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Succeeding at Succession

by James M. Citrin and Dayton Ogden

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Succeeding at Succession

For too long, boards have relied on rules of thumb and conventional wisdom when picking CEOs. So we took a look at the numbers—and found some surprises.

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It's been eight years since the passage of Sarbanes-Oxley, and despite all the work and worry it created for corporate directors, the new regulation did bring about one unambiguously positive change: It led boards to finally wrest control of CEO succession away from incumbent chief executives, who often held too much power over the process.

Today, corporate boards are more proactive about (and simply better at handling) leadership succession, but they still face a significant challenge in picking the right candidates. That's partly because succession decisions have been guided by too little data and too much reliance on rules of thumb, anecdotes, and even fads. During the mid to late 1990s, for instance, after Louis Gerstner's brilliant turnaround at IBM, boards tended to focus on big-name outsiders as the CEO candidates of choice. In the past decade, the sentiment has shifted, and a procession of thinkers—some of them writing in HBR—have argued forcefully that internal candidates are the better bet.

To give boards guidance based on real evidence, Spencer Stuart conducted an 18-month study of the 300 CEO transitions at S&P 500 companies that took place from 2004 to 2008. (For more on our methodology, see "How We Crunched the Numbers.")

The results contained several surprises. Contrary to conventional wisdom, our analysis showed that insiders and outsiders have performed about the same—plenty of each fell into the highest and lowest performance categories. Whether a company chose a CEO from inside or outside did matter—but whether the choice turned out to be wise depended mostly on the health and competitive position of the company at the time of succession.

Another surprising finding: Board members who stepped in as CEO outperformed all other types of candidates. Often a board member is a last resort, someone who is turned to in desperation when a company can't find other suitable candidates. But in fact, directors-turned-CEOs represent a strong blend of insider and outsider. They have more company knowledge than a pure outsider, but they don't have the constraints of a pure insider when it comes to making unpopular decisions or leading painful changes. Having been on the board, they have deep knowledge of a company's strategy, finances, and organization, and just as important, they understand the dynamics and the expectations of the board. And of course, some have already been CEOs of other companies, which gives them an advantage.

The worst-performing CEOs turned out to be a group we call insider-outsiders—outsiders who are hired into a company as president or chief operating officer and promoted to CEO within 18 months. HR directors have favored this approach, and in theory it makes great sense: The candidate has a chance to get acclimated to the culture, learn the company, and settle in before ascending to the top job. But the approach often sets the new leader up for failure. The two-step succession process requires the candidate to "audition" for the top position while serving under the incumbent CEO, and that tends to makes him or her beholden to the current chief executive. What's more, the sitting CEO remains the primary conduit to the board—making it more likely that the outside hire will play things safe and be deferential to the status quo. Ten insider-outsider CEOs were appointed between 2004 and 2008, and our analysis found that none of them achieved top-quartile performance.

Our research also found that many of the criteria boards use to evaluate CEO candidates turn out to be unimportant in predicting performance. These include candidates' ages, where they went to college or grad school, what degrees they earned, whether they needed to relocate or commute to take the job, or whether they began their career at a blue-chip company. Boards should ignore those variables; they simply don't correlate with performance.

In our view, the most important factor in determining which type of CEO candidate to se-

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lect is the health of the company. Insiders are best when the company is performing well; outsiders do better when the company is in crisis. This may be intuitive, but when we've shown this data to board members, they're surprised by how compelling the numbers are.

The leadership challenges presented by a stable, growing company are fundamentally different from those faced by an organization in trouble. Of the 300 transitions we studied, 218 involved companies that were stable or growing—and in that situation, boards chose insiders more than three-quarters of the time. Those insider appointments, in turn, were three times more likely to achieve outstanding performance than the outsider appointments. When outsiders were hired into healthy companies, they were twice as likely as insiders to suffer poor performance.

Why do insiders do better at healthy companies? For one thing, companies that are doing well tend to attract strong talent in the first place. They also have more resources to invest in management development. High-performing companies often develop cultures that make it difficult for outsiders to fit in, partly owing to longtime employees' suspicion over whether an outsider can adapt to company values. The boards of healthy companies are more apt to devote sustained time to the work of leadership development and succession, because they're less busy putting out fires.

