SCIENTIFIC PAPERS
OF THE UNIVERSITY OF PARDUBICE
Series A
Faculty of Chemical Technology
17 (2011)

MEZZANINE FINANCING AS ALTERNATIVE SOURCE OF FINANCING FOR ENTERPRISES

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Received September 30, 2011

The article is devoted to problem issues of mezzanine financing as an alternative source of financing for enterprises. This article aims to explain the nature and role of mezzanine financing in the enterprises and evaluates its possible use in the Czech Republic. Firstly, it defines a term of "mezzanine" in a historical context. Further possible mezzanine instruments are identified and characterized. Attention is also paid to the use of mezzanine financing from the point of corporate objectives. Finally, the situation is evaluated from the viewpoint of the use of mezzanine financing in the Czech Republic within the context of potential development.

Introduction

Nowadays, when the enterprises are affected not only by the globalization, but also by the need of further alternative funding, the importance of alternative sources of

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finance is rapidly growing. Traditional forms of debt financing and equity financing are now complemented with an option to implement alternative (non-traditional) instruments including so-called mezzanine financing [1].

Mezzanine financing instruments representing a mixed form of the equity and debt capital are considered as alternative funding, particularly for small and medium-size enterprises (SMEs) which are key players for the development of local and regional communities being at the heart of the Lisbon Strategy, whose main objective is to turn Europe into the most competitive and dynamic knowledge-based economy in the world [2,3].

This article aims to explain the nature and role of mezzanine finance within the role of corporate financing and to assess its possible implementation in the Czech Republic.

Mezzanine Financing

Mezzanine financing (mezzanine) is an umbrella term for hybrid forms of financing that have both qualities in equity and debt features.

The origin of the term mezzanine is Italian (mezzanino) [2]. This form of financing, the name of which is derived from architecture (in this case the mezzanine is a small extra floor between one floor of a building and the next floor up) is not entirely new. In the USA, mezzanine is now a traditional source of allocations to alternative assets of institutional investors. In Europe, the volume of mezzanine financing has increased, as it has spread geographically from more traditional markets (e.g., the United Kingdom and, to a lesser extent, France and the Benelux countries) to other continental European countries [4].

Specific forms of mezzanine financing emerged as innovative financial instruments derived from classical instruments. Significant differences in the mezzanine financing may yet be visible between the U.S., where mezzanine financing is rather the form of securities, and Europe, which is characterized by a tradition of credit financing [5].

A common feature of the various instruments is that they can be structured flexibly in many different forms in order to provide solutions to the specific financing requirements of private and listed companies [6]. Thus, mezzanine products can offer complex financing solutions in this situation. Figure 1 shows an example of effective combination of senior debt, equity and mezzanine by Silbernagela and Vaitkunase [7].

Typical private Equity structure (% of total assests)	Expected costs (%)
Senior debt 30 % - 60 %	5 % - 12 %
Mezzanine 20 % - 30 %	13 % - 25 %
Equity 20 % - 30 %	25 % +

Fig. 1 Efficient combination of senior debt, equity and mezzanine [7]

Instruments of the Mezzanine Financing

In practice there are different types of mezzanine financing. Each of them has its own unique characteristic [8]. The most common types of mezzanine financing by Tetřevová are shown in Fig. 2.

Senior debt	
Participating debt Subordinated debt Convertible bonds Option bonds Silent participation Preferred stocks	MEZZANINE
Common stocks	

Fig. 2 The most common types of mezzanine financing by Tetřevová [5]

In principle, from the viewpoint of balance mezzanine financing instruments can be divided into mezzanine with a higher degree of equity, or “mezzanine equity”, and mezzanine with a higher tendency to the debt, or the so-called “mezzanine debt” [9].

The preferred shares, warrants and silent partnerships are parts of the financial structure of the company’s own capital; therefore, they are included in group *equity mezzanine.* Nevertheless, it is inevitable to emphasize the fact that the providers of this type of capital limit one or more basic property rights, such as the right to participate in the management of the enterprise. Thus, these funding sources have features of the mezzanine [9].

In contrast, bond options, convertible bonds, debt with a right to share in profits or subordinate bonds are classified, from the point of view of balance, as foreign sources. Therefore, the distribution of the above-mentioned belongs to the *mezzanine debt*. The optional bond is associated with an option to purchase shares of the issuer, and convertible bonds, under certain conditions, provide the opportunity for exchange of shares or another bond of the issuer. Liabilities associated with subordinated debts are offset to the satisfaction of all liabilities and debts of other creditors entitled to share in profits, and as it is implied from the title itself, the amount of payments on the debt depends on the amount of profit of the company. For these reasons, the mezzanine debt investor approaches the position of the holder [9].

