Seeking Alpha

Is A Snap Buyout In Store? Unlikely

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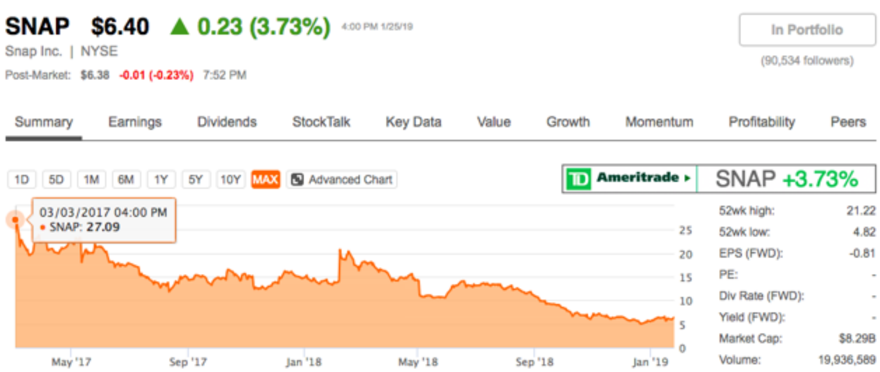
by: Seven Corners Capital Management

Summary

- Snap longs are probably hoping for a buyout to mitigate some of their losses.
- Unfortunately they have no say in the matter, only CEO Evan Spiegel and CTO Bobby Murphy do.
- For tax and other reasons, it makes little sense for the two founders to sell the company, nor are there logical buyers other than Facebook.
- Hence, Snap longs will need to pin their hopes on a turnaround of the flagging underlying business.

It has been a tough row for Snap Inc (SNAP) longs to hoe since the company's March 2017 IPO, with the stock down over 75% from where it initially traded. Disastrous financial results during 2018, combined with significant turmoil inside the company, have resulted in the company's stock losing over half of its value over the past year, with shares recently trading just 33% above all-time lows:



SNAP longs should be forgiven if they view the best path forward as a buyout of the company, rather than trudging on alone. First of all, a buyout at a healthy premium would mitigate some of their unrealized losses in Snap stock. Merger premiums recently for tech companies have been quite healthy. Witness, for example, the 63% premium that IBM (IBM) paid for Red Hat (RHT) (see here); a similar premium for Snap would put the buyout price over $10/share. Second, a sale of the company to a financially healthy buyer (such as Amazon (AMZN), Apple (AAPL) or Alphabet aka Google (GOOG)) would allow Snap to continue scaling its cash-burning business model without distracting funding concerns, as well as stem the recent mass exodus of senior executives (for example, note the unexpected departure of the CFO several weeks ago).

Industry observers have stoked buyout hopes over the past year as Snap's shares have declined. A writer for Techcrunch had the following to say on the matter in late October 2018 (source):

> Snap could...surrender as an independent company and be acquired by a deep-pocketed tech giant. Without having to worry about finances or short-term goals, Snap could invest in improving its features and app performance for the long-term. Social networks are tough to kill entirely, so despite competition, Snap could become lucrative if aided through this rough spot.

Another commentator observed last September as follows (source):

> [Snap faces] a daunting set of challenges, and they collectively make investing in Snap a risky proposition even at current levels. On the other hand, should Google, which reportedly offered $30 billion or more for Snap back in early 2016 and invested in the company when it was privately owned, decide that Snap's plunge presents a good opportunity to get the company at a discount, it has the resources to partly or fully address many of these challenges.
>
> If Google bought Snap, it could improve the company's margin and cash-flow profile overnight by hosting all of Snap's services on its highly efficient data center infrastructure at cost today; it helps host them while collecting a margin. It could also use its ad resources, from its user data to its targeting and measurement tools to its relationships with legions of YouTube video advertisers, to improve Snapchat monetization.

