

Mezzanine Financing: Application Practices and Leadership Aspects

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Abstract. Mezzanine financing instruments are quite common throughout the world, the practice of their application began to appear in Russian Federation. The potential of mezzanine lending is due to the current volatile economic situation, when it is difficult to apply traditional financing methods.

Our paper presents a comparative study of mezzanine financing in Russia and other countries, from the point of view of determining the level of development of mezzanine lending in Russia and the manifestation of characteristic patterns that lead, ultimately, to their own, different from other countries, direction of the formation of the market of mezzanine products.

We discuss the main approaches of Russian and foreign researchers to the concept of “mezzanine financing”, determine the possible forms of its application in practical activities, and analyze the existing practice in Russian Federation and other countries and make conclusions and implications.

1 Introduction

Mezzanine financing is a hybrid form of debt and equity financing, which is usually used to finance the expansion of companies. Despite the fact that mezzanine financing has become a practice in the United States, to date, mezzanine financing instruments have still not found wide application in a number of countries. At the same time, gradually and in the countries of Eastern Europe, the mezzanine is being transformed from a niche instrument used in a limited number of types of financing, into the main, widely used form of borrowed financing and a supplier of growing capital (Amon and Dorfleitner 2013; or Dec and Masiukiewicz 2017).

Considering mezzanine financing as a concept, Leach and Melicher (2014) note the possible goals of financing to expand production, marketing costs, improve products, etc. (Leach and Melicher 2014). The mezzanine financing mechanism is based on the use of classical sources of financing - bank loans, corporate bonds and ordinary shares (Tetřevová and Svědík 2013; Svědík and Tetřevová 2014; Tetřevová and Svědík 2018). According to Anson et al. (2010), mezzanine financing instruments are inserted into the company's capital structure between the “floor” of capital and the “ceiling” of senior debt. The classification of mezzanine financing is based on various criteria, in particular, a mezzanine loan and mezzanine capital (Meluzin and Zinecker 2009; Volkmann et al. 2010). According to Silbernagel and Vaitkunas (2008), mezzanine capital includes senior subordinated debt, convertible subordinated debt and repurchased preferred shares (Silbernagel and Vaitkunas 2008).

Considering the analyzed concept from the point of view of Russian approaches, it should be noted that in Russia mezzanine lending is defined as an alternative to the project financing mechanism and is interpreted as a symbiosis of debt financing and equity financing (Petrikova 2014). Of course, the mezzanine is a type of financing, which is characterized by the simultaneous signs of debt and direct investment. In the context of modern realities, taking into account the increased risks, the attractiveness of mezzanine financing for an investor is due to the ability to receive a higher return on investment. In this case, it is necessary to take into account the absence of risks characteristic of direct investments.

Mezzanine financing begins when the generated cash flows from the investment project are insufficient to service debt obligations on the mezzanine loan (Soloviev 2014). From this moment, an option begins to operate,

which represents the right to purchase a fixed number of sponsor shares or bonds at a fixed price for a certain period of time, or a similar mechanism that provides the lender with the opportunity to participate in the future success of the project (Petríkova 2014). In general, the mezzanine can be represented in the general structure of financing as follows (Henry 2008):

- 1) equity (85-100% of financing, profitability + 35%);
- 2) mezzanine financing (75-85% of financing, the rate of 18-25%);
- 3) "senior" debt - lending and other traditional debt instruments (0-75% of financing, rate <12%) (Henry 2008).

Our paper discusses mezzanine financing in terms of scope, types of tools, the current structure and practice of using mezzanine products, and also analyzes the differences in mezzanine financing in Russia and foreign countries. In addition, we determine that mezzanine financing occupies an intermediate place between traditional debt instruments and own funds, and can be used to capitalize ongoing projects. The work is based on extensive scientific literature, which allows us to take into account the existing research experience, summarize it in this article and form the foundation for further scientific work in the field of mezzanine financing research carried out by Russian banks.

2 Scope and tools of mezzanine financing

Mezzanine financing is appropriate for firms with the following characteristics: operational and financially stable; Having a consistent and proven business model having a positive operating cash flow; experienced management; lack of opportunities to attract traditional financing instruments in the future; inadequate collateral for lending; high levels of financial leverage (Welz 2006; or Konecny 2013).

Typically traditional situations for applying mezzanine financing are (Silbernagel and Vaitkunas 2008): recapitalization; funded buyback (LeveragedBuy-Out); increase in capitalization; acquisition of other companies; refinancing; restructuring of the balance sheet.

Obviously, today there are many options for using mezzanine financing, because its patient, decision-oriented quality makes the mezzanine an ideal capital resource for companies that need capital in addition to senior debt, to meet urgent needs that contribute to the sustainable success of the business.

