IFB219: How a Elevated or Rising Stock Price Helps a Company

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[00:00:00] **Dave:** All right, folks. Welcome to Investing for Beginners podcast. Today, we have episode 219, and we're going to answer a couple of great listener questions we got recently. So I'm going to go ahead and start without any further do so I have, hello, Andrew. I've been bingeing our podcast for some months now; we're learning a lot and really into it. I would like to better understand how companies benefit directly and indirectly from a higher stock price and market cap.

Shareholders obviously gained from higher prices, but I'm only vaguely aware of how other companies are. Other ways the company entities themselves can benefit such as the ability to raise funds by issuing new shares diluting existing shareholders. My understanding is that Tesla, for example, has a competitive advantage at present because Elon can issue shares at a very high price, raising a larger sum of money through the same or less significant relative dilution than, say, Ford or any other car manufacturers can look at their smaller market.

But if a company isn't planning to raise by dilution, how else does it benefit from a higher or rising stock price? This stems from my thoughts about it, if a company doesn't actually hold its own shares, it's not directly gaining capital gains. When the price rises. My understanding of buybacks is that the.

Brought back are typically destroyed, giving existing shareholders increased concentration. If the company doesn't hold ownership of our proportion of own shares, then it has none to sell into a rising price. I think this would be a great topic for an episode of the podcast. We agree. I don't recall this being covered in detail before.

Thanks for consistently. Excellent work on this enjoyable and educational podcast, Dave. So Andrew, what are your thoughts on days? Really, really good.

[00:01:47] **Andrew:** It is a very good question. And I think he's hit the nail on the head with a lot of these points. So maybe we just back up and try to summarize all of it almost in the back to the basics kind of style.

So you have the shares, and you have the business, and it's good to differentiate the two. So the shares that are sold in the stock market represent ownership of a business. So think of it like a pie. If we split the pie into eight pieces, Dave and I took a slice of that pie. We each have one-eighth of the ownership of that business.

Now, when a company issues more shares, which is called dilution, you're basically taking that same company and splitting it into more slices of a pie. So where maybe we had eight slices before, if we sliced it up again to make 16 slices. That one share, which used to be worth one eighth to me, if we were to dilute it now, it's only worth one 16th of the business because we gave up more of the company by allowing more people to buy shares.

But you know, that could be good for me because if the extra money that the company raised from diluting, those shares made the company more valuable. Then I'd rather have one 16th of a more valuable business than one-eighth of. So valuable business. So that's kind of, that's how the whole diluting thing works.

If, if you're kinda new to the investing thing, that's, that's how it works. Now. Do you have anything to add before?

[00:03:19] **Dave:** I know that I think the covers the dilution nicely.

[00:03:23] **Andrew:** Okay, cool. So the next thing would be; once you get to a certain size, what's the advantage of. They are doing that because, at a certain point, that's why companies go to the stock market.

They go to basically sell pieces of their business so that the previous owners can basically cash out. That's one thing. The second thing is. Usually, when you're in the stock market, you have a lot more resources, so you can expand a lot, and you get economies of scale. So if we have a hundred factories, we can be a lot more efficient with our costs than if we had one factory.

And so, a company like Tesla is a great example because they were not profitable, not one bit. And they were subsidized by the government a lot, but Elon was. Matt. He was a magician and was able to. Basically, dilute the company to raise a bunch of capital to now where they are very close to profitable, if not profitable.

And you know, maybe if not on an earnings basis on the cash flow basis, but that's what they did. If you look through their financials over the years, there are different ways to do. We won't get into the specifics of convertible debt, but that's basically how they did it. So it wasn't a straight-up share issuance, but it had aspects of that, which is which diluted the shares.

So the question becomes, is there, you know what, what's the benefit to the company of having a higher share price if they're not going to dilute. And so that's what you will see. Dave and I have talked about the life cycle of companies in the past. They start with. They grow very fast. They oftentimes dilute.

So they're taking advantage of all the capital, right. And kind of splitting up the business and growing in that way, at a certain point they mature and then. They almost like flip; they almost do a 180 where instead of bringing in capital, they start to buy back shares, which is the exact opposite of this whole dilution discussion.

What that means is they take the profits that the businesses earned, and they buy back the shares. So now, if we go back to my PI, I had a one 16th slice if the company took all the profits from that year and bought

back shares. Yeah. Now, this, the pie is back to eight slices. So my one share is now one-eighth of the businesses.

