CEO TENURE AND ITS IMPACT ON COMPANY PERFORMANCE

Is there a natural sell-by date for really successful CEOs?

May 2008

THE
Chairmen's
Research Group
The Board Advisory Partnership

Cass Business School
CITY UNIVERSITY LONDON

INTRODUCTION

We have to preface the findings of our research with the caveat "In normal times…." However, these difficult times will pass so it is useful to think about the dynamics of boards not in times of crisis.

Our starting point was that really successful CEOs often become really unsuccessful CEOs, and that the turnaround in their fortunes can be lightening quick. By really successful, we mean individuals associated with building value over the longer term, by which we mean 5+ years. Therefore we posed the question: Is there a natural 'sell-by' date for even the most successful CEOs? Anecdotes abound that it is around 7 years. Our observation is that only a small number of CEOs turning in strong long term performance manage their own timing well and don't wait for performance to dip. The majority stay in situ too long.

To test the hypothesis that performance diminishes after a certain time, Cass Business School helped us by analyzing 3 financial performance indicators – Earnings Per Share, Share Price and Free Cash Flow in the FTSE 350 over 15 years. An unnecessarily long, but interesting period. Of course, it is never clear how much improvement or diminishing improvement is attributable to an individual CEO as opposed to extraneous factors, but in a large sample, these effects diminish.

SUMMARY OF FINDINGS

Yes. There is an optimal period of tenure after which the rate of performance improvement falls off. While the overall performance of companies with CEOs in situ for 7+ years does not diminish – the trend line remains positive – after the 7th year, the rate of performance improvement diminishes and the trend line flattens. So it is accurate to say that there are the hallmarks of a 'sell-by date' and that years 7-8 are a good time for even the most applauded CEOs to step aside.

TWO ANCILLARY FINDINGS WERE:

a) Including those in post for less than 3 years reveals that in the 15 years analysed, 62% of CEOs were in post for 5 years or less.

b) Companies led by CEOs who were internally appointed performed better than those led by CEOs recruited from outside the company.

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REFLECTIONS

During this recessionary phase of the cycle, some, but few will be engaged in long term succession planning. It may become a luxury which few will be able to indulge. However, outside of the short term, two points emerge:

- **In the instance of high performing CEOs, it is incumbent upon Chairmen with even the highest performing CEOs to actively participate in the succession process and their transition at or around year 7 in order to preserve that individual's and the company's success. It is clearly in the interests of the shareholders to do so. What is less clear is that it is in the interests of the successful incumbent. If a CEO wants to continue in an Executive capacity in the longer term, and many do, the evidence shows that those who manage events proactively are the ones who achieve that goal.(MSP, CEO Career Paths, 2007)**
- **The more philosophical question is what is happening at and around 5 years to create such a tide-line in tenure? The numbers suggest that 5 years is the natural life span of a CEO (in times of growth). Perhaps it would benefit succession planning activity if the assumption of c.5 years tenure was more widely held?**

We leave these with you and welcome your thoughts at any time.