There are various types of mezzanine financing (Vasilescu and Popa 2006; European Commission 2007), each of which has its own unique characteristics. We can distinguish two main types of mezzanine financing - private (not publicly available) mezzanine and public mezzanine. Below is a diagram of private and public mezzanine instruments (Tetřevová and Svědík 2018).

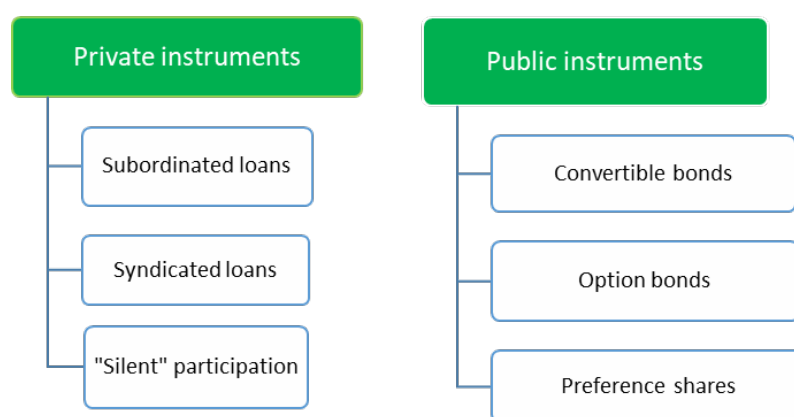


Fig. 1. Types of mezzanine financing instruments
Source: Adapted from Tetřevová and Svědík (2018)

Subordinated loans are unsecured loans. This type of loan has a lower priority in case of bankruptcy compared to senior debt.

Syndicated loans - loans provided to a borrower by two or more lenders participating in a loan transaction in shares previously specified in the agreement. In general, syndicated lending is ordinary lending, but does not give control over property.

"Silent" participation - in this method of financing, the investor (the so-called "silent partner") participates in the business of another person, providing a pledge of capital and in return receiving participation in the company's profits. Silent participation is closer to equity, with the investor acquiring a stake in the company, but

does not assume any obligations to the creditors of the company. According to Leach and Melicher (2014), public mezzanine instruments are characterized as follows:

- convertible bonds - the issuer's financial obligation, which allows the holder in the future (upon redemption of the bond) to receive either a certain amount of money or the issuer's shares;
- option bonds - bonds with a stock option, are debt securities that include options that give the holder the opportunity to purchase shares from the issuer, his parent company or another company for a predetermined period or on one specific date at a fixed contract price;
- preferred shares - are a form of equity investment; in this case, the investor owns the rights to the assets of the company (for example, participation in profits or in excess during liquidation), but does not have voting or management rights.

It can be summarized that mezzanine capital has such characteristics as a long-term investment horizon (mezzanine capital is repayable after a long period, usually from 7 to 10 years), low security (mezzanine financing is subordinate to senior loans), high interest rate, tax status (interest payments) for some types of mezzanine financing are not taxed), the creditor's voting rights or management (the level of control by the supplier of mezzanine capital depends on the type of mezzanine financing; some types of mezzanine capital include the contractual rights to the approval and supervision).

3 Mezzanine financing by instruments and countries

In order to determine the specifics of the Russian market of mezzanine products, it is important to make a comparison in the context of other financing instruments, as well as to determine the differences in the implementation of mezzanine financing in Russia and other countries. This will create a foundation for understanding at what relative stage the development of mezzanine financing is in Russia and whether its own patterns are manifested that will lead to a different way of forming a mezzanine products market from other countries. The table below shows a comparison of mezzanine financing with other debt instruments in Russia (Stepanova 2016).

Table 1. Comparison of sources of financing in Russia

	Bank loan	Mezzanine financing	Direct investments
Current bid	11-15%	18-20%	-
Target return	11-15%	25%	30-35%
Allowed debt level	2-3 × EBITDA	4-6 × EBITDA	2-4 × EBITDA
Participation in activities	Indirect	Indirect	Direct
Security	Discounted liquid assets	Shares, sometimes liquid assets (in the Russian Federation)	-
Term of financing	1-7 years	2-5 years	5-7 years

Source: Own results based on Stepanova (2016)

The available data confirm the intermediate position of mezzanine financing between bank loans and direct investments, while mezzanine lending allows a higher level of debt of the borrowing company and at the same time a shorter lending horizon, as it is understood that with increasing liquidity, the mezzanine product will be replaced by traditional financing instruments - the same direct investment and bank lending.

