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Use of Public Debt Mezzanine Instruments in the Czech Republic

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Abstract

This paper deals with use of public debt mezzanine instruments, which include participating bonds, subordinated bonds, convertible bonds and bonds with warrants, by non-financial corporations and financial corporations in the Czech Republic. It aims to analyse and evaluate use of mezzanine financing instruments in the form of public debt mezzanine by selected economic entities in the Czech Republic in 2006 – 2012, and identify factors affecting the scope of their utilization. The performed research implies that public debt mezzanine instruments are used in the Czech Republic marginally only. Within the monitored period, these instruments were issued in the total volume of CZK13.43bn (i.e. about EUR0.49bn), where subordinated bonds got a share of CZK13.26bn (i.e. about EUR0.48bn). The share of newly issued public debt mezzanine instruments in the total financial sources of non-financial corporations and financial corporations within the monitored period was on the top in 2009, when it amounted to 0.08%. Wider utilization of public debt mezzanine instruments is particularly prevented by the fact that potential issuers are afraid of high costs relating to the process of issuance, but also to the life cycle of such an issue, and they are also afraid of lack of interest of investors (in the case of subordinated bonds and participating bonds), the owners' fear of extension of control (in the case of convertible bonds and bonds with warrants), or the fact that it is difficult to estimate the cost of capital (in the case of participating bonds).

Keywords: Mezzanine capital, Public debt mezzanine, Participating bonds, Subordinated bonds, Convertible bonds, Bonds with warrants

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1. Introduction

The hard conditions of the today's turbulent economic environment place increased demands on all economic entities. The need for a quick response to changes is contingent on a sufficient volume of available financial sources. The financial market thus invents more and more new financial instruments to satisfy the changing needs of creditors, debtors, and investors. And mezzanine capital, in short just mezzanine, can be considered as an innovated financial instrument.

Although some mezzanine financing instruments were already launched in the USA in the 80's of the 20th century, in Europe in the 90's (Vasilescu and Popa, 2006), they still have not been used widely in a number of countries. In view of the fact that the paper authors specialize in the problems of the financial market in the Czech Republic, their attention is focussed on utilization of a selected group of mezzanine financing instruments in this country. In view of

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the European tradition of debt financing (Hobza, 2009; Hucka, Kislingerova and Maly, 2011; Svedik and Tetrevoa, 2013), the research was focussed on alternative financial instruments, i.e. public debt mezzanine instruments. The research question is to what extent these financial instruments are used in the Czech Republic and what facts affect the scope of their utilization.

It aims to analyse and evaluate use of mezzanine financing instruments in the form of public debt mezzanine by selected economic entities in the Czech Republic in 2006 – 2012, and identify factors affecting the scope of their utilization.

The benefits of this paper can mainly be seen in the fact that the given problems have not been dealt with by any other research so far, and that its outcomes can be used as a valuable source of information for international comparisons, especially on the level of the European Union.

2. Literature Review and Hypotheses

Mezzanine capital represents a hybrid form of financing combining the features of equity and debt (Welz, 2006; Konecny, 2013; Silbernagel and Vaitkunas, 2014). The name mezzanine has been derived from architecture, where mezzanine refers to an intermediate storey. As for the financial concept, it refers to a financial source that is inserted into a corporation's capital structure between the "floor" of equity and the "ceiling" of senior, secured debt (Anson, Fabozzi and Jones, 2010).

Mezzanine capital can have different forms, such as the forms of debt mezzanine and equity mezzanine (Meluzin and Zinecker, 2009; Volkmann, Tokarski and Grünhagen, 2010), or the forms of public mezzanine and private mezzanine (Vasilescu and Popa, 2006; Tetrevoa, 2009; Baker and Filbeck, 2013). Debt mezzanine represents mezzanine capital where the features of debt prevail (Meluzin and Zinecker, 2009; Mäntysaari, 2010; Volkmann, Tokarski and Grünhagen, 2010). Its instruments include participating loans, participating bonds, subordinated loans, subordinated bonds, convertible bonds and bonds with warrants (Svedik and Tetrevoa, 2014). Equity mezzanine represents mezzanine capital with prevailing features of equity (Meluzin and Zinecker, 2009; Mäntysaari, 2010; Volkmann, Tokarski and Grünhagen, 2010), and its instruments include silent participations and preferred stocks. Public mezzanine includes mezzanine financing instruments that are publicly tradable on the capital market, i.e. participating bonds, subordinated bonds, convertible bonds, bonds with warrants and preferred stocks (European Commission, 2007; Tetrevoa and Svedik, 2013). Private mezzanine includes mezzanine financing instruments that are not publicly tradable on the capital market, i.e. participating loans, subordinated loans and silent participations (European Commission, 2007; Tetrevoa and Svedik, 2013).

