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Short-term pain for long-term gain: The new CEO's dilemma

CEOs who pivot to a longer view of health and performance make the right moves for their companies, though it's sometimes their successors who reap the rewards.

by Michael Birshan, Thomas Meakin, and Kurt Strovink

New CEOs often hear two conflicting messages: first, get out of the gate quickly because your honeymoon will be short and you need to show results; second, play for the long haul. Can you do both? The answer is yes, but it's hard, and the results can be bittersweet. The companies of new CEOs who shifted their focus to the long term underperformed their counterparts at first and outperformed only after the CEOs had left.

We cross-referenced two robust data sources to get a better view of this problem. The first is our database of almost 600 CEOs and the details of their tenures and performance. Earlier research using this data showed how the companies of new CEOs who make bold moves early on are likely to outperform their counterparts.[1] The second source is data from our colleagues at the McKinsey Global Institute (MGI) in collaboration with FCLTGlobal.[2] Research based on these data found that when companies look forward and manage over a long-term horizon, they outperform their industry counterparts on key financial measures.[3] We define a long-term focus by five measures of a company's orientation, including sustainable margin growth, earnings that track cash flow, and investments that are more consistent and larger than those of companies managed for the short term. By integrating these two data sources, we could assess not only the actions of individual CEOs who made the move to managing for the long term but also how these decisions played out.

CEOs who pivot

Our first finding was that only a small number of CEOs pivoted from the short to the long term. From 2001 to 2014, we found fewer than 80 companies in our sample of 600, and just 25 following the arrival of a new CEO (these 25 CEOs led multibillion-dollar companies across industries).[4] That's worth pondering, since our MGI research clearly suggests that every CEO should seek to shift horizons. Strikingly, new CEOs who pivot to the long term—4 percent of our sample—are even rarer than the CEOs who delivered truly exceptional performance in our earlier research. Those overachievers, the top 5 percent of our sample, logged a fivefold increase in total shareholder returns (TRS) over their tenures.

Second, CEOs pivoting from the short to the long term were somewhat more likely than the other CEOs to have held the top job at another

company in the same industry. They may have arrived with the confidence that goes with having run a company and the determination to create a legacy for themselves as they neared the end of their careers.

Third, long-termism and boldness went hand in hand for pivoting CEOs: as the exhibit shows, new CEOs who shifted to managing for the long term made more strategic moves, such as management reshuffles and strategic reviews, than the average for CEOs in our sample (3.2 versus 2.4). Their status as pivoters means that they also were undertaking more of the long-term-oriented activities identified in MGI research. For example, these CEOs invested more in research and capital projects—particularly when peer companies were retrenching—even at the risk of missing quarterly targets. That's reflected in the pivoters' lower share of business or product closures relative to the sample as a whole. Another characteristic was the ability to increase margins sustainably, looking beyond mere cost cutting to buttress margins and pursue growth in new geographies and products, so that earnings rose in line with revenues. A final characteristic was the ability to generate high-quality earnings that reflected cash flows rather than accounting techniques and in this way signaling to their top teams the importance of solid operating performance.[5]

Delayed 'gratification'

Most notably, we found that *during* their tenures, the bold moves of these pivoting CEOs did not pay off in TRS—that is, they did not outperform their peers and, in fact, slightly underperformed them. However, their actions eventually appear to be reflected in the performance of their companies. When we extended the time period of our analysis to three to four years beyond the end of a pivoting CEO's tenure, we found that their companies slightly *outperformed* the rest of the sample, by one percentage point in TRS growth.[6]

Intriguingly, the research suggested that TRS underperformance was slightly less pronounced for those CEOs who moved

Exhibit

CEOs who operate with the long term in mind make more bold moves early in their tenure and tend to be more experienced.

CEOs who pivot to long term ● Average CEOs

Pivoting requires boldness
Number of strategic moves early in tenure

Share of CEOs who ...		
initiate strategic reviews	36%	23%
reshuffle management	76%	64%
initiate business or product closures	12%	20%

Share of CEOs with ...

... previous CEO experience

... previous industry experience

boldly *early* in their tenures. While the sample size is modest for this set of growth findings, the ongoing nature of our research will provide opportunities to look more closely at the timing and nature of CEO moves and their impact on company performance.

Tilting the institutional framework

This dichotomy of delayed rewards sits at the heart of the debate around long-term capitalism. New CEOs find it daunting to make decisions they know will generate value over the longer term but in the process create short-term pain that may dominate their tenures. The value at stake is sizable. From 2001 to 2014, companies that operated for the long term achieved revenues 47 percent higher and earnings 36 percent higher than their short-term counterparts did. Yet the difficulty in achieving these benefits is nontrivial and probably helps explain why so few CEOs pivot their companies toward the longer term while balancing the demands of quarterly reporting cycles—even though that ultimately pays off for shareholders.

Much of the responsibility for taking a long-term view, of course, should fall not only on the CEO but also the board. To be sure, strong CEOs give their boards and external stakeholders a vision and road map for future value creation and a sense of purpose based on a dispassionate assessment of the starting point. Both can help improve the performance and health of their companies well beyond their own tenures. But board members have a responsibility not only to define incentive schemes that will inspire the right behavior from CEOs but also to give them the time and resources required for the strategy to bear fruit. This is no mean feat, and as the saying goes, good things come to those who wait.

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[1] We found that the most successful CEOs take advantage of their arrival, assessing their starting position and taking bold moves to improve performance. For more, see Michael Birshan, Thomas Meakin, and Kurt Strovink, "What makes a CEO 'exceptional'?," *McKinsey Quarterly*, April 2017, McKinsey.com.

[2] FCLT stands for Focusing Capital on the Long Term. FCLTGlobal is a nonprofit organization (of which McKinsey was a cofounder) that encourages a longer-term focus in business decision making.

[3] The research found that from 2001 to 2014, long-term companies had significantly higher revenues, earnings, and market capitalization. For more, see Dominic Barton, James Manyika, and Sarah Keohane Williamson, "Finally, evidence that managing for the long term pays off," *Harvard Business Review*, February 2017, hbr.org; and "Where companies with a long-term view outperform their peers," McKinsey Global Institute, February 2017, McKinsey.com.

[4] We tested the data for robustness to ensure that a single CEO's behavior wasn't skewing the picture.

[5] MGI found that companies managed for the short term do whatever they can to hit short-term targets, but companies managed for the long term are willing to miss them if needed. Additionally, long-term companies are less likely to overindex on earnings per share (as opposed to true earnings) and less likely to boost earnings per share through, for example, buy-backs.

[6] Compounded annual growth rate (CAGR) in TRS.