ink ADVISORY

August 5, 2025

# ROIC > WACC: THE FORMULA FOR CREATING SHAREHOLDER VALUE



Insights | M&A

# HOW CAPITAL IS STRUCTURED AND WHAT DETERMINES ITS COST?

**To make sure that business growth is sustainable, companies need to invest in working capital and fixed assets – new facilities and technology. These investments can be financed through Equity and/or Debt.**

One of the owner's key tasks is to find the optimal balance between funding sources that maximizes the shareholder value while maintaining adequate level of risk.

## Invested capital (IC[1])

Invested capital is comprised of two components:

1. Equity (share/common capital and retained earnings);
2. Financial Debt (bank loans, bonds, leasing and other borrowings).

## Cost of Capital (WACC[2])

Both shareholders and lenders expect a return on the capital they provide. Lenders earn from interest payments, and what they expect to earn given certain risk profile is cost of debt for the company. Shareholders receive dividends and benefit from the appreciation of their shares, and what they expect to earn also given risk profile of the company is called cost of equity.

From the company's perspective, the overall cost of capital is calculated based on the share of debt and equity in its financing structure – this is the Weighted Average Cost of Capital or WACC. It represents the average cost of each source of capital, weighted by its proportion in the company's total financing structure.

## Return on Invested Capital (ROIC[3])

When a company invests its own and borrowed funds, it is crucial to ensure these funds are utilized efficiently – generating returns exceeding their cost.

This is where a key metric comes in – Return on Invested Capital or ROIC. It measures how much operating profit the company generates for every unit of invested capital.

## The Relationship Between ROIC and WACC

Many companies associate growth with higher sales, expansion, new branches and investments. But growth of business by itself is not necessarily positive for shareholders – it can either create or destroy value. The key question any business owner must ask is:

> "Does each unit of capital invested generate operating profit?
> Or does it merely increase sales?"

To assess how efficiently a business uses capital, ROIC is compared to WACC.

Only when ROIC exceeds WACC, the company is creating shareholder value. If ROIC is lower, then even if the business is growing, it is earning less than what the capital used to finance that growth cost – which means shareholder value is being destroyed.

**ROIC vs WACC: What it Stands for**

| If... | ... it means | Consequences |
|---|---|---|
| **ROIC > WACC** | Capital is generating returns higher than its cost | Business **creates** value |
| **ROIC < WACC** | Capital returns are lower than the cost of capital | Business **loses** value |
| **ROIC = WACC** | No losses, but no added value | **Status quo** |

**How to Calculate WACC and ROIC:**

$$WACC = \left(\frac{D}{D+E}\right) \times Rd \times (1-T) + \left(\frac{E}{D+E}\right) \times Re$$

where:

$D$ – Financial Debt;
$E$ – Equity;
$R_d$ – Cost of Debt;
$R_e$ – Cost of Equity;
$T$ – Corporate Income Tax Rate.

$$ROIC = \frac{EBIT \times (1-T)}{Average\ IC}$$

where:

*EBIT* – Earnings before interest and tax;

*Average IC* – Average invested capital.

*Note: How to estimate Re (Cost of Equity)?

Simplified method:

- If Debt/Equity ≤ 1.0, use a rate of 25% (an approximate rate for organizationally mature mid-sized companies with moderate leverage);
- If Debt/Equity > 1.0, then 25%+ (the higher the debt, the higher the rate).

For example, with Debt/Equity = 0.7, you can assume Re = 25%. A precise calculation requires more complex formulas and inputs – risk-free rate, beta coefficient and market premium. In such a case, it is better to consult an investment advisor.

[1] IC - Invested Capital.

[2] WACC - Weighted Average Cost of Capital.

[3] ROIC - Return on Invested Capital.

