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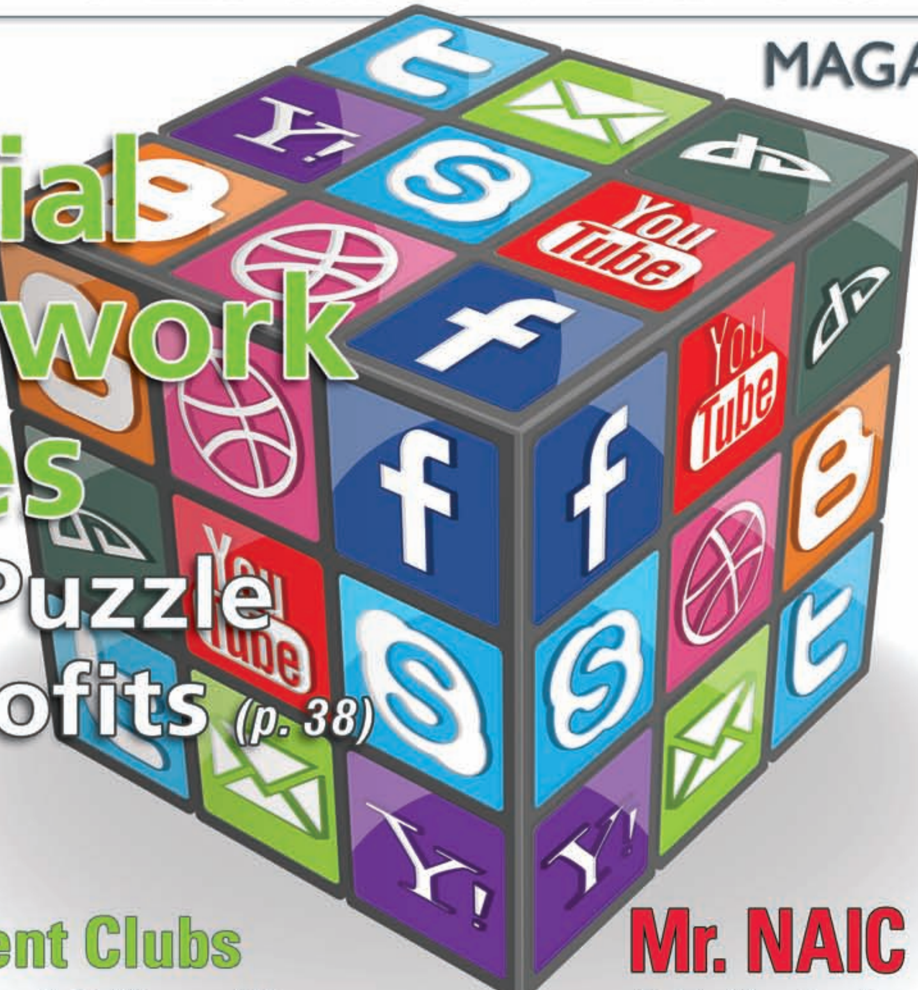

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Social Network Sites

The Puzzle of Profits

by Adam Ritt, Editor, BetterInvesting

The numbers amaze:

Facebook claims 750 million users.

Twitter says it has over 200 million registered users.

LinkedIn: more than 100 million.

These sites all rely on social networking — that is, they allow people to communicate informally with others and create communities — to build traffic. And with numbers these large, it's easy to understand why the business community is so interested in getting their goods and services in front of these users.

Besides the raw numbers of users, social media has another key benefit: The ability to have people share content rapidly among millions of people at little cost. Word of mouth recommendations within social media communities often carry more weight than opinions of experts.

Earlier this year a new wave of initial public offerings of stock from social networking sites began, with LinkedIn among the first. Rumors abound about IPOs from Facebook and Twitter. Some of the early IPOs have attracted initial feeding frenzies for the stock, reminding many of excesses of the dot-com era.

Even if carefully and slowly, however, BetterInvesting members certainly are probing the investment possibilities of social networking businesses. Every month, for example, seems to include at least a few transactions involving shares of LinkedIn (ticker: LNKD), according to data from myICLUB. com. LinkedIn is something like a Facebook more oriented for people's professional life. Users build networks based mainly on their business relationships, and the information they provide usually emphasizes job experience and career goals. Employers also can post job openings on the site.

What has people abuzz about the possibilities of LinkedIn can be applied to many other social networking sites. As these sites

It Seemed Like a Good Idea at the Time: 10 Dot-Com Busts
1. **Webvan:** groceries/30-minute delivery
2. **Pets.com:** pet supplies
3. **Kozmo.com:** convenience store items, DVDs/one-hour delivery
4. **Flooz.com:** online currency
5. **eToys:** toys
6. **Boo.com:** U.K.-based fashion site
7. **MVP.com:** sporting goods
8. **TheGlobe.com:** social networking site
9. **Kibu.com:** online community for teenage girls
10. **GovWorks.com:** for business owners seeking municipal government contracts
Sources: CNET, HowStuffWorks

IPOs, Then and Now

A look at representative IPOs from the dot-com era vs. those of today's social networking businesses. Revenues and earnings are from the last full fiscal year reported in the IPO, unless noted. Earnings per share are pro forma.

