Boards Need to Focus on Leadership Development and Effective Internal CEO Succession

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What really drives a company's success over the long-term? In a country like the U.S. that lionizes success, business leaders who are perceived as contributing extraordinary financial achievement in the short-term often become celebrities. Yet, behind the headlines, the larger question remains: how does the company secure long-term success and value for shareholders. What about the leadership and performance of the organization over an extended period? More specifically, what can we learn about the importance of effective succession management?

To answer these questions, the Kelley School of Business at Indiana University and Fred G. Steingraber, Chairman Emeritus of A.T. Kearney and Chairman of Board Advisors, examined the leadership of the most successful non-financial S&P 500 companies from 1988 through 2007. The 20-year duration was critical to the study because it minimized distortions of performance that could have occurred over shorter time spans of three, five or even 10 years. In addition, this two-decade period was characterized by different economic cycles, globalization, dramatic technology advances, shifting consumer preferences and changes in leaders competing under a wide variety of conditions.

The study found that 36 S&P 500 non-financial companies were consistent, superior leaders over the 20-year span *(see figure 1)*. These companies, representing 25 different industries, include Abbott Laboratories, Best Buy, Caterpillar, Colgate-Palmolive, DuPont, Exxon, FedEx, Honda, Johnson Controls, McDonald's, Microsoft, Nike and United Technologies, among others. This group outperformed the remaining S&P 500 firms in seven measurable metrics: return on assets, equity and investment, revenue and earnings growth, earnings per share (EPS) growth and stock-price appreciation. The superior long-term performance reflected in each of the above metrics demonstrates the ability of "home-grown leadership" to consistently generate superior results.

How did these companies manage to maintain such standards of excellence for two decades? The study attributes their success to internally developed or "home-grown" CEO talent that significantly outperformed other S&P 500 companies. Moreover, the study found that no non-financial S&P 500 company with externally recruited CEOs generated 20-year performance numbers that surpassed or even equaled those of the top 36 in all of the study metrics.

The dramatic results of this research show that responsibility for managing leadership succession is among the most important duties of a board of directors. This responsibility cannot be left to the CEO, the Chief Human Resources Officer, or to chance, where all too often it currently seems to reside. Boards need to develop relationships with CEOs that enable them to monitor, advise and, when necessary, adjust the process to ensure that a talented executive is ready to step in, whether in an emergency or a five- to 10-year transition.

Managing succession is increasingly under scrutiny with many stakeholder groups and now even the Securities and Exchange Commission (SEC), which is accepting proxy resolutions, is requiring more

transparency in the board's role in managing succession, and leading to shareholders demanding more insight into the process.

In recent years, a number of alarming statistics have emerged about CEO succession planning. To begin with, the National Association of Corporate Directors (NACD) and *Chief Executive* magazine, among others, have reported consistent survey results of directors confirming that the number one board challenge is succession planning.

Estimates suggest that only about half of public and private corporate boards have CEO succession plans in place according to a survey by the Center for Board Leadership; and the NACD says just about 16 percent of directors report their board is effective at CEO succession planning. The tenure of a CEO in North America has declined from 10-plus years in the mid-1990s to under five years. More disturbing is the fact that 40 percent of externally recruited CEOs last two years or less, while 64 percent are gone before their fourth anniversary. Moreover, externally recruited CEOs cost 65 percent more than those promoted from within. Two-thirds of S&P 500 directors surveyed believe their company doesn't have adequate succession-planning processes, and only 16 percent believe they currently have an in-house candidate for succession. There appears to be little chance these trends will be reversed any time soon.

With CEO turnover running at 14.4 percent per year according to Conference Board statistics, there were 1,227 CEO transactions in 2009, with 46 percent of successions unplanned. Even more distressing is the fact that nearly half of all directors (48 percent) view CEO succession as the CEO's job, and *more* than half of all directors (52 percent) do not know when their CEO plans to step down.

