

October 23, 2018

## Special Note on Facebook (NASDAQ: FB)

Identifying the obvious requires little skill and even less conviction, falling into the same genre as “following the herd”. Most equities in the current market are trading at high valuations making them unattractive investments. Candidly, “obvious” bargains are few and far between. However, as the saying goes “there’s always an exception”. Facebook (NASDAQ: FB) happens to be that rare exception.

From a number of viewpoints, FB is a deeply undervalued stock hiding in plain sight. Over the past three months LRT has built a sizable position in FB. In fact, FB is currently our largest and our highest conviction investment. With that said, a deeper discussion of FB serves to provide transparency as to the LRT process with the goal of enhancing conviction about the sustainability of our performance.

As of 10/15/2018, FB has declined over 30% from the all-time high established earlier this year. In typical Wall St. fashion, many investors (including those considered to be “professionals”) have a myopic focus on short-term uncertainty while ignoring the fundamental long-term value of the company. Short-term concerns about privacy, users “fleeing” the platform and revenue growth have distracted investors from the strong positive long-term story. The current sentiment surrounding the shares is at a negative extreme. We expect the market’s focus will shift once again towards the factors that really determine Facebook’s long-term value: The moat, growth opportunities and capital allocation. This will lead to exceptionally strong stock returns and translate into strong performance for our investment partnership. We can’t be sure when this shift in sentiment will happen, but we are certain that it will, and when it does we will be richly rewarded.

### Why are shares cheap today?

Facebook’s share trade at a trailing valuation of 21x earnings or 19x earnings excluding cash on the balance sheet. This is a very low valuation for a company that has an exceptional business model with an unassailable moat and a management team that has done a good job of capital allocation.

There is a growing consensus of doubt by many market participants about FB’s moat and the sustainability of the company’s profitability. Some commentators have gone as far as to call social networking a fad! To understand how bad the sentiment surrounding Facebook is consider this: The company’s shares are the WORST performer of the NASDAQ 100 over the past three months. This kind of negative sentiment sets the stock up to significantly outperform as sentiment shifts. But, let’s first consider why the short-term negativity surrounding FB will not impact its long-term fundamentals.

The first piece of uncertainty that has led to the current low stock price was a self-inflicted wound by FB's management during the Q2 2018 conference call. The company's CFO predicted a revenue slowdown and declining margin over the next several years. The news caught Wall Street analysts by surprise as it implied several years during which expenses would grow faster than revenues. As a result, the company's stock price fell sharply during the next trading day (at over \$100 billion in lost value it was the largest single day decline for any company in history) and has declined ever since. We believe management's comments should be taken with a grain of salt, as they have predicted revenue slowdowns and margin declines in the past and in each instance have beaten their low guidance. We believe that the same will occur this time as well.

### **Context, Climate and Cash**

Any discussion of a revenue slowdown must be placed in the correct context. Global online advertising is a duopoly with the lion's share split between FB and Google (Alphabet). Facebook and Google have the most sophisticated advertising platforms and the best data available to target users. To that end, as online advertising continues to take share from other forms of advertising, with more and more dollars shifting online, the overall market is growing. At the same time, the targeting abilities of Facebook and Google, which continue to be a source of competitive advantage, continue to improve and only serve to strengthen the duopoly. The simple truth is that FB and Google are growing while the rest of the online advertising sector, (Twitter, Snapchat along with thousands of "tiny" companies) are fighting over table scraps and shrinking because they cannot compete with the precise ad targeting abilities offered by the duopoly.

FB, while a part of a global duopoly, is in a growing market, gaining share in the overall market with the ability to raise prices (as borne out by increasing CPC rates) as it improves its targeting performance. As referenced earlier, there is much talk about declining revenue growth rates for Facebook but the facts so far tell the opposite story: revenue growth at FB has been accelerating over the past year – not declining. From the data that we have, there are several trends occurring:

- FB user growth while plateauing due to market saturation is still growing faster than competitors.
- Snapchat, the most serious competitor, is losing users and experiencing execution problems.
- Instagram (owned by FB) is growing users with evidence Snapchat users are leaving for Instagram.
- The number of Facebook users continues to grow, not just internationally but also in the US (+2 million over the last year),

These are the hard facts, supported by real data. However, negative sentiment both anecdotal and from "research" abounds. The bulk of worries are from reports about declining user growth or even users outright fleeing the platform. These reports are misleading and in some instances out-right wrong but I address them to help explain why they are unreliable.

