Question 1 of 69

Which of the following is NOT true of mezzanine debt?

- **A.** Mezzanine debt has a fixed coupon rate that is higher than the coupon rate on senior debt.
- **B.** Mezzanine debt is a medium-term, highly illiquid debt instrument that does not involve amortization.
- **C.** Mezzanine debt is unsecured, medium-term debt that often includes a payment-in-kind toggle and an equity kicker.
- ✔ **D.** Mezzanine debt is unsecured debt that does not require credit ratings and has higher priority than leveraged loans.

EXPLANATION • Learning Objective 5.1.5 **ID:** L1-5.1.5-001

Mezzanine debt is an unsecured, medium-term, highly illiquid debt instrument that has lower priority than leveraged loans, does not involve amortization, does not require credit ratings to be issued, and has a fixed coupon rate higher than the coupon rate on senior debt.

Question 2 of 69

VD Linestar, a venture debt fund, is reviewing a potential investment opportunity in a Q-Leap, a start-up company. Q-Leap has previously received equity investment from a venture capital fund, PrimerJenkins. Which of the following is VD Linestar most likely to consider in deciding whether to provide financing to Q-Leap?

I. Q-Leap founders' credit scores
II. PrimerJenkins credit-worthiness and track record
III. Debt-to-equity conversion terms via warrants

- ✔ **A.** II and III only
- **B.** II only
- **C.** I, II, and III
- **D.** I only

EXPLANATION • Learning Objective 5.1.7 **ID:** L1-5.1.7-004

Venture debt funds' decisions to finance start-ups with little or no positive cash flows are based primarily on the -

- Reputation and credit-worthiness of the venture capital firms that provided the initial equity financing.
- Terms for equity conversion via the exercise of warrants.

Other response: Venture lenders do not lend based on start-ups' creditworthiness.

Question 3 of 69

A company with a weighted average cost of capital of 14.5% replaces some of the equity in its capital structure with mezzanine debt. Which of the following is the resulting weighted average cost of capital?

- **A.** It is about 14.5%.
- **B.** It is more than 14.5%.
- **C.** It cannot be determined with this information.
- ✔ **D.** It is less than 14.5%.

EXPLANATION • Learning Objective 5.1.5 **ID:** L1-5.1.5-002

When more expensive equity is replaced with less expensive mezzanine debt, the weighted average cost of capital decreases.

Question 4 of 69

Over the period 2004 to 2016, investments in which of the following credit investment vehicles outperformed relative to the others?

- **A.** leveraged loans
- ✔ **B.** direct lending strategies
- **C.** high-yield bonds
- **D.** business development companies

EXPLANATION • Learning Objective 5.1.1 **ID:** L1-5.1.1-001

Direct lending (and distressed) strategies, which are the most illiquid of the credit vehicles, outperformed the more liquid strategies (i.e., high-yield bonds, leveraged loans, and business development companies).

Question 5 of 69

Which of the following best describes blanket subordination?

- **A.** Blanket subordination permits payment of principal to the LBO investor while the senior debt is outstanding.
- **B.** Blanket subordination permits payment of principal or interest to the mezzanine investor while the senior debt is outstanding.
- ✔ **C.** Blanket subordination prevents any payment of principal or interest to the mezzanine investor until the senior debt has been fully repaid.
- **D.** Blanket subordination prevents any payment of principal to the LBO investor until the senior debt has been fully repaid.

EXPLANATION • Learning Objective 5.1.5 **ID:** L1-5.1.5-024

Blanket subordination is a provision of the inter-creditor agreement between the mezzanine investor and the senior creditors. It prevents payment of principal or interest to the mezzanine investor until the senior debt has been fully repaid.

Other response: Springing subordination permits payments to be made to mezzanine investor while senior debt is outstanding. However, if the issuer defaults on the senior debt, payments to mezzanine investors stop until the default has been resolved.

Question 6 of 69

A firm's bond indenture includes an incurrence covenant. Which of the following most accurately describes this firm's position with respect to this bond?

- ✔ **A.** The firm would not be in technical default on the loan if the incurrence covenant is breached due to an external factor.
- **B.** The firm would be in technical default on the loan if the conditions of the incurrence covenant are not regularly met.
- **C.** The firm would be in technical default on the loan if the incurrence covenant is breached for any reason.

EXPLANATION • Learning Objective 5.1.2 **ID:** L1-5.1.2-012

An incurrence covenant requires that borrowers take or not take a specific action once a particular event occurs. However, a specification not being met due to an external factor (i.e., not due to actions by the borrower) is not considered to violate this covenant and thus does not result in default on the loan.
E.g., an incurrence covenant may require a firm to keep a specific debt/earnings ratio. The firm is in violation of this covenant if it takes on more debt that results in the debt/earnings ratio exceeding the set limit. However, if a decline in earnings causes the debt/earnings ratio to exceed the limit, the incurrence covenant is not violated.

Question 7 of 69

A defaulting firm recently filed for bankruptcy. Which of the following most likely represents the recovery rate of the firm's equity holders?

- **A.** 20%-30%
- **B.** 5%-15%
- ✔ **C.** 0%

EXPLANATION • Learning Objective 5.1.2 **ID:** L1-5.1.2-019

Equity holders of defaulting firms typically have a 0% recovery rate.

UpperMark

Question 8 of 69

The risk of default for high-yield bonds was greatest during which of the following periods?

- **A.** 2019
- **B.** 2005
- **C.** 2014
- **D.** 1990 ✓

EXPLANATION • Learning Objective 5.1.2 **ID:** L1-5.1.2-013

Default rates are higher for low-grade bonds than for investment-grade bonds, and are high in periods of economic or financial distress. Over the past two decades, global default rates for high-yield debt was particularly high (> 9%) in/around 1990, 2001, and 2008.

Question 9 of 69

Which of the following is an issue with using subordinated debt with time-based step-up rates?

- **A.** borrowing firm may not have sufficient cash flows to make the interest payments in later years ✓
- **B.** covenants on the subordinated debt may be prohibitively restrictive
- **C.** borrowing firm may not have sufficient cash flows to make the balloon payment at maturity
- **D.** financial criteria may never be met to increase the interest rate on the debt

EXPLANATION • Learning Objective 5.1.6 **ID:** L1-5.1.6-019

An issue with subordinated debt with time-based step-up rates is that there is no guarantee that the borrowing firm will have enough cash flows from sales to service the debt (i.e., make the interest payments) in the later years when the interest rate on the debt is higher.

Other response: This debt does not involve a balloon payment at maturity.

Question 10 of 69

Which of the following are typically unsecured forms of debt whose repayments do not involve amortization of loan principal?

I. High-yield bonds
II. Leveraged loans
III. Mezzanine debt

- **A.** II only
- **B.** III only
- **C.** I and III only
- **D.** I only

EXPLANATION • Learning Objective 5.1.5 **ID:** L1-5.1.5-029

Both mezzanine debt and high-yield bonds are unsecured debt whose repayments involve no amortization of loan principal (only interest is paid until maturity; then a bullet payment is made).

Other response: leveraged loans are secured forms of debt whose debt repayments involve amortization of principal.

Question 11 of 69

Subordinated debt with warrants provide issuers which of the following advantages compared to other bonds?

- **A.** lower interest rates and less restrictive covenants
- **B.** more restrictive covenants and shorter maturities
- **C.** less restrictive covenants and equity upside potential
- **D.** more credit enhancements and lower interest rates

EXPLANATION • Learning Objective 5.1.6 **ID:** L1-5.1.6-016

Compared to other bonds, subordinated debt with warrants provide issuers the advantages of: 1) lower interest rates and 2) less restrictive covenants.

