Growth vs Profitability: The Importance of ROCE

ROCE companies focus all their strategies on achieving it, says **Shyam Pattabiraman**

Many companies and investors think that growth is the 'be-all', and 'end-all', of value, at the risk of ignoring profitability. Yet, time and again, the capital markets have proven that in the long term, profitability is critical and growth for growth's sake can destroy value.

Analysis

A study of listed companies that constitute the BSE 100 Index indicates that, on average, companies that deliver better Return on Capital Employed (ROCE) – which is a comprehensive profitability metric - experience a higher valuation that is measured in terms of the price to book (P/B) multiple at which their shares trade.

In fact, the analysis reveals that firms arranged in an ascending order of ROCE, exhibit a progressively increasing P/B multiple mean (average). Firms in the lowest ROCE bucket have a mean P/B multiple of 2.27 and a median P/B multiple of 1.96. In contrast, firms that belong to the highest ROCE bucket have a mean P/B multiple of 11.81 (See Chart 1) and a median P/B multiple of 8.34. These findings indicate that the ROCE metric has an important influence on the valuation multiple that a firm enjoys. A firm that can expand its ROCE, can expand its valuation multiple.

What does this mean?

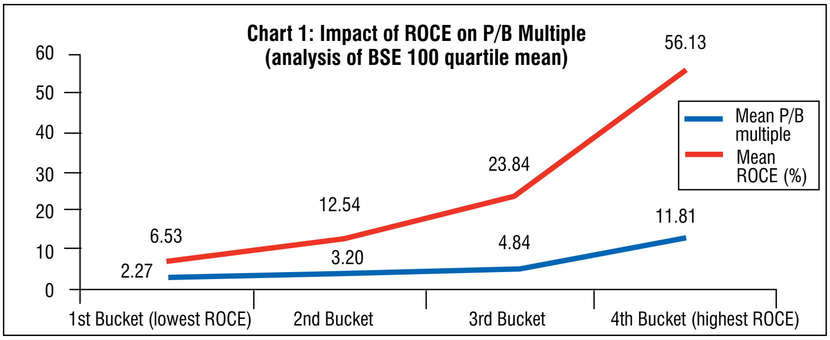
In simple terms, this means that the market rewards firms that can compound the capital they employ in their business at high rates of return, by valuing them at a higher premium compared to peers that compound

Study findings on listed companies show that the ROCE metric has an important influence on the valuation multiple that a firm enjoys. A firm that can expand its ROCE, can expand its valuation multiple

capital employed in their business at low rates of return. The implication of this is also less dilution of equity for future fund raising initiatives for those firms that are superior managers of capital.

The corollary to this is that while the market expects firms to grow, growth for growth's sake without a handle on the ROCE may in fact be value eroding in terms of the market multiple commanded by the firm.

ROCE-linked differences in valuation multiples can be found both within industries and across industries. For instance, textiles vs FMCG, IT services vs manufacturing, or HDFC Bank vs ICICI Bank. The takeaway is that ROCE has both industry-specific and firm-specific components. Even Warren Buffett has gone on record to say that when a management with a reputation for brilliance tackles a business with a reputation for bad economics, it is the reputation of the business that remains intact. Certain industries such as airlines and textiles are by nature poor compounders of capital over the long term due to certain intrinsic characteristics such as, their capital-intensive nature, wafer-thin margins, and inability to pass on cost increases to customers, among others. However, there are a few companies in these sectors such as, Southwest Airlines and Indigo in the aviation space which have bucked this trend by adopting astute strategies. But, taking a look at the IT services or FMCG sector, it is clear that even the smaller and less efficient firms can record a 20 per cent+ ROCE comfortably. As a result, it is common to see companies operating in low ROCE



industries, such as, aviation, textiles and power, leveraging to boost return on equity (ROE), while companies operating in high ROCE industries need no incentive to leverage up, and rightly so.

