

COMPLIANCE WEEK

An Outside Job: External CEO Hires Paid More

By Melissa Klein Aguilar — May 1, 2007

Maybe having the inside track isn't such a big help after all. An analysis of CEO pay at more than 450 large companies shows that chief executives hired from outside the company made significantly more than their internally promoted counterparts.

According to compensation research firm Equilar, external CEO hires received median total direct compensation of roughly \$8.9 million in 2005—a 13.2 percent premium over the median pay for CEOs in place for at least two years. The median total direct compensation for CEOs promoted from within was about \$5.8 million, 26.4 percent less than the median for CEOs in place for at least two years.

Those in place for at least two years were used as the benchmark for median pay so elements like sign-on bonuses and other new hire awards wouldn't inflate pay figures, says Equilar senior analyst Alexander Cwirko-Godycki. "If you look at a larger universe, I think you'd see a similar trend," he says. "The gap would still be there, though it might not be quite as big."

The pay gap between outside CEOs and their internal counterparts is created by equity awards and particularly grants of restricted stock, Cwirko-Godycki says. The median restricted stock award for external CEOs was \$2.63 million, compared with \$1.18 million for CEOs in place for at least two years, and \$1.03 million for CEOs promoted from within.

Cwirko-Godycki says that reflects a trend among companies of moving toward more stock awards and fewer option awards—although outside CEOs also received more in stock option awards. The median option award for that group was \$4.83 million, compared with \$3.87 million for CEOs in place for two years, and \$2.79 million for those promoted from within.

"Those promoted from within aren't getting similar initial equity grants," Cwirko-Godycki says. "That could be because they had already gotten a lot of equity awards, but there's clearly a difference."



London

To some extent, the reason for higher pay for external candidates is simple: "When companies bring in someone from the outside, more likely than not, they're bringing in someone who's already a CEO," says Jeffrey London, a partner at the law firm Reed Smith. That means they'll have to pay more to lure the executive from his current position. The hiring company may often pay an external CEO more to replace compensation he is forfeiting by leaving his current job.


What's more, says Joe Griesedieck, of recruiting firm Korn/Ferry International, the difference in pay between external and internal candidates extends beyond the CEO level. "As a rule of thumb, companies will pay a premium for any external candidate," he says. "The talent pool is getting smaller, and it's in high demand. It's

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harder to replace people.”

For that reason, he says his firm spends more time working with boards on executive *retention* than on recruiting or succession planning. When a client does need to recruit a new CEO, “It’s always better if you can hire from inside the company,” he says.

The CEO failure rate—that is, the percentage of CEOs who “bomb out within their first year or two”—currently stands at about 40 percent, Griesedieck says. “If you have to hire from outside, make that the last resort.”



While Griesedieck recommends promoting from within, that doesn’t mean companies shouldn’t look beyond their own borders for candidates. On the contrary, he says, “Looking outside of the company is good due diligence.”

Despite his preference for promoting an insider as CEO, Griesedieck says most companies actually don’t do so. Other experts concur. Peter Cappelli, director of the Center for Human Resources at the University of Pennsylvania’s Wharton School, says that “virtually every company” now does an outside search for a CEO vacancy.

“Generally, internal appointments only happen when everything is going smoothly and has been for awhile, and the internal appointments happen most frequently in family-dominated companies,” Cappelli says.

What’s more, the door to the coveted corner office is commonly becoming a revolving one, as boards are quick to oust underperforming CEOs in the face of increasing pressure from shareholders.

“The job is much more complex today,” Griesedieck says. “The pressure is far greater; there are more constituents to be concerned about.” In addition, boards, under pressure from institutional investors, hedge funds, and activists, have become “less patient,” he adds. “They’re not going to sit by for six or seven quarters and let lackluster performance continue.”

As a result, the average CEO tenure is down to about three or four years, Griesedieck says. He calls the number of CEOs who left their jobs involuntarily last year “staggering.”

Indeed, CEO departures hit a record high last year. A total of 1,478 CEOs left their posts in 2006; that is 12 percent more than the 1,322 ousters in 2005, according to recruitment firm Challenger, Gray & Christmas.

Are They Worth It?

From a financial performance standpoint, one expert says it doesn’t matter whether the new CEO is an outsider or an insider. Larry Greiner, a management and organization professor at the University of Southern California, says his own past research has shown no difference between outside and inside CEOs when it comes to the bottom line. While outside CEOs make more changes than inside CEOs, that doesn’t seem to affect performance, he says.

OUTSIDE TRACK

Total median direct compensation for CEOs at companies with fiscal years ending between Dec. 15, 2005 and Dec. 15, 2006.

	Total Pay
CEOs hired internally	\$5.81 million
CEOs with at least two years of tenure	\$7.90 million
CEOs hired externally	\$8.94 million

 [CEO New Hire Compensation: An Analysis Of New Hires At S&P 500 Companies \(Equilar, March 2007\)](#)

Greiner notes that successful new CEOs proceed in “certain ways,” like first getting a mandate from the board before making major changes, achieving short-term results to ensure their credibility before launching major strategic changes, and using the existing management team rather than bringing in a whole new one, although they later make some replacements.

Financial performance may not amount to much, but whether a CEO comes from inside or outside the company can affect the corporate culture and morale. Hiring an outsider can help a company change its direction, Cappelli says, and “It’s also likely to shake up the organization. Outsiders tend to bring in their own team and often put in place changes that alter the culture of the organization.”

Cappelli says “Outside hires create uncertainty, at least until they settle in, and that can make the workforce uncomfortable.”

Outsider CEOs do create uncertainty and can unsettle the workforce, but that does not necessarily lead to a demoralized one. What demoralizes employees, says USC business professor Jay Conger, is an outsider who fails to understand the fundamentals of the business, focuses on employee layoffs, and fails to appreciate the healthier qualities of the company culture.

Regardless of whether a company hires a new CEO from within or from the outside, London says there’s a risk that people will leave. Some executives may leave if an outsider CEO comes in and makes changes; others may leave if they believe they’ve been passed over in favor of another internal candidate or because they don’t get along with the internally chosen successor.

“The board should have a succession plan in place to manage expectations,” London says.

The most important factor in any succession process is “to be as transparent as possible to employees and shareholders about the process,” says Griesedieck. “It’s uncertainty that demoralizes people.”

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