When a company is in crisis, however, the data overwhelmingly show that outsiders outperform insiders: The CEOs in our study achieved outstanding performance at three times the rate of insiders. That's because insiders are more likely to be captive to the culture that got the company into trouble in the first place, while outsiders bring a fresh perspective and have more freedom—even permission—to implement big changes.

Examples of how the health of the company should lead the board to look inside or outside abound. At Disney, longtime executive Robert Iger succeeded Michael Eisner in 2005. Despite the boardroom drama that accompanied Eisner's exit, Disney was fundamentally healthy, and as an insider Iger has proved to be the perfect pick. His rededication to storytelling, transformative acquisitions of Pixar and Marvel, embrace of technology, and strong team-building skills have helped Disney outperform rivals in a tough economic climate.

In contrast, consider Philip Schoonover at Circuit City. Hired away from Best Buy in 2004, he served as merchandising chief and president before ascending to become Circuit City's CEO in 2006. By then Circuit City was in tough shape, with Best Buy and Wal-Mart stealing market share, but Schoonover failed to aggressively shift strategies. To cut costs, he laid off 3,400 of the chain's highest-paid (and most experienced) sales associates, a move that backfired as customer service plummeted. He resigned in late 2008—and a few weeks later, Circuit City filed for bankruptcy. For a company that faced such profound challenges, the

How We Crunched the Numbers

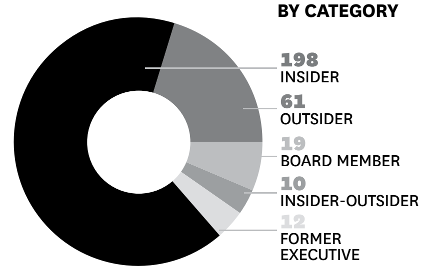
We examined CEO transitions at S&P 500 companies from 2004 to 2008. Over this time, 300 new CEOs were appointed. The CEOs fell into five categories: insiders, outsiders, board members, former executives brought back to retake the helm, and insider-outsiders (executives brought in as the number 2 and then promoted within 18 months).

We began our assessment by looking at more than 25 variables, including company condition, industry sector, whether the new leader was a first-time CEO, his or her functional background, whether he or she had prior public-company board experience, and how many direct reports were replaced in the first year of tenure.

We then evaluated the company's performance under the CEO on the basis of three quantitative measures: shareholder returns relative to peer companies and the overall market, revenue growth, and profit growth. To gain a qualitative sense of company performance under the new CEO, we conducted interviews and examined public information. Specifically, we analyzed changes in the company's reputation, evidence of innovation, and the board's evaluation of the CEO's performance.

We then ranked the CEOs into four quartiles: the top quartile of CEOs were "outstanding," the middle two were "solid," and the bottom-quartile CEOs were "poor."

CEO TRANSITIONS BY CATEGORY



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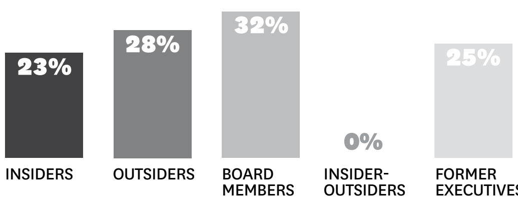
What's the Best Route to the Top?

There are no hard-and-fast rules about which types of candidates make the best CEOs. But our analysis found some solid trends. Among them: Board members shouldn't be a last resort, and "insider-outsider" candidates (who are hired from another company and apprentice under the outgoing CEO before taking over) rarely bring success.

Outstanding Performers

PERCENTAGE OF CEOS IN EACH CATEGORY RATED OUTSTANDING ON THE BASIS OF COMPANY PERFORMANCE AFTER SUCCESSION



Insiders: Robert Iger, Disney. For years Michael Eisner resisted finding a successor, but since Iger took over in 2005, he's led acquisitions of Pixar and Marvel, embraced technology, and renewed the firm's commitment to storytelling.

