



Facebook’s Unsuspected Growth Driver: Virtual Reality



Over the last two years, Facebook has set the stage for Oculus Rift to become the go-to VR headset for gamers. They are about to take a sizeable bite out of the video games market, and to gain a stepping stone for future growth.

February 2, 2016

Executive Summary

Facebook’s social media platform is a mature product in the consumer mindset. The company’s revenue and profit growth is coming from continued efforts to monetize it through advertising.

Virtual Reality is a new business segment, with the potential to disrupt the way people, and the market, are perceiving the company. For the last two years, through PR and media coverage, Facebook has created a demand and a market for a product that hasn’t even been released yet. Oculus Rift has the backing of the developer community, and will be the cornerstone of a new market for VR video games.

Shrewd communication campaigns have established Oculus Rift as the most widely covered product in the media, ahead of its Sony and HTC rivals. Its potential impact on Facebook’s bottom line has been underestimated.

The adoption of VR by the video games community is an opportunity for Facebook to grab a share of a \$100 billion-a-year market. By replicating Apple’s AppStore business model for the new headset, Facebook will diversify its revenues away from ads, and gain a stepping stone for future growth.

Analysis

The Facebook social media platform is a mature product

The Facebook social media platform is a mature product in the mind of the consumer. Its share of media coverage has been steady since 2011, as Facebook has been mentioned in one way or another in 6.4% of all published articles in our database, month after month. Their user base since 2011 has been growing by default, simply because the law of diffusion of innovation takes time. Everybody knows about Facebook already, they just happen to cave in and create an account, because of social pressure.

Its revenue growth is coming from this natural user base expansion, and from increasing monetization efforts through advertising (**Charts 1 & 2**). Facebook has built an unique ecosystem for online advertising, where users are tracked and profiled by design. It is much better positioned to measure the quality of traffic that the ads are receiving, and will benefit from the coming industry shakedown (see our piece on online advertising).

Chart 1: Facebook’s advertising revenue per user in the US, Canada & Europe (source: 10-K filing for FY2015)

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Chart 2: Facebook's advertising revenue per user in the US, Canada & Europe (source: 10-K filing for FY2015)

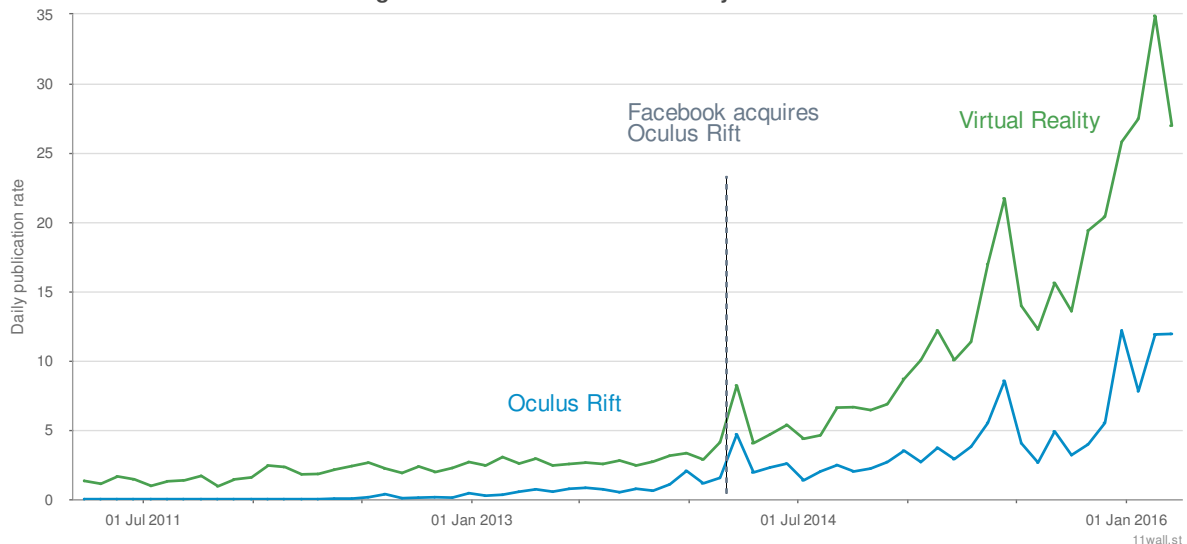
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The 127% increase in average revenue per user has translated into a doubling of the stock price over the period. The stock is valued dearly, around 50x P/E (if we take its 2015 Q4 earnings as point of reference, to account for Q/Q earnings growth). Its valuation on a P/E basis hasn't changed much over the last two years, and as long as its revenues keep growing at the same pace, we don't expect it to come down substantially. We are actually expecting Facebook to grab a bigger share of the online advertising market, as concerns about ad quality and ad fraud materialize (again, see our piece on online advertising).

