MEZZANINE DEBT: BENEFITS OR DRAWBACKS FOR FIRM'S FINANCING?

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Abstract: Mezzanine finance is an alternative source of finance to debt and equity and it can be helpful in financing the start-up and firms' expansion. But in order to take their investment decisions, the firms should compare the benefits and challenges generated by this form of financing in function of their development stage or the specific features of their activities. Despite the fact that mezzanine finance instruments are gaining in importance, and the advantages overtake the disadvantages, they still remain little used compared with traditional forms of financing (loan financing).

JEL classification: G32, M21

Key words: mezzanine debt, financing, firm, benefits, disadvantages

Introduction

Nowdays the access to finance become more and more restrictive: the existing credit lines have been reduced and new loans from traditional lenders are difficult to obtain. Also, the access to the public capital markets is virtually non-existent.

Moreover, in the new circumstances generated by the international financial crisis, the firms have to face the difficult economic condition and an increasing need for major investments. Also, the continuing turmoil from the financial markets made lenders more risk averse and consequently, they continue to reduce the availability of credit and limit leverage (von Bradsky and French, 2008). Therefore, alternative forms of financing such as mezzanine debt are becoming more and more a supplement to the traditional forms of corporate financing for firms (Brokamp et all, 2004), (Glen, 2006).

As a hybrid form of capital, mezzanine debt is placed between senior debt and equity in a company's capital structure and it is used whenever there is a financing gap between the two layers (Abassi, 2004).

In fact, the term "mezzanine" (from the Italian "mezzanino") derives originally from architecture and denotes an intermediate floor between two main floors in a building (Credit Suisse, 2006). Structurally mezzanine debt is subordinated or "junior" in priority of payment to senior debt, but senior to common stock or equity (Silbernagel and Vaitkunas, 2006).

Because to its hybrid nature, mezzanine capital has a range of advantages compared with traditional forms of corporate financing, which allow it to be used for financing the SMEs, as well as the larger companies. Also, mezzanine financing can provide additional capital to middle-market businesses in a manner gaining understanding and acceptance throughout the capital markets (Sprink, 2003).

Mezzanine capital typically is used to fund a growth opportunity, such as an acquisition, new product line, new distribution channel or plant expansion.

The last decade, the role of mezzanine debt gradually moved into different field of lending as a result of an increasing awareness of the many different forms it can take and its potential advantages and benefits for borrowers, shareholders and commercial lenders.

Mezzanine Debt - definition and main characteristics

Mezzanine debt refers to that layer of financing between a company's senior debt and equity, in a three layer structure of a firm's capital, (figure 1).

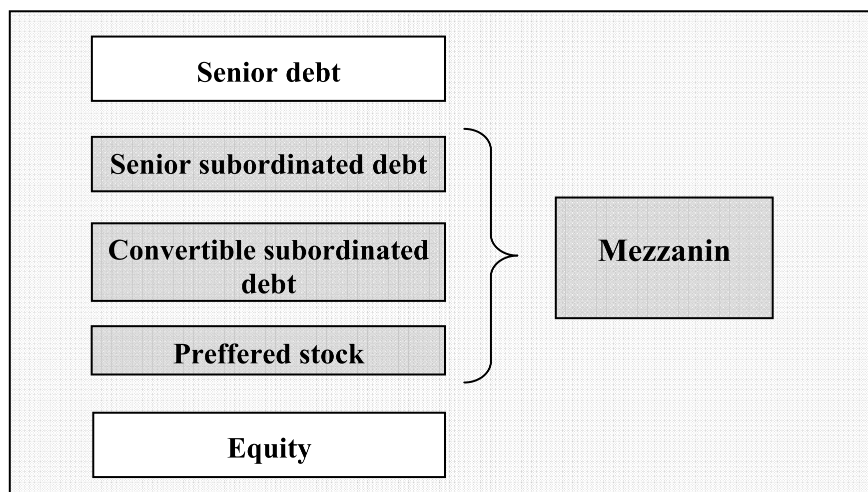

Figure no. 1 Mezzanine debt – bridging the gap between debt and equity
Source: Silbernagel, C., Vaitkunas, D., Mezzanine Finance, Bond Capital, Jan. 2006

