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MEZZANINE CAPITAL AND CORPORATE BONDS - THE CZECH EXPERIENCE

Jan Svědík[1], **Liběna Tetřevová**[2]

University of Pardubice, Studentská 95, 532 10 Pardubice, Czech Republic
Email: [1]jan.svedik@upce.cz; [2]libena.tetrevova@upce.cz

Abstract. The paper is dedicated to the problems of mezzanine financing focussing on the specific types of corporate bonds. The first part defines the term mezzanine capital in the alternative concept and characterizes the properties of mezzanine financing. Next, the paper discusses possible instruments of mezzanine financing, which are also briefly characterized. Further on, the attention is focussed on the mezzanine financing instruments in the form of securities that can be taken into consideration in the conditions of the Czech Republic, i.e. convertible bonds, warrant bonds and preferred stocks. In the end, the paper analyses and evaluates the situation in using corporate, convertible and warrant bonds in the Czech Republic, and at the same time it identifies the key risk factors causing their limited application and also specifies potential change proposals leading to improvements in the given situation.

Keywords: mezzanine capital, mezzanine financing, corporate bonds, preferred stocks, convertible bonds, warrant bonds.

Jel classification: G10, G32

1. Introduction

In the today's demanding conditions of the economic world, where the enterprises still suffer the negative macroeconomic effects of the latest economic crisis, where the microeconomic effects of more and more severe competition become evident particularly due to the extensive supply of cheap Chinese commodities and services, in the period where the growing deficits of the public budgets result in rising tax exposure of all economic entities, utilization of non-traditional financial instruments is one of a large number of preconditions of prosperity and future existence of enterprises. And various mezzanine financing instruments belong to this large number.

The mezzanine financing instruments can be used by enterprises for implementation of a number of development projects of a long-term character. Not only do these instruments make it possible to achieve better flexibility in the corporate capital structure, thanks to which the enterprise is subsequently able to react to the continuously changing market conditions more quickly, which then results in a larger creation of financial sources, but they also contribute to creation of an optimal capital structure, or lead to clarification of the managers' views of the return of individual investments.

The paper aims to characterize the mezzanine capital, identify its types and general features in the context of alternative financial sources, emphasizing the mezzanine in the form of securities, and assess utilization of mezzanine financing in the form of special bond types in the Czech Republic.

The authors of the paper used the following research methods: interpretative-theoretical research, descriptive research and correlation research.

The professional literature pays minimum attention to the problems of mezzanine capital. The paper provides an overall view of the mezzanine financing problems from the point of view of its definition, characteristic features and instruments. Its original contribution can be seen in the analysis of utilization of the mezzanine forms of corporate bonds in the Czech Republic, together with identification of the risk factors of their limited use and the proposed possible partial measures for implementation of changes.

Academicians, company managers and entities active on the capital market can use this paper on the one hand to understand the basis and principles of mezzanine financing, and on the other hand to make themselves familiar with the specific risks related to utilization of the mezzanine capital in the form of bonds in the conditions of the former transforming economy, as the economy of the Czech Republic is.

2. Mezzanine capital

The term mezzanine capital or mezzanine financing (or just mezzanine) represents a relatively new term in the theory and practice of the corporate finance, although we could already meet this form of financing in the United States of America in the 80's of the 20th century.

This term has been alternatively defined by several authors, and so we can mention, for example, the following definitions of this term. Mezzanine capital "refers to that layer of financing between a company´s senior debt and equity, filling the gap between the two" (Silbernagel, Vaitkunas 2006). Mezzanine finance presents "a collective term for hybrid forms of finance which forms a bridge between the two main types of finance; senior debt and pure equity financing" (Vasilescu 2010). Mezzanine capital is "a subordinated debt or preferred equity instrument that represents a claim on company's assets which is senior only to that of company's common shareholders" (Wikimedia Foundation 2011). Mezzanine financing represents "debt capital that gives the lender the rights to convert to an ownership or equity interest in the company if the loan is not paid back in time and in full" (Investopedia 2011). Other possible definitions of the term mezzanine financing can be found in the work called Mezzanine Financing by Welz (Welz 2006).

