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Dear Investment Partner:

Below are some of my thoughts on Facebook, our most recent investment. Please reach out to me with any questions. As always, I want to mention how much I appreciate the opportunity to manage your hard-earned capital alongside my own. It is a privilege that I am very grateful for.

Facebook is Undervalued

"A simple rule dictates my buying: be greedy when others are fearful." *- Warren Buffett*

Buffett wrote those words in an op-ed during the fall of 2008, which was certainly a time of fearfulness. The simple philosophy has been a foundational part of his investment approach for his entire career, and regardless of how often it gets repeated, it remains as useful and as valuable today as it was when Buffett first coined the phrase decades ago. Human nature doesn't change, and the stock market continues to provide opportunities to be greedy when others are fearful.

As I've outlined before, there is no informational edge in most large-cap stocks, but there absolutely is a time-horizon edge for those who are willing to thoughtfully analyze what most people want to avoid out of fear of what the next year might look like.

Currently, fear is creating an opportunity with Facebook. The stock, at $140 per share, is currently trading around 18 times earnings (16 P/E excluding net cash). This is a company that grew its revenue by 49% last year, and while growth will obviously slow from that level, Facebook is one of the most profitable businesses in existence and still has a very long runway ahead. If you have the ability to look out two or three years, this is the time to be capitalizing on that fear.

"Best Business Model Ever Created"

Facebook has one of the best businesses in the world. In some ways it operates like a traditional media company that provides content to readers and collects advertising revenue from businesses who want to reach those readers. But the key difference is that Facebook has the largest readership base in the world (2.3 billion people), and the readers themselves provide the content for free. This is why John Malone once said Facebook has the "*best business model that's ever been created*".

The result of billions of readers providing free content for each other is a massive network effect and a business that can serve each incremental ad at a very low marginal cost. The company's 85% gross margin leaves a lot of meat on the bone that the company can spend on hiring new engineers and developing new technology that is needed to maintain and grow the business. But even after paying the engineers, growing the headcount, spending over $9 billion on R&D, and paying the tax bill, shareholders are still left with around 40 cents of profit for each dollar of revenue.

Facebook reinvests these earnings into data centers, technology, and the occasional acquisition, but even so, the cash in the till has been piling up, and now exceeds $40 billion and counting ($14 per share). Facebook has spent $10 billion on buybacks in the last year, and this will likely accelerate in the coming years.

A Durable Moat

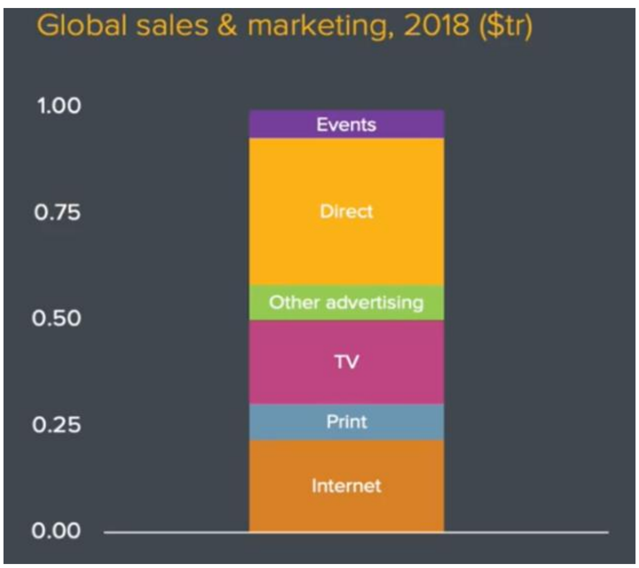
All of Facebook's properties have huge network effects, and the great thing about networks is that as they grow, their moat widens. The sheer size of the network acts like a magnet to get people and businesses to join, and it acts like gravity to get those participants to stay. It's hard to leave a place that all of your friends and acquaintances are a part of. And for the same reason, it's hard for a business to leave a place where all of its customers are. The strength of the network compounds exponentially as it grows.

Facebook's network of 2.3 billion people is much stronger than Twitter's 300 million or Snap's 200 million. And for those who compare Facebook to MySpace: keep in mind the latter had 75 million users at its peak in 2008, roughly 3.3% of Facebook's current user base. So far in 2018 alone, Facebook has added 142 million users, a sum that is nearly twice the number of users that MySpace ever had in total.

Facebook's huge user base doesn't mean the network is invincible, but it is much more durable than many people believe.

