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# MEZZANINE FINANCE FOR THE INDIAN MICRO FINANCE INDUSTRY

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In its nascent stage in India, Mezzanine capital serves as a possible solution to the reducing credit availability for small entrepreneurs, who are largely dependent on bank debt. A hybrid form of capital, it can be structured flexibly in many different forms in order to provide solutions for the specific financing requirements of any organization. The paper tries to evaluate the viability of such financing options for the current Indian micro finance industry, comparing them with those already prevalent. It compares different mezzanine capital instruments to maximize efficiency in capital structure, suited to the Indian scenario. The paper also highlights measures to reduce risk faced by lenders of the mezzanine capital and highlights the challenges and opportunities for a possible government supported program in India. The article indicates that while Mezzanine financing as a tool, can solve problems of the Indian micro finance industry, it bears some inherent uncertainties of its own. A robust legal structure is imperative to safeguard the borrower and lender alike.

**Keywords:** Mezzanine capital, Hybrid instruments, Application of mezzanine for SMEs in India, Subordinated debt

## INTRODUCTION

Since centuries, the poor have been granted access to funds in one form or another. But they were never organized. Money lenders provided loans at very high interest rates and in case of non-recovery of the funds loaned, even adopted unfair practices to recover more than what was due to them. Unorganized borrowing was a door with entry for all but exit for a very few. Amongst the poor in the rural area, very few dared to venture into entrepreneurship, leaving behind traditional sources of income. And even fewer were able to create a sustainable source of

livelihood. The social stigma attached with a failed attempt at entrepreneurship, where the individual was held incompetent, was not always right. Lack of access to adequate finance was an equally important reason of failure. This realization has led to modern microcredit practices to address the social and political impediments to entrepreneurship as much as they try to solve the problem of credit availability and moral hazard.

Micro finance practices are often called a novel approach to provide access to saving and investment facilities to the underprivileged. Efficient provision of savings, insurance and

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credit can enable the poor to smoothen their consumption, manage risks, build an adequate asset base, enhance income and business avenues and elevate their quality of life. The principle agents through which micro finance operates in India are Self Help Group (SHGs), Non-Government Organizations (NGOs) and Credit Agencies. These practices helped the poor to find their own way out of poverty, rather than a one-time donation in the form of food, cash or goods. This is probably, one reason why government initiatives have not achieved desired levels of success. The Government tries to provide subsidies and other one-time initiatives, which do not solve the problem in the long term. The institutions put the power evenly in their hands, giving them a stake in their own success. This section of the society, if given proper guidance, along with capital, can emerge as successful entrepreneurs. We have ample examples of individuals, who have built empires worth of empire, with very humble beginnings.

Entrepreneurs from this strata of the society do not have a worthy asset base to hold collateral and obtain funds from the bank. They are forced to obtain loans from moneylenders, who, haven't changed much over the years. Thus, mortgage free loan has to be provided to them. The success of Grameen Bank in Bangladesh holds evidence that such a model is viable. While the amount of funds required by an entrepreneur for his business far exceed that, loaned in SHGs and its variants. Here, the Micro Finance Institutions (MFIs), are constrained by the risk of default. Enter, Mezzanine Financing.

## CONCEPT OF MEZZANINE FINANCE

Mezzanine Finance refers to a generic term for

financing techniques that integrate elements of debt and equity in a single investment vehicle. A typical mezzanine instrument combines several financing instruments with varying degrees of risk and return, such as subordinated debt, profit participation certificates and equity warrants. It differs from debt finance, in the sense that it entails greater sharing of risk and reward between the user of capital and the investor. But, the risk and the expected returns are lower, when compared with equity. In the event of bankruptcy, mezzanine investors have lower rankings than other creditors, but higher rankings than equity investors.

In the More Economically Developed Countries (MEDCs), the concept of mezzanine financing has prevailed for a long period of time. Vital in the later (expansion) phase of the firm, when the firm starts to generate positive cash-flow and looks for capital injection to grow an already successful business without giving up significant control over the organization.

As a hybrid form of capital, mezzanine debt is placed between senior debt and equity in a company's capital structure and it is used whenever there is a financing gap (Abassi, 2004). Because of its hybrid nature, mezzanine capital has a range of benefits compared to traditional sources of financing, which allow it to fund SMEs, and larger organizations. Funds sourced through mezzanine debt involve moderate risk and moderate cost for the entrepreneur.

Some Traditional Forms of mezzanine finance are mentioned below:

**Subordinated Debt:** Typically an unsecured loan, with terms of rate of interest fixed, and, ranks lower when compared to senior debt at the time of bankruptcy.

**Participating loans:** Normal loans, where in place of fixed return for the lender, the lenders remuneration depends upon the result of the business. Despite profit sharing, the lender's do not get ownership rights. Participation in losses may be contractually excluded. One step further, some lenders assume a stake in the company without any liability towards the creditors.

Some equity related mezzanine finance instruments, present a greater risk profile for the lender but also offer a greater rate of return. The financier has no voting or any other management rights. But the right to be consulted can be contractually included to benefit the company. Thus offering experience to the fresh ideas of the entrepreneur.

Another equity related instrument is the convertible bond. In addition to the fixed interest returns, and principal repayment, holders of convertible bond or bonds with a warrant have the right to acquire stake in the organization instead receiving repayment of the bond. This right is exercisable for a defined length of time and at a prefixed conversion rate. Thus converting debt of the organization to its equity.

