

# Mezzanine Capital as A Tool to Increase Enterprise Value in Crisis

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Received: March 20, 2017    Accepted: March 30, 2017    Published: May 9, 2017

doi:10.5296/bmh.v5i1.10955    URL: <http://dx.doi.org/10.5296/bmh.v5i1.10955>

## **Abstract**

The paper contains an analysis of enterprise financing through mezzanine capital. It is a unique source of relatively capital, especially in the context of finding a company in crisis, and the lack of acquisition of other capital from all available sources of external financing. Crucial from the point of view of the authors of the article seems to be correct to define and theoretical mezzanine capital, because it directs not only the use but also the assessment of efficiency. In addition, synthetically it presents quantitative data on the practical application of mezzanine capital. It shows the main advantages and disadvantages of using this type of financing business activity, not forgetting, however, that this issue requires a very thorough and intensive research is in practice.

**Keywords:** Mezzanine capital, Crisis capital, Enterprise value

## **1. Introduction**

The acquisition of new capital, in other words recapitalization in an enterprise located in a high-risk situation is always a barrier or restriction. This increased risk can mean both planning new investment implementing innovation, entering new, unknown markets and crisis situations in the company. A panacea for these problems may be mezzanine financing to support the construction or reconstruction of the company.

Mezzanine finance is a response to these problems, but it is a form of financing for companies that meet a set of three conditions strong growth potential, stable cash flows or acceptable level of risk. As a hybrid mezzanine financing is quite flexible, taking into account the specific nature of the entity applying for this funding.

The purpose of the article and to demonstrate the usefulness of the instrument mezzanine in a crisis of company, requiring recapitalization of its business activity. The methods used in the work is the analysis of literature, analysis of statistical data and case studies.

## **2. The Theoretical Approach of Mezzanine Capital**

In the world of finance term mezzanine finance is a hybrid form of financing that combines debt financing with equity financing. Also, it seems to be a convenient way to finance higher risk. (Juszczak, & Nagórka, 2009) Mezzanine is a form of private equity investments. In terms of financial debt is defined as a high-risk instrument intermediate between debt financing and equity. It is an element of external financing entrepreneurs who are looking for a way to get funds with the intent to carry out the investment project. (Mezzanine Finance, 2008) Mezzanine financing allows obtaining investment capital, but on the other hand, provides a share of the profits to investors if the project proves to be hit. The specificity of a bullet payment—payment obligations only after the expiry of the contract. In economic terms is mezzanine capital, but in a legal sense becomes debt, where acceptable to the investor's risk is defined as medium or high.

Mezzanine is divided into two types, for instance mezzanine debt and equity mezzanine. Debt mezzanine can be carried out on the basis of: a subordinated loan, loans from shareholders or unsecured loan. Equity mezzanine, in turn, may constitute preferred stock and dormant holdings in the company, such shares are in some countries prohibited by law. (Kurylek, 2014) With this solution, the investor takes possession of ownership rights, more information about the company, and also has the ability to impact on the development of the company. These factors mean that an investor can potentially expect benefits from an increase in the value of the company in the future.

Table 1. Methods of financing by SME risk criterion

Very low risk	Low risk	Medium risk	High risk
Financing secured by assets	Financial Engineering	Hybrid instruments	Private equity venture
<ul style="list-style-type: none"> <li>- factoring and forfaiting</li> <li>- loans secured on assets</li> <li>- promissory notes</li> <li>- Sola bill of exchange</li> <li>- subsidies to the owners of capital</li> <li>- issue new shares</li> </ul>	<ul style="list-style-type: none"> <li>- securitization</li> <li>- corporate bonds with warrants</li> <li>- leasing</li> <li>- subordinated loans</li> </ul>	<ul style="list-style-type: none"> <li>- leaseback</li> <li>- loan from the owners of the company</li> <li>- convertible bonds</li> <li>- mezzanine capital</li> <li>- corporate bonds "junk"</li> </ul>	<ul style="list-style-type: none"> <li>- private equity</li> <li>- venture capital</li> <li>- business angels</li> </ul>

Source: own studies.

