



When a private equity firm conducts a "leveraged buyout", or LBO, it uses a significant amount of debt. The list below is a high-level explanation of the different types of debt instruments that are commonly used in LBO transactions. When purchasing a company, the private equity fund will usually provide anything between 30% to 50% of the purchase price in equity (i.e. the fund's own money), and borrow the rest. The 30% to 50% range varies depending on market conditions and the type of company that is bought, but most LBOs usually fall in that range. The type of debt used, in order of risk (from the lending bank's perspective), includes:

Senior Debt

This debt ranks above all other debt and equity capital in the business, meaning it needs to be repaid before other lenders can receive any cash. The debt has very strict requirements (i.e. must comply with specific financial ratios), and is usually secured against specific assets of the company. This means that the lender can automatically acquire these assets if the company breaches its obligations. Therefore, it has the lowest interest rate of all these types of debt and, from the lender's perspective, this is the most secure form of financing. Debt repayments can be spread over a four to nine-year period or be paid in one final payment in the last year.

Subordinated Debt

This debt ranks behind senior debt in order of priority on any liquidation. Repayment is usually required in one payment at the end of the term (as opposed to spreading the repayments over a number of years), and the maturity can range between seven to ten years. The requirements of the subordinated debt are usually less stringent than senior debt, but since subordinated debt gives the lender less security than senior debt, lending costs are typically higher.

Mezzanine Debt

This is usually high-risk subordinated debt, and ranks behind senior debt and unsecured debt. Interest on mezzanine debt is much higher, but while part of the interest needs to be paid in cash, another part (called a PIK, or “paid in kind”) is rolled up into the principal. For example, if you borrow 100 shares of mezzanine at 10%, with 5% cash and 5% PIK, you will have to pay 5 in cash in interest in the first year, and the remaining 5 will accrue to the principal. Therefore, the following year, you will need to pay 10% on the new principal of 100 + 5 accrued in previous year (which equals 105), and this continues until maturity when the full principal needs to be repaid (usually within 10 years). Sometimes the mezzanine debt will also include warrants or options so that the lender can participate in equity returns.

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