Access the Rest of the Fundamentals Course

Financial Modeling Fundamentals, Module 12: Leveraged Buyouts and LBO Models – Step-by-Step Walkthrough of a Full LBO Model

Table of Contents:

Key Rule #3: The Purchase Price and Debt and Equity Assumptions..... 2
Key Rule #4: Sources & Uses and Purchase Price Allocation 7
Key Rule #5: Projecting the Cash Flows and Debt Repayment 12

Key Rule #3: The Purchase Price and Debt and Equity Assumptions

Starting with this Key Rule, we'll begin walking through a real LBO model for 7 Days Inn, a budget hotel chain in China that was listed in the U.S. before it was acquired by Carlyle (a large private equity firm).

Just like there's subtlety around the true "Purchase Price" in an M&A deal, there are also some shenanigans around the real "Purchase Price" in a leveraged buyout.

However, it gets even more confusing because existing investors and the management team might *participate* in the buyout, "rolling over" their shares in the process.

All the usual items – the Seller's existing Cash and Debt and the fees incurred in the transaction – will affect the true price, but this "rollover" will distort things even more.

As in an M&A deal, we **start** by basing the purchase price on a **premium** to the company's current share price, if it's public, or a multiple of its EBITDA or EBIT if it's private:

Target - "Undisturbed" Share Price (USD):	$ 3.52
Premium Paid to Target's Share Price:	30.6%
Offer Price per Share (USD):	$ 4.60

This deal took place in real life, so we're using the actual #'s here; if it had not, we might have used the average premium in the market.

Then, we calculate the company's Current Equity Value, Current Enterprise Value, Purchase Equity Value, Purchase Enterprise Value, and all the relevant multiples:

Company Valuation @ Current Share Price:

Diluted Shares (Millions) @ Current Share Price:	147.384

Options - Treasury Stock Method @ Current Share Price:

Name:	Number (Millions):		Exercise Price:	Dilution:
Options A	1.858	$	2.82	0.371
Options B	6.636	$	3.49	0.063
Total:	**8.494**			**0.434**

Current Equity Value:	¥	**3,262.2**
(-) Cash & Cash-Equivalents:		(382.3)
(-) Equity Investments:		-
(-) Other Non-Core Assets, Net:		-
(-) Net Operating Losses:		-
(+) Total Debt:		251.4
(+) Preferred Stock:		-
(+) Noncontrolling Interests:		(22.9)
(+) Unfunded Pension Obligations:		-
(+) Capital Leases:		-
(+) Restructuring & Other Liabilities:		-
Current Enterprise Value:	¥	**3,108.4**

Current Valuation of Target:	**$ in Millions**	**¥ in Millions**
Current Equity Value:	$ 519.3	¥ 3,262.2
Current Enterprise Value:	494.8	3,108.4
LTM EV / Revenue:		1.2 x
LTM EV / EBITDA:		5.5 x
Forward EV / Revenue:		1.0 x
Forward EV / EBITDA:		4.2 x

Company Valuation @ Purchase Price:

Diluted Shares (Millions) @ Offer Price:	149.271

Options - Treasury Stock Method @ Purchase Price:

Name:	Number (Millions):		Exercise Price:	Dilution:
Options A	1.858	$	2.82	0.719
Options B	6.636	$	3.49	1.601
Total:	**8.494**			**2.320**

Purchase Equity Value:	¥	**4,313.5**
(-) Cash & Cash-Equivalents:		(382.3)
(-) Equity Investments:		-
(-) Other Non-Core Assets, Net:		-
(-) Net Operating Losses:		-
(+) Total Debt:		251.4
(+) Preferred Stock:		-
(+) Noncontrolling Interests:		(22.9)
(+) Unfunded Pension Obligations:		-
(+) Capital Leases:		-
(+) Restructuring & Other Liabilities:		-
Purchase Enterprise Value:	¥	**4,159.8**

Valuation of Target at Purchase Price:	**$ in Millions**	**¥ in Millions**
Purchase Equity Value:	$ 686.6	¥ 4,313.5
Purchase Enterprise Value:	662.2	4,159.8
LTM EV / Revenue:		1.6 x
LTM EV / EBITDA:		7.4 x
Forward EV / Revenue:		1.4 x
Forward EV / EBITDA:		5.6 x

The true purchase price is **neither** the Purchase Equity Value **nor** the Purchase Enterprise Value.

However, we need to calculate both of these to determine the valuation multiples and to estimates the exit multiples.

At this stage, we can calculate the "Funds Required," the transaction and financing fees, and the Debt and Equity used to fund the deal:

Fees and Other Assumptions:	%:	$ in Millions	¥ in Millions
Advisory Fee %:	0.6%	$ 4.1	¥ 25.6
Debt Issuance Fee %:	3.0%	3.6	22.6
Legal and Other Fees:		9.9	62.4
Minimum Cash Balance:		20.0	125.6
Maximum Cash Available:		40.8	256.6

Funds Required:	$ in Millions	¥ in Millions
Equity Purchase Price:	$ 686.6	¥ 4,313.5
(+) Debt Refinanced:	40.0	251.4
(-) Excess Cash:	-	-
(-) Equity Rollover:	(311.1)	(1,954.6)
Total Funds Required (Excl. Fees):	**$ 415.5**	**¥ 2,610.4**

		Amounts Used:	
Transaction Funding:	**% Used:**	**$ in Millions**	**¥ in Millions**
Debt Used:	28.9%	$ 120.0	¥ 753.8
Equity Used:	71.1%	295.5	1,856.5

We're using the Debt and Equity percentages from the real-life deal; if we didn't have these, we might base the Debt on the median Debt / EBITDA of peer companies.

We always START with the company's Equity Purchase Price, and then add any Debt that's refinanced. If the company uses its own Cash to repurchase its shares, we subtract that. The "Equity Rollover" refers to how the existing investors / management are maintaining their 45-46% stake.

The "real price" here is *approximately* $415.5 million.

It's not *exactly* $415.5 million because we still need to account for the transaction and financing fees, which will add around $18 million to this figure.

This "real price" – whether it's $415 million or $433 million – is NOT only far from the Purchase Equity Value and the Purchase Enterprise Value, but it's NOT even between them!

Instead, it's *below* both of them because the management team and existing investors own ~46% of this company and maintain their ownership in the deal.

A 46% rollover is extremely high, but rollovers in the 5-10% range are common. Management tends to own a much smaller percentage of more established, mature companies.

Types of Debt and Debt Assumptions

In most deals, there are **multiple types or "tranches" of Debt**.

PE firms use multiple tranches of Debt because different investors have different risk appetites.

For example, if a PE firm is acquiring a company using 6x Debt / EBITDA, a conservative bank will not lend that much to fund the deal.

The bank might go up to 2x or 3x Debt / EBITDA, but beyond that, the PE firm will have to find investors that are willing to accept higher risk in exchange for potentially higher returns.

