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Playing With Sentiments: Adjust With Speed, But Mind The Debt

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Problem of practice

*Every Chief Financial Officer (CFO) faces the decision of optimising the mix of debt and equity to finance their firm. What makes the optimisation challenging is that firms' financing decisions regarding what (debt or equity), how much, and when can trigger financial distress and even insolvency. A key question for the office of the CFO thus arises: what cues should their company follow when they want to raise funds: just their internal needs, the market sentiment**, or something else? Zooming in on the when part, does the answer lie in market sentiment? If yes, then should a company raise debt or equity when market sentiment is high? If the answer turns out to be debt, should the company prefer debt with a longer maturity or a shorter maturity? Answers come from recent research by Li, Hoque, and Liu that examines how changing sentiments impact a company's decision to raise debt.[1] A key finding was that during high-sentiment periods, companies increased borrowing and shifted toward shorter-maturity debt. In this article, we examine how this finding varies across company contexts and highlight important considerations for implementation, particularly the risk of debt overhang+ or over-leveraging*

[1] The article 'Investor sentiment and firm capital structure' by Shengfeng Li, Hafiz Hoque, and Jia Liu, featured in Volume 80 of the *Journal of Corporate Finance*, examines how investor sentiment influences companies' borrowing, debt duration, financing choices, and future stock performance

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Capital structure matters

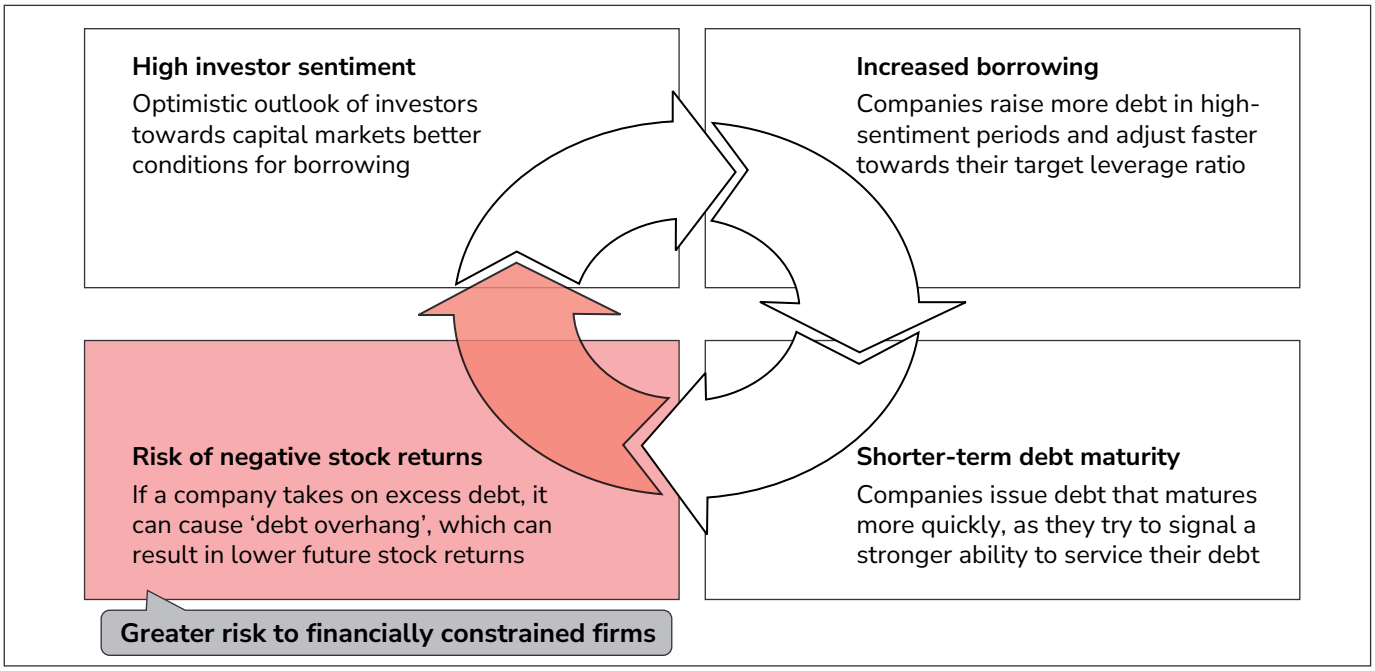
Financing decisions determine the capital structure – the nature and amount of funds firms employ to finance their assets and fund their operations. Capital structure is captured by its leverage ratio, which CFOs and equity analysts typically take as the debt-to-equity ratio: how much debt the firm carries relative to equity capital.[a] Why is this metric important? A company's leverage ratio directly affects its financial stability, profitability, firm value[§], and long-term growth. An optimal leverage ratio can maximise firm value by balancing the tax benefits of debt and the cost of bankruptcy.[2] The strategic nature of financing decisions is highlighted in the reports that CFOs devote around 25% of their time to cash flow management and financial forecasting, and 30% to capital allocation, and restructuring.[3] According to a recent survey of CFOs, 90% plan to fund organic growth at the same or higher levels than the previous year, citing balance sheet health as one of their top concerns.[4] With a strategic focus on reducing new debt issuance and share buybacks, the survey found that CFOs favoured reinvesting operating profits to drive growth while maintaining financial resilience. So, how do CFOs decide when to pull back from or go ahead with new debt issuance? Investor sentiment plays a strategic role in this decision.

