

FACEBOOK: A STORY

Why investors shouldn't fall in love



REUTERS BREAKINGVIEWS

Facebook: A Like Story

Why investors shouldn't fall in love

Edited by Jeffrey Goldfarb and Robert Cyran

Cover design by Troy Dunkley

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PREFACE



WELL-FLAGGED - Facebook and its Chief Executive Mark Zuckerberg have raised some red flags for investors, including how the switch to mobile could be a big problem.

REUTERS/Jim Young

Facebook's initial public offering is the seminal event of the capital markets in 2012. Breakingviews has followed the social network's growth in analytical fashion since soon after it started in Mark Zuckerberg's Harvard University dorm room in 2004. We've compiled a selection of some two dozen of these incisive stories to illustrate Facebook's trajectory and increasing importance, from its origins as a site used by college students to a business with approaching a billion users and, after its IPO, potentially worth more than \$100 billion.

“Facebook: A Like Story” kicks off with a timely, pertinent piece on how governments, rival businesses and Wall Street have become financially dependent on Facebook’s debut. The book also contains a handy number-cruncher - accompanied by an interactive calculator - that allows investors to value Facebook’s stock and see what assumptions are needed to reach the company’s indicated price of between \$28 and \$35 a share.

Moving further back the company’s own timeline, the chapter entitled “The Past” explores how Facebook forged its path to domination in social media, often seemingly by the seat of its pants. Meanwhile, Yahoo’s failure to buy the company ultimately cemented the former high-flying search firm’s own slide towards irrelevance. Facebook also let opportunities pass it by, for instance acquiring Twitter or an equity stake in Zynga. There were fights along the way, including with the likes of the Winklevoss twins, who laid legal claim to Facebook’s lucre. The loss of key employees and the nagging problem of privacy have also been challenges along the way.

Another section of the book, “Proud Parents,” looks at the people and financiers that invested in the original vision. We examine Zuckerberg’s wealth, Facebook’s historical parallels and the company’s contentious origins. Facebook’s backers, from well-connected venture capitalists to clever Russian money-men and lucky mega-corporations, also get scrutiny.

Finally, “Facebook: A Like Story” considers Facebook’s IPO and its future. Breakingviews has been quick to alert readers to potential red flags for investors, such as: how the switch to mobile internet usage presents a serious threat; the dangerous precedents set by other companies that granted super-voting stakes to their founders; and how paying \$1 billion for a 13-person startup, Instagram, suggests a certain degree of panic.

There is of course much to like about Zuckerberg’s creation. But investors should be careful not to blindly fall in love with Facebook.

Robert Cyran and Rob Cox

May 2012

THE PRESENT



REUTERS/Robert Galbraith

NOT LIKE, NEED

BY ROBERT CYRAN

Dependence on Facebook spreads far and deep. It's not just social networking junkies that have grown reliant on Mark Zuckerberg's website creation, which on Thursday filed a new version of the prospectus for its impending initial public offering. Businesses such as online gamer Zynga have been created on its back. Bankers are pegging their careers on floating the firm. And the state of California needs the IPO to help close its yawning budget gap.

It's not too strong to use the term addiction when talking about the type of relationship many Facebook users have with the site. Everyone has a friend who posts compulsively or has heard someone brag about quitting, only to relapse. The data tell the same story. The average user spends more than six hours a month on the site, according to ComScore.

This interaction has provided fertile soil for others. Big advertisers are shifting their advertising to Facebook, as its ballooning revenue shows. And an ecosystem of firms has grown up around the social network. Online gaming prodigy Zynga - worth about \$6 billion - has been trying to wean itself off Facebook. But it generated 94 percent of its revenue off the site in the fourth quarter. A slew of smaller firms make apps for users. They get a ready-made audience but cough up a chunk of sales made on the site and are beholden to Facebook's whims.

Even firms on the other side of the country are relying on Facebook. New stock sales are a lucrative Wall Street niche. True, the social network's heft means it will pay less than the typical 7 percent underwriting fee. But even a fraction of that is nothing to sniff at when a company is raising \$5.7 billion from the sale of new stock. And the prestige of taking Facebook public could pay dividends for years as banks like Morgan Stanley, JPMorgan and Goldman Sachs pitch their services to other companies considering IPOs.

Nobody needs Facebook like California, though. The deal could net the state \$2.5 billion in income tax receipts over the next five years, according to Sacramento. That's enough to make a noticeable dent in its projected \$9 billion deficit this year. Moreover, numerous small businesses have grown up in Facebook's Silicon Valley shadow. These high salaried jobs - and the associated taxes - are good news for California's finances. Facebook's debut is more than Zuckerberg's day in the sun.

Published on May 3, 2012

LIKE THE NUMBERS

BY RICHARD BEALES

Facebook's 31 underwriting banks are mobilizing for the company's initial public offering. In such a hyped IPO, any kind of valuation is possible. But a comparison with the history of the social network's closest thing to a rival, Google, suggests that even \$75 billion - at the low end of the talk to date - would be a stretch. A new Breakingviews calculator shows why, and allows bulls and bears alike to tweak the inputs.

Google's revenue of \$3.2 billion in 2004 was not far off Facebook's \$3.7 billion in 2011. One way to clarify the crystal ball is to assume the social network grows on the same trajectory as the search engine did seven years earlier. Then it's consistent to assume EBIT margins settle at something like Google's average 33 percent level.

Add a 30 percent tax rate and modest outlays for investments, and out pops an annual free cash flow figure to plug into a discounted cash flow model based on one created by Anant Sundaram at Dartmouth's Tuck School of Business. A 15 percent discount rate seems rational for a business in the fast-changing Internet world, resetting lower - along with revenue growth - after 2021.

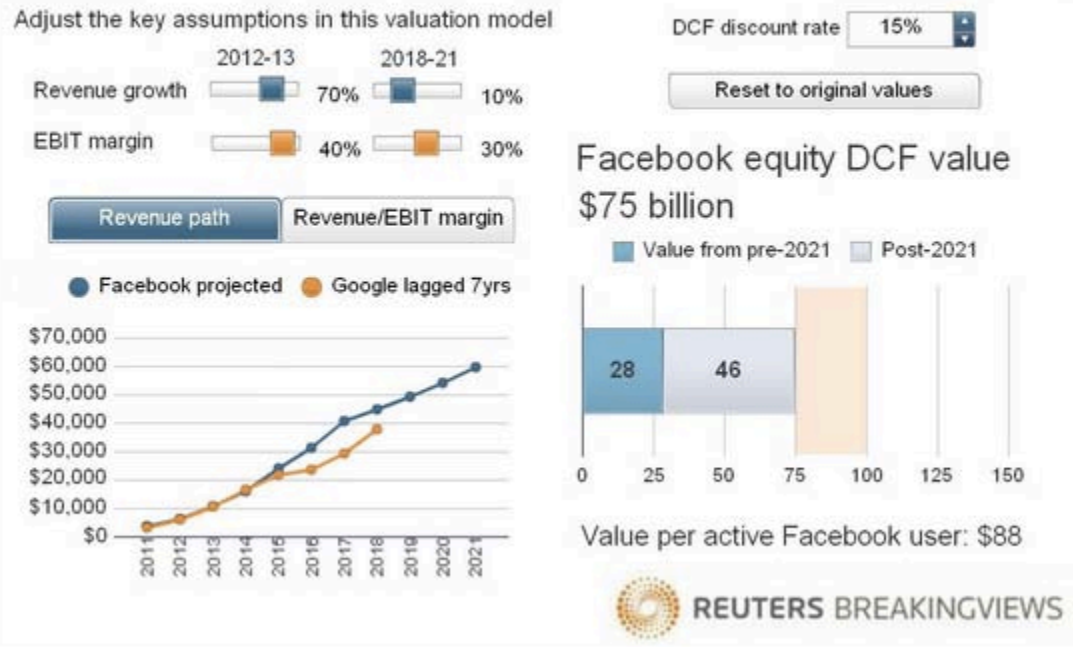
Run those numbers, and Facebook founder Mark Zuckerberg is presiding over a company worth \$75 billion, or about \$30 per pre-IPO share. But the pricing of run-of-the-mill floats is supposed to leave something - say 15 percent - on the table for incoming shareholders. That would knock the figure down below \$65 billion. And with nearly two-thirds of the value stemming from cash flows more than 10 years hence, Facebook is a risky bet.