Public debt mezzanine instruments include participating bonds, subordinated bonds, convertible bonds, bonds with warrants. Participating bonds represent the type of bonds where the yield is specified as a predetermined share in the issuer's profits (Johnson, 2010). Therefore, the yield on this debt security depends on the issuer's economic result like the yield on common stocks. The above characteristics show the combination of debt and equity features, which is typical for mezzanine instruments. Subordinated bonds are bonds whose liabilities (the principal sum and appropriate interest) will be, in the case of bankruptcy, settled after settlement of liabilities towards any other creditors; with the exception of liabilities with the same condition of subordination (Iannotta, 2010). The reason why these bonds are classified as mezzanine financial instruments is their subordination typical for equity. Convertible bonds represent bonds connected with the right of exchange for preferred or common stocks of the given issuer at the time of the bond maturity, or as at any other preagreed dates, using a predetermined conversion rate (Fabozzi et al., 2008). In such a case, the rights connected with holding of a classic bond are combined with the right of exchange of this bond for property securities of the given issuer (Vesela, 2011). Bonds with warrants are bonds connected with the possibility of buying newly issued stocks of the given issuer (Poloucek, 2006). Even this is a case of combination of debt (due to holding of a classic bond) and equity (due to the possibility of buying stocks). The reason why the above instruments are classified as public mezzanine instruments is the fact that bonds usually represent a publicly tradable security (Tetrevoa, 2004; Tetrevoa, 2006).

Although mezzanine financing instruments represent instruments combining the features of equity and debt and it is possible to assume that they combine their advantages, which should result in the fact that they are used by economic entities to a significant extent, it is, on the other hand, also possible to expect that in the conditions of the Czech Republic the companies' aversion to use of publicly tradable instruments will prevail, as it was the case of classic bonds in the past (Tetrevoa, 2006). The reason for this aversion in the case of classic bonds can be seen in the

issuers' fear of high issuance costs (Valach, 2005; Tetrevoval, 2006; Svedik and Tetrevoval, 2012), but also in the fact that it is necessary to release a wider range of information. Therefore, we can formulate the following hypotheses:

H1: In the Czech Republic, public debt mezzanine instruments are used marginally by selected economic entities.

H2: Wider use of public debt mezzanine instruments by selected economic entities in the Czech Republic is prevented by the potential issuers' fear of high issuance costs.

3. Research Method

The paper draws on a secondary analysis, which aimed to draw up an overview of the present state of knowledge in the area of mezzanine financing instruments, focussing on their typology, characteristics, advantages, disadvantages, and risks. The secondary analysis was conducted in the form of a critical analysis of professional books, articles, conference papers, but also bachelor, diploma, and dissertation theses. The research team applied a multidisciplinary approach, where the analyzed secondary sources included sources from the areas of the financial theory, banking, corporate finance, or corporate economy. The research team also used the relevant statistics, e.g. of the Ministry of Industry and Trade of the Czech Republic and the Czech Statistical Office. At the same time, the choice of sources for literature research was influenced by the importance and currency of the given source. The secondary analysis was followed by a qualitative research, which was divided into two phases.

In the first phase, the research team analyzed and evaluated use of mezzanine financing instruments in the form of public debt mezzanine by selected economic entities in the Czech Republic in 2006 - 2012. The monitored economic entities were non-financial corporations and financial corporations within the concept of the classification of institutional units of the European System of Accounts – ESA 2010 (Eurostat, 2013). The other institutional units were disregarded due to the fact that they do not generate, or they cannot distribute, profit, and they also cannot issue stocks in the conditions of the Czech Republic, and so they could issue only one public debt mezzanine instrument, subordinated bonds. In view of the fact that there are no publicly available statistics concerning utilization of individual financial instruments, the information about utilization of public debt mezzanine instruments in the area of the Czech Republic were obtained through directed interviews with representatives of the Czech National Bank (CNB). The Czech National Bank is a regulatory institution without whose consent it was not possible to issue bonds in the area of the Czech Republic within the monitored period. In the case of a publicly offered issue, it was the bond prospectus what was subject to approval by CNB, in the case of non-public issues it was the bond issuance conditions. Three directed interviews, each about 50 minutes long, were conducted with employees of the Department of Securities and Regulated Markets in May and June 2013.

