WILEY FINANCE

Mezzanine financing

TOOLS, APPLICATIONS AND TOTAL PERFORMANCE

LUC NIJS

Contents

For other titles in the Wiley Finance series please see www.wiley.com/finance

Mezzanine Financing

Tools, Applications and Total Performance

Luc Nijs

WILEY

Registered office
John Wiley & Sons Ltd, The Atrium, Southern Gate, Chichester, West Sussex, PO19 8SQ, United Kingdom

For details of our global editorial offices, for customer services and for information about how to apply for permission to reuse the copyright material in this book please visit our website at www.wiley.com.

Library of Congress Cataloging-in-Publication Data

Nijs, Luc.

Mezzanine financing : tools, applications and total performance / Luc Nijs.

pages cm. — (The Wiley finance series)

Includes index.

ISBN 978-1-119-94181-1 (hbk) 1. Finance—Management. 2. Risk management. 3. Finance–Law and legislation. I. Title.

HG173.N54 2013

658.15’224–dc23

2013034153

A catalogue record for this book is available from the British Library.

ISBN 978-1-119-94181-1 (hbk) ISBN 978-1-118-76522-7 (ebk)

ISBN 978-1-118-76520-3 (ebk)

Cover images reproduced by permission of Shutterstock.com

To my parents.
For their relentless support in pretty much everything I do.
That they may continue to thrive in good health.

Preface

For years now, for one and a half decades in fact, I have been engaged in the mezzanine world as an academic, trainer, consultant and as an entrepreneur/investor. Although nothing can replace practice and experience, it is the many students and practitioners I have met in my programs and courses, as well as the many business situations which triggered open-ended questions, that ultimately motivated me to write the book you now have in front of you.

During all those years the mezzanine finance world has changed a lot; it has grown significantly, boundaries have become blurred and financial innovations have made the spectrum more fragmented than before. Not surprisingly, many students and young professionals have wondered if they really understood what was going on, and when it was appropriate to use these products in a variety of situations thrown at them in their professional careers. They wondered which type of product to use and when, what the short and long-term impact would be for their firm, how to legally construct these products and, most importantly, how much risk there would be in each of these products, and therefore what a realistic and meaningful return would be given the risks involved. Some of them ended up in a vicious circle of self-repeating and self-reinforcing questions.

In my students' battle to embrace the dynamics of the product group and assess the adequateness of each product, their eagerness and uncertainty forced me to be clearer and more transparent in the way I communicated about the theme. That clarity is even more important in emerging markets where most of my business engagements are (and also my heart and passion) and where the banking sector has often not yet (fully) commercialized the product group. Sometimes this was because there was no need for the product group, sometimes because overall financial development has not been ongoing at a pace that would justify their introduction, and finally the contractual structure which can, at times, be difficult to understand, and/or difficult to produce, and the position the creditor ends up in when things go wrong, obstructed the introduction of the product group in some of those emerging markets.

This book is written around my experiences during sessions, and is based on years of implementing the product group in many countries, structures and industries while supporting different corporate or entrepreneurial objectives. The book, therefore, has content that can be described as a mix of academic analysis and practical applications for selecting and structuring deals. It is also characterized by a multidisciplinary approach, where economic, legal and financial aspects are intertwined where needed and as deemed appropriate.

I have also included the necessary examples and case studies, as the picture they provide can say more than a thousand words, and will further stimulate those who decide to use the book primarily as a study handbook or guide.

The book's content falls into four major divisions. After an introduction that allows us to look at the mezzanine market and the demarcation of the product group (Chapter 1), the second part of the book will include extensive coverage of the individual products, and contains a list of dos and don'ts for each of them (Chapter 2), the implicit cost of mezzanine products (Chapter 3) and the technicalities with respect to embedded optionalities (Chapter 4) as well as the overall pricing and valuation question. The third part of the book will look at the peculiarities of the product group when applied within certain industries and the implications of highly regulated environments. The banking sector, project finance applications, the real estate sector and private equity settings all pose specific questions and raise individual problems that we need to tackle (Chapters 5–8).

The fourth part of the book will look at the issues of structuring the products, accounting and legal issues, the struggle of rating agencies (Chapter 9) dealing with the product group, cash flow waterfall concerns and, most importantly, the question of an adequate risk–return trade-off for the product group, in particular in distressed situations or issues related to work-outs or (outside) courtroom restructuring programs (Chapter 10). I end in Chapter 11 with an outlook for the product group and what innovation has delivered in this field in recent years. The aforementioned case studies and the necessary appendices which primarily contain legal and contractual support documents complete the book.

