

Getting ROIC right:
how an accurate view of ROIC
can drive improved
shareholder value



New Constructs[®]



EY

Building a better
working world

Improving your ROIC creates value

Savvy investors, boards of directors and C-suite executives of large, sophisticated companies have long recognized that the creation of value is highly correlated with the efficient and effective use of capital. More recently, across the [financial press and academia](#), there has been a renewed focus and energy on identifying and recognizing firms and leaders that explicitly focus on generating high returns on invested capital (ROIC). We believe ROIC is vital to value creation, but many companies don't focus enough on improving their ROIC. In fact, many don't really know what their ROIC is.

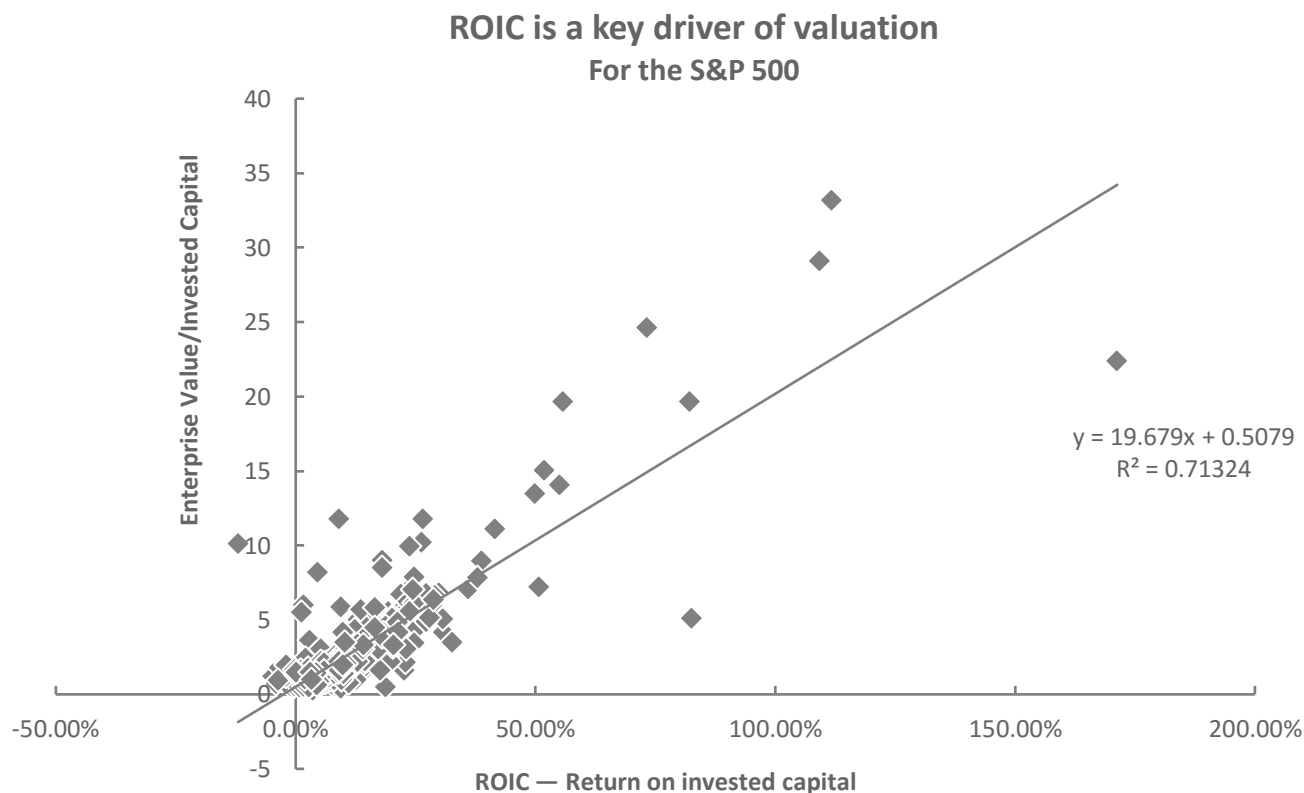
ROIC is important

We expect our clients will continue to experience a business environment with rising interest rates, ongoing shareholder activism with a laser focus on cost effectiveness and transaction synergies, as well as the imperative of accelerating investment in digital technologies and business model innovation to better serve customers, employees and other stakeholders.

