ESG Now Podcast

“Going on a Boeing?”

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Bentley Kaplan

Hello and welcome to the weekly edition of ESG Now, the show that explores how the environment, our society and corporate governance affects and are affected by our economy. I'm Bentley Kaplan, your host for this episode. On today's show, we are going to take a look at what's happening at Boeing, one of the world's biggest aerospace and defense companies. In an industry almost completely dominated by Boeing and its competitor, Airbus, manufacturing safe airplanes is looking like a trickier prospect than it used to. And after a door plug blew out of a fuselage of a 737 Max at 16,000 feet, January suddenly turned into a rotten month for the U.S. company that builds hundreds of commercial aircraft every year. As we unwind the story, we'll be looking at safety controls at the company, the role of regulators, and what governance looks like amid a mini crisis like this one. Thanks for sticking around. Let's do this.

On the 6th of January, an Alaskan Airlines flight flying from Portland, Oregon to Ontario International Airport, which I learned is not in Canada, but California, had a door plug blowout, and that is pretty much what it sounds like, even if you're not an aviation expert. The blowout happened at 16,000 feet and it happened on a Boeing 737 Max 9. The cabin suddenly depressurized, but the pilot and crew were able to make an emergency landing. Very luckily, there were no injuries and Apple may or may not be thinking about a new ad campaign after an iPhone is alleged to have survived the fall. But that's where most of the levity of this episode is going to end, because for many, the incident will have brought back pretty recent memories of two fatal crashes, one in October 2018 in Indonesia and one in March 2019 in Ethiopia. And both of those flights involved the 737 Max 8, one model back from the Max 9 that lost a door plug in January.

This latest incident refreshes what feels like a years' long saga of safety issues for Boeing. Now, this story offers a lot of strands to pull on, which is what we're going to do. Just to help give you some navigation points, what we're doing specifically, is comparing what we can see at the surface of things and what we can find as we start to dig a little bit deeper – what ESG analysis can illuminate about the potential causes that underpin Boeing's current predicament.

Now to help me, I've got the show's very own Mike Disabato, who covers the aerospace and defense industry, and Harlan Tufford out of our Toronto office who researches corporate governance.

So, Mike, Harlan, this is a big story. So, let's start with the obvious. Mike, I'm going to put you up first because this seems like the most logical place to start. What's happening with safety standards at Boeing? How do we see what feels like these high-profile safety lapses occurring in such a highly regulated industry, and why is it happening again? Tell us what's going on here?

Mike Disabato

Before I get into the details, I think I just want to say that this Boeing story is a paradigm of short-term decisions that came at the expense of long-term sustainability for the company. It's like the perfect

ESG example here. And what I mean by that is Boeing took their product quality and safety management from a process of rigor to one that seems to be – from the outside – one guided by production speed. Because before all this mess happened with the 737 Max, Boeing was trying to figure out how to replace the world's aging 737s. And they had to do that quickly because Airbus was going to do it if they didn't. And so, Boeing decided instead of creating an entirely new airplane that they would go with the 737 Max design, which is just a re-engineering of a 737 that was already in flight back in the day.

So, Boeing then also shifted the production from a mostly unionized workforce with a history in Seattle to a largely un-unionized workforce in South Carolina. And then they decided to try and build planes like we do cars. And so, in 2019, during all this mess with the Max, Boeing announced a plan to use what they called smart tools, which is a Bluetooth technology connected to a database that would allow work to be done so precisely they said that the sort of quality control inspections that were done by humans at the moment, they would no longer be necessary. Basically, instead of doing quality checks 100% of the time, inspectors at Boeing would sample 1 in 100 tasks or maybe less. Now it seems that that did not work out with regards to product and safety, quality procedures is something we look at for our ESG Ratings, and Boeing has reversed course on that starting in 2021, and it began to rehire the nearly 900 quality control inspectors that were laid off during this shift to technology in 2019. And I'm not trying to say here that tech can help your quality assurance program, but it seems like Boeing didn't have the right processes in place in order to remove that human element from some parts of its production process.

Bentley Kaplan

Okay, so maybe let's pause there for a sec because I do want to acknowledge it would be really difficult to give a full and complete accounting of the safety checks and oversights that accompany the manufacturing and assembly of a whole aircraft. It must be exhaustive, but safety and product reliability, as you mentioned, Mike, is a big part of how we assess aerospace and defense companies like Boeing, like Airbus in our ESG Ratings model. And I don't think many stakeholders in either aerospace or airlines industries would have too much disagreement with that. It seems like quite a central issue. And if that is the case, if safety is indeed such an important issue and the company fumbles on that repeatedly, what happens? What are the areas that you think the company will feel pressure on, whether that's financial, or reputational or something else?