The term mezzanine originally comes from architecture, where it designates a floor between the ground floor and the first floor, i.e. an entresol. In finance, this term is generally understood as a hybrid form of funding that has both the features of debt financing and the features of equity financing. Table 1 shows the characteristic features of the mezzanine capital as broken down to the senior debt characteristics and equity characteristics.

Table 1. Mezzanine Capital Characteristics (Source: Modified according to (Invest Mezzanin 2006a, 2006b; Vasilescu 2011))

SENIOR DEBT CHARACTERISTICS	EQUITY CHARACTERISTICS
Obligation to repay	Long-term liable capital
Interest-bearing regardless of performance	No claim for repayment upon conversion
Tax-deductible	Subordinated vis-à-vis existing creditors
Covenant oriented	Options on shares in the company
	Performance related interest payments possible

Table 2 compares the mezzanine capital with the senior debt and the private equity.

Table 2. Comparison of Alternative Forms of Funding (Source: Modified according to Henry 2005)

	SENIOR DEBT	MEZZANINE CAPITAL	PRIVATE EQUITY
Instruments	Loan	Loan with warrants	Stock
Investment Horizon	Short term	Long term	Long term
Risk Tolerance	Low	Medium	High
Return Expectation	< 10 %	18–25 %	35 %++
Current Coupon	Floating rate	Fixed rate	n/a
Hidden Costs	Personal guarantees	None	Loss of control
Customization Ability	Rigid standards	Flexible standards	Flexible standards
Seniority/Security	Senior lien	Junior lien	Unsecured
Equity Dilution	None	Low	High

3. Mezzanine instruments

A wide range of possible instruments are bases on the varied features of mezzanine financing, which are a part of them.

Silbernagel and Vaitkunas (Silbernagel, Vaitkunas 2006) state that we can generally consider as the mezzanine financing instruments convertible debt, senior subordinated debt and private mezzanine securities (debt with warrants or preferred equity). The mezzanine financing instruments are similarly classified by Frank (Frank 2004), who differentiates subordinated debt, convertible subordinated debt and redeemable preferred equity.

Merna (Merna *et al.* 2010) notes that mezzanine finance typically takes the form of subordinated debt, junior subordinated debt, bonds and preferred stocks or some combination of each.

Invest Mezzanin (Invest Mezzanin 2006b) then states that mezzanine financing includes the debt mezzanine capital and the equity mezzanine capital. The debt mezzanine capital exists in the form of senior mezzanine and smart loans, which include silent partnership with fixed maturity and options, subordinated loans, shareholder loans, unsecured loans, high-yield bonds, convertible bonds, going public bonds with warrants. On the other hand, the equity mezzanine capital can have the form of the junior mezzanine and sweet equity in the form of atypical silent partnership, privately placed profit participation certificates, preference shares (convertible, cumulative, participating), equity-linked zero bonds and convertible loans.

According to Vasilescu and Popa (Vasilescu, Popa 2006) we can differentiate two main types of mezzanine finance – private mezzanine and public mezzanine. The private mezzanine includes financial instruments of the private character, which are not placed on the capital market directly. These instruments are not connected with the obligation of the company as the recipient of the mezzanine capital to publish information concerning its financial situation as it is with the instruments of the public mezzanine. The public mezzanine represents financial instruments of the public character, which are placed on the capital market in the form of securities. This type of instruments is connected with the legal notification duty consisting in publishing information on the issuer's entrepreneurial activity and on their economic results.

The private mezzanine instruments include the following:

– subordinated loans, which represent unsecured loans. In the case of winding-up of the company, the subordinated loans providers are satisfied prior to the equity investors, but after the senior debt providers.

– participating loans, which represent the classical form of a loan where, however, the yield is not specified in the form of a fixed or variable interest, but in the form of a share in the profit. In this case, the mezzanine providers have no right to be involved in the company management, they are also not responsible for its potential loss and in the case of winding-up of the company they have the same position as the other loan creditors.

