



Return on Invested Capital (ROIC)

The most powerful tool in a long-term investor's toolbox.

Presented by:

Mayur Thaker, CFA

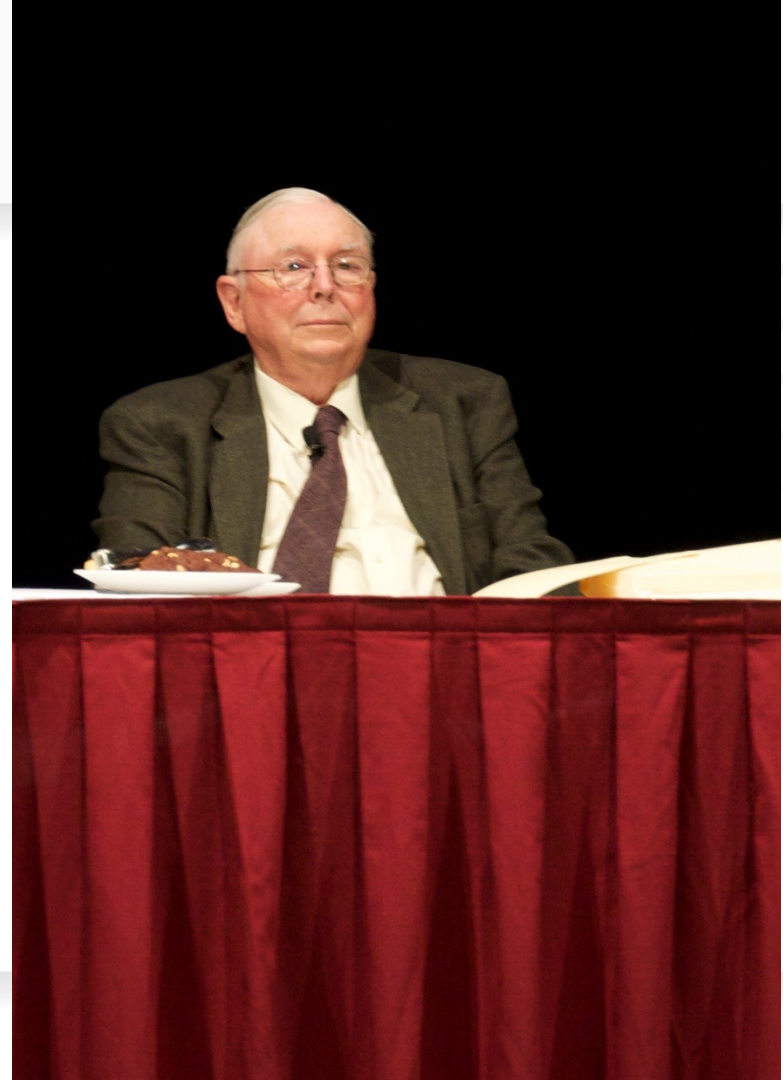
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Over the long term, it's hard for a stock to earn a much better return than the business which underlies it earns. If the business earns 6% on capital over 40 years and you hold it for that 40 years, you're not going to make much different than a 6% return—even if you originally buy it at a huge discount. Conversely, if a business earns 18% on capital over 20 or 30 years, even if you pay an expensive looking price, you'll end up with one hell of a result.

CHARLIE MUNGER — "A LESSON ON ELEMENTARY, WORLDLY WISDOM"

Charlie Munger on ROIC and Moats

- Munger has repeatedly stressed that **sustained high returns on capital** are a hallmark of a truly great business.
- Paraphrased idea: a business compounding at 20% ROIC for many years *mathematically crushes* a 6–8% ROIC business, even if you pay a fair or slightly high price upfront.
- Long-term ROIC is one of the best indicators of whether a company truly has an **economic moat** or not.