Even luminaries of the sports world have chimed in on this subject, with Patriots head coach Bill Belichick in 2017 fantasizing about a "Snapface" or "Instachat". Certainly, no one can doubt the credibility of NFL head coaches when it comes to the advisability of potential large cap tech mergers. (OK, we have inserted this paragraph for some comic relief, however it is timely given a certain upcoming football game involving a certain team from the New England region.)

Unfortunately for hopeful longs, a buyout of Snap remains unlikely for the following reasons:

- Snap shareholders have no input in the matter, only CEO Evan Spiegel and CTO Bobby Murphy do. Despite owning less than 25% of the aggregate economic interest in the company, these two Snap founders control over 95% of the voting power, meaning that most of the company's owners have no say in major corporate decisions such as whether to sell out to the highest bidder. Thus, there may be a conflict of interest at play; namely, the founders have free rein to make decisions in their own self interest (for example, sticking with a go-it-alone strategy for personal financial or other reasons), even if this is diametrically opposed to the economic interest of the Class A holders. Below is the most recent breakdown available of Snap's voting power (source: Snap 2017 Form 10-K):

	Class B Common Stock		Class C Common Stock		% of Total Voting Power
Name of Beneficial Owner	Shares	%	Shares	%	
Directors and Named Executive Officers:					
Evan Spiegel(1)	5,862,410	4.8	111,792,597	50.9	48.4
Robert Murphy(2)	5,862,410	4.8	107,943,924	49.8	47.4
Imran Khan	—	*	—	*	*
Michael O'Sullivan	—	*	—	*	*
Chris Handman(3)	702,735	*	—	*	*
Michael Lynton	—	*	—	*	*
Joanna Coles	—	*	—	*	*
A.G. Lafley	—	*	—	*	*
Mitchell Lasky(4)	65,799,720	53.7	—	*	2.9
Stanley Meresman	—	*	—	*	*
Scott D. Miller	—	*	—	*	*
Christopher Young	—	*	—	*	*
All directors and executive officers as a group (15 persons)(5)	79,006,355	64.5	250,943,036	100.0	98.3
5% Stockholders:					
Benchmark Capital Partners VII, L.P.(4)	65,799,720	53.7	—	*	2.9

- The founders' low tax basis in their shares means they would likely have to pay a high tax bill upon a cash buyout of the company, which would not be the case with respect to most of the other shareholders. One suspects that the vast majority of longs are now severely underwater on a mark-to-market basis, so any tax hit upon a buyout would probably be minimal. Conversely, the two founders seem to have paid almost nothing for their hundreds of millions of Snap shares. Buried far in the back of the March 2017 Snap IPO prospectus (on page F-30), for instance, we find the nugget that Spiegel and Murphy paid just $0.000020835 for each share of their Series FP Preferred Stock (see prospectus excerpt below), which converted on a 1-to-1 basis into 216 million Class C Snap shares upon the effectiveness of Snap's IPO. Moreover, both founders reside in California, where capital gains are taxed at close to the (if not the absolute) highest rate in the world, according to Forbes, at just over 37% for state and federal combined. Thus, the founders would stand to owe a massive tax bill if they ever agreed to a Snap cash buyout by a Google or a Facebook, which would thus mostly wipe out any merger premium they might obtain from a deep-pocketed suitor.

In preference to the holders of our common stock, each share of preferred stock is entitled to receive, on a pari passu basis, cash dividends at the rate of 6% of the original issue price per annum on each outstanding share of preferred stock. Such dividends are non-cumulative and payable only when and if declared by our board of directors. The original issue price per share for the purposes of the dividends and liquidation preferences described herein is $0.208515 for Series A, $0.01453 for Series A-1, $1.95445 for Series B, $3.40893 for Series C, $0.001 for Series D, $0.001 for Series E, $0.001 for Series F, and $0.000020835 for Series FP.