– silent participation, it is the form of mezzanine financing that, unlike the previous forms, is not of the loan character. Silent participation represents a property contribution into the company that is concealed from the public, its provider has no direct liabilities towards the company creditors, but they share the potential loss of the company.

The public mezzanine instruments include the following instruments:

– convertible bonds, i.e. bonds that are exchangeable for the issuer's shares or other property securities;

– bonds with warrants, i.e. bonds that are connected with a separately tradable warrant, entitling the holder of the bond to purchase the issuer's shares or other property securities;

– profit participation rights, i.e. equity investments connected with the right to share the company's profit, its liquidation balance in the case of winding-up, or a preferential issue of shares.

The above mezzanine financing instruments are specified in more detail in the publication of the European Commission called Mezzanine Finance: Final Report, see more in (European Commission 2007).

4. Mezzanine instruments in the form of securities

Based on the conditions and experience of the Czech Republic, we can state that the mezzanine instruments in the form of securities include convertible bonds, warrant bonds and preferred stocks.

From the point of view of research into the given problems, the attention of a number of authors is generally focussed on the problems of corporate bonds (e.g. Brigham, Ehrhardt 2010; Brigham, Daves 2009; Levinson 2009; Madura 2009; Makovský, Tetřevová 2006a; Shim, Siegel 2008; Tetřevová 2003a, 2003b, 2004, 2006; Tetřevová, Makovský 2006; Thau 2010; Valach 2005) or on the problems of preferred stocks (e.g. Bajaj, Mazumdar 2002; Block, Hirt 2008; Brealey *et al.* 2008; Brigham, Ehrhardt 2010; Brigham, Daves 2009; Kadapakkam *et al.* 2004; Levinson 2009; Shim, Siegel 2008; Tetřevová 2006; Valach 2005). However, only limited attention is paid to the problems of the context of securities and mezzanine financing; see more in (Bancel, Mittoo 2004; Dutordoir, Gucht 2009; Loncarski *et al.* 2008; Tetřevová 2009; Tetřevová *et al.* 2009).

Convertible bonds are corporate bonds that are connected with the right to convert the bond to ordinary shares – either at the time of maturity of the bond or as at the dates specified in advance, while the exchange rate and the potential supplementary charge (surcharges can be expressed in percentage of the face value or in percentage of the dividend) are fixed. Convertible bonds are issued with a lower interest rate than non-convertible ones, so they are connected with lower interest costs. Moreover, the interest on such bonds is considered as tax deductible expenditure for calculation of the income tax, unlike dividends. The issuer often decides to issue convertible bonds in the period when the possibility of placing an issue of new shares is limited and the issuer assumes that when the moment of exchanging the bonds for shares comes, the market conditions will be motivating the investors to exchange the bonds for shares. By exchanging the convertible corporate bonds for shares, the issuer ensures non-payable financial resources, but also the control over the company is being extended. Such exchange is particularly advantageous in the situation where the company needs finances to fund other investment activities, or if it is necessary to enlarge the investment.

Warrant 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. After the elapse of the specified period, the bond holders, in the case of using their right, acquire the given number of the issuer's shares for the price specified beforehand. Warrant bonds lead both to an increase in the loan capital until its maturity and to an increase in the own capital after using the option.

The advantage of funding either in the form of convertible bonds or in the form of warrant bonds can be seen in the fact that the issue can bring significant financial means provided by a large number of creditors. And at the same time, as a result of diversification of the risk among a large number of creditors, the interest costs are lower compared to banking loans, and these costs are also tax deductible (it is possible to use an interest tax shield). It is possible to consider as a substantial advantage that an issue of bonds does not extend the voting rights, and the shareholders do not lose their control over the company's activities. Moreover, successful issue (and particularly placement) of such bonds represents a prestigious matter, which enhances the position of the company in the eyes of the public and its business partners. On the other hand, issuance of bonds is connected with considerable costs of issue, consisting of the cost of issue itself (the cost directly related to issuance of the bonds) and the cost of life (the cost arising during the life and related to redemption of the issue). Another disadvantage is the fact that the bond holders can impose some limiting conditions on the issuing company and they have the right to express their standpoints concerning the questions whose solution may affect application of the rights connected with the bond.

