Capital Markets| September 12, 2016 | CFO.com | US

Partying Like It's 1999

Warren Buffet holds more cash and has less debt at the top of the cycle so he can invest at the bottom. You should too.

Gregory V. Milano

On August 11, 2016 the three major US stock indices – the Dow, S&P 500, and NASDAQ – all closed at all-time highs on the same day for the first time since December 31, 1999 – over 6,000 days earlier. In the 1980s all three indices simultaneously peaked on average six times per year and in the 1990s it happened on average nine times per year. But this is the first time we have experienced this phenomenon since we simultaneously feared massive Y2K tech problems and celebrated the coming new millennium. Seems like a long time ago.

Is the market high? An insightful measure of overall market valuation is a variant on the traditional price to earnings (PE) ratio known as the Shiller PE ratio. Named for the Nobel laureate Robert Shiller, the ratio uses smoothed earnings to mitigate the fluctuations in income over an economic cycle. Professor Shiller famously cautioned that the frothy stock market in the late-1990s was a bubble. This seems obvious today, but back then many investors were caught up in the excitement of the "new economy" and thought that the market would keep going up much longer than it did.

This August, the Shiller PE for the S&P 500 was 27.2x per the website www.multpl.com. Using data from that website, we can see that this valuation is higher than 95% of all observations going back to 1881. But if we look closer, we see that during every month from November 1996 through May 2002 the Shiller PE was higher than it is now – a period marked by the rise and fall of the tech bubble. If we exclude those 67 months, the market currently exhibits a higher Shiller PE than 99% of the months during the remaining 111 years. Indeed, prior to the tech bubble, there were only eight months when the Shiller PE was higher than now – the eight consecutive months ending in the October 1929 crash.

There is a counter argument that suggests that the apparently high valuations are consistent with the exceptionally low interest rates. It is true that over the last 50 years, the Shiller PE has generally tended to be higher when interest rates were low and vice versa. But half of the time the market is at least 15% higher or lower than the valuation that could be implied by interest rates alone, suggesting that there are many other factors that are at least as important as interest rates.

To be clear, I am not stating that we are at a market peak nor am I asserting that the stock market is about to fall – and I am certainly not providing personal investment advice. I am merely suggesting that corporate valuations in the stock market are probably closer to the top than the bottom. My purpose in asserting this is to encourage corporate executives to recognize where we are and utilize this to (1) take actions that benefit from relatively high valuations; and (2) implement strategies that will prepare the company to survive and thrive during the eventual downturn that will undoubtedly come.

Benefiting from High Valuations

As the cliché goes, value is created by buying low and selling high. Although businesses and assets shouldn't be sold just because market prices seem high, this may be a good time for many companies to sell or spin off business activities that don't fit in their portfolios. If you aren't sure if any of your businesses fit this profile, now would be a great time to do a thorough portfolio evaluation to identify businesses that don't create value through the cycle and dispose of them while the potential proceeds are high.

This is particularly appropriate for business units outside the core competency of the consolidated company, where an additional benefit from selling such businesses to a "strategic" buyer will pay more than the business is worth to the seller. And for divestitures that generate a large tax liability, a tax free spin-off may be a better alternative.

As for companies making acquisitions during high valuation years, our research shows they tend to have worse relative share price performance than those investing at lower points in the market cycle. This can be all or partially mitigated by using shares to acquire other companies as long as the relative valuations of the businesses support it. If there is a subsequent downturn that makes the acquired business worth less, the value of shares used to make the acquisition will likely decline as well – essentially reducing the price of the acquisition after the fact. For sure, the accounting for goodwill doesn't treat it this way, since the value of goodwill is set at the time of the deal. But economically, stock deals can mitigate the risk of paying too much, when the market is highly valued.

For most executives, selling the entire business is and should be the furthest thing from their minds. But there are companies where the executive succession plan is weak – perhaps due to departures. In other cases, management and the board fear the company has inadequate scale to properly compete and they see merging their business with another as a means of creating more value than remaining standalone. For these and other reasons, selling the business can be a desirable strategic alternative and for companies where this is the case, their shareholders may be better off if the company is sold while the market is high rather than at another lower point in the market cycle.

Finally, for privately owned companies that are planning an initial public offering over the next few years, it might be beneficial to accelerate those plans while the market is high rather than waiting. If, or when, there is a significant market correction, it may be a long time before valuations return to current levels.

Prepare to Survive and Thrive in a Downturn

The energy industry is currently slumping while many other industries are at or near all-time highs. At a recent energy investor conference, most CEOs led off their presentations to investors with a comprehensive discussion of their liquidity, leverage, and financial survivability. These executives who usually boast about their oil reserves, production rates, and equipment technologies instead bragged about cash balances, undrawn revolvers, and extended

debt durations. And a decent number of them got there by “cleaning up” their balance sheet via issuing equity at prices that were 50%, 75%, or more below the high they hit in 2014.

This is what happens in a downturn and the first step in preparing for the next one is recognizing it can happen to you. None of us knows when but we all know that a downturn follows every peak and an upturn follows every trough. At least that is the way it has always worked so far. Some industries lead or lag. Some aren’t as sensitive as others. But the vast majority of companies are exposed to the cycle.

The second step is to build cash and liquidity, constrain leverage, and consider equity or equity-linked issuance now to clean up the balance sheet, while market valuations are generally high. Some executives note that the historically low interest rates suggest this is the time to borrow, not build cash. This makes perfect sense if a downturn never comes, but for those that want to prepare – increase cash on hand.

Consider what Warren Buffet did during the last peak and downturn. At the end of 2005, 2006, and 2007, when the market was roaring ahead, Berkshire Hathaway held cash averaging 37% of book equity. This dropped to 22% on average during the Great Recession over the following three years. Similarly, his total debt to book equity went from 32% to 38% from the first period to the second. He held more cash and had less debt when the market was high and then made investments, including $37 billion to buy Burlington Northern Santa Fe in 2009, causing cash to decline and debt to rise when the market was down. Warren Buffet has an uncanny ability to buy low and sell high. You can too.

And this brings us to the third and final step of preparation. After cleaning the balance sheet to provide a cushion as well as dry powder during the next downturn, develop a strategic plan to invest when others are looking to sell. In reality, many of the best investments will be hard to plan for as they will be opportunistic. Maybe a smaller competitor will struggle for survival and their share price will seem lower than it should be due to liquidity and survivability risks. Or perhaps a larger competitor will look to sell an important division for half the price it would sell for now, or maybe less, in order to raise cash to weather the storm. While other executives try to survive the storm you’ll be prepared to thrive in it.

To be ready, develop and monitor a list of potential acquisition targets, including whole companies, divisions, and particular assets. Include organic investments too. Consider the strategic desirability, the financial viability, and the likelihood of availability in a downturn. Give particular attention to businesses or assets that are more likely to recover quickly in the ensuing upturn. In the energy offshore drilling industry, for example, there is tremendous overcapacity right now and it is the newer and technologically more advanced drilling rigs and drill ships that are viewed as more likely to be contracted sooner as the recovery ensues.

Conclusion

We live in a cyclical world and it is important for executives to realize that there is a cycle and at some point it will decline again. They should do what they can when at, or near, the top of the cycle to take advantage of what may be cyclically high valuations. In addition, it is important to prepare for the next downturn to not only survive but thrive on those rare opportunities that only come so often.

Gregory V. Milano is a regular CFO columnist and the co-founder and chief executive officer of Fortuna Advisors LLC, a value-based strategic advisory firm.