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INVESTORS BEHAVIOUR TOWARDS DEBT-FREE COMPANIES

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ABSTRACT

Off late, even Big corporates are trying to become debt free. While there could be company specific reasons for the same, the attitude of the investors towards debt free stocks is explored in this paper. Its clearly seen that at macro levels, investors are uprating the P/E levels.

Key words: Debt – Free stocks, Risk – Return profile, Volatality

1.0 Research Objectives

Theory suggests that capital structure of the firm must also have debt component from Tax efficiency and growth point of view. However, we are seeing larger corporates trying to become debt free.One compelling reason for becoming debt free could be due to Share Buy back (there could be regulatory hurdles for leveraged company wanting to buy back shares).In this empirical study, its explored wether investors have strong preference for debt fee stock.

2.0 Literature Survey

Malcolm Baker et al concluded that real investors and markets are too complicated to be neatly summarized by a few selected biases and trading frictions. From behaviour finance perspective, sentiment and the limits to arbitrage -- explains which stocks are likely to be most affected by sentiment. In particular, stocks of low capitalization, younger, unprofitable, high volatility, non-dividend paying, growth companies, or stocks of firms in financial distress, are likely to be disproportionately sensitive to broad waves of investor sentiment.(1) Deb et al studied for a period 2001 to 2007 if investors reward Debt free stocks in India and concluded that Debt free stocks out perform leveraged stocks both in risk free and risk adjusted returns. Furthur investors show marked preference to zero debt stocks.(2).Byon et al tried to answer the basic question – "Why do some Firms go debt free ? They reasoned that apart from favourable equity market valuation , there are constraints in raising debts. They also suggested that high dividends for small debt-free firms help them establish good reputations in equity markets, while high dividends for large debt-free firms reduce the agency costs of free cash flow. (3). Tarek e Zaher compared similar size firm , one without debt and other leveraged and found that debt free firms generate higher returns and investors tend to reward those firms that resist debt.(4). Zaheer studied if investors penalize firms carrying debt during recession and reward debt free firms and found debt free firms outperforms their leveraged counterparts. And suggests investors to add liberal numbers of debt free firms in their portfolios. Dawar et al made a 10 year study using generalized Rees Model and found that total debt of the firm is a signal of value.(6).Moid did not find any convincing evidence between debt and profitability. Dhar et al argued that there must be certain level of debt in the capital structure of the firm, and noted that even large corporations from NSE

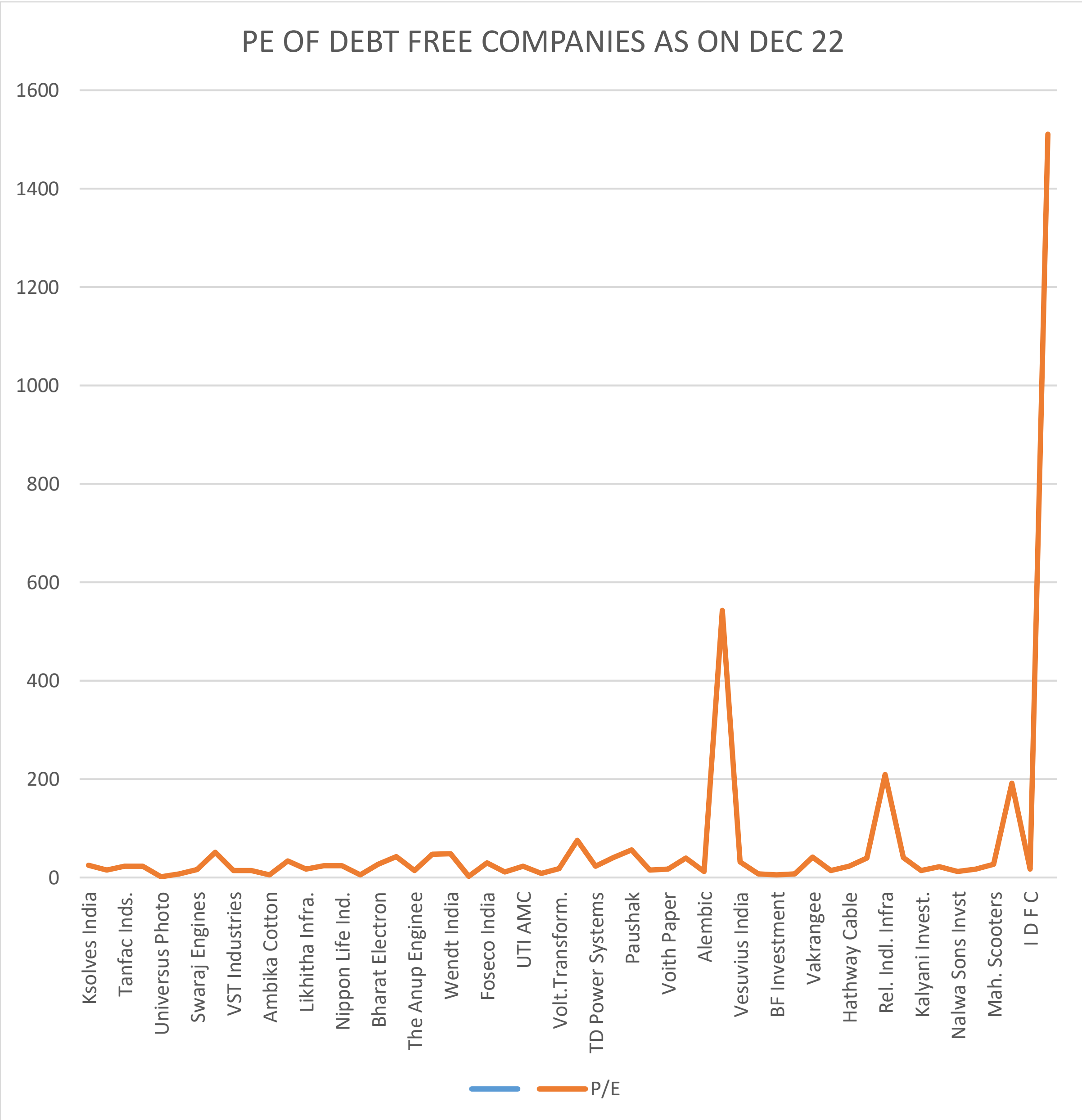
500 are going debt free.(8). Guha et al formed portfolios of debt free companies along with their leveraged counterparts and measured both absolute and risk adjusted returns. They found debt free stocks outperformed their leveraged counterparts both in absolute and risk adjusted returns.

