Sponsor-Focused Buyout Financing (Private Credit)

Interview preparation summary · PC track

IN THIS SUMMARY

- The buyout financing
- The sponsor and the underwriting
- Winning, negotiating and managing the deal

INT.CS.1.a · The buyout financing

Build the sources and uses of a sponsor-backed buyout, and work out the equity contribution, the purchase and leverage multiples and the loan to value that show how thick the cushion under the lender is.

A buyout financing starts with a sources and uses table. Uses are what the money buys: the enterprise value paid to the sellers (including refinancing their debt), the fees and expenses of the deal and any cash put on the balance sheet. Sources are how it is paid for: the lender's debt, the sponsor's cash equity and any management rollover. The two columns must match. The equity contribution is the equity as a share of total sources (or of total capitalisation), and it is the cushion that absorbs losses before the lender is touched. The purchase multiple is enterprise value over EBITDA and the leverage multiple is debt over EBITDA, so equity per turn of EBITDA is the difference. Loan to value is debt over enterprise value. Sponsors in recent years have often put in somewhere near half the capital, but the figure moves with the market and with the quality of the business. Check which EBITDA the multiples use: a price of 10.0x on sponsor adjusted EBITDA can be well above 10.0x on the lender's figure, and the cushion then looks thinner than the headline. Also check that any shareholder loans or preferred equity are fully subordinated and do not pay cash, otherwise they are debt in disguise. A strong answer gives the equity share, the loan to value and the fall in value the lender can absorb, and says which EBITDA was used.

WORKED EXAMPLE: SOURCES AND USES FOR CALDER FIRE PROTECTION

A sponsor is buying Calder Fire Protection, an invented fire-safety servicing group, for 10.0x lender-accepted EBITDA of 25.0m. Fees and expenses are 9.0m and 3.0m of cash goes on the balance sheet. A fund is asked for a 125.0m unitranche. Management rolls over 10.0m and the sponsor funds the rest in cash. Build the sources and uses, then give the equity contribution, the leverage and the loan to value, and test the cushion against a stress of EBITDA 18.0m at 7.0x. Figures are in millions of pounds.

Answer: Equity contribution is 52.3% of the 262.0 sources, leverage is 5.0x, loan to value is 50.0%, and a fall to EBITDA of 18.0 at 7.0x would leave value of 126.0 against a loan of 125.0.

> **Interview tip:** Say which EBITDA you used, then give the equity share, the loan to value and the stress at which the cushion is gone, in that order.

INT.CS.1.b · The buyout financing

Choose between first lien, second lien, unitranche, revolver and delayed-draw structures for a sponsor deal, and compute blended margin, the leverage at which each tranche attaches and detaches, and the recovery each would receive.

A sponsor can split its debt into a first lien and a second lien, or ask one lender or club for a unitranche, a single facility at a blended margin that covers the whole of the debt. Each tranche attaches at the leverage multiple where the debt ranking ahead of it ends and detaches where its own debt ends: a first lien of 4.0x EBITDA attaches at zero and detaches at 4.0x, and a second lien of 1.0x then attaches at 4.0x and detaches at 5.0x. Blended margin is the weighted average of the tranche margins by amount, not the simple average. A unitranche is usually quicker and simpler, with one set of documents and one point of contact, but it concentrates the credit decision on a few lenders and, when the lenders split it between themselves in a separate agreement, the last-out part carries a higher margin for taking the first loss. A super senior revolver ranks ahead of the term debt and should be treated as fully drawn at default. A delayed-draw facility is committed funding for acquisitions or capital spending, with a ticking fee while undrawn; at default it may be fully drawn and then shares the term loan's value. A strong answer states the attachment points, the blended margin, and what each tranche recovers at a stressed value.

WORKED EXAMPLE: TWO TRANCHES OR ONE UNITRANCHE FOR CALDER FIRE PROTECTION

Calder Fire Protection has EBITDA of 25.0m. Option A is a first lien of 100.0m at a 5.25% margin plus a second lien of 25.0m at 9.50%. Option B is a 125.0m unitranche at 6.25%, which the lenders would split into 75.0m first-out at 4.75% and a last-out piece. A super senior revolver of 15.0m is undrawn at closing. Work out the leverage at which each tranche attaches and detaches, the blended margin of Option A, the last-out margin in Option B and the recoveries if value falls to 17.5m times 5.0x.

Answer: The first lien runs to 4.0x and the second lien from 4.0x to 5.0x; Option A blends to 6.10%; Option B's last-out margin is 8.50%; at a default value of 87.5 and a fully drawn revolver the first lien recovers 72.5% and the second lien nothing.

> **Interview tip:** Give the attachment and detachment multiples first, then say that blended margin is weighted by amount and that the revolver is counted as fully drawn.

