Written by

Oleh Kombaiev
Commodities and tech stocks. Deep Value.

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Symbol	Price	% Chg
MTCH	141.00	3.12%
ENSG	82.31	3.04%
HSIC	75.23	1.48%
BKNG	2,305.47	1.26%
EBAY	76.41	1.02%
HEI	127.90	0.97%
CNSWF	1,686.45	0.84%
MA	355.73	0.81%
AAPL	148.60	0.72%
MCO	377.85	0.66%
CMG	1,918.95	0.65%
CTAS	391.69	0.42%
BRK.A	430,901.00	0.28%
DPZ	511.87	0.25%
IDXX	668.27	-0.76%

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Facebook: Fundamental Undervaluation Still Outweighs Risks

Aug. 26, 2021 7:30 AM ET | **Facebook, Inc. (FB)** | 9 Comments | 10 Likes

Summary

- The growth rate of Facebook's audience is slowing down, but this is more than offset by the growth of monetization.
- In terms of its current financial results, the company's price looks quite balanced, and the potential for further growth is clearly present.
- In the context of the current growth rate of key financial indicators, Facebook deserves higher multiples.
- The DCF-based target price of Facebook is offering ~100% upside.
- Regulatory risk will continue to grow. The Chinese government's attempts to tighten control over tech companies is a concentrated global trend.

Urupong/iStock via Getty Images

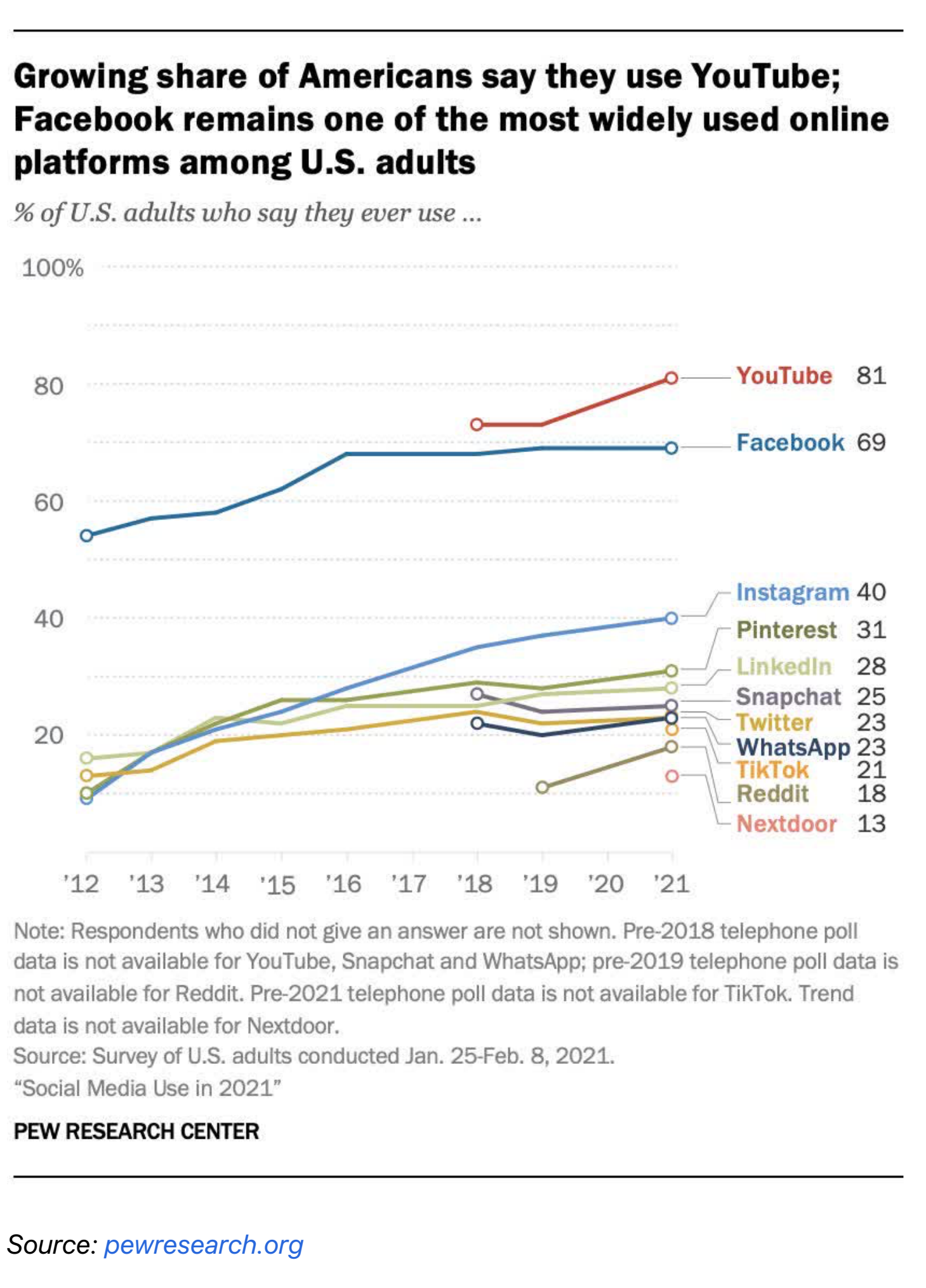
Thesis

Facebook (NASDAQ:FB) remains the dominant global social network with a rather ambiguous future. On the one hand, the company is fundamentally undervalued. On the other hand, signs of reaching the quantitative growth limit and specific risks are forcing investors to be wary of Facebook.

Accelerating or slowing down?

In my opinion, the key characteristic of a company is its growth dynamics. I draw your attention, *not the growth itself, but its dynamics*. In other words, it is critically important whether the company is accelerating or slowing down.

Starting to discuss this topic, in a broad context, it is worth noting that, Facebook and Instagram remain one of the most popular online platforms among US adults:



Growing share of Americans say they use YouTube; Facebook remains one of the most widely used online platforms among U.S. adults

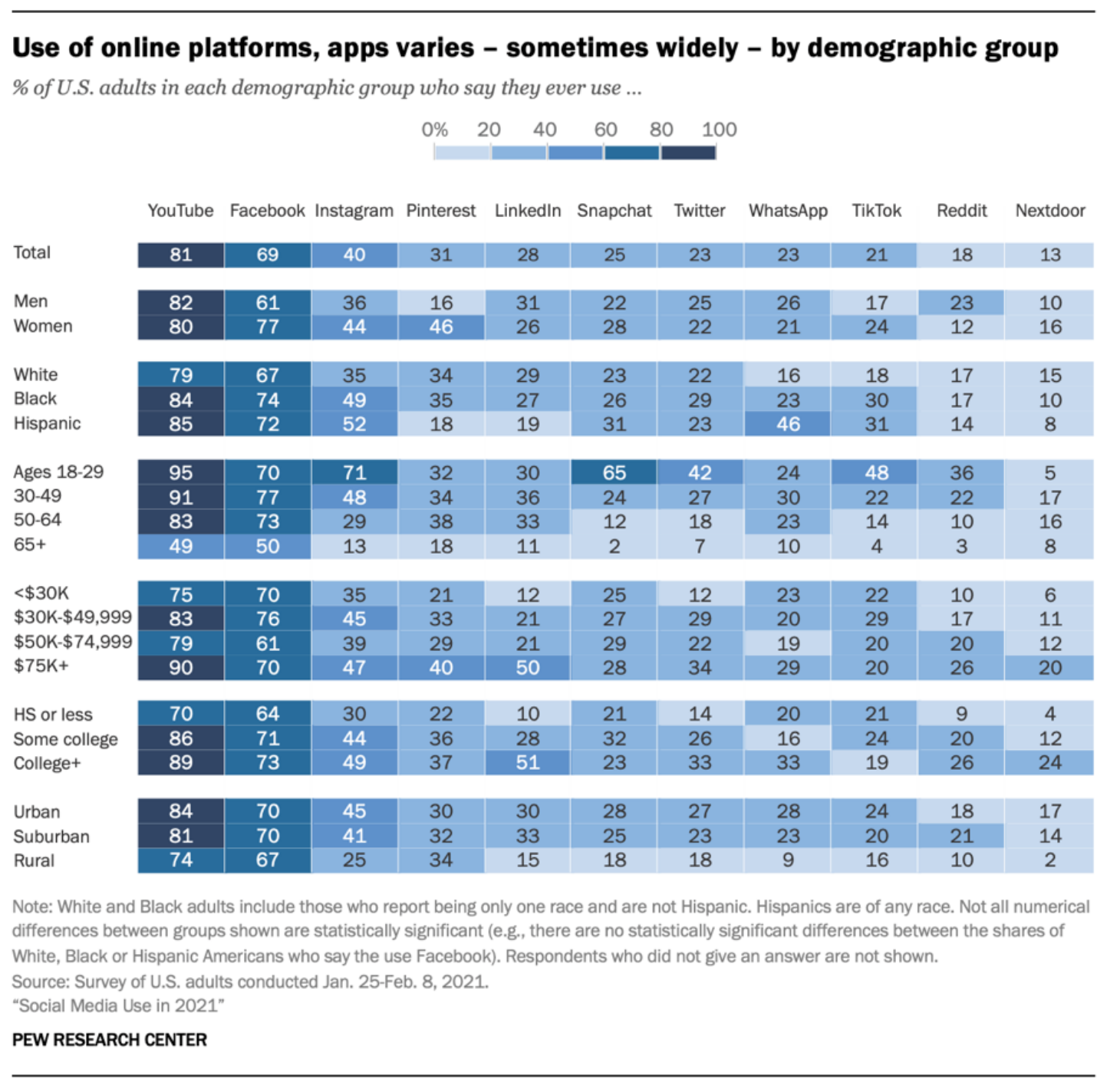
% of U.S. adults who say they ever use …

Note: Respondents who did not give an answer are not shown. Pre-2018 telephone poll data is not available for YouTube, Snapchat and WhatsApp; pre-2019 telephone poll data is not available for Reddit. Pre-2021 telephone poll data is not available for TikTok. Trend data is not available for Nextdoor.
Source: Survey of U.S. adults conducted Jan. 25-Feb. 8, 2021.
"Social Media Use in 2021"

PEW RESEARCH CENTER

Source: *pewresearch.org*

Moreover, those who are now 18 years old are interested in Facebook no less than those who are now 50 years old:



Use of online platforms, apps varies – sometimes widely – by demographic group

% of U.S. adults in each demographic group who say they ever use …

0% 20 40 60 80 100

	YouTube	Facebook	Instagram	Pinterest	LinkedIn	Snapchat	Twitter	WhatsApp	TikTok	Reddit	Nextdoor
Total	81	69	40	31	28	25	23	23	21	18	13
Men	82	61	36	16	31	22	25	26	17	23	10
Women	80	77	44	46	26	28	22	21	24	12	16
White	79	67	35	34	29	23	22	16	18	17	15
Black	84	74	49	35	27	26	29	23	30	17	10
Hispanic	85	72	52	18	19	31	23	46	31	14	8
Ages 18-29	95	70	71	32	30	65	42	24	48	36	5
30-49	91	77	48	34	36	24	27	30	22	22	17
50-64	83	73	29	38	33	12	18	23	14	10	16
65+	49	50	13	18	11	2	7	10	4	3	8
<$30K	75	70	35	21	12	25	12	23	22	10	6
$30K-$49,999	83	76	45	33	21	27	29	20	29	17	11
$50K-$74,999	79	61	39	29	21	29	22	19	20	20	12
$75K+	90	70	47	40	50	28	34	29	20	26	20
HS or less	70	64	30	22	10	21	14	20	21	9	4
Some college	86	71	44	36	28	32	26	16	24	20	12
College+	89	73	49	37	51	23	33	33	19	26	24
Urban	84	70	45	30	30	28	27	28	24	18	17
Suburban	81	70	41	32	33	25	23	23	20	21	14
Rural	74	67	25	34	15	18	18	9	16	10	2

Note: White and Black adults include those who report being only one race and are not Hispanic. Hispanics are of any race. Not all numerical differences between groups shown are statistically significant (e.g., there are no statistically significant differences between the shares of White, Black or Hispanic Americans who say the use Facebook). Respondents who did not give an answer are not shown.
Source: Survey of U.S. adults conducted Jan. 25-Feb. 8, 2021.
"Social Media Use in 2021"

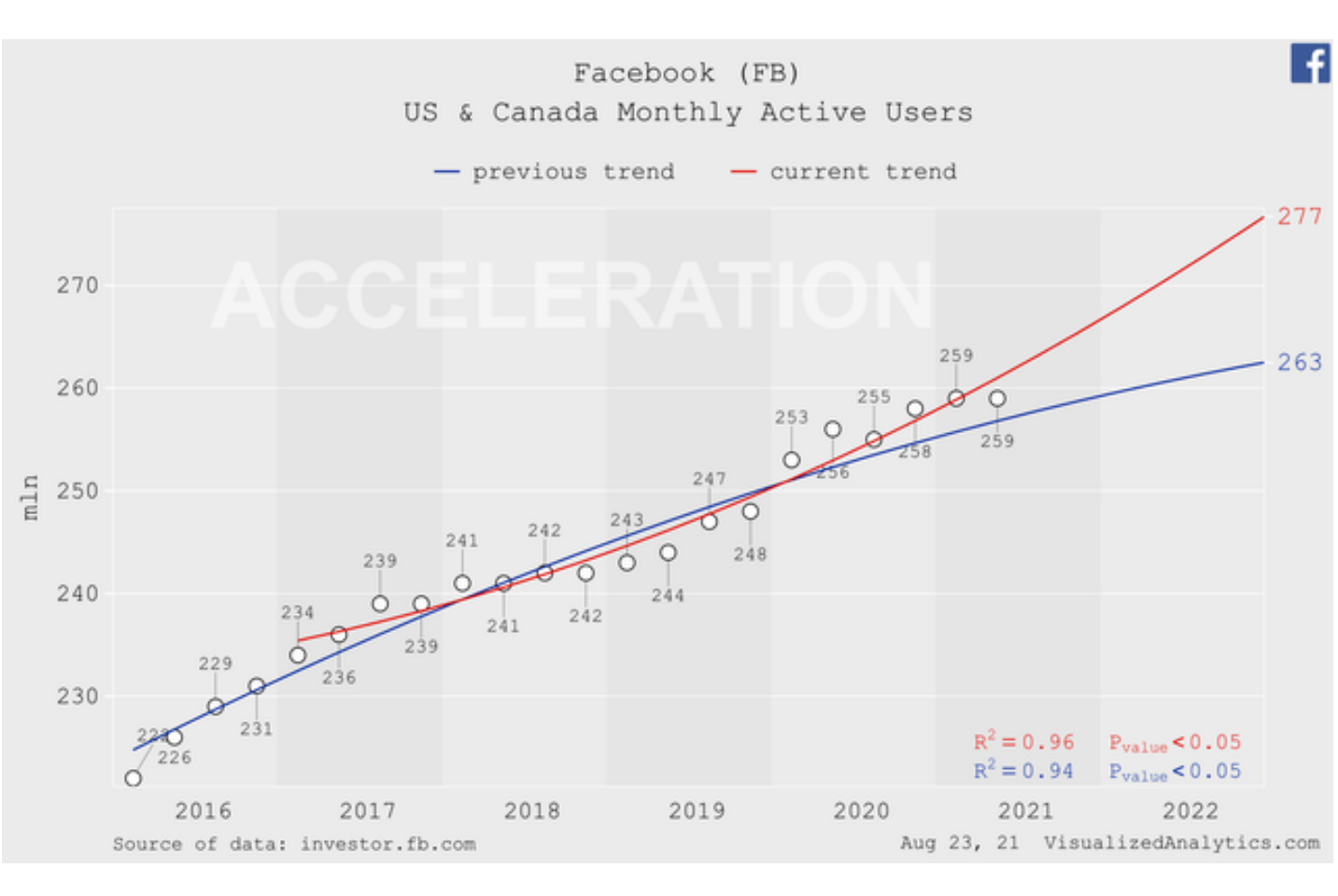
PEW RESEARCH CENTER

Source: *pewresearch.org*

Probably, the world statistics are not very different from this one.

