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# FACEBOOK

On July 27, 2018, Facebook experienced what then was the worst crash in history for a publicly traded company. Over \$120 billion in market value vanished when the quarterly results fell short of expectations and the CFO disclosed the adverse financial effects of changes occurring in the business, such as the massive investments in digital security. In summary: revenue growth would slow and margins would fall. The stock price would go on to decline 42% in less than 6 months.

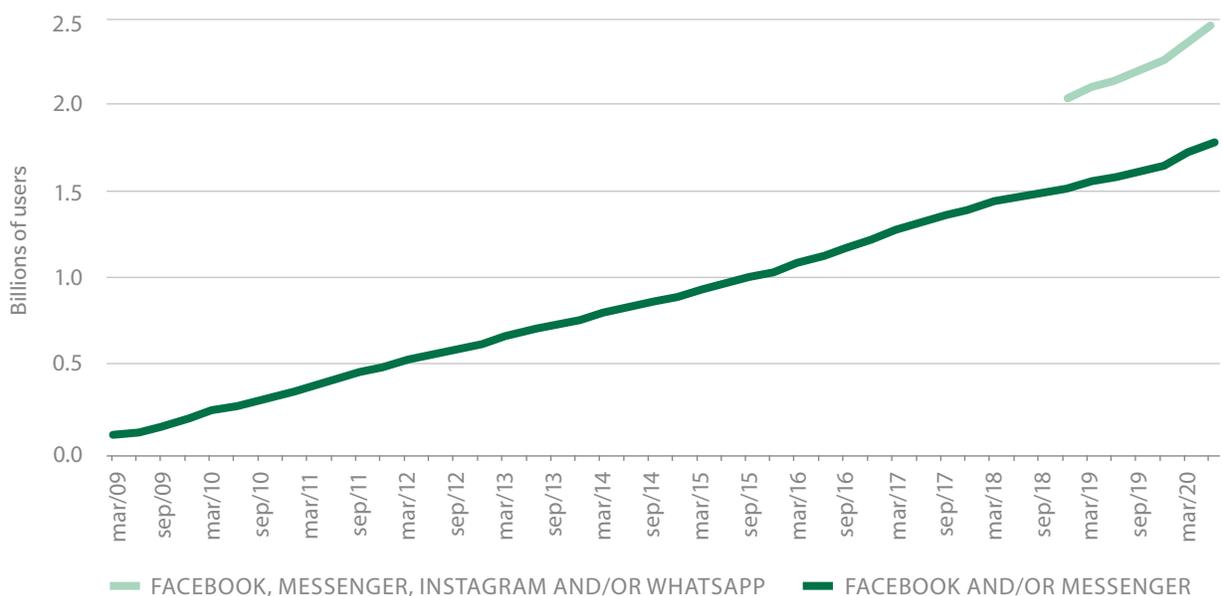
The company's downturn in the market followed the onslaught of criticism it received from the world's major media outlets. Recurring scandals questioned the ethics of executives and accused the platform of several shortcomings in the new era of ubiquitous connectivity.

The collapse motivated us to further our knowledge of the business and evaluate whether an opportunity was emerging to increase a small position held by the funds. We eventually concluded that to be the case. Our investment was acquired in two key stages: during the 2018 collapse and in the recent decline caused by the coronavirus crisis. Today, Facebook is one of the two largest positions in all our funds.

Below, we highlight some aspects of our investment. Although Facebook is a complex and controversial topic, we will spare the readers an exhaustive analysis of all polemics surrounding the company. We will go over the key points of our investment case, divided into four themes: the business, the owner, the crisis and the future.

## THE BUSINESS

FACEBOOK DAILY ACTIVE USERS



Facebook owns four of the five most used applications in the world outside of China: Facebook, Messenger, Instagram and WhatsApp.<sup>1</sup> By the end of June 2020, 2.5 billion people were using at least one of these services every day. This is equivalent to more than twice the number of people who watched the last FIFA World Cup final<sup>2</sup>. While the final happens once every four years, Facebook achieves this every single day.

What attracts such a crowd? The possibility to interact, in several ways, with other people. Facebook's applications are able to capture and channel deep desires inherent to humans: chatting, snooping, and projecting status.

The more people use its applications, the more desirable they become to others, in what is possibly the most powerful collection of network effects ever seen.

Its main application, nicknamed Blue app, has motivated users to declare their real identities, connect with their offline contacts and voluntarily detail profiles with their preferences on a variety of themes. In both the Blue app and in Instagram, algorithms detect each user's reaction to what they see and gradually build robust insights into what they like best.

Not by chance, almost all its revenue comes from advertising: \$73.9 billion in the last 12 months, from 9 million different advertisers. Along with Google,

Facebook is championing an incredible process of inclusion of small businesses to the world of advertising. By segmenting their target audience to the exact cut they're looking for – or allowing Facebook's artificial intelligence system to do the job automatically – campaigns come at a cost that fits in every advertiser's budget.

Since the content is generated by the users themselves, net margins are very high: 31.8% in the last 12 months. From 2011, the year before its IPO, to the end of 2018, Facebook grew from \$1 billion to \$22 billion in annual profit.

