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BTN Thursday Thoughts

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Tech Companies and Capital Needs

(FB, TWTR, TSLA, NFLX AMZN)

With the recent pressure that tech stocks have faced, the debate has begun if it is time to buy the dips or are the companies about to see a prolonged wave of negative investor sentiment that will continue pushing down the stock prices. Some of these companies have lofty valuations and we're not going to comment on that topic here. Instead, we are going to highlight that some of these companies need continual external capital to fund their businesses and others are able to fund their businesses internally.

In our view, companies that are more likely to suffer a prolonged swoon in stock price are the ones that need to raise more equity and debt when perceptions are negative. It quickly becomes obvious that not all of the new tech companies are equal in this area. For example, compare Facebook and Twitter:

Facebook	2017	2016	2015	2014	2013
Cash from Ops	$24,216	$16,108	$10,320	$5,457	$4,222
Less Share Comp	$3,723	$3,218	$2,960	$1,786	$906
Less CapX	$6,733	$4,491	$2,523	$1,831	$1,362
Acquisitions	$122	$123	$313	$4,975	$368
Free Cash Flow	$13,638	$8,522	$4,524	($3,135)	$1,586
Share Count	2,956	2,925	2,853	2,664	2,517

Twitter	2017	2016	2015	2014	2013
Cash from Ops	$831	$763	$383	$82	$1
Less Share Comp	$434	$615	$679	$632	$600
Less CapX	$284	$319	$379	$342	$232
Acquisitions	$1	$168	$579	$311	$340
Free Cash Flow	$112	($339)	($1,252)	($1,204)	($1,170)
Share Count	733	702	622	605	190

In both cases, we adjusted the cash flow for compensation paid with equity as well as acquisitions with stock. Under this method, Facebook had negative free cash flow once in the last five years due to a large acquisition in 2014. Facebook also is not seeing excessive share dilution and it has $42 billion in cash vs. total debt of only $10 billion. It would be free cash flow positive if it paid its employees fully in cash.

We wrote about Twitter a few weeks ago and it is a much different cash flow story than Facebook. No one wanted its stock for an acquisition last year, which stemmed some of the cash flow burn in 2017. The company also cut advertising, R&D, and capital spending to help cash flow and we believe it may already be using fully depreciated equipment. So with all those cuts, TWTR managed its first free cash flow positive year in the last five. The company has been issuing shares much more rapidly. While it still has $4.4 billion in cash vs. $2.4 billion in total debt, that cushion isn't huge for a company that regularly burns through large amounts of cash.

Another name that is in the news quite often is Tesla. We won't spend too much time here because this story of it acquiring Solar City is well known along with the problems it has had delivering cars. It's debatable if this is really a tech company or a car company. What is obvious is teen-age girls at the mall would tip their tiaras to them as Tesla has been able to spend money at a rate few could imagine and is one of the few companies we've ever seen report negative cash flow from operations despite share-based compensation and hefty depreciation:

Tesla	2017	2016	2015	2014	2013
Cash from Ops	($61)	($124)	($525)	($57)	$265
Less Share Comp	$467	$334	$198	$156	$81
Less CapX	$4,329	$1,945	$1,902	$1,224	$303
Acquisitions	$125	$1,933	$12	$0	$0
Free Cash Flow	($4,982)	($4,336)	($2,637)	($1,437)	($119)
Share Count	166	144	128	125	119

So Tesla's cash burn is accelerating, its shares are being diluted at a faster rate, and it has only $3.4 billion in cash with over $23 billion in liabilities. Of the $23 billion, over $10 billion are now bonds and thus incur interest expense. This company does not need another cash cost.

A third company we want to highlight is Netflix, which has been growing its subscriptions and programming.

Netflix	2017	2016	2015	2014	2013
Cash from Ops	($1,786)	($1,474)	($749)	$16	$98
Less Share Comp	$182	$174	$125	$115	$73
Less CapX	$227	$185	$169	$144	$120
Acquisitions	$0	$0	$0	$0	$0
Free Cash Flow	($2,195)	($1,833)	($1,043)	($243)	($95)
Share Count	447	439	437	432	425

The reason Netflix has become such a cash consumer is it has boosted its efforts in licensing and creating its streaming content. It amortizes these assets rapidly, which penalizes earnings. That is a conservative way to account for it and while some assets may last up to ten years, many are amortized when they are aired the first time such as talk shows or the accelerated methods will dramatically cut the value of the asset on the balance sheet very rapidly. While conservative, this also conforms to the basic operating model, which is content assets normally require cash upfront and replacing that content is a huge cash investment every year. Thus, here is what is going on in the cash flow statement:

	2017	2016	2015	2014	2013
Additions to Content - Neg Cash	($9,806)	($8,653)	($5,772)	($3,773)	($3,031)
Amortization of Content - Pos Cash	$6,198	$4,788	$3,405	$2,656	$2,122
Net Cash Flow from Content	($3,608)	($3,865)	($2,367)	($1,117)	($909)

Comparing the negative cash flow from creating content to actual free cash flow, it is clear that Netflix would be cash flow positive if it were not paying so much for new media content. The question is how does this really stop? The company needs to have content to attract and retain customers. The company has $2.8 billion in cash, which is still a large figure even compared to $15.4 billion in liabilities. However, the existing bill coming due for content within 12 months is $4.2 billion vs. the $2.8 billion in cash. Moreover, while Netflix is not seeing massive stock dilution, it has started to borrow money very rapidly.

