Return on Equity

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What is it?	" The ability of a firm to generate profits from its shareholders investments"
How is it calculated?	$\text{Return on equity} = \dfrac{\textit{Net income}}{\textit{Shareholders equity}}$
Why is it important?	Measure of excess profits / Management ability / Aids comparison

Effect of Debt on Return on Equity

Debt (or "leverage") can skew a company's return on equity

Company A is funded by 1,000.0 equity

Company B is funded by 700.0 debt + 300.0 equity. Interest rate on debt is 5.0%

	Company A	Company B
Operating profit	100.0	100.0
Interest	-	(35.0)
Profit before tax	100.0	65.0
Tax (20.0%)	(20.0)	(13.0)
Net income	80.0	52.0
Shareholders equity	1,000.0	300.0
Co A return on equity 80.0 / 1,000.0	8.0%	
Co B return on equity 52.0 / 300.0		17.3%

Effect of Debt on Return on Equity

Disadvantage of debt? Interest on debt is a fixed cost. In bad times when operating profit reduces, net income will drop dramatically

Debt exaggerates ROE down in bad times and up in good times

	Company A	Company B
Operating profit	35.0	35.0
Interest	-	(35.0)
Profit before tax	35.0	-
Tax (20.0%)	(7.0)	-
Net income	28.0	-
Shareholders equity	1,000.0	300.0
Co A return on equity 28.0 / 1,000.0	2.8%	
Co B return on equity 0.0 / 300.0		0.0%


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