

Facebook Inc Class A FB ★★★

Rating as of Jul 28, 2021



Morningstar's Analysis ⓘ

Summary

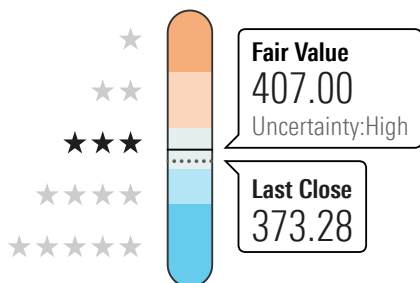
Competitors

Bulls Say/Bears Say

Valuation Jul 29, 2021

Currency in USD

FB is trading within a range we consider fairly valued.



1-Star Price
> 630.85

Economic Moat
Wide

Trend: Stable

5-Star Price

Facebook Posted Impressive Q2 results; 2H2021 Represents Tougher Comps; Increasing FVE to \$407

Ali Mogharabi

Senior Equity Analyst

Analyst Note | by Ali Mogharabi [Updated Jul 29, 2021](#)

We are increasing our fair value estimate of Facebook to \$407 from \$390. The firm reported better than expected second quarter top- and bottom-line results driven by user growth and growing monetization. Economic recovery continues to drive higher ad spending, a big chunk of which is allocated to Facebook and its properties. We are pleased with Facebook's continuing enhancement of its platforms as it improves e-commerce functionality, increases video content, and introduces more audio content, which support the firm's network effect moat source on the user and advertiser sides, increasing overall ad inventory. Facebook is also investing in innovation for

< 244.20

Capital Allocation
 Standard

the long-run, including Metaverse, which we view as the next stage of growth and development in virtual reality. While Metaverse is likely to require more interoperability between many platforms and may slowly erode Facebook's walled garden, the firm's current network effect moat source should maintain more users on the Facebook

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Management guided for significant deceleration in the second half of this year, which we had slightly increased our projections given the uncertainty. While the stock is down in after-hours trading, we think it is fairly valued, in our view.

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Total revenue of \$29.1 billion was up 55.6% from last year, driven by higher prices and an increase in users. Facebook benefited from ongoing strong demand for direct response and the resurgence of brand advertising. Monthly active users increased 7% and 2% year over year and from last quarter, respectively, to nearly 2.9 billion. Engagement remained at around 66% as daily active users increased to 1.9 billion (also up 7% from last year and 2% sequentially). Given last year's tougher comp, ad inventory inched up only 6%, but strong demand from advertisers drove prices 47% higher from last year.

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Business Strategy and Outlook | by Ali Mogharabi [Updated Oct 22, 2020](#)

Facebook is the largest social network in the world, with 2.5 billion monthly active users. The growth in users and user engagement, along with the valuable data that they generate, makes Facebook attractive to advertisers in the short and long term. The combination of these valuable assets and expected continuing growth in online advertising bodes well for Facebook, as the firm generates strong top-line growth and remains cash flow positive and profitable. Facebook has increased users and user engagement by providing additional features and apps to keep them engaged within the Facebook ecosystem. With more Facebook user interaction among friends and family members, sharing of videos and pictures, and the continuing expansion of the social graph, we believe the firm compiles more data, which Facebook and its advertising clients then use to launch online advertising campaigns targeting specific users. While utilization of the data is under scrutiny in different markets, we think Facebook's large audience size will still attract the ad dollars. Growth in Facebook's average ad revenue per user indicates advertisers' willingness to pay more for Facebook-placed ads, as they expect high return on investment from the targeted ads.

29/7/2021	Facebook Inc Class A (FB) Quote Morningstar
<p>We believe Facebook will continue to benefit from an increased allocation of marketing and advertising dollars toward online advertising, more specifically social network and video ads where Facebook is especially well positioned. The firm’s Facebook app, along with Instagram, Messenger, and WhatsApp, is among the world’s most widely used app on smartphones. Facebook is taking steps to further enhance its products, which may increase Facebook user engagement, helping to further generate attractive revenue in the future.</p>	Analyst Note
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Economic Moat | by Ali Mogharabi [Updated](#)

We assign Facebook a wide moat rating based on network effects around its massive user base and intangible assets consisting of a vast collection of data that users have shared on its various sites and apps. Given its ability to profitably monetize its network via advertising, we think Facebook will more likely than not generate excess returns on capital over the next 20 years.

Now that Facebook has emerged as the clear-cut social media leader, we believe that its offerings, consisting mainly of Facebook, Instagram, Messenger, and WhatsApp, have strengthened network effects for the firm, where all of these platforms become more valuable to its users as people both join the networks and use these services. These network effects serve to both create barriers to success for new social network upstarts (as demonstrated by the firm’s success against Snap), as well as barriers to exit for existing users who might leave behind friends, contacts, pictures, memories, and more by departing to alternative platforms.

