viewpoint
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VALUE DESTRUCTION BY THE UNPREPARED

The Cost of Complacency is Rising. Be Prepared.

CEO Demand and Supply are on the Rise

CEO turnover is on the rise and continues to be front page news. Turnover is at the highest level since the recession, according to executive search firm Spencer Stuart. This turnover rate will increase as Boards look to their leaders to revive growth and compete in a sluggish economy. Directors and activist investors are increasingly wielding the power to demand and create change at the top. CEO tenure has dropped to 4.8 years, according to a recent Harvard Business School study. Meanwhile, a post Baby Boom generation of market savvy, technology friendly executives in their late 40s to early 50s are ready for more challenging roles.

Given the increased CEO turnover and bumper crop of successors, Boards can capitalize on an up market. If they're ready. Yet most remain unprepared for the crucial fiduciary responsibility of ensuring effective CEO succession. For every positive story of a seamless transition, 1-2 companies grapple with succession surprises, from health or scandal related turnover to rising investor impatience over lackluster corporate performance, easily catalyzed by activist shareholders.

The Cost of Complacency is Rising

Dramatic stories of bumpy or failed CEO transitions make for riveting front-page copy, but they are not usually good for business. When unprepared, Boards are more likely to hire a CEO from the outside. While outside CEO hires may be the best or only answer in situations such as crises or dramatic turnarounds, the ROI of the external hire isn't favorable to shareholders over the long term. According to a 2013 study by Booz & Co., the median shareholder return over the period 2002-2013 by insider CEOs was 3.9%, compared with 0.65% by outsiders.

Whether it involves hiring an external CEO or not, lack of preparation for effective CEO transition continues to destroy value across a wide range of companies. A Board's passivity can result in one of two all-too-familiar scenarios . Either they are caught napping by surprise failures, or activist investors step in to force changes (see sidebar).

Our view is that successful CEO Succession is neither glamorous nor rocket science. It just takes time and hard work. For example, the Board and incumbent CEO can jointly develop an explicit statement of the future job requirements of the CEO position.

"VALUE DESTRUCTION BY THE UNPREPARED" – A MODERN DAY SAGA

Asleep at the Switch

After 27 years of successful leadership by Sir Alex Ferguson, England's premier football club stumbled mightily under successor David Moyes, who lasted only 10 months.

Once an industry innovator, the company has seen six CEO transitions since 2006 and is headed for bankruptcy protection. All avenues have failed – internal, external and interim CEOs.

CEO Philip Clarke, a 40-year employee, was ousted by the Board of the European grocer and replaced by Unilever veteran Dave Lewis. The stock is slowly rising but is closer to the 52 week low than the 52 week high.

The Activist Shareholder Syndrome

Investor-backed President and CEO Steve Bennett was brought in as the face of a turnaround, but was fired after less than two years on the job. Board member Michael Brown stepped in as interim. Analysts call it a "major black eye".

The Board first stripped CEO Mike Jeffries of the Chairman title after pressure from Engaged Capital LLC, then he resigned several months later. A Board member and top management are acting as an interim Office of Chairman to run the company until a search is completed. The stock continues to slide and is a little more than half of the 52 week high.

Even traditionally strong succession planning by P&G was not foolproof. Activist investor Bill Ackman challenged the company's direction and results, leading to the removal of A.G. Lafley's successor Bob McDonald. Even after a thorough CEO succession process Lafley had to return to the helm. File this under "no one's perfect".

Activists including Carl Ichan pressed for removal of CEO Mark Frissora and oversaw the appointment of outsider John Tague. An overhaul of key leadership positions continues. The stock is still well below the 52 week highs.

Developmental assignments and Board exposure can be created for the potential candidates to allow the Board and the incumbent CEO to evaluate each candidates' ability and ambition to be a viable successor. The candidates themselves can actively pursue their own development, owning the changes they need to make. As a result, Boards and management alike create value through seamless CEO transitions where the successor has the skills necessary to take the company into the future. Rigorous preparation is not sexy, but it works.

A Better Way: Preparation is the Key to Value-Creating CEO Succession

Preparation involves proactive movement of executives into key roles, clear criteria in assessments, high intensity coaching/skill building of potential successors and real-time knowledge of the external market. The following recent examples demonstrate effective preparation by high profile companies.

