The First Cut

Firms With High Sustainable Growth

The First Cut is designed as a starting point for investors. Each issue we list the top stocks that pass relatively simple screens of interest to individual stock pickers. AAII's Stock Investor Pro *screening software is used to generate the First Cut listing.*

Apple's decision to initiate a dividend highlights the trade-off between distributing profits to shareholders and preserving excess cash to fund future growth. Dividends are normally paid by more mature companies that are generating free cash flow and no longer need as much money to fund expansion and growth. The sustainable growth rate is a common calculation that examines the profitability of a firm and how the dividend payment may impact its growth potential. If a firm does not make significant changes to its assets or financial structure, the sustainable growth can be calculated by multiplying the return on equity by the percentage of earnings retained by the firm.

The return on equity (ROE) is equal to earnings divided by shareholder equity (book value) of the firm. The higher the ROE, the more successful the firm has been in acquiring and managing assets that generate income and in financing assets through debt, common stock and retained earnings. ROE can be increased with higher profit margins, more efficient use of assets, or higher levels of debt relative to equity.

The percentage of earnings a firm retains, while generating the same ROE, determines the future earnings growth and provides an indication of its sustainable growth rate. Called the retention ratio, it is equal to one minus the ratio of dividends to earnings per share (the payout ratio). When all earnings are retained, the ratio is 1.0, or 100%. If a quarter of the earnings are paid out, the retention ratio is 0.75, or 75%. The higher the ROE and the greater the retention ratio, the higher the sustainable growth rate.

Stocks that made this issue's First Cut are domestic, exchange-listed stocks, with positive earnings, debt levels below the norm for their industry, positive projected earnings growth rates, and a current return on earnings above their five-year average. The 30 stocks with the highest sustainable growth rates are presented in the table. About one-third of the First Cut stocks pay a dividend, but the retention ratios tend to be high.

—John Bajkowski, President of AAII

Firms With High Sustainable Growth Rates

	Sustain-able Growth (5 Yr) (%)	EPS Growth Hist (5 Yr) (%)	EPS Growth Est (3 to 5 Yr) (%)	Return on Equity (TTM) (%)	Reten-tion Ratio (TTM) (%)	Liab to Assets (%)	Forward Price-Earnings Ratio (X)	Div Yield (%)	Price Change (52 Wk) (%)	Share Price (3/16) ($)	Industry
Coach, Inc. (COH)	42.1	19.7	16.1	54.0	75	39.7	22.2	1.2	53	77.84	Retail (Apparel)
Priceline.com Inc (PCLN)	37.7	65.1	22.9	48.7	100	35.2	21.7	0.0	49	675.50	Business Services
LSB Industries, Inc. (LXU)	36.0	36.1	10.0	40.6	100	41.6	10.7	0.0	14	40.13	Chemical Manufacturing
Apple Inc. (AAPL)	33.8	64.9	19.5	44.3	100	35.1	13.6	1.8	75	585.57	Computer Hardware
CF Industries Holdings (CF)	31.4	105.5	10.1	34.1	96	49.3	8.0	0.9	42	184.21	Chemical Manufacturing
NewMarket Corporation (NEU)	30.5	38.0	8.9	37.8	84	53.9	11.9	1.6	29	184.24	Chemical Manufacturing
IDEXX Laboratories, Inc. (IDXX)	25.9	14.4	14.9	27.8	100	47.7	27.5	0.0	12	84.54	Medical Equip & Supplies
Deckers Outdoor Corp (DECK)	25.8	45.0	17.0	27.7	100	27.1	13.2	0.0	(15)	67.91	Footwear
Dollar Tree, Inc. (DLTR)	25.1	26.8	17.9	33.3	100	42.3	19.0	0.0	75	93.28	Retail (Dept & Discount)
Capella Education Co. (CPLA)	24.6	26.3	12.0	28.8	100	31.0	12.3	0.0	(25)	38.20	Schools
Buckle, Inc., The (BKE)	24.4	20.9	11.5	42.1	75	31.7	14.3	1.7	34	48.44	Retail (Apparel)
Hibbett Sports, Inc. (HIBB)	24.3	12.9	15.5	29.4	100	35.0	20.7	0.0	71	52.57	Retail (Spec Non-Apparel)
NIC Inc. (EGOV)	23.9	15.5	25.0	33.7	100	54.9	33.0	0.0	10	12.13	Computer Services
FactSet Research Sys. (FDS)	23.0	17.1	13.6	32.8	72	18.0	24.2	1.1	2	99.54	Computer Services
Boston Beer Co. Inc. (SAM)	22.3	30.5	9.2	37.2	100	32.2	24.1	0.0	16	99.87	Beverages (Alcoholic)
Medifast, Inc. (MED)	21.9	28.1	17.5	24.9	100	30.6	12.1	0.0	(9)	16.63	Biotechnology & Drugs
Big Lots, Inc. (BIG)	21.6	24.2	13.4	24.4	100	49.8	12.9	0.0	9	45.42	Retail (Spec Non-Apparel)
KapStone Paper & Pack'g (KS)	21.1	120.6	45.4	26.0	100	51.4	11.5	0.0	36	20.93	Paper & Paper Products
Fossil, Inc. (FOSL)	20.8	32.5	20.3	27.9	100	32.7	22.9	0.0	55	125.62	Jewelry & Silverware
EZCORP Inc (EZPW)	20.5	28.6	15.0	20.8	100	15.4	10.2	0.0	15	31.06	Consumer Financial Servs
Starbucks Corporation (SBUX)	20.3	17.3	18.6	28.8	65	39.1	28.8	1.3	52	53.21	Food Processing
Bed Bath & Beyond (BBBY)	20.0	9.8	15.6	23.5	100	33.2	16.9	0.0	44	66.03	Retail (Spec Non-Apparel)
Cummins Inc. (CMI)	19.6	21.9	16.6	35.7	86	52.9	12.3	1.3	28	127.54	Misc. Capital Goods
Intuitive Surgical, Inc. (ISRG)	19.5	45.5	20.7	20.8	100	13.6	36.5	0.0	65	529.74	Medical Equip & Supplies
Neustar Inc (NSR)	19.0	12.0	14.3	25.1	100	63.6	17.0	0.0	41	35.31	Communications Services
C.H. Robinson (CHRW)	19.0	11.4	14.2	34.3	54	41.6	22.3	2.0	(9)	65.67	Misc. Transportation
Bio-Reference Labs. (BRLI)	18.9	25.2	17.5	19.5	100	32.8	15.7	0.0	4	22.75	Healthcare Facilities
Donaldson Company (DCI)	18.7	13.1	12.8	27.1	82	45.6	21.5	0.9	28	72.69	Misc. Capital Goods
American Express Co. (AXP)	18.7	6.9	10.6	26.9	83	87.7	13.3	1.3	30	56.55	Regional Banks
Chipotle Mexican Grill (CMG)	18.5	39.5	21.4	22.4	100	26.7	47.2	0.0	63	410.91	Restaurants

Source: AAII's Stock Investor Pro*, Thomson Reuters, and I/B/E/S. Data as of 3/16/2012.*