



- 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)



Return on Capital Employed (ROCE)

☐ It is expressed as:-

Earnings

ROCE = ----- X 100

Capital Employed

- The numerator is Earnings <u>before Interest & Tax</u>.
 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



What does ROCE say...

- □ It is a useful measurement for comparing the <u>relative</u> <u>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



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)



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)
- \square (Rs.100 / Rs. 500) X 100 = 20%
- 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</u> <u>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



Usually...

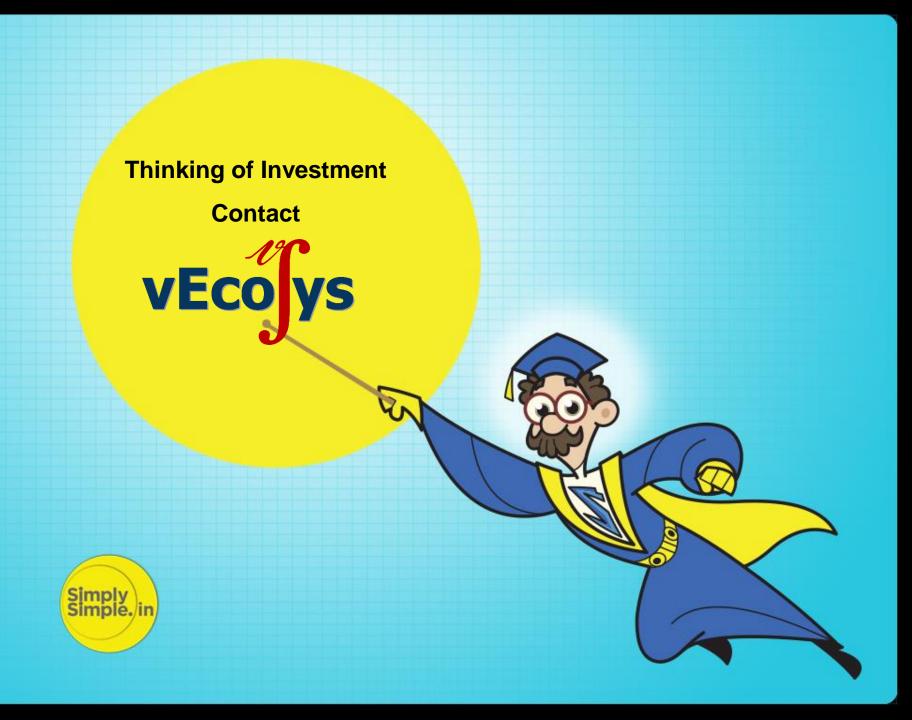
- ROCE should always be higher than the cost of borrowing
- □ An increase in the company's borrowings will put an additional debt burden on the company and will reduce shareholders' earnings
- So, as a thumb rule, a ROCE of 20% or more is considered very good
- If a company has a low ROCE, it means that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