Interest Rates Rising: Is it a Bad Idea to Buy Growth Stocks Today?

Description

Year to date, stocks, particular growth stocks have sold off significantly partly from higher borrowing cost from rising interest rates. Is it a bad idea to buy growth stocks today? It depends. And here's why.

Growth stocks encompass a wide range of stocks. Among them are tech stocks like **Docebo** (TSX:DCBO), which hasn't turned a profit yet, and **TELUS International** (TSX:TIXT), which has earnings. Rationally, it's safer to consider investing in the latter over the former because the latter is making a profit and the former is losing money.

What do rising interest rates have to do with growth stocks?

Higher borrowing costs

Rising interest rates increase the borrowing costs for businesses and consumers. So, businesses and consumers become more careful about their spending. Businesses are more cautious about investing in growth projects, which become less attractive because of higher costs and, therefore, lower expected returns. Ultimately, rising interest rates lead to slower economic growth.

It's a good thing Docebo has little long-term debt on its balance sheet. Its debt-to-equity (D/E) ratio is about 44% with almost 92% of its debt being current liabilities that are due within the year, primarily consisting of deferred revenues (products and services it needs to deliver) and accounts payable, which make up 60% and 29% of its total debt, respectively. Its long-term debt-to-capital ratio is only about 1%. So, it pays very little interest expense.

As a lower-risk investment that's profitable, TELUS International is accordingly able to sustain a higher D/E ratio of 1.07 times. Its long-term debt-to-capital ratio is also higher at about 25%. That said, its interest expense is easily manageable with its earnings and cash flow.

Stock price valuation compression

Docebo was growing its revenues at a high pace before the central bank started raising interest rates aggressively to counter high inflation. The revenue growth is no longer enough to maintain its high price-to-sales multiple (P/S).

It also benefited massively during the pandemic with revenue growth of 52% in 2020. Its P/S was 42.9 in 2020. It is estimated to be about 7.8 times this year with revenue growth of approximately 30-40%. In any case, the valuation compression will make it a bad idea to raise capital in the form of equity offerings on the stock market. Because of quantitative tightening, capital raising on the financial markets has seriously shrunk.

Even though TELUS International has been profitable, it wasn't immune from the stock price valuation compression from rising interest rates. In 2021, the growth stock traded as high as +40 times earnings. At $25 and change per share, it trades at about 16.3 times earnings, which is much more reasonable for its expected earnings-per-share growth rate of about 11-13% per year over the next few years.

The Foolish investor takeaway

Rising interest rates aren't all bad. Because of it, investors can purchase growth stocks at lower valuations for a cheaper price.

It's okay to buy some growth stocks if you limit their percentage in your portfolio. Proper allocation of growth stocks and portfolio diversification can help mitigate risk. It also makes a difference what type of growth stocks you buy. Sticking with ones with earnings can help you sleep better at night and make better risk-adjusted returns.

Between Docebo and TELUS International, the latter would be a better buy today, despite both being whipsawed by higher interest rates.

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TICKERS GLOBAL

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2. TSX:TIXT (Telus International)

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kayng