INTERNAL VS. EXTERNAL CEOS

RESEARCH SPOTLIGHT

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KEY CONCEPTS

Internal Versus External CEO Hires

- Most companies promote inside executives to CEO.
  - (+) Offer continuity.
  - (+) Have deep institutional knowledge.
  - (+) Are well known to the board.
- However, some companies choose to recruit an outsider.
  - (+) Have proven track records
  - (+) Better positioned to make changes to strategy, operations, and culture.

Research is inconclusive whether external CEOs perform better, after controlling for the operating condition of the firm when they are hired.

TRENDS IN HIRING EXTERNAL CEOS

- Murphy and Zábojník (2007) study long-term trends in CEO labor market.
- Sample: ~1,000 largest U.S. companies, 1970-2005.
- Find that companies are more likely to go outside to hire a new CEO:
  - 1970s: 15% of CEOs hired externally.
  - 2000s: 33% of CEOs hired externally.
- Also find that external CEOs receive ~15% higher pay than internal CEOs.

Conclusion: External CEOs have become more prevalent and receive higher compensation than internal CEOs.

PERFORMANCE AND SUCCESSION CHOICE

- Schwartz and Menon (1985) study the relation between firm operating condition and CEO succession choice.
- Sample: 268 companies, 1974-1982.
  - Matched pairs of bankrupt and financially healthy firms.
  - Identify CEO succession events in the 3-year period prior to bankruptcy.
- Find that financially failing firms are significantly more likely to terminate their CEO and hire an external replacement.

Conclusion: Struggling companies are more likely to hire an external CEO.

"In times of financial distress, companies seem to look for an external solution to their problems."

PERFORMANCE AND SUCCESSION CHOICE

- Parrino (1997) also studies the relation between firm operating condition and CEO succession choice.
- Sample: 626 companies, 977 CEO successions, 1969-1989.
  - Categorizes turnover events as “forced” or “voluntary.”
- Finds that:
  - Forced termination is negatively related to firm operating condition (ROA).
  - Companies that terminate their CEO are more likely to hire an external replacement than companies whose CEOs leave voluntarily (50% versus 10%).
  - Probability of external hire also increases with industry homogeneity (i.e., when CEO skills are more transferrable).

Conclusion: Struggling companies are more likely to hire an external CEO.

PERFORMANCE AND SUCCESSION CHOICE

- Farrell and Whidbee (2002) examine additional performance factors that influence a firm's CEO succession choice.
- Sample: 526 companies, 1985-1997.
- Find that companies are more likely to hire an external successor when:
  - Company underperforms relative to analyst expectations (1-year EPS growth).
  - Analyst expectations are more dispersed (i.e., uncertainty about future is higher).

Conclusion: Companies are more likely to hire an external successor in times of uncertainty.

> "Boards of directors are willing to accept the uncertainty associated with an outside replacement CEO when their firm's long-term prospects are both poor and uncertain."

MARKET REACTION TO SUCCESSION CHOICE

- Hayes and Schaefer (1997) study the stock market reaction to the recruitment of an external CEO.
- Sample: 129 recruitments, 1979-1994.
- Find positive abnormal returns in the 3-day (1.1%) and 10-day (4.2%) periods around the announcement.
- Note: do not control for operating condition of company prior to external hire.

Conclusion: Shareholders react positively to the announcement of an external successor.

MARKET REACTION TO SUCCESSION CHOICE

- Borokhovich, Parrino, and Trapani (1996) also examine the stock market reaction to internal and external CEO successors.
- Sample: 588 companies, 618 CEO successions, 1970-1988.
- Find positive, 2-day abnormal returns when:
  - External CEO is selected following a voluntary resignation (0.7%)
  - Internal CEO is selected following a voluntary resignation (0.2%)
  - External CEO is selected following a forced termination (1.6%)
- Find negative , 2-day abnormal returns when:
  - Internal CEO is selected following a forced termination (-0.9%)

Conclusion: Shareholders react positively to external CEO when change is needed.

RELATIVE PERFORMANCE OF INTERNAL VS. EXTERNAL CEOS

- Huson, Malatesta, and Parrino (2004) study the relative performance of internal and external CEOs.
- Sample: 1,344 CEO successions, 1971-1994.
- Observe significant decrease in operating performance (ROA) in the year prior to succession, significant increase in the 3 years following succession.
- Find modest evidence that operating performance improves more significantly when an outside rather than inside CEO is appointed.

Conclusion: External CEOs might perform better than internal CEOs.

RELATIVE PERFORMANCE OF INTERNAL VS. EXTERNAL CEOS

- Khurana and Nohria (2000) also study the relative performance of internal and external CEOs.

- Sample: 200 companies, 221 CEO successions, 1978-1993.
  - Examine forced and voluntary successions separately.

- Findings:
  - Voluntary turnover, followed by insider: no improvement in ROA.
  - Voluntary turnover, followed by outsider: decline in ROA.
  - Forced turnover, followed by insider: no improvement in ROA.
  - Forced turnover, followed by outsider: significant improvement in ROA.

Conclusion: Relative performance of internal and external CEOs is mixed.

"Detailed field research on dismissal and succession illustrates that these two processes are fundamentally intertwined and interact together in affecting subsequent firm outcomes."

CONCLUSIONS

- Companies that hire external CEOs are generally in worse operating condition and require significant change.
- The stock market reacts positively to the announcement of an external CEO in anticipation that they will deliver this change.
- There is some evidence that hiring an external CEO leads to better future improvement in ROA.
- However, it is difficult to determine whether this is due to source of hire or the operating condition of the company when the succession takes place.
- Attempts to separate these factors methodologically are extremely difficult.

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