universität wien

MASTERARBEIT

Titel der Masterarbeit

„Mezzanine Financing“

Verfasserin
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angestrebter akademischer Grad

Master of Science (MSc)

Wien, 2013

Studienkennzahl lt. Studienblatt:	A 066 915
Studienrichtung lt. Studienblatt:	Masterstudium Betriebswirtschaft
Betreuerin:	Univ.-Prof. Dr. Gyöngyi Lóránth

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Abbreviations

AD	The Bulgarian abbreviation for joint stock company
AG	The German abbreviation for joint stock company
AMC I	Accession Mezzanine Capital I LP
AMC II	Accession Mezzanine Capital II LP
BGN	Bulgarian lev
bn	Billion
bps	Basis Point
CAGR	Compound Annual Growth Rate
CAPEX	Capital expenditure
CB	Closing Balance
CEE	Central and Eastern Europe
COGS	Cost of goods sold
D/V	Percentage of financing that is debt
DMC	Debt Mezzanine Capital
e.g.	For example (“exampli gratia”)
E/V	Percentage of financing that is equity
EAD	The Bulgarian abbreviation for sole proprietor joint stock company
EBIT	Earnings before interest and taxes
EBITDA	Earnings before interest, taxes, depreciation and amortization
EBT	Earnings before taxes
EMC	Equity Mezzanine Capital
EUR	Euro
EURIBOR	Europe Interbank Offered Rate
EV	Enterprise value

FCF	Free Cash Flow
GCP	Growth Capital Partners AG
GmbH	The German abbreviation for private limited company
i.e.	That is, In other words (“id est”)
IPO	Initial Public Offering
IRR	Internal rate of return
JEREMIE	Joint European Resources for Micro to Medium Enterprises
k	Thousand
KPI	Key performance indicator
LBO	Leverage Buyout
LIBOR	London Interbank Offered Rate
m	million
M&A	Mergers & Acquisitions
MBO	Management Buyout
Mezzanine/V	Percentage of financing that is mezzanine
MMCE	Mezzanine Management Central Europe
NPV	Net present value
NWC	Net working capital
OB	Opening Balance
PE	Private Equity
PIK	Payment-in-kind
PPE	Property, plant and equipment
R mezzanine	Cost of Mezzanine
R&D	Research & Development
RCP	Rosslyn Capital Partners

Rd	Cost of Debt
Re	Cost of Equity
ROE	Return on Equity
SEE	South-East Europe
S&P	Standard & Poor’s
SG&A	Selling, general & administrative expenses
SPAC	Special purpose Acquisition Company
Tc	Tax rate
TWC	Trade working capital
VC	Venture Capital
vs.	versus
WACC	Weighted Averages Cost of Capital

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1. Introduction

In time, when access to funds becomes more and more limited and when the companies face tough economic conditions and have a growing need to make major investments, the need of alternative forms of financing becomes higher. This is the reason why, during the past decade, together with the conventional forms of financing - equity and senior debt, the so-called mezzanine capital has also entered into the company's financial structure. Mezzanine financing is characterised by versatility and flexibility. These two features make this alternative form of financing suitable to facilitate the tailor-made financial transactions and to form an optimal capital structure.

The term "mezzanine" has entered into business terminology from the Renaissance and Baroque architecture. Today, there are many different forms of hybrid products. Their common feature is that they all offer a risk-return profile that lies above that of debt and below that of equity.

The thesis is comprised of four main parts. The first one is focused on the theoretical background of mezzanine finance. There I represent the mezzanine capital in its "narrower" and "broader" sense. Under the "narrower" sense, it is understood the so-called private mezzanine, which is a long-term, non-amortizing, second secured, subordinated debt instrument that often contains an optional component that entitles to a fix equity tranche. Under the "broader" sense, it is understood all the other hybrid products that perform a bridge function between the pure debt and the pure equity in the capital structure of a company. Besides, various theories, which relate to this type of financing, will also be discussed in brief.

The second part of the thesis is more practically oriented. It deals with various application areas of mezzanine debt in modern corporate life. My focus in this part of the work is directed towards the mezzanine capital as a financial instrument for optimizing the entity's capital structure, as a tool to ensure further growth through implementing major expansion projects, and as a financial component of LBO transactions.

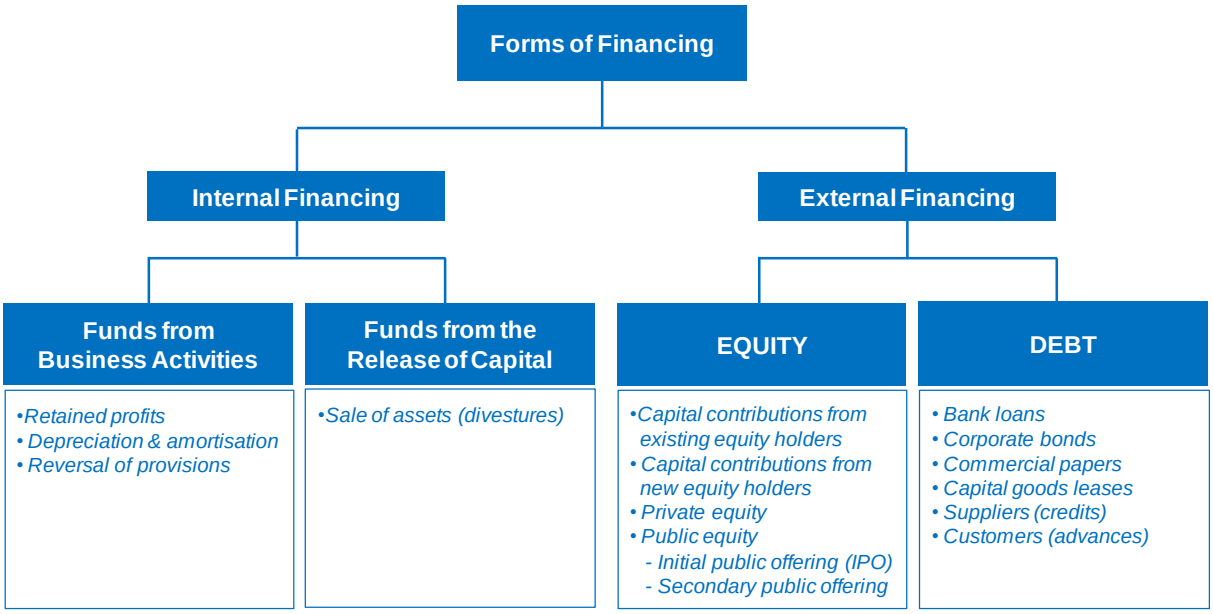
In the third part I will briefly present the market of mezzanine products in Europe and in particular, in my home country, Bulgaria.

In the fourth, final part, I will back-up the reviewed theoretical concepts with one example from real-life based on the empirical study of the Bulgarian mineral water producer – Devin AD.

2. Types of Financing at a Glance

Companies can meet their capital needs in a variety of ways. This results in different types of financing, which can be classified in diverse criteria. As distinguished criteria for systematising of the financing forms is considered the origin of the funding source (internal vs. external financing), as well as the legal status of the investor (equity vs. debt funding). The figure below illustrates in details the classification of the alternative forms of financing according to the above listed criteria.

Figure 1: Financing Options for Companies



Source: Credit Suisse Economic Research, Mezzanine Finance – A Hybrid Instrument with Future, 2006

2.1. Internal Financing

By internal financing the company satisfies its financial needs with available resources. This is possible mainly through the so-called funds from business activities, created by the retaining of profits, realized in the previous years as well as from the reversal of provisions. These types of funds are formed continuously over the years. A company can raise internal funds through the so-called „divestures" too, i.e. through the reorganization of assets into liquid funds.

Among the advantages of this type of financing is the fact that equity holders are independent from the money and capital markets and from the conditions, set by external lenders.

Moreover, the acquired profit for a given period remains entirely at their disposal. Not least by this type of financing in most of the cases the solvency of the enterprise is increased. Internal financing has also its drawbacks. One of them is that the company's growth rate is limited to some extent. Furthermore, the entrepreneurs do not have the incentive to make the company more efficient and thus assure that they have enough funds to cover the principal and interest payments on the raised debt.

2.2. External Financing

By external financing the entrepreneurs obtain the missing resources on the money and capital markets. Externally financed funds come from private individuals and institutions that tend to bring their money through a voluntary act in the business venture. The measures of external financing by all means relate to a capital growth within the company. External financing may take the form of debt or equity.

2.2.1. Debt Funding

Among the most frequent instruments of debt funding are bank loans and corporate bonds. The common thing is that the borrower is obliged to return the principal and the interest payments to the external lender, according to preliminary determined schedules. Therefore we can conclude that the given financial resource can be used only for a limited period of time. The company's property serves as collateral for the repayment of the given credit instrument. In case the company could not meet its financial obligations and the renegotiations with creditors are unsuccessful, each of the parties has the right to initiate a liquidation procedure. Due to the fact that senior lenders neither have ownership in the enterprise and nor have the right to participate in its management, they can not exercise a direct influence on the processes, taking place in the company. Owing to financial guarantees - collaterals and to the rank they take in terms of profit sharing or property distribution in case of liquidation, their risk is moderate which makes debt funding cheaper compared to other forms of financing.

2.2.2. Equity Funding

In case of equity funding the private individual or the financial institution that provides the resource acquires ownership in the company. The investor participates in the control over company's decisions in proportion to the contribution he has made or on the basis of a separate agreement. The profit for the investor is received either in the form of dividends or in the form of a capital gain, realised only after his business share has been sold out. Unlike debt

funding, by equity funding the capital owners are not protected in any way. They rank on last place in terms of profit-sharing or property distribution, after senior lenders, tax authorities, employees etc. and therefore face the greatest risk. This explains the fact why the required rate of return by equity investors is much higher than the one required by senior creditors.

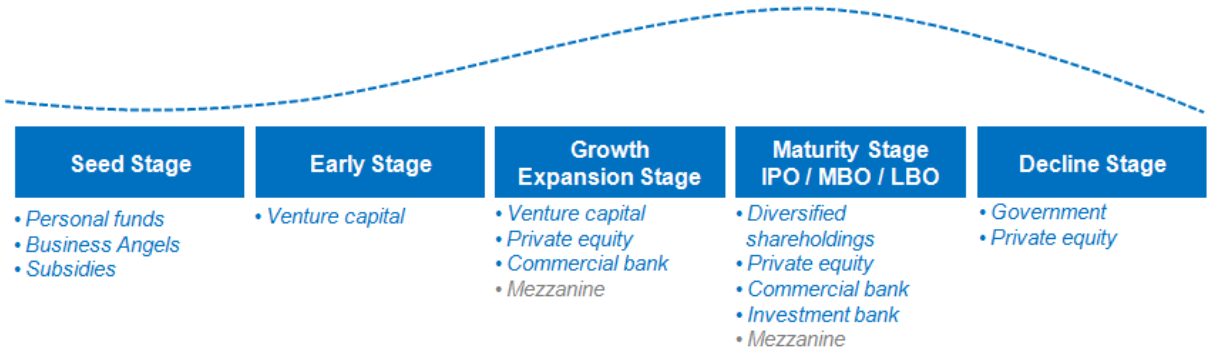
The realized classification of the types of funding was necessary because mezzanine capital is a form of financing, which combines elements of both equity and debt funding. In this regard we could argue that the mezzanine capital is not a stand-alone financing instrument like loan or stock. It presents a wide range of options for the design of various financial structures in respect of the rights and obligations of the parties in the contract[1].

[1] Credit Suisse Economic Research, Mezzanine Finance – A Hybrid Instrument with Future, 2006

3. The Business Cycle Model

The Business Cycle Model is often used to describe the life cycle of business organisations. In the process of its activity, each one of them needs liquid cash and financial resources for its future development. The occurrence of different financing needs, as well as the affluent palette of financial resources they could be met with throughout the various periods of the life cycle result in a change of the entity's optimal capital structure. This section will present the interdependence between the stages of business organisations' economic cycle and the sources of financing in its various stages. The specific features of the main types of investors will be identified and discussed and also the major factors and reasons that play a key role in taking their investment decisions.

Figure 2: The Typical Business Cycle Model



Source: Own illustration based on I. Hristov, "The Importance of the Business Cycle Model in the Financing of Businesses", 2010

There are a number of approaches, described in the scientific literature, for separating the companies' life cycle stages. The model that separates five phases in the business development will be discussed herein below[2]. In each one of these phases, investors invest additional cash prior to the termination of the company as an independent legal entity, i.e. prior to it being liquidated, bough-out or absorbed.

3.1. Seed Stage

The life cycle of an entity starts with the so-called seed stage. This stage is characterized with the introduction of the company into the market environment and formation of its initial structure. In this stage, there are no manufactured goods and services, through the sale of

[2] I. Hristov: The Importance of the Business Cycle Model in the Financing of Businesses, University of National and World Economy, Sofia, 2010

which operating income could be generated. The activity is financed by own funds, funds of business angels[3] or subsidies, whereas the funds attracted are spent for researches and presentation of the new business idea.

3.2. Early Stage

In the event of successful development, the company enters in the stage of early growth. In this stage, the formation of the company as an administrative structure and business model is completed. On the one hand, cash is invested to fund the development of products and services to be marketed by the company, and, on the other hand, capital is invested to finance the production activity. In practice, the principal operating activity of the company commences. Usually, in this stage business is financed by venture capitalists[4], who, in turn of the high risk they assume investing in start-up companies, obtain significant control over company decisions, in addition to a portion of equity. From the perspective of a mezzanine investor, it is important that the company generates sufficient cash flows and is able to substantiate that by a proven track record. Based on the above, it may be concluded that companies that are in the seed or early growth stage of the business cycle can not be target points of mezzanine financing[5].

3.3. Expansion Stage

Companies that are in the early stage of expansion usually have a regular cash flow and need financing to expand their activities. In this stage of their development, they could rely also on repeated capital injections provided by venture capital funds. As there is still a certain degree of risk relating to the future business development, the banks are still reluctant to finance the company's activities in this phase. If, however, the operating cash flows of a company are positive and stable and it has a highly qualified management with innovative business ideas, then its activity could be financed through a mezzanine instrument as well. Such type of financing is made usually in a flexible structure, which allows involvement in the company's governance, without the need to take responsibility for the actual management[6]. Mezzanine capital, provided to companies with low level of operating cash flows, is called equity

[3] Business angels are wealthy individuals with a solid business background who provide financial backing for already operating businesses or small start-ups. The capital they provide can be a one-time injection of seed money or ongoing support to carry the company through difficult times.
[4] Venture capital is the name of capital investments made by financial intermediaries, such as wealthy investors, investment banks and other financial institutions, to achieve significant and relatively quick capital gains by investing in companies with dynamic, long-term growth potential.
[5] S.J. Schwarz: Is Mezzanine Capital right for you?, 2007
[6] A. Lurie: Mezzanine as Expansion Finance, 2002

mezzanine capital or junior mezzanine. When the company reaches the mature stage of its expansion, its competitiveness is high and it gains a stable position on the market. The initial investors seek return on the invested funds, for which additional investments are needed to expand business operations and to position the company in new international markets. In this phase of its development, the companies could be supported financially by venture capital and private equity funds specialized in investments for business development and purchase of businesses. The risk faced by investors is lower than that of previous stages, as the path of company's growth is more predictable. Commercial banks also agree to support the companies' growth through loans, because the robust ability of the companies to generate cash flows, which is expected to continue in the future, gives them assurance and comfort that the future instalments and interests would be paid back. In this stage, mezzanine financing could be attracted in the cases where the senior debt capacity has been exhausted or when the company experiences difficulties in meeting the repayment profile required by a bank. A mezzanine instrument, for example, provides the opportunity to postpone the payment of interest or to pay it as an accumulated amount at exit and thus, the company is able to use the cash flow, accumulated as a result of its activity, to finance the expansion. Based on the above, we could conclude that the mezzanine capital offers considerable flexibility for structuring the coupons, amortisation and covenants, as the purpose is to adjust them to the specific cash flow requirements of a given business so that the investor and the investee could benefit from the result[7]. At this stage of the company's development, mezzanine financing could be used if the company wishes to undertake an investment that is considered to be very risky by banks, such as the implementation of a new production process, development of new product, etc.

3.4. Maturity Stage

The maturity stage is the phase in business organisations' life cycle at which their growth is completed and investors are able to exit their investment and generate return on the invested funds. This process could be accomplished in three ways. The first one is through initial public offering of shares or stocks (IPO) on a stock exchange where even small investors could acquire shares in the company and thus, to provide financing for its activity. The second way is through management buyouts (MBO), where management buys out all shares in the company from the current shareholders and then takes the company private. A large portion of the purchase prise is financed through loans. Quite often, management of a company teams up

[7] R.F. Perille: Mezzanine – Efficient Financing for Recapitalization or Rapid Growth, 1996

with a mezzanine investor to acquire the business, because the transaction is very complicated in terms of accomplishment and requires a significant amount of capital. For this stage of the business cycle model, the so-called leverage buyout transactions (LBOs) occur frequently as well. A leverage buyout is the acquisition of a company, which is made by large portions of debt. As these types of transactions require huge amounts of capital, they are financed through a combination of equity, senior bank debt and mezzanine instruments. Mezzanine financing is inherent to LBO deals, as in most cases management of the acquiring company does not have sufficient security to withdraw a bank loan, which is required to complete the transaction. Besides, through the use of hybrid instruments the dilution of ownership could be avoided, which results in the attraction of new equity[8].

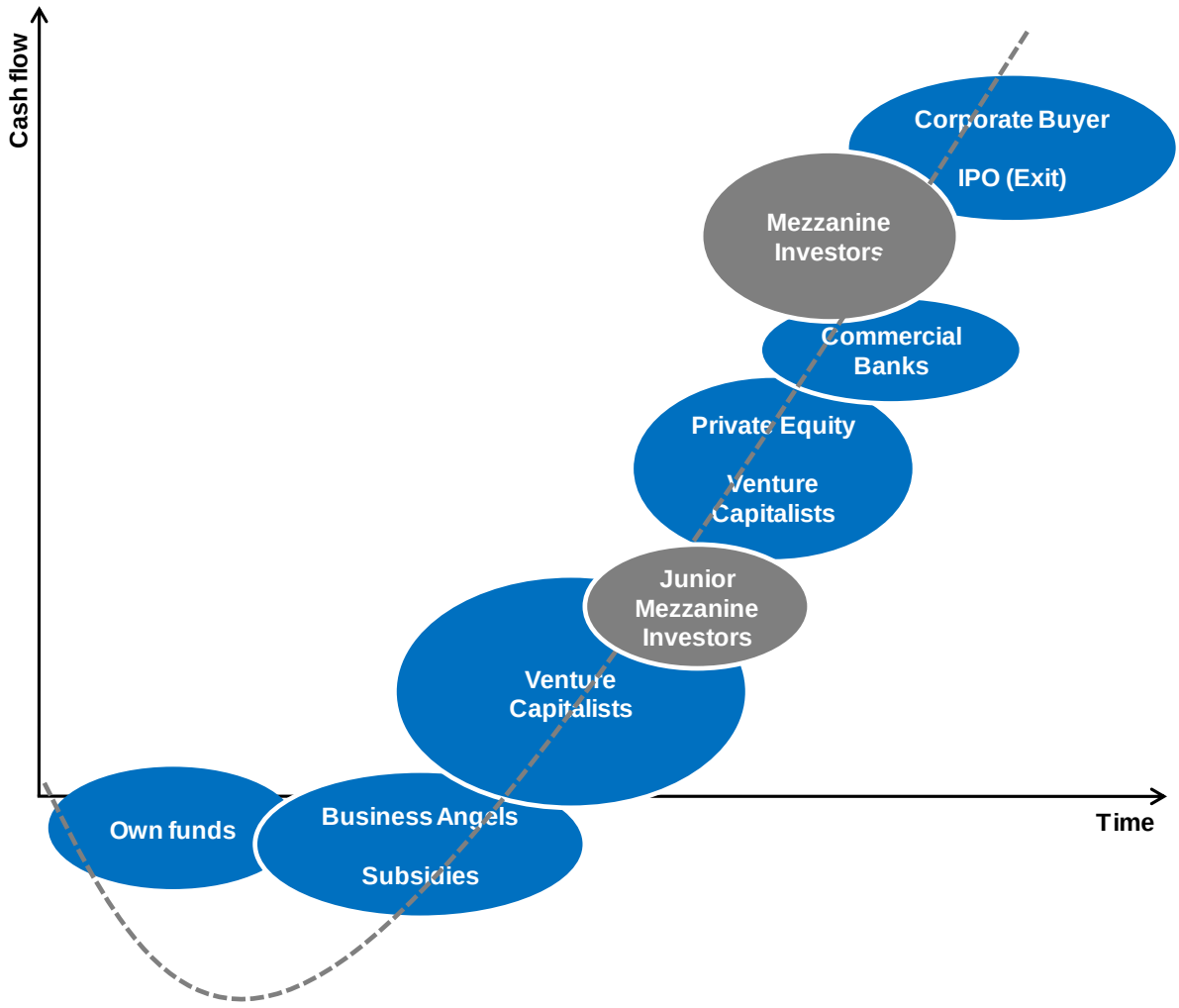
3.2. Decline Stage

However, behind the apparent sustainable and dynamic development of the companies there could be preconditions for a future crisis. In certain cases, the process of maturity leads to saturation of the market and changes in its conjuncture, and as a result, the companies lose their dynamics. In addition to the obsolescence of its products, an entity could enter into a declining stage if it dissipates its activity into a broad scope of directions, as also if it invests a large amount of its capital into high-risk and large-scale projects. However, in the event of successful reorganisation and restructuring of the business, accomplished with the help of rescue financing, the worst scenario, i.e. liquidation, could be avoided. A mezzanine provider will refrain from investing in a company facing financial difficulties as it will not have adequate capacity to produce sufficient cash flows and therefore, it is questionable whether it will be able to meet its liabilities to banks-creditors and those related to mezzanine instruments[9].

The chart on the following page summarises the separate groups of investors that appear in the different stages of the business cycle model.

[8] LBO transactions are discussed in detail in section 6.2.
[9] Credit Suisse Economic Research, Mezzanine Finance – A Hybrid Instrument with Future, 2006

Figure 3: Types of Investors vs. the Life Cycle Stages of the Business Organisations



Source: Own illustration based on O. Grabherr, "Finanzierung mit Private Equity und Venture Capital", 2002

In summary of this section, it could be said that for a mezzanine investor it is of crucial importance that the company is able to generate sustainable and large cash flows. If the above condition is not available, then the company should meet its financial needs through attraction of equity funding[10].

