Research Desk – Update

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Facebook May Delay their IPO until September/October 2012

Galt originally forecasted their IPO of May 2012, Facebook may use the summer market their offering globally – potential delay creates a buying opportunity

Summary

In a piece of surprising news, it was leaked to the Financial Times that Facebook may delay its IPO until the "later part of next year" citing concerns over "employee retention and focus" given the current trading frenzy and selling backdrop underlying the recent Facebook secondary markets in anticipation of an IPO as previously stated as being slated to occur during Q1 of 2012.

Galt has seen opportunity in this scenario. First, the concern about being locked up for over 18 months assuming an October 2012 IPO plus an 180 day hold period has created demand for mid to large sized Broker Dealers to use Galt's SPV structure and provide an internal market for the shares of the SPV within their settlement and administration systems alleviating liquidity concerns.

Second, we have seen seller sitting on the sideline waiting for the IPO not interested in selling as they do not want to wait until April 2013 for liquidity. This should bring on significant buying opportunities in the \$32-\$35 range. Galt has contacted most of the large block shareholders to assess size and price.

In the opinion of the Galt Research Team, there are only two possible perspectives to take in regards to this announcement.

IPO Delay Until September/October 2012

The first, of course, is driven by the assumption that the Facebook speculation should be taken at "Face" value. In this scenario, the much anticipated and ballyhooed Facebook IPO will be and is delayed by up to 6 months. In this case, current and future investors in Facebook will need to adjust their respective return models in order to account for the delay in liquidity resulting from the later announced IPO date. We expect that institutions should now evaluate purchasing Facebook shares in the adjusted range of US\$32.00 – US\$33.50 per share to take account of the potential delay in the liquidity event. While this may not appear to be a "real" discount, the supply of meaningful and credible Facebook shares is getting quite scarce. Based on this scarcity and extrapolating the impact of the material positive news likely to be communicated as part of f8 discussed below, the discount results from the fact that absent such delay, Galt Research would expect Facebook to be trading north of US\$35.00 per share and possibly approaching US\$40.00 per share by the middle of October.

Offsetting the adverse change in potential returns due to an IPO delay (somewhat), is the fact that an IPO in Q4 of 2012 will allow Facebook to market and sell its 2013 forecasted earnings to the Street for purposes of its IPO pricing and valuation.

What would the Facebook valuation likely look like at such time? Based on the latest revised Galt Capital research models (updated for Q2 2011 actual results), even utilizing the "Modest Case" research estimates, we anticipate Facebook earning approximately US$6.3 billion in 2013. As a further nod to conservatism, let's assume that we discount such estimates by 15% for purposes of "sandbagging" earnings estimates and making such estimates easily achievable as public company. In such case, Facebook would be providing earnings guidance to Wall Street analysts for 2013 in the range of US$5.4 billion.

As for valuation multiples and likely trading ranges, there are two interesting data points. The first is the precedent established by Google (GOOG) during its IPO and subsequent 2 year trading history after going public. GOOG is perhaps the closest and most relevant comparable in that fact that it was the market leader and poster child for the *Internet 1.5* generation of companies and led the QQQ out of its Post-9/11 doldrums in the same way that Facebook occupies a similar leadership position for *Internet 2.0* companies and the coming hegemony of unstructured data and social networking.

GOOG traded at P/E multiples ranging from 70.0x – 120.0x during each and every trading day commencing with its IPO and concluding with its 2-year anniversary as a public company. Taking even the low end of that range, and assuming 2.5 billion shares outstanding for Facebook on a fully-diluted, as converted (Treasury Stock method) *pro forma* for its IPO, the resulting valuation for Facebook on the basis of its forecasted 2013 earnings is a market capitalization of US$350 billion or a price per share of US$140.00 per share.

