CEO TRANSITIONS

Leadership change affects a company's enterprise value. Whether that's positive or negative depends largely on measures taken by boards and CEOs in the months leading up to — and following — the change.

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CEO change presents more downside risk than upside potential, with enterprise risk extending well beyond the point of transition. Further, there is more value at risk in unplanned CEO transitions. In particular, the greater the surprise and the higher the potential for corporate strategy shifts surrounding the transition, the more enterprise value is at risk. But the value at risk also increases over time, irrespective of the circumstances related to the transition. Recognizing this environment, boards and new CEOs must take action before, during and after a leadership change to carefully manage the risk inherent in a CEO transition while setting the agenda for the future.

To understand the risks in CEO transitions, the Strategic Communications segment of FTI Consulting recently studied the impact of CEO transitions on enterprise value. FTI Consulting also surveyed members of the financial community to learn how CEO changes affect their investment decisions, expectations and performance guidelines.

CEO transitions are far from rare. Among companies with market capitalizations in excess of $10 billion, nearly a third (31%) announced a CEO transition between July 1, 2007 and June 30, 2010. Among these transitions, 43% were unplanned. In all, the FTI Consulting study evaluated 263 CEO transitions across companies based in 35 countries.

The study also found that the reputation of a CEO is a critical factor in investor decisions to buy or sell a company's shares. In fact, on average nearly a third of investment decisions are based on perception of the CEO. As a result, leadership transitions put a significant portion of the investment decision at risk as opinions of the new leader are formed.

Knowledge of the industry dynamics and a firm grasp of the company's challenges and opportunities are crucial for new CEOs, according to investors. However, investors generally grant new CEOs a six-month "honeymoon" to set the vision and strategy for the company while establishing appropriate expectations for key stakeholders. Once this honeymoon period has ended, investors expect CEOs to begin delivering on their strategy.

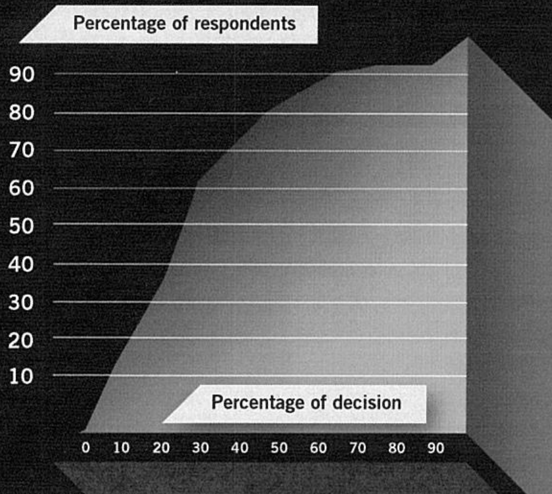
ILLUSTRATION BY TIMOTHY GOODMAN

HOW INVESTORS ASSESS NEW CEOS

The reputation of a new CEO matters to investors. According to the study, investors indicated that nearly a third (32%) of their investment decision, on average, is based on perception of the CEO (see chart below).

In addition, when asked to name the key factors affecting an organization's reputation in the investment community, CEO reputation was among the top six factors cited. That was nearly on par with the company's historical reputation itself and more important than the brand equity of a company's products and services.

When CEOs change, investors are more than twice as likely to sell shares in a company as they are to buy them. All things being equal, nearly 40% of investors said they would sell a stock solely on the basis of the new CEO, the FTI Consulting survey found, while only 15% said they would buy the stock on the same basis.



Not surprisingly, when a CEO transition occurs, investors will perform due diligence on the new CEO's qualifications. Their perceptions will be based primarily on the CEO's track record, which is by far the single most important factor that investors use to evaluate a new CEO (see chart, opposite page).

