

AGENDA

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New Index Calculates Value of Corporate Reputation

By Tony Chappelle December 5, 2011

A good corporate reputation is such a factor in today's media-saturated global economy that a third of companies on the **Standard & Poor's** 500 Index now state in their annual reports and proxies that reputation has a material effect on their value. That's up from just 8% last year, according to **Jim Singer**, an attorney at law firm **Pepper Hamilton**.

So it's perhaps not surprising that one research firm has launched the world's first composite equity index designed to gauge the effect of corporate reputation on share prices.

The RepuStars Variety Corporate Reputation Index is the brainchild of **Nir Kossovsky**, CEO of **Steel City Re**, a Pittsburgh-based company that advises insurers on underwriting risks. If his methodology proves sound, boards and other corporate stakeholders could use the reputation index to help them uncover risks that they may otherwise overlook.

"The real story here is that we are able to measure and, consequently, monetize reputation," says Kossovsky. "Reputation can be managed like any other business process."

Reputation Risk a Factor to Tell the World About

One third, or 161, of S&P 500 companies disclosed that reputation is a material risk for them on the risk factors section of their 2011 10-K filings. That's a huge jump from around 40 companies during each of the previous five years.

The data were compiled by law firm **Pepper Hamilton**.

Beyond the S&P 500, as of May 1, 2011, 350 companies with sales between \$500 million and \$1 billion disclosed that reputation is a material risk. For companies with sales of \$1 billion to \$25 billion, 896 companies named reputation as a risk. For those with sales between \$25 billion and \$50 billion, 52 said reputation is a material risk. And 20 companies with sales of \$50 billion to \$100 billion did so.

In a nutshell, Kossovsky applied a proprietary algorithm to 6,000 companies with market capitalization of at least \$1.5 billion. His algorithm selects up to three companies from 19 sectors and identifies those that have a high reputation value but a low stock price. So the RepuStars index tracks up to 57 stocks that seem to be undervalued based on their reputation metrics.

In 10-year backtesting, the RepuStars index outperformed the S&P 500 by a factor of 25. It is now calculated by Dow Jones Indexes and distributed by Dow Jones, Bloomberg, Reuters, Google Finance and Yahoo Finance.

Kossovsky says several studies have shown that great reputations deliver concrete economic benefits for companies, which in turn should boost their stock prices. These benefits include customers who will pay a premium for products or services; employees who will work for less; lower employee turnover; better terms from vendors and creditors; and regulators that give companies the benefit of the doubt on compliance matters. Kossovsky says the six areas that underpin reputation are ethics, innovation, quality, safety, sustainability and security.

Reputation Arbitrage?

Theoretically, reputation is embedded in stock prices, which are determined by equity investors. But share prices can include noise due to market volatility. They can also be manipulated, as when a company absorbs outstanding shares in a buyback.

Kossovsky's algorithm, by contrast, includes input not just from equity investors but from other stakeholders including customers, creditors, regulators and insurers.

"Sometimes stakeholders don't agree with equity investors," Kossovsky says. "RepuStars is based on the premise that there are stocks with superior reputations set by all stakeholders but which equity investors haven't figured out yet."

Many veteran directors and market mavens greet the idea of unlocked reputation value with skepticism.

"I don't think reputation can be measured," says **John Bogle**, the founder and former chairman and CEO of **The Vanguard Group** mutual funds. Bogle is famous for his view that the market factors almost everything into a company's stock price, and is thus tough to beat. "The market is quite efficient," he says. "It takes reputation into account in a small way."

Herman Bulls, who serves on the boards of **Comfort Systems USA**, **USAA** and the new **ITT Exelis**, likes the idea of quantifying reputation. For one thing, he says, it might help boards prove to proxy advisory firms such as ISS that their corporate governance is actually effective. But Bulls isn't sure whether Kossovsky's algorithm can reliably separate out reputation from other influencers of corporate success.

"If this index is legitimate, accurate and transparent, it could be useful," he says. "But you have to understand whether there's a spurious relationship between whether a company performs well because of its reputation or [other] underlying [factors]." Bulls say

he's open to learning more about the methodology.

Higher-Profile Risk

There's no disputing that boards are thinking more about corporate reputation. A recent survey of 142 public company directors by accounting firm **Eisner Amper** found that boards' next worry after financial risk is reputation risk — surpassing even compliance risk in the post-Dodd-Frank era.

“Reputation is implied in every risk that we have as a company,” says **George Miles**, a director at **American International Group**, **Harley-Davidson**, **EQT** and two other public companies.

John Hoffecker, a managing director at restructuring consultancy **AlixPartners**, says that while companies build reputation over the long term through their operational decisions, events — internal and external alike — can change it in the short term.

“Strategy about operations, such as where you put factories and how you deal with suppliers, moves stock price and value,” Hoffecker says. “Reputation over time adds to that.”

But directors need to stay on top of strategic decisions that can affect reputation like lightning. Hoffecker cites **Netflix**'s recent about-face on pricing and strategy. The online video rental company is forecast to lose 4 million customers by the end of the year after it suggested splitting its video streaming and DVD snail-mail delivery businesses in two and hiking prices by 60% for certain customers.

A former market darling, Netflix has paid heavily for its gaffe. Its shares dropped from \$298 in mid-July to around \$67 at the end of December, and at least one analyst thinks they could fall to \$45 in 2012. TheStreet.com also put CEO **Reed Hastings** on its list of worst technology leaders of the year.

Another company that's grappling with reputation woes is **Research in Motion**. This year, the maker of Blackberry smart phones already had been losing market share to **Apple's** iPhone and **Google's** Android. Then in October, the company's network transmission froze and customers were unable to complete calls for three days. According to research firm **SmarTrend**, Research in Motion has lost 24% of its value over the past three months.

“With the Internet, and as fast as news moves now,” says Hoffeecker from AlixPartners, “one suggestion is for boards and managements to go through war gaming, so that if something happens the company knows ‘What would we do?’ and ‘Who would be involved?’ Role-play those ahead of time.

“Speed becomes important in these situations. I believe a board's role is to make sure that those plans [to manage reputation] are in place ahead of time and that management has looked at them.”