For likers of Facebook, however, it's easy to dial things up. Just trimming 2.5 percentage points off the discount rate, say, adds \$15 billion to the valuation. But the valuation is also sensitive on the way down. Shaving just 5 percentage points off near-term revenue growth and margin assumptions knock it down by \$10 billion.

Facebook shares may prove scarce as would-be owners, potentially including many of its 845 million users, clamor for a piece of the IPO action. A staid DCF analysis could easily be drowned out. But it does at least show how bold the assumptions must be to justify whatever price the underwriters end up persuading investors to pay to cement their friendship.

Published on March 22, 2012

What's Facebook really worth?



NUMBER-CRUNCHER - An interactive Breakingviews calculator runs a discounted cash flow valuation of Facebook.

REUTERS GRAPHIC/Richard Beales and Scott Barber

PRIVATELY PUBLIC

BY ROBERT CYRAN AND ROB COX

Facebook's \$5 billion-plus initial public offering won't bring a major status update. Listing on a stock exchange typically brings lots of changes. But tick through the list, and it's clear that the social network, which filed for its long-awaited U.S. initial public offering on Wednesday evening, is already largely there.

First, consider capital-raising. Facebook, founded in 2004 and led by Mark Zuckerberg, hasn't had any trouble raising money. It has already collected more than \$2 billion from the likes of Silicon Valley venture capitalists, Goldman Sachs and Microsoft. Anyway, it doesn't need money to build out its business, because it has been cash flow positive since 2009. Facebook's operations generated \$1.5 billion of cash last year, while the company invested less than half that amount.

True, the IPO will make it easier for existing investors and employees to cash out – some are selling shares in the offering. But the stock has been trading actively on grey market venues such as SecondMarket for some time. And workers got liquidity from Russian investment fund DST three years ago, when it offered to buy \$100 million of stock directly from employees.

Going public often has the benefit of raising a company's profile, and shareholders can become loyal customers and vice versa. But Facebook has 845 million monthly users worldwide and already has been the subject of an Oscar-nominated film. It's hard to see how ringing the bell on an exchange can make it any better known.

Another major adjustment can be transparency. And for sure, Facebook will have to file quarterly financial statements and everything else regulators demand, and these will be publicly available for the first time. But the company already has about 1,200 shareholders and releases financial information to them. Moreover, Zuckerberg meets with employees regularly and fields probing questions about the firm's finances. So management already knows what it's like to be scrutinized by investors.

It's not even likely that executives will suddenly have to listen more carefully to outside shareholders. Only a small chunk of Facebook is up for grabs in the IPO, and Zuckerberg will retain majority voting control thanks to the 10 votes attached to each share in the special class he and other insiders will own and all the investors who have ceded voting rights to him.

Facebook's IPO, which could value the company at \$100 billion, may be one of the biggest floats in years, but that doesn't mean it changes much. With one 27-year-old geek remaining very much in charge, it may just turn the most public of private companies into one of the more private public ones.

Published on Feb. 1, 2012

DISLIKE

BY ROB COX

Facebook's imminent stock sale risks putting public stock markets to shame. Investors will surely clamor for a piece of the social network. But unlike Google's 2004 initial public offering, everyone who's anyone has already made a killing off Mark Zuckerberg's dorm-room project. At a \$100 billion valuation, it's hard to imagine much could remain.

The list of who gained access to Facebook's value-creation steamroller is extensive. It's not just Silicon Valley elite, including Sean Parker, Peter Thiel and Zynga's Mark Pincus. The roster extends to global billionaires and, naturally, Goldman Sachs. Even Microsoft is up big.

In one respect, that's good. It suggests innovative entrepreneurs can access ample capital from a diversity of sources. And that may mean fewer of the likes of Pets.com tap public investors. But when the question of equality of opportunity in capitalism is being questioned like never before, Facebook shows one clear way the rich get richer.

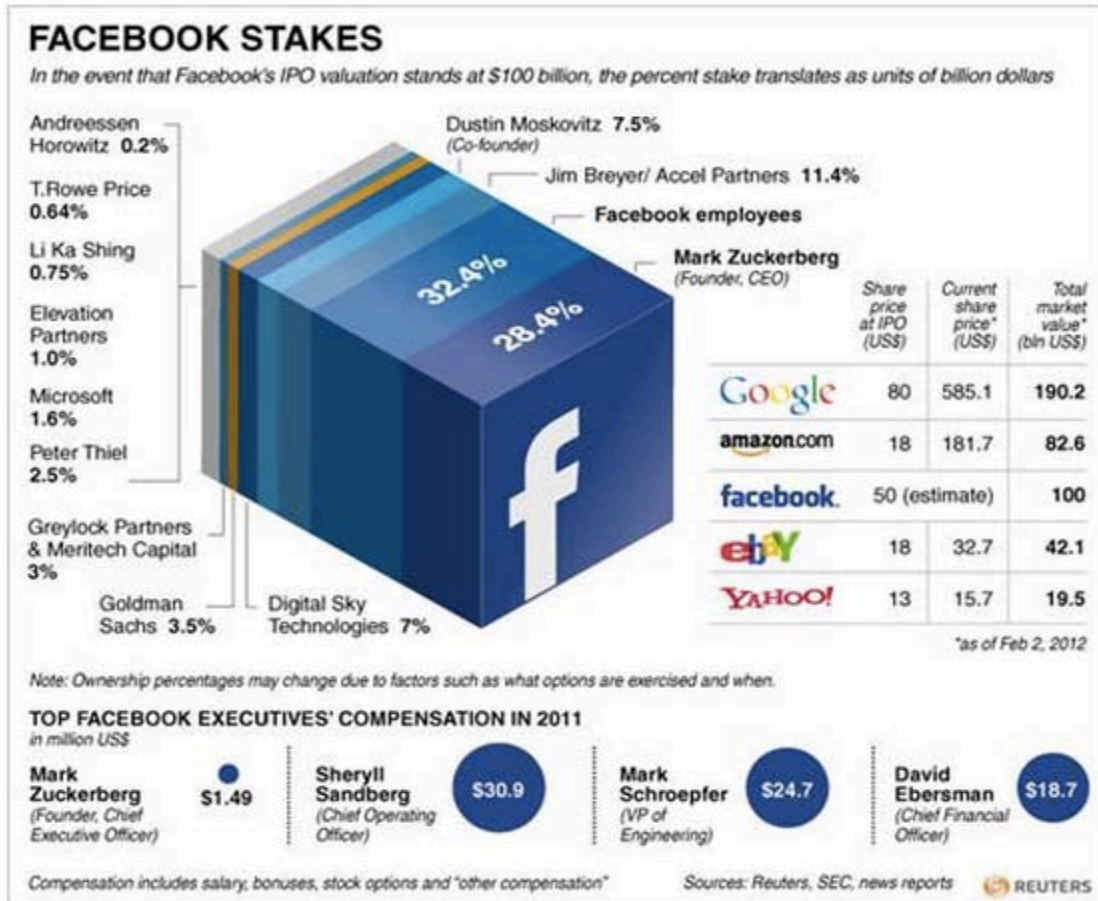
Set aside the earliest funders. Thiel, who invested the year Google went public, gambled on a Harvard dropout with an idea. Accel Partners could easily have seen its \$12.7 million investment in 2005 vanish, rather than rise to \$9 billion on paper.