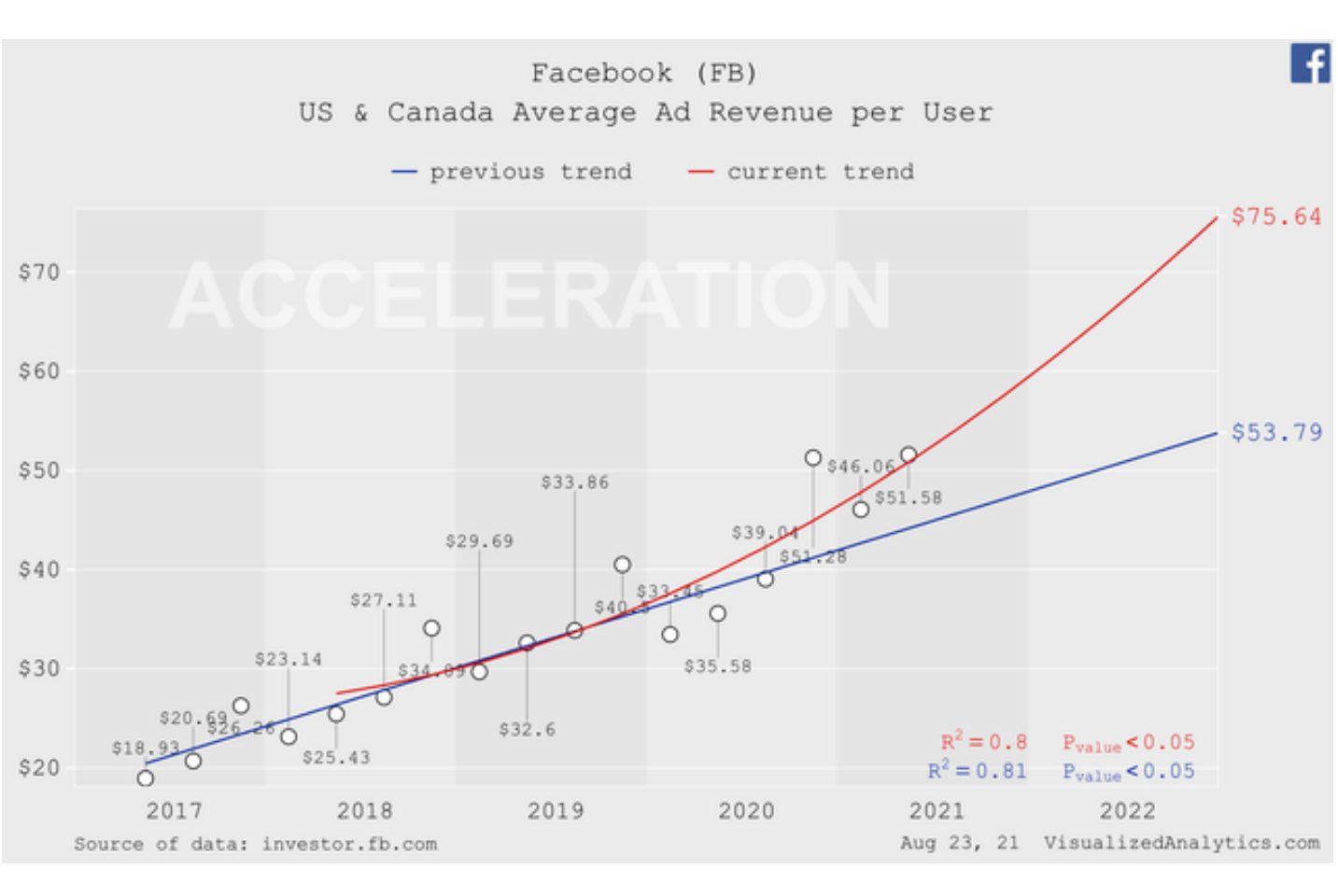
The growth of any company can always be divided into quantitative and qualitative. In the case of Facebook, quantitative growth lies in the growth of its active audience. Quality growth is reflected by monetization. And here we can highlight certain trends.

The coronavirus pandemic has given new impetus to the growth of the social network audience in the United States and Canada. At the same time, the result of the last quarter turned out to be clearly below its trend. It seems that the dynamics of the indicator is gradually returning to the previous logarithmic trend:



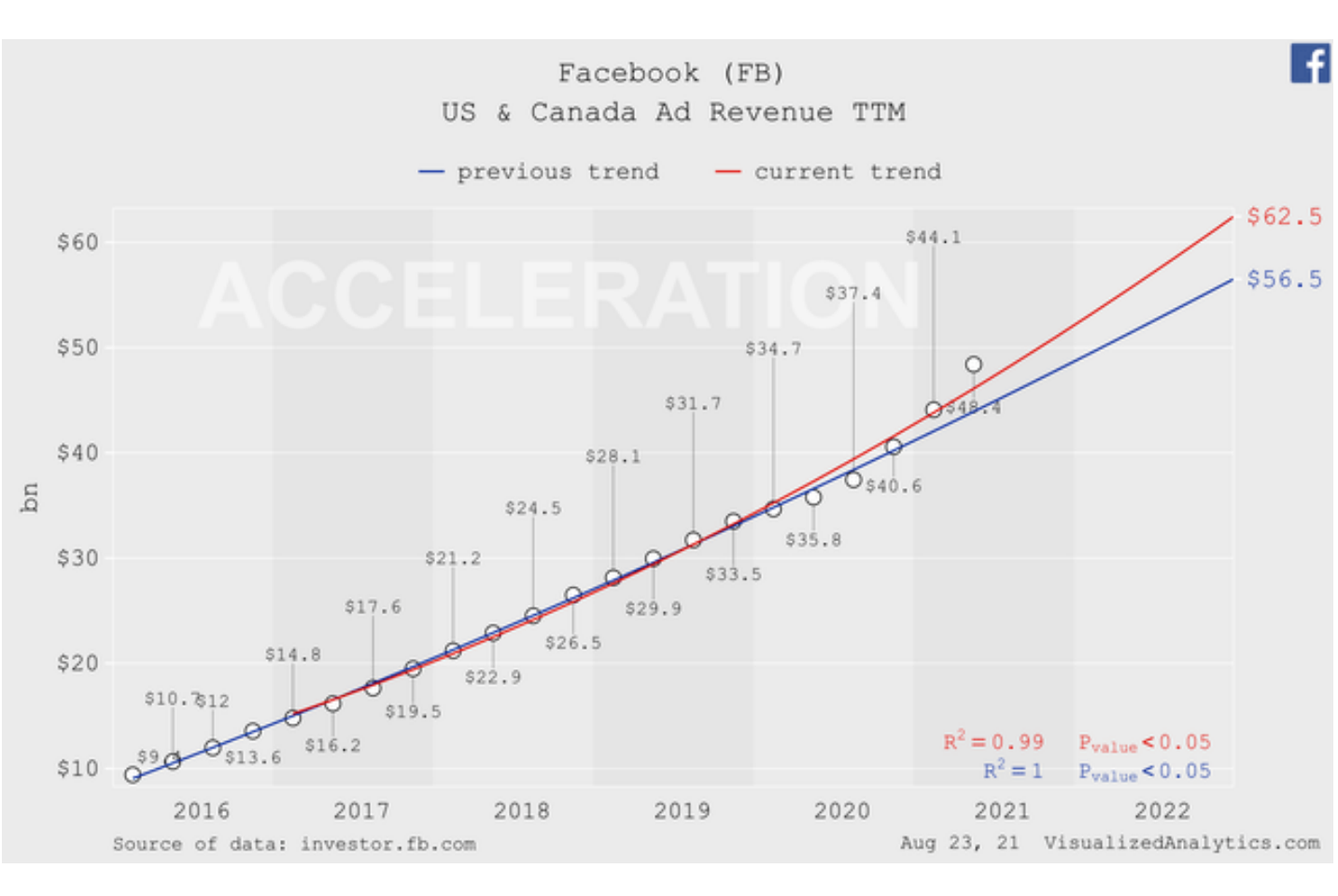
Source: *VisualizedAnalytics.com*

But the average ad revenue per user continues to grow exponentially:



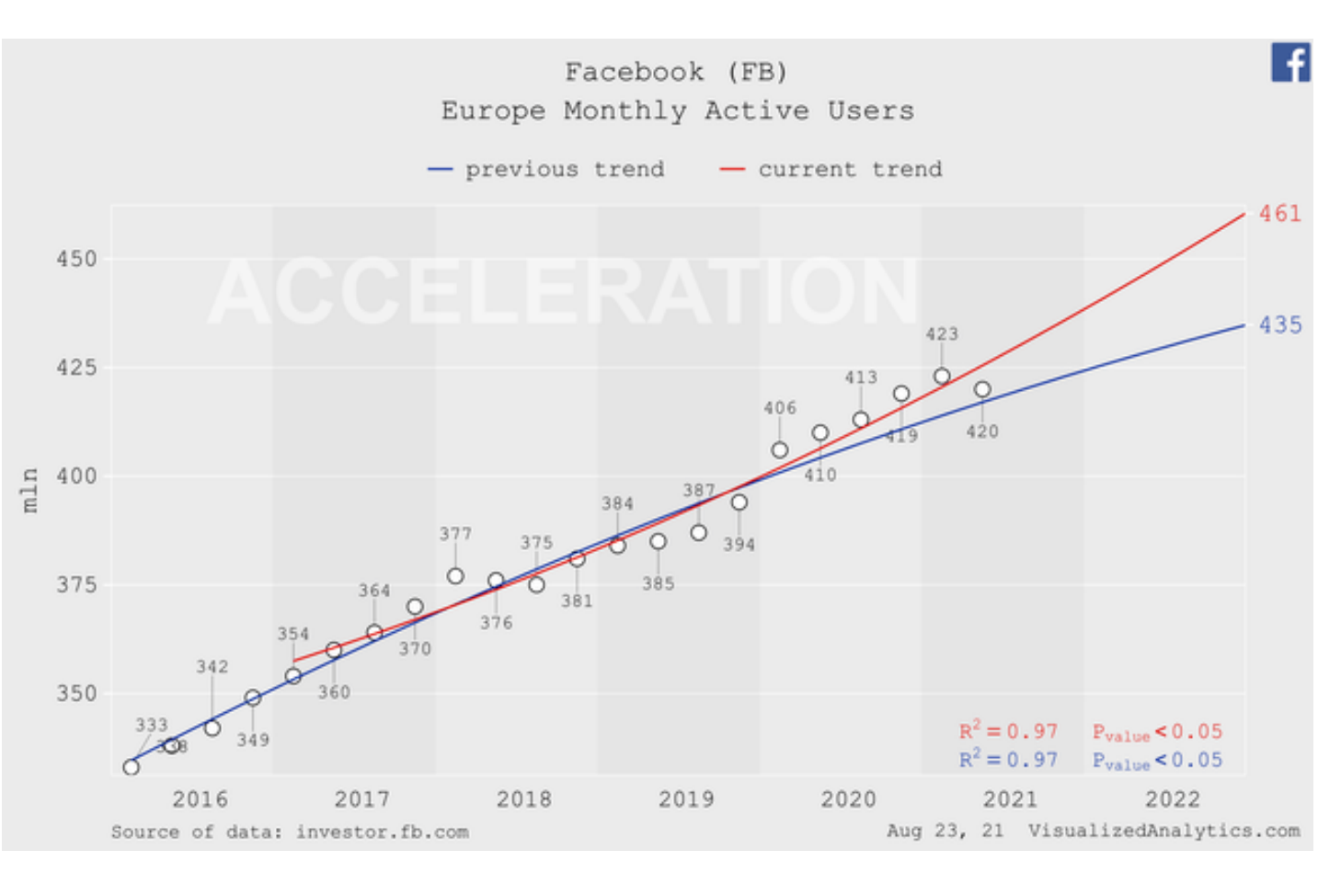
Source: *VisualizedAnalytics.com*

As a result, the total revenue in this segment continues to grow exponentially, and the result of the last quarter turned out to be better than the trend:



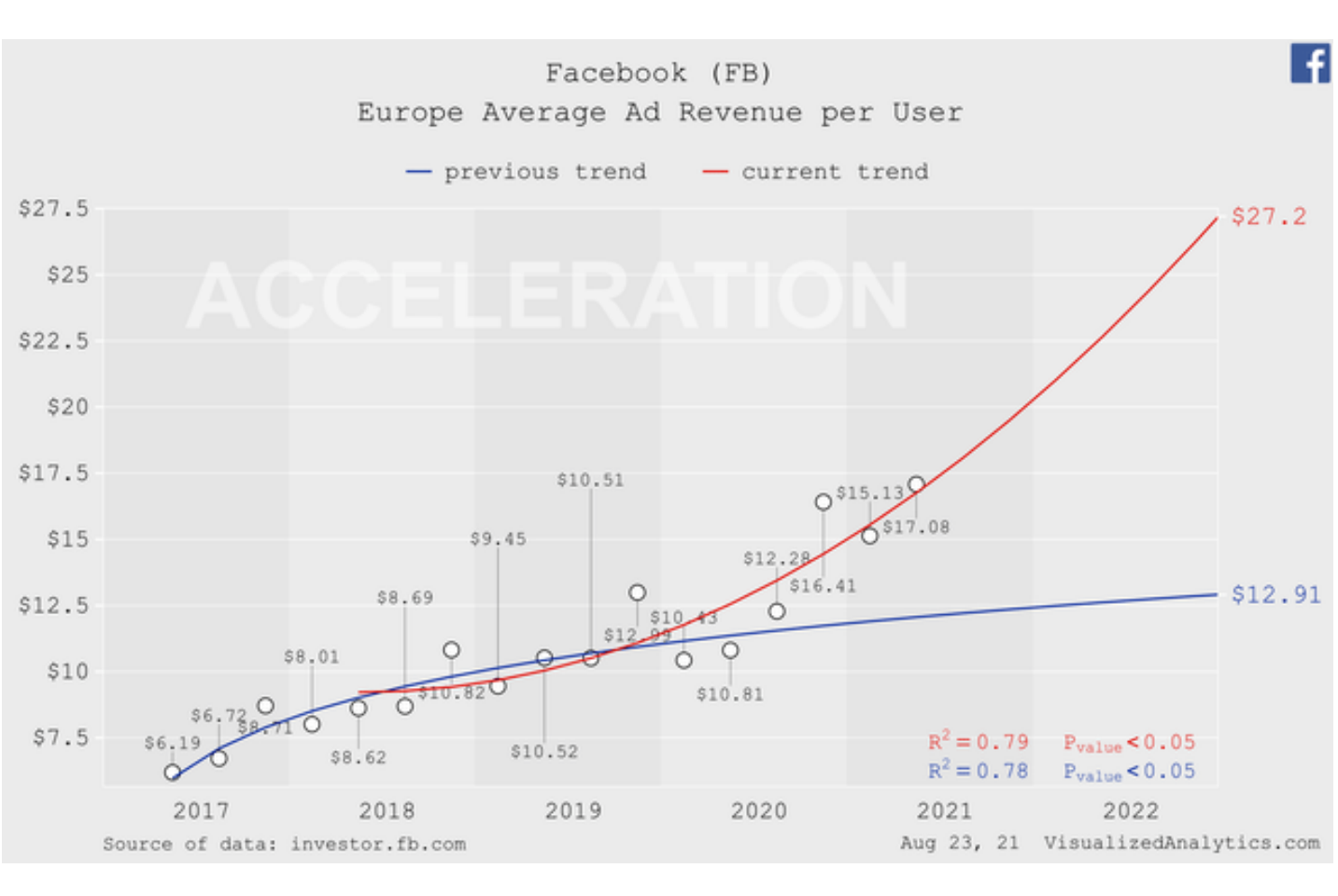
Source: *VisualizedAnalytics.com*

In Europe, we see approximately the same picture. Active audience growth returns to the pre-coronavirus trend:



