S&P Global Ratings

Sustainable1

Environmental, Social, And Governance Evaluation

Air France-KLM

Air France-KLM S.A. (AFKLM) was created by the 2004 merger of national carriers Air France and KLM Royal Dutch Airlines. The group, which continues to have key operating hubs in Paris and Amsterdam, is among the five-largest airlines globally in terms of revenue. It posted pre-pandemic revenue of €27 billion in 2019 and transported 104 million passengers and 1.1 million tons of freight that year.

The ESG Evaluation of 64 reflects S&P Global Ratings' view that AFKLM compares well with the airline industry with regard to the management of its significant exposure to environmental challenges. In particular, the group is working toward ambitious targets to reduce carbon emissions through sizable investments in fleet renewal, fuel-efficiency initiatives (such as route optimization), and the use of sustainable aviation fuel, which is currently in its infancy.

The group's state ownership supports a generally stronger social commitment than peers. During the pandemic, for instance, AFKLM has played an important role in facilitating repatriations and medical supply distribution. We also note that the group has improved previously strained relationships with its employees but expect this will remain a challenge given ongoing restructuring and layoffs.

AFKLM demonstates a capacity to make swift decisions, despite a complex environment for decision-making, which combines a large board of directors, the evolving weight of its state-owners, and influencial stakeholders, such as employees. Beyond short-term operational optimization, which requires significant management resources, the group integrates the mitigation of key long-term disruptions into its strategy, such as regulation and climate change.

PRIMARY ANALYST

Pierre-Brice Hellsing
Stockholm
+46 (0)8440 5906
pierre-brice.hellsing
@spglobal.com

SECONDARY ANALYST

Bertrand Jabouley
Singapore
+65 6239 6303
bertrand.jabouley
@spglobal.com

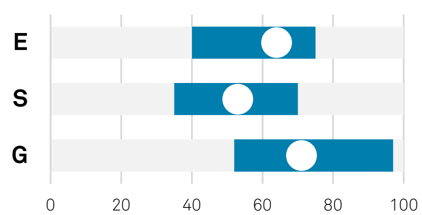
RESEARCH CONTRIBUTOR

Maxime Chul
Paris

Tarandeep Bhatia
Pune

ESG Profile Score

64/100



Company-specific attainable and actual scores

Preparedness Opinion (Scoring Impact)

Adequate (No Impact)

ESG Evaluation

64/100

A higher score indicates better sustainability

Component Scores

Environmental Profile		Social Profile		Governance Profile	
Sector/Region Score	**25/50**	**Sector/Region Score**	**20/50**	**Sector/Region Score**	**32/35**
Greenhouse gas emissions	**Strong**	Workforce and diversity	**Good**	Structure and oversight	**Good**
Waste and pollution	**Strong**	Safety management	**Good**	Code and values	**Good**
Water use	**Strong**	Customer engagement	**Good**	Transparency and reporting	**Good**
Land use and biodiversity	**Good**	Communities	**Good**	Financial and operational risks	**Neutral**
General factors (optional)	**None**	General factors (optional)	**3**	General factors (optional)	**None**
Entity-Specific Score	**39/50**	**Entity-Specific Score**	**33/50**	**Entity-Specific Score**	**39/65**
E-Profile (30%)	**64/100**	**S-Profile (30%)**	**53/100**	**G-Profile (40%)**	**71/100**

ESG Profile (including any adjustments) **64/100**

Preparedness Summary

The airline industry requires constant adjustments to optimize operations, and we consider AFKLM adequately prepared to manage risks facing airlines over the near-to-medium term. Amid the pandemic, the group has demonstrated its ability to secure support from all of its stakeholders and make drastic decisions quickly, while maintaining its fleet renewal program in response to tightening environmental regulations. As the pandemic abates, AFKLM will have to restore its focus on long-term disruptions, while continuing to manage a complex base of stakeholders. Given tensions among stakeholders before 2020, ensuring their continuous cooperation in AFKLM's best interest in a post-COVID-19 environment will remain a challenge for the group.

