Schumpeter

Getting a handle on a scandal

Corporate crises drive the media and politicians wild. But do they damage shareholder value?

Brett Ryder

Print edition | Business Mar 28th 2018

A POPULAR riff doing the rounds in tech circles is that, if data are the new oil, then Facebook's Cambridge Analytica fiasco is the equivalent of Deepwater Horizon. That was the name of an oil platform that exploded in April 2010, coating the Gulf of Mexico and the reputation of BP, the firm responsible, in a toxic slick.

Yet just how damaging are "Deepwater" incidents for firms and their owners over time? Perhaps they cease to matter after the initial burst of media purgatory, grovelling by executives, celebratory cant from competitors and politicians' grandstanding.

Latest stories

Viktor Orban maintains firm control of the Hungarian Parliament

To answer this, Schumpeter has looked at eight of the most notable corporate crises since 2010, including those at Uber and

GRAPHIC DETAIL

Why is Mark Zuckerberg testifying in Congress?
THE ECONOMIST EXPLAINS

Homo sapiens spread to Asia earlier than once believed
SCIENCE AND TECHNOLOGY

See more

Wells Fargo. The evidence shows that these episodes were deeply injurious to the companies' financial health, with the median firm losing 30% of its value since its crisis, when compared with a basket of its peers. Facebook should beware.

When a scandal first breaks, executives at the top of a firm and securities analysts outside it are often myopic, viewing it as a public-relations blip that will not alter a firm's operations or its competitive position. In the case of Facebook, 44 of the 48 Wall Street analysts who cover it still rate it a "buy", according to Bloomberg. Many have downplayed the scandal, even though Facebook's shares have dropped by 18% since the news broke on March 17th.

Of course, speculators and the media do frequently overreact to bad news. Credit Suisse, a bank, analysed 5,400 instances of American firms' shares dropping by over 10% in one day, between 1990 and 2014. On average the shares regained two-thirds of the lost value within the subsequent 90 days. But big corporate scandals are in a different league. They capture the public imagination and lead to heat from politicians and regulators. Infrequent and idiosyncratic, they defy easy analysis.

Consider two infamies from the 1980s. In 1982 Johnson & Johnson had to withdraw 31m bottles of the painkiller Tylenol from shops after seven people were poisoned in Chicago. Seven years later, the *Exxon Valdez*, a ship run by Exxon, struck a reef in Alaska's Prince William Sound and spilled 11m gallons of oil. Yet both firms' share prices recovered within a few weeks, and today they remain among the world's most valuable companies.

Since the 2008-09 financial crisis, plenty has changed. Social media mean that news of scandals spreads faster than ever and often in an exaggerated fashion. But consolidation has muted competition in many industries and made firms bigger and more resilient. Western governments may be willing to protect or bail out big firms, not just banks, because they worry about job losses.

The eight firms in the sample have all been seared by scandal. All were large before their calamity, with a market value of at least $15bn. Their problems were different, but all led to a media scrum and prompted politicians and regulators to intervene. In all but one case, the firm's boss left as a result. The figures measure returns in dollars, including dividends (for Uber, reports of private market valuations are used).

As well as BP, the infamous eight include another energy firm, Petrobras, a Brazilian giant at the centre of the "car-wash" corruption scandal that erupted in 2014. Two firms beginning with "V" are included for their antics in 2015: Volkswagen, which admitted fiddling emissions tests, and Valeant, a drugs firm accused of price gouging and publishing inaccurate accounts. Wells Fargo is included for a mis-selling scandal that blew up in 2016, as is Uber, where the wheels came off in 2017. The last two firms are Equifax, a credit bureau which last year said hackers had gained access to data on 143m clients, and United Airlines, which set new lows for airline conduct when it asked security staff to remove a passenger from an overbooked flight, who was injured in the process.

After their crises struck all these firms suffered an absolute drop in their share prices. At the lowest point the median share price was down by 33%, although it took anywhere from two weeks to two years for different firms to reach this nadir. In most cases the companies have clawed back the absolute losses they suffered. However, what matters is their relative performance compared with a basket of industry peers over the same time period. On this basis the median firm is worth 30% less today than it would have been had the scandals not happened. For the eight the total forfeited value is a chunky $300bn.

Fines and legal costs explain only a small part of this. A big scandal distracts management, leads to other kinds of painful regulatory scrutiny and, if a firm has a stretched balance-sheet, forces it to shrink. BP has spent years trimming its budgets while its longtime rival, Shell, stole a march on it by buying BG, a gas firm. Wells Fargo faces a cap on its size imposed by the Federal Reserve. Equifax may become more heavily regulated. Uber has lost market share to a reinvigorated domestic competitor, Lyft.

Two firms out of the eight come out relatively well. For Petrobras, the explanation is that its share price had already sunk before the car-wash affair began in earnest, reflecting cost overruns that were an augury of the epic mismanagement that the scandal revealed. Volkswagen is the only standout. It got hit by a huge $30bn bill for fines, product recalls and legal costs for "dieselgate", but reacted to its crisis by putting in place an efficiency drive and a big bet on new car models. Even so, it and the other six listed firms in the sample are valued on low multiples of profits compared with their peers, suggesting that investors remain nervous.

Messing up, then fessing up

The aftermath of a scandal is unpredictable. In Facebook's case the absence of established laws and regulations covering social media make it even harder than normal to predict how harsh the backlash will be. Its biggest advantage is its strong balance-sheet, which has $42bn of net cash. Its weakness is a management team that seems keen to downplay the severity of what has just happened. Recent experience suggests that is a mistake.