These more aggressive investors might be hedge funds, merchant banks, or mezzanine funds; they could also be institutional investors that specialize in higher-risk Debt.

Broadly speaking, Debt is divided into **Secured Debt** and **Unsecured Debt**.

Sometimes people term these two categories "Bank Debt" and "High-Yield Debt"; other labels include "Junior Debt" and "Senior Debt," or "Junior Capital" and "Senior Capital."

The main differences are as follows:

- **Secured Debt (AKA "Bank Debt" or "Senior Debt" or "Senior Capital"):**
    - **Collateral:** Yes – if the company defaults, lenders can seize Assets used as collateral, such as Inventory and PP&E.
    - **Interest Rates:** Floating (e.g., LIBOR + 375 = LIBOR + 3.75%), so the rates may change over time.
    - **Amortization:** Possible, but it's often minimal (e.g., 1% per year; sometimes up to 20% per year).
    - **Covenants:** Maintenance covenants (e.g., Debt / EBITDA cannot exceed 5x or EBITDA / Interest must remain above 3x at all times).
    - **Prepayment:** Early repayment of principal **is** allowed.
    - **Tenor (Maturity Period):** 5-10 years.
    - **Investors:** Mostly banks and more conservative lenders.
- **Unsecured Debt (AKA "High-Yield Debt" or "Junior Debt" or "Junior Capital"):**
    - **Collateral:** No – if the company defaults, the lenders lose their money.
    - **Interest Rates:** Higher and Fixed (e.g., 10% or 12%); Interest may also be "Paid-in-Kind" or PIK and accrue to the principal rather than being paid in cash.
    - **Amortization:** None; the entire balance is due upon maturity ("bullet maturity").

- **Covenants:** Incurrence covenants (e.g., The company can't sell Assets or issue Dividends, or if it raises capital, it must use the funds to repay Debt).
- **Prepayment:** Early repayment of principal is **not** allowed; the entire balance might be repaid early, but typically there are penalty fees associated with it.
- **Tenor (Maturity Period):** 8-10 years, sometimes up to 20-30+ years, and sometimes indefinite (Preferred Stock).
- **Investors:** Hedge funds, merchant banks, and mezzanine funds.
- **Other:** Often has **equity options** attached so that the Debt investors may end up owning a portion of the company's equity upon exit.

Here's a tabular summary – note that **these are *general* rules, and there are exceptions:**

Debt Type:	Revolver	Term Loan A	Term Loan B	Senior Notes	Subordinated Notes	Mezzanine
Interest Rate:	Lowest	Low	Higher	Higher	Higher	Highest
Floating / Fixed?	Floating			Fixed		
Cash Interest?	Yes					Cash / PIK
Tenor:	3-5 years	4-6 years	4-8 years	7-10 years	8-10 years	8-12 years
Amortization:	None	Straight Line	Minimal	Bullet		
Prepayment?	Yes			No		
Investors:	Conservative Banks			HFs, Merchant Banks, Mezzanine Funds		
Seniority	Senior Secured			Senior Unsecured	Senior Subordinated	Equity
Secured?	Yes			Sometimes	No	
Call Protection?	No	Sometimes		Yes		
Covenants:	Maintenance			Incurrence		

In real life, PE firms make decisions on the best type of Debt based on what **comparable companies and deals have used**, as well as the company's circumstances.

If similar deals have used 100% Subordinated Notes at 5x Debt / EBITDA ratios, the PE firm might decide *against* Subordinated Notes in a *particular* deal if the covenants are too restrictive.

For example, maybe the company is planning to spend a huge amount on CapEx to build a factory in 2 years, and the covenants on Subordinated Note covenants would restrict that.

In that case, it might make more sense to go against the market and use an alternative Debt structure that better aligns with the company's plans.

For the most part, though, you look at similar deals for companies with similar credit ratings and base the Debt levels on those.

If hotel chains with BB+ credit ratings have been acquired using median Total Debt of 4x, with 2x Term Loans and 2x Senior Notes, you might assume the same combination for 7 Days Inn.

Here are our assumptions:

Debt Assumptions

Debt Amounts:	%:	$ in Millions	¥ in Millions
Total Debt Used:		$ 120.0	¥ 753.8
% Senior Notes:	75.0%	90.0	565.4
% Subordinated Notes:	25.0%	30.0	188.5
Initial LIBOR Rate:	0.30%		
Annual Step-Up:	25 bps		

Other Debt Information:	Interest:	Principal:
Senior Notes:	L + 375	20.0%
Subordinated Notes:	10.0%	0.0%

This means that LIBOR starts out at 0.30% and increases by 0.25% per year in the holding period, so the Senior Note interest rate increases by that much as well.

If this were **not** a real deal, we'd base these figures on the percentages or Debt / EBITDA levels from similar leveraged buyouts in the market at this time.

Senior Notes rarely, if ever, amortize; 20% amortization would be more common for a Term Loan A. So this example diverges from reality for illustrative purposes.

With the Debt and Equity assumptions in place, we're *almost* ready to project Free Cash Flow and the company's Debt Repayment each year.

But we still don't know *exactly* how much the PE firm is paying and how the ownership changes in the deal, so we need to create a Sources & Uses schedule to determine both of those.

Return to Top.

Key Rule #4: Sources & Uses and Purchase Price Allocation

The Sources & Uses schedule in a merger model tells you how much the Buyer is *really* paying, and it serves a similar function in a leveraged buyout model.

The "Purchase Price" can be almost anything, but what matters is how much in **cold, hard Cash (Investor Equity) the PE firm is using to buy the company.**

And that's often very different from the "Purchase Price" because of Assumed vs. Refinanced Debt, fees, and rollovers from existing investors.

In an LBO, the Sources & Uses schedule serves another purpose as well: **It tells you how the company's ownership changes after the deal takes place**.

Existing investors, managers, employees, and anyone else with a stake in the company may choose to *participate* in the deal, which reduces the PE firm's post-deal ownership.

By contrast, the ownership in M&A deals is a moot point unless the Buyer uses Stock – and even if Stock *is* involved, you track ownership with a Contribution Analysis instead.

Typical **Uses of Funds** in a leveraged buyout include:

- **Equity Purchase Price of Company** – How much it costs to buy 100% of the company's shares.
- **Advisory, Legal, and Financing Fees** – How much the company must pay bankers and lawyers to get the deal done and raise the Debt.
- **Assumed Debt** – If Debt is "assumed," it's kept in place or replaced with new Debt that's the same as, or very similar to, the existing Debt.
- **Refinanced Debt** – If Debt is "refinanced," the PE firm repays it using the Debt and Equity funding the deal.

