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Facebook Upgraded - Q2 2011 Beats Galt's Estimates

The Research Team at Galt upgrades Facebook 2011 Revenue from \$3.523B to \$4.039B maintains the IPO Price target at \$60-85/share

Summary

The Research Team at Galt has taken the recently disclosed Facebook 2011 Q2 revenue and earnings numbers that have been leaked to the street and ran some new scenarios based on their accelerating growth rate. Our model published June 20, 2011 had revenues forecasted at \$3,523,740,472 USD and earnings of \$1,212,166,722 USD. With the 2011 Q2 street numbers of revenue at \$1,600,000,000 for the first half of 2011 and earnings of \$500,000,000, Facebook appears to be ahead of our forecast due to growth rate and adoption in foreign markets. The growth rate really accelerated in Q4 2010 as the push in Asia, South America and India occurred and the adoption accelerated in Europe. Galt has modeled the growth rate based on total page views and unique visitors. As well, Facebook is the number one social media website globally, representing over 35% of all internet traffic. We have seen the growth rate from Q3-Q4 2010 continue into Q1 and Q2 2011 and have modeled this to forecast the year end and effects into 2012-2014. Galt has now forecasted revenues in 2011 to be closer to \$4,039,100,000 and with forecasted 36% earnings on revenue we see earnings in the same range as previously forecast due to increased R&D spending at \$1,250,505,360. This spending is related to the competitive response to Google+ and privacy concerns globally.

Galt believes that the Q2 2011 numbers were purposely leaked to the street to provide certainty around valuation activity and to set the stage for their IPO pricing. Market uncertainty, coupled with the fact that Sheryl Sandberg (COO of Facebook) was announced as keynote speaker at the Ignition Conference, indicates that the earliest they can file the S1 is the first week of December 2011 with the hope to hit the April/May 2012 window.

At the time when it was published at the beginning of this year, Galt Capital research viewed the 2011 revenue estimates forecasted by the eMarketer research models of US\$4.5 billion as overly aggressive. In point of fact, the Galt Capital research revenue estimates for Facebook during 2011 in its previous version of our "Modest" Case were US\$1 billion less than such eMarketer estimates. Following our newly revised model and upgrading of Facebook 2011 revenue estimates on the basis of stellar first half performance – 130% top line growth YOY – the gap between such eMarketer estimates have been more than halved as there is now only a US\$460 million difference between their estimates and our new forecast of US\$4.039 billion. This is the power of "hyper growth," as it can mitigate many differences across models that may have earlier appeared irreconcilable. As a result, it would not surprise the research staff at Galt Capital to find, in the final analysis, Facebook achieving the eMarketer estimates



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by the end of the year. We note that it is amazing that Facebook essentially earned the same amount of revenue in the first half of 2011 as it did during the full year 2011.

Analysis

Galt has remodeled the growth rate based on the unique visitors, page views and advertising placements which are reported by Facebook themselves and independent sources in the advertising market. The following chart shows the growth rate of revenue over the last 6 quarters and the projected growth rate for the balance of 2011.

Financial Model - Galt Forecasted Financial Model; Facebook	Q1	Q2	Q3	Q4	Fiscal Year Total
2010 Quarterly Performance Review and Analysis					
Revenues	\$ 336,000,000	\$ 369,600,000	\$ 420,000,000	\$ 554,400,000	\$ 1,680,000,000
Revenue Weighting by Quarter	20.0%	22.0%	25.0%	33.0%	100.0%
Quarterly Growth Rate		10%	14%	32%	
Earnings	\$ 100,000,000	\$ 110,000,000	\$ 125,000,000	\$ 165,000,000	\$ 500,000,000
Earnings Percentage	29.8%	29.8%	29.8%	29.8%	29.8%

