

RISE AND FALL: MARKET REACTION
AND SHORT TERM RESULTS
OF CEO TURNOVER

by

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INTRODUCTION

The decision to part ways with a CEO, as well as the choice of his/her replacement, is a significant one for a firm. CEO turnover, which has increased since the recent economic decline and subsequent recession, puts a company at a crossroad, potentially altering their overall strategy and performance for years to come (Brookman and Thistle, 2009). While the long-term effects of turnover and subsequent replacement are particularly far reaching in regards to strategy and performance, this thesis seeks to explore the immediate and short term results of turnover on firm performance. The question set forth within this paper is: Is market reaction to CEO turnover indicative of subsequent short-term performance?

In order to limit the scope of this research, only turnover resulting from poor performance will be analyzed in the data collection section of this thesis, and CEO origin will be broken down into two separate categories, internal hires and external hires. By adding these stipulations to the original question, other questions can be answered through this research such as whether the market reacts differently to internal hires versus external hires, does the origin of the CEO have an effect on ability to turn around a struggling firm, and does prior poor performance breed poor performance post succession?

In order to gain a proper understanding of this subject that would allow for the question posed by this thesis to be answered, prior research was reviewed on different aspects of CEO turnover, board of director decisions when choosing a new CEO, and leadership's ability to influence organizations. This research was used to form a basis on which to collect data pertaining to CEO turnover, namely market reaction to turnover and

a comparison of the predecessor's performance measures, such as change in stock price, ROE, and ROA, during his/her last year of tenure to the incumbent CEOs first year at the helm. This data is broken down between internal hires and external hires, and then reviewed and analyzed to reach a conclusion in regards to the overarching question of this thesis as well as the hypotheses discussed in the following section.

RESEARCH QUESTIONS

The implications of CEO turnover, particularly forced succession occurring when a business is struggling, can be far reaching and have a wide range of effects on both internal and external stakeholders. A wide variety of different questions have been asked and researched in regards to upper-level succession, both forced and unforced, and there has been a lack of information about how accurately short term expectations are measured in regard to CEO performance, much of this having to do with a disagreement over how much power a CEO actually holds, particularly when first stepping into the role (Hambrick and Fukutomi, 1991). The questions set forth by this thesis is whether initial market reaction to CEO turnover is indicative of the short-term(1 year) results of the successor CEO in the period hiring his/her hire. Before exploring the questions directly set out in this thesis, it will be important to first gather information on the role of CEOs within an organization and the actual power and influence they possess, as well as researching what drives turnover and why a firm would choose an internal candidate over an external candidate.

Hypotheses

Before forming a set of hypotheses, it is important to first define a way to measure expectations, as firms do not simply release their desired results of their new CEOs.

Rather than taking an internal view for expectations, this paper will look at market expectations by gauging the initial market reaction to the firing of the former CEO and the subsequent announcement of his/her successor. This reaction will be measured in two different ways, first by looking at previous research on market reaction to turnover, and then by viewing a selected sample of forced turnover in struggling firms resulting in either insider or outsider succession. The following two hypotheses will be confirmed or denied through this part of the research:

H1: Market reaction to CEO turnover will be inversely related to the firm's prior performance, meaning that previously struggling firms will have a positive market reaction.

H2: The market reaction for an outsider's succession to CEO is greater than that of insider succession.

H1 is formed through the thought process that the market will view the decision to fire a CEO in a struggling company as a proactive measure to replace him/her with someone who will be better able to reverse the firm's poor performance. The reasoning behind H2 is that shareholders may view an insider as someone who is already entrenched in the recent failure of the firm, while an outsider may be able to act as the breath of fresh air necessary to bolster the company.

Upon confirming or denying these hypotheses through research and data collection, it will be possible to research how these market reactions actually correlate with short term results. Much like the research into market reaction to CEO turnover, the first step will be to look at previous research on the topic of how a firm reacts to CEO succession, and then to do quantitative research in regards to short term results yielded by

new CEOs. For the quantitative analysis, it will be crucial to establish what sort of internal measures are used to gauge CEO success within an organization, a point that will be touched upon within the literature review section of this thesis and revisited in the data and results section. There will be an overall analysis of the short-term results of forced CEO turnover in distressed firms and a subsequent comparison of the results of an internal hire versus an external hire in the hopes of confirming or denying the following hypotheses:

H3: The short-term results of an internal hire will be more positive than the results of the previous CEO prior to termination.

H4: External hires will have results, namely stock performance and key financial ratios, similar to those of the previous CEO prior to termination due to a steeper learning curve.

The reasoning behind this set of hypotheses is that due to having a previous understanding of the company, an internally hired CEO will be more able to step into the role and start implementing changes more immediately given that he/she must only adjust to the new role, while an outside hire would have to adjust to both the new role and the new company.