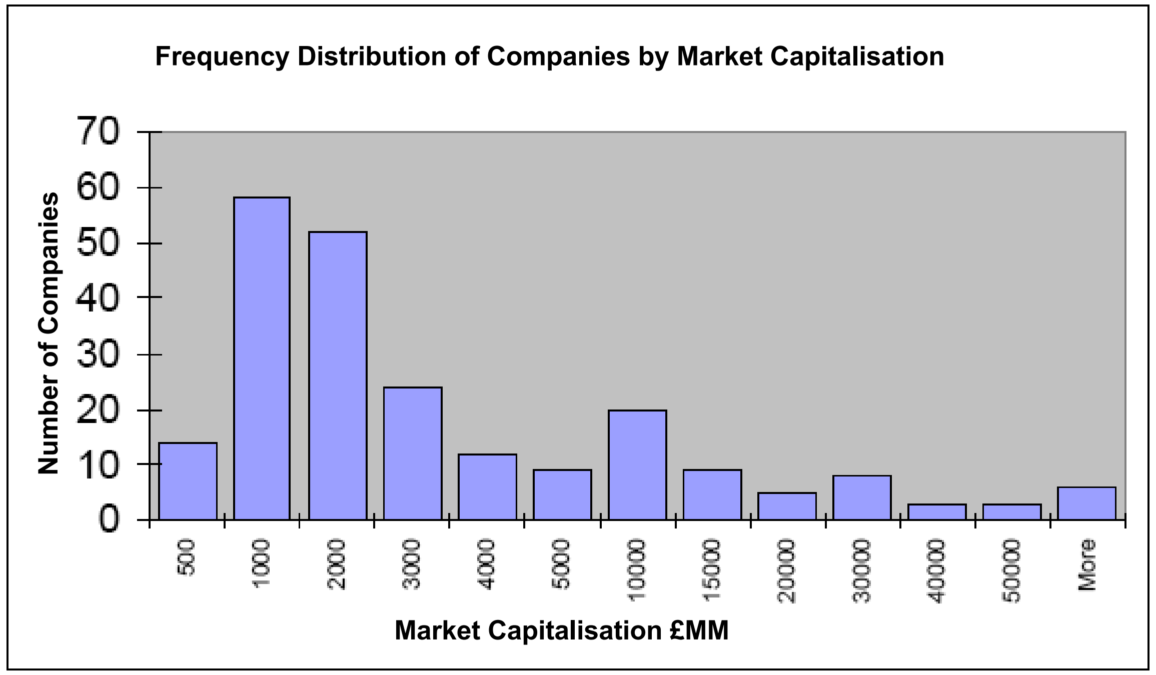
NATURE OF STUDY

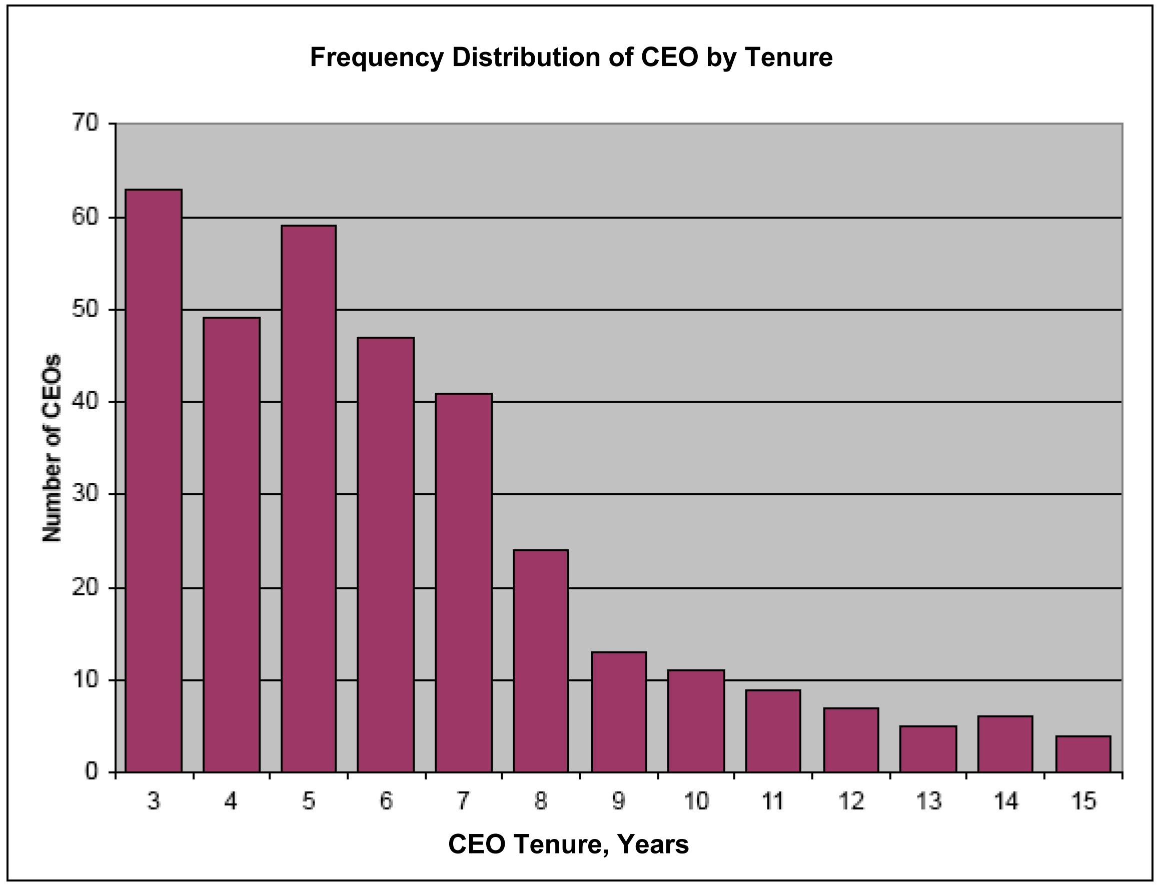
- **Sample consisted of FTSE 350 companies quoted in 2006 (to ensure availability of full-year results), excluding:**
  - Investment trusts
  - Companies whose CEO was appointed before listing
  - Companies where CEO tenure was less than three years
  - Companies which had not been quoted before 2004
- **This left 223 companies of very varied size, a good sample, with 338 CEOs who had 3+ years' tenure between 1992 – 2006 (many companies had more than one CEO during this period).**
- **Market capitalisation was also recorded for each company as at 29th December 2006, as an approximate indicator of size.**
- **The CEOs were then divided into cohorts by length of tenure, from 3-15 years, which did to some extent minimise effects of general market movement and the economic cycle.**
- **For each CEO in each cohort the percentage increase in the three measures – Earnings per Share (EPS), Share Price (SP) and Free Cash Flow (FCF) – was calculated from initial year to final year of tenure; year-end figures were used, except for Share Price, which was averaged over the whole year.**

