Actively developing future CEOs: Boards need to ensure it happens

By Geoff Campbell, Managing Principal, and Peter Boyden, Principal, The Adelante Group

- Proactive development of internal CEO candidates will increase the boards' options for successors, reduce key person risk and improve corporate performance.
- Boards can ensure successor development by giving individuals direct feedback annually.
- Start early — years in advance of any proposed change in CEO to allow time for real development and for the board to ensure gaps have been addressed.

Thirty to forty per cent of CEOs fail in their first three years,[1,2] and it can take ten years to recover from a poor CEO selection.[3] A lack of CEO candidates is reported as an issue by boards, while CEO remuneration levels also suggest a lack of availability. More can be done on the supply side to increase the quality and quantity of potential CEOs. The benefits are manifold. What is needed is more proactive board involvement, and less confusion about who is responsible.

With CEO tenure less than five years on the ASX200[4], ensuring the availability of quality successors is critical. Succession planning is well established, but active development of CEO successors is not. We have reviewed the research on CEO development and succession, and compared practices across Australian corporations. We also sought input from leading Australian chairs and directors to refine our best practice recommendations on this key issue. In short, current approaches vary — there is no norm. While the elements of a successful program are well established, implementation too easily falls in the gap between the board and CEO responsibilities. The easy part is to clarify responsibility. The hard part is the self-reflection and change that potential CEOs must undertake to become tomorrow's successful CEOs. This takes time. We propose practical steps a board can take to enhance the supply of their most important resource.

Development of future CEOs is a governance issue

One of the boards' main roles is the appointment and, if necessary, removal of the chief executive officer. The ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations* place responsibility firmly with the board nomination committee 'for ensuring there are plans in place for the succession of the CEO and other senior executives'.[5] As stewards of the long-term health of the organisation, the board must have confidence they are developing strong CEO candidates to be future leaders of the business. Most companies have a succession plan, and a named executive to step up if the CEO is hit by the proverbial bus. However, as one director put it, it is one thing to have a name for an emergency situation, it is very different for the board to have someone they believe is ready to lead the corporation for the next five years.

In practice we see a lack of basic '101' development activity for CEO successors in many Australian corporations. The norm in middle management is an annual conversation about strengths and development opportunities. A development action plan is the outcome. Group executives are often no longer offered the benefits of this process. As Ram Charan states

> **The easy part is to clarify responsibility. The hard part is the self-reflection and change that potential CEOs must undertake…**

in '*Ending the CEO Succession Crisis*', 'many organisations do a decent job nurturing middle managers, but meaningful leadership development stops well below the apex'.[6]

Future CEOs (who are also key executives today) can be left knowing little about where to focus their development efforts, and how they are viewed by the board. Gaps are sometimes addressed in performance reviews by the incumbent CEO, and this is a step in the right direction, however these reviews are often simply a CEO lens on the executive's performance in the current role. Too frequently here ends future CEO development! There is no development plan or action for these critical leaders. One experienced chair put it this way — 'there is a paucity of best practice amongst boards in how they source their leaders'.[7]

Leaving successor development to the CEO has significant limitations. Few CEOs are secure enough to actively develop strong internal competitors for their role well in advance of their own desired departure time. There are fine exceptions, but many CEOs are uncomfortable developing a successor who they may feel is champing at the bit to replace them. The tendency is to put the focus on results that deliver on their watch. So responsibility in practice must be with the board. Ideally the incumbent CEO is active and supportive in the process. However the subtleties and interpersonal tensions that underpin CEO succession mean that too often no one is dealing with successor development seriously.