Growth Potential

Facebook's business is still growing fast (33% revenue growth last quarter), and despite the company's large size, the runway is still long. Benedict Evans, a partner at the VC firm Andreessen Horowitz, recently pointed out that roughly $1 trillion is spent each year by businesses who are trying to reach customers who are asking the question: "What should I buy?":



(Source: Benedict Evans, a16z)

Facebook has roughly 5% of this market, which I think is a share that will inevitably rise over the coming years as advertising dollars continue to shift from traditional media to the much higher ROI advertising platforms like Google, Facebook, and Amazon.

It’s worth pointing out that only 11% of Facebook’s 2.27 billion monthly active users are in the US and Canada, which mean that the platform has over 2 billion users *outside* of the US.

Despite having most of the platform’s users, Asia and the rest of the world account for a small piece of Facebook’s revenue. As consumers in those emerging economies gain spending power, businesses in those regions will grow and spend more money advertising to those consumers:

Revenue Per User - Last 12 Months	
US & Canada	$104
Europe	$35
Asia-Pacific	$10
Rest of World	$7
Overall ARPU	**$24**

A dollar buys more goods and services in poor countries than it does in rich ones, but even if we adjust for purchase power parity, Facebook has a lot of untapped potential outside of the US.

Instagram & WhatsApp

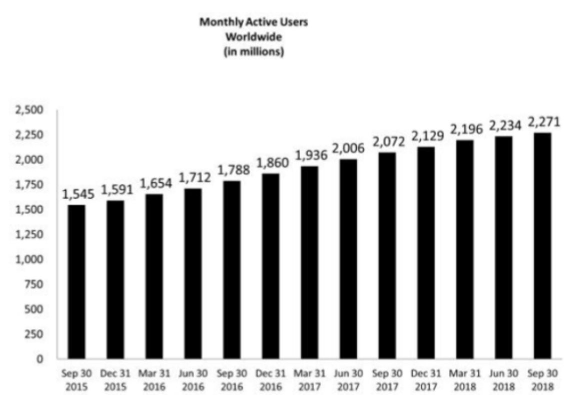
The company also has an enormous potential for growth on Instagram (which is still in the early innings of growth) and WhatsApp (which has over 1 billion users but has yet to be monetized). Over 100 billion messages are sent every day across the company’s services, and in many countries, they are the main tool for communicating. A fast-growing number of these messages are sent between merchants and customers, a service that hasn’t been monetized yet but is obviously very valuable for businesses.

These platforms will make more money from advertising in the near future, but there are also other potential sources of revenue from mobile payments, video content, subscriptions, or even commissions or usage fees from businesses that originate sales on these platforms. These business lines may or may not develop, but they are all possible, and they are all valued as free call options at the current stock price.

Is the Network Still Intact?

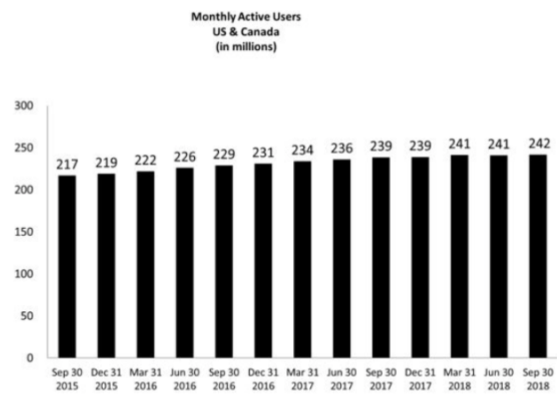
The intense negative sentiment surrounding the health and risks of Facebook’s namesake platform has caused the stock price to decline. As an investor, determining whether people are still likely to continue using Facebook’s properties is the **most important variable to consider.**

The numbers have yet to show any erosion. The user base keeps growing each and every quarter:



Despite its already massive size, Facebook added roughly 200 million users in the last year alone (by comparison, SnapChat and Twitter added a combined 4 million users during that period).

Even in the US, where virtually everyone is already on Facebook, the numbers have remained steady:



Facebook's user base will slow and eventually plateau, but as long as it remains intact and engaged, revenue growth will continue as ad spending keeps shifting toward digital media. And again, the numbers above only refer to Facebook itself, and doesn't include Instagram, WhatsApp, or Messenger.

The network appears to be strong. But this doesn't mean that it is invincible, which brings me to another key variable to consider, which is management: what are they doing to protect the network, and will they be successful?

Facebook's Stadium

My friend and fellow investor Matt Brice has used an analogy of Facebook as a giant stadium where the entire world comes to watch events and interact with each other. The stadium itself is a great asset. It has the largest capacity (in this case over 2 billion) and it holds the concerts and sporting events that everyone wants to watch. The stadium is a very durable asset that doesn't take much to maintain in the short-run. But Facebook's job is to ensure that people continue to come back to future events. This requires spending money on maintaining the building, upgrading the facilities, fixing the occasional leaks in the roof, and installing security guards to root out those who misbehave. I would note that the behavior of a few bad apples doesn't mean that the stadium can no longer hold effective events in the future.