Capabilities	
Awareness	**Good**
Assessment	**Good**
Action plan	**Good**
Embeddedness	
Culture	**Good**
Decision-making	**Excellent**

Preparedness Opinion (Scoring Impact) **Adequate (No Impact)**

ESG Evaluation **64/100**

Note: Figures are subject to rounding.

Environmental Profile

64/100

Sector/Region Score (25/50)

As a large emitter of greenhouse gases (GHGs) and related air pollutants, AFKLM faces the direct risk of rising costs to meet increasingly stringent environmental regulations, especially in Europe, where it generated 70% of its revenue in 2019. In addition, the airline has indirect exposure to land use, given its aspiration to increase reliance on sustainable fuels. While still an important topic for the group, its exposure to waste and water is much less pronounced.

Entity-Specific Score (39/50)

Note: Figures are subject to rounding.

Greenhouse gas emissions	Waste and pollution	Water use	Land use and biodiversity	General factors
Strong	**Strong**	**Strong**	**Good**	**None**

AFKLM's scope 1 carbon intensity of 929 metric tons of CO2 per $1.0 million of revenue is 15% below the global industry median and should further reduce. In the past, efficient piloting techniques, innovative coatings on airplanes, or engine upgrades and a high load factor (87.9% in 2019) have supported the group's performance. AFKLM plans to invest in more fuel-efficient planes (including existing orders of 10 A350-900s and 60 A220-300s) to lower the fleet's average age of 12.1 years in 2020 and increasingly rely on sustainable fuel, with the goal of achieving a 50% reduction in net CO2 emissions by 2030 (per passenger kilometer) compared with 2005 and net zero by 2050. Such targets meet those of the most ambitious airlines. Success will, however, partly depend on the airline business returning to more stable conditions. We estimate that a 1% drop in load factor translates to a rise in carbon intensity (per passenger kilometer) of about 1%.

The airline's management of operational waste is above peers. The group has been, for example, phasing out single-use plastics as part of its efforts to improve recycling rates to 45% of total waste in 2019, compared with industry's median performance of 38%. AFKLM's plan to cut residual waste in half by 2030 compared with 2011 is among the most ambitious industrywide (it was 31% down in 2019). The group complies with tight regulatory requirements for hazardous waste disposal (solvent, paint, oils, etc.), stemming mainly from maintenance, and imposes strict standards for end-of-life airplanes sold for scrap.

Though water use is not a main driver in the industry, it is an important focus for AFKLM. AFKLM, like most peers, has no formal targets to reduce water consumption, but is working to cut consumption where it is most material, in particular in its maintenance activities. This includes developing techniques to wash an airplane with about 150 liters of water, a major reduction compared with 12,000 liters previously.

AFKLM's increasing reliance on sustainable fuel will raise its exposure to land use issues and necessitates ambitious partnerships for a successful implementation. Biofuels accounted for less than 0.1% of total jet fuels in 2019, and will increase to 2%-5% in 2025, 10% in 2030, 25% in 2035, and 50% in 2040 to align with EU requirements. Together with its industry and energy partners, the company is working to establish a sustainable and traceable ecosystem, starting with France and the Netherlands, and expanding to its other hubs over time.

Social Profile

53/100

Sector/Region Score (20/50)

Safety is a prominent risk because airplane accidents, albeit rare statistically, are both visible and deadly. Geopolitical tensions and health concerns can disrupt traffic. AFKLM extensively relies on and must protect the integrity of information technology to manage operations and engage with customers. Human capital management represents another exposure because AFKLM must ensure it has a motivated and skilled workforce (the bulk being in Western Europe) to provide reliable services.

Entity-Specific Score (33/50)

Note: Figures are subject to rounding.