As a result, we think it is highly likely that firms that focus on improving ROIC, and its drivers, will be rewarded disproportionately to their peers through appreciating enterprise and equity value.

Figure 1 compares companies in the S&P 500 on the basis of ROIC vs. [Enterprise Value/Invested Capital](#) (a cleaner version of price/book). It shows that ROIC explains 71% of the differences in valuation for S&P 500 companies.

Figure 1: ROIC vs. Valuation for stocks in the S&P 500



Sources: New Constructs, LLC and company filings.

ROIC explained

Return on invested capital (ROIC) is an important driver of corporate performance. It measures how much profit a company generates for every dollar invested in the company and helps in understanding the company's economic returns. Leading approaches to defining and implementing ROIC as a key management metric focus on underlying operations of both the profit and capital and "eliminate the noise" by normalizing inconsistent accounting treatments. We believe ROIC is a strong driver of stock prices and equity valuation. Top-line growth and profit growth also help drive stock price, 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 dollar of 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.

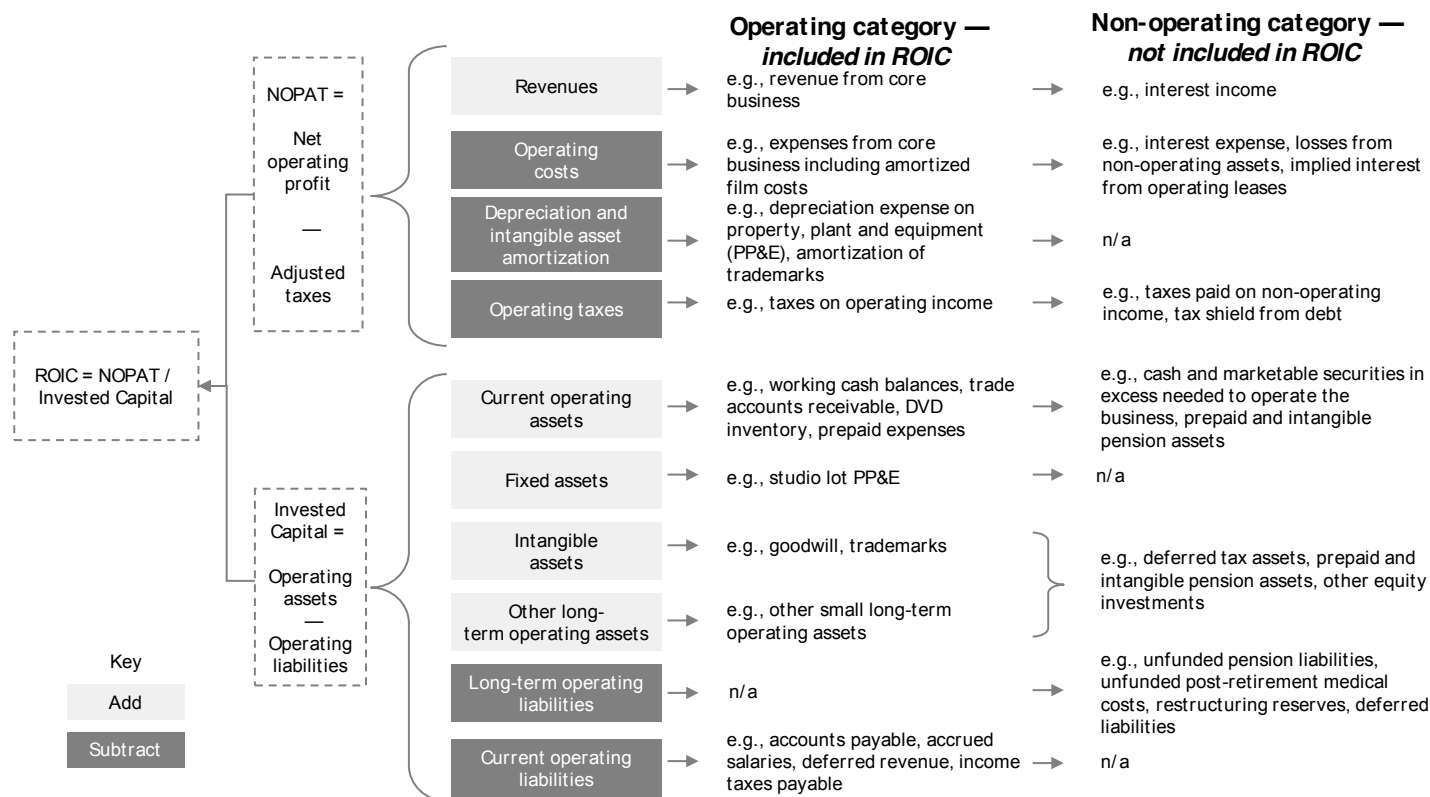
The formula for calculating ROIC at the highest level is relatively straightforward as $ROIC = \text{NOPAT} / \text{Average Invested Capital}$. Yet, many companies aren't able to calculate their ROIC with consistent accuracy, and are even less likely to be able to compare with ROICs of peer companies.