INT.CS.2.a · The sponsor and the underwriting

Assess the sponsor as the counterparty: its track record, repeat business, support in a downturn, willingness to cure, and the fund's concentration of exposure to it, and use these to decide whether to back or decline a deal.

In sponsor finance the lender relies on the sponsor as well as on the company. A sponsor is not legally obliged to put more money in unless it has signed an equity commitment or a guarantee, so its support is a judgement about incentives. Look at its track record on loans that went wrong, with this fund and with other lenders: did it inject equity, engage early and keep its word, or hand back the keys? Look at its remaining capital and fund life, since a sponsor near the end of a fund or with little capital left to reserve has less reason or ability to support. The simplest test of willingness to cure is whether its equity is still worth something: if enterprise value less net debt is positive after the cure, the cheque protects value; if the equity is worth nothing, the cure only buys an option on a recovery. Repeat business matters: a sponsor that the fund knows brings speed and a record of behaviour, and it also has a reputation to protect with the fund. The risk is concentration, because several loans to one sponsor family are linked by its decisions, so funds set a limit on exposure to any one sponsor. A strong answer says what evidence of support it wants and measures exposure against the limit.

WORKED EXAMPLE: WILL THE SPONSOR CURE AT MARLOWE DENTAL SUPPLIES, AND WHAT IS THE FUND'S EXPOSURE

Marlowe Dental Supplies is an invented company owned by a sponsor. Net debt is 135.0m, EBITDA has fallen from 25.0m to 21.0m, and the maximum net leverage covenant is 6.0x. Work out the breach, the cash cure by debt paydown, and whether the sponsor's equity is worth protecting if the market multiple is 8.0x and if it is 6.0x. The fund has commitments of 1,200m and a 15% limit per sponsor; it already lends 70m, 55m, 50m, 40m and 35m to five companies of this sponsor. Figures are in millions of pounds.

Answer: Leverage is 6.43x against 6.0x and a cure needs 9.0; at 8.0x the equity of 33.0 is worth protecting, at 6.0x it is worth nothing and a cure is a bet on recovery; exposure of 250.0 is 20.8% against a 15% limit, 70.0 too high.

> **Interview tip:** Say that sponsor support is a matter of incentives, not an obligation, and test it by asking whether the equity is still worth something after the cure.

INT.CS.2.b · The sponsor and the underwriting

Underwrite a buyout from the quality of earnings report, accepting or refusing EBITDA add-backs and run-rate synergies, and test leverage, cash conversion, free cash flow after interest and interest and fixed charge cover against a downside case.

Underwriting a buyout starts with the quality of earnings report, an independent accountant's review of the target's EBITDA, cash conversion and working capital. Compare the sponsor's adjusted EBITDA with reported EBITDA line by line. Accept adjustments that are one-off, evidenced and already done, and refuse or cap those that are forecast, such as run-rate synergies and cost savings that have not started, since they carry costs to achieve and execution risk. Deduct recurring costs the company has capitalised. Then compute leverage on reported, lender and sponsor figures and show the gap. Next test cash: EBITDA less capex, tax and working capital, then less interest, gives free cash flow after interest, which tells you how fast debt can fall. Interest cover is EBITDA over cash interest; fixed charge cover is EBITDA less capex and tax over interest plus scheduled amortisation. Finally build the lender's downside case from the business: what happens to revenue, how much contribution is lost, what capex can really be cut and whether the covenant breaks. A sponsor model usually grows EBITDA, but the lender must be repaid if it does not. A strong answer shows the lender figure beside the sponsor figure and a downside in which the company still pays interest.

WORKED EXAMPLE: UNDERWRITING CALDER FIRE PROTECTION'S EARNINGS AND CASH

Calder Fire Protection reports EBITDA of 26.0m. The sponsor adds 0.6m of evidenced one-off legal costs, 2.4m of savings already made (annualised), 3.5m of planned procurement synergies not yet started and 1.5m for a price rise not yet agreed with customers. The lender also finds 1.0m of recurring development cost that was capitalised. Debt is 140.0m at 10.5% cash interest with 1.0% amortisation (1.4m). Capex is 5.0m, cash tax 3.5m and working capital outflow 1.0m. Revenue is 200.0m with a 35% contribution margin. Work out leverage on each EBITDA, interest cover, fixed charge cover, free cash flow after interest and a downside with revenue down 10%, capex cut to 4.0m and tax 2.0m. Figures are in millions of pounds.

Answer: Lender EBITDA is 28.0 (5.00x against 4.12x on the sponsor's 34.0), interest cover is 1.90x, fixed charge cover 1.21x, free cash flow after interest 3.8, and in the downside EBITDA of 21.0 gives 6.67x leverage and cash flow of 0.3.

Interview tip: Put the lender's EBITDA beside the sponsor's and say which items you refused and why, then show that the downside case still pays interest.

