

A New Lens on CEO Succession Planning

Compensation Committee Series Webinar
Presented by Pearl Meyer

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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.

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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.

- 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.*

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 data¹ 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*

- 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 survey² participants cited trends with the greatest effect over the next 12 months:

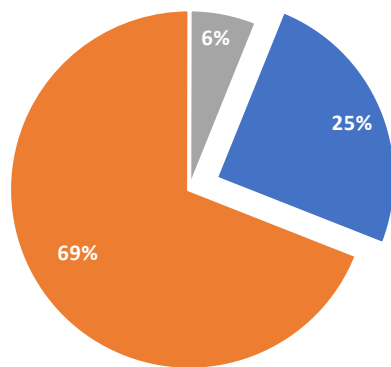
	Public Companies	Private Companies
Change in regulatory climate	49%	42%
Economic slowdown	48%	38%
Cybersecurity threats	42%	37%
Business model disruptions	40%	42%
Pace of technology disruption	39%	35%
Key talent deficits	39%	46%

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

² Data from 2018-2019 NACD Public Company Governance Survey and 2018-2019 NACD Private Company Governance Survey.

- 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?



n=181 participants
■ Yes ■ No ■ Don't Know

31 companies provided details of 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

Traditional Profile & Characteristics

- ❖ Demonstrated strong leadership and a passion for our industry
- ❖ Success in delivering business and financial results
- ❖ Excellence in industry-specific operations and management roles
- ❖ Ability to take calculated risks and follow through
- ❖ Superior communication skills and history of strong relationships with customers
- ❖ Team builder with ability to develop talent

Evolving Profile & Characteristics

- ❖ Leader with strategic agility, who can anticipate market movements and create opportunities
- ❖ Success in driving innovation and transformation
- ❖ Excellent track record in leveraging technology across industries
- ❖ Strong understanding of how the customer experience is being enhanced with data analytics
- ❖ Superior IQ and EQ. Ability to set the right culture and tone at the top
- ❖ Holistic vision that includes environmental, social, and governance issues

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

What honeybee colonies can teach us about business continuity:

When Succession is Planned

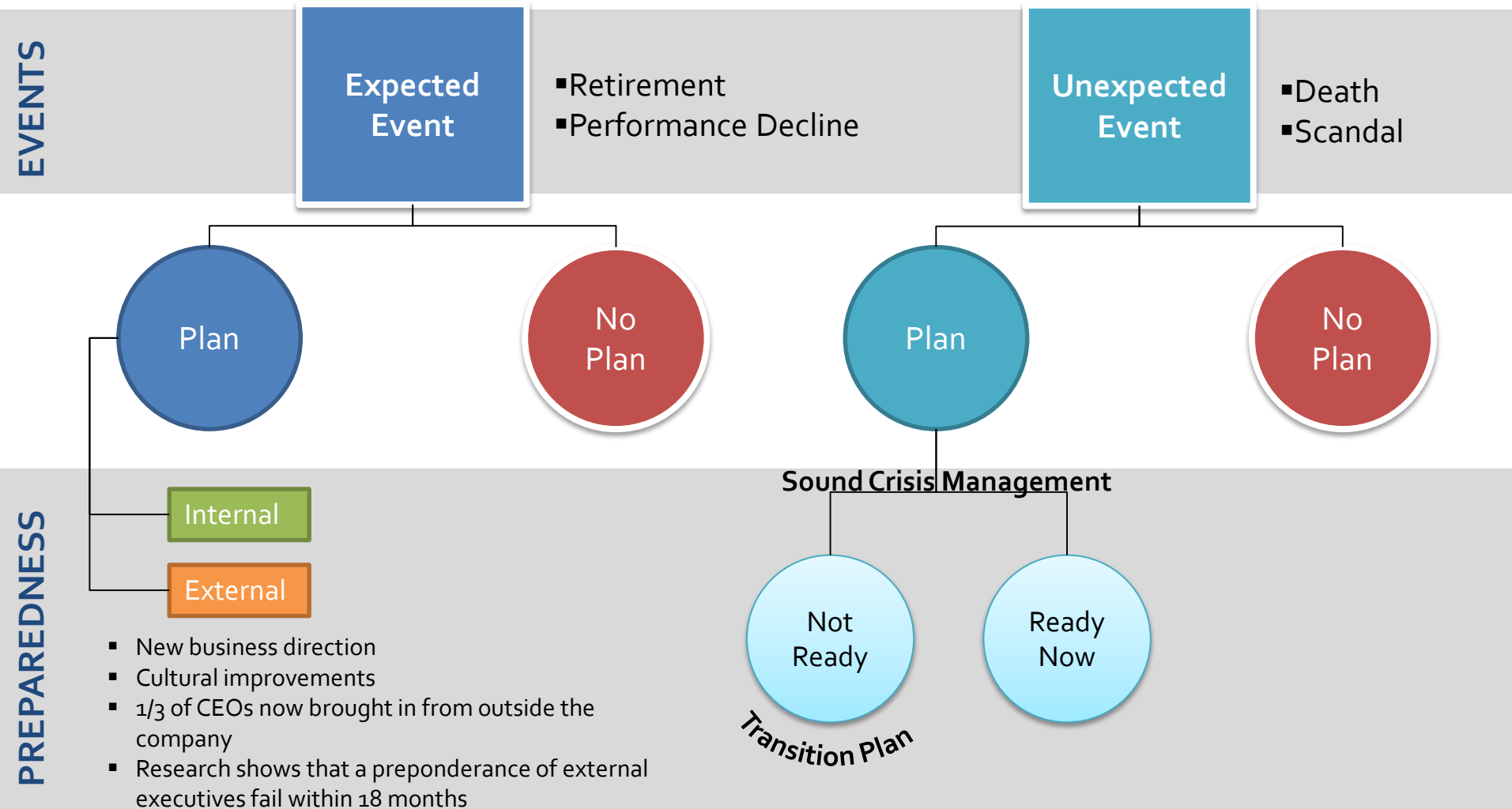
- Multiple candidates groomed
- Efficient transition with the most mature and prepared getting the job when it needs to be filled
- Experience stays behind until success of new leader is ensured (failsafe factor: 30% - 40% of exiting CEOs stay on in some capacity)