Later investors also took risks, though their procession looks more like the Davos caste system. At the \$15 billion mark, there was Microsoft and Hong Kong billionaire Li Ka-shing. Soon after, Russian Internet smarty-pants Yuri Milner cleverly offered to buy stock from Facebook employees. Bono's Elevation Partners swooped in with a deal that might just allow it to raise another fund.

Later came Goldman, buying nearly \$2 billion of Facebook stock for private banking clients and itself at a \$50 billion valuation. Facebook staff shares were available on SecondMarket, but only to accredited investors with experience investing in private firms.

The worry is that after the investing aristocracy has feasted on Facebook, there's little left for the hoi polloi. Google's lifespan as a private firm was shorter before debuting at \$85 a share. They're now \$580 - a valuation approaching \$200 billion. For Facebook to match that performance it would need to become the world's first \$700 billion company

Published on Jan. 30, 2012



REUTERS/Reuters Graphics

FRIENDS WITH BENEFITS

BY ROBERT CYRAN

Facebook has friended a raft of new underwriters for its forthcoming initial public offering. According to the company's latest filing, there are now 31 of them, up from an initial six. That may be overkill, but the social network's clout means it can line up the extra resources and reputational buffing at little, if any, cost.

Mark Zuckerberg's firm is hoping to sell a lot of high-priced stock - \$5 billion or more, with the company valued at up to \$100 billion. That's one reason to bring on board a lot of salespeople with access to different investors. Since 2005, there have been 14 U.S. IPOs with more than 20 underwriters, according to Thomson Reuters data. Microsoft had more than 100 of them for its float back in 1986, raising only about \$60 million.

That said, investment banking has become more concentrated over recent decades, according to research by professors Xiaoding Liu and Jay Ritter of the University of Florida, with fewer banks involved per deal. And technology has made it easier to handle bigger offerings. So Facebook may not really need all its banks. Moreover, there's no clear relationship with stock performance. Offerings with only 10 underwriters showed similar returns over one day, one month and six months to those with more than 20, according to the Reuters analysis.

Yet there are other reasons to have more of them. The banks involved in an IPO are, essentially, putting their seal of approval on a company and its valuation. Many will produce research afterwards - presumably with a favorable predisposition. And underwriters can't publish research in the run-up to an offering, which reduces the chance of negative buzz.

For Facebook, there's another argument, too. The California State Teachers' Retirement System last month criticized the company for its all-male, all-white board. Rightly or wrongly, adding smaller banks founded and run by women and representatives of minority groups, such as Muriel Siebert & Co and Samuel A. Ramirez & Co, may help defuse that controversy.

And with Facebook's scale, it's unlikely to cost much, if anything, extra. The company will only pay a fraction of the 7 percent fee underwriters hope for, anyway, because everyone wants in on such a big deal. Some of the new batch of banks may be friends of convenience rather than necessity. But if nothing else, they count as cheap insurance.

Published on March 12, 2012

THE PAST



REUTERS/Kimberly White

EARLY DAYS

NO FACE OFF

BY DAVID VISE

This has been a rocky year for Yahoo. Its stock price is down more than 30 percent due to slumping ad sales. It has also faced delays in rolling out a new ad platform and has recently lowered its revenue targets. That has eroded management credibility. The rumored purchase of networking site Facebook could turn out to be a tonic for Yahoo's depressed shareholders.

Yahoo, the number one online destination, is all about getting internet users to spend more time on its network of properties and then profiting through selling ads and services. It tried, and failed, to build its own social networking site. Buying Facebook, the white-hot social networking site with high school and college students, would be a great fit.

The rumored price of \$1 billion appears rich, at 10 times estimated revenue. That means Yahoo would be counting on high-octane growth from Facebook in an internet segment where fads can fizzle. The latest round of funding gave Facebook a \$100 million valuation when it had 3.6 million users.

Since then, the number of users has nearly tripled, but the valuation under discussion is up 10-fold. The biggest danger of a hefty price would be if it pressures Facebook to seek willy-nilly growth. If Facebook opens its doors too widely to allow anyone with an email address to take part, the site could lose its popularity and revenue would take a hit. Easing the ability of people to join caused a Facebook user revolt recently.

Also possibly at risk in a deal could be hundreds of millions in guaranteed revenue from Facebook's ad deal with Microsoft. While Yahoo undoubtedly would like to have that ad business for itself eventually, Yahoo has stumbled more than once in the ad space.

A good strategic fit means Yahoo can afford to pay more than rivals for Facebook. Also in its favor: Yahoo has the best track record in Silicon Valley of successfully making acquisitions. When Yahoo lacked its own ad system and search engine several years ago, the company bought several companies in a year and seamlessly blended them in. It has enjoyed success as well with one-off acquisitions like popular photo site Flickr.

Yahoo needs a major stroke to revitalize itself. Provided Facebook isn't a fad and Yahoo doesn't wildly overpay, the strategic sense of a deal with Facebook could make this a home run for Yahoo shareholders and management.

Published on Sept. 21, 2006

Note: Facebook turned down the \$1 billion offer. If Yahoo had raised the bid slightly, it probably would have sealed the deal.

ONE MORE THING

BY ROBERT CYRAN

There may be few second acts in American lives, but Marc Andreessen looks like he's about to embark on his third. His first company, Netscape, kick-started the dotcom era and eventually sold to AOL for \$4.2 billion, although it was pummeled into irrelevance by Microsoft. His second effort, data centre software group Opsware, made less of a splash. But Hewlett-Packard just agreed to buy it for a respectable \$1.7 billion. It's unclear whether his third effort, social networking group Ning, will succeed. But while entering an established business line is a new approach for Andreessen, there's a chance he'll once again radically change the game.



MISSING THE MARC - Netscape founder Marc Andreessen invested in a social networking company called Ning, but later became a director at Facebook.
REUTERS/Brendan McDermid

Think about it this way. Hardly anyone had heard of the World Wide Web when Andreessen first started developing a browser. Similarly, many wondered what on earth he was doing when he co-founded Opsware in 1999. Automating tasks for servers in data centers seemed a technology backwater, especially for someone of Andreessen's caliber. But again, he was ahead of his time. Now, the hottest area in technology for corporations is virtualization, which allows groups to do more tasks on fewer servers. This has created a lot of work for Opsware, which explains HP's interest.

Given his record at the vanguard of those two businesses, Andreessen's interest in social networking seems odd. The business is hardly overlooked, indeed it often seems overhyped. He waded into it two years after MySpace debuted and a year after Facebook did.

