STREET SMARTS: HOW TO GROW IN A SOFT ECONOMY

# Inc.

THE MAGAZINE FOR GROWING COMPANIES

inside



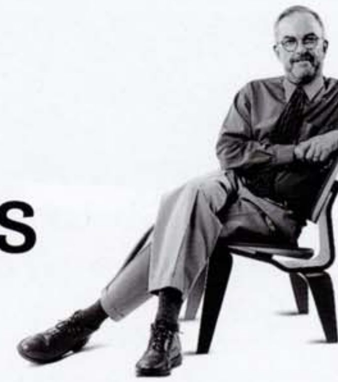
>THE INSIDER'S GUIDE TO MANAGEMENT BUYOUTS<

# BUYOUT YOUR BOSS

Valuations are down, and investors are still looking for companies with skilled management. There's never been a better time to buy the business you work for

# The message behind the buyouts

*by George Gendron*



CONSIDERING THAT IT'S BEEN less than a year since the sale of *Inc.* by its founder, I'd be lying if I told you that the subject of this month's cover story—management buyouts—isn't near and dear to my heart. But under the circumstances, that's probably all I should say.

In any case, I couldn't help noticing an advance copy of a book called *Buyout: The Insider's Guide to Buying Your Own Company* on my desk a few months ago. As it happened, I was heading out of town that day and needed something to read on the plane.

**The conditions for management buyouts have never been more favorable than they are today**

I doubt that many people would find such a book ideal for airplane reading, but I was enthralled by it. The author, buyout expert Rick Rickertsen, writes in clear, authoritative prose and—unlike most deal makers—has the ability to demystify his area of expertise to people outside the world of investment banking. I called him as soon as I landed and expressed my interest in teaming him up with one of our writers to do an article for *Inc.* He liked the idea. As we spoke I pointed out that while his book is directed at managers of large corporations whose founders have long since left, most *Inc.* readers are owners or top managers of companies at which the founder is still present.

"That changes everything," Rickertsen said.

"Right," I said, "and we'll want to focus on those types of situations."

The result is the article by Paul B. Brown, "Buyout," beginning on page 40. In it Brown and Rickertsen make a compelling argument that the conditions for management buyouts have never been more favorable than they are today. Valuations are down; despite the turbulence of capital markets, there's plenty of investment capital available; and skilled, experienced managers are in short supply.

And yet I am most struck by Rickertsen's observation that buyout firms like his would be out of business if American companies just figured out how to harness the power of equity in compensating senior management.

PHOTOGRAPH: FURNALD/GRAY

## Brodsky's timing

AS NORM BRODSKY REMINDS us, there are no bad predictions, only bad timing. After all, he's the guy who told us first in 1996, then again in 1999, that a recession was on the way.

It looks now as though his prediction may finally be fulfilled, although we won't know for sure until a recession is already upon us. Meanwhile, those of you who heeded Brodsky's advice back in January 1999 (see "How to Profit in the Coming Recession") are glad you did. "Your crystal-ball insights are coming about sooner rather than later," one reader wrote in a recent E-mail message to the columnist, "and I'm thankful that I took your preemptive thought processes to heart. At the time, my management team all got copies of the article. We collectively pulled our heads out of the sand. What-ifs were discussed, and we began taking the pulse of the industry differently. We were able to hone our observation skills, in turn enhancing our preparations for what we are facing today. Just wanted to say thanks."

If you didn't take Brodsky's advice back then, you have another chance this month, as the veteran entrepreneur weighs in with a timely but counterintuitive column on dealing with economic downturns. There are certain areas of your business, he argues, in which it now pays to be more aggressive than ever. ■

Photographs by Furnald/Gray


# BUY

Valuations are down, investment capital is abundant, and skilled, seasoned managers are scarce. There's never been a better time to buy the business you work for *by* PAUL B. BROWN

# OUT

**SUPPOSE, FOR A MINUTE, THAT RICK RICKERTSEN** is right. ■ Sure, he has an agenda. He's a partner at a private-equity investment firm, and he makes his money by keeping a steady flow of deals coming his way. Every management buyout Rickertsen's firm invests in yields up to 1% of the sale price up front plus an ongoing management fee that can top $150,000 a year. In addition, the firm earns an expected annualized return of 30% to 35% on its stake in the business when the company eventually gets resold three to five years down the line. So Rickertsen wants deal flow. Heck, he readily admits that's one of the reasons he wrote *Buyout: The Insider's Guide to Buying Your Own Company,* recently published by Amacom. He'd probably be happy if you were to read the book and give his firm a call. (Rickertsen is chief operating officer of Thayer Capital Partners, in Washington, D.C.) So when it comes to whether or not managers buy their companies, he's far from neutral. ■ Still, Rickertsen's self-interest doesn't prevent him from being a good guide to the buyout marketplace. He certainly has the credentials: Stanford University undergrad, Harvard Business School, and a stint at Morgan Stanley. And he has the experience. He's led more than 50 management buyouts. Plus, he's even spent some time with early-stage venture-capital firms and has been chairman of several companies in Thayer Capital's portfolio. He's looked at deals from all kinds of perspectives.

