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META LESSON 1: THE TRUE MEANING OF CORPORATE GOVERNANCE

The power to change…

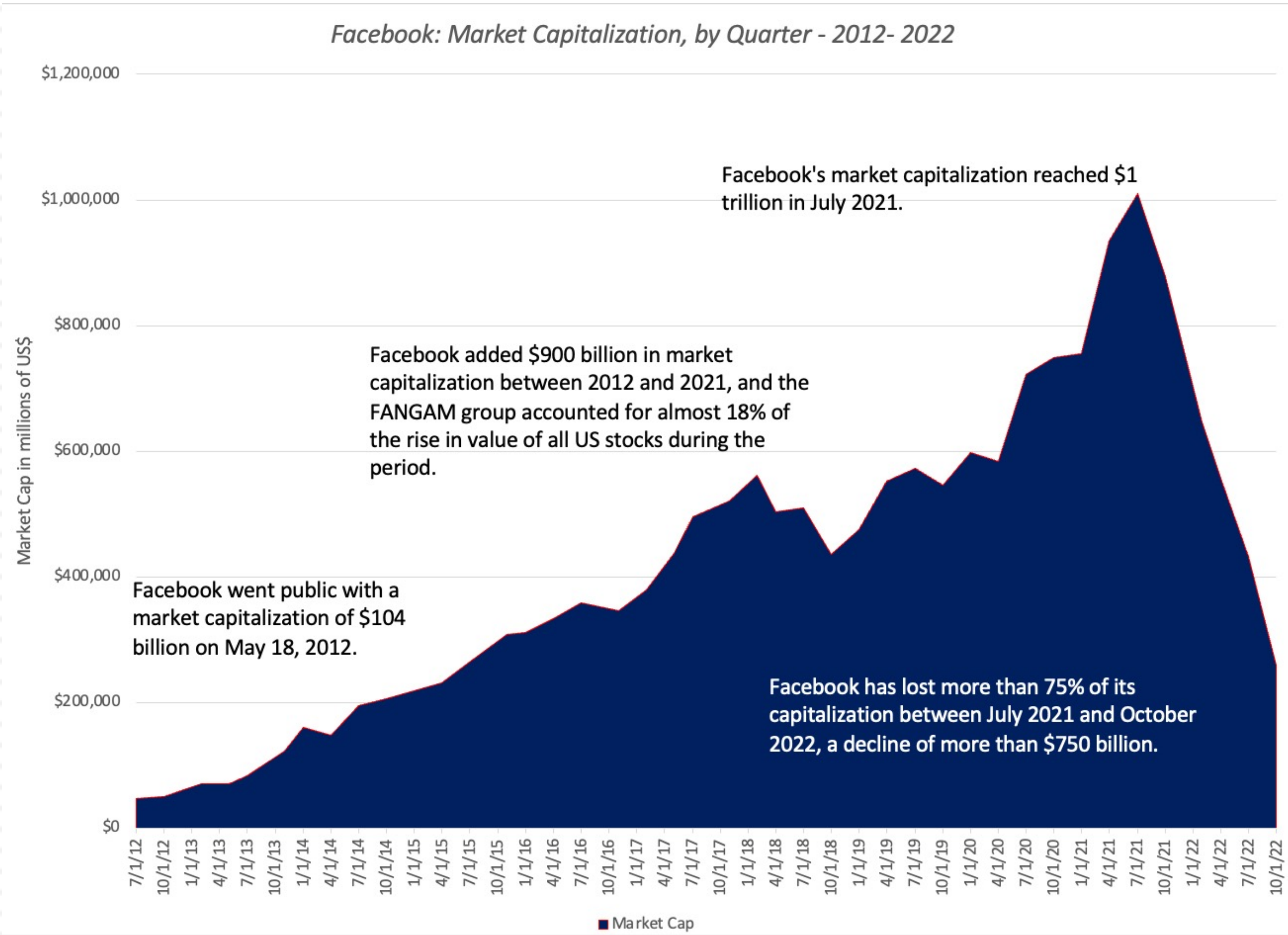
The Fall of Tech?

- As we get deeper into earnings season for the third quarter of 2022, the biggest negative surprises are coming from technology companies, with the tech giants leading the way. Investors, used to a decade of better-than-expected earnings and rising stock prices at these companies, have been blindsided by unexpected bad news in earnings reports, and have knocked down the market capitalization of these companies by hundreds of billions of dollars in the last few weeks.
- Facebook (or Meta, if you prefer its new name), in particular, has been in the eye of the storm, down more than 75% from the trillion-dollar market capitalization that it enjoyed just over a year ago.
    - In its last earnings report, the company managed to disappoint almost every segment of the market, shocking growth investors with a drop in quarterly revenues, and value investors with a sharp decline in earnings and cash flows.
    - In the days after the report, the reaction has predictably fallen into the extremes, with one group arguing that this is the beginning of the end for the company's business and the other suggesting that this is the time to buy the stock, as it prepares for a new growth spurt.

The Big Issues

- In this first post, I will use the investor debate about Facebook to talk about *corporate governance*, what it is, why it matters and how I think governance disclosure research, rules and scoring services have lost the script in the last two decades.
- In the next post, I will use Facebook's most recent earnings surprise to talk about inconsistencies in how accountants categorize corporate spending, and why these inconsistencies can skew investors perceptions of corporate profitability and financial health.
- In the third and final post, I will argue that Facebook's troubles with the market have as much to do with a failure of narrative, as they are about disappointing numbers, and present a template for what the company needs to do, to reclaim the high ground.

