Return on Equity (ROE)

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What Is Return on Equity (ROE)?

ROE is a **measures a financial performance** calculated by dividing net income by share holders equity.

ROE = Net Income/Shareholders equity

ROE is **benchmark of** a corporations **profitability and efficiency**.

ROE ratios varies significantly from industry group or sector to another.

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Key Takeaways

- ROE is expressed as a %
- Net income for calculation is before dividends to shareholders
- The **higher the ROE**, the better a company is at **converting its equity financing into profits**
- **ROE % varies depend on the industry** or sector the company operates in

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ROE and Stock Performance

ROE can be a good starting place for developing **future estimates** of a stock's growth rate and the growth rate of its dividends. Sustainable growth rates and dividend growth rates can be estimated using ROE.

To estimate a company's future growth rate, by multiply the ROE by the company's retention ratio.
The **retention ratio** is the **percentage of net income** that is retained or **reinvested to fund future growth**.

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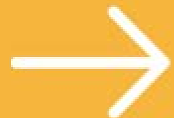

Using ROE to Identify Problems

Inconsistent Profits
High ROE's with large income and small equity can indicate inconsistent profits.

Excess Debt
If a company has been heavily borrowing, it can increase ROE, because equity is; assets, minus debt.

Negative Net Income
Can be a sign of inconsistent profits, or reduced cash flow due to share buybacks. More investigation is warranted.

The Bottom Line

ROE can tell you how well a company is using resources to generate profit, it does not consider a company's entire financing structure, industry, or performance against competition without further analysis.

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