

ROIC and operating margin made easy

ROIC and operating margin are two of the most important numbers when considering investing in a company, and I'm going to try to explain what they mean in simple terms. Since there's no relevant news regarding the portfolio, I'll devote this text to explaining these concepts.

October 26, 2026, Jon García Labiano

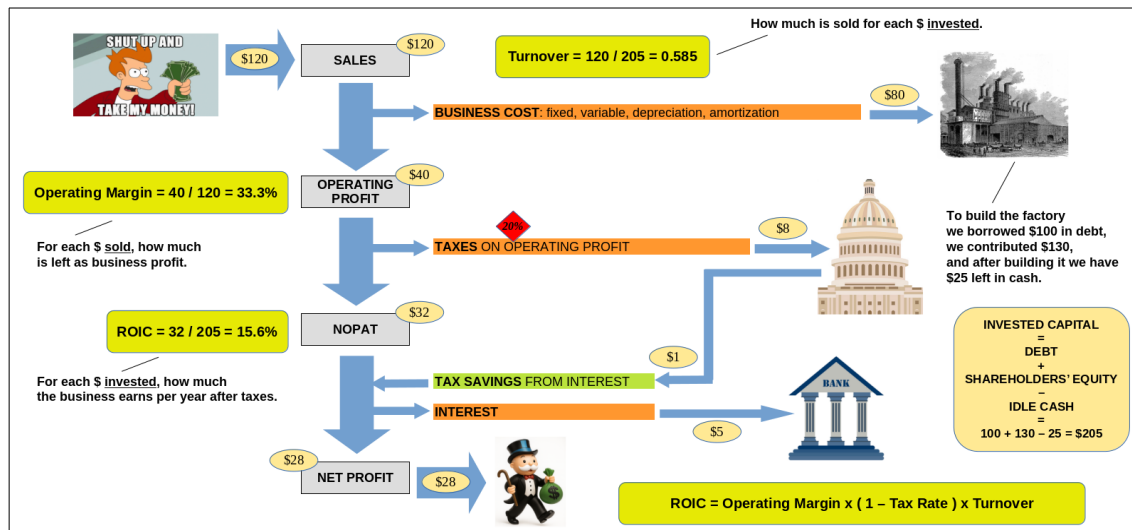
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Data sources: TIKR, TwelveData, Gurufocus. **Tools:** own software.

Monitoring and investment plan: <https://www.jongarcialabiano.com>

First, let's imagine we build a factory

I've created this little diagram to support the explanation. Take a look at it as you follow along with the text.



Let's imagine we build a factory, making anything, soft drinks for example. Suppose we have 130 million and contribute it to build the factory, and we also need to borrow 100 million. Once it's built, we have 25 million left over. What is the capital invested in the factory? Regardless of where the money came from, borrowed or not, the money the factory cost was $100 + 130 - 25 = 205$ million. Objectively, that is the money invested, and we'll call it "Invested Capital".

We start producing soft drinks and selling them. In one year of production, we achieve sales of 120 million. But during the year we've had many expenses inside the factory:

buying water, coloring, sugar, repairing machinery, employees, etc. All of those are the usual costs of running our factory's business, our operating costs.

We've invested our capital, manufactured and sold soft drinks, and incurred expenses to keep the factory running. What is our factory's profit? The first profit we can calculate is what we'll call "Operating Profit", the profit we earn from the pure business: Sales – Business costs. If we've spent 80 million to operate the factory, the operating profit is $120 - 80 = 40$ million.

And now we can calculate a very important number that tells us how efficient it is to keep the factory running. If the factory were given to us for free, all we'd care about would be sales and costs, nothing else; and the measure that tells us how good or bad our factory is from that point of view is "Operating Profit / Sales", which in this case would be $40/120 = 33.3\%$. **The Operating Margin tells us how much is left as business profit for every dollar sold.** In this case, we keep 33 for every 100 dollars sold.

But... we have to pay taxes. Once taxes are paid, what's left is called NOPAT. This is the factory's profit after taxes, regardless of where the money came from, whether it's ours or borrowed; we haven't taken interest into account in this number.

And now we can calculate the second important number, ROIC, which is "NOPAT / Invested Capital". In our case, let's say we pay 20% in taxes, so it will be $32/205 = 15.6\%$. **ROIC tells us how much the business earns per year after taxes for every dollar invested.** In this case, for every 100 dollars invested in the factory, it earns 16 each year. Regardless of where that investment came from, it doesn't matter whether it was borrowed money or not.

And then, we have to pay interest, which gives us the net profit, and from it, it's typical to calculate the P/E ratio.

Another additional metric we can calculate is what's called "Turnover", which is "Sales / Invested Capital". It gives us a sense of speed: it tells us how much is sold per year for every dollar invested.

