

Marek Dylewski

WSB School of Banking in Poznań

e-mail: marek.dylewski@wsb.poznan.pl

MEZZANINE CAPITAL AS A STIMULANT FOR SUSTAINABLE REGIONAL GROWTH

Summary: The issue of financing regional growth is of paramount importance as it pertains to both a region as a whole and to business entities that make up this region. The currently commencing new perspective of EU programming draws up new goals, introduces new logic in terms of intervention objectives and the ways of their financing. The purpose of this paper is to present the guidelines of the new logic of financing in the programming period in the years 2014–2020 together with the significance of mezzanine financing in creating sustainable regional and corporate development. The article presents an approach to sustainable development in the new logic of funding and mezzanine capital in the financing of environmental protection. It also discusses the idea of funding by Polish Investments for Development as a new partner in the financing of investment in regions.

Keywords: local development, the new programming period, the financing of development, mezzanine capital.

DOI: 10.15611/br.2014.1.02

1. Introduction

The issue of financing regional growth is of paramount importance as it pertains to both a region as a whole and to business entities that make up this region. After the period of financial crisis, one cannot underestimate the stability of capital injections and cannot disregard the factor determining competitiveness – that is sustainable growth. Providing access to capital in regions, which will stimulate their development, becomes a challenge.

The currently commencing new perspective of EU programming draws up new goals, introduces new logic in terms of intervention objectives and the ways of their financing. However, it simultaneously changes the approach towards financial engineering. The changes which are brought about by the new period in EU

programming constitute an opportunity for both regions and, above all, enterprises to develop.

The purpose of this paper is to present the guidelines of the new logic of financing in the programming period in the years 2014–2020 together with the significance of mezzanine financing in creating sustainable regional and corporate development.

2. Sustainable growth versus new financing logic

For years now people have been calling upon the respect for resources and for finding the ways of satisfying the needs of the current generation without diminishing the opportunities for the future generations to satisfy their needs as well. Despite the fact that the concept of sustainable growth has developed and evolved, it is still relevant. In the new period of EU financing the emphasis is still put onto sustainable growth. What has changed, however, is the logic of intervention and its financing. The emphasis is put especially onto achieving goals together with a different approach toward financing, instrument construction and using financial instruments in achieving particular development goals.

The new EU intervention system works on the assumption of smart specialization. This assumption stems from the necessity to use resources in an optimal way (sustainable growth) and it also stems from the criticism of using selective support in the previous programming periods [Ministerstwo Gospodarki 2014a]. It has been indicated not only in the government documents but also in the EU documents that strong subject concentration of specialization support which is constituted by competitive advantages in countries and regions will enhance sustainable growth based on efficiency of undertaken actions and notable social and economical effects. Moreover, emphasizing the support for national and regional specializations should result in greater concentration and more efficient use of the EU funds. It should also enhance coordination and synergy between initiatives undertaken at the EU, national or regional levels. According to article 16 of Chapter III of European Commission Announcement III COM (2012) 615: “Member States shall concentrate support, in accordance with the Fund-specific rules, on actions bringing the greatest added value in relation to the Union strategy for smart, sustainable and inclusive growth, addressing the challenges identified in the country-specific recommendations under Article 121(2) of the Treaty and the relevant Council recommendations adopted under 148(4) of the Treaty, and taking into account national and regional needs” [Komunikat KE COM (2012) 615, p. 43]. Ensuring stable and balanced regional development by means of the intervention which is designed for particular enterprises that will give maximum effects not just realization of fragmentary goals (which was the drawback of previous intervention in regions in the former programming periods) is among the prerequisites of the new intervention.