The second phase of the qualitative research was focussed on identification of factors affecting the rate of utilization of public debt mezzanine instruments by economic entities in the Czech Republic. The research was conducted in the form of directed interviews with representatives of selected commercial banks and organizations involved in financial counselling and mediation of financial trade mediating bond issues in the Czech Republic on the one hand and, on the other hand, with representatives of selected entrepreneurial entities. This qualitative research carried out with banking entities involved representatives of banks doing business in the area of the Czech Republic and ranking, in accordance with the CNB methodology, among large banks, i.e. banks with the total assets of over CZK250 billion, i.e. Československa obchodni banka, Ceska sporitelna, Komerčni banka and Unicredit Bank. The qualitative research carried out with consulting firms involved representatives of Broker Trust and WOOD & Company. From the point of view of entrepreneurial entities, the interviews were conducted with representatives of the companies which have issued the given mezzanine instruments, i.e. Ekorent and Orrero. These directed interviews were conducted from June until September 2013 and were 60 minutes long on average.

4. Results

As for utilization of individual mezzanine financing instruments in the form of public debt mezzanine, i.e. in the form of participating bonds, subordinated bonds, convertible bonds and bonds with warrants in the Czech Republic, the situation in 2006 - 2012 was as follows.

Within this period, two subordinated bond prospectuses were approved to Ceska sporitelna (a universal bank) and Wüstenrot (a building saving company). In this period, CNB also approved subordinated bond issuance conditions to Raiffeisenbank (a universal bank) and Ceska sporitelna (a universal bank), and to Ekorent (a company dealing with

financing private medical facilities in the form of a lease purchase or a loan). For more detailed information about the issues of subordinated bonds in the Czech Republic in 2006 - 2012, see Table 1.

In 2006 - 2012, no convertible bond prospectuses were approved. However, in this period CNB approved convertible bond issuance conditions to CONSTRUCT A&D, V. K. INVEST and Orrero. Company CONSTRUCT A&D deals particularly with mechanical vehicle anti-theft systems and in the monitored period it implemented in total two convertible bond issues, in 2006 and in 2007. Company V. K. INVEST operates in the area of lease of non-residential facilities and real estate and real estate administration and maintenance, and in the monitored period it issued convertible bonds in 2006. Company Orrero produces cheeses, and within the monitored period it implemented in total two convertible bond issues, in 2010 and in 2011. For more detailed information of convertible bond issues implemented in the Czech Republic in 2006 - 2012, see Table 2.

Table 1 Subordinated bond issues in the Czech Republic in 2006 - 2012

SUBORDINATED BONDS						
Issuer	Date of issue	Maturity date	Par value (CZK thousand)	Total volume (CZK million)	Yield	Comment
<i>Ceska sporitelna</i>	2/10/2006	2/10/2016	1,000	3,000	6M PRIBOR ^a + 0.45% p.a.	premature as at 2/10/2011, in the case of non-use, the yield increases to 6M PRIBOR ^a + 1.40% p.a. from this date on
<i>Ceska sporitelna</i>	12/3/2009	12/3/2019	10	2,000	5% p.a.	premature as at 12/3/2014, in the case of non-use, the yield increases to 6.5% p.a. from this date on
<i>Ceska sporitelna</i>	23/3/2009	23/3/2019	10,000	6,500	6M PRIBOR ^a + 1.50% p.a.	premature as at 23/3/2014, in the case of non-use, the yield increases to 6M PRIBOR ^a + 3% p.a. from this date on
<i>Wüstenrot</i>	29/1/2010	29/1/2020	1,000	500	5Y IRS CZK ^b + 3% p.a.	premature as at 29/1/2015, in the case of non-use, the yield increases to 5Y IRS CZK ^b + 4.40% p.a. from this date on
<i>Ceska sporitelna</i>	24/3/2010	24/3/2020	10	1,000	6M PRIBOR ^a + 0.40% p.a.	premature as at 24/3/2015, in the case of non-use, the yield increases to 6M PRIBOR ^a + 1.9% p.a. from this date on
<i>Ekorent</i>	1/7/2011	1/7/2013	1,000	10	6M PRIBOR ^a + 7.3% p.a.	
<i>Raiffeisenbank</i>	21/9/2011	21/9/2016	10	125	4.75% p.a.	
<i>Raiffeisenbank</i>	21/9/2011	21/9/2018	10	125	4% p.a.	yield specified for the first yield payment, for next payments from this date on yield specified as 6M PRIBOR ^a + 2.50% p.a.