## THE OWNER

*"This is kind of a formality, just a quick board meeting, it shouldn't take more than 10 minutes.*

*We're obviously not going to sell here."*

– Mark Zuckerberg

*"Ultimately, I think the reason that we built this successful thing is because we just solve problem after problem after problem, and typically you don't do that by making impulsive, emotional decisions."*

– Mark Zuckerberg

When Mark Zuckerberg was 22 years old, he refused a \$1 billion offer for his company. At the time, Facebook had 9 million users and \$20 million in revenue. It had only been two years since the app first appeared at Harvard.

<sup>1</sup> The fifth is YouTube.

<sup>2</sup> <https://www.fifa.com/worldcup/news/more-than-half-the-world-watched-record-breaking-2018-world-cup>

# FACEBOOK

Peter Thiel and Jim Breyer, two of Mark's closest investors and advisors, reminded him that he would receive \$250 million from the offer. Zuckerberg replied he would simply use the money to start a new social network and that he *"liked the one he had"*.

Andy Grove, the legendary former CEO of Intel, once asked him why he had refused the offer. *"I just thought we could do it,"* answered Zuckerberg. Where did such determination come from? *"Jewish mother,"* he replied.<sup>3</sup>

Zuckerberg currently holds 11.6% of Facebook's capital but controls the company through supervoting shares. It is fundamental for any shareholder to understand how he thinks, especially considering the number of controversies in which the company is involved. Our diagnosis, derived from discussions with former executives, can be summarized as follows.

Mark Zuckerberg is, first of all, a brilliant engineer. He can identify problems and apply his singular intelligence to solve them. He believes in technology's ability to advance the world, makes decisions based on the balance of probabilities and risks, and is somewhat reticent to change his mind.

Zuckerberg's stubborn nature is the result not only of his personality, but also of his experience. Since his first step to expand the business beyond Harvard, to Yale University, he found that most new features were met with considerable user resistance. When he launched

the News Feed, which has been Facebook's central hub for years, users organized protests in front of headquarters, furious at the exposure of their profiles. Over time, however, most realized that Zuckerberg's approach had its merits, and adapted. This dynamic was so frequent throughout the company's history that it taught him to trust his judgments despite the initial, and often loud, complaints.

Zuckerberg is notorious for his ability to learn. Sheryl Sandberg, second in command, describes how terrifying it is to work with someone who is younger and gets better every day so quickly. Marc Andreessen, a Facebook board member and co-founder of Netscape and Andreessen Horowitz, also highlighted that important trait in Mark's leadership style. Zuckerberg comes from a generation of entrepreneurs who realized that, in the Internet era, the optimal strategy was not to refine every detail of your service before launching it to the public, but to continuously launch imperfect services and, by attentively observing user behavior, course correct on-the-go. Perfectionism would cost far too precious time. This mentality underpins Facebook's famous motto *"move fast and break things"*. Zuckerberg made his company a testing and learning machine, with a robust technological infrastructure that allowed its engineers to easily experiment. Thousands of these experiments are tested daily on small user samples, noting their reaction in usage metrics and questionnaires.

<sup>3</sup> This conversation is from the book *"Becoming Facebook"*, by Mike Hoefflinger. In another book, *"Facebook: The Inside Story"* by Stephen Levy, there is another quote by Zuckerberg about his mother: *"Good Jewish mother... You know, go home; get 99 percent on the test, Why didn't you get 100?"*

Within the company, he is deeply admired despite the controversies. In the past, he has been so efficient in attracting talent that Google was forced to promote a generalized salary increase to control an unforeseen exodus of engineers. Perhaps inspired by Google, Zuckerberg created a habit of connecting the entire company for a weekly conversation where he makes himself available to answer the toughest questions employees might have.

In 2011, Google tried to put Facebook's dominance and Zuckerberg's leadership skills to the test. It challenged the company with its own social network, Google+. At the time, Google's annual profits were equivalent to four times Facebook's revenues. Despite a huge investment, the dedication of a large team led by veteran Vic Gundotra and the unprecedented banner included in Google's home page, Google+ did not succeed in supplanting Facebook. One year after its launch, Facebook added 200 million monthly users to reach a total of 900 million, far eclipsing Google+ and its 150 million users. In 2019, the service was finally discontinued.

Former executives emphasize Zuckerberg's long-term vision and strong sense of mission. He wants to build a service that makes the world more open and connected. His goal is to make it last for generations and he is obsessive about the difficulties involved. As a reminder, he purposefully kept the obsolete Sun Microsystems'

logo on the back of Facebook's sign when they moved into their old office.

His diligence with threats and attention to opportunities led to the acquisition of Instagram for \$1 billion, essentially over a weekend on the eve of Facebook's IPO – a period in which most companies are dedicated to making sure nothing goes wrong with their offer. Instagram had 13 employees, 30 million users and no revenue. On the day of the announcement, CNN commented that Facebook was “paying a high price for a startup that has a lot of buzz, but no business model”.<sup>4</sup> Today, Instagram is valued at hundreds of billions of dollars and is a fundamental part of Facebook's success.

