Securities as a Mezzanine Financing Instrument

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Abstract: This paper is dedicated to the problems of mezzanine financing in the form of securities, i.e. convertible bonds, bonds with warrants and preferred stocks. The paper aims to summarize the theoretical background of the mezzanine financing with regard to securities as a mezzanine instrument, and evaluate utilization of these instruments in the practice of the Czech Republic. Firstly, it defines the term of mezzanine capital in the alternative concept and identifies and characterizes its instruments. Then, the attention is paid to the mezzanine instruments in the form of securities. It clarifies the problems of bonds in the general concept and convertible bonds and bonds with warrants as specific mezzanine financing instruments. Analogically, it explains the problems of stocks and preferred stocks. And finally, it documents the current situation in utilization of mezzanine financing instruments in the practice of the Czech Republic on the example of convertible bonds, bonds with warrants and preferred stocks.

Key-Words: securities, mezzanine capital, mezzanine instruments, corporate bonds, convertible bonds, bonds with warrants, stocks, preferred stocks.

1 Introduction

The current fast changing economic world environment on the one hand puts increased demands on entrepreneurial entities, and on the other hand also leads to development of a number of innovations. These innovations affect all areas of business activities, be it the areas of manufacturing, sales, organization, personnel, information or finance. In view of the fact that the modern concept of plural corporate objectives considers maximization of the corporate market value as the top, complex target, the key innovations are those in the area of finance as they have a direct impact on increasing the corporate market value.

In the area of finance, innovations are currently implemented mainly in the spheres of project financing, transaction activities (mergers, acquisitions, joint ventures), or financial instruments. And the mezzanine financing instruments can be considered as an interesting innovation in the area of financial instruments.

The paper aims to summarize the theoretical background of the mezzanine financing with regard to securities as a mezzanine instrument, and evaluate utilization of these instruments in the practice of the Czech Republic.

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

2 Mezzanine Financing

The terms of the mezzanine financing, the mezzanine capital, or in short just the mezzanine, come from architecture, where a mezzanine means “an intermediate platform located between the floor and ceiling of a room” [1]. Within this context, the term mezzanine capital expresses the fact that “it is inserted into a company’s capital structure between the “floor” of equity and the “ceiling” of senior secured debt” [2].

As it is apparent from the below mentioned, the mezzanine financing definition is based on this concept.

According to Silbernagel & Vaitkunas [19], mezzanine capital “generally refers to that layer of financing between a company´s senior debt and equity, filling the gap between the two”.

Vasilescu [26] states that “mezzanine finance is 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”.

According to Svedik & Tetrevova [21], mezzanine capital presents “a hybrid form of funding that has both the features of debt financing and the features of equity financing”.

See Table 1 for the basic characteristics of the mezzanine capital in the context of the senior debt and equity characteristics.

Table 1 - Mezzanine Capital Characteristics in the Context of Senior Debt and Equity Characteristics

Characteristics	Senior debt	Mezzanine Capital	Equity
Security	Secured	Subordinated	None
Ranking	Senior	Second	Third
Covenants	Tight	Flexible	None
Coupon	Coupon - floating	Coupon - fixed	Dividend
Rate	Prime	Risk adjusted	Market adjusted
Equity kicker	None	Warrants	Shares
Prepayment penalties	Yes	Fixed period	No
Capital providers	Chartered bank	Private capital	Private capital
Recovery (%)	High	Low	Low
Liquidity	High	Low	Right of sale

Source: [19].

The mezzanine financing characteristics shown in Table 1 can be considered as the basic framework comprising the general features of this financial instrument. Particular characteristics are then given by the character of individual mezzanine finance instruments; see e.g. Anson, Fabozzi & Jones [3], Culp [7], Demaria [9], Jaeger et al. [13], or Yates & Hinchliffe [29].

We can differentiate two main types of mezzanine finance instruments - private mezzanine instruments and public mezzanine instruments [22]. Vasilescu & Popa [27] also call them mezzanine financing private placement instruments and capital market instruments. For the public mezzanine instruments, the European Commission [10] uses the term equity related mezzanine finance instruments.

The private mezzanine instruments include the following [10, 21, 27]:

- subordinated loans (junior debt), 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 are 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, which represents the form of mezzanine financing that, unlike the previous forms, is not of the debt character; silent participation is a property contribution into the company that is concealed from the public, its providers have no direct liabilities towards the company creditors, but they share the potential loss of the company.

The public mezzanine instruments include the following [10, 21, 27]:

- convertible bonds - bonds that are exchangeable for the issuer's stocks or other property securities;
- bonds with warrants - bonds that are connected with a separately tradable warrant, entitling the holder of the bond to purchase the issuer's stocks or other property securities;
- profit participation rights - equity investments connected with the preference rights to the company's assets, e.g. participation in profits or subscription of new stocks, but no voting or management rights; the typical form is represented by preferred stocks.

The mezzanine financing instruments can also be divided from the accounting point of view into the equity mezzanine (mezzanine instruments that are regarded as equity on the balance sheet of the company), the debt mezzanine (mezzanine instruments that are regarded as debt on the balance sheet of the company) and the hybrid mezzanine (mezzanine instruments that, from an accounting perspective, consist of an equity component and a debt component in the balance sheet) [15].

