CORPORATE LIFE CYCLE

Growth Stage Funding

As a firm grows, funding will still be foremost equity-related, but as the shareholder structure shifts towards more risk-averse investors, the firm can gradually assume a slightly higher financial risk profile.

During the growth phase a company is still confronted with a high degree of business risk, despite the launch of the firm´s product or service already successfully achieved. The key emphasis of the firm´s competitive strategy is now focused on marketing activities to ensure growth of sales as well as increasing its market share. Therefore, the firm´s financial risk profile still has to be low, pointing largely towards an equity funding strategy, with dividend payments at best being minimal.

Within the shareholder structure, one may observe a slight shift towards investors requiring a relatively lower return than the early stage investors, such as venture capitalists. Such transfer may be facilitated through an initial public offering (IPO) of shares on a stock exchange, provided the firm is IPO-fit. Alternatively, a private placement to a group of - primarily: private equity – investors may be considered.

Hence, some investors may want to seek an exit at a stage when the firm still requires substantial additional funding. This possible tension is usually addressed by implementing the instrument of a rights issue, whereby current shareholders are given a first right of refusal to participate in a share capital increase to avoid dilution. Current shareholders can – however - decide to waive their participation and sell their rights to new shareholders, whereby their respective stake is diluted. To enable such rights issues, new shares would have to be issued at a slight discount to the fair or (if the firm is already listed) the market value of current shares.

In the growth stage, cash generated will foremost be required for reinvestment: This includes funding the firm´s tangible and intangible asset base as well as working capital expenditures, but also potentially covering losses. Therefore, also in this phase equity investors will primarily be attracted by the prospects of anticipated high levels of future growth, which eventually may materialize, or not.

As the volatility of earnings is still high, this will also justify relatively higher cost of equity: Formally, this can be illustrated by a relatively higher beta factor as the key driver behind this dynamics. The (still) high level of business risk leads to a relatively higher market or systematic risk (benchmarked against the overall market). And this is due to high-growth businesses usually being stronger affected by changes (particularly adverse shocks) in the external environment than equivalent more mature and established ones. – In valuation terms this means that the relatively higher market-related risk results in a relatively higher discount rate to be applied on future expected cash flows.

On the other hand, amid the fact that the firm´s profitability has not yet reached its full potential, valuation parameters, such as the price earnings ratio, will be high. And equity investors will therefore primarily focus on the growth momentum of the share price. This, in turn, can only be justified by substantial earnings growth momentum driven by the aim for a dominating market share in a rapidly growing market.

BUSINESS RISK	HIGH
FINANCIAL RISK	LOW / MEDIUM
FUNDING INSTRUMENTS	EQUITY HYBRID CAPITAL (DEBT)
FUNDING SOURCES	PRIVATE CAPITAL MARKETS (PUBLIC CAPITAL MARKETS)
DIVIDENDS	LOW