Credit Analysis and Underwriting

Interview preparation summary · PC track

IN THIS SUMMARY

- The borrower
- Downside and recovery

INT.CU.1.a · The borrower

Judge the quality and durability of a borrower's business from a lender's perspective, using revenue visibility, concentration, cyclicality and cash conversion.

A lender is paid a fixed margin, so growth adds little to its return while one bad year can destroy principal. Business quality therefore means predictability of cash, not upside. Test revenue visibility (contracted or repeat revenue, renewal rates, and whether retention rests on volume or only on price rises), concentration (top customer and top ten shares, and the contribution margin lost with each), cyclicality (peak to trough EBITDA in a past downturn), cost flexibility (fixed against variable costs) and cash conversion (EBITDA less capex, tax and working capital, as a share of EBITDA). Two companies with the same leverage can carry very different risk once conversion and volatility are compared. The usual mistake is to size debt on peak or reported EBITDA for a cyclical or capital-hungry business and to praise growth. A strong answer ranks the borrowers on cash after capex, says which downside breaks the thesis, and sizes leverage on that.

WORKED EXAMPLE: RANKING TWO BORROWERS ON CASH AFTER CAPEX

A lender can write a 150m loan to one of two borrowers. Tessel Compliance Services has EBITDA over five years of 28, 29, 30, 30 and 31 and capex of 3, 3, 3, 3 and 4. Dunmore Plant Hire has EBITDA of 40, 52, 31, 45 and 55 and capex of 22, 28, 12, 24 and 30 (fleet renewals). Which is the safer 150m credit? Figures are in millions; ignore tax and working capital.

Answer: Tessel is safer: stable earnings (trough 90% of peak), 89% cash conversion and 5.7x leverage on cash, against Dunmore's 56% trough, 48% conversion and 7.0x on cash.

> **Interview tip:** Say that you rank borrowers on EBITDA less capex through a cycle, not on headline leverage, and give the trough-to-peak ratio and the conversion figure in your first two sentences.

INT.CU.1.b · The borrower

Rebuild a borrower's EBITDA the way a lender would: test every add-back for evidence, recurrence and cash, and compare leverage on reported, sponsor and lender definitions.

Sponsors present adjusted EBITDA, and the gap between that and what a lender will underwrite is where leverage is quietly increased. Start from reported EBITDA and test every item for evidence, recurrence and cash. Accept genuine one-offs with documents (a settled legal claim), audited pro forma effects of acquisitions already completed, and above-market owner pay that a replacement would not cost. Challenge restructuring costs that recur every year, run-rate cost savings not yet delivered and projected synergies, and deduct costs that were capitalised although they behave like running expenses, such as development or customer acquisition spend. Then recompute leverage on three bases, reported, sponsor adjusted and lender adjusted, and ask what share of adjusted EBITDA is add-backs. Remember that covenant EBITDA is a legal definition, often more generous than the credit view, so headroom measured on it can mislead. Say what you accept, what you refuse and the leverage you would quote.

WORKED EXAMPLE: LENDER EBITDA FOR QUILLON SOFTWARE SERVICES

Quillon reports EBITDA of 31.0m. The sponsor adds back one-off deal fees of 1.8m, above-market owner pay of 0.9m, a pro forma full year of an audited acquisition completed three months ago of 1.6m and run-rate synergies of 4.0m not yet delivered. Both sides agree to deduct 2.4m of software development costs that were capitalised. Proposed debt is 164.5m. What leverage should the lender quote?

Answer: Lender EBITDA is 32.9m and leverage 5.0x, against 4.5x on the sponsor's 36.9m; the 4.0m of undelivered synergies is the disagreement.

> **Interview tip:** Say what you accept, what you refuse and why in one breath, then quote the leverage on your definition and the sponsor's; the interviewer listens for evidence, recurrence and cash as your three tests.

INT.CU.1.c · The borrower

Compute free cash flow, net leverage, interest cover and fixed charge cover, and read how the capital structure splits risk across tranches.

Four numbers frame most credit discussions. Net leverage is debt less cash over EBITDA, usually shown through each tranche so you can see where your loan attaches and detaches. Interest cover is EBITDA over cash interest. Fixed charge cover is stricter: EBITDA less capex and cash tax, over cash interest plus scheduled amortisation. Free cash flow after debt service shows whether the business deleverages without growth or refinancing. Use cash interest only and treat PIK separately, because PIK raises the balance rather than draining cash. Read the structure as well: how much sits ahead of you, how much junior debt or holdco paper sits behind, whether rates are floating and hedged, and when maturities fall. A ratio that looks comfortable at 4.0x leverage can hide thin cash cover when the margin is high and capex heavy. The common mistake is to quote one headline leverage figure; a strong answer gives leverage through the tranche, both covers and the cash left after debt service.

WORKED EXAMPLE: READING THE STRUCTURE OF VANTAGE PACKAGING

Vantage Packaging has EBITDA of 42m, capex of 9m, cash tax of 5m and a working capital outflow of 2m. It has cash of 18m, a first lien term loan of 140m at 9.5% cash interest with 1% scheduled amortisation (1.4m) and a second lien of 50m at 12% cash. Assess it as the first lien lender. Convention: year-end flows, no hedging.

Answer: Net leverage is 2.9x through the first lien and 4.1x in total; interest cover is 2.2x but fixed charge cover only 1.35x, with about 5.3m of free cash after debt service.