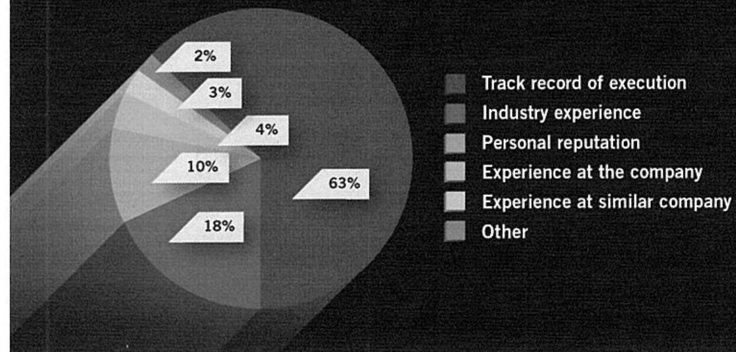
However, investors are also mindful of the circumstances surrounding a CEO's departure. Essentially, with greater surprise comes greater value at risk. For this reason, planned successions present the lowest risk (see chart, page 62) and can even have a positive impact on stock prices at the time of the announcement.

While much attention is paid to the market reaction to the announcement of a CEO change, in reality the months that follow present an even greater period of risk — and reward — with a higher potential for both value destruction and value creation. The outcome depends, in part, on how well the new CEO sets the agenda and manages the transition.

As stated above, investors are generally willing to grant new CEOs a six-month honeymoon. This honeymoon, handled well, can buy the CEO time and maintain the company's value. But handled poorly, this period may lead to serious risk to both the company's value and the CEO's reputation.

For example, in late 2010, after Leo Apotheker became CEO of Hewlett-Packard, he failed to establish a clear strategy. Some nine months into his term, HP confused the market by first discontinuing its TouchPad line of mobile tablets, then selling them at a deep discount, and then restarting production. At about the same time, Apotheker said HP might sell its profitable PC

CHARTS BY CARL DETORRES



division, then said it might not after all. Investors reacted by dropping the price of HP shares some 20% on a single day of trading in August 2011, erasing about $12 billion in market value and leaving the company's stock near six-year lows. (By comparison, the S&P 500 that day closed at 1,123.52, down 17.12, or 1.5%.) Including earlier share price declines under Apotheker's leadership, HP's stock had lost more than 45% of its value. In September 2011, Apotheker was dismissed from the company.

Once a CEO's honeymoon ends, he or she must quickly begin to deliver on the new strategy and performance goals. During this period, investors seek evidence of successful execution of the strategy. This should not be confused with financial performance per se, which most investors expect will take at least 12 months to see traction. When a CEO handles this execution period well, the company's stock value tends to increase; when handled poorly, the company's value — and the CEO's career — may suffer.

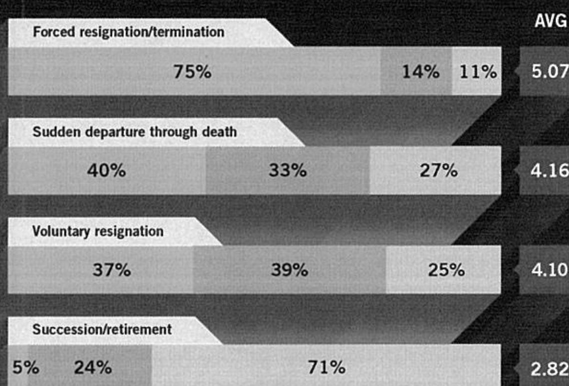
At Yahoo! Inc., Carol Bartz's nearly three-year term as CEO provides an example of the latter. Bartz started with a splash in early 2009, bringing an impressive agenda for a corporate turnaround. Then, during her first six months, she upended Yahoo!'s organizational structure, replaced executives, cut costs and laid off 5% of the workforce. Industry analysts and investors were impressed; the moves, they said, were just what Yahoo! needed. But when the honeymoon ended, Bartz failed to deliver the promised turnaround. In September 2011, less than three years into her reign, Bartz was replaced as CEO; three days later, she also resigned from the board.

A ROAD MAP FOR CEO TRANSITION

Given the impact of CEO transitions on enterprise value, companies should take concrete steps to prepare for and carefully manage leadership change.

CEO succession planning helps reduce the surprise of a transition and should be an integral part of any company's preparation for leadership change. However, it must be accompanied with and informed by a robust due diligence on all CEO candidates. In addition, having a deep knowledge of stakeholder opinions on the company, its strategy and competitive position can help to align board decisions with stakeholder expectations, permissions and needs. This can be particularly helpful in addressing the ongoing risk inherent in transitions involving fraud, regulatory investigations, strategic transformations, bankruptcies and restructuring.

