

Blue Oceans Capital *Integration of PRI Guidelines*

CASE STUDY:

Facebook

Executive Summary

We first purchased shares in Facebook (FB) in September 2017. At the time the company did pose a number of ESG risks however we felt that the company was making significant strides forward in terms of ameliorating those risks. We believed that, on the whole, the product offering was a greater benefit to society than detriment.

During the course of our holding ESG risks continue to build and FB's response has been, in our opinion, inadequate. ESG risks became insurmountable in March, 2019, with the Christchurch mosque shootings being live-streamed on FB. This event coincided with our integration of the following ESG analysis report framework into our existing portfolio holdings. The report highlighted fundamental ESG problems with FB such as inability and/or unwillingness to control content, changes in user and advertiser behaviours in light of the content, and gross inadequacy of governance.

The results of the findings led us to believe that our analysis capabilities could not be confidently applied any longer to FB due to the significant ESG risks currently being exposed and FB's inability and or unwillingness to control those risks. We cannot predict if FB will be successful in meeting these challenges or not, only that that our analysis methods and capabilities cannot be confidently applied. In late March 2019 we removed FB from our portfolio holdings.

Strategy

HIGH LEVEL ESG RECOGNITION

How does the company act as a positive force for environmental concerns?

- Committed to reducing their greenhouse gas footprint by 75% and reaching 100% renewable energy by 2020 (*FB March 2019 Sustainability Overview*).
https://sustainability.fb.com/wp-content/uploads/2019/03/Facebook_Executive_Summary_Final_Mar20192.pdf
- Every new data centre built will be supported by 100% renewable energy
- Between 2011 and 2017, Facebook avoided over 2 million metric tons of CO₂ emissions - the equivalent of taking 266,000 vehicles off the road for a year.
- 1.5b gallons of water avoided in 2017 alone
- Added over 3 GW of renewable energy to the grid as of August 2018
- Waste diversion rate at headquarters is greater than 90%
- US headquarters achieved 100% renewable energy use including 3.6MW from onsite rooftop solar.

How does the company not act as a positive force for the environment?

- Each user emits 299g of CO₂ per year. There will be approx. 3.02 billion users by 2021.
- About 1100 kg of CO₂ generated globally by FB comments every minute.

How does the company act as a positive force for social concerns?

- Certified sustainable workplaces that are healthier for both employees as well as the environment
- Buildings are designed, constructed and operated to support the health and productivity of employees as well as surrounding communities
- It is a great medium to connect with people from different parts of the world
- Helps with staying in contact with friends and provides an easy platform for sharing or staying up-to-date with any developments in their life.
- It is a free platform that allows users to contact and communicate with each other over various mediums such as instant messaging, audio as well as video calling. The only requirement is an internet connection.

How does the company not act as a positive force for social concerns?

- Peer review and grading system (*twice a year*) among the workforce forces employees to forge friendships with coworkers in order to improve their grade
- Former employees say dissent against leadership is discouraged
- Some scandals and leaks could have been caught earlier or prevented if employees were encouraged to speak freely
- An article by CNBC (*Rodriguez, 2019*) described the Facebook workplace which was characterised by former employees as “cult-like”. <https://www.cnbc.com/2019/01/08/facebook-culture-cult-performance-review-process-blamed.html>
- Fake profiles can be easily misleading. The total number of Facebook accounts is more than the total population of Earth. Millions of fake accounts are deleted by FB daily. These fake profiles can further be used to harass other users in many ways. There have been multiple cases of bullying, stalking, blackmailing, etc.
- Social media addiction. Spending hours every day on Facebook and spending less and less time actually interacting personally with people has been a growing concern for a few years now. It can also negatively impact grades, careers and relationships.
- Studies also suggest that spending too much time on social media can be bad for mental health (*Walton, 2018; Bodford, 2014*). <https://www.forbes.com/sites/alicegwalton/2018/11/16/new-research-shows-just-how-bad-social-media-can-be-for-mental-health/#6fbaeaa67af4>
<https://www.psychologytoday.com/us/blog/sex-murder-and-the-meaning-life/201404/7-ways-facebook-is-bad-your-mental-health>
- The platform can be used to spread negative views such as terrorism which are detrimental to society as a whole
- There have been a string of key management personnel who have left FB in the past year including WhatsApp, Instagram & Oculus founders as well as various other key employees (*Business Insider, 2019*). <https://www.businessinsider.in/Facebook-is-being-abandoned-by-top-executives-Heres-everyone-who-has-left-since-the-Cambridge-Analytica-catastrophe-last-year-/March-2019-Chris-Cox-longtime-lieutenant-to-Mark-Zuckerberg-/slideshow/68426598.cms>

How does the company act as a positive force for governance concerns?

- Scheduled to introduce a Clear History tool that will allow users to wipe information about them collected by FB from 3rd party apps and websites (*Rodriguez, 2019*). <https://www.cnbc.com/2019/02/26/facebook-clear-history-coming-in-2019-could-hurt-ad-targeting-wehner.html>
- Efforts to have more messaging products end-to-end encrypted, which would shield the conversations from being read by anyone outside the conversation.

How does the company not act as a positive force for governance concerns?

