Should investors exit debt-heavy companies? Here's what experts say

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NEW DELHI: Having debt or leverage on the books of a particular company is not necessarily a bad thing. But, highly-leveraged companies, with debt in excess of industry average are something that investors need to be wary of.

Whenever market corrects sharply, the first victims are companies which are highly leveraged, and where promoters have a large percentage of the shareholding pledged.

Let's first understand why companies go for debt financing or issuing bonds.

A company has certain assets it needs to operate its business. These assets provide the basic infrastructure of that company, utilising which it either helps in production of its products, or helps in delivering them to its customers or uses them to provide services to their consumers.

These assets can be bought using funds either from equity holders or debt holders. A major portion of the company's funds is financed by equity, and the remaining from issuing bonds or raising bank debt.

"Since the cost of capital for debt is lower, the promoter and existing shareholders of the company are able to enjoy returns on a larger proportion of assets when they use some debt while lowering the cost of capital," says Vikas Gupta, EVP & Fund Manager, Arthveda Fund Management Pvt. Ltd.

"In our opinion, there is absolutely no reason for a majority of investors, including ones who think they are financially savvy, to hold companies with "alarming" debt levels. Investors should typically exit these holdings and look for companies which have safer financial structures," he says.

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The job of investing in highly-leveraged companies should be left to a very tiny, niche segment of professional investors whose focus is specialising in "distressed assets" including equity, debt, convertibles and other related securities of distressed companies.

D K Aggarwal, CMD, SMC Investments and Advisors Ltd, is of the view that if any company has more debt to equity ratio compared to its peer set in the same domain, then we can say that the company is highly-leveraged.

Earlier this week, debt-heavy companies such as Unitech and JP Associates plunged amid worries about delays in further interest rate cuts.

Brokers said speculation over debt repayment defaults by some companies sparked a sell-off in these stocks with liquidation of pledged shares precipitating the declines, ET reported.

Let's look at some ratios of these companies and what investors should do with these shares:

Reeling Under the Debt Burden

Stock	CMP (₹)	% Chg	1 year Return (%)	Total Debt (₹ Cr)	Debt Equity Ratio	Interest Coverage Ratio
Unitech	8.7	-35.34	-54.87	5,396	0.43	3.47
JP Associates	13.1	-20.67	-78.86	72,599	5.16	0.80
HCC	24.1	-12.36	-25.14	11,150	15.09	0.63
Reliance Power	45.7	-11.35	-48.45	30,043	1.51	2.81
Suzlon Energy	20.8	-9.37	-11.58	17,053	53.89	-0.40
SREI Infra	34.9	-8.89	-13.72	19,767	5.50	1.10
JP Power	6.5	-8.06	-70.19	27,503	3.89	1.03

Source: ETIG Database

The companies listed in the table generally belong to the real estate sector or power sector. We have seen in the last few quarters that these companies are finding it difficult to generate revenues, and are not able to complete their projects amid working capital shortages.

"Moreover, in the close vicinity, it looks that the tide would not turn in their favour in the near future as even the interest rates continue to be higher," says Aggarwal of SMC Investment and Advisors.

Experts advise retail investors to keep off such companies debt levels. Those who have them in their portfolios should try to exit near their buying levels or with minimum loss.

"Existing investors can hold the position in the given stocks, but one should avoid fresh entry in the stock at the current level, and should wait till the time any kind of guidance comes from the management on the financial health of the company," says Rohit Gadia, Founder & CEO, CapitalVia Global Research Limited.

"One can hold the position in Srei Infrastructure with the stop loss of Rs 11; Suzlon is looking attractive and can be held with the stop loss of Rs 5. Those with exposure to HCC should hold their positions with stop loss at Rs 7," he adds.

Here's the investment call on the above stocks by Rohit Gadia:

Unitech - Hold the position JP Associates - Hold the position HCC - Hold the position Reliance Power - Close the position Suzlon Energy - Hold the position SREI Infra - Hold the Position JP Power - Hold the position

Take the help of ratios to find out the financial health:

To get some idea about the financial strength or the solvency of the company, there are various ratios one can use. One of the most prominent is debt/equity ratio, which reflects the proportion of debt and equity, which the company is sourcing to finance its business.

Only high debt to equity ratio should not be used in isolation to say that the company has reached alarming debt levels. Aggarwal of SMC Investment and Advisors is of the view that one should also see whether the company is efficient in using the capital, both owned and borrowed.

Before analysing, investors have to understand that different sets of ratios are used for different sectors. To check the health of the companies, one should check the liquidity ratios, leverage ratios, etc. But, debt to equity ratio should be seen within the same industry, which means debt to equity ratio of companies with the same businesses.

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