

What to do with 500 Million Friends

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What is Facebook?

If this question was posed to the average person, they would answer, "A social network that allows users to interact with friends and family." If you then asked, "How does Facebook operate as a business?" the same respondent would struggle to provide an appropriate answer. What began as a dorm-room project at Harvard, over six years ago, has snowballed into an anomaly amongst modern day corporations. Founded by Mark Zuckerberg, Facebook has over 500 million members in over 180 countries. As Facebook continues to stun the business world with unprecedented growth, investors are anxious to buy into the company. It is speculated that Facebook will offer an IPO in the near future, making it important for prospective investors to understand the drivers of Facebook's value. With current revenues of over \$1 billion (U.S.), the company has achieved far greater success compared to any other social network. There has been great debate surrounding Facebook's worth as valuations range from \$10 billion to \$30 billion. Much of this debate stems from ambiguity and confusion surrounding Facebook's business model and revenue streams.

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to traditional social media websites, in which companies pay to have users see their advertisements on a cost per click (CPC) or cost per impression (CPM) basis. The main driver of Facebook's value is its newest revenue stream: sales through corporate fan pages. Corporations may submit a fan page for users to 'Like' a brand or product, which initiates a word-of-mouth effect that allows a brand message to grow exponentially.

Facebook began offering apps to members as a method for increasing the amount of time a user spends on the website. The company does not partake in application design; instead, Facebook allows third parties to operate on the site and charges them a 30% commission on app revenue. This practice reduces the risk of unsuccessful applications and development expenditures.

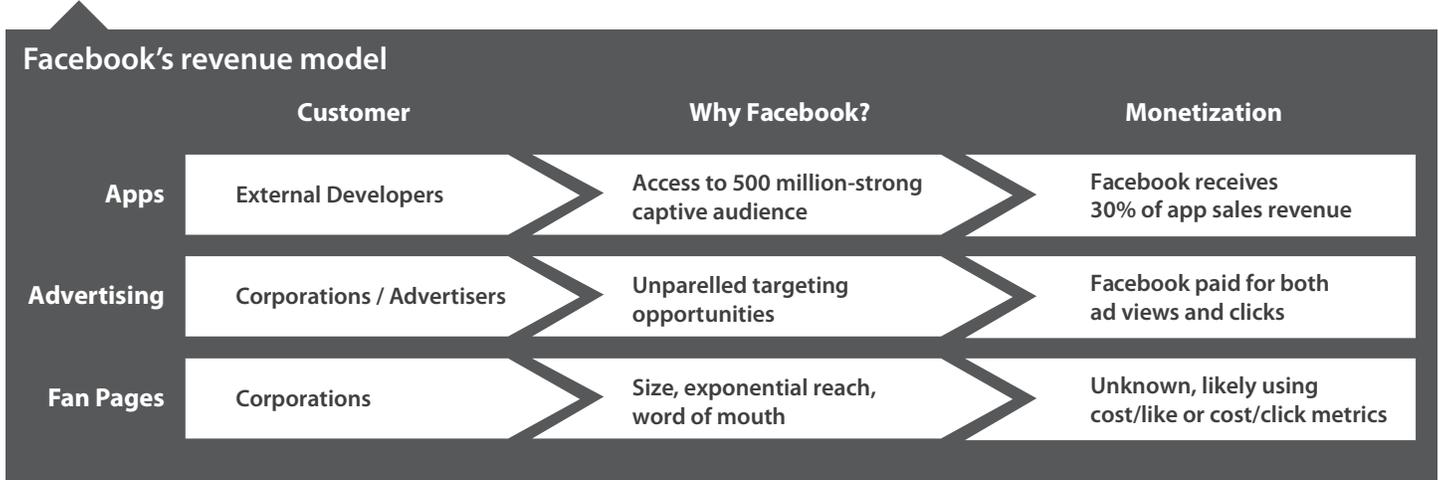
For example, Zynga, a third-party specialist, has launched extremely successful games, including Farmville, Mafia Wars and Cafe World. The massive success of app companies has spurred rapid industry growth, as demonstrated by over 15,000 unique applications currently offered. Facebook maintains the power in these relationships, as developers of

these applications must use Facebook to succeed.

What drives Facebook's value?

