Credit Judgement and Deal Experience

Interview preparation summary · PC track

IN THIS SUMMARY

- Is it a good loan
- Telling your credit story

INT.CJ.1.a · Is it a good loan

Judge whether a loan is a good one by testing repayment capacity, downside protection, structure and whether the price pays for the loss you can foresee.

A lender is paid a contractual spread and gets its money back at par, so the upside is capped and the question is whether the loan can fail to repay. Judge a loan with four tests, each needing evidence. Repayment capacity: fixed charge cover, which is EBITDA less capex and tax divided by cash interest and scheduled repayments, and leverage as net debt to EBITDA on an EBITDA you have rebuilt yourself. Downside: how far EBITDA can fall before cover reaches 1.0x, and what the business and its security would be worth then compared with the loan. Structure: seniority, security, covenants that trip early enough to bring the sponsor to the table, and an equity cushion beneath you. Price: whether the spread and fees pay for expected loss, which is probability of default times loss given default. The usual mistake is to praise the business and ignore the structure. An interviewer wants a lender's answer: a strong company can still make a poor loan if leverage is high or protections are thin.

WORKED EXAMPLE: IS THIS TERM LOAN A GOOD LOAN

Harrowgate Print Logistics is an invented company with EBITDA of 25m and capex of 4m. A sponsor owns the equity and asks for a 100m term loan at a cash rate of 10.0%, made up of a 5.75% margin over a 4.25% base rate. Comparable businesses trade at about 6.0x EBITDA in a downturn and 5.0x in a bad one. Is it a good loan? Convention: ignore tax, amortisation and fees; cover is EBITDA less capex ÷ cash interest.

Answer: It is a reasonable loan, not a great one. Leverage is 4.0x and cover 2.1x, EBITDA can fall 44% before cover hits 1.0x, and the loan is covered 1.05 times at 6.0x in a 30% fall. It is thin at 5.0x, where recovery is about 87.5%, so I would want a leverage covenant with headroom of about 25% and an equity cushion, and I net 4.85% a year over the base rate after expected loss.

Interview tip: Say the four tests in order: cover, break-even fall in EBITDA, value cover in a downside, then price against expected loss. Give each as a number.

INT.CJ.1.b · Is it a good loan

Set pass and kill criteria for a credit before diligence, and run a pre-mortem that ranks the ways the loan could fail.

A kill criterion is a limit set before diligence that ends the deal, or forces a change of structure, when breached. Setting it first matters because a deal team under pressure bargains with its own rules. Typical limits are leverage on your own rebuilt EBITDA, leverage and fixed charge cover after a stated EBITDA fall, recovery at a stressed multiple, sponsor equity as a share of the capital structure, and customer concentration. Pass criteria are the evidence you still need: for example a signed contract, a quality of earnings review or a lender-side call with the largest customer. A pre-mortem assumes the loan has already defaulted and lists why. Rank the stories by likelihood, by the fall in EBITDA each would cause and by how cheaply you can test it. The usual mistake is a generic risk list. An interviewer wants limits with numbers and one named failure that you would test first.

WORKED EXAMPLE: DOES THE LOAN PASS ITS KILL CRITERIA

Calder Marine Services is an invented company asking for a 150m senior loan. The sponsor's EBITDA is 30.0m, which includes 3.5m of cost savings not yet achieved. The fund's kill criteria, set before diligence, are: leverage on its own EBITDA above 5.5x, or leverage above 7.0x after a 20% fall in EBITDA. Does the deal pass, and what would make it pass? Convention: unachieved savings are excluded; round to two decimals.

Answer: On a rebuilt EBITDA of 26.5m the loan fails both criteria: 5.66x against 5.5x and 7.08x against 7.0x after a 20% fall. It would pass at about 145m, or if the savings were evidenced, and I would test the savings first.

> **Interview tip:** Rebuild the EBITDA before you apply any limit, say which limit binds, and finish with the change that would let the deal pass rather than only saying no.

INT.CJ.1.c · Is it a good loan

Separate a good company from a good loan, and compare two loans on spread net of expected loss and on how each behaves in a stress.

A good company is not the same as a good loan. The loan is judged on leverage, cover, security, covenants and price, so a first-rate business at a high multiple of debt with a thin spread can be a worse loan than an ordinary business with modest debt and a wider spread. Compare loans per pound lent. Yield above the base rate is the margin plus the original issue discount spread over the expected life, for example 2 points over 3 years is 0.67% a year. Subtract expected loss, which is probability of default times loss given default, and then repeat the sum with a stressed default rate, because a wider spread that is cheap in a good year can be expensive in a bad one. The usual mistake is to pick the higher headline margin. Interviewers also listen for opportunity cost: which use of the fund's limited loss budget earns most.

WORKED EXAMPLE: SENIOR LOAN AGAINST UNITRANCHE

Two invented three-year loans are on offer. Ibsley Bakeries: senior, 3.5x leverage, margin 5.0%, original issue discount (OID) of 2 points, probability of default 2%, loss given default 25%. Corvane Telecoms Services: unitranche, 5.5x leverage, margin 7.0%, OID of 2 points, probability of default 5%, loss given default 40%. In a stress, the probabilities of default rise to 4% for Ibsley and 10% for Corvane. Which is the better loan? Convention: spread above the base rate, OID spread evenly over three years, no discounting.

Answer: I prefer Ibsley. In a normal year Corvane nets 5.67% against 5.17%, only 0.5 points more for 2 extra turns of leverage. In the stress Corvane nets 3.67% against Ibsley's 4.67%, so the extra spread does not pay for the risk.

