THE PRIVATE EQUITY PLAYBOOK

MANAGEMENT'S GUIDE TO WORKING WITH PRIVATE EQUITY

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To my wife, Alicia, and daughter, Rose,
for keeping me well grounded and for serving as my magnetic north.

To my elder children, Joshua and Amanda,
for all the times I wasn’t there while climbing the corporate ladder.

For my big sister, Bridget,
who passed away recently after a long battle with leukemia
but taught me so much about living.

To my mom, dad, and siblings,
for tolerating my rebellious ways.

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INTRODUCTION

The private equity industry is expanding at a rapid pace. Whether you're a business owner considering selling your business to a private equity firm, or you're a mid-career executive being recruited by private equity for a new position, this industry is most likely an entirely different game than what you're used to.

Private equity in the context of this book refers to firms or funds that use private money to purchase companies. The funds are set up to acquire businesses, expand them, and/or strengthen the firm's balance sheet. The field of private equity involves a new set of rules and players, and you may not be prepared.

It's like a professional athlete deciding to shift from one sport to another; the playing field and dynamics of the game are very different. Don't worry. I'm here to be your coach and help you learn the rules so that when you enter the arena, you'll be prepared to play and win.

THE LOCKER ROOM SPEECH

As your coach, it's important that you know my background. I've been working within the private equity industry for almost twenty years, having run three different national companies that each were owned multiple times by private equity firms. I learned through the school of hard knocks and by trial and error, but these experiences have seasoned me and led me to teach others about the process. My goal is to share the lessons I've learned so that you—or you and your management team—can quickly adapt and thrive in this new world.

A QUICK NOTE ON PROFESSIONAL ADVISORS

This book is not intended to provide financial advice, legal advice, steer you in a particular direction, or answer all your questions. Rather, it will equip you to ask more educated questions to make your decisions. It's an introductory primer that will provide a basic understanding of the private equity game.

However, please note: this book is in no way a substitute for having expertise on your team—attorneys, accountants, investment bankers, and more—because the legal, financial, tax, accounting, and other business issues that you will face are very fact based. The outcome of your transaction will be impacted by laws, rules, and regulations—federal, state, and/or local—the interpretation of which will be very dependent on those facts. Therefore, the advice that you need can be provided **only** by experts who are fully conversant with the details of your life (especially your personal goals), your business, and the proposed transaction. Now is not the time to "save" by scrimping on assembling your A-team.

LIFE GOALS AND BUSINESS LESSONS

I call myself a blue-collar CEO. I started at the bottom, having left home at seventeen, right after graduating high school. As I moved into the workforce, I had two goals and objectives in mind: (1) establish financial security before starting a family and (2) retire early. I also knew that eventually I wanted to enjoy life rather than be a slave to an office and desk every day.

I decided to enlist in the United States Army. The army taught me discipline and leadership and was a valuable foundation from which I established and built my career. I worked as an engineer for a number of years, and it made me a meticulous planner. Eventually, I crossed over from engineering into business during a ten-year stint at General Electric. There, I worked my way up to mid-level management and learned how to run a company. Private equity recruiters came knocking on my door, and I didn't turn them away. Those decisions launched me into a twenty-year career serving as the president of three different companies.

Each business was different. One was a medical company that serviced imaging and biomedical equipment, such as CAT scanners, MRIs, infusion pumps, and bed monitors in a hospital setting. Another was a commercial laundry firm that serviced 550,000 washers and dryers located in 70,000 apartment complexes and laundromats across North America. I'm currently with a third business that is America's largest refrigeration and HVAC service company touching 33,000 different customer locations. All three were national private equity-backed service companies.

As a result of these positions, I have billions of dollars in sell side, merger and acquisition, and financing experience. I know how to run processes and how to buy and sell companies. I've become an investor in private equity funds and an advisor to others. I am frequently asked to look at businesses and offer opinions from an operational perspective. I also have served on several boards of directors.

I think one of the keys to my success is that I recognize that service isn't tangible. Service isn't a product that can be stored in a box and put on a shelf. It's more about relationships and interactions, doing right by customers, and conducting business at the human level. The commonality between the three companies where I've been president is that they're service driven. My focus has always been on people and building company culture. A strong, people-oriented culture inspires an engaged workforce. Staff do their best work when they like what they're doing, enjoy their workplace, and feel supported. That's the kind of company culture that takes care of its customers.

THE GROWTH OF PRIVATE EQUITY

Along with my own professional growth, there's also been growth in the field of private equity. At the end of 1990, there were 312 private equity firms in existence. By the end of 2017, that number had grown to 5,391 firms with current assets under management totaling $2.83 trillion.

With all those firms chasing deals, it's no surprise that since 2006, there have been more than 43,000 private equity-backed company buyouts with an aggregate deal value of $4.249 trillion globally—more than half of those occurring in North America.[*]

THE ATHLETES

This book is for two types of players in the business arena.

THE CEO

Josh is the CEO of a middle-market company and is contemplating selling his business to private equity. He started out as a plumber and drove his own truck. His empire grew over a twenty-year period, and now he has 500 trucks crisscrossing multiple states. Josh is wealthy and is looking to his future. He's received phone calls from private equity firms looking for potential platform companies to buy. He doesn't know a lot about private equity but wonders if it's a viable future and exit strategy. He's asking: What's next? Do I sell this company and cash out my chips? Do I keep on going? How does my future play out? Do my children take over the business? How do I get my wealth out?

THE EXECUTIVE

Rose is a *Fortune* 500 mid-level career executive. She has had a good run so far, and she's starting to get calls from recruiters looking for a CEO or COO in a private equity-backed middle-market company. They want to know if she's interested in applying. Rose is struggling because she doesn't know if this is a good career decision. She wants to rise in her career, but she's asking: Is private equity the right way to go? How do I evaluate private equity-backed companies? What are the factors to consider? Is it just about money?

THE PROMISE

Whether you're a CEO, an executive, a business leader, or entrepreneur, this book will give you an overview of private equity. I'll show you how private equity is structured, how it operates, and what the opportunities look like. I want to demystify the private equity experience so that you have a good understanding as you contemplate your future.

On these pages, you'll learn how to play the game more effectively and avoid some of the mistakes I've made. I promise that you'll be able to leverage what I've learned across multiple decades and companies, multiple industries, and private equity firms.

This playbook will equip you to step confidently onto the field of private equity and play your best game.

Let's get started.

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* 2018 Preqin Global Private Equity & Venture Capital Report, pp. 22, 52, 97 (www.preqin.com).

PART ONE

WHAT IS PRIVATE EQUITY?

In part one, you're going to learn the basics of private equity and follow the history of its growth. You'll learn how private equity firms are measured, the rules they play by, and how they attract limited partners, which is their source of capital. You'll also learn about the different players in the game.

If you're like Josh, the CEO of a mid-market company, you have a business and are looking to cash out your chips and take some money off the table. You want to potentially find a lucrative path to retirement. If you're like Rose, a mid-level career executive at a *Fortune* 500, you're being recruited, and you're nervous. Like them, you are trying to understand private equity as a spectator observing the field, looking at this new game to see how it's played.

CHAPTER ONE

THE FIELD

You're the athlete, accomplished in your own right, but now you're contemplating an entirely different ball game and need to understand the facets of this new game. First up, we'll address the playing field: private equity. What is it? How does it operate? How has it evolved?

DEFINING THE PRIVATE EQUITY FUND

Let's start with the concept of a mutual fund. A mutual fund aggregates money from a variety of investors and pools that money together. A fund manager decides what stocks to buy with the money. The funds have readily available liquidity and are publicly traded. If you want to buy a typical mutual fund, you hop onto your E*TRADE account (or wherever you invest) and purchase a piece of it. That money is then aggregated with everyone else who has contributed. You can hold that investment as long as you want—for one day or five years—but you have no say over the trades made by the fund manager.

I liken a private equity fund to a mutual fund. A private equity fund, by its very nature and name, is private. It aggregates capital from a number of sources: primarily pension funds, wealthy families, individuals, and companies that have meaningful assets available for investment. Depending on the size of the fund, it is typical for an established firm to have a minimum investment size of $5 million. These funds are then used to purchase companies or buy a stake in a company.

People who invest in a private equity fund are called limited partners. Limited partners have no decision-making authority over the private equity firm or the investments made by the fund. The private equity firm serves as the general partner and has total control over the funds' investments. Limited partners pledge capital for a specified amount of time, generally the life of the fund and thus cannot buy and sell on a whim. There generally is no liquidity, and a private equity fund typically has a charter, or a life span, of ten years. This means you're committing capital for a period of up to ten years. (*Note: it's typical for funds to have built in, up to two, one-year extensions that don't require further approval of limited partners, so the money could actually be locked up for as long as twelve years.*)

LIMITED PARTNERS SUPPLY CAPITAL

The way a private equity fund starts investing is by issuing capital calls for the money it needs from limited partners. Here's an example.

You are an investor in a small private equity firm's fund that is $100 million in size. You commit $1 million to the fund, or 1 percent. You don't invest that money up front; rather, you've committed the capital, and as the fund seeks investments, it will issue a capital call when it needs the money.

The private equity firm decides to purchase a company that has $4 million of EBITDA—discussed further in chapter 9, "EBITDA" (pronounced as three syllables: e-bit-dah) is earnings before interest, taxes, depreciation, and amortization. The firm buys this company for 8x EBITDA, or 8x $4 million, for an enterprise value of $32 million. Typically, when a private equity firm buys a company, they use the maximum amount of leverage or debt the cash flow of the company allows. In this example, we will use 5x leverage, so 5x EBITDA is $20 million of debt financing, leaving another $12 million of equity from that $100 million fund needed to complete the purchase. The fund issues a capital call, and as a 1-percent limited partner, you get a call that states you need to send $120,000, which is 1 percent of the $12 million of equity needed. This is the pro rata portion of the equity needed by the firm to purchase the company.

PRIVATE EQUITY MEANS NO LIQUIDITY

The private equity fund is made up of people committed to providing capital. They've signed up for it. They may not get their money back for ten years or more. The firm makes investments and issues capital calls to the limited partners. As a limited partner, you send in your portion to meet the demand for the cash that's needed at the time. Because it's private, there's no liquidity, and a limited partner has no decision power. There's no way to get your capital back on demand. This is typically why investment sizes are large. Private equity firms are not geared to handle nonaccredited investors who may need to get their money out quickly.

The return of capital happens over time. Anytime a private equity fund sells a company or refinances for the purpose of creating a distribution, it returns capital to its limited partners. Using the same example as above, let's say the company is sold five years later. Instead of the $4 million of EBITDA when it was purchased, the company now has $12 million of EBITDA. Earnings increased 3x over a five-year period. The company is sold for the same 8x multiple, only now the enterprise value is $96 million for something that they paid $32 million for five years earlier. That $20 million in original debt financing plus perhaps another $40 million in additional debt and transaction expenses (from buying add-on companies, legal fees, diligence fees, investment banker fees, and carried interest fees) leaves $36 million in equity remaining. As a 1-percent limited partner, you now receive a distribution from the fund for 1 percent or $360,000.

The initial investment was $120,000, but your distribution five years later, net of fees, is $360,000 or a 3x multiple of invested capital (MOIC)—discussed further in chapter 2.

This example shows how a private equity fund receives and distributes money. The capital calls are fulfilled as the fund makes purchases, not up front. In this case, the distribution from the fund back to the limited partner occurred five years after the initial capital call when the purchased company was sold.

Many larger private equity firms often have multiple overlapping funds—some late stage and some early stage—operating with dozens of portfolio companies. Those companies aren't all bought and sold on the same date. There's a flow of money, mostly coming into the fund from limited partners in early years to fund platforms and then mostly being returned in later years as platforms are sold.

LIFE SPAN OF A PRIVATE EQUITY FUND

In the early years of a new private equity fund, the fund will be buying companies that become platforms for growth and will require further investments during their hold period. These are the anchor holdings of the new fund. Some private equity groups state a time limit in their fund's limited partnership agreement that essentially says all platforms have to be bought within the first six or seven years. Others don't include the time limit; typically, the hold period in private equity for each portfolio company purchased by the fund is three to seven years, with five being a good average for general planning purposes.

As soon as the fund buys a platform company, they go about the business of trying to grow that platform. There are many different levers for growth that we'll talk about later in the book.

In the later stages of the fund, the private equity firm works to sell off the remaining assets of the fund. It all works within the ten-year limited partnership agreement that asks for money from the limited partners up front as platform companies are bought, begins to return the money as they are sold, and by the end of the funds term, has returned all capital—plus earnings and less fees—to the limited partners.

Sometimes private equity funds use captive, proprietary, or family-generated funds and don't really need limited partners to make investments. Examples include MSD Capital, which is the private "family fund" of Michael S. Dell of Dell computer fame, and OMERS Private Markets, the direct investing arm of the Ontario Municipal Employees Retirement System, which is a self-contained arm of the pension fund that actually does its own investing. These funds are self-investing their own capital, which means they don't necessarily have to buy and sell within a specific time frame or hold period.

REPORTING REQUIREMENTS

During the fund's life, there are reporting requirements to the limited partners. Let's call it a score card. Typically, a quarterly financial report is sent out to discuss the funds: where the money has been invested, what capital has been returned, and the current value of invested funds.

Most firms hold an annual meeting with the limited partners of a specific fund, especially if it's a large private equity shop that has multiple funds ongoing. The firm gets the limited partners together and presents information about the companies that have been purchased and sold by the fund. They may even bring in some CEOs to speak and/or answer questions about individual portfolio companies.

COMMON FUND TYPES AND STRATEGIES

Private equity firms can invest in various types, styles, and strategies. Here are a few of the more popular fund types and styles typically found in the world of private equity.

BUYOUT FUND

A buyout fund purchases a controlling stake in a company, typically a more mature and established business. Buyout funds tend to have a higher batting average than a venture capital fund, but there are more singles and doubles than home runs. Majority ownership means just that. The entrepreneur who sells the company no longer controls the business and now has a boss for the first time. For the last twenty years, the entrepreneur got to make the decisions, but now he has a partner with a controlling stake, and that partner can fire or replace him. It's a different dynamic. Buyout funds are the most popular style of private equity funds and the primary focus of this book. For both Josh and Rose, this is where the action is!

VENTURE CAPITAL FUND

A venture capital fund makes small minority stake investments, typically to small, early stage emerging businesses. An entrepreneur comes in and pitches an idea, looking to sell a small stake in the company. They have a low batting average, but when they do make a hit, it's a big win. It's a little bit more risk with a little bit higher volatility, and the hope is big wins offset the losses. Typically, in a minority stake investment, the CEO or the company retains most of the control, but the venture capital fund is protected through operating agreements or a shareholder agreement. They may have a say in terms of additional equity coming in, or the timing of an exit, or in controlling the capital they're investing, even if they don't have a controlling stake. Venture capital funds are investors in ideas that show potential, whereas buyout funds are more buyers of established companies with a proven track record.

FUND OF FUNDS

A fund of funds is similar to the concept of a stand-alone mutual fund. A fund of funds takes money in and then invests in several other private equity funds. It allows someone who is making an investment in private equity to diversify and become an owner of several different private equity funds simultaneously.

DEBT FUNDS

Some large private equity firms have private debt funds that loan money to private equity-backed portfolio companies. These funds may be used as a part of the leveraged debt structure used by private equity firms to acquire portfolio companies, provide acquisition financing, or to fund operating lines of credit. Private equity firms with debt funds generally never loan money to their own portfolio companies due to the obvious conflicts of interest that would result.

POOLED COINVESTING

Sometimes private equity funds will pool together to buy a company that is larger than their typical investment size and allows them to extend their reach. When this happens, one firm will have a controlling stake and one will take the minority stake. Or they create an operating agreement that lets them share in decision making based on the size of the investments that were made.

LIMITED PARTNER COINVESTING

Oftentimes, as a means of rewarding an important limited partner, a firm will let that partner come in and make a separate investment. They could be an investor in the fund and then also make a coinvestment in a specific platform company directly. This gives the limited partner the chance to have additional skin in the game. I once ran a company that had three different limited partners who coinvested in the business alongside the private equity fund. It was a larger than normal investment for the private equity firm and additional capital was needed, so they looked to limited partners to bridge the gap.

OPERATING THE PRIVATE EQUITY FIRM

All private equity firms try to be unique in some way, shape, or form because they are competing for the same pool of limited partner capital. They want to be just different enough for someone to invest with them versus another, and so they all have slightly different focuses. They can be huge, like Apollo, Blackstone, Carlyle, or KKR, with more than a thousand employees, individual fund sizes ranging from $10 billion to $20 billion, and several types and flavors of funds ongoing at the same time. Or they can be small, boutique-sized firms with only a handful of employees, funds sizes of less than $100 million, and only one or two active funds making and holding investments at a time.

There are pros and cons to the different types of funds and strategies for investing. Limited partners must do their own diligence to decide where to invest.

