Facebook's financial details raise red flags for some

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Facebook Inc. has opened its books to eager investors, but some don't like what they see.

Profit margins have been shrinking. Costs have been rising. And the stock structure means that founder Mark Zuckerberg controls 57 percent of the voting shares, giving him near-dictatorial power over the company's future.

Other potential problems: Facebook does not operate in China, the world's largest social networking market. The company's regulatory filing this week also showed that it makes little money from advertising on mobile devices, which may soon be the primary way users access the Internet and visit social networks.

"Mobile advertising simply doesn't have the legs that online advertising has," said Nate Elliott, an analyst at Forrester Research. "If all the users moved to mobile, there's no guarantee they could make anything like what they're making now."

Adding it all up, investors eager to get in on Facebook's initial public offering this spring are worrying the company will not be able to live up to the hype and sky-high prices that shares are expected to reach.

"Emotionally, people will want to own a piece of it," said Tim Ghriskey, the chief investment officer at Solaris Group. "But this is a very speculative investment at this point in its life cycle."

That said, appetite for the shares is expected to be strong during the initial public offering this spring. Facebook's 845 million users make it an Internet superpower. The billions of ads displayed to users every day are a clear indicator that marketers believe Facebook's unrivaled trove of user data will let them connect with consumers in a way no other company can.

"Their growth trajectory is huge," said A.C. Moore, chief investment strategist for Dunvegan Associates Inc. "This is the new kid on the block, and it's probably going to move into the center of the arena."

Yet certain kinds of growth are already slowing, while costs are going up.

Facebook's base of daily users shot up 11.6 percent in the last quarter of 2010 - but that growth rate dropped by nearly half at the end of 2011, to 5.7 percent. Most observers believe that Facebook will not be able to sustain the ballooning expansion it has enjoyed for several years.

At the same time, the cost of running its network of data centers has surged. In 2009, Facebook spent $2.78 per active daily user to power its service; by last year that number had jumped to $4.04. And because companies must constantly upgrade their servers to keep up with user demand, Facebook's costs may not ebb any time soon.

The head winds facing the company are disconcerting because investors are expecting such enormous growth from it.

While Facebook shares are not yet trading publicly, sophisticated investors have been able to buy them on private exchanges, where the prices this week valued Facebook at $90 billion. Many analysts expect the market value to go above $100 billion after the IPO.

Most companies of that size have profits many times greater than the $1 billion that Facebook said it made last year. Google Inc., which is worth about twice as much as Facebook, had profits almost 10 times higher last year.

"Enormous growth prospects have already been placed into this stock, and it's difficult to meet those kinds of expectations," said Tim Loughran, a finance professor at the University of Notre Dame.

Moving forward, there are a number of clear roadblocks facing the company's effort to grow profits. In its public filings, the social network said it derived 12 percent of its revenue from Zynga, the maker of popular online games such as "FarmVille."

Zynga users pay to play the game by using Facebook Credits, the social network's online payment system. But that relationship is scheduled to expire in 2015.

Analysts also said Facebook's success will hinge on whether it can follow users from traditional personal computers to the tablet computers and smartphones to which they are moving in droves.

Tablet computers will probably outsell PCs in the U.S. this year, and research firm IDC said recently that by 2015, more users will access the Internet on wireless devices than wired ones.

Also looming in Facebook's future is the specter of when and if it will expand into China, where strict media control has made doing business there difficult for U.S. Internet companies like Google. Facebook and messaging site Twitter are both banned there.

"China is the world's largest social networking market, and Facebook doesn't play there - that's a big problem," said Debra Aho Williamson, an analyst at advertising research firm EMarketer.

Then there's Zuckerberg, the wunderkind who started Facebook in his Harvard dorm room at age 19.

Generally, when companies go public, shareholders gain a voice in determining the future development of the company and helping to iron out the wrinkles. Facebook stock owners will have no such power because of a stock structure that keeps almost all of the power in Zuckerberg's hands.

"It makes us much more cautious on the stock," Ghriskey said. "It's a publicly traded company, but it's not a publicly managed company."

Added Ghriskey: "If you look historically at companies that are run this way, it pays to be wary of them."

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