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RETURN ON CAPITAL EMPLOYED OF BANKING COMPANIES INCLUDED IN NIFTY: A STUDY

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ABSTRACT

In long term if a company wants to remain in business over a long period of time, its return on capital employed should be higher than its cost of capital; if it is not so the continuing operations little by little reduce the earnings available to equity shareholders. ROCE is commonly used to compare the efficiency of capital usage of businesses within the same industry. It is basically used to demonstrate how much a business is earning for its assets, or how much it is losing for its liabilities. It also indicates whether the company is earning sufficient revenues and profits in order to make the best use of its capital assets. High ROCE is a validation of a company's competitive advantage. It indicates that the company has something special to offer-products or services that command a high return. It usually follows that margins are above average. Comparison of the ROCE of a company with others in its sector is a far more pertinent measure than comparison with the market as a whole. Companies with low returns are always suspecting because they are in danger of becoming loss-making if trading conditions deteriorate. Companies with exceptionally high returns may invite competition for their products or services, unless they are fully protected by patents or in some other way. The article analyses the return on capital employed of 8 banking companies included in NIFTY. The data is collected regarding the total assets and operating profit of 8 NIFTY banking companies. The present paper analyses the return on capital employed as a technique of profitability. The paper highlights the uses and drawbacks of return on capital employed as a technique to investors.

KEYWORDS*: EBIT, Profitability, Return on Capital Employed (ROCE), Efficiency, Capital Investments.*

Introduction

Return on capital employed is a measure of returns that a company is generating from the capital employed. ROCE indicates the profit generating ability of a company's capital investments i.e. efficiency. Return on Capital Employed (ROCE) is a measuring tool that measures the efficiency and profitability of capital investments undertaken by a corporation. Return on Capital Employed ratio also indicates whether the company is earning sufficient revenues and profits in order to make the best use of its capital assets. It is expressed in the form of a percentage, and the higher the percentage, the better.

Return on Capital Employed = (EBIT)/ (Capital Employed)

where,

EBIT refers to Earning or Operating Profit before Interest and Taxes.

Capital employed is arrived at by subtracting Current Liabilities from Total Assets.

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EBIT is calculated by taking sales revenues less operating expenses and adding back any non-operating income generated by the business. Operating expenses usually include the cost of goods sold, cost to sell goods, and general or administrative expenses used to generate revenues for the business

Capital employed is the sum of ordinary and preference share capital plus reserves, debentures, loan stocks, all borrowings including obligations under finance leases, bank overdraft, minority interests and provisions. Deductions include investments in associated companies. The basic idea is to arrive at a final figure that will tell you how much money is being employed in the operation of a business. The resultant figure is then compared with the operating profits before tax, exceptional items, interest, dividends payable and share of profits or losses of associated companies. The percentage this figure bears to adjusted capital employed gives investors a measure of the return the business can produce on the capital employed within it.

A Better Measurement

To be more precise, the true representation of the value of the resources employed in the operations of a firm in a given period can be found in the value of total operating costs for that period. To calculate the value of total operating costs for a period, we simply deduct the profit before tax (PBT) from the total turnover. Any result obtained from the measurement based on this new definition of resources (capital) employed will be known as the Enhanced Return on Capital Employed (EROCE). Thus, the formula for obtaining the Enhanced Return on Capital Employed is:

EROCE = Profit before Tax / Total Operating Costs

i.e. EROCE = PBT / (Turnover – PBT)

Where, PBT = Profit Before Tax (Earnings Before Tax)

Importance

In long term if a company wants to remain in business over a long period of time, its return on capital employed should be higher than its cost of capital; if it is not so the continuing operations little by little reduce the earnings available to equity shareholders. The enhanced return on capital employed measures the return or profit on each area expended by the firm for the financial period. This is the true measurement of the return on capital employed because the true capital employed by the business for the period is the amount expended on the period’s operations excluding capital expenditure.

Review of the Literature

Egungwu, 2005: As currently defined, the return on capital employed (ROCE) is a measure of efficiency of management in the application or use of the organization’s funds or resources in a given financial period. It is measured by comparing the profits made by the firm with the capital used in making the profit and set as a percentage or fraction.

Research Methodology

The present study has been undertaken to examine the issues addressed by means of return on capital employed. The article analyses the return on capital employed of 8 banking companies included in NIFTY. The data is collected regarding the total assets and operating profit of 8 banking companies namely:

- AXIS BANK
- BANK OF BARODA
- HDFC BANK
- ICICI BANK
- INDUSIND BANK
- KOTAK MAHINDRA BANK
- STATE BANK OF INDIA
- YES BANK

The objectives of the present study are:

- To analyze the return on capital employed as a technique of profitability.
- To examine the return on capital employed of 8 banking companies included in NIFTY;
- To find out the uses and drawbacks of return on capital employed as a technique for investors.

