WSB Journal of Business and Finance
Year 2024, Vol. 58, No.1
eISSN 2657-4950

Deciphering Sustainable Growth: The Influence of Corporate Financial Metrics on SGR and Stock Returns

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DOI 10.2478/WSBJBF-2024-0011

Abstract

In a diligent quest for outperformance in the market, the paper will delve into the complex dynamics of the Sustainable Growth Rate (SGR) and stock prices. According to Higgins' theory, the SGR is the maximum growth attainable by a company that does not require external funds. It employs Fixed Effects Models and analyses data from 73 major companies in the S&P 500 from 2021 to 2023. The study particularly examines how the factors, including tax and interest burdens, EBIT margin, asset turnover, financial leverage, and retention rate, help shape the SGR after COVID. Most importantly, this study underscores that return on equity (ROE) dominates the effect on SGR, thus stating that profitability and effective equity management are the keys to organizational sustainable growth. Therefore, the influence of the retention rate appears to be less impactful. The findings also challenge the traditional notion whereby long-term growth ensures long-term stock returns, hence more valuable for recommendations in light of this horizon for financial managers and investors, in refining their strategic and investment decisions.

Keywords: Sustainable growth rate, return on equity, DuPont, stock prices, fixed effects model

1 Introduction

1.1. Introduction to Sustainable Growth Rate (SGR)

Over the past decades, investors or big fund managers have, at large, been looking for a way by which they could outperform the market. This was put into deep analysis and still remains in scientific research, with the hope of finding "holy grail" methods for extraordinary returns. For example, Lakonishok, Vishny, and Shleifer (1994) found that stock returns have negative relations with prior growth rates in sales. Titman, Wei, and Xie (2004) confirmed an association between stock returns and capital expenditures, while Xing (2008) explored the impact of these expenditures on stock returns. Anderson and Garcia-Feijóo (2006) demonstrated the impacts brought on by market share on stock returns. Hou and Robinson (2006) find that operating efficiencies are among the factors that impact the stock returns of firms and companies, while Nguyen and Swanson (2007) suggest that total assets will have a relationship with stock returns. Cooper, Gulen, and Schill (2008) have revealed the dynamic turnover of assets-in-place and its relationship with low-risk and systematic returns in their research. Berk, Green, and Najsonn (1999) had done the work to study the factor of asset pricing related to the growth of various factors of a company. These research studies do add or create, in one way or another, a contribution to the body of research

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that aims at understanding and benefiting from the intricate relationships between stock returns and some fundamental research.

Specifically, this research critically analyzes the relationship between sustainable growth rate (SGR) and stock prices. According to the definition of Higgins (2007, p.117), sustainable growth is viewed as the "maximum growth rate at which a company's sales can increase without depleting its financial resources."

The sustainable growth rate (SGR) concept has elicited enormous debate in the finance literature due to its implications for the performance and valuation of the firm. SGR is generally considered the maximum growth rate at which a firm can increase its sales without needing external financing while maintaining a constant financial policy. This interest is by no means without a rationale in works similar to those of Higgins (1981), who laid a basis for analyzing the balance between sales growth, asset increases, and financial ratios under inflationary conditions (Higgins, 1981).

Subsequent research into the components driving SGR examined profitability, asset utilization, financial leverage, and retention rates. For instance, Arora, Kumar, and Verma (2018) indicated that these had a marked effect on the SGR in the Indian manufacturing sector, hence showing a dire need for efficient equity management if sustainable growth is to be experienced. This represents research done by Madoroba and Kruger, which examined South African firms and identified a mixed correlation between SGR and stock prices, indicating that while some firms exhibit a positive relationship, others do not, suggesting diverse strategic orientations and industry contexts (Madoroba & Kruger, 2015).