Looking at reported revenues for 2010, we analyzed the allocation of revenue by quarter and then determined the growth rate quarter over quarter. Q3-Q4 saw a large jump in growth rate due to the adoption in international markets of the online advertising model combined with accelerated user growth internationally. As previously reported, the user adoption through Q4 2010 - Q2 2011 represented insignificant overall adoption as a percentage of population within those countries such as India, Brazil, Malaysia, Philippines and other Asian countries. We only see this market share growth by country rising rapidly on an absolute basis as these countries are heavily populated with a growing middle class. Now let's look at the growth rate as reported into Q1 and Q2 2011:

2011 Quarterly Performance Review and Analysis	Q1	Q2	YTD 2011
Current Forecasted Model - Modest			
Revenues (Previously Stated in the Model)	\$739,985,499	\$880,935,118	\$1,620,920,617
Growth Rate Quarter over Quarter (Previous Model)	33%	19%	

First half growth in 2011 YOY was up 130% and on a sequential basis versus the 2nd half of 2010, the first half of 2011 is up 66%. The forecast for the 2nd half of 2011 anticipates quarterly growth rates of 22% and 25%, respectively or 149% on a sequential basis versus the first half of 2011. The full revised 2011 revenue estimates by Galt Capital research for its "Modest" Case call for an increase in full-year revenue in 2011 by 140%. The ever increasing growth rate during this period of "hyper growth" is attributable to a number of factors, including, but not limited to, (i) the power of the "Facebook Effect" whereby adding another user the network creates synergistic value which exceeds the incremental impact and (ii) the fact that so many of Facebook's business models, such as advertising and credits, notwithstanding their



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absolute size, which seem formidable, are nonetheless in their infancy and a number of years away from hitting steady state maturity.

Galt has modeled a number of growth scenarios including the most likely modest scenario. In the previously published financial forecast by Galt the growth rate would virtually have to drop into single digits for Q3 and Q4 to hit the previously forecast revenue of \$3,523,740,472. This is highly unlikely based on the growth in usage and market share.

In the second scenario we modeled a constant growth rate for the rest of the year, this leads to a revenue upgrade to \$3,916,725,628. In the third scenario we modeled the same growth rate quarter over quarter from 2010 and the revenue upgrade is \$4,516,838,189, very close to the eMarketer forecast from January 2011.

Galt believes that the growth rate will be 22% in Q3 and 25% in Q4 2011 leading to revenues of \$4,039,087,516 based on the three drivers of their business (unique visits, pages views and online advertising market share). The following chart summarizes the various scenarios:

Financial Model - Galt Forecasted Financial Model; Facebook	Q1	Q2	Q3	Q4	Fiscal Year Total
2010 Quarterly Performance Review and Analysis					
Revenues	\$ 336,000,000	\$ 369,600,000	\$ 420,000,000	\$ 554,400,000	\$ 1,680,000,000
Revenue Weighting by Quarter	20.0%	22.0%	25.0%	33.0%	100.0%
Quarterly Growth Rate		10%	14%	32%	
Earnings	\$ 100,000,000	\$ 110,000,000	\$ 125,000,000	\$ 165,000,000	\$ 500,000,000
Earnings Percentage	29.8%	29.8%	29.8%	29.8%	29.8%
2011 Quarterly Performance Review and Analysis					
Current Forecasted Model - Modest					
Revenues (Previously Stated in the Model)	\$739,985,499	\$880,935,118	\$916,172,523	\$986,647,332	\$3,523,740,472
Growth Rate Quarter over Quarter (Previous Model)	33%	19%	4%	8%	
Revised Revenue Scenarios					
Scenario 1: Maintain Q2 Growth Rate					
Revenue	\$739,985,499	\$880,935,118	\$1,048,312,790	\$1,247,492,221	\$3,916,725,628
Growth Rate Quarter over Quarter	33%	19%	19%	19%	
Scenario 2: Mirror 2010 Q2 Growth Rate					
Revenue	\$739,985,499	\$880,935,118	\$1,109,749,434.36	\$1,786,168,137.21	\$4,516,838,189
Growth Rate Quarter over Quarter	33%	19%	26%	61%	
Scenario 3: Modest Growth Analysis					
Revenue	\$739,985,499	\$880,935,118	\$1,074,740,843.96	\$1,343,426,054.95	\$4,039,087,516
Growth Rate Quarter over Quarter	33%	19%	22%	25%	

Galt has then dialed these growth rates into the valuation model to determine 2012-2014 effect on the valuation, noting that Google's IPO multiple effect after completion and current market segment leader valuations are in line with our valuation multiple assumptions.