The book is therefore appropriate for both scholarly and professional purposes. For the academic or student wishing to delve deeper into the specifics of the product group, as well as the practitioner who might be looking for specific answers to the challenges that come with the application of the product group, this book provides the necessary answers and food for thought. The references made in the footnotes facilitate further reading.

The market is continuously in action and financial innovation will, at some point, force this work to be revised. Where possible, I have tried to use foresight to shape the content without leaning towards speculation about certain aspects of the product group’s future and its place in the financing spectrum. Where adequate and properly identifiable, I also refer to regional differences in application or pricing levels of the product group. Finally I have tried to anticipate some of the most pressing questions facing the product group, both from a regulatory and a market point of view. No doubt, the future mezzanine market will be shaped in part by how the lending market and the need for credit will evolve into what will still qualify as significantly unstable markets, as well as the impact of Basel III and the wider regulatory reforms on the banking industry, and the further development of the shadow banking system and the regulation it will face. Each of these aspects will have distinct implications that can currently only be vaguely assessed.

Many times during the writing of this book I have had to use discretionary judgment about what to include and in how much detail. Statistically that must mean that, while exercising my discretionary judgment, I have been wrong on a number of occasions when making those decisions, for which I hope you will forgive me.

The mezzanine product group deserves increased attention and I hope this book contributes to that well-justified longevity. Happy reading!

Luc Nijs
February 2013

1

Introduction

For as long as some sort of trade-centered economy and society has existed for mankind, people have been financing those activities, either directly or through the sort of intermediaries that we now know as banks or financial institutions. Historically, there have always been two types of financing available for businesses which are trying to raise capital to fund their activities.

That sounds somewhat simplistic but ‘debt’ and ‘equity’ have always been the fundamental financing classes tapped into by businesses, despite the many investment vehicles most businesses have access to.

We begin this section by looking at the characteristics of debt and equity and then conclude by defining the scope of the mezzanine product group.

1.1 THE BI-POLAR WORLD OF FINANCE

There are many different ways in which businesses can raise money, the primary ones being ‘debt’ and ‘equity.’ As I mentioned above, that sounds somewhat basic, and I guess it is, looking at the many product choices firms have these days. However, the two groups point at a fundamental difference as we know it in corporate finance. Let’s first look at the characteristics of both groups and then at the individual products that are included in these groups. After that, we will look more closely at the hybrid or mezzanine product group.

Although debt and equity are often characterized by referring to the products that feature their characteristics, i.e., stocks and bonds, the true nature of the difference lies much deeper; in the nature of the cash flow claims of each product.

The first big distinction has to do with the debt claim, which entitles the holder to a contractual set of cash flows to finance the repayment of the principal amount as well as the interests on a period-to-period basis. An equity claim, on the other hand, only holds a residual claim on the cash flows of the firm, i.e., after all expenses and other commitments are honored.

This is the fundamental difference, although the tax code and legal qualifications have contributed to the creation of further distinctive characteristics between both groups.

The second distinction, which can be seen as a direct consequence of the first distinction, is a logical result of the contractual claim that debt holders have versus the residual cash flow claim of equity holders. Debt claims have priority over equity claims, hence the qualification of equity owners as residual cash flow owners. That is true for both the principal amount and interest payments, and is valid until the instrument reaches maturity, even in the case of a bankruptcy or liquidation of the firm (claim by the debt holders on the firm's assets).

The tax laws in most countries make a distinction between the tax treatment of interest versus dividends. Interests paid are tax deductible when paid by the borrowing firm and are therefore cheaper on a net (after tax) basis. Dividends, however, are not tax deductible, as they are considered to be paid out of net cash flows.

