Succession planning comes to founder-led investment firms

As more founders of investment firms retire, they need to carefully consider the leadership, purpose, culture, and governance they'll leave behind. Answering some key questions will help.

Just about thirty years ago, the private equity industry began to boom. Many of the people who founded investment firms starting then—including private equity, hedge funds, venture capital, and real estate trusts—are among the 10,000 Americans who will turn 65 every day for the next two decades.[1] And many of those founders are thinking about an exit strategy, but their firms face two particular challenges as they do so. The first is that no one wants to tell a founder that it's time to leave, which can inhibit the kind of long-term CEO succession planning other companies increasingly rely on. The second is that founder-led firms are so bound up with founders' particular ways of working that leadership, culture, purpose, and governance all need to be managed differently when leadership roles change hands.

1 Guillaume Vandenbroucke, "How many people will be retiring in the years to come?" St. Louis Federal Reserve, May 30, 2019, stlouisfed.org.

The choices these founders make about whether and how to transfer the firm to the next generation of managers has significant implications for limited partners, general partners, and the founder's own legacy. In some cases, founders have so much capital invested that upon retirement they have little choice but to shutter the funds or convert their firm to a family office. The carry that founders anticipate from open funds can also be a factor in determining their exit strategy.

Those investment firm founders who choose to keep their vision and assets alive through succession planning face unique challenges in transitioning. Defining the elements of leadership, culture, purpose, and governance more clearly and visibly helps to transfer them from a single individual to the entire firm.

Leadership

Founder-led investment firms were typically started as single-strategy boutiques. Many have grown to encompass billions of dollars in assets under management, multiple strategies, and multiple funds, often in several offices. This spectacular growth means that one leader will likely not be able to fulfill both roles that founders have filled: the managing partner role (essentially the CEO) and leader of the firm's investment committee. In some cases, the portfolio has become so diverse that even the managing partner role alone is too broad for a single individual.

This is a matter of concern to many in the industry. Limited partners, for example, monitor succession and want to know what leadership changes are next. Some say that they will actively consider not investing in a firm's future funds if they do not see proper succession planning.

As they think through what the new leadership structure should be, firms are exploring a few alternatives. Several have been experimenting with co-president models, which can be based on geography or product. These models can also be functional—with one co-president focused on fundraising and the other on investment management, for example. Another option would be to pair an operating partner, who might have more expertise at leading, with a strong investment leader in a new top team.

We have also seen a growing number of firms test out an advisory council structure, which creates a shared sense of ownership for governing and sustaining the firm while allowing the founder to glean more insight on the strengths of potential leaders. This sort of group dynamic is unfamiliar territory for most firms, and it will take time for firm members to understand and leverage the value it can bring to succession planning.

All such structural experiments also try to accelerate the leadership potential of investment professionals or operating partners. To effectively lead the firm, individuals must have the trust of and develop followership among others in the organization, including their current peers, as well as a proven track record of realized returns. This challenge is heightened in investment firms because the founder often has such a dominant presence. As one founder/CEO told us about his potential successors, "I can give them roles and titles, but if no one is going to follow them, they and the firm are going to fail."

This issue is compounded because investment firms are even less likely than other kinds of companies to bring in external talent for the CEO or investment leadership role, for reasons including the high level of trust required; most founder-led firms also have strong, idiosyncratic cultures that can be hard for outsiders to learn, let alone lead. So, typically, being able to select a leader or leaders from within is imperative for succession to be a viable option.

There will likely not be any one-size-fits-all model for the transition. As founders and their advisors assess their options, important leadership questions to ask include the following:

- **Do I have a potential successor? Is it one person or a team?**
- **Have these successors demonstrated leadership beyond raising funds or producing superior returns?**
- **What development do succession candidates need to be ready for the top job, and how can I accelerate their readiness?**
- **Are these candidates prepared to be the public face of the firm?**
- **What role in the firm, if any, will I have following retirement?**

Purpose

Purpose is at the core of any organization's activity. Recent work by Heidrick & Struggles demonstrates that people at organizations that have a strong, clear purpose assess their organization's performance as twice as strong as do people at organizations where purpose is less clearly defined and integrated.[2]

The purpose of a private investment firm seems, at first glance, to be simple: to produce superior returns for their investors. But how? The founders of each of these firms started with a point of view on where their firm would invest and how potential investments would be evaluated. As founders look to establish a succession process, they must define—and articulate—their firm's purpose which, over time, will guide the scale of its portfolio and global ambition.

