HAMILTON POINT
Investment Advisors, LLC
CHAPEL HILL, NC

ANDREW C. BURNS
President/Chief Investment Officer

RICHARD S. WOODS, CFA
Chief Operating Officer

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Facebook and Farmers

*A recent Wall Street Journal article reported on the growth of mobile messaging apps that have "attracted the attention of Internet giants like **Facebook Inc.,** which in February said it would pay $19 billion for WhatsApp[1]." In our minds, that quote would more accurately have ended, "…pay WhatsApp shareholders $4 billion in cash and $15 billion of Facebook stock." While less succinct, there is a critical point to be made in examining this transaction and what it may say about Facebook's view of its own stock value.*

It is also instructive with regard to what we believe are properly valued companies that are buying back their shares and paying cash for acquisitions rather than building faux empires by casually handing out company shares like candy.

Read the Small Print

As a reminder, the writers of this Newsletter share a common career bond in that we both worked as investment bankers prior to becoming money managers. Similar to real estate agents, investment bankers insert themselves between motivated buyers/sellers and advise their client as to the value of a transaction. In discussing valuation expectations, the prospective seller of a company may say something like, "I turned down $50 million three years ago." In response—and we have seen this—the banker may then ask how much of the $50 million offer was in the form of AFC? The puzzled seller naturally asks for clarification and is told that AFC stands for Actual Friggin' Cash, and not some spuriously valued security.

This point deserves exploring before we talk about recent megadeals and whether they are completed using mostly cash. By way of illustration, imagine a farmer who owns 100 acres of land that he thinks is worth $1,000,000 or $10,000 an acre. Suppose a city-slicker with information about a potential foreign company moving to town buys ten acres from the farmer for $300,000 in cash; or $30,000 an acre. As a result, the farmer may think his other 90 acres are worth $2.7 million if he values his remaining acreage at the most recently traded price of $30,000. Now, what if the farmer pined for a new John Deere combine selling for $300,000 and offered the dealership $30,000 in cash and 9 acres of land worth $270,000 ($30,000/acre x 9= $270,000)? Well, the dealership will likely turn him down since so little of the offer was *AFC* and the value of the land was suspect.

Get While the Getting is Good

Our farming example demonstrates generally how public companies like Facebook consider acquisitions. In Facebook's case, they have 2.6 billion shares which compare to the farmer's 100 acres. In fact, typically 2-3% of Facebook's shares are sold and purchased every business day [2]—volume that compares to the farmer selling 10% of his acres. In Facebook's case, they were desirous of acquiring WhatsApp, rather than a combine. Incidentally, WhatsApp is a text messaging company with a reported 400 million users at the end of 2013. They give away their service for a year and then charge $0.99 per year thereafter, so 2014 revenue of $400 million seems a reasonable projection, even though 2013 revenues are estimated to be closer to $25 million[3].

1) Pfanner, Eric. "Messaging App Line Gains Traction Abroad." *Wall Street Journal*. May 21, 2014.
2) Key Statistics, Yahoo Finance. May 30, 2014.
3) Magister, Holly. "WhatsApp $19B Secret Formula." *Forbes*. February 21, 2014.

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WhatsApp's $19 billion purchase price represents 47.5 times estimated revenues and compares quite unfavorably to the 5.1 multiple of estimated 2014 revenues where all of **Google** currently trades[2]. While WhatsApp sellers *only* get $4 billion in cash—or AFC—that is still a hefty 10x projected revenue multiple. The important point here is that Facebook would offer that much cash up front *plus* another $15 billion in their shares. It may mean that Facebook is both acting with some desperation *and* holding the view that now is a good time to try to buy stuff (combines) with their overpriced securities ($30,000/acre).

It could be wise for a CEO to use stock believed to be overvalued in exchange for something of value (like the farmer using overvalued land for a combine). The problem occurs when it becomes justification for overpaying for an asset (e.g. if the farmer paid $1,000,000 in overvalued land for a combine other farmers would only pay $300,000 AFC for). Taking it a step further, even if the CEO believes it advisable to pay a premium price for an acquisition with stock, why would an investor want to own stock in a company that the CEO is implicitly indicating may be overvalued? If savvy CEOs trade assets that are overvalued, why would other investors do the opposite by buying that company's stock?

Apple's Sauce

So how does this relate to Hamilton Point's investment philosophy? Quite simply, we want to own shares that company executives think are *inexpensive* and are not so eager to dole out. Specifically, we like blue chip companies that are opportunistically buying back their shares and, when they decide to buy a company, use predominately cash. For comparison, **Apple** recently agreed to buy Beats for $3.0 billion, or 2.3 times revenue, using $2.6 billion of AFC, with the remaining $400 million coming in the form of restricted stock based on Beats meeting long-term performance incentives[4]. As a reality check, across our entire Global Core strategy, 22 companies have disclosed the purchase details of material acquisitions in the past year, and all but one deal, which was closer to a "merger of equals," was paid for with predominately with cash. Likewise, 27 Global Core companies thought that their shares were priced reasonably enough that they were buying shares back last year (instead of getting rid of them!)[5].

You might say that one role we play at Hamilton Point is to act like the John Deere dealer who turned down the farmer's offer of cash and acreage. We treat our clients' investment capital as precious, and we will not be swapping it for stock in fashionable companies whose stock valuations are, in our view, well ahead of the business opportunity at hand.

We have devoted past newsletters to making the argument that valuation matters by pointing out simple facts like even though Mercedes makes great cars, most would not pay $1 million for one; the same logic applies to investors buying stocks and CEOs making acquisitions. Overpaying for "nice" things can stroke the ego in the short-run, but we do not believe it leads to good long-term returns for individuals or companies. Instead, we choose to own companies managing their capital judiciously and will not be "friending" those companies completing multibillion dollar acquisitions using little AFC and lots of pieces of paper in the form of stock certificates.

Andrew C. Burns
ABurns@HamiltonPoint.com

Richard S. Woods, CFA
RWoods@HamiltonPoint.com

Hamilton Point Investment Advisors, LLC is an independent and independent-minded wealth advisory firm. Please contact us for a complimentary review of your portfolio. In addition, visitors to the firm's website, www.HamiltonPoint.com, can read past investment newsletters.

4) Karp, Hannah. "Apple Paying Less Than $500 Million for Beats Music Streaming Service." *Wall Street Journal*. May 30, 2014.
5) Bloomberg Terminal, Corporate Actions Reporting as of June 2, 2014; based on stocks held in Global Core Strategy as of May 30, 2014.