

MEZZANINE FINANCE AND CORPORATE RESTRUCTURING

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Abstract: *The article deals with the problems of mezzanine finance in relation to corporate restructuring. The term mezzanine finance is used as a term for hybrid forms of financing that combine elements of debt and equity financing. Mezzanine finance represents an alternative form of financing restructuring activities of companies. The corporate restructuring means the whole reorganization of company, regeneration of all entrepreneurial parts. Corporate restructuring is based on realization of suitable restructuring measures in production, business, organization, information, personnel or financial and property spheres. The attention is paid to basic concept of mezzanine finance and corporate restructuring and to their mutual relations.*

Keywords: *corporate restructuring, NR restructuring, PR restructuring, mezzanine finance, mezzanine capital*

1. Introduction

The term “mezzanine” has Italian origin and comes originally from architecture. This term indicates an intermediate floor between two main floors in a building. In corporate finance, the term “mezzanine” is used for hybrid forms of financing. Mezzanine finance represents a hybrid form of debt and equity financing that is typically used to finance the expansion of existing firms.

Typical situations for mezzanine financing are:

- corporate restructuring;
- ownership restructuring (especially mergers and acquisitions);
- emerging growth opportunities;
- consolidation;
- recapitalizations.

Firm prosperity and competitiveness in fast changing market conditions are not possible without changes. It is necessary for all firms to foresee, pre-empt and accomplish certain changes in the present world - it is necessary to realize process of corporate restructuring. Nowadays restructuring presents very important part of corporate life in the Czech Republic. Financial managers of our firms should take into account a new instrument - mezzanine financing during the process of corporate restructuring.

2. Mezzanine Finance

2.1 Basic Concept of Mezzanine Finance

Mezzanine finance as alternative form of financing corporate activities is becoming the center of attention of financial managers as a supplement to the traditional forms of financing. Mezzanine financing presents a great alternative to other forms of corporate financing. Firms with efficient capital structures use a number of financial (capital) sources including mezzanine financing.

Tab. 1 outlines differences between key types of financial sources.

Tab. 1: Characteristics of Key Type of Financial Sources

	Senior	Stretch	Mezzanine	Equity
Security	Secured	Partial	Subordinated	none
Ranking	Senior	First on Assets	Second	Third
Covenants	Tight	Tight	Flexible	none
Term	Demand	Term	Term/Patient	Patient
Coupon	Coupon-Floating	Coupon-Fixed	Coupon-Fixed	Dividend
Rate	Prime	Prime Adjusted	Risk Adjusted	Market Adjusted
Equity Kicker	none	Success Fee	Warrants	Shares
Prepayment Penalties	Yes	Yes	Fixed Period	No
Recovery (%)	High	Medium	Low	Low
Liquidity	High	Medium	Low	Right of Sale/ Shotgun

Source: SILBERNAGEL, C. *Mezzanine Finance*. 2006. [cit. 2008-09-25]. Dostupné na WWW: <http://www.bondcapital.ca/media/pdf/Bond_Capital_Mezzanine_Finance.pdf>.

Mezzanine financing is basically debt capital that gives the lender the rights to convert to an ownership or equity interest in the company if the loan is not paid back in time and in full. [2]

Mezzanine capital is connected with the following characteristics:

- *Long term investment horizon* - mezzanine capital is repayable after a long term, typically 7 to 10 years;
- *Unsecured* - mezzanine capital is in principle unsecured; mezzanine finance is subordinated to senior loans;
- *Interest rate* - mezzanine finance pays higher interest rates than other debt (20 - 30 %), this rate is fixed;
- *Tax status* - interest payments on some types of mezzanine finance are tax deductible;
- *Voting or management rights* - the level of control by the provider of mezzanine capital is dependent on the type of mezzanine finance; some types of mezzanine capital include contractual rights of approval and control;
- *Convertibility* - mezzanine capital is convertible into shares;
- *Image of the company* - the confidence of a mezzanine capital provider increases the image of the company.

2.2 Instruments of Mezzanine Financing

There are various types of mezzanine finance [1, 6], each having its own unique characteristics. We can differentiate two main types of mezzanine finance - private mezzanine and public mezzanine; see Tab. 2.

Tab. 2: Mezzanine Instruments' Typology

<i>PRIVATE MEZZANINE INSTRUMENTS</i>	<i>PUBLIC MEZZANINE INSTRUMENTS</i>
Subordinated loans	Profit participation rights
Participating loans	Convertible bonds
“Silent” participations	Bonds with warrants

The private mezzanine instruments are: subordinated loans, participating loans and “silent” participations.

Subordinated loans are unsecured loans with a lower ranking in case of receivership compared to senior debt.

Participating loans are normal loans; their remuneration is contingent upon the results of the business. However participating loans do not give rise to an ownership control.

“*Silent*” participations are closer to a stockholding, in this case investor take an equity stake in a company, but without assuming any liability to the company's creditors.