So the one 16th, that's great for me because as long as the business is just as valuable, then my piece of that business has become much more valuable, and that's what the buybacks do. And that's why you see earnings per share go up and all of those great metrics. So. Once a company like Tesla is kind of on that, where, you know, are they still going to dilute or are they going to buy back shares?

What's the advantage? I think I think Dave, the guy who asks the question here, thinks he's kind of spot-on in the sense that, like, there are some ancillary benefits to having a high stock. People want to come work for you. And in some businesses, that's a huge advantage. A lot of times, the talent can, can drive the bus for these companies.

So, you know, customers can get more excited about you because they see your stock price higher. It's almost like the free press in a way when your stock price does well. But outside of that, yeah. If you're not diluting, you're not getting a direct benefit in the same way that Tesla got when they were first starting out where this dilution was like their lifeblood, and they needed it to pay the bills.

Now it's not so much because they're essentially profitable. And so that competitive advantage, if you want to call it, that kind of goes away, but I don't think it goes away completely because there are a lot of other side benefits to having a high stock price.

[00:07:09] **Dave:** Yeah. Those are, those are great points, and those are great examples of some of the ways that a company can benefit.

I think if we back up for just a second and maybe explain why Dave is asking this question, one of the things that any public company does. He needs to grow his capital. And Andrew did a great job of explaining why a company would go public. And a big reason why is to raise capital and young companies like Tesla, even though they've been around for 12, 13, 14 years, whatever it is is still relatively a young company in the market.

And they use the money that we invest in. Give to them as a way of capital of they could use to grow the company, whether that's building more factories, hiring more engineers, you know, buying the equipment, they need to modernize their production line, whatever it may be. And they use all that capital, that cash, that money.

To do all those things. And that's the only way that the company can grow. And if they're not doing those things, then a company like Tesla, Ford, GM, whoever is not going to be able to grow. So that's one way of doing it, the other way of doing it. There are several other ways. The other way to do it is, of course, is, through the operations of the business.

So if the company is a profitable company and it's generally. Cashflow, in other words, it's making money on its money. Then it could use that cash flow as a way of reinvesting in the company or buying all these things that we were just talking about. They also can go to the capital markets, and they can borrow money, so they can issue bonds to shareholders stockholders, and those people can invest in the debt of the company.

And that is a way to raise money. And typically, that is a cheaper way to do it. It is using equity. So when I talk about equity, I, what I'm really talking about is a share of Tesla. So the share of Tesla is more expensive

for Tesla than it is for them to issue debt. Most of the time. Now Tesla is a bit of an interesting dichotomy because it, like Andrew said, it's, it's just now starting to become a profitable company.

So it'll be interesting to see if the. I guess the narrative around the company changes a little bit because now it's not a, now it's a profitable company, so the expectations are going to be different. So that's one thing, but then there's also the fact of that prior to it becoming profitable, it did have debt that an issued, and it was.

What they call it in the bond market at junk level debt. And so it was, it was debt that was very risky for people to invest in, but they also had to pay a higher price to invest in that debt. So they had to pay a bigger dividend to bondholders to encourage them to invest in Tesla's debt. So it may not have been as big of a disparity.

For example, if you look at investing in. Microsoft's a very profitable company, huge market cap, you know, very, very successful business. If you look at investing, buying equity of, of Microsoft versus the buying the debt of Microsoft, there's going to be a wide disparity and the cost of those because.

Tests are, I'm sorry. Microsoft is one of the few companies that has a better credit rating than the United States government. And so their debt is very cheap. And so, it's actually cheaper for Microsoft to raise money by offering debt than it is to sell its shares. And so that would be that would weed a company like Microsoft to not want to dilute like Andrew was talking about earlier because it's more expensive for the company to do that.

Then it is to offer debt. And if they need the money, Microsoft's maybe not the greatest example because they generate so much cash flow. They don't really have to offer a debt offering to raise money for the company. But, it just shows that there are lots of different ways to slice the pie or to slice the pizza.

As I'd like to say, There are a lot of different ways that accompany can go. So when a company is talking about what, when, they're looking at a high share price or a high market cap, that really. It gives them options of how they want to reinvest in their business and make a mistake. It doesn't matter what business is out there.