The synthesis of the research described above and the confirmation or rejection of the previously presented hypotheses should serve to answer the overarching question of whether expectations are indicative of the short-term results of CEO turnover in distressed firms.

Importance of the Research

This research could stand to serve two separate parties; shareholders and boards of directors. Shareholders would stand to benefit from the answer to this question in that their share prices may be regarded as overpriced following CEO succession for equity they hold in distressed firms, particularly if both the hypotheses regarding outside hires rings true. This could potentially lead to a decision to sell high on the announcement date of succession before the stock price falls back to appropriate levels in the short term.

While there is some significance in this research for shareholders, this thesis is more aimed towards the board of directors in struggling companies who have recently made decisions regarding CEO turnover. This research could potentially serve as a guideline as to whether typical measures of CEO effectiveness, such as ROE, stock price, and earnings targets, are appropriate measures of short-term CEO effectiveness. The results of this research could uncover that such measures are only appropriate in regards to certain kinds of succession, or that a new CEO should have the beginning of his tenure measured in non-quantitative results, such as organizational fit, long term strategy, and management effectiveness.

LITERATURE REVIEW

The Role of a CEO

When exploring CEO turnover and its implications on the company, it is important to first gather an understanding of what the role of a CEO is within a company and to explore what sort of performance measures they are charged with. While the actual job description for a CEO will differ from company to company, the CEO is ultimately the link between the board, the company, and external shareholders. Beyond being a

liaison for the firm, the CEO is often charged with leading the implementation of strategy, maintaining corporate governance, and setting “tone at the top” within an organization (Dey, Engel, and Leu, 2011). By understanding the role of a CEO, it is more possible to gather an understanding of how to measure their success and failures.

Boatright(2009) argues that CEOs now act as a special kind of shareholder rather than simply a high powered executive due to the prevalence of stock options being awarded as compensation in the last twenty years. A large investment in the company allows their actions to better align with the Principal-Agent theory, further emphasizing the role of wealth creation as a duty of the CEO rather than CEO success being measured by the growth and operation of their respective companies. As such, stock performance should be considered a major component by which to gauge the success of a CEO.

Even with CEOs acting as the face and de-facto leader of a business, academics such as Hannan and Freeman(1989) question whether top management have a true impact on their companies or if their successes and failures are simply the results of the business environment they are placed in, since most factors, such as economic climate and industry ebbs and flows, are out of their hands. The argument exists that due to the vast size and scope of large businesses, the CEO does not possess the power to implement strategy and change due to either organization bureaucracy or general resistance from upper or middle management (O’Reilly et al. 2010). In some extreme examples, the CEO isn’t charged with real decision making power, but rather is forced to simply act on behalf of the board’s plans, acting more as a glorified figurehead and scapegoat for the board (Pfeffer, 1981).

While scholars such as Hannan and Freeman may argue against CEOs having a true impact on firm performance, there is research supporting a CEOs ability to significantly influence a company (O'Reilly et al. 2010, Mackey, 2008, Hambrick, Mason, 1984). Mackey(2008) presents that the CEO, while not having as drastic of an effect on business profitability as the economic and business environment of the firm in a majority of cases, still has a substantial influence on firm performance and profitability, particularly in firms and industries where managerial decision making is high regarding strategic decision making. Hambrick and Mason (1984) go as far as to argue that the organization as a whole operates as a reflection of top management, meaning that the impact of the CEO would branch beyond financial performance and be as far reaching as the makeup and culture of the firm. This line of thinking is particularly important to the further research of the impact of CEO turnover and its subsequent effect on both the firm and stockholder expectations as it gives merit to the argument that changing the CEO will have an actual effect on the firm and that investors are right in reacting to such turnover.

Types and Causes of CEO Turnover

The type of CEO departures from a firm are various and often case specific, for simplicities sake CEO departure here will be broken up into two separate categories, voluntary and forced. Voluntary turnover occurs in the case that the CEO has reached retirement age (59.5) and that the reason listed as leaving is "retirement," or that the CEO has reached the age of 65, as prior research shows that CEO departure after this age limit are often structured around retirement plans already set in place by either the company or the CEO (Brookman and Thistle, 2009). Forced departure is departure that occurs prior to the age of 60 and is listed by either the firm or a reliable source, such as the Wall Street

Journal as either resigned, retired, or no reason (Denis and Kruse, 2000). Classification of departure type is done by a case by case basis on CEOs who depart between the ages of 60-65. The research in this paper is focused on market reaction and short-term results when firms undergo forced CEO departure. The reason for this choice is that in the case of voluntary departure, it is expected that there is already a plan in place by the company to replace the CEO. As such, the market likely has prior awareness of the impending departure of the CEO, leading to the belief that both the market reaction and the firm's financial performance will likely be smoothed by the effects of this prior knowledge (Dennis and Dennis, 1995).

