ATKEARNEY

"Home-Grown" CEO

One key to superior long-term financial performance
is managing leadership succession

Study performed in partnership with

KELLEY SCHOOL OF BUSINESS
INDIANA UNIVERSITY

preface

Boards of directors often fail when it comes to CEO succession planning. Rather than focusing on leadership development and creating a qualified stable of internal CEO candidates, boards too often end up going outside the organization to fill the top spot.

Unfortunately, their stakeholders more often than not pay a big price for their star search. Outsiders experience a significantly higher failure rate and shorter tenure than insiders. Recruiting at the top is often far more risky, costly and disruptive than seeding succession from within.

Today's CEOs need to know more than how to run a business. They need to understand and effectively leverage their firm's unique culture and differentiated brand. They need to know how to inspire their people and connect with their customers. They need to balance the exogenous forces of a treacherous and continuously changing global business environment with the endogenous forces—and personalities—of their own companies to lead change and move forward. There is no substitute for mature judgment, deep understanding and well forged relationships based on trust developed over time on the playing field. But many boards are not ensuring that internal candidates—the very people imbued with the right cultural norms and sensitivities—get the training and support they need to successfully step into the CEO role.

More than ever, today's companies need top talent at the helm. But they need talent that knows the organization and the playing field well enough to improvise when required, confident that the team will follow his or her lead and execute the play. Often the best resource for that role is already playing for the team. But winning teams need corporate boards to put a premium on finding and developing that talent.

The research in this paper builds a compelling financial case for why boards of directors committed to overseeing superior long-term financial performance need to pay far more attention to leadership development and effective home-grown CEO succession. Fred Steingraber, Chairman Emeritus of A.T. Kearney, a long-term CEO and veteran of numerous boards of directors, partnered with the Kelley School of Business at Indiana University to adeptly illustrate the price shareholders pay when their boards fumble the succession ball.

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The fact that two-thirds of non-financial S&P 500 companies did not survive during the 20-year period from 1988 through 2007 attests to the rapidly changing nature of long-term success. In a country such as the United States that lionizes success, business leaders who achieve extraordinary short-term financial gains for their companies often become celebrities. Yet, behind the headlines, larger questions remain: How does a company secure long-term success and value for shareholders? Does corporate performance correlate with CEO leadership over an extended period? And more specifically, what do we know 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 leaders over the 20-year span *(see figure 1 on page 2)*. 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.[1] The superior long-term performance reflected in each of the above metrics demonstrates the ability of "home-grown leadership" to consistently generate significant:

- Revenue growth
- Profit margins
- Earnings per share
- Productivity (ROA, ROE and ROI)
- Share appreciation

The companies' 20-year average annual performance multiples in the analyzed metrics range from a low of 125.3 percent (return on equity) to a high of 253 percent EPS growth *(see figure 2 on page 2)*. The appendix on page 15 offers a short description of the study methodology.

[1] The total number of "remaining" non-financial companies (designated as Group II) varied from year to year depending on the number of S&P 500 financial companies, but ranged between 375 and 400+.

Figure 1
Group I: Top-performing, non-financial companies with 100% "Home-Grown" CEOs (1988-2007)

Company	Ticker
Abbott Laboratories	ABT
American Airlines	AMR
Apple	AAPL
AT&T	T
Avery Dennison Corp	AVY
Best Buy Co Inc.	BBY
Black & Decker Corp.	BDK
Canon ADR	CAJ
Caterpillar Inc.	CAT
Chevron	CVX
Colgate-Palmolive Co.	CL
Cooper Industries, Ltd.	CBE
Cummins	CMI
Danaher Corp.	DHR
Deere	DE
Dell Inc.	DELL
DuPont	DD
Emerson Electric Co.	EMR

Company	Ticker
Exxon	XOM
FedEx Corp.	FDX
General Electric	GE
Goodrich Corporation	GR
Harley Davidson, Inc.	HOG
Honda Motor Co.	HMC
Illinois Tool Works Inc.	ITW
Intel	INTC
Johnson & Johnson	JNJ
Johnson Controls, Inc.	JCI
McDonalds	MCD
Microsoft Corp.	MSFT
Nike Inc.	NKE
Oracle Corporation	ORCL
Southwest Airlines Co.	LUV
Target Corp.	TGT
Texas Instruments Incorporated	TXN
United Technologies Corp.	UTX