1. First there was the #DeleteFacebook campaign sparked by the Cambridge Analytica controversy. What was lost in the reporting on this movement was that the day after the campaign was launched the Facebook app rocketed to the 1st place in terms of downloads on

the Apple app store. Why would Facebook be the most downloaded app on the Apple app store if users were deleting Facebook? Simple: In a connected world, FB has become a “resource necessity utility” much in the same way as water and electricity. As such, as quickly as it was deleted, it was re-downloaded – users realized they “needed” it. The truth of the matter is that Facebook provides value to its users. It is a place for connecting with friends, family and colleagues. It is place for sharing photos, discussion and documenting major life events. Finally, it provides a convenient “gateway” via login to hundreds of other apps and websites through the “login with Facebook” feature. Because of all of this, it is difficult to truly leave Facebook, and the evidence is that few people do. People may reduce their usage, adjust privacy settings or claim they will leave, but few people truly leave. It is important to look at what people do, not just what they say.

2. A recent 3<sup>rd</sup> party study of US-based android users reveals important information about Facebook’s usage trends. While the data was from strictly from android users, it is indicative of overall trends in the usage patterns of various mobile aps. The study showed FB usage peaking during the first quarter at 58 minutes per user per day, then declined to approximately 53 minutes per user per day around the Cambridge Analytica scandal, then rose again, to a new high of 59 minutes per user per day by July, suggesting no long-term damage from the privacy scandal.
3. In addition to Cambridge Analytica, a recent Pew Research Center study focused on FB, concluded with the sensational headline that “42% of users have deleted Facebook from their phones during the past year”. This study has a large number of problems, which suggest it as unreliable (after all, we know the number of users rose by 2 million during the time in question). First, the study equated the deletion of the Facebook app with leaving the Facebook platform. Secondly, it did not count users who reinstalled the app after deleting it. Finally, it asked users about their actions over a period of one year but was conducted over a ten-day period itself. Self-reported data from individuals is subject to exaggeration and signaling biases. For example, before elections voters regularly self-report a propensity to vote that is often 2-3x greater than actual turnout rates. For all these reasons the Pew study should not be considered a serious source of information on Facebook user engagement.
4. FB Q2 earnings report showed growth of only 1.5% in daily active users (DAU) quarter-over-quarter which was lower than growth in the past. This should not be surprising. Facebook currently has 2.2 billion users – very close to all possible users. For context, there are only 3.5 billion internet users in the world and 900 million are in China where Facebook is blocked. That leaves 2.6 billion potential users of which almost 85% are already on Facebook. The reality is that almost all future user growth for the company will come from global population growth and the spread of the internet to more consumers, not additional market share gains. Finally, during the same time period (Q2), Twitter reported no growth in users at all (flat 335 million), while arch rival Snapchat saw a decline in the number of users by 3 million or approximately 1.5% (to 188 million). This suggests that user growth for Facebook is slowing due to market saturation and not market share loses.
5. Another source of investor anxiety about Facebook has been a few executive departures from the company in recent months. In particular, the departures of Instagram’s founders and the founders of WhatsApp have rattled confidence. Both Instagram and WhatsApp were acquired by Facebook. It is rare for the executives of an acquired technology company to hang around

