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CEO Success Is About Longevity, Performance And Value

Greg Milano

Out of seemingly nowhere, Egyptian footballer Mohammed Salah has taken fans of the world's most popular sport by storm in 2018 by helping Egypt qualify for the World Cup, leading Liverpool FC to the UEFA Champions League final and by breaking the single season scoring record in the English Premier League. Many pundits have discussed whether he should be considered amongst the world's very best players, such as Lionel Messi and Cristiano Ronaldo. Most say that although he has had one of the very best seasons of all time, to be considered truly great requires both a high level of success and a long duration of achieving that success.

Similar criteria apply to chief executive officers. Being considered a truly great CEO requires a high level of success over a long duration of achieving that success. A new metric introduced below, named Market Cap Alpha, captures CEO longevity, annualized relative TSR and company size. But before discussing this metric, we will explore various measures of tenure and success, so that the true benefits of Market Cap Alpha can be better understood and appreciated.

Of course, underperformers tend to not last very long, so being among the longest running CEOs almost automatically implies *success*. Figure 1 lists the top ten CEOs of S&P 500 companies ranked by tenure, which is the number of years they have been in the role.

Figure 1

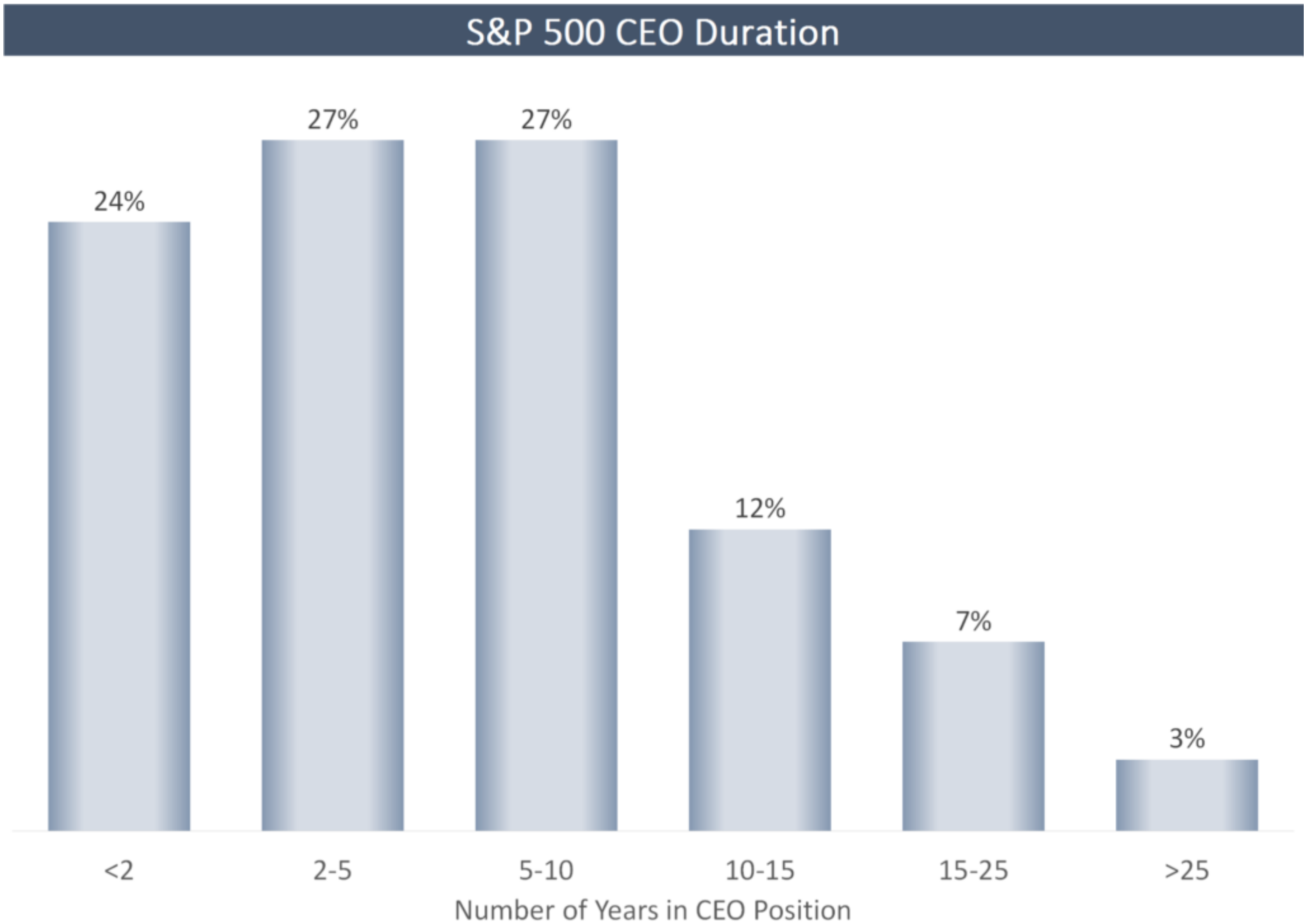
Longest Tenure

Rank	Company	CEO	Years
1	L Brands, Inc.	Leslie Wexner	45
2	Berkshire Hathaway Inc.	Warren Buffett	42
3	Welltower Inc.	Thomas DeRosa	38
4	Robert Half International Inc.	Harold Messmer	31
5	Vornado Realty Trust	Steven Roth	29
6	Aflac Incorporated	Daniel Amos	28
7	Zions Bancorporation	Harris Simmons	28
8	Activision Blizzard, Inc.	Robert Kotick	27
9	Regeneron Pharmaceuticals, Inc.	Leonard Schleifer	27
10	Universal Health Services, Inc.	Alan Miller	27

Notes:
1. Source: Capital IQ as of May 15, 2018.
2. Some of these CEOs have served even longer but in some cases the company went public after they became CEO and for some, their tenure was truncated to match the period for which share price data is available in CapitalIQ.

