GRANT'S
INTEREST RATE OBSERVER®

Vol. 40, No. 21c   233 Broadway, New York, New York 10279 • www.grantspub.com   NOVEMBER 11, 2022

Facebook in the mirror

From its peak 13 months ago, Meta Platforms, Inc. (META on the Nasdaq) has shed $822 billion in market value, with $207 billion of that loss coming after a bullish *Grant's* analysis last summer. Where stand we now? Bullish, still, though plenty chagrined. As to what follows, widows, orphans and aficionados of good corporate governance may avert their eyes.

With 2.93 billion people logging on to at least one of its social media platforms each day in the three months ended September, Meta needs no introduction. Corporate operations are divided between Family of Apps (99% of third-quarter revenues), which includes Facebook, Instagram and WhatsApp, and Reality Labs, the problem-child-cum-great-white-hope, which encompasses virtual reality, augmented reality and the metaverse.

Our Meta story, in the issue of *Grant's* dated July 8, identified the main threats facing Facebook and Instagram: Apple, Inc. had made it tougher for digital advertisers to target and track consumers; a cyclical slowdown in advertising loomed; rival social network TikTok was fast gaining ground on Facebook; and Mark Zuckerberg was turning his pockets inside out to fund the metaverse.

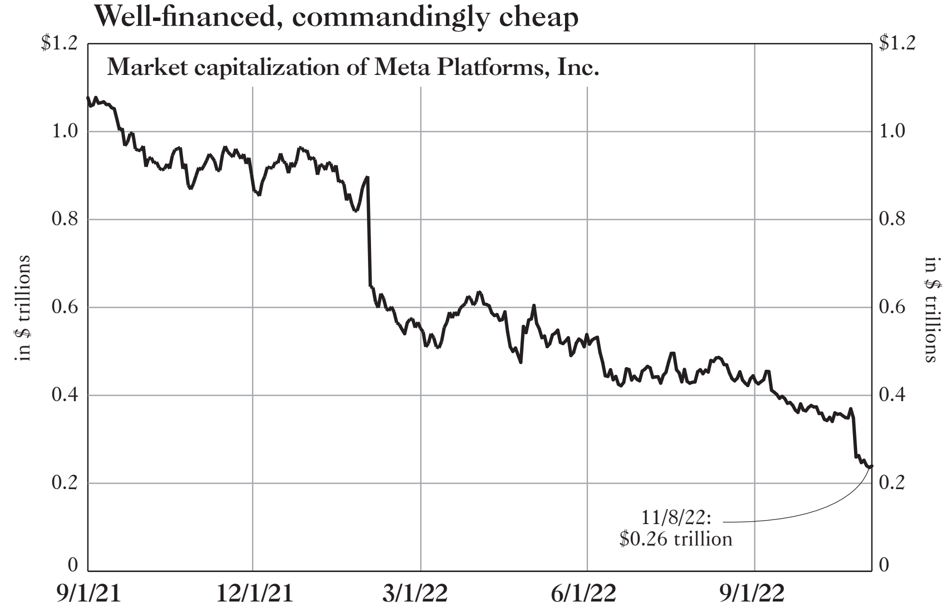
Third-quarter results actually allayed many of those concerns, though you wouldn't know it by the 24.6% slide in the share price on the day following the news. Yes, headline revenues fell 4%, but, adjusting for currency movement, underlying revenue growth was 2%. Zero out the impact of Apple's changes to digital advertising along with Meta's transition to Reels, and organic growth in the Family of Apps division may have been 8%, according to Michael Nathanson, who rates Meta a buy and is one-half of the nameplate MoffettNathanson, LLC.

More importantly, users continue to flock to Meta's social networks. "On Facebook specifically, the number of people using the service each day is the highest it's ever been, nearly 2 billion, and engagement trends are strong," Mark Zuckerberg crowed on the Oct. 26 call. "Instagram has more than 2 billion monthly actives. WhatsApp has more than 2 billion daily actives, also with the exciting trend that North America is now our fastest-growing region."