That's just the tip of the talent problem. The leadership pool (executives ages 35 to 50), which grew 3 to 3.5 percent for the last four decades of the 20th century, has *declined* by 2.5 to 3 percent in the first decade of the 21st. By 2015, estimates suggest the S&P 500 will face a turnover of about half of their workforce. Add to that the fact that 90 percent of the people entering the global workforce in the next 20 years will come from Asia. Will good leaders with the requisite qualifications be in short supply in an increasingly changing and challenging world? Or, as our study suggests, have boards underestimated the importance of leadership development and effective succession execution in achieving long-term viability for their organizations?

There is much to learn about the consequences of succession-management failures.

With nearly half of all board members (48 percent) believing that CEO succession is the CEO's responsibility, it's obvious too many boards give lip service to the process. According to RHR International, a leading global firm of management psychologists and consultants that specializes in executive selection and integration, "the number one responsibility of any board is to ensure that the organization has the ability to sustain excellence in CEO leadership with seamless transitions from one CEO to the next. In fact, directors are often misinformed and get bad advice about succession planning, and are often pressured to look outside the company for the next CEO. It means they are acting on less knowledge rather than more. Often the board has observed an internal candidate over a period of years and knows his or her flaws. The outsider is presented as new talent with few dissenting comments. The board also assumes that the outsider

has the same chance of succeeding in the company as the insider. However, CEOs hired from outside are more likely than "home-grown" leaders to fail—even though their compensation is higher.

A recent study by two graduate-school professors confirms a trend in CEO successions, which have favored outside hires for the past two decades. In their study, Professors Yan Zhang, of Rice University's Graduate School of Business, and Nandini Rajagopalan, of the University of Southern California's Marshall School of Business, expose myths about externally recruited CEOs: that they make bolder short-term changes than internally hired CEOs because they are not bound by "social contracts" with employees and other constituents; that they seldom hesitate to cut costs or lay off workers; that outside succession equals change which equals better performance. In reality, say the professors, bold changes can be detrimental to a firm's performance if they deviate from the firm's core competence or if the company does not have the capacity to execute the changes.

Professors Zhang and Rajagopalan found that "planned, inside CEO successors, on average, outperform non-relay inside and outside CEO successors." This effect was especially noticeable under more challenging contexts, such as low pre-succession firm performance; high post-succession strategic instability; and high post-succession industry instability.

"Our research shows that strategic changes under the leadership of an inside CEO fare much better than under the leadership of an outside CEO," they conclude. "Outsiders are typically good at rapid cost-cutting and divestment, but over time, those opportunities tend to dry up."

Professors Zhang and Rajagopalan also conclude that "the disadvantage of outside CEOs, relative to inside CEOs, is not temporary and persists over time." The departure of experienced top management can deprive the outside CEO—and the firm—of valuable management talent. Renowned business advisor and author Ram Charan notes that the introduction of an external CEO often causes key internal leaders to depart, and their positions get filled by more outsiders. The result, Charan says, is that it can take two decades for the company to develop a truly internal CEO candidate.

The consequences of seeking outside CEO talent are reflected in the financial crisis. One common problem is an excessive focus on short-term performance. In a large-sample empirical study, Professor Zhang found that outside CEOs are nearly seven times more likely to be dismissed after a short tenure than inside CEOs because of the asymmetry, the fact that the CEO candidate knows more about his or her true competency than does the board. As a result, boards are very likely to hire the wrong executive in an outside succession.

And they are likely to pay more for the privilege of hiring that outsider. Median compensation—salary, bonus and equity incentives—for external CEOs is 65 percent higher than for those promoted from within. In order to further reduce risk for the CEO outsiders, companies agree to expensive "golden parachute" severance packages in the event the CEO is dismissed. Not having the right leaders costs American industry an estimated $14 billion a year, and that is not even counting the cost to shareholders in lost market capitalization, the increase in stock volatility, and the impact on the firms in terms of being left floundering, demoralized and often ripe for the picking. Zhang and Rajagopalan's research concludes

that the reason so many outside CEOs fail is not because they are incompetent, but because they are a bad fit for the company. The "good fit" element—defining the alignment of values, beliefs and business philosophies between company and candidate—frequently is missing when a board decides to hire externally.

