

Organic Growth

A firm's organic growth rate indicates its sustainable growth potential, backed by its internally generated funds. Comparing the organic growth rate with a firm's actual balance sheet growth indicates whether the current momentum is medium- / long-term sustainable, or not.

As the Ansoff Matrix illustrates, there are several alternatives to choose from when implementing a firm's growth strategy along products and markets. From a Corporate Finance point of view, focus is on the types of financial sources that can be used for this purpose: The concept of the organic growth rate helps tracking a firm's funding pattern to support its growth momentum.

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

In essence, there are two intertwined drivers supporting a firm's organic growth: Net profit and cash flows generated. – Net profit, disclosed in the income statement, is the amount left after all payments done and provisions filled. A firm's cash flow, on the other hand, will be derived by adjusting net profit through additions and subtractions of non-cash cost items. – Now, cash flows generated indicate funds available a firm can use for various purposes, among them: capital expenditures to support growth. Net income, on the other hand, is an accounting indicator technically "owned" and controlled by shareholders who decide if and how much of it shall be paid out to them and how much re-invested in the firm.

Dividends are the part of the net profit paid out to shareholders: This will be done in cash, leaving the

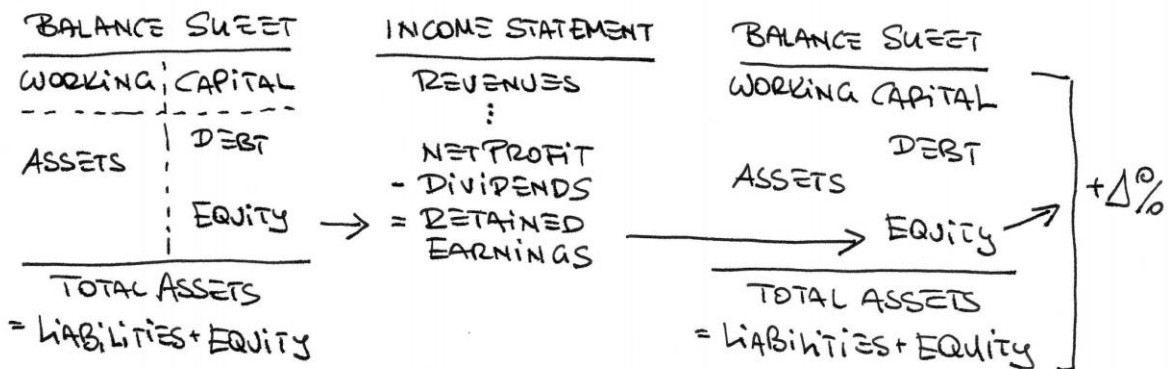
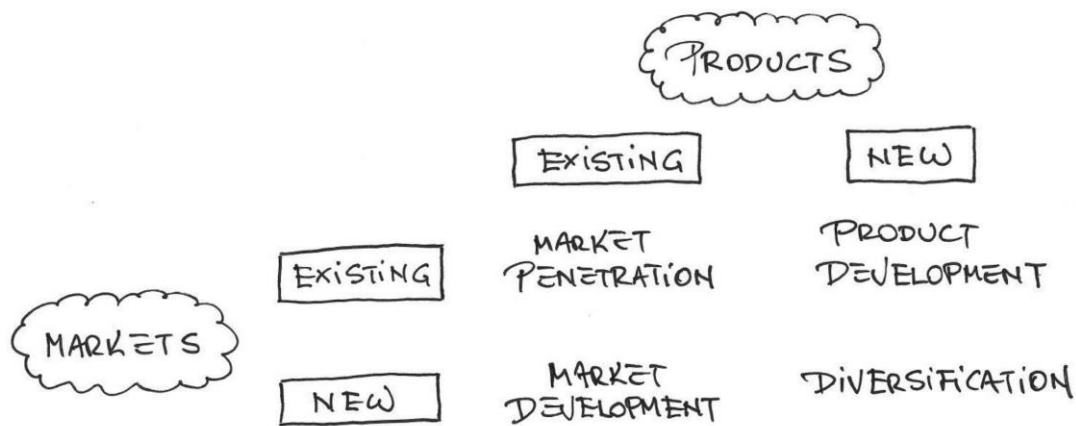
firm, ending up in the pockets of shareholders. The remainder which stays in the firm, is transferred to a sub-position of equity, referred to as retained earnings. In this position historical profits are accumulated which have not been paid out as dividends.

Now, the organic growth rate equals the relative periodic increase of a firm's equity position (i.e. additions to retained earnings): It determines the growth rate of a firm's balance sheet without its debt / equity ratio (i.e. leverage) changing. Alternatively, the organic growth rate can also be derived by multiplying a firm's return on equity with the respective 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 this momentum.

Supporting growth by adding leverage may actually be beneficial in advanced, later growth phases when a firm has already reached a certain stage of maturity: Then, assuming higher levels of debt may – up to a certain point - contribute to the overall cost of capital declining, making a firm's balance sheet more efficient. – On the other hand, corporates in their earlier stages of their respective life cycles or in pursuit of an aggressive growth strategy rather aim to retain earnings. They require a low-risk funding strategy to support a (still) relatively high-risk business strategy.

In other words: As long as a firm's balance sheet grows by approximately 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 financial risk profile will increase.

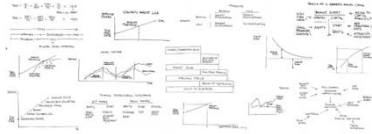


$$\text{ORGANIC GROWTH POTENTIAL} = \text{ROE} \times \text{RETENTION RATE}$$

" (1 - DIVIDEND PAYOUT RATIO)

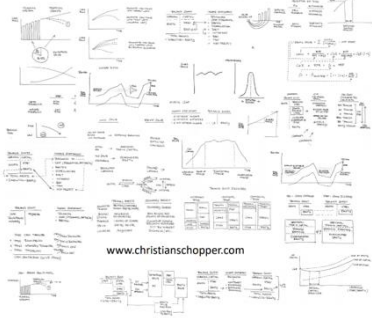
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