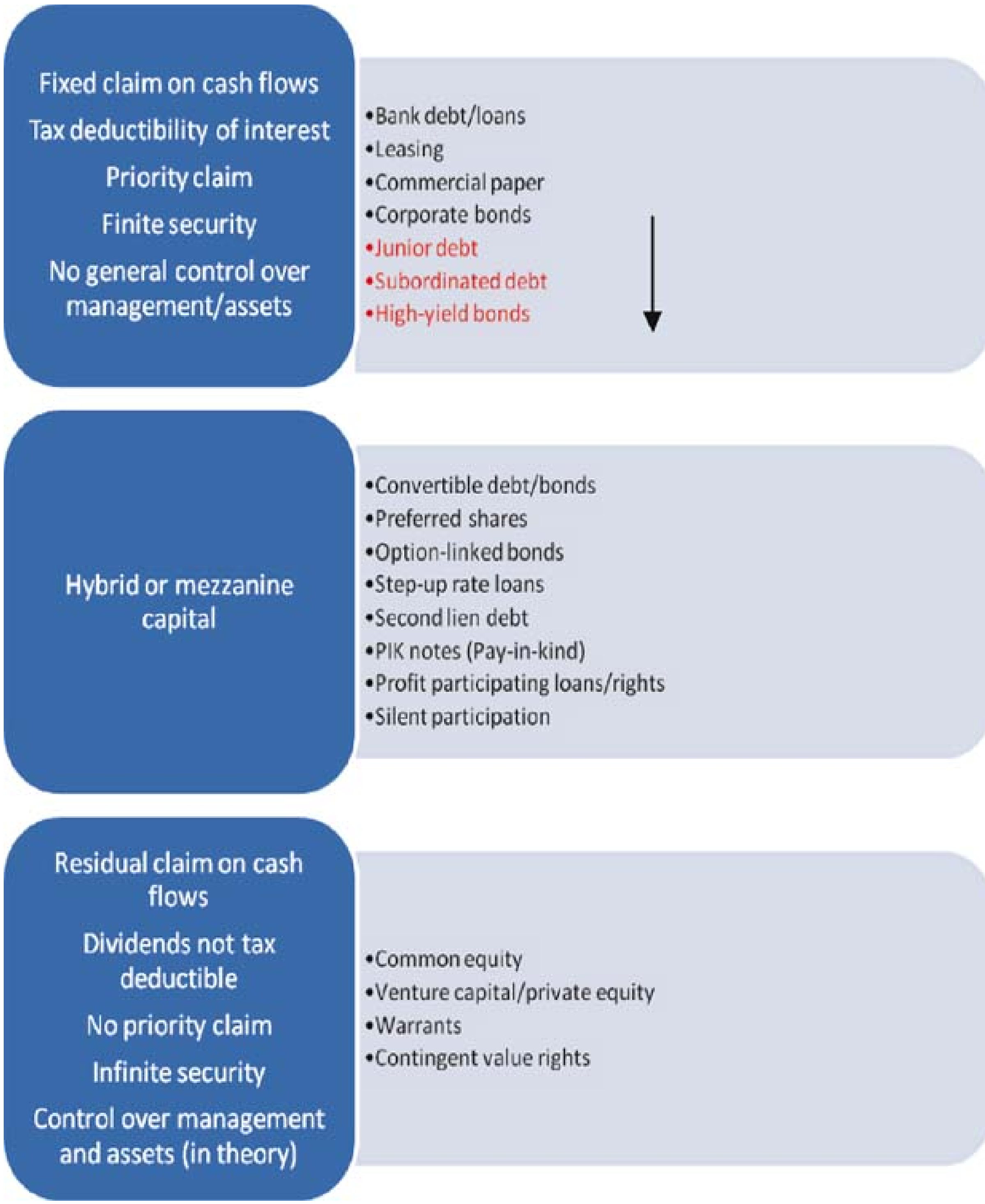
Additionally, debt instruments have a fixed maturity, i.e., the principal amount becomes due at a certain point in time, together with the interests which have not yet been paid. (We will ignore, for the time being, perpetual bonds, which are, in essence, 99/100 year renewable instruments). Equity instruments are perpetual or infinite, i.e., they continue to exist until the firm decides to buy them back and retire them, or to liquidate the firm completely.

Lastly, because equity owners are the residual cash flow owners, they are given control over the assets of the firm and its operational direction. Debt investors usually have a more passive role, often with no power of veto over major decisions in the firm. However, in recent years debt owners have done a pretty good job of getting their foot in the door, by using positive and negative covenants in their loan agreements to have (some level of) control over major transactions that would impact their position in the firm, often by making their investment more risky (i.e., due to increased leverage) or by damaging their chances of being repaid.

In short, debt is characterized by a contractual claim on the firm, benefiting from tax-deductible interest payments, with a finite lifetime and a priority claim on cash flows in both going concern situations and bankruptcy or liquidations. Equity, on the other hand, has a residual cash flow claim on the firm, is an infinite security, where dividend payments do not come with tax deductibility, has no priority, but provides control over the management and assets of the firm (in theory). Securities that have characteristics of both are termed hybrid or mezzanine capital, a definition which we will refine later in this chapter.

