Understanding Executive Compensation

A Practical Guide for Decision Makers

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CEO Succession Management

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The media, shareholder activists and other governance watchdogs pay considerable attention to CEO and executive pay. Some would argue, however, that choosing the right CEO and top management team is even more important than determining how much they are paid. For this reason, these conversations often are held together and the compensation committee of the board is charged with making CEO succession recommendations.

CEO succession planning has undergone two major changes in recent years. First, boards of directors are far more engaged in CEO succession management, including preparing for the possibility of premature departure, than a decade ago when this process was largely driven by the CEO. Second, the norm in boards of public companies is to have a robust succession management process rather than just having a succession plan. As a result, directors are taking a more hands-on role in guiding the selection and development of candidates for the CEO position.

A Hay Group study of 150 of the world’s largest companies, conducted in conjunction with Fortune’s Most Admired Companies research, indicated that 75 percent of boards favor internal candidates to outside hires absent unusual or turnaround situations. This obliges boards to make sure they have a feasible pool of internal talent with the skills and experience needed to succeed as the next CEO. Moreover, they must implement development programs to groom top talent for potential leadership. Simply identifying a list of “high potentials” and giving them increased board exposure is not enough to ensure successful succession. Boards need to have in place a clearly defined...
process of CEO succession in advance of the actual search, one that includes developing internal and external search mechanisms.

This chapter:

• Discusses why CEO succession planning is one of the most important responsibilities of the board of directors and details some of the common mistakes boards make in planning for a CEO replacement.

• Offers a five-step process based on current and future business needs to assist CEOs and boards in developing a proactive succession program. This process should be put in place well in advance of any anticipated CEO departure and includes advice on how to identify and assess potential candidates, how to identify and remedy gaps in a candidate’s skill set, and how to manage the transition into the new position.

Importance of CEO Succession Management

Few decisions can be more devastating to a company than picking the wrong CEO. At the same time, the rapid pace of change in corporate America coupled with increased scrutiny from multiple constituencies has resulted in shorter average tenure in the CEO position. A decade ago, CEO tenure of 10 years was not uncommon. Now, the average global CEO tenure is about seven years, and two out of five CEOs fail in their first 18 months. CEO failure can be incredibly costly — CEO turnover in the United States costs a minimum of 2½ times direct compensation in immediate severance and replacement costs. Additional negative outcomes can include backlash in the financial markets, internal disruption, loss of key talent, misguided strategic direction, inability to meet performance objectives and bleak results for shareholders. The CEO may simply be misfit with the corporate culture, providing leadership that fails to foster team spirit. Hiring an internal candidate is no guarantee against choosing the wrong candidate.

Despite the increased attention given to succession, most directors today admit that their boards could be far more effective in CEO and executive succession management. A study of 800 board members across the United States conducted by the National Association
of Corporate Directors (NACD) found that only half felt that their boards were effective in CEO succession management.

Many corporate experts maintain that selecting the new CEO is the single most important task that the board has. The steps outlined here furnish directors with the comfort of better information and a process that provides the level of due diligence shareholders deserve in this all-important decision.

**Step 1: Identify the Future CEO Role Requirements**

Effective succession management begins by proactively identifying how anticipated changes in the firm’s strategy and organizational structure will affect the requirements for the CEO. Given the importance of this work, all board members should have input into developing this role profile. The resulting discussion can help to clarify role requirements for all parties and align the board in a common direction.

The first step is to ensure that the board is aligned on the three- to five-year strategy. If it is not aligned on the company’s strategy, the board can hardly be aligned in terms of the requirements of future corporate leadership. For example, the requirements for a CEO managing a primarily domestic business with international operations requires far different capabilities than managing one that depends on its growth from emerging markets. As another example, CEOs of companies that plan to go public require quite different capabilities than those that remain private.

Additionally, when a company has a highly effective CEO in place, it is extremely useful to assess him/her as part of the development of the future CEO profile. This process can surface key attributes and capabilities that have made the CEO successful in leading this particular company, thus yielding practical insights that can be used in developing the future CEO role profile. While the next CEO should not be a clone of the current one, understanding which of the current CEO’s capabilities helped foster his/her success can help determine which of these attributes will be equally important in future leadership. The CEO typically finds the assessment process illuminating both from the standpoint of his/her own leadership
and in mentorship of future CEO candidates. The output of this effort is a robust CEO role profile that prioritizes the key position requirements, as trade-offs nearly always will be required and it is important for the board to agree on which requirements are “nice to have” versus essential in future corporate leadership.

Development of future CEO role requirements is the anchor of CEO succession planning. Once the board has agreed upon the future CEO role requirements, this should become the core metric against which all candidates are evaluated and developed. Yet, too often these critical aspects of CEO succession planning are glossed over only to surface at the 11th hour, disrupting the board’s decision making and sometimes even forcing a less desirable compromise hire that may have been avoidable.

Step 2: Identify Potential CEO Candidates

One of the biggest challenges that boards face is whether to consider internal versus external CEO candidates. The decision depends on multiple factors, including the quality of available internal talent, future business challenges, the availability of qualified external talent and the desire to retain current senior executives. After the board has a clear picture of the internal potential successors, informed decisions can be made about whether it is necessary to conduct an outside search for a new CEO.

Identifying the potential internal CEO candidates is not as easy as it seems, given the limited view that the most board members have of executives. (See “Common Errors Companies Make in Succession Planning.”) A critical success factor in identifying potential candidates is to control for the discontinuous shift in accountability in moving from their current senior executive positions to CEO. Public company CEO jobs, in particular, come with a sudden increase in high-stakes external interactions in which most executives (except for the CFO) have little prior experience. CEO candidates need to be identified based on their ability to manage competing internal and external priorities. These jobs tip the scale decidedly in the direction of managing the external environment and accountability areas that cannot be delegated to others — in particular, balancing
the needs of multiple constituencies and stakeholders (e.g., analysts and the investment community, shareholders, government and regulatory bodies).

