Reputation Review 2010

Oxford METRICA

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Reputation Intelligence: Credible Communications to Enhance Value

FOREWORD

I am delighted to present our Reputation Review 2010.

The last decade has witnessed a significant rise in the importance of corporate reputation which is coming under increasing scrutiny. The proliferation of communication technologies is amplifying the impact of events on reputation. In turn, the need for a deeper understanding of the relationship among reputation, communications and value is evident. Corporations need to assemble and manage reputation intelligence as a strategic asset.

The frequency of corporate crises is not slowing. Already this year, we have seen Toyota grappling with these issues in the US and, as I write, BP executives are being interrogated by US Senate committees about their role in the oil spill in the Gulf of Mexico. As you will see in our analysis, this event has cost BP up to $25bn in reputation impairment. We estimate that there is around an 85% chance of a significant crisis in a five year interval for any one company.

We at Oxford Metrica have been studying the relationship between reputation and value for nearly two decades. We have developed an extensive database on reputation events and more importantly, an analytical approach for disentangling the various effects of events on reputation and value. This approach is evidence-based although we make no claim to have prescriptive solutions. However, we are able to offer some unique insights on how events affect value and, in this issue of Reputation Review, we showcase some of our recent assignments.

We show how reputation is affected in a crisis and we measure the financial effect; we illustrate how firms have recovered from a crisis; we demonstrate how firms manage reputation risk; we present how firms identify the key drivers of their reputation value - in short, we describe an approach to the development of reputation policy.

I hope you enjoy the review and I would welcome further dialogue on your own corporate reputation issues.

Dr Rory Knight
Chairman

Dr Rory Knight is Chairman of Oxford Metrica.
He was previously Dean of Templeton College,
Oxford University's business college.

1 INTRODUCTION

The last decade has been eventful. Table 1 highlights a few of the more prominent crises which have occurred. In our work in Reputation and Communications, we are reminded often of the substantial impact of reputation events on human life, on a company's value, of the frequency of such events, and of the ability of management to turn adversity into advantage.

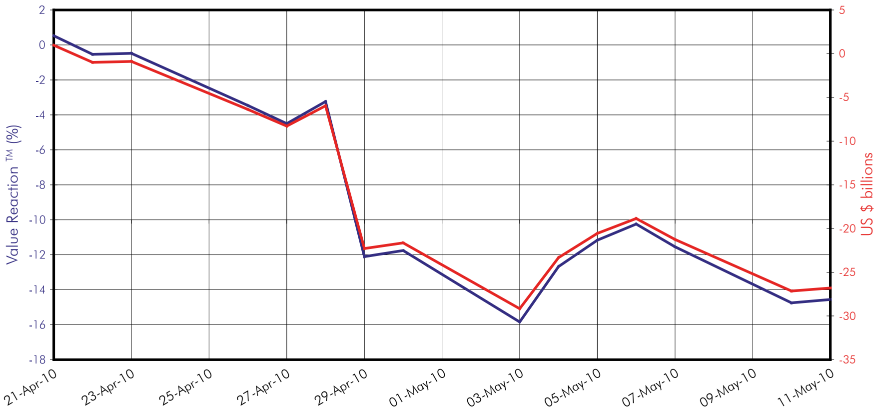
Table 1: Prominent Corporate Crises over the last Decade

Year	Company	Crisis	Fatalities	Value Reaction™
2000	Bridgestone	Tyre recall	46*	-40%
2000	Air France	Concorde crash	113	30%
2001	Cantor Fitzgerald	9/11 terrorist attack	658	-
2001	Enron	Illegal accounting	-	-100%
2003	Parmalat	Illegal accounting	-	-100%
2004	Adecco	Delayed reporting	-	-40%
2005	BP	Refinery fire, Texas	15	-30%
2008	Société Générale	Unauthorised trading	-	-30%
2008	Lehman Brothers	US subprime mortgage crisis	-	-100%
2008	AIG	US subprime mortgage crisis	-	-99%
2008	Sanlu	China milk scandal	6	-100%
2009	Toyota	Safety recalls	34*	-20%

*estimate

As this report is going to print, oil company BP is battling to save its reputation. On 20 April 2010, eleven men lost their lives in an explosion on Transocean's Deepwater Horizon drilling rig. The explosion of the rig, which is licensed to BP, ruptured the deepwater well, an oil source with no human access. The failure of a blowout preventer to activate has resulted in a huge oil slick in the Gulf of Mexico and concerted efforts across the industry to control the spill. Figure 1 shows the initial reaction to BP's share price.

Figure 1: BP: a reputation under pressure



The challenge to protect and build corporate reputation, and enhance financial performance by so doing, is of central interest to Oxford Metrica. The fundamental issues we explore in subsequent sections of this report include:

1 The relevance of reputation management to financial performance;

2 Reputation crises and how to recover from them;

3 The role of communications in managing reputation risk;

4 The value advantage in understanding one's reputation drivers;

5 Making the most of opportunities to build reputation equity;

6 A strategic framework for managing corporate reputation.

The vital artery from the heart of a company to its reputation with stakeholders is a coherent communications strategy. The assignments we share in these pages reveal the essential and inextricable role for credible and evidence-based communications in demonstrating reputation intelligence and creating value.

