Facebook

Tim Beyers | October 24, 2012

CURRENT PRICE: FB $ 235.68 ↑ $ 1.66 (0.7%)

Facebook (NASDAQ: FB) has lost about $20 billion in market value since we first recommended it three months ago. That's the bad news. The good? Today's investors are getting shares of the world's largest marketplace — 1 billion users strong — at a bargain price.

This stock's movement has disappointed us since our August issue, but little else has. We see no reason to doubt that Facebook is well on its way toward wringing oceans of money out of an enormous, one-of-a-kind set of data. If you already own shares, this is a good time to buy more. And if you haven't made a friend of Facebook yet, we think there's plenty to like.

Whoa, Back Up. 'Marketplace'?

No longer a mere social network, Facebook has put in place initiatives for tracking and even enabling commerce — notably Gifts, a mechanism whereby users are offered the chance to purchase a small item for a friend, whether it's to celebrate a birthday or some other special occasion.

The changes mean that the social networking pioneer now sits in the enviable position of playing transactional middleman to nearly 1 billion customers worldwide. Can you imagine? Facebook will soon operate a burgeoning mall that's three times the size of the U.S. population.

Amazon.com and eBay should be shaking in their boots. Even though they're two of the world's largest retailers, their combined 250 million or so active users is well short of the 1 billion Facebook gets to sell into right now. Imagine what might happen were the social network to expand Gifts into a more meaningful e-tail operation.

Skeptics will argue that Facebook has a tendency to fumble new ideas, and they're right. But if we know one thing about CEO Mark Zuckerberg it's that, while he and his company have been prone to mistakes, they rarely slip up the same way twice. I'd expect any steps taken to bolster the social network's commerce efforts to be done with great care — and rapid course-correction when mistakes do occur.

WHAT IT DOES:

Facebook is the world's largest social network, with more than 1 billion monthly active users.

WHY BUY:

- Facebook is the top dog in modern social media.
- Its massive installed base is ripe for new e-commerce experiments.
- A sharp sell-off has priced the stock at levels not seen since pre-IPO, giving Rule Breaking investors a big discount on potential growth.

KEY DATA:

- **Headquarters:** Menlo Park, Calif.
- **Website:** www.facebook.com
- **Sign of a Breaker:** Top Dog
- **CAPS Rating:** 1 star (16 out of 100)
- **Market Cap:** $40,700
- **Cash/Debt:** $3,900 / $706
- **Revenue (TTM):** $4,000
- **Earnings (TTM):** $972
- **Revenue (2009/'10/'11):** $777 / $1,974 / $3,711
- **Earnings (2009/'10/'11):** $229 / $606 / $1,000
- **Recent Price:** $19.00

TALK ABOUT IT:

Visit Facebook's discussion board here!

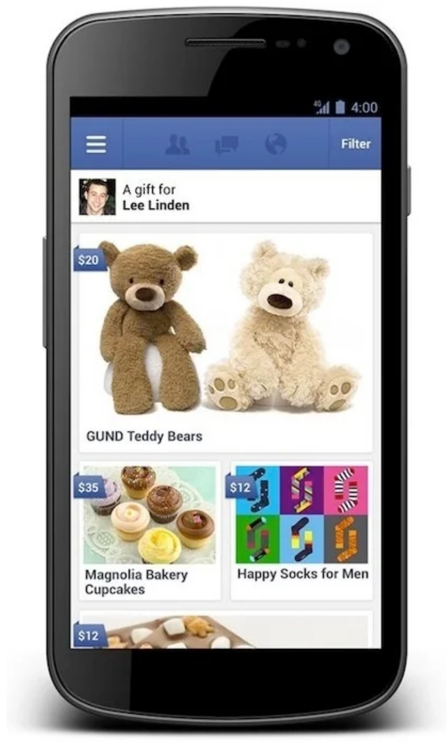
Data as of 10/19/12. *Dollar amounts in millions except recent price.*

There's plenty to build upon. Facebook already gives users the option to like pages and vendors. It's a short leap from "like" to "offer." Call it Facebook Direct, in which the owner of a page presents you with a new offer each time you navigate there. Clicking the buy button would prompt Facebook to kick off a payment to the page owner.

Yet that's what *could* be. We already have Gifts and a related product called Exchange, in which browsing data is used to improve ad targeting; they promise to better monetize data by presenting salient offers at more opportune moments. They also help address known weaknesses in Facebook's mobile strategy, all without requiring the extraordinary expense of developing a smartphone in-house.

The Math of a Massive Opportunity

So Facebook's prospects have expanded. Where does that leave the stock? Some fine-tuning of the valuation is required. Specifically, I've reduced the expected base cash flow from $750 million to $500 million, reflecting the company's need to spend more on expansion. I'm also assuming a lot more spending on equity options for employees — four times as much, in fact.□



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Meanwhile, analysts are pricing Facebook for a decade of 35% annualized gains in free cash flow. They see the stock as no cheaper today than it was when we first recommended it, and that's in spite of a sharp drop since the IPO. Here's why they're wrong.□

Divide my FCF estimate ($500 million) by the active user base (1 billion). Today's valuation presumes Facebook is generating just $0.50 of cash flow for every active user, growing 35% annually to $10.05 a decade from now. Seem massive? Actually, it isn't, especially when you compare it with what Amazon and eBay produce right now.□

Amazon's 152 million active users helped generate $1.1 billion in FCF over the trailing 12 months, or $7.23 each; eBay's base of roughly 100 million active users helped bring in $1.9 billion in FCF over the same period, or a whopping $19.16 each. Facebook is aiming for the middle, at least, but at a much larger scale.□

Risks and When We'd Sell

When we first recommended the stock, we said to expect volatility. We weren't wrong. Insiders and early investors cashed out over the summer and early fall, creating expected selling pressure that drove the stock to new lows. New estimates say another 1.5 billion shares could be sold before year's end. Let the hyperventilating begin, right?□

Here's the problem: Even if hundreds of millions more shares are eligible to be sold in the next two months, we have no idea whether they will be. And if they are, so what? We're in this stock for the long haul — a decade or more — which makes extreme volatility our friend. Nibble away quietly as the doomsayers holler about the end of Facebook, keeping commissions low as you build a position at good prices. □

Then, keep an eye on the cash flow statement. If our thesis is correct, Facebook's FCF growth will accelerate as capital spending needs moderate over the next three to five years. At that point, the stock could easily return to the $100 billion valuation some observers expected at the time of the IPO, doubling our investment. □

And if Facebook's cash flow shows signs of contracting? We'll monitor it, and if the decline lasts for several quarters in a row we may sell and move on to a better position.□

The Foolish Bottom Line

Facebook has been a loser for us so far, but that's OK. We're long-term investors, and we see a business learning from early mistakes and leapfrogging blindsided competitors.□

Zuck has built much more than the world's largest social network. Instead, Facebook is the world's largest captive audience, a virtual mall just as capable of hosting commerce as communication. A quintessential Rule Breaker, in other words, more than worthy of a second spot on our scorecard — and in your portfolio. □

See the team's and David and Tom Gardner's holdings here. The Motley Fool owns shares of Amazon.com and Facebook and has the following options: long JAN 2014 $20.00 calls on Facebook.

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