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Leadership Development

The High Cost of Poor Succession Planning

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LEADERSHIP DEVELOPMENT

The High Cost of Poor Succession Planning

A better way to find your next CEO

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LEADERSHIP
DEVELOPMENT

In August 2013, Steve Ballmer abruptly announced that he would step down as chief executive of Microsoft as soon as his replacement could be found. Thus began one of the most important CEO searches in the past decade—and a case study in the dos and don'ts of senior leadership succession.

At the time Microsoft was the third-most-profitable company in the United States and the fourth most valuable. Nevertheless, this well-respected global technology giant didn't seem to have a plan for replacing Ballmer, even though he had, according to most informed observers, underperformed for years. (Critics cite his slow move into mobile, social media, and video along with ill-fated acquisitions and product reboots.) While a few high-profile executives, such as Windows chief Steven Sinofsky and Xbox head Don Mattrick, had jumped ship during his tenure—another sign of trouble—with a workforce of 100,000, Microsoft surely could have identified other promising candidates in senior management roles, not to mention outsiders, who'd be ready to step in for Ballmer.

Instead, Microsoft seemed to start from square one, concentrating mostly on external candidates. According to the director who chaired the search committee, the board cast a wide net across a number of industries and skill sets, identified more than 100 candidates, talked with several dozen, and then focused intensely on about 20. Among them was Steve Mollenkopf, the COO of Qualcomm, who fell out of contention when he was promoted to that company's top job. Alan Mulally, who had just turned around Ford and was the favorite candidate, took his name off the list in January—at which point the press described Microsoft's board as turning to Plan B.

Finally, in February, six months after Ballmer had declared himself a lame duck, Microsoft announced that an insider, Satya Nadella, would become the third CEO in its history.

We know now that despite that bumbling succession process, Nadella was a terrific pick. He moved Microsoft away from fiefdoms and a "know-it-all" culture and toward a more open, collaborative "learn-it-all" one; built up the cloud-computing business; made Office available on all smartphones; and executed dozens of accretive acquisitions, including the purchase of LinkedIn. In his first nine months as CEO, Microsoft's stock rose 30%, increasing its market value by $90 billion. As we write this, seven years into his tenure, it is the world's second-most-valuable company.

But what if Microsoft hadn't promoted Nadella? What if its hastily put together, extremely broad, and externally focused search had resulted in the hiring of an outsider? What if Mulally, who had no tech sector experience, had been appointed? Why hadn't the board already been grooming Nadella—a 21-year veteran of the company with clear leadership competence, cultural fit, and expertise in

ABOUT THE ART

Balint Alovits's project Time Machine *explores Budapest's Bauhaus and art deco spiral staircases, using perspective and the repetition of form to evoke a sense of infinity.*

IDEA IN BRIEF

THE PROBLEM

Many large companies fail to pay adequate attention to their top-level leadership pipelines and succession processes, which results in excessive turnover and significant value destruction for companies and investment portfolios.

THE RESEARCH

Analysis suggests that the market value wiped out by badly managed CEO and C-suite transitions in the S&P 1500 alone is close to $1 trillion a year. Better succession planning could, by contrast, help the large-cap U.S. equity market add a full point to the 4% to 5% annual gains Wall Street projects for it.

THE ADVICE

Companies—and especially their directors—must plan leadership changes before they're needed, identify and develop rising stars, give them access to the board, look at both internal and external candidates, and partner cautiously with executive search firms.

up-and-coming areas of technology—or any of his similarly qualified peers?

While Microsoft did make the right decision in the end, its lack of planning could have led to a costly disaster.

Like Microsoft, many large companies fail to pay adequate attention to their leadership pipelines and succession processes. And most of them don't get as lucky as Microsoft did. In our combined nine decades of experience in executive search and talent development (Claudio), professional investment (Carrie), and management and financial research (Gregory), we've seen flawed succession practices lead to excessive turnover among senior executives and, in the end, significant value destruction for companies and investment portfolios.

