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Benchmarking

The Misunderstood and Underused Key to Great CEO Succession Planning

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Boards and their companies spend millions of dollars annually on independent advice about how to compensate their CEOs. Among other things, they want to know the going rate in their industry, in other industries, and in companies of similar size. They want to know what mix of incentives and rewards are being offered in the market, and they want to be able to justify their decisions in terms of that broader context. In short, they want benchmarks against which they can measure their own compensation practices.

Yet when it comes to CEO succession planning — that is, deciding *whom* to pay, not how *much* — many of these same boards and their sitting CEOs decline to invest in benchmarking internal CEO candidates against external talent. Based on our experience working with boards of leading companies, we believe it's a mistake not to. A board that forgoes benchmarking is, in effect, conducting succession with blinders on, unable to see or judge talent that is not immediately in front of them

A basketball team, to understand its personnel needs, wouldn't measure the height of its own players only. It would want to know how that height stacked up against the competition, how much difference height would make given the current make-up of the league, and which individuals in the league — and far beyond — used their height to best advantage. Similarly, companies benchmark many of their key processes against best practices in the wider world — their supply chains against Wal-Mart and other leaders, their manufacturing processes against the likes of Toyota, their customer service against companies like Nordstrom's. Boards, in particular, don't operate in a vacuum when they're evaluating company strategy. In fact, it makes no sense to talk about strategy without looking outward. Perspectives on CEO talent shouldn't be limited, either.

Nevertheless, even some of the world's largest corporations forgo external benchmarking of CEO talent. Perhaps the closest they come to it occurs when they are faced with an unplanned succession — the CEO unexpectedly departs, dies, or must be abruptly removed. In those circumstances, if there is no internal heir-apparent already in place, companies will often install an interim CEO while they search externally for a permanent chief executive. Although this executive search resembles benchmarking taken to its logical conclusion, the two should not be confused.

CEO benchmarking is a process through which the board is continually assessing internal and external candidates against company-specific challenges such as organic growth, growth through acquisition, turnaround, and the many other possible strategic and operational issues that the future CEO will likely face. Because these challenges are constantly evolving, benchmarking is an ongoing process that should be in place through planned and unplanned CEO successions alike.

To help boards better understand this much misunderstood and underused practice and get full value from it, we explore here three key issues:

- The sources of resistance to external benchmarking of CEO talent
- How benchmarking fits into a best practices CEO succession planning process
- How benchmarking of CEO talent should be conducted

Benchmarking, properly understood and applied to CEO succession planning, can go a long way toward helping boards better fulfill what is arguably their most important responsibility after fiduciary duty.

Resistance and Its Consequences

Board resistance to CEO talent benchmarking springs from a number of sources and specific objections, but the ultimate source may be found in what is called “paradigm blindness.” We’ve heard for decades about the phenomenon of the “paradigm shift,” but little about the inability to see alternatives because of the norms and unacknowledged assumptions in which we unquestioningly operate. Paradigm blindness is the propensity to do things a certain way because we have always done them that way. So it is with much CEO succession planning: we don't benchmark external CEO talent because we have never benchmarked external CEO talent. *We don't do it because we don't do it.*

The consequences of such blindness can be enormous in terms of value left on the table or value destroyed as a result of choosing less than the best available candidate for the top leadership position. Jim Collins, who has been considered by Fortune the "most influential management thinker alive," has demonstrated that having the right leader at the top is the foundational condition for creating lasting greatness. Likewise, in one of the best studies quantifying the impact of CEO decisions on company value, Harvard professors Noam Wasserman, Bharat Anand, and Nitin Nohria show that the leadership effect is probably the most important controllable source of company value.[1] In some markets, the leader effect can account for up to 40% of the variance in performance or value. For a large US company, the CEO decision has a potential impact on value worth billions of dollars.

Benchmarking is designed precisely to help overcome paradigm blindness and its consequences for CEO succession by measuring internal CEO talent against best-in-class external talent, determining any shortfalls in that internal talent, and using the information to improve the development of internal candidates. Such benchmarking can often be confirmatory: the board sees clearly that the internal candidate is equal or superior to external talent. That information — as valuable as the knowledge that internal candidates come up short — can prevent the board from simply taking the internal candidate for granted.

When explicitly asked to look outside the paradigm and consider external benchmarking of CEO talent, directors often do state specific objections. Among the most common:

[1] "When Does Leadership Matter? The Contingent Opportunities View of CEO Leadership," Harvard Business School Working Paper, No. 01-063, 2001.