Typical **Sources of Funds** in a leveraged buyout include:

- **All Forms of Debt** – The Revolver, Term Loans, Senior Notes, Subordinated Notes, Mezzanine, Preferred Stock, and other Debt all count as funding sources.
- **Assumed Debt** – If Debt is "assumed," it's kept in place or replaced with new Debt that's the same as, or very similar to, the existing Debt.
- **Equity Rollover from Existing Investors** – If existing investors choose to *keep* their shares in the company rather than selling them to the PE firm, that reduces the purchase price. For example, the PE firm might have to pay for only 90% of the company's shares rather than 100%.

- **Excess Cash** – If the acquired company uses its Cash to fund the deal by repurchasing its own shares, that Cash shows up here. Like the Equity Rollover, it also reduces the "real price" the PE firm must pay.

- **Investor Equity** – This one is the *last* item on the Sources side, and it acts as "the plug." You calculate it by taking the Total Uses and subtracting all the Sources *above* this line, and it tells you **how much Cash** the PE firm must use to acquire the company.

Here's the Sources & Uses schedule for 7 Days Inn:

Sources & Uses

Sources:	$ in Millions	¥ in Millions	x EBITDA
Senior Notes:	$ 90.0	¥ 565.4	1.0 x
Subordinated Notes:	30.0	188.5	0.3 x
Target Debt Assumed:	-	-	0.0 x
Founder/Management Rollover:	311.1	1,954.6	[illegible]
Cash for Transaction Fees:	17.6	110.6	0.2 x
Excess Cash from Target:	-	-	0.0 x
Investor Equity:	295.5	=+M84-SUM(F79:F84)	
Total Sources:	**$ 744.3**	**¥ 4,675.6**	**8.3 x**

Uses:	$ in Millions	¥ in Millions	x EBITDA
Equity Value of Company:	$ 686.6	¥ 4,313.5	7.7 x
Advisory & Legal Fees:	14.0	88.0	0.2 x
Financing Fees:	3.6	22.6	0.0 x
Target Debt Assumed:	-	-	0.0 x
Target Debt Refinanced:	40.0	251.4	0.4 x
Total Uses:	**$ 744.3**	**¥ 4,675.6**	**8.3 x**

This "Rollover" indicates that some existing investors are **NOT** selling their shares but keeping them instead, which reduces the price a PE firm must pay.

Investor Equity is always "the plug" in the S&U schedule for an LBO.

"Assumed Debt" appears on both sides and indicates that Existing Debt is kept in place or replaced with new Debt that's very similar.

The "Target Debt Assumed" line tends to cause confusion; here's how you can think about it:

On the Uses side, Existing Debt will always **add** to the funds required to acquire the company because it must be repaid upon "change of control."

But there are 2 ways a PE firm could "repay" this Existing Debt: It could do so using a *combination* of Debt and Equity, or it could simply *replace* the Existing Debt with New Debt that's largely the same.

You start on the Uses side to figure out exactly how much the deal will cost.

And then you move to the Sources side to determine *how* the PE firm will pay for it.

If you do NOT list "Assumed Debt" on the Sources side, you're saying, "We're going to repay this Existing Debt using a *combination* of Debt and Equity."

But if you **DO** list it on the Sources side, you're saying, "We keep the Existing Debt in place, or we replace it with New Debt that is (almost) the same."

Payment for advisory, legal, and financing fees may come from anything on the Sources side: Debt, Equity, or Excess Cash. In this case, it comes from the Seller's Cash balance.

The Sources & Uses schedule also tells us how the **company's ownership changes**:

Sources & Uses

Sources:	$ in Millions	¥ in Millions	x EBITDA
Senior Notes:	$ 90.0	¥ 565.4	1.0 x
Subordinated Notes:	30.0	188.5	0.3 x
Target Debt Assumed:	-	-	0.0 x
Founder/Management Rollover:	311.1	1,954.6	3.5 x
Cash for Transaction Fees:	17.6	110.6	0.2 x
Excess Cash from Target:	-	-	0.0 x
Investor Equity:	295.5	1,856.5	3.3 x
Total Sources:	**$ 744.3**	**¥ 4,675.6**	**8.3 x**

Ownership Percentages:	Pre-Deal:	Post-Deal:
Founder / Management Ownership %:	45.9%	=+F82/(+F82+F85)
Existing Investor Ownership %:	54.1%	0.0%
New Investor Ownership %:	0.0%	48.7%
Total:	**100.0%**	**100.0%**

The Post-Deal figures are based on the relative equity contributions of the PE firm and the existing investors in the deal.

The Pre-Deal figures are all based on the share counts from before the deal closes.

The 49% ownership of the New Investors – the PE firm – is **far lower** than the typical percentage they own after an LBO takes place.

This low percentage could be positive: Management is on board and wants to make the deal work.

But it could also be negative: The PE firm doesn't have as much control if something goes wrong and needs to be fixed.

Purchase Price Allocation

You can also complete the Purchase Price Allocation (PPA) process for leveraged buyouts.

It works the same way as it does for M&A deals: Write down the Seller's Common Shareholders' Equity completely, write up Assets, write down existing Deferred Tax items, create a new DTL, and create Goodwill based on those changes.

But in LBO models, you often skip this process and the Balance Sheet adjustments because they don't make a big impact on the results.

Items such as the Depreciation & Amortization of Asset write-ups are **non-cash**, and, therefore, affect only the company's taxes.

But in most M&A and LBO deals, they don't even affect the company's taxes because they're not deductible for cash-tax purposes!

You pay more attention to these items in M&A deals because they *do* affect the company's EPS and, therefore, the EPS accretion/dilution, and you focus on those metrics in merger models.

But leveraged buyouts are all about **cash flow**, and so these items are far less important.

In more advanced models, you will create a Purchase Price Allocation Schedule – but these items still barely make an impact.

We skipped this entire process for 7 Days Inn, but here's the Purchase Price Allocation Schedule for a leveraged buyout of CEC Entertainment, AKA "Chuck E. Cheese's":

Goodwill Creation & Purchase Price Allocation:

Goodwill Calculation:	$ in Millions
Equity Purchase Price:	$ 946.7
(-) Seller's Common Shareholders' Equity:	(160.8)
(+) Write-Off of Existing Goodwill:	-
Total Allocable Purchase Premium:	**785.9**
(-) Write-Up of PP&E:	(27.7)
(-) Write-Up of Intangibles:	(414.1)
(-) Write-Down of Existing DTL:	(57.8)
(+) Write-Off of Existing DTA:	2.1
(+) New Deferred Tax Liability:	170.7
Total Goodwill Created:	**$ 459.1**

Fixed Asset Write-Up:	%:	$ in Millions
PP&E Write-Up:	4.0%	$ 27.7
Depreciation Period (Years):	12.5	
Yearly Depreciation Expense:		2.2

Intangible Asset Write-Up:	%:	$ in Millions
Excess Purchase Price to Allocate:		$ 785.9
Indefinite-Lived Intangibles:	50.9%	400.0
Definite-Lived Intangibles:	1.8%	14.1
Amortization Period (Years):	15	
Yearly Amortization Expense:		0.9
New Deferred Tax Liability:		170.7

Given the tiny amount of new D&A, this Purchase Price Allocation made almost no difference in the final output.

