

Investors' Thoughts on a Company's Return on Invested Capital

“What are your thoughts on a company’s ROIC and where in your investment process do you use it as a basis for measurement or consideration before making an investment in a particular company?”

Ipreo asked select buy-side analysts and portfolio managers, “What are your thoughts on a company’s ROIC and where in your investment process do you use it as a basis for measurement or consideration before making an investment in a particular company.” Although most investors surveyed said they use ROIC at some point in their investment process, responses were mixed in regards to the level of focus they put on the metric. Roughly 54% of buy-siders said that ROIC is a metric they focus on, while the remaining 46% of responses ranged from, “We don’t really take that into consideration as an evaluation metric” to “We look at the company’s ability to improve it over time, but we tend to be a little more free cash flow focused so I wouldn’t necessarily say it is a top consideration.” One investor mentioned that ROIC is one of the primary things they use to measure a company’s ability to generate cash and “track the return on the capital that the business needs to operate”, making it an important metric for that firm. Others noted that they use the metric to get a gauge for the long-term health and quality of a business and to see how management teams incentivize their employees to focus on ROIC. Contrarily, one PM argued that the way companies disclose ROIC is not uniform, making it a tough metric to “paint a broad brush with” compared to metrics like ROE, earnings growth, and free cash flow.

Associate Portfolio Manager/Analyst at a \$75.7B (EAUM) Growth-Oriented Investment Manager

Sector Coverage: Generalist

“ROIC is one of the primary things we use to measure a company’s ability to not only generate cash, but also track therein the return on the capital that the business needs to operate. We view it as a primary metric of where the long term health and the quality of the business is, and secondarily, to see how management teams incentivize their people to focus on return on invested capital as part of their incentive programs. It is a very important metric for us.”

Portfolio Manager at a \$5.6B (EAUM) High Turnover Hedge Fund

Sector Coverage: Generalist

“Our firm cares more about FCF. We’re focused on the yields and the ability to generate free cash flows and how much of it is going to be potentially at risk because of the variable annuity portfolio, but we think we are being more than compensated for that risk.”

Portfolio Manager/Analyst at a \$650.0M (EAUM) High Turnover Hedge Fund

Sector Coverage: Healthcare

“I would say it’s middle of the road for me. I mean it’s definitely something I’m cognizant of but it’s really not a metric that I have at the top of my list when I am evaluating a company.”

Analyst at a \$137.1B (EAUM) Value-Oriented Investment Manager

Sector Coverage: Technology

“We certainly use it to evaluate our long term thesis and forecast, and we also use ROIC to sanity check a company versus its own history and, separately, the company versus its competitor set.”

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Analyst at a \$3.5B (EAUM) Growth-Oriented Investment Manager

Sector Coverage: Healthcare

“We really look at ROIC on a risk adjusted basis. XYZ in the healthcare space is in the lower tier of risk of companies that we look at in that sector. It's a necessary but not sufficient condition and again it's all in terms of once you have generated that return/ free cash flow, how effectively does management use it.”

Portfolio Manager at a \$75.7B (EAUM) Growth-Oriented Investment Manager

Sector Coverage: Insurance

“It is very important. It is a strong consideration in how we think about any company because that is the return on the capital that they are investing into the business. A key part of our investment process is analyzing the sustainability and improvement potential of that metric.”

Analyst at a \$20.0B (EAUM) Value-Oriented Investment Manager

Sector Coverage: Generalist

“ROIC is a very important metric we look at. Being a value fund, we are looking for situations where we have an improving return on capital and/or companies that have historically shown a good return on capital over a cycle and the market is doubting its ability to keep going with that. So the metric definitely plays a role in our decision-making process before an investment is made. And as important as the metric is, I do not know that the stock ever gets credit for it.”

Analyst at 442.2M (EAUM) High Turnover Hedge Fund

Sector Coverage: Utilities

“ROIC is definitely important. Frankly, there is too big of a focus on dividend yield in the utilities space and there should be a bigger focus on metrics such as ROIC.”

Analyst at a \$121.0M (EAUM) High Turnover Hedge Fund

Sector Coverage: Financials

“It's an important measure that I look at quite often.”

Analyst at a \$10.9B (EAUM) Growth-Oriented Investment Manager

Sector Coverage: Utilities

“It is important to us because we like to know that our companies evaluate projects based off of ROIC. Having said that, ROIC is a fluid number because in different economic times ROIC will obviously be better or worse. With returns being relatively low right now, we do not have a certain number that is a threshold for us to invest in a company.”

