HollAnd Advisors

Holland Views: Facebook/Meta Price: $332; Mcap: $925bn

Owner Manager Inc.

What follows are comments on the investment opportunity that is Facebook today. Many (too many) column inches have been written by others on Meta and Miss Haugen's revelations. As those that know our approach might expect we will try to look at this from a different perspective – i.e. from Facebook's core which is an entrepreneurial lead growth company. As such this report is not just about Facebook/Meta. We will also use it as a way to remind readers and ourselves to think a little more broadly about the best owner manager businesses.

GARP fishing revisited

In April we published our first piece of research on Facebook (*Holland Views: Facebook – GARP Fishing, April 2021*). Like the work we did on Apple in February 2019 *(Holland Views: Apple – Sticky, Loyal and Rich, Feb 2019)* we tried to take a forest vs. trees approach. We sought perspective and some rationality on the business where we thought others were a little buried in dogma. Since then, the dogma and noise seem to have only got louder. We have listened and read a great deal of new information about the company since April. However, whilst clearly some things are changing (a new name and c.$50bn price tag of Metaverse investment!) the core of our beliefs remain the same. These being as then stated that:

- Digital ads are still a secular growth market and Facebook is one of the established global market leaders (c.17% M/S).
    - It positions looks to be only getting stronger.
    - FB controls hugely important networks for SME companies around the world.
- Facebook's business model looks to us like a digital town square/free newspaper. As personally curated and free to all there is little incentive to ever switch to another one.
- There are huge monetization opportunities in the networks still yet to come:
    - ARPU catch up of non-US regions + Pricing power in US.
    - Massive ecommerce opportunities in FB and IG
- We think its Owner Manager's range of skills are underestimated. Zuckerberg innovated brilliantly when very young. Then he cloned, grabbing the best ideas from others to use in his position as market leader. More recently he has allocated capital well (buy backs).

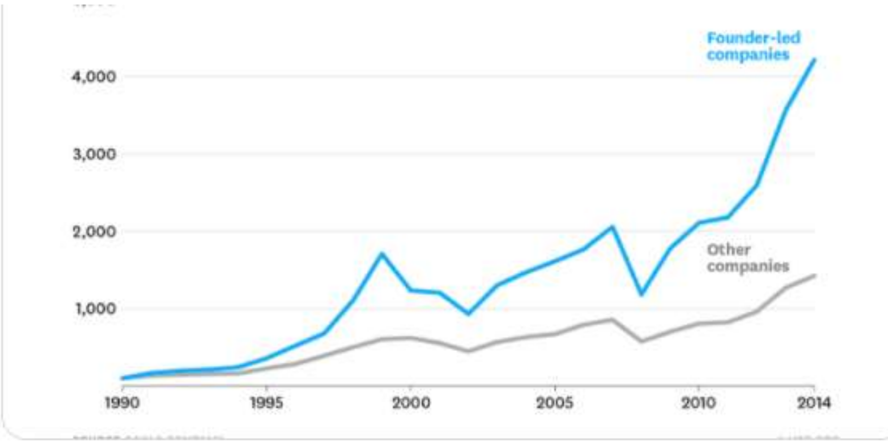
When others write off (or underestimate) a driven owner manager with a brilliant track record is when our ears prick up. That is where we find ourselves today.

Do you invest in Entrepreneurs – REALLY?

These days we explain how we invest in owner-managed companies. As we do, we see our audience nod a little too easily, seemingly accepting how 'wise' it is to invest alongside those who create the wealth in society. Examples of Founder-led companies are of course Apple, Berkshire Hathaway or Next, but these are 'easy' companies to invest alongside the Owner Manager that will usually give a smooth, stress-free ride for the investor.

But when the ride gets a little bumpy is when investor conviction is tested. This is why we often qualify the owner manager companies we seek with the pretext of 'unloved' for that is how we get great value at the time of purchase.