Source: Kelley School of Business at Indiana University study, 2011

Figure 2
Non-financial S&P 500 performance analysis, 1988-2007 annualized results

		Returns			Growth		Margin	
Study group	Description/ number of companies	Return on assets (ROA)	Return on equity (ROE)	Return on investment (ROI)	Revenue growth	Earnings per share (EPS)	Profit margin	Share apprecia-tion
Group I	36 non-financial S&P 500 firms, 100% home-grown CEOs	9.5%	20.3%	13.3%	11.9%	13.9%	7.9%	16.7%
Group II	S&P 500 firms, excluding Group I and financial companies*	4.9%	15.8%	8.2%	4.4%	4.6%	6.0%	12.7%
Group I average annual performance multiples over 20 years		179.2%	125.3%	152.8%	238%	253%	129.5%	127.4%

** The total number of non-financial companies in the S&P 500 in Group II varied from year to year depending on the number of financial companies, but ranged between 375 and 400+*
Source: Kelley School of Business at Indiana University study, 2011

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 the Securities and Exchange Commission (SEC) requiring more transparency in the board's role in managing succession, and leading to shareholders demanding more insight into the process.

This paper addresses the current state of leadership and succession planning, the causes and consequences of failures in CEO succession, how external constituencies regard the importance of succession planning, and best practices in succession management.

The Current State of Succession Planning

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 regular survey results of directors confirming that the number one or two 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.[2] 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.[3] Moreover, externally recruited CEOs cost 65 percent more than those promoted from within.[4] 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,

[2] *Dayton Ogden and John Wood, "Succession Planning: A Board Imperative,"* Business Week*, 27 March 2008; and NACD In the News.*
[3] *Nat Stoddard with Claire Wyckoff, "Pick a CEO Who Truly Fits the Company," Forbes.com, 9 April 2009.*
[4] *Executive Pay Tracker Equities Inc.; Cari Tuna,* The Wall Street Journal*, "Hiring a CEO from the Outside is More Expensive," 28 July 2008.*

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. Finally, while 65 percent of the world's GDP is currently produced in developed countries and 35 percent in developing countries, current estimates suggest the next 20 years will see that statistic flip as two-thirds of the world's GDP will come from emerging markets, including China, India, Korea, Brazil and Russia. The implications of these statistics will, in all likelihood, have a transformational impact on leadership development and succession management for boards and stakeholders going forward.[5]

To fully understand the crisis in CEO succession, it's important to explore why successions fail and what happens when they do.

Causes and Consequences of Succession Failures

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.[6] Given their typical culture of collegiality, it is often difficult for directors to raise issues about succession when the CEO is also the chairman. Activist investors, such as ValueAct Capital founder Jeff Ubben, insist that the roles must be separate for succession planning to work, and that those who carry both titles are, naturally, blind to the conflict: "They don't see it. How could they? Who wouldn't want to manage his performance evaluation and compensation? Who wouldn't want to be his or her own boss?"

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." RHR believes CEO successions are pivotal but tend to be disruptive, often because directors are misinformed and get bad advice. As an example, directors are often pressured to look outside the company for the next CEO, which 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. According to RHR, however, CEOs hired from outside are more likely than "home-grown" leaders to fail—even though their compensation tends to be higher.

Study exposes myths. 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

[5] *John Hamre, Center for Strategic and International Studies, Washington, D.C., Chicago Council on Global Affairs, Board Retreat, 2006.*
[6] *John Wilcox, June Eichbaum and Matteo Tonello, "The Role of the Board in Turbulent Times: CEO Succession Planning," The Conference Board Executive Action Series, August 2009.*

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."[7] 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.

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 our study.

The professors say that new outside CEOs often feel they have a mandate for change and the freedom to assert their will on the company almost immediately—at the risk of not fully understanding the company, its culture and its key people. In fact, new outside CEOs often think that getting rid of key people is the best way to rid the company of past failings.

Not so, say the professors. "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." Their conclusion is corroborated by Kevin and Edward Coyne's study in the *Harvard Business Review* on how outside CEO succession is a disruption to the firm, as it is usually followed by turnover of other management-team members. The departure of experienced top management can deprive the outside CEO—and the firm—of valuable management talent. In the Coynes' study of the top 1,000 U.S. companies from 2002-2004, when a new CEO from outside the company was brought in, the involuntary turnover of senior management listed in the proxy statement averaged 26 percent—or nearly four times the rate when the CEO did not change. 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.

