A New Lens on CEO Succession Planning

Compensation Committee Series Webinar
Presented by Pearl Meyer

May 16, 2019
Meet the Presenters

**Jesse Rhodes (moderator)** Jesse Rhodes is the managing editor of *NACD Directorship* magazine. From 2008 to 2014, Rhodes was an editorial assistant at *Smithsonian* magazine. Prior to that role, he was with the Library of Congress Publishing Office and contributed to *The Library of Congress World War II Companion*.

**Yvonne Chen** is a managing director in the New York office of Pearl Meyer. With more than 25 years of experience, Yvonne consults with clients on the development of compensation objectives, value-based pay and performance alignment, incentive design, and governance matters.

**Michael O’Malley** is a managing director in Pearl Meyer’s New York office, where he is responsible for a broad range of talent management initiatives centered around compensation design, leadership development, and organizational effectiveness.

**Jane Park** is a principal in the New York office of Pearl Meyer. With more than 10 years of experience, Jane advises public and privately-held clients on executive and non-employee director compensation issues.
Submit a question and receive your answer directly from Pearl Meyer, either during today’s webinar or as a follow-up. You will also be opted-in to receive future executive compensation thought leadership from Pearl Meyer.

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- You will automatically receive 1 NACD credit for your participation (live program only).

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- Presentation slides are available today at www.pearlmeyer.com/ceo-succession-planning and within the webinar console.

- The replay will be available early next week at www.NACDonline.org and www.pearlmeyer.com/ceo-succession-planning.
Today’s Agenda

• Succession Planning Matters – A Lot!
• Changing Dynamics of Succession Planning
• “Best Practices” for the Succession Planning Process
• Getting Compensation Right
• Key Takeaways
Succession Planning Matters – A Lot!

• CEO succession planning isn’t the board’s favorite topic
• But getting it wrong is costly for stockholders and employees
• Over 75% of companies say they have either a formal or informal CEO succession plan, but does it work?

The New York Times

College Admission Scandal’s Other Big Names Are Titans of Finance and Law

BARRON’S
CEO’s Sudden Exit Can Hurt...or Help a Stock

The Washington Post
It’s a dangerous time to be a bad CEO

Chief Executive

#MeToo Movement Exposes Lack Of Succession Planning
Polling Question 1

Q: Which of these statements best describes your CEO succession plan?

1. *We have a robust succession plan that’s updated regularly.*

2. *We have a succession plan, but we could do better.*

3. *We have an informal CEO succession plan.*

4. *It’s like an episode of Survivor; we improvise on the battlefield.*
Changing Dynamics of Succession Planning

Four trends are changing how boards need to address succession planning:

• A generational turnover in the C-suite is on the horizon

• Tech disruption is readily apparent in certain industries (retail) and its impact is spreading/accelerating

• CEOs will need to have strengths other than traditional leadership characteristics

• Succession planning is more visible and investors are watching closely
A generational turnover in the C-suite is on the horizon

External Factors

- Multiple external factors are tending to accelerate CEO turnover
  - Economic downturn: boards are more likely to make a CEO change if results are poor
  - Activist investors: corporate strategy and new leadership are common themes
  - Surprise exits: #MeToo and other scandals have ousted several long-tenured CEOs
  - Job alternatives: talented leaders are choosing private equity’s promise of risk/reward

Top 200 Data

- Pearl Meyer Top 200 data shows CEO turnover of 10% to 25% per year
  - More than half of the Top 200 have a different CEO vs. five years ago
  - 31% of the Top 200 CEOs have tenure of three years or less
  - The median age is 59 years; the two youngest CEOs are Mark Zuckerberg and Larry Page

1 Based on Pearl Meyer’s annual study of the largest 200 publicly-traded companies, by revenue as of the prior year end. For the 2018 study, median FYE 2017 revenues were $23.1 billion and median market cap was $49.6 billion.
Poll Question 2

What is your company’s anticipated timeframe for CEO succession?