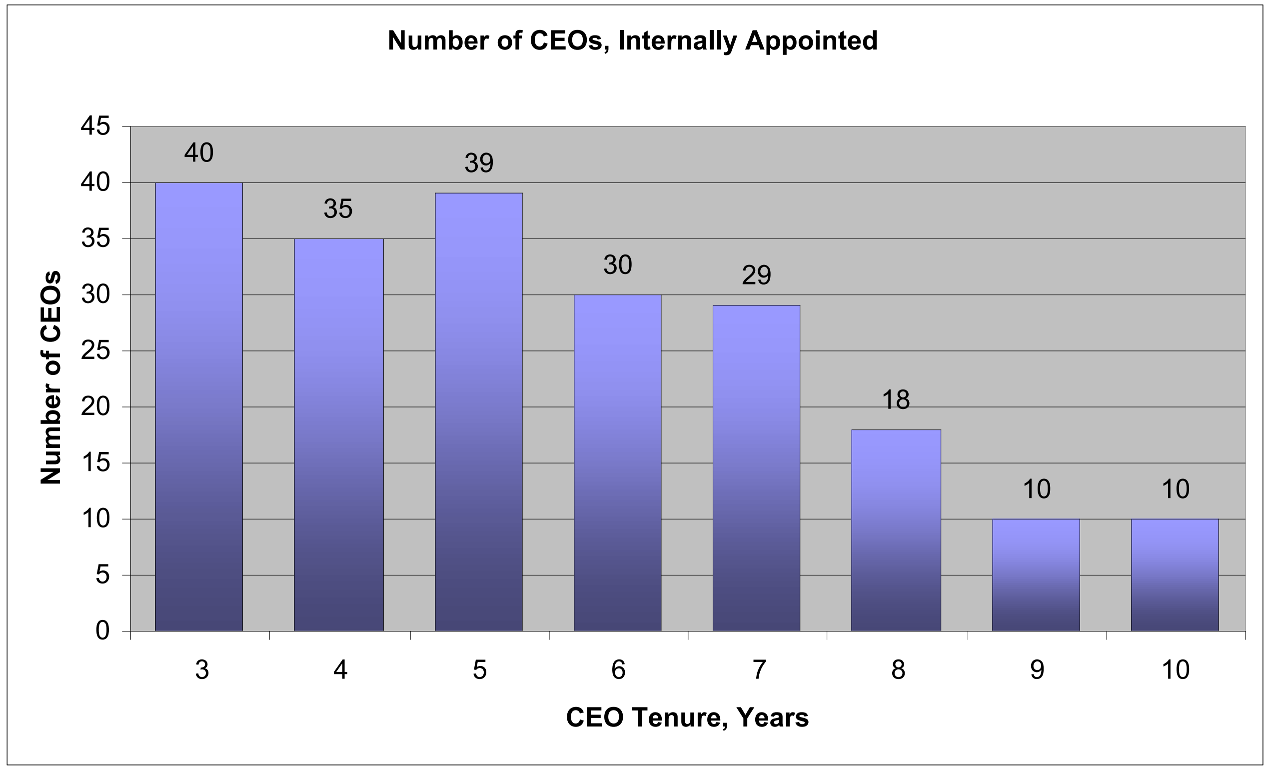
- For each cohort the Median, Upper Quartile (UQ) and Lower Quartile (LQ) values were calculated; these were then plotted in graphs representing the whole sample, and trend lines calculated.
- Separate graphs and trend lines were produced for up to 15 and 10 years' tenure respectively.
- Supplementary analysis was carried out, to split the sample into CEOs appointed from inside the company, and those appointed from outside, to see if there were any performance differences between them (upto10 years' tenure only).
- Those were then compared on each of the three measures, and graphs plotted separately for Medians and trend lines only.

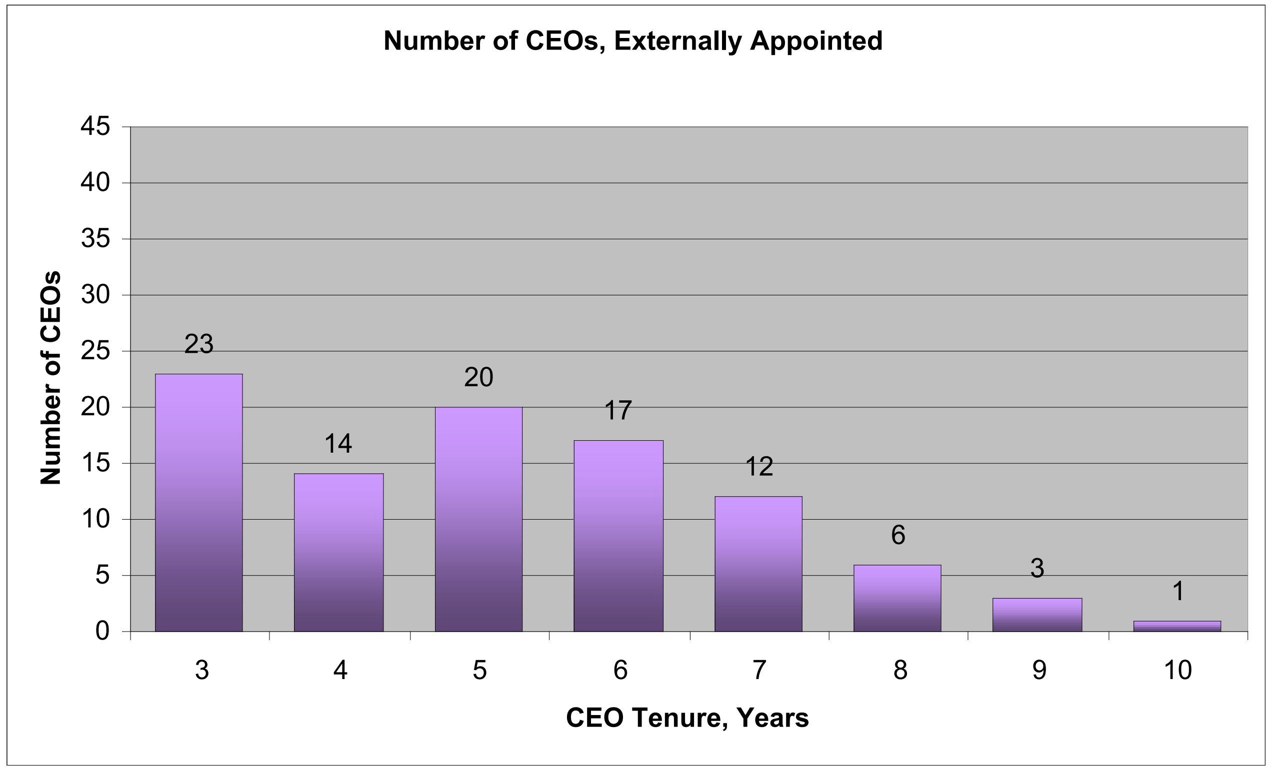
RESULTS AND CONCLUSIONS

- For the main sample, the trends are clear, in spite of some volatility (most marked for FCF). They show steady increase, with no indication of reaching a peak or plateau, and then declining, at any stage, even for longer periods of tenure, up to 10 years.
- Smaller sample size over 10 years, and greater volatility (especially for FCF), make this conclusion unproven for later years, though for EPS it might still be valid.
- Findings clearly contradict the common assumption of optimum period of tenure, after which a decline in performance is inevitable; at least up to 10 years, the performance of companies, and thus presumably CEOs, does improve with tenure, though above 10 years the results are inconclusive.
- For the split sample, internally appointed CEOs performance is clearly superior overall on EPS and SP; for FCF there is little difference up to 7 years, but externally appointed CEOs appear higher thereafter – which may be a distortion due to smaller sample size.
- Common sense conclusion is that experience in job improves performance, at least as judged by these measures, and that insiders perform better than outsiders.
- This study has focused solely (as generally does the market) on publicly available measures of financial performance, and there may of course be leading indicators of future decline in performance by a CEO at any length of tenure, and especially after 10 years, which it would be irresponsible for a Board, and notably the Chairman, to ignore.
- These leading indicators may include operational measures, which vary from sector to sector, or more subjective signs or qualitative indicators, often concerning how effectively the CEO handles relationships – including the Board, major customers, subordinates, institutions, brokers, banks and the media amongst others.