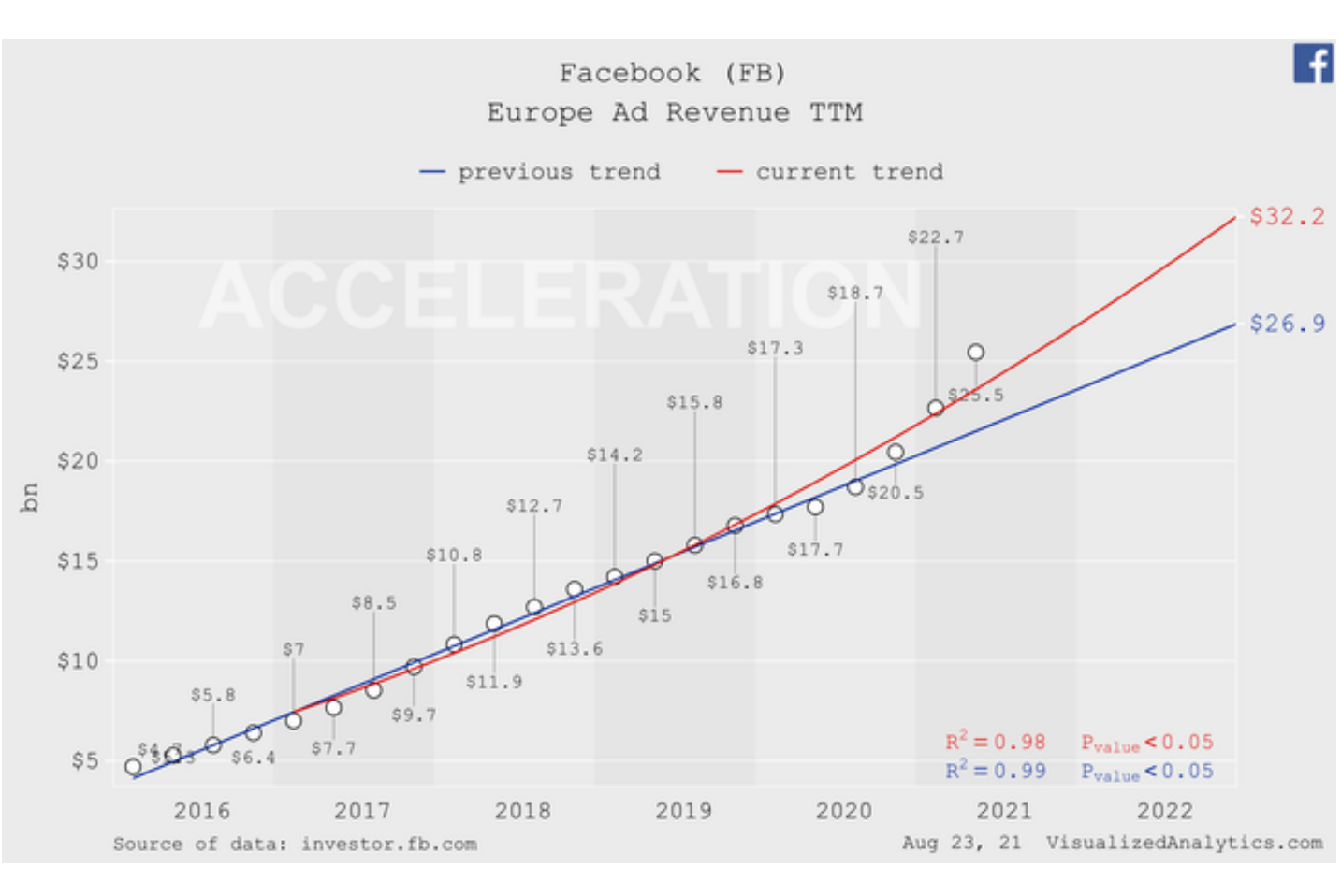
Source: *VisualizedAnalytics.com*

But ad revenue per user continues to grow exponentially:



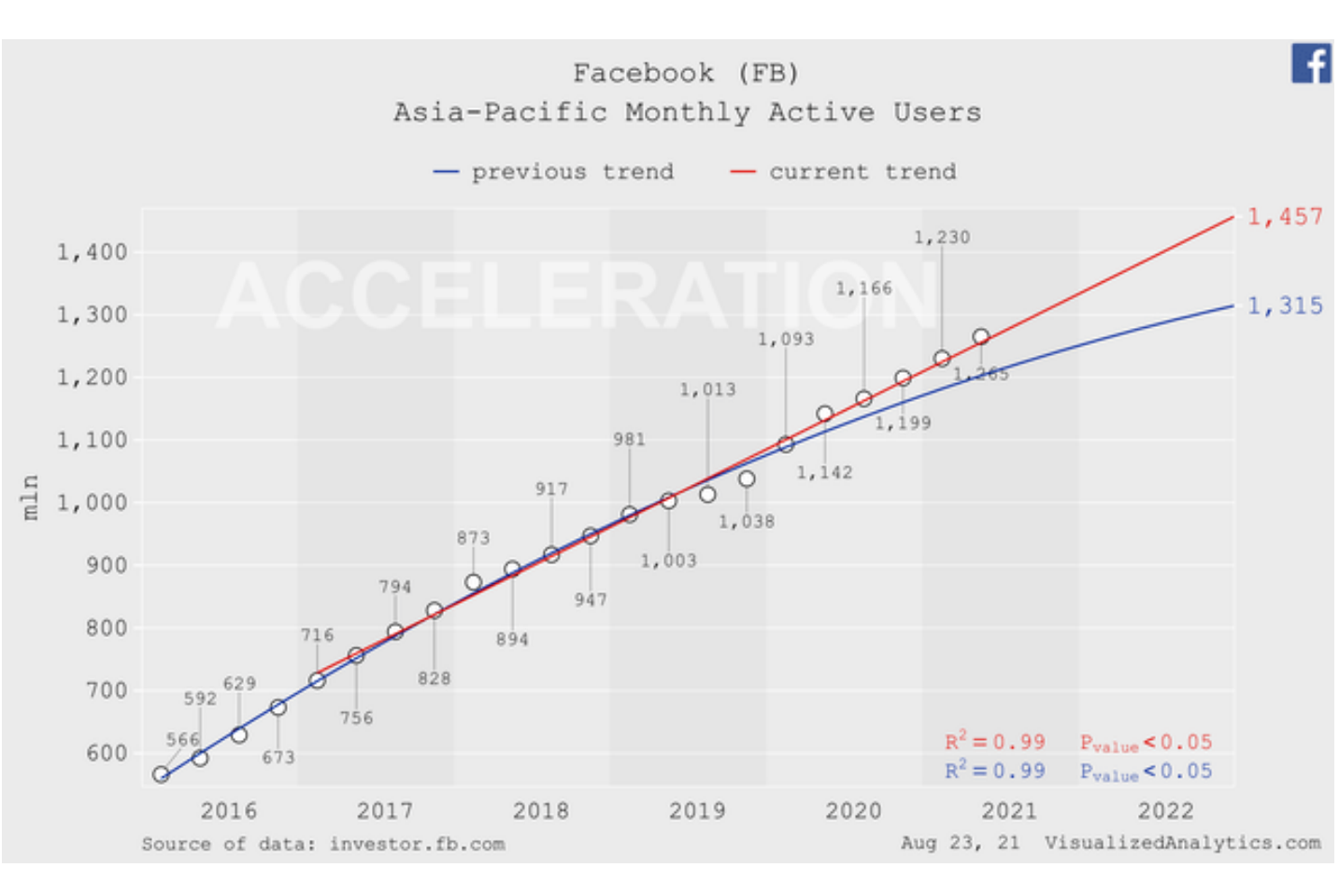
Source: *VisualizedAnalytics.com*

As a result, the segment's total ad revenue continues to accelerate:



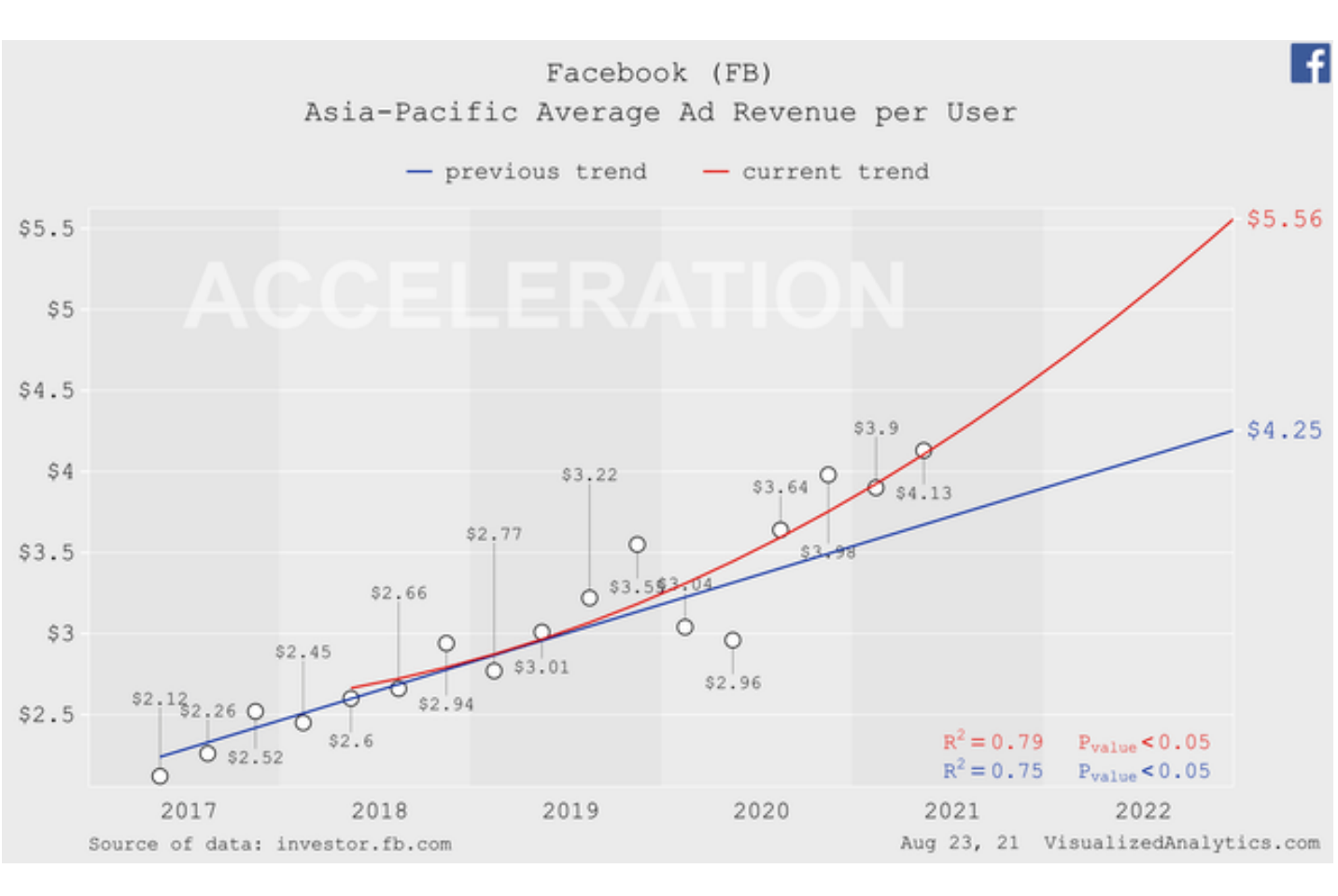
Source: *VisualizedAnalytics.com*

The "Asia-Pacific" segment is still an exception. Here, audience growth continues in accordance with the current, linear trend:



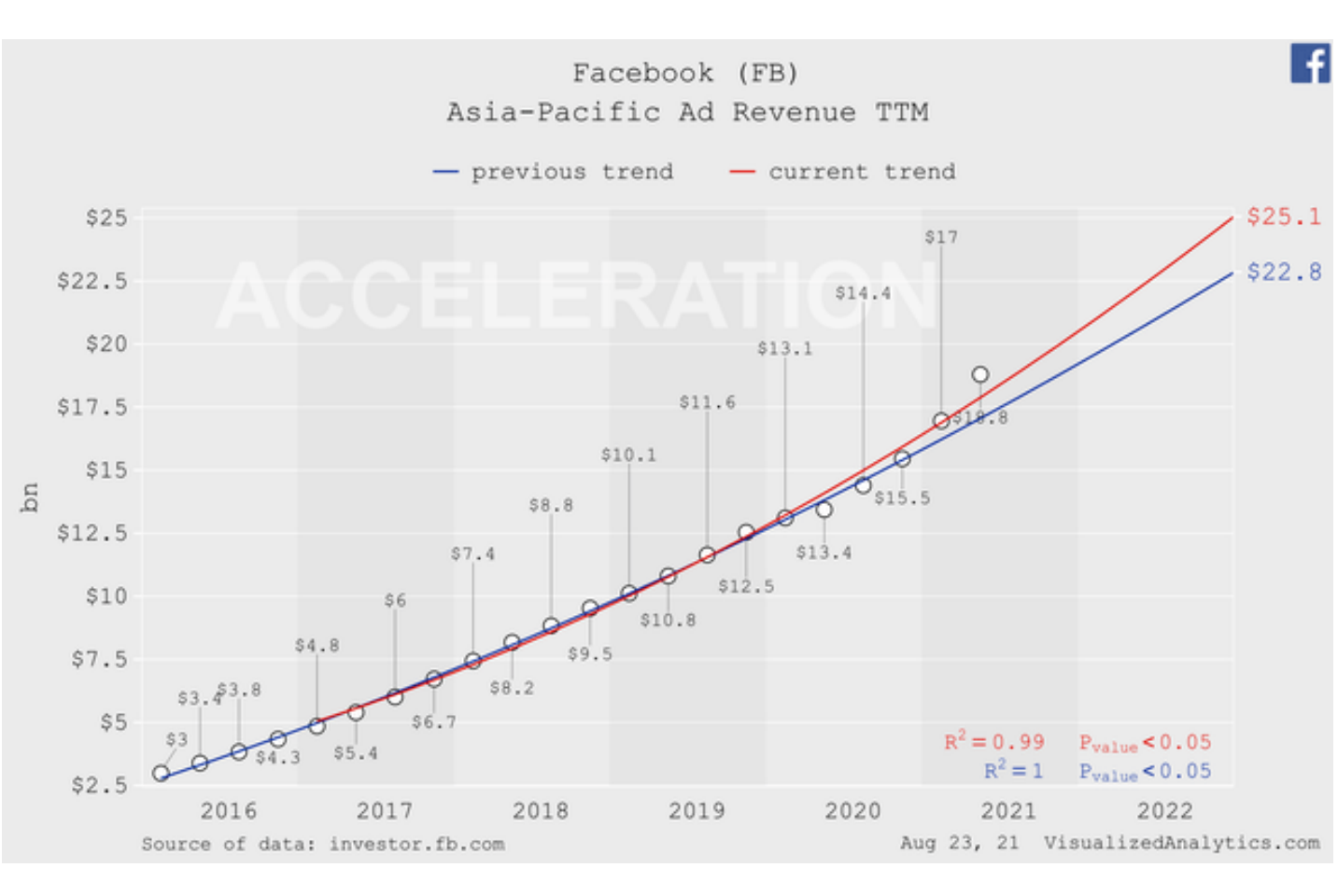
Source: *VisualizedAnalytics.com*

Ad revenue per user is also following its trend:



Source: *VisualizedAnalytics.com*

And the total ad revenue is accelerating:

