Succession Planning for Private Equity Firms

- Steve Standbridge, Managing Partner, Capstone Partners

Is building a firm that outlasts the founding partners a realistic goal?

Yes, but it is not easy and can create some short-term turmoil; however, with the right leadership, culture and structure, private equity firms can survive generational changes. Private equity is still a relatively young asset class so many of the early innovators in our industry are just going through transitional periods. As you would expect, some are managing succession well while others have struggled and, as a result, we are seeing a proliferation of successful spin-out funds as talented younger partners seek to run their own firms.

What are the common characteristics you see in firms that have managed succession well and those that have had issues?

As I mentioned, it really comes down to leadership, culture and structure. When private equity was a cottage industry, funds tended to be smaller and founding partners were able to run a firm while still being involved in the day-to-day aspects of executing deals and managing portfolios. As firms have grown and the regulatory environment has evolved, firm leaders have had to adapt to managing complex organizations while still setting the strategic direction, culture and underwriting standards of the firm. This leaves less time to be involved in the day-to-day business of working on deals so their roles on the deal front have evolved into mentoring key deal partners, providing advice on the underwriting of deals, and giving direction to portfolio companies through their role as board members.

The best firm leaders also realize a big part of their role is to observe the development of their team and identify and mentor the future leaders. We see issues when founders or current managing partners are either too involved in the day-to-day execution of deals and ignore the development of the firm, or their egos lead them to believe that they are irreplaceable, which is common in our industry.

The best firm leaders also promote an ownership culture in the firm beyond just economics. Firms run as heavy-handed command and control organizations lead to dissatisfaction among younger partners who end up feeling as though they are just employees building wealth for the senior partners without any long-term view towards putting their own stamp on the firm. With a culture of open and honest communication, collegiality and a feeling of ownership and accountability, junior partners will act in the long-term interest of the firm and their investors, which ultimately leads to a smooth transition to future partners.

The last important factor in successful succession is making sure the economic and partnership structure allow for fair sharing of the economics and ultimately treat all parties fairly as partners move into retirement. Private equity professionals are economic and capitalistic animals by nature, but that doesn't mean that there isn't a middle ground where all parties can be satisfied. As senior partners' roles start to diminish, they need to be willing, with successive funds, to commensurately lessen their ongoing economic interest in the funds and the partnership. We have raised many funds over the years for talented young professionals who were tired of senior partners continuing to take the lion's share of the economics even as their full-time involvement in the firm and deals wound down. The most effective way to deal with this issue has been to reassign the carry in each successive fund to reflect the increasing contributions of the junior partners. In some cases, GPs have even set up new management companies for each fund, which allows the senior partners to wind down ownership and avoids valuation disagreements if there is a need to buy a founding partner out of a position in a management company. Bottom line is that none of this can be accomplished without a founding or senior partner whose objective is for a firm to outlast his or her legacy.

If there is a need to buy out founding or senior partners, are there sources of capital available to facilitate a transaction?

There are several options available to junior partners who may not have accumulated enough wealth to buy out founders or senior partners who are looking for near-term liquidity. The three most common sources of capital are: (i) secondary firms, (ii) fund investors that are looking to increase their returns through sponsoring private equity funds, and/or (iii) the sale of an interest to a third party.

We regularly receive calls from secondary buyers asking if we are aware of funds that are nearing a succession event. They are willing to provide capital to buy out a founder's interest and structure a transaction where the younger partners can buy out their interest over time. This can be an attractive transaction for all parties as it satisfies liquidity needs while still giving LPs comfort that there is a path to full recapture of economics by the new generation of general partners.

Likewise, we are seeing more traditional fund investors look to act as sponsors of firms so they are willing to provide transitional capital to buy out founders. These transactions are structured similar to a deal with a secondary player where a sponsor's ownership positon can be diminished over successive funds.

A third option is the outright sale of part of the firm to a third party. The challenges in this kind of transaction are how much of the firm is being sold, the role the buyer will play in the governance of the firm, and whether there is a mechanism provided for a future buy back of the position. Limited partners have mixed feelings about these types of transactions as they want to make sure that the bulk of the economics still rests with the investment team.

One other option is taking a firm public, but that is really only a viable option for a small percentage of large multi-product managers.

How and when should a private equity firm go about building a succession plan?

One thing that I have observed through meeting with hundreds of private equity firms is that they often don't eat their own cooking. I think most private equity firms would agree that if a board and management team didn't have a reasonable management succession plan in place, they would be shirking their fiduciary duties; however, many private equity firms don't consider their own succession plans until it is too late. I go back to my earlier comments on leadership and firm culture when it comes to succession planning. The best leaders recognize that they will one day need to transition their position so they give their younger partners opportunities to grow as future leaders. They can do this not only through developing their deal skills, but by involving them in managing a specific investment sector, recruiting, team building and fundraising. In other words, the process starts early and is reinforced throughout a junior partner's career.

There will inevitably come a point when one or more partners may be anointed as the new leaders and this can create turmoil as others feel passed over, but that is part of the natural process in the evolution of a firm and limited partners understand that dynamic. I am aware of one firm that actually rotated partners through the managing partner role before choosing the next leader and that firm has successfully worked through their succession. The other reason for early development of a succession plan is so that the firm is well positioned in the event of an unforeseen circumstance, such as a health issue, requiring a rapid change in leadership.

When should a succession plan be communicated to LPs?

Succession planning has become a major diligence topic for limited partners as they have recognized that a poorly executed plan can lead to key partner turnover, potentially leaving them stuck in a fund with insufficient resources to manage a portfolio of investments. Every diligence questionnaire will include a question about succession planning, and as founding and senior partners age, investors will inevitably ask questions in the pitch meetings about the succession plan. Most investors will also spend time with each partner at the firm and get individual perspectives on how they see the firm evolving. Lack of consistency or a poorly articulated plan can lead to investors passing on potential commitments to a fund. In terms of timing of communication, the ideal situation is to have the transition occur over a couple of funds. For instance, it would be appropriate to talk about a founding partner lessening their involvement in a fund currently being raised, thus creating the expectation that the transition will occur over the course of this fund with the full transition completed when they return to market for their next fund.

Capstone Partners

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