Codifying purpose begins with clarifying the founder's values: what they were at the firm's outset, what they are now, and what they must become to carry the firm forward. More than CEOs of large public companies, founder/CEOs of investment firms who are now approaching retirement have typically had decades to define their firm's purpose, even if they have not stated it to the outside world. Purpose can change with succession, but firms that lack any alignment around purpose are far more likely to veer off course after the founder retires.

Today, defining and articulating a unique purpose has an added benefit. Being part of a business that has a clear purpose is valued far more by the generation now entering the workforce than it has been in the past. Firms that clearly articulate their purpose increase their ability to attract and retain early-career talent.

Founders anticipating a transition should start by asking themselves the following questions:

- **What is the purpose of this firm beyond producing superior returns and realizing my own goals?**
- **Who will have a voice in determining our purpose in the future?**
- **Do our investment decisions reflect social or other considerations beyond striving for superior returns?**
- **Do we, as a firm, have responsibilities to a broader group of stakeholders, and if so, what are those responsibilities?**
- **Which potential successors have perspectives on these questions that will help the firm grow? How do their principles resonate with—and vary from—mine?**

2 Alice Breeden, Becky Hogan, and TA Mitchell, "Bringing your organization up to speed," Heidrick & Struggles, September 12, 2019, heidrick.com.

Culture

In our examination of limited partners' views last year, several cited firm culture as a key factor in their investment decisions.[3] Cultural considerations include how current members of a firm work together; how the firm defines itself to junior recruits, thinks about diversity, and executes on it; and how the firm's culture is reflected in its portfolio companies. That concern, other work by our firm suggests, is well placed. Companies that pay attention to building a winning culture consistently outperform their competitors.[4]

Many investment firms have begun to codify their culture. Succession planning creates the opportunity to consider further ways to quantify it. As they contemplate how their firm will maintain or improve results after they retire, founders need to reflect on which aspects of their culture accelerate performance and which may act to derail performance.

To understand the current role of their firm's culture and the culture they want to leave behind, founders should ask themselves questions such as the following:

- **Does the way we engage with each other maximize our investment decisions?**
- **Does our environment encourage productive disagreement to ensure our choices are fully aligned with our risk/reward objectives?**
- **How do we want our people to treat each other day in and day out?**
- **What is our investor relations philosophy, and how do we want to engage with limited partners?**
- **How do we currently develop our people, and how do we want to do so going forward?**

3 Will Moynahan and Tom Thackeray, "Private equity: What do limited partners think of the talent within general partners?" Heidrick & Struggles, October 11, 2018, heidrick.com.

4 Larry Senn and Jim Hart, *Winning Teams, Winning Cultures,* Huntington Beach, CA: Senn-Delaney Leadership Consulting Group, 2010.

Governance

With the exception of those that have gone public, founder-led investment firms typically do not have a board of directors. Power tends to be centralized, if not in one individual—the founder/CEO—then in co-founders or managing partners. That means individuals being considered for succession must show that they can flex the right muscles to make and stand by difficult decisions independent of the founder. It also means there is no one to tell founders that it is time for them to begin preparing the firm for the time they will no longer be part of it. And it means founders are heavily reliant on their own judgment to determine who, if anyone, in the firm can succeed them.

A good governance practice is for founders to review succession every year, whether their retirement is imminent or not. Leadership transitions, after all, can happen for reasons other than retirement.

Key governance questions for founders to consider include the following:

- **How will decisions about the firm and investments be made after the founder retires?**
- **How will conflicts be resolved?**
- **Does the structure need to be changed to better disperse decision making and to reflect the reality that the firm may not have the talent to manage as well after the founder retires?**
- **Where will the firm's future leaders look for the wisdom and guidance that the founder has historically provided?**

Succeeding with succession

The transition within an investment firm from the founder to one or more future leaders is fraught with risk. Many firms that were previously very successful have faltered at the moment of succession. Those founders who proactively prepare for their exit, starting by asking themselves the right questions, will leave their firms better positioned to sustain their vision, aspirations, and performance expectations over time.

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