But Ning has an interesting business model. It allows anyone to create a social network, and even embed it in other networks, like Facebook. This essentially flips the current centralized model on its head.

And social networking may be particularly prone to revolutions. After all, the first commonly used service was probably sixdegrees.com, which was started in 1996. And Friendster, which led the fray after its 2002 launch, was rapidly eclipsed. Andreessen's record suggests it would be foolish to dismiss his view that the next big social networking trend will be decentralization. If he's right, it would mean hot sites such as MySpace and Facebook may suffer the same fate as their now-forgotten forebears.

Published on July 24, 2007

PORN STARS AND ZOMBIES

BY ROB COX

Have you been bitten by a zombie lately? Had a plate of spaghetti thrown your way? Figured out your porn star name? Been sent a buttery nipple? If none of the above, you obviously haven't been one of the 30 million Facebook users who have downloaded some 80 million such applications on the social networking website since May.

As frivolous as many of these software functions appear, they've become a cornerstone of the internet company's success and have attracted huge buzz - not just among the geeks of Silicon Valley. Barry Diller's Expedia, the \$8 billion online travel agency, just paid \$3 million to acquire one of them, "Where I've Been." This piece of software, developed by a Facebook denizen, allows users to display a world map detailing all the places where they've lived or visited.

Expedia's purchase, which will be folded into its TripAdvisor subsidiary, isn't the first of a Facebook application, but it's certainly the largest. It values each of Where I've Been's 2.4 million users at about \$1.30 a pop. Now, those aren't big numbers. But it gives a glimpse of the potential value to be mined on Facebook, which has approved 3,000 applications since opening the website to developers.

As a result, venture capitalists, corporate chieftains and investment bankers have been crawling all over the website, downloading applications, testing their utility and concocting plans to commercialize them. Sure, some popular ones - like Food Fight, which allows people to throw electronic pasta at each other; BoozeMail, which allows one to send virtual cocktails, including buttery nipples; and Zombies, whose 2.6 million users can bite and infect their friends, are of dubious financial relevance.

But it's easy to see how other Facebook functions might attract greater strategic interest. For example, Apple might find music-sharing applications, such as Boombox, created by an independent San Francisco developer; or iLike, whose backers include Diller's IAC and former

MTV boss Bob Pittman. Similarly, Amazon may find Visual Bookshelf of interest. An online brokerage may find the Fantasy Stock Exchange of value. And there are countless dating and matchmaking appliances littering Facebook that Diller's IAC and others might find desirable.

The question is what's in all this for Facebook and its youthful founder Mark Zuckerberg? After all, when some big company pays a college kid in his pajamas a few million to acquire his creation, no money lands in Facebook's coffers. And when the application is rebranded by its new owner - as Expedia is doing with its purchases - it effectively becomes free advertising, for which Facebook, again, gets nothing.

It's not yet clear how Facebook will exploit this bonanza. Inevitably, charging developers some sort of advertising fees may prove irresistible. The worry, however, is that this might change the character of the site. One of Facebook's attractions is that it is more collegiate and less overtly commercial than Rupert Murdoch's MySpace.

One solution that would allow Facebook to capitalize on the ferment would be to take equity stakes in the applications in exchange for unleashing them on the website's rapidly growing user base. That way, Facebook has an incentive to promote them without cluttering up its interface.

Published on Aug. 17, 2007

SEARCHING FOR A LITTLE PRIVACY

BY ROBERT CYRAN

If advertisers didn't want to know, and influence, consumers' desires, Google wouldn't exist. Internet search is a fantastic way to collect data, and create highly effective, targeted advertising. Not only do advertisers waste less money on sending their message to the wrong people, they can also target small groups that couldn't be reached economically through mainstream media.

The next step in the evolution of internet advertising, knowing and influencing how groups of people relate, is potentially far more valuable. A number of so-called Web 2.0 businesses and services have sprung up to find this El Dorado. Yet the trade-off between privacy and economic

desires is far more evident in the Internet's second wave. In fact, the forfeiture of privacy is fundamental to the success of Web 2.0.

Of course, privacy problems aren't new. Search engines have their own set of them. Years ago, AOL released the search histories of more than 650,000 anonymous users. User 4967938, for example, searched for happy birthday mary-kate & ashley, ugly puppies and how to make a bomb. A sample of searches can make a normal person look like a polygamous hypochondriac with criminal tendencies - or vice versa. One can imagine the damage such information could cause in the wrong hands.

So what has changed? New broadband services make it easier and faster for people to upload lots more data about themselves. This has fostered giant new businesses such as social networks MySpace and Facebook. Users like the fact that they can keep their friends up to date. They, and advertisers, also like to peer into other users' lives. Both activities present conflicts which can alienate customers and lower the amount of advertising revenue that can be harvested from each user.

For example, in September 2006, when Facebook first unveiled its News Feed, which made users' changes in their profiles public, the backlash was huge. Within a day, protests among Facebook's then-collegiate audience of 8 million users surged. One group that promised a petition got 285,000 members in 24 hours. Users were part of the News Feed unless they specified otherwise.

Over time, Facebook's users actually grew to love the feed. That clearly emboldened the website to push things further. A little over a year later, Facebook launched a service that collects data about users purchases from partner sites and makes that (potentially embarrassing information) visible across its social network. The ensuing controversy caused advertisers to hesitate. Management eventually apologized and made it easier for customers to opt out of the program.

Similar controversies have popped up in other social networks and in other countries. StudiVZ, a popular German social network, had to back down from plans to share client data with advertisers after a user backlash.

In sunny Silicon Valley, of course, the privacy backlash isn't just creating gloom; it's also seen by many as a business opportunity. Ask.com may not be at the avant-garde of search; it only has a 5 percent share of the market, but it recently introduced a feature that allows its users to delete their search histories from its servers.

This is a worthy idea, but such schemes may be hard to put into practice. After all, Ask.com, a division of Barry Diller's IAC Interactive, contracts its search function out to Google, which can

use the data for its own purposes. Deleting this data also creates tradeoffs that some consumers may find cumbersome. For example, it's harder to save web links or search results after deleting the information.

And to make it really confusing, what is socially acceptable will change over time. Just look at Google's free email service, Gmail. Google mines messages so that it can insert context-related advertising. Just a few years ago, this seemed like an outrageous incursion into privacy. Now, Gmail is common, and the number of accounts doubled in the past year. It may just take a bit of time for people to realize privacy is dead.

Published on Dec. 21, 2007

THE BEST DEAL EVER

BY JEFF SEGAL

Online exhibitionists everywhere can stop drooling. Merger talks that would have seen social networking hotshot Facebook acquire Twitter for \$500 million have reportedly ended. It seems both companies were trying to pull one over on each other. Their methods shed light on critical vulnerabilities at the Silicon Valley darlings.

A combination makes some sense. Facebook is the world's largest social network and is still growing. But some of its buzz has been stolen by Twitter, whose 6 million users tell clients, employees or the general public what they are doing or thinking through pithy cell phone or computer updates.

The proposed deal had Facebook acquiring Twitter for \$500 million in stock at the \$15 billion valuation Microsoft attached to Facebook when it invested in the social network last October. Yet Facebook's internal valuation is now believed to be \$4 billion. If the internal mark is correct, the \$500 million in stock offered to Twitter would really be worth around \$130 million.