	2017	2016	2015	2014	2013
New Borrowing	$3,021	$1,000	$1,500	$400	$500
Total Net Debt *	$11,180	$8,158	$4,875	$2,970	$2,421
Equity	$3,582	$2,680	$2,223	$1,858	$1,334
Operating Inc.	$839	$380	$306	$403	$228
ROI	5.70%	3.50%	4.30%	8.30%	6.10%

*Total Net Debt is the sum of outstanding LT Debt + LT Content Obligations + ST Content Obligations – Cash – ST Investments

We believe the content liabilities clearly represent debt that will be paid quickly. The borrowing figure above only represents increases in debt in the form of bonds or bank borrowing. We believe the ROI is declining here but the timing of when debt is incurred vs. the earnings period can skew that figure. We ran that simply as 12 months trailing Operating Income divided by period ending Total Net Debt and Equity. Before content spending exploded and a growing drag on cash flow, Netflix ROI was higher. It is important to note that the company is borrowing money at 3-5/8%-5-7/8% now. ROI is not covering the cost of funds very often and borrowing new money amid rising interest rates may become a problem here.

Amazon.com is another company that often is part of the large tech stocks. This one is has seen cash flow pressure as it builds its Cloud business and its logistical network.

Amazon.com	2017	2016	2015	2014	2013
Cash from Ops	$18,434	$17,272	$12,039	$6,842	$5,475
Less Share Comp	$4,215	$2,975	$2,119	$1,497	$1,134
Less CapX	$11,955	$7,804	$5,387	$4,893	$3,444
Cap Leases	$4,799	$3,860	$2,462	$1,285	$775
Acquisitions	$13,972	$116	$795	$979	$312
Free Cash Flow	($16,507)	$2,517	$1,276	($1,812)	($190)
Share Count	493	484	477	462	465

Since Amazon started its AWS (Cloud Storage) operation, capital spending has risen very rapidly. It is even a bigger investment as it has bought much of the equipment via capital leases. This allows traditional cash flow measures to appear larger. Cash from operations only include the interest expense, not the principal payments. Cash from Investing Activities are not penalized for the capital spending as the payments flow through over time in the financing section. The amount of spending in this area has picked up considerably:

	2017	2016	2015	2014	2013
Capital Lease Additions	$9,637	$5,704	$4,717	$4,008	$1,867
Capital Lease Payments	$4,799	$3,860	$2,462	$1,285	$775

If these assets were bought with cash and flowed through the investing section, free cash flow would be much lower. All the purchases eventually become debt that is repaid with interest and consumes cash flow.

Amazon still has $31 billion in cash, which exceeds its debt. It also has faster turning current assets like inventories and payables that become cash. We have issues that Amazon's retail operation may face higher logistical costs going forward and it is already lower margin than several bricks-and-mortar retailers. We think the cash flow here may be pressured going forward because of the Cloud and the leases. But, eventually, the Cloud operation should involve hefty maintenance investment, but the cash flows should be stronger. Even adjusting for capital leases the company is free cash flow positive.

To summarize these companies – all seek to preserve cash by paying employees with stock. This works if the stock price is strong and employees see it becoming higher pay. If the stock price declines, the compensation from equity declines and eventually employees want more cash wages. Facebook and Netflix probably have the least pressure in this area. Facebook has been cash flow positive even if all of this was turned into a cash expense. Netflix has a much smaller amount of pay here.

On recent cash flow trends, we have a much greater issue with both Netflix and Tesla. Both appear to need rising levels of capital to fund their new spending. Amazon fits this mold now with the Cloud build-out. However, Amazon still has significant cash on hand and it could shrink the cash burn by slowing the rollout of the Cloud business. We also do not expect Amazon to make a Whole Foods type of acquisition every year and that was a big part of its enormous spending in 2017. So, this is a question of inherent cash flow burn vs. either a one-time event or expanding at a faster pace.

Social media is coming under the most regulatory pressure right now. That should impact both Facebook and Twitter. Regulation normally means more expenses. Facebook would again be in a stronger position to absorb that and has much greater liquidity. We believe Twitter will need to see higher R&D and higher capital spending going forward before any regulatory issues.

It's worth pointing out that during Mark Zuckerberg's testimony on Tuesday, all of these stocks were responding very favorably. In the S&P 500, AMZN, FB, NFLIX are 4.35% of the index and in the Nasdaq 100, AMZN, FB, NFLIX, and TSLA are 16.78% of the index. Passively run index and index hugging strategies have some sizable exposure to companies with cash flow problems. We would be leery of problems like these hurting returns in the future.

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