Mike Disabato

Every issue with the Max now puts Boeing in a defensive position even when it's not a problem with the Max design, which to be clear, this Alaska Airlines incident, which was caused by loose bolts and the fuselage door plug was not due to a Max design. It was due to a quality control issue at Boeing, at its main supplier Spirit Aero systems. The two devastating accidents of 2018 and 2019, those were due to the Max design, but this fuselage plug door ejection was not because of how the Max was designed. It was because of how Boeing is conducting its quality assurance checks before sending the planes off to customers like Alaska Airlines, and customers because of this, are starting to question Boeing's ability to make planes, because this situation is one of many, there was a missing bolt on the 737 rudder that was discovered last month.

There were mis-drilled holes by Spirit on the aft pressure bulkhead on a 737 that was discovered before that. Now people are finding more loose bolts or missing bolts on door plug doors for both the Max and older 737s. Now, this is why we have controversies in our Ratings methodology, because

Boeing is in a very, very regulated system, and so they are going to have the right policies in place on paper to be on top of the industry compared to any other of their aerospace and defense peers that just do military contracts, let's say. But then you look at their quality systems in practice with these controversies and you see that these policies seem to not have been followed in practice. And that is why we are seeing with the Max this quality escape that happened at Spirit Aero Systems and that Boeing failed to catch and caused this incident at Alaska Airlines that luckily no one was sitting next to that door. And so, we're not talking about a fatality in this instance.

Bentley Kaplan

Yeah, I mean that's something I really do want to work through, because almost regardless of the industry, the safety and quality control systems that a company has in place are important. Whether they're making microwaves, or coffee machines, or airplanes. And like you say, if you're an investor, you can look at what a company says it's doing in its annual reports or at its investor days. But then you also want to have that sort of triangulated with what's happening in reality. And in Boeing's case, it's hard to match up claims about having very high quality standards with these recurring safety slipups. And if you know there's this risk here with whatever company you can plan accordingly, maybe opting to pressure the board through engagement, underweighting the stock, maybe getting out of a position altogether. But there's another crucial layer that you touched on when you said that Boeing's operating in a highly regulated system and that is something that's very different from most other companies like a microwave manufacturer.

And that's because there are obviously a lot of human lives potentially at stake here if something does go wrong. And if you're an air traveler, you're climbing onto these airplanes and you're probably not just relying on companies doing their own safety checks with a pinky promise, you're probably also counting on regulators to keep companies honest and to make sure that the planes that are operating are safe and reliable. So in this case, Mike, can you tell us what's going on with the regulators? How involved are they in overseeing Boeing's operations, and what would an incident like this mean for future manufacturing and output? And then, without wanting to create too many spoiler alerts, because we've spoken about this when we weren't recording. Safety aside, are there any further side effects of having production delays on Boeing's part for their downstream customers?

Mike Disabato

The US federal regulator, the FAA, the Federal Aviation Administration, they have a strained relationship with Boeing right now. It's strained. They are in or they need couples therapy because the FAA was deceived by Boeing with the certification of the Max. This was all revealed in the 2019 grounding and accident investigations of Lion Air and Ethiopian Airlines, those crashes that happened in 2018 and 2019. And so what the FAA did is they removed authority from Boeing to certify new Maxes as airworthy, meaning the FAA has to sign off on each new delivery of the Max, an expensive issue for Boeing. And the FAA said they have to do the same thing for the faltering 787 Dreamliner after there were production and quality problems found at Boeing's Charleston final assembly line. And so Boeing is in a difficult situation right now and they even have not been able to get two of the aircraft designs in its Max family, the Max 7 and the Max 10 to be certified by the FAA.

The Max 7 certification delay is because of a safety issue. And the Max 10 certification has been slow because of all these problems with Boeing's planes. So these delays are really messing with Boeing. Southwest is Boeing's biggest customer for the Max 7. And it basically said, as of today, as of January 25th, that it's not expecting any of those Max 7 to fly in 2024. And United is one of the biggest customers for the Max 10. And it went a step further recently saying the Max 10 may not even be part of their plane lineup in the future. So that's not great for Boeing. And these delays are also not great for the environment because new aircraft are more fuel efficient than old aircraft. The Max reduces fuel use and carbon emissions by 20% compared to older 737 models. So if airlines have old fleets and are expecting new Boeing planes to reduce their emissions and their fuel use, of course, this isn't going to happen as soon as they'd like.