Question 12 of 69

Which of the following statements apply to the practices of bank and non-bank venture lenders?

I. Bank lenders provide larger loans than non-bank lenders.
II. Banks engage in venture lending to secure future business from the start-up.
III. Non-bank lenders charge higher interest rates than bank lenders.
IV. Non-bank lenders' primary motivation is generating high yield.

- **A.** I and III only
- **B.** I, II, and IV only
- **C.** II, III, and IV only
- **D.** II and IV only

EXPLANATION • Learning Objective 5.1.7 **ID:** L1-5.1.7-012

Bank and non-bank lenders engage in different practices and with different motivations.

- Bank lenders offer smaller loans and lower interest rates than non-bank lenders.
- Bank lenders aim to develop a relationship with the borrower and secure their deposit accounts, while non-bank lenders aim to generate high interest income.

Question 13 of 69

Which of the following subordinated debt products repays its loan in a one-time lump-sum payment at maturity?

- **A.** subordinated debt with payment-in-kind interest
- **B.** subordinated debt with step-up rates
- **C.** subordinated debt with warrants
- **D.** subordinated debt with profit participation

EXPLANATION • Learning Objective 5.1.6 **ID:** L1-5.1.6-014

Subordinated debt with payment-in-kind interest repays its loan in a bullet (i.e., one-time lump-sum) payment at maturity.

UpperMark

Question 14 of 69

A $1.8 million loan, arranged using a profit participation model, starts in January 2019 and has a maturity date of 2021 when its principal will be repaid. The profit participation scheme is 3.5% of earnings before interest and taxes (EBIT), with an annual floor and cap of $75,000 and $85,000, respectively. The yearly EBITs from 2019 through 2021 are $2,000,000, $2,300,000, $2,700,000, respectively. Which of the following is the profit participation amount the lender will receive in 2019, 2020, and 2021, respectively?

- **A.** floor; $80,500; cap ✔
- **B.** floor; floor; cap
- **C.** 70,000; $80,500; 94,500
- **D.** 70,000; $80,500; cap

EXPLANATION • Learning Objective 5.1.6 **ID:** L1-5.1.6-011

Floor = $75,000; Cap = $85,000
PPS calculations and amount lender receives are in the table below.

	2019	2020	2021
EBIT	$2m	$2.3m	$2.7m
PPS (= EBIT × 3.5%)	$70,000 (= $2m × 3.5%)	$80,500 (= $2.3m × 3.5%)	$94,500 (= $2.7m × 3.5%)
Amount lender receives	$75,000 (Receives floor since PPS < floor)	$80,500 (Receives PPS since PPS is between floor & cap)	$85,000 (Receives cap since PPS > cap)

Question 15 of 69

The Alliance Company is seeking debt financing. It believes that it can pay 11% on its debt because it has started to generate stable revenue, but it does not have collateral to offer for the debt. Which of the following best describes whether mezzanine financing would be appropriate for Alliance?

- **A.** It would not be appropriate, because it cannot pay a high enough return on its debt and there is no collateral.
- **B.** It would not be appropriate, because the stable cash flow means that Alliance can get higher-rated debt financing.
- **C.** It would be appropriate, because it has stable cash flow and the 16% return on the debt is usually sufficient for mezzanine debt investors.
- **D.** It would be appropriate, but it is likely that Alliance would have to offer an equity kicker. ✔

EXPLANATION • Learning Objective 5.1.5 **ID:** L1-5.1.5-016

Mezzanine debt is unsecured and typically used when a firm has a stable cash flow. Total return on mezzanine financing is 12%-17%, most of which comes from the debt's coupon rate (~10%-14%), with the equity kicker providing an additional return. Therefore, Alliance's 11% return is sufficient for current income to debt holders, but it will need an additional return (at least ~1%) from an equity kicker.

Question 16 of 69

Which of the following have the highest recovery rates?

- A. senior unsecured bonds
- ✓ B. first-lien term loans
- C. secured bonds
- D. subordinated debt

EXPLANATION • Learning Objective 5.1.2 **ID:** L1-5.1.2-020

Average recovery rates -

- 76% on first-lien loans
- 56% on secured bonds
- 44% on senior unsecured bonds
- 20%-30% on subordinated or junior debt
- 0% on equity

Question 17 of 69

Which of following are reasons for start-up firms to choose venture debt financing over equity financing?

- ✓ A. lower cost of financing and reduced ownership dilution
- B. speed of financing raise and considerable management focus
- C. increased number of equity financing rounds and equity dilution
- D. adding lenders to the board and drawing on their expertise

EXPLANATION • Learning Objective 5.1.7 **ID:** L1-5.1.7-010

Main reasons start-up firms use venture debt financing -

1. Reduced equity dilution – Raising capital without giving up significant equity stakes.
2. Cheaper than equity – Debt helps increase returns to founders and early VCs; requires less management focus; interest paid on debt is tax-deductible.
3. Flexible structure – Typically quicker than raising equity financing; does not give away board seats or voting rights.
4. Additional capital to reach valuation milestones and increase company's value – Debt can delay equity financing by allowing to reach interim valuation milestones with fewer equity rounds.

Question 18 of 69

Distressed debt investing is particularly exposed to which of the following types of risks?

- ✓ A. business risk
- B. credit risk
- C. market risk

EXPLANATION • Learning Objective 5.1.8 **ID:** L1-5.1.8-012

The main risk faced by distressed debt investors is the business risk associated with the troubled firm not recovering from its distressed state.

Question 19 of 69

Which of the following subordinated debt products eventually gives its investors equity in the issuing firm?

- **A.** subordinated debt with profit participation
- ✓ **B.** subordinated debt with warrants
- **C.** subordinated debt with payment-in-kind interest
- **D.** subordinated debt with step-up rates

EXPLANATION • Learning Objective 5.1.6 **ID:** L1-5.1.6-015

Subordinated debt with warrants eventually give its investors equity in the firm (via the warrants).

Question 20 of 69

Which of the following is true of project finance of an infrastructure project?

- ✓ **A.** The loans are paid back with cash flows from the project.
- **B.** The loans provided are typically recourse loans.
- **C.** The loans are funded with an equal mix of equity and debt.
- **D.** The loans provided are not secured.

EXPLANATION • Learning Objective 5.1.6 **ID:** L1-5.1.6-018

Project finance is the long-term financing of projects by investors who provide loans (typically non-recourse loans) to finance a specific project, and are repaid with the cash flows generated by the project. The loans are secured by the assets of the project.

Question 21 of 69

Which of the following is FALSE regarding the risk and rewards of venture debt funds and venture capital funds?

- **A.** Venture debt funds are exposed to less downside from failing investments than venture capital funds.
- ✓ **B.** Break-even investments result in a total loss of venture debt funds, while venture capital funds recoup their initial investment.
- **C.** Profitable investments generate higher equity gains for venture capital funds than for venture debt funds.
- **D.** Venture debt funds depend on a low rate of defaults because they do not have sufficient upside exposure in successful investments to compensate for failed ones.

EXPLANATION • Learning Objective 5.1.7 **ID:** L1-5.1.7-011

Break-even investments do not result in a total loss for venture debt (VD) funds. In break-even investment scenarios (e.g., IRR = 0%), VD funds' performance is in fact higher than VC funds' performance, since VD funds get repaid with interest, while VC funds generate no return on their invested capital.

