CORPORATE LIFE CYCLE

Funding Principles

Along the corporate life cycle, business risk declines, as product, market and management all prove increasingly robust. With diminishing business risk, a firm´s financial risk profile can gradually be stepped up, opening the possibility to increasingly rely on debt-related funding.

The life corporate cycle model can be useful to illustrate the phases of risks companies are going through during the stages of launch, growth, maturity, and decline: Whereby, the business risk is the risk associated with the nature of a particular business and the implementation of a specific competitive strategy. It deals with the volatility of operating cash flows (therefore excluding all sources linked to risks inherent in the firm´s funding structure).

A firm´s financial risk profile, on the other hand, relates in its most basic definition to its funding structure, the mix of debt and equity: Whereby it is important to understand that debt and equity have opposite risk profiles from the perspective of an investor vis-à-vis the perspective of an issuer (alas: a firm).

From the perspective of an investor, debt is of relatively low risk: The investor receives regular interest payments, the principle is to be redeemed at maturity and in the case of default the investor enjoys preferential treatment or can even grab certain assets right away.

From the perspective of an issuer, however, debt is of high risk, as it comes along with strict constraints as well as financial and other covenants, and these financial obligations have to be met as agreed. If not, a firm will default with potential devastating consequences. – Therefore: As debt hardly provides any degree of flexibility for the issuer, it is considered as high-risk from an issuer´s perspective. – Firms with a high level of leverage are therefore referred to as having a high financial risk profile.

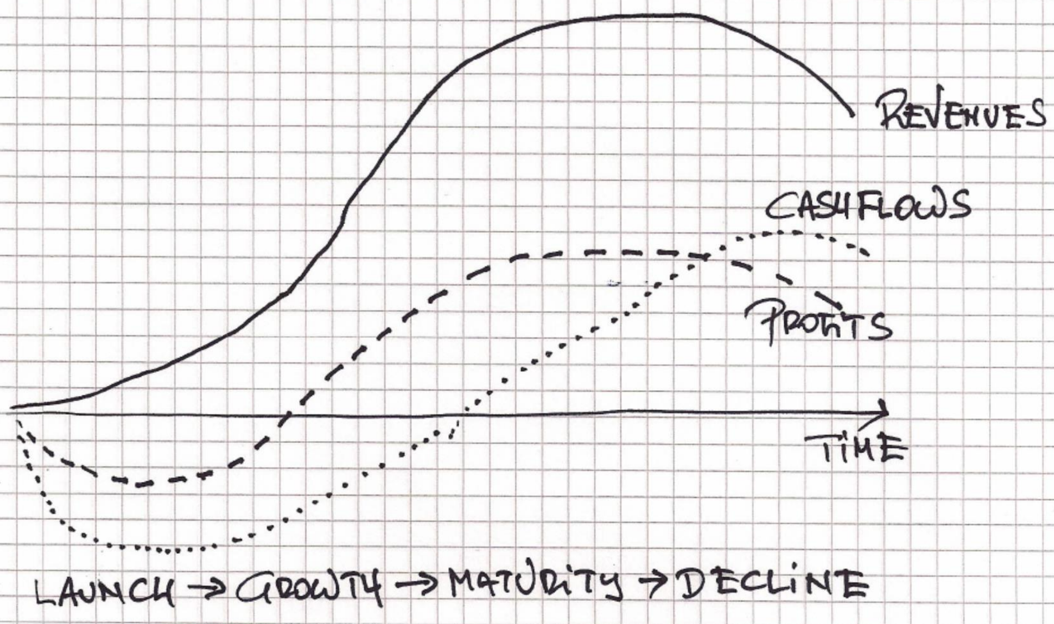
Equity, on the other hand, can be considered a low-risk funding instrument (whilst being a high-risk investment instrument from the perspective of its investor): To start with, the issuer has all flexibility upon whether to pay dividends or not. Also, it does not come along with any covenants. And finally, equity is a permanent funding instrument. There are no obligations to redeem it.

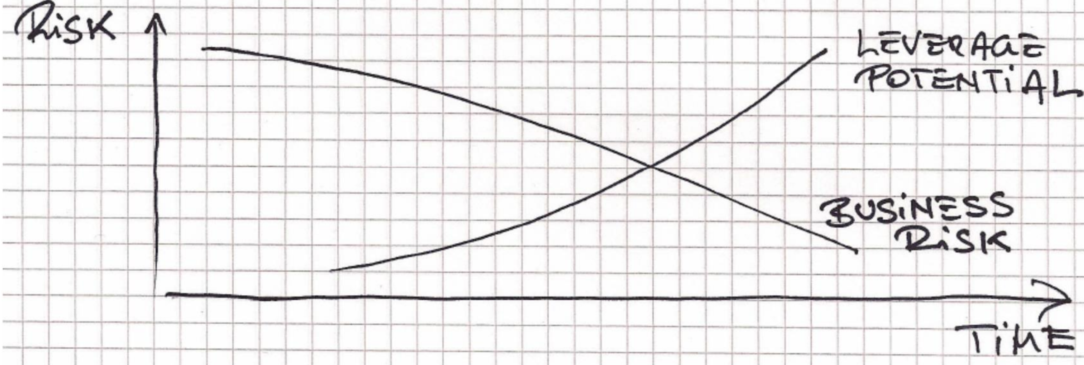
The funding mix needs to be specifically tailored to the phase and the circumstances a firm is in. For example, it would be inappropriate for a company with a high business risk to adopt a high-risk financial risk profile. Instead, in this case a low financial risk profile has to be adopted. As time passes by, the firm reaches more advanced stages and the business risk decreases, the funding mix can gradually be shifted towards a higher financial risk profile: This may include higher leverage as well as pursuing a dividend policy of increasing payouts.

Therefore, during its start-up phase a firm will be funded with equity only, such as by venture capital. Also, it will aim to keep its cost base as variable and discretionary as possible. Logically, dividends cannot be paid, as the firm seeks to immediately re-invest any available cash. - Hence, this example already vividly illustrates why there should be an inverse correlation between the business risk of a company and its financial risk profile.

A firm´s financial strategy is driven by the flows of funds into and out of it, which form the basis to generate profits, depending upon how efficiently a firm operates. These profits are then paid out as dividends or maintained as retained earnings. How much is subsequently available to shareholders will depend on the firm´s dividend policy. And this will be influenced by the stage in the life cycle a firm is in, determining the level of debt a firm has taken on, and the interest burden which results out of this.

Therefore, in running a business over time, management has to make the following finance-related decisions, which need continuous updating: How large shall the asset base be? How much of the company`s finance shall be as debt? How much of the profit shall be paid out in dividend (or how much shall be retained)? – And eventually overall: How much equity is required or should new equity be issued?





	DEBT	EQUITY
ISSUER PERSPECTIVE	HIGH RISK	LOW RISK
INVESTOR PERSPECTIVE	LOW RISK	HIGH RISK