- Mark Zuckerberg acting as both CEO and board chairman. Very few limits to his authority within the company.
- Data privacy issues (*GDPR compliance*).
- Multiple scandals regarding data privacy.
- Not enough content restrictions/oversight.
- Can be used to spread and promote political agendas.
 - One major example is the Brexit/Cambridge Analytica scandal where personal user data was accessed to build psychometric profiles and there is suspicion that this data was used for targeted paid ads on FB to influence voters on both sides of the Brexit movement (*Satariano, 2018; Cadwalladr, 2019; MacAskill, 2018*). <https://www.nytimes.com/2018/11/06/technology/cambridge-analytica-arron-banks.html>
<https://www.pressenza.com/2019/04/facebooks-role-in-brexit-and-the-threat-to-democracy/>
<https://www.reuters.com/article/us-facebook-cambridge-analytica-leave-eu/what-are-the-links-between-cambridge-analytica-and-a-brexit-campaign-group-idUSKBN1GX2IO>
 - Plans to integrate infrastructure of WhatsApp, Instagram, and Messenger. Data would be shared between the three apps and could allow FB to create a single user profile that would track all user activity through the three apps (*Isaac 2019*). <https://www.nytimes.com/2019/01/25/technology/facebook-instagram-whatsapp-messenger.html>

What external ESG factors affect the company?

Major influencing factors include:

- The Paris Agreement is an environmental accord adopted by nearly every nation in 2015 to address climate change and its negative impacts. It provides a global framework as well as incentives to meeting the reduced carbon emissions target set out in the agreement and is meant to help in transitioning towards a sustainable economy (*Denchak, 2018*). <https://www.nrdc.org/stories/paris-climate-agreement-everything-you-need-know>
- General Data Protection Regulation (*GDPR*) is a replacement for the 1995 Data Protection Directive in the EU. It was brought into effect in May, 2018 and is intended to bring sweeping changes in the way every company operating in the EU handles user data and privacy. For a company like FB which derives a majority of its revenue from consumer data, it has had a big impact on privacy policy and compliance will continue to be a large part of FB privacy policy and terms of use for the foreseeable future. Fines for violating the agreement could be as high as €20m or 4% of the company's global turnover (*Hern, 2018*). <https://www.nrdc.org/stories/paris-climate-agreement-everything-you-need-know>
- The current withdrawal of the United Kingdom from the European Union (*Brexit*). Since GDPR applies across all EU member states, there may be some problems with data flow with the UK withdrawing from the EU. If there is a 'no-deal' Brexit, there are some concerns surrounding the data flow from the EU to companies operating in the UK (*Walker & Jones, 2019*). <https://www.itpro.co.uk/policy-legislation/31772/gdpr-and-brexit-how-will-one-affect-the-other>
- Increase in competition and technical innovation by competitors.
- Patent infringement.
- Change in local, national, or international regulations re internet or data privacy.
- Oculus, a subsidiary of FB, might face supply chain bottlenecks or technical difficulties with third-party manufacturers.
- Due to a string of data privacy and content oversight concerns regarding FB, both local as well as global governments are trying to impose restrictions and there are various lawsuits both past and ongoing against FB. For example, due to the recent Cambridge Analytica

scandal, there is an ongoing lawsuit against FB in the District of Columbia that could lead to legal penalties ranging in billions of dollars. A further example involves a lawsuit in 2011 that led to millions of dollars in settlement as well as changes in FB privacy policies.

MANAGEMENT

How has the company demonstrated its awareness of ESG factors in the economy and within its industry?

- Comprehensive list and explanation of various ESG factors that could affect the company have been included in the Risk Factors in their annual report. For example:
 - Government restrictions on Facebook could harm their ability to sell advertising in those countries and have a harmful impact on revenue.
 - Anticipated that more instances of misuse of user data by third parties on the FB platform.
 - FB has addressed increasing and changing data privacy laws and regulations in the US, as well as foreign laws and how they could negatively affect the company including increased costs due to government investigations, penalties, or settlements.
- After news broke about studies on the negative impact of FB and other social media platforms on mental health, the company came out with multiple tools and features that could reduce or counteract this effect (*Levin, 2017*). <https://www.theguardian.com/technology/2017/dec/15/facebook-mental-health-psychology-social-media>

Where has management demonstrated its commitment to addressing ESG challenges?

- Committed to reducing global carbon footprint by 75% and having 100% renewable energy use by 2020, *“We have set an aggressive science-based target to reduce our greenhouse gas emissions by 75% by 2020.”* - Edward Palmieri, Sustainability Director, Facebook.
- CEO, Mark Zuckerberg spoke out against the announcement by Trump to withdraw from the Paris Agreement and highlighted the importance of climate change and the need to stop it. *“Withdrawing from the Paris climate agreement is bad for the environment, bad for the economy and it puts our children’s future at risk. For our part, we’ve committed that every new data center we build will be supported by 100 percent renewable energy. Stopping climate change is something we can only do as a global community, and we have to act together before it’s too late.”* - Mark Zuckerberg, CEO, Facebook <https://sustainability.fb.com/>
- By encouraging employees to use public transports or carpooling to reduce emissions from vehicles. Also provide showers for employees who cycle to work.
- FB was the largest corporate renewable buyer in 2018.
- In response to the Christchurch attack in March, FB announced on May 14, 2019 that it would crack down on users using its live-streaming feature to spread malicious and violent content. There would be a one-strike policy with any user found spreading such content through live streaming would be barred from using the service again (*Paul, 2019*). <https://www.reuters.com/article/facebook-extremists/facebook-restricts-live-feature-citing-new-zealand-shooting-idUSL5N22R05J>

How has management demonstrated its knowledge on the company’s ESG risks?