Given the high level of CEO turnover today, lasting over 25 years in the role is quite commendable regardless of any other performance factors. As can be seen in Figure 2, almost a quarter of CEOs have been in the job less than two years and half have been there less than five years. In one sense, it may be reasonable and even desirable that CEOs are quickly replaced when they are not performing, but on the other hand it often takes time to develop and execute new business strategies. It can take even longer to identify desired changes to corporate culture and make them happen. Frequent leadership changes can make employees cynical and less apt to accept new strategic and cultural direction from a new leader. Employees can feel that, “we don’t need to accept the strategic changes since the CEO won't last long and someone new will be in his or her chair asking for new changes [that we also won't accept]."

Figure 2



Nearly all the long tenured CEOs, including even the revered Warren Buffet, have faced tough periods with undesirable results. For example, over the 20 months from June 30, 1998 through February 29, 2000, Berkshire Hathaway fell 44% while the S&P 500 rose 23%. During the internet bubble, it may have seemed rational if Berkshire's board had said, "Given this new high tech world we live in, Warren's skills no longer fit our needs. Berkshire Hathaway needs a CEO more in tune with the times – one that can look beyond antiquated concepts like profit, cash flow and return on capital, and understands the value of network effects, internet clicks and eyeballs on websites." Fortunately, his board stayed the course as Mr. Buffet has since delivered a 573% total shareholder return, or TSR, which is over three times the 184% return of the S&P 500. Note that TSR includes both dividends and share price appreciation.

Over the last 42 years, Berkshire Hathaway has delivered cumulative TSR of 444,975%, which tops the list for highest Cumulative TSR delivered during the tenure of all current S&P 500

CEOs, as shown in Figure 3. With inflation, $1000 in 1976 is worth about $4440 in 2018, but an investment of $1000 in Berkshire Hathaway in 1976 would be worth nearly $4.5 million today. Due to the power of compound interest, one important driver of cumulative TSR is tenure in the job, and this is reflected in that five of the top ten CEOs on the Cumulative TSR ranking are also on the Longest Tenure top ten. But the list includes five new CEOs that are not on the Longest Tenure list, and of particular note is Wilmot Hastings of Netflix, who made this list with the shortest tenure as a public company CEO at 16 years.

