CORPORATE LIFE CYCLE

Cost of Capital Optimization - Applied

Cost of Capital (CoC) is defined as the cost of the funds used to finance a business, usually a combination of debt and equity. Whereby, estimating the corridor for an optimal funding mix within the web of ever increasing Cost of Equity (CoE) as well as Cost of Debt (CoD) - along with adding leverage to a firm´s balance sheet – is indeed an art.

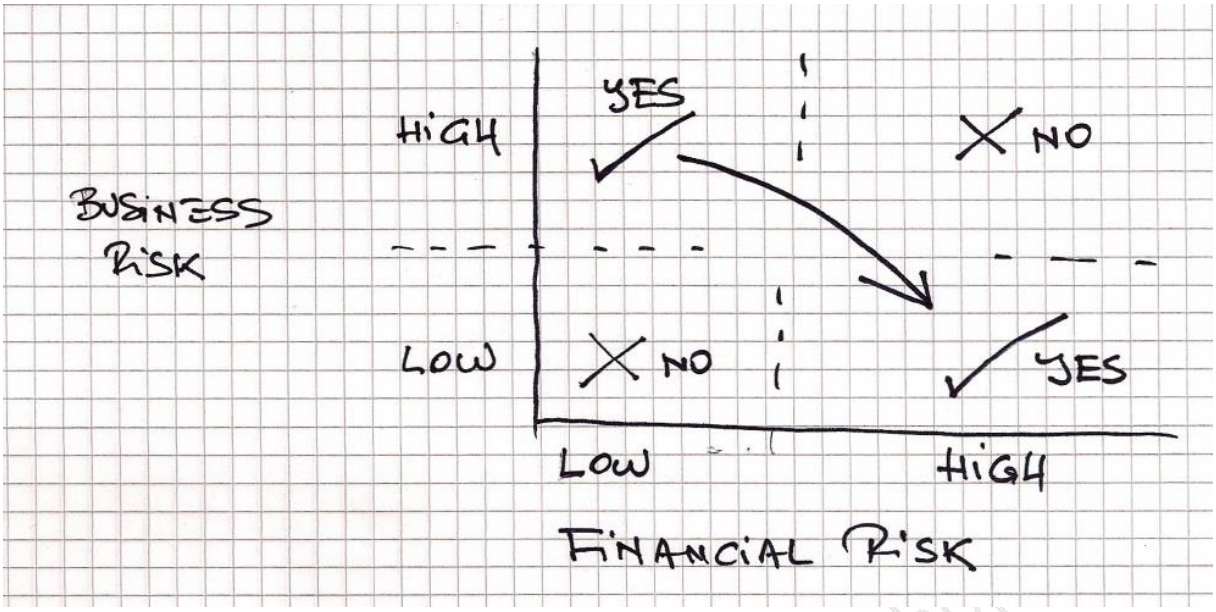
In tackling this issue, as an initial step the firm´s business risk has to be assessed. Only then one can move to determine the optimal funding mix. Thereby, one has also to be mindful that any determined funding mix would need to accommodate the risk-return expectation of current and future investor clusters in the firm. And, one has to also keep in mind that investors´ preferred investment themes, investment regions or risk appetite frequently change.

In the early stages of the corporate life cycle, equity is the appropriate funding instrument for a firm: Equity provides a maximum of flexibility (no requirement to pay dividends, no capital redemptions) and comes along with only a minimum of financial constraints and obligations. In a phase when the products of a firm, its markets or even its management team are all untested, the company will aim to retain as much cash as possible to fund anticipated losses as well as capital expenditures. Unknowns comprise among others: Will the product work? Will there be a market for the product, how big is it, how competitive, how long will it be around? Will management perform accordingly? – Investors will naturally foremost focus on the growth potential of the firm and are therefore interested in an increase of the share price. At this stage, dividends are irrelevant. In this early phase investors are mostly business angels, venture capital funds, maybe private equity firms.

As the firm reaches later growth stages and enters maturity, cash flows start rolling in. This progress towards stability allows the company to increasingly consider debt-related instruments for funding. Such instruments are – other than equity-related funding – associated with financial constraints and obligations (requirement to pay interest; redemptions; covenants) and are therefore regarded as high-risk funding for a firm.

But also the risk profile and appetite within the group of shareholders will change, latest when a company reaches the stage of maturity: Whilst in early stages shareholders are foremost focused on an increase in the share price, in later stages – as the firm has a lower level of business risk and generates healthy cash flows – the shareholder base will migrate to such investors who prefer cash dividends instead of steep share price increases. - Such shifts in the shareholder base of a company have to be managed carefully, otherwise a firm´s share price may be negatively impacted.

With the firm reaching late maturity or entering the phase of decline, the business risk has practically vanished, except that the speed of market deterioration is still a major unknown. In that stage less equity is required to support a firm´s strategy. Therefore share buy-backs as well as special dividends will be considered. – Having said this, excessive leverage in late stages can be risky, as the market may decline faster than anticipated, possibly compromising a firm´s debt capital-related redemption requirements.


YES
HIGH
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BUSINESS
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