IFB316: Sales to Capital Ratio: The Key Metric for Predicting Company Growth

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Dave [00:00:00]:

All right, folks, welcome to Investing for Beginners podcast. Today we have episode 316. Today we're going to talk about the metric everyone is sleeping on, sales to capital ratio. So Andrew is going to talk to me about this ratio. He's going to basically interview me, and we're going to talk a little bit about how I use the ratio and how it can help you guys. So with that, I guess I'll turn it over to my friend Andrew and let the fun you, Mr. Dave.

Andrew [00:00:27]:

So why should investors care about the sales to capital ratio? What does it tell us about a company?

Dave [00:00:36]:

Well, the sales to Capital ratio, the easiest way to kind of define it is it measures the changes in sales, the future changes in sales based on the capital that the company has, that they use to generate those sales. So when you talk about capital, you're really looking at the debt or the equity that the company has or the invested capital, if you want, of the company. And you can measure that against the change in sales. That's how you use it.

Andrew [00:01:03]:

So it's capital efficiency or is it something more than that?

Dave [00:01:07]:

It's a little both. So it's a little bit of the efficiency of the capital, but it's also the kinds of capital that they're using. And it will depend on each company. You'll measure it the same way. So you look at the invested capital. It's basically, you take the bottom part of the ROIC formula that we talk a lot about. Use that number as the capital, and you measure the revenue that the company generates, because ideally, that capital should generate more growth in revenue.

Andrew [00:01:38]:

So it's more of a growth metric than an efficiency metric.

Dave [00:01:41]:

Yes. ROIC is definitely an efficiency ratio where the sales to capital ratio would be more of a growth metric.

Andrew [00:01:47]:

Okay. With the idea that a higher sales to capital ratio means a company who can grow higher.

Dave [00:01:54]:

Yes.

Andrew [00:01:55]:

Faster or grow faster.

Dave [00:01:56]:

Yeah, exactly.

Andrew [00:01:58]:

Now, explain that relationship. Maybe give me an example. What would a high sales to capital ratio look like if I was like, a lemonade standard? Or you could use a real company, too. Either waY, whatever you think is best for teaching. Okay.

Dave [00:02:10]:

And probably the easiest way to look at it is just to compare actual companies. So one of the companies that Andrew and I both own is Texas Instruments, and it's a great business, and they generate very high returns on capital, but they also don't grow very quickly. So they're growing four, five, 6%. So somewhere in the range of GDP, maybe a little bit more. So they're not a fast grower, but their ROICs are very high. They're 30, 40, 50%. So they're very efficient with the capital. But if you look at their sales to capital ratio, the last DCF that I did, which was about a year ago, it came in around 1.4.

Dave [00:02:51]:

So that means that it's not a super fast grower, and it shows, because the capital that the company is using to generate more revenue doesn't grow very quickly. So it's not growing super fast. Then, conversely, if you look at a company like Mercado Libre, which is the South American ecommerce company that also has payments, they're growing super fast. They're growing at 25% to 40%, kind of give or take. And if you look at the sales capital ratio for them, it's pushing four. So it's quite a bit higher for the sales to capital ratio than it is for Texas Instruments, for example. And it shows that even though their ROIC is in the low 20s, so it's not nearly as capital efficient at this point as Texas Instruments is, but they're growing a lot faster with the capital that they have.

Andrew [00:03:42]:

Okay, that's helpful. So when we're saying growth in this context, we're talking about sales growth, not necessarily profits growth.

Dave [00:03:48]:

That's correct, yes, exactly.

Andrew [00:03:50]:

Would a unprofitable company and a profitable company, they could have the same sales to capital ratio?

Dave [00:03:57]:

Yes. If you look at a company like Crowdstrike or Sentinel, some of the unprofitable, at this point, cloud security companies, those are unprofitable businesses, but they are growing very fast. They're growing in the 40 to 50, 60% range, depending on which company. And they have very high sales to capital ratios, they'll have Four, five, six to one.

