Determining a sustainable growth rate

Here's a quick way to determine a sustainable growth rate using profitability, variable assets and variable liabilities:

First determine the company's net profit after taxes as a percent of sales. For example, if sales are $100,000 for a given period and profits $2,000, the number would be .02. This assumes all profits are retained in the business and not distributed as dividends, bonuses, etc.

Then add up all assets that tend to vary with sales levels. They might include cash, accounts receivable, inventory and prepaid expenses; they could also include equipment. If you are unsure of whether an asset varies with sales, include it. The effect will simply be to make your growth target more conservative. Express this number as a percent of sales, for example, if variable assets add up to $45,000 on sales of $100,000 the number is .45.

Now sum up variable liabilities such as accounts payable and any expenses accrued but not yet paid. Include only those liabilities that vary as sales vary, for example, don't add in any notes payable to the bank. If liabilities are $20,000 on sales of $100,000 they would be expressed as 20.

Using the formula below, determine the company's maximum sustainable growth rate without incurring new debt or taking on outside investment.

In this scenario, the company's growth is limited to 8.7 percent based on the relationship between the level of assets required to support those sales and the cash it is able to generate internally, i.e. from operations. Needless to say, a certain amount of frustration will set in if the market suggests sales could grow by 35 percent, for example, and the company is limited by financial constraints to 8.7 percent. With this wide a gap it is probably safe to say that, even after internal operations are tuned to free up the most cash possible, some amount of new debt and/or equity will be needed if the company is to expand.

You need a financial strategy to manage growth. This begins with an understanding of the interrelationships between growth, the assets needed to support it and the liabilities necessary to fund them. It means knowing that there are appropriate levels of debt in relation to a company's equity, industry norms and the cost of borrowing; that there are optimum debt-to-equity ratios (leverage) which will yield maximum sustainable growth; and that there are optimum growth rates to target based on a company's financial constraints. It means appreciating that these parameters can be determined with the help of advisors such as an NH SBDC business advisor, a banker or other financial professional.

Once known, they can be managed and monitored to ensure that, in the good times, a business is able to grow without putting itself at risk of bankruptcy.