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For the value tribe

Evan Lorenz writes:

The S&P 500, down by 20.1% from its high on Jan. 3, still commands a cyclically adjusted price-earnings ratio of 29 times compared with a 50-year average of 21.1. Even so, green shoots of value are poking up here and there, including, we think, in the shares of former *Grant's* pick-not-to-click Meta Platforms, Inc. (META on the Nasdaq). In preview, we're bullish on them.

Lots has happened since we had our bearish say on Mark Zuckerberg's creation in the issue of *Grant's* dated Aug. 11, 2017. In 2019, Facebook paid $5 billion to settle federal charges of violating its customers' privacy; in November 2021, there was the famous name change, to Meta Platforms; and on June 1, longtime Facebook/Meta chief operating officer Sheryl Sandberg announced her decision to lean out of the company she helped to build. In that busy half-decade, Meta's stock has been flat while the S&P 500 registered a 71.2% gain (reinvested dividends included).

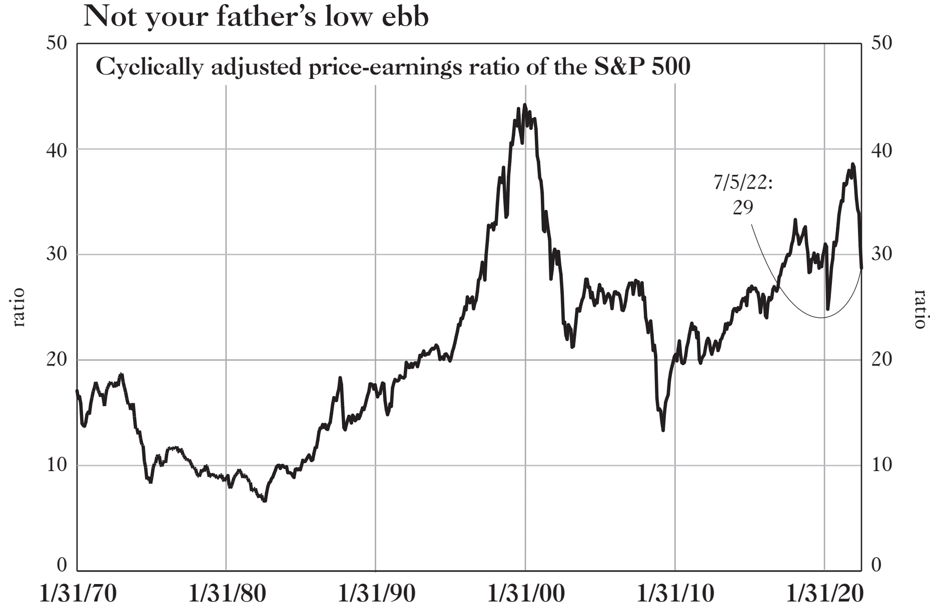
One thing that hasn't changed is the company's sheer ubiquity. In the first quarter, Facebook, Instagram, Messenger and WhatsApp counted 2.87 billion daily users and 3.64 billion monthly (or more frequent) ones. The four networks generated 97.5% of Meta's first-quarter revenues. Reality Labs, which invests in what we have learned to call the "metaverse" and sells the virtual-reality headset Meta Quest and the video-calling device Meta Portal, chipped in the balance.

As to Zuckerberg himself, he owns 12.8% of shares outstanding and 54.4% of the votes through his Class B holdings. Facebook bought Instagram for $1 billion in 2012, and everyone said the CEO overpaid. He actually underpaid. As to his cringey screen presence (see last year's video of him introducing the concept of the metaverse), controversial "fact-checking" protocols and hoodie, we hereby put them to one side.

Saturation and cyclicality buttressed the bear case that featured in these pages five years ago. At some point, we said, Facebook, which then counted 1.4 billion daily visitors, would run out of new faces. Corporate revenue, driven by digital advertising, would post turbocharged growth only as long as the company continued to take share from the analog world, we said. Sooner or later, Facebook's revenue growth would approximate that of the overall cyclical advertising market, which the stock market would not fail to notice, we likewise contended.

