Return on Investment (ROI)

This is a measure used to evaluate how effectively an investment has performed.

ROI = Investment net profit / Capital invested

Example

Annual	Value £
Investment	10,000
Profit	1,000
ROI %	10%

Investment value would be all the costs to complete any investment. For a project such as the investment in a piece of machinery this would include transportation and any commissioning costs incurred in making the equipment operational.

Profit would be the net profits generated by the investment. For example when looking at a piece of machinery you would consider the gross margin made on the products (labour/materials) made less any other costs such as energy costs and maintenance costs.

There is no defined measure of profitability so the calculation is very versatile but that also means that it can also be manipulated!

What is a good ROI?

This will depend on the type of investment and it will also depend on the speed with which you expect to return the initial investment.

An investment in land and buildings might not make an immediate return on investment. It may save you some money on rent and repairs to a building. However this may be small in percentage terms compared to the value of the investment. However investing in this sort of asset may also give you a capital gain if the asset is worth more in the future than it is today, like your house for instance. ROI might be in single figures for such a long term investment.

An investment in a depreciating asset such as some machinery may need a more attractive ROI to ensure that you payback your investment before the asset is beyond its useful economic life. An ROI of 15% would take approximately 7 years to payback.

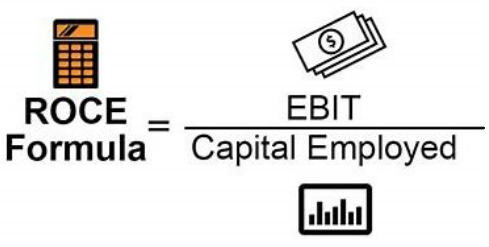
Payback = 100 / ROI% = 6.67 years

This is a very simplistic way to look at the investment. Obviously your returns in the earlier years are worth more than the returns in 6 years time due to inflation. Often cashflows are discounted in future years to reflect that the value of these revenues are lower than if the returns were made today !

If the asset only has a useful economic life of 3 years then you would need to generate an ROI on excess of 33% in order to make this viable. Otherwise you would be investing every 3 years in something which does not return more cash than was invested initially.

Return on Capital Employed (ROCE)

This looks at how effective a company is in generating profits from its Capital employed. This measure is more clearly defined and is more of a company measure and allows you to compare different companies.



ROCE = net operating profit / (total assets - current liabilities)

Operating profit is earnings before Interest and taxes (EBIT). This shows the profit generated from operations without showing the impact of borrowing and the marginal tax rate paid by the company.

When making comparisons on ROCE you should look at companies in the same market sector , you should look at similar accounting periods.

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