Generally, mezzanine finance providers are in a position that is subordinate to the "traditional creditor", but superior to the owners of a company [10]. As a result, mezzanine investments produce returns higher than interest rates yielded on deposits with banks, but lower than the dividend yield of shareholders. The level of control exercised by the provider of mezzanine primarily depends on the type of the selected mezzanine financing. Some types of mezzanine enable providers to become a mere creditor, while other mezzanine types give them the right to control or approve [9,11].

According to Henry the differences among senior debt, mezzanine and equity could be seen in the Table I

Table I Mezzanine financing in structure of financial sources by Henry [12]

	Senior debt	Mezzanine finance	Equity
Investment horizont	Medium term	Long term	Long term
Risk tolerance	Low	Medium	High
Current coupon	Flexible rate	Fixed rate	Depend on profit
Hidden costs	Personal/property guarantee	None	Widened control
Individual conditions	Yes	Yes	No
Equity dilution	None	Low	High

Return on capital invested in the company through mezzanine financing can be implemented in two ways [13]. The first option is the interest that can be set as fixed or floating interest rates. The second option is called "*equity kicker*". Equity kicker gives the lender or investor rightful claim to a percentage increase in property covered by the mezzanine financing. These two methods can be also combined [7].

Possibility of Using Mezzanine Financing

Mezzanine financing is a suitable alternative for financial management and a business owner especially when the senior loan capital can no longer be obtained. Another important fact is that this financing structure imposes a lighter burden on the cash resources of a developing company [11,14]. The use of mezzanine financing is recommended for businesses reached the later stages of the life cycle of a business. On the contrary, it is not recommended to use this form of financing for enterprises in the early stages of their business life cycle which mainly business angels and venture capital focus on.

Mezzanine financing can be used for example for financing [5]:

- developing capital - is used to develop a business for example to launch a new product or service into the market or to penetrate geographically distant markets;
- capital for mergers and acquisitions - is the capital which is used for mutual buying, transfer of ownership shares and mergers of companies; the acquisitions are now reported as most frequently used investment management buy-in (capital enabling a manager or group of managers to enter a company from outside is referred to as management buy-in) [9]) and buy-out (management buy-out denotes capital that enables the existing management and investors to acquire an already existing production company [9]);
- capital to finance corporate debt - is used when running already promising projects fall into short-term losses to be offset;
- capital for corporate restructuring - capital acquired for the purpose of corporate restructuring process is used for overall changes in the company based on the implementation of appropriate restructuring measures;
- capital funding for various growth opportunities.

Mezzanine Financing in the Czech Republic

The total amount of investments such as mezzanine financing has not been, unfortunately, monitored in the Czech Republic. Nevertheless, on the assumption that the mezzanine financing is considered a part of investment called private equity, and that the development of mezzanine financing was the same as the development of this private equity, we can reach certain results.

Private equity investments have been implemented in the Czech Republic since 1990. Aan association of investors, Private Equity and Venture Capital (CVCA) was established in the Czech Republic in 1997. However, other investors, who are not members of the CVCA, can also be found there. They are not usually typical private equity investors even though their investment structure may resemble the "traditional" type of private equity investments [15].