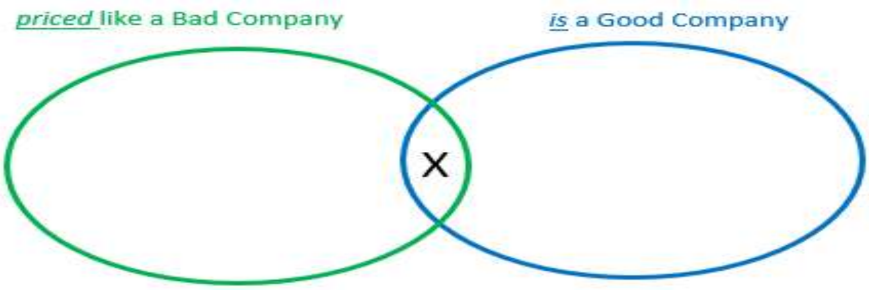
Fig.1 Founder led companies outperform



Source: Bain & Company

Deciding today that Amazon is a powerful business run by a brilliant owner manager or that Tesla is an innovative company run by a similarly innovative leader is maybe a reasonable conclusion. But both are clearly conclusions held by the wider market also. Thus, the valuation of these companies likely reflects these views. As we search for compounding and growth, we do so also with an eye on Margin of Safety i.e., via reasonable starting prices (yes, there are still investors still trying to do this in 2021!). Thus, we are challenging Mr Market's pre-conceived views on Quality vs Price. This is why time and time again we have used the pictorial in Fig 2 below to show the short-cut in our investment process.

Fig.2 Our process super simplified



Source: Holland Advisors

Again, when we show this picture, the nods come maybe a little too quickly. This is the simplest chart in investing but actually one that must be reflected on. **What is it really like to be an owner manager vs a CEO of large org?** and **What is it really like to buy shares in a company when everyone around you is telling you are an idiot to do so?**

Owner manager vs large org CEO

We have been reproducing Fig.2 in our research for maybe five years now. It helps us focus a little more on the odd depressed entrepreneur-led company realising that it just might be a great company in a tough spot. However, recently we spent a little more time reflecting on the real DNA differences that will have resulted in a business founder ending up owning and running a company rather than being a CEO running say a government department or a large organisation.

The more we reflected on these personality differences the more we realised and could understand why some Owner Managers ended up in spats or at odds with Mr Market on occasions. Hence why periods of mispricing can occur.

Owner Manager Traits

- Is likely someone who will have constantly challenged consensus thinking
- Will have turned left when all others turned right for long parts of their life
- They will have constantly been told to comply with certain rules. Not done so and likely proved the rule makers wrong
- They probably want to break existing industry norms by **revolution**
- They will have fought bureaucracy every step of the way
- They are **outsiders,** not insiders. They hate the status quo
- They may have been outsiders at a young age, not fitting in and not looking to fit in
- Their success will have emboldened them that such non-consensus actions whilst not always successful, do yield real world results in time
  - As a result, when confronted with future requirements to ‘comply’ they are brave enough to almost always say no
  - They are likely to remain non-consensus in their thinking for life
- Owner Managers tend to be either quietly influential or charismatic. If their product is working well, then are those around them know it and there is buy in. The ‘need’ for having to ‘sell’ themselves stopped many decades ago

Large Org CEO Traits

- In order to have been recognised and promoted in mainstream org. to a high level they need to have excelled academically in a conventional sense
- They had to be able to build consensus views that were popular with those above and below them
- They have to be able to lead in conventional sense
- They have to be able to cope with bureaucracy and compliance and grow despite its burdens
- They probably want to grow and change existing norms but by **evolution**
- They are very much **insiders** of the existing systems, not outsiders
- Crucially large org CEO’s have to be good at selling themselves or they would never have got promoted in the first place above the c.45,000 other people whom they now lead
- Also, without self-promotion skill they are unlikely to get their next role

…and our point is…?!

The idea of the above list is not to idolise all founder-led companies and demonise all career CEO’s. That is of course foolish. It is instead to try and get inside the head of founder leaders and realise that they are unusual people with unusual driving forces. Some are a little prickly at times and may struggle to articulative themselves. Some whom you may meet as an investor may be rightly bored of meeting short term investors vs their own 25y understanding of their cherished company. Others might not like being backed into a corner by competitors or regulators.

As researchers but also managers of an investment fund with c.90% of its assets invested in owner managed companies we can reflect that all of these managers built something special. Whether they can do it again or keep doing it is always the relevant question for investors. **But as mere investors who did not build a $1bn company from our garage, pub or basement we need to pause sometimes before we so easily ask the questions assuming we are right and they are wrong in terms of what happens next. They have been there, seen it and… got the T-shirt.**

Facebook/Zuckerberg reflections
We had these thoughts in our head in the last week or so as we saw the reaction to Facebook's significant investment and pivot towards Meta. A name change and Opex investment of $10bn in 2022 (likely $50bn in 5y) was not something we expected when considering the company's valuation this spring. Many others did not except it either it seems and are rushing for the exits. Our long and often evolving relationship with numerous owner managers tells us not to rush such a decision. Our hunch tells us those doubting the company may be wrong.