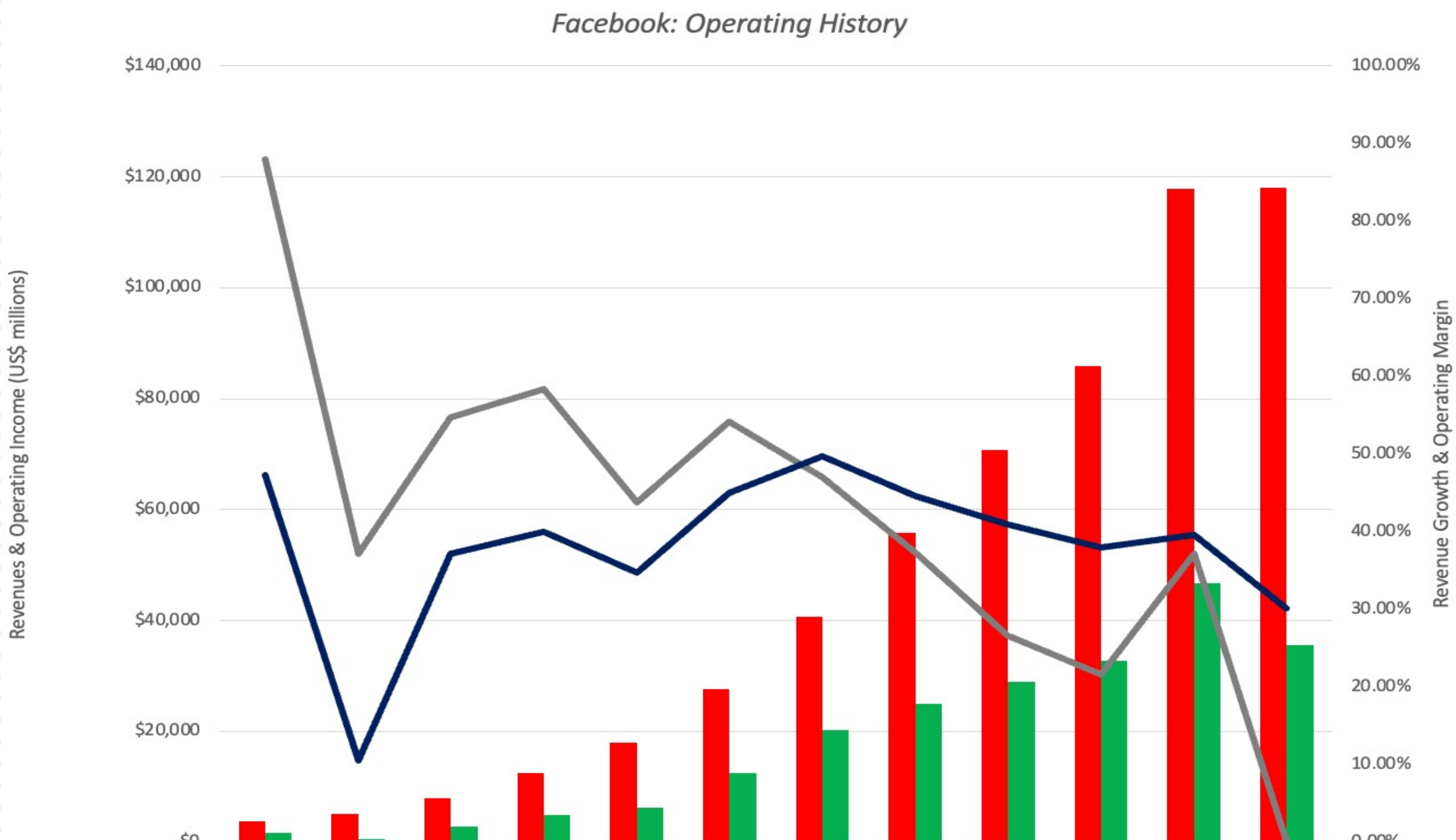
Background: Facebook's Market Journey



Facebook: Perspective

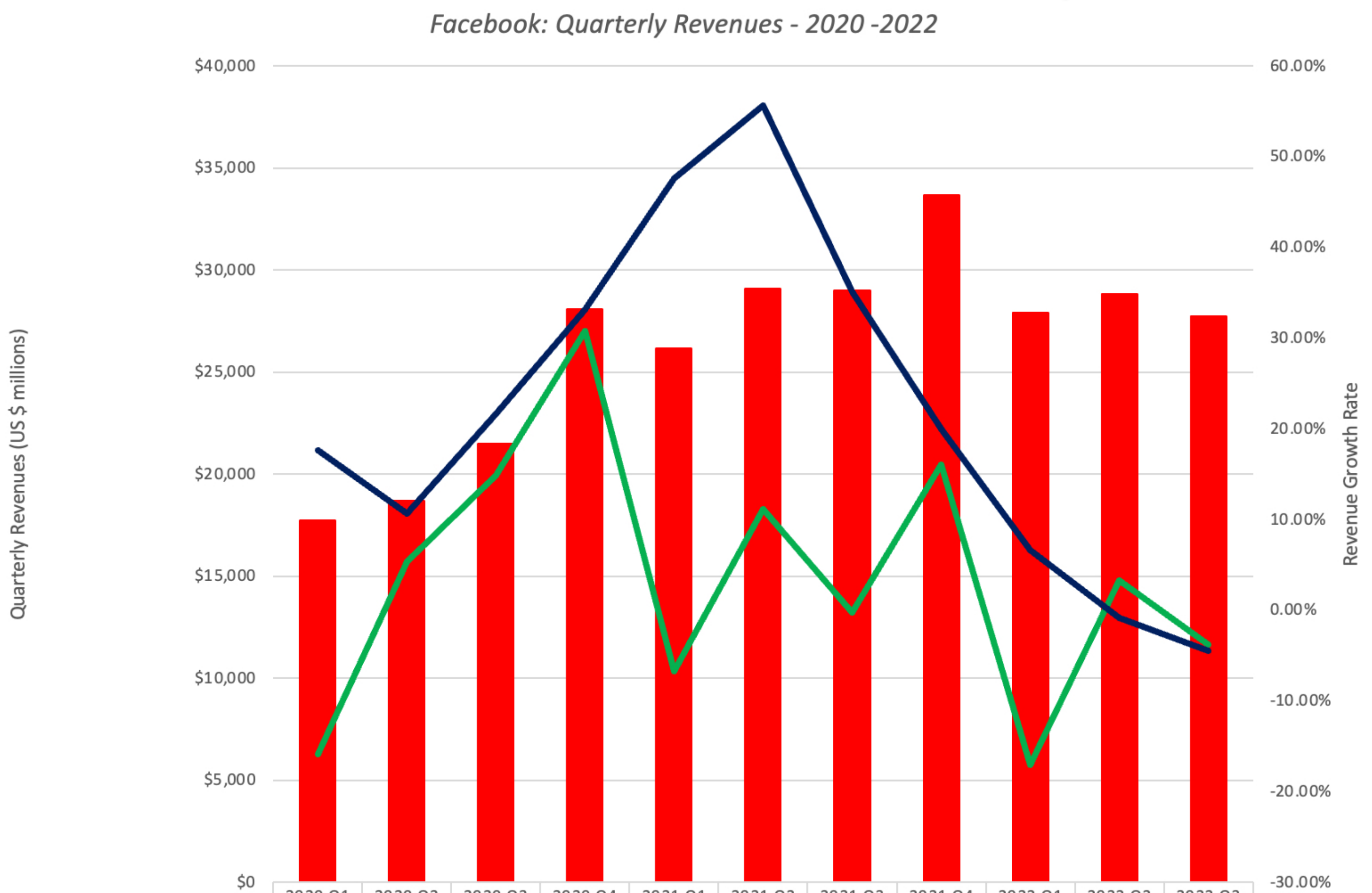
- Buy and hold returns: If you had bought shares in Facebook on its first trading day, you would have paid $38.12, and if you had held the stock through October 27, 2022, when it was trading at $93/share, that would have translated into a cumulative return of 144%. That would have left you lagging the 181% price appreciation that you would have earned on the S&P 500 during the period, and even more so, if you consider the fact that you would have earned no dividends on Facebook, while generating about a 2% dividend yield, every year on the index.
- Current standing: At a roughly $250 billion market capitalization, Facebook is a large market-cap company, but it has lost its standing among the largest market cap companies in the world that if occupied for an extended period during the last decade.
- Trader's game: Along the way, Facebook has had its ups and downs, and a savvy trader who was able to time entry and exit into the stock at the right times, would have made a killing on the stock. I know that can be said of any stock, but the swings in fortune are much greater at companies like Facebook, making them them the preferred habitat for traders of all stripes.

