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# CEO SUCCESSION PLANNING

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# LABOR MARKET FOR CHIEF EXECUTIVE OFFICERS

- The “labor market for CEOs” refers to the process by which available supply of talent is matched with demand.
- For the labor market to function efficiently, information must be available on the needs of the corporation and the skills of the individuals applying to serve in executive roles.
- The efficiency of this market has implications for governance:
  - Correct hiring decisions (better “fit”)
  - Incentive to perform (or risk being replaced)
  - Appropriate compensation (fair market wage)
- If the market is inefficient, executives will be matched to wrong job, causing loss of shareholder value.



# CHALLENGES TO LABOR MARKET EFFICIENCY

Several challenges exist to labor market efficiency.

1. Executive skill sets can be difficult to evaluate. Success in a previous company or role may not translate to new position.
2. The labor market is limited by its size and by the ability of executives to move among or within companies.
3. Companies are not uniform in their circumstances or hiring practices:
  - Internal promotion vs. external candidate.
  - Sound operating condition vs. turnaround situation.
  - Long scheduled retirement vs. sudden transition.

# LABOR POOL OF CEO TALENT

## THE CHIEF EXECUTIVE OFFICERS OF PUBLIC U.S. CORPORATIONS

U.S. CEOs	
NUMBER OF CEOs	> 5,000
AVERAGE TENURE AS CEO	8 years
%, 0-5 YEARS AS CEO	59%
%, 6-10 YEARS AS CEO	24%
%, 11-15 YEARS AS CEO	9%
%, 16+ YEARS AS CEO	8%
SAME COMPANY ENTIRE CAREER	19%

U.S. CEOs	
PRIOR TO CEO: FINANCE	22%
PRIOR TO CEO: OPERATIONS	20%
PRIOR TO CEO: MARKETING	20%
PRIOR TO CEO: OTHER	38%
INTERNATIONAL EXPERIENCE	34%
MILITARY EXPERIENCE	7%
MBA DEGREE	40%

Spencer Stuart (2007, 2008); The Conference Board (2014)

# CEO TURNOVER

- CEO turnover ranges from 9 and 14 percent per year, globally.
- CEO turnover is inversely proportional to performance. (CEOs who underperform are more likely to be terminated.)
- However, CEO turnover is not very **sensitive** to performance. (Termination rates for CEOs who underperform are not much higher than those for CEOs who outperform.)

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	Top Quartile	Bottom Quartile
ROA	12.0%	-3.7%
CEO Termination Rate	0.8%	2.7%

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Huson, Parrino, and Starks (2001)



# CEO TURNOVER

- Some evidence exists that companies with strong governance are more likely to terminate an underperforming CEO:
  - Boards that are not “busy”
  - Boards with high percentage of outside directors
  - Directors own large percentage of shares
  - Shareholder base concentrated among handful of institutions
- Shareholders react positively to news that underperforming CEO is terminated and replaced with outsider.

Evidence is consistent with the theory that independent oversight reduces agency costs and management entrenchment.

Fich and Shivdasani (2006); Brickley (2003); Huson, Parrino, and Starks (2001)



## NEWLY APPOINTED CEOS

- Most new CEOs are internal executives (80 percent).
- Companies with strong performance are more likely to select an insider as the new CEO.
- Mixed evidence that companies who select an internal CEO tend to exhibit superior market-adjusted returns over the long term. (Did the internal CEO perform better, or inherit a better situation?)
- Internal CEOs receive lower first-year total compensation.
  - External CEOs must be bought out of contracts.
  - Companies in poor financial condition have to pay more to attract a qualified candidate.

The Conference Board (2014); Parrino (1997); Equilar (2013)



# MODELS OF SUCCESSION PLANNING

In general, there are four models of CEO succession planning.

1. External candidate
2. President and/or COO
3. Horse race
4. Inside-outside model



# 1. EXTERNAL CANDIDATE

Company recruits an external candidate.

- (+) Tends to have proven experience as CEO
- (+) More free to make strategic, operating, cultural changes
- (-) Less familiar with company
- (-) Leads to disruption among operations and staffing
- (-) Board has not evaluated performance first-hand
- (-) Leadership style might not translate to new environment



## 2. CHIEF OPERATING OFFICER

Company promotes a leading candidate to position of president and/or chief operating officer (COO).

- (+) Board observes performance before promotion
- (+) Scope of position is customized to company's needs
- (+) Executive gains experience interacting with board, analysts, press, and shareholders
- (-) Adds complexity to the organization, decision making
- (-) Responsibilities need to be clearly defined
- (-) Responsibilities need to be clearly differentiated from CEO
- (-) Risk of becoming “lifetime COO” if left in role too long



### 3. HORSE RACE

Company promotes two or more internal candidates to high-level operating positions who compete to become CEO.

- (+) Board observes performance before promotion
- (+) Board does not commit to preferred candidate in advance
- (+) Executives develop specific skills needed to succeed
- (-) Highly public and brings unwanted media attention
- (-) Creates internal factions who advocate a favored candidate
- (-) Precipitates a “brain drain” when losers resign



## 4. INSIDE-OUTSIDE MODEL

Company develops internal talent and simultaneously evaluates external candidates.

- (+) Internal candidates develop new skills and experiences
- (+) Levels the field between internal and external candidates
- (+) External validation assures board that best CEO is selected
- (-) Requires significant planning and oversight
- (-) Breakdown in process can lead to erosion of trust



## CONSIDERATIONS IN SUCCESSION PLANNING

- Succession planning relies on the full engagement of the board and senior management.
- As a best practice, succession planning is ongoing and includes preparation for both scheduled and unscheduled transitions.
- Continued development of internal talent is critical.
- Companies should maintain a list of candidates they can turn to in an emergency. They should also list the primary candidates to replace the CEO in a planned succession.



# CONSIDERATIONS IN SUCCESSION PLANNING

- When a succession event is scheduled, the board convenes an ad hoc committee to oversee the process.
- Directors should be selected based on their qualifications and engagement, rather than their availability.
- The outgoing CEO plays an important role in succession.
  - Develops talent
  - Coaches and mentors
  - Challenges executives to learn new skills
- At the same time, it is important that the board maintain primary control. The CEO should not be allowed to disrupt or influence the objectivity of the evaluation.



## CONSIDERATIONS IN SUCCESSION PLANNING

- The board should develop a written document that outlines the skills and experiences required of the next CEO.
- The profile serves as a yardstick against which internal and external candidates are evaluated.
- After a new CEO has been selected, the board should take active steps to facilitate a smooth transition.
  - Engage in open and honest dialogue
  - Be forthcoming about expectations
- The outgoing CEO should remain behind the scenes but be accessible to the new CEO to answer questions.



## HOW ARE BOARDS DOING?

- Survey data indicates a surprising lack of preparedness.
  - 51% could name a permanent successor if required.
  - 39% claim **zero** viable internal candidates.
  - Boards spend an average of 2 hours per year on succession.
- Companies emphasize emergency rather than permanent succession.
  - 70% have identified an emergency candidate.
  - 68% report that this candidate is not a candidate for the permanent position.
- Board members have insufficient knowledge about internal candidates.
  - 55% understand strengths/weaknesses of senior management team “well”.
  - 23% participate in senior management performance reviews.
  - 7% of directors serve as a professional mentor to senior managers.



## CONCLUSIONS

- The evidence suggests that boards do not engage in rigorous succession planning.
- This might explain why so many companies are ill-prepared when a CEO steps down.
- Succession planning would be improved if it were treated as an element of risk management. Viable candidates (internal and external) should be identified in advance of a transition.
- Succession planning is more than “names in a box.”



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