DOES CORPORATE REPUTATION MATTER?

Op Ed by Dr Rory Knight

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JOONGANG SUNDAY

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The violent ejection of a passenger from a United Airlines flight by officers of the Chicago Department of Aviation, at the request of airlines staff, has propelled the issue of corporate reputation once more into the spotlight. There has been a spate of such reputation wrecking events in recent months including the Samsung S7 product recall and the VW diesel scandal. These events certainly test the mettle of management. Moreover the effects are exacerbated by the ability of social media to broadcast such events far and fast. In the case of the United Airlines incident the video of the expulsion was seen live probably by millions of viewers before the CEO was even made aware of the crisis. This universal visibility can only increase in future. But do these events have any lasting effects on corporations? In short, does corporate reputation matter even one jot?

One view is that reputation is no longer an important factor. It is pointed out that there has been no dramatic impact on United Continental's share price, that Samsung has experienced no major ill effects and that VW's profits have actually gone up. In this view reputational crises are simply a tiresome bump in the corporate road, a normal part of business life from which one can move on without worrying too much about the longer-term damage. If a firm is competitive, customers will continue to queue up to buy its products willy-nilly. In fact without worrying about reputation the world is a far easier and better place. Companies can therefore rest on their laurels and simply rely on customer loyalty. The vast cost and effort of PR campaigns is unnecessary can be avoided without fear of harm.

In fact, though, there are many contrasting cases where loss of reputation has led to catastrophic financial effects. Union Carbide lost significant market value after the Bhopal tragedy in India, a loss which led to the company's eventual demise. In the aftermath of the Deepwater Horizon oil spill in the Gulf of Mexico BP lost close to 50% of its value (over $80 billion) and the CEO was fired. The loss of value was far in excess of the bottom-line cost of the oil spill itself. In the service sector reputation is particularly paramount. Such crises may cause firms to fail, Arthur Andersen, the accounting firm, is the prime example: put out of business due to the collapse in its reputation in the wake of the Enron scandal.

Oxford Metrica has been studying the relationship between reputation and value for more than twenty years and amassed a large database on the field. The headline results are summarized in figure 1. This shows the average impact on share price of hundreds of such events over the last three decades tracing the impact on share price as a percentage relative to the date of the event. On average such events are associated with an initial drop of around 5% in the first 20 trading days. This is approximately the amount that the United Continental share price lost in the immediate aftermath.

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This would seem to show that such events do have a significant impact overall. However, a more detailed analysis, as shown in figure 1, does not support the idea that reputation effects are fleeting - indeed quite the opposite.

Two overriding features emerge:

1. There are two distinct groups: winners and losers. Losers suffer a larger 12% drop in share price which accumulates to around 15% over the next year. This represents a permanent impairment in value of around 15%.

2. Winners by contrast recover the initial losses and accumulate a perhaps surprising permanent increase in value of around 10%.

Further analysis reveals other factors that distinguish winners from losers. For example service firms are more severely impacted. Most importantly, the occurrence of fatalities is likely to result in permanent impairment. Killing or injuring your customers is never a good idea, and no amount of smooth PR is able to get round that fact!

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What figure 1 demonstrates is that markets make a hard-headed assessment of the likely impact of the loss of reputation on the value of the business taking into account the effects of management responses. Paradoxically, therefore, a catastrophe may actually result in the enhancement of reputation and improve share price. An example is the effect on the share price of Air France of the Concorde crash. The process was managed very effectively and despite the tragic loss of life, Air France emerged with an enhanced reputation. The key features of their response was a rapid taking of responsibility, clear communication and treating the relatives with respect. Generous payouts were made to the families almost immediately. This is in stark contrast to the handling of the families in the more recent MH37O tragedy experienced by Malaysian Air.

Prior preparation for catastrophes is necessary but not in itself sufficient. Few if any among the winners group did not have preparedness programmes although some of the losers had such programmes. The message for corporate boards is that, while they should develop protocols for dealing with such events, more importantly they need to recognize that by their nature such events are spontaneous and unpredictable and demand adequate and agile responses. Corporate lawyers are often an inhibiting factor, introducing an understandable reticence to admit liability. Evasive foot-dragging behaviour immediately damages credibility. The old adage that the customer is always right is a far better guide for action. Failing to openly reach out promptly to customers and their families with a compensation offer augurs badly. Whatever lawyers might say a drawn-out legal battle with customers rarely does reputation any good at all.