Today, there are, indeed, signs that Meta is nearing the point of user saturation. The number of people logging into Facebook daily declined between the third and fourth quarters, to 1.929 billion from 1.930 billion, before picking up to 1.960 billion in the first quarter. In the first three months of the year, 3.64 billion users logged into the Zuckerberg family of apps at least once a month. As Meta's networks are blocked in China, this represents 56% of the company's addressable world. And Facebook's trail-

Not your father's low ebb



source: Prof. Robert Shiller

ing price-earnings multiple has slumped to 12.8 times trailing earnings from 37.6 times on Aug. 11, 2017. Two out of three ain't bad.

Digital ads seem to be neither gaining nor losing share against print, TV and other legacy media. In the first quarter, measured year over year, overall revenue climbed by 7% in dollar terms and by 10% in constant currency terms, the halving of the share price notwithstanding. Changes in the digital advertising markets cloud the strategic picture.

A little history may be in order at this point. In 2012, Apple, Inc. created "identifiers for advertisers" (IDFA) so that marketers could target consumers online while also respecting their privacy. Alphabet, Inc., the parent company of Google, quickly followed with its own IDs. This system worked, at least for the marketers. Sites like Facebook, online stores and third-party vendors quickly amassed a wealth of information about each online identifier. They may not know your name, but they know who you are.

By placing a marker on merchant websites, Facebook could not only count the number of eyeballs that saw an ad, but also the number of hands that purchased the advertised product. Technology had rendered obsolete the old saw about marketing: "Half my advertising dollars are wasted, but I don't know which half."

Then came Apple—the date was April 26, 2021—with an innovation to empower the users of its iPhone operating system. Would the iPhone masses prefer to grant or withhold permission by any old random vendor to track their digital whereabouts? Not surprisingly, most have chosen to withhold. This loss of signal creates two problems: First, how do you micro-target the people who are most likely to buy a product or download an app? Second, once you serve an ad on, say, Instagram, how can you tell whether that prompt led to a purchase?

"We believe the impact of iOS overall as a headwind on our business in 2022 is on the order of $10 billion," said CFO David Wehner on the Feb. 2 Meta earnings call. For context, the company generated revenue of $117.9 billion in 2021.

The rise of TikTok, subsidiary of China's ByteDance Ltd., has compounded the consumer-empowerment problem. Facebook and Instagram deliver content based on the people and companies that users follow, whereas TikTok serves short-form videos based on an AI-algorithm. Wildly popular with the sub-30-year-old set, TikTok is siphoning attention away from Meta's networks. In the first quarter, according to Data.ai, TikTokkers spent 28.7 hours a month on the app compared with 15.5 hours on Facebook and 7.8 hours on Instagram (the information covers Americans using the Android operating system).

Responding in kind, Meta is pushing its own AI-recommended short-form videos under the brand "Reels" on Facebook and Instagram. So far, so good: Reels accounted for more than 20% of the time spent on Instagram in the first quarter and is rapidly growing on Facebook, though the original Facebook news feed continues to outpace Reels in ad displays.

All of which helps to explain the push to online virtual reality, the metaverse. Success in the new virtual world would mean liberation from the data and advertising strictures imposed by Apple and (now) Alphabet. Of course, success is no sure thing, and operating losses at Meta's Reality Labs soared to $10.2 billion in 2021 from $6.6 billion in 2020 and $4.5 billion in 2019.

Myriad one-off and cyclical factors also weigh on the ad market. For instance, online vendors are more likely to buy digital ads than their brick-and-mortar counterparts are. During the pandemic, locked-down consumers stepped up their online ordering, boosting the e-commerce share of total retail sales to 16.4% in the second quarter of 2020 from 11.1% in the fourth quarter of 2019.

The online share has subsequently declined—it came in at 14.3% in the first three months of this year—even as the advertising market as a whole is starting to slow. "In the latter portion of Q1, advertisers in a wider variety of industry groups reported concerns related to the macro operating environment, including continued supply chain disruptions, rising input costs, economic concerns due to rising interest rates, and concerns related to geopolitical risks stemming from the war in Ukraine," Derek Andersen, chief financial officer of social-media rival Snap, Inc., told his April 21 earnings-call audience. Andersen went on to issue disappointing second-quarter guidance—and revised it still lower on May 23.

