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Concerning Mark Zuckerberg

In the second quarter, Facebook, Inc.'s advertising revenues surged by 51%, to $7.9 billion, and Alphabet, Inc.'s by 19%, to $21.4 billion. In 2016, the two supernovas of the FANG constellation commanded 20% of worldwide advertising outlays and 60% of total digital-ad spending. The question before the house is how much more can they cop.

We ask in service of a skeptical analysis of Facebook, of which there is none other (FB on the Nasdaq). Actually, we're bearish on Facebook. We choose the word "skeptical" in deference to the world-beating success of the Mark Zuckerberg/Sheryl Sandberg enterprise, which—including subsidiaries Instagram, Messenger and Whats App—serves more than two billion customers a month. A tip of the hat, too, to the $35 billion of cash and near cash on the Facebook balance sheet, to the nonexistence of long-term Facebook debt, to the 47% Facebook operating margin, to the 13% Facebook tax rate and—not least—to the 49% year-to-date uplift in the Facebook share price.

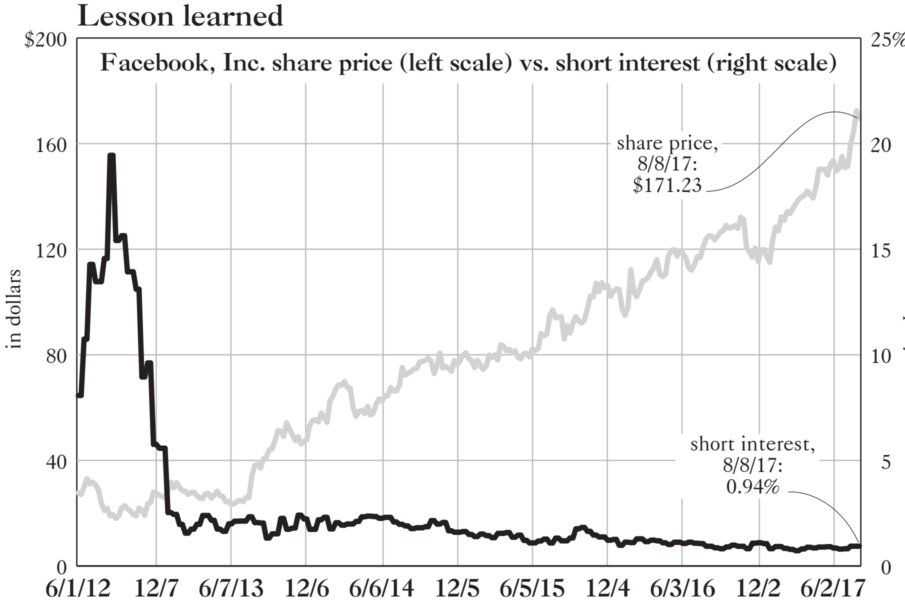
Others likewise defer, and not only to the company that grandly seeks "to bring the world closer together." The four FANG names—Amazon.com, Inc. and Netflix, Inc., besides Facebook and Alphabet, the parent company of Google—are notable for how much respect they command from the oft-burned bears. "Collectively, the short bets against FANG stocks accounted for just 2 percent of their traded shares," Bloomberg reported last Thursday. "Exclude Netflix, and the average short interest for the group drops to just 1 percent. That compares with an average of 4 percent for the S&P 500."

Perhaps the bears have finally learned what the bulls (like our friend Shad Rowe, a smart and prospering Facebook investor and the guest on this week's *Grant's* podcast) figured out long ago: namely, that here is the greatest advertising juggernaut ever devised. Or maybe growth, momentum and dazzling stock market performance have obscured the problems that will ensure that not even Zuckerberg's tree ascends to the sky. Such potential difficulties, of which more below, include the inherent limits on a company growing faster than the markets in which it operates, emerging intra-FANG competition, advertiser resistance to a digital duopoly, regulatory attack on the same, a vulnerable dependence on mobile devices and good old-fashioned managerial overreach.

"Alphabet is a very different behemoth," observes colleague Evan Lorenz. "Besides owning the world's dominant search engine and the premier online video network (that would be YouTube), the Google parent invests in autonomous driving, cloud computing and the life sciences. What Facebook and Alphabet share is a money-making address, on the street called Madison Avenue. In the second quarter, advertising contributed 98% of Facebook's revenues and 87% of Alphabet's."