Note: ^a6M PRIBOR (Prague InterBank Offered Rate) is the interest rate on loans which banks provide to each other on the Czech interbank market with the fixation period of six months; ^b5Y IRS CZK is the interest rate representing the average of the current quotations of the "Offer" rates for a five-year interest rate swap for the Czech crowns.

Source: Own

Table 2 Convertible bond issues in the Czech Republic in 2006 - 2012

Issuer	Date of issue	Maturity date	Par value (CZK thousand)	Total volume (CZK million)	Yield	Convertible into stocks
<i>CONSTRUCT A&D</i>	9/5/2006	31/12/2008	500	16.50	4% p.a.	preferred
<i>V. K. INVEST</i>	1/6/2006	1/6/2010	1,000	21.00	7% p.a.	common
<i>CONSTRUCT A&D</i>	10/1/2007	31/12/2008	500	24.00	4% p.a.	common
<i>Orrero</i>	10/3/2010	30/6/2013	5	78.74	average the CNB Lombard rate for previous 12 months + 2.5% p.a.	common
<i>Orrero</i>	15/6/2011	30/6/2013	5	26.24	average the CNB Lombard	common

					rate for previous 12 months + 2.5% p.a.	
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Source: Own

In the monitored period, CNB did not approve any prospectuses or issuance conditions of participating bonds or bonds with warrants, which means that these mezzanine financing instruments were not used in the Czech Republic in the monitored period.

For a summary overview of utilization of public debt mezzanine instruments by the defined entities in the Czech Republic in 2006 - 2012, see Table 3.

Table 3 Utilization of public debt mezzanine instruments by non-financial and financial corporations in the Czech Republic in 2006 - 2012

PUBLIC DEBT MEZZANINE (CZK million)	2006	2007	2008	2009	2010	2011	2012	Total
<i>Participating bonds</i>	0.00	0	0	0	0.00	0.00	0	0.00
<i>Subordinated bonds</i>	3,000.00	0	0	8,500	1,500.00	260.00	0	13,260.00
<i>Convertible bonds</i>	37.50	24	0	0	78.74	26.24	0	166.48
<i>Bonds with warrants</i>	0.00	0	0	0	0.00	0.00	0	0.00
Total	3,037.50	24	0	8,500	1,578.74	286.24	0	13,426.48

Source: Own

As Table 3 shows, subordinated bonds represent the most widely used public debt mezzanine instrument in the Czech Republic in 2006 - 2012. The total volume of this instrument reached, thanks to the bank issues, CZK13,260 million. The second most widely used public debt mezzanine instrument was a convertible bond, whose total volume in the monitored period reached CZK166.48 million. The remaining two public debt mezzanine instruments were not issued in the Czech Republic in the monitored period.

Table 4 shows comparison between the volume of newly issued public debt mezzanine instruments and the volume of financial sources of non-financial corporations (with 100+ employees) and financial corporations in the Czech Republic in 2006 - 2012.

Table 4 Comparison between the volume of financial sources and the volume of newly issued public debt mezzanine instruments from the point of view of non-financial and financial corporations in the Czech Republic in 2006 - 2012

FINANCIAL SOURCES (CZK billion)		2006	2007	2008	2009	2010	2011	2012
<i>Non-financial corporations</i>		3,403.80	4,065.00	4,191.50	4,204.60	4,972.00	5,381.10	5,785.10
<i>from that</i>	<i>Equity capital</i>	1,709.90	2,131.30	2,168.80	2,193.70	2,516.00	2,676.90	2,911.90
	<i>Debt capital</i>	1,631.40	1,910.60	1,979.90	1,918.80	2,354.40	2,610.50	2,771.80
	<i>Other</i>	62.50	23.20	42.80	92.10	101.50	93.70	101.40
<i>Financial corporations</i>		4,967.60	5,670.60	6,228.00	6,211.70	6,393.30	6,662.40	7,033.30
<i>from that</i>	<i>Equity capital</i>	533.80	641.00	808.60	722.30	866.90	929.50	1,047.70
	<i>Debt capital</i>	4,327.90	4,934.00	5,334.00	5,423.90	5,470.80	5,674.10	5,934.10
	<i>Other</i>	105.90	95.60	85.40	65.60	55.60	58.80	51.50
<i>Total volume of financial sources (CZK billion)</i>		8,371.40	9,735.60	10,419.50	10,416.30	11,365.30	12,043.50	12,818.40
<i>Total volume of public debt mezzanine instruments (CZK billion)</i>		3.04	0.02	0.00	8.50	1.58	0.29	0.00
<i>Share of public debt mezzanine instruments in total financial</i>		0.04	0.00	0.00	0.08	0.01	0.00	0.00