[10] Steven J. Schwarz: Is Mezzanine Capital right for you?, 2007

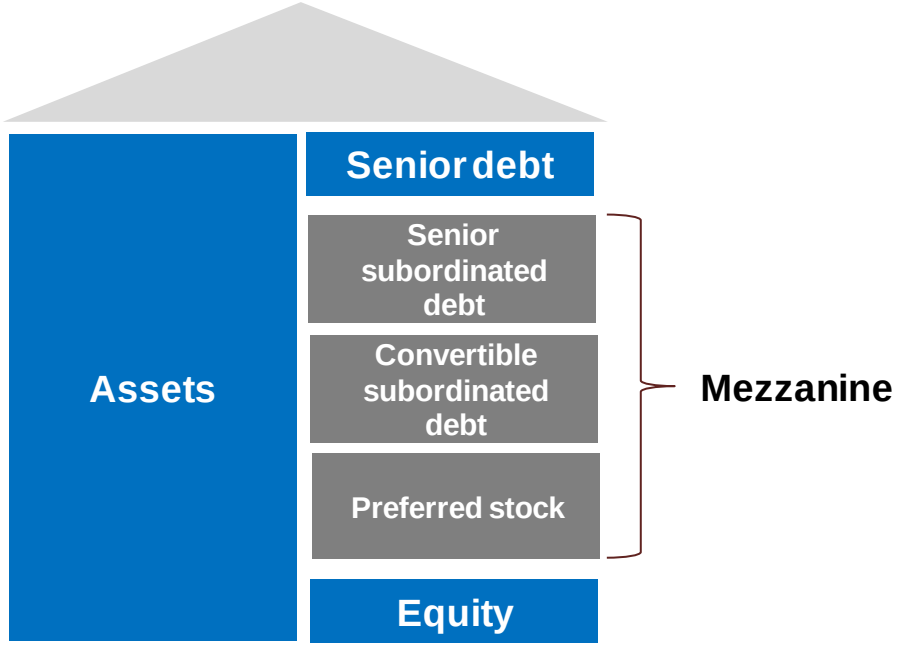
4. Mezzanine Financing – Theoretical Background

4.1. Definition

There is no universal clear-cut definition of mezzanine capital. The term mezzanine comes from the Italian word "mezzanine", which means "middle". It derives originally from the Renaissance and Baroque architecture and stands for an intermediate floor between two main floors in a building[11]. In most of the cases mezzanine floors are located between the ground floor and the first floor but it is not uncommon to have mezzanine floors in the upper floors of a building, right below the rooftop.

Originally developed in the North American financial market, mezzanine capital is positioned between pure debt and pure equity in the capital structure of a company. It contains characteristics of both – debt and equity financing and is used whenever there is a need for filling the gap between these two forms of financing.

Figure 4: Mezzanine Finance as an "Intermediate Floor" between Debt and Equity



Source: Own illustration based on C. Silbernagel and D. Vaitkunas, "Mezzanine Finance - Bond Capital", 2006

[11] Credit Suisse Economic Research, Mezzanine Finance – A Hybrid Instrument with Future, 2006

Let us assume that the financing side of the balance sheet illustartes a building.

The ground floor symbolizes shareholders' equity, which is positioned on the right downside of the financial statement. It is known to be the first paid-in capital, when a new business is formed and the last paid-out capital in the event of liquidation. Equity capital remains relatively stable during the whole lifetime of a company and serves as a capital base. Above equity funding, on the right upside of the balance sheet, is located senior debt. Reason for this is the fact that senior lenders are always legally better protected than equity holders and face the lowest risk. Therefore debt funding is assumed to represent the upper floor in a building[12].

Mezzanine capital, situated in the middle layer of firm's capital structure, serves as a buffer for lenders, being subordinated in priority of payment to senior debt. At the same time it has a higher ranking in comparison to common stock. Mezzanine finance is thus one hybrid instrument[13] and thanks to its unique nature it has a range of advantages compared to the traditional forms of corporate financing.

The table on the following page gives the main comparative features between equity, senior debt and mezzanine financing:

[12] Oliver Müller – Känel, „Mezzanine Finance – Neue Perspektiven in der Unternehmensfinanzierung", 2009

[13] A hybrid security is so called because it combines some features of a debt security with some features of an equity security. It may have the recognisable legal features of the one category but the economic features of the other or it may offer an option to convert the instrument from one form to another. McCormick, Roger/Creamer, Harriet (Hybrid Corporate Securities, 1987)

Table 1: Comparison of the Three Basic Types of Financing

Comparison	EQUITY	MEZZANINE	DEBT
Economic perspective	Equity capital	Equity capital	Debt capital
Legal perspective	Equity capital	Debt capital	Debt capital
Ranking	Junior	Contractually subordinated	Senior
Security	None	Yes - 2nd ranking	Yes - 1st ranking
Covenants	None	Trach those of senior debt, but looser	Comprehensive & restrictive
Liability	At least in accordance to the paid-in capital; co-enterpreneurship	To the extend of the convertible claims	None - lender position
Profit sharing	Aliquot (profit / loss)	Performance based income	None - fixed interest claims
Participation to ownership	Aliquot	Yes - optional	None
Investor's involvement in management	Direct involvement: participating, voting & controlling rights	No direct involvement: potential participating, voting & controlling rights	No direct involvement: lender position
Term	Open ended	Limited term: 5 to 12 years	Limited term: 3 to 7.5 years
Collateralization	No collateral	No collateral	Company's property
Cash interest	None	100 - 200 bps above senior	Cost of funds + 250 - 300 bps
Repayment	None	Bullet at exit or matuirity	Amortising from cash flow
Warrant	Not applicable	Almost always	Not applicable
Taxation	Tax on capital	Debt interest deductible	Debt interest deductible

Source: O. Grabherr, "Finanzierung mit Private Equity und Venture Capital", 2002, Credit Suisse Economic Research, Mezzanine Finance – A Hybrid Instrument with Future, 2006 & Presentation provided by Sortis Invest, 2009 (www.sortis.bg).

The existing literature distinguishes between "narrower" and "broader" sense of mezzanine finance.

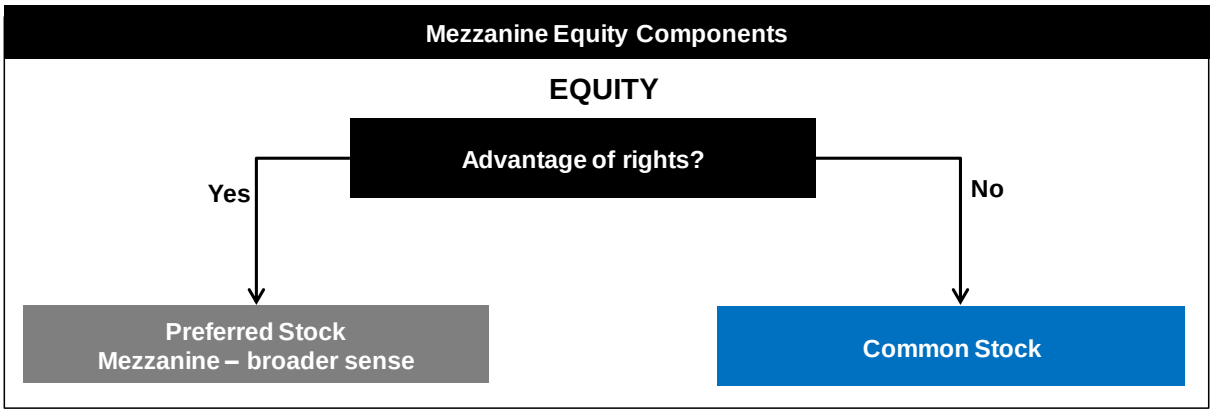
According to the general view "The Narrower Sense" under mezzanine finance is to be understood the so-called "Private Mezzanine", which is a long term, non-amortizing, second secured, subordinated debt instrument[14] composed by the following elements[15]: (1) a cash component - a loan with instalments, (2) a zero-coupon component - a loan with accumulated interest payments or payment-in-kind (PIK) payments and (3) an optional component that entitles to a fix equity tranche called "equity kicker"[16].

[14] www.mezzmanagement.com
[15] Oliver Müller – Känel, „Mezzanine Finance – Neue Perspektiven in der Unternehmensfinanzierung", 2009
[16] An equity kicker is a right, exercisable warrant, or other feature that is added to a debt instrument to make it more desirable to potential investors by giving the debt holder the potential option to purchase shares in the issuer.

The other approach "The Broader Sense" considers the general definition of mezzanine capital for too narrow. According to the broader view "junior" or "junk" and other types of subordinated debt, as well as preferred stock count as mezzanine instruments as well.

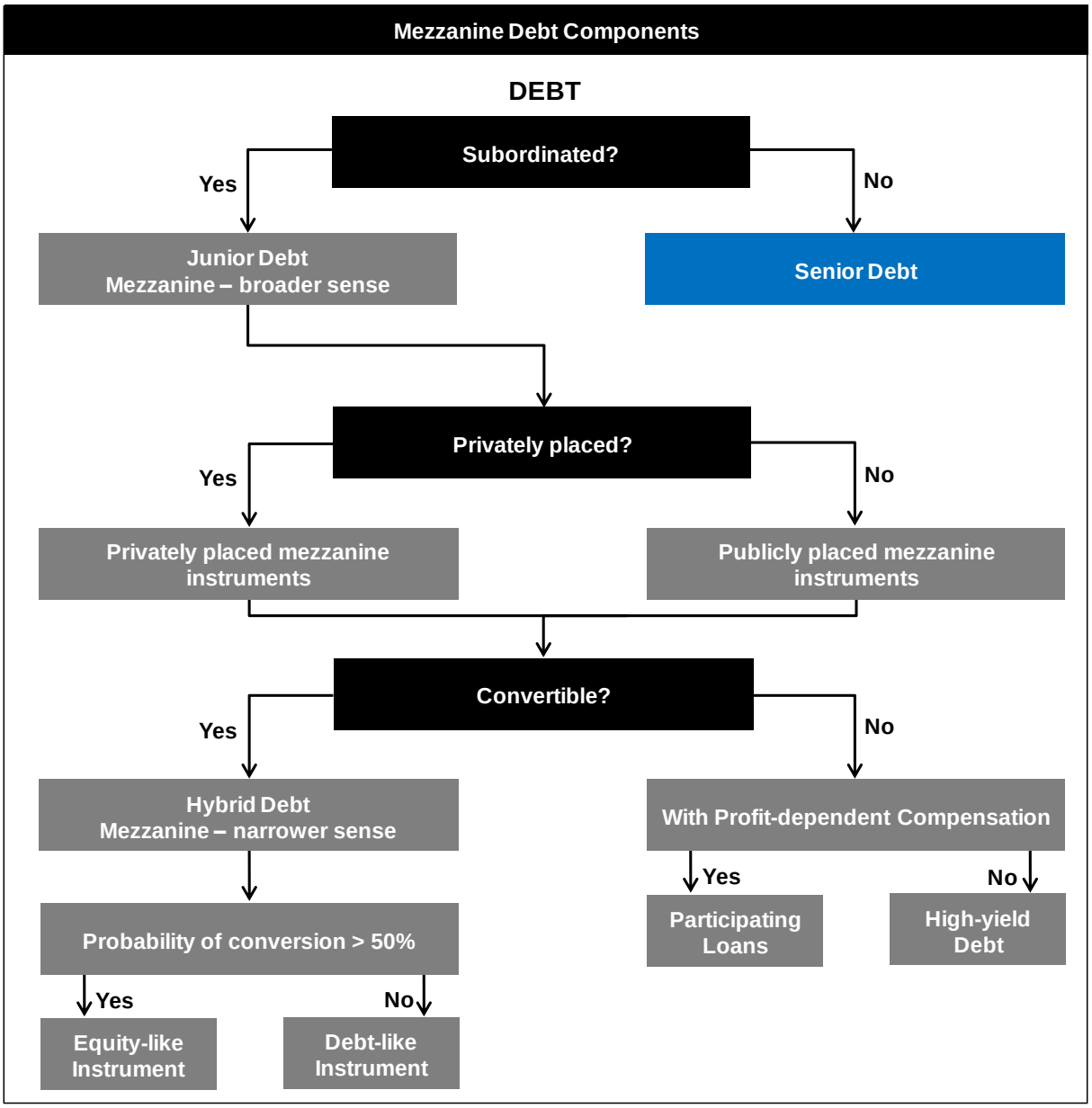
The two figures below illustrate the distinctive features of mezzanine financing both in broader and narrower sense.

Figure 5: Mezzanine Equity Components



Source: Oliver Müller – Känel, „Mezzanine Finance – Neue Perspektiven in der Unternehmensfinanzierung", 2009

Figure 6: Mezzanine Debt Components



Source: Oliver Müller – Känel, „Mezzanine Finance – Neue Perspektiven in der Unternehmensfinanzierung", 2009

4.2. Overview of the Most Important Mezzanine Theories

Modigliani and Miller proved in their seminal work, published in 1958, that the value of the company is determined by its real assets rather than by the issued securities. However the idealized conditions of their model never exist in real life. If the type of financing does not affect the value of a company, then there would be not so many forms of funding as observed

in practice. Thus, the presence of decisions relating to capital structure, taxes, transaction costs and asymmetric information still influence the value of a company[17].

Initially it was considered that the mezzanine instruments are used mainly by companies, whose bankruptcy costs and leverage are higher than average, but the management team believes in the favourable development of the enterprise in the future. For the popularity of convertible debt contributed the researches of Pilcher (1955), Brigham (1966) and Hoffmeister (1977). Their studies have shown that convertible debt is an attractive form of financing for two reasons. On the one hand, it is considered to be a cheap form of financing. Namely that reduces the chance of financial troubles and also the probability that companies with financial difficulties will be forced to pass valuable investment opportunities. On the other hand, a lot of managers consider the issuance of convertible debt as an opportunity to issue equity at a premium to the current share price[18].

In the early 1980s some approaches spread, based on the credit rationing seen over the capital markets. It was generally observed that a part of the economic participants seeking to take out a loan can not obtain such or can not obtain the amount of funds they need, even if the market is supplied with liquid sources.

According to Jaffee/Russell (1976) and Stiglitz/Weiss (1981) the credit rationing can be explained with the existence of informational asymmetries. In the traditional macroeconomic model the interest rate is the one that ensures the balance of supply and demand for loans. However if there is an asymmetry of information between lenders and borrowers, the bank determines the interest rate somewhere around the average level of risk. In this case, the customers who are "good" borrowers can easily exit the market because the premium interest, associated with the level of average risk, becomes too expensive for them. The exit of the market by the best borrowers is followed by new increase of the interest rate on loans as a result of which the market is left by other relatively good debtors, i.e. on the credit market is observed the so called adverse selection scenario, which arises as a result of the asymmetric information and the sensitivity to interest rates[19].

[17] F. Modigliani, M. H. Miller: The Cost of Capital, Corporation Finance and the Theory of Investment; The American Economic Review, Vol. 48, No. 3, 1958, pp. 261-297.
[18] K. Krishnan: Choice between Mandatory and Ordinary Convertible Securities: An examination of Signalling and Agency Effects, 2003
[19] Y. Dinibütünoglu: Bank-Strategien und Poolverträge in Krisen der Firmenschuldner, 1 Auflage, 2008

For the overshadowing of the credit rationing has contributed to a large extend the occurrence of mezzanine instruments and the non-bank financing. By using hybrid instruments it becomes possible a higher risk to be taken whether by further leveraging or by undertaking riskier investments, which is compensated by an option-like component. The latter provides bondholders with the opportunity to participate in any increase in enterprise value that results from the increase in risk. Therefore it can be concluded that convertible debt not only helps to reduce the existence of asymmetric information, but also controls the problem of risk-shifting.

In the past the companies have easily acquired sufficient and cheap loans, because the management had a great experience in presenting "favourably" the credit capacity of the enterprise. While many companies were profitable, and many have also failed, as a result the lenders began to offer loans with higher interest rates, thus compensating their risk exposure. Gompers (1995) explains the increase in borrowing costs with the increasing of monitoring costs. The increase in borrowing cost is essentially a result of asymmetric information. The increased interest rates reduce the capital supply and therefore only the most conservative projects will be funded. This is the reason why lenders need more information in order to get a real picture of the actual risks that they can face.

Kirilenko (2001) offers a solution for informational asymmetries in the form of contractual terms by assigning a greater control right to the capital provider, as a result of which the problem caused by asymmetric information can be prevented and risk sharing can be improved. Hybrid instruments offer several possibilities to solve the problem mentioned above. Furthermore, mezzanine capital allows not only taking out a lower portion of senior debt, but also reduces the amount of required equity.

In 1988 Brennan and Schwarz gave a new explanation of why companies issue convertible bonds. According to them many enterprises, such as pharmaceutical and electronics companies, advertising agencies, hold a significant amount of R&D, software, brand development and other intangible assets on their balance sheet. Their value is difficult to be accurately assessed. Therefore the assets, which serve as collateral for the loan further increase the risk undertaken by the lender. However investors agree to assume this additional risk and provide funds due to the availability of well-designed convertible bonds, which allay the uncertainties about risk. As reported by the authors the most important feature of convertibles is their insensitivity to company’s risk. Thus, on the one hand lenders have the opportunity to take part not only in loss, but also in profit sharing and on the other hand

companies, seeking capital, are allowed to issue securities on terms that look fair to the management even when the issuing company is considered by the market for too risky [20].

Since the early 1990s theories oriented towards equity began to dominate. They highlighted the importance of convertible securities and warrants in cases where the assessment of the credit risk was very expensive or impossible or when investors had doubts that management did not act in their interest.

Published in 1992 the so called "Back Door Equity" hypothesis of Jeremy C. Stein contradicted the previous views, which firstly considered the convertible bonds as cheap loans and secondly bound this form of financing with companies that had low credit ratings. In his publication the author uses the argument that companies will likely issue convertible bonds and thereby will indirectly attract equity "through the backdoor" when the conventional equity issues are unattractive due to informational asymmetries. Furthermore the author points out that although the issue announcements for convertible debt are negative on average, they are not interpreted as a bad signal by investors as the issue of ordinary shares.

Stein's model suggests that money does not have time value and the world is without risks. The model assumes three different types of companies – G ("good"), M ("medium") and B ("bad") and three different time periods - 0, 1, 2. The information asymmetry in his model appears in a way that the majority of the companies have private information and know whether they belong to "G", "M" or "B" type as of time 0, which is the date when financial decision is made. Investors understand the quality category of the companies, seeking external capital, with a delay at date 1, but still earlier than date 2, at which their option on company's stock expires[21].

In Stein's model it is possible to achieve a balanced state by means of convertible bonds, in which the companies from the above given quality categories can receive an adequate assessment. The author points out that this state can only be achieved by the use of hybrid instruments. In the optimal case, when none of the companies has interest to deceive investors, a company of type "G" has to be financed by long-term debt as it bears no expected cost of financial distress in the future. A poor performing company of type "B" would issue equity to finance its operations, since in case it issues a convertible debt it may face the risk of being unable to force a conversion and therefore it may be left with a debt burden, which can

[20] M. Brennan, E. Schwarz: The Case for Convertibles, Journal of Applied Corporate Finance, 1998
[21] Jeremy C. Stein: Convertible Bonds as "Back Door" Equity Financing, 1992

lead to financial distress. Last but not least a company of type “M” would be unable to issue long-term debt due to the higher interest rates caused by higher financial distress costs and at the same time would be unwilling to issue more equity because of the negative signal it sends to the market. Therefore the most appropriate type of financing for companies characterized by higher business/financial risk and strong growth opportunities would be the issuance of convertible securities.

In his paper “Convertible Bonds: Matching Financial and Real Options” David Mayers suggests that the theories, which explain the issuance of convertible bonds as cheap debt or delayed issuance of equity at a premium, are misleading. According to him, a convertible bond corresponds to a combination of a straight bond and an option to buy company’s stock. The difference in the market prices of convertibles and straight bonds is the price that investors are willing to pay for the conversion option. Convertible bonds are considered to be "cheap" only if company’s stock does not rise and there is no conversion. The other argument can be also highly controversial because the bond owner can later convert the bond, if company’s stock rises, but may not do so. With regard to this, if a company has a need for equity, then the issuance of convertible securities is not a reliable way for its supply[22].

In his paper from 1998 David Mayers argues that many companies, mainly those with high growth potential, face the so called "Sequential investment opportunities". According to the author, these companies can most effectively finance their investments with uncertain term and costs, through the issuance of callable convertible bonds. Mayers states that attracting capital, without the use of hybrid instruments will be unfavourable in all cases. If the company obtains the whole amount of foreign capital needed for a given investment during the first stage of the investment process, it must confront the possibility that with time, risk increases and therefore individual investors may leave, which will reduce the available free cash flow for the company. However, if a company attracts financing prior to an investment option, this will significantly increase the cost of the given transaction[23].

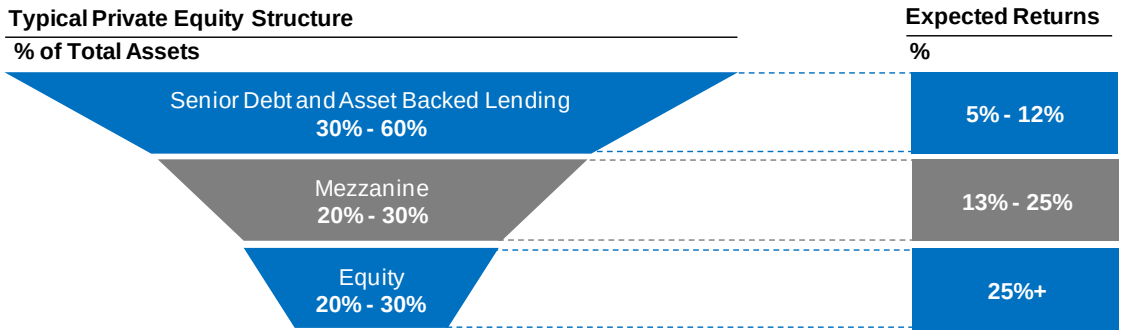
[22] D. Mayers: Convertible Bonds: Matching Financial and Real Options
[23] D. Mayer, Why Firms Issue Convertible Bonds: The Matching of Financial and Real Options, 1998

4.3. Types of Mezzanine Capital

Mezzanine capital includes all hybrid forms of financing instruments that are positioned between shareholders' equity and collateralised senior debt in the capital structure of a company.

There are basically two types of hybrid capital - Equity Mezzanine Capital (EMC) and Debt Mezzanine Capital (DMC). The distinction whether a mezzanine instrument can be classified as EMC or DMC is neither in literature nor in practice clearly drawn, because of the very wide range of structuring options that exist. However, both types carry a few key features that allow the differentiation between these two categories. The figure below shows the typical share of each form of financing in a company's capital structure and their risk-return profiles respectively.

Figure 7: Forms of Financing and Risk-return Profiles



Source: C. Silbernagel and D. Vaitkunas, "Mezzanine Finance - Bond Capital", 2006

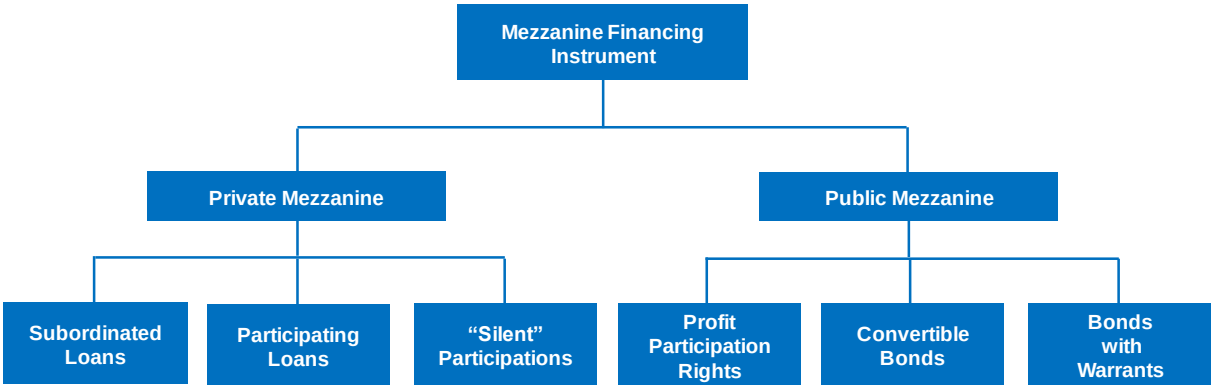
Generally, equity mezzanine includes such financial arrangements that place the investor in a position, which is relatively similar to that of a stockholder. The most important feature of EMC is the right to subscribe for common stock through the provision of convertible options or warrants, the latter also known as equity kickers. By this form of mezzanine funding the borrower does not have to pay any interest or installment payments at early stage. The redumption usally takes place close to exit. Since the return of an equity-like mezzanine investor depends largely on the change occurred in the value of the funded company, in his interest is the efficient functioning of the given enterprise. This type of hybrid financing is emblematic for companies with low operating cash flows, but with high growth opportunities, where the mezzanine provider shows up as a co-investor next to a venture capital firm.

