

ALTERNATIVE SOURCES OF BUSINESS DEVELOPMENT: MEZZANINE FINANCING

Sergey Petrovich Sazonov, Irina Alexandrovna Ezangina, Elena Anatolievna Makarova, Natalia Valerievna Gorshkova, Konstantin Dmitrievich Vaysbeyn

Abstract: *The purpose of the study is to conduct a comprehensive analysis of the nature of mezzanine financing, its pros and cons, role in the system of investment activity in the world practice, as well as to assess the degree of adoption of the tool at the national capital market in Russia. The study lists multiple options of realization and tools of mezzanine financing with private placement. The characteristic features of this type of financial product are listed. Belonging to the mezzanine area of bridge financing is proved, as well as a new mortgage refinancing tool – "factory of mortgage-backed securities." The significance of the use of the mezzanine product in the state support programs abroad, as well as in Russia in the field of residential mortgage lending and co-financing of international transactions, was emphasized. The admissibility of various structures of the transaction and therefore its universality were determined as the basic advantage of mezzanine financing. The subjects of mezzanine capital were described, acting both as a lender and investor due to its specifics. The conclusion emphasized the limited possibilities of the development of mezzanine financing practice in Russia, mediated by the passivity of credit institutions, as well as the imperfection of the legislation regulating loan subordination and mortgage loan securitization.*

Keywords: *Mezzanine financing, Mezzanine loan, Option, Bridge financing, Mezzanine financing fund, Mortgage security, Convertible debt note.*

JEL Classification: *E52, G11, F21, O16.*

Introduction

In the conditions when the banking organizations cannot come to terms with the incurrance of operating losses, while demanding to secure the loan agreement with highly liquid collateral, the offers of alternative loans become inevitable. In such cases, public offering usually significantly transforms the ownership structure, which does not always meet the expectations of the owners of small and medium businesses. In addition, there is no guarantee that investments will be proportional to the business value in the process of public offering. As a rule, the floatation and the asset valuation are carried out by venture funds that try to minimize their risks.

Feeling the banking pressure "from the bottom" and the venture pressure "from the top", the business is looking for inflow of available funds. Experience in financing international companies showed that one of the most effective alternative tools is a mezzanine loan product.

1 Methods of research

Applying of the method of abstraction was used to identify a number of key concepts that reflect the financial and economic substance of mezzanine financing. As a result of the system analysis, typology, institutions, variations in the structuring of mezzanine

transactions are indicated. Comparative analysis was used to identify the advantages and disadvantages of mezzanine financing as compared to other debt instruments. Statistical analysis was actualized in the study of international experience, the practice of Russian companies and the state in realizing the benefits of mezzanine schemes. The study is based on the official data of large Russian companies, associations, online projects of information agencies and analytical groups; publications in Russian and foreign periodicals devoted to the development of mezzanine financing.

2 Results of the study

Word "mezzanine" comes from Italian "mezzano" – "medium, intermediate", "located in the center", which goes back to the Greek "mezos" – "medium". Mezzanine financing is a hybrid between debt financing and direct investment; way to finance the realization of a venture project where the investor does not join the capital of the company but rather contributes resources for its development through debt obligations with the simultaneous acquisition of the option with the right to purchase stocks of the borrower in the future at a pre-determined price. Accordingly, the financier acts both as a lender and investor (shareholder) in the mezzanine financing. The instruments of mezzanine financing are: subordinated debt obligations, preferred stocks, warrants, special zero-coupon bonds (PIKs – payment in kind) [9].

Mezzanine lending is an unsecured financial product that does not require liens on liquid assets. With a weaker security than that of a bank loan, the mezzanine debt for investors is accompanied by an increased rate of return. On the other hand, the collateral mediates the fact that the required rate of return for the mezzanine investor is lower than the yield expected by private equity funds for their investments. The lender who has granted a mezzanine loan assumes the part of the shareholder risks, but can receive big profit due to the freedom to decide whether to realize the acquired option or not until last [19].

The target yield of mezzanine financing is 25-35% per annum and is composed of two parts:

- Current interest payments on mezzanine loan; the rate corresponds to the market rate or below, depending on the deal;
- revenues from the sale of the share in the company (participation in the growth of the company's value, which can be structured through the options and warrants).

The strategy of exit from the mezzanine deal can be realized through: the sale of a stake to a strategic investor; the sale of a stake to a private equity fund; arranging the IPO (the first public sale of shares of a joint-stock company); distribution of dividends; execution of the put/call option.

