MEZZANINE CAPITAL IN THE FORM OF PARTICIPATING AND SUBORDINATED LOANS AS A SOURCE OF FINANCING METALLURGICAL ENTERPRISES

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Abstract

This article deals with two specific forms of long-term bank loans in the form of mezzanine capital, i.e. participating loans and subordinated loans. Mezzanine capital instruments are hybrid forms of capital, combining the features of debt and equity. These instruments represent an interesting opportunity to finance enterprises operating in capital-intensive industries, such as metallurgy. When making decisions about their incorporation in the corporate capital structure, it is necessary to consider their qualitative and quantitative characteristics. The authors aimed to characterize and evaluate participating loans and subordinated loans, and also to identify, structure and quantify the cost of these forms of private debt mezzanine within the context of classic bank loans in the current conditions of the Czech Republic. The paper characterizes participating loans and subordinated loans and evaluates their pros and cons from the qualitative point of view. The attention is also paid to the quantitative point of view - the cost of the above forms of capital. The paper specifies a detailed structure of the cost items, both as for the acquisition costs and as for the life-cycle costs of participating loans and subordinated loans. Subsequently, individual cost items are quantified from the point of view of the current conditions in the banking practice of the Czech Republic.

Keywords: Metallurgical enterprises, bank loans, mezzanine capital, private debt mezzanine, participating loans, subordinated loans, cost of capital

1. INTRODUCTION

Enterprises can only be successful in the demanding conditions of the present turbulent environment on condition they are adaptable. The necessity of quick adaptation to the changing market conditions places high demands on the company management not only in manufacturing, sales, organizational, and personnel areas, but also in the area of finance. Company management must be able to ensure a sufficient volume of financial sources in the optimal structure. Not only is it necessary to consider the equity to debt ratio or the ratio of short-term sources to long-term sources, but also the cost of acquisition and holding of the given source and a number of additional aspects [1], including the company's position and role in the supply chain [2]. The choice of long-term financing sources appears to be the key factor, particularly within enterprises operating in capital-intensive industries, such as companies dealing with acquisition and processing of metals and their alloys.

An alternative to the classic financing sources that should be taken into consideration by the financial managers of these enterprises when choosing financing sources is represented by the innovated forms of financing. They include mezzanine capital, which represents a hybrid form of long-term financing combining the features of equity and debt; see more in e.g. [3, 4, 5, 6]. Mezzanine financing tools include silent participations, preferred stocks, participating loans, participating bonds, subordinated loans, subordinated bonds, convertible bonds and bonds with warrants [4, 7, 8, 9, 10]. The above list shows that the forms of mezzanine capital include specific forms of bank loans. At the same time, the classic bank loans represent an important source of business financing in the Czech Republic [11]. This fact is based on the European tradition of loan financing [12, 13, 14], but also on the conservative approach of Czech finance managers [15]. However, mezzanine forms of bank loans represent a new form of capital in our conditions, and it is still not very widely spread [8, 16].The authors aimed to characterize and evaluate participating loans and subordinated loans, and also to identify, structure and quantify the cost of these forms of private debt mezzanine within the context of classic bank loans in the current conditions of the Czech Republic. Therefore, this paper should help to spread the knowledge of the qualitative and quantitative aspects of participating and subordinated loans.

This paper is based on combination of two key knowledge areas, the theory and practice of financial management and banking. The starting point was a secondary analysis aiming to process the current knowledge of the solved problems. It was based on research into the domestic and foreign scientific literature. The secondary analysis was followed by a qualitative survey focussed on identification of the structure and volume of the cost items of bank loans in the form of mezzanine in the current conditions of the Czech Republic. The survey was conducted in the form of directed interviews with representatives of selected banking institutions operating in the area of the Czech Republic. The survey involved the banks ranking, according to the methodology of the Czech National Bank, among large banks, i.e. banks with the sum of their balance sheet exceeding CZK250bn [17]. They include: Ceskoslovenska obchodni banka, a.s., Ceska sporitelna, a.s., Komercni banka, a.s. and Unicredit bank, a.s. The directed interviews were conducted from June to September 2014 and were 60 minutes long on average.

2. PARTICIPATING AND SUBORDINATED LOANS

A participating loan represents an analogue of a classic bank loan, but it differs from it in the way of determination of the yield. In this case, the payment to the creditor is not specified on the basis of a fixed or variable interest rate, but it is completely or partly dependent on the economic result of the enterprise as the debtor [18]. Therefore, participating loans, representing, from the point of view of the company's balance, debt, are connected with the characteristics typical for equity, as the return on these instruments depends on the corporate economic result like e.g. dividends [19]. The above combination of debt and equity features is the reason why to classify participating loans as mezzanine capital, specifically private debt mezzanine, where private mezzanine includes instruments that are not publicly tradable on the capital market [7] and debt mezzanine includes mezzanine instruments with a higher debt tendency [20], which belong, from the point of view of the balance sheet, to debt financing sources.

