Valuation of Social Networking: Private Equity and Venture Capital

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Introduction

The purpose of this paper is to explore the topic of social networking sites from the vantage point of private equity and venture capital. This report will examine the trends of social networking sites, as well as whether the future of these sites shows potential increases in the number of users and the financial returns that can be made for investors. In addition, a discussion will be provided about the ways in which private equity and venture capital valuations of companies are made and the possible valuations of the top 10 social networking sites today. Possible valuations using both types of models will also be provided. In the end, this paper will use all of the data and information to determine if social networking sites are better for investment purposes from the standpoint of venture capital and private equity. In addition, using the valuations, a discussion will be provided as to whether it makes sense for a private equity firm to try and take over a social networking site that may not be performing as well as would be liked.

Social Networking Sites

The information on the popularity of social networking web sites, such as Myspace and Facebook provide both joy and concern for those seeking to invest in these types of ventures. At the end of 2007, it was estimated that the total number of users of all social networking sites around the world was more than 230 million. What is even more impressive is that this number is expected to continue to grow until 2012. The problem, however, is that within the next 4 to 5 years, the actual growth of social networking sites is expected to level off as the number of people that are available to become new members becomes smaller (DataMonitor 2007, 7).

At least at the present time, there is clearly a draw among people to visit social networking sites. A recent poll reported that about 37% reported that they checked Facebook once to twice day. Even more, 8% of those in the poll actually reported checking the site as many as 10 times per day. In addition, nearly 15% reported being logged onto the site through the day to check for messages and updates from friends (DataMonitor 2008, 234). This suggests that social networking sites are clearly very popular and are being used as a way to keep in touch with friends and even strangers.

While these numbers do show the popularity of these types of web sites, the purpose of this paper is to explore this phenomenon from the perspective of investors from the world of private equity and venture capital. When this perspective is used, the trends and future potential for social networking sites becomes a little more difficult to understand. In total, revenues generated by social networking sites are about $965 million. This number is actually expected to increase to $2.4 billion by 2012. However, as has already been stated, the problem is that this number is expected to level off after 2012. From there it is much harder to predict what will happen with these types of sites in terms of their revenue-generating abilities (Social Networking's Explosive Growth 2007).

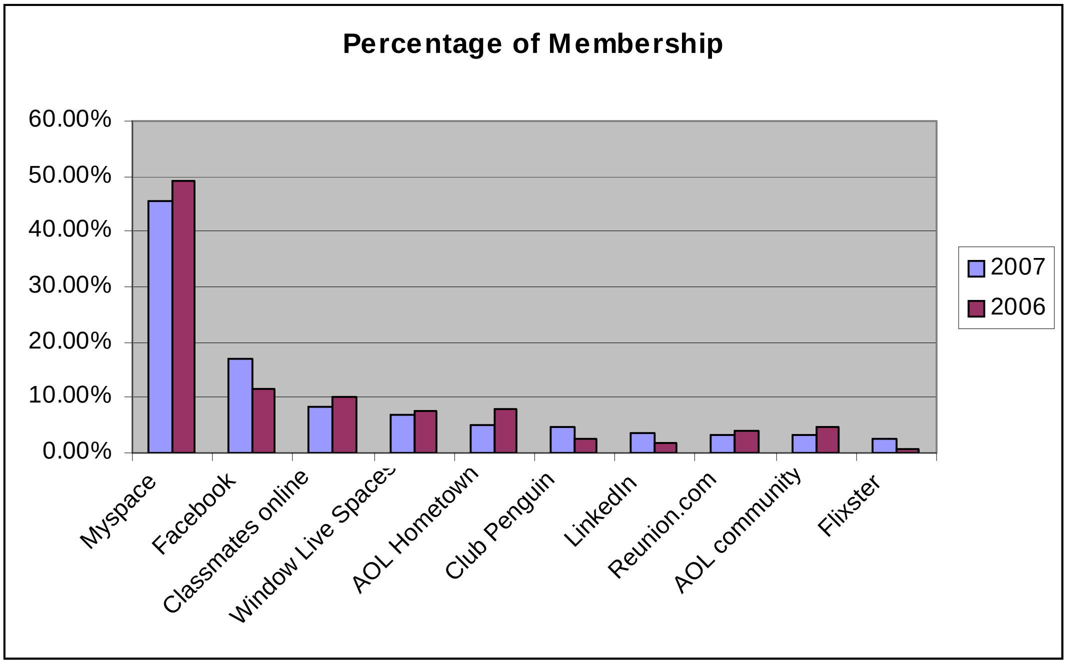
What is also problematic is that not all social networking sites are seeing growth year after year. In fact, the current top 10 social networking sites in terms of membership have not seen increases in users from 2006 to 2007. Popular sites such as Myspace and Facebook have seen nice growth in terms of members. Others, however, such as AOL Hometown and Reunion.com have seen decreases in the number of members (Nielson Online 2007). This only adds to the confusion about the potential future value from any investments in these web sites. Figure 1 shows the membership numbers for the top 10 social networking sites from 2006 to 2007.