3.0 Research Methodology

From the stocks listed in BSE and NSE website, debt free companies were identified and their PE computed. The results were graphically visualized. And for some of the recently debt free converted stocks, theie PE before and after becoming debt free was visualized. P/E ratio was used as it's a better metric to measure the investors willingness to pay higher premium.

4.0 Results and Discussions.

Figure 1 shows the line graph of PE ratios of 53 companies studied. The graph is highly skewed with very few companies having dominant PE ratios.



3.1 Computation of PE and market capitalization of debt free stocks and market average is presented in Table – 1.

TABLE - 1

PE of debt free stocks	67.05778
PE of market Average	23.69
Debt free stocks market capitilization	Rs.884765.43
Market capitalization	Rs. 28,320,834.65 crores

The above table clearly shows that only a small fraction of listed stocks are debt free. And clearly P/E ratio of debt free stocks are much higher than than the market average.

3.2 In view of the reason P/E chart shown in figure 1 was highly skewed, some typical companies which recently became debt free was studied as under:

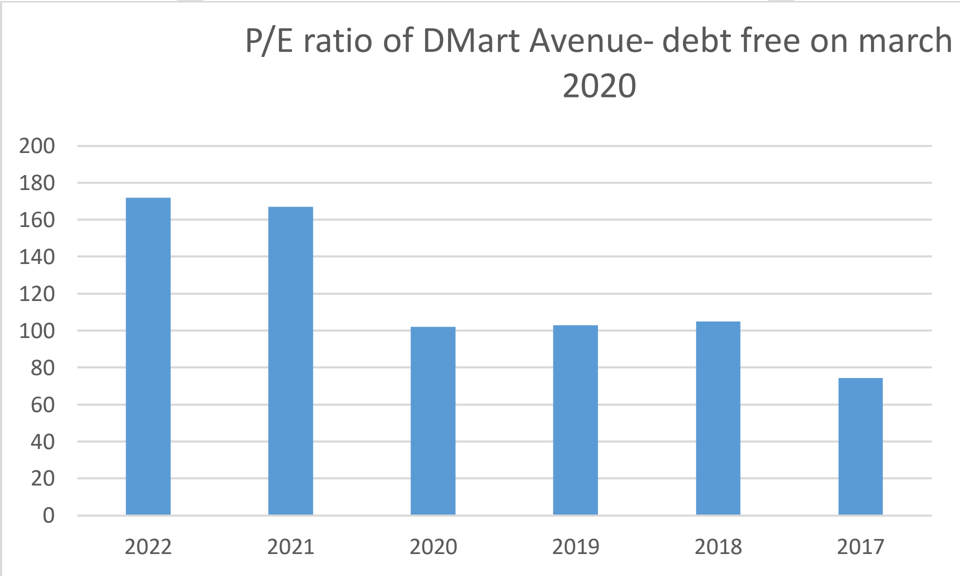


Figure 2

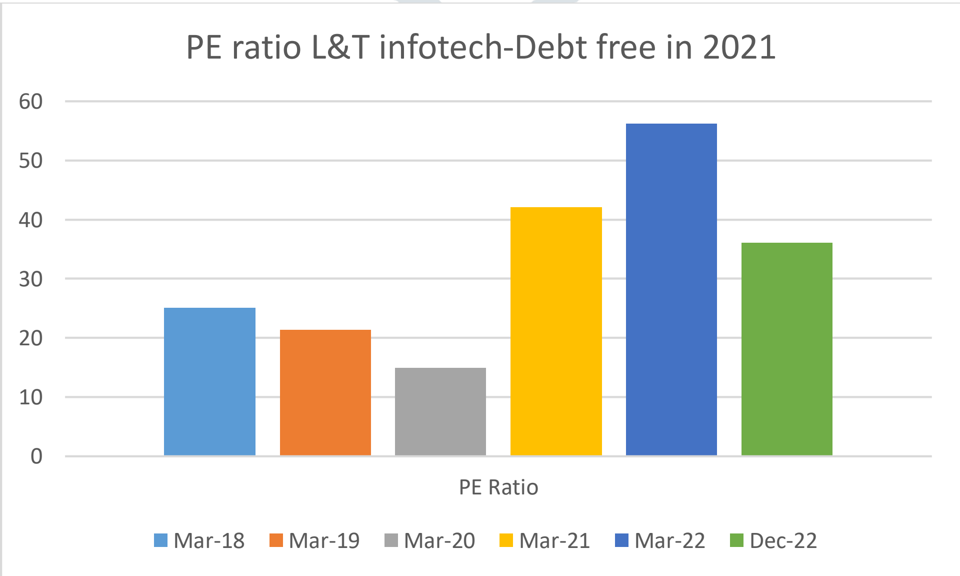


Figure 3

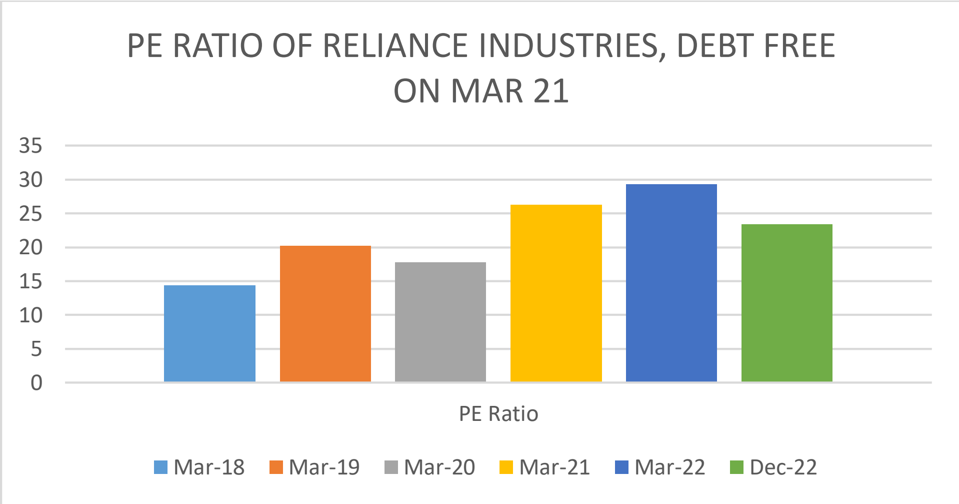


Figure 4

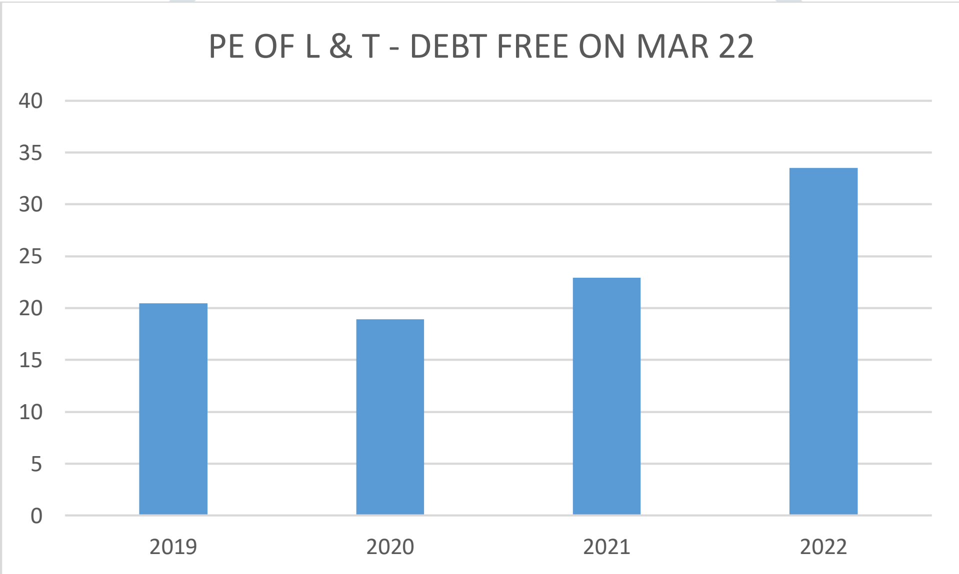


Figure 5

Its clear from figures 2 to 5, Stocks that are going debt free are being re-rated by the investors with higher Price Earnings multiples.

5.0 Conclusions:

1. On a macro level, there is clear investor preference towards Debt free stocks.
2. As the markets are essentially present bets for future expectations, there is investor expectations of superior returns from debt free stocks.
3. There is a strong possibility of risk – reward profile being re – rated with reference to debt free stocks by the investors.
4. There are also few low PE debt free stocks which are not captured in broder macro picture.

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