All About Leveraged Finance – from a Director in the UBS Leveraged Finance Team

It's finally here – that Leveraged Finance interview you've been asking for since we started this interview series.

Unlike every other interview on the site, this one is **not anonymous** – it's a discussion with **Josh Pearl**, a Director in Leveraged Finance at UBS Investment Bank and co-author of the best technical reference guide around, *Investment Banking: Valuation, Leveraged Buyouts, and Mergers and Acquisitions*.

Most of the other interviewees have been at the analyst or associate level, so I wanted to publish this one and get a crash course in all things Leveraged Finance straight from a senior banker.

The Disclaimer

Since Josh works for a publicly traded company and since this is *not* an anonymous interview, there are certain topics that we could not discuss here (which will become apparent when you read through it).

It's still a great interview and you will learn a lot, but please be aware of this before asking about why a certain topic was not covered – in all likelihood it's because we could not discuss it due to the circumstances of the interview.

Q: Josh, thanks for taking the time out to speak. Can you give us a quick overview of how you got started in the industry and how you ended up at UBS?

A: Sure. I received my undergraduate degree from Indiana University's Kelley School of Business and began my investment banking career at a regional firm, A.G. Edwards, which eventually became part of Wachovia (and therefore Wells Fargo).

While I enjoyed my brief time at A.G. Edwards, I wanted to focus more on developing my technical skill set and I was very interested in leveraged finance. I became interested in leveraged finance after reading books such as *Den of Thieves* and *Barbarians at the Gate*. I wanted to understand how leveraged buyouts and high yield financings actually worked.

I contacted a prominent Indiana alumnus who was the Head of Leveraged Finance, Americas at Deutsche Bank at the time, arranged an interview, and ultimately moved to DB. After spending five years at DB, I moved to Capital Markets at Moelis & Company, a boutique investment bank founded by former UBS Investment Bank President, Ken Moelis.

While Moelis is an incredible firm and I'm still close to my former colleagues there, a couple of my old DB colleagues moved to UBS and my co-author, Josh Rosenbaum, is there as well, so it made sense for me to join. Currently, I'm a Director in Leveraged Finance at UBS, primarily covering industrial companies.

Q: Right, that story shows the value of networking for anyone else who's thinking of making the move from boutique / middle-market bank to bulge bracket.

What exactly do you do in the Leveraged Finance team?

A: Broadly speaking, in Leveraged Finance, we structure and execute leveraged debt financings for corporate and private equity clients and then seek to source investors for those debt financings.

So let's say that a chemicals company is looking to acquire another company, and they want to explore financing options. Ideally, they are an existing client and we have a fairly regular dialogue – in this scenario, we would present different alternatives to them, focusing on different types of debt they might raise – bank debt, high-yield debt, etc. – and then show how each alternative would impact their existing capital structure and operations.

If they ultimately decide to actually go through with the deal and raise debt, we would market the offering to debt investors and help them raise the capital.

It's similar to the IPO process, but deals can be done faster as leveraged debt offerings are typically initially sold to large institutional investors, known as qualified institutional buyers.

Q: And how has the debt market changed since the financial crisis? Immediately after the credit crunch a lot of people were saying that leveraged financed groups were not great areas to go into, but do you think that's still true?

A: The market has improved dramatically since then. 2010 saw over $265 billion of new high yield bond issuance compared to $175 billion of issuance in 2009 and just under $55 billion in 2008.

Leveraged loan volume has rebounded as well with over $235 billion of pro rata and institutional volume in 2010, but far from the $535 billion seen in 2007. It is important to note, however, that loan refinancings via the bond market and amend-to-extend transactions replaced some of the potential loan volume.

In terms of LBO volume, we're still not even close to 2006 to mid-2007 levels, but LBOs are happening once again; and while we're not seeing $30B deals, there have been a number of recent multi-billion dollar LBOs (Note: as of the end of 2010 / early 2011).

These days, the majority of our business – around 60% over the past year – has come from **refinancings**. Between now and 2014, around $400 billion worth of leveraged loans and roughly $500 billion of high-yield bonds will mature, so the refinancing market will likely continue to be strong over in the near-term.

