CEO TALENT

A DIME A DOZEN, OR WORTH ITS WEIGHT IN GOLD?

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SEPTEMBER 27, 2017

INTRODUCTION

In recent years, there has been considerable criticism of the amount of money that CEOs earn to run the largest U.S. companies. One prominent observer calls CEO pay "out of control."[1] Another claims that the rise of CEO pay is "unstoppable."[2] According to a third, executive compensation is a "first-order" problem that "the self-correcting mechanisms of the market cannot be relied on" to fix.[3] Implicit in these criticisms is the idea that CEOs are overpaid relative to what they are worth to companies and their shareholders (see Exhibit 1).

Governance researchers have expended considerable resources examining executive compensation in an effort to determine whether pay levels are set fairly. They have studied the relations between CEO pay and performance, company size, average worker pay, the pay levels of senior executives just below the CEO, and the pay levels of other highly compensated professionals (such as hedge fund managers, private equity managers, lawyers, athletes, etc.) to determine whether CEO compensation is rewarded through an efficient process or is indicative of governance failure. The results of these studies are generally mixed.[4]

An important and related question, however, is rarely asked: Just how scarce is CEO talent? How many people are very well qualified to run a large, publicly traded company? Stated differently, what is the size of the qualified labor pool for talent in a given industry, and how difficult is it to identify, attract, and recruit those qualified to serve as CEO? These questions have important implications not only for CEO pay levels, but also for the efficiency of the CEO labor market, performance evaluation, succession planning, and internal talent development and retention.

CEO TALENT POOL

The perspectives of corporate directors are critical for understanding the depth and quality of the CEO labor market. As corporate overseers, directors are highly knowledgeable about the number, quality, and performance of top talent in their industry—both internal to their company and across their peer set. Through regular succession planning discussions, they should have identified specific individuals or candidate pools to turn to in an emergency or scheduled transition. They are also directly responsible for evaluating talent, making CEO hiring and firing decisions, and closely monitoring performance.

For these reasons, Stanford Graduate School of Business and the Rock Center for Corporate Governance at Stanford University conducted a survey of directors currently serving on the boards of the largest 250 U.S. companies by revenue (Fortune 250) to better understand their perspective of the size and quality of the labor market for CEO talent.[5]

The survey finds that directors overwhelmingly believe that the CEO job is very difficult and that only a small handful of executives are qualified to run companies in their industry. Almost all directors (98 percent) describe the CEO job at their company as extremely or very challenging. Practically none (2 percent) believe it is moderately, slightly, or not at all challenging (see Exhibit 2).

When asked to estimate how many executives are capable of stepping into the CEO role at their company and performing at least as well as their current CEO, directors estimate that fewer than 4 executives have the requisite skills. Their assessment of a small labor market is not confined to their own company and extends to other companies in their industry. When asked how many executives could step into the CEO role of their biggest competitor and perform at least as well as that company's CEO, directors estimate that only 6 executives would be qualified. They also believe that only 9 executives would have the skills needed to turn around a company struggling in their industry.

One respondent explains: "The CEO role is difficult and increasingly complex. Finding truly qualified talent in recent years has gotten more difficult." According to another, CEO talent is "difficult to vet and costly if you make a mistake. … The risk of selecting the 'wrong' candidate is greater than any time in the past." A third emphasizes the difficulty that newly promoted executives have in getting up to speed as CEO: "There is no such thing as 'stepping' into a CEO role." Cultural fit is also seen as a limiting factor: "I am less concerned about talent being available than I am about the cultural fit of outside talent."

Fortune 250 directors strongly agree that CEOs in their industry have "specific skills that are extremely hard to replicate," rating this statement a 7.5 on a scale of 1 to 10 (with 10 indicating that it completely reflects their point of view and 1 indicating that it does not at all reflect their point of view). They also believe that both general management expertise and industry expertise are "critical for being a successful CEO," assigning these scores of 9 and 8, respectively. Furthermore, they believe having top talent is critical for their company's overall success, agreeing that "it is impossible to be the top company in our industry without having the top CEO in our industry" (7 on a scale of 1 to 10).[6]

At the same time, many admit that it is not easy to evaluate CEO talent. On average, directors believe that "it is difficult to evaluate prospective CEO talent during a search process because a candidate might meet all the criteria in terms of previous work experience but it is still hard to tell whether he or she would be a successful CEO" (7 on a scale of 1 to 10 – see Exhibit 3).