Mezzanine financing is used when there is an equity gap, i.e., the entity is not able to obtain financing loan from the bank, and on the other hand, measures the existing shareholders are also not sufficient. It is a form of financing intended for both well already successful companies, as well as being in crisis. Characterizing mezzanine financing it must be emphasized that mezzanine financiers to accept a higher level of risk than venture banks, and on the other hand, require a smaller share of the profits than the owners, but more than ordinary shareholders for issue of shares. This is the reason why mezzanine financing involved in the development of the company and are able to wait for the increase in the value of the company.

Another advantageous feature of the mezzanine is the fact that the debt is usually at the end of the funding period. It is also possible to exit capital providers in all of the investment. This is a big relief for cash flow the company during the project (e.g., The implementation of the restructuring program). In addition, the flexibility of mezzanine (repayment time, manner, time of payment of interest, the type of hedging instrument) are advantageous to operate the time horizon of the investment. It is also characteristic protection mezzanine. These are usually stocks or shares of the recipient capital, not the company's assets, as it applies in the case of credit (loan). The most popular solutions are junior mezzanine and Warranted mezzanine. The first option is used mostly in Western Europe and the United States and involves hedging in the form of a high interest rate loan or a bond, and the latter may include the instrument PIK (payment in kind), which means the payment of interest by successive bonds. Warranted mezzanine, also used in Poland, is the possibility to exchange the bonds into other securities. Warrant means a security personal privileged entitling them to purchase shares (this might pertain to privileged voting rights, dividend rights, etc.). Banks often treat mezzanine as part of the equity of the borrower, which is beneficial. However, the company's balance sheet capital is classified as debt.

The expected return on investment ranges from 14 to 21%, compared with up to 35-percent gain expected by private equity investors is not high level. In table 1 summarizes the main characteristics of the three main types of finance companies. Solutions "junior mezzanine" and "Warranted mezzanine" vary greatly in design and method of financing. "Junior Mezzanine" is a solution close to the classic loan accepting a higher level of risk, and therefore, is higher

interest rates and better protected. “Warranted mezzanine” is a type of debt, which at the same time gives the right to participate in the capital-funded entity or the profits of the financed project. Mezzanine financiers take into account two issues related to the human factor: an assessment of the management and evaluation of the project sponsor. If executives are judged her achievements and her experience (Panfil, 2008).

Deciding on financing projects in the next few years and delaying the repayment of debt as well for a few years, mezzanine financing assesses the risk the success of the project through the prism of the experience and quality of their work management. From the results of their work depends largely not only potential income mezzanine financing, but also the ability to recover the borrowed amount. The Management Board will be subject to a detailed assessment, especially in terms of having features such as: a vision of the project, the ability for strategic planning, leadership, good organization of work, efficient system of decision-making and problem-solving, excellent knowledge of the market, products and technologies, skills and financial management cost control, as well as the creativity and energy. An equally important element is the so-called assessment. Project sponsor, or entities participating in the project both financially and operationally, mezzanine financing fully passive role here. Sponsors are usually entrepreneurs, private equity funds or managers.

### **3. Mezzanine Recapitalization as An Instrument in Crisis**

In developing countries, access to financial markets is more difficult for small and medium-sized enterprises, especially when it comes to capital in the conditions of crisis. (Kuryłek, 2014) Difficult access and the high cost of financing combined with a lack of knowledge of modern sources of financing creates equity gap.

These are not the only conditions the company should move the negotiation process with due diligence, as well as an assessment of the management, the project sponsor and the board. The latter should be subjected to study the history of activities, strategic planning, decision-making system and financial management. Proceedings restructuring and recovery (recovery) undertakings usually binds to the recapitalization. However, access to credit (loans) and loans in such a situation, limited or non-existent. The use of mezzanine instrument can be a panacea out of the crisis, especially analyzing the data contained in the table below.

Table 2. Main types of enterprise financing

No.	Items	Loans	Mezzanine	Own funds
1	Type in economic terms	debt	capital	capital
2	Type in the legal sense	debt	debt	capital
3	Acceptable risk	low	medium/high	high/very high
4	The level of expected return on capital	5%-15%	15%-20%	15% - 25%
5	The timing of return on equity	during the funding	at the end of the financing (no fixed deadline)	at the end of the financing (no fixed deadline)
6	The tax consequences	interest is tax expense	interest is tax expense	no tax shield
7	Securing legal debt	full	possible partly	none
8	Ability to adapt to the specific enterprise	small (rigid procedures)	big	big

Source: own studies.

