



Epsilon Theory

Stock Buybacks!™ and the Monetization of Stock-Based Compensation

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“Here’s your capital back, Mr. Shareholder, returned to you in a tax-advantaged way!”

I love stock buybacks.

I mean, there are only five things that profitable companies can do with their cash:

1. they can expand their existing operations by building new facilities, funding new projects and hiring new people,
2. they can pay down any debt they might have,
3. they can give the cash back to shareholders directly as a dividend,
4. they can acquire another company, or
5. they can 'acquire' their own company by buying back shares.

When I was running my hedge fund back in the day, I loved it when the management team of a company with good organic earnings growth would buy back shares and shrink the share count. Depending on the cost of capital and the degree to which a buyback would magnify that earnings growth per share, I was even fine with management borrowing money to do a buyback.

In my experience, cash burns a hole in most management teams' pockets. Their natural instinct is to spend the cash – and it is MY cash as a shareholder, not their cash – on an empire-building acquisition or internal expansion, and if they're not going to give me MY money back directly in the form of a dividend (on which I have to pay taxes, so ugh, but okay), then the least harm they can do is buy back shares and shrink the share count.

AND SHRINK THE SHARE COUNT.

See, the flip side of my love for management teams that used stock buybacks to shrink the share count and give me a greater fractional share of a growing organic cash flow was my hate for management teams that diluted my fractional share of a growing organic cash flow by awarding themselves absurd amounts of stock. Worst of all were the management teams that announced a stock buyback program with great fanfare that only offset the stock they had already awarded themselves!

This circular process of issuing new shares to employees and then buying those shares back with company money – MY money as a shareholder – is called 'sterilization'.

Sterilization has been around forever, and to a limited degree it's fine. Yes, management teams and employees should get some reasonable level of stock-based compensation. Yes, it may make sense to use some of my cash to sterilize those shares and keep the share count from expanding. But don't tell me that the sterilization of newly issued shares is anything other than a direct compensation expense that I am paying for with MY money. Don't tell me that the sterilization of newly issued shares is somehow a "return" of cash to ME, because it's just not. The sterilization of newly issued

shares is a direct transfer of my money to YOU, the recipient of those newly issued shares. Nothing more, nothing less.

I believe that there has been a sea change in markets over the past ten years in the size and scope of these sterilizing stock buybacks.

I believe that there has been a truly astronomical transfer of wealth – well more than a trillion dollars – over the past ten years from shareholders of publicly traded companies to managers of publicly traded companies. Not founders, not entrepreneurs, not risk-takers ... *managers*.

I believe that this sea change has been driven by the intentional trumpeting of three narratives by management teams, boards of directors and their rah-rah Wall Street/CNBC accomplices:

- *“Our Interests Are Aligned”* to justify larger and larger amounts of stock-based comp,
- *“Non-GAAP is the Best Way to Understand This Company’s Fundamentals”* to justify downplaying stock-based comp and share dilution as a crucial issue for investors, and
- *“We’re Returning Cash to Shareholders”* to justify the sterilization of that stock-based comp with stock buybacks.

Here’s how it works:

Step 1: Boards and management teams award themselves and mid-level to senior executives large amounts of stock-based comp to “align our interests with shareholders” and “retain talent”.

Step 2: Wall Street/CNBC analysts treat that stock-based comp as a non-cash, safely ignored item in their “non-GAAP” estimates that drive the narrative around company performance and shareholder expectations.

Step 3: Boards and management teams use stock buybacks to monetize stock-based comp with shareholder cash.

Step 4: Wall Street/CNBC analysts trumpet the sterilizing stock buyback as “returning cash to shareholders”, encouraging shareholders to not only ignore the transfer of their money to management, but to *embrace* it.

Wash, rinse, repeat.

This is what transforms stock buybacks, a perfectly reasonable and often investor-friendly use of cash, into *Stock Buybacks!™*, a perverse system of self-dealing and never investor-friendly use of cash.

I love stock buybacks, but I despise *Stock Buybacks!™*.

I'm going to show you two examples of investor-wrecking *Stock Buybacks!™* and one example of investor-enriching stock buybacks.

The villains in this story are Meta and Google, two companies whose major purpose in this world is apparently to create thousands of mid-level executive millionaires at the expense of shareholders. These two companies alone have transferred more than \$300 billion from shareholders to employees in their monetization of stock-based comp over the past ten years.

The hero in this story is Apple, the most prolific user of stock buybacks in the world (more than half a trillion dollars!), but a company that actually returns capital to shareholders with its buybacks rather than sterilizing outrageous stock-based comp.

Okay, we'll start with just the basic facts about stock buybacks and share counts for these three companies over the past ten years. All of this information is taken straight from the companies' SEC filings and is current through 9/30 of this year (that's ten full years of data for Apple, which has a 9/30 fiscal year, and nine full years plus the first three quarters of 2022 for Meta and Google, which have a 12/31 FY).