Preferred stocks represent property securities connected with the preferential right to get dividends before the common shareholders, and in the case of winding-up of the company, this preferential right entitles them to share the liquidation balance before the common shareholders. The amount of the dividend is fixed in such a case. Most preferred stocks are issued with the cumulative obligation, i.e. the company also has to pay off all the previously unpaid preferred dividends before they start to distribute any dividends to their common shareholders. These shares are not connected with the voting rights and they can be redeemed at a certain time for a certain price. Their advantage is the fact that issuing preferred stocks does not extend the control over the company, non-payment of dividends from the preferred stocks has smaller impact than non-payment of interest from debt instruments, preferred stocks are connected with lower demands on dividend payment than the primary shares, and if the profit rises, the dividends paid from the preferred stocks do not increase. On the other hand, dividends do not belong to tax deductible expenditure, and that is why in the case of profitability, the company cannot use the tax shield.

5. Corporate bonds as mezzanine financing instruments in the Czech Republic

An analysis of utilization of corporate bonds as mezzanine financing instruments in the Czech Republic can be based on the overview of corporate bonds available for trading at the Prague Stock Exchange, Table 3.

Table 3. Corporate bonds traded at the Prague Stock Exchange (Source: Prague Stock Exchange 2011)

Name of corporate bond	Issuer	Area of business	Issue duration (in years)	Issue volume in CZK/ EUR million
ABS JETS 6,50/16	ABS Jets, a.s.	airline transport	5	450
CETELEM ČR VAR/14	CETELEM ČR, a.s.	trade	3	1 000
ČEZ VAR/14	ČEZ, a.s.	power engineering	15	2 500
DALKIA ČR 4,24/15	Dalkia Czech Republic, a.s.	power engineering	7	10
ECM VAR/12	ECM REAL ESTATE INVESTMENTS A.G.	construction	5	1 000
GREENVALE VAR/14	GREENVALE, a.s.	services	5	400
HOME CR. BV VAR/12	Home Credit B.V.	trade	3	2 500
HOME CR. BV 0,00/15	Home Credit B.V.	trade	5	2 900
ISTROKAP.CZ 10,0/16	ISTROKAPITAL CZ a.s.	trade, services	7	150 EUR
ORCO VAR/20	Orco Property Group S.A.	construction	14	1 400
SM VAK OVA 5,00/15	North Moravian Water Works and Sewerage Ostrava a.s.	services	10	2 000
UNIPETROL VAR/13	UNIPETROL, a.s.	chemical industry	15	2 000
ZONER SOF.10,00/14	ZONER software, a.s.	IT	5	76.69

The above table shows that now (as at 10 October 2011) there are only 13 issues of corporate bonds at the Prague Stock Exchange, the total issue volume of which is EUR 799.5 million (with the exchange rate of CZK 25/EUR 1). However, none of the corporate bond issues is connected with the right to be converted into shares or with the right of option.

Table 3 implies that, in the conditions of the Czech Republic, corporate bond issues represent only an exceptional way of raising funds. The same conclusion is valid for the specific kinds of bonds in the forms of convertible bonds and warrant bonds. This fact originates in the European tradition of debt funding on the one hand, and in the risks that are specific for the Czech Republic, on the other hand. These risks can be seen both on the side of the demand for capital represented by the issuers, and on the side of the supply of capital, i.e. the investors. In their historical context they are dealt with by Tetřevová (Tetřevová, Hávová 2000; Makovský, Tetřevová 2006b; Tetřevová 2007).

The basic risk factors on the side of the demand for capital can be seen in the economic conditions in the Czech Republic, worries about failing to place the bonds, and last but not least, the considerable cost of issue.

From the point of view of the economic situation in the Czech Republic, it is not only the impact of the recent worldwide economic crisis that has risk effects, but it is also the lack of profitable investment projects connected with a reasonable rate of risk. Thanks to this, the company managers are careful while making decisions, and they prefer implementation of rather less extensive investment actions using the traditional ways of funding.

