

How to choose between **growth and ROIC**

Investors reward high-performing companies that shift their strategic focus prudently, even if that means lower returns or slower growth.

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**Article
at a
glance**

One key to creating value is understanding how to manage the subtle balance between growth and returns on invested capital. Empirical evidence suggests that companies enjoying strong ROIC can afford to let it decline over the short term to pursue growth—and that companies with low returns are better off improving ROIC than emphasizing growth.

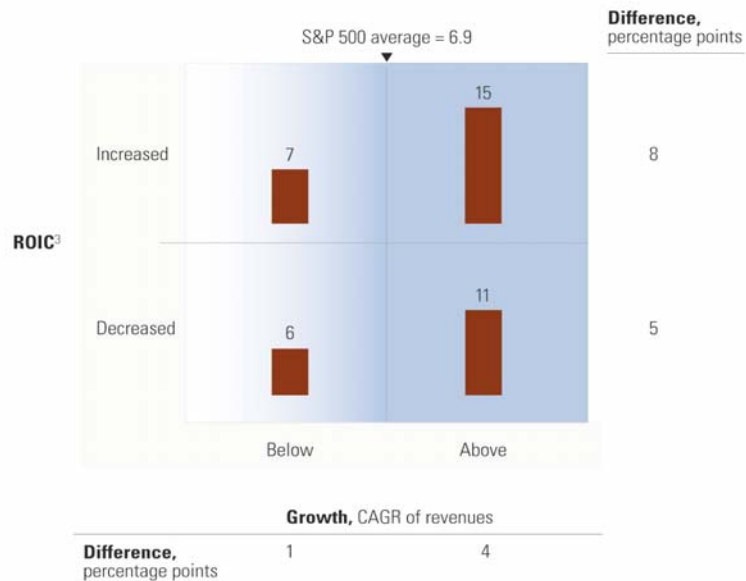
Value-minded executives know that although growth is good, returns on invested capital (ROIC) can be an equally—or still more—important indicator of value creation.¹ Yet even executives at the best companies often wrestle with strategic decisions in order to reach the right balance between growth and returns. We repeatedly come across executives whose companies earn high returns on capital but who are unwilling to let those returns decline to encourage faster growth. Conversely, we see executives at companies with low returns working to promote growth instead of improving their ROIC.

Large companies in particular can find it difficult to grow without giving up some of their existing returns.² What’s more, many executives are accustomed to seeing growth and returns improve (or decline) hand in hand as market conditions change. As a result, decision makers may hesitate to alter strategic directions, fearing a lag in market acceptance.

EXHIBIT 1
High ROIC

Total returns to shareholders (TRS)¹ for companies with high returns on invested capital (ROIC),² 1996–2005, %

■ Median TRS exceeds market



¹Median of compound average annual TRS from 1996 to 2005 for each group of companies, adjusted for compound 1996–2005 average TRS of S&P 500 index companies (6.9%).

²78 companies with 10-year average ROIC ≥20% and market capitalization >\$2 billion in 1995.

³Excluding goodwill.

To understand better how value is created over time, we identified all nonfinancial

US companies that had a market cap of more than \$2 billion³ in 1995 and had been listed for at least a decade as of that year. When we examined their growth and ROIC performance over the subsequent decade, we found clear patterns in the interaction between the two measures. These patterns can help guide value creation strategies suited to a company's current performance.

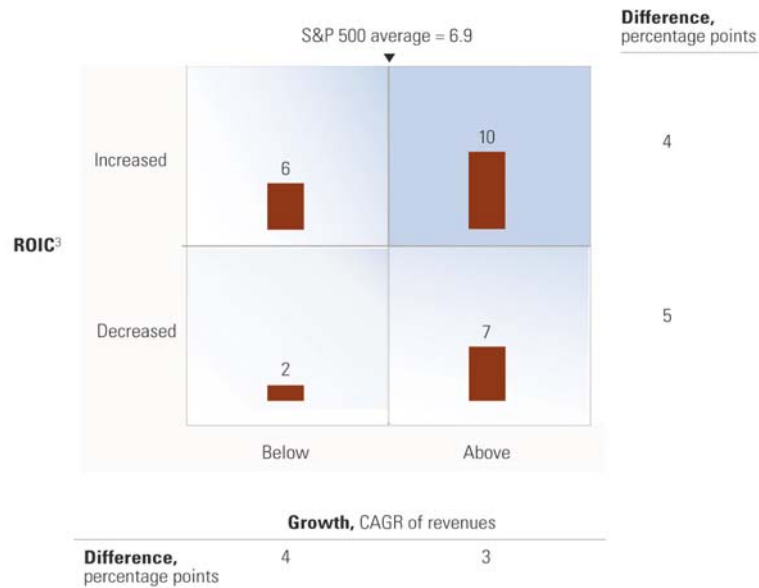
For companies that already have high ROIC,⁴ raising revenues faster than the market generates higher total returns to shareholders (TRS) than further improvements to ROIC do (Exhibit 1). This finding doesn't mean that companies with high ROICs can disregard the impact of growth on their profitability and capital returns. But executives do have the latitude to invest in growth even if ROIC and profitability erode as a result—as long as they can keep ROIC levels in or above the medium band.