1.2. Understanding SGR Dynamics

Higgins' model emphasizes the importance of maintaining a balance between growth and financial stability, suggesting that firms with higher SGRs are better positioned to sustain long-term growth without resorting to excessive external financing. Further investigation has more clearly honed in on understanding how exactly the components of SGR affect stock market performance. Platt, Platts, and Chen (1995) argue that firms in financial distress may be unable to fulfill these special growth conditions. Channon and McGee (2015) discussed the fact that debt policies and dividend policies, especially in financial strategies, directly impact the growth rate a firm can sustainably realize.

Subsequent research has expanded SGR's geographic and sectoral scope, further substantiating its principles in a much broader validation. Accordingly, in a study by Vuković, Tica, and Jakšić (2022) analyzing Eastern European companies, it was concluded that the impact of liquidity and leverage on the sustainable growth of companies is negative, whereas, at the same time, they further encourage that profitability promotes it. In his contribution to the importance of the SGR in Macedonian companies, Naumoski (2022) highlighted the role of profitability, asset turnover, and financial leverage. The subtlety of operational performance and the subtlety between operational performance and capital structure for sustainable growth have been elaborated on in the study (Naumoski, 2022).

1.3. Stock Returns

Fama and French (1992) developed the three-factor model, which includes market risk, size, and value factors as determinants of stock returns. This model was later extended to include profitability and investment factors (Fama & French, 2015). The relationship between firm fundamentals, such as growth rates, and stock returns has been a central theme in asset pricing literature.

1.4. SGR and Firm Performance

Numerous studies have investigated the impact of SGR on firm performance. For instance, Higgins (1981) demonstrated that firms with higher SGRs tend to exhibit superior financial performance. Similarly, Lang, Stulz, and Walkling (1991) found that firms with higher SGRs are associated with higher profitability and lower financial distress.

1.5. Contradictory Findings: SGR and Stock Prices

Several empirical studies have explored the direct relationship between SGR and stock returns. Bhandari (1988) showed that firms with higher SGRs tend to have higher subsequent stock returns. In contrast, Fama and French (1993) argued that while growth rates are important, they should be considered alongside other factors such as size and book-to-market ratios. The findings of Lockwood and Prombutr (2010) establish that high SGR is expected to correspond to low default risk and, hence, low stock returns. This view is key in that, among other reasons, it underscores that high growth does not necessarily beget high returns, possibly because of the associated risks and how the market prices such risks. More recent studies, such as those by Chen, Novy-Marx, and Zhang (2011), have emphasized the predictive power of SGR in determining future stock returns.

1.6. Utility of the DuPont Mod

The DuPont Analysis is very widely applicable in providing profitability and growth potential within a multifaceted appraisal framework because DuPont analysis is applicable. Mangiero (2004) added that the DuPont model helps in the decomposition of Return on Equity (ROE) to explain its drivers of profitability and help in the analysis of sustainable growth rates (SGR) pertinent for business valuation and income forecasting. This model relates quite effectively to operational, investing, and financing metrics in making predictions of changes in ROE and relating them to future values, thus connecting financial strategy to firm growth. Although it is susceptible to management manipulation in financial reporting, its robustness for use supports its wide application for a range of studies seeking to explain the relationship between financial leverage and efficiency in asset management and ROE within different industrial contexts, such as Pouraghajan et al. (2012) and Almaqtari et al. (2019). These attributes confirm that the DuPont model is very useful in modern times for financial analysis of the company and makes this relevance highlight most especially for the relevance of its components in the SGR and effects on the firm's valuation (Mangiero, 2004; Altahtamouni et al., 2022).

Sustainable growth goes beyond a mere numerical indicator and contains the concept's critical dimensions. It comprises the policy of a firm in relation to earnings retention and its prowess in managing and containing operational costs, the effectiveness with which it uses its assets, and the overall strategy of its financial structuring. Collectively, these elements form the cornerstone of a firm's operational efficacy and are pivotal in determining its overall market performance:

$$SGR = \underbrace{\text{Tax burden}*\text{Interest burden}*\text{EBIT Margin}*\text{Asset Turnover}*\text{Financial Leverage}}_{ROE} * \underbrace{\text{Retention rate}}_{RR}$$

where SGR is the sustainable growth rate, and ROE is the return on equity ratio.

