Top Private equity Interview question and answers

1. Who are the financial buyers?

A financial buyer is a type of acquirer in an M&A that is primarily interested in buying the company with the intention to sell later at some point, thereby generating returns. These buyers see companies as projects and have some exit strategies.

Private Equity firms' investments can be a good example of financial buyers.

This is not the case with a strategic buyer who is primarily interested in acquiring the company to achieve synergies and expand businesses.

2. Difference between strategic buyers and financial buyers?

Strategic buyers must carefully analyze purchases based on how the targets will "tie in" with their existing company and business units since they frequently incorporate the acquired business into a larger corporation. Moreover, strategic buyers are primarily interested in acquiring the company to achieve synergies in the long run.

Financial buyers, on the other hand, typically assess an opportunity as a stand-alone organization because it won't be incorporated into a larger company. A financial buyer is primarily interested in the company's potential for rapid growth so they can generate a maximum return and have an exit plan in the future.

3. What is dry powder?

Dry powder is the amount of committed but unallocated capital that a venture capital (VC) or private equity (PE) company has on hand. It is, in other words, a cash reserve that has not yet been invested. Investors and businesses strategically use dry powder, a highly liquid asset, to achieve financial success.

4. What is the difference between Private Equity and Venture Capital?

Capital invested in a business or other entity that is not publicly listed or traded is known as private equity.

Private Equity investors prefer to invest in stable companies, whereas Venture Capital (VC) investors usually come in during the start-up phase.

5. What are the various stages of funding?

There are 8 Stages of funding given below:

- Pre-seed funding stage
- Seed funding stage
- Series A funding
- Series B funding
- Series C funding
- Series D funding and beyond
- Exit via IPO

6. What is Pre-money / post-money valuation?

Pre-Money Valuation - Pre-money valuation is the value of a firm before any outside capital or most recent round of funding has been added. Pre-money is best defined as the potential value of a start-up before it starts to receive outside funding.

This valuation not only provides investors with a sense of the current worth of the company but also the value of each share that has been issued.

Post-money, on the other hand, refers to the company's value following the receipt of funding and subsequent investments.

Post-money valuation takes into account recent capital infusions or external finance. Knowing which one is being discussed is crucial because they are key ideas in valuing any firm.

7. What is equity dilution?

Equity dilution is the reduction in shareholders' stock holdings in a firm. Whenever shareholders provide equity ownership to external investors (like private equity firms) in return for money, it is called equity dilution.

8. What is a term sheet?

A non-binding agreement that outlines the basic terms & and conditions of an investment. It serves as a model for creating more comprehensive, binding documents.

9. What is a leveraged buyout (LBO) for a PE firm?

An LBO is the purchase of a business, whether it is privately held or publicly listed, in which a sizeable portion of the purchase price is financed by debt. The remaining sum is covered by equity contributions from the financial sponsor, and, in some situations, stock transfers made by the current management team of the business.

The purchased company will have undergone a recapitalization and changed into a highly leveraged financial structure by the time the deal closes.

Usually, the sponsor will keep the money for five to seven years. The acquired firm will use the cash flows it generates from its operations to cover the necessary interest payments and reduce some of the debt principal during the holding period.

When evaluating an investment, the financial sponsor typically aims for an IRR of at least 20–25%.

10. Walk me through the mechanics of building an LBO model for financial buying.

Step 1 – Entry Valuation - Calculating the implied entry valuation based on the entry multiple and LTM EBITDA of the target firm is the first step in creating an LBO model.

Step 2 - Sources and Uses, the proposed transaction structure will then be shown in the "Sources and Uses" section. The "Sources" side will describe how the deal will be funded, while the "Uses" side will determine the overall amount of funds needed to make the acquisition. The biggest question that needs to be resolved is: How much equity must the financial sponsor contribute?

Step 3 - Financial Projections - Following completion of the Sources & Uses table, the company's expected free cash flows (FCFs) will be determined by the operating hypotheses (e.g., revenue growth rate, margins, interest rates on debt, tax rate). The amount of cash available for debt amortization and the annual interest expense are both determined by the FCFs generated, making them a crucial component of an LBO.

Stage 4: Calculating Returns In this last step, the exit assumptions for the investment are made (exit multiple, date of exit, etc.), and the total funds collected by the private equity company are used to compute the IRR and cash-on-cash return, with a number of sensitivity tables linked below.

11. What is the basic intuition underlying the usage of debt in an LBO?

A high percentage of borrowed money is typically used to finance an LBO, and the private equity sponsor contributes just a modest amount of equity to the deal. The sponsor will be able to earn more money when selling the investment because the debt's principal will be reduced throughout the course of the holding period.

