Freshfields Bruckhaus Deringer

Knowing the risks, protecting your business

Crisis Management

A global study

Crises often spook the markets and fragment company boardrooms. But which type of crisis causes most damage?

To help you better understand the impact of major crises, we carried out a global study. We analysed 78 crises, with reputational implications, that took place from August 2007. They are divided, roughly equally, into four categories according to the type of event that prompted the crisis.

1. Behavioural — crises triggered by reports of the illegal or questionable conduct of the company in general or by specific employees. These may include claims of bribery and corruption, money laundering or tax fraud, senior employee misconduct or human rights violations.

2. Operational — crises that seriously impair the company's ability to function properly. These may include significant product recalls, environmental incidents, accidents and disasters or terrorism.

3. Corporate — crises that affect the corporate and financial wellbeing of the organisation including hostile bids, changes of law, material litigation, tax or accounting issues, breach of financing covenants or liquidity crises.

4. Informational — crises that seriously affect a company's IT infrastructure or electronic data systems including system failures, hacking or loss of customer data.

Forewarned is forearmed

Whatever type of crisis you face, knowing how it will affect your business will ensure you respond logically and rationally. Here are six findings from our research to help you keep your head when all about you is unsettled.

1. Use the breathing space
Use the first 48 hours wisely. No matter what sort of crisis you face, this is generally the time when share price movements are relatively modest. This is when to put the crisis management protocols you've already rehearsed into play to prevent or dampen any larger market reaction.

2. Bad behaviour delivers deepest cut
A crisis that stems from poor employee behaviour will have the biggest immediate impact on share price; it can tumble 50 per cent or more on day one. These crises tend to raise more questions about governance and therefore have the most impact on corporate reputation.

3. Data dramas least damaging
A crisis that's caused by IT mismanagement or system infiltration does the least short-term damage, with share prices falling about 10 per cent on day one.

4. Preventable or not?
How much influence do you have over the crisis? An incident beyond your control, like hacking, will have a short and sharp impact on share price. But it tends to recover quickly. The effects from incidents that you could or should have prevented will reverberate in the markets more harshly and much later.

5. Keep your finger on the business pulse
Difficult though it might be, don't get sidetracked by the unfolding crisis. Keep a close and continual eye on your core business to make sure it performs as well as it can in the circumstances.

6. Delays can cost jobs
Board directors at companies whose share price fails to return to pre-crisis levels within six months are 11 per cent more likely to lose or leave their jobs than those at companies whose price recovers. Be aware that delay in restoring the company's fortune might carry a personal cost.

4 types of crisis

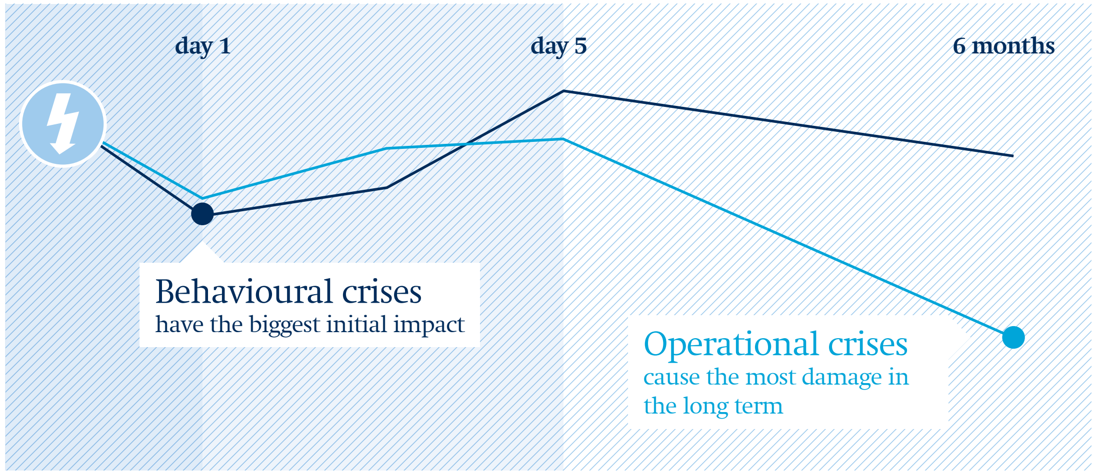
A company's fate largely depends on the type of crisis it has to tackle. Operational or behavioural crises anger the markets most and deliver the biggest hits on share price.

