Impact of CEO Succession on Stock Returns.

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This study is an effort to find out the impact of Chief Executive Officer (CEO) succession on the stock returns to investors. For this purpose, ten CEO successions in Pakistani companies, listed on Karachi Stock Exchange, during the period 2005-2008 have been analyzed. Stock returns for 12 months preceding and following CEO succession have also been gathered to find out the changes in stock returns due to change in CEO. Regression with CEO change as dummy variable and stock returns as dependent variable, provided us with the results that there is no impact of CEO change on stock returns occurring in the period before CEO succession. However evidence of significantly negative returns in the period following CEO succession has been found

Key Words: Chief Executive Officer, Succession, Stock returns.

Introduction

Human capital and their intangible capabilities, along with other capital assets, contribute a lot to the organizational capital which in turn determines the value of a firm. It is due to this reason that importance of human capital for any organization has grown up in recent past. Human capital can be converted into human resource by aligning their interests with that of organization. A number of activities in this regard have been identified such as career development programs, training facilities, performance appraisal systems, work life balance etc (Ingham, 2007).

In order to decide what organization should be in future, how it should be done, and who should be doing it, it is important to focus not only on the present needs but also on future trends and challenges. Succession planning in this regard plays a key role. It helps an organization to be what it needs to be, rather than simply to replicate the existing organization. Succession planning is a systematic process where the organizations

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identify, assess and develop their staff and successors who are the right people, with the right skills, at the right time to make sure they are ready to assume leadership and other key positions within the company. These seemingly high potential candidates are selected very carefully and then trained by developing their skills and competencies to undertake future leadership challenges.

Succession planning is not limited to only replacement of chief executive officer and other executive positions rather it also includes whole management team and other key employees. Succession planning for staff is usually done at managerial level where as that of key executives positions are done by board of directors according to the vision of organization. Succession planning for the Chief Executive Officer (CEO) is one of the most important decisions and responsibilities of a board of directors (Olson and Halloran, 1997). There could be two ways to select a new CEO, either to bring some one outside the organization or promote some one internally to assume this key position. Which way to go depends upon a number of factors like profile and role of a CEO, experience according to the future requirement of business, leadership needed in future, and capability to deal with internal and external challenges.

Succession planning is considered to be one of the most important factors on which future success of organization depends (Olson and Halloran, 1997). The reason might be that CEO possesses a significant importance in determining a firm’s strategy, design, performance, and corporate culture etc which collectively indicates the firm’s future (Rhim et al, 2006). Also the CEO replacement serves as a mean to overcome the perceived downturn in the performance of organization (Farrell and Whidbee 2002).

Efficient stock markets respond immediately to any negative or positive news arriving in the market. Investors respond positively to the stocks of the firm’s which are likely to flourish in future in order to get higher returns and vice versa. CEO succession serves as a critical event to assess the firm’s performance. Arrival of new CEO can be perceived as a good or bad signal for future growth depending on circumstances and person taking charge as CEO. Thus any such news to market can cause an upturn or downturn in stock prices of the firm. Several studies have shown that for stakeholders, like shareholders and customers, succession serves as an indicator of future success or failure of the firm (Davidson et al, 2002; Friedman and Singh 1989).

CEO Turnover is under close close observation in US (Plitch 2003). In Pakistan, with an increased emphasis over corporate governance practices, importance of CEO has also been increased. Literature has also proved the impact of various HR practices and CEO succession on performance of a firm and its stock returns in various countries. This study is an effort to find out how the stock market responds to the expected financial performance of the firm at the announcement or event of CEO succession. Main aim is to examine whether any change of CEO in Pakistan really affects the firm performance and stock returns or not as any such evidence in Pakistani context has not yet been found through literature. This study would be a thought provoking effort in this regard.

