HOW FAST SHOULD YOUR COMPANY GROW... HOW FAST CAN YOUR COMPANY GROW?

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Abstract

If you have got it... Flaunt It : If you haven't got it... Try to get it : If you can't get it . Get out.

1990 onwards, marked the transcendence of India, from a closed economy to a liberalized one. Another decade will see the full process of globalization and liberalization truly unfold. The ripple effects... felt by corporate India...led to a change... a change in the picture that corporate India now represented. This change is still in the unfolding process.. however, thus emanated the need of the hour.. Business sustainability, which went hand in glove with corporate growth... Key questions thus emanated : How fast should a company grow ? or How fast can a company afford to grow?

Introduction

What comes to mind when one hears the phrase "Fast growth" is probably a company which serve markets, that has seemingly inexhaustible appetites for its products. Limitless lines of investors and spiraling stock prices are usually part of that image. Starting a business requires cash .. yes we all know that, and growing business requires even more. A big challenge for corporations growing or established would be to strike that **proper balance** between **consuming cash** and **generating it.**

Few understand that a profitable company that tries to grow too fast can run out of cash even if its products are great successes. "Forty Five Minutes" is a short video that encapsulates what excessively fast growth without the appropriate sustainability pillars in place can do. This video is about the hellish, short lives of broiler chickens that have been genetically engineered to put on weight faster than normal chickens . The poor creatures had trouble standing on their spindly little legs, whose growth did not keep up with their bloated bodies. The message is clear.. **Grow .. but grow sustainably.. grow fast, but how fast ?** Many corporations today, operate under the assumption that there is no limit to growth, as long as sales increase . Growth, however, can easily outstrip a company's financial resources. The key for corporations today is to determine an **"Affordable Growth Rate".**

Another dimension less thought of is the "Humanistic angle". To begin with, people want to work with high growth companies in order to further their career prospects, if the growth isn't there the talent will go elsewhere. Moreover, if a company is thinking of going public a growth rate of 10% is the least expected. The earlier paradigm of privately held companies with 25 or fewer employees and whose growth was steady doesn't work anymore, as today markets place a high premium on high growth. "There's too much money out there, too much consolidation, in addition to an explosion in Information Technology". This in turn is what is

dragging a lot of traditionally oriented companies today.

One thing seems clear in today's economy, growth seems more random and more unexpected than ever, So perhaps a fitting response to that reality is that companies must find a way to plan for that random growth.

Corporate executives are at times concerned only about financial growth of their companies. After all, making money, is the one concrete way the world tells a company whether it's doing things right. Moreover, if a company stops making money, it may stop altogether.

All kinds of corporations today dot the corporate landscape:

- High growth companies
- Some that lack the financial resources to fully exploit available product market growth opportunities
- Those that don't have opportunities adequate to match their financial capacity

Financial Resources and Product Market Opportunities help determine how fast a company can grow, but given those two ingredients, How fast should a company grow? And is growth always important? From a shareholder's perspective growth is desirable if it adds value to his stock, and this is a thought shared by most noted economists too. What is interesting, is to understand under what circumstances does growth add value to a company's shareholders.

Exploring the realm of shareholder value, when the company creates a positive spread, between its return on equity and its cost of capital . In simple terms, this would mean that the company is generating profits that exceed what investors would require from companies in the same class of risk . Value is also added to shareholders through tapping growth opportunities, at a positive spread. Yet, one must also keep in mind that if the spread turns negative which would entail the ROE being lower than the cost of capital, faster the company grows, the faster will be the destruction pace.

Management should thus evaluate the outcome of strategic decisions for all business units, including those that create shareholder value. Such an evaluation either confirms the current growth strategy's validity or points out better alternatives. At the very least, evaluating the implications for shareholder value, contributes to a better understanding of the assumptions on which current strategy is predicated and prepares top management to respond strategically to future developments.

An examination of the interaction between Inflation, Capital Costs, Profitability, Growth and the Market Value of a company's common stock, provides a further insight.

Inflationary Impact

Inflationary Impact is important on corporate growth patterns. Assume that the expected inflation rate is say 1%, and if investors demand a 9% real return for investing in your company. If your company expects to earn a 10% ROE, on an capital base of say Rs 100, it will find the capital valued in the market at Rs 100. This is because equity returns and equity costs are exactly equal, therefore as seen the market value represents 100% of book value.

However, if the long term inflation expectation rise from 1% to 11%, and your company's anticipated ROE stays at 10%, how can investors achieve adequate returns ? By driving down the equity value to Rs 50. Inflation, directly effects the cost of equity capital for a company. Investors act to protect the purchasing power of their assets, by pricing securities at levels that would cover inflation and at the same time produce a real return consistent with the risk assumed in owning a share of common stock.