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We see the IPO share price at \$60-85 IPO pricing through 2012, however if the IPO delays to Q3/Q4 2012 Facebook might be priced off 2013 revenues, lifting the IPO price to \$100.00 per share. Revenue growth will maintain its 100%+ growth rate through 2012 and 2013 using Galt Capital's modest forecast models. With some economic recovery in North American and Europe this could exceed 150% annualized growth (Optimistic Forecast Model). While revenue may be growing at 100%+ per year the real effect is the scalability of the earnings; earnings grow on a percentage basis faster than revenue as Facebook leverages their infrastructure and move earnings to sales ratio from 36% to 50%. This effect is one major driver for the high multiple and valuation you are seeing on Facebook. Don't forget Facebook only represents 1% of the overall Global Ad spending and has a long way to go before it reach saturation.

The following chart shows the updated financial model reflecting the Modest Growth Analysis in the chart above:

	2010	2011	2012	2013	2014
Members	550,000,000	825,000,000	1,000,000,000	1,500,000,000	1,043,000,000
Imputed \$ Value per Member	\$90.91	\$136.42	\$211.87	\$254.42	\$621.53
Unique Visits	132,666,000	176,093,333	212,426,333	248,759,333	285,092,333
Unique Visit Growth	13%	33%	21%	17%	15%
Revenue Growth	116%	110%	96%	81%	70%
Revenues	\$1,680,000,000	\$4,039,100,000	\$8,117,654,545	\$16,062,058,182	\$30,011,850,182
Advertising	\$1,428,000,000	\$3,141,600,000	\$6,283,200,000	\$12,252,240,000	\$22,054,032,000
Advertising %	85%	78%	77%	76%	73%
Advertising Growth	104%	120%	100%	95%	80%
Virtual Gifts & Credits	\$252,000,000	\$882,000,000	\$1,764,000,000	\$3,528,000,000	\$7,056,000,000
Credits %	15%	22%	22%	22%	24%
Credit Growth	224%	250%	100%	100%	100%
Other Ventures		\$15,500,000	\$70,454,545	\$281,818,182	\$901,818,182
Other Venture %		1%	2%	5%	9%
Other Venture Growth			355%	300%	220%
Expenses	\$1,108,800,000	\$2,585,024,000	\$4,870,592,727	\$8,834,132,000	\$15,606,162,095
Op. Margin	\$571,200,000	\$1,454,076,000	\$3,247,061,818	\$7,227,926,182	\$14,405,688,087
Op Margin %	34%	36%	40%	45%	48%
Taxes	\$85,680,000	\$203,570,640	\$422,118,036	\$867,351,142	\$1,440,568,809
Taxes %	15%	14%	13%	12%	10%
Earnings	\$485,520,000	\$1,250,505,360	\$2,824,943,782	\$6,360,575,040	\$12,965,119,279
Market Cap	\$50,000,000,000	\$112,545,482,400	\$211,870,783,636	\$381,634,502,400	\$648,255,963,927
P/E	103	90	75	60	50
Shares Outstanding	2,000,000,000	2,354,000,000	2,500,000,000	2,600,000,000	3,000,000,000
Stock Price	\$25.00	\$47.81	\$84.75	\$146.78	\$216.09



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Background Information Supporting Growth

There are three main indicators that are driving revenue for Facebook; the growth rate of each of these drives the revenue model.

