BEST FOODS CORPORATIONS – **HOW SUSTAINABLE A GROWTH RATE IS**?

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This case elucidates the process of determining growth rate based on financial data of a firm. This case focuses upon determining return on equity which is an important factor affecting growth rate of any firm. Sustainable growth rate is widely used in determining value of many companies. Dividend policy of any firm has direct impact on such sustainable growth rate.

Key Words: Sustainable growth rate (SGR), Return on equity (ROE), Cumulative Annual Growth rate (CAGR), Intrinsic Value.

BACKGROUND

Analysts and financial consultants devote almost much of their time and energy to analyse growth prospects of various listed companies on stock exchanges to determine its proper value. Growth prospects of any firm are related with its important decision making of how much of their earnings to be retained for planned investment in to new projects or to be distributed as dividends. Analyst grapple with the issues pertaining to determination of proper growth rate based on such planned investment into new venture or project of the firm. Profitability of any planned investment of any company is reflected in its return on investment/equity (ROE). This case better captures the essence of determining such return on equity as well as growth rate. Thus, Analysts and experts in markets are focusing upon financial data to identify growth opportunities in any firm, but question remains how sustainable a growth rate is when it is taken into account for determining valuation of companies in this ever changing world.

Mr. Nilesh Shah, CA and CFA, is an analyst at the Clear Advice Investment Consulting Firm (CAIC). He has been assigned the task of assessing sustainable growth rate of Best Foods Corporations (BFC) so that proper valuation of BFC can be carried out further.

Best Foods Corporations is large diversified FMCG Company. Approximately 75% of its revenues come from processed dairy and food products with remainder from other Agri. products. Company is better positioned in Indian market having 16 major products capturing highest sales compared to other competitors.

Mr. Darsh Shah, Head of Clear Advice Consulting Firm, is of an opinion that annual growth rate in earnings is better estimate of calculating proper value of BFC. He strongly believes that CAGR of earnings or sales will be sufficient to assess the intrinsic value of any company.

Mr. Darsh Shah to Mr. Nilesh Shah, "Nilesh, I think, we can use past 5 to 10 years of net income or net sales to find out growth rate of BFC and this growth rate figure can be embedded into calculation of intrinsic value"

Mr. Nilesh Shah to Mr. Darsh Shah, " Sir, rather than using CAGR of earnings data, we can simply measure return on equity of this firm which is one of the basic factor in determining firm's growth rate of earnings. Return on equity can further be decomposed into five major segments to check firms' leverage, burden of tax and interest, productivity and efficiency. Each component of

ROE is meaningful and the process will serve to focus upon factors influencing performance of BFC in better manner.

Mr. Nilesh Shah to Mr. Darsh Shah, “Sir, its sustainable growth rate that matters most”

“Sustainable growth rate is better input to capture the contribution made by the company in its growth without borrowing money” said Mr. Nilesh Shah to Mr. Darsh Shah.

Mr. Darsh Shah to Mr. Nilesh Shah, “ Nilesh, too much reliance upon accounting data will not help you to capture market sentiments and whole valuation exercise will lose its purpose”

Mr. Nilesh Shah replied, “ Sir, BFC has been ranked very higher so far as its corporate governance practices are concerned, its disclosure compliance is also good, we can definintely rely upon data to measure its sustainable growth rate based on return on equity.

Mr. Nilesh Shah to Mr. Darsh Shah, “ Sir, A firm’s ROE is a key determinant of the growth rate of its earnings and if we divide its components, we will be able to track its performance over time”

Mr. Darsh Shah to Mr. Nilesh Shah, “ you can go ahead with using sustainable growth rate and ROE for measuring proper value of this firm, but just check it out that you may have to face comparability problems in this”

Table 1 Financial Overview

Particulars	2008	2009
Income Statement (in millions)		
Revenue	5000	5600
Cost of Goods Sold	2250	2450
Selling, general & admin exps	1500	1610
Depreciation	200	260
Goodwill amortization	50	80
Operating income:	1000	1200
Interest expenses	100	120
Income before tax:	900	1080
Income taxes	315	378
Net Income:	585	702
Earnings per share	2.34	2.925
Average shares o/s	250	240

Mr. Nilesh Shah to Mr. Darsh, " we can assess distortions in earnings due to change in valuation of inventories, depreciation and interest expenses before measuring ROE which will clear your doubts regarding sustainable growth rate calculations"

Mr. Nilesh Shah, who believes that economic earnings are more important for issues for valuation, whatever their shortcomings, accounting data still are useful in assessing the economic prospects of the firm. Quality of firm's earnings can be systematically analysed and even be used for finding out intrinsic value.

Table 2 Financial Overview

Balance sheet (in millions)	**2008**	**2009**
Cash & Bank	550	735
Bills receivables	750	810
Stock	700	890
Net property, plant & machines	1100	1200
Intangible Assets	400	465
Total Assets:	3500	4100
Current Liabilities	600	900
Long term debt	400	500
Shareholder's equity	2500	2700
Total Liabilities:	3500	4100
Book value per share	Rs. 10	Rs. 11.25
Annual Dividend per share	Rs. 0.72	Rs. 0.895

There are many measures that a company can use to measure growth. For example, it can measure it by increased market share, greater volume of sales or larger profit. The sustainable growth rate (SGR) is the maximum rate of growth that a firm can sustain without having to increase financial leverage or look for outside financing. The SGR is a measure of how large and how quickly a firm can grow without borrowing more money. After a firm has passed this rate, its growth will decline in the long term, and it must borrow funds to facilitate additional growth. Achieving SGR is every company's goal, but some headwinds can stop a business from growing and achieving its optimal SGR.

CAGR is the year-over-year growth rate of an investment over a specified period of time. It's an imaginary number that describes the rate at which an investment would have grown if it grew at a steady rate. The return on equity (ROE) measures how much the shareholders earned for their investment in the company. The higher the ratio percentage, the more efficient management is in utilizing its equity base and the better return is to investors.

QUESTIONS:

1) "Return on equity is the most important metric of financial performance" Do you agree with this statement of Mr. Nilesh Shah, Explain in detail.
2) Based on above data, Calculate ROE for the year 2009 for Best Foods corporations
3) Based on above data, Calculate sustainable growth rate for 2009 form firm's ROE and retained earnings ratio.
4) Discuss major obstacles in the way of an analyst while relying upon past financial data as narrated by Mr. Darsh Shah.