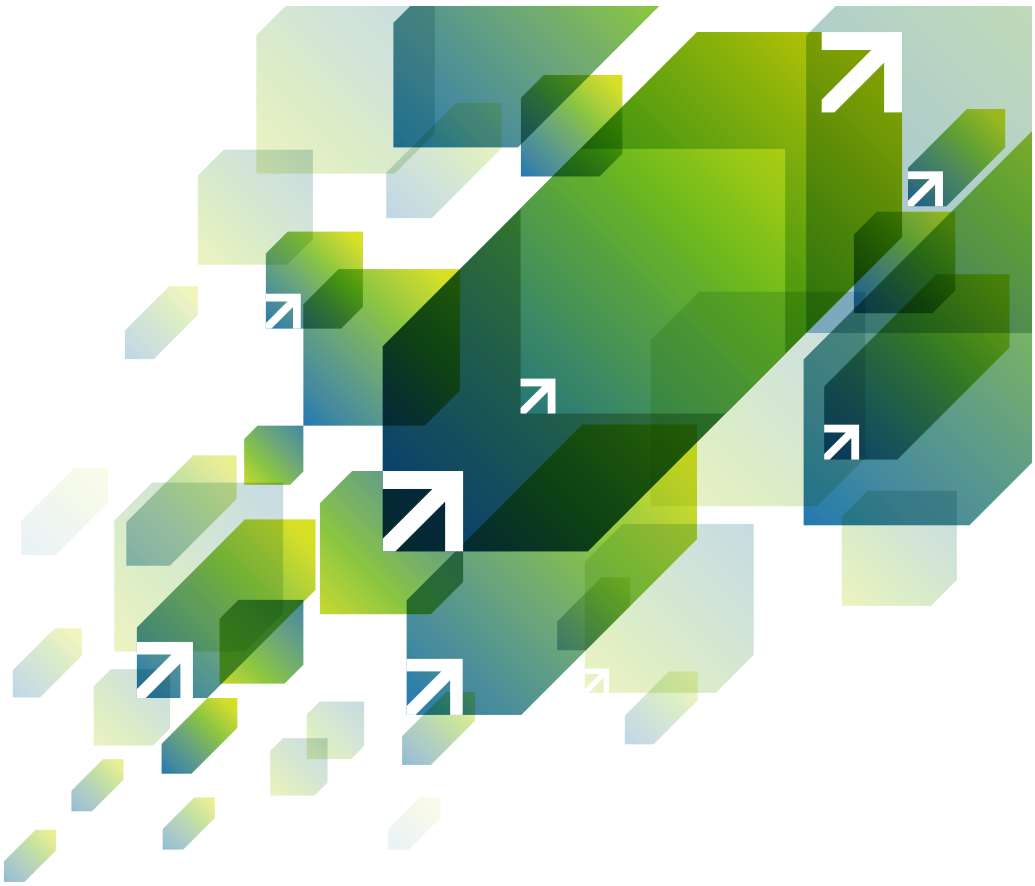
COMMUNICATING CRITICAL EVENTS:

CEO TRANSITIONS AND THE RISK TO ENTERPRISE VALUE

Leadership change affects a company's enterprise value. Whether that's positive or negative depends largely on measures taken by boards and CEOs in the months leading up to -- and following -- the change.

FTI Consulting | Strategic Communications Practice



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INTRODUCTION

CEO change presents more downside risk than upside potential, with enterprise risk extending well beyond the point of transition. Further, there is more value at risk in unplanned CEO transitions. In particular, the greater the surprise and the higher potential for corporate strategy shifts surrounding the transition, the more enterprise value is at risk. But the value at risk also increases over time, irrespective of the circumstances related to the transition. Recognizing this environment, boards and new CEOs must take action before, during and after a leadership change to carefully manage the risk inherent in a CEO transition, while setting the agenda for the future.

To understand the risks in CEO transitions, the Strategic Communications practice of FTI Consulting recently studied the impact of CEO transitions on enterprise value. FTI also surveyed members of the financial community to learn how CEO changes affect their investment decisions, expectations of incoming CEOs, and performance guidelines.