The three layer structure consisting of senior debt, mezzanine debt and equity is the most commonly used in the private equity world. Each layer is different and has its own unique characteristics and its own risk/reward profile:

- First layer - *Senior Deb* which involve low risk, low cost, short term and is the least flexible. This is the most common form of financing used by businesses. It is generally the least expensive form of capital and has first priority in the event of liquidation (Jamison and Bitoni, 2007);

- Second layer - *Mezzanine Debt* involve a moderate risk, moderate cost, long term, flexible. Structurally, the mezzanine debt is subordinate in priority of payment to senior debt, but senior in rank to common stock or equity. Mezzanine debt generally has a higher risk and potential return than senior debt but a lower risk and potential return than equity (Carew, 1996);

- Third layer - *Equity* which involve high risk, high cost, long term and it is the most flexible.

Regarding the using of the three layer structure the followings should be mentioned:

- each layer of capital can be used on its own or in conjunction with other layers in varying degress for any given transaction;

- there is no rule that requires equity to be used in every transaction nor is there a rule that requires senior debt or mezzanine debt to be used in every transaction;
- each of these layers has advantages and disadvantages and can be mixed and matched to fit the unique needs of each business.

In a broader sense, mezzanine debt may take the form of convertible debt, senior subordinated debt or private "mezzanine" securities (debt or preferred equity) (Credit Suisse, 2006).

The most common form of mezzanine debt is the *subordinated debt,* which is an unsecured loan with a lower ranking in case of bankruptcy compared to senior debt. Providers of subordinated loans receive a fixed interest rate and are ranked before equity investors should the borrower be wound up.

Participating loans are normal loans, but rather than there being a fixed return, their remuneration is contingent upon the results of the business. Despite sharing in profits, participating loans do not give rise to an ownership relationship. Participation in losses is contractually excluded.

In legal terms, a *"silent" participation* is closer to a stockholding than a subordinated or participating loan. The distinguishing feature of this form of financing is that one or more persons take an equity stake in a company, but without assuming any liability to the company's creditors. The typical "silent" participation affects only the company's internal affairs and is not apparent to outside observers. Participation in profits and losses and contractual rights of approval and control are structured flexibly.

There are also equity related mezzanine finance instruments. These instruments present a greater risk profile to the lender and, in turn offer a higher rate of return. Mezzanine products with *profit participation rights* are more related to equity and under company law the holder is entitled to rights over the company's profits. In general the financier has no voting or management rights. However, the instrument is rather flexible and the right to be consulted on business decisions can be included in the contractual documents.

A further equity mezzanine financing instrument is the *convertible bond.* In addition to the usual right to fixed interest payments and repayment of principal, holders of convertible bonds or bonds with warrants have the right to acquire shares in the company instead of accepting repayment of the bond. This right is exercisable for a defined period and at a predetermined conversion or subscription rate. This way the issuer may convert debt into equity.

Another equity mezzanine financing instrument is the *bond with warrants*, which in principal is similar to the convertible bond. The main difference is that the warrants (subscription rights) are separate from the bond and thus can be traded independently.

A common feature of these various instruments is that they can be combined in many different forms and offers flexibility with numerous amortization and interest payment scenarios in order to provide tailor-made solutions for the specific financing requirements of private and listed companies.

The mezzanine finance can be a complementary source of finance to debt and equity and can be helpful in financing the start-up and expansion, innovation and business transfers (figure 2).

The types of transactions that are typically financed through mezzanine debt are: capital to finance acquisitions and investments; buy outs such as management and

leveraged buyouts; buy-ins; recapitalizations; middle to late stage expansion or growth capital; divestitures; recapitalizations; public to private transactions.

