MEZZANINE FINANCE AND CORPORATE BONDS

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1. Introduction

Mezzanine finance represents a relatively new form of financing the corporate activities in local conditions of transformed economy (e.g. the Czech Republic, the Slovak Republic or Rumania). 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.

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 of corporate activities. This is addressed in mezzanine finance.

Some of its tools are based on classical instruments which have been innovated – such as special types of corporate bonds, while others are completely new.

The aim of this article is to show the possibilities of using corporate bonds as instrument of mezzanine finance during the process of corporate financing.

2. Mezzanine Finance
2.1 Basic Concept of Mezzanine Finance

Mezzanine finance represents a hybrid form of debt and equity financing that is typically used to finance the expansion of firms. *Typical situations* for mezzanine financing are:

- corporate restructuring (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.);
- ownership restructuring (changes of ownership structure, especially mergers and acquisitions or joint ventures);
- recapitalizations;
- emerging growth opportunities.

Mezzanine finance can use firms with following characteristics (Marks and co-authors, 2005; Invest Mezzanin, 2004):

- operationally and financially stable firms;
- sustainable and consistent business model;
- positive operating cash flow;
- strong management;
- insufficient senior financing;
- insufficient collateral;
- high leverage;
- not a turnaround situation.

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 finance presents an important alternative to other forms of corporate financing. Firms with optimal capital structures can use a number of financial sources including mezzanine financing. Table 1, Table 2 and Table 3 outline main characteristics and differences among key types of financial sources. Figure 1 outlines alternative long-term

financial sources and the role of mezzanine in corporate capital structure.

Table 1: Characteristics of Senior Debt

	Senior Debt
Typical structure	Revolving Debt
Investment Horizon	Short Term
Risk Tolerance	Low
Return Expectation	< 10 %
Current Coupon	Floating Rate
Hidden Costs	Personal Guarantees
Customization Ability	Rigid Standards
Seniority/Security	Senior Lien
Equity Dilution	None

Source: HENRY, D.: Opportunities, Trends and Issues in Mezzanine Finance [on-line]. [Cit. 2008-29-09]. https://events.cobioscience.com/docs/David_Henry.ppt.

Table 2: Characteristics of Mezzanine Debt

	Mezzanine
Typical structure	Debt with Warrants
Investment Horizon	Long Term
Risk Tolerance	Medium
Return Expectation	18 – 25 %
Current Coupon	Fixed Rate
Hidden Costs	None
Customization Ability	Flexible Standards
Seniority/Security	Junior Lien
Equity Dilution	Low

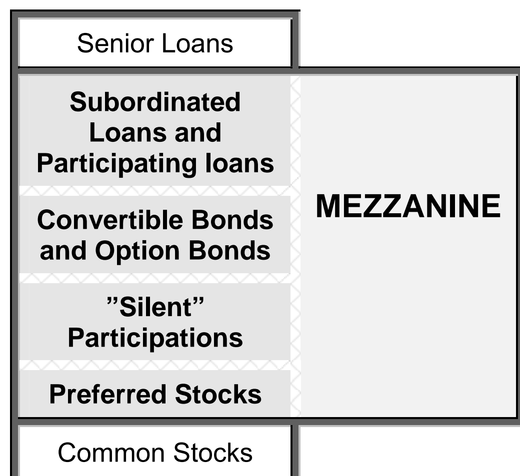
Source: HENRY, D.: Opportunities, Trends and Issues in Mezzanine Finance [on-line]. [Cit. 2008-29-09]. https://events.cobioscience.com/docs/David_Henry.ppt.

Table 3: Characteristics of Private Equity

	Private Equity
Typical structure	Preferred Stock
Investment Horizon	Long Term
Risk Tolerance	High
Return Expectation	35 %++
Current Coupon	n/a
Hidden Costs	Loss of Control
Customization Ability	Flexible Standards
Seniority/Security	Unsecured
Equity Dilution	High

Source: HENRY, D.: Opportunities, Trends and Issues in Mezzanine Finance [on-line]. [Cit. 2008-29-09]. https://events.cobioscience.com/docs/David_Henry.ppt.

Figure 1: Role of Mezzanine in Capital Structure



Source: Own.

2.2 Instruments of Mezzanine Finance

There are various types of mezzanine finance (Vasilescu and Popa, 2006; European Commission, 2007), each having its own unique characteristics. We can differentiate two main types of mezzanine finance - private mezzanine and public mezzanine.