Before looking at Facebook we would ask readers to look at a short piece we wrote in 2108 which is re-attached: *Holland Advisors: Engine Overhaul (January 2018).* It was a generic commentary about Owner Managed business during investment phases.

Walls of Worry that become Moats

Returning to Facebook we have found the recent events and market reaction of interest. We now have quite a lot of experience of such events, i.e., seeing a company whom you think are just about to do one thing, do another (i.e., being wrong!). During such periods it is important not to overreact we think in either direction. (i.e., *"what the damn are they doing, I am selling"… "or it does not matter I will just double up"*). We offer a little reflection below, but are inclined to be optimistic, mostly due to the strength of the underlying business:

Blowing past IOS changes
Six months ago, investors were told the greatest risk to Facebook was the impending changes to the IOS software system. With users having already given many personal interest preferences via FB groups we saw this as less of a threat than others. Nevertheless, that these changes are now largely complete and yet FB is still growing sales at a rate of c.30% is telling and impressive. Were the situation reversed and a company still seeing declining sales in the face of a one-off positive event stopping investors would scream disaster. To us this is unequivocal good news that is being lost in other noise. A threat to the secular growth rate of this business appears to have passed without a hitch. All other things being equal the shares we suggest might be 30% higher on the resolution of this issue alone without other issues having arisen.

US growth debate
Quarter after we read that Facebook is an ex-growth business by all that speak to their US teenager sons or daughters that do not use it any more. Facebook then routinely reports c.30% sales growth, even reporting that growth rate in the US in this latest quarter. Clearly there is limited US subscriber growth, but when you control a high share of the largest online platforms in that country you have a lot of pricing power perhaps the way the Network TV stations had in the past. We are seeing that in the huge pricing increases that the company reported in the last quarter. Whilst such growth rates most likely fade that the network has pricing power reflects our point of a Virtual Town square concept. There is little sign of this reversing/being lost we believe.

Unknowns… that are now known
We find ourselves wondering whether things just cannot get any worse for this company news wise. It might seem a strange conclusion, and of course yet more revelations could come out from the Facebook files. Tactically, maybe we have to wait a month more to know for sure, but it feels like any shoe shine boy or yoga instructor inside Facebook who wants to tell all has/had a platform to do so. The co-ordinated attack on the company by the US press we find remarkable and whilst we are based abroad, we cannot remember a time when they have joined forces in this way. We may have to wait a few more weeks/month for the chances of everything possible to come out, but surely soon that will be the case.

What we also thought interesting about the testimony of Miss Haugen was that she had some empathy for both the company and Mark Zuckerberg. She seemingly wants the issue of social media regulation brought higher up the political agenda. So, to our understanding does Facebook itself. When the ‘Facebook Papers’ stories first broke we were of course nervous as to their potential revelations. Considering the scale of documents that have come out we do not see them as containing anything damning or indeed anything the company should be hiding from, or ashamed of. Future regulation we think could bring welcome clarity.

Never enough/More than enough

Miss Haugen’s actions raised further still the important debate about safety online and the use of huge company resources and systems like AI to manage the various Facebook and other company social networks to make them all safer. Across 150 languages the cost of such compliance is now enormous with Facebook claiming it was employing 20,000 people and spending c.$5bn on the process in 2021 alone. Whether it is from politicians or activists the question constantly being asked is, “yes, but is *that* still enough?” In truth it is for regulators to answer this question, not for us as investors.

What we think investors should be doing however is seeing the other side of this coin. They need to be considering that all this investment is creating a far stronger and hopefully in time a far more trusted and safer network. It will also be a far more compliant network, in many many more languages. **If Facebook was a hard business to replicate three years ago in terms of scale and reach, the new compliance requirement just made its moat 10 feet wider.**

This we think is an important point. Many in US politics and the media are rushing to complain about the state of social networks today. but they are not considering what they might look like tomorrow. If regulators one day required greater compliance by social networks, which companies will best be able to comply? If they go a step further and ban Facebook in a sort of prohibition type event people will just flock to other less well-regulated networks. Is that success? Equally, what if regulation were brought in and saw lots of trolls and fake accounts leave meaning Facebooks/IG user number fall. Would that mean advertisers would spend more or less as a result? Likely we suggest it would make no difference, or they would spend more. Why? Because they already know such accounts are fake and don’t spend real money/read ads.

