The Hottest Metric in Finance: ROIC

By

wsj.com

Return on Invested Capital *(R-O-I-C, or ROY-ck, or ROW-ick)*: A financial metric that measures how efficient a company is in earning cash flow from where it has invested its capital. The formula divides a rough measure of cash flow by a company's equity and debt minus its cash, a gauge of how much it has invested.

Last year, General Motors Co. fended off a group of activist investors with the help of an esoteric financial metric to which it had previously paid little heed.

The century-old auto maker began publicly touting the statistic, known as return on invested capital, or ROIC. It tied compensation to a 20% target and said that above a $20 billion cushion, cash it couldn’t earn that return on would be handed back to shareholders.

The steps placated the activists.

GM’s move underscores that, as much as a financial metric can be, ROIC is all the rage.

The popularity of the figure is also more evidence of the influence activists have come to wield in boardrooms. For ROIC lovers, which also include traditional stock pickers, the measure is the best way to distill what activists view as the most critical skill of management: how they allocate capital.

The typical ROIC equation divides a company’s operating income, adjusted for its tax rate, by total debt plus shareholder equity minus cash. It aims to show how much new cash is generated from capital investments.

For example, at GM, over the four quarters ended in March, adjusted operating earnings were $11.4 billion, up from $8.1 billion a year earlier. The denominator shrank as GM reduced, partly via buybacks, its equity, even though debt went up. ROIC rose to 28.5% from 19.5%, showing it was earning more with less.

“ROIC provides the clearest picture of how we are managing our capital and our business,” said GM Chief Financial Officer Chuck Stevens. “It’s really starting to become part of the DNA of our decisions.”

$$\text{ROIC} = \frac{\text{EBIT (1-tax rate)}}{(\text{Debt} + \text{Equity}) - (\text{Cash} + \text{Equivalents})}$$

ROIC isn’t perfec There are other efficiency metrics, such as return on equity, that are better for certain industries. Some said ROIC is untrustworthy and not everyone agrees on how to calculate it. (There is also disagreement over how to pronounce it: Some say each letter aloud. Some pronounce it as “ROW-ick” and others “ROY-ck.”)

GM isn’t the only auto company focused on ROIC: Fiat Chrysler Automobiles NV Chief Executive Sergio Marchionne has publicly called for consolidation to help the whole industry improve its ROIC, even giving a presentation he titled “Confessions of a Capital Junkie” last year.

New York University finance professor Aswath Damodaran said ROIC is a lazy shortcut for executives, because companies should have visibility into the cash flowing from projects on a more granular basis.

“I could write a paper on perverse ways you could destroy your company by raising your ROIC,” he said.

Still, in 2015, 672 U.S. companies cited the metric, up 42% from five years earlier, according to an analysis of securities filings. Surveying global investors, Rivel Research Group found recently that more investors care about ROIC than any other financial metric, including per-share earnings growth.

There is evidence ROIC correlates to higher, less volatile shareholder returns, said Frank Zhao of the Quantamental Research group at S&P Global Market Intelligence. Investing in companies with the highest ROIC relative to their peers in the S&P 500, adjusting for size and reallocating each month, earned a 10.5% annual return from 2003 through the first quarter. The S&P 500 returned 9.6% in the same period.

At Goldman Sachs Group Inc., the co-heads of activist-defense banking, Steven Barg and Avinash Mehrotra, now bring clients pages of data showing quantitative metrics investors care about. Near the top of the list is ROIC compared with a company’s cost of capital. If a company scores poorly in that equation, it is a red flag.

“It becomes a disease, and the symptoms show up elsewhere,” Mr. Barg said.

At iRobot Inc., which makes the Roomba vacuum cleaner, activist investor Red Mountain Capital Partners LLC is fighting for board seats. It argues the Bedford, Mass., company has failed to earn its cost of capital and questions the returns on projects like “remote presence,” which are robots for video chats.

The company rejects the activist’s ROIC calculation and said exploring new robots is necessary for growth. Meanwhile, the company questions Red Mountain’s own investment prowess, according to one person familiar with the fight. Concerns about investor withdrawals led Red Mountain to restructure its fund last year, which will no longer make new investments, according to a letter it sent to its investors.

People familiar with Red Mountain said the fund change was meant to establish permanent capital so it couldn’t be forced to sell before driving value at iRobot and other holdings. It aims to raise new funds later, one person said.

The focus on ROIC helps explain why activists push decisions sometimes labeled short term.

Activists said they aren’t inherently opposed to investment projects, but that companies have to justify spending. If a plant or a new line of business falls short on expected returns, companies should find a different project or give the cash back to shareholders, they said.

“We want to make sure they are making the right decisions,” said Clifton S. Robbins, the founder of activist fund Blue Harbour Group LP who counts ROIC as one of the most important metrics he watches.

When Mr. Robbins’s Blue Harbour took a stake in Progressive Waste Solutions Ltd. in 2013, he had concerns a rush of deals at the garbage collector hadn’t yielded good returns. In part at the fund’s urging, Progressive Waste slowed its deal making and concentrated on operations with a low ROIC, Mr. Robbins said. This year, Progressive Waste agreed to combine with Waste Connections Inc. Blue Harbour sold out at a roughly 50% gain.

A new report from S&P said there is no direct link showing activists actually improve ROIC once they take a stake, though stocks with a high one and activist investors outperform.

At GM, the board in 2014 tied long-term bonuses to the new ROIC target and disclosed it the next year. Just then, the activist group argued the company wasn't transparent enough about its investing process and was holding too much cash.

GM now uses ROIC in decision making throughout the organization, said Mr. Stevens.

Early last year, the auto maker announced it would idle a plant in Russia, backing away from a market that had been expected to generate significant growth. Mr. Stevens said GM decided it would struggle to earn sufficient returns on $1 billion it needed to invest to comply with new regulations. GM can't be everywhere, he said.

"These are the types of decisions I would say we didn't make in the past," Mr. Stevens said.

—Kate Linebaugh contributed to this article.

Write to David Benoit at david.benoit@wsj.com

Corrections & Amplifications:
Goldman Sachs Group Inc.'s co-head of activist-defense is Avinash Mehrotra. An earlier version of this article misspelled the last name as Mehrota. Separately, concerns about investor withdrawals led Red Mountain Capital Partners LLC to restructure its fund. An earlier version incorrectly said withdrawals forced the change.