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TRANSCRIPT

Governance and War and Boeing's Déjà vu

Featuring:

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Bentley Kaplan:

Hello, and welcome to the weekly edition of ESG Now, where we cover how the environment and society and corporate governance affect and are affected by our economy. I'm Bentley Kaplan, your host for this episode.

And on today's show, we are going to get into the headaches that are plaguing the boards of US companies that still have operations and employees in Russia. We'll get into the sweet smelling weeds of corporate governance to figure out what really matters in a time of war and how investors can understand the board dynamics as companies navigate a crisis. And then we'll unpack the tragic crash of China Eastern Airlines in range in Southern China. We don't know the technical details or the reasons for the crash, which may take months to emerge. So in this early take, we'll talk you through what it could mean for Boeing, especially for Boeing in China, a key market for the company's growth strategy. We'll also look at how broken trust has changed the relationship between Boeing and its regulators. Thanks for sticking around. Let's do this.

Over the past few episodes, we've looked at Russia's war with Ukraine from various angles. Our early takes focused on energy and gas in particular, starting with the Nord Stream 2 pipeline, and then into the relationships between European oil majors and Russia state own companies. And then we looked at issues like content moderation and misinformation in the time of propaganda. We took that then into understanding employee safety and how companies navigate risks in Russia and Ukraine. And more recently, how investors could try and understand the defense industry through an ESG lens.

But one side that is conspicuously absent is corporate governance, and with good reason. It's a complex and nuanced topic. Questions about how investors can think through the potential board dynamics of companies with strong connections to Russia, either through direct to market exposure or more subtle ties. So it's high time that I dragged in someone like Harlan Tufford. He's based in our Toronto office and MSCI is hashtag blessed to have a global team of researchers that can navigate the plethora of themes and topics that pepper the modern world of corporate governance. To lay the groundwork, I started off by asking Harlan about what happens to a company's board when there's a crisis. Not a war necessarily, but any event that threatens revenue or operations, even the physical safety of company employees.

Harlan Tufford:

If you've ever done any formal governance training, any best practice guide for directors or just spoken to a director about what it is that they do, there's a very good chance you've heard the phrase nose in, fingers out. And what this means is that directors shouldn't try to do management's job. Directors do director's job. They monitor management's performance, ask them questions and push back on the answers when they aren't satisfied. And that is mostly good advice. Understanding the boundaries between the board's job and management's job and respecting those boundaries while still doing effective oversight. But it's important to understand how context changes that balance and what nose in, fingers out means depends on what it takes to satisfy the board that management has the situation in hand, that the company's not imperiled. And something like the Russia Ukraine war can just totally toss out that paradigm and require directors to spend way more time working at a way deeper level of detail than they ever normally would've, maybe than they ever expected they would have to.

Bentley Kaplan:

Right. So in a sense, a board's role is not only to oversee a company management in the nine to five of a Monday and weekday, but to be there when the unexpected hits the fan. And it depends on who you ask, but Russia invading Ukraine was probably in the general ballpark of the unexpected. So I asked Harlan to narrow down the scope for us, to lay out how a board's crisis machinery starts operating when there's an actual war. And in particular, I asked him to talk about companies based outside of Russia, but those that have strong ties into the country because of their operations, their revenue streams, or something more complicated.

Harlan Tufford:

If you're a director of a Western company, the scale of meetings that you're taking, the scale of information that you're receiving, we call them pre-reads, just thousands of pages that directors have to pour through and read. It all just increases exponentially. If you're a Western company and a significant portion of your revenue or your assets comes from Russia, comes from Belarus, you have to consider the laundry list of things. Will Western sanctions allow you to continue operating there? Or your suppliers and customers, will they be able to continue doing business with you? You've got a wide range of stakeholders like employees and consumers and potentially investors who may be expressing moral outrage about the fact that you're continuing to operate in Russia.

And you have to balance those calls to scale down or exit the country entirely with questions about what does that even mean if you can't transact with your assets due to sanctions? Will you be able to replace the revenue generating business you have in Russia? Or will you be in breach of contract if you leave? And what duty to owe to your Russian employees? And for companies with exposure to Ukraine in the same vein, the impact of war, the physical cost of it, the human cost of it has potentially devastated your ability to operate in that country. If you have a strategic office, should you try to relocate it to Warsaw? Can you? What do you do for your Ukrainian employees?

Balancing all of this requires significantly greater decision making discussion time from the board. And there's this concern that some directors may not be able to scale up their involvement sufficiently to actually meet the challenge that comes in a crisis? Director capacity is precious. And especially for directors who serve on a lot of boards or who have full-time jobs in addition to serving on boards. They may not be able to make that transition.

Bentley Kaplan:

Okay. So that's the 101 of corporate boards and crisis management. As Harlan points out, the one thing that really changes during a crisis is that time demands for directors very suddenly skyrocket. And now comes my favorite part, where we get into the weeds of all of this.