Andrew [00:04:19]:

Okay. Yeah, that's helpful. So are there ways that the sales to capital ratio could be negative, or if you have capital going the wrong way, like it's not growing or sales are not growing, how does that affect the ratio?

Dave [00:04:35]:

You'll see a decline, you'll see a negative ratio, or you'll see it very low. I'm trying to remember one of the companies I looked at not too long ago, their sales to capital ratio was like, 0.4 or something like that. So that means that indicated that this was not a fast growing company. And so as I was working through the DCF, I could see that they didn't grow very fast. They didn't do a very good job of using their capital to grow the business. And maybe the capital that they were using to invest was not the right one, or that they were doing maybe purchasing a lot of other companies, and that was driving up their invested capital, but they weren't seeing a realization of revenue growth from those acquisitions. And that can drive the sales to capital ratio down as well.

Andrew [00:05:24]:

Yeah, it's a good example. Could you give an example of what we mean by capital? If you're a beginner and you're like, I don't even know what invested capital means, what does that mean? And how does a company grow it?

Dave [00:05:36]:

Yeah, invested capital. There's two ways to think about it. There's the asset side, and then there's the financing side. So if you think about the operations of a business, if you look at a balance sheet, the company has a combination of assets and liabilities that they use to try to grow the business. So, for example, if you look at a company like Walmart, which is an easy example to think about, they sell inventory. So inventory for them is an asset, because the more inventory they buy, the more assets or more inventory they can sell, in theory, but they have to pay for that inventory. So something like accounts payable would be a liability that they use to buy potentially that inventory. And so if you kind of look at the balance sheet, it's a combination of good assets and good liabilities that allow the company to buy the things they need to sell.

Dave [00:06:35]:

Now, Walmart's an easy example because they are selling stuff in their store, whether it's groceries, whether it's tennis shoes, tennis rackets, whatever. If you think about Netflix, Netflix, basically, their inventory is buying shows, creating shows that they can sell to us for our subscription. And so that is an asset for them. And the more efficiently they buy great assets, like creating shows that everybody wants to watch, the more revenue they can generate, because they can go out and advertise that, and that's an asset for them. The other way you can look at invested capital is you can look at how they finance those assets. And most companies have basically two different ways they can try to finance assets. One is this is without them doing it internally. So if the company generates free cash flow, they can use their own cash to buy it, but they can also use debt, which is they sell bonds in the marketplace for people to invest in Walmart, for example, they give Walmart money, Walmart pays them a dividend, and then they use that money to go out and buy stuff.

Dave [00:07:44]:

The same apply with equity, which are shares. So if they go out and sell shares on the open market, that money that they raise from selling Walmart shares, they can go and buy more inventory to sell to their consumers. And so invested capital basically occupies. You can look at it, the numbers balance, it depends on how you want to look at it. You can look at from an operations side or you can look at from a financing

side, and it really depends on which way. I personally like the asset side because it allows me to see how the business does what they do. But the capitalization or the raising money part is probably quicker and easier to get to because you can find that information on the balance sheet a lot faster. So it really depends on which way you want it.

Dave [00:08:26]:

Two sides of the pie just depends on which. Do you like the pumpkin side or the Apple side better? I like the pumpkin side bettEr.

Andrew [00:08:32]:

Personally, I do too, and in both meanings. So I don't know if this is splitting hairs or not, but I'm just going to ask it. So in the Walmart example, if, let's say in 2018, and I'm not saying this is accurate, I'm just saying as an example, let's say they had a lot of inventory, and then you come to 2023 and they had a lot less inventory. So would that be a way to reduce the invested capital to make the sales to capital ratio better?