In the present study, we utilize the model articulated by Higgins—a decision that we would claim does not necessarily point to foundational assumptions inherent within this framework. First and foremost, the Higgins model assumes that the firm in question follows a given financing or capital structure with a constant dividend policy that it endeavors to maintain. It underlines the very strategic financial decisions that the company takes, which have far-reaching ramifications over its growth and valuation. At the same time, the model operates on the assumption that management is either unwilling or unyielding in the case of new equity issuance. Emphasizing the level of dependence on internal financing and its effects on potentiality for growth brings it to a more human-level conversation. Such are the underlying assumptions that would influence the interpretation and application of the sustainable growth rate within the context of this research.

1.7. Implications for Financial Theory and Practice

This paper aims to examine the complex relationship between stock returns and Sustainable Growth Rate (SGR), particularly emphasizing how different corporate financial indicators affect SGR dynamics. What makes our article unique and significantly adds value to financial literature is that it provides a more detailed and nuanced analysis of Sustainable Growth Rate (SGR) than its counterparts and components in relation to stock prices. Our study has, therefore, used a model by Higgins to examine how the tax burden, interest burden, EBIT margin, asset turnover, financial leverage, and retention rate affect SGR. Instead of focusing on SGR or using more generic models, our research alters this to reach that end. This approach generally enables an understanding of SGR dynamics and takes deeper insights into the underlying factors that drive sustainable corporate growth without external financing.

Through this paper, we will strictly test the impact of the sustainable growth rate on stock returns concerning a series of hypotheses. This framework leads us to three research questions we will explore in the subsequent sections.

2 Materials and methods

2.1. Data and variables

This study focuses on the top 73 firms in terms of market capitalization in the S&P 500 index. The selection criterion is aimed at analyzing firms that exhibit market influence and stability, as it provides a robust base for evaluating the impact of sustainable growth rates on stock performance.

Data for the study was carefully collected from Yahoo Finance over a three-year period, 2021-2023. This dataset includes the annual financial metrics reports on important key metrics and stock performance indicators of this important key metric, which is critical in the course of its analysis of the relationship of sustainability between growth rates and stock valuation over time. This allows the capture of the current financial trends and growth

behaviors over the last three years, hence offering updated and relevant context in light of the recent economic conditions. This timeframe also helps to understand the resilience and performance of these firms, given economic fluctuations, to get insights into how well these companies manage growth sustainably under varying economic pressures.

Table 1 explains the variables used in this research. For variables that are in logarithmic form, we wrote L before variable names.

Table 1. VARIABLES, DESCRIPTIONS AND FORMULAS

Variable	Description	Formula
SGR	Sustainable Growth Rate	Retention Rate × Return on Equity
Lreturn	Natural Logarithm of Stocks	Ln(stock_price)
ROE	Return on Equity	Net Income / Equity
Retention_Rate (RR)	Retention Rate	(1-dividend payout ratio)
Tax_Burden (TB)	Tax Burden	Net Income / Earnings Before Tax
Interest_Burden (IB)	Interest Burden	Earnings Before Tax / EBIT
Ebit_Margin (EM)	EBIT Margin	EBIT / Total Revenue
Asset_Turnover (AT)	Asset Turnover ratio	Total Revenue / Total Assets
Financial_Leverage (FL)	Financial Leverage ratio	Total Assets / Equity

Table 2 reports descriptive statistics for financial metrics from the 73 firms in the S&P 500. The average Asset Turnover was 0.615, indicating efficient asset utilization, while the average ROE was 0.330, reflecting solid profitability across the sampled firms. The mean SGR of 0.232 showcases the potential for sustainable growth within these leading companies.

