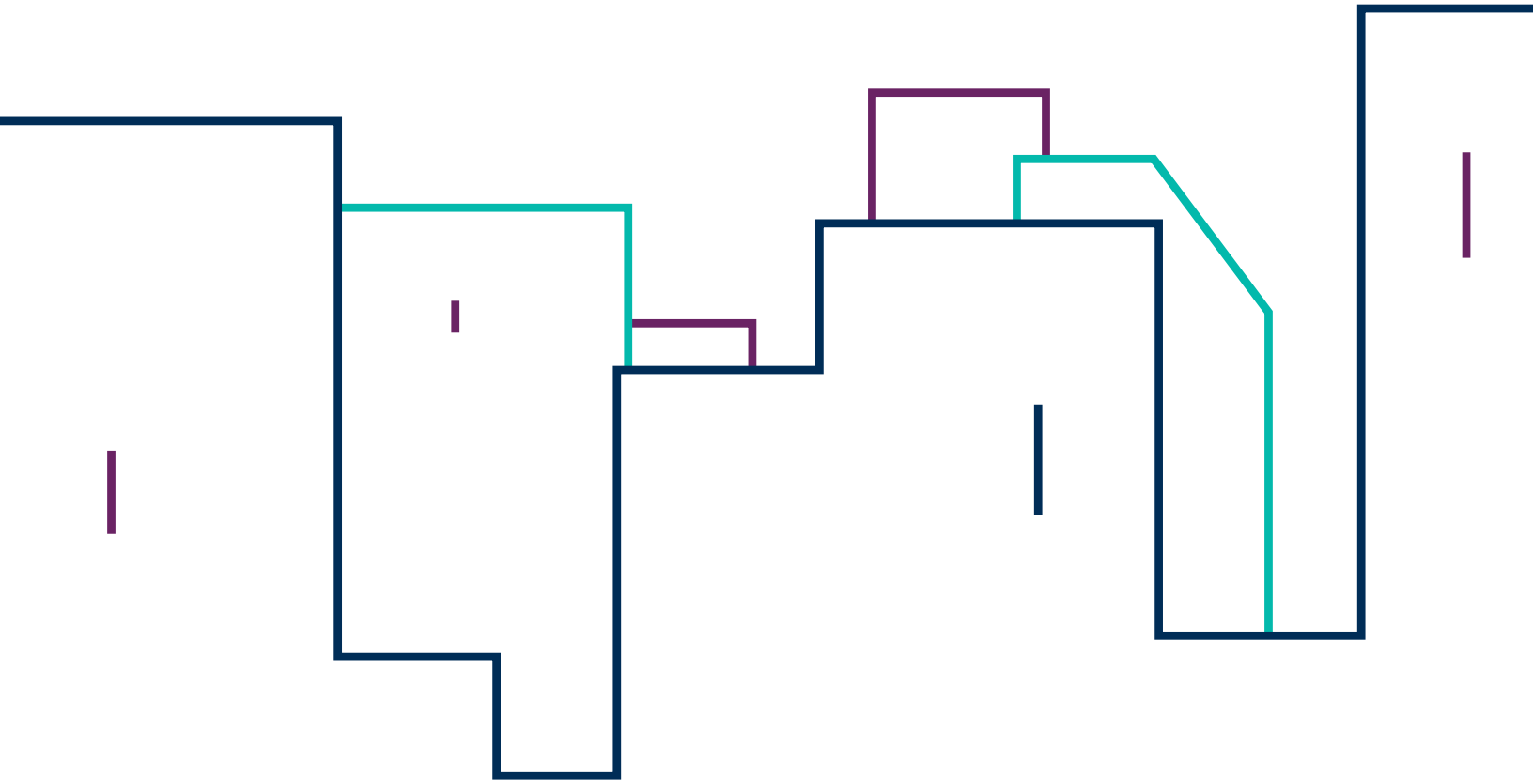
CEO Transitions: Mitigating Risks and Accelerating Value Creation



Russell Reynolds ASSOCIATES

CEO transitions have always been challenging, but never more so than in today's environment. As a board governance, leadership consulting and search firm, Russell Reynolds Associates is asked regularly to conduct CEO searches and support long-term CEO succession planning. We advise our clients not to forget about transition planning as a distinct process that needs attention and planning. We use succession planning and transition planning to describe different phases of a leadership transfer. Succession planning is first and includes the steps related to defining the success criteria, as well as the critical work related to identifying, assessing and developing potential CEO candidates. Transition planning encompasses the decision on which candidate to select (while it may not yet be formally announced) and the steps related to role transfer from the outgoing to the incoming CEO.

