MINORITY SHAREHOLDERS WATCH GROUP
BADAN PENGAWAS PEMEGANG SAHAM MINORITI BERHAD
(Incorporated in Malaysia – Registration No.: 200001022382 (524989-M)

New Straits Times, Business Times – Thursday, 19 October 2023

CRITICAL FACTOR IN INVESTING

BE AWARE OF THE LEVERAGE

DEVANESAN EVANSON

LEVERAGE is a critical factor to consider when investing in a company. It refers to the use of borrowed funds (such as loans or debt) to finance operations and investments, with the goal of potentially maximising returns for shareholders.

However, it also comes with risks that can amplify gains but also magnify losses. Understanding a company's leverage is crucial for making informed investment decisions.

Firstly, leverage can magnify returns. When a company uses debt to fund its operations or expansion, it can potentially generate higher profits than it would have without borrowing.

This is due to the amplification effect — the company can invest in projects that generate a higher rate of return than the cost of borrowing, thus benefiting shareholders through increased earnings and potentially higher stock prices.

However, leverage also increases risk. If a company takes on too much debt and cannot generate sufficient cash flows to cover its debt obligations, it may face financial distress or bankruptcy.

This could lead to a decline in the company's stock price and significant losses for investors. Therefore, it is essential to assess a company's ability to service its debt and manage its leverage.

Businesses across the board fall during major market downturns, such as the Covid-19 pandemic or the Ukraine-Russia conflict.

During the Covid-19 pandemic, there was a marked reduction in incoming cash flow.

Highly leveraged companies still had to service their loan repayments along with the interest expense with monthly clockwork precision.

In such instances, highly leveraged companies had a greater risk of being unable to service the repayments and may end up classified as a PN 17 company or may become bankrupt.

Investors typically analyse a company's leverage using financial metrics such as the debt-to-equity ratio, interest coverage ratio and debt ratios.

The debt-to-equity ratio measures the proportion of a company's financing that comes from debt compared to equity.

A high debt-to-equity ratio suggests higher financial risk, as the company has more debt than equity.

Equity share capital, as we know, does not have a cost, as dividends on shares are declared at the discretion of the board of directors.

The interest coverage ratio indicates a company's ability to meet its interest payments on outstanding debt. A higher interest coverage ratio implies that the company can comfortably meet its interest obligations, reducing the risk of default and financial distress.

Furthermore, the type and terms of the debt matter.

Fixed-rate debt provides predictability in interest expenses, while variable-rate debt exposes the company to interest rate fluctuations.

Short-term debt can be riskier due to the need for frequent refinancing and potential volatility in interest rates.

Beware companies that use short-term financing to finance long-term projects. If the company cannot refinance the short-term financing for whatever reason, the long-term project will be at risk.

Economic conditions, interest rate trends and the company's growth prospects should be factored in when evaluating leverage.

A company's history of managing leverage and its plans for future borrowing are also essential considerations. A consistent and disciplined approach to debt management is typically viewed positively by investors, as it demonstrates prudent financial decision-making.

All things being equal, low or no borrowed funds is preferred as the company will be in a better position to weather the onslaught of ongoing monthly interest charges in dire circumstances.

Thus, it is common for companies to carry out fundraising exercises either through a rights issue or share placement to retire the interest-expense incurring borrowed funds. Such actions should be commended.

Rights issues incur costs and take time, but has no interest cost. Placements, though faster than a rights issue, have no element of interest cost.

Excessive placements dilute existing shareholders' percentage shareholdings substantially and this may incur the wrath of the diluted shareholders.

A company's leverage is relevant in investment decisions because it can significantly impact the risk and return profile.

Before making investment choices, due consideration must be given to assessing a company's leverage, understanding its implications and considering the broader economic and industry context.

Borrowing is well and good for both companies and individuals, but it comes at a cost — the regularly incurring interest cost — both in good times and bad times.

There is no one right fixed ratio between equity and borrowed funds. Companies use a blend of these to extract maximum value for the company and its shareholders.

Balancing the potential for increased returns against the risks associated with leverage is crucial for successful investing.

The writer is chief executive officer of Minority Shareholders Watch Group.