Holland Views – Facebook Inc – Price: \$310; Mcap: \$875bn

GAR[1]P Fishing

Some of you will remember a report we wrote on Apple in January 2019 (Holland Views – Apple: Sticky, Loyal and Rich). It is one of the research pieces we are most proud of. Not just because the shares have tripled since but because it encapsulated the essence of our investment process well. That is to say we don't think we just got lucky in identifying a great business that was clearly mispriced (read it again if you don't believe us!).

What was maybe interesting about our Apple call was that it empowered us, as generalists, to have confidence in taking a high-level 'Forest for the Trees' view on a stock when we think appropriate. We did this also with PayPal, Boohoo and Schwab.

Today we offer a perspective on another stock that previously we may have deemed 'too hard' – Facebook Inc. That said, this is an uncomfortable call which prompted a lot of the usual internal analytical friction! That the stock has rallied 20% since we started working on the idea is unfortunate, but it does not deter us from sharing our findings with you.

Our stance is summed up as follows:

1. Facebook Inc. (FB, more pertinently the Facebook.com, Instagram.com, Messenger and WhatsApp <u>platforms</u>) collectively has >>2.5 *billion* active users. FB is thus the equivalent of a de-facto **global digital Town Square**. What is more, FB knows more about its users than any other direct advertising medium and it makes a fortune from this knowledge. Yet FB's market cap is just 60% of Alphabet's.

   For a huge cohort of the platform's *users* (seeking community, profit or fame) and *advertisers* (seeking attention and monetisation for brands), <u>there just is no comparable alternative on a global scale.</u> As scale begets scale, begets innovation and begets pricing power, we see FB as a unique global <u>utility-like</u> platform business dominating long into the future – a rare bird.

2. FB is a business that we think might be '**pregnant with profits'**. In plain English we think the massive gap of ARPU in the US (\$53) vs. Asia (\$4) reflects wide gaps in regional GDP and advertising spend. The rising tide of the rest of the world economies should offer substantial future ARPU and subs growth to FB in due course (analogous to Coca-Cola Co in the 1980s?). On top of this is the ongoing and fast-paced shift of FB beyond advertising into e-commerce.

3. In this context, FB's share valuation perhaps takes on a new light. OK, FB is nowhere near as reasonably priced as Apple was back in 2019 (can you believe Apple was on 10x?!). Still – **in the context of a mega duopolist with huge runway of growth, c.22x P/E[2] for 20% <u>prospective</u> earnings growth seemed not an egregious valuation**. This is also a business – long assumed to be capital light – that actually reinvested 50% of its net income in each of the last 3 years and is likely to buy back significant stock with excess capital in the future.

[1] Recently Reasonable, now a little less so!

[2] This was the PE when we started our work – today it is closer to **<u>27x</u>**. As ever, we just can't write fast enough!

Our approach to this complex business

Calling oneself a generalist is not an excuse to avoid the hard work of due diligence on an idea. We have read lots on this industry (including four books that we highly recommend[3]). That said, just like we had not undertaken 'channel checks' on iPhone pricing etc. back in 2019, so too today we say upfront – we are not over familiar with global advertisers' thinking regarding allocation of advertising budgets to FB, Google et al. Nor, frankly do we understand the minutiae of ad auction pricing (the mind boggles on that one). Neither of us have ever been Facebook users either (though both our wives are!). That all being said, we know a good business when we see one.

In researching FB the amount of articles and books on the company and its Silicon Valley peers is vast. Most of the recent "analysis" focuses on the gossip of how some college kids turned into billionaires, how they are secretly surveying the world or how the regulators are going to kill the business. In addition how the platform today is out of fashion, no longer used by younger Americans and perhaps therefore set up for decline. In short, most of it focused on the trees, not the forest.

We saw a very different company when we looked at the big picture. We focus on three areas:

1. Digital Ads: a proper growth market. But investors seem wary?
2. Facebook as the global digital Town Square
    a. Asian ARPU catch up
    b. The importance of Groups
3. The next leg: Pivot to e-commerce

A proper growth market

The digital ad space is a big, opaque and a complex beast of a market. We promised a Forest for the Trees note, so we will try to keep our observations brief in this area. John Malone knows a thing or two about the media business so his comment below sets the tone, maybe!