Typical equity mezzanine instruments are preferred stocks, profit participation rights, convertible bonds and bonds with warrants.

In contrast to an EMC provider, a DMC provider remains in a very bank-related investment strategy, in which the interest income stays in foreground. This type of mezzanine funding is provided usually by banks and financial institutions, which mainly finance the functioning of companies that generate stable operating cash flows and thus are able to meet their financial obligations in the future. The construction of mezzanine debt instrument is much more flexible than the one of a standard straight line term borrowing, and consists of a subordinated loan, which maturity and size of repayments are mutually agreed by the two parties of the contract. Unlike EMC, DMC is a form of financing, which is representative for the expansion and maturity stages of the business cycle of a company. Therefore the risk born by the debt mezzanine provider is smaller and the return on the undertaken investment, required by him, is lower than the one required by an equity mezzanine provider. Typical debt mezzanine instruments are subordinated loans, participating loans and high-interest unsecured loans, which do not contain an equity-like component.

Mezzanine instruments can be classified according to their tradability as well. Based on this criteria, we distinguish between publicly and privately placed mezzanine. The figure below gives a brief overview of the most common mezzanine instruments classified by their tradability.

Figure 8: Mezzanine Instruments in Respect to Their Tradability



Source: Credit Suisse Economic Research, Mezzanine Finance – A Hybrid Instrument with Future, 2006

4.4. The Most Important Mezzanine Instruments

4.4.1. Preferred Stocks

In contrast to their name, preferred stocks usually cover a very small part of companies' needs of funding. At the same time, however, they could prove to be a very good source of financing upon merger of companies or in other exceptional cases. Preferred stocks are similar to both stocks and bonds. The latter, like bonds, offer a fixed line of payments for investors in the future and thus, they could be viewed as endless long-term bonds. They bear a resemblance to bonds also in that they do not give a voting right to their holder upon making decisions about the company's management. The type of issued preferred stocks quite often is a cumulative preferred stock. The most important feature of this type of stock is that the company is not allowed to pay dividends to the holders of ordinary shares until the time it has paid dividends to all holders of cumulative preferred stocks. If the company does not pay the actual dividend attributable to preferred stocks, the holders of preferred stocks acquire the right to vote and may exercise this right until the company pays all outstanding dividends. In case of bankruptcy, the holders of preferred stocks rank right after the holders of bonds in the list of order in which the creditors will be satisfied, but receive priority before the holders of ordinary stocks. Dividends paid to preferred stocks do not reduce the tax liability of the company-issuer in contrast to the interest paid to bond holders. This disadvantage, however, is compensated by the tax preferences provided to preferred stocks, and namely, when an entity acquires preferred stocks from other company, the buyer should pay a tax only on a certain amount of the dividend received.

4.4.2. Convertible Preferred Stocks

An entity issuing convertible preferred stocks is able to exchange them for convertible bonds. Convertible preferred stocks are issued usually by entities that bear a higher financial risk. Unlike entities that issue convertible bonds, the entities that report losses are able to use only indirect tax preferences, and namely that 75-80 % of their dividend income is considered a tax exempt income. If the entity becomes profitable in a foreseeable future and should pay income tax, then the issuance of convertible preferred stocks may prove to be the ideal solution. If its business activity is profitable, the entity may pass a decision to exchange these

convertible preferred stocks for convertible bonds and in this way to reduce its tax base by the amount of interest[24].

4.4.3. Warrants

In fact, the warrant is a purchase option issued by an entity. The significant difference between the call options traded in a stock exchange and the warrants is that in order to utilise the warrant the entity should issue new shares which leads to a higher number of traded shares and a reduced price per share. The holders of this type of options use them if there is a trend of growth in equity markets, which will produce capital gains for them. Not typical of call options traded in a stock exchange, the warrant ensures income for the entity as the buyer of the warrant will pay the price of the transaction. The warrant is issued usually together with other types of securities aiming at making the non-so-attractive security more attractive to investors. In most cases, warrants may be separated, i.e. they may be traded independently.

4.4.4. Convertible Bonds

Convertible bonds enable their holders to exchange their bond to a certain number of company shares within a time period set in advance. Convertible bonds bear lower interest rates compared with traditional bonds, thus compensating the option to which the bond is bound. This option is favourable to the bond holder if it is expected that there will be a significant increase in share prices. New shares are issued on the exchange of a bond. Convertible bonds may be viewed as a combination of an ordinary corporate bond and a warrant relating to a certain share, the difference being that the share is to be paid not in cash, as in the case of warrants, but with the bond itself. Another difference between convertible bonds and warrants is that in the case of convertible bonds the bond and the option are related to each other and cannot be bought and sold individually. Convertible bonds and warrants are issued almost always by risky companies which have a low rating. Consistent with Jensen (1986) hypothesis, firms with more free cash flow issue convertible bonds, while firms with less free cash flow issue convertible preferred stock.[25]

[24] H.W. Lee, R.E. Figlewicz: Characteristics of firms that issue convertible debt versus convertible preferred stock, The quarterly review of economics and finance, 1999
[25] M.C. Jensen: Agency costs of free cash flow, corporate finance, and takeovers, 1986

4.4.5. High Yield Bonds

High yield bonds are not an investment grade bonds[26]. As these bonds do not reach the investment grade category, the risk that the company issuing the particular bond can go bankrupt is accordingly much higher. High yield bonds are often called speculative or high-risk ("junk") bonds.

High yield bonds are used most often in high-leverage transactions such as LBOs, but they are issued also by companies that are at the start of their existence or by firms experiencing severe financial difficulties and an extremely high level of risk. These bonds, however, promise a much higher yield than that available from a traditional corporate bond. In most cases, high yield bonds are not covered[27].

[26] Based on the two main credit rating agencies, high-yield bonds carry a rating below "BBB" from S&P, and below "Baa" from Moody's. Bonds with ratings at or above these levels are considered investment grade.
[27] High yield bonds will be discussed further in section 6.2.

5. Private mezzanine

The most important feature of private mezzanine originates from its subordinated nature. In case of bankruptcy or liquidation procedure, the investor providing private mezzanine capital is included in the list of creditors after senior creditors, but before equity holders. It is important to note that this subordination covers also the payments; i.e. the individual providing mezzanine funding can receive the interest payments only if the company has paid the full amount of its actual interest liability to banks-creditors.

In the course of mezzanine financing the company and the investor determine the loan term, the interest rates and the optional, proportionate share of the capital. Thus, private mezzanine financing is made within a structure that fits the best with the peculiarities of the particular transaction[28].

Other special features of private mezzanine include[29]:

- The mezzanine capital is provided against the estimated future cash-flows of the investee.
- The loan term is finite, either mid-term or long-term (5 to 12 years).
- The transaction amount usually ranges from EUR5m to EUR100m, although this interval is flexible and may be changed in certain conditions. The amount of the desired transaction depends primarily on the amount of the managed fund or, to a lesser extent, on the industry sector where the company operates.
- Mezzanine capital provides usually a suitable alternative for medium-sized enterprises.

Mezzanine financing provides certain advantages compared to debt and own financing sources due to its hybrid nature; however, it shares also the disadvantages of the above-mentioned methods of financing, which would be further discussed in the next sub-chapter.

The table on the following page gives a brief review of the distinction of the individual financial instruments from private mezzanine capital:

[28] Presentation provided by Sortis Invest, 2009 (www.sortis.bg)
[29] Faraz Abassi: Mezzanine Financing – An Alternative for Middle Market Companies, 2004

Table 2: Distinction of the Individual Financial Instruments from Private Mezzanine

Comparison	Senior debt	High yield debt	Private mezzanine	Convertible bond	Equity / VC
Cash pay interest	20-200 bp	300-1200 bp	flexible	-50-150bp	-
Annual internal rate of return	5-12%	8-15%	13-25%	5-10%	25%+
Maturity	3 to 7 years	up to 25 years	5 to 12 years	5 to 7 years	3 to 7 years-VC
Emission	private	public	private	public	private
Deal size	-	over €80m	€5m - €100m	€80 - 160m	-
Callability	flexible	hardly possible, high termination fees	flexible	posibble	-
Tradability	illiquid	liquid	illiquid	liquid	illiquid
Equity kicker	not applicable	uncommon	almost always	permanent	not applicable
Share of capital - expansion stage	10-20%	10-25%	10-25%	10-25%	60-70%
Share of capital - maturity stage	40-50%	10-30%	10-30%	10-30%	30%

Source: Oliver Müller – Känel, „Mezzanine Finance – Neue Perspektiven in der Unternehmensfinanzierung", 2009

5.1. Advantages and Disadvantages of Mezzanine Financing

A company using mezzanine financing gains several advantages, which a similar company that uses only traditional forms of funding can not have.

One of the most important advantages of mezzanine capital is that, it enables the enterprise to attract additional source of financing, in case the raised equity funds and the bank loans are not sufficient or if the company intends to achieve the desired investment without dilution of ownership. This is especially important in companies where the owner is head of the company as well. Furthermore, the mezzanine investor is usually not willing to actively participate in the management of the company, thus this form of financing provides greater autonomy not only for the management team, but for the existing shareholders as well, in contrast to attracting additional pure equity financing.

An indirect advantage of mezzanine capital is that it affects positively the company's balance sheet, since mezzanine instruments are considered as part of equity from economic prospective. The improvement of the leverage ratio[30] affects positively the company's credit rating, owing to which the company can not only take out bank loans at more favourable conditions, but can also get wider range of traditional loans offered on the market.

[30] A ratio used to calculate the financial leverage of a company to get an idea of the company's methods of financing or to measure its ability to meet financial obligations.

From the perspective of many companies the mezzanine financing is an attractive alternative compared to publicly raised capital. This is firstly due to the fact that mezzanine investors participate also in small and mid-sized transactions in contrast to other capital providers, and secondly for the reason that the implementation of the transaction is carried out faster than in other cases of financing.

Other benefits for the company[31]:

- Mezzanine capital represents a stable source of financing due to its relatively long term maturity - 5 to 12 years.
- It represents a cheaper source of finance compared to pure equity issuance.
- The incorporation of mezzanine capital in the capital structure of a company does not change its ownership and does not lead to loss of control rights.
- In contrast to debt financing, mezzanine capital is more flexible and less restrictive.
- There are no principal repayments until maturity and interest can be deferred, which increases the solvency of the company.
- Mezzanine financing allows tax optimization, because interest expense is tax deductible.
- A mezzanine investor, entitled to an equity tranche, has an incentive to support company's growth.
- Mezzanine capital can be easily amalgamated with other financial instrument.

On the other hand mezzanine financing has also certain disadvantages for the company[32], that should be considered:

- Mezzanine instruments have higher interest rates than conventional bank loans.
- The principal and the accumulated interest, payable at exit or maturity, can represent a considerable load to the investee in certain cases.
- The required transparency by mezzanine financing is stricter than by other forms of financing.
- There is a requirement for minimum transaction size.

[31] www.mezzmanagement.com & presentation provided by Sortis Invest, 2009 (www.sortis.bg)
[32]Credit Suisse Economic Research, Mezzanine Finance – A Hybrid Instrument with Future, 2006 & presentation provided by Sortis Invest, 2009 (www.sortis.bg)

Advantages for the mezzanine investor[33]:

- Through his investment, the mezzanine provider gains access to new segments on the market.
- The cancellation of the loan[34] is easier than the withdrawn from the company through the sale of equity holdings.
- The risk faced by the mezzanine investor is justified by attractive returns on the investment.
- The investment is independent from the fixed-income and equity markets.

As a disadvantage for the mezzanine provider can be pointed out the fact that the wrong estimation of the investee's financial position can lead to unfavourable returns.

5.2. Costs of Mezzanine Financing

Mezzanine capital is more expensive form of financing than traditional debt funding, because the risks, faced by the mezzanine providers are greater than those of senior lenders. This is due to the fact that the returns of mezzanine investors have subordinated priority in terms of security. In certain circumstances the future of the company, seeking capital, can be estimated too optimistically i.e. its solvency or the commitment of its management can be overestimated. On the other hand, the cash flow, realized through mezzanine financing is cheaper than the one, realized through debt funding. The company has no obligation for repayment of principal until the end of the loan period. Besides this there is also an opportunity for accumulated payment of interest at maturity, in consequence of which the released cash flow can be used to finance the business development of the company.

The costs of private mezzanine financing consist of several elements:

5.2.1. Up-front Fee

This is an administrative type of cost, which has to be paid at the start of the term. Its size is usually 1% to 3% of the transaction value[35].

[33] Credit Suisse Economic Research, Mezzanine Finance – A Hybrid Instrument with Future, 2006
[34] This is possible only in case such conditions exist.
[35] Steven J. Schwarz: Is Mezzanine Capital right for you?, 2007

5.2.2. Cash Interest Payments

Mezzanine debt can be structured with fixed or floating interest rate[36]. By fixed rate coupons, the investee company can accurately assess the amount of interest payable in the future. In contrast to fixed rate coupons, by floating rate coupons the amount largely depends on the future macroeconomic changes that occur on the market. A disadvantage of the fixed rate coupon is the fact that it can not be changed during the term of the mezzanine lending. In Europe, mezzanine debt is typically structured as a floating rate loan with a combination of cash and PIK interest. U.S. mezzanine debt, on the other hand, has usually fixed rate coupons. The interest coupons are paid quarterly and typically provide an annual income of 7% to 12%[37], depending on the credit rating of the investee company. By the structuring of the interest rate are considered firstly, the risks faced by the investor and secondly, the terms of the contract. Generally, the longer the duration of the funding the higher is the interest rate. In certain circumstances the amount of the interest rate can be increased during the term of the lending i.e. if the company is not able to fulfil any of its obligations under the contract[38].

5.2.3. Payment-In-Kind Interest (PIK Interest)

The periodic form of payment, where interest is not paid in cash, can be associated with the so-called payment-in-kind (PIK) component. The essence of this type of payment is that the company does not pay cash interest throughout the life of the investment, but instead increases the amount of the principal, payables at exit or maturity, by the sum of the interest accrued in the meantime[39].

5.2.4. Equity Kicker

There are two types of equity kicker components: an equity ownership and an equity-like return. The ownership component, which usually is identified by an attached warrant or other conversion option, provides an opportunity for the mezzanine investor to convert part of the loan capital into equity stake at certain conditions determined in advance. The other equity kicker component is the so-called participation payout. Instead of equity, it provides an

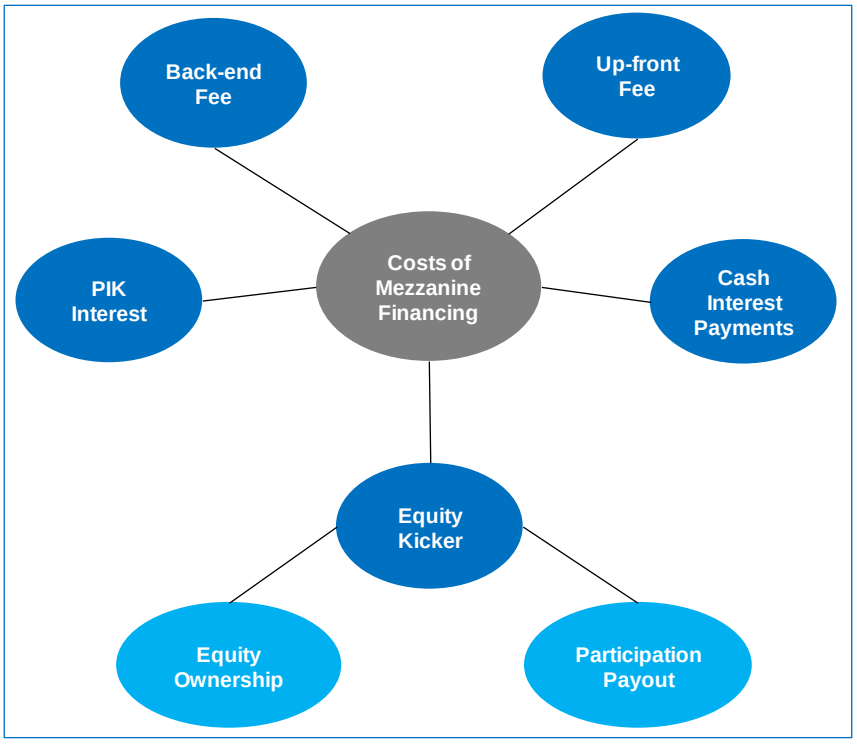
[36] The indicative interest is usually LIBOR or EURIBOR.
[37] Presentation provided by Sortis Invest, 2009 (www.sortis.bg)
[38] For example, if the company can not pay its interest obligations on time
[39] Bond Capital Mezzanine Finance, 2010

equity-like premium in the form of a percentage[40], which size depends largely on the success of the company's performance[41].

5.2.5. Back-end Fee

This type of cost is a single fee, payable in cash at maturity, which typically represents 1% of the transaction value[42].

Figure 9: Costs of Private Mezzanine Financing



Source: Own illustration

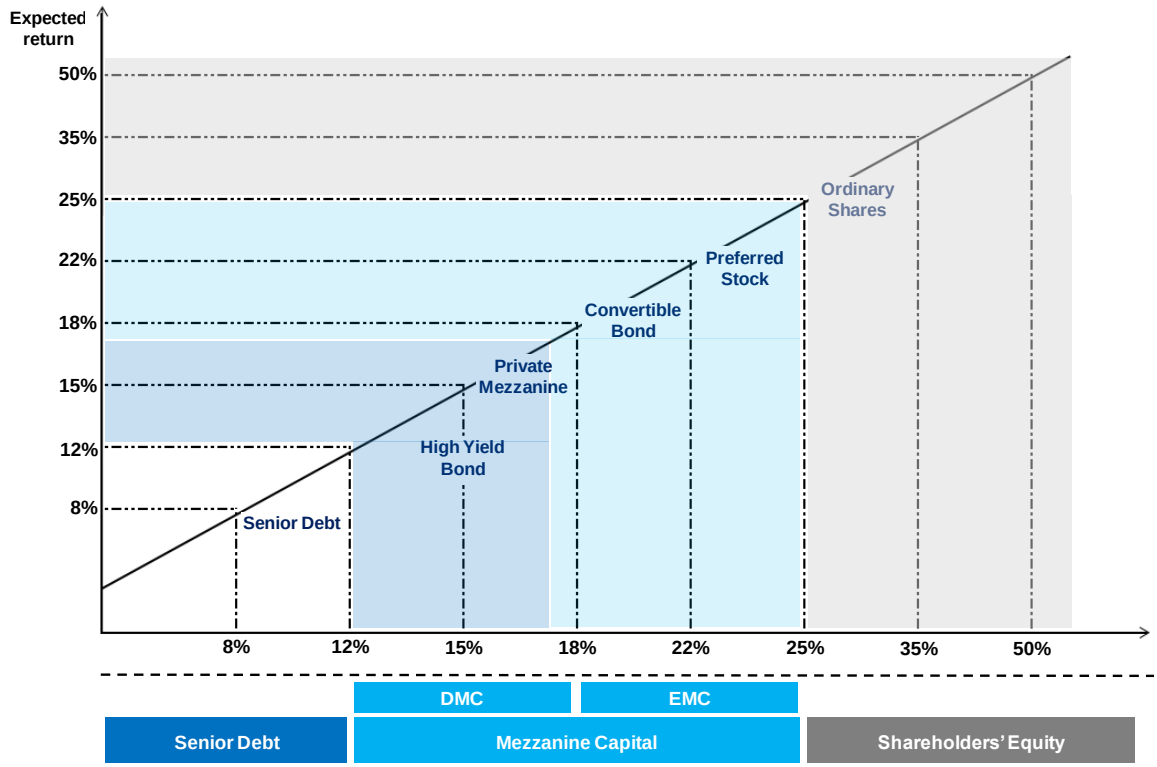
The amount of costs for mezzanine financing, required for a given transaction, depend primarily on the past performance of the company seeking finance, its credit rating, the projections for its future cash flows, its profitability, the experience of its management and the conditions on the market.

[40] The company's performance can be measured as a percentage of total sales or EBITDA.
[41] Bond Capital Mezzanine Finance, 2010
[42] Factsheet CSA Mezzanine, Credit Suisse AG, 2010

5.3. Risk-Return Profiles of the Individual Mezzanine Instruments

The expected returns earned by the individual mezzanine instruments can differ in accordance to the risks faced by the mezzanine providers. The figure below illustrates the wide range of mezzanine products in respect to their risk-return profiles.

Figure 9: Risk-Return Profiles of the Individual Mezzanine Instruments



Source: Own illustration based on O. Grabherr, "Finanzierung mit Private Equity und Venture Capital", 2002

The figure shown above has the objective to provide only a theoretical overview of the classification of the individual mezzanine instruments based on their risk-return profiles. In real life the features that relate to their risk-return profiles could be easily changed, considering the individual risks associated with a particular transaction.

The realized return largely depends on the future performance of the company seeking finance. If the corporate value decreases or remains unchanged ("Downside scenario") the return of the investor remains fixed, expressed as the sum of the accumulated interest payments during the term of financing. However, if the value of the company changes positively ("Upside scenario"), the individual, providing mezzanine financing earns an extra

profit on the invested funds[43]. Based on the above, it may be concluded that the better the company performs, the higher the yield gap between the company/management, the private equity fund and the mezzanine investor[44].

5.4. Mezzanine without warrant

In parallel with the fast-growing market of mezzanine products, the market itself also underwent a serious development in an attempt to continue being attractive for both the current investors and for those now entering the market. At the beginning of the new millennium, a new type of mezzanine financing is being developed and introduced to the market, i.e. mezzanine without warrant. This form rose from almost nothing to be one of the most popular among investors. The evidence is that in 2003 more than 50% of all mezzanine capital invested in Europe is mezzanine without warrant[45].

Many of the traditional investors however do not prefer the construction of mezzanine without warrant, as they believe that even the higher fixed interest rate than that offered by the traditional mezzanine transactions can not compensate the component ensuring participation in the capital of the financed company through which the investor is able to earn profits from any possible positive change in its value. Moreover, they deem that mezzanine without warrant does not provide income sufficient enough to compensate the risk they assume. Nevertheless, the popularity of mezzanine without warrant is continuing to grow thanks to the new investors penetrating the mezzanine market - institutions[46] investing in high interest bonds that appreciate the fixed interest rate more than the insecure participation in the capital, which the warrant provides to investors.