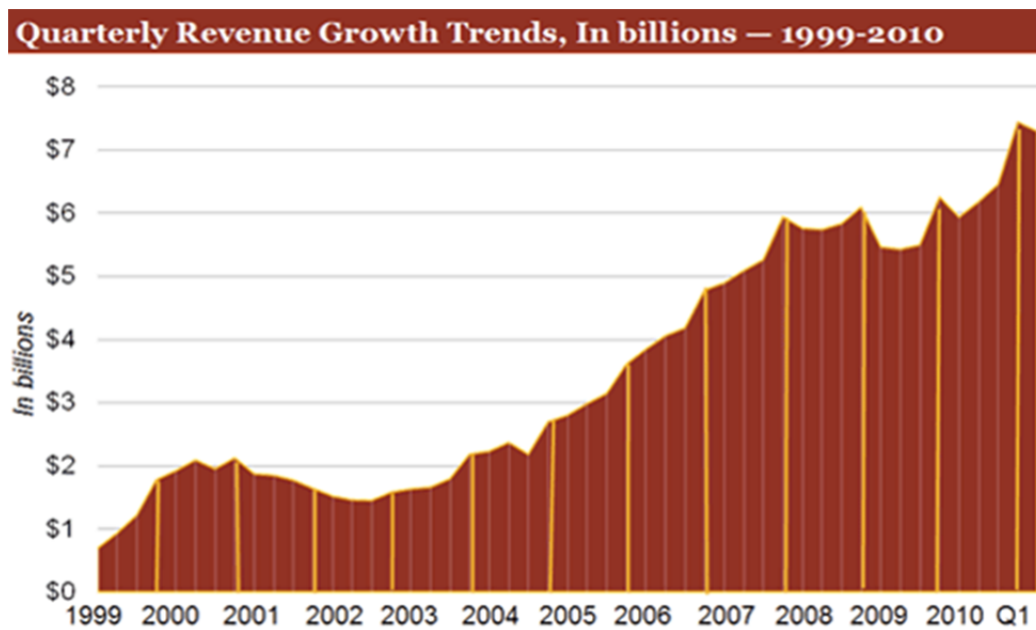
On-line Advertising Revenue: These are the display and banner ads down the right and on the top of the Facebook page

Total Page Views: This is an indicator of usage relative to the number of subscribers of Facebook

Unique Visitors: This is a measure of a user that has visited the site for the first time, also a growth indicator

How big can the revenues grow for Facebook?

Facebook is driven primarily by ad revenue in which online display advertising is a small portion of the overall global advertising market. The global annual advertising market is estimated at \$400 billion plus. If we use Google's 54 percent U.S. revenue take as a proxy, and extrapolate from Google's \$8.58 billion number Q1 revenue number (i.e. multiply it by 4), that would mean global web ad spend could be about \$63.6 billion annually, or about 16 percent of total global ad spending. Digital advertising (Facebook and Google) has got a lot more of the pie to eat yet. The following chart shows the quarter over quarter growth of the digital advertising market:





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23% Year-Over-Year Increase Demonstrates Growing Importance of Digital Marketing & Advertising

Global Spending and Share of Ad Spend by Medium, 2006 -2010 (\$ Millions)

	2006	2007	2008	2009	2010
Newspapers	\$123,031	\$124,047	\$127,366	\$130,955	\$134,829
	29.0%	27.8%	26.8%	26.1%	25.4%
Magazines	\$52,959	\$54,393	\$56,427	\$58,518	\$60,588
	12.5%	12.2%	11.9%	11.7%	11.4%
TV	\$160,356	\$168,359	\$180,335	\$189,110	\$198,894
	37.8%	37.7%	37.9%	37.7%	37.5%
Radio	\$35,347	\$36,472	\$37,782	\$39,437	\$41,032
	8.3%	8.2%	7.9%	7.9%	7.7%
Cinema	\$1,870	\$1,984	\$2,180	\$2,414	\$2,691
	0.4%	0.4%	0.5%	0.5%	0.5%
Outdoor	\$23,516	\$25,126	\$27,145	\$29,099	\$31,249
	5.5%	5.6%	5.7%	5.8%	5.9%
Internet	\$27,185	\$35,999	\$44,583	\$51,963	\$60,888
	6.4%	8.1%	9.4%	10.4%	11.5%

Source: ZenithOptimedia (via AdAge.com)

The US Online Display advertising market is a small sub-segment of the overall online or digital advertising market. Display advertising could grow to around \$12.3 billion in the U.S. according to Bloomberg for 2011. While Google leads the search advertising market, Facebook is the clear leader when it comes to display ads with a 17.7% share. [Yahoo](#) and Google come in next with 13.1% and 9.3% of the market followed by Microsoft with 4.9%. ^[2] Facebook and Google have been expanding their market share rapidly in the last couple of years at the expense of Yahoo and Microsoft.

