MEZZANINE GAINS GROUND IN RUSSIA

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Mezzanine loans are becoming an increasingly popular financing method in Russia and the CEE, largely due to the reluctance of many Russian banks to lend to anyone but large corporations as well as the depression in the equity markets.

However, despite its increasingly popularity, the mezzanine finance market is still severely underdeveloped.

In this publication, Squire Sanders lawyers Claire Scott-Priestley and Eugenia Bektasheva discuss the mezzanine finance opportunities within Russia and the CIS, the challenges facing the mezzanine providers and compares how mezzanine finance operates in the West.

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The credit crisis has clearly resulted in a lack of confidence within the markets in developing countries. With Russian banks still reluctant to lend to anyone but large corporations and the depressed equity markets presenting challenges, mezzanine finance seems set to offer great opportunities to support the development of companies in Russia.

The market for mezzanine finance is still undeveloped in Russia however. Russian banks are not yet generally providing this form of financing and corporates are unfamiliar with it. However, specialist private equity funds – Such as HI Capital and New Russia Growth (NRG) – have been increasingly pursuing opportunities for mezzanine finance. Where Russian banks are only willing to lend for working capital purposes, mezzanine is being considered by Russian companies seeking expansion capital to grow their business, acquire a competitor or buy out a partner.

One of the challenges for the mezzanine providers is to educate Russian companies as to how mezzanine finance works in practice. However, the increasing number of deals in the last couple of years is a clear demonstration that the combination of offering debt and an equity investment (typically a 5-15 percent stake) is appealing to potential borrowers.

Where traditional Russian banks usually seek huge collateral for their loans, generally amounting to a controlling interest over the company, the minority equity stake taken by mezzanine providers is appealing to companies seeking to retain corporate control. Accordingly, Russian mezzanine funds often work with developing companies which may have difficulty obtaining capital but do not want to be exposed to traditional private equity funds where the shareholder dilution implied by raising additional equity capital is unattractive. This strategy fits well with the growth plans of many second-tier Russian companies.

However, mezzanine finance generally comes at a greater cost than senior bank debt. In the West, mezzanine is frequently added to the mix to diversify a credit portfolio comprised of relatively cheap senior debt, which may be hard to obtain, and expensive equity. In such deals mezzanine providers are seeking a return of up to 25 percent. In Russia, however, returns are much higher with percentage returns for the debt being 30-40 percent and the equity being 40-50 percent.

The higher returns being realised by the Russian mezzanine specialists are largely due to mezzanine being used rather more like a structured subordinated financing in Russia.

In the West, most mezzanine investments are characterised by a longer tenure (generally, one or two years longer than any senior facility) with a targeted exit on the debt and equity within a specified timeframe (typically five to eight years), on the occurrence of a liquidity event such as an IPO, buyout or similar.

As mezzanine is frequently being used in Russia to finance a deal where senior debt is unavailable, the investment often requires the owners of the borrower to sign up to a buy-back option permitting the mezzanine provider to exit following closing of the transaction being financed. This permits the company to execute the targeted transaction with the use of mezzanine and then, following closing, to refinance the whole deal with cheaper, more traditional debt provided by one of the big Russian banks.

The use of mezzanine finance in Russia in the last couple of years demonstrates its flexibility as a product. The deals being done highlight it can be used in many more ways than simply to complete a credit portfolio as frequently seen in the West. Consequently, its popularity in Russia is likely to continue to grow.

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