A totally new approach towards financing the intervention was proposed and it is going to be based on moving away from the common instrument of subvention. Subventions will be given mostly to projects burdened with high risk, those connected with the realization of particular goals and enterprises which will enhance smart and sustainable growth. This system of non-returnable funding will be also used to support the purchase of technologies burdened with high technological risk, such as those purchased only as know-how in case of the very first implementation on a world scale. The intervention connected with the use of particular types of returnable financial instruments is also going to change. These instruments will be mainly used to purchase new technologies, machinery and equipment (business risk connected with the implementation). It is mezzanine financing, the use of guarantee funds, initiating capital such as private equity (PE) and venture capital (VC) that gains in importance [Ministerstwo Gospodarki 2014b, pp. 32–33, 46–49]. This new approach intends to stimulate the development of private financing sources of high risk projects.

Institutions engaged in designing, implementing and monitoring of the support system should aspire to a situation in which a higher number of risky ventures could be financed. In Poland companies should still be able to use the state assistance in risky, in terms of the market, stages of an investment process (including technological innovations supporting the environment and development). This support should help companies in swifter social and economic development, which, in turn, will give equal opportunities for underdeveloped regions (which is the prerequisite of the current doctrine of sustainable growth) [Ministerstwo Gospodarki 2014b, p. 24].

Providing financial support from the EU funds needs to be accompanied by entrepreneur's own resources (that is the continuation of previously adopted policy in former periods of EU programming). Due to the necessity of providing proper planning and proper spending of resources by an entrepreneur, public support will have the character of external funding.

The major drawback of the system in the years 2007–2013 was the lack of unambiguous criteria of innovative projects assessment. The crucial flaw of the former period was the demand character of EU resources absorption, usually short-term, intended to solve current problems. That is why both the procedures and the criteria did not fully reflect the needs of creating new values which were assumed in the programming period [Hausner (ed.) 2013, p. 132].

The adopted guidelines of drawing up and implementing the criteria of project assessment should be welcomed as they enable the complex assessment of the projects. Companies, especially small and medium-sized enterprises, used to have problems finding investors, as without the complex approach towards projects, including the assessment of the engagement, the experience and the capabilities of the people running a company, they could not count on acquiring resources. The new logic of intervention is aimed not only at eliminating the above-mentioned system

drawbacks, but also it sets new guidelines and principles. It calls for balancing costs and benefits stemming from the degree of the complexity of the assessment system and from the system of monitoring projects. And above all, it stresses that the system should be simplified, the procedures should be much shorter and entrepreneur-friendly, especially in the case of small and medium-sized enterprises.

In this new logic of intervention the emphasis is put onto the effectiveness of providing financial support. It should be monitored, and conclusions should be used in making decisions regarding economic policy and financial instruments themselves. In the former programming period multiple measurement problems, the inadequacy of measuring instruments to programs under realization, or flaws in construction of measuring instruments were observed, which is stressed in a number of publications and reports. The evaluation of the instruments of financial support is becoming one of the most essential system elements in the new intervention logic [Ministerstwo Gospodarki 2014b, p. 50].

One needs to emphasize that the prepared prerequisites of the new intervention logic in the years 2014–2020 are to contribute to the increase in the effectiveness and efficiency of the absorption of the EU funds together with the sustainable growth and innovativeness of Polish economy. It is small and medium-sized enterprises that used to have most serious problems in terms of staying on the market and also in terms of creating and increasing innovativeness. This problem has been noticed in the new intervention logic. It must be stressed that it is in Poland that the SME sector is of particular importance, as it comprises 99.8% of all companies on the Polish market¹, creates work places and generates almost 71.8% of GDP [Tarnawa, Zadurka-Lichota (eds.) 2013, p. 15]. SMEs need development support by means of getting access to capital. This is the problem that entrepreneurs contend with (especially the SME sector). One also needs to bear in mind that in Poland this sector is to much bigger extent dominated by micro companies which constitute 96% of all companies and this is higher than the EU average (91.8%) [Brussa, Tarnawa (eds.) 2011, p. 16]. These business entities need financial solutions (especially financial instruments, not just subventions which are inefficient) so that the whole Polish economy could develop in a balanced way.