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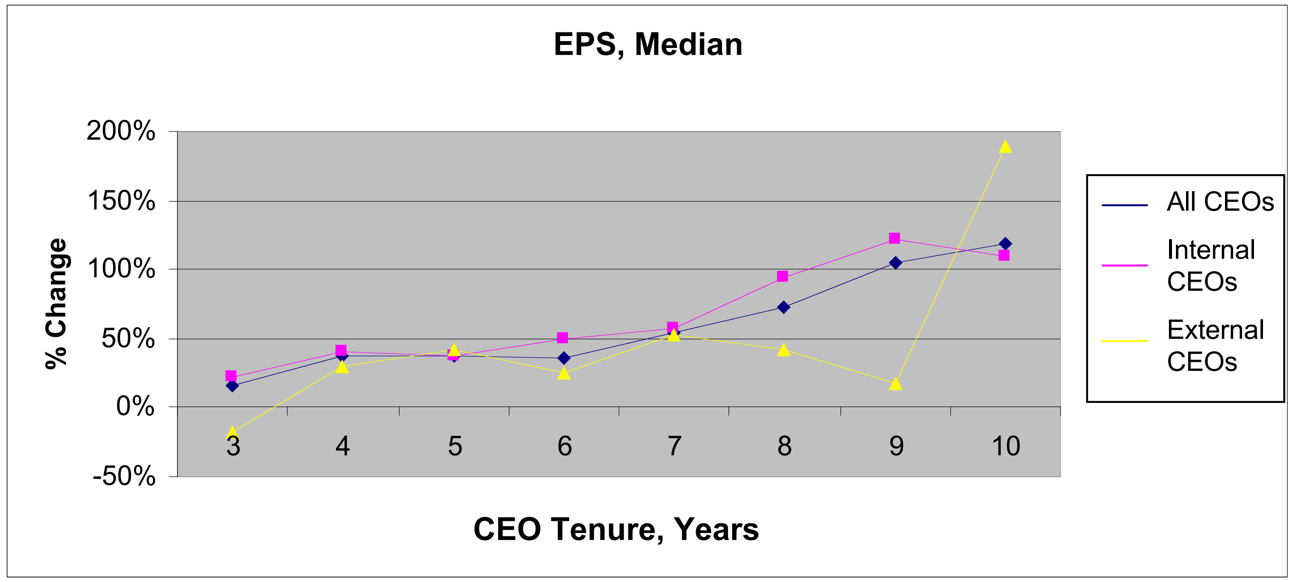