Of the 60 analysts who cover Meta, only two say sell (as distinct from the many who wished they'd said sell). On June 29, JPMorgan Chase & Co. analyst Douglas Anmuth reiterated his neutral stance on META but lowered his price target to $225 from $275. For hold-rated Meta to hit his target, the share price would have to rally by 34% (which one might call bullish).

The short interest is negligible, while, since the start of the year, insiders have sold 90,031 shares for proceeds of $18.3 million. As prodigious as that may seem, it's a big drop in the customary pace of insider selling, and Zuckerberg, who unloaded heavily in

Now for the upside

source: The Bloomberg

years gone by, has not sold a share since Nov. 8, 2021, when the stock price was roughly double today's.

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The bad news has made an impression, and META trades at the aforementioned 12.8 times trailing price to GAAP earnings. It's a valuation that incorporates $9.8 billion in stock-compensation expense (a line item that most tech companies wish was invisible) and a $11.3 billion operating loss in Reality Labs in the 12 months ended March 31. Two weeks ago, index provider FTSE Russell rubbed salt in the wounds of the growth-stock bulls by adding Meta to the Russell 1000 Value Index. Given that those index constituents change hands at an average of 15.4 times trailing earnings, Zuckerberg's pride and joy is priced at a 17% discount even to "value," or, at least, to Russell's notion of value.

"We are given a price for the business, and we are making assumptions about the earnings-power years in the future," Craig Inman, a portfolio manager at Artisan Partners, L.P., which holds a position in Meta, tells me. "If the business doesn't perform great, the asking price is pretty undemanding, so we are not going to get run over. That is part of what has tilted the odds in our favor."

Of course, if Meta had ceased spending on Reality Labs 12 months ago, operating income would be 26% higher. With the stock price down 56% from its Sept. 7, 2021 high, management seems to be paying more attention to the bottom line. On the April 27 earnings call, the company lowered guidance for 2022 operating expenses to $87 billion–$92 billion from a prior guesstimate of $90 billion–$95 billion and from the $71.2 billion spent last year. Meta is clearly trying to preserve its dented margins.

On the Thursday before the (now customary) four-day Fourth of July weekend, Reuters released excerpts from the recording that it had been slipped of Zuckerberg reciting the facts of bear-market life in an address to employees. "Realistically," the CEO said, "there are probably a bunch of people who shouldn't be working here.... Part of my hope by raising expectations and having more aggressive goals, and just kind of turning up the heat a little bit, is that I think some of you might decide that this place isn't for you, and that self-selection is OK with me."

Meanwhile, Meta is putting its substantial cash-flow generation to good use, at least from the owner's perspective. Thus, the front office repurchased $44.5 billion in stock last year and $9.5 billion in the first quarter (in the context of a $455 billion market cap).

It should be noted that last year's Apple upheaval touched every company that deals in online ads, not just Meta. It is likewise relevant that the largest social-media business on the planet has more resources than most to figure out how to improve ad targeting and measurement.

When Apple changed the advertising ecosystem, according to Eric Seufert, founder of online-advertising research boutique Mobile Dev Memo, on the May 19 *Stratechery* podcast, "Mark Zuckerberg by fiat threw 2,500 engineers at this problem. The ability to do that is unmatched. Who else could do that? The other thing is if you look at their opex, yeah, a lot of the opex spend is going to Reality Labs, but a lot of it is to go into the ad platform and beefing it up. They're spending a tremendous amount of money."

Online advertising existed before Apple's introduction of IDFA and will no doubt continue long after IDFA is gone. "I think it will lead to the advertising industry to look for alternative solutions," says Mathieu Roche, co-founder and CEO of ID5, of the thunderclap from Cupertino, Calif.

The bigger threat to Meta is that the Facebook and Instagram hordes find something else to do with their time besides stare at their phones. The decision to push Reels when the industry is working through the Apple-induced ad problems shows the "benefit of founder control," contends Ben Thompson, founder of tech research firm Stratechery. "Meta could have delayed its response to TikTok until [the advertising changes] worked its way through the system, but instead the company is fundamentally changing its products at the very moment its results are the most impacted by Apple's changes. The easier decision, particularly for a manager, would have been to wait a quarter or two, when the comps would have been easier, and the excuses clearer, but founders have the freedom to prioritize existential risks over financial ones."