Operational crises
Events such as major product recalls are the most likely to spook the market over time and lead to a share price fall on day one (37 per cent of companies affected).

Though these operational crises make up the majority of price-fallers up to the four-week mark, behavioural crises then overtake them. Note too that here the extent of the impact on share price is contained. At the end of the first day after the crisis becomes public, no company experiencing an operational crisis saw its share price fall by 30 per cent or more. However, despite only causing modest share price movement in the first 48 hours, the negative impact lasts longest — down almost 15 per cent after six months.

Behavioural crises
Behavioural events, such as the bribery and corruption problems at Willis Group and Aon, trigger the biggest day-one falls in a company's value. Although they make up just a quarter of all day-one share price falls, this is the only type of crisis to lead to an instant drop of 50 per cent or more.

Behavioural and operational crises' impact on share price



The flipside, however, is that despite having the greatest short-term impact on share price, behavioural crises are the quickest to recover. Companies regain, on average, their pre-crisis share price value after six months (down just 2 per cent).

Informational crises
Data crises, such as Zurich UK's loss of back-up data in South Africa and the data hacking of 94 million TJX customers, don't fluster the markets too much. None of the companies suffered a loss in share price of more than 3 per cent on day one, while the impact was relatively conservative in the longer term too. No company affected by an informational crisis saw its shares fall by more than 30 per cent after one year.

Corporate crises
Corporate crises are resolved the fastest. Although they made up more than a quarter of companies that experienced a drop on day one, after six months only one in seven was still affected. None was down by 20 per cent or more.

Statistical highlights

Operational crises are most likely to lead to a fall in share price on day one (37 per cent) but never by more than 30 per cent.

On average, firms hit by an operational crisis see their share prices fall by 15 per cent after six months.

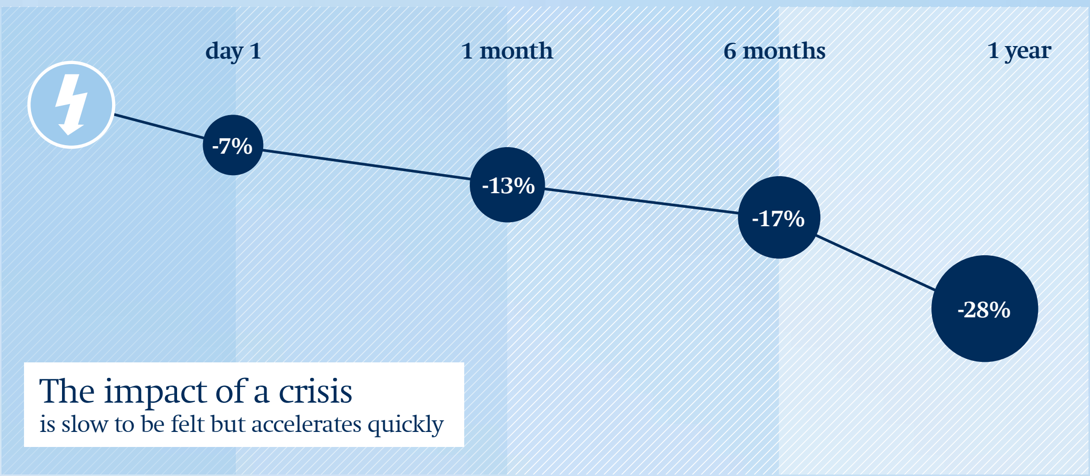
Behavioural crises are the only type of crisis to see share-price falls of 50 per cent or more on day one.