They all have to reinvest at some point at some level, even companies as amazing and, you know, almost run themselves like visa or MasterCard. They still have to reinvest in their business. And if they don't, eventually competitors will catch up, and they'll die. And so, like Andrew was saying about kind of the evolution of the life cycle.

If you're not ahead. You're behind, and it's really hard to catch up. And so I guess another thing that I was thinking about what Andrew was talking about this, another advantage to having a high share price, is it encourages more investment inequity in the business. And if the company wants to dilute its shares, a higher market price is going to give them more options.

It's going to give them higher and higher equity to be able to invest, to use that money, to turn around, to reinvest in the company. And it also attracts more investments. So I think probably more people jumped on a Tesla bandwagon over the last year and a half than probably had invested in a company in totality in the previous 12 years.

So. As the share price went up, more and more people wanted to partake in what was going on with Tesla. And that, in turn, helped drive up the price. And it just kind of became this, you know, a self-inducing self-

reinforcing ladder that helped the price go up. And so those are all advantages, I think, to a share price increase.

And I think Andrew kind of weighed out the dilution aspect of it and the other aspects, I think.

[00:13:06] **Andrew:** There is a book written by George Soros called Alchemy of Finance. He talked about this theory of reflexivity, and it kind of perfectly illustrates what you're talking about, how the successful self perpetuates on itself. And so, yeah, there's a lot of great benefits to a company, stock price going up most of the time.

And sometimes you can't always see it. And sometimes it's not always logical, but. That, that flywheel kind of gets going, and you get stories like Tesla where success begets success. And that can be a cool thing that you see when you invest in companies.

[00:13:40] **Dave:** Yeah. Yeah. It really can. And you know, it's kind of interesting.

They are just looking really quickly at the financials of the company. You can see that the company is diluting, and it has been diluting since 2017. That's as far back as I can see with this quick look here, so they've gone from 830 million shares to 1.1 billion in the last five or six years. So they have been diluting along the way.

And, but you can also see that the net income or the earnings, the money that the company has made has gone from a negative 1.9 billion to a positive 5.5 billion. So, I mean, that's, that's a very encouraging sign for sure. So yes, I can actually say something positive about Tesla from time to time.

Don't get used to it, though. Folks don't get used to it.

Sorry,

[00:14:29] **Andrew:** I'll move us onto the next question. All right. Record this, right? Like take this down in, in the history of

[00:14:37] **Dave:** the last time, don't get used to it.

[00:14:40] **Andrew:** All right. The next question. Hey guys. I just started investing, and this thought always pops into my head. I want to run it by you as a strategy. One of many for investing, I think many stocks are overvalued now.

So what I've been doing is finding what I think a good price is and deciding if I want to pay the currently cheaper but still inflated price. If yes, I buy; if no, I think. Why not just limit, or they're at another price. I think it's worth it if it doesn't hit that price. Okay. I thought that was too overvalued anyway.

And heck, there's a lot of stocks out there. I'll just find another one if it hits the price. Woo. So I've been thinking of this, not really doing it, whether you think nothing to lose. Right. As long as I don't let it get away from me, the stocks I think are going to take off; so grateful for your podcast. It's super helpful.

Thanks for all that you do, Brent. And then he says, Kobe, Japan, just so you know how far you're reaching.

[00:15:35] **Dave:** Isn't that amazing Kobe, Japan. That's just nuts. You think about it, that somebody in, in Kobe Japan, is listening to our little podcasts. It's just kind of blows me away. So this is a really interesting question, Brent, and, you know, I, I would admit I don't this is not a feature of investing that I use.

And so. I'm not entirely sure how that works. Do you, are you familiar with this?

[00:16:03] **Andrew:** Yeah, so like, let's say Microsoft training at 310, and we wanted to buy it at 280. You could set a limit or there in the market to say. Basically, buy the stock when it hits 280. And so if, if Microsoft stays at 300, 310, it's not going to buy.

And then as soon as it drops down to 280, then your broker is going to execute, and that's basically how a limit or they're on the buy-side works.

Okay. And so is there, is there a cost to doing this? No. No, no cost. Okay. So the next question then is, is there a time limit on how long you can set the limit order?

