UNIVERSITY INVESTMENT CLUB

5.0 LBO Model Guide

Sources & Uses, Debt Paydown, and Returns Analysis

Guide 5 of 6 | IB & PE Interview Prep Series

Compiled for internal club use. Questions are illustrative and drawn from commonly tested technical themes in IB and PE recruiting — not affiliated with, or sourced verbatim from, any bank or recruiting firm.

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Leveraged buyout questions are core to Private Equity interviews (and common in IB as well). The interviewer wants to see that you understand what actually drives sponsor returns — not just how to fill in a template.

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1. LBO Basics

Q1.1 Walk me through a basic LBO.

- A financial sponsor acquires a company using a mix of debt and equity, with debt typically making up 50–70% of the purchase price.
- The target's own cash flows are used to pay down that debt over the holding period (typically 3–7 years).
- The sponsor grows the business operationally (revenue growth, margin improvement, add-on acquisitions).
- At exit, the sponsor sells the company (or takes it public), and returns are driven by the combination of debt paydown, EBITDA growth, and any multiple expansion.

Q1.2 Why does using leverage boost equity returns?

Because the sponsor only puts in a fraction of the purchase price as equity, while capturing all of the equity upside from the full enterprise's growth and debt paydown. A smaller equity check earning the same dollar of value creation produces a higher percentage return — leverage magnifies both gains and losses.

Q1.3 What makes a good LBO candidate?

- Stable, predictable, recurring cash flows (to comfortably service debt).
- Low ongoing capital expenditure requirements.
- A strong market position / defensible competitive moat.
- Room for operational improvement, or a credible growth/add-on strategy.
- A clean, unlevered (or under-levered) starting Balance Sheet.

2. Sources & Uses and the Debt Schedule

Q2.1 What goes on the Sources side and the Uses side of a Sources & Uses table?

Uses (what you need to pay for): the Equity Purchase Price, repayment of existing Debt, and transaction/financing fees.

Sources (how you pay for it): New Debt tranches (revolver, term loans, high-yield bonds), the sponsor's Equity contribution, and sometimes rollover equity from existing management/owners. Sources must equal Uses.

Q2.2 What are the typical tranches of debt used in an LBO, and how do they differ?

- **Revolver:** a flexible credit line for working capital needs; cheapest, most senior.
- **Term Loan A / B:** senior secured debt, amortizes over time, moderate cost.
- **High-Yield / Subordinated Debt:** unsecured or junior, typically bullet repayment (no amortization), higher interest rate to compensate for higher risk.
- **Mezzanine / Preferred Equity:** most junior, often includes equity-like features (warrants, PIK interest), highest cost of capital.

Q2.3 What's a cash flow sweep?

A mandatory provision requiring the company to use a portion (often 100% for senior tranches) of excess free cash flow each year to pay down outstanding debt early, beyond scheduled amortization — this accelerates deleveraging and is a key lever behind LBO returns.

Q2.4 What financial covenants might lenders impose on an LBO borrower?

- Maximum Leverage Ratio (Debt/EBITDA).
- Minimum Interest Coverage Ratio (EBITDA/Interest Expense).
- Restrictions on additional debt issuance, asset sales, or dividends.

3. Returns Analysis

Q3.1 What are the main ways to calculate LBO returns?

- **IRR (Internal Rate of Return):** the annualized percentage return over the holding period.
- **MOIC (Multiple of Invested Capital):** total cash returned divided by total cash invested (e.g., a 3.0x MOIC means the sponsor got back 3x what it put in).

Q3.2 What are the primary drivers of returns in an LBO?

- **EBITDA growth** — from revenue growth and/or margin expansion during the hold.
- **Debt paydown** — reducing leverage increases the equity's share of enterprise value at exit.
- **Multiple expansion (or contraction)** — selling at a higher (or lower) EV/EBITDA multiple than the entry multiple.

Q3.3 All else equal, how does a longer holding period affect IRR versus MOIC?

MOIC can keep growing the longer you hold (assuming continued value creation), but IRR tends to decline over a longer hold if the rate of value creation slows, because IRR is annualized — the same dollar gain earned faster produces a higher IRR.

Q3.4 Why might a sponsor do a dividend recapitalization mid-hold?

To return cash to Limited Partners earlier (boosting IRR by pulling cash flow forward) by raising additional debt against the company and paying out the proceeds as a dividend, without fully exiting the investment. This increases leverage and can push Shareholders' Equity on the Balance Sheet negative.

4. Value Creation & Advanced Topics

Q4.1 How would entry multiple versus exit multiple assumptions affect your recommended offer price?

If you conservatively assume the exit multiple will equal (or be lower than) the entry multiple, you're relying on operational improvement and deleveraging — not multiple expansion — to hit your target return, which supports a more defensible, lower maximum purchase price. Assuming multiple expansion at exit lets you justify paying more today, but is a riskier bet on market conditions.

Q4.2 What's an add-on acquisition, and why do sponsors pursue them?

A smaller acquisition made by an existing portfolio company (the "platform") to expand scale, product lines, or geography. Add-ons are attractive because they're often acquired at lower multiples than the platform itself, and combining them can create "multiple arbitrage" — the platform's larger scale may command a higher exit multiple than the sum of its parts would individually.

Q4.3 How would you approach an LBO for a company with volatile, cyclical cash flows?

Use a more conservative leverage level (lower Debt/EBITDA), stress-test the debt schedule against a downside case to confirm the company can service interest through a trough, and consider more flexible debt structures (e.g., covenant-lite terms, higher cash cushion / revolver availability).