RETURN ON CAPITAL EMPLOYED

vEcoSys

Return on Capital Employed

– By Prof. *Simply* Simple™

RETURN ON CAPITAL EMPLOYED

- Return on Capital Employed (ROCE) is used in finance as a measure of returns that a company is realizing from its capital employed
- *Capital Employed* is represented as total assets minus current liabilities. In other words, it is the value of the assets that contribute to a company's ability to generate revenue
- ROCE is thus a ratio that indicates the efficiency and profitability of a company's capital investments (stocks, shares and long term liabilities)

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Return on Capital Employed (ROCE)

- It is expressed as:-

$$ROCE = \frac{\text{Earnings}}{\text{Capital Employed}} \times 100$$

- The numerator is Earnings ***before Interest & Tax***.

  It is net revenue after all the operating expenses are deducted

- The denominator (capital employed) denotes sources of funds such as equity and short-term debt financing which is used for the day-to-day running of the company

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What does ROCE say…

- **It is a useful measurement for comparing the <u>relative profitability</u> of companies**
- **ROCE does not consider profit margins (percentage of profit) alone but also considers the amount of capital utilized for those profits to happen**
- **It is possible that a company's profit margin is higher than that of another company, but its ability to get better return on its capital may be lower**
- **So, ROCE is a measure of efficiency also**

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Example…

Company A makes a profit of Rs. 100 on sales of Rs. 1000

Company B makes a profit of Rs. 150 on sales of Rs. 1000

In terms of <u>pure profitability</u>, Company B has profitability of 15% (Rs. 15 / Rs. 1000)

This is far ahead of company A which has 10% profitability (Rs. 100 / Rs 1000)

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Now…

- **Let us assume that Company A had employed Rs. 500 of capital and Company B used Rs. 1000 to earn their respective profits**

- **So, ROCE of A is:- (earnings / capital employed)**
- **(Rs.100 / Rs. 500) X 100 = <u>20%</u>**

- **While ROCE of B is:-**
- **(Rs. 150 / Rs. 1000) X 100 = <u>15%</u>**

- **Thus ROCE shows us that Company A makes <u>better use of its capital</u>, though its profit percentage is lower than that of Company B**

- **In other words, it is able to squeeze more earnings out of every rupee of capital it employs**

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Usually…

- **ROCE should always be higher than the cost of borrowing**
- **An increase in the company's borrowings will put an additional debt burden on the company and will reduce shareholders' earnings**
- **So, as a thumb rule, a ROCE of 20% or more is considered very good**
- **If a company has a low ROCE, it means that it is using its resources inefficiently, even if its profit margin is high.**

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Hope you have now understood the concept of ROCE

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