Equally important, new CEOs must align their organizations to respond to change by setting the vision and strategy, establishing the appropriate expectations across stakeholder groups, and then engaging with stakeholders through new and diverse communications channels. The study found that six months after the start of the new CEO, stock performance often reversed from the knee-jerk euphoria or disenchantment at the time



THE CENTERPIECE OF ANY SUCCESSION PLAN SHOULD BE THE VETTING AND IDENTIFICATION OF A NEW CEO CANDIDATE.

of the announcement. This indicates that effective situation management and communications can mitigate the value at risk of leadership transitions and enhance shareholder returns.

FOR THE BOARD. The importance of having a succession plan cannot be overstated. CEO turnover is high, and unplanned successions generally carry more risk for a company's enterprise value than planned successions. The centerpiece of any succession plan should be the vetting and identification of a new CEO candidate.

One paradox was unearthed by the study: Although a CEO's prior track record of execution is critical, 80% of new CEOs have no prior CEO experience. Therefore, there is often minimal publicly accessible independent information of past performance available. For internal candidates, the board and management team can address this paradox by showcasing the depth and breadth of the management bench (and one or more potential successors). This increased level of exposure and positioning can be instrumental in managing unplanned transitions.

Apple Inc. provides a case in point. CEO Steve Jobs's surprising resignation for health reasons, in August 2011, could have been perilous for the company's stock. Never before, it seemed, had any company been so closely associated with its top executive. Yet on the day of Jobs's resignation, Apple's stock price dropped by only 5% in after-hours trading. This relatively small change resulted from several factors: Apple had announced a succession plan more than two years earlier; Jobs had previously revealed his illness to the general public; and Jobs's heir apparent, Timothy Cook, was well known and well liked by key stakeholders. As a result, even the shock of Jobs's death mere weeks later was quickly absorbed by investors.

Of course, it is not enough for a board to simply name a CEO candidate. The board must also perform due diligence, ensuring that the candidate possesses the qualities investors and other stakeholders seek. In this way, the board helps protect share value.

How do investors assess a CEO? Mainly, they expect a positive track record of past execution,

as well as some industry experience. In the FTI Consulting survey, industry experience was identified by nearly 20% of investors as a key factor shaping their initial opinion of a CEO.

Apple again provides a good example. Cook, successor to Jobs and now the company's CEO, had earned a solid reputation for both execution and industry experience during his 14 years of working for Apple. As the company's COO, Cook had outsourced much of Apple's manufacturing, improving the company's margins. Also, because Cook is an Apple insider, he knows the company's business and industry, and this smoothed the transition after Jobs's surprising resignation.

Yet industry outsiders can succeed too, as long as they can demonstrate an understanding of the company's situation and a relevant track record of execution. For example, Alan Mulally has successfully led Ford Motor Co. despite his lack of prior experience in the auto industry. Mulally became Ford's president and CEO in late 2006; he had previously served as CEO of Boeing Commercial Airplanes. Under Mulally's leadership, Ford — which had lost tens of billions of dollars during the recent recession — has posted eight consecutive quarters of net profits. Ford is also the only one of the Big 3 U.S. car companies to have avoided a government-sponsored bankruptcy.

