Booz | Allen | Hamilton

Business Council of Australia

CEO Turnover in 2003

Governance and Succession Planning

CEO Turnover in 2003

Update on Global and Australian Trends

1. Introduction

In 2003, the global economy finally emerged from its financial downturns. Stock prices increased, corporate profits expanded and business investment resumed in most industrialised economies. In line with this calmer global economic climate, and continued strength in Australia, the annual Booz Allen Hamilton Global CEO succession study showed CEO turnover reduced compared to 2002.

However, despite this year's reduction, CEOs still face a "revolving door", with more than 9% turned over globally each year. In Australia, the CEO turnover rate has also declined. However, at 14% the Australian CEO turnover rate is still significantly above the global average.

Beyond the obvious link between performance and CEO departure, turnover is linked to other factors such as corporate governance and succession planning within a company.

Globally, there is also a difference in CEO turnover rates according to whether the CEO was recruited externally or grown from within. Outsiders brought in to complete a 'turnaround mission' on a company are more likely to be forced to step down. In 2003, in North America 55% of outsiders were forced to resign, while in Europe 70% of these outsiders left involuntarily. By contrast the picture is quite different in Australia, where outsiders perform better than insiders.

To more fully understand the extent to which these trends in the global CEO turnover study also apply locally, Booz Allen Hamilton extended the global study to Australia as a joint initiative with the Business Council of Australia.

In addition to analysing CEO turnover for ASX 200 companies in 2003, Booz Allen also interviewed 10 CEOs and Chairmen to gain a deeper perspective on the structural differences between Australia and international markets, and also discuss possible solutions going forward.

Key Findings of the Australian CEO Turnover Study Were:

- Australian turnover rates, although declining compared to the pervious year are still significantly higher than the global average
  - globally CEO turnover reduced from 10.7% in 2002 to 9.5% in 2003
  - in Australia CEO turnover also declined – from 16.8% in 2002 to 14.2% in 2003
- Australian CEO tenure continues to hover below the global average. Tenure was 5.6 years in 2003 versus global average of 7.6 years
- Contrary to global trends, in Australia outsider CEOs outperformed insider CEOs, as measured by shareholder returns delivered over their full tenure (16.4% returns for outsiders versus 10.0% for insiders)
- Outsider CEO appointments are on the rise in Australia – 57% of all CEO appointments last year were from candidates outside the organisation

The findings have significant implications not just for chief executives and senior management, but also company boards, shareholders and the wider Australian market.

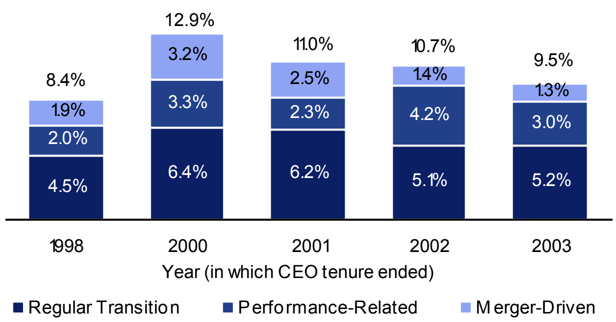
Locally, the results suggest the Australian market environment may be a relatively tough one for CEOs. In response, the Board's traditional governance role may need to change from one characterised by control and risk management to one in which partnerships are developed with CEOs to sustain superior performance. Company Boards in Australia might also consider the implications of a higher proportion of outsiders being appointed CEO in leadership transitions. Given the scarcity of proven CEOs and their cost, it may be in the long-term interests of shareholders that Boards place a higher priority on developing the next generation of leaders from within and therefore ensuring that succession planning becomes an institutional trait.

2. Global Update: 2003 Findings

In line with improved performance of the global economy, CEO turnover rates declined to 9.5%, down from 10.7% in 2002.

This reflects a continuation of the downward trend since 2000, when difficult economic conditions led to a record level of departures. The key contributing factor to last year's result was a 25% reduction in the number of performance-related departures.