Traditionally, the return on a mezzanine investment, which contains a warrant as well, is characterized by the following factors: the payment of a fixed annual cash interest rate of 3-4%, PIK of 4-5% + LIBOR and income ensured by the warrant of up to 3%. In contrast to that, in the case of a mezzanine investment without warrant the PIK component is of 7-8% + LIBOR, which is apparently much higher than that of a typical mezzanine construction[47].

The opinions about the future of mezzanine without warrant are different, some people believe that it will spread further, but others think that the days of mezzanine without warrant

[43] S. Thornbill: Growing your business with mezzanine financing, 1998
[44] O. Grabherr, "Mezzaninefinanzierung in Österreich"
[45] J. Hickey: Does warrentless mezz have a future?, 2003
[46] AIG MezzVest, CDOs, Goldman Sachs, Alliance Capital, Oaktree, Axa
[47] J. Hickey: Does warrentless mezz have a future?, 2003

are over. One of the most favourite arguments of the upholders of mezzanine without warrant is that this type of hybrid product does not burden the entity's cash flows during the term of financing, as the annual fixed interest rate is almost as high as that of a construction that contains a warrant. In addition, they point out the fact that the additional interest rate margin offsetting the warrant is to be paid in the form of an in-kind payment in the period end.

At the outset of mezzanine financing, companies using it eagerly welcomed the appearance of the mezzanine financing without warrant, because they were not forced to give capital to mezzanine investors in the event of upside scenarios. Some companies, however, would prefer to enable the mezzanine investor to continue to participate in the capital, through the warrant, as in this case they could bring closer the interests of equity holders with those of mezzanine investors. In the event of a possible bankruptcy, the only goal of the mezzanine investor, who does not hold a warrant, is to receive back its loan from the entity, while the mezzanine investor, who holds an option to participate in the capital, tries to find the best possible solution from the point of view of the entity. Besides, the payment of the accumulated high interest PIK at the period-end not only burdens the entity's cash flows, but also could cause the formation of a lower profit as contrasted with the dilution caused by the issuance of warrants.

5.5. Requirements for Mezzanine Financing

Mezzanine financing is usually carried out by pension funds, hedge funds, business development companies, private equity funds, insurance companies as well as sole wealthy individuals. All of the above mentioned mezzanine providers may impose their own individual requirements on the companies willing to raise mezzanine capital. However, there are such prerequisites, which are present on the list of each mezzanine investor. The most important preconditions for raising mezzanine capital are listed below[48]:

- Healthy financial position and strong earnings power.
- Transparent, concise strategy and sustainable long-term performance orientation.
- Skilful and experienced management with high level of financial involvement.
- Transparent and reliable co-operation between the mezzanine investor and the investee.

[48] Credit Suisse Economic Research, Mezzanine Finance – A Hybrid Instrument with Future, 2006

- Positive cash flows that tend to remain stable or to increase in the future, which can be forecasted reliably.
- Low gearing level.
- Mature and transparent capital market.

As private mezzanine debt is subordinated in priority of payments and security to senior debt, whether a company can pay back the raised capital and the accumulated interest payments during the term of financing depends to a large extend on the generated future cash flows. Therefore, we may conclude that for a mezzanine investor it is of great importance whether the investee has a profitable business and a well-established market position. Another important factor that influences the investor's decision is the existence of a convincing track record for the quality of the management team, as well as the implementation of an appropriate finance and accounting system. Last but not least, an important factor to pay attention to is how the company intends to use the raised capital. The application of hybrid products when financing major investment projects, facilitating an LBO or recapitalizing a company are good examples of when mezzanine capital is most helpful. Thus, the main focus of mezzanine is placed on businesses with stable and positive cash flows, which possess a clearly build-up and long-term strategy.

There are companies that can not be classified as good candidates for mezzanine capital, due to the fact that they cannot meet the above listed preconditions. Companies in growth and early stage of the business cycle model could be classified as such, as also those that do not possess a thorough business experience and are not able to provide a precise estimate of their future cash flows. In general, it is not desirable to use mezzanine financing for companies "in trouble", with poor credit rating and weak market position, as well as in the cases of financial restructuring or turnarounds, when business performance is extremely volatile.

5.6. Covenants

Mezzanine investors are not always interested in the fact whether the company's assets are used as guarantees to diminish the risk of investment they have made. Whether there are guarantees or not, the creditors usually rely on specific contractual mechanisms to keep their investments and inherent risks under control in order to prevent the occurrence of a possible insolvency situation. This is valid for both the senior creditors and the mezzanine providers. These specific contractual mechanisms are called covenants. Covenants, which relate to credits, are contractual obligations of the creditor and the borrower that protect the creditor's

investment. They provide the creditor with the ability to control the result of the financed entity and to ensure that the transactions pursued correspond to the business plan and the forecasts; thus, the creditor is able to timely react to changes in the financial position of the entity.

Covenants perform the following functions:

- Protection of the ability [of the borrower] to repay the loan.
- Protection against financial restructuring.
- Protection against bankruptcy or other failures.
- Signalling function.

In most cases, mezzanine covenants are the same as that used for contracts with senior creditors. Besides, the level set for some or for all financial covenants in a mezzanine loan agreement may be lower than that set for a senior loan agreement e.g. while the maximum permitted amount of the ratio Debt/EBITDA[49] for a bank is about 3.5, for an investor providing mezzanine financing it is rather between 4 and 5. The so-called negative covenants, which describe in detail what the entity is not allowed to do, are also a typical feature. Such are, for example, the prohibition to merge, the prohibition to sell or purchase assets, to issue liabilities, etc. The most common covenants in the mezzanine financing relate to the ratio Debt/EBITDA and the fixed charge coverage ratio. The first indicator shows the ability of an entity to repay its loans and the second one assesses its ability to make interest and principal payments. The table below summarizes the specific boundary values of the individual ratios:

Table 3: Covenants & Boundary Values

Financial Covenants	Boundary Values	
	MEZZANINE DEBT	SENIOR DEBT
Debt / EBITDA	max. 4.0 - 5.0x	max. 3.0 - 3.5x
EBITDA / Financial Expense	min. 3.0 - 4.0x	min. 4.0 - 4.5x
Equity / Debt	min. 20 - 30%	max. 25 - 35%

Source: Factsheet CSA Mezzanine, Credit Suisse AG, 2010

[49] The amount of mezzanine the company would like to withdraw is not included in the company's debt when calculation the ratios.

In most cases, if the prescribed amount of covenants is not complied with, certain sanctions could be imposed. Many times, the capital provider requires a higher interest rate because of the violation of covenants. In the end, the payment of premium interest could endanger the entity's ability to operate and thus, a hybrid structure could be chosen as an alternative.

5.7. Investment Process

Despite of the type of transaction to be made by the entity financed by mezzanine financing, it could be beneficial to include the mezzanine provider on an early stage of the deal process. Thus, there will be no unnecessary management meetings, requests of information and due diligence work, carried out by independent third parties. All this will enable management of the investee and external advisors to concentrate on the major business process. A smooth transaction where all contracting parties cooperate well and where all the required information is available continues from six to eight weeks in total.

Having made the connection between the company seeking finance and the mezzanine investor, the latter should ensure that the company meets the requirements for mezzanine financing described in sub-chapter 5.5. If the entity could be characterized as a good candidate for mezzanine, the investigation of its financial statements and market position could start, then the meetings with its management team and the detailed presentation of its business plan and financial needs.

To receive a full and deep picture of the planned future transaction, it is necessary to involve in the process a third independent party, which shall carry out an independent financial, tax, legal and commercial review, based on the information provided by the borrower. After the due diligence report is fully completed and if there are not any negative issues included therein, the terms and conditions of financing could be set. The mezzanine provider issues the so-called Term Sheet, which does not legally bind the parties, but is a document that is intended solely for discussion purposes. It contains the basics of the given transaction and describes the stages and amounts of mezzanine financing.

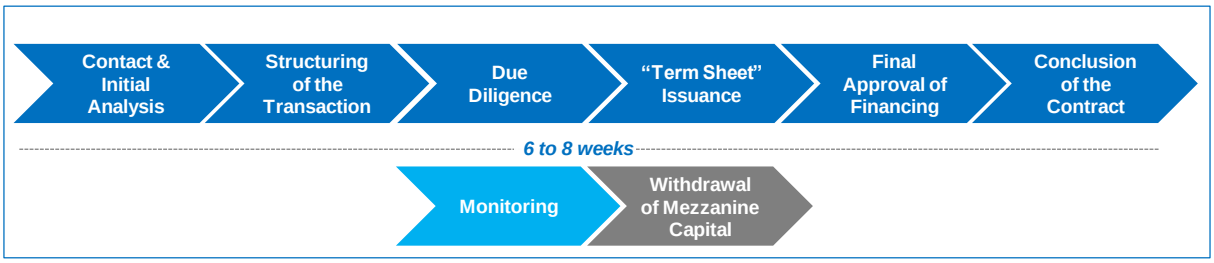
The final approval of the financing is given by the mezzanine investor's Investment Committee, a process that usually takes only a couple of days. Prior to signing the contract, all issues relating to options / warrants bound to the mezzanine instrument, collaterals, covenants etc., shall be precisely agreed upon.

The role of the mezzanine investor does not end with the conclusion of the contract. The mezzanine investor usually monitors the development of the company's activity, as also the transaction, and to the end it seeks to add value through his experience. Since the mezzanine capital provider is usually looking for a longer-term capital deployment which receives a return proportionate to risk assumed, we may conclude that its goal is not to complete a short-term illiquidity event, but to ensure a pace of growth for the investee, wherefrom he could benefit as well.

Mezzanine financing ends with the withdrawal of mezzanine capital from the capital structure of the financed company. This could be made through the cash generated by the investee and a change-of-control sale, recapitalization of the company, as well as, although in rare cases, through IPO.

The chart below illustrates the individual steps of the mezzanine capital investment process:

Figure 11: Investment Process



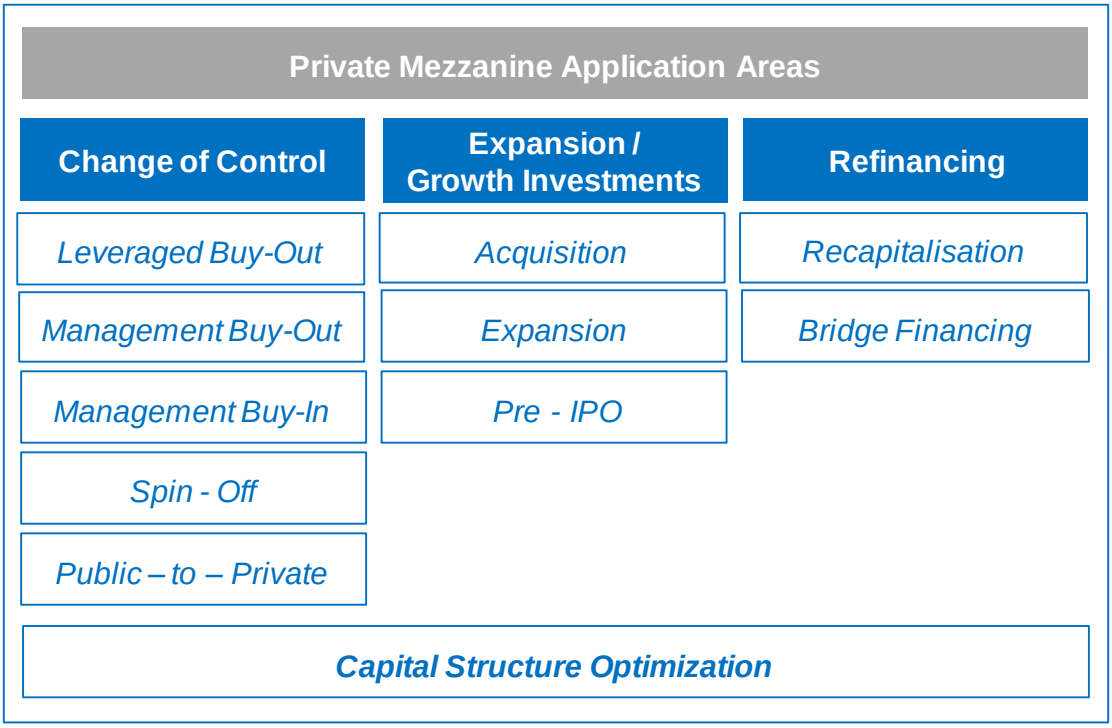
Source: www.alpinvest.com, www.mezzmanagement.com and www.ics-mezzanine.de

6. Private Mezzanine Application Areas

Mezzanine capital can be used in a broad spectrum of situations. It is an appropriate financial instrument not only in the cases where there is a change of control, but also in the cases of business expansion and refinancing.

As I have already mentioned in the previous sections of my thesis, in general, mezzanine investors concentrate their attention to companies having strong earnings and well established market positions and wishing to finance further their growth through expansion projects. Quite often, mezzanine is applied also in acquisitions and buy-outs. This is due to the fact that the funds available to the management team of the company are usually limited and the biggest part of the purchase price should be financed by external investors. With the aid of hybrid products, used in combination with senior debt, the amount of equity required in the business could be reduced. As the use of the equity is the most expensive and dilutive form of capital, it is normal to aim to create an anti-dilutive capital structure at the lowest cost, which maximizes the existing shareholders' wealth and, at the same time, ensures the resources that are necessary to implement the business plan. The table below illustrates the broad range of areas of application of mezzanine capital as a way of financing:

Figure 12: Private Mezzanine Application Areas



Source: www.mezzmanagement.com & www.investmezzanine.at

Mezzanine financing, however, is used mostly in the development of optimal capital structures, for financing as part of the structure of LBO transactions, and for funding of further growth. Consequently, in the pages to follow I will discuss the application of mezzanine just in the listed above areas.

6.1. Development of Optimal Capital Structure

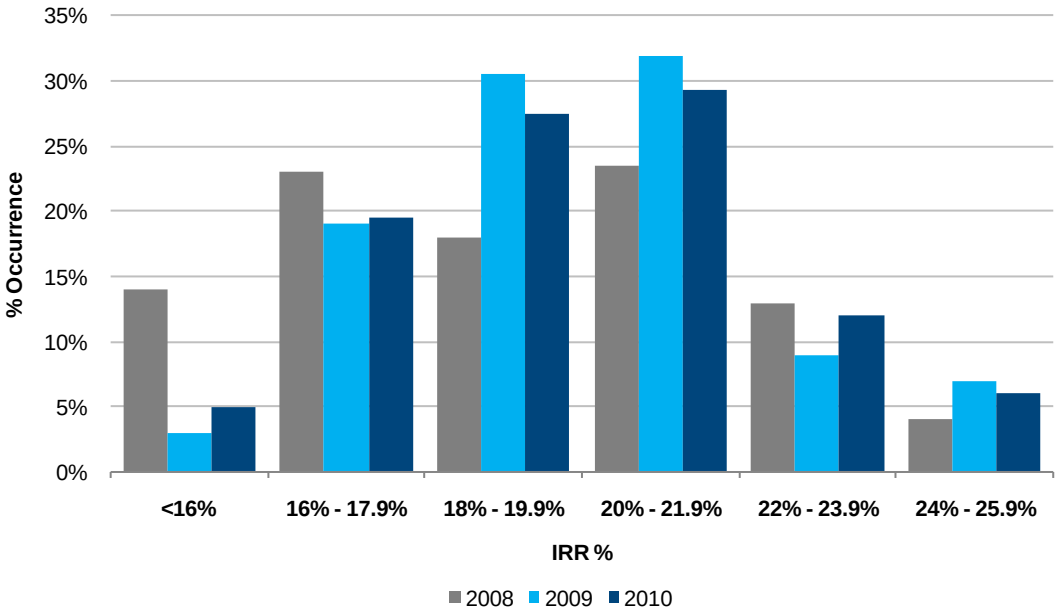
For companies in their mature stage of the expansion, mezzanine becomes a more popular alternative of risk capital. For example, the work of Bagella and Becchetti[50] of 1998, where they stated that in the case of a company that could be identified to a large extent with a company in the phase of the business cycle model, discussed above, the optimal form of financing of a project would be a combination of bond and associated warrant. According to Perille[51](1996), if a given mezzanine instrument is well-structured the mezzanine financing is able to ensure an income that could be expected from the equity at risk levels incidental to preference senior loans.

When adopting a financing decision, the company aims at finding a combination of available funds to ensure the lowest weighted average cost capital possible, as, where WACC is minimised, the value of the company or, in other words, the shareholders' wealth, is maximised. The conventional capital structure consists of a mixture of equity and debt and as WACC is the simple average between the cost of equity and the cost of debt, it is normal to ask ourselves, which one of these two components is cheaper and then to select more of the cheaper one and less of the more expensive one as to reduce the average of two. The answer is that the cost of debt is cheaper, since the senior debt is less risky than equity and the required returns needed to compensate the debt investors are less than those of equity investors. What happens, however, when a company is refused further financing by its banks-creditors, notwithstanding there is more financial capacity to support long-term borrowings. In such cases, the companies often turn to mezzanine capital. Very often it is deemed a positive move for mature companies, because usually all parties involved in the capital structure end up benefiting. In this section of my graduation thesis, I will present to you how a given company, which properly incorporates mezzanine debt into its capital structure, can take its WACC down and at the same time move up its return on equity (ROE).

[50] M.Bagella & L. Bechetti: The optimal financing strategy of a high-tech firm: The role of warrants", 1998
[51] R.F. Perille: Mezzanine – Efficient Financing for Recapitalization or Rapid Growth, 1996

In financial practice, there are not strict rules to help us to optimize an entity's capital structure. To set a proper target ROE should be our priority when taking business decisions. In order to achieve the profit objective we should just guarantee that the carrying cost is less than the internal rate of return expected from the investment. Although mezzanine financing is more expensive form of financing than traditional senior debt, it is also advantageous because the desired returns vary between 13% - 25% which is lower than equity and helps reduce the overall cost of capital.

Figure 13: Mezzanine Targeted Returns for the Period 2008-2010

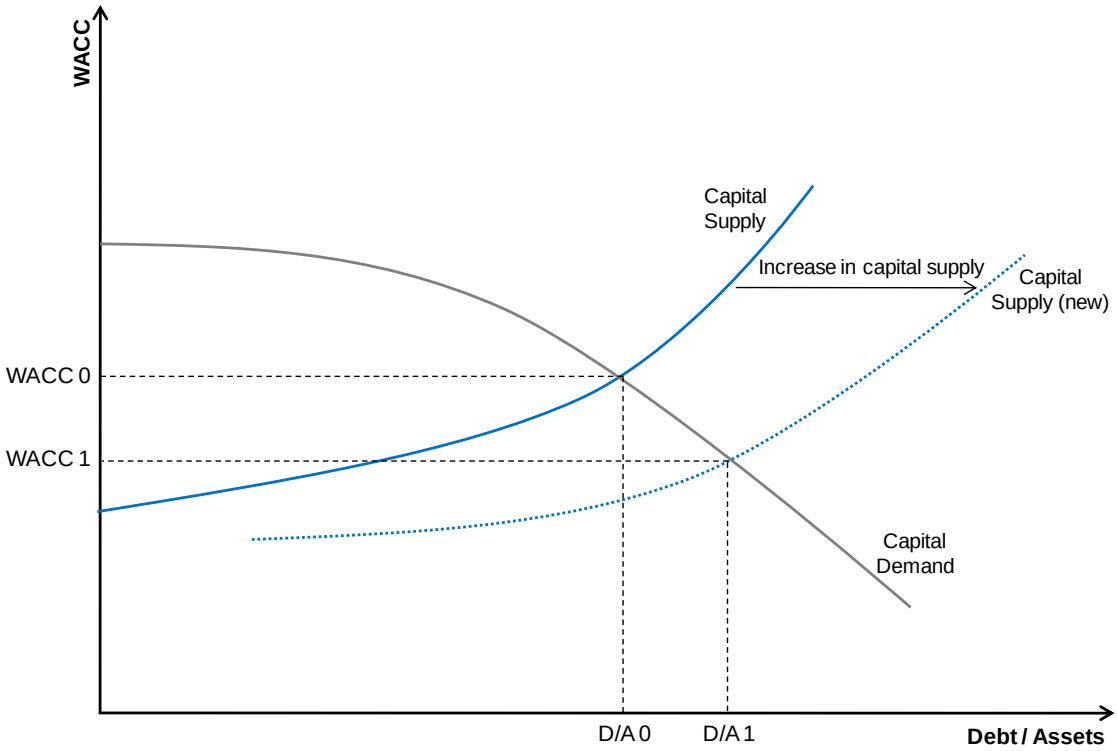


Source: Bond Capital Mezzanine Finance, 2010

From the utility function of the creditor and the borrower, the implicit function of demand and supply of funds on the capital market could be drawn up. In the model I would like to present, there are only senior creditors on the side of supply of capital. As a result of the use of more debt the marginal utility of creditors is reduced. The latter will require yet higher interest margin in return of the increased risk, proportionately to the amount of the extended loan, which permanently increases the loan costs of the company. On the other hand, this increases the volatility of dividend payments to shareholders, i.e. increases the financial risk faced by them. And here we reach the point where we could ask which one of the two has the greater effect - the reduction in the WACC caused by having a greater amount of cheap debt or the increase in the WACC caused by the increase in gearing.

Based on the above arguments, Anderson and Clark[52] (2003) show that the curves of demand and supply of capital intersect in one point and this point defines the amount of both the balanced WACC and the balanced capital structure. With the appearance of mezzanine debt, the aggregated supply of capital has increased and the curve of supply has shifted right, thus reducing the amount of WACC at the equilibrium point. The figure below illustrates the above-described process:

Figure 14: The Effect of the Mezzanine on WACC and Capital Supply



Source: J. Clark, R. Anderson, "Identifying the optimal capital structure for a second stage growth company using mezzanine financing", 2003

Let's illustrate the following two cases. In the first case the company is considered to be financed by equal proportions of debt and equity, or 50% each of them. In the second case the company is regarded to use a higher degree of leverage, or 60% debt, 20% mezzanine and 20% equity. The model presumes that the cost of mezzanine is lower than the cost of risk capital. To calculate WACC, we will use the well-known formula, but supplemented to introduce the mezzanine instrument into the capital structure.