Facebook's Operating Journey



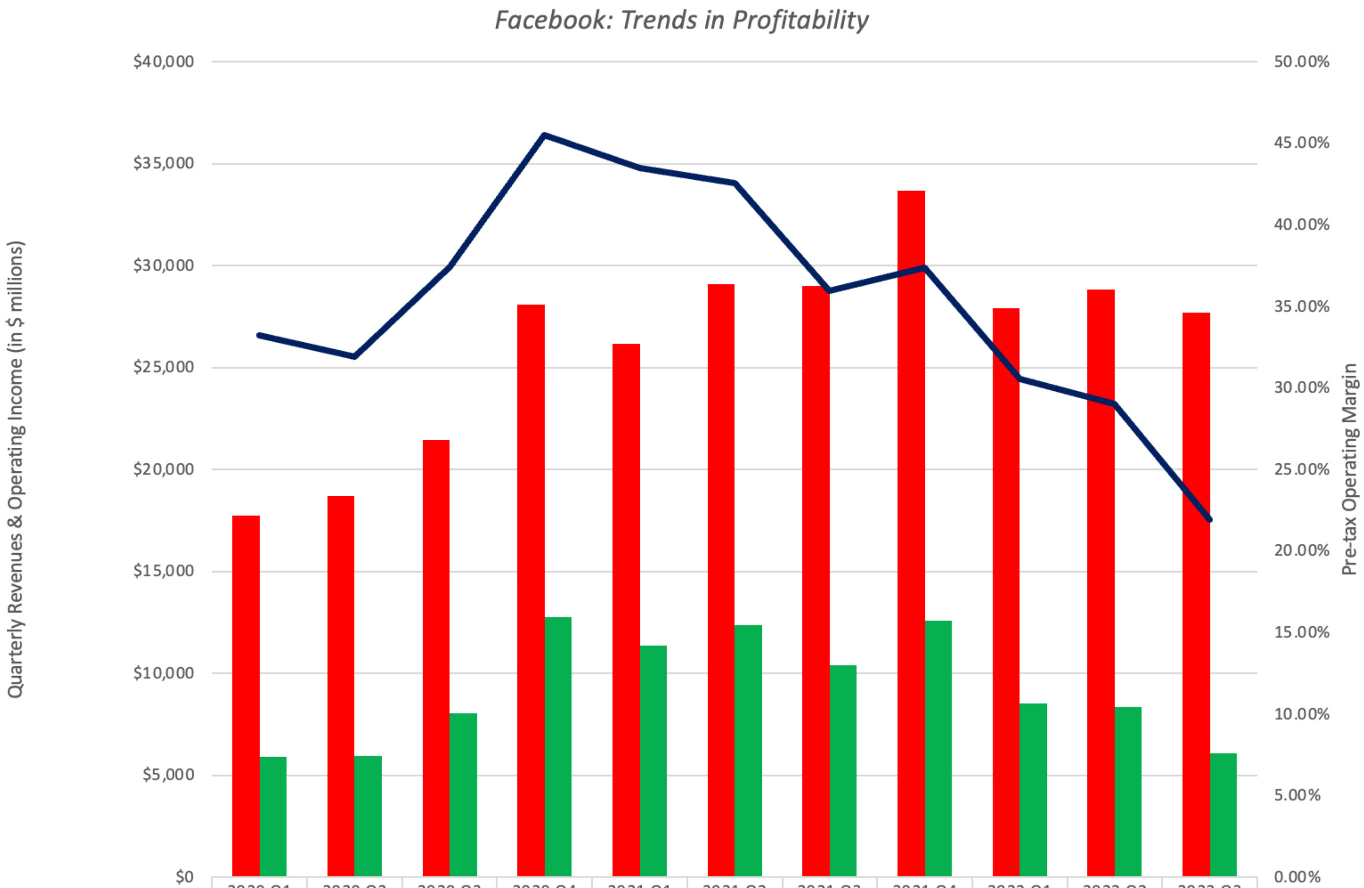
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	LTM
Revenues	$3,711	$5,089	$7,872	$12,466	$17,928	$27,638	$40,653	$55,838	$70,697	$85,965	$117,929	$118,115
Operating Income	$1,756	$538	$2,921	$4,994	$6,225	$12,427	$20,203	$24,913	$28,986	$32,671	$46,753	$35,543
Revenue Growth	87.99%	37.13%	54.69%	58.36%	43.82%	54.16%	47.09%	37.35%	26.61%	21.60%	37.18%	0.16%
Operating Margin	47.32%	10.57%	37.11%	40.06%	34.72%	44.96%	49.70%	44.62%	41.00%	38.01%	39.65%	30.09%

The 2022 Surprises: Flat Revenues



	2020 Q1	2020 Q2	2020 Q3	2020 Q4	2021 Q1	2021 Q2	2021 Q3	2021 Q4	2022 Q1	2022 Q2	2022 Q3
Quarterly Revenue	$17,737	$18,687	$21,470	$28,072	$26,171	$29,077	$29,010	$33,671	$27,908	$28,822	$27,714
Growth Rate (over last qtr)	-15.87%	5.36%	14.89%	30.75%	-6.77%	11.10%	-0.23%	16.07%	-17.12%	3.28%	-3.84%
Growth rate (YOY)	17.64%	10.67%	21.63%	33.16%	47.55%	55.60%	35.12%	19.95%	6.64%	-0.88%	-4.47%