Only 10 per cent of firms hit by informational crises see shares fall on day one.

No predicting how markets will react

There are no rules for how financial markets will respond to a crisis. Hits on share price will vary in scale and duration. Many companies will fail to return to pre-crisis levels within six months.

Accelerating impact of crises on share price



Not all companies experience a falling share price when a major incident first becomes public. For those that do, the impact can vary.

After the first full day's trading following a crisis, fewer than half the companies we analysed saw a fall in their share price. This rises to just over half after two days and, a month on, there is commonly a peak in negative feeling, with six out of 10 companies affected. One year after the crisis, share prices do not regain pre-crisis levels at more than half the affected companies.

Statistical highlights

46 per cent of companies hit by a crisis see shares fall on day one.

At the end of day two, more than half (54 per cent) suffer a share-price drop.

The peak is at the four-week point, when 60 per cent of companies experience a drop in share price.

The number of firms that experience falls in their share price of 30 per cent or more rises from 3 per cent on day one to 21 per cent after one year.

The extent of share price falls

The impact of a crisis is felt slowly in the market but accelerates quickly. At the end of the day on which the crisis first becomes public, share prices hardly move. They fall, on average, just 1 per cent. However, this accelerates to an average fall of 6 per cent after six months.

A snapshot view after five days' trading shows that a third of the 38 companies whose stock values fell experienced a corporate crisis; a further third suffered a behavioural crisis. We analyse the impact of different types of crisis in greater detail on page 5.

Insight

Advance preparation

Though crises are unpredictable, companies that prepare for the unexpected and have a properly thought-through disaster management policy are better equipped to lessen the adverse effects. They will be better able to fulfil their legal obligations, such as document control, market disclosures and maintenance of legal privilege, while the crisis is in full flow.

Planning will not address every conceivable risk but it will provide the headline actions to simplify the response in an emergency. A tested and established strategy sets out logical steps to address the unfolding crisis. It enables companies to better handle communications and legal obligations, to marshal resources and to alleviate the immediate and ongoing financial and reputational impact.

Breaking the news

Don't expect to break your own story – the news channels and social media may get there first. But manage the process as best you can to keep messages consistent and accurate.

Crises are, by their nature, unexpected. But what matters is the way they become public. We found that only a small number of companies remain in sole charge of the way in which the news breaks.

Announcements of more than 80 per cent of crises were wholly or partly out of the hands of the company concerned. Affected companies announced only 14 crises, either in a statement or through a blog. The media revealed just over half, while the media and the company itself announced a third almost simultaneously, including one case exposed by Wikileaks.

The London 2012 Games were prepared for almost every conceivable disaster. For most companies, budget and resource limitations make a response on this scale prohibitive. But this doesn't mean it's impossible to prepare. You can rehearse simulated crises and, if disaster strikes, implement a step-by-step plan. This walks you through what you need to do and when you need to do it to get your crisis response off the ground.

Case study

Robust governance delivers Olympic performance

The London 2012 Olympic and Paralympic Games — possibly the UK's biggest-ever exercise in risk management — played out under extreme public scrutiny in summer 2012. Freshfields' employees helped to support the legal team of the London Organising Committee of the Olympic Games (LOCOG) to not only mitigate risk but to prevent problems from ever happening.

With just one opportunity to get everything right, nothing was left to chance. London drew on the combined resources of the public and private sector to handle planning, development and construction. It was here that Freshfields helped to identify the entities involved in delivering the Games, including local planning authorities, police, security, emergency services and transport, and to develop a structure that would enable the city to move forward and keep to timetable. We helped devise draft legislation to bring together multiple functions under a single government body — the Olympic Delivery Authority — simplifying the decision-making process and execution.

This rigorous governance framework held together the entire organisation of the Games. The Audit Committee, intrinsically involved from 2007, provided rigorous oversight of risk assessment on a monthly basis.