Outsiders: William D. Perez, Wrigley. After stumbling as an outsider at Nike, Perez became the first non-Wrigley family member to lead the chewing gum company. Within two years of becoming CEO he negotiated Wrigley's sale to Mars, earning shareholders a 28% premium.

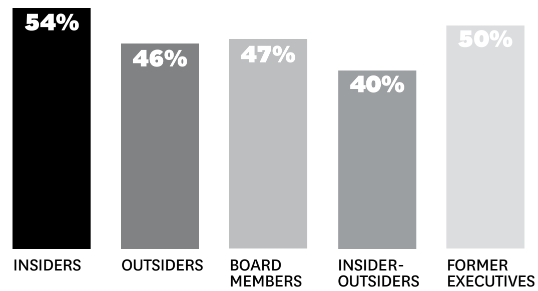
Board Members: Delta Airlines. Gerald Grinstein, a former railroad CEO and Delta board member, served from 2004 to 2007.

Insider-Outsiders: 0%. In theory, insider-outsiders should work really well, but in practice they don't. Their apprentice role makes them too deferential to the incumbent CEO and too invested in the status quo.

Former Executives: Charles R. Schwab, Charles Schwab. Like Steve Jobs, Howard Schultz, and Michael Dell, Schwab is a founder who returned as CEO when his company hit hard times. From 2004 to 2008, he led a near-perfect turnaround and groomed a new successor.

Solid Performers

PERCENTAGE OF CEOS IN EACH CATEGORY RATED SOLID ON THE BASIS OF COMPANY PERFORMANCE AFTER SUCCESSION



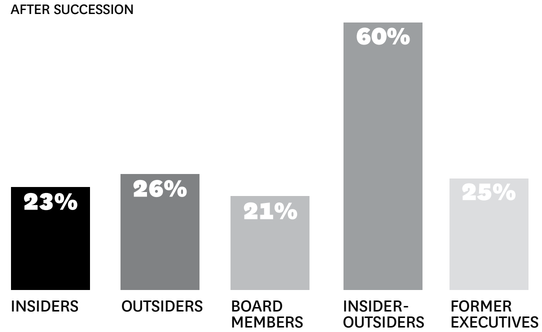
Outsiders: Starwood Hotels. Frits van Paasschen, former CEO of Coors, had no hotel industry experience.

Board Members: James McNerney, Boeing. He was CEO at 3M and a director at Boeing when the airline manufacturer's chief resigned following a sex scandal. McNerney took over in 2005, winning solid reviews despite delays on the Dreamliner 787 program.

Former Executives: John Mack, Morgan Stanley. Pushed out in 2001 by CEO Phil Purcell, Mack returned in 2005 after Purcell's management style led to a talent exodus. Mack, who retired in early 2010, steered the bank through the financial crisis.

Poor Performers

PERCENTAGE OF CEOS IN EACH CATEGORY RATED POOR ON THE BASIS OF COMPANY PERFORMANCE AFTER SUCCESSION



Insiders: Philip Schoonover, Circuit City. He presided over the chain's demise, resigning six weeks before it filed for bankruptcy. Most notable move: laying off the chain's most experienced sales associates, which hurt customer service.

Outsiders: 26%. When outsiders are hired to lead healthy, growing companies, they underperform—partly because these companies often have strong cultures that are slow to accept newcomers.

Insider-Outsiders: Sears. Aylwin Lewis oversaw the merger with K-Mart and ran Sears until 2008.

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fresh perspective of a true outsider may have been a better choice.

CEO selection will always be part art, part science. This data can help guide boards' choices. But the process also relies on intuition—and even experienced directors can make the wrong call. A few years ago, our firm placed a CEO at a large technology company. We did all our due diligence and believed he was the perfect leader for the job. Soon after he was brought in, however, he began speaking disrespectfully about his predecessor. He quickly launched a hit new product largely developed under the former CEO's watch and then took a disproportionate amount of credit for it. He performed very well for a time, but he wasn't able to get the company to innovate or reignite its product development pipeline. Within a couple of years, the wheels fell off and he tendered his resignation. It's a sobering reminder that even as boards have become far more engaged and effective in succession issues, making the right decision can still be very challenging indeed.

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