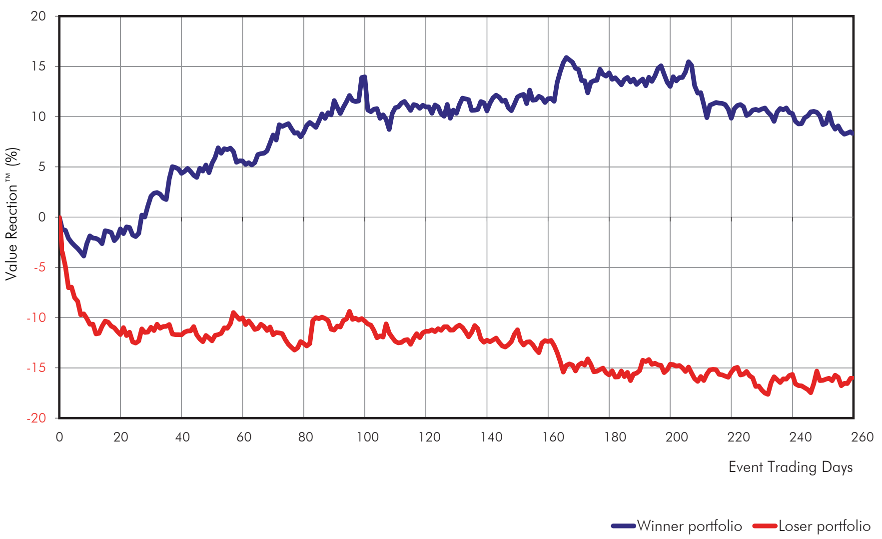
2 REPUTATION AND VALUE

Reputation is important. Corporate reputation regularly tops the survey rankings of companies' most valuable asset, and reputation risk regularly is voted the most dangerous threat to a company's performance.

Reputation is as fragile as it is important. Oxford Metrica has a databank bursting with reputation stories; losses, triumphs and ongoing journeys. It is from these that we have the benefit of drawing when evaluating a given corporate situation.

Figure 2 illustrates the impact on share price of a portfolio of reputation events.[1] Market-wide factors are stripped out so as to capture a company-specific value reaction. The value impact over the post-event year is modelled, whereby the starting date of each event in the portfolio is aligned on Event Day zero.

Figure 2: The Value Impact of Reputation Events



Whilst the initial impact on all companies is a drop in value, very rapidly the market begins to make its judgement and there emerges a clear distinction between the *Winners* and the *Losers*. As the aftermath plays out, the divergence between the two groups becomes ever more apparent. Indeed, the Winners succeed in transforming their crises into value-creating events and their companies emerge with enhanced reputations.

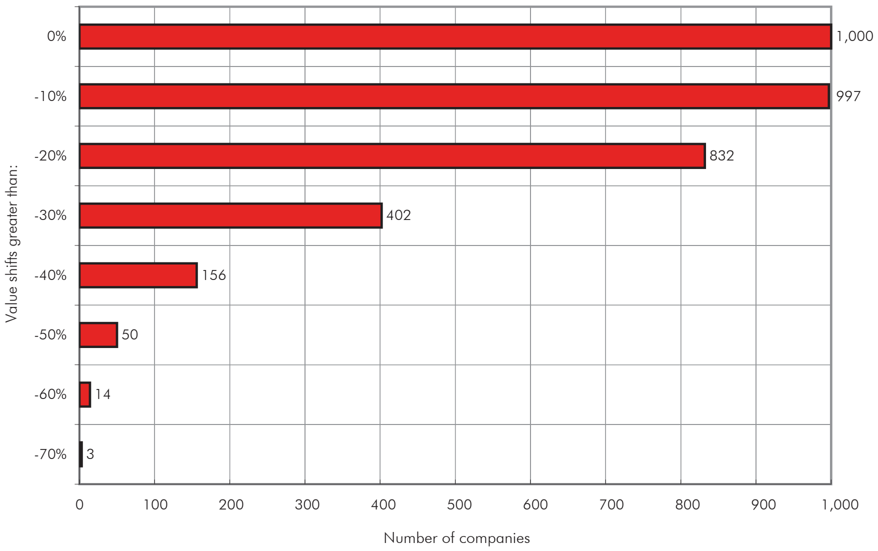
A critical reputation event – positive or negative, but an event which has the potential to affect corporate reputation in a significant and sustained way – is a real opportunity for senior management to grasp the nettle and drive the future direction of their business. The spotlight is upon them, and the way in which management responds to the challenge provides new information to investors and other stakeholders about the management team's ability to perform under pressure.

1 *Reputation and Value: the case of corporate catastrophes*, OM research commissioned by AIG

The evidence reveals consistently that the top drivers of reputation recovery are strong leadership by the Chief Executive Officer (CEO) and effective communications.

So how likely are these critical reputation events? More likely than we care to imagine. Figure 3 shows a frequency diagram for the Global 1000 over a five-year period, and the incidence of a negative reputation event prompting a value loss exceeding a particular level in a single month.[2]

Figure 3: The Likelihood of Reputation Events



For example, there is shown to be an 80% chance of a company losing more than 20% of its value, over and above market movements, at least once during a five-year period.[3] Alternatively, there is a 40% chance of a company losing more than one-third of its size in a single month. In each case, the measurements were calculated over and above the market, and the triggering events occurred suddenly and unexpectedly.

