Financing Decisions in Family Business in replacing Midcap Standard Mezzanine Programmes in Germany

*by Mark Hill and Thomas Henschel**

Abstract: *We explore financing decisions in midcap family companies to investigate whether a financing strategy exists, what elements this strategy consists of and how it is applied to in a specific refinancing process. The developed framework helps midcap companies in establishing or improving the existing financing strategy to overcome identified inefficiencies in current financing decisions. Furthermore, the research tries to migrate several qualitative research strings on financing decisions and capital structure like behavioural corporate finance and strategic capital structure theory.*

Key Words: *Behavioural corporate finance; Financing decisions in family business; Financing strategy; Midcap financing; SME*

Aim of the Paper

The aim of the study is to investigate the current state of the management decision process in family companies to provide an increased understanding on whether a formal financing strategy has been formulated and will be followed through this specific refinancing process. It highlights the efforts and behaviour of the management to cope with current and future challenges in a changing financing environment.

Specifically, this study seeks to answer the following three research questions:

1. Which aspects have been the dominant factors in determining the chosen financing instrument and have these factors been grounded upon a formulated financing strategy?
2. Has there been an increased risk by the company in the availability of suitable financing instruments during the refinancing process?
3. Has the capital structure changed significantly because of the absence of an adequate mezzanine refinancing instrument?

Mark Hill is a DBA student at Edinburgh Napier University, UK. He is also lecturer in corporate finance at the Technische Hochschule Mittelhessen, Germany and Senior Manager at KPMG Deal Advisory in Germany. Prior to that, Mark worked for several national and international banks in the structured finance and corporate finance departments. His research is mainly concentrated on financing midcap companies in Germany.

Thomas Henschel is a professor in management accounting at the Hochschule für Technik und Wirtschaft in Berlin, Germany. Until March 2012, Thomas was lecturer in accounting at the Edinburgh Napier University, UK. He has published two books and several academic articles and led a number of consultancy projects. Thomas is also engaged with the technology transfer to small and medium-sized enterprises.

Address correspondence to: Mark Hill, KPMG AG, The Squaire Am Flughafen, 60549 Frankfurt, Germany. Tel: +49 69 9587 3704. Email: mhill2@kpmg.com.

Background Literature

Standard mezzanine financing in Germany played an important role between the years 2004 and 2007 in midcap and family-owned companies in Germany as standard mezzanine allowed to close a gap between senior bank lending and family equity (Gündel & Hirdes, 2008). Existing literature on the refinancing of standard mezzanine in Germany suggests that a considerable part of the borrowers will face significant difficulties in finding a suitable replacement (Hommel, Nohtse, & Schneider, 2011; Lehmann-Tolkmitt, Knöll, & Elmers, 2010) that might even lead to an insolvency risk for the company (PwC, 2011).

Two research projects on the usage of standard mezzanine in Germany (Brüse, 2011; Nohtse, 2012) lagged to clearly identify one of the generally accepted theories on the capital structure by examining the relevant determinants for the initial choice to use standard mezzanine as a financing instrument and did not identify a strategic planning for the upcoming refinancing or the existence of a formulated financing strategy.

In 2010, Börner, Grichnik, & Reize surveyed debt financing decisions of 10.692 German SME and midcap companies from the KfW-Mittelstandspanel (KfW-midcap panel). They acknowledge that even though they find evidence for pecking order theory, financing theories that are including inefficient market approaches are more suitable for their survey, as efficient capital markets are not given for midcap financing. Like in their 2003 study, key result of their research was that the companies have to optimise their financing mix, if they want to follow a rational financing strategy. However, especially SME can not act autonomous in their financing decisions, but are constraint by the offerings from their financing partners, especially their relationship banks. (Börner et al., 2010, p. 248).

Research by Koropp et al. in 2014 on financing decisions in family firms found support that management teams follow a strategic approach to their firm's capital structure. They identify that financing decision making is subject to personal behaviour and characteristics like attitudes and perceived norms of the manager (Koropp, Kellermanns, Grichnik, & Stanley, 2014, p. 321). Even though strategic capital structure theory (Barton & Gordon, 1987, 1988) and notable aspects of behavioural finance like optimism and overconfidence (Bernardo & Welch, 2001; Kahneman, Knetsch, & Thaler, 1991; Kahneman & Tversky, 1984) emerged during the same decade, Koropp et al. are one of the first researchers that link their findings with the propositions of strategic capital structure theory (Barton & Gordon, 1987, 1988).