Launched in February 2004, Facebook initially targeted college students and expanded via emails and word of mouth. With more requirements in order to register on the site, we think that most users felt safer to engage with other users from their schools and from other schools, than they did on other early social network websites like MySpace. In addition, the flexibility of choosing which other users would have access to one's profile attracted more users and increased user engagement, which resulted in users spending more time on Facebook and, in turn, an early establishment of a network effect. At the end of 2019, Facebook had nearly 2.5 billion monthly active users.

Today, we see that Facebook, Instagram, Messenger, and the different features and apps surrounding them have increased user engagement on various devices. Facebook also is slowly becoming an entertainment hub,

which helps increase engagement and user time spent on Facebook. The users are posting more videos and providing a live video feed from where they are at a certain point in time. Additional apps created by developers on the Facebook platform also help maintain users within the Facebook ecosystem. According to eMarketer, on average, users spend 65 minutes per day on Instagram (a combined 65 minutes per day on Instagram and Facebook) posting videos, sending messages, making comments, uploading content, and more. This demonstrates the strength of its network effect for the firm. It is very likely that time spent on those platforms have increased and will continue to possibly further strengthening Facebook's

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Outside of network effects, Facebook has developed additional intangible assets. Unlike any other online platform in the world, Facebook has accumulated data about everyone with a Facebook and/or an Instagram account. Facebook has its users' demographic information. It knows what and who they like and dislike. It knows what topics and/or news events are of interest to them. In addition, without the need for cookies enabled on desktop or mobile browsers, and based on the Facebook Login, the firm knows its users' browsing history on many non-Facebook sites or apps. With access to such data and to billions of photos and videos uploaded by its users, Facebook continues to enhance the social network by offering even more relevant content to its users. This virtuous cycle further increases the value of its data asset, which only Facebook and its advertising partners can monetize.

We think Facebook is well positioned to come out of the coronavirus pandemic with a stronger network effect moat source. In our view, as more individuals remain at home due to lockdowns and quarantines, they will spend more time on Facebook and Instagram not only engaging with other users, but also seeking additional information regarding many COVID-19-relevant topics. Over time, users are likely to become further dependent on and spend more time using Facebook and Instagram, which will continue to attract advertisers, resulting in a stronger network effect.

In our opinion, with this type of information about each one of its 2.5 billion monthly active users, Facebook provides unique and attractive advertising opportunities for advertisers and businesses, which will allow the firm to generate excess returns on capital over time. Facebook monetizes such information only by using it to increase the effectiveness of its advertisers' ads. The company does not sell the data to ad-tech companies or other third parties. The value of such data and advertisers' willingness to use it is

demonstrated by the 26% average annual growth of Facebook's average ad revenue per user during the past five years, which we view as indicative of the price that advertisers pay Facebook for ad placement. During the same period, Facebook's monthly average users have grown 12% annually.

Facebook's large and growing user base at Analyst Note
 help advertisers post more effective target Business Strategy and Outlook
 resulting in high return on investment. Wit Economic Moat
 jump on board, allowing Facebook to furth Fair Value and Profit Drivers

Antitrust enforcement and further regulati Risk and Uncertainty
 intangible assets, data. However, increase Capital Allocation
 usage would apply to all firms, not just Fac Close Full Analysis
 and the continuous consumer engagement are likely to continue to drive
 demand for Facebook ad inventories, although possibly at lower prices.

Facebook has also expanded its user base in the growing mobile market, which positively affected the network effect as it became more valuable to advertisers, and resulted in more ad revenue growth. The main driver behind growth in online advertising has been growth in the mobile ad market and the video ad format. Most Facebook users are now accessing Facebook and its apps via mobile devices.

While smartphone users in the U.S. spend more time on social networking applications, and more time on Facebook than any other social networking application, users around the world spend more time on messaging apps such as Facebook's WhatsApp. The firm has not monetized WhatsApp, as its attempt with bots was not welcomed by WhatsApp users. Facebook is now offering WhatsApp to businesses (WhatsApp Business), which can use the platform to not only highlight various products and services but also as a customer support platform.

Other features, such as sending money and receiving money, have already been added to Facebook's Messenger. By working with advertisers, Facebook is also adding a similar click-and-buy feature to photo and video ads, especially on Instagram, where viewers can click on a product they like within the video and get more information about it or purchase it. In the long run, we believe these strategies can further strengthen Facebook's network effect, driven by growth in user base (although at a slower rate) and user time spent on the platform, and businesses having more options on how to market their brands and products.

While not a primary source of moat, we also think that Facebook benefits from modest customer switching costs. Although it is easy for customers to

sign up and use alternative platforms like Snapchat, departing Facebook and its owned platforms may cause some friction for users. Facebook users today would lose data, such as posts, pictures, video clips, and contact information, their nearly one hour per day interaction with other users, and much more. Even though many users access more than does not appear to be at the cost of declining within the Facebook ecosystem.