Successful reputation damage limitation strategies therefore can be bluntly summarized as follows:

The do's

1. Do be prompt

2. Speak always through the lips of the CEO alone

3. Accept responsibility, show appropriate contrition and provide adequate compensation

4. Quickly put in place a credible recovery plan of action.

The don'ts

1. Don't delay your response

2. Don't try to hide behind lawyers or use lower echelon executives as your mouthpieces

3. Don't make excuses or try to shift blame.

All might not have been lost in the United Airlines case if the firm had moved swiftly to assume responsibility, made a generous compensation offer and rewritten their rules regarding overbooking and the use of the police in handling customer relations. But perhaps airlines feel they are perceived to be so bad at customer relations that they conclude they have no reputation to lose. The same might be true also of certain cigarette brands. An example of this was the recall of cigarettes by Philip Morris for health reasons. There was no impact on its share price whatever perhaps because no tobacco company has any reputation at all to lose when it comes to the health of its customers!

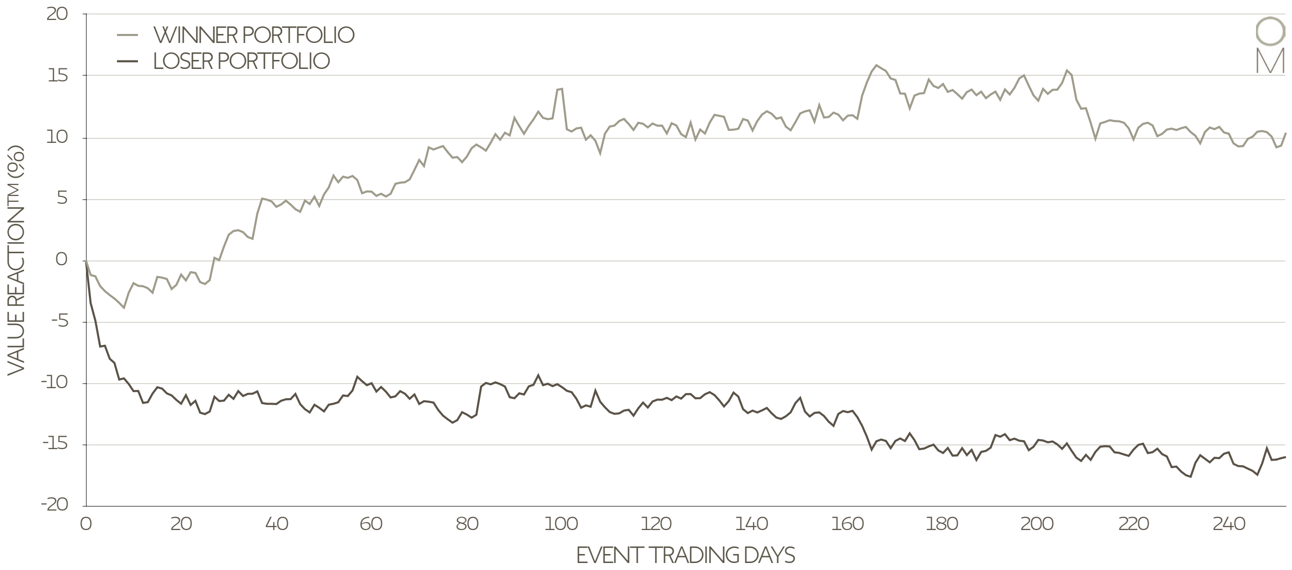
> "No, make no mistake about it: reputation is all. It takes years and years to build but only seconds to destroy."

But is the impact on share price the only or even the right metric anyway? True, it is a useful financial proxy. It is a measure of the long-term value of the firm and should in even a mildly efficient market reflect long-term expected financial consequences. The shareholders are the residual claimants so any negative effects on the business should be transmitted to those at the end of the queue. However share price impact focuses on one stakeholder group only: the shareholders. It is perceived as a short-term measure which ignores many other factors such as the impact on employees. There may be other major reputational consequences not reflected in the share price such as the firing of the CEO or a corporate re-branding or even a take-over. So when these crises occur it is not only reputation which is at risk but its future recruitment attractiveness, the tenure of top management and even the long-term fate of the corporation itself.

One last comment:

imagine a world which proclaimed that reputation had no importance or value whatsoever. What a sorry state of affairs that would represent! Companies could just behave as badly as they wanted without fear of the consequences. Year after year they could continue to treat their customers like cattle, thoughtlessly feeding them products and services and complacently trusting in their bovine stolidity. No, make no mistake about it: reputation is all. It takes years and years to build but only seconds to destroy. It is an asset of immense worth and as such demands serious management at the high levels.

FIGURE 1
Impact of crises on share price



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