But Twitter would have a hard time justifying a \$500 million valuation. It has zero revenue and is known for frequent system outages. Add that to the fact that \$500 million is the current market capitalization of, say, Brinker, a restaurant group that makes \$4.6 billion a year in

revenue, and you've got a case of two slippery salesmen.

Like the discards from a rummy player's hand, the method each company used reveals key weaknesses. Facebook's valuation has dropped precipitously as the economy slows and it

continues to burn cash. The firm's devotion to its former \$15 billion valuation may scare off future investors from providing lifelines.

As for Twitter, it needs cash - the company apparently walked away from the deal because it wanted more cash and less stock. Its investors may not be as patient as the company whittles away its funding to remain in business.

Perhaps Twitter will rethink the logic behind walking away from an offer when the IPO market is dead and M&A has virtually dried up. Or maybe Facebook will recognize remaining in the public spotlight is central to its success. Both companies need to temper their negotiating tactics.

Published on Nov. 25, 2008



HELPING HAND – Sheryl Sandberg joined Facebook as chief operating officer from the U.S. Treasury Department in March 2008, shortly before reports surfaced that the company was trying to buy Twitter.

REUTERS/Christian Hartmann

GROWING UP

SELLING INTERNET AIR

BY JEFF SEGAL

Selling nothing for something seems like the ideal business model. As fantastical as it may sound, some web companies have actually found a way to do just that. The sale of so-called virtual gifts, services and other fictitious charms on the Internet is becoming a big business. Yet while billions may be made, this made-up industry faces some very real barriers.

First, it helps to explain what a virtual good actually looks like. It is essentially a product or service that has a real value to a user online but no tangible value in the outside world. It can range from imaginary flowers you plant on a friend's Facebook page, to virtual lipstick smeared on a user's online character, or avatar. In online gaming it might include virtual flaming swords for bit-to-byte combat.

While small in the grand scheme of things, it represents a big and fast-growing business. Chinese social network Tencent recently reported a 75 percent annual increase in first-quarter revenue to \$366 million. Nearly all of that came from sales of virtual goods to internet and mobile phone users. Not surprisingly, the company's operating margins on these imaginary products is an eye-popping 70 percent.

China isn't the only place where real money is being made from virtual stuff. Facebook sold some \$40 million worth of virtual gifts last year, according to analysts. Now it is developing a payments system for developers' virtual goods that gives the company a cut of the resulting revenue. The overall virtual goods market on Facebook is expected to bring in \$500 million in revenue this year, according to executives at Super Rewards, a virtual currency company.

While the industry is promising, it also presents some problems. There's no legal precedent stating that users actually own their goods. As a result, counterfeiting could undermine the business. There are also the issues of novelty and overproduction. How long can a product with no real-world value stay useful? And how fast do prices drop when such items are mass produced? Companies will have to churn out different goods in limited editions just to keep users amused. And, of course, there's the chance that users will realize they're paying something for nothing and go buy some real flowers. Until then, these companies have the ultimate business model.

Published on May 14, 2009

AUTOMATIC DIGGING

BY ROBERT CYRAN

Facebook is digging its moat deeper only now it's doing so on autopilot. The social networking firm has said before its operations throw off more cash than they consume. So news that operating profit also more than covers capital expenditures doesn't surprise until you realize the company added another 50 million users over the past three months. This self-financed infrastructure build-out is significant.

The closely held firm is being parsimonious with details. But such growth requires lots of everything from servers to optic fiber to real estate. Such investment is extremely expensive, especially since it is being done post-haste. Read narrowly, this means the company's profit must be growing quickly if it can now cover these expenses.

There's a more important point though. Throw in the fact that Facebook's user universe at 300 million strong is already almost as large as the United States itself, and it's becoming increasingly clear this endeavor is nearly impossible to replicate. The financial costs would be huge and they are growing as more people join its network. How quickly Facebook can reap monopoly profit is now the relevant question.

Published on Sept. 16, 2009

WHY BOTHER

BY ROBERT CYRAN

Silicon Valley darlings have long faced a choice: sell to an established rival or go public after two or three rounds of venture capital financing. Now, the hottest new companies on the Internet, including Facebook, games developer Zynga, and local online guide Yelp - are accepting later and larger financing in what some are calling D-round deals. It's a good way to reap the benefits of a float while staying private: expect more of these.

Typically, companies involved in these types of deals invest a chunk of the proceeds of the fund-raising to fund growth, while the remainder is used to buy stock off any employees or investors wishing to take some money off the table.

The question is why bother with a D round (so named for the first three stages A, B, C that venture capitalists typically consider) when the public markets seem generally willing to fund

the next big thing. A company like Facebook could go public any time it wished. Its operations throw off sufficient cash to cover operating costs and capital expenditure, yet it is gaining millions of users monthly.

Zynga and Yelp are in similarly advantageous positions. Yelp even turned down a reported \$500 million takeover offer from Google before accepting a \$100 million investment from Elevation Partners, the private equity firm backing Palm.

It's simple. At a time when too much venture capital is chasing too few attractive opportunities, D round investments allow companies to raise capital on advantageous terms. In its deals for Facebook and Zynga, Russia's Digital Sky Technologies attached valuations more akin to public markets than venture capitalists typically offer.

This reflects the strong negotiating positions of the recipients of the capital: they are expanding quickly and aren't desperate for cash. Digital Sky has identified nearly 50 startups that could consider D rounds. Some Valley bankers suggest the route is suitable for well-known operations including micro-blogger Twitter and LinkedIn.

Moreover, the founders remain fully in control of their destiny, as the investors are only buying minority stakes. Itchier shareholders can cash out, leaving management to concentrate on their businesses, rather than answering questions on conference calls or complying with disclosure rules.

At some point, of course, the time will come to cash out D-round investors with an initial public offering. But the patience afforded by this extra round of financing gives the hottest tech companies the benefit of further dictating the terms of their debuts.

Published on March 29, 2010

NEGATIVE NETWORK

BY ROB COX

Witness the power of Facebook. About a month ago, one of the social networking site's users set up a discussion forum entitled "No I will not pay \$3.98 a month to use Facebook as of July 10th 2010!" Within a few weeks, more than 825,000 people joined his page. Trouble is the whole thing was based on a faulty premise: Facebook has no such intention to charge.

This perfectly illustrates the so-called network effect that is both Facebook's greatest strength, and its potential Achilles heel. In its most positive iteration, the network effect works like this: the more people who join Facebook, share their information and make friends, the more compelling the proposition becomes. This creates a virtual barrier to entry in a business where conventional barriers should, theoretically, be very low.

But as the campaign to drum up opposition to a phantom Facebook fee plan illustrates, the network effect can cut both ways. The strength of Facebook's connections - and the ease with which its users share information - actually serves to amplify its very defects. Nowhere have these become more evident than in the area of privacy.

Indeed, many of the site's users had no idea of recent changes to privacy settings that allowed personal data to be shared with non-Facebook sites. But almost instantly, status updates, emails and notices sped across the network, many expressing outrage and disappointment with the seemingly sneaky decision taken by Facebook's management and founder Mark Zuckerberg. Others instructed friends how to change the settings to disable the new and intrusive function.

This groundswell, made possible by the network, is now a business threat. So much so that Facebook has again had to roll back its privacy changes, a measure that almost certainly will slow attempts to make money. The alterations introduced on Wednesday may quell most of the recent concerns among the Facebook faithful - if not the thousands who have pledged to commit digital suicide on May 31, according to Quitfacebookday.com.