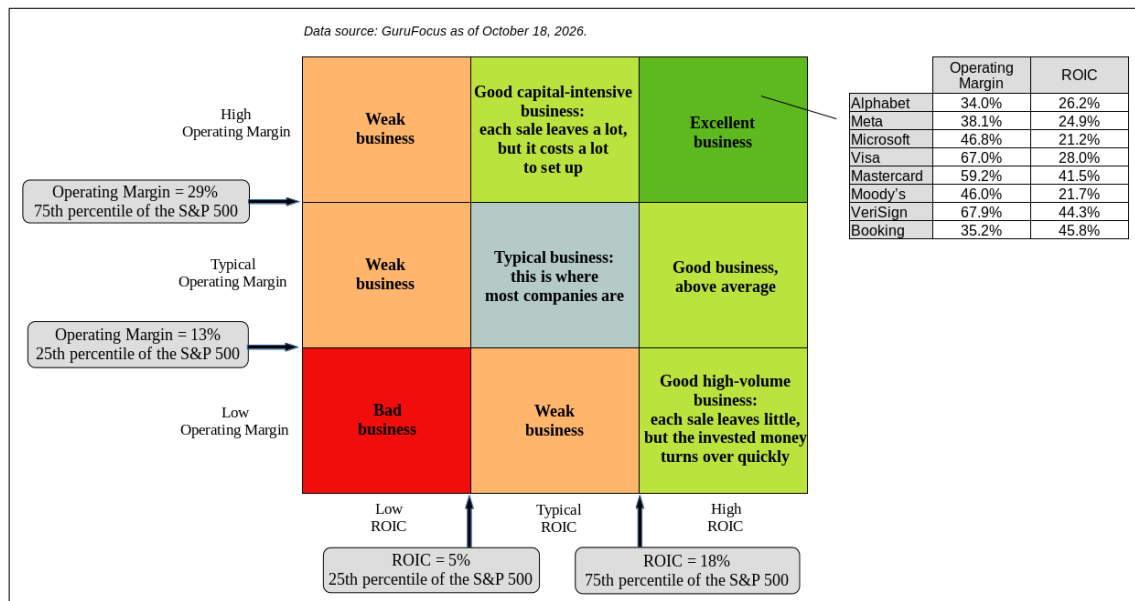
Now, let's reflect a bit

Let's dig deeper into the meaning. Let's recall:

- **Operating Margin tells us how much is left as business profit for every dollar sold.**
- **ROIC tells us how much the business earns per year after taxes for every dollar invested.**

In other words, the factory cost 205 million, and every year it generates 32 million in after-tax profit; that's what ROIC tells us. And the factory sells 120 million a year, and 40 million remains after deducting all the costs of operating the factory; that's what Operating Margin tells us.

They are two different points of view. A good company can be achieved in different ways. We can relate the two concepts in a table like the following and see more clearly the different types of businesses, and whether they are high quality or not.



A business with a low ROIC, below average, is a bad or weak business, because the return it earns is lower than its cost of capital. A business with a typical ROIC needs a high Operating Margin to be above average, and this would be the typical capital-intensive business whose sales leave a lot of money behind.

And now, entering high-ROIC territory, all green... this is the ideal ground. If the Operating Margin is low, it's a good high-volume business: the money turns over quickly even though each individual sale leaves little profit. If the Operating Margin is average, it's a good, above-average business. And when the two come together, high ROIC and high Operating Margin, we're looking at an EXCELLENT business. And that's the goal: to buy businesses with high ROIC and high Operating Margin at a fair price. These are businesses that need little capital and earn very high returns. For example, companies of this type that I hold in my portfolio: Alphabet, Meta, Microsoft, Visa, Mastercard, Moody's, VeriSign, Booking.

Where do a high ROIC and a high Operating Margin come from?

We can ask ourselves what makes a company reach those numbers. The answer lies in competitive advantage. A company with an extraordinary competitive advantage will inevitably end up with a high ROIC and high margins.

Extraordinary competitive advantage => high ROIC and high margins over time

But be careful!! A high ROIC and high margins only sometimes mean there's a real competitive advantage!! We can use ROIC and margins as a starting point to explore, but that advantage may be merely circumstantial; we have to think about whether it has a solid foundation to be durable.

And how do high-ROIC companies grow?

The growth of a high-ROIC company is something that can be modeled very easily, and you'll understand Charlie Munger's comments about the return on capital and why

he liked this type of high-return company so much. But remember that this is only theory; in the real world, everything is more complicated.

Let's imagine we create a company: we start with capital "C" and a number of shares "A", with no debt and no cash.

After one year, we'll have profits equal to " $C \times \text{ROIC}$ ".