A current working paper by Adam, Burg, Scheinert, & Streitz (2014) showed that managerial optimism affects not only the choice between debt and equity, but also certain debt design features such as performance-pricing provisions, which specify that the interest rate rises if the borrower's performance deteriorates. Even though this survey focus on companies with stronger credit profiles, their approach to assess whether optimistic CEOs, i.e., managers who persistently overestimate their firms' future expected cash flow, are more likely to issue performance sensitive debt ("PSD") than rational managers. PSD can be summarised as debt contracts that involves an interest margin ratchet that adjusts interest rates depending on the current leverage ratio (or other key financial indicators) of the respective company. They investigated that optimistic managers are indeed more likely to issue PSD than rational managers and suggest that managerial optimisam can be identified in the design of debt contracts of the firm and that this optimism is not only impacting the general leverage ratio but also the financing instrument chosen and the riskiness of such instrument (Adam et al., 2014, p. 20).

Therefore, the existence of a financing strategy is seen as an important element to cope with the identified deficiencies in financing decisions and the involvement of management behaviour in these decisions (Psillaki & Daskalakis, 2008), in some research summarized as behavioural corporate finance (Fairchild, 2010). Nevertheless, research so far primarily focus on more quantitative-driven approaches like database surveys to identify aspects of midcap financing decisions (e.g. Fairchild, 2010; Koropp, Grichnik, & Kellermanns, 2013; Koropp, Kellermanns, Grichnik, & Stanley, 2014) and financing strategies (Börner et al., 2010) rather than exploring on a more qualitative basis the aspects of such decisions and the factors that build a financing strategy to adhere. Even though this research focus on a refinancing of a specific instrument and on financing behaviour of German family business, the findings are also relevant to explore financing behaviour of family business in other economies (Beck, Demirguec-Kunt, & Maksimovic, 2008; Psillaki & Daskalakis, 2008).

Methodology

This study seeks to provide an in-depth investigation of financing decisions in family firms in general and with regard to the performed refinancing of standard mezzanine in particular. In order to do so the research is based on a case study approach (Miles, Huberman, & Saldana, 2013; Yin, 2008) For this research, the refinancing of standard mezzanine facilities of seven midcap companies have been explored.. It involved the following steps:

1. Data Collection

Data collection consists of three methods. The first were semi-structured interviews with two participants per case. One of the interview partners was a member of the executive board and in most cases also a shareholder of the company. The second participant was employed at the second management level, usually the head of treasury or the hed of finance, who were responsible for the operational negotiation and execution of the refinancing. These interview pairs allowed for an in-depth investigation whether a formal financing strategy existed in the respective case and whether it had been adhered to in the situation explored.

The second method was the analysis of key financial ratios of the cases and their impact on an external rating tool that was used by many of the standard mezzanine providers: Moody's KMV RiskCalc. For this research, the rating was not only performed prior to the refinancing, but also an additional rating prior to the original standard mezzanine financing was performed to be able to compare the operational development during the usage of standard mezzanine. The third method was a document review, analysing relevant material such as executed financing contracts, executive memos and presentation to the supervisory board or shareholders.