While the focus will be on forced turnover in underperforming firms, the type of hire will be broken down into two categories, inside hires and outside hires. Firms tend to choose inside hires in the vast majority of cases when choosing to replace their CEO (Agrawal, Knoeber, and Tsoulouhas, 2006, Parrino, 1997). An inside hire is the tendency for a multitude of reasons, such as prior relationship with the board, an understanding of the company and industry, and reduced costs of finding the replacement (Agrawal, Knoeber, and Tsoulouhas, 2006). In many cases, for both planned and unplanned turnover, the company is already grooming an heir apparent to the CEO to be ready when the time comes to have a new leader at the helm (Mobbs and Raheja, 2012). Even branching out beyond the firm's familiarity with insiders as opposed to outside candidates, the firm is sending a message to all stakeholders that the company is able to cultivate talent within the company, whereas turning towards someone outside the company may signal that there is a dearth of talent at the top level of the company (Agrawal, Knoeber, and Tsoulouhas, 2006). Though inside hires are far more prevalent,

the firm will turn to talent outside of the company if they are able to identify a candidate who is more qualified than any of the internal ones or if they wish to undergo, or at least signal, a change in strategy (Agrawal, Knoeber, and Tsoulouhas, 2006).

With the focus being on forced turnover, it is important to view what some of the causes and signals are of such turnover in order to understand why both the market and the firm would react in a certain way. In the most simplistic terms, firms that are performing poorly will have an incentive to dismiss their CEO, but when dealing with such a high powered position that has so much scrutiny aimed towards it, there is often a more in depth process than simply looking at firm performance when making a decision to find a new CEO (Brookman and Thistle, 2009). CEO turnover can be caused by a board decision that the CEO is not a good fit, either culturally or strategically for the organization (Weisbach, 1988). Turnover is caused by poor firm performance, especially in areas that are measures within the typical CEO compensation contract, such as stock prices not reaching expected levels, a failure to realize corporate earnings targets, or falling below select financial ratios, such as ROA, ROE, and profit margin on sales (Puffer and Weintrop, 1991, Kiesler and Sproull, 1982, Coughlan and Schmidt, 1984, Weisbach, 1988). The aforementioned financial measures give a company's Board of Directors something to quantitatively review their CEO's performance with and allows investors and outsiders some sort of gauge to look at as to whether the current CEO is likely to be let go (Coughlan and Schmidt, 1984). Besides firm performance, another indicator of turnover is when a firm has recently been mentioned in business publications such as *The Wall Street Journal* on multiple occasions (Farrell and Whidbee, 2002). CEO turnover can also be caused by such things as scandals, death, internal company politics,

or a range of other reasons, but for this particular research the evaluation of turnover will be focused on cases of CEOs being forced to depart due to poor firm performance.

Prior Research on Market Reaction

While less extensive than the research regarding firm performance after CEO turnover, there is a great deal of insight into to how the stock market reacts to CEO turnover within publicly traded companies (Bonnier and Bruner 1988, Setiwan, 2008, Warner, Watts and Wruck, 1987). Prior research has shown mixed results as to how the market reacts in regards to CEO turnover, but much of the insignificant results found by people such as Warner, Watts, and Wruck (1987) can likely be attributed to the sample they used. The sample used by many of these researchers includes all types of turnover, most notably planned and unplanned. The reason this is significant is because planned turnover tends to have a smoothing effect, given that the market is aware of the succession prior to the actual turnover, and the firm often already has an heir being groomed to take over the position (Bonnier, Bruner, 1988). In samples that either don't include planned CEO turnover or separate different types of turnover in their analysis, the market reaction is found to be inversely related to firm performance under the prior CEO, meaning that the market will react favorably to turnover that is following periods of poor performance (Worrell, Davidson, and Glascock 1993). This is particularly relevant to the research set forth by this thesis, since the objective is to identify firm and market reaction in the instance of forced CEO turnover caused by poor performance.

By once again breaking forced turnover into the two categories of hires, inside the firm and outside the firm, it is possible to gather an understanding of how the market reacts to each kind of succession. As discussed previously, inside succession tends to be

far more common than outside succession (Agrawal, Knoeber, and Tsoulouhas, 2006). In the case of inside hires, the prevailing consensus is that the market reaction is inverse to the previous CEO's performance, as shareholders view the forced resignation of the CEO as the board of directors being reactive to the negative performance and are replacing the CEO with a known quantity who will be able to garner more positive results, while an outsider would come in as a more "disruptive" force since there would be a period of him/her adjusting to the role and the firm and company management likewise adjusting to him/her (Bonnier and Brunner, 1989). Due to the disruptive nature of an outside hire, along with some of the negative aspects that an outside hire could inadvertently signal to investors, such as a lack of talent within the firm or a need for a complete overhaul in the strategy of upper-management, the reaction for an outside hire will often be stagnant or negative (Bonier and Bruner 1988, Agrawal, Knoeber, and Tsoulouhas, 2006). While this may seem logical in the majority of cases, within distressed firms an outside hire could be viewed positively, as it would show that the firm is actively attempting to reverse a negative culture of failure (Jalal and Prezas, 2012). So while some of the initial findings in regard to market reaction may serve to disprove hypothesis H2, the specific causes of turnover being reviewed within this thesis may go on to disprove such research and find that an outside hire may be viewed as a positive signal of future firm performance on the external market.

