Our Commitment to Internally Financed Growth

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Since our founding in 1987, internally financed growth has been a foundational pillar of the Riverbridge investment philosophy. More than any other investment discipline we deploy, internally financed growth shapes our compelling downside protection in weak markets and contributes to the relative predictability of our investment returns. Despite its primary importance within our portfolio construction framework, few on Wall Street embrace this discipline. Many investors prefer more aggressive investment strategies applying leverage in hopes of achieving outsized returns. Like the Aesop fable, The Tortoise and the Hare, the predictable and steady returns of owning internally financed companies generally prevails over longer periods of time.

Internally financed growth is commonly defined as companies using profits or internally generated cashflows from operations as a source of capital. Every Riverbridge portfolio company has the ability to internally finance their growth. Several of our companies do utilize the capital and credit markets, but they all can finance a baseline level of growth through internally generated sources of capital. The alternative to internal financing is using outside capital to facilitate the growth of a business. When used properly, external capital may serve as an accelerant for growth. Borrowing from the credit markets is a popular option for all businesses due to its ease and its structure. Selling equity or a portion of the company to raise capital is also a common practice. Both, however, contain drawbacks.

In theory, external financing sounds appealing. Applying leverage during periods of economic strength can lead to superior returns. External financing allows companies to expand faster than they normally would have the ability. However, the risk profile of a company after accepting external capital changes dramatically. Should the macro environment deteriorate to an extent that suppresses demand for the product or service the company produces, debt and equity financing can have quick and forceful repercussions to the business. With debt financing, companies rely on cashflow from their operations to make its debt repayments. Many analysts will monitor a firm's debt coverage ratio which essentially measures the borrower's ability to repay its debt. Should a business applying debt leverage fail to grow or – worse yet – shrink, its inability to repay its obligation will prove costly and could ultimately trigger a default.

The current market environment highlights the risks of an excessive appetite for debt. The accommodative Federal Reserve policies following the 2008 financial crisis has effectively encouraged many companies – large and small alike – to borrow significant sums of money. Many firms used this "cheap money" to pursue an acquisitive strategy whereby they financed major acquisitions. Furthermore, in many instances, the acquirers were forced to pay more for their targets due to increased competition for deals caused by the abundance of capital. Today, many of these companies are coping with their levered balanced sheets and facing the prospect of rising interest rates. Venerable companies such as General Electric and AT&T are facing severe cash flow crises due to the cost of their debt service. They are being forced, in some instances, to sell off divisions or product lines to raise proceeds to satisfy their debt obligations. In addition to declining share prices, investors in these businesses have also suffered dividend reductions.

Companies making the choice to deploy outside capital make the intentional decision to sacrifice some control of their own destiny. Borrowing funds definitionally requires a sacrifice of future cash flows that now must be earmarked for debt repayment. Selling equity to the external markets cedes a portion of corporate control to an external party. This diminution of control may result in a loss of a board seat or some other form of corporate authority to an external equity holder. The most important loss of control by those seeking external capital is their assumption that this fountain of cash represented by external capital will remain available. Over the last couple of decades, we have witnessed periods of time when access to capital was severely restricted. Companies dependent on external financing during such periods are forced to decelerate or even halt their growth. Wall Street pressures companies to grow as rapidly as possible. Disciplined management teams have the fortitude to resist this pressure to ensure they have a sound capital structure.

Riverbridge remains committed to investing in companies that have the ability to internally finance their growth. Historically, the Riverbridge strategies have performed relatively well during more turbulent periods in the market. This downside protection emanates from our portfolio companies' ability to internally finance their growth, thus allowing for more predictable revenues, earnings, and returns on invested capital. Many investors do not emphasize internally financed growth as one of their disciplines because in most market environments external capital is readily available. Yet when access to capital is restricted, no investment discipline matters more.

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