SMALL FIRMS

Small firms typically invest out of one active fund at a time but will start to raise the next fund when the existing fund has deployed approximately 70 percent of its capital. In this fashion, it may have two funds at different life stages with holdings at one time. Limited partners don't want the small private equity firm distracted by raising too many funds at once. Limited partners want the firm's smaller number of investment professionals focused on managing its platform companies versus raising capital. The ultimate goal for any private equity firm, big or small, is not to run out of committed capital available to invest. They always want to have money available to make new platform investments. Some firms insert a guideline within the limited partnership agreement that allows them to raise new funds as previous funds reach a certain percentage of capital deployed.

LARGE FIRMS

Large firms have offices across the globe, and their teams include hundreds of investment professionals who specialize in specific areas or types of investments. They typically have multiple funds and fund types all operating at the same time. They might be split into styles and by verticals —technology, industrial, health care, education, infrastructure, growth—

and they have adequate resources (people) to manage multiple funds at a time.

HOW THE PRIVATE EQUITY FIRM MAKES MONEY

Going back to our mutual fund example, oftentimes when you invest in an actively managed mutual fund there are management fees associated with that fund. Private equity acts in the same way. They typically charge a management fee of about 2 percent. Management fees are how private equity firms cover their overhead, not how they generate wealth.

They generate their wealth through carried interest. Limited partners typically pay 20 percent of every dollar of profit back to the private equity firm. If as a limited partner you have $1 million invested, you're being charged a 2 percent management fee every year for the capital that's invested, and then when they sell a company, you pay 20 percent carried interest on the profit. Typically, there is a minimum rate of return that limited partners must receive, called the preferred return, before the general partner (the private equity firm) can charge carried interest and collect the fee.

Let's go back to the example of providing $120,000 of capital. When you got the $360,000 back, that included $240,000 of net profit. The carried interest charge, 20 percent, goes to the private equity firm and was already deducted prior to the distribution. That is their profit and where wealth is generated within the private equity world.

These firms also invest in their funds. Limited partners want to know that the people working to invest their money have skin in the game. Therefore, private equity firms will create a subfund so their employees can invest their own money and coinvest alongside the fund every time the fund buys a platform company.

PRIVATE EQUITY EVOLUTION

There is an old saying that imitation is the sincerest form of flattery. Pioneering firms had such massive success that it fueled the growth of more than 5,000 copycats over the last three decades. As a result, it should come as no surprise that the collective deal activity touching private equity has exploded right along with it. During the 1980s, less than 1 percent of merger and acquisition activity involved private equity. Today, it is estimated by EisnerAmper, in their *4Q 2018 PE Insights Report*, that approximately 35 percent of all mergers and acquisitions completed in the United States in 2018 involved private equity and that within five years, that number is expected to eclipse the 50-percent mark.

TAKEAWAYS

Private equity funds typically beat most benchmark indices. They're a popular investment vehicle, especially for pension funds and wealthy investors who are looking for alternative investments and higher returns.

The funds have no liquidity, so limited partners have to be able to invest money for a very long time.

The number of private equity firms continues to expand rapidly. Total assets under management are growing rapidly along with it. As a business owner, it's more and more likely that you will be approached by a private equity firm to purchase your business. If you're a *Fortune* 500 executive, you are likely to be getting calls from recruiters and encounter a private equity firm in your career pursuits.

Understanding the game is the key to making good decisions and navigating these opportunities successfully.

In short, it's why I wrote the book!

CHAPTER TWO

THE RULES

In chapter 1, we examined the field of private equity funds, how they operate, how they make money, and how they've grown over time. Now it's time to delve into the rules of the game. In order to know how best to play the game, it's not enough to know what a private equity firm is; you have to understand how they're measured, how they are differentiated from other firms, and how they operate.

It's important to understand the rules whether you are Josh, contemplating selling your business to a private equity firm, or Rose, getting calls from recruiters looking for a CEO, COO, or other senior executive role in a private equity-backed company. In both these instances, you're potentially becoming what I like to call a pseudo-limited partner. You're not necessarily investing in the fund directly, but you're going to either invest in or receive incentive stock from one of the holdings within the fund—the company you either are selling (Josh) or coming to work for (Rose). When you're making an investment or receiving part of a profit interest pool, you're aligning your interests with the private equity firm and the limited partners that provide the fund with capital.

If you're selling your business, you might be asked to roll over some of your proceeds, instead of taking 100 percent of the cash out at close. I personally like to take 66 percent of my pretax invested cash out at close and roll 34 percent forward tax-deferred to stay invested in a meaningful way in the business. My goal is to always work hard with the new private equity owner and make the next payday bigger than the last! More on rollover strategy in part 2.

Note: When either Josh or Rose makes an investment in the platform company—whether they use cash, rollover funds, or are issued stock from an incentive pool—they do not pay any of the fees or carried interest charges that limited partners do. Those fees are paid by investors in the private equity fund, not the employee investors in the company.

GAUGING A FUND'S SUCCESS

Because you now have skin in the game, it matters whom you partner with! Some firms and funds perform better than others, so it's important to know the metrics that help limited partners gauge the potential success of each private equity firm's funds. History is never a guarantee of future success, but it can directionally be an indicator.

There exists a ranking system for private equity funds, just like for mutual funds. Most of you will have heard of Morningstar—within that construct, mutual funds can have a one- to five-star rating with one being the worst and five the best. There are different categories, different lengths of time, and there are means for an individual to evaluate and compare several mutual funds' performances using these parameters.

The same thing exists for private equity funds, and like Morningstar, these rankings are generally done by independent institutions. There are three key individual rankings. Instead of being rated by stars, they are separated into quartiles. A top quartile is the top 25 percent, second quartile is 25–50 percent, third quartile is 50–75 percent, and the fourth quartile is in the bottom 25 percent.

Funds are ranked against each other by vintage (the year a fund makes its first investment establishes its vintage year) in order to isolate general background economic trends or conditions that might have impacted performance of all funds of one era versus another. This is the only way to look at relative head-to-head performance.

There is no overall combined quartile ranking; rather, each ranking is rated separately. If a private equity firm wants to start a new fund, having an existing top-quartile fund makes it more attractive to the limited partners considering making investments.

Note: While the rankings are typically used by limited partners to evaluate the track record of a firm's funds, they are also semi-important to pseudo-limited partners like Josh and Rose. Both the business owner and the Fortune *500 employee looking to transition to a private equity-owned company need to know these statistics exist, too. If you are riding the coattails of a private equity firm, it's good to know how they have performed historically versus their peers and with companies similar to yours. That being said, don't put too much emphasis on the number or placement. Seventy-five percent of the private equity funds can't be in the top quartile, just by very nature of the rating system! It's just another factor to consider, one of many we will discuss in coming chapters.*

INTERNAL RATE OF RETURN

The most important ranking is the internal rate of return (IRR), which is the net return earned by limited partners over a particular period and expressed as a percentage (%). The calculation itself is very complicated, but at a high level, the number takes into account all of the various cash flows going in and coming out, including capital calls, management fees, carried interest fees, and distributions. The IRR is time dependent and uses the present sum of cash contributed, present value of distributions, current value of unrealized investment, and then a discount is applied.

The IRR value is important to a limited partner because he is tying up a portion of money for an extended period, with the inability to invest that capital elsewhere. If the average rate of return in the stock market over time is 7 percent per year, then the limited partner is losing the ability to earn that same percentage if he was to invest in a total stock market index fund over an extended period. Thus, the IRR of the private equity fund better be higher than 7 percent net of all fees and carried interest.

IRR is important, but you can't spend it. It's not cash! However, it remains the number one litmus by which private equity funds are rated. A good IRR is typically in the mid-teens, around 14–15 percent in today's world net of all fees and carried interest charges. A great IRR is higher than 20 percent. Because there has been a huge growth in private equity, there is a lot more money chasing deals. Prices paid for companies have gone up, and the amount of return has gone down. Private equity firms are underwriting investments a little bit lower than they used to because of the competition. That dynamic can change over time, just like a buyer's market and seller's market when it comes to housing. There is currently nearly $1 trillion in capital looking for investments, but the private equity funds' IRR continue to outpace typical stock market returns, and thus, the entire industry continues to grow.

MULTIPLE ON INVESTED CAPITAL

The next number to consider is the multiple on invested capital (MOIC). This is simply the return divided by the invested capital. It's a secondary measurement to IRR; however, this is the cash return. Whereas you can't spend IRR, you can definitely spend MOIC.

The difference is that MOIC does not take into account the hold period. If you invest $1 million and get a return of $3 million, that's a 3x MOIC. However, it can take one year or ten years to see that return, and there's no way to measure that impact with this particular metric. An investment that returned 3x MOIC in three years would have a higher IRR than one that returned it in seven years. Same cash return but a vastly different IRR. That's why you look at both measurements!

DISTRIBUTIONS TO PAID IN CAPITAL

The final ranking is distributions to paid in capital (DPI).

The DPI measures the ratio of money that is distributed by the fund against the total amount of money paid into the fund. At the beginning of a fund, DPI is zero. As distributions are made, the fund breaks even with a DPI of one. DPI is more useful when comparing new or active funds of the same vintage, as the DPI will ultimately be near or equal to the MOIC after a fund is fully matured. On an active fund, the DPI showcases the velocity of how fast the fund is returning money to shareholders at the various stages of its ten-year life span.

FULL AND ACCURATE MEASURE

These three measurements are somewhat interrelated. Limited partners use all three to come up with an opinion about the private equity firm, how a current fund is performing, and how the firms' historic funds have performed in the past. IRR is most important, MOIC is next, and then last comes DPI.

Note: Each of these rankings can be generated for gross or net returns, and it often depends on who generates the reports. People view them in different ways, but it's key to look at them all in the same way.

Limited partners may consider the funds of 5,400 different private equity firms to invest in, so they need to have some means of knowing the difference between one fund and another. They may be considering venture capital funds, buyout funds, fund of funds, or different verticals, such as health care or technology. They may seek to build a portfolio of investments with different kinds of private equity firms and funds, but they need these rankings to help differentiate and as a critical point of consideration to make decisions on where to invest. As an individual, you'll have a hard time finding these ratings without subscribing to an industry service. For our purposes, I just want you to know that these ratings exist and, with a little effort, can be accessed.

TAKEAWAYS

Don't just look for the highest bidder in a sales process. When you're rolling over equity or you're coming to work for a private equity-backed company, you're either investing or getting stock in a company. You are now a pseudo-limited partner in a portfolio company of a private equity fund, and you should know if it's a good firm with a strong track record of successful investing.

By knowing how private equity firms are measured, you can begin to ask their ratings and determine their success with similar investments that look like your company. You'll find a list of questions in chapter 4 to use as a guideline. I guarantee that you'll learn a lot by asking and be thought of in a different and more sophisticated light by the private equity professionals you interact with.

CHAPTER THREE

THE PLAYERS

Chapter 1, "The Field," discussed the history and growth of private equity. Chapter 2, "The Rules," discussed how limited partners think about private equity, decide where to put their money to work, and what ratings to evaluate. Now it's time to discuss the players. Who are these private equity firms and fund managers?

The first thing to note is that private equity is a young player's game. It's a very intense world. But if you understand these players, how they're measured, what success looks like to them internally, and what their needs are, you'll know how to play the game.

Not only will you know how to play the game, but you'll also play on a much more advanced level because you'll have a base of understanding.

As we discussed before, there are big and small private equity firms. A small firm most often has a small staff, with people filling multiple roles. Consider it like the owner of a small business who handles her own human resources, accounts receivable, sales, and the back office. A large firm will have a lot of employees who complete very specific tasks. There may be numerous verticals of funds that the managers run. Consider it like a large company with separate departments.

Private equity firms are very hierarchical in how they operate, which is why it's critical to know the players, regardless of the size of the firm.

THE SENIOR-LEVEL PLAYERS

I equate these positions to a sports team manager. The senior players hold titles of partners or managing directors—although there's no real functional difference between the titles.

The partner or managing director has the most tenure—typically fifteen to twenty years or more of experience. They've been around the block, and they're the deal guys. They've worked at all the different levels of private equity and now run the show. They're the manager of the baseball team.

This role is the interface to the CEO of the private equity-backed company. Whether you are Josh or Rose, you will most likely be working with the partner or managing director of the private equity firm, as these are the people who make the decisions.

So what does this role do? They have control. The partner or managing director has the authority to tell the CEO what to do and is often appointed as the chairman of the board. It's often through using the board construct that the chairman exercises their control and so, in essence, is now the CEO's boss. They make the hire/fire decisions on the CEO and often influence those decisions on senior staff. Internally, they're also the ones who are responsible for the investment and portfolio company. Keep in mind that a private equity firm may have multiple funds active at one time, and each partner or managing director may have many portfolio companies beneath them. The firm that owns my current company has more than fifty portfolio companies that they currently oversee. The partners backed these investments and internally are on the hook to the firm's senior leadership and to the limited partners who backed the fund.

Private equity firms often have investment and management committees that approve initial platform purchases and review their performance during the hold period. The partner doesn't want his portfolio company to do badly, because it puts the heat on him internally within the firm. As the senior person, they are responsible for the investments and answer to the various committees.

In large firms, there may be many partners who specialize based on verticals or specific roles. This specialist is like a pitcher on a baseball team. They do only one thing: throw the ball and hopefully strike out the batter. In small firms, the partner is a generalist who oversees any kind of company. This partner is a utility infielder who may play any position on the infield.

THE MID-LEVEL PLAYERS

At the mid-level of private equity firms, you have the principals or vice presidents. I equate these people to the first and third base coaches or the hitting and pitching coaches. They're not the manager of the team, but they're helping. With typically ten to fifteen years of experience or more, those in the mid-level positions help to manage the investment. They're working toward becoming a partner or a managing director, and they are usually the secondary interface to the CEO.

As a CEO, a principal or vice president may call me but typically won't give me specific instructions. That will come from a partner level. Instead, this level is more consultative and typically connects more directly with the CFO of the business. The mid-level player is responsible for providing the day-to-day oversight of the portfolio company, actively working, and doing a lot of heavy lifting, whereas the partner is responsible for the overall investment strategy. There's a need for data and numbers to see how the investment is performing and how initiatives are doing. The mid-level player stays on top of this and reports back to the partner.

THE JUNIOR-LEVEL PLAYERS

The junior-level players are the sports team scouts or statisticians. They're called analysts or associates within the private equity firm, and they are typically early twenties in age, fresh out of top-tier undergraduate programs, and demonstrate very high potential. They don't often connect directly with the CEO of the business; rather, they are a secondary interface to the CFO and have more of a direct interface with levels below the C-suite. They work with the controllers, directors, and VP of finance and are tasked with specific projects that are assigned by the principals or the vice presidents.

When Josh sells his company, he hires an investment bank. That investment bank brings in private equity groups to take a look at the company, and they begin by modeling and doing research on the industry. The analyst does this research and starts to ask questions: What's the industry like? Is it growing?

Is it dying? How does it do in a recession? How does it do in a strong economy? The analysts build an investment model that determines how much a firm offers for the company.

This role works ungodly hours. The associates or analysts inside a private equity firm often work sixty to eighty hours a week. Private equity people in general are all very highly educated with very high potential. They operate at a very advanced level in terms of financial analytics, but they don't typically operate companies. Those senior players in the high-stakes world of private equity have an incessant need for data, and so the analysts or associates do the grunt work to help provide the answers required by their firms and limited partners.

Once a company is purchased, the analysts turn to the operating phases where they take the models and now help the management team execute. They also continue to analyze and answer questions. If something didn't go the way they thought, they need to know what happened. What do they need to do to adjust the model? Are economic conditions changing? Is the company doing what they thought it would do? The models keep adjusting, and every quarter the firm reports back to the limited partners on how investments are performing. Analyst roles are very cyclical. Often junior analysts will work for a few years after getting their undergraduate degrees, then leave the private equity world to go back to get their advanced degrees before returning to pursue senior analyst roles in hopes of becoming a principal or vice president one day.

For every fifty companies a private equity firm looks at, they might buy one of them. There are thousands of private equity firms looking at potential businesses to purchase. Out of those, thirty firms might get an investment book or a confidential information memorandum on a given company. Out of those thirty, ten firms might get a management meeting. Then the company goes up for a bid and rebid process. Multiple firms are left in the cold, even after spending an inordinate amount of time—and in some cases capital—doing diligence on potential investments in an attempt to determine what's a good investment so that their fund does well over its life span.

OPERATIONS

Many firms also employ some level of back office support staff that focuses on fulfilling the internal needs of the firm itself and providing various support services to portfolio companies.

Most larger firms will have dedicated resources assigned to various tasks including, but not limited to, raising new funds, marketing their offerings to potential limited partners, managing communications to existing limited partners, managing capital markets, maintaining investment banking relationships, fulfilling legal, and so forth.

