Two-thirds of public company directors count reputation as their firm's #1 concern. Here's why.

Dr. Nir Kossovsky

REPUTATION, STOCK PRICE, AND YOU

Why the Market Rewards Some Companies and Punishes Others

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For Bear

Contents

About the Author

Dr. Nir Kossovsky is an authority on business process risk and reputational value. With a career spanning the worlds of risk, probability, and intangibles, Kossovsky is cofounder, chief executive, and director of Steel City Re, reputational value specialists. Kossovsky holds more than a dozen patents, including an algorithmic reputational value measurement system currently enabling insurance solutions (patent pending), third-party investment strategies, and governance products. He is the executive secretary of the Intangible Asset Finance Society, a professional organization, for which he edits the *Mission:Intangible* blog under the *nom de plume* Huygens.

He served on the boards of Patent & License Exchange and Littlearth, Inc.; was a consultant to the U.S. Food and Drug Administration's medical device advisory panels; and is featured in case studies from Harvard and Darden Schools of Business. Formerly a practicing physician with an M.D. degree from the University of Chicago, Kossovsky earned an MBA from the University of Southern California and a BA in Philosophy from the University of Pittsburgh. Kossovsky was a tenured member of the faculty of the UCLA School of Medicine, Chief of the UCLA Medical Center's Autopsy Service, and a Deputy Coroner in Los Angeles County. He is a Trustee of Excela Health Systems, a community-based healthcare provider. He graduated from the U.S. Navy War College and was honorably discharged with the rank of Captain from the U.S. Navy Reserves. He is the author of more than 200 scholarly articles, lay articles, and books.

About the Contributors

Michael D. Greenberg is a senior behavioral scientist with the RAND Corporation and director of the RAND Center for Corporate Ethics and Governance. He is a clinical psychologist and an attorney by training. Greenberg's work at RAND has involved designing and leading empirical research projects on topics spanning healthcare, civil justice, national security, and law and business issues. He has led or co-led projects in all of these areas, and some recent examples of his work include studies on fair value accounting and systemic risk; medical malpractice litigation and hospital-based patient safety; and the impact of the 2008 financial crisis on the U.S. civil justice system. In his role as the Director of RAND's Center for Corporate Ethics and Governance, Greenberg leads RAND Corporation efforts in developing new research and path-breaking round -table events designed to contribute to better policy on matters ranging from organizational compliance and behavior, to government regulation of business organizations, to the role of organizational boards in institutional oversight. RAND reports authored by Greenberg include *Directors as Guardians of Compliance and Ethics Within the Corporate Citadel* (2010); *For Whom the Whistle Blows: Advancing Corporate Compliance and Integrity Efforts in the Era of Dodd-Frank* (2011); and *Corporate Culture and Ethical Leadership Under the Federal Sentencing Guidelines* (2012).

In addition to his work at RAND, Greenberg has held adjunct and teaching appointments at the University of Pittsburgh School of Law, the University of Pittsburgh School of Medicine, and the Heinz College of Public Policy at Carnegie Mellon University. He received his Ph.D. degree in clinical psychology from Duke University, and following an internship at Dartmouth Medical Center in New Hampshire, he entered law school, received his J.D. degree from Harvard, and worked as an attorney at Ropes & Gray, a Boston law firm.

Robert C. Brandegee was cofounder and principal of Brandegee, Inc., Pittsburgh-based management consulting/communications firm. He served as VP of Creativity and played a lead role on many assignments related to the management of change in business organizations, as well as in nongovernmental organizations (NGOs) and government agencies. Clients included Westinghouse, Alcoa, U.S. Steel, PPG, Heinz USA, Cyclops/Armco Steel, University of Pittsburgh, Carnegie Mellon University, Chatham University, the City of Pittsburgh, and Allegheny County, as well as U.S. government agencies Departments of Energy, Defense, and Transportation (DOE, DOD, and DOT).

For many of these assignments, Brandegee pioneered a change management technique called strategic concept mapping that uses visual/verbal displays of evolving strategic frameworks. These were a key tool in iterative planning with client groups for corporate culture change, and yielded a common model of problems and needs shared among management and employees. The output was a strategic action plan distilled to a single page. This provided ongoing guidance and encouraged regular reference and ease of revision as change processes progressed.

Brandegee is a graduate of Williams College. Now retired from Brandegee, Inc., he continues to advise and write for selected clients in fields he has identified as having significant potential for broad societal improvement.

