A guide to R.O.C.E
Return On Capital Employed

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A guide to R.O.C.E - Return On Capital Invested

ROCE – Return On Capital Employed

Companies use capital to run their businesses and to generate profit. Capital belongs to the business owners, the business shareholders, and the lenders, which would primarily be banks.

All parties want to know how well their assets are being used and what return they are achieving on their investment – this is known as capital employed.

Any return on investment made/employed should be at least equal to or preferably higher than the interest available from investing in the bank.

Return on capital employed (ROCE)

R.O.C.E = Net profit before interest and tax (EBIT) / Total capital employed x 100

Taxation or interest rates are not within the control of the business and therefore a judgment of profit made should be the profit that comes from ordinary activities, before taxes and interest are deducted, because this is the value controllable by the management.

What is a relevant ROCE for my business?

In simple terms the higher the value of the ratio the better because ROCE measures profitability and no shareholder/lender will complain about too higher levels of profit!

If the ROCE is less than interest rates generally available in the market, then the shareholder/lender would have been better advised to leave/place their money in the bank.

A poor level of ROCE could result in the business experiencing difficulty in servicing its borrowings, especially if a low return is being earned for any length of time.

In manufacturing businesses, it could be expected that ROCE is in excess of 10% ranging to over 25% at the higher end.

Retail business would normally achieve lower figures ranging between 5% and 15%.

As a rule of thumb most businesses, shareholders and lenders would regard 20% as an acceptable level.

ROCE would be subject to a number of factors:

- The industry sector
- The state of the economy
- The short- and long-term interest rates in the economy
- The size and age of the business entity.
- It would typically be expected that an established, larger business would be achieving ROCE ratio.
- The business, shareholders and lenders will likely view their investments either in the short-term or the long-term. Often meaning that short-term will look for a higher ROCE whilst long term would accept a lower level and be prepared to wait longer for the business to deliver the desired profit levels.

As a with many other business ratios, ROCE should be reviewed against previous business returns.

In monitoring the level of ROCE achieved a level achieved of 20% may be very acceptable acceptable, however this would not be the case if historically the business was achieving 30% for example. This reduction in ratio would inform the business principles, shareholders, and lenders that the business performance is in decline, needs investigating and action taken to address the position.

When ROCE is in decline, a number of actions can be taken by the business, such as:

- Increasing the profit generated by the same level of capital employed by an improvement in efficiency
- Maintaining profits levels generated, but using less capital

Because ROCE is a valuable ratio that demonstrates how a business uses its capital in relation to the profit it achieves, it can help investors review growth forecasts and demonstrates a measure of corporate performance.

Return on Capital Employed (ROCE) Defined

The ratio looks like this:

The return, typically expressed as earnings before interest and taxes (EBIT), includes profit before tax, exceptional items, interest, and dividends payable. These items are located on the Profit and Loss Statement. The denominator, or the capital employed, is the sum of all ordinary and preferred-share capital reserves, all debt and finance lease obligations, as well as minority interests and provisions.

Alternatively, ROCE can also be calculated by subtracting current liabilities from total assets, which will be found on the balance sheet.

ROCE: Other considerations

Undoubtedly ROCE is a good ratio to measure business profitability, this is not always true for those companies that carry a large cash reserve. Such reserves may have been obtained form a recent equity issue and as such whilst such a reserve will be counted as part of the capital employed there is a potential timing issues in as much as they may not yet be employed.

Additionally, ROCE may understate the amount of capital employed. Intangible assets which would include such items as trade-marks, brands and research and development are not counted as capital employed as they are too hard to accurately value and therefore left out. Despite this the still represent the capital employed.

Data taken from the balance sheet are by their nature a set of historical figures and as such the situation will likely have moved on from that position and is another demonstration that knowing, monitoring and reviewing data is an essential part of the management of any business.

Also, other investment risk factors should be taken into account from investments made by the business.

For any investor be it business owner, shareholder or lender ROCE can be a powerful aide in determining businesses who are able to consistently deliver a high return on the capital employed. A business that can demonstrate an increasing ROCE ratio would signal a strengthening in long term profitability.

If you would like further advice on this key business ratio and how to measure and improve your business ROCE, please contact ACT Business Consultants Limited.

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