Workforce and diversity	Safety management	Customer engagement	Communities	General factors
Good	**Good**	**Good**	**Good**	**3**

AFKLM has a clean safety record, with no major airplane accidents in over a decade. In addition to a heavy focus on flight safety, the goup's policies cover the prevention of psychosocialogical risks throughout the organization, and extend its requirements to suppliers, leveraging third-party monitoring.

AFKLM has been developing more constructive relationships with its employees. For instance, several agreements with unions supported the group's drastic pandemic-related measures, which includes 12,500 redundancies and salaries cut. Its gender diversity (one-third of women in management position), training (22.7 hours annually per employee), and turnover (about 11% on average pre-COVID-19) are in line with the industry, along with salaries and benefits, which do not go beyond minimum legal standards. In addition, AFKLM engages in targeted measures to manage the replacement of its ageing workforce (close to 40% of which is above 50 years-old), including reskilling, career support, and flexible working conditions.

AFKLM's 38% state ownership supports a generally stronger social commitment than peers. This was illustrated in particular during the pandemic when the airline organized 5,200 flights to repatriate people to Europe with lower profitability requirements, deployed its cargo capacity to transport medical equipment, and offered more generous commercial policies than its peers, including booking of fully flexible tickets, as well as postponement and reimbursement solutions.

Customer satisfaction, which has improved during the pandemic, is at the center of the group's strategy and part of the CEO's variable remuneration. Air France's measured net promoter score is lower than peers', partly linked to the poor performance of its main Paris airports, with significantly stronger scores at KLM. Still, AFKLM boasts one the highest cabin load factors of its peer group. The group requests feedback from a sample of passengers after every flight and has not seen any breach in the data in its custody, contrary to several peers.

Notwithstanding its role during the pandemic, AFKLM's community initiatives are aligned with the industry. The group is working to reduce noise pollution, down 40% since 2000 thanks to fleet modernization, and meets the ICAO Chapter 4 Noise Standard.

Governance Profile

71/100

Sector/Region Score (32/35)

AFKLM is headquartered in France and listed in both France and The Netherlands. In 2019, the group generated more than two-thirds of its revenue in Europe and about 15% in the U.S. Both regions have well-articulated governance standards and a robust rule of law, including comprehensive regulations for listed companies.

Entity-Specific Score (39/65)

Note: Figures are subject to rounding.

Structure and oversight	Code and values	Transparency and reporting	Financial and operational risks	General factors
Good	**Good**	**Good**	**Neutral**	**X or None**

AFKLM's 19-member board and the varying interests of a few key shareholders add complexity to the group's decision-making. In addition, double voting rights may affect the influence of long-standing shareholders over time. The group is committed to raising the proportion of independent directors. It currently stands at 47% excluding four employee representatives in line with local calculation rules, which slightly lags both the French and industry median and does not meet the AFEP-MEDEF Code's recommendation of at least 50%. Other board characteristics--including women participation (37% of all members), average tenure (six years), and directors' assiduity (97%)--meet the high local standards and practices. The nationality mix broadly matches the group's geographic footprint, and the directors' skills (sustainability, aviation, finance, IT, etc.) are appropriate. All four committees (Audit, Appointment & Governance, Remuneration, and ESG & Compliance) are chaired by independent directors.

The group has a comprehensive code of conduct that applies to all employees and suppliers at both the group and company levels, in line with its peers and local practice. They cover standard topics, such as anti-fraud, whistleblowing, political donations, and anti-corruption. The pay of AFKLM's CEO is broadly aligned with the group's strategy and that of peer companies. For instance, about 30% of his long-term variable remuneration is tied to nonfinancial indicators, including reducing CO2 emission intensity and increasing the share of women in management.

Transparency and reporting practices generally meets local and international standards. In particular, reporting follows the requirements of the French Nonfinancial Performance Declaration, with independent third parties providing limited assurance on the nonfinancial information report. Scope 1 emissions, which fall under the EU ETS and CORSIA schemes, are the only metrics that benefit from a reasonable assurance, in line with European peers. Transparency meets international best practice in some specific areas, such as safety management or noise pollution. Tax reporting allows differentiation between the French and Dutch operations, but does not provide details at the country or segment level.