¹ Data available at: http://www.poig.gov.pl/2014_2020/Strony/Wsparcie_dla_firm_w_latach_2014_2020_23012014.aspx (08.07.2014).

3. Mezzanine capital in financing of environmental enterprises

3.1. Essence of mezzanine financing and its market advantage in financing development

In the current economic situation in regions many companies struggle with the lack of capital. This problem was observed before, but companies suffering from the financial gap could count on their shareholders. Nowadays, after the financial crisis, shareholders are not so eager to invest as they used to be. They are waiting for a noticeable upturn in the economy. Simultaneously, banks have introduced tighter criteria of granting loans (either due to their own decisions or because of adopting International Regulatory Framework for banks Basel III, or due to the regulations of the Banking Union). Financial crisis was used as a lesson, which resulted in individual investors' and institutions' reluctance to invest in highly risky ventures. However, the present social and economic situation forces people to undertake high risk investments. Polish regions need not only innovations and ideas, but also complex technologies that require research and where one needs to wait for results. Due to the current situation and the lesson of the financial crisis investors have become much more careful and they are reluctant to invest in high risk technologies or innovation for whose results they need to wait for a long time. This leads to a situation in which entrepreneurs have a limited access to capital, which means they also have limited resources that can be allotted for development.

The solution to the aforementioned problems with capital access is mezzanine finance. It is a way to finance companies under higher risk. Mezzanine financing complies with the three requirements:

- it combines the elements of own resources and debt capital,
- it does not require collateral on company assets, stocks and shares of a financed entity are usually used as collateral,
- it is characterized by deferred repayment.

There are different classifications of mezzanine capital. One of the basic criteria is the degree of the resemblance to own or borrowed capital. On the basis of this particular criterion two types of capital are distinguished. The first group comprises instruments that are similar in their character to borrowed capital (debt mezzanine), such as: unsecured money loans, subordinated loans, subordinated promissory notes, asset-conversion loans and loans with options. The second group, on the other hand, which is more similar in character to own capital (equity mezzanine) comprises financial resources in the form of loans given by partners, securities allowing share in the profits and other privileges in the partnership, typical and untypical *Tokumei kumiai* shares and non-voting preference shares [Doerscher, Hitz 2003, pp. 606–607]. The latter criterion is connected with the type of instruments used and with

the way of exit of financing capital from a company being financed. On that basis one can distinguish two types of mezzanine capital: junior mezzanine and warranted mezzanine. In junior mezzanine loans bearing high interest and bonds, especially those with so-called payment in kind loans which do not provide for any cash flow from the borrower to lender between the drawdown date and they make it possible to repay some or all the interest on the maturity date together with the principal. In warranted mezzanine it is usually bonds with share warrant, exchangeable bonds or preferred stock that are mainly used [Węclawski 2010, pp. 750–752].

Mezzanine capital has the advantage of being used in non-standard investments, which makes it much more attractive when compared to bank capital. Moreover, it allows for financing subjects which, according to the banking standards and procedures, do not comply with positive evaluation of creditworthiness. The third advantage of mezzanine capital is that it is secured at the shareholders level.

In mezzanine financing the important element of a transaction is so-called capital exit which is repaying the capital to the lender. There are two possibilities here which are dependable upon applied financial instruments. In the case of junior mezzanine a necessary element is to accumulate capital towards the end of a financing agreement, which can be difficult for a company. In the case of warranted mezzanine the problem could be the profit from the transaction itself as realizing the share warrant will bring a company a few per cent of capital and the capital provider needs to see the possibility of selling the shares. Certainly, this problem does not apply to public limited companies. Moreover, in the case of public limited companies, existing shareholders might commit themselves to buying shares from the financing person or to look for a sector investor. However, one needs to bear in mind that in the case of junior mezzanine what counts is the business and the reputation of a company, while in the case of warranted mezzanine organizational form is its limitation (financing medium and large enterprises).