1. We had a new CEO within the past three years
2. Near-term (1-2 years)
3. Mid-term (3-5 years)
4. Unlikely in the foreseeable future
5. I don’t know
Broadening Impact of Technology

• Tech disruption is readily apparent in certain industries (retail) and its impact is spreading/accelerating (IoT, Big Data)

• Just as directors with IT knowledge are in demand, the next generation of CEOs will need to succeed in a tech-enabled environment
  – Consider the tech impact on distribution and supply chain, mass customization, customer/market segmentation, product and service enhancements

• NACD survey\(^2\) participants cited trends with the greatest effect over the next 12 months:

<table>
<thead>
<tr>
<th></th>
<th>Public Companies</th>
<th>Private Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in regulatory climate</td>
<td>49%</td>
<td>42%</td>
</tr>
<tr>
<td>Economic slowdown</td>
<td>48%</td>
<td>38%</td>
</tr>
<tr>
<td>Cybersecurity threats</td>
<td>42%</td>
<td>37%</td>
</tr>
<tr>
<td>Business model disruptions</td>
<td>40%</td>
<td>42%</td>
</tr>
<tr>
<td>Pace of technology disruption</td>
<td>39%</td>
<td>35%</td>
</tr>
<tr>
<td>Key talent deficits</td>
<td>39%</td>
<td>46%</td>
</tr>
</tbody>
</table>

– AI, IoT, and automation were cited as technologies most likely to disrupt their organization

Evolving CEO Succession Profile

- CEOs will need to have strengths other than traditional leadership characteristics
  - Technology and digital transformation experience will be in demand
  - The next generation of CEOs may also be more diverse

- A recent Pearl Meyer Quick Poll asked:

  Has your company/board of directors changed the CEO succession profile (the skills, experience, and characteristics required for the position) within the past three years?

  - Yes: 42%
  - No: 25%
  - Don't Know: 6%

  n=181 participants

  31 companies provided detailed information on their CEO profiles

  42% of the CEO profiles that were detailed cited experience with Technology, Digital and/or Innovation, Change and Transformation
Evolving CEO Succession Profile

• CEO succession profiles are unique to each company, but the key characteristics are evolving in response to business transformation

<table>
<thead>
<tr>
<th>Traditional Profile &amp; Characteristics</th>
<th>Evolving Profile &amp; Characteristics</th>
</tr>
</thead>
<tbody>
<tr>
<td>✤ Demonstrated strong leadership and a passion for our industry</td>
<td>✤ Leader with strategic agility, who can anticipate market movements and create opportunities</td>
</tr>
<tr>
<td>✤ Success in delivering business and financial results</td>
<td>✤ Success in driving innovation and transformation</td>
</tr>
<tr>
<td>✤ Excellence in industry-specific operations and management roles</td>
<td>✤ Excellent track record in leveraging technology across industries</td>
</tr>
<tr>
<td>✤ Ability to take calculated risks and follow through</td>
<td>✤ Strong understanding of how the customer experience is being enhanced with data analytics</td>
</tr>
<tr>
<td>✤ Superior communication skills and history of strong relationships with customers</td>
<td>✤ Superior IQ and EQ. Ability to set the right culture and tone at the top</td>
</tr>
<tr>
<td>✤ Team builder with ability to develop talent</td>
<td>✤ Holistic vision that includes environmental, social, and governance issues</td>
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</table>
The definition of “best in class” for succession planning is evolving

**More Transparency**
- Succession planning has become more transparent over the past decade
  - In October 2009, the SEC determined that shareholder proposals relating to CEO succession planning would no longer be excludable on ordinary business grounds
  - Since then, disclosure has improved and boards are spending more time on succession
  - Over 60% of Fortune 100 companies mention succession planning in their proxy filings

**Emergency Succession Plans**
- Recent CEO exits/scandals put pressure on emergency succession plans
  - Investors and rating agencies view CEO transition as a vulnerable time period
    - CNBC’s Jim Cramer: “...remember that unexplained high-level executive resignations equals sell.”
  - Stock prices can be negatively impacted, even when there is a robust succession plan
  - Boards are expected to be more involved throughout the process, not just when a new CEO is selected
Succession Done Well or Poorly

What honeybee colonies can teach us about business continuity:

When Succession is Planned
- Multiple candidates groomed
- Efficient transition with the most mature and prepared getting the job when it needs to be filled
- Experience stays behind until success of new leader is ensured (failsafe factor: 30% - 40% of exiting CEOs stay on in some capacity)

When Succession is Not Planned
- Conflict-laden/in-fighting
- Negative effect on organizational performance
- Messy transition often with sub-optimal replacement
Plan or No Plan

It is impossible to anticipate every contingency and have a rote response prepared, but companies should have plans for both the foreseen and unforeseen.