Figure 3

Highest Cumulative TSR

Rank	Company	CEO	Cumulative TSR
1	Berkshire Hathaway Inc.	Warren Buffett	444,975%
2	L Brands, Inc.	Leslie Wexner	203,173%
3	Monster Beverage Corporation	Rodney Sacks	117,323%
4	Amazon.com, Inc.	Jeffrey Bezos	81,681%
5	Netflix, Inc.	Wilmot Hastings	27,359%
6	Microchip Technology Incorporated	Stephen Sanghi	22,677%
7	NVIDIA Corporation	Jensen Huang	16,698%
8	Robert Half International Inc.	Harold Messmer	12,827%
9	Welltower Inc.	Thomas DeRosa	12,427%
10	Universal Health Services, Inc.	Alan Miller	6,697%

Notes:
1. Source: Capital IQ as of May 15, 2018.
2. Some of these CEOs have served even longer but in some cases the company went public after they became CEO and for some, their tenure was truncated to match the period for which share price data is available in CapitalIQ.

Mr. Hastings is essentially the Sandy Koufax of CEO success, given the unbelievably high performance over a relatively shorter period. The Baseball Hall of Fame elected Koufax in 1972 as the youngest player ever elected, and, unlike many other members of that revered institution, Koufax played just 12 years and his greatness was concentrated in a mere six seasons! But to be fair, those were six especially magnificent seasons! This is not to suggest that Mr. Hastings' success is coming to an end, but to recognize that so far he has achieved great success relatively quickly.

To separate performance, in terms of TSR, from longevity, we can annualize TSR over the tenure of the CEO by determining the constant annual growth rate that achieves the cumulative TSR over the years on the job. The problem with annualized TSR is that seemingly great performance over very short periods can seem more impressive than it is. For example, Brian Niccol took over at Chipotle Mexican Grill in March and the stock is up 33% so far, which is great, but when we annualize such a short period it gives us an astronomical 330% annualized TSR. Although success so far seems great with Mr. Niccol steering Chipotle, a sense of sustainability is required, so only CEOs in their job at least two years were included in this and all subsequent rankings below.

One shortcoming of the annualized TSR metric is its disregard for what is happening in the general stock market. It may be harder to deliver strong TSR during a period when market returns are low versus another period when the market is rising and, as they say, lifting all boats. To address this, we compare the annualized TSR during the reign of each CEO to that of the S&P 500 during the same period, a technique known as Relative TSR.

Annualized Relative TSR provides a very different top ten than cumulative TSR, as shown in Figure 4, which is evidenced by seven of the top ten Annualized Relative TSR CEOs not being on the Cumulative TSR list. It's no surprise that Wilmot Hastings makes this list, or that he is followed by Jeff Bezos at Amazon and Strauss Zelnick at Take-Two.

The biggest change when we convert to Annualized Relative TSR is the rise of some CEOs that have been in their role for much shorter periods. Joseph Hogan has been CEO at Align Technology for just three years, but has driven cumulative TSR of 364%, which is 68.1% when annualized and 56.7% above the performance of the S&P 500. Six of the top ten CEOs on Annualized Relative TSR have been CEO for less than five years, and we may require more time to see how good they really are.

Figure 4

Highest Annualized Relative TSR			
Rank	Company	CEO	Annualized Rel. TSR
1	Align Technology, Inc.	Joseph Hogan	56.7%
2	NRG Energy, Inc.	Mauricio Gutierrez	40.8%
3	Netflix, Inc.	Wilmot Hastings	34.1%
4	Amazon.com, Inc.	Jeffrey Bezos	29.9%
5	The Boeing Company	Dennis Muilenburg	28.3%
6	Electronic Arts Inc.	Andrew Wilson	27.1%
7	Global Payments Inc.	Jeffrey Sloan	25.6%
8	NVIDIA Corporation	Jensen Huang	24.1%
9	Take-Two Interactive Software, Inc.	Strauss Zelnick	21.9%
10	Advanced Micro Devices, Inc.	Lisa Su	21.6%

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3. Only includes CEOs in place for at least two years as of May 15, 2018
4. Relative TSR measured versus the S&P 500.

It is worth noting that Relative TSR is a great measure of success over long periods of time, but the methods typically used to apply it to long term incentives introduce problems. These were detailed in an article titled, The Relative TSR Conundrum. To summarize, current uses of relative TSR ironically lead to a poor correlation between average Relative TSR payouts and shareholder rewards over long periods. Within a given year, the executives will face very different reward opportunities depending on the month and day that the three-year cycle ends. We minimize these shorter-term compensation problems when we determine Relative TSR over the full reign of the CEO.