Facebook has done its homework, getting ready for its incursion in Virtual Reality, and it will change the way the market perceives the whole company

A huge boost to the company's bottom line will come from a segment that has nothing to do with advertising, or its social media platform. Media coverage of virtual reality (VR) has grown tenfold over the last two years, and media coverage of Oculus Rift has grown seven times (**Chart 3**), currently capturing roughly half of all articles about VR. Consumer awareness for both VR and Facebook's headset is increasing rapidly, even before the product is actually released to the public.

Chart 3: Long-term news flow for "virtual reality" and "Oculus Rift"

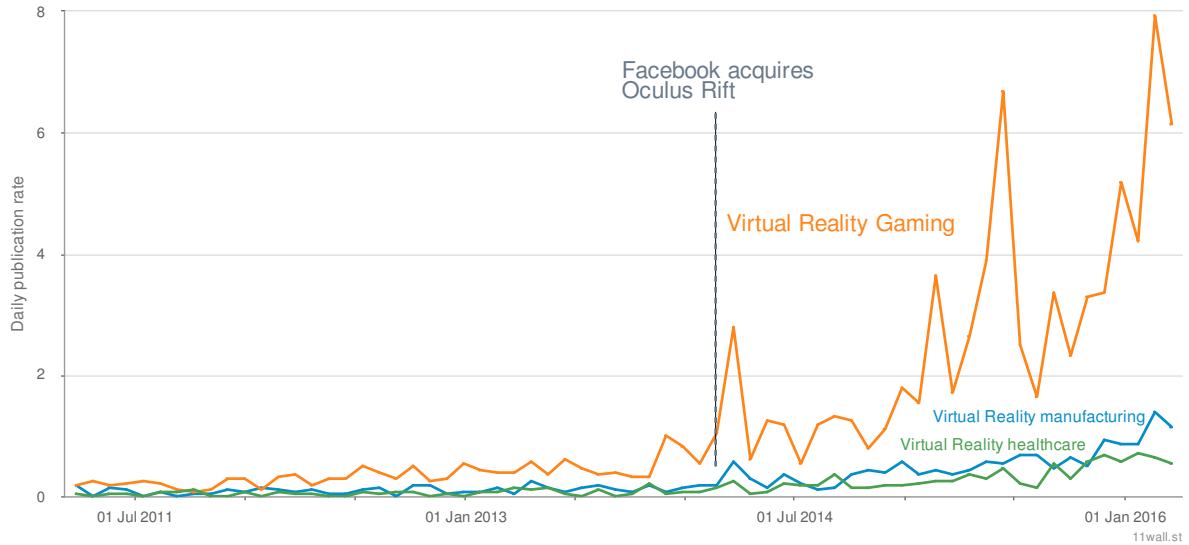


Media coverage and public interest for VR started picking up right after Facebook's acquisition of Oculus Rift back in 2014. Whether it's just good timing, or a concerted effort by Facebook to build up consumer awareness for its product, is unclear. The only thing that matters right now is that Facebook managed to create an interest and a market for its product even before it's released.

They did so by focusing not only on the product, but on the whole ecosystem. VR has been traditionally considered as a niche B2B market, used in industrial design or medical environments. This has suddenly changed over the last year, and a new market is being created for consumers: video games (**Chart 4**). Oculus Rift is very friendly to third-party developers, and prototypes of its headset along with developer kits have been available for a long time, to let app developers get ready for the official product launch.



