Stock options and share dilution

Amazon letters: 2001, 1997 · Difficulty: Intro

Summary

Paying employees with **stock options** saves cash but adds shares. **Dilution** spreads the same cash flow over more shares, so value per share falls. In 2001 Bezos set a target for net dilution from employee options of about 3% per year.

2001 letter

Because a share of stock is a share of a company's future cash flows, and, as a result, cash flows more than any other single variable seem to do the best job of explaining a company's stock price over the long term. If you could know for certain just two things--a company’s future cash flows and its future number of shares outstanding--you would have an excellent idea of the fair value of a share of that company’s stock today. (You’d also need to know appropriate discount rates, but if you knew the future cash flows for certain, it would also be reasonably easy to know which discount rates to use.) It’s not easy, but you can make an informed forecast of future cash flows by examining a company’s performance in the past and by looking at factors such as the leverage points and scalability in that company’s model. Estimating the number of shares outstanding in the future requires you to forecast items such as option grants to employees or other potential capital transactions.

Ultimately, your determination of cash flow per share will be a strong indicator of the price you might be willing to pay for a share of ownership in any company.

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Our trailing twelve-month pro forma net income should, roughly but not perfectly, trend like trailing twelve-month cash flow. Limiting share count means more cash flow per share and more long-term value for owners. Our current objective is to target net dilution from employee stock options (grants net of cancellations) to an average of 3% per year over the next five years, although in any given year it might be higher or lower. Relentless commitment to long-term shareholder value As I’ve discussed many times before, we are firm believers that the long-term interests of shareholders are tightly linked to the interests of our customers: if we do our jobs right, today's customers will buy more tomorrow, we’ll add more customers in the process, and it will all add up to more cash flow and more long-term value for our shareholders.

1997 letter

We understand the importance of continually reinforcing a cost-conscious culture, particularly in a business incurring net losses. • We will balance our focus on growth with emphasis on long-term profitability and capital management. At this stage, we choose to prioritize growth because we believe that scale is central to achieving the potential of our business model. • 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 by our ability to attract and retain a motivated employee base, each of whom must think like, and therefore must actually be, an owner.

Source: Jeffrey P. Bezos, Letters to Amazon.com Shareholders: 2001, 1997 (ir.aboutamazon.com). Excerpts © Amazon.com, Inc., all rights reserved; reproduced in part for non-commercial teaching. “…” marks skipped text. The summary is original course material by Jaeyoon Yu; not affiliated with or endorsed by Amazon.com, Inc.