Most Private Equity firms will give you modelling tests to complete realtime at their offices from scratch. Without practice, this can be challenging, even for seasoned investment bankers. Here are a few tips and an example of a test you will likely get:

LBO Modelling Tips

Tip#1: Spend enough time to understand all the requirements properly

Read in detail the information provided, as well as what is asked. Often, candidates fail to answer the question asked by trying to do too much or waste time as they add complexities that are not required.

Tip#2: Always keep models simple

Do not try to "show off" by building complex models and advanced functions. Build a practical model that answers the question; only if you have enough time, then add a few more advanced functions or clean up the formatting, but this is not necessary.

Tip#3: Watch your time, and if you are running out of time, simplify

If you get stuck on a point, just simplify it; at minimum, provide an IRR output. If you build only half of the model, then your ability to build a full LBO cannot be judged. But if you take a shortcut on some parts but still build the full LBO and IRR calculations, you might be able to get away with it.

Tip#4: Have a well-practiced template in mind

Make sure you have a very well-rehearsed basic template in mind with the following items:

- Simple Source and Uses table (one or two branches of debt). Input your entry/exit multiple assumptions here
- Basic income statement (Revenue, EBITDA, D&A, EBIT, Taxes, Interest, Net profit - that's it). Leave Interest blank and link it later on from your debt schedule.


- Debt Schedule: Here you need to detail the Debt Repayments and Interest Paid. You can then link those to the Cash Flow and P&L.

- IRR Calculation. The cash flows should come from your cash flow statement and you only need to insert the IRR Calculation here. You should also insert some sensitivity tables for different exit years and different entry/exit multiples.

LBO Model Test Example (2 hours)

For practice, try to solve this case:

LBO Model Assumptions

1. A Private Equity Firm wants to acquire a German business for €280m + any Advisory Fees equivalent to 2% of the transaction value. Assume a transaction date of 30 June 2012 and no cash.

- Senior debt of 3.0x EBITDA at transaction date has been obtained from a regional bank.

- The seller has also agreed to provide an additional €35m in the form of a vendor loan.

- The private equity firm will invest the balance in the form of a shareholder note.

3. The Senior Bank Debt pays 7% per annum (cash pay), with this repayment plan in place: 5% repaid in year one, 15% in year two, 20% in year three, 30% in year four, and 30% in year five.

4. The Vendor Loan pays 8% (non-cash) which accrues annually. This vendor loan is subordinated to the bank debt.

5. The Private Equity Firm shareholder loan pays a 15% non-cash pay coupon, which accrues annually. This loan is subordinated to the senior bank debt and to the vendor loan.

6. The Company needs to maintain a minimum of €1m operating cash at all times. Assume a full cash sweep for any amounts above €1m.

7. The Private Equity Firm wants to maintain control of the company and at the time of the acquisition will have 85% shareholding in the company, while the management will retain 15%.

8. Sales at closing were €100m; assume this will grow by 5% in year one, and 7% p.a. thereafter

9. EBITDA margins will increase from 35%, and increase by two percentage points per year until 2017.

10. It is thought that Capex over this period will be €15m per annum (equal to depreciation).

11. The Company has 10 days (of sales) funding gap in working capital.
12. Tax will be charged at 30%.

Questions

'A. What is the Private Equity firm IRR, and cash on cash returns at 7.0x, 8.0x and 9.0x EBITDA exit multiples in years four and five?

'B. What are the returns if you assume senior debt of 2.5x and 3.5x EBITDA? What are the issues that we need to consider in deciding the necessary level of bank debt?

'C. What is your recommended level of bank debt?

'D. Which EV exit is realistic given the data provided, and what return would you expect?

'E. What kind of return should you be looking for with this kind of business?

'F. What is the benefit of a vendor loan?

'G. What would be a sensible strategy you would adopt with regards to the vendor loan in two or three years?

H. How much of the exit proceeds will go to shareholders and how much will go to management

For a fully worked out answer, please refer to the LBO Model.