Facebook's value is derived from three streams of revenue: online apps, banner ads and corporate fan pages. Applications on Facebook are free for use but encourage users to purchase add-ons to enhance the app experience. Banner ads operate similarly

Facebook's advertising revenues are primarily driven by its ability to provide unmatched flexibility to advertisers. Although corporations use traditional banner ads, Facebook's deep user database creates the ability to advertise only to specific consumer subsets. For example, no other business can instantly identify the reach of an advertisement targeting 22-year-old males in California who enjoy working out, Laguna Beach and Justin Timberlake.



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Further flexibility is provided by offering choices between CPC and CPM and by adjusting prices based on daily demand and supply. However, this revenue stream has plenty of room for improvement. Clients experience a very low clickthrough rate at 0.1%, compared to others such as Google's 10%. Facebook offsets this low clickthrough rate by offering clients an opportunity to improve brand recognition, as 23% of time online is spent on social networks.

Fan page revenues are a more recent addition to Facebook's business model. Initially, these pages were free, but Facebook has recently begun to monetize them. Since Facebook is privately held, the details of such contracts are not publicly available but a number of theories exist as to how corporations are charged. Instead of a set monthly fee, it is more likely that Facebook charges a performance-based fee in addition to a monthly payment. In this model, Facebook could charge based on views, fans, or 'Likes' once a page reaches a certain viewership level.

Corporations stand to gain from fan pages since they use social reinforcement and can expand exponentially. When users 'Like' a brand, their friends are informed of their decision, either on their profile or home pages, creating an 'earned media' effect. Since each 'Like' is shown to multiple users, it can quickly propagate through the huge Facebook community; Nike has 3 million 'Likes', Coca-Cola 20 million

and Starbucks 18 million. Companies can also use their pages to advertise at low cost in an interactive test market. For example, Nike posted a pilot commercial to their page during the 2010 World Cup, receiving feedback and gaining exposure while avoiding expensive advertising rates. Facebook is continuing to use its 'Like' button and now allows companies to feature the button on external web pages, resulting in even more fan page growth.

What kind of company would you compare Facebook to?

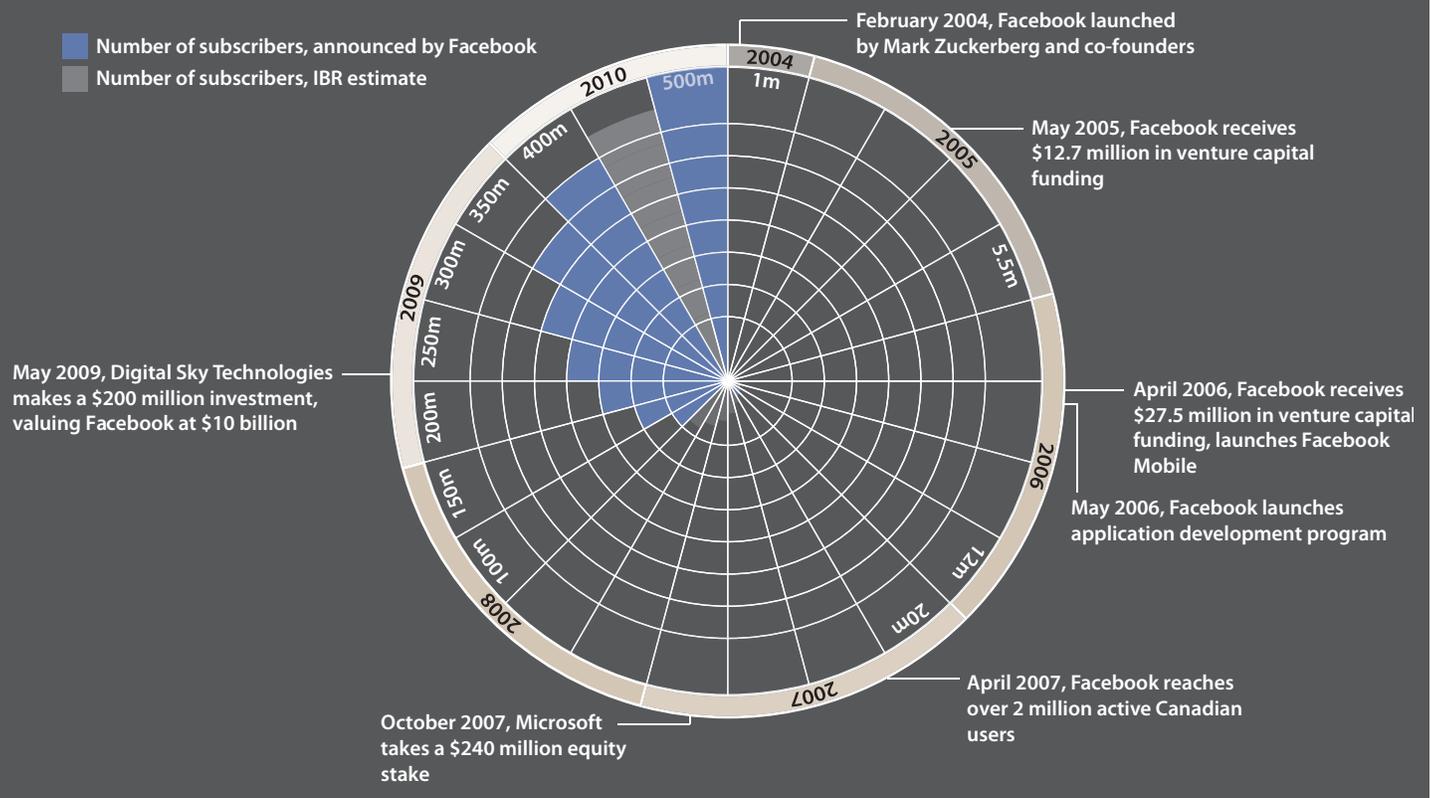
To value Facebook, analysts and potential investors would traditionally categorize the company and attempt to compare it to industry competitors. However, Facebook's varying revenue streams indicate that the company cannot be simply categorized.