As illustrated in Figure 2, NOPAT is, in simple terms, an adjusted income statement while Average Invested Capital is, in simple terms, an adjusted balance sheet. NOPAT aims to represent the normal, unlevered operating profit of a business after tax. Invested capital aims to represent all capital invested in a business over its life without regard to accounting name or financing form. We can apply these concepts to all businesses: public or private, financial or industrial, foreign or domestic. When performed correctly, the ROIC calculation is comparable, or apples-to-apples, across all businesses.

The important point here is that ROIC is an important concept, the calculation of which need not be shrouded in a black box or unnecessary complexity, which is often the case with current accounting treatments.

Nevertheless, getting an accurate and universally comparable ROIC requires accurate and universally comparable NOPATs and Average Invested Capitals. This requires significant scrubbing of financial statements and accounting data. Figure 2 below and other parts of this paper focus on the importance of getting it right.

Figure 2: Defining the elements of ROIC (Operating method)



Source: EY & New Constructs, LLC

Getting ROIC right is important

Many clients today already engage us to assist them to improve the numerator (NOPAT) and denominator (Invested Capital) of the ROIC. The challenge, in the past, has been to help companies use this information to rapidly identify improvement opportunities and measure the impact of their business transformation efforts.

It's vitally important for companies to get an accurate calculation of ROIC. Inaccurate calculations can have a significant negative impact on the company's business and shareholders, in either direction.

A flawed calculation that understates ROIC will make it harder for management to sell investors on the company's long-term prospects. It could also lead to underinvestment in projects that would create significant value for shareholders.

On the other hand, a flawed calculation that overstates ROIC can lead to a false sense of security and an overstatement of program investment return. Management may miss needed cost-saving initiatives or make value-destroying investments based on an inflated metric that doesn't accurately reflect operating performance.

Getting ROIC right is not as easy as it seems

In theory, calculating ROIC seems like a straightforward task. In practice, it can be tricky.

Companies often disclose significant non-operating income or expenses buried in hundreds of pages of footnotes that must be found and adjusted out of NOPAT. Similarly, items such as operating leases are also buried deep in the footnotes and can comprise a significant portion of invested capital.

It's not enough to dig through one annual report either. An accurate calculation of ROIC needs to go through prior years to account for changes in reserves and add back all the capital that management has written off over the years. Furthermore, ROIC becomes most useful when compared against the trend lines of peers and competitors. This means those benchmark companies also need a rigorous ROIC calculation scrubbing, so comparisons are valid. That is a lot of work, and **most ROIC analytics come from internal calculations that won't tie to peer comparisons or from investment research that is not always set up to dig into the details consistently across a peer group.** Additionally, large data providers don't always have the organizational DNA to perform that kind of work.

Testing our hypothesis

To test our hypothesis of the importance in getting the data right to drive meaningful improvement dialogue with our clients, EY worked with an independent analytics firm, [New Constructs](#). New Constructs uses machine learning technology to read through annual and quarterly reports and make numerous adjustments to close accounting loopholes and provide apples-to-apples comparability across thousands of companies.

We conducted an ROIC analysis of four firms and analyzed the side-by-side results of New Constructs data in comparison to two of the largest financial data houses.

These four firms (Peer1, Peer2, Peer3 and Peer4) are large publicly-traded fortune 500 companies across the Diversified industrial Products, Chemical, Telecommunications and Transportation industries.

The analysis is outlined below in Figure 3.

Figure 3: Large variations between data sources for ROIC



Sources: New Constructs, LLC and company filings.

Our analysis demonstrates that the ROIC calculations for the selected companies varies significantly across the three data sources over a six-year period.

