A glance at the niche market of Mezzanine Finance

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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.

Keywords: Mezzanine Finance, Corporate Bonds, Debt Financing

Introduction
Mezzanine finance is often described as a ‘hybrid’ or ‘halfway house’, combining elements of debt and equity funding. And while that combination may seem to introduce an unnecessary degree of complexity into the funding equation, mezzanine finance can be an effective and relatively cost-effective way to finance growth strategies that entail an element of risk.

Mezzanine finance combines elements of debt financing and equity investment and can provide a relatively inexpensive alternative to private equity funding.

Content
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. 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.

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.

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.

The Benefits of Mezzanine Capital

- Non-amortizing, resulting in improved cash flows

Senior debt usually has a highly structured amortization schedule with relatively short maturities, often no more than three years for privately held companies. Most junior capital securities have longer maturities, usually five to seven years, with the principal paid at maturity. Because mezzanine financing does not require amortization during the term of the debt, companies are able to use the increased cash flow to: (i) pay down senior debt, (ii) invest in working capital, product development, or other expansion, or (iii) accumulate the cash on the balance sheet to take advantage of future unforeseen opportunities.

- Source of flexible long-term capital

As a rule, mezzanine financing offers significantly more flexibility in coupon structure, terms, and amortization than banks and senior debt providers. A mezzanine investment can easily be tailored to a company’s particular financial situation and concerns. Unlike a traditional bank loan, mezzanine
capital is unsecured and thus, requires no readily marketable collateral. Because mezzanine investors are more equity oriented than senior lenders, they tend to be more amenable to customizing their investment to meet the borrower’s financial, operating, and cash flow needs.

- A less expensive, tax-advantageous alternative to equity

Mezzanine capital, when utilized in conjunction with senior debt, reduces the amount of equity required in a business. Since common equity is the most expensive form of capital and is not tax deductible, mezzanine debt can create a more efficient structure that lowers the after-tax cost of capital, is less dilutive than equity financing, and enhances the return on equity.

Mezzanine financing offers other benefits to companies focused on optimizing their capital structures and expanding access to funding. Since mezzanine capital providers take a long-term view of a company, banks may look at firms with institutional investors in a more positive way, extending credit with more attractive terms and relinquishing the need for personal guarantees. Additionally, mezzanine investors help diversify a company’s funding relationships, reducing dependence on any one investor or lender.

**Considerations in Mezzanine Financing**

Of course, no single type of funding is perfect for every situation, and borrowers need to make sure that the lenders and terms are right for them. In addition, there may be certain business or transaction characteristics which make it difficult to utilize mezzanine financing. These attributes may include but are not limited to the following:

- High customer concentration
- Capital expenditure intensive business
- Lack of management
- Commodity-like products or services
- Cyclicality resulting in volatile cash flow
- A current debt to EBITDA ratio close to or exceeding the market value of the company

**The Problem with Mezzanine Funds**

Mezzanine and debt focused fund strategies are fraught with difficulties. Here are some of the roadblocks.

- **The Goldilocks Principle.** This principle which dictates that the size of a deal can’t be too big or too small, but just right. Inherently, the mezzanine loan holder needs the ability to take over the senior loan should the project go awry. This requires a capital reserve at the fund level which can be managed for one or two deals, but becomes more difficult to get right when the entire fund is predicated on this strategy.

- **Timing.** Most mezzanine loans are short term arrangements that bridge the transformation from ‘fixable’ to ‘fixed’. The loans will provide great returns, but are short lived. So, getting your money back in 1-2 years with a reasonable multiple is tough to fit into a fund structure that is long term.

- **Inter-Creditor Agreements.** Mezzanine loans require strong inter-creditor agreements which are difficult. Thus, mezzanine loan often end up looking more like a preferred creditor investment than a classic loan.

- **Borrower vs Lender Expectations.** Traditionally, banks have provided subordinated loans at cheap rates. Because the risk weightings at the banks were relatively low, this equity-like instrument was far cheaper than the actual risk incurred. Finding a deal to work for both parties is challenging. Since a mezzanine loan is debt sandwiched between the senior loan and the equity, theoretically mezzanine interest should also sit somewhere between the debt return and the equity return. This range can be huge and finding the ‘right’ spot is hard.

- **Bank Licenses.** Lending is lending. So, what doesn’t require regulation and a license in some countries may require a license elsewhere. While it may be possible for mezzanine funds to get a lending license or structure instruments that legally work, the overall framework for mezzanine is lending. So, to fill the ‘lending gap’ and be scalable, investors will have to sort out this puzzle.
Conclusion

Mezzanine finance has certain advantages. It is certainly cheaper than private equity, with the cost of capital typically coming in the high teens or low twenties in percentage terms. It can also be cash flow friendly. A term loan from a bank will require regular repayments, monthly or quarterly, creating a drain on the cash that is available to the business. Mezzanine loans are usually repaid at annual intervals. In addition, the loans are often structured with the bulk of the money repayable towards the end of the life of the loan agreement. This arrangement allows the business to implement its growth strategy with low repayments (and therefore a low drain on cash) at the front end of the agreement. That can be a double-edged sword, as a company that fails to deliver on its growth projections will nevertheless be looking at large repayments towards the end of the term. Mezzanine providers will take rights on a percentage of the company’s equity. However, this will be a much smaller percentage than would be the case in a conventional VC or angel investment. This factor makes mezzanine finance attractive to many owners. Again, no single type of financing is appropriate for every instance. There are cases where mezzanine financing may not be available to a company, but for well-managed companies with strong cash flow and good business prospects, mezzanine financing can be a smart solution for a variety of liquidity or expansion needs hence creating a niche market for itself.

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