CEO transitions are far from rare. Among companies with market capitalizations in excess of $10 billion, nearly a third (31 percent) announced a CEO transition between July 1, 2007, and June 30, 2010. Among these transitions, 43 percent were unplanned. In all, the FTI study evaluated 263 CEO transitions across companies based in 35 countries.

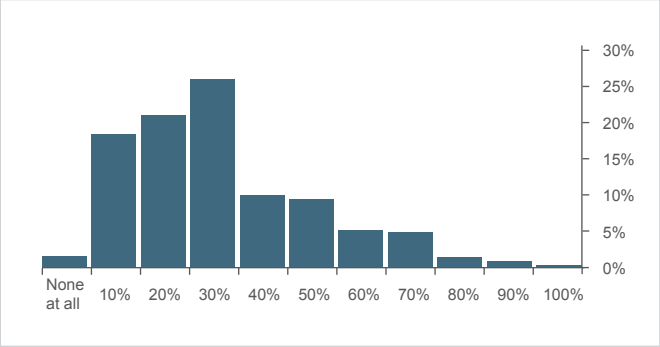
The study also found that the reputation of a CEO is a critical factor in investor decisions to buy or sell a company's shares. In fact, on average nearly a third of investment decisions are based on perception of the CEO. As a result, leadership transitions put a significant portion of the investment decision at risk as opinions of the new leader are formed.

A firm grasp of the company's challenges and opportunities, as well as knowledge of the industry dynamics, are table stakes for new CEOs, according to investors. However, investors generally grant new CEOs a six-month "honeymoon" to set the vision and strategy for the company while establishing appropriate expectations for key stakeholders. Once this honeymoon period has ended, investors expect CEOs to begin delivering on their strategy.

HOW INVESTORS ASSESS NEW CEOS

The reputation of a new CEO matters to investors. According to the study, investors indicated that nearly a third (32%) of their investment decision, on average, is based on perception of the CEO (see chart, below).

% of investment decision based on perception of CEO

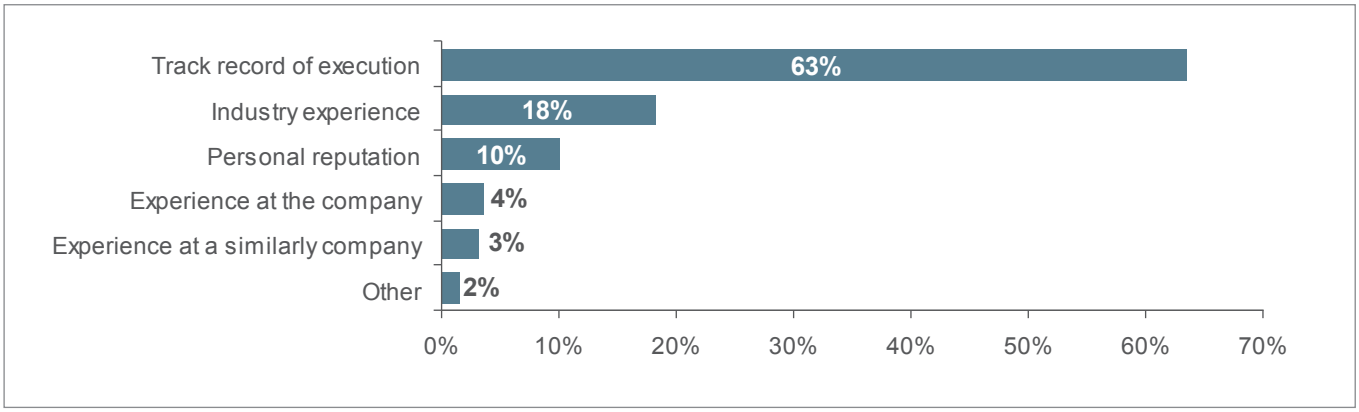


In addition, when asked to name the key factors impacting an organization's reputation among the investment community, CEO reputation was among the top six factors cited. That was nearly on par with the company's historical reputation itself and more important than the brand equity of a company's products and services.

When CEOs change, investors are more than twice as likely to sell shares in a company as they are to buy them. All things being equal, nearly 40 percent of investors said they would sell a stock solely on the basis of the new CEO, the FTI survey found, while only 15 percent said they would buy the stock on the same basis.