Even against a backdrop of declining CEO tenure, these results tell us that most CEOs will have to deal with at least one of these events on their watch. Our research reveals further that the majority (72%) of the underlying triggers for these sudden drops in value were strategic in nature. In other words, the underlying peril neither could be hedged away via the derivatives markets nor insured away through the commercial insurance markets.

Across all the events Oxford Metrica has analysed and advised upon, advance knowledge of the particular company's key drivers of reputation is key to confident leadership and well-targeted communications. Evidence-based communications are essential to sustained value performance.

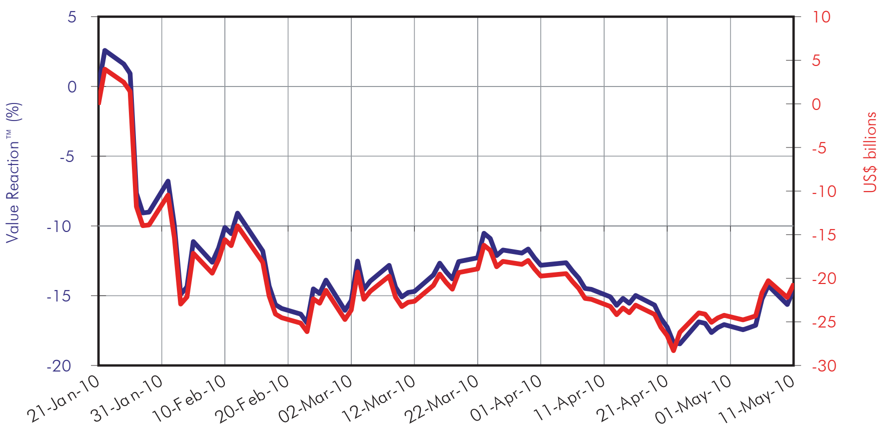
2 *Risks That Matter*, OM research commissioned by Ernst & Young
3 as referenced by *The Economist*, 10 April 2010

3 RECOVERY FROM CRISIS

Reputation crises are at the extreme end of the spectrum. However, it is the extremes which bring into sharp focus lessons for managing the everyday.

Arguably the most prominent corporate reputation in crisis as we enter a new decade is that of Toyota. The motor company has been forced to make a series of recalls relating respectively to: accelerator pedals becoming stuck in floor mats, faulty pedals, brake system problems in the hybrid models and, most recently, concerns over corroding cables which could allow spare tyres to fall into the road. Figure 4 shows the company's dramatic decline in value.

Figure 4: Toyota: a reputation in crisis

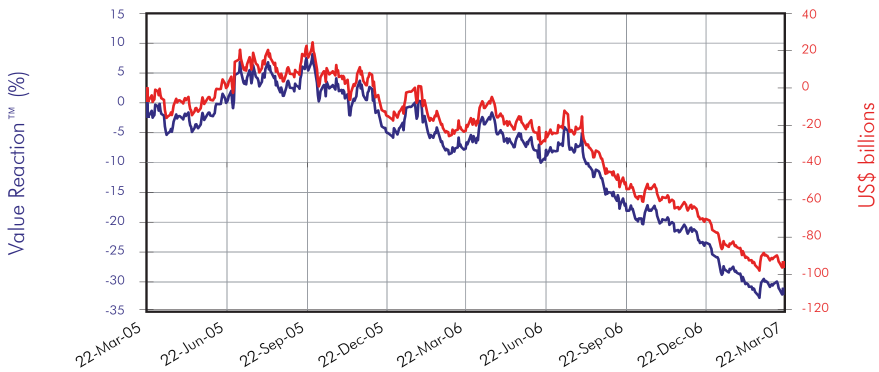


As acknowledged by President Toyoda, the genesis of the quality issues lies in a rapid expansion programme during which the priority migrated away from the customer. There is no doubt, however, that the negative reaction to Toyota's travails has been exacerbated by the company's response which was late, ill-coordinated and poorly communicated. Attributes which give rise to a more positive value reaction include:

- Immediacy of response;
- Strong leadership by the CEO;
- Coordinated communications, both internally and externally;
- Honest and sensitive communication;
- Prompt analysis of information.

Also failing to recognise the severity of the situation early, was oil company BP following the tragic explosion at its refinery in Texas City, in which fifteen people died. This fatal incident began a sequence of events through 2005 and 2006 which diminished the reputation of BP and caused a loss in value of approximately US$100 billion; Figure 5.

Figure 5: BP: the hundred billion dollar loss



The managerial awareness of what is required in a 'mass fatality event', and the courage to act accordingly, are essential ingredients for recovery. Our research suggests that the presence of mass fatality in an extreme corporate event acts as a multiplier on the value impact.[4] Figure 6 illustrates this result, where the 'Extreme event' portfolios are those which involved mass fatalities.