At the moment, the mezzanine financing is implemented in the following versions:

- Mezzanine loan is usually unsecured in the US and subordinated in Western Europe. Subordination means that the lender is provided the right to subsequent retention or pledge of the property with the conclusion of interloan agreements. The "structural subordination" is also possible, in which the senior lenders enter into loan agreements with the companies holding the assets secured by the assets themselves or guarantee from such companies, while the mezzanine lender provides to the borrower's holding company a loan secured by the stocks of companies that hold real assets;

- financing with registration of "non-public" participation of the investor who acquires a stake in the borrower's company but does not assume any liability to the creditors of the company;
- financing secured by the issuance of convertible bonds providing for fixed payments of interest and repayment of principal at the end of the financing term while enabling the investor to acquire stocks of the borrowing company at a predetermined conversion price instead of the return of principal;
- financing secured by the issuance of preferred shares of the borrowing company that provide preferential rights to participate in the profits and liquidation value in comparison with the holders of other shares of the company [14].

Thus, a mezzanine loan must be distinguished from mezzanine financing. The term "mezzanine financing" is broader and also includes financial instruments (stocks, bonds, options, etc.) used in the securities market. In addition, the mezzanine financing differs from project financing. Repayments within the project financing is made with the funds generated by the project, while within mezzanine financing it is made with the proceeds from the sale of assets or stocks of the company, which is the object of investment. Finally, the borrowed funds for the projects are raised through the open market or through a loan from a pool of lenders; mezzanine financing is only made through the financial instruments placed directly following the results of negotiations between the investor and the borrower in private using the buy-and-hold strategy [18].

Mezzanine financing may also take a form of bridge financing, a type of short-term lending that allows the enterprise to quickly and reliably obtain the necessary amount of funds for a perspective deal without suspending its operations or a project. Bridge loans are offered by the established syndicate of investors who financed the company at the previous stages.

The main feature of bridge financing is that it is directly connected to the future issue of securities and limited in period by a placement date, i.e. the loan is repaid when the company receives funds from the public deal. Bridge financing is often made in the form of convertible debt notes, using which the company can achieve the next stage of long-term financing. The interest rate on the notes usually accumulates and is paid when they are redeemed. The parties make a preliminary agreement (Term Sheet) prior to the bridge financing campaign. The document stipulates the basic arrangements between the company management and the lenders, including on the terms of the conversion of the bridge notes in the company's shares. The notes are converted into shares either automatically (upon the occurrence of a certain event) or at the request of the holders with an additional fee and a discount on the price. Investors can optionally convert the debt notes into "future" stocks, the issuance of which is expected in the next round of funding [20].

In 2012, JSC "Megafon" has raised a bridge loan of \$2 bln from a syndicate of non-resident banks: Citibank N.A, BNP Paribas Bank, Barclays Bank PLC. The loan was provided for 6 months with the option of extension for another 6 months. The borrowed funds were provided in tranches within 1-3 months from the date of conclusion of the agreement. The purpose of the loan was buyback of 25% of the own shares from Russian holding Altimo, part of "Alfa Group"[15].

In 2013, the size of the bridge loan raised by NK "Rosneft" to buy 50% of TNK-BP amounted to \$11.88 bln. A group of banks including Bank of America, Merrill Lynch,

Barclays Bank and BNP Paribas were lenders and arrangers of the loan. Share of one bank in the bridge loan is about \$720 mln. Both of the above-noted companies have used the proceeds from the placement of bonds to repay the bridge loan [1].

The interest rate is mediated by the short term of lending, low volume of financing and risks undertaken by the investor. In Russia, the cost of raising capital for two months at 70% per annum will be about 11.6% and may be covered by growth in the value of real estate sold [2].

In this case, the cost of bridge financing in the volume of all the costs will not affect the financial stability and the financial performance of the project. On the contrary, the funds raised will help cover the needs in initial investment, carry out obligations to contractors on time and meet the deadlines of the project.

In world practice, Kohlberg Kravis Roberts (KKR) in the merger with Del Monte Foods decided to issue 119 bonds of the new enterprise to raise investments in 2010. To realize the plan, the company took advantage of the bridge loan totaling \$1.6 bln, paying 8.75% in 60 days after the issue and the rest within a year. In addition, loan notes may be converted into bonds with 11.75% coupon [16].