[52] J. Clark, R. Anderson, "Identifying the optimal capital structure for a second stage growth company using mezzanine financing", 2003

WACC = Re*E/V + Rd*(1 – Tc)*D/V + R mezzanine*(1 – Tc)*Mezzanine/V, where:

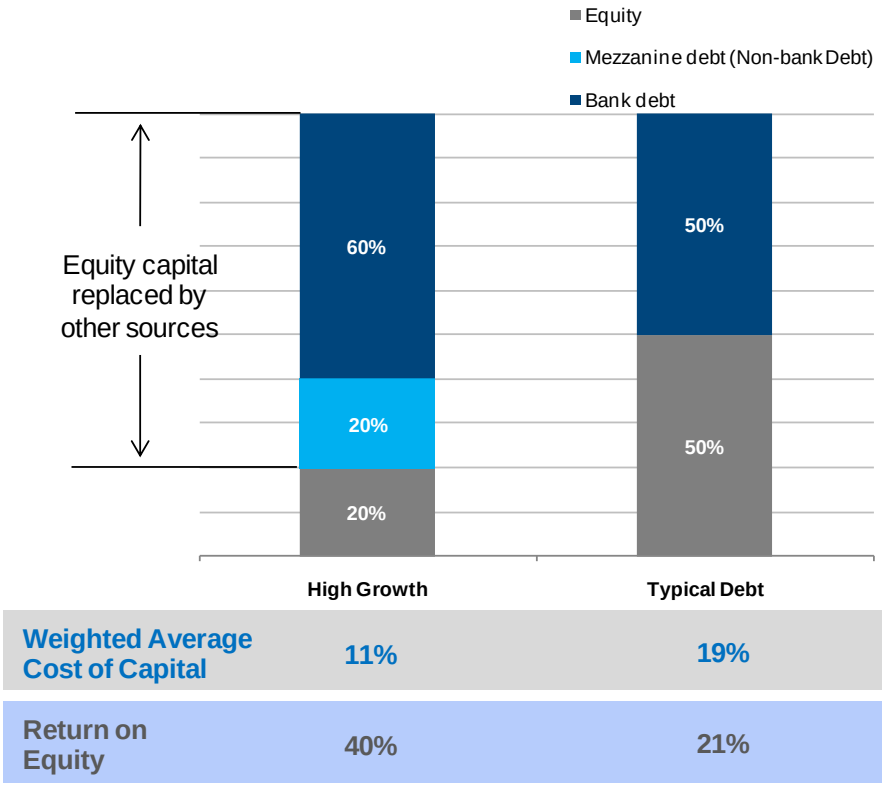
Re	Cost of equity
Rd*(1 – Tc)	Cost of debt after tax
R mezzanine*(1 – Tc)	Cost of mezzanine after tax
Tc	Tax rate
E/V	Percentage of financing that is equity
D/V	Percentage of financing that is debt
Mezzanine/V	Percentage of financing that is mezzanine

The average cost of capital is formed in the above two cases as follows:

$$\mathbf{WACC}_{(\text{Case 1})} = \mathbf{Re*0.50 + Rd*(1 - Tc)*0.50}$$

$$\mathbf{WACC}_{(\text{Case 2})} = \mathbf{Re*0.20 + Rd*(1 - Tc)*0.60 + R\ mezzanine*(1 - Tc)*0.20}$$

Figure 15: The Effect of the Mezzanine on the Capital Structure



Source: Bond Capital Mezzanine Finance, 2010

The figure above shows how the application of mezzanine instruments lowers the company's cost of capital and improves the return on equity. Mezzanine lowers WACC due to the

following two reasons: on the one hand, it is a cheaper form of financing in comparison with the risk capital, and on the other hand, interest payable on mezzanine reduces the tax base.

The decrease of WACC is an important issue because of a number of reasons. By lowering WACC, many projects could be realised, instead of being abandoned by the companies. For example, a project with IRR of 17% and WACC of 19% will be abandoned as its net present value (NPV) will be negative. If, however, with the help of mezzanine the project's WACC could be reduced below 17%, it'll be worth to implement it. Besides, mezzanine increases the project's NPV – now NPV will be a positive figure – and its income, thanks to which the investor, who has provided the mezzanine financing, will be able to actively participate in the creation of value.

6.2. Structure of Financing in the Case of LBO Transactions

A leverage buyout (LBO) is the acquisition of a company using debt to finance a large portion of the purchase price. The remaining portion is funded with an equity contribution by a financial sponsor[53] of venture capital, wishing to earn pre-defined income from its investment. This income is measured through the indicator Internal Rate of Return (IRR)[54]. The attraction of any debt or debt-like instrument with costs of capital lower than that of venture capital increases IRR. The use of leverage at LBO transactions is supported also by the trade-off theory of capital structure, according to which the entity's value could be optimized through the attraction of a particular amount of debt. The correct determination of the level of leverage shall be based on the ability of the company to generate stable cash flows. Thus, the company will be able to serve its debt in the future without there being any financial difficulties[55] and negative impacts on its operations. A financial sponsor will be able to determine the structure of financing of a LBO when he knows the exact amount of the purchase price. As the banks creditors have their own established practices, the financial sponsor could determine, with a relatively high level of certainty, what would be the maximum amount of senior debt to be extended to him. Based on that, the investor could calculate the amount of venture capital he

[53] The term "financial sponsor" refers to private equity (PE) firms, merchant banking divisions of investment banks, hedge funds and special purpose acquisition companies (SPACs). PE firms and hedge funds raise the majority of their investment capital from third-party investors, which include public and corporate pension funds, insurance companies, endowments and foundations, sovereign wealth funds and wealthy individuals.

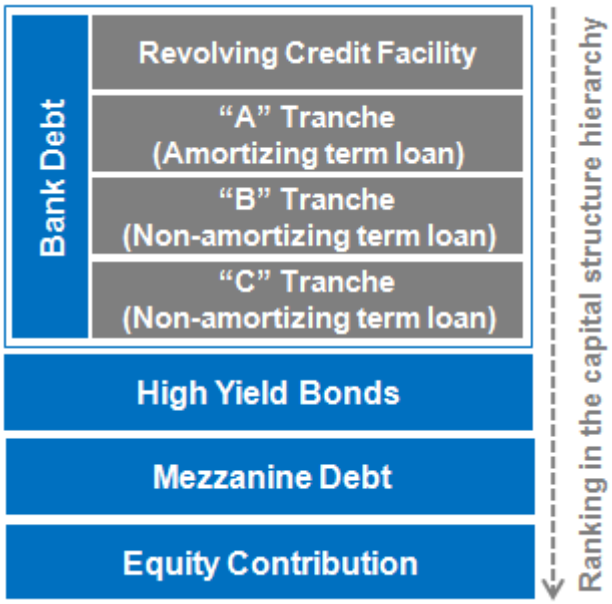
[54] The internal rate of return measures the total return on a sponsor's equity investment, including any additional contributions made, or dividends received, during the investment horizon. It is defined as the discount rate that must be applied to the sponsor's cash outflows and inflows during the investment horizon in order to produce a net present value (NPV) of zero. The targeted IRR varies between 25%-40%.

[55] Simultaneously with increasing the leverage, the credit risk also increases, which leads to higher costs of debt, including higher interest payments, costs of financial distress etc.

would need to achieve the planned IRR. As the average amount of a LBO transaction is within the range of EUR100m, in most cases, the portion of bank debt and the portion of equity contribution are not enough to cover the purchase price, and therefore, additional financing is required. When an instrument is to be selected to fill in the gap between the pure debt and the pure equity, it is extremely important to see what the effect of this instrument will be on the financial sponsor's IRR. The most preferred instruments to fill in the gap within the structure of financing of a LBO transaction are the high yield bonds[56] and mezzanine debt - quite often they are used in combination.

In a traditional LBO, the portion of debt usually takes 60% to 70%, and the equity contribution varies within the range of 40% to 30%, respectively. The figure below presents the separate groups of financial resources within the LBO structure, and their ranking within the capital structure hierarchy.

Figure 16: General Ranking of Financing Sources in a LBO Capital Structure



Source: Own illustration based on J. Rosenbaum & J. Pearl, "Investment Banking – Valuation, Leveraged Buyouts & Acquisitions", 2009

[56] High yield bonds are discussed in section 4.4. According to the "broader" sense of mezzanine, they are also part of the group of mezzanine instruments, as this group covers all instruments situated between the pure debt and the pure equity in the capital structure of a company.

The debt portion of the LBO financing structure includes a broad range of loans and other debt instruments that can be distinguished by their terms, conditions and providers. Herein below, we will discuss each one of them separately[57].

The bank debt forms an integral part of the structure of financing of a LBO and serves as a significant source of capital. It is considered a cheap form of financing; however, its amount is limited. Bank debt is a senior secured credit facility and usually comprises a revolving credit facility and one or more term loans.

A revolving credit facility is a type of bank loan that could be extended by a bank or a group of banks. It enables the borrower to withdraw different amounts according to a pre-fixed limit for a certain period of time. It is typical for this type of financing that the financial sponsor has the right to freely repay the loan amounts at any time and to re-borrow them again within the agreed term[58] of the credit agreement. In most cases, a revolving credit facility is used to cover the seasonal working capital needs of a company, and thus, it could be considered a source of liquidity, although it is possible to finance a small part of the purchase price in an LBO. Along with a nominal commitment fee, which is a charge, there are also interest expenses that should be covered by the financial sponsor.

A term loan is a bank loan with fixed maturity that requires the repayment of principal and the payment of interest due thereon in accordance with a pre-set repayment schedule. In contrast to the revolving credit facility, this type of loan cannot be re-borrowed after the full repayment of principal. In practice, term loans are classified by an identifying letter such as "A", " B", "C", etc, taking into account their amortization schedules and terms.

"A" term loans usually fall within the so-called "amortizing term loans" category, as they require significant payments on the principal throughout their relatively short life[59]. This is also the reason why they are considered loans of lowest risk and together with the revolving credit facilities they are the lowest priced source of financing in the capital structure of a company.

[57] To understand the empirical analysis presented in the last section of my thesis, a classification of the individual instruments forming the debt portion within a LBO financing structure will be necessary.
[58] A revolving credit facility tends to have maturity from five to six years.
[59] An amortizing term loan usually matures simultaneously with the revolving credit facility. Its life is on average six years.

"B" and "C" term loans fall within the category of the so-called "non-amortizing term loans". Usually, they are larger in size and have longer maturities[60] and higher interest payments. Besides, they are characterized by the so-called "bullet payment at maturity" structure, where the amount of the principal is paid in one single instalment, upon the expiry of the credit agreement.

According to the "broad sense" of mezzanine capital, a high yield bond is a kind of a mezzanine instrument with non-investment grade, typically structured as senior subordinated. Similarly to the above-described non-amortizing term loans, this type of debt securities is also characterized with bullet payment at maturity, with the date of payment being usually from seven to ten years after their issuance. In contrast to the non-amortizing bank debt, high yield bonds bear much higher interest[61] as to compensate investors of the higher risks assumed by them. Another distinctive feature of high yield bonds is the existence of PIK toggle, which allows the payment of interest in the form of additional notes, instead of cash payment. This option enables the issuer to retain the cash flows generated, which is a special advantage during the early years of the investment period, when the leverage is highest. On the other hand, however, the selection of payment with PIK, instead in cash, leads to increasing the coupon by 75bps. High yield bonds are one of the pillars of LBO financing. Their use in combination with bank debt enables the financial sponsor to increase the level of leverage beyond the level provided to the traditional credit market. This type of financing is attractive mostly because of its less restrictive covenants compared with that of bank debt, longer maturities and absence of mandatory amortization during the life of the bond. On the other hand, however, costs of issuance[62] of this type of bond are relatively high. Moreover, high yield bonds have a non-call feature, which prohibits their voluntary redemption[63] and this could adversely impact the exit strategy of a financial sponsor.

Mezzanine debt is a highly negotiated instrument between the mezzanine provider and the investee, which is tailored to meet the financing needs of the given transaction and the required IRR. One of its biggest advantages is that it neither obstructs the payment of

[60] The average life of non-amortizing term loan is up to seven years. In rare cases, seven and one-half years.
[61] The interest rate is usually fixed and determined at the time of bond issuance. Payments are usually made on a half-year basis. Although this type of debt securities can be structured by a floating interest rate as well, this is not a common practice of financing of LBO transactions.
[62] These costs include fees for issuance ranging from 3% to 4.5% of loan capital, as well as legal fees and administration fees.
[63] A voluntary redemption can be made if the financial sponsor agrees to pay a substantial fee, the so- called "call premium".

instalments or interest on senior debt nor burdens the company's free cash flows. The payment of principal, which is made at once together with the bullet payment at maturity, is deferred for almost a year, after the full repayment of the bank debt. Its interest is usually a combination of cash and PIK payments and can be structured with both a fixed rate and a floating rate. The average term of repayment of mezzanine debt varies considerably, depending on the amount of the LBO transaction. It typically matures outside the non-investment grade bonds and, in most cases, it does not exceed a term of twelve years. As with high yield bonds, the early repayment of mezzanine debt could appear to be disadvantageous to the mezzanine provider, for example in the event market interest rates decline, and thus, his reinvestment risk is protected by high call premiums. Last but not least, mezzanine debt could be structured in such a way as to enable the mezzanine investor to receive part of equity as compensation for the risk assumed, through warrants convertible in common stocks. The equity upside potential is the reason underlying the mezzanine provider's interest in entity's prosperity. While bank creditors are primarily interested in the generated cash flows that will cover the repayment of senior debt until the expiry of its term, the sustainable increase in enterprise value is what it matters to the mezzanine investor. If the enterprise value is expressed as a multiple of EBITDA[64], the table below summarises the typical structure of LBO financing at different purchase prices.

Table 4: Structure of LBO financing

EBITDA Multiple	<= 3.5	4 x	5.5 x	6 x	7 x	8 x	10 x +
EQUITY	-	-	0.1 - 1.5	1.0 - 1.5	1.5 - 2.0	1.5 - 2.5	2.0 - 4.0
MEZZANINE	-	0.5 - 1.0	1.0 - 1.5	1.0 - 1.5	1.0 - 1.5	1.0 - 1.5	1.0 - 2.0
DEBT	<= 3.5	3.0 - 4.0	3.0 - 4.5	3.0 - 4.5	3.5 - 4.5	3.5 - 4.5	3.5 - 4.5

Source: O. Grabherr, "Finanzierung mit Private Equity und Venture Capital", 2002

In a transaction, the purchase price of which is 10 times EBITDA of a company, 45-50% of the purchase price will be financed by venture capital provided by a financial sponsor. If, however, the purchase price is 8 times EBITDA, then 30% of the purchase price will be financed by the entity's equity. If the purchase price is 6 times, only 25% of the transaction amount will be financed by investor's funds. Based on a simple rule, applied in the practice, the borrowed external capital, including bank debt and mezzanine debt, can be no more than

[64] Earnings before interest, tax and depreciation

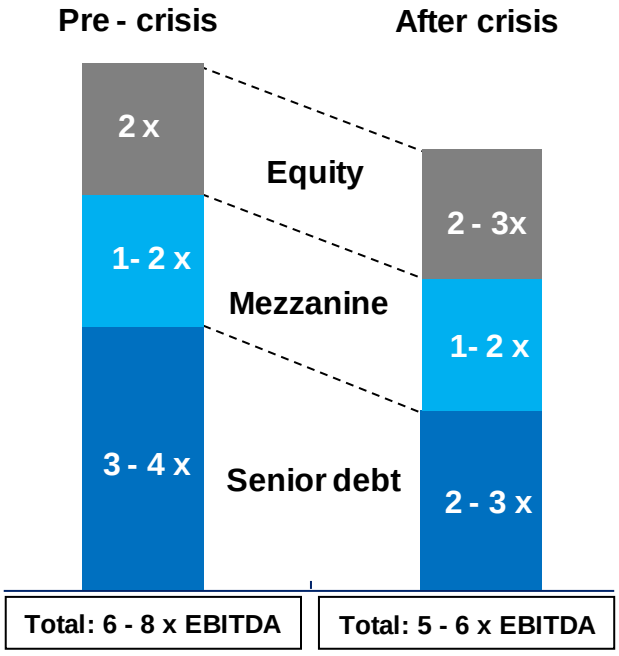
5.5 times of EBITDA in the structure of LBO financing, whereas the amount of its collateral should be 3.5-4.5 times EBITDA. Last but not least, the purchase price of the company subject to acquisition depends to a large extent on its capital structure.

7. The Mezzanine Market

7. 1. Central and Eastern Europe (CEE)

The use of hybrid forms of financing is not considered a novelty in corporate finances. In the United States of America the financing with mezzanine capital dates back to 1980s. In Europe, this type of instruments was introduced into corporate life at the beginning of 1990s[65]. The market for mezzanine products in Central and Eastern Europe, similar to any other markets in the world, has been growing steadily in the recent years. The first independent mezzanine fund in CEE was launched in 2000 and was called Mezzanine Management Central Europe ("MMCE"). The pioneer of mezzanine products in the region has a network including offices in Vienna, Budapest, Warsaw, Bucharest and Kiev. To date, the Austrian Fund has completed 27 transactions in 8 countries for the total amount of EUR376m[66]. Unfortunately, as it was the case with traditional banking, the mezzanine financing was also affected by the negative consequences of the global credit crunch.

Figure 17: Acquisition and Leverage Multiples (CEE Countries)



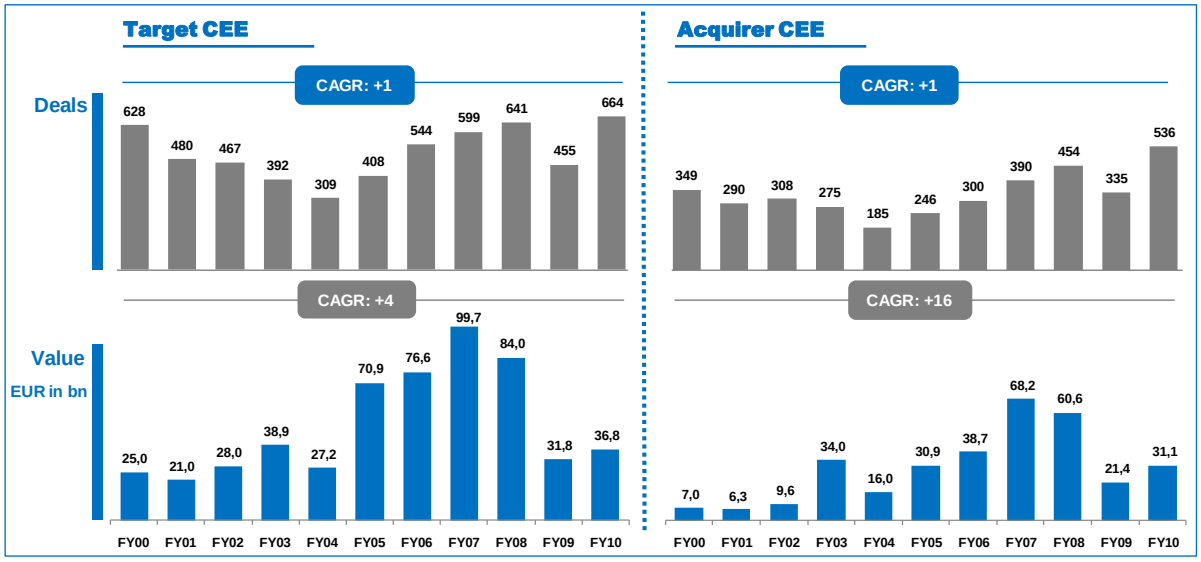
Source: Presentation provided by Sortis Invest, 2009 (www.sortis.bg)

Prior to the crisis, there was a plenty of liquidity on the CEE market. Debt financing was a cheap source of finance, which was readily available on the market at multiple of 3-4 x

[65] Credit Suisse Economic Research, Mezzanine Finance – A Hybrid Instrument with Future, 2006
[66] www.mezzmanagement.com

EBITDA. In addition, a private equity fund could ensure mezzanine capital at multiple of 1-2 x EBITDA and thus, to pay an EBITDA multiple of 6 to 8 for the acquisition of an entity. The financial crisis led to collapse of the banking system, which resulted in a dramatic shrinkage of the overall bank lending. The figure on the previous page shows that the decline in senior debt is partially compensated by equity. Mezzanine capital remained however stable and at the same level of EBITDA multiple. The lack of liquidity on the market, in turn, has had a fundamental impact on the number and amount of leveraged transactions in this region.

Figure 18: M&A Activities in CEE for the Period FY00-FY10



Source: M&A activities in CEE/SEE in 2010 – Waiting for the next growth phase, 4th annual snapshot report, Roland Berger, 2011

M&A transactions in Europe have reached their peak in 2007. A study of Roland Berger shows that after the beginning of the crisis, their volume on the Old Continent has decreased sharply by two thirds. CEE accounts for about 10% of the total European M&A activity. The data of the global strategy consultancy firm shows also that since 2010 there has been a slight increase by 16% of M&A transactions, mostly in the countries of Central Europe; however, there are still a number of countries[67] in the South region where they remain at a low level and show an unsteady trend close to stagnation[68].

Unfortunately, there is no accurate statistic data of the level of decrease in the number of leveraged transactions occurring in the region, although there is data of the changes, which have occurred in the structure of mezzanine financing.

[67] Slovenia, Croatia, Serbia, Montenegro, Bosnia and Herzegovina, Bulgaria and Macedonia
[68] Roland Berge: M&A activities in CEE/SEE in 2010–Waiting for the next growth phase, 2011

While prior to the crisis 70% of mezzanine funds were provided for buyouts, which took place in CEE with an aggregate value EUR5.9bn, after the crisis the larger buyouts have slowed down dramatically down to EUR216m. While buyouts decreased post crisis to 40%, the level of mezzanine capital invested for growth and expansion has remained stable. Another 30% of the mezzanine capital available on the market is currently used for refinancing. The latter is caused by the fact that prior to the crisis, as mentioned previously, senior debt (“ B” and “C” Tranches) was provided at higher multiple levels. A characteristic of the bigger part of this debt is the so-called “bullet payment at maturity” structure. As it has to be paid back at once and the banks would grant funds to refinance at lower debt multiple level compared to pre-crisis level, companies seeking finance are faced by a dilemma. They have two options available: they can either inject more equity funding, which is quite expensive, or refinance their operations by mezzanine capital.

Under the investigated period, not only the number of transactions, but also their size has decreased. While prior to the credit crisis, large syndicated transactions with an average size of EUR30m EBITDA prevailed, as also medium-sized deals within the range EUR3-15m EBITDA, a negative trend is observed on the current mezzanine market. To realize large transactions becomes even harder without the involvement of senior lenders and without the existence of a syndicated loan market. Mezzanine funds operating in the CEE region report that after the credit boom they are sought mostly to finance stand-alone deals, without the involvement of senior debt where the transaction is completely mezzanine funded. On the one hand, this could turn out to be a positive trend, if the markets pick up. On the other hand, however, if the credit markets prove to be less receptive, the mezzanine providers could end in a situation where they will just support a long-term non-amortizing instrument.

With regard to covenants, the mezzanine providers become much more conservative after the shrinkage of the market. This is due also to the fact that senior banks have reduced almost to a minimum their risk appetite and stagnated their requirements for granting loans. The days of a cheap and covenant lite debt have left in the distant past. After the credit boom, mezzanine investors demand from their investees to fulfil such documentation agreements that would require a full suite of covenants.

On the market of hybrid products in Central and Eastern Europe, there has been also a change in the investment strategies of the mezzanine providers for the last few years. The market was overwhelmed with renewed concentration on value creation in businesses in terms of cost

control, revenue and growth initiatives. After the sunset of the leveraged buyout activity, private equity funds start to concentrate more intensively to the so-called buy-to-hold investments, which enable them to benefit from equity upsides by way of warrants and, at the same time, to obtain higher returns from the PIK, as this type of investments is characterised by longer holding periods. The availability of equity kickers, as well as the "bullet payment at maturity" structure of these investments, make the mezzanine providers more flexible and patient, compared to senior lenders, as, first of all, they do not dry up the current cash flows of the lender and, second of all, as their returns depend to a degree on the investee's future business performance. According to data, in the first half of 2009 51% of all closed deals in CEE were add-on acquisitions, with most of them being of companies showing financial distress.