2. Data Analysis

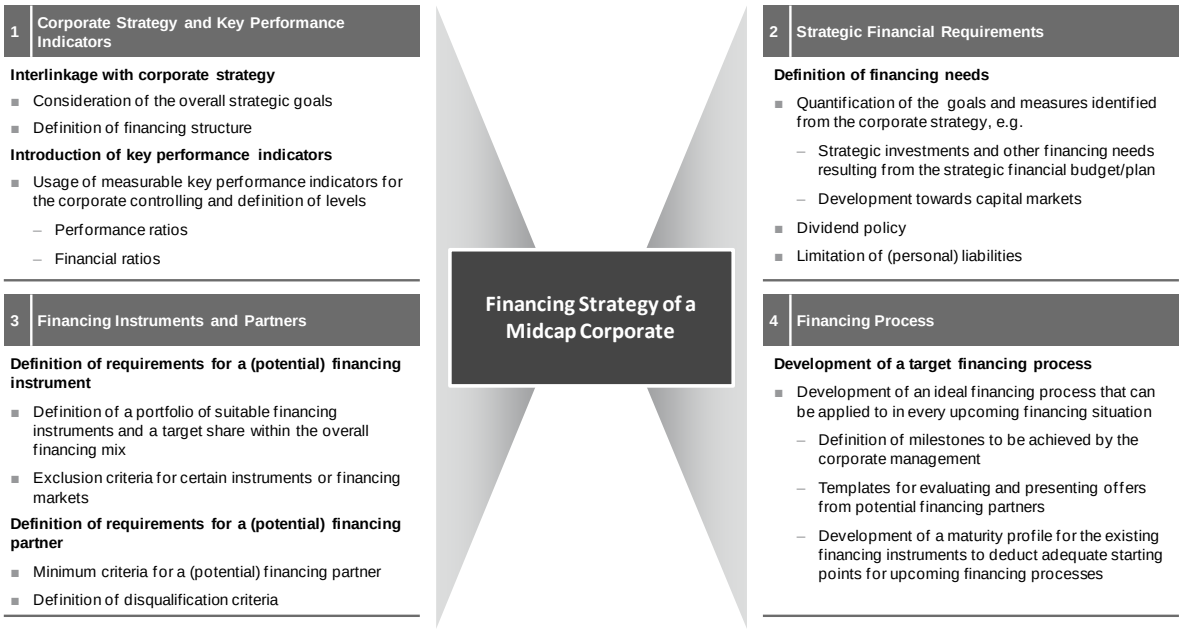
The data analysis followed a three-phase approach. The first phase was a within-case analysis of every company by transferring the interview content protocols into tables for a first-round descriptive coding to identify first labels. Answers were substantiated or challenged by using the results from the Moody's KMV RiskCalc rating and the findings from the document review. The second phase consisted of a between-case analysis, performed as a comparative analysis between the cases. It allowed for second-level coding as the first labels were grouped into categories or themes. The third phase followed with an across-case analysis by using a matrix that was developed based on the categories and themes identified through phase two. After the drawing of first conclusions, these were back-tested with the generated tables in phase one and – in case of unclear conclusions – a re-check with raw data was performed. Conclusions were substantiated by if-then tests to allow for an investigation of potential connections between categories and themes. Finally, the conclusions were reconstructed to answer the original research propositions.

Results and Implications

Based on the analysis of the cases and the identified deficiencies in implementing and following a financing strategy, this research identifies qualitative and quantitative aspects (like key performance indicators, rating factors, preferred financing partners, information requests, contractual restrictions and capital structure) that are forming the basis of the financing strategy and resulting financing principles of midcap companies. These financing principles can be found in Figure 1 below.

Figure 1

Elements of a Financing Strategy for a Midcap Corporate



Source: Own illustration.

Not surprisingly, some of the factors were more prominent in the interviews than others. Nevertheless, by contrasting these with the document analysis it became obvious that some aspects had a larger share in the negotiation process than indicated by the interview analysis, such as transferability of the financing instrument by the lender. SMEs and midcap companies should therefore critically reassess their existing financing strategy or routine after every financing decision to adopt to recent developments.

In addition, the findings led to the development of recommendations for SMEs and midcap companies how to improve their financing principles and their decision making process to facilitate and substantiate the evaluation of financing options and the selection of appropriate financing instruments. These recommendations result in an exemplary framework to be used as a basis in the development of an individual financing strategy and are displayed in Table 1:

Table 1

Recommendations and Examples for the Development of Financing Principles

Element of Financing Strategy	Financing Principle	Examples / Explanation
1. Corporate Strategy and Key Perfor-mance Indicators	a. Financing structure	• Financing at level of [holding company / subsidiaries / special finance vehicle] to cope with the overall strategic plan of the company, e.g. diversification or internationalisation strategies) • Ensure optimal utilisation of financing capabilities of the overall company / group by centralising / decentralising the financing function • Inclusion of requirements for special financing situations, such as subsidised loans
	b. Limitation of financial risks	• Mitigation of the following potential risk factors – Credit risks – Pricing and volatility risks – Liquidity risks • Mitigation of these risk factors by adopting an appropriate hedging strategy
	c. Financial ratios	• Leverage (defined as Net debt to EBITDA) not exceeding [x.x]times EBITDA • Minimum equity ratios of [xx.x]% • [other / sector specific ratios] • Inclusion of defined events that allow for a temporary shortfall in these ratios, e.g. because of unplanned additional investment needs or special events and mechanisms to return to the defined ratios
	d. Profitability and performance ratios	• ROCE of [xx.x]% at company level • Target minimum cash flow • Target EBIT(DA) or respective margins • [other / sector specific ratios] • Benchmarking with competitors
	e. Flexibility	• No limitations or restrictions of financing capacity at holding level caused by financing activities at subsidiary level • Definition of minimum funding reserve for unexpected events or unplanned additional investment needs, benchmarking with competitors

