FINANCIAL NEWS
PRIVATE EQUITY NEWS

Private Equity Paves Road to Succession

Well established private-equity firms are taking steps to put in place the next generation of leaders

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Carlyle co-founders David Rubenstein and William Conway have made moves this year to transfer power to other executives. Getty Images

More private-equity firms are preparing to pass the leadership baton to a new generation of professionals, but, unlike their corporate counterparts, that transfer often is likely to be a gradual process.

This year, publicly traded firms Carlyle Group LP and KKR & Co. both laid the ground work for the eventual transfer of their firms' leadership by elevating midlevel professionals to co-leadership roles. Meanwhile, Apollo Global Management LLC also named co-presidents, although, according to a recent report in The Wall Street Journal, a person familiar with the firm said the promotions were less about succession planning and more about rewarding the two professionals.

The three listed firms join a growing line of private-equity managers launched in the past few decades that are taking steps to lock in the next generation of professional leadership. Such firms can face pressure on several fronts. As founders at more established firms age, limited partners increasingly want assurances there will be a solid professional team in place to steward a fund before they commit capital that will be tied up for a decade or more. At the same time, as investors allocate more capital to the asset class in their quest for strong returns, the temptation among midlevel professionals to strike out and launch their own firms perhaps has never been stronger. Firms that don't show their top midlevel talent a path to future leadership could potentially jeopardise their franchise.

Exactly how the transfer of power and economics occurs, however, remains the trickiest part of the process, say lawyers, consultants and the fund managers themselves. They add that more firms are laying the groundwork for succession earlier, engaging outside consultants to help with process and spreading future leadership among more than one person.

Such steps can help ensure a smoother transition around what is typically an opaque and sometimes tense process.

“This is kind of like the Vatican waiting for the puff of smoke to come out to see do we have a Pope yet?” said Hugh Shields, senior partner at executive coaching and transition consultant Shields Meneley Partners LLC. “When the PE firms go into the meeting divided, there’s not a lot of sharing about what goes on down in the trenches, because that can be pretty politically fraught with danger.”

The Co-CEO Model

As more firms like Carlyle and KKR put succession plans in place, increasingly those plans involve passing firm leadership to two individuals with equal power.

Private equity may be one of only a few industries, if not the only industry, in which the co-chief executive leadership model isn’t only accepted, but often embraced. Firms that have adopted a co-leadership model include H.I.G. Capital, Riverside Co., Sun Capital Partners, Thomas H. Lee Partners and Warburg Pincus.

But as more established firms pass the leadership baton to a new generation of professionals, this governance model will be put to the test. The skills a new generation of leaders need to carry their firms forward may differ from those required by their predecessors. At the same time, a new generation of co-leaders may not have worked together as long as a firm’s founding generation.

Private-equity professionals say that the co-CEO governance model’s appeal evolved partly from the structure that many private-equity founders adopt in creating their firms.

“Most of those firms are built on partnerships,” said Brian Gallagher, co-founder of Chicago-based funds-of-funds manager Twin Bridge Capital Partners, adding that such partnerships are often marked by consensus decision-making. “So there’s a natural inclination not to stick one guy in charge.”

At the same time, many firms invest considerable time and money to grooming their junior and midlevel professionals. Elevating one at the expense of another can leave a firm at risk of losing strong talent that it still wants or needs, often at a considerable cost. Private-equity professionals also say that co-CEOs often will have different skill sets that are equally necessary to the firm’s continued growth and success.

“Sometimes one person is really strong externally, really great with investors, and the other is a particularly strong manager of the business, so they complement each other,” said John Ayer, an attorney at law firm Ropes & Gray LLP.

Having more than one leader at the helm also leaves a firm less vulnerable should something unexpected happen, a lesson some firms have learned the hard way. The premature death in early 2016 of Claudio Sposito, founder of Italian buyout shop Clessidra, forced the firm to temporarily suspend fundraising efforts for its third vehicle and deal making. Ultimately, after a period of uncertainty, Mr. Sposito’s widow sold the firm to Italmobiliare Group, an investment holding of Italy’s Pesenti family, and, after putting a new key-man provision and management team in place, the firm wrapped up its third fund in late 2016.

Although such instances are relatively rare, private-equity firms with a sound succession plan in place can help ensure their franchises are insulated from the unexpected.

“The goal is to get to a place where if you get hit by a bus, life moves forward,” said Bill Stoffel, U.S. private-equity leader at Ernst & Young.

As more firms think about transferring power and economics to the next generation, consultants say they are starting the process sooner, often years in advance.

"They give people an indication earlier as opposed to, here's a bright line moment where we have a winner and we have losers," said EY's Mr. Stoffel. "It kind of evolves."

Long Perspective

Private equity's longer perspective can contrast sharply with the world of public corporations, in which leadership transitions can often be abrupt, prompted by shareholder pressure, poor performance or some combination of the two.

CRG, a health-care debt investor founded by veteran private-equity investor Charles Tate, four years ago began discussing plans to transfer both the economics and decision-making power from Mr. Tate to Partner Nathan Hukill.

"If you're going to build an organisation that's going to help investors solve their long-term investment needs, you need an organisation that thinks long term and acts long term," said the 73-year old Mr. Tate, who was also a founding partner of now defunct buyout firm Hicks Must Tate & Furst.

The firm finalised a plan in late 2015 that will transfer decision-making power and enable Mr. Tate to continue receiving carried interest from the firm's fourth and fifth funds, albeit at a significantly reduced percentage than he currently receives. In order to enable Mr. Tate to monetise the equity he built in the firm, he will be entitled to a portion of the cash flows of the firm's general partner for about 10 years starting March 31, although at a reduced level from when he was the controlling partner. He will transfer decision-making control of the firm to Mr. Hukill effective that day.

Consultants and investors say a gradual transfer of power gives firms time to work out any kinks in the process as well as enabling employees and investors to adapt.

The generational transfer process at Boston-based TA Associates, for example, was honed over the better part of two decades, thanks partly to former long-term Managing Partner Kevin Landry, who passed away from cancer in 2013.

"One of the things that's always been a core value of our culture is meritocracy," said Chairman and Managing Partner Brian Conway. "Kevin absolutely abhorred the idea of people who were retired in place. He routinely would go to other private-equity firms' websites and see someone as a managing director and say, 'They don't even live in New York [full-time]'."

Transition Period

When an investment partner who has spent at least 20 years with TA decides he wants to retire, the managing director will enter a three-year transition period during which he will gradually reduce his activities at the firm, according to Mr. Conway. At the end of that time, the managing director will become a senior adviser.

In reality, Mr. Conway added, many MDs don't actually end up significantly scaling back their activity until the third year or, in a few cases, even until they assume the senior adviser role.

The economic transition, however, is much clearer cut. MDs seeking retirement must notify the firm at least six months before the launch of a new fund. As the person transitions, he or she will receive a significantly reduced percentage of the carried interest in the firm's next fund and receives no portion of the carry from the fund after that.

"All of these things give us time to make more gradual transitions than abrupt changes right or left," Mr. Conway said.