> (*Facebook has) the best business model ever created"* – **John Malone, CNBC, Nov 2016**

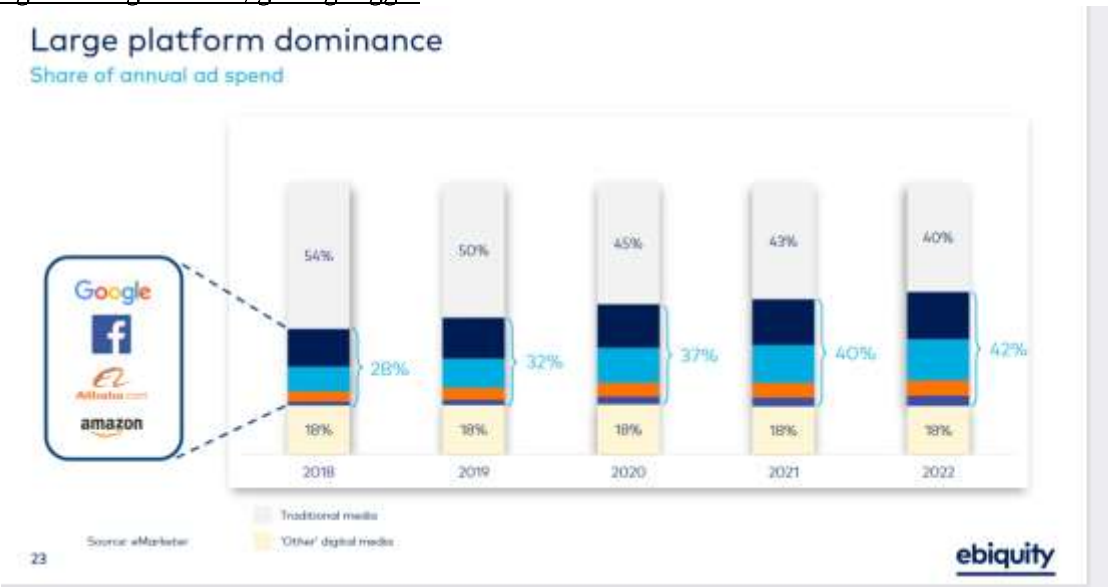
If you want to find a proper growth market, digital advertising is great starting point. Worldwide spending on digital advertising was c.$150bn in 2015 and this year is expected to reach c.$440bn[4]. Simply put, there are not many $400bn markets compounding at a 20% clip in this world. That digital ad spending still only accounts for 60% of total worldwide ad spending suggests that this is far from a saturated market. Fig.1 below shows the increasing domination by the major platforms in that spending. In the US, that dominance is even greater with FB and Google a clear duopoly with closer to c.80% share! In case you were wondering, FB has compounded revenues at 42% since its 2012 IPO!

> Senator Hatch: *"So, how do you sustain a business model in which users don't pay for your service?"*
>
> Zuckerberg *"Senator, we run ads,"*

[3] The Facebook Effect, David Kirkpatrick; The Age of Surveillance Capitalism, Shoshana Zuboff,; Chaos Monkeys, Antonio Garcia Martinez & Subprime Attention, Tim Hwang

[4] Source: eMarketer

Fig.1: A huge market, getting bigger



Source: eMarketer

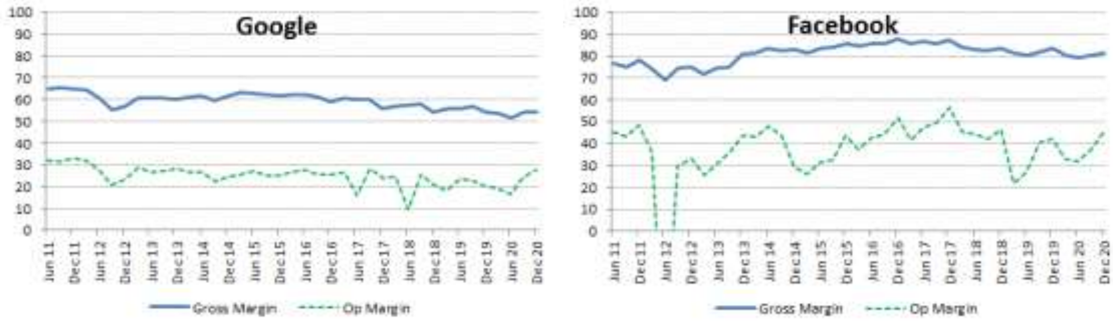
The following excerpt from a newsletter offered a useful comparison of the digital duopolists. It caught our eye as the title was "Everyone Hates Facebook"! Again and again we read the term aggregator to describe FB's model – and it is a great way to describe the business. FB aggregates consumers by offering services from news to community sharing, promotion, messaging and e-commerce. On the other side, it then aggregates advertisers (businesses and ad agencies) and offers them the profiling tools to select and find their tribe, their chosen demographic or simply their audience.

