JTD
Financial Services, LLC

33 South Commercial Street
Manchester, New Hampshire 03101
Tel: 603-641-1010
Fax: 603-641-0707
e-mail: fdemaio@jtdfinancial.com
www.jtdfinancial.com

THE FACEBOOK IPO

The frenzy is building. Should you care?

Provided by Frank DeMaio*

Anticipation is high. Facebook filed an S-1 form with the Securities and Exchange Commission on February 1, taking its first big step toward going public. It aims to raise $5 billion through its upcoming IPO. Some of the details from the S-1 form:

- Facebook's revenue climbed from $777 million in 2009 to $3.71 billion in 2011.
- Its annual profits went from $229 million (2009) to $1 billion (2011).
- Its profits grew by 65% last year alone.
- Its top source of revenue is advertising. (12% of Facebook's 2011 revenues came from Zynga, a social network gaming company.)

The Google IPO raised $1.9 billion, and this IPO could potentially dwarf that.[1]

Will this IPO live up to all the hype? It might; it might not. Let's examine some other key tech IPOs and see how those shares have done since.

- ***Google.*** The IPO set the share price at $85. Here in early February 2012, the share price is now around $580. A home run by any definition.
- ***LinkedIn.*** On the day of the IPO, the share price climbed from $45 to a peak of $122.70 and settled at $94.25. At the start of February, LinkedIn was trading for about $72.
- ***Pandora.*** Shares were offered at $16 in June 2011; eight months later, they were trading at $13.
- ***Zillow.*** Shares were offered at $20 in July 2011 and ended at $35.77 on the day of the IPO; in early February, Zillow traded at around $30.[2,3]

All in all, these numbers look pretty good, right? Sure they do, to institutional investors. Keep in mind that the little guy gets there second. It is the institutional investor - not the small investor - who gets first dibs on the stock and who frequently realizes the terrific upside. The individual investors get to get in after the shares take off; sometimes they pay a price.

Lessons from the dot-com (and dot-bomb) years. The 1990s may seem like ancient history, yet there are examples from the past worth noting when it comes to IPOs.

- University of Florida finance professor Jay Ritter has maintained a huge database on IPOs for decades. He did a study of 1,006 IPOs from 1988-1993 (these were all IPOs that raised $20 million or more) and found that the median IPO underperformed the Russell 3000 by 30% in the first three years after going public, and that 46% of the IPOs produced negative returns.
- In 1999, 555 firms went public and the median share price gain for these issues on the day of the IPO was 30%. But what if you bought after the first day? If you did, the median gain after three months averaged 0%. Additionally, almost 75% of all U.S. Internet-related IPOs from mid-1995 to 1999 traded underneath their offering price at the moment of publication.[2]

Should Mom & Pop dive in? As MarketWatch columnist Mark Hulbert pointed out, Facebook's IPO will be three times as expensive as Google's and about 40 times as expensive as the average large IPO since 1975. As Hulbert found in the wake of a chat with Professor Ritter, Facebook's price-to-sales ratio (PSR) looks to be about 26, with 2011 revenues of $3.71 billion and a reported IPO valuation of circa $100 billion. Google's PSR was 8.7 at the time of its IPO. [1,3]

Looking back, Ritter found 76 companies since 1975 with trailing 12-month sales from the date of their IPOs of $3 billion or more (in 2011 dollars), firms with more or less reliable revenue streams. Their average PSR: 1.0. AT&T Wireless was the highest of them at 8.9, and that was a 2000 IPO.[3]

So in other words, Facebook would need staggeringly high revenues (or a consistently remarkable profit margin) for its shares to behave as well as Google shares did in those first few years out of the gate.

Could the tech sector see a "Facebook effect"? Yes, remember the "wealth effect" of the Google IPO? Some of the "best and the brightest" in the tech sector became overnight millionaires and went off and founded their own profitable firms. That sort of thing could happen again; there are tens of thousands of start-ups now generating revenues off of Facebook's platform, so you have a whole ecosystem of smaller firms that are anticipating the IPO as much as institutional investors.[4]

Caution might be in order for those awaiting Facebook's IPO. Individual investors have swung for the fences many times in situations like this, only to strike out.

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Citations.

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