Benchmarking external CEO talent is disloyal. Some directors may feel that by seeking independent assessments of best-in-class external CEO talent they are showing a lack of trust both in the sitting CEO who may have been grooming a successor and in the heir-apparent. But it's no more disloyal to measure internal talent against external talent than it is for a basketball team to understand the attributes of outstanding players on other teams. It's not a matter of the board's loyalty; it's a matter of responsibility.

There's no need to look at external talent when there are a number of attractive internal candidates. Many companies certainly have strong talent benches with highly competent executives who may well be potential CEOs. But unless the board benchmarks them against external talent it will simply never know what shortfalls they might have in the competencies that the company will need in the future. Further, internal candidates have been promoted and evaluated on the basis of their performance, not their potential. Their experiences and their accomplishments, no matter how impressive, simply may not be relevant to what the company will need most — a determination that benchmarking can help make.

Bringing in an outsider who doesn't understand the business is so risky that benchmarking is beside the point. Even if there exists external talent that possesses all of the competencies that a company will need in the future, the board may understandably worry that the downside risk of someone new to the business is simply too great. Experience has shown that such concerns are certainly not unreasonable. However, benchmarking can provide the basis for making an informed decision about the trade-off between an internal successor with knowledge of the business and an external successor with precisely the skills that the company will require. Further, even if the board is highly unlikely to look outside, benchmarking can identify what the knowledgeable insider must do to prepare for the top job.

Looking outside might cause internal candidates to look outside, too. Board members fear that by seeking information about outside CEO talent they will alarm internal executives who feel that they may be in the line of succession. Feeling insecure and perhaps offended — the objection goes — an executive will jump ship at the first opportunity, costing the company a valuable leader in the present and a possible successor for the future. First, insofar as benchmarking is an ongoing board process, as it should be, internal executives are unlikely to be disturbed by it. In fact, because really talented people have little to fear from benchmarking they usually welcome it. Second, talent is almost always looking around for opportunities and people looking for top talent inevitably find it — a powerful equation unaffected by benchmarking.

People will talk. Directors worry that news will get around that the company is assessing external CEO talent. They fear that people will conclude that the company is in trouble and that the stock price will therefore suffer. Worse, the company could inadvertently be put in play. These fears are groundless — benchmarking external talent as part of an ongoing succession planning process does not mean conducting interviews with external talent or otherwise sending signals that the company is in the market for a new CEO.

In fact, benchmarking is not only innocent of all those charges but, more positively, it plays an integral role in a best practices approach to CEO succession planning. The Center for Creative Leadership (CCL) has conducted extensive research on executive selection, and their conclusions clearly show that *it is always better to consider both internal and external candidates for a senior appointment*. Specifically, they found that the candidate pools of companies whose internal selection proved successful contained more external candidates than did the candidate pools of companies whose internal selection did not succeed.[2]

[2] Valerie I. Sessa and Jodi J. Taylor, *The Executive Selection: Strategies for Success* (Center for Creative Leadership, Jossey-Bass, 2000), pp.73-74.

Benchmarking and Best Practices in Succession Planning

A decade ago the National Association of Corporate Directors (NACD) addressed the question of CEO succession planning. In a formulation that has stood the test of time, *The Report of the NACD Blue Ribbon Commission on CEO Succession* offered five basic principles of the process:

– The goal of CEO succession is finding the right leader at the right time.

– CEO succession is a board-driven, collaborative process.

– CEO succession is a continuous process.

– The board should ensure that the CEO builds a talent-rich organization by attracting and developing the right people.

– Succession planning should be driven by corporate strategy.

Benchmarking external CEO talent helps realize all five of those principles, and those principles suggest how and where such benchmarking should be used in the CEO succession planning process:

The Right Leader at the Right Time In the case of the unplanned succession, a board that has benchmarked external CEO talent enjoys some considerable advantages. They know with a much greater degree of certainty whether an internal candidate is fully prepared to take over. Further, if the board concludes that no internal candidate is ready, then the board already has a head start on what needs to be a rapid and effective search for a new CEO.

In planned successions, benchmarking can be equally valuable in assuring that the company appoints the right leader at the right time. “Right leader/right time” is shorthand for the best possible conjunction of the CEO’s competencies and the company’s circumstances in the marketplace. Yet board members have few ways in which their activities directly and concretely engage them with the company’s marketplace. Benchmarking

CEO talent, because it entails a consideration of how the skills of individuals fit the strategic needs of the company, gives board members a palpable feel for the business as few other things can and, in the process, leads them to better decisions about the business and its leaders.