for long once their business is sold. In fact, Instagram's founders stayed with the company for over six years after the acquisition, and WhatsApp founders stayed for four years. Both are considered a long time by Silicon Valley standards. I have spoken with several marketing directors for brands that advertise heavily on Instagram. I have intentionally omitted the names of the departed executives. Two-thirds did not even know that the founders have left, and none was able to name them. The truth about the departure of Kevin Systrom and Mike Kreger (the co-founders of Instagram) is this: They are billionaires who worked at a company whose destiny they did not control. They were both in their mid-thirties with young families. Their departures signify nothing about Instagram's future as revenue contributor to Facebook. Six months from now they will become the Leon Trotsky of Facebook (if you had to look up who Leon Trotsky was in Wikipedia, I have made my point). Executive departures matter if the executives in question are founders of the company. It is Snapchat which is bleeding executives, with nine out of eleven of the founding members now gone. Facebook on the other hand has a large stable of executives with long tenures. Chris Cox, the Chief Product Officer, has been at Facebook for over 12 years. Andrew Bosworth, head of hardware, +12 years. Dan Rose, VP Partnerships, +11 years. Javier Olivan, VP of Growth, +10 years. Alex Schutlz, VP of Growth Marketing and Analytics, +10 years. Sheryl Sandberg, COO, +10 years. Elliot Schrange, VP of Communications, +10 years. Mike Schroepfer, CTO, +10 years. Jay Parikh, VP of Engineering, +8 years. I can go on, but I think you get the picture. Facebook's top leadership is very stable.

6. Another set of reasons investors are "down on Facebook" has to do with hacking, privacy concerns and the controversies about "selling data". The recently announced Facebook security breach, which affected an estimated 30 million users is not good, but it is hard to believe that it will have significant regulatory or revenue impact on Facebook. While 30 million sounds like a lot, it is only 1.4% of Facebook's users. Furthermore, if history is any guide, what matters are the consequences of the security breach, as the breach itself is quickly forgotten. Just over a year ago, Equifax, the credit rating agency was hacked. Credit reports for over 100 million Americans were stolen. What happened since? While Equifax stock declined immediately after the breach, it has since recovered all of the losses, as the hacking event did not result in significant regulatory changes or crippling financial damage to the company. Similarly, a Facebook "data breach" is abstract to most users, and while some may be upset at the company, there is very little evidence of users "quitting" Facebook because of it, just like very people quit credit cards because of the Equifax breach.

My personal view is that most FB users don't really care about privacy. People say they want privacy and are upset about Facebook not protecting their data, but only a tiny number of users stop using the service because of privacy concerns. In fact, I believe that the majority of people neither care nor expect privacy on the Internet – what they want is quality and convenience. The fact of the matter is that privacy is a fairly new idea for humanity. For most of human history, people lived in small communities, often in small tribes or extended families sharing a sleeping place. In such communities everyone knew everything about everyone else. Anyone who has lived in a rural American town knows what I mean. If you move to a small town, most people you meet will know something about you before you even meet them ("I've heard about you from so and so..."). For most of human history, privacy was a non-existent concept. In fact, the word "privacy" did not appear in the dictionary till the 15th century and has only been defined as a "right" in the United States since 1890. The ability to keep information private and live an anonymous life are relatively new developments. What is not new is the tribal nature of our society: the human need

to share stories, pictures and arguments in a community. The need to connect with others is a primordial need that FB fulfills.

There has been a lot of ink spilled on the idea that Facebook “**sells your data**”. Nothing could be further from the truth. Data is valuable, and Facebook does not sell it. It sells access to an audience, defined by the data. Data is valuable because it is scarce. If Facebook sold your data, it would no longer be as valuable. What’s more, FB actually buys data from other providers. For example, Facebook buys data from traditional retailers and merges it with the data it already has in order to improve ad targeting. This allows it to target cosmetic ads to users who shop at Sephora but who have not expressed any preference for the brand (for example “liking” the page) on the Facebook platform. This data exchange happens automatically and in near real time, and because of Facebook’s scale it has become the de facto data repository for the entire advertising industry. This data advantage allows the company to deliver more targeted ads and it is an advantage that grows stronger every day. This might sound unsettling, but the truth is that retailers and marketers have for decades been gathering information on consumers. Thousands of companies have consumers personal information and use that information to target advertising. FB has a product named “Custom Audiences”, where an advertiser can target specific users on the platform by submitting a dataset to Facebook which the company then uses to identify those users. You can see what “Custom Audiences” you are a part of by going to Facebook.com on your desktop then clicking: Settings -> Ads -> Advertisers you've interacted with -> Who have added their contact list to Facebook. This will show you a list of advertisers that have your personal information and have used it to target you on Facebook. In my particular case there were over 1,000 organizations listed.

