

## MEZZANINE FINANCING INSTRUMENTS AS ALTERNATIVE SOURCES OF FINANCING INDUSTRIAL ENTERPRISES

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### Abstract

The paper deals with mezzanine financing instruments as a possible source of financing large industrial enterprises. Mezzanine financing instruments represent a hybrid form of funding combining the debt and equity features. Generally, these instruments can be considered as suitable tools for financing large enterprises with capital-intensive manufacturing, such as metallurgical, chemical, or machinery industry enterprises. These enterprises can use them both for implementation of development projects and for restructuring projects. However, there is a whole range of mezzanine financing instruments, and each of them has its specific characteristics. The authors of the paper aimed to compare the advantages and disadvantages of individual mezzanine financing instruments, in particular of participating loans, participating bonds, subordinated loans, subordinated bonds, convertible bonds, bonds with warrants, silent participations and preferred stocks. Individual instruments were evaluated on the basis of the identified key factors, which included the volume of the provided capital, its availability for enterprises of different sizes, individual conditions concerning its provision and repayment, the limiting conditions from the side of the creditors, non-extension of the control over the corporate activities, the increased demands on the credit capacity of the enterprise, improvement of the company creditworthiness, the financial risk growth, the sanctions for non-payment, participation of the provider in growing profits or incurred losses, tax deductibility of payments, the necessity of securing, and the existence of issue costs. The evaluation was performed using the binary scale, where individual instruments were subsequently compared with each other.

**Keywords:** debt, equity, mezzanine capital, mezzanine financing instruments, industrial enterprises

### 1. INTRODUCTION

In the present demanding conditions of the economic world, where businesses are faced with the negative macroeconomic impacts of the fading away, but also threatening economic crisis, where they are threatened by growing competition, especially from Asian countries, where the growing public budget deficits result in an increase in the tax load of all economic entities, any future existence and prosperity of enterprises is conditioned by utilization of unconventional economic tools, procedures and practices. For quick, quality and often individual satisfaction of the customers' needs and requirements, it is more and more important to manage information, material and financial flows. Therefore, we can see permanent development and implementation of new concepts, techniques and practices enhancing the value through collaboration [1]. From the point of view of corporate financial management, mezzanine financing instruments can be considered as innovated tools.

Mezzanine financing instruments, which connect the features of debt and equity, are mainly suitable for large industrial enterprises, such as enterprises dealing with acquiring and processing of metals and their alloys. Such businesses can use them both in implementation of development projects of a long-term character, and to increase the financial flexibility, or in the capital structure optimization, where the enterprise is subsequently able to react more quickly and more accurately to the permanently changing market conditions, which leads to larger creation of financial sources.

However, mezzanine financial sources now stand outside the main interest of Czech finance managers. One of the reasons is the fact that company managers are afraid, as a consequence of the effects of a number of risk factors, to use new and unconventional financial instruments, as they do not have sufficient knowledge of this way of financing or experience connected with its application. But in fact, mezzanine financing as an alternative source of funding of corporate needs can represent an important opportunity for entrepreneurial entities, and its suitable utilization can support fulfilment of the top corporate objective, which is maximization of the corporate market value.

The presented paper aims to compare the advantages and disadvantages of individual mezzanine financing instruments with respect to the possibilities of their utilization by industrial enterprises in the Czech Republic. The benefits of the presented paper can be seen in the extension of the knowledge of advantages and disadvantages of mezzanine financing instruments both in the line of individual instruments and in their mutual relations with respect to the current conditions in the Czech Republic. The novelty of the contribution consists in elaboration of the overall evaluation of mezzanine financing instruments as a possible source of financing of industrial enterprises, which still has not been created.

## **2. MEZZANINE FINANCING**

Mezzanine financing "is inserted into company's capital structure between the "floor" of equity and the "ceiling" of senior, secured debt" [2]. According to Silbernagel & Vaitkunas [3] mezzanine "generally refers to that layer of financing between a company's senior debt and equity, filling the gap between the two". Svedik & Tetrejova [4] state that mezzanine financing presents "a hybrid form of funding that has both the features of debt financing and the features of equity financing".

In the financial theory and practice, we can find various types and instruments of mezzanine financing, and each of them has its own and very often unique characteristics.

Meluzin and Zinecker [5] distinguish, from the point of view of the corporate balance, equity mezzanine and debt mezzanine. Under the term of equity mezzanine, they include mezzanine financing instruments with a higher rate of the equity, which are silent participations and preferred stocks. The term of debt mezzanine includes mezzanine financing instruments with higher debt tendency, which are participating debts (which can be in the form of loans or bonds, the authors' comment), subordinated debts (which can be in the form of loans or bonds, the authors' comment), convertible bonds and bonds with warrants.