<i>sources (%)</i>							
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Source: (Ministry of Industry and Trade of the Czech Republic, 2013; Czech Statistical Office, 2014)

Table 4 shows that the rate of utilization of public debt mezzanine instruments by the defined entities was marginal in the monitored period compared to the total financial sources.

As for the reasons for the limited use of the mentioned mezzanine financing instruments, we can divide them into general ones – valid for all types of public debt mezzanine instruments, and specific ones – valid for particular types of public debt mezzanine instruments. The generally valid reason is the fear of the potential issuers of high costs relating to the process of issuance, where a significant part is represented by fixed costs. This means that an issue of public debt mezzanine instruments (i.e. bonds) does not become profitable unless reaches a certain volume. Moreover, a failure to allocate a bond issue would subsequently lead to serious financial impacts on the issuer as a result of the necessity of settlement of these costs.

The specific reasons from the point of view of subordinated bonds can be particularly seen in the unwillingness of economic entities to pay higher costs, which are required by this instrument, in combination with high issuance costs, and also the fear of lack of interest of investors resulting from the bond subordination.

From the point of view of convertible bonds, the reason for their limited use can be found mainly in the owners' fear of extension of the control over the corporation, accompanied by a decreased profit per stock resulting from an increase in the number of stocks. The same reasons also lead to non-utilization of bonds with warrants, where another reason resides in the fact that in the case of exercise of the option to purchase stocks, the issuer is obliged to continue with payment of the yield on these bonds, including their principal sum.

The reasons why participating bonds are not used mainly refer to the fear of companies of high interest connected with this financial instrument in the case of their rising profitability or, by contrast, the fear of lack of interest of potential investors, who might not be interested in this type of bonds due to the expected low return on the provided capital in the case of the issuer's bad economic results. Another reason resides in the fact that it is difficult to estimate the cost of capital acquired in such a way (from the point of view of the issuer) on the one hand and, on the other hand, the rate of return of such an instrument (from the point of view of investors). A significant reason is then the fact that an interest payment defined in such a way is not, in accordance with the legislation currently valid in the Czech Republic, a tax deductible expense, and so it increases the cost of capital.

5. Conclusion

The performed research implies that public debt mezzanine instruments (participating bonds, subordinated bonds, convertible bonds and bonds with warrants) were used marginally by non-financial corporations and financial corporations in the environment of the Czech economy in 2006 - 2012. H1 (In the Czech Republic, public debt mezzanine instruments are used marginally by selected economic entities.) was thus proved true. Within the monitored period, these instruments were issued in the total volume of CZK13.43bn (i.e. about EUR0.49bn), from which CZK13.26bn (i.e. about EUR0.48bn) went to subordinated bonds, and CZK0.17bn (i.e. about EUR0.01bn) went to convertible bonds. The above mentioned implies that participating bonds and bonds with warrants were not issued in the monitored period at all. The share of newly issued public debt mezzanine instruments in the total financial sources of non-financial corporations and financial corporations was, in the monitored period, reached the peak in 2009, when it amounted to 0.08%, and the second largest share was achieved in 2006, when it amounted to 0.04%.

A wider use of public debt mezzanine instruments is mainly prevented by the potential issuers' fear of high costs relating to the process of issuance, but also to the life cycle of the issue, and also the fear of lack of interest from the side of investors (in the case of subordinated bonds and participating bonds), the owners' fear of extension of control (in the case of convertible bonds and bonds with warrants), or the fact that it is difficult to estimate the cost of capital (in the case of participating bonds). So, H2 (Wider use of public debt mezzanine instruments by selected economic entities in the Czech Republic is prevented by the potential issuers' fear of high issuance costs.) was proved true. The performed research implies that this factor can be considered as deciding when finance managers are making decisions about potential issues in the case of any public debt mezzanine instruments.

The paper deals with utilization of public debt mezzanine instruments in the Czech Republic. Its limiting factor is the national orientation creating space for further follow-up surveys mapping utilization of these instruments internationally, e.g. within the European Union countries.

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