SUCCESSION PLANNING - THE LONG TERM VIEW

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Introduction

Increasing globalization and rapid technological change bring new challenges for businesses. How can boards ensure they evolve to meet these future needs?

Traditionally, in the UK succession planning was considered at best only once a year as part of an annual evaluation, and most companies did not approach directors' succession with a long-term view. This was particularly true of NEDs, whose assumed tenure once appointed was nine years (three terms of three).

It is becoming clear now that to ensure success in our seemingly more rapidly changing environment, boards need to have more of an eye for the challenges and risks ahead and start to plan to nurture and build appropriate skills on their board to address them. Traditional tenure patterns can no longer be relied upon. Succession planning needs to be a continual process, and this is now made easier here in the UK with the requirement for the annual re-election of directors.

As Grant Thornton's 16th Annual Corporate Governance Review shows, only 14% of the FTSE 350 give any real insight (good or detailed) into their succession planning. The majority of companies provide only basic or general explanations around mid–term succession, for instance NEDs planning to retire, while information about emergency and long-term succession plans is rarely disclosed. Considering that most common reason for non-compliance with the UK Corporate Governance Code is a temporary imbalance of executive and non-executive directors, this suggests that many boards have not prepared sufficiently for transition be it planned or otherwise.

Just under half of FTSE 350 companies appointed at least one new board member in the year; 70% named the search firm they used, with one firm accounting for nearly a quarter of these searches. The FRC's guidance for effective boards promotes the need to have a wide diversity of experience, background and style of thinking as well as gender, in recognition that truly diverse board may be harder to chair, but is more likely to bring a level of challenge that will make it truly effective. If this small number of search firms continue to draw candidates from their traditional pools, companies will struggle to improve their gene pools to address the challenges that currently sit just over the horizon.

For the last five years, there has been a great deal of focus on introducing greater female representation onto the board. However, the picture for gender diversity looks far more mixed this year. While on average 26% of FTSE 100 board roles are filled by women, 38 FTSE 100 companies have less than 25% female representation on their boards. In the FTSE 250 just over a quarter have 25% women on their boards. If the largest companies are to address the targets set by the 2016 Hampton-Alexander review, executive search firms will have to broaden their contact pools significantly, and nomination committees redouble their efforts to look further ahead.

In addition, it is important to take a holistic approach to diversity and inclusion in the organization, which is not limited to gender. For the last years there was far less focus on the benefits of wider diversity. Therefore, it is encouraging to find that the number of FTSE 350 companies mentioning different kinds of diversity, such as ethnicity, race, nationality, cultural background, age, sexuality and religion, in their annual reports rose to 87%, over double the 42% of 2014.

Nevertheless, to really gain value from board diversity, this should be linked to company's strategic vision and longer-term succession. For instance, boards planning to enter new markets should consider candidates with relevant international experience or background. With Brexit increasing the need for the UK to penetrate new international markets, the focus, role and workload of nomination committees is likely to increase significantly in the next few years. Investors also have a role to play by probing much harder where details about a company's succession plans are anything less than transparent.

Our research reveals that boards are becoming more comfortable with giving insights into the risks and challenges of their strategy, i.e. focusing on the future; viability statements are looking out between 3 and 5 years and the number of companies giving helpful insights into their future strategy has increased significantly from 48% to 64%. However, the link between evolving strategic objectives and future needs of the board composition is limited. Successful execution of strategy is greatly dependent on having the right people at the right time. The majority of companies neither align their succession plans with strategy, nor take into account their principal risks, which show where this strategy might be 'knocked off course'.

One of the most concerning areas is technology, which for decades has been considered as an operational matter with boards not engaging on digital and other technological topics in a meaningful way.

Given the fundamental change in society, the current emphasis on technological development and the recent spate of cyber-attacks, it suggests that there is some way to go before succession planning catches up with the longer term emerging needs of companies.

