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A STUDY ON RETURN ON NET WORTH AND RETURN ON CAPITAL EMPLOYED OF TOP SELECT COMPANIES AS FOUND IN AUTOMOBILE SECTOR

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1. INTRODUCTION:

Return on net worth measures the return of profits after tax to the shareholders on their funds invested in a business enterprise. Returns in this context means profits after tax

Return on capital employed is the return to the suppliers of funds including the loan lenders and shareholders. Returns in this context imply the profits after tax plus the interest paid to the suppliers of loan funds. Capital employed means the funds provided by the share holders plus the loan funds provided by various parties to whom interest is being paid.

In this context, I am making a departure from the conventional method of calculating capital employed. Normally, we take capital employed as Shareholders funds + long term debt funds.

Here, I am making a departure from this definition by including within the definition of capital employed, even the short term borrowings from banks or financial institutions which are almost permanently used in business since interest is also being paid on those funds and these funds even though classified as current are in fact permanently current in nature.

2. OBJECTIVES:

Taking the above considerations into account, the return on net worth in those companies which have taken debt should be more than the return on capital employed in order to reap the advantages of financial leverage to the shareholders.

The objective is to find out to what extent the above hypothesis holds good in the sample companies.

3. Methodology :

To examine this hypothesis that return of net worth should be more than the return on capital employed, I have selected three companies which are topping the list of automobile sector in India in terms of the turnover and tried to understand the relationship between the two in these companies.

This study is restricted to a period of 5 years and covers the period from 2011 to 2015. The companies covered are as follows:

A. Mahindra and Mahindra.
B. Tata Motors.
C. Maruti Suzuki India.

4. ANALYSIS AND DISCUSSION :

A. MAHINDRA AND MAHINDRA:

(figures in crores)

Years	Net Worth	Loan Funds	Capital Employed	Finance Cost	Net Profit after tax	Return on net worth	Return On capital employed	Debt: Equity
2010-11	10,313	2,321	12,634	72	2,662	25.81	21.64	0.23
2011-12	12,171	3,174	15,345	163	2,879	23.65	19.82	0.26
2012-13	14,659	3,227	17,886	191	3,353	22.87	19.81	0.22
2013-14	16,791	3,745	20,536	259	3,758	22.38	19.56	0.22
2014-15	19,255	2,620	21,875	214	3,321	17.25	16.16	0.14

INFERENCES:

a. In all the above years from 2010-11 to 2014-15, the return on net worth is more than the return on capital employed, indicating productive use of loans availed.
b. The debt equity ratio is above 20% of equity in the first four years, whereas in the year 2014-15, it has declined to 16% of the equity.
c. Therefore, in the year 2014-15, the margin between return on net worth and return on capital employed is a narrow i.e 1.09 (17.25-16.16)
d. Whereas in all the previous four years the margin between return on net worth and return on capital employed is in the range of 2.82 to 4.17%
e. With lower debt equity ratio in the years 2012-13 and 2013-14, the margin between the two narrows down.
f. In the year 2015, the net profits have declined; the company has rightly brought down the debt content in the year and reduced the finance costs.
g. The return on net worth is the lowest at 17.25% in 2015 during the last five years.
h. The return on net worth has declined over the last five years along with the return on capital employed, although the return on net worth is maintained at a rate more than the return on capital employed which is a very favourable feature.
i.

B. TATA MOTORS:

Tata Motors (figures in crores)

Years	Net Worth	Loan Funds	Capital Employed	Finance Cost	Net Profit after tax	Return on net worth	Return on Capital employed	Debt: Equity
2010-11	20,013	14,638	34,651	1384	1,812	9.05	9.22	0.73
2011-12	19,626	11,012	30,638	1219	1,242	6.33	8.03	0.56
2012-13	19,135	14,269	33,404	1388	302	1.58	5.06	0.75
2013-14	19,177	14,516	33,693	1338	335	1.75	4.97	0.76
2014-15	14,863	20,081	34,944	1612	-4,739	-31.88	-8.95	1.35

INFERENCES:

1. In all the years from 2010-11 to 2014-15, the company has a return on net worth less than the return on capital employed, which indicates that the loans availed have not proved productive.

