Return On Invested Capital (ROIC): Explanation & Examples

Return on invested capital (ROIC) is not only the most intuitive measure of corporate performance, but it is also the best. It measures how much profit a company generates for every dollar invested in the company. It is the true measure of a company's cash on cash returns.

As we demonstrate in "ROIC: The Paradigm For Linking Corporate Performance To Valuation", ROIC is the primary driver of stock prices. Growth and duration of profit growth also help drive stock prices, but ROIC is, by far, the most important driver because the market cares most about assigning value to the companies that produce the most cash per capital invested in them. If the opposite were true, the market would quickly go bankrupt. If you believe in any sort of efficiency in the stock market, ROIC is preeminent.

The formula (see Figure 1) for calculating ROIC is easy. The hard part is finding all the data, especially from the footnotes and MD&A, required to get NOPAT and Invested Capital right. When we calculate ROIC, we make numerous adjustments to close accounting loopholes and ensure apples-to-apples comparability across thousands of companies.

Figure 1: How To Calculate ROIC

NOPAT/Invested Capital

Or

NOPAT/Revenue * Revenue/Invested Capital

Sources: New Constructs, LLC and company filings

"If ROIC Is So Great, Why Isn't Everyone Using It?" The short answer is twofold: (1) most research comes from sell side firms whose underwriting businesses are not aligned with exposing the true profitability of companies and (2) it is a lot of work. As an independent firm, we have no conflicts with our clients. Our cutting-edge technology to analyze footnotes enables us to scale our unique ROIC model building expertise.

We make it easy for the average investor to leverage the benefits of a high quality ROIC model. As our research continues to proliferate, it gets harder for investors and executives to overlook its merits. Figure 2 shows the companies with the highest and lowest ROIC out of 3000+ companies under coverage.

Figure 2: Companies With Best/Worst ROIC Over the Last 12 Months

Ticker	Name	ROIC	Stock Rating
Highest Return On Invested Capital			
AAPL	Apple Inc.	256%	Attractive
VEEV	Veeva Systems	233%	Dangerous
CHKP	Check Point Software Technologies	180%	Attractive
EDU	New Oriental Education & Technology	175%	Attractive
UBNT	Ubiquiti Networks	166%	Neutral
Lowest Return On Invested Capital			
TXMD	TherapeuticsMD	-149%	Very Dangerous
CRDS	Crossroads Systems	-174%	Very Dangerous
ANTH	Anthera Pharmaceuticals	-183%	Dangerous
MBVX	MabVax Therapeutics	-230%	Very Dangerous
RSPI	Respirerx Pharma	-283%	Dangerous

Sources: New Constructs, LLC and company filings. Only includes companies with positive NOPAT

Apple's 254% ROIC is the highest of all companies under coverage. We've previously covered reasons we feel such a high ROIC is not sustainable. In fact, since 2011, Apple's ROIC has fallen from 339%. See Apple's ROIC each year dating back to 1998 here.

Veeva Systems (VEEV), Check Point Software Technologies (CHKP), New Oriental Education & Technology (EDU), and Ubiquiti Networks (UBNT) earn the second through fifth highest ROIC. However, ROIC alone doesn't mean a company is a good investment. On one hand, Check Point Software was highlighted as a Long Idea in June 2015. Meanwhile, Veeva Systems earns a Dangerous rating due to misleading earnings and a high valuation. Here's the Adjustment Page from our model, which shows exactly how we adjust Checkpoint's GAAP net income to calculate NOPAT, the numerator in our ROIC calculation. We also show how to convert total assets to Invested Capital, the denominator in our ROIC calculation.

Respirerx Pharma (RSPI) earns the lowest ROIC of all companies under coverage. See RSPI's ROIC for each year since 1998 here. Over the past decade, RSPI has earned a positive ROIC only once, in 2010. MabVax Therapeutics (MBVX), Anthera Pharmaceuticals (ANTH), Crossroads Systems (CRDS), and TherapeuticsMD (TXMD) round out the five lowest ROICs across 3000+ companies under coverage. See the adjustments page from our model of Crossroads Systems, where we show the adjustments to calculate NOPAT and invested capital. See CRDS's ROIC throughout the company's history here.

Our models and calculations are 100% transparent because we want our clients to know how much work we do to ensure we give them the best earnings quality and valuation models in the business.

Disclosure: David Trainer and Kyle Guske II receive no compensation to write about any specific stock, sector, style, or theme.

New Constructs® – Profile

How New Constructs Creates Value for Clients

We find it. You benefit. Cutting-edge technology enables us to scale our forensics accounting expertise across 3000+ stocks. We shine a light in the dark corners of SEC filings so our clients can make safer, more informed decisions.

Our stock rating methodology instantly informs you of the quality of the business and the fairness of the stock's valuation. We do the diligence on earnings quality and valuation so you don't have to.

In-depth risk/reward analysis underpins our ratings. Our rating methodology grades every stock, ETF, and mutual fund according to what we believe are the 5 most important criteria for assessing the quality of an equity. Each grade reflects the balance of potential risk and reward of buying that equity. Our analysis results in the 5 ratings described below. Very Attractive and Attractive correspond to a "Buy" rating, Very Dangerous and Dangerous correspond to a "Sell" rating, while Neutral corresponds to a "Hold" rating.

QUESTION: Why shouldn't fund research be as good as stock research? Why should fund investors rely on backward-looking price trends?

ANSWER: They should not.

Don't judge a fund by its cover. Take a look inside at its holdings and understand the quality of earnings and valuation of the stocks it holds. We enable you to choose the best fund based on its stock-picking merits so you do not have to rely solely on backward-looking technical metrics.

The drivers of our forward-looking fund ratings are Portfolio Management (i.e. the aggregated ratings of its holdings) and Total Annual Costs. The Total Annual Costs Rating (details here) captures the all-in cost of being in a fund over a 3-year holding period, the average period for all fund investors.

Our Philosophy About Research

Accounting data is not designed for equity investors, but for debt investors. Accounting data must be translated into economic earnings to understand the profitability and valuation relevant to equity investors. Respected investors (e.g. Adam Smith, Warren Buffett and Ben Graham) have repeatedly emphasized that accounting results should not be used to value stocks. Economic earnings are what matter because they are:

1. Based on the complete set of financial information available.
2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

Additional Information

Incorporated in July 2002, New Constructs is an independent publisher of investment research that provides clients with consulting and research services. We specialize in quality-of-earnings, forensic accounting and discounted cash flow valuation analyses for all U.S. public companies. We translate accounting data from 10Ks into economic financial statements, i.e. NOPAT, Invested Capital, and WACC, to create economic earnings models, which are necessary to understand the true profitability and valuation of companies. Visit the Free Archive to download samples of our research. New Constructs is a BBB accredited business and a member of the Investorside Research Association.

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