Decline Stage Funding

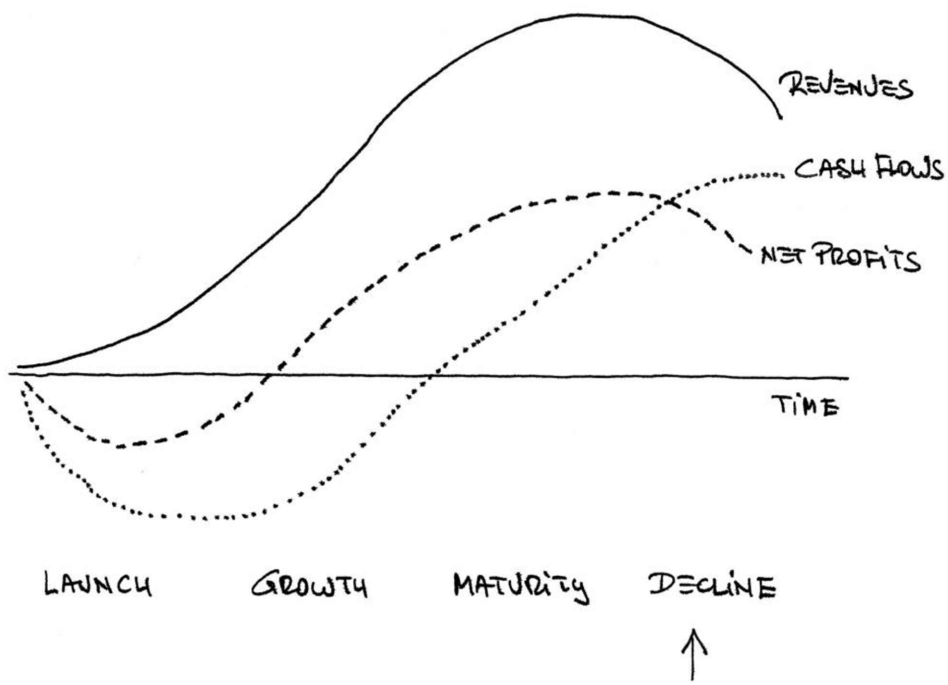
The only significant business risk of a company in decline is the length of this final stage, which in most cases is unknown. With its business risk low, the firm can now – at least theoretically - assume a high financial risk profile.

The core issue for a firm entering decline is: How much longer can or may business operations be maintained? - Therefore, management will focus on reducing fixed costs, avoid any additional long-term financial commitments, and concentrate on the short-term: For instance, any capital expenditure will have to be assessed by its payback period, rather than any (long-term focused) cash flow methodologies.

Theoretically, the firm´s low business risk would justify a high-risk funding strategy, as plenty of debt capacity should be avail. And, with operations not having significant funding requirements any longer, this additional debt capacity could also, among others, justify high dividend payout ratios. Such may even exceed net profits, as long as sufficient retained earnings are available. – Technically, excess dividends hand back capital to shareholders. Hence, they can be interpreted as a redemption of equity, an alternative to share buybacks.

In the capital markets and from a valuation perspective, the decline of the business will not only be reflected in a firm´s low price earnings ratio, but over time also lead to a declining share price. Such seemingly unattractive investment proposition can be mitigated by series of extraordinary dividend payments.

Typically, debt funding capacity is supported by future expected cash flows and earnings parameters to ensure that interest and redemptions can be met. However, in a firm´s decline stage, debt funding will foremost focus on realizable values of assets. This approach does not only justify lending at this stage, but may also markedly reduce the costs associated with a firm´s possible future financial distress. Hence, structuring of borrowings will likely focus on enabling lenders to take possession and realize value of their respective security swiftly, especially when the business no longer has an economically viable use for these assets.



DECLINING STAGE

BUSINESS RISK	LOW
FINANCIAL RISK	HIGH
FUNDING INSTRUMENTS	DEBT
FUNDING SOURCES	PRIVATE CAPITAL MARKETS (PUBLIC CAPITAL MARKETS)
DIVIDENDS	HIGH - EXCESSIVE

For more concepts click on: