CASE 1 The Value of Social Media Giants

In May 2012, Facebook held its initial public offering, setting a new record as the biggest in Internet history. At its peak, the company's initial offering produced a market capitalization of over US$104 billion. Although the company lost over half its value in the months that followed, the stock has since rebounded and as of May 2014, the company has a market capitalization of over US$160 billion. With so much value in the marketplace, one might expect Facebook to generate substantial revenue to create value for its investors. Not so; in 2013, Facebook generated just US$1.5 billion in net income on US$7.8 billion in revenue. By way of comparison, when Facebook went public, another technology company, Samsung Electronics, had a market capitalization of about US$163 billion. During that same year, Samsung generated US$22 billion in net income on US$69.5 billion in gross revenues (which excludes the high cost of goods sold that Samsung's hardware business requires). Obviously investors are counting on Facebook's revenue to grow in the future, and Samsung has been around for much longer in a different industry than Facebook. But the fact remains that both are technology companies that at different points in their histories have been worth similar amounts to investors, despite a huge difference in the amount of profit being produced for shareholders.

Early in 2014, Facebook announced that it would acquire the popular mobile messaging platform WhatsApp for US$19 billion. With over 500 million users (and a million more joining every day), WhatsApp certainly attracted an impressive user base in the short five years since its creation. WhatsApp's business model relies on its users paying US$1 per year for the service, and the first year of service is free. While the company was acquired before it was publicly traded, we can still infer that yearly revenues are no larger than about US$500 million, which is less than 3 percent of the company's total valuation.

Why is Facebook valued so highly in the marketplace? And why would Facebook be willing to pay US$19 billion for a platform that generates relatively little revenue? The list goes on. Twitter went public in 2013, garnering a valuation of US$25 billion, despite never having turned a profit. Snapchat, a messaging service that has not yet found a way to monetize its service, was recently valued at over US$4 billion. Airbnb and Uber, discussed in an earlier case, are valued at US$2.5 billion and US$3.5 billion, respectively. Just how much value is there embedded in these social platforms? Is it possible that the market is repeating some of the mistakes that led to the dot-com bubble and subsequent recession? Some researchers argue that some of these valuations are a form of delusion. Others argue that there is great value in the vast user bases of these services. Thus far, the market seems to agree with the latter position.

Perhaps the biggest reason supporting these large valuations is the direct access that these companies have to their tens or hundreds of millions of users. These vast audiences actively use these services, and the service providers thus have a "captive audience" to which they can market products and services. In addition, many social platforms can gather large amounts of valuable information about their users. Consider as an example the social platform Pinterest, recently valued at over US$3.8 billion. Pinterest has tens of millions of active users who "pin" items in which they are interested to "pinboards" that can be viewed and followed by friends within the network. Aside from the tens of millions of people to whom Pinterest and future business partners can market products and services, Pinterest is constantly and explicitly informed regarding what its users are interested in. Armed with such detailed information about users' preferences, a company can very specifically target users who will be most responsive to the product or service being offered. Female users who post many items relating to the latest fashion trends, for example, are sure to be much more susceptible to a marketing campaign from Chanel or Gucci than middle-aged male users who frequently pin items about sports cars. Thus, these social networks, with their huge numbers of users providing very detailed information about demographics and interests, can offer marketing companies a degree of market segmentation that was previously unattainable.

Of course, not every social media company with a multibillion-dollar valuation will ultimately succeed. As we have seen with the likes of MySpace and Apple's social music service Ping, even services with huge user bases or substantial financial resources are not immune from failure. Some investors are likely to be disappointed when the company they chose as the winner ultimately loses steam and joins MySpace in the cyber graveyard. Business models will continue to evolve as these platforms find new ways of deriving value from their massive numbers of users. It will be an exciting battle to watch.

Questions

5-44. Do you think that the huge valuations for these companies are justified? Why or why not?

5-45. What factors will be key to the success of the budding social platforms mentioned in the case?

5-46. Do you think that Facebook will be replaced by a successor? What social media service would be the most likely candidate?

Based on:

Guynn, J. (2013, November 16). Social media startups' value is enormous—if you trust investors. *The Los Angeles Times*. Retrieved May 28, 2014, from http://articles.latimes.com/2013/nov/16/business/la-fi-tech-values-boom-20131116.

Heuer, C. (2012, October 25). Measuring—and capturing—the value of social media. *The Wall Street Journal*. Retrieved May 28, 2014, from http://deloitte.wsj.com/cio/2012/10/25/measuring-and-capturing-the-value-of-social-media-investments.