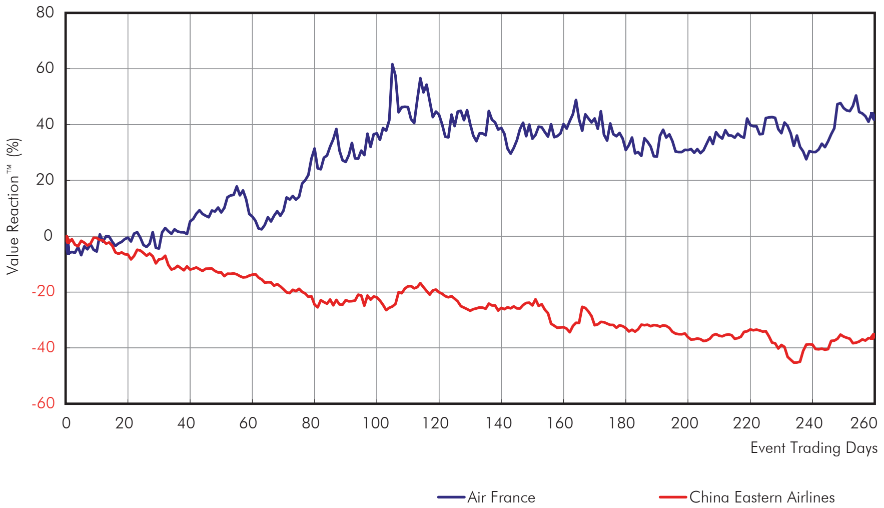
Figure 6: Mass fatalities: the worst crises

Such tragic events are a gruelling ordeal for any management team. The circumstances are not only logistically challenging but also profoundly emotionally traumatic. Mass fatality events demand strong leadership, honest communication and compassion. Oxford Metrica has worked extensively with the airline industry and the oil industry to identify and forge best practice in reputation recovery.

Figure 7 illustrates the strikingly different managerial responses – captured by their value reactions - to the tragic scenario of a fatal air crash.

4 *Protecting Value in the face of Mass Fatality Events*, OM research commissioned by Kenyon International

Figure 7: Air France versus China Eastern



The Concorde supersonic jet crashed within minutes of taking off for New York from Roissy-Charles de Gaulle airport near Paris on 25 July 2000. 113 people died. Investigations concluded that a stray piece of metal on the runway fell from a Continental Airlines DC10, slashed one of Concorde's tyres and caused it to burst. The tyre debris was propelled into one of the fuel tanks, causing shock waves to rupture the tank from within, and cause a major fuel leak and fire. On 2 February 2010, Continental Airlines faced charges in court in one of the largest corporate manslaughter trials in France.

The response by Air France CEO Spinetta is an impressive exemplar of successful reputation management. Rather than focusing on the company's reputation itself, Spinetta understood and acted upon the core drivers of that reputation. In particular, the company demonstrated[5]:

- Strong personal leadership by the CEO, with a visible, decisive presence early on;
- Sensitive, compassionate communication; the bereaved were the clear priority;
- Rapid, credible response; immediate action, thorough safety investigation and unquestioning investments in safety modifications.

This response contrasts sharply with that of China Eastern Airlines whose aircraft crashed into a frozen river within seconds of taking off for Shanghai from Baotou airport in Inner Mongolia on 21 November 2004. 55 people died. The crash was caused by a failure to de-ice the aircraft prior to take-off, prompting a build-up of ice on the aircraft wings and a loss of speed during take-off.

The void of information surrounding the crash spelt the sustained slump in the company's reputation and share price. Primarily three factors were responsible for the reputation damage:

- Lack of communication, allowing rumours to flourish and frustrations to rise;
- Insensitive management of compensation, where pressure was applied to sign deals prematurely;
- Excessive delay in explanation, prompting allegations of a cover-up.

5 *Reputation and Value Recovery: A Focus on the Airline Industry*, OM research commissioned by Kenyon International

The response by each airline to its reputation crisis could not be more different and the share price tells the story. The contribution of credible, coordinated and respectful communications to value recovery is significant. The communications strategy is the means by which senior management conveys its action and intent to stakeholders while the share price captures a synthesis of their opinions about the company's future performance.

4 MANAGING REPUTATION RISK

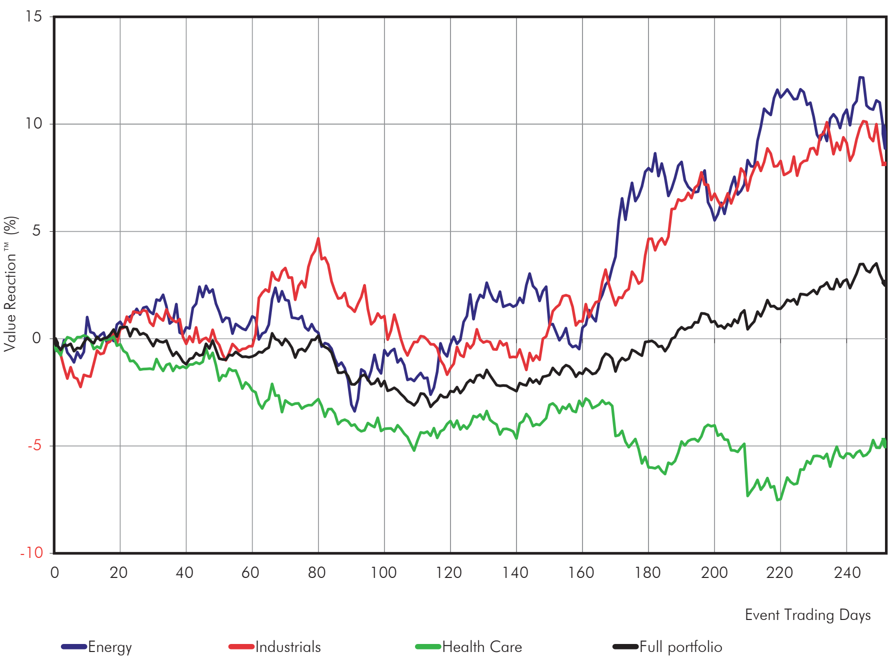
In this section, we highlight an Oxford Metrica assignment in which one of our health care clients is keen to prepare for an industry issue should any damaging events from it arise. Following the major bribery scandal at Siemens (and now Daimler), our client is interested in how best to manage such infractions of the Foreign Corrupt Practices Act and violations of corporate policy.

