Investment Judgement

Interview preparation summary · PE track

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INT.IJ.1.a · Is it a good business

Judge the quality of a business and its market using pricing power, cash conversion, recurring revenue and management, and say what evidence would support each claim.

A good business is one whose profits are likely to persist and to turn into cash. Test it in layers, and for each layer ask for evidence rather than adjectives. Market: size, growth, structure and cyclicality. Position: share, and the reason customers choose the company, which should be something other than the lowest price. Pricing power: a price rise above cost inflation, held for several years with little loss of volume or retention, and gross margin that compares well with peers. Recurring revenue: contract length, retention and renewal history. Cash conversion: EBITDA less capex less the working capital build, divided by EBITDA, because two companies with the same EBITDA can produce very different free cash flow. Management: depth below the founder, a record of hitting budget, and incentives. A common mistake is to list a strong brand and a large market without any test. Interview point: for every strength you claim, say what number you would look at to prove it, and what number would make you change your mind.

WORKED EXAMPLE: TWO BUSINESSES WITH THE SAME EBITDA

Fenner Cable Ducts and Orrin Bulk Haulage are invented companies. Each earns EBITDA of 20m and is offered at 200m, which is 10.0x. Fenner has capex of 3m and a working capital build of 1m. Orrin has capex of 9m and a working capital build of 4m. Last year Fenner raised prices 6% while its input costs rose 4%, and its volume fell 1.5%; its revenue is 100m and its cost of sales is 60m. Which is the better business, and what is the evidence? Convention: ignore tax and interest, annual figures.

Answer: Fenner is the better business on this evidence: 80% cash conversion against 35%, an 8.0% against a 3.5% cash yield at the same price, and a price rise that outpaced costs with little volume loss. Orrin needs proof that its capex is growth.

> **Interview tip:** Name the number that proves each claim: cash conversion for quality of earnings, price against volume for pricing power. Then say what would change your mind, which is the part interviewers listen for.

INT.IJ.1.b · Is it a good business

Identify and size red flags such as customer concentration, aggressive EBITDA adjustments, founder dependence and capex hidden in operating costs, and say how each affects price or structure.

A red flag is a feature that makes reported earnings less reliable or less durable, and the skill is to test and size it, not just name it. Customer concentration: find the top customer's share, contract term and renewal date, then compute the EBITDA lost at contribution margin (revenue less variable cost, not gross margin) if it leaves, and the leverage that results. Aggressive adjustments: look for add-backs that recur every year, pro forma credit for contracts not yet live, and founder pay added back with no replacement cost; rebuild EBITDA from the accounts and compute the multiple on your figure. Founder dependence: find who holds the key relationships and know-how, and structure around it with rollover, deferred consideration, a non-compete and a deputy. Capex hidden in operating costs: recurring replacement spend booked as an exceptional cost and added back, or pushed into leases, so judge EBITDA less all cash reinvestment. Each flag should end in a number: a lower price, lower debt or a condition before signing.

WORKED EXAMPLE: READING A SELLER'S EBITDA AND ITS BIGGEST CUSTOMER

Dunmore Signs is an invented company with revenue of 100m and reported EBITDA of 18.0m. The seller shows adjusted EBITDA of 25.0m by adding back 1.5m of founder pay above a market salary, 2.5m of one-off repairs and 3.0m for a contract signed but not yet started. The seller asks 9.0x adjusted EBITDA, which is 225m. Repairs cost 2.4m, 2.6m and 2.5m in the last three years. The largest customer is 30% of revenue, earns a 40% contribution margin and is managed personally by the founder. A buyer would borrow 4.5x EBITDA. Assess the position.

Answer: On a rebuilt EBITDA of 19.5m the ask is 11.5x, and 9.0x would be 175.5m. Losing the top customer takes out 12.0m and leverage goes from 4.5x to 11.7x, so renewal, rollover and an earn-out are conditions.

> **Interview tip:** For each flag give the number it changes: EBITDA, price, leverage. Interviewers want to hear a quantified effect and a structural response, not just a list of worries.

INT.IJ.2.a · Is it a good investment

Show how price decides whether a good company is a good investment, state what must be believed to reach the hurdle, and test the leverage the business can carry in a downside.

A good company is not automatically a good investment: the price decides the return. For any price, work out what must be believed to reach the fund's hurdle of about 20% IRR and 2.5x. That means the EBITDA growth, margin change and exit multiple needed, and whether the evidence supports them. Be wary of a case that needs the exit multiple to match or beat the entry multiple, because that relies on the market staying generous. Leverage capacity comes from the downside, not the base case: ask how far EBITDA can fall before interest cover or covenants fail and the debt cannot be repaid, and who will lend on what terms. Show the downside next to the base case and say what happens to the equity. A strong answer states the price and implied multiple, the base and downside returns, and the highest price at which the return still works. Common mistake: praising the quality of the business and forgetting to say what it costs.

WORKED EXAMPLE: THE SAME COMPANY AT TWO PRICES

Cartwright Lab Services is an invented company with EBITDA of 20m, planned to grow to 32m in five years. A buyer would borrow 4.0x EBITDA, which is 80m, and repay 30m, leaving net debt of 50m at exit. The seller might accept 8.0x or hold out for 12.0x. The fund wants 20% and 2.5x. Compare the returns and say what must be believed at 12.0x. Convention: five years, ignore fees and tax, one exit cash flow.

Answer: At 8.0x the deal returns 2.58x and 20.8%. At 12.0x it returns 2.09x and 15.9% even with no multiple contraction, and it needs growth of 13% to 18% a year to reach 2.5x. The walk-away price is about 8.1x.