Introducing Market Cap Alpha

An ideal measure of CEO success would capture their tenure and the annualized relative TSR over that tenure. Another important dimension is size. A 30% TSR from a company with a market capitalization of $100 billion creates more value than a 40% TSR from a company worth only $1 billion. One way to pull tenure, relative TSR and size together is to use a new measure named Market Cap Alpha, which determines how much higher, or lower, the market capitalization of a company is now versus what it would be had the company delivered the same TSR as the S&P 500 during the CEO's tenure.

Amazon and Apple make for an interesting comparison. Apple has a current market capitalization of $924 billion, which is simply the share price multiplied by the number of shares outstanding. The same figure for Amazon is $777 billion. Jeff Bezos has led Amazon for 21 years as a public company CEO while Tim Cook has led for only 7 years, and Bezos has annualized relative TSR of 29.9% versus 7.3% for Cook. Fully 99% of Amazon's current market capitalization is performance in excess of what they would be worth today had they delivered the same return as the S&P 500, while the similar stat for Apple during Tim Cook's reign is only 34%. Now because of Apple's size, they are still third in the ranking – a great outcome for a CEO over just 7 years – but Tim Cook has not outperformed by as much or for as long. The top ten Market Cap Alpha CEOs are listed in Figure 5.

Figure 5

Highest Market Cap Alpha			
Rank	Company	CEO	Mkt. Cap. Alpha
1	Amazon.com, Inc.	Jeffrey Bezos	$772,542
2	Berkshire Hathaway Inc.	Warren Buffett	$485,758
3	Apple Inc.	Timothy Cook	$317,597
4	Microsoft Corporation	Satya Nadella	$316,093
5	Facebook, Inc.	Mark Zuckerberg	$275,726
6	NVIDIA Corporation	Jensen Huang	$152,043
7	Netflix, Inc.	Wilmot Hastings	$141,018
8	Mastercard Incorporated	Ajaypal Banga	$136,852
9	The Boeing Company	Dennis Muilenburg	$95,540
10	Alphabet Inc.	Lawrence Page	$94,394

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3. Only includes CEOs in place for at least two years as of May 15, 2018
4. Relative TSR measured versus the S&P 500.

The total market capitalization of the ten companies is currently over $5.4 trillion, but would be $2.6 trillion if their companies had performed the same as the S&P 500 since each CEO took over. So collectively, these ten CEOs and their teams of managers and employees have created $2.8 trillion worth of Market Cap Alpha.

In essence, Market Cap Alpha is the true value creation of the CEO, along with their teams of managers and employees, over the CEO’s tenure. It reflects the cumulative amount by which they have grown the value of the company in excess of what investors would have realized if they had simply invested in the broader market. If public companies paid executives like private equity, they might structure pay to be very modest on an annual cash salary and bonus basis, but with a hefty share of the Market Cap Alpha paid at the end of say five and ten years. This is pretty far from standard public company executive compensation practice, and it is particularly hard to significantly stray from the norm in this field.

Even if Market Cap Alpha isn't directly used to determine pay, compensation committees should use this new metric as a guide to CEO success, since there really isn't a better way to simultaneously evaluate longevity, performance and size. It wouldn't be very difficult to determine how total compensation, including the eventual value of long term incentives, compares across the industry to Market Cap Alpha. This provides a clear sense of whether those that have created more value have been paid more and vice versa.

Market Cap Alpha can serve as a test of how well the various components of pay are collectively aligning with true success over time. Among many other causes, executives are sometimes paid too much or too little versus Market Cap Alpha performance because of the use of poor performance measures, setting targets that are too easy or too hard to reach, or by relying on fickle measures, such as 3 year relative TSR cycles, which can provide very different answers depending on which day vesting occurs.

When the alignment is not ideal, Market Cap Alpha can serve as a diagnostic tool to consider alternative performance measures and pay mechanisms that can better align the interests of management with the creation of long term shareholder value. By improving the alignment, we better motivate executives to build enduring organizational capabilities and competencies, and to embrace and execute the best strategies for long-term success.

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