An increase in regulatory actions against corporations charged with ethics violations in foreign markets has prompted a range in communications responses including: pre-emptive disclosure, reactive disclosures only, acceptance of responsibility, diversion of blame on to foreign subsidiaries, or even silence.

This health care client holds itself to high ethical standards and is determined to ensure that its hard-earned reputation does not suffer any more than is absolutely necessary if such violations occur. It is not clear, however, which communications strategies will be the most successful in restoring reputation in such circumstances.

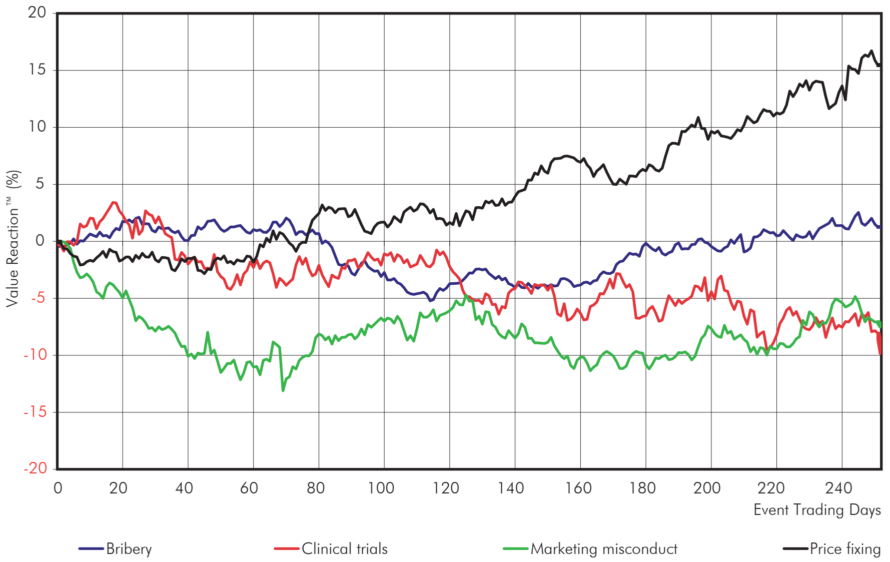
A portfolio of over fifty unique cases of ethics violations was produced and analysed extensively. Figure 8 shows the portfolio value reaction by industry sector. The instincts of the client were proved correct, as the evidence reveals health care companies particularly to be vulnerable to reputation damage from such infractions.

Figure 8: Health Care Companies at Risk



Consistent with this result, Figure 9 shows that marketing misconduct and clinical trial violations are penalised more than cases of bribery or price fixing, for example, which perhaps are perceived more as 'victimless' crimes. Marketing misconduct and clinical trial violations are almost entirely health care issues.

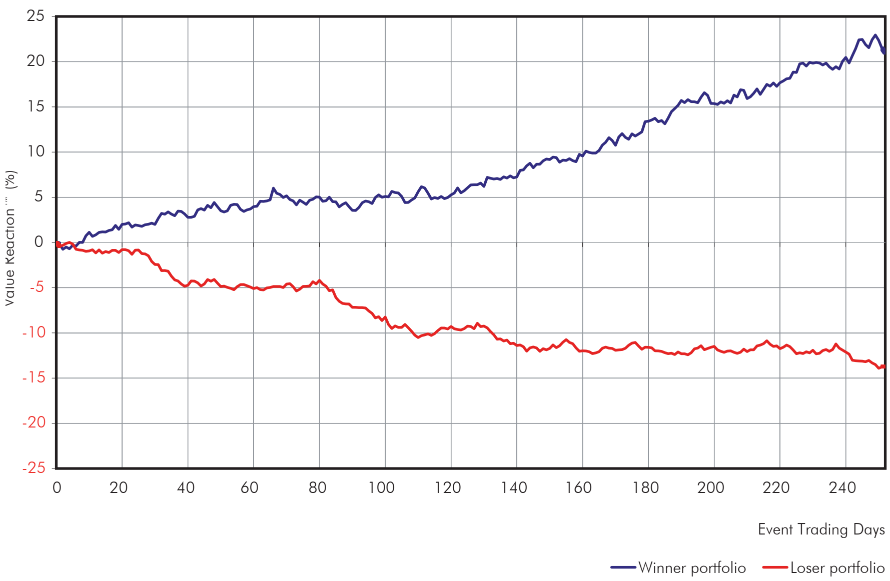
Figure 9: Value Destroyed by Marketing Misconduct



Where an issue resonates with a core facet of a company's reputation – be it Toyota quality or health care and ethical standards, for example – the subsequent value impact tends to be more acute. A baseline of behavioural expectations has been established and any disappointment attracts greater punishment by stakeholders.

The evidence reveals that the value at risk from ethics violations is significant. Showing greater explanatory power than either industry sector or type of infraction, however, is the communication strategy adopted. As shown in Figure 10, a clear distinction emerges between those companies with effective communications strategies and those with poor communications.

