Reported Date: 7/21/2020

Facebook, Inc.

NASDAQ: FB

Recommendation: Hold

Analyst

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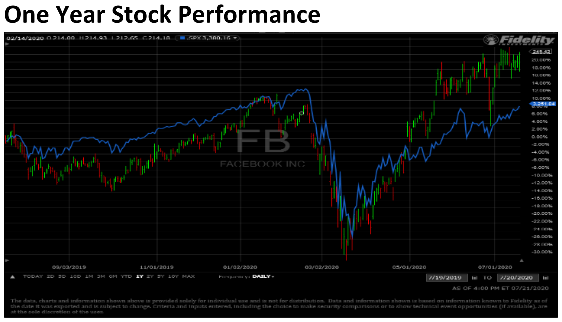
Current Price	$239.87
Target Price	$258-322

Company Overview

Facebook, Inc. is a social media platform that generates its principal revenues from advertising on its products: Facebook, Instagram, Messenger, and third- party affiliated websites or mobile applications. Increasingly, the company has explored other sources of revenue. These sources of revenue are generated through sales of Oculus, and net fees generated from developers using their payment infrastructure. As Facebook continues to develop their payments product strategy, they stand to generate significant possible revenues in the future.

Stock Performance Highlights	
52 Week High	$250.15
52 Week Low	$137.10
Beta	0.87
Share Highlights	
Market Cap	$699.69B
Shares Outstanding	2,851,336,000
Price/Sales (TTM)	9.62
Price/Book	6.65
EPS (TTM)	7.30
P/E Ratio (TTM)	33.62
PEG Ratio (5-Yr)	2.05
Company Performance Highlights	
Net Margin	28.57%
ROA	21.54%
Sales/Assets	0.57
Financial Ratios	
Current Ratio	4.60
Debt/Capital	8.28%

One Year Stock Performance



Coronavirus Slowdown Overshadows Increased Engagement and Strategic Product Investment

Investment Thesis

A reduction in ad revenue, and continued investments will eat margins in the short term. However, their continued investments in SMB, product features on existing platforms, and new business ventures or M&A activity will spur new engines of growth. We recommend an outperform cautiously, due to the uncertainty surrounding their short-term profitability and U.S. privacy policy.

Investment Positives

Increased Engagement

- ▲ Community metrics, such as MAU and Family MAP reflect increased ATH engagement as people around the world shelter in place.

Product Innovation W/ Monetization Opportunities

- ▲ Instagram Checkout, Explore Tab, Video Watch, Messenger Rooms.

Diversifying Stream of Ad Revenue

- ▲ Witnessing a rapid adoption of brick and mortar stores creating digital storefronts, and business pages.

Strong Balance Sheet and Cash Flow

- ▲ FCF surged 37.4% YoY to $7.34B in 2020Q1.

Investment Negatives

Reduced Ad Demand

- ▼ Management remains cautious on revenue growth and expects sales to be hurt by weakness in travel and auto.
- ▼ More companies are freezing ad spend, due to Facebooks regulation of hate speech.

Increased Spending

- ▲ Ramping up investments in headcount, and security costs are rising

Privacy Concerns

- ▼ Apple has given the users the option to decline app ad tracking, this will make it harder for Facebook to provide targeting ads.

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Executive Summary

We are issuing a HOLD rating on Facebook, Inc., with a target price range of $258-$322. The current price is $239.87, that results in a return of 7.5-34.2%.

Facebook will benefit from strong user growth and engagement offset by a reduced demand for advertising. The continued investments in the engineering talent and product strategy will hurt short term profitability in exchange for spurring long term growth.

Given economic, and political conditions over the next year remains uncertain we remain cautiously optimistic that a coronavirus vaccine will arrive by early 2021. Therefore, our model reflects this optimism through increased ad demand and pricing, offset by a higher than expected OpEx due to R&D. As a result, we are flat to guidance for FY2020.

To arrive at our target price range, we used a multiples method and industry average for their forecasted P/E. It should be noted though, a DCF/EP valuation would be more appropriate due to the wide range of P/E multiples in the industry and should be explored for a comprehensive valuation.

2020 Q1 Earnings Review

Financial Highlights

- **Facebook daily active users (DAUs)** – Avg. DAUs were 1.73B, +11% YoY.
- **Facebook monthly active users (MAUs)** – Avg. MAUs were 2.60B, +10% YoY.
- **Family daily active people (DAP)** – Avg. DAP was 2.36B, +12% YoY.
- **Family monthly active people (MAP)** – MAP was 2.99B, +11% YoY.
- **CapEx** – Capital expenditures, including principal payments on finance leases, were $3.66B.
- **Cash and cash equivalents** –$60.29B as of March 31, 2020. Entered into an agreement to invest in Jio Platforms Limited, $5.7B, and paid the $5.0B settlement amount FTC order.
- **Headcount** – Headcount was 48,268 as of March 31, 2020, an increase of 28% year-over-year.