An example of a fixed-term bridge financing is 7 bln euros approved by creditors and received by Greece in 2015, which almost immediately left the country to repay the expiring loan from European Central Bank (3.5 bln euros), as well as arrears to the International Monetary Fund totaling 2 bln euros. The remainder of funds was to finance current government spending before negotiations on a new three-year loan program in the amount of about 86 bln euros [6].

The use of mezzanine financing in the state support programs abroad was noted (see Table 1).

Tab. 1: Use of mezzanine financing in the state support programs abroad

Country/development institute	Description of the programs used	Annual volume
Germany/German State Bank KfW (Germany's federal government owns 80% of shares, Germany's federal states own 20% of KfW)	ERP-Innovations program: unsecured loans for R&D up to 5 mln euros and for the implementation up to 2.5 mln euros (term is up to 10 years). "Entrepreneur's capital" program: the division of a refinanced loan into "senior tranche" (risk is born by a partner bank) and "subordinated tranche" (100% of risk is born by KfW)	800 mln euros
France/OSEO (Agency for support of small and medium enterprises of innovation businesses)	"Contrat de Developpement Participatif" program: a loan for "intangible" expenses, acquisition of shares in companies, IT expenses, staff training, marketing. The key component is a seven-year subordinated loan with a two-year grace period of up to 3 mln euros	930 mln euros
USA/SBA (Small Business Administration, the US government agency that provides support to entrepreneurs and small businesses)	Small Business Investment Companies: investment companies set up with the SBA support (through the issuance of debt securities, SBA offers \$2-3 for the "senior" tranche per \$1 of investment in the "junior" tranche from private investors). Instruments are subordinated loans + PIK (Deferred interest – PIK – Pay-In-Kind) and warrants. Recipients of support include Apple Computers, FedEx	1.9 bln dollars
Canada/ Development Bank of Canada (the bank is fully owned by the government of Canada)	Subordinated loans for a period of 3 to 7 years up to 10 mln Canadian dollars + additional instruments (revenue share, % from the increase in the company value, etc.). The main focus is medium-sized companies with strong growth rates and good market positions	500 mln dollars

Source: [13,3,12,22]

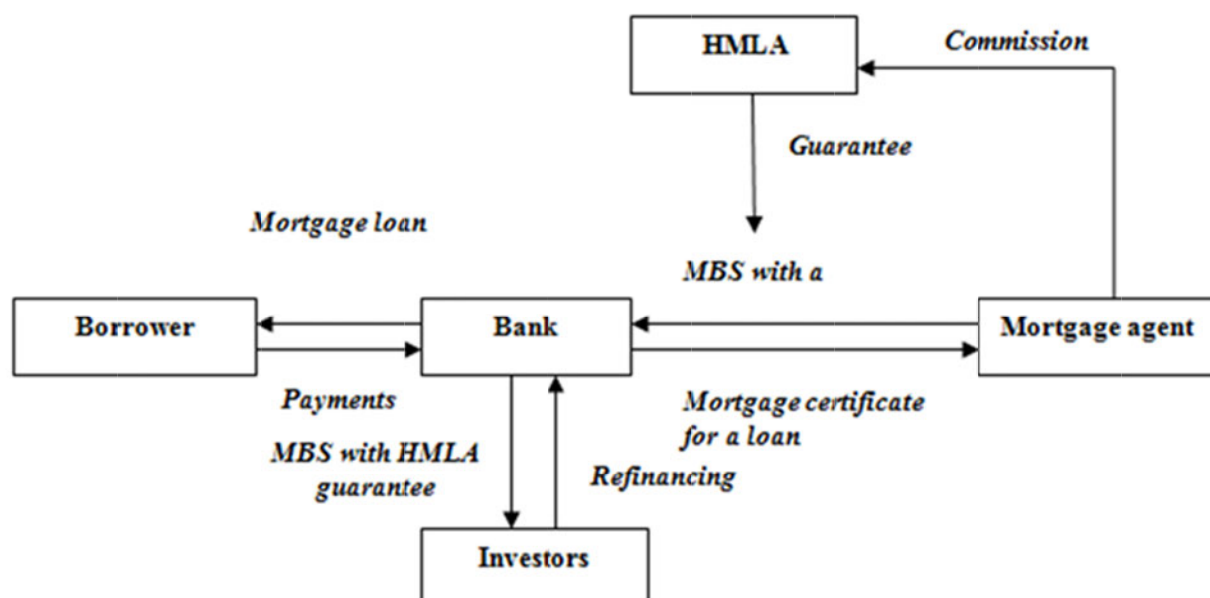
In order to reduce the cost of housing for builders and consumers and development of the rental housing market in Russia, the Unified Development Institute in the housing sector represented by the Housing Mortgage Lending Agency (HMLA) is going to take the following measures as part of the Development Strategy for 2015-2020:

