The Progress Group

Who Should Lead the Organization?

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The Progress Group
Driving progress by sharing knowledge and experience with the market.

SquareWell Partners gives investor-focused advice, grounded in precedent and facts, to facilitate a strategic and tactical approach to shareholder relations.

We believe that all stakeholders in the financial market can drive progress and positive change. In particular, we think that when diverse stakeholders participate in thoughtful discussion and debate, great ideas are generated. That is why we consider it imperative that stakeholders have opportunities to come together, discuss issues, and share their knowledge and experience with the market through the Progress Group. Each Progress Group has different participants with the aim of publishing a concise report. Invited thought leaders participate on a voluntary basis and we are grateful for their time and contribution.

Who will get the corner office? In the lifetime of a company, there are few questions that will prove as decisive for its future success—or failure—as this one. The choice of the new leader will probably be the most critical decision that board members will have to make during their tenure. The new Chief Executive Officer (CEO) will essentially review the company’s strategy and roadmap as well as shape the management team and corporate culture for the years to come. Their ability, skills, experience and vision will be critical in making sure that the company is able to successfully execute its long-term strategy while negotiating all the hiccups, setbacks and potential market crises. As management quality remains one of the key factors for fundamental investors, the profile of the new leader will directly impact upon the valuation of the company. Academic research has evidenced that companies that are not ready to appoint a successor in a timely manner will lose an average of $1.8 billion in shareholder value\(^1\). The longer the process, the worse they subsequently perform relative to their peers.

Given all of the above, one can understand why getting the CEO succession plan right is of critical importance. The relative absence of disclosure by companies on this topic may therefore come as a surprise. The last 30 years of corporate governance evolution, including the empowerment of shareholders and the rise of stewardship, have had surprisingly little impact in this regard. The cynics among us would see this as confirmation of the

unpreparedness of companies and boards, while others would justify this opacity with the necessary confidential nature of succession plans. For this issue of the Progress Group, SquareWell Partners decided to focus on this topic to understand how succession planning has evolved, what a good process looks like and how companies could improve their communication with shareholders on this critical matter. Our discussions have certainly revealed a range of practices, approach and views.

### Changing Attitudes

The members invited to our Progress Group all agree that succession planning is clearly not a new concept. However, Kati Najipoor-Schütte and Dick Patton, who are in charge of the Board and CEO Succession Advisory practice at Egon Zehnder, highlight that the processes around it have “changed dramatically”. According to Najipoor-Schütte, there was “very little objectivity and robustness in the succession planning process, with the outgoing CEO already knowing the man/woman within the organization who was going to replace him/her.” However, “as CEO tenure has fallen dramatically”, she continues, “that has triggered a lot of change and the requirements of succession planning have really evolved.” Michel de Fabiani, board member and chair of the Policy Committee of the European Confederation of Directors’ Association (“ecoDa”), has seen these plans evolve and improve during his career: “from usually one successor to several possible successors; from having only internal successors to an open succession with internal and external successors.”

“The process has become less personal” adds Dick Patton, “and is now a process independent of the CEO.” This makes succession planning “more palatable for the board to do that”, says Patton. Fabiani shares a similar view: “at first, managers were afraid that we wanted to get rid of them when we were asking about succession planning. By getting the discipline of always having a succession plan for all top managers, this removes the emotional aspect out of it.”

Another major evolution has been the creation of nomination committees which has helped to organize succession planning in a more formal and structured manner.

### Everchanging Ideal CEO Profile

As succession planning processes have become more professional, the CEO profiles that boards are looking for have also evolved. It used to be all about finding a charismatic executive who was a strategic visionary with the relevant sector expertise and a successful track record. Boards are increasingly paying more attention to the soft skills of their new leaders. As stated by Najipoor-Schütte and Patton, “the role of a CEO has dramatically changed, they need to be able to deal with multiple stakeholders who all have different needs and viewpoints, rather than just the investors.” A major requirement is how effective the candidate is in managing and developing trustful relationships, both externally and internally. The CEO will need to be able to balance roles and responsibilities with the board and the non-executive chair, when there is one, points out George Dallas, Head of Policy at the International Corporate Governance Network (“ICGN”).

The profile of CEOs has evolved in other ways too. Fabiani explains that “boards are now searching for profiles with international experience and comprehension beyond sector-specific knowledge.” Board members will take a close look at the track record, the perception and personality of potential successors.
In addition, the successor’s profile will need to be tailored to the company’s strategic needs. Is the board’s objective to find someone who could aggressively move the company into new markets and focus on the development of new innovative products? Or somebody who will need to reorganize the company to reduce costs? Depending on the objective, the perfect candidate will have a different set of skills, characteristics and experience. This underlines the need for succession plans not to be set in stone but to evolve with the market situation, the sector dynamics and the company’s strategy. The right CEO profile for the company post-Covid-19 might be very different from the one before the crisis.

