Batten Down the Hatches All the Way to the Bank: The Changing Face of the CEO Role

In recent years in Australia, there has been a scarcity of firing of CEOs of large publicly listed companies. Either CEOs are doing better in the eyes of shareholders or boards are savvier and more proactive in managing CEO succession, particularly for underperforming CEOs.

There is good reason to believe that boards are rewarding CEOs for what they consider to be a job well done. Beset by anaemic revenue growth, many companies have successfully boosted profitability by trimming costs, deferring capital spending where feasible, undertaking restructuring, spinning off non-core assets and lifting payout ratios to cater to investors' insatiable appetite for income. The profitability for many non-mining companies has now returned to or exceeded their pre-GFC peaks without an assist from higher gearing; leverage for the ASX200 companies in aggregate remains close to decade lows.

The zeitgeist of capital and cost discipline is reflected in the changing nature of the CEO's CV. CEOs with a track record of acquisitive behaviour achieved during the credit boom years of high leverage no longer command a premium in the labour market for managerial talent. Boards no longer expect CEOs to chase the pipe dream of double digit revenue growth and empire building at the expense of profitability and shareholder value.

It is a welcome development that CEOs have turned inwards, and are focussing on what they can control. CEOs are probably spending more time grooming and nurturing talent internally, identifying and focussing on what their core competitive advantage is, and less time being wined and dined by investment bankers, which represents a desirable outcome for shareholders.

<u>A trend towards short CEO tenures</u>

The recent stability in forced CEO successions however, cannot hide the long-term and secular trend towards shorter CEO tenures.

Management consultancy, Strategy&, formerly Booz & Company, undertakes a global annual survey of CEOs which sheds light on the nature of CEO succession. For a sample of the largest 2,500 largest public firms in the world, the authors do an impressive job of documenting the frequency of CEO turnovers and have done so each year since 2000.

CEO turnover has remained broadly stable at around 15% in recent years and is above the 2000 estimate of 13%. A one year reduction in tenure is significant considering the vast annual salaries CEOs command. Another study reports a similar rise in CEO turnover in the US over a longer period; CEO turnover averaged 16.8% between 2000 and 2007, well above the average 14.9% from 1992 to 1999.

Boards today are more willing to fire CEOs for poor stock performance and bad luck plays an important role in the decision to dismiss a CEO; boards fire CEOs following bad overall market performance and poor returns from the industry the company operates in. Adverse industry shocks are more likely to lead to a CEO being fired when the firm is under-performing its peers, suggesting that bad management also contributes to the demise of a CEO.

Boards are reluctant to fire CEOs that under-perform their industry peers when overall stock market conditions are strong. The asymmetry might reflect the fact that board directors feel the burden of accountability from shareholders more during bad times than in booms. Alternatively, bad times might reveal more about the management skills and attributes of a CEO than during good times.

The anxious CEO: A case of vigilant boards

The nature of CEO succession and trends in CEO turnover can shed light on board efficacy and director accountability. After all, arguably the most important decision a board make are to retain or fire a CEO, and in the case of dismissal, the hiring of an insider or outsider to run the firm. Boards ought to have more autonomy to make these decisions given the trend towards greater board independence. It is reasonable to think that increased board independence and vigilance have contributed to shorter CEO tenures, and the greater propensity for boards to fire under-performing CEOs.

Three developments have contributed to a greater focus on corporate governance and board vigilance, particularly the willingness of shareholders to outsource the monitoring function to boards: the growing size and complexity of firms, the spread of diffuse share ownership, and investors embracing the benefits of diversification.

First, population growth, globalisation and the secular shift in economic activity towards services and intangible 'goods' has led to an expansion of average firm size and increased complexity, which has raised the costs that shareholders incur to directly monitor and evaluate managerial performance.

Second, the benefits of direct monitoring have diminished as ownership concentration has declined. In their pioneering analysis published almost a century ago, Adolf Berle and Gardiner Means argued that a diffuse share ownership base reduces monitoring incentives due to the free rider problem. Those who engage in monitoring incur significant costs but the benefits are spread across all shareholders.

Third, monitoring incentives have been further weakened by the fact that many investors own well diversified portfolios. The benefits of diversification espoused by modern portfolio theory and rapid growth of low cost index funds and exchange traded funds have seen investors willing and able to eschew as much stock specific risk from their portfolios.

A golden era for corporate profitability

Glenn Stevens, the Reserve Bank Governor, recently implored equity analysts, shareholders, fund managers, commentators to stop asking 'where's your cost cutting or capital return plan?', and start to ask 'where's your growth plan?' But this is unlikely to happen anytime soon. Australia has been stuck in a nominal recession for over two years now and there is little sign of a sustained pick-up in growth of nominal GDP, particularly given the Reserve Bank's reluctance to use monetary policy to revive entrepreneurial risk taking.

The Reserve Bank is clearly willing to tolerate an extended period of deficient aggregate demand, to safeguard against what it considers to be looming tail risks and imbalances associated with excessive financial risk taking, inadequate bank capital ratios and rapid growth in house prices.

While its timid approach to monetary policy will probably see the economy remain stuck in a nominal recession, the boom in corporate profitability should continue as long as CEOs continue to combat revenue headwinds by retrenching spending, trimming costs and boosting efficiency to preserve or expand profit margins. For now, eschewing entrepreneurial risk taking and battening down the hatches is the surest way CEOs can meet their EPS growth and ROE hurdles, and collect their short and long term incentives.

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