To achieve this, Zuckerberg gave Instagram's founders the freedom and tools to develop the company – just as he did with WhatsApp two years later. Monetization efforts only came later, when the services had reached unquestionable critical mass. These revealed a new weapon in Zuckerberg's arsenal: his talent as an M&A strategist.

Both current and former executives defend Zuckerberg's ethics, but highlight two aspects of his personality that help explain the recent difficulties: idealism and immaturity. Zuckerberg has long believed that connecting people was an inherently positive act. Yes, there would be problems, but if you gave the community the right tools, these would be corrected

<sup>4</sup> [https://money.cnn.com/2012/04/09/technology/facebook\\_acquires\\_instagram/index.htm](https://money.cnn.com/2012/04/09/technology/facebook_acquires_instagram/index.htm)

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over time in a collective learning process. It took him a long time to accept that his services had become the preferred stage for harmful actors that he had the obligation to deter.

## THE CRISIS

*“Your fundamental problem is that people think you’re too powerful and you don’t care.”*

– Nicholas Clegg, in conversation with Zuckerberg, before being hired as VP of Global Affairs and Communications.

The Trump election in 2016 generated a revolt in the media and in Silicon Valley. The search for culprits found a reliable target in Facebook. Trump was extremely active on the platform during the campaign. He benefited from tools that were equally available to both candidates, whereas Clinton’s team was more restrained. Trump’s staff set up a group dedicated to the platform and invested much more aggressively than Hillary in digital ads. He was able to use Facebook’s powerful ad tools to test hundreds of variations of each ad campaign and direct them to the most appropriate audiences. Obama’s digitally-driven success in 2008 and 2012 was a big lesson for Trump. However, unlike the Democrat, Trump’s achievements were riddled with controversies.

Evidence soon surfaced to suggest that Russian agents had acted on Facebook to support Trump’s presidential efforts. In 2018, it was reported that the

Trump campaign hired the service of a company named Cambridge Analytica. Through Facebook, it had gathered data from tens of millions of users – against the company’s policies – and used the platform’s advertising tools to manipulate voters in swing states with carefully focused messages.

While it is questionable whether the Russians or Cambridge Analytica had a decisive<sup>5</sup> impact on the elections, the scandals exposed deep weaknesses in Facebook’s security policies. From a celebrated web phenomenon, the company’s name became commonly associated with terms like filter bubbles, fake news and hate speech. Its aggressive growth tactics were dissected and blamed for the addiction of its users, which were being manipulated by dark patterns designed by the company and several malicious advertisements. People would be giving up their privacy, gathering into increasingly strident groups, isolating themselves from opposing ideas and, in the process, ruining democracies.

Aggressiveness in execution had left a series of skeletons in Facebook’s closet, which now cost the company dearly. The consequences came in three fields: privacy, content security and antitrust.

## Privacy

In many of the world’s countries, there was no internet privacy law – until recently. There was only the

<sup>5</sup> <https://www.washingtonpost.com/news/monkey-cage/wp/2018/03/23/four-and-a-half-reasons-not-to-worry-that-cambridge-analytica-skewed-the-2016-election/> and <https://www.nytimes.com/2017/03/06/us/politics/cambridge-analytica.html>

obligation to warn users what would be done with their data – usually hidden in the Terms and Conditions nobody really reads.

Facebook made it clear that it used the stated preferences and behavior of users – inside and outside its applications – to select the content and ads most pertinent to them. The issue was that the company, in the past, broke the terms that determined to whom the data was disclosed to. It was warned and forced to adjust its conduct by the FTC<sup>6</sup> as early as 2012.<sup>7</sup>

The main problem began with an initiative, launched in 2010, to bring in external developers to produce applications that utilize user information. It was a bet to amplify the platform's network effects, gathering data from third parties that could enhance both Facebook's knowledge about its users and its usefulness to them. Crucially, the program allowed users to share not only their own data but also that of their friends – who were obviously unaware. When the 2016 elections transpired the program had already been disabled, but the crisis powered on. The data Cambridge Analytica leveraged was collected during 2013 by a university researcher. Only 270,000 users had agreed to participate in the study, but it ended up gathering information from 87 million people.

In 2019, as part of the government's response to the scandal, Facebook agreed to pay a \$5 billion penalty

in a new deal with the FTC. One provision determined that, from then on, Zuckerberg would have to personally certify that privacy practices were followed – making him personally liable if new blunders were to occur.

The internet privacy discussion is maturing fast throughout the world. Several countries are drafting their own data laws, and Facebook has adapted without major problems. We believe most internet users prefer their ads to be relevant and accept some monitoring to make this possible. For a generation that has grown up sharing their lives on social media, the concept of privacy is less restrictive than for previous generations. A balance should come from new regulations and targeting restrictions from browsers and operating systems, such as Chrome, iOS and Android. Through them, those uncomfortable with monitoring will have more explicit ways to avoid it.