This is not the first time that Meta has sacrificed short-term results for the sake of a better tomorrow. In the second quarter of 2018, management promoted Stories, user-generated photo or video collections, to thwart rival social network Snapchat. Notably, observes Michael Nathanson, one-half of the double-barreled research partnership MoffettNathanson, LLC, Stories initially garnered fewer ads than the news feed, just as Reels does today. It was a decision that "amounted to a 7% revenue headwind, which coincidentally is close to the 2022 revenue headwind we estimate that is not explained by Apple iOS changes."

To be sure, TikTok presents a more serious threat than Snapchat did, but

Meta Platforms, Inc. at a glance
all figures in $ millions except per share data

	TTM*	2021	2020	2019	2018
revenue	$119,666	$117,929	$85,965	$70,697	$55,838
operating income	43,899	46,753	32,671	23,986	24,913
net income	37,338	39,370	29,146	18,485	22,112
earnings per share	13.19	13.77	10.09	6.43	7.57
shares outstanding	2,742	2,859	2,888	2,876	2,921
cash	43,890	47,998	61,954	54,855	41,114
debt	0	0	0	0	0
operating leases	14,053	13,873	10,654	10,324	-
total assets	164,218	165,987	159,316	133,376	97,334

*12 months ended March 31, 2022.

source: company reports

controversy swirls around that digital pied piper. Thus, TikTok-disseminated political misinformation has corrupted elections from the Philippines to Colombia, a June 28 Bloomberg report alleges. And TikTok videos, playing on the anxieties of teenage girls, have exacerbated the many tribulations of adolescence, according to *The Wall Street Journal*. The paper registered dozens of accounts in the guise of 13-year-old girls, according to a Dec. 17, 2021 article. TikTok thereupon "served them tens of thousands of weight-loss videos within a few weeks of joining the platform. Some included tips about taking in less than 300 calories a day. . . . Other videos showed emaciated girls with protruding bones, a 'corpse bride diet.'"

"At its core," Brendan Carr, a commissioner at the Federal Communication Commission, charged the other day, citing a June 17 *BuzzFeed* article, "TikTok functions as a sophisticated surveillance tool that harvests extensive amounts of personal and sensitive data." He invited Apple and Alphabet to remove the ByteDance subsidiary from their respective app stores.

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Also in the vein of silver linings, the collapse in the prices of tech stocks (not excluding META's own) may address one of Zuckerberg's top operational headaches. Super-abundant venture-capital dollars and a heretofore bubblish Nasdaq created a seller's market in digital-engineering talent. Now adversity is turning the tables, and Meta, with its stable finances and strong cash flow, may appeal to the kind of bright employable engineer who has just received his walking papers from a shiny new Silicon Valley startup.

Certainly, the Meta balance sheet is a confidence-builder. The March 31 edition showed a cash balance of $43.9 billion, no debt and operating lease liabilities of $14.1 billion. It happens that that cash balance was 3.6 times the combined trailing revenues of competing social-media networks Pinterest, Inc., Twitter, Inc. and Snap.

Meta's unparalleled consumer reach is arguably an even more valuable asset than those plentiful dollar bills. A March 31 dispatch from *The Information* relays the story of Bill Price, co-founder of Seattle-based Billy Footwear. Owing to issues with measuring ad performance, Price's ads on Google appeared to perform better than his ads on Meta's networks. So he stopped advertising on Facebook.

"But it soon became clear that the move was hurting sales of Billy Footwear shoes through its retail partners, which include Nordstrom and Target and generate about 60% of the company's revenue," *The Information* reports. "Price said he realized that 'customers are window-shopping on Facebook and Instagram, learn about the brand, then go to Google' en route to making a purchase through his company's website or his retail partners' sites." So it was back to Facebook again.

"Meta's properties make up the backbone of the social-media experience for 3.6 billion individual users around the world and allow marketers to reach these potential customers with more efficiency and precision than has ever been possible," Shad Rowe, managing partner of Greenbrier Partners Capital Management, LLC, and an early and prescient enthusiast for the Zuckerberg enterprise, writes in his second-quarter letter to clients.

Correct, then and now. What's changed is the price, and therefore the odds. Your turn, value tribe.

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