And a drop in profitability…



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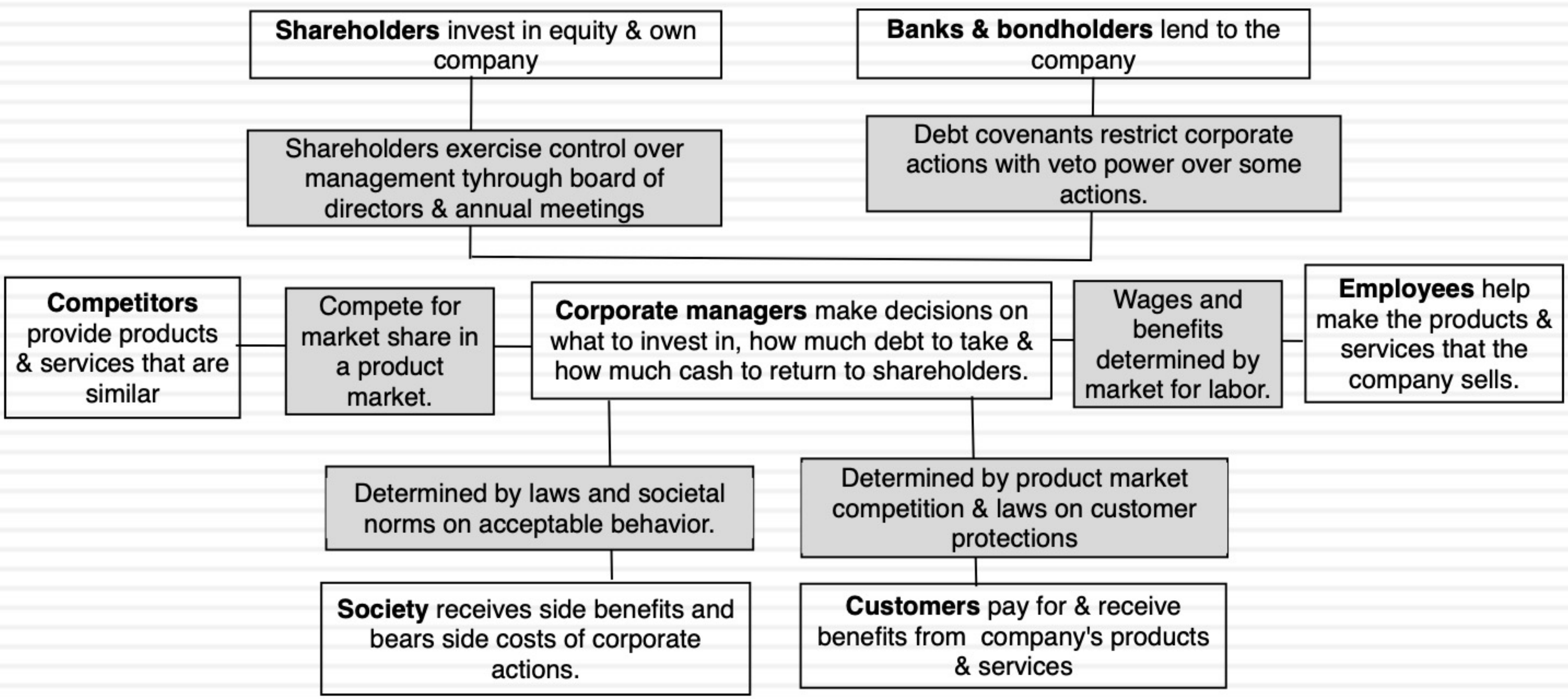
Operating Income	5,893.0	5,963.0	8,040.0	12,775.0	11,378.0	12,367.0	10,423.0	12,585.0	8,524.0	8,358.0	6,077.0
Operating Margin	33.22%	31.91%	37.45%	45.51%	43.48%	42.53%	35.93%	37.38%	30.54%	29.00%	21.93%

The Bigger Challenges

1. Online Ad Market Leveling off: Facebook is an online advertising company, and for much of its early years, it benefited from growth in the online advertising market, largely at the expense of traditional advertising (newspapers, television etc.). As online advertising approaches two-thirds of all advertising, that growth is now leveling off, and as one of the two largest players (and beneficiaries) of the market, Facebook is facing a growth crunch.
2. Online advertising is cyclical: As online advertising has grown over the last decade, there were some who argued that online advertising would be more resilient than traditional advertising, in the face of economic shocks, but this year's developments have shown otherwise. As economic growth has slowed and concerns about a recession have risen, revenue growth has dropped at all the companies in this space has declined. The conclusion is that online advertising is cyclical, and if we are in the midst of an economic slowdown, the companies in this space will feel the pain.
3. Reputation effects: While Facebook made it through the privacy challenges with revenue growth and profitability intact, it is undeniable that the company's reputation took a beating. In my view, this toxicity, as much as the desire to enter a new market in the Metaverse, explains why Facebook changed its name to Meta in November 2021.

Corporate Governance: The Stakeholders



Shareholder vs Stockholders

- It is true that conventional corporate finance (and the Delaware courts) give primacy to shareholders, and it is not because shareholders are a special or protected group, but It is because *they are the only claim holders that do not have a contractual claim on the firm; as shareholders you get what's left over after contractual claims (wages, interest expenses) have been met*.
- There is of course a notion that managers should be accountable to all stakeholders. Stakeholder wealth maximization is fanciful in its belief that it is management's job to juggle the divergent interests of different stakeholders and dangerous insofar as it makes managers accountable to everyone, and by extension, to no one.

Conflicts of Interests: Consequences

- If you are looking at a privately owned business, with a sole owner who also runs the business, the interests of owners and managers converge, but this is the exception, not the rule.
  - Even in a family-owned business, where one family member runs the business, you can have other family members disagree about how it is run, leading to frictions and legal battles.
  - As businesses seek external capital to grow, either from private hands (venture capitalists) or public equity, the divergence between the interests of those running businesses and the owners of these businesses will increase.

Where conflicts of interest are greatest…

- If the conflict of interest that is at the heart of corporate governance is that between the owners of a business and those who manage that business, it will begin when private businesses seek out capital from external sources, as founder and venture capital interests can diverge.
- These conflicts will expand, as companies go first go public, and the interests of insiders and founders, who run the firm, can be at odds with the interests of outside shareholders.
- As companies age, founders will move on and get replaced by professional managers, and these managerial interests can clearly be at odds with those of shareholders, with boards of directors, in theory, watching out for the latter. In short, conflicts of interest exist at almost all businesses, though the nature of the conflict will change as companies go from private to public, and as they age.

Consequences of conflicts of interests..

- When the interests of decision makers or managers at a business diverge from those of its owners, it is inevitable that there will be decisions made that advance the interests of the former at the expense of the latter.
  - With private business that access venture capital, founders may make decisions (on product design, business models, marketing) that venture capitalists may not find to their liking.
  - With public companies that are run by founders/insiders, the decisions made by inside shareholders to advance their interests may not align with the interests of outside shareholders.
  - In older public companies, the investing, financing and dividend decisions that managers make may by in direct opposition to what shareholders would like them to do.

Checks on conflicts of interest…

- In private firms with venture capital investors, VC investors are often actively involved in management, and, if they have the power, have few compunctions about pushing out founder/managers who don't serve their interests.
- In public companies, with insiders and founders in charge, the only recourse that outside shareholders often have, if they feel their interests are being ignored, is to sell and move on, hoping that the resulting drop in stock prices causes a change in course.
- In theory, the boards of directors at these companies are supposed to protect shareholder interests, but that protection is sporadic and often ineffective.