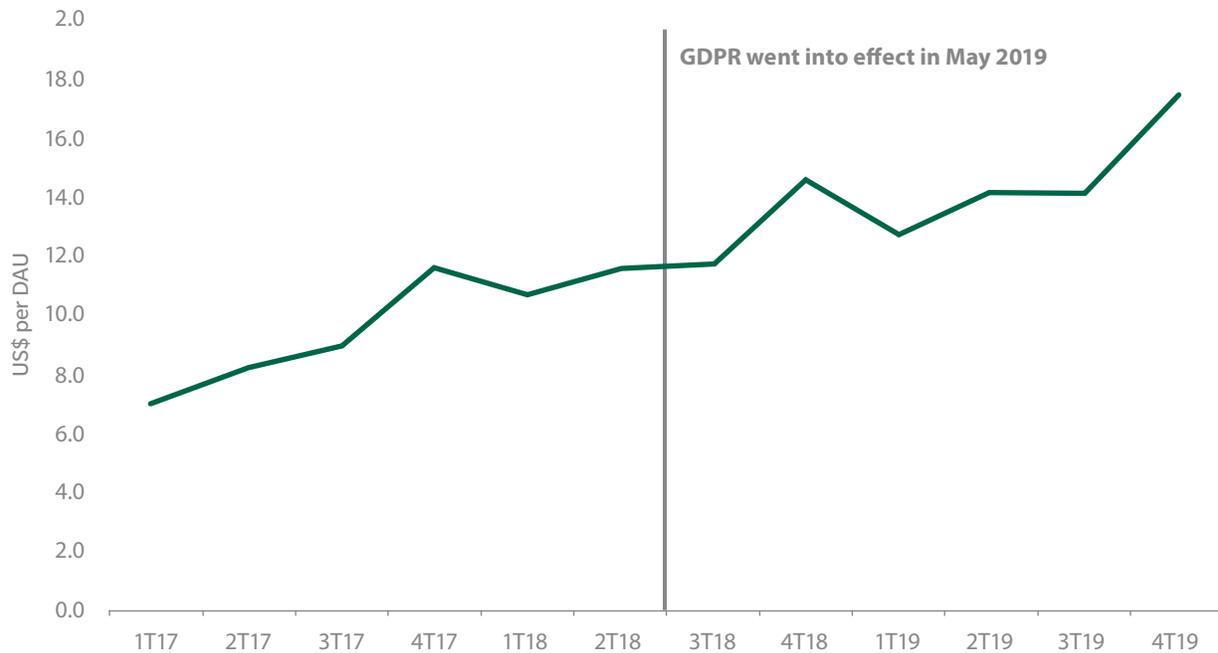
In May 2018, for example, Europe published its General Data Protection Regulation (GDPR). Among other measures, it forces companies to obtain explicit user approval for data collection. That virtually eliminated a chain of data-gathering players<sup>8</sup> that silently acted on the European internet and further concentrated the market in major companies such as Google and Facebook. The graph below shows how the new regulation caused no visible negative impact to the company's revenue growth per user in Europe.

<sup>6</sup> Federal Trade Commission: American agency responsible for antitrust and consumer protection.

<sup>7</sup> <https://www.ftc.gov/news-events/press-releases/2011/11/facebook-settles-ftc-charges-it-deceived-consumers-failing-keep>

<sup>8</sup> Internet privacy issues are far from being limited to Facebook. The digital advertising industry is full of players – invisible to users – who have evolved their practices in a competitive and opaque context. Every time we open a web page, a huge number of small programs run silently to collect and transmit data in order to allow the most relevant ad to be selected. In the world of digital advertising, especially that of images and videos (display), knowledge about the characteristics of the user behind the screen is incredibly valuable – it is, after all, the key to finding the most effective ad. The result is that, in the open web, users have much less control over what happens to their data than on Facebook or Google.

## REVENUE PER DAILY ACTIVE USER IN EUROPE



Given the volume of data Facebook captures in its own applications and direct relationship with users, we believe it is well positioned to continue to accurately target its ads. The targeting advantage that Facebook and Google enjoy over smaller players tends to strengthen as new restrictions arise. The recent agreement with the FTC has ended an important chapter of the company's recent crisis. We believe Zuckerberg and Facebook, at the very least out of self-interest, have learned their lesson.

### Content Security

Facebook's security problem is more complex. A tragic example of this challenge was the Christchurch

massacre, in March 2019, when a 28-year-old man carried out a mass shooting inside a mosque in New Zealand while live-streaming it on his Facebook page. He killed 51 people and injured 40. The video was available on the shooter's account for a few hours before Facebook removed it from the app. Over the next 24 hours, the company removed roughly 1.5 million new posts from the video by other users, many of whom edited the video in an attempt to overcome Facebook's censorship. The experience, well documented in a New Yorker article<sup>9</sup>, conveys some of the complexities of managing the safety of content created by billions of people.