Note: There are two basic types of leveraged debt, "bank debt" and "high yield bonds." While many of the covenants in credit agreements (that govern bank debt) and indentures (that govern high yield bonds) are similar in nature, a key difference is that traditional bank debt features financial maintenance covenants while high yield bonds have less restrictive incurrence covenants.

Financial maintenance covenants require the borrower to "maintain" a certain credit profile at all times through compliance with certain financial ratios or tests on a quarterly basis. Financial maintenance covenants are also designed to limit the borrower's ability to take certain actions that may be adverse to lenders (e.g., making capital expenditures beyond a set amount), which allows the lender group to influence the financial risks taken by the borrower.

Incurrence covenants only prevent the issuer from taking specific actions (e.g., incurring additional debt, making certain investments, paying dividends) in the event it is not in pro forma compliance with a "Ratio Test," or does not have certain "baskets" available to it at the time such action is taken.

Recruiting & On the Job

Q: How is recruiting different for leveraged finance groups on Wall Street compared to other groups? Is there anything in particular you look for in resumes or in interviews?

A: Many of the analysts and associates who interview for leveraged finance groups see it as a pathway to securing a job on the buy-side, so it's one of the more competitive groups to break into at banks.

If you're just interviewing for a generalist position and you'll select your group later on, there's not too much specific to leveraged finance you'll be asked at the interview stage.

However, if you're interviewing for a leveraged finance team specifically, you will likely be asked more technical questions – everything from accounting to valuation, capital structure, and LBOs. Interviewers are obviously cognizant of expected knowledge base. For example, I might not ask a liberal arts major quite as many technical questions, unless I see that they are very well prepared for the interview.

There are 2 reasons for this:

1. **Technical questions are a great way to screen people** - A lot of times it's hard for us to tell who's serious and who isn't just by asking "fit" questions. But if you can't learn enough on your own to answer questions about an LBO model, for example, you probably won't be a good fit for leveraged finance.
2. **The resources are out there** - Years ago you might have had trouble learning all this on your own, but today there are plenty of books, websites, classes, and training programs teaching these leveraged finance and capital structure concepts. So there's no reason why you can't learn it before interviewing.

Q: What is the difference between a capital markets and leveraged finance group? I've gotten dozens of questions on that one.

A: It depends a bit on the bank and the groups, and sometimes they can be quite similar.

But the general differences are as follows:

- **Capital Markets:** Focuses more on tracking market activity, key trends and terms, and communication with investors. They assess the tone of the market and serve as the liaison between bankers, traders, and the sales team. They also assess market appetite for particular financing constructs.
- **Leveraged Finance:** Focuses more on structuring, credit analysis, and client interaction – i.e., devising financing scenarios, performing due diligence, and communication with executive-level individuals at client companies. You usually get more modeling experience at the analyst/associate level and work with your team to ascertain whether a particular proposed capital structure works, given a company's financial projections.

Q: So let's say you're working on a debt issuance for an industrial company under an LBO scenario. What would the analyst in the industrials group do, and what would the analyst in the leveraged finance team do?

A: Generally the industry analyst focuses more on due diligence, the company itself, and assumptions behind an operating model for that company.

The leveraged finance analyst would look at the debt side, crunching numbers, focusing on the credit profile of the issuer (credit statistics, debt repayment, etc.), as well as analyzing IRR and cash returns to the sponsor.

A large part of our job is centered on deciding what type of capital structure is most appropriate for a particular scenario, and what package would be most appealing to the company, the sponsors, and the ultimate debt investors.

For example, does a cash flow revolver/term loan/senior notes construct make sense or would an ABL/secured notes structure work better? Could we do first lien/second lien? Which one is better for the company, and which one will investors be more likely to buy?

An analyst would build a model to help answer questions like these and then offer insight on the various scenarios so we can make the best recommendations to clients.

Q: Right, that makes sense. What about the culture of leveraged finance groups compared to others at a bank?

A: Difficult to say, my experience as well as those of friends of mine at other banks is that **the culture at most banks is very similar and somewhat cliché**: work hard, play hard.