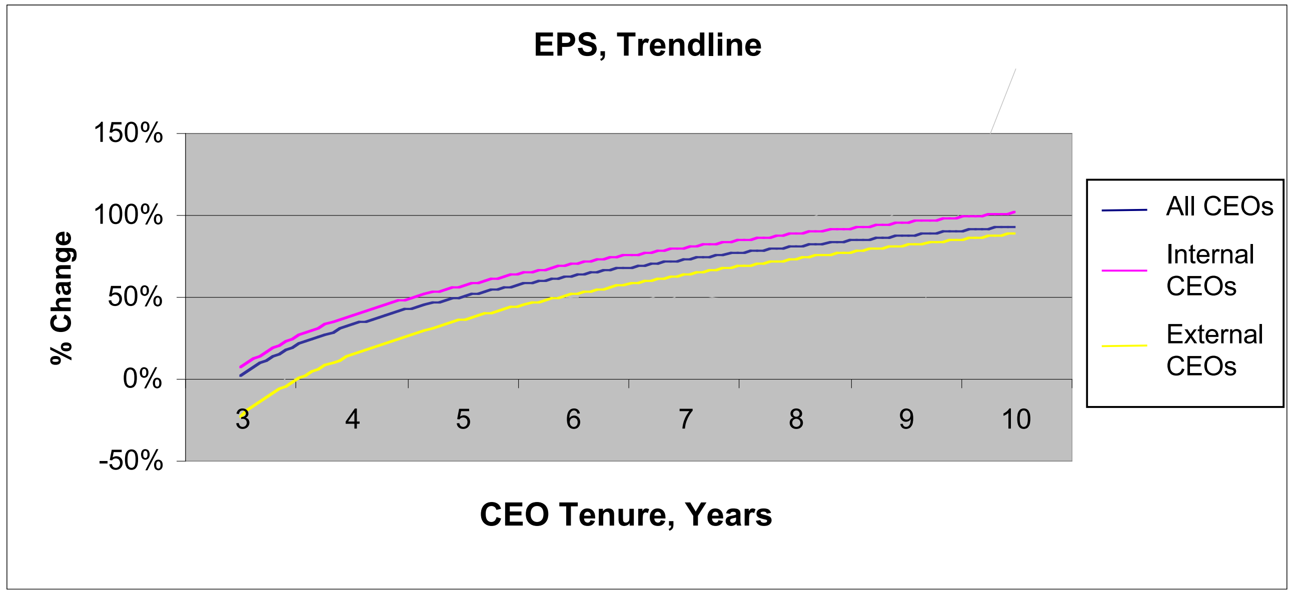

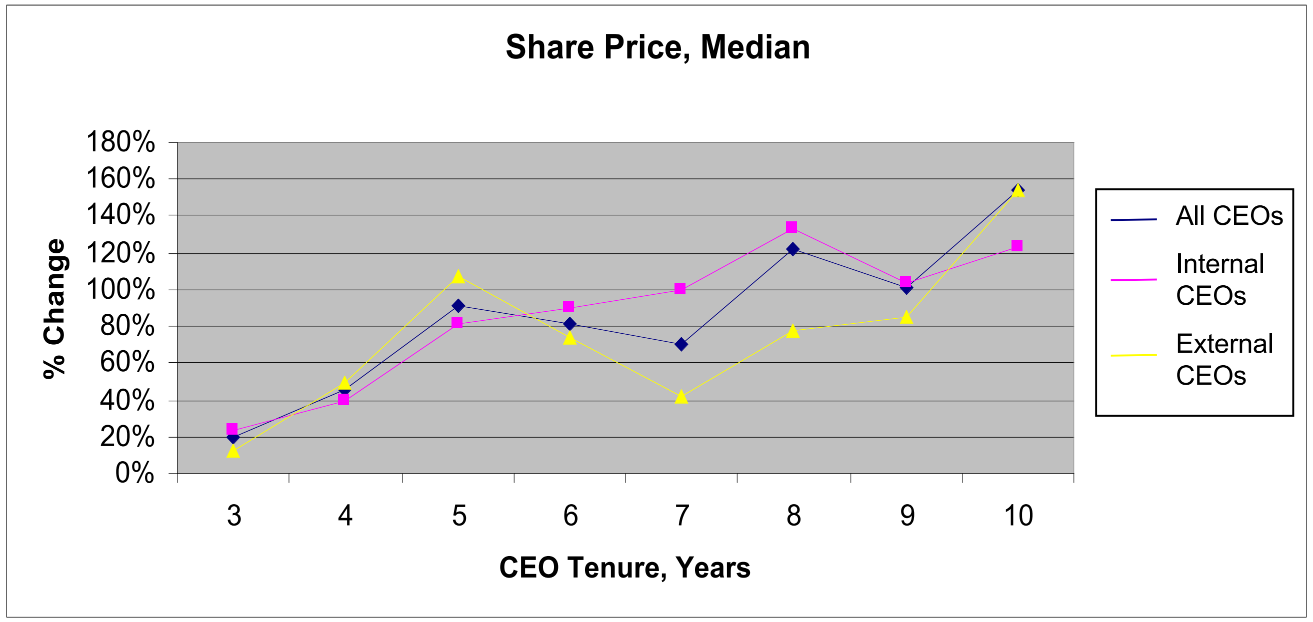

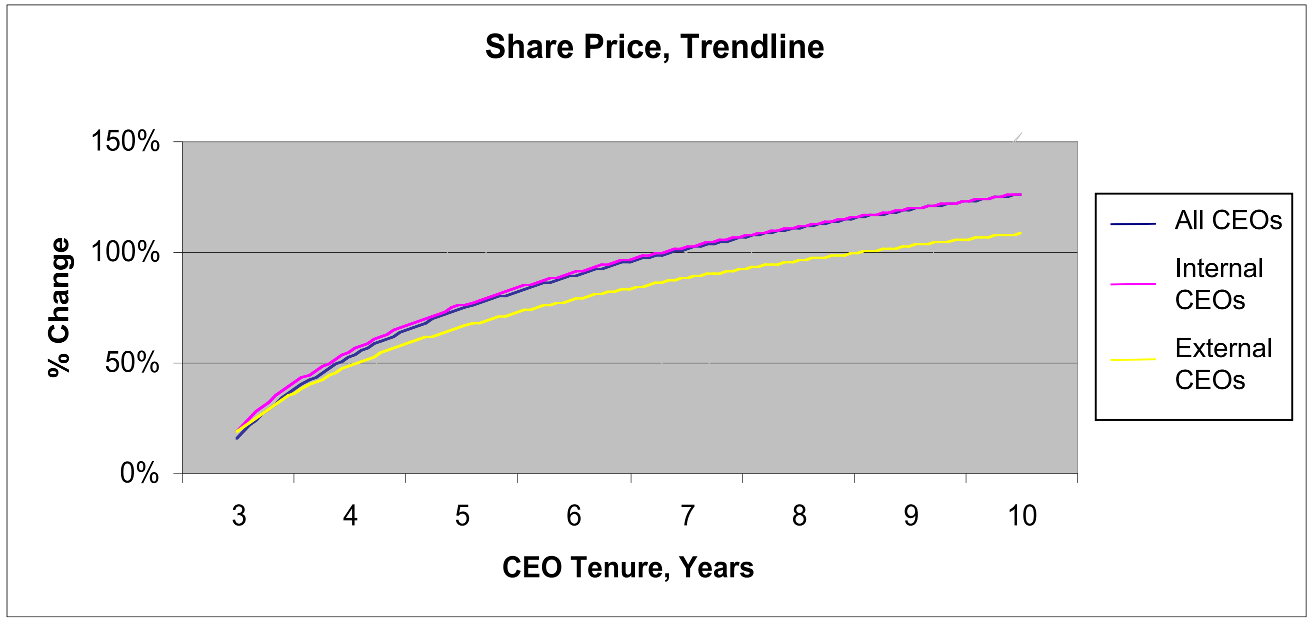

