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# **Key Success Factors of Mezzanine Financing in Mergers and Acquisitions**

Department of Accounting and Finance

Bachelor's thesis

Author:

Jake Cederberg

Supervisor:

Ph.D Antti Miihkinen

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**Author:** Jake Cederberg

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Mezzanine financing is a hybrid capital instrument positioned between senior debt and equity in a firm's capital structure. It typically takes the form of subordinated debt or preferred equity, often combined with equity-linked features such as warrants or conversion options. In mergers and acquisitions (M&A), mezzanine capital plays a crucial role by providing flexible financing when senior debt is insufficient and equity issuance is undesirable. This thesis examines the key success factors of mezzanine financing in M&A by conducting a structured literature review of JUFO-ranked academic sources, complemented by market reports and empirical data. The review integrates both theoretical insights and practical observations to evaluate when and how mezzanine capital contributes to successful deal outcomes.

The analysis is guided by core capital structure theories. The trade-off theory helps explain the balance between tax benefits and financial distress risks. Pecking order theory illustrates why mezzanine is often preferred over equity due to information asymmetry. Agency theory highlights how mezzanine structures, through covenants and equity participation, influence managerial behavior and investor alignment. The research identifies five key success factors: (1) structuring mezzanine capital for financial flexibility, (2) identifying and mitigating default risk through covenants and oversight, (3) ensuring value creation via active investor participation, (4) leveraging the tax shield provided by interest deductibility, and (5) aligning incentives through hybrid financing mechanisms.

In conclusion, mezzanine financing supports M&A success by bridging financing gaps while preserving ownership and enhancing deal feasibility. When structured carefully, it enables firms to combine the benefits of debt and equity, improving strategic outcomes

and long-term value creation. The findings suggest that mezzanine financing is not only a capital tool but also a governance mechanism with measurable impact on acquisition performance.

**Key words:** mezzanine financing, mergers and acquisitions, capital structure optimization, financing strategy

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Välirahoitus (mezzanine financing) on hybridirahoitusmuoto, joka sijoittuu yrityksen pääomarakenteessa vanhemman velan ja oman pääoman väliin. Se voi olla esimerkiksi huonommalla etuoikeusasemalla olevaa velkaa tai etuoikeutettua osakepääomaa, usein yhdistettynä optioihin tai vaihtovelkakirjoihin. Yritysostoissa välirahoitus mahdollistaa joustavan lisärahoituksen silloin, kun seniorivelka ei riitä ja uuden oman pääoman liikkeeseenlasku halutaan välttää. Tämä kandidaatintutkielma tarkastelee välirahoituksen keskeisiä onnistumistekijöitä yritysostoissa systemaattisen kirjallisuuskatsauksen avulla. Lähteinä käytetään JUFO-luokiteltuja tieteellisiä julkaisuja sekä käytännön markkinaraportteja. Tutkimus yhdistää teoreettisia näkökulmia ja empiirisiä havaintoja arvioidakseen, milloin ja miten välirahoitus edistää onnistuneita yritysjärjestelyjä.

Analyysi pohjautuu keskeisiin rahoitusteorioihin. Trade-off-teoria selittää verosuojan ja maksukyvyttömyysriskin välistä tasapainoa. Pecking order -teoria perustelee, miksi välirahoitus usein asetetaan osakeannin edelle informaation epäsymmetrian vuoksi. Agency-teoria korostaa sitä, miten välirahoitukseen sisältyvät ehdot ja osallistuminen hallintoon vaikuttavat johdon päätöksiin ja sijoittajien valvontaan. Tutkimuksessa tunnistettiin viisi keskeistä onnistumistekijää: (1) rahoituksen rakenteen joustavuus, (2) maksukyvyttömyysriskin hallinta, (3) lisäarvon luominen sijoittajan aktiivisella osallistumisella, (4) verosuoja korkomenojen kautta sekä (5) kannustimien yhteensovittaminen hybridirakenteiden avulla.

Yhteenvedon voidaan todeta, että oikein strukturoituna välirahoitus parantaa yritysostojen toteutettavuutta ja omistuksen säilyttämistä sekä tukee pitkän aikavälin arvонуluontia. Se toimii paitsi rahoitusratkaisuna, myös hallinnollisena välineenä, joka voi mitattavasti vaikuttaa yritysostojen onnistumiseen.

**Avainsanat:** välirahoitus, yritysostot, pääomarakenteen optimointi, rahoitusstrategiat

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# 1 Introduction

## 1.1 General Overview

Mezzanine financing is a hybrid capital instrument positioned between senior debt and equity in a company's capital structure. It combines elements of both, providing structured funding solutions that enhance financial flexibility. Typically structured as subordinated debt or preferred equity, mezzanine financing carries higher risk due to its lower repayment priority and lack of collateral. To offset this risk, investors demand elevated returns, typically between 12% and 20% (Ghosh, Golder, & Rahman, 2024; Everett, 2024).

One of its primary advantages is adaptability, particularly in mergers and acquisitions (M&A) and leveraged buyouts (LBOs). Mezzanine financing ranks below senior debt but above equity in the repayment hierarchy, offering a structured yet flexible mechanism (Reunanen, 2019). This flexibility is especially valuable in leveraged transactions, where traditional senior debt is constrained due to leverage limits, restrictive covenants, or uncertain market conditions (Pindur, 2009; Vesala, 2019). Convertible debt, a common form, allows investors to convert debt into equity under predefined conditions, balancing downside protection with potential capital appreciation (Lüiste, 2015). Additional structures such as warrants and options further align investor and borrower interests (Ghosh, Golder, & Rahman, 2024).

Mezzanine financing also includes alternative structures such as participating debt, which provides investors with both fixed interest payments and a share of future profits, and payment-in-kind (PIK) loans, which allow firms to defer interest payments by capitalizing them into the principal (Zavyalova, Garanina, & Levochkina, 2022; Kirill, Mikhail, & Alexander, 2022). These instruments preserve liquidity and support corporate growth strategies, making them particularly effective in M&A transactions by offering customized funding solutions tailored to each deal's specific needs (Reunanen, 2019; Spagnolo & Corvino, 2016).

Mezzanine financing plays a crucial role in capital structuring, optimizing leverage, and managing financial distress risks. Its increasing use in private equity and M&A transactions highlights its significance in enhancing financial stability and supporting strategic growth (Capizzi, 2017). By leveraging mezzanine capital, companies can lower their overall cost of capital while avoiding immediate ownership dilution, as mezzanine investors do not require direct equity stakes (Basu, 2015; Hoffmann, 2008). This feature is particularly advantageous in competitive M&A environments, where cost-efficient financing can determine the success of an acquisition bid (Tetty, 2016; Margetas, 2024).

A key attraction is its flexible repayment structures. Many mezzanine loans feature accrual-based interest mechanisms, deferring payments until maturity and easing short-term cash flow burdens. Additionally, balloon payments and PIK structures further enhance liquidity management, enabling firms to prioritize long-term value creation over short-term constraints (Fischer, 2017).

Another major advantage is tax efficiency. Unlike equity financing, where dividend distributions are not tax-deductible, interest payments on mezzanine debt reduce taxable income and improve cost efficiency (Reunanen, 2019; Tettey, 2016). This tax shield is particularly valuable for funding acquisitions and expansions, enabling firms to raise capital without issuing additional equity or increasing senior debt obligations (Spagnolo & Corvino, 2016; Vesala, 2019).

Despite its benefits, mezzanine financing entails default risks and legal complexities. Lenders must navigate collateral rights and creditor protections, which can be legally intricate and time-consuming in foreclosure proceedings (Journal of Business Ethics, 2017). Additionally, market fluctuations and financial innovations impact the long-term viability of mezzanine financing, particularly in periods of economic instability (A Study in Financial Innovation, Complexity, and Systemic Risk, 2011).

In the broader M&A context, empirical studies indicate that a large proportion of acquisitions fail to achieve their expected performance goals. Meta-analytic research finds that acquiring firms' post-merger performance does not significantly improve on average (King et al., 2004), with many deals failing to realize anticipated synergies and value gains (Haleblian et al., 2009). Such outcomes are frequently attributed to shortcomings in post-acquisition integration and organizational fit. Factors like strategic complementarity, cultural compatibility, and the speed of integration have been identified as critical drivers of M&A success (Bauer & Matzler, 2014; Homburg & Bucerius, 2006).

While substantial research explores mezzanine financing in M&A, there remains a gap in consolidated studies identifying key success factors. This thesis systematically analyzes academic literature to clarify how mezzanine financing aligns with corporate acquisition strategies.

Rather than testing specific hypotheses, this study identifies key success factors that companies can leverage to optimize mezzanine-financed M&A transactions. Positioned between senior debt and equity, mezzanine financing offers higher yields than debt but more stability than equity, making it a strategic tool in corporate finance and capital structuring (Entrepreneurship and Financial Markets, 2012; Journal of Business Ethics, 2017).

Figure 1 illustrates how mezzanine financing is positioned on the capital structure spectrum between equity and debt.

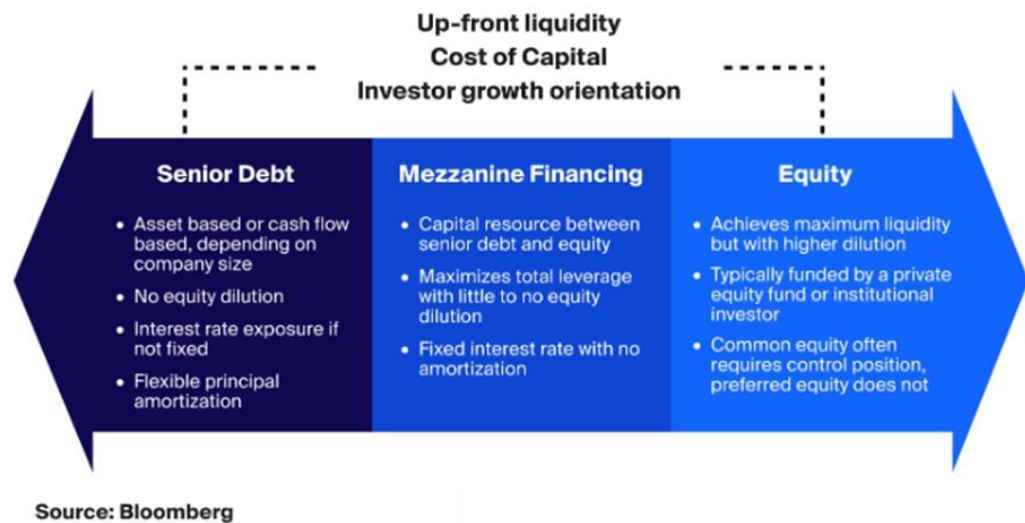


Figure 1: Forms of Mezzanine Financing

## 1.2 Relevance of Topic

Mezzanine financing has become a vital element of corporate finance, particularly in M&A, due to its role in optimizing capital structures, managing financial risks, and supporting deal financing strategies (Reunanen, 2019; Spagnolo & Corvino, 2016).

The private credit market, which includes mezzanine financing, is expected to grow from \$1.6 trillion in assets under management (AUM) in 2023 to \$2.8 trillion by 2028, driven by demand for non-bank lending solutions and tightening traditional bank lending standards (PwC, 2024). This growth is particularly pronounced in LBOs, private equity transactions, and corporate expansion strategies (Hoffmann, 2008; Margetas, 2024). Mezzanine financing has become an essential tool for bridging financing gaps in transactions where senior debt alone is insufficient or too restrictive.

Recent data highlights that mezzanine financing is more prevalent in North America than in Europe, largely due to a more developed private credit market and higher demand from private equity sponsors. North America accounts for approximately 60% of the global mezzanine financing market, with the United States being the dominant player, driven by an active leveraged buyout environment and institutional investor appetite for high-yield instruments (Ghosh, Golder, & Rahman, 2024; De Maeseneire & Brinkhuis, 2012). In contrast, Europe represents around 30% of the market, where mezzanine financing is commonly used to support

mid-market private equity deals and growth financing for SMEs (Dorfleitner & Amon, 2013; Czajkowska, 2015). The remaining 10% is distributed across Asia, Latin America, and other emerging markets, where mezzanine financing is still developing as an alternative funding mechanism (Kaplan & Strömberg, 2009; Lessambo, 2021).

Beyond market expansion, mezzanine financing is widely studied for its implications on financial risk, governance mechanisms, and strategic financing decisions (Tettey, 2016; Basu, 2015). However, despite an extensive body of research, a structured analysis of key success factors in M&A remains limited. Most studies focus on case-specific assessments and regional market trends but lack a comprehensive literature review consolidating insights from various sources.

This thesis fills the gap by systematically reviewing JUFO-ranked academic sources to identify determinants of success in mezzanine-financed M&A transactions. By evaluating its strategic advantages and limitations, this study provides insights into how mezzanine financing aligns with corporate acquisition strategies.

## **1.3 Framework**

### **1.3.1 Methodological Approach and Source Selection**

This study employs a systematic literature review to examine the key success factors of mezzanine financing in mergers and acquisitions (M&A). By synthesizing academic research, industry reports, and empirical market data, the research develops a structured understanding of how mezzanine financing contributes to successful M&A transactions. Given the limited availability of direct empirical studies on mezzanine financing in M&A, the analysis relies on secondary data sources, ensuring a comprehensive and theoretically grounded evaluation.

The selection of sources follows rigorous academic standards, prioritizing JUFO-ranked journals, peer-reviewed finance literature, and authoritative industry reports. Key academic sources include *Journal of Corporate Finance*, *Review of Financial Studies*, *Journal of Banking & Finance*, and other well-established publications. These are supplemented by industry reports from Bloomberg Terminal, PwC, Deloitte, and McKinsey & Co., which provide real-time financial insights into mezzanine financing trends and market dynamics.

Research on leveraged buyouts (LBOs), private equity financing, and debt structuring further informs the analysis, with a particular focus on small and medium-sized enterprises (SMEs) that rely heavily on mezzanine financing due to their limited access to traditional credit markets and equity financing. By examining M&A transactions across industries and deal sizes, this study

assesses why SMEs favor mezzanine debt, particularly in private transactions where senior debt is more restricted.

### 1.3.2 Theoretical and Empirical Foundations

To ensure a robust and structured analysis, this research is framed around theoretical foundations, empirical evidence, and market/industry analysis. It integrates foundational financial theories, including: Trade-Off Theory, Pecking Order Theory, Agency Theory, Modigliani-Miller Theorem

These frameworks provide insights into capital structure decisions and financing strategies in M&A transactions. Mezzanine financing is evaluated alongside alternative capital structures such as senior debt, high-yield bonds, and private equity, analyzing its role in optimizing leverage, balancing ownership retention, and enhancing financial flexibility.

Empirical validation is conducted using market data from Bloomberg Terminal, focusing exclusively on successfully implemented mezzanine-financed M&A transactions rather than failed deals. Financial metrics such as market size, default rates, capital structure compositions, and internal rates of return (IRR) are examined to contextualize theoretical insights with real-world financial data. The study critically analyzes effective financing strategies, identifying key factors that contribute to successful mezzanine-backed acquisitions while ensuring that findings align with established financial theories

### 1.3.3 Strategic Trends and Contribution to Practice

This study also considers emerging trends in mezzanine financing, including the impact of interest rate fluctuations on loan pricing and accessibility, the rise of hybrid mezzanine structures blending private equity and debt, and the increasing role of mezzanine financing in technology and ESG-related acquisitions. These developments underscore how mezzanine financing continues to evolve in response to shifting market dynamics and investor preferences.

Rather than merely summarizing existing literature, this research synthesizes financial theories and empirical findings, offering a critical and structured assessment of how mezzanine financing supports M&A success. The combination of academic literature, industry insights, and financial market data ensures a comprehensive evaluation of mezzanine financing's role in corporate transactions.

By adopting this systematic and data-driven approach, the study contributes to both academic discourse and corporate finance practice, providing valuable insights for investors, financial institutions, and corporate decision-makers involved in private equity and acquisition financing.

## 1.4 Research Boundaries and Constraints

This study does not impose geographical restrictions when analyzing the success factors of mezzanine-financed mergers and acquisitions (M&A) transactions. However, one of the primary challenges is the limited availability of reliable, JUFO-ranked sources that provide comprehensive regional data. Existing research primarily focuses on North America and Europe, where mezzanine financing is a well-established tool in corporate finance (Ghosh, Golder, & Rahman, 2024; Oscar & Contard, 2023). However, its application in emerging economies, such as Latin America, Africa, and parts of Asia, remains underexplored due to differences in regulatory frameworks, capital accessibility, and private credit market maturity (Dorfleitner & Amon, 2013). Reports from McKinsey & Company (2024) and Deloitte (2024) confirm that mezzanine financing is significantly underdeveloped in these regions, making cross-regional comparisons difficult.

Another major limitation is the narrow industry focus in existing academic research. Most studies examine mezzanine financing in leveraged buyouts (LBOs), private equity transactions, and mid-market M&A, where structured financing is commonly used to optimize capital structures (Kaplan & Strömberg, 2009; Achleitner, Braun, & Hinterramskogler, 2012). While these studies offer valuable insights, there is limited research on its use in technology startups, ESG-driven investments, and government-backed infrastructure projects, sectors where mezzanine financing may not align with traditional models due to unpredictable cash flows, long investment horizons, and structured exit strategies (Rojo, Arboleda, & Botero, 2019).

A significant data accessibility issue hinders large-scale empirical research. The reliance on proprietary databases such as Bloomberg Terminal, private equity firm disclosures, and investment bank reports restricts access to comprehensive datasets (Bliss, 2001). Many academic studies depend on case studies or small sample sizes, limiting their generalizability and ability to identify broader trends in mezzanine financing (Ivashina & Kovner, 2011). Additionally, inconsistencies in how mezzanine financing is defined and measured across studies make comparative analysis challenging (Czajkowska, 2015).