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

Subordinated loans are unsecured loans. This type of loans has a lower ranking in event of bankruptcy compared to senior debt.

Participating loans present normal loans; their remuneration is depended on the results of the business (actual profit). 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 accepting any liability to the company’s creditors.

The public mezzanine instruments are: convertible bonds, option bonds and preferred stocks.

Convertible bonds and *option bonds* are characterized in details in chapter 3.2.

Preferred stocks 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.

We can summarize that **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 stocks;
- *Image of the company* - the confidence of a mezzanine capital provider increases the image of the company.

3. Corporate Bonds

3.1 Basic Concept of Corporate Bonds

We should to define the basic terms that are closely related to the problems of corporate bonds – a promissory note, a bond, a draft, and it is also necessary to define their mutual relationships.

The most general one from the above terms is the term **promissory note**. It is a legal document confirming the debtor’s obligation to pay back the debt and some interest within an agreed period. Promissory notes can be issued in series or individually, for long or short periods. As for the volume of the issue and the maturity, we can divide promissory notes into two basic types: bonds and drafts. Apart from these two basic types, there can be some other special types of promissory notes.

Bonds are promissory notes usually issued in big series for long periods (their maturity is longer than one year) and they are usually also publicly tradable. ***Drafts*** are promissory notes issued individually, usually for a short period (their maturity is usually shorter than one year).

Bond represents a long-term, in series issued, usually publicly tradable, owing security (promissory note), confirming the issuer’s commitment to pay the owner of the bond yields and settle the nominal value at fixed dates.

Bonds can be issued by different entities – a company, a bank, a state, a community or a region. Bonds issued by entrepreneurial entities are called corporate bonds, or industrial bonds (In the Czech Republic corporate bonds can be issued by legal entities only that were established at least two years ago and that have approved and audited at least two last successive final accounts, see

Act No. 190/2004 Coll., on bonds; as amended, Article 3, Section 1.). They are bonds that are issued by industrial, trading, and also e.g. transport companies or service-providing companies.

Corporate bonds represent a security, i.e. a document or a record on a certain data medium, expressing the owner's receivable from the entity that issued the security. It is a long-term security, i.e. with maturity longer than one year; it is usually issued in series; it is usually also publicly tradable, i.e. this security can be bought or sold on public markets; an owing or credit security, based on a credit relationship, when the investor buys this security with the condition that the debtor shall settle the lent sum plus the interest within the stipulated period. Corporate bonds are issued by entrepreneurial entities, i.e. entities carrying out entrepreneurial activities for the purpose of gaining profit. They confirm the commitment (obligation) of the issuer (debtor) to pay the owner (holder, creditor, investor) yields (annuity, fee paid for provision of capital), which can be of different characters and frequency and, in addition to that, settle the principal (nominal value) by specified dates.

3.2 Type of Corporate Bonds

In the market economies, you can meet a number of different types of corporate bonds. Corporate bonds can be assorted from the point of view of character of issue, when they can be divided according to a number of other related criteria (See Tetřevová, 2006).

The basic assorting aspect for their classification is the character of issue. As for the character of issue, corporate bonds can be further classified according to:

- character of yield;
- way of redemption;
- guarantee;
- country and currency;
- form;
- secondary tradability and other rights

As for the **character of yield**, corporate bonds are divided into corporate bonds with fixed interest, those with floating interest, profit bonds and bonds with a zero coupon. *Fixed income bonds* present bonds with a fixed interest rate derived from the market interest rate at the moment of issue, from expected trends in bond rates, from the trend of inflation, etc. *Floating rate bonds* represent bonds with variable interest rates. A typical feature of these bonds is the fact that they do not have a fixed interest rate, but their interest rate changes in relation to the changes in the market conditions. The changes in the interest rate can be derived either from the inter-bank rates of interest - PRIBOR, LIBOR, etc. In the case the changes in the interest rate are derived from the inflation rate changes, we call them *index bonds*. *Profit bonds* are bonds equipped with the right to sharing the profit. Profit bonds exist in two forms. As for the first form of a profit bond, its owner gets, in addition to the fixed interest, a share of profits defined with a certain method (it is usually defined in certain proportion to a dividend). The second form of these bonds is not connected with a fixed interest, but only with a certain right to profit. *Bonds with a zero coupon* are not connected with a regular disbursement of interests, but their selling price is deep below their nominal value. The investors yield is then represented by the difference between the price the investor paid and the nominal value, the investor will be paid at the bond maturity date (it is a so-called discount).

