




Mezzanine Financing as a Source of Financing for Business Activities in Russia in a Crisis

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Abstract: The article considers mezzanine financing as a source of financing for the growth and development of Russian companies. This financial instrument is quite widespread in the market economy of foreign countries. In Russia mezzanine financing has been introduced relatively recently. However, this tool has a great potential for development. It is due to the fact that in the conditions of an unstable economic situation caused by various reasons, including the coronavirus crisis, it becomes difficult for medium-sized businesses to apply traditional external sources of financing, such as bank loans, project and venture financing. In this situation companies can use mezzanine capital, which is a hybrid financial instrument that combines elements of equity and debt capital. Special attention is paid to the characteristics of the debt and equity parts of the mezzanine financing transaction. Conclusions are drawn about the industry availability of mezzanine financing for medium-sized businesses in Russia. The minimum threshold level of return on sales for such businesses has been calculated in order to qualify for mezzanine financing from a large Russian mezzanine investor – Sberbank


1 INTRODUCTION


A lot of Russian companies have financial needs significantly exceeding the volume of available domestic financial sources. Therefore, their development is impossible without raising external funding. Raising debt financing makes it possible to increase the volume of company's financial resources and invest in fixed and working capital.

Russian scholars pay attention to the study of traditional external sources used by organizations to finance their activities and development. O. M. Turygin considers the possibility of using borrowed capital to increase the financial resources of Russian companies, determining the potential for increasing borrowed sources of financing based on the interest coverage ratio (Turygin, 2020). S. Fungachova and L. Solanko study the role of a commercial bank as a financial intermediary that provides credit to various business entities, assessing the cost and efficiency of these services (Fungachova and Solanko, 2010). At the same time, the researchers emphasize that a small

part of investments in fixed assets comes via bank loans. Theoretical foundations and analysis of the venture capital investment market in Russia were studied by V. P. Postnikov and K. A. Trubnikov (Postnikov and Trubnikov, 2020). A. G. Filippov and E. V. Gruzdeva, developing the ideas of venture financing, examine the sources of venture investment, analyze the features of Russian and American models and organizational forms of venture financing, explore investment exit strategies, identify the problems of using venture capital in Russia and ways to overcome them (Filippov and Gruzdeva, 2019). O. V. Motovilov considers the possibility of creating a corporate venture fund, venture investment aims, options for functioning of venture divisions in domestic companies (Motovilov, 2016). The problems of development and use of project financing, its prospects and features are revealed in a joint study by I. I. Marushchak, N. N. Matnenko and T. S. Salnikova (Marushchak, Matnenko and Salnikova, 2017). I. V. Shenaev examines the role of banks in project financing organization, the

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mechanism of interaction between the borrower company and the bank, as well as the types and risks of project financing (Shenaev, 2006). However, in foreign practice, a hybrid form of financing companies' activities – mezzanine financing – is becoming increasingly widespread.

This form of financing is investigated by various foreign researchers. Arthur D. Robinson, Igor Fert, Mark A. Brod, using conceptual approach, revealed the conditions and products of mezzanine investment, as well as the documentary and informational support of mezzanine financing of US corporations (Robinson, Fert and Brod, 2011). Analysis of using mezzanine capital in Europe is presented by Jennifer Bollen (Bollen, 2015). L. G. Vasilescu considered the features and advantages of mezzanine as a tool for launching and expanding the activities of small and medium-sized businesses from the point of view of investors and borrowers and also identified the main problems of its use in the European financial market (Vasilescu, 2010).

In our country, research into mezzanine capital is just beginning, although there is already a number of publications. The study of the conceptual approaches of Russian and foreign reserachers of the concept of "mezzanine financing", the characteristics and features of the use of its various tools is presented in the work by E. A. Tarkhanova and K. A. Cheredov (Tarkhanova and Cheredov, 2019). Yu. S. Ovanesova examines the features of uing mezzanine capital in the United States, European countries and Russia, revealing the reasons for its appearance and the purpose of application (Ovanesova, 2015). E. M. Petrikova explores the possibilities of using mezzanine capital in the Russian financial market, highlighting the role of commercial banks in mezzanine financing (Petrikova, 2013).

Despite the attention paid to the problems of mezzanine financing in the works of modern Russian researchers, the possibilities and features of using this financial instrument by Russian companies require constant analysis due to their continuous development, which determines the relevance of this work.

2 RESULTS AND DISCUSSION

Trends in financial systems development indicate an increase in interest in mezzanine finance during periods of economic crises and restrictions. This method of financing allows to cover the need for investment projects sources for companies with low capitalization.

Despite the fact that in developed countries mezzanine lending has existed since the 1980s and is used by large, medium-sized and small businesses, a limited number of businesses have access to it in Russia.

Being a hybrid form, mezzanine financing combines the features of both debt and equity financing. Mezzanine financing is a type of financing that makes it possible to convert a company's debt into a share in its capital when certain events occur. There is always a debt part in mezzanine financing which is represented by a loan (with or without collateral), as well as a subordinated loan. When dealing with the debt part, the investor provides more flexible terms of repayment and payment of interest compared to other sources and does not require unconditional collateral.

