

# Why Facebook still doesn't look cheap

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In this May 18, 2012 file photo provided by Facebook, Facebook founder, Chairman and CEO Mark Zuckerberg, center, rings the Nasdaq opening bell from Facebook headquarters in Menlo Park, Calif. Robert Greifeld, second from right, CEO of the Nasdaq-OMX Stock Market, Inc., said Sunday, May 20, the stock exchange is "humbly embarrassed" by its bungling of Facebook's debut. Facebook's stock was expected to start trading at 11 a.m. Friday, but didn't open until 11:32 a.m., and some investors didn't learn for hours whether their orders went through. (AP Photo/Nasdaq via Facebook, Zef Nikolla, File)

(AP) -- If you were thinking of picking up a few shares of Facebook last week, when it went public at a price of \$38, you might be seriously tempted now that the stock has fallen \$7 in two days.

But forget the dramatic drop. Investors should focus on the only question that matters: How much money will Facebook earn over the next several years, and is that enough to justify its market value right now?

The conclusion is hard to escape: Facebook might be a bargain someday, but not now.

Though it's a rough guide, one way to value a stock like Facebook is to divide its price by its annual per-share earnings. The result is the price-to-earnings ratio. A higher ratio suggests a stock is expensive, and lower suggests it is cheap.

When Facebook set its offering price at \$38, the ratio was high - more than 100 times its per-share earnings last year. It's still high, at 85 times earnings per share, even after a two-day drubbing left it at \$31 a share.

The [Nasdaq composite index](#) of [technology stocks](#) trades at 15.7 times last year's earnings, according to FactSet, a provider of financial data. Apple trades at 13.6 times and [Google](#) 18.2 times.

Of course, investing isn't as simple as price-to-earnings ratios. Some companies grow their earnings faster than others, turning a high ratio - and a seemingly expensive stock - into a low ratio and a cheaper stock.

If you just looked at Facebook's earnings growth last year, an impressive 65 percent, you'd think it's just such a company.

If Facebook can keep up that pace, its \$1 billion in earnings last year will be \$7.4 billion in 2015. That would be enough to bring Facebook's ratio more in line with Apple's.

But that's with the stock not rising from \$31. If you assume the stock rises 10 percent a year, you have to add nearly another year to that waiting period.

Then there is the problem with assuming that Facebook - or any company, for that matter - can maintain torrid [earnings growth](#). One

reason Apple is trading at just 13.6 times earnings is that investors don't think it can maintain its 85 percent growth rate.

Just projecting one year out is difficult. Among 10 analysts surveyed by FactSet, projections for Facebook's earnings for next year range from \$333 million to \$1.7 billion. On average, they expect \$993 million.

Facebook reported \$3.7 billion in revenue for last year. The average projections for this year is \$5.1 billion.

Brian Wieser, an analyst at Pivotal Research Group, is a Facebook doubter. In a report Friday, he estimated earnings will slow, and they will be only \$3.6 billion in 2015 - half of what they would be if Facebook maintained its growth rate.

Another problem with the stock is that Facebook may have waited too long to go public.

Think of the gains investors would have made if the company had debuted in 2009, a turnaround year for Facebook. The company had lost \$56 million in 2008 but was finally churning out profits. They more than doubled in 2010.

In August 2009, investors trading private shares of Facebook on Sharepost, a secondary exchange, paid \$2.40 per share. Though the numbers are only roughly comparable with today's figures, that gave Facebook a market value of less than \$7 billion.

The \$38 offering price assigned Facebook a market value of \$104 billion. Based on Tuesday's closing stock price, that had fallen to \$85 billion.

If Facebook had gone public with a market value of \$7 billion and that

had increased to last Friday's value of \$104 billion, investors in the hypothetical IPO of 2009 would have seen their investment grow 15-fold.

Of course, other companies priced themselves at high price-to-earnings ratios at their IPOs and still managed to reward shareholders. But they tended to be younger businesses than Facebook, which was born eight years ago.

Amazon.com went public in 1997, two years after it opened for business. Back then, its business model was online bookselling. The Kindle, video downloads and cloud-computing hadn't been dreamed up.

Of course, Facebook founder Mark Zuckerberg could dream things up, too. And Facebook has a real business, real profit and real revenue today. But social media is still unproven in many aspects as a business model.

A lot of people use Facebook on their mobile devices, for example. Facebook gets 82 percent of its revenue from advertising, but no one has figured out how to make substantial money from mobile advertising. In what turned out to be very poor timing for Facebook, General Motors stopped advertising on it during the week of the IPO.

You can also turn that argument on its head. Facebook is just getting started. It will figure a way to make money on mobile, and it will come up with businesses and revenue streams no one has thought of, as Amazon did. But investors in [Facebook](#), at least in the last two days, seem to have their doubts.

One skeptic, Scott Freeze, the president of Street One Financial, says he won't touch the [stock](#) until it falls to a level justified by its [earnings](#). He says that might be \$25 - another steep fall from here.

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