A variant of the above, bonds with warrants, allows the subscription right to be different from the bond and thus can be traded independently.

Thus, it is clear that a plethora of forms of financing are enabled due to hybrid capital. These can be structured to suit the needs of each individual organization.

Mezzanine forms of financing offer a variety of benefits:

1. With lower amount of funds sourced from debt and equity sources the structure of the Balance Sheet improves over time. The firm

is able to avoid high costs of capital associated typically with debt instruments and avoids mortgaging assets to the provider of the funds.

2. It smoothens the path for the firm to raise further loans or equity as the funds provided by the mezzanine capital provider instills confidence in the credit worthiness of the organization.
3. Provides greater freedom to the entrepreneur who is now free to take decisions, but also grants him the option to consult the mezzanine investor (through participating rights).
4. Long term funds (Usually 3-7 years) ensure stability for the firm. The firm can forget about raising additional funds and focus on expanding its business. With a few initial grace years, the firm can reinvest cash flows generated back into the business. Amounts attracted via mezzanine financing can be substantial. While leveraging company can leverage its cash flow, a typical organization can obtain senior debt between 2x to 3.5x cash flow, compared to a total debt of 4x to 5x cash flow using mezzanine instruments, depending on the risk appetite in the debt market (von Bradsky and French, 2008).

Keeping the above in mind, one must not forget the disadvantages it brings to the table:

1. Mezzanine debt proves to be more costly for the firm.
2. Mezzanine capital is difficult for firms to obtain, largely because of the austere transparency requirements, which are nevertheless necessary. There is a lack of trust in a newly setup business to generate positive cash-flows, which would in the end lead to repayment of the principle a few years down the line.

3. Interest component and debt-like characteristics of mezzanine finance make it difficult for suppliers to exit early. Wrong assessment by the provider of the funds, leads to lower returns over time. The lenders would require a credible source for rating the business on a scale, much like the one used by credit rating agencies.

### **RELEVANCE OF MEZZANINE FINANCE FOR LOW-TIER SMES**

Mezzanine finance offers an appealing form of financing for owners of privately held companies who are not suitable/ not ready for public equity and don't want to dilute control of the organization. But for relatively newly setup organizations, the providers of mezzanine finance need to assess the credit worthiness of the business as well as the business idea. While, the concept of SHGs can be adopted to suit needs of entrepreneurs, where funds are provided by institutional investors to groups of entrepreneurs who belong to the same strata of the society. The institutional investors provide knowledge and experience resources to these groups of entrepreneurs, who meet and consult with the providers on a regular basis. The investors would be interested in guiding the entrepreneurs because their principal repayments are dependent on the ability of the entrepreneur to generate positive cash flows. The investors do undertake risk, but the returns are equally high. Regular meetings also enable the groups to become more cohesive, offering each other advice to solve challenges faced.

Unlike upper tier SMEs, these enterprises lack most prerequisite for commercial mezzanine finance, such as proven track record, experienced management or solid cash flows. They often face heavy constraints in tapping sufficient external

capital due to the fact that they are considered high-risk and are usually still operating at a loss. The primary target group for most issuers of not-for-profit mezzanine finance are companies, which rely on their own capital, subsidies, angel investors and capital provided by relatives and friends.

### **POSSIBLE GOVERNMENT INTERVENTION PROGRAM**

Private Institutional investors may not always be able to reach the nooks and corners of the country, this could result in truly credit worthy and potential entrepreneurs bereft of adequate funds. The following are some possible intervention strategies that the government can adopt:

1. The Government can create funds that invest in mezzanine finance for Small and Medium Enterprises (SMEs). In many economically developed countries, the government has formed special funds that invest alongside private investors in SMEs. Some of these funds may invest specifically in mezzanine vehicles while others could invest partially in other securities, thus balancing the risk in each asset class. The central government could play a key role in setting up special funds much like those referred above and charge nominal step-up rates of interest from the capital provided. Once setup correctly, these special funds could be self-sustaining for the government in the long term.

The government can support mezzanine financing from private investment companies by providing them funding at highly attractive terms. Under the Small Business Investment Company (SBIC) mechanism in the United States, a government agency issues debt and makes

funding available to the privately owned and managed investment companies (SBICs), which provide funding (in equity or mezzanine form) to SMEs. The government agency charges a nominal interest from the SBICs, irrespective of the fact that the small business in SBIC's portfolio is generating returns or not, with the option of a few initial grace periods. The idea is for the lender to pass on the grace periods to the small business. The government support takes the form of funding at highly attractive terms.

## CONCLUSION

In practice, it is possible to apply either the private mezzanine instruments and/or the public mezzanine instruments. The public mezzanine instruments have the character of securities in the form of convertible bonds, bonds with warrants or preferred stocks. However, utilization of these instruments in practice is entirely different. Very few investors are willing to invest in an organization without proper collaterals especially, when the amount of funds in question is this huge and there is no guarantee of the repayment of the principal. Sound sources to check the credibility of the business and rationality of the lender in case of a default are essential for effective results by any kind of mezzanine instrument. The need for government to step in cannot be overemphasized. With right sources of finance, the government may be able to provide required funds to the entrepreneurs willing to start a venture in the country.

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