## Cost of Capital Optimization - Applied

**Cost of capital is the cost of the respective funds used to finance a business, in its crudest 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 move on and determine an optimal 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 lower-cost leverage will reduce average cost of capital. However, with both, cost of equity and debt ever increasing along with added leverage, cost of capital will bottom out in a corridor, defining a firm´s optimal capital structure.

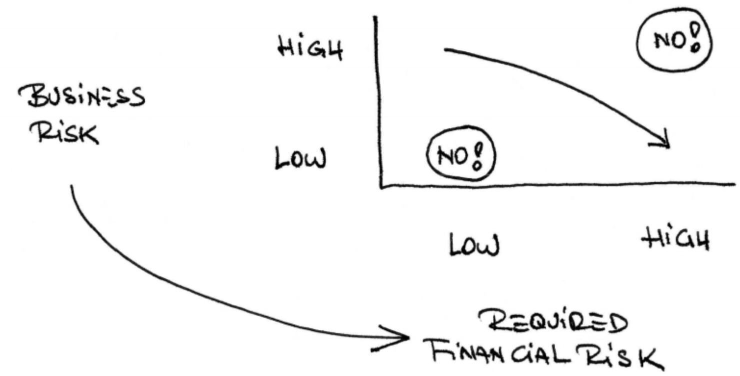
The implementation of that requires insights into the risk-return, including dividend expectations of current and future investor clusters. Increasingly important, though, is that nowadays investors follow very specific, even narrow investment themes, such as technologies, industries or geographies as well as focus at specific stages in a firm´s life cycle, with their risk appetite all too frequently changing.

In the early stages of its 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). It comes along with only a minimum of financial constraints and obligations. In a phase when a firm´s products, its markets or even its management team are all untested, the company 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 exclusively 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 the firm reaches later growth stages, eventually entering maturity, cash flows start rolling in. Progress towards stability allows the 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.

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

With the firm reaching late maturity, then the phase of decline, its business risk has almost vanished, except the speed of a market´s deterioration still a major 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) will be considered. Whereby, additional leverage in late stages may be implemented with caution, as a firm´s customer base could decline faster than anticipated, subsequently even endangering a firm´s debt capital-related commitments, such as required redemptions.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