Prior Research on Firm Performance/Reaction

Research focusing on the effects of CEO turnover and the effects of leadership as a whole on firm performance tends to be ambiguous and far stretching, not to mention taking a long term view which does not align with the short term questions raised within

this thesis (Huson, Malatesta, and Parrino, 1997). To simplify these conclusions, company reaction will be broken into three separate schools of thought, each with research and common sense merit to back it up: CEO turnover will have a positive effect on the firm, CEO turnover will have a negative effect on initial performance, and CEO turnover does not affect firm performance. Each of these theories hold some ground of reason, and upon further analysis it may become clearer which one or ones most aptly apply to the questions set forth in this particular paper.

Positive Effect

The theory that CEO succession will have a positive effect on firm performance is derived from the notion that fresh blood is brought in to breathe fresh air into stagnant strategies and perhaps offer a more positive outlook, as well as signaling across the organization that the board is being proactive in improving the performance of the firm (Brown, 1982, Dennis and Dennis, 1995 Huson, Malatesta, and Parrino, 1997). In support of this theory, Weisbach's(1988) findings suggest that CEO turnover is negatively correlated to firm success. Generally speaking, if turnover occurs at a time when the firm is performing poorly, the board is ultimately replacing the CEO with somebody better suited for the position, leading to positive results. This can be referred to as an expectations theory, in which the firm would not be expected to implement change at the top unless a better fit is available. An important aspect that applies to this theory being relevant is the belief that top management, particularly the CEO, has a significant effect, or at least is believed to have a significant effect, on firm performance (Pfeffer, 1977). In the long term, the effect of the CEO on company performance will be greatly determined by his/her own initiative to lead, the initial positive results would be caused by employee

and firm reaction to the turnover itself, and the redistribution of power across other high level executives, as CEOs tend to accumulate power as their tenure increases and they become more entrenched in the firm (Brookman and Thistle, 2009, Hambrick and Fukutomi, 1991). This line of thinking would seemingly support hypothesis H3 in that the firm ultimately would only hire a new CEO if he/she was a better fit for the position than the previous CEO, leading to positive results from the succession.

Negative Effect

The opposite of the theories presenting a positive correlation between firm performance and CEO succession, is that turnover acts as a disruptive force within the firm, serving more as a distraction than a boon to firm management (Brown, 1982). Brown presents, with support from previous studies, that managerial succession causes an increase in tension in firms that are already performing poorly, and a subsequent decline in performance due to the extra time and effort it takes to implement change at the CEO position and within company strategy. This theory on turnover looks at turnover as a “vicious cycle,” in which poor performance causes turnover, and the turnover causes further poor performance. Beyond the idea of disdain towards new management presented by Grusky(1960), which didn’t gain much support in subsequent studies, is that poor performance following succession could occur due to a control and information lag that occurs as the new CEO enters into an adjusting period as he/she steps into his/her new role, supporting hypothesis H4, that there would be a struggle for an outsider CEO, who would have a steeper learning curve, to turn around the performance of the firm in the short term, leading to continued negative results carrying over from the prior CEOs

tenure in office (Agrawal, Knoeber, and Tsoulouhas, 2004, Hambrick and Fukutomi, 1991).

No Effect

This particular line of thinking holds that top management doesn't have significant influence on the company, meaning that CEO acts as a scapegoat for poor performance during forced succession rather than the actual cause of poor performance (Grusky, 1963). Though this line of thinking has research behind it, and could ultimately be a supporting factor for hypothesis H4, there is too much emphasis placed on CEOs to not have an effect on organizational performance, even if it's only caused by subordinate and external belief in CEO power. As an important note, this theory applies to a long term view on CEO power, so while findings may suggest that a CEO lacks ability to influence a company in the short term due to an adjustment period; this theory isn't necessarily supportive of only a temporary lack of power.

METHODS & RESULTS

This section of the thesis will lay out how the applicable data was gathered and utilized to either confirm or deny the hypotheses presented within this thesis.