Support services to the portfolio companies can include anything from introducing relationships with recruiting firms to help fill key positions to expense management—structuring a group purchasing program to leverage volume across the portfolio for shipping or a telecom discount.

Almost all private equity firms in today's world also have a network of experienced senior professionals from various industries and areas of functional expertise that they can tap into to help a portfolio company transform itself once it becomes a fund holding.

Private equity firms exist to source, purchase, help improve, and sell companies using the capital of limited partners. The resources available vary by firm size and sophistication, but they are typically extensive and very helpful in creating shareholder value at the portfolio company level. Don't be afraid to ask for assistance when working in a private equity-backed environment.

THE INVESTMENT BANKER

There's another key player on the field: the investment banker. The investment banker is an independent player who acts in the same way as a Realtor does in a home sale transaction. Most houses are bought and sold with the services of a Realtor. In the private equity world, most companies are bought and sold with the services of an investment banker.

The investment banker works with the companies to help prepare them for sale, create marketing material, run a sales process, conduct management meetings, provide access to the management team, and handle the bidding, rebidding, and diligence process. In some cases, investment bankers help to raise the capital for the debt that's required when buying a company. Investment bankers, like Realtors, often are hired by both buyers and sellers to help negotiate the mechanics of the sale or purchase.

This player wears an independent jersey or acts in many ways as a paid referee. Investment banks cover expenses via project-specific retainers, but they earn a living through commissions on successfully seeing the transactions close. It is very rare for a private equity firm not to use an investment bank when buying or selling a company. There is a lesson to be learned here for Josh in that the fees paid are worth the price of admission! Just like private equity firms, investment banks come in all shapes and sizes. Investment banks often have specialties and sweet spots based on the size of the company being sold or purchased. Research is important to find the right Realtor, and the same premise is also true with investment banks.

TAKEAWAYS

Understanding private equity firm roles is critical for both Josh and Rose.

For Rose, when *Fortune* 500 employees are being recruited, it's because there's a need within an existing portfolio company that has been identified. The private equity firm works with the portfolio company's leadership team to determine what new positions to fill and to evaluate existing positions where a talent upgrade is needed. Knowing who the players are will help you navigate the interview process more effectively. Ultimately, interviews will likely have multiple rounds and include some of the private equity players responsible for the investment.

For Josh, it's important to know and understand who the private equity players are because these people will become his partners during the typical three- to seven-year hold period. While analysts will come and go with regular frequency, the mid-level and senior-level guys will typically be with you for the entire hold period. Make sure you like them and can get along with them!

PART TWO

FINDING THE RIGHT TEAM

Armed with what you've learned in part 1, now you're going to jump in and pick the right private equity firm to partner with. You'll learn how to evaluate the private equity firms and how to navigate the equity structure, shareholder agreement, and employee contracts. You'll also learn how to potentially create generational wealth by working with private equity over time.

If you're like Josh, you will be looking beyond the financial offers to make sure that you're partnering with a firm you work well with. You're learning that it's better to play long ball because you'll be invested in the company's growth and success. If you're like Rose, you will also be looking at the firm's culture, and you'll be looking for ways you can invest in the portfolio company to see wealth beyond just your salary and bonus structure.

CHAPTER FOUR

EVALUATING PRIVATE EQUITY FIRMS

As Josh, you've built a business over many years and have finally decided you'd like to sell your company. You speak to trusted friends and personal advisors about how you should go about doing this (perhaps your lawyer or accountant), and before you know it, you stumble upon an important player on the field that we discussed in part 1 of the book: the investment banker. This role is also sometimes referred to in the industry as the advisor. After researching and evaluating further, you'll select someone to represent you in the sale of your company.

Their logical target market will typically be either a financial buyer like a private equity firm, or a strategic buyer, which is a larger company looking to expand through acquisitions. Once the transaction goes through, their typical success fees are between 1 percent and 3 percent of the sale price, with fees decreasing as the transaction size increases. Sometimes, on larger projects, private equity firms will hire two bankers who will then split the fees based on the work to be performed by each.

Note: Fee structures for advisors can vary widely, especially when the company being sold is small. On a small company sale, fees might more resemble that of a Realtor where 5–6 percent is more typical. Large company fees are typically as low as 1 percent, and sometimes a success fee includes an increased percentage for exceeding a certain price target or threshold.

The investment banker or advisor you hire will help you market your company and find potential buyers. They will help you get the business ready for sale by creating marketing material, and then once ready, the process will begin. They will usually outreach to many potential buyers who get a short teaser to gauge level of interest.

Initial conversations (known in the industry as "fireside chats") may take place to generate interest with a select group of potential buyers. As the process unfolds, there could be upward of thirty buyers interested in your business. One or two of the interested parties could be strategic companies, larger than yours, who are seeking to purchase your company, but for the most part, it will be private equity groups. It's important for you to know how to evaluate these firms. How do you find the right one? What constitutes the best potential partner to work with? The goal of this section is to help demystify the process of selling the company and to learn how to evaluate different private equity firms.

As Rose, you're being approached by recruiters to move from your *Fortune* 500 position to a new one at a private equity-backed company. You also need to know how to evaluate these firms and the opportunity. This section will provide you with some of the questions to ask and the details to look for as you evaluate whether this is a good fit for your particular skill set and the best career opportunity for you.

PRICE ISN'T EVERYTHING

Obviously, price is a big component when you're selling your company. If I add up all of the economic activity that I've been involved in, either as a buyer or a seller, I can tell you that many times the business owner focuses only on price. Yes, it's important, but it's not the only factor.

In today's world, it's fairly common to run a limited sale process. Gone are the days of sending out two hundred investment books to potential buyers. The more common approach now is to target a small group, of perhaps thirty potential buyers, by giving them marketing material—referred to as your "confidential information memorandum" (CIM). The CIM is a document that outlines the company being sold, its history, products and services, customers, financial performance, management team, and growth strategies. Out of thirty lookers, perhaps ten will submit an indication of interest (IOI). These ten will be given an opportunity to meet with some subset of your management team to receive a presentation about the company in person.

Those ten potential buyers will most likely be asked to present refreshed bids as part of the sales process not too long after the management presentations are completed. It is common to see a separation in the offers. You'll have the lead bidders who really want your company and offer the most money. Then you'll have the rest of the pack. At this stage, ten interested parties will likely become two or three. The investment bank or advisor will work those buyers against each other to obtain maximum value. Soon after, you will receive one or more letters of intent that spell out salient terms of their purchase offer, and you are off and running!

THE IMPORTANCE OF OUTSIDE COUNSEL

As I mentioned in the introduction, it is absolutely imperative that you engage competent legal counsel and tax advisors. Law, like practicing medicine, includes generalists and specialists. Buying and selling of companies is a specialty area of legal practice. You'll find most regional and larger firms have separate practices for business law with lawyers who specialize in transactions.

While billing rates may be higher than a generalist, using a specialist is highly recommended when you are selling an asset as large and as important as your company. These lawyers are experts and very efficient at navigating the complex purchase agreements to be negotiated as a part of the transaction. Oftentimes, you'll actually spend more per hour but less in total, because the experienced business lawyer will take less total time and deliver a more thoughtful, well-balanced document in the end. By the same token, using a competent accountant for tax advice can help you maximize the deal structure to limit your tax exposure and maximize the cash potential in the sale. Like attorneys, you don't want to skimp on tax advice either! A top-tier accountant will pay for themselves in helping you plan for your windfall.

Oftentimes, the business owner looks at price and picks the highest bid. If your goal is to sell and retire, this may be the right call to make. But if you care about your employees or are concerned about legacy, you may want to dive deeper into the potential buyers. You should also consider sticking around and not fully retiring. It can be very lucrative to partner with private equity. You'll get subsequent paydays when today's buyer sells three to seven years from now. It's possible to get secondary paydays that potentially can be even larger than the first, and if you are staying, price isn't the only important factor; rather, it's how the relationship between you and the private equity firm will be managed after the sale.

One thing to keep in mind for Josh: private equity firms may buy companies, but they invest in management teams. A motivated seller who wants to continue with the business is a positive for buyers. If your company is to become a platform investment, your staying on may in fact be critical to getting a deal done. Transitions are OK, but stability for some minimal amount of time is absolutely necessary. Having a strong second person in command who can take over for you can be helpful to your exit, whenever that time does come.

THE SCOREBOARD

You have your field, the rules, and your players. Now it's time to take a look at the scoreboard. At a baseball stadium, the scoreboard tells you more than just the score. It tells you the players, their positions, and their batting averages. When a pitcher throws the ball, the scoreboard showcases how many balls and strikes the player has. It also documents the speed of the pitch.

All of these factors are important and can be evaluated. It's the same for private equity. Price is the score, but there are other important numbers to consider.

THE HANDS-ON, HANDS-OFF METER

Private equity firms run anywhere on the spectrum between full hands-on and full hands-off. I've worked with firms that are very hands-off, which means interactions were mostly limited to monthly phone calls to review financial performance and quarterly board meetings in person to delve deeper into how the business is performing and the various initiatives we were working on. The hands-off firm leaves me to run the business, and they mostly stay out of the day-to-day minutiae. That's not to say they are out of the loop completely, just less intrusive. The private equity group consists of the financial experts, so they assist and add extreme value when it comes to capital structures and finance matters, but hands-off is more of a separation of expertise.

On the opposite end, you have the hands-on private equity group. In these instances, I have experienced weekly phone calls with a subset of the board of directors. They provide me with to-do lists. In essence, they want to tar my bat and put my helmet on my head and tell me which pitches I should swing at.

Again, there's no right or wrong; it's just a matter of assessing what kind of private equity group you're dealing with and if it's a good fit. This is the time to be a little introspective about your own personality, how you like to operate, and how you want your future to look. There is an old saying among CEOs in private equity—"If your company isn't performing, you are going to get lots of help. Want freedom and autonomy? Don't require any help!"

If you're Josh and you have a very strong-willed, entrepreneurial, type-A personality, where you say, "Nobody's going to tell me how to run my damn business," you will probably not thrive in a full hands-on environment. Whereas a person who likes a collaborative effort that provides encouragement will do well with a full hands-on firm. Rose, coming from the *Fortune* 500 world, is probably used to being constantly pushed to do her job. She's used to a high level of rigor and interaction with her boss and may actually prefer the style of a more hands-on private equity partner, but she should still assess her individual style and determine how she works best with others. "What would constitute a good partner for me?"

No matter your role, you will most likely be an investor in this company, or at the very least the recipient of incentive stock, and you want it to do well. So if you don't necessarily like hands-on, but the private equity fund is pushing you to excel and grow the company, it may not be a bad thing when it's time to sell the company and get a payday down the road.

Consider the professional athlete. They're the best at what they do in a given sport, but they still go out and practice every day. They are constantly being pushed by coaches and managers to perform at a very high level, and to some degree, this hands-on approach is helpful to maximize their potential.

WHAT ELSE TO CONSIDER

Price is important. Key indicators are important. Hands-on, hands-off is important. So is your relationship with the key players. We're not talking about the associate level, which may rotate in and out the door. Those relationships will change as the people change. But the principal or vice president, and partner or managing director, they won't change during the course of the investment. These positions are more stable in the private equity firm, and these people will often be there for the entire length of the investment in the company, so it's worth considering, do you like that person? Can you get along with them? Can you partner with and respect them for the next three to seven years?

An additional consideration is governance. It is typical for a private equity group to put governance instructions in place for a company that they own or operate. For Josh, it's important to look at how tight the governance will be. Is he going to run the company as he used to, or is every decision now going to be micromanaged? If he has to now jump through hoops, he fails to have the autonomy to run and do things as in the past. Opportunities might be missed, leading to failed outcomes. The goal is to find a balance that allows the company to operate in the ordinary course without approval but brings in the input from the financial partner when appropriate. An example would be: the limit on what the CEO spends in ordinary course should be large enough to allow the CEO to operate the company. But if he's approving an expense that is not ordinary course, paying bonuses to employees—including himself—giving raises to senior staff, or selling a large fixed asset, the board of directors may want to approve. Governance should never be a big issue. Rose will be accustomed to accountability, but for a former entrepreneur like Josh, there should be a discussion.

ASKING THE QUESTIONS

Inevitably, during a meeting with a private equity group, there will be a portion of time dedicated to giving Josh an overview of the firm. As a part of this interaction, there will be an opportunity to ask questions of the firm.

All too often, entrepreneurs stay silent, mostly because they simply don't know what questions to ask. Don't stay silent!

Based on what we have learned already, here are some insightful questions that you (Josh) can ask the private equity firm:

- How have your previous funds performed?
- What has your typical IRR been at the fund level?
- What has been the typical MOIC at the fund level?
- Have your funds historically been top quartile?
- What have your typical results been when you've purchased companies or partnered with people like me?
- What has been your typical IRR for similar companies?
- What has your typical MOIC been for similar companies?
- Will you consider allowing me to make a rollover investment?
- Can you walk me through your investment model for my company and show me how my rollover investment performs if you hit your assumptions?
- Give me examples of companies similar to this. How did they perform? Are there any lessons learned?
- Can you tell me about the average tenure of your employees at the various levels?
- How do you work with your current portfolio companies?
- What is your rhythm with management?
- What is your governance philosophy?
- How typical is it for you to make changes in senior leadership?
- Can I speak with the CEO's references? (Ask for one that had a good outcome and one where they fired a person. You want the good, the bad, and the ugly.)

Here are some questions you should ask those references:

- What was it like to work with this private equity group?
- What was their management style? Were they hands-on or hands-off?
- From a governance perspective, how much autonomy did you have to truly make decisions?
- Were you treated fairly at all stages of your employment?
- Did you have a good outcome?

- Any recommendations about things you would have done differently?

Rose needs to ask similar questions of the private equity firm during her hiring process:

- How have your funds performed over time?
- Are your funds typically top quartile?
- How does your firm perform on types of investments like this company you're recruiting me to work at?
- Can you walk me through your original investment thesis when you bought this platform company?
- Is the company performing to expectation?
- Is there incentive equity for key executives working at the firm?
- How does that incentive equity work under your various exit scenarios?
- Are there opportunities for me to invest?

Beyond that, each private equity fund has its own personality, which should be important to both Josh and Rose. How does the private equity firm interact with you specifically? There's no right or wrong; there's just different. Everyone seeks a good outcome, so the interests need to ultimately align.

TAKEAWAYS

Never play short ball and focus on just price—unless price is all that matters to you. Be cognizant of the firm's personalities and reputations. Pick a firm that you can work well with and one where you have the ability to accelerate your growth. This is playing long ball. Josh should consider staying for a length of time and potentially rolling over equity or remaining an investor in the company. Success requires finding the best partner to get to an attractive outcome within the next three to seven years, and it may involve working with the firm that offers you a little less money today.

CHAPTER FIVE

EQUITY STRUCTURE, SHAREHOLDER AGREEMENT, AND EMPLOYEE CONTRACTS

You've interviewed the private equity firms, and they have studied you. Josh has, at this stage, narrowed it down to his top choice and is now going to enter into the diligence and contract phase of the sales process.

For Josh, diligence may eventually feel like a proctology exam that never ends. Private equity firms have limited partners and investment committees to answer to. There is a fiduciary need to turn over every rock and ensure the investment to be made has full visibility to any potential issue or problem. Don't worry, your advisor or investment banker has been through this before and will help guide you through it.

Concurrent with diligence, the contract phase will also begin, and all the various agreements will begin to take shape. Common documents encountered in this phase include, for Josh, a purchase contract, possible shareholder agreement, and possible employment agreement—assuming Josh is rolling over a portion of his proceeds and is staying. If you're Rose, you will need to negotiate an employment contract, potentially become a party to an incentive equity agreement, and a shareholder agreement—if you are also writing a check—more on that in a little bit.

One person is contemplating selling a company, one person is contemplating joining a company, but you are both now looking at the documents that will govern your relationship with the private equity firm.

Note: Usually only the C-level employees have employment contracts. Below the C level, it's more typical to just use a standard offer letter. Regardless, most key positions at the senior level will include some type of incentive equity and perhaps even an opportunity to write a check and invest in the company.

ENSURE ALIGNMENT VIA EQUITY

The most important aspect here is to ensure alignment. In general, private equity wants to have alignment with their executives. You never want to be in a situation where something that's bad for the executive is good for the private equity group. You want something that's good for both of you or bad for both of you, because you don't want to be at odds with your partner. You want to make decisions in unison and be aligned. This will ensure that the outcome is predictable, and neither side is doing something detrimental to the other.

The best way to do this is to create an equity structure that management participates in.

When a private equity firm purchases a company, they typically will use the maximum amount of leverage, or debt financing that the target company can afford based on its cash flows, and use the least amount of cash equity from the fund as possible. This allows the fund to preserve its cash to purchase other companies and to support the other platforms they currently own. This excess capacity is known as "dry powder." These buyouts are known as "leveraged buyouts" because the debt financing, or leverage, is the main source of the purchase.