All three companies use the same basic formula for ROIC, with modest differences driven by slightly different calculations. The majority of the difference, though, comes from New Constructs' machine learning approach, which leverages technology to calculate ROIC by applying accounting adjustments that may be buried deeply in the footnotes across thousands of companies.

The other advantage of New Constructs is the transparency in disclosing calculations and all the data behind them. It is hard to determine the calculations at a granular level from the reports of many data providers.

Below are examples of ROIC calculation adjustments that New Constructs made for Peer2, Peer3 and Peer4.

Peer2 adjustments

NOPAT: Removed \$621 million (2% of revenue) of non-operating expenses in operating line items on the income statement.

Invested Capital: Removed \$2,683 million for deferred tax assets, which is 8% of reported net assets. Deferred Tax Assets increase reported assets but do not help generate operating profit.

Peer3 adjustments

NOPAT: Increased reported taxes by \$900 million so taxes more accurately reflect operating profits.

Invested Capital: Removed \$4 billion in excess cash to more accurately measure operating assets. Excess cash is the cash beyond what the company needs to run its business.

Peer4 adjustments

NOPAT: Made 14 adjustments to convert the company's reported 2016 earnings to NOPAT, for a net impact of \$1,608 million. Netted 5 income adjustments of \$3,488 million against 9 expense adjustments of \$5,096 million.

Invested Capital: Removed \$4,483 million for Other Comprehensive Income (OCI), which is 16% of reported net assets. Removed OCI from invested capital calculation to (1) better represent the actual capital on hand for management to generate a return and (2) avoid the noise from the fluctuations of OCI.

Figure 4 compares New Construct's calculation of ROIC with two other data houses for Peer1's Fiscal Year 2015. New Constructs accounts for a large number of items, both on the NOPAT and the Invested Capital side, which are not included in the other data sets.

Figure 4: Comparison of ROIC calculations for Peer1 FY 2015

	2015		
	New Constructs	Data house A	Data house B
Total operating revenue	\$ 48,778	\$ 48,778	\$ 48,778
+ Equity in earnings of nonconsolidated affiliates	\$ 674	\$ -	\$ -
- Total operating expense	\$ 42,824	\$ 42,614	\$ 43,239
+Total non-operating expense hidden in operating earnings	\$ 613	\$ -	\$ -
EBIT/EBT	\$ 7,241	\$ 6,164	\$ 5,539
+ Goodwill amortization	\$ -	\$ -	\$ -
EBITA/EBTA	\$ 7,241		
+ Change in reserves	\$ (561)	\$ -	\$ -
+ Implied Interest for PV of operating leases	\$ 105	\$ -	\$ -
NOPBT	\$ 6,785	\$ 6,164	\$ 5,539
- Cash operating taxes	\$ 2,274	\$ 2,312	\$ 927
NOPAT	\$ 4,511	\$ 3,853	\$ 4,612
ROIC (NOPAT/Invested capital)	6.6%	8.9%	10.9%
Financing approach			
Average invested capital	\$ 68,383	\$ 43,397	\$ 42,290
Reported debt	\$ 17,210	\$ 17,214	\$ 809
+ Off-balance sheet operating leases	\$ 2,075		
Total adjusted debt	\$ 19,285	\$ 17,214	\$ 809
+ Underfunded pension liabilities	\$ 9,119	\$ -	\$ -
+ Other Long term liabilities	\$ 4,719	\$ -	\$ -
+ Minority interest	\$ 809	\$ 809	\$ 809
Long-term operating liabilities	\$ 33,932	\$ 18,023	\$ 1,618
Stockholder's equity	\$ 25,374	\$ 25,374	\$ 25,374
-Excess cash	\$ 9,061	\$ -	\$ -
+ Accumulated asset write-downs	\$ 3,989	\$ -	\$ -
+ Accumulated unrecorded goodwill	\$ 4,485	\$ -	\$ -
+ Other equity equivalents	\$ 950	\$ -	\$ (473)
-Net deferred tax assets	\$ 1,845	\$ -	\$ -
Operating stockholder's equity	\$ 23,892	\$ 25,374	\$ 24,901
+ Accumulated other comprehensive loss	\$ 8,667		
Final operating stockholder's equity	\$ 32,559	\$ 25,374	\$ 24,901

Sources: New Constructs, LLC and company filings.