Return to Top.

Key Rule #5: Projecting the Cash Flows and Debt Repayment

Once you have the Purchase Price, Debt and Equity assumptions, and Sources & Uses schedule, you can project the company's **cash flows** and Debt repayment.

You do **NOT** need full 3-statement projections for the company: You just need its Income Statement and portions of its Cash Flow Statement.

But even if you use simplified or partial statements, you must reflect any **fundamental business shifts** in these forecasts.

For example, if the company is switching to a more capital-intensive or less capital-intensive business model or its margins are expanding or shrinking, you need to reflect those trends.

At the time of this deal, 7 Days Inn was moving away from "Leased & Operated Hotels" that it owned directly and into a franchised business model with "Managed Hotels."

It's the same way McDonald's makes money: The company licenses its name and systems to franchisees, who then start restaurants, run them, and pay McDonald's royalty fees.

Managed Hotels are much less capital-intensive than Leased & Operated ones, but they're also riskier because the parent company has less control.

We want to reflect this shift away from L&O Hotels, so we start by assuming relatively low growth in that segment:

		Historical			Projected				
Revenue Assumptions:	*Units*	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17
Days in Year:	*# Days*	365	365	**366**	365	365	365	366	365
Total # of Hotels:	*# Hotels*	568	944	**1,345**	1,704	2,049	2,394	2,714	3,034
Leased & Operated Hotels:									
Leased and Operated (L&O) Hotels:	*# Hotels*	321	411	**492**	541	586	631	671	711
# New L&O Hotels:	*# Hotels*	85	90	**81**	49	45	45	40	40
Total L&O Hotel Rooms:	*# Rooms*	32,825	43,021	**51,725**	56,276	60,957	65,638	69,798	73,959
Rooms per L&O Hotel:	*# Rooms*	102	105	**105**	104	104	104	104	104
Average L&O Occupancy Rate:	*%*	91.0%	87.9%	**82.9%**	80.0%	78.0%	78.0%	76.0%	76.0%
L&O Average Daily Rate (ADR):	*¥ as Stated*	164.9	166.2	**167.0**	168.0	170.0	172.0	174.0	176.0
L&O Revenue per Available Room (RevPAR):	*¥ as Stated*	150.1	146.1	**138.4**	134.4	132.6	134.2	132.2	133.8
L&O Hotel Revenue:	*¥ M*	¥ 1,301.6	¥ 1,750.3	¥ 2,179.9	¥ 2,537.4	¥ 2,723.7	¥ 2,984.9	¥ 3,176.8	¥ 3,407.7
Non-Room Revenue:	*¥ M*	¥ 63.8	¥ 71.4	¥ 122.3	¥ 123.4	¥ 132.4	¥ 145.1	¥ 154.5	¥ 165.7
% L&O Hotel Revenue:	*%*	4.9%	4.1%	**5.6%**	4.9%	4.9%	4.9%	4.9%	4.9%

New L&O hotels per year is well below historical levels.

L&O revenue still grows, but comprises a smaller and smaller % of the total.

The company's Managed Hotels segment grows more quickly, but it also brings in far less in revenue because 7 Days Inn charges a royalty fee of only 9-10% of total sales:

Revenue Assumptions:	Units	Historical FY10	FY11	FY12	Projected FY13	FY14	FY15	FY16	FY17
Managed Hotels:									
Managed Hotels:	# Hotels	247	533	**853**	1,163	1,463	1,763	2,043	2,323
# New Managed Hotels:	# Hotels	146	286	**320**	310	300	300	280	280
Total Managed Hotel Rooms:	# Rooms	23,585	51,663	**81,772**	111,756	140,584	169,412	196,318	223,224
Rooms per Managed Hotel:	# Rooms	95	97	**96**	96	96	96	96	96
Average Managed Occupancy Rate:	%	84.0%	81.5%	**80.3%**	78.0%	78.0%	76.0%	76.0%	74.0%
Managed Average Daily Rate (ADR):	¥ as Stated	156.7	155.8	**158.0**	159.0	161.0	163.0	165.0	167.0
Managed Hotel RevPAR:	¥ as Stated	131.6	127.0	**126.9**	124.0	125.6	123.9	125.4	123.6
Managed Hotel Sales:	¥ M	435.9	1,093.1	**2,399.0**	3,701.6	5,122.5	6,356.7	7,775.4	8,855.2
Managed Hotel Net Revenue:	¥ M	¥ 89.7	¥ 179.3	¥ 262.1	¥ 370.2	¥ 512.3	¥ 603.9	¥ 699.8	¥ 797.0
% Total Managed Hotel Sales:	%	20.6%	16.4%	**10.9%**	10.0%	10.0%	9.5%	9.0%	9.0%

Managed Hotels are growing far more quickly than the L&O Hotels... but...

...With a franchise business model, 7 Days Inn gets only a small percentage of the hotel sales.

As a direct result of this shift, we assume slower expense growth and less CapEx spending on a per-hotel basis in the future:

Expense and Cash Flow Assumptions:	Units	Historical FY10	FY11	FY12	Projected FY13	FY14	FY15	FY16	FY17
Operating Costs per L&O Hotel:	¥ M / Hotel	¥ 3.69	¥ 3.88	¥ **4.13**	¥ 4.26	¥ 4.38	¥ 4.52	¥ 4.63	¥ 4.75
Operating Cost Growth:	%	(10.5%)	5.2%	**6.6%**	3.0%	3.0%	3.0%	2.5%	2.5%
SG&A % Revenue:	%	10.8%	12.9%	**11.1%**	11.5%	11.0%	11.0%	10.5%	10.5%
D&A per Hotel:	¥ M / Hotel	0.32	0.26	**0.24**	0.22	0.20	0.19	0.18	0.17
D&A per Hotel Growth Rate:	%		(18.3%)	**(7.5%)**	(10.0%)	(8.0%)	(6.0%)	(6.0%)	(5.0%)
Other Non-Cash Charges % Revenue:	%	(0.1%)	(0.2%)	**(0.3%)**	(0.3%)	(0.4%)	(0.4%)	(0.5%)	(0.5%)
Change in WC % Change in Revenue:	%	6.0%	11.5%	**12.6%**	12.0%	12.0%	13.0%	13.0%	14.0%
CapEx per Hotel:	¥ M / Hotel	0.75	0.60	**0.41**	0.32	0.23	0.18	0.15	0.12
CapEx per Hotel Growth Rate:	%		(19.9%)	**(32.4%)**	(20.0%)	(30.0%)	(20.0%)	(20.0%)	(20.0%)
Effective Cash Interest Rate:	%	0.8%	1.4%	**1.8%**	1.8%	1.8%	1.8%	1.8%	1.8%
Effective Interest Rate on Existing Debt:	%	3.8%	4.3%	**7.3%**	7.3%	7.3%	7.3%	7.3%	7.3%
Repayments of Existing Debt:	¥ M				(40.5)	(88.0)	(33.4)	(33.4)	(33.4)
Equity Income (Loss) in Affiliates:	¥ M				-	-	-	-	-

Declines due to the rise in Managed Hotel revenue.