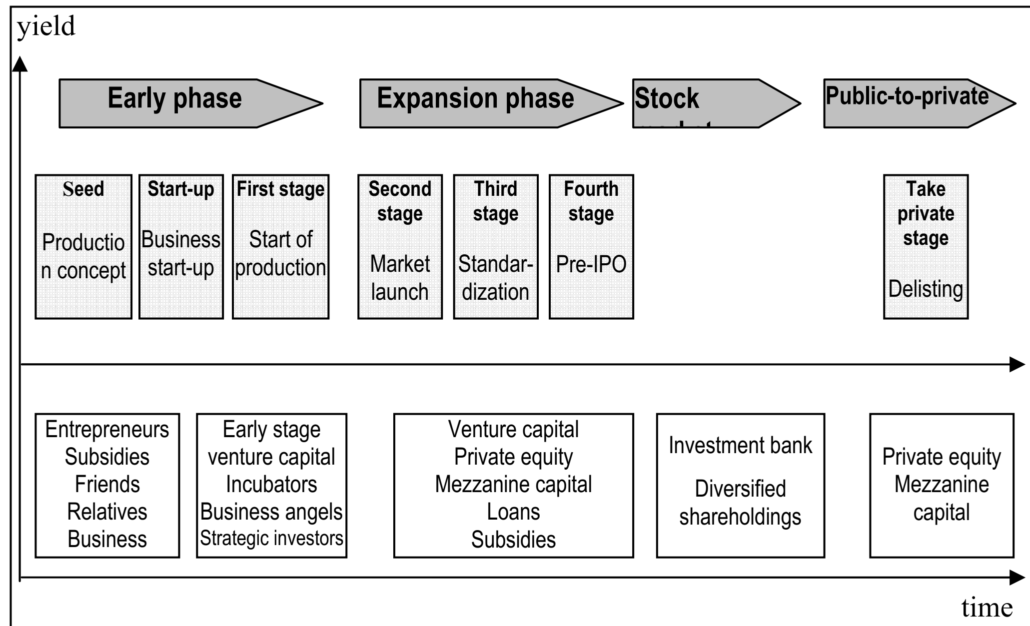

Figure no. 2 Phases in a firm's development and financial instruments

Source: European Commission, Mezzanine Finance. Final Report, Roundtable between bankers and SMEs, Enterprise Publication, 2007

Companies considered "ideal" mezzanine transactions have consistent historical cash flows, a diversified base of customers, a proprietary product, a market and/or a technology edge, an experienced management team and a well capitalized balance sheet. Additionally, mezzanine investors seek to invest in companies in which the management team owns a sufficient equity stake to ensure that the team is adequately motivated to build a successful company (Abbasi, 2004).

Pros and Cons for using the mezzanine debt

In general, mezzanine debt is a flexible financing alternative for companies which fulfill the following requirements:

- insufficient/unavailable possibilities for funding from own resources or loans;
- healthy financial position, stable cash flows and steady profit growth;
- focused business strategy and long-term development prospects;
- appropriate finance and accounting function, open information policy.

In order to make their option for this form of financing, the firms should take into consideration the advantages and disadvantages of the mezzanine debt.

Mezzanine finance products usually have the following positive features:

- improves the balance sheet structure;
- offer a better access to additional loans or equity (leverage effect) because the confidence of a mezzanine capital provider increases the image of the company;
- greater entrepreneurial freedom for the company and limited right of mezzanine investor to be consulted. The company can retain control over the company

and avoid surrendering ownership rights, using the appropriate form of mezzanine finance, because mezzanine investors do not usually seek the right to be consulted and to participate in the management of the investee company;

- strengthens economic equity capital without the need to dilute equity holdings or surrender ownership rights;
- stability of financing given its long-term availability;
- offer tax-deductible interest payments;
- the flexible remuneration of a mezzanine instrument. Thus, the standard arrangement includes, in addition to an interest component, a performance-related bonus in the form of a share in the performance of the company, or an option to acquire or receive equity interests;
- it can be a very useful financial tool in the cases of business expansion, business transfer, innovation and public to private transactions.

Also, it should be taken into consideration that most mezzanine loans are from five to seven years in length, with the possibility of early repayment. Repayments are often not required until maturity, unlike bank debt, which usually requires amortization. Thus mezzanine financing allows a business owner to reinvest cash flow in growth opportunities rather than paying back senior debt.

Amounts attracted via mezzanine financing can be substantial. A company can leverage its cash flow and obtain senior debt between two times and 3.5 times cash flow. With mezzanine debt, it can raise total debt to four to five times cash flow depending on the risk appetite in the debt markets (von Bradsky and French, 2008).

The companies with foreign operations may get additional benefits of:

- alignment of the shareholder base with the asset, revenue, profit, tax and customer bases;
- further cost of capital improvements that can arise from some cross-border structures.