Aside from the myths uncovered by the studies, what causes directors to hire CEO talent from outside the company? The answer is seen in the

[7] Yan Zhang, Nandini Rajagopalan, "CEO Succession Planning: Finally at the Center Stage of the Boardroom," Business Horizons 2010 (53-455-462), Kelley School of Business, Indiana University.

growing view that "the succession process is driven by the board's desire to quickly restore investor confidence rather than a careful consideration of the CEO competence and fit the firm really needs."[8] In addition, the pressure to outperform competitors over the past decade has resulted in adulterating sound decision-making, effective risk-management and ethical behavior in business leadership, all of which contribute to higher levels of CEO turnover and a desire to restore perceived confidence.

As Fred Wackerle, author of "The Right CEO: Straight Talk About Making Tough CEO Selection Decisions," asks in a Corporate Board Member article, *Succession Planning—Grow Your Own CEO*, "Why do you assume that other companies can develop leaders better than you can?" The author of the article, Julie Connelly, appropriately observes: "It's easy to be seduced by a charismatic messiah when you haven't invested in the multi-year process of figuring out what you really need in the person who is going to run the company. But, the transition from one CEO to another, difficult enough for an insider, becomes even more fraught when the new person has no history at your outfit."[9]

Litany of sins. The consequences of seeking outside CEO talent are reflected in the litany of sins committed by organizations that failed in the financial crisis. The list includes striving to achieve unrealistic goals; taking excessive risks; making decisions based on numbers flawed by assumptions, poor estimates or even fraud—and an excessive focus on short-term performance. There's also the problem of placing too much emphasis on improving share price as opposed to improving a company's quality, productivity and business performance, or excessively compensating executives for poor performance due to the "Lake Wobegon effect"—the belief that a firm has top quartile leaders who will automatically deliver top quartile performance. A more subtle—but nonetheless critical—problem is the loss of institutional culture and values due to short leadership tenure and high leadership turnover during a period of great change.

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. A reason given for this is that outside CEO successions are associated with a greater level of asymmetry between the board and the CEO candidate—that is, 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 as noted previously, 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. Equifax, an executive-pay tracker, examined nearly 1,300 companies across three major S&P indexes and found that outsiders were paid more on average at all companies, regardless of size.

But it doesn't stop there. 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. "Thus, the average cost of replacing a CEO after 18 months ranges from $12 million for small-cap firms to $52 million for large-cap firms."[10] And there's this statistic: Not having the right leaders costs American industry an estimated $14 billion a year, and that is not even counting the cost to

[8] *Margarethe Wiersema, "Holes at the Top: Why CEO Firings Backfire,"* Harvard Business Review*, volume 80, number 12, 1 December 2002.*
[9] *Julie Connelly, "Succession Planning—Grow Your Own CEO,"* Corporate Board Member*, volume 5, number 2, March/April 2002.*
[10] *Nat Stoddard with Claire Wyckoff, "Pick a CEO Who Truly Fits the Company," Forbes.com, 9 April 2009.*

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.[11] 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.

Prime examples. Consider the market-capitalization decline when then-Bank of America CEO Ken Lewis announced in October 2009 his plan to leave by year-end. Without a succession plan in place, Bank of America conducted a search from September 30 to December 15—during which time its stock fell 10 percent as the Dow Jones Industrial average rose 7.5 percent. After extending offers to outside candidates who publicly declined, insider Brian Moynihan was offered the job on December 16, 2009, and took office two weeks later.

And look at 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.

In short, multiple studies and anecdotal evidence demonstrate that the risks are greater and the costs higher when a company goes outside to hire a CEO. That being the case, one might well wonder about the effectiveness of corporate boards and how stakeholders react to CEO succession failures.

Succession Planning and Management: Everyone Has a Role

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.

According to a 2009 Towers Perrin study, all stakeholder groups have expressed concern about the growing uncertainty surrounding succession-management processes and their likely outcomes.[12,13]

[11] *Nat Stoddard with Claire Wyckoff, "Pick a CEO Who Truly Fits the Company," Forbes.com, 9 April 2009.*
[12] *Bruce Sherman and Harriet Sebald, "Leadership Succession Practices Take on Growing Importance for Companies and Stakeholders Alike," Towers Perrin, February 2009.*
[13] *In January 2010, Towers Perrin merged with Watson Wyatt to form Towers Watson.*

At the same time, the complexity of leadership is increasing due to competition, globalization, regulation, technology, intellectual capital and the growing demand for more transparency of succession plans.

