Stock-Based Compensation:

NO LONGER A "COSTLESS" EXPENSE

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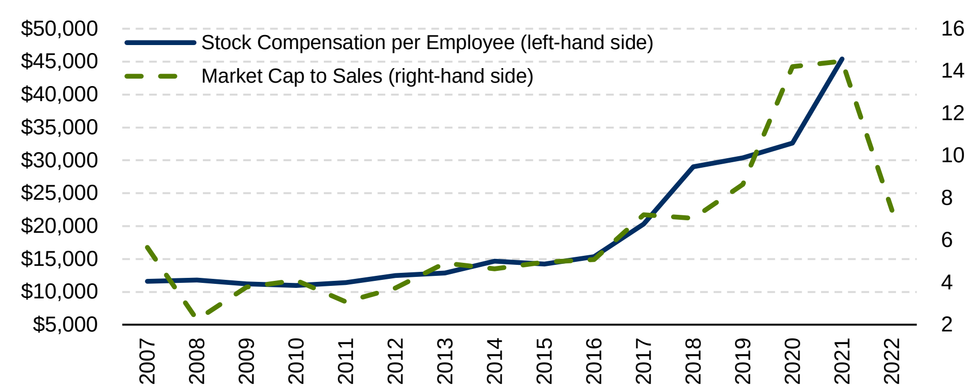
THE VIRTUOUS CYCLE OF AGGRESSIVE STOCK ISSUANCE TO EMPLOYEES, ELEVATED 'ADJUSTED' EARNINGS, RISING STOCK PRICES, AND STRONG EMPLOYEE ENGAGEMENT CAN BECOME VICIOUS WHEN IT UNWINDS.

The use of stock-based compensation (SBC) in the technology sector has proliferated in recent years, driven by the war for talent and a period marked by low cost of capital, plentiful access to capital, and rising valuations. By our calculation, the stock compensation per employee has tripled in the last five years alone (**Chart 1**).[1] Additionally, SBC represents 3.8% of revenues for global technology companies and reaches levels as high as 15%-50% for faster growing companies.[2]

Chart 1. Virtuous Can Be Vicious



As of 03/31/22; Source: FactSet, Company reports. Uses data for 65 mid and large cap technology companies.

During good times, stock compensation creates a virtuous cycle: employees receive an ownership stake in the company, companies present aggressive adjusted earnings, the value of the company rises, employees benefit from rising valuations, loyalty and commitment grow, and morale is high. However, this virtuous cycle can become a vicious one when it unwinds, as we see happening today. By our estimation, the market seems to be underappreciating the potential impact of this situation.

A RECKONING

Aggressive users of stock-based compensation are facing a myriad of staffing, balance sheet, and tax issues. Declining stock prices are generating widespread dissatisfaction among employees as the value of their previously granted stock-based compensation plummets. To manage employee attrition, companies are being forced to increase cash

[1] The 65 mid and large cap technology companies in the sample represent the largest firms in the FactSet data set with ample data to analyze.
[2] Source: Altrinsic research, FactSet data. Calculations based upon technology companies in the MSCI World Index. SBC/revenue calculation is the median.

compensation expenses and/or issue new restricted stock units. This further dilutes shareholders and has significant implications for cash flows, tax rates, and earnings growth. As investors seek opportunities amidst the carnage, the following issues should be analyzed while determining companies' intrinsic values:

- **Issue #1: Shares are worth less than the taxes paid, resulting in unhappy employees.**
  Employees whose Restricted Stock Units (RSUs) vested in 2021 paid taxes based on the inflated share prices during that time. Many kept those shares, expecting further gains. Today, most employees are underwater on these shares, and in some cases, the shares themselves are now worth less than the taxes that the employees paid. This scenario is a morale killer. Companies may be forced to compensate employees for these 'tax losses' – or risk facing higher turnover levels.

- **Issue #2: Share dilution is set to rise significantly, upsetting existing investors.**
  RSU grants from 2021 and prior years are worth significantly less than employees assumed they would be, and many considered these grants as good as cash. Following the dotcom crash, many companies were persuaded to reprice or accelerate (a few backdated as well!) options. Given the current environment, we expect companies to come under similar pressure to make employees whole by issuing more RSUs.[3]

> To gauge the impact of the share dilution resulting from making employees whole, we analyzed the filings of fifteen leading companies in the software, ecommerce, and payments sectors. In 2021, these companies issued RSUs equal to 2% of outstanding shares. To make employees whole on paper losses, this group would, on average, need to issue RSUs equal to another 2.4% of outstanding shares for total share count dilution of 4.4%. This level of dilution is simply unsustainable and will not be accepted by investors.

- **Issue #3: Effective and cash taxes are set to rise, pressuring free cash flow and valuations.**
  Rising stock prices benefited US technology companies significantly over the past decade, as it drove a reduction in effective and cash tax rates from high RSU expenses. With lower stock prices, these benefits will decline and both effective and cash tax rates will rise, affecting free cash flow generation. This outcome is likely to add further stress on valuations and potentially more downward pressure on share prices.

- **Issue #4: The war for talent is intensifying, further challenging P&Ls of the entire industry.**
  Companies that are unwilling or unable to adjust compensation for employees' paper losses associated with SBC could quickly experience a further rise in attrition levels, which are already at historic highs. In addition, many employees will now prefer cash compensation to the uncertain value of SBC, a shift that will pressure companies' cash flows. These dynamics present a challenge for a wide swath of unprofitable tech companies that were previously able to compete by leveraging an array of creative (non-cash) compensation options. Now, profitable industry leaders will likely be able to accelerate even faster, leveraging their scale and cash flow advantages and further intensifying the war for talent and overall industry competition.

[3] The 15 companies used in the sample for the analysis highlighted in the gray box were selected at random from important sub-sectors of the technology industry.

A New Reality

The cost of doing business in the technology industry is rising, and the virtuous cycle of employee engagement and company growth via stock-based compensation will come under pressure. We believe the risks associated with shifting compensation schemes are underappreciated. As the new reality sets in, we expect investors to increasingly focus on the true impact of both cash and non-cash compensation costs on companies' bottom lines.

The difference between pro-forma and GAAP operating margins is well over 20% at many leading software and "new economy" companies. In fact, many of these companies are unprofitable on a GAAP basis. Given the deteriorating macro backdrop in markets and the global economy, along with changing investor focus, the technology sector is rapidly pivoting away from a mentality of "growth at all costs" to one of improving profitability. The pace and level of profitability improvement will not be enough to sustain current valuations, but we expect some companies with true pricing power and experienced management teams to successfully manage this transition. At Altrinsic, we are deeply engaged within the technology ecosystem to uncover long-term investment opportunities in this period of dislocation.

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[4] As of 03/31/22

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