CEO Ability, Pay, and Firm Performance

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Abstract. Do CEOs really matter? Do cross-sectional differences in firm performance and CEO pay reflect differences in CEO ability? Examining CEO departures over a ten year period, we first find that the stock price reaction upon departure is negatively related to the firm’s prior performance and to the CEO’s prior pay. Second, the CEO’s subsequent labor market success is greater if the firm’s pre-departure performance is better, the prior pay is higher, and the stock market’s reaction is more negative. Finally, better prior performance, higher prior pay, and a more negative stock market reaction are associated with worse post-departure firm performance. Collectively, these results reject the view that differences in firm performance stem entirely from non-CEO factors such as the firms’ assets, other employees or “luck”, and that CEO pay is unrelated to the CEO’s contribution to firm value.
Do CEOs really matter? Does CEO ability have any effect on firm value, performance, and CEO pay? A large literature takes the relevance of CEO ability as given. Yet, a plausible alternative view is that the firm’s performance is largely determined by the nature of its core competence, the quality of its products, other employees and stakeholders, its life cycle, and even possibly by luck. According to this view, CEO ability is relatively unimportant for firm value. Collingwood (2009), for example, reports that “James March, a management professor at Stanford, goes so far as to say that in any well-run company that’s conscientious about grooming its managers, candidates for the top job are so similar in their education, skills, and psychology as to be virtually interchangeable. All that matters is that someone be in charge.” Collingwood (2009) further wonders “how much difference can a CEO make, anyway? The answer doesn’t seem as obvious today as it did a few years ago.” An even more cynical view is that, far from meaningfully increasing firm value, CEOs are in fact in a unique position to entrench themselves and extract “rents”. Shleifer and Vishny (1989) argue that managers can entrench themselves by making manager-specific investments that make it difficult for shareholders to replace them. Bebchuk and Fried (2004) argue that CEOs can easily capture their boards and essentially set their own pay. Pay, according to this view, is determined more by managerial power than by ability.

The recent financial crisis and the storm over the pay of executives in financial firms have brought the question of whether CEOs meaningfully add value to the companies they manage, and whether their pay reflects ability or rent extraction, into even sharper focus. However, while these questions are central ones, empirical resolution of these issues has been difficult. The main problem is that CEOs are not randomly assigned to firms, and isolating CEO attributes from firm attributes is difficult, particularly in a purely cross-sectional study. One of the best opportunities to do so is to study the change in a firm’s market value and performance around a CEO change. The financial market’s reaction to the news of a CEO’s
departure is one way to gauge the contribution of that CEO relative to a potential replacement. If CEO pay and firm performance reflect CEO ability, then the financial market’s reaction to the departure news should be related to the pay and performance prior to departure. Prior pay and performance should also be related to the external labor market’s perception of managerial ability (as measured by the subsequent labor market progress of the manager), and the subsequent operating performance of the firm that loses the CEO. To test these predictions, we study a sample of 298 CEO departures (both voluntary and forced) over the 1992-2002 period, and consider evidence from the financial and labor markets and directly from firm performance after the CEO departure.

First, we hypothesize that if financial markets did not attribute differences in prior firm performance to differences in CEO ability, there would be no association between the firm’s performance under the CEO’s management and the stock price reaction to the news of the CEO’s departure. In contrast, if the financial market attributes performance differences to differences in the CEO’s managerial ability, one should observe a negative relationship. Similarly, if CEO pay is unrelated to either the CEO’s managerial ability or to the CEO’s ability to extract rents (the so-called “skimming” view), there should be no association between the pay and the stock market’s reaction to the departure news. We focus on the “relative” pay of the CEO in relation to the pay of the other four highest-paid executives in the company to filter out the effect of potentially unobserved factors that affect the pay levels of top executives in a company. Thus, if higher relative pay is associated with a more negative stock price reaction, the null hypothesis is rejected in favor of the managerial ability hypothesis; if the association is positive, it is rejected in favor of the skimming hypothesis. Our empirical results are consistent with the financial market’s associating prior performance and CEO pay with the CEO’s managerial ability. An increase in prior three-year industry-adjusted buy-and-hold stock returns leads to a decrease in abnormal stock return (from one
day before to seven days after the departure announcement). An increase in relative pay leads to a decrease in the abnormal stock return.