One respondent explains that, "CEO talent is very difficult to identify by resume, particularly for mega-cap companies." Another believes that, "It is hard to judge talent before it is challenged. Many can run a company if things are going well and the economy is healthy. The real test is when things aren't going well and the economy is not supportive." According to another, "Even internal candidates can deviate from expectations once they are in the big job."

Directors offer more varied assessment of the size of the labor pool when asked to estimate the number of people who could replace the CEOs of prominent companies not in their industries, although the numbers are still exceedingly small. Of note, they believe that replacing visionary founder CEOs is significantly more difficult than the professional managers who oversee large blue chip corporations. For example, they believe Jeff Bezos of Amazon to be the most difficult CEO to replace, estimating that only 2 individuals could serve as viable replacements for him. Other visionary founder CEOs—such as Warren Buffett of Berkshire Hathaway, Elon Musk of Tesla, and Larry Page of Alphabet (Google)—receive similarly small assessments. By contrast, they estimate the size of the labor market for more established companies such as ExxonMobil and General Motors to average between 10 and 15 candidates (see Exhibit 4). They also believe that technology and traditional retail are by far the most difficult industries for finding highly qualified CEOs—technology because it requires specific skills and retail because it is facing new competitive threats (see Exhibit 5).

These findings have important implications for corporate governance:

- *Efficiency of the labor market for CEO talent*. Given the scarcity of outstanding CEO talent among large corporations, it is unlikely that the labor market for CEOs functions efficiently. That is, the matching process for linking qualified talent with suitable job opportunities likely does not occur as economically as it does for other job types. With an inefficient labor market, management might face less pressure to perform and distortions can arise in the balance of power between the CEO and the board, and in compensation.
- *Compensation*. A tight labor market for CEO talent might help to explain high compensation levels, particularly among the largest U.S. companies. If only a limited number of executives are qualified to run these companies—and if outstanding CEO talent is critical for their success—then it is reasonable to expect that boards will offer large sums of money to attract their top candidate or retain their current CEO. The cost of losing him or her to a competitor would be too high.
- *Performance Evaluation*. Directors' view that capable CEO candidates are extremely scarce is likely to color their assessment of their CEO's performance as any evaluation that implies that the CEO should be replaced requires the board to take on the risk associated with finding a replacement. This risk aversion may encourage boards to tolerate both performance and behavior that would be not be acceptable if they perceived the existence of a large pool of highly qualified candidates.
- *Succession planning*. If directors believe that executives require special and rare attributes that are difficult to identify (including the right set of functional, industry and managerial experience combined with leadership qualities and cultural fit), identifying these candidates prospectively becomes even more important and reinforces the need for rigorous succession planning.
- *Talent development and retention*. Internal executives continue to be the most promising source of candidates for most companies when it comes to future succession. Given the board's familiarity with them, the visibility of their track record, and their tested cultural fit, it is more economic for most companies to invest in—and retain—their best internal talent.

WHY THIS MATTERS

1. Governance experts have vigorously debated the appropriateness of CEO compensation in recent years. And yet, there has been very little sophisticated effort to provide insight into the size, quality, and efficiency of the labor market for CEO talent, which is a key determinant of pay. What type of research can be done to provide rigorous insights in this area?
2. Survey evidence in this Closer Look shows that directors

overwhelmingly believe that the CEO job is exceptionally challenging and that only a handful of executives are qualified to run their company and others in their industry. This suggests that the labor market for outstanding CEO talent is significantly tighter and more competitive than governance experts might realize. What is the cause of this labor shortage: inadequate talent development or an inability to accurately assess a candidate's skills and fit prior to promotion? How should companies change their strategic approach to talent development?