<table>
<thead>
<tr>
<th>EVENTS</th>
<th>Expected Event</th>
<th>Unexpected Event</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>Retirement</td>
<td>Death</td>
</tr>
<tr>
<td></td>
<td>Performance Decline</td>
<td>Scandal</td>
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<table>
<thead>
<tr>
<th>PREPAREDNESS</th>
<th>Internal</th>
<th>External</th>
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- New business direction
- Cultural improvements
- 1/3 of CEOs now brought in from outside the company
- Research shows that a preponderance of external executives fail within 18 months
Poll Question 3

When your current CEO took over, did the former CEO stay on for a period?

Internal Hire
A. No
B. Yes

External Hire
C. No
D. Yes
Key Steps for Developing a Succession Plan

Developing leaders is not a special project but fundamental to what companies ought to do. Succession is part of a continuous process of leadership development that is conducted throughout the ranks.

1. Articulate Leadership Strategy
   - Identify key positions
   - Define skills and competencies needed for today and for the future
   - Develop succession profile for each position
   - Who does the organization need to succeed?

2. Assess Leadership Pipeline
   - Develop inventory of talent (who is in the pipeline)
   - Assess individuals against succession profiles
   - Identify succession gaps
   - Do you have them?

3. Implement Succession Plan
   - Assign accountabilities for different aspects of program development and maintenance
   - Draft succession plans and monitor against current and future needs
   - Create and implement development plans for individuals in the talent pipeline, assigning coaches and mentors as warranted
   - How will you keep them engaged prior to advancement?

4. Review and Update
   - Develop scorecard to document ongoing progress toward goals, including diversity
   - Regularly update on plan status and ensure succession plan is nurtured
   - Track retention and movement of talent
   - Are you maintaining the numbers and mix of talents you require?
## The Board’s Role in the Succession Process

### CEO Succession Practices Performed by the Board

<table>
<thead>
<tr>
<th>Practice</th>
<th>Private Firms</th>
<th>Public Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discussed long-term succession planning (e.g., 3-5 years)</td>
<td></td>
<td>67.5%</td>
</tr>
<tr>
<td>Identified an interim CEO in the case of an emergency</td>
<td></td>
<td>63.2%</td>
</tr>
<tr>
<td>Developed a pipeline of internal candidates</td>
<td>29.9%</td>
<td>48.9%</td>
</tr>
<tr>
<td>Communicated with management about information the board requires</td>
<td>33.3%</td>
<td>36.0%</td>
</tr>
<tr>
<td>Changed the role of an internal candidate to assess his or her leadership potential</td>
<td>24.8%</td>
<td>32.8%</td>
</tr>
<tr>
<td>Assigned clearly defined roles to its standing committees</td>
<td>19.7%</td>
<td>26.2%</td>
</tr>
<tr>
<td>Assigned clearly defined roles to the full board</td>
<td></td>
<td>35.9%</td>
</tr>
<tr>
<td>Discussed a detailed succession timetable</td>
<td>17.9%</td>
<td>23.7%</td>
</tr>
<tr>
<td>Drafted or reviewed a formal, written CEO succession plan</td>
<td>17.9%</td>
<td>23.9%</td>
</tr>
<tr>
<td>Performed a competency analysis against future strategic needs</td>
<td>17.9%</td>
<td>18.6%</td>
</tr>
<tr>
<td>Used an assessment survey to review candidates’ fit</td>
<td>11.1%</td>
<td>12.9%</td>
</tr>
<tr>
<td>Worked with an executive search firm to identify a CEO successor</td>
<td>11.1%</td>
<td>12.6%</td>
</tr>
<tr>
<td>Attended continuing education events on CEO succession planning</td>
<td>6.9%</td>
<td>15.4%</td>
</tr>
</tbody>
</table>

**Source:** NACD

### 1
- About 1 in 3 identified successors are not prepared or unavailable when the time for replacement approaches
  - Must have multiple candidates in mind
  - Robust retention plans

### 2
- David McLean, the 20-year chair of the Canadian National Railway, calls the attributes of executive success, “royal jelly” – the ingredients that a company wants to see in their leaders
Getting Compensation Right

Compensation is designed to support three phases of strategic CEO succession

1. Development of succession candidates
2. New CEO pay packages
3. Follow-on pay actions for prior CEO

Compensation also has a role in emergency or forced succession situations

- Interim CEO
- Board pay premium for search committee

Solutions are as unique as each company’s CEO succession plan
Compensation opportunity should be reasonably competitive

**Communication**
- Candidates should be informed when the committee is ready
  - Cadence of compensation increases can signal an individual’s importance to the company and movement, over time, toward the senior leadership position