Dave [00:09:03]:

Yes, potentially it could. One of the challenges with looking at a company like that is the timing of when you do it, because a balance sheet, when you look at it, is a snapshot of one day in time. And it's not an accrual kind of metric. So you don't see a build up in inflow and an outflow. You just see this is what they have. And this is a great question. So a really good way to mitigate that, especially for a company like Walmart that is so reliant on inventory, for example, is to look at an average. And so to look at the beginning of one year, the end of the next year, or look at it over two or three years to get a good sense of this is what their average invested capital is.

Dave [00:09:53]:

And then you can compare that to the sales, or you could compare that to the return on invested, use it in the return on invested capital. You could do it that way as well. There's a lot of different ways to kind of slice the numbers, but that's a really good example of when you're looking at it as a snapshot in time, it could cause the number to be higher or lower than it may normally be. One of the things that I always like to do when I'm looking at the sales to capital ratio, is to calculate it over four or five years. Especially if it's volatile. And so

look at it over four or five years and then average it, and then just use that for the average through the course of valuing a company, because that can help mitigate some of those abnormalities that you may see, especially if there are things like that where there's huge run up in inventory and then there's a huge decrease in inventory, or if a company is an acquisitive company, but maybe they go in fits and spurts of buying companies. And so you can use that average to get you more of a baseline number as something that's really skewed because they just spent $60 billion to buy Activision or 95 or whatever their number is to buy Activision. And that really can skew their number over a period of time until it gets integrated and they can start realizing the revenues from that acquisition.

Andrew [00:11:09]:

Yeah, that's great advice. I love the idea of averaging. I think that's always a good thing, especially if you have results that are volatile. So let's say you're a beginner. I got this new tool. I want to use it. How do you recommend going about using a tool like this?

Dave [00:11:24]:

Yeah, that's a great question. The way that I try to use it and the way I think people should use it is a way to measure the growth and efficiency. A little bit of a combination of both, but really more the potential growth of a company based on the assets that they're buying. And when you're trying to value a company, one of the hardest parts of measuring the growth of the company is how fast are the revenue is going to grow. And a ratio like the sales to capital ratio can give you a good baseline to use in the DCF to help you measure that growth without going nuts. And especially when you're talking about these really big growth companies, we were talking about Crowdstrike earlier or Mercado Libre or wise, these are companies that are all growing in the high twenty s to forty percent, fifty percent revenue growth. It's real easy to think that's going to last forever. And the blunt fact is it won't.

Dave [00:12:26]:

As the companies get bigger, they're working off a bigger base. And so that will just naturally cause it to start to slow down. But using a ratio or a tool like the sales to capital ratio can help ground you, the company. All companies have to invest to grow. Amazon, Google, Microsoft, Walmart, all of them all have to. And this can help you ground how fast you think that's going to grow. And the assets that they're buying because it doesn't always correlate to the ROIC. They can be a little bit different.

Dave [00:13:00]:

But one of the things that you want to see when you're looking at, especially a growth company, is you want to see it grow fast, early, and then eventually it's going to turn a corner and become more profitable, and then the growth is not going to be maybe as necessary. And so using a ratio like the sales to capital ratio can help you measure that over a longer period of time. And you'll start to see that that will kind of start to taper off as it gets farther into your forecast. Because when you're trying to value a company, you're just guessing. None of us know for sure how fast a company like Mercado Libre is going to grow. And we can estimate it, and we can use a tool like this to help us estimate it. But at some point, they will start to slow down, and that's just the nature of the game that we're playing. And I try to use the sales to capital ratio to help me measure that when I'm trying to value a company.

Dave [00:13:56]:

Like how well do they use their assets to grow, and how long do I think that that can last?

Andrew [00:14:02]:

All right, well, I'm going to ask the smarty question from the back of the room. Why don't you just look at revenue growth instead?

