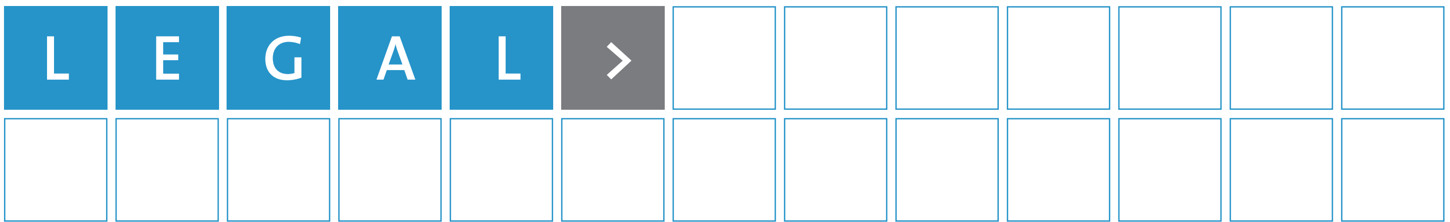

GUEST COMMENTARY

Put the 'success' in succession

A private equity firm's smooth transfer of generational leadership is where the interests of founders, successors and investors intersect – as such, succession planning is getting a hard look from all concerned.

By John MacMurray, Ropes & Gray

The issue of private equity succession involves somewhat strange atmospherics and dynamics for professional organizations that pride themselves on disciplined procedures. Edgar Allan Poe faintly sounds in the subject, a complex of morbid and egotistical undertones.

Among founding partners there is a reluctance to address the issues, abetted by the perception that the risks of procrastination are low. But while succession issues thus slumber at the top, the anxieties of junior members in the organization toil and trouble. To founders' chagrin, succession, unaddressed, can in a moment become a matter of founders' deconstruction.

Limited partners have become increasingly wary of firms that have no succession plan. They know that underlying issues can erupt in many different ways, nearly always in unwelcome form.

For example, founders, invariably 'key men' by definition and in fact, can depart an organization as a result of premature death or disability, as would be the case for many successful firms whose founders may still be in their early fifties; founders can wander off the path, entangling themselves with the SEC or in other regulatory investigations; even amicable and uncontroversial departures of founders can threaten the triggering of key man provisions.

Finally, founders' thickheadedness in putting off succession planning can forestall transition adjustments that, so blocked, can prompt mutinies and spin-offs at junior professional levels.

A sampler of all of these has occurred in our experience over the past several years, usually taking the affected organizations completely by surprise and without a plan. Such occurrences threaten the viability of the organization and in turn the effective management of investors' assets.

Increasingly, prospective investors are asking fundraising sponsors, "Do you have a succession plan for your founders?" If the answer is, "Yes, we have no bananas," GP fundraising efforts may prove fruitless.

What follows are observations that might serve in establishing a tailored and sound plan of succession.

THE MANAGEMENT COMPANY IS THE BOGY

Retirement provisions with respect to general partners (as distinguished from managers) are generally workable when founders retire. But retirement treatment of ownership interests in the management company is another matter. Management company ownership agreements that are silent on the subject of founding partner retirement are hazardous in the extreme, not only to the health of the sponsors, but also to the junior members of the firm and investors.

Ownership of the management company may be held predominantly by the founders without the dilution of interests having been redistributed to the more proven of the junior members of the firm, notwithstanding that carried interest sharing at the general partner level for the most recent fund may be dramatically different. In such cases, there may be little incentive for founders to settle differences among themselves in advance, and resolution of valuation issues can become entrenched at great risk to all concerned interests.

Founders may argue that their contributions to the firm's value is not adequately accounted for solely by their past participation in its economics. They also may fear that an extraordinarily happy capital event will be visited on the sponsor firm after the founders' retirement, and they will be left out. Accordingly, founders find unpersuasive a book value or 'sunset' approach to their retirement economics.

By contrast, junior members view retirement economics that derive from 'franchise' value or a buyout analysis (multiples of EBITDA, based on assumptions of normalized compensation and projected income streams over some stipulated future period) as indenturing them to pay off the founders on the basis of assumptions that may never be realized.

For people whose profession it is to deal with valuation issues, there is surprisingly little comfort taken by the opposite sides in resolving these issues strictly as a matter of professional technique.

