

# CEO succession: making the right choices

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A study of CEO transitions in FTSE 150 companies.

## About Spencer Stuart

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## About the authors

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Ever since the Cadbury Report advocated the separation of powers at the top of UK companies, the role and influence of the chairman has been steadily growing. One of the most important tasks for the chairman is deciding when, and how, to replace the CEO. More often than not the board chairman also chairs the nomination committee, which is responsible for managing the CEO succession process on behalf of the board.

Boards have long recognised the value that a robust succession planning process brings to the continuity and long-term health of the business. But for succession planning to be truly effective, chairmen need a more sophisticated understanding about the age-old question of whether to go for an insider or bring someone in from outside the organisation.

Commentators, and indeed boards themselves, are inclined to generalise about the value of outsiders or the benefits of internal succession. Thinking seems to go in cycles and whichever preference is being advanced at the time, a few examples are usually provided to illustrate the prevailing point of view.

We felt that more evidence-based research was needed. In order to give boards proper guidance, we also sought to identify some key principles (based on this evidence) that should underpin any thoughtful and objective leadership succession process. We conducted a detailed study of the CEO transitions occurring within the current list of FTSE 150 companies between 2004 and 2008. Over the five-year period of our study, 60 per cent of the CEO appointments were insiders and 30 per cent were outsiders. The rest were mostly former executives or board members.

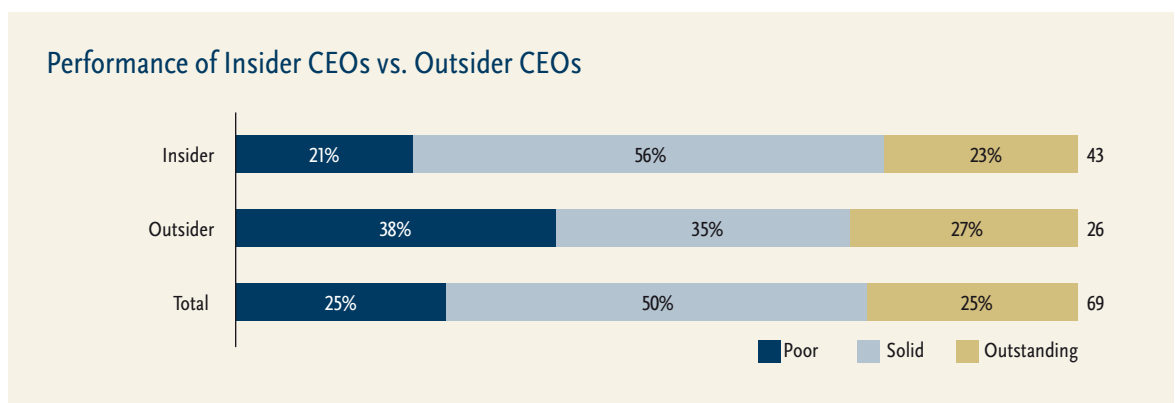
The results of our UK research contain a number of surprises. Most significantly, they show that a blanket declaration that either insiders or outsiders as a group are the best way forward is no longer sufficient — a more specific approach is needed.

Our analysis shows that there is no clear performance advantage between insiders and outsiders — performers in the highest and lowest quartiles came from each category. That is not to say, however, that it did not matter whether a company chose a CEO from the inside or outside. The health, stability and competitive position of the company at the time of transition were the critical factors in determining whether an insider or an outsider was the best choice.

### The overall performance of insider vs. outside CEOs

The performance of outsider CEOs has carried more risk of poor performance, but also delivered more return. When taken as a whole, outsiders were more likely to be in the lower quartile of performers, but they were also more likely, than insiders, to be among the top performers.

Insider CEOs have a significantly lower rate of bottom-quartile performance, but they also have a lower rate of top-quartile performance. Insider CEOs are far more likely to put in a solid performance (middle quartile) than outsider CEOs: 56% vs. 35% (see the chart below).



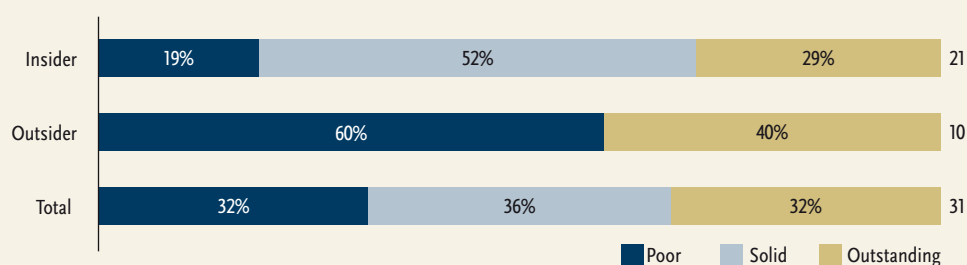
### The condition of the company

The condition of the company when the leadership transition takes place appears to be a primary determinant of the optimum source of candidate.

