
Impact of ROCE on valuation

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Abstract

Our study of listed companies that constitute the BSE 100 Index indicates that, on an average, **companies that deliver better Return on Capital Employed (ROCE) experience higher valuation - measured in terms of Price/Book (P/B) multiple** at which their shares trade.

What this means is that, the market rewards firms that can compound capital at higher rates of return by valuing their existing equity base at a higher premium compared to peers that compound capital at relatively lower rates of return. The implication of this is lower cost of capital and less dilution of equity for future fund raising initiatives of firms that are superior managers of capital.

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

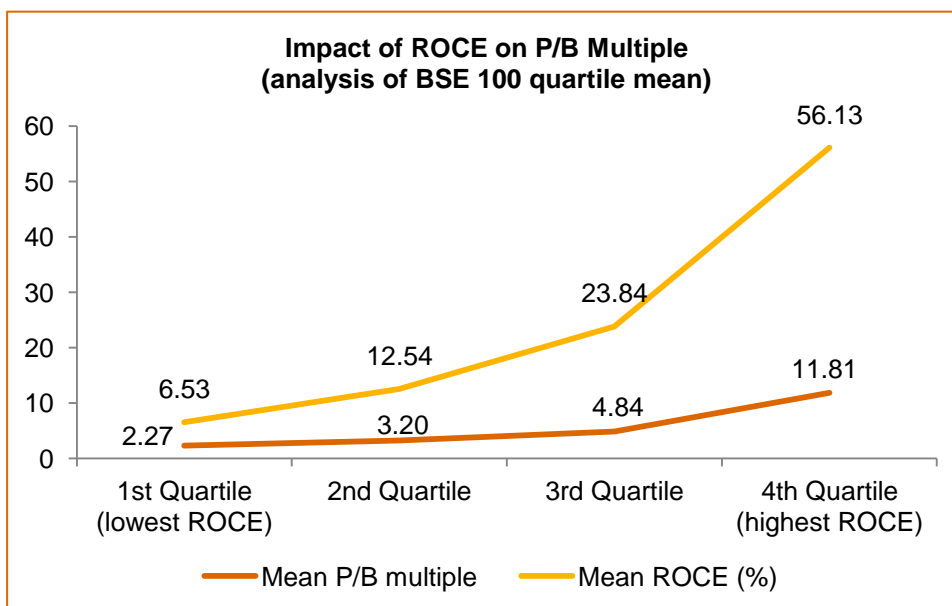
We believe that a keen eye on ROCE is a must during the ideation and implementation of business plans, and this is where enterprise performance management is crucial. A robust ROCE based performance management framework will translate organisational strategy into appropriate functional level goals, which can be tracked and monitored at the right levels and frequency, to improve ROCE and thereby improve valuation.

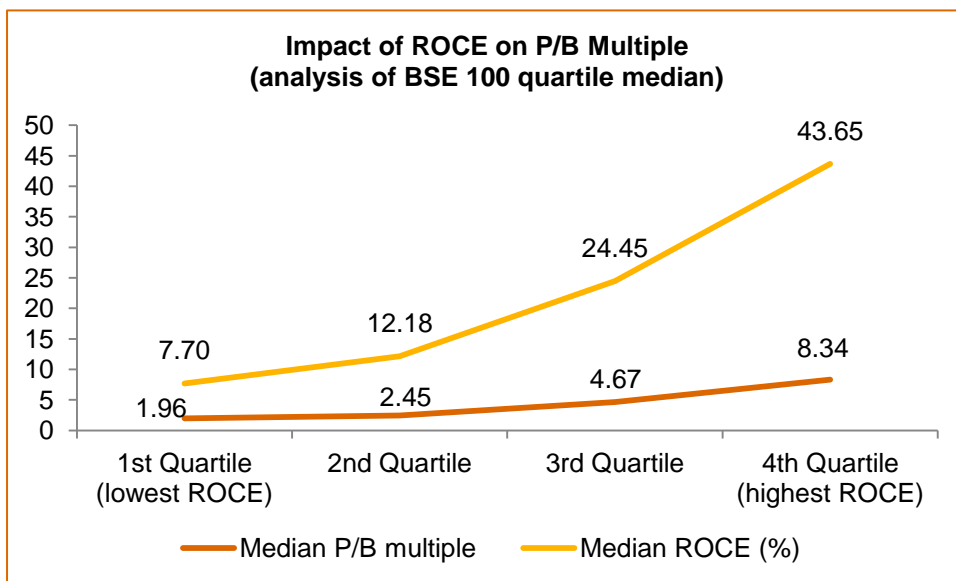
Analysis

A sample set of 79 leading listed companies in India were analysed to study impact of ROCE on valuation. In order to keep the basis for comparison similar, P/B multiple was chosen as the representative for valuation. The firms were sorted in the ascending order of their ROCE and then grouped into four buckets (quartiles). The means and medians for ROCE and P/B were computed for each quartile and plotted to observe possible trends.

Among the quartiles, it was observed that P/B multiple followed the same trend as ROCE.

Findings





Source, Assumptions and Data Sets

Source data for analysis extracted for BSE 100 firms using Capitaline screeners

ROCE computed based on standalone financials for FY 10

Price/ Book value computed based on BSE closing share price for Jan 14, 2011 and standalone book value of equity for FY10

Number of firms considered for analysis: 79

(Firms in BSE 100 Index = 100, minus Financial services firms = 18, minus firms with incomplete data or negative ROCE = 3)

Quartiles for analysis formed by clustering firms that were pre-sorted in ascending order of ROCE

1st quartile (lowest ROCE) = 20 firms; 2nd quartile = 20 firms; 3rd quartile = 20 firms; 4th quartile = 19 firms

Summary

Our analysis of the BSE 100 Index revealed that firms grouped into quartiles based on ascending order of ROCE, also exhibit progressively increasing P/B multiple in terms of quartile mean and median. **Firms in the lowest quartile of ROCE have a mean P/B multiple of 2.27 and median P/B multiple of 1.96** while **firms that belong to the highest quartile of ROCE have a mean P/B multiple of 11.81 and median P/B multiple of 8.34**. These findings indicate that ROCE has an important influence on the valuation multiple that a firm enjoys (*ceteris paribus*).

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