This brings us to two key thoughts : A forecast of future inflation and a return commensurate with acceptance of a certain level of risk. What return

matches what level of risk, is also affected by the key paradigm, that risk " differs from industry to industry, and within industry it differs from player to player". Is risk systematic or unsystematic ? Ponder .. Well simplifying systematic risk, means a risk which cannot be avoided, e.g. the movement of interest rates in a country. However, unsystematic risk is a risk which is avoidable, for e.g. don't invest in a company, if you feel that sector outlook, or company outlook is bleak . Thus when we talk about a return commensurate with the amount of risk taken, what we are really looking at is systematic risk, the return of bearing which is called BETA FACTOR, in financial parlance.

Travelling back to our earlier case, of an investor who expects a 9% real return for investing in your company. Now, if this investor harbors long term inflation expectations of 10% (11% - 1%), taking this into account, the cost of equity capital for your common stock of average risk ought to roughly 19%. (This would be equal to an expected inflation rate of 10% + risk premium of 9%)

Profitability and growth

Assume we have four companies, each with a growth rate just fast enough to stay even with inflation nominal terms, they grow at 10% every year, BUT they are not growing at all in real terms. Their return on equities differ, and each follows a particular kind of investment opportunity.

Company 1 : Say, I Invest Rs 100 in this company, which is offering a 25% return on equity . The profit yield is Rs 25. As there is no opportunity for real growth, I would need to reinvest Rs 10, in order to support a 10% nominal growth during a time when inflation is 10%. This allows Rs 15 as dividends. We continue this till such time as returns no longer exceed the cost of equity capital say 20% now. Then the company liquidates and returns the accumulated book value to investors. On calculation of the present value of dividends and final liquidation payment is Rs 129 . I as an investor have earned Rs 29 more than my initial investment of Rs 100. **Thus this company has earned a rate of return for me far exceeding its equity capital cost. Every rupee of capital invested has yielded Rs 1.29 in terms of market value to the shareholders, helping their cups brim over…**

Company 2: Now let us hop across to a company giving me a return on equity of only 10% on my Rs 100 investment. As there is no opportunity for real growth, I would need to reinvest Rs 10, in order to support a 10% nominal growth during a time when inflation is 10%. This allows NIL dividend, since financing the inflation induced growth absorbs all the profit. Finally on calculation, final liquidation payment is less than my initial Rs 100 investment. **This company earned a rate of return far below the cost of equity capital. The company may describe its 10% sales growth as progress, but in fact, this was entirely due to inflation (we know…). Thus we see, this company's need to retain and invest capital has actually destroyed shareholder value**

Corporate valuation versus growth paradigm

Poor Performing companies tend to have rates of reinvestment far higher. Naturally, this reinvested money is used either for issuance of stock aimed at the company's diversification, or to fund attempts of profitability enhancement of existing sagging businesses.

Looking the other way, there are cases where high rates of reinvestment, would greatly add to shareholder value, yet the reinvestment rates are highly restrained.

Travelling back down history lane, I can't help but remember the classic story of Xerox. The year 1972 was a time when Xerox corporation was at its peak, ten years later come 1982, things had reversed a whole 180 degrees. At this time investors may have evidently believed that Xerox could not in future achieve an ROE equal to its cost of capital. **Why this bleak picture in the minds of investors ? You would wonder…**

During the 1970's, Xerox's highly profitable franchise in the copier market came under attack from rising competition form U.S Federal Trade Commission, IBM as well as the Japanese. The erosion of profitability in their core area of operation, manifested by a disastrous history of acquisitions, led to their downfall come 1982.

Coming back to our initial question,
How fast should a Company grow, and under what circumstances does growth add value to shareholders?

The answers to both these questions are balanced on the pretence of whether future profitability (Return on Equity) exceeds or falls short of the cost of equity capital. If the ROE> Cost of Capital, higher the growth, the better. But inadequate profitability coupled with a need, to do nothing more than growth just equal to inflation, can lead to disastrous implications. If a company cannot improve profitability, maybe they could think of divesting their negative contributing products from their product portfolio's. Profitability, thus is the key to value.

Another interesting dimension is calculating an organization's "Self financeable growth rate", taking into account three critical factors :

(a) A Company operating cash cycle (the amount of time a company's money is tied up in inventory and other current assets before customers pay for goods and services)
(b) The amount of cash required to fund each dollar of sale
(c) The amount of cash generated by each dollar of sale

Managing some, or a combination of these factors would lead to being able to determine a balanced self financeable growth rate for companies.

At the end, we know that speed is critical for success: " You have to grow quickly, or others will beat you at your game", yet companies must take care as speed can undermine quality and fiscal discipline . It is vital to keep in mind, in today's highly competitive liberalized scenario that not only is it important as to how fast the company grows, but also in this era of mergers and acquisitions, how successfully can one shepherd ones company before handing it over to others is vital as well. It is the best way you can in a volatile economy, and whatever strategy works best in achieving the aim is the right one.
To conclude success in business is growing not only at the "Right Pace but also in the Right Manner".

REFERENCES

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