3 Securities as a Mezzanine Financing Instrument

3.1 Bonds, Convertible Bonds and Bonds with Warrants

Bonds represent a long-term, usually publicly tradable, debt security issued on a mass scale. This security confirms the issuer's commitment to reimburse the bond holder for the yields and redeem the nominal value in accordance with the stipulated schedule. Bonds can be issued by various entities – the state, municipalities, banks, or enterprises. Bonds issued by entrepreneurial entities are called corporate bonds.

In practice, we can meet a number of different types of corporate bonds from the point of view of the character of issue, where bonds are classified according to the character of yield, the way of redemption, the guarantees, the country and currency of issue, the form, their transferability, their tradability, and other rights connected with the bond; see e.g. Brigham & Ehrhadt [4], Brigham & Houston [5], Choudhry [6], De Spiegeleer & Schoutens [8], Megginson & Smart [16], Megginson, Smart & Lucey [17], Yagi & Takashima [28].

As it has already been stated, convertible bonds and bonds with warrants are considered as mezzanine financing instruments, specifically the public mezzanine; see e.g. Svedik & Tetrevova [21], Tetrevova [23], Tetrevova et al. [24].

Convertible bonds represent corporate bonds connected with the right to exchange them for stocks of the given issuer. Such an exchange can be performed either upon maturity of the bond, or on the dates stipulated in advance. The exchange rate, as well as any potential surcharge, which can be expressed e.g. in percentage of the nominal value or in the percentage of the dividend, are also specified beforehand.

Bonds with warrants represent corporate bonds connected with the right to obtain a certain number of the given issuer's stocks as at the specified date for the specified price. However, by using the option the credit relationship resulting from the bonds does not cease to exist, but the holder of bonds with warrants continues to receive the interest until the maturity date of the bonds. Thus the issue of these bonds leads not only to an increase in the volume of debts (until their maturity), but also an increase in the equity in the case the option is used.

Using corporate bonds as a financial source is, from the point of view of the company as the issuer, generally connected with a number of advantages. By issuing bonds, it is possible to get a significant volume of funds provided by a large number of creditors, which makes the required risk bonus decrease; moreover, the yields are tax deductible and it is possible to use the interest tax shield. Another substantial advantage is the fact that the stockholders do not lose their control over the company activities, and also it is not often required to secure the bond in the form of pledges. This method also brings clarification of the management's view of the return on investments, and a successful issue and allocation of bonds improves the corporate image. In the case of convertible bonds and utilization of the option in bonds with warrants, there is another advantage in the form of obtaining an unpayable financial source. Furthermore, convertible bonds are also connected with a lower interest rate in comparison with non-convertible bonds, i.e. lower cost of capital. However, financing through corporate bonds is also connected with certain disadvantages consisting e.g. in significant cost of issue, high investors' demands on the issuer's credit rating, restricting conditions set by the bond holders, or the necessity of timely redemption of the yields and the principal sum regardless of the fact whether the company makes any profit or not. In the case of exchanging convertible bonds for stocks and utilization of the option in bonds with warrants, there is another potential disadvantage in the form of an extended control over the company.

3.2 Stocks and Preferred Stocks

A stock represents a security certifying its holder's rights and their ownership share in the corporate property. Basically, stocks divide into common stocks and preferred stocks; see e.g. Gibson [11], Hitchner [12], Mayo [14], Ravid et al. [18], Svedik & Tetrevova [20], Tetrevova [23], Valach [25].

Common stocks are connected with the right to participate in the company management by taking a vote at the general meeting, to share the company profit in the form of dividends and the liquidation balance in the case the company winds up. At the same time, they are also connected with the preference right to newly issued corporate stocks.

Preferred stocks represent a hybrid form of funding as they have features of both stocks and debts. As it has already been mentioned above, they are considered as one of the forms of the public mezzanine. They are characterized by the fact that, just as common stocks, they are connected with a share in the company profit in the form of dividends. However, the amount of the dividend is fixed and specified beforehand, which is why they resemble debts. Moreover, unless the profit is not high enough to pay of all dividends, preference stockholders are first to receive dividends, i.e. they are preferred to common stockholders. Most preferred stocks are also connected with a specified cumulative obligation, which implies that the company shall also disburse all preference dividends that were not disbursed in the past before it start to disburse dividends to common stockholders. Differently from common stocks (and the same as in the case of debts), preferred stocks are not connected with any voting rights. Their holders could only acquire these rights in the case no dividends are distributed. Furthermore, preferred stocks are also characterized by the fact that in the case of winding-up of the company, their holders have the preference right to share the liquidation balance before common stockholders. Also, these stocks can be, just as debts, payable on a specified date for a price specified beforehand.