Figure 10: Effective Communications Central to Risk Management



Specifically, companies in the *Winner* portfolio were able to build reputation from the incidents and add 21% in value whereas those companies which communicated poorly around their violations lost an average 15% in value over the post-event year.

The evidence reveals that the *Winners* consistently have:

- Disclosed promptly;
- Exhibited transparency and candour in their disclosures;
- Taken responsibility for their actions or agents' actions appropriately;
- Demonstrated credible follow-up behaviours.

In contrast, the *Losers* consistently have:

- Either delayed communications responses or failed to respond entirely;
- Issued opaque or partial responses;
- Failed to take responsibility or express contrition;
- Attempted to shift blame.

The analysis exposes clearly which communications strategies yield most value and help to restore a company's reputation in a particular set of circumstances. Each company will have a different set of key reputation issues and a different set of key reputation drivers. It is through identifying these company-specific factors and understanding their inter-relationships that we can begin to develop credible communications strategies which enhance value and safeguard corporate reputation.

5 IDENTIFYING REPUTATION DRIVERS

Managing reputation is not exclusively a defensive exercise. By examining thoroughly the core facets of corporate reputation, it becomes possible to identify the set of communications activities which have the most potent effect. Expressed simply, such a process involves three main stages:

1. Identify the communications activities associated with a core aspect of one's corporate reputation,
2. Measure the effect of each activity on shareholder value, and
3. Rank the activities in terms of their impact on value and ability to affect reputation.

Such a process enables senior management to identify which communications activities are most value-adding and which are perhaps less so and, therefore, allocate communications resources more effectively towards a value creating strategy.

For companies in technology, computers, telecom equipment, engineering, medical products, pharmaceuticals and chemicals, for example, research and innovation are central to their operations. Substantial investment is made by these companies to ensure that the strategic sense of these investments is communicated effectively to stakeholders and translated into value.

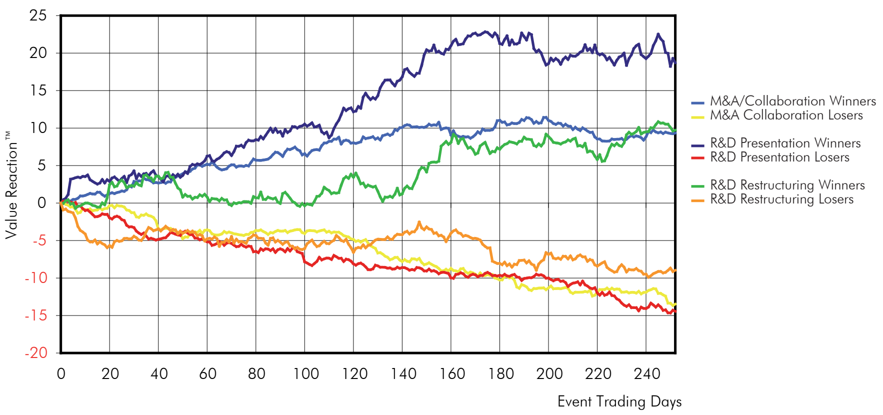
One of our clients, for whom Research and Development (R&D) is a core element of its business and reputation, is keen to ensure an efficient allocation of communications resources. In the first stage of the process, we identified over 160 specifically R&D-related reputation events for the client and its industry peer group over a five-year period. The communications strategies and public disclosures are analysed extensively; disclosures include, for example, corporate press releases and presentations, newspaper reports and articles, broker and analyst reports, and journal references.

The second stage of the process involves measuring the impact of each R&D reputation event on shareholder value. This particular company's communications activities around R&D could be grouped into a number of categories, the most prominent being those related to:

- Restructuring; investing in new R&D facilities, strategic R&D recruitment;
- Mergers and Acquisitions, collaboration, alliances, joint ventures;
- Presentations; special R&D days, R&D analyst or investor meetings.

The portfolio value reaction for each category is illustrated in Figure 11. It is the client's R&D presentations which are revealed to be the most value-adding and, consistently, the most value-destroying set of communications activities. Getting the presentation right can add an average 19% in value, while a poor presentation can destroy an average 14% in value. R&D presentations often are timed with analyst meetings when most critical information is shared. These presentations are also an opportunity for senior management to reinforce (or not) the strategic direction of the company.

Figure 11: The Potency of Presentations



The evidence demonstrates that, for this client and its peer group, communications resources have most impact in their R&D presentations. In contrast, their disclosures relating to R&D restructuring activities have least impact, positive or negative. Further analysis reveals more specific reputation drivers within these broad categories. These company-specific insights are now being used to shape the client's R&D communication strategy and enhance its reputation further.

By including a peer group in the analysis, it is possible to benchmark the client against its peers in terms of the company's ability to generate reputation equity from R&D communications. This offers reassurance for where the company is leading the industry and lessons for areas of improvement. One notable observation from the final R&D Reputation Equity ranking is that a number of the top ranking firms in the industry are takeover targets where the acquirers are in the lower half of the ranking. This prompts a challenge for the acquirers to retain the reputation jewels in the acquired, for which a premium invariably is being paid.

This example of a company seeking to reinforce its reputation - by achieving a deeper understanding of its reputation drivers and of how its communications activities impact value - relates to R&D specifically. The facets of corporate reputation appropriate for this type of analysis, however, are many and varied. Another area on which Oxford Metrica has focused is evaluating the benefits of investment in Corporate Social Responsibility (CSR) or aspects thereof; environmental management, energy efficiency, product stewardship, employment ethics or community engagement. Alternatively, the focus of analysis might be a particular type of reputation risk; product recalls, operational hazards, service disruption, financial losses, leadership issues, lawsuits, or business practices, for example.