3. The research cited in this Closer Look attempts to assess the labor market for CEO talent by directly measuring perceptions of the directors who are responsible for making hiring and firing decisions. What other sources of information could researchers use to supplement their assessment? Does a director's extreme familiarity with their company and industry make them well informed about the number of potential replacements for their CEO, or does it bias them into believing that their CEO is more irreplaceable than he or she actually is?
4. The research cited in this Closer Look includes the perspective of only the directors of very large, complex corporations. Do these results generalize to small or mid-cap companies? Does the size of the CEO labor market grow as you move down the spectrum to smaller companies? If so, how does the size of the CEO labor market vary with company size, and how does this influence the compensation, succession planning, and the other governance issues discussed above? ■

[1] Roger Lowenstein, "CEO Pay Is Out of Control. Here's How to Rein It In," *Fortune* (Apr. 18, 2017).

[2] Gretchen Morgenson, "An Unstoppable Climb in CEO Pay," *The New York Times* (Jun. 29, 2013).

[3] Cited in: "Neither Rigged Nor Fair," *The Economist* (Jun. 25, 2016).

[4] For a review of the research on executive compensation levels, see David F. Larcker and Brian Tayan, "CEO Pay Levels," Quick Guide Series: Research Spotlight (2017).

[5] Surveys were mailed to 1,100 directors and responses received from 113, representing a fairly high response rate of 10.3 percent for a study of busy respondents. The data and quotations throughout the remainder of this Closer Look are derived from: Stanford Graduate School of Business and the Rock Center for Corporate Governance at Stanford University, "CEO Talent: America's Scarcest Resource? 2017 CEO Talent Survey," (2017).

[6] In contrast to some management research, directors consider CEOs a much more important contributor to company performance. See David F. Larcker and Brian Tayan, "CEO Attributes and Firm Performance," Stanford Quick Guide Series: Research Spotlight (2016).

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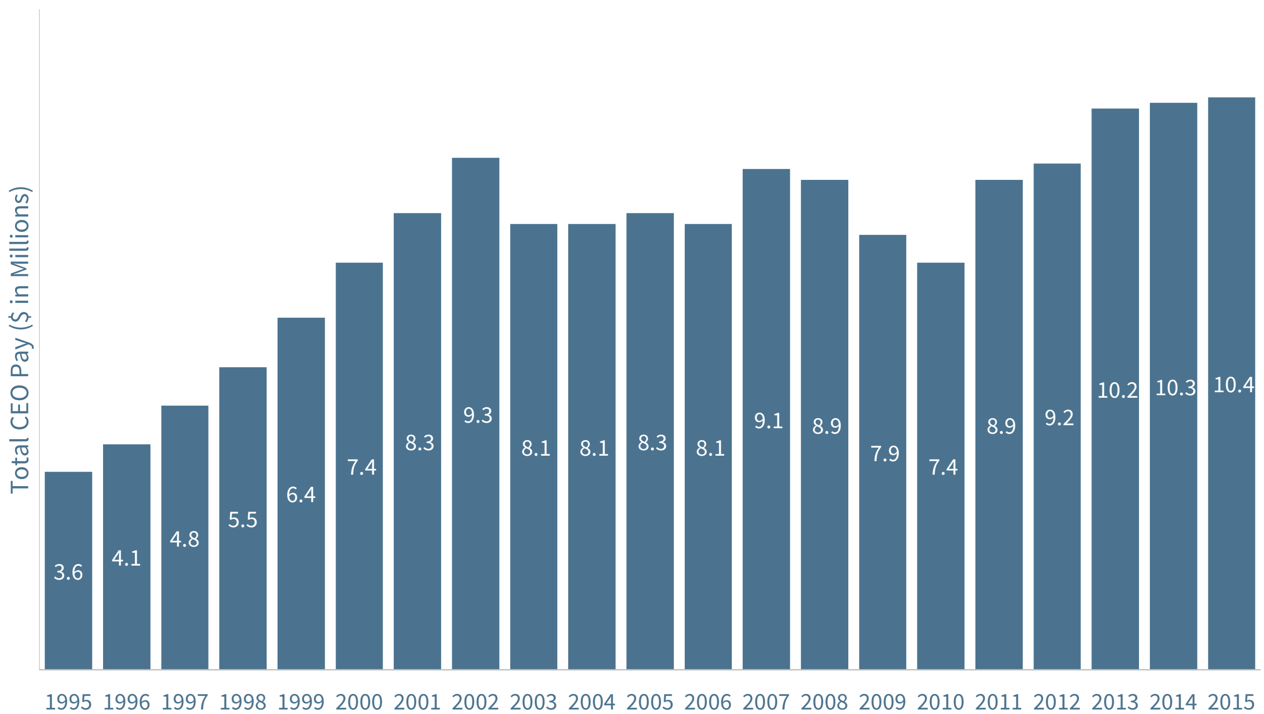
The authors would like to thank Michelle E. Gutman for research assistance in the preparation of these materials.