It's no front-page news that the digital-ad market, especially the smartphone segment, is booming. Not so widely appreciated is that digital booms alone; no other advertising medium

Lesson learned



source: The Bloomberg

comes close. In the three months ended June 30, the ad agencies Interpublic Group of Companies, Inc. and Publicis Groupe S.A. generated year-over-year organic growth of a mere 0.4% and 0.8%, respectively. Omnicom Group, Inc. posted 3.5%. Why such lackluster gains in a world economy that at long last seems to be finding its legs? A sudden drop in Chinese ad spending is one publicly invoked reason; "political gridlock," especially in the United States, along with associated macroeconomic uncertainty, is another. Soft ad outlays by the big consumer packaged-goods companies makes a third.

How changing consumer tastes and a supermarket price war are plaguing companies like Kraft Heinz Co. and Campbell Soup Co. is familiar fare to the readers of these pages (e.g., *Grant's*, March 24). TreeHouse Foods, Inc., a vendor of packaged foods under its own and private-label brands, contends that the first quarter of 2017 was the worst in the history of the American food industry, a period which presumably encompasses the inflation of the 1970s as well as the deflation of the 1930s, if not the Pilgrims' first Thanksgiving. The second quarter delivered only pockets of improvement, TreeHouse reports.

Calendar 2017 will mark an advertising sea change, prophesies ZenithOptimedia, a Publicis-owned agency. It's the year in which "internet advertising will overtake advertising in traditional television to become the world's biggest advertising medium, accounting for 37% of total ad expenditure." If so, the reasons won't be far to seek. MoffettNathanson Research estimates that 941,000 American households cut the cord on pay TV in April–June, the greatest quarterly drop on record.

It's a fact that prompts the defining question for investors in Alphabet and Facebook. "I think the only medium that ever had 100% share of advertising spending was newspapers, and that was back in the 1820s, and that is because they came first," Jon Swallen, the chief research officer of Kantar Media, an ad-tracking firm owned by WPP plc, tells Lorenz. "Digital is still ascending. Increasingly it is not taking share from television but from radio, print media and other media."

Like Alexander the Great, Zuckerberg has only one world to conquer. Then, again, unlike Alexander's world, whose dimensions were geographically fixed, Zuckerberg's market is both expandable and contractible. Video holds the potential for growth and shrinkage alike.

Facebook has high hopes for moving pictures, though the front office cautions that it will be a lower-margin business than what it is likely to supplement or supplant. On the July 26 earnings call, CFO David M. Wehner cautioned that the more time people spend watching videos, the less time they have for the ads scrolling by on News Feed, the company's top revenue producer.

Zuckerberg added his own measured words. The analysts, one after the other, had probed about Messenger. The CEO asked his Wall Street fans to understand that the free mobile-messaging app, along with WhatsApp, would make their tangible contribution to the parent over the next three to five years. Video was the immediate focus.

"So, I mean," said Zuckerberg, "one of the big questions that we're focused on as we build this out—we're very committed to building it out because it's what people in the community want—but one of the big things that we're really very focused on is making sure that we get this right, so that even though this business will likely be—not likely, I think almost certainly will be—a lower margin source of revenue than the current thing that we do, there's this big question of how incremental is that behavior going to be." As we hear Zuckerberg and Wehner, the road to the future resembles a little bit the construction-plagued, frequently congested Brooklyn-Queens Expressway.

