Bulog Capital

Bulog Capital, LP, directly lends to private equity (PE) financial sponsors in the software-as-a-service technology industry. Kelvin Falsey, CFA, is a manager in Bulog's underwriting and origination group. He is currently underwriting a debt proposal to help a PE firm, Crane Capital, finance an add-on acquisition and is creating a preliminary term sheet to present to Bulog's investment committee for approval.

Crane wishes to subordinate an existing mezzanine loan at a holding company (HoldCo) subsidiary. The subsidiary's only asset will be its interest in the common equity of the operating company (OpCo), which will pledge assets as collateral to the lender.

Bulog's preliminary term sheet outlines a $200 million, 5-year unitranche loan facility with a proposed interest rate of the SOFR plus a quoted margin of 700 bp per annum, reset and paid quarterly. The 90-day SOFR is currently 5.38%. The term sheet further proposes a first lien pledge of all assets. Origination fees, call features, and various debt incurrence covenants are also included in the terms.

Another lender, ADLADS Capital, has submitted a competing term sheet with a more traditional first lien and second lien leveraged loan structure, with the following proposed terms summarized in Exhibit 1:

Exhibit 1 ADLADS Capital Summary Terms

Terms	First Lien Tranche	Second Lien Tranche
Size (par)	$150 million	$50 million
Interest rate	SOFR + 600 bp per annum	SOFR + 1,200 bp per annum
Tenor	4 years	7 years
Covenants	Maintenance covenants TBD	Incurrence covenants only

Assume for both proposals that the SOFR base rate remains unchanged for four quarters.

After several quarters, Crane completes a private offering of $50 million of preferred stock at the OpCo. A year later Crane is able to sell the portfolio company to another PE firm for $500 million. At the time of the sale, the company had $200 million in secured loans and the $10 million mezzanine loan as the only debt claims outstanding. The preferred stock has a $60 million liquidation preference and 5% transaction costs.

Question 1.1

Based only on annual interest expense, which financing proposal is *less* costly to the sponsor?

A. Bulog's proposal

B. ADLADS's proposal

C. Bulog's and ADLADS's proposals are equally costly

Question 1.2

If Crane subordinates the mezzanine loan to other debt, which of the following *best describes* the form of subordination?

A. Lien priority

B. Structural

C. Contractual

Question 1.3

If Crane issues $50 million of OpCo preferred stock, which of the following *best describes* the mezzanine debt's claim on OpCo assets?

A. No claim

B. Second lien claim

C. Subordinated debt claim

Question 1.4

With the sale of the entire company, the value ($ millions) returned to shareholders is *closest* to:

A. 205

B. 230

C. 290

WBCP Private Debt

Roy Garza, CFA, is a portfolio manager at a large asset management firm, WealthBuild Capital Partners (WBCP). He is developing and maintaining custom portfolios to meet the needs of the firm's clients, which consist of both ultra-high-net-worth (UHNW) and institutional investors.

Garza is reviewing the income-generating ability of a portfolio that includes public fixed income and private debt for a UHNW client, Cheung Lee. The current economic environment is characterized by a slowing economy and low interest rates. However, Garza believes that as the economy begins to recover next year, the central bank will raise interest rates to stave off inflation. He expects equity returns to be muted in response to this environment. He wants to position the portfolio to be able to take advantage of the potentially higher interest rates while also being cautious due to current economic developments.

At lunch, Garza speaks to the firm's economist, Shang Dian, about the current market and lagging economy. Dian notes that credit has been less available due to the deteriorating economy, which has resulted in increased competition among lenders in high quality, recession-resistant businesses. Transaction activity has slowed significantly, existing loans are being amended, and maturities are being extended. Garza ponders what this means for the types of transactions he should target.

Later that day, Garza is working with an insurance company client, Ding Hao Life Insurance (DHLI). DHLI is considering allocating a portion of its portfolio to private debt. The company is conservative and prioritizes investments that offer steady income with minimal volatility. As a secondary consideration, DHLI is concerned about liquidity and risk. Garza considers several investment vehicles available on WBCP's platform to assess whether any of them would allow DHLI to access private debt efficiently.