Characteristics of ROCE

The main characteristics of ROCE as an investment measure are as follows:

- High ROCE of around 20% or above shows an organization's competitive advantage. It tells that the organisation has something special to offer–it may be products or services that command a high return.
- Comparison of the ROCE of an organisation with others in its sector is a far more pertinent and relevant measure than comparison with the market as a whole. Organisations with low returns are always suspecting because they are in danger of becoming loss-making if trading conditions deteriorate. Organisations with exceptionally high returns may invite competition for their products or services, unless they are fully protected by patents or in some other way.
- The obvious attraction of a high ROCE is that a greater than average amount of profit can be ploughed back into the business for the advantage of shareholders. The plough-back is then employed again in the business at a higher rate and helps to generate further growth in EPS. For this reason, a high ROCE is usually a common denominator of great growth stocks.
- The ROCE of a organisation should always be compared with the current cost of borrowing. If the ROCE is significantly higher, further borrowing adds to EPS; if the ROCE is lower, further borrowing will reduce EPS
- Organisations with low ROCE are often the subject of changes in management control which, in turn, are frequently followed by a rights issue. The most acid test of new management is whether or not it is able to lift the return on capital employed.

Problems Associated with Return on Capital Employed

There are certain problems which arise while analyzing return on capital employed of various companies such as:

- ‘Capital’ can be interpreted in a variety of ways. It may be gross capital employed or net capital employed or average capital employed.
- Trading profit can be distorted by accounting policies and other unrelated expenses.
- ROCE ratios use historical data. Historic data is not always a very good basis for future earnings.
- The ROCE can vary due to short-term influences such as poor historic results resulted by one particularly unprofitable contract.
- Often different accounting policies are ignored. Investors & industry often fail to carry out deep fact based comparative analysis with similar companies
- Investors & industry often find it difficult to get industry benchmark ROCE ratios especially for unquoted stock.
- Investors & industry place too much emphasis on the ROCE ratio without carrying out analysis of other key profitability ratios.

Investors’ Use of ROCE

Return on capital employed (ROCE) helps the company and the investors in the following ways:

- Investors are concerned in the ROCE ratio to see how proficiently a company uses its capital employed and its long-term financing strategies. Companies’ returns should always be higher than the borrowing rate to fund the assets. If companies borrow at 11 % and can only achieve a return of 6 %, they are losing money.
- ROCE is used to show how much a company is losing for its liabilities or gaining for its assets.
- It is also used to compare the performance of two organisations and for assessing whether a business generates enough returns to pay for its cost of its capital. Thus, ROCE should always be higher than the rate at which the company is borrowing; Thus, ROCE denotes the return that a business should generate for it to continue.
- Some investors consider ROCE as the primary measure of profitability since it compares the total capital invested into the company with the profits generated by the company.
- Industry and investors will possibly look at the relative size of the ROCE ratio. This is because a high ROCE percentage shows that the company is profitable.

Return on Capital Employed of Banking Companies Included in Nifty

An analysis of return on capital employed of Banking Companies included in NIFTY (8 companies) is done in this research paper. The data regarding the total assets and operating profit or earnings before Interest and Tax (EBIT) is taken from the annual accounts of 8 banking companies for the year ending March 31, 2017:

S. No.	Name of the Company	Total Assets/ Capital Employed (Rs. In Crores)	EBIT (Rs. In Crores)	Return on Capital Employed (%)
1	Axis Bank Ltd	151846.67	6402.01	4.216
2	Bank of Baroda	138860.73	4728.36	3.405
3	HDFC Bank Ltd	203610.58	14269.00	7.007
4	ICICI Bank Ltd	194559.00	7739.91	3.978
5	IndusInd Bank Ltd	37588.68	1470.23	3.911
6	Kotak Mahindra Bank Ltd	47485.14	2798.32	5.893
7	State Bank of India Ltd	776095.43	17680.28	2.278
8	Yes Bank Ltd.	51722.47	1852.02	3.580

Source: Annual Report of respective companies.

Total assets (Capital Employed) have been computed by subtracting current liabilities from the total of fixed assets and current assets;

Capital Employed (Total Assets) = Fixed Assets + Current Assets – Current Liabilities.

EBIT or operating profit is taken from the Profit and Loss Account of the above companies.