Another interesting data point is the current trading valuation underpinning Salesforce.com (CRM). CRM is the market leader in "software as a service" (SaaS), aka "Cloud Computing," which is viewed as another "hot" sector of the technology market with favorable growth dynamics. CRM currently trades at a valuation of more than 70.0x its consensus forecast 2013CY earnings. This trading multiple is being applied to a company (CRM) which is expected to exceed US$2.0 billion of revenue this year growing to US$2.8 billion in CY2013. CRM is forecast to earn approximately US$165 million this year growing to almost US$250 million in CY2013. The absolute two-year growth rates associated with its revenue and earnings are 40% and 51%, respectively. The growth rates anticipated in revenue and earnings between CY2012 and CY2013 are 28% and 39%, respectively.

Perhaps the most fundamental simple tool utilized in the valuation analysis of tech companies is the PEG Ratio or the Price-Earnings Multiple stated as a function of earnings growth. Over time, the best technology companies revert to mean PEG Ratios equal to or slightly higher than 1.0x. During periods of hyper growth, many market leaders in various segments of technology can trade at a far higher premium PEG Ratios to this long-term mean. CRM is currently trading at a CY2013 PEG Ratio of 1.83x.

By comparison, even under the most conservative of our research models, Facebook is forecast by Galt Capital research to have revenue and earnings growth in CY2013 of more than 80% and most likely in excess of 100%. A PEG Ratio of 1.0 for Facebook, even with the most conservative of assumptions, yields an 80.0x CY2013 P/E Multiple and an expected Facebook market capitalization of US$430+ billion or a price per share in excess of US$170 per share. If Facebook were to trade at the same CY2013 PEG

Ratio that CRM was currently trading at, its forecasted market cap would be US$790 billion or a price per share of US$315+ per share. There can be no doubt that Facebook enjoys better current operating results, higher growth prospects and a larger TAM than does CRM. It therefore would not be at all surprising if Facebook actually trades at a similar or higher CY2013 PEG Ratio when compared to CRM instead of the normalized long-term PEG Ratio.

Thus, these two different data points or valuation methodologies triangulate on very similar expected valuations (e.g., US$150 per share) for Facebook's IPO on the basis of its CY2013 earnings. Even after applying a generous IPO discount of 20%, this generates an expected pricing range for Facebook in the latter part of 2012 of between US$110.00 – US$120.00 per share.

From an IRR perspective, what all this means is as follows. For purposes of the Galt Capital research team's calculations, we have assumed an investment basis today of US$32.00 per share and a liquidity horizon of 24 months, assuming an IPO date of 15 December 2012, a 6-month post-IPO lock-up period (the "Lock-Up") and an orderly selling program of four months to achieve total liquidity. These assumptions are conservative as (i) the Facebook IPO will likely be consummated sooner than this for the reasons stated below; (ii) the Lock-Up most likely will be slightly less than six months, as Facebook management is likely to seek "special treatment" from its IPO underwriters in terms of a shorter lock-up period than is standard in such underwritings; and (iii) the size and supply and demand fundamentals for the stock are such that liquidity is likely to be achieved far more expeditiously and efficiently than this conservative four-month exit assumption.

The assumed exit price is for our IRR calculation purposes is US$110.00 per share, which is likely to be the pricing range of such a delayed IPO and thus assumes no aftermarket "pop" once Facebook has gone public. This is an extremely conservative assumption as Facebook has perhaps as much pent up "retail demand" across its global user base as any stock ever offered in the US markets. The intrinsic valuation of Facebook for 2013 called for the updated Galt Research estimates pursuant to the "Modest Case" is US$146.75 per share.

What does all this mean? Based on these assumptions, which we consider to be conservative in regards to every metric, even under this delayed timeline, the IRR for a Facebook investment today is greater than 85% and may approach 115% if the Galt Research intrinsic valuation is achieved.

IPO Consummated as Previously Anticipated: On or Prior to April 2012

The second possible scenario is that Facebook continues, instead, upon its previously announced path of being a public company on or prior to the April 2012 deadline imposed by the US Securities and Exchange Commission ("SEC") to become a "reporting entity" with all that this entails, including but not limited to, complying with onerous Sarbanes-Oxley regulations governing financial disclosures and reporting for public companies.