> **Interview tip:** Say the business is good, then say the price is the problem and give the number: what you must believe at their price, and the price at which the return works.

INT.IJ.2.b · Is it a good investment

Break a value creation plan into levers with owners and probabilities, judge the exit route and buyer, and compare deals by risk-adjusted return and opportunity cost.

A value creation plan is a list of levers, each with a size, an owner, a timetable and a probability. Start by bridging the equity gain into EBITDA growth, multiple change and debt paydown; if much of it comes from things the fund does not control, such as market growth or multiple expansion, the case is weaker than the headline. For each lever name who delivers it: current management, a hire not yet made, an operating partner, or the deal team through acquisitions, and whether that person is in place and funded. Weight each lever by its likelihood to get an expected return, and compare that with the hurdle. Then test the exit: who buys (a strategic buyer, another sponsor, a listing), at what multiple on comparable deals, and whether they could finance it in five years. Underwrite on the buyer you are sure of, and treat a strategic premium as upside. Finally, a deal must beat the next best use of capital and time, so compare deals on risk-adjusted return, capital absorbed and downside, not on headline IRR.

WORKED EXAMPLE: WHO DELIVERS THE PLAN, AND WHAT IS IT WORTH IF SOME LEVERS FAIL

Pellam Industrial Coatings is invented. EBITDA is 24m, bought at 7.5x for 180m with 96m of debt and 84m of equity. The plan lifts EBITDA to 36m by year five, exit at 7.5x with net debt of 60m. The 12m lift has three parts: 4m from market growth, 4m from a pricing programme to be led by a commercial director not yet hired, and 4m from two bolt-on acquisitions run by the deal team and the finance director. Judge the plan. Convention: five years, ignore fees and tax.

Answer: The headline plan returns 2.5x and 20.1%, but weighted for the chance each lever is delivered it returns 2.14x and 16.5%. I would reprice, or firm up the hire and the bolt-ons before committing.

> **Interview tip:** Always attach a name and a probability to each lever. Then say the return on the weighted case, and say what you would do to close the gap.

INT.IJ.3.a · Deciding and passing

Run a pre-mortem, set kill criteria, and read a short IC-style summary to check that its numbers tie and to find what is missing.

Deciding starts with trying to break the idea. A pre-mortem assumes the deal has failed in year three and asks why. The answers, such as the key customer left, the acquisitions stalled, rates rose or the chief executive quit, become diligence items, and where they cannot be tested before signing they become risks to price or structure. Kill criteria are conditions set in advance that stop the deal if they are met, for example a top customer that will not renew, quality of earnings EBITDA below a stated figure, or financing terms above a stated cost. They stop momentum from overriding judgement, and they should not be rewritten when they are breached. When you read a short investment committee summary, first re-derive the headline return from the stated entry price, growth, exit multiple and debt, to see whether it ties and what it quietly assumes. Then list what is missing: downside case, adjustments, concentration, who delivers the plan, exit buyers and financing terms, and rank the gaps by what could change the decision.

WORKED EXAMPLE: READING A ONE-PARAGRAPH IC SUMMARY

An associate hands you this summary of Project Tern, an invented foodservice distributor. We recommend investing 48m of equity at an enterprise value of 120m, which is 7.5x EBITDA of 16.0m, with 72m of debt. The company is the regional leader with strong relationships and an experienced management team. Base case EBITDA reaches 24.0m in year five and, at a 7.5x exit multiple, the return is 2.9x and a 24% IRR. Net debt at exit is 40m. Check the numbers, then say what is missing. Convention: five years, ignore fees and tax.

Answer: The 2.9x ties, but only if EBITDA grows 50% and the multiple holds; at 20.0m of EBITDA it falls to 2.29x and 18.0%. The summary lacks a downside case, earnings quality, concentration, an owner for the growth and an exit buyer.

> **Interview tip:** First show you re-derived the return, then show what it depends on, then list the gaps in order of importance. That order tells the interviewer you check numbers before you trust them.

INT.IJ.3.b · Deciding and passing

Decide when to pass, say no with reasons and a reconsideration price, and handle a deal you like but cannot make work at the asking price.

Passing is a skill, not a failure. Pass when the price needed for the hurdle is below what the seller will accept, when a kill criterion is met, when the downside loses capital, or when the plan depends on something you cannot control or test. For a deal you like but cannot make work, calculate the price at which it works, the gap to the ask, and whether structure can close the gap: an earn-out that pays only for performance above your base case, a lower-debt structure, or a rollover. Beware structures that only move the price into the future, such as a vendor loan, because the fund still pays for it. Then say no clearly: give the decision, two or three reasons with numbers, and the price at which you would reconsider, and keep the relationship warm. Avoid vague reasons such as not a fit, and avoid bidding a price you do not believe in order to stay in the process. Saying no on price protects returns and is often how the next deal is won.

WORKED EXAMPLE: SAYING NO TO A BUSINESS YOU LIKE

Holloway Cold Storage is an invented company with EBITDA of 20m that the seller values at 9.0x, which is 180m. A buyer would borrow 80m. The plan lifts EBITDA to 28m, with an exit at 8.0x and net debt of 50m at exit. The fund needs 2.5x. Work out whether to bid, what to offer, and how to say it. Convention: five years, ignore fees and tax.

Answer: At 180m the return is 1.74x and 11.7%; the price that works is about 150m, 7.5x. I would offer 150m with an earn-out above 32m of EBITDA, and if refused, pass with those numbers.

> **Interview tip:** Give the decision first, then two or three numbers, then the price at which you would reconsider. Do not apologise or hide behind not a fit.

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