

## Return on Equity: The Shareholder Perspective

**Assuming a shareholder's perspective, Return on Equity (RoE) assesses whether holding a certain stock has created value.**

Shareholders have a stake of ownership in a firm: With their 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, and up to 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 with the respective beta factor for the underlying or a comparable risky asset. - 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).

As RoE is merely a figure, though, it has to be interpreted and put into perspective: Next to observing trends in a corporate's RoE, the appropriate benchmark to reach or exceed is the Cost of Equity (CoE) as per the CAPM. But even then, merely presenting upward trends or beating the CoE benchmark is not sufficient for a full appreciation of RoE: If, for example, a firm announced that RoE did increase, then at first sight this should be good news. However and perhaps counterintuitively, this may actually not be the case, unless one has an understanding of the drivers behind the trend. Therefore, one needs to split RoE into its core components: Net margin, asset turnover and leverage:

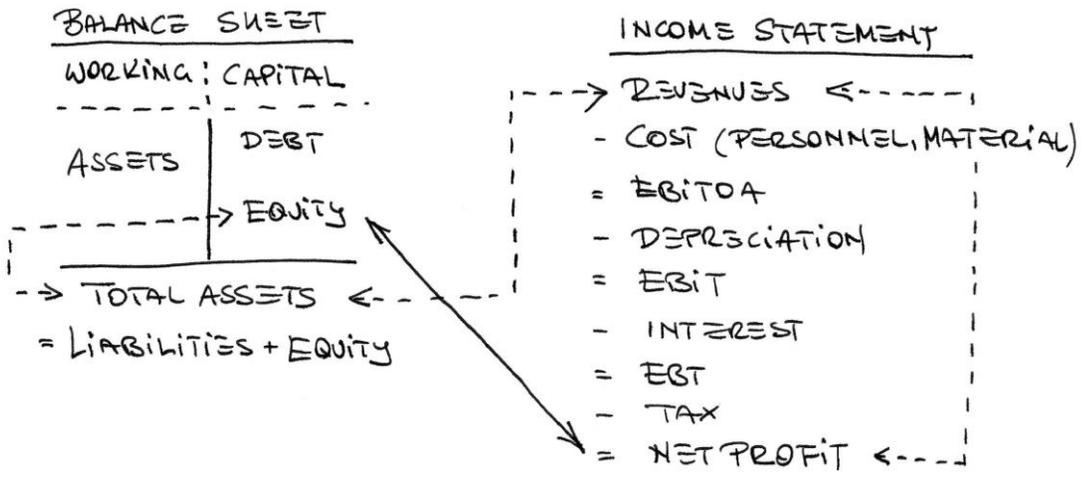
The net margin (net income / revenues) indicates how well a company converts revenues into profits.

An increase in the net margin may be interpreted as a positive signal.

Asset turnover (revenues / total assets) is an indicator of how efficiently assets are deployed in generating revenues. Whilst an increase of this ratio usually points towards improved efficiency, one should also analyze, if recent investments in operations have been adequate according to the stage of a firm's life cycle. An underinvestment in, for example, fixed assets would increase asset turnover but eventually result in the firm's asset base being simply run down (with the backlog of capital expenditures to be dealt with rather sooner than later).

And, finally, leverage or the equity multiplier (total assets / equity) provides a preliminary insight into the funding structure of a firm: Whereby, an increase in leverage is commonly interpreted as a firm having increased its financial risk profile (earnings volatility). – The rationale behind this conclusion is as follows: Higher leverage means not only that a higher percentage of the firm's balance sheet is funded with debt, therefore also resulting in higher interest payments. In addition, in most cases interest payments are fixed costs: And, unlike variable costs, they remain constant regardless whether revenues increase or decrease. Hence, higher interest payments will add a layer of fixed costs and fluctuations in a firm's revenues will directly cause a significantly higher volatility in the firm's net earnings (i.e. increasing its risk profile).

Therefore, a firm may have increased its RoE simply by aggressively leveraging up (its risk profile), whilst its net margin or asset turnover meanwhile even having deteriorated. – On the other hand: If, for example, a firm previously tended to rely on equity-related funding, then a higher level of leverage may positively contribute to its performance. As the CoE is higher than the cost of debt, adding leverage to a balance sheet's funding structure can – up to a certain extent – result in a decrease in the average cost of capital and ultimately create value, not least to the benefit of shareholders.



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