These both decline sharply because the company stops *owning directly* most of its hotels. So if this business shift works as planned, its FCF will increase substantially.

In real life, we didn't sit down and create all these assumptions in one fell swoop.

It was an **iterative process**: We looked at the company's filings and investor presentations, tried different numbers, saw the results on the Income Statement and Cash Flow Statement, and then went back to tweak the assumptions.

For example, if CapEx fell to an unreasonably low level, then we would tweak our assumptions so that it ends up in a more reasonable range by the end.

Here's the preliminary Income Statement based on these assumptions:

Income Statement:	Units	Historical			Projected				
		FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17
Revenue:	¥ M	¥ 1,498.9	¥ 2,003.4	¥ 2,557.2	¥ 3,031.0	¥ 3,368.4	¥ 3,734.0	¥ 4,031.1	¥ 4,370.4
Revenue Growth:	%	*31.3%*	*33.7%*	***27.6%***	*18.5%*	*11.1%*	*10.9%*	*8.0%*	*8.4%*
(+) Hotel Operating Costs:	¥ M	1,182.9	1,593.3	**2,033.5**	2,303.1	2,569.5	2,849.8	3,106.3	3,373.7
(+) Selling, General & Administrative:	¥ M	161.9	259.0	**283.4**	348.6	370.5	410.7	423.3	458.9
Total Operating Expenses:	¥ M	**1,344.9**	**1,852.3**	**2,316.9**	**2,651.7**	**2,940.0**	**3,260.6**	**3,529.5**	**3,832.6**
Operating Income:	¥ M	**154.1**	**151.1**	**240.3**	**379.3**	**428.3**	**473.4**	**501.6**	**537.8**
(+) Interest Income:	¥ M	3.1	6.2	**7.9**					
(-) Interest Expense - Existing Debt:	¥ M	(2.1)	(7.2)	**(21.5)**					
(-) Interest Expense - New Debt:	¥ M	-	-	**-**					
(+) Equity Income / (-) Loss in Affiliates:	¥ M	(0.0)	0.1	**-**	-	-	-	-	-
Pre-Tax Income:	¥ M	**155.1**	**150.2**	**226.7**	**379.3**	**428.3**	**473.4**	**501.6**	**537.8**
(-) Income Tax Provision:	¥ M	(35.8)	(36.3)	**(67.5)**	(97.4)	(110.0)	(121.5)	(128.8)	(138.1)
Net Income:	¥ M	**119.2**	**114.0**	**159.2**	**281.9**	**318.3**	**351.8**	**372.8**	**399.7**

You should leave the **Interest Income / (Expense) section** blank initially.

This section depends on the Debt and Cash balances, and we need the company's cash flow projections to forecast both of them.

Here's the start of our cash flow projections:

Cash Flow Statement:	Units	Historical			Projected				
		FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17
Operating Activities:									
Net Income:	¥ M	¥ 119.2	¥ 114.0	¥ 159.2	¥ 281.9	¥ 318.3	¥ 351.8	¥ 372.8	¥ 399.7
(+) Depreciation & Amortization:	¥ M	180.8	245.4	**323.5**	368.9	408.1	448.2	477.6	507.2
(+/-) Other Non-Cash Charges:	¥ M	(1.8)	(3.7)	**(7.1)**	(9.1)	(13.5)	(14.9)	(20.2)	(21.9)
(+/-) Change in Working Capital:	¥ M	21.6	58.2	**69.8**	56.9	40.5	47.5	38.6	47.5
Cash Flow from Operations:	¥ M	**319.7**	**414.0**	**545.4**	**698.5**	**753.4**	**832.6**	**868.8**	**932.6**
Investing Activities:									
(-) Capital Expenditures:	¥ M	(425.6)	(566.8)	**(546.2)**	(553.6)	(466.0)	(435.6)	(395.0)	(353.3)
(+/-) One-Time and Other Items:	¥ M	268.7	(117.8)	**10.0**	-	-	-	-	-
Cash Flow from Investing:	¥ M	**(157.0)**	**(684.7)**	**(536.2)**	**(553.6)**	**(466.0)**	**(435.6)**	**(395.0)**	**(353.3)**
Free Cash Flow:	¥ M				**144.9**	**287.4**	**397.0**	**473.8**	**579.3**
Beginning Cash Balance:	¥ M				271.6	125.6	138.6	535.6	1,009.5
(+) Free Cash Flow:	¥ M				144.9	287.4	397.0	473.8	579.3
(-) Repayments of Existing Debt:	¥ M				-	-	-	-	-
(-) Minimum Cash Balance:	¥ M				(125.6)	(125.6)	(125.6)	(125.6)	(125.6)
Cash Available for New Debt Repayment:	¥ M				**290.9**	**287.4**	**410.0**	**883.8**	**1,463.1**

From the IS.

Both projected on a per-hotel basis; could also be percentages of Revenue.

These are percentages of Revenue or the Change in Revenue.

This is neither Levered FCF nor Unlevered FCF - since it includes Interest but no principal repayments!

$0 since the existing Debt was refinanced.

These projections are similar to the ones in a DCF, with a few differences:

- **Difference #1:** The *purpose* is different because we're estimating how much Debt the company can repay, not its Implied Value.

- **Difference #2:** You start with Net Income rather than NOPAT because you *want* to reflect the Net Interest Expense – it reduces how much Debt the company can repay.

- **Difference #3:** You don't "stop" at Free Cash Flow. You have to go beyond that because Debt repayment isn't necessarily the same as FCF in a leveraged buyout.

Just like in the DCF and merger model, we **ignore Stock-Based Compensation**: If we factored it in, we'd also have to estimate how the PE firm's ownership changes over time, which is tricky and not worth the effort.

The "Free Cash Flow" above is neither Unlevered nor Levered FCF: It's just Flow from Operations minus CapEx.

This metric approximates **how much Debt principal a company could repay each year**.

But it's not perfect.

For example, if a company starts out with Excess Cash, it can use some of that to repay Debt.

Also, if the company has a high Minimum Cash Balance, it can't use *all* its FCF for Debt repayment since it must maintain Cash above a certain level.

Finally, if the company's Existing Debt is *not* refinanced, repayments on that Existing Debt continue and take priority over repayment of the New Debt.