We find adjustments to the numerator and denominator across many accounts, but some of the most common and impactful ones often include unusual gains and losses in operating items on the income statement, non-operating and non-cash taxes in the income tax provision, treatment of write-offs, lease accounting, deferred compensation and more comprehensive capture of equity compensation liabilities. Through this detailed analysis, New Constructs shows specific analytical issues that affect proper ROIC calculation of NOPAT for Peer1¹, such as:

- Treats equity income as operating revenue instead of as an offset to operating expenses to provide comparability with businesses that do not have equity income (a)
- Excludes restructuring charges from the NOPAT calculation because they are not part of the normal operations of the business. Adding this back has a positive impact on NOPAT (b)
- Adjusts operating expenses to remove “hidden” non-operating line items (e.g., non-operating elements of pension items, gains on sale, severance costs, asset write-downs). These non-operating items are one-time gains/charges that distort normal cash flows. Exclusion of these expenses increases the NOPAT while exclusion of these gains decreases NOPAT – (c)
- Adds back the change in reserves to NOPAT by New Constructs so that companies cannot use reserve accounting to manage their earnings. The change in reserves is positive (increased operating profit (**NOPAT**) vs. net income) whenever the loss provisions exceed actual charge-offs or last in, first out (LIFO) reserves increase. It is negative (lower NOPAT vs. net income) when loss provisions are less than actual loan charge-offs or LIFO reserves decrease. Loan loss provisions can be manipulated to boost a company’s earnings by bleeding off reserves. Or they can cause problems when companies need to “catch up” and take big provisions to raise reserves to more appropriate levels (d)
- Adds back Implied interest for the PV (present value) of Operating Leases to (and increases) NOPAT to provide the comparability of NOPATs for companies with and without off-balance sheet debt (e)²

In addition, the **New Constructs calculation** and treatment of Invested Capital for Peer1 reveals the following³:

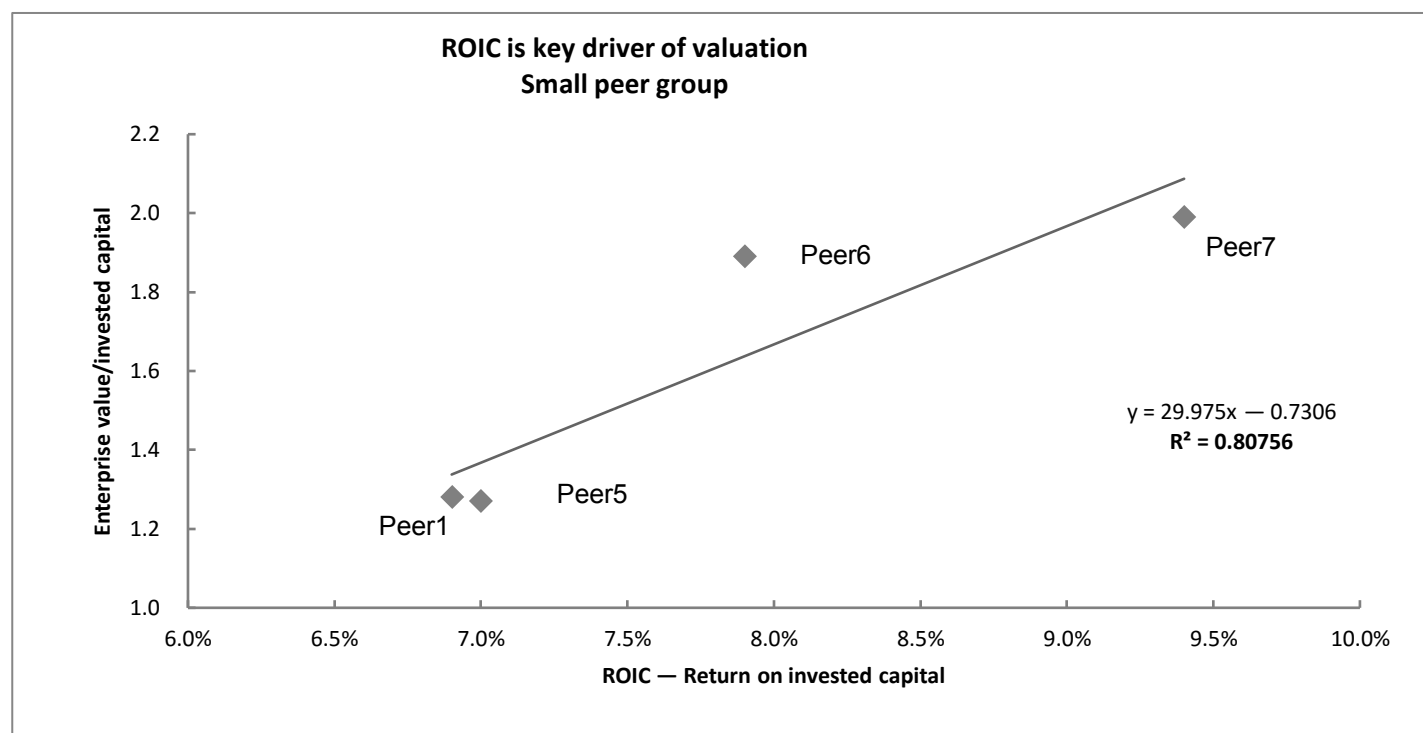
- Adds back operating leases to invested capital that represent off-balance sheet debt that is capitalized. This adjustment also certifies that each company is held responsible for earning returns on all the capital invested in the business, not just the assets on the balance sheet (f)
- Adds back reserves to Invested Capital to ensure management is held accountable for all capital in the business. Reserves are contra asset accounts that reduce asset values for probable future losses (in the case of inventory or loan-loss reserves) or resolve the difference in accounting treatments (in the case of LIFO reserves). Since probable losses are calculated at management’s discretion, companies can use reserve accounts to manipulate earnings and the carrying values of the assets to which the reserves apply. Inventory reserves are added back to invested capital (g)
- Adds back asset write-downs (after tax) to invested capital. “Accumulated asset write-downs” are kept in invested capital so that the invested capital holds companies accountable for all the capital invested in their business over their operating lives (h)
- Adds back accumulated goodwill amortization to a company’s invested capital prior to Statement of Financial Accounting Standards 142, *Goodwill and Other Intangible Assets*, even though goodwill amortization no longer takes place and the accumulated amount no longer changes. At the same time, added back goodwill amortization (increases) NOPAT (i)
- Removes accumulated OCI from invested capital to better represent the actual capital on which management can generate a return and to avoid the noise from the fluctuations of OCI (j)