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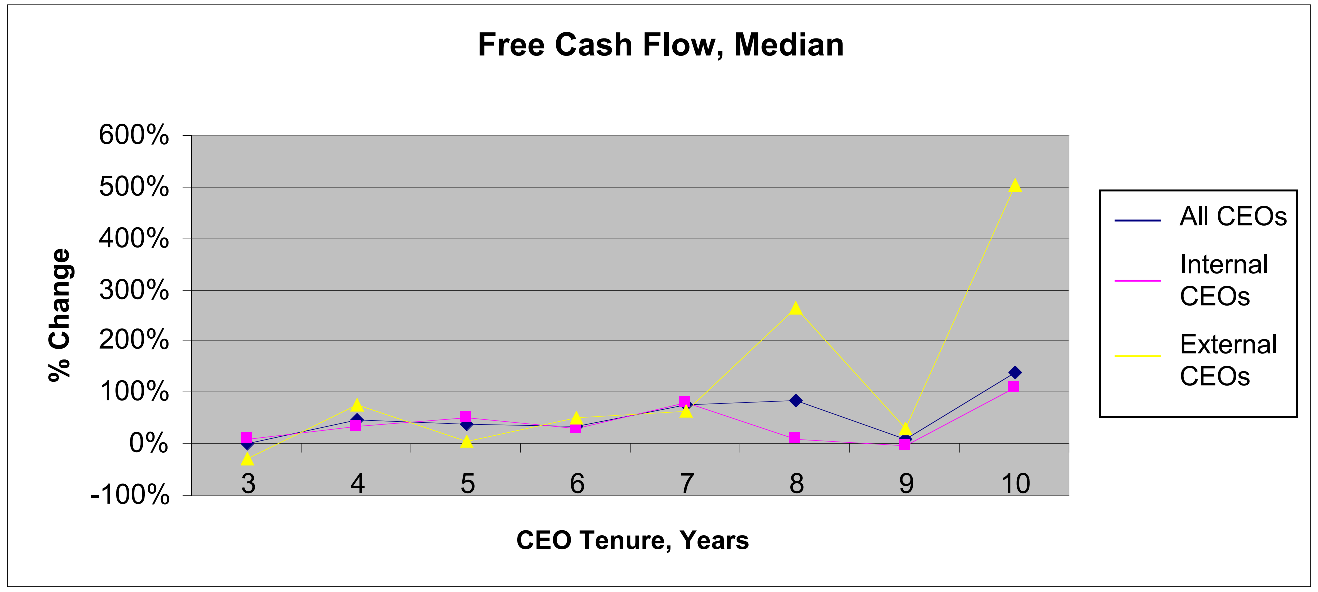
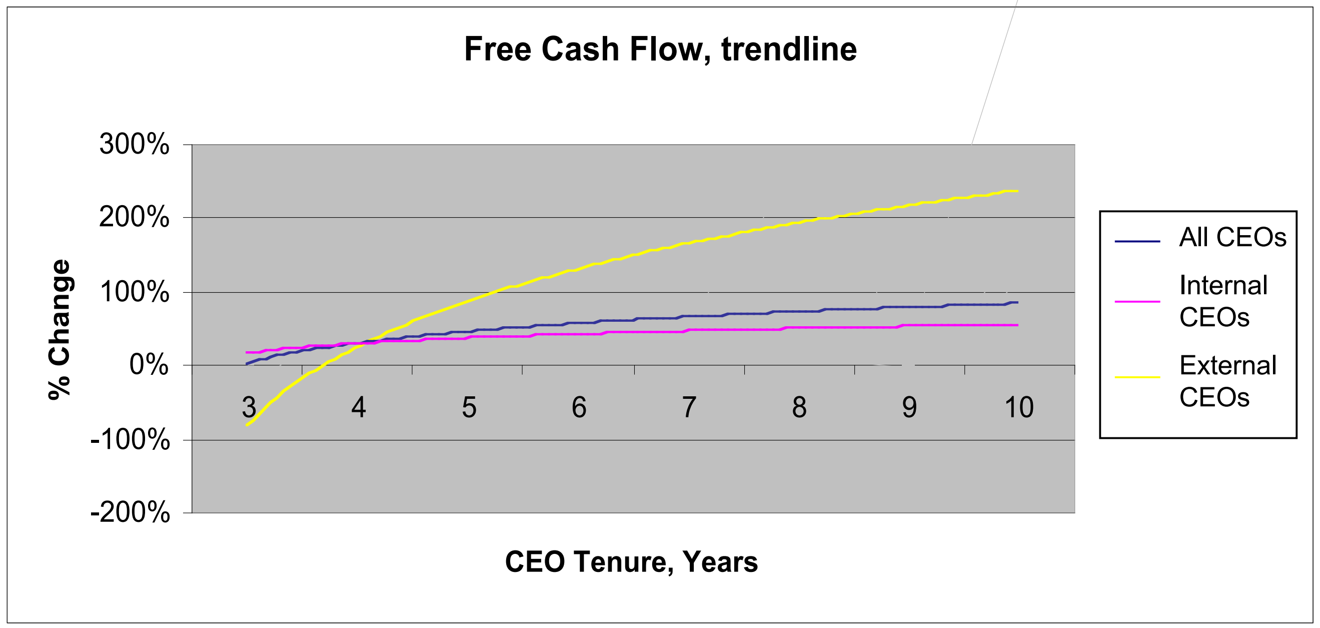
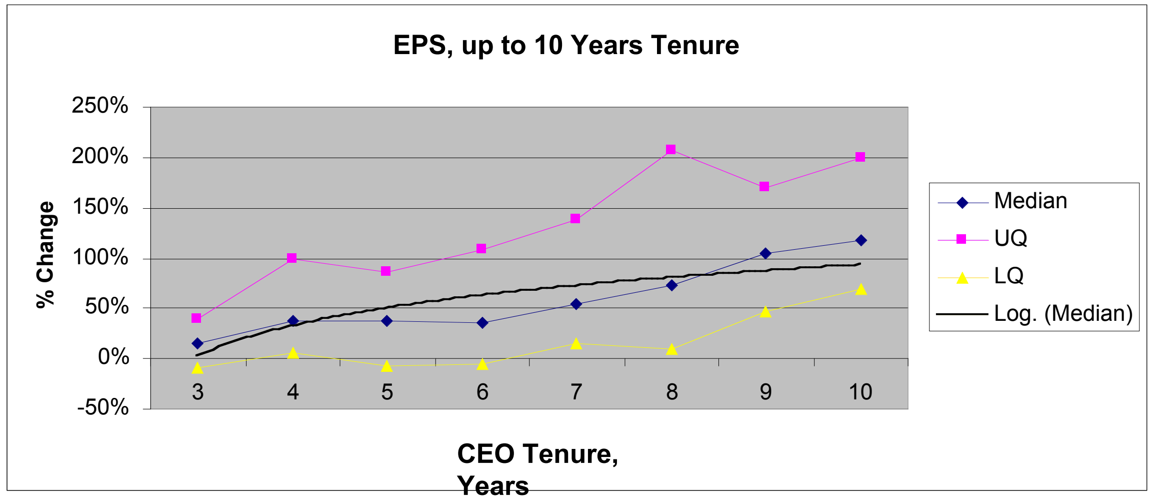
