Investors: Beware of Stocks That Hold Too Much Debt

Description

Too often, we select stocks to buy or sell without taking a close look at their financial fundamentals. While you want to pay close attention to money coming into a company by way of revenues and how much of that revenue turns into profit, you also need to look at the liability side of the balance sheet to ensure the company isn't drowning in debt. If a company has to much debt and not enough income coming in, that company could be headed for bankruptcy.

Debt-to-net-equity ratio

If you are trying to decide if a company is carrying too much debt, a helpful calculation to use is the debt-to-net-equity ratio. You take the company's total liabilities and divide them by the net equity or shareholders' equity. You can find both of these figures on a company's balance sheet. Balance sheets are often posted on the company or investor websites, such as Google Finance. Companies release updated balance sheets when they release quarterly results.

For this ratio, the lower the number, the better. Lower numbers mean the debt load is low. If you see a ratio over one, you should be concerned. This means a company has more debt than it does equity. A ratio of exactly one means the company has the same amount of debt as equity. Lower than one means the company has more equity than debt. Sometimes newer companies that are trying to invest in new products have higher debt levels, but they still need to be able to manage these debts. If a company has more debt than equity over a long period of time, this is usually a sign of trouble.

To illustrate this ratio, we will look at the debt levels from three companies listed on the TSX: **Sierra Wireless, Inc.** (TSX:SW)(NASDAQ:SWIR), **Aurora Cannabis Inc.** (TSX:ACB), and **Altagas Ltd.** (TSX:ALA).

Company	Liabilities (in millions)	Equity (in millions)	Debt-to-net-equity ratio
Sierra Wireless Inc.	210	382	0.54

Aurora Cannabis Inc.	35	162	0.21
Altagas Ltd.	5,358	4,741	1.13

We can see that Sierra Wireless and Aurora Cannabis both have ratios under one, with Aurora Cannabis having the lowest debt level. This is good. Altagas has a ratio of 1.13, which means the company has a concerning amount of debt. However, another important caveat is to compare a company to the other players in its industry.

When you compare Altagas to other energy companies, you will discover that most, if not all, of them have higher levels of debt than equity. The debt level is less concerning when every industry player has the same issue. If Altagas had been the only industry player with high debt levels, this would have been a huge red flag for the stock.

How else debt can be an issue

When looking at stocks, it's also important to consider debt levels outside the stock you want to buy. There are high levels of consumer and corporate debt across North America. Your selected stock may not have a debt issue, but it could be a company affected by other people's debt problems. For example, financial institutions like **Toronto Dominion Bank** (TSX:TD)(NYSE:TD) make a lot of their money from the interest they charge when they lend money. If consumer debt default levels become too high, this will have a negative effect on the bank's bottom line.

Investor takeaway

As an investor, you want to use your hard-earned money to make more money, not lose it on poor stock choices. Always take the time to investigate a company's fundamentals before you decide to buy. Too much company debt is one problem that can sink your investments.

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TICKERS GLOBAL

1. NASDAQ:SWIR (Sierra Wireless)
2. NYSE:TD (The Toronto-Dominion Bank)
3. TSX:ACB (Aurora Cannabis)
4. TSX:ALA (AltaGas Ltd.)
5. TSX:SW (Sierra Wireless)
6. TSX:TD (The Toronto-Dominion Bank)

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