> *There are a lot of good business models on the internet, but Facebook's might be the best of all. To understand why, it's helpful to compare Facebook's business with Google's. Facebook makes money by aggregating consumer attention and data through its four main properties, and selling both to advertisers so that they can reach the right people with personalized ads. Facebook and Google are the only companies that Ben Thompson refers to as "Super-Aggregators": This, then, is a super-aggregator: zero transaction costs not just in terms of user acquisition, but also supply acquisition, and most importantly, revenue acquisition, and Google and Facebook are the ultimate examples. In other words, Facebook has almost zero marginal costs – they don't pay to get me to use their products, I go there to see my friends' content (which Facebook also doesn't pay for), and advertisers self-serve through Facebook Business Suite without talking to an expensive sales person.*
>
> *While **Google is intent-based** – I search for shoes and Google serves me ads for companies that make shoes – **Facebook is interest-based** – I am a 24-35-year-old male with feet who likes running, so companies that sell running shoes can reach me and others like me across Facebook's properties (and on other sites via its Audience Network). Google can show me different variations of something I want, Facebook can show me products I didn't even know I wanted.* – **'Notboring' newsletter, Nov 2020 (emphasis ours)**

So, simplistically, we have in FB, a duopolist (especially in the US Market). Consequently you would expect commensurately high profitability. Sure enough, as per Fig.2 (RHS), FB Inc. enjoys exceptional profit margins >45% at the operating line. The comparison to Google's margins is quite interesting though.

Google, seemingly deemed as *the* superior business by most of Silicon Valley and Wall St (thanks to its engineering prowess and de facto monopoly in search), actually has a *lower* margin structure.

Fig.2: Beautiful profit margins



Source: Holland Advisors

This is revealing to us. Google's lower gross margins reminds us that Google partly pays for traffic (not least the estimated >$12bn it pays to Apple annually for inclusion as an iPhone/IOS search app). This highlights a *possible* Achilles heel for the social media platforms which is their lack of ownership of the underlying hardware upon which users activate their apps(phones). In short, they don't own the distribution.

Whilst Google worked around this partly through its savvy Android ecosystem development and deployment, today's ad platforms largely rely on third party distributors (i.e. phones and PCs) to allow their business counterparties (users and ad buyers) to engage. In this light, Zuckerberg's recent pronouncement that Apple is his #1 competitor is more understandable. There is no question that Apple's launch of IDFA (improved app privacy) is certainly a headwind for FB this year. Perhaps the recent settlement with Australian media content owners also suggests that FB's margins might be in the crosshair more broadly than is realised.

> *"I do want to highlight that we increasingly see Apple as one of our biggest competitors"*
> – **Mark Zuckerberg, Q4 2020 investor call**

Whilst we are very mindful of these risks, we feel their real ultimate impact is overstated against the 20% pa growth potential (Fig.1) and those profit margins (Fig.2)

Investor resistance – is it digital snobbery bias or just out of touch?

It sounds odd to say that a company now trading on 26x earnings is out of favour with the market, but if John Malone is right – that this is one of the most unique businesses ever – shouldn't this stock trade on an even higher multiple considering its margins, returns and growth prospects? For a business with such growth and profit attributes, in this market, yes we think FB stock warrants much closer attention. Hence the GARP title.

We wonder whether investors have a bias against Facebook. Apparently, social media apps (as distinct from Search) have a much higher usage among females than males and our anecdotal observations would support this assertion. We have read too that Twitter is one of the few social media apps with higher male adoption than female (again, makes sense when we consider: https://twitter.com/andrewhollingw). Given that the Facebook core product is designed for the masses, it seems likely your average 45 year old male equity analyst might have a bit of condensing disdain for it...? Readers of our work on Greggs and Wetherspoons know that we love it when this happens i.e. when the financial community is out of touch with what the woman on the street likes!

Fig.3: Showing your biases (or, 1.5bn people must be wrong!)

Source: Twitter

This disconnect between the Facebook we hear about at work or read about and the one we see experienced at the other end of the sofa is what piqued our interest originally. Of course, we realise that privacy matters and that sharing an individual's personal data is not a way to endear users to you. However, Facebook users today chose voluntarily to give more and more of their information and preferences away through their membership of Facebook Groups. This is an important fact we think perhaps lost on some investors and regulators. If such a Group of say, skiers were to be shown ads for hedge trimmers that would be both pointless to the company running the ad but importantly also annoying to the user. That the 600m or so users of Facebook Groups are voluntarily giving their interests and that such profile data is valuable to marketers is very important to consider when the true risk of regulation or privacy control is being assessed.

And a brief word on digital ad technology

We mentioned above how "the mind boggles" in understanding digital ad auction technology – the process by which the digital ad industry captures and aggregates its users' digital footprint, converts it into a monetisable profile and auctions it automatically via an real-time digital ad exchange. One of us is a trained engineer and worked in the tech industry in a former life. Yet following the data trail that is created and hoovered-up by these ad companies is simply bewildering. In short, it seems to us incredibly difficult if not nigh-on impossible task for the regulators to keep pace with these ad platforms as the technology is moving so fast and is so opaque.