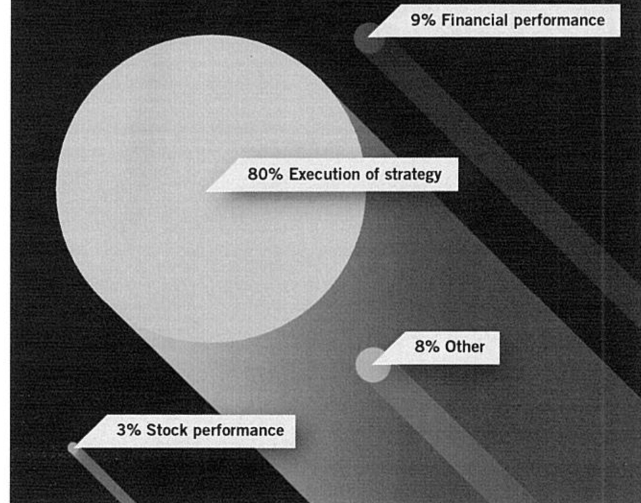
Investors, as part of their due diligence on a new CEO, will seek insights from a broad range of information sources, including internal and external stakeholders, both past and present. In particular, the FTI Consulting study found that customers, partners and the candidate's former colleagues were the sources that most influenced investors' opinions of new CEOs. In addition, investors will look to the board for reassurance that the candidate's management approach is likely to be in harmony with the company's situation and overall approach. Accordingly, companies should leverage perception studies and anecdotal evidence to better understand the stakeholders' views on a CEO candidate.

FOR THE NEW CEO. During the first six months in office, a new CEO should be dedicated to articulating a new vision and strategy, establishing appropriate expectations and managing internal talent. Investors, in their initial interactions with a new CEO, will be watching to see how well the CEO takes command. It is no longer sufficient to serve as a command and control executive. Instead, investors are looking more for "hard" attributes — including a grasp of the company's situation and plans for the future — than for "soft" ones, such as leadership style, charisma and personality.

During the CEO's second six months, investors expect to see evidence that the strategy is being executed successfully (see chart below). To stay

MEASURING CEO EFFECTIVENESS

Investors base their assessment of a new CEO on several sources.



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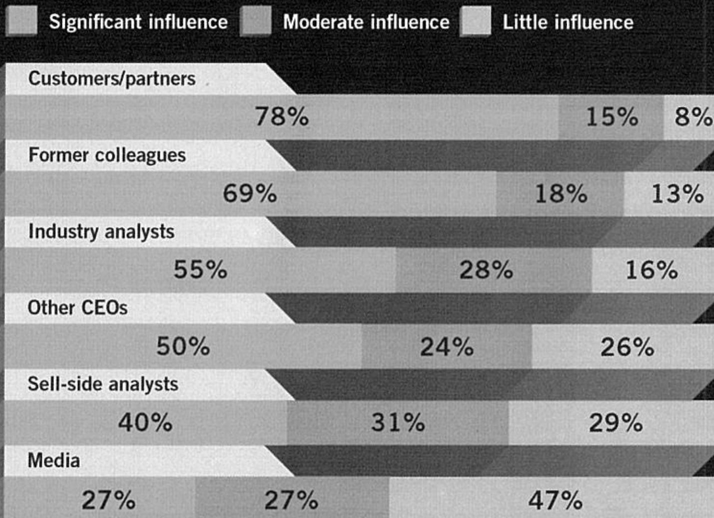
ahead of investor expectations, a CEO should carefully set the expectations against which he or she wants to be measured. Then the CEO can begin to meet stated financial objectives, improve the company's financial performance, and boost market performance and valuation over the ensuing 12 months, which is in line with investor expectations. Also, in evaluating performance success, the study reinforced the principle that the investment community values metrics associated with stewardship of capital and cash flow, such as return on invested capital and free cash flow, far more than bottom-line metrics such as earnings per share and net income.



THE HIGH VALUE OF GOOD COMMUNICATION

For a new CEO, communicating effectively with all stakeholders is critical to managing risk and its impact on a company's enterprise value. While communications are important at any time of major change, they are especially vital during a CEO transition.

How to communicate effectively? New CEOs should begin by listening to the market. For example, CEOs can conduct research to gauge perceptions and test company messaging. This can help them identify any gaps between what the company says and what its stakeholders actually hear.

New CEOs also need to have a well-honed corporate narrative to tell the company's new story. To achieve this, a CEO should develop a comprehensive communications strategy that is linked closely to his or her vision and strategy. This may involve the development of appropriate messages and channels for different groups, according to what will best reach and persuade them. For example, at The Coca-Cola Co., CEO Muhtar Kent has made a point of communicating his strategy and other changes through new channels to better engage with the company's workforce, especially those based outside its headquarters. Kent does so, in part, by conducting