The equity part of the mezzanine financing is based on financial instruments that will provide their owners the right to purchase the company shares at certain price when certain conditions occur. The instruments of the equity part of the mezzanine are usually options, warrants, agreements on the right to demand joining the sale (drag-along right), agreements on the right to join the sale (tag-along right), as well as preferred shares. The equity part of a mezzanine may not be realized. The investor is ready to apply the equity part of the mezzanine only if the borrower company brings higher profit than the loan interest in the future.

The composition of the debt and equity parts of mezzanine financing transactions determines their main characteristics, summarized in table 1.

Table 1: Main characteristics of mezzanine financing

Mezzanine financing	
Debt part	Equity part
payment of current and capitalized profitability; urgency repayment of financing collateral behavioural and financial covenants	additional profit (equity kicker) is not guaranteed and depends on: <ul style="list-style-type: none"> ▪ business value growth; ▪ operational and financial indicators; possibility of conversion to equity (ordinary shares); the right to manage the company a limited set of corporate decisions requiring investor's approval; English contract law

Such parameters of mezzanine financing transactions imply the higher risk level for the investor than that of debt financing. Nevertheless the amount of this risk is lower than that of direct

investment. This forms the scope of the investor's expectations on such investment profit up to 25% per annum, which is higher than that of traditional financing, but lower than that of direct investment (Figure 1).

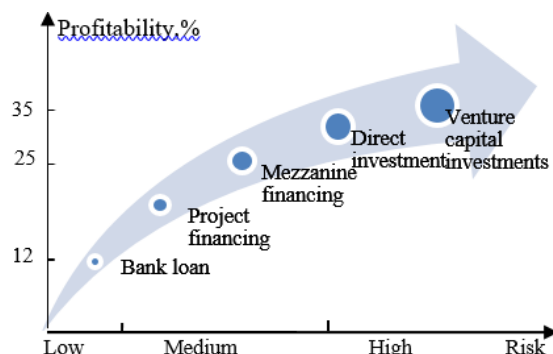


Figure 1: Relation between different sources of financing depending on the level of risk

The level of risk of mezzanine financing transactions is determined by the aims of the investment project, the project budget and the availability of its own sources of financing.

The main aims of the companies' investment projects within mezzanine financing are structured in Figure 2.

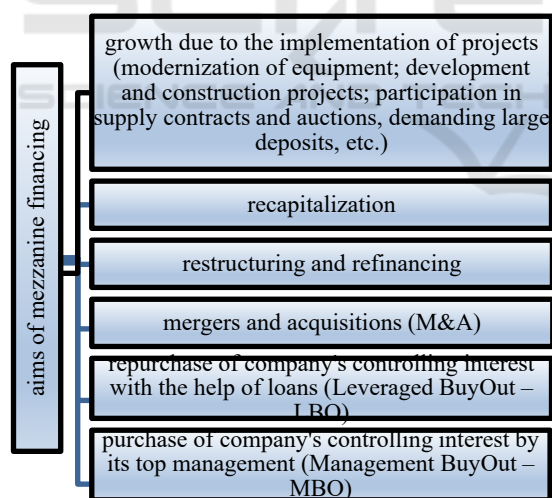


Figure 2: Aims of mezzanine financing.

The mass demand for mezzanine financing is determined by the first three goals, which are of interest to almost all companies at any stage of their life cycle. A wide range of mezzanine products can be developed for such purposes, including products with unified parameters. M&A transactions and purchase of controlling interest are single cases, so

mezzanine products parameters are individual and non-public.

The experience of mezzanine financing transactions shows that it is applicable for projects with any share of equity. However, based on the risk-return ratio, the investor is ready to finance projects with at least 20-30% of the budget accounted for by equity.

Mezzanine financing is provided to companies that generate positive cash flow during the entire period of the mezzanine transaction. The main criteria for selecting investment projects are the scale of the business (large or medium-sized companies); the presence of a formulated development strategy; growth prospects and high operational efficiency.

In the world practice large banks, hedge funds and private equity funds act as mezzanine investors. In Russia, the main institutional mezzanine investors are systemically significant banks: Sberbank, VTB, Otkrytie Bank, Credit Bank of Moscow, and Alfa-Bank. Moreover, transactions are conducted through banking groups subsidiaries since the properties of mezzanine financing instruments meet the capital requirements of Basel II Capital Accord, but do not meet the criteria for the first level of capital of Basel III. The promotion of development institutions by the state brings new players into the mezzanine market in the form of venture funds (Skolkovo Ventures, a Russian venture company), state corporations (VEB.RF) and private equity funds.

It should be noted that there is no reliable statistics on the volumes and parameters of mezzanine transactions in the Russian economy. The available information is presented in experts' analytical reviews, surveys of financial market participants and press releases of participants in mezzanine transactions.