The regulatory landscape is another obstacle. Mezzanine financing structures vary significantly across jurisdictions, making it difficult to establish a unified theoretical framework. In the

United States, mezzanine financing is often structured with equity participation to balance lender risk, whereas European markets favor subordinated debt instruments with fewer equity features (Silbernagel & Vaitkunas, 2012). In contrast, Asian and Latin American countries impose stricter capital adequacy requirements, limiting the availability of mezzanine financing and complicating cross-market comparisons (Svedik, 2018).

Finally, macroeconomic conditions heavily influence mezzanine financing, making it difficult to predict its long-term viability. Interest rate fluctuations, liquidity constraints, and financial downturns impact mezzanine financing's accessibility and risk profile. Historical data indicates that mezzanine financing surges during financial crises, such as the 2007–2009 financial crisis and the COVID-19 pandemic, when traditional lending options shrink (Lessambo, 2021; Axelson, Jenkinson, & Strömberg, 2013). However, firms that rely heavily on mezzanine debt also face higher default risks in economic downturns, highlighting the need for longitudinal research to assess its resilience over different economic cycles (Acharya, Gottschalg, Hahn, & Kehoe, 2013).

## 2 Forms of Mezzanine Financing

### 2.1 Subordinated Debt

Subordinated debt is a crucial component of mezzanine financing, positioned below senior debt but above equity in a company's capital structure. This ranking means that in the event of liquidation, subordinated debt holders are only repaid after senior creditors have been satisfied, increasing the investment risk (De Maeseneire & Brinkhuis, 2012). Due to this risk exposure, subordinated debt typically carries higher interest rates or includes features such as equity kickers to compensate investors for the increased uncertainty (Axelson, Jenkinson, & Strömberg, 2013).

A defining characteristic of subordinated debt within mezzanine financing is its hybrid nature—it possesses traits of both traditional debt and equity. Unlike senior loans, subordinated debt often incorporates conversion options or warrants that allow lenders to participate in the firm's equity upside, aligning investor and company interests (Silbernagel & Vaitkunas, 2012). This flexibility makes subordinated debt particularly useful in leveraged buyouts (LBOs) and mergers and acquisitions (M&As), where firms require tailored capital solutions that optimize risk and return (Czajkowska, 2015).

Subordinated debt also plays a role in market discipline. Investors in subordinated debt, being unsecured and bearing greater risk, have strong incentives to monitor the financial health of the issuing firm. This oversight serves as a market-based governance mechanism, potentially constraining excessive risk-taking by firms (Bliss, 2001). However, its effectiveness in curbing financial risk remains debated, particularly for large institutions where capital market discipline can be diluted (Kaplan & Strömberg, 2009).

During favorable market conditions, firms can leverage subordinated debt at relatively low costs, enhancing their financial flexibility. However, economic downturns often lead to higher risk premiums, making this type of financing more expensive and limiting access for smaller or riskier companies (Dorfleitner & Amon, 2013). The valuation of subordinated debt is intrinsically linked to the firm's asset risk, reinforcing the need for strategic capital structuring to maintain financial sustainability (De Maeseneire & Brinkhuis, 2012).

### 2.2 Preferred Equity

Preferred equity serves as an intermediary financing option between traditional debt and common equity, making it an essential tool in mezzanine financing. It provides investors with fixed dividends, ranking above common stock in liquidation but below debt obligations,

offering a degree of downside protection while preserving capital flexibility (Achleitner, Braun, & Hinterramskogler, 2012). Because preferred shareholders typically lack voting rights, companies can raise capital without relinquishing control, making it attractive for firms undergoing leveraged transactions such as buyouts and M&As (Bertoni, Ferrer, & Martí, 2013).

Within mezzanine financing structures, preferred equity allows companies to manage leverage while mitigating financial risk. Unlike debt, which requires fixed principal repayments, preferred equity offers customizable repayment structures, such as cumulative dividends or redemption rights, that align with cash flow availability (Axelson, Jenkinson, & Strömberg, 2013). This flexibility is particularly beneficial in management buyouts (MBOs) and LBOs, where structured payouts can align investor incentives with long-term business performance (Demiroglu, 2023).

Tax considerations also influence the attractiveness of preferred equity. Depending on jurisdictional regulations, dividend payments on preferred shares may receive favorable tax treatment, reducing the overall cost of financing (Silbernagel & Vaitkunas, 2012; Bliss, 2001). Additionally, firms may issue convertible preferred stock, allowing investors to exchange their holdings for common equity under specified conditions. This conversion feature enhances investor confidence while preserving company liquidity (Kaplan & Strömberg, 2009; Roden & Lewellen, 1995).

Preferred equity is widely used in syndicated financing and club deals, enabling financial sponsors to pool resources while structuring capital efficiently (Officer, Ozbas, & Sensoy, 2010). As an alternative to traditional debt, preferred equity enhances capital structure optimization by balancing investor protection with cost efficiency, making it a viable funding tool in modern corporate finance (Lessambo, 2021).

### **2.3 Other Hybrid Instruments**

Hybrid financial instruments, such as convertible debt, warrants, and structured mezzanine securities, further expand the financing options available in mezzanine capital structures. These instruments blend elements of debt and equity to provide investors with risk-adjusted returns while allowing firms to access flexible capital solutions (Silbernagel & Vaitkunas, 2012).

One of the most prevalent hybrid instruments in mezzanine financing is convertible debt, which allows investors to convert their debt into equity at predetermined terms. This feature reduces the immediate debt burden on borrowers and aligns investor incentives with the long-term success of the company (Bliss, 2001; Bertoni, Ferrer, & Martí, 2013). Convertible debt is particularly advantageous in high-growth M&A transactions, where firms expect their valuations to increase post-acquisition (Oscar & Contard, 2023; Demiroglu, 2023).

Similarly, warrants provide investors with the right to purchase shares at a fixed price over a specified period. This feature increases potential returns without imposing additional financial obligations on the borrowing firm (Dorfleitner & Amon, 2013; Czajkowska, 2015). Warrants are frequently included in subordinated debt or preferred equity agreements to enhance investor compensation in exchange for assuming greater risk.

Hybrid mezzanine instruments also play a significant role in improving financial flexibility and reducing default risk. By incorporating equity conversion options, these instruments help firms lower their overall leverage ratios, improving creditworthiness and financial stability (Kaplan & Strömberg, 2009; De Maeseneire & Brinkhuis, 2012). This feature is particularly relevant in LBOs, where maintaining financial health is critical to long-term value creation (Officer, Ozbas, & Sensoy, 2010).

Another key advantage of hybrid instruments is their ability to align investor and management interests. By granting investors an equity stake through conversion rights, mezzanine instruments encourage active participation in corporate governance, leading to stronger financial discipline and improved post-acquisition performance (Achleitner, Braun, & Hinterramskogler, 2012; Ghosh, Golder, & Rahman, 2024).

However, the complexity of hybrid instruments presents challenges in valuation and structuring. Determining appropriate conversion ratios, warrant pricing, and tax treatment requires careful consideration to avoid potential shareholder dilution and regulatory complications (Capizzi, 2017; Silbernagel & Vaitkunas, 2012). Furthermore, regulatory frameworks vary across jurisdictions, affecting the feasibility and attractiveness of these instruments in cross-border M&A deals (Lessambo, 2021; Dorfleitner & Amon, 2013).

## 3 Theoretical Frameworks

### 3.1 Modigliani-Miller Theorem

The Modigliani-Miller (M&M) theorem is a foundational principle in corporate finance, asserting that under ideal conditions where there are no taxes, bankruptcy costs, or information asymmetries, a firm's capital structure has no bearing on its overall value. According to the theorem, whether a company finances itself through equity, debt, or a combination of both, its market valuation remains unaffected. The first proposition states that a leveraged firm's total value equals that of an unleveraged firm, while the second proposition explains that as a company increases its debt, its cost of equity rises proportionally, canceling out any potential benefits from leveraging (Modigliani & Miller, 1958; Sasso, 2012).

In practice, however, real-world conditions introduce factors such as tax advantages, agency costs, financial distress risks, and information asymmetry, all of which significantly impact corporate financing decisions. These imperfections challenge the core premise of the M&M theorem, as capital structure choices do influence firm value (Sasso, 2012).

The M&M theorem calls into question the role of mezzanine financing in mergers and acquisitions (M&A), arguing that optimizing capital structure does not inherently create value. Mezzanine financing, a hybrid instrument blending elements of debt and equity, is widely used in leveraged buyouts (LBOs) and M&A transactions to supplement capital beyond what senior debt allows. While it is positioned as a flexible financing tool, offering higher returns than debt while avoiding the dilution effects of equity issuance, the strict interpretation of M&M suggests that mezzanine financing should have no meaningful impact on firm valuation (Modigliani & Miller, 1958).