Other responses -

- Profitable investments (e.g., IRR > 0%) provide more upside equity participation to VC funds; the upside to VD funds is limited to their interest and warrant gain.
- Failed investments (e.g., IRR = -100%) result in a total loss for VC funds, while VD funds may recoup some of their capital and the security pledged against the loan.

Question 22 of 69

According to Schultze, which of the following represents the most important skill for distressed investing?

- **A.** locating firms with strong balance sheets
- **B.** identifying the fulcrum security ✓
- **C.** originating debt with a loan-to-own perspective
- **D.** purchasing impaired debt in a fire sale

EXPLANATION • Learning Objective 5.1.8 **ID:** L1-5.1.8-015

According to Schultze, the most important skill for distressed (or vulture) investing is identification of the fulcrum security. This is because vultures earn the largest profits from holding post-bankruptcy/recovery equity (not from the cash recovery values of debt senior to the fulcrum security).

Question 23 of 69

A three-year non-amortizing bond with an initial principal of £1,800,000 has an 11% payment in kind (PIK) annual compounding interest rate. Which of the following comes closest to the total PIK interest paid by the borrower and the total cash received by the investor (assuming no default)?

- **A.** Borrower pays £653,028.80; investor receives £2,348,145.80.
- **B.** Borrower pays £661,735.80; investor receives £2,461,735.80. ✓
- **C.** Borrower pays £653,028.80; investor receives £2,453,028.80.
- **D.** Borrower pays £661,735.80; investor receives £2,686,358.80.

EXPLANATION • Learning Objective 5.1.6 **ID:** L1-5.1.6-005

With no amortization and a PIK feature, investors receive no interest payments prior to bond maturity.

Quickest way to do these problems -

Total cash received by investor at bond maturity = £1.8m$(1 + 0.11)^3$ = £2.4617358m

Calculator keystrokes -

TI BAII Plus: 3 **N** 11 **I/Y** **-**1,800,000 **PV** 0 **PMT** **CPT** **FV** => FV = 2,461,735.80

HP-12C: 3 **n** 11 **i** **-**1,800,000 **PV** 0 **PMT** **FV** => FV = 2,461,735.80

Total PIK interest paid by borrower = £1.8m$(1 + 0.11)^3$ - £1.8m = £661,735.80

NOTE: You could also do this by calculating the interest for each period, as in the table below.
Total PIK interest paid (from table below) = £198,000 + £219,780 + £243,955.80 = £661,735.80

Year	Beginning Debt Balance	PIK Interest	Ending Debt Balance
1	£1,800,000	£198,000 (= £1.8m × 0.11)	£1,998,000 (= £1.8m + £198,000)
2	£1,998,000 (= £1.8m + £198,000)	£219,780 (= £1.998m × 0.11)	£2,217,780 (= £1.998m + £219,780)
3	£2,217,780 (= £1.998m + £219,780)	£243,955.80 (= £2.21778m × 0.11)	£2,461,735.80 (= £2.21778m + £243,955.80)

Question 24 of 69

Which of the following least experience(s) early negative returns associated with the J-curve effect?

I. Direct lending funds
II. Mezzanine financing
III. Venture capital funds

- **A.** II only
- **B.** I only
- **C.** II and III only
- **D.** I and II only ✓

EXPLANATION • Learning Objective 5.1.5 **ID:** L1-5.1.5-030

Lending strategies (e.g., direct lending funds and mezzanine financing) are less subject to the early negative returns associated with the J-curve effect than other private fund strategies (e.g., venture capital) - due to the immediate cash-on-cash returns of debt.

UpperMark

Question 25 of 69

In which of the following ways do warrants differ from equity options?

- **A.** They have shorter maturities.
- ✓ **B.** They are dilutive to the underlying stock.
- **C.** They are standardized securities.
- **D.** They are issued by listed firms.

EXPLANATION • Learning Objective 5.1.6 **ID:** L1-5.1.6-017

Differences between warrants and equity options -

1. They are issued by unlisted firms.
2. They are dilutive when issued by the firm (since exercise results in additional shares of common stock).
3. They are not standardized securities.
4. They have longer maturities (years vs. months for equity options).

Question 26 of 69

A traditional bank provides a company with mezzanine financing, where the amount of the loan is greater than the collateral value of the company's available assets. This form of financing is referred to as which of the following?

- **A.** blanket financing
- ✓ **B.** stretch financing
- **C.** excess financing
- **D.** subordinated financing

EXPLANATION • Learning Objective 5.1.5 **ID:** L1-5.1.5-028

With stretch financing, a bank lends more than is typically lent per traditional lending standards. The "stretch" part of the financing is the excess of debt beyond the collateral value of a company's assets. Senior lenders (e.g., banks) often provide stretch financing, and typically require an equity kicker in return.

Question 27 of 69

A provision that prohibits mezzanine investors from being repaid until the senior debtholders have been repaid completely is referred to as which of the following?

- **A.** springing subordination
- **B.** takeout provision
- ✓ **C.** blanket subordination
- **D.** PIK

EXPLANATION • Learning Objective 5.1.5 **ID:** L1-5.1.5-021

Blanket subordination is a provision that states that mezzanine investors cannot be repaid until senior creditors have been completely paid off.

Other responses -

- Springing subordination permits payments to be made to mezzanine investors while senior debt is outstanding. However, if the issuer defaults on the senior debt, the payments to mezzanine investors stop until the default has been resolved.
- Takeout provisions give mezzanine investors the right to pay off the senior debt after some part of the debt has been repaid.
- Payment-in-kind (PIK) are notes used in lieu of cash to make the coupon payments on the debt notes.

Question 28 of 69

MetaSchool, a virtual reality education start-up, is considering financing options for its growth over the next 5 years. Which of the following advantages of venture debt financing may lead MetaSchool to choose venture debt over equity financing?

A. higher operational support provided by the lender

B. securing financing over the long term

C. significantly lower equity dilution ✓

D. low interest rate on the warrants issued to the lender

EXPLANATION • Learning Objective 5.1.7 **ID:** L1-5.1.7-002

A key appeal of venture debt financing compared to equity financing is the reduced equity dilution rate. Equity kickers issued to venture lenders in the form of warrants typically translate to less than 2% equity dilution.

Other responses -

- Venture debt interest rates are high to compensate for the high risk of default
- Lenders are not typically involved actively in running the businesses
- Venture debt financing is relatively short term (2-4 years)

Question 29 of 69

A distressed debt investor purchases a fulcrum security as part of a strategy to take ownership of a distressed company undergoing Chapter 11 organization. Which of the following best describes the investor's rationale for selecting this security?

- **A.** The security will be able to execute a cramdown on the distressed firm due to the security's subordinated position.
- **B.** The security is most likely to convert to equity in the reorganized company after the company emerges from Chapter 11 bankruptcy. ✓
- **C.** The security is most likely to hold a blocking position in the distressed firm as the firm goes through Chapter 11 organization.
- **D.** The security will receive the largest cash payout in the reorganized company after the company emerges from Chapter 11 bankruptcy.

EXPLANATION • Learning Objective 5.1.1 **ID:** L1-5.1.1-004

A fulcrum debt security is most likely to receive equity (not cash) in a reorganized company after it emerges from bankruptcy.

Other response: A cramdown (of a reorganization plan) is executed by a bankruptcy court, not by a creditor of the distressed firm. Also, a fulcrum debt security is a senior debt security, not subordinated debt.