Figure 1.1a brings the categories and characteristics together but requires some explanation. Starting from the debt and equity positions we have already discussed (which make up boxes 1 and 3), the figure substantiates those two financing classes by indicating which types of instruments can be classified as being either debt or equity and further introduces the hybrid capital category (box 2) with an indicative set of products included.

Figure 1.1a The financial spectrum



For the sake of completeness, and to provide a level playing field, I will review most of the products mentioned at this stage. Additionally, all terms are explained in the glossary, which can be found at the end of this book, and which includes a review of all technical terms used in this book, regardless of whether they have already been explained in the core text.

Box 1, which reflects the debt products, includes the following instruments:

(1) Bank debt or loans which are fixed-income instruments with a fixed or floating interest rate and a pre-determined maturity. Often these loans are secured and therefore repayment is secured by collateral.

(2) Leasing, which is a form of asset financing where banks or specialized leasing institutions provide the financing for a specific (im)movable asset. The asset also serves as collateral in case the lessee (the person who has requested the finance) is unable to meet the lease payments. Two main categories exist, i.e., financial (or capital) and operational leases. In an operational lease, the lessor (or owner) transfers only the right to use the property to the lessee. At the end of the lease period, the lessee returns the property to the lessor. In case of a financial lease, the lessee has an option to acquire the asset (often at the end of the lease contract). Technical criteria distinguish operational from financial leases, and there are numerous accounting implications that are beyond the scope of this book. The distinction is also under review by the IASB (accounting body governing IFRS/IAS statements) which has been in its final phase for some time now (at the time of publication). For our purposes the distinction matters less as both types involve the lessee making payments to the lessor, which include a repayment of the loan underlying the asset purchase by the lessor. The lease payments include much more, i.e., insurance, depreciation, maintenance costs etc.

(3) Commercial paper: when companies want to raise debt they traditionally have two options, they raise bank debt or issue a corporate bond (which can be listed or raised through a private placement). In both cases the firm will face significant costs, either because of the fees that come

with bank debt or in terms of the capital raising fees it will have to pay to the investment bankers raising capital for the company. In case of bank debt those expenses can be as significant as 3–6% of the amounts looked for. In the case of a bond this can be anywhere between 3 and 7% depending on the investment bank one uses, the region where capital is raised and the amount sought. A cheaper alternative for organizations is to raise debt directly in the market through commercial paper. Commercial paper is an unsecured instrument that allows companies to raise short-term debt (quite often the maturity will not exceed 270 days or nine months) often to finance current assets such as inventory, account receivables and other short-term liabilities. Because this type of instrument is unsecured, it can only be used by significantly creditworthy companies. In practice, the instrument is open to companies with an A credit rating or higher.

(4) The next category in box 1 is junior debt, which can be qualified as those instruments that are ‘junior’ to other debt obligations a company has. That is, they are ranked lower on the repayment schedule than the more ‘senior’ debt instruments a company has committed to. They are also often unsecured.

(5) Subordinated debt: Subordinated debt (which is mostly unsecured) is debt that is ranked lower than other debt instruments a company is committed to. In that sense they are also ‘junior’ as a debt instrument and aren’t backed by a security. Subordination can happen in two ways: the first is contractually – the loan contract will explicitly indicate that the interest and principal of this instrument will only be repaid after all other senior instruments have been repaid first. The subordination can also happen structurally – when the conditions and maturity of the loan have been structured in such a way that all other loans will be repaid before the structurally subordinated loan will be repaid. That can happen because the maturity of the loan is

further in the future than all other loans and/or the interest is rolled up towards the instrument's maturity. In the meantime, all other senior lenders will be repaid.

(6) High-yield bonds (aka junk bonds) are debt instruments with a poor credit rating (in practice a non-investment grade rating which comes down to BB+ (S&P and Fitch), Ba1 (Moody) or lower categories.

In box 3, which is the equity box, one can find common equity, the mother of all equity instruments. Equity provided by private equity firms and venture capital firms fits into this category as well. Warrants, once converted, entitle the holder to a certain pre-determined stake, in most cases, in the equity of the firm which issued the warrants. A warrant can therefore be qualified as an instrument that entitles the holder to purchase or receive common equity in the warrant's issuing company. Contingent value rights are like an option where the holder of the rights is entitled to buy additional shares in the issuing company when certain events happen, under pre-determined conditions and pricing. This often happens after an acquisition or restructuring, where shareholders of the target company can acquire additional shares in the acquiring company (if, for example, the value of the shares of the acquirer drops below a certain point before a certain date).