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



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

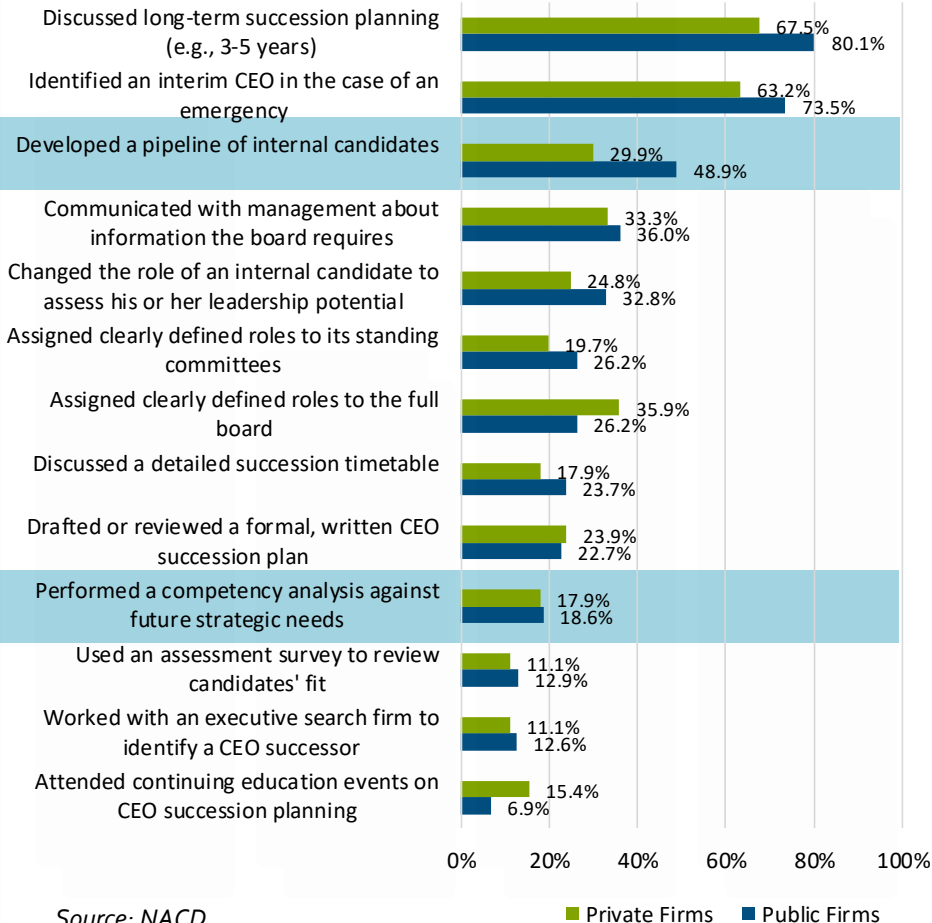
- Develop scorecard to document ongoing progress toward goals, including diversity
- Regularly update on plan status and ensure succession plan is nurtured
- Track retention and movement of talent

Are you maintaining the numbers and mix of talents you require?

Like making a will or planning your estate, succession is one of those things companies know they should do but often do not.

The Board's Role in the Succession Process

CEO Succession Practices Performed by the Board



1

2

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"

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

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

	Initial Salary	Initial Target TDC
Internal CEO	\$900	\$3,000
External CEO	1,100	5,300

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

Pay Element	Shorter Term COBs (<1 Year)	Longer Term COBs (non-founders)
Target Total Cash	Typically equal to CEO	Target cash may be cut back but still represents the majority of the pay mix
Total LTI	<ul style="list-style-type: none"> • 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

Emergency or Unexpected CEO Succession – Special Board Pay

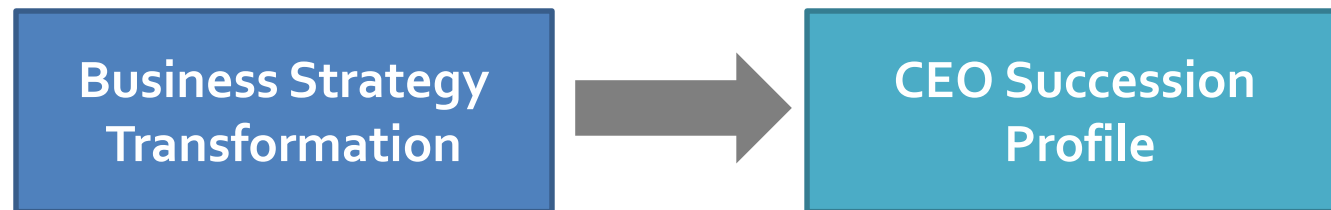


During the interim CEO period, the board will typically establish a special CEO search committee to identify internal or external CEO candidates

- 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

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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