¹ For a full comparison of the three NOPAT methodologies, see Figure I in Appendix.

² On 2/25/16, the Financial Accounting Standards Board announced new rules requiring a lessee will be required to recognize assets and liabilities for leases with lease terms of more than 12 months.

³ For a full comparison of the three Invested Capital methodologies, see Figure II in Appendix.

Figure 5: ROIC is a key driver of valuation



Sources: New Constructs, LLC and company filings.

Figure 5 shows that 80% of the Enterprise Value/Invested Capital (EV/IC) ratio movement is correlated to ROIC for this group of companies. Companies below the trend line may be undervalued, possibly because of lack of ROIC understanding or uncertainty about future ROIC. Based on the linear equation in Figure 5, Figure 6 shows that if Peer1 could come up to the trend line, possibly by convincing investors it will maintain its ROIC of 7%, Peer1 could create more than \$4 billion in shareholder value.

Figure 6: Peer1 Valuation at 7% ROIC

Implied EV/IC ratio	1.34
Current invested capital	\$ 79,099.00
Implied enterprise value	\$ 105,809.00
Net non-operating assets and liabilities	\$ (30,537.00)
Implied market value	\$ 75,272.00
Current market value	\$ 71,005.00
Incremental market value opportunity	\$ 4,267.00
Shares out	1,123.50
Incremental share price	\$ 3.80
Current share price	\$ 63.20
Implied share price	\$ 67.00

Sources: New Constructs, LLC and company filings.

Figure 7 shows the potential upside to Peer1 market value of a 100 basis point increase in ROIC. If Peer1's ROIC were to increase to 8%, Peer1 implied valuation could increase to ~\$90/share, 43% upside from its current valuation.

Figure 7: Peer1 valuation at 8% ROIC

Implied EV/IC ratio		1.67
Current invested capital	\$	79,099.00
Implied enterprise value	\$	131,890.00
Net non-operating assets/liabilities	\$	(30,537.00)
Implied market value	\$	101,353.00
Current market value	\$	71,005.00
Incremental market value opportunity	\$	30,348.00
Shares out		1,123.50
Incremental share price	\$	27.00
Current share price	\$	63.20
Implied share price	\$	90.21

Sources: New Constructs, LLC and company filings.