Element of Financing Strategy	Financing Principle	Examples / Explanation
2. Strategic Financial Require-ment	a. Securing the funding base	• Basis is the strategic corporate planning / budget • Definition of financing needs and timing for such needs to avoid shortfall in financing strategic investments or general corporate needs • Definition of minimum available funding reserve to be obtained during the horizon of the strategic corporate planning
	b. Dividend policy	• Definition of general dividend principles (sometimes already included in the company's articles of association); e.g. Limitation on annual dividends as long as the minimum equity ratio is located below the target ratio or the Leverage exceeds a certain range • Careful evaluation of different forms of organisation and impact on general dividend layout
	c. Limitation of (personal) liabilities	• Definition of general rules and limitations for liabilities for the company that external financing partners typically envisage • Regulation on potential personal liabilities of the owners / shareholders, depending on the form of the respective organisation e.g. limited partnerships
3. Financing Instru-ments and Partners	a. Mixture of instruments and maturities	• The company's financing should [be a diversified portfolio of instruments / be based on long-term bilateral bank financing / syndicated loan facilities / capital market instruments] • The maturity profile of the financing mix reflects the nature of the business • The instruments chosen avoid significant refinancing risks based on single refinancing events • All financings should include a maturity profile that is adequate to the respective usage of the funds / investment
	b. Optimisation of funding cost	• Finding a financing portfolio that optimises (but not necessarily minimises) the cost of funding for the company by maintaining the other financing principles
	c. Collateral	• Definition of collaterals that are available to secure external debt / Negative pledge
	d. Relationship to banks / financing partners	• Definition of core or relationship banks and depth of relationship, e.g. new financing business at company or group level only to be discussed with defined core banks • Criteria for defining a banks as core or relationship bank, such as Rating, regional presence and focus, competence in relevant products and services
	e. Potential new financing partners and investors	• Definition of criteria for accepting a new financing partner such as a leasing companies, pension funds or insurance companies • Disqualification criteria – especially with regard to capital market instruments – e.g. no hedge funds, no financing partners with a jurisdiction outside the EU, no sovereign funds
4. Financing Process	a. Exemplary financing process	• Development of an exemplary financing process that includes all key milestones; starting from internal preparation, covering selection and approach of identified potential financing partners, selection and negotiation process until funding of the new financing instrument • Maintain a stringent financing process with a timely execution to avoid refinancing risks
	b. Templates	• Design of templates for executing the financing process as well as for the selection and internal approval process(es)
	c. Maturity overview	• Establish a company-wide banking ledger that avoids any unexpected refinancing event to occur as well as to be able to execute the developed exemplary financing process

Source: Own illustration.

Conclusion

This study makes the following specific contributions to existing research. First, this study contributes to the young field behavioural corporate finance, especially for SMEs and midcap corporates and provides additional aspects that should be considered in developing hypotheses and variables in future empirical research. Second, the study adds to the already existing research on standard mezzanine refinancing as it contrasts or confirms findings from the research that has been performed prior to the refinancing with the factual refinancing. Finally, the study can be seen as a further step to migrate several qualitative research strings on financing decisions and capital structure like behavioural corporate finance and strategic capital structure theory.

This research has several limitations that should be kept in mind. For example, only Midcap companies in Germany have been investigated and inference to other countries should be made with caution. Financing markets and practices as well as legal systems vary across countries and regions and therefore may influence financing strategies and financing decisions. Furthermore,

Furthermore, we relied on a single respondent, the managing director or owner-manager, from each firm, meaning that only a limited view is provided. Ideally, future research would also include other perspectives, for example, that of the firm's key employees, as a means to obtain a more balanced understanding of governance practice in small firms. Another potential limitation of this study is the small sample size of SMEs and the cross-sectional research design. The sample was not random and was derived from one geographic population. The study is limited to the extent to which it can be generalised to a wider population of small firms. However, the paper uses a qualitative methodology that involves in-depth, semi-structured interviews which is very uncommon in corporate governance research and provided new insights regarding the governance in small firms which can be investigated with a wider questionnaire survey to make the results of this study more robust.

