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Four Ways High Share Price Companies Can Boost Value

Most executives always think their share price should be higher, but coming to grips with high valuation can lead to productive strategic decisions.

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Admittedly, few CEOs or CFOs ever admit their share price is too high — at least not out loud. Given all the time these executives spend generating investor interest in their stock, it would be very hard for them to ever see, much less say, it is overvalued. It would be like a Chevy salesman telling a customer that Ford is actually better.

ANALYSIS

We all know that stocks are sometimes undervalued and sometimes overvalued. This can be due to general market conditions, such as during the 1999 Internet bubble. With the benefit of hindsight we can see that most stocks were overvalued relative to how they are valued on average and over time.

Users of the same approach, however, undervalued most stocks during the credit crisis of 2009. The challenge is often recognizing this at the time. Overvaluation or undervaluation can also be applied to an industry or individual company that is running hot or cold.

It's ironic that even when the overall market is hot, most senior executives tend to believe their own stock is undervalued. This belief is often reinforced by bankers who won't even use the term "overvalued," preferring instead to refer to companies using the code words "fully valued."

This obsession with seeing your own shares as "cheap" leads to some unfortunate corporate actions. First and foremost is the propensity to buy back shares at the peak of the market. In the peak stock market year of 2007, the members of the S&P 500 index bought back $579 billion worth of their own stock, which was over 4.2 times as much stock as they repurchased in 2009 when the S&P 500 index hit a level that was 57 percent below the 2007 peak.

What should companies do if management suspects its share price might be overvalued? The following four actions can create value when the share price is high.

1. Use Your Stock to Make Acquisitions. Cash acquisitions usually don't create value at the top of the stock market cycle. Our research shows that over the decade of the 2000s, the worst year for acquirer relative share price performance was 2007, when the market last peaked. The absolute price-to-book values paid were highest that year, even though the average premium paid above the price before the acquisition was below average.

The risk of overpaying is mitigated by exchanging your own potentially overvalued stock for the stock of the acquired company. This strategy can lead a company that believes they are particularly overvalued to actually seek acquisitions to take advantage of the high-valued currency their shares represent.

From an accounting point of view, stock deals still lead to the potential for very high goodwill because the acquisition price drives the determination of goodwill whether cash or stock is used. And in the next downturn, this goodwill may end up being written off. If this happens and there really is nothing wrong with the acquired company, then this write-off is just the recognition that the price paid was really much less than it seemed when valuations are normalized.

2. Issue Shares. Sound crazy? You might be sitting on piles of cash you don't know what to do with and the suggestion that you issue more shares may seem downright ludicrous. For some companies, like Apple, this would be unwise. But for many, this might be a good time to reduce leverage below the long-term target to build in a cushion to soften the next downturn. As a general rule, it is better to have more leverage during an up-cycle to accelerate the share-price appreciation and to have less leverage during a downturn to dampen the decline.

This can also help build the financing capacity needed to make opportunistic acquisitions when stocks are next undervalued. But be careful, since investors may react negatively in the short term — especially if the company has a history of making investments that don't earn adequate returns. If management doesn't have a disciplined process of making only investments that truly create value, investors may fear the extra financing capacity may be deployed on ill-advised investments.

3. Issue Convertible Debt. When stock prices are at cyclical peaks, they are less likely to rise in the coming years and so convertible debt is less likely to convert — making this a potentially attractive form of financing when stock prices are high. This is essentially "stock-issuance lite" and has many of the same potential benefits and risks discussed above. For managements concerned they cannot convince investors of the merits of stock issuance, issuing convertible debt is a back-door way to at least take some advantage of an unusually high share price.

4. Avoid Buybacks. Given the discussion above, refraining from share repurchases should go without saying. But it's worth repeating that most companies should avoid the temptation to buy back stock when the market is high. Companies that buy back stock when the price is high earn much lower returns on their buybacks than those that buy when the price is low. Further, our capital market research shows that earnings-per-share growth generated from buybacks is valued on average at about half the P/E multiple of EPS growth from operations. Don't do it!

This may all seem straightforward. But the question remains: How do you know if you are overvalued? You never really know until you look back later, but management needs to be as careful in its analysis as it would be when examining a potential acquisition. Try to compare valuations not just to peers in the market now, but to the company and peers historically. Be sure to give all valuation context over time and avoid being lulled into thinking your stock is cheap just because it appears so in relation to other companies that might also be overvalued.

Another approach involves creating a forecast that reconciles to the current share price through a discounted cash-flow valuation. This is a good way to judge whether the current price is reasonable in the context of what management believes is achievable in the business.

However you assess your valuation, try to maintain objectivity. If the company appears overvalued or undervalued, make sure to take strategic actions that capitalize on the view of the market.

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