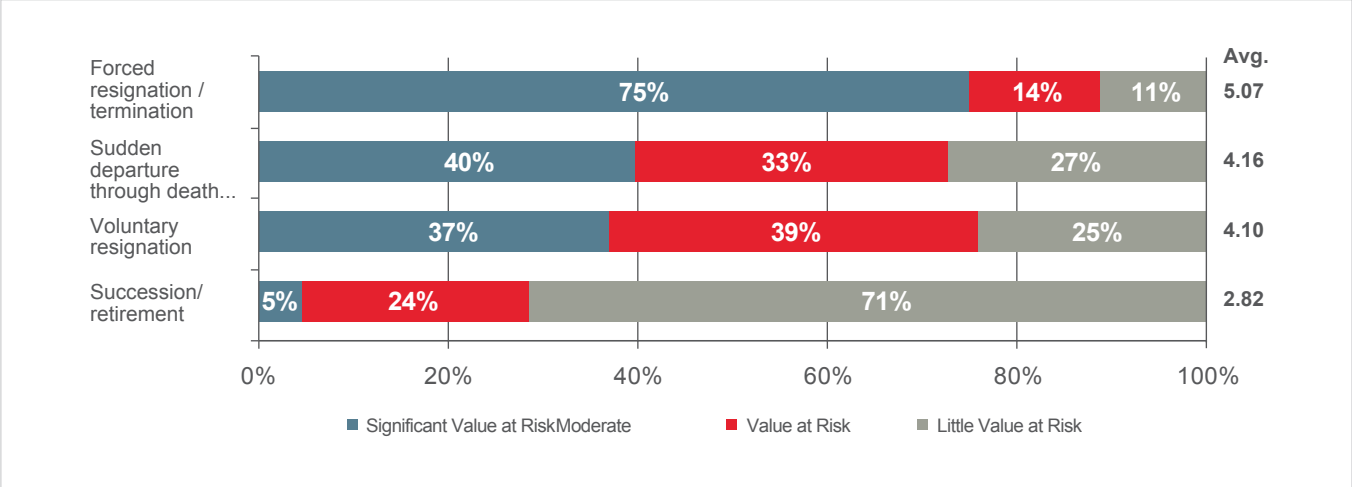
Not surprisingly, when a CEO transition occurs, investors will perform due diligence on the new CEO's qualifications. Their perceptions will be based primarily on the CEO's track record, which is by far the single most important factor that investors use to evaluate a new CEO (see chart, below).

Key factors shaping initial opinions



However, investors are also mindful of the circumstances surrounding a CEO's departure. Essentially, with greater surprise comes greater value at risk. For this reason, planned successions present the lowest risk (see chart, below) and can even have a positive impact on stock prices at the time of the announcement.

Value at-risk due to outgoing CEO circumstances



While much attention is paid to the market reaction to the announcement of a CEO change, in reality, the months that follow present an even greater period of risk -- and reward -- with a higher potential for both value destruction and value creation. The outcome depends, in part, on how well the new CEO sets the agenda and manages the transition.

As stated above, investors are generally willing to grant new CEOs a six-month honeymoon. This honeymoon, handled well, can buy the CEO time and maintain the company's value. But handled poorly, this period may lead to serious risk to both the company's value and the CEO's reputation.

For example, in late 2010, after Leo Apotheker became CEO of Hewlett-Packard (HP), he failed to establish a clear strategy. Some nine months into his term, HP confused the market by first discontinuing its TouchPad line of mobile tablets, then selling them at a deep discount, and then restarting production. At about the same time, Apotheker said HP might sell its profitable PC division, then said it might not, after all. Investors reacted by dropping the price of HP shares some 20 percent on a single day of trading in August 2011, erasing about $12 billion in market value and leaving the company's stock near six-year lows. (By comparison, the S&P 500 that day closed at 1123.52, down 17.12, or 1.5 percent.) Including earlier share-price declines under Apotheker's leadership, HP's stock had lost more than 45 percent of its value. In September 2011, Apotheker was

dismissed from the company.
Once a CEO's honeymoon ends, he or she must quickly begin to deliver on the new strategy and performance goals. During this period, investors seek evidence of successful execution of the strategy. This should not be confused with financial performance per se, which most investors expect will take at least 12 months to see traction. When a CEO handles this execution period well, their companies' stock value tends to increase; but when they handle it poorly, the company's value – and their career – may suffer.