If you recall, the example company we used earlier was bought for an enterprise value of $32M, of which $20M was debt financing and $12 million was equity from the fund. In the new capital structure, shares of stock are issued in various ways that create a means to incentivize management to hit the targets established in the investment model by the private equity firm. Let's discuss some of the more common incentive equity structures Josh and Rose will encounter.

ABC WATERFALL

The ABC waterfall is what I see most often. In this structure, there are three different classes of stock. When the higher class reaches a certain criterion, money "waterfalls" from that class to the next class.

As we discussed earlier, private equity firms earn their money by charging management fees—to keep the lights on—and then they charge carried interest of their limited partners, which is typically 20 percent of every dollar of profit generated on a company that they buy, grow, and sell. By nature of a ten-year limited partner agreement, they are going to be buying, improving, growing, and then selling portfolio companies over a three- to seven-year time frame. This is what makes private equity a very lucrative career path for anyone involved—including Josh and Rose. They get to ride the coattails of very sophisticated investors, and there will be a liquidity event, or a sale, every three to seven years. This is how management generates wealth. What is better than selling your company once? Perhaps it's getting the opportunity to sell the same company two or three times and participate in the value creation each time!

First, when a company is purchased, a holding or acquisition company is put in place to provide separation from the private equity fund and any liability that may exist now, or in the future at the company level, and there's an equity structure where the various parties are buying stock that gets issued in multiple classes. The private equity firm puts equity into the company through a Class A instrument, where Class A stock is preferred stock. The firm typically invites management to also buy equity, so Josh gets the chance to roll over some of his proceeds from the sale—or Rose gets to make a cash investment—and purchase this same Class A stock.

It's a little ironic for Rose, because often when you consider a new job, you want to know if there is a bonus opportunity. In the private equity world, it's the opposite. You're hoping for the chance to write a check and invest in Class A shares. This is the place where equity originally comes into the company. If it costs $10 million of equity to buy a company, then there will be Class A shares issued that equal $10 million—every company I have seen starts out with Class A shares valued at $1,000 a share, so in this case, there would be 10,000 shares of Class A stock issued.

Class A stock may or may not include a preferred yield. For those firms that implement it, there may be a compounding preferred yield; typical in today's world, it's 7–10 percent. Using 8 percent as an example, at the end of the first year, $1,000 is now worth $1,080, and at the end of the second year, it's worth $1,166.44. In essence, it's a guaranteed return for the equity that's put into the business. Some firms choose not to use a preferred yield on the Class A shares, and some do. It's not right or wrong, just different. Kind of like hands-on versus hands-off, different firms use different strategies. The important factor is to understand how it works and compounds in the specific instance that you are looking at.

Note: If there is a preferred yield, the shareholders who hold the Class A instrument could get a disproportionate amount of the profit ahead of those holding the Class B and C incentive stock. This, of course, is the reward for putting up the equity to buy the company.

Let's discuss how equity is cashed out. Let's say equity in a company costs $100 million. The private equity fund puts up $90 million of equity, and members of the management team put in $10 million. Everyone who puts in equity, including management, gets a 10 percent preferred yield. After one year, every dollar invested is worth $1.10. When the company is sold, the debt is paid back first. Then equity is returned, first to the Class A shareholders who get back their original dollar, plus the first 10 percent of interest that has compounded over time.

Once equity and the preferred yield are paid back, any remaining money waterfalls over to Class B. Class B is the second class of stock. Of this class, typically 10 percent is issued to management through some type of a profit interest unit, or an incentive pool. It looks like a stock option but gets capital gains treatment. There's a tax advantageous benefit to management in the way that this is structured.

Again, the private equity firm is seeking alignment, and they want the management team to do well. There might be as many as fifteen or twenty members of the management team who get stock. It's a free equity incentive to do a good job. Of the 10 percent, the CEO typically gets 30–50 percent, the CFO another 10–20 percent, and the COO gets 5–10 percent of the pool. The remainder is divided among vice presidents, directors, and other key employees. As a CEO, I tend to take the lower percentage in the typical range for myself in order to have more to offer those in lower levels of the leadership team. I prefer that they participate in the incentive equity as it provides the motivation I'm looking for to go the extra mile.

Going back to our example: $100 million of equity, this time with no preferred yield, is used to buy a company. When the company is sold, debt and transaction expenses are paid first, then equity is returned with no preferred yield compounding; the first dollar of profit starts the Class B waterfall where management is now sharing in 10 percent of the profit or as the capital structure dictates.

Class C is the third class of stock. In this class, management is generally given 25 percent of the pool. It's further incentive to do well and is triggered when the private equity fund hits a particular return threshold on capital, most often tied to an MOIC threshold. It is typical to have Class C shares start earning once MOIC is above 2.5 to 3.0 times return. Once the Class C threshold is reached, remaining proceeds flow from Class B shares into Class C shares. It's this flowing at various points and thresholds that causes me to label this structure the ABC waterfall.

I should point out that the waterfall keeps pouring as long as the sale price of the company is high enough to fund it. If the company is sold five years down the road and the sale price covers only debt and Class A, then Class B and C—where management's incentive pools are funded from—are simply shut out because the waterfall has run dry. Typically, a private equity shop will work with management in these cases to provide some nominal bonus as a thank-you for the efforts. Call it a consolation prize. As with any investment, there is no guarantee of performance, and there is always plenty of risk.

To recap, essentially, the ABC waterfall has three classes. Class A is where equity came in. When a company is sold, debt is paid off first, then the Class A equity is returned. If it has a preferred yield, the preferred yield is also returned. Once you've cleared those, the equity rolls over to Class B where management is typically getting ten cents on the dollar until a certain MOIC threshold is reached. From there, it rolls over to Class C where management now has twenty-five cents on the dollar of profit that they're going to share in until the waterfall runs dry.

This is all incentive for management to do a good job. It works well for some people but not others. If you're Josh, you may want to roll forward millions of dollars. And if you're Rose and you've been working for a while, you might also be able to write a nice-sized check to purchase equity. If you're getting a preferred yield of 10 percent, this is advantageous. If you're not in either of those positions to roll equity or write a check, it raises the hurdle to when you will start receiving money from the incentive pool. You will be in Class B stock and not paid until it rolls over from Class A. Do you see now why it's better for management to have an ABC waterfall without a preferred yield? All other things being equal in a sales process, if I had two competing bids and one buyer had a preferred yield and one did not, I might choose the one without. Price matters, but in a tie game, the scoreboard may hold the key in terms of choosing door number one versus door number two.

When companies do well and management teams are aligned with their shareholders, everybody makes money. And since the platform companies are sold every three to seven years on average, there are opportunities over the life of a career to get multiple paydays. Where private equity makes their money by getting carried interest, management makes money when companies are bought and sold, and these stock structures distribute the proceeds. When a company does well, everyone makes money. That's what I call alignment!

While we are on the subject of what's not good for management, I should also mention that some private equity firms charge management fees to cover their overhead at the company level and collect the payments quarterly from the company's cash flows. On a larger company that has sufficient cash flow to cover it, I have seen fees as high as $2 million per year paid in quarterly installments. When management fees are funded by the company, they reduce the cash flow that could be used to pay down debt or make investments. This is also detrimental to management's equity from the incentive stock pool and can once again be a door number one versus door number two differentiator when selecting between two firms at the tail end of the process.

ACCELERATED METHOD

Accelerated method is a less commonly used structure, but one I have encountered and feel is worth mentioning. In this, there are typically two to three classes of stock—and no options or incentive pools exist. Everybody gets a chance to write a check. If you can't write a check, you're not involved in the returns. This means fewer numbers of management can participate, although sometimes you can attempt to negotiate a "grant" for a pool of money for employees to receive stock that can be distributed below the senior executive level.

This structure is based around the concept of accelerated return. If the investment does a 2x MOIC, the private equity fund through the holding company might agree to pay the management team 5x their investment. If the investment does 3x MOIC, they might give management 10x their investment. It's disproportionate, or an accelerated amount of return that favors management, but it requires management to invest and buy stock to play. The private equity fund can pay the accelerated returns because management winds up holding a very small overall portion of the equity structure when compared to an ABC waterfall, and they want to incentivize management to do well and ensure alignment. The first class of stock is issued to the private equity fund and coinvestors—if any—and the second class with the accelerated returns is issued to management. Sometimes a third class is added for outside advisors and board members that pays a return higher than the investor class and lower than the management class. This third class sits between the other two.

In a way, it's like management gets a large preferred yield, or preferred return, that the other shareholders in the private equity fund don't get. It works, provided you can write a check large enough to create personal motivation to do a good job. If you can't write a check and no grant exists, it can create some tension among employees who, in the last round, may have had equity and are now locked out.

I have seen both the accelerated method and ABC waterfall in action. Both work well when a company does well. Like everything else we have talked about, there is no right or wrong; there is just different. Each method has pros and cons. Understanding how it all works is the key. Private equity partners are more than happy to explain how their capital structure works and how management participates. Remember, alignment is to their best interest.

EARNOUT

There is another potential add-on structure for Josh called an earnout. I've seen entrepreneurs make a great deal of money under earnouts, and it's another way to be incentivized to do a better job. If you want a higher price and aren't getting it, it's possible that a private equity firm might put an earnout in place that says, "If Josh grows the company from X to Y over the next three years, he'll get additional consideration paid to him."

In essence, this is a way to raise the purchase price by continuing to grow the company post-sale. I'm not usually a big fan of earnouts when I'm buying several companies at a time and combining them because it can lead to diverging interests and make alignment a bit more difficult. However, it's definitely a tool that in certain circumstances is a viable way to increase the purchase price for an entrepreneurial-led company that might be underperforming for some particular and known reason. Sometimes the earnout potential is the difference between yes and no when Josh was expecting a higher purchase price but not getting it.

LOOKING INTO AGREEMENTS

It's important to be a good consumer and make a choice, whether you're Josh and want to do this deal or you're Rose and considering leaving your current *Fortune* 500 position. The benefit of being a free agent is negotiation. Start by asking questions and looking into your agreements.

QUESTIONS TO ASK

There are several key questions to ask:

- What is the model for investment? The private equity firm should be able to spell out what specifically they are going to do over a three- to seven-year period to increase the value of the company and when they

hope to sell it. Whenever this liquidity event takes place, every three to seven years, there will be a payday.
- What is the equity structure? Explain to me what I get at your different levels of return that you've modeled.
- Do you have a preferred yield on equity investments?
- Do you charge management fees that are paid by the company?
- Ask for specific examples at different return levels. "Show me your base case, upside case, and downside case." All firms typically model three cases: the base case, a scenario if there is a home run, and a scenario for if something goes wrong.

SHAREHOLDER AGREEMENT

Once you've made your decision, agreements and contracts will be drafted. If you're Josh, you're going to have a purchase agreement—whether an asset or stock agreement—depending on how you're selling the company. If you're Rose, you have been recruited to come into the company and typically will be given and become a party to a shareholder agreement that walks you through the equity structure (using ABC waterfall structure below as an example) that you are participating in.

The shareholder agreement will govern the prioritization of liquidity events that take place, typically in this order:

1. Debt
2. Equity
3. Preferred Yield (if there is one)
4. B Pool
5. C Pool

Rarely are the shareholder agreements negotiable. Josh may have very minor luck, depending on whether he is a platform acquisition or an add-on to an existing platform, but Rose will be walking into an environment where the agreements are already in place. Where you will have more latitude typically is in the employment contract or offer letter.

EMPLOYMENT CONTRACT

The employment contract sets out the terms of employment with the company. Josh will review the continuing employment with the company or a consulting agreement if he plans to transition out. Rose will look at the agreement that brings her to the executive team.

If someone is in a junior position—vice president level—they may or may not have a contract. In some states, it's better not to have one as there are more rights to the employee without an agreement than there are with one.

In the agreement, you'll have the ability to negotiate items such as base salary, bonus potential, vacation time, raises, severance amount and how it's paid (weekly or lump sum), COBRA, continuing benefits, termination for cause definitions, noncompetes, and so forth.

EQUITY STRUCTURE

The equity structure is typically pretty rigid and management has to work within the parameters designated. The private equity firm typically has a preferred structure already in mind that is replicated many times over in other portfolio companies. As a result, management is really just a party to a preexisting agreement that represents how the firm does business.

I have, however, seen what I like to call a little kicker. It's not married to any of the methods, but sometimes private equity groups have or will add a provision for dilution protection.

It is not uncommon for a company to need additional equity at some point for a large acquisition. Everyone who owns stock in the company has to get out their checkbooks and contribute additional money, equal to their percentage of equity they currently hold. Management doesn't *have* to write a check, but if they don't, their equity percentage would be diluted because the other shareholders would cover management's lack of contribution. And by virtue of that, the shareholders would then own a slightly higher percentage of the issued stock than any management who didn't contribute.

Some private equity firms don't want management worried about whether or not they'll have to fund additional equity, so they put in place a "dilution protection." In this, if an acquisition is made that requires equity, the private equity firm automatically gives some shares that were held aside to management so that they maintain their ownership percentage without being diluted. There have been a few times in my career where I had to write checks when certain acquisitions were made to avoid dilution, and this concept of dilution protection sure would have been nice!

TAKEAWAYS

We've talked about different equity structures, and the key is that you want to have alignment between parties. Private equity is in the business of buying companies, growing them, and selling them. They want alignment so that everyone is working to move forward together. All parties do well when the company does well. That's the ultimate goal and objective.

There is more flexibility to negotiate employment contracts, and a lot less ability to negotiate shareholder agreements, but it's important to understand both in order to make the best decision.

Note: As I mentioned in the introduction, I always recommend you obtain legal, financial, and tax advice from a competent attorney and accountant.

CHAPTER SIX

GENERATING WEALTH

True, multigenerational wealth is created by running and investing in companies that are owned and operated by private equity. Here's my take on how this works.

Very typically, a seller such as Josh is focused only on price. He never looks at the scoreboard, doesn't consider management styles, doesn't think about personalities, doesn't look at whether it's an ABC waterfall or accelerated method—with or without preferred yield—and instead looks at selling his company as a one-time event. I often hear the Joshes of the world saying, "I don't want stock if I'm not in control." Given the growth of private equity and the sophistication of the industry, I think it's not necessarily a wise position to take!

Let's consider another path, a path I personally have spent almost twenty years actively pursuing.

ROLLING FORWARD

As mentioned earlier, private equity funds have a life span of ten years. They buy platform companies in the beginning, grow the companies in the middle, and sell them at the end. The typical hold period of a platform company ranges from three to seven years. They generate wealth for their firm by charging carried interest on the returns that limited partners earn. Bottom line: to generate wealth for their own firm, they need to make money on their platform companies. As an equity investor employee of a platform company, you get to ride their sophisticated coattails!

Because I know how this game works and because I've been playing it for a long time, I know that any company I run is going to be sold every three to seven years (call it an average of five). So this is how I view the process: why take one bite out of the apple when you can take two, three, or more?

My personal record is five, seven-figure paydays in the same company over a thirteen-year period. I'm not offering investment advice; I'm just telling you how I personally have generated transformational wealth for my family during my career.

A PLAY-BY-PLAY

You're probably confused at this point, so let me explain how it works.

When you are Josh and you sell your company, you're going to have a liquidity event. If you're retiring, riding off into the sunset, and you're going to be replaced, you're fine. Take your money and go. But if you're not retiring, you should consider rolling forward a portion of your proceeds and keeping that money working for you. When the company is sold at the next exit, you'll potentially make more in the second transaction than you did in the first.

This, of course, assumes the company has the runway to keep growing and to keep improving as it gets bigger. Not all companies can; you know your company far better than I do. Suffice it to say, private equity is generating attractive returns such that the industry continues to grow. Whatever the secret sauce is, it seems to be working given the growth of the firms, fund sizes, and total capital under management.

Rose can make money this way as well, because private equity uniquely is able to offer this opportunity even to those who didn't found the business—like me. Remember that for a private equity firm, IRR is the most important measure; selling faster is more important than selling later because IRR is time dependent. It's this phenomenon that positions employees in a portfolio company to generate wealth multiple times as a company grows.

In today's world, it's fairly typical for private equity to target or underwrite a 3x return on investment as their base case, or 3x MOIC. Most entrepreneurs don't value rollover equity. If given the opportunity to roll over zero, they would choose that. My suggestion is to contemplate trying something different. On the first sale, for every dollar you're paid, you do two things to help with liquidity and diversification:

- Roll forward. Take thirty-four cents and roll it forward. This is typically tax-deferred treatment because these are proceeds from the sale of a company, and you're not realizing them now. Check with your accountant or tax advisor to be sure. This action represents the investment for the future.
- Cash out. Take sixty-six cents out. Depending on the capital structure, you will pay taxes on a portion of this. The rest goes into your bank account. This action represents the asset diversification.