2.2. Descriptive Analysis

Table 2. DESCRIPTIVE STATISTICS

Variables	Observations	Minimum	Maximum	Mean	St. Deviation
ASSET_TURNOVER	219	0.007396	2.567859	0.615086	0.416096
EBIT_MARGIN	219	-0.037231	173.7391	1.353823	12.28638
FINANCIAL_ LEVERAGE	219	-9.237416	19.55421	3.467058	3.795197
INTEREST_BURDEN	219	-4.416300	2.170332	0.907270	0.386150
RETENTION_RATE	219	-32.71154	1.000000	0.472389	2.288054
ROE	219	-0.555541	2.370432	0.330447	0.361168
SGR	219	0.000870	1.914780	0.232085	0.277583
TAX_BURDEN	219	0.003082	2.333887	0.835543	0.193511
LRETURN	219	3.500137	6.819536	5.251446	0.793431

2.3. Hypotheses

The study formulated the following hypotheses to examine the relationship between the sustainable growth rate, the components of the DuPont model, and stock prices.

- Hypothesis 1 (H1). There is no statistically significant effect of TB, IB, EM, AT, FL, or RR on SGR.
- Hypothesis 2 (H2). ROE and RR have no statistically significant effect on SGR.
- Hypothesis 3 (H3). There is no statistically significant effect of LSGR on Stock Prices.

2.4. Method Selection

To find the suitable econometric approach in the analysis of the relationship between the sustainable growth rate and other financial metrics, this study uses a systematic procedure that employs established statistical tests to choose between pooled ordinary least squares (POLS) and the panel data method (Fixed Effects Model (FEM) or Random Effects Model (REM)).

The Breusch-Pagan Lagrange Multiplier test for random effects determines whether to use pooled ordinary least squares (POLS) or panel data models. A p-value above 0.05 indicates the adequacy of the POLS model, while a p-value below suggests a panel data approach (FEM or REM). If the POLS model is rejected, the Hausman test is employed to choose between Fixed Effects or Random Effects models. A p-value above 0.05 favors the REM model, while below 0.05 supports the Fixed Effects model as more appropriate for modeling the dataset.

Based on the supplied econometric procedures for testing these relationships and their results, a systematic evaluation has been done so that the most feasible method that might be applicable in testing the relationship between the sustainable growth rate and the various financial metrics under different hypothetical bases is arrived at. To begin with, the Breusch-Pagan Lagrange Multiplier test was applied to decide whether to pool using ordinary least squares (POLS) or employ the panel data models. These statistically significant p-values found for each hypothesis (all $p < 0.05$ for the "Both" category) imply that the null hypothesis is rejected and, therefore, it provides evidence in favor of POLS models not being adequate. This finding indicates the complexities of the data structure and likely includes unobserved heterogeneity across the entities, hence suggesting that a panel data approach be adopted.

Table 3. LAGRANGE MULTIPLIER TESTS FOR RANDOM EFFECTS

Hypothesis 1	Lagrange Multiplier Tests for Random Effects	Cross-section	Test Hypothesis Time	Both
Breusch-Pagan		116.41503 (0.0000)	1.33255 (0.2484)	117.74759
Hypothesis 2				
Breusch-Pagan		100.59908 (0.0000)	0.51851 (0.4715)	101.11760 (0.0000)
Hypothesis 3				
Breusch-Pagan		150.2392 (0.0000)	0.07698 (0.7814)	150.3162 (0.0000)

Following the indication of panel data models as more appropriate, the following decision between Fixed Effects Model (FEM) and Random Effects Model (REM) was guided by the results of the Hausman test. For each hypothesis, the Hausman tests produce very low p-values ($p < 0.05$) and, hence, strongly favor the Fixed Effects Model. This result provides evidence of correlated individual effects, meaning that unobserved variables, which are correlated with the regressors, are better captured using the FEM approach.