But thanks to the network effect, it's a fair bet that shaky management decisions over the way it treats users' information, an area where Facebook appears to have more than its fair share, will keep costing it friends.

Published on May 26, 2010

LIKE

BY ROBERT CYRAN

Andrew Carnegie said a man who dies rich dies disgraced. Facebook's 26-year-old co-founder, Mark Zuckerberg, is taking note early, giving \$100 million to city schools in Newark, a troubled U.S. city. It's a generous move - and a burnished reputation will probably help the social networking magnate's business, too.

It's impressive that Zuckerberg is giving away such a chunk of his fortune at Internet speed. Sure, he has plenty - he is worth an estimated \$6.9 billion, according to Forbes' new rich list, more than Apple's Steve Jobs and up sharply from \$2 billion last year. And it won't be difficult for him to cash out a little of his stock - investors such as Russia's Digital Sky Technologies and Elevation Partners have been eager to buy more of the company.

But Facebook turned free cash flow positive only last year, and the firm is not yet public, so he will have to sell his stock on the private gray market that exists. And Zuckerberg is young to be making grand philanthropic gestures. The impact of his gift is also uncertain, because Newark's problems are convoluted, with endemic corruption and troubled families just the start.

The move is, however, likely to have a more easily defined favorable effect on Zuckerberg's reputation. Whether by coincidence or not, his gift is well-timed in this regard. The Social Network, an unflattering semi-fictional film on the creation and rise of Facebook, makes its debut on Friday. Appearing on Oprah Winfrey's TV show the same day with New Jersey's governor and Newark's mayor to announce his donation - as is expected - isn't a bad riposte. The timing of the gift also happens to counter the impact of the Forbes list.

Of course, for the children of Newark it doesn't really matter whether Zuckerberg was driven by pure altruism or partly by self-interest. But Facebook's value over the long term depends upon the trust of its users. If they think its figurehead is generous and community-minded, customers are more likely to continue to flock to the site and feel comfortable disclosing information about themselves. The company can then turn this into advertising revenue and profit.

Carnegie's generation may have had their legacies in mind. With Zuckerberg's future business success depending more heavily on a benign reputation than theirs did, getting on the philanthropy trail early may mean he has more to give away over the long run.

Published on Sept. 23, 2010

VIRTUAL LIGHT

BY ROBERT CYRAN

Facebook has to work hard to justify its soaring valuation. Inserting itself as a financial middleman - by offering Time Warner flicks online for Facebook Credits - is a good start. But while movies, games and books may be a natural fit for Facebook money, it's far from becoming an internet reserve currency.

The way it works, customers buy credits using credit cards, mobile phones or gift cards. The credits are pegged at 10 to the dollar, yet customers can't take them out of the Facebook system, exchange them for cash or give them to other users. So it's a much more limited system than, say, eBay's PayPal system. But they can be used for virtual goods such as characters in online games or applications for genealogical research on Facebook - and now for Warner movies.

Facebook takes a hefty 30 percent cut of the transaction. The company can partly justify this charge by saying it provides services such as billing and payments security. But PayPal's cut is only in the single digits, and it offers these services and more.

Yet Facebook has the economics of digital content production on its side. The marginal cost of making one more copy of a film, book, game or virtual sword for a game is close to zero. If distributing to Facebook's 600 million users results in additional revenue, the social network's fees may well be worth it for content producers. Online gaming company Zynga, for example, generates most of its revenue through Facebook, and is currently valued at more than \$6 billion in gray market trading.

Moreover, Facebook isn't shy about throwing around its weight. It will require all game developers that use its platform to process payments through Facebook Credits starting July 1.

Facebook Credits aren't about to replace the dollar, or even PayPal for that matter. Its limitations mean it won't generate anywhere near the total transactions that PayPal does. Yet the system still potentially leaves lots on the table for the social network. China's Tencent, for example, gets about half of its revenue from online gaming, of which selling virtual goods is an important part. The firm is valued at more than \$50 billion by the market.

Of course, Facebook is already valued at \$65 billion by the market. Yet the company's - and investors' - focus has mainly been on advertising. The lighting of the Facebook Credit engine may help lift it to investors' lofty goals.

Published on March 8, 2011

STAGE TWO

BY ROBERT CYRAN

Facebook has added 150 million members over the past six months, bringing its total to 750 million. The end of the social network's rocket ride may, however, be in sight. The company's growth rate has been slowing. It took less than eight months to go from 100 million to 200 million users. The latest doubling took about a year and a half.

New technologies tend to follow the famous S-curve. A few people try things out early, some late, while most pile on in the middle. If Facebook follows a similar trajectory - as appears to be the case - the company would plateau with about 1 billion regular users.

Of course, the game could change. Rivals could catch trends and erode Facebook's market share. Or more positively, China could let the U.S. leader operate within its borders, opening up a huge new market. Moreover, about four billion people currently use cellphones but not the Internet. If hordes of them shift to Web-ready smartphones, Facebook stands to attract hundreds of millions more users to its network.

Yet there's a second variable - how heavily a network is used. People share about 4 billion photos, status updates and chats on Facebook daily. Founder Mark Zuckerberg says the amount of information people share is doubling every year, and will continue to do so.

But for how long? The number of messages received per person, by whatever media were available, increased about a thousand-fold over about two centuries leading up to 2000, according to Andrew Odlyzko, an academic and former AT&T Labs researcher. That's less than 5 percent per annum on average. Giant jumps that accompanied innovations like the telegraph or phone eventually turned to a crawl. Furthermore, Cisco says Internet traffic has grown only about 50 percent per annum over the past five years, and thinks the rate is slowing. Facebook can't outgrow network traffic as a whole indefinitely.

Facebook is currently valued at about \$80 billion in gray market trading, or more than 100 times last year's earnings. It has said it's likely to go public in 2012 at the latest. Zuckerberg might want to ensure that happens before the company's booster engine shows signs of slowing, too.

Published on July 14, 2011



CRITICAL MASS – *By early 2011, Facebook CEO Mark Zuckerberg was just one of 600 million users on the social network.*

REUTERS/Robert Galbraith

MOTHER LODES

BY ROBERT CYRAN

Facebook's success may seem *sui generis*. But the social network's disputed paternity and burgeoning value - as much as \$85 billion at last check - is creating a familiar commotion. People are coming out of the woodwork to claim a share of Mark Zuckerberg's creation. In that respect, the story bears striking parallels with past bonanzas, especially Nevada's wild silver rush 150 years ago.



DOUBLE TROUBLE - Twin brothers Cameron and Tyler Winklevoss were among those who laid claim to the mother lode of bounty afforded by Facebook. REUTERS/Stephen Lam

The Comstock Lode was the Silicon Valley of its day. The market value of companies excavating its wealth was around \$40 million by 1865, about half the value of all the real estate and personal property in San Francisco at the time. That would equate to about \$60 billion in today's economy. The ecosystem that sprung up around the mines included engineers developing new technologies to extract silver from stone. Hundreds of companies were formed.

A few captured nearly all the spoils.

Just as today, the combination of uncertain ownership and tremendous wealth invited controversy. Miner Gould & Curry, for example, attracted 15 lawsuits in one year. Such legal claims consumed an estimated 20 percent of the revenue generated by the Comstock Lode in the first several years of operation.