Question 30 of 69

An eight-year non-amortizing bond with an initial principal of $2.6 million has an 12% payment in kind (PIK) annual compounding interest rate. Assuming no default, which of the following comes closest to the total cash received by the investor?

- **A.** $5.6865m
- **B.** $5.8275m
- **C.** $6.2165m
- **D.** $6.4375m ✓

EXPLANATION • Learning Objective 5.1.6 **ID:** L1-5.1.6-006

With no amortization and a PIK feature, investors receive no interest payments prior to bond maturity.

Total cash received by investor at bond maturity = $\$2.6\text{m}(1 + 0.12)^8 = \$6.4375\text{m}$

Calculator keystrokes -

TI BAII Plus: 8 **N** 12 **I/Y** -2.6 **PV** 0 **PMT** **CPT** **FV** => FV = 6.4375

HP-12C: 8 **n** 12 **i** -2.6 **PV** 0 **PMT** **FV** => FV = 6.4375

Question 31 of 69

Which of the following is a typical parameter of venture lending deals?

- **A.** 3%-4% interest income
- **B.** 25% or more equity participation
- **C.** 10%-15% fee income
- **D.** 12%-18% target IRR ✓

EXPLANATION • Learning Objective 5.1.7 **ID:** L1-5.1.7-005

Venture lending funds typically seek 12%-18% IRR on investment consisting of:

- 1%-2% fee income
- 9%-15% interest income
- warrant gains

Other response: equity participation via the exercise of warrants is typically in the single digits.

Question 32 of 69

An investor has purchased a non-investment-grade bond. Which of the following may represent the credit rating of this bond?

I. S&P's BBB
II. S&P's B
III. Moody's Baa
IV. Moody's Ba

- **A.** I and III only
- **B.** II only
- **C.** I and II only
- **D.** II and IV only ✓

EXPLANATION • Learning Objective 5.1.2 **ID:** L1-5.1.2-010

Non-investment-grade debt: Moody's: Ba, B, Caa, Ca, C, and D; S&P BB, B, CCC, CC, C, and D.
Investment-grade debt: Moody's: Aaa, Aa, A, and Baa; S&P AAA, AA, A, and BBB.

Question 33 of 69

DMZ is a start-up with a valuation of $60 million, looking to raise an additional $40 million. After a previous round of equity financing by VEQ1, a venture fund, DMZ's founder holds 65% of the equity. DMZ has approached a venture equity fund, VEQ2, for 70% of the new round and a venture debt fund, VDT, for the remaining 30%. To sweeten the deal for VDT, DMZ is attaching a warrant with coverage of 8% of loan value. Which of the following comes closest to DMZ's founder's stake after the second round of financing?

- **A.** 32.55%
- **B.** 36.53%
- **C.** 43.84% ✔
- **D.** 46.86%

EXPLANATION • Learning Objective 5.1.7 **ID:** L1-5.1.7-009

Need to find DMZ's founder equity %age after the 2nd round of financing, so first need to find VEQ & VDT's total equity %age.

VEQ & VDT's total equity %age = VEQ2's equity %age + VDT's equity %age from warrant
= (VEQ'2s equity / Post-money valuation) + (Equity from warrant / Post-money valuation)

Find the unknowns on the right side of the equation. Post-money valuation includes all of the unknowns.
Post-money valuation = Pre-money valuation + Equity raised + Equity from warrant
= $60m + (70% x $40m) + (Warrant coverage x Venture debt amount)
= $60m + $28m + (8% x [30% x $40m])
= $60m + $28m + $0.96m = $88.96m

Substitute the components into VEQ & VDT's total equity %age:
VEQ & VDT's total equity %age = (VEQ'2s equity / Post-money valuation) + (Equity from warrant / Post-money valuation)
= ($28m / $88.96m) + ($0.96m / $88.96m)
= 31.47% + 1.079% = 32.55%

Thus, 100% – 32.55% = 67.45% of ownership is DMZ's founder and VEQ1.

Therefore, founder's equity percentage = 65% x 67.45% = 43.84%.
[VEQ1's percentage = 35% x 67.45% = 23.61%]

Note: you could express VEQ & VDT's total equity %age as one fraction (as below) instead of as two fractions (as above).
Total equity %age = Equity %age + Equity %age from warrant
= (Equity + Equity from warrant) / Post-money valuation
= ($28m + $0.96m) / $88.96m = 32.55%

Question 34 of 69

A U.S. company recently emerged from Chapter 11 bankruptcy. Which of the following most likely resulted for the company's stakeholders?

- **A.** Senior debt holders received a 115% haircut on new debt.
- **B.** Equity holders suffered 110% loss of capital.
- ✓ **C.** Subordinated debt was converted into the company's equity.

EXPLANATION • Learning Objective 5.1.2 **ID:** L1-5.1.2-021

In a reorganization firm, subordinated debt is often cancelled and converted into the firm's equity.

Other responses -

- In a reorganization firm, senior debt holders often take a haircut, but the haircut is less than 100% (since it involves the debt holder accepting new debt with a lower face value than the old debt).
- Equity holders can lose at most 100% of their capital.

Question 35 of 69

Which of the following is consistent with growth of the distressed debt market?

- **A.** more cov-lite loans, increasing default rates, and increasing recovery rates
- **B.** fewer cov-lite loans, declining default rates, and increasing recovery rates
- ✓ **C.** more cov-lite loans, increasing default rates, and declining recovery rates
- **D.** fewer cov-lite loans, increasing default rates, and declining recovery rates

EXPLANATION • Learning Objective 5.1.2 **ID:** L1-5.1.2-014

Cov-lite (i.e., covenant-lite) loans are loans with few covenants; i.e., they place few restrictions on borrowers. As a result, when more cov-lite loans are used, default rates tend to increase and recovery rates decline. This environment leads to more distressed debt.

Question 36 of 69

Baltech Corp. has declared Chapter 11 bankruptcy and presented a reorganization plan to its creditors. Viktors Licis, a creditor of Baltech, plans to block the reorganization plan by establishing a blocking position. Which of the following would enable him to accomplish this?

- **A.** if he files an objection to the reorganization plan within 120 days after the bankruptcy filing
- **B.** if he holds two-thirds of the dollar amount of any claimant class
- ✓ **C.** if he holds one-third of the dollar amount of any claimant class
- **D.** if he files an objection to the reorganization plan within 60 days after the bankruptcy filing

EXPLANATION • Learning Objective 5.1.8 **ID:** L1-5.1.8-017

A blocking position constitutes one-third ownership of any class of claimants. The position forces the debtor company and the other parties to negotiate with the blocking creditor.

Question 37 of 69

Pixelate, a start-up game developer, seeks to raise $30 million: 70% in equity and 30% in venture debt with a warrant coverage of 10% of loan value. Given that Pixelate's pre-money valuation is $50 million, which of the following most closely corresponds to the equity percentage of the warrants?

- **A.** 1.25% ✓
- **B.** 1.27%
- **C.** 1.80%
- **D.** 1.84%

EXPLANATION • Learning Objective 5.1.7 **ID:** L1-5.1.7-007

Equity percentage from warrant = Equity amount from warrant / Post-money valuation
Find the values on the right side of the equation.

Equity amount from warrant = Warrant coverage x Venture debt amount
= 10% x (30% x $30m) = 10% x $9m = $0.9m

Post-money valuation = Pre-money valuation + Equity raised + Equity raised from warrant
= $50m + (70% x $30m) + $0.9m = $71.9m

=> Equity percentage from warrant = $0.9m / $71.9m = 1.25%

Question 38 of 69

Which of the following characterizes the business approach of different categories of venture lenders?