At Yahoo! Inc., Carol Bartz's nearly-three-year term as CEO provides an example of the latter. Bartz started with a splash in early 2009, bringing an impressive agenda for a corporate turnaround. Then, during her first six months, she upended Yahoo's organizational structure, replaced executives, cut costs and laid-off five percent of the workforce. Industry analysts and investors were impressed; the moves, they said, were just what Yahoo needed. But when the honeymoon ended, Bartz failed to deliver the promised turnaround. In September 2011, less than three years into her reign, Bartz was replaced as CEO; three days later, she also resigned from the board.

A ROADMAP FOR CEO TRANSITION

Given the impact of CEO transitions on enterprise value, companies should take concrete steps to prepare for and carefully manage leadership change.

CEO succession planning helps reduce the surprise of a transition and should be an integral part of any company's preparation for leadership change. However, it must be accompanied with and informed by a robust due diligence on all CEO candidates. In addition, having a deep knowledge of stakeholder opinions on the company, its strategy and competitive position can help to align board decisions with stakeholder expectations, permissions and needs. This can be particularly helpful in addressing the ongoing risk inherent in transitions involving fraud, regulatory investigations, strategic transformations, bankruptcies and restructuring.

Equally important, new CEOs must align their organizations to respond to change by setting the vision and strategy, establishing the appropriate expectations across stakeholder groups, and then engaging with stakeholders through new and diverse communications channels. The study found that six months after the start of the new CEO, stock performance often reversed from the knee-jerk euphoria or disenchantment at the time of the announcement. This indicates that effective situation management and communications can mitigate the value at risk of leadership transitions and enhance shareholder returns.

For the board: The importance of having a succession plan cannot be overstated. CEO turnover is high, and unplanned successions generally carry more risk for a company's enterprise value than planned successions. The centerpiece of any succession plan should be the vetting and identification of a new CEO candidate.

One paradox was unearthed by the study: Although a CEO's prior track record of execution is critical, 80% of new CEOs have no prior CEO experience. Therefore, there is often minimal publicly accessible independent information of past performance available. For internal candidates, the board and management team can address this paradox by showcasing the depth and breadth of management bench (and one or more potential successors). This increased level of exposure and positioning can be instrumental in managing through unplanned transitions.

Apple Inc. provides a case in point. CEO Steve Jobs' surprising resignation for health reasons, in August 2011, could have been perilous for the company's stock. Never before, it seemed, had any company been so closely associated with its top executive. Yet on the day of Jobs' resignation, Apple's stock price dropped by only 5 percent in after-hours trading. This relatively small change was due to several factors: Apple had announced a succession plan more than two years earlier; Jobs had previously revealed his illness to the general public; and Jobs' heir apparent, Timothy Cook, was both well known and well liked by key stakeholders. As a result, even the shock of Jobs' death mere weeks later was quickly absorbed by investors.

Of course, it is not enough for a board to simply name a CEO candidate. The board must also perform due diligence, ensuring that the candidate possesses the qualities investors and other stakeholders seek. In this way, the board helps protect share value.

How do investors assess a CEO? Mainly, they expect a positive track record of past execution, as well as some industry experience. In the FTI survey, industry experience was identified by nearly 20 percent of investors as a key factor shaping their initial opinion of a CEO.

Apple, again, provides a good example. Timothy Cook, successor to Steve Jobs and now the company's CEO, had earned a solid reputation for both execution and industry experience during his 14 years working for Apple. As the company's COO, Cook had outsourced much of Apple's manufacturing, improving the company's margins. Also, because Cook is an Apple insider; he knows the company's business and industry, and this smoothed the transition after Jobs' surprising resignation.

