Organic Growth

The organic growth rate indicates a firm´s sustainable growth potential, driven and supported by its own, internally generated funds. In comparing the organic growth rate with a firm´s actual balance sheet growth, one can conclude whether the current momentum is medium- / long-term sustainable, or rather not.

Finance merely assumes a support function in the implementation of strategic growth concepts, such as laid out in the Ansoff Matrix in regards to, for instance, products and markets. – From a Corporate Finance point of view, focus is on which financial sources could or should (ideally) be used for such purpose: The concept of the organic growth rate helps to better understand a firm´s funding momentum in supporting ongoing growth.

Organic growth is defined as the expansion of a firm's operations backed by its own, internally generated, funds: Hence, growth through acquisitions, mergers, but especially growth funded by outside borrowing (i.e. additional debt) is not regarded as organic.

In essence, there are two intertwined drivers contributing to a firm´s organic growth: Next to a firm´s net profit, also other, additional cash flows generated can be considered. – Whereby net profit is disclosed in the income statement: This is the amount left after all payments done and provisions filled. A firm´s cash flow is derived by adjusting its net profit by a set of additions and subtractions for cash in- and outflows.

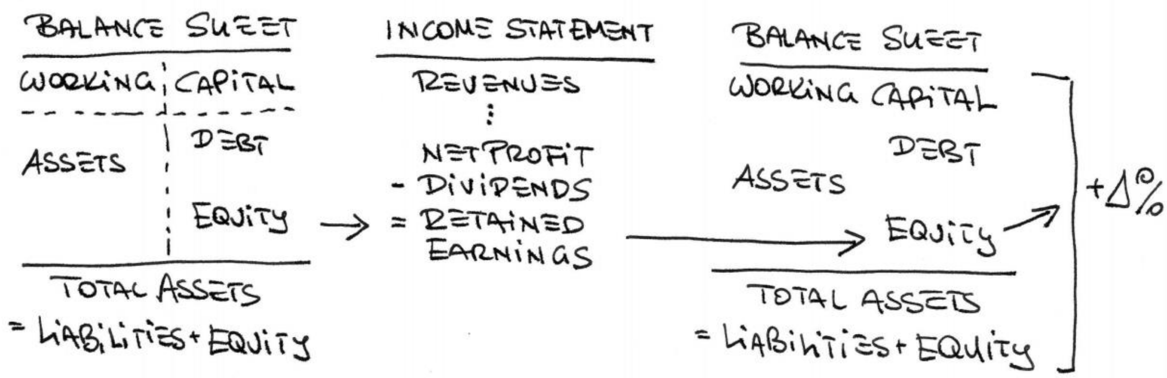
Now, part of the net profit may be paid out to shareholders in form of dividends: This is cash leaving the firm, ending up in the pockets of shareholders. The remainder (i.e. the amount not paid out) also belongs to the shareholders, but indirectly only, just from an economic point of view: That amount stays in the firm, in a sub-position of equity, named retained earnings and represents accumulated historical profits not having been paid out as dividends. – Whereby it is management deciding how to best allocate these funds.

The organic growth rate equals the relative periodic increase of a firm´s equity position (by adding retained earnings): It determines the growth potential of a firm´s balance sheet without increasing its leverage. Alternatively, this parameter can be derived by multiplying a firm´s return on equity with the retention rate (i.e. the percentage of net income not paid out as dividends).

Therefore, if a firm´s balance sheet growth exceeds that of the organic growth rate, then additional outside (debt) funding is required to support it. At some point, though, this will have to be followed by a share capital increase to avoid excessive leverage. This is also the reason why corporates pursuing an aggressive growth strategy rather aim to retain earnings and do not pay out dividends.

In other words: As long as a firm´s balance sheet grows by the same percentage as the relative increase of its equity - or less than that – one may assume that such growth momentum is organic, driven by the firm´s internally generated funds. Whereas, if actual balance sheet growth exceeds the organic growth rate, then a firm´s leverage as well as its risk profile will increase.

		PRODUCTS	
		EXISTING	NEW
MARKETS	EXISTING	MARKET PENETRATION	PRODUCT DEVELOPMENT
	NEW	MARKET DEVELOPMENT	DIVERSIFIKATION



ORGANIC GROWTH POTENTIAL = RoE × RETENTION RATE

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(1 - DIVIDEND PAYOUT RATIO)

For more concepts click on: