SOFTWARE & TECH

Paper Lbo Example

PUBLISHED
November 25, 2026

REFERENCE
#1795580916282371

Understanding the Paper LBO Example: A Complete Guide to Mastering the Leveraged Buyout Model

A paper LBO example is one of the most critical exercises you will encounter when preparing for a career in private equity, investment banking, or corporate finance. It tests your ability to think structurally under pressure, to understand how leverage amplifies returns, and to build a simplified leveraged buyout model without the aid of a computer. For anyone serious about breaking into finance, mastering the paper LBO is non-negotiable. In this comprehensive guide, we will walk through what a paper LBO example actually entails, break down every component, work through a step-by-step numerical illustration, and highlight the common pitfalls you must avoid. By the end, you will have a thorough, practical understanding of how to approach any LBO case on paper.

What Is a Paper LBO and Why Does It Matter?

A leveraged buyout (LBO) occurs when a financial sponsor, such as a private equity firm, acquires a company using a combination of debt and equity. The debt is secured against the assets of the target company, and the goal is to generate a high return on equity by improving the company's performance and eventually selling it at a higher valuation. A paper LBO is a simplified, hand-calculated version of this transaction. It typically involves estimating the purchase price, determining the financing structure, projecting financial performance over a hold period (usually five years), and calculating the internal rate of return (IRR) to the sponsor.

The paper LBO example is widely used in interviews because it reveals a candidate's comfort with financial mechanics, their ability to make reasonable assumptions, and their understanding of how debt and equity interact. Recruiters are not looking for perfect precision; they are looking for logical thinking, speed, and a clear grasp of the key drivers of value creation.

The Core Components of a Paper LBO Example

Before diving into a concrete example, it is essential to understand the building blocks that every paper LBO must contain. These components form the skeleton of the analysis and will be present in any LBO case you encounter.

The Purchase Price and Valuation Assumptions

The starting point is always the enterprise value of the target company. In a paper LBO example, you are typically given a valuation multiple, such as 10x EBITDA. If the company has EBITDA of $100 million, the enterprise value would be $1 billion. From there, you need to consider the company's net debt (total debt minus cash) to arrive at the equity purchase price. The sponsor will acquire the equity, and the debt will remain with the company or be refinanced.

Financing the Deal: Debt and Equity Mix

Once the purchase price is established, the next step is to determine how the acquisition will be financed. In a classic LBO, a significant portion of the purchase price is funded with debt. Typical debt tranches include senior secured loans, mezzanine debt, and sometimes high-yield bonds. The remaining portion is the sponsor's equity contribution. The debt-to-equity ratio is a critical metric; a higher leverage ratio amplifies returns but also increases risk. In a paper LBO example, you are often given a specific debt structure or asked to assume a reasonable one.

Projecting Operating Performance

To calculate the return on investment, you must project the company's future financial performance. This usually involves forecasting revenue growth, EBITDA margins, capital expenditures, and working capital changes. In a paper LBO example, these projections are simplified. You might assume a constant growth rate or a fixed margin improvement. The key is to keep the math manageable and focus on the most important drivers.

Debt Repayment and Cash Flow Allocation

As the company generates cash flow over the hold period, a portion of that cash is used to pay down debt. The faster the debt is repaid, the more equity value accrues to the sponsor. In a paper LBO example, you typically assume that all free cash flow is used for debt repayment. This is a simplifying assumption but a powerful one for illustrating the impact of deleveraging.

The Exit Strategy and Return Calculation

At the end of the hold period (usually year five), the sponsor sells the company. The exit valuation is typically based on a multiple of the projected EBITDA at exit. The net proceeds after repaying any remaining debt represent the sponsor's equity value. The return is then expressed as an internal rate of return (IRR) or a multiple of invested capital (MOIC).

Step-by-Step Paper LBO Example: A Numerical Walkthrough

Let us now work through a realistic paper LBO example to see how these components come together. We will use round numbers to keep the math straightforward, but the logic applies to any scenario.

Step 1: Establish the Purchase Price

Assume the target company has EBITDA of $100 million. The purchase multiple is 10x EBITDA. Therefore, the enterprise value is $1,000 million. The company has $200 million in net debt (total debt minus cash). The equity purchase price is enterprise value minus net debt, which equals $800 million. The sponsor must pay $800 million to acquire all the shares.

Step 2: Determine the Financing Structure

For this paper LBO example, we assume the following financing mix:

- Senior debt: $400 million at 5% interest
- Subordinated debt: $200 million at 8% interest
- Sponsor equity: $200 million

The total debt is $600 million, and the equity contribution is $200 million. The debt-to-equity ratio is 3:1, which is typical for a mid-sized LBO. The total purchase price of $800 million is fully funded.

Step 3: Project the Company's Performance

We assume the company will grow revenue at 5% per year, and the EBITDA margin will remain stable at 40%. Depreciation and amortization are $20 million per year. Capital expenditures are $25 million per year, and the

change in working capital is negligible for simplicity. The tax rate is 25%.

Year 1 EBITDA: $105 million (assuming $100 million base grows at 5%)Year 2 EBITDA: $110.25 millionYear 3 EBITDA: $115.76 millionYear 4 EBITDA: $121.55 millionYear 5 EBITDA: $127.63 million

Step 4: Calculate Free Cash Flow and Debt Repayment

Free cash flow to the firm (FCFF) is calculated as EBITDA minus interest expense minus taxes minus capital expenditures minus changes in working capital. In this example, we calculate interest expense as the weighted average interest rate on the total debt. The weighted average interest rate is (400 x 5% + 200 x 8%) / 600 = 2.67% + 2.67% = 5.33% approximately. However, for simplicity in this paper LBO example, we can track debt repayment sequentially, paying off the most expensive debt first.

Let us simplify further and assume that interest is paid on the outstanding debt balance at the start of each year, and all free cash flow is used to repay debt. The calculations for year 1 are as follows:

EBITDA: $105.00 millionInterest expense: $600 million x 5.33% = $32.0 million (approximately)EBT: $73.0 millionTax at 25%: $18.25 millionNet income: $54.75 millionAdd back D&A: $20 millionSubtract CapEx: $25 millionFree cash flow: $49.75 million

This free cash flow is used to repay debt. Assuming we repay the subordinated debt first (higher cost), the new debt balance after year 1 is $600 million minus $49.75 million, which equals $550.25 million. We continue this process for each year.

For the purpose of a paper LBO example, these calculations are typically done in a simplified manner. Many candidates use a rule of thumb that free cash flow is roughly EBITDA minus interest minus taxes minus CapEx, and then they estimate debt paydown over five years.

Step 5: Determine the Exit Value

At the end of year 5, we assume the company is sold at the same multiple of 10x EBITDA. The exit EBITDA is $127.63 million, so the exit enterprise value is $1,276.3 million. The remaining debt at exit must be subtracted. If we assume that $250 million of debt has been repaid over five years (a reasonable estimate given our free cash flow generation), the remaining debt is $350 million. The exit equity value is $1,276.3 million minus $350 million, which equals $926.3 million.

Step 6: Calculate the Sponsor's Return

The sponsor initially invested $200 million in equity. At exit, the sponsor receives $926.3 million. The multiple of invested capital (MOIC) is $926.3 / $200 = 4.63x. The internal rate of return (IRR) over five years can be approximated. A 4.63x multiple over five years corresponds to an IRR of roughly 36% per annum. This is a strong return, driven by the combination of EBITDA growth, multiple expansion (none in this case since the exit multiple equals the entry multiple), and deleveraging.

Key Drivers of Returns in a Paper LBO

Understanding what drives returns in a paper LBO example is essential for both your analysis and your interview performance. There are three primary levers:

1. EBITDA growth: As the company's earnings increase, the enterprise value at exit rises, directly boosting the equity value.
2. Multiple expansion: If the exit multiple is higher than the entry multiple, the sponsor benefits from multiple expansion. In many paper LBO examples, the multiple is held constant, but in real life, this can be a significant driver.
3. Deleveraging: As debt is repaid with free cash flow, the equity value increases because less debt must

be repaid at exit. This is often the most important driver in a typical LBO.

In the example above, the return was driven primarily by EBITDA growth and deleveraging. The debt-to-equity ratio started at 3:1 and declined over time, which amplified the equity return.

Common Variations in Paper LBO Examples

Not all paper LBO examples are the same. Depending on the context, you may encounter different variations:

- Add-on acquisitions: You might be asked to model an LBO where the sponsor makes a bolt-on acquisition during the hold period. This adds complexity because you must account for additional financing and integration costs.
- Dividend recapitalization: Sometimes the sponsor will take on additional debt to pay a dividend to themselves during the hold period. This changes the cash flow dynamics and can be a tricky twist in a paper LBO example.
- Different exit scenarios: The exit could be an IPO, a sale to a strategic buyer, or a sale to another sponsor. Each scenario has different implications for valuation and timing.

Regardless of the variation, the fundamental structure of the analysis remains the same. If you understand the core components, you can adapt to any twist.

Tips for Acing a Paper LBO in an Interview

If you are preparing for interviews, here are some practical tips that will help you perform well when presented with a paper LBO example:

- Start with the end in mind: Know the key metrics you need to calculate: purchase price, debt capacity, free cash flow, exit value, and IRR. Keep your work organized.

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