So suppose Rickertsen is right. Suppose there really never has been a better time to buy the company you work for. Should you do it?

Rickertsen certainly thinks the timing's right. Here's why.

■ **There is a huge amount of money available to help you finance your purchase.** Spurred by the stellar returns of early buyout firms, the money people on Wall Street have been rushing for much of the past decade to create buyout funds. Back in 1989 there were half a dozen buyout funds that had $1 billion or more to invest. A decade later there were nearly 40, says Rickertsen. He estimates that today there are about 500 buyout firms with a total of $150 billion to invest. The main goal in life of these firms is to back management teams that want to do buyouts. And when you figure that banks will lend at least $2 for every $1 of equity that is put into a deal, that means there is nearly $300 billion out there waiting for you. (For a step-by-step look at how the buyout process works, see "Buyouts by the Numbers," on page 47.) Not even the Nasdaq crash has hurt the pot, since the two main consequences of the decline have tended to cancel each other out. Yes, the big institutions that put money into buyout funds may have less to invest because of damaged portfolios, but the reduced investment appeal of publicly traded companies has prompted those same institutions to consider investing their resources elsewhere—which is to say, possibly on you.

The message Rickertsen wants you to take away from all this: it has never been easier to find money for this type of deal.

■ **Investors need you.** While money isn't a problem, Rickertsen contends that finding management talent is. There are just not enough senior managers to run all the companies that could be funded by private-equity deals. Thus, the laws of supply and demand come to the fore. Before management-buyout (MBO) funds became all the rage, managers who were involved in the buyout of the company they worked for might have ended up with a 10% equity interest in the business. Today 17% is the norm, and the figure can go as high as 22%, depending on how much work you're willing to do up front before the deal is done. So, says Rickertsen, from the perspective of the would-be management team, the deals are as good as they've ever been.

■ **Prices are falling.** The Nasdaq's troubles and the looming recession may not have diminished the money available for buyout deals, but they have slashed the prices people are willing to pay for businesses. You, the salaried manager, may be willing to overpay for the chance to run your own company, but the buyout firms are not. Paying less makes it easier for them to generate the returns they require. Every deal is different, but Rickertsen says that this general observation is true: before the slowdown, companies were selling at 7 to 7.5 times cash flow. Today they're going for multiples of 6 to 6.5.