- The egos of Snap's two young founders should be yet another obstacle to a buyout. Take a possible Facebook buyout, for example. Back in 2013 Spiegel apparently turned down a $3 billion cash buyout offer from Mark Zuckerberg, saying at the time "There are very few people in the world who get to build a business like [Snap's]. I think trading that for some short-term gain isn't very interesting" (source here). And just last May Spiegel spent time blasting Facebook for their privacy issues, as well as for copying Snapchat's format with Instagram Stories (source here). Given this background, would it really be logical for Spiegel and Murphy to now "surrender" their company to a victorious Zuckerberg, even if it meant a large payday for them? Or is it more logical to assume that they would prefer a go-it-alone strategy and fight Facebook to the death (in which case they would at a minimum save face and in an ideal scenario triumph gloriously over Goliath)?
- There are no apparent logical suitors to buy Snap other than Facebook. Snap's gigantic cash burn rate would probably dissuade Twitter (TWTR) from making a bid for the company (note that Snap burned through almost $1 billion from operations and acquisitions in the first three quarters of 2018, despite printing 67 million of new shares to pay compensation to employees in stock rather than cash). Google is no longer in the social network business after permanently shutting down Google+ for consumers (see here), thus it does not seem likely they would be interested in bidding. Apple traditionally does not make large acquisitions (preferring organic growth instead), nor are they in the social networking business. And an acquisition of Snap by an Amazon, Microsoft (MSFT) and Netflix (NFLX) simply seems highly speculative, as none of these have business models that would benefit materially from a relatively sub-scale and stagnating (if not outright declining) social network such as Snap's.

Because of the foregoing, we believe SNAP longs will need to pin their hopes on a turnaround of the underlying business rather than a possible buyout. In this respect, the company has announced that Q4 2018 earnings will be released on February 5th (see here). Any turnaround will need to hinge on DAU and MAU growth, as well as Snap's ability to monetize its existing user base. Investors can refresh themselves on the market's reaction to the company's last earnings release (for Q3 2018) here.

Disclosure: I/we have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.

Comments **(18)**

yviktor8

FB's fake account allegations will cause advertisers to revamp their campaigns for Q1 2019, also Snaps android revamp is getting traction. FB will drag down IG with it to some extent as not clear how many fake accounts were established on IG. Snap should be trading at 10+ after these earnings and new guidance for 2019.

28 Jan 2019, 12:45 PM

joshokelly

I don’t know if you’re going to be right on this, but I sincerely hope you are

28 Jan 2019, 01:02 PM

A_Fava

Ad campaigns are determined based on ROI, not necessarily user base, though naturally that contributes. Facebook and Google are the best ways for small business to advertise.

28 Jan 2019, 01:49 PM

yviktor8
ok, just curious for how many millions you have bought and sold ad space? I highly recommend to get a better understanding on what metrics an ad campaign is designed and priced and how an ROI is established for a campaign; for that matter curious how would you gauge or for that matter calculate an ROI on an ad campaign that was priced on distorted user data and contact rate metrics, very curious to see your answer for that?

28 Jan 2019, 02:02 PM

BigEarn
@yviktor8 Why is it that desperate longs such as yourself rush to the SNAP message boards to defend Snap (against other commenters.....) on matters that have already been discussed in great detail by experts on things like ROI and ad campaigns? Just as @A_Fava mentions, it is already known that Google and FB are the best at targeting and ROI for businesses to advertise. Not hard to Google this on your own or watch the many interviews from ad buyers where they talk of how impressive the ad campaigns are from Facebook and Google. Snap isn't even in the conversation so why bring them up? These facts don't simply change because you refuse to give up on your losing position in SNAP.

28 Jan 2019, 03:32 PM

User 2656541
They are burning $300m a quarter. Due to their in place cloud contracts, their costs will continue to escalate regardless of what the user base is doing... so they will be fortunate to keep the losses at $300m a quarter, assuming revenue growth. At that rate, they have 12 months before they are out of cash. They need to demonstrate that there is either way more user growth potential or that they can monetize users at a much higher rate in the next few months.

28 Jan 2019, 09:17 PM

Peter Tan, Contributor
yep user 2656. they binded themselves to multi year contracts for cloud services.