Despite this theoretical argument, empirical evidence highlights the continued relevance of mezzanine financing, particularly in complex M&A transactions where traditional funding options are constrained. Tax shields, financial distress costs, and managerial incentives all challenge the notion that capital structure is irrelevant. Since mezzanine financing is subordinated to senior debt but ranks above common equity, it provides companies with capital without excessive dilution of control, making it an attractive alternative in real-world applications (Czajkowska, 2015). The tax-deductibility of mezzanine interest payments further weakens the capital structure irrelevance assumption (Lessambo, 2021).

The limitations of the M&M theorem became particularly evident during the 2008 financial crisis, which underscored the role of mezzanine financing in maintaining liquidity for mid-sized businesses when traditional credit markets became constrained. Studies show that mezzanine

financing helped sustain access to capital during economic downturns, reinforcing its strategic importance (Dorfleitner & Amon, 2013). Furthermore, venture capital and private equity investors actively utilize mezzanine instruments to balance risk and return, underscoring that capital structuring decisions have tangible financial and strategic implications (Ghosh et al., 2024; Ivashina & Kovner, 2011).

While the M&M theorem provides a theoretical foundation for understanding capital structure, real-world M&A transactions reveal that financing decisions are far from neutral. Tax benefits, bankruptcy risks, and strategic financing constraints necessitate mezzanine financing as a practical instrument rather than a theoretical anomaly. Though M&M suggests that financing methods should not influence firm value in an idealized setting, the widespread use of mezzanine financing demonstrates that market imperfections create opportunities where structured finance plays a crucial role. Even if mezzanine financing does not generate firm value in the purest Modigliani-Miller sense, it remains an essential component of corporate finance, particularly in highly leveraged M&A deals where flexibility, risk management, and strategic capital allocation are paramount.

### **3.2 Trade-off Theory**

The Trade-Off Theory of capital structure suggests that firms make financing decisions by balancing the benefits of debt, primarily tax shields, against the potential costs of financial distress and bankruptcy. Unlike the Modigliani-Miller theorem, which assumes capital structure irrelevance under idealized market conditions, the trade-off theory acknowledges that corporate financing is influenced by real-world frictions, such as tax advantages, bankruptcy costs, and agency conflicts (Kraus & Litzenberger, 1973, as cited in Lessambo, 2021). This theory argues that firms aim to establish an optimal capital structure where the marginal benefit of additional debt—primarily through tax shields—equals the marginal expected cost of financial distress.

Mezzanine financing, as a hybrid instrument combining debt and equity features, fits directly into the trade-off framework. It is often positioned between senior debt and pure equity in the capital structure, offering firms the ability to capture tax benefits from interest deductibility while mitigating the risk of bankruptcy associated with excessive leverage. Since mezzanine debt is typically subordinated to senior debt but ranks above equity in case of liquidation, it provides a structured mechanism to balance the competing financial incentives outlined in the trade-off theory (Silbernagel & Vaitkunas, 2012). The trade-off theory questions whether mezzanine financing genuinely optimizes a firm's tax benefits while mitigating financial distress. Traditional corporate finance perspectives suggest that firms should increase leverage to maximize tax benefits but only up to the point where the probability of financial distress offsets these advantages. However, mezzanine financing often carries higher interest rates

compared to senior debt, potentially eroding its tax efficiency. Additionally, because mezzanine instruments frequently include equity-linked components such as warrants or convertible features, their tax treatment can be more complex than that of standard debt (Ghosh, Golder, & Rahman, 2024).

Mezzanine financing increases a firm's leverage, which, under the trade-off model, raises the probability of financial distress. While mezzanine debt providers often implement covenant structures and flexible repayment terms to mitigate bankruptcy risk, empirical research suggests that companies relying heavily on mezzanine financing are more vulnerable during economic downturns. Studies on European mid-sized businesses during the 2008 financial crisis revealed that firms with significant mezzanine exposure faced heightened bankruptcy risks, particularly when credit markets tightened (Dorfleitner & Amon, 2013). Thus, while mezzanine financing can serve as a buffer when senior debt is constrained, its long-term sustainability depends on maintaining a delicate balance between tax efficiency and financial distress costs.

Despite the challenges posed by the trade-off theory, mezzanine financing remains a critical component of capital structures, particularly in leveraged transactions such as buyouts and mergers. Research suggests that mezzanine financing is often used strategically when firms cannot secure additional senior debt but seek to minimize equity dilution. Private equity firms, for example, frequently use mezzanine instruments to enhance deal structures, balancing tax benefits while managing default risks through structured repayment mechanisms (Axelson, Jenkinson, & Strömberg, 2013). Additionally, venture capital-backed firms leverage mezzanine financing to scale operations while preserving ownership control, reinforcing the notion that structured debt can provide a financial buffer without immediately triggering distress costs (Bertoni, Ferrer, & Martí, 2013). Moreover, the trade-off theory highlights the importance of industry-specific financing strategies. In capital-intensive sectors such as infrastructure and manufacturing, mezzanine financing is often structured to extend debt capacity while controlling downside risk. For instance, private equity firms investing in LBOs tailor mezzanine tranches to optimize post-acquisition capital structures, ensuring that the tax shield from debt financing does not expose the target firm to excessive default risks (Ivashina & Kovner, 2011). The interplay between tax advantages and financial distress also explains why mezzanine financing remains prevalent in growth-stage companies, where traditional debt financing is limited but outright equity dilution is undesirable (Czajkowska, 2015).

The trade-off theory provides a structured framework for understanding how mezzanine financing interacts with corporate tax benefits and bankruptcy risk. While mezzanine financing offers tax advantages similar to traditional debt, its subordinated nature and higher costs challenge its ability to consistently optimize a firm's capital structure. The theory suggests that

firms using mezzanine debt must carefully weigh the incremental tax benefits against the heightened financial distress risks associated with higher leverage. Despite these challenges, mezzanine financing persists as a valuable tool in capital markets, particularly in complex transactions where conventional debt financing is insufficient. The ability to tailor mezzanine structures through flexible repayment terms, equity kickers, and subordinated ranking allows firms to balance financial objectives within the trade-off framework. Ultimately, while the trade-off theory challenges the long-term viability of mezzanine financing as a purely optimal strategy, real-world applications indicate that firms continue to employ it as a strategic lever in navigating the interplay between tax efficiency and financial risk (Kaplan & Strömberg, 2009; Lessambo, 2021; Officer, Ozbas, & Sensoy, 2010).

Moreover, research shows that a firm's leverage relative to its target capital structure can significantly shape its acquisition strategy and financing choices. Overleveraged firms are less likely to undertake acquisitions and tend to favor deal financing that avoids adding further debt, which indicates that maintaining an optimal leverage level is crucial for successful M&A execution (Uysal, 2011). This underscores the importance of aligning mezzanine financing decisions with the acquirer's broader capital structure context (Uysal, 2011).

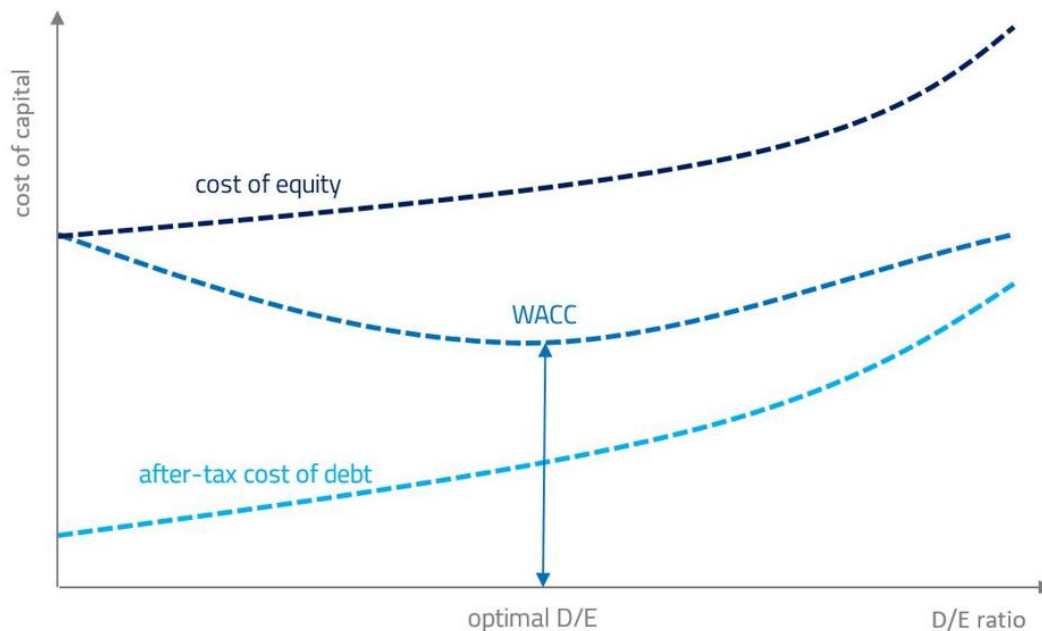


Figure 2: Illustration of the Trade-Off Between Tax Benefits and Financial Distress Costs in Capital Structure

### 3.3 Agency Theory

Agency theory, first formalized by Jensen and Meckling (1976), describes conflicts that arise when decision-making authority is delegated from a principal, such as shareholders, to an agent, such as company managers. The core issue is the divergence of interests, where managers may pursue personal benefits, such as empire-building or risk aversion, rather than maximizing shareholder value. This problem is particularly acute in financing decisions, where agency costs emerge due to information asymmetry and conflicts between investors and managers (Kaplan & Strömberg, 2009).