In our recent research we've attempted to quantify those costs. According to our analysis, the amount of market value wiped out by badly managed CEO and C-suite transitions in the S&P 1500 is close to *$1 trillion* a year. We estimate that better succession planning could help the large-cap U.S. equity market add a full point to the 4% to 5% annual gains that Wall Street projects for it. In other words, company valuations and investor returns would be 20% to 25% higher.

In this article we'll examine those findings and then make recommendations for how to significantly improve corporate performance and investor returns through better practices for grooming and selecting CEOs. Of course, these lessons can apply to succession planning for other key senior management roles as well.

QUANTIFYING THE PROBLEM

In our opinion large companies' excessive tendency to hire leaders from outside is one of the biggest problems with succession practices. This propensity incurs three major kinds of costs: underperformance at companies that hire ill-suited external CEOs, the loss of intellectual capital in the C-suites of the organizations that executives leave behind, and for those companies promoting from within, the lower performance of ill-prepared successors.

A landmark study that Rakesh Khurana and Nitin Nohria of Harvard Business School conducted years ago sheds light on the first kind of cost. Khurana and Nohria examined the impact that different types of CEO succession had on operating returns in 200 organizations over a 15-year period. They compared four scenarios: (1) an insider promoted in a firm doing reasonably well; (2) an insider promoted in a firm doing poorly; (3) an outsider hired in a firm doing reasonably well; and (4) an outsider hired in a firm doing poorly. They found that, on average, insiders didn't significantly change their company's performance. That makes sense: Similar people working in similar ways at the same company will produce similar results. With outsiders, the change was much more extreme. In the infrequent cases when a company was doing very poorly, outsiders added great value, on average. But at companies doing reasonably well, outsiders destroyed massive value. This suggested that companies looking for a new CEO should hire external candidates only in exceptional cases, when a major turnaround or cultural change is called for.

Other research has confirmed that external hiring usually doesn't deliver on its promise. For example, Matthew Bidwell of the Wharton School of Business found that while outsiders often appear to have better experience and education than insiders do, they are paid more, perform worse, and have higher exit rates. Additional studies support that: One by Cláudia Custódio, Miguel Ferreira, and Pedro Matos showed that external CEO hires were paid 15% more than internal hires, on average; and one by Sam Allgood and Kathleen Farrell revealed that CEOs brought in from the outside have an 84% greater chance of turnover than insiders in the first three years, usually for poor performance.

Another recent study found that companies often choose outsiders because they have already served as CEOs elsewhere—indicating the firms value previous experience in the role over insiders' potential to excel. But that experience rarely guaranteed success: When the researchers looked at S&P 500 CEOs who had led more than one company, they found that 70% had generated better performance the first time around.

Despite those downsides, S&P 1500 companies hired their CEOs from outside 26% of the time from 2014 to 2018, according to ExecuComp data—perhaps because, as Wharton's Peter Cappelli has found, companies have an irrational bias toward exciting and unblemished external hires whom they know less about.

We wanted to investigate how external CEOs performed relative to what insiders might have done in the same positions. Without the ability to rewind time and play out

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different scenarios, that would seem impossible to do. However, we believe that with statistics, we can predict what would have happened with different CEO hires.

We used a technique known as structural self-selection modeling (SSSM), directly derived from Nobel Prize winner James Heckman's research. It is similar to the multiple regression modeling that companies frequently employ in forecasting and scenario-planning exercises. We first identified 80 independent variables, including firm characteristics (like size and capital expenditures), sector, risk, board structure, and short- and long-term performance before and after a change in CEOs. The performance metric we used was cash-flow return on assets, which unlike operating return on assets accounts for the reorg and restructuring costs that are frequent following the arrival of an outsider CEO.

We then looked at every instance in which an outsider CEO was hired to lead a public U.S. firm over a 17-year period and calculated the change in cash-flow return on assets for his or her tenure. We plugged the 80 independent variables for each of those companies into the SSSM to create a "counterfactual": what the expected change in cash-flow return on assets would have been if the company had promoted an insider. We found that only 39% of outside hires would have done better than a theoretical inside hire.