Mezzanine capital can of course be designed to be used for a successful venture, but it is not the only situation in which the mezzanine is used. It may also be:

- Financing and reorganization of the company out of the crisis,
- Funding for innovation,
- Financing of changes in the composition of shareholders,
- Financing the company during the preparations for the IPO,
- The financing of mergers and acquisitions (M & A) businesses.

This can be an important instrument for supporting the implementation of the second chance for entrepreneurs fallen in the European Union. The company is characterized by a cycle of funding methods. In the early stages it is mostly equity, then the loan or lease, finally—the issue of bonds and shares. Mezzanine financing can be a good solution supporting lending or method of financing during the economic downturn and the tool used when changing owners.

In times of economic downturn, when the issue of shares seems to be a good solution, mezzanine can bring many advantages over the IPO. Organizing emissions combined with higher costs associated with marketing, service advisory from the firm consulting and investor relations professionals. Besides, each issue of shares requires a lot of time to prepare and carries the risk of failure. Bank loan, in turn, also has its requirements—i.e., it is not only security for the loan but creditworthiness. Mezzanine finance can be a supplement to loan financing, since it is usually treated by banks as a form of equity, and secondly—it is repaid in second place.

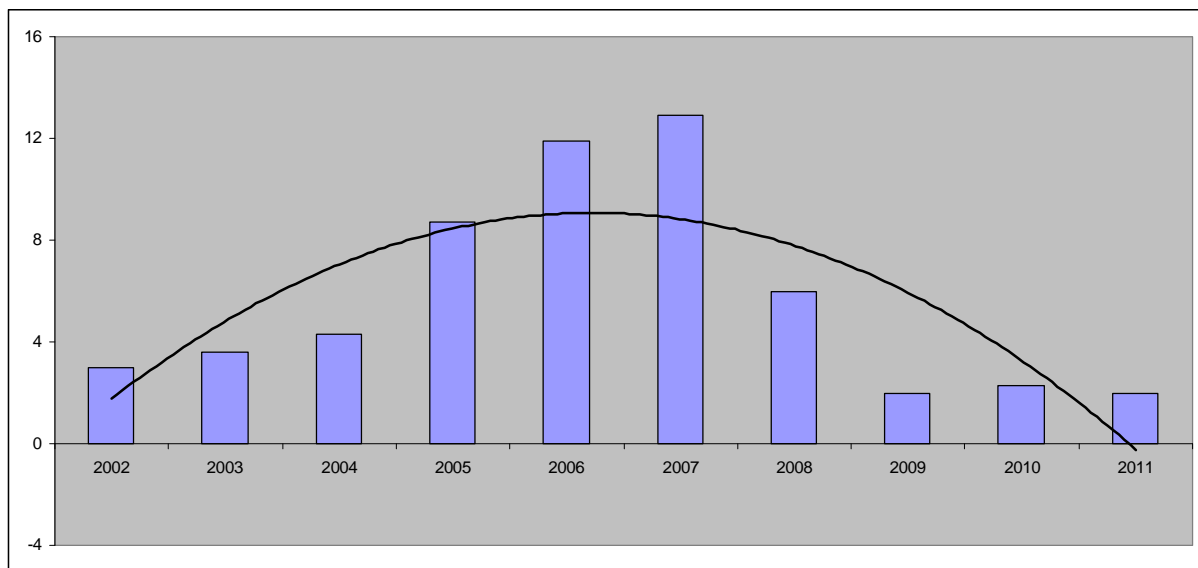
In turn, silent partner participates in the profits achieved by the company and its share in covering the losses may be partially or even completely off. In these cases, when it participates in the coverage of losses, its share is limited to invested within the silent participations amount. The remuneration for the silent partners is realized in the form of fixed interest and part of the host name “kicker”, the amount of which is dependent on the profit

achieved by the company. Kicker should be a significant part of the revenues earned by the investor, in otherwise the instrument could be classified as a loan giving a share of the profits, not as silent partnerships. Typical silent participations are in most cases classified in terms of the balance sheet as foreign capital. On the other hand, within the framework of the structural analysis of the balance of the typical silent participations, characterized by inferiority in relation to certain elements of foreign capital, they are classified in most cases to the economic equity. In this case, however, it requires long-term commitment of capital in the company.