What goes wrong... The Witch hunt works

As we have watched events unfold at Facebook over recent weeks, we have reflected on a variety of perhaps eclectic companies that serve as examples for such period of flux. There are those with political and regulatory interference and those with aggressive investment periods. As a result, the risks we see in Facebook today are twofold;

That the witch hunt works

As Wells Fargo fans we were perhaps too eager to dismiss the cross-selling scandal when it first emerged due to the relatively small nature of the historic offences. What caught us out in the latter years was the knock-on consequences. Clearly the FED decision to impose an asset cap was a crucial one. But as important in the years after the scandal broke was different parts of the bank gradually getting block-listed out of say corporate bonds or wholesale finance transactions.

Today Facebook is still very popular with its advertising clients as it allows them to access the customer base their wish to target. The coordinated campaign against Facebook may or may not have merit. However, if it gets enough parties on one side or other of the Facebook networks to stop using it then the slur/reputational damage becomes real business damage.

We note that the company has already survived numerous 'delete Facebook' campaigns and is far less is the thrall of big business who tend succumb to these trends. Its SME customers want to use an online advertising service that reaches their clients and for now Facebook is still their first (and second!) choice.

Investing longer and deeper

The second risk we see is that the $50bn investment outlined for Metaverse is only the start of what the company will spend in this area. Our past work on owner managers and their investment phases tells us they always spend more, for longer than people think. Why? Because they want to make sure the end product/service is really good. Is the case of Metaverse/virtual reality that price tag could be very large indeed? We will speak later about our alignment with Zuckerberg on this issue, but our hope is that at a point future spending becomes success orientated. That all said this is a genuine risk for this company today that was not the case six months ago.

Mark Zuckerberg – Owner Manager

We hope that readers will take the time to read again our *Holland Advisors: Engine Overhaul, January 2018* piece that accompanies this note. It provides important but light hearted context to our thinking about owner managers during such investment phases.

Of course, history does not repeat itself but it rhymes and we see and hear these rhymes in Mark Zuckerberg's actions today. As we stated in April so far, he has grown fantastic shareholder value in his life (and he is only 37) through a combination of talents. Firstly, by brilliantly innovating at an early age. The next trait that we are attracted to perhaps more that those in the tech sector is his cloning skills i.e., he copied great ideas from others and rolled these out inside Facebook Inc. Those in tech we think pride themselves on their originality and this maybe look down on such cloners…? However, once you already have scale there is no shame in copying. Indeed, cloning we have seen powerfully used by many great businesses (Amazon/Costco/Ryanair/Alibaba ++). <u>If we have an edge in Facebook at all it is in this area of mental models and seeing what the company is doing well from outside tech, not inside the sector.</u>

We also think Zuckerberg then also morphed pretty well into an industry leader i.e., *trying* to look at what to do about areas like policing when the regulators don't want to regulate. Clearly, they are not getting everything right here but this is one hell of a hard problem to solve we must all accept. Also, in terms of maturing as a company and what to do with excess cash. They just gave give it back to shareholders in buy backs (no vanity projects, until...?).

But what is he up to now?

Zuckerberg's recent years actions up to the point of the recent Meta announcement were all incrementally onward developments of the FB group and its gradual ongoing improvement and in some cases monetisation. The Metaverse/VR move is not a surprise as has been flagged for some time, but the scale of the investment is, as is the length in timescale towards any likely return on it (c.7-8years). This is why the Meta announcement is shocking for some investors. In short, we think that is because they were starting to model the company like a large corporate, forecasting cashflows and growth.

However crucially at its heart it was always still Zuckerberg's owner managed company. This is the important distinction of owner manager companies that we are trying to explain. Sometimes they just make sharp turns! Some investors can understand that, and others cannot. Our guess is that the bigger your spreadsheets for companies is the more trouble you are having!