Of course, nobody knows in advance what the performance of any appointed executive will be. But boards should base consequential and risky hiring decisions on their best estimate of future outcomes. Our analysis shows that in only 7.2% of instances will an outside CEO hire have a 60% chance of outperforming an insider, and in a mere 2.8% of cases will he or she have a 90% chance of outperforming an insider.

Dramatic as those figures are, they tell only part of the story. One key knock-on effect of external choices for CEO and other senior positions is the loss of intellectual capital in the C-suites of the firms those executives were hired from. And because on average executives perform worse at the company they jump to, the negative impact on the entire market is even greater. We can calculate the effect that loss of intellectual capital has on market valuations by both analyzing the impact of sudden CEO departures and using the economic model provided by Hanno Lustig, Chad Syverson, and Stijn Van Nieuwerburgh to track how much intellectual capital a departing manager can transfer to his or her next employer.

Our analysis shows that the decrease in intellectual capital at new executives' previous employers leads to a 0.7 percentage point reduction in total shareholder returns for the S&P 1500, or $255 billion, each year. When we add in the underperformance at the firms hiring external CEOs, total shareholder returns fall by about another half a percentage point, costing investors an additional $182 billion. The final impact, where companies do promote CEOs from within but fail to properly prepare them to take over, costs an additional 0.3 percentage point, bringing the total loss across the S&P 1500 portfolio to $546 billion. To calculate the third cost, we drew from a study of 2,900 companies done by Olubunmi Faleye of Northeastern University, which found that the return on assets of firms with poorly prepared internal CEO successors is significantly lower than that of firms that properly prepared them. A simple extrapolation of these findings to global equity markets, collectively worth about $58 trillion at the time of this writing, implies that the total annual costs to global shareholders would amount to $870 billion. This global estimate is probably conservative, given that governance, succession, and talent practices usually are significantly better in the United States than in most other countries. We're currently extending our analysis to other major equity markets to try to confirm it.

Another negative by-product of poor succession planning and excessive outside hiring is rising CEO compensation as companies compete for the same top executives. *Financier Worldwide* reported that at the top 350 U.S. companies, average CEO pay had climbed to $17 million in 2018, or about 278 times a typical employee's compensation. From 1978 to 2018, CEO pay had jumped by more than 1,000%, while the average worker's pay had risen just 12%. Though those figures are shocking, our analysis shows that skyrocketing CEO compensation actually plays only a small role in value destruction. The main costs of ill-considered successions remain poor performance by outsider CEOs, loss of C-suite intellectual capital at the firms that CEOs and other top executives leave behind, and ill-prepared internally promoted executives.

One final note: We intentionally focused this analysis on large firms because we believe that's where the problem of poor succession at the top is most acute. Small firms usually lack a deep talent pool, so they can be better served by hiring CEOs from the outside.

LEADERSHIP DEVELOPMENT

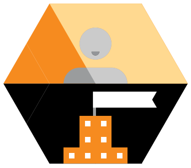
IMPLEMENTING SOLUTIONS

Why are some of the world's biggest and most powerful organizations getting CEO appointments so wrong? For five main reasons: lack of attention to succession, poor leadership development, suboptimal board composition, lazy hiring practices, and conflicted search firms. Here are some recommendations for fixing those problems.

Plan succession well before you think you need to. According to PwC's latest *Strategy&* "CEO Success" study, in 2018 turnover among CEOs at the world's largest 2,500 companies reached nearly 18%—the highest rate PwC had ever tallied. A disturbing 20% of those departing CEOs were forced out, and for the first time in the study's history, more CEOs were dismissed for ethical lapses than for financial performance or conflicts with their boards. Looking forward, we suspect that unanticipated CEO turnover will continue to rise because of the growing attention to moral issues (such as sexual harassment) and industry and market volatility.

