

Walk me through an LBO model

Private Equity › Interview Preparation



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An common question you get during private equity interviews is "can you please walk me through an LBO? feel free to make your own assumptions". While this may sound a bit daunting at first, the trick here is to keep things simple. The theory behind an LBO is actually fairly simple.

In what level of detail should you go? What the interviewer is trying to test is only that you have a good understanding of the mechanics of an LBO, so there is no need for you to go into a lot of details. Details will come during the LBO modelling test! Here is what you should be able to understand and the steps you should take.

If possible, lay out some assumptions on a piece of paper.

Step one: Lay out the Sources and Uses assumptions assumptions and some example company.

"Lets assume we have an consumer retail company. My first step would be to lay out some assumptions with regards to source an uses.

- I need to know how much I will pay for the company. This can be expressed as a multiple of EBITDA. Let's assume 8 times of current EBITDA, which I think is a reasonable multiple. If current sales are 500 and EBITDA margin is 20%, then EBITDA is 100, that means $8 \times 100 = 800$ is what I need to pay.

- I need to know how much of that purchase price will be paid in equity and how much through debt. Lets assume that I will use 50% of debt and 50 % of equity. So that means I used 400 of equity and 400 of debt.

- Also, lets now assume that we will sell this company in 5 years, at a same 8 times EBITDA multiple.

Step 2. Make some basic cash flow assumptions

"Now I need to know about the financial forecast to see what the cashflow looks like and see how much of debt I can repay over the period. My cashflow before debt repayment is calculated as: EBITDA - Capex - Changes in Working capital - Interest paid on the debt - Taxes.

[Here you may be asked to go into detail of how you come up with each number, or you may jump some steps - interviewer will guide you].

I assume EBITDA can grow from 100 to 150 over five years. Then lets say that based on those forecasts, I am able to repay 20 of debt per year [you may be asked to derive the amount you can repay based on the details you calculated above], that is 100 over the next five years."

Step 3. Calculate your IRR

-I have spent 400 of equity and taken 400 of debt

-After 5 years, EBITDA is 150, and assuming I can sell at a 8 times multiple, I will get $150 * 8 = 1,200$. From that 1,200, I need to repay the 400 of debt but I already repaid 100 over the last 5 years, therefore I only have 300 left to repay. That leaves me with $1200 - 300 = 900$ of equity.

-My overall return is therefore $900 / 400 = 2.25x$ return over 5 years, which is roughly an 18% IRR [to be able to estimate IRRs, you need to memorise IRR conversion tables]

For more advanced private equity LBO modelling practice, you can also refer to our [tips and LBO practice example](#)

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