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How Successful is Your CEO?

To be a top value creator, a CEO must deliver a high total shareholder return in a large company for a long time.

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There are many ways to view a CEO's success, but one fairly simple indicator is the longevity of his or her reign as the chief executive. Admittedly some ineffective leaders keep their job for a while but those CEOs that last two or three or even four decades are generally very successful.

For example, consider Howard Solomon who has been CEO of Forest Laboratories since 1977. By virtually any benchmark, Forest Laboratories has been an outstanding company over this 36 year period.

ANALYSIS

Mr. Solomon navigated successfully in a dynamic industry seemingly in a perpetual state of technological and market transformation. The pharmaceuticals landscape is littered with companies that were once thought to be stars but are now gone. In this survival-of-the-fittest world, Mr. Solomon has proven to be quite fit and has endured a very long time (though former Bausch & Lomb CEO Brent Saunders will be replacing Solomon, due to retirement, on October 1st).

Another way to judge CEOs is by the total shareholder return, or TSR, they deliver for shareholders. The TSR measure reflects dividends and share price appreciation as a return over time. It can be calculated on an annual basis and it can be compounded over the years.

Forest Laboratories, for example, has had a share price in the $44 range recently but if you go back to 1977, the share price was about $0.03 on a split adjusted basis. This translates into a TSR of over 170,000% which is about 23% per year compounded over 36 years. This is such a strong performance against the S&P 500 return of 8% per year over the same period that an investment in Forest Laboratories when Mr. Solomon took over would be worth over 100 times as much today as a similar investment at that time in the S&P 500 index.

Although TSR seems a cut and dry measure of success, it can be hard to compare companies. For example, would investors as a group have been better off in Howard Solomon's Forest Laboratories or would they have been better off over the 10 plus year reign of Jeff Boyd as CEO of priceline.com?

Mr. Boyd's priceline.com delivered 54% per year when the S&P 500 delivered only 6%. But he only did it for 10 years versus Mr. Solomon's 36 years. Which is better? What are the implications of the fact that priceline.com has a market capitalization that is four times Forest Laboratories?

The Financial Times Global 500 ranks companies based on the size of their market capitalization which is simply the number of shares outstanding times the value of each share. Many would rightly argue that market capitalization alone doesn't dictate success. In fact, perhaps the easiest way to build a company worth $400 billion is to start with a company worth $600 billion, but we would hardly deem this as a success.

Nevertheless, market capitalization does matter. Would you rather earn 30% on $100 or 20% on $5000?

If we bring all of this together, the ideal measure of success for shareholders during the tenure of a CEO would capture longevity, TSR and market capitalization. One way to do this is to determine how much higher, or lower, the value of a company is now versus what it would be if the company delivered the same TSR as the S&P 500 during the reign of the CEO. This will tell us how much value the company created under his or her leadership relative to an investment in the S&P 500.

If the Forest Laboratories share price had grown from $0.03 in 1977 to $0.44 today the return would have matched the S&P 500. Today's actual share price of about $44 could drop about 99% and Howard Solomon's company would have matched the index. Said differently, $11.7 billion of the company's current $11.8 billion market capitalization is value creation over his tenure in excess of the performance of the stock market.

Similar calculations for Jeff Boyd's priceline.com show that 98% of his company's current market capitalization is excess return. This is slightly lower than the 99% for Forest Laboratories but on a four times larger current market capitalization. In dollars, Jeff Boyd has created $48.9 billion of value in excess of the return of the market which is much more than Howard Solomon has created.

The messages to CEOs (and CFOs) are perhaps more important than the calculations. First of all, longevity is important. These days it is seemingly getting tougher and tougher to hold onto a C-level job for a long period of time, but it's critical to being successful.

To endure, capital allocation must be a top priority. Over a ten or twenty year period, the mix of business pursued by a company can be improved dramatically by disproportionately allocating capital to areas where growth and returns are strong and away from areas where growth and returns are weak. And of course, risk management is critical to enduring over time as well.

The second important message is that TSR over the reign of a CEO is critical, but it is just as important to realize that even when the right strategies are pursued, investors often wait for results to materialize. The share price might lag for a while until the success becomes apparent. Management must not stray from pursuing the right strategies in order to avoid negative investor reaction, especially when it's from short-term investors.

And lastly, size matters. Building a large, successful company affords more opportunities for creating large amounts of value as long as size doesn't become an end in itself. Investments need to be value creating or they shouldn't be pursued. Just as larger companies have the opportunity to create more value for any given level of positive TSR they also can destroy more value for the same level of negative TSR. Being larger increases the opportunity but also the responsibility.

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