Column

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AVOIDING THE EMBARRASSMENT OF THE NEW CEO WRITEDOWN

Considerations for listed businesses to help protect shareholder value when a new chief is appointed.

The average CEO tenure is now less than five years. Even for a director, ten years is a good innings. But on the buyside, portfolio managers are often in place for 20 years or more. This means we monitor, or actively invest in, companies across a series of CEO and board tenures. For the most part, we are also looking across multiple sectors. This means experienced fund managers develop both a lengthy and broad perspective. This helps us to recognise patterns – in market cycles, mean reversion, capital allocation and management and board behaviour.

Sadly, one pattern we see recur across the market is the 'new CEO writedown' – when the share price suffers after a new chief is appointed. There are several components that typically create this dynamic, such as a long-serving, well-performing incumbent CEO, a determination by the departing CEO to go out on a high and a perceived sense on the part of the board it would be pedantic to challenge too hard on the valedictory result. Or perhaps there is merely an overly-high level of trust in the number struck by the outgoing CEO. The new CEO then brings a desire to clear the decks and lower the base from which a new long-term incentive (LTI) may be struck. Add all these ingredients, mix thoroughly and the stock is often written down.

The basic recipe can receive additional spice from an external CEO appointment, complex asset carrying values and inventory adjustments, as well as the judicious use of provisions or adventurous capitalisation of software.

The departing CEO benefits from monetising his or her remaining LTIs at a high share price, while the incoming CEO gets to set LTIs from a low base. This works well for everyone – except for long-term shareholders who must wear the volatility that results.

Laid out like this, it's clear letting an incumbent CEO deliver an inflated final result, then allowing a new CEO to release a swathe of bad news at his or her first result, is an ethically-challenged value transfer from shareholders to management. Since boards are staffed by highly competent and principled individuals, it's difficult to understand how this dynamic continues to recur.

As with all unsatisfactory remuneration outcomes, the root cause ultimately has to be a level of weakness in the board's oversight. When watching company outcomes from the sidelines, we expect to be surprised every now and again. But it's hard to fathom boards being surprised by a foreseeable dynamic such as this.

In practical terms, avoiding the new CEO writedown requires deft moves. Perhaps the chair and the chief financial officer need to agree the number of the final result, without involving the departing CEO in this task. At the very least, the board should be especially vigilant around valedictory results and should require a fresh set of eyes around carrying values and amortisation writedowns. Planning ahead, LTI plans should be structured to remain on foot well past the departure date, to ensure the CEO's time horizon doesn't shrink as the tenure concludes.

One of the board's paramount tasks is to put the right CEO in place. Successfully discharging this duty requires managing misaligned incentives that may arise during a CEO transition. With diligence and foresight, Australian boards could consign the new CEO writedown to the bin of governance outcomes.

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