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Facebook: Speculation or Investment?

"I like this place and willingly could waste my time in it."
- William Shakespeare, As You Like It

The Social Network

Facebook is a company that we've been watching for some years now. The first few months following their IPO in May 2012 were tumultuous as share prices fell more than 50%, but since then the stock has soared in value, recently breaking $100 a share. The question has always been, how do we value this company? Is it a meaningless way to waste time, a fad destined to follow its predecessors Myspace and Xanga into oblivion, or is it a revolutionary social platform? With Facebook now generating revenue and its share price rising to over 100 times earnings, questions regarding valuation seem more important than ever. Is Facebook a speculative investment or is it destined to be one of the most important companies in the world? In exploring this question, we hope to share with you the kinds of thinking we employ when trying to rationally understand and evaluate companies.

One of the most common concepts thrown around regarding Facebook is the idea of the network effect. The network effect describes a situation where each additional user of a service increases the value of the service for all users. In its early days Facebook competed with other college social websites by encircling them. Facebook would aggressively spread to surrounding college campuses and draw away the user base of competing websites in short order. That was an example of the power of the network

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effect—the more of my friends are on Facebook, the more value I derive from being on Facebook. Today, the enormous network effects enjoyed by Facebook provide considerable economic moat, just ask the folks at Google+.

So, the network effect begins to get to an important conclusion: Facebook, due simply to the immense size of its network, is likely here to stay. But despite the amount of attention dedicated to the network effect in media coverage of Facebook, the story doesn't end with this concept. After all, just as growing networks can explode in value, shrinking networks can quickly disappear—the disappearance of Myspace, a social networking site once valued at over $12 billion, happened practically overnight. Moreover, all communications services benefit from and suffer through network effects, so this effect by itself does little to differentiate Facebook. We need a broader theory to color in the implications of the network effect for flesh and blood human beings, then we can get to the heart of the economic importance of Facebook.

The important fact about Facebook is that it's not a network of standardized information sharing electrical nodes—it's a social network, populated by friends from college, family members, students, wanderers, politicians, astronauts, rabbis, musicians, stick-up men, comedians, and—well, to put it succinctly—people. People, given their varying interests and legacies, like to exchange. To take a simple example: Adam likes apples and Karl likes pears, Adam has more pears and Karl has more apples, so Adam gives some of his pears to Karl in exchange for some of Karl's apples. The beauty of this process is that both parties are made better off through it—in other words, insofar as it is not zero-sum, exchange creates *pure value*, or economic surplus. We believe that the true importance of Facebook has to do with its place as a platform for surplus generating exchange.

What's a "like" worth?

Increasingly, individuals and companies are becoming more aware of the opportunities for exchange through Facebook. Liking a musician's Facebook page, for example, might grant you access to privileged content. Brands as diverse as Sephora, L.L. Bean, Nutella,

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Zappos, Starbucks, and Burt's Bees use their Facebook pages to distribute special promotions, hold lotteries, relay stories and information, and share recipes and beauty tips. These are all exchanges—"likes" are traded for specific content. In this way, "Likes" and "shares" have become powerful currencies in Facebook's internal economy—they represent the value of the consumer's engagement with a brand. This is something that companies crave, and because of Facebook, they can initiate a world of smaller exchanges with prospective customers towards establishing stable relationships. Each of these trades makes both parties better off and generates economic surplus without a dollar (but with many "likes") changing hands. We at Northstar can't think of any other companies that have their own internal value generating economy like Facebook's.

What is all of this worth? We think it's certainly worth a lot to both consumers and companies, but just how much remains to be seen. From a bird's eye view, this process of continual exchange and feedback through Facebook allows companies to better tailor and customize products to consumers' wants—companies thus can make better products and sell more. So, in aggregate, this process can promote value creation and economic efficiency insofar as it can make consumers and producers better off by allowing for the development of better products. While it's still unclear how much of this will be translated into revenues, we think this gives a strong reason to believe that Facebook will be around for years to come—its continued existence is in the interest of both consumers and producers, and its internal economy offers continual benefits that keep users engaged. Facebook, in other words, is providing a service that is investment worthy over the long-term.

More specific questions regarding time-frame of revenue growth remain important to answer, but maybe from the above we can begin to see why so many companies are devoting more and more of their marketing budget to Facebook. In other words, these aren't just theoretical musings—real companies are using Facebook in exactly the ways described above. In addition to the possibilities of exchange offered through Facebook, the company's use of network analytics for optimal ad placements is potentially another major draw for ad money. Facebook's long-term goal in this regard is to take over the internet.

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Whereas in the old "informational web" of Google we would navigate the internet—maybe through our Google Chrome browser—using Google searches, in the new "social web," Facebook intends to serve as the main interface between us and the internet. Already, more and more websites provide "like" buttons on their external web pages and more and more services allow us to sign in through our Facebook account—this all points towards Facebook's envisioned social web: a future when our Facebook profiles will provide us with a unified internet representation of ourselves. As more and more of our internet activity is moderated through Facebook, the company gains more information into our behaviors, interests, and interpersonal connections, allowing it to optimize how it presents advertising. Importantly, once an ad is placed through Facebook, unlike in Google, the effect of the ad is magnified as it is shared by users and spread, as it were, through a kind of word of mouth. As far as advertising is concerned, this is the true power of the network; needless to say, all of this represents an important source of direct revenue for Facebook.

Rational Investing in the Information Age

We have suggested that the potential surpluses to be generated by Facebook's social web are considerable—also, these aren't always adequately accounted for in conventional valuations of the company. Uncertainty over valuation could be a continuing source of volatility in the share price. But if Facebook succeeds in its grand plan of creating a new social web, the value of the company and its share price should only increase over the medium to long term. However, in order to achieve this, Facebook may need to prioritize structural investments and long-term strategic moves over short-term revenue. This, along with generalized stock market corrections and business cycle swings could create many attractive buying opportunities in the short to medium term. As always, our primary commitment is to the financial dignity of our clients and their individual needs and goals. With that in mind, we continue to watch this important company and look for ways to rationally invest in it.

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We at Northstar hold dear a simple but key insight popularized by the great investors Benjamin Graham and Warren Buffett: "Shares are not mere pieces of paper. They represent part ownership of a business." This drives home the fact that we're investing in real companies that provide valuable services to flesh and blood human beings—we at Northstar have taken this mantra to heart both during times of volatility as well as exuberance in the stock market. As exemplified by the above, this is the starting point of much of our stock analysis. While we don't strive for outperformance or claim to generate outsized returns, we have found that many of our best investments have resulted from carefully considering brands, core business, and other tangible, value generating behaviors of corporations.

While hard data and information remain crucially important to this process, often times identifying value in companies involves developing new ways of assimilating and understanding data, rather than simply generating more data. In other words, novel interpretive frameworks—new ways of thinking about what businesses do and how they generate value—can, over the long term, often be more important than adding another column of predigested financial information to the spreadsheet. We try to engage in this exercise with companies as diverse as Whole Foods and Union Pacific. The above is an example of some of our attempts to think creatively about Facebook.