United is a great example of that because United has the oldest fleet in our coverage, 16.4 years old on average. Of course, an airline's fleet age is always by the decimal and they're expecting new Max planes to bring that age down, to bring their fuel use down, and to bring their emissions down. Now that they aren't going to receive those planes or they're expecting not to receive those planes because they are saying publicly that they've lost confidence in Boeing. That is now in flux, emissions will remain high. And all these airlines which have very ambitious carbon reduction plans are now looking at this chance to reduce their emissions in an easy way and reduce the fuel use in an easy way as being in flux.

Bentley Kaplan

I think you touched on something interesting here, Mike, with the question of carbon intensity, because obviously, safety is the high-priority topic and it's in the news right now. It's very important today, it will be tomorrow, it will be in five years' time. But then you also have these slower burning issues like carbon intensity or carbon efficiency of your aircraft. That may not be absolutely critical today, but it feels like something that's becoming increasingly more important with time. So, company leaders, the board at Boeing is having to hold these different objectives simultaneously, combined with these long order lists, and production delays, and cost overruns and things like this. And when there is what feels like a crisis of confidence, you need leadership to not only navigate this type of a scenario, but then to also reassure investors, your airline clients, and of course travelers that things are well in hand and there's some sort of playbook to follow, which is the perfect segue to bring on Harlan. So, Harlan, from a governance angle and oversight perspective, how do you see what's happening at Boeing? How does something like safety connect up to a company's board?

Harlan Tufford

Yeah, so I think the first thing you do in a situation like this is look at the board, look at what it's done to prevent a situation like this. And when we flip through Boeing's proxy circular, there's a lot of talk about safety, right? In the chair's letter, which is a pretty good indication of what's important to the company. They use the word "safety" eight times in the first three paragraphs. The board has established a standing aerospace safety committee. Safety is part of the skills matrix. The company has created a chief aerospace safety officer role. So it's clear that safety is top of mind. If you talk to corporate governance people about how to evaluate a company's priorities, one of the things they're going to look at right away is the pay incentive structure. Particularly, at a US company where its set of pay is quite competitive and there's not a lot of talk to go along with the walk.

When we look at the pay structure at Boeing, with the CEO's total target pay package of I think just under \$22 million, less than 1% of that was linked directly to safety. And to give you kind of a

ridiculous example of this, let's say you were my employee and I have tasked you to work at my factory, and I say that 99% of your job is going to be based on how many widgets you produce and 1% is going to be based on how well you can learn conversational Aramaic by the end of the year, it's probably going to take you more than 1% of your time to learn Aramaic. The most you could ever get for doing that is 1% of total pay. The rational thing to do is not learn Aramaic and ignore that objective and focus on making widgets. And that's a ridiculous example at Boeing because the company's safety record and the company's financial results are not totally divorced.

But at the same time, if you're a CEO, you're a rational actor, you're looking at the levers you can pull in the pay structure, which ones you need to pull a bit harder, which one's a bit less so and which ones you can ignore. And at the end of the day, if less than 1% of your pay is going to be directly related to safety, you're probably going to deprioritize that. And that's what the board is telling us with its pay structure – that it has deprioritized that. And there's a lot of things they could have done differently around that, right? Beyond just they could have weighted it higher, but they could have also had different objectives that were a bit more stringent. They could have made safety kind of a super metric. You see this from time to time, for example, in the materials industry where there's a higher frequency of workplace fatalities where if Boeing had had a major avoidable safety incident, the bonus didn't pay out, or the bonus pay it out at a kind of maximum threshold regardless of performance on the other metrics. And maybe the biggest one is the board could have incorporated a safety metric into the long-term incentives, which make up the vast majority of pay and would kind of make sense to me given that this does seem like a systemic issue.