#### **4. Scope of Use Mezzanine Capital in Research**

Mezzanine financing dates back to the 70s of the last century in the US, when the insurance companies and savings banks offered such a solution. In recent times, until the subprime crisis, mezzanine intensively developed in Europe, reaching its peak in 2006, amounting to 13.3 billion euros. European advanced countries considering this type of funding are the United Kingdom, France and Germany. Unfortunately, there is a broader study of mezzanine financing. They are available while the case studies.

On the graph 1 shows the value of the transaction mezzanine in Europe. The greatest value they had in 2006-2008, which confirms the opinion that it is a good instrument for funding during the crisis.



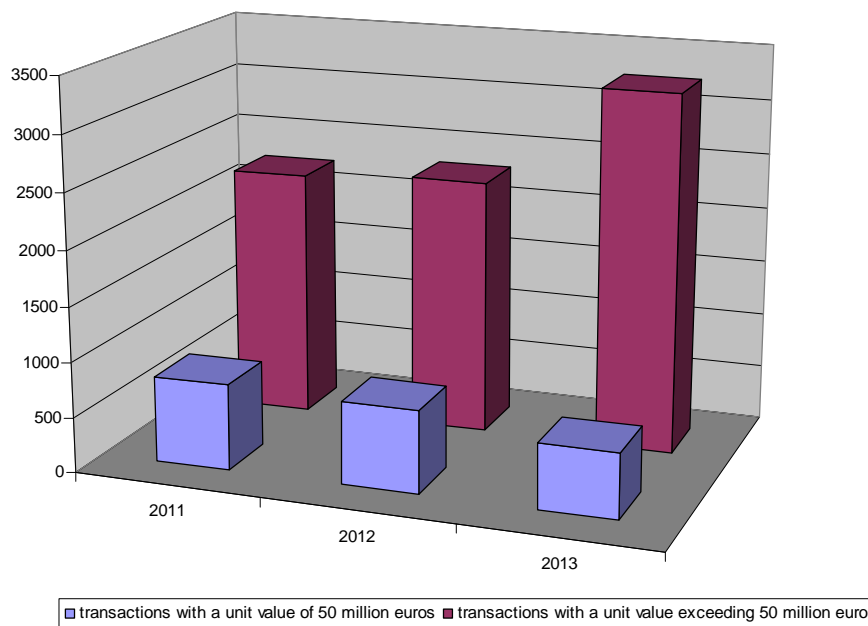
Graph 1. The value of the transaction mezzanine billion in Europe

Source: Central and Eastern Europe Statistics 2011, by CEE Task Force EVCA.

Most of the funds have accumulated specialized private equity funds in Austria (190 000 euro), Finland (60 000 euro), France (152 000 euro), Germany (301 000 euro), Switzerland (over 146 000 euro), the UK (over 98 000 euro). The increase in the value of accumulated funds to invest mezzanine may indicate a general increase in investor interest in this form of financing in Europe. EVCA is also developing reports on private equity funds in Central and

Eastern Europe. (Mikolajczyk, 2012) Based on a report EVCA Central and Eastern Europe Statistics 2011-ES countries in the value of funds on mezzanine investments by private equity funds in 2007-2010 showed a downward trend.

Every year the European Private Equity and Venture Capital Association (EVCA) is preparing a report on the activities of revolving funds of private equity capital, which in Europe are the largest suppliers of mezzanine capital. For this purpose, EVCA has developed a questionnaire that was given to companies involved in private equity capital (including mezzanine). The survey of 2011 was conducted in 30 European countries. (EVCA, 2011) (graph 2)



Graph 2. The value of the transaction mezzanine in Europe (EUR million)

Source: Development Grant Thornton on the basis of a report Invest Partners “Mezzanine debt market in Europe”, January 2014.