Whatever is the core driver of a company's reputation, a deeper, evidence-based understanding of the impact of its communications activities will facilitate more efficient resource allocation and better targeted communications. Companies then are well-positioned to develop their reputation equity and release latent value.

6 BUILDING REPUTATION EQUITY

There are many opportunities which companies may generate to build their reputation in a significant and sustained way. Oxford Metrica has worked with several companies around the world to reinforce or develop corporate reputation substantially, and to measure the impact of the reinforcement steps taken. The success of these opportunities is intimately linked to corporate communications and investor relations. Selected examples include:

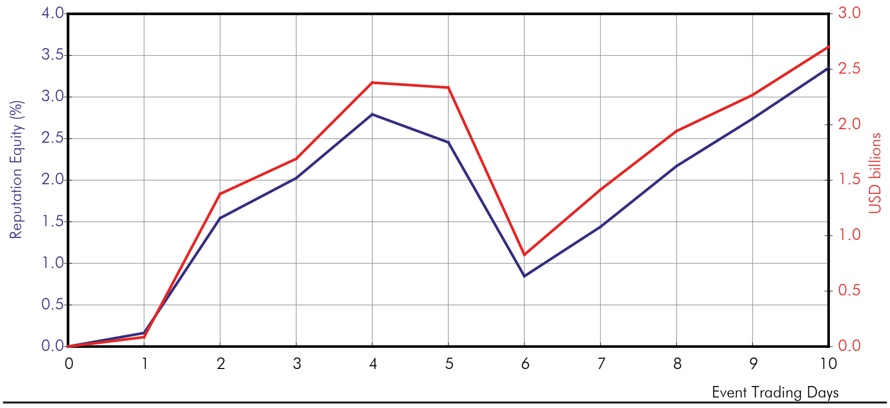
- Launches of new products or strategies;
- Advertising or other promotional campaigns;
- Changes in leadership or governance;
- International listings.

One of our consumer goods clients, with a considerable annual investment in advertising, sought to measure the impact of its promotional activities relative to a key competitor. We constructed a portfolio of its promotional activities which includes product launches, themed print advertising, a new advertising campaign, and a commercial spot during the Super Bowl (which attracts an audience of over 90 million viewers). Then, for the same period, we constructed an analogous portfolio of reputation events for the key competitor (which also included a Super Bowl spot).

Figure 12: Benchmarking Reputation Management

Figure 12 shows the impact of each portfolio of reputation activities on shareholder value for two weeks following the start of each activity; where all events are aligned such that they start on Event Day zero. The graph illustrates that the client in this case is managing its reputation events better than its competitor. Figure 13 calibrates the effect on reputation equity in dollar-terms. Relative to its competitor, the client has added over US$2.5 billion in reputation equity over the period. This is equivalent to over 3% in market capitalisation.

Figure 13: Client Builds Reputation Equity

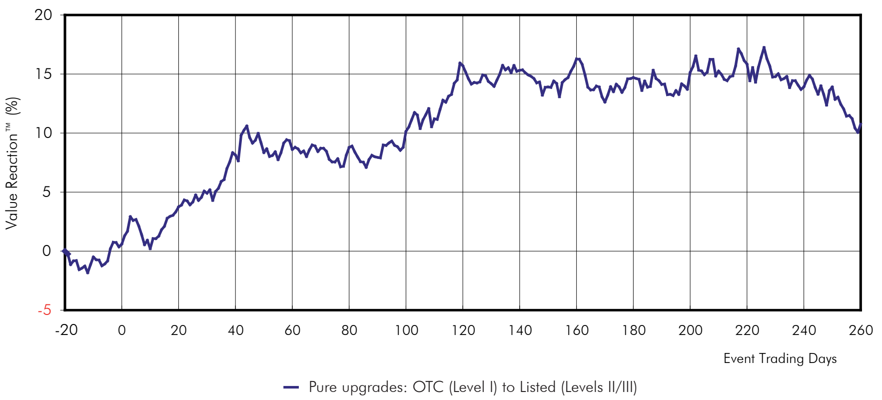


The methodology we use is extremely versatile and can be adapted and customised to a wide range of corporate situations. An area in which we have worked extensively is international listings.[6] Companies wishing to offer international investors cost-effective access to their shares in the form of a security local to a US investor, typically do so via an American Depositary Receipt (ADR). There are many practical benefits to companies and investors from establishing an ADR programme but the reputation advantage from doing so perhaps is the most significant.

To establish a listed ADR requires full registration with the Securities and Exchange Commission (SEC), reconciliation with US GAAP and annual reporting. The costs of compliance are not trivial. However, the value created by voluntarily adhering to higher standards of governance and increased disclosure is not lost on the markets. Companies may choose to establish either a listed programme as described or an over-the-counter (OTC) programme which is not subject to such disclosure requirements. The ability of companies to upgrade from an OTC programme to listed status enables us to isolate the effect of greater disclosure and measure the value impact.

Figure 14 captures this effect for all such companies worldwide, for one calendar year following an upgrade in ADR status. As illustrated, an average 15% of value is added to these companies as management sends a strong reputation signal to investors of its willingness to embrace greater transparency.

