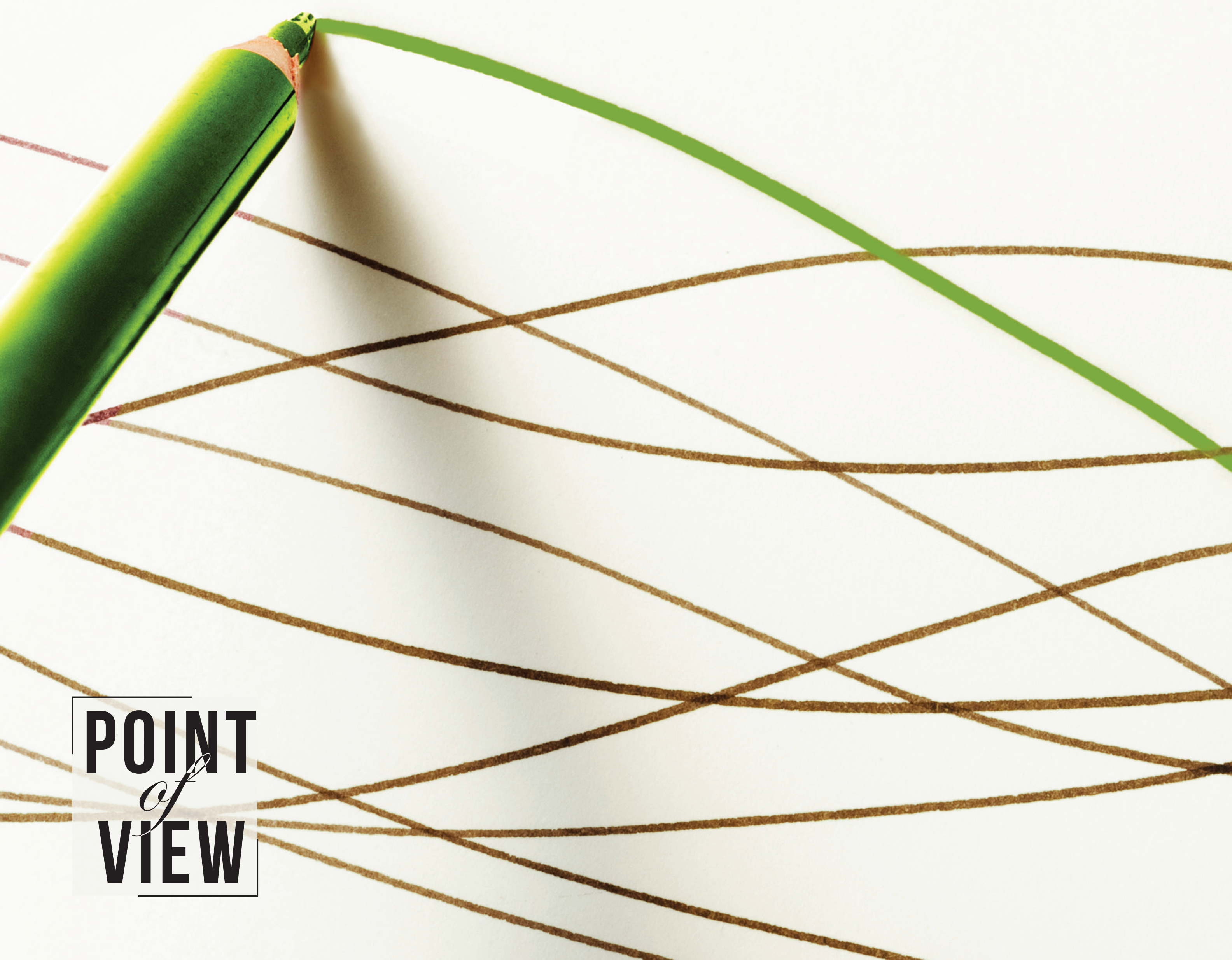
The Four Biggest Hidden CEO Succession Risks and How to Avoid Them



POINT *of* VIEW

Improving the Odds of Having a CEO-Ready Internal When the Time Comes

When it goes well, CEO succession planning produces a strong internal successor who, in the short term, is well-received by the organization and Wall Street and, in the long run, has the right vision and strategy for the business and drives the company to achieve above-market growth and shareholder value creation. Most boards strive for a best-in-class process that maximizes the future readiness of internal talent, aligns directors behind the ultimate selection and, of course, identifies the best candidate for the CEO role.