Exhibit 1
Global Rate of CEO Turnover



Note: *Figures above column represent percentage of firms that experienced a turnover event. Figures within columns are the breakdowns by type of turnover event*

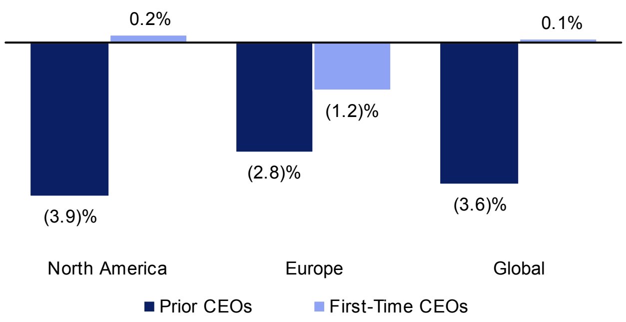
Key Trends Have Been Confirmed in this Year's Global Study:

The study highlighted the merit in being older and wiser – CEOs departing for performance reasons are typically younger than those departing in regular transitions.

Globally, outsiders continue to be a high stakes gamble. Outsider appointments to the CEO position deliver lower average returns than insider CEO appointments and, as might be expected, more often depart for performance reasons.

Interestingly, first time CEOs deliver superior returns than their more experienced counterparts – although this effect varies somewhat by region.

Exhibit 2
Median Shareholder Returns for First-Time and Experienced CEOs for the Six Years Studied



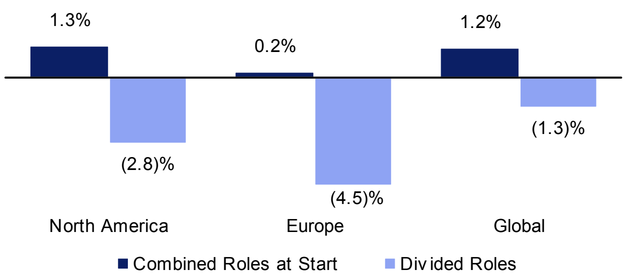
Corporate Governance Can Drive Succession

Corporate governance is a very topical issue, in particular the public discussion around the merits of potentially dividing the Chairman and CEO roles. New data shows that while separating these roles may be beneficial for oversight and control, it may not lead to higher returns and potentially drives higher CEO turnover.

In overseas markets, separating these roles has been a major focus of shareholder activism in recent times. This is based on a belief that the combined role places too much power in the hands of one individual and reduces the scope for an appropriate level of board oversight of executive management.

In companies where the Chairman and CEO roles were combined, the survey showed slightly higher shareholder returns than for those companies where the roles were divided.

Exhibit 3
Median Shareholder Returns by Chairman Status for the Six Years Studied



3. Australian Results

With a much smaller economy and a relatively isolated geographic footprint, Australia is structurally quite different from other Western markets. Compared to other economies, Australia has also undergone a more radical restructuring towards a service-based economy, with Financial Services emerging as the dominant sector.

Although the Australian results present a picture more in line with global results than last year, there are several major and interesting differences.

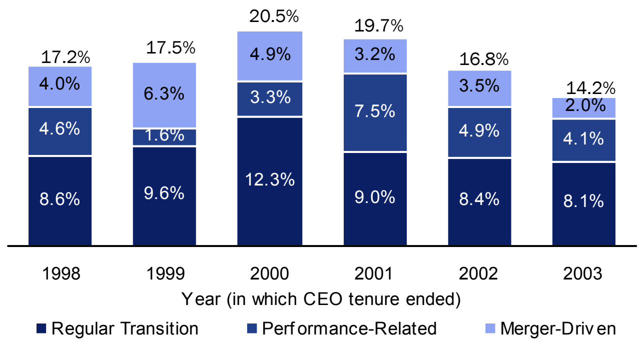
Average tenure for Australian CEOs continues to be significantly below that observed for CEOs globally. This year, for the first time, the Booz Allen/BCA study included in-depth interviews with 10 leading CEOs and Chairmen to explore how differences in the Australian business environment might impact CEO transition and succession. In the discussions it emerged that Australia has a higher propensity for churning CEOs, driven mainly by structural differences. "Australia is structurally hampered by its size and relative geographic isolation compared to other large markets like the US. Competition for capital and investor approval on a global scale drives the need to expand into other markets to meet ever increasing expectations for growth," commented one CEO.

