Facebook Inc Class A

As Facebook opens its advertising platform, the company's leadership position is almost unrivaled.

Investment Thesis 01/29/2015

Facebook is building the foundation to revolutionize online advertising. However, the company will need to leverage its proprietary consumer data beyond Facebook as an intermediary to place advertising across the Internet at large.

Facebook's massive base and engagement arguably create advertising opportunities that capture reach and target based on specific criteria. Growth in Facebook's user base across geographies has been impressive. Monthly active users exceed 1.3 billion while daily active users are nearing 900 million, representing the largest social network on the Web. These users are logging into Facebook at least once a month, communicating with friends, posting pictures, and using applications. We believe hundreds of millions of users face switching costs that keep them from leaving Facebook. People are unlikely to leave unless they can take their network of friends, content, and applications with them.

The company's growth in mobile usage has been equally impressive, particularly considering that Facebook was very slow to market with a downloadable application. The company's mobile usage is skyrocketing, and there are almost 1 billion mobile users, with more than one third of MAUs accessing Facebook only from a mobile device. There are now more mobile-only users than desktop-only users, and revenue from mobile ad products exceeds revenue from desktop. After its long delay in building mobile advertising products, we believe the company is a pre-eminent mobile advertiser.

Despite our bullishness about its prospects, the company will need to aggressively increase advertising revenue per user to justify a premium market valuation, in our view. As the company is already the most visited desktop and mobile site in the world, Facebook will have to find new and innovative ways to continue increasing advertising units and pricing. Ultimately, this growth is not limitless, and we believe any meaningful slowdown will have a negative impact on what the stock is worth.

Economic Moat 01/29/2015

In our view, Facebook has a wide economic moat based on its social graph, communications layer, and competitively advantaged platform for brands, application developers, and advertisers. We look at three considerations for the company's moat: Facebook as an identity, Facebook as a platform, and Facebook as a destination site. Largely, Facebook's ownership and control of its user data afford the firm substantial competitive advantages. The company continues to build a rich database of friends, actions, demographics, and applications, but only shares the data with business partners. Third parties cannot track information that happens on the Facebook platform.

We believe identity is the most important component of a social network. Facebook partners can easily use the company's log-in credentials through Facebook Connect instead of requiring users to separately register a new ID and password. This functionality is good for both Facebook and the partner, as data can be more easily shared between the companies, allowing for better personalization, ad targeting, and social functionality, such as sharing. Furthermore, we have seen data suggesting that websites convert casual users into registered users twice as often after deploying Facebook Connect log-in functionality. This rich data set is extremely difficult to replicate. While all partners may not benefit, we believe Facebook has an early and sustainable advantage here.

Using Facebook Connect to own a person's identity is important, but the platform creates a virtuous circle of the sharing of data among Facebook and its partners, including brands, merchants, and developers. Recognizing this opportunity, the company has made the obvious move, opening its platform to third parties, including application and content developers. For mobile applications, Apple's iOS platform and Android developers can connect their apps to the Facebook platform as well. Through the social graph, third parties can distribute applications and content for "discovery" by customers, use Facebook data for better personalization (for example, TripAdvisor shows reviews posted by friends), and use future platform capabilities such as payment capabilities. This value creates a virtuous circle between Facebook and its platform partners. Several tech luminaries have commented to us that Facebook integration is a best-practice equivalent to optimizing a site for search engine discovery by Google and others.

The traffic data alone is encouraging, although we believe this is the weakest pillar of Facebook's moat. While daily users have been growing even faster than monthly users, we expect that competition for people's time and attention will naturally pull people away from Facebook's website. However, because many people use Facebook for communication rather than simple entertainment, we wouldn't expect users to abandon their use of the website. The fact that increasing numbers use Facebook on a daily basis is encouraging, in our view.