Sample

In order to identify instances of CEO turnover, the Forbes published list of *Fortune 500 CEO's* were analyzed from the years 2006-2011. This particular range of dates was used due to the accessibility of the information and because it gave ample room in which to measure the short-term contributions of any CEOs who came into power during this time span. After identifying cases of turnover within Fortune 500 companies during this time period, the turnovers were examined against news sources such as *The*

Wall Street Journal and *Businessweek* in order to identify whether the succession occurring was; internal or external, and occurring due to poor performance. While the origin of the successor was readily available, the actual cause of the turnover and the state of the firm were not included in many articles involving the turnover, leading to a more in depth analysis of the firm's performance during the predecessor's tenure. In order to gauge if turnover likely occurred due to poor performance when relevant news sources did not make the cause readily available, the firm's stock price and ROE during the preceding CEO's final year of tenure were measured using *Bloomberg*. As discussed in the literature review section, the insider succession is much more prominent than outside succession, but this particular research used an equal sample of each type and used seven example of inside succession and seven examples of outside.

One issue encountered with this particular time period, however, is many of the turnovers happened in 2008 or 2009 after the economic collapse. In order to guard against the results only being relevant post-decline or during a recession, two instances from both internal hires and external hires occurred pre-crash.

Measurement of market reaction

Market reaction to turnover was measured using *Bloomberg*. In order to gather an understanding of how the market responded to turnover, a period of two days prior to two days after the announcement was taken to measure any abnormal returns in regards to the announcement. In the cases where an immediate successor was not named upon the announcement of the departure or intent to depart of the previous CEO, a measurement was taken for both the announcement of the predecessor's departure and the later announcement of the successor, as seen in Table 2. The majority of cases in which a

successor was not immediately named occurred when outside succession took place, which is unsurprising given that it is much easier to identify a successor when choosing externally compared to searching externally. This presented an interesting finding in regards to market reaction that will be visited within the results section of this thesis.

Market Reaction: Internal Hire

Table 1: Internal Hire Stock Price Δ			
Company	Announcement	Δ Stock Price (prior)	Δ Stock Price(subsequent)
TWX	insignificant	-11.28%	-38.70%
AMR	-83.95%	-81.01%	-70.12%
AAPL	35.62%	-38.55%	109.79%
GGP	13.21%	-95.89%	114.71%
HD	5.12%	-5.52%	-17.40%
BNY	insignificant	-21.05%	-9.84%
PFE	7.36%	-28.57%	0.57%

As can be seen in Table 1, the market had a tendency to react either favorably or not at all to turnover in under-performing firms in which an internal hire was chosen to replace the previous CEO. Though there was a case of a negative market reaction when American Airlines chose to replace their CEO in 2011, upon further analysis this reaction was caused by the belief that the turnover was an indicator of future bankruptcy, an assumption that came to fruition. The positive reactions ranged anywhere from a 5.12% increase over normal expectations to 35.62% in the case of Apple upon the announcement of Steve Jobs returning to the CEO role. These findings act as a confirmation of previous research and agree with the conclusion reached by Bonnier and Brunner(1989), who stated that the market will react favorably to CEO turnover in distressed companies.

Market Reaction: External Hire

Company	Announcement (turnover)	Announcement (hire)	Δ Stock Price (prior)	Δ Stock Price (subsequent)
HIG	7.97%	insignificant	-79.13%	-16.98%
TXT	6.43%	n/a	-30.75%	11.44%
CPB	12.66%	insignificant	-8.82%	-13.23%
HPQ	8.24%	-9.09%	-41.19%	-33.70%
YHOO	8.65%	insignificant	-60.28%	26.27%
PCG	insignificant	n/a	-9.43%	14.85%
NOK	9.13%	n/a	-35.19%	-41.44%

Some of the cases of external turnover analyzed had two separate instances in which to view the announcement of an external hire, the announcement of the former CEO's leave and the announcement of the successor's hire, as the search process often started or continued after the former officer had either been let go or resigned. In these cases there was a positive reaction to the announcement of resignation, but either an insignificant or negative reaction to the announcement of a successor. In cases where the successor was an outsider and their announcement as the new CEO coincided with the departure of the old CEO, there was a positive reaction, though there is a chance that this was perceived as an internal succession or that the market was simply reacting to the announcement of the old CEO leaving. What is particularly interesting about the lack of reaction to the announcements of some of these incoming CEOs is that there were three of which were considered to be "turnaround CEOs," such as Campbell's Doug Conant who eventually did turn around the fortune of the firm.

Short Term Results

Short term results were measured by viewing how incumbent CEOs first year in the position measured in comparison to the last year of the previous CEOs tenure from a financial perspective. The financial measures used to gauge success were one-year changes in stock prices, ROE, and ROA, as seen in tables 3 and 4. These particular measures were used in accordance with the findings in the literature review section that

suggests that these items are often included in CEO contracts in regards to how compensation is awarded. The financial ratios were retrieved through *Bloomberg* and were measured over the last four quarters of the predecessor's tenure and the first four quarters of the incumbent's tenure. Stock performance was compared using the last year of performance leading up to the turnover and the year directly following it, though in some cases the latter period was extended to gather how the market reacted to the release of the first set of financial statements for which the new CEO was fully entrenched.

