The Sustainable Growth Rate of a Cooperative Firm

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In many strategic planning sessions the board and CEO develop a vision of what the cooperative will look like ten years in the future. That vision invariably brings up a conversation about growing the cooperative. While there are cooperatives that remain small and stay successful most cooperative organizations have a desire to grow. As producers grow their operations there is a need for the cooperative to grow in order to remain relevant. All of the agribusiness input industries are becoming more concentrated which requires cooperatives to have a larger scale in order to compete. Cooperative boards also want their cooperative to be of a size and scale that they can compete for talent at both the CEO and mid-level management positions. A vision for growth of a cooperative leads to the next question. Is the desired growth achievable?

The sustainable growth rate for a cooperative, or any other business, is the maximum growth rate a business can achieve while maintaining its financial leverage (debt/equity ratio) at the desired level. Another way to look at the sustainable growth rate is the maximum growth that can be achieved given the cooperatives sales volume, profitability, asset utilization, member payments and debt ratios. One formula for the sustainable growth rate is that growth is equal to the return on equity times the retention ratio. The retention ratio is simply the percentage of profits that are not being distributed to members through cash patronage and equity retirement payments.

For example if a cooperative has equity retirement payments averaging $80,000/year and profit before patronage averaging $8.00,000, then equity retirement represents 10% of profits before patronage. If that cooperative paid 50% cash patronage then total member payments are 60% of profits (10% of profits go to equity retirement and 50% go to cash patronage). The cooperative's retention ratio is 40%.

That 40% of the profits which are retained in the cooperative determine the rate at which the cooperative can grow. If the cooperative has an average return on equity of 15% it can growth at 40% of that rate implying a sustainable growth rate of 6%. If the cooperative was able to avoid drought and other challenges and maintain a constant 6% growth rate it would be roughly a third larger at the end of five years. Growing any more rapidly than that would require increasing the debt to asset ratio and thus the risk level of the firm.

This first stab at the sustainable growth rate provides the initial answer to the question as to whether the desired or envisioned growth of the cooperative is achievable. The sustainable growth rate concept also allows the board and CEO to dig deeper into the possible future of their cooperative. All of the components of the sustainable growth ratio, the return on equity, the desired amount of leverage and cash patronage and equity redemption payouts are determined directly, or indirectly by decisions of the board and management.

I’ll dig deeper into how cooperative leaders can change their sustainable growth rate in my next newsletter.

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