Among mezzanine capital providers one can find most often private equity funds or company management. Managers are the driving force of a company and are responsible for achieving the goals of a company as they play two important roles. The first one is the role of finance participation in a realized project (as a capital provider), and the second one is active operational participation in a project.

3.2. Mezzanine financing in the new programming period

In the new programming period it is assumed that structural funds will provide financing of financial engineering instruments for companies (especially for SMEs operating in regions and city areas), such as venture capital funds, guarantee funds, credit funds, urban development funds and the funds offering financing projects concerning energy efficiency and the use of renewable energy in buildings and ensuring environment protection. An important instrument that uses the EU support

in terms of financial resources is the Enterprise Development Program 2020 (EDP Program).

The EDP Program assumes activities that are supposed to stimulate innovativeness and entrepreneurship in regions that are going to finance high risk projects which are going to bring about specific pro-developmental results in particular regions. The financing from structural funds in the way of venture capital is aimed at entrepreneurs from the SME sector with high growth potential (SME-HGP), at the stage of acceleration or expansion. One needs to bear in mind that there are problems and barriers of various kinds on the market (which was already mentioned) which make it impossible for innovative SMEs to find capital investors. SMEs seek capital for high risk innovative projects at the very beginning of their development, and these projects are burdened with high risk and high costs of management and realization which are comparable with the costs of investing in more developed and less risky investment projects resulting in high profit return. Additional limitation is this qualification of an entrepreneur as the one belonging to the SME sector [Ministerstwo Gospodarki 2014b, p. 82].

The Enterprise Development Program assumes providing public support that diversifies the investment risk by means of dividing risk between public and private subjects, and thus by diminishing the risk of losses and increasing investors' inclination to get engaged in small and risky investments. The market of capital investors in Poland, especially business angels and capital funds is at the very early stage of its development. These subjects still need to gain experience, learn from each other and develop cooperation in terms of syndicated investment. This gives the basis for mezzanine investment of initiatives proposed by SMEs, and on the other hand it diminishes the costs of debt service (which makes both the realization of a project and the chances of remaining on the market more probable).

The Enterprise Development Program includes support for high risk investment funds such as venture capital/private equity, business angels and loan funds and guarantee funds. Supporting them will be connected with the resources providing the capital for financing high risk projects proposed by SMEs at all stages of their development. It is also assumed that the participation of venture capital (VC)/private equity (PE) funds, business angels, and loan funds and guarantee funds will differ depending on the stage of a project (enterprise) development that SMEs want to finance with public resources (from EDP Program). That is why the instrument of support designed by the Ministry of Economy will consist of a few elements, each of which will stress a different stage of the company development. The stages are as follows [Ministerstwo Gospodarki 2014b, p. 83]:

1. Concept stage: R&D financing which will comprise financing the development of a concept itself, R&D, prototype, pilot (demonstration) installation, pre-production testing. This very stage requires access to non-repayable forms of supporting entrepreneurship.

2. Growth stage: financing implementation. This stage will comprise implementing the new technology itself together with own R&D results (first implementation). Financing will be by means of subventions but it will also be of a mixed type, that is including grants and private capital (including mezzanine capital which could be supported by VC/PE fund financed by EDP Program).

3. Expansion stage: development of new technologies, machinery and equipment, installations will be based not only on repayable financial instruments but also on venture capital, PE, individual investors (Business angels networks). Joint ventures of entrepreneurs and institutions providing financial support for entrepreneurs together with venture capital funds are especially adequate at this stage of development. Here it will be possible to select particular methods of R&D projects applied by the funds together with financing by these funds.

The aforementioned stages of company development will be supported in terms of supplying venture capital through the following mechanisms realized as tenders:

- providing direct advisory or financial support for advisory services for entrepreneurs seeking capital investors and those in need of analyses indispensable to find a capital investor (mezzanine financing),
- providing direct support for entrepreneurship incubators so that they would buy shares in SMEs (as mezzanine capital),
- making loans and guarantees to syndicates consisting of at least two capital investors (creating mezzanine capital),
- providing financial support for creating and operating of networks of capital investors, support for capital funds (private equity/venture capital) in the form of taking up shares in SMEs with high development potential in cooperation with the funds as mezzanine capital).

