

Investors Identify Their 7 Top Concerns Relative to Succession Planning

“When Bank of America CEO Kenneth Lewis said that he was resigning, no one was surprised. Except, it seems, B of A’s board of directors” -- USA TODAY, November 11, 2009

Succession, particularly CEO succession, is receiving unprecedented scrutiny from investors and the media. Investment analysts, private equity firms and rating agencies are increasingly factoring succession issues into investment decisions and ratings. Large institutional investors and activist investment funds are targeting companies – and their boards - who appear to have high risks relative to succession planning. Investors have begun to raise questions about succession planning – and whether the board has adequately addressed it – in meetings with directors and CEOs, at investor conferences, on analyst calls and even by sending letters on this issue to selected companies in their portfolios.

In October of 2009, the SEC announced a major policy reversal on shareholder resolutions which has led to an increase in succession planning-related proposals. The Laborers’ International Union of North America (“LIUNA”) has now filed 14 of these resolutions at companies that have had the same CEO for five years or more, or have had a new CEO in the past year including American Express, Whole Foods and others. Connecticut Retirement Plans and Trust Funds is submitting related proposals that ask boards to adopt policies that the achievement of goals related to succession planning will be incorporated into the formula for determining one or more elements of the CEO’s variable compensation.

To explore those factors of primary importance to investors relative to succession, Integral Advisors, LLC and Board Advisor, LLC conducted qualitative research with a variety of players within the investment community to identify the key “succession risks” that they were concerned about. Twenty interviews* were conducted with investment analysts, institutional investors, investment banks, activist investment funds, private equity investors and rating agencies between October, 2009 and January, 2010 and supplemented with website reviews of the major rating agencies. From this study, seven key areas of succession concerns were identified and a Succession Risk Index© established that can be used in analyzing a company’s exposure – and that of its board – in this area.

The Succession Risk Index© can be used in a comprehensive analysis of a company’s succession planning programs conducted on behalf of the Board of Directors**. It provides the board with the value of an objective, experienced analysis of their succession planning efforts to date– and those of company management – gauged relative to the seven succession issues of greatest concern to investors. Using this analysis and the recommendations generated from it, the board and management can take steps to shore up areas of succession risks that have not been adequately addressed. Areas where the company and its board scores well, may actually be highlighted to investors either when these issues arise in investor meetings or through disclosure in the company’s proxy, governance guidelines, etc.

**A list of organizations interviewed for this study is found at Appendix A.*

*** Sample output from this type of analysis is found at Appendix B.*

Seven Key Succession Risks

1. **Succession planning process:** Does there appear to be a comprehensive succession planning process in place? Has the board developed criteria for the next CEO that reflects the company's business model and long-term strategy – or does this appear to be a “cookie cutter” effort? Have high potential internal candidates been assessed against these criteria using credible and objective evaluation methodologies? How are those with greatest potential being developed? Is there an emergency succession plan – and who does it cover?
2. **Senior team tenure:** Does the company have a long-tenured team or is there a mix of seasoned and more recently promoted executives? Is it likely that the entire senior team will retire at the same time as the CEO? Or has the senior team been turning over faster than a revolving door in their office building?
3. **Key executive exposure:** Succession planning for a “founder” or other “iconic leader” is the most difficult. As such, where these elements are present, a heightened level of diligence on the issue of succession planning is required.
4. **Bench depth:** Are there top positions without successors in the first and second levels of the organization? Is there low or high executive turnover – and what are the ramifications of this for the company's talent pipeline? Does the company provide the board with a bench strength report that gauges readiness of succession candidates against job requirements? Or do they just receive a binder of photos and CVs?
5. **Board engagement in succession planning:** Is succession planning a regular item on the board's agenda and that of the board committee overseeing succession? How has the board become involved in succession planning efforts to date, such as the development of future CEO criteria, the review of development plans for top candidates, the creation of an emergency CEO succession plan? Does the board get meaningful exposure to internal candidates for the CEO and other key executive roles?
6. **Management development:** Are there well-defined career development strategies? Are high potentials being given new job assignments designed to facilitate their development or is movement relatively low – or alternatively, characterized by far too much turnover? Are management development and/or succession planning goals reflected in CEO evaluation and/or evaluations of other executives?
7. **Cultural factors:** Is the culture of the organization likely to facilitate or inhibit succession planning?