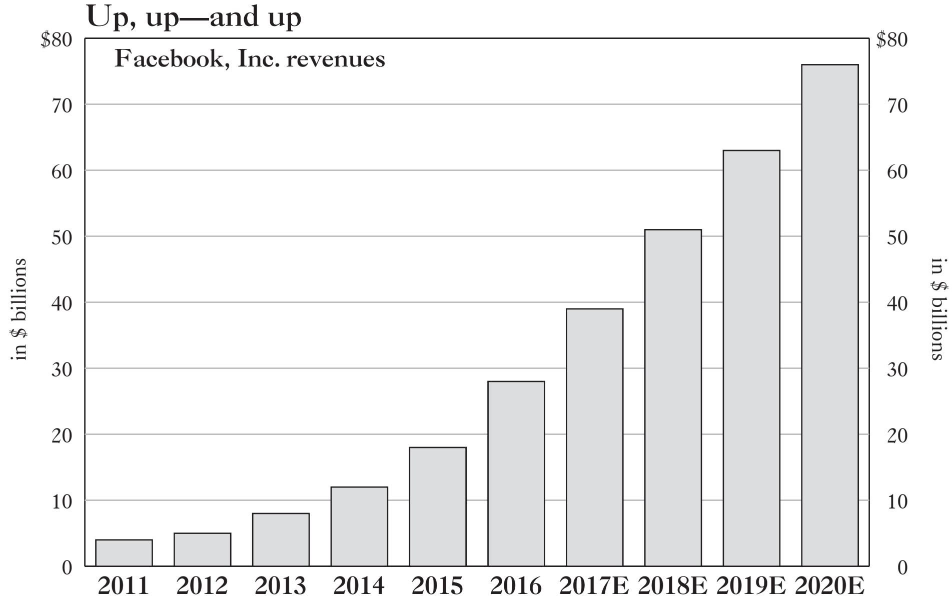
For a frame of reference on what the future may hold, TV's share of worldwide ad dollars peaked at 39.4% in 2012, according to Zenith. At least one Facebook partisan, Michael Nathanson, founder and one-half of the MoffettNathanson nameplate, predicts that digital's share will reach 50% by the end of this decade.

Some dispute it, but nobody knows. Perhaps the device, or medium, on which the ads reach consumers will in some way define the size of the ultimate opportunity. As of the second quarter, 87% of Facebook's ad revenue was attributable to smartphones, up from 41% only four years earlier.

The bulls insist that phone-borne digital is doing more than just gobbling up advertising dollars. It's devouring entire marketing budgets as well. "It is taking direct-response budgets," says Nathanson. "It is taking public-relations budgets. Coupon budgets. They are going after small to medium enterprises that don't go on TV. When you look at the overall size of the market that digital can take from, it is not just taking from television advertising. It is possible for TV to be stable to grow while digital is taking clients who would never be on TV and taking direct-response money."

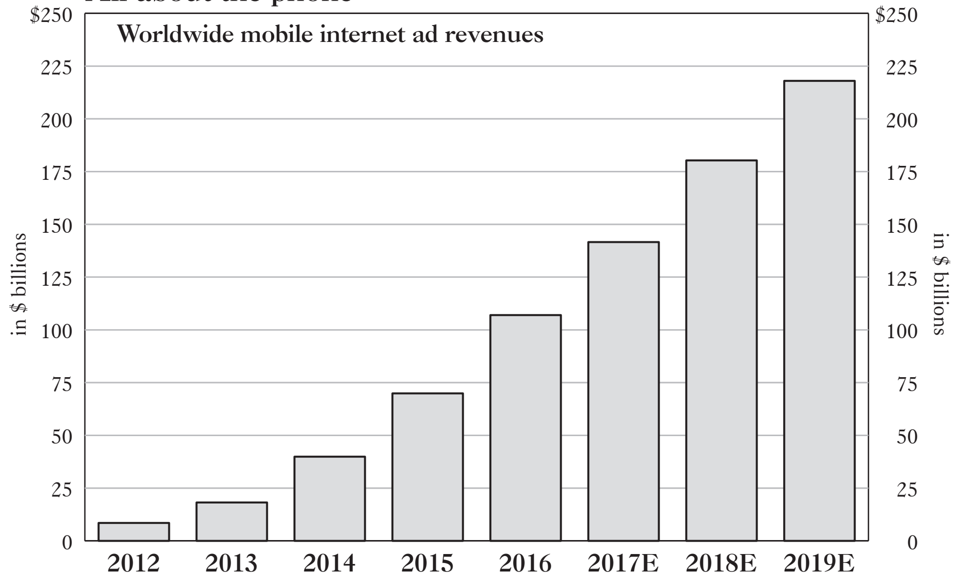
Facebook will show $5.83 in adjusted earnings per share in 2017 and $11.68 in 2020, analysts project. At today's $171.23 share price, the three-

Up, up—and up



source: The Bloomberg

All about the phone



source: eMarketer, Inc.

year forward multiple works out to 14.7 times. Omnicom, Interpublic and Publicis—the previously cited big, mature ad agencies—trade at an average of 15.1 times trailing net income. On the supposition that digital advertising reaches maturity in 2020, it is possible to venture that Facebook is fairly valued at 14.7 times those presumptive three-year forward earnings.

