

Management Succession



Assess

Decide

Define

Engage all
STAKEHOLDERS IN SEQUENCE

Start
VERY EARLY

In search of excellence in CEO succession – the seven habits of highly effective boards

With chief executives' tours of duty becoming ever shorter, choosing the right person for the job is a crucial function of any Board. Max Landsberg looks at how to manage a successful appointment of a new CEO.

Selecting the new CEO is one of the Board's three most crucial tasks, matched only by a decision to merge or sell the company, or the selection of a new Chairman.

Merely announcing who your next CEO will be can move the market value of your company by 5% or more,¹ and research by Harvard Business School on the value of a great CEO suggests figures of around 15% of your company's market value.² Furthermore, the share prices of companies with successions that are unplanned typically underperform their peers by more than 2%.³

Yet this 'bet the company' decision is still often tackled too late, with no recourse to a contingency plan, and without the benefit of enough data. As a recent client commented, "there was less data in the process than in a footnote of a monthly Board pack".

To help Boards address this important topic, this article sets out the seven steps required for addressing a specific foreseeable succession need, and concludes with briefer suggestions for longer-range planning.

Seven steps to address an identified succession need

Our experience in working with clients on CEO succession suggests the crucial importance of each of the following steps:

1. Start very early
2. Engage all stakeholders in sequence
3. Define the selection criteria clearly
4. Explicitly decide on the mix of internal / external investigation
5. Assess the candidates thoroughly
6. Define the roadmap and development plans
7. Plan support for the eventual transition.

While these steps might appear simple, their effective execution requires careful consideration.

1. Start very early

Most companies that have achieved a successful transition to a new CEO started at least eighteen months before the transition date. This apparently lengthy period is needed to allow for the wide range of findings

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that may emerge on the journey to a final selection decision, and is further demanded by the shortening tenures of CEOs.

Even where there are internal candidates that appear viable, there are three major blocks of activity for which time must be allowed:

- Defining the selection criteria, and assessing the internal candidates. This can take from one to three months, depending on the number of candidates and the range of information to be obtained on them.
- In addition, potentially, needing to see one or more of the preferred candidates in action in an expanded role. For example, if the preferred internal candidate is currently the CFO and has strong

strategic and intellectual skills but less proven skills in managing executives who have profit-and-loss responsibility, the Board (and the candidate) may wish to expand or change his or her role to develop and test these additional abilities.

As another example, the role of COO sometimes provides an appropriate opportunity to develop and appraise broader skills?. Overall, this step may add six to twelve months to the succession period, and the need for this is often not predictable prior to completion of the detailed assessment of the internal candidates.

- Even after these two steps, an external search may still be needed. This need may arise if the assessment of the internal candidates ultimately yields unsatisfactory results – or if the preferred candidate leaves the company unexpectedly. It may take six to nine months (or more) to find and engage a CEO from outside the business, particularly once a notice period is taken into account.

Time for an effective transition also needs to be built in. Prudent planning therefore allows a minimum of eighteen months prior to the intended succession.

2. Engage all stakeholders in sequence

A wide range of stakeholders have significant interests in the selection decision. These include, in approximate order of required engagement:

- The Board – seeking confidence in a successful CEO appointment and transition, less apprehension and mystery about the succession process, clarity about retention risks of the senior team, and more confidence in the robustness of the leadership pipeline.
- The Outgoing CEO – looking to assure his or her own legacy by pinpointing and testing the specific skills, competencies and experience that will enable the future leader to take the company to the next stage successfully.
- Members of the Top Management Team – individually, requiring reassurance that their own candidatures will be considered fairly, and collectively, hoping the Board selects the right person for the job in line with corporate aspirations and strategy. Especially if they are unsuccessful, they may expect that the Board's scrutiny of them will yield some sort of increased role or greater opportunity to develop.
- Shareholders – seeking assurance that the Board is rigorously managing this most critical company event and has oversight of the company's overall talent management process.

- The Incoming CEO – aiming to use the selection process to understand the Board's perspective of the company's challenges, opportunities, and challenges.

Effective preparation therefore includes an explicit communications plan that addresses each of these constituencies in turn?.