Figure 1: Memberships for Top 10 Social Networking Sites

There is also the problem of actually generating steady revenues for these sites. Social networking sites rely on advertisements as the primary source of revenue. The actual services are provided to users for free. This means that many sites spend a great deal of time trying to increase membership numbers as a way to becoming more attractive to advertisers. What also makes the future of these sites difficult to predict is that technology is likely to change in the next five years. This may mean that interest in social networking sites will wane as new means of communicating and connecting with friends, such as virtual worlds, come into play (Ranger 2008, 46).

What is also problematic is that the actual market share of the top 10 social networking sites from 2006 to 2007 when compared only with each other, and not with all of the social networking sites that are available, has changed differently than the level of membership. For example, Myspace has grown from 55 million members in 2006 to 60 million in 2007. However, as a percentage of the market share among the top 10 sites, it has decreased from 49% to 45% (Nielson Online 2007). Depending on how to evaluate growth, or the lack thereof, a specific site may be growing or it may be declining in terms of users and market share. Figure 2 shows the membership percentages in terms of comparison among just the top 10 sites.

Figure 2: Percentage of Membership for Top 10 Sites



From the standpoint of valuation, all of this means that it is very difficult to put a value on social networking sites using traditional valuation models. The lack of real data about revenues and growth means that determining the current value based on a future rate of return lacks the same level of specificity that might be found in other industries (Knowledge@Whatarton 2006). Instead, putting a value on these sites depends on how other similar sites have received funding, either from venture capital or private equity, as well as the technology and services that are offered. Many social networking sites only offer a way to communicate and stay in touch. This is a service that can easily be provided by anyone and is not something that is proprietary to one company over another.

Valuation Information

Some data is available that can help to provide a basis for putting a value on social networking sites. Some of this information is based on what other companies have invested in these sites, as well as the little information that is public about the generation of advertising revenues. For example, takes in about $180 million a year in advertising revenue (Davis 2006). However, it must be remembered that Myspace is the largest social networking site in the world. It has the most members and advertisers realize that Myspace can provide a lot of potential viewers of their marketing efforts.

Some of the current list of top 10 social networking sites have also received funds from venture capitalists. Facebook has received a total of $13 million in venture capital. LinkedIn, however, has received nearly $17 million in venture capital. Friendster falls right in the middle of these two sites with a little over $15 million in venture capital funding (Loizos 2005, 5). The problem arises when you try to compare the amount of funding with actual information about membership. It is easy to determine that the level of funding is not always based on the actual membership numbers at the time of investment.

In terms of private equity investments, Myspace has been valued at around $15 billion based on a $580 million offer made by News Corp. for a stake in the company. However, some have argued that this valuation is a little inflated considering that Myspace would need to take in $270 million a year in advertising revenues to actually hit the $15 billion valuation. The fact that the company does not take in $270 million in revenues means that the valuation provided with the News Corp. offer was too high (Knowledge@Wharton 2006).