Dot-Coms Social Versus Networking Sites

Company	Revenues (thousands)	Earnings	Company	Revenues (thousands)	Earnings
eToys	$29,959	($0.35)	**Groupon**	$713,365	($2.66)
Amazon.com	15,746	(0.25)	**Zynga**	597,459	0.11
Pets.com[1]	5,787	(3.48)	**Pandora**	137,764	(0.01)
TheGlobe.com	5,510	(3.37)	**LinkedIn**	120,127	(0.05)
Kozmo.com	3,509	(1.29)	**Renren**	76,535	(0.94)
Webvan[2]	395	(0.14)	**Jive**	46,268	(0.67)

Notes:
1. Feb. 17-Dec. 31, 1999
2. Six months ended June 30, 1999

build active users, they become attractive platforms for advertising. Just as Google has generated a lot of income by allowing companies to buy advertisements based on what people are searching for — an established and growing revenue source for the search engine giant — Facebook, LinkedIn and other social networking sites can offer ads based on users' interests, professions, gender and other variables interesting to marketers. These sites can also sell additional services; LinkedIn, for example, has a premium service that provides extra features of membership and advanced networking capability.

Investors are forgiven if all the claims surrounding new uses of technology seems familiar. Over a decade ago the market welcomed dot-com stocks with open arms. Many of these businesses promised great rewards, but their plans for earning profits were murky at best and in many cases nonexistent. The publication I worked at during this time was approached by at least two groups seeking content for their websites. Requests for further details on the groups' plans for profitability were met with vague replies; we didn't pursue partnerships.

To be fair, many dot-com businesses might have been ahead of their time. People weren't as comfortable with the Internet and reliant on it as they are now. As the table detailing dot-com busts shows (*see above*), many of the ideas for these businesses have had successful variants. Kozmo, for example, delivered DVDs and convenience store goods within an hour. Netflix, however, found a way to make mailing DVDs overnight work.

The management behind today's IPOs seems to have learned some lessons from the dot-com era. The table above compares the revenues and earnings of some notable dot-com era IPOs versus recent IPO filings for companies with social networking aspects. (Not all the recent examples are for stocks trading publicly yet.) Besides LinkedIn, the list includes Groupon, which allows subscribers to buy coupons for discounted goods and services; Zynga, the folks who bring you a lot of the social games you see on Facebook, such as FarmVille; Renren (RENN), a Chinese-based social networking site; and Jive Software, which provides social networking platforms for enterprise applications.

There's also Pandora (P), an Internet radio music service that allows users to create personalized stations and share the station playlists with others. Though not what many people think of as a social networking site, Pandora allows users to provide feedback to the company on song choices for the stations.

In the table comparing IPOs, two ideas emerge: 1) Companies generally are waiting until they've proven themselves somewhat before filing, with a much larger revenue stream. 2) They're closer to profitability than in the past, with Zynga actually showing earnings and Pandora and LinkedIn very close to turning a profit.

Investigating Social Media Companies

BetterInvesting generally counsels that investors seek companies with at least five years of financial history available. Many IPO filings with the Securities and Exchange Commission, however, contain only up to three years of data, and the earnings per share information is "pro forma" because it's based on various assumptions. Before the stock begins trading publicly, there also isn't any price-earnings ratio information. So IPOs, even if the related S-1 registration statement filing includes abundant financial information, at best have a speculative element to them. For that reason longtime BetterInvesting members have shied away from IPOs.

On the other hand, our membership is always interested in new industries and avenues for growth. And many well-diversified portfolios have a little room for speculation.

As previously mentioned, members' recent speculation in social networking seems focused mainly on LinkedIn.

But even the most speculative long-term investor should require profitability at some point because the stock price eventually reflects a company's earnings and future earnings potential. So keep in mind the following when conducting any studies of social networking companies:

- **Nontraditional accounting metrics.** These are sometimes used by companies in attempts to steer analysis toward favorable conclusions. In one example, Groupon's IPO registration included a figure called the "adjusted consolidated segment operating income." The idea with this figure is to exclude some of the major expenses, such as the costs of marketing and acquisitions, from the company's operating income. Not surprisingly, using the adjusted operating income figure results in a far higher number.

  Groupon argues that adjusted CSOI presents a fairer view of the company's financial health. The very high marketing costs exceeding $260 million in 2010, for example, won't remain that high in future years.

  The SEC reportedly wasn't sure it agreed with Groupon. The company later amended its preliminary IPO prospectus to downplay adjusted CSOI and instead listed unadjusted CSOI. (An Aug. 25 article on Dow Jones' AllThingsD site reprints what it believes is a memo to employees from Groupon's CEO, Andrew Mason, in which Mason still stands behind the metric.)

- **Ability to scale.** Social networking sites create value for advertisers when they have lots of users. What happens to a company's costs as more people join the network is a key consideration.

  Pandora, for example, currently has more than 34 million users. According to an article from Renaissance Capital posted at Seeking Alpha, Pandora's content costs are around 50 percent of sales and driven by listener hours. As people increasingly adopt Pandora, its licensing costs could increase. For example, if Pandora's subscriber base continues building, you can bet performance rights group SoundExchange will ask for higher royalty rates when this key licensing deal expires in 2015. (Netflix could well be faced with a similar situation. The huge growth in Netflix's streaming service has not gone unnoticed by the studios providing content.)

- **Low barriers to entry.** Social networking sites are easily subject to trends and someone coming along with a better mousetrap. Before Facebook became the dominant force in social networking (no IPO yet, though), there was Friendster. Friendster's reported 8.2 million users today seem quaint when compared with Facebook's 750 million. Given many people's love-hate relationship with Facebook, it isn't hard to believe that someone will come along with the new Facebook. Perhaps it will be a revamped version of MySpace, the once-popular site that today is groping for a new identity.

Whatever your interest is in investing in this latest phase of the Internet Era, it's likely that social networking will have a place in future Web-based businesses. Even if you decide not to add the companies we've discussed here to your portfolio, the numbers of people who can see a company's well-placed ad or marketing content are staggering. Businesses will continue trying to take advantage of social networking's immense power. B