Table 4. CORRELATED RANDOM EFFECTS-HAUSMAN TEST

Hypothesis 1	Correlated Random Effects- Hausman Test	Chi-Sq. Statistic	Chi-Sq. d.f	Prob.
Cross-section random		83.82597	6	0.0000
Hypothesis 2				
Cross-section random		8.70402	2	0.0128
Hypothesis 3				
Cross-section random		13.87636	7	0.0002

3 Results

Table 5. RESULTS OF FIXED EFFECTS MODEL

Hypothesis 1	FEM					
Variable	Coefficient	p-value	S.E of regression	R-squared	F-value	Durbin-Watson
TB	0.184447	0.0044	0.101179	0.914677	19.24144	3.351712
IB	0.057019	0.0034				
EM	0.002655	0.0035				
AT	0.725302	0.0000				
FL	0.073341	0.0000				
RR	-0.015195	0.0004				
Hypothesis 2	FEM					
Variable	Coefficient	p-value	S.E of regression	R-squared	F-value	Durbin-Watson
ROE	0.783775	0.0000	0.031731	0.991369	223.5035	3.268054
RR	-0.002448	0.0574				
Hypothesis 3	FEM					
Variable	Coefficient	p-value	S.E of regression	R-squared	F-value	Durbin-Watson
LSGR	0.036698	0.2822	0.254552	0.931539	27.02715	3.235322

We reject the null hypothesis for Hypothesis 1. The Fixed Effects Model results indicate that the Tax Burden (TB), Interest Burden (IB), EBIT Margin (EM), Asset Turnover (AT), Financial Leverage (FL), and Retention Rate (RR) significantly impact the Sustainable Growth Rate (SGR). Asset Turnover (AT) demonstrated the most substantial effect on SGR, followed by Tax Burden (TB) and Financial Leverage (FL). Interest Burden (IB) exhibited the smallest significant impact among the variables.

These findings underscore the importance of operational efficiency (as evidenced by high asset turnover) and tax management in driving sustainable growth. Financial leverage's significant effect aligns with financial theory, which posits that optimal debt levels can enhance growth by leveraging assets more efficiently, though it also introduces greater risk.

Regarding hypothesis 2, we reject the null hypothesis regarding ROE and fail to reject the null hypothesis regarding RR at the conventional 5% level but reject it at the 10% level. The relationship between Return on Equity (ROE), Retention Rate (RR), and SGR was explored. The model found a highly significant effect of ROE on SGR, with a coefficient of 0.7837. This indicates that for every one-unit increase in ROE, SGR increases by approximately 0.7837 units, holding other factors constant. Conversely, the effect of RR on SGR was much weaker and only significant at the 10% level, suggesting that while RR contributes to SGR, its impact is minimal.

This finding is pivotal as it highlights ROE's critical role in driving sustainable growth. The significant influence of ROE reinforces the concept that profitability, when coupled with efficient equity use, is a crucial determinant of a firm's ability to grow sustainably without needing external financing.

We fail to reject the null hypothesis for Hypothesis 3. The analysis investigating the impact of the Long-term Sustainable Growth Rate (LSGR) on Long-term Stock Returns (RETURN) revealed that the effect was not statistically significant (p-value = 0.282). This suggests that, within the sample and periods studied, LSGR does not have significant predictive power on stock returns, contrary to what might be expected.

These results contribute valuable insights into the financial determinants of sustainable growth and their impacts on firm performance. The significance of operational and financial metrics in driving SGR, alongside the nuanced role of retention rates and the unexpected non-significance of LSGR on stock returns, provide a complex picture that warrants further investigation.

4 Conclusion

The intricate relationship between SGR and key fundamental financial metrics that is highlighted is of critical importance both in the realm of theoretical exploration and practical application within corporate finance. The primary motive of this study was to unravel the nuances of this relationship and examine how various components like tax burden, interest burden, EBIT margin, asset turnover, financial leverage, and retention rates affect the SGR

of the firms. By so doing, this research sought to provide more details on its components and thereby add value to the existing economic theories shaping our understanding of the dynamics of corporate growth.

It revealed a detailed picture of the dynamics determining sustainable growth rates. The first hypothesis tests show that tax burden, interest burden, EBIT margin, asset turnover, financial leverage, and retention rate are statistically significant determinants of SGR. Rather, it was related to asset turnover and financial leverage, which means the necessary efficient asset management and sustainability in strategic financial structuring for business growth.