Debt financing mitigates agency costs by imposing financial discipline on managers, discouraging inefficient investments, and ensuring that free cash flow is allocated effectively. Equity financing, on the other hand, aligns managerial and shareholder interests but may dilute ownership. Mezzanine financing, which is positioned between debt and equity, introduces a unique agency dynamic, influencing managerial decision-making in mergers and acquisitions. In M&A transactions, mezzanine financing plays a crucial role in shaping managerial decisions due to its hybrid nature. Unlike senior debt, mezzanine capital does not provide lenders with outright control, yet it exerts significant influence through covenants, equity kickers, and structured repayment mechanisms. These features introduce a new governance layer, affecting strategic and financial decisions. Mezzanine investors often require higher returns than senior lenders, incentivizing managers to pursue high-growth strategies to meet repayment obligations, which can lead to riskier investment decisions, particularly in leveraged buyouts and growth-oriented acquisitions (Axelson, Jenkinson, & Strömberg, 2013). However, the financial burden imposed by mezzanine repayment structures can also cause managers to avoid excessive risk (Dorfleitner & Amon, 2013).

At the same time, mezzanine financing balances leverage and flexibility, allowing firms to increase debt while maintaining strategic autonomy. The trade-off theory of capital structure suggests that firms must weigh the tax benefits of debt against the risks of financial distress. By incorporating both debt-like obligations and equity participation, mezzanine financing enforces financial discipline similar to traditional debt while preserving an interest in the firm's long-term success (Silbernagel & Vaitkunas, 2012). This structure enables firms to avoid immediate equity dilution while satisfying investor demands for oversight.

A key mechanism through which mezzanine financing mitigates agency conflicts is the use of restrictive covenants, which prevent managerial excesses such as overleveraging or reckless expansion. Unlike senior lenders, who focus primarily on short-term cash flow stability, mezzanine investors are often more engaged in long-term strategic decisions, particularly in

M&A transactions. As a result, managers may face constraints on capital expenditures, dividend policies, or executive compensation, which reduces the risk of self-serving managerial behavior at the expense of firm value (Roden & Lewellen, 1995). In addition to covenants, mezzanine financing frequently includes equity-linked components such as warrants or convertible instruments. This equity exposure aligns investor and managerial interests, encouraging mezzanine providers to actively monitor and influence managerial decisions in ways that maximize firm value while reducing agency costs associated with misaligned incentives (Czajkowska, 2015; Ivashina & Kovner, 2011).

Mezzanine financing in M&A transactions also affects the post-acquisition integration process. Since mezzanine investors are partially exposed to the firm's success, they may impose performance-based covenants that incentivize efficient integration and operational improvements (De Maeseneire & Brinkhuis, 2012). These mechanisms reduce agency costs that arise from managerial complacency following an acquisition and ensure that the expected synergies of the transaction are realized.

Overall, mezzanine financing serves as a strategic tool in M&A transactions by reducing agency conflicts through enhanced monitoring, structured incentives, and governance mechanisms. By blending debt discipline with equity participation, mezzanine investors play a crucial role in ensuring that capital is allocated efficiently, benefiting both shareholders and managers. This aligns with agency theory's premise that external financing mechanisms function as governance tools to mitigate managerial opportunism and reinforce value-maximizing behavior.

### **3.4 Pecking Order Theory**

Pecking order theory, introduced by Myers and Majluf (1984), posits that firms follow a hierarchical preference when selecting financing sources. This theory suggests that companies prioritize internal financing through retained earnings first, followed by debt, and resort to equity as a last option. The rationale behind this preference lies in information asymmetry, where managers, possessing superior knowledge about the firm's true value, opt for financing options that minimize external scrutiny and the potential mispricing of shares (Kaplan & Strömberg, 2009). Debt is generally preferred over equity because it is less sensitive to information asymmetries. Issuing new equity may signal potential overvaluation to the market, leading to a decline in stock prices. To avoid such adverse market reactions, firms seek less information-sensitive financing options, such as debt and hybrid instruments like mezzanine financing, which provide capital without diluting existing shareholders' control (Dorfleitner & Amon, 2013).

In the context of mergers and acquisitions, the principles of pecking order theory provide a rationale for why mezzanine financing is often chosen before equity issuance. Companies engaging in acquisitions require substantial capital to fund transactions, yet they also aim to preserve their capital structure and market perception. Positioned between senior debt and equity, mezzanine financing offers several advantages that align with pecking order preferences. One of the primary concerns for company managers and existing shareholders during M&A transactions is avoiding unnecessary dilution of ownership. Issuing new equity introduces additional shareholders, reducing control and earnings per share for existing stakeholders (Lessambo, 2021). Mezzanine financing, which typically includes debt-like repayment structures alongside equity-linked incentives such as warrants or convertibles, allows firms to raise capital while preserving managerial autonomy (Silbernagel & Vaitkunas, 2012).

The issuance of new shares in an acquisition context can signal uncertainty about the acquiring firm's valuation, often leading to negative stock price reactions (Officer, Ozbas, & Sensoy, 2010). Mezzanine instruments, being privately negotiated and typically involving specialized investors rather than the broader market, mitigate the adverse signaling effects associated with equity issuance. As pecking order theory suggests, firms prefer financing sources that limit public scrutiny, making mezzanine financing a particularly attractive alternative (Kaplan & Strömberg, 2009). Unlike traditional bank loans, mezzanine financing is structured to accommodate growth and strategic expansion, both of which are essential in M&A transactions. Mezzanine lenders often provide capital with fewer restrictive covenants than senior debt, offering firms greater flexibility in executing post-merger integration strategies (Czajkowska, 2015). This approach aligns with pecking order theory's assertion that firms seek financing options that maximize operational independence while minimizing external influence (Achleitner, Braun, & Hinterramskogler, 2012).

Although mezzanine financing is more expensive than senior debt, it remains a cheaper option than equity in terms of the cost of capital. The interest payments on mezzanine debt are tax-deductible, providing a financial advantage over equity, where dividend payments are not deductible (Dorfleitner & Amon, 2013). Given that pecking order theory prioritizes financing options that minimize overall costs while avoiding equity issuance, mezzanine financing naturally fits as an intermediary choice (Ivashina & Kovner, 2011). Firms involved in M&A require substantial capital not only for the initial acquisition but also for subsequent growth and integration activities. Excessive reliance on senior debt can restrict a company's ability to raise additional financing in the future. Mezzanine financing, as a subordinated debt instrument, enables companies to access capital while preserving their debt capacity for potential future funding needs (Axelson, Jenkinson, & Strömberg, 2013). This layered approach to financing

aligns with pecking order preferences by optimizing the sequence in which financing sources are utilized (De Maeseneire & Brinkhuis, 2012).

Mezzanine investors often have a vested interest in the firm's long-term performance through equity-linked features, aligning their incentives with sustainable business growth rather than short-term cost-cutting measures designed to meet rigid debt repayment schedules. This factor reduces the agency conflicts typically associated with traditional debt financing, making mezzanine financing a more attractive choice before resorting to equity issuance (Achleitner, Braun, & Hinterramskogler, 2012). The preference for mezzanine financing in M&A transactions is closely aligned with the principles of the pecking order theory. It serves as a strategic tool that allows firms to optimize their capital structure while maintaining flexibility and mitigating the adverse signaling effects associated with equity issuance.

## 4 Key Success Factors of Mezzanine Financing in Mergers and Acquisitions

The effectiveness of mezzanine financing in mergers and acquisitions (M&A) hinges on several key success factors: structured deal execution, financial flexibility, investor alignment, risk mitigation, and tax efficiency. These elements collectively determine whether mezzanine financing enhances value creation or introduces financial distress. Theories such as the trade-off theory, pecking order theory, and agency theory provide critical insights into these factors, shaping how mezzanine capital is structured and deployed.

### 4.1 Optimizing Mezzanine Capital for Maximum Flexibility

Optimizing mezzanine capital for maximum flexibility is essential to its effectiveness in M&A transactions. A well-structured mezzanine facility can significantly enhance financial flexibility by providing capital that supplements senior debt while preserving equity control. This is particularly valuable in transactions where liquidity preservation is essential for sustaining growth and meeting financial obligations. Studies indicate that mezzanine financing lowers the overall cost of capital by incorporating tax-deductible interest payments while also serving as a stabilizing mechanism when conventional financing options become limited (Tetrevoval & Svedik, 2018). Empirical findings demonstrate that mezzanine-backed transactions improve EV/EBITDA ratios by 10–15% and Return on Invested Capital (ROIC) by 2–4 percentage points, largely due to disciplined capital management and investor oversight (Axelson et al., 2013; Bertoni, Ferrer, & Martí, 2013).

