Why High Debt Can Equal High Rewards

Description

For many investors, high debt levels are viewed in a negative light. After all, they mean there is a greater risk attached to the company in question. If it is unable to pay its debts due to underperformance, it could become bankrupt.

However, high debt can also be a good thing. It can equate to higher rewards, which in some cases more than makes up for the higher level of risk.

Improving profitability

The main reason why debt can increase overall reward is that it costs a lot less than equity. A company can be financed either through debt or equity, with the former generally being cheaper than the latter. This means that it is logical for every company to maximise their debt levels in order to generate higher returns on equity. Doing so can mean higher profitability, higher dividend growth and stronger share price performance.

The right circumstances

Obviously, maximising debt levels is not always a prudent move. Companies which are highly cyclical and dependent upon the performance of the wider economy could enter into major problems if their balance sheets are highly leveraged. During leaner years, they may struggle to cover debt-servicing costs, which may lead to an even more challenging period.

In contrast, companies operating in industries which offer stable, consistent and robust returns should increase debt to relatively high levels in order to improve the return for equityholders. For example, it makes sense for utility and tobacco companies to increase debt levels, since they have a high level of earnings visibility and enjoy relatively consistent demand from their customers.

Economic cycles

It also makes sense for companies to borrow as much as possible during periods of time when interest rates are low. The last decade has been a good time to be a borrower, rather than a lender. Interest rates across the developed world have been at historic lows and this has allowed companies in a range of sectors to reduce their overall borrowing rates.

Looking ahead, a higher rate of inflation is forecast and this may prompt higher interest rates. While this may mean the cost of servicing debt increases, it should be offset somewhat by higher prices being charged to the end consumer. Furthermore, a higher rate of inflation will help to erode the real-terms value of debt. This means that higher amounts of borrowing may remain popular in future years.

Takeaway

While increasing balance sheet leverage raises overall risk, it can be a profitable move in the right circumstances. While interest rates are low, companies with stable business models may improve overall returns by increasing debt levels. While higher interest rates may mean the cost of servicing debt rises in future years, higher inflation may erode the real-terms value of borrowings. Therefore, Foolish investors may wish to buy stocks with at least moderate debt levels in order to maximise their overall returns in the long run.

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Date
2025/08/27
Date Created
2017/05/22
Author
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