- Acknowledged mistakes made after multiple data privacy scandals.
- Steps taken to reduce the company’s carbon emissions and improve water and energy efficiency.
- Management has stated they are trying to make messaging through all their apps end-to-end encrypted so as to reduce the data privacy risks.
- A Clear History tool for deleting all personal user data collected by FB was set to be launched in 2018 but was delayed due to technical difficulties. It is set to be launched later in 2019.
- Lack of knowledge demonstration surrounding social risks.

How does strategy align with ESG opportunities?

- By making sure all new data centres, which are one of the biggest sources of CO₂ emissions today, are using 100% renewable energy.
- Plan to integrate all their messaging apps in order to apply end-to-end encryption to all messages.
- Plan to release a tool for giving users the power to delete any private data collected by FB or connected third parties.

Is there evidence of the company reporting highlighting future ESG risks and does the strategy allow for these anticipated risks?

Yes. Examples of highlighted future ESG risks include:

- Cyber attacks that may compromise user data privacy.
- Misuse of user data due to inadequate content oversight and security.
- Misuse of FB services and products by third parties to spread misinformation.
- CEO Mark Zuckerberg has majority voting rights and thus has control over any key decisions.
- Use of third-party manufacturers for consumer products could have future supply chain risks.

What is the extent of ESG performance reporting?

- High. Have a website dedicated to their efforts to improve their ESG performance. <https://sustainability.fb.com/>
- Provide executive sustainability report that summarises their ESG efforts. https://sustainability.fb.com/wp-content/uploads/2019/03/Facebook_Executive_Summary_Final_Mar20192.pdf

Do reports link ESG factors to financial performance?

No.

What is the company's position in relation to current and potential operational licences, supply chain, and resource bottlenecks?

- Responsible Supply Chain program provides suppliers with a framework of standards and expectations.
- Address labour, environment, health and safety, ethics, and management systems with the Responsible Business Alliance Code of Conduct. <http://www.responsiblebusiness.org/code-of-conduct/>
- Commitment to combating forced labour with their Anti-Slavery and Human Trafficking Statement. https://s21.q4cdn.com/399680738/files/doc_downloads/quick_links/Anti-Slavery-and-Human-Trafficking-Statement-2018.pdf
- Conflict Minerals program promotes responsible sourcing of tin, tantalum, tungsten, and gold (3TG) used in our consumer electronic products. <https://investor.fb.com/corporate-governance/Conflict-Minerals-Policy/default.aspx>
- Require suppliers to meet applicable and locally mandated environmental laws and regulations and look beyond compliance to minimise their environmental impact.

What is the extent of management involvement of customers, employees, government, and other stakeholders? How do they gather data on their sentiment/opinion?

- Allowed users to vote on changes to terms of use in 2011 due to previous criticism on policy changes. Unclear if actual policy was affected by the voting.
- There has been government intervention in the past regarding data privacy policy.
- Recent string of scandals might also invite further government participation in data privacy policies as well as general company governance.
- Employees can give and receive feedback through an online application at any time and management espouses an open work culture where transparency is key. Though recent

news suggests the employee review system and leadership discourage any dissent and forces employees to have positive interactions with colleagues in order to get better reviews. Anonymous former employees have spoken out about 'cult-like' work culture and pressure to act happy and as though they love working there even if it is not true. <https://www.cnbc.com/2019/01/08/facebook-culture-cult-performance-review-process-blamed.html>

How responsive is the company to investor engagement?

- Collaborate and share ideas with stakeholders as well as the broader community to develop solutions that can benefit the industry.
- Member of the Responsible Business Alliance and the Responsible Minerals Initiative. <http://www.responsiblebusiness.org/>
<http://www.responsiblemineralsinitiative.org/about/>

Does the board support ESG issues?

- Insufficient Data. Only CEO Zuckerberg has made statements regarding ESG issues.

Financial Reporting

INCOME STATEMENT

REVENUE

Identify the main drivers of revenue for both volume and price.

- Targeted advertisements
- Daily active users
- Monthly active users
- Seasonality
- Ability to attract new users while maintaining interest of current users
- Time spent on FB properties
- Growth of FB properties in emerging economies.

How do these drivers align with sustainable ESG factors?

- Stricter data privacy regulations would lead to decrease in efficiency of targeted ads which would lead to third-party advertisers allocating a smaller percentage of their budget to advertising on FB.
- The string of recent scandals could reduce popularity among users and lead to decrease in number of active users that would in turn reduce advertising spend.
- Extremism on live feed could force FB to remove the feature opening an opportunity for competitors to offer the service and take market share from FB.
- If negative material continues to propagate through FB properties, advertisers may choose to retract their advertisements due to negative and inappropriate associations made by viewers.