Whether ethically or morally this past use of data is right or reasonable is a moot point (we each have our personal views). However from a business perspective, the ability of the tech companies to stay ahead of regulators and reinforce their dominance (and profits) should not be under-estimated. We'd bet on the platforms staying ahead in the regulatory battle, but importantly not because of tactics or power but because consumers like the product that they see daily and the platforms innovate.

> "*We even evaluate the laws and regulations we live under today and project how they might be interpreted 10 years from now – we call this "reinterpretation risk."*"
>
> **Jamie Dimon- April 2020**

The Financial Times recently published an in-depth piece[5] entitled "W*hy are targeted ads so terrible*?" This is a frequent question nowadays (just this morning one of our kids was complaining of health insurance adverts on her Playstation's Spotify playlist! ☺) but it was a comment in the online Comments section of that same FT article from a "professional social media buyer" that we found most revealing.

[5] If Big Data has our data, why are targeted ads so terrible?, Financial Times, March 17 2021

The comment in Fig.3 references the extent of the pervasiveness of FB in all our online activities across **all** websites – not just FB's. This pervasiveness is not well appreciated by lay people. The revelation might be shocking and seem unethical to some but, frankly, it also is an extremely valuable data asset to those wishing to either get our attention or sell us something.

It reveals the vast pervasiveness of FB into the internet and challenges facing regulators in trying to reduce these companies' dominance of data.

Fig.3: a Facebook pixel in every website…

Social media buyer explains Facebook's role

I'd like to suggest that Elaine Moore (Magazine, March 13) considers more carefully her dismissal of targeted ads. As a professional social media buyer, I would never advise using Facebook's "interest data" for targeting. I know it is inaccurate. By suggesting that this is what is used to run successful marketing campaigns you are underestimating us all. And you are allowing Facebook to become ever more powerful.

Almost every site on the internet has a Facebook pixel installed, which tracks everything you do and shares it with Facebook. The network then aggregates the data and uses it to create an understanding of an individual which is far more powerful and more subtle than their "interests".

Most advertisers never use interest targeting — they use pixel data and lookalike modelling to find similar consumers to those on their site.

The Airbnbs and other global companies may have less discipline in their media buying strategies, but the beauty of Facebook advertising is that it allows the smaller companies that understand the platform to compete and win.

Jennifer Cunningham

London SW6, UK

Source: Financial Times

If there is a risk to our investment thesis of FB we think it lies here – in the hidden data. Is it more of a driver of profits than we can see? Regulators we think may change this cross use of data but our observations on Groups we provide a powerful potential alternative data source – given completely voluntarily. As per Jamie Dimon's comments above, Zuckerberg et al saw this coming.

Global Digital Town Square – where else are you going to go?

Zuckerberg himself has referred to FB as the "digital equivalent of a Town Square"[6] and we think it an apt metaphor. Others have likened it to a giant stadium[7] ("*where the entire world comes to watch events and interact with each other. The stadium itself is a great asset. It has the largest capacity (in this case over 2 billion) and it holds the concerts and sporting events that everyone wants to watch. The stadium is a very durable asset that doesn't take much to maintain in the short-run. But Facebook's job is to ensure that people continue to come back to future events.*").

Whilst your typical FB user might only enjoy a network (or in the Facebook lingo 'Group') of say 150 people, the fact that the overall platform has c2.8bn users means a) you will surely find your best and optimum network amongst the masses 2) the data gleaned by FB at such scale ought to be more accurate and 3) the advertisers cannot ignore such a mass of attention-seeking bodies.

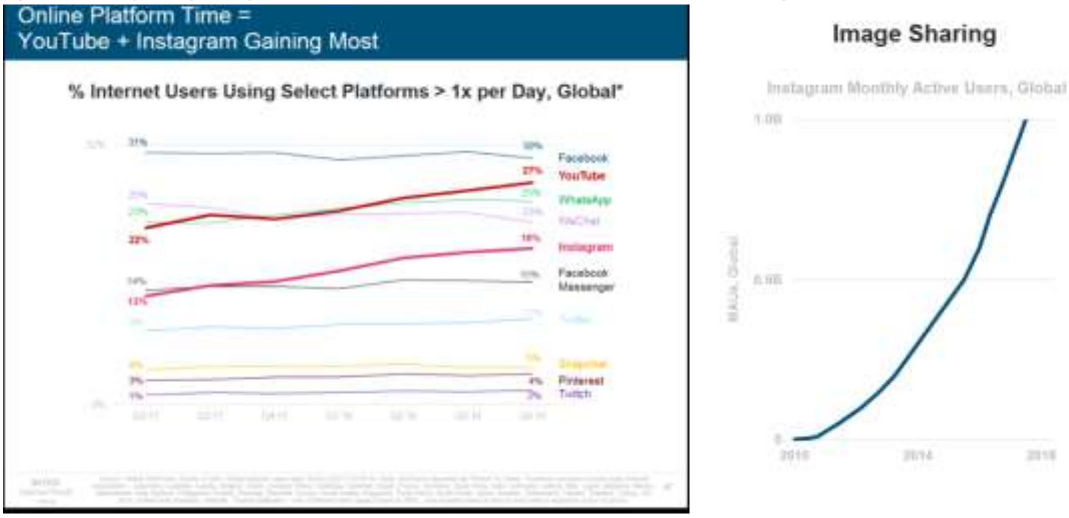
[6] https://www.facebook.com/notes/mark-zuckerberg/a-privacy-focused-vision-for-social-networking/10156700570096634/

