Advanced LBO Modeling Test Prompt

**Situation Overview**

A private equity firm ("Lead Sponsor") is in the process of the take-private leveraged buyout of JoeCo, a publicly-traded coffee company. The latest closing price of JoeCo was $14.25 per share, but JoeCo’s shareholder board and shareholders had pre-determined $12.00 as the basis of the takeout offer. The takeout offer value per share was a 25% premium over the normalized share price.

The private equity firm leading the deal has offered Wall Street Prep Capital Partners ("WSPCP") the opportunity to co-invest into the deal via a preferred equity investment into JoeCo. The amount invested would be $475mm and the preferred equity will PIK at an 8.5% accrual rate with the optionality to convert. Also, WSPCP would be receiving a $5mm monitoring fee each year for its consulting services to JoeCo. The remaining equity contribution required will be funded entirely by the Lead Sponsor in the form of common equity.

To pitch the deal, the Lead Sponsor has mentioned two potential levers to increase equity returns, 1) the add-on acquisition of TeaCo and 2) a dividend recapitalization.

The Lead Sponsor has mentioned that its ideal plan is to acquire TeaCo in 2021 and then to complete a dividend recap in 2024. The reason being, the Lead Sponsor expects JoeCo to perform in-line with its base case, whereas TeaCo has a high likelihood of outperforming and following the upside case. In terms of the exit, the Lead Sponsor has indicated that it is under the belief that the two firms would be able to exit to a strategic at a multiple near the entry multiple.

Based on the lender agreements, the sponsors are restricted from issuing themselves a dividend for the first two years and the maximum leverage that the additional debt can be raised up to is a total leverage multiple of 6.0x (i.e. based on the initial leverage multiple). In addition, the interest coverage ratio (EBITDA / Interest Expense) must remain above 2.0x throughout all years.

**Instructions:** Using the information provided and the assumptions listed below, create a functional forecast model that calculates the returns to WSPCP from this potential co-investment in JoeCo.

**Transaction Assumptions**

- The normalized share price of JoeCo is $12.00 and a 25% premium will be the takeout offer
- JoeCo has 315mm basic shares outstanding and three tranches of options (1mm @ $3.00, 2mm @ $5.00, and 2.5mm @ $10.00)
- The transaction fee paid will be 2.5% of the total offer equity value
- Upon closing of the deal, the Cash to B/S must be $25mm and all existing debt will be refinanced
- JoeCo's Intangible Assets will be written up 10% with a useful life assumption of 15 years
- JoeCo's PP&E will be written up 10% with a useful life assumption of 8 years
- Upon closing of the deal on 12/31/2020, the share price of JoeCo will be adjusted to a dollar basis (i.e. each common share will be worth $1.00)
- Use a tax rate of 25%

**Financing Assumptions**

- The revolver was left undrawn at purchase, priced at LIBOR + 400, maximum revolver capacity of $1,000mm, and an unused revolver commitment fee of 0.25%
- Unitranche Term Loan was raised at 6.0x of LTM EBITDA, issued 98 of par, and priced at LIBOR + 400 with a 1% floor, 5% mandatory amortization, and full cash sweep
- Assume the financing fees amortization period is 8 years for all periods and a financing fee of 2% for all debt tranches (excluding the revolver)
**Investment Assumptions**

- WSPCP’s investment is of preferred convertible equity and the total investment amounts to $475mm with a PIK accrual rate of 8.5%
- The conversion strike price on the WSPCP’s investment is $1.25
- A 5% management option pool was reserved with the strike price being issued in-the-money (“ITM”) at $1.00

**Management Contingency Compensation Assumptions**

- There will be contingency-based management compensation if certain EBITDA targets are met, there will be three levels and the maximum that can be earned is $10mm each year (minimum @ $2mm, midpoint @ $3mm, and outperformance @ $5mm)
- The minimum EBITDA target in 2021 was set at $350mm and each year the target will increase by 15% YoY
- The midpoint and outperformance will be 10% higher than one another, and will similarly increase by 15% YoY

**Add-On Assumptions**

- The Lead Sponsor believes it can acquire TeaCo at 9.5x LTM EBITDA
- Funding for the acquisition will come from JoeCo’s FCF and the revolver
- For the add-on acquisition, the institutional lender has agreed to provide a revolving line of credit of $1,000mm
- There is no restriction on the year that TeaCo could be acquired
- In 2020, TeaCo generated $100mm in Revenue, $30mm in Gross Profit, $10mm in SG&A, and $5mm in R&D – for an EBITDA of $15mm
- TeaCo in 2020 had 250 stores in the U.S. with 50,000 annual orders per store
- TeaCo has no D&A or other sources of income / (expenses)
- Assume there are no revenue or cost synergies from the add-on, and ignore tax implications

**Dividend Recap Assumptions**

- Additional debt raised for the dividend recap will in the form of bonds with a fixed interest rate of 8.5%, no required amortization, and NC/L (i.e. no prepayment allowed for life)
- If a dividend recap is to be completed, it will be completed right at the beginning of the year
- In terms of how the dividend will be distributed between the Lead Sponsor and WSPCP, the percentages will be based on the initial equity contributions at purchase

**Note:** The LTM financials of JoeCo and TeaCo, and the assumptions for the key drivers of each company are included in the first sheet of the model template.