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Facebook's Numbers Don't Add Up

By Marty Wolf

Facebook (FB) is a remarkable story of a service that has changed our lives, making us more connected in a meaningful way – me included.

As much as I appreciate Facebook as a service, as a tech investor (although not in Facebook), I see another side to the story. Facebook is a company struggling to monetize its users and create value for investors who bought the story at the time of its IPO. This struggle is likely to continue for some time.

Still overvalued

Last August, I wrote that Facebook was grossly overvalued and for its shares to climb back to their May IPO price of $38 a share would take about 32 quarters – or eight years. From a pure numbers perspective, Facebook is even more overvalued now. So today, I am revising that prediction to 58 quarters – or about 14.5 years.

I reached this conclusion using the same method of analysis I used 10 months ago. I started with the price-to-earnings (P/E) ratios of five tech leaders based on their last 12 months of earnings at market close on a particular day. The five tech leaders I chose are Apple (AAPL), Google (GOOG), LinkedIn (LNKD), Microsoft (MSFT) and Yahoo! (YHOO) – a bellwether group I used to measure the relative performance of Facebook.

On August 1, 2012, the median P/E ratio of the five stocks was 18. This year, on June 5th, it was virtually unchanged at 17.9 – so I again used 18. Last August 1st, Facebook's stock was at $20.88 a share and its P/E ratio based on its last 12 months of earnings was 72.4. Using simple math, I applied the P/E ratio benchmark of 18 to show that Facebook stock should have been worth just $5.22 a share – not $20.88. This June 5th, Facebook's stock price was $22.90 and its P/E ratio based on its last 12 months of earnings was 501.50. Again applying the P/E ratio of 18, Facebook's stock price now should be just 82 cents per share – not $22.90.

There's more.

Capital IQ's current estimate of Facebook's earnings-per-share (EPS) growth is 27.5 percent (compared with last year's projection of 26.2 percent). Both years I assumed that Facebook profits would remain roughly constant. Then I used the same simple math to show that it could take Facebook 58 quarters – or 14.5 years – to achieve revenue and EPS that would justify its IPO stock price of $38 share.

Breaking it down, Facebook would need to increase its EPS from the estimated $.05 to $2.11 and grow its revenue from its current $5.5 billion annual run rate to $254 billion. If Facebook does this, the stock value of 82 cents per share (based on that median P/E ratio of 18) would climb to $38 share (82 cents x 46.24).

The other side

Now of course, this is a purely numerical analysis devoid of any of the emotion that investors often bring with them to public markets. So Facebook fans could protest: "Facebook's revenue is up 38 percent to $1.46 billion in the first quarter of 2013 over the same quarter a year ago!" That's a fact. But Facebook's expenses are up 60 percent over the same quarter a year ago. Facebook says this is necessary to attract its next billion users.

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But Facebook is growing revenue by growing users at the expense of profit. With notable exceptions such as Amazon (AMZN), this is nearly always an enterprise value killer.

Another protest might be: “But Facebook added 86 million monthly active users in the first quarter of 2013, bringing the total to 1.11 billion. Surely they can be monetized in ways that grow revenue and profit!” Perhaps. But so far, Facebook hasn’t proven it can do that and it’s only going to get harder. Of those 86 million new active users, 32 million of them are mobile-only users. Subtracting new mobile-only users from total new users leaves 54 million new users. Which means that the growth of new Facebook users that fit the mold of existing users has been essentially flat over the last year.

Why is this distinction between traditional and mobile users of Facebook important?

Let’s look at a key metric: Facebook's worldwide average revenue per user, or ARPU. For the first quarter of 2013, Facebook’s ARPU was $1.35. That’s up from the same quarter a year ago, when it was $1.21. But it’s down 12 percent from $1.54 in the previous quarter. Under Facebook’s current strategy, ARPU is going in the wrong direction.

Some of that decline is due to Facebook growing more quickly in developing markets than in developed markets. But it’s mostly because Facebook mobile users are less drawn to advertising than other types of Facebook users – and Facebook makes most of its money from ads.

It's about growth and revenue

My point is that ARPU has a huge impact on the question of how long it will take Facebook to achieve the revenue and EPS necessary to justify a stock price of $38 a share. Let’s do that math now.
I noted earlier that the company would need to hit $254 billion in annual revenue and EPS of $2.11 to justify a stock price of $38 based on a P/E ratio of 18. Here’s the catch: Facebook's first quarter 2013 ARPU of $1.35 annualized would be $5.40. At its current ARPU, the company would need 47 billion active users to achieve the revenue side of the equation. With just 7.1 billion people on the planet, Facebook would need to find new active users elsewhere in the universe – and fast.

But let’s get serious. Facebook has achieved a remarkable 1.1 billion users and counting. Now the company needs to grow ARPU in a meaningful way.

In my view, the best way for Facebook to grow ARPU is to create new services and products that users want to pay for – and not rely just on advertising. For starters, when users don’t pay for a service, they are the service – and users are becoming increasingly uncomfortable with companies that make money by gathering and selling data about them.

Then, putting my Facebook user hat back on for a moment, I am sure I’m not the only one who feels as if Facebook ads have become more intrusive in recent months and have lessened the enjoyment many of us have had using Facebook.

Another path to growth for Facebook would be to monetize its billion-dollar-plus acquisition of Instagram and make others with similar potential. That’s one reason why the recent breakdown in Facebook’s acquisition talks with the Israeli social mapping company, Waze (which was later acquired by Google), was very disappointing.

Still, with more than a billion users and a platform that is attractive to potential acquisitions, Facebook has much of what it needs to succeed.

And here is something else: At any time, investors could become enamored with Facebook all over again, and the stock could fly through the roof regardless of whether its revenue and earnings justify it. Pure numerical analysis has its limits – especially when those numbers just don’t add up.

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