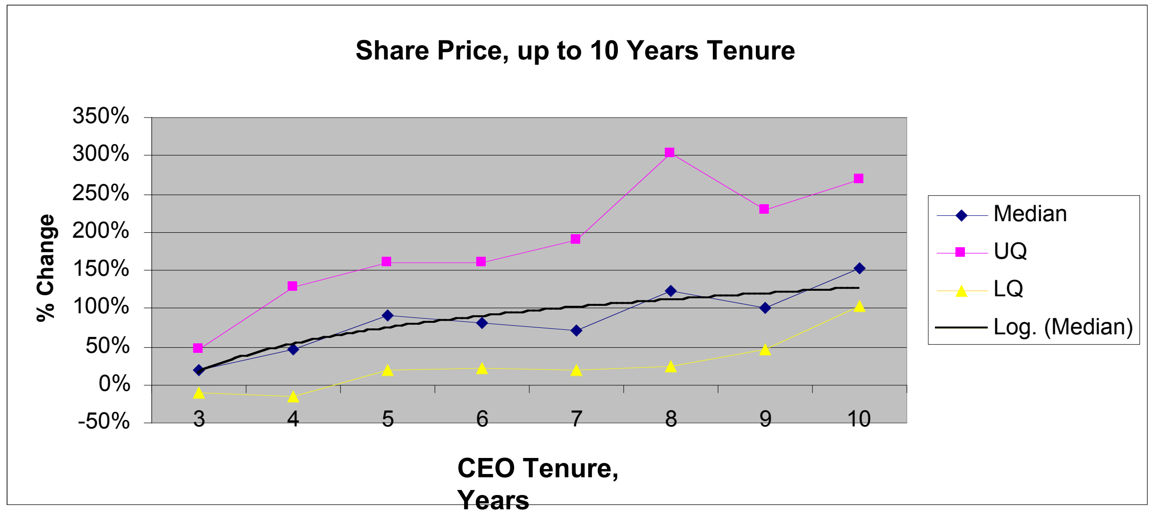
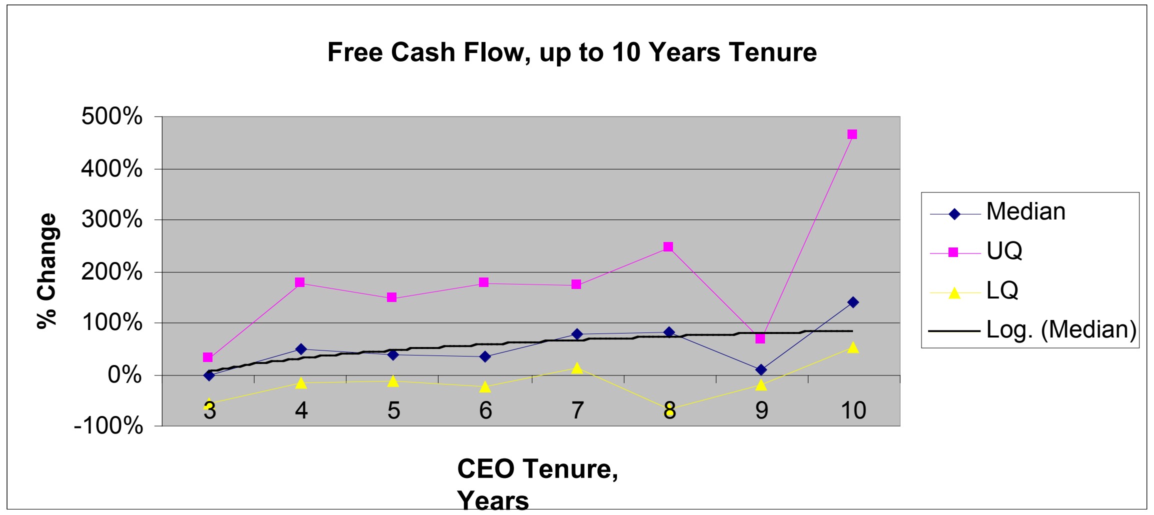
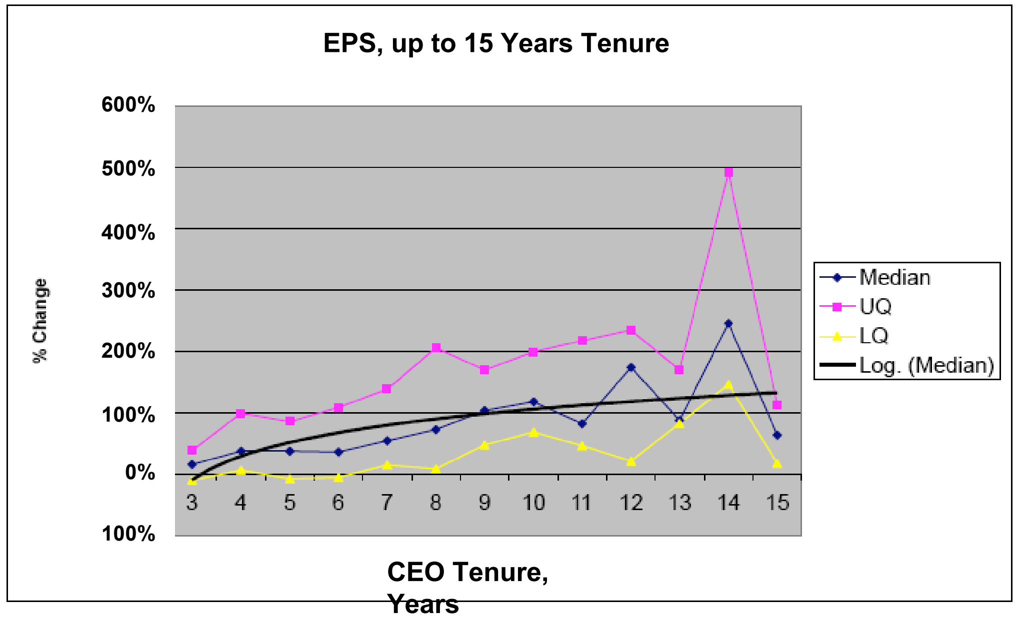


