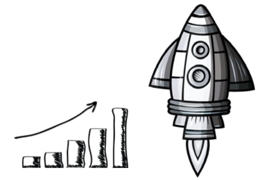
# CO/INVESTOR CLUB



# STOCK BASED COMPENSATION


Prepared by:

**President**: Mike Pruitt
**Analyst**: Adam Allen
**Analyst**: Sam DiFiore
**Intern**: Lane Welborn

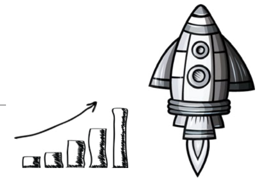

## Stock Based Compensations

Stock Based Compensations (SBCs) are a form of employee compensation that is usually awarded for meeting specific performance metrics set ahead of time by contract and paid out through stock options, preferred stock, restricted stock, common stock, or "phantom stock." These are structured in a broad number of ways and well-designed compensation plans can serve to provide incredible incentives to executive suites and poorly structured SBCs can rob value from investors through dilution or bloated corporate costs.

## SBC Proponents

It is important to acknowledge the importance of Stock Based Compensations in attracting talent in the labor market. A company cannot expect to attract a talented crop of executives if they are not compensating their officers competitively and equity compensation can be a tax efficient way to do so. Most publicly traded companies today implement some form of SBCs as a major part of their executive pay plans. Many of the modern companies have it as part of their corporate DNA, with Jeff Bezos going so far as to say in his 1997 letter to shareholders "We will continue to focus on hiring and retaining versatile and talented employees and continue to weight their compensation to stock options rather than cash. We know our success will be largely affected buy our ability to attract and retain a motivated employee base, each of whom must think like, and therefore must actually be, an owner." Stock option plans are particularly valuable for cash strapped startups or smaller companies that don't have the pure capital needed to attract the talented labor needed to scale quickly. These plans are relatively consistent among modern public companies, but several variations exist on how to execute these plans.

A popular version of SBC is the issuance of restricted stock. Restricted stock is an "agreement to issue shares of stock after the recipient satisfies a vesting period." This plan offers several advantages over options. First is the more straightforward nature of valuing this as an expense. Restricted stock can have a specific value at the time of the grant whereas options valuation can be difficult and subjective. Second is that restricted stock has a more durable incentive structure. The issues of a restricted stock can have a specific predetermined monetary value in their compensation, whereas options can lose much, or all, of their incentive ability if the share price falls well below the option's exercise price. Fairfax Financial Holdings is an example of a company that implemented a restricted stock plan post-1999. An alternative plan is demonstrated by the Alleghany Corporation's executive compensation plan. Alleghany awards executives "performance shares" based on rolling four-year periods of book value growth. These are sized in proportion to the employee's salary based on a book value growth rate of around 7% year-over-year. Further, for Alleghany's wholly owned subsidiaries, it issues "phantom stock" that tracks the book value of these businesses and awards compensation based on their individual hurdle rates. Another company that utilizes this type of performance share compensation plan is Cimpress N.V.



## SBC Critics

There exist a few high-profile detractors of bloated executive SBCs (particularly those steeped heavily in options). These are generally centered around a lack of downside risk for executives and the misalignment in incentives that this can cause. Most of these critics don't fully dismiss equity as a part of compensation but instead advocate for forms of employee purchase plans or other ways to help employees to purchase company stock in order to ensure they maintain the same downside risk that common shareholders have.

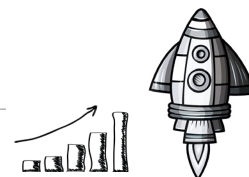
Undoubtedly the most famous critic of the modern executive compensation plan is Warren Buffett, saying that "No owner has ever escaped the burden of capital costs, whereas a holder of a fixed-price option bears no capital cost at all. An owner must weigh upside potential against downside risk; an option holder has no downside." Instead of options, Berkshire works to employ compensation plans that vary by business unit and provide managers with incentives on the upside as well as symmetrical disincentives on the downside of meaningful hurdle rates in returns on capital. These carrots on the upside can be enormous, with bonuses sometimes approaching five times annual salary for high performing business units. Further, all managers are encouraged to then purchase Berkshire shares in order to build equity in the company and align their interests with shareholders through ownership.

