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Compensation Strategies for Succession Planning

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The stock market's response to PepsiCo's recent announcement that long-time CEO Indra Nooyi would retire shows that even when a company has a good succession process in place and selects a replacement who is fairly well-known to the market, investors will assign risk to the change and stock price will decline accordingly.

The fact is, how that successor will perform in the top job and how the rest of the management team will reshape and work as a unit, is unknown. It's almost inevitable that there will be a stock price drop when a successful CEO departs—and recent studies show that stock prices are still down as much as a year after the transition. Gaining investor trust is not just a one- or two-quarter process. The challenge for boards is what can you do to minimize the downside impact of the CEO change and how can you shorten the length of that downside?

(There's an important executive compensation point to interject here: as you set up pay plans for a new CEO, structure equity incentives so they are based on the stock price after the market has absorbed the bulk of the hit to the share price. There have been numerous circumstances where options are granted immediately upon a promotion, yet within a few days, the value of those options are 10-15 percent underwater. This is demoralizing to the successor and does not achieve the supposed aim of your incentive plan.)

We all know that boards should have solid, well-planned leadership development and succession planning processes in place. What these plans can do—in addition to the obvious benefits—is help directors convince the market when a change does occur, the risk of a performance decline has been minimized.

The process should assess both internal and external candidates. (Bringing in an outside advisor to assess the group can provide a useful, objective process for evaluating contenders and planning for their future development.) Boards should become close to the candidates, set up the process (loosely outlined below), and stay involved at every step.

Begin to identify individuals but take care not to be overly forthcoming. Markets and organizations are savvy and will begin to understand the landscape as this process unfolds, but you want to ensure there's no artificial inflation of the "race" or pitting of team members against one another, which is counterproductive to your succession plan and

ongoing operations. Provide each identified rising star with a clear job path that enables them to gain new and needed skills and experiences and allows opportunities to demonstrate leadership capabilities.

From a compensation perspective, very little added effort is needed at this time. The mere fact they have been noticed and encouraged provides the short-term reward and recognition. However, there is a point further along in the process when the leadership development work gives way to a smaller handful of potential successors. This will become clear externally and the marketplace will notice. Your candidates will suddenly become sought-after recruiting targets and potential retention issues, and at this point, compensation planning and communication have a critical role to play.

The goals of such a pay plan will be fairly uniform: develop, retain, and reward success. The specifics will naturally depend on myriad factors, including the company's business strategy, culture, industry and market position, and the candidate pool. Here are two real-world examples.

Case 1: The company had a clear three-candidate race for succession. The board arranged special long-term incentive grants of restricted stock that would vest not just based on time, but also on the culmination of the race. For all three executives, half of the grant would vest when a CEO successor decision was made and the second half would vest one year after that decision had been made. This had several effects: It gave the board a better opportunity to hold their stars in place and, upon a decision that would inevitably disappoint two of the three, it helped maintain a solid leadership team in the near-term. Communication about what to expect and when had been clear, and there was recognition and reward for having been in the race.

Case 2: The company embarked on a succession planning exercise well in advance of the CEO's expected retirement. The board hired a consultant to help identify and evaluate potential leaders internally and externally. A slate of candidates was selected and each was provided with a board mentor who had been either a chief financial officer or a CEO and who had been through a similar process. A compensation plan was implemented for each individual that was slightly more heavy on equity than was typical and the board had an in-depth conversation with each to walk through how their pay would progress over the course of time. As these executives inevitably began receiving more external attention from recruiters, they had to evaluate career options (e.g., "Do I want to be a bigger fish in a smaller pond, or do I want to stay and see if I can win the tournament?"). This purposeful compensation and communication effort ensured that in the event of an attractive outside offer, the candidates didn't have to guess about the pay opportunities and timeframes at their current company.

There are as many varied scenarios as there are organizations. The key to weathering a leadership change successfully is to put well-constructed processes and plans in place long before they're needed and nurture them continuously. Boards must also know what to realistically expect from the market in the days, weeks, and months after a transition.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management helping organizations build, develop, and reward great leadership teams that drive long-term success. Our strategy-driven compensation and leadership consulting services act as powerful catalysts for value creation and competitive advantage by addressing the critical links between people and outcomes. Our clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private organizations to the Fortune 500.