As a result, institutional investors, analysts, rating agencies, shareholder advisory services, the National Association of Corporate Directors and others are focusing intensely on an organization's leadership and succession planning. The problem is, however, that there is no common framework of metrics or processes that all stakeholders have agreed upon. In addition, it is very difficult for outsiders to obtain a realistic understanding of a company's leadership "bench strength," let alone the processes deployed in leadership development and succession planning. Even directors lack a good understanding of these important factors, and so are at a disadvantage in assessing their company's capacity for growth or the risks it faces.

The reason so many outside CEOs fail is not because they are incompetent, but because they are a bad fit for the company.

Succession planning tends to be important to analysts where leadership is known to be especially critical, such as those companies headed by founders, iconic leaders, long-tenured CEOs and highly visible management teams with clear track records. For example, some analysts project the impact of management change by measuring CEO tenure against total shareholder returns (TSR) for that period of time. In light of the frequent leadership failures in recent years, analysts are increasingly conducting deeper corporate bench-strength analyses.

The previously mentioned Towers Perrin study found that in their investment discussions, institutional investors, such as the CalPERS and TIAA-CREF, view effective succession-planning processes as essential. They appear to pay close attention to how effectively succession planning bridges the leadership skills required to implement today's strategies and those likely to be required in the future. They are interested in the degree of formality of processes used to identify and develop leaders and in the extent to which the board is engaged in those processes. They are also focused on how boards and management work together to develop, measure and manage leadership development and succession-management programs. Boards have relied too much on CEOs to manage succession. As a result, the processes are often less than effective and less than objective. Boards have failed to build confidence in the processes, which in turn prevents them from being at all confident about internal CEO candidates.

Historically, rating agencies have not focused on executive succession unless a crisis occurs—but recent events are changing that attitude. Rating agencies now consider the robustness of an organization's succession program as a reflection of the quality of board governance practices. They also are moving from a narrow focus on CEO succession toward a broader view. For example, Moody's use of "key person" risk (formerly "keyman" risk) attempts to assess the extent to which key business decisions are dependent upon a single individual or small group of executives.

Both Moody's and Standard and Poor's publish related factors in their ratings reports. Like institutional investors, rating agencies view leadership and succession management as shared responsibilities of the board and management. Moody's, in fact, notes that every board should not only have an emergency CEO succession plan in place, but should ensure effective leadership-development and CEO succession plan processes.

Because companies that rely on a single leader are at higher risk of not being able to meet tough business challenges, Moody's considers compensation ratios of executive teams and the degree of reliance on the CEO as indicators of effective—or ineffective—succession practices. Depending on the industry and rating institution, a high-risk leadership profile can lead to a less-than-investment-grade rating by investors as well as agencies.

The National Association of Corporate Directors (NACD) regularly surveys directors on priorities for their attention. For the past several years, succession planning has consistently been among the top three priorities. In 2006, the NACD published a best practices study titled "The Role of the Board in CEO Succession." The directors interviewed for this study stated explicitly that succession has become their board's top concern. They stressed that selecting the CEO is their most important job, and that the board must run the process.

In fact, the majority of directors interviewed for the study 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."[14]

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

[14] *Division of Corporate Finance, Securities and Exchange Commission, SEC Staff Legal Bulletin 14E (Shareholder Proposals) No. 14-E, Rule 14a-8 (i) (7) (C), 27 October 2009.*

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.

Best Practices in Succession Management

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.

The overwhelming evidence is that, overall, internal CEO successors are better for a company's sustained performance and for superior long-term shareholder returns. As the Zhang-Rajagopalan study concludes, outside CEOs have greater liabilities than inside CEOs, and outside succession has greater adverse consequences for both the firms and the CEOs themselves.

If internal leadership succession is superior in principle and preferable in practice, it requires the thoughtful development and effective execution of a deep pipeline of executive talent over time. As Jeffrey M. Cohn, Rakesh Khurana and Laura Reeves write in their 2005 *Harvard Business Review* article, "Growing Talent as if Your Business Depended on It," a critical role for the board is to ensure the existence of a robust senior leadership program that spans multiple organizational levels and includes not only top management but also middle management. At minimum, such programs should include in-depth annual assessments of the top three tiers of management, tracking assignment success, identifying development needs and outlining appropriate career paths for higher level responsibilities. While the CEO and chief human resources officer play a critical role in managing such a program, the board must be engaged and responsible for ensuring that the program is working.

