Here we go again

Mezzanine financing makes a comeback

By Dr. Nina-Luisa Siedler

Mezzanine financing acquired a bad rap during the financial crisis. This was primarily because standardized mezzanine programs (also called standard mezzanine) bundled participation rights in securitization vehicles. When offering such mezzanine financing, particularly in the latter years of the crisis, the necessary care was not always taken. As a result, a number of investors incurred significant losses.

Mezzanine financing is now making a comeback and is again being offered by investors in various forms. The variety of forms mezzanine finance can take often masks what exactly this type of financing involves. The instruments that are typically offered as mezzanine capital—subordinated loans, silent participations and profit participation rights—are subject to rudimentary regulation at best. The contractual freedom that prevails in Germany allows for an almost unlimited range of structures. It is therefore worth reading through the fine print to find out exactly what type of capital is involved in each individual case.

Both debt and equity

The defining characteristic of any mezzanine financing is that it has features of both debt and equity—depending on the viewpoint. The distinction between equity and debt is important, particularly from the accounting and the taxation perspective. It is also significant in terms of ratings (external ratings by rating agencies and internal...
ratings by banks). In each of these cases, mezzanine capital can only constitute either equity or debt. At the same time, mezzanine capital may be classified as equity from one perspective and as debt from another. And that is exactly what mezzanine financing aims to do: From an accounting perspective and for rating purposes, it must create equity in order to strengthen the capital ratio, an important financial indicator. From a tax perspective, however, it creates debt so interest payments can be deducted since the costs of equity do not enjoy such tax treatment. But only a few of the instruments offered under the heading of mezzanine financing achieve these aims.

**Reported equity**

Ideally, mezzanine financing is reported as equity on the balance sheet. Under the accounting regulations of the German Commercial Code (Handelsgesetzbuch, or HGB), financing instruments based on company law must initially be classified as equity. This pertains in particular to capital contributions by shareholders, including, where applicable, those in reserves. If there is no such company-law basis, a purely contractually based financing instrument will only qualify as equity under specific conditions as outlined below. The situation is similar though not identical under the International Financial Reporting Standards (IFRS).

Firstly, to be reported as equity, the capital provided must be subordinate to other liabilities as regards repayment. This comes as no surprise. An intrinsic feature of mezzanine capital is that it is subordinate to senior financing (typically the traditional bank loan). In this regard, IFRS is stricter than the HGB and even requires the financing to be placed on the level of the most subordinate class of investors, that is, equal to shareholders.

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Another requirement of reported equity is that the interest owed for such financing must be linked to performance. IFRS seems to be somewhat more generous on this point and only requires the returns to be primarily linked to earnings. However, fixed interest is prohibited under both accounting systems. A typical simple subordinated loan is thus excluded from being an equity capital instrument.

Under the HGB, participation in losses up to the full amount is also a prerequisite for classification as equity. IFRS refers here to a pro-rata right to liquidation proceeds—along with all those in the most subordinate class, that is, shareholders. This criterion disallows both the subordinated loan and the typical silent partnership, in both of which, as a rule, there is no participation in losses.

Finally, under the HGB, reported equity must be provided on a longer term basis. A five-year term together with a two-year termination notice should suffice. Short-term bridging finance is therefore not sufficient.

Accordingly, this essentially means that only atypical silent partnerships (which differ from typical silent partnerships primarily a result of the loss-participation feature) and equity-like participation rights have the potential to be recognized in the balance sheet as equity capital instruments. Instruments that do not fulfill all of the above criteria must be reported as debt on the balance sheet.

**Borrowed capital for tax purposes**

In addition to the aim of creating equity on the balance sheet, mezzanine financing should, from a taxation perspective, create borrowed capital so interest payments can be reported as a tax-deductible expense. Such funds must not be assessed as (non-tax-deductible) dividends. Dividends represent revenue from shares in companies and in participation rights that involve the investor in both the profit and the liquidation proceeds of the issuer. The same applies to revenue from financial instruments equivalent to equity participation rights. These include instruments for which a profit-related interest is payable and for which repayment may be claimed only upon liquidation of the debtor or in the distant future (after at least 30 years). All other payments on funds that do not meet these criteria essentially qualify as interest.

This clearly shows that “genuine” mezzanine instruments that create equity on the balance sheet but are regarded as borrowed capital for tax purposes are rare. These include equity participation rights that involve investors in the profits and losses but not in liquidation proceeds. Appropriately designed subordinated loans with profit participation may be included. The same applies to atypical silent partnerships. But, unlike common practice, they must be designed in such a way as not to create a commercial partnership for tax purposes.
Bank view

There are, however, hardly any providers that offer these types of instruments. For most investors, the risk is too high due to the obligatory participation in losses. It is therefore easier to find structures involving simple subordinated loans or typical silent partnerships without loss-sharing. In this regard, it is worth talking to the financing banks: Even if such instruments do not provide equity on the balance sheet, internal bank rating systems may allow them to qualify as equity. It is often the financing banks’ minimum capital ratio requirements that prompt a company to look into mezzanine financing.

The strict accounting view is not critical in such cases. The balance sheet and the balance sheet ratios derived therefrom only form the basis of the rating. In the course of their rating process, the banks make adjustments that better illustrate the economic reality. These include evaluating what—in strict accounting terms—constitutes loan instruments, such as equity capital. The requirements in this respect are not uniform. Often subordination suffices although the “depth” requirements of subordination essential for the mezzanine investor may vary. Sometimes subordination behind bank loans is enough, which nevertheless allows the mezzanine capital to rank above genuine equity and, if the bank is secured, puts the mezzanine investor on the same level as other unsecured creditors. Sometimes qualified subordination is required (down to the shareholder level). The requirements of the relevant bank should therefore be explored in detail.

Structural subordination

Finally, there is also the possibility of mezzanine financing at the shareholder level of an operating company. In this regard, the mezzanine investor provides a loan to the shareholder as the holding company of the operating company, and the holding company channels funds to the operating company. This may take place either (a) by way of a contribution to the capital reserves, whereby fresh equity is created, from all perspectives, at the operational level, or (b) the funds are provided as a (subordinated) shareholder loan. Such subordinated shareholder loans are also recognized by many banks as (economic) equity.

In this structure the mezzanine investor has no direct access to the assets of the operating company. The investor only participates in the profits of the operating company via dividend payments or payments on the subordinated shareholder loan made to the holding company it is financing. A formal subordination agreement is not necessary. Subordination simply arises from the structure. This arrangement is also known as structural subordination.

The appeal of this structure is that it is so straightforward. The investor provides a standard loan (without subordination, loss participation or the like) to the holding company. At the level of the operating unit, competition between the various investors is avoided. There is no inter-creditor agreement, which would normally be necessary to regulate the relationship between the senior lender and the mezzanine provider should both provide financing directly at the operational level. The mezzanine investor may be given securities such as share pledges over the shares in the holding company and, where possible, over the shares in the operating company without such security being prevented from foreclosure by subordinating the mezzanine investment.

In economic terms, such a loan is still a mezzanine investment with the corresponding risk position between borrowed and equity capital. The risk is reflected—as with any mezzanine financing—in the cost of financing. <–