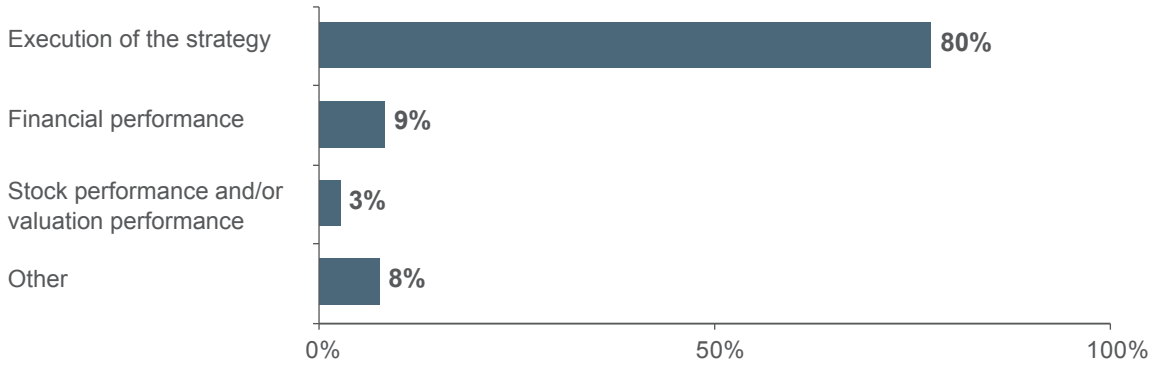
Yet industry outsiders can succeed, too, as long as they can demonstrate an understanding of the company's situation and a relevant track record of execution. For example, Alan Mulally has successfully led Ford Motor Co. despite his lack of prior experience in the auto industry. Mulally became Ford's president and CEO in late 2006; he had previously served as CEO of Boeing Commercial Airplanes. Under Mulally's leadership, Ford -- which had lost tens of billions of dollars during the recent recession -- has posted eight consecutive quarters of net profits. Ford is also the only one of the Big 3 U.S. car companies to have avoided a government-sponsored bankruptcy.

Investors, as part of their due diligence on a new CEO, will seek insights from a broad range of information sources, including internal and external stakeholders, both past and present. In particular, the FTI study found, customers and partners, and the candidate's former colleagues, were the two sources that most influenced investors' opinions of new CEOs. In addition, investors will look to the board for reassurance that the candidate's management approach is likely to be in harmony with the company's situation and overall approach. Accordingly, companies should leverage perception studies and anecdotal evidence to better understand the stakeholders' views on a CEO candidate.

For the new CEO: During their first six months in office, new CEOs should dedicate themselves to setting and articulating a new vision and strategy, establishing appropriate expectations and managing internal talent. Investors, in their initial interactions with a new CEO, will be watching to see how well the CEO takes command. It is no longer sufficient to serve as a command and control executive. Instead, investors are looking more for "hard" attributes – including a grasp of the company's situation, and plans for the future -- than for "soft" ones, such as leadership style, charisma and personality.

During the CEO's second six months, investors expect to see evidence that the strategy is being executed successfully (see chart, below). To stay ahead of investor expectations, CEOs should carefully set the expectations against which they want to be measured. Then they can begin to meet stated financial objectives, improve the company's financial performance, and boost market performance and valuation over the ensuing 12 months, which is in line with investor expectations. Also, in evaluating performance success, the study reinforced the principle that the investment community values metrics associated with stewardship of capital and cash flow, such as ROIC and free cash flow, far more than bottom-line metrics such as EPS and Net Income.