Corporate Governance: The Distractions

- In the aftermath of the Enron and Tyco scandals in the United States, where insider-dominated boards were negligent in their oversight responsibilities, the Sarbanes-Oxley Act was passed in 2002, with improved corporate governance as one of its objectives.
- At about the same time, you saw the advent of services that used the disclosures that companies were required to make on governance to estimate corporate governance scores.
- It is clear that twenty years later that all that Sarbanes Oxley has accomplished is replacing ineffective insider-dominated boards with ineffective independent boards, while creating hundreds of pages of disclosure that no one reads and giving rise to scores that are close to useless in judging governance.
- With the push towards diversity in board composition now taking precedence, this process is hurtling even more into irrelevance, with the only positive being that the ineffective boards of the future will meet all our diversity criteria.

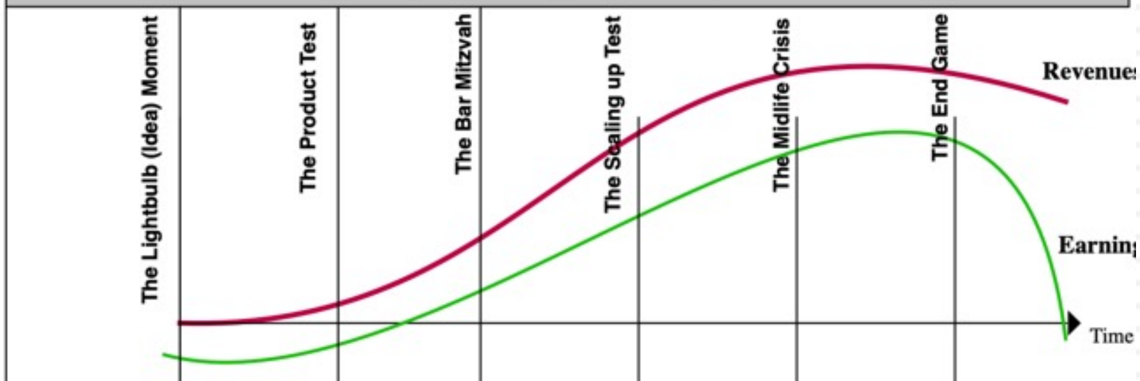
Corporate Governance and Management Change

- We have to reframe the meaning of good corporate governance, shifting away from a board-centered, check-box driven view to one that is centered on giving shareholders the power to change company management, if they choose to.
- In fact, good corporate governance is like a good democracy, where shareholders (voters) get the power to change management (governments), when they believe that their interests are not being served.
  - As in a democracy, there is no guarantee that shareholders will make the right or even informed choices, sometimes choosing not to make changes, even when change is required, and sometimes deciding to replace good managers with bad ones.
  - Good corporate governance is sometimes chaotic and often unsettling, and it is no surprise that there are many who are drawn to the benevolent dictatorship model, where "qualified, well-intentioned managers" are given lifetime tenure, with shareholders stripped of the power to challenge them.
  - That latter model was the default for publicly traded companies in much of the world, for the twentieth century, and even in the US, you had managerial apologists like Marty Lipton and corporate strategists arguing that corporate management would be more effective, without shareholder oversight.

Source: Honey, I shrunk the ESG alpha

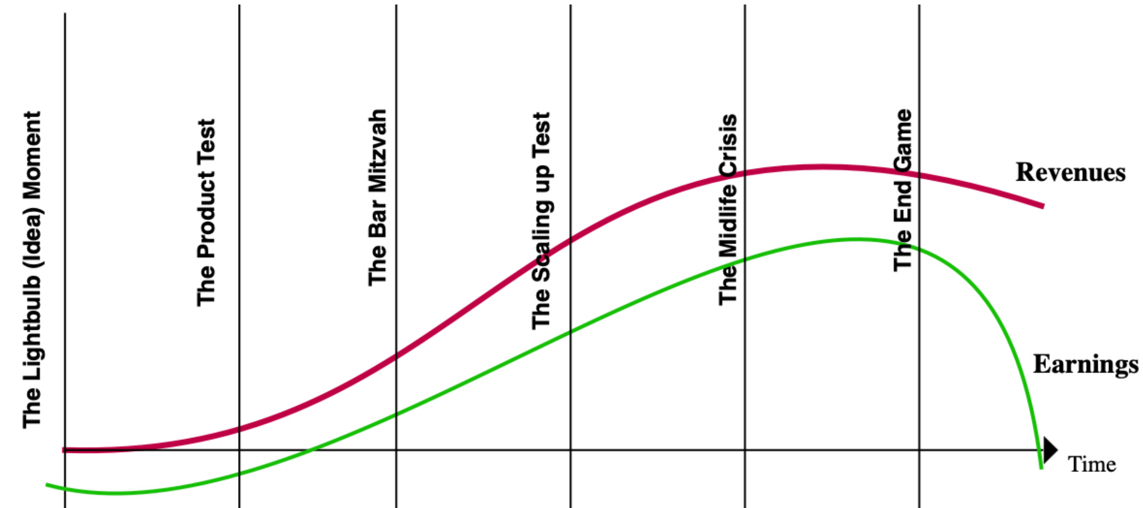
Management Matches: The Life Cycle

The Corporate Life Cycle: The "Right" CEO



Lifecycle stage	Start-up	Young Growth	High Growth	Mature Growth	Mature Stable	Decline
Management's Importance	Critical, in selling vision & creating business model		Decreases as firm matures, and more so in macro businesses			Significant, since denial or desperation can be costly.
Management role in narrative/ numbers	Visionary/Story Teller	Stay consistent with words & actions	Deliver numbers to back up story	Keep narrative in sync with numbers	Adjust your narrative to reflect where you are in the life cycle.	Act your age (in terms of narrative & choices)
Management key function	Sell a vision (story) to investors and employees	Build a business model to deliver on vision	Scale up the business model	Extend the business model into new maarkets	Defend the business model against competitors	Scale down the business model
The Right CEO	**Steve, the Visionary**	**Paula, the Pragmatist**	**Bob, the Builder**	**Oscar, the Opportunist**	**Donna, the Defender**	**Larry, the Liquidator**

Management Mismatches: The Life Cycle



Lifecycle stage	Start-up	Young Growth	High Growth	Mature Growth	Mature Stable	Decline
Reasons for Mismatch	1. Purism over pragmatism 2. Control fixation 3. Low interest/skillset in business building		1. Scale up at any cost 2. Too risk averse to scale	1. Scaling over profitability 2. Living in the past	1. Growth delusions 2. Empire building 3. Moat Neglect	1. Denial 2. Desperation 3. Survival at any cost
Catalysts for Management Change	Disgruntled VCs or unhappy co-founders	Insider shareholders with large stakes	Activist investor, with divergent views on scaling	Change at the top (voluntary)	Activist institution, with coalition-building skills	Private Equity and activist investors
Barriers to Management Change	Founder's controlling stake	1. Founder Worship 2. Shares with differential voting rights	1. Founder equity stake 2. No scaling consensus	1. Insider ownership 2. Glow from past success(es)	1. Passive investor base 2. Charter amendments 3. Complex structures.	1. Social pushback 2. Legal Process