Step 3: Objectively Assess Potential CEO Candidates
Once the board agrees on the future-oriented CEO profile, top internal candidates for the CEO position should be assessed to determine their current degree of fit with the requirements. Clearly,
it is critical to evaluate candidates against the requirements identified for the future CEO position — not merely to consider their performance in their current roles.

CEO succession decisions should not be made solely on the basis of the board’s previous familiarity with company executives. An outstanding CFO, general counsel or functional leader does not always have the skills and capabilities required to become CEO of the same organization. Perhaps most importantly, measuring candidates against the role profile can help identify gaps and longer-term risk factors that can be targeted in creating tailored leadership development plans for top internal candidates.

Too often, board members get only a narrow view of company executives through presentations at board meetings and interactions at company dinners. While many board members are good judges of character, proper due diligence on one of the board’s most important decisions should involve multiple considerations:

- The CEO’s view on the candidates
- Board members’ perspectives
- Formal executive assessments by a professional third party calibrated to the future CEO requirements
- 360-degree feedback from within the company
- Performance on stretch assignments for candidates with regular check-in points with the board.

By gathering multiple perspectives, the board obtains a more complete picture of candidates and, therefore, has better information for decision making. At the conclusion of the executive assessment, reports are generated about individual capability and potential relative to the CEO profile. Feedback often is provided to the candidates in a one-on-one development planning session.

Objective assessments against the CEO profile allow the board to measure all candidates against common criteria, diminishing the influence of familiarity in final decision making. Moreover, tools such as behavioral (“critical incident”) interviewing can provide a more level playing field in making comparisons between the capabilities of external candidates with those from inside the organization. In our client work, Hay Group often is asked to conduct
a job analysis of external candidates to go behind their titles and examine the key components of their jobs so that the board can gain greater insights to fairly compare the capabilities of outside versus inside candidates before making a choice.

When boards feel compelled to conduct an outside search as proper due diligence, it is critical to use the same platform to compare inside and outside candidates, starting with common CEO role requirements. Moreover, outside searches need not all go to a formal assessment process if internal candidates appear to be making good progress; a silent search or benchmarking study may give the board the comfort it needs.

Ideally, capability assessments should be conducted several years in advance of an anticipated CEO transition event so they can be used to identify top talent and create plans for further development in relation to the future CEO role demands. However, they also can be used closer to the time of an actual candidate decision. While such assessments should never substitute for the board’s own judgment in CEO selection, they invariably provide useful insights that boards can incorporate into a more robust view of the candidate pool.

**Step 4: Identify and Manage Succession Risks**

For imminent succession needs, boards should evaluate the top candidates against the requirements of the job and the potential risk — for both the organization and the candidate. Contrary to longer-term evaluation, this requires a laser-like definition of the suitability of a candidate against the role requirements. Given that no fit is perfect, this allows the board to identify the risks each candidate poses and any development needs that, if appropriately addressed, might minimize those risks.

Risks are not created equally. Gaps in critical knowledge and skill areas often can be addressed through education and on-the-job experiences designed to provide professional development. But gaps in required leadership often become more difficult to address the later they are identified and the higher the individual is in the organizational hierarchy. For instance, CFOs with no history of
leading business delivery teams often lack fundamental leadership competencies that are core to line management roles — the ability to translate strategic objectives into clear implementation goals, leading large organizations and providing direct feedback in a manner that enables team members to enhance their performance (rather than coming across as overly critical). Business leaders often fine-tune these leadership capabilities over years through trial and error. The absence of such capability can pose serious risk without focused efforts to provide leaders with the opportunity to develop and refine these skills.

For longer term situations, targeted development plans — often involving skill building, business exposure or both — can be created for the most promising internal candidate to address gaps. Running a global business, having formal exposure to more parts of the organization or taking on a key matrix role are examples of the types of development steps that may be put into place. For such stretch assignments to work, the CEO should be held responsible for ensuring the accountability of candidate progress against the plan and should furnish regular updates to the board.

An additional possibility could involve restructuring the office of the CEO to take advantage of the strongest capabilities of the best candidate, while leveraging the capabilities of additional parties. For example, partnering a strong finance or legal professional with an equally adept operational leader may result in a stronger team and help to ensure continuity and stability within the organization.

**Step 5: Manage the Transition**

Once the board has identified the best candidate and addressed the risks he/she (and the organization) faces along with any capability gaps, a comprehensive on-boarding plan should be developed that is tailored to the specific situation (e.g., Is the current CEO leaving voluntarily or involuntarily? Is the CEO candidate a logical successor or a “dark horse” candidate who may not be as known to investors and all leaders?). This plan should include not only a development plan for the individual, but also the specific accountabilities that the board has in making the transition successful, as well as the
outgoing CEO, if appropriate. If there is a planned transition, there is much more opportunity to manage these risks than if there is a sudden CEO departure. Contingency plans should be in place to manage multiple succession scenarios involving planned or untimely departure of the current CEO.

Current CEO succession planning processes vary widely, ranging from informal discussions to well planned and executed strategies. For some CEOs, the succession planning process starts from the first day on the job. Unfortunately, many major corporations fail to take a sufficiently rigorous approach, resulting in a thin slate of internal candidates or creating an urgent need to hire externally, creating unnecessary risks for the board and the organization. By bringing same level of objectivity and metrics to succession planning that the company does for strategic business planning, the board can reduce risk and fulfill its fiduciary responsibility to shareholders.