Top-performing companies that have successful programs, such as GE, McDonald's, Intel, Colgate and Johnson Controls, have multiple internal leadership candidates. These companies aspire to and achieve higher internal placements. In short, they retain and grow talent while building a cohesive culture.

The following highlights best practices from the leaders:

Involve the board early. A key component of the talent-pipeline process is for directors to have access to internal talent, both informally and formally, on a regular basis. In a 2010 webinar conducted by the Kelley School of Business, 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." This led to a discussion on succession planning and talent-development practices in global companies. Citing his experience at McDonald's, McKenna said, "At McDonald's, the board of directors has six regularly scheduled board meetings, and one of these meetings is entirely devoted to a discussion of succession planning and talent development at the C level and throughout the company. Beyond this one meeting, a portion of every board executive session is devoted to a discussion of succession planning and talent-development issues." Finally, McKenna noted that he can "identify several current leaders at

McDonald's around the world who have demonstrated a performance profile such that they have been identified as potential C-level leaders 10 years from today at McDonald's."

This level of board involvement in succession planning is the main reason McDonald's was able to quickly and effectively manage three CEO transitions (due to two sudden deaths) within two years—all with internal candidates.

Colgate is another top-performing company in the study that takes these matters seriously. At Colgate, every quarterly budget review includes a "high potential" review, and the company tracks unplanned turnover in the high-potential pool with an objective of achieving a 90-percent retention rate. The company enforces this objective by putting one-third of its leaders' short-term compensation at risk. That is, Colgate—like several companies we studied—ties each divisional leader's compensation to filling executive openings through internal succession.

It is important to note that directors need to rely not 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. This does not require directors to become talent managers, but it does require them to take responsibility for ensuring that effective processes for talent development, assessment and promotion are in place, that they are being deployed effectively, and that they are yielding timely and high-quality results. As such, boards should consider the critical value of having a director with significant experience and skills in managing leadership development and succession planning programs. They may even want to establish a dual reporting relationship for the chief human resource officer reporting to both the CEO and the board of directors, much like the internal audit or chief compliance officer functions.

There is a variety of processes and practices—multiple role experiences, mentorship and assessments, for example—that are useful in preparing potential leadership candidates. Some companies have programs for leadership development designed around meaningful experiences in a variety of roles in different functions, geographies and business units. Such activities require on average three-year rotations in each of three roles, with positive evaluations as a threshold for qualifying for a leadership role.

One such company is Johnson Controls. A top performer in our study, this global technology and industrial leader 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 create an urgency for developing talent. As Keyes put it, "Developing and growing people through your organization has benefits for everyone."

Mentorship is key to that development and growth. Mentorship is a function of aligning future leaders with senior executives and/or board members who do not have organizational responsibility for the candidates. This allows them to function in a constructive counseling capacity. These discussions, however, should not involve personnel evaluation, compensation or out-counseling matters that would put a mentor in an awkward or even conflicted position. 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. This "fit criteria" has brought greater credibility to psychological testing. In an article posted on Forbes.com, authors Nat Stoddard and Claire Wyckoff write that the fit criteria must be considered from the perspective of two key subcultures. "The first is the team the CEO will be expected to lead, and the second is the team the CEO will become a member of—namely, the board of directors." Stoddard and Wyckoff write that "another critical consideration involves carefully assessing a candidate's values, beliefs and business philosophies."[15]

Assessment tools can be very effective in improving the selection process's probability of success. Companies that have significant experience with leadership-development programs often use personal assessment tools early on, when executives are in their thirties and have been with the firm for four or five years. In fact, some leading MBA programs have introduced this concept into their curriculum to help individuals with their own self-assessment in targeting career plans, including roles, industries and companies.

With all senior leadership programs, the board must be engaged and ensure they are working.

Some companies, wisely, have introduced rigorous assessment programs into their CEO leadership-screening process that begins early in a candidate's career. The assessment includes the candidate's recruitment record; promotion of top-quality talent in prior roles; sharing of

[15] *Nat Stoddard with Claire Wyckoff, "Pick a CEO Who Truly Fits the Company," Forbes.com, 9 April 2009.*

top-quality talent across functions, geographies and business units; and the potential candidate's success in growing and promoting internal talent in prior roles.