It was suggested that Australia is a tougher environment for CEOs, who are given less time and leeway to implement a winning strategy.

CEO Turnover in Australia More in Line with Global Results in 2003

In line with global findings, Australian CEO turnover also declined, from 16.8% in 2002 to 14.2% in 2003. The most significant reductions were observed in merger-related transitions, which declined by 20%.

Exhibit 4
Australian Rate of CEO Succession 1998-2003



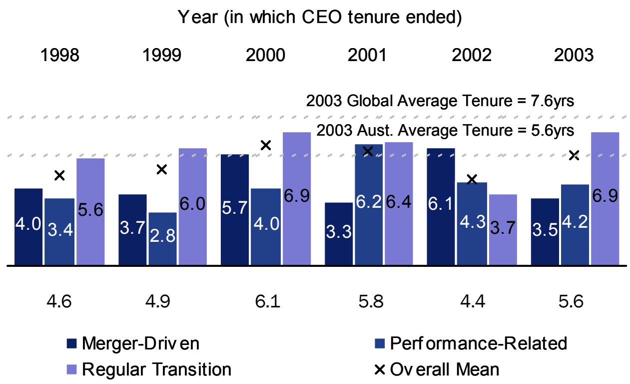
Note: *Figures above column represent percentage of firms that experienced a succession event. Figures within columns are the breakdowns by type of succession event*

Tenure Still Below Global Averages

At 5.6 years, the tenure of the average Australian CEO remains significantly below the global average of 7.6 years.

Going forward we would expect this difference to be maintained. One factor explaining the difference is that in Australia the roles of Chairman and CEO are not generally combined in one person. Our analysis has shown that 'Imperial' CEOs – more the norm in the US and in some European markets – have a longer tenure.

Exhibit 5
Mean Tenure of Departed CEOs in Australia



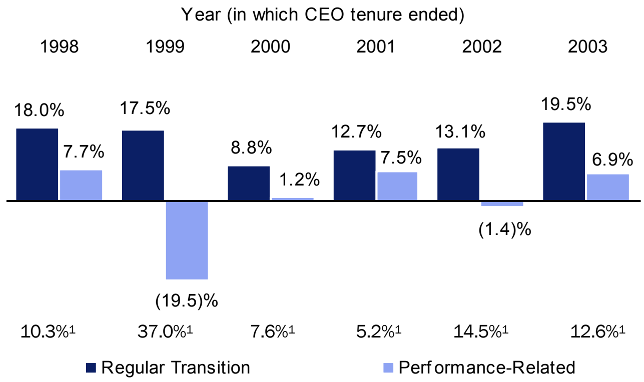
While the average tenure of CEOs departing for performance related reasons continues to fall, tenure for CEOs departing in regular transitions has increased. It is worth noting that results for regular transitions were skewed by a small number of long-term CEOs leaving office, notably Jim Brown of Coates Hire and Alan Newman at Futuris.

Poor Performance Driving Departures

The proportion of CEO turnover events attributed to poor performance appears greater in Australia and Europe than the US.

Where Australian CEOs departed for performance reasons, their organisations delivered shareholder returns significantly below those of organisations where a regular transition occurred.

Exhibit 6
Comparison of Annual Shareholder Returns



1. Variance Between Shareholder Returns of the Two Groups of CEOs

Differences of 14.5% and 12.6% respectively for 2002 and 2003 are observed in the returns delivered by companies experiencing regular versus performance-related departures.

The Australian environment may therefore be less tolerant of CEOs leading underperforming organisations compared to the US.