- Issuance of infrastructure bonds secured by a flow of lease payments and their sale to market investors through the Special Project Financing Companies (SPFC) (start in 2016-2018);
- issuance of mortgage-backed securities (MBS) secured by obligations of the lessor on security of the built rental housing;

- introduction of a new effective mortgage loan refinancing tool – "MBS factory" (Figure 1). "MBS factory" provides the following mechanism: the bank issues loans to borrowers and transfers mortgage certificates to a mortgage agent who expeditiously releases and registers single-tranche MBS in the Bank of Russia after receiving HMLA guarantees. The bank may keep MBS received from the mortgage agent on the balance sheet or sell them to foreign investors, thus receiving refinancing. Advantages of the "MBS factory" are: affordable funding of banks in the sufficient target volume for mortgage lending; reduction in a mortgage rate thanks to reduction in the reserves of originator's banks, simplification and reduction in the cost of loan refinancing procedures; standardization of MBS, their approach to the level of risk on federal loan bonds (FLB). From September 2009 to November 1, 2015, 22 guarantees for a total amount of 101.2 bln rubles have been granted under the program of provision of guarantees on mortgage securities of third parties.

In 2014, Housing Finance Bank with the support of HMLA and VTB Capital has completed a series of transactions totaling 2.4 bln rubles for the securitization of part of its mortgage portfolio. Three tranches ("A", "B" and "C") of mortgage bonds totaling 1,179,109 thous. rubles were placed within the first transaction. The amount of tranche "A" amounted to 1,002,243 thous. rubles (coupon rate is 9.5%). The amount of tranche "B" (mezzanine tranche) totaled 58,955 thous. rubles; the amount of junior tranche "C" totaled 117,911 thous. rubles. The maturity date of the issue is 28.02.2046. Three tranches ("A", "B" and "C") of mortgage bonds totaling 1,218,107 thous. rubles were placed within the second transaction. The amount of tranche "A" totaled 1,035,391 thous. rubles (coupon rate is 9.25%). The amount of tranche "B" (mezzanine tranche) totaled 60,905 thous. rubles; the amount of tranche "C" totaled 121,811 thous. rubles. The maturity date of the issue is 28.07.2044.

Fig. 1: Innovative mechanism of MBS issue ("MBS factory")



Source: [4]

While issuing the senior tranche that floats the market, the bank reserves the junior tranche as a credit support in order to be able to undertake first risks in the pool of mortgage loans and thus ensure a high ranking for the senior tranche. The greater the amount of the

junior tranche is, the less profitable the securitization transactions for banks are. HMLA has decided to buy back the middle between the junior and senior tranches – a mezzanine tranche – in order to reduce the required amount of credit support. The mezzanine tranche accumulates not so much the credit risks of the pool as the risks associated with the legal protection of the mortgage and mortgage-backed securities market functioning, as well as the existing infrastructure [11].

When studying the areas of common interest of the state support mechanism, practice of international cooperation, and mezzanine financing, we should note the establishment of a platform in 2015 by Russian Direct Investment Fund (RDIF), Russian-Chinese Investment Fund (RCIF) and China Construction Bank (CCB), which will allow to increase lending to Russian and Chinese companies from Chinese banks. The potential volume funding amounts to \$20-25 bln. This entails not direct loan guarantees but rather deal co-financing mechanism: the fund will participate in the financing of the company that receives a loan from the Chinese investor (mezzanine financing). At that, the company subject to investment issues two tranches of financial instruments with varying degrees of reliability: the first tranche is more reliable, the second is less reliable; the first tranche holders bear reduced risks, the second tranche holders get a higher rate for the greater risks. The potential funding volume amounts to \$20-25 bln [5].

3 Own findings

Mezzanine financing has advantages for both parties to the transaction. For investor, debentures represent a priority in the bidding line, while an option allows the recipient of funds to pay the lender in a convenient form in the future. In addition, the mezzanine financing allows to avoid blurring of the charter capital, as most of the lender's compensation comes from interest payments, and the company often has the right to buy back the shares issued in favor of the mezzanine investor [24].