Dave [00:14:10]:

You can look at revenue growth, but past revenue growth is no guarantee of future revenue growth. And just because a company that you really like Grew, we were talking about Rivian earlier today. Just because it grew 4025% last year doesn't mean that it'll grow 4025% next year. It may and it may not, most likely won't, but at some point that will come back to normal and maybe only be 40 or 50%. But past results don't guarantee future results. And using a tool like a sales to capital ratio can ground you in some numbers and help you keep things maybe a little more realistic. It's like any other tool. You can play with it and get the number you want, but that's not the way to do it.

Dave [00:15:02]:

The way to do it is to look at the numbers and be consistent. And if you measure invested capital one way for Texas Instruments, you got to do it the same way for Mercado Libre. You can't do one for the other just because it's a different business or because you like one or the other. The inputs are only going to be as good as you make them, and any DCF is going to be like that. And any number you can plug in numbers to get it to say what you want it to say. If you want it to be two plus two equals fish, you can make it do that. But the sales to capital ratio, as a tool can help ground you in what the invested capital is, because no company grows without invested capital, whether it's Rivian or whether it's Microsoft, they all have to invest. How they invest is different, but they all have to invest.

Dave [00:15:49]:

And you have to measure that when you're trying to measure the growth of a company. And if you don't, then you might as well be throwing darts at a dartboard, because you're just completely guessing.

Andrew [00:15:58]:

So this might have been a little bit of an AhA moment to me while you were talking. We obviously have our two different sides of a DCF pie. I don't use this ratio. Does it basically help you just to pick on Rivian, just because you said it out loud? If Rivian is able to raise $1.5 billion and so its sales growth is through the roof, but because it had to raise the money, the sales to capital ratio won't get out of whack, where the revenue growth is kind of like a big one, because they raised a bunch of capital. So is that kind of what it's trying to prevent, or is there something I'm missing there?

Dave [00:16:39]:

That's what it's trying to give you, a way to measure the potential revenue growth based on the assets that the company has. So, whether it's Rivian or whether it's Walmart, which is a completely different, opposite end of the spectrum, they can only grow based on the assets that they have. And the sales to capital ratio can help you measure that and keep it somewhat within reason. Every company will grow as fast as they can. But a company like Rivian, because they're growing off such a small base that they have a bigger opportunity to grow faster than Tesla does, which is one of their competitors, just because they're working off a smaller base to work off of, and their assets may be more efficient or they may not, but the sales to capital ratio can help you when you're trying to value a company. Try to keep that within reason, I guess, is the best way of putting it. The only other thing I was going to throw out there was that it's not really feasible to use in a free cash flow to equity model because of the invested capital part of it.

Andrew [00:17:50]:

Okay. Yeah, probably. So what would be some examples of a good sales to capital ratio and a bad sales to capital ratio?

Dave [00:17:57]:

That's a great question. Well, first of all, I think anything over generally, the higher the number, the better. That's really what you would like to see. Some of it will depend on where the company is in their lifecycle of the business. So, for example, we were talking about Texas Instruments earlier. Obviously a fantastic business, very efficient, great margins, super wide moat, but they're more on the end of mature than a company like CrowdStrike is in their evolution. And so it would be unusual to see a more mature company. If you do a sales to capital ratio for a company like Johnson Johnson, or ABV or Walmart or any more mature company, you're going to see lower to sales to capital ratios, because the companies are growing slower and their revenues compared to their capital, they're not going to be generating as much.

Dave [00:18:52]:

Whereas if you look at a company, younger company, that's earlier in their growth cycle or lifecycle, like a Crowdstrike or like a Mercado Libre, you're going to see higher sales to capital ratios. Those generally, you're going to see three and a half or higher. CrowdStrike has around a six. I was looking at wise earlier today, and they're close to seven. And those are much, much younger companies. And so they have higher sales compared to their invested capital. And that makes sense. It all correlates.

Dave [00:19:23]:

They're not as efficient as Texas Instruments, certainly. THey're certainly not as profitable. They don't generate near the same kind of free cash flow that a company like Texas Instruments does. But they're also at different ends of their lifecycle. And so you generally want to kind of think about how mature is this company and where are they in the lifecycle, and then kind of compare where that is. And I'll give you a couple other examples that maybe aren't so great. Fiserve, which is a company I own, FIS and GPN, these are all three very big legacy payments players. All of them are definitely more on the mature side, but they also made huge acquisitions three or four years ago.