Short-Term Results: Internal Hire

Company	Δ Stock Price (prior)	Δ Stock Price(subsequent)	Δ ROE (prior)	Δ ROE (Subsequent)	Δ ROA (prior)	Δ ROA (Subsequent)
TWX	-11.28%	-38.70%	-28.14%	-30.29%	-34.59%	-35.66%
AMR	-81.01%	-70.12%	n/a	n/a	-432.24%	36.18%
AAPL	-38.55%	109.79%	-104.35%	136.15%	-104.35%	136.15%
GGP	-95.89%	114.71%	-90.97%	91.78%	-90.91%	-87.89%
HD	-5.52%	-17.40%	4.34%	-10.02%	-1.58%	-26.15%
BNY	-21.05%	-9.84%	-10.59%	-8.29%	-20.45%	-46.07%
PFE	-28.57%	0.57%	-20.67%	12.54%	-24.02%	29.14%

The short term performance of the internally hired CEOs sampled in this researched showed results that closely mirrored those of the previous CEOs. In cases where firm performance and stock value were stagnating or declining under the leadership of the previous CEO, the predecessor was able to do little to reverse the fortunes of the company. Two obvious outliers in this data are Apple, which saw a tremendous bounce back in stock price and other performance measures following the hire of Steve Jobs, and General Growth Properties, whose turnover and subsequent improvement seemed to be linked more closely to the market improving as a whole rather than a change in strategy implemented by the new CEO. By inquiring into the long term performance of the new CEOs through the investigation of financial results and published articles, results showed that many of the CEOs observed were still in their respective

positions, and about half had shown improvement, especially when compared to the results of their predecessors in the period prior to their release.

Short-Term Results: External Hire

Company	Δ Stock Price (prior)	Δ Stock Price (subsequent)	Δ ROE (prior)	Δ ROE (Subsequent)	Δ ROA (prior)	Δ ROA (Subsequent)
HIG	-79.13%	-16.98%	46.38%	52.15%	51.11%	46.31%
TXT	-30.75%	11.44%	-110.57%	163.06%	-109.70%	25.21%
CPB	-8.82%	-13.23%	-14.33%	-19.17%	-12.39%	-22.79%
HPQ	-41.19%	-33.70%	-17.33%	-331.58%	-23.91%	-290.66%
YHOO	-60.28%	26.27%	-7.21%	25.06%	24.24%	90.24%
PCG	-9.43%	14.85%	-12.31%	14.33%	-31.40%	11.13%
NOK	-35.19%	-41.44%	106.28%	-165.85%	108.44%	-162.55%

The short term results for external hires were very similar to those for internal hires, in that the majority of cases observed showed results that closely mirrored those of the previous CEO, with the firms performing well following a similar pattern as was observed in GGP where performance improvement was likely a result of an overall market improvement rather than a strategy change. Once again taking a longer view at CEO performance showed a mixed bag of results. Outside hires for Campbell and Textron in particular were able to implement long term strategic changes and initiatives to help rescue their firms from all-time lows in regards to performance. This helps to establish that this data set is offering insight into the short term effectiveness of successful and unsuccessful CEOs, making the conclusions formed from the data collected more widely applicable rather than only pertaining to a certain set of CEOs.

DICUSSION

While the sample size analyzed was small, the information offers relatively consistent results. Coupled with the understanding of CEO turnover gathered in previous research, the questions and hypotheses being researched within this thesis were able to be confirmed, denied, or answered, along with certain findings that were not the original intent of this thesis were uncovered.

Hypotheses

H1

Hypothesis H1 stated that market reaction to CEO turnover would be inversely related to the predecessor's performance. The hypothesis was made that the market would see CEO turnover as a positive sign going forward and that a new CEO would be able to reverse the poor performance of the company by bringing in fresh ideas or a new strategy. The initial research of literature pertaining to reactions to turnover supported this hypotheses and led to the initial conclusion that there would be a spike in stock prices caused by the announcement of a poorly performing CEO leaving his/her position, particularly when the incumbent CEO would be coming from inside the firm. The data collected in the previous section, as it pertains to both internal and external hires, further supports this hypothesis, as there was an observed increase in stock price in ten of the fourteen observed cases that correlated with the departure announcement. When excluding the reaction of the announcement at American Airlines, which appears to be an extreme case of negative market reaction caused by impending bankruptcy, the stock price increased by approximately 8.8% upon announcement in the observed cases. Although there are certain limitations attached to this conclusion, the research conducted suggests the confirmation of this hypothesis. One of the limitations of the original hypotheses and the conclusion reached that H1 was originally formed under the belief that the announcement of the former CEO stepping down would coincide with an announcement of the incumbent CEO stepping in. While these two events did coincide in a majority of the observed cases of insider succession, the announcement of an outside

hire usually came anywhere from a week to three months after the initial public release of the turnover. This is an issue that will be discussed more in depth in relation to the next hypothesis

