USE OF MEZZANINE FINANCING IN BUSINESS

*The case is presented in **Mika Reunanen**: Mezzanine Financing. A Comparison between the Finnish and International Financial Market Regulation (Helsinki 2019)*

The Pekka IT Group case regards IT services group that provides its services specifically for financial and public sector. All six main subsidiaries operate in the same industry. Each of them have a geographically defined responsibility area without major overlaps. The international dimension, i.e. comparison of legislations in the home states of subsidiaries, is, though, left out of the case description, and the point of view is that of the parent, not the subsidiaries.

The parent company Parent Finland Oyj is a Finnish Company, listed on the Helsinki Stock Exchange – Nasdaq OMX Helsinki - with a market cap of MEUR 500. Mr. Pekka Virtanen is the largest owner with a 30 % shareholding. Other shareholdings are split between hundreds of shareholders all having individually less than 4 % of the shares. Three Nordic banks are the main banks of the group. Additionally, each subsidiary is served by 2-3 smaller banks located in each subsidiary´s home country.

The main priorities of Pekka IT Group for the coming years are to conserve liquidity and address its capital structure. Due to the positive outlook of the industry and strong market position the group also wants to prepare itself for a major acquisition. As of December 31, 2017, the total interest-bearing debt of the group was MEUR 312, consisting of

- MEUR 200 in bank debt
- MEUR 40 in vendor debt and
- MEUR 72 in bond debt.

All external non-current debt including all vendor and bond debt is in the balance sheet of the parent company Parent Finland Oyj. Out of the total debt MEUR 100 of bank debt and MEUR72 of bond debt matures within the next three years. As alternative for just turning to the bank and bond markets for new financing the group is negotiating a restructuring solution with the existing bank syndicate and bondholders. In addition, the group is looking at possibility to attract new capital in the amount of at least MEUR 100 to secure sufficient liquidity through 2022. The new capital of min. MEUR 100 would be subordinated to senior financing. The vendor debt provided by the business partner has longer maturity with small amortisations and needs not to be restructured.

The balance sheets of the subsidiaries are without external long-term bank debt. The banking needs of subsidiaries are limited mostly to cash management and trade finance (documentary collections, documentary credits, guarantees and standby letters of credits (L/Cs) services). Subsidiaries are financed by parental equity input and shareholder loans from the parent. Additionally, the managements of the subsidiaries have been rewarded with minor amount of preference shares issued by the respective subsidiary in the past. Due to pressure from trade finance banks and external vendors there is a need to reconsider also the balance sheet structure of the subsidiaries. The group management has therefore planned to convert the senior ranked shareholder loans to subordinated shareholder loans to provide more comfort to business partners.

Pekka IT Group is planning now to execute the recapitalisation plan which shall be implemented in two steps:

1. creating a stable platform and
2. recapitalisation.

The first plan is to create a stable platform in the interim period. This should be done by extending maturity of the parent company bank credit facilities until December 2020. The second step - a recapitalisation - would be completed after that. The key elements of the recapitalisation are as follows:

- refinancing of bonds through new bond issuance with targeted maturities not earlier than 2025
- five-year maturity extension for all existing bank facilities, however no facility will mature later than December 2024.

- amortisation relief of approx. 40% for all bank facilities.

In return Pekka IT Group will plan to act as follows:

- raise an amount of minimum MEUR 100 in new funding subordinated to the secured bank facilities and with maturity after the secured bank facilities
- agree to cross collateralisation of all the secured bank facilities
- agree to increase the minimum liquidity covenant from MEUR 25 to MEUR 50
- increase the margin on the secured bank facilities with 100 bps (basis points = 0,01 %)
- convert existing shareholder loans to five subsidiaries totalling MEUR 5 into subordinated loans.

Both industry and enterprise risks of the Group are moderate.

The financials are strong and the financial standing is stable (see Figure 24 below). Forecast for 2018 represents the management view assuming no major acquisitions. The overall business volumes and profitability are fairly stable.

Figure 24: Financials of Pekka IT Group

INCOME STATEMENT, MEUR	2015	2016	2017	Forecast 2018
Net sales	1 531	1 538	1 446	1 482
Operating profit (EBIT)	424	395	356	370
Total income	372	298	246	265

BALANCE SHEET, MEUR	2015	2016	2017	Forecast 2018
Non-current assets	536	490	450	459
Current assets	780	739	667	788
Total assets	1 316	1 229	1 117	1 247
Equity	452	626	649	729
Non-current liabilities	536	431	312	357
Current liabilities	328	172	156	161
Total equity and liabilities	1 316	1 229	1 117	1 247

STATEMENT OF CASH FLOW, MEUR	2015	2016	2017	Forecast 2018
Cash generated from operations	347	395	329	344
Net cash flow after operations[2129]	262	360	266	289
Total net cash used in investing activities[2130]	-211	-201	-230	-229
Total net cash used in financing activities[2131]	-6	-160	-54	40
Change in cash and cash equivalents	45	-1	-18	100
Cash and cash equivalents at the end of period	343	342	324	424

KEY RATIOS	2015	2016	2017	Forecast 2018
Operating margin, %	27,7	25,7	24,6	24,9
Return on equity, %	41,8	30,7	27,8	30,1
Return on capital employed, %	54,2	38,4	32,4	35,1
Interest Coverage[2132]	32,6	21,1	23,0	31,3
Equity ratio, %	34,3	50,9	58,1	58,4
Debt/EBITDA[2133]	1,0	1,1	1,0	1,0

In the forecast the following assumptions are made with regards to Pekka IT Group debt:

1. All bank maturities and amortisation profiles are extended by 3 years.
2. Maturity of the bond debt of 72 MEUR will be extended by 3 years
3. Group can raise an amount of minimum MEUR 100 in new bond debt subordinated to the secured bank facilities and with maturity after the secured bank facilities.
4. Interest is assumed to be increased by 100 bps and bond interest becomes PIK (payment in kind: the interest is not paid out during the loan period but instead is accrued to the principal which is then repaid at the end of the loan period.
5. Terms of vendor financing are unchanged.

Main assets in 2017 included goodwill of MEUR 320, other intangible assets of MEUR 61(mainly own-developed software), tangible assets of MEUR 67 (mainly IT equipment) and accounts receivables of MEUR 160. Book equity was increased to 58,1 % although major dividend payment of MEUR 173.

The security package Pekka IT Group includes 1st priority pledge in those shares of Parent Finland Oyj that are owned by Pekka Virtanen i.e. 30 % of all the shares of the company. The loan agreements of Pekka IT Group contain mechanisms for regular reporting of operational and financial performance to financiers regularly. The reporting obligation includes also reporting of financial covenants on quarterly basis.

The facilities of Pekka IT Group carry a maintenance covenants on leverage and interest coverage, which are tested on quarterly basis. The leverage covenant Debt/EBITDA is set at the level of max. 2.50x and interest coverage covenant EBITDA/Net Financial items is set on the level min. 10.00x. Both covenant levels are easily achieved here.

Loan agreements include also restriction for the borrowers to commit to actions which are not commonly agreed. Such clauses include negative pledge and restrictions on financial indebtedness, disposals and mergers.

Consider the company specific implementation of the recapitalisation plan, taking into accoung especially the provisions of the Finnish Limited Liability Companies Act (LLCA).

Try to present a simplified split of equity and liabilities in the balance sheet of Parent Finland Oyj (a) before the recapitalisation, (b) after the recapitalisation if subordinated bond does not fulfil the capital loan criteria of the LLCA, and (c) after the recapitalisation if subordinated bond fulfilled the capital loan criteria.