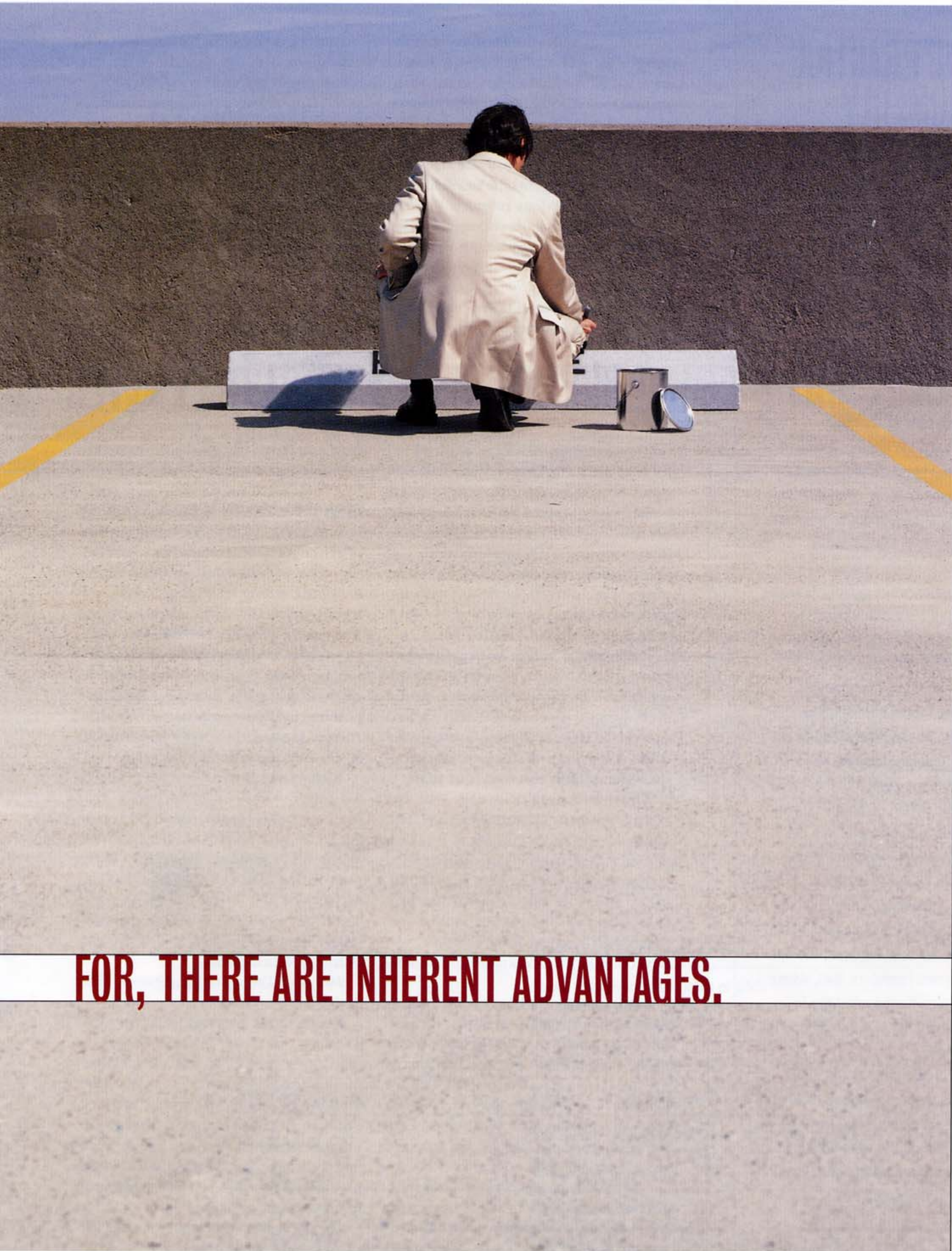
The upshot of all those factors is that it's a terrific time to buy. Lower prices mean that not only will buyers have to pay less, but they won't have to borrow as much. If Rickertsen's valuation numbers are right, the amount of debt needed to finance a buyout is about 20% less than it was a year ago.

Of course, there are the inherent advantages you bring to the table if you're buying the company you already work for. You know the business, so there is no learning curve. Better, you know what fat can be chopped with a minimum amount of pain. In an in-house deal, secrecy is more assured. The owner may not want it known that he or she is shopping the company, and selling to managers makes it less likely that the news will slip out. And, finally, you can do the deal in less time than an outsider could—four months would not be out of the question.

So the case for buying is compelling. But so are the potential problems—for both you and the company you are acquiring.

*(Continued)*

# IF YOU BUY THE COMPANY YOU WORK



# FOR, THERE ARE INHERENT ADVANTAGES.

# THE PRACTICE FORMERLY KNOWN AS ...

*Management* buyout?

If you're thinking that the process used to be described as a *leveraged* buyout (LBO), you're absolutely right.

Before we talk about why the name changed, let's first make sure we all agree about what we are talking about.

Here's the way Rick Rickertsen of Thayer Capital describes this type of deal: "Management buyouts (MBOs) are acquisitions of operating companies or corporate units in which the current or future senior management of the business participates as a significant equity partner in the acquisition."

As for the name change, blame Michael Milken. The term *LBO* has fallen from favor in an attempt to make people forget the excesses of the 1980s, when corporate raiders floated junk bonds to buy out companies—a concept that Milken honed to perfection at Drexel Burnham Lambert—and greedy financial types got a bad name for showing up at the aptly named Predators' Ball, where the raiders celebrated the fleecing of all they had come in contact with.

As Rickertsen writes in his book, *Buyout: The Insider's Guide to Buying Your Own Company,* "The term *LBO* is no longer used in the industry, or in polite company."

Let's start with you. Despite what the money people will tell you, you will have to jump through a significant number of hoops before you will be able to get the funding you need. The buyout firm will examine your track record to see if you and the deal you want to do are a good fit. You'll have to have profit-and-loss responsibility, a tangible record of success, and a decade of experience before someone from the buyout firm will be willing to return your call.

Equally important, buyers can't overreach. "If you had been running a $20-million company before, you shouldn't look at anything larger than $40 million," says Rickertsen. "Anything smaller is always going to be fine." And buyers need industry experience. If you've been running a finance division, you aren't going to be able to buy a retailer, unless you bring in someone with significant retail experience as part of the deal.