Management Mismatches: Consequences

CEO and Company Mismatch: Consequences

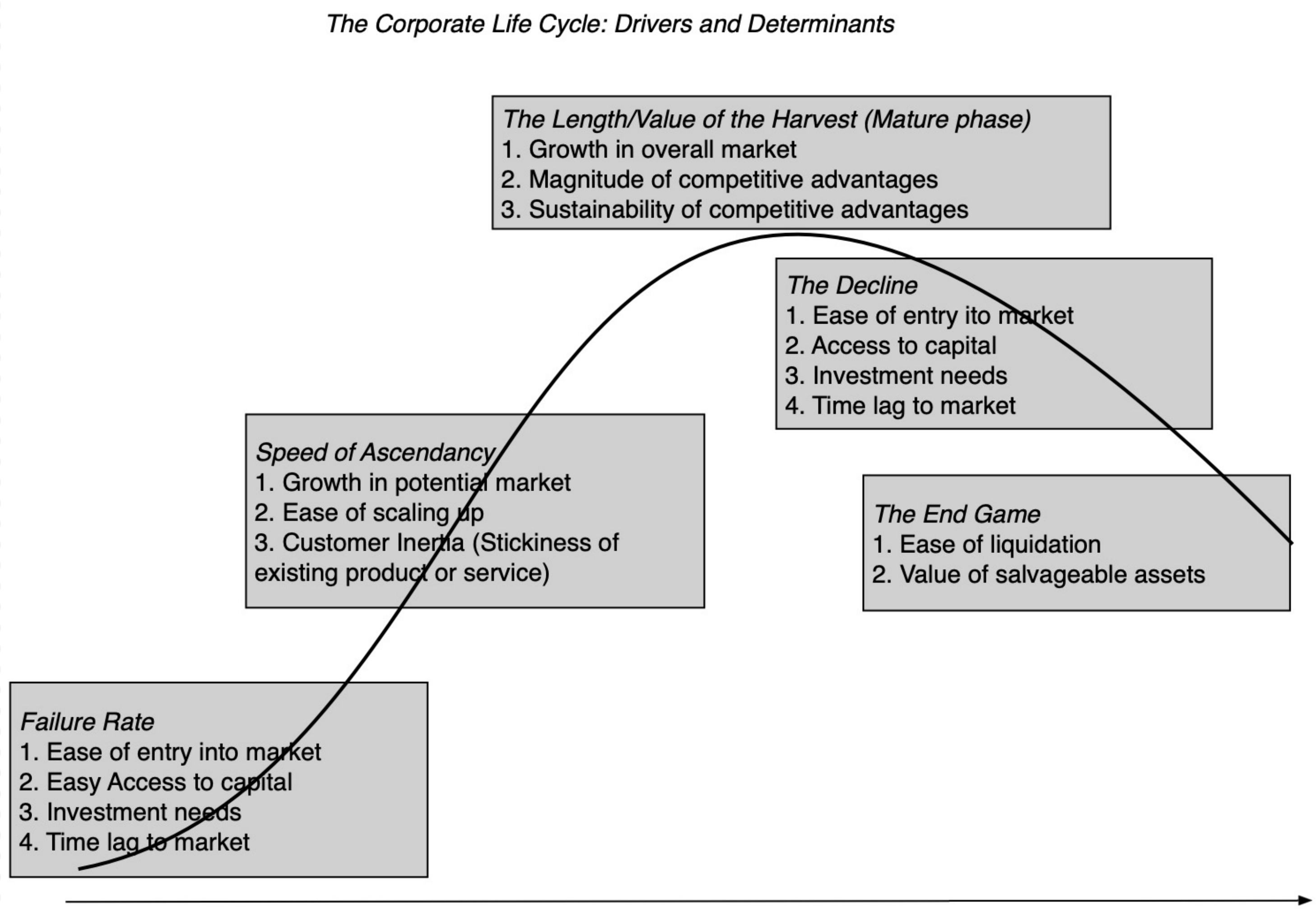
Benign Scenario	Intermediate Scenario	Malignant Scenario
The mismatched CEO recognizes the mismatch and gets a partner or co-executive to fill in the gap.	The intermediate CEO is replaced, albeit after damage is done, with longer waits leading to more damage.	The mismatched CEO, left unchecked and unchallenged, continues to act in destructive ways.