Since it is clearly much more than a social network, prospective investors may instead associate Facebook with other websites such as YouTube and Google. However, Facebook differs from these mediums as well through its detailed user database. This resource implies that Facebook is also a market research firm that can help companies by collecting and analyzing data

about consumer buying patterns and habits. Thus, Facebook has transformed from a social network that was unable to leverage its user base into a successful advertising medium with the data analysis capabilities of a market research firm.

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Timeline of membership growth



The future of Facebook

With a billion dollars in revenue and a new direction, is Facebook really worth \$30 billion? Not yet. But the potential for such a valuation is real. As Facebook seeks to unlock its promise, it is crucial that the company continue to carefully manage its growth, while leveraging its scale and unrivalled user information. Currently, the company allows clients to use its database as a targeting tool. They should take the targeting approach one step further by using the database to help firms develop successful marketing strategies. Facebook should hire market research specialists to effectively leverage its massive database for internal and client use.

By helping corporations strategically use its data, Facebook will enhance customer insight and make itself increasingly irreplaceable to its clients. This strategy, however, may see increased challenges with regard to privacy issues and regulations. The way in which Facebook collects data compromises the ability to profit from user information, as the average consumer is not expecting to have their information sold.

To avoid these constraints, Facebook could only sell overarching trends and patterns. Facebook profile pages contain a plethora of valuable information. Access to 500 million of these pages is a powerful resource which most businesses could only dream. Facebook must make sure to leverage this data fully.

After fully monetizing the aforementioned revenue streams, Facebook can integrate other internet-based services into the current business model. On November 15th, 2010, after acquiring the domain name fb.com, Facebook announced its plan to integrate e-mail into its platform to compete directly with the likes of Google, Microsoft, and Yahoo. Facebook may also eventually compete with other high-traffic websites through the introduction of video conferencing and video hosting. Platform expansion will allow Facebook to achieve revenue growth in each of its advertisement streams.

As users spend more time on Facebook by checking their email or video conferencing with friends, the reach and effectiveness of Facebook's advertisements will increase in value accordingly. The possibilities are endless for Facebook. Looking outside the Internet realm, Facebook could establish itself as a technological conglomerate and compete in the mobile phone industry. Given the company's technical expertise, Facebook could even one day join the Mac/Windows rivalry and create operating software of its own. Some of these endeavours may seem far-fetched, but few people saw Google achieving the success it has experienced. After all, it started as a simple search engine. Facebook started as a social network.