As a backer of such managers, we do not have a problem with such moves. They are always surprising, even shocking when they happen. We need to be mindful as to the motivations, i.e., are our interests ultimately aligned with that of the owner manager and do they have the best longer-term interests of the company at heart? If so, then more often than not it is right just to trust the owner managers judgement even if it means the next few years where not the ones we might have expected.

A few other observations

- The reviews for Qwest II are very very good – particularly how good value for money it is. Reviewers also note how no one else will bother to make a VR handset now because it is so clear that Facebook will just slash prices to dominate this space!
    - I.e., this is a company dominating Virtual Reality already – that is what the reviewers say
    - Having listened to the Connect presentation we are impressed with Zuckerberg's conviction, commitment and desire to lead in the space. Whether it makes for good ROIC's we cannot say
- Why did Facebook spend so much <u>now</u>? While the merit of Metaverse will or will not in time stand on its own we thought the size of the investment notable and that it was announced now. i.e., $10bn in opex straight away.
    - We note that without this cost increase Facebook shares would likely have gone up c.20% due to its 35% ongoing sales growth and modest need for opex costs in the day-to-day platform
    - Did they make a decision that in the face of political flack they did not want to be reporting higher profits….?
- Whilst the scale of the investment is high and is a drag on profitability it is at least a) being shown as a separate divisional item straight away and b) being taken as opex not capex
    - So it is easy for the underlying profitability for the rest of the company to be seem
    - This is not a vanity project being hidden, but a growth initiative out front and centre
- The other interesting contrast vs investment phases we have seen at other companies we have looked at in the past is the huge ongoing scale of growth of the core business
    - As such the Metaverse investment is highly affordable
    - Clearly distinct from a hugely cash generative, fast growing dominant core business

Deferred gratification

Our April piece was entitled G.A.R.P. fishing. We still are. Even with the company spending $10bn of opex on the Metaverse project in 2022 we are be paying a headline PE of c.20x for Facebook. If we ex-out that investment and the cash on the balance sheet the PE falls to only 16-17x. For the company that most recently just grew <u>revenues</u> at 35% and prudently might continue to grow <u>sales</u> at 20% for years to come that is still a remarkably low price to pay.

In closing we leave you with a thought on deferred gratification and 'trying stuff'. Deferred gratification is something that Charlie Munger has clearly taught us that it is important to learn to love. Via Mr Markets understanding of Amazon and Costco it too has embraced the concept. In more recent years the growth in the Nasdaq and stocks like Tesla has seen deferred gratification be an important driver of investment performance as far out growth has driven investment returns today.

Against this backdrop we find Facebook's Meta investment interesting. We have no idea if it will be brilliant or foolhardy. But when so many other ventures are being so surely backed to succeed, we find it interesting that this has been priced as dead-on arrival by our friend Mr Market. As a free option on top of our GARP investment we can take that.

Try stuff

Another way to look at this is through the lens of *'try new stuff and see what works'*. This is a way of doing business we have noticed some of our owner managers use. Mike Ashley once observed on this point. "*I just throw mud at the wall and some of it sticks.*" As entrepreneurs search for new avenues of growth, they use all the resources they have. When they were young, that used to be time, or inventory, or servers. When older, and richer it is capital also. We saw many an investor dismiss Sky because they could not understand its investment in ITV or Sports Direct due to any one of his crazy investments made. These were the new stuff, the mud. But the core business often grew strongly in the background despite these distractions.

We return to the theme of how investors think vs how owner managers think. Facebook's investment in the Metaverse seems expensive and out of character to some that own the shares today. But we see it as classic owner manager behaviour. $50bn is a huge sum of money to invest…. or is it when you are a fast growing hugely cash generative company that makes that in EBIT in single year?

We remain Facebook and Zuckerberg fans.

Andrew **firstname@hollandadvisors.co.uk**

Further Watching/Reading
https://www.youtube.com/watch?v=VKPNJ8sOU_M
https://www.youtube.com/watch?v=mseanDhl3zA
https://www.amazon.co.uk/Facebook-Inside-Story-Steven-Levy/dp/0735213151
Book: No Filter by Sarah Frier – Thank you Client X for the excellent recommendation

Contact:

HollAnd Advisors

Holland Advisors London Limited
The Granary, 1 Waverley Lane
Farnham, Surrey
GU9 8BB

Tel: (0)1483 449363
Mob: (0)7775 826863
www.hollandadvisors.co.uk

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