Now, on the second sale, let's call it five years later, the thirty-four cents you rolled forward—if it's a 3x MOIC—yields you $1.02. After this sale, roll thirty-five cents forward and take sixty-seven cents out. Do this repeatedly, incrementally nudging up what you roll forward and take out. As long as you can get 3x MOIC, every next payday will be larger than the last.

Why sell your company once when you can sell it twice? Or three times? Results of course can vary; your returns might not be 3x MOIC in each instance. They may be lower or higher. In my personal case, I have never lost money when investing alongside private equity.

I've spent almost twenty years running three different, national private equity-backed companies. These companies are bought and sold on average every three to seven years. I invest money and write checks when I come to a company. I participate in those different stock structures. And when I sell a company, I roll money forward and take some out. It's been a perfect way for me to diversify investments while at the same time staying invested for the future in the companies I run and can directly impact through my efforts.

And here's the thing. You don't have to be Josh. Rose can do this, too. Josh built a company. Josh spent decades, potentially, building a business. But Rose can also get multimillion-dollar paydays without having created anything. By coming out of the *Fortune* 500 world and engaging with private equity in a middle-market-type environment, you can build wealth through your own investment and through the receipt of incentive equity. All of this of course is predicated on the continued growth of the company. I know this because once upon a time, I was Rose and left the *Fortune* 500 world to join the private equity game.

RISK EVALUATION

There's always an element of risk, but there is in everything you do. In staying with your *Fortune* 500 company, there could be massive layoffs, they could close plants, or simply put you out to pasture because of some new idea or restructure. When you're called by a recruiter, look into it. It's more than a title change. If you go to a smaller company that's owned by private equity, it could potentially open up a true wealth-generating opportunity and send your career down a different path. It's a fork in the road: do you go left or right? The decision is up to you, but hopefully, you now are better prepared to decide.

Do your homework. Ask questions. Evaluate the opportunities. You're reading this book; you now understand what private equity is and how the game is played at a very cursory level. Consider telling the recruiter, "Yes, I am interested!" Talking never hurts, and interviewing can expand your knowledge even if you decide not to take the position.

I could have stayed at GE. I was earning a six-figure salary and living comfortably. But since I left, over the last eighteen years, I've generated tens of millions of dollars in wealth that came because of the types of opportunities I discussed above. When I originally evaluated making the move, I asked my mentor, "Is it better to stay at the company and be one of a thousand people like me in middle management? Or should I go become president of my first, much smaller company?"

He responded that it's far better to go take your first role as president. Once a president, always a president. You'll never be thought of again as anything other than a president. Hindsight being twenty/twenty in my case, he was right!

At that time in my career when the phone first rang, I wasn't necessarily chasing transformational wealth. I was chasing title and paycheck. The opportunity to generate wealth through private equity incentive stock plans happened to be a bit of dumb luck that I stumbled into—but now focus on with laser intensity in every opportunity I pursue.

TAKEAWAYS

As a CEO, this chapter may be a mind shift. You want to consider diversifying rather than retiring. There's no reason to take all your chips off the table, as subsequent transactions of the same company can return a larger profit than the first one. Take the opportunity to continue working with a private equity firm. What better company to invest in than the one you already know! What I personally like about this strategy is that I can take chips off the table and diversify my asset base but continue to have an opportunity to generate additional wealth without having to start over in a different company.

As a mid-level manager coming from a *Fortune* 500 company, build your pedigree there and then potentially leave for a private equity-backed company. You can build a name at a much higher senior level and potentially make more money through investment opportunities. Not a lot of people make seven figures a year in the *Fortune* 500 world as a percentage of the total employee base. Compare that to private equity-backed middle-market companies and you might be surprised. A six-figure employee in middle management in the *Fortune* 500 world can be a seven-figure employee in the middle market once you factor in base, bonus, stock incentives, and investing alongside private equity.

In either position, it's key to be well aligned with the private equity firm. They can push you—even if it pisses you off! But remember, it's OK. They have your best interest in mind, too. You'll benefit financially from riding the coattails of sophisticated investment professionals.

Note: As I mentioned in the introduction, I always recommend you obtain legal, financial, and tax advice from a competent attorney and accountant. The information I share here is based on my personal experience. Every situation is different, and any decision to change careers, make investments, or negotiate contracts should be carefully considered and in conjunction *with the advice of your own peer networks, financial advisors, and attorneys.*

PART THREE

THE GAME BEGINS

You have found the right private equity firm to team with. You are in alignment and vested in the company's future success. It's opening day of a new season, and you're in the big leagues! It's a totally different speed than you're used to, and you'll need all the help you can get.

Josh and Rose are now acting in the same position as CEO or upper management of the private equity-backed company. You're going to be working with a board of directors, and it's key to understand not only how you'll be reporting to them but also the benefits of having them in your corner. You built a plan of execution and it's time to deliver. You need to come out of the gate at full speed, and that may mean making some difficult personnel decisions. You may also find that you're spending money differently now that the company is being rated on a new set of parameters—EBITDA.

CHAPTER SEVEN

THE EARLY DAYS

We've discussed private equity, what it is, the history, and the growth. We've talked about the players and the roles, the process of selling a company, evaluating the partners, and how to negotiate contracts. Now you are in. You've chosen the private equity firm and moved forward. Josh and Rose are now the same person, merged together. Neither of them owns the company outright, and both of them have some type of equity investment. They will benefit if the company does well and the actual gains begin.

What does the new playing field look like now?

BOARD OF DIRECTORS

You have a new boss, and it's the board of directors. *Note: If the legal structure of the holding company is an LLC, it may also be known as a board of managers. These two terms in the context of private equity functionally mean the same thing.* A lot of entrepreneurs don't like to be micromanaged, but it's something you'll have to get used to. It's in your own interest as you have rolled your money forward as a pseudo-limited partner, your money is aligned with the private equity firm, and the board is here to help.

If the private equity firm is a majority stakeholder, they will most likely implement a board with five to seven members. Two or three will be from the private equity firm, there will potentially be an outside advisor or two who is paid a stipend and/or is afforded the chance to make a small coinvestment, and perhaps you've been added as well. Don't ever lose sleep about whether or not you are an official board member; it just doesn't matter—you ceded control when the company was purchased by private equity.

OPERATIONS

Some boards operate formally, keeping minutes down to the second and asking for motions, seconds, and a show of hands to approve every last line item. Others are informal without a motion the entire time they own the company. It shouldn't matter to you at this point. If you've done your due diligence and followed the previous chapters, you are aligned with a private equity group that has the same vision and mindset as you. The board of directors is now just an extension of that. They are a consultative group of people making decisions on directions, investments, and how best to propel the company forward.

The board of directors will usually schedule a monthly call to review results with management and ensure continued alignment. This may include only the private equity firm, not the full board. Quarterly meetings are typically in person with a board dinner before or after, allowing the directors to socialize and get to know other members and management. Budget planning sessions occur once or twice annually with the full board. Specific issues can require special board meetings, perhaps to approve an acquisition, or a new capital structure.

Involve the board of directors. Reach out to them as needed and use them as thought partners. I promise you, it is worth the time and effort to engage these people. They have a level of sophistication that typically exceeds your own when it comes to both financial and operational matters. If you have questions, pick up the phone and call them. Perhaps you wonder what a board meeting presentation should look like. Call your private equity partner and ask for some sample board decks from other portfolio companies. Like everything we have discussed, working with a board may be new to you, but it's not to them. Ask questions!

Your new partners want to be engaged; in fact, they feel better when they are engaged. If you can go out of your way to purposely include them in decisions that are appropriate and to use them as a thought partner, they'll be a lot more comfortable with how this new arranged marriage is working.

GOVERNANCE

The board may issue formal governance to which management must adhere. It should allow you to operate the company under ordinary course without having to go get approval from the board members, but you may have to get input for unusual operations and can turn to the board for advice.

Independent advisors often move to board positions toward the end of their careers because they have expertise in particular industries. They still want to contribute but don't necessarily want to continue working full time. There is a saying—"'Old gomer' CEOs never die; they just become advisors!" They're involved because they've run companies before. They most likely have experience in your field or a similar-related field, and as an advisor they can offer input and help to move the company forward. As my own career continues, I know a pivot point is eventually coming for me, too. Who knows? One day you might just encounter me as the old gray-haired guy on your board! Think of the fun we could have working together!

When limited partners invest their capital with a private equity firm, they like to see knowledgeable independent advisors on the board. They find comfort in knowing high-profile people with successful track records are actively engaged, rather than just seeing a few finance guys from the private equity firm. In fact, having a large network of old gomers is often a recruiting tool that private equity firms use when fund-raising to attract limited partners.

The advisor role is something you may consider shifting to in the future. It's a great way to work part time and be a designated hitter once you're ready to hang up your full-time cleats.

THE FIRST DAYS

In these early days, there's a period of gelling. It's an arranged marriage of sorts. You need to get to know the people you met during the process, where everyone was on their best behavior. Once the deal has closed, the real people show up, and it is time to get to work!

There is a need for speed. Remember that the number one way private equity firms are measured by their limited partners is on their fund's IRR, which takes into account the time value of their investment. Time is not your friend when it comes to IRR. You're going to be selling this company every three to seven years, and it's in your personal best interest to do it sooner rather than later, simply because there are more paydays over the course of your career if you do. In order to make the math work, you need to hit the ground running hard.

STUB YEARS AND BUDGETING

Typically, companies aren't bought and sold at the beginning of a fiscal year, so there's always some type of a stub year in the beginning. During this stub year, you'll begin work on executing the investment plan that was modeled and contemplated back during the sale process. You'll also prepare for the next fiscal year with a series of budget planning sessions. Typically, the first budget is not immediately adopted, and a series of what-if exercises is undertaken to add some level of stretch to the budget plan. Stretch, plan, and reforecast is something that happens over a few repetitive cycles.

Josh wasn't necessarily a sophisticated budgeter, because he didn't need to be. But in the private equity world, budgeting and forecasting is imperative to the private equity players. You may need to bring on an upgraded accounting team to handle the higher sophistication required by private equity to satisfy internal constituents and lenders. It's a long process, and the fiscal year-end numbers for the current year define the starting point for the next year. You'll go through a detailed budget process every year, so get used to the rigor that it entails.

TIME TO EXECUTE

Prior to the sale of your company to private equity, you were painting a rosy future of the business while you educated the private equity firm about why they should buy your company. Now you need to show that the story you sold the firm is fact, not fiction. Remember those hockey stick growth projections that showed how bright the future looked once the new owner took control? Time to deliver!

The private equity partner has underwritten a model that includes specific growth levers. Understand what those growth levers are. Translating levers to initiatives, and initiatives to actions, is key to your future success. Be ready to jump and start executing. The time to create the plan is not post-close; it's before the close.

I've coined a short, modern proverb: "Disrupt yourself, less ye be disrupted by others." Oftentimes, Josh does things the way Josh has been doing things for the last twenty years. There's been no need to challenge his own conventions or status quo, but this is why it's key to understand the investment thesis and the specific growth levers that will be used to grow the business. Remember, in order to make your next payday bigger than the last, we need to double or triple the value of the existing business in three to seven years. To do this, you need to think differently. The company I'm running today had a historic growth trajectory (known as compound annual growth rate [CAGR]) of 10 percent per year for fifteen years prior to my arrival. That trajectory, after two years on the job, is now a CAGR of 25 percent. It took a lot of heavy lifting to change that trajectory; it didn't just happen on its own. How are you going to change your trajectory?

You can't rest on your laurels. You may have just put millions in the bank, but the private equity guys haven't put anything in their account. They are spending cash, so they want to bank time. Achieve full potential by developing a plan. Put together specific actions on how to reach full potential, and then, as with every strategic plan, if you can't measure it, it will never get done. Choose a handful of critical measures, not a thousand. Assign owners to each action, someone who is incentivized to do a good job.

Speaking of planning, let me give you a personal example of how I handle it. Before I came to the company I currently run as an employee, I spent thirty days working two days a week as part of a discovery phase. I met with many levels of people inside the company and took copious notes during the conversations. I leveraged the information gathered across eighty different interviews and began to look for common themes or issues across different categories. I then thought about causation and looked for what conclusions I could draw based on the material I had obtained.

Before I even started at the company, I had written a one-hundred-page strategic plan. I documented the underlying symptoms and causes, what changes were required, and detailed my plan of attack. I shared that plan with my staff during a two-day session and then boiled it down to a ninety-minute presentation that I gave to the top sixty leaders in the company. From there, I created eight YouTube videos that I sent out to the entire company over an eight-week period. Just as private equity wants to align incentives, I wanted to align every employee in the company to understand my vision for the future and to prepare them for the changes that were coming.

We've been executing on that plan for two years now.

I've done this, or something similar, in every company I've had the privilege to lead. You may not have a month to do the same discovery phase, but you will have had management meetings prior to the sale. A banker would have helped you craft your story by writing the CIM. Take those efforts as the early basis for your strategic plan so that you know what you will do differently on day one.

TAKEAWAYS

You have new partners, a new board, and need to make sure they're included in your thinking. You aren't operating in a vacuum anymore. All news should be shared: the good and the bad. They want to know when things aren't happening according to plan.

The expectation post-close is that the leadership team will celebrate their success and the closing of the transaction for about forty-eight hours, and then put their heads back down and dig in. It's like a baseball team celebrating winning a division championship. Spray champagne tonight, but remember the World Series starts in a few days!

The CIM that was used to attract private equity and tell the company's story now has to be translated into a strategic plan that can be executed. If it wasn't done beforehand, time to do it now.

CHAPTER EIGHT

WELCOME TO THE BIG LEAGUES

We've made it through the planning stages and early days; now it's time to truly play the game. As we've mentioned before, the private equity firm expects you to perform on numbers and in a timely fashion. Not only that, the partner or managing director assigned to your company—the one who was the patron saint of getting your company purchased—is now responsible for the results of your company. They convinced an investment committee of other people to make the purchase, and they are now your partner. They have numbers to hit just like you do. Their reputation is on the line.

When you're drafted for the first time, walk out onto the field to the pitcher's mound and pick up the ball. What do you want to do? You want to throw strikes.

What does that mean here? We talked about IRR being the key private equity measurement, so it's important to get out of the gates early. Hit your numbers and establish your credibility as a leadership team. They've made an investment in you. In chapter 7, we talked about a board of directors being like an arranged marriage where you're getting to know each other. When you can build credibility and hit your numbers, it shows you have a good command and control of your business. You had a strategy, and now you're showing you can execute.

We talked about hands-on, hands-off when it came to evaluating private equity firms. If a company fails to perform or gets out of the gate slow, that needle will swing more toward hands-on. If you establish credibility, start taking action, and are doing things to execute on the plan you presented, the needle naturally moves to hands-off. Private equity firms typically own or are involved with several companies. The companies that aren't performing well get all of their time. The companies that are performing well don't need as much hand-holding even if the firm is considered more hands-on. If hands-off is what you seek, it will help if you develop a reputation as a person who hits numbers early on.

THE PACE INCREASES

Private equity moves at a very fast pace. The players who play with private equity for the first time need to understand that the pace of the game is going to change. As an athlete gets older, the speed of his skills changes. Picture how fast a professional-level hockey player covers the ice compared to a high school athlete. For a first-time professional player in the NHL, you'll hear him say, "God, it's a faster game up here!" In the early days with private equity, it's going to be a different game. Things move at a much faster pace, and the field suddenly seems very small, because people cover a greater distance faster.

It's this way because the time is ticking with IRR. In a private equity-backed company, the environment can be twenty-four hours a day. You have associates working sixty to eighty hours a week. They're firing off emails at 2:00 a.m. I'm getting up at 4:00 a.m. to respond. There is a high level of dedication. You, as the management team and a player in this new private equity environment, have to get used to a faster pace. You have to learn how to deal with frustration and stress. This is where you need to make sure you did your homework, picked the right firm to partner with, put the best contract into place, and confirmed that everyone is aligned. It feels good to move at a fast pace and have people push you because it'll make you a better athlete.

In this way, both you and the company will achieve a better outcome. As an investor in the company, you benefit fiscally in two ways: first, by being fully engaged and, second, by allowing the faster pace and smaller field to push you. Athletes often talk about the need to be surrounded by other athletes who push them. The reason they train so hard and practice daily, even though they're the best in their field, is simply because it helps them become champions. It helps them achieve and stay at a very high level of performance. It’s all good. Just know you need to hit the ground running and throwing strikes.

STRONG ACTION OUT OF THE GATE

Upgrades to the company and its key personnel may be required in order for you to propel the company to the next level. Now that the game is quicker, now that the company is going to get bigger, do you have the right players on the field?

If someone is struggling today, imagine their struggle when the company is twice the size and 3x the speed. You have to quickly evaluate. Ask yourself, “Is the team I have on the field today able to perform? Are they capable of making the leap to double our size and speed?” You may have loyalty to your employees, but you also have a job to finish. It’s time to do an assessment of the leadership team and determine where you need changes. Ideally, you would have been thinking about this long ago and actually already have a plan in mind to address talent in the organization. If not, now is the time to catch up! There is an excellent book I’d like to recommend on the process of managing human capital: */move—The CEO’s Playbook for Capturing Value* by Sandy Ogg.

