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RETURN ON EQUITY TRAPS

and how to avoid them

by Dr John Price
The Conscious Investor

Many investors rely on return on equity or ROE as a guide to future performance. Since it is net profit divided by equity, it tells us how well management is using the equity in a company to generate profits.

Given the extreme volatility of the market, does this approach still make sense?

Results over the past 12 months show that generally the answer is yes. Companies on the ASX with ROE above 15 percent had an average total shareholder return (capital gains plus dividends) of 19.76 percent compared to only 1.94 percent for those with a positive ROE less than 15 percent.

However, without care there are value-destroying pitfalls with this approach.

Consider JB Hi-Fi, the discount retailer of electronic goods. At the end of June 2010, its return on equity was a healthy 40.5 percent. Just 12 months later, it had leapt to a remarkable 88.1 percent. Surely this would indicate it is set for record performance. Many analysts reported that they believed this would be the case.

Unfortunately the outcome was the complete opposite. Its current price is about half what it was 12 months ago.

This dramatic leap in ROE for JB Hi-Fi is due to the first of what I call ROE traps. On the surface it looks as if JB Hi-Fi has increased sales and profits driving up its ROE, but underneath it is a different story.

Putting it briefly, since ROE is a ratio of net profit and equity, it can increase because the net profit has increased – a good sign. Or ROE can increase because the equity has decreased – a bad sign. In the case of JB Hi-Fi the increase in ROE was due to a 50 percent drop in equity.

What is Return on Equity?

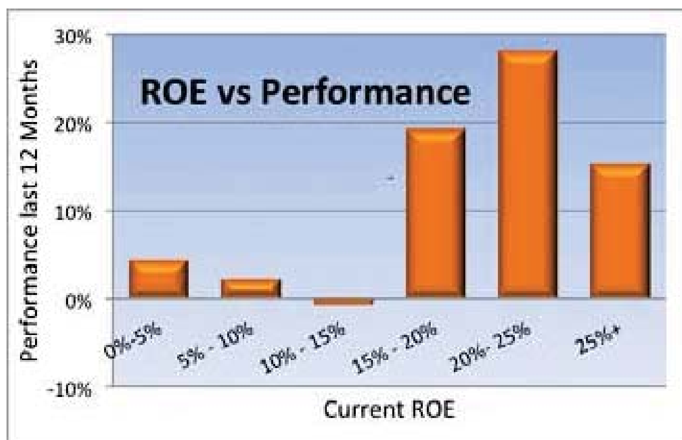
Return on equity is the net profit of a company divided by its equity. It is a useful measure of the ability of management to use the equity to make profits for the company. Related performance ratios are return on capital and return on assets.

ATTRACTIONS OF ROE

Before describing how to recognise and avoid these traps, including why the equity of JB Hi-Fi suddenly dropped by 50 percent, it is worth reviewing three of the attractions of high ROE shares.

1. Growth in Share Price

The first attraction of ROE is that generally higher ROE means a faster growth in share price. This is seen in the chart ROE versus Performance. The performance over the past 12 months was higher for the companies that had a higher ROE.



The reason for this is that ROE sits at the centre of a rule of thumb to project the growth of share price.

ROE GROWTH RULE

A simple rule of thumb for projected growth in share price is ROE multiplied by the dividend retention ratio, the proportion of earnings retained by the company and not paid out as dividends.

Consider Ramsay Health Care, the owner and operator of hospitals. Over the past five years, its ROE and dividend retention ratio have been approximately 14 percent and 48 percent. According to the rule of thumb, the growth in share price should have been around 6.7 percent, the product of these two numbers.

Five years ago the price of Ramsay was around $12.50; today it is approximately $18. This is an average annual increase of around 7.5 percent, close to the estimated rate.

2. Calculation of intrinsic value

A second attraction of ROE is that it is the main input in a variation of the dividend discount method for calculating intrinsic value. The idea is that the higher the ROE, the faster the dividends will grow, and so the higher the intrinsic value.