The largest component of the Internet advertising is the Search segment, Google dominates this space. As Galt stated in a previous report, the Microsoft partnership where Bing (Microsoft's search engine) has been integrated into Facebook's social graph is creating better search results. The market share of Bing/Facebook is small compared to Google, but 2011 saw the highest growth rate of the search market was between Microsoft and Facebook. This revenue segment is very small within Facebook right now



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but as their market share grows, revenue will accelerate for Facebook. This category will be a major revenue driver in the future for Facebook. The following table shows the growth rates for Search:

Top Properties Worldwide Where Search Activity Is Observed

March 2011 vs. March 2010

Source: comScore qSearch

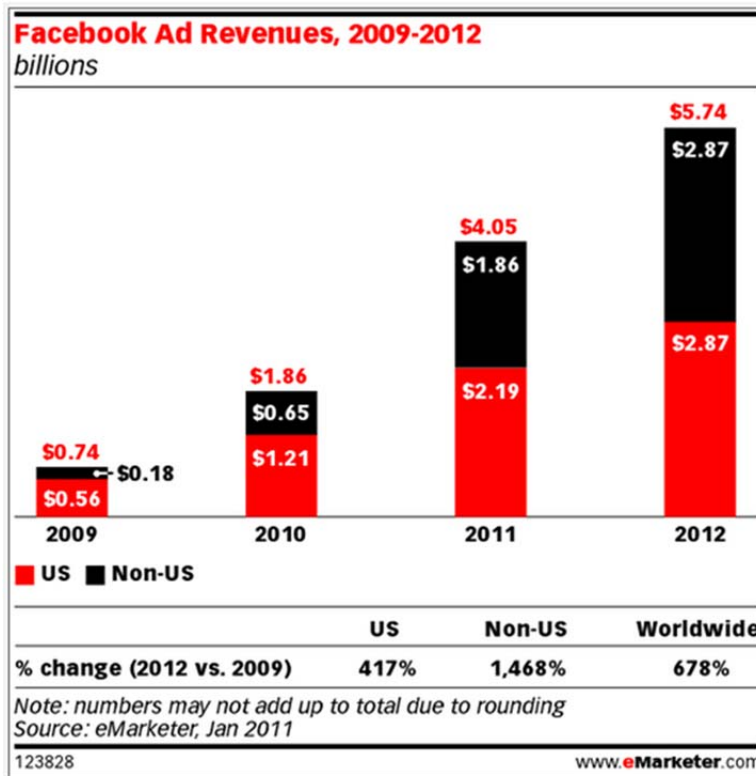
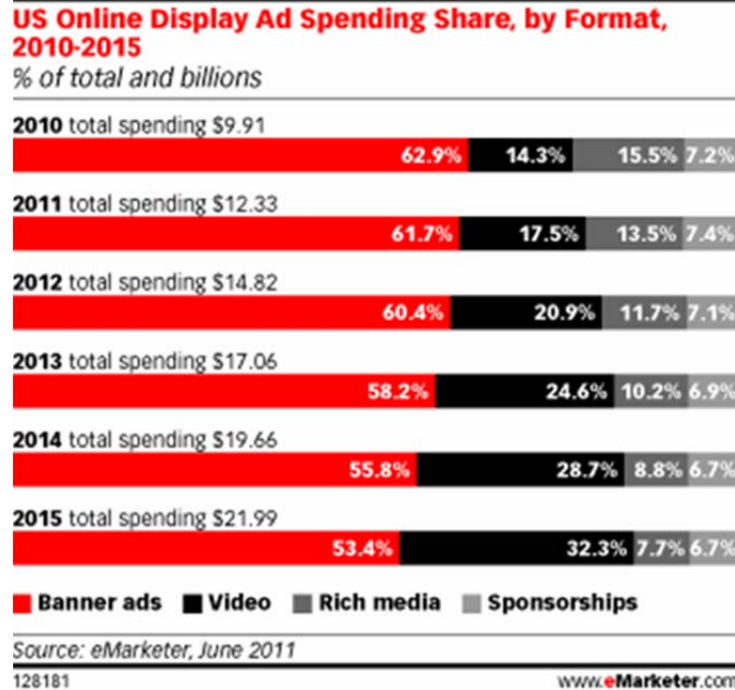
Audience: All Persons Ages 15+