Another view of the types of mezzanine financing is offered by the European Commission [6], Vasilescu & Popa [7] or Tetrejova [8], who distinguish, from the point of view of public tradability, private and public mezzanine. Private mezzanine includes mezzanine instruments that are not publicly tradable, i.e. participating loans, subordinated loans and silent participations. Public mezzanine includes mezzanine instruments that are publicly tradable on the capital market, i.e. participating bonds, subordinated bonds, convertible bonds, bonds with warrants and preferred stocks.

## **3. MEZZANINE FINANCING INSTRUMENTS**

Individual mezzanine financing instruments are characterized by specific features determining their advantages and disadvantages. Now, we will focus our attention to the basic characteristics of individual mezzanine financing instruments.

Participating loans represent loans similar to classic loans, from which they differ by the way of specifying the yield [9]. These loans do not have a fixed interest rate, but the payment for the loan depends on the economic results of the enterprise, as it is in the case of equity, where the yield attains the form of a dividend or a profit share [10].

Participating bonds represent an analogue of classic corporate bonds, from which they differ by the way of specifying the coupon payments, which are dependent on the economic results of the issuing enterprise and specified as a profit share determined in advance [11]. Therefore, these debt financial sources have, in this respect, very similar characteristics as the equity.

Subordinated loans represent loans whose providers are not, in the case of the enterprise's bankruptcy, entitled to settlement until all the liabilities towards the classic loans providers and other creditors have been settled [12]. The equity providers are then paid off after the creditors providing a subordinate loan [13]. Subordination is a reason for classifying these loans among mezzanine financing instruments; the thing is that it is a feature that is typical for the equity [14].

Subordinated bonds represent corporate bonds connected with the right to settlement of the liabilities (redemption of the nominal value and payment of the appropriate yield) in the case of bankruptcy, to settlement of the liabilities towards all the other creditors, with the exception of the liabilities with the same condition of subordination. At the same time, the owners of subordinate bonds are settled before the equity providers [15]. In this case, subordination is the reason why they are classified as mezzanine financing instruments.

Convertible bonds combine both the rights connected with holding of a classic bond, and the right to exchange of this bond for another security of the given issuer [16]. Mezzanine instruments include convertible bonds that are exchangeable for preferred or common stocks, i.e. such convertible bonds that combine the features of debt and equity. Exchange of a convertible bond for the company stocks is made possible for the investor thanks to the call option [17, 18, 19, 20], which is inseparably connected with this bond [21]. This option entitles the convertible bond holder to decide whether to use the conversion right within the specified period and obtain stocks of the given enterprise, or not to use the conversion right and in such a case to receive the nominal value of the bond [22].

Bonds with warrants represent bonds connected with the possibility of buying newly issued stocks of the given issuer [23]. However, bonds with warrants combine the features of debt financial sources representing the rights, connected with holding of a classic bond, and the features of the own financial sources in the form of the possible purchase of stocks. The bond holder is provided with the right of purchase by the warrant. It can be traded as an integral part of the bond with warrants, or it can be separated from the bond with warrants and traded separately [24].

Silent participations represent provision of investments into the enterprise by silent partners, who thus share the business activities of the given enterprise [25]. The enterprise then undertakes to pay the silent partner a part of the net profit in accordance with the agreed conditions [26]. Within silent partnerships, a silent partner participates in any profits and in any losses made by the given entrepreneurial entity to the same extent [14]. This financial source belongs to the oldest ways of corporate hybrid financing. The reason why it is classified among mezzanine financing instruments is the fact that it is a capital investment into an enterprise, where the silent partner shares the profit and the loss, and this partnership is conditioned by a special type of a contract on the basis of which the given enterprise is obliged to give the investment back to the silent partner within the specified period [26].

Preferred stocks represent a corporate financial source combining both the features of the equity (common stocks), and the features of the debt capital (particularly of corporate bonds) [27]. They entitle the investors to a share in the assets, but not to take part in making decisions about the business [28]. By issuing preferred stocks, enterprises increase their equity, but the existing ratio of voting rights of the company owners remains unchanged [29]. The rates of dividends are fixed, and thus preferred stocks resemble debt instruments.

#### 4. EVALUATION OF MEZZANINE FINANCING INSTRUMENTS

This part presents overall evaluation of pros and cons of mezzanine financing instruments in the forms of participating loans, participating bonds, subordinated loans, subordinated bonds, convertible bonds, bonds with warrants, silent participations and preferred stocks.

The evaluation was performed using the binary (nominal) scale [30], which is based on the operation of conformity (or variance), which is defined by binary logic code “1”, or “0”. The alternative, in this case the mezzanine financing instrument, meeting the evaluated criterion (the specified desired feature is present) obtains binary code “1”, while the alternative that does not fulfil the evaluated criterion (the specified desired feature is not present) obtains binary code “0”. Subsequently, the positive values are added up, and the alternative with the highest number of responses “yes”, i.e. “1”, is preferred.