Mezzanine financing instruments have their typical characteristics both in the USA, Europe and Asia, and in Russia. Under the conditions of a European, more developed capital market, mezzanine instruments appeared and developed as a type of publicly traded bonds; later, mezzanine lending developed. As for Russia, of all varieties of mezzanine in modern realities, we can only speak of mezzanine lending. Of course, problematic in Russia due to regulatory restrictions, rather high costs for structuring such transactions, as well as additional risks for the investor in the absence of proven mechanisms to minimize them, are the use of bonds or preferred shares in mezzanine transactions. Table 2 shows the comparative characteristics of mezzanine lending in the EU and Russia (Stepanova 2016).

In Russian Federation, banking institutions and investment funds are most active in terms of mezzanine financing (Lurie and Melikhov 2014; Lurie and Melikhov 2019). The first mention of this tool by Russian researchers is noted 10 years ago (Pyrkova 2017). In March 2007, the Kaliningrad retailer Vester signed a loan agreement with Sberbank of the Russian Federation in the amount of \$300 million, stipulating that the bank will be able to acquire up to 10% of the company's shares within four years. The mezzanine transaction was completed earlier than the deadline, and in May 2010, a subsidiary of Sberbank of the Russian Federation - Sberbank Capital - converted the retailer's debts to Sberbank into a controlling stake with a right to buy back in 2013. This bank continues its mezzanine financing activities at present. In particular, in 2017, OI Group attracted a syndicated

mezzanine loan to refinance a loan in the amount of \$ 200 million, originally organized in 2014 with a maturity in May 2017. Refinancing is guaranteed by O1 Properties Limited (Tarkhanova and Cheredov 2019).

Table 2. Parameters of mezzanine lending in the EU and Russia

Parameter	EU countries	Russian Federation
Target return	Up to 13%	Up to 25%
Требуемая текущая доходность	8%	18-20%
Ensuring targeted return	The right to join the sale (tag along)	Put option The right to demand a sale (drag along). Personal guarantee
Ensuring current profitability	Pledge of shares of the target (less often - operating) company	Subsequent pledge of property, including real estate (less often - primary pledge). Pledge of shares of the target and, as a rule, operating company. Personal guarantee
Exit strategy	Initial public offering (IPO) of shares, joining the sale to a strategic investor	Exercising a Put or Call Option
Attraction fees	Missing or fixed	Up to 2%
Market offer	Many funds are represented, banks directly organize mezzanine financing	Several specialized funds, large banks organize mezzanine financing (Sberbank, VTB, Gazprombank, etc.)

Source: Own results based on Stepanova (2016)

The first mezzanine financing fund in Russia was created by New Russia Growth in 2009. Private and institutional investors, including EBRD and Nomos Bank, became its investors. Today, there are a sufficient number of existing funds providing services in the field of mezzanine financing.

Since 2011, Hi Capital Fund has financed 18 projects totaling more than 1 billion U.S. dollars. Priority in financing are projects not credited by commercial banks, such as mergers and acquisitions of companies, transactions to scale the business. The size of the fund's transactions is from 15 to 200 million dollars and does not have restrictions on industries. Priority projects are those related to the purchase of competing companies, the repurchase of shares from shareholders and the modernization of production. The debt repayment period is 5–7 years. Such transactions amount to billions of dollars.

Studying the practical aspect and prospects of mezzanine transactions in Russia, we can say that, of course, today Sberbank of Russia can be called the Russian leader in the mezzanine financing market.

4 Results and discussions

Our study of the mezzanine financing practice indicates that in Russian and foreign mezzanine practice there are characteristic features of debt and equity forms of financing a business due to the hierarchy of the mezzanine loan in relation to other loans, which is reflected in higher lending risks and, consequently, higher profitability. The differences between Russian practice and foreign practice are in the higher cost of the product at the current stage and greater difficulty in application due to the inability to directly apply English law.

We found that mezzanine financing has undoubted advantages, and in some cases provides exceptional opportunities for the investor and borrower. There is no doubt that in connection with this tool is used on the Russian market, albeit in an insufficient volume, mainly through the provision of mezzanine loans (loans) by large financial institutions using structural subordination, shareholder agreements, share pledges (shares) and options. Given the peculiarities of Russian legislation and the lack of a unified practice of mezzanine financing, participants in mezzanine transactions are actively trying to use the institutions of English law.

Moreover, despite the obstacles and difficulties, a gradual increase in the volume and quality of mezzanine financing is noted, which allows us to look rather optimistically at the future of mezzanine financing in Russia, as well as to predict the complication of the mezzanine and increased interest in related legal and economic issues. A further study of the Russian practice of using mezzanine financing instruments will help determine possible guidelines for the use of mezzanine products with the aim of further improving mezzanine financing.

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