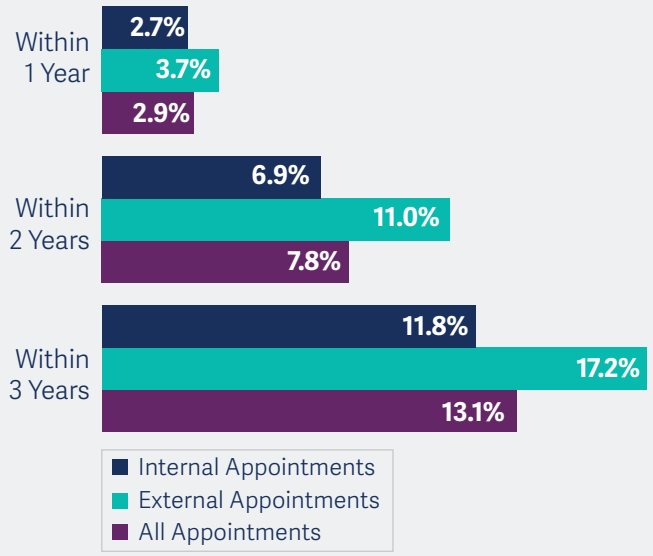
To gain a sharper sense of the challenge posed by CEO successions and transitions, as well as the risk involved, Russell Reynolds reviewed the member companies of the S&P 500 (as of August 1, 2018) and analyzed their CEO tenure and turnover rates between Jan. 1, 2003, and Dec. 31, 2015.[1] Across these 500 companies, there were 688 CEO transitions over that 12-year period, with 40 percent of the firms experiencing two or more CEO transitions.

While the average departing S&P 500 CEO had a tenure of 5.9 years during that period, a surprising number of CEOs departed quickly: Fully 13.1 percent of new CEOs leave in under three years, with more than half of them leaving in less than two. Given the cost and investment in CEO appointments, these are expensive misses. When looking at just external CEO appointments, the numbers jump to a 17.2 percent departure rate in three years and 11.0 percent within two years—a notable rate of failure. These are not untested leaders or unsophisticated enterprises. These appointments were the product of the succession and onboarding processes used by some of the world's largest and most successful companies. Yet, almost one in seven CEOs failed to be around for the third anniversary of their appointment.

The root causes for these departures varied. RRA looked at each transition and its circumstances to determine if it was planned or unplanned. In our research, we considered a range of disparate factors. A small number were related to a change in personal circumstances for the CEO. Some departures were the result of mergers and acquisitions, and a few were for bigger opportunities for the CEO. Unfortunately, a large number seemed to be due to the new CEO being unsuccessful or ineffective and being removed by the board (sometimes due to activism). On occasion, these are portrayed to the public as a decision to retire, but some circumstances and company performance would indicate otherwise.

Departure Rates for Newly-Appointed CEOs

All CEOs Appointed to Current Members of the S&P 500, 2003-2015



n=688 CEO transitions
Source: RRA reviewed every CEO transition occurring between 1 January 2003 and 31 December 2015 at all current members of the S&P 500 (as of August 2018).

Of course, early CEO departures carry real financial consequences and lost opportunities. According to a 2015 study by PwC Strategy&, "Companies that have to fire their CEO forgo an average of $1.8 billion in shareholder value compared with companies that [have a succession] plan, regardless of whether the replacement is an insider or outsider." The study also noted that companies that experienced unplanned successions "would have generated, on average, an estimated $112 billion more in market value in the year before and the year after their turnover if their CEO succession had been the result of planning."

According to Michelle Edkins, global head of Investment Stewardship at BlackRock (the world's largest asset manager), "Deliberate and thoughtful planning for CEO succession is one of the board's most important responsibilities. Unexpected CEO departures will happen. But poor planning for and process around

[1] RRA looked at CEO service only through the end of 2015 in order to provide an adequate window of time to gauge the volume of early departures for those appointed recently. We reviewed and considered the circumstances around each transition to look at success and failure of the CEO.

CEO succession have significant potential to impact long-term performance and destroy shareholder value." We do not see boards placing enough emphasis on CEO transition planning, which, done well, should help reduce the failure rate of CEO appointments, particularly of external appointments. Boards should reconsider their approach to long-term succession planning and include a more deliberate process around transitions to reduce unexpected CEO departures and potential value destruction.