The real value of Facebook is not selling your data, which again it does not do, but rather the ability to link your web activity to a real person. By signing into Facebook, you reveal your real identity allowing the company to use this to target advertising to you even outside of Facebook through its product “Facebook Audience Network”. Facebook knows who you are everywhere on the Internet: On your phone, at work, at an Internet café, on a public WiFi hotspot and at home. Imagine scrolling through your Facebook news feed at your office and see a product that you want to buy being advertised. It may feel tacky awkward pulling out your credit card at the office with your coworkers around – after all you should be “working” not shopping. So, you let it go. Then you check YouTube during lunch as you wait in line for checkout at a local fast food place. You see an ad for the same product you saw earlier. Finally, you get home and look at your Instagram feed. You see the ad again for the very same product. You click and purchase item. The ad you saw in the morning, the Youtube video, the ad on Instagram, the “click” and purchase in the evening; all of these happened on separate devices, on different parts of the Internet and on different Internet connections. Facebook can tie all these actions together and back to you. The advertiser can measure the effectiveness of their ads and their true cost. That level of attribution is the real value of the advertising platform the company has created. Facebook offers the closest thing there is to the holy grail of internet advertising: Real identities. Advertisers value these capabilities immensely.

### **What matters to Facebook’s long-term value?**

Short-term headlines only matter to the extent that they affect one of the previously mentioned elements. If they do not, they are simply noise. The long-term enterprise value of Facebook will be driven by three (3) management aspects:

1. The moat
2. Growth
3. Capital allocation.

### **The Moat:**

How difficult would it be to replicate Facebook? Will users stick around? Facebook's moat arises from the company's network effect. People join and stay on Facebook because their friends are on Facebook. Personally, I have several "groups" of friends on FB: High school in Poland, high school in Missouri, college in New Jersey, graduate school in Missouri, co-workers, friends from Hong Kong and now friends in Austin, TX. It is impossible to stay in touch with so many people across so many geographic areas without a platform like Facebook. There is no obvious alternative for me to leave Facebook and retain the utility to seeing updates from friends from so many different parts of my life, not to mention the ease of communicating with them through Facebook Messenger. The history of my life is chronicled almost exclusively on Facebook: There are 10 years' worth of photos, along with comments from friends, picture tags, and much more. When I am 90, I will be grateful that Facebook exists, and I am far from an active Facebook user. The entire world is uploading the history of their lives onto Facebook, at a pace of over 1 billion photos per day. The company's moat is growing wider every day.

Facebook's moat will remain intact as long as no viable alternative exists and as long as the intrinsic part of human nature remains: The need to be "connected". No man is an island, as such the human need for "shared experience" does not change. Facebook's ability to enable us to share photos and stories from our lives requires focusing on user engagement over any other metric, and the company's management has done so. For example, earlier this year Facebook decided to deprioritize news stories in users' news feeds and focus more on content generated from your friends, a trade-off with negative short-term revenue consequences but a positive for long-term engagement. Facebook has consistently acted in a manner that prioritizes engagement ("stickiness") over short term financial gains (decreasing ad loads, reducing news stories, policing fake news and negative behavior on the platform). As long as it continues to do this, it is unlikely for a viable alternative to Facebook to be created, as the network effect creates barriers to entry that are nearly insurmountable.

Investors often talk about wanting management to focus on the long term. Facebook is one management team really does so: They have consistently taken steps that strengthen and widen the company's moat, even at the expense of short term results. The evidence of this focus is the list of competitors that Facebook has faced and vanquished over the years. Who has tried to assault Facebook's network effect and failed? Orkut (Google's early foray in to social media), Twitter (user growth stalled at 15% of Facebook's size), Google+ (Google's second attempt at social media, recently shut down), Snapchat (8.5% of Facebook's size and losing users), and many, many others.

