

Buyouts

GUEST ARTICLE

More Buyout Firms Confront Succession

By Katharina Lichtner, Capital Dynamics

Everyone running a larger private equity portfolio will have in the past or will in the future decide not to re-up with one of their core relationships because leaders have failed to manage succession to the next generation.

Firms such as **The Blackstone Group**, **Kohlberg Kravis & Roberts**, **TPG** and others feature regularly in articles discussing succession. However, from a portfolio point of view, this is only the tip of the iceberg. Of the 3,463 managers listed in the Thomson Reuters database for United States and Europe, 351 have raised their fourth fund and many of those are heading for or are already in the middle of management succession issues. While this is only about 10 percent of the total pool of fund managers, the amount of capital involved is much larger (see chart below). Of the roughly 340 managers that my firm, **Capital Dynamics**, has invested with or is monitoring on behalf of its clients, about 61 are in this stage. With this article we take a look at succession issues, at the question of which organizations are more prone than others to successfully transition management, and how limited partners should deal with the issue to mitigate the impact on their own portfolios.

From a conceptual point of view, succession will typically become an issue for managers in their fourth to fifth fund. This transition is driven by several factors. Professionals are typically in their early- to mid-forties when they set up a private equity partnership. By the time a fourth fund has been raised, the managing partners are typically in their mid- to late-fifties, will reach retirement age halfway through the fund and start reducing their involvement. At the same time, they often retain a disproportionate share of the economics and control over the company. Most succession discussions are not necessarily about the amount former leaders work, but about the share of the economics and control they retain in relation to more junior partners now doing the heavy lifting of portfolio investment and management.

Succession also becomes entwined with the strategic evolution of managers. In a changing environment, despite a high degree of actual stability within the team and strategy, firm management teams need to evolve in order to remain highly



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competitive within their market segment and generate exceptional returns going forward. Implementing crucial developments often becomes difficult as leaders with an eye on retirement prefer to spend their last years in business in their accustomed routines rather than driving change and adjustment. This maintenance of the status quo quite often leads to frictions within the team and is often the cause for the next generation of junior partners to leave and to set up independent shops where they can fully implement their own strategic vision with a much more attractive share of the economics and control of the overall business.

Vulnerability

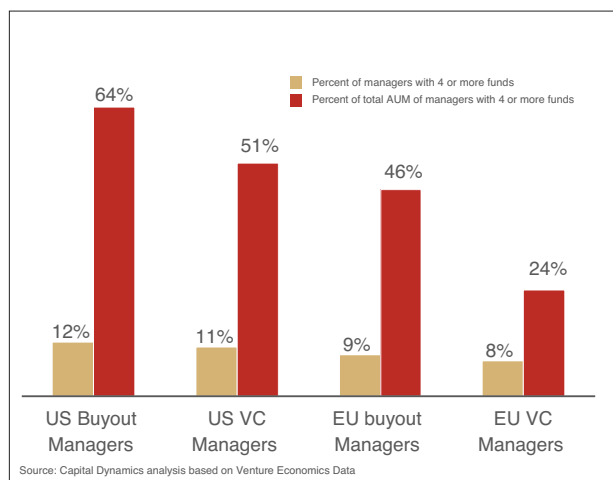
Some organizations are more prone than others to suffer during transitions. In the very early days, private equity was dominated by charismatic stars raising money on a deal by deal basis. These managers subsequently raised their first institutional funds, which were controlled by the founder or founders.

While some firms have been and still are clearly dominated by one individual, for others a group of partners lead the firm in a more partnership-like style. Over the

years, especially in the larger end of the LBO and venture space, many managers have evolved into institutional-type organizations that more closely resemble small investment banks or asset managers rather than the old model of entrepreneurially driven organizations led by a founder.

At the smaller end of the market, many organizations tend to be dominated by one or two entrepreneurial leaders; few managers in this category have built organizations with institutional systems and processes. From a succession point of view, organizations led by one or two founders are much more prone to experience problems with succession. These organizations are typically geared to the preferences of one or two managing partners, who also tend to retain the bulk of the economics. In addition, many such founders find it hard to give credit to others in the team or to adequately develop talent outside of this dominance. Quite often organizations that are driven by entrepreneurial founders fail to adequately compensate and retain the next generation of leaders and are not able to build a brand that is perceived as independent of the founders. Often these teams suffer from the repeated loss of potential successors that set up their own funds or move to an organization where they feel their talent is better recognized and rewarded and where they see a chance to ultimately manage the organization.