Over the past ten years ...

	<u>Meta</u>	<u>Google</u>	<u>Apple</u>
Total buyback amount (\$m):	\$ 95,838	\$ 156,014	\$ 554,338
Dilution from employee stock grants:	18.2%	12.8%	5.6%
Total change in share count:	12.4%	-1.2%	-37.9%
Shares issued to employees (m):	431	1,691	1,465
Shares bought back (m):	378	1,875	11,820
Buyback sterilization %:	100.0%	90.2%	12.4%

All of the entries marked with a \$ sign are in millions of dollars, so, for example, Meta has bought back \$95.8 billion worth of its stock over the past ten years. The share count data is in millions of shares, so, for example, Google has issued 1.7 billion new shares to employees over the past ten years, diluting its starting share count by 12.8%. Google has also bought back 1.9 billion shares with its \$156 billion worth of buybacks, but because of the newly issued shares that only shrank the original share count by 1.2%.

[A quick aside on the timing of stock issuance and stock buybacks. For all three of these companies, the level of new stock issuance to employees has been pretty constant over the past decade. There has *not* been an acceleration in the dilution to shareholders over this period, which is to the credit of all three companies. In fact, the largest dilution for employee stock at Meta – about 1/3 of the total – took place in 2013-2014, so if you want to back this out the numbers for Meta look better (please note, though, that I have backed out new shares issued for corporate and acquisition purposes so that they are not included in the totals above). What isn't constant, though, is the use of stock buybacks. Among the three, Apple began buying back stock first (2013), followed by Google (2015), followed by Meta (2017), and the numbers have grown significantly over time. For example, the total amount spent on stock buybacks in 2021 was ~\$180 billion across the three companies, more than 4x the ~\$41 billion they spent on stock buybacks in 2017. As a result, Meta and Google can truthfully say that they have, in fact, been shrinking their share count through stock buybacks in recent years (2021-2022 for Meta, 2019-2022 for Google), but this ignores the prior years of share count expansion. Now that Google has successfully sterilized its employee issuance over the past decade and essentially returned to its 2012 end-of-year share count, it will be very interesting to see if the company continues with the same level of share count-reducing stock buybacks in 2023 or scales them back. End of aside.]

The ratio of new shares issued to employees divided by the shares bought back by the company is the *buyback sterilization percentage*. This is the percentage of stock buyback dollars that went to sterilize the dilutive new shares owned by employees. It can't be greater than 100%, which happens when – as you see with Meta – the stock buybacks don't fully sterilize the newly issued shares. I'm highlighting the buyback sterilization percentage because you multiply that percentage by the actual stock buyback dollars to figure out how much cash went to monetize the stock-based comp. That's the first line in the chart below, and that's my starting point to figure out how much of MY money as a shareholder is being spent on this monetization.

Over the past ten years ...

		<u>Meta</u>		<u>Google</u>		<u>Apple</u>
Buyback sterilization (\$m):	\$	95,838	\$	140,719	\$	68,725
Taxes on stock paid by company (\$m):	\$	23,109	\$	48,021	\$	28,940
Option exercise cash rec'd (\$m):	\$	(103)	\$	-	\$	-
Total cash cost of stock grants (\$m):	\$	118,844	\$	188,740	\$	97,665
<i>Total cash cost of stock as % FCF</i>		76.9%		63.0%		14.5%
<i>Total cash cost of stock as % CFO</i>		46.3%		40.3%		12.5%

But wait, there's more! In addition to the cash used to sterilize the new issuance of stock-based comp, most publicly traded companies today also use shareholder cash to pay for the taxes that employees owe on the stock-based comp. This is part of the magic of Restricted Stock Units (RSUs) that have almost completely replaced the old mechanism of awarding stock-based comp, which was options issuance that the employee could exercise by paying some low price to the company. With RSUs there is (typically) no cash impact on the employee receiving the stock-based comp at all, and (typically) no tax consequences, either.

The way this works is that the company will award, say, 10,000 RSUs to an employee, vesting (i.e., converted into actual stock and given to the employee) at the end of the year for accomplishing certain goals of the job. The value of those 10,000 shares (no longer RSUs, but newly issued shares) is considerable for the employee, and he or she will owe taxes on that. Moreover, since this is ordinary compensation, the company is required to withhold taxes on this and send it to the IRS. So the company takes back, say, 30% of the shares it just handed out in order to satisfy that tax withholding obligation. And since the company doesn't want to sell those shares on the open market, it pays the IRS cash for the current value of those withheld shares. In the case of Google, for example, \$48 billion of shareholder money has been spent over the past ten years paying for its employees' taxes on RSU awards. This is exactly the same thing as the company buying back shares in the open market, except that they're not buying back shares in the open market but are buying back shares directly from employees.