Insiders perform more consistently when their companies are in a healthy state at the time of appointment, whereas outsiders perform better when the company is in some form of crisis. This may sound intuitive, but the point is not well understood and has surprised many boards with whom we have shared the data.

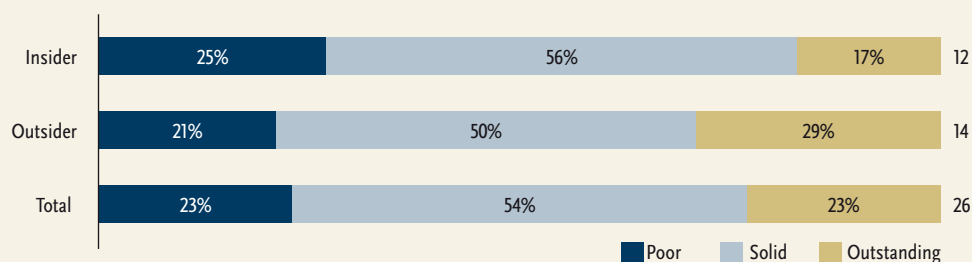
Our study found that insiders were appointed more frequently than outsiders to stable or rapidly growing companies. In these instances, 29 per cent achieved outstanding performance, 52 per cent performed solidly and only 19 per cent of CEOs could be classified as performing poorly. By contrast, the performance of outsiders coming in to lead healthy companies is far more polarised: 40 per cent achieved outstanding results — a higher proportion than insiders — but 60 per cent performed poorly. Although some outsiders do succeed when coming in to lead healthy companies, plenty do not.

#### CEO performance at healthy companies (stable and rapidly growing)



The risks attached to appointing an outsider to a stable and growing company appear, therefore, to be significant, as the chart above shows.

#### CEO performance at “challenged” companies



Although insiders were just as likely as outsiders to be appointed to challenged companies, the evidence shows that outsiders have out-performed their insider counterparts when taking over the reins of a troubled company (see chart on previous page).

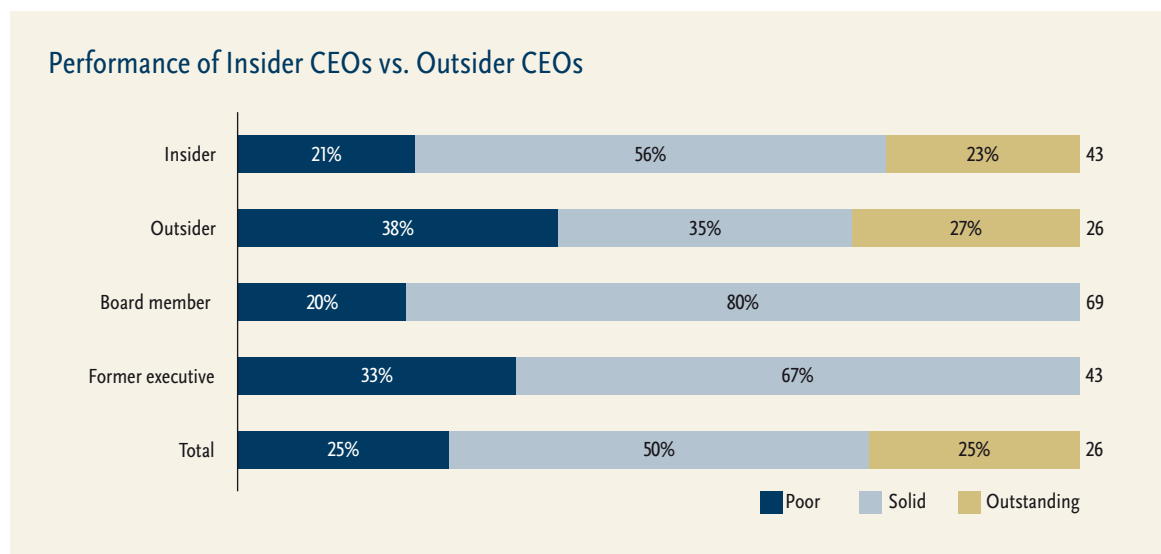
Why do insiders perform better at healthy companies? A number of factors are at play. For internal succession to be effective, there must be a strong pipeline of talent in the organisation. Healthy companies are more likely to attract first-rate talent, providing the board with a broader choice of quality candidates with the potential to become CEO. More resources are often available for the development of senior management and greater effort is sometimes given to fast-tracking high-potential executives. Likewise, the board will have more time to focus on the development of likely CEO successors if they are not in crisis mode. One of the most valuable aspects of a contender's development is gaining experience as a non-executive director on the board of another company; boards should be encouraging this whenever possible. The strong culture of a healthy company may be an impediment for an outsider who will need to spend time carefully getting the measure of the organization before having the chance to make an impact. Besides, if there is no burning platform for change, outsiders may encounter organisational resistance to change and a lack of enthusiasm for the incoming CEO's agenda.