When the board manages a long-term well-executed process that results in a great internal successor, everyone feels good about the outcome. However, CEO succession planning can be fraught with hidden risks and challenging dynamics that, if not recognized and managed, can derail the process and destroy value.

Getting succession planning right is not a hypothetical consideration for most companies. Consider that, in the four-year period from 2012 to 2015, 74 percent of the new CEOs appointed to S&P 500 companies were promoted from within, an increase from 63 percent during the 2004-2007 period. And 91 percent of those CEOs had no prior CEO experience.

This article draws on an analysis of more than 100 CEO transitions in the past seven years and conversations with 25 chairmen, lead directors, and incoming and outgoing CEOs involved in recent CEO succession situations at companies with revenues ranging from $2 billion to $50 billion. The analysis reveals hidden succession risks and identifies the characteristics of the processes that achieve the best succession outcomes.

#1

Losing your best internal candidates

Losing a strong internal succession candidate is a greater risk than many boards appreciate. You should assume that the strongest internal candidates frequently receive calls about opportunities at other companies. When they trust the succession process and timeline, they don't take recruiter calls — but that can change abruptly. All too often, the CEO and board do not know enough about what's on the minds of these executives. There can be many reasons why a leading internal candidate might begin to mistrust the process. Insiders often have too little transparency into the succession process and the relative roles of the board and CEO in developing and selecting the CEO successor. But the turning point for many is a comment (often off-hand) from the CEO suggesting a change in the timeline. A casual comment about "staying a year longer" can be enough to create uncertainty.

Don't leave potential insider candidates with a lack of clarity about the succession process and general timeline, or certainty about their value to the organization. One of the most important things the board can do is to establish an open line of communication with potential successors. This begins by creating opportunities for executives to interact with the board directly. The stated purpose of these interactions is simply to ensure the board gets to know key leaders and that the leaders get to know the directors. The CEO should make this happen by suggesting recurring check-ins, which should occur more often as a CEO transition approaches, in conjunction with each board meeting, for example.

Because some CEOs can be sensitive to the board wanting to meet directly with potential successors, which can make them feel like a lame duck, it is safest and most natural to focus the conversations on the business or function the executive is leading today, and individual development plans. For example, it can be effective to have a director spend a day with an executive reviewing the business or addressing the team, which provides a platform for a more natural interaction outside of the formal board meeting environment. This is your opportunity to let the executive know how much the board values him or her. If you create a safe environment and build a strong relationship, the executive will feel comfortable sharing his or her plans and concerns.

> "I had not been taking calls for years, but then after the CEO mentioned he might stay a couple more years, I started taking calls. It only lasted two days, and then, by chance, I ran into the lead director in the office. He told me how much the board appreciated my impact and, when I asked, he assured me that the timeline was not changing as far as the board was concerned. Fortunately we had this conversation before I got a call for a great CEO role."
>
> Internal CEO successor

Board engagement with internal candidates can provide an additional benefit as the succession process nears its conclusion: When the board has been actively engaged with internal candidates and garnered their trust during the process, it will be in a stronger position to approach the runner-ups after the selection about their future plans. Every CEO transition carries the risk that executives who are critical to the success of the business will leave the company, especially if they vied unsuccessfully for the CEO role. When the lines of communication have been open, directors can have authentic conversations with runners-up about their value to the company, increasing the chance that they will be willing to stay.

#2

Overlooking the best internal options

Boards have a very narrow window of observation on internal candidates. As a result, internals are often pigeonholed — force fit into a simple narrative. For example, the strong operator with weak communication skills may be viewed as insufficiently strategic. This kind of generalization is natural given the limited information available to the board. If an executive does not make a great impression in the limited interactions with the board, lacks charisma or is not the best verbal communicator, directors have a hard time seeing that person as a viable CEO successor. In fact, we have seen cases where the board (and the CEO) were enamored of a very polished, charismatic leader, whom they assumed to be more strategic, and discounted a less charismatic leader's track record of consistently outpacing the industry as, "He can handle slow change and incremental growth, but he is not strategic enough to handle all the change that lies ahead for us."

