Investment Insight

Facebook: Real and Perceived Risk and Opportunity

Recent news headlines have created concerns around Facebook and its data privacy policies. The shares have declined about 13% in light of this disclosure, albeit in a market falling 6% unsettled by the uncertainty around US trade policy and Jerome Powell's first announcement as chair of the US Federal Reserve. Facebook has faced other negative headlines over the last year, most notably the fake Russian accounts which stirred controversy during the 2016 US presidential election. Digital transformation is all about internet platforms using user data to provide services to their customers with their consent and within appropriate regulatory boundaries. Internet usage of the internet has grown exponentially with countless new services and increasing ease from smartphones. A company like Facebook was launched less than fifteen years ago. Today it has 2.2 billion monthly active users, a population larger than any country, who derive a real and significant benefit from their Facebook accounts. We believe that users, companies, regulators and we as investors are just at the beginning of understanding the implications of this digital transformation and must continually evaluate its opportunities and risks. Facebook has been a position in our World Stars portfolio since January 2017 and we thought we should share our thoughts on the real and perceived issues and impacts on Facebook based on our analysis and the information that is available to us.

This latest news story harks back to 2013, when a Cambridge University researcher created a personality quiz app on Facebook that was installed by around 270,000 people. At that time, in the process of installing the app, people also gave consent to the app to access other information. One of the consents given was to access their friend list and information on their friends. Given the network effects, this meant that the university researcher had in fact access to information on around 50 million people. This was permissible under Facebook policies at the time. It was also nothing new. For example, during the 2012 US elections, more than a million people signed into the campaign website of President Barack Obama using their Facebook login and gave consent for the campaign to access their Facebook friends list and data too. This information proved valuable to target swing voters.

Several months later, in 2014, Facebook recognised the problem with accessing friend data and announced that it was changing the entire platform so that apps would be limited in terms of the information that they could ask consent for. If an app wanted access to a friend list, then it would require explicit prior approval from Facebook. This would prevent any replica apps such as the one from the University researcher being used to collect data from people who had not explicitly consented to it. Even prior to this change it was already against Facebook policies for developers to share data without people's consent. If, as is alleged, this researcher then subsequently sold on this data, he was in direct breach of these policies.

Facebook was notified of this data sharing by investigative journalists in 2015 and took immediate action, banning the app and also requiring legal certification that all the parties including Cambridge Analytica (who had purchased the data) had deleted all the improperly gained information, which they apparently provided. However, according to the latest news reports they did not delete the data or stop using it. Facebook has stated that it has hired

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forensic auditors to confirm whether the data was deleted or not. We would like to see Facebook pursue legal action as they underscore their seriousness in enforcing its policies.

Facebook has now taken further steps to address this issue of data privacy. It is regrettable that Mark Zuckerberg, the high-profile CEO and founder of Facebook, did take several days to publicly address the situation as he was considering the most appropriate response. He apologised in various TV and media outlets as well as on his own Facebook page. As we noted, Facebook had already taken the most substantive action in 2014 when they prevented any similar information gathering. As part of their next steps, Facebook has said that they will make it clearer for users to see which apps they have already allowed access to their data. Similarly, they will further restrict app developer's data access. For example, if a user has not used an app in the last three months, then Facebook will remove the developer's access to the user's data.

Whilst we recognise the negative headline risk to Facebook, we note that it is not the first and probably will not be the last negative headline for the technology sector regarding trust, ethics and data. For example, we remember Apple and the controversy it faced with the FBI in accessing the San Bernardino shooter's mobile phone. We also do not discount the likelihood that there could be more negative headlines for Facebook, including that of a threat of class action lawsuits from disgruntled users, as well as possible connotations for other large technology companies such as Alphabet and Apple.

In our outlook for 2018, we noted that regulation was one of the key themes for the technology sector. Just a couple of months into 2018, this has indeed transpired. With the rapid evolution of the technology sector, it is both right and necessary for companies to self-regulate themselves in terms of responsible, sustainable and ethical business practices. Their customers should and will be the ultimate arbiters of their success. However, regulators have a role and responsibility. In a market economy regulation should be as strict as necessary to ensure the proper functioning of markets but as light as possible to allow for innovation and progress. Regulators have to base their actions on their analysis of industries and issues as they occur and can be 'behind the curve' at times. We expect that regulation will further be in the spotlight with the European General Data Protection Regulation directive coming into force this year. It worth noting that the approach Facebook took in 2014 of requiring explicit consent is at the core of the European GDPR directive.

As regards our investment in Facebook, we have to consider the real and perceived impact of the issues. Our starting point is to assess the effect this will have on the 2.2 billion monthly active users on Facebook. Despite a #deletefacebook hashtag trending on Twitter in the direct aftermath, it does not appear that many users have left the platform. The trending hashtag has slipped away much quicker when compared to the similar #deleteuber hashtag, which itself only lost 200,000 users and did not have a material effect on Uber. Facebook has already taken steps at the start of the year to prioritise more effective engagement on the site, which may now result in users being more aware and cautious over their activities. There has also been some initial sabre-rattling by some large advertisers. We think that this is reminiscent of the same time last year, when major brands threatened to withdraw advertising on YouTube if they were positioned next to videos promoting extremist views and hate speech. Whilst there was a flurry of negative headlines at the time, the financial impact on YouTube and Alphabet was minimal.

We believe that Facebook will remain a very important channel for consumer orientated brands and marketers. Their huge addressable audience and ability to target is very rare, only Google has a similar ability. We estimate that Facebook accounts for less than 20% of global online advertising market and just a single digit percentage of total advertising spend, which gives it significant room to grow for a very long time.

Critically, we think that rather than declining engagement because of privacy concerns, we think that it is much more likely that increasing user awareness, better Facebook policies and clearer regulation will lead to greater confidence and higher user engagement, meaning that users and advertisers will get greater benefits from their Facebook accounts. Additionally, with several large revenue growth drivers, such as Instagram monetization, messaging platform monetization, video advertising and augmented reality, we believe that the company has tremendous growth potential outside of core Facebook.

Facebook shares now trade at a forward price/earnings ratio of 15.5x and on just 14x when adjusting for their significant cash level. These are lower multiples than the average of the S&P 500. With its revenue growth of more than 30% and similar if not greater earnings growth, we believe that whilst there is real and perceived risk to Facebook and its franchise, this is more than adequately reflected in the current share price.

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