As for the worries about failing to place the bonds, potential issuers are afraid that, in the case of a bond issue, these bonds might not be placed, i.e. there would not be enough investors willing to invest into these securities. Enterprises would be willing to issue such bonds only on condition that the issue organizer was able to ensure enough potential investors before making the intention public.

The last important risk on the side of the demand for capital is the cost of issue because any bond issue is connected with extensive costs (the cost of advisory and legal services, of preparation of the appropriate documentation, of the print or registration of securities, fees for intermediation of the issue, fees for acceptance of the bonds for trading at the stock exchange, etc.), while their important part has the character of fixed costs, and so the issue becomes worthwhile from a certain volume of issued bonds. Moreover, a number of costs would have to be covered even in the case the company did not succeed in placing the planned bond issue on the capital market, and in such a case the existence of the company itself could be significantly endangered.

On the side of the capital supply, the key risk factors can be seen in the insufficient information equipment of the investors, the limited information openness of the businesses and the distrust of the investors.

The investors, and particularly the small investors, in the Czech Republic do not have, for the time being, sufficient knowledge and experience relating to investment into securities. They are not familiar with the fact what bonds represent or with what advantages and disadvantages investment into this kind of securities is connected, with what risks, but also strengths they are connected compared with the other types of investments.

The information problem is also connected with another risk factor on the side of the capital supply, which is the lack of information concerning individual issuers and their securities. Most issuers are not willing to disclose enough information about themselves, on the base of which the investors could make responsible decisions. The fact is that the level of sharing information is still low in a number of companies in the Czech Republic (Vlčková 2011).

As for the investors' distrust, this distrust mostly results from the investors' bad experience from the 90's of last century, when the imperfect legislation and basically non-functional regulation of the capital market resulted in inadequate protection of the investors, and some market players applied unfair practices. The above problem is also made worse by a low liquidity of the security market, particularly of the bonds.

6. Conclusions

The mezzanine financing instruments are suitable as a source of funds for well-established and stable enterprises with a prospective future growth. They are distinguished by a number of advantages, the basic ones of which can be seen in the fact that enterprise will get a considerable volume of financial means with flexible conditions for a long period. That is why they can take advantage of the growth opportunities and achieve an increase in the market value of the company. At the same time, in the case of this form of funding, there is usually no extension of the control over the company, nor any required material or personal guarantees. On the other hand, utilization of the mezzanine capital is also connected with certain disadvantages. From the procedural point of view, acquisition of the mezzanine capital is demanding, and its utilization is connected with considerable business transparency requirements. Other disadvantage can be found in the obligation to redeem at the fixed time, also the right of the mezzanine provider to affect certain corporate decisions, but above all it is the fact that the mezzanine capital is, as compared with the classical debt instruments, much more expensive (on the other hand, it is cheaper than the equity).

In the theory and practice of the corporate finance, we can find a number of instruments belonging to the category of the mezzanine capital. From the point of view of placement on the financial market, where we differ between the private and public mezzanine, it is more interesting to look at the public mezzanine instruments. That is why the paper is focussed on the public mezzanine debt instruments, i.e. convertible bonds and warrant bonds.

In conclusion, we can state that as a result of the risks both on the side of the demand for capital and on the side of the capital supply, which are mutually closely connected and affect behaviour and decision-making of both company managers and the investors, there are basically no convertible and warrant bonds exploited in the Czech Republic (as well as it is in the other former transforming economies). Broader utilization of these mezzanine financing instruments is conditioned by, for example, implementation of changes in the areas of legislation and processes (e.g. ensuring an efficient system of courts, it is also possible to establish a specialized court for the capital market), and in the area of the capital market (e.g. strengthening of transparency and ensuring maximum information openness, or linking the Prague Stock Exchange to a stock exchange that is a leader in the integration of the European market, or creation of new possibilities of utilization of debt securities, e.g. for securitization of assets). The above changes should be institutionally supported and implemented both by the Czech National Bank (as the regulatory and supervisory authority), and by the Prague Stock Exchange.

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