This financing source is, from the corporate point of view, connected with a number of advantages. It can be acquired by enterprises of any size, and also by enterprises that cannot obtain funds through issues of securities, e.g. stocks or bonds. The terms and conditions of its provision and repayment are stipulated on an individual basis, and the control over the company activities is not extended, either. Another advantage can be seen in the fact that in the period when the corporate profits decrease, the payments for provision of this financing source fall, too.

On the other hand, when financing through participating loans, the enterprise has to have a certain portion of equity financing sources available, and it is a limited source of capital compared to an issue of corporate bonds or stocks. Moreover, securing in the form collaterals is required. Another disadvantage is the fact that the enterprise cannot use the tax shield, as the repayments do not represent a tax deductible cost. Moreover, if the enterprise achieves high profits, the cost of holding of the given source increases. It is also a disadvantage that the payments for provision of the loan and the repayments of the nominal value have to be settled in time and properly. Otherwise, the enterprise is in danger of serious sanctions. Another disadvantage can be seen in the fact that the creditors may impose certain limiting conditions on the enterprise in relation to this instrument.

A subordinated loan represents a loan whose grantors are entitled, in the case the enterprise goes bankrupt, to settlement only after settlement of all the liabilities towards the grantors of senior debts and other creditors [21]. The equity capital providers are then paid off after the creditors providing a subordinated loan [22]. At the same time, subordination is a reason for classification of these loans among mezzanine financing instruments, as it is a characteristic typical for equity [23]. Subordinated loans, as well as participating loans, represent private debt mezzanine instruments.

Financing of corporate needs through subordinated loans is also connected with certain advantages. Some of them are identical to those in the case of participating loans. Subordinated loans can also be acquired by enterprises of any size, and also by those who cannot obtain funds through issues of securities. Also in this case, the terms and conditions of provision and repayment are stipulated on an individual basis, and there is no extension of the control over the company activities. Moreover, the paid interests represent a tax deductible cost, and so the enterprise can use the interest tax shield. Another significant advantage is in the fact that incorporation of subordinated loans into the corporate capital structure makes it possible to obtain a senior debt under more favourable conditions.

As for the disadvantages of financing through subordinated loans, a number of them are identical to the above specified disadvantages of participating loans. They refer to the fact that if this financing source is used, the enterprise has to have a certain portion of its own funds available and it is, from the point of view of the volume, a limited source of capital. Also, securing in the form of collaterals is required, and the creditors may impose some other limiting conditions on the enterprise. Also in this case, the interests and repayments of the nominal value have to be settled in time and properly if the enterprise wants to avoid serious sanctions. Moreover, subordinated loans are connected with a higher interest rate, i.e. with higher cost of capital compared to the classic loans.

3. THE COST OF PARTICIPATING AND SUBORDINATED LOANS WINTHIN THE CONTEXT OF THE CLASSIC BANK LOANS

The professional literature does not pay much attention to specification of the costs of specific forms of bank loans in the form of mezzanine capital, such as participating loans and subordinated loans. Therefore, we can only draw on the knowledge of the costs of the classic bank loans. The cost of a classic bank loan mainly consists of the interest the enterprise is obliged to pay its creditors [24, 25]. In addition, they include various fees paid to the bank, relating both to the process of acquisition of the bank loan, and to its drawing and repayment [15, 26, 27]. This means that the costs of bank loans, no matter whether in the classic or mezzanine forms, can be divided, in our opinion, into two basic groups: the loan acquisition costs and the loan life cycle costs. The loan life cycle costs can then be further divided into the loan interest and other life cycle costs.

The loan acquisition costs consist, according to Simana and Petera [27], of a one-time fee for evaluation of the application for a loan and processing of a loan agreement, so-called fee for loan application acceptance and assessment. According to Reznakova [26], there are also fees relating to securing of a loan. The conducted research into the current banking practice in the Czech Republic implies that these costs also include, apart from the above fees, a fee for granting of a loan.

As for the interest, it represents a significant cost item. Its rate is affected by a number of factors, especially by the volume of the loan, the loan maturity, and the way of loan servicing or the debtor's creditworthiness; see more e.g. in [28, 29, 30]. As for participating loans, it is also necessary to take account of the fact that the interests on these loans are increased by or directly related to participation in profits. As for subordinated loans, in most cases a higher interest rate, compared to the classic bank loans, is required for the reason of subordination of this liability.

The other loan life cycle costs are given by the fees relating to loan implementation. Reznakova [26] includes in them loan account administration fees, Simana and Petera [27] a loan administration fee and a commitment commission. The performed survey implies that the other loan life cycle costs incurred in the current banking practice include, apart from a loan administration fee and a commitment commission, a fee for transactions in the loan account and a fee for sending an account statement. They might also include a fee for an extraordinary repayment, a fee for a change in the contractual conditions required by the client, a fee for a takeover of the debt by another client, or a fee for an outstanding amount reminder.