Ford	BlackRock	Starbucks Coffee	Owens Corning	Marsh & McLennan Companies	Kraft / Mondelēz International	Morgan Stanley
SITUATION						
Transition from CEO Alan Mulally to Mark Fields.	Management moves: Charles Hallack (49) promoted to co-President and Rob Goldstein (40) promoted to COO.	CEO Howard Schultz promotes CFO Troy Alstead to COO.	Intensive development for Group Presidents and Division GMs, including on-the-job development assignments.	A Board-led planning process to ensure smooth transition from Brian Duperreault to then President and COO Daniel Glaser.	Broad scale, consistent assessment of top executives in preparation for Kraft/Mondelez split.	CEO James Gorman added several executives to the Operating Committee.
VALUE CREATION PROPOSITION						
Growth. Fields widely seen as capable of managing the next growth phase.	**Sustainability**. The moves promote younger executives to key positions after half of the co-founders left or retired from active roles.	**Strategy**. Hands over day-to-day operations to longtime insiders while Schulz focuses on next generation retailing.	**Sustainability**. Develops the CEO and C-Suite leadership pipeline and advances strategic initiatives.	**Stability**. MMC had been through major changes in years prior. The uneventful transition was a welcome change. Duperreault did not need to stay on the Board afterwards.	**Portfolio management**. Both companies have balanced management strength with development plans for senior leaders.	**Diversification**. Maintained a balance of managers from different units who are capable of rotating across businesses in the future.

As mentioned earlier, effective CEO succession is less about rocket science and more about due diligence. Based on our experience with clients and lessons learned from successes and failures, the following practices will help Boards prepare effectively for CEO Succession.

Build to last. Create a CEO profile built on what the company needs in the future so you can assess and develop internals now against that spec. Don't just ask, "Who's ready to succeed the incumbent?" Also ask "What does the company need in future CEOs, and how do our first, second and third generation internal candidates compare to that profile?" This is important because the bar is rising in terms of CEO skillset. Companies are bigger and more global in an environment of accelerating competition, even in emerging markets. Executives must also adapt to quicker technological changes such as mobility and social media. Succession happens in the future, so be ready now.

Put your executive development programs on steroids. Don't just ask, "How long until they are ready?" Also ask, "What specific experiences are internal candidates being given to prepare them for a job they've never done before?" At the level of C-Suite candidates, most executives require intensive development experiences to break through old habits and transform into more enterprise level leaders. Plain vanilla assessments and canned programs won't cut it. CEO candidates frequently need to "crack the code " on development challenges they've been avoiding for years, such as conflict aversion, rocky peer relationships, or lack of self-awareness. This isn't easy. They also need exposure to tough constituents and will benefit from real-world experience presenting to analysts, investors, the Board, unions, etc.

Know the external market. Don't just ask, "Which Executive Search firm would we use if we went outside?" Also ask, " Which executives in other companies/industries fit best with our future CEO profile, and how likely would they be to come on board?" Convergence in many industries means that the Board should be tracking executives in other industries, not just their own. Market knowledge is at a premium. Boards can engage executive search firms in a process known as "market mapping", where external targets are identified but not approached.

Know your own. First hand knowledge of the "heirs apparent" beats talent reports every time. Boards shouldn't just ask for names of internal candidates; they should get to know them formally and informally, beyond presentations. One interview in a search process is insufficient at best. Ajay Banga, CEO of Mastercard, procatively sets up formal and informal interactions between the company's top talent and the Board on a regular basis.

Summary – the CEO Succession Strength Meter

Like the strength meter of your password on a website, you can test the strength of your CEO Succession Process using the scale below. The closer to green, the closer your company is to being adequately prepared for all scenarios of CEO Succession.

THE RIVER STRENGTH METER

WEAK		MODERATE		STRONG	
Only a "Sudden Loss of Leadership" plan in existence (internal interim identified).	A handful or less of internal candidates deemed ready within 2-3 years.	Clear specification of future CEO to be used in internal assessments.	Intensive development of first and second generation CEO candidates.	Board members with in-depth first-hand knowledge of internal candidates.	Market mapping of potential external candidates, evaluated against internal candidates.

CEO SUCCESSION

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