Of course, this is an awful lot of supposing for one medium-length sentence. All the analysts can do is to hazard informed, often hopeful, guesses. Our friends at Horizon Kinetics suggest a way forward. "Of course," they begin, "as Google's and Facebook's share of worldwide advertising expenses increases, they must eventually reflect the cyclical attributes of the industry that clearly everyone expects they will dominate. Eventually, the price/earnings ratios accorded to their shares will come to reflect the cyclicality of the industry. The problem is that no one can predict what their maximum market-share percentage will be. . . . Ultimately, the situation for an investor today is that of two cyclical firms that appear now and will continue to appear to be growth companies until they achieve true dominance of the industry—a position they are almost on the verge of achieving—and then there is likely to be valuation-multiple compression."

. . .

That Facebook and Alphabet will absorb entire marketing budgets the way Amazon does whole industries is surmise, not fact, and not everyone believes it. One dissenter is Pivotal Research Group analyst Brian Wieser. Out of 47 people who cover Facebook, Weiser is one of exactly two who rates the shares a "sell."

"People who think about it—if they think about it at all, and most don't—assume that digital will take marketing budgets and not just advertising budgets," Wieser tells Lorenz. "I see no evidence to support that claim."

Take LendingClub Corp., the online-only consumer lender which was founded in 2007 to do things differently. Of all companies, you'd expect that LendingClub would not be looking for new clients through the U.S. Postal Service (*Grant's*, Jan. 23, 2015). In fact, it is. "Currently, we believe reputation, word of mouth and our direct marketing via mail drives continued organic growth in our investor and borrower base," states the LendingClub 2016 10-K report. The 21st-century lender sounds positively analog.

Then, too, advertisers may choose to detach themselves from the two hulking internet titans. "To me what is most startling, within the slice of the pie that is called digital, is how much the Facebook and Google duopoly accounts for," says the afore-quoted Swallen. "By some calculations, if you look at the amount of incremental money moving into digital and the amount of incremental money moving into Facebook and Google and compare the figures, their growth is essentially accounting for all the growth in digital. . . . That is not technically right because there are other players who are growing and other players who are losing. . . . To me it is not how big the digital pie can get but how big can Facebook and Google get before advertisers begin to feel they have too many eggs in one basket."

One under-the-radar challenger is none other than Jeff Bezos. Amazon.com itself is an advertising vehicle: Type "potato chips" into the search bar and, in addition to the top results, you will see a sponsored ad for Kettle Brand. (For a fee, the Everything Store will customize your product listing.) Though Amazon, unhelpfully, does not break out ad revenues, research firm eMarketer, Inc. estimates that Amazon's ad revenue doubled to $1.4 billion in 2016, from $0.7 billion in 2013, and that it will grow by 29% this year.

Amazon threatens its fellow FANGs in other ways. For instance, the e-tailer has launched Spark, a social network focused on shopping, and is working on Anytime, a standalone messaging app. Amazon's Echo line of products, which allow customers to order goods from its site by voice, likewise constitutes a thrown gauntlet. Certainly, if you order a USB drive through Echo, you will not be patronizing the Google search engine.

It would be well for the Facebook bulls if nothing disrupted mobile telephony. It is, as mentioned, the prime delivery vehicle for digital advertising. Zenith estimates that outlays on mobile-borne advertising will grow by $76 billion between 2016 and 2019—even as total spending on digital ads increases by just $62.2 billion dollars. Obviously, if Zenith is correct, something has to give. Candidates for contraction include desktop internet ads (down $7.5 billion) and magazine and newspaper ads (down $13.8 billion). TV, outdoor, radio and movie ads are projected to go up by $7.5 billion.

"Even so," Lorenz points out, "the mobile-ad market would already seem to be saturated, both in terms of consumers' use of mobile devices and in terms of ad load. Many states prohibit cellphone usage behind the wheel. The few remaining alert pedestrians now dodge the somnambulant hordes checking their iPhones. Throwing the cognizant ones a lifeline, municipalities are passing laws to restrict pedestrians' usage of cellphones. Last month, Honolulu passed a law making it illegal to cross the street while staring at one."