In terms of pricing, mezzanine financing becomes more expensive and while prior to the crisis the talk was about "mid teens" pricing, nowadays there is a trend of "mid to upper teens" pricing.

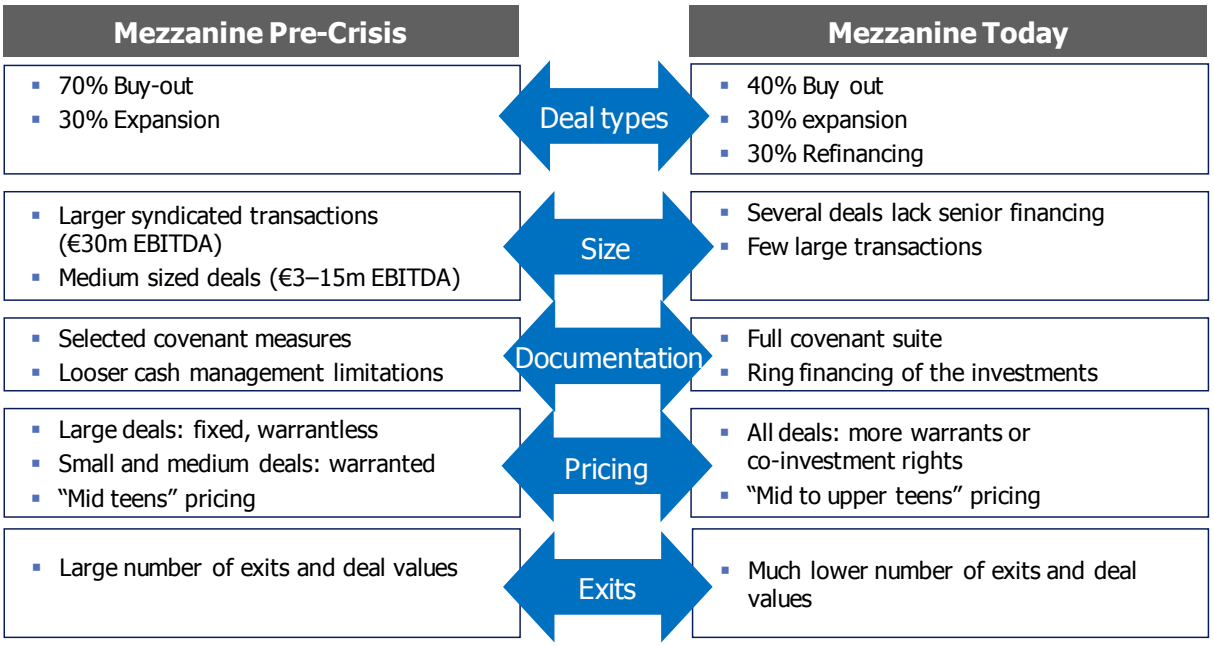
In the period before and after the credit crisis, there is a sharp decrease in the number of exits in the CEE countries. The statistics shows that during the peek of the transactions realized with the help of mezzanine capital, there were 28 exits in the aggregated amount of EUR3bn. During the first half of 2009, they dropped to 7 and amounted to only EUR196m in total. Exists effected through IPOs almost disappeared from the market. The number of the secondary sales has increased, which is a result of the higher number of private equity funds in the region offering alternative exit routes.

In parallel with the volume and size of leveraged transactions, the number of mezzanine providers in CEE has decreased as well. This result is due to the fact that in view of the still unstable and insecure market banks are not willing to grant high amounts of debt and none of the active mezzanine investors is prepared to underwrite amounts in excess of their approved final holds.[69]

All discussed so far could be seen in the figure on the following page.

[69] Presentation provided by Sortis Invest, 2099 (www.sortis.bg)

Figure 19: Mezzanine Market Comparison (CEE Countries)



Source: Presentation provided by Sortis Invest, 2009 (www.sortis.bg)

The countries that are preferred by mezzanine providers in the CEE region are Poland, Check Republic, Slovakia and Romania. The reason underlying this investor's interest is the size of the economy of these countries and the relatively stable macroeconomic satiation they are characterized by. Countries that could be designated as unattractive are Russia, Ukraine and Baltic countries, where the depth of recession and fragile economy are an obstacle to the realization of high potential growth opportunities. Alternative energy, telecoms, construction seem to be the most interesting target industries in CEE. Cyclical businesses, such as retail and heavy-duty manufacturing, are of less interest to mezzanine investors. In general, mezzanine funds operating in the CEE region focus their attention to targets, with relatively low leverage, reliable future cash flows, strong management team and attractive valuations.

In conclusion, the outlook for mezzanine in CEE remains extremely positive. The entire region is expected to be back on growth track relatively quickly, almost thanks to its underlying benefits – the low cost production base, the lack of investment activity in the past, the coverage with Western European markets, the EU funded investments in the field of infrastructure, etc.

7.2. Bulgaria

Bulgaria is a country considered to be an area of high risk. The local capital adequacy ratio required by the Bulgarian banking system is 12%, which is higher than the minimum requirements of 8% in the European Union. This is the reason why risky capital instruments are used very rarely in the country. The preferred option is the traditional bank financing.

Corporate hybrid instruments[70] are still relatively unknown as a form of financing and therefore continue to be little used. Their market is still very young, at the early stage of its development[71]. It started to develop in the years preceding the crisis. On the one hand, the growing activity of businesses and the resulting need of long-term resources could be pointed out as reasons for that. On the other hand, the State and the domestic credit institutions are ready to support the capital market development. This is why, in the first few years of the new century, three large commercial banks with foreign participation, playing the role of investment intermediaries – Raiffeisen Bank, UniCredit Bulbank and United Bulgarian Bank, made attempts to trade with debt hybrid products. These capital instruments were offered under more favourable conditions compared to the conditions offered under traditional bank loans, with the aim to lay the foundations for application of this type of financing. However, this innovative process stopped with the progress of the financial crisis in Bulgaria in 2008[72].

Out of the foreign mezzanine providers in Bulgaria, the most active one is Mezzanine Management Central Europe ("MMCE"). To date, through its two funds, AMC I and AMC II, the Austrian investment company completed eight investments in the country[73].

When the crises calmed down, Joint European Resources for Micro to Medium Enterprises, or JEREMIE, which is a joint initiative launched by the European Commission and the European Investment Bank group, also contributed to the implementation of capital hybrid instruments at the Bulgarian capital market. The goal of this initiative is to improve the access to financing for small and medium-sized enterprises within the European Union using its Structural Funds. In Bulgaria, the holding fund under JEREMIE is financed by the European Regional Fund, with a 15% co-financing from the State budget. Under the JEREMIE Initiative in Bulgaria,

[70] Corporate hybrid products may be issued in Bulgaria by joint stock companies. They could be issued through a private placement in accordance with the provisions of the Commercial Act or through public offerings in accordance with the provisions of the Public Offering of Securities Act.

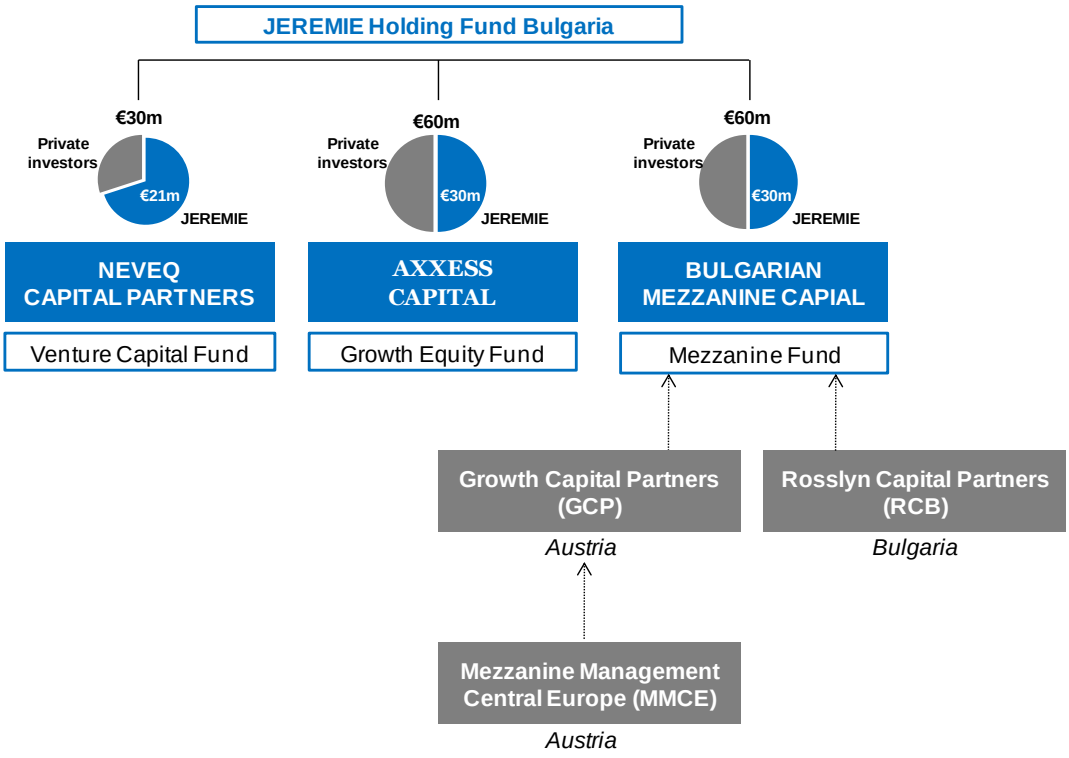
[71] Unfortunately, at present there are no precise statistical data about the volume and number of hybrid transactions, which have been completed. The fact that most of them have been recorded by the banks as a special kind of credit solution is one of the reasons for that.

[72] Conducted interview with Mrs. Petya Tsekova, Chief economis at United Bulgarian Bank

[73] A brief description of each one of the accomplished eight transactions is included in Appendix 1.

instruments have been developed, which ensure support in all staged of the entities' business cycle – seed financing for start-up companies, venture capital for the entrepreneurs in early stages, and expansion finance for companies that are in a more mature phase of their business development[74]. Financial instruments have been classified in two groups – debt instruments and equity instruments. Debt instruments, which will not be discussed in detail herein, as they are not part of the topic of my graduation paper, include a guaranteed scheme intended to facilitate bank lending. Equity instruments include three funds – venture capital, growth equity fund and mezzanine fund[75].

Figure 20: JEREMIE Holding Fund Bulgaria



Source: Own illustration based on information, sourced from www.regal.bg and www.jeremie.bg/bg/mezz-fund/

The funds will become operational in periods when it is difficult to find financing due to the difficult current business environment and thanks to them the entrepreneurs in Bulgaria will have at their disposal capital resources of almost EUR150m for the next four or five years. The basis of these funds is split into two parts: EUR81m of the capital will be ensured by the JEREMIE Initiative, and the remaining amount will be attracted from private investors.

[74] http://www.mi.government.bg/bg
[75] http://bgbusinesshelp.com/what-happens-with-jeremie/

Moreover, the goal of these three funds will be to educate small businesses on how venture capital funds and share investment schemes operate.

NEVEQ Capital Partners will manage the venture fund to be used from start-up companies. To implement its goal, the fund will have to ensure a private resource of EUR9m to be added to the amount of EUR21m provided by JEREMIE. Everything relating to technology in education, energy effectiveness and mobile services will be part of its range of vision, and its management team will focus on not more than ten projects for the entire life-cycle of the fund.

The second fund will be focused on more mature firms. Its goal will be to provide resources for development to finance the entities' growth and expansion. The fund will be managed by Axxess Capital and will start its operations with a capital base of EUR60m. Half of this amount will be ensured by JEREMIE, and the other half will have to be ensured by the management team.

The first Bulgarian specialised mezzanine fund will be managed by a local team, and namely Rosslyn Capital Partners[76], which will be supported by Growth Capital Partners AG, established by the founders of Mezzanine Management Central Europe, in the transactions review, approval and structuring. As regards its targets for financing, it will not differ from that of mezzanine funds in Western and Central Europe. The focus will be placed on businesses in a period of expansion or mature phase, and the extended mezzanine funds will be used to expand, acquire, construct and restructure businesses. The budget of the JEREMIE Initiative for financing the mezzanine fund amounts to EUR30m, or 50% of the total capital of the instrument. RCB and GCB should attract at least 50% of the capital from private investors, and thus, the total capital of the instrument will reach EUR60m. The accumulation of private resource commenced back in 2011. It is expected that the fund will close at the end of 2012. Fifteen transactions are scheduled for the next five years, with the amount of each one of them being within the range of EUR2-6m. The fund will invest up to 70% in small-sized and up to 30% of its funds in medium-sized companies.

Criteria to be met by the Bulgarian entities applying for mezzanine financing are listed herein below[77]:

[76] Rosslyn Capital Partners is a leading private equity and investment management firm based in Sofia, established in 2002. RCP has structured and managed 5 Share Investment Funds with more than 30 direct investments made primarily in the territory of Bulgaria.
[77] www.mezzanine.bg

- A well-established business, a clear development strategy.
- Sales amounting to at least EUR10m.
- Top 3 in the respective industry or a particular market niche.
- A clear and sustainable competitive advantage.
- Stable management by dedicated owners.
- Sale potential of the company.
- To operate in the following industries: production (other than heavy industry), business and financial services, fast-moving goods.

8. Empirical Analysis Based on Devin AD Acquisition

In chapter six I explained the use of mezzanine capital for building-up a more efficient capital structure and discussed a LBO transaction. In this last chapter, I will back-up the theoretical concepts with a real-life example. Using an empirical analysis based on both historical and projected data, I will demonstrate the effect of the incorporation of a mezzanine debt in the financing structure of a transaction and its effect on the equity IRR and money multiple of a private equity firm. This chapter will be divided into seven sub-chapters that follow the chronological order of my thesis and provide the reader with an in-depth understanding of the model. Initially, I will present briefly the history and business profile of the company, the subject-matter of my empirical analysis. Then, I will direct your attention to the components underlying the financial model, as also the sources of information I have used for its construction and the scenarios to be compared. The third sub-chapter is focused on the thorough presentation of the assumptions, which I have made, underlying the projected data. The forth sub-chapter discusses the enterprise value of the Target at the time of the acquisition. It aims at presenting the ratio between the individual debt instruments and equity in the financing structure of the company at the starting point of the analysis in each one of the three scenarios. It is the selection of the most optimal structure of financing that increases the investor's profitability in the exit year. In the fifth sub-chapter the Target's financial statements – balance sheet, income statement and cash flow for the reviewed period 2006 – 2009 will be presented for scenarios one, two and three. In the sixth sub-chapter I will briefly comment on the effects of the selected financial structure in each one of the three scenarios. The seventh and last sub-chapter concentrates on the ending point of the holding period of the LBO transaction under review. It will present the figures for equity IRR and money multiple and based thereon, a summary of my findings on the presented financial analysis.

8.1. Brief Presentation of Devin AD[78]

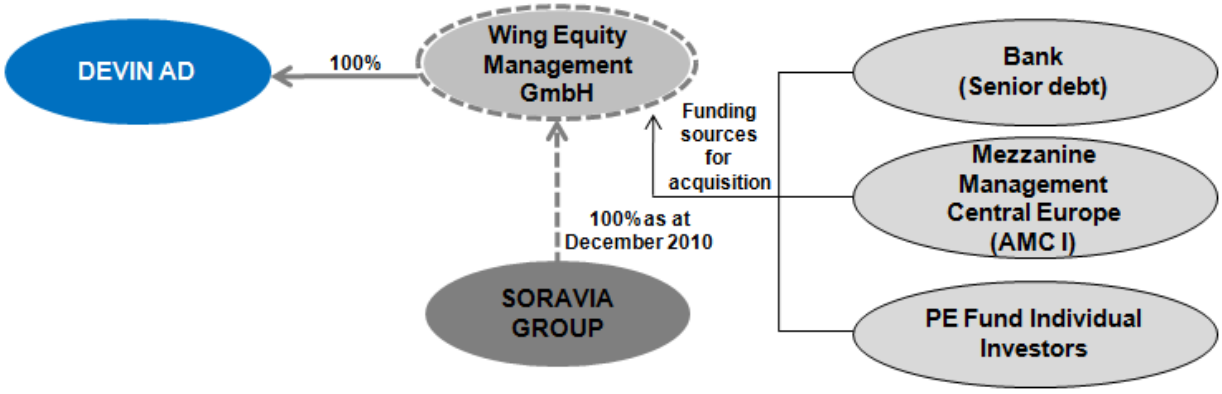
The subject-matter of my empirical analysis is the company Devin AD operating in one of the most perspective sectors in Bulgaria – the sector of bottled water that is often in the focus of foreign investors. Devin AD holds about 30 per cent of the market of bottled water in Bulgaria, which makes the company a leader in this segment. Moreover, the company is well known for its powerful distribution network in the country, as well as in the neighbouring countries, which contributes to its strong position. The product range of Devin AD comprises

[78] AD is the Bulgarian abbreviation for joint stock company.

mineral water, spring water, flavoured water, carbonated soft drinks, still fitness drinks and ice teas. In 2007, the company enlarged its portfolio becoming the exclusive distributor of the globally recognised energy drink Red Bull for Bulgaria, and later of the premium juice brand Granini as well.

The company Devin was incorporated in 1992 as a limited liability company owned by private individuals and the Devin Municipality. Since 1999 the company has been functioning as a joint stock company with 100% private capital. At the beginning of 2006, the Austrian investment fund Wing Equity Management[79] with rich experience in making extensive investments in the CEE region became the majority owner of the Bulgarian mineral water brand "Devin". The institutional buy-out had been made in cooperation with the Austrian mezzanine fund "Mezzanine Management Central Europe", which provided a significant part of the acquisition finance. The empirical analysis I have developed is focused particularly on this stage of the enterprise's life.

Figure 21: Parties Involved in the LBO of Devin AD



Source: Own illustration based on Devin information memorandum for public offering as at June 30th 2007, www.devin-bg.com

8.2. Model Structure, Sources of Information and Scenarios under Review

The empirical analysis is based on a financial model that is based on the three basic financial statements – income statement, balance sheet and cash flow statement. The time horizon

[79] Wing Equity Management GmbH is a private equity fund domiciled in Vienna, Austria. Initially, Soravia Equity GmbH, part of Soravia Group, held shares in Wing Equity equal to less than one third of its capital. In December 2010, Wing Equity merged into Soravia Equity GmbH and to date it is recorded in the Companies Register of Austria as an obliterated company. Soravia Group is an Austrian company operating in Central, Eastern and Southern Europe with experience in the real estate development and investment sectors.
Source: Companies Register of Austria and www.soravia.at

covers four years as on average the exit in the case of LBO transactions is made usually within the observation period selected by me. The starting point is the year of the transaction – 2006. At the point of Devin's acquisition in January 2006, as well as for the year preceding the transaction, no financial data was available at the Bulgarian Trade Register. Therefore, for the purpose of simplifying my analysis, I used debt figures as at December 2006 of the audited financial statements as a starting point for the calculation of the equity IRR and the money multiple. This assumption was possible, since the majority of loans in the debt structure of the company are non-amortizing with a bullet payment at maturity. As it will be discussed below, only "A" term loan of the debt structure of Devin AD is an amortizing term loan and its original balance at the beginning of financial year 2006 could have been higher potentially by BGN[80]100k, which is not material. The ending point of the holding period of the LBO transaction under review is assumed to be 31 December 2009.

The data entered into the model as at 31 December 2006 are the Target's actual historical financials, and for the remaining three years – 2007, 2008, 2009, the data is projected and based on assumptions, which will be presented in detail in the following sub-chapter of the thesis.

The sources of information I have used are as follows:

- ✓ Target consolidated[81] financial statements as at December 31st 2007
- ✓ Devin information memorandum for public offering as at June 30th 2007
- ✓ Financial information relating to the LBO transaction of Devin AD, provided by Sortis Invest

To study the effect of the incorporation of mezzanine capital into the financial structure of the deal under review on the equity IRR and money multiple, I will compare three separate scenarios. In the first scenario, it will be assumed that the acquisition of Devin will be made only through the use of pure debt and pure equity. The capital structure in the second scenario will comprise the following three components: equity, senior debt and mezzanine debt with warrant, with the right of exercising at the date of the exit, or 31 December 2009. In the third scenario, the above components will also be included in the structure of financing of the LBO

[80] 1 BGN Lev = 0.51 EUR Euro

[81] Devin AD has two subsidiaries: Atlantic Devin AD and Devin Royal EAD. This is the reason why the company is obliged to present consolidated financial statements.

transaction, with the only difference being that in this case the mezzanine investment will be structured without warrant, but with the right to a straight equity investment at the point of the acquisition in January 2006 for the party providing the mezzanine financing.

8.3. Assumptions

Assumptions presented below are valid for all three scenarios to be discussed. The table contains the income statement, the balance sheet and the enterprise value assumptions, as also a debt schedule, which is the "load-bearing column" of the presented financial model.

Table 5: Assumptions

Assumptions	2007 Projection	2008 Projection	2009 Projection
Income statement			
Sales growth (in %)	290%	12%	12%
Cost of goods sold (as % of sales)	60%	60%	60%
Selling, general and administrative expenses (as % of sales)	30%	30%	30%
Tax rate (in %)	0%	0%	0%
CAPEX (BGN in thousand)	2,540	2,540	2,540
Depreciation (BGN in thousand)	2,540	2,540	2,540
Anmortization (BGN in thousand)	1,845	1,845	1,845
Balance sheet			
Trade receivables (as % of sales)	8.49%	8.49%	8.49%
Inventory (as % of sales)	9.36%	9.36%	9.36%
Other assets (in %)	0.10%	0.10%	0.10%
Trade payables (as % of COGS)	21%	21%	21%
Other liabilities (as % of COGS)	0.4%	0.4%	0.4%
Debt schedule			
Repayments			
"A" term loan (BGN in thousand)	103	103	103
"B" term loan (BGN in thousand)	-	-	-
"C" term loan (BGN in thousand)	-	-	-
Mezzanine debt (BGN in thousand)	-	-	-
Revolving credit facility (BGN in thousand)	-	-	2,454
Leasing (BGN in thousand)	57	57	57
Loan from related parties - Soravia (BGN in thousand)	978	-	-
Interest payments			
"A" term loan (in %)	5.10%	5.10%	5.10%
"B" term loan (in %)	5.10%	5.10%	5.10%
"C" term loan (in %)	6.63%	6.63%	6.63%
Mezzanine debt (in %)	8.00%	8.00%	8.00%
Revolving credit facility (in %)	6.18%	6.18%	6.18%
Leasing (in %)	7.48%	7.48%	7.48%
Loan from related parties - Soravia (in %)	10.00%	10.00%	10.00%

Source: Target consolidated financial statements as at Dec 31st 2007, Devin information memorandum for public offering as at June 30th 2007, www.capital.bg

8.3.1. Income Statement Assumptions

The assumed sales growth is based on the fact that the sales of bottled mineral water in Bulgaria mark peculiar records in the last few years and there is no any other drink that is sold in the commercial network, the consumption of which develops with such high and steady rates[82]. Since the sales of Devin AD for the period 2004 – 2006 are in line with this market trend, I have assumed that they will continue growing in the future as well, with a constant growth rate of 12 per cent until the end of the holding period. The strong increase of 290 per cent in 2007 has been adapted to the sales figures included in the audited financial statements as at December 31st 2007 and partially it could be explained with the fact that from the beginning of 2007 Devin is the official importer and distributor of Red Bull for Bulgaria. The projected figures for COGS and SG&A have been calculated as a percentage ratio from the sales for a given period and are based on the forecasted figures reported in the Devin's information memorandum for public offering. Regarding the tax rate, it is assumed to be 0 per cent because according to the official data[83] the company is exempt from taxes till 2009 as it is considered to operate in a region with high unemployment rate. It was assumed that the business has long-term capital needs. Considering that in the period 2005-2006 investments made for long-term fixed assets – primarily for plant and equipment, amounted on average to BGN2.540k, I have assumed that the company will preserve this level of CAPEX for the future as well. Depreciation for each year of the model's time horizon was assumed to be equal to CAPEX and thus, to assure the sustainable level of assets. The intangible assets of Devin, representing 52% of the company's assets at the point of acquisition, include mineral and spring assets, trademarks, client base, etc. They are considered to have a useful life of 12 years and respectively, to be amortised on a straight line basis by EUR1.845k per year. All of the assumptions enumerated so far are linked to the projected income statement and cash flow figures of the Target.

