Impacting Your Sustainable Growth Rate

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In my last newsletter I introduced the concept of a cooperative's sustainable growth rate. That is the rate that the cooperative can grow without increasing its debt ratio. The sustainable growth rate is a function of the cooperative's return on equity and its retention ratio. The retention ratio is in turn, the percent of profits that are not distributed to members as either cash patronage or equity retirement. In simple terms a cooperative's growth is limited by the amount of profits it is retaining.

The return on equity can in turn be broken down into three components: turns, earns and leverage. "Turns" refers to the cooperatives total asset turnover and is measured by the ratio of sales to total assets. Total asset turnover indicates how many dollars of sales the cooperative generated for each dollar it had invested in assets. It is a measure of how efficiently and how intensely the cooperative is using its assets. The cooperative can improve its "turns" by having the right assets and working them hard. Among other things, that means divesting of assets that are not creating sufficient sales. Creating more sales for every dollar of assets is the first step of increasing the sustainable growth rate. Most members would support a cooperative increasing its "turns". The exception would be members using a service with under-performing assets.

The second component of return on equity is "earns" or the profit margin. The "earns" component measures how much profit the cooperative makes for every dollar of sale. The profit margin is impacted both by the price charged and the costs of providing the good or service. Cooperative members support a cooperative improving "earns" by becoming more efficient but not when the profit margin was created through less favorable prices. "Good sold at market prices" is a key cooperative principle so every cooperative should strive for at least a competitive profit margin. The profit margin component raises the question as to whether members would pay just a little more in order to grow their cooperative.

The last component of return on equity is the leverage ratio. The concept of sustainable growth rate represents the growth we can obtain without changing leverage. Cooperative leaders may still want to consider whether their current level of leverage is the best level for their cooperative.

I'll discuss leverage and how it impacts sustainable growth in my next newsletter.