Earnings per share for this first year will be " $C \times \text{ROIC} / A$ ".

And we do two things: we reinvest part of the profits in the business and use the rest of the profits to buy back shares. We'll reinvest a fraction "r" and buy back the remainder " $(1 - r)$ ". Reinvesting means expanding the factory, for example.

So, the total invested capital at the start of year 2 would be " $C + C \times \text{ROIC} \times r$ ".

And the shares at the start of year 2 would be " $A - C \times \text{ROIC} \times (1 - r) / \text{Price per share}$ " or, in terms of P/E, " $A \times (1 - (1 - r) / \text{PE})$ ", since NOPAT would equal net profit because we have no debt, and P/E is "Price per share / Earnings per share".

And at the end of this second year, we have profits equal to " $(C + C \times \text{ROIC} \times r) \times \text{ROIC}$ ", or equivalently " $C \times (1 + \text{ROIC} \times r) \times \text{ROIC}$ ".

And we're almost done. At the end of this second year, we'll have earnings per share of " $C \times (1 + \text{ROIC} \times r) \times \text{ROIC} / (A \times (1 - (1 - r) / \text{PE}))$ ", or, simplifying a bit, " $(C \times \text{ROIC} / A) \times (1 + \text{ROIC} \times r) / (1 - (1 - r) / \text{PE})$ ".

If you look closely, we've multiplied earnings per share from one year to the next by the factor " $(1 + \text{ROIC} \times r) / (1 - (1 - r) / \text{PE})$ ".

That is, the annual growth rate of earnings per share is the following, which we'll call "k":

$$k = \frac{1 + \text{ROIC} \times r}{1 - \frac{1 - r}{\text{PE}}} - 1$$

For example, if ROIC is 5% ($\text{ROIC} = 0.05$) and the P/E is 25, and we reinvest 75% ($r = 0.75$), we'll get annual earnings per share growth of 4.8% ($k = 0.048$).

And if we reinvest 100%, we'll get an earnings per share growth rate exactly equal to ROIC. And since, over the long term, the price follows earnings per share, the stock price will grow at a rate equal to ROIC. But this is nothing more than theory, and it assumes that you can reinvest 100% and that the market accepts your product; that is, if you have a great competitive advantage.

To wrap up, here are tables with different reinvestment rates, ROICs, and P/Es to put everything in perspective.

Expected annual EPS growth with 0% reinvestment and 100% buyback		PER				
		15	20	25	30	35
ROIC	5%	7.1%	5.3%	4.2%	3.4%	2.9%
	10%	7.1%	5.3%	4.2%	3.4%	2.9%
	20%	7.1%	5.3%	4.2%	3.4%	2.9%
	30%	7.1%	5.3%	4.2%	3.4%	2.9%
	40%	7.1%	5.3%	4.2%	3.4%	2.9%

Expected annual EPS growth with 25% reinvestment and 75% buyback		PER				
		15	20	25	30	35
ROIC	5%	6.6%	5.2%	4.4%	3.8%	3.5%
	10%	7.9%	6.5%	5.7%	5.1%	4.7%
	20%	10.5%	9.1%	8.2%	7.7%	7.3%
	30%	13.2%	11.7%	10.8%	10.3%	9.9%
	40%	15.8%	14.3%	13.4%	12.8%	12.4%

Expected annual EPS growth with 50% reinvestment and 50% buyback		PER				
		15	20	25	30	35
ROIC	5%	6.0%	5.1%	4.6%	4.2%	4.0%
	10%	8.6%	7.7%	7.1%	6.8%	6.5%
	20%	13.8%	12.8%	12.2%	11.9%	11.6%
	30%	19.0%	17.9%	17.3%	16.9%	16.7%
	40%	24.1%	23.1%	22.4%	22.0%	21.7%

Expected annual EPS growth with 75% reinvestment and 25% buyback		PER				
		15	20	25	30	35
ROIC	5%	5.5%	5.1%	4.8%	4.6%	4.5%
	10%	9.3%	8.9%	8.6%	8.4%	8.3%
	20%	16.9%	16.5%	16.2%	16.0%	15.8%
	30%	24.6%	24.1%	23.7%	23.5%	23.4%
	40%	32.2%	31.6%	31.3%	31.1%	30.9%

Expected annual EPS growth with 100% reinvestment and 0% buyback		PER				
		15	20	25	30	35
ROIC	5%	5.0%	5.0%	5.0%	5.0%	5.0%
	10%	10.0%	10.0%	10.0%	10.0%	10.0%
	20%	20.0%	20.0%	20.0%	20.0%	20.0%
	30%	30.0%	30.0%	30.0%	30.0%	30.0%
	40%	40.0%	40.0%	40.0%	40.0%	40.0%