> "The board does not have enough insight to select internal candidates. They just don't have it. They come in once a quarter for one-and-a-half days. There is no way to know insiders through the board's typical interactions with insiders."
>
> Outgoing CEO

In other situations, boards fail to entertain the high-potential candidate at the next level down. We have seen many situations where a more junior executive with enormous potential has been promoted to the CEO role and outperformed the company's peer group. This is only possible when boards are willing to cast the net wide enough to consider executives who have more potential over the long term but require more development time. A longer process provides the time to uncover and develop these "unexpected" candidates, allowing the board to get to know them and become more comfortable with promoting the next-generation leader into the CEO role.

Internal CEO Successors

136 were promoted from within the company over four years

91% were first-time CEOs

47% were promoted from the chief operating officer role

24% were promoted from division CEO

8% were promoted from the chief financial officer role

42% served on a public company board before becoming CEO

Source: Spencer Stuart study of internal CEO successors in S&P 500 companies from 2012 through Q3 2015.

The remedy for these risks is a formal executive assessment of potential internal successors, ideally by a credible and objective outside third party. A formal assessment should provide a baseline understanding of insiders' capabilities, developmental gaps and potential long before a decision needs to be made. Assessments of executives should include a review of their track records leveraging strategic and operational capabilities similar to what the next CEO will need, as well as their ability to stretch into the more complex, demanding and ambiguous CEO role. From there, executives can be provided specific development opportunities and support. Many companies find it useful to tap an outside expert who can establish an appropriate process for a specific set of development needs. Boards should be aware of the biases that can form about internal candidates — assuming a stellar operator isn't a strategic thinker, for example — and challenge themselves to be specific about the development needs and action plans for the key internals, observe their growth over time, and be open to new narratives about individuals.

#3

Insufficient time to close the developmental gaps of internal candidates

When boards do not have a good handle on the timing of the CEO's retirement plan or a strong sense of the internal succession candidates, they can find themselves in a bind when the CEO's departure is rapidly approaching. It's a frustrating scenario for boards: The CEO plans to retire in less than a year and assessments reveal significant gaps in the top contender's capabilities or experience, or the board simply does not feel comfortable with the readiness of internal candidates to step into the top role. This can happen when the CEO gets ahead of the board, honing in on a particular succession candidate, when the board and CEO disagree about the strength of that internal candidate or when the process did not start soon enough to provide sufficient time to identify and address the development needs of internal candidates. It also can be the result of the unexpected emergence of an activist who forces an accelerated CEO transition. When internal candidates have "unfixable" weaknesses or lack the time to address developmental needs in time for the transition, it increases the likelihood that the board will have to look externally.