What are the future prospects for these drivers? Including the fundamental tailwinds that support their future growth.

- Growth of programmatic advertising industry could be a tailwind for FB if they can adapt to data privacy regulations and convince users of the safety of their data after the number of scandals surrounding leaked user data.
- Global growth in the number of internet users with internet access becoming increasingly available even in remote areas would lead to more prospective users for FB.
- Business growth in emerging markets would also present more advertising opportunities which would lead to advertisers investing a larger portion of their budget.
- Increasing adoption of smartphones would also lead to more access to the internet and subsequently FB.
- There has been a large increase in consumption of media on mobile platforms as well as the number of hours an average person spends on the internet every day.

What major risks exist in the potential of these future prospects to not become a reality?

- FB has historically always had issues with data privacy since their platform structure has inherent flaws that make it easy to exploit user data.
- The technical overhaul required for complete data privacy would deprive FB of its main source of revenue, that is targeted advertising.
- Innovative programmatic advertising competitors would have an advantage over FB due to better data privacy policy and improved platforms making them seem like better alternatives compared to FB.
- There have been increasing numbers of studies on the negative mental effects of social media which have led to a small but growing sentiment that people should put more conscious effort into reducing daily social media usage.
- The live streaming feature has also opened up a whole host of problems such as streaming of graphic or unsuitable content which can be viewed by anyone without supervision. The latest example of that is the Christchurch attack that was streamed live by the attacker on FB and the video stayed online for 2 hours before it was removed. FB relies on users to flag or report content so that it can be brought to the attention of content moderators and even then it takes a minimum of 1 hour before it is removed. In the 2 hours that the video was online it had already been downloaded and shared across the internet and there was no stopping it at that point. This is not the first time the live-streaming feature has been used to stream violent content. There have been live streams of killings, torture, suicides, etc. on FB in the past where FB was too slow to remove the content. After the Christchurch attack thousands of human moderators were apparently hired by FB to mitigate this problem but there has yet to be any changes in policy or technology to truly prevent or reduce live streaming of such content (*Klonick, 2019*). <https://www.newyorker.com/news/news-desk/inside-the-team-at-facebook-that-dealt-with-the-christchurch-shooting>

How might ESG trends impact this company's core markets?

- GDPR and the Paris Agreement have defined data privacy regulations that need to be met. This is and will further limit FB's ability to efficiently use user data for targeted advertising, which is their major source of revenue.
- The continuous string of scandals and data privacy breaches might cause users to lose trust in the brand and actively stop using the platform. Such a social revolt could be catastrophic for Facebook.
- Legal action by local or global governments could result in billions of dollars of penalties as well as restrictions on the platform that could be detrimental to its revenue stream.

What legislative or regulatory change is anticipated?

- EU ePrivacy Regulation was part of GDPR and supposed to be effective alongside it but was delayed and is now expected to be effective late 2019. It is an update to the ePrivacy directive first introduced in 2002 and revised in 2009.
- California Consumer Privacy Act (CCPA) - broader definition of personal data compared to GDPR.
- Brexit could cause problems for data being transferred to, from or through the UK
- Cross-Border Data Transfer Pact/Privacy Shield - transfer of data between the EU and the US may become more problematic.

Are the company's key markets sustainable in terms of resource use and disposal?

- The company's major resource are the consumers themselves and the data they generate. Sustainability could be negatively affected if the number of active users decreases or stricter data privacy regulations decrease the value of the data to the advertisers, which would lead to a decrease in revenue.
- Subsidiary Oculus deals in virtual reality (VR) and sale of VR headsets that are manufactured by third parties so there may be sustainability concerns in this regard.

Are the company's key markets sustainable in terms of consumer preferences and social trends?

- Yes, if FB can adapt to data privacy regulations. Social media is one of the largest ongoing trends in the world right now and it was kickstarted, in a large part, by Facebook.
- There has been concern among advertisers that their content could be displayed on inappropriate pages or send the wrong message because of the inadequate content oversight on FB.
- Many prominent advertisers pulled out from FB after the Christchurch attack and it could lead to a social revolt against FB as well.
- Subsidiaries such as WhatsApp, Instagram, and Oculus are unlikely to be affected by the social negativity faced by facebook.com.

COSTS

RAW MATERIALS

Is there a risk input costs will rise?

Yes.

1. A portion of content will be paid for that was previously free.

Facebook has traditionally had a policy of not paying publishers to produce content for its news feed however that stance has changed in more recent times. An article by CNBC (*Castillio, 2018*) described how Facebook is testing monthly subscription plans and will offer ways for advertisers to find sponsorship opportunities for its creators.

While this strategy may raise the overall cost of inputs, it is also seen as a source of competitive advantage with the potential to move content creators from YouTube who currently offer methods of remuneration to its content providers.

2. Cost of screening and filtering the raw material (*user uploads*) is set to significantly increase.

Recent years have seen Facebook plagued with scandals of fake news and inappropriate posted content. At its extreme this was seen as influencing the 2016 United States election (*Cadwalladr & Graham-Harrison, 2018; Menn & Dave, 2018; Persily, 2017*) and becoming a platform for terrorist propaganda as seen in the 2019 Christchurch mosque shootings (*Perrigo, 2019*). In an effort to better screen this material out, Facebook is now spending huge amounts on human capital and technology

to identify and take down the material.