Of course, if you're buying the company you work for, you probably already have the right experience. And if everything works out, you'll likely end up with a 10% to 20% interest in the deal, consisting of stock or stock options that usually vest over four years.

The question, of course, is, Will that equity be worth anything to you? The company you're about to lead is taking on potentially crushing debt. And you're trading your current boss for another one—the buyout firm that provided you with the money. And if you think your current boss is tough, you haven't met an unhappy equity partner.

Many managers have never had to meet with a board of directors, Rickertsen says. When they participate in an MBO, they have to get used to board meetings—and to the fact that there won't be a lot of room for error. "If you miss your plan by 20% for two consecutive quarters, we are going to have some very hard discussions," Rickertsen says with classic understatement. You serve at the behest of the board, he explains. "They normally can fire you anytime."

And, of course, the buyout firm controls the board. "At the end of the day, it's all about the numbers," Rickertsen says. "The buyout guys like me are fiduciaries; we're pension-fund fiduciaries investing for sophisticated institutions, and we've got a job to do on behalf of those institutions. We need to do the best we can with their money."

Rickertsen says firms like his are willing to work with you when things are bad. But you need to know going in where their loyalties lie.

OK, but a 10% or 20% interest in your current company is a lot more than you have now. And you're used to pressure, right?

# IF YOU'RE NOT TALKING TURKEY AFTER

### When the company is the boss's baby

IF YOU STILL THINK YOU'RE THE KIND of manager who's ready for an MBO, then consider the last variable: who's doing the selling. Things get a little different when the owner is a founder, Rickertsen says. To explore those differences in depth, we talked to Rickertsen specifically about what happens when a company's creator sells the business to his own managers.

***Inc.*:** How different is it doing an MBO when the seller is a founder?

**Rickertsen:** Very. If you're a potential buyer, you need to recognize that the boss holds all the cards. So you've got to be very careful. At best, as soon as there's a whiff of disloyalty, you've put yourself into a penalty box that you may not be able to get out of. At worst, you'll get fired the moment the boss learns something is up. That's the risk of trying to bring it up.

***Inc.*:** So if I'm a potential buyer, what do I do?

**Rickertsen:** You have two options. The first, which may or may not work, is to plant the seed early. You tell the entrepreneur casually that if he or she is ever thinking of selling, you would be interested in buying. That way the owner won't be shocked later on. In the interim, you make yourself as important as possible. That way you increase your leverage over time.

***Inc.*:** How does an owner react to the planting of a seed?

**Rickertsen:** An owner might say something like "Well, I'm not a seller now. Let's just keep building the business." But sometimes the response is: "At this point in my career, I don't want to sell, and if you want to get on the team, get on the team. If you don't want to be on the team, get off the team. I just can't have a buyout clouding our strategy."

***Inc.*:** Is there a way around that?

**Rickertsen:** Yes. You don't make the approach yourself. You find a buyout firm to make the call to see if the owner wants to sell. Owners get calls like that all the time. That way it's much easier. There's no question about your loyalty, because the owner doesn't know—or isn't sure—it's coming from you.

***Inc.*:** Is there any way of telling how an owner might react when that call comes from "out of the blue"?

**Rickertsen:** Sort of. Owners are always in one of three places: They're not sellers under any circumstance right now; that's where most of them are. Or they're tire kickers. They'll talk to everybody who wants to buy their company, but they still really are not sellers. They just like taking meetings and getting a handle on what the business is worth. There are lots of tire kickers. And then there are real sellers. One of the most interesting things about being a buyout person is figuring out who is a tire kicker and who's serious, because you can waste colossal man-years on tire kickers.

***Inc.*:** Is there a tip-off?

**Rickertsen:** If you're not talking real turkey after three meetings, give up. You have to give them that long for a couple of reasons. First, you almost never talk money right away, and second, for founders, the company is their baby. It's their whole life. It is never easy for them to sell, even if you offer them a screamingly high price. So you're never going to get very far until the third meeting. But if after the third meeting they're not ready to show you their financials, you only have a tire kicker.

***Inc.*:** OK, suppose he's a serious seller, and he learns that the management team—*his* management team—is the potential buyer. How does everyone deal with the inherent conflicts, especially about valuation and about how the company will be run during the negotiations?

**Rickertsen:** Let's take the owner's position first. There are a lot of potential problems. Not only does he probably want the highest price while the buyers want to pay the lowest, but the buyers—his managers—are in a position to truly hurt the company. They can harm the business if they don't stay. They can sabotage relationships. There have been situations where the manager-buyers intentionally didn't perform as well, in order to get the price down. So you as the manager have an obligation to your employer to behave well.