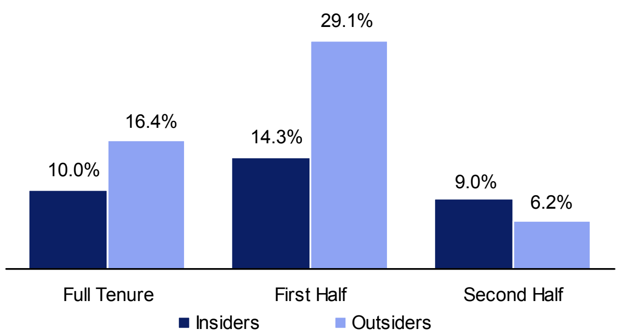
Outsiders Are "In"

CEOs appointed from outside the organisation rather than promoted from within play a more important, and increasing, role in Australian business compared with other markets.

In direct contrast to the global trend, outsider CEOs in Australian companies deliver average returns in excess of those delivered by internally sourced candidates.

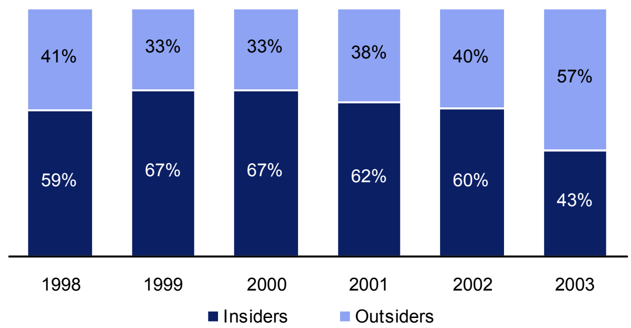
Outsiders deliver outstanding shareholder growth during the first half of their tenure, but suffer from a second-half decline similar to that experienced by insider appointments. Overall, however, they deliver higher results than internally appointed CEOs.

Exhibit 7
Shareholder Returns of Outsider CEOs versus Insiders in Australia for the Six Years Studied



Perhaps not surprisingly given these results, CEOs are increasingly being hired from outside the company. The trend increased this year, with 57% of appointments being outsiders in 2003, up from 40% the previous year.

Exhibit 8
Internal or External Sources of Succession (1998-2003)



As a result, succession planning and leadership development have become an increasingly pressing issue in boardrooms, given the relatively smaller talent pool in Australia and the intensifying competition for proven, tested CEOs.

Australian Conditions Test the Mettle

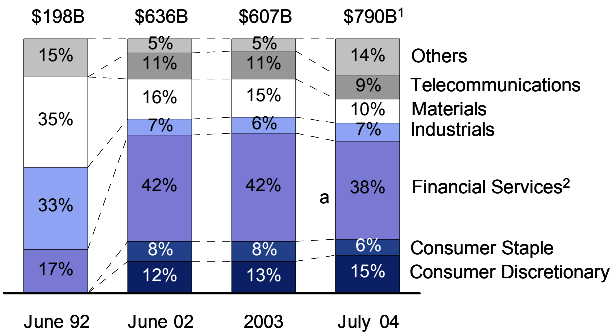
Compared to other Western markets, Australia has distinct characteristics that influence the propensity for CEO turnover. Australian companies are generally smaller, more dispersed and change relatively rapidly, all of which can drive CEO turnover.

Australia's smaller domestic economy means that acquisitions and mergers are disproportionately important in delivering growth. At the same time, M&A as a growth avenue inherently carries greater execution risk and a stronger likelihood that one of the CEOs involved will depart.

The Australian market is also isolated geographically, with the nearest Asian market some five hours flying time away. Expansion into these markets exposes companies to considerable commercial risks associated with cultural differences, not to mention the complexities of managing across multiple time zones and long distances.

Most importantly, the Australian market has undergone rapid change and discontinuity. Today, the composition of its leading listed company index hardly resembles that of 12 years ago.