A Different Approach: Thoughtful, Disciplined and Tailored

Any CEO succession and departure introduces inherent risks to the company and its shareholders. Combined with a less-than-thoughtful CEO transition, it increases the risks to shareholders. A thoughtful CEO transition presents an opportunity to get the new CEO quickly up to speed and focused on issues that will enhance shareholder value. As Ron Williams, former chairman and CEO of Aetna Inc., noted, "Actively managing the CEO transition is prudent risk management. It is well known that leadership transitions can be a challenging and risky time for a company or any large organization." Thoughtful succession and transition plans can increase a new CEO's understanding of the company and its strengths and weaknesses, reducing the chances the new CEO will fail.

A new CEO must quickly develop relationships with numerous key constituencies in an environment defined by uncertainty and anxiety. This is true even when the CEO is an internal successor: The company's strategic intent may remain largely unaltered, but style and expectations change from leader to leader. When done well, CEO transition planning engages the organization's stakeholders and proactively alleviates potential areas of stress, keeping the top team focused on the business and on value creation.

This paper will examine how to establish a transition management process that sets up the new leader and institution for success and protects the company from becoming another cautionary tale about failed CEO transitions.

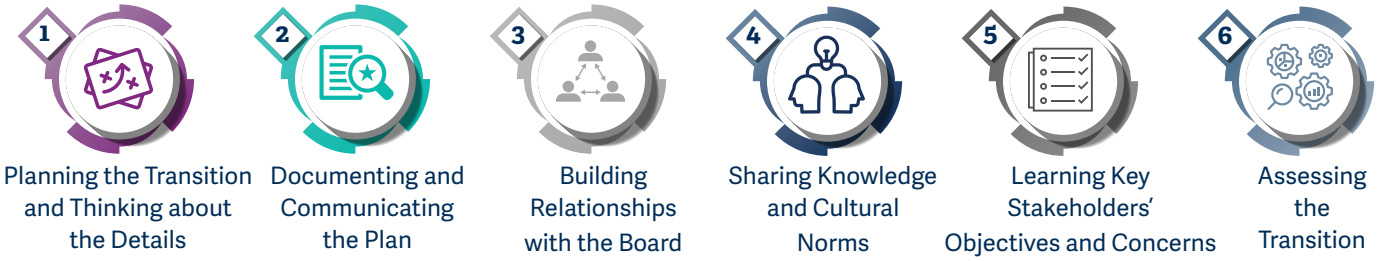
Long-Term CEO Succession Planning, before the Transition

Our experience has proven, time and time again, the importance of boards preparing CEO and executive succession plans thoughtfully, systematically and well in advance of a specific CEO transition. In the last decade, we have seen greater emphasis by boards on thoughtful, analytical CEO succession planning, and in the last five years, external advisors have developed and refined predictive assessment tools to help ensure better candidate selection. These efforts should produce better results around CEO candidate selection in the coming years.

Proper CEO succession planning for a leadership change begins four or five years before one is anticipated. This effort starts with the board regularly engaging the sitting CEO around long-term succession planning, starting early in his or her tenure. The board should ask how the current CEO and the CHRO are identifying and developing the best internal candidates, as well as the strength of the overall bench. As part of their fiduciary obligation, boards should benchmark their internal candidates against external candidates to better understand the internal candidates' strengths and weaknesses.

Eventually, the time will come to begin the formal transition process. Assuming an orderly evaluation and selection process, boards (particularly the chairman or lead independent director) can guide and support the new CEO as they prepare to move into the new role. Whether they are promoted from within or hired from outside, incoming CEOs will benefit tremendously from an orderly and thoughtful plan that the board encourages and reviews. As Ryan Marshall, CEO of PulteGroup Inc., noted, "Rising from an executive role to the CEO role challenges you to take accountability for things that were not part of previous roles. Having a roadmap of the key constituents and issues along with insights into how to manage them was invaluable."

Ideally, the formal transition process begins nine to 12 months in advance of the expected transition date. While there is no one-size-fits-all approach, we recommend that the incoming and outgoing CEO build the plan together and review it with the board. Many CEO transitions are an afterthought and not well planned, with CEOs and boards not adequately focusing on the framework or documenting a plan. By contrast, we have found that well-thought-out transition processes are generally comprised of six phases but should be refined to fit the specific circumstances.



Phase 1: Planning the Transition and Thinking about the Details

Working with the incoming and outgoing CEOs, a process owner (e.g., general counsel, CHRO or trusted external advisor) should develop a strawman transition plan to reflect priority areas. The plan should include a clearly defined sequence of meetings, decisions and communications to make the transition as smooth and transparent as reasonably possible.