The outcomes resemble Facebook's travails. Early and important figures - Eduardo Saverin at Facebook or James Finney at Comstock - were celebrated as genial figures, but pushed out for a fraction of the eventual riches. And like the Winklevoss twins suing Facebook today, others who claimed to own Comstock Lode land but who didn't do any heavy lifting were given a chunk of cash and told to go away.

Outsiders can't tell whether today's claimants are victims or opportunists. The latest is Paul Ceglia, a wood-pellet salesman and accused larcenist, who says he bought half of Facebook in

2003. Some mine owners took money from investors before telling them a rich shaft was worthless. Other plaintiffs submitted fabricated evidence against wealthy miners.

The parallels do have their limits. Zuckerberg isn't like Henry Pancake Comstock, for whom the lode was named. Comstock finagled his way in using \$50 and a blind horse. Zuckerberg actually built Facebook. That's significant. An untapped mine with rich silver deposits is worth a fortune. An undeveloped social network is just a good idea.

Published on April 17, 2011

PROUD PARENTS

MARK TO MARKET

BY JEFF SEGAL

Microsoft has been falling behind badly in the internet supremacy mêlée. After losing key partnerships with AOL and MySpace to Google, the folks in Redmond needed a leg up on their upstart rival. The company's purchase of a \$240 million stake in Facebook, the hot social network, fits the bill. But make no mistake, the clear victor in this round is Facebook's 23-year-old founder Mark Zuckerberg.

Even the tech stock boom's heyday yielded few deals as frothy as this one. Microsoft is getting less than a 2 percent stake in Facebook, valuing the business founded out of Zuckerberg's Harvard dorm room at \$15 billion, or 100 times this year's revenue. Facebook is sticky, but that's an exceedingly large multiple for a business model still in its proving grounds. Not even Google at its peak carried such a lofty valuation.

True, concomitant with the equity stake Microsoft receives exclusive rights to sell ads on Facebook's network until 2011. With around 200,000 new users registering each day, this 40 million-plus network of educated users is unique and potentially lucrative. But the economics of this ad-serving deal are not public, so it's hard to know whether Bill Gates' minions scored an arrangement as lucrative as the \$900 million deal that Facebook rival MySpace finagled from Google last year.

Of course, for a company with some \$30 billion on its balance sheet and a serial history of capital misallocation, this is an inconsequential drop in the bucket. Not so for Zuckerberg and his investors, including Accel Partners. Even after the tiny dilution of this financing round, the lad's near-22 percent stake is worth over \$3 billion.

For this he has Google's last-minute attempt to swivel into the deal to thank. Not only has he made himself a paper billionaire (he'd match Donald Trump and hedge fund wunderkind Ken Griffin on the Forbes 400 list), he has some cash to help further Facebook's growth and perhaps one day prove it's worthy of such largesse.

Published on Oct. 25, 2007

PAY FOR PREFERENCE

BY ROB COX

Holy cow, Facebook's worth \$10 billion? That may be how the social networking website would like the world to interpret its latest capital infusion. But don't be fooled. While that may represent a target valuation for Facebook, the actual worth, today, of Mark Zuckerberg's dorm-room creation may be much lower.



FROM RUSSIA WITH LIKE-
When Digital Sky Technologies Chief Executive Yuri Milner invested \$200 million in 2009, it gave Facebook a \$10 billion valuation.
REUTERS/Gonzalo Fuetes

That's not to completely dismiss the headline figure. Under terms announced on Tuesday, Russian internet investment group Digital Sky Technologies is plugging \$200 million into the company for a 1.96 percent stake. By that arithmetic, Facebook would indeed be worth \$10 billion.

For a company that, by its own admission, won't generate positive cash flow until sometime next year, that's an impressive figure to think about. True, Facebook's last capital-raising 18 months ago, which brought Microsoft and Hong Kong tycoon Li Ka-shing in as investors, put a \$15 billion price tag on the company. But considering the trajectory of financial markets since then, the price attached to DST's trade actually looks even more robust.

Shares in technology bellwethers Microsoft and Google have plunged about 45 percent since November 2007. Assume a similar decline in Facebook's value and, on a market-adjusted basis, DST is arguably paying a 20 percent-plus premium to Microsoft's entry price (ignoring growth in Facebook's business in the meantime).

Either way, for ordinary punters trying to value Facebook, there's a catch in these headline figures. The company didn't just sell regular stock to DST - or to Microsoft for that matter. It sold preferred shares. The company won't talk about the details, but these shares confer rights and privileges not attached to common stock - and are therefore worth more.

So while \$10 billion could be a valuation Facebook and DST are aiming for, it may not reflect the company's real worth right now. But DST has also agreed to buy \$100 million worth of shares held by Facebook employees.



WHY IS THIS MAN SMILING? - Hong Kong tycoon Li Ka-shing was an early-ish investor, who bought in to Facebook at a \$15 billion valuation.
REUTERS/Siu Chiu

The price DST pays for these shares, and the price at which insiders are willing to part with them - bereft as they are of special privileges - will reveal more about Facebook's value today than any press release the company might craft.

Published on May 26, 2009

A FRIEND INDEED

BY ROBERT CYRAN

Facebook has latched on to some good friends. Venture capital firm Elevation Partners just gave the social networking company a valuation of some \$23 billion with the purchase of another 2.4 million shares on the secondary market. That's more than triple what Facebook appeared to be worth a year ago. And at nearly 30 times trailing sales, it's about twice the multiple Google achieved when it went public in 2004.

Valuing Facebook, even on the back of an envelope, isn't easy. The grey market trading in shares doled out to employees is illiquid. The private company discloses limited data. But Facebook is growing at a breakneck pace - it now has almost 500 million users, almost twice as many as last summer. The company has said it is cash-flow positive, but profit, and Facebook's ability to scale up, are still unclear.

So consider revenue instead. Facebook generated almost \$800 million, mostly from advertising sales, in 2009. That's roughly 2.5 times as much as it did in 2008 based on the buzz in Silicon Valley. There's potentially plenty of growth to come. The average working adult spends more than 12 hours a week online, yet the Internet accounted for just 13 percent of all ad spending last year, according to ZenithOptimedia. Facebook's rising popularity means it should be attracting a bigger chunk of a rapidly enlarging pie.

On that optimistic basis, a multiple of 30 times revenue is certainly rich, but not necessarily absurd. When Google floated, its revenue was increasing at a similar pace. The search giant went public at about 14 times trailing revenue, and the stock more than doubled in four months. Sales and the shares both continued to rise sharply.

Yet the comparison's value stops there. Revenue is nice, but it's not profit. Google charged into the black earlier on. What's more, Facebook's expansion relies on places such as India and Russia, where many customers are relatively poor. And the company's ability to generate more cash from existing users may be hamstrung by privacy concerns. As a business, Facebook has promise. But investors appear to be way out in front of it.

Published on June 29, 2010

PRIVATE-CY CONCERNS

BY ROBERT CYRAN

Goldman Sachs' old-school Facebook deal brings a new set of challenges. The bank is raising up to \$1.5 billion from clients to invest in the social network while putting in \$450 million itself. Like Morgan Stanley's reported deal with online coupon service Groupon, it looks like classic merchant banking. With hot firms in the driver's seat, however, the banks could find themselves in for a wild ride.

Internet darlings, with their growth, profitability and cash, face little pressure to go public yet still have some use for what a fundraising can provide. So instead of an IPO, they rely on so-called D-rounds. This allows them to raise money at favorable valuations for internal use, while buying stock back from employees or early-round investors who want to cash out.