<sup>9</sup> <https://www.newyorker.com/news/news-desk/inside-the-team-at-facebook-that-dealt-with-the-christchurch-shooting>

The reality is that by 2016, Facebook had invested modestly in content security. The company's focus had remained heavily skewed to growing users and revenue. After a period of reluctance, management began to react in the face of growing criticism. Since then, Facebook's security infrastructure, in terms of both people and technology, has evolved considerably. In the earnings call for the second quarter of 2017, Zuckerberg mentioned<sup>10</sup> how his team began testing methods to detect terrorist postings using artificial technology. By the end of 2017, 96.7% of these postings were already proactively deleted before any user reported it. Today it's at 99.6%. The same occurs with other categories that primarily use images, where it is relatively easier to train machines to identify and delete inappropriate content: adult nudity (98.4% automatically deleted), infant nudity and sexual exploitation (99.3%), violent content (99.5%) and suicide-related (98.0%).

The harder job is to monitor written content, since context is paramount to determine whether a transgression has happened. Today, for example, only 13.3% of bullying-related content is proactively removed, a level that has not evolved much in recent years. Facebook explains that this type of situation is extremely subjective and usually relies on a user complaint to intervene.

Another field with a high degree of subjectivity is hate speech. This is a highly debated issue in the US,

particularly after Trump's election. The American president seems particularly fond of controversies and attacking his enemies through social networks. This puts Twitter and Facebook in the difficult position of censoring the most powerful man in the world for violating their platforms' rules. Inevitably, this kind of attitude (or lack of it) leads to accusations of political bias and a host of new problems. The recent boycott among advertisers, for instance, emerged after Trump threatened protesters and Facebook decided not to censor the message.

This battle cannot be won. In this political tug-of-war, one side will always be dissatisfied. Facebook, however, should be somewhat more flexible with politicians while continuing to intervene when regular users share hateful messages. This has been happening more often. In the fourth quarter of 2017, Facebook acted on a total of 1.6 million posts. In the second quarter of 2020 this number climbed 14x to 22.5 million. It is also rapidly improving the platform's ability to proactively remove content. Despite the subjectivity involved, the company has evolved from removing 23.6% of the problematic postings at the end of 2017, to 60.7% at the end of 2018 and 94.5% in the last quarter – before users flag them.

The team involved has also ballooned. While in November 2017, Facebook had 10,000 people working on security and content moderation, by 2020 this number exceeded 35,000. It is the largest team of its

<sup>10</sup> [https://s21.q4cdn.com/399680738/files/doc\\_financials/2017/Q2/Q2-'17-Earnings-call-transcript.pdf](https://s21.q4cdn.com/399680738/files/doc_financials/2017/Q2/Q2-'17-Earnings-call-transcript.pdf)

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kind in the world. Every day, it works on a huge volume of content, refining criteria, evolving algorithms and building a proprietary database that serves as fuel for more intelligent machines. With it, Facebook is creating a new vector of competitive advantage. While a future when Facebook solely depends on artificial intelligence for content moderation seems distant, it is certainly feasible to expect AI machines to multiply human productivity. This already allows the company to alleviate recent margin pressures.

It is impossible to have a large scale open platform that is 100% clean. And while examples of misinformation, hate and tragedy continue to arise within Facebook, Google or Twitter, the companies will keep facing criticism. This could bring upon tougher regulations, which might even attempt to make the platforms liable for the content produced on their services. While relatively unlikely, one consequence of this scenario would be to materially increase the difficulty faced by possible competitors, who don't possess the content moderation expertise that Facebook has been accumulating.

In 2020, Facebook is addressing the challenge of handling both the COVID-19 crisis and the upcoming American election. So far, throughout the pandemic, it has shown little tolerance for misinformation. As for the elections, it has developed a program aimed to assist the registration process of at least 4 million voters and

attract thousands of election officials to reduce queues during this particularly demanding election process. Disagreements, mistakes and course corrections will continue, but the company demonstrates that it has developed the antibodies required to act positively.

## Antitrust

Naturally, an examination of the company's issues would not be complete without mentioning antitrust concerns. As the collective indignation for Facebook's mistakes grew stronger, so did the call to "break up" the company. Even one of its co-founders, Chris Hughes, decided to join in. The clamor amplified the noise that surrounded the company and likely contributed to the weakness in the stock price.

Our conclusion, after countless discussions with antitrust experts, is that the risk of something concrete happening that impairs value is low. Attempts to split the business – Instagram, for example – would be severely challenged by the company. In the USA, antitrust is a matter for the courts and the legal precedent accumulated over the last 50 years is favorable to the company's argument. More importantly, the American antitrust framework focuses on impact to consumers, not to competition. There is no knowledge of a case, in this period, in which the FTC or the Justice Department tried to reverse a previously approved merger. The last case of a company being broken up was AT&T, in 1982. While regulators and

academics still try to understand all of the externalities – negative and positive – produced by Facebook’s dominance, AT&T’s monopoly was clear since 1913 and produced direct losses to consumers. Even so, the company’s split was settled not by court order, but in an agreement with the U.S. government, in exchange for the freedom to sell computers – restricted to AT&T since 1956, a result of yet another antitrust settlement.

