When looking inside for your next CEO

Steps you can take to facilitate increased exposure of internal talent to the board.

By Jeff Sanders, Samantha Smith and Carolyn Vavrek

An overwhelming majority of boards select an internal candidate as their next CEO. Over 80% of the Fortune 1000 companies who named a new chief executive last year promoted a successor from within the company (Heidrick & Struggles F1000 CEO Turnover Data). The National Association of Corporate Directors found in its *2013-2014 NACD Public Company Governance Survey* that executive talent management and leadership development ranked fifth in priority of governance issues for directors, up from 13th and 12th place in 2008 and 2009, respectively.

However, when the time comes to select a CEO successor, a striking irony often hangs over board deliberations. As the date of a planned succession approaches, or when an unplanned succession is triggered, directors may find that they are better informed about the qualifications of external successor candidates than they are about the viability of executives who have been running their company. In addition, if the planned succession is sufficiently far in the future, directors are often not aware of the full roster of insiders worth watching over the long term.

Basic steps

In order to avoid this common pitfall, board members can take these simple steps:

• ***Establish a regular cadence for talent conversations at board meetings.*** While the CEO, CHRO, and management team are ultimately responsible for implementing and executing talent management programs, it is important for board members to request regular updates on the state of the talent pipeline and on the performance and development of top executives at the company. Establishing a cadence to talent discussions enables the board and CEO to become comfortable discussing successors, while also paving the way for increased board exposure to the internal candidates as a succession transition draws closer. Executive turnover, changes in strategy, and altered competitive environments may impact prospective candidates — or cause new ones to emerge. Due to these changes, it is crucial that boards hold regular reviews to stay abreast of current and emerging talent at the senior management level. By beginning these conversations early and by positioning succession planning as one component of a broader talent review, boards are more likely to enlist the full support and engagement of the CEO.

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The board must make it clear that the heightened interest in engaging with potential successors does not necessarily signal a crisis of confidence in the CEO, a desire to hurry his or her departure, or dissatisfaction with the direction of the company. The CEO's insight into the requirements of the role and capabilities of the management team is invaluable and enables the board members to develop a deeper understanding of internal talent than they otherwise might.

• ***Formally and regularly review the progress of senior managers.*** The compensation committee, in its review with management of the company's "Compensation Discussion & Analysis" (CD&A), will have a window into what behaviors the company is trying to incent among top executives and may have a sense of how well individual executives are performing against those metrics. However, these largely technical matters, intended to help guide investors, do not sufficiently capture leadership potential. The company's annual performance reviews and higher-level management assessments are more relevant in helping understand an executive's strengths, weaknesses, potential and aspirations. The consolidated results of such assessments should be shared with the board by the CEO and CHRO.

Ideally, such assessments should be based on a company-specific competency model that helps identify the developmental needs of the executive. In addition, the CEO and CHRO should partner these assessments with a development plan that lays out action steps for how those needs will be met. When there is a long lead time before a planned succession, the CEO has an opportunity to plan developmental assignments that thoughtfully rotate high potential executives through a variety of roles to provide them with a broader set of experiences. Some companies may use an executive coach to help leverage the executive's strengths and shore up weaknesses, accelerating development. In addition, board members may volunteer to mentor a specific executive — acting as a sounding board, coach and, eventually champion, if the director finds that such advocacy is warranted.

• ***Systematically expose directors to potential successors through a combination of both formal and informal interactions.*** In the normal course of business, directors are often exposed to members of the top executive team. However, that exposure is likely to be unevenly distributed among candidates, focused on their responsibilities in their current role and highly structured. These interactions are incomplete and at times provide a distorted perspective on the executives' leadership potential. The board may have little understanding of the executives' experience prior to joining the company, their accomplishments with the company, how they lead their teams and interact with customers, and their ongoing development and aspirations. Further, directors may typecast executives according to the function they head, the division they run, or the unconscious biases they trigger based on their performance in the boardroom. Ultimately, such biases may unnaturally limit the growth of high potential talent.

Exposure to potential successors can include both highly formal encounters and informal interactions. In each case, these interactions should be scheduled to ensure that exposure is appropriately allocated among candidates as well as directors while minimizing the impact on business operations. Ideally, these interactions would be scheduled over increments of 12 to 18 months so that the approach is systematic, comprehensive, and substantial.

