The DuPont Method

Idea In Short

Never accept a return on equity number at face value. Decompose it with the DuPont formula into profitability, asset efficiency and leverage, because identical ROEs can hide radically different businesses. Two grocers at 27 percent tell two entirely different stories once the three drivers separate.

A Business School Keeper

Geek alert: the DuPont Method ranks among the most durable takeaways from any business school finance course. It calculates return on equity [ROE], and more importantly it gives a consultant a fast way to get smart on a company. As a first step in tearing apart financials and comparing companies within an industry, little else matches it. The starting question answers itself. Return on equity is exactly what it sounds like: assets equal liabilities plus equity, you hold equity, so what is your return on it? The simple formula reads net profit divided by shareholder equity. That version is boring, and worse, it never explains why the returns arrive. Two grocers, Kroger and Sprouts Farmers Market, both posted ROE near 27 percent while running very different businesses, which is precisely the puzzle the simple ratio cannot solve.

Three Ratios in One

The DuPont formula, crafted at the DuPont company in the 1920s, breaks ROE into three parts.1 Profitability asks whether the company makes money on each sale. Asset efficiency asks whether it sells enough stuff relative to what it owns. Leverage asks how much debt amplifies the returns. Three parts feel longer than one, and the trade is worth it, because the expansion delivers a three-for-one special: a slice of the income statement and the balance sheet rolled into a single ratio. Written in full, ROE equals net profit over sales, times sales over average total assets, times average total assets over shareholder equity, with the interior terms elegantly canceling to leave the original ratio intact.

Kroger: Volume, Thin Margins, Heavy Debt

Apply the method to Kroger, a grocer with more than 2,700 stores and 122 billion dollars in revenue. A free screener shows the outline: net margins near 1.5 percent and leverage in the five-to-six-times range.2 For the full decomposition, a data service that lists each element separately works best, and the trailing-twelve-month picture resolves cleanly.3 Profitability sits at 1.55 percent, which is not great. Asset efficiency runs about 3.3 times, which is strong. Leverage stands near 5.4 times, which is a little scary. Translated into high-school English: Kroger sells a lot of stuff at almost no profit and borrows heavily to do it. The math cross-checks too, since return on assets of roughly 5.2 percent equals profitability times asset turnover.

Sprouts: Same ROE, Different Machine

Curiosity being a virtue, run the same decomposition on Sprouts Farmers Market, a grocer with about 300 stores and 4.8 billion dollars in revenue. The contrast instructs. Sprouts earns much higher margins than Kroger, consistent with premium products and stores segmented into affluent neighborhoods. Its asset turnover is good, below Kroger's, and notably improved from 2.57 a few years earlier. Leverage is the big difference, with Kroger carrying roughly twice the borrowing. Identical 27 percent returns, produced by two entirely different machines: one grinds volume on thin margins with heavy debt, the other earns rich margins at moderate scale with restraint.

The Detective Questions

The decomposition is the beginning of analysis, not the end, and this is why consulting and business generally stay fun: it is a big detective hunt. On profitability, are both companies purely grocers, given that Kroger also owns jewelry stores and gas stations? What does product mix look like, and which categories earn? With five-to-one leverage, even a 30-to-50 basis point margin improvement would supercharge Kroger's equity returns, so how might margins rise? On asset efficiency, Kroger's size should confer economies of scale, so what is best-in-class turnover for grocery? What assets does each company own, since outsourcing distorts any apples-to-apples comparison? Why does Sprouts hold a tenth of the stores yet far less than a tenth of the revenue? On leverage, is five-to-six times high or low for a business with steady cash flows, and can current bills be paid comfortably? Each question emerged only because the single ratio split into three.

Extending the Method

Two extensions multiply the tool's value once the basics feel routine. The first is time series. Running the decomposition across five years of a single company reveals which driver is improving or eroding, catching a margin decline hidden behind rising leverage before the headline ROE ever moves. The second is peer sets. Decomposing four or five industry rivals side by side exposes the different strategic postures within one sector, separating premium players from volume players from balance-sheet athletes at a glance. Analysts should also respect the method's limits, since one-time charges, buybacks that shrink equity and accounting choices can distort any component in a given year. The formula starts conversations with the numbers. Judgment still finishes them.

So What

The DuPont Method looks long-winded at three steps instead of one, and that is exactly its value, because it teases out the root causes of return. The classroom favorite makes the point vividly: a luxury jeweler and a discount retail giant can both post ROE in the 13-to-15 percent range while being as different as rival houses in a fantasy saga. One earns through fat margins on few sales, the other through razor margins on enormous volume. Memorize the formula, run it on every company you meet and let the three drivers start the conversation the single number always hides.

- 1DuPont Analysis
- 2Finviz
- 3Morningstar

Summary

The DuPont Method turns one boring ratio into three revealing drivers. Identical returns can rest on thin margins with heavy debt or rich margins with modest leverage, and the decomposition launches the detective questions that make company analysis fun. Memorize it, use it weekly.