Generally, the default. That day where we're at the end of the day, Ansell's buy, you can make an option to say, keep this, or they're open until. I cancel it. Okay. So you're, you're, you know, if you go or there's no such thing as a ticker-tape anymore, right. It's all electronic, but if you're able to go and you can look, and you could see your open or there, wherever they store all the orders, you would be able to see that, you know, you put in the Northern here for this price.

And then, so it would just be a matter of waiting until it got executed if that ever did get

[00:17:13] **Dave:** executed. Okay. So, in theory, it's probably not a bad idea. I guess the two things that pop into my head about this kind of idea is number one; you'd have to determine ahead of time what you think companies are.

Overvalued and where you think the price could drop to now, we have seen some pretty substantial market fluctuations on particular companies. I know Robin hood recently went from, I think, 20% down to 21% up in a day. So you know, there's, there's been, I know there's been some pretty wild swings, so I guess determining.

That would be interesting. And then I guess you would also have to do some research on whether you think the company is going to go up or not from the time that you buy it. And, you know, in theory, I think it's not a bad idea. I think the better idea is to do the research, to find the companies that are undervalued and use that as a way of trying to find.

Good investments at that time. I mean, there are some companies I think you have to do a lot of research on to determine whether it's cheaper, not Google, Microsoft visa, MasterCard, Costco. These are all undeniably fantastic companies, but you could argue that some of them are overpriced. You could argue some of them are underpriced depending on where you sit on the, on the, on the timeline.

Yeah, I was just looking at Costco, for example, and you look at everything, and it's, you know, everything looks great, but then you look at the price, and you think, and I'm not talking about the actual physical price. I'm talking about intrinsic value. What I think is a fair price to pay for a company like Costco, and it can appear to be expensive, but then it comes up then that whole, what are you willing to pay?

For a good company over a long period of time. And that's where it gets a little dicey; I guess I'm curious what your thoughts are on this. Andrew,

[00:19:25] **Andrew:** lots of thoughts. I'll; I'll try to organize them somewhat. First, I like where Brent's head's at. I think it's a super, super good idea to stick to where you think a company's.

A fair price. So, if it's not at your fair price, don't compromise the morals of your value valuation just because you really love a company. And I like how he also mentioned that you know, there are lots of other stocks out there. So if I'm not seeing what I want to see, that's all right. And that's very important to, you know, fall in love with a business, just because you think it's the best business in the world.

The price matters as well. And you want to stick to that. And I think those are super, super key things to hone in on as an investor. And if you can master it at the beginning of. You're going to go. Good places. I think the only problem now that I see with this kind of a strategy implementing, the nuts and bolts of it just think about this.

So like what, what are you losing, and what are you gaining from this? So, you know, we're gaining. Let's say 5%, 10%. You know, if we see a stock where it's 5% or 10% overvalue, that we're waiting for it to drop down to that, you know, that's something where we are beginning. If, if the strategy is winning, if we're talking about stocks that are like 25, 50% of our value, do you really want to lock up your money?

Because when you put that limit, or they're in, you can't do anything else with that money. So it's not being invested; it's just sitting there. So do you really want to lock up your money for something? Where the stock might not crash for a long time. So then, so there's that factor. I mean, if you look at I'm going a little bit of tangent, I'll come back.

If you look at the probabilities of the stock market, there are more days that you have green than you have read. And so if you're going to wait for days where the market is red, that's a less than 50, 50 chance. So you're, you're, you're kind of waiting on the less than 50, 50 chance. So the odds are stacked against you.

If you're waiting for stocks to come down, we'll say that I'm not talking about next year. I'm not talking about the next three years. I'm talking about a ten-year, 20 year period, less than 50 50 chance that the stocks are gonna be. Where I get really worried about it, though, is let's say you find the best business that you could, and you were right.

It continues to be a super great business. Chances are, it's not going to dip to where you want it. And so imagine missing out on a stock where it doubled, and you didn't, you didn't pull the trigger because you were waiting for it to come down. So, you know, you. I'm not saying if it was super overvalued; I'm just saying if you're in this gray area of like, okay, it's 5% overvalued.

Should I pull the trigger or not? I would have rather put the money somewhere where I think it's a fair value versus having the money sit, waiting for the market to come down. The market could never come down. You can look at how many all-time highs we've had, and it's. There are a lot of places where the market never comes down.

You could be waiting for five, ten years, four to ever come down, work. It never comes down to that point. So I don't like the idea of having the money sit where it's not being invested. It's not working for you. And you're waiting for the odds, which are not in your favor, for the market to go down or that stock to go down until you can deploy it.