It is no surprise we have a shortage of potential CEOs, and that CEOs command a significant remuneration premium. In a 2009 survey of 236 experienced US directors, 67 per cent of directors claim that 'too few good candidates for CEO succession is the No. 1 challenge facing board members'.[8] The same report identifies that while all boards want a great CEO, nearly half of directors (47 per cent) say that their board is 'not good at CEO succession'. The well-respected US Securities & Exchange Commission considers that poor CEO succession planning poses a great business risk.[9]

The hard work of internal successor development

Your next CEO most likely works for the organisation today. In 2013, 68 per cent of ASX200 CEO appointments were internal candidates.[10] This is below the global average of 76 per cent. The longer term numbers reflect the same trend: 80 per cent of the ASX20 have found their CEO internally since 2005. The media generally expects an internal candidate, unless there are company specific reasons for an external. Why? External candidates have twice the failure rate, shorter tenures and deliver just half the shareholder returns of internal candidates.[11]

You would expect potential CEOs to be in intensive development programs. If athletes, once selected for the Australian Olympic team, received less coaching to improve their performance, we would expect fewer gold medals and demand more development support for our best athletes. In Australia, CEO direct reports often get less performance feedback and development opportunity than more junior leaders.

We find that where CEO successor development programs do operate, there can be a lack of clear feedback about how group executives need to develop. Succession planning too easily becomes a box ticking exercise, with little meaningful successor development. This leads to the executives boxing shadows, and wasting valuable energy that could be expended on focused development. An annual 'steer' by the board, and professional assistance, is required.

Key to better outcomes is starting the process soon after a new CEO is appointed. There are three key reasons to start early.

1. All potential future CEOs will have capability gaps and some behavioural issues. These are the 'devil you know' issues. These can be addressed successfully in many cases. High-potential future CEOs in our experience are strongly motivated to be the best they can be. However this takes time — generally years, not months. Individuals need to understand the issues, explore ways of addressing them, practice new approaches and consistently

demonstrate improvement. US CEO coaching guru, Marshall Goldsmith, recommends up to 18 months for a behavioural change process focused on just one or two key areas, and states further changes will take another 12 to 18 months.[12]

2. The board needs also to allow time to build confidence that an executive has truly addressed development gaps. This can take a year, and is critical to reduce risk and build a board consensus that prior views about an individual no longer apply. Starting the succession process one year out from a CEO transition leaves too little time for real development. Internal candidates are under prepared, and the attraction of an external recruit increases with associated risks.
3. By starting early the board also avoids any suggestion their involvement relates to moving the current CEO on. Boards can simply state that they are ensuring they have a pipeline of successor options internally, as well as continuing development of the senior team — it is simply what we do around here.

A governance guide to increase the supply of quality CEOs

The following steps summarise our research findings and our experience with 100 CEO transitions and have been refined by discussion with leading chairs and directors.

1. Have an annual process of direct board interaction with each successor candidate (and potentially all group executives). This may take the form of a one-to-one discussion between the chair of the nominations committee and each executive. The intent is to ensure that the board understands each executive's aspirations, and each candidate has an understanding of their development areas in the view of the board.
2. Disconnect the successor development program from the timing of the current CEO's departure. This minimises risks of creating perceptions the incumbent CEO will be departing soon.
3. Encourage successor candidates to be 'the best executive that they can be' rather than focusing on winning the CEO succession race. This provides better motivation for change. A development focus also enhances retention prospects for those who are not selected to be the next CEO.
4. Allow sufficient time for CEO candidates to address behavioural change and skill gaps. Changing behaviours takes time. Time to identify change, time to implement change, time to embed new practices. Further time is required for the board to be convinced that change is genuine.
5. Ensure the process is perceived to be fair and pro-active. Use separate service providers for the three main components of the process to avoid conflicts of interest: mentoring/development, external search/benchmarking and assessment. It is important the competing executives see that there is no bias in the process towards particular internal candidates, or between an internal or external candidate. Perception is as important as reality. If each executive considers the process has been fair and transparent, and knows they still have work to do on themselves, disappointment for the unsuccessful is less likely to become anger and disillusionment, which can be toxic.

