Small-Cap Takeaways From Facebook's Year of Falling Face-First

By Adam J. Epstein

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By most measures, 2018 was a tough year for Facebook. In addition to losing nearly a quarter of its stock market value between June and December, Facebook was a constant fixture in the news for all the wrong reasons, a dynamic that rapidly chipped away at investor trust. For founders and boards of high-growth companies, there are three key lessons to be learned from the social media giant's travails.

Ensure messenger credibility. Aside from operating fundamentals, erosion of trust with investors can happen when the company's primary "messenger" is increasingly viewed as untrustworthy. In public companies, the messenger is usually the CEO.

For reasons best left to communication and sociology experts, some CEOs come across as credible and trustworthy, and some don't. It became clear in 2018 that Facebook CEO Mark Zuckerberg has a credibility problem.

Though the board of Facebook is constrained from doing a whole lot given the company's ownership structure, the moral of the story is that boards need to act quickly when the trustworthiness quotient of the CEO is deteriorating.

There are three fundamental choices: 1) require the CEO to undertake immersive communication training; 2) if the CEO won't do that, or if the training isn't effective, then the company should appoint another officer or director as the company's spokesperson; and/or 3) terminate the CEO. When boards become aware that the CEO has a material credibility problem, inaction is not an option.

Drop the other shoe. Another principal way that companies erode trust with investors is when bad news comes out in dribs and drabs, typically after public attestations to the contrary. In another era, the "deflect, delay, and deny" strategy had a chance of working because information wasn't a mouse-click away. That communication methodology is challenging to effectuate in today's marketplace, and the result is always the same: investors get trained to wait for the other shoe to drop.

From a buy-side perspective, bad news always needs to be delivered in a timely, transparent, and thorough manner. In 2018, Facebook broke this rule more than once, and it's going to be arduous for Zuckerberg and Chief Operating Officer Sheryl Sandberg to recover their stature with investors, US legislators and regulators, and foreign governments.

There is never a good time to deliver bad news, but deflecting, delaying, and denying is always going to make matters worse.

Sunset certain share structures. It's impossible to discuss Facebook without alluding to its share structure. Zuckerberg owns nearly 60 percent of the voting shares of the company, predominantly by virtue of a special class of stock that gets 10 votes per share.

As many experts have noted, including Commissioner Robert L. Jackson Jr. of the US Securities and Exchange Commission, dual class structures can be beneficial for a period of time because they allow visionary entrepreneurs to build for the longer term without fear of losing their jobs due to pressure from investors with a shorter-term focus. But, as noted by the Council of Institutional Investors (CII), the gains associated with dual class structures tend to wane over time and become an impediment to shareholder value creation. CII and others have argued that dual class structures should take on a "one share, one vote" structure after a maximum of seven years following an initial public offering (IPO).

Memo to founders: You hold all of your employees accountable on a daily basis because successful companies are meritocracies. Seven years post-IPO is a sufficient period of time for you to be exempted from the meritocracy you built.

Interestingly, May 18, 2019, will mark seven years since Facebook's IPO—and an increasing number of shareholders believe the company could benefit from different leadership.