I think the two best ways to mitigate those conflicts are: Number one, just put them on the table. Talk about them. The second way is for the seller to bring in a professional to make sure the sale is managed fairly. Part of that means finding out if there are other potential buyers. The owner may have no intention of selling to anyone else, but it keeps the management team honest and on track. If the managers are the only potential buyers, and if they turn out to be bad actors, they may hold an owner hostage. They can threaten—directly or otherwise—to do all kinds of damage if their price isn't met.

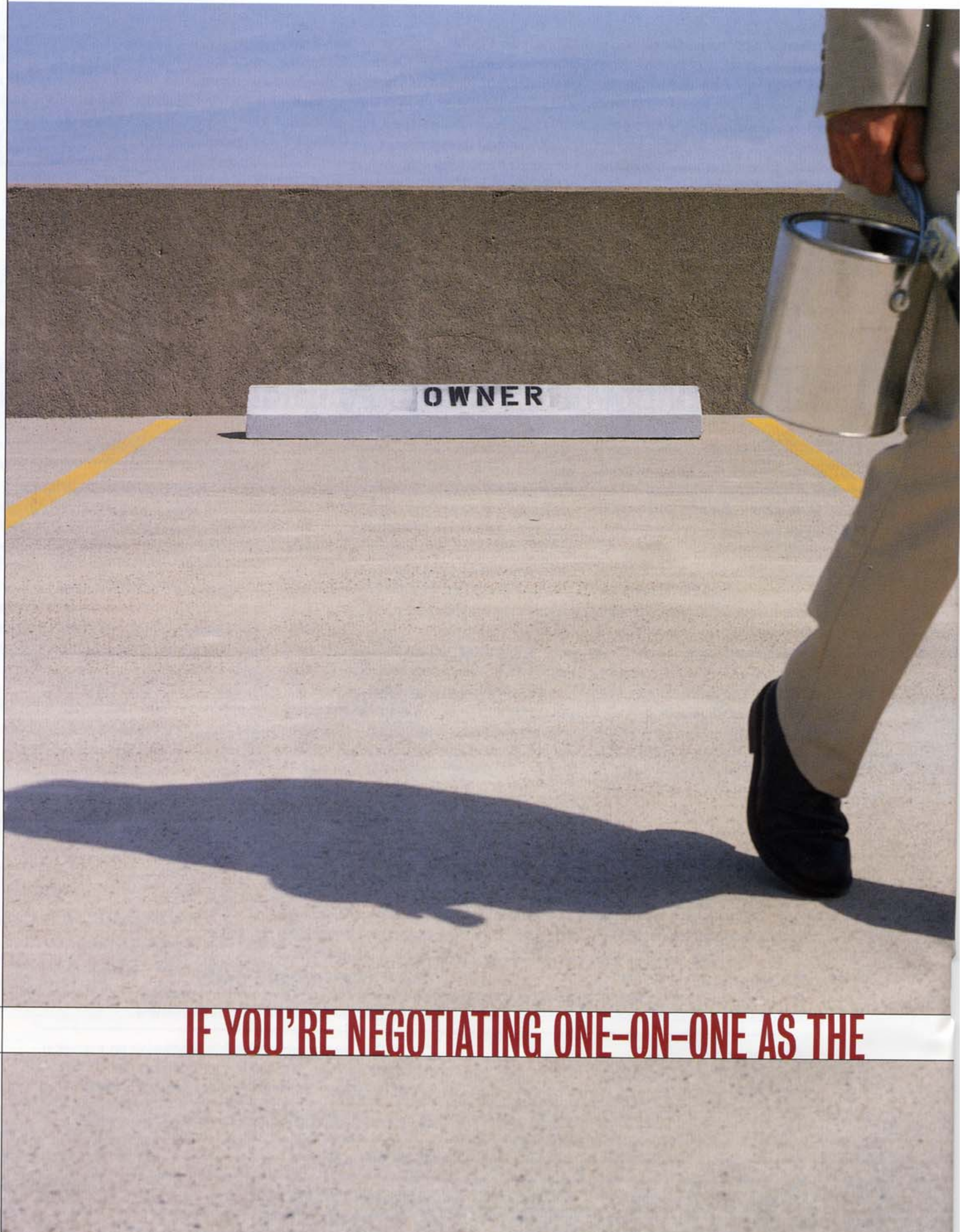
That's why as a founder you hire someone to run the process for you, and you start talking to other potential

## THREE MEETINGS, GIVE UP. YOU ONLY HAVE A TIRE KICKER.

## SAY WHAT?

Here are some terms that buyout firms frequently use and translations of what those terms actually mean, according to Rick Rickertsen.

