Pearl Meyer

ADVISOR BLOG

Compensation Strategies for Succession Planning

AUTHOR

David Swinford
President & CEO

The stock market's response to PepsiCo's recent retirement announcement of long-time CEO Indra Nooyi shows that even when a company has a good succession process in place and selects a replacement who is fairly well-known to the market, investors will assign risk to the change and stock price will decline accordingly. The fact is, how that successor will perform in the top job and how the rest of the management team will reshape and work as a unit, is unknown. It's almost inevitable that there will be a stock price drop when a successful CEO departs. And recent studies show that stock prices are still down as much as a year after the transition. Gaining investor trust is not just a one or two quarter process. The challenge for boards is what can you do to minimize the downside impact of the CEO change and how can you shorten the length of that downside?

(There's an important executive compensation point to interject here: as you set up pay plans for a new CEO, structure equity incentives so they are based on the stock price after the market has absorbed the bulk of the hit to the share price. There have been numerous circumstances where options are granted immediately upon a promotion, yet within a few days, the value of those options are 10-15% underwater. This is demoralizing to the successor and does not achieve the supposed aim of your incentive plan.)

We all know that boards should have solid, well-planned leadership development and succession planning processes in place. What these plans can do—in addition to the obvious benefits—is help directors convince the market when a change does occur, the risk of a performance decline has been minimized.

The process should assess both internal and external candidates. (Bringing in an outside advisor to assess candidates can provide a very useful and objective process for evaluating candidates and planning for their future development.) Boards should become close to the candidates, should set up the process (loosely outlined below), and stay involved at every step.

Begin to identify individuals, but take care not to be overly forthcoming. The markets and organizations are savvy and will begin to understand the landscape as this process unfolds, but you want to ensure there's no artificial inflating of the "race" or pitting team members against one another, which is counter-productive to your succession plan and ongoing operations. Provide each identified rising star with a clear job path that enables them to gain new and needed skills and experiences and allows opportunities to demonstrate leadership capabilities.

From a compensation perspective, very little added effort is needed at this time. The mere fact that they have been noticed and encouraged provides the short-term reward and recognition. However, there is a point further along in the process where the leadership development scenario gives way to a smaller handful of potential successors. This will become clear externally and the marketplace will notice. Your candidates suddenly become sought-after recruiting targets and potential retention issues, and at this point, compensation planning and communication have a critical role to play.

The goals of such a pay plan will be fairly uniform: develop, retain, and reward success. The specifics will naturally depend on myriad factors including the company's business strategy, culture, industry and market position, and the candidate pool. Here are two real-world examples.

Case 1: The company had a clear three-candidate race for succession. The board arranged special long-term incentive grants of restricted stock that would vest not just based on time, but also on the culmination of the race. For all three executives, half of the grant would vest when a CEO successor decision was made and the second half would vest one year after that decision had been made.

This had several effects: it gave the board a better opportunity to hold their stars in place and upon a decision that would inevitably disappoint two of the three, it helped maintain a solid leadership team for the near-term. The communication about what to expect and when had been clear, and there was recognition and reward for having been in the race.

Case 2: The company embarked on a succession planning exercise well in advance of the CEO's expected retirement. The board hired a consultant to help identify and evaluate potential leaders internally and externally. A slate of candidates was selected and each was provided with a board mentor who had been either a CFO or a CEO and been through a similar process themselves.

A compensation plan was implemented for each individual that was slightly more heavy on equity than was typical and the board had an in-depth conversation with each to walk through how their pay would progress over the course of time. As these executives inevitably began receiving more external attention from recruiters, they had to evaluate career options (e.g., "Do I want to be a bigger fish in a smaller pond or do I want to stay and see if I can win the tournament?"). This purposeful compensation and communication effort ensured that in the face of an attractive outside offer, the candidates didn't have to guess about the pay opportunities and timeframes at their current company.

There are as many varied scenarios as there are organizations. The key to weathering a leadership change successfully is to put well-constructed processes and plans in place long before they're needed and nurture them continuously. And know what you should realistically expect from the market in the days, weeks, and months after a transition.

About the Author

David Swinford, President and Chief Executive Officer, joined Pearl Meyer in 1998. Dave works closely with boards to link compensation with business and leadership development strategies in order to build and maintain strong executive teams that create value over the long term. He provides a strong focus on developing performance standards, balancing retention with pay for performance alignment, and compensation-related corporate governance issues. For more than 35 years, Dave has worked with boards and management teams in all major industries.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management on the alignment of executive compensation with business and leadership strategy, making pay programs a powerful catalyst for value creation and competitive advantage. Pearl Meyer's global clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private companies to the Fortune 500 and FTSE 350. The firm has offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, London, and Los Angeles.

Pearl Meyer

NEW YORK
570 Lexington Avenue, 7th Floor
New York, NY 10022
(212) 644-2300
newyork@pearlmeyer.com

ATLANTA
One Alliance Center
3500 Lenox Road, NE, Suite 1708
Atlanta, GA 30326
(770) 261-4080
atlanta@pearlmeyer.com

BOSTON
93 Worcester Street, Suite 100
Wellesley, MA 02481
(508) 460-9600
boston@pearlmeyer.com

CHARLOTTE
3326 Siskey Parkway, Suite 330
Matthews, NC 28105
(704) 844-6626
charlotte@pearlmeyer.com

CHICAGO
151 N. Franklin St, Suite 450
Chicago, IL 60606
(312) 242-3050
chicago@pearlmeyer.com

HOUSTON
Three Riverway, Suite 1575
Houston, TX 77056
(713) 568-2200
houston@pearlmeyer.com

LONDON
Collegiate House
9 St. Thomas Street
London SE1 9RY
+44 (0)20 3384 6711
london@pearlmeyer.com

LOS ANGELES
550 S. Hope Street, Suite 1600
Los Angeles, CA 90071
(213) 438-6500
losangeles@pearlmeyer.com

For more information on Pearl Meyer, visit us at www.pearlmeyer.com or contact us at (212) 644-2300.