WHAT DOES A NEW CEO COST?

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Based on academic studies[1], it is commonly assumed that hiring a new CEO from outside is more expensive than promoting a senior executive from within. Furthermore an external hire is often in a strong bargaining position and thus can end up being more expensive than the outgoing CEO was.

In line with our emphasis on research based consulting, McDowall Associates decided to test these assumptions in the Canadian market. Our approach compared the compensation of six external CEO hires and six internal CEO promotions for the following publicly traded companies, based on their 2012 and 2013 proxy circulars.

External CEO Hire Companies	Internal CEO Promotion Companies
BlackBerry	Enbridge
Encana	Enerplus
Finning	Great-West Lifeco
IGM Financial	Quebecor
Rogers Communications	Suncor
Tim Hortons	Sun Life

The CEO compensation data was examined from two lens:

1. The target CEO compensation package, and
2. The actual first year CEO compensation.

We were not surprised to find that the six external CEO hires, as expected, cost more as a group than the six internal CEO promotions. They also cost more than their predecessor CEOs. Meanwhile, as expected, the internal promotion CEOs cost less than their predecessors.

Target Compensation Comparisons

Due to the significant impact that one CEO's compensation can have on the averages (e.g. BlackBerry), our comparisons focus on the median results for the two CEO groups.

1. External CEO Hire Findings

The six external hires were given 7% higher median Target Total Cash Compensation[2] than the six internal promotion CEOs were[3] and 6% higher median Target Total Direct Compensation[4]:

	External CEO Hires (millions)	Internal CEO Promotions (millions)
Base Salaries	$0.96	$0.98
Target Total Cash	$2.08	$1.95
Target LTI	$4.32	$4.03
Target Total Direct	$6.53	$5.98

[1] E.g. "Managerial Capital and the Market for CEOs", Kevin Murphy and Jabojnik, October 2006 ("Murphy").

[2] "Total Cash Compensation" includes annual base salary and annual incentive awards.

[3] Interestingly, the 7% Canadian total cash premium is much less than the 22% external hire premium that the Murphy study found in the US from 1990-2000 (Murphy, page 27).

[4] "Total Direct Compensation" includes annual base salary, annual incentive awards and the present value of long-term incentives awarded in the year, such as restricted stock units, performance stock units and stock options.

Meanwhile, the external hires got 10% lower Target Total Cash, but 6% higher median Target Total Direct Compensation than their predecessor CEOs did, due to 11% higher target Long Term Incentive (LTI) awards:

External CEO Hire Companies	Previous CEOs (millions)	New CEOs (millions)
Base Salaries	$1.08	$0.96
Target Total Cash	$1.20	$2.36
Target LTI	$4.21	$4.32
Target Total Direct	$6.77	$6.53

Only one external hire CEO (Encana) was given a lower Target Total Direct Compensation package than his predecessor had.

2. Internal CEO Promotion Findings

The internal promotion CEOs got 17% lower median Target Total Cash and 12% lower median Target Total Direct Compensation than their predecessors did, primarily due to their 19% lower median base salaries.

CEO Promotion Companies	Previous CEOs (millions)	New CEOs (millions)
Base Salaries	$1.20	$0.98
Target Total Cash	$2.36	$1.95
Target LTI	$4.21	$4.03
Target Total Direct	$6.77	$5.98

Only one internally promoted CEO (Quebecor) got a higher Target Total Direct Compensation package than his predecessor had.

Actual First Year Awards

Both the external hires and the internal promotions were given higher first year compensation awards than their Target Total Direct Compensation, typically in the form of additional Long-Term Incentive awards.

Median Actual Total Direct Compensation was $2.26 million higher than their annual Target Total Direct Compensation for the external CEO hires and $1.79 million higher for the internal CEO promotions.

	External CEO Hires (millions)	Internal CEO Promotions (millions)
Target Total Direct	$6.53	$5.98
Actual First Year Total Direct	$8.79	$7.77

It should be noted that internal CEO promotions can significantly increase company pension costs due to the retroactive impact of the increases in their higher CEO compensation on the actuarial value of their defined benefit credits for their previous years of service.

- Five of the six internal CEO promotions participated in defined benefit pension plans.
- We estimated the median actuarial value of the impact of the promotional increases in their compensation to be $1.7 million.

Other Forms of Compensation

Few special pension arrangements were provided to the new CEOs (Rogers, Enbridge, and Suncor) and few were given special perquisites (Encana, IGM, Great-West Lifeco).

New CEO termination arrangements tend to be somewhat less generous than some of the outgoing CEOs had, but are still very expensive, especially if a company's performance has been poor and the CEO has to be terminated. We noted the following trends:

- A 2 year severance package is typical if a CEO is terminated, in line with typical court awards (except Enerplus which gives 2.5 years and Suncor 3 years severance).
- "Double triggers"[5] are typically required in order for a CEO to receive cash severance and benefits after a Change of Control (COC), except for Rogers's new CEO who has a "single trigger" arrangement whereby he can resign immediately and get his full severance package.
- Ten of the twelve companies have immediate "single trigger" COC vesting in their LTI plans, notwithstanding the institutional investors' strong preference for "double triggers": only Suncor and Finning have "double trigger" LTI vesting.

