SMEAD capital management

Missive

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Companies Still SOIL-ing Themselves

Dear fellow investors,

I was reminded in a recent read of Robert Hagstrom's book, *Warren Buffett: Inside the Ultimate Money Mind*, how Warren Buffett and Charlie Munger define the economic earnings power of a business. They refer to it as owner earnings. They take net income and add back depreciation, but adjust for the cost of the reinvestment of capital assets of a business to understand the real costs of being an owner. While being similar to free cash flow, it may need more adjustment depending on the capital assets of the business. Most would then use this to come to the natural conclusion that businesses with less capital-intensive business models would be superb companies to own based on owners' earnings. However, this just exposes the fly in the ointment.

To explain the issue that arises, we must start out by recognizing that less capital-intensive businesses are people or labor-oriented. They drive their economic returns from ideas that their people create. What a wonderful way of accounting for human progress!

This isn't compensated like a traditional cash expense. Many asset-light businesses pay a large portion of their compensation to their employees in stock-based compensation. Rather than giving them cash bonuses, they give them stock in hopes that it will lock them into the business based on the vesting schedule.

If you follow the cash flow statement, these stock-based bonuses look identical to a secondary stock offering. It's an inflow from financing, but an expense in the income statement. In GAAP accounting, this expense reduces your net income. When calculating free cash flow, you add it back. The issue is what adjustment you should make when you go to calculate owner earnings.

In 1999, Warren Buffett railed against the treatment of stock options in compensation. Under GAAP then, it was not recorded as an expense as it is now. He joked that if it's not an expense, what is it? The same could be said of stock-based compensation now when calculating free cash flow or owner earnings. You need to remove it because it was a real economic cost to the shareholder coming in from financing activities. No different than adjusting for the economic costs of assets.

A better way to define stock-based compensation is to call it secondary stock offerings in lieu of cash expenses (SSOILCE) or what I will abbreviate to SOIL (stock offering in lieu). What reminded me of this was the exercise of analyzing DocuSign (DOCU) recently. We had warned investors in the fall of 2021 about the expectation built into the security in our piece titled, The McNealy Problem. Things we demonize at one point, we love to dig back into when prices fall apart as they have done. The danger is whether the economic returns in owner earnings justify being an owner at much lower prices.

In DocuSign's case, we look at the estimated fiscal year 2023 (ending 1/31/2023) free cash flow which stood at $438.8 million. Their stock-based compensation or SOIL was $510.8 million over the last 12 months. If you are using your mental calculator while reading this, yes you are reading that correctly. When adjusting for SOIL in owner earnings, DocuSign produced a negative return. How can a rational investor watch a stock decline over 80% from the peak to end up with a business producing negative owner earnings at the end? It's like asking how many licks to the center of the Tootsie Pop. The world may never know.

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We are aghast to learn that a world-dominating business like DocuSign (with the moat that they have) is unable to produce positive owner earnings. This isn't just to pick on DocuSign, but the American-style compensation that is going on in the S&P 500 today. To steal further from Hagstrom's book, it's the institutional imperative to do what others are doing which is causing these companies to SOIL their owner earnings. They are not worried that the community's compensation practice is actually bad. You won't find this SOIL-ing process abroad. This has an American intensity not found in other parts of the world.

Do we think the mania has ended in the investment markets? No. These practices to the detriment of shareholders are still alive and accepted. Does this cause former darling growth stocks to look more attractive to us? No, not until we see these maturing companies start acting like adults rather than teenagers. Teenagers may be giving these companies too much credit. After all, these companies, like toddlers, are still SOIL-ing themselves.

Fear stock market failure,

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