Funding Principles

As progressing along its life cycle, a firm´s business-related risks gradually decline, with products, markets and management all proving increasingly robust. This enables a firm to increase its financial risk profile, by adding debt-related funding.

The model of the life cycle illustrates the spectrum of risk profiles a company assumes whilst going through the phases of launch, growth, maturity, and decline. Thereby, two categories of risk are particularly relevant in the context of the life cycle model: A firm´s business risk and its assumed financial risk.

A firm´s business risk is associated with the nature of a particular business and the implementation of its competitive strategy. As operating cash flows are a good proxy for a firm´s operational performance, the volatility of these cash flows are an equally solid indicator for its business risk. Not least, as operating cash flows are independent from a firm´s capital and funding structure.

A firm´s financial risk profile, on the other hand, addresses the risks associated with a certain funding structure, in its most basic form a mix of debt and equity: Whereby debt and equity have opposite risk profiles from the perspective of an investor vis-à-vis that of an issuer (i.e. a firm).

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

From an issuer´s perspective, however, debt is of high risk: Coming along with strict constraints as well as financial and other covenants, debt-related obligations and commitments have to be met as agreed. Otherwise, a firm may default with potentially devastating consequences, ultimately even cease to exist. – Therefore: As debt does not provide much, if any flexibility for an issuer, it is considered high-risk from a corporate´s perspective. – Hence, firms with highly levered balance sheets are regarded bearing high financial risk.

Equity, on the other hand, can be considered a low-risk funding instrument from a firm´s perspective, whilst for an investor it is a high-risk investment instrument: For instance, it is the issuer who decides whether dividends are paid or not. Besides, equity does not come along with any covenants. And, equity is a permanent funding instrument: There is no obligation to redeem it.

A firm´s funding mix needs to be specifically tailored to the life cycle phase and the environment a business is operating in. A company with a high business risk, for instance, requires low-risk funding. As time passes by, though, and with a firm reaching more advanced stages and its business risk decreasing, it may gradually assume a higher financial risk profile: In most cases this is reflected in a firm´s balance sheet´s higher leverage as well as in a dividend policy with increasing, higher payouts.

In contrast to this, a startup needs to be funded with equity only, such as provided by venture capital funds. Whilst aiming to keep its cost base low, besides as variable and discretionary as possible, no dividends will be paid, as a startup will instantly reinvest any cash available. - This illustrates why there must be an inverse correlation between a corporate´s business risk and its financial risk profile.

A firm´s financial strategy is therefore broadly determined by the consistency and quality of cash flows, both in and out. Whereby these should become ever more stable over a firm´s life cycle. Depending upon how efficiently a firm operates, cash flows provide the basis to generate profits, which are subsequently either paid out as dividends or kept as retained earnings. In a broader context, though, they will also determine the level of debt a firm can assume.

Hence, in running a business, over time corporate management has to make a range of finance-related decisions, requiring continuous updating, though, such as:

- What is the appropriate size of the firm´s asset base?
- How much (new / additional) funding is required?
- What is the optimal funding mix?
- How much of the profit shall be paid out in dividends (or be retained)?

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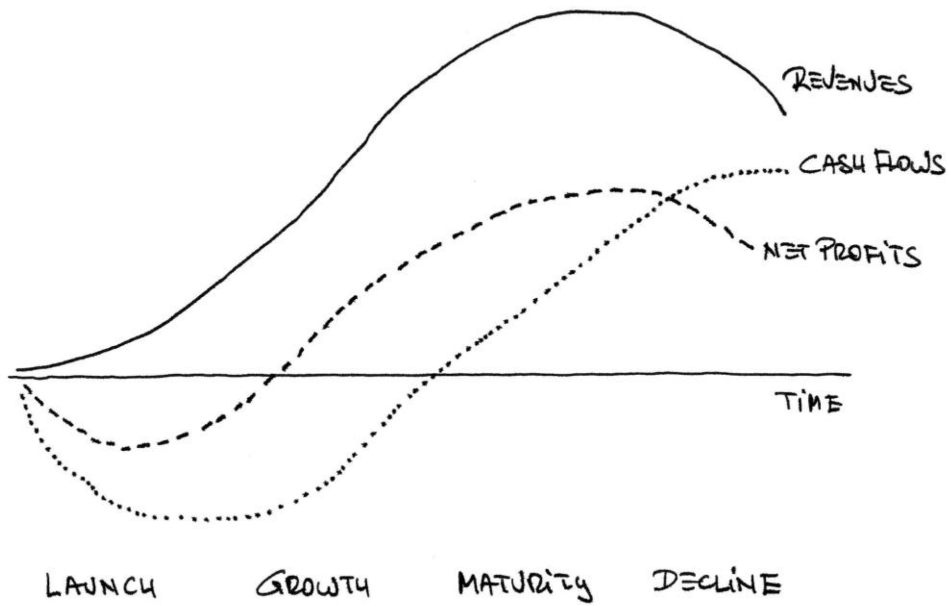
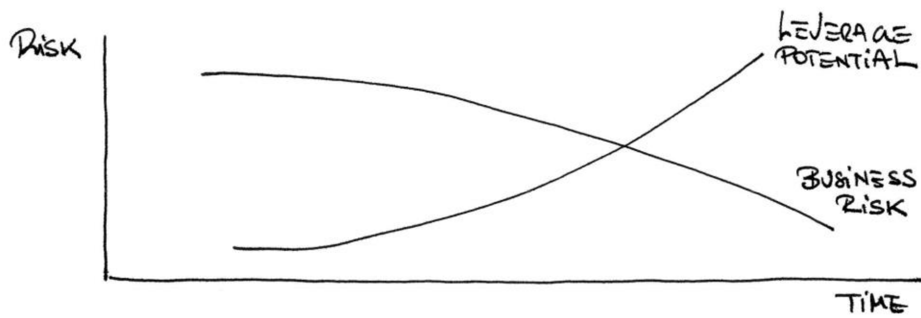
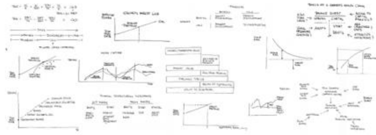




	DEBT	EQUITY
ISSUER PERSPECTIVE	HIGH RISK	LOW RISK
INVESTOR PERSPECTIVE	LOW RISK	HIGH RISK

For more concepts click on:



Corporate Finance Concepts

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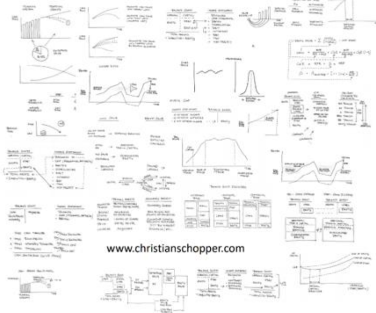

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