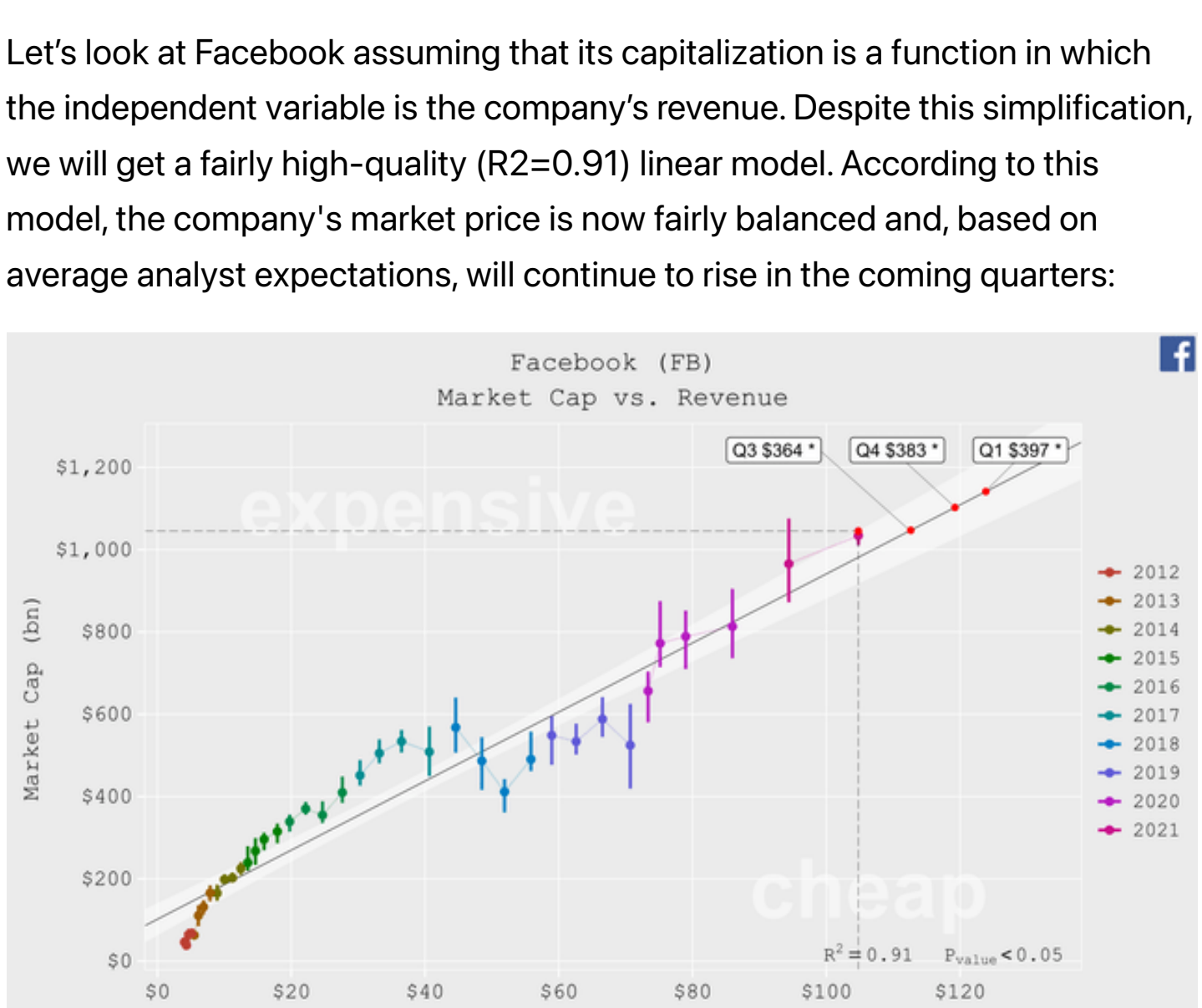


Source: *VisualizedAnalytics.com*

Returning to the concept of quantitative and qualitative growth, it should be recognized that the growth rate of Facebook's audience is slowing down, but this is more than offset by the growth of monetization. This is a separate topic to discuss where the limit to the growth of monetization is. But at this stage it has definitely not been achieved.

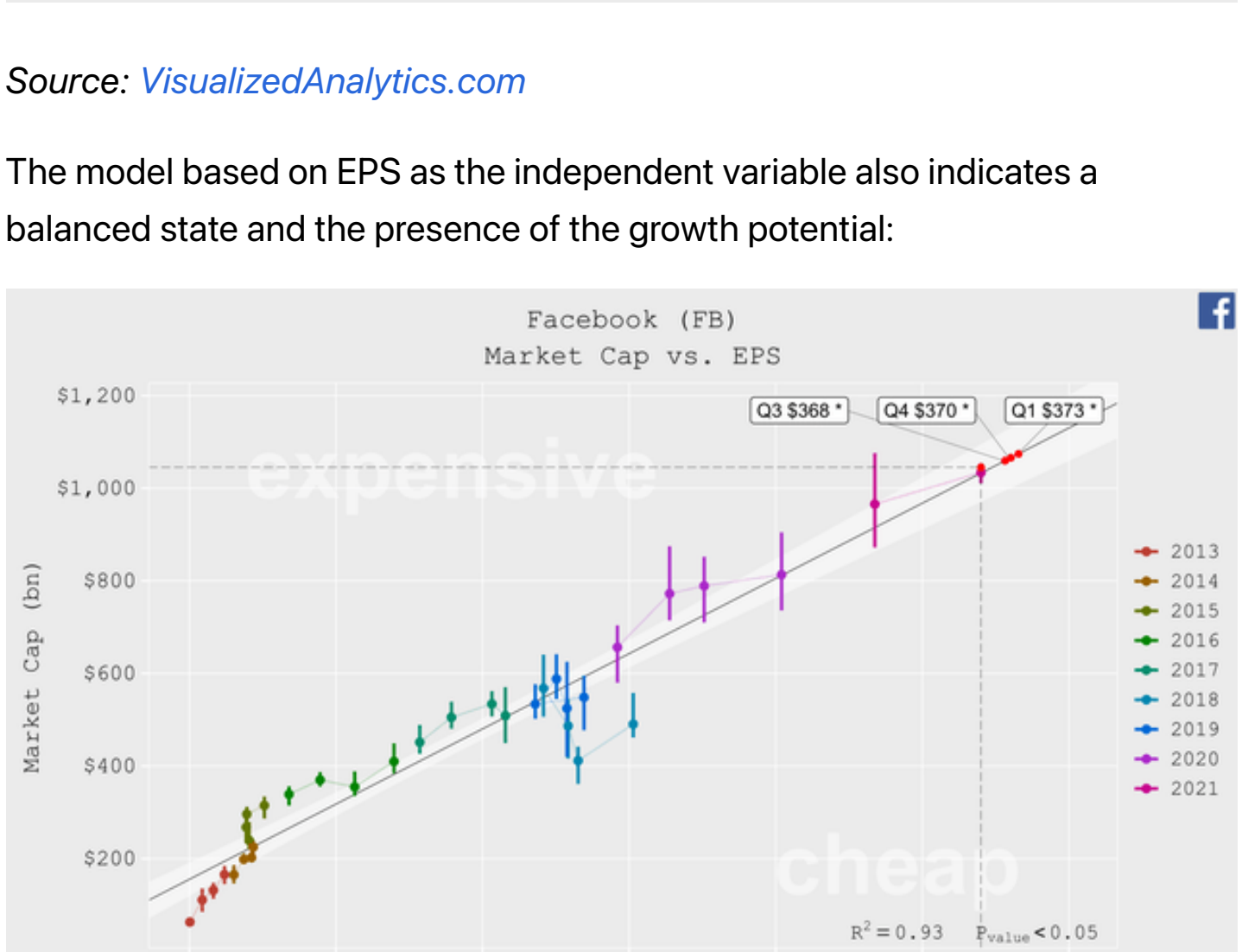
Market cap vs financial results

Let's look at Facebook assuming that its capitalization is a function in which the independent variable is the company's revenue. Despite this simplification, we will get a fairly high-quality (R2=0.91) linear model. According to this model, the company's market price is now fairly balanced and, based on average analyst expectations, will continue to rise in the coming quarters:



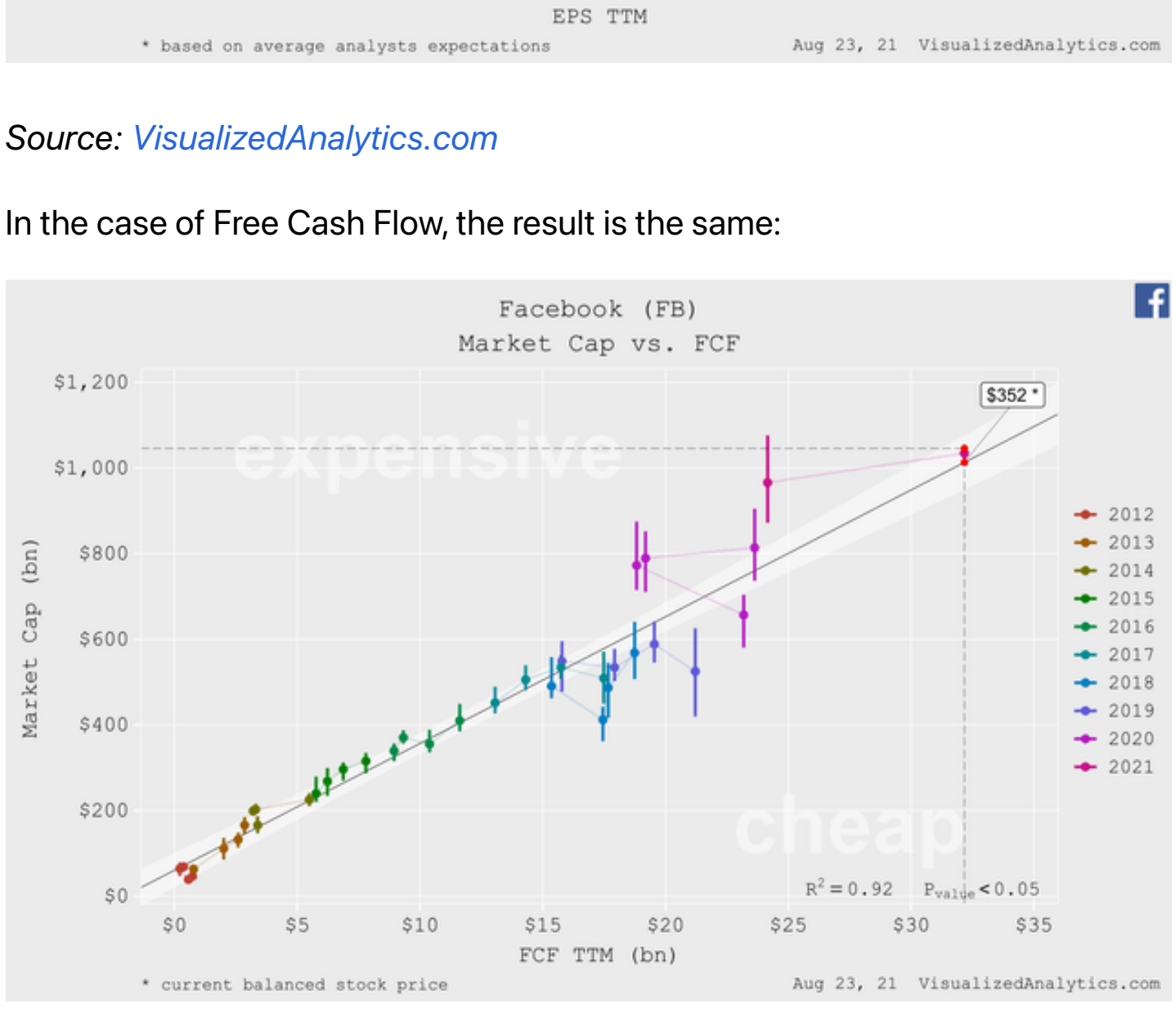
Source: *VisualizedAnalytics.com*

The model based on EPS as the independent variable also indicates a balanced state and the presence of the growth potential:



Source: *VisualizedAnalytics.com*

In the case of Free Cash Flow, the result is the same:

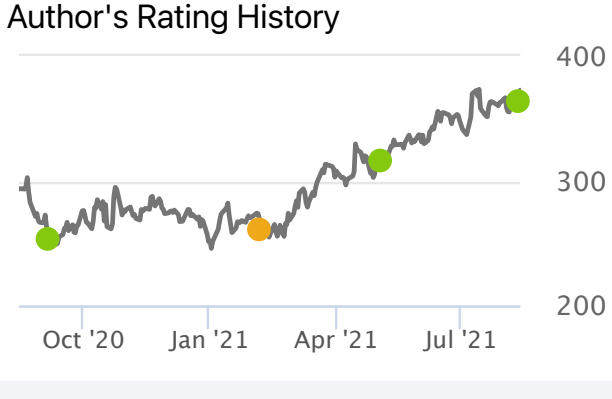


Source: *VisualizedAnalytics.com*

About This Article

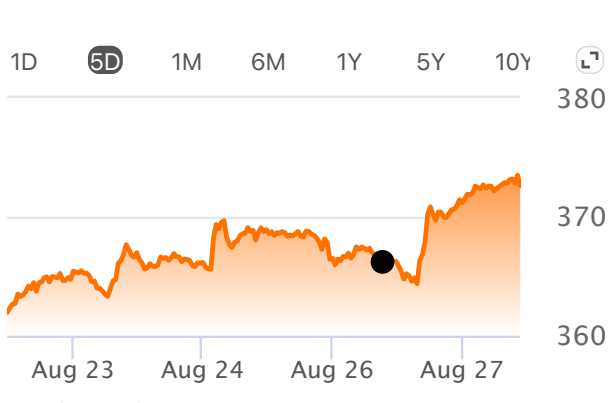
Ticker Covered	FB
Author's rating at publication	Bullish
Price at publication	$368.38
Change	1.16%
S&P 500 change	0.35%

Author's Rating History



About FB

Symbol	Last Price	% Chg
FB Post	372.63 372.38	2.26% -0.07%



PE (FWD)	26.39
Yield (FWD)	-
Rev Growth (YoY)	39.43%
Short Interest	1.23%

Compare to Peers

FB Ratings

SA Author	Bullish	3.85
Wall Street	Bullish	4.41
Quant	Very Bullish	4.91

Quant Ranking

Sector	Communication Services
Industry	Interactive Media and Services
Ranked in Industry	4 out of 47
Ranked in Sector	7 out of 199
Ranked Overall	68 out of 4002

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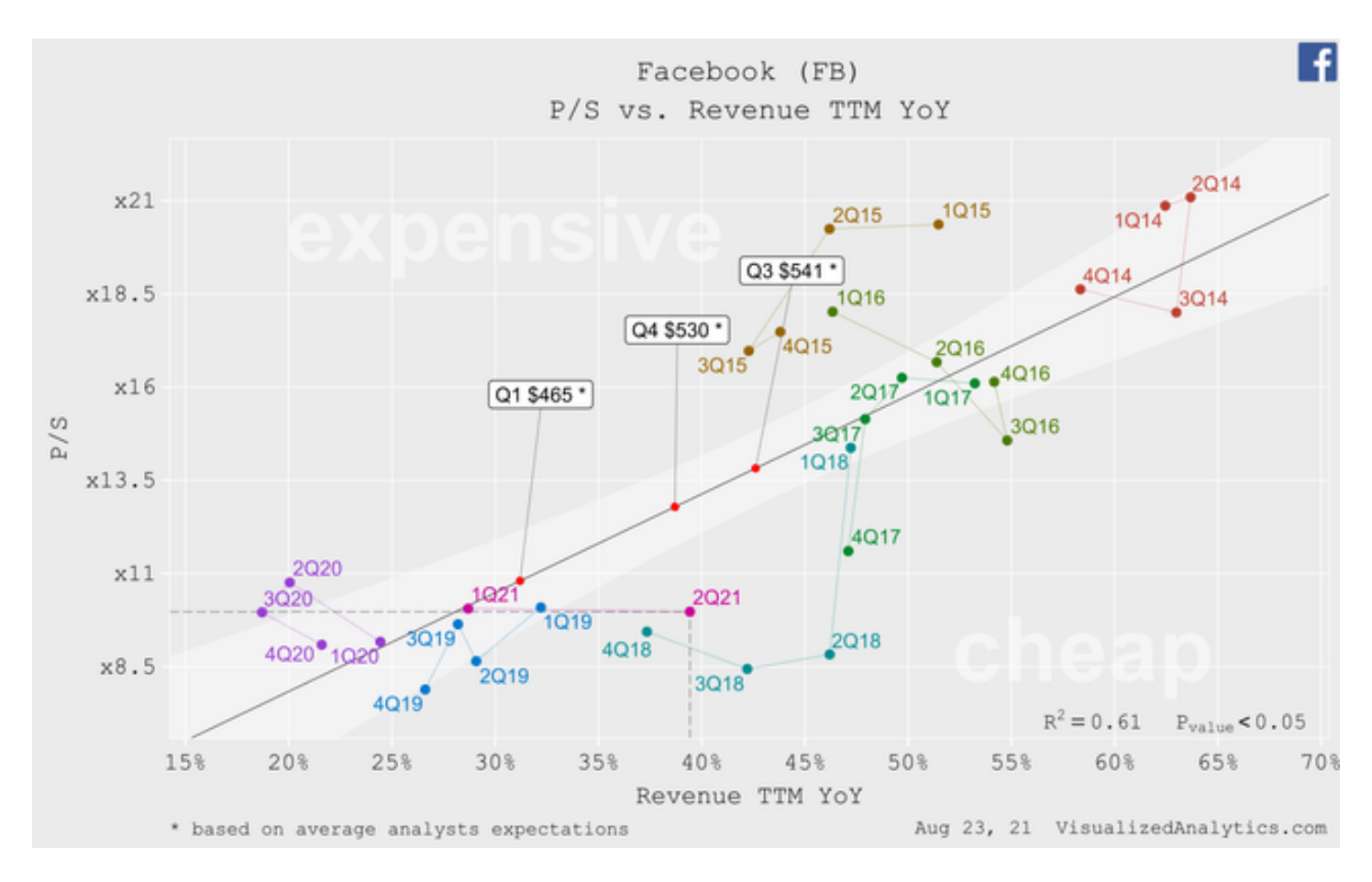
In terms of its current financial results, the company's price looks quite balanced and the potential for further growth is clearly present.