For external successors, it is important, where possible, for the outgoing CEO and the new leader to have a roadmap for meetings and knowledge transfer between them, a process which takes planning given that the new leader is not yet part of the organization.

For internal successors, creating the detailed transition plan is a good opportunity for the new CEO to begin thinking about changes to how the company is organized and led. For an external successor, it is a good opportunity to make early observations about the organization's executive talent. The critical parties (CEOs and board leadership) need to agree on an orderly transfer of roles and responsibilities, as well as on the resolution of the numerous issues that will inevitably arise during the transition. If the departing CEO will be staying on as executive chairman, that role must be clearly defined—and limited—to ensure that the board and everyone at the company truly see the new CEO as the "full CEO." In these circumstances, it is helpful for both leaders to agree on a mutually defined set of roles and responsibilities, which are reviewed and approved by the board. Additionally, we find that it is very important that the executive chairman (former CEO), the lead independent director and the new CEO align around how they will work together and organize themselves regarding key issues such as agenda setting, CEO feedback and engagement with independent directors. As many people in this situation have noted, there is a there is a lot of room for confusion and dropping the ball.

Phase 2: Documenting and Communicating the Plan

Next, the transition process and decisions should be memorialized and communicated throughout the organization. It is an iterative process. During transitions, the leaders a level or two below the CEO often feel the greatest anxiety. The possibility for confusion most often occurs during drawn-out transitions or when the former CEO remains as executive chairman without a clearly defined role completely separate from that of the new CEO.

A clear communication of the process, roles and responsibilities will demonstrate stability and thoughtfulness to senior leaders and other stakeholders. Senior leaders should be included as appropriate while the plan is finalized to ensure clarity and senior executive buy-in. Communication of the transition plan should be as transparent as reasonably possible and provide a well-defined management framework to reduce uncertainty.

Phase 3: Building Relationships with the Board

Institutional investors have increased their expectations of boards, and directors have responded. Boards are more active on behalf of shareholders, and the relationship between board and CEO is more dynamic and engaged than ever before.

To succeed, any new CEO must understand and engage with the board as a whole, as well as build or maintain strong relationships with each individual board member. If the new CEO is an internal candidate(s), starting 18 to 24 months before the transition, the potential internal CEO candidates should enjoy increasing visibility in board meetings as well as an increase in the scope and nature of their participation. Post announcement and increasingly closer to the transition, there should be an agreed-upon schedule for the new CEO to assume his or her board responsibilities. Also, there should be

opportunities for the outgoing CEO (and board chair) to coach the incoming CEO regarding the boardroom norms and expectations.

It is also important that the new CEO build strong ties with each individual director. The new CEO should meet with each director one-to-one to understand their views and develop relationships with them as individuals. This is wise even if the incoming CEO already has relationships with many members, as his or her role and its associated expectations will be changing. Board members have an equal responsibility to be candid with the new CEO and accept a new style and some degree of related change in boardroom dynamics.

"Internal candidates have the benefit of often knowing the board members, but the downside is that they're often typecast by their prior position," said Kevin Clark, CEO of Aptiv (formerly Delphi Automotive). "As the CFO, they knew me in one capacity. When I became CEO, I had to purposefully engage with them individually and collectively so they could begin to know me in a different capacity."

For an external candidate, such an extended grooming period is not possible. It is critical that the departing CEO or lead director begins working with the new CEO as soon as the announcement is made. Whether the incoming CEO is an external or internal choice, the departing CEO should serve as a coach for the new leader, providing guidance on building a productive relationship with the board.

Phase 4: Sharing Knowledge and Cultural Norms

The next phase of a transition calls for the outgoing CEO to share knowledge with the new CEO about important organizational relationships and the institution's cultural attributes. This is especially critical when the CEO is selected from the outside to ensure that she or he avoids early missteps due to a lack of cultural familiarity. Knowledge transfer is equally important for an internal successor, who will be working with new constituencies.

To succeed, a transition plan must include developing a deep understanding of the company's goals, strategy and the formal and informal elements of its culture. Therefore, the outgoing and incoming CEO should have a series of discussions focused on the business and competitive environment, the strategy, the organization, its culture and its people—particularly the executive talent. Any new CEO must learn to appreciate board members' expectations as well as the board's operating style. An external leader needs to know the history of the company culture and "the way things are done around here." At the appropriate point, selected members of the executive team should be included in the knowledge transfer process through individual meetings.

