About Sustainalytics

Sustainalytics supports investors around the world with the development and implementation of responsible investment strategies. The firm partners with institutional investors, pension plans, and asset managers that integrate environmental, social and governance information and assessments into their investment decisions.

Headquartered in Amsterdam, Sustainalytics has offices in Boston, Bucharest, Frankfurt, London, New York City, Paris, Singapore, Timisoara and Toronto, and representatives in Bogotá, Brussels, Copenhagen and Washington, D.C. The firm has 200 staff members, including more than 100 analysts with varied multidisciplinary expertise and a thorough understanding of more than 40 industries. In 2012 and 2013, Sustainalytics was voted best independent sustainable and responsible investment research firm in the Thomson Reuters Extel’s IRRI survey.
Executive Summary

Ready for takeoff?

The Aerospace & Defence (A&D) industry is part of the industrial sector and can be considered a high-technology industry. It covers a diverse set of companies providing products and services to civil and military customers. The industry’s operations and product offerings are associated with various sustainability impacts. The key ESG issues we have identified include Bribery and Corruption, Product Quality and Safety, Energy Use and GHG emissions, Supply Chain, Human Capital and Sustainable Products and Services. The fundamental perspectives for the industry are rather mixed. While aircraft manufacturers benefit from continued growth in global demand fueled by emerging market prosperity, defence companies are dependent on government expenditures and have come under some pressure lately due to budget cuts in the US and Europe. Going forward, competitive advantage in the industry will also be driven by companies’ ability to manage their key ESG exposures. In this report we discuss whether the industry overall and whether individual companies in particular appear to be “ready for takeoff”.

High barriers of entry, diverse product offerings

The Aerospace & Defence industry consists of a diverse set of companies, including large conglomerates developing and manufacturing a wide range of A&D products and niche players supplying specific technologies or products. The barriers to entering this industry are high. Limited access to specialised technologies, high development costs and government support make it difficult for new companies tapping the market. The commercial aerospace market comprises a few prime contractors producing aircrafts and engines as well as numerous companies supplying subcomponents. In contrast, the defence market has a much more diverse character, ranging from companies developing complex software to those simply producing metal ammunition cases, for example. Commercial aircraft manufacturers depend on highly cyclical demand from the airlines industry, while defence companies rely heavily on government military spending.

Various sustainability impacts

The Aerospace & Defence industry affects climate change not only through its operations but also through its product offerings. Due to increasing fuel prices, a stricter regulatory environment and stakeholder pressure, companies have started to consider environmental impacts within product design. Thus, A&D companies face customer pressure to develop energy-efficient products and identify alternative fuel options.

With regards to social issues, the retention and recruitment of highly skilled employees is a challenge in light of talent shortages, especially in developed markets. Manufacturers must also be observant of robust product quality and safety practices, since even minor issues can pose material risks. Expensive delays to product launches can result in the loss of customer and investor trust, while product issues can also entail – in extreme cases – severe impacts like fatalities.
Governance concerns are mainly related to transparency surrounding corporate political contributions and lobbying and breaches of arms trade regulations, as well as bribery and corruption. Specifically, involvement in the latter presents significant business risks due to potential blacklisting or exclusion from investments.

Key issues – High exposure, room for improvement

The industry’s operations and product offerings are associated with various sustainability impacts on its stakeholders and the environment. In this report, Sustainalytics focuses on six key ESG issues that have the most significant impact from a sustainability and/or a business perspective for the Aerospace & Defence industry.

Bribery and Corruption

The Aerospace & Defence industry is highly exposed to bribery and corruption due to its close business relationships with governments, its competition for a limited number of high-value contracts and massive secrecy surrounding military procurement. Several severe controversies illustrate this high exposure to bribery and corruption cases. Overall, the industry shows a high level of preparedness, since policies and programmes on bribery and corruption are relatively widespread in the industry. However, several companies have been involved in bribery- and corruption-related controversies in recent years. Therefore, we consider the overall performance with regards to this key ESG issue as moderate and anticipate a stable performance in the future. In general, we expect that this key ESG issue will remain material in the coming years.

Product Quality and Safety

Product quality and safety is crucial for Aerospace & Defence companies to maintain investor and customer trust. This is especially important since companies in the industry often compete for a limited number of high-value contracts and face an immense product innovation pressure. Prominent quality and safety incidents in recent years and a lack of disclosure regarding robust quality and management systems show there is room for improvement. We expect that product quality and safety will gain further importance as a key ESG issue for the industry. Hence, we anticipate that the A&D industry’s performance with respect to this issue will improve in the coming years.