In Facebook’s case, the damage to consumers caused by a lack of competition seems tough to prove – especially considering its services are free.<sup>11</sup> The Instagram and WhatsApp acquisitions were approved without difficulty. When purchased, Instagram was not even a social network, but a photo app. A closer analysis of the company’s history shows that its success has been directly shaped by Facebook, both in terms of user growth and in providing the necessary infrastructure to run the platform at scale. The idea that Instagram’s success was inevitable strikes us as a myopic interpretation of the facts. In WhatsApp’s case, it is questionable whether the company operates in the same market as the Blue app. In the messaging vertical, the service has relatively low penetration in the US – led by Apple’s iMessage – which makes it harder to assemble a compelling case against the company.

Europe, which so far has been the most active region in antitrust regulation against Big Tech, is also investigating Facebook. In Germany, there is an interesting case in which the country seeks to

punish the company via antitrust for collecting user behavior on third-party websites. The argument is that Facebook’s terms of use were abusive to consumers – and were so because of the company’s dominant competitive position. Possible punishments range from fines to more direct limitations on data collecting practices. The theory is audacious and has been met with reluctance in the courts. Either way, Facebook today already allows users to elect not to be monitored on third-party sites, which makes the discussion puzzling.

We also do not believe in a European maneuver that aims to separate recent acquisitions from Facebook ownership. Such an attitude would have deep geopolitical repercussions and was already publicly dismissed by sheriff Margrethe Vestager, leader of the European antitrust body.

Regulating digital platforms that offer free services is a complex task that does not easily fit within consolidated antitrust theory. There is a strong desire among regulatory bodies in several countries to set limits on Big Tech, but, so far, they have been unable to find productive ways of doing so. A large part of these companies’ competitive advantage stems from profound network effects and the data they capture. This causes regulators to gravitate towards demanding interoperability with competitors or ways to share the giants’ data with entrants. But this stumbles upon other equally pertinent privacy challenges,

<sup>11</sup> In recent decades, antitrust case law in the United States has consolidated the “consumer welfare standard”. Simply stated, it prioritizes the impact on consumer prices in the analysis of whether a merger should be prevented.

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since it would result in precious user data being disseminated across numerous entities – something the Cambridge Analytica debacle has proven to be highly problematic.

The result of this confusion leads us to believe the antitrust noises are greater than the potential damage to Facebook. We expect to see fines, conduct adjustments, new legislation and innovative taxes, but we are not convinced that their potential impact outweighs the attractiveness of the investment.

## THE FUTURE

*“The difference between baseball and business, is that baseball has a truncated outcome distribution.*

*When you swing, no matter how well you connect with the ball, the most runs you can get is four. In business, every once in a while, when you step up to the plate, you can score 1,000 runs. This long-tailed distribution of returns is why it’s important to be bold”*  
– Jeff Bezos, in its letter to the shareholders on 2016.

The logic behind our investment in Facebook is in the combination of a protected business that generates immense engagement and profitability, with an ambitious leader that has an extraordinary learning capacity. It is a powerful recipe for value creation available today at a very reasonable price – around 24x our estimated net income for 2021.<sup>12</sup>

There are several opportunities for growth. The first, and most immediate, is simply the maturing demand for online ads. Businesses around the world are becoming more digital and, consequently, adopting online tools to advertise their products. The current clientele of 9 million advertisers is but a small fraction of the 180 million companies present within Facebook’s apps. Given the assertiveness of Facebook’s ads, their adoption tends to grow for a long time.

For instance, thousands of companies have recently learned how to generate internet sales with direct response ads, where user reaction – and therefore the return on ad spend – is precisely measurable. It was the most resilient ad format during the COVID crisis, both for Facebook and YouTube, and it is easy to understand why: the sale depends on the ad.<sup>13</sup>

The second opportunity comes from improving the effectiveness in generating sales within Facebook’s apps. The more ads can generate business, the more valuable they are.<sup>14</sup> However, buying on Facebook or Instagram has so far been a friction-rich process. When clicking on an ad, users will typically be redirected to the seller’s website and required to fill in – with the small cell phone keypad – all their data: full address, phone number, payment method, etc. It’s annoying enough that many give up on the purchase. To solve this problem, the company has implemented a series of initiatives, such as Facebook Pay.

<sup>12</sup> We use EV/NOPAT to exclude net cash from market value.

<sup>13</sup> By 2020, online advertising should exceed 50% of global advertising spend for the first time. Its biggest driver is the growing participation of small advertisers, attracted by the revolutionary ease and effectiveness of digital advertising. Because of them, we expect to see the share of advertising in US GDP to grow again in the coming years, after two decades of stagnation caused by the collapse of print media.

<sup>14</sup> It is worth remembering that Facebook’s ad allocation system works by auction, with prices determined by supply (of space for ads) and demand (of advertisers). The supply is a result of the daily engagement of users and the frequency of ads presented. Demand, in turn, depends on advertisers’ adoption of Facebook’s tools and their ability to generate sales with the ads. The price is a result of the balance between the two forces.