The Stanford Closer Look Series is a collection of short case studies that explore topics, issues, and controversies in corporate governance and leadership. The Closer Look Series is published by the Corporate Governance Research Initiative at the Stanford Graduate School of Business and the Rock Center for Corporate Governance at Stanford University. For more information, visit: http:/www.gsb.stanford.edu/cgri-research.

EXHIBIT 1 — CEO COMPENSATION LEVELS

CEO TOTAL COMPENSATION, S&P 500



Sample includes CEO compensation of companies listed in the S&P 500 Index, median values.

Source: Data 2010-2015 from: Equilar CEO Pay Trends; Data 1995-2009 from: Kevin Murphy Executive Compensation: Where We Are, and How We Got Here," *Handbook of the Economics of Finance* (2012).

CEO TOTAL COMPENSATION, BY COMPANY SIZE

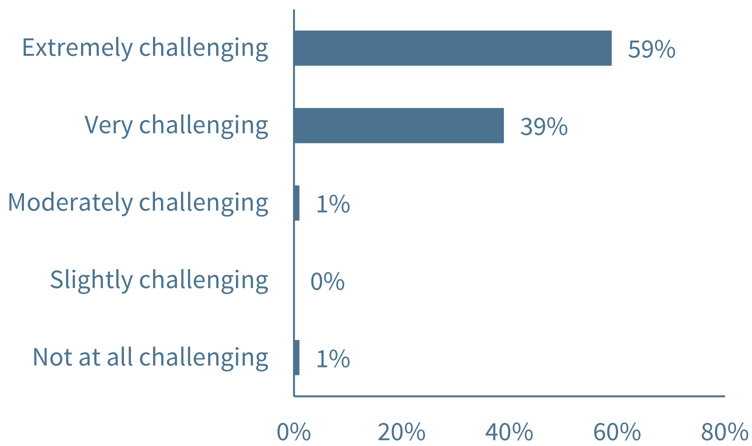
Firm Size	Total Expected Compensation	Market Value ($ in Thousands)
Top 100	$13,713,000	$104,413,000
101 to 500	$10,656,000	$21,710,000
501 to 1,000	$6,458,000	$6,086,000
1,001 to 2,000	$3,981,000	$2,016,000
2,001 to 3,000	$2,092,000	$624,000
3,001 to 4,000	$900,000	$144,000
1 to 4,000	$2,869,000	$1,143,000

Median values. Sample includes largest 4,000 U.S. companies included in the Equilar compensation database, fiscal years ending June 2013 to May 2014.

Source: Data from Equilar; calculations by the authors.

EXHIBIT 2 — DIRECTOR VIEW OF CEO LABOR POOL AMONG FORTUNE 250 COMPANIES

IN GENERAL, HOW CHALLENGING IS THE JOB OF CEO AT YOUR COMPANY?



ROUGHLY HOW MANY PEOPLE, INCLUDING THOSE BOTH INSIDE AND OUTSIDE YOUR COMPANY, ARE CAPABLE OF STEPPING INTO THE CEO ROLE AT YOUR COMPANY TODAY AND DOING AT LEAST AS WELL AS YOUR CURRENT CEO?