The leadership challenges facing troubled or challenged companies are quite different. The data clearly shows that outsiders are more likely to excel and outperform insiders at companies that are in crisis; their risk of failure is also lower. Whereas insiders are more likely to be locked in to a problem culture, outsiders have more freedom to impose change on the organisation; indeed they are expected to do so. What's more, internal candidates have developed relationships throughout the organisation over many years and this can make it extremely difficult for them to make unpopular decisions and drive the transformation that is needed when they become CEO.

## Board members and former executives

Non-executive directors who took over as CEOs have proven, for the most part, to be a safe pair of hands. Their performance was rarely spectacular, but they were less likely than any other group to perform poorly. CEOs who have already served as directors are sensitive to the board dynamics and bring considerable knowledge of the company to the post. Unfettered by the normal concerns of an insider, they are better placed to make the difficult decisions.

Former executives can also bring the combined benefits of an insider and an outsider. They have deeper knowledge of the company than an outsider and will have gained experience elsewhere at the top level that will prove equally valuable. However, there may be limiting perceptions from within the business about a former executive's ability that may hinder his or her effectiveness. The chart below shows the relative performance of all the CEOs in our study, showing each of the four categories — insider, outsider, board member and former executive.



### The fifth category: “insider-outsiders”

There is one further category of CEO that needs to be considered, on the strength of compelling evidence from our US study. We refer to this group as “insider-outsiders” — outsiders hired into companies in a senior leadership capacity (for example as chief operating officer) who are then promoted to CEO, usually within 18 months.

There were not enough cases in the UK of insider-outsiders to enable us to reach firm conclusions. However, in the US we were able to analyse multiple instances of both categories, and the results were fascinating.

In our US study, insider-outsiders turned out to be the worst-performing CEOs. While in theory it makes sense to bring in an executive for a defined period, allowing them time to get acquainted with the business and its people, this approach often creates pitfalls for the new leader. The succession candidate has to serve under the incumbent CEO, while simultaneously being scrutinised for his or her ability to take over the position. In order to become CEO, the candidate needs to embrace what the current CEO is doing, which may create difficulties when he or she takes over and wants to bring about change. Deferring to the CEO is also necessary to gain the approval of board, another possible area of compromise. Our analysis of ten insider-outsider CEOs appointed in the US between 2004 and 2008 found that none of them achieved top-quartile performance.



## What this study tells us about succession planning

Contrary to the received wisdom about CEO candidate selection, our research indicates that criteria related to candidates' age, where they went to university, the number of degrees they hold or whether they began their career at a blue-chip company were unhelpful in predicting candidate performance. Practical matters, such as the need to relocate or commute, were also poor indicators of a candidate's likely success. Our recommendation is that boards should remove these factors from consideration in assessing prospective CEOs, since there is no evidence that they correlate with performance to any significant degree.

In our view, the most important factor to be taken into account when deciding which type of CEO candidate to select is the health of the company. Insiders are best when the company is performing well; outsiders do better when the company is in crisis. Boards that consider carefully both the evidence we have presented and the reasons we cite for variations in performance will greatly improve their chances overseeing a successful CEO transition.

CEO selection will always be part art, part science. The process of selecting a new CEO always relies to some extent on intuition, but we hope that our data can help guide boards' choices and provide further rigour to the succession planning process.

### Our methodology

We examined CEO transitions at FTSE 150 companies over the five-year period from 2004 to 2008. During this time, 97 new CEOs were appointed. We excluded 20 transitions, either because the company went public during the period in question, there was an interim appointment, or there was a change in governance structure (for example, the roles of chairman and CEO splitting). We then completed a detailed case study for each of the remaining 77 transitions.

We evaluated each CEO transition using a combination of quantitative and qualitative measures. We looked at more than 25 variables, including the condition of the company at the time of hire; the industry sector; whether the new leader had any previous experience as a CEO; his or her functional experience; exposure to a listed company board; and the number of direct reports replaced by the CEO in the first year.

We chose several quantitative measures for evaluating the company's performance during the new CEO's tenure: shareholder returns compared with peer-group companies and the market as a whole, revenue growth, and profit growth.

On the qualitative side, we used a combination of publicly available information and interviews to ascertain other aspects of company performance, such as the company's reputation, achievements in innovation, and how the board assessed the CEO's performance.

We then ranked each CEO, whose performance fell into one of four quartiles: the top quartile of CEOs were "outstanding," the middle two were "solid," and the bottom-quartile CEOs were "poor."

Earlier in 2010, Spencer Stuart had conducted a similar study in the US, which examined the 300 CEO appointments at S&P 500 companies during the same period. Interestingly, the average annual turnover of CEOs during the period was similar: 12 per cent of the S&P 500 and 13 per cent of the FTSE 150.

The results of our US study were published in the November edition of the Harvard Business Review as an article by James M. Citrin and Dayton Ogden titled Succeeding at Succession.



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