These reasons explain why the Cash Flow Available for Debt Repayment differs from Free Cash Flow in most of this model:

		Projected				
Cash Flow Statement:	*Units*	**FY13**	**FY14**	**FY15**	**FY16**	**FY17**
Free Cash Flow:	¥ *M*	**144.9**	**287.4**	**397.0**	**473.8**	**579.3**
Beginning Cash Balance:	¥ *M*	271.6	125.6	138.6	535.6	1,009.5
(+) Free Cash Flow:	¥ *M*	144.9	287.4	397.0	473.8	579.3
(-) Repayments of Existing Debt:	¥ *M*	-	-	-	-	-
(-) Minimum Cash Balance:	¥ *M*	(125.6)	(125.6)	(125.6)	(125.6)	(125.6)
Cash Available for New Debt Repayment:	¥ *M*	**290.9**	**287.4**	**410.0**	**883.8**	**1,463.1**

There's a difference here because the company's Beginning Cash balance far exceeds its Minimum, so the excess is available for Debt repayment.

These figures are the same because the Beginning Cash Balance = the Minimum Cash Balance.

In these years, the Beginning Cash Balance is always higher than the Minimum, so Cash Available exceeds FCF.

Once you have this item, you can track **how much Debt the company repays each year**:

Debt Schedule:	Units	Projected FY13	FY14	FY15	FY16	FY17
LIBOR:	%	0.55%	0.80%	1.05%	1.30%	1.55%
Senior Note Interest Rate:	%	4.30%	4.55%	4.80%	5.05%	5.30%
Subordinated Note Interest Rate:	%	10.00%	10.00%	10.00%	10.00%	10.00%
Beginning Senior Notes:	¥ M	¥ 565.4	¥ 274.5	¥ -	¥ -	¥ -
(-) Mandatory Repayment:	¥ M	(113.1)	(113.1)	-	-	-
(-) Optional Repayment:	¥ M	(177.8)	(161.4)	-	-	-
Ending Senior Notes:	¥ M	**274.5**	**-**	**-**	**-**	**-**
Beginning Subordinated Notes:	¥ M	188.5	188.5	188.5	188.5	188.5
(-) Mandatory Repayment:	¥ M	-	-	-	-	-
(-) Optional Repayment:	¥ M	-	-	-	-	-
Ending Subordinated Notes:	¥ M	**188.5**	**188.5**	**188.5**	**188.5**	**188.5**
(+) Interest Paid on New Debt:	¥ M	43.2	31.3	18.8	18.8	18.8
(+) Interest Paid on Existing Debt:	¥ M	-	-	-	-	-
(-) Interest Income on Cash:	¥ M	(4.8)	(2.2)	(2.4)	(9.4)	(17.8)
Net Interest Expense:	¥ M	**¥ 38.4**	**¥ 29.1**	**¥ 16.4**	**¥ 9.4**	**¥ 1.1**

LIBOR increases by 0.25% per year, and, therefore, so does the Senior Note Interest Rate. The Subordinated Note Rate is fixed.

The minimum between the set annual amount (20%) and the Beginning Balance.

The minimum between (Cash Available for Debt Repayment - Mandatory Repayment) and (Beginning Balance - Mandatory Repayment).

Subordinated Notes almost never change because they don't amortize, and "prepayments" (i.e., optional repayments) are not allowed.

The Interest figures could be based on the Average Debt and Cash Balances, or linked to the Beginning Balances each year to avoid "circular references."

This Debt schedule is simple because the Subordinated Notes stay constant the whole time and the Senior Notes amortize at an even 20% per year.

In real life, "Senior Notes" almost never amortize, or if they do, it's at a very low rate, such as 1% per year – we set up the schedule this way solely for *illustrative/teaching* purposes.

Term Loan A might amortize at 10% or 20% per year, but Term Loan B, C, and anything else beyond it would have minimal (~1%) amortization or no amortization at all.

In real life, optional repayments of Senior Notes are rarely allowed; we showed them here simply to illustrate the concept.

A company might be able to repay *the entire* Senior Note balance early, but it would often pay a penalty to do so.

Optional repayments *mostly* come up with Term Loans (A, B, and C). The "Senior Notes" in this schedule function more like a Term Loan A than true Senior Notes.

A few formulas here deserve explanation:

- **Senior Notes, Mandatory Repayment:** =-MIN(J237, G70*M70)
  - This formula compares the *Beginning* Senior Note balance in the year to the set annual amortization amount, which is 20% * ¥565.4 = ¥113.1 here.

We never want to amortize *more than* the remaining Debt on the company's Balance Sheet. If only ¥50.0 of Debt remained, we'd amortize that entire remaining amount. It would make no sense to amortize ¥113.1 because it exceeds the remaining amount of Debt.

- **Senior Notes, Optional Repayment:** =-MIN(+J208+J238, +J237+J238)
  - This formula compares (Cash Available for Debt Repayment minus the Mandatory Repayment) to (Beginning Senior Notes Balance minus the Mandatory Repayment).

    We never want to repay *more than* the remaining Debt on the company's Balance Sheet. If the Beginning balance were ¥50.0 and the Mandatory Repayment were ¥20.0, exactly ¥30.0 would be left.

    If the company had ¥40.0 in Cash Available for Debt Repayment, it would repay the remaining balance of ¥30.0.

    But if it had only ¥20.0 in Cash Available for Debt Repayment, it would repay only ¥20.0.

Interest is based on the average Debt and Cash balances or the beginning balances.

Using the average balances creates a "circular reference" because the Ending Balance depends on the company's FCF and Interest, but both of those also depend on the Ending balance.

Circular references make the model harder to modify, so many models use the Beginning Balances or use switches to toggle between the Beginning and Average Balances.

The Revolver

One possibility we did *not* consider in this Debt Schedule was **what happens if the company doesn't have enough Cash Flow to pay for its Mandatory Debt Repayments**.

It's an *incredibly* unlikely scenario, given 7 Days Inn's high Cash balance, substantial FCF generation, and low Mandatory Debt Repayments.

But if the company had much lower FCF – for example, only ¥100 million in the first 2 years rather than ¥145 million and then ¥287 million – then this would be a real possibility.

In that case, the company would have to set up a **Revolver** with its lenders that allows it to borrow extra to meet these repayment requirements.

Some sources describe the Revolver as a "credit card for companies," but it's better to think of it as a **personal overdraft account** at your bank.

If you suddenly need more in cash than what is available in your checking account, you can borrow extra with this overdraft account and pay interest and fees on this extra borrowing.

When you get your next paycheck, repay the extra borrowing and stop paying the extra interest and fees.