The volume of cost items relating to bank loans in the form of mezzanine capital is determined by the amounts of cost items relating to the classic bank loans, and also with respect to the fact that mezzanine financing instruments are not in the portfolios of products standardly offered by banks in the Czech Republic.

As for the loan acquisition costs, representatives of all the monitored banks agreed on an individual approach when determining their structure and rates. Nevertheless, the respondents from Ceskoslovenska obchodni banka, a.s., Ceska sporitelna, a.s. and Komercni banka, a.s. provided information about the general rates of such fees; see more in **Table 1**.

Table 1 Acquisition costs relating to loans granted to businesses by selected banks in the Czech Republic

Type of fee	Ceskoslovenska obchodni banka	Ceska sporitelna	Komercni banka
Fee for loan application acceptance and assessment	0.3% of loan amount (at least CZK2000)	individually (at least CZK5000)	individually
Fee for assessment of risks connected with real estate collateral	0.03 - 02% of analyzed collateral value (at least CZK2000)	individually	individually
Fee for granting of a loan	0.5% of loan amount (at least CZK5000)	no fee	CZK1000 + 0.6% of loan amount

As for loan interest rates, the representatives of Ceskoslovenska obchodni banka, a.s. and Unicredit bank, a.s. stated that they do not have any predetermined interest rates (or their range), but that they take account of a number of criteria with each applicant. Apart from the loan amount and the loan maturity, the interest rate is affected by the applicant's creditworthiness, the value of the collateral, the applicant's position on the market, the purpose of the bank loan, or the willingness to transfer the system of payment and other banking services to the given banking institution. However, they consider the information about already granted loan interest rates as a trade secret, which is why they could not provide such information. The above statement was identical to the outcomes of the directed interview with a representative of Ceska sporitelna, a.s. who also added that Ceska sporitelna, a.s. is now ready to offer businesses operating in the area of the Czech Republic classical loans with an interest rate starting as low as the value of PRIBOR increased by about 1.4% p.a. However, Ceska sporitelna, a.s. only grants this bank loan interest rate in the case of creditworthy enterprises with collateral of a high value, who are already clients of Ceska sporitelna, a.s. or who are willing to transfer all their systems of payment to this bank, or meet some other conditions. A directed interview conducted with a representative of Komercni banka, a.s. implied the same conclusion as it was with the above banks. This financial institution also determines loan interest rates on the basis of individual assessment of a particular enterprise, and their publishing is subject to trade secret protection.

As for the other loan life cycle costs, all the bank representatives agreed on an individual approach when determining the structure and rates of their fees. Nevertheless, also in this case the respondents of Ceskoslovenska obchodni banka, a.s., Ceska sporitelna, a.s. and Komercni banka, a.s. provided information about the general rates of such fees; see more in **Table 2**.

Table 2 Other loan life cycle costs relating to loans granted to businesses by selected banks in the Czech Republic

Type of fee	Ceskoslovenska obchodni banka	Ceska sporitelna	Komercni banka
Loan administration fee	CZK500/month	CZK300/month	CZK600/month
Commitment commission	0.1 - 3.5% of undrawn loan	0.5 - 1% of undrawn loan	individually
Fee for transactions in the loan account	no fee	CZK10	no fee
Fee for sending an account statement	CZK17/statement	CZK17/statement	CZK20/statement
Fee for an extraordinary repayment	0.3% of loan repayment (at least CZK5000)	individually	individually
Fee for a change in the contractual conditions required by the client	0.3% of current balance (at least CZK5000)	0.3% of current balance (at least CZK2500)	individually
Fee for a takeover of the debt by another client	individually	0.5% of unpaid balance	individually
Fee for an outstanding amount reminder	first CZK300, each next CZK500	CZK500	first CZK100, each next CZK500

4. CONCLUSION

Participating loans and subordinated loans represent specific forms of bank loans having the features of debt and equity. For this reason, we classify them as mezzanine financing instruments. They are innovated financing instruments enjoying, in the conditions of the Czech Republic, a marginal interest of corporate finance managers even though they could represent an interesting opportunity for enterprises in capital-intensive industries, such as metallurgy.

Just as in the case of the classic financing sources, also in the case of mezzanine financing sources managers have to consider, when making decisions about their incorporation into the corporate capital structure, a number of qualitative and quantitative criteria. The qualitative criteria include characteristics of individual financial instruments determining advantages, disadvantages, and risks connected with the respective source of finance, which are described and evaluated in the paper from the point of view of participating and subordinated loans.

An important role is also played by quantitative criteria. It is, above all, the rate of costs of individual financing sources. As for participating loans and subordinated loans, such costs include loan acquisition costs, interest payments, and other loan life cycle costs, which are structured in the paper in detail, and their structure is identical to the structure of the cost items of the classic bank loans. As for their current rates in the conditions of the Czech Republic, they are derived from the rates of costs of the classic bank loans (in the case of loan acquisition costs and other loan life cycle costs they are analogous, while in the case of interest payments they differ with respect to the above defined specifics of participating loans and subordinated loans), and their specific rate is always determined on the basis of individual assessment of each loan.

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