Multiples vs growth

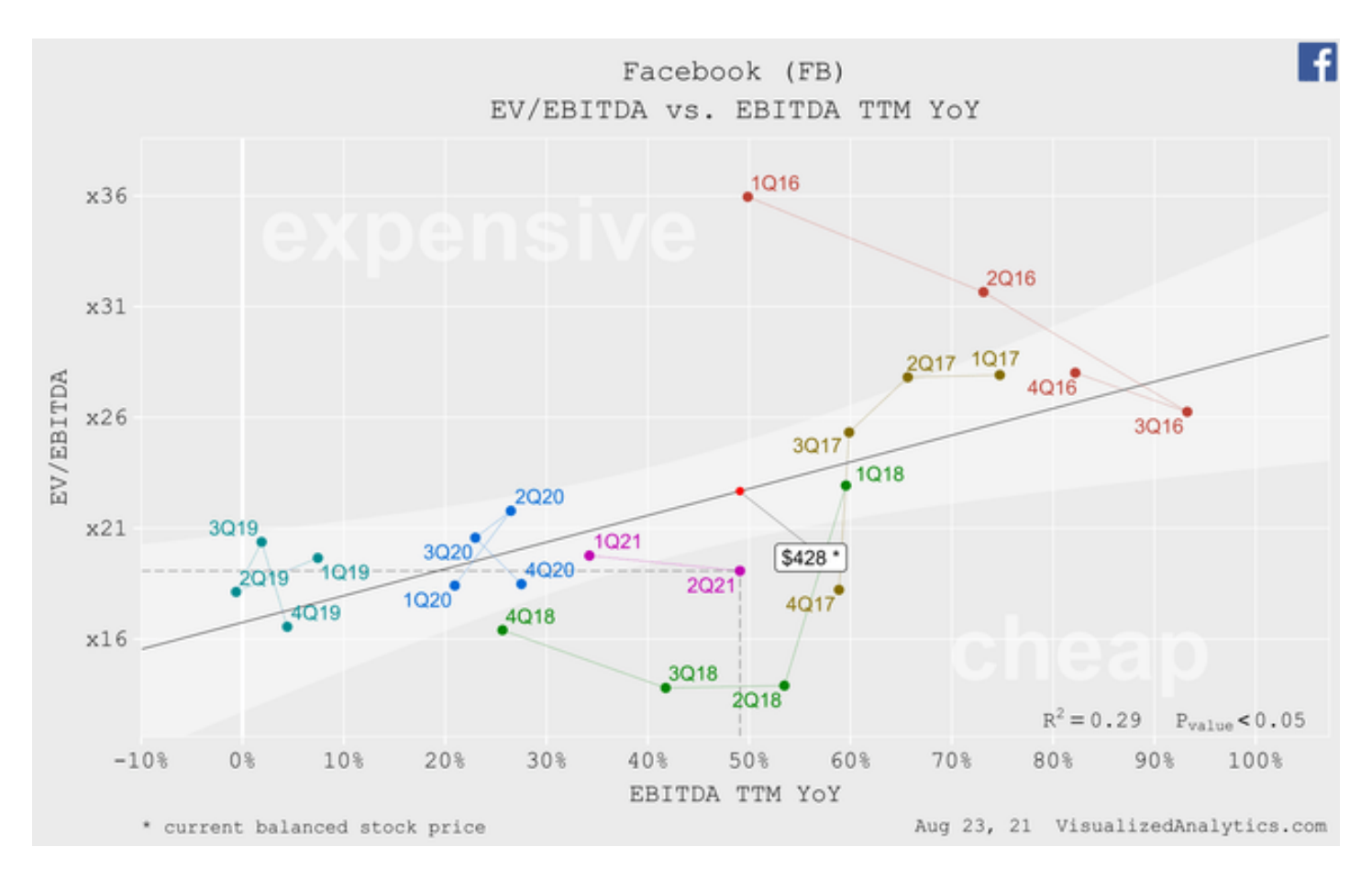
As a rule, there is a direct relationship between the rate of growth of the company's financial indicators and the level of its multiples. This is due to the fact that during periods when the company is growing faster, investors are willing to pay higher multiples. And vice versa.

Having considered the relationship between Facebook's revenue growth rate and its P / S multiple, it should also be recognized that the current ratio of the multiple is in the "cheap" zone. If we take the analysts' average expectations as a basis, within the bounds of this model Facebook's balanced price per share in Q4 2021 will be around $530:



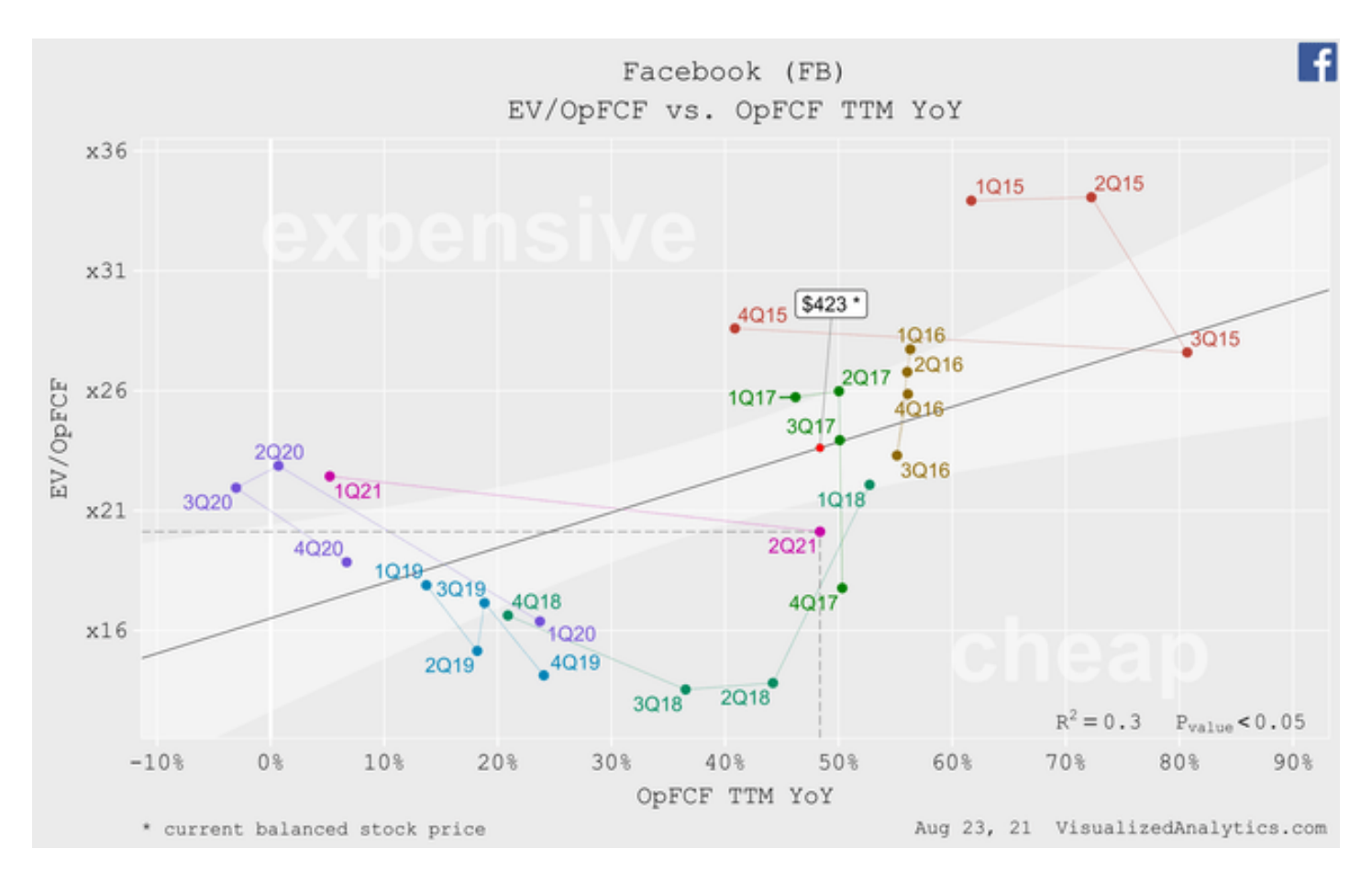
Source: VisualizedAnalytics.com

The same conclusion is true of the EV / EBITDA multiple:



Source: VisualizedAnalytics.com

and the EV / OpFCF multiple:



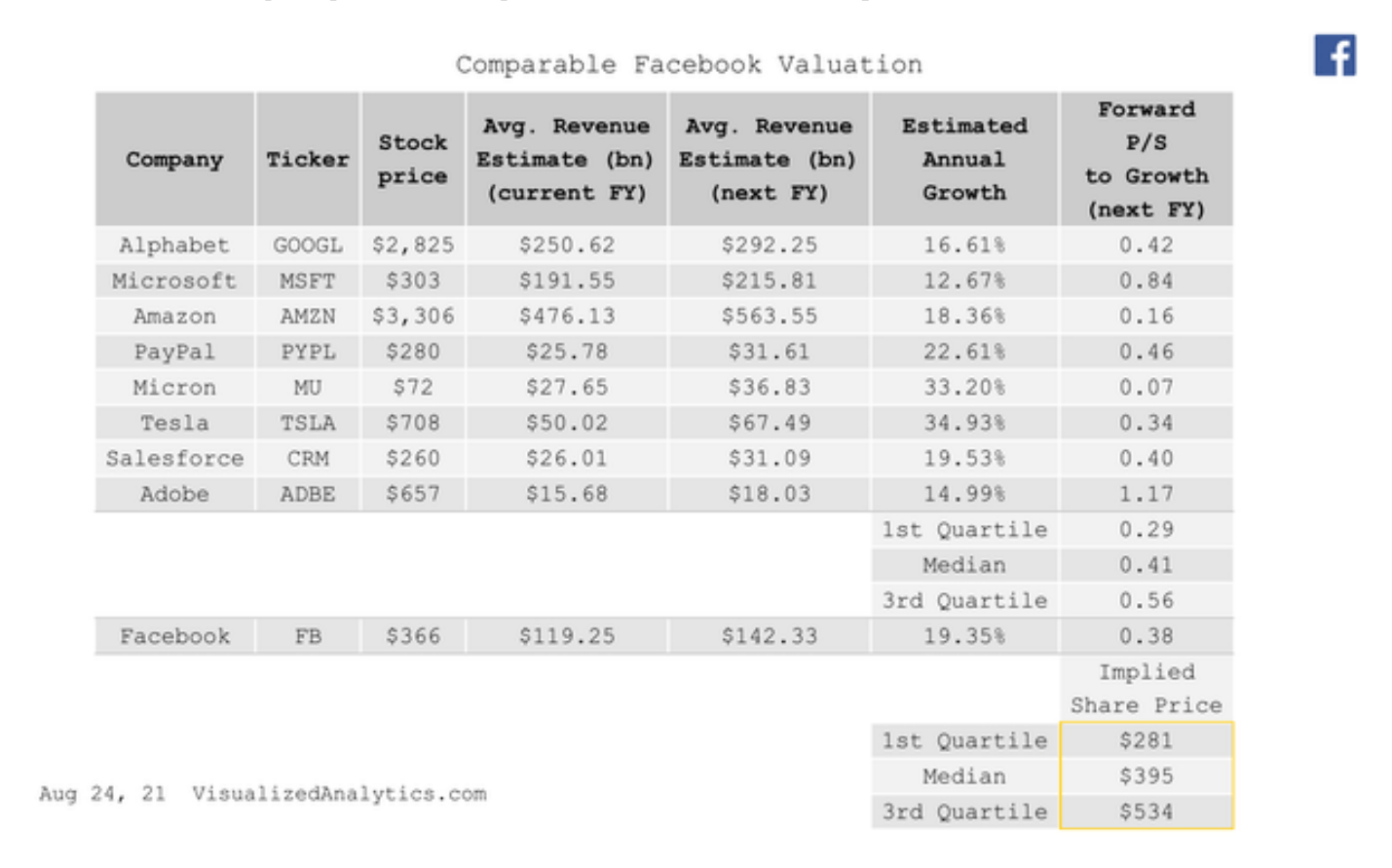
Source: VisualizedAnalytics.com

It can be concluded that in the context of the current growth rate of key financial indicators, Facebook deserves higher multiples.

Comparative valuation

I compared Facebook with a broad sample of US tech companies using various multiples. I used forward, historical and adjusted multiples. *All models showed that the company is balanced or undervalued.*

The forward P/S (next FY) to Growth multiple:



Comparable Facebook Valuation

Company	Ticker	Stock price	Avg. Revenue Estimate (bn) (current FY)	Avg. Revenue Estimate (bn) (next FY)	Estimated Annual Growth	Forward P/S to Growth (next FY)
Alphabet	GOOGL	$2,825	$250.62	$292.25	16.61%	0.42
Microsoft	MSFT	$303	$191.55	$215.81	12.67%	0.84
Amazon	AMZN	$3,306	$476.13	$563.55	18.36%	0.16
PayPal	PYPL	$280	$25.78	$31.61	22.61%	0.46
Micron	MU	$72	$27.65	$36.83	33.20%	0.07
Tesla	TSLA	$708	$50.02	$67.49	34.93%	0.34
Salesforce	CRM	$260	$26.01	$31.09	19.53%	0.40
Adobe	ADBE	$657	$15.68	$18.03	14.99%	1.17
					1st Quartile	0.29
					Median	0.41
					3rd Quartile	0.56
Facebook	FB	$366	$119.25	$142.33	19.35%	0.38
						Implied Share Price
					1st Quartile	$281
					Median	$395
					3rd Quartile	$534