For further information and to learn how an analysis of your company's succession planning against our Succession Risk Index© can benefit your Board of Directors and senior leaders, please contact:

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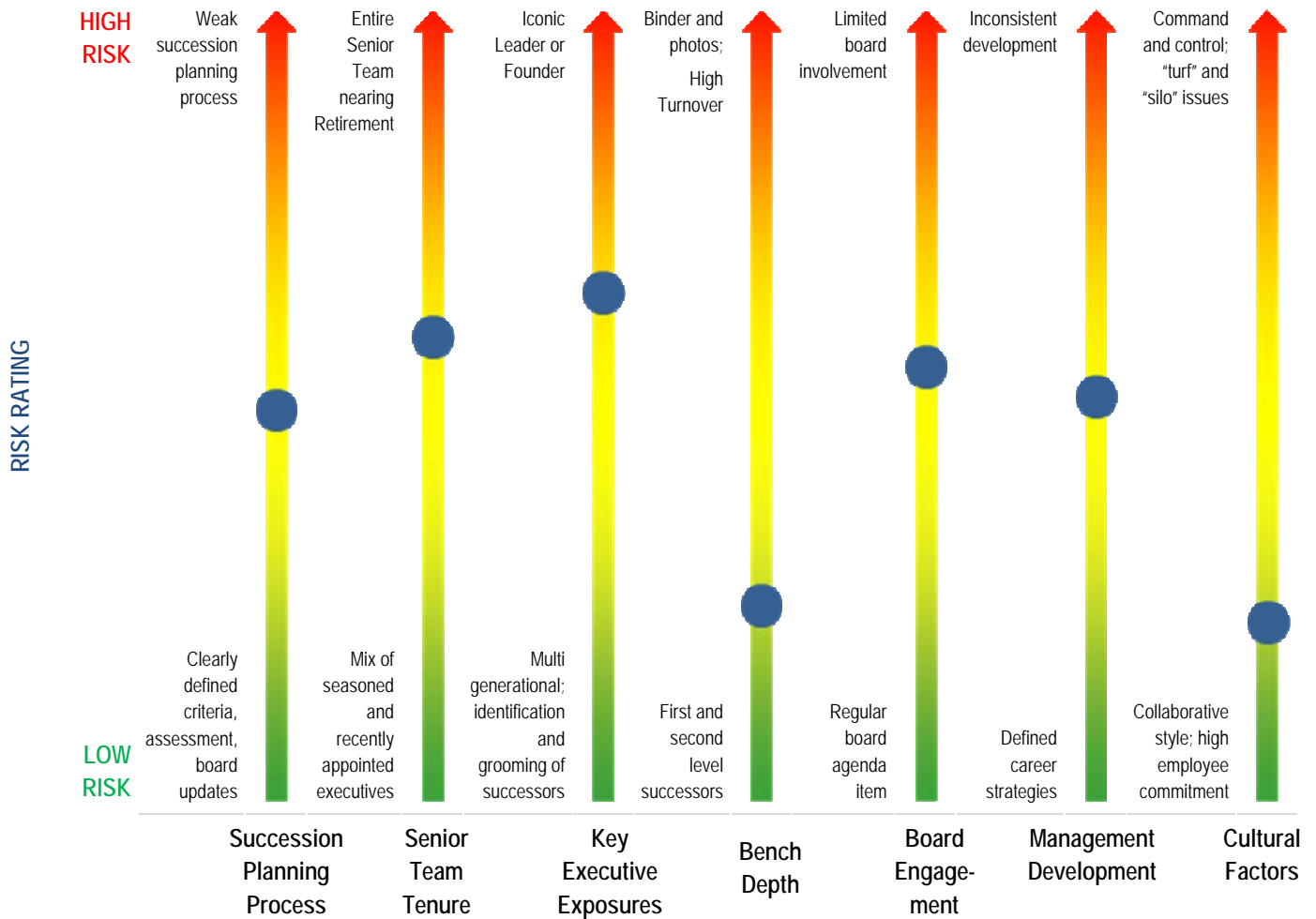
Other Key Findings from the Research