Despite this trend, boards continue to be caught off guard because they haven't spent enough time developing talent and mapping out possible lines of succession. Some believe that having a casual "if the CEO gets hit by a bus tomorrow" plan, which picks a replacement but doesn't prepare or vet that person or weigh alternatives, is enough. It is not. Others delegate succession planning to the CEO, which is an equally unacceptable abnegation of duty. For instance, we know of a major company, valued at hundreds of billions of dollars, with a CEO in his late sixties who has been unwilling to properly develop any potential replacements. Unfortunately, because the firm's recent results and stock market performance have been good, board members are afraid to confront him.

Succession planning should start the moment a new CEO is appointed. Take Ajay Banga, the former chief executive and current chairman of Mastercard: He began discussing when he might cede the CEO role to a successor even as he was interviewing for the job himself. The process should remain robust, with directors constantly monitoring and if need be adjusting the pipeline. If there isn't already a potential successor among the CEO's direct reports, the board should look to the next level and consider advancement and development opportunities that will help executives there progress. If that level is empty, directors can promote or hire high potentials into it or the C-suite. While hiring externally



is usually not ideal, it's much less risky to do it at a lower level than in the top job.

Purposefully identify and develop your rising stars. By now most directors know the attributes and skills that senior executives need. At the leadership advisory firm Egon Zehnder, where one of us (Claudio) worked for three decades, the list used for CEO searches includes intelligence and values. The firm also assesses candidates on strategic orientation, market insight, results focus, and customer impact, and their competence at collaborating with and influencing others, organizational development, leading teams, and change management. Meaningful succession planning calls for finding rising managers who either have the right levels of all those capabilities or, more likely, the potential to develop them. Four critical traits—curiosity, insight, engagement, and determination—signal potential, and with the proper coaching and support, people who demonstrate them can be groomed for high-level positions. (For more on this subject, see "Turning Potential into Success: The Missing Link in Leadership Development," HBR, November–December 2017.)

One important development area for any CEO is emotional intelligence, which encompasses flexibility, adaptability, self-control, and relationship management. You might think that those soft skills would be more challenging to learn than hard ones such as calculus or coding. But as Richard Boyatzis of the Weatherhead School of Management has conclusively demonstrated, people can pick up these crucial leadership competencies even as adults.

Another way for boards to help potential successors get ready is to insist that they be given challenging rotations and stretch assignments, as was common at General Electric in its glory days and is practiced with great success at Unilever and McKinsey today. When you expose your highest potentials to new geographies, businesses, situations, and functions, you can become a leadership factory.

Appoint the most promising executives to the board—or give them more access to it. In the United States, in part because of regulatory mandates following executive malfeasance at Enron, Tyco, and other companies, most large companies' boards have become fully independent, with the CEO as the only employee director. Faleye found that the proportion of U.S. boards set up this way exploded from about a third in 1998 to more than two-thirds in 2011. Our analysis shows that the percentage of fully independent boards has continued to increase, rising to 76% by 2018.

While there are clear benefits to getting oversight and advice from outside experts, we believe independent boards are less equipped to manage CEO succession. With so little exposure to internal up-and-comers but extensive knowledge of potential external hires from their own organizations and other board experiences, directors are understandably more likely to favor outside CEO candidates or be unduly influenced by individual opinions. As one veteran director recently told us, "It's scary to see how little insight boards have about top internal executives these days; a lot of the views are painted, either too positively or too negatively, by the sitting CEO."

We believe that boards should make room for one to three executives who are potential successors to the CEO. Not only does that allow directors to see likely candidates in action, but it better prepares those individuals to take on the top job. When Faleye compared the performance of internally promoted CEOs who had prior director experience against that of insiders who lacked it, he saw that during their first two years the CEOs with board experience had an average return on assets that was 12.5 percentage points higher. Interestingly, this massive difference disappeared during year three, suggesting that while both types of executives had similar levels of competence and potential, the exposure to strategic board-level discussions as well as the relationships established with directors drastically flattened learning curves.

