SUSTAINABLE GROWTH RATE

How Fast Should Your Company Grow?

Almost every business owner intuitively knows that their business can grow too fast even if the company is well managed during the growth period. Also, advisors to smaller firms have learned by experience that many firms that fail ***do*** so in the year of their highest sales. What is needed is the ability to calculate the rate of sales growth that a particular business can afford so that realistic growth objectives can be established.

Professor Robert Higgens of the University of Washington has developed a simple technique for calculating the **sustainable growth rate** (SGR) for a company that can be easily used by business owners and managers. Once the sustainable growth rate has been computed, management can see whether growth objectives are realistic, and incorporate techniques to find solutions when desired growth is higher than the affordable rate for the company.

The Model

To calculate your firm's sustainable growth rate using the Higgens approach, you will need the following financial information for your company:

P = Profit Margin on Sales After Taxes[1]
R = Percent of Profit Returned to Owners[2]
L = Debt to Equity Ratio[3]
A = Asset to Sales Ratio[4]

The model for computing sustainable growth rate is:

$$\text{Sustainable Growth Rate} = \frac{(P)(1-R)(1+L)}{A-(P)(1-R)(1+L)}$$

Financial data for a typical manufacturing business will be used to illustrate the Sustainable Growth Rate Model.

P = .055 (5.5%)
R = .333 (33.3%)
L = .88 (88%)
A = .73 (73%)

$$\text{Sustainable Growth Rate} = \frac{(.055)(l-.33)(1+.88)}{.73-(.055)(1-.33)(1+.88)} = 10.5\%$$

The actual growth rate for this company **should not exceed 10.5% of sales** given its existing capitalization structure.

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[1] P = Net Income / Sales
[2] R = Distribution to Owners / Net Income; Average for Wisconsin = 0.4
[3] L = Leverage = Interest Bearing Debt / Owner's Equity
[4] A = Total Assets / Sales

If a business owner wants to <u>grow beyond the sustainable growth rate</u>, the model may be used as a planning tool. The variables in the model include the decision areas that can increase the sustainable growth rate for a business. When management wants to grow ***beyond*** the sustainable growth rate of a business, one or a combination of the following actions should be considered:

1. Raise prices, or reduce expenses, and use the increased profit margin (P) to finance growth.

2. Reduce the profit returned to owners (R) and use the increased retained earnings to finance growth, i.e., invest in the business.

3. Make, or attract, an equity investment to finance growth.

4. Increase debt to finance growth.

5. Increase operating efficiency, and increase sales generated by existing assets, to support growth.

Once you have decided what variables can be changed for your company, recalculate your sustainable growth rate until you find the right combination of adjustments that will allow you to afford your growth objective.