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# SUSTAINABLE Versus UNSUSTAINABLE SOURCES OF GROWTH

Surely one of the most frequently used gauges for trying to assess the potential for the future performance of a common stock is its past performance. Some words of caution are in order for those using this technique, however. It seems imperative, if a stock has risen or fallen, to ask "why" it has risen or fallen.

The price of a common stock goes up or down for either one or both of two reasons: Either (1) the market sector of which it is a part, as a whole, goes up or down and carries the stock with it, or (2) the fundamentals of the underlying company improve or deteriorate and cause the price of the stock to move relative to the market. The most common manifestation of the former is a change in price-earnings ratio, while the most common manifestation of the latter is a change in earnings per share.

To the extent that a stock goes up or down solely because the market goes up or down, we have no indication that the prospects for the stock in question are any better or any worse than those of the average stock. To the extent that the change in the price of a stock is attributable solely to a change in its price-earnings ratio, it is also difficult to conclude much of value about its prospects. To the extent that a stock's price rises or falls as a result of rising or falling earnings, however, we may have an indication of the stock's potential for future appreciation or depreciation.

If a company's earnings have grown, we should next inquire as to why they have grown to see if it is wise to extrapolate that growth. Let us first consider some reasons why such earnings growth might not be extrapolative.

To the extent that earnings growth comes about because of an expansion of profit margins, such growth is probably not sustainable. If the new higher level of profit margin is sustainable, the higher level of profits might be sustainable, but not necessarily so the rate of growth of profits.

Profit margins may increase for either one of two reasons: Either (1) prices may be increased or (2) unit costs may be reduced. The forces of competition will eventually limit the former; while a combination of external and internal constraints will put a limit on the latter.

The impact on the bottom line of an expansion in profit margins can be enormous; hence its character should not be overlooked. As an example, let us consider a company that manufactures 10 widgets at a cost of $9 each and sells them at $10 each. It has total sales of $100, operates on a 10% margin of profit, and makes a net profit of $10.

If that same company is able to increase its unit sales by 10%, it will sell 11 widgets and bring down a profit of $11. A 10% increase in unit sales, then, produces a 10% increase in profits. If, however, this same company is able to increase the price of its widgets by 10%, to $11 each, even if it sells no more, it will increase its profits by 100%. Similarly, if it can cut its cost per widget by 10%, it will increase its profits by 90%.

(For the average Standard & Poor's 1000 company, assuming that unit sales remain the same, it is calculated that a 1% increase or decrease in prices will, respectively, increase or decrease operating profits by 12.3%.)

Though both of these techniques can produce most dramatic results in a company's earnings, they should not be counted upon necessarily to produce beneficial results that are long-lasting. In fact, over the longer term, they might prove counterproductive. If the raising of prices invites new entrants into the business and the addition of capacity by present competitors, it may result in the ultimate loss of market share; and, if costs are reduced by cutting back on long-lead-time investments such as research and development, advertising, and training, future earnings declines will probably be the consequence of today's earnings increases.

Leveraging the balance sheet is another unreliable source of continued earnings growth. If, for example, a company increases its earnings per share by taking on large amounts of added debt and buying its own outstanding common stock in the open market, the short-term effect on earnings may be impressive, but the policy cannot be counted upon to be one indefinitely sustainable.

Similarly, if a company enjoyed significant earnings growth as a result of the reduction in the corporate income tax rate from 46% to 34% in the 1980s, the increase in the corporate rate from 34% to 35% in 1993 clearly demonstrated that the earlier windfall was nonrecurring.

About the only source of earnings growth that even stands a chance of being sustainable over the long-term is that which emanates from sales growth; but, even here, we must be careful to take note of how a company achieves its sales growth. If it does so by making acquisitions and giving the store away in the process, the prognosis for earnings may not be all that good. If a company increases its sales by making an acquisition paid for with excessive amounts of borrowed money or by issuing excessive amounts of common stock, the longer-term effects may well be inimical to the longer-term interests of present shareholders. To the extent that such acquisitions are paid for with internally generated funds, they may prove more beneficial to the long-term earnings stream. Even internal sales growth financed through the continual issuance of new common stock can be a pretty sorry source of growth as testified to by so many of the nation's electric utilities which have been forced to use this technique to finance their revenue growth but which, as a result, have enjoyed only nominal earnings growth, if any at all.

All is not lost, however. Not all earnings growth is short-lived. That growth in earnings per share that is attributable to growth in sales per share is good and stands the best chance of being sustainable. But there is a caveat even here. To the extent that a company's sales growth is attributable to growth in its market share, it may not be as easily sustainable as that growth attributable to growth in the total market. But, even then, more often than not, a high-growth industry will typically attract so many new participants that it may be harder to hold market share than it is in a slower growth industry.

Nevertheless, as a rule-of-thumb, it seems prudent to hypothesize a long-term rate of future growth in the price per share of a common stock no greater than what can be hypothesized for a rate of future growth in the underlying company's earnings per share and prudent to hypothesize a rate of future growth for earnings per share no greater than what can be hypothesized for the rate of future growth in sales per share.

A careful look at the past record of a company's growth in sales per share can be of very great value in this endeavor.

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