- **A.** International financial institutions are the primary venture lenders and they pursue social objectives.
- **B.** Specialized venture banks charge the highest rates and convert warrants into large equity stakes.
- **C.** Venture debt funds seek high growth, shorter-term investments, and charge high interest rates. ✓
- **D.** Venture debt funds are less expensive than banks since they have access to low cost capital.

EXPLANATION • Learning Objective 5.1.7 **ID:** L1-5.1.7-003

Venture debt funds seek 2-5 year investments in high-growth companies and offer relatively expensive financing with rates driven by hurdle rates.

Other responses -

- Specialized banks typically charge lower rates than funds and do not typically exercise warrants into equity stakes.
- International financial institutions often target investments in view of pursuing specific social objectives and do not represent the majority of venture lending.

Question 39 of 69

A firm's assets are financed with 65% debt at an interest rate of 7% and the rest in equity. The firm's beta is 1.2. The expected return on the market portfolio is 10% and the risk-free rate is 3%. Which of the following comes closest to the firm's weighted average cost of capital?

- **A.** 8.16%
- ✅ **B.** 8.54%
- **C.** 9.36%
- **D.** 9.82%

EXPLANATION • Learning Objective 5.1.5 **ID:** L1-5.1.5-005

$$\text{WACC} = (\text{weight in debt} \times \text{cost of debt}) + (\text{weight in equity} \times \text{cost of equity})$$
$$= (65\% \times 7\%) + (35\% \times \text{cost of equity})$$

We need to find the cost of equity, which can be done using the CAPM:

$$R = R_f + \beta[E(R_m) - R_f] = 3\% + 1.2[10\% - 3\%] = 11.4\%.$$

Now substitute this into the WACC:

$$\Rightarrow \text{WACC} = (65\% \times 7\%) + (35\% \times \text{cost of equity})$$
$$= (65\% \times 7\%) + (35\% \times 11.4\%) = 8.54\%$$

Question 40 of 69

A borrowing firm is required to submit periodic audit reports to its creditors. This requirement is referred to as which of the following in the firm's bond indenture?

- ✅ **A.** affirmative covenant
- **B.** negative covenant
- **C.** maintenance covenant
- **D.** incurrence covenant

EXPLANATION • Learning Objective 5.1.2 **ID:** L1-5.1.2-015

Affirmative covenants require borrowers to take a specific action. In this case, the borrower is required to submit periodic audits to its creditors.

Other responses -

- Negative covenants prohibit borrowers from taking certain actions.
- Incurrence covenants require borrower to take or not take a specific action once a specified event occurs.
- Maintenance covenants require that standards be regularly met.

Question 41 of 69

A $4 million loan is arranged using a profit participation model. The loan starts in January 2016, and its principal will be repaid at maturity in 2019. The profit participation scheme is 4.6% of earnings before interest and taxes (EBIT), with an annual floor and cap of $235,000 and $250,000, respectively. The yearly EBITs from 2016 through 2019 are $5,000,000, $5,200,000, $5,400,000, and $5,800,000, respectively. Which of the following is the profit participation amount the lender will receive in 2017 and 2019, respectively?

- **A.** $239,200; $250,000
- **B.** $239,200; $266,800
- **C.** $235,000; $250,000
- **D.** $235,000; $266,800

EXPLANATION • Learning Objective 5.1.6 **ID:** L1-5.1.6-007

Floor = $235,000; Cap = $250,000
PPS calculations and amount lender receives are in the table below.

	2017	**2019**
EBIT	$5,200,000	$5,800,000
PPS (= EBIT× 4.6%)	$239,200 (= $5.2m × 4.6%)	$266,800 (= $5.8 × 4.6%)
Amount lender receives	$239,200 (Receives PPS since PPS is between floor & cap)	$250,000 (Receives cap since PPS > cap)

Question 42 of 69

Typical venture lending terms are characterized by which of the following?

I. Duration of 1-3 years
II. Arrangement, prepayment, and success fees of 1%-2% of capital
III. Repayment schedules of interest-only periods followed by amortization
IV. Warrant coverage of 20%-25% of the loan amount

- **A.** II and III only
- **B.** I, II, and IV only
- **C.** I and III only
- ✓ **D.** I, II, and III only

EXPLANATION • Learning Objective 5.1.7 **ID:** L1-5.1.7-006

Typical terms for venture lending -

- Tenors of 1-3 years
- Total fees of 1%-2%
- Repayment schedules with an interest-only period followed by scheduled amortization
- Warrant coverage of 5%-15% of loan amount
- Interest rates of 9%-15%
- Loan amounts of $1m-$20m

Question 43 of 69

A distressed debt investor invests in a bond portfolio with a 24% annual default rate. If 68% of each bond's value remains unrecovered in the event of default and the investor requires a 6% risk premium from this investment, which of the following best represents the investor's minimum criterion for success?

- **A.** minimum credit spread of 10.32%
- **B.** minimum credit spread of 13.68%
- **C.** minimum credit spread of 17.68%
- ✓ **D.** minimum credit spread of 22.32%

EXPLANATION • Learning Objective 5.1.8 **ID:** L1-5.1.8-002

Distressed investors want to receive at least enough credit spread (above the risk-free rate) to cover expected annual credit losses (i.e., to exceed the portfolio's expected loan loss rate) plus a risk premium.

Credit spread ≥ Credit loss rate + Required risk premium

≥ (Default rate × Loss rate given default) + Required risk premium

= (24% × 68%) + 6% = 16.32% + 6% = 22.32%

Question 44 of 69

Which of the following bonds has the smallest credit spread?

- **A.** a bond rated A
- **B.** a bond rated Aa
- **C.** a bond rated D
- **D.** a bond rated Caa

EXPLANATION • Learning Objective 5.1.2 **ID:** L1-5.1.2-011

Bonds with the highest ratings have the smallest credit spread.
Investment-grade debt ratings: Moody's: Aaa, Aa, A, and Baa; S&P AAA, AA, A, and BBB. Therefore, of the choices, a bond rated Aa is the highest rated and thus has the smallest credit spread.

Question 45 of 69

A company's capital structure is composed of senior debt, mezzanine debt, and equity, the cost of which is 6%, 14%, and 18%, respectively. If 30% of the firm's capital structure is equity and the rest is senior debt and mezzanine debt, and the firm's weighted average cost of capital is 10%, which of the following comes closest to the percentage of senior debt?

- **A.** 45%
- **B.** 47%
- **C.** 65%
- **D.** 68%

EXPLANATION • Learning Objective 5.1.5 **ID:** L1-5.1.5-004

$$\text{WACC} = (\%\text{ age of senior debt} \times \text{Cost of senior debt}) + (\%\text{ of mezz. debt} \times \text{Cost of mezz. debt}) + (\%\text{ of equity} \times \text{Cos}$$
$$10\% = (\%\text{ age of senior debt} \times 6\%) + (\%\text{ of mezz. debt} \times 14\%) + (30\% \times 18\%)$$

With 30% equity, 70% is in senior and mezzanine debt. To solve an equation, we can only have one unknown. Therefore, we write mezzanine debt in terms of senior debt as "70% - senior debt" in the WACC formula above.

$$\begin{aligned}
10\% &= (\%\text{ age of senior debt} \times 6\%) + ([0.70 - \%\text{ age of senior debt}] \times 14\%) + (30\% \times 18\%) \\
10\% &= (6\% \times \%\text{ age of senior debt}) + 9.8\% - (14\% \times \%\text{ age of senior debt}) + 5.4\% \\
10\% - 9.8\% - 5.4\% &= (6\% \times \%\text{ age of senior debt}) - (14\% \times \%\text{ age of senior debt}) \\
-5.2\% &= (-8\% \times \%\text{ age of senior debt})
\end{aligned}$$

$$\Rightarrow \%\text{ age of senior debt} = \frac{5.2\%}{8\%} = 65\%$$

Question 46 of 69

Investors who seek to buy the debt of distressed firms that they expect to experience a turnaround, often for a fraction of the debt's face value, are sometimes referred to as which of the following?

