Funding Principles

Along a corporate´s life cycle, business-related risks gradually decline, as product, markets and management all prove increasingly robust. This development allows a careful, sequential increase in a firm´s financial risk profile, opening up the possibility to add debt-related funding.

The model of the life cycle illustrates the spectrum of risk profiles companies are assuming whilst going through the phases of launch, growth, maturity, and decline. Thereby, two categories of risk are especially 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 flow is 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 risk 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: It comes along with strict constraints as well as financial and other covenants, whereby all these financial obligations and commitments have to be met as agreed. Otherwise, a firm will default with potentially devastating consequences. – Therefore: As debt does not provide much flexibility for the issuer, it is considered high-risk from a corporate´s perspective. – Firms with highly levered balance sheets are therefore regarded bearing high financial risk.

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

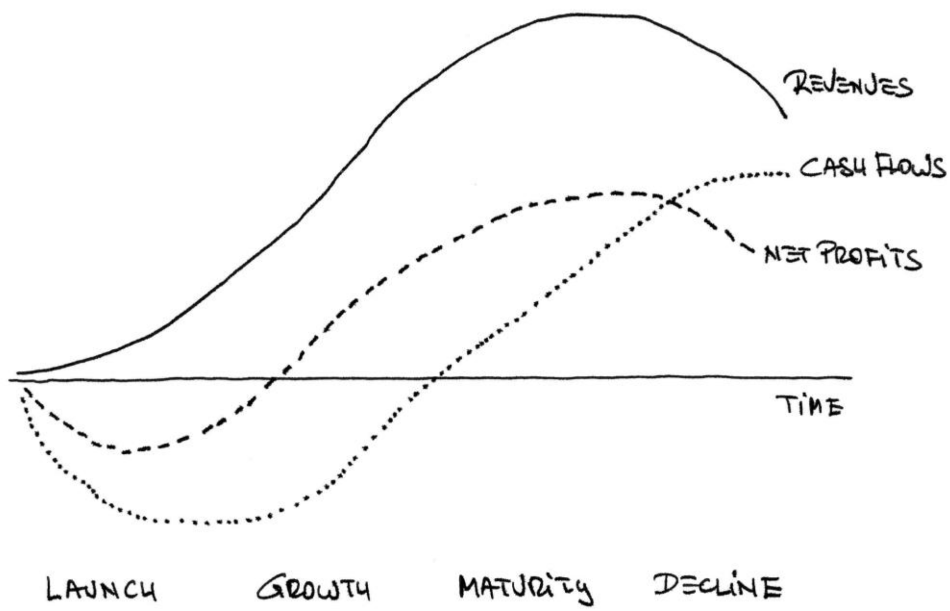
A firm´s funding mix needs to be specifically tailored to the phase and the circumstances a business is in. For example, a company with a high business risk requires low-risk funding. As time passes by and with the firm reaching more advanced stages and business risk decreasing, a corporate may gradually assume a higher financial risk profile: This will in most cases be reflected in a firm´s balance sheet´s higher leverage as well as pursuing a dividend policy with increasing payouts.

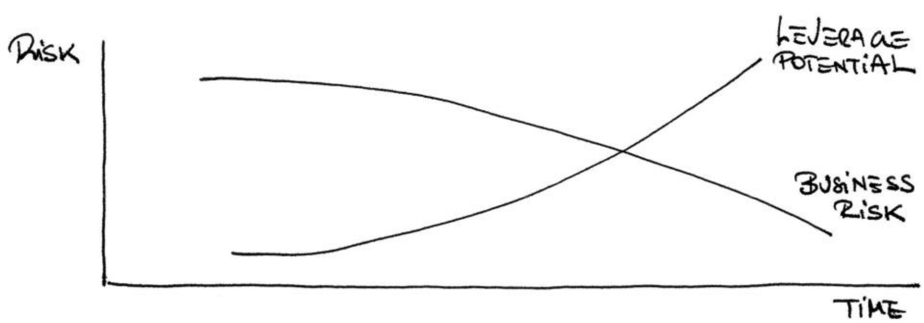
Therefore, during its startup phase a firm needs to be funded with equity only, such as by venture capital. Whilst aiming to keep its cost base as variable and discretionary as possible, no dividends will be paid, as the firm seeks to immediately reinvest any available cash. - This example already illustrates why there should be an inverse correlation between a company´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 of it. Such should become ever more stable over a firm´s life cycle. Depending upon how efficiently a firm operates, cash flows form the basis to generate profits, which are subsequently either paid out as dividends or kept as retained earnings in a firm. In a much broader context, though, they will also determine the level of debt a firm can take on.

Hence, in running a business, over time corporate management has to make a range of finance-related decisions, which require 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 funding mix to be composed of?
- How much of the profit shall be paid out in dividends (or how much be retained)?





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

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