CORPORATE ANALYSIS

RoE: The Shareholder Perspective

Return on Equity (RoE) is the ultimate perspective from a shareholder point of view in assessing whether value has been created for an investment in a stock.

Shareholders have a stake of ownership in a firm: With their rights to ask questions and vote in shareholder meetings they share responsibility for the operations of a firm by electing a board. The dividends they receive in return for the capital invested are not guaranteed and only paid at the discretion of the board.

As per the Capital Asset Pricing Model (CAPM) an investment in a stock is attractive, provided that investors are compensated over the anticipated holding period with a return equal or higher than the risk free rate plus a premium. Latter is defined as the multiple of the market risk premium and the beta for the underlying asset or comparably risky assets. - Economically and from a Corporate Finance point of view, shareholders "own" the firm´s net income as well as its equity. Therefore, the appropriate ratio to measure the attractiveness of an investment in a stock is to apply the RoE (net income/ equity).

But RoE is merely a figure. Therefore, it has to be put in a perspective: Next to observing trends in the RoE, the appropriate benchmark to meet or exceed as per the CAPM is the Cost of Equity (CoE). But even then, merely presenting upward trends or beating the CoE benchmark is still not quite enough for a full understanding: If, for example, a firm´s CFO announced that the RoE increased, then at first sight this seems like good news. However, one should better understand how this trend has been achieved and which drivers have been behind it. To analyze this, one would need to de-compose RoE into its core components: Net Profit Margin, Asset Turnover and Leverage:

The Net Profit Margin (net income / revenues) indicates how well a company converts revenues into profits. An increase in the Net Profit Margin is usually interpreted as a positive signal.

The Asset Turnover (revenues / total assets) is an indicator of how efficient assets are deployed in generating revenues. Whilst usually an increase of this ratio points towards improved efficiency, one should also investigate whether recent investments in operations have been adequate according to the stage in the life cycle of the firm. An underinvestment in, for example, fixed assets would certainly increase Asset Turnover but eventually result in the firm´s asset base being simply run down.

And, finally, the Leverage or Equity Multiplier (total assets / equity) provides a preliminary insight into the funding structure of a firm: An increase in leverage is commonly interpreted as the firm having increased its risk profile, its earnings volatility. In that regards, the reasoning goes like this: Higher leverage results in a higher percentage of the firm´s balance sheet now being funded with debt. And, higher debt usually implies higher interest payments. Now, as interest payments are in most cases fixed costs (they remain constant, regardless whether revenues increase or decrease, unlike variable costs) this additional layer of fixed costs eventually leads to a higher volatility in the bottom line, the net earnings. – And higher volatility - in finance - is the equivalent of higher risk.

Therefore, a firm may have increased its RoE simply by increasing leverage whilst the Net Profit Margin and the Asset Turnover could even have deteriorated. – On the other hand: If, for example, a firm was previously too much equity-funded, a higher leverage will be beneficial for the firm´s performance, as the CoE is always higher than the cost of debt. Therefore, adding debt to the funding structure of a balance sheet can – up to a certain amount – result in an overall decrease in the average cost of capital and ultimately benefit shareholders.

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SHAREHOLDER PERSPECTIVE

BALANCE SHEET

WORKING | CAPITAL

ASSETS | DEBT

EQUITY

TOTAL ASSETS

= LIABILITIES + EQUITY

INCOME STATEMENT

REVENUES

- COST (PERSONELL, MATERIAL)

= EBITDA

- DEPRECIATION

= EBIT

- INTEREST

= EBT

- TAX

= NET PROFIT

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