Other high-profile executives who represent departures from the norm of SBC's include Prem Watsa on Fairfax Financial Holdings pre-1999, Tom Gayner of the Markel Corporation, and Mark Leonard of Constellation Software. Fairfax Financial maintained a straight salary for partners with a profit-sharing pool of up to 30%. This was coupled with a share purchase program that allowed for an interest free loan to employees to buy ownership in the company or for employees to contribute up to 10% of their salary to stock purchases that would then be matched from 30-50% by the firm. The Markel Corporation attached cash compensation incentive to a 15% year-over-year book value growth hurdle rate. This is enhanced by Markel including the company's stock in all employee 401K plans and an employee stock purchase plan where associates can allocate up to 10% of income to the purchase of Markel stock, with the added incentive of a buy 10 get 1 free deal on stock purchases. Constellation Software CEO Mark Leonard waived all compensation in 2014 and based his entire net worth on his performance as CEO and the corresponding stock appreciation. All of these alternative solutions to equity compensation look to solve the misalignment with the limited downside risk associated with traditional SBCs.

## Accounting for SBC's

Per GAAP Accounting principles, executive option grants must be expensed against income which can significantly impact earnings. Because of this, many firms choose to report non-GAAP accounting numbers in order to bloat their earnings, thinking of SBCs (particularly options) as a non-cash expense. The fault in this argument is that extensive options grants can meaningfully dilute shareholder ownership and therefore erode shareholder value.

When considering accounting regarding SBC's, three components need to be considered. First, the grant date, which is the awarded date and/or approval date, usually by the board of governors. Second, the service period, often referred to the vesting period, which is the timeframe that must pass before a stock or stock option can be owned. The third and last component is performance condition, which is a goal set forth that must be attained before the stock option can be realized. Performance metrics like Return on Equity or Earnings per Share Growth are common measurements for executives to hit. Generally, what is being captured in the accounting practice is recognizing the costs of what an executive contributes as service to the company and the value that the company will get out of the service at a fair market value. Over the service period, expenses are accrued and this is coming from a probability that the vesting period and performance goals will be achieved by the executive. If neither the vesting period nor performance goals are hit, a reversal of realized compensation is enacted.



## The Impact on Investors

The way that a company decides to account for SBC's has a very real impact on investors. It is important to understand that a company can mask real earnings with SBC's. Non-GAAP earnings can give an illusion to shareholders that earnings are strong and growing; but in reality, GAAP earnings can tell a different story. Some large and very well know companies out there may just not be profitable, yet still they could be providing great services and goods for the general public. If investors don't realize that great companies do not always equal great investments, they can be blindsided by their returns. Relying solely on non-GAAP earnings, they can be holding on to a losing investment. It takes some digging into the income statement and footnotes to uncover the specifics of how a company is reporting their earnings. If the difference in non-GAAP earnings is large compared to GAAP expenses, this should raise concern for an investor. It may say that the company is hiding much of its true earning power behind SBC's and not displaying it as a true expense.

It is common knowledge under GAAP that SBC's are indeed a real expense. When a company that has large SBC's, they are essentially taking dollars from shareholders and paying employees, which in return dilutes ownership creating a real expense that an investor should be very concerned with. Just because the expense can't always be exactly quantified doesn't mean it isn't real. As Warren Buffett has said, "Shareholders should understand that companies incur costs when they deliver something of value to another party and not just when cash changes hands. Moreover, it is both silly and cynical to say that an important item of cost should not be recognized simply because it can't be quantified with pinpoint precision."

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