Our review of FTSE 350 annual reports shows that the average number of technology-related risks reported increased by 11% this year and that 73% of FTSE 350 companies reported at least one technology risk. However, despite an increase in the number of 2017 board appointments of directors with technology expertise, more than half of companies, who report IT and technology as a key risk to their business, do not disclose having technology expertise represented on their board. Of particular note is the financial services sector, where 53% of companies highlight technology related risks but only one quarter of these appear to have discernible technology expertise represented on their boards (Table 1).

Table 1. How many companies disclose technology as a key risk?

Industry	Basic Materials	Consumer Goods	Consumer Services	Financials	Health Care	Industrials	Oil & Gas	Techn ology	TELCOM	Utilities
Technology risk	27%	72%	96%	53%	73%	86%	67%	100%	100%	86%
Technology expertise on board (of companies disclosing technology risks)	33%	29%	56%	24%	27%	58%	33%	100%	100%	83%

In general, 45% of the FTSE 350 now have directors with expertise in technology/IT, up from 39% in 2016. This is a welcome albeit lagging trend in the right direction. Nevertheless, investors should be aware that introducing expertise to a board and a risk being mitigated are not instantaneous.

Clearly then there is a growing need for technology expertise to be a must have skill for many boards. However, it doesn't mean that companies have to appoint a technology expert as a NED, rather it has to be considered and measured against the other strategic demands of the business. As one board member of a quite technically orientated FTSE 100 once observed to us: “We have 15 directors on the board and many of them are there because of the specific technical understanding. The problem is when their subject matter is not the focus of the debate they step back, and when it is they demand far too much detail making the board dysfunctional“. NEDs need to be strong contributors across the whole board agenda. It is still possible for the board to use external advice to address specific technical issues in more detail, but also greater attention should be paid to how board expertise can be strengthened in short and longer term. Corporate secretary should monitor a need for board training on technology issues on ongoing basis and employ other available tools to link board experience to company's strategic challenges.

Using a skills matrix, which incorporates an organisation's strategic priorities, business model, industry and regulatory developments, can help to identify directors training needs as well as short and longer-term composition needs. These are widely used by US and Australian companies and include more common skills found on listed company boards as well as other core competencies which are closely linked to each company.

Skills matrices are not only useful for the board when evaluating the merits of a new board member or identifying its optimal structure, but are also a reassurance for investors that the board has a robust process in place to assess the mix of skills and experiences if disclosed on regular basis. By linking a board skills matrix to the output from a board evaluation, such disclosure can help to improve investor confidence in the company's ability to address issues relating to skills gaps and succession planning.

Our research shows that the quality of explanations around the outcomes arising from the board evaluation have increased this year, with nearly half (47%) of the FTSE 350 providing insight around the outputs and actions arising from their board effectiveness evaluations (2016: 37%). Best practice in this area includes explaining both the key strengths and issues identified in the evaluation, planned actions and a timescale or plan for implementing changes. It also discusses desired expertise for the short and long-term.

> It might be challenging especially for smaller listed companies to find and to attract the individuals they need. **Thus, alongside external candidate searches, it is equally important in long term, to develop internal talent and to build a strong executive pipeline.**

The board and nomination committee should satisfy themselves that appropriate management development and internal talent spotting is taking place. A variety of different talent developments programs can be used including executive mentoring and training and can help to proactively address any perceived need to introduce greater diversity in the senior roles.

In May 2016 the FRC published a Feedback statement on its UK Board succession planning discussion paper. This will be taken into account during the review of the UK Corporate Governance Code later this year. The statement shares some practical examples of how companies can approach succession.

Conclusion

In our opinion, it is critical for every board to consider several important question in relation to their to their succession planning:

- How does the nomination committee identify gaps in the skills or experience mix of the board?
- Is the board satisfied that short, mid and long-term plans are in place for succession to the board and to senior management?
- Does the board consider potential sources of recruitment outside of the normal pool?
- What type of information does the board receive on talent development and how does the board use this data to make decisions?

In summary, boards are growing more comfortable about disclosing the future challenges and risks they are facing. They now need to turn their attention to using that same longer term focus to identify and nurture the desired skill sets in order to future proof themselves against the strategic challenges that are coming over the horizon.

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