Facebook: Buyer Beware

Facebook is the poster child of social networking and one of the most successful young companies of all time. In just eight years, the social media giant has grown from zero to $4 billion in annual revenues with nearly one billion active users.

With its global reach and pervasive social impact, it is no wonder we are receiving questions about the initial public offering. Those who know us well will not be surprised to hear we do not intend to purchase Facebook shares any time soon.

We are not dismissive of social media or unfamiliar with the company. Many of us appreciate how it enables us to keep in touch with family and friends, and even rekindle old acquaintances. In this respect, Facebook is truly a transformational company. Moreover, unlike many Internet IPOs of the "dot-com" bubble years, it actually generates substantial revenue and turns a profit. Our reservations about Facebook as an investment today stem simply from its rich valuation and questions about the durability of its franchise.

According to its SEC Registration Statement, Facebook generated $3.7 billion in revenue in 2011, and produced operating earnings of $1.7billion, for an impressive 45% operating margin. Net income margins (after taxes and other expenses) were a healthy 27%. However, the massive size of the stock offering means that investors are paying dearly for these revenues and earnings on a per-share basis. Specifically, the price-to-sales and price-to-earnings ratios are 28x and 88x respectively. For perspective, Apple shares change hands today at 3.5x sales and 13x earnings (trailing); Google at 5x and 19x.

It is certainly possible that Facebook will "grow into" its lofty valuations, but that prospect requires a leap of faith about its business model and ability to monetize its franchise. Thus far, the only proven path to profits for Internet companies is advertising revenues. With Facebook users accustomed to a relatively hassle-free experience, will they readily accept the clutter and intrusions of annoying advertisements? So far, Facebook has been unable to effectively advertise on its mobile platform, which is an increasingly important segment.

The company's vast trove of personal data lends itself to other more subtle forms of targeted advertising – but will users accept even greater invasions of privacy? Privacy concerns and integrity of personal data are a serious potential threat to all Internet franchises, and this risk needs to be factored into the valuation equation. Furthermore, the technology sector poses unique challenges for investors. As Facebook's meteoric ascension shows, change occurs rapidly and unexpectedly. Will users tire of the Facebook experience? What alternative platforms might emerge? Remember MySpace? On the Internet, sustained competitive advantages and economic "moats" are simply more elusive.

If or when Facebook reaches a point where we can justify a commitment of our clients' capital, based on a sound assessment of the investment opportunity, we will give it serious consideration. Until then, we will watch the IPO and the company with interest.

Market Log- May 16, 2012

S&P 500: 1324.80
10 year T-Note: 1.746%
Crude Oil: $92.81
Gold: $1,571.60

If you have questions or comments regarding this or any other Research Note, please email the H.M. Payson & Co. Research Department at **hmpresearch@hmpayson.com.**

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