INT.CS.3.a · Winning, negotiating and managing the deal

Negotiate pricing and documents with a sponsor in a competitive process: compute the effect of margin, original issue discount, fees and call protection on yield, and respond to requests on covenants, add-back caps, incremental debt and portability, while managing the club, speed and the commitment papers.

Sponsors run competitive processes and ask for lower margin, higher discount, weaker call protection and looser documents. The lender's first job is to price what is being conceded. Yield is base rate plus margin plus upfront points (original issue discount and fees, and any call premium) divided by the assumed life, so a shorter life makes call protection worth more. Compare the lender's offer and the sponsor's counter on a three-year and a two-year life, and say which assumption you used. On documents, know the usual requests and the lender's counter-positions. Cov-lite creep is the loosening of private loan packages towards the syndicated market. Sponsors ask for no maintenance covenant or a springing one, uncapped or wide add-backs, large free-and-clear incremental capacity with ratio debt and no MFN, and portability on a sale. A lender can hold a cap on add-backs and on the time to realise savings, tie ratio debt to closing leverage, ask for an MFN, and make portability depend on a leverage test and a quality of new owner. Speed and certainty matter to a sponsor: a lender with limited conditionality and a clear credit process can win against a cheaper rival, but the lender should know its right to walk under the commitment papers and should say no when terms breach its limits. Where the loan is larger than its single-name limit, it needs a co-lender.

WORKED EXAMPLE: ANSWERING A SPONSOR'S COUNTER-OFFER ON THISTLEDOWN SOFTWARE

A sponsor wants a 200.0m unitranche for Thistledown Software Services, an invented company, and has two offers. Offer A (the fund's): base rate 4.0% plus 6.00% margin, issued at 98.0, 1.0% fee, call protection of 102 in year one and 101 in year two, par afterwards. Offer B (a rival's): 5.50% margin, issued at 99.0, 1.0% fee, call protection of 101 for the first six months only. Compare the yield on a three-year and a two-year life, say what the margin difference is worth in cash a year, and note the fund's hold limit if it is 8.0% of 2,000m and the deal is 240.0m.

Answer: Offer A yields 11.00% against 10.17% on a three-year life and 12.00% against 10.50% on a two-year life; the fund can hold at most 160.0m of the 240.0m and needs a co-lender for 80.0m or more.

Interview tip: State the life assumption, show how much of the sponsor's ask is worth in yield, and say which terms you will trade and which you will not.

INT.CS.3.b · Winning, negotiating and managing the deal

Monitor and manage a sponsor-backed loan through reporting, covenant tests and a watch list, size what to ask of a sponsor in an amendment or amend-and-extend, compare it with enforcement, and explain in an interview why you back or decline a sponsor's deal.

After closing the lender receives monthly or quarterly management accounts, a compliance certificate with the covenant calculations, a budget and variance report, and notice of events. It tests the covenant, headroom and liquidity each quarter and compares performance with the model it underwrote. Early warnings are falling headroom, missed forecasts, a falling order book, customer loss, rising working capital and the sponsor asking for add-backs or documentation changes. Loans with such signs go on a watch list, which means closer reporting, an action plan and earlier talks with the sponsor. When a covenant is under pressure the sponsor will ask for a waiver, a reset or an amend-and-extend. The lender should ask for something in return: new equity applied to repay debt (sized to restore the leverage it wants), a fee, a margin step-up, tighter reporting, restrictions on distributions and a reset covenant with less headroom than the sponsor first asked for. Compare the options

with enforcement by estimating recovery in a default, and remember that the injection also improves later recovery because the loan is smaller. For the behavioural angle, be ready to say why you like sponsor finance (repeat relationships, structure, speed) and how you decide: you back deals where the equity is thick, the lender case works and the sponsor has a record of support, and you decline or counter when terms break your limits, even if the margin is attractive.

WORKED EXAMPLE: RESETTING THE COVENANT AT OSTLER PACKAGING SYSTEMS

Ostler Packaging Systems is an invented sponsor-backed company with a 150.0m term loan and net debt of 142.0m. EBITDA has fallen from 28.0m to 23.5m against a maximum net leverage covenant of 6.0x (it was 6.5x at closing, when net debt was 146.0m). The sponsor asks for a reset. The lender wants leverage restored to 5.5x by a sponsor injection applied to repay debt. If the business is enforced, stressed EBITDA of 21.0m is valued at 6.0x with costs of 6%. Work out the headroom at closing and now, the injection, and the recovery with and without it. Figures are in millions of pounds.

Answer: Leverage has moved from 5.21x to 6.04x, the injection needed is 12.75m, recovery would rise from 79.0% to 86.3%, and the lenders earn about 1.88m from the fee and step-up.

> **Interview tip:** Say what you want in exchange for relief and quantify it: an injection that restores the leverage you wanted, and what it does to your recovery.

Summary of the Charta interview-preparation topic. Companies and figures in the examples are invented. Draft content, not yet expert reviewed.