Let's start with IPG Photonics Corporation, a manufacturer of fiber lasers. We're going to skip the explanation of what a fiber laser is. Like any laser, they're obviously pretty cool and they're used in things like welding, micro machining, optical amplification, medical applications, and a bunch of other things too. But why IPG is on Harlan's radar is because they're a US based company with a fair proportion of operations outside the US. And as of December 2021, a fair chunk of those operations were based in Russia, meaningful operations like R and D and manufacturing, and 30% of the company's full-time employees. And for IPG's board, responding to Russia's war in Ukraine might be a little more complicated than for most others.

Harlan Tufford:

We consider a director to be overboarded, they sit on potentially too many boards if they're sitting on four or more in our coverage. None of IPG's directors are over boarded. That's a good signal. They may be better equipped. There's less chance that their outside commitments are going to get in the way of their ability to scale up at IPG.

But something that's interesting, maybe a bit of a double-edged sword here, is that one of the directors, Jeanmarie Desmond, serves on the board of another company in our coverage with significant Russian exposure, Sylvamo, a US paper company. And the knowledge and experience that Desmond may bring to the board of IPG from experiences at this other company could be really beneficial potentially to IPG. Sharing experiences like that between different companies is one of the great value adds that directors can have and one of the benefits of serving on multiple boards. But at the same time, having to see two separate public companies through this kind of a crisis could reduce overall effectiveness there.

Another thing about IPG that's interesting is the fact that the company's late founder, the current CEO, and a director with family ties to that late founder, all appear to have strong personal connections to Russia. And it's not clear that that would have any impact, but it may result in different perspectives from insiders on what the company's future in Russia should be compared to what minority investors may expect. So it'll be interesting to see how that plays out in the months to come.

Bentley Kaplan:

So IPG has some complex ties with Russia, which does pose questions and challenges that the board will need to figure out, but they may actually be in pretty good shape to do that. IPG's directors don't look like they're spread too thin and they've got a pretty solid attendance record. And maybe these attributes don't mean all that much, which is why I wanted Harlan to take us through a second company, Sylvamo Corporation. And Harlan did mention Sylvamo Corporation because the company has a director in common with IPG. Now Sylvamo is a paper producer, and like IPG is also a US based company with operations in Russia. In 2021, 10% of Sylvamo's long lived assets and 15% of their net sales were based in Russia. And that includes a paper mill and harvesting rights on 860,000 hectares of government owned forest land. But compared with IPG, Sylvamo's board may find it a little more challenging to navigate the uncertain future that stems from Russia's invasion of Ukraine.

Harlan Tufford:

One thing that stands out is that more than a third of the independent directors at Sylvamo are active CEOs of public companies. And given the significant time commitment of being a public company CEO that may inhibit these directors' ability to really scale up their involvement at this other company when they have their own company to run. And that concern is really significant for J. Paul Rollinson, director of Sylvamo, who's also the CEO of Kinross Gold, a Canadian mining company that also has significant operations in, you guessed it, Russia. And I expect that those operations are going to demand the lion's share of Rollinson's attention.

Russian experience is the expertise that boards will try to see seek out when they have operations in Russia, when they're looking to invest in Russia. But in situations like this, how you've acquired that experience on your board becomes really important because the person's attention may be drawn to something of greater importance to them. And that's the concern we have here at a company like Sylvamo.

When everything's going according to plan, being a public company director can look like a dream job, but the tragedies like this war, remind us that directors don't get paid for the good times. They're paid for the crises that they manage to avoid and the crises that they can't avoid. And it's more so the latter, because the buck stops with the board. If you're a director, you cannot delegate your ultimate responsibility for the company. You are responsible for literally everything that happens at the company from the perspective of fiduciary duty. And I think for a lot of companies, this war will tell us who built a board for the easy times and who built one that's ready to do some hard work.

Bentley Kaplan:

For our next story, we are going to move on to another company that is navigating a challenge and tragedy that may be a little bit more familiar to its board. On March 21st, a China Eastern Airlines flight heading from Kunming to Guangzhou crashed in the mountain rage about one hour after taking off. Although specific details of the crash are still emerging, it's been widely reported that all people on board lost their lives, including 123 passengers and 9 crew, making it China's worst air disaster in more than a decade.

Now, the plane that crashed was a Boeing, but not the Boeing 737 Max that was involved in the Lion Air crash in Indonesia that resulted in the death of 189 people in October 2018, and the Ethiopian Airlines crash in Ethiopia that caused the death of 157 people in March 2019. Instead, the recent crash in Southern China involved the Boeing 737 800 series, which until now had a pretty reassuring track record. And of course, this tragedy matters to Boeing for a bunch of different reasons. We'll discuss two that are at the top of the list.