# THREE CASES: HOW CAPITAL STRUCTURE AND PROFITABILITY AFFECT BUSINESS VALUE

Consider three hypothetical companies with the same amount of invested capital but different capital structures and profitability levels:

1. Companies A and B have the same capital structure (debt makes up 30% of total capital), while Company C is more dependent on borrowed funds (debt share – 70%).
2. Return on Invested Capital (ROIC[3]) is identical for Companies A and C (25%), whereas Company B invests capital less efficiently (ROIC = 15%).

This example illustrates how differences in capital structure and business efficiency influence each company's ability to increase shareholder wealth.

### Company A: Equity-dominated capital structure and high investment efficiency

Company A achieves the highest economic profit (₽ 33,6 M) due to:

- Relatively low cost of capital (WACC[2]) thanks to low debt and, consequently, lower risks;
- A high ROIC[3] level, indicating strong operational efficiency.

### Company B: Equity-dominated capital structure but lower investment efficiency

Company B destroys shareholder value because its WACC exceeds its ROIC:

- Its core operations are inefficient – with the same sales level and capital structure, its operating profit[1] is lower and does not cover the cost of capital;
- Company B has the same WACC as Company A, but even relatively cheap capital does not allow it to create shareholder value.

### Company C: Debt-dominated capital structure and high investment efficiency

Company C generates low economic profit despite a high ROIC:

- High debt levels increase the company's financial risks;
- Elevated financial risks drive up the cost of both equity and debt.

### The Effects of Capital Structure and Business Profitability on ROIC, WACC and Economic profit (EP), ₽ Million

| Indicator | Company A | | Company B | | Company C | |
|---|---|---|---|---|---|---|
| | ₽ M | Cost, % | ₽ M | Cost, % | ₽ M | Cost, % |
| **Average invested capital** | **1 000** | **21,6%** | **1 000** | **21,6%** | **1 000** | **24,5%** |
| Equity | 700 | 24,4% | 700 | 24,4% | 300 | 35,1% |
| Debt | 300 | 19,0% | 300 | 19,0% | 700 | 25,0% |
| **NOPAT[1]** | **250** | | **150** | | **250** | |
| **WACC[2]** | | **21,6%** | | **21,6%** | | **24,5%** |
| **ROIC[3]** | | **25,0%** | | **15,0%** | | **25,0%** |
| **EP Spread[4]** | | **3,36%** | | **-6,64%** | | **0,48%** |
| **Economic profit (EP[5])** | **33,6** | | **(66,4)** | | **4,8** | |

1 NOPAT – Net Operating Profit After Tax.
2 WACC – Weighted Average Cost of Capital.
3 ROIC – Return on Invested Capital.
4 EP Spread – Difference between ROIC and WACC.
5 Economic Profit = NOPAT – WACC × Average Invested Capital.

Source: ink Advisory calculations

# CAPITAL EFFICIENCY:
# A PUBLIC COMPANY CASE STUDY

**MDMG (the "Mother and Child" Group) is a leading player in the Russian private healthcare market, consistently ranking among the Top 3 in revenues and market coverage. Since 2018, MDMG has only delivered positive economic profit to its shareholders – a direct indication of the company's effective use of invested capital.**
**MDMG's business generates returns (NOPAT) that exceed the cost of both equity and debt capital (IC). This means the company's shareholder value has been steadily increasing.**

In 2024, MDMG's Economic profit (EP) reached a record ₽ 1,6 B. A key driver of this success is the consistently high and growing ROIC – rising from 14,7% in 2018 to 26,9% in 2024. At the same time, MDMG's Weighted Average Cost of Capital (WACC) has remained below 23%, resulting in a substantial positive spread.

This gap between returns and the cost of capital means that each ruble invested generates increasing additional value.

The growth in NOPAT margin (from ~20% to 27%) also reflects improved operational efficiency and better cost management.

It is worth noting that MDMG maintains a balanced capital structure: the share of debt financing has been gradually decreasing, while equity has been growing, providing a stable financial platform.