Preparedness Opinion

Adequate
(No Impact)

Preparedness	Low	Emerging	Adequate	Strong	Best in class

AFKLM is adequately prepared to manage risks facing the airline industry in the near-to-medium term. As the pandemic abates, the group will have to restore its focus on long-term disruptions, while continuing to deal with its complex stakeholder environment.

COVID-19 illustrated AFKLM's capacity for timely decision-making in extreme circumstances. The group's viability was at stake, creating a strong incentive for its various stakeholders to cooperate. This was a clear departure from AFKLM's record of tensions, with some of its stakeholders standing firm to defend their interests in the past, sometimes at the expense of the group. However, this support was not necessarily unconditional. For example, the French government asked for more ambitious emission-reduction targets and the discontinuation of routes when a train alternative exists for short flights, in return for its financial support. In addition to shareholders, AFKLM leaders have intensified their dialogue with employees, with monthly updates on the group's strategy, while continuously assessing potential training needs to meet objectives. When operating conditions normalize, they will test recent cohesion and efficiency. The upcoming generational change in the group's workforce could also deepen its sustainability culture.

In the context of the pandemic, the group's assessment and management of disruptions appears to concentrate mostly on the near-to-medium term. AFKLM's leadership focuses extensively on elements impacting load factor and hence efficiency and profitability, with swift action plans. For instance, the group runs regular scenarios on the fleet evolving age (impact on environment and noise pollution), or the balance between leased and owned airplanes. It has furthermore demonstrated some agility in deploying Transavia to address increasing demand for no-frills, affordable services, while phasing out its A380s, whose load factors did not meet expectations in the context of fluctuating demand.

Still, the group is aware of and acting on its main long-term disruptions and opportunities, including climate change and regulation. Through both top-down and bottom-up processes, the group regularly updates its view of key, long-term emerging risks, including extra-financial risks, feeding into an annual strategic review. We consider that the group's large board, with government and airline representatives, a potential advantage in terms of remaining aware of the trends shaping its business environment. As the pandemic abates, it will be critical for the group's leadership to devote attention to its long-term purpose and strategy. Key long-term disruptions for which the group is building long-term action plans include climate change and regulation. Regulations are tightening in relation with climate change issues, urging companies to drastically reduce emissions, especially in Europe. This may explain why the pandemic has not questioned the sustainability ambitions of the group, which did not revisit its large fleet investments, for instance. Regulations can also impact the competitive setting, as it did in the U.S. in 1978 with the Airline Deregulation Act, or influence airports capacity. Laws also impact the group's operational flexibility when it comes its workforce management. Other disruptions include the future of business travel, given the growing sophistication of tools enabling online meetings, together with cyberrisks, since the group owns substantial customer information and complex systems manage airplanes.

Sector And Region Risk

Primary sector(s)	Transportation
Primary operating region(s)	France Netherlands United States China Brazil

Sector Risk Summary

Environmental exposure

Transportation includes airlines, air freight and logistics, road transportation, shipping, and rail. As a result, its subsectors face distinct environmental risks, notably related to greenhouse gas emissions, other types of air pollution, and to a lesser extent waste. We view airline, shipping, and trucking companies as facing the greatest environmental risks from high and increasingly stringent environmental regulations. For airlines, environmental risk derives primarily from emissions, which represent a rapidly increasing share of the global total. Such risks in the medium to long term largely relate to the 2016 U.N.-sponsored International Civil Aviation Organization emissions-reduction rules that apply to international routes. While the requirements can be met using current and planned aircraft engine technology, compliance could become gradually more costly. European airlines face a separate additional emissions trading scheme. Companies that are able to improve fuel efficiency and lower emissions in a cost-effective manner could benefit over the long term. Shipping companies are subject to regulations promulgated by the International Maritime Organization that mandate lower emissions of sulphur compounds and greenhouse gases. As a result, the industry must transition to using cleaner fuels or scrub emissions. It also must manage biodiversity risk related to the transport of ballast water and invasive species, while waste and fuel spills may also occur. Trucking must also comply with regulations for fuel efficiency, greenhouse gases, and other air emissions. Rail faces environmental regulation but in general the risks are lower. Transportation equipment leasing companies generally do not face direct regulation, but are indirectly affected by regulations on their transportation company customers. Being material-intense industries, many companies in the transportation sector also need to deal with vehicle, aircraft, and ship end-of-life management. Dismantling used ships typically causes leakage of hazardous materials into the environment while harming workers' health and safety. The disposal of other transportation assets, including aircraft and vehicles, is easier.