Human Capital

Adequate human capital management is considered crucial for Aerospace & Defence companies to maintain good relationships with employees, compete in the global race for talents, avoid labour conflicts and mitigate operations-related risks such as strikes or lawsuits. Many companies in the industry have room for improvement with respect to the implementation of employee policies and programmes. However, compared to other manufacturing industries, Aerospace & Defence companies have been less involved in employee-related controversies. Therefore, we consider the current industry performance as moderate with a neutral outlook. At the same time, we expect that human capital will continue to gain further importance in the medium and long term since the race for global talents is gathering momentum.
Supply Chain

Aerospace & Defence companies depend on a functioning supply chain, especially due to growing product innovation pressure. The integration of environmental standards in procurement decisions is likely to gain importance in the near future, e.g., in light of growing consumer expectations towards fuel efficiency improvements. Compared to other industries, A&D companies tracked by Sustainalytics have not been involved in severe controversies related to supply chain management in recent years. Nevertheless, there is room for improvement in terms of establishing social and environmental procurement policies and programmes for the industry as a whole. Only a few A&D companies demonstrate best practice, having implemented strong supply chain standards. Due to product innovation pressure to develop energy-efficient products and growing stakeholder expectations, we expect that A&D companies will increase their social and environmental systems for supply chain management.

Energy Use and GHG Emission

As a manufacturing industry, Aerospace & Defence is confronted with rising energy prices, resulting in higher operational costs. However, regulatory pressure and stakeholder expectations towards lower operational carbon emissions also present a challenge to the industry. Our analysis shows that most companies (75 percent) in the industry have learned their lessons and implemented programmes to reduce their direct greenhouse gas (GHG) emissions; a remarkable increase compared to 2011. However, there is still room for improvement with respect to carbon emissions disclosure and performance. Nevertheless, we expect that the industry will reduce its carbon footprint and strengthen its programmes in the future. Energy prices and stakeholder demands regarding lower operations-related GHG emissions are likely to grow in the near future. In particular, regulators, customers and non-governmental organisations (NGOs) target the carbon footprint of manufacturing industries. Therefore, A&D companies are motivated to further reduce their carbon footprint. We expect that Energy Use and GHG Emissions will gain importance as a key ESG issue over the coming years.

Sustainable Products and Services

Aerospace & Defence companies have an impact on climate change, through both operational GHG emissions and product offerings. Several companies in the industry have started to address this environmental impact. Leading industry players are utilising life-cycle assessment strategies in product development and maintenance to bring more efficient products to market. In particular, aircraft manufacturers are expected to develop more energy-efficient products and explore alternative fuel options. Innovative industry leaders can benefit from new market opportunities, while industry laggards that do not meet consumer demands face significant business risks. Currently, there is room for improvement since products with a very clear sustainable dimension still account for a relatively low share of the A&D companies' portfolios. Therefore, we consider the current industry’s performance as weak. However, we see a positive outlook and expect that Sustainable Products and Services will further gain significant importance as a key ESG issue.
Selective results of our bottom-up analysis

**Industry leaders:** As the best-performing company in the Aerospace & Defence industry, the Canadian Bombardier reveals an outstanding performance in terms of its social supply chain and human capital, reflecting a strong commitment to mitigate related risks. With a remarkable one-year rating increase of 17.3 points, MTU Aero Engines is the second-best company overall and the momentum leader. Best-in-class environmental standards and programmes, in combination with an immaculate environmental controversy record, assure the Airbus Group the third place.

**Size effect:** In contrast to most other industries, the ESG performance of the A&D industry is size independent, and large companies do not systematically outperform smaller ones.

**Momentum:** Over the last three years, A&D companies consistently displayed positive momentum. The steadily increasing environmental performance of the A&D industry is especially noteworthy. While often criticised for its intensive environmental pollution, the industry increasingly recognises its duties and continuously strives to minimise its environmental footprint through appropriate standards and innovative products. To date, approximately 76 percent of the companies in this industry have started to address their heavy environmental impact with programmes to reduce their direct GHG emissions.

**Geographic particularities:** Most A&D companies are based in North America, with a strong focus on the US (12 companies). Europe hosts ten A&D companies, and Asia-Pacific and Israel (Rest of World) have one A&D company each. In terms of regional performance characteristics, we find that European companies on average outperform their North American peers (total scores: 67 vs. 60 points).

**Differences between E, S and G:** The bell-shaped distribution of ESG scores indicates that the A&D industry has developed minimum standards (in the range between 61 and 70 points) with which the majority of companies comply, while some strive to do better, and others still face problems to reach the threshold. This distribution characterises all three ESG subthemes.

**Qualitative Performance (controversies):** Due the industry’s high exposure to bribery and corruption risks and potential indirect involvement in human rights issues linked to the production of weapons delivered to areas of conflict, Business Ethics as well as Society and Community are subject to the most intense controversies and pose the highest risks to the company.

**Controversial product involvement:** Our analysis of the industry’s involvement in ethically controversial products reveals that 14 out of the 27 listed A&D companies produce or sell controversial weapons. Furthermore, 26 percent reveal business relationships with the nuclear industry, though no company is directly involved in the production of nuclear bombs.