H2

Hypothesis H2 stated that the market reaction for outsider succession will be more positive than that of insider succession. The reasoning behind this hypothesis was that when a firm is struggling, shareholders may have a lack of trust in the ability of internal agents to turn around the fortune of the company, and that a fresh perspective from someone not mired in the recent or long-term failure of the company may be more effective at implementing new strategy. The formal review of literature brought initial doubts into this hypothesis, as multiple sources stated firms reaching outside of the firm to fill C-level positions were viewed as having a dearth of talent, meaning even an experienced CEO coming from outside the firm would not have a strong management team to work with. Researching market reaction to outsider succession in poorly performing firms suggested that rather than a negative reaction, stock prices did not appear to have any significant change up or down. In four of the seven observed cases of outside succession, the announcement of the former CEO being fired and the hiring of the new CEO occurred at two different times. In three of these cases, there was no significant reaction to the announcement of the new CEO, and in one there was a negative market reaction. These results, coupled with the findings in the literary review section of this thesis, lead to the rejection of hypothesis H2.

While research on market reaction to outsider succession led to the rejection of H2, it also led to an extension of the question raised about reaction to CEO turnover; is the market reaction to turnover a reaction to the dismissal of an underperforming CEO or

the announcement of a new CEO? For insider succession, it was difficult to separate the two events, given an incumbent is often in place upon the announcement of the former CEO leaving the firm. What leads to this question being raised is that in the majority of cases in which an outsider succeeded a CEO, there was a gap between the announcement of the retirement or firing and the announcement of the new CEO, but a positive market reaction at the time of the dismissal announcement, whether the firm stated they would be searching externally or not. While this question is not explored within this particular paper, it could potentially be researched in the future.

H3

Hypothesis H3 states the short-term results of an internal hire will be more positive than the results of the previous CEO prior to termination. This hypothesis was formed with the belief that an internal CEO would have a deep enough understanding of the company to have a significant impact early, and that the board of directors would choose an internal candidate they felt could best improve the firm. The findings in the literature view prove to be inconclusive, with multiple sources citing different conclusions about the impact of internal succession on the firm, and the impact a CEO has in general. Data collection showed that first year performance was reflective of the predecessors previous year of performance given that nine of the fourteen cases of turnover observed showed continued negative growth in regards to stock price, ROE, and ROA. These findings led to the rejection of hypothesis H3.

Much like the results that led to the rejection of H2, the data collected in regards to H3 leads to further question, such as whether CEOs truly have an effect on firm performance, or if turnover is the result of the board using CEOs as a scapegoat.

H4

Hypothesis H4 states that external hires will have short-term results similar to those of the previous CEO prior to termination due to a steeper learning curve. Much like the data gathered from literary review for an internal hire's short-term affect on firm success, it was difficult to get a definitive answer as to whether there would be a positive, negative, or lack of an effect on short-term firm performance when distressed firms hired an external candidate. The sampling of CEOs taken for this research and their subsequent performance in the year following their hire was very similar to that of their predecessors, seemingly confirming hypothesis H4.

Much like the acceptance of H1, this confirmation comes with a caveat. The hypothesis was derived from the notion that the similar performance would be caused by a steep learning curve when joining the firm, but many of the observed cases of outside succession involved leaders from within the industry, some of whom had experience turning around ailing firms. This, coupled with the similar results experienced by the sample of internal hires, suggests that the cause of the turnover does not have an effect on short term performance, which could be either because the learning curve for both internal and external hires is similar, or there is a different underlying cause, such as company performance being beyond the control of the CEO, leading to the lack of difference between the successor and predecessor's performance.

Overarching Question

The hypotheses within this thesis were formed in order to set the parameters of how to answer the overarching question, is market reaction to CEO turnover in distressed firms indicative of short term results? Through the research conducted to reach a positive

of negative confirmation in regards the four hypotheses, the answer to this question appears to be no, but rather that short-term results will be more reflective of the performance of the previous CEO.

IMPLICATIONS

The implications of the findings of this research would appear to have the greatest impact on board members and voting shareholders. The reason these findings could be considered significant to these two groups is that it shows that typical measures of CEO performance, such as ROE and stock performance that are often included in CEO contracts, are perhaps not appropriate measurements to use when evaluating a new officer during his/her first year in office. More appropriate short term measures would be more qualitative, such as does he/she appear to be an organizational fit, how is top management responding to the CEO, does he/she have an effective plan going forward, and other criteria that would most likely be obtained by questioning the people that he/she works with on a daily basis.