Using preferred stocks as a financial source is favourable for a company for several reasons. The basic advantage is the fact that the volume of the capital can be significantly increased without the necessity of extending the voting rights, i.e. the control over the company. Another substantial advantage is the fact that if the company disburses no preferred stock dividends, the consequences for the company are not as significant as with failing to pay the interest on debts. Moreover, these dividends are lower compared to common stock dividends, and they do not rise in the case of an increase in profits. On the other hand, funding through preferred stocks is, from the point of view of the company, also connected with certain disadvantages consisting mainly in considerable cost of issue and also in higher maintenance cost of the given capital form compared to debts, as dividends are not tax deductible expenditure and so it is not possible to use the tax shield. Another thing that can also be considered as a disadvantage is the fact that in the case of a decrease in profits, it is still necessary to disburse a stable amount of dividends.

4 Convertible Bonds, Bonds with Warrants and Preferred Stocks in the Czech Republic

Let’s now pay our attention to the current situation in utilization of the public mezzanine instruments, i.e. mezzanine in the form of securities – specifically convertible bonds, bonds with warrants and preferred stocks in the practice of the Czech Republic.

The structured interviews with the representatives of the Czech National Bank, the regulator in the area of issuing securities, imply that in 2006 - 2012 entrepreneurial entities subscribed 5 issues of convertible bonds and 1 issue of preferred stocks in the Czech Republic. There were no issues of bonds with warrants within this period. For an overview of the issuers of these securities, see Table 2.

Table 2 - Public Mezzanine Instruments in the Practice of the Czech Republic

Year of issue	Issuer	Type of security
2006	CONSTRUCT A&D, a.s.	convertible bonds
2006	V. K. INVEST, a. s.	convertible bonds
2007	CONSTRUCT A&D, a.s.	convertible bonds
2010	ORRERO a.s.	convertible bonds
2011	ORRERO a.s.	convertible bonds
2012	Spa Resort Údolí Bratrouchov a.s.	preferred stocks

Source: Own.

Table 2 shows that company CONSTRUCT A&D, a.s., which deals with production and assembly of vehicle security systems, subscribed two issues of convertible bonds within the monitored period. The first issue was subscribed on 9 May 2006 and it was payable on 31 December 2008. The issue consisted of 33 pieces of convertible bonds with the nominal value of CZK500,000, i.e. the total volume of the issue was CZK16.5 million. The second issue was subscribed on 10 January 2007 and it was payable on 31 December 2008. There were 48 pieces of convertible bonds in the nominal value of CZK500,000, i.e. the total volume of the issue amounted to CZK24 million. In both cases, the bonds were issued with a fixed interest rate of 4% p.a., and they were paper bearer bonds.

Another issue of convertible bonds was subscribed by the estate agent of V. K. INVEST, a.s. on 1 June 2006, payable on 1 June 2010. 21 pieces of convertible bonds were issued with the nominal value of CZK1 million, i.e. the total volume of the issue was CZK21 million. These bonds had a fixed interest rate of 7% p.a. and they were in the form of a paper bearer bond.

The last two issues of convertible bonds were issued by company ORRERO a.s., dealing with production and sale of cheeses. The first issue was subscribed on 10 March 2010 and was payable on 30 June 2013. It contained 15,747 pieces of convertible bonds with the nominal value of CZK5,000, i.e. the total volume of the issue amounted to CZK78.735 million. The second issue was subscribed on 15 June 2011 and payable on 30 June 2013. 5,248 pieces of convertible bonds were issued with the nominal value of CZK5,000, i.e. the total volume of the issue reached CZK26.24 million. In both cases, the issuer opted for a floating interest rate corresponding with the average Lombard rate of the Czech National Bank for the twelve months preceding the date of disbursement of the interest plus 2.5% p.a. In both cases, they were registered paper bonds.

Table 2 also shows that the only preferred stocks issuer in the monitored period was company Spa Resort Udoli Bratrouchov a.s., which issued these stocks on 11 July 2012. This company issued 235,500 pieces of preferred stocks with the nominal value of CZK50, i.e. the total volume of the issue amounted to CZK11.775 million. They are registered book-entry stocks with an expected regular dividend of 10% p.a. paid quarterly.

However, none of the above securities has been traded at the Prague Stock Exchange.

5 Conclusion

Mezzanine finances represent a layer of sources lying between the equity as the basic layer of financing and the debt as the second layer of financial sources and they have features of both the equity and the debt. In practice, it is possible to apply either the private mezzanine instruments and/or the public mezzanine instruments. The public mezzanine instruments have the character of securities in the form of convertible bonds, bonds with warrants or preferred stocks.

Utilization of these instruments in practice is very different. It is determined by the funding traditions, financial managers' knowledge and experience, or by the level of development of the financial market. In the Czech Republic, the mezzanine financing instruments are generally not used very often, which was also proved by the research focussed on the problems of the public mezzanine instruments. The reasons can be found, on the one hand, in the fact that financial managers are afraid of entering the capital market connected with fulfilment of an extensive information obligation and, on the other hand, in high cost of issue including a significant proportion of fixed costs, which only makes an issue budget-wise if the volume of the issue exceeds a certain level, but nowadays a number of companies do not have investment plans of such an extent. The reason can also be seen in the fears of potential non-placement of the issue as a result of distrust and lack of information on the side of investors. As for convertible bonds and bonds with warrants, another reason is the potential possibility of extending the control over the company, in the case of preferred stocks also impossibility of using the tax shield.

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