> **Interview tip:** Quote leverage through your own tranche first, then both covers, then the cash left; say the headline 2.2x cover and the 1.35x fixed charge cover side by side to show you know the difference.

INT.CU.2.a · Downside and recovery

Build a downside case, work out covenant headroom as a share of EBITDA, and reverse stress test to find what breaks cash flow.

A downside case is not a forecast; it asks whether the loan survives a plausible bad outcome. Build it from drivers (volume, price, margin, working capital, capex that cannot be cut) rather than a flat percentage, and tie it to the business, for example the loss of the top customer or a repeat of the last recession. Then measure covenant headroom as the fall in EBITDA that would reach the covenant level: one minus actual leverage divided by the covenant level, holding net debt constant for a clean test. Check step-downs, because a covenant that tightens over time erodes headroom even if earnings hold. Finish with a reverse stress test: solve for the EBITDA at which cash flow after interest and capex turns negative, and how long cash and the revolver last past that point. Typical mistakes are treating a breach as a loss rather than an early warning, and testing only the covenant, not liquidity. A strong answer quotes headroom, the breakeven EBITDA and the runway.

WORKED EXAMPLE: HEADROOM AND DOWNSIDE FOR PELLAM FOODS

Pellam Foods has revenue of 240m, an EBITDA margin of 15% and net debt of 162m. Its net leverage covenant is 6.0x now and steps down to 5.5x next year. A downside case has revenue 8% lower and a margin of 12.5%. Net debt is held at 162m. How much headroom is there, and does the downside breach?

Answer: Headroom is 25% now and 18.2% after the step-down; the downside gives 5.87x, which breaches 5.5x, so the covenant would trip before cash runs short.

> **Interview tip:** Give headroom as a percentage fall in EBITDA, mention the step-down unprompted, and say that a breach is an early-warning event that opens a negotiation, not the same thing as a loss.

INT.CU.2.b · Downside and recovery

Estimate recoveries by valuing the business at a stressed EBITDA and multiple, deducting costs and priority claims, and filling claims in order of seniority.

Recovery analysis answers one question: if this borrower defaults, what do we get back? Start with the stressed EBITDA at the point of default, not the peak, and apply a stressed multiple that reflects distressed buyers, often well below the entry multiple. For asset-heavy or asset-based credits cross-check with liquidation value, applying haircuts to inventory, receivables and equipment. Deduct administration and restructuring costs, then pay claims in order: a super senior revolver or other

priority claims, first lien, second lien, then unsecured. Recovery rate is value received over claim, and loss given default is one minus recovery. Assume the revolver is fully drawn at default, because borrowers draw before they fail, and remember that pari passu creditors share pro rata. Show the sensitivity to the multiple, since small changes decide whether a junior tranche recovers anything. The common mistakes are using the entry multiple, ignoring a drawn revolver and ignoring structural subordination.

WORKED EXAMPLE: RECOVERY WATERFALL FOR DALBY LOGISTICS

Dalby Logistics was bought at 8.0x EBITDA of 38m. At default, EBITDA is assumed to have fallen to 22m. Debt is a fully drawn super senior revolver of 15m, a first lien term loan of 85m and a second lien of 30m. Costs of administration are 6% of enterprise value. What does the first lien recover at a stressed 5.0x, and at 4.0x?

Answer: At 5.0x the revolver and first lien are repaid in full and the second lien gets 11%; at 4.0x the first lien recovers 79.7% and the second lien nothing.

> **Interview tip:** Open with the stressed EBITDA and the multiple you chose and why, then walk the waterfall in order, and finish by naming the multiple at which your own tranche starts to lose.

INT.CU.2.c · Downside and recovery

Size a loan against several constraints, estimate expected loss as probability of default times loss given default, and explain a risk rating and what moves it.

Debt capacity is the lowest answer from several tests: a leverage ceiling, a minimum interest or fixed charge cover at the all-in cash rate, a loan to value limit on enterprise value, and a recovery test in the downside. The binding constraint changes with the business, and naming it is the insight to give. Expected loss is probability of default times loss given default, and the useful comparison is spread less expected loss, not spread alone, since a wider margin on a weaker credit can be worth less. A risk rating, usually on a scale of one to five, summarises the borrower's probability of default and the loan's recovery, drives pricing, provisioning and monitoring frequency, and moves on trends such as shrinking headroom, not only on breaches. Equity cures and sponsor support are helpful but are not a fix for deteriorating earnings. The usual mistake is sizing to the sponsor's ask. A strong answer names the binding test, the expected loss and the trigger for a downgrade.

WORKED EXAMPLE: SIZING A LOAN FOR ORRIN DENTAL GROUP

Orrin Dental Group has lender EBITDA of 30m and a proposed enterprise value of 240m (8.0x). The fund's limits are total leverage of 5.0x, interest cover of at least 2.2x at an all-in cash rate of 9.5%, and loan to value of 55%. Probability of default is 3.5% a year, loss given default 35% and the margin 6.25%. How much can the fund lend, and what is the spread after expected loss?

Answer: The fund can lend 132m (4.4x), bound by the loan to value limit; expected loss is 1.2% a year and the spread after expected loss is about 5.0%.

> **Interview tip:** Always name which test binds and why, then give expected loss as PD times LGD and the spread net of it; mention what would make you downgrade the loan, for example headroom falling below 15%.

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