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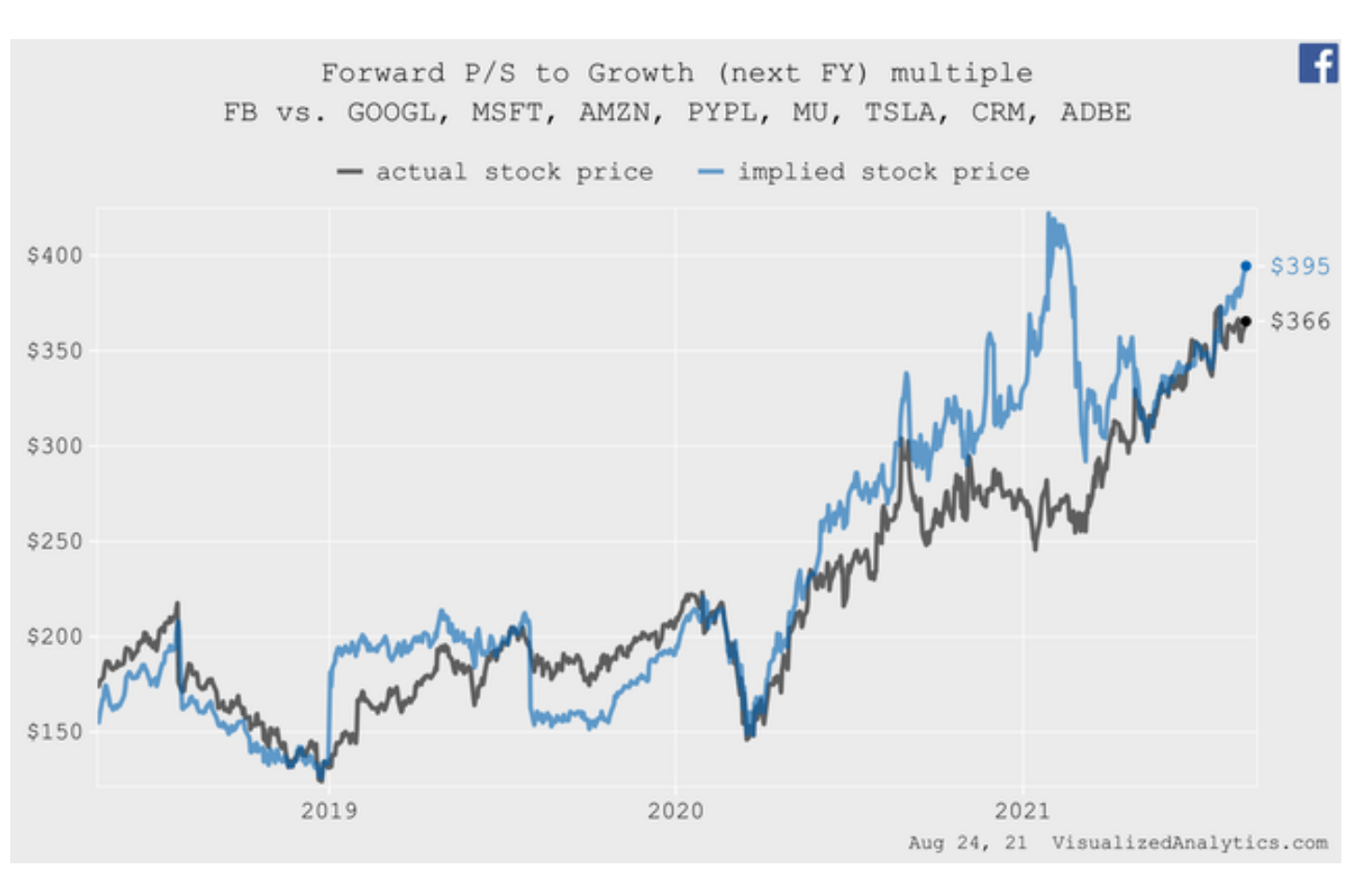
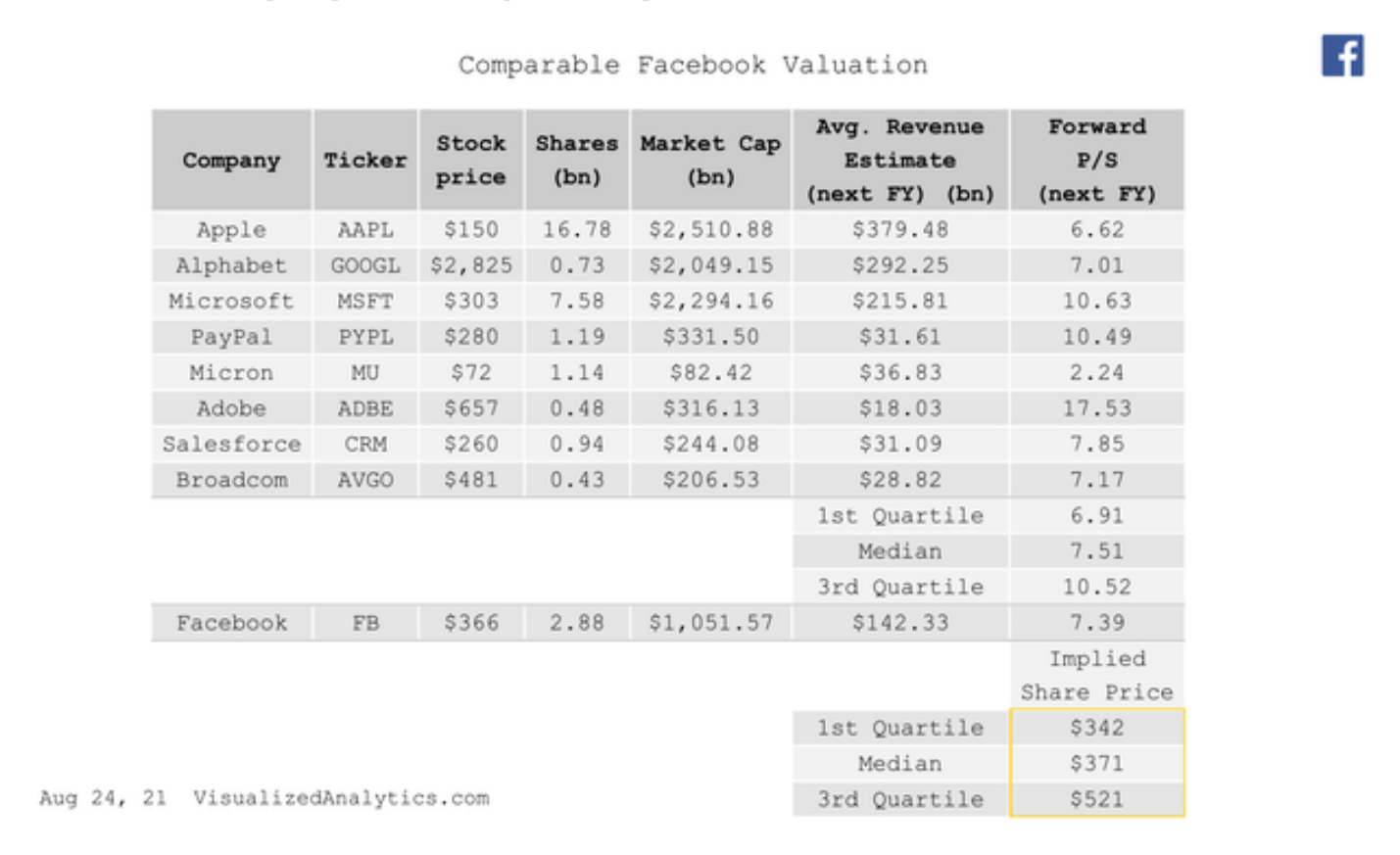


Source: VisualizedAnalytics.com

The forward P/S (next FY) multiple:



Comparable Facebook Valuation

Company	Ticker	Stock price	Shares (bn)	Market Cap (bn)	Avg. Revenue Estimate (next FY) (bn)	Forward P/S (next FY)
Apple	AAPL	$150	16.78	$2,510.88	$379.48	6.62
Alphabet	GOOGL	$2,825	0.73	$2,049.15	$292.25	7.01
Microsoft	MSFT	$303	7.58	$2,294.16	$215.81	10.63
PayPal	PYPL	$280	1.19	$331.50	$31.61	10.49
Micron	MU	$72	1.14	$82.42	$36.83	2.24
Adobe	ADBE	$657	0.48	$316.13	$18.03	17.53
Salesforce	CRM	$260	0.94	$244.08	$31.09	7.85
Broadcom	AVGO	$481	0.43	$206.53	$28.82	7.17
					1st Quartile	6.91
					Median	7.51
					3rd Quartile	10.52
Facebook	FB	$366	2.88	$1,051.57	$142.33	7.39
						Implied Share Price
					1st Quartile	$342
					Median	$371
					3rd Quartile	$521

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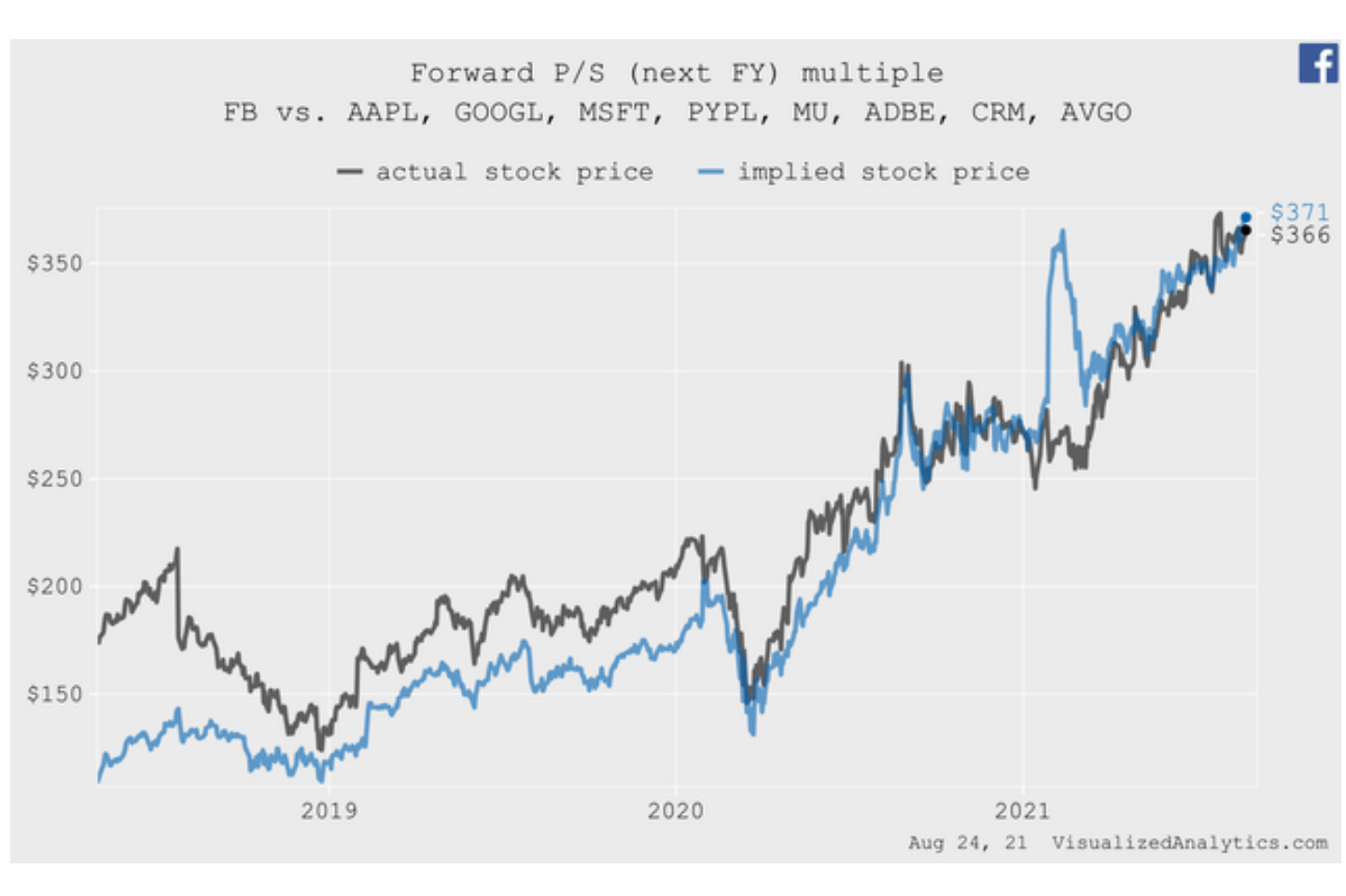
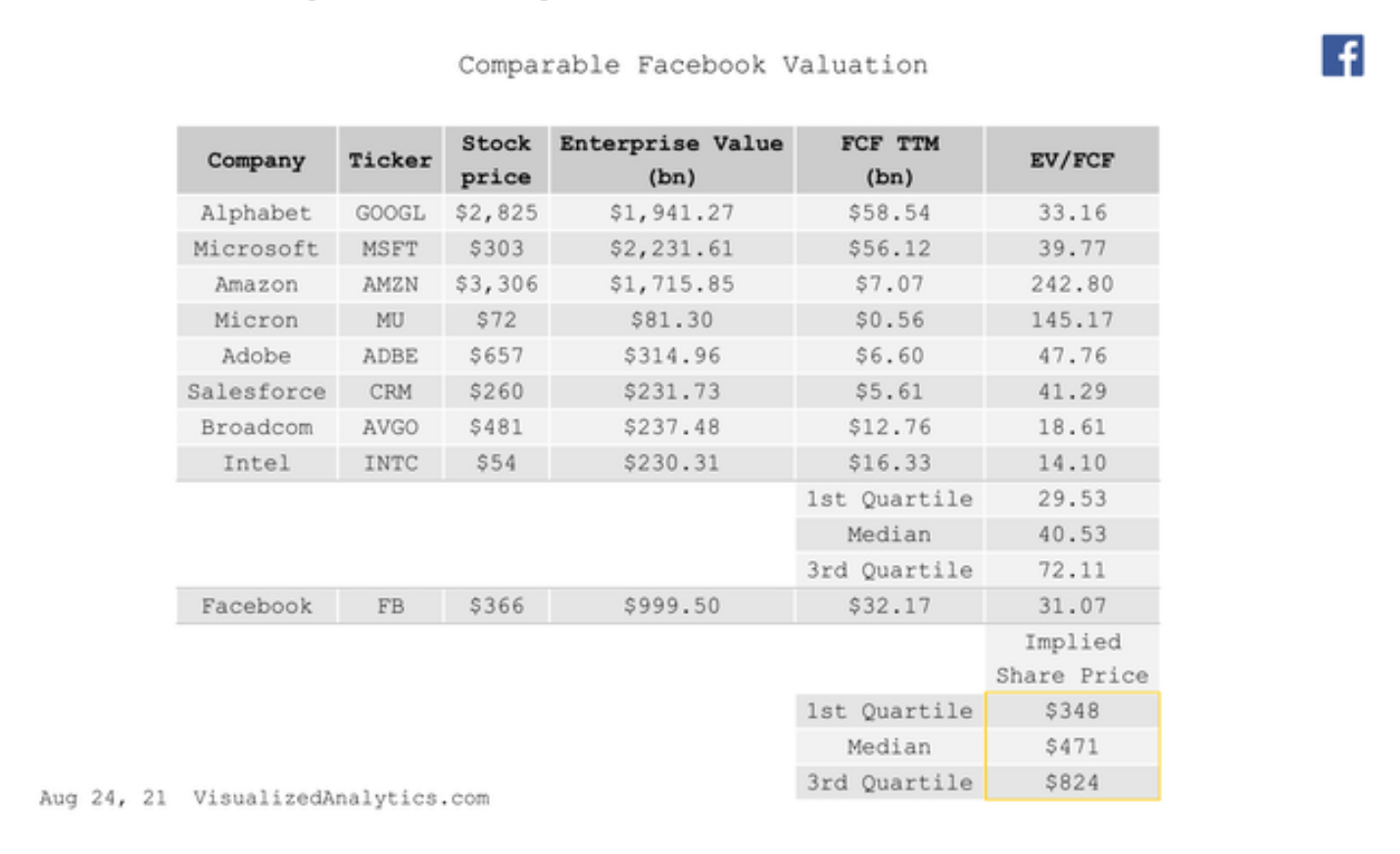


Source: VisualizedAnalytics.com

The forward EV / FCF multiple:



Comparable Facebook Valuation

Company	Ticker	Stock price	Enterprise Value (bn)	FCF TTM (bn)	EV/FCF
Alphabet	GOOGL	$2,825	$1,941.27	$58.54	33.16
Microsoft	MSFT	$303	$2,231.61	$56.12	39.77
Amazon	AMZN	$3,306	$1,715.85	$7.07	242.80
Micron	MU	$72	$81.30	$0.56	145.17
Adobe	ADBE	$657	$314.96	$6.60	47.76
Salesforce	CRM	$260	$231.73	$5.61	41.29
Broadcom	AVGO	$481	$237.48	$12.76	18.61
Intel	INTC	$54	$230.31	$16.33	14.10
				1st Quartile	29.53
				Median	40.53
				3rd Quartile	72.11
Facebook	FB	$366	$999.50	$32.17	31.07
					Implied Share Price
				1st Quartile	$348
				Median	$471
				3rd Quartile	$824

