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# What does a $100bn valuation for Facebook mean?

**If you follow financial or technology news, you've probably already read plenty of stories about Facebook going public. You know about all the Facebook millionaire (or billionaire!) employees, its financials, its mission to "connect" the world, and the unusual degree of control that Mark Zuckerberg will hold. My colleague Miklos Sarvary has two very good posts on the INSEAD blog here and here, putting Facebook's dominance and valuation into the general context of social media and advertising.**

I want to add my two cents about Facebook's 100 billion dollars valuation.

Last week I was teaching customer valuation at an executive programme and the topic of Facebook came up. We were discussing the idea that relationships to customers could be thought of as assets that provide a firm with a stream of earnings. For instance, I am a loyal Amazon.com customer and spend about €500 a year on books and music. If Amazon.com has a gross margin of 20%, then they can consider me an "asset" that generates about €100 of earnings each year. We can then compute how much my relationship to Amazon.com is worth to them in monetary terms. That number can then be used to guide their customer retention activities, promotions, etc.

Now let's get to Facebook and allow me to use approximate numbers. According to the S-1 filing, they have 850 million users. They made $3.7bn in revenue and $1.0bn in profit in 2011. These numbers mean that the average revenue per user was 4.4$ and the average income per user was $1.2 (I am rounding up, just to be generous with Facebook).

That last number matters. Any marketer that is worth her name can estimate the value of a customer who provides a yearly income of $1.2. Let me show you the easiest way to get a decent approximation of that value. You will need 2 additional numbers. First, you need an idea of how long the customer is going to stick around. We often use the retention rate, defined as the probability that a customer who is active this year, would be active next year. Companies measure this number by keeping track of the yearly attrition rate of customers. Second, as in any valuation exercise, you need the discount rate (e.g. people often approximate this using the WACC). The approximate value of that customer assuming nothing changes is given by $m*r/(1+i-r)$, where $m$ is the income ($1.2 in our case), $r$ is the retention rate and $i$ is the discount rate (check the Wikipedia entry). I don't know the retention rate or the discount rate for Facebook, so I will continue to be generous and assume that the retention rate is 95% and the discount rate is 9%. As it turns out, the value of a customer who yields earnings of $1.2 and remains active year-on-year with 95% probability, discounted at 9% is $8.1. In other words, the lifetime value of this customer is worth eight bucks!

The customer base as a whole is worth 850 million X $8.1 = $6.9bn. This is very far from $100 bn.

Maybe you think I am being unfair to Facebook, because they are building new services, engaging customers, or monetizing new features. As a result, the revenue and profit per customer will grow. Let's assume it grows. If we assume that Facebook can grow the income per customer by 5% a year , the customer valuation goes up to about 12$. That leaves the valuation of the entire customer base at $10.4bn, still one-tenth of the implied valuation.

But I am also forgetting that the mission of Facebook is to "connect the world". And the world is much larger than 850 million users. What is the limit? Zuckerberg himself admits that it is unlikely that they can reach the entire world population and they aim to reach, at best, about 3 billion users. Let's believe him, and compute again the valuation of Facebook, with all our benevolent assumptions plus the assumption that magically tomorrow they wake up with four times more users. Even this fantastic scenario leaves Facebook with a valuation well below $50bn. And let us not forget that the "untapped" market is untapped for a reason, and the next 850 million customers will not join Facebook as quickly as the first 850 million did. Moreover, it is likely that the marginal customers are not going to be as profitable and sought after by advertisers.

The whole point of this post is to make sense of the current valuation of Facebook in terms of the profits they can make per user. If the value of the company comes from its discounted cash flows, and those cash flows come from advertisers who want to reach the users and from users who pay for specific services, we can easily link the value of the company to the value of individual customers. I admire Facebook and I expect it to grow in numbers and margins, but I am sceptical that this growth will be as phenomenal as the valuation implies.

Admittedly, I left many things outside of this little valuation exercise. I have not analyzed the value of the brand to enter other categories (Facebook Phone, anyone?), or the technological innovation that will come out of the team of millionaire hackers in Facebook's basement. Perhaps that is where the remaining $50bn are. In any case, let us all agree that accepting that Facebook is worth $100bn means accepting that they will take over the entire social media market very soon as well as grow the profit per customer fast and consistently.

I don't know how Facebook's future looks like, and I am the first one to admit that we should never underestimate great companies in nascent industries. But I am still trying to link the market expectations with the basic customer fundamentals.

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