The public mezzanine instruments are: profit participation rights, convertible bonds and bonds with warrants.

Profit participation rights present a form of equity investments; in this case investor holds the rights over the company's assets (e.g. participation in profits or in the surplus on liquidation), but has no voting or management rights.

Convertible bonds and bonds with warrants are corporate bonds that are connected with the right to exchange for shares (or other bonds) of the given issuer, which happens at the maturity of the bond or at certain dates defined in advance, while the exchange proportion and potential surcharge are given (the surcharge can be expressed e.g. in percentage of the nominal value or percentage of the dividend).

Bonds with warrants enable their owner to get shares of the given company. Differently from convertible bonds, the credit relationship does not cease to exist by taking the shares; the bond holder keeps receiving interest until the maturity date. Using his right, the bond owner obtains a specified number of the issuer's shares for a predefined price after a fixed period expires. *Bonds with warrants* lead both to an increase in someone else's capital, until their maturity, and to an increase in own capital when the put option is used.

3. Corporate Restructuring

3.1 Basic Concept of Corporate Restructuring

The corporate restructuring changes can be carried out both at companies' level as the whole and at the level of companies' single parts. The corporate restructuring means a significant realignment of organization strategies, structure, and processes with the new environmental realities.

The **corporate restructuring** represents the process of the whole changes based on the realization of suitable restructuring measures in all spheres of business activities (i.e. production, business, organization, information, personnel or financial and property spheres). These changes are not of marginal importance and can have a significant influence on future corporate activities.

Starting the process of restructuring may arise from a whole range of problems. In principle they can be summed up in the four main groups - crises, problems, prevention and chances.

The *crises* are the first typical reason calling for a necessary restructuring. A company is in a crisis endangering its prosperity, stability and future existence and this situation must be solved radically. The second reason states for *problems*. A company must solve less urgent, partial problem situations and conditions that arise during its life cycle and which might lead to much more difficult situations – crises. Another reason, which might issue in restructuring, is a *prevention* aimed at avoiding potential problems in future. The last reason is *chances*. A company may apply selected restructuring measures to use ahead of the competition and to stabilize its position in the market.

The reason why the company decides to implement certain restructuring measures determines the character of both the restructuring process and the applied restructuring measures. We can define two main kinds of restructuring [4]:

- restructuring caused by negative reasons, so-called **NR restructuring**;
- restructuring caused by positive reasons, so-called **PR restructuring**.

In the case of restructuring for the reason of solving critical or problem situations and conditions, NR restructuring is applied. The measures of **NR restructuring** are based on the reduction and its effects show immediately.

If companies begin restructuring for the reason of prevention or making use of chances, we speak about PR restructuring. The measures of **PR restructuring** are of a strategic character and it is typical for them that their effects show gradually during a longer time period, often with a certain time lag. The measures of PR restructuring are connected, above all, with a developing stage of the company life cycle, but the companies can use them even in the case of restructuring for the reason of problems and crises, when these measures follow the measures of NR restructuring.

The relation between the reason for restructuring and the character of the restructuring process is shown in Fig. 1.

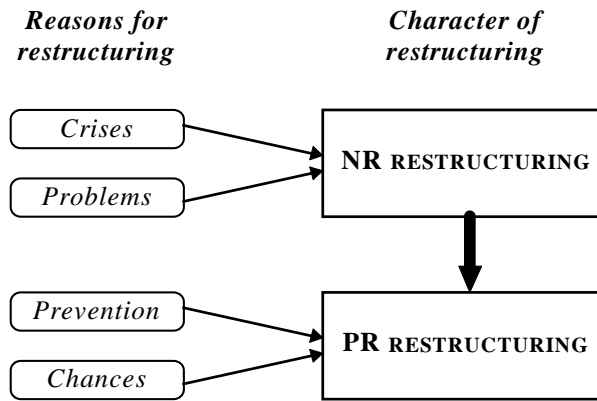


Fig. 1: NR and PR Restructuring

Source: TETŘEVOVÁ, L. *Financování projektů*. Praha: Professional Publishing, 2006, p. 69.

3.2 Spheres of Corporate Restructuring

The successful restructuring process requires the realization of restructuring measures in all spheres of business activities. It means some measures in the sphere of finance, properties, production, business, organization, information and human resources.

The process of corporate restructuring, in the complex interpretation, includes:

- financial restructuring (focused both on the financial, property areas and on the ownership structure of the company);
- production restructuring (which involves both the produced goods and the provided services, and the used production equipment or technology, and also the organization of the production process);
- business restructuring (directed at the area of inputs and mainly at the area of outputs from the organization);
- organizational restructuring (focused on the organizational structure of the company defining the functional roles and relationships within the company processes);
- informational restructuring (i.e. solution of the problems of information systems of the organization in the complex concept);
- personnel restructuring (where the attention is paid to human resources - quantity, structure, quality).