Finally, in category two, the instruments that have characteristics of both debt and equity either simultaneously or subsequently are listed. In Chapter 2 we will discuss extensively each of these instruments and compare their technical characteristics. For now it is sufficient to understand that each of the products included in box 2 will have, with varying degrees of intensity, characteristics of debt and equity and consequently their risk profile will be very different. Some will be hardly any different from a normal debt instrument as included in box 1 and others will show extreme similarities with the equity product group in box 3. What is striking, though, is that almost all are packaged in what qualifies legally as a debt instrument (with the exception of preferred stock), despite their significantly higher risk profile, a risk profile that sometimes hardly differs from an equity instrument.

In the wider context of financing options, mezzanine qualifies as an external source of funding as categorized in Figure 1.1b.

Figure 1.1b Financing options for companies

Source: Credit Suisse economic research

Forms of financing			
Internal financing		External financing	
Funds from business activities: •Retained profits •D&A •Reversal of provisions	**Funds from the release of capital:** •Sales of assets (divestitures)	**Equity:** Capital contribution from existing equity holders Capital contribution from new equity holders Private equity Public equity (IPO, Secondary offering)	**Debt:** •Banks (loans) •Capital goods leases •Suppliers (credits) •Customer (advances) •Bonds
		Mezzanine financing	

1.2 DEMARCATION OF THE PRODUCT GROUP

Now that we have the categories in place, we are left with the grueling task of finding the demarcation line as precisely as possible and defining it as accurately as possible.

We could do that by looking at the reality of how the instruments are used, positioned or otherwise, but that would prove to be a mixed bag as well, and further, would not really help us develop a clearer picture of the product group.

Looking at the legal qualification would force us to drag many hybrid instruments back into either the debt or the equity category, mostly the former, hence the need for a separate category of hybrid capital.

The above issues have left those wishing to define the product group in the difficult position of having to describe the product group by its characteristics. Though I don't want to go out on a limb here, I will take on the challenge of breaking down the individual characteristics, to see where the rough edges are or question marks could be placed.

By looking at the mezzanine product group as a whole, the following characteristics can be identified:

- The individual products *are all unsecured products, i.e., there is no collateral and/or firm lien on some or all assets of the borrowing firm*. Second lien loans are an exception to this criterion, but aren't strictly part of the mezzanine group.
- All the products carry a compensation scheme which includes the provision that *(at least part of) the compensation is dependent on the future profitability of the firm (or, by extension, the return on equity or economic value creation of the firm)*. This one raises some additional questions. Products like junior debt, subordinated debt or unsecured debt all tend to be unsecured in their positions, but otherwise do enjoy the equity kicker that many other mezzanine products do. So some discretionary judgment is needed. On the one hand, these products are legally debt just like most other mezzanine products. On the other hand, they are also unsecured just like all the other mezzanine products. Where they deviate is that they do not directly enjoy the equity uptick that other products have built into their

mechanics. It could be argued, however, that the higher spread that is built into the compensation scheme intrinsically includes that equity component. The counterargument is that an increased spread cannot reflect equity performance, it can only reflect higher risk patterns absorbed by the instruments, and in no way can it reflect the potential up- or downside that equity exposure can bring. So you could either argue that they belong to the debt product group (if you overweight the legal debt qualification) or that they are positioned in the outer space of the mezzanine cosmos (if you overweight the unsecured position and the higher overall risk profile they have relative to their peers in the debt group). One could say that there is a difference when defining mezzanine products *sensu lato* and *sensu stricto*.
- *Some products are finite and others are infinite in nature. Besides the perpetual loans and non-redeemable preferred shares, all products are finite in nature*.
- *Most of the products (except for preferred equity) are debt instruments (in their legal qualification)*, which raises the question about the semantics of the term mezzanine capital versus the term mezzanine debt. Nevertheless, most of the products have a risk profile much closer to equity than their legal qualification initially suggests.

So, you can see for yourself that the jury is still out on some of these products in terms of their qualification, or at least that there is a mixed bag of characteristics within the mezzanine product group. An alternative way of looking at the product group is through its risk profile, which we will do in Section 1.4.