Mark Zuckerberg, Q4 2018 earnings call, *“For the past couple of years, most of our focus and energy has gone into addressing some of the biggest social issues around the future of the Internet, including election integrity, content governance, safety and security, data privacy and digital wellbeing, and these are all complex issues, but we’ve made real progress.”* He goes on to say, *“Still, there’s a lot more to do and I expect it will take strong execution through 2019 and beyond before we get all our systems to the level that we need.”*

We anticipate these costs to increase – Facebook’s very existence depends on providing a safe environment and to achieve that at massive scale and under a live upload environment will be extremely challenging if not impossible.

Is the company aware of these risks?

Yes.

In regards to paying for publisher’s content this is seen as an upside opportunity with potential to draw business away from YouTube.

In regards to moderating content the company has been making significant investment in this area for years now. Has greatly increased investment since the 2016 election interference.

Attempts to moderate content over time have not been working adequately.

Do cost projections take into account these risks?

Yes.

TABLE 1. GROSS INCOME AS A PORTION OF REVENUE

Company	FY18	FY17	FY16
Facebook	83%	87%	86%
Alphabet	57%	59%	61%
Amazon	42%	37%	35%
Twitter	68%	65%	65%

Gross income as a portion of revenue for selected competitors and peers. Source: Factset.

In the table above, Facebook shows clear leadership in profitability, albeit with a notable downward trend. This highlights a favourable business model and cost efficiency.

Note that Amazon is included as a peer in size, its quite different business model that requires much greater capital outlay, needs to be taken into account in comparison.

LABOUR

In assessing a company’s efficiency in labour and spend on R&D, we use these metrics as a portion of gross income. We use gross income instead of revenue as gross income is the funds available for these investments. If we use revenue then a company could be running at a loss compared to its profitable competitor and still spend a similar portion. However, it would not be as sustainable as its competitor as it did not use cash flow generated from its own activities for these expenses.

Labour is measured in gross income above and also in general and administrative expense below.

TABLE 2. PORTION OF GENERAL AND ADMINISTRATIVE EXPENSE OF GROSS INCOME

Company	FY18	FY17	FY16
Facebook	24%	21%	23%
Alphabet	32%	30%	32%
Amazon	56%	59%	57%
Twitter	52%	63%	74%

Investment in General and Administrative expense as a portion of gross income. Source: Factset.

The table above again highlights Facebook's efficiency in general and administrative expense and is well ahead of peers and competitors.

R&D INVESTMENT

TABLE 3. R&D SPEND AS A PORTION OF GROSS INCOME AND TOTAL (USD BILLIONS).

Company	FY18	FY17	FY16
Facebook	22% (\$10.27B)	22% (\$7.75B)	25% (\$5.92B)
Alphabet	28% (\$21.42B)	25% (\$16.63B)	26% (\$13.95B)
Amazon	30% (\$28.84B)	34% (\$22.62B)	34% (\$16.09B)
Twitter	27% (0.55B)	26% (0.54B)	42% (0.7B)

Investment in R&D as a portion of gross income and total in billions of USD. Source Factset.

Table 3 above shows Facebook's spend on R&D lagging peers and competitors and having declined as a percentage of gross income from FY16. This may be a result of increased spending on human capital in an effort to maintain quality of content under recent circumstances as highlighted above.

What is the product development strategy? What is the percentage of sales from new products?

- Continue to roll out stories
- Continue to roll out Watch
- Build out capabilities in various communities such as jobs, buy and sell marketplace, small business, events, fundraisers, and volunteers.
- Continued development of Oculus

Percentage of sales from new products not broken out.

What are the pending patent applications and is there in-house venture capital?

Specific patent numbers not broken out.

Yes. The company actively pursues venture capital opportunities in-house.

NON-RECURRING AND EXCEPTIONAL EXPENSES

What are the organisational and incentive structures?

Litigation history is as follows:

- ConnectU.com 2004 lawsuit

ConnectU founders Divya Narendra, Cameron Winklevoss and Tyler Winklevoss filed a lawsuit against FB in September, 2004, alleging that Zuckerberg broke an oral contract to build the social networking site and used their source code to create FB. FB countersued in regards to Social Butterfly, a project put out by a partnership between ConnectU and i2hub. The lawsuit was

settled in 2008 with FB acquiring ConnectU's assets for \$20M cash and 1,253,326 FB shares.