[7] https://sabercapitalmgt.com/facebook-is-undervalued/

Whether you are a gardening group or a civil rights group – Facebook is probably your best bet in finding your tribe or your news. Similarly, if you are an ad man seeking 40-something stockbrokers' wives in southern Ireland to advertise Fiat 500s to, Facebook is your best bet to find them.

FB monetisation of its platform is all about reach and allowing advertisers to reach specific categories of prospective buyers. All four core platforms (Facebook, WhatsApp, Instagram and Messenger) are among the highest volume platforms globally as shown in Fig.4 (LHS). The growth of Instagram (an acquired asset) within the Facebook group (RHS) is truly parabolic.

Fig.4: A very large digital town square. Platforms (LHS) and Instagram (RHS)



Source: Mary Meeker, BOND internet trends

We did speak to some ad industry experts as part of our research. Most that we spoke to thought that Facebook was an opaque 'black box' in terms of actual reach and user insight. *"You are right to question purported ROIs*", we were repeatedly told with conviction. Advertisers and their agents believe that digital ad ROIs are very hard to verify and that brands were wary of being tarnished by inflammatory social media comments adjacent to their brand imagery. The conventional wisdom aligns with the FT article mentioned above – targeted ads are not as effective as they seem. But on reflection, perhaps had we spoken to a similar ad person in 1995, they might have been just as critical of the effectiveness of a TV ad on ITV! The point is, there is huge nuance in this field – at the end of the day, most choose to trust $ earned more than anecdotes.

Yet – and this is the crucial point - all those we spoke to also said, "**Where else are you going to go?**"

If you are an SME business with a small budget and clear demographic of target customers, Facebook probably represents your best and perhaps cheapest option for reaching that marketplace. Similarly for global brands – if one billion users (of a high earning and spending age) are on Instagram – do you have any choice but to have an advertising presence there too?

> *small businesses are very reliant on personalized ads, the ability to use data in a very privacy safe way, to get the customers who are interested in their products and services. And that makes sense. Big businesses, we can buy an ad to the whole country. We can buy an ad to a whole region. Small businesses can't. They have to find the precise audiences they want. And I think, one of the mainstays of our business is we've enabled that targeting in a very privacy safe way, without giving information without permission to advertiser* – **Sheryl Sandberg Q4 20**

Here is some of the latest stats from FB's Q420 update reminding us of the magnitude of this business globally. The update on Facebook Shops is particularly impressive indicator of momentum into e-commerce.

- 2.6bn users use at least one of FB platforms daily.
- 200m (mostly small businesses) advertisers
- 600m members of Facebook Groups
- 175m people message daily on WhatsApp (out of more than 1bn WhatsApp users!)
- 1m active **Facebook Shops** (only launched in mid-2020!)
- 250m Monthly active Shop users!

Innovating the Sam Walton way

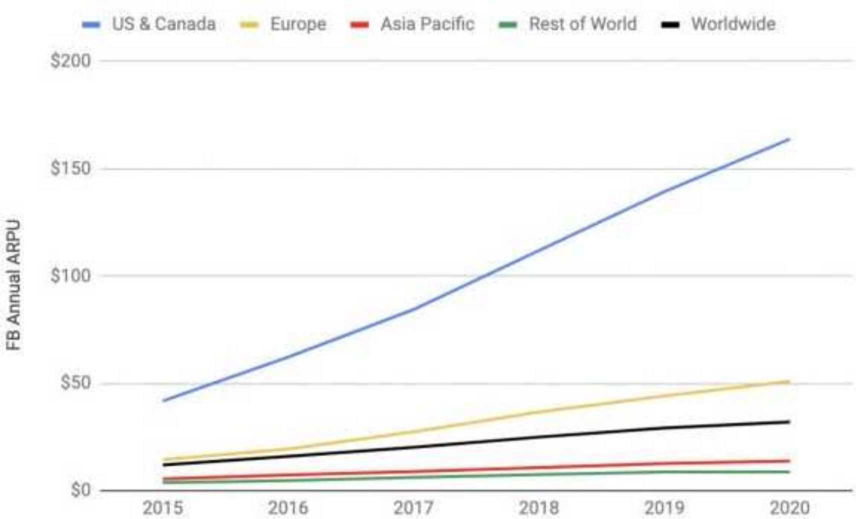
Taking our analysis up to a higher level again we reflect that these growth metrics were not achieved by accident. That there is much fast growing innovation occurring in the social media space outside of FB is self-evident. The speed of growth and success of Tik Tok has lead more than a few investors to assume that Facebook's dominance may be challenged by competitors innovating faster than it is. We see things differently. Sam Walton c.30 years ago was famously found lying down in the aisle of one of his competitors stores to measure its width. Walton, like Ryanair and others, was an excellent copier of others ideas. Whilst we do see internal innovation inside FB, crucially we also see a culture of being prepared to clone others ideas from the industry and of course act as an aggregator. This being the role it performed when purchasing WhatsApp and Instagram.