References

Adam, T. R., Burg, V., Scheinert, T., & Streitz, D. (2014). *Managerial Optimism and Debt Contract Design*. Berlin.

Barton, S. L., & Gordon, P. J. (1987). Corporate Strategy: Useful Perspective for the Study of Capital Structure? *Academy of Management Review*, *12*(1), 67–75.

Barton, S. L., & Gordon, P. J. (1988). Corporate Strategy and Capital Structure. *Strategic Management Journal*, *9*(6), 623–632.

Beck, T., Demirguec-Kunt, A., & Maksimovic, V. (2008). Financing patterns around the world: Are small firms different? *Journal of Financial Economics*, *89*(3), 467–487.

Bernardo, A. E., & Welch, I. (2001). On the evolution of overconfidence and entrepreneurs. *Journal of Economics & Management Strategy*, *10*(3), 301–330.

Börner, C., & Grichnik, D. (2003). Von der Pecking Order zur strategischen Mittelstandsfinanzierung - Ergebnisse einer Kombinationsstudie [From pecking order to strategic midcap financing - results of a combination study]. *Finanz Betrieb*, *11*(2003), 681–689.

Börner, C., Grichnik, D., & Reize, F. (2010). Finanzierungsentscheidungen mittelständischer Unternehmer -Einflussfaktoren der Fremdfinanzierung deutscher KMU [Financing decisions of midcap companies - influencing factors on debt financing of German SMEs]. *Zeitschrift Für Betriebswirtschaftliche Forschung*, *62*(3), 227–250.

Brüse, M. (2011). *Mezzanine-Kapital für den Mittelstand [Mezzanine-capital for midcap companies]*. Lohmar-Köln: Josef Eul Verlag; PhD thesis Wuppertal University.

Fairchild, R. (2010). Behavioural corporate finance: existing research and future directions. *International Journal of Behavioural Accounting and Finance*, *1*(4), 277–293.

Gündel, M., & Hirdes, M. (2008). Mezzanine-Finanzierung als Schutz vor Kreditverknappung [Mezzanine financing as protection against credit tightening]. *SteuerConsultant*, 38–41.

Hommel, U., Nohtse, K., & Schneider, H. (2011). Die endfällige Tilgung von Programm-Mezzanine und ihre Folgen [Consequences from the bullet repayment of programme mezzanine]. *Corporate Finance Biz*, *2*(3), 213–220.

Kahneman, D., Knetsch, J. L., & Thaler, R. H. (1991). Anomalies: The endowment effect, loss aversion, and status quo bias. *The Journal of Economic Perspectives*, *51*(1), 193–206.

Kahneman, D., & Tversky, A. (1984). Choices, values, and frames. *American Psychologist*, *39*(4), 341–350.

Koropp, C., Grichnik, D., & Kellermanns, F. (2013). Financial attitudes in family firms: The moderating role of family commitment. *Journal of Small Business Management*, *51*(1), 114–137.

Koropp, C., Kellermanns, F. W., Grichnik, D., & Stanley, L. (2014). Financial Decision Making in Family Firms An Adaptation of the Theory of Planned Behaviour. *Family Business Review*, *27*(4), 307–327.

Lehmann-Tolkmitt, A., Knöll, A., & Elmers, N. (2010). *Mezzanine-Kapital – Bilanz und Lehren der Standardprogramme [Mezzanine capital – results and lessons from the standard programmes]*. Frankfurt am Main.

Miles, M. B., Huberman, M. A., & Saldana, J. (2013). *Qualitative Data Analysis: A Methods Sourcebook* (3rd ed.). Thousand Oaks: Sage Publications.

Nohtse, K. (2012). *Programm-Mezzanine-Finanzierungen deutscher Unternehmen [Program-Mezzanine-Financings of German corporates]*. Wiesbaden: Springer Gabler; PhD thesis EBS University.

Psillaki, M., & Daskalakis, N. (2008). Are the determinants of capital structure country or firm specific? *Small Business Economics*, *33*(3), 319–333.

PwC. (2011). *Fälligkeit Standard-Mezzanin - Herausforderungen für den Mittelstand [Maturing standard mezzanine - Challenges for German midcap companies]*.

Yin, R. K. (2008). *Case Study Research: Design and Methods* (4th ed., Vol. 5). London: Sage Publications.