Generational Transitions at VC Firms « Top Tier Capital Partners Blog

7-9 minutes

There are right ways and wrong ways to handle generational transitions at venture capital firms. This concept is most often associated with family businesses, which inevitably are required to pass the leadership reigns if they expect to maintain family control through time. If done correctly at a VC firm, the plan will enable a smooth and natural change of guard that can give confidence to investors that the firm is being built as a lasting franchise. If done incorrectly, investors will lose confidence in the stability of the platform.

We will focus on intentional changes, but we acknowledge that some generational transitions are voluntary, such as self-imposed change in the form of mandatory retirement age, and some are involuntary, driven by internal conflicts.

Preparing for the first generational transition is always the most difficult as there is no framework set up, but the discussions will be most productive if both parties enter into negotiations with a mindset of fairness and respect. In our experience, having a culture from inception that embraces step-ups and step-downs as careers naturally progress as well as integrating the concept that leaders eventually will pass on the firm can take the emotion out of the changing of the guard.

Since venture capital is a mentorship model, experiences generally are passed on from senior to junior team members in the form of double-teaming on meetings and activities, such as board meetings, investor meetings and company or fund manager pitches. Learning takes place as individuals become more exposed to how the business works, the questions to ask and how to offer advice and conduct oneself in a value-added way that is in line with the culture of the firm. At Top Tier, we talk a lot about pattern recognition, which is definitely what long-term industry participants have and what people coming up in their career are working to obtain. Therefore, the exchange of knowledge and expertise will happen in a mentorship model. However, firms must purposefully construct multi-generational teams so that individuals can build business relationships with their peers. In a perfect world, the generational relationships mature in such a way that the next generations are moving up to lead their firms in a similar timeframe.

The details will vary, but the issues to consider are similar amongst all firms. If methodology doesn't already exist, engaging legal counsel for both parties is important to ensure reasonable commercial terms that will offer protection for both the business and the individual. It is imperative to clearly define and agree upon the appropriate communication both internally and externally and what is expected of each party in the future.

The venture capital industry is still relatively young in Europe and China with carry just starting to be paid out, and as a result, there have not been many successful generational transitions to learn from. Instead, we've seen a number of spin-outs of junior partners who have not been willing to wait around for the generational transitions to take place, especially in China. Therefore, most of our learnings are based upon experiences with US VC firms.

Two of the most obvious questions to answer when undergoing generational transitions are <u>when</u> to start and <u>how</u> to implement a generational transition plan. In our view, **a plan should be in place one fund cycle before a generational transition takes place.** For example, if senior leaders or founders are reducing their activities in Fund VI, this should be communicated when raising Fund V. In that way, investors in the fund will have an entire fund cycle to evaluate the change and the firm will have a fund cycle to absorb the changes.

It is of utmost importance that the go-forward **roles and responsibilities** of the person reducing their time and the **economics,** on both a current and go-forward basis, be agreed upon between both parties. Firms that are well prepared for generational transitions have a plan in place and spend a lot of time and effort building a pipeline of "partner-ready" individuals who can step up when the time comes. How the

LPs and others perceive these changes is of utmost importance and should be communicated with a clear and consistent message. Areas that must be addressed include:

- Time commitment (days per week spent on firm business and years of additional service):
  - Many senior partners and founders move on to advisory or emeritus roles versus cutting ties to the firm altogether, but there are many variations that can occur.
- Clearly defined roles (investment team, investment committee, firm business and fundraising)
- Deliverables:
  - Investment responsibilities – company boards and managing current investments to liquidity
  - Mentorship – ongoing mentorship of team
  - Firm ambassadorship – representation going forward such as speaking engagements, interviews and social media presence
  - Transfer of relationships – entrepreneurs, investors and service providers

Importantly, there should be a clearly defined process for measuring how things are progressing, which can be done in the form of OKRs and tied to future compensation. Which leads us to the very important, and often sensitive, topic of economics.

- Carry: This is how wealth is generated at most VC firms. Carry should be reduced proportionately with the level of investment activity in the new funds. Historical carry should not be affected.
- Ownership: VC firms generally are not built to create value at the management company level nor do they expect to exit through an IPO or M&A transaction; instead firm ownership is often commensurate with the share of annual payouts (bonus, excess fees).
- Compensation: A reasonable level of compensation is appropriate if there is continued business activity as a representative of the firm. Management fee income is generated over a 10+ year timeframe, and if the person is a key person in a fund, their portion of the income stream from that fund should continue. At many VC firms, a person's carry percentage also drives their share of income distributions.
- Benefits: The most important benefit (at least in the US) is ongoing healthcare coverage, but additional negotiated benefits may include the continued use of an office and firm resources.
- Outside activities: Since it is highly unlikely that long-term industry participants exit the business fully, the ability to make investments (angel or otherwise) or generate income (sit on outside boards) that is not in conflict with the firm's activities will be an important topic to negotiate. This may include an obligation to show all relevant deals to the firm before investing personally. In addition, it might be necessary to agree upon a track record that he or she can use in the future.

Lastly, we'd be remiss if we didn't mention reputational risk, which is important to both the firm and the individual. Services businesses, like VC firms, are built upon the reputations of their people; we all know that a reputation takes a very long time to build, but can be destroyed in an instant. Firms that undergo successful, multi-generational transitions will have individuals that have experienced both a step-up and a step-down in their roles and economics, and having an empathetic point of view of the process is imperative. We strongly believe that developing a thoughtful generational transition strategy can be the golden ticket for creating a lasting institution.