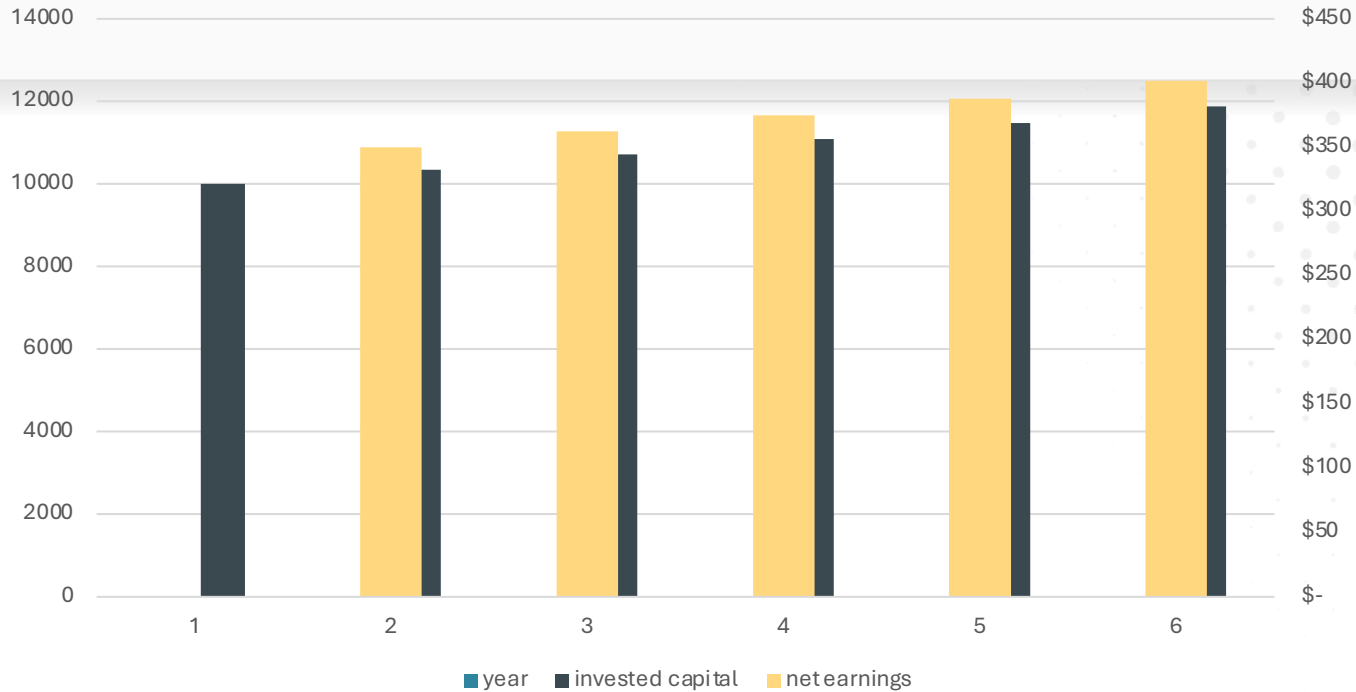
What Is ROIC?

- $\text{ROIC} = \text{Net Operating Profit After Tax (NOPAT)} \div \text{Invested Capital}$
- Measures how efficiently a company turns all capital from debt and equity providers into after-tax operating profit.
- Unlike EPS, ROIC controls for how much capital is tied up in the business; it is a direct lens on value creation vs. mere growth.

Growth vs ROIC

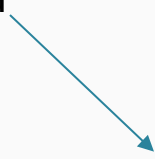
- A business can invest its cash into a simple high-yield savings account and compound its capital at 3.5%
- But does this create shareholder value in the market?
- Ultimately, if a company cannot **sustainably** earn a return on its invested capital above its cost of capital, it destroys shareholder value
- Companies also manufacture growth by acquisitions, but astute investors who pay attention to ROIC know precisely when such an acquisition is value-destructive
- Takeaway: growth is clearly important, but within the context of high ROIC. Great businesses are ones who grow at a high ROIC-WACC spread.

compound growth of \$10,000 @ 3.5%

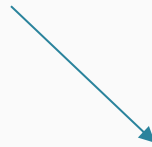


Is this a good business?

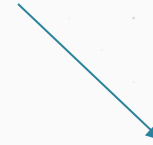
Idea



Investments in
property/equipment/
working capital, etc.