Methods of Valuation

Private Equity

Before actually trying to decipher the valuation of social networking sites and create concrete values, at least in theory, it is important to understand how private equity and venture capital places values on potential investments. From the standpoint of private equity, the valuation process can be difficult to understand because there is really no specific standard that is used (Harrington 2004, 44). Instead, there are guidelines and procedures, and even precedents that come into play. For the most part, however, most private equity firms use a net present value based on a discounted cash flow to determine the value of a potential investment (Yescombe 2007, 286).

The discounted cash flows are usually discounted based on the perceived rate of return that could be obtained for selling the investment (Yescombe 2007, 286). In other words, if a private equity firm believed that selling an investment in a social networking site would yield a rate of return of 20% in the future, then the firm would use a discounted rate of return to value the investment of 20%. The discount rate can be set to whatever a private equity firm thinks it can obtain in the future. However, private equity firms also operate under pressure to use a fair value and not to try and take advantage of small companies that may be desperate to receive any funding possible (Harrington 2004, 44).

This takes us back, however, to the problem about actually determining a value for companies for which a history of revenues is not really available. When a history of revenues, or a history of stable revenues, is not present, then private equity firms have to determine how to provide a valuation, or even if the valuation and the eventual investment is worthwhile. Not being able to put a value on an investment can make it very difficult to determine a fair value or really any value at all.

What this means is that putting a value on social networking sites really depends on looking at comparable companies and determining, based on such factors as expected revenues, what a company is worth. While this is certainly not the desired method for private equity that likes to be able to look at the revenues and determine a book value based on price and equity (Draho 2004, 161). Of course, the inability to do this in a scientific manner may mean that investing in social networking sites is really not appropriate for private equity.

Venture Capital

The most common method for venture capital to value a company is known as the comparable method. This method is simply how it sounds: a venture capital firm will research what other firms have invested in similar types of companies and base their valuations on those numbers along with how the current potential investment performs in relation to the comparable information (Camp 2002, 222). What this means is that another venture capital firm may have given $10 million to a company that is twice the size of the one in question. If both companies appear to have similar prospects for growth, then the venture capital firm might value the investment in the current company at $5 million.

In some respects, the method of valuation that is used for venture capital seems much easier than the method that is used by private equity for firms that really lack a long history of performance. Rather than trying to predict what a company may do in the future in terms of financial performance, a venture capital firm can determine what others have invested in similar companies and what they have believed is a sufficient investment to see a return.

Valuation

Based on the information about the way in which private equity and venture capital use to value investments and the value of companies, it is possible to use those methods to create values for the top 10 social networking sites. First, it is necessary to determine the expected revenues for these companies. Since not all companies have accurate revenue information available to the public, the method that will be used is to use the revenues from Myspace and estimate revenues for the other companies based on the revenues per member. In the case of Myspace, the revenues per member come out to $2.99. This is used to determine the estimated revenues for the other social networking sites. Table 1 shows the estimated revenues for each site.

Table 1: Estimated Revenues for Social networking Sites

	Expected Revenues
Myspace	180,000,000
Facebook	67,604,818
Classmates online	32,188,207
Window Live Spaces	26,522,028
AOL Hometown	20,523,426
Club Penguin	19,040,996
LinkedIn	14,387,062
Reunion.com	12,248,769
AOL community	12,185,878
Flixster	9,274,923

As the table shows, the estimated revenues range from $180 million, which is the actual reported revenues for the company, to an estimated low of just over $9 million for Flixter. It is important to explain that this method of creating revenue valuations is not entirely inappropriate. The cost that advertisers pay to display their ads on these sites is paid per 1,000 thousand impressions. The rate for this is determined based on the number of people who are actually members of these sites (Davis 2006).

