Volkswagen Emission Test Scandal – *Investor Relations Case Study*

In what is the latest scandal to shock the markets, on September 18 a story broke that would change the way investors looked at The Volkswagen Group (XETRA: VOW3) forever. The largest carmaker in Europe had been deceiving investors, customers and more importantly, regulators regarding the toxic emission levels of their vehicles.

On **September 18**, the carmaker admitted to systematically manipulating U.S. emissions tests on over 11 million cars and engaging in unfair competition practices under state and federal law. As more information became available, the market reacted, selling off the company's shares in the international markets and causing the stock price to fall 43.2% from US$ 167.8 on September 17 to US$ 95.2 on September 29, thereby incinerating off one-third of the company's valuation.

The stock's collapse was fast and unstoppable; each decrease seemed to be correlated to the scandal's latest news.

- ***On the day the news broke*** - The stock price falls to US$ 162.4, from US$167.80 (a 3.2% decline) closing price the prior trading day.

- ***September 22*** - Stock price falls further to US$ 106.0; or 19.8% as a result of VW's silence regarding the scandal.

- ***September 23*** – Martin Winterkorn, under criminal investigation due to the scandal, resigned as VW's Chief Executive Officer. 2 days later, Matthias Mueller, former Porsche CEO, was named VW's new CEO. Winterkorn's departure and Muller's appointment aid VW's stock to reach US$ 111.5 (+5.18%) by the end of the day.

Source: Yahoo Finance

- ***September 28*** – VW launches the new electric and emission-free Passat GTE and Passat Alltrack; despite efforts to turn attention towards the positive news, the stock price falls dangerously below US$ 100.0 (-7.5%).

- ***September 29*** – Announcement issued that the stock will be pulled from the Dow Jones Sustainability Index on October 5, 2015. Also, Tesla Motors, one of Volkswagen's biggest competitors in the U.S., launches its Model X all-electric SUV, raising the competitive bar in the electric car market.

Why did VW do this?

Back in 2011, Martin Winterkorn, VW's former Chief Executive Officer announced the company's goal of tripling U.S. sales by 2020. One way VW aimed to reach this goal was by **betting on diesel-powered cars versus the hybrid-electrics** on which the Japanese car makers were focusing. This ambition was the catalyst for VW's unethical practices. The group ultimately struggled to extract higher profits and the stock dropped 13% in the first half of 2015. VW ironically marketed the brand as "Clean Diesel" in a last ditch effort.

However, the Environmental Protection Agency (EPA), by way of the California Environmental Protection Agency in the U.S., noticed several discrepancies in the testing results for VW vehicles during lab testing. It seemed that although the Volkswagen cars were able to fulfill Clean Air Act standards when they were tested in the lab, this was only due to a "tripping mechanism" that VW had intentionally installed in their vehicles in order to manipulate the results. In reality, nitrogen oxide emissions on the roads were at much higher levels than permitted by the authorities.

What does this mean for VW's?

In a nutshell Volkswagen faces:

1. Billions of dollars in costs from 50 **private class action suits** in the U.S. and Germany, and **government fines** related to the US$ 51 million in tax incentives for VW's diesel vehicles granted based on the falsified emission results.

2. **Product recalls and buy-back expenses** on vehicles in the US involved in the fraudulent tests that are expected to exceed US$ 9 billion[1].

3. Grave danger of having **future sales losses** of at least 2% on an annual basis[2] (sales revenue 2014 = approx. US$ 244.9 billion).

4. **Criminal investigation** involving Martin Winterkorn and VW's engineers.

5. Erosion of **brand integrity**.

In terms of its ***Investor Relations,*** the company also faces a significant number of challenges:

- A potential irreparable loss of credibility with the international markets.
- Devastation of market value.
- Material changes in management and internal restructurings.
- Additional hindrance to its overall market competitiveness.
- Flawed corporate governance thanks to VW's unusual hybrid of family control, government ownership and labor influence, making it difficult to determine where the responsibility falls.
- Multiple sell-side downgrades[3]:

Current Analyst Coverage - as of September 30, 2015

Firm	Recommendation	Firm	Recommendation
Landesbank Baden-Wuerttemberg	hold	J.P. Morgan	neutral
Evercore ISI	buy	Bankhaus Metzler	***sell***
Kepler Cheuvreux	hold	Credit Suisse	***underperform***
Goldman Sachs	***Sell/Neutral***	UBS	buy
Bernstein	outperform	Berenberg	***Under Review***
Independent Research GmbH	hold	Exane BNP Paribas	neutral
Bankhaus Lampe	***sell***	Societe Generale	hold
Oddo & Cie	***reduce***	Commerzbank	***Under Review***
Natixis	neutral	Erste Group	***sell***
Equinet Institutional Services(ESN)	accumulate	DZ Bank AG	hold
HSBC	hold	Barclays	equalweight
Morningstar, Inc	buy	M.M. Warburg Investment Research	buy
Redburn (Europe) Limited	buy	Day by Day	***sell***
Morgan Stanley	Equalwt/In-Line	MainFirst Bank AG	outperform
Nord/LB	buy	Banco Sabadell	buy
Baader-Helvea	buy	EVA Dimensions	hold
Hamburger Sparkasse	neutral	Dr. Kalliwoda Equity Research	buy
AlphaValue	***sell***		

[1] (Source: Societe Generale note for Volkswagen AG, Sept. 28, 2015).
[2] (Source: Trefis note for Volkswagen AG, Sept. 24,2015).
[3] (Source: Bloomberg).

Areas for VW to Work on

1. **Damage control** –VW is already seeking ways to control the damage to its tarnished image. Other companies in these situations have reacted with:

    - Press conferences
    - Corporate restructuring, starting with top management
    - Full cooperation with the regulatory authorities to rectify the issues
    - Immediate internal investigations by the company itself
    - Restating the corporate message to investors and revamping branding for consumers
    - Public apologies
    - Meeting with investors and analysts

2. **Define costs** – Volkswagen must immediately inform shareholders about potential costs derived from the crisis. Considering government fines and settlements, recall expenses, private settlements and loss of future sales, the entire costs are estimated to be at least US$ 34.5 billion; yet, the group has set provisions of only US$ 7.2 billion in 3Q15[4] to cover current costs related to the scandal.

3. ***Full transparency*** from the company; now is the time to face angry investors and make amends! ***Focus on strengthening and promoting*** VW's core values – emphasize "*Professionalism*", "*Integrity*" and "*Trust*". Stakeholders must be able to perceive VW's commitment to making things right.

4. **Rectify** – Volkswagen must share with the market the rectification measures planned in order to regain their trust; for example:

    - Bring the vehicles into compliance with the federal and state emissions regulations.
    - Assure customers and owners that their vehicles are safe and legal to drive.
    - Immediately repair the tampered automobiles.
    - Prevention: re-vamp Research and Development to ensure this never happens again.
    - Work with governments and authorities to determine who is responsible.
    - Increase efforts in the area of Sustainability aimed at correcting environmental damage, i.e. clean air organizations, clean-ups, sponsoring of community service groups, etc.

Conclusion

Some events are predictable surprises; and a good IR team can start setting up a crisis plan before an event like this happens. Nonetheless, during a crisis communication event, the IR team must act fast! DO NOT run away from the story. The most successful cases of damage control involve acting quickly and effectively. While VW is already involved in damage control, it hesitated to own up to its deception when the story broke. The market will remember that.

Only time will reveal if the company will be successful in undoing the reputational damage caused by the scandal. The financial community and the global consumer are not typically quick to forgive or forget.

[4] (Source: Trefis note for Volkswagen AG, Sept. 24, 2015).