Social exposure

Transportation companies vary in their exposure to social risk. Key areas of focus are health and safety, and managing workforce and labor issues. The airline industry is particularly sensitive to health and safety concerns, including airline safety incidents with reputational consequences and legal liability. It is also particularly exposed to health issues such as pandemics, which can dramatically reduce air traffic, revenue, and earnings, potentially leading to structural industry-wide changes. Labor relations is an important consideration because many airlines are heavily unionized and strikes can be costly and disruptive. Community opposition in relation to noise hindrance or pollution tends to be more focused on airports rather than the airlines themselves. Road, shipping, and rail freight transportation are exposed to health and safety risks relating mostly to workforce safety and accidents that endanger others (such as toxic or flammable spills from rail accidents). Companies in the rail industry tend to be heavily unionized, in contrast to shipping and trucking. Most shipping and some road firms typically utilize contract labor sourced from multiple countries, and historically have faced a higher risk of labor rights violations.

Regional Risk Summary

France

France is among the most advanced countries in terms of ESG regulations including mandatory disclosures and reporting sustainability indicators. Overall, corporate governance is in line with advanced economies' standards. In addition to the EU Non-Financial Reporting Directive's recommendations requiring the disclosure of ESG data, French companies must also disclose the social and environmental consequences of their activities under domestic law (Grenelle Act), the financial risks they face from climate change, and their remediation strategies (Energy Transition Law). Under article 173 of the Energy Transition Law, institutional investors must disclose the ESG factors incorporated in their investment policies and their contribution to the energy and ecological transition. Under the law Pacte, which came into effect in May 2019, companies must consider environmental and social issues when developing their strategy. The strong regulatory framework is complemented by the Afep-Medef Code, the corporate governance recommendations from AFG (the French Asset Management Association), and the recommendations from the Financial Markets Authority. All three provide non-binding guidance for best practice on governance and pay. Despite waves of privatization, the state remains an important player in the French capital markets as a shareholder of several large listed companies. On diversity, the Copé-Zimmermann Law has required listed companies to reach at least 40% female board membership since 2017 in a bid to reach parity.

Netherlands

The Netherlands has strong institutional effectiveness and rule of law. It has a very active pension fund industry that has been a leader in sustainable investing and stewardship, creating an advanced ecosystem for sustainable finance. In terms of reporting, companies of over 500 employees are implementing the EU Non-Financial Reporting Directive, which mandates disclosing ESG (including diversity) risk. Compared to other European countries, the Netherlands has more dispersed ownership structures with few controlled listed companies. The Frijns Committee (Corporate Governance Code Monitoring Committee) publishes the Dutch Corporate Governance Code, last edited in 2017. The code follows the stakeholder model and focuses on long-term sustainability. There is high compliance with the code's recommendations. Equally, the new Dutch Stewardship Code, went into effect January 2019, considers all stakeholders' interests, not just shareholders'. In February 2019, the government completed a consultation period on a bill proposal to implement a 250-day thinking period for boards. The proposal, which could be an anti-takeover mechanism, raised concerns about shareholder rights because it would give the supervisory board 250 days if shareholders submit a proposal to appoint or remove a director, or if there's a takeover bid. Shareholder rights provisions are otherwise strong, including a binding vote on executive remuneration.