Research Associate at \$42.0B (EAUM) Very Active Turnover Hedge Fund

Sector Coverage: Banking

“As bank investors, we focus more on ROA or ROE, because the investment capital, I think CAPEX is one of the determinants of the investment capital and there's no CAPEX in a bank. But in terms of returns, ROA and ROE are very important. I'd say number 1 or number 2 considerations.”

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"What are your thoughts on a company's ROIC and where in your investment process do you use it as a basis for measurement or consideration before making an investment in a particular company?"

Analyst at a \$9.5B (EAUM) Growth-Oriented Investment Manager

Sector Coverage: Utilities

"It is a very important valuation metric to us. We try to find improving ROICs in companies. However with regulated utilities, since ROE is dictated and cost of debt is a little less important because it is effectively a pass-through we look more at ROE."

Analyst at a \$1.6B (EAUM) Value-Oriented Investment Manager

Sector Coverage: Basic Materials

"It is certainly an area we look at. We look at the company's ability to improve it over time, but we tend to be a little more free cash flow focused so I wouldn't necessarily say it is a top consideration, but it is one that we take a look at in the context of all of the fundamentals."

Analyst at a \$28.5B (EAUM) Specialty-Oriented Investment Manager

Sector Coverage: Healthcare

"Yes, we look at return on capital for every company we look at and try to establish a baseline cost of capital and then make a calculation of their return on capital. There are two things we look at - the absolute spread and if there is some type of trend that we can see; e.g. that over the next 2-5 years you are going to break open and earn much greater than your cost of capital."

Analyst at a \$160.2B (EAUM) Value-Oriented Investment Manager

Sector Coverage: Metals and Mining, Real Estate

"It's very important, front and center for us when you look at other metrics. Valuation and returns on the capital and free cash flow generation are the three things I look at. If you lay it out, anybody can go out and buy anything and make it accretive to earnings today, based on what interest rates are doing. So without comfort that is actually ROI/ROIC beneficial over time, it's something that I wouldn't hold against a company, but we take a skeptical view towards it. Long story short, that is a very important metric in our process."

Analyst at a \$750.0M (EAUM) High Turnover Hedge Fund

Sector Coverage: Utilities

"Return on equity is more important than return on invested capital so I would say modest."

Analyst at a \$8.9B (EAUM) Value-Oriented Investment Manager

Sector Coverage: Utilities

"XYZ is under earning a little bit when it comes to utilities and ROIC. It's more of an input into earnings than an output to what they do with their assets. In utilities, I am very focused on ROIEs and what a utility is able to earn on their authorized ROE."

Portfolio Manager/Analyst at a \$541.1M (EAUM) Value-Oriented Investment Manager

Sector Coverage: Technology

"Actually, based on our value-oriented investment strategy, we don't consider ROIC, because we are specifically looking for out-of-favor stocks, which are being overlooked by the investment community and are trading below their intrinsic value. The stocks, that we would buy, would tend to have terrible ROICs. That's OK with us, based on our methodology, because we are looking for stocks that could rebound in the future."

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Portfolio Manager at a \$210.0M (EAUM) Commodities- Focused Investment Manager

Sector Coverage: Utilities

"It is difficult to really say since it is pretty asset specific. I think the way companies disclose ROIC is not uniform at all so it is a tough metric to paint a broad brush with. Some other metrics I use more often are ROE, earnings growth, and cash flow I find to be more useful. ROIC I get is a legitimate metric but it is hard to put everybody in an apples-to-apples basis so I tend not to use it as much."

Analyst at a \$12.4B (EAUM) Value-Oriented Investment Manager

Sector Coverage: Utilities

"I have a couple of factors that come into play. I would say against their peers I would expect them to perform at least in line or maybe slightly better simply due to better liquidity and some of their recent successes that are going to push earnings growth higher. Against the general market, I have to say I don't think they're going to perform as well because I believe interest rates are going to rise over the next several quarters. As I mentioned previously, I'm cautious with respect to utilities in general."

Analyst at a \$5.1B (EAUM) GARP-Oriented Investment Manager

Sector Coverage: Technology

"It is not a focus here. Personally, I like the metric, but we don't build an investment case around it. It is an anecdotal attribute of a company and not much more."

Analyst at a \$58.0B (EAUM) Growth-Oriented Investment Manager

Sector Coverage: Utilities

"Generally speaking ROIC is one metric that we measure in addition to free cash flow, dividend return policy, and all of those things."

Analyst at a \$19.4B (EAUM) Value-Oriented Investment Manager

Sector Coverage: Utilities

"Looking at realized and implicit forward ROIC is one of the first things I do in my investment process."

Analyst at a \$34.8B (EAUM) Value-Oriented Investment Manager

Sector Coverage: Utilities

"I don't look at that too much. It's just hard to figure out because they are just fully depreciated assets."

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