Findings from the Above Data Analysis

The findings from the above analysis show that:

- There are eight banking companies included in NIFTY at present.
- In case of banking and finance companies HDFC Ltd. commands a high ROCE because its operating profit is high.
- Though the EBIT is high in case of SBI but its ROCE is lowest because its capital employed is very high.
- All banking companies have ROCE between 1 per cent to 10 percent which is termed as low.
- SBI has the highest capital employed among the banking companies while Indusind bank has the lowest capital employed.
- HDFC bank has the highest EBIT among the banking companies while Indusind bank has the lowest EBIT.
- Indusind bank as the lowest capital employed as well as lowest EBIT among the banking companies included in NIFTY
- Kotak Mahindra Bank is second among the banking companies in terms of return on capital employed.
- ICICI bank though second largest bank of India is not attractive in terms of ROCE.
- Kotak Mahindra Bank is looking good as not so big bank but its ROCE is attractive among the eight banking companies.

Karl Pearson's Coefficient of Correlation

Karl Pearson's Coefficient of Correlation is calculated between return on capital employed and capital employed of 8 banking companies included in NIFTY for the year ended March 31, 2017 which comes to-0.46 which indicates low degree negative correlation because when capital employed increases return on capital employed decreases.

Correlation between ROCE and Capital Employed.
r = -0.46

Karl Pearson's Coefficient of Correlation is also calculated between return on capital employed and operating profit (EBIT) of 8 banking companies included in NIFTY for the year ended March 31, 2017 which comes to -0.014 which indicates very low negative correlation between ROCE and EBIT. As a rule if EBIT increases ROCE should increase but if simultaneously capital employed also increases ROCE remains the same.

Correlation between ROCE and EBIT

r = -0.014

Drawbacks of Return on Capital Employed

Return on capital employed is a powerful tool for investors to analyze the company from the point of view of investment. How it suffers from several drawbacks. The important ones are:

- While ROCE is a good measure of profitability, it may not provide an accurate reflection of performance for companies that have large cash reserves, which could be funds raised from a recent equity issue. Cash reserves are counted as part of capital employed even though these reserves may not yet be employed. As such, this inclusion of the cash reserves can actually overstate capital and reduce ROCE.
- The main drawback of ROCE is that it measures return against the book value of assets in the business. As these are depreciated the ROCE will increase even though cash flow has remained the same. Thus, older businesses with depreciated assets will tend to have higher ROCE than newer, possibly better businesses. In addition, while cash flow is affected by inflation, the book value of assets is not. Consequently revenues increase with inflation while capital employed generally does not (as the book value of assets is not affected by inflation).
- The true measurement of efficiency in the use of capital resources cannot be done using capital employed as defined in a company's balance sheet. This is because the balance sheet capital employed is a static measure of capital employed at a date and not for the entire period. Hence, the result to be obtained from such measurement would invariably be influenced by the static nature of the value of capital employed as at that date.
- One limitation to ROCE is the fact that it does not account for depreciation of the capital employed. Because capital employed is in the denominator, a company with depreciated assets may find its ROCE increases without an actual increase in profit.
- It does not consider project life/timing of cash flows
- It will vary with specific accounting policies

Suggestions

After going through the above study the researchers presents the following suggestions:

- A public company must raise more money in a cost effective way, which puts it into a good position to see its share price increase; ROCE measures a company's ability to do this.
- ROCE should always be higher than the rate at which the company is borrowing; otherwise any incremental borrowing will reduce shareholders' earnings.
- Investors & industry place too much emphasis on the ROCE ratio without carrying out analysis of the supporting key profitability ratios. So along with ROCE other profitability ratios such as GP ratio, NP ratio, operating profit ratios should also be considered by analyzing the profitability of companies.

Conclusion

The return on capital employed is a significant measure of a company's profitability. A ROCE ratio, as a very general rule of thumb, should be at or above a company's average borrowing rate. Firms can increase their Return on Capital Employed Ratio by cutting costs so as to increase the Profit Margin ratio and buying raw material and other goods at cheaper costs. A company's ROCE should always be compared to the current cost of borrowing. If an investor puts Rs. 100 into a bank for a year at 6% interest, the Rs. 6 received in interest represents a reasonable return on the capital. To justify putting the Rs. 100 into a business instead, the investor must expect a return that is significantly higher than 6%. To deliver a higher return, a public company must raise more money in a cost effective way, which puts it into a good position to see its share price increase; ROCE measures a company's ability to do this. There are no such firm benchmarks, but as a very general rule of thumb, ROCE should be nearly double the interest rates. ROCE any lower than this suggests that a company is making poor use of its capital resources.

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