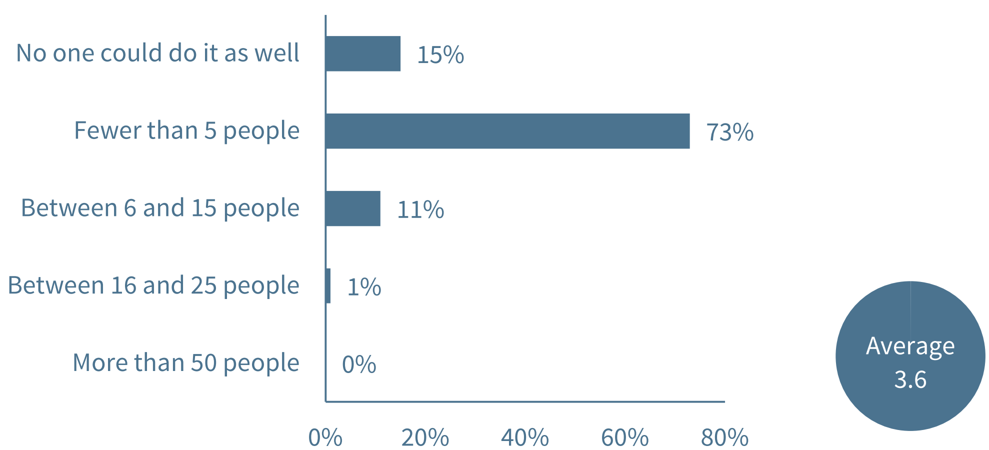
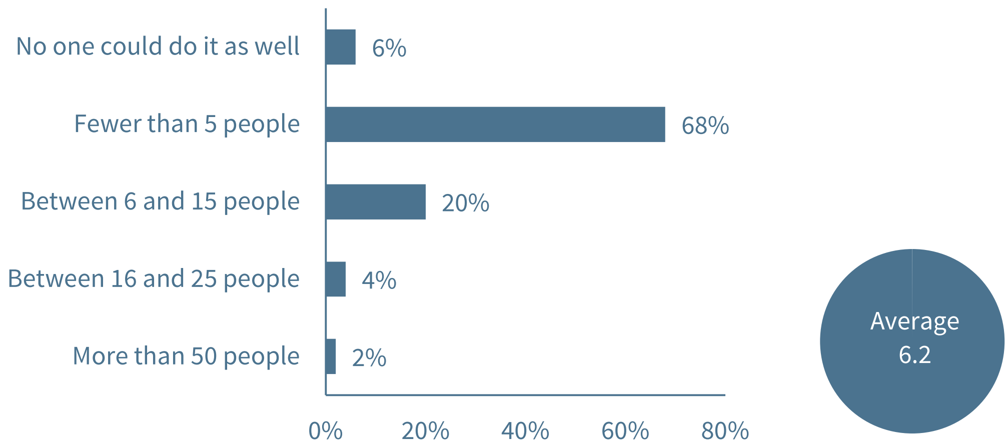
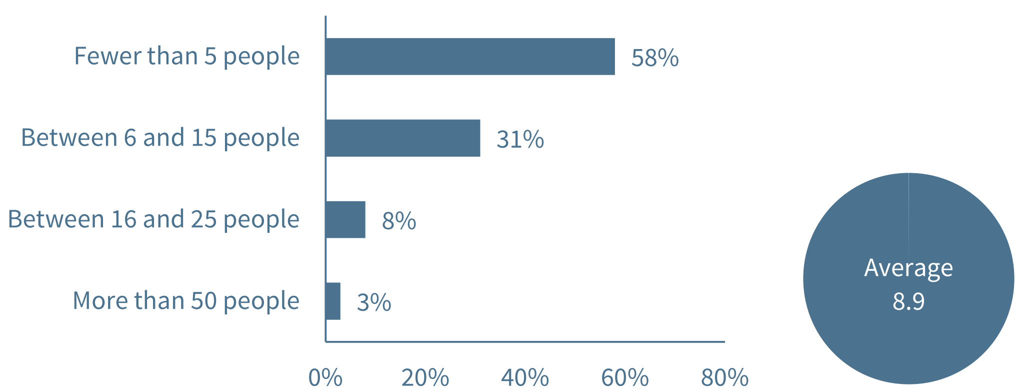


EXHIBIT 2 — CONTINUED

HOW MANY PEOPLE, INCLUDING THOSE BOTH INSIDE AND OUTSIDE THEIR COMPANY, ARE CAPABLE OF STEPPING INTO THE CEO ROLE AT YOUR BIGGEST COMPETITOR AND DOING AT LEAST AS WELL AS THEIR CURRENT CEO?