Literature Review

CEO succession and its impact have been evaluated by taking various aspects, related to CEO change, into consideration. Lausten (2002) examined the relationship between the replacement of CEOs and corporate performance in Danish firms. He tested the hypothesis that CEO turnover is inversely related to firm performance. Using several measures of corporate performance and corporate governance he found that threat of turnover force the CEO to act in the interest of the shareholders which strengthens the relationship between CEO turnover and firm performance.

CEO change can be anticipated or unanticipated. A CEO retiring on his due date is an example of anticipated change whereas resignation of CEO is an anticipated event. Since stock market is already aware of anticipated CEO change, it does not react abnormally to this CEO succession. Firm’s with anticipated CEO succession does not show any down turn in performance prior to retirement of CEO but shows a little improvement afterwards (Denis and Denis, 1995). However stock market responds more positively to an unanticipated CEO change (Rhim et al, 2006)

CEOs normally do not resign willingly. It is the firm's poor performance and their inability to handle the situation that forces them to resign. There fore any unanticipated change in CEO is considered to be the positive sign for organization. Denis and Denis (1995) provided the evidence for significantly poor performance of a firm prior to unanticipated CEO resignation and a significant improvement in firm performance afterwards.

Stock market reaction to any CEO succession depends upon its efficiency. Efficient stock markets incorporate the effect of any news arriving in market immediately and share prices are adjusted accordingly. Stock markets respond more positively to unanticipated change of CEO as compared to that of anticipated change (Rhim et al, 2006).

New CEOs can be appointed from outside organization or from within organization. CEO appointed from inside is supposed to work better as he is enriched with more inside information and gives sustainability. However in some cases, outside CEO proves to be a better choice as he comes up with a new vision and new mind set for organization and pull the company out of problems occurring due to legacy systems. Literature says that in case of poor performing firms or bankruptcy chances, out side appointment of CEO results in more positive market reaction (Davidson et al, 2002). Improvement in financial performance of a firm due to appointment of CEO outside the company has also been proved by the Denis and Denis (1995).

Davidson, Worrel and Dutia (1993) examined the impact of CEO successions on stockholder wealth in large firms faced with the bankruptcy. Results found that succession announcements, succeeding and following bankruptcy announcements, resulted into positive abnormal returns. Also the market reaction towards CEO from outside firm was comparatively more positive, especially in case of succession happening after bankruptcy.

Shen and Cannella (2003) found that the market responds more favorably to the news of a particular type of succession known as "relay succession process". Relay succession refers to the process of identifying and grooming next heir. Results showed that stock market reacts positively to the initiation and successful completion of the process. However it responds negatively if heir exits the firm during process. Also strong positive reaction for outside CEO appointment has been observed.

Murphy and Zimmerman (1992) evaluated the behavior of various financial variables surrounding the CEO turnover simultaneously. By controlling firm performance and endogenous CEO turnover little evidence was found for earnings management i-e exercising discretion over accounting and investment variables , by outgoing CEOs, in order to increase their earnings-based compensation before leaving the organization. However the reduced growth rate of R&D, advertising, and capital expenditures prior to departures explains the overall poor performance of the firm.

In Pakistan normally businesses are family owned. That is maximum number of shares are held by members of one family. CEOs and key executives are also from the same family. This provides the chances to manipulate exact performance of a firm and also biasness of decisions and exploitation of share holders is expected. CEOs belonging to the ruling family are less likely to resign or to be removed by board members in case of poor performance of the firm. Whenever any family CEO is departed from the firm, it gives a positive sign to the market and thus stock prices respond positively. But this pattern of stock prices is observed only when CEO is replaced by a non-family successor (Hillier and McColgan, 2005).

Methodology

Sample

In Pakistan no such formal forum is present where the record of all the changes in corporate world including the changes in CEOs of the firms is kept. This limitation forced us to confine our sample up to only ten CEO change announcements/ events. As it is hard to find any such information, only ten CEO change events from 2005 to 2008 have been evaluated in this study. All of the CEO successions considered are in Pakistani companies listed on Karachi stock exchange.