Facebook Pay is a service that allows users to store their preferred payment method and delivery data. With this, the shopping experience becomes dependent on the push of a button. The same applies to Instagram.

Facebook is also enabling payments functionality in its messaging platforms, WhatsApp and Messenger, worldwide. This will allow anyone to pay their friends and services directly through messages. Users will no longer have to open their bank app to transfer money and then send an image of the receipt. The purpose is not to monetize transactions, but to increase engagement and utility. The added revenue will come from the increased use and value of ads on Facebook and Instagram, like those that take the user to a WhatsApp conversation with a single click.

This year in India, Facebook paid \$5.7 billion for a 9.9% interest in an innovative mobile operator, Reliance Jio. In under 4 years, Jio has brought 388 million Indians online with its 4G network. WhatsApp is one of the most used apps in the country, with a user base of 400 million people. The two companies created a partnership to connect over 6 million small neighborhood stores (kiranas) with their customers. Simply send a message to start the purchase and delivery process. The initiative is an important step for Facebook to establish a larger presence in a country that will soon surpass the 600 million internet users milestone.

Recognizing that more businesses are formed to sell directly to the consumer (DTC), using Facebook and

Instagram as their primary platform for acquiring customers, the company also created Shops. It allows sellers to set up a store within both apps to display their products and benefit from a simplified checkout process. The initiative was crafted in partnership with Shopify and other e-commerce service providers. In particular, it has the potential to consolidate Instagram as a virtual mall, where advertisers, influencers and a huge number of customers are already present. The perfect place to discover new interesting products – and essential for brands to position themselves. With Shops, Facebook takes a decisive step towards participating more actively in the growth of e-commerce around the world.

Facebook Pay and Shops are examples of the growing verticalization of the business. If Google organizes the world's information with tools such as Search and Maps, Facebook apps organize people around interests and activities – that is, social utilities. With this, it becomes more and more ingrained in the lives of its users and further reduces the risk of abandonment. Other examples include: Dating (a service akin to Tinder), Gaming (Twitch) and Marketplace (eBay). With an audience of 2.5 billion daily users, Facebook has an open field to create new specialized platforms and has shown enormous capability of quickly iterating new concepts.

For the last layer of opportunity, we will consider a few optionalities that the business offers. We do not include these in our projections for the company, but this does not eliminate their potential. Following Jeff Bezos' logic,

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Zuckerberg is not afraid to bet on bold initiatives that might have huge upside.

One of the most unusual bets was the creation of a digital currency, called Libra, in the midst of a turbulent period in Facebook's relationship with governments. This provoked a strong reaction from regulators around the world, worried about losing control of their currencies. The initiative has not been terminated, but advances have been slow as the company continues to seek government approvals.

Another ambitious investment is in virtual and augmented reality (AR and VR). With the acquisition of Oculus in 2014, Facebook became the leader in this promising segment. The bet is that VR/AR will constitute a new computing paradigm – the next step for PCs and smartphones. Its main attraction is the feeling of presence – of feeling in a completely different place. The most immediate application is in the gaming market, but Facebook bets that in the future it will evolve to become a valuable tool to connect people. It is creating experiences where users can interact in a virtual world, while still feeling close to each other.

With Oculus Quest, Facebook created a product that we consider to be the first great success in this market. Integrated and relatively inexpensive, it offers a good experience for first time users and a robust foundation for future iterations. The challenge will not be easy, as Facebook may eventually face Apple in the path for mass adoption. However, the experience earned in

combination with its gaming ecosystem should prove valuable for the bigger step towards augmented reality.

With so many opportunities ahead, it is critical not to lose track of the risks. More important than regulation, which we dealt with earlier, is competition.

Despite the enormous volume of users and the strength of its network effects, Facebook's success is not guaranteed. There is a crucial entertainment aspect to its services. This demands constant attention from the company in order to anticipate and react to changing user behavior. Despite the criticism around its excessive power, Facebook is more of a surfer than a driver of user behavior<sup>15</sup>.

In the past, Facebook has managed to act decisively by acquiring or copying innovations it deemed valuable. With this, it was able to manage a substantial "in-house" user migration towards Instagram, capture the growing popularity of messaging applications and react to the innovation of ephemeral content introduced by Snapchat. Today, the acquisition path is unavailable given antitrust oversight. That leaves it with the defensive tactic of copying competing features. A recent example is Instagram Reels, Facebook's reaction to TikTok.

TikTok mixes the concept of short videos, similar to the late Vine, with memes and music to create an addictive "slot machine" of digital entertainment. The user opens the application for a vertical video experience, in full

<sup>15</sup> An excellent argument by Benedict Evans: <https://www.ben-evans.com/benedictevans/2017/2/17/surfing-users-facebook-and-snap>

screen, with the sound already on and starts to react to the content. The algorithm quickly detects what the user likes and automatically suggests new videos – improving its hit ratio successively.

As the videos are short and the app offers good editing tools, it is much easier to create content there than on YouTube. Also, because they are short, TikTok's signals are more frequent, which means its algorithm can learn faster. The infinite feed hooks the user to always watch the next video and get that next hit of dopamine. It is a powerful new media format, where it is not required to follow anyone for an enjoyable experience and it is not necessary to be followed to go viral – the algorithm does this job.

