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INTERNET SERVICES VALUATION STUDIES – PART 3: SOCIAL MEDIA

Since the beginning of the new millennium, the internet has evolved from a compendium of static websites to a dynamic array of web communities built upon user-created content and interactions. This global "Web 2.0 community", a term coined by Darcy DiNucci in 1999, provides the framework for collaborative exchanges through social media as well as the virtual formation of an online community[1]. The professionals at Cogent Valuation ("Cogent") have explored the intricacies of valuing social media companies and developed valuation methods to apply to the industry metrics of social media firms. In our previously published articles of this three-part series, we discussed the elements that drive the financial metrics and market multiples of companies in the data storage and customer relationship management industries. This final article of the three-part series focuses on specific valuation techniques for estimating future revenues of social media companies. Here we describe the process for identifying key drivers of revenue generation and growth, which is crucial when capitalizing industry metrics as well as using implied market pricing from recent financing rounds to estimate the market or fair value of a social media company.

SOCIAL MEDIA GROWTH AND OPERATIONS

The social media industry is relatively new, but possesses the potential to become a primary resource for advertisers and marketing firms. Currently, it is estimated that 163.5 million people in the United States use social media, which accounts for 67.2% of all internet users[2]. By 2017, the number of users is expected to grow to 183.8 million. Generally, social media companies follow a three-step process in creating and capitalizing a user community. First, social media firms design and introduce a product or service that targets a specific niche need of consumers. Services may include, among others, video, photography, or one-line "shout-outs" as provided by Twitter. Second, social media firms distribute the product within mediums such as web or mobile and launch campaigns to build traction within the market to develop a base of dedicated users, which will further promote the product through word of mouth. Third, social media companies implement revenue generation models that leverage their user base, which is expected by investors to lead to positive cash flows. Currently, the social media industry is facing challenges in designing business models for creating sources of revenues. Implementing an advertising model is the most feasible method for generating revenues. Furthermore, the online advertising market is experiencing strong growth, which is exhibited by an increase in market size from $86.4 billion to $116.8 billion between 2011 and 2013[3]. Each user is a potential source of revenue for advertisers. In the following sections, Cogent describes the methods used to estimate revenue potential, which provides one of the the key variables that drive social media company value.

COGENT METHODS AND ANALYSIS

Traditional valuation methodologies, which capitalize the financial metrics of a company and analyze future earnings' potential through cash flow creation, are generally not appropriate for the valuation of social media companies. Often, a social media company cannot provide a meaningful forecast for profitability and may even lack estimates of future revenues if a revenue model has not been formed. Nevertheless, Cogent has performed valuations of social media companies using publicly available information and specialized research to capitalize industry-specific metrics.

Page views are recognized as the primary driver of revenues for online advertising firms. Therefore, an online advertising firm will pay for the number of views ("impressions") for their content. The revenue generated by each impression varies by the type of advertisement, but websites and search engines, such as Google, have implemented advertising-based revenue models and have achieved profitability by using such strategies. Likewise, social media benefits from advertising by leveraging its own user base. Social media companies may even possess greater potential for revenue generation than individual websites and search engines because user interactions and preferences can be gauged by analytical software for direct marketing. In turn, the ability for an advertising company to create targeted marketing strategies within social media content provides the incentive for them to pay a premium in the face of such opportunity. Revenue created by advertising can be measured by *revenue per thousand impressions* ("RPM"). RPM is a traceable measurement that provides the framework that enables social media companies to monetize and leverage their user base when generating revenues from advertising sources.

Build-up of RPM-Based Forecasting

The value of a social media company can be developed by preparing revenue forecasts through RPM estimation. Forecasting revenues begins with the RPM factor, which will be established by an advertising firm. RPM is much like the price for a product or service offered by a company. In traditional revenue models, total revenues can be calculated in its simplest form as the price of a unit multiplied by the number of units sold. For social media companies, the units sold are equivalent to the social media company's user base. By measuring revenue potential, we can predict the revenue generated by the social media company's current user base and develop metrics to be used in market comparisons. However, the RPM multiplied by the users metric does not capture all of the drivers of revenue accretion. Individual users often interact with social media periodically or even daily. Therefore, in a single day the user may generate multiple impressions. The combination of users and their impressions creates a better profile of the "volume" of sales that a social media company is capable of achieving. The combination of RPM, number of users, and impressions generated by users over the lifetime of their activity can provide a revenue estimate as of today for all currently active users[4].

Growth potential for nascent social media sites is an integral variable for capitalizing future revenue metrics. Growth in social media is generally measured through a combination of user churn[5] (a decrease in growth) and user acquisition[6] (an increase in growth). Although an estimate can be made for the average lifetime impressions of each user, it may be more reasonable to measure the number of impressions per month of each user multiplied by the combined churn and acquisition rates. Such a calculation forms a basis of how vested users are in using the social media company's platform and low churn rates may provide the social media company with more power when negotiating the RPM factor. User acquisition is the number of new users that adopt the social media company's platform each month. Social media companies rarely use traditional advertising methods to attract users. Instead, the word-of-mouth activism of current users, "virality"[7], is the primary source of market awareness generated for the social media company. Virality varies from platform to platform, but can be tracked by new user signups. If virality exceeds churn, then the social media company's value is expected to be higher in the future.

When combining all five factors impacting revenue potential, we design formulae for estimating the expected revenues in the current month (t_o) and in subsequent months (t_n) of a social media company[8]:

Revenues (t_o) = Users * RPM * Impressions per user per month

Revenues (t_n) = Users * RPM * Impressions per user per month * [1 + (Acquisition Rate - Churn Rate)]

RPM is not the only industry-specific variable and other variables exist that measure different factors such as clicks per month and unique users. Furthermore, a monthly formula can be adjusted to provide annual projections when annual growth rate assumptions are used. Irrespective of the measure used, investors can apply the fundamental concepts of price, volume, and growth to create an estimate of revenues for the purpose of valuing a social media company.

Concluding Remarks

While traditional methodologies are inadequate for valuing social media companies, industry-specific measurements can be used in conjunction with fundamental concepts to estimate revenues, which can be capitalized to develop indications of value. Cogent has performed valuations for over one hundred internet and social media firms and is experienced in applying industry-specific metrics when performing business valuations. While social media defines an emerging industry, the methods used in valuing such companies have been substantiated through the techniques applied to web-based firms and search engines during the last twenty years.

Footnotes:

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