- ConnectU.com 2008 lawsuit

They filed another lawsuit in March 2018 to rescind the settlement, claiming that the value of the stocks granted to them in the previous settlement had been overstated. A district court ruled that the settlement would stand. The Winklevoss twins disputed the ruling but dropped the suit in 2011 (*Singel, 2011; Carlson, 2010*). <https://www.wired.com/2011/06/winklevoss-facebook/>
<https://www.businessinsider.com.au/how-facebook-was-founded-2010-3?r=US&IR=T#we-can-talk-about-that-after-i-get-all-the-basic-functionality-up-tomorrow-night-1>

- Aaron Greenspan trademark dispute

Aaron Greenspan created a student web portal called houseSYSTEM in Harvard. In 2008 he filed a petition to cancel the “Facebook” trademark as well claims of prior use and fraud by Facebook Inc. against USPTO. Formal settlement in May 2009 but no details disclosed (*Brisbane Times, 2008; FB Newsroom, 2009*). <https://www.brisbanetimes.com.au/technology/facebook-founder-and-ex-friend-fight-over-trademark-20080416-ge9ve9.html>
<https://newsroom.fb.com/news/2009/05/facebook-and-think-computer-corporation-resolve-trademark-dispute/>

- FB & Zynga class-action lawsuit 2009

California resident Rebecca Swift filed a potential class-action lawsuit against FB and Zynga for allegedly profiting from “scam-ads” appearing in gaming applications offered by Zynga, which offer free trials of various services with claims that users can cancel subscriptions within a certain period but then preventing users from cancelling them, resulting in unwanted recurring charges. Lawsuit against FB was dropped in 2010 (*Tate, 2009; Davis, 2010*). <https://www.mediapost.com/publications/article/121206/scamville-lawsuit-against-facebook-dropped.html>
<https://gawker.com/5408472/facebook-named-in-federal-class-action-suit-over-scammy-zynga-ads>

- Paul Ceglia lawsuit 2010

In 2011, Paul Ceglia filed a complaint in the Federal Court in Buffalo claiming to be the owner of 50% of FB. He produced a two-page contract and emails from 2003, when Zuckerberg was working for him on a project called StreetFax.com. He allegedly paid Zuckerberg \$1000 to work on it and another \$1000 to work on The Face Book. The emails showed conversations between the two where Zuckerberg apparently agreed to a 50/50 partnership over FB. The lawsuit was seen as fraudulent and tossed out in court with Ceglia ending up being arrested for fraud (*Dignan, 2011; Carty, 2012*). <https://www.cbsnews.com/news/paul-ceglia-who-sued-facebook-ceo-mark-zuckerberg-for-half-the-company-arrested-on-charges-he-forged-records/>
<https://www.zdnet.com/article/paul-ceglia-vs-facebooks-mark-zuckerberg-heres-the-complaint-and-its-a-good-read/>

- Lane v. Facebook, Inc.

In 2010, class settlement of this lawsuit was approved. The lawsuit stated that user's private information was being posted on Facebook without consent using Facebook's Beacon program. The Beacon program ended up being terminated and FB paid \$9.5M for the release of the plaintiffs' class claims. \$6.5M of that amount went to a charity that would fund programs to protect personal information (*The Recorder, Law.com, 2012*). <https://www.law.com/therecorder/almID/1202572122256/?sreturn=20190414033150>

- Fraley v. Facebook, Inc.

In 2011, a class action lawsuit against FB was filed over the “Sponsored Stories” program, alleging that it was unlawful to use people's names and photos for advertising without their consent. The case was settled in 2013 and settlement cheques were mailed in 2016 (*Citizen.org, 2016*). <https://www.citizen.org/litigation/fraley-v-facebook-6/>

- Terms of Use Controversy

There have been various controversies and complaints made by Facebook users due to changes made in FB Terms of Service. One such change was made in February, 2009 which allowed Facebook to retain and use copies of User Content even after the user deleted their account. A formal complaint was made by The Electronic Privacy Information Center to the Federal Trade Commission. FB returned to its original terms of use to calm criticism. On February 26, 2009 Facebook introduced a feature that allowed users to vote on potential changes to the terms of use before they were officially released. The new terms were again met with criticism and led to further complaints to the FTC which again led to temporary suspension of the new terms of use in February, 2011.

- Lawsuit over 2012 IPO

Shareholders accused FB of concealing internal concerns about the negative impact growth in mobile devices might have on revenue, and at the same time warning their banks to cut their forecasts. A settlement of \$35 million was reached in February, 2018 (*Stempel, 2018*). <https://www.reuters.com/article/us-facebook-settlement/facebook-settles-lawsuit-over-2012-ipo-for-35-million-idUSKCNIGA2JR>

- Cambridge Analytica lawsuit

In December 2018, the attorney general of the District of Columbia filed a lawsuit against FB for allowing Cambridge Analytica, a political consultancy, access to more than 87 million users' personal information beginning in 2014, disregarding the users' privacy settings. This could be a potential violation of an agreement brokered by the US government in 2011 which required FB to improve its privacy practices. If found guilty, the penalties could be in billions of dollars. The lawsuit is still ongoing (*Romm et al, 2018*). https://www.washingtonpost.com/technology/2018/12/19/dc-attorney-general-sues-facebook-over-alleged-privacy-violations-cambridge-analytica-scandal/?noredirect=on&utm_term=.232c28ff4e06

What is the extent of stakeholder research?

Extensive. Facebook invests in internal research directed towards how its business affects its users and governments where it operates around the world.

What is the company doing to mitigate ESG risks in regards to costs?

- Developing technology to automate the identification and take down of unsavoury content. Currently this task is performed by automated software alongside a massive team of people that are continuously monitoring content. Building out automated technology and Artificial Intelligence in this arena will lower costs.
- Facebook's data centres require huge amounts of power. The company is investing significant amounts renewable energy will lower this significant cost and reduce ESG risks long term.