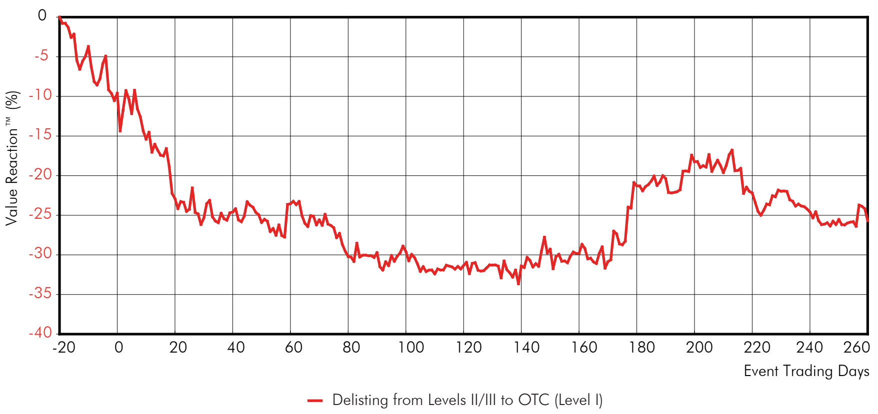
Figure 14: Greater Disclosure Adds Value



6 *Depositary Receipts: Investing in a World Asset Class*, OM research commissioned by BNY Mellon

Figure 15 reminds us, however, of the fragility of a reputation premium. The graph illustrates the market reaction to a portfolio of companies which choose to delist their ADR programmes from listed to OTC status. Investors' reaction to the management decision to withdraw from the disclosure requirements necessary for a listed programme is dramatic and the company's reputation for transparency is damaged severely. Indeed, the reputation penalty for withdrawing disclosure is greater than the premium for increasing disclosure, as investors have become accustomed to the improved transparency and question what the company may have to hide.

Figure 15: Disclosure Withdrawn Damages Reputation



The opportunity to build reputation in this way is relevant particularly for companies from emerging markets as they seek to demonstrate to new investors a higher standard of governance and transparency.

The ultimate criterion on which these reputation initiatives should be judged is the value created. Oxford Metrica has a suite of tools and techniques to help clients evaluate the impact of their reputation investments and to monitor their performance, both over time and against their selected peers.

7 DEVELOPING A REPUTATION POLICY

Effective reputation management is founded on evidence, insights and experience. In these pages, we have shared a few examples of our approach being applied to a diverse set of reputation management challenges. Sometimes, the client has an intuitive idea of the direction of the results but seeks primarily to "put numbers to it". By applying some rigorous quantitative techniques to the evidence, we are able to test client hypotheses, benchmark performance against a selected peer group, monitor the results over time, and facilitate a more efficient resource allocation. In other cases, the evidence may reveal some counter-intuitive results which offer a new direction for corporate reputation policy. In all cases, an evidence-based approach is crucial.

From some clients, the task we are assigned is entirely strategic and requires the design of an integrative framework for reputation management. Such a framework, as we designed for oil giant, Royal Dutch Shell, and global supermarket chain, Tesco, should be:

- Consistent with the company's strategic direction;
- Linked firmly to its financial objectives;
- Be versatile across all operations;
- Be flexible enough to evolve with the business.

Our experience with both these companies taught us that the process itself was as least as valuable for the client as was the final product. For each company, the greater awareness of reputation risk and the ability to affect outcomes improved internal reporting and made for better-informed decision-making.

This report highlights some of the core elements of reputation management to be embraced when developing a corporate reputation policy:

1. Measure the dynamic between reputation equity and financial performance;
2. Examine reputation crises to prepare for the extremes and improve the norm;
3. Promote an evidence-based communications strategy to manage reputation risk;
4. Identify, measure and rank the company's reputation drivers;
5. Measure and monitor the company's communications activities to build reputation equity.

Oxford Metrica has a wealth of reputation resources – ideas, databanks, tools, techniques, and experience – to serve companies in their quest for credible communications and sustained value creation. In a world of instant and global communication, a coherent reputation policy is more important than ever for companies seeking to safeguard and leverage their reputation asset.

OXFORD METRICA CLIENTS

ABB
Accenture
AIG
Aon
Ashurst
Aviva
BAA
BAE Systems
Baxter
Blue Rubicon
BNY Mellon
BP
Bristol Myers Squibb
Cisco Systems
Credit Suisse
De Beers
Deloitte
Deutsche Bank
Edelman
Ernst & Young
Exxon Mobil
FM Global
Freehills
General Mills
General Electric
Giuliani Group
Gold Fields
Hill & Knowlton
Hitachi
Huhtamaki
IBM
Ince & Co
ING Group
Intel
Invesco
Johnson & Johnson
KBC Peel Hunt
Kenyon International
Kone
Marsh
Merck Serono
Munich Re
Nestlé
Novartis
Novo Nordisk
Office-Shadow
Oracle
P&O Ferries
Pink OTC Markets
Porter Novelli
PricewaterhouseCoopers
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Our proprietary databases, research methods and worldwide network of expertise is placed at the disposal of our clients in the services we provide. We support Chief Communications Officers concerned with corporate reputation. Our service is founded on pioneering research in reputation and our unique database of thousands of reputation events over thirty years.

Reputation Review is published annually by Oxford Metrica Press on developments in corporate reputation. It provides a useful overview of reputation events with commentary from leaders in the field.

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