Phase 5: Learning Key Stakeholders' Objectives and Concerns

At the appropriate time, the new CEO should engage the company's broader leadership group and key stakeholders and understand their perspectives. In addition to the board, the new CEO should meet with the company leaders and members of the investment community to develop a thorough appreciation of the company's issues and stakeholders' concerns. Some organizations have engaged an outside party to conduct the interviews, synthesize the results and prepare the new leader for stakeholder meetings. The interviews can also serve as a vehicle for delivering key message signals to essential constituents—among the most important being that the new leader listens to and values outside perspectives. Bill Nash, CEO of CarMax, noted, "It was very helpful for Tom [the former CEO] and me to visit the stakeholders [externally and internally] and explain the motives for the transition. It gave them comfort that the succession was a thoughtful process."

Careful planning should be devoted to building relationships with important stakeholders such as institutional investors and regulators. Most internally promoted successors have not had enough substantive interaction with the investor community. Ideally, there should be increasing visibility about one year ahead of the expected transition (although this can be complicated when there are multiple internal candidates). The existing CEO can play an important role by personally introducing the new leader to important constituents and helping them create—or redefine—their stature in the organization. Nash further noted, "I grew up inside this company, but when I became CEO, I recognized that the role required a different mindset. I reprioritized how I spent my time and focused on building relationships that would have the greatest impact for our organization."

Phase 6: Assessing the Transition

The last element of a successful transition entails assessment of its progress and the identification of any potential problems so that they may be resolved quickly. An effective assessment method must candidly and comprehensively evaluate each aspect of the transition. It should also provide a roadmap for addressing any concerns that arise, with all parties committed to working through any disagreements.

Conclusion

Boards that get successions right can ensure a smooth transition of power with minimal disruption to the business, while those that slip up may lose momentum or even stumble. The key to a successful transition is disciplined and thoughtful planning. Although no two transitions will follow the exact same path, the process overview and issues discussed in this article represent important considerations when building a responsible transition plan. Done thoughtfully and systematically, a CEO transition creates value for the organization, reduces risk and enables the new leader to hit the ground running and create immediate value for the company and for shareholders.

The Executive Chairman: The Importance of Clarity

To ensure an effective transition, the outgoing CEO, incoming CEO and board members must all understand and agree on their roles in the transition plan, including the extent—and limits—of their authority and accountability. One of the most challenging issues they will have to work through is whether or not the departing CEO stays on as executive chairman. There can be only one CEO. How does everyone ensure there is no confusion over who is in charge?

The trend toward outgoing CEOs taking the role of executive chairman offers significant opportunities and unique pitfalls. On the positive side, the presence of a former CEO enables the company to continue to benefit from his or her knowledge, skills and relationships. She or he may also serve as a valuable informal advisor to the new CEO. The executive chairman can also provide a sense of continuity to the workforce as the new leader finds his or her footing in the corner office.

Those benefits, however, come with risks. The outgoing CEO may not cede informal control to his or her successor, intentionally or unintentionally undermining their first days in office. Additionally, the presence of a former CEO on the board can limit a new CEO's ability to be a change agent or even to be seen as the ultimate leader. Such problems are of particular concern in the case of a family business or a situation where the company retains its founding CEO. Indeed, under some governance schemes, such as in the UK, a CEO cannot be elevated to chair of the company where he or she was CEO.

Some successions are so well thought out and planned in advance that they require little advance notice and no overlap between the incoming and outgoing leader. The transition between Kenneth Chenault and Stephen Squeri at the helm of American Express is one recent example.

The executive chairman's role should be clearly defined, limited, and understood and agreed upon in advance by the outgoing and incoming CEOs and the board. Importantly, for the executive chairman, there should be an initial term with an expected duration to be reviewed annually. A recent analysis of Fortune 250 CEO transitions by Russell Reynolds shows that 84 percent of executives holding both the chairman and CEO roles retained the executive chairman title after stepping down as CEO but did so for an average tenure of just 11 months. We recommend to our clients that such roles are limited to no more than one year, but we have seen successful longer-serving executive chairmen. If they last longer, the relationship should be reviewed annually and effectiveness regularly reviewed by the board and CEO.

Given the heightened sensitivities surrounding a CEO succession, all parties should be prepared for tense moments and not allow them to derail the process. Incoming leaders understandably look forward to their new role with enthusiasm, while departing CEOs often struggle to let go and cannot help but focus on their legacy.

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