Data and Data Source

In order to check the impact of CEO succession on stock prices of the firm, we have taken the monthly stock prices one year prior to and one year after the CEO succession. These stock prices are taken from the official website of Karachi Stock Exchange. Monthly logarithmic returns are then calculated by using following formula:

$$\mathbf{R_t = 100 * Ln\ (P_t / P_{t-1})}$$

Where:
$\mathbf{R_t}$ = Continuously compounded rate of return
Ln = Natural Log
$\mathbf{P_t}$ = Share Price at the end of Month t
$\mathbf{P_{t-1}}$ = Share Price at the end of Month t-1

Data pertaining to CEO succession comprise of ten CEO change events. Evidence for these changes has been gathered from the balance sheets of the respective companies.

Methodology

With monthly stock returns being dependent variable and CEO succession being independent variable, following regression equation with dummy variable has been applied to the gathered data.

$$\mathbf{R_t = \beta_0 + \beta_1 d_{2t} + \varepsilon_t}$$

Where:
$\mathbf{R_t}$ = Monthly stock return
$\mathbf{d_{it}}$ = Dummy variable for days after CEO succession
$\boldsymbol{\beta_i}$ = Coefficients for the days before and after CEO succession
$\boldsymbol{\varepsilon_t}$ = Error term

d_{2t} here is the only independent dummy variable. For the returns occurring after CEO succession, d_{2t} is assigned value of one and for returns occurring in days prior to CEO change; its assigned value is zero. β_0 here is coefficient for returns prior to CEO succession and β_1 is the coefficient for returns after CEO succession. As CEO assume charge at some time during the month, we have included CEO change month in period after CEO change.

Hypothesis

Null hypothesis for the purpose of this study is that states that stock returns prior to and after CEO succession are equal to each other. In equation form it can be written as:

$$\mathbf{H_0: \beta_1=0}$$

Contrary to this, alternative hypothesis states that there is no equality in stock returns prior to and after CEO succession. Significantly positive value of β_1 would show the positive impact of CEO succession on stock returns and vice versa.

Empirical Analysis

Descriptive Statistics

Table A below presents the descriptive statistics for the stock returns prior to and after CEO succession from period 2004-2008.

Table A
Descriptive Statistics for Stock Returns around CEO Succession

	Before Succession	**After Succession**
Mean	3.72	-4.01
Median	-0.29	-1.99
Std Dev	44.66	22.61
Minimum	-120.41	-144.17
Maximum	319.31	41.36
Count	120	120

Above table shows that although mean returns for period after CEO succession is a higher value (-4.01) , as compared to that of mean returns before CEO succession (3.72), its negative sign shows that negative returns occur to investors after the CEO succession. This shows the negative relationship of CEO succession and Stock returns. Also magnitude of loss after succession is higher than before succession.

Standard deviation for mean returns before CEO succession i-e 44.66 is higher than that of standard deviation after succession i-e 22.61. This shows that returns before succession are more volatile than the returns after succession.

Regression Analysis

Table B below shows the results for regression with dummy variable, applied to the stock returns around CEO succession during period 2005-2008.

Table B
Regression Analysis for Stock Returns around CEO Succession

	β_0	β_1
Coefficients	3.7161	-7.7309
t- statistic	*(1.1305)*	*(-1.6261)***
R^2	0.0116	
F- Value	2.6441	
N	240	

**Significant at 90% level of Confidence
β_0 is coefficient for period before CEO succession
β_1 is coefficient for period after CEO succession

Results shows that the coefficient for period before the CEO succession is positive but insignificant (β_0 = 3.72, t-value = 1.13) which means that there exist no relationship between period before CEO succession and stock returns. Stock return does not improve or deteriorate in the period before CEO succession. However the negatively significant coefficient for the period after CEO succession (β_1 = -7.73, t-value = -1.63) shows that investors get negative returns in the period after CEO succession. These are the same results as was depicted by descriptive statistics. Thus in light of our results we are tend to reject our null hypothesis which states that stock returns prior to and after CEO change remains same.