The use of mezzanine financing may allow to optimize the conditions for concurrent obtaining a bank loan for a specific project. This is due to the credibility and professionalism of mezzanine investors, which increases the reliability of the project in the eyes of the lending bank. Risk reduction is also achieved due to avoiding dependence on a single lender [23].

A key advantage over other instruments is that mezzanine financing allows many variations of the transaction structure. This allows to use mezzanine in virtually all types of transactions, including: working capital financing; business expansion/capital investments; lombard financing; leveraged buyouts (LBO); merger of two companies; buyout of the company together with the direct investment fund; manager buyout (MBO); buyout by one of the owners; owner's partial cash out; investment project for companies using the light taxation system (Table 2).

Tab. 2: Options for the development of business and the use of various sources of funding

Type of transaction	Source of funding		
	Bank loan	Mezzanine financing	Direct investment
Working capital financing	+	+	
Business expansion / Capital investments	+ (only on security of assets)	+	+
Lombard financing	+	+	
Leveraged buyout		+	+
Merger of two companies		+	+
Buyout of the company together with the direct investment fund			
Manager buyout		+	
Buyout by one of the owners		+	+
Owner's partial cash out		+	+
Investment project for companies using the light taxation system		+	+

Source: [17].

Hedge funds, pension funds, private equity funds, insurance companies and banks with the relevant departments usually act as mezzanine investors. In Europe, mezzanine capital is provided by banks and specialized independent "investment boutiques." In the US, the main participants in this market are historically the insurance companies, pension funds and trust funds.

In Sberbank's corporate and investment unit (Sberbank CIB), Sberbank Merchant Banking (MB) operates – a structural unit realizing its own investment aimed at further development of the largest enterprises in various sectors of the economy, the bank's clients. At that, MB identifies the following perspective areas: consumer goods, medicine and pharmaceuticals, financial services and retail. MB provides capital to finance projects such as organic growth, mergers/acquisitions (M&A), financial restructuring, and participates in the deals on consolidation of assets in separate fragmented sectors of the Russian economy.

The activities of the specialized mezzanine financing funds in Russia should be noted, in particular:

- Hi Capital: 18 projects have been financed totaling more than \$1 bln with a target yield of 20-25% (IRR);
- Mezzanine Financing Fund (MFF), the company selection parameters: ratio of Debt/EBITDA < 5X; share of government contracts in the company's portfolio no more than 15%; turnover of the company at least 300 mln rubles; availability of a unique sales proposition and established development strategy; investment payback period 3-5 years; size of transactions 100-1,000 mln rubles; profitability of the project at least 30% IRR [17].

- FIRST ICG: investment consulting group in the area of fundraising, debt restructuring, investment planning, M&A and consulting in the field of corporate finance;
- Volga River Growth: target capital size is \$300 mln. Investors of the Fund are both Russian and foreign individuals and institutional investors, including EBRD. The target size of financing is \$10-50 mln. Investment term is up to 5 years. 3 transactions are in the active phase. Features of investment policy and the parameters of the transaction of the Fund are shown in Figure 2.

Fig. 2: Features of investment policy and parameters of mezzanine transactions of Volga River Growth Fund

Investment policy

Focus on fast-growing medium-sized companies	<ul style="list-style-type: none"> • Revenue > \$30 mln • Growth in revenue > 15% per year • Positive cash flow • Relatively low debt level (debt/EBITDA≤4)
Financing of the organic growth and M&A	<ul style="list-style-type: none"> • LBO, MBO • Working capital • Debt refunding
No sectoral focus	<ul style="list-style-type: none"> • Countercyclical sectors (fast food, discounters) • Non-cyclical sectors (food) • Export-oriented sectors (petrochemicals) • Import substitution (agriculture, pharmaceuticals)

Parameters of transactions

Structure	<ul style="list-style-type: none"> • Hybrid investment (debt + investment bonus) • Investment term: 18-48 months • Amount of investment: \$10-50 mln.
Security	<ul style="list-style-type: none"> • Deposit of shares of the holding company • Personal guarantees of the owners
Target yield	<ul style="list-style-type: none"> • Current yield of 10% + rate of mezzanine debt • Investment bonus increases the yield to 25%

Source: Authors

In addition, foreign mezzanine funds have participated in the activities of Russian entities in the market of financial capital. For example, a microfinance institution (MFI) "Center for Financial Support" LLC (Viva Money brand) raised external funding from the British fund Izurium Capital in the amount of \$10 mln in early 2014. The company provides Russian citizens access to microlending and other financial services, especially in small towns, where such services are most in demand [8]. The funds obtained through mezzanine financing were additional funding source for the MFI and were aimed at increasing the portfolio and expansion of the branch network within the geographic expansion [25].