Number one is that Boeing sees China as a key growth market. After the crash, the company may have to re-run their numbers on that. And number two is that Boeing is going to be stepping into a very different regulatory landscape after the 737 Max safety issues.

Now, of course, as a caveat for the discussion that follows, a lot of the technical detail related to the crash has not been released by either the Chinese authorities or by Boeing, and it may be weeks or months until they are. So while we wait on that, I bugged Umar Ashfaq in MSCI's New York office to get his initial take on the incident and on what types of early questions investors may be asking themselves or may be asking Boeing.

Umar Ashfaq:

The biggest question that investors have on their mind is that, is this the Max series all over again? By extension, did the engineers at Boeing willfully conceal safety risks? Let me take a step back a little bit of background there. So Boeing entered into a deferred prosecution agreement with the US department of justice, and that was in essence in admittance of guilt. And ultimately the company had to make a settlement of $2.5 billion, which to an extent is not a significant portion of its revenue or profits. But another important clause of the deferred prosecution agreement was that the company would not be having any additional violations in a similar vein over the next three years.

Now, this deferred prosecution agreement was entered into 2021. So we are definitely not out of the three year probation period, so to speak. And that might compound the issues. If this was a technical error, then Boeing does have a lot to lose. As we already know, in terms of reputation, the company has suffered quite a bit. Regulators all over the world have at one point in time stopped the flights of Max.

Another key thing here, which makes this slightly different is that China in itself was the first country, the regulators were the first to halt flights of the Max and to date, while the company has received re-certification, China remains the last country where the Max is yet to resume commercial operations.

Bentley Kaplan:

Umar's focusing here on the regulatory risk for Boeing, and that's because commercial airlines are very heavily regulated. Lapses in safety can mean fines. Even with the hefty scale of Boeing's overall business, a $2.5 billion hit still hurts. And beyond penalties, an aircraft manufacturer can see hundreds of its planes grounded over safety concerns. And these actions by both national and global regulators are driven by a common primary goal, ensuring the safety of air travel. And safety is a big deal for travelers too, travelers that aren't necessarily rational in thinking about safety. Because even though the risk of stepping onto an airplane doesn't compare to the risk of stepping into a car, everyone knows at least someone who's afraid of flying. So for airlines and airplane manufacturers, a small trust deficit is a big deal. Three fatal crashes in four years is much more than that.

Umar Ashfaq:

The 737 800 NG, the plane that crashed, is not a new plane. This is a predecessor to the Max series. The technology used is fairly different. And the 737 800 NG does not use the flight augmentation system MCAS, which was installed in the Max planes and which was ultimately responsible for the crashes. The 800 NG is considered one of the safest planes to have taken the skies overall based on fatal crash intensity. At the same time, incidents like these can really mar public perception.

Statistically while flying may be safer even on the Boeing Maxes than crossing the road or driving, Boeing is now associated with three plane crashes between 2018 and now.

At this point in time, the China Eastern Airline has grounded its fleet of the 800 NGs. But we don't know whether the Chinese regulators will be halting the entire fleet of the 800 NGs. And that's important because the 800 NGs single largest market, 29% of planes currently in service are in China. China has been considered a really key market for Boeing. Boeing stands a lot to lose if something detrimental to the technical aspect comes out when it comes to the ultimate investigation.

Bentley Kaplan:

So Boeing is bracing for the upcoming turbulence, but there was more food for thought from Umar. You see, after the 737 max incidents, there was some pretty dramatic change in the relationship between Boeing and US regulators. Before that, regulators invested a significant amount of trust in aircraft manufacturers to follow safety protocols, and in many cases to self-report on potential issues. The postmortems of the 737 max crashes showed that trust to be misplaced. It forced regulators to take a much harder stance.

But for regulators, clearer and bolder lines between themselves and the regulated may strengthen their resolve to have the backs of their primary stakeholders, air travelers. Air travelers that may be stepping aboard with a little bit more trepidation than usual. And coming back to our first story, Harlan left me thinking about the boards of IPG and Sylvamo, or indeed the boards of the many companies that are tied into Russia, Belarus, or Ukraine, because picking away through a war, a humanitarian crisis, disrupted supply chains, sanctions, and shifting markets was never going to be easy. But as Harlan so aptly described, the role of a board is to oversee company management, to put noses in and fingers out on behalf of investors. And that is a role that counts both in the easy times and the hard. For the ESG savvy investor, it's about asking the right questions, probing beyond the surface to figure out just which directors and which boards are not going to blink when the going gets tough.

And that is it for the week. A massive thanks to Harlan and Umar for their take on the news with an ESG twist. Thank you very much for tuning in. It's always a pleasure to be able to put together a show for you and this week has been no exception. We hope you're enjoying the show. Don't forget to rate and review us wherever you're listening. All and any feedback is great for us. It helps us to get better and to get you what you really want to hear. Michael, we're back again with you next week. So in the meantime, thanks again for listening and stay safe.

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