# The McNealy Problem

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Dear fellow investors,

Investors often ask our team at Smead Capital Management what we spend our time on. We believe reading is the best use of our time to learn and think about the way that we can profitably apply capital for our investors. We recently read Ben Inker's letter from GMO. In the letter was a 2002 quote in *Bloomberg* from the former Sun Microsystems CEO Scott McNealy. McNealy was explaining ex-ante how irrational the financial euphoria of the late 1990's was when he said:

> *...2 years ago we were selling at 10 times revenues when we were at $64. At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current revenue run rate. Now, having done that, would any of you like to buy my stock at $64? Do you realize how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. What were you thinking?*

McNealy put it succinctly what the odds of success were from that level of valuation for Sun Microsystems. We call this 'the McNealy problem'. As we read McNealy's statement a couple times over, it made us think of 1999. How did that financial euphoria episode in tech compare to today's freakish price-to-sales multiples in the stock market? However, we recognized one thing in his statement that the market isn't assuming for many of today's glamour tech businesses. McNealy assumed the businesses wouldn't grow. Today's market favorites have high growth rates built in. We then decided that the best way to arbitrate 'the McNealy problem' was to assume the best in today's companies. In other words, they will grow. Where would this take us in ideal circumstances?

**The Rule of 40**

As a quick sidetrack on this discussion of growing businesses, a colleague of mine mentioned to me the rule of 40, which we had never heard of before a few weeks ago. If you haven't yet heard of it either, strap yourself in. The rule of 40 applies to software as a service (SaaS) businesses. The rule of 40 says that if revenue growth plus operating margin is greater than 40, venture capital and public investors are much more willing to pay high multiples for the business. The general idea is that SaaS businesses are able to tradeoff between revenue and margin. Investors will also use other profitability measurements, instead of operating margins like EBITDA, at times. If revenue growth backs off, you can lower your sales and marketing costs to increase your margins. It is treated as though there is a simple business relationship between revenue growth and margins. Put it in the calculator and it will tell you what to do..

## Today's McNealy Problem

As we continued to ruminate on this, we began to experiment with outcomes. McNealy had used a 10-year time frame on a 10x price-to-sales company. We wanted to use a longer time, so we chose DocuSign. It trades for 27-times sales, so we would build our outcome based on 27 years. Further, we needed to assume the business grows, as most investors are. Since we now know that many investors are using the rule of 40 in their business decision-making, we needed to assume they will achieve this over the 27 years. We wanted to be aggressive and give them the benefit of the model, so here's what we came up with.

Over 27 years, DocuSign would have 20% revenue growth. Our starting point was their fiscal year 2022 expected revenue of $2.083 billion. We further assumed they would have 30% margins (EBITDA) each year for the whole 27-year period. We gave them a 21% corporate tax rate. We also assumed 100% of their after-tax profits would be paid out in dividends and assumed no dilution of shares during the 27 years. Lastly, we gave them a 20-times earnings valuation at the end of the 27-year period. We comped this valuation with Cognizant Technologies, a services business that has produced huge success since being spun out of Dun & Bradstreet in the late 1990s. Cognizant has been a 23-year winner. It's closer to what we are looking for in favorable end results from our SaaS valuation.

Why did we give them these incredible numbers and certainty? We are trying to understand the outcomes of a yet unknown future. We want to ask if everything goes their way, what would the future return be? Based on the numbers provided above, DocuSign would compound at roughly 13.8% over the 27 years. This is the problem. Under ideal circumstances, the model we've built would make 13.8% returns. Cognizant, in comparison, has compounded capital at 27% for 23 years, so far. If you pay a steep price-to-sales multiple of 27 times, Cognizant's return would be in line with what your compensation should be for large unknown future risks. The 13.8% return isn't enough.

## For the Cynic

The cynic reading this would start to poke holes in our assumptions. Revenue growth of 20% for 27 years would be top decile performance. The best we can find is Microsoft's first 27 years as a public company at roughly 28%. Operating (EBITDA) margins are not present in DocuSign, so we are giving DocuSign a huge benefit of the doubt in that there are no margins currently. Wall Street sees them getting to 22.5% EBITDA margins in the next few years. We give them more credit sooner. Our corporate tax rate looks generous at 21%, since the U.S. Government has a lot of borrowed money to pay back. Further, the cynic can argue that paying dividends isn't a worthy investment for a growth business like DocuSign. We agree, but are not punishing the numbers for their generous stock-based compensation system. We look at that as a push. Overall, we are painting large advantages into the future for DocuSign.

## Bunking History

We are using the corporate history of Microsoft and Cognizant Technologies to understand what other businesses like DocuSign will need to have in order to produce huge corporate success. The only question that remains after you look at their balance sheet, income statements and cash flow is, what price would you pay? At 27-times revenue, it looks like a greater probability that DocuSign will stumble short of the 13.8% compounded return we calculated. This is the McNealy problem. Price doesn't account for anything short of ideal. Scott was right.

Does that mean that DocuSign can’t succeed individually in today’s financial euphoria? No. The McNealy problem speaks to the psychology and mood of the participants in the market, not necessarily to the corporate success. “‘Gold rushes’ wrote Bill Gates in a prophetic conclusion to his book, ‘tend to encourage impetuous investments. A few will pay off, but when the frenzy is behind us, we will look back incredulously at the wreckage of failed ventures and wonder, *Who funded these companies? What was going on in their minds? Was that just mania at work.’”*[i]

The last thing the cynic is thinking with the McNealy problem is that we are using the past as a guide with Microsoft and Cognizant Technologies (the past) to look at DocuSign (the future). We are also speaking to financial euphoria that we haven’t seen since the late 1990’s, when Scott McNealy was the CEO of Sun Microsystems. The cynic would say that those past instances are irrelevant and you must look at how great these companies are. They will utter the four most damaging words known to investors: it’s different this time. Let us not forget this is an American specialty. “As the nineteenth-century financial writer William Fowler observed, ‘Imagination in this country, lives in the future rather than the past.’ Only in America could a man declare that history was bunk.”[i] This is the McNealy problem.

Fear stock market failure,

**Cole Smead, CFA**

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[i] Source: E Chancellor, *Devil Take the Hindmost: A History of Financial Speculation*, 31 Dec. 1998.



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