Put these cash tax payments together with the sterilized percentage of the cash stock buybacks and you have the total cash cost of monetizing stock-based comp (there's a small off-setting amount in options exercise cash that Meta employees paid the company). Now I want to compare that total monetization cost of stock-based comp to the free cash flow (FCF) and cash flow from operations (CFO) that these companies have generated over the past ten years (every company calculates FCF and CFO a little differently; this data is taken straight from how the companies report it to Bloomberg).

I'm making this comparison because free cash flow (and to a lesser extent cash flow from operations) IS the money generated by a company that belongs to me as a shareholder. It's the cash that's left over after the company has spent whatever it *must* spend, and deciding how to spend this cash is among the top two or three strategic decisions that a board of directors and senior management team must make.

I am trying to think of the right word to describe a board and senior management team that would deliberately choose to spend 77% or 63% of a company's free cash flow *over a decade* to monetize the stock-based comp awarded to that company's employees, above and beyond the billions and billions in cash compensation paid to those employees.

I am trying to think of the right word to describe a board and senior management team that would deliberately characterize the lion's share of that free cash flow spend – the sterilization of newly issued shares – as a “return of capital to shareholders”.

The best word I have is the same best word that Tennessee Williams had.

Mendacity

Three hundred billion dollars worth of pure mendacity on the part of Meta and Google's boards and senior management teams over the past decade. Hundreds of billions of dollars worth of still more mendacity from all the other boards and senior management teams of publicly traded companies that have joined hands with Wall Street to do the same *Stock Buybacks!*[™] dance to monetize their stock-based compensation.

Oh, I know what the response will be, both from these companies and the Stockholm-syndrome investors who will defend them.

You're conflating management with rank-and-file employees, and this level of stock-based comp is necessary to retain our amazing employees here at Meta/Google. Otherwise, they would leave us for Google/Meta.

You're just another mindless critic of stock buybacks who clearly doesn't understand basic math or accounting principles. Stock-based compensation is reported in our quarterly income statements, stock buybacks are simply a tax-advantaged way of returning capital to shareholders, and you must be a socialist Bernie Bro to suggest otherwise.

Management's interests can only be aligned with shareholder interests through stock-based awards, and the superb stock market performance of Meta/Google shows that shareholders have benefitted enormously from the wise decisions of this board and senior management.

Oh wait, I guess maybe I won't be hearing that third argument so much these days.

My response is simple. First, bah! Second, it doesn't have to be this way, and I can prove it.

Over the past ten years ...

		<u>Meta</u>		<u>Google</u>		<u>Apple</u>
Buyback to shareholders (\$m):	\$	-	\$	15,295	\$	485,613
Dividends to shareholders (\$m):	\$	-	\$	-	\$	131,945
Total capital to shareholders (\$m):	\$	-	\$	15,295	\$	617,558
<i>Total capital to shareholders as % FCF</i>		<i>0.0%</i>		<i>5.1%</i>		<i>91.9%</i>
<i>Total capital to shareholders as % CFO</i>		<i>0.0%</i>		<i>3.3%</i>		<i>79.3%</i>
Average buyback price per share:	\$	253.54	\$	83.21	\$	46.90
Current price per share:	\$	90.79	\$	86.58	\$	138.38

In addition to using 88% of its stock buybacks in a non-sterilizing, actual share count reducing manner that does in fact return capital to shareholders in a tax-advantaged way, Apple also returns capital directly to shareholders through a dividend.

Put these together and Apple has returned more than 90% of its free cash flow to investors through stock buybacks and dividends over the past decade, a total of more than \$600 billion.

I am also at a bit of a loss for words here, but in awe rather than disgust.

Is it Warren Buffett's influence that led to this? The majority of Apple's stock buybacks have occurred since Berkshire Hathaway took a position in Apple (although Apple started buying back stock years before Meta and Google). Or is this sort of incredibly supportive board and management attitude towards shareholders why he took a position in the first place?

I dunno. Probably both. Whatever the source, I really am kinda blown away by Apple's decisions when it comes to free cash flow allocation and stock-based comp dilution. THIS is what capitalism is all about, and THIS should be everyone's go-to example for how stock buybacks can absolutely work for investors.

A final thought.

For the past decade, an overwhelming tide of infinite central bank liquidity lifted all boats. Sure, companies like Apple, with an immensely shareholder-supportive board and management team, did well in the stock market, but so did companies like Meta and Google, with boards and management teams that were ... errr, not so shareholder-supportive. So did companies that were even more aggressive in their shareholder dilution and stock-based comp schemes than Meta and Google.

Mendacity was not just ignored over the past decade, but was rewarded time and again. Quality of board and senior management direction, where quality is defined by putting the interests of the owners of the company (the shareholders!) above the interests of the managers of the company ... well, that really hasn't mattered to the market in a long time.

I think that board and senior management quality may matter again, as the tide goes out.

I think that board and senior management mendacity may be punished again, as the tide goes out.

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