May 8, 2012

Facebook (FB) - IPO week of May 17

Thesis - Facebook is tricky in that the media has created a "darling" that most investors feel like they must have a part of. While we would definitely concur that FB's 900m+ users will eventually be monetized, creating significant revenue, and ultimately, earnings, our concern lies in the short term (over the next few years). Facebook is focused on continuing to grow its user base. This is obviously something the company has excelled at in its relatively brief history. We expect that to continue, albeit at a slower pace of growth. In this case, we think the law of large numbers may play a roll. It seems reasonable that FB would grow its user base 10%+ annually for the foreseeable future. Currently, there are about 2B Internet users worldwide. Note that this doesn't include China. However, given that China is a controlled society, we don't feel comfortable adding in Chinese Internet users into our forecast. As a result, it would seem reasonable that FB would grow to 1.5B users over the next 4-5 years. Monetizing those users is a different story.

Concerns - FB's growth opportunities are widely known. Not only user growth, but also the amount of time users are on the FB website. The key to those users is advertising. And, FB compiles significant amounts of information on its users. In time, we would expect FB to use that information, which we concede would be extremely beneficial to advertisers, especially considering the demographics of FB's heaviest users.

Our primary fear is that FB will likely, at least initially, be more concerned with user growth than revenue growth. This is an important distinction; especially since analyst's growth estimates will be predicated on the revenue growth side of the equation. As such, this distinction may lead to analyst's estimates being too optimistic. We fear that improving the user experience will be the goal, rather than shareholders. While we hope this will change over time, this will likely prove to be the case over the first few years as a publicly-held entity.

A related point is that the company's CEO, Mark Zuckerberg, will still control 58.8% of the company's voting power, even after the IPO. Moreover, there are both A and B shares which brings up an issue that we have at SPC: a shareholderoriented management team. In this case, Mr. Zuckerberg has the ability to do essentially anything he wishes without any influence from anyone. This is something that cannot be overemphasized. In our view, this is a huge red flag.

Competition is also something that should not be overlooked. While FB has done an incredible job of growing its user base, the company offers a free product and only recently began to monetize its users through advertising revenue. Google and Microsoft are two formidable competitors that can't be overlooked.

Valuation - Based on the initial range of the IPO, it appears that FB will have an enterprise value in excess of $100B. With 2011 revenue of $4B and EBITDA of $1.75B, that represents a valuation of 25x trailing revenue and 57x EBITDA. However, while that would be absurd for most companies, looking backward is not reflective of where FB is going. Although FB's expected valuation will likely be very high, FB will probably do a pretty good job of growing into that lofty valuation, albeit over time. Our concern again is that Wall Street is predicated on meeting and exceeding expectations. We fear that the expectations may likely prove to be too high for Facebook to reach.

All of that said, based on media buzz helping further stimulate investor demand, there is a pretty strong possibility that FB shares will appreciate in the first few days of trading. However, we'd note that any investment would have to be considered with only risk-based capital in mind. We think that there will likely be better opportunities to buy FB, similar to GOOG after its initial public offering, once the company is able to grow into its seemingly lofty valuation. There may also be an opportunity to enter the stock (or increase a position in the stock) when the lock-up period expires. A lock-up period is the window of time for which pre-IPO shareholders are restricted from selling their shares. As per the prospectus, after 91 days pre-IPO shareholders are allowed to sell their shares. Typically, you expect to see some pressure as these pre-IPO investors monetize their gains.

We at SPC are value investors. We like companies that have moats around their businesses, making it difficult for competitors to compete. We love great balance sheets and companies that generate barrels full of free cash flow. Lastly, we like to buy a dollar of value but are only willing to pay $0.50. That way, if the expected value only materializes to be worth $0.75, that's ok since we only paid $0.50.

Warren Buffett would call this a "margin of safety". We think of this as common sense. Most investors would disagree.

That said, sometimes, for a very small part of your portfolio, it's hard to fight the Street. And, in this case, it does seem like the demand for Facebook shares will outstrip the supply. If that occurs, the shares may appreciate significantly beyond their offer price.

We hope you find this useful. As always, feel free to call with any questions you may have.

Best,

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