

Facebook and Zuckerberg Face a “White Knuckle” Period Ahead with the Street Fearing the R Word (Regulation)

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Prior to last weekend the biggest worries for Facebook investors were trying to discern data points around the MAU growth trajectory in 1Q18 (March), advertising momentum into 2018, a bull/bear debate around the stock multiple, and better understanding video content initiatives for the coming year. This was all before the “Nightmare on Elm Street week” that Facebook and Zuckerberg encountered post the Cambridge Analytica debacle which has unleashed a 14% sell off in shares, regulatory chatter/noise coming from the Beltway and EU, Zuckerberg now likely testifying in front of Congress on the near-term horizon, the launch of an FTC investigation, and a #Delete Facebook user campaign which appears to be gaining steam worldwide. With a data leak of 50 million+ users potentially exposed in the Cambridge Analytica situation and growing worldwide criticism of Facebook’s handling of this situation, we would characterize this as a “defining period” for Facebook, Zuckerberg, and the Street’s ability to navigate through this hurricane-like storm with the company’s business model still well intact. While many will fret around near-term user growth/defections and advertising worries with the noise growing louder over the coming weeks, we ultimately believe Facebook can still manage this risk during this hand holding period, however this dark chapter has opened up a Pandora’s box of bad news that will clearly weigh on shares in the near-term. In a nutshell, 1) this is either a golden buying opportunity to own a unparalleled social media user base of 2 billion+ and advertising fortress of \$50 billion annually, ~30% top-line grower the next few years, with \$10+ of earnings power in 2020 and a fair value valuation range we believe is between \$210 to \$240 per share in a year OR 2) the Cambridge fiasco represents a seminal negative moment that will change the future business model and growth trajectory of Facebook with a modest/significant regulatory oversight on the horizon and therefore fair value is in the \$150-\$170 range. While this is a fluid situation and Zuckerberg & Co. will be heavily tested over the coming months as they navigate this PR minefield situation and we will also be keeping a close eye on user defections/engagement and advertising trends through consumer surveys in our GBH Tech Tracker during this crucial period, we ultimately believe Facebook will emerge from this crisis with minimal regulatory changes and limited financial damage to its user base and advertising kingdom as we remain bullish on the name

with a compelling risk/reward in shares at current levels. While the stock could be range bound as Facebook and Zuckerberg walk regulators, users, and advertisers through its data privacy/content procedures and making sure the Cambridge issue will never be repeated, we believe the stock will make the climb back to the \$180-\$200 range as the dust settles over the next few quarters with fundamentals remaining on track despite this representing the darkest chapter for Facebook and Zuckerberg in its 14-year history. **We maintain our Highly Attractive rating and \$225 price target.**

A closer look at the regulatory landscape Facebook will be facing. Facebook will be facing regulatory scrutiny from regulators and politicians both in the Beltway and EU as a result of this Cambridge debacle for the coming months and possibly over the next year. Zuckerberg and the rest of the Facebook team needs to convince regulators that breaches like this will never happen again and thus explain step by step how this Cambridge data leak transpired (e.g. expanding on the timeline in Zuckerberg's blog post), the level of responsibility Facebook has, and a remorseful tone in public hearings such as Congress with Zuckerberg front and center. Importantly Facebook will need to in a detailed fashion walk through its new data leak/privacy procedures along with outside audit and investigation firms helping the social media stalwart compile and analyze third party apps and data containment over the past few years to support its claims and strategic action plan going forward. While the drumbeat around users and regulators continue to show massive frustration and bewilderment how Cambridge could happen with the nature of its potential involvement in the Trump 2016 campaign adding fuel to the inferno, the biggest and most important question for investors is what type of regulation if any does this situation leads to down the road. We believe true regulation in any form for Facebook (and its social media brethren) would take years to work out and implement through the red tape and do not expect over the next 18 to 24 months any regulation that could significantly impact its business model from an advertising perspective. That said, we do believe self-regulation imposed by Facebook themselves and some form of quasi regulation both in the

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Beltway and EU could be on the horizon as Facebook possibly would be restricted in certain data able to be provided to third party apps and/or stricter data content and privacy procedures going forward. To this point, this May when the GDPR regulations hit in Europe, Facebook will have to comply with this stricter and heightened data privacy issues which was already on the docket for the company before the Cambridge situation happened. It would be a stretch in our opinion for true and tight regulation of the company's advertising model to manifest from this process post Cambridge given the complex nature of Facebook's model and advertising stronghold that would be a slippery slope for regulators, however this will remain a lingering risk around the name over the next year as Facebook works out with regulators new tighter procedures, advertising content transparency front and center, and policy changes it might need to adopt in light of this latest data issue and public backlash. While we estimate roughly \$5 billion of annual advertising revenues is "at risk" in a worst case/moderately heightened regulatory environment, this would still represent ~10% of overall revenues for 2018 and is not a game changing thesis changer to our bullish view of Facebook in our opinion. The FTC case we ultimately believe given previous cases will end with a fine in the tens of millions and is more noise than an impact to the company's operations over the coming years. In sum, the Cambridge issue is either a dark chapter that helps define new and improved changes to the Facebook platform and data content/privacy policies with minimal impact to its long term fundamental profile OR is a black eye that kicks off a rocky period which leads to significant regulation over the coming years for Facebook (and its tech peers including Alphabet and Twitter) and drastically impairs the advertising monetization engine going forward. To this point, we believe while this represents a scary and rollercoaster period for Facebook investors, this is a "manageable risk" with the onus on Zuckerberg & Co. to now carefully hand hold its stakeholders through these difficult coming months and emerge on the other side of this chapter with its core business model, massive installed base, and key monetization engine still fully intact.