Non-US ARPU/Subs catch-up

The disparity between regional ARPU's really caught our attention when we first looked at Facebook. In the US, Facebook generates over $150 per user compared to $50 in Europe and just c.$5 (not a typo) in the rest of the world. Now, one might argue that ARPU is a dodgy metric considering that in this case, the user does not actually contribute any revenue (remember the distinction between the user and the true customer – the advertiser).

But the disparity reflects the gap of media spending between the US and the rest of the world (ex-China) which is currently very large. But the corollary is that it also seems logical to us that as GDP (and thus Marketing and Advertising spending) rises across the developing world, it would be rational to assume this would benefit Facebook's group ARPU in due course.

Fig.5: Facebook ARPU disparity by region



Source: SeekingAlpha, Facebook

The same distinction can also be made in its subscriber growth. The Facebook platforms stalled subs growth (saturation) in the US is often noted. The consistency and scale of subscriber growth in all other regions (ex US) however in more notable to us.

Thus, we find in FB a company where the investor experience (US 40-somethings and teenage offspring) might see stagnation in user growth and ARPU locally. However, a very different picture of still strong growth in users and spend outside the US looks set for many years into the future.

The pivot to e-commerce

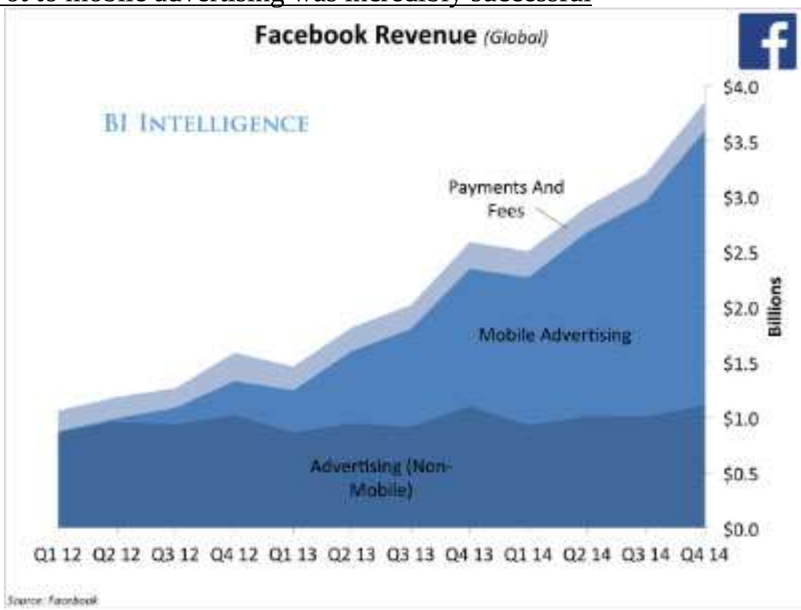
> Michael Wolf, Viacom (2005) "*Why don't you sell to us?*" (The offer was $1.5bn)
>
> Zuckerberg "*I don't really need any money and anyway, I don't think I'm ever going to have an idea this good again*"

Zuckerberg famously said he never thought he'd ever have a better idea than Facebook and he has shown an incredible astuteness in nurturing that idea over the last decade. Crucially Zuckerberg like many of the best managers has showed that he is not afraid to pivot, clone ideas, or block competition. In short Zuckerberg has displayed all the ruthlessness and business savvy of other great tech owner managers like Gates or Bezos. By the way, one of Zuckerberg's early mentors was Buffett's mate Don Graham of the Washington Post.

> *"Simply put: we don't build services to make money; we make money to build better services."*[8] **– Zuckerberg's 2012 pre-IPO letter**

For example, Facebook was originally a PC-native platform – the business was formed before smartphones became ubiquitous. This was a major problem in 2012 when Facebook IPO'd – investors were extremely sceptical that the young Zuckerberg would be able to sustain the business through the inevitable and necessary migration onto phone platforms. But this he did with impressive speed – what Wharton magazine called 'the most epic tech pivot of the decade". The transition can be clearly seen in 2012 below in Fig.6.