Revenue



Operating Profit

Basic ROIC Formula

- **NOPAT** \approx Operating Income \times (1 – tax rate)
/
- **Invested Capital** = Net working capital + Net PP&E + capitalized intangibles (goodwill, R&D adjustments, etc.) minus excess cash
- ROIC is best compared to the firm's **cost of capital** (WACC) to judge whether growth creates or destroys value.

Mauboussin: ROIC as the Core Value-Creation Metric

Michael Mauboussin: *“A company creates value when one dollar invested in the business is worth more than one dollar in the market.”*

ROIC above the opportunity cost of capital = economic profit; ROIC below it = value destruction, regardless of reported growth.

Mauboussin emphasizes:

Get the **denominator** (invested capital) right: adjust for excess cash, operating leases, R&D, acquisitions.

ROIC tends to **regress toward the mean**; very high or very low ROIC levels are rarely permanent.



Mauboussin: ROIC, Growth, and Strategy

Growth only adds value when **ROIC > cost of capital**, and destroys value when $\text{ROIC} < \text{cost of capital}$.

Simple identity: sustainable growth rate $\approx \text{ROIC} \times (1 - \text{payout ratio})$.

Persistent high ROIC usually reflects:

Differentiation: pricing power, brand, switching costs.

Cost leadership: structurally lower unit costs vs. peers.

ROIC vs. Accounting Profit

- High EPS with low ROIC often reflects:
 - Heavy capital intensity.
 - Value-destroying M&A.
 - Poor working capital discipline.
- Lower EPS but high, stable ROIC often reflects:
 - Disciplined capital allocation.
 - Pricing power and rational reinvestment.
- ROIC captures **how much capital it took** to earn those profits, not just the size of the income statement.

ROIC and Long-Term Equity Returns: Evidence

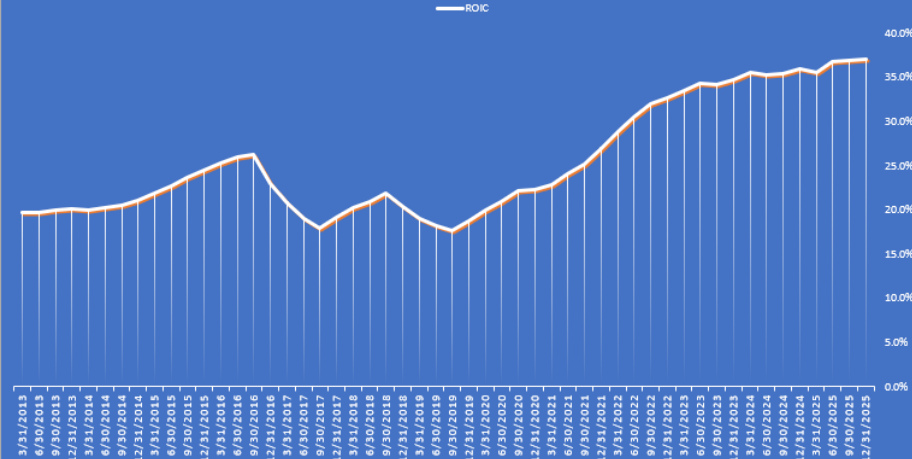
- Studies and practitioner work (e.g., Morgan Stanley IM; Mauboussin) find that:
 - Companies with **high and stable ROIC** tend to outperform over long horizons vs. low-ROIC peers, even after controlling for sector.
 - Portfolios tilted toward high-ROIC, high-spread (ROIC – WACC) firms have historically delivered **higher returns with lower drawdowns** than the broad market.
- Conceptual link: over long periods, stock returns approximate **earnings growth + dividends +/- valuation change**, and earnings growth is bounded by internally funded growth capacity, which is a function of ROIC.

Cross-Sectional Evidence on ROIC

- ROIC is strongly correlated with **valuation multiples**: high-ROIC firms generally trade at higher price-to-book and EV/EBIT multiples than low-ROIC firms.
- Yet, even after paying higher multiples, investors in persistent high-ROIC firms often earn **excess returns** because:
 - The level of ROIC is higher than the market embeds.
 - The **duration** of excess ROIC (moat length) is longer than expected.