- **A.** scavengers
- **B.** hunters
- **C.** prefs
- **D.** vultures

EXPLANATION • Learning Objective 5.1.8 **ID:** L1-5.1.8-001

Distressed debt investors were often referred to as vultures. Some investors seek out firms that are currently in trouble but that they expect will become successful.

Question 47 of 69

Which of the following claimants have the highest claim to assets during a bankruptcy?

- **A.** mezzanine debt
- **B.** senior unsecured debt
- **C.** subordinated debt
- **D.** preferred equity

EXPLANATION • Learning Objective 5.1.2 **ID:** L1-5.1.2-018

Priority of claims to assets during a bankruptcy is as follows.

1. Senior secured first-lien debt
2. Senior secured second-lien debt
3. Senior unsecured debt
4. Junior/mezzanine/subordinated debt
5. Preferred equity
6. Equity

Question 48 of 69

Which of the following terms is used to describe a fee paid to lenders of subordinated debt with payment-in-kind interest to compensate for the time lag between commitment on the loan and disbursement?

- **A.** arrangement fee
- **B.** origination fee
- **C.** ticking fee
- **D.** detention fee

EXPLANATION • Learning Objective 5.1.6 **ID:** L1-5.1.6-013

A fee paid to lenders by borrowers to compensate for the time lag between the loan commitment and disbursement is called a ticking fee.

Question 49 of 69

According to Antczak, Lucas, and Fabozzi (2009), which of the following are ways in which covenants may control risk for lenders?

I. Performance and reporting requirements
II. Control of market risk
III. Preservation of collateral
IV. Use of excess cash flow

- **A.** I and III only
- **B.** II and IV only
- **C.** I, II, III, and IV
- ✔ **D.** I, III, and IV only

EXPLANATION • Learning Objective 5.1.2 **ID:** L1-5.1.2-017

Antczak et al provide five ways in which covenants may control risk for lenders.

1. Preservation of collateral - Lenders may require a maximum loan-to-value ratio of 50% for inventory; 60% for property, plant, & equipment; and 80% for receivables. Each asset should only be pledged as collateral to one lender.
2. Appropriation of excess cash flow - Lenders often require that most or all of the value of asset sales and new debt be paid to debt holders (not to equity holders).
3. Control of business risk - Lenders should limit the types and sizes of investments, mergers, and debt that companies can undertake due to the inherent conflict of interest between stockholders and bondholders (i.e., a distressed firm taking on risky projects may benefit stockholders as long call option holders, but is typically detrimental to bondholders).
4. Performance requirements - Negative covenants require borrowers to maintain strong financial ratios.
5. Reporting requirements - Affirmative covenants require borrowers to report their financial results and other material information to lenders.

Question 50 of 69

Which of the following is true of mezzanine debt?

- **A.** It is the least expensive form of debt financing and is more subject to the J-curve effect than other private funds.
- **B.** It is the least expensive form of debt financing and is less subject to the J-curve effect than other private funds.
- **C.** It is the most expensive form of debt financing and is less subject to the J-curve effect than other private funds. ✓
- **D.** It is the most expensive form of debt financing and is more subject to the J-curve effect than other private funds.

EXPLANATION • Learning Objective 5.1.5 **ID:** L1-5.1.5-027

Mezzanine financing is the most expensive form of debt because it is the last form of debt to be repaid, ranking just above equity.
Mezzanine debt is less subject to the early negative returns of the J-curve effect (in contrast to private equity funds).

Question 51 of 69

In the context of the bankruptcy process, which of the following best describes the notion of cramdown?

- **A.** A situation in which the bankruptcy court sells off the assets of the troubled firm and uses the proceeds to pay off the senior creditors.
- **B.** A situation in which a few of the creditors of a firm that has filed for reorganization buy out all of the small creditors and the equity holders of the troubled firm.
- **C.** A situation in which a bankruptcy plan cannot be agreed upon between a debtor firm and its creditors and the bankruptcy court imposes a plan on the parties. ✓
- **D.** A situation in which the equity holders and the creditors of a troubled firm force the management to file for bankruptcy protection.

EXPLANATION • Learning Objective 5.1.8 **ID:** L1-5.1.8-018

Companies that file for Chapter 11 bankruptcy get protection from having to pay their debt and are able to work on or implement a reorganization plan. But if the debtor firm and its creditors do not have a reorganization plan and cannot agree on one, the bankruptcy trustee assigned by the court can impose a plan on the parties - this is referred to as a cramdown.

Question 52 of 69

Comparing mezzanine debt to leveraged loans, which of the following characteristics do the two forms of financing have in common?

I. Cash coupons
II. Method of amortization
III. Require a credit rating
IV. Term to maturity

- **A.** I, III, and IV only
- **B.** II and III only
- **C.** I and IV only
- **D.** I and II only

EXPLANATION • Learning Objective 5.1.5 **ID:** L1-5.1.5-013

Mezzanine debt usually has a maturity of 4-6 years and leveraged loans have a maturity of about 5 years. Both mezzanine debt and leveraged loans pay cash coupons. Mezzanine debt may also make payments-in-kind.

Other responses -

- Mezzanine debt does not amortize; it has bullet payments. Leveraged loans have amortized installments.
- Mezzanine debt does not require credit ratings, while leveraged loans require credit ratings.

Question 53 of 69

Which of the following is governed by Chapter 11 of the U.S. Bankruptcy Code?

- **A.** debt management
- **B.** corporate restructurings
- **C.** corporate liquidations
- **D.** mergers and acquisitions

EXPLANATION • Learning Objective 5.1.8 **ID:** L1-5.1.8-019

Chapter 11 governs corporate restructuring. Firms that file for Chapter 11 get relief from the demands of paying their debt and are able to implement a reorganization plan.

Question 54 of 69

SUP, a start-up with a current valuation of $40 million, seeks a $20 million second round of financing for the next phase of its growth. A previous round of equity financing by VC1, a venture fund, has left SUP's founder with 70% of the equity. SUP has approached VC2, another venture fund, for the second round of equity financing. Which of the following represents the equity percentage that SUP's founder will give up after the second round of financing?

- **A.** 21.57%
- **B.** 23.33% ✓
- **C.** 25.25%
- **D.** 28.52%

EXPLANATION • Learning Objective 5.1.7 **ID:** L1-5.1.7-008

Need to find the founder's post-raise equity percentage and compare it with the current 70% equity.

First find VC2's equity %age:
VC2's equity %age = Equity / Post-money valuation
= $20m / (Pre-money valuation + Equity raised)
= $20m / ($40m + $20m) = 33.33%
Thus, 100% – 33.33% = 66.67% of ownership is the SUP's founder and VC1.

Given that the founder had 70% of equity, his equity %age = 70% x 66.67% = 46.67%.
Therefore, the founder gives up: 70% – 46.67% = 23.33% of the company.

Question 55 of 69

Use the information below to answer questions 55 through 56.