A Board-Driven, Collaborative Process Boards differ of course in the degree of their involvement in CEO succession planning. At one end of the spectrum, some boards are minimally involved. At the other end, some boards completely control the process. In the middle stand boards that drive the process in close collaboration with the current CEO. This broad spectrum of behavior suggests that in the post Sarbanes-Oxley world many boards are still feeling their way forward from the days of rubber-stamp boards toward the right degree of board activism. But given the importance of CEO succession and today's higher expectations of board performance, the question is no longer *whether* to actively participate in the process but *how*. Benchmarking of external CEO talent provides boards with a constructive way to drive the process without being contentious.

A Continuous Process Between 1995 and 2006, CEO turnover increased 59%. Since 2003, the average CEO tenure has declined from eight years to four years. In 2007, more than one third of CEOs had a tenure of less than three years. More than ever, succession planning has become a continuous process rather than a once-every-five-years or so event. Benchmarking ensures that succession is continuous in more than a pro forma way by keeping the focus on both internal and external candidates and, as the company's needs evolve, reflecting that evolution in the changing cast of candidates, which acts as a hedge against complacency about already having identified a successor.

Building a Talent-Rich Organization Given the shrinking tenure of CEOs, boards must not only be thinking about the next CEO but also about the CEO after that. Benchmarking helps with understanding current CEO talent and can be used to assess internal and external high-potentials who could one day be CEOs. With an understanding of how the next tier of internal high-potentials stacks up against external talent, the board and the company can better develop or acquire outstanding talent at that all-important executive level, building a talent-rich organization and potentially preparing for the succession-after-next.

Corporate Strategy Although the idea that succession planning should be driven by corporate strategy is listed last in the NACD report, it should come first conceptually. Before considering any particular candidate to succeed the current CEO, the board should understand the strategic context in which the next CEO will have to operate: the key business drivers, industry trends, competitive landscape, markets, and financial goals that will help shape the company's future. Then it is possible to define the competencies that the next CEO will need. Obviously, for example, a company that is likely to be in turnaround needs different competencies in a CEO than does a growth company planning to expand aggressively in new markets. To alter slightly a familiar saying: if a company doesn't know where it's going, any CEO can take them there.

Given the sophistication, complexity, and range of strategies that companies might adopt, the competencies required of a CEO candidate can be highly specific, numerous, and hard to find. Once those competencies have been clearly defined, external benchmarking can tell the board how widely distributed such competencies are, where they are likely to be found, and how likely it is that anyone anywhere possesses all of those competencies in the highest degree. The exercise can reveal gaps in the competencies of internal candidates or it may confirm that no ideal candidate exists and that the internal talent comes off relatively well against external talent.

Benchmarking People

Benchmarking has long been used as a tool for evaluating processes, products, functions, and other elements that can be compared through a variety of techniques and metrics. For example, companies benchmark their distribution practices against industry leaders through such metrics as percentage of on-time deliveries, customer satisfaction, costs, and the many other measures of distribution efficiency and effectiveness. Manufacturing can be benchmarked using such metrics as plant downtime, capacity utilization, scrap, inventory, rework, and so on. Competing products can be reverse-engineered and compared to the company's offerings. In all of these cases, benchmarking is a reasonably precise, often highly quantitative procedure.

When the focus falls on human beings, however, many people unreflectively think of "benchmarking" as a synonym for loosely comparing individuals in an impressionistic and often intuitive way. In fact, in the right hands, the benchmarking of executives is a highly structured, systematic procedure that requires both science and art. Best practices include:

- Using an experienced third party to assess external and internal candidates in order to bring the requisite objectivity and uniformity
- Giving the third party extensive exposure to the organization, its structure, its culture, and its aspirations
- Defining the job specification for the CEO in terms of the company's future strategy and the competencies that will be required to achieve it
- Ensuring that the third party evaluates all internal and external candidates using proven, quantitative and qualitative methods of assessment
- Using the results to guide development activities for internal candidates

Such a systematic, proven approach to the benchmarking of CEO candidates provides board members with precise, actionable information that they can use to help ensure a truly best-practices succession planning process. No longer a misunderstood and underused tool but a sharp lens for focusing the future, benchmarking keeps the board positioned at all times to appoint the best possible CEO for the company — transforming succession planning into planning for success.