Supporting the final beneficiary, that is SMEs, might take the form of capital investment, taking up stocks and shares or debt instruments by equity/venture capital funds, business angels or other subjects [Ministerstwo Gospodarki 2014b, pp. 84–85], which is in accordance with the guidelines of mezzanine financing.

The above-mentioned guidelines of the program are designed to stimulate company development in regions in a selective way. Especially, as far as SMEs are concerned, creating special instruments designed to stimulate innovativeness, development based on new technologies or R&D activity is being planned. These are essential aspects of regional growth which can provide the regions with equal opportunities in accordance with the policy of sustainable growth.

It might be inferred from the aforementioned guidelines of the program that the emphasis is put on both creating mezzanine capital and on its use for particular purposes. The planned activities are designed to not only familiarize SMEs with mezzanine capital but also to make investors more inclined to get involved in small and risky investments, in venture capital market development and also in building up trust in SMEs at various stages of their development.

4. New partner in financing regional investments²

The Enterprise Development Program 2020 is not the only way of influencing corporate development, competitiveness and innovativeness in the regions. There is another one, namely “Polish Investment Program” announced on October 12, 2012. Its major goal is maintaining high dynamics of investment in infrastructure projects in the extended time horizon together with long-term financing and engaging capital. The essence of Polish Investment Program (PIR) is the concentration on the most significant, from the balanced growth perspective, areas of development, such as energy infrastructure (distribution and generation) and gas infrastructure (transmission network, excavation, warehousing), managing carbohydrate deposits (including shale gas), transport infrastructure, self-government (waste management, transportation), industry and telecommunications. Realization of the program is based on two institutions that are supposed to provide finance: Bank Gospodarstwa Krajowego (BGK) and Polish Investments for Development plc. BGK realizes government policy based on statutory goals and from the point of view of the essence of mezzanine capital use it will be disregarded.

Polish Investments for Development plc is the subject that in its statutory goals assumes being capital investor and provider of mezzanine finance in infrastructural projects. It needs to be mentioned that Polish Investments for Development plc acts on the premises that they should support projects contributing to the sustainable growth in the following areas: energy, carbohydrates, transportation, self-government infrastructure. However, other areas that contribute to Polish GDP growth and create new work places or increase efficiency are not disregarded.

The basic assumption on which financing is based is investing into projects according to market rules and activating private capital to invest in infrastructural projects. These projects are considered to be very risky due to their character. That is why financial engineering provided by Polish Investments for Development plc can be considered mezzanine finance. Polish Investments for Development plc supports greenfield investments (investments comprising creating a totally new entity by means of erecting buildings, installing equipment and starting up business activities that are usually considered risky) and brownfield investments (buying stocks and shares of an existing company or restructuring a taken-over company, or revitalization of areas and buildings connected with high pollutant emissions³). Polish Investments for Development plc has drawn up the following criteria for investment:

- 1) special purpose vehicle is used in order to realize a project in terms of project finance;
- 2) the amount of money that Polish Investments for Development plc needs to invest must be between PLN 50–750 mn;

² Official web page of Polish Investments for Development: <http://www.pir.pl/> (28.08.2014).

³ Definition from: [*Moving sustainably...*].

3) it assumes taking up minority stake up to 49% or junior mezzanine (but PID's stake can be higher);

4) it allows entering a financial syndicate together with subject of rights (banks, or institutions with foreign capital), self-governments (using public-private partnership formula), public institutions, including those with the participation of the State Treasury;

5) it does not assume preferential ways of financing;

6) it assumes the participation in PPP projects up to 80%.