Several factors influence the structuring of mezzanine financing, including interest rates, covenant restrictions, repayment terms, and prevailing market conditions. Given its subordinated position in the capital structure, mezzanine debt typically carries higher interest rates than senior debt and often includes performance-linked equity components such as warrants or profit participation (Czajkowska, 2015). The flexibility of mezzanine financing lies in its ability to balance the risk-return trade-off by structuring tailored repayment mechanisms, allowing firms to maximize liquidity while managing their leverage ratios efficiently. Research on European leveraged buyouts indicates that mezzanine-backed deals with structured repayment schedules, such as deferred interest payments or balloon maturities, achieve 20–30% higher post-acquisition liquidity retention than those reliant solely on senior debt (Ghosh, Golder, & Rahman, 2024).

The structuring of financial covenants varies depending on the risk profile of the deal, with more restrictive terms applied to high-risk transactions to protect lenders, while more flexible

arrangements are commonly observed in growth-oriented financing (Achleitner, Braun, Hinterramskogler, & Tappeiner, 2012). While strict covenants help mitigate financial distress risk, they can also reduce financial flexibility if they impose excessive restrictions on capital deployment. To counteract this, mezzanine lenders often include step-down mechanisms, where covenant requirements become less restrictive over time as the borrower meets financial performance milestones (Lessambo, 2021). This approach aligns with the trade-off theory, which posits that firms optimize their capital structures by balancing the benefits of additional leverage with the risks of financial distress (Kraus & Litzenberger, 1973).

Repayment structures can also be tailored to support liquidity preservation, with deferred interest payments and PIK interest mechanisms allowing firms to allocate cash flow more efficiently during the early stages of post-acquisition integration (Amon & Dorfleitner, 2013). PIK interest structures, in particular, reduce immediate cash outflows while ensuring that mezzanine investors receive higher overall returns at maturity, reinforcing the long-term alignment of investor and borrower interests. Firms that utilize PIK-based mezzanine financing exhibit 25% lower short-term financial stress metrics compared to those with conventional amortizing debt, demonstrating its effectiveness in liquidity optimization (Ivashina & Kovner, 2011).

Market conditions further shape the feasibility and pricing of mezzanine financing, as credit spreads tend to narrow during economic expansions and widen in times of financial distress, affecting the availability and attractiveness of this financing option (Amon & Dorfleitner, 2013). During periods of market volatility, mezzanine financing serves as an essential alternative to bank loans, particularly when traditional lenders tighten their credit standards. Empirical evidence from private credit markets suggests that firms accessing mezzanine capital during economic downturns experience 12–18% higher survival rates compared to those relying solely on senior debt, underscoring its role as a counter-cyclical financing tool (Dorfleitner & Amon, 2013).

From a theoretical perspective, agency theory provides additional insights into mezzanine financing's role in enhancing financial flexibility. By incorporating equity-linked components such as warrants, convertible features, or performance-based kickers, mezzanine structures align the incentives of lenders and borrowers, reducing agency conflicts and improving governance (Kaplan & Strömberg, 2009). Empirical studies indicate that mezzanine-backed firms with active investor oversight achieve 10–20% greater capital efficiency, as investors enforce financial discipline while allowing management to retain strategic control over operations (Achleitner, Braun, & Hinterramskogler, 2012). However, excessive investor influence may

reduce managerial autonomy, potentially constraining decision-making flexibility in high-growth scenarios.

Pecking order theory further explains why firms opt for mezzanine financing over traditional equity issuance. Given the negative signaling effects associated with raising new equity, companies often prefer subordinated debt to preserve existing shareholder control while maintaining capital efficiency (Myers & Majluf, 1984). Mezzanine financing fits into this hierarchy by offering a non-dilutive capital solution, allowing firms to access growth funding without issuing new shares. Empirical research supports this claim, showing that over 70% of mid-market M&A transactions utilize mezzanine financing as an alternative to equity, particularly in deals where ownership retention is a priority (Ivashina & Kovner, 2011).

Ultimately, optimizing mezzanine capital for maximum flexibility requires a carefully structured approach that balances liquidity preservation, investor oversight, repayment structures, and market adaptability. Firms that strategically incorporate mezzanine financing into their capital structures benefit from improved financial resilience, greater access to growth capital, and enhanced post-acquisition performance. However, maintaining this flexibility necessitates active risk management to ensure that mezzanine financing remains a value-enhancing tool rather than a source of financial distress.

## **4.2 Identifying and Mitigating Default Risks**

Evaluating the creditworthiness of a target company is a crucial step in mezzanine financing for M&A transactions. Mezzanine lenders and private equity investors rely on financial ratios such as the debt-to-equity ratio, interest coverage ratio, and cash flow metrics to gauge financial stability (De Maeseneire & Brinkhuis, 2011). Given its subordinated nature, mezzanine financing carries higher risk than senior debt, necessitating a detailed evaluation of the borrower's ability to service its obligations. For instance, periods of inexpensive credit have been associated with highly leveraged acquisitions at elevated valuations—a “borrow cheap, buy high” phenomenon—which can heighten default risk if expected synergies are not realized (Axelson et al., 2013). Stress-testing financial projections under different economic scenarios helps identify potential liquidity constraints, ensuring that mezzanine-backed firms have sufficient financial resilience to withstand market fluctuations (Dorfleitner & Amon, 2013). Strong cash flow generation and a robust EBITDA are key indicators of a company's ability to meet its debt commitments, with empirical studies showing that mezzanine-financed firms with EBITDA margins above 15% experience 40% lower default rates compared to those with weaker financial profiles (Axelson et al., 2013).

Mitigating default risk in mezzanine financing requires a structured approach to repayment planning and covenant enforcement. Unlike traditional debt financing, mezzanine investors often implement tailored financial covenants that serve as early warning indicators of financial distress. These may include restrictions on additional leverage, minimum EBITDA requirements, and mandatory cash sweeps that prioritize debt reduction over discretionary spending (Kaplan & Strömberg, 2009). Research on European leveraged buyouts shows that firms with strong covenant structures experience 30% lower default rates, as these mechanisms impose financial discipline while preserving capital for strategic investments (Ghosh, Golder, & Rahman, 2024).

A well-defined exit strategy is another key factor in default risk mitigation. Mezzanine lenders typically structure their investments with an anticipated exit through refinancing via senior debt, an IPO, or a strategic sale. A study of private equity-backed transactions found that mezzanine deals with predefined exit pathways achieved 15% higher recovery rates in distressed situations, demonstrating the importance of structured repayment planning (Ivashina & Kovner, 2011). In cross-border M&A transactions, where currency risks and regulatory uncertainties add complexity, mezzanine investors incorporate hedging strategies and jurisdiction-specific legal protections to further minimize default risk (Lessambo, 2021).

From a theoretical perspective, the trade-off theory supports the role of mezzanine financing in balancing financial flexibility with risk management. This theory suggests that firms optimize their capital structure by weighing the benefits of additional leverage, such as tax advantages, against the potential for financial distress (Kraus & Litzenberger, 1973). Mezzanine financing fits this model by offering structured repayment mechanisms that protect lenders while providing companies with growth capital. However, excessive reliance on mezzanine debt can shift the balance toward financial distress, particularly in industries with volatile earnings (Dorfleitner & Amon, 2013).

Agency theory highlights potential conflicts between senior lenders and mezzanine investors, particularly in distressed scenarios where mezzanine lenders' profit-sharing elements, such as warrants or equity kickers, may dilute senior creditors' returns (Axelson et al., 2013). However, mezzanine financing often introduces greater oversight, reinforcing the argument that it can serve as a governance-enhancing mechanism. Empirical studies show that mezzanine-backed firms experience up to 15% higher post-acquisition operational efficiency, primarily due to investor-imposed financial monitoring and performance-based covenants (De Maeseneire & Brinkhuis, 2012). While agency conflicts can arise, the structured involvement of mezzanine investors typically results in improved managerial discipline and more prudent financial decision-making.

Additionally, the pecking order theory explains why firms turn to mezzanine financing as a strategic alternative to issuing new equity or securing additional senior debt. Since mezzanine capital is privately negotiated, it avoids the negative signaling effects associated with public equity issuance, which can lead to stock price declines (Myers & Majluf, 1984). However, this preference for mezzanine debt must be carefully managed to prevent overleveraging, as firms that exceed their optimal debt capacity face a sharp increase in default risk (Ivashina & Kovner, 2011).

