Cost of Capital Optimization - Applied

Cost of capital is the cost of funds used to finance a business, in its most basic form a combination of debt and equity. Whilst estimating the corridor of an optimal funding mix is relatively straightforward, its implementation is rather an art, though.

Once a firm´s business risk has been assessed, one can start with determining an appropriate funding mix: Estimating the corridor for an optimal capital structure is actually straightforward. Whilst the cost of capital of a firm´s unlevered balance sheet will equal its cost of equity, adding relatively lower-cost leverage will reduce average cost of capital. However, with both, cost of equity and debt ever increasing along with added leverage, average cost of capital will bottom out in a corridor (often in a 30/70 to 35/65 per cent mix of debt / equity, as of market capitalization), defining a firm´s optimal capital structure.

The implementation of that requires insights into the risk-return, such as dividend expectations of current and future investor clusters. Increasingly relevant, though, is a trend whereby investors follow very specific, by times actually even narrow investment themes: This can regard certain technologies, industries or geographies as well as specific stages in a firm´s life cycle, with investor risk appetite all too frequently changing.

In the early stages of its life cycle, equity is a firm´s appropriate funding instrument: Equity provides a maximum of flexibility (no requirement to pay dividends, no capital redemptions). It comes along with a mere minimum of financial constraints and obligations. In a phase when a firm´s products, its markets or even its management team are all untested, a startup will aim to retain as much cash as possible to fund expected and unexpected losses as well as anticipated 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? – Investors will naturally focus on a firm´s growth potential, are therefore foremost interested in an increase of its share price. At this stage, when dividends are irrelevant, investors include mostly friends and family, business angels, venture capital funds, perhaps private equity firms.

As a firm reaches later growth stages, eventually entering maturity, cash flows are increasing. Progress towards stability allows a company considering debt-related funding instruments. Such are, other than equity-related funding, associated with financial constraints and obligations (e.g. requirement to pay interest, more or less regular redemptions, covenants) and therefore regarded as high-risk funding.

However, risk profile and appetite among shareholders will change over time as well, latest when a company reaches maturity: During a firm´s early stages, shareholders are foremost focused on share price increases. With a firm gradually assuming lower levels of business risk, now generating healthy cash flows, its shareholder base will gradually migrate with a preference for cash dividends. - Such transformations need to be carefully managed, not least as larger blocks of shares may change hands with a firm´s shareholder composition moving towards more conservative, risk-averse investors.

Once a firm reaches late maturity, then entering the phase of decline, its business risk has almost vanished, except the speed of a market´s deterioration will remain an unknown. In that stage, only moderate levels of equity are required to support a firm´s strategy. Therefore, share buybacks as well as special dividends (exceeding net income generated) can be considered. Whereby, additional leverage in late stages may be implemented with caution, as a firm´s business could decline faster than anticipated, subsequently even endangering debt capital-related commitments, such as redemptions.

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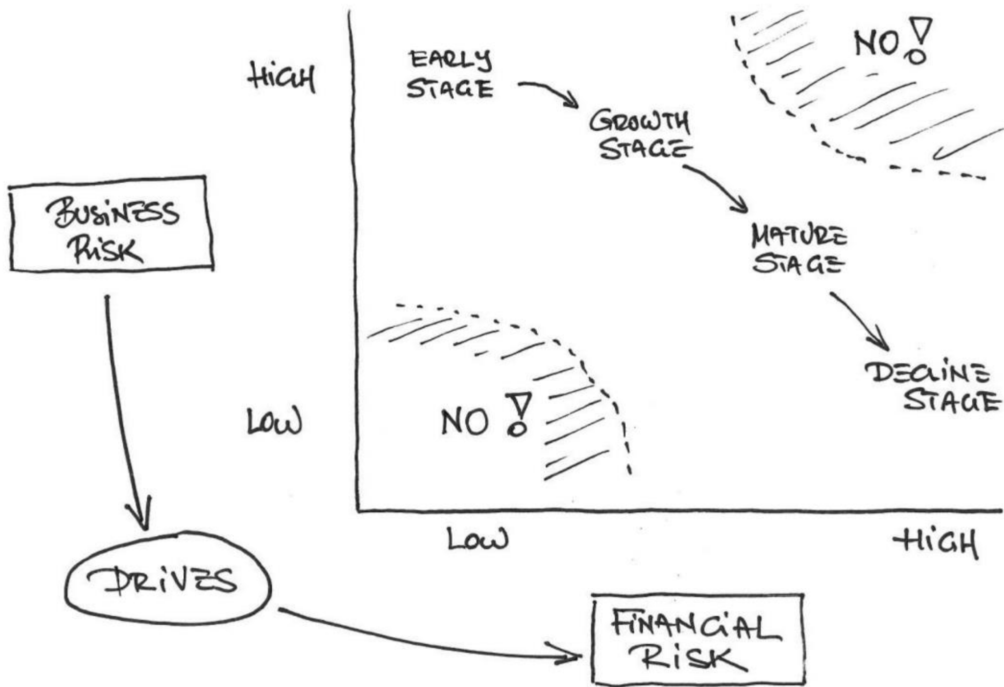

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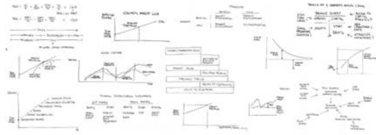

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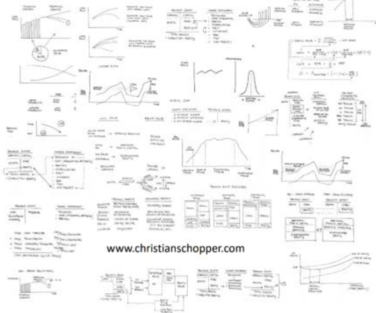

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