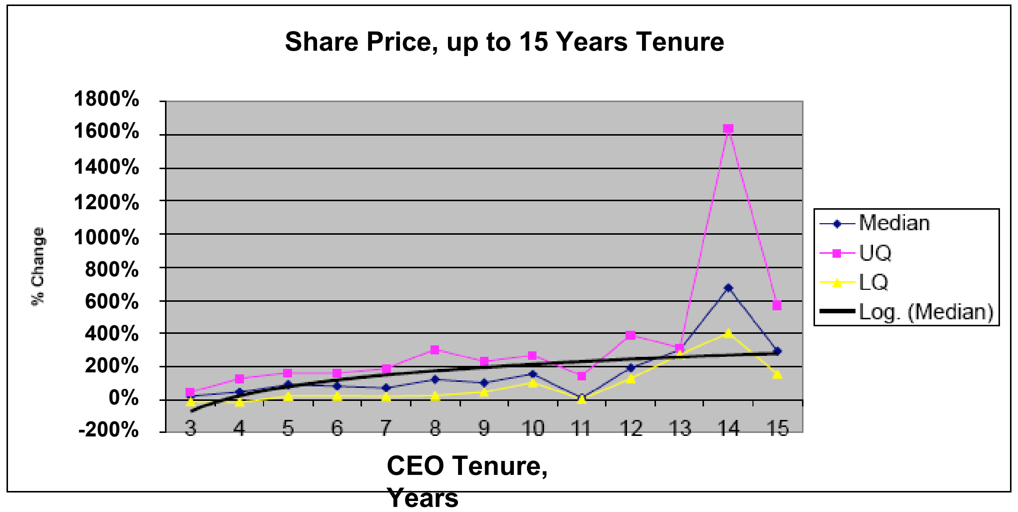


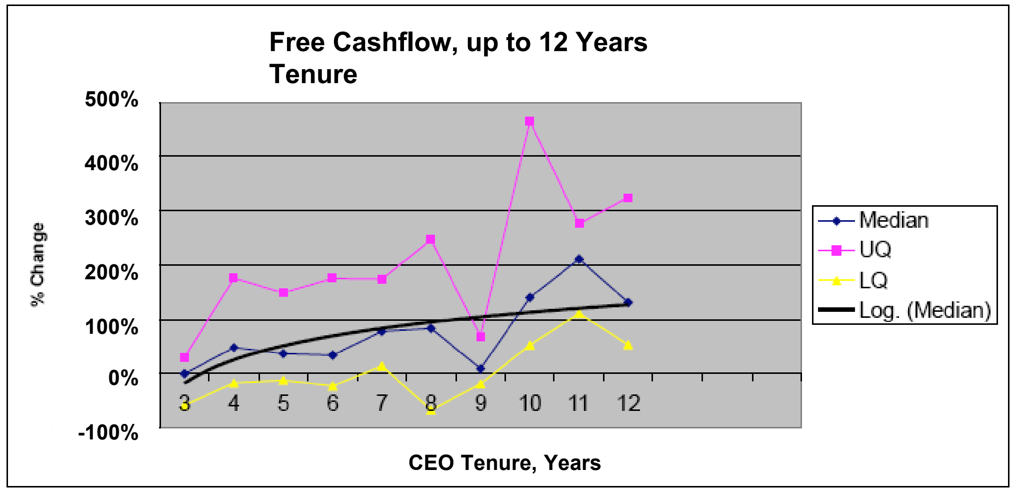

EPS, up to 10 Years Tenure
% Change
250%
200%
150%
100%
50%
0%
-50%
3 4 5 6 7 8 9 10
CEO Tenure, Years
Median
UQ
LQ
Log. (Median)


Share Price, up to 10 Years Tenure
% Change
350%
300%
250%
200%
150%
100%
50%
0%
-50%
3 4 5 6 7 8 9 10
CEO Tenure, Years
Median
UQ
LQ
Log. (Median)


Free Cash Flow, up to 10 Years Tenure
% Change
500%
400%
300%
200%
100%
0%
-100%
3 4 5 6 7 8 9 10
CEO Tenure, Years
Median
UQ
LQ
Log. (Median)


EPS, up to 15 Years Tenure
% Change
600%
500%
400%
300%
200%
100%
0%
100%
3 4 5 6 7 8 9 10 11 12 13 14 15
CEO Tenure, Years
Median
UQ
LQ
Log. (Median)


Share Price, up to 15 Years Tenure
% Change
1800%
1600%
1400%
1200%
1000%
800%
600%
400%
200%
0%
-200%
3 4 5 6 7 8 9 10 11 12 13 14 15
CEO Tenure, Years
Median
UQ
LQ
Log. (Median)


Free Cashflow, up to 12 Years Tenure
% Change
500%
400%
300%
200%
100%
0%
-100%
3 4 5 6 7 8 9 10 11 12
CEO Tenure, Years
Median
UQ
LQ
Log. (Median)

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