Reels—where you go for 15-second videos served up by an AI algorithm—is Meta's answer to TikTok. As a new product, Reels monetizes at lower rates than Facebook's newsfeed and Instagram's Stories, so pushing Reels in the midst of the clustering problems posed by Apple, TikTok and advertising income would necessarily darken current-period results. Yet, said we, it was the right thing to do, a case of the "benefit of founder control."

Meta estimates that Reels cost $500 million in foregone advertising last quarter, though it's paying dividends elsewhere. According to Zuckerberg, the time that users spend watching Reels has been incremental to the time that they spend on Facebook and Instagram.

Well-financed, commandingly cheap



source: The Bloomberg

Meanwhile, engagement with TikTok may have peaked, at least temporarily. According to data-analytics firm Sensor Tower, Inc., the number of minutes that Americans spent scrolling through TikTok feeds declined to 789 billion in the third quarter from 794 billion in the first three months of the year. "We believe that we're gaining time-spent share on competitors like TikTok," Zuckerberg declared.

Nor is that rival social network owned by Chinese parent company ByteDance Ltd. doing itself many favors in America. According to an Oct. 20 *Forbes* exposé, ByteDance drafted plans to track the locations of at least two U.S. citizens, individuals who had never worked at the short-form video company, through the TikTok app. This follows a June BuzzFeed News report that Chinese employees have helped themselves to American data. Federal Communications Commission Commissioner Brendan Carr last week declared that the U.S. government should ban the app entirely.

So much for the good news. In updated guidance two weeks ago, Meta said it plans to spend about $86 billion this year and between $96 billion and $101 billion next year. Reality Labs is a key driver of this expense growth. In the 12 months ended Sept. 30, the unit generated an operating loss of no less than $12.7 billion, a sum greater than the trailing 12-month revenues of Expedia Group, Inc. and News Corp. The earnings release warned that "Reality Labs operating losses in 2023 will grow significantly."

Capital expenditures, too, are pointed higher, to as much as $39 billion next year from perhaps $32.5 billion this year and $18.6 billion in 2021. Based on the midpoint of management's guidance for this year's revenues and the Street's estimate for next year's, capex intensity would increase to 28.1% of sales in 2022 and 29.6% in 2023, up from 15.7% in 2021.

The business case for this massive growth in capital outlays is more defensible than the bet on the metaverse, shocking as those latter figures may seem. Prior to Apple's crackdown, social media sites had a single digital identifier with which to tie the ads that users saw on Facebook or Instagram to the purchases those people later made at digital storefronts (and you thought they were just reading your mind). Re-creating such data without that ID is computationally intensive, which means few companies other than Meta and Alphabet, Inc. can afford the necessary investment. Algorithmically recommended videos are also data-intensive, but Reels appear to be driving higher engagement on Meta. Nevertheless, the quantum of money that Meta is investing is remarkably large.

In other words, the existential threat from TikTok appears to have abated some, but Meta has a spending problem. One would expect that, since most of his net worth is tied up in Meta's share, Zuckerberg will eventually focus on the bottom line. On the one hand, Sunday's *Wall Street Journal* scoop on thousands of looming layoffs would suggest that he is already doing so. On the other, Zuckerberg, like Xi Jinping, is the unquestioned ruler of his domain. Though the co-founder and chairman and CEO owns just 12.8% of Meta shares outstanding, his Class B holdings grant him 54.4% of the votes. Certainly, there are two sides to the coin of "founder control."

Despite the wanton spending, Meta is well-financed and commandingly cheap. The company is valued at an enterprise value (that is, market cap less net cash) of 6.4 times trailing earnings before interest and taxes and 8.3 times the guesstimate for next year's Ebit, losses in Reality Labs included. As of Sept. 30, the balance sheet showed a cash balance of $41.8 billion against $9.9 billion in debt.

Perhaps the best news in the third-quarter release was the 49% year-over-year plunge in Reality Labs revenue. If Zuckerberg's forays into virtual reality fail early, he may staunch the red ink. Excluding the Reality Labs losses, Meta would trade at 4.7 times EV to trailing Ebit, a lower multiple than such cyclical companies as Reliance Steel & Aluminum Co. command.

•