Google or Facebook ?, Part I

There was a time when investors were asking: Coca-Cola or Pepsi? Although I have not heard that in a long time, today I keep hearing instead: "Google or Facebook?" Which of these two companies is a better investment? Let's try to find an answer. (Even though Google is not actually named Google anymore, by the way, no one calls it anything else.)

The key to understanding the two companies is to be clear about what is the main source of their revenue. This year, Google will achieve revenues of approximately USD 108.5 billion. Of this, USD 94.3 billion will be revenues from advertising. Facebook is anticipating total revenues of USD 39.8 billion this year, of which USD 39.2 billion will be from advertising. Advertising revenues therefore constitute 87% of Google's total revenues and 98% of Facebook's. This means that as opposed to the very widely perceived idea that Google and Facebook are technology or software companies, they are in fact advertising companies. This is why the size, growth, and dynamics of the advertising market are decisive for their future growth.

Fortunately, we know quite a lot about that because advertising is an established and well-mapped sector. Global advertising expenditures in 2016 were about USD 580 billion. Over the long term, this number is growing relatively slowly. That rate corresponds very roughly with nominal growth of the world economy, and it also shows strong cyclicality in periods of recession. This year, total advertising expenses could range around USD 600 billion. As stated above, Google and Facebook together will this year have advertising revenues of USD 133.5 billion and a 22.2% share in the world advertising market. Their share in internet advertising is even greater, at 58.5% of an estimated USD 228 billion.

How high can Google's and Facebook's advertising revenues grow? Let's assume that the growth rate in their advertising revenues over the recent years will continue and that they will double over the next 3 years. In 2020, these would collectively be USD 267 billion, or 39.5% of the global market, the size of which could be USD 675 billion in 2020 (at 4% annual growth). If Google and Facebook were to hold a 60% combined share in internet advertising, then global internet advertising would have to increase to USD 445 billion and its share to 66% from the current 39%.

This scenario cannot be excluded, but it would be very difficult to achieve for several reasons. First, the growth dynamics for Google and Facebook users has slowed substantially. Facebook claims to have 2 billion users. Let's think about that for a moment. The total number of people on the planet with access to the internet is estimated at 3.5 billion. When we subtract states where FB is banned, such as China and Iran, the number of potential FB users drops to 2.75 billion. Then there are countries such as Russia where a domestic alternative to FB is dominant. This further reduces the potential to 2.6 billion. Of course, we cannot expect that 100% of people with internet access will use FB. Even in the US, this proportion does not exceed 75%. Even in a case that all other countries reached the same penetration (which is very improbable), the global number of FB users would be 1.95 billion. According to its own statements, FB claims to have exceeded that number. So, even if we gloss over the question as to just how reliable is that claim, Facebook is simply running out of people.

Google is in a similar situation. Its reach depends upon the spread of the internet (no radical leaps can be expected) and the availability of Google's services. That availability is frequently limited in various countries, and it is also noteworthy that Google is facing strong local competition in many places around the world. The Czech Republic is a beautiful example of that, and Google itself mentions Seznam.cz in its annual report as an important local competitor.

Another thing that will limit the growth of Google and Facebook is the effectiveness of their advertising. That depends on two things. First, how much advertising it is even possible to press into the users, and second, what advantage it will create for those who are paying for it. The average FB user has a little over 300 friends. This means that FB can place several hundred posts daily from his or her friends and other relevant sources into his or her feed. To this number, we must add the paid posts FB must show to users based on the advertising sold. It is clear that for each user there exists a maximum quantity of posts that the user is able to perceive. As that level is approached or even exceeded, the advertising becomes ineffective. Google has the same problem, it just looks different on its website.

Doubts have been increasing as to the effectiveness of internet advertising. Especially large companies such as Unilever, Procter & Gamble, and ABInBev, which have advertising budgets measured in the billions of dollars, are finding out how inefficient internet advertising actually is. Here are the words of Marc Pritchard, brand officer at Procter & Gamble: "In our quest to do dynamic, real-time marketing in the digital age, we were producing thousands of ads, posts and tweets because we thought the best way to cut through the clutter was to create more ads. People are voting with their fingertips: they're saying that too much of our advertising is uninteresting, uninspiring, and therefore ineffective. The media supply chain is so murky and non-transparent, and so wasteful and even fraudulent — we're wasting huge amounts of money."

The sister of a friend of mine works in advertising for Danone in New York and indirectly says the same thing: "When we put an ad on TV, we reach the viewer when he or she is relaxed and perceptive, and we always see the impact on our revenues immediately. When we put an ad on the internet, we see nothing."

Warren Buffett frequently says that even among bosses of large companies there sometimes occurs a kind of "group think" whereby one company copies another, with the main motivation being not to remain on the side lines. Perhaps we are witnessing something similar in internet advertising. Its effectiveness is not clear, and it is possible that this fact will be reflected also in its future growth if advertisers begin to look at it more sceptically.

The following explanation is important for investors. Even if the share of internet advertising grows rapidly and Google and Facebook hold onto their dominant position, sooner or later they will hit the limitation inherent to the advertising market itself. That market will not grow any faster than it otherwise would just so that Google and Facebook can continue their rapid growth. The advertising market will keep growing at its steady rate of around 4% per year in good times and will slow cyclically or even shrink in times of recession. Google and Facebook must eventually demonstrate the same characteristics. They will be slowly growing, cyclical companies. According to the current valuations of the two companies, the market is not yet anticipating that fact. Most investors either do not think about these limitations or believe that this state would occur only far into the future and that there is no need to think about it now.

That is a rather risky game, because the market can change its view of things literally overnight. Once the market stops seeing Google and Facebook as fast-growing companies without visible limitations and views them instead as slowly growing and cyclical businesses, then their valuations will decrease substantially. If you try to calculate how big the global advertising market would have to be, how large the share of internet advertising within it, and the share of Google and Facebook within that, you will find that even an ideal combination of these three factors may not be sufficient to justify the current market capitalizations of the two companies – and that is especially true for FB.

I think we can find a lot of better investments, but if I had to choose just between these two companies, I would choose Google. The only way to get out of the advertising market straightjacket is to develop another business with a comparable impact on profit. Google is closer to doing that. Its business is more robust and more diversified than is that of FB. This is no simple task, however. History shows that developing a strong and profitable “Act 2” is very difficult. Microsoft has never had a product financially comparable to Windows and Office. Apple has nothing that could make as much money as iPhone. And that is the case even though both those companies had and still have practically unlimited resources to come up with something. There are plenty of similar examples. This is one of the reasons why it would be very difficult for Google and Facebook to come with something the profitability of which could compete with that of their current businesses.

Invest with care!

Daniel Gladiš, 15 October 2017

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