Exhibit 9
Market Capitalisation by Sector in Australia (1992–2004)



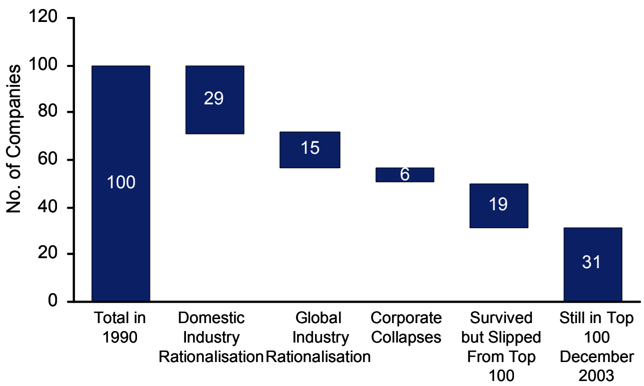
1. Based on the total Market Capitalisation of the ASX 200 companies as of 19 July 2004
2. July 2004 data for Financial Services includes companies classified under Property Trusts

The unparalleled growth of the financial services sector in the last 12 years demonstrates that sector's ability to innovate and find new sources of value. Its emergence as the dominant sector of the economy is in contrast to the relative decline of sectors such as Materials or Industrials, whose relative importance has halved.

Apart from mergers, acquisitions or exits which may directly drive CEO turnover, the challenge of delivering growth in a declining sector appears to be a difficult one.

As one CEO noted: "Natural growth opportunities [locally] are limited, and because of Australia's position within Asia, all acquisitions into Asia are, by comparison, more risky ... [which] may therefore impact tenure".

Exhibit 10
Change in Composition of ASX 100



Source: Port Jackson Partners, Booz Allen Hamilton

In any case, only a minority of companies have been able to maintain a position within the top 100 listed companies over the last 14-year period as shown by the Port Jackson/ Booz Allen Hamilton analysis. Domestic consolidation, global rationalisation and corporate failures or downgrades have accounted for more than two thirds of the original Top 100 constituents departing this list since 1990.

Culture and practice may also play their part. In Australia, the CEO and Chairman roles are typically separated, which globally has been shown to increase CEO turnover. Australia's small investor community may also be a cause, as institutions and media may have a stronger influence in driving perception of the CEO performance, leading potentially to faster turnover.

The conditions described all contribute to the relatively higher incidence of CEO turnover in Australia, and to Australian CEOs enjoying relatively shorter average tenure than their global counterparts.

4. Implications

The findings have significant implications not just for chief executives and senior management, but also company boards, shareholders and the wider market.

Low Tolerance for Non-Performance

Overall the tenure for Australian CEOs remains shorter than for their global counterparts - there is less time to execute the change agenda and the ongoing structural alignment of the economy demands greater organisational agility and adaptability for change from Australian companies. Given the very public scrutiny of a small market and low tolerance for failure, the growth agenda needs to be carefully architected. This implies often proactively managing the risk associated with potentially cross-cultural joint ventures and acquisitions, and finding new ways to incorporate continuous innovation into the company's organisational architecture. Additionally, managing investors' expectations by setting relative return targets is even more critical in the Australian market.

Partner for Growth

Boards and their Chairmen need to actively develop the partnership with the CEO, and not simply supervise the execution of strategy. To that end we believe the governance debate should be rebalanced towards Boards being encouraged to proactively developing deeper and strategic ties with their executive team. Boards should focus more on helping the CEO and management team sustain superior performance, and on creating viable leadership successors.

Keep Insiders Inside

While Australia bucks the global trend of outsider CEOs underperforming by continually going outside, Boards may actually be precluding a culture of internal leadership development.

Succession planning has traditionally been a key role of Boards, and a key component in ensuring sustained performance. One CEO interviewed summed up the challenge: "Succession planning is a difficult topic and often not well executed, however it is clear that internally groomed candidates are by far less risky".

Effective succession planning requires a long-term commitment to developing a leadership pipeline. Best practice companies like GE have made succession planning an institutional trait, and deeply ingrained it in their corporate DNA. This approach implies marrying leadership development and succession planning rather than treating the two separately in different silos of the organisation, identifying critical positions, and ensuring that future leaders have broad exposure to relevant parts of the organisation. Not least important is the need to measure progress against set leadership development targets.

Given the scarcity of proven CEOs and the remuneration they command, it may be in the long-term interests of shareholders that Australian Boards place a higher priority on developing future CEOs from within.