United States

With robust institutions and rule-of-law standards, the U.S. demonstrates many strong characteristics but lags several other countries with respect to ESG regulations and social indicators. Income inequality is higher than in other OECD countries and has been so for over a century. Social services are similarly less generous than in most wealthy countries. Governance is characterized by a very stable political system, strong rule of law, a powerful judiciary, and effective checks and balances. Conditions of doing business are generally high. The U.S. follows a rules-based approach to corporate governance focused on mandatory compliance with requirements from the major exchanges (NYSE and NASDAQ) as well as legislation. State corporate law is also a key source of corporate governance, particularly Delaware where over half over all U.S. listed companies and close to 70% of Fortune 500 companies are incorporated. Exchanges mandate high standards of corporate governance. The NYSE requires companies listing on its exchange to have boards made up of a majority of independent directors and have separate remuneration and nomination committees. However, formal requirements on ESG reporting are not as established as they are in European countries. While a growing number of companies have an independent chair, the combination of CEO and chair roles is still popular. This can undermine management oversight. Remuneration continues to be a contentious point, because U.S. executive pay dwarves global pay levels. The CEO-to-worker pay ratio is ever-increasing, leading to social tensions and shareholder criticism.

China

Social standards are in line with most other major developing economies. The government recently strengthened legal protection for workers and consumers. Chinese corporate governance standards are also on par with other economies at this stage of development. The central government's recent push to reform state-owned enterprise structures in line with good governance practices is a major development. In 2018, China revised its Code of Corporate Governance for listed companies, accounting for OECD requirements and particularly focusing on ESG disclosure and board diversity. Official corruption has become less of a problem over the past few years due to the central government's anti-corruption drive. This effort has also been extended to government-related companies and financial institutions. Still, corruption among private enterprises remains an issue. Although judicial reforms are ongoing, the private sector has yet to trust that the rule of law is significantly improving.

Brazil

Brazil's regulations and complex federal and state tax code impose heavy compliance costs for businesses and encourage informality and tax evasion. Most of the workforce remains in the informal sector of the economy and poverty has been rising. Corruption at the highest government levels has created a strong public backlash and led to several political and business leaders being jailed as part of the Lava Jato investigations. In terms of corruption, Brazil is stagnating in the bottom half of South American countries, ranking 106 out of 180 on the Transparency International 2019 Corruption Perceptions Index. The judicial system, which operates at federal and state levels, can make applying laws complex and slow. While Brazil has comparatively strong laws and regulations, particularly on corporate governance, the main issue is implementation. We expect this to strengthen following recent significant improvements such as stronger B3 stock exchange listing rules on governance (Novo Mercado segment), new governance guidelines for state-owned enterprises, and greater shareholder-rights protection. For instance, instruction 614 from the Brazilian Securities Exchange Commission (CVM) which came into effect on Jan. 1, 2020, improves shareholders' rights in relation to the election of directors. Concentrated ownership is common and the use of multiple-class share structures with unequal voting rights may negatively affect minority shareholders. The Brazilian Institute of Corporate Governance's Corporate Governance Code is the best practice reference document in the market. It is not mandatory, but since 2017 companies must report on its recommendations on a comply-or-explain basis. Despite improvements to board independence and diversity, Brazil lags behind developed markets. There are limited formal requirements for ESG disclosure, but companies, particularly large ones, tend to report widely on their environmental and social efforts.

Related Research

- "The ESG Risk Atlas: Sector And Regional Rationales And Scores," published July 22, 2020
- "Our Updated ESG Risk Atlas And Key Sustainability Factors: A Companion Guide," published July 22, 2020
- "Environmental, Social, And Governance Evaluation: Analytical Approach," published December 15, 2020
- "How We Apply Our ESG Evaluation Analytical Approach: Part 2," published June 17, 2020

This report does not constitute a rating action.