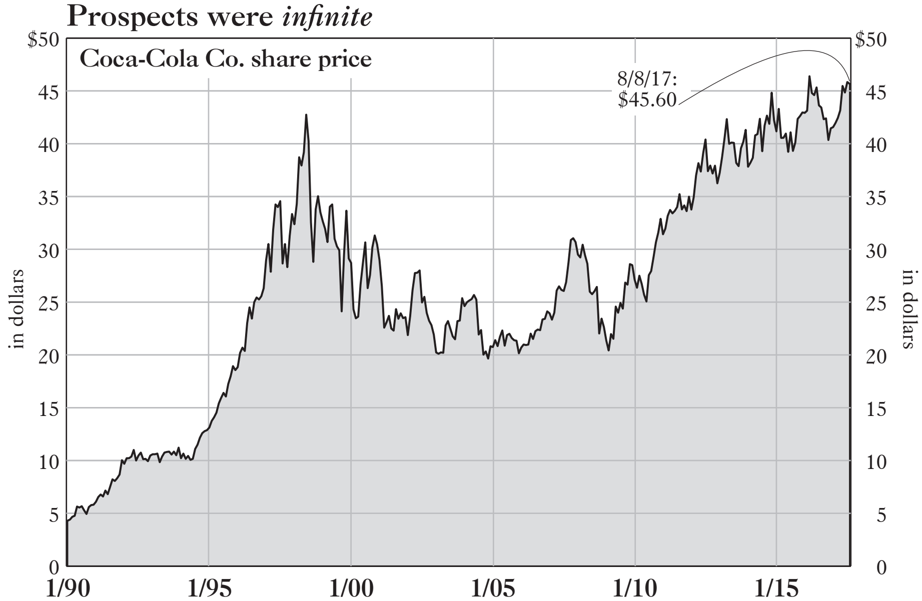
As television was taking advertising market share from radio in the mid-1950s, Stan Freberg wrote a calypso-style jingle about the boob tube. The lyrics went: *The kiddies never run and playing out of door. / On top of that they never reading books no more. / You ask them who's the father of our country, mon. / They say was either Walt Disney or Ed Sullivan.*

Now comes the September issue of *The Atlantic* with an attack on smartphones by Jean M. Twenge, professor of psychology at San Diego State University and a longtime student of intergenerational differences. "Have Smartphones Destroyed a Generation?" the headline inquires, beneath which the sub-head replies, "More comfortable online than out partying, post-Millennials are safer, physically, than adolescents have ever been. But they're on the brink of a mental-health crisis."

Plenty of things are objectively not good for you. Still, they continue to find a place in American life. There's the possibility—perhaps the probability—that smartphones will be exonerated in the court of mental health. There is likewise a risk that they will be indicted, our collective digital addiction notwithstanding. Coca-Cola Co. was a seemingly invincible, world-conquering growth stock 20 years ago. Roberto C. Goizueta, a CEO out of the Lord of Creation mold, liked to talk about "our virtually *infinite* opportunity for growth" (the italics were his). "To listen to Goizueta," said the issue of *Grant's* dated Oct. 11, 1996, "the stockholders face no meaningful risk from any contingent event because all relevant outcomes are under the control of the board of directors." Somehow it never occurred to the bulls that a meaningful cohort of consumers would one day decide that they would rather drink water. The Coca-Cola share price peaked in 1998 and spent the next 16 years in growth-stock perdition.

The previously quoted Facebook CFO, David Wehner, talking the analysts down from possibly exaggerated expectations, observed that loading more ads on a user's feed would no longer be the revenue driver that it used to be. As it is, Facebook displays one ad for every 7 to 10 posts on its iconic social network; many more such impressions, and users might decide to take their business elsewhere. The hope for Facebook's growth nowadays is rather higher prices—deservedly higher, the company insists, as online advertising delivers the goods. Some customers must agree, as average ad rates in the second quarter jumped by 24%. Analytics enhanced by artificial intelligence and more arresting advertisements—"thumb-stopping creatives," as they say in the Silicon Valley end of Mad Ave.—will continue to validate the Facebook value proposition, or so the front office contends.

Prospects were *infinite*



source: The Bloomberg

"There are two sides to a pancake," our friend the former Michele Lynd is wont to say, including—we would add—the digital one. In the quarter ended June 30, Procter & Gamble Co., the world's largest advertiser by dollars spent, slashed its online advertising budget by $100 million–$140 million, according to *Adweek* estimates. P&G's chief financial officer, Jon R. Moeller, explained on the July 27 earnings call: "What it reflected was a choice to cut spending from a digital standpoint where it was ineffective, where either we were serving bots as opposed to human beings or where the placement of ads was not facilitating the equity of our brands. . . . We didn't see a reduction in the [revenue] growth rate. So, as you know, we delivered over 2% organic sales growth on 2% volume growth in the quarter. And that, what that tells me is that that spending that we cut was largely ineffective."