Severance Awards

Five of the twelve outgoing CEOs received significant termination payouts:

External CEO Hire Companies (millions)	Termination Cost (millions)	Internal CEO Promotion Companies (millions)	Termination Cost (millions)
BlackBerry	$12.5 US	Enbridge	Nil
Encana	$7.3	Enerplus	$6.0
Finning	Nil	Great-West Lifeco	Nil
IGM Financial	$3.6	Quebecor	Nil
Rogers Communications	$17.0	Suncor	Nil
Tim Hortons	Nil	Sun Life	Nil

[5] "Double trigger" COC arrangements require the executive to have been terminated following a Change of Control in order to receive special compensation. It should be noted, however, that most of these arrangements allow the CEO to resign following a COC for "good reason" as defined in the relevant documentation, e.g. due to a material reduction in the executive's compensation and/or overall responsibilities, being forced to move to another location, etc.

Total CEO Turnover Cost

CEO turnover is expensive. To examine the total cost of the twelve CEO turnovers, we included the cost of terminating the outgoing CEO, the difference between the former CEO's and the new CEO's Target Total Direct Compensation TDC, the value of any incremental first year compensation awards over their Target Total Direct Compensation, and the incremental value of pension benefits.

The total cost resulting from CEO turnover varied widely from one company to another:

External CEO Hire Companies (millions)	**Termination**				
Company	Outgoing CEO Cost	Change in New CEO's Target Total Direct Compensation vs. the Outgoing CEO's Target	New CEO First Year Actual Total Direct Compensation over Target TDC	New CEO Pension Value (for any Enhanced Benefits)	Total CEO Turnover Cost
BlackBerry	$12.5 US	$10.1 US	$65.8 US	Nil	$88.4 US
Encana	$7.3	-$0.9	$4.2	Nil	$10.6
Finning	Nil	$0.3	$0.9	Nil	$1.2
IGM	$3.6	$0.2	$1.5	Nil	$5.3
Rogers	$17.0	$0.5	$3.6	$0.4	$21.5
Tim Hortons	Nil	$0.1	-$0.2	Nil	-$ 0.1
Median Cost					$8.0

Internal CEO Promotion Companies (millions)	**Termination**				
Company	Outgoing CEO Cost	Change in New CEO's Target TDL vs. the Outgoing CEO's Compensation Target Direct TDC	New CEO First Year Actual Total TDC over the CEO's Target TDC	Retroactive Impact of CEO Promotion on Pension Value	Total CEO Turnover Cost
Enbridge	Nil	-$1.6	$2.6	$4.0	$5.0
Enerplus	$6.0	-$0.3	$0.6	Nil	$6.3
Great-West Lifeco	Nil	-$0.8	$0.7	$3.7	$3.6
Quebecor	Nil	$1.5	$8.8	$0.8	$11.1
Suncor	Nil	-$3.5	$2.1	$2.6	$1.2
Sun Life	Nil	-$0.6	$1.1	$0.3	$0.8
Median Cost					$4.3

Interestingly, the median CEO turnover cost in the internal CEO promotion situations was about one half the median cost in the external hire situations.

While BlackBerry is the most costly CEO turnover example at $88.4 million US, the company's stock price has increased by some 60% as of the date of writing since their new CEO came on board in November 2013, resulting in over $2 billion rebound in shareholder value. The CEO turnover cost equates to 4% of this growth.

Issues to Consider

Whether promoting a CEO from within or hiring an outsider, the key compensation issues Board of Directors need to consider include:

- Do we have sufficient market data?
- How does the outgoing CEO's compensation package compare to the market data?
- How does the incoming CEO's current compensation package compare to the market data?
- How important is it to the company that the CEO's compensation be market competitive? And over what time frame, especially if the candidate has no previous CEO experience?
- What implications would the proposed compensation package for the new CEO potentially have on the compensation of the other key members of the senior executive team? I.e. consider the potential ratcheting effect and retention risks for those who passed over for the CEO job.
- What changes should be made to the new CEO's short and/or long-term incentive compensation that would better reinforce the organization's strategic plan? E.g. is it time to change the performance measures?
- What changes should be made to the new CEO's compensation program in the current "good governance" environment, e.g. less generous severance and LTI vesting terms, no abnormal perquisites or special pension benefits?
- What special compensation, if any, is appropriate when the CEO appointment takes effect? E.g. special long-term incentive award, hiring bonuses, etc.?
- At the end of the day, are all the CEO compensation decisions being made in the best interests or the organization?
- Do the current plan documents and/or employment agreements need to be updated to ensure they in fact support the best interests of the organization? E.g. are the recitals adequate?
- How will the CEO compensation decisions be communicated to the organization's key stakeholders?

When hiring a current CEO from outside, a major issue will typically be the magnitude of the compensation the candidate will forgo on resigning from his or her current employer, whether or not the organization should offer special compensation to make up part or all of the forfeited amount, and if so in what form. This issue is extremely contentious, and usually requires experienced outside compensation and legal counsel. At the end of the day, the board needs to decide what is in the best interests of the organization, including the alternative of "just saying no".

When promoting an executive from within, the board also needs to know what the ratcheting effect of the CEO's proposed compensation would be on the accrued value of his or her pension benefits.

CONCLUSION

Selecting the most appropriate candidate for the position of CEO is the arguably most important responsibility of the board of directors.

The cost of a new CEO needs to be carefully examined to ensure that it makes sense and will stand up to scrutiny both internally and externally.

When considering an outside CEO hire or an internal CEO promotion, it is important to ensure that the proposed compensation is fair to both parties, and has been negotiated in good faith.

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