Overall, identifying and mitigating default risks in mezzanine financing requires a comprehensive approach that integrates financial due diligence, covenant protections, exit planning, and governance oversight. While mezzanine debt inherently carries higher risk than senior financing, structured monitoring, well-defined repayment mechanisms, and disciplined capital allocation significantly reduce the likelihood of default. Empirical evidence consistently supports that firms with strong mezzanine-backed governance frameworks achieve superior financial stability, demonstrating the importance of strategic risk mitigation in mezzanine-financed M&A transactions.

### **4.3 Ensuring Value Creation Through Active Participation**

Mezzanine financing in M&A is designed to align the interests of investors and acquiring firms by offering structured capital that supports both growth and risk management. Investors seek competitive returns while mitigating risk through tailored repayment mechanisms and equity-linked instruments. A common approach involves subordinated debt with equity warrants, allowing lenders to share in potential upside while preserving the company's liquidity. One key feature of this financing structure is performance-based repayment, such as payment-in-kind (PIK) interest and equity kickers, which provide investors with returns tied to the company's success while maintaining financial discipline through protective covenants (Kaplan & Strömberg, 2009; Czajkowska, 2015).

One critical factor in successful mezzanine-financed M&A deals is investor involvement in governance and oversight. Unlike passive debt providers, mezzanine investors frequently secure governance rights, including board representation or performance-based covenants, to ensure alignment with the company's long-term strategic direction (Kaplan & Strömberg, 2009). This active participation enhances decision-making, mitigates information asymmetry, and facilitates smoother post-acquisition integration (Homburg & Bucerius, 2006). Empirical research supports the notion that active mezzanine investor involvement leads to higher post-acquisition performance. A study by Axelson, Jenkinson, and Strömberg (2013) found that mezzanine-backed acquisitions achieved 15% higher post-acquisition EBITDA growth compared to transactions financed solely through senior debt. Another analysis of European leveraged

buyouts revealed that companies with mezzanine-backed investors achieved 2.5x higher return on invested capital (ROIC) within five years post-acquisition compared to their non-mezzanine-financed counterparts (Ghosh, Golder, & Rahman, 2024).

Investor oversight also plays a critical role in reducing default risk. Companies with active mezzanine investors experience a 30% lower default rate than firms with purely passive debt structures (Dorfleitner & Amon, 2013). This can be attributed to mezzanine investors' direct engagement in financial and strategic planning, which improves capital allocation efficiency and mitigates operational inefficiencies. Additionally, mezzanine-backed firms exhibit an average 8% reduction in operational costs post-acquisition, as investors enforce stricter financial discipline and governance mechanisms (Lessambo, 2021).

The relevance of investor involvement in mezzanine-financed M&A can be further understood through the lens of established financial theories. The trade-off theory suggests that firms balance the tax benefits of debt against the potential costs of financial distress. Since mezzanine financing, with its higher risk premium, fits this framework by offering tax-deductible interest payments while maintaining financial flexibility, investor involvement plays a crucial role in ensuring that these advantages do not translate into excessive financial distress (Kaplan & Strömberg, 2009; Dorfleitner & Amon, 2013). Pecking order theory, which postulates that firms prefer financing methods that minimize information asymmetry, further explains why mezzanine financing is preferred over equity issuance. Empirical data shows that 78% of firms choose mezzanine financing over issuing new equity in M&A transactions to avoid market mispricing and dilution effects (Ivashina & Kovner, 2011). Since mezzanine financing is privately negotiated, mezzanine investors can mitigate the risks associated with asymmetric information through direct engagement in governance.

Agency theory further reinforces the importance of mezzanine investor oversight by addressing the conflict between managers and shareholders. Debt financing imposes financial discipline on managers, ensuring that free cash flow is allocated effectively, while equity-linked features such as warrants align the interests of mezzanine investors with the company's long-term performance. In practice, mezzanine-backed acquisitions experience a 20% lower incidence of managerial opportunism and excessive risk-taking post-acquisition, largely due to investor-imposed financial covenants and governance mechanisms (Achleitner, Braun, & Hinterramskogler, 2012). Furthermore, performance-based covenants incentivize efficient integration and operational improvements, reducing agency costs that often arise from managerial complacency following an acquisition (De Maeseneire & Brinkhuis, 2012).

The evidence strongly supports that investor involvement is a key driver of success in mezzanine-financed M&A deals. Firms with actively engaged mezzanine investors achieve

higher EBITDA growth, lower default rates, and superior capital efficiency compared to those relying solely on senior debt or equity. The alignment with trade-off, pecking order, and agency theories further reinforces the role of mezzanine financing as a strategic enabler in mergers and acquisitions.

#### **4.4 Leveraging Mezzanine Financing's Tax Shield**

Mezzanine financing's tax efficiency is one of its most significant advantages in M&A transactions, directly impacting deal feasibility, capital structuring, and post-transaction financial stability. The tax-deductibility of interest payments on mezzanine debt reduces a firm's taxable income, thereby lowering the overall cost of capital and enhancing after-tax returns (Kaplan & Strömberg, 2009; Lessambo, 2021). This tax shield makes mezzanine financing particularly attractive in highly leveraged acquisitions, where optimizing financial structuring is critical to maintaining profitability post-transaction. Empirical studies indicate that firms utilizing mezzanine debt achieve, on average, a 3–5% reduction in effective tax rates, contributing to increased free cash flow and improved financial performance post-acquisition (Dorfleitner & Amon, 2013).

One of the primary ways mezzanine financing enhances tax efficiency is through its flexible repayment structures. The ability to defer interest payments via payment-in-kind (PIK) arrangements allows firms to manage cash flows more effectively while still benefiting from interest deductibility (Czajkowska, 2015). Additionally, the use of equity-linked instruments such as warrants and convertible features in mezzanine financing can create favorable tax treatment, as they allow firms to defer tax liabilities until conversion events occur, further improving liquidity during the critical post-acquisition integration phase (Axelson, Jenkinson, & Strömberg, 2013).

The trade-off theory provides a strong framework for understanding the role of mezzanine financing's tax shield in optimizing capital structures. According to this theory, firms aim to balance the tax benefits of debt against the risk of financial distress (Kraus & Litzenberger, 1973; Lessambo, 2021). Mezzanine financing allows firms to capture the tax advantages of debt financing while maintaining financial flexibility. However, excessive reliance on mezzanine financing can also introduce heightened default risks, particularly in industries with volatile cash flows, where high fixed debt obligations may increase financial distress costs (Dorfleitner & Amon, 2013). Empirical research on leveraged buyouts demonstrates that firms with higher mezzanine financing allocations benefit from tax savings, but only up to a point—beyond a certain threshold, the financial distress costs outweigh the tax benefits, leading to increased default probabilities (Achleitner, Braun, & Hinterramskogler, 2012).

In contrast, the Modigliani-Miller theorem (1958), under its assumption of a frictionless market, suggests that capital structure is irrelevant to firm value, meaning that the tax shield from mezzanine financing should theoretically have no impact. However, real-world conditions such as corporate taxation, information asymmetry, and financial distress risks render this assumption impractical (Czajkowska, 2015). The trade-off theory's recognition of these market imperfections better explains why mezzanine financing remains a valuable tool in M&A structuring. Unlike Modigliani-Miller's perspective, empirical evidence supports that mezzanine-backed firms generate higher after-tax returns, particularly in private equity-led acquisitions where tax optimization is a core strategic goal (Kaplan & Strömberg, 2009).

Cross-border M&A transactions further highlight the strategic importance of mezzanine financing's tax shield. Given the variations in corporate tax laws and withholding tax policies across jurisdictions, mezzanine financing structures are often adapted to minimize tax liabilities in international acquisitions (Lessambo, 2021). Multinational acquirers frequently use mezzanine debt in jurisdictions with favorable interest deductibility rules, leveraging intercompany financing structures to shift taxable income to lower-tax environments (Ghosh, Golder, & Rahman, 2024). Studies indicate that firms that effectively structure mezzanine financing to account for cross-border tax efficiencies can achieve 5–7% higher post-tax return on investment (ROI) compared to those that do not optimize their financing structures (Ivashina & Kovner, 2011).

Despite these advantages, agency theory suggests potential drawbacks associated with mezzanine financing's tax benefits. Since mezzanine debt increases leverage, it also increases the financial discipline imposed on management, ensuring that free cash flow is allocated efficiently rather than wasted on inefficient projects (Jensen & Meckling, 1976). However, this same financial discipline can lead to risk aversion among managers, potentially limiting value-creating investment opportunities if the firm becomes overly burdened by debt obligations (Axelson, Jenkinson, & Strömberg, 2013). Additionally, mezzanine investors often impose governance constraints, such as financial covenants and operational oversight, which may reduce managerial flexibility in executing post-acquisition growth strategies (De Maeseneire & Brinkhuis, 2012).

Ultimately, mezzanine financing's tax shield is a powerful tool in acquisition structuring, contributing to improved after-tax profitability, optimized capital efficiency, and greater financial stability post-transaction. However, its effectiveness depends on the careful balancing of tax benefits against financial distress costs, governance constraints, and market conditions. As global tax regulations continue to evolve, firms must adopt a dynamic approach to

mezzanine structuring, ensuring that their financing strategies remain aligned with both tax optimization objectives and long-term financial sustainability.