Crucially, the first of these stakeholders, the Board, must decide on the respective roles in the selection process of the Chairman, Board as a whole, Nominations Committee and the current CEO. Preferred practice sees the Board or subcommittee jointly drive this process with the CEO (48%), followed by the Board alone (32%), the Nominations Committee alone (14%), or the CEO alone (3%)⁶.

3. Define the criteria clearly

The next step is to define the selection criteria – driven by the company's strategy, and linked to a formal description of the CEO's role. The Board will need to recognise that there may be good reasons for these criteria and role descriptions to differ in some way from those relating to the role of the incumbent CEO. It is important that the Board avoids the trap of, "Bob was great – we need another Bob", and the Nominations Committee will typically have prime responsibility for this in partnership with the current CEO.

Research suggests this step of defining the role and criteria is crucial. It is by far the most powerful differentiator between successful and unsuccessful CEO selection decisions, and rated as the most important factor by directors involved in successions that were later deemed successful? Since there are many characteristics that would be 'nice to have' in any CEO (see text box – The ten personas of the CEO), crucial questions of focus typically arise such as, which criteria are the most important, given the company's strategy and foreseeable challenges over the next five years? Which criteria can we trade-off against others? What is the relative importance of knowledge, experience, skills? How far are we willing to trade-off cultural fit versus seasoned expertise?

In this context, the profiles of the existing members of the top team need to be factored in. Issues include the individual's strengths that could support a new CFO in specific areas, likely need for individual succession, and the aggregate need for the new CEO to forge a disparate team versus taking an already high performing team to new heights.

In working on this aspect of succession with our clients we typically start with our thoroughly researched and validated framework for leadership competencies, and work with the Board to home in on the five to six factors that will constitute the 'acid tests'.

The Ten Personas of the CEO

1. Grand Master of the Corporate Strategy
2. Chief Architect of the Corporate Structure
3. Vocal Exponent of the Corporate Values
4. Rigorous Shaper of the Talent Portfolio
5. Inspiring Forger of Exemplary Top Teamwork
6. Brahma-Creator; Vishnu-Maintainer;
Shiva-Destroyer
7. Scrutineer of Quality Customer Service
8. Executive Settler of Disputes and Resolver of
Dilemmas
9. Umbilical Cord to Chairman and Board
10. Fluent Spokesperson to the World

4. Explicitly decide on the mix of internal/external investigation

Although approximately 70% of CEOs are selected from inside the company, and 30% from outside, our experience suggests that even when a Board expects to select an internal candidate it will want at least some form of mapping or comparison against the external alternatives. And even when the Board starts with a strong presumption that the company has a strong internal candidate, an external candidate is ultimately selected in as many as 50% of cases.

The Board should therefore develop an explicit hypothesis on the mix of internally, versus externally focused work required, since this will inform important decisions such as:

- Which internal candidates to invite to participate into the process
- How to phase communications to the top management team
- How to position the assessment of the internal candidates – e.g. as purely for selection, or as a genuine mix of selection and personal development
- Whether the internal assessment should be undertaken by an executive search firm to effect a bridge into comparison with the external talent pool

- In how much detail to map out the external pools of talent, and which ones to consider

The decision on where the appropriate balance lies is typically a function of three considerations - the availability of viable internal candidates, the degree of change in the company's market, and the company's needs for turnaround versus rapid organic growth, etc.⁹

For example, if the company is performing well in an industry that is stable and there appears to be a single internal candidate, then the Board may favour what researchers have called a 'relay handover to heir apparent',¹⁰ and less work would be focused externally. On the other hand, the Board may be less sure that an internal candidate will prove able to meet the challenges of the future strategy, in which case earlier effort would need to be put into at least a confidential scan of the external alternatives.

In all cases, however, consideration of both internal and external talent is required. Crucially, the Board must also establish the 'departure risk' for each internal candidate, identifying both the circumstances which might cause the executive to leave the company if not selected as CEO – and more importantly the motivating factors that the Board can appeal to in encouraging the executive to stay.

5. Assess the candidates thoroughly

Recent research by Nohria and colleagues at Harvard Business School illustrates the huge impact of correctly identifying whether the CEO candidate fits the company's leadership needs.

In their sample, CEOs with a good fit generated abnormal positive returns to shareholders of 14.0% per annum over the first three years of their tenure. A poor fit resulted in negative returns in excess of 30%.¹¹ Boards sometimes rely exclusively on either in-house assessments, or ones conducted by external third parties – yet the best results come using the two approaches in combination.