2. Return on net worth has been deteriorating over the last five years and in 2015, it has a dismal performance with return on net worth standing at negative figure of 31.88%.
3. Return on capital employed has also shown a decline from 9.22 in 2011 to a negative figure of 8.95% in 2015.
4. The company has an alarming performance in 2015, where the net worth has started eroding.
5. The debt equity ratio shows that the company has taken debts during the year 2014-15, which has primarily gone to fund the losses, as the losses incurred in 2015 is almost equal to the additional loan funds taken during the year.
6. Unless the return on net worth is more than the return on capital employed, the loans availed would only put more burden on the company.
7. The finance costs is also mounting adding to the unproductively of loan funds.

C. MARUTI SUZUKI INDIA:

(figures in crores)

Years	Net Worth	Loan Funds	Capital Employed	Finance Cost	Net Profit after tax	return on net worth	Return on Capital employed	Debt :Equity
2010-11	13,868	170	14,038	25	2,289	16.51	16.48	0.01
2011-12	15,187	1,078	16,265	55	1,635	10.77	10.39	0.07
2012-13	18,579	1,389	19,968	190	2,392	12.87	12.93	0.07
2013-14	20,978	1,685	22,663	176	2,783	13.27	13.06	0.08
2014-15	23,704	180	23,884	206	3,711	15.66	16.40	0.01

INFERENCES:

1. The return on net worth is higher than the return on capital employed in the first four years, whereas in the year 2015, it is lower.
2. However, the above does not affect the performance of the company in the year 2015, since the loan funds are meagre and the debt equity ratio is at 1%.
3. In the year 2011, the return on net worth was fairly high at 16.51%, however it declined in the year 2012 to 10.77 %. Thereafter, it has shown an increasing trend over the last four years, improving the ratio to 15.66%.
4. The debt equity ratio shows that the company raised a maximum of 8% debt of the equity in the year 2014.
5. The return on capital employed followed a similar trend as in the case of return on net worth.
6. The finance costs was higher in 2015, the reasons for the same are needed to be looked into. For this reason, the return on net worth was lower than the return on capital employed. However, since the debt is only 1% of equity, the consequences are not serious.

5. FINDINGS:

a. Mahindra and Mahindra has the highest return on net worth as compared to Tata Motors and Maruti Suzuki India. However, this ratio has declined down from 25.81% to 17.25% in 2015, still it remains at the highest level.
b. In case of Tata Motors, the return on net worth was at 9.05% in 2011 which itself was not very favourable being below 10%. Even this ratio has deteriorated to an alarming negative figure of 31.88% in 2015.
c. Even though, Tata Motors as per sales volume is the top leader in the industry, its performance of profitability is dismal.

d. The productivity of loans used in case of Tata Motors is in the negative, adding to losses. The productivity of loans is in the negative because return on net worth is less than of return on capital employed.
e. The use of financial leverage in case of Tata Motors is in the negative, with increasing debt: equity ratio.
f. Maruti Suzuki India is having a good return on net worth ratio at 15.66% in 2015.
g. In the initial four years of Maruti Suzuki, the return on net worth is marginally higher than return on capital employed for the reason that the debt equity ratio is at a low level of 7 to 8%.
h. Maruti Suzuki is not resorting to the use of financial leverage in any significant manner as in the case of Mahindra and Mahindra, which is using the financial leverage to the extent of around about 23% in the initial four years. As a result in case of Mahindra and Mahindra, the return on net worth is higher than return on capital employed to a considerable extent and has a positive impact.
i. In case of Tata Motors, the debt: equity ratio is on the higher side and that too it has an negative impact. Increasing the debt equity ratio with a negative impact has an effect of adding to the losses.

6. CONCLUSIONS:

a. The return on net worth should be higher than the return on capital employed; so as to ensure that the productivity of loan raising has a positive impact as in the case of Mahindra and Mahindra.
b. Whenever the return on net worth is lower than the return on capital employed the increase in the debt: equity ratio will have a negative impact and will add to losses as in the case of Tata Motors.
c. In case of Maruti Suzuki India, the return on net worth is marginally higher than return on capital employed, and has a limited use of debt; therefore the return on net worth is lower as compared to Mahindra and Mahindra.
d. In other words, a company will be facing losses when the return on capital employed is more than the return on net worth. It leads to conclude that in a loss making company (2015) as in Tata Motors, the return on capital employed is more than the return on net worth; which is adding to further losses.
e. In case the financial leverage does not add to profits, then the loans prove to unproductive.
f. This means that the interest paid on loans is too costly than the returns accruing to the shareholders from such loans.

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