Consider last year's stunning resignation of Mark Hurd as Hewlett Packard's CEO, which not only resulted in an 8 percent drop in the company's stock price but focused attention on the HP board's failure to deal with leadership development and CEO succession planning—a failure that first became evident with the recruitment of outside CEO Carly Fiorina, who walked away with a $42 million severance package when she was ousted in 2005. Hurd had been recruited from NCR—he, too, departed HP with a $42 million package. HP's recruitment of a third new outside CEO within 11 years became a public spectacle, which ended in September 2010 when Leo Apotheker was named to the post. His first-year compensation is said to be worth about $30 million if he stays through 2013.

The HP drama shows that when the unexpected happens in the corporate world, the board's involvement in CEO succession becomes public. Late last year, Pfizer Chairman and CEO Jeffrey Kinder suddenly resigned, citing exhaustion after four years at the helm. Kinder joined the company as general counsel in 2002 and became a contender for the CEO post along with two other internal candidates. Upon his resignation, the well-prepared board immediately promoted insider Ian Read as CEO and, a week later, named independent director George Lorch chairman. Not surprisingly, Pfizer has long been regarded as a leader in corporate governance.

Leaders, directors, shareholders, rating agencies, even regulatory authorities all have a vested interest in the quality of leadership development, succession management and corporate continuity. Given what the studies tell us about the state of succession planning these days, it is wise to consider what stakeholders are saying and doing about it.

For the past several years, succession planning has consistently been among the top three priorities in the National Association of Corporate Directors survey of their members. The majority of directors voiced a strong preference for growing internal CEO candidates, noting that if the board is compelled to look outside for a new CEO, the board has failed. Some commented that hiring outsiders is risky because they are unfamiliar with the company's people, products and culture. Some said it is impossible for outsiders to inspire loyalty from the people in line operations, another contributor to the huge failure rate among outsider CEOs.

The NACD study concludes that the lack of suitable external candidates, higher cost, shorter tenure and higher turnover all support the argument for internal development of leadership. In the few instances where directors described an outside hiring, they noted they brought the candidate in years in advance to learn the company's business and culture.

The SEC has modified its position on CEO succession planning as it relates to proxy proposals. Prior to November 2009, the SEC excluded consideration of proposals on succession plans in proxies, since those plans were perceived to relate to termination, promotion and ordinary business matters. Now

the SEC declares that "one of the board's key functions is to provide for succession planning so that the company is not adversely affected due to a vacancy in leadership." The commission explicitly acknowledges that "CEO succession planning raises a significant policy issue regarding the governance of the corporation that transcends the day-to-day business matters of managing the workforce."

As a result, shareholder proxies on succession planning may be considered by the SEC for placement in the proxy statements—another strong signal that boards will need to play a more active role in overseeing leadership development and CEO succession planning in their companies.

Clearly, all key stakeholders associated with corporate success and sustainability are coming to acknowledge the importance of a sound succession planning process that emphasizes internal candidate development—and the importance of holding their board accountable for it. Boards are well advised to study and understand the current best practices associated with leadership development and succession planning.

Leadership may be difficult to define, but we all know it when we experience it. Unfortunately, many decision-makers often do not experience leadership candidates directly, relying instead on resumes, interviews and third parties who may—or may not—have sufficient insight or experience.

Two things—an effective process of succession-planning and fully engaged boards of directors—are critical to selecting the right leader. The process must be comprehensive and institutionalized in the company, and it must include a long-term understanding of candidates' records, references, leadership style and values under various conditions and in different roles.

What are the best practices for boards and succession planning?

Involve the board early--Directors need access to internal talent, both informally and formally, on a regular basis. McDonald's Chairman Andrew J. McKenna said, "I think that the greatest risk facing a board is that they do not pick the right CEO or, in turn, that the CEO does not pick the right people behind him," said McKenna at a Kelley School forum noting that McDonald's has six regularly scheduled board meetings, with one entire meeting devoted to a discussion of succession planning as well as a regular agenda item at every meeting. This board involvement in succession planning enabled McDonald's to quickly and effectively manage three CEO transitions (due to two sudden deaths) within two years—all with internal candidates.