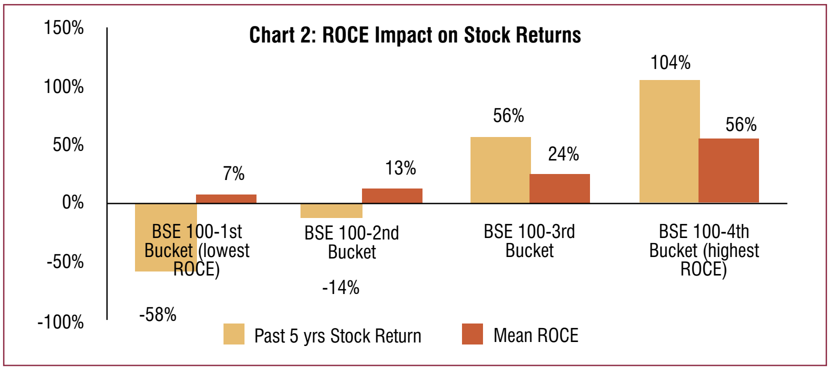
High ROCE is correlated with superior stock returns especially during high inflation

Among the major events that have taken place in the last five years are, the following: a) the Mumbai stock market Sensitive Index (Sensex) peaked in January 2008, and is yet to scale its previous high; b) India has experienced a period of extraordinary inflation; and c) the world has undergone a mighty recession, and is yet to fully recover from it. These factors have caused investors to shift to gold investments leading to a run up in its demand and consequently, its price.

However, an analysis of BSE 100 companies based on ROCE levels indicates that companies in the highest ROCE bucket have on average, delivered stock returns of 104 per cent in the last five years compared to 73 per cent returns posted by gold (measured in USD). Chart 2 shows that the two higher ROCE buckets of BSE 100 firms have posted positive returns vis-a-vis the market during this period, while the two lower ROCE buckets have posted significantly negative returns vis-a-vis the market.

On the other hand, firms with a ROCE that did not even compensate for the returns from risk-adjusted equivalents (safer alternatives) such as, returns from fixed deposits, were losing money in real terms during this period. When a company consistently does not get a ROCE which is in excess of returns from safer alternatives (such as, the fixed deposit), the capital employed by the firm is better off getting re-deployed elsewhere. The market penalises such firms with negative stock returns and rewards those that continue to add economic value (high ROCE firms) with positive returns. Especially in periods of high inflation and high interest rates, a business that seemed viable in a low interest rate and low inflation rate period can become unviable.

High ROCE companies have the required margin of safety to continue generating positive ROCE over and above high interest rates and inflation, during difficult times. Nestle is one such company from the high ROCE bucket that clocks average ROCE in excess of 100 per cent. Nestle will continue to be an economically attractive business, despite interest rates or inflation moving to double digits, because the difference between the safer FD returns and what its business generates is considerably large. The difference is also attributable to the FMCG sector, to which Nestle belongs. It is really hard for a company to be in the FMCG business and generate less than a 20 per cent ROCE. No surprises that the FMCG index has recorded 132 per cent returns during the last five years compared to -6 per cent for the Sensex.



Linkage to strategy

Having a keen eye on ROCE is a must during the stages of ideation and implementation of a strategy – be it for running a business or for investing. Unfortunately, the abundant and cheap availability of capital can cause firms to lose sight of profitability in the lure of empire building. During such times, arguments such as, 'owning a small portion of a large pie is better than having a large portion of a small pie', are made without thinking about the quality of the pie in the first place. This usually results in investments in mediocre projects, non-core expansions, over-priced and grandiose M&As, and other decisions which lack fundamental soundness but can be justified in the name of growth and market share. This is exactly what happened in the early part of this millennium – with almost every Indian company or group aspiring to raise capital, diversify, pursue M&A, and go global.

In the past few years, Indian firms have had to face pressures of increasing cost of capital and operating costs (thanks to inflation and commodity bubbles), as well as a slowdown in growth. Many companies saw their ROCE eroding, and subsequently, their valuation. The effect is more pronounced in a few sectors such as, infrastructure-related businesses, compared to others.

Conclusion

ROCE is an important shareholder value metric, yet most annual reports of companies do not even talk about it. It has been observed that organisations which have a superior ROCE compared to their industry, have a relentless focus on driving their organisations towards achieving it. Such organisations link all their strategic and operational initiatives, including performance metrics across functions and levels, to the key ROCE value drivers such as, fixed asset productivity, working capital turns, and operating margins. Targets are set against these during the planning and budgeting process, and initiatives are prioritised based on how important they are in preserving or enhancing ROCE. One company with a good ROCE discipline is Bajaj Auto, which has put its small car project on hold, despite having invested time and money in this effort, because the project did not meet its ROCE requirements. ■

Shyam Pattabiraman - Manager, Finance Effectiveness, PwC Consulting