Hubris and the risks of over-mighty tech bosses

History is littered with tales of the tragic downfall of entrepreneurs who let success breed overconfidence. So, how can investors tell when a lack of accountability becomes a problem?

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All superheroes have their flaws. Achilles has his heel. Ironman his heart. Superman kryptonite. For today's corporate crusaders it is hubris.

History is littered with tales of the tragic downfall of entrepreneurs who let success breed overconfidence.

This year has seen rather a lot of hubris punished. Take the demise of Sam Bankman-Fried's cryptocurrency platform, FTX; the chaos descending on Twitter following Elon Musk's takeover; or Facebook's Meta-morphosis.

Investors love a superhero. We recognise and value the energy and commitment of founder-entrepreneurs. But we must also understand the risks when handing over our cash to them. Many of the world's largest technology companies are not as accountable to shareholders as you might think.

Often when coming to the market, the founders award themselves a different class of shares that can carry 20 times the voting power of those available to us "ordinary shareholders". In 2020, roughly 60 per cent by value of US initial public offerings (IPOs) used dual voting class shares. In 2018 it was 17 per cent.

Retaining the majority of the voting rights can give these founders the power to do what they like and suggests an attitude of not wanting to discuss things with outsiders or to be held to account. But if you do not want to be accountable, why become a public listed company?

Zoom

In early 2019 we met the management of a little-known company called Zoom. We liked the business. We did not like the excess stock-based compensation model, which we believed put too much power in the hands of Eric Yuan and other founders.

We declined to participate in the IPO. That decision looked foolish as pandemic gripped the world and Zoom's shares soared. Today, though, the share price is down 84 per cent from its October 2020 high.

2020's IPOs

Looking back on how some of the largest of the class of 2020 IPOs have fared is enlightening. Airbnb's shares are down 43 per cent this year.

DoorDash, the US food delivery platform founded by 37-year-old chief executive, Tony Xu, and friends Andy Fang and Stanley Tang, is down 60 per cent.

Both companies gave their founders significant power through "Class B" shares when floated.

So did cloud data warehousing business Snowflake, though it decided earlier this year to abandon its dual share structure. Its shares are down 56 per cent. By comparison, the US Index is down just 17 per cent over the past year.

Tech

Many of the largest technology companies also have dual share classes. Meta and Alphabet's founders have just over half the voting rights. Shares in Meta have fallen by 67 per cent over the past year, while Alphabet's have dropped 32 per cent.

Amazon.com does not have dual voting rights, but founder Jeff Bezos still owns near 10 per cent. The shares are down by 45 per cent this year.

Microsoft has a "one share, one vote" principle. Its shares are down 26 per cent this year.

Signs of hubris

How can you tell if hubris is becoming a problem? Throwing money at projects that have little to do with your core business comes to mind — sending rockets into space or building self-crashing cars. Hubris can put management teams' visions ahead of value for shareholders.

Another sign is expanding headcount faster than the company is growing. Amazon now has around 1.6mn employees, more than the NHS and putting it almost up with the Chinese Red Army in complexity. But over the past five years dollar sales per employee have fallen by 8 per cent.

Meta's dollar sales per employee have remained stagnant in the face of a workforce that has more than tripled in size to 87,000. That was before the recent announcement of 11,000 job cuts.

Meanwhile, at Microsoft, where the workforce has nearly doubled to 221,000, dollar sales per employee are up 40 per cent.

When the good times end

The concern that investors should have over dual share structure companies is similar to the concern about political risk. What happens if things start going wrong?

There are many reasons for the demise of tech stocks this year — for Zoom the lifting of lockdown, for others inflation, recession fears or concerns about revenue. But companies that do not want to be held accountable to shareholders frequently become problematic in bear markets.

How well our all-powerful founder-bosses manage in the coming year will be interesting. Most have not had to control costs so carefully for a long time.

The four established giant technology companies I have mentioned all disappointed the market with their most recent financial statements. However, one of them seems to have more stable prospects than the others. Suffice to say, Microsoft is a top 10 holding for us.

In general terms, the financial announcements made for the third quarter of the year saw revenues at many tech companies disappoint. They also saw costs rising, sometimes by surprising amounts.

Much of this comes back to people – skilled professionals who had been paid in shares wanting cash instead. Paying in shares has become a common way for US companies to reward staff. It has been tax-efficient and can help mask true employee costs in financial reports.

But when share prices are weak it is cash, not shares, that staff need to pay their bills. In Alphabet's last report costs and expenses (people) rose nearly 18 per cent, while revenues rose 6 per cent. This is why, when valuing a company, we always try to calculate what costs would look like if senior staff were paid market rates in cash rather than share options.

How well our all-powerful founder-bosses manage in the coming year will be interesting. Most have not had to control costs so carefully for a long time. They may struggle to balance the needs of their business with the interests of shareholders. Sadly, those shareholders may have little influence over their decisions.

It cannot be denied that over the past decade many of the tech superheroes have done a great job. Investors have been rewarded. We have participated in that success ourselves. But it pays to understand the risk you take on when you buy a stake in a company where your vote counts for so little. You have to put a lot of trust in these chief executives and their mythological powers. Is that trust still justified?

Simon Edelsten

Manages:
'Global select' strategy

Simon manages Artemis' 'global select' strategy with Alex Illingworth.

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