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THE $40 TRILLION SUCCESSION RISK

MOST BOARDS THINK IT'S HEDGED, BUT IT ISN'T

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Changing CEOs carries indisputable risk to shareholder value. Corporate boards should reframe their thinking about succession planning into risk-management terms. Mitigating this talent risk requires adhering to key tenets, including creating success profiles for top executives based on future strategy; using scientific assessments to measure candidates against the profile; developing bench strength; and keeping succession and talent on the board agenda.

The total market capitalization of the world's publically traded companies is approximately $40 trillion—shareholder value that is put at risk whenever companies transition to a new chief executive officer (CEO). And yet corporate boards are typically not preparing for, let alone truly managing, this risk.

The tales of abrupt or poorly handled CEO transitions decimating stock prices are legion. Such risk is unnecessary, but boards give CEO succession only a cursory level of attention, and their approach is mostly qualitative. CEO departures are no black swan; indeed, they are unavoidable. Nearly 10 percent of S&P 1500 companies lost their CEO yearly between 2007 and 2009 (see Figure 1).

Almost 25 percent of these vacancies at the top were filled by executives external to the company (see Figure 2). Why? In many cases boards are forced to go outside because internal candidates are not prepared to ascend—a situation that might have been avoided if rigorous succession processes for the entire C-suite had been in place.

Even at those 75 percent of companies that had internal promotions to CEO, a board should be asking whether those individuals were as prepared as possible when they stepped up. Some research has found that 40 percent of all new CEOs are fired or retired within eighteen months (Stoddard and Wyckoff 2009). Outside hires just lose their charm much more often: they are 6.7 times more likely to be dismissed than internally promoted CEOs (Zhang and Rajagopalan 2010). How much shareholder value might be lost or suboptimized by inadequately groomed or poorly chosen successors?

As with many forms of risk, boards believe they have properly hedged their talent risk right up until the moment they discover that they have not. According to a 2011 survey by the National Association of Corporate Directors, one-third of the largest public companies have no formal CEO succession plan at all, let alone one that covers the whole C-suite. Even of those that do, the methods commonly employed are subjective (if not outright biased), short on strategic analysis, and lack regular quarterly oversight.

Figure 1

CEO departures in the S&P 1500

Financial research firm Equilar tracked CEO changes between 2007 and 2009 and found that 381 companies changed CEOs over those years (Barrett 2011a), 48 of them more than once (Barrett 2011b).

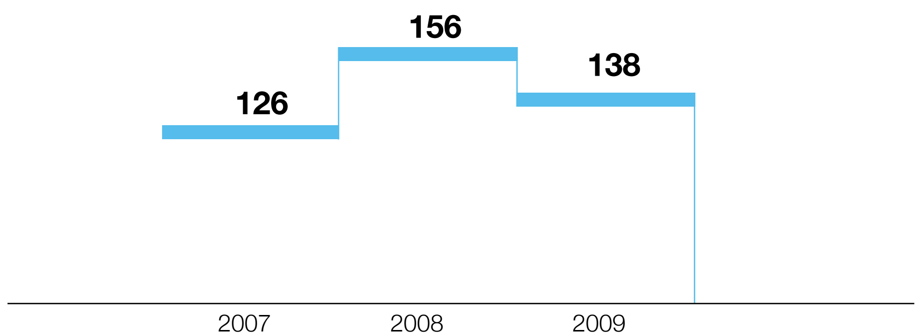
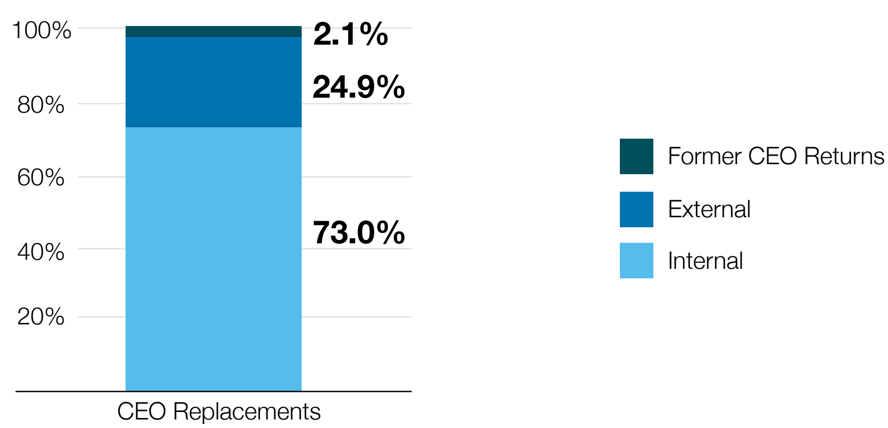


Figure 2

Internal vs. external CEO appointments

The CEOs who took the reins in Equilar's analysis of the S&P 1500 were primarily internally promoted, but nearly 25 percent came from outside (Barrett 2011a).



To determine whether C-suite talent risk is hedged, a board should ask itself three questions:

- Is the board leading succession planning down through the C-suite?
- Does the board have empirical assessment data on each succession candidate?
- Has the board outlined the experiences, capabilities, and competencies needed to achieve the company's future strategy?

If the answer to any of these questions is no, the board has not managed the talent risks inherent in the inevitable turnover of its senior management.