What must be analyzed and discussed is the true nature of the founders' 'equity' in the firm. Should there be a value attached to passive ownership in the firm? In other words, is it true equity? If so, more commonly understood valuation methods can be applied. If not, the conclusion must →

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be that founders' equity, like everyone else's, is really only a right of participation in profits so long as the equity holder is actively involved in producing them.

CONTINUITY IS KEY

The immediate concern of investors is the continuity of a firm sufficient to manage assets to realization. But the concern of founders and other participants in a private equity firm goes well beyond managing assets and commitments currently in hand. In fact, that's usually the easy part.

A founder's involvement in two interrelated elements necessary for the continuity of an independent private equity firm should be given a very hard look.

First, the *sine qua non* of fundraising. The real business of a private equity firm is to raise successive funds. Cynicism aside, this is the elemental fact of a sponsor firm's life. The end game for any sponsor firm would be presiding over the run-off activities of its last fund. That demoralizing and economically crippling prospect is presented on a recurring basis every four to six years, given the current market convention for investment periods of five to six years and adjustments in the management fee base at the end of the investment period. Without dry powder at the ready, it is predictable that the professional organization (and the sponsor firm's supposed or real franchise value) will reduce to a puddle in relatively short order. Responsibility for fundraising invariably involves one or more of the founders in the lead role, who perforce control as well as manage investor relations. Parachuting a successor into these roles is a very tricky and unwise business. This element must be addressed in connection with the retirement of a founder.

Second, the art of the performance presentation. Where results are middling, the art of walking on hot coals must be prized. In those cases founders usually handle the job of juggling the multiple balls of mitigating J-curves and explaining the percentage and timing of commitments invested, net IRRs, multiples of cash on cash returns, etc. This parlor trick must be transferred to the founders' successors. Even when results are brilliant, and where no particular artistry is required to walk on a bed of rose petals, there may be a founders' issue. Sometimes a virtuoso founder is perceived to be so linked to the firm's successful performance that the he or she simply cannot be replaced.

An adroit plan of succession, keying on the special circumstances of the founders in regard to performance, will design a structure that 'institutionalizes' credit for results of operations, without impuning the creativity and other talents of individuals. While the border between a boutique and an institution may be fuzzy, institutional investors will know it when they see it, and whatever succession plan is adopted must be creditable in this regard. The willing participation of the founders in this regard, which is more than a tacit nod in the direction of succession, is critical.

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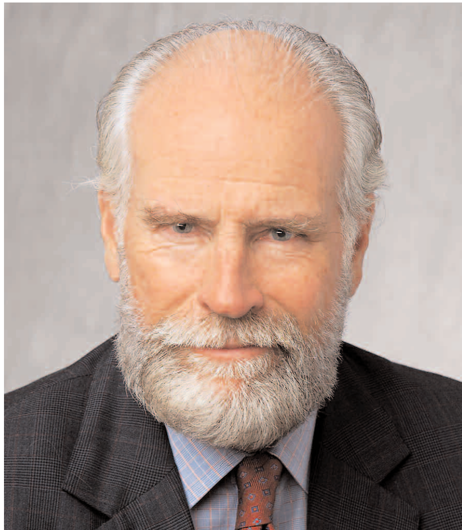
SPREAD THE WEALTH

Nothing corrodes the morale or promotes factions within a private equity firm more than the sense that there is an unconscionable disparity in the sharing of the firm's economic success. Frustration of junior members over the issue will accumulate like magma under a geological fault.

Insofar as participation in carried interest is concerned, shares are normally sorted out at the time of the formation of each new fund. However,



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there is no structural trigger to revisit shares in the management company, and non-founders' participation in current income (bonuses and distributions from the management company) may not be adequate to the purpose. Current cash not only underwrites lifestyle, but invariably serves to fund capital contributions.

Minus a succession plan in this regard, founders are generally in an unwitting death spiral, as their legitimate claim to their original economic shares may be quite as legitimately undercut by the increasing contributions of junior members. Interestingly, a reduction in a founder's share of the management company is not always made up for by a rising tide of profits, and that can be a serious sticking point. Recognition of the need for a fair value proposition for the junior members is a *de facto* step in the direction of succession.

A founder-induced habit of adjusting participations in the economics of the management company from time to time will reinforce progress in institutionalizing the sponsor firm. It will also facilitate the solutions to those vexing issues arising from the valuation of founders' equity in the management company upon retirement. ■

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