Based on these revenues, and using the investment from News Corp of $580 million in Myspace, which resulted in a total valuation of the company at $15 billion, it is possible to determine a valuation for the other nine social networking sites. This is done by using the $15 billion total value of Myspace and taking into account the advertising revenues in relation to the valuation. Using this ratio, the valuation of the other companies based on their advertising revenues is created. Table 2 shows the valuations that have been created for the social networking sites.

Table 2: Theoretical Private Equity Valuations

	Private Equity Valuation
Myspace	15,000,000,000
Facebook	5,633,734,860
Classmates online	2,682,350,592
Window Live Spaces	2,210,169,040
AOL Hometown	1,710,285,505
Club Penguin	1,586,749,634
LinkedIn	1,198,921,869
Reunion.com	1,020,730,733

AOL community	1,015,489,818
Flixster	772,910,289

It is easy to see the problems that this can create. Using this method of valuation for private equity means that Facebook is worth about $5.5 billion. However, a site like Flixster is worth nearly $773 million. It has to be remembered, however, that this is based on an investment of $580 million. In other words, many of these social networking sites would not be a good investment for private equity because a large part of their value would actually come from the money invested by the private equity firm. Even more, the fact that many of these sites have shown decreases in member over the past year means that advertising revenues will likely decrease.

From the standpoint of venture capital, the information that is available has shown that venture capital firms have invested between $13 and $15 million in these types of sites regardless of the actual level of membership. For Facebook, the $13 million in venture capital funding translates into about $0.57 per current member. However, the $14.9 million venture capital funding of LinkIn translates into about $3.10 per member. It is likely, however, that the differences are based on perceived level of growth in the short-term. LinkIn has more than doubled its membership from 2006 to 2007. Facebook has also nearly doubled its membership numbers, but it already had more than 10 million members when the investments were made. This would likely mean that there is more potential for growth from LinkIn than Facebook in the short-term.

If this method is used, then it would suggest that a company with less than 10 million users should receive a valuation of $3.10 per current member. Social networking sites with over 10 million members should receive a valuation per member of $0.57. Table 3 provides the estimated valuation of investments using the venture capital method of pricing. The values for Facebook and LinkIn are not present because they were used as the comparables for creating the valuations of the other companies.

Table 3: Venture Capital Valuation of Investments

	Venture Capital Valuations
Myspace	$34,259,280
Facebook	
Classmates online	$6,126,360
Window Live Spaces	$27,453,600
AOL Hometown	$21,244,300
Club Penguin	$19,709,800
LinkedIn	
Reunion.com	$12,679,000
AOL community	$12,613,900
Flixster	$9,600,700

What can be seen from this method of determining an appropriate investment is that the numbers seem much more in line with the actual projections about revenues. The investments range from around $10 million for Flixster to about $27 million for Windows Live Spaces. However, if you were to take into account changes in actual members from 2006 to 2007, then all of the numbers would likely hover around $10 to $15 million to take into account declining memberships for some of these sites. If you were to reduce the valuations based on the percentage decreases in membership over the past year for those sites that have lost members, the new and final valuations would be as they appear in table 4.

Table 4: Final Valuations Taking into Account Lost Memberships

	Venture Capital Valuations	Sites that Lost Members
Myspace	$34,259,280	
Facebook		
Classmates online	$6,126,360	$5,751,300
Window Live Spaces	$27,453,600	
AOL Hometown	$21,244,300	$14,489,400
Club Penguin	$19,709,800	
LinkedIn		
Reunion.com	$12,679,000	$11,944,300
AOL community	$12,613,900	$9,067,500
Flixster	$9,600,700	

The new values for those sites that lost memberships from 2006 to 2007 provide even further evidence that the venture capital model is more appropriate for these companies. All of the investments lie within the range of $5 million to about $25 million. What is also important, however, is that all of these values are relatively in line with previous venture capital investments in Facebook and LinkIn. The only major outlier in the group is Myspace. This is not surprising considering the much larger popularity of the site and its overall revenues.