| WHAT THE BUYOUT FIRM SAYS | WHAT THE BUYOUT FIRM MEANS |
|---|---|
| Basically on plan | There is a revenue shortfall of 25% |
| Considerably ahead of plan | We hit plan in one of the last three months |
| Entrepreneurial CEO | The CEO is totally uncontrollable, bordering on maniacal |
| Ingredients are there | Given two years, we might find a workable strategy |
| Long selling cycle | We haven't found a customer who likes the product |
| Niche strategy | Small-time player |
| Turnaround opportunity | Lost cause |
| We're working closely with management | We talk to them on the phone once a month |




# IF YOU'RE NEGOTIATING ONE-ON-ONE AS THE

buyers even if your goal is to sell to management. The move puts the management team on notice that if they get too far off the reservation, the company is going to get sold to some other strategic party and they may lose their jobs.

If you are negotiating one-on-one as the owner, the risks are too great. There's the price conflict, the employee-performance conflict, and the employee risk in general. Your risks as a founder are too great, because you're turning too much leverage over to your employees. That's why I'm a big advocate of having a real process.

***Inc.:*** I understand the idea of bringing in other potential bidders, but how receptive are owners to turning over control of the process to someone else, especially when it comes to valuation?

**Rickertsen:** Not very. Some 90% of the owners in this country begin with the position "My company is the best company in the world. And despite what the comparables show, my company should sell at twice the industry norm." Entrepreneurs who live in that world—and stay in that world—don't ever get their companies sold. I understand their position. They built the company from scratch. It's their baby, and no parents have ever thought they had an average baby, let alone an ugly one.

Still, the entrepreneur needs some level of objectivity, and that's where the professional comes in. If you ever do want to get your company sold, you need to acknowledge that there is a market determining what companies trade for. If you don't, then you can't complain that you can't sell your company.

***Inc.:*** What do I do as a manager-buyer if it looks as if the owner may actually sell to another company?

**Rickertsen:** If it's all about price, strategic buyers always win, period. They can always take out costs from a seller's owner on what you can do for the company and what continuity will do for the company and for the employees. You should be as aggressive on price as you can. But at the end of the day, if a strategic buyer wants it, you're just not going to own it.

***Inc.:*** Do owners want to sell to management?

**Rickertsen:** A lot of them are inclined to do it to preserve their legacy. They like the idea that the company will continue as is. It can be a very satisfying way to exit.

***Inc.:*** How often do owners give the management team a break on price? Even if they want to, don't they always have family members and advisers telling them to go for the highest possible payoff?

**Rickertsen:** Obviously, it's the owner's call. The owner has lived with those people [the management team], and the advisers haven't. If the owner wants to do a deal at the low end of the market to sell the company to the employees, then that's a great thing for the employees. But again, the owner needs to know what the company is worth. As an owner, you hire a professional who comes in, runs the comparables, and says, "Companies like yours trade at 1.5 to 2 times revenue. And that makes your business worth between $7.5 million and $10 million." If you wanted to sell the company to your employees for $7.5 million, that would be supportable, and it would be good for the employees.

If you go that route, you keep the continuity and all those soft feelings that we talked about before, and the company doesn't get absorbed into some massive bureaucracy. But you want to make sure your employees can get this done; don't even think about selling the company to them unless you believe they can get it done. So you help them.

**OWNER, THE RISKS ARE TOO GREAT.**

income statement, which means they can show more profit, which means they can pay a higher price. In that situation, the management team is always going to lose.

***Inc.:*** I've got no shot?

**Rickertsen:** You should compete with the outside buyer. You should sell the You introduce them to three buyout firms, and you give them a six-week lead before entertaining other offers.

That way you've created a good dynamic, because you've given your employees a proprietary shot. But they're on notice that if they screw it up and the deal doesn't get done, the company gets

## BUYOUTS BY THE NUMBERS

### A step-by-step primer on how a management buyout is done

There's no such thing as a typical deal, but here's how most management buyouts (MBOs) should work, according to buyout veteran Rick Rickertsen. (Note: What follows is a "straight vanilla" deal. There are infinite variations, including ESOPs—employee stock ownership plans.)

**STEP 1** **Be confident.** "You can't have any doubts," says Rickertsen. "If you have doubts about embarking on a buyout, you just shouldn't do it."

*What can go wrong during Step 1?* The flip side to not wanting a deal enough is wanting it too much. If, say, you're willing to pay too high a price or want to buy something that's twice as large as anything you've ever run, you won't get funding.

**STEP 2** **Find or create an opportunity.** Identify how the company can make more money.

*What can go wrong during Step 2?* You can look too far afield. If you're working for a manufacturing company and you're thinking of buying one of the companies that sells your product, "that is going off-spec," Rickertsen says. "Retail is a different business."