At the heart of the assessment should lie a rigorous appraisal of the candidate's track record and abilities, against the agreed criteria. This is best accomplished through interviews that probe systematically how the candidate tackled specific challenges in the past (so-called behavioural event interviewing). A search firm that specialises in leadership assessment can be especially useful in benchmarking each candidate against the realistic alternative talent pool.

This information is then combined with that from other sources such as 360° feedback, internal reference taking, and potentially with external references from clients or customers, suppliers, and regulators. Given the challenges of corporate leadership, and the risks of derailment through emotional factors,¹² it is also valuable to gain psychometric insights and may be

appropriate to engage an industrial psychologist to assess more deeply factors such as motivation and resilience.

Finally, the candidates need to be assessed against the quality and clarity of their manifestos. There are several ways to do this, but the best route is often a presentation by the candidates to a selected panel of Board members on proposals for the company's strategy and culture.

To make an informed decision about next steps, the Board needs to complement the assessments of internal candidates with findings in two further areas:

- External candidates. As mentioned above, the Board typically will have commissioned an external scan for relevant external CEO talent, without yet having launched a full search. It will thus need to consider the desk research on external alternative candidates.
- Potential successors to internal candidates. The Board will typically want to know the knock on effects of selecting any internal candidate, in terms of the availability of executives to move up to the vacated role. In practice, this means having access to assessment data for several levels below the CEO.

6. Define the roadmap and development plans

Armed with this information on candidates, the Board will take stock and is usually faced with one of three scenarios:

- A qualified internal candidate exists. In this case the Board needs to plan the timing of the official decision and announcements, steps to retain the positive engagement of unsuccessful candidates, and the steps mentioned below under 'Plan support for the eventual transition'.
- Alternatively, there are one or more possible internal candidates, subject to confirmation of a specific skill area. In this more complex case the Board needs to define the relevant developmental and assessment steps for seeing the relevant candidates in action in a revised role.
- Or, the internal candidates do not meet the selection criteria. In this case an external search will clearly be required.

As the Board makes progress along one of these paths over subsequent weeks, it is important that related processes are linked in seamlessly – for example, having the Remuneration Committee stay alert to the possible need to fine-tune the compensation package for the intended CEO.

7. Plan support for the eventual transition

At some point the Board will have selected and hired the new CEO but the succession process still has one

further step – ensuring effective integration of the new CEO into the role.

Although statistical evidence is hard to come by, our observations suggest that the high turnover of CEOs in recent years owes as much to the challenges of their transition and integration into role as it does to any shortcomings in the process of selection.

The transition to the CEO role can be just as demanding for an internal candidate as for an external one – and indeed an externally-sourced CEO will usually have the advantage of having played the role before, whereas an internal one may not.

Transitional support needs to reflect the new CEO's agenda, which is likely to include:

- Building relationships 'upwards and outwards' – with the Board, with the financial markets and possibly with regulators and key clients
- Setting and energising the agenda for corporate strategy and cultural change, and deciding what linkages are needed to divisional or business unit strategies
- Building the top executive team, and more broadly establishing governance mechanisms and performance indicators, and a view of the company's top talent
- Re-tuning his or her personal effectiveness including prioritisation and delegation, and targets for quick wins

In the sometimes lonely role of CEO, the newcomer typically needs substantive support from a mentor within the company and/or an external coach, as he or she embarks on the intellectual and social journey of integration.

Longer-term action to support CEO succession

Over the longer term, the Board can be fully prepared for decisions relating to CEO succession only if it has a regular and thorough approach to reviewing the talent pipeline at senior levels within the company, and taking steps to foster development where needed. In brief, this requires:

1. Clear responsibilities. The CEO has explicit responsibility for identifying future successors to the CEO role and is expected to report on this at least annually and the Nominations Committee has explicit responsibility to ensure the Board remains informed about the talent pipeline more generally.
2. Talent reviews by Board. The Board reviews the senior executive group, person by person, at least once a year using inputs from line management, from HR and potentially from selective special reviews of executives.

