# Sustainable Growth Rate

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One of the major problems for businesses is when they become successful and grow their sales (revenue or turnover).

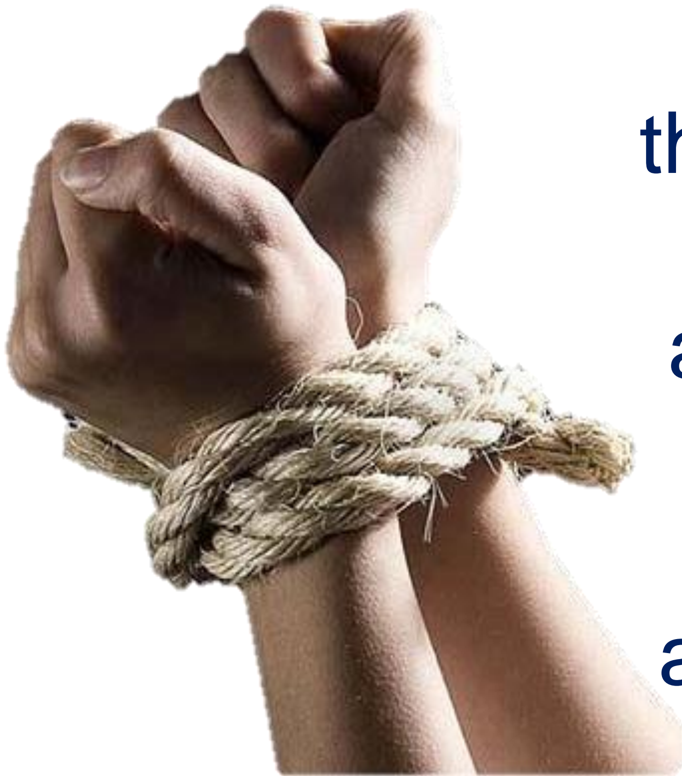
Sales growth, especially when it's significant and rapid, has implications for the funding needs of businesses.

The growth phase of a business’ life-cycle is the most dangerous phase because that’s when cash and capital are usually in short supply and funding for growth often comes from borrowed money.

But why does this growth become a problem for businesses – why don’t they simply grow at a pace that is suited to their available funding?

Because they want to grow as fast as the market will allow – if they see an opportunity for sales growth, they're going to take it – duh!

Owners are often unwilling to dilute their ownership or share their good fortune by issuing new equity – in the case of smaller businesses, they may not be able to issue new equity because of a lack of interested investors.



Companies may have a target capital structure (sometimes imposed on them by lending banks by way of loan covenants) and, sometimes, a target dividend policy to maintain so access to additional borrowing may be restricted anyway.

So, a business' sustainable growth rate is the rate at which it can grow its sales (revenue) without negatively affecting its balance sheet structure through increasing its debt.

There are four key elements in the determination of the sustainable growth rate that can be found in a set of annual financial statements;

- total asset turnover ratio (i.e. revenue or turnover divided by the total assets figure)
- leverage (i.e. total assets at the balance sheet date divided by shareholders' equity at the beginning of the accounting period, i.e. the equity figure from the *previous year's* balance sheet)
- net (income) profit after-tax margin (expressed as a percentage)
- profit retention rate (i.e. percentage of after-tax profits not paid out in dividends)

Let’s take a look at an example;

Say that the annual financial statements show the following;

| | |
|---|---|
| Revenue (turnover) | 1,500,420 |
| Total assets | 834,362 |
| Shareholders’ equity from previous year’s balance sheet | 524,775 |
| Net (income) profit after tax | 648,388 |
| Retained income (profit) for the year | 389,033 |

Then

$$\text{Total asset turnover ratio} = \frac{1{,}500{,}420}{834{,}362} = 1.80$$

$$\text{Leverage} \quad \frac{834{,}362}{524{,}775} = 1.59$$

$$\text{Net (income) profit after tax} \quad \frac{648{,}388}{1{,}500{,}420} = 43.21\%$$

$$\text{Profit retention rate} \quad \frac{389{,}033}{648{,}388} = 60\%$$

So, the calculation is;

1.80 x 1.59 x .4321 x .60

Which means that the business could have grown its revenue (turnover) by 74.2% without negatively affecting its balance sheet structure

However, keep in mind that this is a historical figure – it is the sustainable growth rate for the past financial period and is of limited value to lenders making a future-based decision.

Its major usefulness is in comparing it with the change in revenue (turnover) during the past financial period to determine whether the business did, in fact, manage to grow at least by its optimum level (i.e. at the sustainable growth rate) given its existing debt to equity structure.

So, to help with our risk assessment we need to gain insight into the *future* sustainable growth rate of the business.

How could we do this?

It’s simpler than you’d think!

You need to know two things;

- the shareholders’ equity figure from the most recent balance sheet
- the expected retained (income) profit for the current financial year.

Expressing the expected retained income as a percentage of the shareholders’ equity figure will give you the future sustainable growth rate for the current financial year.

The future sustainable growth rate is then compared to the anticipated growth in revenue (turnover) provided by the management of the business and………..

……….assuming that the working capital management practices do not change…..

If the future sustainable growth rate is higher than the anticipated revenue (turnover) growth rate, the balance sheet structure will not be negatively affected and additional funding for the growth will not, therefore, be necessary.

If the future sustainable growth rate is lower than the anticipated revenue (turnover)growth rate, the balance sheet structure will be negatively affected and you will need to calculate the financial gap.

What the future sustainable growth rate is not;

It is not a *limit* on the rate at which a business can grow its revenue (turnover).

It is not a indicator of *good or bad* rates of revenue (turnover) growth.

It is not the *ideal* rate at which a business can grow its revenue (turnover).

It is not the minimum rate at which a business *should* grow its revenue (turnover).