> **Interview tip:** Always net the spread for expected loss and then stress the loss rate. The point is not which loan has the higher margin but which one still pays in a bad year.

INT.CJ.2.a · Telling your credit story

Tell a deal story in a lender's structure: the situation, your role, the numbers you owned, the key risk, the outcome and the lesson.

A deal story is a short, structured account of a loan you worked on or analysed, and interviewers use it to see how you think and what you personally did. A reliable order is: the borrower and the loan in one sentence; why it was attractive to a lender; your role, using I for your own work and we only for joint decisions; the numbers you owned, such as leverage, cover or a downside case; the key risk and how it was handled; the outcome; and the lesson. Open with the conclusion so the listener knows where you are going. Allow about 90 seconds, which is roughly 225 words, and leave room for follow-ups instead of reciting everything. Choose figures you could rebuild if asked. The usual mistakes are a long description of the company, a story told entirely in we, and no number that can be checked. Marks go to structure, evidence and honesty, not to how impressive the deal was.

WORKED EXAMPLE: BUILDING A 90-SECOND CREDIT STORY FROM THE FACTS

You helped on a 54m unitranche to an invented sponsor-owned distributor of laboratory equipment, Vantry Lab Supplies. Facts: EBITDA 12.0m, purchase price 96m, cash interest rate 10.5%, and you built the downside case with a 25% fall in EBITDA. Prepare the numbers you would quote and the order of the story. Convention: cover is EBITDA ÷ cash interest; no tax.

Answer: The story: a 54m unitranche at 4.5x to a lab-supplies distributor bought at 8.0x with 43.75% equity. I built the downside case; at a 25% EBITDA fall, leverage reached 6.0x and cover stayed at 1.59x, so I recommended a covenant at 5.5x. We agreed the terms as a team. The lesson was to test supplier concentration earlier.

> **Interview tip:** Lead with the conclusion, own one deliverable with a number, and name one thing you would do differently. If you do not have a deal, use this shape on a company you followed.

INT.CJ.2.b · Telling your credit story

Defend your credit view under challenge, and critique another lender's described loan by rebuilding its leverage and cover.

Two skills are tested together. When you defend your view, restate the evidence, ask what new evidence the other person has, and move only if the numbers change. Holding firm without reasons looks rigid; giving way at the first push looks as if there was no view. When you critique someone else's loan, rebuild it before judging it: take the described EBITDA, strip the add-

backs that are not evidenced, and recompute leverage and fixed charge cover on that base. Then check the equity cushion, the covenants, the price against the risk, and the concentration of customers. Ask questions rather than declaring the loan bad, because you are missing facts, and say what answer would change your mind. The usual mistakes are praising a loan because the sponsor is well regarded and criticising it only on margin. An interviewer wants the arithmetic first and the opinion second.

WORKED EXAMPLE: CRITIQUING A LOAN SOMEONE ELSE DESCRIBES

A lender describes a loan to Opal Road Garages, an invented sponsor-backed garage group: 80m term loan at an 11.5% cash rate, adjusted EBITDA of 15.4m, covenant-lite, and capex of 3.0m. The adjustments are 3.9m, of which 2.6m is expected synergies from acquisitions and 1.3m is one-off costs. The lender says the sponsor is strong. What is your critique? Convention: cover is EBITDA less capex ÷ cash interest.

Answer: I would not lend at 80m on this description. Leverage looks like 5.2x but is 6.3x without the synergies, and cover falls from 1.35x to 1.07x. A quarter of the EBITDA is adjustments, there is no covenant, and the sponsor's strength is not a number I can test. I would reconsider with signed synergy contracts or a loan of about 64m.

> **Interview tip:** Rebuild first, opinion second. State the base you used, the question that would change your mind and the size of loan you would accept.

INT.CJ.2.c · Telling your credit story

Answer honestly about outcomes and mistakes, and, with little deal experience, analyse a loan or company you followed as if you had underwritten it.

Interviewers probe outcomes to see whether you separate the quality of a decision from the result. A loan that was repaid at par may have been repaid because a sponsor injected equity, not because the thesis held, and a loan that lost money may have been sound underwriting with bad luck. A strong account names the assumption that was wrong, sizes the miss against the downside case you ran, says what you changed, and does not blame others or the market. Use the same discipline if you have little deal experience: say so plainly, then pick a company whose debt you can follow from public information, rebuild leverage and cover, run a downside, and give a lend or pass view with terms. Never present another person's deal as your own or invent a failure. The usual mistakes are a rehearsed fake weakness, vagueness, and claiming credit for outcomes you did not control.

WORKED EXAMPLE: A LOAN REPAID AT PAR, BUT WAS IT A GOOD DECISION

The invented loan: Tarn Coast Ferries, 80m senior, underwritten on EBITDA of 20.0m with a downside case of a 15% fall. Actual EBITDA fell 25% to 15.0m and breached a 5.0x leverage covenant. The sponsor injected 10m to repay debt, the margin rose by 1.0% in an amendment, and the loan was later repaid at par. You were the analyst. How do you account for the result? Convention: leverage is debt ÷ EBITDA.

Answer: The loan was repaid at par with a higher margin, but I would not call the underwriting a success. I set a 15% downside, EBITDA fell 25%, leverage reached 5.33x and the covenant tripped. It was repaid because the sponsor injected 10m. Since then I test to break-even and ask what support the sponsor would give.

> **Interview tip:** Name the assumption that was wrong, size it against your downside case, and say what you now do differently. With no deal of your own, use a public company and say so.