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Fair Value and Profit Drivers | by Ali Moghara

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Our fair value estimate is \$407 per share, r

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value/adjusted EBITDA multiple of 14 time

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annual growth over the next five years. As

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research and development and content creation and virtual reality and

augmented reality offerings, in addition to data security, we see average

operating margin remaining around 39%, comparable with the previous three years.

Facebook's revenue growth will be driven primarily by growth in online advertising and increasing allocation of online ad dollars toward mobile, video, and social network ads. We expect a 40% increase in 2021 followed by 17% growth in 2022, assuming a global economic rebound. We expect a 7% five-year CAGR in Facebook's monthly active users, mainly due to strong growth in Asia and other regions. We also assume deceleration in overall advertising ARPU growth to 15% per year over the next five years, from the average annual 22% growth the firm displayed over the past five years.

We look for higher growth in operating expenses in 2021 as the economic recovery will allow the firm to more aggressively increase its R&D. We have assumed a 40% operating margin for 2021, higher than 38% in 2020. A portion of those investments is in content and data monitoring, which requires a higher headcount. In addition, given the pressure the firm faces from users and lawmakers, legal fees could continue to affect margins. The operating margin is likely to expand in 2024 and 2025 to nearly 40%, as lower growth in operating expenses (driven by more automation of content, data, and user monitoring), coupled with revenue growth, will create operating leverage. Our five-year average operating margin of 39.5% will be above the 39% the firm averaged the last three years. Our fair value uncertainty rating for Facebook is high, based on uncertainty over future advertising growth rates and additional regulations restricting Facebook's access to and use of data, both of which drive growth in the firm's source of revenue.

Risk and Uncertainty | by Ali Mogharabi [Updated Oct 22, 2020](#)

We believe that while barriers to exit for the 2.5 billion users may be increasing, the risk of another disruptive and innovative technology, more recently TikTok, coming onto the scene and luring users away from Facebook and its apps remains. We do not expect competition in the form of a substitute for Facebook, as most consumer network. However, given the fixed number usage and engagement on one social network social networks, reducing user engagement investment for advertisers. Decline in ads bottom line, reducing return on invested capital. Furthermore, even with Facebook's dominant market, its high dependence on continuing to heighten the negative impact of a lengthy the company, resulting in a much lower fair value estimate.

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The risk remains that limitations could be imposed by regulatory agencies around the world on what user and usage data Facebook can compile and how the data can be utilized. In addition, some governments may simply forbid access to Facebook, which could result in lower user growth and user interaction. Similar to Alphabet, Facebook also faces limitations on the M&A front as the U.S. and other countries attempt to lessen the firm's dominance in advertising and the overall Internet market.

Capital Allocation | by Ali Mogharabi [Updated Apr 29, 2021](#)

We assign a Standard stewardship rating to Facebook's management, although the firm initially had some difficulties addressing data privacy and security issues, such as the Cambridge Analytica scandal in early 2018. Our assessment was conducted using our prior Stewardship methodology. We will be transitioning our assessment mechanism for the company, and the balance of our stock coverage, to the Capital Allocation methodology by the end of September 2021. Through different acquisitions, such as WhatsApp and Instagram, the management team--more specifically, founder and current CEO Mark Zuckerberg--has demonstrated its focus on long-term return on investments, which we view as positive. With its large amount of cash and cash equivalents, along with no debt, Facebook is well positioned to make additional investments in the form of acquisitions or more research and development. We expect the firm to continue to make decisions regarding capital allocation that are beneficial for its social network users and its shareholders. We also applaud management's walled garden strategy as it continues to protect the firm's most valuable asset, its user and usage data. However, the U.S. and other governments around the world may also impose restrictions on Facebook's acquisitions and/or data utilization. Management

has responded well as it continues to increase its influence in Washington, D.C.

COO Sheryl Sandberg joined Facebook in 2008. Before that, she was Google's vice president of global online sales and operations.

Analyst Note

Our main knock on Facebook's management is its centralized structures that may limit the voice of minority shareholders. This is more of an issue given how Facebook is advertising-driven, which has led to some shareholders wanting more transparency of the company. Some continue to believe that Facebook may result in significant conflict of interest over its strategies and whether they generate excess cash flow as they have in the past.

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Company Profile

Business Description

Facebook is the world's largest online social network, with 2.5 billion monthly active users. Users engage with each other in different ways, exchanging messages and sharing news events, photos, and videos. On the video side, the firm is in the process of building a library of premium content and monetizing it via ads or subscription revenue. Facebook refers to this as Facebook Watch. The firm's ecosystem consists mainly of the Facebook app, Instagram, Messenger, WhatsApp, and many features surrounding these products. Users can access Facebook on mobile devices and desktops. Advertising revenue represents more than 90% of the firm's total revenue, with 50% coming from the U.S. and Canada and 25% from Europe. With gross margins above 80%, Facebook operates at a 30%-plus margin.

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