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A Private Equity Roadmap for Assessing Reputational Risk

"Aspirational marketing is not reputation risk management."

Reputation risk is the peril of economic damage from angry disappointed stakeholders often triggered by a company's ethical, safety, security, sustainability, quality, or innovation failures.

Private Equity Challenge

Reputational risk carries tangible consequences evidenced throughout a company's profit and loss statements, and ultimately, valuation. Private equity investors need new tools for:

- measuring that risk in companies they consider for investment,
- mitigating it in companies already in their portfolio, and
- translating their management of reputational risk into a higher valuation multiple.

Uber's disclosures of its reputational issues in its own S1 filing, its warning that "failure to rehabilitate [Uber's] brand and reputation will cause [the] business to suffer," and the performance of its stock since its IPO were all warning signals heard far and wide by private equity investors.

These types of risk present themselves across a broad spectrum of companies, particularly the kinds of fast-growing, relatively young companies private equity firms often target, and highlight the need to add reputational risk to investment evaluation criteria as well as to governance and oversight practices for board members.

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Steel City Re has pioneered synthetic quantitative measures of reputational value that inform our advisory work and price reputation insurances. These measures are also used by Wall Street for equities arbitrage strategies, Lloyd's and other insurers for parametric risk transfer; and risk managers for better insurance captive compliance. Through our advisory arm, we help deploy state-of-the-art reputation risk governance and enterprise risk management solutions. Our risk financing and risk transfer arm provides pricing and underwriting support for insurance captives and risk transfer through insurances.

Mapping the Route

Reputation – and perceptions about reputational resilience – affect value. Investors must take care to ensure that the fund managers sitting on the boards of their portfolio companies have the skills and experience to provide appropriate reputation risk governance. Evidence of appropriate ongoing processes to protect reputation should be demanded.

Aspirational marketing-related statements, including CSR and ESG campaigns, while often noble and

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appealing to certain audiences, are inherently perilous when trying to mitigate reputational risks based on operational deficiencies. The more future investors expect in terms of ethics, innovation, safety, security, sustainability, and quality, the greater the risk and cost of failure from reputation tornados like gender pay, gun ownership, the #metoo and #timeisup issues.

If companies are going to aspire to lofty goals such as BP's infamous claim to be "beyond petroleum," which seems to be the direction many large public companies are taking – as evidenced by the Business Roundtable's statements about "improving our society" and "serving all Americans" – then the risk of failure to meet those aspirations needs to be managed, and the potential reputational consequences need to be anticipated.

"Balancing the shareholder's expectations … against other priorities is one of the fundamental problems confronting corporate management," noted the Business Roundtable in 1981 foreshadowing its recent declaration. Therefore, reputation risk management is one of the fundamental tasks of corporate management.

Understanding the Nature of the Risk

Reputation is based on expectations. Reputational risk is the gap between stakeholder expectations and actual performance. When boards disclose reputation as a material risk without truly understanding it or appropriately mitigating it, they are putting themselves and their companies in greater peril. Reputation risk is not merely the risk of negative media coverage, to be managed by marketing people. It is an enterprise risk management issue and should be addressed accordingly. Media coverage is simply a byproduct – an amplification of the disappointment, disaffection and anger felt by stakeholders when their expectations are not met.

Companies that are managing reputational risk well have placed it into the portfolios of risk managers, who understand how to work across silos and bring together myriad company resources to address operational issues that pose risks. And they understand the power of third-party warranties on governance, in the form of analysis, underwriting and insurance, to mitigate stakeholder disappointment through their proven ability to diffuse anger with an authentic story that is simple to understand, credible, and completely convincing.

Ongoing Assessment

The assessment of risks and the understanding of stakeholder priorities and sensitivities must be an ongoing process – something that is often overlooked in the fast-moving culture of

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early stage, growth-oriented companies. A mild breeze can quickly become a reputational tornado – one day, offering National Rifle Association affinity cards is good business, the next it's not; one day, leadership can overlook a "boys will be boys" culture, the next it cannot.

Board members need to institute processes that facilitate looking around corners and being alert to the subtle signs of lurking reputational crises. And when a potential crisis does hit, Boards need protocols already in place to coordinate a response. Failure to do so can lead to a reputational disaster, a spiraling loss of trust and confidence with serious implications for the overall business. One need look no further than Uber's S-1 to appreciate this viscerally.

Continual Self-Assessment

Expectations are the essence of reputation and its value. They are shaped by experiences and promises. Companies and their leaders need to have governance practices in place that shine light on issues and welcome honest and if necessary, critical, self-assessment. Often, it is beneficial to engage objective, outside experts, either on a consulting basis or as part of a reputation risk underwriting process, to help the board and leadership determine whether they are truly on top of changing expectations.

Guideposts for Forging Reputation Resilience

- **Foundational.** Who are our stakeholders and what do they expect?
- *Has our firm's enterprise risk management apparatus developed a schedule of operational risks and stakeholders, and modeled the expected flow and costs of stakeholder disappointment and anger if any of those risks are realized?*

- **Actionable.** How are we mitigating the peril of economic harm from angry disappointed stakeholders?
- *Is our firm's enterprise risk management apparatus holding all departments accountable for expectation management and process control solutions? Is our treasury operation prepared to fund reputation losses with insurance captives or risk transfer solutions? Do we have a crisis management plan that will communicate a simple, easy to understand, and completely credible narrative to all of our stakeholders?*

- **Self-Protection.** As constituent members of a company's C-suite or Board, how are we mitigating the peril of personal reputation risk jointly and severally?
- *Do we know who are our stakeholders and what they expect of us? Is our understanding of reputation risk at the level expected by our stakeholders? Have we communicated our authentic and sincere efforts to mitigate risk? Have we demonstrated the effectiveness of our efforts? Are we utilizing expressive strategies such as warranties and insurances to substantiate our communication efforts?*

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