Valuation 01/29/2015

We are increasing our fair value estimate to $66 per share from $60 to account for recent results. Our valuation represents a multiple of 34 and 22 times our 2015 adjusted earnings per share and adjusted EBITDA estimates, respectively. In modeling the company, we forecast 10 years of financial statements. Admittedly, there is a great deal of uncertainty about Facebook's ultimate growth trajectory and profit profile, but the exercise is important to us for several reasons. First, we believe the company will reach its structural maturity within 10 years, whereby it has normalized operating margins and cash flow yields. Second, understanding the size of the revenue opportunity at the end of our explicit forecast period helps quantify our level of optimism about the firm's revenue potential. While we would not feel comfortable about our level of precision in forecasting the absolute level of revenue in three years, we do think our 10-year forecast results in a fair representation within a range of possible outcomes. The key value drivers in our model include revenue of nearly $50 billion in 2022, operating margins normalizing in the mid-40s, and forward returns on invested capital of more than 30%. Facebook's revenue would still be meaningfully lower than Google's, according to our forecasts, but profitability metrics would be similar. We expect Facebook to have to continue investing in sales and marketing, which would drive additional operating expenses. Additionally, the company will have to increase its revenue sharing with third parties for an advertising network, and we would also expect local and payment businesses to have higher-cost structures that the existing business.

Risk 01/29/2015

Although the revenue opportunity for Facebook is large, the company faces several risks that could ultimately prove our investment thesis to be overly optimistic. First, regulators may prevent the company from tracking its users. Significant regulatory action could detract from the value of its advertising platform. Second, excessive advertising or privacy fears could lead to a mass exodus of users. Other social networks (for example, MySpace, owned by News Corporation) have experienced declines. Lastly, if agencies and advertisers experience a permanent lack of visibility into advertiser return on investment, Facebook's advertising opportunity may be significantly constrained.

Management 01/29/2015

Mark Zuckerberg founded Facebook and has held the role of CEO since 2004. He also serves as chairman of the board. Chief operating officer Sheryl Sandberg has worked at Facebook since 2008 after spending more than seven years in an executive-level role at Google. We have a positive view of the skill set and performance of the management team to date and believe its patience and capital allocation have enabled it to drive profits and competitive advantages. While we expect Facebook to continue to be patient as a young public company, we acknowledge management may feel pressure to pursue revenue growth in areas that may actually weaken the firm's economic moat.

The concern about capital allocation becomes even more paramount because Zuckerberg controls about 57% of the voting shares of the company. In 2012, the company acquired Instagram, a social networking site for sharing photos. Although the purchase only represented approximately 1% of the value of Facebook, it has been reported that the deal happened with very little involvement from the board of directors. If Zuckerberg loses discipline in allocating the company's capital, there can be no guarantee that any such mechanism would prevent the company from destroying shareholder value.

Overview

Profile:

Facebook's 1.3 billion monthly active users create the world's largest online social network. More than 890 million people use Facebook daily, spending more time there than any other website, according to most third-party reports. Users go to Facebook to communicate with friends, share news, and play games, providing the company with a treasure trove of information to target online advertising. Currently, the U.S. represents about 15% of traffic but more than 45% of overall revenue.

Morningstar's Take

FB

- Analyst

Price 02-11-2015	Fair Value Estimate	Uncertainty
76.28 USD	66 USD	High

Consider Buy	Consider Sell	Economic Moat
39.6 USD	102.3 USD	Wide

Stewardship Rating
Standard

Bulls Say

- People spend more time on Facebook than any other website.
- By collecting information about users, their social connections, and their activities on the Internet, Facebook has a lucrative database that is highly valuable to advertisers.
- Despite relatively low advertising rates, the company's low expense base drives high levels of profitability and returns on capital.

Bears Say

- Many advertisers are unsure if they are spending money wisely on Facebook ads today.
- Management recently mentioned that the company may not be able to increase the concentration of its ads shown in its news feed.
- Laws and regulations surrounding privacy may hinder product development.