4 Discussion

The mezzanine funds abroad do not actively participate in the management of the assets of the funded companies and originally agree with the strategy, personnel and operating decisions of the shareholders. In Russia, one of the requirements for control is a seat in the board of directors. However, the interest of the mezzanine investor is focused not on earnings from the maximum rise in price of shares of the investment object, but rather on receiving the expected return on mezzanine investments.

There is another difference between venture capital funds and mezzanine funds. Most venture capital funds employ personnel with experience in the field of high technologies. In contrast, mezzanine funds tend to employ finance professionals who know how to conduct negotiations on the participation in the capital as part of mezzanine financing transactions.

Mezzanine financing is used by the companies which:

- do not count on project financing due to lack of own funds and have exhausted the possibilities of raising bank loans [7];
- hope to raise long-term money (up to 5 years), while enjoying stable cash flows or a significant amount of capital.

Builders usually resort to mezzanine loans in financing of real estate in order to provide additional funding for construction. Mezzanine loans of this kind are provided on security of not the building object of real estate, but rather the shares of the holding company of the builder [10].

An example of the use of mezzanine financing for business expansion is announcement of Softline, a global provider of IT solutions and services, about fundraising from "Sovcombank" in the form of a mezzanine loan for 4 bln rubles. Softline will invest it in the uptake of IT companies in Russia, CIS countries, Latin America and Southeast Asia. The funds raised will allow Softline to implement a global strategy – to become the largest player by the scale of business in target markets thanks to a unique set of assets, and to carry out an initial public offering (IPO) [21].

Conclusion

The advantages of mezzanine financing for the borrower can't be ignored thanks to the possibility to postpone the payment of a substantial part of the investor's revenue until the full repayment of the mezzanine debt and to deduct the cost of raising and maintaining mezzanine financing from the taxable profits of the borrower with proper structuring of the transaction.

However, mezzanine financing also has negative features:

- High cost and complexity of arrangement compared to bank financing because of higher interest rates and individual structuring of each transaction;
- strict requirements to the management team, transparency and accountability of the borrower;
- limited possibility of early exit of the investor, particularly in the case of financing small and medium-sized enterprises without debt securitization [14].

The current Russian legislation makes loan subordination impossible, which mediates the need to use a foreign special-purpose vehicle (SPV), which receives the main and mezzanine financing and then provides a loan to the Russian company. SPV is usually established in the country of Anglo-American law. The investor acquires shares of such SPV at par value. In this case, the bank can issue the loan either to the SPV or directly to the Russian operating or subholding company. Options and shareholder agreements in respect of the SPV are subject to English law, which allows to securely formalize and implement approaches to arranging mezzanine transactions that have been used in the West for decades but are unattainable under the Russian legal system.

The existing mechanism of securitization in mortgage housing lending also has disadvantages. The instrument is inconvenient for banks and investors due to its lack of liquidity and regulatory benefits and the long duration of the MBS issuance process. Many issues of such securities are "technical" in nature and are used as collateral for repo (repurchase agreement) with the Bank of Russia [4]. Finally, the reasons hampering the development of this financial instrument include lack of information about the service and unwillingness of many banks to develop this instrument because of its high risks.

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Contact Address

Sergey Petrovich Sazonov, Ph.D.

Volgograd State Technical University
Russia, 400005, the city of Volgograd, Lenina Avenue, 28

Irina Alexandrovna Ezangina, Candidate of Economic Sciences

Volgograd State Technical University
Russia, 400005, the city of Volgograd, Lenina Avenue, 28

Natalia Valerievna Gorshkova, Ph.D.

Volgograd State University
Russia, 400062, the city of Volgograd, University Avenue, 100

Elena Anatolievna Makarova, Candidate of Economic Sciences

Volgograd Economic and Technical College
Russia, 400007, the city of Volgograd, Prospect of Metallurgists, 17

Konstantin Dmitrievich Vaysbeyn,

Volgograd State Technical University
Russia, 400005, the city of Volgograd, Lenina Avenue, 28

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