The list of attributes for the perfect CEO candidate seems to only be getting longer. In the words of Najipoor-Schütte, the position of the CEO “has become a ‘Herculean job’”. They also need to constantly “arbitrate, not just decide, and take account of all the positions and not hold his/her own view as the best” resumes Fabiani. “The world has become more complicated, the CEO will need to find the right balance between the commercial objectives, the financial returns and the stakeholders’ interests while avoiding the systemic risks”, Dallas analyses.

**Internal vs External Successor**

The choice between an external or internal successor is not an easy one and depends on many factors, including the inflection the board wants to give to the company’s strategy. Whenever the board is looking for an external candidate, it will tend to look for a name-brand leader with a track record of success and those come with a hefty price tag. By having to look externally for the next CEO, this could be interpreted as the board and the previous CEO having failed to manage the internal talent pipeline. Picking an internal candidate should ensure a smooth(er) transition as the new CEO will already have a good understanding of the company, its strategy and its culture.

SquareWell’s latest research – CEO Dismissals and Appointments at the World’s Largest Companies – shows that 66% of recent hires were insiders. The two representatives of Egon Zehnder caution that the appointment of many of these internal hires may not have been made for the right reason. Patton underlines the fact that boards may be “afraid to look outside because it will expose what’s really going on in the company and they could lose the senior leaders” who failed to win the position. Dallas agrees that “boards will not always consider all the options, whether by laziness or by fear of bringing in an external candidate”.

However, internal candidates are not without risks. The board will usually overlook the need to integrate the internal candidate as the new CEO even though this may be their first time leading a company: “just because you reach the finish line and make the appointment, it does not mean that the process ends there” adds Patton. Transition may be more challenging for an internal than an external candidate and that should be taken into account by the board. The entire life cycle of the CEO should be considered and an extensive onboarding process developed. According to SquareWell data, of the new lead executives appointed since 1 January 2019, only 12% had previous experience as a CEO in a listed entity.

Ultimately, the current performance of the company will often be the decisive factor as to the choice of an internal or external candidate. In the case of a failing company, “it becomes an optical risk to promote someone from within the company who has allegedly contributed to the poor performance of the company up until that point” points out Patton. Investors would expect the appointment of an outsider to turn the company around. Likewise, if the CEO has been dismissed as the company is embroiled in a scandal, a fresh pair of eyes might be needed to reform the company’s practices and culture.
Opportunity for Healthy Boardroom Debates

Patton and Najipoor-Schütte warn that succession planning should not be seen as simply a selection process but as “a series of discrete steps, some of which are sequential and some of which are parallel”. Patton therefore argues that boards should ask themselves questions such as ‘who has potential on the team?’, ‘what external candidates might be out there that the board wants to develop a relationship with?’, ‘what development activities would be required for the people you know inside and outside the company to be ready for the CEO role?’, ‘what is the actual mandate?’ Is it transformation, is it growth acceleration, is it geographic expansion, is it something else?’ According to Patton, the “process becomes much more manageable for a board if the right questions are asked at the beginning.” It also makes the process “robust and thoughtful” Patton continues, and “the dialogue among board members that goes along with a well-designed succession plan is incredibly useful because areas of alignment and misalignment emerge, and healthy debate – if facilitated well – can also emerge about where those areas of misalignment are.”

During these board discussions, the timing of the succession should also be considered. A good succession plan can be rendered useless if not implemented in a timely manner. Even though the topic can be sensitive, it is healthy for the board to discuss the potential retirement date of the CEO with him or her to ensure a timely transition period. Without these discussions, board members may be at the mercy of the incumbent CEO and, if the selection process starts to drag on, internal candidates might be increasingly entertaining external opportunities.

CEO Involvement in His/Her Own Succession

Regarding the selection of the CEO, the letter of the law is clear: the board, with its nomination committee, is clearly in charge. For Fabiani, it is essential that some committee members are executives or former executives of listed companies in order to fulfill certain key responsibilities.

CEOs also have an obvious role to play as they will pick their management teams and are in charge of the leadership development internally. As Dallas explains, “The CEO’s responsibility is to monitor who the rising stars are who have the potential to get on to the C-suite.” However, Najipoor-Schütte cautions that “there is too much dependence on the judgment of the CEO – that is great of course because the CEO will know his/her people – but that’s just one data point.” Fabiani agrees that “the process should always include external consultation. You need to have an independent external view.”

The best way to reduce dependency on the CEO, who may have a personal interest in not having any potential successor at all, is for the board to widen the scope of the succession planning. Taking a broader view and reviewing the whole leadership succession helps to create a discipline and culture internally and then “CEO succession planning does not imply that there is something wrong with the current CEO, but rather it becomes a natural, professional and proper process”, argues Najipoor-Schütte. This will also allow the board and the nomination committee to familiarize themselves with the whole executive committee, to understand their strengths and weaknesses and to monitor that the talent pool is sufficiently broad to fit the company’s needs although, for example, it is not the role of the board to decide who will be the next Chief Financial Officer (CFO) as this is the CEO’s prerogative. However, the board should work with the CEO to review internal succession plans and get to know the different top managers.
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The Dilemma: What to Say to Investors?