How a focus on ROIC creates value

Having an accurate, comparable measure of ROIC isn't just important because of the consequences shown above. It also helps to align all stakeholders, both investors and employees, around a common set of goals that they believe will lead to maximum value creation and reward.

Also important is the communication of accurate ROIC measurement to the investor community. To maximize the value of focusing on ROIC and the effort of righting the calculations, management needs to effectively communicate this valued-based strategy to the investment community and show they are dedicated to it. Investors are looking for the following when assessing management's focus on ROIC:

- a) **Leadership:** The focus on ROIC needs to start at the top, with the CEO. If the boss doesn't back the plan, then it is hard to believe that everyone else will.
- b) **Tie to capital budgeting:** Every capital allocation decision needs to pass the "Net Present Value" test, which measures whether ROIC is greater than WACC, i.e., expected cash flows are high enough to cover all costs, including the equity cost of capital.
- c) **Tie to compensation:** Linking compensation to ROIC shows management wants to be accountable for the real drivers of valuation and sends a strong message about its priorities.
- d) **Investor communication:** In addition to highlighting EPS growth, revenues, and other traditional metrics, management should highlight ROIC, and how it is driving improvement in that metric.
- e) **Performance metrics:** Promote accountability for capital efficiency deep into the organization to drive better decisions — using measures such as Operating Profit After Capital Charge, for example.

Indeed, showing a clear link between management strategy and creating value for shareholders will likely compare well to the typical Wall Street road show. The more specific that management can be about how it is driving a focus on ROIC through the organization, the more likely it can earn a valuation worthy of its ROIC.

We also think the size of the prize is large enough to warrant management's attention.

Conclusion

This paper demonstrates the importance of ROIC as a driver of enterprise value. Further, we show that an accurate calculation of ROIC requires more diligence than often occurs in some of the common, off-the-shelf ROIC calculations. Only by scouring the footnotes and management's discussion and analysis (MD&A) can investors get an accurate calculation of ROIC.

This robust approach to ROIC enables companies to make safer, more informed decisions that create trust with and value for stakeholders.

Appendix

Figure I shows how New Constructs calculates NOPAT, comparing with two data houses. This includes the New Constructs interpretation of the build-up of the data house numbers (which are not disclosed, making independent analysis a challenge with this data set). The bold blue numbers link to the sections of the footnotes and MD&A where New Constructs collected each hidden non-operating item.

Note: “Excluded” refers to items found on the income statement and balance sheet that are treated as unusual and not included in NOPAT or Invested Capital. “Not collected” refers to items found by New Constructs in the footnotes and MD&A that the other data houses either don't collect or choose not to incorporate into their ROIC methodology.

Figure I: Comparison of NOPAT methodology for Peer1 2015

Line item	New Constructs	Data house A	Data house B
Revenue	\$ 48,778	\$ 48,778	\$ 48,778
Equity in earnings of non-consolidated subsidiaries — (a)	\$ 674	(Excluded)	(Excluded)
Cost of sales	\$ (37,836)	\$ (37,626) ⁴	\$ (37,836)
Research and development	\$ (1,598)	\$ (1,598)	\$ (1,598)
Selling, general and administrative expenses	\$ (2,971)	\$ (2,971)	\$ (2,971)
Amortization of intangibles	\$ (419)	\$ (419)	\$ (419)
Restructuring charges — (b)	(Excluded)	(Excluded)	\$ (415)
Sundry income (expense) — net	(Excluded)	(Excluded)	(Excluded)
Interest income	(Excluded)	(Excluded)	(Excluded)
Interest expense and amortization of debt discount	(Excluded)	(Excluded)	(Excluded)
Reported operating expenses	\$ 42,824	\$ 42,614	\$ 43,239
Hidden non-operating expenses			
Write down on investments	\$ 2	(Not collected)	(Not collected)
Asset impairment	\$ 91	(Not collected)	(Not collected)
Asbestos defense costs	\$ 83	(Not collected)	(Not collected)
Amortization of capitalized interest	\$ 78	(Not collected)	(Not collected)
Acquisition costs	\$ 12	(Not collected)	(Not collected)
Postretirement interest cost	\$ 59	(Not collected)	(Not collected)
Pension interest cost	\$ 975	(Not collected)	(Not collected)
Expected return on plan assets	\$ (1,382)	(Not collected)	(Not collected)
Amortization of unrecognized gain	\$ (11)	(Not collected)	(Not collected)
Amortization of unrecognized loss	\$ 706	(Not collected)	(Not collected)
Total non-operating expenses hidden in operating earnings — (c)	\$ 613	(Not collected)	(Not collected)
Adjusted total operating expenses	\$ 42,211	\$ 42,614	\$ 43,239
EBIT	\$ 7,241	\$ 6,164	\$ 5,539
Change in total reserves — (d)	\$ (561)	(Not collected)	(Not collected)
Implied interest for pv of operating leases — (e)	\$ 105	(Not collected)	(Not collected)
Net operating profit before tax	\$ 6,785	\$ 6,164	\$ 5,539
Cash operating taxes	\$ (2,274)	\$ (2,312)	\$ (927)
Net operating profit after tax	\$ 4,511	\$ 3,852	\$ 4,612