Does the company report on these risks?

Yes.

What is the company's capacity to sustain or improve operating efficiency?

Immense. Facebook is very profitable. In FY18 it produced \$46.5 Billion USD in Gross Income that translated into \$22 Billion USD in Net Income. Facebook probably has the most capacity of any company in the world, if not one of the highest, to sustain and improve its operating efficiency.

Table 4. Executive Remuneration

Name and Pricipal Position	Fiscal Year	Salary (\$) ⁽¹⁾	Bonus (\$) ⁽²⁾	Stock Awards (\$) ⁽³⁾	All Other Compensation (\$) ⁽⁴⁾	Total (\$) ⁽⁵⁾
Mark Zuckerberg	2018	1	-	-	22,554,542 ⁽⁴⁾	22,554,543
CEO	2017	1	-	-	9,101,965 ⁽⁴⁾	9,101,966
	2016	1	-	-	6,015,431 ⁽⁴⁾	6,015,432
Sheryl K. Sandberg	2018	843,077	638,310	18,426,523	3,823,508 ⁽⁵⁾	23,728,418
COO	2017	795,769	640,378	21,072,431	2,687,643 ⁽⁵⁾	25,196,221
	2016	738,077	1,293,635	19,908,426	2,609,319 ⁽⁵⁾	24,549,457
David M. Wehner	2018	753,846	499,494	18,423,523	9,250	19,686,113
CFO	2017	711,539	633,317	21,072,431	9,000	22,426,287
	2016	662,692	940,421	14,931,596	9,566	16,544,275
Christopher K. Cox ⁽⁶⁾	2018	753,846	499,494	18,423,523	9,250	19,686,113
Former CPO	2017	711,539	567,404	21,072,431	9,000	22,360,374
	2016	658,846	933,209	14,931,596	9,538	16,533,189
Mike Schroepfer	2018	753,846	570,744	18,423,523	9,250	19,757,363
CTO	2017	711,539	633,317	21,072,431	9,000	22,426,287
	2016	658,846	859,356	14,931,596	9,377	16,459,175

Other compensation for the CEO and COO include costs for personal security of the individuals as well as security for the CEO's family and residences. It also includes cost related to personal usage of private aircraft.

- The CEO, Mark Zuckerberg being such a public and well-known figure has probably been the reason for the increased costs of his private security. The fact that he does earn only a base salary of \$1 and no other compensation, either cash or stock-based, is also a good indicator. The co-founders of Google have the same salary but they further do not take any other expenses or compensation from the company at all.
- The COO Sheryl Sandberg on the other hand has a significant base salary as well as both cash as well as stock-based compensation along with the extra expenses for her private security and the use of private aircraft.
- Facebook have the highest security and private aircraft usage costs among their peers by a large margin.
- Also, with the current string of scandals that have plagued FB, there are questions about the performance of the management and whether Zuckerberg has too much power with the controlling interest he has in the company along with being the CEO as well as the Chairman of the Board. With no criteria provided for the performance evaluations of the management, we cannot be sure if the remunerations are fair, especially for the COO.

Growth in Shares Outstanding

Diluted shares outstanding grew 2.93% from 2009 (2,201.27 million) to 2018 (2,854 million).

BALANCE SHEET

ASSETS

What percentage of total assets are intangible assets?

TABLE 5. INTANGIBLE ASSETS AS A PORTION OF TOTAL ASSETS.

Company	FY18	FY17	FY16
Facebook	20%	24%	32%
Alphabet	9%	10%	21%
Amazon	11%	13%	5%
Twitter	13%	17%	19%

Source: Factset.

Table 5 above shows Facebook as having the highest percentage of intangible assets as a portion of total assets compared to competitors and the peer. This is a result of its acquisitions.

What are the environmental provisions and are they sufficient versus the company's historical costs and those of its peers?

No data regarding any such provisions provided.

Do notes to the balance sheet recognise environmental risks to physical assets?

No.

Do notes to the balance sheet or management discussion recognise ESG risks to reputation?

Yes, recognised in Risk Factors in the annual report.

What percentage of total assets are intangible assets?

- Intangible assets are approx. 20% of Total assets.
- Not including Goodwill is 1%.

How strong is the company brand?

- As a brand, Facebook is one of the most well-known names in the world and along with peers such as Google, makes up the bulk of the internet in use today.
- Acquisitions of most other upcoming social media such as WhatsApp and Instagram have also promoted the FB brand and made sure that there are no true competitors to Facebook in the social media market.

What is the strength of customer satisfaction and loyalty?

Customer loyalty is waning with the number of data privacy and leaks scandals Facebook has had. There could be a social revolt with users actively avoiding FB if this trend continues.

Does the company have pricing power?

- Facebook is and has been a unique platform in the sense that the amount of data it can collect on individuals that could help with targeted advertising is immense and uniquely detailed in a way that cannot be replicated by any other platform. So the service it provides to advertisers is almost one-of-a-kind and would give them huge pricing power. The costs of ads on Facebook as well as ad impressions have been increasing over the last few years and look like they could keep improving, which clearly showcases pricing power.
- The long string of data privacy problems Facebook has been having along with recent scandals may lead to stricter data privacy policies being imposed on Facebook by governments or due to social pressure, which would decrease the value of the

ads to advertisers and could lead to a decrease in Facebook's pricing power.