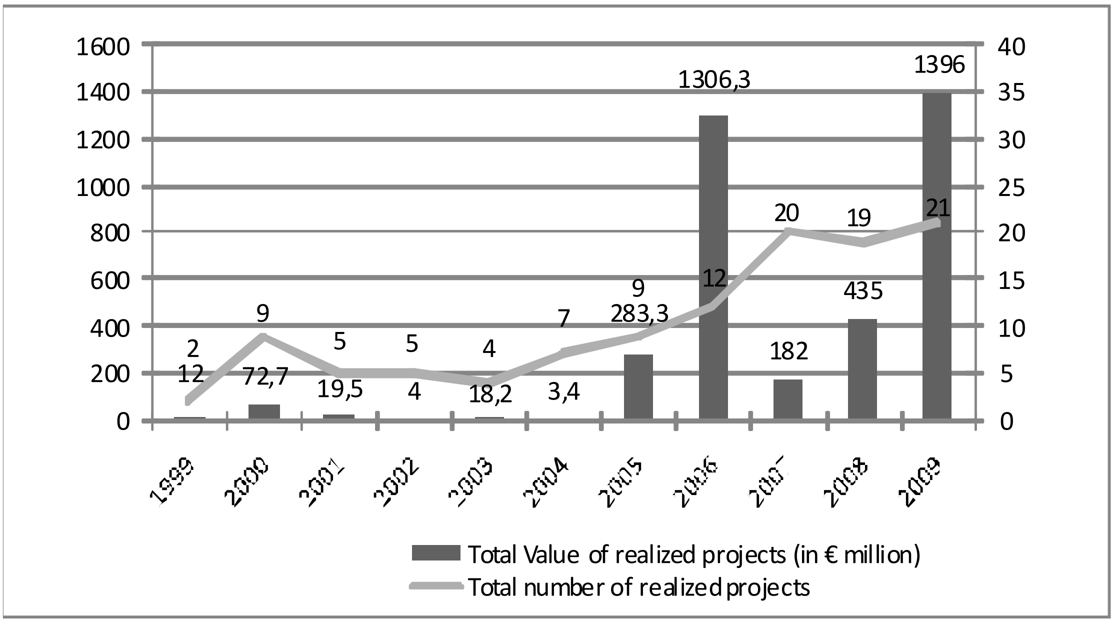

Fig. 3 The development of private equity investments of CVCA members in the Czech Republic [15]

Table II Value of investments (in €×1,000) of private equity according to the enterprise life cycle in the Czech Republic, Central and Eastern Europe and total of Europe (no bank leverage included)

	Czech Republic	Central and Eastern Europe	Total Europe
Seed (2009)	0	1 561	144 093
Start-up (2009)	0	10 562	1 848 213
Later-stage Venture (2009)	28 248	31 295	1 829 421
Growt (2009)	205 889	390 861	4 4963 697
Rescue/turnaround (2009)	400	6 800	583 160
Replacement capital (2009)	139 650	170 745	1 774 590
Buy-out (2009)	1 021 797	1 843 960	11 917 294
Total 2009	1 396 299	2 455 783	22 690 468
Total 2008	434 553	2 479 998	52 674 787
Total 2007	182 368	2 344 007	72 011 881
Total 2006	1 306 300	1 667 013	67 807 541

Source: Ref. [16]

CVCA members have carried out more than 100 investments from 1990 to 2009 whose value was around 2 400 mil. EUR. Currently, regular members of the association manage around 20 Czech investments in their portfolios, and others are prepared [15]. The development of private equity investments of CVCA members in the Czech Republic between 1999-2009 is shown in Fig. 3.

A noticeable surge in the value of projects in 2006 can be seen from Fig. 3. This increase was due to the investment in Česke Radiokomunikace where the total value of this transaction amounted to 1.2 billion EUR. Further, another sudden increase occurred in 2009 as a result of investment in StarBey the value of which exceeded 1 billion EUR. The growth of private equity investments in the Czech Republic in recent years was mainly due to the gradual expansion of managers' and entrepreneurs' awareness in these investments in the Czech Republic. Another positive factor can be seen in an increasing interest of the investment funds in investing in Central and Eastern Europe, which is mainly due to successful economic development of countries in this region [15].

Table II depicts the value of investments of *private equity* according to the enterprise life cycle and compares the Czech Republic with areas of Central and Eastern Europe and Europe as a whole.

Conclusion

For a company, mezzanine financing represents a financing layer lying in between the debt and equity. Enterprises currently use this funding mainly to improve the capital structure or, for example for their expansion. This kind of financing is very often used only as a complement funding to the debt or equity financing.

One of the key strength of the mezzanine financing is flexibility, where the equity and the debt financing components can be combined by the various financing preferences. Therefore, there is no typical mezzanine financing, so that individual, hybrid forms represent an alternative for example for the financing of SMEs [2].

The advantages of mezzanine financing can be seen especially in the fact that the provider of mezzanine financing does not interfere with the enterprise. Other advantages of this financing rest in the increase in the shares value or in the fact the mezzanine financing providers tend to become long-term investors. On the other hand, the drawback of the mezzanine financing might mean the mezzanine financing agreements may contain various restrictive conditions; mezzanine may be costly compared to the senior loan or a lengthy process of obtaining this capital. Although mezzanine financing can be one of the important sources of financing enterprises in the EU, it is used almost only in economically developed countries such as, for example, Germany. Even though the positive trend of EU mezzanine financing in recent years is taken into account, yet in the EU economies like the Czech Republic or Slovakia a significant improvement of the current mezzanine financing position fails to be expected.

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