As typical mezzanine capital they can enter a project by means of repurchasing shares in the partnership and increasing initial capital in the existing partnership or they might create a new special purpose vehicle for the purpose of a project. Polish Investments for Development's exit from a project will be carried out by means of repurchase of company's shares on a given date with the agreement of a company and its owners, redeeming shares owned by PID from the profits generated by the special purpose vehicle (realizing projects and exploiting infrastructure designed for a project), entering the Stock Exchange or in other way agreed with an owner and a company. Figure 1 presents the essence of financing projects from PID funds.

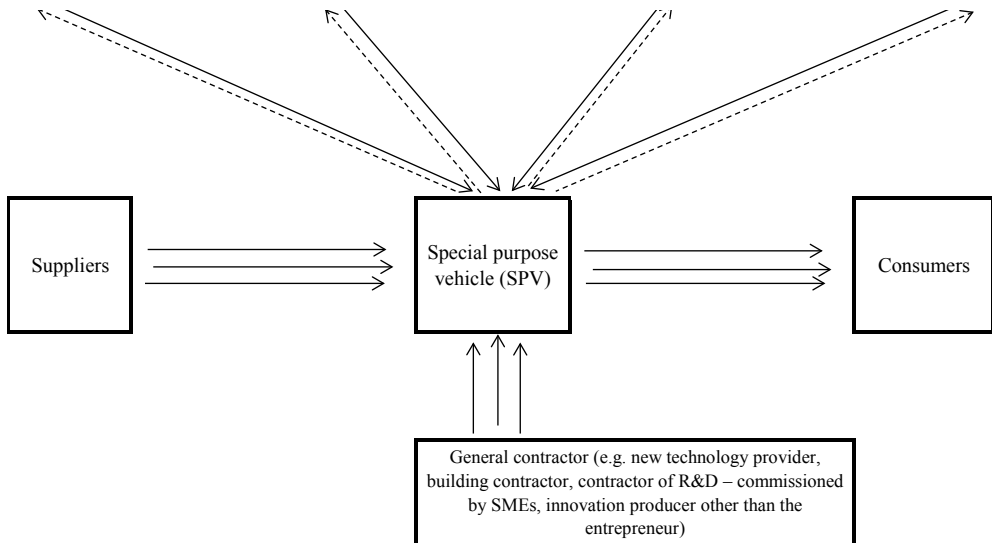


Figure 1. Essence of financing projects by PID

Source: own study on the basis of <http://www.pir.pl/>.

One needs to bear in mind that PID supports the realization of projects of high value and high risk. These projects concern very specialized enterprises that enhance both entrepreneurs development and social and economic development of a region while taking into account positive influence onto the environment. An important

aspect is the possibility of using the profits generated by an enterprise that is the result of realizing a project to pay debt towards PID.

Therefore, it could be indicated that mezzanine capital is an important element of realizing investments in the environment- and inhabitant-friendly infrastructure supporting economic growth in regions.

5. Conclusion

The European Union recognizes the necessity of increasing competitiveness of the economy and companies on the one hand while respecting the principles of sustainable growth and on the other hand, which enforces more efficient use of assistance funds (increasing the emphasis on repayable financing and moving away from subventions). The change of EU intervention in the new programming period enforces a totally new approach on the part of entrepreneurs (especially SMEs) towards using resources and building up financial engineering. Mezzanine capital has acquired a lot of significance as the new logic comprises goals and projects involving high risk.

SMEs not only should adapt to ensuing changes but also learn how to use other resources than subvention and non-repayable financing. Mezzanine capital might become a significant source of finance allowing for not only the increase in EU resources absorption but also making SMEs development possible and increasing their competitiveness in regions.