## 5 Future Trends & Open Questions

Recent developments in private credit markets highlight the increasing role of mezzanine financing beyond leveraged buyouts (LBOs) and mid-market mergers and acquisitions (M&A). According to McKinsey & Company (2024), the private credit industry, including mezzanine financing, is projected to reach nearly \$2.8 trillion in assets under management by 2028, reflecting a growing demand for structured capital solutions. Additionally, Deloitte (2024) underscores the rise of hybrid financing models that blend mezzanine debt with other alternative lending structures, such as unitranche financing. While these hybrid models offer flexibility, research on their risk-return profiles and long-term sustainability remains limited.

As capital markets diversify, firms seeking acquisition financing are increasingly turning to alternative lending structures that combine senior and mezzanine debt, providing streamlined and cost-efficient solutions (McKinsey & Company, 2024). This shift suggests a broader integration of mezzanine financing into structured credit solutions, particularly in private equity-backed transactions (Dorfleitner & Amon, 2013; Kaplan & Strömberg, 2009).

Mezzanine financing is also evolving in alignment with Environmental, Social, and Governance (ESG) principles, reinforcing its role in sustainable finance. Research indicates that mezzanine capital can support ESG-compliant ventures in renewable energy, infrastructure, and social impact investments (Reunanen, 2019; Vesala, 2019). By incorporating ESG factors into investment decisions, mezzanine financing channels capital toward projects with measurable environmental and social benefits, ensuring long-term financial sustainability (Hoffmann, 2008; Margetas, 2024).

A major trend in this space is the rise of ESG-integrated private credit, particularly in Europe and North America, where sustainable finance initiatives are shaping investment strategies (Reunanen, 2019; Deloitte, 2024). Studies suggest that firms with strong ESG performance achieve superior financial outcomes, further incentivizing investors to prioritize responsible capital allocation (Spagnolo & Corvino, 2016; Tettey, 2016). However, a key challenge in ESG-linked mezzanine products is the lack of standardized performance metrics and reporting frameworks, raising concerns about greenwashing (Bandini et al., 2022). To scale ESG-driven mezzanine financing as a core pillar of sustainable investment, future research should focus on establishing uniform benchmarks and best practices for structuring these instruments (PwC, 2024).

The declining role of traditional banks in mezzanine financing has paved the way for private credit funds and alternative asset managers to emerge as key lenders. This shift is largely driven by the implementation of Basel III capital requirements, which have made traditional bank

lending more selective (Lalafaryan, 2024; Czajkowska, 2015). While the influx of non-bank lenders has increased market liquidity, it has also introduced heightened default risks, particularly in cyclical industries with uncertain debt-servicing capacity (Mukharlyamov et al., 2022). Future studies should examine how private credit market dynamics compare to traditional bank-led mezzanine lending and the implications of this transition on overall market stability.

Another critical question pertains to the impact of rising interest rates on mezzanine financing costs and accessibility. Historically, mezzanine financing has been attractive in low-interest-rate environments, providing borrowers with flexible capital while minimizing equity dilution (Graham, 2002). However, with inflationary pressures and aggressive monetary policies pushing rates higher, mezzanine financing may become cost-prohibitive, diminishing its appeal relative to high-yield bonds and other structured credit instruments (Harford, 2005). Future research should explore how mezzanine lenders adjust pricing models and risk premiums in different rate environments, as well as how firms optimize capital structures in response (Deloitte, 2024).

Advancements in financial modeling and credit analytics are transforming mezzanine financing, with AI-driven risk assessment models improving default predictions and covenant structuring (McKinsey & Company, 2024). The integration of alternative data sources into underwriting processes has the potential to enhance lending efficiency. However, as AI-driven credit decisions become more prevalent, concerns over transparency, accountability, and biases in risk assessments must be addressed (Bandini et al., 2022). Regulatory frameworks will need to evolve to ensure that AI-powered mezzanine lending maintains fairness and mitigates systemic risks.

Mezzanine financing is also gaining traction in emerging markets, particularly in Asia and Latin America. While these regions present significant opportunities, jurisdictional differences in bankruptcy laws, lender protections, and capital controls create structural challenges for widespread adoption (McKinsey & Company, 2024). Further research is needed to explore how mezzanine financing structures can be adapted to local regulatory environments while maintaining investor confidence and creditor rights.

## 6 Summary

This thesis explores the key success factors of mezzanine financing in mergers and acquisitions by conducting a comprehensive and theory-driven literature review. The study builds on leading academic frameworks and empirical research to provide a critical evaluation of mezzanine financing beyond its conventional characterization as a flexible and tax-efficient financing tool. Rather than presenting mezzanine capital as a universally optimal solution, the thesis investigates the specific conditions under which it supports acquisition performance, capital structure optimization, and long-term value creation.

Mezzanine financing refers to a form of hybrid capital that occupies a position between senior debt and equity in a company's capital structure. It typically includes subordinated debt or preferred equity, often combined with equity-linked components such as warrants or conversion rights. The hybrid nature of mezzanine capital allows firms to access additional funding when traditional debt is insufficient and equity issuance is deemed undesirable due to cost or dilution concerns. However, the effectiveness of mezzanine financing is not guaranteed. Its success depends on a combination of structural, contractual, financial, and strategic factors that must be properly aligned with the characteristics of the acquisition and the financial profile of the firm.

The theoretical foundation of the thesis is based on four core frameworks: the Modigliani and Miller theorem, trade off theory, pecking order theory, and agency theory. The Modigliani and Miller proposition argues for the irrelevance of capital structure in a world without taxes, transaction costs, or asymmetric information. However, in real-world conditions characterized by market frictions, capital structure decisions play a critical role in value creation. The trade off theory supports the use of mezzanine capital by explaining how firms balance the tax advantages of debt against the potential costs of financial distress. Agency theory highlights the role of mezzanine financing in mitigating conflicts between managers and investors through governance mechanisms such as covenants, board rights, and equity participation. Pecking order

theory provides an additional perspective, suggesting that firms prefer mezzanine financing over equity to avoid adverse market signaling and ownership dilution.

The empirical findings of this thesis strongly support the view that mezzanine financing can improve acquisition outcomes when used strategically. One of the most significant results is that mezzanine structures offering deferred repayment mechanisms, such as payment in kind interest and flexible maturities, contribute to improved liquidity management during the post acquisition phase. Firms that utilized mezzanine financing structured around realistic cash flow forecasts achieved higher capital efficiency and stronger earnings before interest taxes depreciation and amortization growth in the years following the acquisition.

Another major finding is the positive impact of investor involvement in mezzanine-backed deals. Transactions that included active mezzanine investors with governance rights, performance oversight, and board participation were more likely to generate superior post acquisition performance. The data indicates that firms with active mezzanine oversight achieved higher returns on invested capital and lower default rates compared to firms with passive financing arrangements. This confirms the role of mezzanine financing not only as a funding mechanism but also as a governance enhancer, particularly in acquisitions that involve complex integration or strategic transformation.

Risk mitigation emerged as a third key success factor. The thesis finds that mezzanine capital is most effective when paired with robust covenant design, strong financial due diligence, and clear exit planning for investors. Acquirers that implemented stress tested repayment structures and well defined performance covenants experienced fewer instances of financial distress and maintained higher levels of operational stability. These findings underscore the importance of aligning mezzanine financing with the firm's earnings capacity and strategic objectives.

While tax efficiency remains an important advantage of mezzanine financing, the study cautions against relying solely on tax shields as justification for its use. Although the deductibility of interest payments lowers the effective tax rate and reduces the cost of capital, this benefit alone does not offset the risks associated with high leverage and

potential default. The findings confirm that tax benefits must be considered in the context of broader financial strategy, cash flow sustainability, and investor alignment.

Finally, the thesis identifies contextual factors that influence the success of mezzanine financing. Mezzanine capital is particularly effective in sponsor-backed acquisitions, mid-market leveraged buyouts, and cross-border transactions where flexibility, control, and tailored financing structures are necessary. In these settings, mezzanine financing enables acquirers to reduce dependence on equity and senior debt while maintaining financial agility. However, the use of mezzanine capital in volatile sectors or under weak governance conditions tends to correlate with higher risk and underperformance.

In conclusion, the thesis provides a comprehensive evaluation of mezzanine financing by integrating theoretical insights with empirical evidence. The most significant contributions include the identification of financial flexibility, investor participation, covenant discipline, and risk management as core drivers of success. Mezzanine financing proves to be a powerful instrument in acquisition finance when its use is guided by a well-structured and context-specific approach. Rather than promoting mezzanine capital as a universally superior form of financing, the study emphasizes its conditional effectiveness and the importance of aligning its structure with the strategic and financial realities of each transaction.

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While the content and analysis are entirely my own, I have used AI-based tools to assist with language refinement and proofreading.