Establishing some sort of means to accurately assess a CEO's early tenure should be regarded as extremely important, especially considering that the average tenure of CEOs has been dropping over the course of the last twenty years, and that on average the first year will constitute roughly 1/7th of the CEOs time in office (Kaplan, Minton, 2008). Getting an early gauge on whether a CEO will be successful or not in their position also offers a chance for a firm to be proactive in regards to turnover rather than reactive. In the data sampled, companies that waited until they were on the verge of failure to replace their CEO, such as American Airlines and HIG, underwent bankruptcy quickly after undergoing what was deemed as necessary turnover. If these companies had a more

effective means of establishing the future effectiveness of CEOs during their first few years of tenure, they may have been able to avoid such a disastrous fate by identifying the need for a new CEO prior to poor performance preceding the CEO's departure. This also would set a precedent of what the board believes a CEO should accomplish during the start of their tenure in office, which in turn would give the incumbent CEO a stronger idea of what short term expectations would be believed to be tied to desired long term results.

Established short-term standards could also serve the board to be able to find a better fit during the hiring process. While it can be difficult to predict what sort of long-term results a new CEO will bring to a company, it can likely be gauged in an interview if an incumbent's strategic view and management style would be a strong fit with what the company desires in a long term manager. This would in turn help prevent excessive turnover, such as that seen by companies such as Yahoo and HP in recent years. These two companies, by not hiring CEOs who were a good fit within the company, have established almost yearly turnover at the CEO position over the last six years. This excessive turnover in turn caused stockholder distrust, causing prices to fall upon announcement of turnover in cases where the firm was performing poorly due to stockholder belief that the company lacked direction and an effective means of hiring a new manager. If boards choosing CEOs can establish strong short-term expectations, they may be able to avoid this type of negative turnover.

CONCLUSION

This thesis was ultimately conducted with the mission of answering the question of whether market reaction to forced CEO turnover was indicative of short-term results in the period subsequent to the turnover. By forming an understanding of CEO turnover,

market reaction, and a CEO's ability to dictate firm results, I was able to establish a base on which to gather actual market data. The data collected, centering on initial market reaction and comparison of key financial metrics between the fired CEO's last year of tenure and the new CEO's first year of tenure, suggests that the market reacted in a positive way to the announcement of CEO turnover, but the firm is likely to continue to decline during the beginning of the incumbent CEO's tenure.

While the firm's key performance metrics such as stock price and ROE may not rebound in the short term that does not mean that the market's reaction to the turnover is necessarily an overreaction, however. Turnover at least suggests, and should therefore signal to shareholders, that the board is holding leadership accountable for poor firm performance and is at least attempting to get the best possible candidate for the job in order to turn around the fortunes of the company. It would most likely be more relevant to look at the correlation between market reaction and long-term results, allowing time for the new CEO to become properly entrenched in his/her position and begin to implement change that he/she would deem necessary before judging if the market overreacted to the announcement of change at in the C-suite.

The findings of this thesis suggest that:

- 1) The market reacts favorably to the announcement of turnover in poorly performing companies.
- 2) CEOs seem to have little influence in the short-term in regards to firm performance, from the perspective of key indicators, with their first year results tending to either reflect the last year performance of their predecessors or to follow overall market fluctuations.

While the research conducted within this paper served to answer the overarching question and its attached hypotheses, it also led to a multitude of other questions to possibly be answered through further research. It may be interesting to see if the market has a preference in regards to CEO origin, or if they are actually indifferent to the incumbent and simply interested in seeing a poorly performing CEO ousted. Another important question to be asked in regards of how to measure CEO performance is to examine how much influence a CEO can truly have over the performance of a large firm, as some of the findings during data collection suggest that CEOs may have little influence on a firm, at least from a short term perspective. Overall, the research and data collected within this thesis suggests that while the market may react positively to the announcement of CEO turnover in poorly performing firms, their expectations of improvement are not likely to be met in the short-term.

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ABSTRACT

This thesis exams CEO turnover and whether the initial market reaction upon announcement of CEO turnover is indicative of the incumbent's first year of performance, particularly in cases in which a CEO was released due to poor firm performance and falling stock prices. Additionally, it is explores whether there is a difference in reaction and subsequent performance based on the origin of the incumbent CEO. To answer these questions, I set out to evaluate past research on topics such as causes of turnover, market reaction to turnover, advantages and disadvantages of internal hires versus external hires, and the overall effect that turnover has on firm performance, as well as research on the effectiveness by which leadership is able to influence performance within large firms. To supplement prior literature regarding these topics, a sample was taken of fourteen cases of CEO turnover, seven internal and seven external, and measured the initial market reaction and short-term effect of the turnover on key performance indicators such as stock price and ROE. The findings, coupled with prior research, suggest that though the market will react favorably to the announcement of turnover, the new CEOs short-term performance will closely reflect the performance of his/her predecessor.