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Informal interactions

Informal interactions could include conversations with one or more directors over a meal or could be scheduled in conjunction with a site visit or company event. Directors might also observe candidates in their "native habitat" by watching them interact with their teams during internal business reviews or accompanying them on visits to key customers. The firsthand observations that a director or directors take away from these encounters can then be shared in the board's executive sessions.

Even with carefully scheduled interactions and commitment to deeper engagement with potential successors, time is limited and directors should therefore make the most of these encounters. While discussions might be free-form in some instances and more structured in others, they should aim to determine whether candidates have the requisite qualities of leadership. What is the executive's perspective on the company's industry and strategy? What role has he or she played in that strategy? How did the executive assemble his or her team? And how does he or she motivate the team, hold individuals accountable, and develop them?

Other possible topics for discussion may include asking candidates about their strengths and weaknesses as leaders, their aspirations, how and why these aspirations might have changed, and how they expect to achieve them. Direc-

(Left to right) **Jeff Sanders** is vice chairman and managing partner of the Heidrick & Struggles North American CEO Practice. He is responsible for the firm's focus on assisting companies with CEO succession and also leads a number of nonexecutive director searches. His broad range of expertise spans across the technology, consumer, financial services, and industrial sectors. **Samantha Smith** is an engagement manager at Heidrick & Struggles and specializes in assisting companies with C-level succession planning as well as searches for CEO, COO, CFO and nonexecutive director positions. **Carolyn Vavrek** is a partner in the global Leadership Consulting Practice, where she advises senior executives on leadership and talent management issues.

tors who have had these probing discussions with potential CEO successors, tracked their progress, and encountered them in numerous formal and informal settings often tell us how surprised they have been to find that their initial views of a candidate were way off the mark.

Formal interactions

The board can also create opportunities for potential successors to interact formally with the entire board. Candidates might present to the board on a topic outside of their areas of direct responsibility — on strategy, for example, or on a complex issue with implications across the enterprise. During a board review of the company's overall bench strength, candidates might be called upon to discuss their teams in depth — why they were assembled, individual and team strengths and weaknesses, and what the leader is working on to create a high performing team. Budget reviews also provide an opportunity for candidates to offer their perspectives on one of the chief responsibilities of a top leader — the allocation of company resources.

As the date of a planned succession draws near, the board should further formalize the evaluation process. As early as three to five years prior to the expected transition date, the board should develop an Experience & Leadership profile that is based on the company's strategy and articulates what type of skills, experiences and leadership qualities the next CEO should have. The CEO, CHRO, or an independent third party should also begin to assess the candidates against the CEO Experience & Leadership profile, as well as their annual reviews, which assesses performance in the current role.

During this time frame, the board should also conduct an external market scan to enable directors to more effectively benchmark the internal candidates against external talent. The board should ensure that they both refresh the external market map regularly, and update the Experience & Leadership profile annually, to capture any shifts in the company's strategy or competitive landscape that might alter the competencies required for the next CEO.

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When the board and CEO believe that a CEO transition will take place within the next 12 to 18 months, the board members, or a committee of the board, usually conduct formal interviews with each of the internal candidates. At this point, candidates should be questioned deeply not only on all competencies required for the CEO role, but also on the company's strategy and the candidate's vision. Importantly, the quality of the questions, and the board's ability to evaluate the answers, will be greatly improved as a result of the board having regularly engaged with candidates and observed them firsthand. During this stage, it is important that the board designates one director as the point person to set expectations, outline the formal process, and communicate regularly with the internal candidates.

Multitude of benefits

Facilitating increased exposure to internal candidates not only prepares the board to make a more informed choice when the time comes — including in an emergency succession — but also provides a number of additional benefits. It extends and deepens the dialogue between the board and management, providing as much of a learning opportunity for directors as it does a career opportunity for candidates. Additionally, it fosters a culture of executive development that starts at the very top, helping lower the risk in executive transitions throughout the upper echelons of management. Increased attention from directors also helps in the retention of talented executives by signaling how highly the company values them. Most importantly, should one of the candidates assume the CEO role, the board will have already established a solid foundation of mutual understanding and trust with the incoming executive. ■

The authors can be contacted at jsanders@heidrick.com, ssmith@heidrick.com, and cvavrek@heidrick.com.