Optimism about future cash flows makes firms more inclined to use debt with shorter maturities as a positive signalling mechanism of their financial solvency

Sentiment-led capital decisions

In their recent study, Li et al. examined the role of investors' sentiment in shaping firms' capital structure decisions, building on prior findings that confirmed the sensitivity of both equity and debt to investor sentiment. The study examined the effect of investor sentiment on three capital structure-related decisions: leverage ratio, debt maturity, and speed of adjustment (SOA) (see **Figure 1**). Here, SOA measures how fast a company changes its actual debt levels to reach its target debt ratio. The study highlights the economic consequences of increasing leverage for corporate value and offers practical insights for managers and investors. *In practice, short-term debt is typically defined as debt maturing within 5 years, but analysts also use alternatives such as 1 year or 3 years or less, depending on the context.*

Figure 1: Impact of high investor sentiment on borrowing



Source: Created by the authors based on the article by Li, Shengfeng, Hafiz Hoque, and Jia Liu. "Investor Sentiment and Firm Capital Structure." Journal of Corporate Finance 80 (June 2023): 102426. https://doi.org/10.1016/j.jcorpfin.2023.102426.

[a] Academic research, including the study we draw on here, typically uses the debt-to-assets ratio (D/A), total debt divided by total assets. D/E and D/A move together, and the strategic direction/prescriptions on when to raise debt and what kind to raise apply equally either way.

The underlying dynamics are that in periods of high sentiment, firms tend to overestimate their future cash flows, which, in turn, increases their debt capacity. In other words, firms' prospects are viewed more favourably during high-sentiment periods, which motivates them to expand, potentially reducing credit risk. The improved creditworthiness enhances their debt capacity.

Further, shorter debt maturity is considered a signal of higher firm quality, since it exposes them to more frequent monitoring. The SOA is also high, as the cost of external funds is lower during high-sentiment periods, motivating managers to move toward their target leverage ratios more quickly.[5] This also explains why financially constrained firms, relying more on external funding, have a more sentiment-sensitive leverage ratio. They try to benefit from lower external financing costs during high-sentiment periods.

Finally, periods of high sentiment tend to be followed by weaker stock returns, and Li et al. show that this effect is amplified when firms increase their leverage. The practical takeaway for equity investors is direct: in high-sentiment periods, be cautious about firms that increase leverage, as they tend to experience weaker subsequent stock returns than firms that maintain their leverage.

The research also highlights that unconstrained firms do increase leverage when sentiment is high, but they do so less aggressively than financially constrained firms; their leverage is less sensitive to shifts in sentiment. This contrast was evident in how two US firms used the recovering credit market conditions of 2020. Apple, an unconstrained AA+/Aa1-rated firm with substantial cash reserves, raised US$8.5 billion in May 2020 at exceptionally low coupons, including short-term debt, largely to support shareholder distributions rather than operating needs. Its borrowing was therefore opportunistic rather than necessary. Ford Motor Company was in a very different position. It had just been downgraded to junk and was facing heavy pandemic-related losses. It raised US$8 billion in high-yield bonds in April 2020, with most of the issue concentrated in shorter maturities. Ford was also using the reopening of credit markets, but from a position of constraint: it needed to secure liquidity while leaving room to refinance once conditions improved.