As the complexity of a company increases, an evolutionary process takes place. Some people can’t make the transition. Some people can. Some people need additional education or training. You can invest in people; you can help them by sponsoring their MBAs or to get further certification. It’s incumbent on us as employers to invest in our people and prepare them for the next level. At the same time, it’s vital for the employer to recognize when a person doesn’t have the capability and needs to be let go.

It’s better to transition them out early rather than slow down the process. Evaluate everyone holding a key position and take action swiftly. I once attended a leadership summit sponsored by my current private equity firm where the topic of the session was human capital. A question was thrown out and debated by more than fifty CEOs—specifically, “When is the right time to make a move and take action on a person who appears to be struggling in a key position?” The collective wisdom in the room, based on hundreds of years of combined managerial experience at the most senior of levels, was "the very first time you think that action might be necessary."

I know in my own company that I am running today, I gave everyone in a senior leadership position a good six-month opportunity to succeed. As Rose, I was new to the company and wanted to take the time to evaluate key players. Two years down the road, ten of twelve direct reports are new people who did not hold their current position when I first arrived or new positions that didn't exist when I started. Those who didn't make it were very good people, but change was necessary to alter trajectory. With every new leader who has arrived, they too have also turned over key leaders or added new ones where needed. The result: revenue is up over 50 percent in two years, and EBITDA is up by over 200 percent.

Taking action on a human level isn't always easy. Oftentimes when a new coach takes over a team, changes are made to key players in order to change the trajectory. In my company, we have an inner circle that reviews talent in key positions on a monthly basis. Watching key leaders, interacting with them, mentoring them, and investing in their knowledge is important to sustainable success. I am currently sponsoring four rising stars who are pursuing their MBAs.

CONSIDERING CULTURE

Some worry that making personnel changes comes at the expense of culture. It doesn't have to. During the same two-year period that transitions were occurring on my staff, our employee engagement scores—*the percentage of employees who are fully absorbed by and enthusiastic about their work and thus take positive action to further the organization's reputation and interests*—were also through the roof at 83 percent. Our net promoter score—*an index that ranges from –100 to 100 and measures the willingness of employees to recommend their company as a good place to work to others*—during this period also climbed to 29, and our employee turnover decreased by 50 percent. Yes, you can manage change and strengthen culture all at the same time!

ADAPTING TO CHANGE

Win as a team; lose as a team. It's not about me; it's about we. If something starts to go south, engage early with the private equity partners and board members. Just as they challenge you, you need to challenge them, especially when something isn't moving as fast as you'd like, or if adjustments need to be made. It may not have anything to do with your strategic plan; something may have happened in the economy or in politics. Keep in mind that diligence and sale processes might last four to six months.

Economic conditions may change between the time you go out to market and the time you find a new partner. Here is where you engage the team, letting them know, "Hey, things aren't happening the way I thought they would. Help me with my analysis. Let's talk about this as a board and agree on direction." Make them a part of the decision process on how to react or adjust. They now have ownership in the direction that's been decided. If things go well, everyone is happy. If things continue to be a challenge, you have an across-the-board buy-in, and you're less likely to be blamed for the results when the team has made the decision on play call.

I remember back in late August 2008 when I closed on the sale of the company I was running, only to wake up a few weeks later and find myself in the biggest recession since the Great Depression! No one saw that coming in our models. Sometimes situations change through no fault of our own. Adapt, evolve, and overcome—that's how obstacles are conquered! How did that company turn out? Well, in seven years we increased both revenue and EBITDA by 220 percent each. It took a little longer due to the recession, but while most companies were struggling, we were growing and hiring, just not as fast as we would have liked. It wasn't a home run by any stretch, but given the large size of the company and the nationwide financial meltdown occurring around us, our private equity firm was very happy with the outcome when the company was sold.

TAKEAWAYS

You now have an investment and skin in the game, and you are incentivized to execute. If you do well, you get the opportunity to sell the company, roll over some of the profits, and get that next bite of the apple. This is where you generate wealth for your family. Oftentimes, you'll be looking at a seven-figure-plus payday if you do a good job. Looking at it this way, there is nothing wrong with being pushed. You're a professional. You're in your prime. This is what you do. Play with intensity and play well. You are in the big leagues now!

The speed of the game you have been playing will increase. Private equity firms have a relatively short three- to seven-year horizon to impact change in order to achieve a 3x MOIC return on the investment. The nature of IRR says, "Quicker is better than longer," but IRR and MOIC need to be optimized for the best level of success.

Strong action is necessary to create a pivot point and change trajectory. Evaluate the team and make quick changes where needed. Get the right players in the right seats so the bus can leave the station!

Be flexible. Adapt to changing situations and be ready to alter plans and directions. Things will happen that are outside of your ability to control. Better to ride the wave and direct tangentially your direction than stand in front of the wave and be crushed by it.

Win as a team; lose as a team. It's all about execution.

CHAPTER NINE

EBITDA: IT'S A DIFFERENT BALL GAME

As we touched on earlier, EBITDA is a key factor in the private equity world. The term comes from the acronym for *earnings before interest, taxes, depreciation, and amortization*. Why is this number important? What's the game here?

EBITDA is the level playing field on which all companies are valued by private equity. It's how your company was valued when the private equity group bought it, and it's how other firms will value it when the company is sold in the future.

A LOOK AT TAXES

Before we get into the role of EBITDA, we need to take a step back and look at taxes. When you're a private company, you're programmed to not pay taxes, or to at least minimize them. In the private equity world, it's drastically different. In addition to private equity, the firm used leveraged debt to buy the company; and because interest on that debt is a tax write-off, they tend to build up *net operating losses* (NOLs). In a private equity-owned environment, that company most likely won't be a taxpayer ever again (or at least as long as the investment is playing out over the next three to seven years) because there will be interest payments that are netted against earnings of the company.

A typical business owner like Josh historically had little debt, didn't focus on EBITDA, and ran his private company based on cash. He wanted to make sure that he was limiting his taxable burden by recognizing all kinds of expenses, but he never paid attention to where they hit his financial statements. In a private equity environment, limited tax burden is inherently built in by the nature of capital structures, and where expenses are recorded matters. The rules are changed.

LINE ITEMS

How EBITDA is determined involves a shift in thinking. The two categories impacted on the financial statement are operating expenses (opex) and capital expenses (capex).

Opex lowers EBITDA because operating expenses are "above the line." Examples include operating leases for equipment and salaries. Capex doesn't lower EBITDA—and won't lower enterprise value with future buyers unless there is too much of it, because capital expenses are "below the line." Examples include buying office equipment or vehicles outright. *One exception to note is real estate. Private equity does not want to tie up capital and assume the liability and cyclical risk of owning real estate because it is not time and capital efficient. Josh should have sold any owned real estate prior to selling the company or moved it to a different legal entity and put in place a fair market value lease with the company.*

This mysterious "line" is a place you can look at on the financial statement for a company. At the top is revenue, followed by direct expenses. These are costs associated with servicing revenue or manufacturing a product. Below that are the sales and general administration (SG&A) expenses, next comes the EBITDA line, and beneath that you have the basement, which is where your taxes, depreciation (capex), and amortization hides. In all seriousness, if you need help understanding your financial statements, sit with your CFO and go through all the various components. All companies report slightly differently, so I'm painting with very broad brushstrokes.

On a financial statement, EBITDA is just an arbitrary place where you're spitting out earnings in some type of normalized fashion. EBITDA should not be confused with cash profit. A lot of activity takes place below this line. A public company tends to be valued at a price-to-earnings ratio: the price of the stock versus the earnings of the stock in a public environment. In private companies that are private equity owned and operated, valuation is made at the EBITDA line. From there, each industry typically trades at a different multiple. So a company is normalized at the EBITDA line, and then if the industry trades at 10x, you'll multiply EBITDA by ten to obtain the enterprise value.

There are many aspects to EBITDA that you will need to understand. The accounting department closes the books each month with the raw, as-reported numbers, and the EBITDA is determined. From there, expenditures that are one-time, nonrecurrent in nature, and permissible under a credit agreement can be added back to create an "adjusted" EBITDA. "TTM EBITDA" is the trailing rolling twelve-month EBITDA and "run rate" EBITDA is what the company projects on a forward-looking twelve-month basis. You'll also hear terms such as *comping up* (TTM EBITDA is increasing) and *comping down* (TTM EBITDA is decreasing). Both Josh and Rose would benefit from a conversation with the private equity sponsor and the company CFO to understand how all these various forms of EBITDA will be thought of and defined in their company.

ADD BACKS AND ADJUSTMENTS

There are some expenditures that can get added back to EBITDA when valuing a company for a sale or purchase. Let's say Josh had some personal cost buried in the company prior to sale. When the private equity group does an analysis on Josh's company, they may look at expenses that will no longer exist in a new ownership environment. These become add backs and are good for Josh because they raise the EBITDA. EBITDA is adjusted to reflect the change and becomes pro forma when it considers what the new run rate would be with that expense removed. Adjustments cut both ways, though. If Josh owned real estate, as an example, and didn't charge any rent to his company, the private equity firm would add a fair market rent to their calculations, which would lower the pro forma EBITDA. All of these *puts* and *takes* feed into what the private equity world refers to as a quality of earnings (Q of E) analysis.

OPERATING DIFFERENTLY UNDER EBITDA

When it comes to operations and expenses, the mindset changes now that you're a private equity-backed company. Your goal and objective is to trade operating expenses for capital expenses, within reason. If you put too much into capex, firms will start to discount earnings because they'll say you have too much capital expense. There's a nuance here in how you think about running the business, because now you're rewired to be thinking from an EBITDA-friendly perspective versus a cash perspective. Overall, these are subtle changes at best, not a lever for growth. You're just looking to become EBITDA efficient by rethinking operating strategy. The game changed, and I want you to understand the nuances.

For example, wages paid to employees are an operating expense and will lower EBITDA. However, if you hired a consultant to come in for a one-time engagement to help you make something more efficient, you might pay more for the consultant than the salaried employee, but as a one-time expenditure, it gets added back to EBITDA. It's beneficial in a private equity environment to use consultants for nonrecurring special projects versus hiring additional employees who remain an ongoing expense. That's the financial reason to use consultants, but there are also operational reasons. You are renting expertise that brings broad, best practices obtained from literally dozens of similar engagements with other companies. More on consultants in chapter 13.

Or let's say you own a plumbing company and have five hundred trucks on the road, regionally and interstate. In the past, you measured yourself on cash and tried to not have taxable income, so perhaps you used operating leases to acquire your vehicles. Operating leases for equipment or vehicles lower taxable income, create operating expenditures, and preserve cash, but the expense is recognized above the EBITDA line and thus reduces EBITDA. As a private equity-backed company, you might look into purchasing the vehicles outright to turn the same expense into capex and push it below the line. In a large fleet, this nuanced difference in accounting for the expense might raise EBITDA by several million dollars. And remember that if a company has a 10x multiple, every dollar of EBITDA increase is actually worth $10 in increased shareholder value. There are plenty of operational reasons to own your fleet versus leasing the fleet—namely, the ability to extend the useful life of the vehicles well beyond the lease term. Modern vehicles are more reliable and last longer, often going for more than 250,000 miles. In most cases, it makes better sense to own the vehicles rather than lease them in the first place.

EBITDA MULTIPLES

Industries tend to have different multiples assigned to the EBITDA; however, there's always a range. You might encounter an industry that trades at 6x–8x EBITDA, and there's a difference between what gets rated at a six versus an eight. Is the company growing, shrinking, or stable? What's the customer concentration of the revenue? What's the sophistication of the leadership team? What is the EBITDA margin of the business? There are a variety of factors, but you are seeking to have attributes about your company that are more favorable than others in your industry. That nets you a higher multiple within your range.

Sometimes economic conditions cause the range of multiples to shift up or shift down. Currently, we're in a very strong economy with more than a trillion dollars of private equity capital chasing companies. There are not enough companies to buy, so prices are going up. If we hit a recession, this will likely shift. Some companies do better in recessions than others.

Private equity groups spend a lot of time analyzing and trying to understand economic conditions that will have an impact on valuations, and they determine where your company falls in the multiple range. The analysts dig into the industry and analyze comps. They also consider the size of the addressable market, whether it's growing or shrinking, and who the customers are. They look at customer concentration and the historic performance of the company. They build a model and then determine the value of the company. There's a story to be told, and that story is vetted.

TAKEAWAYS

Companies often have EBITDA and *adjusted* EBITDA. As someone in management, you can analyze the current operating practices and often find there are multiple paths to choose from with respect to cost management. One may be more friendly than another with respect to EBITDA. Since EBITDA is where companies are valued, it's important to be cognizant of that. It's a new ball game. You want to grow EBITDA in a private equity environment because when the company is sold, purchase price is directly tied to this number. Cash and cash flow matter, especially when it comes to determining how much leverage a company can sustain, but the real object of the game is to increase EBITDA.

Managing EBITDA by focusing on where expense hits your financials is NOT a growth lever! But rewiring yourself to think a bit differently is required because the game has changed for both Josh and Rose.

PART FOUR

GAME DAY STRATEGIES

You've made it through the beginning of the game and have perhaps even done some restructuring. Now it's time for the game day strategies to kick in. This is the time of accelerated growth for the company. You'll be looking at those different growth strategies, including organic, margin expansion, and buy and build.

As Josh or Rose, you'll be looking at different growth strategies and determining which one(s) is/are better suited for your business. You will work with the private equity firm, the board, and most likely various consultants to implement these strategies in hopes of accelerating growth, achieving full potential, and selling the business again for a 3x MOIC or higher down the road. This is when you start to see exponential growth in your investments as well.

CHAPTER TEN

ORGANIC GROWTH

There are strategies in the way private equity is used to help you grow your business. Virtually every company owned by private equity focuses on three levers of growth that can be used to increase shareholder value: organic growth, margin expansion, and merger and acquisition. This chapter focuses on the first of the three.

WHAT IS ORGANIC GROWTH?

According to Investopedia, *organic growth is the growth rate a company can achieve by increasing output and enhancing sales internally. This does not include profits or growth attributable to takeovers, acquisitions, or mergers.* The goal is to increase revenue from current customers or finding new customers, but the company will essentially do the same thing it did before the private equity firm purchased it. There are two components to organic growth: price and amount of product/service sold.

PRICE

If you sell widgets, you can increase revenue by either selling more widgets or selling the same amount at a higher price. Price is often overlooked because it involves difficult analysis of your current customer base and price elasticity in the marketplace. Can you add a few percent to the prices you're charging? I think you can with some concerted effort.

Sometimes companies get locked into a product or service pricing mentality that hasn't allowed for adjustment in decades. The concern is that customers will leave if you raise your price, but the reality is that every other product has increased in the past twenty years, and yours should, too. My suggestion is that companies review their prices at least annually.

Inflationary wages increase, benefits costs increase, the cost of gasoline might increase, among other factors. These are all operating expenses. It's incumbent on the company to constantly evaluate the price it charges for products and services and to raise prices when it can to provide coverage for that. I believe strongly in testing the waters on price in multiple increments across various markets and seeing how increased price impacts sales.

Consider airlines. First, they began adding fuel surcharges to the price of a ticket. Now they add a baggage fee if you fly a particular class. As their costs increase, they find ways to pass that on to the consumer. In 2017, charging baggage fees added $4.6 billion in revenue to airlines without adding any real cost to service. Let's face it, we always traveled with luggage before—and still do today. In retail, things are always "new and improved," which according to an old joke, typically means, you "get less and pay more!"

PRODUCT OR SERVICE SOLD

Another way to achieve organic growth is by increasing the amount of a product or service that's sold. You can certainly do this by looking for additional customers, but there's also a way to redesign the approach and processes being used to yield incremental sales gains.

UPDATE SALES AND MARKETING TO ACCELERATE GROWTH

Look at restructuring the sales and marketing efforts. Are you taking advantage of modern CRM software and the supporting mobile technology? Are you presenting the best image for the products and services that are out there?

At my current company, I discovered that the sales team predominantly represented only 40 percent of the revenue of the company for the services that we provided. Almost nobody focused on the other 60 percent of the business. That revenue stream was inadequately represented, and nobody was focused on looking for new customers. They were charged with just maintaining or servicing the existing customers. Lots of farmers, no hunters, to use some sales vernacular. I brought in a consulting group (EBITDA friendly) to help us restructure and rethink the entire sales and go-to-market process using a group with tremendous expertise in this area.

TIERING PRODUCTS AND SERVICES

Does your company focus on only one product or service? You may be losing out to people who want a different class of product. For service companies, let's consider FedEx. They offer to deliver a package overnight by 10:30 a.m. or the next afternoon. They have two-day service and FedEx Ground. How fast do you want a package to go from point A to point B? There's a different price point based on time to serve.