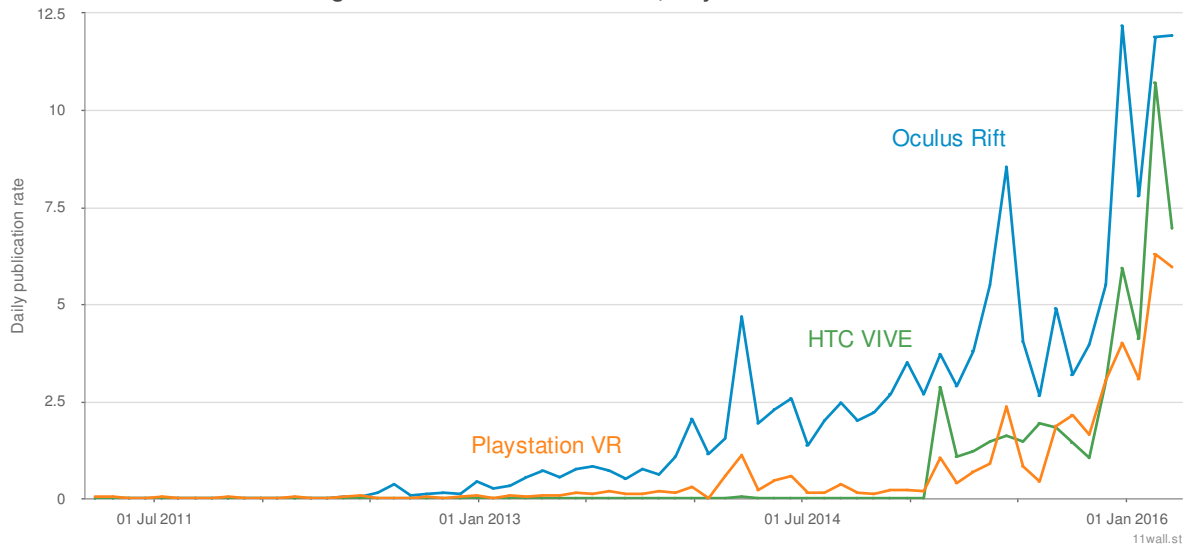
Chart 4: Long-term news flow for VR in contexts of manufacturing, healthcare and video games



Oculus Rift is already perceived as the reference for VR headsets by consumers, but misunderstood and underestimated by the market

In the consumer mindset, Oculus Rift is the headset that's been around the longest among the three big players (along with HTC and Sony), and is predominant in media coverage (**Chart 5**). The market is theirs to be taken, as Oculus Rift's PR has been just so much more powerful and effective.

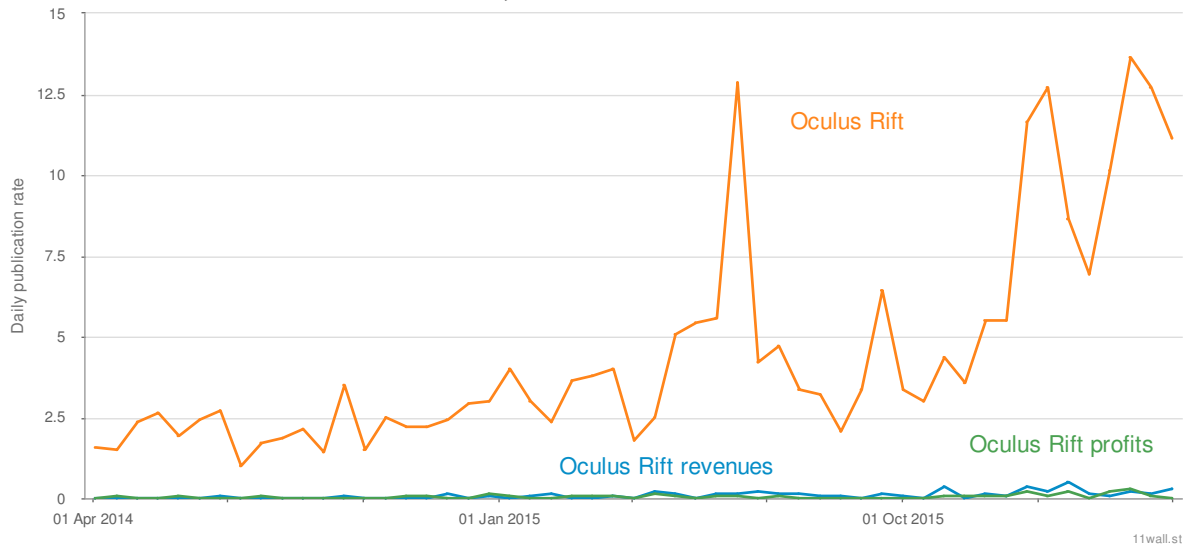
Chart 5: Long-term news flow for Oculus Rift, Playstation VR and HTC VIVE