As for the **method of redemption**, corporate bonds are divided into single-payment bonds and bonds payable in instalments, convertible and callable corporate bonds. *Single-payment bonds* are bonds that are redeemed at once at the time of their expiry. *Bonds payable in instalments* - their redemption starts by expiry of a certain period after the issue, and it is carried out on the basis of a given schedule of instalments

(redemption). Some bonds can be gradually redeemed, and for this purpose the bonds are issued in several issues with different maturity. But also, individual bonds can be redeemed partially. *Convertible bonds* are corporate bonds that are connected with the right to exchange for other bonds or stocks 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. Redemption of corporate bonds can be performed by call - *callable bonds*. The right of call can be on the side of the issuer of corporate bonds - the call option. So within a certain period the issuer has the right to buy out some or all bonds from their owners for the price specified in advance, which is higher than the nominal value. However, the owners of corporate bonds might also have the right of cancellation - the put option. It is the right of the bond owners to sell them to the issuer at the given terms for the specified price. This right is usually connected with meeting or not meeting certain conditions.

As for the **guarantee**, the bonds can be divided into guaranteed bonds and debentures. *Guaranteed bonds* can be secured with a certain type of the issuer's property, e.g. securities, real estates, facilities, or they can be secured by another entity, e.g. another company or bank. *Debentures* represent bonds that are not secured with any particular property or by another entity; they are guaranteed by the good name of the issuer only.

Bonds can be issued in different **countries and currencies**. From this point of view, we can divided bonds into *domestic bonds* - issued by a domestic issuer in the currency of the country where they were issued, *foreign bonds* - issued by a foreign issuer in the currency of the country where they were issued and *Eurobonds* - issued by a domestic or foreign issuer in a currency which is not the currency of the country where they were issued.

Bonds can be also issued in different **forms** - as documentary and dematerialized bonds. *Documentary bonds* represent certain paper instruments meeting statutory requirements. *Dematerialized bonds* present the securities that are registered in an electronic form.

Bonds can be **tradable** on public markets - *publicly tradable bonds*, or tradable in private - *publicly untradeable bonds*.

Issuers connect issued corporate bonds with **certain rights and benefits**; we can distinguish e.g. natural bonds, option bonds or priority bonds. *Natural bonds* are bonds connected with certain payments in kind. *Option bonds* enable their owner to get stocks of the given company. Differently from convertible bonds, the credit relationship does not cease to exist by taking the stocks; the bond holder keeps receiving interest until the maturity date. *Priority bonds* are bonds connected with certain benefits for investors, compared with other bonds. These can be, for example, the creditor's priority right to settlement of their receivable in the case of going into bankruptcy, declaration of insolvency or another settlement.

4. Conclusions

Corporate bonds represent an alternative source of financing. Certain types of corporate bonds represent also possible instruments of mezzanine finance. We can sum up that issuing corporate bonds can be used firstly for cash flow improvement, secondly for financial structure optimization, however also within ownership restructuring (Tetřevová, 2007).

Cash flow improvement can be achieved by applying measures in terms of profit rate, property and further by gaining external financial sources of both a long-term and a short-term nature. Corporate bonds are one of alternative external long-term sources.

Corporate bonds present an instrument that can be used by company managements to reach an optimal financial structure. Currently, the financial sources selection by Czech company managers complies with a hierarchical order theory.

Within a process of ownership restructuring corporate bonds can be applied in integrations in a form of acquisitions. They can also be used by strategic alliances based on a common property – either in a form of a holding or a joint venture. Corporate bonds may play their roles even in other types of ownership restructuring that may rest in an exchange of convertible corporate bonds for stocks or in setting up a claim with option bonds. Corporate bonds can be used as an active or preventive tool for protection against a hostile takeover as well.

As regards usage of corporate bonds - bonds provides the issuer a number of benefits (more flexible capital structure, significant volume of funds, interest tax shield, not require security and not rise ownership control), on the other hand, bonds are also connected with some drawbacks (significant costs of issue, necessity of high credit eligibility, yields and the principal has to be settled in time, certain limiting conditions).

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