Return on Equity: The Shareholder Perspective

Assuming the shareholder point of view, Return on Equity (RoE) assesses whether holding a stock creates value.

Shareholders have a stake of ownership in a firm: Equipped with rights to ask questions and vote in shareholder meetings they share responsibility for a firm´s operations by electing a board. Payment of dividends in return for capital invested is not guaranteed, though, as up to the discretion of the board.

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

RoE must be interpreted, though, and put into perspective: Next to observing trends in a corporate´s RoE and benchmarking it with peers, the appropriate threshold to meet or exceed is the Cost of Equity (CoE) as per the CAPM. However, even upward trends in a firm´s RoE or beating the appropriate CoE benchmark may actually be misleading: Instead, one must look behind the drivers of a firm´s RoE and decompose it by splitting it into its core components: net margin, asset turnover and leverage.

The net margin (net income / revenues) indicates how well a company converts revenues into profits. An increase in a firm´s net margin may be seen as a positive signal.

Asset turnover (revenues / total assets) indicates how efficiently a firm´s assets are deployed in generating revenues. Whilst its increase points towards improved efficiency, one should also analyze, whether recent investment levels in operations have been adequate and are in line with the stage of a firm´s life cycle. For instance, a chronic underinvestment in fixed assets would likely increase a firm´s asset turnover. However, such would not be sustainable: With a firm´s asset base simply run down, the backlog of capital expenditures would have to be dealt with, sooner than later.

And, finally, leverage or the equity multiplier (total assets / equity) provides a preliminary insight into a firm´s funding structure: Whereby, an increase in leverage is commonly associated with higher financial risk, due to higher earnings volatility. – The rationale behind this assumption is as follows: Higher leverage means that a higher percentage of a firm´s balance sheet is funded with debt. And along with this, interest payments will assumedly be higher, too. Now, in most cases, interest payments are actually fixed costs: This means that unlike variable costs, they remain constant regardless whether revenues increase or decrease. Hence, in most cases higher interest payments will add a layer of fixed costs. And therefore, any fluctuations in a firm´s revenues will directly lead to a significantly higher volatility in net earnings (i.e. increasing a firm´s financial risk profile).

Therefore, a firm may have increased its RoE simply by aggressively levering up – and thereby merely increasing its risk profile -, whilst its net margin and / or asset turnover may meanwhile have deteriorated.

On the other hand, a firm increasing its leverage could be a positive sign and actually welcome: If, for instance, a corporate previously foremost relied on equity-related funding, then higher leverage will likely contribute to an improved performance. With CoE higher than cost of debt, adding leverage to a balance sheet´s funding structure can – up to a certain extent – result in the decrease of a firm´s average cost of capital. And this would ultimately create value, not least for shareholders.

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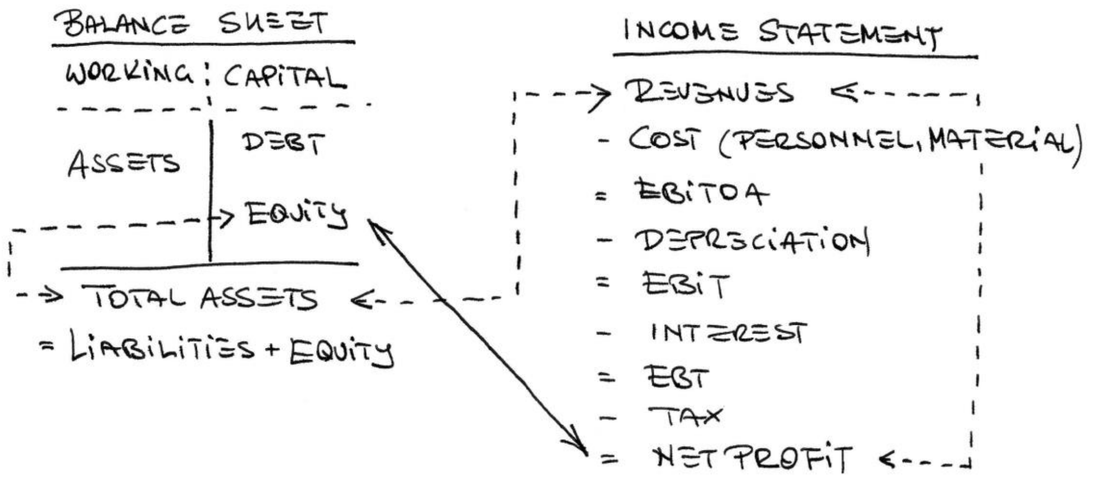

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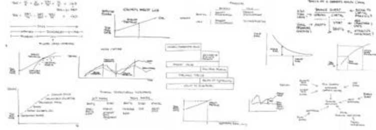

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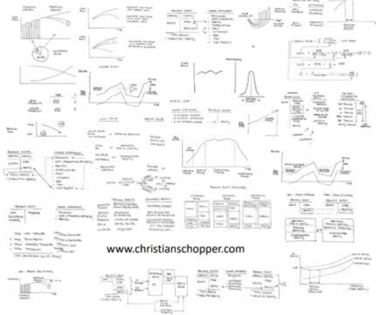

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