← *Effect on Value of the Company* →

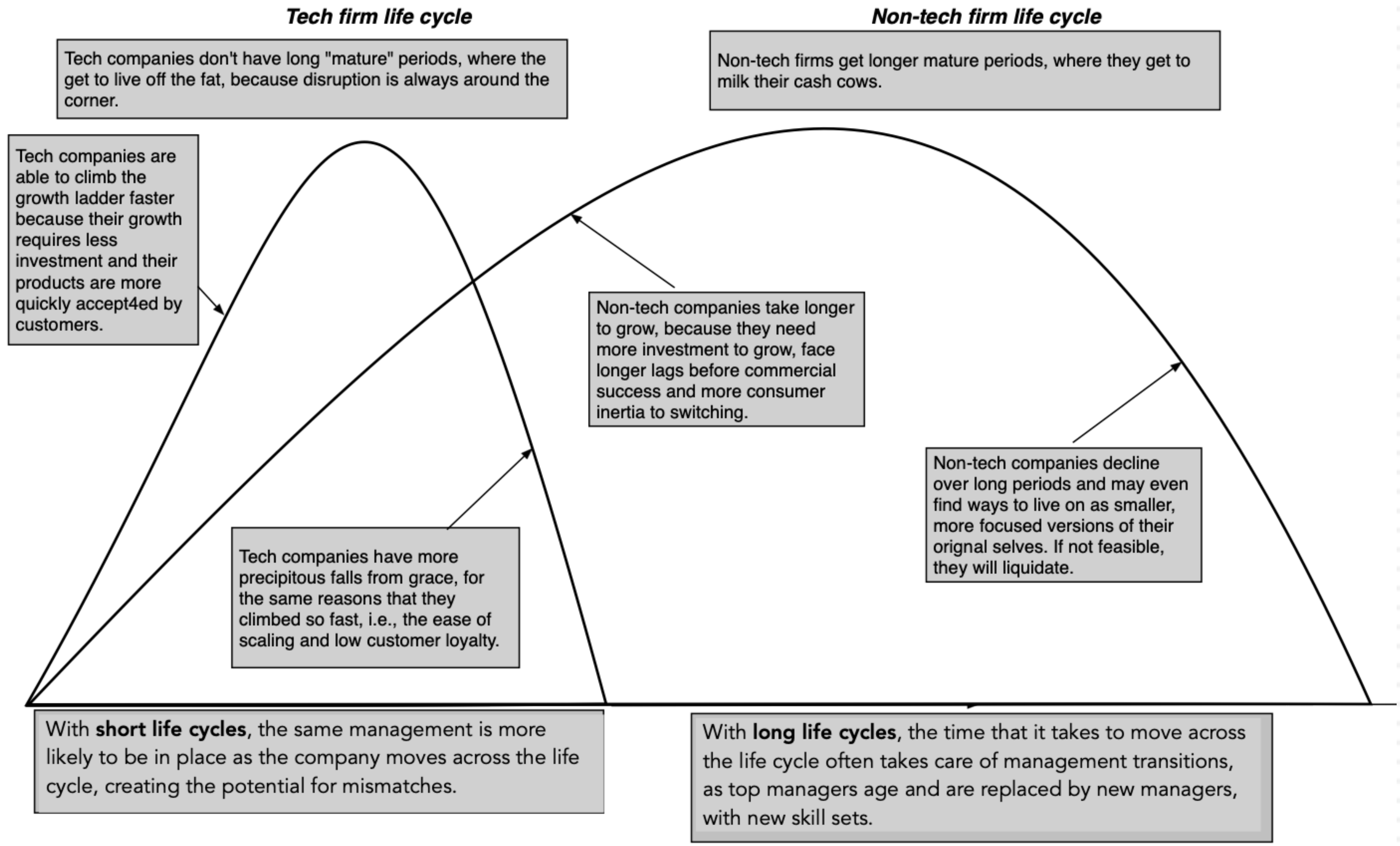
Low to non-existent

High to Catstrophic

The Life Cycle: Determinants



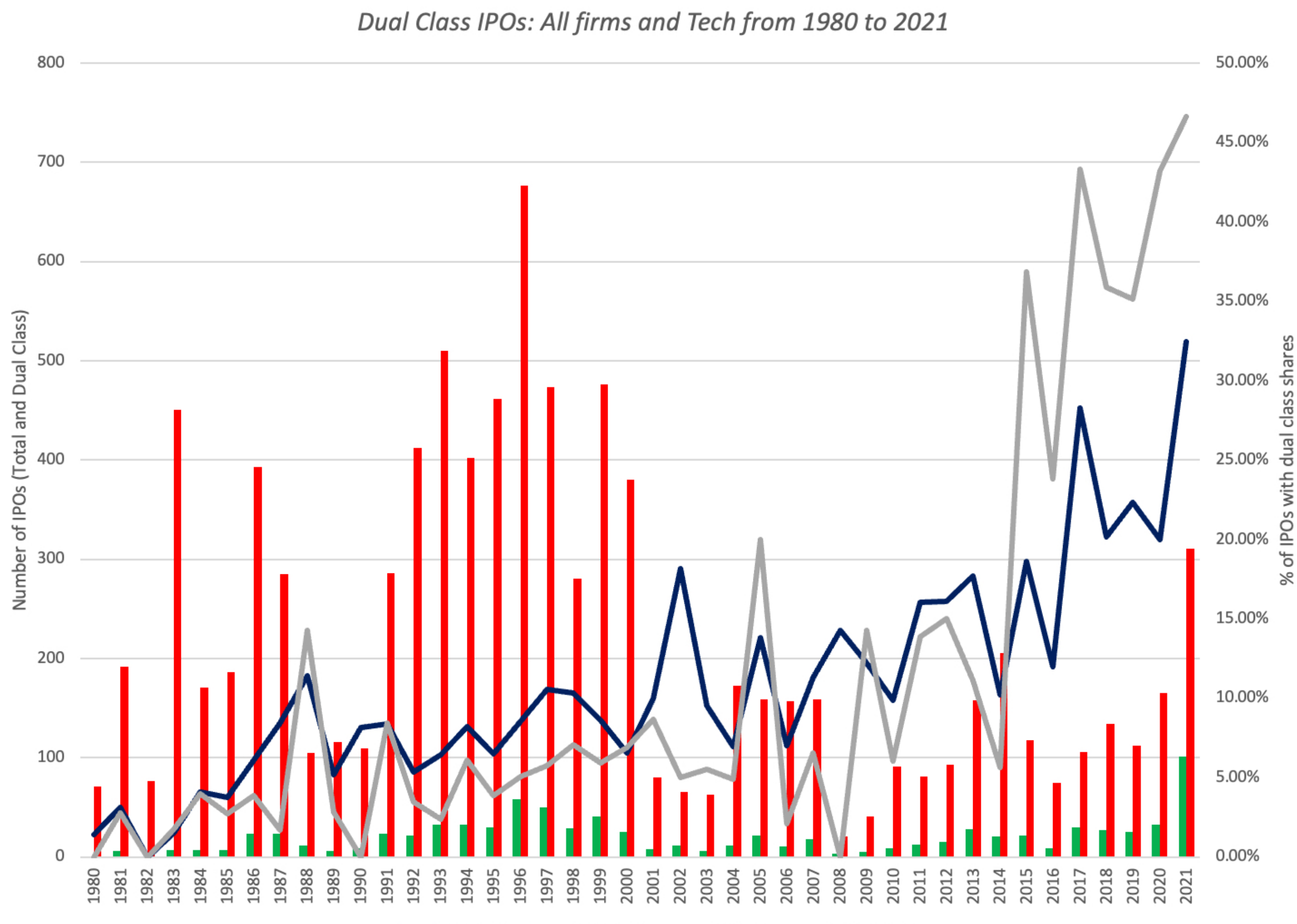
Tech Companies: Life Cycle Effects



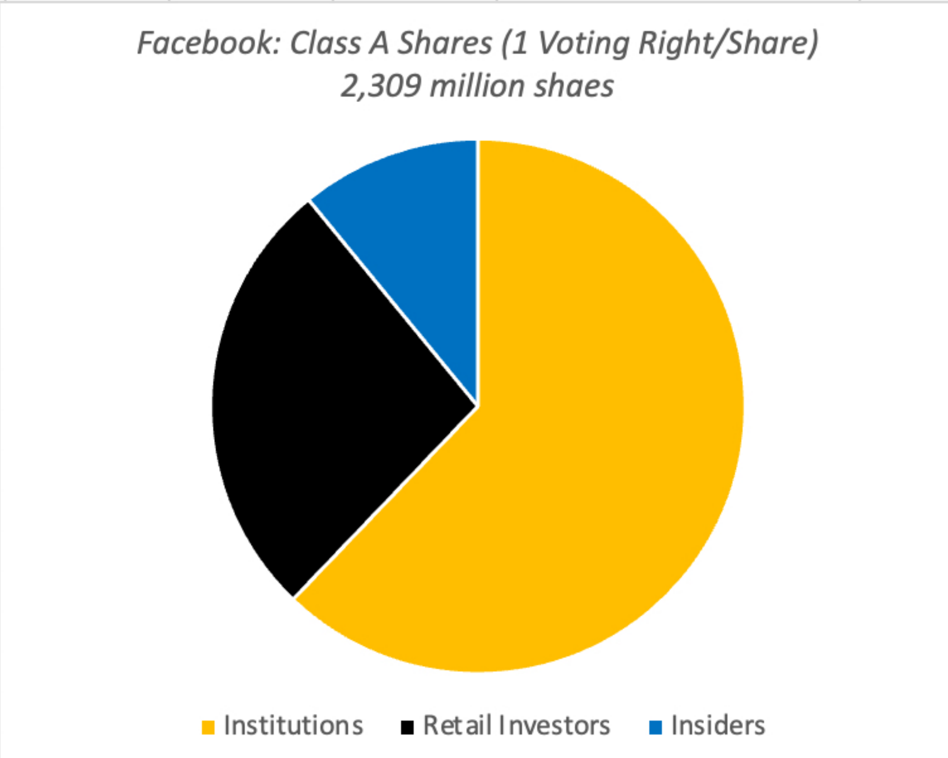
Management Mismatches at tech firms

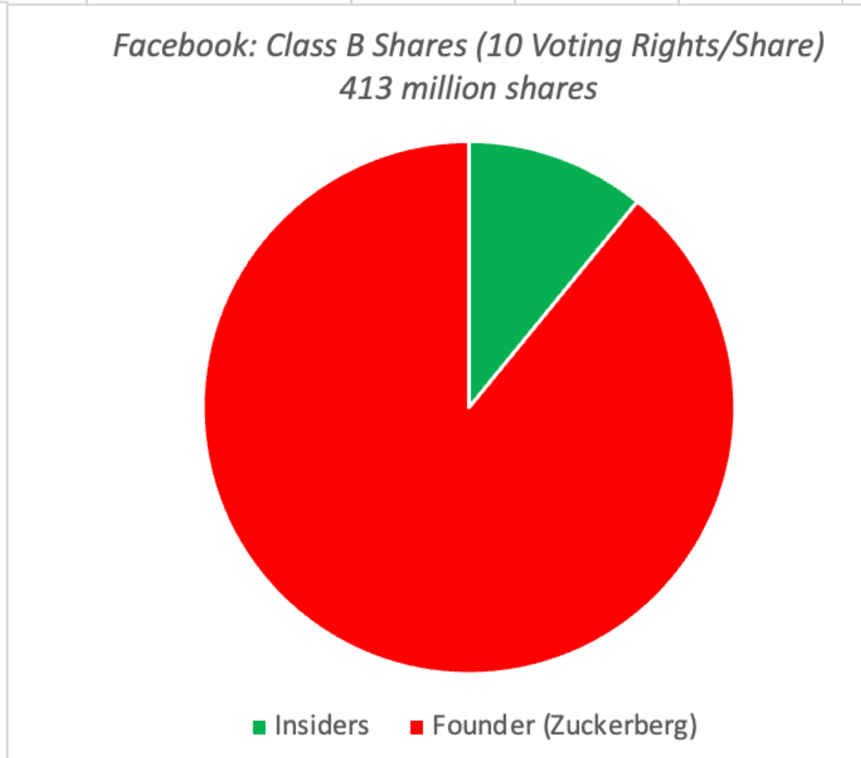
- With the long life-cycle companies that characterizes the twentieth century, companies and managers both aged over time, allowing for transitions to occur more naturally. To see, why consider how corporate governance played out at Ford, a twentieth century corporate success story.
  - Henry Ford, undoubtedly a visionary, but a crank on some dimensions, was Ford's CEO from 1906 to 1945. His vision of making automobiles affordable to the masses, with the Model T (but only in black), was a catalyst in Ford's success, but by the end of his tenure in 1945, his management style was already out of sync with the company. With Ford, time and mortality solved the problem, and his grandson, Henry Ford II, was a better custodian for the firms in the decades that followed.
  - In contrast, consider how quickly Blackberry, as a company, soared, how short its stay at the top was, and how steep its descent was, as other companies entered the smartphone business. Mike Lazaridis, one of the co-founders of the company, and Jim Balsillie, the CEO he hired in 1992 to guide the company, presided over both its soaring success, gaining accolades for their management skills for doing so, as well as its collapse, drawing jeers from the same crowd. By the time, the change in top management happened in 2012, it was viewed as too little, too late

The Investor Surrender



And at Facebook…





	% of shares	% of voting rights
Institutions	52.72%	22.29%
Retail Investors	22.83%	9.65%
Insiders (no Zuckerberg)	10.93%	10.92%
Zuckerberg	13.52%	57.14%

The Culprits…

1. Market-share seeking Stock Exchanges: For much of the last century, starting with a de facto ban in 1926 and a rule in 1940, the New York Stock Exchange barred companies listed on the exchange from from issuing shares with different voting rights, and with its dominance over US equity markets, that became the rule followed by most US companies. The American Stock Exchange adopted slightly looser rules, hoping to get market share from the NYSE, but it was the NASDAQ that threw caution to the winds entirely and removed all restrictions on voting and non-voting shares.