TikTok does not substitute Facebook's apps, but that is not necessary to steal user engagement time from them. It has surpassed 800 million users and began to suffer from its Chinese origins, being banned in India and facing a similar fate in the USA. This gives Facebook a golden opportunity to react.

TikTok made popular a new form of expression, as did the tweet, post, vlog, selfie, square photo and stories. It is up to Facebook to participate.

\* \* \*

The uncontrollable popularity of smartphones in the last 13 years has promoted an explosion of internet penetration in the world. In 2007, the year the

iPhone was launched, 1.3 billion people came online. Nowadays, there are 4.6 billion, of which 4.0 billion are social media users.<sup>16</sup> The consequences of this brutal increase in connectivity are still being understood.

Since man discovered fire, technological progress has brought benefits always accompanied by consequences. The internet, social networks and the arrangement of content through algorithms are only the most recent examples. Books, like Roger McNamee's "Zucked", and documentaries, like Netflix's "The Social Dilemma", deal with the traps that open content platforms bring to society.

We disagree with the view that these services, usually supported by advertisements, are mere behavior manipulators. They do aim to engage their users, like every business, and are effective at revealing preferences. Their value is in connecting curiosities and desires with content and products. If some of these are unacceptable, even if permitted by law, it is up to society to discuss, review and, eventually, regulate.

The same applies to children using its apps. In the 90's and 2000's, a huge debate questioned the effect of addictive and violent videogames in teenagers. The issue remains relevant, but with much less controversy, given the knowledge accumulated by parents to help their children explore this universe safely.

We see this as a necessary and positive discussion. After a period of uncertainty, it has already motivated some

<sup>16</sup> <https://wearesocial.com/blog/2020/07/digital-use-around-the-world-in-july-2020>

# FACEBOOK

changes in the design of the services. Some examples:

(i) on Facebook, the shift in focus towards content from friends and family rather than news from 2018 onwards, the expansion of an independent fact checking program and the creation of reliable information centers for issues such as COVID and climate science, (ii) on Instagram, the decisions to remove public likes count and to let users know when they have finished viewing new photos, (iii) on WhatsApp, limitations on multiple message forwarding, (iv) on YouTube, rest and bedtime reminders, and (v) on iOS and Android, monitoring and more advanced controls to limit screen time for users and their kids. We expect to witness more adjustments like these over time.

Mark Zuckerberg has demonstrated he was correct in refusing to sell at 22. He has expanded his business masterfully. He has matured with challenges of enormous complexity. He controls today the most used internet applications in the planet and has the immense responsibility of keeping them virtuous. He is one of the major founder-CEOs in Silicon Valley, at only 36 years of age. What will he have achieved at 50?

## MISCELLANEOUS

“Money is always there but the pockets change.”

— *Gertrude Stein*

“Gold is money. Everything else is credit.”

— *John Pierpont Morgan*

“There’s no such thing as public money, there is only taxpayers’ money.”

— *Margaret Thatcher*

“Among our socialist opponents there is great confusion. Some of them regard private enterprise as a tiger to be shot. Others look on it as a cow they can milk. Only a handful see it for what it really is: the strong and willing horse that pulls the whole cart along.”

— *Winston Churchill*

“The saddest aspect of life right now is that science gathers knowledge faster than society gathers wisdom.”

— *Isaac Asimov (1920-1992)*

“Technology is nothing. What’s important is that you have a faith in people, that they’re basically good and smart, and if you give them tools, they’ll do wonderful things with them.”

— *Steve Jobs, 1994.*

“He was always fascinated by what interested people. And what interested them?  
Other people.”

— *Reid Hoffman, cofundador do LinkedIn, sobre Mark Zuckerberg*

“There is a huge need and a huge opportunity to get everyone in the world connected, to give everyone a voice and to help transform society for the future. The scale of the technology and infrastructure that must be built is unprecedented, and we believe this is the most important problem we can focus on.”

— *Mark Zuckerberg, 2012*

“I’m much more motivated by making sure that we have the biggest impact on the world than by building a business or making sure we don’t fail. I have more fear in my life that we aren’t going to maximize the opportunity that we have than that we mess something up and the business goes badly.”

— *Mark Zuckerberg, 2017*

“I think the strategy of Facebook is to learn as quickly as possible what our community wants us to do—and that requires a culture that encourages people to try things and test things and fail.”

— **Mark Zuckerberg, 2017**

“I’m changing the goal I give our product teams from focusing on helping you find relevant content to helping you have more meaningful social interactions.” (...) “We demote things like clickbait headlines and false news, even though people often click on those links at a high rate.” (...) “Now, I want to be clear: by making these changes, I expect the time people spend on Facebook and some measures of engagement will go down. But I also expect the time you do spend on Facebook will be more valuable. And if we do the right thing, I believe that will be good for our community and our business over the long term too.”

— **Mark Zuckerberg, 2018**



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