A **Revolver** works the same way for companies, and it's especially common in LBO scenarios. Here's an example from a more advanced LBO model:

	C	E	M	N	O	P	Q
484	**Sources of Funds:**						
485	Beginning Cash Balance:	$ M	20.7	15.0	15.0	15.0	15.0
486	(-) Minimum Cash Balance:	$ M	(15.0)	(15.0)	(15.0)	(15.0)	(15.0)
487	(+) Cash Flow Available for Debt Repayment:	$ M	32.7	41.8	41.6	37.7	35.0
488	**Subtotal Before Revolver:**	$ M	38.4	41.8	41.6	37.7	[illegible]
489	(+) Revolver Borrowing Required:	$ M	=MAX(0,M501-M488)	-	-	-	-
490	**Total Sources of Funds:**	$ M	**38.4**	**41.8**	**41.6**	**37.7**	**35.0**
491							
492	**Uses of Funds:**						
493	*Mandatory Debt Repayment:*						
494	Existing Debt:	$ M	-	-	-		-
495	Revolver:	$ M	-	-	-	-	-
496	Term Loan - A:	$ M	25.4	25.4	25.4	25.4	25.4
497	Term Loan - B:	$ M	5.1	5.1	5.1	5.1	5.1
498	Senior Notes:	$ M	-	-	-	-	-
499	Subordinated Note:	$ M	-		-	-	-
500	Mezzanine:	$ M	-	-	-	-	-
501	**Mandatory Repayment Total:**	$ M	**30.4**	**30.4**	**30.4**	**30.4**	**30.4**

We compare the company's total available Cash Flow to the Mandatory Debt Repayment Total.

If the company doesn't have enough, we draw on the Revolver, pay interest and fees, and then repay it when we can.

Banks charge companies an **Undrawn Revolver Commitment Fee** on the portion they're *not* using (e.g., $100 million of a $150 million Revolver if the company is using only $50 million).

And then the company pays a fairly low interest rate, usually based on LIBOR plus a small spread, as well as fees on the portion that it *is* using.

These fees discourage companies from taking on Revolvers "just in case."

Linking the Income Statement, Cash Flow Projections, and Debt Schedule

With the Debt schedule set up, we can return to the other financial statements and link everything:

Cash Flow Statement:	Units	FY13	FY14	FY15 (Projected)	FY16	FY17
Cash Available for New Debt Repayment:	¥ M	**290.9**	**287.4**	**410.0**	**883.8**	**1,463.1**
Cash Used for New Debt Repayment:	¥ M	(290.9)	(274.5)	-	-	-
Beginning Cash Balance:	¥ M	271.6	125.6	138.6	535.6	1,009.5
(+/-) Net Change in Cash:	¥ M	(146.0)	13.0	397.0	473.8	579.3
Ending Cash Balance:	¥ M	**125.6**	**138.6**	**535.6**	**1,009.5**	**1,588.7**
Beginning Existing Debt Balance:	¥ M	-	-	-	-	-
(+/-) Repayments of Existing Debt:	¥ M	-	-	-	-	-
Ending Existing Debt Balance:	¥ M	**-**	**-**	**-**	**-**	**-**
New Debt - Ending Balance:	¥ M	**462.9**	**188.5**	**188.5**	**188.5**	**188.5**
Total Debt Balance:	¥ M	**¥ 462.9**	**¥ 188.5**	**¥ 188.5**	**¥ 188.5**	**¥ 188.5**
Net Debt:	¥ M	**¥ 337.3**	**¥ 49.9**	**¥ -347.2**	**¥ -821.0**	**¥ -1,400.3**
Beginning Shareholders' Equity:	¥ M	3,723.1	4,005.0	4,323.3	4,675.2	5,047.9
(+) Net Income:	¥ M	281.9	318.3	351.8	372.8	399.7
Ending Shareholders' Equity:	¥ M	**4,005.0**	**4,323.3**	**4,675.2**	**5,047.9**	**5,447.6**

Mandatory + Optional Repayments from the Debt Schedule. Use negatives for everything.

Equal to FCF Generated - Repayments of Existing Debt - Repayments of New Debt.

All 0 since the Existing Debt is refinanced in the deal.

Equal to the ending Senior Notes + Subordinated Notes each year.

Right after the deal, the Equity = PE Firm's Equity Contribution + Rollover - One-Time Transaction Fees. Net Income adds to it and Dividends reduce it each year.

Once we've projected the Debt, Cash, and Shareholders' Equity balances, we can return to the Income Statement and link the Interest Income and Interest Expense from the Debt Schedule:

Income Statement:	Units	FY13	FY14	FY15 (Projected)	FY16	FY17
Revenue:	¥ M	**¥ 3,031.0**	**¥ 3,368.4**	**¥ 3,734.0**	**¥ 4,031.1**	**¥ 4,370.4**
Revenue Growth:	%	*18.5%*	*11.1%*	*10.9%*	*8.0%*	*8.4%*
(+) Hotel Operating Costs:	¥ M	2,303.1	2,569.5	2,849.8	3,106.3	3,373.7
(+) Selling, General & Administrative:	¥ M	348.6	370.5	410.7	423.3	458.9
Total Operating Expenses:	¥ M	**2,651.7**	**2,940.0**	**3,260.6**	**3,529.5**	**3,832.6**
Operating Income:	¥ M	**379.3**	**428.3**	**473.4**	**501.6**	**537.8**
(+) Interest Income:	¥ M	4.8	2.2	2.2	8.3	16.5
(-) Interest Expense - Existing Debt:	¥ M	-	-	-	-	-
(-) Interest Expense - New Debt:	¥ M	(43.2)	(32.6)	(20.7)	(18.8)	(18.8)
(+) Equity Income / (-) Loss in Affiliates:	¥ M	-	-	-	-	-
Pre-Tax Income:	¥ M	**340.9**	**397.9**	**454.9**	**491.0**	**535.4**
(-) Income Tax Provision:	¥ M	(87.5)	(102.2)	(116.8)	(126.1)	(137.5)
Net Income:	¥ M	**253.4**	**295.7**	**338.1**	**364.9**	**398.0**
EBITDA:	¥ M	**¥ 748.2**	**¥ 836.4**	**¥ 921.6**	**¥ 979.2**	**¥ 1,045.0**
EBITDA Margin:	%	*24.7%*	*24.8%*	*24.7%*	*24.3%*	*23.9%*

The Net Interest Expense isn't *that* high because the company hasn't raised that much Debt and because its Cash balance grows by a massive amount over 5 years.

Net Income is down in the early years, but not by as much as you might expect - for the reasons above.

After we link the Interest Expense properly, the company takes more time to repay the Senior Notes: 3 years rather than 2 years.

And it ends up with a *slightly* lower Cash balance of ¥1.5 billion rather than ¥1.6 billion.

In traditional leveraged buyouts with higher Debt levels (e.g., 5.0x Debt / EBITDA instead of 1.3x Debt / EBITDA), there would be *far* more of an impact from linking the Interest Expense.