Property	Searches (MM)		
	Mar-2010	Mar-2011	% Change
Total Internet	140,542	156,871	12%
Google Sites	92,844	107,352	16%
Yahoo! Sites	9,984	10,182	2%
Baidu.com Inc.	10,098	10,120	0%
Microsoft Sites	4,170	5,406	30%
Facebook.com	2,812	3,623	29%
Yandex	2,262	2,969	31%
eBay	2,134	2,564	20%
NHN Corporation	1,960	2,199	12%
Ask Network	1,618	1,425	-12%
Alibaba.com Corporation	1,051	1,228	17%
TENCENT Inc.	921	1,132	23%
Amazon Sites	644	729	13%
craigslist, inc.	701	714	2%
Sohu.com Inc.	266	663	149%
Mail.ru Group	...	587	N/A
AOL LLC	844	547	-35%
Daum Communications	...	500	N/A
MIH Limited	369	490	33%
SCHIBSTED Group	89	356	300%
Apple Inc.	308	320	4%



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From the previous chart, “Facebook Ad Revenues, 2009-2012”, notice the highest growth rate in the international markets. Facebook growth rate in these markets has just begun; clearly the revenue generation here will be significantly larger than the USA contribution over the next few years, possibly by a magnitude in size.

Other arguments that support massive revenue growth for Facebook with no end in sight:

- The younger generation is spending more time on Facebook per week than in front of the TV. This means as this generation hits their mid to late 20’s and older that \$400B global ad spend is going to shift to Facebook. This generations’ kids will not even know what a TV is by the time they hit their teenage years.
- Facebook is going after Google in the search advertising market, their revenues there are insignificant now but the search growth rate on Facebook and Bing is the highest we have ever seen.
- Integration of Video into Facebook will create more video advertising revenue and start cannibalizing the TV ad market shares.
- Of the \$400B+ advertising model, Facebook has 1% market share by the end of 2011. That is insignificant in the overall market yet Facebook may very well be the most valued company on earth in a few years with maybe 8-10% market share.

Conclusion

Facebook has moved into the number one spot for online display advertising, which is a small segment of the overall online advertising space dominated by Search advertising. The Microsoft/Facebook partnership around social search has seen the largest growth rate in search over the last year; they are coming after Google and that Search Ad market. Right now the revenue as a percentage of the Facebook revenue is less than 10% overall, watch this growth over the next few years at the expense of Google.

The online advertising market is 11% of the overall advertising market with the only market share growth rate. It is starting to cannibalize the traditional market segments in global advertising and is now just getting started. Massive markets like India and China may never see a traditional advertising market as their younger generation and growing middleclass is already highly internet based and wireless. Watch this segment continue its growth rate and the battle between Facebook and Google emerge on a global scale.

With all of this to consider, combined with the upgraded revenue forecast, we have increased our earnings forecast and share estimates for 2011 – 2014. We believe that Facebook is only just getting



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started and we believe that Facebook will surpass Google in valuation within 18 months of its IPO and Apple within 36 months after its IPO.

We have a strong buy recommendation on Facebook at \$33-35/share and with the potential delay in the IPO, our pricing range is to the upper range of \$60-85/share.

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