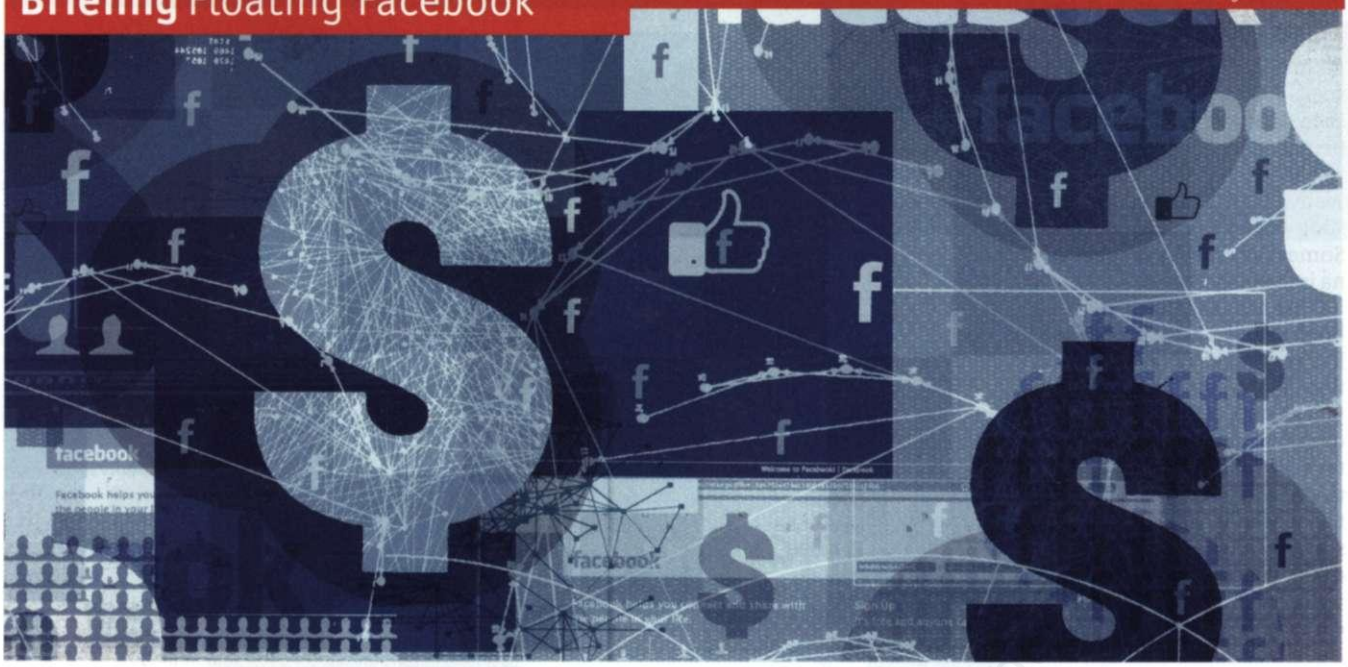


The value of friendship

SAN FRANCISCO

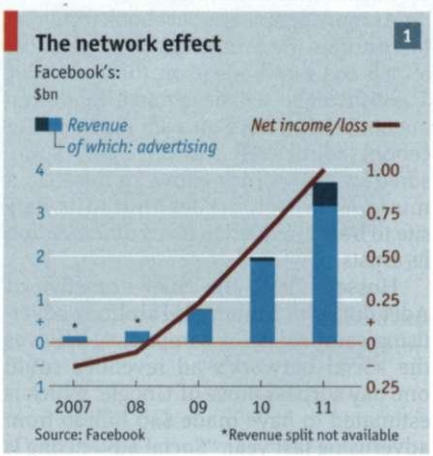
Facebook is likely to become a gargantuan company. That will bring risks as well as rewards

MARK ZUCKERBERG, Facebook's founder and chief executive, has talked for years about the notion of a "social graph" which connects people to their friends and all of the things they are interested in. By encouraging hundreds of millions of people to share their deeds and reveal their innermost thoughts, profane or profound, online, his company has in effect mapped a portion of this graph on its computers. According to the Onion, a satirical publication, the whole thing was the CIA's idea; digging up this amount of information the old-fashioned way would have cost the spooks a fortune.

