Financing for Long-term Growth in an Integrating World Economy

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In the decade that followed the fall of the Berlin Wall in 1989, the world enjoyed a period of strong economic growth driven by two main factors – politics and technology. I mention politics first because this has been the key to reconciling large segments of world economy to modern capitalism. This, in turn, cleared the way for integrating Eastern Europe and Asia into the world trade system. The forces of integration combined with a period of rapid technological change to give a promise of rapidly improving living standards. While the world growth of the 1990's was followed by a slow-down in 2000-2001, the recovery is underway. I think the prospects are good for these same forces to give rise to sustained growth for quite a few years to come.

This period of economic growth brought with it not only excellent investment opportunities but risks as well. One may attempt to enter a market too early or too late. One may the develop the wrong products or technologies. And in making decisions about locating facilities political risks and organisational risks are inevitable.

As if all this is not enough to worry about, the growth-oriented firm must take care to get its finances right as well. For finance not the innocent handmaiden of growth. On the contrary, experience and recent research have shown that finance "matters". A firm that has developed a sensible strategy for expanding into a new market at the right time and with the right organisation may still run into trouble if it gets its financial structure wrong. In a growing economy the firm needs to think ahead when making its financing decisions.

The natural reaction of the firm wishing avoid financial difficulties is for it to adopt what it considers to be a "conservative" financial strategy. But what is "conservative finance" in a growing, integrated world economy?

"Conservative" is often taken to mean "borrow little." But to grow you need capital and you have little choice but debt or equity. (Most sophisticated structured financings can be viewed as bespoke mixtures of these two building blocks of finance). Firms are often reluctant to raise capital through the issue of new equity because this would increase its focus on short-term results and undermine the firm's ability to pursue its long-term growth strategy. Thus sometimes it seems borrowing is the only reasonable way forward. However, even if the firm is far away from its debt capacity so that it could easily borrow more, it should realise that this greater leverage may have an adverse impact on its growth at later times. In particular, if an investment opportunity arrives at a time when the firms' existing assets are not doing very well, the fact that the firm is highly indebted may reduce the expected return on equity for a new investment. That is, borrowing more now may put the firm on a lower growth trajectory in the long-run.

Similarly, a firm that is pursuing long-term growth will want to take a forward looking approach to managing liquidity. Often it may seem foolish to tie up the firm's resources in relatively low return liquid assets when there are projects available promising a higher return. In fact, this might be too short-sighted. For the opportunity of investing available funds now in a business venture must be weighed against the prospect of investing those funds later when an even better business opportunity may present itself. Furthermore, if one takes into account the high dilution costs from possible future distressed refinancings, keeping cash does not look so wasteful.

Finally, we point out that the growth-oriented firm needs to take the long view as well in thinking about its approach to risk management. A firm operating in different currency areas will face currency risks which potentially can be hedged using forwards and futures. For near-term cash flows that are fairly accurately predicted now, this may indeed make sense. But many of the most important risks for the growing firm are associated with long-term investments. In this context hedging with mark to market instruments may result in important fluctuations in cash flows. Consequently hedging and liquidity management needed to be considered in an integrated way. Rather than hedging long-term cash flows with financial derivatives it may make sense to develop self-financing growth strategies. For example, one can try to marry a cash cow in a currency area with growth opportunities in that same area. However, these cash cows need to be tightly controlled to assure that the cash is not diverted. Also, the firm must consider whether the cash cow will be a distraction that could bring with it a loss of focus.

In finance as in other aspects of guiding a growing firm in a fast-changing world, there are few simple answers. In order to weigh the pros and cons of alternative strategies, the firm needs to develop a vision about where its opportunities lie and about the principle factors shaping the business environment where it operates.