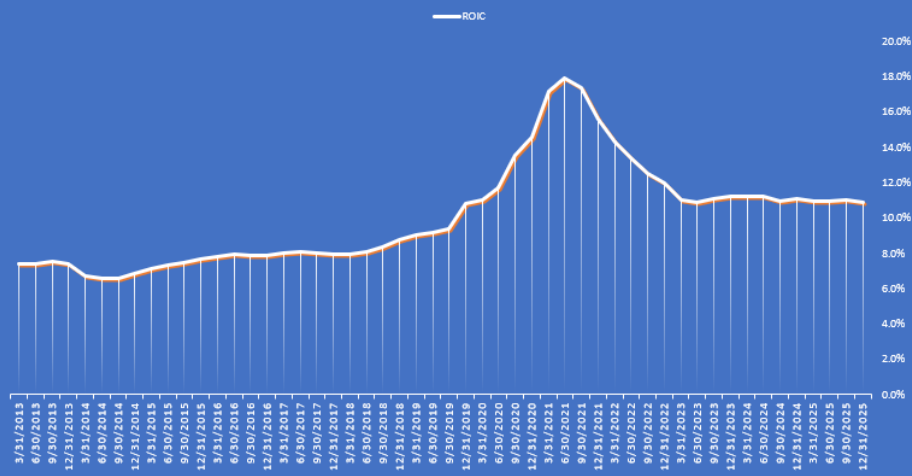
The absolute key is that a business must earn an ROIC above its cost of capital, which is usually around 6-8% for most large companies.

However, a company that earns 20% ROIC on a fixed capital base is not necessarily superior to a company that earns 10% ROIC on a rapidly growing capital base.

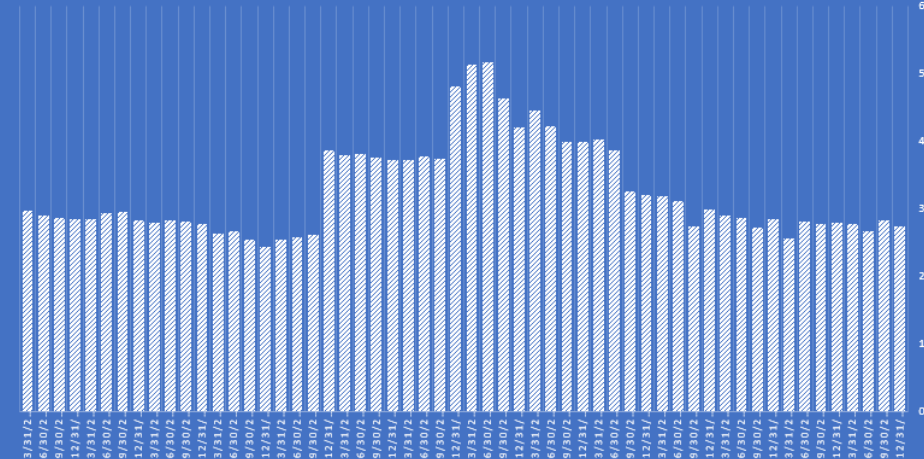


THERMO FISHER

RETURN ON INVESTED CAPITAL

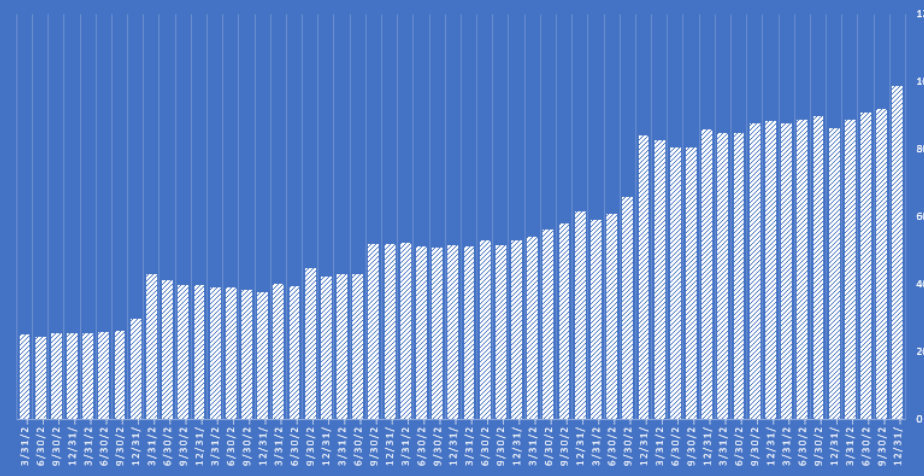


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INVESTED CAPITAL



Once $ROIC > WACC$ has been established, the company that can deploy the *most* amount of capital generates the most growth in economic profit, and therefore creates the most shareholder value.

Stated differently, a 10% ROIC business can still dramatically outperform a 30% ROIC business if the 10% business is allocating vastly more capital each year.

The key question is: does management have the capability to capitalize on a large opportunity?

Mean Reversion and the “Decay” of ROIC

- Mauboussin: “*ROIC tends to regress toward the mean*” across time and across cohorts.
- Drivers of mean reversion:
 - Competition attacking high returns.
 - Innovation and changing technology.
 - Regulation and capital inflows chasing attractive economics.
- Investment implication: focus not just on the current ROIC level, but on **why it exists and how long it can last.**

Practical ROIC Calculation Issues

- Common adjustments Mauboussin and others highlight:
 - Remove **excess cash** from invested capital.
 - Capitalize R&D and certain marketing or customer-acquisition costs where appropriate.
 - Adjust for leases and pension obligations, especially for retailers and industrials.
 - Be careful with financials: standard ROIC formulas often don't apply cleanly.
- One-time items (impairments, restructuring) can distort NOPAT and make ROIC volatile; use **multi-year averages** where possible.

ROIC vs. Other Quality Metrics

- ROIC vs. ROE:
 - ROE is sensitive to leverage; ROIC is capital-structure neutral.
- ROIC vs. margin:
 - High margins with heavy asset intensity can still yield mediocre ROIC.
- ROIC vs. growth:
 - High growth with low ROIC destroys value; modest growth with very high ROIC can be extremely value-accretive.

Using ROIC in an Investment Process

- Screen:
 - Sort universes by **ROIC level**, **ROIC stability**, and **ROIC – WACC spread** over 5–10 years.
- Analyze:
 - Decompose ROIC into NOPAT margin × capital turnover to identify whether a business is margin-driven or asset-turnover-driven.
 - Study the **sources of the moat**: brand, cost, network, regulation, switching costs, data, etc.
- Value:
 - Use ROIC and reinvestment assumptions to drive DCF forecasts and terminal economics, not just near-term EPS.

ROIC in Different Industries

- Capital-light sectors (software, asset-light services) often show:
 - High ROIC, high dispersion, and high sensitivity to competitive erosion.
- Capital-intensive sectors (utilities, heavy industry):
 - Lower ROIC, tighter regulatory constraints, but sometimes more stable spreads vs. cost of capital.
- Industry structure, regulation, and technology all shape the achievable ROIC range.

Munger & Mauboussin: A Unified View

- Munger's core message: **own a few truly outstanding businesses that can reinvest at high rates for a long time**; ROIC is the quantitative expression of that idea.
- Mauboussin provides the **toolkit**:
 - Calculate ROIC properly.
 - Compare to cost of capital.
 - Analyze competitive dynamics and mean reversion.
- Combined, they point to a practical playbook: pay reasonable prices for **high-ROIC, durable-moat businesses with long reinvestment runways**.

Limitations and Pitfalls

- ROIC is backward-looking; it can't, by itself, predict **future disruption**.
- Accounting choices and one-time events can distort both NOPAT and invested capital.
- Financials and some asset-light platforms require **different metrics** (e.g., unit economics, underwriting returns).
- High ROIC can come from under-investment; the question is whether the firm is **forgoing good projects** to preserve optics.

Summary

- ROIC is the central metric linking **business quality, growth, and long-term equity returns**.
- Munger's emphasis on high, sustainable returns on capital and Mauboussin's analytical framework around ROIC and competitive dynamics are deeply aligned.
- For investors, the practical question is not just "Is ROIC high?" but:
 - "Why is it high?"
 - "How long can it stay high?"
 - "What is the spread vs. the cost of capital?"
 - "What price am I paying for that stream of excess returns?"

We maintain a portfolio of high-quality businesses that we believe satisfy the core tenets of the ROIC framework:

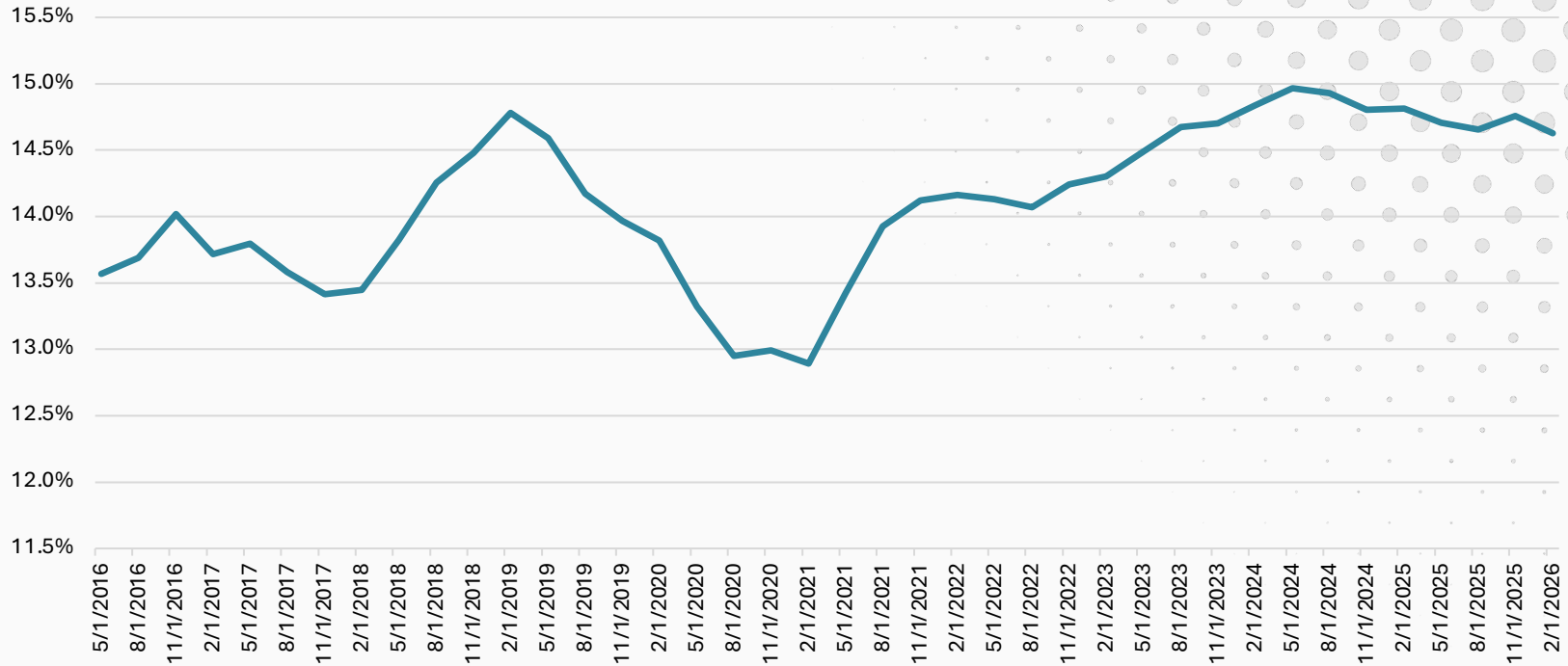
High ROIC

Durable ROIC

Strong free cash flow conversion

This is the Zacks Earnings Certain Proxy

return on invested capital zacks earnings certain proxy



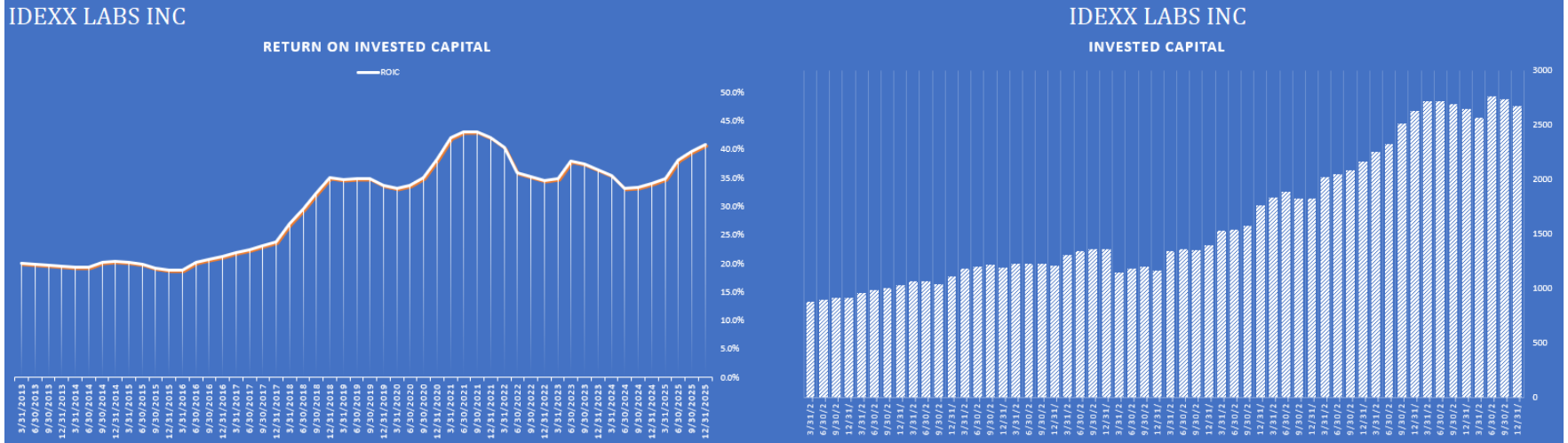
High & durable ROIC

High earnings per share linearity

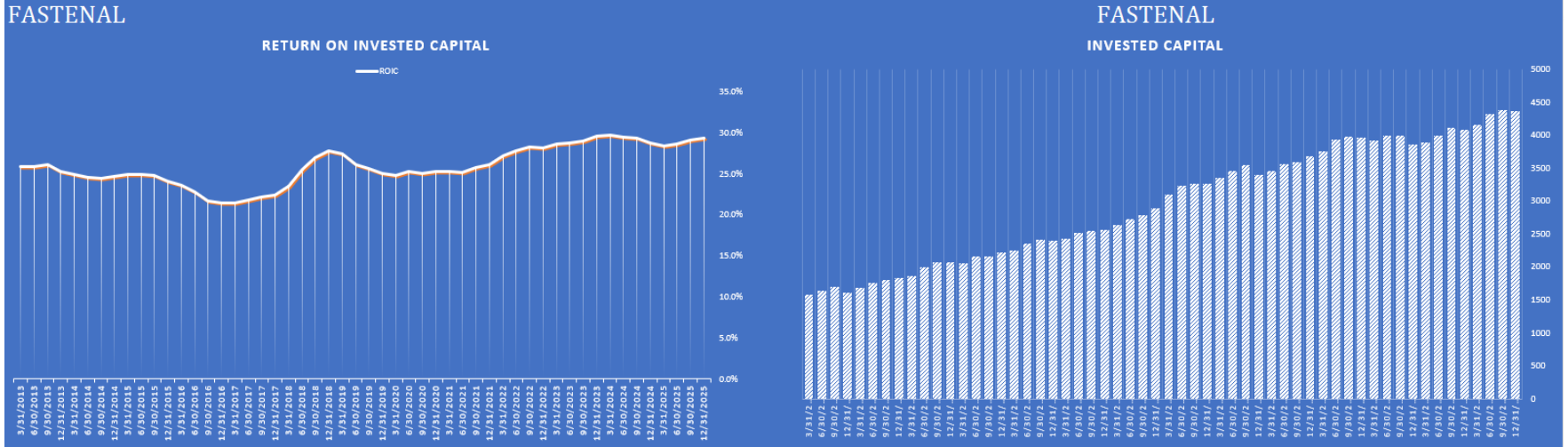
High & consistent free cash flow conversion