Leveraged finance and most investment banking groups on Wall Street require long hours and hard work, and everyone has the same goal of providing the best possible advice to the client. In my group, we do try to spend time out of the office together and we do have late Friday afternoon beers and pizza – little things like this go a long way in maintaining morale and developing a strong group dynamic.

That said, I don't think there's much unique to leveraged finance that you wouldn't see in other groups – it really comes down to the people in your group and how well you work with them. At the analyst/associate level, it is important to seek out mentors, whether formally assigned or not, to help guide your career.

Q: What about the typical work hours, especially at the junior levels?

A: Banking is banking – expect the typical 80-90 hours per week, sometimes more, sometimes (rarely) less.

Analysts in more capital markets-related roles might not work quite as many hours as those in traditional corporate finance because they follow market hours – but you're still looking at 12-hour days at the minimum (and sometime much more), so it's far from a 9-5 job. Capital markets analysts are in the office early and their days are pretty much non-stop action.

Q: You mentioned before how many analysts in your group desire to move to the buy-side – what are the most common exit opportunities?

A: Well, obviously, we seek to keep the best and brightest analysts by promoting them to the associate level. However, it has become a norm that analysts seek to move to private equity, hedge funds, or mezzanine funds. Some choose to move to business development positions in corporations, start businesses of their own, or pursue graduate degrees.

Note: "Mezzanine debt" above refers to a layer of capital that lies between traditional debt and equity. Mezzanine debt is a highly negotiated instrument between the issuer and investors that is tailored to meet the financing needs of the specific transaction and required investor returns. As such, mezzanine debt allows great flexibility in structuring terms conducive to issuer and investor alike.

Typical investors include dedicated mezzanine funds and hedge funds. For the investor, mezzanine debt offers a higher rate of return than traditional high yield bonds and can be structured to offer equity upside potential.

The Book – *Investment Banking: Valuation, Leveraged Buyouts, and Mergers and Acquisitions*

Q: So far your book has been very well-received – what motivated you to write it in the first place?

A: Most of the accounting, valuation, and financial modeling textbooks out there were written by finance professors and have much more of an academic focus. A lot of professors that publish finance textbooks are trying to advance the field of finance by devising new approaches or attempting to solve perceived issues.

This can make it confusing if you're new and trying to learn the basic concepts. During our research and writing process, we referenced numerous finance textbooks and worked with several of the top finance professors in the world, so we have the utmost respect for academia.

However, we wanted to focus more on how you value and model companies in the real world – and there was no book that walked you through the primary valuation methodologies in a logical, step-by-step manner. We wanted to fill the void in current finance literature and make the knowledge available to everyone.

Q: Right, so what has the feedback been like so far and who's using your book as training material?

A: So far over 50 undergraduate and MBA programs are using it that we know of, and numerous investment banking training programs have adopted as well. The feedback we've received from everyone from juniors in undergraduate programs to some of the best hedge fund managers and private equity partners in the world has been outstanding and very encouraging.

Q: What level of finance knowledge do you need to get started? Is this a guide that someone can go through at the last-minute and quickly get up to speed?

A: The original intended audience was **liberal arts majors as well as those with undergraduate finance and MBA backgrounds seeking to break into investment banking** - it's a crash-course in accounting, valuation, and modeling that anyone can look at and learn quickly. All the basics are in the first chapter, and after that it gets progressively more difficult.

We've had dozens of success stories from students at liberal arts colleges, including readers who landed offers at bulge bracket firms with minimal finance training.

Since publication in May 2009, the book has been and continues to be the best-selling valuation book in the world, and it has spread mostly through word-of-mouth at this point.

Q: Great, thanks for your time and for sharing your experience in Leveraged Finance and writing the book. Everyone should check it out right here on Amazon.

A: Sure thing – enjoy reading and your readers can contact me at josh@investmentbankingbook.com with any questions.

Investment Banking Groups

Tags: debt issuance, financial modeling, industrials, investment banking career, leveraged buyouts, leveraged finance, LevFin