R^2 for this study is too low i-e 0.0116 but this is might be due to the reason that we have considered only one single variable to assess the returns around CEO succession keeping aside all rest of the factors which can influence stock returns in this case. However there could be a number of variables which affects stock returns in any way.

Our results are not in accordance to the previous studies which found positive and favorable reaction of stock market for the CEO succession (Denis and Denis, 1995; Rhim et al, 2006; Davidson, Worrel and Dutia (1993) due to various reasons. In Pakistan people are normally risk averse and any change in existing setup is perceived to be risky. This high level of uncertainty regarding performance of a firm in future might be the reason for having negative stock returns in Pakistan for the period following CEO succession.

Conclusion

This study is an effort to find out the impact of CEO succession on the stock returns to investors. For this purpose, ten CEO successions in Pakistani listed companies during the period 2005-2008 have been analyzed. Results show that there is no impact of CEO change news/event, on stock returns, during the period before CEO succession. However significantly negative returns to investors has been observed during the period following CEO succession which shows negative relationship between CEO change event and stock returns.

Studies have proved that CEO change is perceived to be good for company's performance in future (Farrell and Whidbee, 2002; Rhim et al, 2006) however this is not the case with Pakistan. In Pakistan more uncertainty prevails regarding the future performance of the firm. This uncertainty leads to the negative returns after CEO change.

Another reason could be the mentality of investors that any firm changing its CEO is considered to be in downturn phase and thus new CEO is also considered a risky decision to boost up the firm's performance. This risky situation leads the investors to reduce their demand for that company's shares.

Pakistani stock market is inefficient i-e its stock prices are not adjusted according to any news arriving in market (Hasan, 2007). This can also be the reason that no significant improvement or deterioration in stock returns prior to CEO succession is observed. Again uncertainty plays its role that unless CEO is changed, investors are not sure whether it will be done or not. And this uncertainty continues even after CEO succession actually took place (in shape of uncertainty about firm future). Another viewpoint is that in case of efficient markets no one can predict future prices. However as Pakistani stock market is inefficient one, this trend of stock prices after CEO change may enable the investors to predict the future prices in event of CEO change.

In Pakistan most of the businesses are family owned. It is evident from literature that in case of new CEO outside the controlling family, market responds positively and in case of CEO from same family, market responds unfavorably (Davidson et al, 2002; Denis and Denis, 1995). In case of new CEO belonging to same controlling family, individual investor feels unsafe and threat of being exploited discourage them to make further investments rather they tend to divest. In presence of this argument and pattern of share holding in Pakistan, we may associate our results with the assumption that new CEO's taking charge of the firm are from the same controlling group and that's why market responded negatively. However for a definite picture of actual situation a more detailed analysis in this regard is required in future as this can not be the situation with all of the firms under study.

Another argument discussed in literature is that an unanticipated change of CEO is reflected into positive response of stock market (Denis and Denis, 1995; Rhim et al, 2006). In light of this argument we may justify our negative stock returns after CEO succession as a response of anticipated CEO change.

This is just an elementary level study indicating that even in Pakistan, CEO change impacts stock returns. To find out exact situation of how much and in which direction CEO change impacts stock returns in Pakistan (prior to change and after CEO change) a detailed analysis covering all aspects is required. All this are the areas of further research. This situation of negative returns could be reversed if we enhance our event window i-e positive returns as a result of CEO change might be observed if we include the stock returns even beyond 12 months of succession. Similarly, different pattern in returns prior to CEO change can also be found. A comprehensive analysis of family owned businesses and their CEO succession and also the impact of anticipated and unanticipated CEO change can give us more reliable results. And last but not the least, extended data i-e maximum number of CEO change announcements/ events may be analyzed along with extended event window to find out the true picture regarding stock returns preceding and following CEO change, in Pakistan.

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