Interlend is a large private equity firm that specializes in issuing mezzanine loans to a variety of businesses. Interlend has participated in many LBOs and has built up a sizable equity stake in many companies through their activities in this area. Many of these LBOs were by the management of the companies. A few years ago, Interlend provided funds so that the managers of a company could take over the company and immediately initiate research and development into products the managers had been trying to pursue against the wishes of the previous board of directors. Interlend benefited from generous equity kickers when the products the managers were researching went into production. Recently, Interlend was approached by the CEOs of Broadbox Inc. for funding for recapitalization. Broadbox's CEOs want to increase leverage, but do not wish to use commercial banks for loans or investment banks to issue bonds. One reason the Broadbox CEOs want to avoid banks is that Broadbox already uses a significant amount of bank debt financing. Broadbox's CEOs are requesting that Interlend consider extending several forms of mezzanine capital. Broadbox's CEOs have asked about receiving mezzanine financing in the form of senior subordinated mezzanine debt, junior subordinated mezzanine debt, and convertible preferred stock. Which of the following would likely be Interlend's response?

- **A.** All three types of financing are available. ✓
- **B.** A mezzanine financing firm can issue tiers of debt, but not preferred stock.
- **C.** There are no tiers of mezzanine financing.

EXPLANATION • Learning Objective 5.1.5 **ID:** L1-5.1.5-015

Mezzanine financing may involve several tranches of subordinated debt or preferred equity. Thus, it may take the form of senior subordinated mezzanine debt, subordinated mezzanine debt, and convertible preferred stock.

Question 56 of 69

Use the information below to answer questions 55 through 56.

Interlend is a large private equity firm that specializes in issuing mezzanine loans to a variety of businesses. Interlend has participated in many LBOs and has built up a sizable equity stake in many companies through their activities in this area. Many of these LBOs were by the management of the companies. A few years ago, Interlend provided funds so that the managers of a company could take over the company and immediately initiate research and development into products the managers had been trying to pursue against the wishes of the previous board of directors. Interlend benefited from generous equity kickers when the products the managers were researching went into production. Recently, Interlend was approached by the CEOs of Broadbox Inc. for funding for recapitalization. Broadbox's CEOs want to increase leverage, but do not wish to use commercial banks for loans or investment banks to issue bonds. One reason the Broadbox CEOs want to avoid banks is that Broadbox already uses a significant amount of bank debt financing. Broadbox's CEOs are requesting that Interlend consider extending several forms of mezzanine capital. Broadbox has conventional loans from commercial banks. If Interlend intends to receive payments on the mezzanine debt before the bank loans are paid off, it should take which of the following steps?

- ✔ **A.** Interlend should include a springing subordination clause in the inter-creditor agreement.
- **B.** Interlend should include a blanket subordination clause in the inter-creditor agreement.
- **C.** No steps are necessary, since mezzanine debt can be paid without any approval from senior creditors.
- **D.** No steps are possible, since mezzanine debt cannot be paid any cash return while senior debt exists.

EXPLANATION • Learning Objective 5.1.5 **ID:** L1-5.1.5-023

A springing subordination clause in the inter-creditor agreement allows payments of principal and interest to be made to mezzanine investors while senior debt is outstanding, but subordination "springs up" to stop such payment in the event that the borrower defaults on senior debt or a covenant is violated. Payments may resume after the default has been resolved.

Question 57 of 69

An insurance company has provided mezzanine financing to LongTerm, Inc. As part of the financing agreement, the insurance company can purchase the senior debt once a certain portion of it has been repaid. This agreement is referred to as which of the following?

- **A.** debt structure flexibility
- **B.** acceleration of repayment
- ✔ **C.** takeout provision
- **D.** springing subordination

EXPLANATION • Learning Objective 5.1.5 **ID:** L1-5.1.5-025

Takeout refers to mezzanine investors being able to purchase the senior debt once a certain portion has been repaid.

Other responses -

- Debt structure flexibility - this refers to the mezzanine debt being of any size, form, or maturity.
- Acceleration of repayment - this refers to senior creditors requiring the debt be repaid sooner than scheduled (due to a violation of a covenant).
- Springing subordination - this allows mezzanine investors to receive interest payments while senior debt is outstanding, but the payments stop if the issuer defaults on the debt or a covenant is violated.

Question 58 of 69

Which of the following is required before bankruptcy approval can be sought for acceptance of a plan of reorganization?

- **A.** Two-thirds of the claims in each class of creditors vote in favor of the reorganization plan.
- **B.** Two-thirds the number and one-half the dollar amount of the claims in each class of creditors vote in favor of the reorganization plan.
- **C.** At least half the claims in each class of creditors vote in favor of the reorganization plan.
- ✔ **D.** One-half the number and two-thirds of the dollar amount of the claims in each class of creditors vote in favor of the plan.

EXPLANATION • Learning Objective 5.1.8 **ID:** L1-5.1.8-016

Bankruptcy approval is sought for acceptance of a plan of reorganization once half the number and two-thirds of the dollar amount of the claims in each class of creditors vote for the plan.

Question 59 of 69

Hannibal Merlot is a distressed debt investor who recently purchased a distressed company's fulcrum securities. Which of the following most accurately characterizes these debt securities?

- **A.** mezzanine
- **B.** junior
- ✔ **C.** senior
- **D.** high-yield

EXPLANATION • Learning Objective 5.1.8 **ID:** L1-5.1.8-005

Fulcrum securities are senior debt securities. They are securities that are very likely to be converted into the company's equity once the distressed company has been reorganized.

Question 60 of 69

Natasha Petrovsky is considering an investment in either mezzanine debt or high-yield bonds. Her goal is to invest in a relatively short-term investment of about 5-7 years with reasonable liquidity. Compared to high-yield bonds, mezzanine debt is more appropriate for Natasha with respect to which, if either, of these two properties?

- **A.** short-term horizon only
- **B.** neither liquidity nor short-term horizon
- **C.** both liquidity and short-term horizon
- **D.** liquidity only

EXPLANATION • Learning Objective 5.1.5 **ID:** L1-5.1.5-012

Mezzanine debt typically has a shorter maturity than high-yield bonds: 4-6years vs. 7-10 years.
Neither mezzanine debt nor high-yield bonds provide considerable liquidity: mezzanine debt has minimal liquidity, while high-yield bonds have low liquidity.

Question 61 of 69

A large company's credit risk is affected by which of the following factors?

I. Company-specific risks
II. Macroeconomic events
III. Broad liquidity crises

- **A.** I, II, and III
- **B.** I and II only
- **C.** I only
- **D.** II and III only

EXPLANATION • Learning Objective 5.1.2 **ID:** L1-5.1.2-022

The credit risk of a company is affected by all of these factors: company-specific risks, macro events, and broad liquidity crises.

Question 62 of 69

Which of the following best describes mezzanine debt compared to high-yield bonds?

- **A.** Mezzanine debt has a longer tenure, lower coupon rate, and lower recovery rate.
- **B.** Mezzanine debt has a longer tenure, higher coupon rate, and higher recovery rate.
- **C.** Mezzanine debt has a shorter tenure, higher coupon rate, and lower recovery rate.
- **D.** Mezzanine debt has a shorter tenure, lower coupon rate, and higher recovery rate.

EXPLANATION • Learning Objective 5.1.5 **ID:** L1-5.1.5-014

Compared to high-yield bonds, mezzanine debt has a shorter tenure (4-6 years vs. 7-10 years), higher coupon rate (12%-15% vs. 8%-12%), and lower recovery rate (20%-30% vs. 40%-50%).