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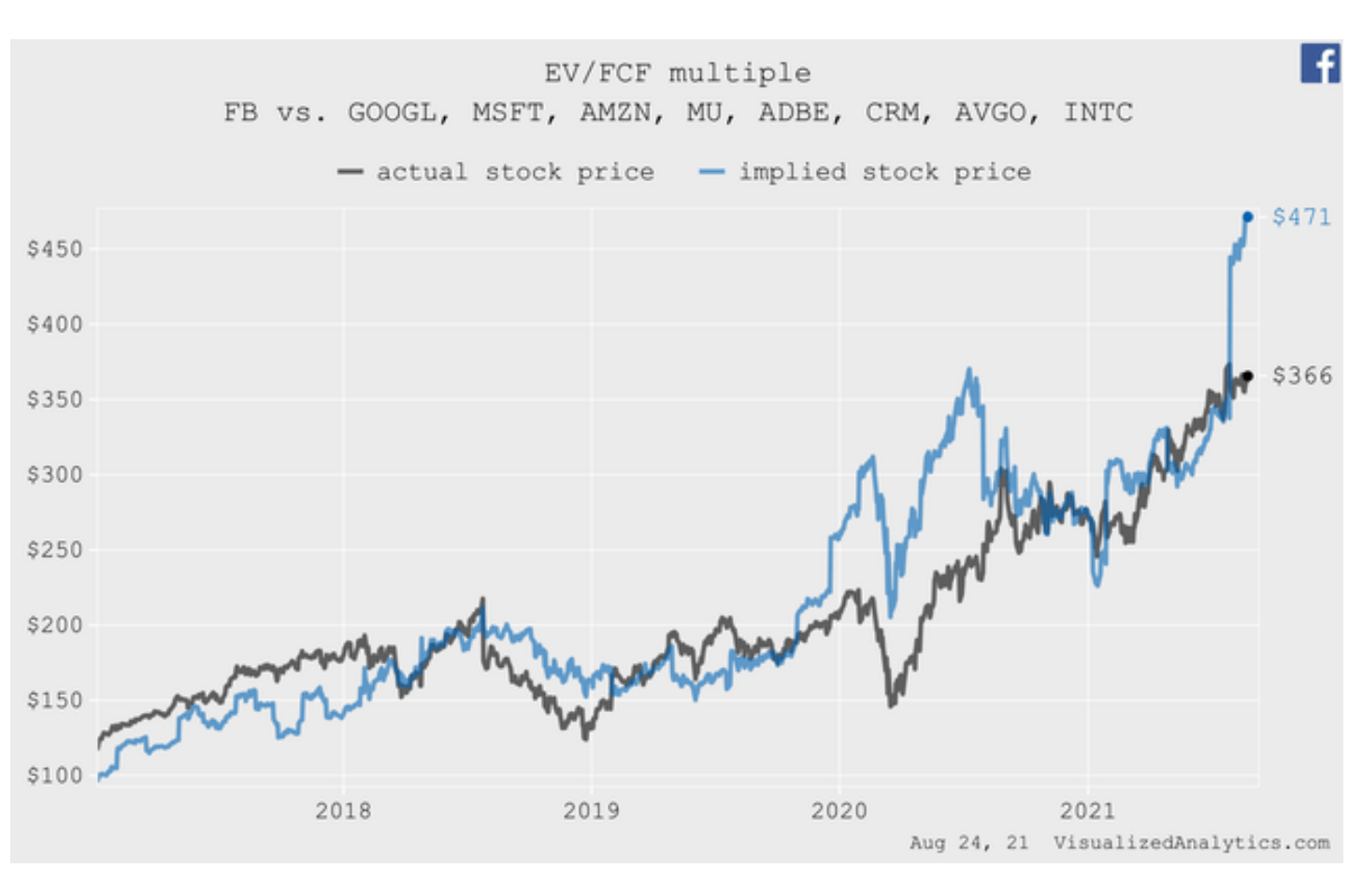
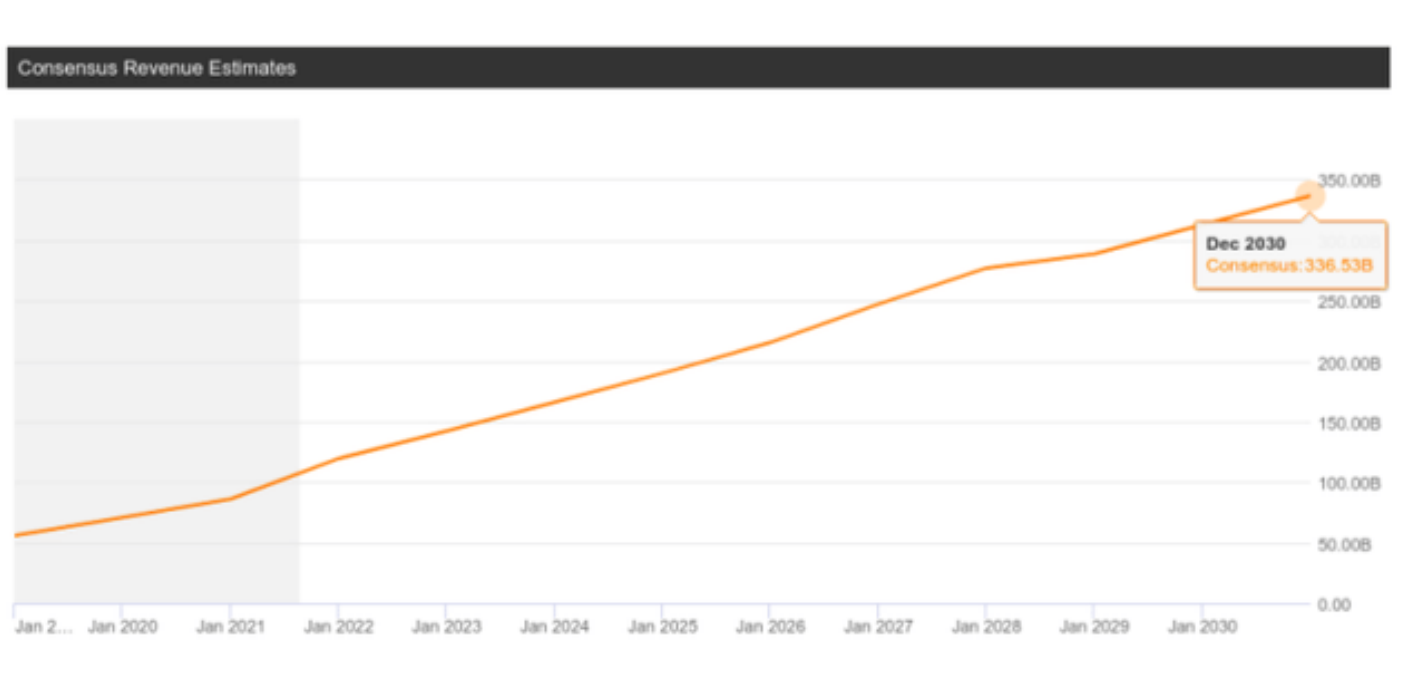


Source: VisualizedAnalytics.com

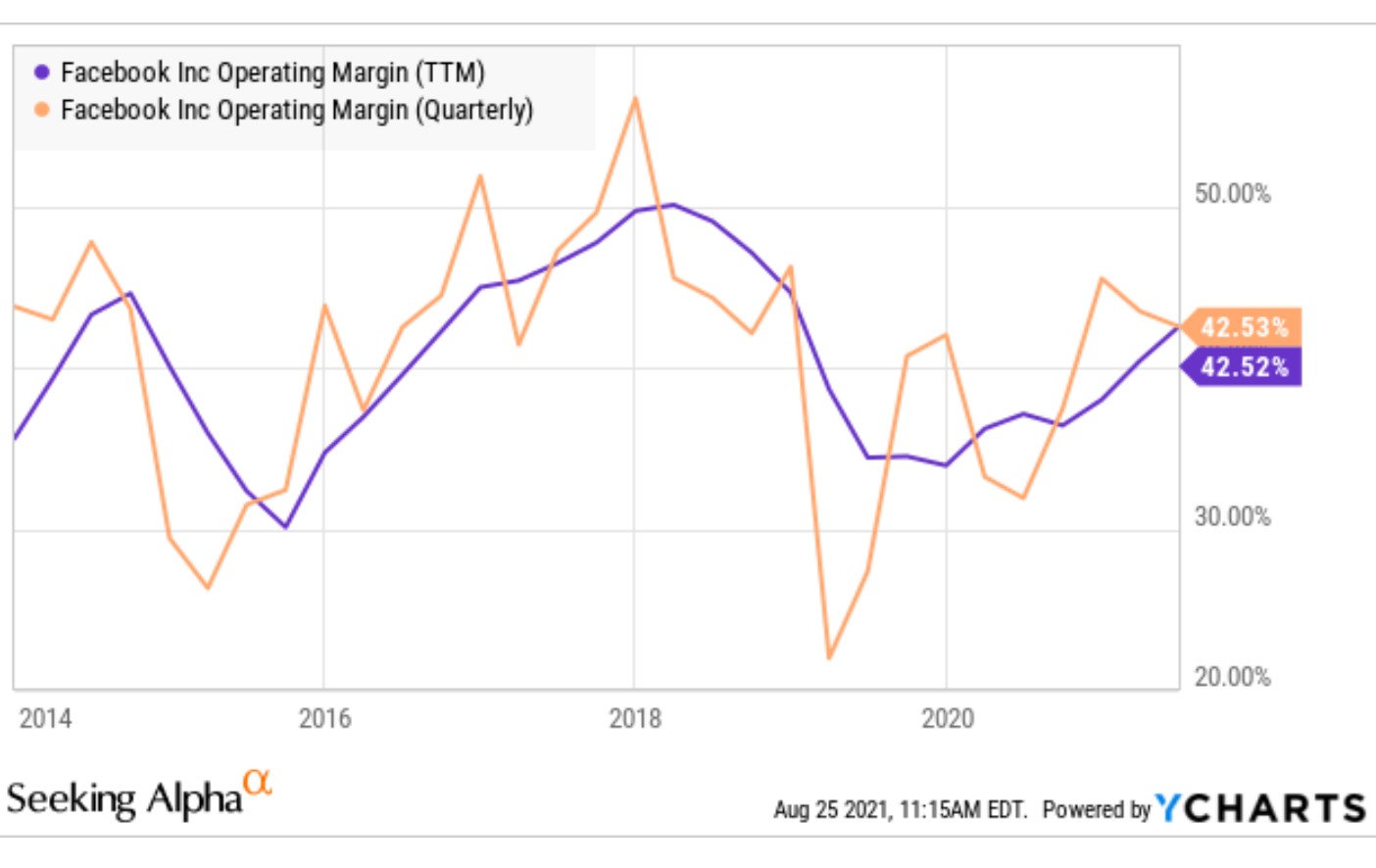
Discounted cash flow valuation

When predicting Facebook's revenue for the next ten years, I proceeded from the average expectations of analysts. According to consensus forecasts, in the next decade, the company's annual revenue will exceed $330 billion, demonstrating a CAGR of 14.6%:



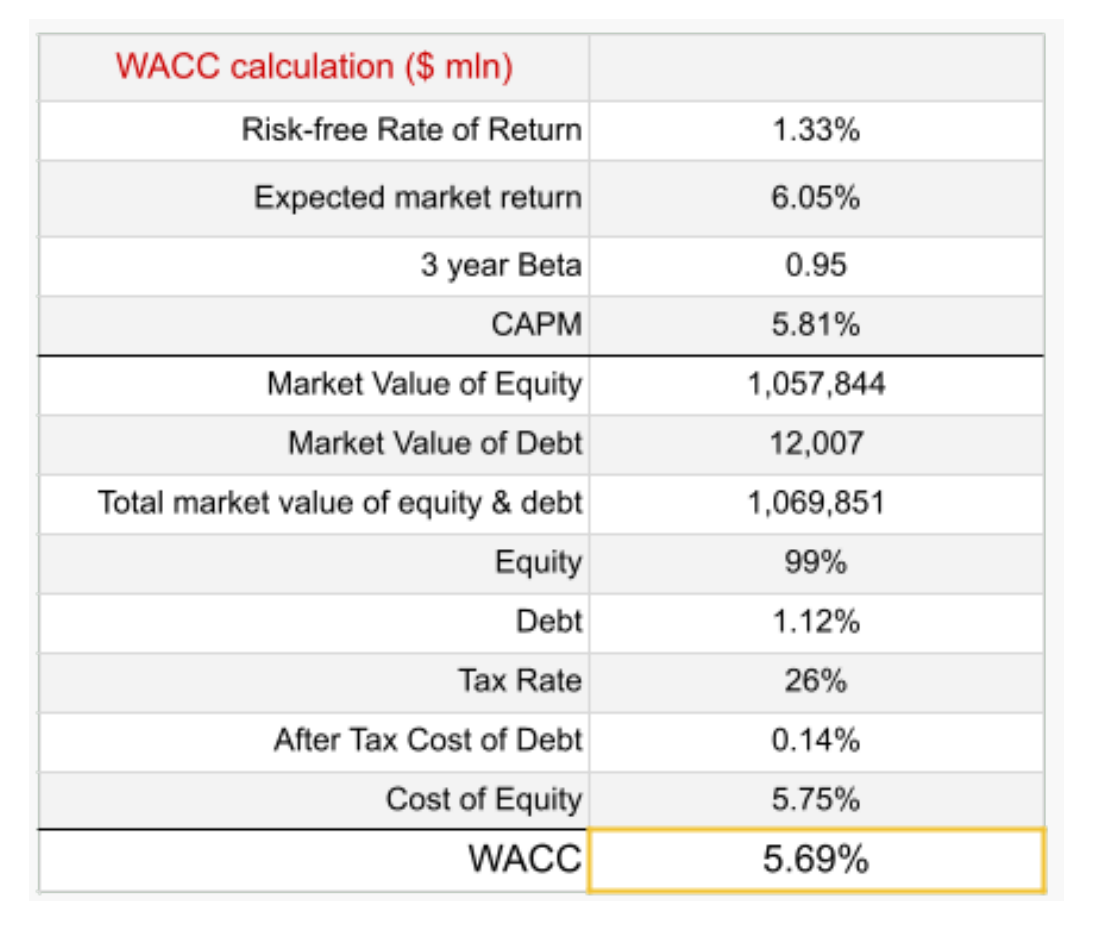
Source: *Seeking Alpha Pro*

Facebook's operating margin has hovered around 40% over the past seven years. But the model is based on the assumption that the operating margin over the next 10 years will gradually decline to 36% in the terminal year. This is a standard approach based on the likely increase in competition.