This tough stance was backed up by internal audit. For every event, rigorous scenario planning and risk assessments ensured that everything would be ready in time for the opening ceremony on 27 July 2012.

The LOCOG legal team was part of this mammoth risk management exercise, challenging and asking 'what if …' to encourage thinking and preventative action around real, potential and even barely conceivable risks. The teams also worked to ensure that private sector contracts were watertight and uniquely tailored to cover multiple contingencies and to nail down actions and responsibilities in the event of crisis.

This massive risk-management exercise, with an iron fist over planning, ensured that the London Games were one of the most talked-about UK success stories of 2012.

Effective communication

In a crisis, everyone wants to know what's happening. Some things must be communicated immediately — because of legal requirements to disclose to the markets or regulators, for example. For other matters, we would urge brevity and caution to reduce the risk of litigation or overstepping regulatory boundaries.

It's crucial to consider:

- who will be the public face of your crisis;
- who will communicate with investors, analysts, regulators, employees, suppliers, tax authorities or business partners;
- who will identify the priority public audiences; and
- the consistency of your messages.

Crises that are hardest to forgive

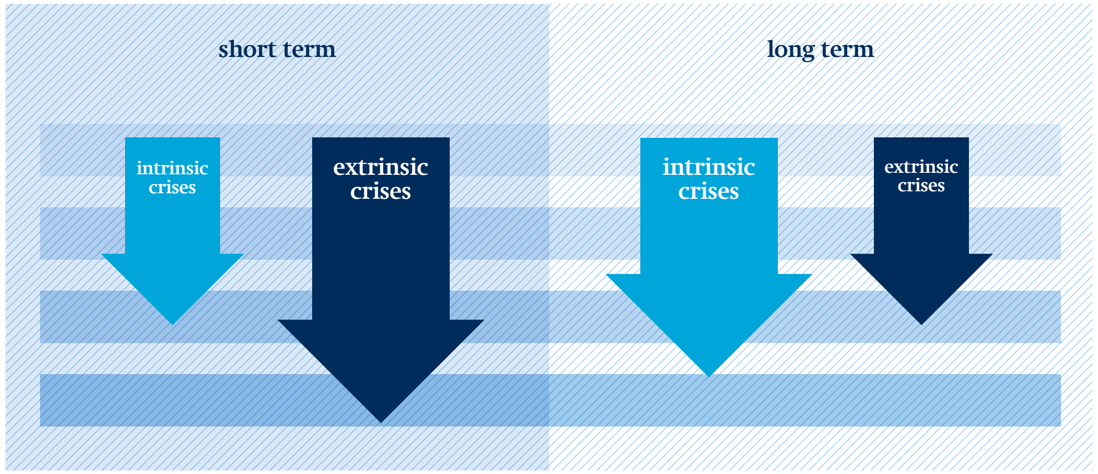
Some crises are inconceivable but have the greatest upfront impact on share price. Other crises, more likely because of the nature of the business, tend to deliver deepening fallout over time.

Crises can be thought of as:

- intrinsic — where the problem appears to result from an issue within the company's control, such as the network outage that affected over four million RIM BlackBerry users; or
- extrinsic — an event that originates outside the business and could not be predicted, such as the expropriation of Repsol's YPF assets from Argentina.

The nature of the crisis tends to dictate how long it lasts and how severely it affects the share price. In the few weeks following an announcement there is no significant difference in the likelihood of either type of crisis delivering a severe blow to the share price.

The behaviour of extrinsic and intrinsic crises



Over the longer term, the market is more lenient on companies that have been struck by an extrinsic crisis. They inflict a cut in share price of over 50 per cent on the first day and are more likely to harm the share price in the first week. But after a year only a quarter of firms that experience an extrinsic crisis continue to suffer a drop in share price of 70 per cent.