These findings seem to underscore asset turnover and financial leverage in particular, and it's not surprising that the same conclusions were drawn by Liow (2010). Nevertheless, we will differ from the results of Cooper, Gulen, and Schill (2008) in that we will not consider much the effects of asset growth without emphasizing the tax burden or EBIT margin together with this effect. Our detailed approach puts forth a more nuanced interplay of the multiple variables rather than the simple models of most of the earlier studies.

Hypothesis 2 suggests that the individual role of return on equity (ROE) and retention rate in shaping SGR will be provided. The results of this model very strongly support an important positive influence of ROE on SGR, which shows that profitability and efficient management in equity is one of the important factors for sustainable growth. On the other hand, the impact through the retention rate is smaller and only marginally significant, perhaps indicating that while retaining profit contributes to growth, it has a relatively lesser magnitude. This conclusion is consistent with the general financial theory that profitability (measured through ROE) has a crucial impact on sustainable growth, as evidenced in the research of Arora, Kumar, and Verma (2018), where they have highlighted ROE as one of the key drivers of SGR in Indian manufacturing firms.

The less impactive retention rate contrasts earlier studies' findings that postulated a significant role for earnings retention in promoting growth, such as Nastiti, Atahau, and Supramono's research (2020) on asset utilization mediating between working capital management and sustainable growth.

Hypothesis 3 tested the relationship between long-term sustainable growth rate (LSGR) and long-term stock returns. The findings are particularly insightful in the sense that they showed no significant correlation between LSGR and stock prices—contrary to one of the many things thought to have been established. This may indicate that a larger set of factors than just sustainable growth expectations influences market valuations. It certainly implies some very important insight that does not follow the path of the general conventional financial theory, which normally predicts a positive relation between sustainable growth rates and stock prices.

This finding is particularly intriguing in light of the result by Vassalou and Xing (2004) and Avramov and Chordia (2006), who identified a linkage between the growth rates and risk perceptions, which purport to influence stock returns. Our study, however, would suggest that this relationship is not quite so straightforward or of universal applicability, highlighting investors' need to consider more varied factors in looking at implications deriving from growth metrics. The major contribution of this research is the in-depth analysis of the components of the DuPont identity as determinants of SGR, hence giving a very detailed insight into the growth facilitators within firms.

In this context, the results achieved from this study will help financial managers and corporate strategists identify those areas that are key to operational improvement, and for the formulation of policy, they can also be helpful for investors in more accurate assessments of firm growth potentials. However, so much distance still remains along the path of the investigation into firm growth sustainability.

Although this study offers insightful information on the connection between stock returns and Sustainable Growth Rate (SGR), it is crucial to recognize its limitations. First off, the research may not accurately reflect the market as a whole because it is based on data from 73 significant S&P 500 businesses. Furthermore, the study's scope is constrained to the three years between 2021 and 2023, which may not be sufficient to capture long-term changes. Additionally, the accuracy of the results could be impacted by the assumptions and simplifications made by the econometric models used in the analysis. Ultimately, this research is susceptible to potential biases and omitted variable issues that come with using observational data analysis, just like any other empirical study. When interpreting the results of this investigation, these limitations need to be considered.

Future researchers are strongly recommended to explore the sector-specific impacts of these variables and possibly develop models that would be sensitive to the unique characteristics of different industries. Longitudinal studies would also present the long-term trends and the effects of the economic cycles on these relationships. Briefly, if nothing else, this research could go some way to provide salient insights into influencing factors of sustainable growth within the rapidly changing nature of global markets and the ever-changing advent of new financial technologies that will always have a say.

Therefore, these have been very enlightening studies concerning the factors that influence sustainable growth; the evolving nature of global markets and the new advent of financial technologies will continually shape these dynamics. In this regard, ongoing research remains very core, as it remains of the essence to get abreast of the changes to ensure that the theoretical frameworks and practical applications developed are relevant and effective.

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