The Cost and Considerations for External Executive Candidates

By Angela Moe and Brian Bueno

SUCCESSION PLANNING IS ARGUABLY the board's single most important responsibility. In an era of high executive turnover, boards and their committees spend significant time identifying, developing, and recruiting executive leadership. While some companies have robust management development and succession plans and can regularly rely on internal talent, other firms must consider external candidates, which come with their own risks and rewards.

Trends in Executive Turnover

Over the last five years, CEO and chief financial officer (CFO) turnover at publicly traded companies has dramatically increased. Before 2019, less than 10 percent of S&P 500 companies had new CEOs or CFOs in a given year. Recently, this has risen to between 12 and 18 percent for CEOs and 15 and 22 percent for CFOs, according to a Farient Advisors analysis.

In 2024 alone, 18 percent of S&P 500 companies appointed a new CEO, and 22 percent named a new CFO. Despite experiencing a spike in 2019, the rate of new chief operating officer (COO) appointments has been relatively consistent, at about 11 percent in 2024.

Interestingly, the CFO role has the highest turnover rate, and it continues to increase over time. According to Russell Reynolds Associates' Global CFO Turnover Index, retirement is the primary driver of this trend, as CFO job responsibilities have expanded and intensified amid ongoing shareholder activist pressures and tumultuous financial cycles.

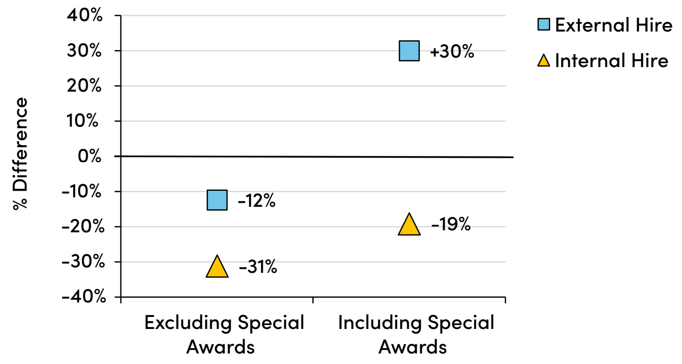
Internal Versus External Hires

A closer look at newly appointed executives over the last 10 years reveals that the majority of new CEO, CFO, and COO appointments have been internal promotions rather than external hires. According to Farient's analysis, nearly 90 percent of all new CEOs, 80 percent of COOs, and 65 percent of CFOs in the S&P 500 were internally promoted over the last five years. While there have been fluctuations in the rate of internal promotions compared to external hires, this rate has remained mostly flat for 10 years.

So, why do some companies hire externally? In some cases, poor succession planning by the board can result in a situation where there are no internal candidates ready to take the helm. In other cases, externally hired CEOs are recruited to improve performance, shift strategy, or transform culture.

Take the Boeing Co., for example. Dennis Muilenburg was fired as CEO in 2019 after fatal crashes involving the company's 737 MAX aircraft. He was succeeded by Dave Calhoun, chair of Boeing's board, who was tasked with addressing oversight and product issues. Despite Calhoun's efforts, activists continued to pressure the board to recognize that it needed fresh leadership. He stepped down as CEO in 2024 and was replaced by Kelly Ortberg, who previously served as CEO of Rockwell Collins and Collins Aerospace.

Difference in Target Pay for New CEO vs. Outgoing CEO Among External vs. Internal Hires



Source: Farient Advisors

Successful companies and their boards typically hire executives with leadership experience at companies in similar or adjacent industries when hiring outside candidates. Between 2022 and 2024, approximately 60 percent of S&P 500 CEOs who were externally hired came from companies in the same sector, and the remaining 40 percent were recruited from different sectors, according to Farient's analysis.

However, hiring from different industries can create friction. Starbucks Corp. experienced this in 2022 when it appointed Laxman Narasimhan from Reckitt Benckiser Group as its CEO. His consumer health background seemingly did not translate to the retail food and beverage industry, resulting in declining sales and a public relations issue. He left in 2024. Starbucks then hired Brian Niccol, former Chipotle CEO, and paid him nearly $100 million in his first few months.

Executive Pay and New-Hire Awards

As with Niccol at Starbucks, executives recruited externally rather than promoted from within can come at a higher cost.

Executive Hire	When It Makes Sense	Compensation Considerations
INTERNAL	• As the default decision, unless there are no suitable candidates or the company requires a shift in strategic direction. • The board has maintained an ongoing succession planning process and has a ready roster of candidates. • The company's unique situation or business model requires internal experience and expertise.	• Before the current executive's departure, retention awards to successor candidates may be needed to secure their commitment. • Promotional, or incremental, awards can be used to recognize off-cycle promotions and bring executives to their new level of pay. • Additional retention awards may be needed for those executives not elevated to a new role; some executive turnover can be expected.
EXTERNAL	• Next-in-line candidates are not yet prepared or willing to take on the role. • The company is seeking to make a major strategic shift that requires new leadership. • The company needs to revamp culture. • There is overwhelming shareholder or activist pressure for this change.	• Above-market ongoing or target pay packages may be required, depending on the new executive's level of experience. • Replacement or make-whole awards may be required to buy out the candidate's existing equity with another company. • Special performance or inducement awards may be required, particularly if the prior executive had major performance issues. • Retention awards for existing executives may be needed; in addition, new, external executives may wish to hire other executives that align with their strategy and desired culture.

Among S&P 500 companies with new CEOs in 2024, compared to the respective outgoing CEOs, externally hired CEOs were paid 12 percent less, while internally promoted CEOs were paid roughly 30 percent less, according to Farient's analysis. These amounts exclude the impact of special sign-on or replacement awards received upon joining a company and promotional awards received for an internal placement.

Looking at these special awards reveals an even starker difference: External hires more frequently received greater up-front replacement or sign-on awards than internal hires did, and the value of such awards was much larger than special promotional grants. Companies often make external hires whole for the ownership or unvested awards they may lose when leaving their prior employers.

Internally promoted CEOs usually do not receive special equity awards. Instead, they are given larger equity grants commensurate with their new role and responsibilities. According to Farient's analysis, all external hires received some special award in the year they were hired compared to roughly 30 percent of CEOs promoted from within.

When including the total value of any special new hire or promotional awards, externally hired CEOs were paid 30 percent more than the outgoing CEOs. For comparison, internally promoted CEOs were paid roughly 20 percent less than the outgoing CEOs.

Moreover, the size of new CEO awards varies for external hires. Their values typically range from $5 million to $13 million, or roughly half to one time the ongoing long-term incentive value. However, as seen in the Starbucks example, these values can become exorbitant. Nevertheless, investors typically support the appointment of a new CEO and the pay package, especially if, under the prior CEO, the company suffered a period of underperformance.

Even though investors and proxy advisors typically dislike the use of special awards, they will often support these awards if they are reasonable in quantum, explained clearly, long term, and tied to performance. Even after Niccol's appointment and sign-on awards of more than $90 million were announced, Starbucks received say-on-pay support of 86 percent.

Considerations and Strategies for Boards

Ideally, boards should evaluate candidate slates that include both internal and external candidates, recognizing that there may be unique pay considerations for each approach.

Boards should avoid situations in which their compensation decisions for newly appointed executives taint what should otherwise be a positive development of new leadership. D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