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Stock-Based Compensation: Impact of Declining Stock Prices

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Companies often issue stock to employees as part of their compensation. This has become quite popular in high technology over the past 5 years as two things have happened: 1) software engineer compensation has ballooned along with their demand, and 2) many early-stage tech companies don't have the cash to pay these huge salaries. Easy solution – give them a small cash salary and a large amount of stock options or stock grants on top.

This looks great from an accounting perspective for the company, as these companies have low cash costs, making them appear more profitable on a cash flow basis. But the real labor cost hasn't disappeared, it is now just being paid by the shareholders through a dilution of their ownership, rather than by the company in cash.

This process has continued for years, with some companies putting through staggeringly large stock compensation numbers. But this strategy only works so long as employees remain happy with the shares they receive, and shareholders continue to ignore their dilution (which happens if the company is growing fast enough). In particular, the employees tend to stop being happy when those shares decrease significantly in value- as we have seen this year.

> *Note – there are some companies who issue a lot of stock to employees, but also buyback the same amount of stock to ensure there is no dilution to shareholders (e.g. Meta Platforms). In this case, the real cash cost of labor is still a real cash cost, it's just being moved to a different section of the cash flow statement for accounting purposes.*

To give a real example of where this issue can cause problems, let's look at one of the biggest offenders, **Snapchat**:

Over the last twelve months, SNAP recorded revenue of $4.35bn and paid $1.13bn of their labor costs in stock-based compensation (over a quarter of their entire revenue went out in stock comp). Over the same period, SNAP reported positive operating cash flow of $283m in its numbers, which got many investors very excited. But they only produced $283m in cash because they paid their employees $1.13bn in stock, not in cash salaries or bonus. Don't forget that they still paid that price in real terms, they just did it by diluting their

shareholders around 3% in the process, who were happy to look the other way while the stock was going up.

Now, the fact that the business is producing a real negative cash return of almost $1bn is bad, but it gets a whole lot worse when you consider that the share price of SNAP has recently halved. For the employees, that's effectively a 50% salary cut. That leaves SNAP with two options: 1) lose the employees to another tech company, or 2) increase the amount of share compensation to make up for the fact that each share is now worth much less.

So SNAP is faced with possibly having to lift stock-based comp to around 50% of their revenue, and around 6% of the market cap of the entire company. In just 3 years, that would mean almost 20% dilution. The poor shareholders would need a 20% stock price increase just to stand still.

These are real issues, facing numerous tech companies right now. Here are just a handful:

Name	SBC ($m)	SBC as % of Revenue	SBC as % of Mkt Cap	Real Cash flow ($m)	Stock Price YTD	Adj SBC as % of Revenue	Adj Real Cash flow ($m)	Adj SBC as % of Mkt Cap	Dilution over next 3yrs
Snapchat	1,131	26%	3%	(847)	-50%	51%	(1,978)	6%	18%
Palantir	778	50%	5%	(444)	-60%	84%	(963)	8%	25%
Snowflake	605	50%	1%	(495)	-56%	89%	(970)	2%	7%
Teledoc	277	13%	6%	(96)	-65%	20%	(245)	9%	26%

SBC → Stock-Based Compensation

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It will come as no surprise that we tend to avoid these kinds of situations. Instead, we seek to own companies that produce enough operating cash flow to be able to cover all their real business costs and ideally more, such that their opportunity set actually increases when market share prices are cratering.

What do we mean by that? Well, we want to own companies that produce so much cash that they have numerous options during a market crash such as: 1) continue investing in their core products and people while everyone else has to pull back, 2) pursue attractive M&A opportunities at fire sale prices, or 3) rather than dilute their shareholders, they can do the opposite and repurchase shares at more accretive prices.

It is only during times of stress that you really see who has been taking too much risk (both companies and investment managers), and it is during these same periods that the strong companies can increase their relative position versus the competition.

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