Data by YCharts

Here is the calculation of the Weighted Average Cost of Capital:



WACC calculation ($ mln)	
Risk-free Rate of Return	1.33%
Expected market return	6.05%
3 year Beta	0.95
CAPM	5.81%
Market Value of Equity	1,057,844
Market Value of Debt	12,007
Total market value of equity & debt	1,069,851
Equity	99%
Debt	1.12%
Tax Rate	26%
After Tax Cost of Debt	0.14%
Cost of Equity	5.75%
WACC	5.69%

Source: Author

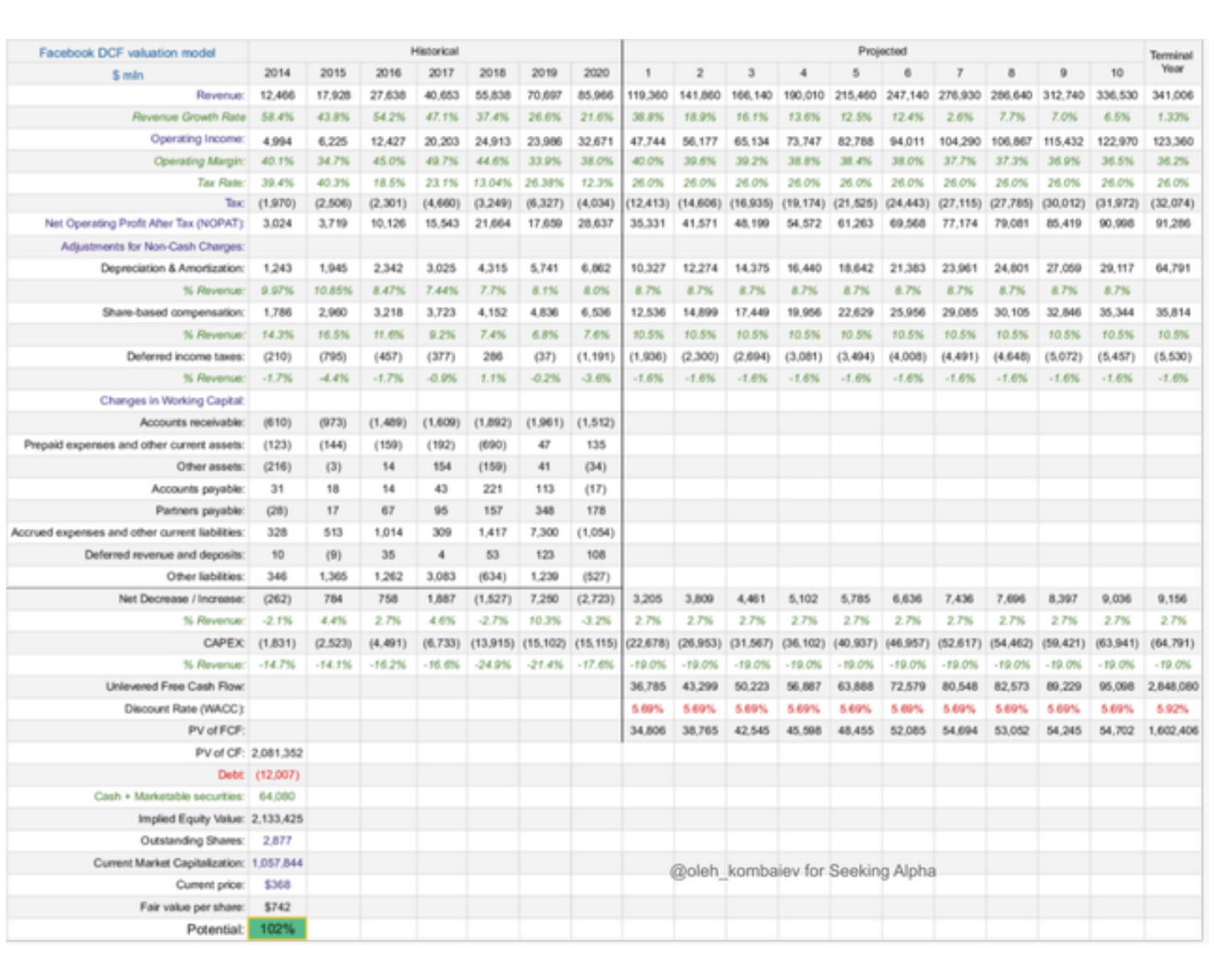
Some explanations:

- In order to calculate the market rate of return, I used values of equity risk premium (4.72%) and the current yield of UST10 as a risk-free rate (1.33%).
- I used the current value of the three-year beta coefficient. For the terminal year, I used Beta equal to 1.
- To calculate the Cost of Debt, I used the interest expense for 2019 and 2020 divided by the debt value for the same years.

When building the model, I used the following key assumptions:

- The relative size of CAPEX will be at the average of the previous five years (14%).
- The average tax rate will amount to 26%.

Here's the model itself:



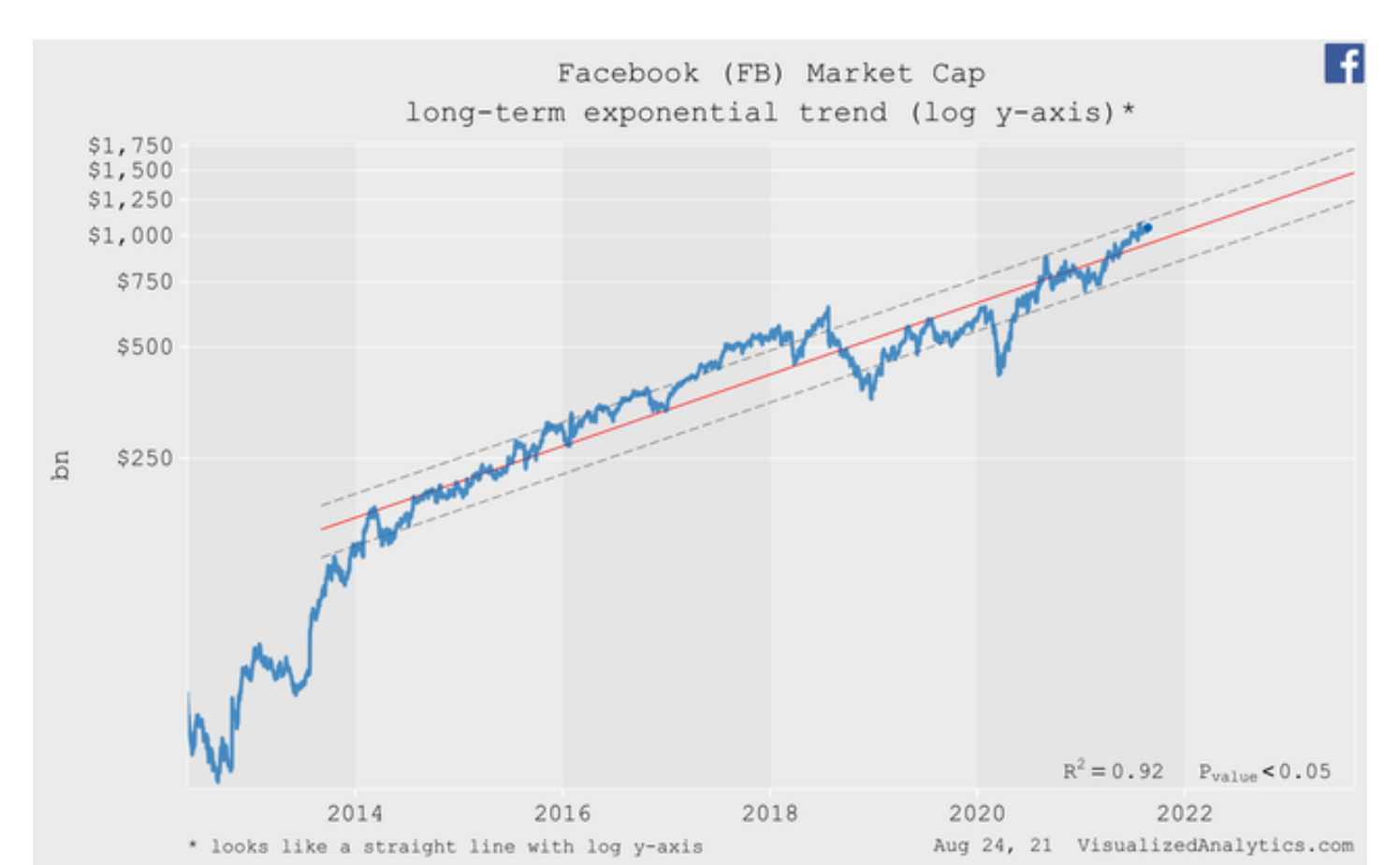
(high resolution)

Source: Author

The DCF-based target price of Facebook's shares is $742, offering ~100% upside. Comments are superfluous.

Technical picture

The entire history of Facebook's stock price growth is well-described by the exponential trend which appears as a straight line on the graph with a logarithmic y-axis:



Source: VisualizedAnalytics.com

Since mid-2020, Facebook's actual stock price has been fluctuating along this trend. *It means, that the company's capitalization is growing in full accordance with its natural, long-term trend.*

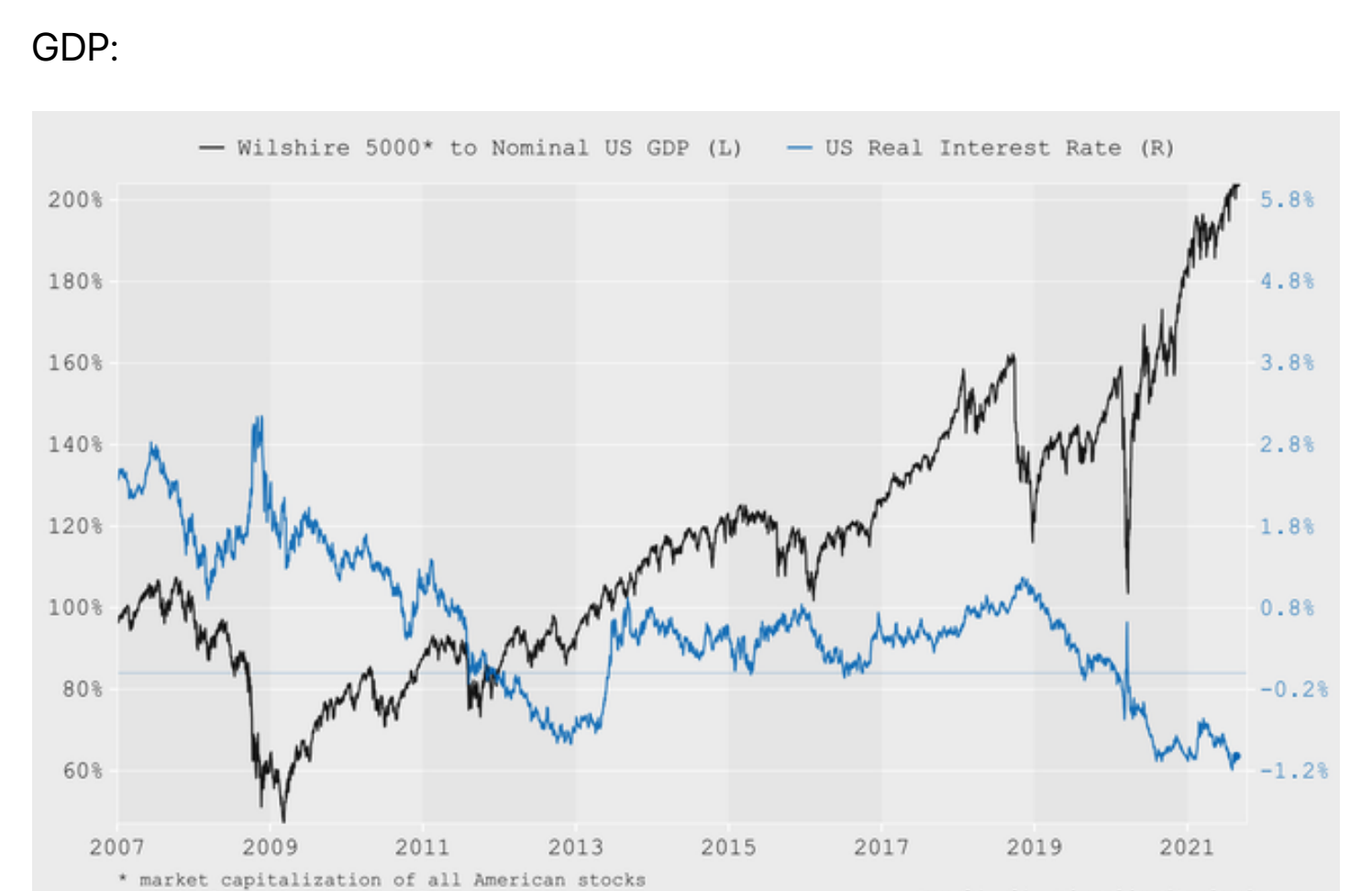
Risks

In my opinion, investing in Facebook is associated with three key risks: (1) reaching the growth limit, (2) regulatory risk and (3) market risk.

In the very beginning, I already wrote about achieving the natural limit for the quantitative and qualitative growth of the company. I can only summarize once again that so far there are only signs of a quantitative slowdown in the company's growth, which is compensated by the acceleration of qualitative growth. Let's see what the next quarter shows.

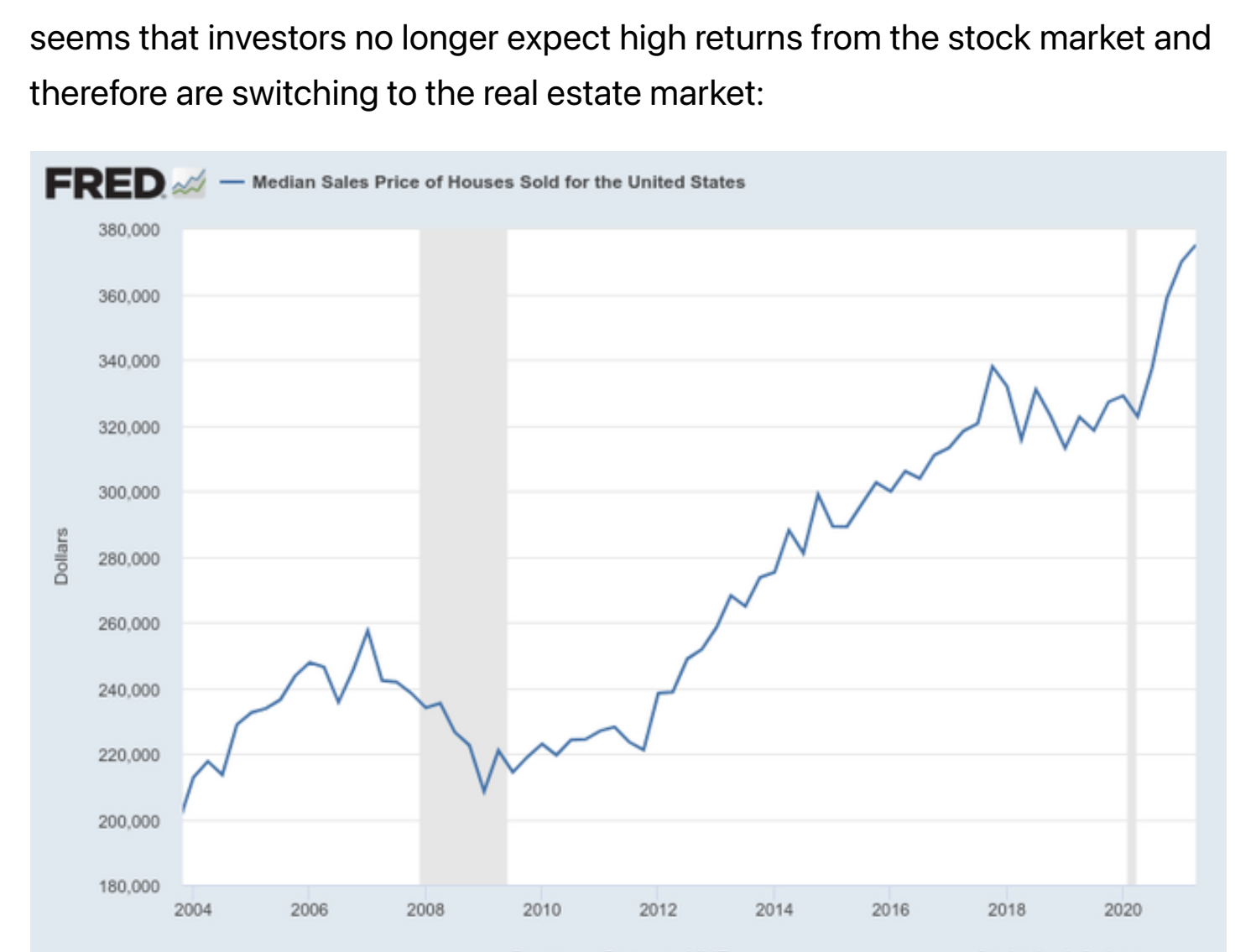
Regulatory risk will continue to grow. The Chinese government's attempts to tighten control over tech companies is a concentrated global trend. This whole Cambridge Analytica story will serve as a reminder to governments of all countries of the power of data. So, *state control will definitely strengthen and most likely this will negatively affect the company's growth.*

In the context of *market risk*, I want to note that now the entire US stock market has reached extreme points in many respects. First of all, this concerns the relative size of the market - the Wilshire 5000 index is now twice the US GDP:



Source: VisualizedAnalytics.com

Second, real estate prices are growing suspiciously fast in the United States. It seems that investors no longer expect high returns from the stock market and therefore are switching to the real estate market:



Source: fred.stlouisfed.org

And all this is complicated by the fact that most likely monetary policy in the United States will soon begin to tighten.

Bottom line

I tried to analyze Facebook as versatile as possible, and did not come to the conclusion that the company is overvalued or shows signs of a steady slowdown. DCF's upside potential of 100% deserves special attention.

Therefore, in my opinion, the balance between risks and the potential return at the moment allows the company's capitalization to continue to grow.

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