Indian examples suggest that shorter-maturity borrowing may reflect sector conditions, liquidity needs, and firm-specific financing windows, not only broad market-wide sentiment. For example, Fibe (formerly EarlySalary) raised funds through non-



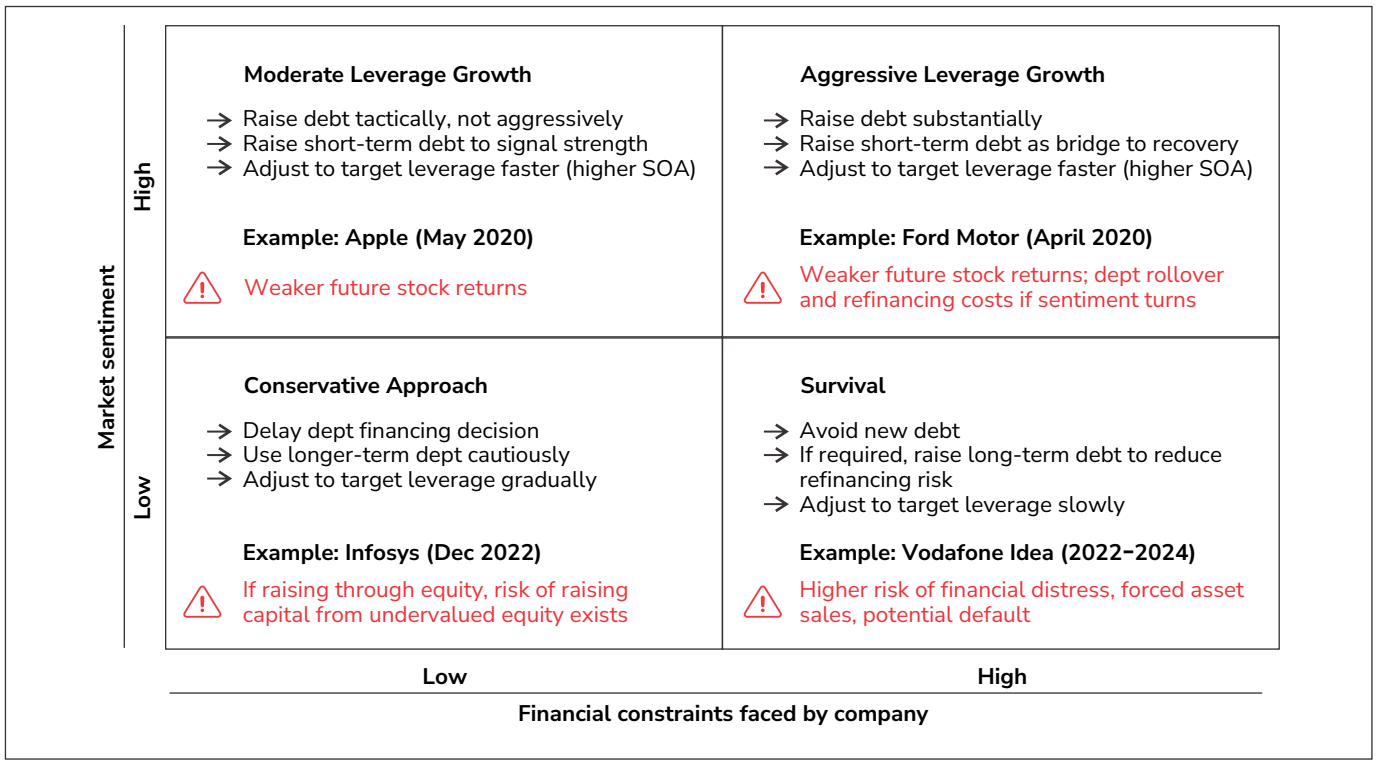
convertible debentures to expand its lending operations, amid growing investor confidence in India's digital financial services.[6] While Li and team excluded financial firms from their sample, the broader pattern, firms accessing short-term debt during favourable financing windows is observed in the Indian financial sector too. Even capital-intensive firms can use this logic. Reliance Industries, for example, has raised commercial paper to meet liquidity requirements during favourable financing windows.[7]

Corporate finance decision matrix

During periods of high market sentiment, the traditional approach is for corporates to issue equity.[8] However, the research by Li et al. suggests that during such periods, companies can also raise more debt, leading to an overall rise in leverage ratios. The strategic decision depends on whether the company is financially constrained or unconstrained. We illustrate this decision in **Figure 2**, which covers four scenarios and the appropriate strategy for each.



Figure 2: Corporate financing strategy matrix - Prescriptions & risks



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The two high-sentiment quadrants are illustrated by the Apple and Ford Motors examples discussed earlier. Apple, raising debt opportunistically rather than out of necessity, illustrates the Moderate Leverage Growth quadrant (high sentiment, low constraints). Ford, using the same window to secure liquidity, illustrates the Aggressive Leverage Growth quadrant (high sentiment, high constraints).