That's me.

[00:22:50] **Dave:** Yeah, that's a great point. Then, I guess, the time cost of money that you tie that up, you could have been using to invest in something else along the way. And I like, I agree. I like we're; we're more Brent's head with this. And if he's doing the research to define, defined companies that he thinks are undervalued, and he's willing to wait.

And it kind of appears that he is, you know, his attitude is right. It's, you know, there are plenty of other companies out there that you can, that you can take a stab at. And everything is when you think about doing the research to find, trying to find a company you want to invest in. Even if you do find a company that is worthwhile, but for whatever reason, the price is not the one you want, that researcher that time spent is not wasted because at some point.

The company will come to a place where you have an opportunity to buy it, and it may not be tomorrow. And it may be a year from now, maybe three years from now. But the work that you've done to learn about that company will stay with you, and the knowledge that you learned learning about that company compounds, and the more that you do that, the more practice you get, the better you'll get at it.

And the more comfortable you'll feel with all these things and the quicker turnaround, it may be on being able to buy. PayPal at a generational price or whatever it may be. Sometimes the company just doesn't come down, and it just goes up into the right, and there's just nothing you can do about it.

And it is what it is. And I was reading recently that Charlie Munger and Warren buffet were, are both still kicking themselves for not buying Google when at IPO mode all those years ago because. As they said, in hindsight, it's obvious to just about anybody that was paying attention that it was an outstanding business and had a chance to be one of the best ever.

And the past. For whatever reason, they chose not to take taken advantage of it, and they're still waiting, and they may wait forever. Who knows? So I'm not, it's not investment advice, and it's not a recommendation to go out and buy Google at any price. But I guess my point is is that sometimes.

There's just me. They're baby companies. You just have to, you might have to wait, and you just might have missed, and that's okay because there are lots of other great opportunities out there that you can get invested in, and that can make you a ton of money without having to be by the greatest company ever.

Whichever that could be,

[00:25:20] **Andrew:** yeah. A good, good example is Google. I mean, he didn't get Google. Right. But he got apple. Right. And he got Apple very right. And how many investors can say they got Apple, right. So you don't have to get Apple, Google, Microsoft. You don't have to get all of them. Right. You just have to get maybe one or two of them.

Right. And it can make you. Extraordinarily wealthy, you know, even compared to the market. And that's what we're shooting for here. We're not shooting for perfect people. We're actually you for perfect attendance. It's not one more if that's what you want. Good luck.

[00:25:49] **Dave:** Right, exactly. And there are lots of; there's lots of data out there that show.

So that you don't have to, you don't have to swing at every pitch. And we've talked about that in the past. Eh, going back to our favorite baseball analogies, you don't have to swing at every pitch. And just because you

do some research or you find a company that you really liked, but you start digging into it, and you discover that maybe that's not the best option.

You don't have to swing. You don't have to take a flyer on it. You can just go, okay. Too hard, pile and move on. And that's okay. There are times when I have tried to learn about it. Internet security or something more technically complicated like that. And I started digging into the business. I knew I just, I don't, I don't understand that.

And, and that's okay. There are lots of other things out there that I can invest in. And even though I may think that that's going to be something that could be very beneficial and do very, very well over that. Five ten years. It's not something that I can understand, and I can move on. I'm okay with that.

There's plenty of other stuff out there that I do understand. And I'm willing to take a look at and work on, and I don't have to swing at every pitch that comes my way.

[00:26:56] **Andrew:** Yeah. Well said.

[00:26:57] **Dave:** All right, folks. Well, with that, we are going to wrap up our discussion for this evening. I wanted to mention that if there is anything in the podcast today that we've talked about that may be a little confusing or maybe. You're not quite sure about the terms on; we have a website einvesting for beginners.com.

That is for you. There are lots of great resources, articles, lots of great stuff, videos, all kinds of things that can help you learn about the basics of the stock market and everything beyond that. And so. If you're struggling with some of the terminology or things like that, go to EA investing for beginners.com.

Look for the search bar, search that topic, and you'll find something that'll help you learn more about what we discussed today. And with that with that, I will go ahead and sign us off—you guys. Go out there and invest with a margin of safety emphasis on the safety. Have a great week. We'll talk to you all next week