⁴ We cannot verify why data house A has a Cost of Sales that is \$210 million lower than what is reported on the income statement.

Figure II compares the New Constructs analysis compared to the two data houses for the Invested capital calculation. This includes the New Constructs interpretation of the build-up of their numbers (which are not disclosed, making independent analysis a challenge with this data set. No links are provided for adjustments in this table as many of the values are tied to accumulated items over all prior years, while others correspond to items already linked to above.

Figure II: Comparison of average invested capital methodology for Peer1 2015

Line item	New Constructs	Data house A	Data house B
Notes payable	\$ 454	\$ 454	\$ 454
Current portion of long-term debt	\$ 541	\$ 541	\$ 541
Long-term debt	\$ 16,215	\$ 16,215	\$ 16,215
Off-balance sheet operating leases — (f)	\$ 2,075	(Not collected)	(Not collected)
Total adjusted debt	\$ 19,285	\$ 17,214⁵	\$ 17,210
Other long-term liabilities			
Underfunded pension obligations	\$ 9,119	(Excluded)	(Excluded)
Asbestos related liabilities	\$ 387	(Excluded)	(Excluded)
Other non-current obligations	\$ 4,332	(Excluded)	(Excluded)
Minority interest	\$ 809	\$ 809	\$ 809
Total long-term operating liabilities	\$ 33,932	\$ 18,023	\$ 18,019
Stockholder's equity	\$ 25,374	\$ 25,374	\$ 25,374
Equity equivalents			
Excess cash	\$ (9,061)	(Not collected)	(Not collected)
LIFO reserve — (g)	\$ 8	(Not collected)	(Not collected)
Accumulated goodwill amortization	\$ 569	(Not collected)	(Not collected)
Write-down	\$ 117	(Not collected)	(Not collected)
Foreign exchange loss — (h)	\$ 132	(Not collected)	(Not collected)
Write-Down on Investment	\$ 1	(Not collected)	(Not collected)
Asset impairments	\$ 123	(Not collected)	(Not collected)
Accumulated write-downs from prior periods	\$ 3,989	(Not collected)	(Not collected)
Accumulated unrecorded goodwill — (i)	\$ 4,485	(Not collected)	(Not collected)
Net deferred tax assets	\$ (1,846)	(Not collected)	(Not collected)
Total equity equivalents	\$ (1,483)	(Not collected)	(Not collected)
Adjusted stockholder's equity	\$ 23,891	\$ 25,374	\$ 25,374
Accumulated other comprehensive loss — (j)	\$ 8,667	(Not collected)	(Not collected)
Operating stockholder's equity	\$ 32,558	\$ 25,374	\$ 25,374
Data house B plug value	\$ —	\$ —	\$ (473) ⁶
Invested capital	\$ 66,490	\$ 43,397	\$ 42,920
2014 invested capital	\$ 69,902	N/A	N/A
Midyear acquisition adjustment	\$ 187	(Not collected)	(Not collected)
Average invested capital	\$ 68,383	\$ 43,397	\$ 42,920

Sources: New Constructs, LLC and company filings.

⁵ We cannot verify why Data house A has a total debt number that is \$4 million higher than what is reported on the balance sheet.

⁶ This plug value represents a \$473 discrepancy in Data house B's Invested Capital number for which we cannot account.

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