Illustrative case study of best practice

A top corporate organisation had a strong CEO who, after a year in the role, had in place a good team of group executives. During the annual succession planning process several senior executives were mentioned as future CEO successor candidates, but the board believed that all had significant shortcomings that required development. The board agreed to provide external support for each candidate to maximise the opportunity for an internal successor to be the next CEO. Each executive worked with their respective (separate) mentor on their leadership approach, skills, and behavioural development areas. The mentors received direct feedback from the CEO, HRD, peers and direct reports to refine the development work. The board (via a nominated director) also provided annual one-to-one informal feedback to each executive on how the board viewed their development was progressing.

The executive who ultimately became the CEO successor had a very different style to the incumbent CEO. Over time this appealed to the board, but the individual was uncertain that he wanted the role, since he was not clear on how he could be the CEO and in his own way. The development program focussed on how to leverage his strengths in his existing role and in the potential future group CEO role. There were also some areas of skill development.

Teamwork at the group executive level improved as all executives became aware of their development areas, and the need to be true team players. Two of the group executives became viewed by the board as viable CEO successors by the fourth year of the incumbent CEOs tenure. In the fifth year the board settled on the strategy and CEO profile best suited for the next five years. Concurrently the chair and incumbent CEO discussed the CEO changeover timing.

The board then initiated a confidential external search to seek any outstanding candidates and benchmark the internal candidates. A separate assessment firm was used provide an independent view of the internal and leading external candidates. By the time of the candidates pitch presentation to the board, the directors had significant confidence their leading internal candidate was the person best suited to lead the organisation through its next phase. The CEO appointment was well received, the changeover went smoothly with momentum maintained. The new CEO introduced his change program and he and the organisation performed well, supported by the feedback system and mentoring that had been established over prior years.

Developing your senior executive team can increase your company valuation.

The majority of the unsuccessful internal candidates remained positive, and stayed with the company. The board then repeated the process, the second place candidate developed further and became group CEO on the next succession.

Manifold stakeholder benefits

While our main focus here is ensuring stewardship of the organisation across generations of CEOs, the benefits of a proactive CEO successor development program go beyond this.

Developing your senior executive team can increase your company valuation. The investment community knows the value of a strong executive team. A 2012 Deloitte global survey of 445 investment analysts demonstrated that the majority of analysts consider senior team effectiveness to be more important than company forecasts or ratio analysis when valuing a company. Investment analysts place a 16 per cent premium on a good senior team and a 19 per cent discount on a poorly regarded team, a 35 per cent valuation impact.[13]

Developing the senior team increases employee engagement. Many leaders appear to boards to be effective — yet studies consistently find the prevalence of leadership failure to be around 50 per cent.[14] The impact of poor leadership on employees can be particularly damaging, and lead to a toxic environment and culture. We have many examples of leaders in active development programs substantially increasing employee engagement in large teams.

A strong C-suite of executives, focused on being the best they can be, has major benefits for current employees and shareholders. It also ensures good stewardship of the corporation as CEOs come and go.

Geoff Campbell can be contacted on 0414 063 063 or by email at geoff.campbell@theadelantegroup.com and Peter Boyden can be contacted on 0419 575 555 or by email at peter.boyden@theadelantegroup.com.

Notes

1 Ciampa D, *Almost Ready*, Harvard Business Review, January 2005.

2 Saporito T J & Winum P, *Inside CEO Succession*, 2012.

3 Shekshnia S, INSEAD, Paris.

4 Strategy&, The 2013 Australian Chief Executive Study.

5 ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations*, 2014.

6 Charan R, *Ending the CEO Succession Crisis*, Harvard Business Review, February 2005.

7 Saporito TJ & Winum P, *Inside CEO Succession*, 2012.

8 Ibid.

9 US Securities Exchange Commission, *Staff Legal Bulletin*, 2009.

10 Strategy&, The 2013 Australian Chief Executive Study.

11 Booz Strategy + Business, *CEO Study*, Issue 67, May 2012.

12 Goldsmith M, *Coaching for Behavioral Change*, 2005.

13 Deloitte, *The Leadership Premium*, 2012.

14 Hogan R and Kaiser R B, *What We Know About Leadership*, Review of General Psychology, 9(2) 2005.