For product companies, Mercedes-Benz offers another example. The flagship S-Class sedan can cost $140,000. For consumers who can't afford that, there is the E-Class that costs half that amount and then finally the C-Class for those who want Mercedes quality for $40,000. All three vehicles get you from point A to point B, all have the cachet of Mercedes-Benz, but the price points widen the customer base to capture more total revenue. Tier your products and services to drive growth.

I should note that some customers are also looking to spend more, not less. While tiering products and services, make sure to create a product that is higher priced. You'd be surprised how some people buy the top tier merely to have the best product or service offered. It can also help people buy your old premium product when they are value shopping because the old premium is now the mid-tier.

REBRANDING

I've run three companies as a president over the last twenty years, and during that time, we changed the name of all three! That's another strategy that can be used to drive organic growth: rebranding.

I often find that a company tends to have a name or brand that has nothing to do with the product or services offered. There are different reasons why you might change a name, but the classic example that I like to use is my own.

I was hired to run a company named WEB Service Company. I bet you're thinking it was an internet company. If so, you are wrong. It was actually a commercial laundry service company.

The business started in the 1940s, and the founder of the company kept coming up with cool names for a company. Each name was taken, so somebody finally said, “Why don’t you use your initials?” William E. Bloomfield yielded WEB Service Company. In 1947, that was fine because there was no internet. In 2008, when private equity acquired the company from the family, it was no longer fine. As a matter of fact, it was downright confusing and time for a change.

We hired consultants (again, EBITDA friendly) to help us come up with a new name. Internally, we came up with our own placeholder called Wash Multi-Family Laundry. WashLaundry.com was available, so we secured it. The consultants finally came back to us and said, “Look, no matter how much money you spend, we cannot come up with a name that’s better than the one you already did.” WEB Service Company became Wash Multi-Family Laundry.

Rebranding is an organic growth strategy. Sometimes new and improved excites the marketplace. It’s a new splash. It’s a new beginning. It’s a new website. It’s an opportunity to tell a refreshed story.

REVAMP MARKETING

With the sale of the company, you now have the power to ask why you do the things you do. Companies made good decisions once upon a time, but they often don’t challenge the strategies that have been in place for twenty years. These strategies make a modern company less efficient.

Let’s take another example. At one of the companies I ran, we still printed marketing material. We distributed five thousand copies of every new brochure to our salespeople, who inevitably shoved them in a closet and then went back to using their favorite pieces. Of course, the first thing that happens after you print something is you take one last look at it and say, “Damn, I wish I would have made this other point.” Or, “I should have changed this word to that.” You print again, have multiple versions, and are no longer controlling the message. The marketing efforts become uncoordinated.

One thing we did to modernize the company was move to electronic marketing material. We handed all of the salespeople iPads and provided them with an app called Offline Pages. Any changes we made to marketing pieces instantly coordinated across all devices. When the salesperson woke up each morning, she had the most current marketing material, and everyone was using the same wording. Instead of having wasted copies and revision control problems, we now had very efficient, colorful, streamlined marketing material. Since it was on the iPad, they could customize the message and send it directly to the customer via email or print. This electronic medium also allowed us to now embed videos to further enhance the story we were telling.

FINDING BLUE OCEAN

For those of you who have obtained your MBA, you may have heard the term *blue ocean*, first coined by Professors W. Chan Kim and Renée Mauborgne in their 2005 book *Blue Ocean Strategy: How to Create Uncontested Market Space and Make Competition Irrelevant.* Blue ocean in this context relates to finding new opportunities for organic growth and is centered on the concept of pivoting away from red ocean (water that is red from the blood of competition) in favor of new markets with little to no opposition. This provides you with new opportunities to accelerate organic growth by serving adjacent markets that historically have been untapped.

As an example, I currently run a company with 1,200 service technicians who provide refrigeration and HVAC service in the food retail end market (grocery stores). In times of disaster, getting food and water is important to people. A few years ago, there were hurricanes in Florida and Texas. Our team positioned gasoline and generators at our offices to make sure our trucks could be back on the road as soon as the storm cleared. The technicians ran from store to store, getting them back online because that's what we did. It had been our core addressable market.

In Florida, people were dying in assisted care facilities because they didn't have refrigeration or HVAC to help in meeting their medical needs. Our company could have been rolling trucks to assisted care facilities to fix air-conditioning or refrigeration just as easily as we could have been going to grocery stores. Out of that disaster and that human tragedy, it opened our vision to a new line of customers.

We started thinking about our own business. We started pivoting a little to the left and right of the customer base that we'd been servicing and redefined our customer as anyone who thought of refrigeration and HVAC as being *mission critical* to their operations, and we suddenly found billions of dollars in new market potential that had not historically been the target of this particular company. Additional pivots since then have increased our total addressable market from $5 billion to more than $50 billion. Those pivots helped increase our ability to deliver sustained organic growth.

Another example: Years ago, I took over as president of a medical device repair company. When I arrived, I found that the business model had failed. The company had started in the 1970s and failed to adapt to changing times.

The customer base was hospitals that contracted with the company to provide services for all the devices within the hospital. Those devices fell into two categories: biomedical (monitoring equipment, IV pumps, heart monitors) and imaging (MRI, CT, ultrasound) equipment.

In the 1970s and 1980s, the company would put their own people inside to handle the biomedical equipment and outsourced the imaging equipment to be repaired. Over time, the biomedical equipment stayed the same, but the imaging equipment evolved. Superconducting magnets in MRI and consumable X-ray tubes on a CT scanner might cost upward of $100,000. The business model no longer worked, because outsourcing this sophisticated work became too expensive.

The company was now providing service on a part of their business that had become more or less commoditized. They were losing money. The company had failed to recognize that they could no longer be an insurance provider in imaging. They had to do imaging service because that was in their contract, but they couldn't keep up this path. I came in, took a look at the business and marketplace, and decided to do one small acquisition of a parts company. Having our own parts would cover the biggest expense on the imaging equipment repair. I then built an imaging repair service arm inside the company.

Instead of doing only self-performance on biomedical equipment, we could now also self-service imaging equipment in the radiology department. This changed the financial dynamics, and the company became highly profitable. It was a failed business model that we changed, allowing us to increase margin, become more competitive, and sell to new customers, which ultimately drove organic growth. Because I bought a company to help facilitate the pivot, increase margins, and enable organic growth, this is also an example of combining all three growth strategies in one move and achieving a "triple lindy" (referring to a level of difficulty in a dive exhibited by Rodney Dangerfield in the 1986 comedy *Back to School*).

A lot of times, companies get stale or stagnant, and organic growth drops off. That doesn't mean that organic growth is unavailable. It simply means that people need to rethink, retool, redesign, and potentially pivot.

QUESTIONS TO ASK YOURSELF

1. If we hire more salespeople or restructure sales strategy, will we grow faster?
2. Do we have a good balance of hunters and farmers?
3. Is our sales process representing all of our products and services adequately?
4. Are we selling what our customer wants or trying to force them into purchasing the product/service we happen to sell?
5. Can we tier our products and services to widen customer appeal and capture incremental volume?
6. When is the last time the company name/website/marketing material was updated?
7. Are we challenging the status quo or just doing things the way they've always been done?
8. Can we pivot to find blue ocean?

TAKEAWAYS

The ultimate goal in a private equity-owned environment is to hit the top end of the value range when selling the company. One of the three key ingredients to accomplishing this is by sustaining double-digit organic growth. That's not always feasible in every industry, but that certainly is the target. As one of three growth levers, it adds significantly to shareholder value because every new dollar of EBITDA generated is multiplied by the industry multiple the company sells for. If the industry multiple is 10x, then every $1 in new EBITDA equates to $10 in shareholder value created. See now why organic growth is important to creating shareholder value?

For organic growth, sales and marketing are the key drivers. No company is totally optimized. Even if you achieve what you think is total optimization, every year you have to challenge your own status quo. You have to reinvent yourself because the world is changing. You have to make a concerted effort to restructure your sales process and strategy; often, this includes raising your price. Consider tiering your products and services, which may include offering a cost-reduced version and a new premium, higher-priced version.

Organic growth is typically slow and takes a lot of effort. It takes change, new people, new processes, and new marketing material. It may take pivots left or right to find new blue ocean. People may have to go out there and start knocking on doors, which can take time, but it's vital to the long-term health of the company, and without it, the company will fetch a lower price when it's time to sell.

In chapter 11, we will take a look at how to increase margins, our next lever to explore for maximizing shareholder value.

CHAPTER ELEVEN

MARGIN EXPANSION

A second lever for growth that private equity pursues in any investment is margin expansion. This is a way to grow EBITDA and add shareholder value without raising price, without adding a single customer, and without selling a single new product or service, all of which we just covered in chapter 10. Margin expansion is simply becoming more efficient at servicing the revenue you already have by working on process efficiency.

KEYS TO MARGIN EXPANSION

From my experience having run, built, and sold three different mature, national companies, we were able to grow EBITDA margins significantly in each case. If you can take the business you have and increase the profit margin, you'll increase the EBITDA. Organic growth then allows you to accelerate the sale of new widgets, new customers, and new services more profitably.

INVEST IN TECHNOLOGY TO DRIVE PRODUCTIVITY

Technology can be vital to a company's growth. There are so many ways that software and devices can transform your platform, from sales to marketing to operations.

For the laundry company I ran, we worked with a lot of quarters. Essentially, we had 550,000 machines installed in 70,000 different locations. Some had card systems or electronic payment methods, and certainly that technology is increasing very fast, but back in the day, it was run almost entirely on quarters dropped into the slots of washers and dryers. Back in 2004, we kept track of these customers using a very manual method: three-by-five paper index cards. Our collectors would drive to their managed locations and collect quarters, keeping track of the collection activity using an index card system that looked like a throwback to the old Dewey Decimal System cards used in library catalogs.

We used this system to determine collection routes. If we added a new location, a collector servicing the area would determine where best to slot the collection call in the catalog of locations that he managed. If a location was lost, the card was removed from the drawer. The first thing we did when I arrived was to invest in technology. We began to track the movement of vehicles using satellites. We loaded the locations into the system and used algorithms to calculate routes based on how busy some locations were compared to others.

The computer's much higher sophistication determined the best routes for the collectors. The end result was a huge increase in employee productivity. Now the collectors were carrying so many quarters in their trucks that they started breaking axles while driving down the road. We didn't foresee that problem happening, so it's what I call a high-class problem. We had to redesign the vaults and reposition them in the trucks so they were forward of the rear axle and balanced. Some routes with more volume needed heavier duty trucks.

We moved from index cards to technology, taking an existing process and making it much more efficient. We didn't raise prices, and we didn't add a single customer; however, we lowered the cost of servicing the revenue, which made the collectors more efficient and vastly improved our margins. Every dollar of margin gained in this fashion drops right to EBITDA and creates the most shareholder value of the three growth levers because the incremental cost of sustaining is very low in comparison to the benefit.

CHALLENGE THE STATUS QUO

It's always critical to challenge the status quo. People become very complacent, especially in a mature company. Processes that have existed for years, decades, or generations are never reconsidered. Many companies adopt a mentality of "if it isn't broke, don't fix it." What they don't realize is that what isn't broke may not be efficient.

Status quo often leads to mediocrity. To be a champion, you have to push yourself constantly and have people around who will push you. It's what creates a championship team, and it's why some teams are perennial favorites to win championships. Every practice, every game, every shot, every at bat, every pass, everything matters. In business, disruption is key. It starts with a question: "Why do we do the things that we do?"

As I mentioned in chapter 7, every time I come to a new company, I begin with a discovery period and interview the employees. I spend time asking questions, seeking opinions, and doing ride-alongs with the major job classes to better understand what people do at work. Spreadsheets aren't sufficient to see the entire picture. I want a vision of what these people do every day. I don't make assumptions; rather, I try to find out what I can learn from the employees themselves. In essence, I'm a scout for a baseball team. I'm looking at the team we're going to play next week so I can understand what they do, how they do it, and how I can take advantage of it when it comes time to play them.

I make observations, I watch behaviors, and I look for strengths, opportunities, and weaknesses.

At the laundry company, we talked about improving margin by implementing technology to improve the routes. On my original ride-alongs back in 2003, I learned that each collector carried hundreds of keys on a string attached to their belt. As they would go from location to location, someone who had been doing the job for years could reach down and, with muscle memory, pull out the correct key to service a particular machine. To make it even more complicated, each route had its own string of keys, a different one for each day, and a different one for each route.

I was amazed at the complexity and the skill of these collectors. I was like, "Let me try this." I took a string of keys, and each time I tried, I reached for the wrong damn key. I had to painstakingly correlate each key and machine with their numbers on the index cards. It took me hours to complete one roomful of machines. I kept thinking, *This collector moves quickly from muscle memory, and he's doing a great job. But what if I put him on a different route? Or what if he retires and I need to bring someone else in?* Productivity would drop off dramatically.

When I got back to the office, I started asking why the hell we used this process. Inside every branch office, there was a room with little drawers for all the different keys used in each city. There was a steel cage for security and someone whose job was literally to watch the keys to the kingdom. There were cameras on the wall and loss prevention people watching the guy who watched the keys. This security was amazingly detailed but also drastically inefficient. I asked a collector why he did it this way. He had no idea; it was just how he had been trained. I kept asking until finally someone told me the story behind this methodology.

Back in the 1960s, the biggest theft problem the company had was lock picks. These guys didn't look like criminals. They wore nice clothes and would walk into a laundry, pick the locks on the machines, take the quarters, put the machines back together, wipe them off, and disappear. The collectors would appear, and the money would be gone.

This ended up being the most critical problem the company faced. It was so rampant that they took extreme measures to defeat the lock picks. They had manufacturers create special locks with keyways that no locksmith in the country could get and make keys for. It was proprietary to the company. Then they created specific rules. You couldn't use the same key in the same room. You couldn't use the same key more than a certain number of times in the same city, and you couldn't use the same key more than a certain number of times in the whole company.

I heard the story and went straight to loss prevention and asked when was the last time somebody picked a lock on one of our machines. "They haven't done that since the 1960s."

Great, problem solved. But is it necessary today? Has the threat shifted?

The average criminal today is going in with a sledgehammer to beat the hell out of a machine until it capitulates and gives up its quarters! The loss prevention team defeats that problem with an entirely different strategy that has nothing to do with keying.

With my newfound knowledge, we started an initiative called "One Room, One Key, One Lock." We still have limited the number of times you use a key, but if you walk into a room and have the right key, you can open every machine in that room. Then you roll that key over your key string, and when you get to the next room, you pick up the second key and that opens every machine in that room. The result was another huge increase in productivity.

Looking back at the original problem, the process was grounded in very good science. There was a great reason they implemented the system, but the problem and threat had changed, and nobody adapted the process. In defeating the problem, a new one was created. Nobody ever asked, "Why do we do it this way, is it still relevant, and is there a better way?"

When you combined simplified keying with our other initiative for more efficient routing, it led to a total increase in employee productivity of 42 percent. The result was millions of dollars in additional EBITDA. It also led to more quarters, but as I mentioned, the company addressed that problem already with new vaults and heavier trucks!

In a manufacturing environment, you can streamline the process by mapping out the operations and look for bottlenecks. Identify capacity and identify where the bottlenecks limit that capacity. By fixing bottlenecks, you can do more with the same process, yield increased output, and impact efficiency. For example, as electronic circuits have become more complicated, they've also become more condensed. As computer chips get faster, they can do more calculations. We move from cutting by hand to cutting with lasers.

The process of challenging the status quo and asking why you do the things you do is applicable to anything. Whether it's a consulting business, a service business, or a manufacturing business, these are uniform concepts.

TAKEAWAYS

Challenge the status quo. Challenge conventions on why you do the crazy things that you do. Become faster and more reliable. Provide better customer service. Lower your operating cost. This is pure margin expansion. It doesn't take a single new location. It just takes understanding how to become more efficient by servicing the revenue that you already have. Couple margin expansion with increased organic growth and you really build shareholder value fast—and fast is ideal from a private equity perspective.

In the next chapter, we'll look at how to use mergers and acquisitions to reach maximum potential.

CHAPTER TWELVE

BUY AND BUILD

The most popular way that private equity likes to grow a company is to use the "buy and build" strategy. With IRR, time is never your friend, and unfortunately, organic growth and margin expansion take time. While they are still ultra-important, because they maximize value and create sustainable growth, the fastest way to grow a business is to buy other businesses and bring them on board. Create a platform company that the private equity firm will build from.

MERGERS AND ACQUISITIONS

There are three reasons why you typically seek to buy and build, also known as completing mergers and acquisitions.

The first is to fill a strategic need (as when my medical company bought the imaging parts company to support our technicians to service the imaging equipment). This helps the company pivot left, pivot right, find new blue ocean, and find new markets to serve. The second reason is to build density in existing geography, and the third reason is to expand the geography that you cover by launching into new territories.

