The value of profitable growth

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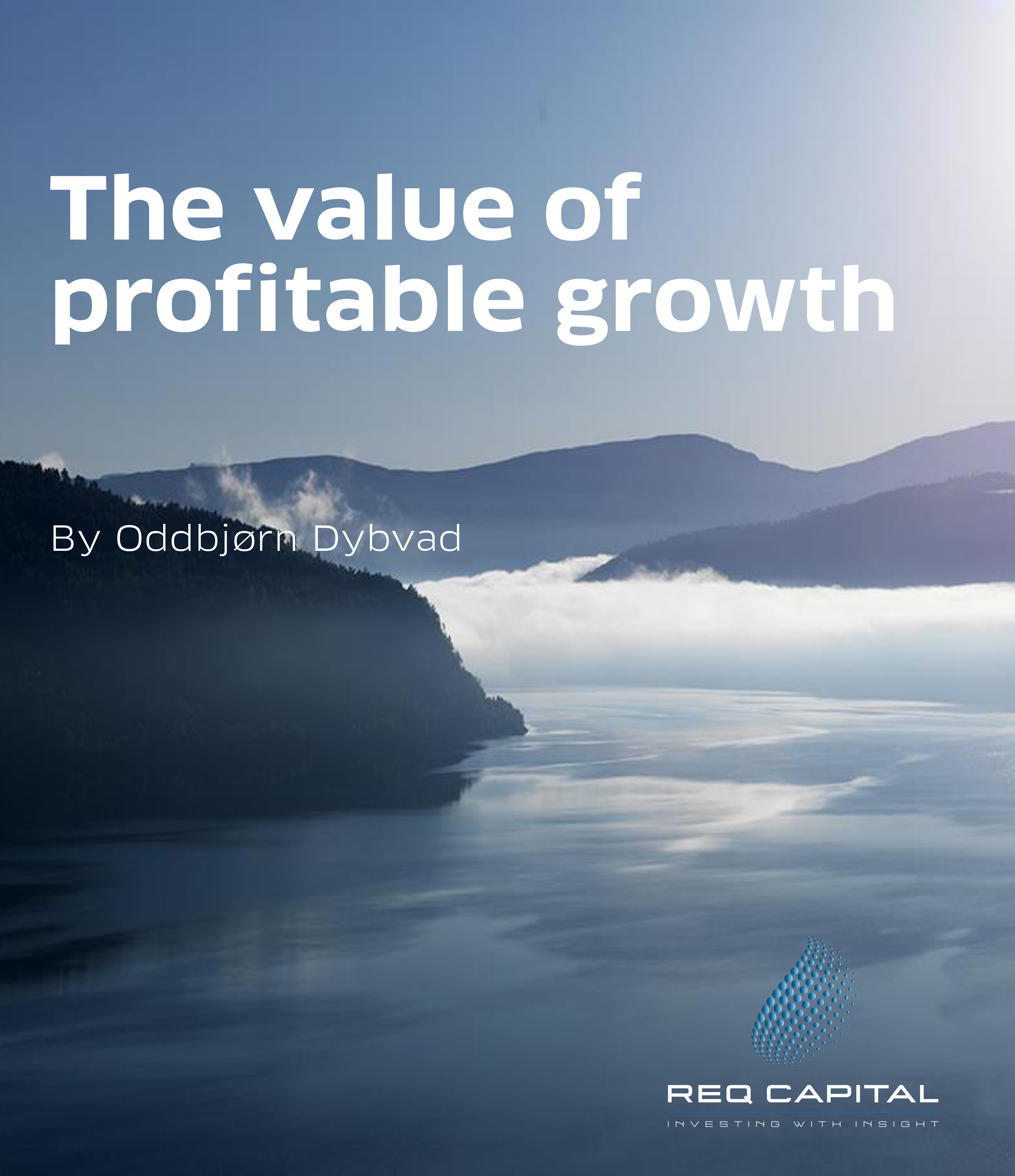

REQ CAPITAL

INVESTING WITH INSIGHT

What is the fair price to pay for an exceptional company that can reinvest cash flow and grow with high incremental returns on capital over time?

Value is created when a company grows with a return on capital that exceeds its cost of capital. No value is created in companies whose growth is 0%, or in companies that are unable to generate a return on capital above the cost of capital.

With that in mind, let us look at what you can justify paying for different companies that are able to deploy incremental capital (growth) at various rates of return (equal to or above the cost of capital).

Below is a table showing what premium you should be willing to pay for a company with different returns on capital and growth prospects, compared to a company with zero growth opportunities or a company earning exactly its cost of capital (which we have set at 9.5%*). The latter example is "the market" for all practical purposes.

		Return on Capital				
		9,5 %	**12 %**	**16 %**	**18 %**	**22 %**
Growth	**5 %**	0 %	24 %	46 %	52 %	64 %
	6 %	0 %	36 %	70 %	81 %	98 %
	8 %	0 %	111 %	217 %	252 %	304 %

If a company grows with an incremental return on capital equal to the cost of capital (9.5%), the growth does not create value, as shown in the first column.

However, if the incremental return on capital is 16% and the company grows by 5%, you can justify paying 46% more than a company with no growth. At the extreme, a company with an incremental return on capital of 22% and 8% growth is worth three times as much as a company with no growth.

What is striking is how valuable growth is when returns on capital are high. An increase in growth from 5% to 8% increases the value of a company with a high return on capital many times over. The CEO of a company with an 18% return on capital should spend all of his or her time finding growth opportunities rather than trying to continue to increase profitability.

Think about this for a while when discussing market pricing.
Exceptional companies are worth more than you can imagine.

*The assumption is a standard DCF-model with a cost of capital of 9,5%.

Sources:
- *Investing in Value Creators* by Oddbjørn Dybvad
- *Value Investing: From Graham to Buffett and Beyond* by Bruce Greenwald