Dot-Com Bubble, Part II? Why It's So Hard to Value Social Networking Sites

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Less than three years after emerging from nowhere, the hot social networking website MySpace is on pace to be worth a whopping $15 billion in just three more years. Or is it?

Is the much smaller Facebook, run by a 22-year-old, really worth the $900 million or more Yahoo is reported to have offered for it? Maybe. Or maybe this is *Dot-Com Bubble, Part II*, with MySpace, Facebook, YouTube and the other new Internet phenoms destined for oblivion when the fad fades.

"What makes this hard is that these companies seem to be so many years away from the kind of earnings that the valuation numbers are forecasting for them," says Andrew Metrick, finance professor at Wharton. The $15 billion MySpace figure "would imply that a lot more people will be on MySpace than are currently on it."

While the social networking sites vary considerably, each relies heavily on content provided by users who can post personal profiles and build networks among friends and others with shared interests. For the most part, these users have free access and the sites are funded with advertising revenue. To lure advertisers, young sites typically offer deep discounts that make profitability elusive, and it is unclear when they will be able to push ad rates higher, if ever.

The problem, as Wharton accounting professor Robert W. Holthausen sees it, is a dearth of information to plug into the standard valuation models. "You have little data on what kind of revenues they can generate and what their cost structure is."

Valuing advertising-driven sites is particularly hard because the same numbers -- such as the number of users or page views -- can mean different things depending on how the advertisers are billed, Holthausen adds. "How often do they get paid for that advertising? Is it just when the advertisement appears? Or does there have to be a click through?" Similarly, not every user has the same value. That depends on how much the typical user is likely to spend and what he or she is likely to buy. Finally, Holthausen notes, a site will be more valuable if it uses a proprietary technology than if it simply offers services competitors can easily duplicate.

The $15 billion MySpace prediction was issued late in September by RBC Capital analyst Jordan Rohan, fresh from a meeting with Fox Interactive, the News Corp. unit that acquired MySpace's parent company, Intermix Media, about a year ago for a then-astounding $580 million. Rohan cited MySpace's phenomenal growth. It now has more than 90 million active users, twice as many as a year earlier, making it a magnet for advertisers. It recently signed a deal with Google to display search results and sponsored advertising links in exchange for $900 million over three years. In setting the $15 billion forecast, Rohan pointed to Google, which also relies on ad revenue, and which has a market capitalization of $120 billion.

But is Google a good benchmark? Google is without question the premier Internet search service, while MySpace is one of a number of competitors scrambling for market share in a new industry. Google has a proven track record of profitability, while MySpace does not.

Moreover, even Google's $120 billion market cap may reflect some irrational exuberance, making it a misleading model. Its shares sell for about 55 times annual earnings, roughly triple the price-to-earnings ratio of the average Standard & Poor's 500 company. Using the same 55-times-earnings figure, MySpace would need about $270 million in annual profit to justify a $15 billion value. Can it do that in three years, given it is expected to generate only about $200 million in revenue this year? It looks like a reach.

Consider some of the figures bandied about for Facebook. Last January, Facebook founder Mark Zuckerberg, now 22, reportedly turned down a $750 million offer from Viacom, holding out for $2 billion, according to news accounts. This fall he is said to be mulling over a $900 million offer from Yahoo. Those are big numbers considering that the business, started early in 2004, has a modest nine million users and is believed to have annual revenue of around $50 million, though some experts expect that to double soon. If Facebook were valued at 55 times earnings, it would need a $16 million profit to justify a $900 million price.

"Discounted Cash Flow"

Still, there are sure to be some winners in social networking, and sites that are already pulling in significant revenue must certainly have an edge over the dozens of lesser-known competitors. "That's a lot of revenue," Metrick says, noting that this distinguishes Facebook from the dot-com bubble firms. "There were a lot of Internet companies in 1999 that had no revenue.... That kind of [$900 million valuation] doesn't seem so crazy if you believe there is a lot of growth built in." But, he adds, "There are a whole lot of examples of firms like Netscape which grew -- and then eventually lost."