Due to the decline in the profitability of project financing transactions and the scarce M&A transactions, the interest of Russian mezzanine investors in financing medium-sized business projects, involving investing in real investments as well as business growth/development, is currently growing.

Sberbank, which takes a significant share of the mezzanine lending market and offers a wide range of mezzanine products, works not only with large, but also medium-sized businesses that generate revenue growth (more than 10% per year over the past 3 years) and EBITDA margin (more than 20%).

The slowdown in the growth of national economies due to the COVID-19 pandemic will inevitably lead to relaxation of the quantitative criteria for selecting companies with real investments

projects to provide mezzanine financing. Sberbank mezzanine products already provide access to financing for various medium-sized companies that have an EBITDA margin of less than 20%.

Sberbank product range includes 2 products that finance business development: Pay Once (classic mezzanine) and Equity Participation (with mezzanine elements) (Table 2).

Table 2: Sberbank mezzanine products available to medium-sized businesses.

	Equity participation in equity	Pay Once
Goal	Financing of business development with a commitment on the part of the Client to conduct a liquidity event within the agreed period	Business development financing
Volume	Up to 500 million rubles	Up to 500 million rubles
Period	Up to 7 years old	Up to 5 years old
Size	Up to 50% of the share capital	Up to 70% of the project cost (including senior debt)
Payment of interest	Missing, dividends paid	At the end of the term. No payment of interest and the body of debt during the term of the transaction
Tool	Separate class of shares with reserved matters	Loan and conclusion of an additional yield agreement (warrant) Preferred or ordinary shares with a put option
Support	Prohibition on alienation of assets (negative pledge) Pre-emptive right to return the investment in the event of a liquidity preference event)	Pledge of shares Secondary collateral of assets Sureties of operating companies
Metrics	Operating Debt / EBITDA < 3.5 x LTV < 90%	Debt / EBITDA < 4.0 (end-to-end) LTV/LTC < 70% over the entire term of the transaction
Exit mechanism	Liquidity Event Call option Right to demand a sale (drag along)	Repayment at the expense of funds from the sale of the company, its part (IPO) or individual assets Repayment due to accumulated flows from the project Refinancing with senior debt

The minimum volume of mezzanine financing transactions implemented by Sberbank is 250 million rubles. To meet the requirements of the mezzanine products, the project initiator company, based on the "Operating Debt/EBITDA" metric, must generate an operating profit of at least 125 million rubles for the Pay Once product, and from 72 to 142 million rubles for the Equity participation product.

In the course of the study a list of industries, where functioning medium-sized enterprises can apply for mezzanine financing, has been devised (Table 3).

Table 3: Industry availability of mezzanine financing for medium-sized businesses.

Type of activity	Return on sales, %*	Profit, billion rubles		
		revenue 2 billion rubles	revenue 1,5 billion rubles	revenue 1 billion rubles
metallurgical production	25,2	402,6	301,9	201,3
activities related to real estate transactions	24,3	391,0	293,2	195,5
manufacture of chemicals and chemical products	21,6	355,3	266,4	177,6
clothing manufacturing	16,3	280,3	210,2	140,2
production of computers, electronic and optical products	13,5	237,9	178,4	118,9
information and communication activities	12,8	227,0	170,2	113,5
manufacturing industries	12,2	217,5	163,1	108,7
manufacture of textile products	11,8	211,1	158,3	105,5
construction	8,1	149,9	112,4	74,9

*Source: Order of the Federal Tax Service of Russia of 30.05.2007 No. MM-3-06/333@ "On Approval of the Concept of the System for planning on-site tax audits" – Appendix No. 4.

The study includes the types of economic activities of the real sector of the economy. At the same time, raw materials industries are excluded since they are traditionally dominated by big business. The calculations use the industry average return on sales by type of activity in 2020, calculated as the ratio of profit from sales to cost of sales. The sample of Russian companies by type of economic activity was compiled according to Rosstat data. The average industry value of return on sales in 2020 in all types of economic activity is 9.9%. The maximum

value of the revenue indicator of 2 billion rubles is determined by the norms of the federal law "On the Development of Small and Medium-sized Businesses in the Russian Federation" of 24.07.2007, No. 209-FZ.

The results of the study indicate that companies that have return on sales above the industry average have the ability to generate revenue, ensuring compliance with the required level of EBITDA marginality for mezzanine products for business development. The data presented in Table 3 shows that medium-sized companies having revenue of 1 billion rubles with return on sales at 14.3%, can receive mezzanine financing for the Pay Once product for the implementation of their investment projects. Medium-sized companies that generate revenue close to the limit of 2 billion rubles have this opportunity with a return on sales of more than 7%.

3 CONCLUSIONS

The ability of medium-sized business initiators, which form the basis of the Russian economy, to generate income allows investors to develop mezzanine financing products, creating their unified versions, even in the conditions of the financial crisis, the EEC countries and the USA sanctions policy, and the ongoing pandemic caused by COVID-19.

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