Most important measures of effectiveness



THE HIGH VALUE OF GOOD COMMUNICATIONS

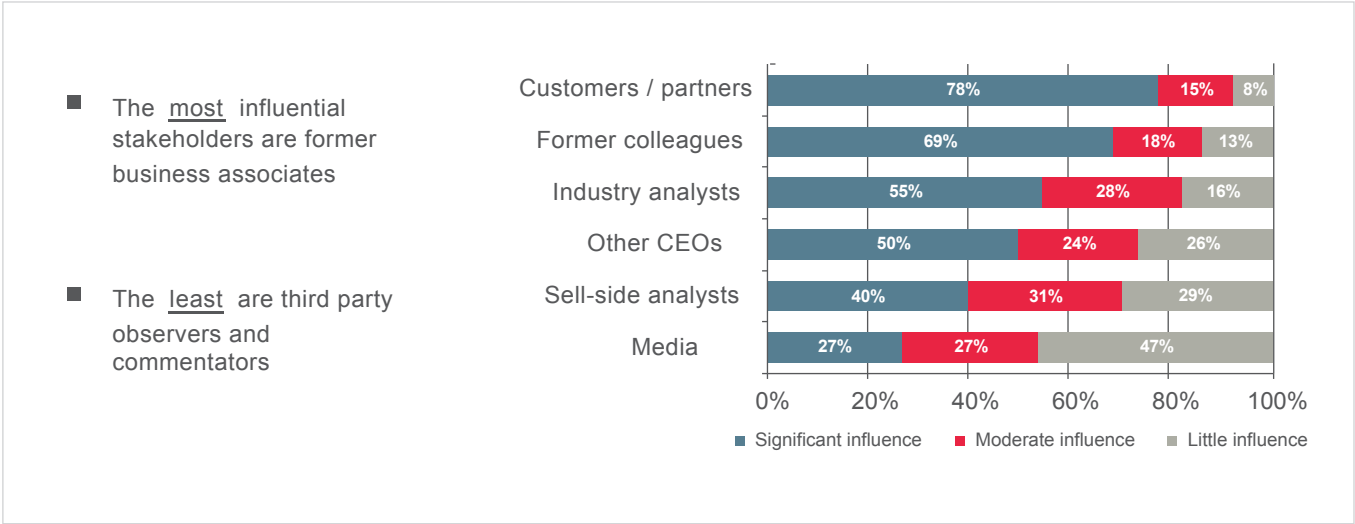
For new CEOs, communicating effectively with all stakeholders is critical to managing risk and its impact to a company's enterprise value. While communications are important at any time of major change, they are especially vital during a CEO transition.

How to communicate effectively? A new CEO should begin by listening to the market. For example, they can conduct research to gauge perceptions and test company messaging. This can help the new CEO identify any gaps between what the company says and what its stakeholders actually hear.

A new CEO also needs to have a well-honed corporate narrative to tell the company's new story. To achieve this, CEOs should develop a comprehensive communications strategy that is linked closely to their vision and strategy. This may involve the development of appropriate messages and channels for different groups, according to what will best reach and persuade them. For example, at Coca-Cola Co., CEO Muhtar Kent has made a point of communicating his strategy and other changes through new channels to better engage with the company's workforce, especially those based outside its headquarters. Kent does so, in part, by conducting town halls at bottling facilities and sending text messages to workers' mobile phones, as many employees of Coca-Cola cannot readily access email, video or other means of communications during their workday.

Also, while many companies focus their communications efforts on the media, the FTI survey indicates that it is not a terribly influential constituency for investors. When investors were asked for the key external source shaping their opinion of a company, only 27 percent named the media, far less important than those much better placed to judge the capabilities of an executive, such as customers, business partners and former colleagues (see chart, below).

Key external sources shaping opinions



CALL TO ACTION

Because CEO transitions create a potential risk for enterprise value, all companies should make CEO succession planning an integral part of their risk-mitigation strategy. At the same time, companies should be aware that CEO succession planning cannot take into account all factors that affect stock value.

When announcing a CEO succession plan, the board should also emphasize the CEO candidate's track record of execution. Again, this track record is by far the most important factor for investors. Industry experience and personal reputation are a distant second and third.

Next, once the new CEO is in place, he or she should align the organization by communicating with stakeholders, establishing credibility and setting reasonable expectations across stakeholders.

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To protect share value, all companies should remember that surprises increase risk. Therefore, boards should strive to create CEO transitions that are both smooth and well thought-out. A CEO's planned retirement, for example, involves far less risk than a forced resignation. But even when a CEO transition hurts the stock price in the short term, the right management initiatives later can often restore value over the long term.

HOW THE STUDY WAS CONDUCTED

The Strategic Communications practice of FTI Consulting conducted its Global CEO Transition Study in the second quarter of 2011. The study considered all CEO transitions among companies with a market capitalization in excess of $10 billion at any point between July 1, 2007, and June 30, 2010. In all, the study identified 263 CEO transitions in 35 countries.

These CEO transitions were then grouped into three main categories: succession/retirement; resignations (both voluntary and not); and special situations, including bankruptcy, fraud, health, etc.

Also, to determine the value at risk, selected CEO transitions were analyzed based on their net stock-price performance relative to an index (e.g., "alpha performance"). The companies' stock prices were benchmarked against relevant, comparable and country-specific indices, including the S&P, DAX and Nikkei.

FTI also surveyed portfolio managers and analysts to better understand the nature of investment risk presented by CEO transitions. In all, FTI surveyed 358 portfolio managers and analysts in 37 countries.