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3. Special reviews. The Board ensures that the performance and recommended development of senior managers are analysed fully. GE's Session C13 is considered best practice, and includes every year selecting a different set of twenty to twenty-five leaders with potential for CEO or top functional roles, and then combining a particularly deep analysis of their historical development trajectory with their current performance and likely future potential, for presentation to the Board.

4. Rotation of senior executives. In reviewing the senior talent pipeline, the Board checks that executives are being stretched through new assignments – and particularly checks that executives are being rotated between divisions in sufficient number that a senior cadre with cross-divisional experience is developed, from which a realistic future CEO may emerge.

5. Board sight of senior executives. The Board's familiarity with individual executives is fostered by considered invitations to present to the Board, and extended by other formal and informal meetings – including for example visits to company sites or meetings with third parties.

Planning for the CEO's succession is one of the Board's primary responsibilities. If conducted well, it can create substantial market value – and if done poorly can destroy it. Longer-term, broader reviewing of the company's senior executive cadre and pipeline can support both the selection of the next CEO, and also the strategic growth of the company. ■

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CEOs over 20 years; figures ranged as high as 40% for hotels sector). Burson Marsteller. (2001). Building CEO Capital. Nearly 50% of a company's reputation is linked to CEO reputation (based on a survey of 1,155 business leaders in the US).

³ Centre for Economics and Business Research (cebr). An analysis of the impact of succession planning on the share price of FTSE 350 companies. (2005 research conducted for Investors in People.)

⁴ Bennett, Nathan and Miles, Stephen. (2006). Riding Shotgun: the Role of the COO. Stanford University Press.

⁵ Cohn, Jeffrey and Khurana, Rakesh. (May 2003). "How to Succeed at CEO Succession Planning". Directorship. Complemented by Heidrick & Struggles interviews.

⁶ Felton, Robert F. and Fritz, Pamela Keenan. (2005). "View from the Boardroom". McKinsey Quarterly. Based on a survey of 1,016 corporate directors.

⁷ Felton, Robert F. Op. cit.

⁸ Fortune 1000: proportions relatively stable over the period 1999-2003 at 63% internal, 37% external (according to Burson Mastellar and RHR International) FTSE 350 for 12 months to May 2005: 71% internal, 29% external (Heidrick & Struggles analysis).

⁹ Corporate Leadership Council. (October 2004). CEO Succession Planning Imperatives (Literature Review).

¹⁰ Zhang, Yan and Rajagopalan, Nandini. (2006). Grooming for the Top and Ending the CEO Succession Crisis. Organizational Dynamics, VOI25, No. 1, pp. 96 – 105.

¹¹ Groysberg, Boris, McLean, N. Andrew, and Nohria, Nitin. (May 2006). "Are leaders Portable?". Harvard Business Review. Research tracked in detail 20 former GE executives who had taken CEO roles in other companies. The abnormal returns quoted above are averages across four dimensions of potential fit.

¹² Lombardo, Michael M. and Eichinger, Robert W. (1989). Preventing Derailment – what to do before it's too late. Center for Creative Leadership Press. Hogan, Robert and Kaiser, Robert B. (2005). "What We Know About Leadership". Review of general psychology, vol. 9, no 2, pp. 169 – 180. "...the Board can be fully prepared for decisions relating to CEO succession only if it has a regular and thorough approach to reviewing the talent pipeline at senior levels within the company..."

¹³ Charan, Ram. (February 2005). "Ending the CEO Succession Crisis", Harvard Business Review. Describes in detail GE's process of every year selecting a different set of 20 to 25 leaders with potential for CEO or top functional roles and combining in-depth analysis of their historical development trajectory with their current performance and likely future potential, for presentation to the Board.

¹ From Heidrick & Struggles' internal research. For example, on the 2005 announcement of Mark Hurd's joining HP from NCR, HP's share price increased by 4% (\$4.6 billion) and NCR's] decreased by 5% (\$0.6 billion). Boeing's shares leapt 7% (\$3.9 billion) and 3M's slumped 10% (\$2.7 billion) on the 2005 announcement of McNerney's move. Our UK research of the 16 changes in CEO within the FTSE100 during 2005 shows that the market value change on announcement exceeds twice the daily fluctuation.

² "Tough at the Top". (23 October 2003). The Economist. Cites research by Nitin Nohria and colleagues at Harvard Business School that the leader accounts for 14% of a company's performance (based on examination of a group of companies that had an average of three