3.3 Measures of NR and PR Restructuring

Corporate restructuring is characterized by changes related to any aspects and factors of the firm. The spheres and the measures of restructuring changes are determined by the character of restructuring process. Different areas and measures will be involved in case of NR restructuring or PR restructuring. [5]

NR restructuring process is focused on the spheres such as financial, property, production, business and personnel.

In the financial and property spheres attention is paid to:

- sale of unnecessary assets;
- rent the spare assets;

- sale and leaseback of necessary assets;
- restriction or freezing the expenses on research, development, investments etc.;
- exaction of irrecoverable claims;
- sale of irrecoverable claims or the change in debts structure and extension terms of return.

In the production spheres attention is focused to:

- the reduction of production capacity;
- modification of production volume and structure according to the costumers' needs.

In the business sphere attention is paid to:

- the re-evaluation of the price policy or sales policy.

In the personnel spheres attention is focused to:

- changes in top management;
- temporary reduction of salaries, reduction of bonuses, non-monetary dues;
- reduction in number of employees;
- re-qualification of some employees.

During the PR restructuring process attention can be paid to all spheres of company activities, i.e. into financial, property, production, business, organization, information or personnel spheres.

In the financial and property spheres attention is paid to cash flow improvement based on measures in area of profitability and assets, acquisition of external financial resources, optimization of a financial structure based on compliance with rules for funding and optimization of company's financial structure, higher efficiency and optimization of investments evaluation and their selection using an efficient investment strategy according to profitability and liquidity, ownership and partnership restructuring based on changes in ownership and partnership structure.

In the production area attention is usually focused to the structure of production plan, structure and quality of production-technology base, preventive care of machinery equipment, production process, quality improvement, innovation and changes in production lines (cost reduction, quality increasing, shortening of necessary time - in production and distribution, in the course of ablation non-production time, during developing new productions line).

The orientation on customers is the most important in business area; it is necessary to carry out monitoring, evaluation and satisfaction of customers' needs; to create the friendly atmosphere for customers in company; to create and implement new methods and allow customers to provide company their feedback. Moreover, for many companies seems to be essential to join the e-business and especially e-market.

The creation of company structure as easy as possible as for hierarchic, communication contexture is the main idea of organizational restructuring. The organization structure should be adaptable, flexible and should react promptly to the changing conditions. Changes not only in organization structure and forms but also in company processes should be realized, even a creation of a process organization can be considered. Also, changes in external cooperation

should be taken into account - either their expansion or reduction. Outsourcing and double-sourcing are other possible changes.

In information area, it is necessary to create and develop the data transferring systems, management information systems, systems of document management (for office support) and systems of internal and external communication.

In human resources attention is paid to a systematic employee education, increase of their independency and business thinking, supporting their initiative and activity. Moreover, managing and motivation systems should be chosen carefully and appropriate process of employing people and their evaluation should be applied.

4. Conclusion

Mezzanine finance represents a relatively new form of financing the corporate intentions in local conditions of the Czech Republic. Nevertheless, one can exploit foreign experience since mezzanine finance has been commonly applied in the US since the eighties. In the nineties it has spread into a several European countries. Based on traditions of financing (as stocks dominate the US contrary to the tradition of European credit financing) and legislative environment (tax laws, bankrupt laws etc.) also different forms of mezzanine apply. However, all instruments of mezzanine financing have one common feature – they couple features of debt and equity instruments.

Recently, when not only our economy bears the consequences of the world financial crisis, it has been of importance to seek new ways of supplementing the traditional forms of financing. This is addressed in mezzanine finance. Some of its tools are based on classical instruments which have been innovated while others are completely new, as it should be apparent from this paper.

Instruments of mezzanine financing are widely applicable in corporate financing, in our local conditions as well. Assuming that, each corporate change represents a specific form of corporate restructuring, one can claim that, mezzanine financing represents potential source of NR and PR restructuring.

Due to the characteristic features of the NR restructuring and unfavorable financial situation of corporate, which is typical for this period, mezzanine financing has only a limited use. Utilization of instruments of public mezzanine does not come into consideration at all, instruments of private mezzanine can be considered solely in case of “silent” participations.

In case of PR restructuring, instruments of mezzanine financing can be applied to financing changes in all areas of corporate activities, primarily in financial, production, business, organization, IT and human resource areas. Mezzanine financing has a unique position in ownership restructuring, mainly in financing merges and acquisitions and in other types of ownership changes

An opinion that mezzanine finance is suitable for financing PR restructuring can be supported by a fact that, execution of each restructuring program requires a considerable amount of financial resources. Mezzanine can be considered as a suitable source of demanded financial means.

Effective utilization of mezzanine financing instruments in corporate restructuring, when some financial tools and precautions are applied more or less in each area of restructuring changes, should always lead to fulfillment of the major restructuring goal, meaning that the market value of a given firm should be increased, or to increasing market value of stocks in case of the joint-stock company.

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