This approach allows the company not only to generate profits but also to minimize risks associated with leverage. Taken together, these trends highlight the maturity of MDMG's business model and its strong ability to create long-term shareholder value.

### MDMG: Efficiency of Invested Capital, ₽ Billion

| Reporting period | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 |
|---|---|---|---|---|---|---|---|
| Revenues | 14,9 | 16,2 | 19,1 | 25,2 | 25,2 | 27,6 | 33,1 |
| NOPAT | 3,0 | 3,0 | 4,3 | 6,5 | 4,8 | 7,3 | 8,8 |
| *NOPAT Margin* | *20,1%* | *18,4%* | *22,7%* | *25,7%* | *19,1%* | *26,6%* | *26,5%* |
| **Average invested Capital**[1] | **20,4** | **23,0** | **25,3** | **27,1** | **27,4** | **30,8** | **32,7** |
| Equity | 15,3 | 16,9 | 18,9 | 21,5 | 25,0 | 30,8 | 32,7 |
| Debt | 5,1 | 6,1 | 6,4 | 5,6 | 2,4 | 0,0 | 0,0 |
| **ROIC** | **14,7%** | **12,9%** | **17,2%** | **23,9%** | **17,6%** | **23,9%** | **26,9%** |
| WACC[2] | 14,4% | 12,1% | 11,9% | 15,9% | 16,3% | 20,0% | 23,4% |
| **EP Spread** | **0,3%** | **0,8%** | **5,3%** | **7,9%** | **1,2%** | **3,8%** | **3,5%** |
| **Economic Profit (EP)** | 0,1 | 0,2 | 1,3 | 2,1 | 0,3 | 1,2 | 1,1 |

[1] In this case, invested capital is calculated at book value and does not reflect the increase in MDMG's market capitalization.

[2] For comparability purposes, WACC is estimated based on the company's actual balance sheet capital structure.

Sources: www.mcclinics.com, consolidated IFRS financial statement, ink Advisory calculations

# CAPITAL EFFICIENCY:
# THE CASE OF TWO PRIVATE COMPANIES

**This case clearly demonstrates how significantly capital efficiency impacts creation of shareholder value. Despite having similar revenue levels in 2020, the two companies show fundamentally different dynamics in ROIC, WACC and Economic Profit (EP).**

**Company X** is an example of efficient growth. Its NOPAT margin has been steadily increasing (1,5% to 6,5%) and by 2022 its ROIC exceeded 40%. At the same time, the cost of capital (WACC) has been gradually declining and since 2021 EP has remained consistently positive. This indicates that the business is scaling without losing efficiency and is creating additional value for its owners..

**Company Y**, on the other hand, is unable to deliver returns above its cost of capital even as revenues grow. In 2021, ROIC temporarily exceeded WACC, but by 2022 operating profitability deteriorated (NOPAT margin fell into negative territory), while WACC consistently remained above ROIC. This resulted in negative EP and destruction of shareholder value.

**A sustained excess of ROIC over WACC is the key hallmark of an efficient, resilient business that creates shareholder value. Even moderate growth with high profitability is better than expansion accompanied by negative economic profit.**