**STEP 3** **Develop a sound business plan.** "You want to be aggressive," Rickertsen says. But you also have to develop a plan that's achievable and credible. If your industry is growing at 7% a year, *(Continued on page 48)*

(Continued from page 47) say, and you claim that you're going to increase your sales by 30%, you're telling the world that you're planning to take market share away from other companies—"and that is very difficult," says Rickertsen.

How you structure the business plan is crucial. Rickertsen's tips:

• The executive summary is key. You always suspected that if you didn't hook people on page one, you were doomed. You were right.

• Research is key, too. Your description of the market needs to be better than any other summary that investors can find on their own.

• Don't exaggerate. Never say you have little or no competition. Says Rickertsen: "The phrase means that either you're too dumb to recognize that you have competitors, or you believe the investor who's reading the business plan is too dumb to know better."

*What can go wrong during Step 3?* A buyout firm is going to hold you to your forecast. As Rickertsen puts it, "If you don't make plan, you're toast."

**STEP 4 Strike an agreement with the seller.** In most cases, you want to avoid doing the negotiations yourself, Rickertsen says, since the process can be very emotionally charged. It's always helpful to have a "bad guy" around, like an accountant or a lawyer, who can negotiate on your behalf.

As for what you offer in the deal, Rickertsen has some interesting thoughts:

"You come in one dollar above insulting. Everyone has to negotiate," he says.

"When I started out in the buyout business, [I figured it would go like this]: 'You want to sell me your company? Here's my deal: $7 million. If you don't want to do that, forget it.' I don't like to haggle.

"What I learned is that everyone wants to negotiate. Everyone wants to win something. So you always come in lower than where you want to end up," he says. Say that a company is up for sale and the owner gets comparables indicating that it could go for anywhere between $7 million and $10 million. The investor offers between $6 million and $9 million. "I would probably come in at $6,375,000, for two reasons. One, because it's not insulting. And two, because it looks scientific," he says.

*What can go wrong during Step 4?* The parties involved in the deal can let their emotions carry the day. For instance, the owner could hear the comparables and say something like "Hogwash. Those may be other companies, but mine is special." The potential buyers, on the other hand, sometimes become so smitten with the thought of buying the company that they're willing to pay too high a price.

**STEP 5 Strike a deal with an equity investor.** If the deal closes, the cost of doing the MBO—including the accounting and legal fees and the money paid to the buyout firm and banks—usually comes to 3% to 5% of the sale price, which is added on top. That means that in a $50-million MBO you have an additional $1.5 million to $2.5 million to pay off. (If the deal falls through, the buyout firm traditionally eats most of the costs.) Plus, in a deal of that size, the buyout firm might take a $150,000-a-year management fee.

What would the buyer and new CEO get? Fifteen percent of the company is the middle of the range these days, and it could come in the form of stock or stock options that usually vest over four years. Managers could get a bigger piece if they put up some of their own money. Buyout firms like Rickertsen's generally insist that they do.

(Continued on page 50)

sold to somebody else. It creates consternation in the organization on one hand, but on the other you've given them a proprietary shot. That's fair.

***Inc.*:** Does that happen a lot?

**Rickertsen:** It's one way it happens. The other is that the owner basically says: "Look, I built this business. I own all the equity. I deserve the biggest payday possible." And really, the best way to get the biggest payday is to conduct an auction.

If it goes that route, two things can happen. Option one: there is an auction, and the employees never get involved because the owner is worried about all those conflicts we talked about before. But if the founders don't let the managers bid, they almost always pay a bonus to the employees from the proceeds when the company gets sold. The number depends on the size of the company, but it usually works out to be about 5% for sales up to $20 million, a lesser percentage as the price tag goes up. By doing that, owners keep everybody on the reservation while they're going through a tough process. It's not only nice; it's smart business.

The second option is, the owner sells the business through a process but gives the employees an equal—not a proprietary—shot, and they run around and try to make a deal happen. In those circumstances, what I've often seen is that if the employees show up with an offer that's within 10% of the high bid, the owner will often sell them the company. If they're much more than 10% lower than the high bidder, they usually don't get it.

***Inc.*:** One reason owners might sell to their managers at a discount is that they don't want to sell to some real or imagined enemy, right?

**Rickertsen:** Absolutely. But there is a flip side to that. The owner says: "I've run this business for 20 years, and I've done OK. I sell it to my employees. It does three times as well as OK. The only variable is, I'm not running the business. I don't think I want to be in that position." All parents want their children to do better than they have. And then when they do, the parents feel really uncomfortable.