These billions of electronic nodes and links will soon make a fortune for Mr Zuckerberg, still only 27, who owns 28.4% of Facebook and will continue to control most of the voting rights. It will also enrich other shareholders, many of them employees. On February 1st the company announced plans for an initial public offering (**IPO**) that will raise $5 billion, maybe more, in the largest flotation ever of an internet company. Not since Google's **IPO** in 2004-the year that Facebook was founded-have techies and venture capitalists been so aflutter. Facebook's flotation, which is likely to take place in the spring, will create a publicly quoted tech giant that will stand alongside American technology titans such as Amazon, Apple and Google itself.

The document Facebook filed with the Securities and Exchange Commission (**SEC**) revealed details of its finances for the first time (see chart 1). Last year the company had sales of $3.7 billion, a little below recent estimates, and made a net profit of $1 billion. The network boasts 845m users, which, were Facebook a country, would make it the world's third most populous, behind China and India. Some of the other statistics associated with it are also mind-boggling. Every day 250m photos are uploaded to the site. One out of every seven minutes spent online is on Facebook, according to comScore, a research firm.

Facebook's stunning progress has earned the company estimated valuations of between $75 billion and $100 billion. Private trading in its shares on secondary markets has implied a value of more than $80 billion. That would be more than 20 times last year's revenues—and more than 80 times last year's net income. These are eye-wateringly high multiples.



The case for thinking such a valuation is justified rests in part on a couple of broad technological trends that show no signs of going into reverse. The first is the rapid spread of internet connectivity, which is making Facebook accessible to ever more people. (The Boston Consulting Group reckons that around 3 billion people will be online by 2016, up from 1.6 billion in 2010.) The second is the rise of the mobile phone. Already more than 425m people are tapping into Facebook on these devices and in future most of the social network's growth will come from the mobile web. Together, these trends could propel the number of users beyond 1 billion.

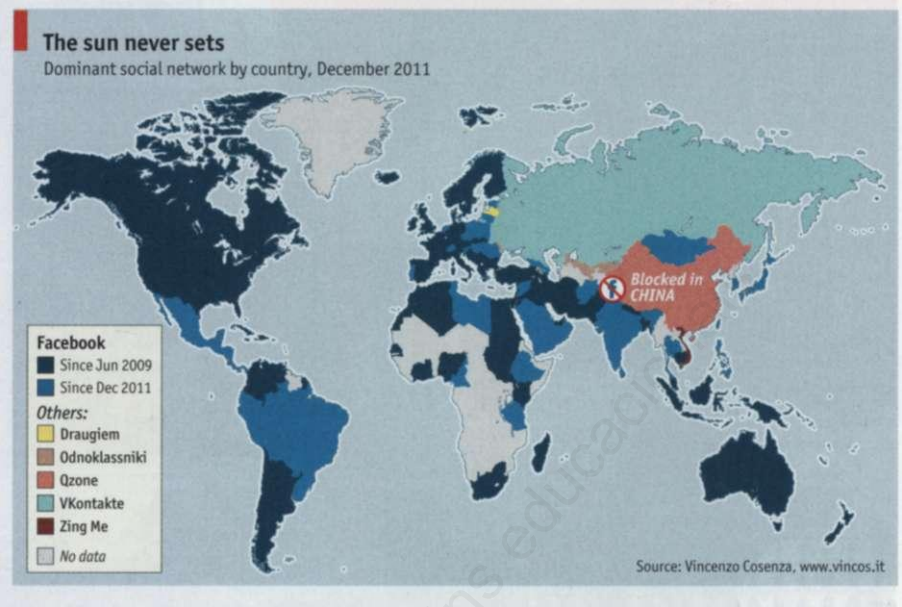
Admittedly, other social networks will be helped by this too. But Facebook stands to benefit the most because Mr Zuckerberg and his colleagues have cleverly positioned the site as a "social utility", as he once put it, which lets people do all kinds of things, from passing on newspaper articles to playing games or posting photos of themselves, their friends or their pets. They can do more and more, because Facebook has enticed outside developers to create software "apps" that run on its platform and has itself constantly improved the platform. The site is just beginning to roll out its latest innovation, Timeline, which encourages Facebookers to build an online chronicle of their entire lives.

