Market Research #009

This is the ninth in a series of Independent research produced by the Murray Wealth Group Research Team. The purpose of this series is to provide insight into our portfolio construction and how our research shapes our investment decisions. We welcome any feedback or questions you may have on these monthly commentaries.

Facebook: controversy in the rear-view, growth resumes

In early 2018, the rallying cry of Facebook's opposition, a gang upset with a myriad of perceived abuses from fake news, election propaganda, bots (fake accounts that push an agenda, be it advertising or public opinion) and unauthorized use of user data, was pushed into the spotlight sparking fears that the public would abandon the service. It was becoming evident that the internet technology sector was in need of regulation and Facebook was the poster child for the movement. As titans such as Google and Amazon have risen to become the dominating players in internet media and commerce, lawmakers and the public alike have firmly set the sector in their political and economic crosshairs.

It's not surprising Facebook encountered bumps in its growth. It reached US$50B in revenue quicker than any other company in history (inflation adjusted), and while we believe CEO Mark Zuckerberg is a visionary, his blind spots for his baby, birthed in a Harvard dorm room (watch the movie *"The Social Network"* for the fascinating story), has necessitated some reorganization and focus on privacy and security.

It is common for high growth companies to have flaws exposed in their business models as their products or services become more mainstream, attracting critics and detractors. We detail examples of two other high growth companies (below in Figure 1) that faced similar controversy. Nike had to deal with the sweat shop controversy and McDonalds had to manage through pressure from health advocates and the documentary "*Supersize Me*". While these events impacted their financials and share prices short term, over time, both companies were able to adjust and fix these issues, and with strong business models that customers value, continue to prosper.

Figure 1: Nike and McDonald's both encountered growing pains with criticism levied at the companies' core product lines.

Company	**Controversy**	**Initial Reaction**	**Response**
Nike Inc.	Sweatshop/unfair wages in manufacturing factories	Nike Denial, deflect blame to sub-contractors	Factory code of conduct, Factory audits, Re-organization of worker incentives
McDonalds	Super Size Me documentary/Obesity lawsuits	Smaller "Super Size" portions, McD balanced critique of film	McDonald's introduced healthier options, Eliminates 'Super Size' Option

MCD fell 16% in 4 months leading up to the release of Super Size me in May 2004 before rebounding to new highs by year-end

Nike suffered massive underperformance in 1993, falling 50% in a year the S&P 500 was up 25% in part due to concerns surrounding sweatshop issues

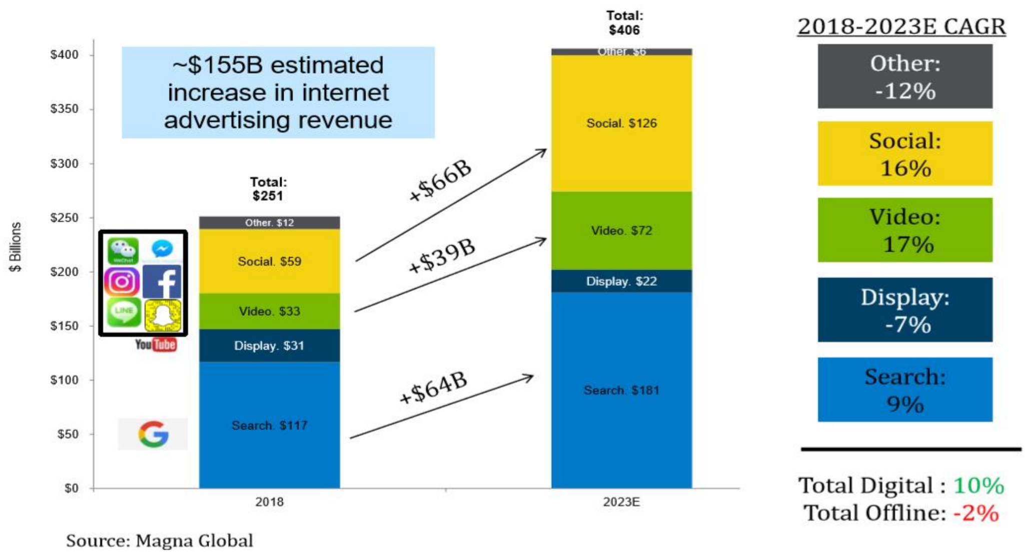
In July 2018, Facebook announced a several billion dollar increase in spending to improve security and content moderation as well as new standards surrounding data and advertising targeting. While necessary, it was a negative surprise, causing the shares to fall approximately 40% from peak levels.

Figure 2: In July, Facebook announced a major spending program on security and content moderation which severally impacted near term growth and margins, with 2019 EBITDA estimates falling from US$43B to US$37B by year-end 2018.

Six months later, Facebook is back on the offensive. User growth in developed markets has stabilized and revenue per user continues to surge as Facebook monetizes its multiple properties. In the 4th quarter of 2018, revenue was 3.2% higher than expected, the first revenue surprise since last March. This is significant given the enormous opportunity that is still in front of Facebook over the next decade. According to Magna Global

Research, the social network advertising market will increase from US$59B in 2018 (Facebook has a >80% share in this market) to US$126B in 2023.

Figure 3: Global Social Media Spending should continue to grow from US$59B to US$126B in 2023 with Facebook capturing >80% share.



It is likely that Facebook will maintain or possibly even grow its market share in social networking. In its latest conference call, management commentary was focused on new revenue initiatives through Facebook's four properties (highlighted below in Figure 4). Additionally, competitors such as SnapChat and Twitter have failed to generate meaningful user growth and continue to operate a single platform.

Figure 4: Facebook revenue growth initiatives by platform

Property	Initiative	Result
Facebook	Watch (FB original content)	Video advertising, user engagement
Instagram	Shopping/Payments	+ Business spend, commerce $
Messenger	Ads, payments	Ad revenue, fee for payment services
What's App	Ads, payments	Ad revenue, fee for payment services

The worst is likely over for Facebook. Analyst are starting to raise target prices again and after it settles a record fine (in the billions of dollars) with the U.S. Federal Trade Commission, it should have less regulatory pressure and fewer news headlines in the year ahead. As new initiatives start to drive engagement, we expect further additional revenue and extremely high margins to drive strong share price outperformance.

Figure 5: Facebook financial projections

in US$ billions, except EPS

	2017	2018	2019	2020	2021
Revenue	40.7	55	68	82.3	96.4
EBITDA	27	33.4	36.8	44.4	52.4
EPS	6.16	7.57	7.56	8.86	10.71
Free Cash Flow	17.5	15.4	14.3	19.1	25.2
Cash on Hand	8.1	10	19.6	31.9	46.7

Source: Thomson Reuters Refinitiv

In conclusion, we anticipate that Facebook's share price, like that of Nike and McDonalds before it, will continue its recovery based on the enormous opportunity set in front of it, the lack of alternatives for advertisers, its large user base and new monetization opportunities that should provide impressive growth for a company of Facebook's size. As investors become more comfortable with the company's handling of social network abusers, we could see the multiple expand as well. We maintain a 4.5% weight in the Global Growth portfolio and have a US$221 target price on the stock (it currently trades at US$163), which represents 33% upside.