Next, we examine whether prior firm performance and CEO pay are related to the CEO’s success in the managerial labor market. Given that the stock market reaction is consistent with the recognition of CEO ability, we hypothesize that more negative abnormal returns are associated with better labor market progress. In addition, if differences in prior performance and relative pay reflect variations in CEO ability, the CEO’s labor market progress should be better when the prior performance is stronger, and the prior relative pay higher. We classify labor market progress on the basis of whether the CEO finds another managerial appointment, and whether the CEO is better paid in the new job or ends up in a bigger firm. Our results strongly support the managerial ability hypothesis. An increase in the prior three-year buy-and-hold returns leads to an increase relative pay, decrease residual abnormal returns (i.e., the part of abnormal announcement returns unexplained by prior performance and pay), and increase the probability of successful labor market progress.

Examination of the stock market’s response is very informative about a CEO’s contribution to firm value when there are no confounding contemporaneous announcements, since the market reacts to the news of the departure alone. The labor market outcomes are also especially informative because the process of selection and recruitment is likely to assign significant weight to managerial attributes that are observable to the recruiter but not to the researcher. However, as stock price reactions around the time of management turnover reflect investors’ expectations regarding these outcomes, but may not reveal the outcomes themselves. Perception, rather than actual ability, could also be relevant for the managerial labor market. To investigate whether actual or perceived ability explain the results from the stock and labor markets, we also examine whether the firm’s post-CEO-departure performance is related to the prior performance, relative pay and abnormal returns around the
announcement date. Consistent with the managerial ability hypothesis, the firm’s industry-adjusted operating performance one or three years after the departure is worse if the prior stock performance is better, the CEO’s relative pay is higher, and the abnormal stock returns around the departure announcement date are lower. We find similar results for the firm’s stock market performance over one to three years after the departure.

An important advantage of our three-pronged approach is that even if alternative explanations could be plausibly offered for any of the individual results, it is difficult to offer one alternative explanation consistent with all our results. For example, it might be argued that CEOs “jump ship” and quit voluntarily when they expect future prospects to deteriorate, and are forced to quit (for example, as a result of a governance change) when the prior performance is poor. This may explain why prior performance is negatively related to announcement returns and future operating performance but not why managers’ labor market progress should be positively related to past pay. Such an explanation requires prior pay to be low when performance is poor, quite the opposite of a governance-change explanation. Two additional findings further rule out this alternative explanation. First, the departure announcement abnormal return of the firm the CEO leaves and the appointment announcement abnormal return of the new firm the CEO joins are negatively and significantly correlated. This is consistent with the notion that the market value of the old firm will decrease more and that of the new firm will increase more if the CEO’s ability is higher. Second, the operating performance of the firm the CEO joins improves more if the CEO’s relative pay in the previous job is higher and the stock market’s reaction to the departure news is more negative.

Our study makes several contributions. First, we provide evidence that CEO ability differences exist and affect firm value and performance. Second, our results show that CEOs of higher ability also receive higher pay. In contrast, Bebchuk, Cremers and Peyer (2008)
find that, in a sample of firms in which the managers are entrenched, the CEO’s pay relative to the pay of the four other highest-paid executives in the company is negatively associated with firm performance. They interpret this as evidence that high CEO relative pay represents rent extraction by CEOs. We find that CEO relative pay is no longer significant for a subsample of departures with poor governance characteristics. However, our results are stronger, both economically and statistically, in the complementary subsample of firms with good governance characteristics. These results suggest that governance does matter for the pay-performance relationships,