2. Founder Worshippers: For the last few decades, we have glorified the founders of technology companies, and while there is much to admire in their accomplishments, there is a danger in putting them on pedestals and attributing to them heroic or superhuman qualities. In the case of companies like Google and Facebook, and especially so at the time of their public offerings, there were many investors, including some of the largest institutional players, that were willing to make the trade off of giving up power to change management in return for being invested in companies run by "young, tech geniuses".
3. Lazy Investors: Most of us, as investors, chose to give away our voting rights willingly because we wanted shares of the "next big thing", and at the time we did so, we rationalized it by arguing it that we would not need that voting power any time soon.
4. Lax Regulators: For some of you reading this post, the villain is going to be the SEC and regulators, with the argument being that they could have protected you by banning dual class shares.

Consequences for Corporate Governance at Tech Companies

1. <u>Chaotic Management Transitions</u>: It is true that we have made it more difficult to change management at tech companies, even when that change is overdue. That said, there will be tech companies where change will occur, but my prediction is that this change will often be forced by either insider in-fighting (where co-founders and insiders turn on each other) or precipitated by a pricing collapse.
2. <u>Locked-in Mismatches</u>: There are other tech companies where the game has been so thoroughly tilted in favor of insiders and incumbent management that change is impossible. In these companies, as an outside investor, you have to build that reality into your valuations, leading to discounts to your value that reflect how much you trust management. In short, if management has adopted policies that are value-destructive, in the long term, there will be a much smaller chance of reversal at companies with locked-in management than at companies where change remains possible.
3. <u>Voting Share/Non-voting Shares</u>: When tech companies go public, it is entirely possible that there will be a honeymoon period, perhaps even an extended one, where investors are dazzled by scaling successes and are willing to overlook shortcoming, when shares with different voting rights trade at the similar prices. As disillusionment sets in, I would expect voting share premiums to rise, and to rise more at those firms where investors trust managers the least.