But since the Debt level is low, and since the company generates a huge amount of Cash, there's little impact after linking the Net Interest Expense:

Cash Flow Statement:	Units	Projected FY13	FY14	FY15	FY16	FY17
Cash Available for New Debt Repayment:	¥ M	**262.4**	**264.8**	**383.3**	**811.1**	**1,388.7**
Cash Used for New Debt Repayment:	¥ M	(262.4)	(264.8)	(38.2)	-	-
Beginning Cash Balance:	¥ M	271.6	125.6	125.6	470.8	936.8
(+/-) Net Change in Cash:	¥ M	(146.0)	-	345.1	466.0	577.5
Ending Cash Balance:	¥ M	**125.6**	**125.6**	**470.8**	**936.8**	**1,514.3**
Beginning Existing Debt Balance:	¥ M	-	-	-	-	-
(+/-) Repayments of Existing Debt:	¥ M	-	-	-	-	-
Ending Existing Debt Balance:	¥ M	**-**	**-**	**-**	**-**	**-**
New Debt - Ending Balance:	¥ M	**491.5**	**226.6**	**188.5**	**188.5**	**188.5**
Total Debt Balance:	¥ M	**¥ 491.5**	**¥ 226.6**	**¥ 188.5**	**¥ 188.5**	**¥ 188.5**
Net Debt:	¥ M	**¥ 365.8**	**¥ 101.0**	**¥ -282.3**	**¥ -748.3**	**¥ -1,325.8**
Beginning Shareholders' Equity:	¥ M	3,723.1	3,976.5	4,272.2	4,610.3	4,975.2
(+) Net Income:	¥ M	253.4	295.7	338.1	364.9	398.0
Ending Shareholders' Equity:	¥ M	**3,976.5**	**4,272.2**	**4,610.3**	**4,975.2**	**5,373.2**

With the Net Interest Expense factored in, the company's Cash balance grows to a lower level, and it takes more time to pay off the Senior Notes.

Calculating Key Metrics and Ratios

We can also calculate **Key Metrics and Ratios** for this leveraged buyout model.

These metrics and ratios let us:

- See if the company could potentially take on *more* Debt or if it's using *too much* Debt;
- Determine if we might be able to use a different capital structure; and
- Evaluate the operating assumptions and see if they make sense.

In case studies and modeling tests, for example, interviewers might look at a big increase in margins over the next 3-5 years and ask questions such as:

"Why are you certain that the company's operating margin will increase by 5%? Is its business model changing? How?"

Here are some questions that interviewers might raise based on our projections:

Key Metrics and Ratios:	Units	Historical FY10	FY11	FY12	Projected FY13	FY14	FY15	FY16	FY17
Revenue Growth:	%	31.3%	33.7%	**27.6%**	18.5%	11.1%	10.9%	8.0%	8.4%
Operating Margin:	%	10.3%	7.5%	**9.4%**	12.5%	12.7%	12.7%	12.4%	12.3%
EBITDA Margin:	%	22.3%	19.8%	**22.0%**	24.7%	24.8%	24.7%	24.3%	23.9%
Net Margin:	%	8.0%	5.7%	**6.2%**	8.4%	8.8%	9.1%	9.1%	9.1%
Effective Tax Rate:	%	23.1%	24.1%	**29.8%**	25.7%	25.7%	25.7%	25.7%	25.7%
D&A % Revenue:	%	12.1%	12.3%	**12.7%**	12.2%	12.1%	12.0%	11.8%	11.6%
CapEx % Revenue:	%	28.4%	28.3%	**21.4%**	18.3%	13.8%	11.7%	9.8%	8.1%

These margins are all increasing a modest amount - will the switch to Managed Hotels *really* result in this much of an increase?

CapEx as a % of Revenue is decreasing quite dramatically - do the hotel counts in each segment justify that? And why isn't D&A falling even close to as rapidly?

Here's what we can conclude from the credit stats and ratios:

Key Metrics and Ratios:	Units	Projected FY13	FY14	FY15	FY16	FY17
Total Debt / EBITDA:	x	0.7 x	0.3 x	0.2 x	0.2 x	0.2 x
Total Debt / (EBITDA - CapEx):	x	2.5 x	0.6 x	0.4 x	0.3 x	0.3 x
Total Debt / (EBITDA - CapEx +/- Change in WC):	x	2.0 x	0.6 x	0.4 x	0.3 x	0.3 x
Net Debt / EBITDA:	x	0.5 x	0.1 x	(0.3 x)	(0.8 x)	(1.3 x)
Net Debt / (EBITDA - CapEx):	x	1.9 x	0.3 x	(0.6 x)	(1.3 x)	(1.9 x)
Net Debt / (EBITDA - CapEx +/- Change in WC):	x	1.5 x	0.2 x	(0.5 x)	(1.2 x)	(1.8 x)
EBITDA / Net Interest Expense:	x	19.5 x	27.5 x	49.9 x	92.8 x	446.1 x
(EBITDA - CapEx) / Net Interest Expense:	x	5.1 x	12.2 x	26.3 x	55.4 x	295.3 x
(EBITDA - CapEx +/- Change in WC) / Net Interest E	x	6.6 x	13.5 x	28.9 x	59.0 x	315.5 x
Total Debt / Equity:	x	0.1 x	0.1 x	0.0 x	0.0 x	0.0 x
Total Debt / Capital:	%	11.0%	5.0%	3.9%	3.6%	3.4%
Net Debt / Equity:	x	0.1 x	0.0 x	(0.1 x)	(0.2 x)	(0.2 x)
Net Debt / Net Capital:	%	8.4%	2.3%	(6.5%)	(17.7%)	(32.8%)
Debt Service Coverage Ratio:	x	1.0 x	2.0 x	6.8 x	25.3 x	30.8 x
Cumulative Debt Paydown:	¥ M	262.4	527.2	565.4	565.4	565.4
Cumulative Debt Paydown % of Initial Debt:	%	34.8%	69.9%	75.0%	75.0%	75.0%
Free Cash Flow Conversion Analysis:						
EBITDA:	¥ M	¥ 748.2	¥ 836.4	¥ 921.6	¥ 979.2	¥ 1,045.0
(-) CapEx:	¥ M	(553.6)	(466.0)	(435.6)	(395.0)	(353.3)
(-) Net Interest Expense:	¥ M	(38.4)	(30.4)	(18.5)	(10.6)	(2.3)
(-) Taxes:	¥ M	(87.5)	(102.2)	(116.8)	(126.1)	(137.5)
(+/-) Other Non-Cash Items:	¥ M	(9.1)	(13.5)	(14.9)	(20.2)	(21.9)
(+/-) Change in WC:	¥ M	56.9	40.5	47.5	38.6	47.5
Free Cash Flow:	¥ M	**¥ 116.4**	**¥ 264.8**	**¥ 383.3**	**¥ 466.0**	**¥ 577.5**
FCF Conversion %:	%	15.6%	31.7%	41.6%	47.6%	55.3%
FCF Yield %:	%	3.1%	6.9%	10.1%	12.2%	15.2%

The company pays off what little Debt it used in the deal *very* quickly, and it starts accumulating a huge Cash balance. It's never in any real danger of not making its interest payments.

These stats suggest that the company could *easily* use more Debt in the deal, or, at the very least that it could issue some of its Excess Cash to the PE firm in the form of a Special Dividend.

The key driver behind these results is that the company's FCF generation improves significantly, since it transitions into a less capital-intensive business model.

Return to Top.