Maturity Stage Funding

Companies reaching the stage of maturity benefit from a substantially lower level of business risk, justifying an increasingly leveraged balance sheet.

Even the maturity stage is not without business risk, such as potential aggressive (price) competition, perhaps due to excess capacity, or sales growth slower than originally anticipated. However, ideally firms enter the maturity stage with a commanding, solid market share based on previous investment and marketing activities implemented successfully during the previous growth stage. Nevertheless, some key issues remain, such as: For how long will the company be able to maintain its market share? How fast will the market eventually deteriorate?

With business risk substantially reduced, a firm can now assume a higher financial risk profile by increasing its leverage: Strong cash flows enable the firm to service significantly higher levels of debt. And, financial institutions feel confident, not least as the firm has now plenty of assets available which can also be pledged as collateral, providing additional comfort to lenders.

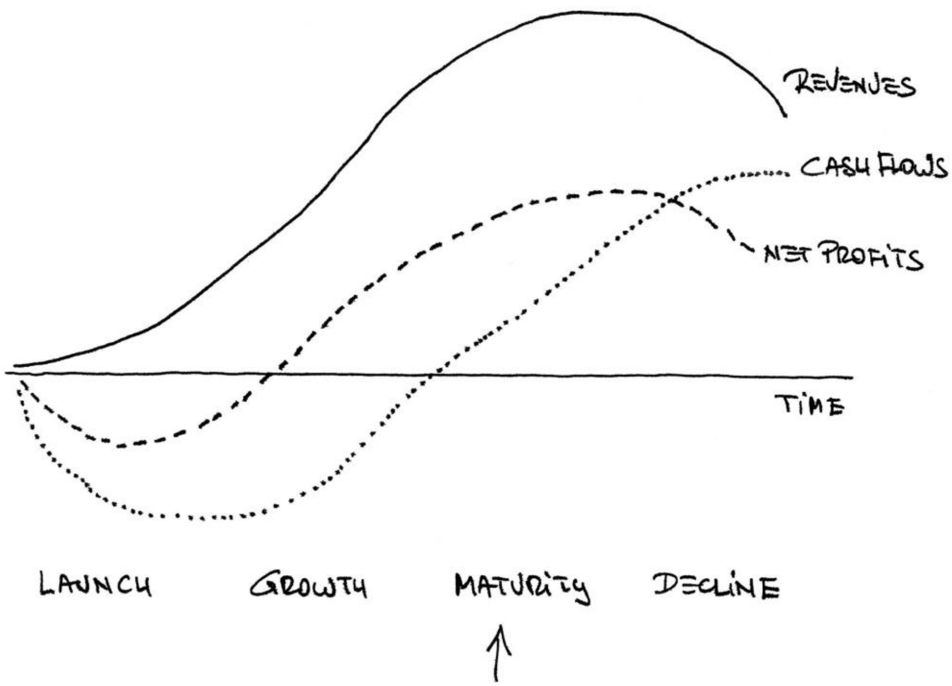
The firm´s enhanced debt capacity opens an opportunity to approach new, additional sources of funding. These could potentially even contribute to the value of the company increasing, as a wider range of lower-cost funding becomes available. Therefore, one of management´s tasks in this stage should be to optimize the firm´s funding mix of debt and equity.

However, observations indicate that management teams are often cautious in this regards: Executives have a tendency to favor strategic flexibility. Therefore, in quite some cases more equity (as well as cash) is kept than necessary, serving as cushion, despite the fact that the firm already operates in an environment of significantly reduced business risk. Such caution may lead to a firm seen by the capital markets as underleveraged. In ultimate consequence, such inefficient capital structure could attract suitors, especially financial sponsors, with the firm all of a sudden becoming an attractive takeover target, not least due to its significant debt capacity.

Having entered a mature stage, dividends can now be paid in full or at least increased handsomely compared to previous levels, as net cash flow will have turned healthily positive. This may also be due to the fact, however, that the number of attractive growth opportunities has diminished. Consequently, holding a larger amount of cash on a firm´s balance sheet can rarely be justified any longer.

The combination of rich cash inflows, but lower growth prospects will also be reflected in a lower price earnings ratio, later perhaps even followed by a gradually declining share price. Medium-term efficiency gains could moderate these trends. Combined, though, the net result of these forces are in most instances a considerably more stable share price.

In this stage, shareholders are foremost focused on dividend yield, lesser on capital gains. Therefore, shareholder composition may change once again, as growth investors give way to yield investors: Managing this transition requires a clear communication strategy vis-à-vis a firm´s investor base, outlining the altered market conditions and the position a firm is in.



MATURE STAGE

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

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