It's a calculated pay-to-play on the banks' part. By stumping up for Facebook and Groupon, Goldman and Morgan Stanley put themselves in a strong position to underwrite the eventual IPOs. They make the tech firms happy by providing stronger headline valuations, in Facebook's case \$50 billion. And the intermediaries score points with their well-heeled clients by enabling them to put money into hard-to-access investments.

Finally, the deal appears to align the interests of Facebook, Goldman and its customers. During the dot-com bubble, stocks of unprofitable and often revenue-less companies were floated cheaply to orchestrate a first-day pop. But when Facebook does go public, Goldman should be well incentivized to convince the market Facebook is worth well north of \$50 billion.

The arrangement isn't all rosy, though. Regulators may question whether Goldman's Facebook collective skirts the spirit of a rule that private companies either disclose more information or go public once they reach 500 investors. What's more, it creates a potentially risky triangle of expectations that may make setting a stable IPO valuation more difficult.

Investors are baking an extraordinary amount of growth - far greater profit gains than the average company for a decade - into their Facebook valuation. It's true, many scoffed at the \$15 billion valuation ascribed to the social network following Microsoft's investment three years ago. But any sign that Facebook is slowing down could create headaches for the bank now at the center of the situation. Another year, another sticky situation for Goldman to manage.

Published on Jan. 3, 2011

The Future



REUTERS/Yuriko Nakao

VIRTUAL HORMUZ?

BY ROBERT CYRAN

What's the biggest risk facing Facebook? Hint: it may be in the palm of your hand. Half of the social network's 845 million users now access the site through their cellphones, and that number is surging. Problem is Facebook currently receives virtually no display advertising revenue from small screens. The rapid shift to mobile Internet usage could be Mark Zuckerberg's biggest threat - and he knows it.



SLEEPER CELLS – *The biggest challenge Facebook confronts is how to generate revenue from small screens.*

REUTERS/Suzanne Plunkett

In the United States, where Facebook made 56 percent of its \$3.7 billion of revenue last year, sales of mobile devices outstripped those of PCs. While one of the first applications downloaded may be Facebook, the 90 million Americans who own smart phones are increasingly supplanting time spent on their computers with time on their mobiles.

That's a problem for Facebook. Americans now spend about a quarter of their screen time in front of a computer, even though advertising dollars don't yet reflect this shift away from television and other media. But ad sales are even further behind in the mobile environment, which is one reason Facebook reports negligible mobile ad revenue.

So far, this hasn't retarded Facebook's growth. It served up 42 percent more ads in 2011 at prices 18 percent higher than the year before. But Facebook's growth has been decelerating as mobile internet usage has surged.

Advertisers will eventually become more comfortable with the mobile medium. Cellphone ads could even command a premium some day. The ability to pinpoint a customer's location and target offers geographically should make everything from real estate to restaurant pitches more effective. But this could take a few years, leaving PC advertising-reliant Facebook in the lurch.

The bigger risk - which Facebook acknowledges in its prospectus - stems from the fact that rivals Apple and Google control the mobile operating systems powering 90 percent of smartphones sold in the United States. They'd be daft to restrict access to Facebook, given its popularity with consumers. And any hint of unfairly squelching Facebook would have antitrust regulators dusting off their Microsoft/Netscape playbooks.

But Facebook notes that mobile ad sales are projected to grow from \$1.5 billion in 2010 to \$17.6 billion in 2015. With numbers like that to shoot for, there's plenty of incentive for rivals to use their operating systems as a chokepoint to throttle Facebook's growth.

Published on Feb. 3, 2012

SNAPPING A RIVAL

BY ROBERT CYRAN

Facebook's defensive purchase of Instagram raises a red flag. Online photos are supposed to be a core Facebook competence. Paying \$1 billion for the popular picture-sharing app may boost the social network in mobile. But paying over the odds for revenue-free rivals is usually the hallmark of anxious, mature firms - not a growth company seeking to go public at a \$100 billion valuation.

It's impossible to say exactly what Facebook gets for the oodles of cash and stock it is handing over to Instagram, founded just two years ago by Kevin Systrom and Mike Krieger. Traditional metrics don't apply - Instagram is just embarking on an actual business plan, and the firm was worth just \$20 million a year ago. What it does have are lots of users - more than 30 million - and super-fast growth. More than 1 million more users signed up in 12 hours for its new Android app last week.

Facebook is clearly acquiring the firm for other reasons. People are spending an increasing amount of time connecting via their mobile phones. This shift is worrying for the formerly desktop-focused Facebook, whose own prospectus warns of the risks to its business of an increasingly mobile Internet. Most smartphones use operating systems made by Apple and Google. If Facebook doesn't run well on these phones, rival social networks such as Google + could get a leg up.

Buying two-year-old Instagram could help give Facebook the whip hand. It hopes to use the experience it is gaining to "build similar features in our other products." Instagram has figured out the easiest way to date of putting pictures on the web, and how to capture the attention of mobile users. These are valuable skills and tools in Facebook's fight against other social networks.

What's worrying for potential Facebook investors is why Mark Zuckerberg and his merry hackers couldn't produce their own version of Instagram. He says this is a one-off. "But providing the best photo-sharing experience is one reason why so many people love Facebook and we knew it would be worth bringing these two companies together."

The precedent is worrisome, though, if it means every time a startup encroaches on one of Facebook's presumed strengths it will need to take out its pocketbook to defend its turf. That's hardly a robust justification for a lofty valuation.

Published on April 9, 2012

RUPERT ZUCKERBERG?

BY ROB COX

How long before Mark Zuckerberg morphs into Rupert Murdoch? It may take decades or, given the accelerated lifecycles of Internet companies, just a few years. At some point, though, the overwhelming control investors are ceding to the 27-year old Facebook wunderkind is bound to stop being in their best interest.

At least that's the lesson learned from Zuckerberg's forerunners in the media industry. Murdoch's News Corp, Sumner Redstone's Viacom and the Sulzberger family's New York Times Co are among the myriad companies controlled by individuals or families whose ambitions no longer fully align with those of a majority of their shareholders.

For now, Facebook's backers seem pleased with Zuckerberg's iron grip on the social network. Many, including sharp-elbowed venture capitalists and billionaires, are giving him the right to vote on their behalf. That's understandable, as Zuckerberg is about to fetch a valuation of at least \$75 billion for his dorm-room project, or as much as the combined market capitalizations of Viacom, News Corp and The Times.

Because of the proxies, and his ownership of shares with 10 times the say-so of ordinary ones, Zuckerberg wields 57 percent of the vote off 28 percent of Facebook's economics. That lets him overrule the majority. As long as his visionary decisions create long-term value, that's probably just fine. Same goes for similar structures that allow the founders of Zynga, Google and other relatively young tech companies to do as they please.

But investors probably felt the same way when Murdoch was assembling his media empire years ago. Today, he's increasingly at odds with the other 88 percent of News Corp's owners. In October, a majority of those who don't share the media mogul's last name snubbed the nomination of his sons, James and Lachlan, to the board. The extra voting power allowed him to ignore their votes.

Redstone exerts similar dominance at Viacom. It's perhaps no coincidence that shares in both companies have traded at significant discounts to their component businesses over the past decade. Zuckerberg may represent a different kind of mogul. But if history is any guide, that won't last forever.

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