For the purpose of application of the evaluation using the binary scale, the assessed criteria, i.e. pros and cons, were expressed as the positive (desired) features. They are the criteria that were identified as fundamental from the point of view of the important experts in the given area, i.e. Ehrhardt & Brigham [31], Ostrizek [32], Svedik & Tetrevoa [33], Tetrevoa [34], Valach [35] and also the outcomes of the directed interviews performed with representatives of selected commercial banks as bank loan providers and security issue intermediaries and finance managers of selected industrial enterprises as persons making decisions about utilization of individual forms of capital. The following 14 criteria were identified as the key criteria - the possibility of obtaining a significant volume of capital, availability of the given financial source for businesses of all sizes, special conditions of provision and repayment of the financial source, also the fact that potential creditors will not set any limiting conditions, the fact that application of the given instrument will not result in a wider control (voting rights) over the enterprise, or that the demands placed on the credit capacity of the enterprise will not grow or, by contrast, the possibility that the creditworthiness of the enterprise will improve, that the financial risk will not increase (as a result of an increase in the share of debts in the total capital), the fact that the company will not, in the case the payment of the yield or the potential payment of the nominal value are not performed in time and at the proper amount, face any serious functions, the fact that the financial source provider will not share the growing profits but, by contrast, will share a potential decrease in profits or potential losses, also the possibility of using the interest tax shield, and the absence of securing and issue costs. **Table 1** shows the evaluated criteria and the outcomes of the performed evaluation.

**Table 1** implies that, on the basis of the performed evaluation, silent participations took the first place and preferred stocks, i.e. both representatives of equity mezzanine instruments, the second. Debt mezzanine instruments occupied the next places. The third place was taken by subordinated loans, the fourth by subordinated bonds, the fifth by participating loans, and the last, the sixth, place was taken by participating bonds, convertible bonds and bonds with warrants. The above shows that equity mezzanine sources are connected with a higher number of pros unlike debt mezzanine sources. From the point of view of private and public mezzanine, the differences are not so significant, but within individual categories of instruments the private mezzanine instruments (i.e. particularly loans or silent participations) come before the public mezzanine instruments (i.e. securities).

#### CONCLUSION

The necessity of permanent responding to the changing market conditions makes company managers search for new tools, procedures and practices. In the area of financial management, mezzanine financing instruments can be considered as such tools. In practice, we can meet a number of these instruments, where each of them has unique characteristics determining their advantages and disadvantages. The authors of this paper aimed to introduce these instruments and evaluate and compare their strengths and weaknesses focussing on their utilization by large industrial enterprises in the conditions of the Czech Republic. The paper implies that so-called equity mezzanine instruments (silent participations and preferred stocks) can be considered as more

advantageous in comparison with debt mezzanine instruments (subordinated loans, subordinated bonds, participating loans, participating bonds, convertible bonds and bonds with warrants). Private mezzanine instruments then proved to be more advantageous than public mezzanine instruments within individual categories.

**Table 1** Evaluation of mezzanine financing instruments using the binary scale

Evaluated criterion	Mezzanine financing instruments							
	Participating loans	Participating bonds	Subordinated loans	Subordinated bonds	Convertible bonds	Bonds with warrants	Silent participations	Preferred stocks
1. Big volume of the capital	0	1	0	1	1	1	0	1
2. Availability for businesses of all sizes	1	0	1	0	0	0	1	0
3. Special conditions	1	0	1	0	0	0	1	0
4. Creditors set no limitations	0	0	0	0	0	0	1	1
5. No possibilities of extended control over the corporate activities arise	1	1	1	1	0	0	1	0
6. Demands on the corporate credit capacity do not increase	0	0	0	0	0	0	1	1
7. Improvement of corporate creditworthiness	0	0	1	1	0	0	1	1
8. Financial risk does not increase	0	0	0	0	0	0	1	1
9. No threat of sanctions if a payment is not performed in time and at proper amount	0	0	0	0	0	0	1	1
10. Financial source provider does not share growing profits	0	0	1	1	1	1	0	1
11. Financial source provider bears consequences of decreased profitability	1	1	0	0	0	0	1	0
12. Tax deductibility of payments	0	0	1	1	1	1	0	0
13. Absence of security in the form of a pledge	0	1	0	1	1	1	1	1
14. Absence of issue costs	1	0	1	0	0	0	1	0
$\Sigma$	5	4	7	6	4	4	11	8
<b>Order</b>	<b>5</b>	<b>6</b>	<b>3</b>	<b>4</b>	<b>6</b>	<b>6</b>	<b>1</b>	<b>2</b>

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