Because debt has a lower cost of capital than equity, it is advantageous for sponsors to invest little equity. The fact that debt is positioned higher in the capital structure and that the interest paid on it is tax deductible, creating an attractive "tax shield," are two factors contributing to the lower cost of debt. As a result, the firm can more easily exceed its returns level thanks to the enhanced leverage.

In order to reduce the danger of bankruptcy, private equity firms optimize their use of leverage while maintaining a reasonable level of debt.

The firm will have more unused cash (sometimes known as "dry powder") after employing larger debt levels, which can be used to make additional investments or buy expansions for their portfolio companies.

12. What are the private equity firms' investment exit strategies?

A PE firm will typically monetize their investment in one of the following ways:
Sale to a Strategic Buyer: Sales to strategic buyers typically have higher valuations and are more convenient since they are willing to pay more for the likelihood of synergies.

Another alternative is to sell to another financial buyer (often known as a sponsor-to-sponsor deal), although this is a less-than-optimal exit because financial purchasers cannot pay more for synergies.

Initial Public Offering (IPO) — The portfolio company can go through an IPO and sell its shares in the public market as a third way for a private equity firm to monetize its earnings, but this option is only available to larger firms (such as mega-funds or club agreements).

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13. What are the main LBO return-generating levers?

1) Deleveraging – As more loan principal is paid down with the help of the cash flows produced by the acquired company, the value of the equity held by the private equity firm increases over time.

2) EBITDA Growth Increasing EBITDA can be done by introducing new growth strategies to boost revenue, cost-cutting initiatives to improve the company's margin profile, and accretive add-on acquisitions.

3. Multiple Expansion A financial sponsor ideally wants to buy a business at a low entry multiple ("going in cheap") and subsequently sell it at a higher multiple. Higher economic conditions, better investor sentiment in the relevant industry, and favorable transaction dynamics can all enhance the exit multiple (e.g., competitive sale process led by strategic buyers).

Most LBO models, however, use the cautious assumption that the company would be sold at the same EV/EBITDA multiple at which it was bought. The rationale is that the future transaction climate is uncertain, making it riskier to rely on several expansions to satisfy the return threshold.

14. What qualities make a company the perfect candidate for an LBO?

A candidate for an LBO should possess the majority (or all) of the following qualities:

A mature industry with a defendable market position, a business model with recurring revenue, a strong, committed management team, and a variety of revenue streams with little cyclicality; and steady, predictable cash flow generation Low Capex Needs and working Capital Requirements Currently Market Undervalued (i.e., Low-Purchase Multiple)

Leverage ratios link a company's debt holdings to a particular cash flow indicator, most frequently EBITDA. The financing climate and the industry will have a significant impact on the leverage ratio parameters; nonetheless, the total leverage ratio in an LBO ranges from 4.0x to 6.0x, with the senior debt ratio normally being around 3.0x.

- Total Debt / EBITDA
- Senior Debt / EBITDA
- Net Debt / EBITDA

Interest coverage ratios look at a company's ability to use its cash flows to fulfill its interest obligations.

As a general rule, it is preferable to have an interest coverage ratio that is larger than 2.0x.

16. Name a few warning signs you would watch out for while evaluating a potential investment opportunity.

Industry Cyclicality: A potential LBO contender should produce a steady cash flow. Therefore, from a risk perspective, investment is less appealing when revenue and demand changes are very cyclical and reliant on the current economic conditions (or other external variables).

Customer Concentration: As a general rule, no one customer should represent more than 5–10% of total revenue as the risk of losing that key customer due to unanticipated events or the customer's refusal to continue doing business with them (i.e., decides not to renew their contract) presents a significant risk.

Customer or Employee Churn: Although each situation will be unique, high rates of customer and employee churn are typically viewed as a bad sign. High customer churn necessitates ongoing new customer acquisitions, while low employee retention indicates problems with the target's organizational structure.

17. What is PIK interest?

PIK interest ("paid-in-kind") is a form of non-cash interest, meaning the borrower compensates the lender in the form of additional debt as opposed to cash interest.

PIK interest typically carries a higher interest rate because it has a higher risk to the investor (i.e., delayed payments result in less certainty of being paid).
From the perspective of the borrower, opting for PIK conserves cash in the current period and thus represents a non-cash add-back on the CFS.

However, PIK interest expense is an obligation that accrues towards the debt balance due in the final year and compounds on an annual basis.

18. How does the treatment of financing fees differ from transaction fees in an LBO model?

Financial Fees → Financing fees are related to raising debt or the issuance of equity and can be capitalized and amortized over the tenor of the debt (~5-7 years).

Transaction Fees → On the other hand, transaction fees refer to the M&A advisory fees paid to investment banks or business brokers, as well as the legal fees paid to lawyers. Transaction fees cannot be amortized and are classified as one-time expenses

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