For the two low-sentiment quadrants, Infosys is a good example of the conservative (low sentiment-low constraint) quadrant. It was financially unconstrained, with a debt-free and liquid balance sheet, yet did not use debt to fund shareholder payouts. Its US$1.13 billion buyback in 2022 was funded from free reserves, showing that it returned capital from internal resources rather than increasing leverage.[9]

Vodafone Idea is a good example of the survival (low sentiment-high constraint) quadrant. It was financially constrained in a weak sector environment and relied on equity-linked relief and fresh equity capital rather than a straightforward debt-funded expansion. Between 2022 and 2024, it pursued sequenced equity-based deleveraging, including a government-approved conversion of US$1.95 billion of statutory dues into equity and a US$2.16 billion follow-on public offer in April 2024.[10,11] This shows how constrained firms can manage refinancing pressure when debt markets are unfavourable.

The matrix's prescriptions, however, carry important caveats. In high-sentiment periods, financially constrained firms may find funding windows opening quickly, though this often takes the form of equity rather than debt. During the 2014–18 economic boom, tech-led firms such as Flipkart and Ola raised substantial funding by capitalising on strong investor sentiment in India's digital and platform economy. However, when sentiment softened in 2019, many highly leveraged or cash-burning startups faced liquidity pressure. Many of them undertook restructuring and cost-control measures. The implication is that financing windows close faster than they open, and firms that rely on them must plan for their closure.

The risk is sharper when firms use the window to raise debt, since a higher leverage ratio can create debt overhang and weigh on future stock returns. The implication is that if the firm has loaded up on short-term debt and sentiment turns, refinancing becomes expensive or near-impossible. Jet Airways illustrates the worst form of this trap. In anticipation of recovery, the airline relied on significant short-term borrowing amid rising fuel prices and weakening cash flows. However, as refinancing tightened and cash flows continued to deteriorate, the airline could not roll over its obligations and was grounded.

The cautionary practical takeaway: in high-sentiment windows, the prescription to raise debt is conditional: (i) match debt duration to the duration of the cash flows that will service it, and (ii) avoid building a borrowing strategy around the assumption that the window will

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stay open. DHFL is another example of how over-leveraging can turn into corporate distress when sentiment reverses. DHFL borrowed heavily during easier funding conditions, including through short-term commercial paper, but when funding sentiment turned after the NBFC liquidity shock, it could not raise money quickly enough to meet repayments. In June 2019, CRISIL downgraded DHFL's commercial paper to default, noting that US$108 million of its US$122.4 million outstanding commercial paper was due that month, and liquidity was inadequate.[12]

Businesses, particularly financially constrained ones, can use the strategic corporate financing matrix to align debt-raising decisions with periods of high sentiment. This still accounts for sector conditions, liquidity cycles, regulatory changes, and refinancing risk. Companies can track market-based sentiment proxies such as

equity-index momentum, volatility indices, credit spreads, Initial Public Offering (IPO) and fundraising activity, and sector-specific financing conditions, alongside broader indicators such as consumer confidence. These signals can help CFOs anticipate sentiment shifts and use scenario analysis to test how changes in market conditions may affect financing costs, refinancing risk, and future stock returns.

Bottom line

We started out by helping the CFO's office answer a practical capital structure question: is there a better time for a company to raise funds, and if so, should it be debt or equity? We examined recent research by Li et al. and found that companies can exploit the financing window created by high capital market sentiment. This window is especially valuable for financially constrained firms, which may be able to raise debt more easily and reduce funding pressure when external financing costs are lower. CFOs can certainly use this insight, but they should do so with caution: excessive debt can hurt future stock returns and raise default risk when sentiment turns.

Glossary of technical terms used

** **Market sentiment:** Also known as investor sentiment, it refers to the outlook of investors, i.e., optimistic or pessimistic, over the economy, sector, or the financial market.

(*Source: Tim Smith, "Market Sentiment Explained: Definitions, Indicators & Real-World Examples," Investopedia, August 25, 2025, https://www.investopedia.com/terms/m/marketsentiment.asp.*)

+ **Debt overhang:** a situation in which a firm has taken on too much debt, reducing its ability to take on more debt to fund new projects.

(*Source: Julia Kagan, "Understanding Debt Overhang: Causes, Effects, and Solutions," Investopedia, December 3, 2025, https://www.investopedia.com/terms/d/debtoverhang.asp.*)

§ **Firm value:** Firm value refers to the entire value of the firm, including the value attributable to equity shareholders, as well as debt holders, cash, and other financial obligations. It ultimately reflects the price an investor/acquirer pays to purchase the business.

(*Source: Jason Fernando, "Enterprise Value (EV) Formula and What It Means," Investopedia, https://www.investopedia.com/terms/e/enterprisevalue.asp.*)

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