When I ran the laundry company, we purchased dozens of different companies and folded them into the parent entity. They were essentially doing similar work, and it was beneficial to build scale in order to be more efficient operationally. We used these acquisitions to build our route density, enter new geography, and open new regions—even in new countries. When you have a lot of guys in trucks, which is what a route-based service business is all about, you want them spending their time working on equipment. Time spent behind a windshield driving is a productivity waster. That laundry company had so much density in some cities that our field employees (like a UPS driver) could literally spend their entire day working within a few mile radius.

You can use mergers and acquisitions to build density in existing markets, enter new markets, or solve strategic problems, but the most important aspect of this strategy is that it grows the company very rapidly. When you fold in another company, you get exponential growth. Private equity predominantly uses additional debt in order to execute this strategy. I call it OPM: other people's money. Using additional debt to fund most of, or all of, the purchase price is very efficient and preserves the private equity funds capital for other projects.

ACQUIRING COMPANIES

When a private equity platform buys a company with financing, it gets credit for pro forma EBITDA, including synergies. Synergies are positive gains that result from merging the two companies together. It can be like rolling two accounting departments or human resources departments into one, or it can be that you get a discount when purchasing parts because it's a much larger purchase order. These synergies yield reductions in operating cost and increase profitability for the overall combined company. Lenders give the company credit for these synergies even before the deals are closed, which allows the company to borrow more money (debt) to fund the purchase of the acquisition target.

Let's say the platform company has 5x EBITDA in debt but is itself a company that sells for 10x. If the private equity firm can buy an add-on company for 5x EBITDA, it can use 100 percent debt financing because that equals the leverage of the parent. It's a very popular method and an efficient way to scale and grow. If the firm pays more than the current leverage, some additional equity may need to come in.

How does this translate to shareholder value created? Simple. If the target company has pro forma \$5 million in EBITDA and is bought for 5x, the purchase price would be \$25 million. If the parent company sells for 10x, then the shareholder value created by this acquisition is 10x the \$5 million EBITDA added (\$50 million) minus the debt required to buy it (\$25 million) for a total increase of shareholder value of $25 million. In this example, we added $25 million to shareholder value without spending one dime of the company's or private equity firm's money. That's what OPM is all about! Now you know why it's so popular for companies to buy other companies. Virtually a day doesn't go by without a news report involving some big merger or acquisition.

A UNIQUE SKILL SET

Mergers and acquisitions are a very efficient method of scaling a business. It isn't your only method. You need to use all components of growth, but this method in particular is critical for IRR because it can accomplish big things in a short time. It also requires the expertise of a deal team inside the company in order to sustain as a long-term growth strategy.

Acquiring companies requires a unique skill set. Those involved have to be able to identify targets, work with the owners and management teams of those targets, know how to conduct due diligence, build financial models, draft nondisclosure agreements, draft indications of interest, draft letters of intent, evaluate operations, plan for integrations, and more. The private equity firm brings all of this to the table, making it very beneficial after you partner with them. Most companies do not have a team in-house that could execute a buy-and-build strategy on day one. That's where a partnership with the private equity firm actually allows them to shine. They will flood you with analysts. They have built-in relationships with low-cost specialized law firms, brokers, and diligence partners to help you analyze benefits, liabilities, as well as wage and hour issues.

As the company grows, you will begin to develop your own in-house deal team—for instance, general counsel to do light work—while still quarterbacking the outside firms for actual contracts. It's cost inefficient to write contracts in-house, but in-house counsel can still draft the letters and watch over multiple deals at a time. It also requires additional resources working in business development, financial analysis, and integration specialists. At my current company, we added all the required key players as employees and built an entire deal team in-house. Why not use consultants? We do for some tasks, but we added the staff because buy and build is not a one-time project for us—it's going to be a way of life for many years to come, and given the shareholder value it adds, having a skilled team on our payroll is critical to success.

INTEGRATION OF ACQUISITIONS

Integrations are like game strategies. On any given day, two opposing teams have developed strategies on how they will attack the other team, exploiting weakness to put points, goals, or runs on the board. Like any action a company takes, an integration will go smoother when it's well planned. You need an integration playbook that answers the following questions (and more):

- Are you going to remain two separate businesses or pull the second business in?
- Is the entrepreneur or management team sticking around to join your team?
- What are you going to do with the employees? Are the benefits different?
- Is technology different? Is the software different? How do you bridge those gaps?
- What customers are they servicing? What customers are you servicing? Is there an overlap?
- Are the contracts different?

This playbook will take the integration and break it down into Gantt charts and time lines with tasks, owners, and an orderly flow. It requires a skill that most private equity firms can help with. They can deploy assets and resources from their own organization. They can also help make introductions to consulting groups that specialize in integrations.

A generic integration playbook should be on the shelf and adapted for specific situations as soon as you identify a target. Begin to look at how to integrate the business and what things will look like after the deal closes. When we purchased a laundry company in a new country, we needed experts to help us with the new laws and contracts. We hired a consulting group to help us plan for that acquisition and integration. The money was well spent and was an add back to EBITDA. The consultants had experience with large-scale integrations, and they could help us clearly identify potential issues.

VALUE STRATEGY OF MULTIPLE EXPANSION

You've played the game and increased EBITDA. Now what? As companies grow, they tend to be worth more money and at a higher multiple for EBITDA. Let's say the private equity fund bought a platform company at 8x EBITDA, does an add-on acquisition at 5x, and then sells the company a couple of years later at 10x.

The fund is getting two turns of increased value for shareholders on the original company it paid 8x for. They bought the add-on company at 5x for a five turn increase in value. Then they get the full 10x for any organic growth and margin expansion.

This is how private equity can take a company, change the dynamics, help it rethink strategy, increase organic growth, improve process, challenge status quo, ask the question why, increase the margin, and use buy and build to scale the company larger—all to yield a higher value. Private equity truly adds value in gross for businesses.

OTHER IMPACTS ON EBITDA

Economic market conditions can also have an impact. We've been through different recessionary cycles in our history. The worst one since the Great Depression started in 2008, ran through 2009 and 2010, and it took several years for some industries to recover. Some could argue that certain industries (like housing) still haven't fully recovered. In any event, economic conditions in a broader economy can drive the multiple value of a company up or down. There are both good and bad markets.

Sometimes the state of the economy can impact the timing of when to sell a company. Some do well in a recession; others do poorly. Private equity groups are very savvy investors, and they represent limited partners, who are also very savvy investors. They have a wealth of expertise and a depth of resources that they can bring to help a company to get a good return.

We talked earlier in the book about alignment and the importance of the management team being aligned via their own investments. This is where Josh and Rose can truly benefit from riding the coattails of sophisticated investors.

With the growth of private equity, there's currently $1 trillion in committed capital, waiting and looking for things to purchase TODAY! It's become a bit of a feeding frenzy, which drives up prices. It's a good time to be Josh in the marketplace! As prices continue to increase, you're getting more value if you're selling a company.

TAKEAWAYS

While growing organically and expanding margins are important strategies, buy and build is the most important to the companies I have run. Not all companies are in industries where strong organic growth is possible, especially in mature industries, so the fastest way to create shareholder value is by acquiring other companies.

Given the need for speed in private equity-backed companies, this strategy is the surefire path to fast growth. It can be used to pivot left or right, strategically solve a problem, build density in an existing area, or expand into new geographies. Because buying companies adds debt, it's not the most accretive way to add shareholder value, but the sheer volume and speed overcomes any lack of efficiency.

Buy and build is also a great way to increase return, because it's efficient with capital and rarely requires another call for investments. When combined with organic growth and margin expansion, a company can truly create maximum potential.

CHAPTER THIRTEEN

THE ROLE OF CONSULTANTS

I have to say that my own personal opinion of consultants has changed dramatically over the last two decades. As a young guy, I used to joke with a bit of arrogance, “If you can’t do, teach or consult.”

Since then, I’ve totally changed my tune. As a leader, as a CEO, I recognize that there is a time and a place to bring in consultants. Josh and Rose, who now work with a private equity group for the first time, will quickly find that private equity groups like to use consulting groups for several reasons.

- EBITDA: Consultants represent an add back. Even though you’re expensing cash, it’s not a permanent expense. Consultants can be expensive, but it’s a one-time cost, and if you have the cash, don’t sweat it!
- Best practices: Consulting groups spend a significant amount of time working with companies, and they pick up best practices. They come into an organization and impart wisdom that the company itself does not have.
- Different views: Within a company, everyone has a job, a task list to complete, and so it’s not always easy to take a step back and conduct a successful self-assessment or assess a project when the goal is to focus on serving current and existing customers. Consultants come in with a fresh set of eyes and will quickly spot what you can’t.

We bring in consulting groups to my companies frequently. They help us look for process bottlenecks, help redesign existing processes, and help us build a better mousetrap. In this way, we can serve existing customers and future customers more efficiently and cost effectively, increasing our EBITDA by improving margin.

CONSULTANTS HELP SURGE

I spend a great deal of capital to work with consultants. They bring to the table not only tremendous knowledge and best practice sharing, but they also provide our company with surge capacity. They add enough boots on the ground to help us address a large-scale problem and manage that process with speed.

As an example, I'm working on a large redesign of the sales organization and account management in my current company. We hired a sophisticated consulting group that services many *Fortune* 500 companies, and they focus only on sales redesign. My team doesn't have the expertise, nor do we have the capacity to actually conduct a five-month project and stop doing our day jobs to manage it.

The consultants split the project into various work streams and then tap into cross-functional sales and operations teams from the company. These employees work on steering committees for each work stream to help educate the consultants on our industry and specific issues, but my team is spending only an hour here or there in meetings. The actual number crunching, analysis, and redesign is happening behind the scenes. The consultants do the work and have meetings with the teams to keep them updated and informed, solicit feedback, and keep the project on track. Employee disruption is minimal.

Sure, I could probably solve this problem by hiring a couple of employees and taking a few years to do this project, but the consultants can provide surge capacity and completely redesign the sales process from top to bottom in a couple of months. At the end, I have a new comp plan, new job descriptions for the different players, and a manager's playbook that discusses metrics and the cadence that should be put in place.

WHEN TO HIRE A CONSULTANT

Consultants can come in at various points in the process. In fact, the private equity firm will utilize consulting groups before even buying your company. The firm may have familiarity with your type of industry or business, but they don't necessarily have specific knowledge. During this time of diligence, as they look at the company's processes, they will bring in different consulting groups for assessment. One may assess the industry at large. How big is it and who are the big players? Then they may hire a group to assess the strength of departments. For IT, how is the security? What platforms do they use? Is there a risk?

Once the purchase has been made, any future consultants will be hired with the go-ahead of the board of directors.

TAKEAWAYS

Josh and Rose are typically not fans of consultants. Josh is the expert. He built the business and knows every aspect of it. There's not a single consultant out there who can come in and tell him how to run his business better. And Rose has a pedigree where she's worked in the biggest companies on the planet.

That was my attitude when I came into the world of private equity and running companies, but I very quickly rethought that position. The consultants aren't necessarily experts in *your* business, but they are experts in certain areas of running *a* business. I now fully embrace consultants.

The private equity group you work with will have referrals on hand. You can tap into their knowledge, and they will have a ready list of consulting groups. "This is the group we call. We've had great success with them over the years. Let me put you in contact with them."

This is a part of embracing that partnership with the private equity firm. You've aligned with a private equity firm that wants to help you grow your business in the best possible fashion, so they can sell it again for a higher price and make you even more money.

The key is to assess exactly where you are. Do you know everything? Do you have the expertise? And more importantly, do you have the bandwidth? If you do, fine. Consultants probably aren't necessary. But if there are problematic areas of the business or ones that could use improvement and you don’t have the time or expertise to attack them, consulting groups can help.

Ask for help, engage your partners, get the board of directors on board, and move forward.

CONCLUSION

If you're Josh, you could sell your company and retire, or you could potentially partner with a private equity firm, stay on, and grow your wealth.

Owning your business outright can be amazing, but it can be even better if you bring in a financial partner. Sell your business multiple times, keep investing, diversify your asset risk, and you'll make a wonderful living for decades to come.

If you're Rose, you could stay working in the *Fortune* 500 world and make a very comfortable six-figure salary. But middle-market private equity is a place where you can earn a tremendous amount of money, and get seven- or even eight-figure paydays every three to seven years. It's a place where you can truly create generational wealth for your family.

I've built three large companies following the methods defined in this book. I've had a great time and made a lot of money along the way. At the same time, it's very intense! That IRR clock is ticking, and the private equity firms are anxious. There are a lot of people asking a lot of questions and requesting a lot of data. It's a totally different ball game that runs at a greatly accelerated speed.

You're moving from high school sports through college to the professional level. Speed and intensity are different—not good or bad different, just different. It's something you need to be aware of as you make the transition, because you don't want to be caught off guard. Depending on how the governance goes and how hands-on or hands-off the private equity firm is, your emotions will be in play. This is why you need to make a good, properly aligned choice.

As I stated in the introduction, I'm not providing legal, career, or financial advice in this book. Every situation is uniquely different and requires the input of experts who know your situation intimately, but this process can be very lucrative. In a typical private equity-backed company that's doing a typical private equity return, there are a lot of people making significant returns. There are many CEOs in middle-market private equity-backed companies who make a lot more money here than if they stayed in the *Fortune* 500 world. Every three to seven years, there's the potential for a big payday, and the added benefit is that you build lasting relationships with people and develop a solid reputation.

If you are successful, engaged, work hard, and have good outcomes, I can tell you that you're going to get calls frequently. I receive calls all the time from private equity groups, recruiters, and consulting firms looking for someone to come run another private equity venture.

Since I've navigated this world for the last twenty years, I now know many key players. It's fun and a good place to be involved. It's almost like doing business with friends. Companies will come and go, employees may come and go, but the people in the private equity industry tend to be fairly stagnant. You keep crossing paths with people, so it's imperative to treat them well and with integrity.

I try to be a good steward to both employees and shareholders. It's a balance because private equity is in and out. They have a shorter focus because of IRR and the fact that their fund charter is ten years, and they're going to buy and sell every three to seven years. As a CEO, I'm probably looking at a longer horizon and also looking out for my employees and their families. I run service businesses and believe very heavily in people. People are my core product, and culture is crucial.

CALL TO ACTION

Get outside and play the game.

We've talked about the history of the private equity world, the growth of private equity, who the players are, and how they're measured by their limited partners who invest in them.

We've talked about what it's like to analyze and determine who could be a good partner and who could be a bad partner. Josh might be looking at many firms as a potential buyer, and Rose might be looking at a singular firm offering her a job, but she's interacting with multiple firms and trying to decide the best career move and fit.

We've talked about how to contract with the private equity groups and what those parameters look like. We've talked about the importance of being aligned and how you can invest money and grow a business and get a payday every three to seven years.

We've talked about the pace increasing and keeping everyone in alignment. We've discussed the different strategies that are used to accelerate growth within a company and to create that return on investment.

I hope after reading this book you have a better sense of the private equity world from a business owner's standpoint. My goal was to provide a basic foundation and understanding of what it's like to evaluate, to work with, and to build a company with private equity as your partner. All that's left is for you to get out there and do it!

I would challenge you to learn and to grow from here. This book serves as a primer and can't answer all of your questions. Pursue further answers to the questions that pertain to you, your company, and your industry. Learning never stops. Seeking answers never stops. Dig deep and expand your horizons.

This is your halftime. Take a moment to pause, reflect, better understand the game, and then adjust for the second half to yield an even better result. It's time to create the new you—version 2.0.

As for me, it's time to get back to work. I have a company to run—ticktock—and the IRR clock is running!

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ABOUT THE AUTHOR

ADAM COFFEY has spent almost 20 years as President and CEO of three national service companies, each in different industries. Adam's first company, Masterplan, was a medical device service company owned by Three Cities Research (NYC) and Camden Partners (Baltimore) that was subsequently sold after his departure to Berkshire Partners (Boston) in 2007 and later became a division of Aramark (NYSE:ARMK) in 2011. Adam's second company, WASH Multifamily Laundry, a commercial laundry service company, started as a family owned business that during Coffey's tenure was subsequently sold in 2008 to Code Hennessy & Simmons (Chicago) and was then sold again in 2015 to EQT Partners (Stockholm). Adam is currently building his third company, CoolSys, a commercial refrigeration and HVAC service company for the Audax Group (Boston).

Known for building strong employee centered cultures, and for executing a buy and build strategy, Coffey is highly sought after by private equity and is considered an expert in running industrial service businesses. Adam is a former GE executive, an alumnus of the UCLA Anderson Executive Program, a pilot, and is a Veteran of the US Army. He is married, a father, and makes his home in Yorba Linda, California. Adam can be found on LinkedIn at www.linkedin.com/in/adamecoffey.