There are as many ways to manage succession as there are firms. And the spectrum of handling this issue ranges from excellent to destructive. Some firms



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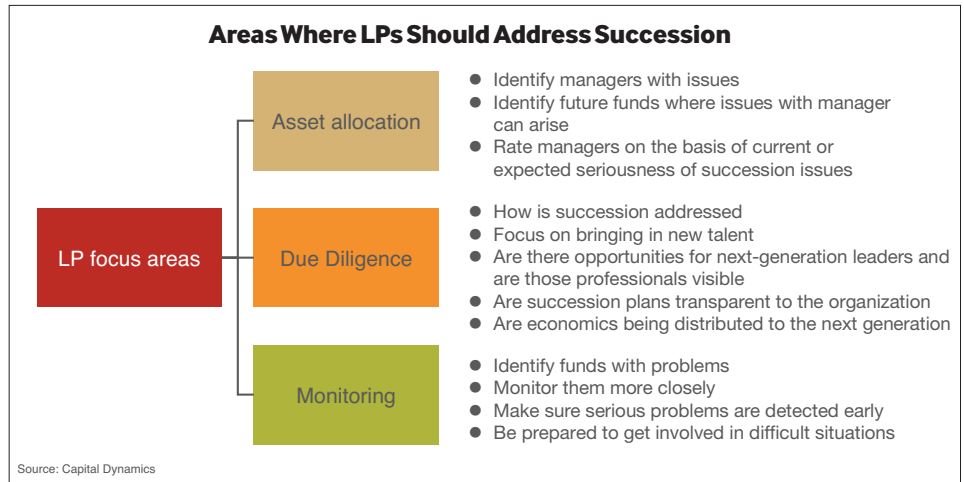
manage succession very well; their leaders start thinking about it early, involve the organization effectively, are transparent about what they want and stick to it. These firms are adopting the best practices discussed by **Francisco Paret** of Egon Zehnder earlier this year in an article in this journal (*Buyouts*, Jan. 21 2008). Those managers focus relentlessly on bringing the best and brightest into the firm and carefully developing them. They provide opportunities for next-generation leaders to emerge by exposing them to limited partners as well as by sharing ownership down the ranks. In firms where this is handled less optimally, leaders shy away from the discussion even so far as to deny the issue, with the result that they are either removed by pressure from the next generation in endless and painful negotiations or the team disintegrates, leaving LPs with the responsibility to react in order to ensure that the remaining assets are adequately managed.

So the big question is how to deal with succession from an LP perspective in order to make sure the issue does not have a negative impact on current as well as future portfolios. There are generally three areas where succession has to be taken into account: asset allocation, due diligence and monitoring (see chart at right).

Experienced investors, as well as fund-of-funds managers that are proactive in their asset allocation, typically run forward calendars, systematically keeping track of when they expect managers in their group to return to the market. As a core group of managers matures, it becomes increasingly important to analyze the group and determine which managers are likely to have succession issues or have already reached this stage. In addition, for those managers facing these issues, ratings should be assigned that accurately gauge how likely they are to resolve succession issues successfully. Based on the number of managers that are in danger of failing to resolve succession issues, investors know to what extent they have to replenish their pool of preferred managers with new names in order to retain the ability to maintain their allocation targets in the future. It also enables an investor to track which managers have succession issues that need to be addressed in more detail during the next due diligence.

Assessing Risk

In their due diligence, investors should assess to what extent managers are dealing with succession. They need to develop an independent view as to whether the structure of the organization leaves the manager prone to such issues. Furthermore, discussion should start in the early funds to have a point of reference as the group develops. Often leaders of firms discuss succession freely in the early days, but when the time comes closer to the event, the topic becomes problematic and this



development should be monitored. One of the key factors is to understand if the founder or founders have an interest in seeing the organization survive or if that is less of a priority.

Those that desire a surviving organization will devote time to clearly articulate their culture and values, which is an essential prerequisite of being able to pass them to the next generation. A further indicator of how well a firm will be able to successfully manage through a succession is the amount of time that is devoted to hiring and adequately rewarding the best and the brightest in the market. Often the importance managers give to human resources is an indicator of how serious organizations are about this aspect. In this context, it is important to discuss succession matters with more junior members in the team to gauge their perception of the process.

In firms that manage the issue well, junior members are well informed, and feel comfortable discussing succession issues with LPs. In addition, in teams that are serious about active succession management, economic interest and control is gradually distributed down from a small group of founders to emerging leaders and the wider organization. In this context it is also important to gain an understanding of who controls the actual management company. Often control of the day-to-day operation is shared, for example, by creating functional heads in a transition to a more institutional organization. However, if founders retain full control of the management company they maintain full control over the flow of management fees, which especially for larger funds allows them to retain control over much of the overall economics. Again, where possible this should be monitored over successive due diligences, to ensure there are not drastic changes to the approach, which might indicate potential problems.

Finally, succession needs to be one of the key parameters in monitoring portfolios. It is

important to identify those managers that have or could have issues in order to look out for warning signs and be able to react quickly. This information needs to flow back into asset allocation and due diligence, which is especially challenging for those investors that separate allocation and investment activities from monitoring portfolios. While limited partnership agreements in reality leave investors with few legal remedies, managers are generally open to discussions with their LPs. A good understanding of the issues enables an investor to discuss and hopefully resolve possible issues early. Continuous monitoring is especially important in the rare cases where teams disintegrate over succession issues, because early detection and action will help to protect the investor's interest.

In conclusion, we believe the industry has matured to a point where most portfolios contain managers that face succession issues. Succession is clearly becoming a critical issue going forward and we tried to make a start in identifying a set of issues that will require further work over the coming years. With more managers reaching this stage we expect more disruptions to occur, with teams disintegrating, leaving orphaned portfolios behind. In our view, a systematic approach as described above is the best way to mitigate the risk and to fulfill the fiduciary responsibilities towards the ultimate stake-holders. ❖

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