The market-capitalization method of valuation is typically used with a public company -- a free standing entity that sells stock to the public. And it's best for stating a current value rather than a future one. Analysts also like to factor in a company's future prospects, using any number of calculations to derive a figure for "discounted cash flow." Essentially, they look at expected revenues over a given number of years and subtract expenses to arrive at a figure for "free cash flow." Then, using various assumptions about interest rates, they determine what money received in the future is worth in today's terms.

Analysts can never be sure about any company's future revenues and expenses, but the problem is even worse when dealing with a young company in a fledgling industry. The assumptions used in any valuation model are ideally based on experience of at least six or seven competitors, Metrick says. But there is no good peer data in the new social networking business.

With older industries, analysts often value a company on some ratio, such as a multiple of revenues. "But the problem is you are assuming the valuations put on these are rational," says Holthausen, arguing that expectations for new industries are often not rational. During the dot-com bubble, some companies that did have substantial revenues were valued far beyond what any standard analysis would say they were worth, he adds. "You totally had to suspend belief."

After the bubble burst, valuing the survivors did become more sensible, and some are assessed fairly easily with standard approaches, according to Wharton marketing professor Peter Fader. That's especially true of publicly traded companies involved in ordinary commerce, such as bookseller Amazon.com and auction site eBay. Their stocks trade at 45 and 39 times earnings, respectively.

"You're not going to see an Amazon being overvalued like [Internet stocks] used to be," he says, "but these social network sites are the Wild West. This is an area where it has been notoriously fickle. It's not like search engines, where you can really compare them on objective criteria," he suggests, referring to established players like Google and Yahoo.

Among the unknowns: How well can social networking sites hold on to their users? One player, Friendster, burst onto the scene a few years ago, then largely deflated. On the other hand, users go to considerable trouble to upload information and images to these sites, and to establish elaborate networks of friends for electronic sharing. They are not likely to abandon all that effort as casually as they would switch from one online bookseller to another. "It does seem to me there is some stickiness to the model," Holthausen says.

Networks Based around Products

Metrick believes social networking sites will not be a passing fad. But there's no guarantee that MySpace, Facebook or any of the other current players will be the big winners in the end. Fader, too, believes social networking is here to stay, but he thinks it may work best not as a freestanding function but as an additional feature on sites that draw users for other reasons. Hence, the winners may turn out to be other sites that adopt social networking features. Or they may be new players, or current networking sites that broaden their offerings.

Many sites may ultimately be acquired in the way MySpace was bought by publicly traded News Corp., the enormous multi-national media company run by Rupert Murdoch. Part of the News Corp. strategy is to let advertisers link users into networks based around products, such as movies or music groups. More than a million bands have profiles on MySpace, for example.

If MySpace becomes the model, social networking sites will be quite different from the classic dot-com bubble companies which tried to cash in big by going public while staying independent. The risks are not the same when an iffy venture is part of something bigger, says John R. Percival, adjunct professor of finance at Wharton. "This is kind of like the oil and gas business. The risk might not be as great as you think, and a high valuation might be justified."

A small, independent oil driller faces a huge risk in drilling a new hole, which may be dry, he says. Compared to that, risks from changing oil prices and demand are relatively small. But the situation is reversed when the driller is part of a bigger enterprise that drills many wells. A dry hole here and there doesn't matter, but changes in oil prices and demand do.

Social networking sites may be risky for their founders and the venture capital firms that fund them in the early years, but they don't appear to be pumping huge amounts of risk to the marketplace the way tech firms did in the late 1990s. "If you have a little bit of money invested in this and you're already invested in other things," says Percival, "frankly the risk is not as big as you think."

Recalling the first dot-com bubble six years ago, Fader notes, "We all look back and laugh and say we will not go through that exercise again, but this could easily be a case of history repeating itself."