01 Feb 2019, 07:52 AM

joshokelly
After reading a good bit on this in the past couple days I can say there is only two ways SNAP jumps up. They have already whispered to be at the top of their expectations, with no resultant stock movement that I would call substantial given their losses. SNAP is either going to have to announce tonight that they have increased their DAU's or they have substantially increased their monetization of the ones they have. I am hoping their new contract with Amazon and their Android update have worked. There are over a billion android users in the world, and tapping more into that would really help the growth. Only time will tell though.

05 Feb 2019, 02:02 AM

yviktor8
You are right, there was a recent channel check by analysts on Android and I did one too before that. Its showing a positive trend for Andriod, also the way Snap sells advertising is highly cost of effective. We will see, but Snap likely to 10 + a share today.

05 Feb 2019, 08:03 AM

bob kodadek
I am so far down, on SNAP. I will just hold it. one never knows what tomorrow will bring.

28 Jan 2019, 02:19 PM

Glen Rivard
Google was interested but hard to say if they still are. Plus it is possible such a purchase could be blocked.

Really it would have to be Google or Facebook to buy. Anyone else would have a tough time getting the value as they would not have the advertising network to leverage.

Media buyers are now pretty set on the two ecosystem and be hard to get them to learn a third. Heck two is tough. Just they have to know the two.

29 Jan 2019, 08:15 AM

A_Fava
Amazon has no problem blowing money on content irrespective of profitability. Look at Prime: they charge yearly and its combined with their retail while spending half a billion on LOTR. IT would make sense within their desire to go into advertising and help bolster their cloud business. However, none of that means they

would buy it, as it could be too little too late.

31 Jan 2019, 09:14 AM

MBI70

Time for a secondary to raise some capital. I’m sure they can find a bank to underwrite, spin a positive story and slap a strong buy rating and 20 pt on it. Might as well let Evan control these shares too. Sure...I mean who cares what the books look like? Didn’t matter in the past. Or they were too eager to cash out and ipo rather than let the company grow a bit and create a solid foundation and business plan. But maybe that was Evans plan. Well it worked. Get rich, marry supermodel and act like a jack A Only hope snap rises so investors can get some money back.

30 Jan 2019, 03:06 AM

Seven Corners Capital Management, Contributor

Author’s reply » "Get rich, marry supermodel and act like a jack A"

No, the order was (1) act like a jack A, (2) get rich and (3) marry supermodel. He was acting like a sleazebag way before SNAP [see link below]. Please get the sequencing correct ;)

valleywag.gawker.com/...

30 Jan 2019, 11:02 AM

MBI70

Ah, you are correct. Thanks for the correction.

31 Jan 2019, 04:56 AM

The_ROC

FB is not going to buy snap.

1) The purchase would never be approved, especially in this political climate. FB already owns Instagram, WhatsApp, & FB Messenger. Do you really think they would be allowed to purchase Snap, too?

2) FB already has superior versions of what Snap has. Instagram has crushed Snapchat, which has similar demographics, so why would FB pay $10+ billion for it? They've even copied some of their most popular features already. FB also has Oculus, which I think has much more potential than what Snap is doing with hardware (e.g. Spectacles, etc.)

3) Snap appears not to be a well run company. It's a cool app, just not a great company. Even potential buyers, like Google, would likely have to clean up the business. When companies pay billions for a company, I think they're looking for something that already runs well on its own.

Just my thoughts.

31 Jan 2019, 02:43 AM

A_Fava

Snap hardware was always a joke. If Google gave up on Glass, they shouldn't be in spectacles. But the biggest concern for any buyout at this point is price.

31 Jan 2019, 09:17 AM

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yviktor8

Snap clearly is showing they have the potential to become a profitable business. A buyout is definitely not off the table. Though with new key management team in place and clearly showing revenue growth that is impressive, with potential to regain user growth next 3 quarters, Snap is definitely back in the game.

05 Feb 2019, 06:55 PM