On the Facebook call one day earlier, Sandberg, Zuckerberg's No. 2, cited the fabulous returns on digital-ad investment logged by, among others, Delta Air Lines and Ben & Jerry's. And Sandberg gave every assurance that Facebook itself was in the vanguard of measuring ad dollars not by clicks or page views but by hard commercial results: "See an ad, and you buy a product."

Still and all, Procter & Gamble, which laid out $7.2 billion to advertise in fiscal 2016 (of which an estimated $1.5 billion was earmarked for digital), is a thought leader as well as a big spender. It was P&G that, in 2012, announced that $1 billion of savings were within its grasp thanks to a switch to cheaper and more efficient digital ads from more expensive and less targeted analog ones. Now the same mega-advertiser is reversing field while discovering that it's no worse off for that change in tactics. "Most critically," Wieser comments, "because P&G indicated its view that reductions did not impact revenue growth, the statement will undoubtedly add fuel to the fire of large brands more carefully scrutinizing their digital-advertising choices. Large advertisers represent around 30% of Facebook revenues, on our estimates."

Fraudulent clicks, brand-diminishing content (including the odd ISIS recruiting video) and truly fake news are familiar complaints of disappointed digital-ad buyers. A study by The&Partnership and m/SIX, a pair of

WPP plc agencies, estimates that 19% of 2016 digital-ad spending, in the sum of $12.5 billion, was for naught.

Do consumers even notice what the marketers are trying to sell them? The question is as old as advertising, though no less urgent on account of that fact. In a September mea culpa, Facebook admitted that it had overestimated viewing time for video ads (and thus overcharged advertisers) for at least two years.

The Media Rating Council's viewability standard requires that at least half of an ad be visible on a screen or phone for at least one second. If GroupM, the parent company to WPP plc's media agencies, were to get its way, every ad would have to be visible for at least half of the time that advertisers purchase, or for 30 seconds, whichever is greater. The idea is that Facebook and Alphabet should earn nothing for ads that nobody sees. Some advertisers are even pushing to move digital-ad payments to a cost-per-second model, away from the industry standards of cost-per-click, cost-per-view or cost-per-thousand impressions.

You can find other concerns about Facebook's long-term growth in the opening pages of the company's own 2016 10-K. "For example," Zuckerberg's authors allow, "while user-provided data indicates a decline in usage among younger users, this age data is unreliable because a disproportionate number of our younger users register with an inaccurate age. Accordingly, our understanding of usage by age group may not be complete." Customer loyalty is another question mark. Facebook was the top choice for 56% of *New York Times* readers in response to the polling question, "Which tech giant would you drop?"

John D. Rockefeller was no more popular with 19th-century oilmen than Zuckerberg is with 21st-century newspaper and magazine publishers, or with a certain kind of reader or writer who cannot share Sandberg's enthusiasm for "short-form snackable content." Some may thrill to Zuckerberg's evangelical conception of the role of his profit-making company—"Last month," the CEO told the analysts, "we had our first-ever Facebook Community Summit to talk about our product roadmap, focused on building what we call meaningful communities." Others, reading those words, may choose to put them down and pick up an Ayn Rand novel. It may or may not boost Facebook's investment appeal that the company is developing a solar-powered airplane with which "to beam internet to parts of the world that currently don't have access," as Zuckerberg puts it.

"What provocation might cause users to cancel their accounts?" Lorenz asks, and he answers: "On Aug. 2, Zuckerberg hired Joel Benenson, a Democratic pollster and the chief strategist for Hillary Clinton's 2016 presidential campaign. While Benenson's stated job is to consult on Zuckerberg's philanthropic efforts, the hire—in conjunction with Zuckerberg's highly publicized state-by-state tour of America—fans speculation that the Facebook chief plans to run for president in 2020. This Zuckerberg flatly denies. If, however, he ran as a Democrat, a certain kind of Republican may say, concerning FB, 'No más.' And, of course, vice versa."

Meanwhile, Facebook insiders are regular and heavy sellers of the stock which they know best: In the past month alone, they unloaded four million shares for proceeds of $640 million. Perhaps they seek to join the meaningful community of the rich and the liquid.

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