3. Warren Buffett and ROE

Finally, for many the primary attraction of ROE is the belief that this is what Warren Buffett does and so they do it in order to mimic "the world's greatest investor". As explained later, they have not read what he says closely enough.

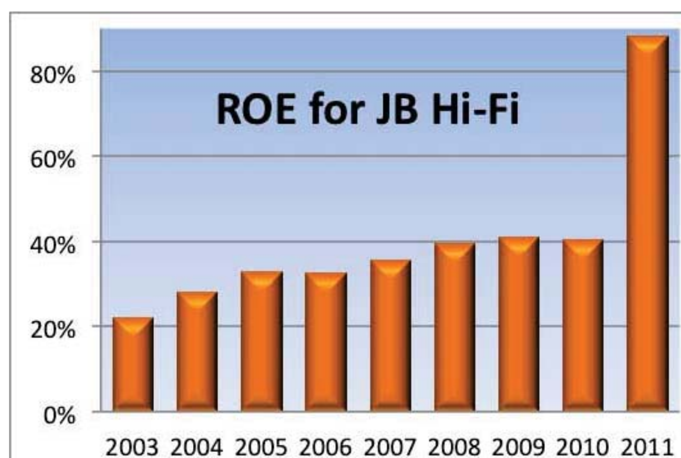
Regrettably these three reasons contain a number of essential assumptions, some obvious and some hidden, that render as extremely dangerous any simple screening of stocks looking for those with high ROE. The main problem is that ROE comes with a lot of baggage and traps.

ROE TRAPS

Recognising the following traps can help avoid companies headed for mediocre performance.

TRAP 1 Increasing ROE

The first trap is the belief that high ROE is always good and even better if it is increasing. The chart of ROE for JB Hi-Fi shows an example of ROE gently increasing before suddenly doubling in value. How could this happen?



Suppose that a company borrows $1.0 million. So long as the money remains in the bank or is used to buy an asset worth $1.0 million, the equity does not change because the amount is added to both sides of the ledger, the assets and the liabilities.

However, if the money is used to buy back shares, this time the equity immediately drops by $1.0 million because the shares are cancelled and are no longer an asset. Assuming that the net profit stays the same, ROE will increase because the denominator has decreased. It is really a problematic increase because equity has been destroyed.

In my book *The Conscious Investor* I described the ramifications of a company borrowing money to buy back its shares. I included it as a theoretical example not for a moment suspecting that any company would do this.

But I was wrong. In 2011, JB H-Fi announced to the market that it intended to buy back up to 10 percent of its shares "funded largely through an expansion of JB Hi-Fi's existing debt facilities". Because of this extra debt the borrowings of the company jumped from $34 million in June 2010 to $233 million 12 months later.

This extra debt was used to buy back its own shares and cut the equity in half. The result is that ROE more than doubled.

This is an example of the riskiness of a company increasing because of the large increase in debt, yet its ROE has also increased.

Before looking at the next trap, it is worth noting that if a company has the money, buy-backs are usually beneficial for shareholders and therefore to be welcomed.

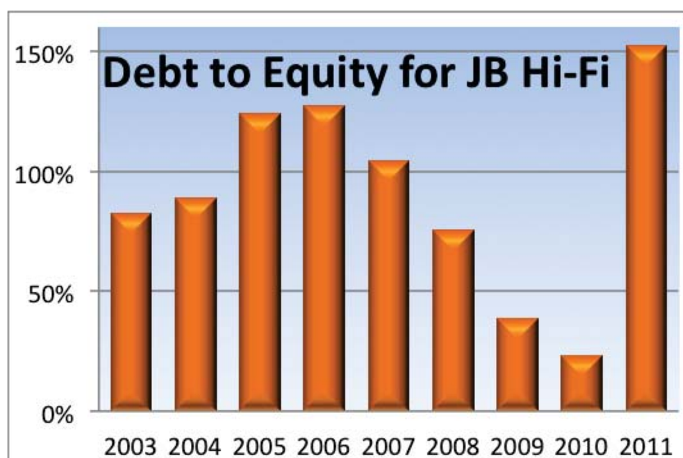
This is because they reduce the numbers of shares used to calculate earnings per share resulting in their increase. JB Hi-Fi stated that this was one of the reasons that they authorised their buy-back earlier in the year.

The annual reports of JB Hi-Fi show a different story. There has only been a marginal decrease in the actual number of diluted shares outstanding used in calculating earnings per share. As yet we cannot say that there has been an increase in earnings per share due to the buy-back.

TRAP 2 ROE drives the share price

The previous example shows that the rule of thumb described above using ROE to project growth in share price can quickly move into areas where it is dangerous to apply. In the case of JB Hi-Fi the rule would imply the growth of the share price should actually double. Yet what the company actually did was take on more debt and destroy equity, not actions that would normally improve the share price.

In fact, raising debt to equity from 34 percent at the end of the 2010 financial year to 153 percent at the end of the 2011 financial year would be seen by most as a dramatic increase in the risk profile of the business. This is particularly true in these times of high share market insecurity and retail uncertainty.



TRAP 3 ROE and low dividends

Common folklore is companies with high ROE should always pay low dividends. The argument goes like this: Since management has been getting a high ROE, shareholders are best served by management retaining and investing the surplus cash rather than handing it back as dividends.

The fallacy of this argument is that management has to have the opportunities to invest the retained earnings at a rate similar to the existing high ROE. Unfortunately it is all too common that the retained earnings are used to fund dubious acquisitions or make excess bonus payments. Studies show that between 50 percent and 75 percent of acquisitions fail. Hence paying high levels of dividends rather than continually making acquisitions is usually the better path for creating shareholder wealth.

In the case of JB Hi-Fi, instead of paying higher dividends, in 2004 the company acquired 70 percent of the Clive Anthonys business for $24.15 million. Seven years later "following several years of disappointing returns", JB Hi-Fi announced costs of $33.4 million (pre-tax) as a restructuring charge for Clive Anthonys. In other words, JB H-Fi recorded an extra loss of $33.4 million related to this earlier acquisition.

TRAP 4 ROE and intrinsic value

Some market commentators like to use ROE and combine it with the dividend payout ratio to calculate what they call intrinsic value. This is done by making assumptions (usually disguised or not mentioned at all) about the levels of ROE and the payout ratio out to infinity. Unfortunately, even minor changes in the input variables can lead to outcomes varying from highly under-priced to wildly overpriced. I cover this in detail in my book *The Conscious Investor.*

When ROE can vary by 100 percent or more simply by taking on debt as in the case of JB Hi-Fi, the folly of these formulas is even more apparent.

TRAP 5 Warren Buffett and ROE

It is often said that Warren Buffett encourages the use of ROE to make decisions about investment purchases. Yet, this is only part of the story and without the full details it is at best a dangerous half-truth. He certainly often refers to this ratio. In his annual letter to shareholders he mentions ROE 32 times over the past 20 years. However, he also makes it clear that ROE on its own is not enough.

For instance, each year in the annual report of Berkshire Hathaway Buffett says that he looks for "businesses earning good returns on equity *while employing little or no debt*". (My italics.) The problem is that many seem to refer only to the first part of this quote when invoking Buffett as a justification for investment decisions based on ROE. But talking about ROE without talking about debt and capital structure is precarious and fool-hardy.

Return on Equity Traps

1. Increasing ROE
2. ROE drives the share price
3. ROE and low dividends
4. ROE and intrinsic value
5. Warren Buffett and ROE

MORAL OF THE STORY

Return on equity can assist the stock filtering process. But be wary if the companies also have high debt levels and doubly wary if those debt levels are increasing. Also watch for companies that have high ROE but pay low dividends. Check what they are using the retained cash for instead of paying dividends. Finally, be wary of using methods that use ROE to calculate intrinsic value without understanding the assumptions of the formula and the details of the calculations.

Dr John Price is author of *The Conscious Investor: Profiting from the Timeless Value Approach* (Wiley, 2011) and director of research for Teaminvest Pty Ltd: www.teaminvest.com.au.