That evening, Garza receives an email from a large institutional client, Zian Yazhu of ZY Foundation, who is concerned about the structuring of various debt deals her foundation is investing in. Yazhu specifically wants to ensure that the foundation always maintains a senior claim on the underlying company's operating assets, regardless of the type of debt involved. Yazhu is less familiar with different types of subordination and asks Garza about the best way to ensure the foundation maintains a senior claim, particularly when considering more complex debt structures. Garza evaluates the best options for Yazhu to meet this goal.

Question 2.1

Based on current economic conditions and Garza's contrarian view, which of the following types of debt is *most appropriate* for Lee's portfolio?

A. High-yield bonds

B. Leveraged loans

C. Convertible bonds

Question 2.2

Assuming the credit environment described by Dian, the type of loans Garza should *most likely* target are:

A. sponsored.

B. covenant-lite.

C. nonsponsored.

Question 2.3

Which of the following is *least appropriate* for Garza to recommend to DHLI?

A. Mezzanine debt

B. Direct lending funds

C. Collateralized loan obligations (CLOs)

Question 2.4

Yazhu's focus on ZY Foundation maintaining a senior claim would be *least likely* accomplished by investing in private debt with:

A. structural subordination.

B. contractual subordination.

C. an intercreditor agreement.

Apex Capital Partners (ACP)

Apex Capital Partners (ACP), a middle-market direct lending firm based in the US, offers comprehensive capital structure solutions for financial sponsors focused on technology companies. Teuna Liselot, CFA, an origination vice president on temporary assignment from the Amsterdam office, must train a new associate, Gustavo Terance.

Liselot asks Terance to tell her what he knows about private direct lending. Terance, who has experience exclusively with high-yield bonds, states:

Statement 1: Mezzanine debt typically has a shorter tenor to limit the period during which lenders receive paid-in-kind interest.

Statement 2: Intercreditor agreements define the actions lenders can take in the event of a borrower defaulting on its debt.

Statement 3: When a borrower's capital structure includes both senior secured and mezzanine debt, structural subordination is typically applied.

Later, Liselot gathers financial data projections from a sponsor's budget on a deal she is currently underwriting to finance the buyout of PMM LLC. She asks Terance to compile and review credit ratios based on the sponsor's three scenarios.

Exhibit 1 PMM LLC Scenario Analysis

	Revenue	EBITDA	Gross Debt	Retained Cash Flow	Interest Expense	Cash
TTM actual	18,252	2,282	9,128	1,415	652	800
Scenario 1	18,570	2,600	7,800	1,378	546	350
Scenario 2	19,688	2,559	8,189	1,346	640	500
Scenario 3	17,642	2,646	7,409	1,386	529	300

TTM = trailing twelve months

After discussions with client sales reps, Liselot learns that the demand for the underwriting from ACP's co-investors is not strong and she must consider modifications to the loan to make it more appealing. Due to internal risk limits, ACP must syndicate any amount above its maximum hold limit, which is 40% of any loan tranche.

Liselot is assigned another deal to underwrite but notices that it is unlike most ACP transactions. Based on the marketing materials, the prospective borrower has no financial sponsorship. A wealthy entrepreneur is bringing the deal to several middle-market lenders as a one-time investment using her own equity capital.

Question 3.1

Which of Terance's statements is *most likely* correct?

A. Statement 1

B. Statement 2

C. Statement 3

Question 3.2

The *most appropriate* modification to the terms of a syndicated leverage loan offering with low demand would be to:

A. renegotiate the covenants.

B. increase the discount margin.

C. tie interest margin to leverage tiers.

Question 3.3

Based on Exhibit 1, in which scenario would PMM LLC *most likely* receive a credit rating upgrade?

A. Scenario 1

B. Scenario 2

C. Scenario 3

Question 3.4

Compared to public debt markets, which of the following *best describes* a distinctive risk of private debt markets?

A. The lack of a sponsor

B. Structural subordination

C. The need to hold loans to maturity