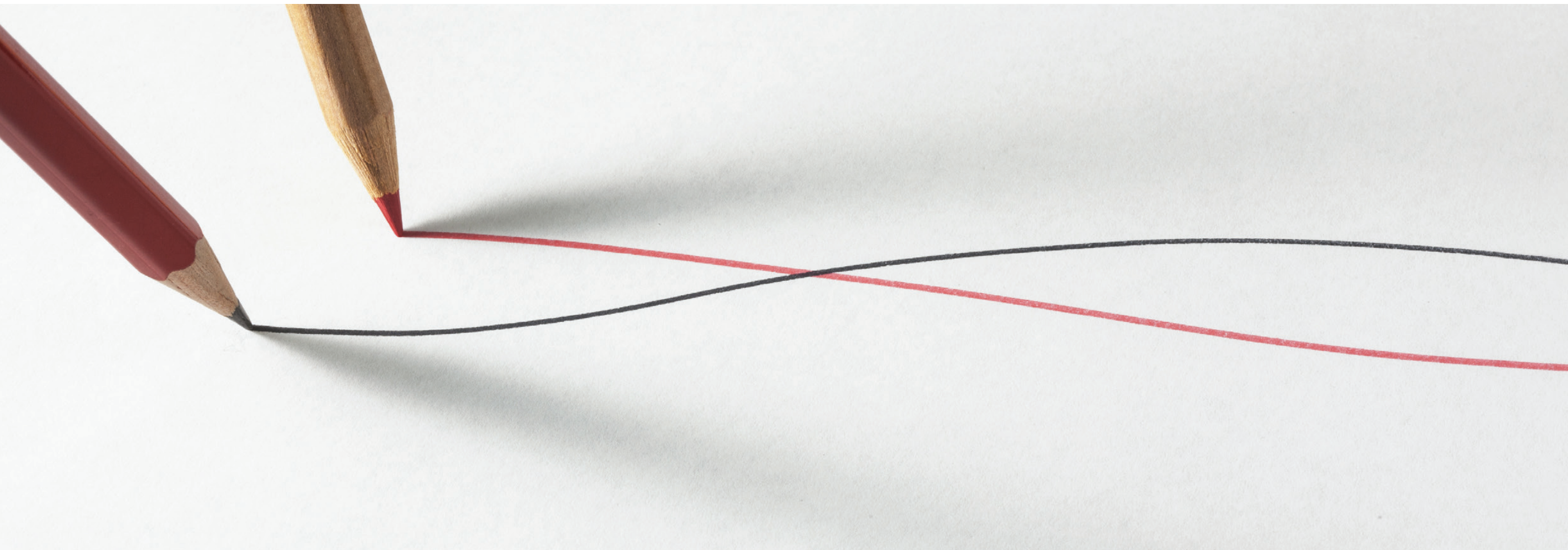
> "We had a sense at some point the CEO planned to retire, but the announcement was abrupt, lacking in forethought and transition planning. We'd had conversations about potential successors, but the board hadn't engaged in a way it should have. When the CEO made his announcement, we were in disarray."
>
> Lead director

Again, starting the process early is critical. Conducting formal assessments of internal candidates early provides high-potential internal talent the time they need to develop; potential successors may need to be assigned to new roles to gain experience, and prove that they can be stretched. Potential successors are much more likely to be ready if development plans are set early and are based on a clear understanding of individuals' strengths and gaps, and the board has a chance to observe progress against goals. A minimum of one year is required to make meaningful and sustained progress in key developmental areas, and even more time is needed to close gaps in experience.

It also is valuable for directors to deepen their understanding of the external talent market. Confidential external benchmarking — which identifies outside talent that might be considered for the CEO role, typically without contacting those individuals — can provide directors with a good sense of the relative strength of the internal candidates, and help them see any experience gaps more clearly. In short, external benchmarking is another step in the process that boards should take when evaluating CEO succession candidates in order to feel comfortable that they are making the right decision.

An internal succession candidate rarely will be entirely ready, but the board will be much more comfortable betting on the individual's continued progress if directors have seen growth and a sense of his or her trajectory over a longer development period. By monitoring executives' progress on an ongoing basis, the board can observe patterns of performance and develop a more nuanced point of view on their strengths and weaknesses. When this is the case, boards tend to be much more aligned as a group and are more confident that they are making the best decision. This is critical to the next CEO, who will inevitably hit rough patches. The next CEO deserves to have a board that is aligned behind him or her.

> "I have found that the idea of promoting from within can be tough for the board because directors are looking at candidates who have never done the job before. Many directors are instinctively disposed to getting someone who already has been a CEO. An objective process that gets directors to focus on the real factors that will drive success helps build consensus among directors."
>
> Board chair



BOARDS KNOW THEY SHOULD START EARLY, SO WHY DO THEY WAIT?

Boards today understand that they are responsible for CEO succession and, when companies are performing well, want to oversee a strong succession process that produces an internal successor who is ready to move into the top role. This does not mean that boards find it easy to initiate discussions about succession with the CEO.

