PASSING THE TORCH

Succession issues will have to come to the fore if GPs are to raise new funds. *François Rowell* and *Julian Longhurst* investigate

Managing succession issues effectively has always been important for GPs in Europe, as it has for many of their privately-owned investees. But it could be argued that European GPs lag behind their more experienced US counterparts in this area and at this point in the cycle it is becoming clear that they are going to have to up their game if they are to stand any chance in securing new funds and retaining top young talent. As Louis Elson, co-founder of Palamon Capital Partners, explains: "We are at a critical point – a time when LPs have absorbed the hit taken during the downturn and are ready to invest again. But they are doing so on a much more sophisticated basis this time around so the issue of succession is of decisive importance now"

What is clear is that the troubles which have plagued the economy over the last couple of years, combined with heavily leveraged portfolios, have taken their toll on private equity funds. As a result, many GPs, especially in the buyout area, are finding that their current crop of funds are well and truly underwater. For the heads of these GPs, especially those that may have been through a full cycle already, the poor conditions present a difficult decision: rebuild their brands or exit the industry altogether. "The fact that short- to medium-term carry prospects are poor can really change the way people behave and it might be enough to convince the top partners to bow out now," says Rhonda Ryan, head of private funds group Europe at PineBridge Investments.

Dangerous disillusionment

Such decisions, when they occur, can obviously cause significant tensions among senior partners, unsettling both leadership and team management structures. Even in cases where the top partners choose to "stay and fight" it is possible in the current environment that succession issues get left on the back burner. In both cases, any mid-ranking executives within these firms who have not been correctly incentivised and who cannot see the appropriate succession structures in place, will quickly become disillusioned. As Marc Gomer of Craton Partners, which provides analysis support to new private equity or corporate finance firms, notes: "It is highly likely that a number of talented individuals or teams will look to spin out or start up alone in the coming years".

In amongst all of this a key issue is remuneration: all too often in private equity, it can be a top-heavy affair, with senior partners of firms taking the lion's share, while mid-ranking executives are reliant on performance-related carry. In such cases, funds which have underperformed during the downturn will have trouble keeping their up-and-coming talent as poor prospects of carry income and uncertainty regarding future fundraising, lead many to contemplate where their future lays. Marc Gomer, agrees: Talented executives, usually in the middle management positions, are increasingly looking at their options for the next few years as a direct result of poor remuneration and limited promotion prospects."

Admittedly, many of the larger GPs, influenced by their substantial US LP bases have already taken these issues onboard and have become more sophisticated in their succession management as a result. But, that still leaves a large number of mid-cap and smaller investors, arguably the engine room of European private equity. And it is this segment of the market that will see the most intense competition to secure the currently elusive LP commitments.

It is true that LPs are tentatively re-opening shop after keeping their heads down over the course of 2009. However, having suffered bad experiences with some of their existing GP relationships in recent times, it is also very likely that those active LPs will be taking a much tougher line on investor due diligence in general, and key-man issues and succession planning in particular. Reference checking will be done even more vigorously and close analysis is being paid to carried interest distributions made within general partnerships.

Incentivisation is key

As Rhonda Ryan puts it: "LPs want more protection and stronger key-man terms. Clearly if we are to commit to a fund for 10 years, we have to consider the age and motivation of the key men". And this is not lost on the GPs and those that represent them. "A key element of the investor due diligence process that is set to carry a greater weight in future fundraising is the issue of succession in investment teams," asserts Alexander Chaplin of global placement agent BerchWood Partners. "A solid incentivisation scheme for the retention and promotion of top talent is integral to a well considered succession plan, and we would work with management to put this in place before presenting their fund to LPs" he adds.

So where does this leave the smaller private equity houses that are led by their often charismatic founders/patriarchs? Clearly, as one investor puts it: "Some LPs will continue to go down the route of backing the jockey rather than the horse, particularly if the jockey has plenty of years left in the tank". But in the longer term there are legitimate questions regarding the ability of individual-led firms to be able to offer up a similar talented and charismatic leader to replace the founder. As a result there is very likely to be a shift over the next 5 years to a more institutional model as investors look to minimise risk.

This obviously has significant repercussions for those looking to spin out of larger structures and getting their succession planning will be crucial. That said, as Louis Elson points out, spinouts might not be the most practical option at present and the only other option available to disgruntled executives talent would be to follow the money elsewhere and leave the private equity industry altogether. As he says: "Private equity has drawn in a lot of talent during the recent boom years; it's now quite likely to spit some of it back out". ■