Fig.6: The pivot to mobile advertising was incredibly successful



Source: Business Insider

[8] Zuckerberg IPO S-1, Feb 12, https://www.sec.gov/Archives/edgar/data/1326801/000119312512034517/d287954ds1.htm

Neither, at the time, was it obvious that Zuckerberg's $1bn acquisition of Instagram (in 2012) or $19bn acquisition of WhatsApp (in 2014) made commercial sense. Of course in hindsight, they now look inspired. Instagram allowed a pivot to a younger generation of users and is now the jewel in the Facebook Inc. crown. WhatsApp allowed the extension of the user base to include messaging and notably is today only beginning to be monetised properly.

> *"Instagram and Facebook are the storefront, WhatsApp is the cash register."* – **WhatsApp Chief Operating Officer, Matt Idema**

We think another pivot is underway at FB – the pivot to e-commerce. In many respects FB has been on this pivot for a little while. In January 2020, Zuckerberg said that the three areas he was *"most focussed on for the next chapter of our company"* were **private messaging, virtual reality and payments.**

That is, shifting from the public Town Square (open conversations) to also being the defecto platform for (private) messaging and ultimately e-commerce via messaging. Zuckerberg alluded to this in a letter he published in 2019[9].

Fig,7: Instagram evolution from picture sharing to commerce

Source: Mary Meeker, BOND internet trends

The following excerpt (from the aforementioned newsletter) we thought insightful – credit again to Notboring). The insight here into customer-driven innovation is fascinating and is more common in smaller start-ups. That the innovation originated in Asia is also fascinating given our comments earlier on the prospect for higher Asian ARPUs.

> *Increasingly, Facebook is backward integrating from simply being an advertising platform into building the tools to facilitate customer communication and commerce in-app. Just like Tencent built tools for businesses in WeChat after seeing businesses communicating with customers in the app, Facebook saw businesses in Thailand use profiles on WhatsApp, Facebook, and Messenger as their homepages and leaned in by adding features. They built catalogs, then a Marketplace Tab, then power tools. Now, Facebook powers roughly 1% of Thailand's GDP (~$5 billion in GMV), and Facebook is rolling out the tools that it built there in the US and around the globe. Over the past year, Facebook has undertaken two related projects to unify the Family of products and help businesses sell through them: Messaging Interoperability and* ***Shops****.* – **'Notboring' newsletter, Nov 2020**

[9] https://www.facebook.com/notes/mark-zuckerberg/a-privacy-focused-vision-for-social-networking/10156700570096634/

With these innovations in mind we return again to the other end of our sofas and the real users of Facebook and Instagram that we wake up with each day. The innovations that have taken place on Instagram are to them, broadly speaking: gradual, iterative and largely welcome. Again ads are typically seen as targeted, relevant and enjoyable. This is a very different perspective from that which some negative investors might offer.

Facebook shops: entertainment + shopping

We had not heard of Sea Ltd and its Shoppe platform until a few months ago and it is a revelation in how quickly shopping habits are changing in parts of the world. Part Tik Tok, part gaming app and part eBay, the Shoppe app is gaining huge traction in South East Asia and Brazil where is attracts younger consumers drawn to entertainment assets (Sea's 'Garena' gaming business had the most popular gaming app globally for the last two years). The Shoppe app matches these wily consumers with local brands who list their store inventory alongside games. Shopping has truly become entertainment. For a useful background on Sea Ltd we suggest a read of the following[10].

We think FB is watching – closely. It is employing similar tactics in trialling new innovative e-commerce opportunities. We mentioned the momentum in Shops earlier and Fig.7 showed the already available ecommerce attributes of the Instagram sites.

The following press releases give an indication of the innovation momentum through last year at FB including the aforementioned Shops but also a much-anticipated launch of Digital Wallet (called Novi).

Introducing Facebook Shops: Helping Small Businesses Sell Online
May 19, 2020
Facebook has always been about connecting you to what you love. That means friends and family, but also products, brands and businesses. For years, people have used our apps to buy and sell things from the early days of posting a photo of a bicycle with the caption "for sale," to selling your coffee table on Marketplace and now shopping styles from your favorite brands and influencers on Instagram. It was the people who use our apps who envisioned social commerce. We're helping them make it a reality.

