Are There Any Resources on the Subject "Sustainable Growth Rate?"

By Susannah Sabnekar, CPA/ABV, DABFA

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The Question as presented:

Are there any books or published papers regarding the subject of "sustainable growth rate?"

The Answer

While there are a few publications that give detailed insight into the determination of sustainable growth, this remains an area where professional judgment must enter into the calculation. Two particular publications, offering some insight, will be discussed.

Publications

Many publications relating to business valuations discuss the application of a long-term sustainable growth rate, but they rarely provide insight into the determination of a reasonable estimate for such sustainable growth. After review of various books, articles, and databases, two publications were found which identify the specific components to be included in determining sustainable growth rates. These books are as follows:

- *SSBI Valuation Edition 2004 Yearbook* by Ibbotson Associates
- *Understanding Business Valuation: A Practical Guide to Valuing Small to Medium-Sized Businesses* by Gary R. Trugman

Ibbotson Associates

Ibbotson focuses on the concept that long-term sustainable growth rate is based on the overall economy. Even industries that experience rapid growth will eventually slow to a more stable rate that is more in line with the economy as a whole. This approach suggests that long-term sustainable growth is comprised of two main factors: the long-term inflation rate and some addition for real growth.

Inflation Rate

In order to obtain a reasonable estimate of the long-term inflation rate, it is important to analyze the conventional bond market. The market's forecast of inflation is embedded within the long-term yield of treasury bonds. The long-term yields of treasury bonds are broken down into three different components.

- Expected Inflation Rate
- Expected Real Riskless Rate of Return
- Horizon Premium

Ibbotson readily admits that none of these three components are directly observable. Moreover, the actual calculation is a bit complicated.

Another source noted is the inflation-indexed bonds where the face value of the bonds is set at the consumer price index. However, these bonds are a relatively new investment and have not been adequately tested for reliability.

Real Growth

Ibbotson suggests that the growth in real Gross Domestic Product (GDP) has been relatively stable throughout the years; therefore, the historical average of this index is a good source for predicting future performance. Please note that the GDP from 1929 to 2003 was approximately 3.5 percent.

The derived long-term inflation rate and the real growth rate are combined to reach a reasonable estimate for the sustainable growth rate of a company.

Trugman

Trugman states that the sustainable growth rate of a company is based upon the appraiser's professional judgment after consideration of specific factors. These factors include: the economic environment, the industry outlook, the company's historical growth, and management's forecast for future growth and the company's ability to achieve such goals.

An additional aspect to consider is that even though a company may be currently achieving remarkably high growth rates, this may not be feasible throughout the life of the company. All businesses experience cycles of rapid growth, stability, as well as declines. Furthermore, a company generally can increase growth potential only so much before competition forces those returns to be shared with other upcoming companies. Therefore, the sustainable growth rate should represent a reasonable and indefinite level of growth that can be experienced by the company.

That being said, financial experts generally predict the long-term growth rate of a company to average from three percent to five percent. According to Trugman, in most cases, the sustainable growth of a company should be only slightly greater than inflation.

General Theory

There also appears to be some consensus within the appraisal community that the proxy for long-term sustainable growth cannot exceed the sum of:

1) regional population growth predictions plus

2) the growth in real GDP over a period of at least twenty years, if not over the full period available (1929 to 2003).

Work Cited

Please call for references.