All this explains why people are now spending far more time on Facebook than on rival web services such as Google (see chart 2 on the next page) and why it has benefited from strong network effects. It is spreading fast across emerging markets ▸▸

• such as India and Brazil, where it recently dethroned Google's Orkut as the leading social network (see map). One reason why Facebook was able to topple Orkut is that people began to join it in droves to keep in touch with friends abroad who were already on the network. In Russia it is tussling with local rivals such as VKontakte. Some countries have tried to block it; China is the biggest one.

The fact that China is off-limits to Facebook leaves a huge hole in its social graph. It also leaves the world's largest population in the hands of Chinese social networks such as Renren and Tencent, which owns Qzone. In the past, Facebook has toyed with trying to find a local partner in the country. And Mr Zuckerberg has even taken Mandarin lessons as one of the personal challenges he likes to set himself (another was to eat only animals he had killed with his own hands). But for now, the country remains tantalisingly out of reach.

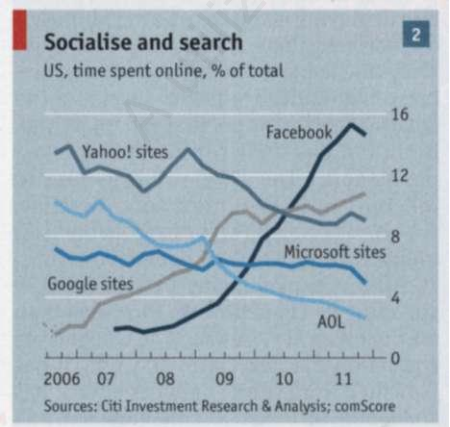
If it can crack China in future, Facebook will become an even more attractive destination for advertisers. Last year the social network surged past Yahoo! to become the biggest force in America's online display-advertising market (see chart 3 on the next page). Some 85% of its revenue came from ads and there are grounds to think it can mint far bigger sums of money from advertising in future.



What friends are for

For a start, the network is working overtime to harvest even more data from Facebookers which it can use to aim ads at them. Last September, it unveiled a new set of social apps (including a forthcoming one from The Economist) that allow people to do things like watch films, listen to music and read news on Facebook rather than going elsewhere on the web to do so. These are all part of its ambitious plan to map all of the connections between people and the things that interest them.

Facebook could also make more money by creating an advertising network that takes advantage of the already extensive reach of its tentacles across the internet. Millions of websites are integrated with it through various software it has developed, including "social plug-ins" that allow people to share their activities and interests elsewhere on the web (a song they are listening to, say, or a newspaper article they have read) with their Facebook friends. This has made it an important source of traffic to other websites and it could offer to help them sell ads, pocketing a percentage of the money raised. Some analysts think this could bring in as much revenue as ad sales on Facebook's own site.



There is also a strong possibility that the company will attack the online-search business, which accounts for almost half of online ad revenue in America, according to the Interactive Advertising Bureau, an industry body. After all, the social network already knows a lot about how people's recommendations affect their friends' choices. "Some form of social-discovery feature on Facebook is inevitable," saysjoe Green, the boss of Causes.com, a web business that promotes activism and philanthropy. Google, which dominates search-related advertising, clearly agrees: last month it began incorporating data from Google+, its own, much smaller social network, into its search results.

As more people use Facebook from mobile phones, the company will also be able to sell ads that appear on these devices. The difficult bit will be to find formats that are not too intrusive on a small screen. Facebook could well end up using "sponsored stories", which allow, for instance, a music publisher to pay for a link to its website to be embedded in posts that mention its artists.

Hussein Fazal, the chief executive of AdParlor, which manages Facebook advertising campaigns for companies, believes the social network's ad revenues could one day surpass those of Google, which is estimated to have made $40 billion from advertising last year. "Social advertising is a massive movement," he says.

It probably is, but movements can take many years to come to fruition. And it will be harder to build an advertising business based on a social network than one based on search, like Google's. Google's ads are effective because they are presented when people are looking for something specific. Facebook's may be less effective, because people go to the site when they want to socialise, not search for stuff or buy things. That is why Google's search ads command higher rates than Facebook's display ads. And the effectiveness of Facebook advertising is trickier to measure.

Moreover, although some brands, such as Starbucks, have managed to draw huge, engaged audiences on Facebook, others have had a frustrating experience. To some extent, they should blame themselves: a study by Socialbakers, which gathers social-media statistics, found that 95% of posts to brands' pages on Facebook went unanswered. The chances are that Mr Zuckerberg will use at least some of the money the firm raises from its **IPO** to buy ad-measurement firms and social-media consulting outfits to help its corporate customers get more out of the network.

At the same time, Facebook will pour more resources into areas other than advertising. A promising one is a nascent online-payments service based on Facebook Credits, a virtual currency. The social network insists that gamesmakers use Credits within their apps that run on Facebook and pockets 30% of the proceeds from sales of digital and virtual goods. So far a single firm, Zynga, a social-gaming company that staged its own **IPO** in December, accounts for most of this income—and for **12%** of Facebook's total revenue.

Mr Zuckerberg hopes that other firms will use Facebook's platform to disrupt industries from travel to health care in the same way that Zynga has shaken up the

world of electronic games. That would allow Facebook to make even more money from the blossoming transactions on its platform. Payments and other fees brought in $557m last year, up from $106m in 2010.

There could be a much bigger prize, especially if Facebook can turn Credits into a currency that is accepted elsewhere on the web-and perhaps even off it. The network could try to strike deals to let its currency be used on other sites that are already integrated with it. It could even seek to compete with online-payments giants such as PayPal, an arm of eBay. Coping with the thicket of rules in this area would be a nightmare, but the rewards could be huge: last year PayPal's revenues amounted to $4.4 billion.

Facebook's currency may also come in handy if the company makes a serious effort in social commerce, the buying of goods and services through social-networking sites. A number of firms, such as Procter & Gamble, an American consumer-goods company, have set up virtual shops on Facebook and it is still too early to tell whether "s-commerce" will catch on. But some observers think that the influence of friends on people's buying habits mean it will be huge. Booz & Company, a consulting firm, has estimated that the value of goods sold through social media will rise from $5 billion in 2011 to $30 billion by 2015.

Myemptyspace

Even its rivals admit that Facebook has the potential to be one of the most valuable companies on the planet. Much will depend on its management. In 2008 Mr Zuckerberg cleverly poached Sheryl Sandberg from Google to be Facebook's chief operating officer. The only other "critical person" named in the offer document this week, Ms Sandberg has become almost as well known as the founder. Hanging on to her may be difficult (some people wonder whether she could be lured into politics). Many of Facebook's employees will soon be enormously rich. The transition from edgy start-up to established giant will not be easy. And there are other risks too.

One is that people stop using Facebook, either because they lose interest or because they are put off by its behaviour. As News Corporation discovered to its cost after it splashed out $580m on Myspace in 2005, network effects can also go quickly into reverse. Once large numbers of people started leaving the service, which became more cluttered than a teenager's bedroom, it proved hard to stem the tide. Last year, News Corp sold the business for just $35m.