EXHIBIT 2

Medium ROIC

Total returns to shareholders (TRS)¹ for companies with high returns on invested capital (ROIC),² 1996–2005, %

■ Median TRS exceeds market



¹Median of compound average annual TRS from 1996 to 2005 for each group of companies, adjusted for compound 1996–2005 average TRS of S&P 500 index companies (6.9%).

²129 companies with 10-year average ROIC ≥9% but <20% and market capitalization >\$2 billion in 1995.

³Excluding goodwill.

Companies that fall in the middle of the ROIC scale⁵ (Exhibit 2) have no latitude to let their performance on either measure decline. For these companies, improving

ROIC without maintaining growth at the pace of the market or generating growth at the cost of lower ROIC usually results in a below-market TRS. In most cases the market rewarded these companies with above-market returns only when they maintained their growth and improved their ROIC.⁶

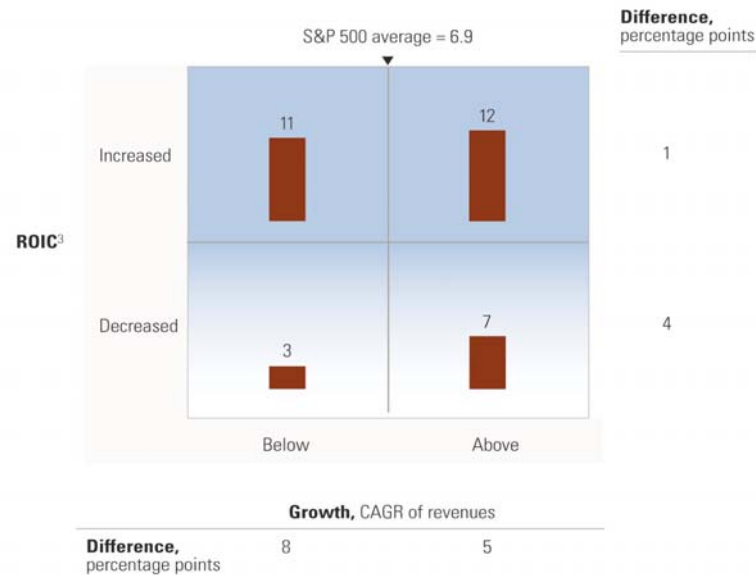
The pattern continues for companies with low ROIC⁷ (Exhibit 3). Although both ROIC and growth are still important, an improvement in ROIC is clearly more important: companies that increased their ROIC generated, on average, TRS 5 to 8 percent higher than those that didn't. Growth relative to the market made less difference (1 to 4 percent) for shareholders, particularly if the company improved its ROIC. This result isn't surprising. Because such companies were generating returns at or below their weighted-average cost of capital, they would have had difficulty accessing capital to finance further growth unless they improved their operations and earned the right to grow. Indeed, nearly one-third of the companies in this category from 1995 were acquired or went bankrupt within the following decade.

EXHIBIT 3

Low ROIC

Total returns to shareholders (TRS)¹ for companies with high returns on invested capital (ROIC),² 1996–2005, %

■ Median TRS exceeds market




¹Median of compound average annual TRS from 1996 to 2005 for each group of companies, adjusted for compound 1996–2005 average TRS of S&P 500 index companies (6.9%).

²64 companies with 10-year average ROIC ≥6% but <9% and market capitalization >\$2 billion in 1995.

³Excluding goodwill.

Of course, when an industry reaches maturity and consolidates, companies may find

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it impossible to avoid slow growth and, at the same time, compressed margins. And when a company cannot find growth opportunities or improve its returns on investment, executives might better serve shareholders by selling the company to owners who can drive higher growth or by returning capital to shareholders through stock buybacks. 

¹ Bing Cao, Bin Jiang, and Timothy Koller, "Balancing ROIC and growth to build value," *McKinsey on Finance*, Number 19, Spring 2006, pp. 12–16.

² For more on this topic, see Nicholas F. Lawler, Robert S. McNish, and Jean-Hugues J. Monier, "Why the biggest and best struggle to grow," *McKinsey on Finance*, Number 10, Winter 2004, pp. 17–20.

³ Normalized to 2003 dollars.

⁴ Those with a ten-year average ROIC greater than or equal to 20 percent in 1995.

⁵ Those with a ten-year average ROIC in 1995 greater than or equal to 9 percent but less than 20 percent.

⁶ Because our data represent the median of a group, a company could achieve above-market TRS even though its growth was below market or its ROIC had declined.

⁷ Those with a ten-year average ROIC in 1995 greater than or equal to 6 percent but less than 9 percent.

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