Bentley Kaplan

So, I hear what you're saying. You've got the situation where safety is cited as being important and mentioned frequently, but when you look at the actual setup in terms of incentives, it's not really being set up as a type of connective tissue of governance. Instead, in terms of actual incentives, you can make the case that safety seems like more of a peripheral issue, which is a little bit strange because given how profile these safety issues have been and the potential downsides for investors for the company itself, why haven't we seen Boeing's board take more drastic or extreme steps in this area? What's kind of holding them back? Why aren't they doing something that makes eyebrows raised in the opposite direction to say, "Wow, they've really gone aggressive in terms of building in safety performance as a pay metric." Or something like that?

Harlan Tufford

I mean, I look at the composition of the board and the composition of the pay committee. And one of the things that we notice, one of the things we flag in our ESG Ratings report is that a significant portion of this board comprises other CEOs and CEO pay is established relative to peer practices. And so CEOs may have an interest in propagating pay metrics that are a bit easier to hit, aren't quite as onerous as they could be. There may be familiarity there. There may be a sense of comradery. And when we look at the pay committee in particular, it's pretty stark. Every single member of that pay committee is or was CEO of a company under coverage or another major company. And you look at David Joyce in particular, was on that board. He was a General Electric lifer. He was a CEO of General Electric, and so too was Calhoun.

So there's a lot of familiarity there and a potential conscious, unconscious bias, that's marking a close colleague's homework.

And that kind of applies across the whole board here. Calhoun, interestingly – you don't see this a lot – Calhoun was an independent director before he became CEO. And so he's worked with all of these directors for years before coming into the CEO role. And so he's got existing relationships with these people who were previously peers and colleagues and who are now responsible for setting his objectives and holding them accountable. And the transition in that relationship is another factor that could make it harder to really be stringent, set effective goals, make the kind of hard choices when it comes to setting pay decisions.

Bentley Kaplan

Yeah, I mean it really does feel like there are some areas that the board might want to look at moving forward. And the same goes for investors. You want to know that whatever frameworks you can put in place, whatever incentive structures that are possible, that you use them as much as you can to try and clamp down on the safety risk, which seems to have a ripple effect across so many different parts of the business. It's not just that you might get fined, right? It's this question of what happens to production. And if you are already behind on orders, you've got a long order book and you're trying to fulfill that and you all of a sudden have to speed things up, it's going to put a lot of pressure on the system. So guys, there are a lot of things I think we've touched on here looking at the overall situation at Boeing. Final thoughts on where things are, where they might be going?

Mike Disabato

Okay, so I have a question for you, Harlan. How rare is it to have this kind of safety committee in the structure of the board? Is that a common thing?

Harlan Tufford

The fact that they've got a safety committee shows that the board thinks this is super important and that the board is trying to take seriously. And we see it in the board composition too, right? The board has included safety and its skills matrix. Over two thirds of the board identifies themselves as being expert in safety. And so, despite that we're seeing these outcomes in the company's products, it's clear that it's not enough. And I think that's why we have to start looking beyond the board to the next level down the management team and beyond there and asking, are they being really encouraged to focus on these issues? Are they being encouraged to focus on other corporate objectives?

Bentley Kaplan

I think in a way, that really helps to tie a thread through this whole story, which is not necessarily something that's easy to do. For me, listening to both of you talk through this, it's really been a story about the gap between how things appear at the surface, versus what you find when you dig a little bit deeper hearing that Boeing's board has a standing safety committee and that a bunch of its directors have got safety listed as one of their skills. It sounds great, but then as you touched on earlier, Harlan, the wiring that goes from the top level down into management, the carrot and sticks, that would embed safety as a central priority. It doesn't seem like it's there in a meaningful way. And the same goes for operational considerations, right, Mike?

I mean, you mentioned how Boeing reports a lot of public detail on how robust its safety controls and quality checks are, but these safety incidents – whether they're tied to its suppliers, its own manufacturing, all these sort of assembly processes – suggest that all is not well. And yes, ultimately all of this stuff seems much clearer with hindsight. A big incident typically, will make us look for flags that could have hinted at what's coming or what just happened. But I think the truth of it is that a lot of these factors were probably there for some time. Some of this stuff is not particularly new, but they definitely would've sparkled a little bit more clearly if you were looking through an ESG lens.

And that is it for the week. A massive thanks to Mike and to Harlan for their take on the news with an ESG twist. And thank you very much for tuning in. Don't forget to rate and review the show wherever you happen to be listening. And if you're that way inclined, do slap the subscribe button, which makes sure that this episode and future ones will make its way into your podcast playlist without you having to lift a finger. Thanks again and take care of yourself and those around you.

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