For many directors, there never seems to be a good time to raise the issue. In high-performing companies, boards can be reluctant to raise the topic for fear of signaling to the CEO that it wants a change at the top. Paradoxically, in under-performing companies, directors often want to avoid rocking the boat and causing the CEO to worry about his or her job security at a sensitive time. Sometimes, the board just wants the current CEO to stay in the job longer. As one CEO recalled, "I had to convince my board that I was leaving. I kept telling them, but they did not act on it." In addition, boards sometimes avoid raising the topic of succession because they want to be respectful of the CEO's role in developing leadership talent.

Ironically, the least awkward time to start the conversation about succession may be shortly after a new CEO takes over, although this rarely happens, even among the most enlightened boards. However, several directors voiced strong support for starting succession planning in a new CEO's first year; the board and CEO have a fiduciary responsibility to address enterprise risk, and few risks are more important to the business than CEO turnover.

> "I know we should start the process now, but we are all too fatigued from the most recent succession process."
>
> Lead director

At a minimum, the board should own the succession transition two to three years before an anticipated transition. If the board hasn't started succession planning, it can ease some of the tension surrounding the issue if the initial conversation with the CEO focuses on the emergency/contingency plan — the "name in the envelope" in case of an unexpected health or family emergency. From there, it can be easier to extend the discussion to the CEO's timeline, making clear the expectation that the CEO will inform the board of his or her plans two or three years in advance to allow for an orderly succession plan.

As the transition nears, the board and CEO will want to define a more concrete time line for succession. The CEO should be encouraged to shift his or her mindset from "what am I leaving" to "what am I building" and think in terms of the legacy left by preparing the next CEO and handing over the reins at the right time, and this includes making room for the development of succession candidates.

#4

A bumpy handoff and slow start for the new CEO

Even boards that manage an effective succession planning process resulting in the promotion of an internal successor sometimes "wing" the actual transition between the departing and new CEOs. The immediate transition can involve a wide range of activities: communicating with a variety of stakeholders, developing a transition plan for the outgoing CEO, negotiating compensation for the new CEO, meeting SEC reporting requirements, and planning retention strategies for non-selected candidates and other key management players. In one succession situation in which we were involved, the successful internal CEO candidate was encouraged to develop plans for three phases of the transition: before the announcement was made, between the announcement and taking over the role, and after becoming CEO, focusing on four stakeholder groups — investors, customers, suppliers and employees.

Without an engaged board to provide guidance, the outgoing CEO may become too hands on — interfering with the transition or acting out in other ways as the organization pivots to the new leader — or too hands off, not providing the necessary support to the new CEO. The board can be invaluable in advising the outgoing CEO to play an appropriate role in the transition and coaching the incoming CEO through the initial transition period.

> "As opposed to a big bang, we had a gradual transition of responsibilities. We developed a matrix of what was changing and shared it with the senior leadership team so they knew what to expect."
>
> Internal CEO successor

Avoiding the succession risks

CEO succession represents a critical turning point for companies when tremendous value can be created or destroyed. Furthermore, succession planning is complicated, requiring the board to manage through the complexity and risk of the decision and the different ways in which events may unfold over time. Succession planning also can be a highly personal and charged topic, particularly for the CEO. Part of the board's role is to diffuse these issues and minimize the emotion of the process.

When done right, directors have maximized the chance that the company will have a ready internal successor; made a great decision about the next CEO; and fully aligned behind the next CEO. But without a thoughtful plan, there are big risks, some obvious, others hidden, suggesting three main themes for the board.

1. Start early and review the plan regularly. In the best processes, objective, third-party assessments of internal talent occur early enough to provide candidates time to develop and the board time to build a fuller, more nuanced view of internal players. The board should review the plan and candidates' progress at least once annually.
2. Build and maintain trust in the process. Once they have been through it, directors often remark on the power of the succession process to align the board around the strategic direction of the business, the capabilities needed in the next CEO and in the ultimate CEO successor. This only happens when the board oversees an effective, transparent process, ensures that the stakeholders understand the process and maintains an open line of communication with internal candidates.
3. Remain vigilant even after a decision is made. The board should stay involved in the CEO transition to ensure the incoming CEO establishes a clear plan for the early days of the transition and that it is executed in a disciplined manner. The board also should make sure that the outgoing CEO provides the necessary support to the new CEO without seeming to interfere.

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