Intrinsic crises account for two-thirds of firms that experience a fall in share price of 30 per cent or more after 13 weeks. After six months this rises to more than three-quarters (78 per cent), with share prices still down 70 per cent one year after the event became public.

The upshot is that unpredictable crises have the greatest upfront shock value, while problems that go to the heart of the company's operations deliver a longer-term negative impact.

Statistical highlights

All crises with a fall of 70 per cent or more in share price on day one are extrinsic.

After six months, intrinsic crises make up 78 per cent of those experiencing a drop in share price of 30 per cent or more.

After one year, intrinsic crises make up three-quarters of falls in share price of 70 per cent or more.

Impact in the boardroom

Unsurprisingly, the longer the share price is down the more likely it is that directors will quit. However, a well-managed crisis can increase shareholder value. Companies that recover quickly are less likely to shed directors than businesses that haven't been affected by a crisis.

A crisis can often lead to senior executive resignations. In our sample, 87 of the 899 board directors in companies whose share price was hit left within six months of the crisis breaking. This is a departure rate of almost 10 per cent.

Just 39 directors stated publicly that the crisis was the reason for their departure. It seems reasonable to assume, therefore, that some of the other 48 left as part of a general board restructuring in the wake of the crisis.

Investigating further, we found that 15 per cent of directors (68) at companies that suffer a fall in share price of six months or more leave the business.

On the other hand, the attrition rate in companies whose share price recovered to pre-crisis levels within six months was substantially lower. Of the 447 directors serving their boards, only 4 per cent left the company.

It's not surprising to find a difference of 11 per cent between the number of directors who lose their jobs at firms that suffer a long-term share price fall and firms whose prices bounce back more quickly. What is surprising, however, is that directors at firms that recover are half as likely to lose their jobs as their counterparts at firms on the same exchange that have not been affected by a major incident. Here, 8 per cent of directors left their roles.

In terms of type of crisis, the majority of resignations (40 per cent) came from companies hit by behavioural crises, followed by 34 per cent at companies experiencing corporate crises, while 22 per cent of our sample quit companies hit by operational problems.

No directors at firms hit by an informational or operational crisis, and whose share price returned to pre-crisis levels within six months, lost their jobs.