He also designs and markets contemporary furniture, combining antique hand hewn beams, logs, and barn siding with glass and other materials.

Acknowledgments

This is a "how-to" book providing a governance framework and a diversity of execution strategies to help the market recognize and reward companies for creating authentic reputational value. I expect readers will enjoy this book's content and style only because my own effort in channeling the wisdom and experience of many has been heroically augmented by the superior communications skills of a few.

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PART

I

Précis

CHAPTER

1

Avoiding Hara-Kiri

A reputation for a thousand years may depend upon the conduct of a single moment.

—Ernest Bramah

In one of the final scenes in the 1993 murder mystery film, *Rising Sun*, a police inspector stands in a Japanese corporate boardroom at the top floor of a towering office building. In front of the entire board, he prepares to accuse one member of criminal culpability. With tension rising, fellow board members begin to distance themselves physically from the soon-to-be-accused. Taking the cultural cue, the executive takes the honorable route and leaps out of a window, mercifully ending the crisis for all.

In an example of real life imitating art, the scene was replayed on Tuesday, 15 June 2010, when five major oil company executives lined up at a witness table for a House Energy and Commerce Committee hearing to investigate the Deepwater Horizon oil rig disaster, which at the time was still pouring 50,000 barrels of oil a day into the Gulf of Mexico. Exxon Mobil CEO Rex Tillerson said, "We would not have drilled the well the way [BP] did." Chevron CEO John Watson and Shell Oil Co. president Marvin Odum concurred. Rep. Joseph Cao, who had emigrated from Vietnam, closed the scene: "In samurai days, we would just give…[the Chairman of BP]…a knife and ask [him]…to commit hara-kiri."[1]

But the simple solution of seppuku that might have sufficed in an earlier Japanese culture is not available in our complex multifaceted world. BP did not have the luxury of quickly and mercifully ending the fallout from the corporative event that best exemplifies a modern reputational crisis: the explosion of the Transocean Deepwater Horizon oil-drilling rig in the Gulf of Mexico.

The explosion on 15 April 2010 of the Deepwater Horizon platform, situated 40 miles southeast of New Orleans on the Macondo Prospect oil field, killed 11 and critically injured 17 of the 126-member crew. Within hours, Deepwater Horizon was completely destroyed. As it burned and sank, severance of the connection between the well-head and the rig opened the spill of oil into the Gulf of Mexico. On the day of the Energy and Commerce Committee hearing, a government panel confirmed that this oil spill was the largest in U.S. history.

Anatomy of a Reputational Crisis

The Deepwater Horizon disaster was yet another mishap—"…an industry accident," as BP CEO Tony Hayward explained shortly before he stepped down.[2] Oil spills happen all around the world and, as Hayward implied, are an inevitable part of doing business. According to the Oil Spill Intelligence Report, spills in the size range of at least 10,000 gallons have occurred in the waters of 112 nations since 1960.[3] The Deepwater Horizon spill was a very large one, releasing 205.8 million gallons, but still ranks second to the deliberate release of about 240 million gallons of crude oil into the Persian Gulf during the 1991 Gulf War.[4]

Accidents involving oil tankers, pipelines, and offshore platforms have caused a number of very large oil spills. Platforms have several failsafe systems to reduce accidental spills. The weight of the drilling fluid/drilling mud acts as the first line of well control. If an influx of pressurized oil or gas breaks through the mud, well-control is maintained through the rig's emergency-closure devices (rams) that seal off the well and route the wellbore fluids to specialized pressure controlling equipment.[4] Both systems failed the Deepwater Horizon in April 2010.

Chapter 2 picks up the BP story and explains why the Deepwater Horizon spill was more than an accident. But to provide context for this and the many other case studies that follow, it is important first to introduce the variables that can transform a business operational event into a reputational event:

- The event affects a large number of stakeholders comprising many different interests.
- Reputation-impacting business processes are at the heart of the event.

- 24/7 news coverage and incessant exposure through social media promote awareness of the event.
- The company's antecedent PR campaign(s) is dissonant with the unfolding facts of the event.
- The company's inept crisis communications exacerbate the ill-will triggered by the event.

Because all these key variables were present, BP's accident was a modern reputational perfect storm. Deepwater Horizon is the poster child for a reputational event in which the market punishes a company.

Reputational Stakeholders

The stakeholders who impact directly the profit and loss statement are customers, employees, vendors and suppliers, and creditors. Investors set the earnings multiple. The special stakeholders, by virtue of their enterprise-wide as well as industry-wide influence, include corporate directors, analysts, and regulators.