How are employees incentivised and what is the degree of engagement and staff loyalty?

- Employees are provided with a range of benefits including health/dental insurance, paid leave for new parents, adoption and surrogacy assistance, competitive retirement plans, life insurance, survivor support, relocation packages for new hires, generous vacation days and paid cell phone.
- Employee bonuses were based on factors like user growth, increased sharing by users and improvements in product quality. Recently a social factor was added to the calculation as well. These social goals include "building new experiences that improve people's lives today, supporting businesses that rely on FB services and better communication about the company and its role in the world" (*Lev-Ram, 2019*). <http://fortune.com/2019/02/05/facebook-bonus-social-issues/>
- Facebook has always proclaimed that all its offices are built with the social benefit of its employees and the surrounding communities in mind. The COO has a mantra of "authentic self" which supposedly encourages employees to be themselves and to always be open and direct about any problems or issues they have in the workplace.
- Former employees however disagree. There have been dozens of former FB employees who have come forward anonymously to criticise the work culture at FB. They describe a top-down approach where major decisions are made by company leadership and employees are discouraged from voicing any dissent.
- Facebook's 'stack-ranking' employee performance evaluation system has also been a target of criticism. This system requires employees to get reviews from approx. five of their peers twice a year. This peer review system creates pressure on employees to always be happy and forge friendships so as to get positive reviews. It has led multiple former employees to call the work culture as "cult-like" (*Rodriguez, 2019*).

What is the structure (relevant committees) and diversity of the non-executive board?

- Facebook is a controlled company (CEO Zuckerberg holds controlling interest in the company), therefore they do not need to comply with SEC regulations regarding independent committees for compensation and audit & risk. But, the company still has both committees set up with the non-executive board also having the CEO as Chairman as well as the COO on the board.
- Independent board members have annual terms and are nominated at the end of each year at an Annual Meeting by the current board with input from the CEO and COO as well.
- Individual Performance for cash based bonuses as well as equity based compensation are all determined by the Compensation Committee on which the CEO and COO sit as well. No specific criteria is provided on how exactly individual performance is measured by the committee.

How dynamic and committed is executive management?

- Appears that Lacks diversity of input. Zuckerberg has strong opinions about the direction and responsibility of the company and appears to block contradicting thoughts.
- Strong commitment by Zuckerberg and Sandberg however disagreements and long list of those who have quit the company due to lack of alignment show a lack of commitment or agreement leading to disengagement.

Are pension assets being managed by ESG aware practitioners?

Unknown.

LIABILITIES

Are liabilities short or long-term? An ability to negotiate long-term debt agreements can signal a trusted relationship and lender confidence.

- Negligible short-term debt
- No long-term debt

How efficiently is working capital managed?

- DSO has come down from 51.4 days in 2013 to 49.59 days in 2018.
- DSP has come down from 103 days in 2013 to 90 days in 2018.

How reliable are relationships with suppliers and customers?

- Current environment of data privacy and content quality is jeopardising these relationships. What have traditionally been quite reliable advertisers and content generators may now be reassessing their relationship with FB.
- Supplies - Advertising agencies now reassessing their FB relationship
- Customers - Changing the way they use FB. Trend away from FB and to Instagram.

What is the extent of off-balance sheet commitments?

Limited and contained risks identified.

Is excessive leverage eroding stakeholder trust and raising the cost of equity?

No.

Do debt covenants specify any aspects of ESG risk management?

Not relevant. Insignificant debt.

CASH FLOW STATEMENT

Cash Flow From Operations**TABLE 6. CASH FLOW FROM OPERATIONS (CFFO) AND NET INCOME.**

Metric	FY18	FY17	FY16	FY15
CFFO	29,274	24,216	16,108	8,599
Net Income	22,111	15,920	10,188	3,669

Source: Factset.

Table 6 above displays CFFO and Net Income. If CFFO is significantly less than net income the income statement may have been manipulated. This is a measure of earnings quality. Here we can see CFFO above Net Income in each year.

Are operating expenses being reduced by investment in new resource-efficient technology?

Yes.

- Major investments in Artificial Intelligence (AI) to reduce requirement for manual identification of unsavoury content, a current significant expense.

Is capital expenditure covering asset depreciation?

Yes.

Does capex investment in operational and resource efficiency today reduce the need for capex in the future and therefore point towards improvements in free cash flows?

Yes.

Does due diligence on acquisition targets cover long-term ESG risks? Is there a risk that inadequate ESG due diligence results in greater than expected environmental liabilities post-acquisition?

Yes - Acquisitions to date have ameliorated current and long-term ESG risks.

Are there favourable long-term debt facilities that indicate a good relationship with lenders? What are the available borrowing costs? Could the company qualify for a lower rate if it improved its management of ESG risks, specifically in the case of project finance?

Not relevant.

Valuation

Looking over the factors highlighted through the analysis above, how should the cash-flow projections be altered or what margin of safety do we require to be comfortable to make a purchase?

In light of the significant ESG factors identified above we are not comfortable in projecting future cash flows for Facebook.

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