But mezzanine finance provides also some disadvantages for the firms:

- mezzanine debt is more expensive than debt financing. Mezzanine capital should therefore be seen as complementary to traditional debt capital and appropriate only in cases where the funding requirement is larger than the amount that can be raised using conventional debt financing and equity resources;
- mezzanine debt is often difficult to obtain by small firms because there are more stringent transparency requirements to meet in order to obtain this type of finance;
- the interest component and the debt-like characteristics of mezzanine finance make it difficult for suppliers of mezzanine finance to arrange an early exit;
- mezzanine debt is an unsecured form of financing that is principally a loan relying on an "equity kicker" – usually a warrant – to boost the return on the loan to compensate for the greater risk inherent in a junior position to a senior lender (Abassi, 2004);
- in contrast to equity capital, mezzanine funds are generally made available for a limited period of time, until the business can generate sufficient "genuine" equity capital from retained profits;
- this form of financing is not appropriate for particular types of company and business phases. Therefore, the mezzanine is unsuitable for financing restructurings; the companies with a weak market position and negative development prospects; with inadequate finance and accounting function; with high leverage or low equity resources.

From the investors' perspective, mezzanine debt have also some advantages, as follows:

- access to a new investment segment;
- investment platform independent of stock and bond markets;
- optimal opportunities for diversification;
- the revenues for providers of mezzanine finance are higher than for debt;
- mezzanine lenders can provide valuable strategic assistance;
- lower exit risk and better protection of capital compared with private equity investments because in the case of mezzanine finance the contract usually provides for the repayment of the principal, and the remuneration of the instrument is covered by the company's cash flows.

There are also few disadvantages of mezzanine finance for investors such as:

- the difficulty to exit early and the wrong assessment of creditworthiness leads to lower returns;
- the mezzanine provider cannot rely on real security in making an investment decision because mezzanine capital is subordinated and unsecured. The ability of a company to repay capital raised therefore depends largely on the total cash flows it will be able to generate in the future. Consequently, it is an important precondition for raising mezzanine capital that the earning power and market position of the existing business should be well established and stable.

Conclusions

Mezzanine debt is a collective term for hybrid forms of finance: it has features of both debt and equity. Thus, the key feature of the mezzanine debt consist on the followings:

- subordinate financing (to debt capital);
- no collateral required;
- serves as economic equity and helps to strengthen the company's equity ratio;
- allows additional borrowing if necessary (leverage effect);
- long-term financing and repayment at end of maturity;
- flexible pricing (fixed and variable components).

In a company's capital structure, mezzanine debt is subordinated to senior debt but ranks ahead of equity. It carries a higher rate of interest than senior debt and is often bundled with warrants on the company's equity. Beyond these common characteristics, mezzanine securities can be designed to meet a broad range of financing needs and risk/return targets by combining various structural features. Together, these features can create compelling investment opportunities, combining the relative security of a debt instrument, attractive cash flow characteristics and the potential to participate in the profits of the borrower.

As alternative source of finance to debt and equity, mezzanine debt can be can be raised for a variety of purposes by the firms, such as:

- acceleration of organic growth or expansion into new markets;
- enabling capital for an identified acquisition;
- partial liquidity events for estate planning purposes (e.g., recapitalizations);
- restructuring debt mix to reduce reliance on senior debt.

Because of its hybrid nature, mezzanine capital combines the benefits of debt and equity finance, such as: protection of ownership rights, no dilution of existing holdings, stability of financing given its long-term availability; ease of budgeting

thanks to fixed-interest agreements; improvement in balance sheet structure. By mixing the characteristics of debt and equity instruments, mezzanine debt provides borrowers with financial flexibility and investors with attractive risk-adjusted returns and current cash flow.

On the other side, the mezzanine finance provides also some challenges for firms: it is more expensive than debt financing; the difficulty in obtaining the mezzanine debt because there are more stringent transparency requirements; capital is provided for a limited term in contrast to pure equity capital. For the investors, the fact that the mezzanine capital is subordinated and unsecured can generate a lack of security in making an investment decision.

In spite of the obstacles, the mezzanine debt is an alternative worth exploring for firms and an useful tool in corporate finance because it can be negotiated and structured to precisely meet the financial requirements of a company. The mezzanine debt market is very sophisticated and the loan structuring possibilities are limited only by the creativity of the negotiators.

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