### Companies X and Y: Efficiency of Invested Capital, ₽ Billion

| | Company X | | | | | Company Y | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2020 | 2021 | 2022 | 2023 | 2024 | 2020 | 2021 | 2022 | 2023 | 2024 |
| **Revenues** | **6,9** | **7,1** | **9,6** | **10,5** | **13,7** | **6,2** | **6,5** | **7,6** | **6,5** | **8,1** |
| **NOPAT** | **0,1** | **0,3** | **0,8** | **0,7** | **0,9** | **0,4** | **0,3** | **0,4** | **(0,1)** | **0,3** |
| *NOPAT Margin, %* | *1,5%* | *4,0%* | *8,3%* | *6,4%* | *6,5%* | *7,0%* | *3,9%* | *4,9%* | *-0,9%* | *4,2%* |
| **Invested capital**[1] | **1,6** | **1,4** | **2,3** | **3,5** | **6,0** | **2,4** | **2,4** | **2,7** | **2,7** | **2,8** |
| Equity | 0,4 | 0,5 | 1,1 | 1,7 | 2,6 | 0,9 | 1,0 | 1,1 | 1,0 | 1,0 |
| Debt | 1,1 | 0,9 | 1,2 | 1,8 | 3,5 | 1,5 | 1,4 | 1,6 | 1,7 | 1,7 |
| **ROIC** | **6,8%** | **19,0%** | **43,1%** | **23,4%** | **18,8%** | **19,6%** | **10,6%** | **14,7%** | **-2,3%** | **12,4%** |
| WACC2 | 8,5% | 9,5% | 19,1% | 15,2% | 17,3% | 8,7% | 9,6% | 18,0% | 14,8% | 17,0% |
| **EP Spread** | **-1,7%** | **9,5%** | **24,0%** | **8,2%** | **1,5%** | **10,9%** | **1,1%** | **-3,4%** | **-17,0%** | **-4,7%** |
| **Economic Profit (EP)** | **0,0** | **0,1** | **0,4** | **0,2** | **0,1** | **0,2** | **0,0** | **(0,1)** | **(0,5)** | **(0,1)** |

[1] In this case, invested capital is calculated at book (historical) value.

[2] For comparability purposes, WACC is estimated based on the company's actual balance sheet capital structure.

Source: SPARK, ink Advisory calculations

# NUANCES IN CALCULATING ROIC and WACC

When comparing ROIC and WACC, it is important to keep in mind several nuances to avoid “comparing apples to oranges”.

| Pitfalls in calculating ROIC and WACC | How to avoid calculation errors? |
|---|---|
| **Incomparable bases**<br>When calculating ROIC, balance sheet (or historical) values of equity and debt are used. For WACC, however, market values should be applied for public companies or levels of leverage from comparable companies for private firms. | ▪ First and the most obvious method – calculate WACC using the company’s actual (balance sheet) capital structure.<br>▪ Second method – keep WACC based on market values but compare it with “Marketable ROIC”, where market values of equity and debt are used instead of balance sheet figures. But if market capitalization goes up, this metric could be underestimated.<br>▪ Third method – regularly revalue assets at market. |
| **Different sources of metrics**<br>ROIC is calculated based on operating profit (NOPAT) – a metric from the Profit & Loss statement (P&L) that reflects a company’s operational efficiency. WACC usually incorporates current market cost of capital, which reflects market expectations. This means that past performance (ROIC) is being compared to future expectations (WACC), creating a timing mismatch that should be taken into account. | ▪ Compare ROIC and WACC not just for a single period but over time, monitoring how the spread between them changes. A consistently positive and widening spread is a strong sign of value creation, whereas a narrowing or negative spread calls for deeper analysis.<br>▪ Use ROIC and WACC from the same period to ensure comparability. Alternatively, use a forecasted ROIC (based on budgets or financial models) and compare it with a forecasted WACC. |
| **ROIC can be manipulated through cost capitalization**<br>Capitalizing costs directly affects invested capital and, therefore, ROIC. | ▪ Analyze cost structure over time and look for anomalies in the financial statements. |
| **Presence of non-Operating assets**<br>ROIC should only account for operating assets. Excess cash, surplus real estate or other non-operating assets should be excluded. Including them inflates invested capital and reduces ROIC. | ▪ Remove non-operating investments, surplus real estate and other non-operating assets from invested capital calculations. |

# ABOUT US

ink Advisory is an investment banking group founded in 2024 by a team of professionals with decades of experience in the US, CIS and EU.

Prior to establishing ink Advisory, the team had been known in the investment banking market as Lead Advisory division of Crowe CRS (Russaudit).

ink Advisory advises clients in M&A deals, establishing joint ventures and raising equity, and builds corporate strategies and capital growth strategies.

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