In 2014 again it recorded a very good year for private equity funds. Then their investments reached the amount of nearly 45 billion euros. And what’s more, it was the second highest level in 2010-2014. Only in 2013 was more, when this amount totaled almost 55 billion euros. The number of new funds increased to a record 298 in 2011 and it was growth in all segments of private equity, private equity in all segments, Including buyouts, growth, mezzanine and venture capital. (Invest Europe, 2015)

### 5. Mezzanine in Poland

Mezzanine financing is gaining significance in Poland. To a large extent this is due to FIZAN Mezzanine fund managed by Noble Funds TFI and Credit Value Investments for a little over two years the fund realized over forty transactions of this kind, diversifying landscape of



financial instruments available for Polish companies. So far, the low popularity of this instrument resulted, among others, the level of its complexity. Typically, it is a combination of debt and equity. An entrepreneur in this situation receive debt financing, but in addition must also give a few or even several percent share in equity for the award of funding or in the future through warrants. The introduction of item ownership means the need to negotiate the parameters of departure for investor mezzanine, as well as its corporate rights. [Panfil, 2008]

Tar Heel Capital Private Equity over 15 years helping Polish companies to achieve the position of market leaders and investors to deliver above-average returns. He keeps a rigorous investment strategy and successfully combines it with being a business partner. It is thanks to the company, which have invested, on average, they tripled its profits.

It is also worth to mention here LBO—leveraged buy-out, where a group of investors and managers takes control of an existing company, in order to increase the value of its shares and sell them later for the implementation of the related profit. A specific feature of this type of transaction is the financing structure. It consists primarily leverage, or debt financing. The share of foreign capital can be as high as 80%, while the own resources collected by the investors represent a small part of the total funding. The leveraged buyout is carried out using a SPV (Special Purpose Vehicle—SPV), which is created in order to acquire the shares of the acquired entity. Thus, it is a party to all contracts, including those for funding, its property and provides security for the debt. After the transaction, the attachment is taken out of the SPV company. Increasing the value of the shares of the acquired company, to carry out the profit is achieved through actions aimed at investors. Large transaction of this type in Poland in last year was the buyout of cable TV operator Aster City by investment funds Mid Europa Partners. In addition, the mezzanine was used for the redemption of leveraged companies manufacturer Solaris Bus & Coach SA and network clinics and hospitals LUXMED. What is important is the expected investor return on investment ranks between 17% and 20%, and mezzanine capital is offered usually in the form of a subordinated loan, combined with warrants or convertible bonds into shares. In addition, in 2016 European sites Investment Bank for the first time in Poland it acquired a mezzanine trenches under the securitization of consumer loans. For the first time carried out a hybrid bond issue, which was structured and acquired by the EIB, it should be added that this was the first such transaction on the Polish bond market companies.

## **6. Conclusions**

Mezzanine financing is a good instrument for recapitalization in times of economic downturn, it is prepared for risky projects, is a good complement to or a substitute for bank credit, and can be cheaper than the issue of shares.

The observations allow the following conclusions:

- Mezzanine can be useful to all types of businesses, especially in crisis situations, mergers and acquisitions, changes in ownership and the lack of sufficient collateral for a bank loan,



- The type of mezzanine financing is particularly useful during the downturn in the stock market,
- This type of financing can be a lifeline for bankrupt enterprises as a result of such financing also through state funds.

As the financing of hybrid mezzanine is often tailor-made and flexible enough, since parameters such as duration, payment of interest, collateral and type of instruments used are adapted to the type of transaction, and usually deferred debt allow for greater flexibility in managing cash flows during financing, giving businesses the opportunity to develop faster. Mezzanine is growing not only in the US and Western Europe, but it is an interesting prospect for companies of Central and Eastern Europe, especially in difficult economic conditions and the slowdown or bearish on the stock market. Among the managers and owners of companies, however, there are concerns about the use of this instrument. And it is connected with its rare occurrence but the lack of knowledge on the subject. You can expect that in the coming years mezzanine financing will become a popular instrument in the world, as well as in the countries of Central and Eastern Europe will become irrelevant.

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