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What Makes a First-Time CEO Vulnerable?

Climbing to the penultimate rung in the corporate ladder to be considered for the CEO position requires hard work, long days and family relocations while chasing one promotion after another. The path is not for the timid, and although the journey teaches many things, it often neglects to teach one of the most important things a CEO must know: What drives shareholder value?

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In many respects, this should be expected given the career path of a vast majority of CEOs. Many start their career in sales or operations. The salesperson learns how to generate sales, while the operations person learns how to reduce costs and become more efficient. Those who are good at selling or operating are often promoted to manager, where they learn how to manage both sales and costs, along with the added responsibility of learning how to lead others.

Many, if not all, typically attend courses on leadership, but few take a finance or accounting course. Prior to climbing to a CEO position, a manager's entire career is focused on the P&L. Since most companies don't make it a prerequisite to understand all the financial statements, the CEO candidate often only knows one half of the equation of what drives shareholder value. This is reinforced by the overwhelming bias toward discussing only earnings in the news media and in brokerage research reports.

By the time an executive is considered for the CEO position, there is an expectation that somehow they must understand what all the financial statements mean, including the balance sheet. It is the balance sheet that completes the puzzle on what drives shareholder value.

Consequently, as the executive makes the transition from a business unit leader to a first-time CEO, there is often a rude awakening that what they thought was "profit" was never a true measure of profit. The profit measure that they managed for so many years neglected to take into account the total cost of capital, which includes the cost of equity. This cost of equity represents shareholders' expectation of getting a return on the capital they've invested. Shareholders expect CEOs to invest their capital in assets that will generate a minimum return of profit greater than what they would have achieved in a similarly risky investment.

A first-time CEO, who is adept at negotiating capital budgets, has never been held accountable for generating a return on those assets. It is, therefore, critical that CEOs and boards ensure that a succession plan includes the appropriate financial training for rising stars, so that they not only understand the income statement, but also understand the balance sheet and the economic importance of capital investment, cash flow and how it drives shareholder value.

By understanding the balance sheet, the manager is able to link strategy, finance and risk in a meaningful way that will resonate in a board room. The manager that understands the balance sheet can address the tradeoffs between the

risk of deploying capital and the return it generates, and not simply sell the merits of a decision as being "strategic", which is often code for "I don't have a financial justification".

Knowing how to drive shareholder value goes beyond taking a generic finance course. Knowing how to truly measure and make decisions that create value comes from "doing". Not unlike riding a bike, telling someone that the handle bars are for steering, the pedals propel the bike forward, and the seat is for sitting, doesn't mean someone will know how to ride a bike.

Mastering the science of value creation starts by:

1) Understanding the practical application as it relates to the business manager's actual income statement and balance sheet

2) Helping them uncover real opportunities to create value in their own business using their numbers

3) Coaching them in the field in real-time to solve real-life operating decisions that will impact the balance sheet and ultimately the value of their business. Like riding a bike, it requires practice, but by having a coach you can help minimize the scrapes and bruises while increasing the learning curve.

4) The final and most profound step in helping a manager know how to create value is by linking incentives, management practices and reporting toward generating a true measure of profit. This final step will not only create a deep bench of candidates that will know exactly what drives shareholder value on their first day as a CEO, but also will create a culture of ownership where they get to share in the value that they actually create.

For more than 19 years, Marwaan Karame has been an adviser to CEOs and CFOs on how to create value through strategic and financial planning, capital structure, process improvement, cost reduction, pricing, incentives, and M&A transactions. Prior to joining Fortuna Advisors, he worked for DLJ/CSFB in Investment Banking, Stern Stewart & Co., Xerox, and his own company, IDG Capital Group and Economic Value Advisors.