Nor can directors rely only on their CEO for talent information, but also on lower-level leaders. Boards should be involved in, or at least exposed to, the benchmarking of potential leadership and gaps in leadership, and in overseeing the development of action plans to close the gaps. In essence, the talent imperative is critical for achieving sustainable long-term success. Directors do not need to become talent managers, but to take responsibility for ensuring that effective processes for talent development, assessment and promotion are in place. Boards should consider having a director with significant experience and skills in managing leadership development and succession planning programs as well as adding a board reporting relationship to the chief human resource officer, much like the internal audit or

chief compliance officer functions.

A top performer in our study, Johnson Controls had just two CEOs—both internally developed—in the 20-year study period. James Keyes joined the company in 1966, became president in 1986, and served as CEO from 1988 until 2004. John Barth joined the company in 1969, served in a variety of management roles before becoming president in 1998, and served as CEO until 2009, when another internally developed leader, Stephen Roell, became CEO. Roell still mans that post and also serves as chairman.

The period of Keyes' leadership was dramatic in terms of delivering value to shareholders. When he became CEO, the company had sales of $3 billion. By the end of 2003, sales were more than $22 billion, and Keyes had established an enviable record for increasing earnings. The key metrics from 1987 until 2007 include average annual returns of 17.8 percent stock appreciation, 13.9 percent revenue growth, 14.9 percent return on equity, 9.1 percent earnings-per-share growth, a 9.01 percent return on investment and a 5.8 percent return on assets.

Talent development is a core focus for Johnson Controls' leadership team. Keyes, now retired, remembers it this way: "We were growing rapidly and we were always looking for leaders to run new businesses. We gave people lots of responsibility, and the good leaders grew quickly. You put someone in a new situation and you could see how they handled it, how they managed. What was always key was how they developed people."

Several internal business leaders at Johnson Controls competed for, but did not get, the top position, yet they went on to become CEOs at other organizations. (The same has been true at GE.) Growing businesses creates an urgency for developing talent. As Keyes put it, "Developing and growing people through your organization has benefits for everyone."

At a minimum, boards must devote more time to leadership development and succession planning and becoming well acquainted with the internal talent pool.

Find the proper fit. One reason so many successions fail so quickly is that new CEOs often do not fit into the organization's culture (or powerful subcultures) well enough to do what is needed in ways that will be accepted by the people they have been hired to lead. Fulfilling this criteria can be facilitated greatly by using psychological assessments which take into account the fit of candidates with the cultures of the board and the corporation.

Establish a nominating committee. Boards willing to embrace primary responsibility for succession management should establish an effective search and nominating committee made up exclusively of independent directors. Although the board may task a CEO to participate or even lead parts of the effort, it should never abdicate responsibility for the selection process and for delivering quality results. Because boards' responsibilities have grown exponentially in the past decade and time commitments have increased, creating such a committee is critical.

Engage the incumbent. It is critical that incumbent CEOs are actively engaged in and committed to the CEO succession-planning process, including understanding that their performance evaluation will be influenced by the quality of internal leadership talent they effectively develop. Former Xerox Chairman and CEO Anne Mulcahy took the reins in 2001, as she put it, "by default, not by design," adding that the board vowed never to let that happen again. She shared accountability for succession planning with the board, but it was her responsibility to ensure that the plans for her eventual successor were carefully plotted to ensure the right fit. Ursula Burns' promotion from president to CEO and chairman was highly praised.

CEO succession is too often seen as an event rather than a process. Research and experience confirm that companies savvy enough to foster internal leadership succession achieve superior long-term results, and that effective succession management is absolutely vital to a company's sustainability. High risk, significant disruption and burgeoning costs await boards that are not fully engaged in these processes—superior results and high returns await those boards that are.