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SUSTAINING GROWTH

How to Avoid Growing Yourself Out of Business

You are an entrepreneur.

You are well versed in managing suppliers, customers, employees, and if you are lucky enough to be growing, managing your own company's growth. Rapid sales growth is one of those "problems" many wish they had. But if not managed, it can damage or kill a company's future as easily as slumping sales.

You have heard the high-growth stories. Large companies like Google, Twitter and Facebook grab headlines with huge sales growth without even the suggestion that growth needs to be managed. In fact, in these instances it probably doesn't. But unless your production costs are near zero and your working capital investments are self-funded (like the above), you have to manage growth or watch your capital structure weaken, which inhibits the opportunity to reach your vision.

The simple accounting measurement of Return on Equity (ROE = Net Income/Owners' Equity) provides a decent proxy for how much top-line growth your company can sustain. **You can grow the top line at a rate that approximates your ROE, assuming:**

- Sales growth offers similar gross margins as existing sales
- No changes in working capital requirements
- Steady debt/capital ratio

The "Return" (i.e., net income) must be retained by the business to fund the expansion. Most small business owners take out over half of the earnings produced by the company just to pay taxes. Thus, the ROE calculation, for purposes of determining growth capacity, has to be adjusted to reflect this. This simple calculation (Net Income less Distributions (including shareholder loan repayments)/ Owners' Equity) is called Retained ROE.

TABLE A – STEADY GROWTH	YEAR 1	YEAR 2	YEAR 3
Sales	$20,000,000	$22,000,000	$24,200,000
Growth Rate	10%	10%	10%
Net Margin	$1,000,000	$1,100,000	$1,120,000
Net Margin	5%	5%	5%
Owner Distribution	60%	60%	60%
Dollars to Owner	$600,000	$660,000	$726,000
To Retained Earnings	$400,000	$440,000	$484,000
ROE	10%	10%	10%
Spending (excess of Depreciation/Sales)	1.0%	1.0%	1.0%
Net Spending	$200,000	$220,000	$242,000
Net Working Capital Investment	$4,109,589	$4,520,548	$4,972,603
Bank Line of Credit	$2,000,000	$2,190,959	$2,402,014
Debt/Capital*	33%	33%	33%
Shareholder Equity	$4,000,000	$4,440,000	$4,924,000

*Interest-bearing debt/interest-bearing debt plus equity

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As an example, referring to Table A – Steady Growth, Company XYZ ends Year 1 at $20 million in sales with book equity of $4 million and $2 million in bank debt. Company XYZ earns pretax margins of 5% (i.e., $1,000,000), which is about average for U.S. manufacturing companies. As a Subchapter S corporation, the taxes are the owner's responsibility. In order to pay the taxes and offer some cash return to the owners, 60% of pretax margin is distributed, leaving only 2 percentage points in the business for growth and investment. Company XYZ's Retained ROE is 10%, (i.e., in Year 1 (($1,000,000- $600,000)/$4,000,000) = 10%). In this example, we held all working capital requirements steady relative to sales and forecasted a capital spending plan in excess of depreciation equal to 1% of revenue. If your company is experiencing any real revenue growth, it is also likely experiencing real spending growth as well.

In Table A, we see Company XYZ can sustain top-line revenue growth of 10%, accommodate capital spending, and fund working capital growth—all without changing its debt/capital ratio. In fact, it improves slightly. Additional working capital financing requires additional funding, but debt-to-capital levels are maintained at the same 33%. This is because additional debt is being matched proportionally with retained earnings, leaving the capital structure at a similar level of leverage or risk even though debt increased by $400,000 by Year 3.

TABLE B – EXPLOSIVE GROWTH	YEAR 1	YEAR 2	YEAR 3
Sales	$20,000,000	$30,000,000	$45,000,000
Growth Rate	10%	50%	50%
Net Margin	$1,000,000	$1,500,000	$2,250,000
Net Margin	5%	5%	5%
Owner Distribution	60%	60%	60%
Dollars to Owner	$600,000	$900,000	$1,350,000
To Retained Earnings	$400,000	$600,000	$900,000
ROE	10%	13%	16%
Spending (excess of Depreciation/Sales)	1.0%	1.0%	1.0%
Net Spending	$200,000	$300,000	$450,000
Net Working Capital Investment	$4,109,589	$6,164,384	$9,246,575
Bank Line of Credit	$2,000,000	$3,754,795	$6,386,986
Debt/Capital*	33%	45%	54%
Shareholder Equity	$4,000,000	$4,600,000	$5,500,000

*Interest-bearing debt/interest-bearing debt plus equity

To explore the impact of a significant growth spurt, Table B – Explosive Growth increases sales growth to 50% in Year 2 and Year 3 without changing any working capital relationships. Net margins remain the same as in the first example (a simplifying assumption, as net margin would actually have to improve at the operating level to at least cover interest expense).

Earnings nearly double from $1.1 million in Year 3 in Table A to $2.2 million in Table B. ROE actually improves from 10% to 16% over the three-year period. There is sufficient cash flow to fund capital spending, but increased funding to support working capital adds $4 million in bank debt and 21 percentage points to the Debt/Capital ratio. At this point, your lender has more capital invested in the business than you do.

Everything in this scenario can be seen as positive: Margins were maintained at good levels, and both receivables and inventory were well managed. But Company XYZ lost control of its capital structure. The additional debt service adds a fixed expense to Company XYZ, and earnings volatility will increase as a result. Additionally, you now have an unintended, and perhaps unwelcome, partner in your business.

Your bank may happily fund the expansion for a while, but at some point, they will want their money back. Operations are using all excess cash flow and increasing bank debt. There is no room for repayment unless your company starts to shrink. The decision to shrink your company is now in the hands of your banker, and you do not want to be there.

The best case is your lender does not get nervous but institutes a series of covenants that manage and control growth going forward. You do not want to be there either.

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At this point, you are likely confused. Everything about your company points to success, but your lender is expressing concerns. What is going on? Well, you have doubled sales in two years but only increased equity 37%. That is why the ROE has improved. The company is not more profitable; it's simply bigger and it got there through debt, subjecting the entire operation to more risk.

In the Explosive Growth example above, most things went right, but the company still faces a potential capital problem. In most high- or sudden-growth cases, we see margins pressured—as a new big buyer is discounted, or receivables become extended with a big buyer paying slower, or just the simple math of carrying the last 60 days of sales, which are significantly higher than the preceding period, begins to put stress on the operation. And the trade actually becomes more demanding as you begin to place oversize orders.

Under those circumstances, you could wind up in a liquidity crisis with the bank putting on a squeeze when you can least afford it.

Growth is a very welcome opportunity, but without proper planning it can create another wave of anxiety for the business owner. Many aspects of your company will be stressed and tested in high-growth environments. Planning for the organizational impact of growth is important. Understanding its financial implications is critical. Many companies have grown themselves out of business.

Build a simple forecast, test some assumptions and then communicate the information to your lenders. An insightful banker will welcome the discussion. An excellent one will initiate it. In finance, risk is defined as uncertainty. The more uncertainty you can remove, the greater your probability of your success.

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