It can happen. The way to protect yourself [as the owner] is to ask for "home-run warrants." You sell the company to your team, and say: "Look, I'm selling you this thing for $7.5 million. I want you to be successful. But I want a

(Continued from page 48)

"It's really important for me that you have some skin in the game. It doesn't have to be a ton, but it has to be something that's meaningful to you," says Rickertsen. "Some managers can cut a check for $250,000 to $500,000. For managers who don't have a lot of liquidity, we ask them for $15,000. Some buyout firms like it to hurt. They want you to be very leveraged and very focused. We don't believe that's the right answer, because managers may be prone to taking short-term draconian actions that may impact the company longer term. But I want you to write a check, to show that you're there alongside me."

*What can go wrong during Step 5?* Even after writing the check, you'll have a minority interest in the company. The board, which will be handpicked by the buyout firm, will control everything, from the decision about when the company will be sold—within three to five years—to whether you'll keep your job.

Buyers need to think of the deal they make with their equity partners as a marriage, and they need to be candid with one another up front, Rickertsen says. If your equity partners don't tell you up front what the conditions are under which they might make a management change, ask them. There probably won't be a lot of negotiating room there, but you can do some things to protect yourself. Rickertsen suggests being very specific by saying something like "If you fire me in the first year, 25% of my equity should vest." And a year's salary as severance is not out of the question.

As part of such discussions, spend a lot of time on exit strategies. The buyout firm will want to be out of your business within five years, but you may not want to be. If you pick the wrong buyout firm, you can be in for a lot of unpleasant surprises. Don't shortchange this step.

**STEP 6** **Arrange bank financing.** From the buyer's viewpoint, this is the easiest part of the process. You don't do anything. The buyout firm has a list of banks it works with, and it does the deal.

*What can go wrong during Step 6?* "There's a real credit crunch going on," Rickertsen says. "The banks have been burned in some large buyouts. They lost a lot of money in the telecom and dot-com worlds. So banks have been pulling back aggressively since about October. Today you can only borrow 2.5 to 3 times cash flow. Before the crunch, you could have gotten 4 or 4.5. That means you have to be tougher on price, and your partners need to be prepared to put in more equity."

**STEP 7** **Complete the due diligence.**

*What can go wrong during Step 7?* Contracts with key customers that you thought were bulletproof aren't. There are expenses that haven't been accrued. You might find litigation bombshells.

**STEP 8** **Close the deal.**

*What can go wrong during Step 8?* Says Rickertsen: "In 30% to 40% of cases, you have an 11th-hour heart attack."

**STEP 9** **Build the company.**

*What can go wrong during Step 9?* In the venture-capital world, out of every 10 deals, "2 are screaming home runs, 3 flame out, and 5 are the walking wounded where you'll probably get your money back," Rickertsen says. "With private-equity deals, which involve later-stage companies that already have income statements and balance sheets, you probably have one to two deals that flame out. You have one that's a big home run because all of the stars lined up in a way that you could never have anticipated. And then you have six or seven moderately successful companies generating 15% to 25% returns on invested capital." ■

warrant that says if you guys sell it for more than $12 million, I get 15% of the proceeds [over $12 million]." That protects you on the back end.

***Inc.*:** What happens if the management group bids and loses?

**Rickertsen:** They need to be prepared for that going in. You must be prepared to lose. Be gracious about it, but don't be stupid. Ask for a fee at the time of the sale. You helped build the company, and you should get something.

***Inc.*:** How long does the whole process take?

**Rickertsen:** Normally, 120 to 180 days. Some deals drag on for up to a year if they're very large and complex.

***Inc.*:** What is a common mistake that owners make during the process?

**Rickertsen:** There are two. First, they wait too long. Sell when things are going very well. Buyers need to believe that they can make money on the deal. A lot of owners sell after the cycle has crested, and they just hurt themselves, because the buyer knows the company is past its peak. Buyers are never dumb. And they'll see that you are trying to sell during a downturn. The result? You'll get four times cash flow, rather than the six you would have gotten a year ago when things still looked pretty good.

The second mistake is, the owner doesn't have a strong succession plan. If you're the owner, you're just going to hurt yourself, because the buyers are going to pay a lower price—my price goes down by 30%—to reflect the fact that your leaving represents a massive business risk.

So it's really important to think about it in advance. Be strategic. Put in a good succession plan and all the necessary systems [complete with financial reports]. And sell when there's still some money on the table, because that's when you're going to get the best price.

***Inc.*:** If managers had a piece of the action to begin with, would management buyouts become extinct?

**Rickertsen:** Absolutely. If America were smarter about how it compensated its executives, you would find much less management-buyout activity. And you'd find that companies would have greater profits and would perform better. ■

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