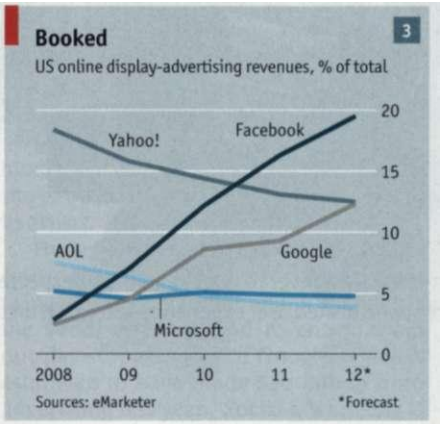
There is some evidence that Facebook's growth may be slowing in some markets. But this is because just about everybody who might join the social network in those countries has already done so, rather than because of any widespread dissatisfaction. That said, there has been some grumbling about Facebook, most recently because of its decision to force people to adopt the Timeline feature rather than allow them to opt into it. Such imperiousness could also damage the firm's ability to generate money. John Gerzema of **Y & R**, an advertising agency, notes that its surveys of consumers show that Facebook is perceived as increasingly arrogant. "I'm not sure that an 'Occupy Facebook' movement is coming next," he says, "but there is a cold, steely image emerging that could limit the network's penetration and usage."

Being seen as something other than warm and cuddly is not in itself a bar to becoming a gigantic business. There are plenty of precedents, Y&R'S research also shows that Apple is perceived as arrogant, but that has not stopped people treating its products with almost religious reverence and turning it into the world's most valuable listed company. Nevertheless, users could be less forgiving of Facebook in future if it infuriates them.

Facebook has also had occasional brushes with privacy watchdogs, for which the social network has become something of a bête noire. Last year Facebook incurred the wrath of America's Federal Trade Commission (FTC). The commission had been inundated with complaints that the company was making public data about its users that it had said would be kept private. As part of a settlement with the **F T C**, Facebook agreed to submit to an external audit of its privacy policies and practices every two years for the next 20 years.

The bigger risk to Facebook is that growing concern over online privacy translates into a wave of legislation around the world that makes it far harder for the company to exploit the mountains of data it is collecting. That would throw a spanner into the works of its money-spinning advertising machine. So far there has been little sign of such a backlash, though governments are paying closer attention to privacy. America is thinking of creating a general consumer-privacy law and the European Union is updating its rules.

Facebook will also need to tread carefully as it seeks to use its internal currency to extract rent from its platform. If it gets too greedy, it could deter new firms from using its ecosystem and ultimately drive away those that are already paying it substantial sums of money. There has in the past been friction between it and Zynga, which is building a web and mobile platform of its own, called Zynga Direct, in order to reduce its reliance on Facebook.



It could be, of course, that Facebook is so dominant in social networking that Zynga and others find themselves with no alternative. In that case, Facebook could run into trouble of a different sort: as it gets bigger, the company may find itself under the gaze of antitrust regulators.

Markets in which network effects are important have a tendency towards monopoly. The most topical example is search: Google seems to be the focus of trustbusters' attention. But as Facebook expands, it too could find itself being accused of abusing its dominance by smaller fry. For this and other reasons, one of the things Facebook is certain to do with the cash it raises will be to hire a much bigger army of lawyers and lobbyists.

The social network's IPO will also set the stage for an epic battle between the titans of the tech industry. It has been clear for some time that Google is squarely in Facebook's sights-and that Facebook is in Google's. But as Facebook builds its social-app platform and takes it onto mobile devices, it will pose more of a competitive threat to Apple and Amazon too. Perhaps Facebook will be tempted to use some of the cash from its **I P O** to strike a partnership with a hardware company to produce a "Facebook phone" with a Facebook-created social operating system.

Such a device would be entirely in keeping with Mr Zuckerberg's belief, outlined in a letter which accompanied the **I P O** filing, that things should be "social by design". The missive went on to explain that anyone investing in the company's stock would be buying into a firm that would sometimes put its long-term mission of making the world more open and connected ahead of short-term financial considerations.

Mr Zuckerberg's social-ist manifesto also made clear that Facebook would stick to what he calls "the Hacker Way"—a nod to "the **HP** Way" which encapsulated the ethos of the founders of Hewlett-Packard. Facebook has hitherto been able to focus on fostering an innovative culture that encourages employees to move fast and take risks. New programmers are encouraged to push out code onto its platform in their first week on the job and the company regularly holds all-night "hackathons". Preserving this spirit will be vital if Facebook is to present its new investors with the graph that they will most want to see: one that shows a steadily rising share price.

Fonte: The Economist, London, v. 402, n. 8770, p. 23-26, 4 a 10 Feb. 2012.