The historical distinction between debt and equity doesn't make our life a lot easier. In fact, you might wonder if there is a justification for treating debt and equity in such different ways. In particular, the different tax treatment has raised many questions among scholars, none providing a compelling argument for why the difference emerged, nor for why we should keep the distinction intact, especially since the differences trigger specific behaviors among market participants. Given the (lower) net cost of debt there is an inclination among market agents to use (too) much debt to fund their activities. That in itself is not evil, but raises the fixed cost levels in the firm (as they are fixed commitments). In days of poor economic performance or market volatility, or just lower levels of liquidity in the banking sector, that situation can trigger issues for firms operating high levels of debt, as the 2008 financial crisis demonstrated.

Furthermore, as a country you can wonder if it is so attractive to have a lot of thinly capitalized firms in your economy, as they pose an intrinsic risk to other market participants through enhanced counterparty risk when dealing with them. Many countries have therefore introduced 'thin capitalization rules' in their tax code, which essentially are there to cap the amount of deductible interests a firm can deduct for tax purposes in any given period. The technical way that is determined differs slightly for each country, but the rules either put a nominal cap on the amounts of interests that can be deducted and/or put in place maximum debt/equity relations for any given period. For example, if your debt to equity ratio is higher than 3:1, the interest due on any debt amount above the 3:1 ratio is no longer deductible for tax purposes, making the instrument more expensive on a net basis.

However, only one country in the world went as far as abolishing the distinction between debt and equity for tax purposes. That country is Belgium. In 2007 (yes, before the financial crisis) the Belgian government introduced what is known as the 'notional interest deduction.' The mechanism allows for the tax deductibility of an artificial dividend from the equity side of the financing mix. They don't look at the effective dividends (which are not tax deductible) but at an artificially constructed dividend based on the T-bond rates in that period increased by a certain spread. The level of the spread is then based on certain conditions. This way an equity investment holds the same benefits as a debt investment.

Besides the significant impact the introduction of this rule had on the budget, the government intended to ensure a better capitalized economic environment in the country. That is pretty understandable as the country enjoys major inbound investments every year, and is often the prime location for overseas investors to locate their European holding (and consequently Belgian holdings capitalize many subsidiaries in other European countries). Consequently, the capitalization of that holding determines the economic strength of its subsidiaries in Europe, especially when the economic tide shifts. Since 2007, the rule has been adapted a few times to remove possible abuse situations and non-intended usages within international tax planning schemes.

Going even beyond that, questions can be raised about the true nature of an equity or debt instrument. All too often we look at the legal characteristics of the product to judge its nature. In most cases that is fine, but there are some exceptions that might make you wonder. If one provides a loan (in legal terms) to a firm which is in such a desperate economic state that it almost certainly will not be able to pay back the loan and interests due, one can wonder if the legal qualification is still adequate.

The jurisprudence in many countries has responded to these situations by denying the deduction of the interest, re-qualifying the loan to equity and/or re-qualifying the interest to a 'deemed dividend.' In order to do that, the legal system needs to allow the tax authorities to ignore the legal reality of a business transaction in favor of the economic reality underlying the business transaction.[1] Whether a legal system allows the economic theory doctrine to be applied is often a matter of legal principle in that jurisdiction and the answer often needs to be derived from other parts of the law beyond the tax code. In countries which do not have an economic theory in place, the tax authorities will have to turn to the ‘abuse of law’ provisions in their tax codes and argue that the participants in the deal were intending a different outcome to the one the legal qualification would normally imply. That is an uphill battle for tax authorities and disputes are therefore mostly settled out of court.

I think it is fair to temporarily conclude that the debt to equity spectrum is a diamond with many angles, which are colored differently depending on your perspective.

1.3 POSITIONING AND USE OF MEZZANINE FINANCE

Maybe we will get some further answers when looking at the reason why mezzanine finance exists to begin with and for what purposes it is used. When looking at the transactions for which mezzanine finance is used there is a long list of transactions that keep coming up.

On that list are:

- Funding M&A activity (industry related or not) or funding organic growth and spin-offs.
- Restructuring or reorganization of the business.
- Funding the acquisition of portfolio companies by private equity firms (LBOs or otherwise).
- Management buy-ins/outs.
- Internationalization.
- Succession planning.
- Project finance.
- Change of strategic direction.
- Providing ‘bridge’ financing to portfolio companies on their way towards an IPO (when owned by a private equity firm).
- Recapitalizations.
- Funding the introduction of new products or service groups, plant expansion or the development of new distribution channels.