Managements Guidance

- Ad revenues showed signs of stability in April with broad based weakness across the board.
- Guided total CapEx downward from $17-19B to $14-16B, noted that this is a deferral into 2021 rather than a savings.
- OpEx savings from travel, events and marketing as well as from slower headcount growth in its business functions offset by 10,000 more people in product and engineering for FY2020.
- Guided total expenses from $54-59B to $52-56B. Nevertheless, the revised escalation in OpEx is expected to hurt operating margin in 2020, due to sluggish revenue growth.

Q1 Themes Carrying Over Q2

Positive Themes

- ▲ Strong user growth from Asia and ROW primarily driven by tech and gaming ads. Asia is driven by Ad revenue from gaming, so this is a trend likely to continue through FY2020.
- ▲ Benefitting from growth in new features – Messenger Rooms, Instagram Checkout, Ad experiments (Recently, the company started placing ads on the Explore tab that is expected to drive the top line), allowing small businesses to build a digital storefront quickly (ordering food through Messenger etc.).
- ▲ Ad revenue will be better than expected driven by a slight recovery in auto and continued
- ▲ Sustained engagement.
- ▲ Continual product innovations.

Negative Themes

- ▼ Investments in R&D, and headcount are likely to hurt profitability in the near term.
- ▼ Growing competition in the ad space and increasing backlash due to its failure to eliminate hate speech causing top of funnel brands to freeze spending, or switch platforms entirely (Amazon, Google, YouTube). This is likely to hurt profitability in the near term especially in the U.S.
- ▼ Due to Coronavirus uncertainty, management will likely guide conservatively or not share information at all.

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2020 Q2 Earnings Preview: What to Expect

Facebook is scheduled to release earnings July 29, 2020. Facebook is expected to report $1.37/Share on $17.2B in revenue.

Potential Catalysts

- ▲ User Engagement trends continuing strong despite stay at home orders being released.
- ▲ Mixer merger, and stronger than expected growth in live streaming.
- ▲ Directly addressing concerns regarding hate speech, and apples new option to disable targeted ad tracking.

Concerns

- ▼ No response to advertisers leaving platform.
- ▼ Engagement metrics show signs of weakness.
- ▼ Weak guidance.

Questions

- What was the net impact of the ad boycott?
- How diversified is FBs ad revenue?
- What percentage of total revenue does the top 100 advertisers represent? What is the risk these brands leave?
- How is FB addressing the concerns over privacy, and hate speech?

Model Summary

This model uses Monthly Active People (MAP) growth rates and Average Revenue Per Person (ARPP) to project future revenue, and ratio analysis to complete the income statement. A multiples valuation was used to determine Facebooks 12-month target price. The models FY2020, and FY2021 are calibrated to consensus estimates with quarterly deviations based on my view of macroeconomic business conditions.

Due to growth in Asia and stronger than expected engagement revenues are projected at 17.4B vs 17.2B. A 5% increase in ARPP in Asia with continued strength in engagement should drive incremental revenues of ~245MM. The incremental revenue from Asia will be offset by a contraction in U.S. and European revenues due both the stop paying for hate campaign and a worse than expected recovery from Covid-19. Additionally, OpEx will likely be higher than expected due to Facebooks continuing commitment to hire talent and deliver products.

The model estimates EPS slightly higher vs consensus estimates of $1.37 for a $0.02 surprise.

Revenue Decomposition

Revenues are forecasted based on different geographical regions, which include U.S. and Canada, Europe, Asia, and Rest of World (ROW). We forecasted an 8% growth in Asia, offset by slower world recovery (see chart).

Region	1Q20	2Q20E	QoQ Var
U.S. and Canada ($M)	8,562	8,070	-6%
Europe ($M)	4,254	4,183	-2%
Asia Pacific ($M)	3,257	3,502	8%
Rest of World ($M)	1,664	1,661	0%
	17,737	17,416	-2%

Since Family metrics more closely resemble how users interact with Facebooks suite of products, (Facebook, Instagram, Messenger, and WhatsApp) revenue is based on MAP and ARPP. To arrive at each region's revenue, each geographies MAU mix is derived to determine the likely estimate for MAP, and MAP growth rates reflect my view on the accelerated mix shift towards Asia and ROW.

ARPP growth rates are also subject to my own macroeconomic views regarding social and political response to the coronavirus. In NA and Europe, revenue growth is likely to be sluggish due to the drop off in demand from travel and top of the funnel advertisers offset by an increase in SMB growth. Revenue growth in Asia is projected to be strong due to their unwavering focus on gaming and tech which have seen strong growth as a result of the worldwide lockdown. ROW is projected to implement austerity measures, and shrinking budgets mean advertising will only cut into lower than expected margins.

Conclusion

A lot of uncertainty remains regarding the pandemic; however, I am optimistic that we will survive, and things will return to normal. Advertisers will return. People will continue to use Facebook and Facebook will continue to find ways to monetize that.

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Important Disclaimer

Disclosure: I am long FB. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

Additional disclosure: I am not a financial advisor. All articles are my opinion - they are not suggestions to buy or sell any securities. Perform your own due diligence and consult a financial professional before investing or trading.