Though the perspectives and values of stakeholders vary, each of them forms *expectations* of how a corporation will behave. In chapters devoted to each of the stakeholders, Parts 2 and 3 of this book show how expectations stakeholders hold about a company help shape a company's reputation and its stock price.

Reputation-Impacting Corporate Behaviors

Behaviors in six key areas of business performance underpin reputation: ethics, innovation, quality, safety, sustainability, and security (Table 1-1). Reputation is the summation of stakeholder *expectations* in these six areas of behavior.

Table 1-1. The Six Key Business Processes Underpinning Reputation[5]

Business Process	Definitions
Ethics	The moral principles by which a company operates; integrity is the act of adhering to those moral principles. Ethics are an integral part of governance that, along with integrity, affect the reputation value of all other intangible assets. Ethics are also the keystone intangible asset because they form the basis for trust and confidence.

Innovation	The design, invention, development, and/or implementation of new or altered products, services, processes, systems, organizational structures, or business models for the purpose of creating new value for customers and financial returns for the firm. Intellectual Property is part of this.
Quality	The extent to which a product is free from defects or deficiencies. The extent to which a service meets or exceeds the expectations of customers or clients, especially in comparison to peers. The extent to which products and services conform to measurable and verifiable criteria.
Safety	The state of being reasonably certain that a set of conditions will not accidentally cause adverse effects on the well-being of employees, the public, or the environment.
Sustainability	The making, using, offering for sale, or selling of products and services that meet the needs of the present without compromising the ability of future generations to meet their own needs.
Security	The degree of protection a company offers against events undertaken by actors intentionally, criminally, or maliciously for purposes that adversely affect the firm. Because fear is the great disruptor of life and commerce, it is useful to think of security, the most ethereal of the intangible assets, as "absence of fear."

The chapters that follow show how companies' cultures lead to choices in managing ethics, innovation, quality, safety, sustainability, and security that shape stakeholders' expectations. They show how companies' reputations affect stakeholders' economic behaviors and, in turn, how those behaviors create reputational value shaping companies' profit and loss statements and stock prices. The book builds the business case for reputation awareness by operating executives, reputational management by senior executives, and reputation oversight by the board of directors. We conclude that since measurements facilitate management, reputational value metrics can help companies do the right thing by their stakeholders.

Reputation, Marketing, and Crisis Communications

Reputation is an expectation of behavior shaped by direct personal experience and by information from diverse secondary sources.[6,7] The cacophony of secondary sources has increased in step with the growth in the democratic capabilities of the Internet: every individual armed with a keyboard, camera, and Web access or even just a smartphone can be an investigative journalist. While it remains true that communications professionals can help disseminate information and shape a story with authentic content, they have less impact on reputation creation than in the past.

Many businesses are still somewhat uncertain about whether to perceive reputation as the outcome of actual business practices or as an image created through company-generated communications. This book shows that it is both. It is a diversity of communications channels and third-party signals, reflecting authentic corporate behavior, that can help shape the expectations of stakeholders. It also shows that when image-making is not grounded in substance, it can produce highly counterproductive results.

Reputation and Risk Management

Executives are seeking reputation management advice, even if they're not sure where to look for it.[8] They intuit a link between reputation and intangible asset value and recognize that intangible assets comprise more than 65% of the value of the average traded firm. Many have heard that improving a firm's reputation can add on average 6% to its enterprise value,[9] and that the average major crisis will shave 7% of a firm's market capitalization. Growing awareness of the importance of reputation is also showing up in corporate annual reports. As of June 2012, 355 of the annual reports of the S&P 500 constituent companies were disclosing the significance of reputation risk, up from only 40 firms in 2009.

This book considers the subject of reputation from the perspective of a risk underwriter of reputational value. Most case studies conclude with action points, and each chapter provides an actionable summary. The content is geared toward improving readers' understanding of the links between corporate culture, behaviors, reputation, and value. The single most important management lesson is that managing reputation means managing the business processes underpinning reputation. Consider this:

Reputation is a consequence of corporate behavior that motivates stakeholders to behave in ways that either reward or punish the corporation.

Organization of the Book

Chapter 2 is an overture that fleshes out the BP reputation story and details the failure of reputation-linked business processes. It describes how the reputation of BP evolved within each stakeholder group, how that evolution changed each stakeholder's expectations of BP, and how those changes triggered economic consequences.