IF A LARGE COMPANY IN YOUR INDUSTRY WERE IN NEED OF A TURNAROUND, HOW MANY PEOPLE HAVE THE SKILLS REQUIRED TO SUCCEED AS ITS CEO?



Source: Stanford Graduate School of Business and the Rock Center for Corporate Governance at Stanford University, "CEO Talent: America's Scarcest Resource? 2017 CEO Talent Survey," (2017).

EXHIBIT 3 — DIRECTOR VIEW OF CEO TALENT AND RECRUITMENT PROCESS AMONG FORTUNE 250 COMPANIES

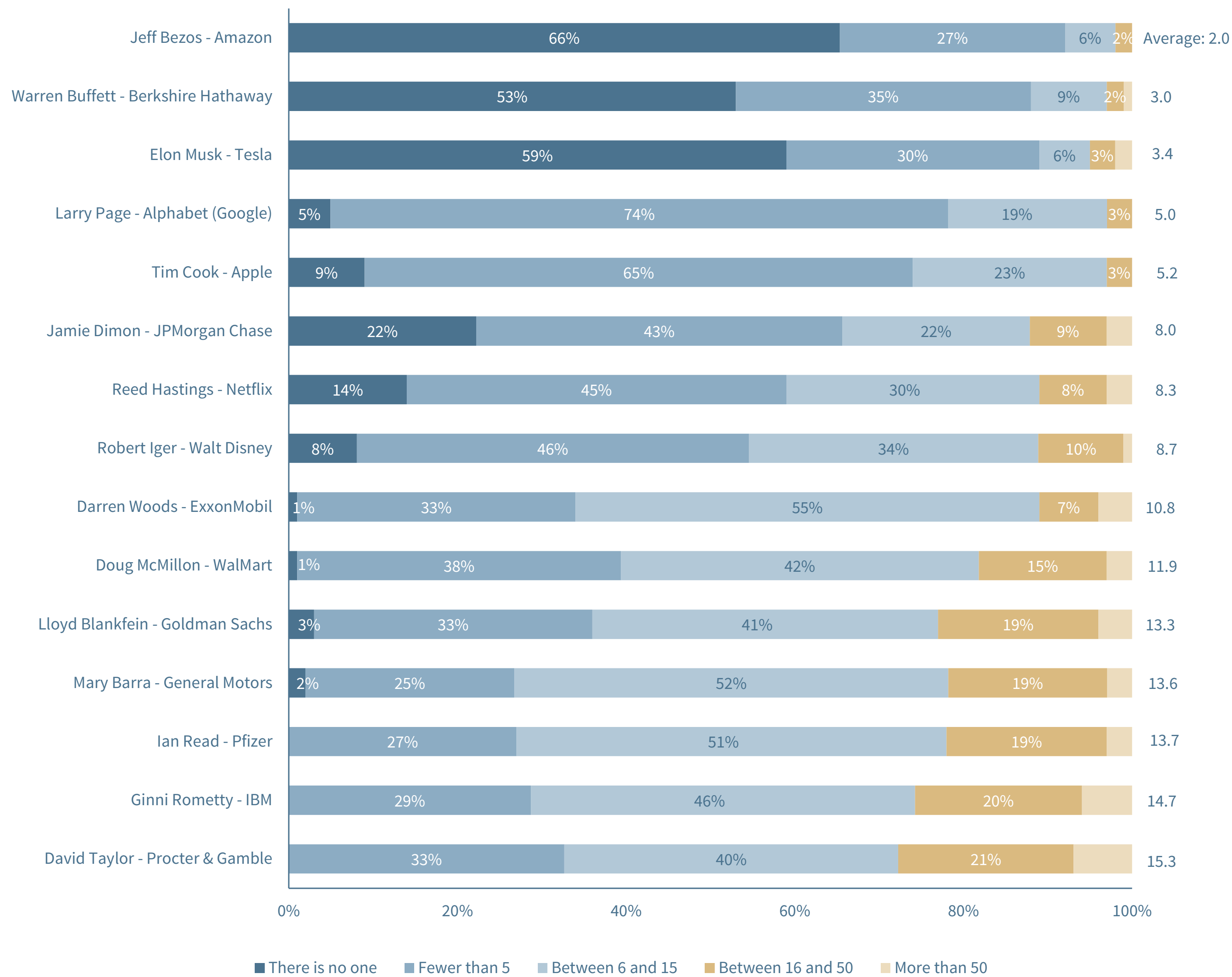
HOW WELL DO EACH OF THE FOLLOWING STATEMENTS REFLECT YOUR POINT OF VIEW?
(SCALE OF 1 TO 10; 1 = DOES NOT AT ALL REFLECT MY POINT OF VIEW, 10 = COMPLETELY REFLECTS MY POINT OF VIEW)