8.3.2. Balance Sheet Assumptions

The projected figures for the two largest positions on the assets side of the balance sheet – "Property, plant and equipment", and "Intangible assets", are calculated using roll forwards[84]. In building up the two roll forwards, the values of the respective asset items at December 31st

[82] Z. Markova: "It is plain sailing", The Capital Newspaper, 2007
[83] Devin information memorandum for public offering as at June 30th 2007
[84] In accounting the term "roll forward" refers to the systematic establishment of new accounting period balances by using prior accounting period data on assets and liabilities.

2006 have been used as a starting point. In calculating the ending balances of tangible assets for the separate projected periods, the assumed CAPEX and depreciation figures, presented in section 8.3.1., have also been taken into account. In calculating the ending balances of intangible assets, the assumed amounts of amortization for each projected period, also described in the previous section, have been considered[85]. Trade receivables and inventories, items of the assets side of the balance sheet as well, have been calculated as a percentage ratio of sales and are based on the forecasted data as at December 31st 2007. In the available financial data there was no information about the item "Other assets". As their amount, compared to that of the other assets, is immaterial, I have assumed that it will grow by 0.10 % per year. Short-term liabilities comprise trade payables and other liabilities. Their projected amounts have been calculated as a percentage ratio of COGS for 2007, 2008 and 2009 respectively, based on the forecasted figures included in the Devin's information memorandum. The assumptions described in this section are linked to the projected balance sheet figures of the Target.

8.3.3. Debt Schedule Assumptions

As it was mentioned already, the debt schedule is an integral component of the financial model built up by me. It serves to layer the effects of the selected financial structure in each one of the three scenarios on the Target's financial statements. The debt schedule enables to:

- Complete the projected income statement from EBIT to net income.
- Complete the projected long-term liabilities and shareholders' equity sections of the passive side of the balance sheet.
- Complete the projected financing activities[86] of the cash flow statement

The debt structure of Devin AD is composed of the following debt instruments enumerated according to their hierarchy in the Target's equity structure:

- As stated in theory, the structure of each LBO typically includes a **revolving credit facility**, the main purpose of which is to provide ongoing liquidity for the seasonal working capital needs. The **revolver** in the debt structure of Devin AD has a balance

[85] The roll forwards for PPE and intangible assets are presented in detail in the Appendix 2.
[86] These activities include interest and debt repayments.

of BGN2.454k at the last date of December 2006; it matures in 2009 and bears an annual interest rate of 6.18 per cent[87].

- An **"A" term loan** amounting to BGN822k as at December 31st 2006 is the only amortizing loan in the debt structure of the company and it is assumed to require equal annual instalments of BGN103k until its expiry. The annual interest charged thereon amounts to 5.10 per cent[88].

- A **"B" term loan** amounting to BGN2.376k and a **"C" term loan** amounting to BGN11.299k as at December 31st 2006 fall within the group of non-amortizing loans and are characterised with bullet payment at maturity. As evident, they are bigger than the **"A" term loan** amortised throughout the years, which is in line with the theoretical hypotheses. Their interest rates are sourced from the audited financial statements and amount to 5.10 per cent for **"B"** and to 6.63 per cent for **"C" term loans,** respectively.

- The **mezzanine instrument,** which is part of the debt structure of Devin AD, has been provided by the Austrian mezzanine provider "Mezzanine Management Central Europe". Its balance amounted to BGN9.779k as at December 31st 2006. The repayment of the principal, similar to that of **"B"** and **"C" term loans**, does not burden the cash flow of the company during the holding period as it is done at once by the bullet payment at maturity. Its interest is structured with a fixed rate of 8 per cent[89] and is relatively higher than the interest rates of the above-enumerated senior bank loans, which is in line with the theoretical hypotheses. Annually, the mezzanine interest payments represent a fixed cost for the company of BGN782k. In the second scenario we will assume that the **mezzanine instrument** is structured with warrant that gives the Austrian investor the right to obtain 14.29 per cent of the common stock of Devin AD at exit. In the third and last scenario we will assume that the mezzanine provider has been compensated for the risk assumed not through a warrant, but through the right to receive 14.29 per cent[90] of the shares in Devin AD at the date of the acquisition in the form of a straight equity injection.

[87] The balance, the maturity and the interest rate of the revolver are sourced from the audited financial statements of the Target as at December 31st 2006.
[88] As stated in the Target's consolidated financial statements as at December 31st 2007.
[89] As stated in the Target's consolidated financial statements as at December 31st 2007.
[90] As stated in Devin information memorandum for public offering as at June 30th 2007

- The **subordinated loan from related parties** amounting to BGN978k at the last date of 2006 was extended by Soravia Group that, at the time of realization of the LBO transaction, held shares in Wing Equity Management. Unfortunately, the sources I have used do not contain detailed information about this debt instrument, except that it matures in 2007[91]. Therefore, I have assumed that the annual interest rate of this loan is higher than the interest rates of all other debt instruments within the debt structure of Devin AD and amounts to 10 per cent. This assumption is based on the fact that the loan was extended by equity providers that come last in terms of profit-sharing, bear the highest risk and therefore, to compensate all these, they require higher rate of return[92] than the other capital providers.

- Besides the debt instruments enumerated so far, the debt structure of Devin AD includes a **finance lease** of plant and equipment amounting to BGN1.131k. Its repayment on an annual basis is assumed to be equal to 5 per cent, or BGN57k. The annual interest rate of 7.48 per cent has been calculated as an average arithmetic of the interval from 5.75 per cent - 9.20 per cent presented in the Target's consolidated financial statement.

All interest expenses for the projected period 2007-2009 have been calculated using roll forwards[93]. The assumptions described in this section are linked to the projected financial statement figures, as follows:

- Projected debt payments – balance sheet and cash flow statement

- Projected interest payments – income statement and cash flow statement

8.3.4. Enterprise Value Assumptions

Since the sources of information I have used do not contain data about the existence of goodwill on a consolidated level I calculated the enterprise value of Devin AD at the starting point of my analysis – January 2006 as a sum of debt and equity investments equal to EUR42.539k for all three scenarios. Enterprise value at exit was assumed to be at 7.6 EBITDA multiple as indicated by Sortis Invest.

[91] As stated in the Target's consolidated financial statements as at December 31st 2007.
[92] In connection with this statement, please refer to chapter 2.2.2 Equity Funding
[93] The roll forwards are presented in detail in Appendix 2.

8.4. Financial Structure at Acquisition Date

Based on the assumptions described above, I generated my integrated financial model, comprising income statement, balance sheet and cash flow statement. This sub-chapter of the thesis is focused on the financial structures at acquisition date (January 2006) in each of the scenarios, with this feature being the only thing that distinguish them one from the other.

Table 6: Financial Structure at Acquisition Date

Financial structure at Acquisition Date - January 2006

	Scenario 1		Scenario 2		Scenario 3	
	Financials without mezzanine		Mezzanine with warrant		Mezzanine without warrant	
BGN in thousand		*as % of EV*		*as % of EV*		*as % of EV*
"A" term loan	822	2%	822	2%	822	2%
"B" term loan	2,376	6%	2,376	6%	2,376	6%
"C" term loan	11,299	27%	11,299	27%	11,299	27%
Revolving credit facility	2,454	6%	2,454	6%	2,454	6%
Leasing	1,131	3%	1,131	3%	1,131	3%
Loan from related parties - Soravia	978	2%	978	2%	978	2%
SENIOR DEBT	19,060	45%	19,060	45%	19,060	45%
MEZZANINE DEBT	-	0%	9,779	23%	9,779	23%
Direct equity investment "MMCE"	-	0%	-	0%	1,958	5%
Equity "Wing Equity"	23,479	55%	13,700	32%	11,742	28%
EQUITY	23,479	55%	13,700	32%	13,700	32%
ENTERPRISE VALUE AT ACQUISITION DATE	42,539	100%	42,539	100%	42,539	100%

Source: Target consolidated financial statements as at Dec 31st 2007, Devin information memorandum for public offering as at June 30th 2007, www.capital.bg

The table above shows that the senior debt, including the revolver, "A", "B" and "C" term loans, finance lease and loan from Soravia, remains at a constant level of 45 per cent as a percentage of enterprise value for all three scenarios. This is due to the fact that after the level of leverage of a company reaches a certain level, senior lenders are reluctant to provide further source of financing as they are not ready to face a risk higher than that already assumed.

In "Scenario 1", where the financial structure does not include a mezzanine instrument, the remaining source of financing amounting to BGN23.479k, which equals to 55 per cent of the enterprise value, is fully provided by Wing Equity in the form of an equity contribution.

In the financial structure of “Scenario 2” part of the remaining amount of financing after the senior debt, or BGN9.779k, was provided by the Austrian mezzanine provider “MMCE”. In this case, as it has already been mentioned in the previous sub-chapter, the mezzanine investment included an embedded warrant for 14.29 per cent equity stake in Devin AD at the time of exit. In this scenario, it is clear that the equity contribution of risk capital by the financial sponsor drops to 32 per cent as a percentage ratio of the enterprise value.

In “Scenario 3” the mezzanine investment remains at the same level as that in “Scenario 2”. Here, however, instead of the right to exercise a warrant the mezzanine investor is allowed to invest BGN1.958k in equity. Thus, the amount of the invested risk capital by Wing Equity drops by another 4 per cent vs. the previous scenario, reaching the amount of BGN11.742k.

8.5. Financial Figures

8.5.1. Financial Figures without Mezzanine

Table 7: Devin AD – Income Statement (Financial Figures without Mezzanine)

Devin AD - Income statement				
BGN in thousand	2006 Actual	2007 Projection	2008 Projection	2009 Projection
Sales	**13,814**	**53,875**	**60,340**	**67,580**
Cost of goods sold	(10,629)	(32,325)	(36,204)	(40,548)
Gross profit	**3,185**	**21,550**	**24,136**	**27,032**
Selling, general and administrative expenses	(6,336)	(16,162)	(18,102)	(20,274)
EBIT	**(3,151)**	**5,387**	**6,034**	**6,758**
Net interest	(1,618)	(1,193)	(1,134)	(1,049)
EBT	**(4,769)**	**4,195**	**4,900**	**5,709**
Tax	29	-	-	-
Net income	**(4,740)**	**4,195**	**4,900**	**5,709**
Depreciation	1,718	2,540	2,540	2,540
Amortization	810	1,845	1,845	1,845
EBITDA	**(623)**	**7,927**	**8,574**	**9,298**

KPIs (as % of sales)				
Gross profit	23%	40%	40%	40%
EBITDA	(5%)	15%	14%	14%
EBIT	(23%)	10%	10%	10%
FCF	n/a	7%	12%	12%

Source: Target consolidated financial statements as at Dec 31st 2007, Devin information memorandum for public offering as at June 30th 2007

Table 8: Devin AD – Balance Sheet (Financial Figures without Mezzanine)

Devin AD - Balance Sheet				
BGN in thousand	2006 Actual	2007 Projection	2008 Projection	2009 Projection
Cash	164	1,839	8,081	12,636
Trade receivables	2,242	4,574	5,123	5,737
Inventory	1,798	5,041	5,646	6,323
Property, plant and equipment	15,850	15,850	15,850	15,850
Intangible assets	22,144	20,299	18,453	16,608
Other assets	58	54	60	68
Assets	**42,256**	**47,656**	**53,213**	**57,222**
Shareholder equity	23,479	23,479	23,479	23,479
Acummulated profit / loss	(4,740)	(545)	4,355	10,064
Equity	**18,739**	**22,934**	**27,834**	**33,543**
"A" term loan	822	719	616	513
"B" term loan	2,376	2,376	2,376	2,376
"C" term loan	11,299	11,299	11,299	11,299
Mezzanine debt	-	-	-	-
Revolving credit facility	2,454	2,454	2,454	-
Leasing	1,131	1,074	1,018	961
Loan from related parties - Soravia	978	-	-	-
Debt	**19,060**	**17,922**	**17,763**	**15,149**
Trade payables	4,362	6,680	7,482	8,379
Other liabilities	95	120	135	151
Equity and Liabilities	**42,256**	**47,656**	**53,213**	**57,222**

Source: Target consolidated financial statements as at Dec 31st 2007, Devin information memorandum for public offering as at June 30th 2007

Table 9: Devin AD – Cash Flow (Financial Figures without Mezzanine)

Devin AD - Cash Flow				
BGN in thousand	2006 Actual	2007 Projection	2008 Projection	2009 Projection
EBIT	n/a	5,387	6,034	6,758
add back Depreciation	n/a	2,540	2,540	2,540
add back Amortization	n/a	1,845	1,845	1,845
EBITDA	**n/a**	**9,773**	**10,419**	**11,143**
+/- Teade receivables	n/a	(2,332)	(549)	(615)
+/- Inventory	n/a	(3,243)	(605)	(677)
+/- Trade payables	n/a	2,318	802	898
+/- TWC	**n/a**	**(3,257)**	**(352)**	**(394)**
+/- Other assets	n/a	4	(6)	(7)
+/- Other liabilities	n/a	25	14	16
+/- NWC	**n/a**	**(3,227)**	**(344)**	**(386)**
CAPEX	n/a	(2,540)	(2,540)	(2,540)
FCF	**n/a**	**4,005**	**7,535**	**8,218**
Interest	n/a	(1,193)	(1,134)	(1,049)
Debt repayments	n/a	(1,138)	(160)	(2,614)
Tax	n/a	-	-	-
Cash Flow	**n/a**	**1,675**	**6,241**	**4,555**
Cash OB	n/a	164	1,839	8,081
Cash Flow	n/a	1,675	6,241	4,555
Cash CB	**164**	**1,839**	**8,081**	**12,636**

Source: Target consolidated financial statements as at Dec 31st 2007, Devin information memorandum for public offering as at June 30th 2007

8.5.2. Financial Figures with Mezzanine

Table 10: Devin AD – Income Statement (Financial Figures with Mezzanine)

Devin AD - Income statement				
BGN in thousand	2006 Actual	2007 Projection	2008 Projection	2009 Projection
Sales	**13,814**	**53,875**	**60,340**	**67,580**
Cost of goods sold	(10,629)	(32,325)	(36,204)	(40,548)
Gross profit	**3,185**	**21,550**	**24,136**	**27,032**
Selling, general and administrative expenses	(6,336)	(16,162)	(18,102)	(20,274)
EBIT	**(3,151)**	**5,387**	**6,034**	**6,758**
Net interest	(1,618)	(1,975)	(1,917)	(1,831)
EBT	**(4,769)**	**3,413**	**4,117**	**4,927**
Tax	29	-	-	-
Net income	**(4,740)**	**3,413**	**4,117**	**4,927**
Depreciation	1,718	2,540	2,540	2,540
Amortization	810	1,845	1,845	1,845
EBITDA	**(623)**	**7,927**	**8,574**	**9,298**

KPIs (as % of sales)				
Gross profit	23%	40%	40%	40%
EBITDA	(5%)	15%	14%	14%
EBIT	(23%)	10%	10%	10%
FCF	n/a	7%	12%	12%

Source: Target consolidated financial statements as at Dec 31st 2007, Devin information memorandum for public offering as at June 30th 2007

Table 11: Devin AD – Balance Sheet (Financial Figures with Mezzanine)

Devin AD - Balance Sheet				
BGN in thousand	2006 Actual	2007 Projection	2008 Projection	2009 Projection
Cash	164	1,057	6,516	10,289
Trade receivables	2,242	4,574	5,123	5,737
Inventory	1,798	5,041	5,646	6,323
Property, plant and equipment	15,850	15,850	15,850	15,850
Intangible assets	22,144	20,299	18,453	16,608
Other assets	58	54	60	68
Assets	**42,256**	**46,874**	**51,648**	**54,875**
Shareholder equity	13,700	13,700	13,700	13,700
Acummulated profit / loss	(4,740)	(1,327)	2,790	7,717
Equity	**8,960**	**12,373**	**16,490**	**21,417**
"A" term loan	822	719	616	513
"B" term loan	2,376	2,376	2,376	2,376
"C" term loan	11,299	11,299	11,299	11,299
Mezzanine debt	9,779	9,779	9,779	9,779
Revolving credit facility	2,454	2,454	2,454	-
Leasing	1,131	1,074	1,018	961
Loan from related parties - Soravia	978	-	-	-
Debt	**28,839**	**27,701**	**27,542**	**24,928**
Trade payables	4,362	6,680	7,482	8,379
Other liabilities	95	120	135	151
Equity and Liabilities	**42,256**	**46,874**	**51,648**	**54,875**

Source: Target consolidated financial statements as at Dec 31st 2007, Devin information memorandum for public offering as at June 30th 2007

Table 11: Devin AD – Cash Flow (Financial Figures with Mezzanine)

Devin AD - Cash Flow				
BGN in thousand	2006 Actual	2007 Projection	2008 Projection	2009 Projection
EBIT	n/a	5,387	6,034	6,758
add back Depreciation	n/a	2,540	2,540	2,540
add back Amortization	n/a	1,845	1,845	1,845
EBITDA	**n/a**	**9,773**	**10,419**	**11,143**
+/- Teade receivables	n/a	(2,332)	(549)	(615)
+/- Inventory	n/a	(3,243)	(605)	(677)
+/- Trade payables	n/a	2,318	802	898
+/- TWC	**n/a**	**(3,257)**	**(352)**	**(394)**
+/- Other assets	n/a	4	(6)	(7)
+/- Other liabilities	n/a	25	14	16
+/- NWC	**n/a**	**(3,227)**	**(344)**	**(386)**
CAPEX	n/a	(2,540)	(2,540)	(2,540)
FCF	**n/a**	**4,005**	**7,535**	**8,218**
Interest	n/a	(1,975)	(1,917)	(1,831)
Debt repayments	n/a	(1,138)	(160)	(2,614)
Tax	n/a	-	-	-
Cash Flow	**n/a**	**893**	**5,459**	**3,773**
Cash OB	n/a	164	1,057	6,516
Cash Flow	n/a	893	5,459	3,773
Cash CB	**164**	**1,057**	**6,516**	**10,289**

Source: Target consolidated financial statements as at Dec 31st 2007, Devin information memorandum for public offering as at June 30th 2007

The financial statements for the purpose of "Scenario 2" – "Mezzanine instrument with embedded warrant" and "Scenario 3" - "Mezzanine instrument with straight equity investment" are identical one another. This is the reason why they have not been presented separately.

8.6. Brief Commentary to the Presented Financial Figures

8.6.1. Effects on the Income Statement

The exit year in the empirical analysis is identical for all three scenarios. During the period 2007 – 2009 the financial figures in the income statements have also remained identical for all scenarios under review up to the level of EBIT. The difference between "Scenario 1" and the other two scenarios originates from the difference in the amount of interest payments that are higher for the scenarios where there is a financial structure with incorporated mezzanine instrument. This is so because of the fact that the company has to pay its interest liabilities not only to senior creditors, but also to the mezzanine provider. Besides, the annual interest rate of the hybrid instrument is relatively higher than that of the traditional bank loans. The higher interest expenses respectively reduce the realised net income throughout the years.

8.6.2. Effects on the Balance Sheet

All positions on the asset side of the balance sheet, except for cash, remain identical for all scenarios under review. The "Cash" position in the scenarios with mezzanine is lower. This result is due to the higher expenses on financing activities in the company's cash flow because of the additional interest obligations assumed to the mezzanine investor. From the point of view of the liability side of the balance sheet, there is a difference in the amount of shareholder equity between "Scenario 1" and the other two scenarios. While in the scenario without mezzanine it amounts to BGN23.479k, in the other two scenarios its amount drops to BGN13.700k as 23 per cent of the equity contribution is replaced by the incorporation of the mezzanine instrument. This circumstance affects the differences in the structure of the "Long-term liabilities" section of the balance sheet. The position "Accumulated profit/loss", calculated using roll forwards[94], which is based on the changed amounts of net income discussed above, is not identical as well.

8.6.3. Effects on the Cash Flow

There are no cash flow figures for the exit year 2006, due to the lack of data for the previous year. The cash flow statement remains identical for all scenarios at the level of FCF. The amount of financing activities, including interest and debt payment, is different for the scenarios without and with mezzanine, as discussed above, due to the differences in interest

[94] The roll forwards are presented in detain in the Appendix 2.

expenses. Debt payments remain identical as during the holding period only the revolving credit facility, the "A" term loan, the finance lease and the loan from related parties are repaid, all of them being debt instruments included in all three scenarios.

8.7. Return Analysis

After my thorough analysis of the selected structure of financing for each one of the scenarios, in this last sub-chapter I will concentrate my attention on the returns they bring to the financial sponsor of risk capital, taking into account the proposed purchase price at exit and the equity contribution at acquisition date. The returns of a private equity fund at a LBO transaction are measured by the following financial indicators:

- *Internal rate of return (IRR)*[95]
- *Money multiple*

For Devin AD's analysis, I assumed that the financial sponsor – Wing Equity would exit in the year 2009 at a multiple of 7.6 x EBITDA, as indicated by Sortis Invest. In 2009 the Target was projected to generate an EBITDA of BGN9.298k, translating into an implied enterprise value of BGN71.000k, or by 67 per cent higher than the entry value of the company under review. The accumulated senior debt repayments for the selected four-year time horizon amounted to BGN3.911k that is the opening balance in 2006 amounting to BGN19.060k less the closing balance in 2009 amounting to BGN15.149k. The table below summarizes my findings based on the empirical analysis.

[95] The historically targeted IRRs by financial sponsors are in the range 25%-40%.