Dave [00:20:01]:

And of the three, Biserve is really the only one that's seen any sort of more serious revenue growth from those acquisitions. As a matter of fact, FIS has announced that they're going to spin off the company that they bought because it's kind of been a bust for them. And they spent 40, 50 billion on these acquisitions. So it was not a small chunk of change. Their returns on invested capital have been pretty awful, all three of them. And their sales to capital ratios have also been pretty awful. FIS has started to perk up over the last year. Plus, as they've been able to integrate Clover and carrot into their systems and they've been able to generate more revenue growth, higher revenue growth from those platforms.

Dave [00:20:47]:

But the other two companies, GPN and FIS, have been dogs. And their sales to capital ratios, I think GPN was less than 4.4 and FIS was like 0.5.6. So really not good. And their RoiCs are sub single digits. So they have not done well. And so those acquisitions did not turn out well for those companies. But you can see it in the numbers. And when you try to value the companies, you can see they're not reinvesting efficiently, they're not generating any revenue from the platforms that they acquired.

Dave [00:21:22]:

And so they haven't done a good job of integrating them. And so you can see that in the numbers that they were bad acquisitions for them or they just did a bad job of integrating them.

Andrew [00:21:31]:

So would you say you kind of have a baseline of company that I own should have a sales to capital ratio of at least one?

Dave [00:21:37]:

Yes. If you start seeing a creep below that, that's probably a sign that it's either on the other side of continuing to grow, at least at the level that you want to see for the company or GDP level, or that they've maybe made some poor acquisitions or they've done some bad ass allocation internally in the company.

Andrew [00:21:58]:

Got you any ways that a company could manipulate this ratio? Not to say that companies are out there behaving to explicitly manipulate this ratio, but is there ways that ratio could be distorted?

Dave [00:22:12]:

Yeah, the easiest way that I can think of it would be to. Because depends on how you treat the whole goodwill part of invested capital. And if you don't include it in your invested capital decisions, there are companies that if they divest those acquisitions or if they write them off, that could reduce their goodwill, which could increase their sales to capital ratio because you would see the invested capital number drop, but the revenues stay the same or maybe bump up a little bit. That would be kind of gaming the system a little bit, but it would only be temporary because it wouldn't be something you would see over a long period of time. Eventually that would all kind of start to even out.

Andrew [00:22:56]:

And I guess the other downside being it's a backwards looking as well, right?

Dave [00:23:00]:

Yeah, for sure. It's definitely a backwards looking metric. It's a tool that looks back at what the company has done. But even though revenue is something maybe you can't project forward, I feel like invested capital is maybe a little easier to project forward simply for the fact that those assets and those liabilities that you're buying or selling are not always super liquid. And so manipulating those can be a bit of a challenge. And they're also a lot closer tied to management, and the decisions that they make versus revenues is sometimes out of their hands. And so if a capital allocator does a good job of allocating capital, chances are they'll continue to do that. The chances are better that they'll continue to do that.

Dave [00:23:45]:

All right, well, with that, we will go ahead and wrap up our conversation on sales to capital ratio. Hopefully we didn't put you to sleep too much with all the accounting chatter, but it's an important tool that you can add to your toolbox to help you when you're trying to value companies or just see who's good at allocating capital and how they can generate revenue from that. So hopefully you guys enjoyed that. And with that, we will go ahead and wrap up our show. Don't forget to subscribe to our show on your podcast app. If you enjoyed our little show, if you would kindly consider giving us a five star review, it greatly helps our show. And don't forget to browse the incredible materials we created for you envestingforbeganners.com. It's a resource there to help you get better.

Dave [00:24:24]:

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