We seek to pick companies that not only demonstrate high ROIC right now, but have proven to deliver high ROIC consistently in the past, and have a product or service that is a must-have, which gives us great confidence those results can be expected to continue indefinitely into the future.

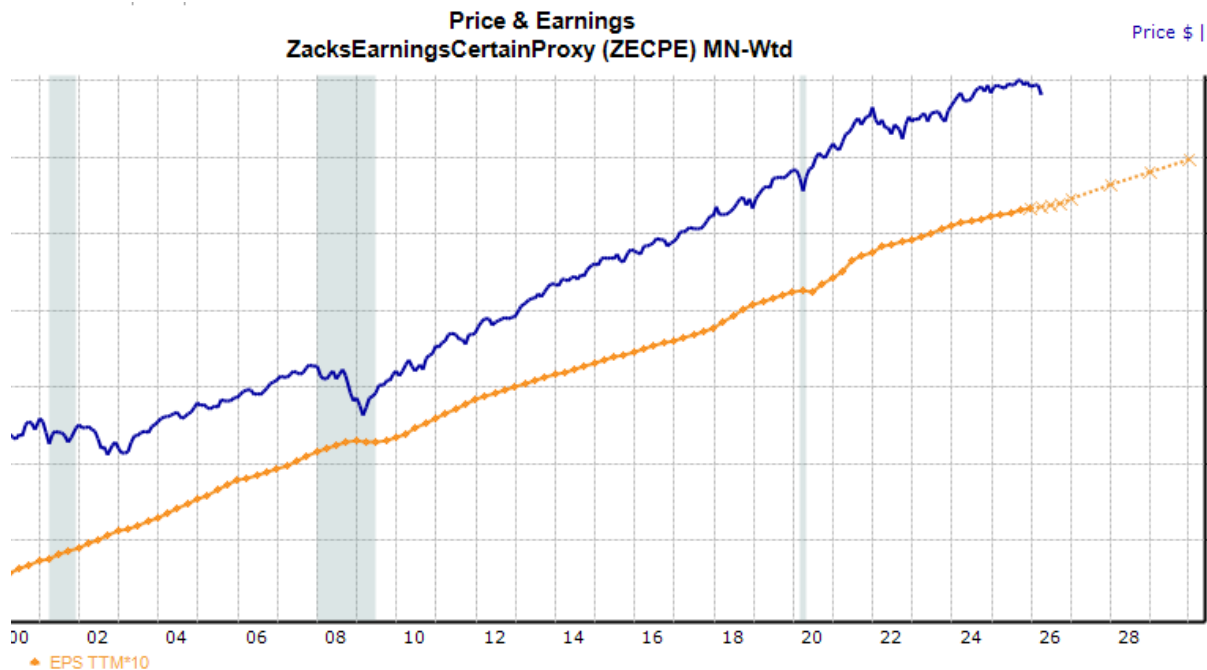
IDEXX LABORATORIES – A COMPOUNDING MACHINE IN PET CARE



Fastenal – A Compounding Machine in Industrials



Steady Growth + Durable ROIC: The Dual Engine of Shareholder Value Creation



The Zacks Earnings Certain Proxy is therefore a collection of 60 such hand-picked businesses we believe are high quality, long-term compounders that deliver high & sustainable ROIC alongside steady growth—the dual engine of long-term investment results.

866-794-6065

researchdesk@zackspro.com

www.zackspro.com



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