How would such a scenario differ in material respects from the first case detailing the delay outlined above? Under this scenario, Facebook would be going public on the basis of its 2012 forecasted earnings and any investment in Facebook private shares today would be able to realize liquidity within 15 months or sooner.

An investor's basis should still be in the range of US$32.50 to US$33.50 per Facebook share in this scenario. The Galt Capital research staff has revised its CY2012 earnings estimates for Facebook based on Q2 2011 actual performance, even in the "Modest Case" to be US$2.824 billion. Facebook's CY2012 revenue and earnings growth is forecast to exceed l or approximate 100%, respectively. Applying the same metrics regarding the GOOG precedent and a 2012 PEG Ratio of a minimum of 1.0x, dictates the use of a 100.0x P/E multiple for purposes of a Q1 2012 IPO date. Taking the same 15% haircut to the earnings estimates for purposes of setting low targets to hit, leaves us with an IPO net income figure of US$2.4 billion.

The resulting valuation is an expected market cap for Facebook of at least US$240 billion or US$96 per share. Even with the application of an aggressive IPO discount of 20% and the unrealistic assumption of the lack of any trading "pop" in the aftermarkets, a valuation for Facebook of US$75.00+ per share is extremely conservative.

From an IRR perspective, these inputs into our model – a US$32.00 per share investment basis, a 15-month liquidity time horizon and an exit price of US$75.00 per share – leads to even more favorable return characteristics than the first "delayed IPO" scenario analyzed above. The revised research estimates of Galt Capital pursuant to the "Modest Case" call for an "intrinsic" valuation of Facebook during 2012 of US$84.75 per share. **Under these assumptions, the IRR to be achieved by a Facebook investment today by investors is more than 95% and quite well may exceed 100%.**

Reasons Facebook's Announced Delay May Be a "Smokescreen"

As to the procedural elements regarding the press release, Galt Capital has had many discussions over the course of the past 24 hours since its impromptu publication with "partners" that we consider to be very close to the company. They were also surprised that the press actually published this article. The opening paragraph of the publication cites "people familiar with the company." There was no official source on this and its otherwise comprises total speculation but for the fact that Peter Thiel, an existing member of the Board of Directors of Facebook, cited certain retention advantages in having leading private companies (such as Facebook) stay private as long as possible. In his comparisons Mr. Thiel cited Google as a precedent.

Facebook itself hasn't said anything and the internal workings at Facebook instead suggest a contrary finding. First, the "headline" numbers published over the course of the past ten days was leaked strategically to show the market that the company is performing against analyst research estimates. This is typically done and is the kind of thing which not only supports the current stock price, but provides a baseline or context for any company to go public on such basis. Perhaps, more pointedly, is that fact that Galt Capital has reason to believe that the potential underwriters and lawyers supporting and advising Facebook on its potential IPO are working overtime at the moment to prepare the first draft of its Form S-1 registration statement ("Registration Statement") to be in a position necessary for an early December filing with the SEC.

However, taken at "Face" value, what would the incentives be for Facebook's management to pull a misdirection play by backing such a "delayed IPO" rumor and, nonetheless, for it to proceed on track in filing its highly anticipated initial draft of its Registration Statement by the first week of December of 2011 (if not sooner) for SEC comment?

The stated purpose for such delay is to eliminate, or at least minimize, employee retention and distraction issues for a "period of critical development" in the coming months for Facebook and its development team. How would such a misdirection play accomplish these stated intentions?

First, Facebook management could rightfully expect that yesterday's rumor is likely to have a "chilling" effect on the secondary shares market for Facebook, at least prior to next April. This is notwithstanding the fact that the returns associated with even the delayed scenario are extremely favorable relative to other investment opportunities in today's markets.

After such time, the SEC reporting mandate takes effect for what essentially would be a non-public reporting company. In April, the scrutiny and "distraction factors" for Facebook management and employees would actually be exacerbated due to what then would be its unique positioning as a "non-public, public" entity.

We must first accept the starting premise that the recent announcement is likely to take the "lid off of the pressure cooker" for its developers and other key employees over the next 6-7 months – even at the cost of increasing the limelight and scrutiny under a microscope thereafter.