Indra Nooyi, for example, joined PepsiCo's board when she was the company's CFO—five years before becoming its CEO. Watching her firsthand, the board became confident in her competence and potential and, after her appointment as CEO, was more open to her plans to radically transform the company by expanding its portfolio beyond sugary drinks and steering it toward greater social responsibility. During Nooyi's tenure as CEO, PepsiCo's net profit increased 122%.

If you have too many directors already or too many promising potential CEO successors in your ranks, an alternative (though suboptimal) approach is to ask your rising stars to frequently attend and present at board meetings. This will improve their exposure, contributions, and development. Before the pandemic, good boards ran dedicated off-sites or group trips where directors and top executives, and even their spouses, could connect professionally and

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personally. As boards get back into their rhythms post-Covid, we hope that such in-person social interaction will resume. For further development, you might also encourage some of your most likely successors to selectively join other companies' boards.

Look at internal and external candidates. The best practice is to carefully outline your ideal CEO profile and then look both inside and outside for the person who best matches that description. While we believe that every company should first master the art of spotting internal talent and create succession plans based on its current roster, we also see value in external searches for benchmarking and comprehensiveness. (And so do companies like Mastercard, PepsiCo, P&G, and American Express.) Research from the Center for Creative Leadership has consistently shown that when companies consider wide pools of insiders and outsiders, executive appointments are more successful. Whether you're shopping for a house or for your next top executive, comparative evaluations produce better decisions.

Make sure to conduct thorough assessments of all candidates, even the insiders who are well known to the board. Consider not who has performed the best until now but who is ready to meet the future challenges of the CEO role and has the potential to continue adapting in a volatile, uncertain, chaotic, and ambiguous world. Judge everyone against your job specs, grill candidates in well-structured interviews, and conduct in-depth reference checks. This is the only way to avoid appointing the wrong people to the job.

If you partner with search consultants, avoid the usual perverse incentives. Executive search firms can usually add great value to succession efforts. Consultants with the right training and experience can identify the competencies that each senior position requires, get more out of interviews and reference checks, and distinguish potentially great performers from the rest. Such consultants also tend to have trusting relationships with candidates, sources, and references.

However, the search profession as a whole still probably hurts as much as it helps, owing to two blatantly perverse incentives: the contingency arrangement and the percentage fee. Most search consultants are compensated when they produce a hire, regardless of that person's fitness for the job or origin. They make no money on inside hires, who don't need to be found and brought in. Traditionally, search consultants are paid a third of the new executive's annual cash compensation (salary plus bonus). As a result, whether consciously or unconsciously, many oversell high-priced outsiders and shoot down internal alternatives. The solution is to swap the percentage fee with a prearranged fixed fee that's based on the importance of the position and the complexity of the search and to replace the contingency fee with a retainer so that the consultant is paid the same no matter who is appointed. (Of course, the retainer fee makes financial sense only if you're planning to use the consultant for enough search and advisory work to justify the cost.)

Even if you have those two things right, you should still use search consultants only in special situations—for example, if your internal candidates are unsuitable, you can't identify or access appropriate external candidates on your own, or your company is entering a new business, region, or period of strategic change. Then approach the selection of your consultant as you would any other people decision: Ask for recommendations, consider multiple firms, and check references. Once you've developed a short list, meet the recruiters in person to get a read on their relevant experience, as well as their level of professionalism, candor, and concern.

COMPANIES AND INSTITUTIONS must do a better job of getting CEO succession right—their organizations, their industries, and their market returns depend on it. We hope this article helps senior executives, directors, and investors recognize the magnitude of the problem and act accordingly. Microsoft shouldn't have required a long and public search to conclude that Nadella was the right leader to get the company back on track after Ballmer's years of struggle. It should have already had him—and even other potential successors—waiting in the wings. How many rising stars like Nadella do you have at your company—and what can you do tomorrow to put them on a path to becoming your next (and ideally best ever) CEO?

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