**Manage Retention Risk**
- Retention risks may increase but tools can be deployed
  - Multi-year performance periods for long-term incentives
  - Regular cadence of equity grants that vest over time (e.g., restricted stock)
  - Supplemental equity grants that vest over multiple years
  - Judicious use of above-market compensation elements (e.g., base salary, LTI grants, etc.)
  - Clear and simple cash retention programs

**Example**
- Large utility completed a succession a few years ago
  - Four NEOs identified as CEO succession candidates
  - Multiyear assignments that provide board exposure
  - Each candidate provided a $1.5M retention award with five-year “step” vest
  - One person was eventually named CEO in the following year but there was continuity in the senior leadership team with “runners up”
New CEO Pay Packages

Benchmarking pay can support planning for the new CEO’s pay package

**Internal Successors**
- 25th percentile target total compensation in the 1st year as CEO can be a reasonable start
- Plan to achieve alignment with the compensation philosophy over time

**External Successors**
- External CEO hire will likely require median or higher compensation opportunity

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**Large Utility Example – Two Companies in the Same Peer Group**
- Internal promotion: Modest starting pay program, substantial increases over first three years, relatively “flat” pay over next three years, 15% increase in 6th full year serving as CEO
- External hire: Starting pay program was at median immediately, base salary increased ~3% per year thereafter, larger LTI grants in following two years

<table>
<thead>
<tr>
<th></th>
<th>Initial Salary</th>
<th>Initial Target TDC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internal CEO</td>
<td>$900</td>
<td>$3,000</td>
</tr>
<tr>
<td>External CEO</td>
<td>1,100</td>
<td>5,300</td>
</tr>
</tbody>
</table>
Prior CEO’s Transition Compensation

### Incumbent CEO

- Plays a critical role in strategic CEO succession planning
  - Can work with the board to identify future succession candidates and mentor/guide the new CEO
- Often transitions to an executive chairman role to ensure a successful transition; then often either retires or transitions to a non-executive chairman role
- Time in the executive chairman role may be a year or so assuming successor is well integrated, but can be longer
- Executive chairman compensation is typically less than the CEO but sometimes founders are paid more

<table>
<thead>
<tr>
<th>Pay Element</th>
<th>Shorter Term COBs (≤1 Year)</th>
<th>Longer Term COBs (non-founders)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Target Total Cash</td>
<td>Typically equal to CEO</td>
<td>Target cash may be cut back but still represents the majority of the pay mix</td>
</tr>
</tbody>
</table>
| Total LTI | • Cut back or no grant (depends on timing of award)  
  • Sometimes provide favorable equity vesting | Total LTI is cut back more dramatically than cash compensation |
Emergency or Unexpected CEO Succession

Vitally important for the board to identify at least one individual that they are confident can step in and run the company successfully

- Retention of this interim CEO is key
  - Typically current executive or board member
  - Interim role generally less than 1 year

- Interim CEO is an unusual role, so pay practices and levels vary widely
  - Interim job typically earns ~1/3 the amount of the full-time CEO but ratios can range from less to equal the full time CEO
  - Pay programs usually emphasize retention over performance

- Example #1: Monthly base salary, paid until successor hired
  - Sometimes provided additional target bonus or retention RSU award
  - Bonus is tied to individual or non-financial measures
  - RSUs vesting typically earlier of 1-3 years or upon hire of successor

- Example #2: Pre-Determined Annual Compensation Arrangement
  - Annual base salary, target bonus opportunity and RSU award
  - Bonus is tied to individual or non-financial measures
  - RSUs vesting typically earlier of 1-3 years or upon hire of successor
During the interim CEO period, the board will typically establish a special CEO search committee to identify internal or external CEO candidates.

- Market practices vary widely based on a subjective assessment of anticipated workload
  - Some provide no additional compensation
  - Most provide cash retainer, similar to other standing committees
  - Few companies provide a meeting attendance fee or an incremental equity award

- Setting compensation prospectively is best practice
  - Improves optics for decision-making
  - Assessment of pay after work is completed can be perceived negatively
Key Takeaways

**TAKE ACTION NOW** before the need is critical

13% have no CEO succession plan. If you’re one of those, get going!

- Re-evaluate the skills and characteristics for your next CEO
- Assess your talent pipeline—your “stars” may not match the new profile

Tailor Compensation to the CEO Succession Plan

- **Planned CEO Succession**
- **Emergency CEO Succession**
- **Transition Initial Support**
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