Making It Easier to Shop and Sell on Our Apps
We're creating new ways for people to shop on our apps and providing tools to help businesses sell online.
August 25, 2020

Update on December 1, 2020 at 6:05AM PT:
Libra changed its name to Diem.
Originally published on May 26, 2020 at 7:00AM PT:
A New Digital Wallet for Libra
Today, we're excited to introduce Novi — the new name and brand for the digital wallet that will help people send and hold Libra digital currencies. While we've changed our name from Calibra, we haven't changed our long-term commitment to helping people around the world access affordable financial services. Whether you're sending money home to support the family members who supported you, or you're receiving money from your friends no matter where they are, the Novi wallet will make money work better for everyone.

Source: Facebook Press Releases[11] [12]

[10] https://www.reuters.com/article/us-sea-southeast-asia-tech-focus-idUSKBN2BF0I2
[11] https://about.fb.com/news/2020/05/introducing-facebook-shops
[12] https://about.fb.com/news/2020/05/welcome-to-novi

The bear arguments & Valuation

The bear arguments go as follows:

- Toll operators (notably, Apple) will demand a share of profits (aka a Toll) or structurally impede growth (again: Apple's IDFA – 'identfier for advertisers')
- Regulators will hamper business growth, or force limitation or break-ups
- Users will defect to 'the next big thing' platform
- Advertisers will defect (citing low or falling ROI) to Amazon/Twitter/Snap/Pinterest/ Bytedance et al

We might also add

- The capital cycle could mean that Facebook's margins might get eroded due to competition.

As we have tried to express above, we think these risks are real but are likely out-weighed, in the long run, by the entrenched position that the Facebook's (four – not one) platforms enjoy and the growth prospects. This is FB's market to lose and we think there is little sign of 'fade'. Given Zuckerberg's track record we are not inclined to bet against him. We see his combined innovation, cloning and blocking skill set as underrated. Each of the above risks could have a further 10 pages dedicated to them and the brevity of this section is not meant to downplay them. Rather we have deliberately tried to focus on what the market is not thinking about today – the big picture opportunity.

Valuation

Bob Metcalfe famously formulated Metcalfe's law which astutely showed that the value of a network derived from (the square of) number of users using it. NB – this is a power law, a non-linear just like compound interest!

> **Metcalfe's law** *states that the value or utility of a network is proportional to the square of the number of user's of the network* (n^2).

On that basis, FB's network assets (i.e. its platforms) must have the potential to be the most valuable in the world.

It was certainly easier writing the Apple valuation section in January 2019 but this is a different beast than Apple. We wonder whether Apple's IDFA launch in the coming weeks might cause a large enough bump in the road to offer a more sober P/E entry level for new FB investors.

Conclusion - The world's best FREE utility

What attracted us to Facebook in the last few months was that we found ourselves more and more seeing the other side of the negative investor sentiment & perceived regulatory threats being presented against it.

When regulators argue over how FB should be controlled and regulated more, they cite legislation such as Section 230. This law was established 25 years ago to exempt so-called digital 'town squares' from liability resulting from the views that are expressed within them. The more we listened to regulators fight over this issue, the more they inadvertently endorsed our thesis! FB is the defacto Town Square utility of this era, a monopoly that will be super hard to replace even if you managed to build a new out-of-town square (because folks will likely keep going to the old one!) This was, in effect, Bob Metcalf's legendary insight too.

Another way we think investors can view FB as an entity (ie including Instagram etc) is as a newspaper. But one that is not wedded to a certain form of content which it refuses to change over time. Instead, as it sees its customers tastes change and competitors innovate, then the format of its offering does too. Why do we use the newspaper comparison? Because of the regularity with which the sites are looked-at (daily) and that the platform provides FB users with in-effect personally curated news. Crucially however, this newspaper as well as being enjoyed by many billions globally and innovating to suit changing tastes, is also free to its readers. Our *curated* news point was highlighted in the recent Australia/FB spat, when during exchanges FB admitted that only a minority (c.15%) of the content viewed on its websites was content produced by new outlets.

This we think is telling. Arguably FB have created a new daily habit for many billions of people and the content that supports it is largely internal (or at least collected by FB and provided for free by its users). Other business models of the past show us that if there is no incentive to switch away from such a service, unless you are offered a better product/service or a cheaper price. Otherwise, consumers do not leave.

As such it is a combination of traits that underpins the lasting utility idea of FB. That the cost to the user is zero, that the experience is enjoyed, that the company innovates (Groups/e-commerce) and also clones other's ideas when they think it right to do so.

This utility structure (and customers' enjoyment of it) gives us more confidence that the current assets of FB (and their attractiveness to advertisers) will be largely unchanged by regulation or privacy changes. It also suggests to us that future growth will fade less quickly than others fear and that more innovation may yet still come along as free options on growth

Paying 22x earnings for what looked like 20% multi-year earnings growth looked very attractive to us initially. At 27x, we now accept a little more is priced-in, but our reflections on the fundamentals remain the same.

We are Facebook Inc fans

With kind regards

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