## **Growth**

Facebook's revenue growth will slow but it is far from over. The company can continue to grow faster than GDP for many years to come, as both the Internet advertising market and the company's own share of that market grows. The company's growth can be deconstructed into the growth in the number of users and growth in revenue per user. While the growth in users is soon going to mirror population growth, the growth in average revenue per user (ARPU) has a long way to go. For example ARPU in North America grew by 33.6% in the recent quarter compared to the same quarter a year before. What's more, revenue per user in North America is more than 2.5x that of Europe, and more than 10x that of Asia Pacific (where most of Facebook's users reside). There is enormous scope for growth in ARPU outside the United States as those economies mature, internet penetration increases and income per capita rises. Facebook has also barely begun monetizing its video platforms (IG TV, Facebook Watch, Facebook Live, gaming videos, etc.), Facebook Messenger and WhatsApp. There are many more levers that the company can pull to increase revenue. In addition, Facebook continues to invest new projects for future sources of revenue.

## **Capital Allocation**

Facebook's capital allocation has been excellent overall. Many forget that FB is still in its infancy, founded in 2004 and going public only six short years ago in 2012. Facebook has invested in its core product and made several fantastic acquisitions over the past several years. Specifically, Instagram and WhatsApp have turned out to be two of the greatest deals in modern history. Instagram especially, is estimated to be worth more than 100x what the company paid to acquire it. Similarly, WhatsApp has become immensely more valuable and has become the de facto communication standard in most countries in the world. Where WhatsApp is not dominant, Facebook Messenger rules the day (countries firmly fit into one camp or the other, suggesting that the network effect in communication services is largely country specific).

Overall, Facebook's capital allocation has been exemplary, and the company continues to execute its strategy well. Management is highly incentivized to perform as the bulk of their fortunes are tied up in the company's stock. Additionally, FB has only recently begun a share repurchase program. Most importantly, Facebook's management is long term focused: they continue to focus on user engagement and continue to invest heavily in future products, despite the short term costs of such investments.

## **Conclusion**

Trump's victory in 2016 shocked many. It was an especially big shock for liberal media elites. Many people still cannot accept Trump's victory. They cannot come to grips with the fact that a large part of the US population does not subscribe to the dominant liberal world view. As a result, they have been looking for a scapegoat ever since: The electoral college system, Russians, Facebook, etc. Facebook has become a scapegoat of Trump's victory – one wonders if Hillary Clinton was president, would we have had so many hearings about "Russian interference" or the impact of "fake news"? Being dragged in front of Congress can be embarrassing, but the US Congress is a paper tiger. Most elected representatives do not comprehend how online advertising platforms work nor are they able to craft policies that will curb their influence. The specter of their involvement may serve as "theater" for some, via the occasionally contentious hearings held

during an election year, precipitating attention-grabbing headlines that may be inaccurate or in the worse "fake news". In sum, any regulatory action that comes out of Washington will almost certainly entrench incumbents – in the words of Sheryl Sandberg, Facebook’s COO, “we’re open to regulations...”. Washington D.C. will be a source of noise but not a threat to Facebook’s profitability.

I’ve often spoken about the “optics” of value companies. In many instances, an exceptional situation can “look” down right ugly by conventional measures. Moreover, “moats” are not instantaneously constructed. Any “structure” with longevity takes time to build and completion is not without continual challenges and hurdles (internal and external). This is particularly true in the case of technology growth companies. “Does FB have “growing pains”? YES. However, “Does FB have an unassailable position online?” YES. Simply, there may be challenges that distort the underlying positive narrative. More importantly, FB is continually fortifying its “moat” by focusing relentlessly on user engagement over all else.

As management executes, LRT expects the negative sentiment surrounding Facebook will dissipate as investors focus again on what matters: revenues and profits. We believe that Facebook will continue to grow and produce record profits in the months and years ahead. Today’s low valuation and depressed investor sentiment represent an excellent opportunity for strong returns ahead, which positions LRT to be well-rewarded for our patience, discipline and conviction.

I hope this letter helps clearly explain our thinking and conviction about Facebook and why we have it as LRT’s largest position. If you would like to discuss Facebook or any other portfolio holdings with me, please don’t hesitate to contact me. I welcome the opportunity!

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