Methodology for the Global Study

This study required the identification of the world's 2,500 largest public companies, defined by their market capitalisation on 1 January 2003. Market capitalisation rather than revenue was used because of the different ways financial companies recognise and account for revenue.

The Compustat/Global Vantage database of public companies provided a list of all publicly traded companies on 31 December 2002.

To identify the companies among the top 2,500 that had experienced a chief executive turnover event, a global business-to-business contact database of executive decision makers (idEXEC) was utilised. This was augmented by an extensive literature review of the leading financial press and research engines as well as by accessing the global Booz Allen research capability.

Each company that appeared to have experienced a CEO change was then investigated to confirm that a change had occurred in 2003 and to confirm the key details of the outgoing executive. Information collected about the outgoing executive included: title upon succession, start and end dates of tenure as chief executive, age, education, whether he or she was an insider or outsider immediately prior to the start of tenure, whether he or she had served as a CEO elsewhere prior to this tenure, and the true reasons for succession.

Average growth rates (CAGRs for total tenure, first half and second half) were calculated for two types of financial and shareholder information during the executive's tenure: net income and total shareholder return. Net income was provided by S&P (Custom Projects), quarterly data provided by North American-traded securities was also collected and annual data was provided for other firms. To enable meaningful cross industry comparisons, income data information for the relevant industry and region, and total shareholder returns (TSR)[1] data, was provided by Thomson Financial Datastream. Regionally adjusted TSR AGRs were calculated by subtracting the Morgan Stanley regional shareholder return indices from the company's performance during the period in question.

Methodology for the Australian Study

The study required the identification of ASX 200 companies since 1998. The data set for Australia includes 244 unique companies since 1998. In 2003, 197 companies in the ASX 200 were researched to determine if and when a CEO turnover event took place. This approach was replicated for all the ASX 200 companies since 1998.

To identify the companies among the ASX 200 that had experienced a chief executive turnover event, annual reports and press searches for each individual company were used. Annual reports provided information on the CEOs for each of the financial years and press searches were used to complement the data from annual reports and to confirm the CEO turnover event and reason for the turnover. A variety of printed and electronic sources including *Lexis Nexis, AFR, SMH, BRW*, etc was used. Additionally *Factiva* was used for any announcements of retirements or new appointments of CEOs, presidents and MDs for the ASX 200 companies in each year since 1998. TSR data was provided by *Datastream* and included capital gains, dividends and reinvestment of dividends.

Each company that appeared to have experienced a CEO change in 2003 was then investigated to confirm that a change had occurred, and to collect key details of the outgoing executive and identify the true reason for the turnover event.

Consistent with the global study we identified three reasons for a CEO transition event, i.e. *Merger-based*, in which a CEO's job was eliminated after an acquisition, *Regular transition*, which included planned retirements, the CEO's acceptance of a better position elsewhere, health-related departures or death in office, and *Performance-related,* which included any departure initiated by the board, attributed by the media to poor financial or managerial performance, or incidences where there was a demonstrable performance shortfall but the departure was described as for "personal reasons" in press.

Australian Companies Surveyed

The survey identified 28 Australian companies within the ASX200 that had experienced CEO turnover events in 2003.

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Booz Allen Hamilton has been at the forefront of management consulting for businesses and governments for 90 years. Booz Allen combines strategy with technology, and insight with action, working with clients to deliver results today that endure tomorrow.

With 14,000 employees on six continents the firm generates annual sales of US$2.2 billion, Booz Allen provides services in strategy based transformation, organisation, operations, systems, and technology to the world's leading corporations, government and other public agencies, emerging growth companies and institutions.

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About the Business Council of Australia

The Business Council of Australia is an association of Chief Executives of leading Australian corporations.

The Council was established in 1983 to provide a forum for Australia's business leadership to contribute directly to public policy debates in order to build a better and more prosperous Australian society.

The Council's aspiration is to make Australia the best place in the world to live, to learn, to work, and to do business.

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[1] *The TSR calculation includes both share price appreciation and dividends*