Pearl Meyer

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Setting Pay for an Internal CEO Hire

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Setting executive compensation levels for a new CEO or other senior executive involves the consideration of multiple inputs, both external and internal. For example, market data informs the external worth of the position and what the market will bear in terms of the going rate for the role. But if the organization is considering promoting from within (and there are many reasons to do so), numerous internal factors, such as tenure, performance, current role criticality, and internal equity also come into play.

It's common practice for the market rate to play a large role in how compensation is leveled for an external hire. Yet despite the number of possible—and important—factors that can be used to level compensation for an internally promoted executive, getting it just right can be elusive. Far more nuance goes into the "calculations" than is required for a peer group analysis.

In practice, most companies set compensation below the market rate for an internally promoted executive. The common thinking is that since the individual is new to the role and thus has yet to demonstrate proficiency in the role, something less than market rate is appropriate. This leads to two questions. First, exactly how should compensation be structured at the time of the executive's promotion, and second, how do you know when the executive is fully functioning in the role such that paying the market rate (or higher) is warranted?

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In terms of initial leveling of compensation for a newly promoted executive, we often recommend a discount to the market median to provide room for future adjustments based on demonstrated future competence and performance in the role. Further, reflecting that discount to market primarily in base salary positioning can allow the variable, performance-based elements (i.e., the annual and long-term incentives) to be set at or near market median since they will be earned based, in part, on the executive's future performance in the role. It is also important to consider internal equity among the executive team. Setting the annual incentive target as a percent of base salary, and long-term incentive value consistent with the executive's internal peers creates internal alignment and consistency.

Future adjustments to base salary and, as necessary, to annual and long-term incentives should then reflect how the executive is performing in the role with an eye toward bringing the individual to market norms over a two- to four-year period. To earn an appropriate return on the organization's investment in executive talent, particularly when they become a "market-priced" executive, it is important to be able to establish and communicate the skills, competencies, and performance expected of the executive. And then be able to develop and assess for those skills and competencies. In theory, this should be no different than the attributes that would be outlined upon executing an external search.

There are multiple advantages to "hiring" through an internal succession process as opposed to an external search. Internal candidates bring institutional knowledge of the company and its business strategy and culture, reducing the ramp-up time that comes with an external hire. Leadership continuity promotes organizational stability and communicates to next-level executives that there are senior-level career progression opportunities within the company, which helps with the retention of top talent. Of course, developing talent internally requires investment and resources, but such long-term investment can have strong ROI.

About the Author

Steve advises compensation committees and senior management years on executive and director compensation, with 30+ years of board-level Fortune 500 experience, is a frequent presenter at national executive compensation forums and conferences.

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.