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To FB, or not to FB

As I write, Facebook has made its much spoken-about debut on Nasdaq and after some swings in value, is making 7% return in the opening few hours for the lucky ones who laid their hands on the stock before it went public. There are stories on every website about how much money which owner is making, who owns how much of Facebook (I recently discovered that there is an entire website dedicated to who the owners of Facebook are…), how big the FB IPO is etc. People who can't tell a mutual fund from a fixed deposit are posting on their Facebook accounts that Facebook is going "public". All this hoopla made me think if it makes sense to invest in the company's stock if one looked at it from the perspective of the long term investor. (and by 'long term' I do NOT mean 6 months). I have been thinking about doing this for some time now, but being caught up in one thing or another, I could not do much about it.

So, let me just begin by asking the most basic of questions: why do you buy a stock? The answer, of course, is: to become a part owner of a company and thereby to become a partner in the profits of the company. Indeed, in normal cases, we pay to buy a stock because throughout the existence of the company, this stock will earn profits for us. So the question of whether to invest in a particular company or not depends on how much the company will earn for me and how much do I have to pay for it. There is no point buying a company's stock for 100 rupees, if it earns only 10 rupees throughout its lifetime.

Now, the market is valuing FB at $110 billion (bn). (about 7% of India's GDP!) To put that in perspective, the world's most valuable company, Apple Inc is valued at around $500 bn and India's most valuable company, TCS (at today's closing prices, anyhow) is valued at just over $40bn. To put this in another perspective, when India was facing a slowdown in 2008, our Government announced a stimulus package to revive the ENTIRE economy which was estimated at that time to be… hold your breath… $ 6 bn. FB is worth 18 times that!

So, the market is giving a lot of value to the business activities of FB, which means it perceives that FB will be able to earn a lot for its investors. Compared to its sales and profits, FB does not appear cheap on the first look. The company is trading at a Price/Earnings ratio of over 67x. Comparatively, other leading Technology stocks like Google and Apple are trading at Price/Earnings ratios of 19x and 13x, respectively (all based on estimated figures). It is clear that to justify its valuations, FB will have to substantially increase its profits. And soon. For instance, to ensure that an investor putting his money right now gets a return of 15% over the next five years, FB will have to increase its value to over $ 220 bn. Assuming that the market at that point values it at the same level as it is valuing Google today (i.e. a P/E of 19), FB's earnings will have to be over $ 11 bn. In other words, FB will have to crank up its earnings by nearly 50% every year for the next 5 years, in order that an investor buying its stock today ONLY JUST gets rewarded adequately. It is a tough ask, but companies in their early growth phase have been known to exhibit even higher growths.

Before we answer that question, however, first let's see how FB generates its income? 85% of its revenues last year came from advertising. Although FB is looking at a lot of options to increase its revenue streams, advertising seems the most likely to form the 'bedrock' of the revenues for at least a few years. How do these guys increase revenues? It could be by increasing advertisement rates, which is already being tried and has a limitation because of the supply and demand for ad space. FB could increase the volume of advertisements, but that would be tricky to achieve without adversely affecting the ad rates, thus negating the ad volumes increase to some extent. The impact of increase in advertisements, however, could be trickier than only that. Remember the movie, *The Social Network*? There is one scene in the movie where the character of Mark Zuckerberg says that he has a “cool” asset and he will not do anything to destroy the coolness of it. That is such great business sense, which has worked wonderfully well for FB so far. Can you imagine a FB where ads pop up every time you comment on your friend’s photograph? The challenge before FB would be to increase its ad revenues while keeping its “coolness quotient” intact.

There is another point that I have not understood, being “technologically challenged” myself. And it is this – how effective are ads on FB? While this could be a subject of intense debate, General Motors does not seem to think too highly of them. They recently withdrew their paid ads worth $ 10 million from FB. Even recent studies have found that advertisement click-through rates on FB are half as effective as the rest of the internet. The reasoning given behind this phenomenon is that a typical user goes to FB in search of entertainment and socializing and is therefore is less likely to buy stuff or check out advertisements. Whatever be the reason, this highlights the challenges facing FB in increasing its ad revenues.

It is interesting to see what has been happening to the revenue increases recently. These are the percentage increases in the revenues of FB, compared to the same period last year, for the past 3 quarters: 104%, 55% and 45%. The revenue growth has fallen from 104% to 45%, well below the 50% that we said we needed. More damning is the trend – it has fallen drastically. In fact, compared to the previous quarter, revenues in March 2012 have actually *fallen*. Although this may well be a blip in the overall growth, this could just as easily be the sign of things to come. In yearly terms, FB is expected to increase its revenue by 64% in 2012, which one assumes would only fall in the time to come. Coupled with the paragraph above, these figures put doubts in one’s mind over the ability of the advertisement revenue stream to pull through the company’s growth rate sufficiently (i.e. a minimum of 50%).

And what if the company does manage to do its stuff quite well and manages to show a 50% growth in income over the next 5 years? The investor only *just* makes money. Of course, there is the possibility that the growth rate turns out to be much higher than 50%, or the market values FB’s earnings well above 20x, in which case the investors make a lot of money. But the chances of such a scenario are slim. The question, then, is this – is the risk worth taking? Are the odds in favour of or against the investor? While this is a question that each investor must answer for himself/herself, I am not rushing over to invest any time soon!!