Another critical factor is the process of benchmarking talent depth and breadth. While many companies will "check the box" and say they perform well with regard to succession planning, they really mean only that they have a back-up name on their succession chart. In most cases, the same back-up candidate is listed for more than one position. In fact, a succession back-up candidate should be a person who is well-prepared at the time of appointment, not someone the company or board works with to fill the role following appointment. Unfortunately, this is the way succession planning is handled far too often—and it falls woefully short of what is needed.

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. Professor Zhang found that firms with formal nominating committees are less likely to dismiss their CEOs after a short tenure (up to three years) than those without a formal nominating committee. In addition, he found that nominating committees comprised of external directors serving on average no more than 1.75 other boards are more effective because they have more time to carry out their duties. Directors with more board appointments are as ineffective as boards with no formal nominating committee.

Director expertise is extremely important on a search and nominating committee, just as it is on an audit committee. Specifically, directors with deep knowledge of the industry and its firms are invaluable. When that kind of expertise exists on a nominating committee, it is better prepared to identify and select CEO candidates whose leadership skills and experience are well suited to the firm.

Engage the incumbent. It is critical that incumbent CEOs are actively engaged in and committed to the CEO succession-planning process. Obviously this is not easy, on a personal level, for even the best CEOs and organizations. Former Xerox CEO (and current Chairwoman) 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. When Mulcahy resigned the CEO post in 2009, she enthusiastically endorsed her successor, Ursula Burns, but found it "painful" to participate in board discussions about a time when she would no longer be CEO.

"I've been with Xerox for 32 years," Mulcahy once told an NACD luncheon audience. "I love the place and could stay forever." In a *Fortune* magazine article, she said she was proud of her role in developing Burns, promoting her to president and generally helping to ensure that Xerox had an effective succession plan. She also conveyed the emotion she felt about leaving a job and a company she loved.

As Professors Zhang and Rajagopalan point out, CEOs can significantly influence the succession process's outcome and effectiveness, since they are inevitably closer to potential internal candidates. The CEO knows the firm's culture and day-to-day realities better than even the most well-informed directors.

How the board engages the outgoing CEO, then, is critical. It requires the succession-planning process to be clearly identified, understood and accepted by the CEO at the time he or she is appointed—and well ahead of being put in motion. Together, the board and the new CEO should regularly review key tasks, including leadership development and the candidate-identification process, with program reports submitted both to the board and the nominating and search committee. There should be clear guidelines for direct CEO reports—including timing plans—designed to prepare individuals who are considered CEO candidates. Finally, the board and the CEO should meet a minimum of once every two years to discuss the CEO's plans for retirement or other transitioning.

Independent of the processes for leadership development and succession planning for internal candidates, boards must have emergency plans in place should the unforeseen occur. This means the board should identify an internal candidate they would anoint in an emergency. If no such candidate exists internally, the board should do some external research and come up with a list of acceptable external candidates. This process should be updated annually, as internal talent develops and the target pool of external candidates may change.

Finally, board ownership and oversight of an explicit, ongoing process for managing CEO succession should be incorporated into the board by-laws and become a standing agenda item.

Conclusion

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.

Authors

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APPENDIX: Summary of Study Methodology

The Kelley School of Business at Indiana University and Fred G. Steingraber, Chairman Emeritus of A.T. Kearney and Chairman of Board Advisors, LLC, examined the leadership transition of CEOs for the non-financial S&P 500 companies over a 20-year period, from 1988 through 2007. The team then divided the non-financial companies into two groups: Group I included 36 companies that had exclusively internal CEO succession during the study period; Group II included all others in the non-financial S&P 500. The total companies in Group II varied from year to year, depending on the number of financial companies in the S&P 500. The team then analyzed performance of each group against the following seven financial metrics:

- Return on assets (ROA)
- Return on equity (ROE)
- Return on investment (ROI)
- Revenue growth
- Earnings per share (EPS) growth
- Profit margin
- Stock price appreciation

The 20-year timeframe was selected for this analysis as a benchmark of longer-term performance and, as such, the length would minimize distortions in performance that could have occurred over a shorter time span, such as three, five or seven years. In addition, the two-decade study period was characterized by different economic conditions, new competition, globalization, dramatic technology advances, shifting consumer preferences, and changing leadership under a variety of conditions. This analysis was augmented by interviews with board members, CEOs and other experts, and included a significant review of literature, research, surveys and publications on the issue of leadership development, succession planning and the board's role with respect to each.

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