	Average	Median
In our industry, having general-management expertise is critical for being a successful CEO.	8.5	9.0
In our industry, having industry-specific expertise is critical for being a successful CEO.	8.2	9.0
CEOs in our industry have specific skills that are extremely hard to replicate.	7.5	8.0
It is difficult to evaluate prospective CEO talent during a search process because a candidate might meet all the criteria in terms of previous work experience but it is still hard to tell whether he or she would be a successful CEO.	7.4	8.0
In our industry, you can win if the CEO is among the top three. He or she doesn't need to be number one.	7.3	8.0
It is impossible to be the top company in our industry without having the top CEO in our industry.	7.2	8.0
CEOs in our industry have leverage over pay packages because talent is scarce.	7.0	7.0
CEOs in our industry are responsible for the vast majority of value created at their companies.	6.3	6.5
Top executives in our industry have so much unvested equity that it is hard to recruit them to another company.	6.2	6.0

Source: Stanford Graduate School of Business and the Rock Center for Corporate Governance at Stanford University, "CEO Talent: America's Scarcest Resource? 2017 CEO Talent Survey," (2017).

EXHIBIT 4 — DIRECTOR VIEW OF MOST DIFFICULT CEOS TO REPLACE

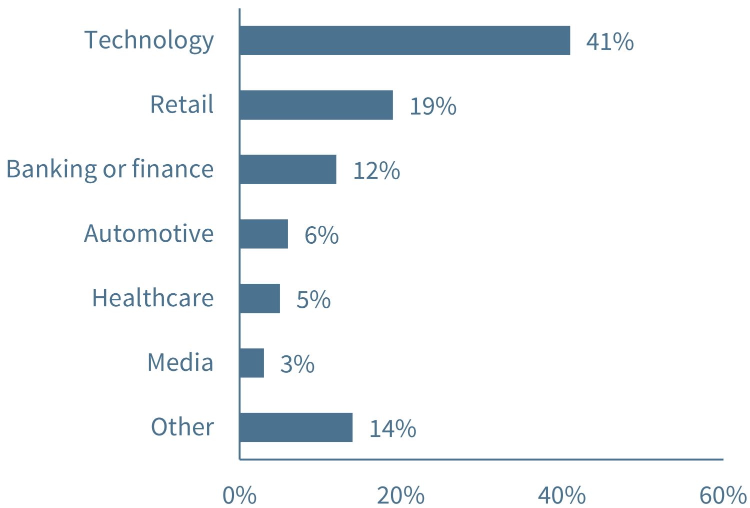
BASED ON WHAT YOU KNOW ABOUT THE COMPANIES BELOW, HOW MANY PEOPLE ARE CAPABLE OF STEPPING INTO THE CEO ROLE TODAY AND DOING AT LEAST AS WELL AS THE CURRENT CEO?



Source: Stanford Graduate School of Business and the Rock Center for Corporate Governance at Stanford University, “CEO Talent: America’s Scarcest Resource? 2017 CEO Talent Survey,” (2017).

EXHIBIT 5 — DIRECTOR VIEW OF MOST DIFFICULT INDUSTRY FOR RECRUITING CEO TALENT

IS THERE A SINGLE INDUSTRY (OTHER THAN YOUR OWN) IN WHICH IT IS MOST DIFFICULT TO FIND CEO TALENT? (MOST FREQUENTLY CITED INDUSTRY, UNAIDED)



Source: Stanford Graduate School of Business and the Rock Center for Corporate Governance at Stanford University, "CEO Talent: America's Scarcest Resource? 2017 CEO Talent Survey," (2017).