Private Equity and Social Networking Sites

The analysis of the valuation models suggests that private equity is not well suited to make investments in social networking sites. The method of pricing such investments is simply not suited to companies that may not have long-term histories of generating revenues year-after-year. Even more, the data and information available indicate that even when valuations are made by private equity, they may be inflated in terms of the actual value of the company and the actual ability to generate the required return on the investment.

This would also seem to suggest that private equity firms are also not well suited to take over a social networking site that is under performing. The reason is that a site that is already in trouble will be hard to value in terms of future potential revenues. Even more, the ability of the private equity firm to be able to produced a return by selling its investment on a secondary market may not be that great. In the end, the nature of private equity and the desire to be able to sell investments in the future for a specific rate of return is not appropriate for social networking web sites. The future of revenue generation, as well as the future of the industry in general, makes these types of investments too risky for private equity.

Discussion and Conclusion

The purpose of this paper has been to examine the value of social networking sites from the standpoint of private equity and venture capital. In addition, this paper sought to determine if it appeared that one form of investment might be better suited than another for these types of companies. The analysis of this issue showed that trying to put a value on social networking sites using the private equity valuation method is really not very accurate and requires too many assumptions for some of these companies. The lack of revenue data for some of these companies, either because of the lack of information or simply the lack of a revenue-generating history, makes the investment too risk for private equity.

Even more, there is also the concern that these sites are simply overvalued based on the potential for future returns by selling these investments on secondary markets. It has been shown that some believe that even for a sight like Myspace, a valuation of $15 billion in the private equity world is too high for the level of revenues that are generated by the site. If a site like Myspace that is very popular and is the top rated social networking site in terms of membership is hard to accurately value, then it is not difficult to understand the troubles that are possible in attempting to place a value on other companies with fewer members and less market share.

Venture capital is best suited for investment in these types of sites because they can provide an investment that can likely be returned within a specified amount of time without having to worry about the future of trying to sell the investment on other markets. This may be especially true for shorter-term investments that are made for a period of two to four years. The reason for this is that the overall market for social networking sites and for revenue generation on these sites is expected to level off by 2010. This does not necessarily mean that they will stop generating revenue. Instead, it means that growth may level off and these sites may become stagnant in their ability to generate growth year-after year.

Venture capital firms have more freedom to focus on the short-term to move in and provide a company with necessary capital and then seek repayment of the investment in one way or another. In addition, venture capital firms, by their very nature, are in a position to give smaller amount of money to companies in order to provide a source of capital for future growth. Rather than being determined about book values, equity, and changes in revenue, they can be more concerned about helping a company get off the ground or grow through a period of transition.

This evaluation also shows that there is a reason why there are private equity firms and venture capital firms. Both types of investments are not right in all situations. Even for companies and industries that, at least on the surface, seem like a strong growth area, both types of firms may not have the methods to ensure that their investments and the desired outcome from these investments will be safe and secure. Even more, there is the possibility, especially for private equity, that the investment may be larger than can really be supported by the growth potential for the company in question to see the desired return on investment.

Finally, the question was raised as to whether a private equity firm could take over a social networking site that is not performing well and turn it around. It would appear from the analysis in this report that venture capital might actually be a better method for this than private equity. A site that is already underperforming may simply present too much of a risk for private equity investors. However, a venture capital firm may be able to provide enough cash to a social networking site with a good idea that simply lacks the capital to advertise their idea and effectively manage the business. Then, once the site becomes more profitable, the venture capital firm can see a return on their investment without the concern about long-term growth and the ability to sell the investment.

The importance of this research is that it truly shows that dangers that are present in assuming that the latest trends in an industry can be a good investment. Instead, proper due diligence and a proper understanding of how to determine the value of investment are necessary. Without these things, it is quite possible for a firm, either venture capital or private equity, to invest money in a way that may result in a lack of return on an investment. It could also mean a major risk for a private equity firm that is looking for its own growth in the future.

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