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Facebook is not Google

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Note: I will be on Bloomberg TV tomorrow (Friday the 10th) at 7:45am eastern time, and on Fox Business Network at 4pm eastern on Friday the 24th. Mark your calendars….

Amidst all of the ink that has been spilled on the Facebook IPO – and let me tell you, 2.8 million Google hits for "Facebook IPO" is a lot of ink – there's one aspect that's been somewhat overlooked:

Facebook is not Google.

I cannot begin to tell you how many articles I have read comparing the two companies, most of which have made the implicit (or explicit) suggestion that since Google shares have risen six-fold since their 2004 initial offering, why can't Facebook shares do the same? Yes, both companies were growing very quickly at the time of their respective IPOs, and yes, both companies make money using the "internets." Moreover, the letter "O" appears twice in both "Google" and in "Facebook." But there the similarity ends.

The first big difference between the two IPOs is simple: Size matters. In 2011, Facebook generated $3.7 billion in sales, and $1 billion in net income. In the twelve months prior to its IPO, Google generated $2.2 billion in sales and $190 million in net income. Now, there's nothing stopping companies with tens of billions in revenue from growing at a fast clip – Apple is still doing just fine – but it is harder to compound a nearly $4 billion top line than one that was a bit more than half that size.

The second difference is the business model. Although Facebook has tons of data about its users, advertisers still have to a) make an educated guess as to whether users with particular characteristics would be interested in their wares, and b) hope that they notice the ads which appear while the user is checking out his or her friends, playing a game, or whatever.

By contrast the buyer of a Google ad word is almost 100% certain that someone searching for that term has at least some level of interest in a related product. More importantly, the buyer of a Google ad knows that he's targeting someone who is actively looking for information, as opposed to the Facebook user who is engaged in some other activity. In my opinion, the return on investment (ROI) of search advertising is much higher than the ROI on social-media advertising.

The third difference is in how the two companies are approaching their initial public offerings. Facebook, of course, is using a traditional IPO process, wherein it hires an investment banker to sell its shares to buyers. The incentive in this process is to price the shares as richly as possible – "all the market will bear" – since a higher price raises more money for the company and (don't forget!) generates a higher fee for the investment banks managing the IPO.

Google, by contrast, did not use the traditional IPO process, choosing instead to sell its shares to the public via a "Dutch auction." In a Dutch auction, buyers submit bids for how many shares they are willing to purchase at specific prices, and the lowest successful bid becomes the "clearing price" which every bidder ultimately pays. This creates a very different pricing dynamic, because there's no army of salespeople flogging the shares to potential buyers, as there are in a traditional IPO.

I think it's reasonable to posit that a price set by tens of thousands of anonymous and independent agents is less likely to be irrational – that is, overpriced – than a price set by an investment bank whose fee rises with the IPO price. In other words, the Dutch auction gave Google shares some room for upside, whereas that seems less likely to be the case for Facebook shares.

Valuation, of course, is the fourth and most important difference between the Google IPO and the Facebook IPO, and the one that is most likely to impact the future returns of potential Facebook shareholders. If the current "chatter" of a $75 to $100 billion valuation for Facebook comes to pass, Facebook shares will be *significantly* more expensive at the time of its IPO than Google's shares were when it went public in 2004.

Here are the numbers. As noted above, Google cranked out $2.2 billion in revenue and $190 in net income in the twelve months prior to its IPO. The company was growing sales at just over 100%, and had a very scalable business, so let's assume that investors were forecasting $4.4 billion in sales and $700 million in net income for the twelve months after the IPO. (I dug up some analyst reports from late 2004, and this is not too far off.) Google was valued at $23 billion when it went public at $85 per share. That's a trailing price-to-sales ratio of about 10 times, a forward price-to-sales ratio of 5 times, a trailing price-to-earnings ratio of 121 times, and a forward price-to earnings ratio of 32 times.

Facebook, as noted, generated $3.7 billion in sales in 2011, and $1 billion in net income. It's growing sales at a nice clip, averaging just under 100%, but net income has been growing a little slower as Facebook has been plowing money into areas like marketing and research & development. So, let's generously assume Facebook does $7 billion in sales this year, and $1.8 billion in net income. Assuming an IPO valuation of $90 billion, Facebook will be valued at a trailing price-to-sales ratio of 24 times, a forward price-to-sales ratio of 13 times, a trailing price-to-earnings ratio of 90 times, and a forward price-to-earnings ratio of 50 times.

Is 50 times forward earnings insane for Facebook? No. But it's sure not cheap, and it's a lot higher than Google's valuation at the time of its IPO, which leaves a lot less margin for error. Buyers of the Facebook IPO may wind up doing fine if Facebook continues its blistering growth

– but the expectations for Facebook are much higher today than the expectations were for Google eight years ago, which means the odds for excess security returns are commensurately lower.

Caveat emptor.

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