RETURN ON NET WORTH

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Return on Net Worth

– By Prof. *Simply* Simple™

RETURN ON NET WORTH

- Return on Net Worth (RONW) is used in finance as a measure of a company's profitability
- It reveals how much profit a company generates with the money that the equity shareholders have invested
- Therefore, it is also called 'Return on Equity' (ROE)
- This ratio is useful for comparing the profitability of a company to that of other firms in the same industry

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Return on Net Worth (RONW)

- **It is expressed as:-**

$$\text{RONW} = \frac{\text{Net Income}}{\text{Shareholder's Equity}} \times 100$$

- **The numerator is equal to a fiscal year's net income (after payment of preference share dividends but before payment of equity share dividends)**
- **The denominator excludes preference shares and considers only the equity shareholding**

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Example…

- **A company's net income for the year was Rs. 60,000 and shareholder equity for the year was Rs. 3,00,000**
- **This gives us a <u>Return on Net Worth of 20%</u> (Rs. 60,000 net income / Rs. 3,00,000 shareholder equity)**
- **This means that for each rupee invested by shareholders, 20% was returned in the form of earnings**
- **So, RONW measures how much return the company management can generate for its equity shareholders**

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Therefore…

- **RONW is a measure for judging the returns that a shareholders gets on his investment**
- **As a shareholder, equity represents your money and so it makes good sense to know how well management is doing with it.**
- **Last week, we spoke about Return on Capital Employed (ROCE) which is a way of assessing a company's profitability from its overall operations**
- **Let us now try to understand how RONW is a more appropriate tool for decision making than ROCE**

Difference between Return on Capital Employed (ROCE) and Return on Net Worth (RONW)

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Example of ROCE…

- A and B both started a business by investing initial capital of Rs. 10,000 each
- After one year, A had an after-tax profit of Rs. 4,000 while B made only Rs. 3,000
- The return on capital employed for A was 40% (Rs. 4,000 / Rs 10,000) while for B it was 30% (Rs. 3,000 / Rs 10,000)
- On the face of it, it appears that A was the better manager since he earned more profit and therefore a higher return than B – though both started their businesses with the same amount of initial capital

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So, therefore as an investor you are likely to feel encouraged to invest in A rather than B

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But, RONW says…

- **Now, assume that A's business had shareholder equity of Rs. 45,000 and net income of Rs. 4,000**
- **While B's business had shareholder equity of Rs. 30,000 and net income of Rs. 3,000.**
- **RONW of A is Rs. 4,000 / Rs. 45,000 = 8.88%**
- **RONW of B is Rs. 3,000 / Rs. 30,000 = 10%**
- **Now, with this measure of RONW, we find that**
- **B has done better than A!**

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To sum it up…

- **ROCE considers <u>total capital</u> which is in the form of both equity and long term debt such as loans and borrowings**
- **While RONW considers only <u>equity shareholding</u> as the base for deciding efficiency of a company's operations**
- **So, for an <u>equity investor</u>, RONW is a better measure of efficiency than ROCE, since he is interested in knowing the <u>return on his equity investment</u> rather than return on the company's total capital**

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So….

ROCE is an appropriate measure to get an idea of the overall profitability of the company's operations

while

RONW is an appropriate measure for judging the returns that a shareholder gets on his investment

Hence successful investors like Warren Buffet assign more importance to a company's RONW to understand their investment growth potential

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Hope you have now understood the concept of RONW

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