- Private equity firms tend to focus on “quality of management” more than succession planning per se, but they are concerned about a company’s current management quality (their ability to deliver results) and the sustainability of management quality 1-2 levels below the CEO level. They tend to get most of the information on which they make judgments in this area from discussions with company executives and with others in the industry who know the company and its top people through doing business with them etc. Underwriters are very focused on succession prior to an IPO.
- Institutional investors note that proxy and other disclosure on succession is typically minimal, boilerplate or non-existent. They review the tenure of the senior team - and its turnover from proxy data but primarily rely on their discussions with board members and CEOs to form opinions about the adequacy of their approach to succession planning. As one interviewee noted: “If the board members are clearly very articulate on this subject and can discuss it readily and in specific detail, you know they’re on their game. If they show up to a meeting with a bunch of lawyers, seem to be reading from notes and are unable to readily talk about succession issues, you know right away they haven’t done their homework and this company is at risk.” A weak bench results in lower valuation for investors.
- The LIUNA pension fund – the most aggressive of all institutional investors to date in the area of CEO succession planning – has actually sent letters to the boards of dozens of companies that they invest in seeking details on their CEO succession planning efforts.
- Analysts – including Moody’s, Standard and Poor’s and Risk Metrics – include succession planning factors in their ratings. In Moody’s Bank Financial Strength Ratings (“BFSR”), Moody’s reviews a bank and financial institution’s “Key Man Risk” which is defined as the degree to which a bank’s key business decisions are dependent upon a single executive or group of executives. Moody’s believes that in the event of key departures, banks with high Key Man Risk will face significant challenges, regardless of established succession processes. They also factor succession planning into their analysis of not-for-profit hospitals, health systems and family-controlled organizations. Succession planning has a direct impact on credit ratings.
- Several interviewees – particularly those from major institutional investors – encouraged boards who have invested significant efforts in developing effective succession plans to include disclosure about their processes with a level of specificity that would give investors comfort in this area in their proxies, governance guidelines etc. This is a means by which effective boards can distinguish themselves, given that many have not addressed this issue. Clearly, names of potential successors should not be disclosed.
- Company culture—many investors cited strong bureaucracy, silos, command and control leaders and an aversion to risk taking as barriers to high performance.

Appendix A: Research Participants

- Alliance Bernstein
- Bank of America
- Brookfield Asset Management
- CalPERS- California Public Employees' Retirement System
- Canada Pension Plan
- Edgewater Capital
- Fitch
- GTCR - Golder Rauner
- Hermes
- LIUNA – Laborers' International Union of North America
- McNally Capital
- Moody's
- Morgan Stanley
- Risk Metrics
- Royal Bank of Canada
- Royal Bank of Scotland
- Shamrock Capital
- Standard and Poor's
- Sterling Capital
- Wells Fargo

Appendix B: Sample Succession Risk Index © Report



Integral Advisors, LLC and Board Advisor, LLC have developed a proprietary diagnostic using the Succession Risk Index © for jumpstarting CEO and executive succession planning efforts and reducing succession risks to boards, investors and other stakeholders. The Succession Risk Index © and Review Process were developed using input from investment analysts, rating agencies and institutional investors outlined earlier in this report. Its major benefits are:

- Providing boards and senior management with a comprehensive, independent assessment of management and succession risks gauged against issues of greatest concern to investors
- Helping boards and management identify and address succession risk issues before they become problematic using best practices and recent innovations in this area;
- Proactively and quickly assessing talent and risk exposure, including providing the board with a bench strength assessment to better fulfill their responsibilities in overseeing executive talent management and development.