Table 13: Mezzanine Debt with / without Warrant Boosts Equity Return at Exit

Use of mezzanine with / without warrant boosts equity returns at exit

Actual finance structure

	Scenario 1	Scenario 2	Scenario 3
	Financials without mezzanine	Mezzanine with warrant	Mezzanine without warrant
Initial investment:			
Mezzanine debt	-	9,779	9,779
Equity "MMCE"	-	-	1,958
Equity "Wing Equity"	23,479	13,700	11,742
Total investment	**23,479**	**23,479**	**23,479**
Proceeds distribution:			
Senior debt	15,149	15,149	15,149
Mezzanine	-	9,779	9,779
Warrant equity "MMCE"	-	6,584	-
Direct equity investment "MMCE"	-	-	6,584
Equity "Wing Equity"	55,851	39,488	39,488
Total proceeds distribution	**71,000**	**71,000**	**71,000**
EBITDA	9,298	9,298	9,298
Senior debt / EBITDA	1.6	1.6	1.6
Total debt / EBITDA	1.6	2.7	2.7
Wing equity ownership at acquisition date	100%	100%	86%
Wing equty ownership at exit	100%	86%	86%
Equity IRR	24%	30%	35%
Money multiple	2.4	2.9	3.4

Source: Own calculations

The IRR depends primarily on the projected financial performance of the Target, the proposed purchase price and the financial structure selected at the date the company was acquired – particularly the size of the risk capital invested by the financial sponsor. For "Scenario 1", where there is no incorporation of a mezzanine debt, it is the highest – BGN23.479k, for "Scenario 2", where there is a mezzanine with embedded warrant, it amounts to BGN13.700k, and for "Scenario 3", respectively, where the right of warrant for the mezzanine provider is replaced with the right for a direct equity investment of 14.29 per cent, it is the lowest, or BGN11.742k.

In calculating IRR and money multiple, I have assumed that there are no additional cash inflows in the form of dividends distributed to Wing Equity or additional outflows in the form of additional investments made by the financial sponsor during the holding period. Therefore, the calculation of IRR and money multiple is based only on the sponsor's initial equity contribution at the beginning of 2006 and on the assumed equity proceeds at the end of 2009.

The internal rate of return for Devin AD's LBO is calculated using the "IRR" formula in Excel, where the initial equity contribution is shown as a negative value on the timeline, since it represents a cash outflow for the sponsor, whereas the proceeds received at exit are shown as positive values as they are cash inflows for Wing Equity. The money multiple is calculated by dividing the value of equity of the PE fund at the end of 2009 by the value of capital invested by it at the beginning of 2006.

Herein below we will discuss the financial indicators presented above, which measure the profitability for the financial sponsor of risk capital in each one of the three scenarios.

In "Scenario 1", where besides the traditional senior debt the capital structure includes only equity, the profitability in terms of IRR is 24 per cent and the money multiple earned on the investment is 2.4. An IRR below 25 per cent falls outside the interval, which is a target for most providers of risk capital. Therefore, we could conclude that the structure of financing under review is not optimal and it shall be subject to a second review.

In "Scenario 2", the use of a mezzanine debt with warrant increases the profitability up to 30 per cent in terms of IRR and up to 2.9 in terms of cash returns. This is a result of the higher total leverage. While in "Scenario 1" the ratio of total debt to EBITDA is at the level of 1.6, in the case of "Scenario 2" it increases by 65 per cent, reaching the level of 2.7. The reason for that is the introduction of the mezzanine instrument into the Target's capital structure. Moreover, as it is expected that the company will operate well, the mezzanine provider may take advantage from its right to exercise the warrant and thus, to obtain about 14 per cent share in the company, or BGN6.548k. The result would be a decrease in the shareholding of Wing Equity to 86 per cent at the end of the holding period. In this scenario, the IRR is within the desired range of return of PE funds. Therefore, we could conclude that the use of mezzanine increases the return of financial sponsors and the capital structure selected in this case is optimal.

In “Scenario 3”, the mezzanine investor “MMCE” is provided with the right to make a direct equity investment in Devin AD at the time of the acquisition. This reduces the investment, required to be done by Wing Equity at the starting point of the analysis by BGN6.584k. The total leverage, including the mezzanine debt, remains at the same level as that in “Scenario 2” – the “Total debt/EBITDA” ratio amounts to 2.7. The equity IRR in this scenario reaches the record-breaking 35 per cent, and the money multiple grows up to 3.4, which is a result, first of all, of the incorporation of the mezzanine capital and, second of all, of the reduced to a minimum initial investment of the private equity fund. This scenario expresses the most optimal investment strategy since it maximizes the return for the financial sponsor. Moreover, it illustrates the actual financial structure of Devin AD’s LBO deal[96].

All the above show that the risk capital invested by Wing Equity decreases from “Scenario 1” to “Scenario 3”. However, the financial indicators for profitability, IRR and money multiple, go up. In all three scenarios the level of senior debt remains constant. The only thing changed is the proportion among mezzanine debt, equity provided by the PE fund and equity provided by the mezzanine fund. Through the empirical analysis it was proven that the use of a mezzanine debt in the financial structure of a LBO transaction would reduce the need of risk capital by the financial sponsor and at the same time would boost the return on that capital. On the one hand, this is good for the PE fund individual investors as they could hope to receive higher returns on the funds provided by them to the fund. On the other hand, the advantage for the PE fund is that the ability to inject a smaller amount of risk capital in a given investment enables it to invest the remaining capital into other transactions and thus, to diversify its portfolio of investments.

[96] Information provided by Sortis Invest

9. Conclusion

Mezzanine capital combines elements of own and external capital, which makes it an extremely flexible source of financing. In some cases, a mezzanine instrument may be structured in a way guaranteeing the participation of a mezzanine investor in the distribution of any extra profit generated as a result of the increase in enterprise value over time, by converting part of the loan into equity. In other cases, where interest income accumulated during the life of the instrument comes first, the structure of a mezzanine product resembles that of a bank debt. This flexibility, arising out of the hybrid nature of mezzanine capital, enables the development of the most optimal structure of financing of a transaction, which is favourable to both the mezzanine provider and the company seeking sources of financing. In the case of mezzanine investments structured with warrants, the mezzanine investor is interested in entity's successful performance in the future. The option like feature is the one that reduces almost to a minimum the information asymmetry and protects the investor against the possibility that the management team will increase the risk of the company. From the practical point of view, the company attracting mezzanine financing should duly perform its obligations relating to the mezzanine instrument, as thanks to its existence, the return on its own risky capital is improved and thus, new possibilities to make valuable investments occur, which the company would not be able to finance otherwise. From the point of view of senior creditors, the inclusion of a mezzanine instrument into the structure of financing of a transaction improves their position within the hierarchy of security, since in practice the mezzanine capital functions as equity due to its subordinate nature to bank debt. In the cases where the transactions with mezzanine financing involve refinancing and restructuring, senior creditors can even reduce the amount of their credit exposure and thus, to reduce the risk faced by them. In conclusion, we may summarise that mezzanine investors not only act in their own best interest, but to a certain extent also protect the interests of banks and investees, thus improving the effectiveness and contributing to the optimal functioning of capital markets.

If mezzanine financing spreads in Bulgaria, this will complete the palette of financial options available in the country to finance companies with good credit ratings and innovative business ideas, and therefore, it could increase their number in the future. And namely the diversity of options for finding resources is of key importance to the formation of a friendly eco system for the Bulgarian business. At times when it is difficult to find financing and refinancing in

Bulgaria, when the traditional channels for attracting capital or debt financing are very limited and will remain such in the foreseeable future, to provide the Bulgarian capital market with mezzanine instruments, as an alternative financing, could fill in the gap formed throughout the years of a tempestuous financial crisis.

Appendices

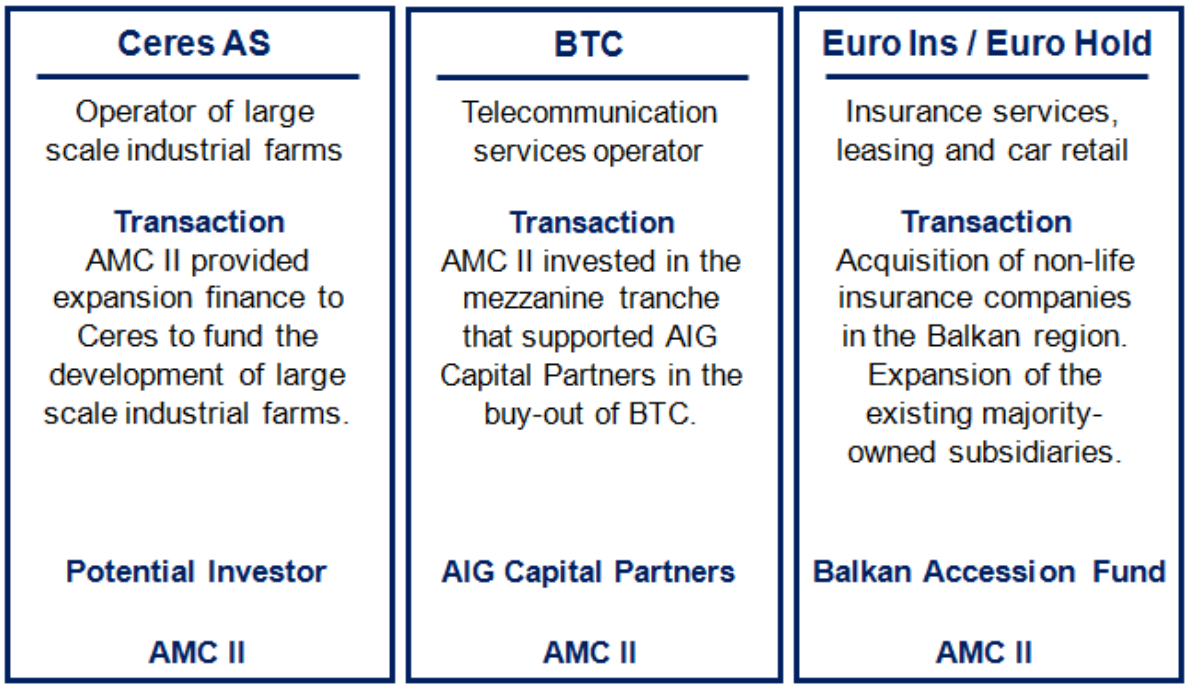
1. Completed Investments in Bulgaria

1.1. Accession Mezzanine Capital I LP (AMC I)

BTC	JET FINANCE	DEVIN AD
Telecommunication services operator **Transaction** Acquisition of a 65% stake in BTC. AMC I acted as arranger and underwriter for the total acquisition mezzanine tranche.	Finance provider **Transaction** AMC I provided expansion finance to fund the increasing Jet Finance loan portfolio.	Largest bottled water company in Bulgaria **Transaction** Buy-out of Devin from private Bulgarian individuals & the Bulgarian American Enterprise Fund. AMC I provided a significant part of the acquisition finance
Advent International **AMC I**	**Balkan Accession Fund** **AMC I**	**Wing Equity (Soravia Group)** **AMC I**

Telelink AD	NOVERA
Provider of telecommunication networks **Transaction** AMC I provided mezzanine capital to finance the company's geographical and product expansion.	Waste collection and street cleaning **Transaction** Institutional Buy-out. AMC I provided a significant part of the acquisition finance
Potential Investor **AMC I**	**Equest Investmnets Balkans Ltd.** **AMC I**

1.2. Accession Mezzanine Capital II LP (AMC II)



2. Roll Forwards

2.1. Financial Figures without Mezzanine

PPE BGN in thousand	2006 Actual	2007 Projection	2008 Projection	2009 Projection
Opening balance	-	15,850	15,850	15,850
CAPEX	-	2,540	2,540	2,540
Depreciation	-	(2,540)	(2,540)	(2,540)
Closing balance	**15,850**	**15,850**	**15,850**	**15,850**

Intanglible assets BGN in thousand	2006 Actual	2007 Projection	2008 Projection	2009 Projection
Opening balance	-	22,144	20,299	18,453
Amortization	-	(1,845)	(1,845)	(1,845)
Closing balance	**22,144**	**20,299**	**18,453**	**16,608**

Accumulated profit/loss BGN in thousand	2006 Actual	2007 Projection	2008 Projection	2009 Projection
Opening balance	-	(4,740)	(545)	4,355
+/- Income/Loss	-	4,195	4,900	5,709
Closing balance	**(4,740)**	**(545)**	**4,355**	**10,064**

Revolving credit facility BGN in thousand	2006 Actual	2007 Projection	2008 Projection	2009 Projection
Average balance	2,454	2,454	2,454	1,227
Interest expense	-	(152)	(152)	(76)

"A" term loan BGN in thousand	2006 Actual	2007 Projection	2008 Projection	2009 Projection
Average balance	822	771	668	565
Interest expense	-	(39)	(34)	(29)

"B" term loan BGN in thousand	2006 Actual	2007 Projection	2008 Projection	2009 Projection
Average balance	2,376	2,376	2,376	2,376
Interest expense	-	(121)	(121)	(121)

"C" term loan BGN in thousand	2006 Actual	2007 Projection	2008 Projection	2009 Projection
Average balance	11,299	11,299	11,299	11,299
Interest expense	-	(749)	(749)	(749)

Mezzanine debt BGN in thousand	2006 Actual	2007 Projection	2008 Projection	2009 Projection
Average balance	-	-	-	-
Interest expense	-	-	-	-

Loan from related parties - Soravia BGN in thousand	2006 Actual	2007 Projection	2008 Projection	2009 Projection
Average balance	978	489	-	-
Interest expense	-	(49)	-	-

Leasing BGN inthousand	2006 Actual	2007 Projection	2008 Projection	2009 Projection
Average balance	1,131	1,103	1,046	990
Interest expense	-	(82)	(78)	(74)

2.1. Financial Figures with Mezzanine

PPE BGN in thousand	2006 Actual	2007 Projection	2008 Projection	2009 Projection
Opening balance	-	15,850	15,850	15,850
CAPEX	-	2,540	2,540	2,540
Depreciation	-	(2,540)	(2,540)	(2,540)
Closing balance	**15,850**	**15,850**	**15,850**	**15,850**

Intanglible assets BGN in thousand	2006 Actual	2007 Projection	2008 Projection	2009 Projection
Opening balance	-	22,144	20,299	18,453
Amortization	-	(1,845)	(1,845)	(1,845)
Closing balance	**22,144**	**20,299**	**18,453**	**16,608**

Accumulated profit/loss BGN in thousand	2006 Actual	2007 Projection	2008 Projection	2009 Projection
Opening balance	-	(4,740)	(1,327)	2,790
+/- Income/Loss	-	3,413	4,117	4,927
Closing balance	**(4,740)**	**(1,327)**	**2,790**	**7,717**

Revolving credit facility BGN in thousand	2006 Actual	2007 Projection	2008 Projection	2009 Projection
Average balance	2,454	2,454	2,454	1,227
Interest expense	-	(152)	(152)	(76)

"A" term loan BGN in thousand	2006 Actual	2007 Projection	2008 Projection	2009 Projection
Average balance	822	771	668	565
Interest expense	-	(39)	(34)	(29)

"B" term loan BGN in thousand	2006 Actual	2007 Projection	2008 Projection	2009 Projection
Average balance	2,376	2,376	2,376	2,376
Interest expense	-	(121)	(121)	(121)

"C" term loan BGN in thousand	2006 Actual	2007 Projection	2008 Projection	2009 Projection
Average balance	11,299	11,299	11,299	11,299
Interest expense	-	(749)	(749)	(749)

Mezzanine debt BGN in thousand	2006 Actual	2007 Projection	2008 Projection	2009 Projection
Average balance	9,779	9,779	9,779	9,779
Interest expense	-	(782)	(782)	(782)

Loan from related parties - Soravia BGN in thousand	2006 Actual	2007 Projection	2008 Projection	2009 Projection
Average balance	978	489	-	-
Interest expense	-	(49)	-	-

Leasing BGN inthousand	2006 Actual	2007 Projection	2008 Projection	2009 Projection
Average balance	1,131	1,103	1,046	990
Interest expense	-	(82)	(78)	(74)

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Interviews:

Mrs. Petya Tsekova, Chief economist: United Bulgarian Bank

Electronic correspondence:

Mr. Dimcho Dimitrov, Associate – Investment Banking: Sortis Invest

Zusammenfassung

Das Mezzanine-Kapital verbindet in sich Elemente des Eigen- und des Fremdkapitals und deshalb ist eine außerordentlich flexible Finanzierungsquelle. In bestimmten Fällen kann ein Mezzanine-Instrument auf eine solche Art und Weise strukturiert werden, die dem Mezzanine-Investor die Beteiligung an der Verteilung des infolge der Erhöhung des Unternehmenswerts im Laufe der Zeit generierten zusätzlichen Gewinns durch die Umwandlung eines Teils des Darlehens in Eigenkapital garantiert. In anderen Fällen, wenn der Zinsertrag während der Lebenszeit des Instruments im Vordergrund steht, ähnelt die Struktur eines Mezzanine-Produkts der Struktur einer Bankschuld. Diese sich aus der Hybridnatur des Mezzanine-Kapitals ergebende Flexibilität erlaubt die Errichtung der möglichst optimalen Finanzierungsstruktur einer Transaktion, die sowohl für den Mezzanine-Anbieter als auch für die eine Finanzierungsquelle suchende Gesellschaft günstig ist. Bei den mit Optionsscheinen strukturierten Mezzanine-Investitionen ist der Mezzanine-Investor an der erfolgreichen Performance der Gesellschaft in Zukunft interessiert. Nämlich die optionsähnliche Charakteristik reduziert fast zum Minimum die Informationsasymmetrie und schützt den Investor vor der Möglichkeit, dass das Managementteam das Risiko der Gesellschaft erhöht. Aus dem praktischen Gesichtspunkt sollte die eine Mezzanine-Finanzierung in Anspruch nehmende Gesellschaft ihre mit dem Mezzanine-Instrument verbundenen Pflichten gewissenhaft erfüllen, weil dank seines Vorhandenseins die erzielte Rentabilität des angelegten eigenen Risikokapitals erhöht wird sowie die Möglichkeiten zur Tätigung wertvoller Investitionen, welche die Gesellschaft sonst nicht finanzieren könnte. Aus dem Gesichtspunkt der bevorzugten Gläubiger verbessert die Verwendung eines Mezzanin-Instruments in der Finanzierungsstruktur einer Transaktion ihre Position in der Sicherungshierarchie, weil das Mezzanin-Kapital infolge seines untergeordneten Charakters gegenüber der Bankschuld praktisch als Eigenkapital funktioniert. In den Fällen, in denen die Transaktionen mit Mezzanin-Finanzierung eine Refinanzierung und eine Umstrukturierung einschließen, haben die bevorzugten Gläubiger sogar die Möglichkeit, die Höhe ihrer Kreditexposition und auf diese Art und Weise auch ihr Risiko zu reduzieren. Abschließend können wir behaupten, dass die Mezzanine-Investoren nicht nur in ihrem eigenen besten Interesse handeln, sondern auch gewissermaßen die Interessen sowohl der Banken als Gläubigerinnen als auch der Investitionsempfänger wahren und so die Effektivität verbessern und zum optimalen Funktionieren der Kapitalmärkte beitragen.

Die Verbreitung der Mezzanin-Finanzierung in Bulgarien wird die Palette der Finanzoptionen im Inland für die Finanzierung von Unternehmen mit guter Bonität und innovativen Geschäftsideen abrunden und könnte zur Erhöhung ihrer Anzahl in Zukunft führen. Nämlich die vielfältigen Möglichkeiten zur Ressourcenbeschaffung sind für die Bildung eines guten Ökosystems für das bulgarische Business entscheidend. Im gegenwärtigen Zeitpunkt, wenn die Bereitstellung von Finanzierung oder Refinanzierung in Bulgarien sehr schwer ist und wenn die traditionellen Kanäle für die Kapitalbeschaffung oder Schuldenfinanzierung stark begrenzt sind und in absehbarer Zukunft so bleiben werden, könnte die Vorstellung der Mezzanine-Instrumente auf dem bulgarischen Kapitalmarkt als eine Finanzierungsalternative den in den Jahren der tobenden Finanzkrise entstandenen Abgrund füllen.

Curriculum Vitae

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WORK EXPERIENCE

PricewaterhouseCoopers Oct 2011 – To date

Consultant, Transaction Services, Advisory

- Prepared well structured and integrated data packs, including B/S and P&L figures as well as other key financials
- Performed in-depth analyses of B/S and P&L, such as Seasonality, Last Twelve Months (LTM), Current Year Trading (CYT) and Net Working Capital analyses
- Assisted in the preparation of quality of earnings and net debt analyses
- Performed an extrapolations of financial data regarding sales, gross margins and EBITDAs based on historical, seasonal business patterns
- Took active role in the preparation of due diligence reports for companies operating in various types of industries

New Stages Ltd. Jun 2011 – Sep 2011

Accountant, Accounting & Controlling Department

- Prepared and analyzed accounting records, financial statements and other key financial reports
- Analyzed business operations and industry trends with the goal to project future revenues and costs
- Reported the findings to the management of the company

Deloitte. Jan 2011 – Apr 2011

Intern, Audit Department

- Designed and performed tests of internal controls concerning clients' accounts payable and receivable, cash and cash equivalents
- Prepared trial balances and audit report lead sheets

- Performed analytical review of audit documents and presented the results to the management of the company

KPMG Jun 2010 – Aug 2010

Intern, Transactions & Restructuring Department (Corporate Finance Group)

- Performed data research, market and business analysis to create internal reports, including sector performance and outlook, company performance and positioning
- Participated in the preparation of a valuation model for a 20% stake in a large shopping centre.
- Performed due diligence for companies from the non-alcoholic beverage industry and the energy sector in Bulgaria to identify potential targets

MKB Unionbank Jul 2009 – Aug 2009

Intern, Large Corporates, Project Financing and Institutions Credit Risk Management Department

- Analyzed the financial results of the Bank's large corporate clients and determined the degree of risk involved in extending credit
- Participated in the evaluation of capital, collateral and liquidity requirements of potential clients and reported the results to the Head of the Bank's Large Corporates Credit Risk Management Department

MKB Bank Jul 2007 – Aug 2008

Accountant, Reporting Department

- Prepared reports concerning the Bank's equity trading turnover and presented the results to the National Bank on a daily, weekly and monthly basis
- Prepared the balance of payment and reported it to the Financial Supervisory Authority on a monthly basis
- Operated SQL and SAS software on a daily basis with the purpose to extract reporting data

EDUCATION

University of Vienna - Faculty of Business, Economics and Statistics Oct 2008 – To date

Master of Science

University of Aarhus - Aarhus School of Business Feb 2010 – Jun 2010

Master of Science

Erasmus Student Exchange Program in Aarhus, Denmark

Budapest Business School –

Faculty of International Management and Business Sep 2004 – Feb 2008

Bachelor of Science in Economics (International Business)

Thesis: Calculating Credit Risk according to Basel II, grade 5.00/5.00

Overall grade: 4.00/5.00

Balassi Bálint Institute Sep 2003 – Jun 2004

Hungarian Language Institute for Foreign Students

Completed the Hungarian language course with excellence and successfully passed the university entry exams

Sofia university of National and World Economy Sep 2002 – Jun 2003

Bachelor of Science in Economics

Completed the 1st year exams with excellence

Awarded by the Bulgarian Ministry of Education and Science with full scholarship for the Bachelor degree studies in Hungary

Bulgarian - Austrian High School in Finance and Business Sep 1997 – Jun 2002

Decree, Republic of Austria, Federal Ministry of Education, Science and Culture

Specialized in Economics, Accounting and Management

Overall grade: 6.00/6.00

SKILLS AND INTERESTS

Languages: Bulgarian (native), English (fluent/B2), German (fluent/C1), Hungarian (fluent/C1)

IT: MS office (advanced), SQL (intermediate), SAS (intermediate)

Interests: piano, skiing, snowboarding, tennis, swimming, aerobics, biking, socializing with my friends