Oculus Rift is mentioned 21 times in Facebook's 10-K SEC filing for FY 2015, versus 13 for Messenger, 13 for WhatsApp, and 10 for Instagram. It's clearly a big bet on the future. However, news flow hasn't focused on Oculus Rift's impact on Facebook's revenues and profits (**Chart 6**). The lack of enthusiasm from the financial perspective might be due to the fact that the product will sell at cost (no profits on equipment), and because Facebook has been burned before by the freemium business model (failure to monetize WhatsApp, after spending \$20B to acquire it).



Chart 6: News flow for Oculus Rift, and Oculus Rift in the context of financial metrics



Oculus Rift is set to be a stepping stone for Facebook’s growth as a business, and a formidable catalyst for its share price

At 50x P/E, every additional \$65 million in earnings is worth one percentage point in Facebook’s share price. Juniper Research anticipates 30 million VR headsets will be sold by 2020. As Facebook grabs a share of this market, its stock will soar on the new source of revenue and earnings (much like Amazon beefed up its traditional revenue line with Amazon Web Services).

Even if Facebook is not making money on the headset, they are engaging customers who can afford \$600+ for a piece of entertainment equipment. Customers will be committed to pay for additional features and apps, very unlike for WhatsApp users. This is also a crucial pivot in terms of strategy for Facebook, away from ads and into consumer electronics.

Quite conveniently, \$600 is also approximately the price tag for an iPhone. Facebook’s attempt to launch its own phone died in 2013, a few months before its Oculus Rift acquisition. This was back in the days when Amazon was trying to get into the smartphone market as well (Jeff Bezos gave up on the idea in mid-2014). Whether by luck or foresight, Mark Zuckerberg has executed the shift perfectly.

The worldwide video games market grew past \$90 billion in 2015 (source: Newzoo). As customers switch to the new VR environment, it creates an opportunity for Oculus Rift to step in and grab a share of the market away from established old-timers. With an iTunes AppStore - like business model that rakes in 30% of third-party sales, every percentage of video games’ market share translates into \$300 million in revenue, and a 5% increase in Facebook’s share price at 50 P/E valuation levels.

Roadmap & Playbook

Facebook's share price has grown in line with its earnings from advertising, which, along with the lack of media coverage of Oculus Rift's impact on the company's finances, leads us to believe that the VR segment is not priced in the company's valuation.

Honestly, it's all guesstimates at this point, but the stage is set for Oculus Rift to be a success. A repricing of market expectations of future Facebook's earnings, with an anticipated 5% market share in worldwide video game sales, gives the stock 25% of upside. More importantly, the VR segment will increase Facebook's revenue growth rate, and will probably lead to a repricing of the stock into the 60-70s in terms of P/E. All in, a successful expansion into VR could add up to 50% to the current share price, for a target of \$160 over the next two years.

Probability	Event	Early signs
60%	VR grows, Oculus Rift gains market share (> 30%), and Facebook monetizes it through apps and subscription services	<ul style="list-style-type: none"> • Strong sales • Oculus Rift starts working with Apple • Media coverage of VR continues growing • Good quality, successful third-party apps • Involvement of blue chip companies in the app ecosystem
10%	VR grows and Oculus Rift gains market share (>30%), but Facebook fails at monetizing it	
10%	VR grows as a whole, but Oculus Rift fails to get significant market share	<ul style="list-style-type: none"> • Media coverage focuses on high-quality, established franchises (Sony & Valve benefit, not Facebook) • Little development of third party apps
40%	VR headsets fail to sell, remain a niche product	<ul style="list-style-type: none"> • Media coverage fades • Reports of bugs, disappointing user experience • Little development of third party apps • No involvement of blue chip companies in the app ecosystem

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