References

- Brussa A., Tarnawa A. (eds.), 2011, *Raport o stanie sektora małych i średnich przedsiębiorstw w Polsce*, PARP, Warszawa.
- Doerscher M., Hitz H., 2003, *Mezzanine capital – Ein flexibles Finanzierungsinstrument fuer KMU*, Finanz Betrieb, nr 10.
- Hausner J. (ed.), 2013, *Konkurencyjna Polska. Jak awansować w światowej lidze gospodarczej?*, Fundacja Gospodarki i Administracji Publicznej, Kraków.
- <http://www.pir.pl/>, (10.08.2014).
- Komunikat KE COM (2012) 615 Wniosek. Rozporządzenie Parlamentu Europejskiego i Rady ustanawiające wspólne przepisy dotyczące Europejskiego Funduszu Rozwoju Regionalnego, Europejskiego Funduszu Społecznego, Funduszu Spójności, Europejskiego Funduszu Rolnego na rzecz Rozwoju Obszarów Wiejskich oraz Europejskiego Funduszu Morskiego i Rybackiego objętych zakresem wspólnych ram strategicznych oraz ustanawiające przepisy ogólne dotyczące Europejskiego Funduszu Rozwoju Regionalnego, Europejskiego Funduszu Społecznego i Funduszu Spójności, oraz uchylające rozporządzenie Rady (WE) nr 1083/2006.
- Ministerstwo Gospodarki, 2014a, *Krajowa Inteligentna Specjalizacja. Program Rozwoju Przedsiębiorstw*, Dokument Rządowy z 8 kwietnia 2014 r., Warszawa, <http://www.mg.gov.pl/Wspieranie+przedsiębiorczosci/Polityki+przedsiębiorczosci+i+innowacyjnosci/Krajowe+inteligentne+specjalizacje> (30.08.2014).

- Ministerstwo Gospodarki, 2014b, *Program Rozwoju Przedsiębiorstw do 2020 r.*, Program wykonawczy do Strategii Innowacyjności i Efektywności Gospodarki, Warszawa.
- Moving Sustainably – Guide to Sustainable Urban Transport Plans*, <http://www.movingsustainably.net/index.php/movsus:mshome> (08.08.2014).
- Perspektywa 2014–2020. Co dla firm?*, http://www.poig.gov.pl/2014_2020/Strony/Wsparcie_dla_firm_w_latach_2014_2020_23012014.aspx (08.07.2014).
- Tarnawa A., Zadura-Lichota P. (eds.), 2013, *Raport o stanie sektora małych i średnich przedsiębiorstw w Polsce w latach 2011–2012*, PARP, Warszawa.
- Węclawski J., 2010, *Debt Equity Swap i Debt Buy Backs jako instrumenty restrukturyzacji finansowej przedsiębiorstwa*, *Annales Universitatis Mariae Curie-Skłodowska*, vol. XLIV, 2 Sectio H.

KAPITAŁ MEZZANINE JAKO STYMULANTA ZRÓWNOWAŻONEGO ROZWOJU REGIONÓW

Streszczenie: Kwestia finansowania rozwoju regionalnego ma poważne znaczenie, ponieważ odnosi się zarówno do regionu jako całości, jak i do podmiotów gospodarczych, które tworzą ten region. Wraz z rozpoczęciem nowej perspektywy programowania UE opracowuje nowe cele, wprowadza nową logikę w postaci celów interwencyjnych oraz sposobów ich finansowania. Celem artykułu jest wskazanie na zasady nowej logiki finansowania w okresie programowania 2014–2020 oraz na znaczenie finansowania typu *mezzanine* w kreowaniu zrównoważonego rozwoju regionów i funkcjonujących w nich przedsiębiorstw. W artykule przedstawiono podejście do zrównoważonego rozwoju w nowej logice finansowania i rolę (w tym zastosowanie) kapitału *mezzanine* w finansowaniu ochrony środowiska. Ponadto autor przedstawił ideę finansowania poprzez Polskie Inwestycje Rozwojowe jako nowego partnera w finansowaniu rozwoju regionów, wykorzystującego kapitał *mezzanine*.

Słowa kluczowe: rozwój lokalny w nowym okresie programowania, finansowanie rozwoju, kapitał *mezzanine*.