Question 63 of 69

Compared to non-venture capital-backed start-up companies, venture capital-backed companies exhibit higher rates of which of the following?

I. Survival
II. Initial public offerings
III. Acquisition
IV. Failure

- **A.** I, II, and III only
- **B.** II and III only
- **C.** I, II, III, and IV
- **D.** II, III, and IV only

EXPLANATION • Learning Objective 5.1.7 **ID:** L1-5.1.7-001

Long-term evidence shows that VC-backed firms have significantly higher success rates than non-VC-backed firms: llower failure rates, higher acquisition rates, and higher IPO rates.

Question 64 of 69

A portfolio's annual default losses as a percentage of its value is 14.3% and the portfolio's expected recovery rate in the event of default is 44%. An investor who is keen to invest in this portfolio requires a 7.2% risk premium. Which of the following comes closest to the minimum credit spread that the investor would require to invest in this portfolio?

- **A.** 12.04%
- **B.** 15.2%
- **C.** 18.23%
- **D.** 21.5%

EXPLANATION • Learning Objective 5.1.8 **ID:** L1-5.1.8-014

Distressed investors want to receive at least enough credit spread (above the risk-free rate) to cover expected annual credit losses (i.e., to exceed the portfolio's expected loan loss rate) plus some risk premium.
Credit spread ≥ Credit loss rate + Required risk premium
≥ 14.3% + 7.2% = 21.5%

Note: The 44% recovery rate is included in the annual loss rate (which is the 14.3% annual default losses as a percentage of the portfolio's value), since: Loan loss rate = Default rate(1 −Recovery rate).

Question 65 of 69

Timothy Maven is a portfolio manager who focuses on alternative investments and often purchases fulcrum securities for his portfolio. Which of the following best describes Timothy Maven?

- **A.** He is a commodity pool operator.
- **B.** He is a real estate investor.
- ✓ **C.** He is a distressed debt investor.
- **D.** He is a mezzanine debt investor.

EXPLANATION • Learning Objective 5.1.8 **ID:** L1-5.1.8-004

Fulcrum securities are debt securities that are often converted into the equity of a reorganized firm. They are typically purchased by investors investing in distressed debt and seeking to gain control of the distressed company.

Question 66 of 69

Which of the following applies to the risk exposure of venture loans?

- **A.** Venture loans have higher exposure to start-up failure than equity investments.
- ✓ **B.** Venture loans have low default rates since they are usually repaid before start-ups fail.
- **C.** Venture lenders have a subordinated claim to early round equity investors.
- **D.** Venture loan defaults outnumber start-up failures.

EXPLANATION • Learning Objective 5.1.7 **ID:** L1-5.1.7-013

Venture lenders typically provide funding between rounds of equity capital raising and are repaid before start-ups fail.

Other responses: Venture lenders have senior claims to assets and lower exposure to start-up failure than equity holders.

Question 67 of 69

An investor purchases a firm's fulcrum securities. Which of the following investment strategies is the investor most likely pursuing?

- **A.** active distressed debt not seeking control
- ✓ **B.** active distressed debt seeking control
- **C.** leveraged buyout
- **D.** passive distressed debt

EXPLANATION • Learning Objective 5.1.8 **ID:** L1-5.1.8-003

Investors implementing active-distressed-debt-seeking-control strategies would most likely buy fulcrum securities, which are more senior debt securities that are most likely to be converted into the equity of a reorganized firm.

Question 68 of 69

Which of the following apply to direct lending strategies?

I. Fund manager fees are assessed on invested capital.
II. They suffer early negative returns of the J-curve effect.
III. Most of the loans are secured or senior in the capital structure.
IV. Borrowers of the loans are above investment grade.

- **A.** II and IV only
- **B.** I and III only (correct)
- **C.** I, II, and III only
- **D.** II and III only

EXPLANATION • Learning Objective 5.1.4 **ID:** L1-5.1.4-002

In direct lending strategies -

1. Fund manager fees are assessed on invested capital.
2. Most of the loans are secured or senior in the capital structure.

Other responses: In direct lending strategies -

1. They do not suffer the early negative returns of the J-curve effect (due to lower fees [since fund managers' fees are typically assessed on invested {not committed} capital] and higher cash yields).
2. Borrowers are below investment grade. This is why they need to get loans outside of the traditional banking system.

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Compared to corporate bonds, loans have:

- **A.** less default risk, less interest rate risk, and less liquidity. (correct)
- **B.** less default risk, more interest rate risk, and less liquidity.
- **C.** more default risk, less interest rate risk, and less liquidity.
- **D.** more default risk, more interest rate risk, and more liquidity.

EXPLANATION • Learning Objective 5.1.3 **ID:** L1-5.1.3-010

Compared to corporate bonds, loans have less default risk (since they are the most senior debt instruments), less interest rate risk (since they tend to have floating rates), and less liquidity (since they are not publicly traded).

Answer Key

Question #	Question ID	Correct Response
1	L1-5.1.5-001	D
2	L1-5.1.7-004	A
3	L1-5.1.5-002	D
4	L1-5.1.1-001	B
5	L1-5.1.5-024	C
6	L1-5.1.2-012	A
7	L1-5.1.2-019	C
8	L1-5.1.2-013	D
9	L1-5.1.6-019	A
10	L1-5.1.5-029	C
11	L1-5.1.6-016	A
12	L1-5.1.7-012	C
13	L1-5.1.6-014	A
14	L1-5.1.6-011	A
15	L1-5.1.5-016	D
16	L1-5.1.2-020	B
17	L1-5.1.7-010	A
18	L1-5.1.8-012	A
19	L1-5.1.6-015	B
20	L1-5.1.6-018	A
21	L1-5.1.7-011	B
22	L1-5.1.8-015	B
23	L1-5.1.6-005	B
24	L1-5.1.5-030	D
25	L1-5.1.6-017	B
26	L1-5.1.5-028	B
27	L1-5.1.5-021	C
28	L1-5.1.7-002	C
29	L1-5.1.1-004	B
30	L1-5.1.6-006	D
31	L1-5.1.7-005	D
32	L1-5.1.2-010	D
33	L1-5.1.7-009	C
34	L1-5.1.2-021	C

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35	L1-5.1.2-014	C
36	L1-5.1.8-017	C
37	L1-5.1.7-007	A
38	L1-5.1.7-003	C
39	L1-5.1.5-005	B
40	L1-5.1.2-015	A
41	L1-5.1.6-007	A
42	L1-5.1.7-006	D
43	L1-5.1.8-002	D
44	L1-5.1.2-011	B
45	L1-5.1.5-004	C
46	L1-5.1.8-001	D
47	L1-5.1.2-018	B
48	L1-5.1.6-013	C
49	L1-5.1.2-017	D
50	L1-5.1.5-027	C
51	L1-5.1.8-018	C
52	L1-5.1.5-013	C
53	L1-5.1.8-019	B
54	L1-5.1.7-008	B
55	L1-5.1.5-015	A
56	L1-5.1.5-023	A
57	L1-5.1.5-025	C
58	L1-5.1.8-016	D
59	L1-5.1.8-005	C
60	L1-5.1.5-012	A
61	L1-5.1.2-022	A
62	L1-5.1.5-014	C
63	L1-5.1.7-001	A
64	L1-5.1.8-014	D
65	L1-5.1.8-004	C
66	L1-5.1.7-013	B
67	L1-5.1.8-003	B
68	L1-5.1.4-002	B
69	L1-5.1.3-010	A