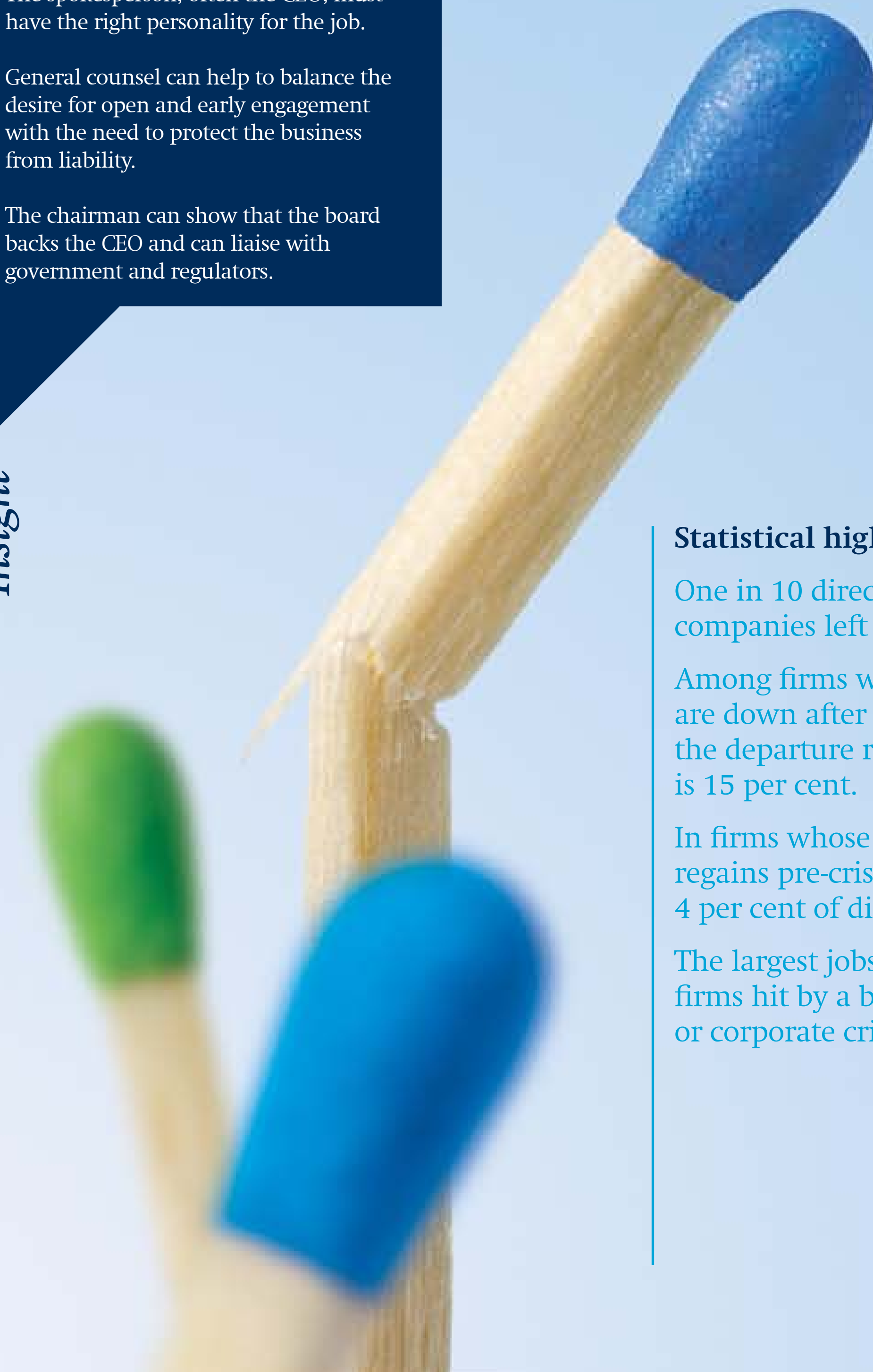
Public face of a crisis

The way senior board directors respond to financial markets and the media can have a direct bearing on their own tenure at the company in the aftermath of the crisis. The spokesperson, often the CEO, must have the right personality for the job.

General counsel can help to balance the desire for open and early engagement with the need to protect the business from liability.

The chairman can show that the board backs the CEO and can liaise with government and regulators.

Insight



Statistical highlights

One in 10 directors at crisis-hit companies left after one year.

Among firms whose shares are down after six months, the departure rate of directors is 15 per cent.

In firms whose share price regains pre-crisis levels, only 4 per cent of directors quit.

The largest jobs toll is at firms hit by a behavioural or corporate crisis.

Research methodology

This research, conducted in August and September 2012, is compiled from our analysis of 78 crises that took place since August 2007 at large, internationally listed businesses.

By analysing share price movements in the early stages of the crises, we sought to determine how financial markets react.

We assessed:

- average closing stock price six months and five days before the crisis;
- average price and opening and closing price one day before and on the day of the crisis;
- average price and opening and closing price one day, two days and five days after the crisis; and
- average price and opening and closing price one month, six months and one year after the crisis.

We weighted each share price against the average performance of companies on the same exchange and in the same sector. Using stock market announcements, we assessed the composition of corporate boards at the time the crises broke and one year later. We tagged the cause of each crisis as either intrinsic or extrinsic to the company's operations.

When companies are listed on more than one exchange, we used share price movements on the primary exchange. We sourced share price data from Bloomberg. We consulted companies' own websites, annual reports and press archives for information on changes in senior management.

Contact us

In a crisis you need advice you can depend on. Find out how we can support your crisis management strategy. Speak to your local Freshfields contact or get in touch with a member of our team.

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