5 Reasons Why Certain Stocks Can Ignore Rising Interest Rates

Description

If the Bank of Canada hikes the overnight rate target, it will eventually lead to rate hikes in loans such as commercial loans, consumer loans, and mortgages.

Investors shouldn't fear rate hikes too much, though. Generally, the Bank of Canada won't increase the rate unless the economy is improving. And each time, it tends to only tweak it marginally to ensure it doesn't throw off the economy, the businesses, and the people.

Besides, there are ways for businesses to counter rising interest rates.

Operate in a growing industry

Rising interest rates lead to increased borrowing costs for businesses. However, businesses in industries that are growing will have more opportunities for investment and growth, and the increased borrowing costs may be negligible.

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For example, **Open Text Corp.** (TSX:OTEX)(NASDAQ:OTEX) provides software for more than 100,000 customers around the world to manage enterprise information.

With information growing exponentially, and Open Text being a consolidator in the space, there's a lot of room for the company to grow. The analyst consensus estimates Open Text will continue growing at an average double-digit rate for the next few years.

Maintain strong credit ratings

No matter if interest rates are high or low, companies with high credit ratings will always get lower rates compared to companies with lower credit ratings.

Utilities **Fortis Inc.** (TSX:FTS)(NYSE:FTS) and **Emera Inc.** (TSX:EMA) both have investment-grade credit ratings, but Fortis's S&P credit rating is higher at A- (compared to Emera's BBB+).

Stable regulated utility Fortis has a debt-to-cap ratio of ~51%, and it's estimated to bear an average interest rate of ~4%. Emera has a debt-to-cap ratio of ~59%, and the utility is estimated to bear an average interest rate of under 5.6%. That's one reason why the market commands a higher yield of ~4.4% from Emera compared to Fortis's ~3.5% yield.

Management has strong capital-allocation skills

Management with outstanding skills in capital allocation know the best way to raise cash as well as the best places to put the cash, whether that be by investing back into the business, acquiring another business, paying down debt, paying out dividends, or even buying back shares.

Companies with exceptional management are characterized by consistently high returns on equity. For example, **Alimentation Couche Tard Inc.** (TSX:ATD.B) has had a return on equity of at least 15% since fiscal 2008 and at least 20% since fiscal 2010.

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Keep debt levels reasonable

In the last decade or so, Couche Tard's average financial leverage mostly oscillated between two and 2.7. There was only one year in which it had an outlier of 3.3. So, if Couche Tard's financial leverage exceeds three, it'd be time for some investigation.

Investors should also compare the financial leverage between the companies in the same industry to see if they're aligned. And if not, figure out why and decide if it's reasonable.

Has above-average stock price stability and growth

Debt is just one way for stocks to raise capital. Companies that maintain stable and growing share prices have the option of issuing stock at a good price.

Of course, it'd require cooperation from the market. Also, issuing stock is not preferable, because it's dilutive to existing shareholders. However, if shares have appreciated ahead of fundamentals, it would be a good opportunity for companies to raise funds that way.

Value Line, the independent investment research company, gives a rating of stock price stability and price growth persistence for the stocks it covers.

In its most recent reports, it gave Fortis and Emera a stock price stability rating of 100 out of 100. This is not surprising because utilities tend to be stable by nature. However, it gave them a price growth persistence rating of 35 and 55 out of 100, respectively, which aren't spectacular.

Value Line gave Couche Tard a stock price stability rating of 65 and a price growth persistence rating of 95, which implies Couche Tard’s share price can have some volatility but tends to appreciate.

Investor takeaway

Do not worry about interest rate hikes. Instead, focus on businesses that are growing, that maintain high credit ratings and reasonable debt levels, and have exceptional management.

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