Starting from the future, strategically speaking

A few years ago, the board of a securities exchange was asked where it thought its next CEO would come from if it did not have an internal successor. The directors thoughtfully described several possible candidates from the capital markets—a good start. But, they were asked, why not someone from Google or Amazon?

Like so many boards, this one was basing its ideas on the current requirements of the role but it should be thinking about the competencies needed for future digital/electronic strategy. That's not to say that the next CEO needed to have a technology background, but just to point out how easy it is to limit one's thinking in dangerous ways. Boards should always build a CEO succession profile that takes future strategy into account.

And yet, there's also been a lack of process rigor and board alignment on strategic priorities. So no wonder it's hard for directors to weigh the readiness and appropriateness of multiple alternative successors for the future. Directors also want to avoid "horse races" and are discomfited by addressing the topic with the incumbent CEO, especially if the CEO is unwilling to confront his/her own mortality. That is why boards are best served by a succession strategy that is simply an extension of the company's ongoing talent development program.

Six steps to fully hedge succession risks

How then should the board blend its CEO selection and risk management responsibilities? Six tenets define the gold-standard succession plan.

Align the board on C-suite profiles that are sculpted to match the future business strategy. Most talent scorecards used to assess successors rely on the scope of candidates' work experience and their demonstrated ability to achieve results. And yet every director should know this truism: historical performance may not be indicative of future results. To gain insight into future talent results, boards need scientifically valid psychometric assessments. Among the attributes to be considered: approach to decision making, emotional strength, tolerance for ambiguity, personal values, and career motivations.

Boards should also measure levels of Learning Agility, the fusion of self-awareness, cognitive flexibility, resourcefulness, and interpersonal skills that is the best predictor of success after a promotion. Highly learning agile executives give an added measure of insurance: even if the strategy has to change, they are excellent at shifting gears and making adjustments on the fly.

Management's opinion of the individual's readiness can be taken into account, but boards need an assessment system to get at empirical and unbiased information. They need a framework and evaluation mechanisms.

Assess candidates against industry benchmarks. After gauging the talent the company has, a board should ask, "How do our people compare with relevant executives outside the company?" The board should be actively and regularly involved in discussions about the executive talent pool and also review a map of the internal leadership bench augmented with external candidate profiles. For the purposes of this process, the chief human resources officer should have a dotted line reporting responsibility to the chair of the nominating or compensation committee, just as the chief auditor reports to the audit committee chair.

In risk management terms, it's important to know where the company sits among its competitors for talent. The bench strength of leadership should be a regular agenda item, and boards should be as vigilant in assessing this risk as they are enterprise risk.

Think two to three moves ahead; don't just replace the incumbent. Developing the next CEO can take a decade. As it evaluates internal candidates, the board needs to consider how deep into the pipeline it knows the executives. Good risk management demands fully understanding the limits of one's knowledge.

By thinking at least two CEOs into the future, the company will have time to:

- Put succession candidates into stretch assignments.
- Enroll them in formal leadership development programs.
- Give them international assignments to gain valuable global experience.
- Expose them to both line and staff roles to broaden their knowledge across the matrix.
- Test their ability to succeed in new situations and grow or transform businesses.

None of that, however, can be done when facing a near-term need for the next CEO. Talent and leadership development is not a nice-to-have; it's the only way to hedge future leadership risks.

Develop C-suite successors with a mix of on-the-job training, intensive coaching, mentoring, and learning/education. There is an infrastructure—including assessments, performance reviews, key experiences, stretch assignments, feedback, and coaching—that can help ensure the readiness of internal candidates. The appropriate board subcommittee should review the developmental road map for each succession candidate to make sure he or she is exposed to the right mix of people, cultures, and business cycles—as well as put through some genuine challenges. Boards also should review the assignment of mentors and sponsors, and apply robust coaching when appropriate.

Names on a "talent depth chart" are simply not enough. Leadership development on the path up to the C-suite is the best way to increase the probability that a board will get its CEO succession right.

Become intimately familiar with the bench and its potential. The appropriate board subcommittee should be expected to have an in-depth view on talent, and supply the board's perspective on decisions on whom to develop and promote.

In a Fortune 500 company, if the development infrastructure and succession processes are state of the art, there should be generations of potential CEOs and C-suite executives identified. In smaller companies, this is harder so hedging the risk is more difficult.

Make succession a standing board agenda item. For the board to drive a disciplined C-suite succession process, it must exhibit its own discipline: it needs to keep talent on the board agenda and monitor progress and development plans closely. Maintaining succession as a routine topic also will make working with the CEO on succession less fraught.

Employing these six tenets, a board leaves little to chance.

In the world of risk management, people often focus on errors of commission—decisions that, after considering all the alternatives, still don't lead to success. But the most common and unforgivable mistake is an error of omission, when decisions are made without considering all the viable choices. A tight time frame may cause a good CEO candidate to be overlooked, but often succession errors of omission are simply the result of offhanded decision making.

C-suite succession planning attacks both of these risks with equal vigor. Omission is reduced by looking deep into the talent pool of each function for generations of C-suite leaders. Meantime, the rigor, alignment with strategic priorities, and the targeted development reduce the likelihood of making a poor choice.

Collectively, there is a $40 trillion reason why succession planning has to evolve. A more rigorous process prompts deeper analysis, longer term planning, and tough questioning from the board. That's precisely what a board is for.

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