A culture of secrecy traditionally surrounds succession planning. For obvious reasons, boards keep the names of potential successors confidential for as long as necessary. At the same time, investors need to be reassured that the appropriate processes are in place and that the right person will be ready to step up if the CEO were to be hit by the proverbial bus. Facing this dilemma, most companies prefer to remain silent. SquareWell’s research found that only one out of five companies that have appointed a new CEO since January 2019 provided comprehensive disclosure of their succession planning process.

With succession planning being the board’s exclusive preserve, there are differing opinions as to whether the company should enter into a dialogue with shareholders on this topic. Some argue that shareholders must respect the prerogatives of the board and will have the opportunity to vote at the Annual General Meeting. On the other hand, Fabiani believes that succession planning must be part of the governance discussion between the company and its shareholders and that companies can still provide information to their investors regarding the process, the use of external consultants or how the board reviews the high potential executives. From the investor point of view, Dallas thinks the “succession plan is a legitimate topic of discussion, particularly when the company is going through a crisis and there is going to be imminent change.” Investors should voice their concerns whenever they are aware that the successor profile is completely misaligned with their own expectations and views.

Patton recommends shareholders demand the systematic integration of succession planning in their engagement with board members as well. He also advises them to “ask themselves if they have met other executives of the company besides the CEO and CFO” as a company taking succession planning seriously should allow its different executives to gain experience in engaging with investors. For Fabiani, investor focus should be on the frequency of the review of the succession plans and asking boards how they ensure that the pipeline of potential candidates and the successor profile are always aligned with the evolution of the company’s strategy. Investors could also question the company’s leadership development programs to understand how the leaders of tomorrow are being groomed. The quality of the board’s answers to these questions should reveal how prepared the board really is to face the next CEO transition.

Final Thoughts

SquareWell’s latest research on leadership changes sheds some light on the recent trends and the reasons for CEO departures. In the United States, 28% of departing Lead Executives had a tenure of three years or less. As CEO tenure is becoming shorter, the topic of succession planning will only become more relevant. As such, we expect investor pressure for better disclosure from companies to keep growing. There might be a misunderstanding that investors expect to learn the names of potential successors or to micromanage the choice of the next leader while what they actually want is to see evidence that the board is fulfilling its fiduciary duty and is ready to ensure a smooth transition for all scenarios. Providing disclosure regarding the succession planning process is the first step. The topic could also be addressed during investor roadshows when board members can provide certain insights into how the board monitors internal and external talent, challenges the CEO on executive succession planning or the development of an internal pipeline of candidates. Whatever the case, boards will always have the final say in making that ultimate decision: who gets the corner office.
18 recommendations board members should consider about succession planning

**PROCESS**

- Make an open succession planning process part of the corporate culture. Throughout the organization, ensure that the topic of role progression is discussed openly.
- Do not limit your work to CEO succession but ensure that you focus on senior leadership succession as well. Investors will appreciate your attention to talent development.
- Identify early in the process – and regularly review – internal and external high-potential individuals who might be future candidates for the CEO role.
- Prepare for both an organized and a sudden succession.
- Ensure that the CEO is aware of his/her responsibility in the succession planning process to monitor high-potential individuals and is willing to facilitate the development of potential CEO candidates.
- When reviewing candidates, particularly internal, avoid relying too much on the opinion of the incumbent CEO and always include an external view, e.g. a search consultant.
- Avoid a lengthy selection phase as this may intensify tensions among potential internal candidates and be detrimental to the morale of the senior leadership team if an external candidate is selected.
- Ensure that the nomination committee, who should take a leading role in the succession planning process, has adequate diversity and expertise – and preferably include some members with experience in executive roles.

**APPOINTING THE RIGHT SUCCESSOR**

- Ensure that the profile of the CEO you are seeking is aligned with both the current strategic position of the company and the risks and opportunities presented by the external environment.
- As the need for balancing financial returns with the interests of non-shareholder constituencies continues to increase, recognize that the CEO’s role will involve building relationships with a multiple range of stakeholders and be skeptical of candidates with a poor track record of balancing the competing interests of different stakeholder groups.
- Always consider external candidates, even if you believe there is strong internal talent and the company is well positioned from a strategic standpoint. External candidates can serve as a benchmark for the evaluation of the internal candidates.
- Avoid forming your view of potential candidates based only on “staged” situations, e.g. formal presentations to the board.
- Create a robust onboarding process for the new CEO, even if he/she is an insider.

**COMMUNICATION**

- Be ready to engage actively with shareholders regarding your succession planning and present it as a matter that is regularly addressed by the board. For example, describe how frequently the board reviews its succession plans, the scope of these plans, how the board is managing the internal talent pipeline or if it engages search consultants for potential external options.
- Incorporate feedback from shareholders in your succession plan.
- Investors will appreciate assurances that succession planning is aligned to the company’s current strategic position and future risks – including environmental and social aspects.
- If the company is going through a challenging period, be prepared for investors to reach out directly and expect suggestions or questions with regard to your approach.
- Assure investors that an emergency succession plan is in place, with one or more executives capable of taking on the CEO role if an emergency scenario were to occur.