The most important task right now is to focus on upgrading the stadium's security so that those bad actors can no longer slip past the guards, and this is exactly what Facebook is doing—operating expenses grew by over 50% last quarter as the company hired more people and spent more money on security.

Facebook is a cash flow machine. The incremental revenue is very high margin, which leaves lots of cash left over to reinvest back into the business, and still maintain healthy free cash flow margins. The company will spend over $10 billion on R&D and close to $20 billion in capital expenditures in the next year, with most of those resources going toward the general goal of protecting and growing the platform.

It's evident to me that protecting the stadium is the top priority at Facebook.

Mission-Driven Focus

I think the company's efforts to fix the problems will be successful, because based on my conversations with employees at the company, their motivation for cleansing the platform is genuine, and genuine effort put forth by talented and hardworking engineers who love solving problems is a recipe for progress.

Mission-driven companies often have intangible qualities outside of money that motivate individuals. Facebook's mission of connecting the world has gotten overshadowed by the current issues and the negative news momentum, but I don't think the mission is any less meaningful. Zuckerberg has certainly taken a beating this year, but I've always been impressed with his foresight and his focus on the company's long-term future. He's faced adversity before (transitioning the company from desktop to mobile was a monumental feat), and his focus on doing what he thinks is best for the long-term health of the platform is what all shareholders should want.

I also think it's comical to watch pundits debate whether Zuckerberg should step down. He and Sheryl Sandberg have created more equity value in the last decade than just about every other management team alive, and just like when reporters started questioning Tom Brady's future in 2014 after an early season blowout loss in Kansas City, sometimes the market's short-termism leads to a large gap between perception and reality. The Patriots went on to win 8 straight games after that question was posed, and Tom Brady ended the year as the Super Bowl MVP.

As I've said before, football fans, media members, and stock market participants all tend to overemphasize the relevance of recent events and get overly influenced by negative sentiment, and this causes inaccurate assumptions and extrapolations, both in football and in stocks. In the market, this is how stocks get mispriced.

Valuation

At the current stock price of $140, we are paying 16 times earnings (excluding net cash) for a company with 40% profit margins, huge returns on incremental capital, 30% top line growth and a long runway as advertisers continue to shift their spending to higher ROI digital platforms.

I think the company has a lot of growth left that we aren't paying much for at the current price.

However, the key to analyzing Facebook is not to get precise with forward estimates, but to **determine whether the company's network will remain strong**. If so, the stock is very cheap.

A strong network leads to Facebook grabbing a much greater share of the $1 trillion (and growing) global ad/marketing industry. Revenue from ads alone could easily be twice the current size, which means that Facebook is a $100 billion business before counting any of the possible upside from payments, messaging, or any of the other potential business lines that the company could develop on the back of its large network effect.

Facebook's operating margins went from 25% in 2012 to over 50% last year. This operating leverage is an inherent part of their business model, and it has not disappeared. Costs could rise faster than revenue in the next year or two, but they will eventually be spread over what I believe is an inevitably rising revenue base as advertisers continue to shift money to digital platforms that offer more effective ways to reach customers.

Facebook generates far more cash than it can use, and it's likely that Facebook spends more of its growing cash hoard ($42 billion, or $15 per share) on buybacks.

I estimate that the large market opportunity, operating leverage, free cash flow generation and the potential for buybacks will result in Facebook's earnings growing to $15 per share in the next five years, with plenty of growth still remaining.

Summary

The negative sentiment surrounding Facebook is extreme. Fears about the health of the platform has created an extreme negative sentiment in the stock.

If you can look out 2-3 years and ignore the day-to-day news, you're likely to see two things: sentiment that has normalized and a business that continues to grow its earning power.

If you compare the current price to the powerful network effects, the economics of the business and attractive industry prospects, the risk reward is outstanding at the current price of $140 per share.

Facebook will not be completely free from problems, but management and the employee base will make significant progress in their fight to preserve the safety and soundness of their platform, and the inherent profitability and quality of the business model will get valued more appropriately as a result.

John Huber is the portfolio manager of Saber Capital Management, LLC, an investment firm that employs a value investing strategy with a primary goal of patiently compounding capital for long-term oriented investors.

To read more of John's writings or to get on Saber Capital's email distribution list, please visit the Letters and Commentary page on our website. Email John at john@sabercapitalmgt.com.