In such "alternative scenario," Facebook will accomplish the same employee retention and focusing on objectives by effectively attempting to calm the frenetic secondary market activity between now and the first week of December. Moreover, Facebook will effectively eliminate it on a going forward basis pursuant to SEC rules and regulations, as once the first draft of the Registration Statement is filed with the SEC there is a "blackout" on sales and transfers of any shares in the absence of an SEC-reviewed and approved Registration Statement . Under this misdirection scenario, Facebook management and employees would not then be subject to any additional scrutiny period as a "non-public" reporting entity, as it would be a full-fledged public company by such time.

In either case, one has to ask what is so fundamentally important to Facebook's management about the likely next 6-7 months of Facebook's development efforts that it has decided to "play along" with this ruse of a delayed IPO?

September18, 2011

Anticipated Facebook Development Revelations at the f8 (Facebook Developers Conference September 22, 2011, Palo Alto, CA)

The annual Facebook Developer Conference (f8) will take place in less than a week (all day) in San Francisco on 22 September.

The event is scheduled later in the year this time than ever before, but Facebook will nonetheless use the format to lay out their vision for 2012 and beyond. Typically, the event is a must attend for developers – this year will likely feature more than a few user-facing surprises as well.

Galt Capital research expects the following topics to be covered at f8 (at a minimum), including the following "revelations":

f8 will constitute the official launch of Facebook Music. Two of the key features to be included are scrobbling and track unification. "Scrobbling" is the term made popular by Last.fm whereby when a song is listened to it is automatically sent to your profile. ***An interesting subtext or sidenote here is whether this functionality immediately (or over time) will allow Facebook users to import songs listened to from their iTunes library and then freely trade, exchange and share with the rest of the world.***

The track unification or resolution service turns Facebook Music into the great social music unifier, in that users can share songs with friends without having to worry about whether the streaming service formats are incompatible. Founding streaming participants in Facebook Music are expected to be Spotify, MOG, Rdio, Turntable.fm and, potentially, Amazon. Don't be surprised to see Music for Credits included on the Music Dashboard, as well.

f8 will constitute the official launch of a new mobile photos sharing application allowing its users to share and shoot video. This extension makes perfect sense as Facebook is the leading photo sharing app on the internet with more than 100 billion photos uploaded by its user base. This application is said to be a combination of functionality derived from Instagram, Color and Path. It has been built first and foremost for and with an emphasis on *iOS*, but is believed to be easily ported to *Android* and other platforms with the *HTML5* elements in place.

Finally, and most importantly (in our opinion), f8 will mark the official reveal of *Project Spartan* or whatever "more politically correct" name is provided for this undertaking at f8. As Galt Research understands it, *Project Spartan* is the codename for a new Facebook platform that is entirely HTML5-based and targets the more than 250 million active Facebook users on mobile and smart phone devices.

The rationale for such project is essentially the core of the Facebook mobile strategy. Since Facebook doesn't control a mobile OS themselves, this is their bold attempt to siphon off or otherwise get hooks into populating outside mobile app data into Facebook on both iOS and Android. While at first the 80+ outside developers, whom are divided into teams working on apps for the *Project Spartan* platform that range from gaming, to news-reading to the weather, were asked to focus on *mobile Safari,* the project is now focused on desktop, *iOS* (including *iPad*) and *Android.*

Essentially, once the mobile web version of Facebook is loaded, *Project Spartan* will provide the ability to download apps comparable to (and some day as broadly as) the App Store. All of these apps which are downloaded will be immediately surrounded by a Facebook "wrapper" which will give the app certain basic Facebook embedded functionality and compatibility, as well as the ability to use certain key Facebook elements, such as Credits. By providing Credits on a built-in basis for developers to sell apps and offer in-app purchases, Facebook aims to replicate the ease and STP which is so attractive in the App Store payment system. Additionally, it is believed that a mobile version of the *Like Button* will be integrated into each platform.

One offshoot of *Project Spartan*, of course, is that Facebook, with more than 750 million users, may eventually be in the best position to use Apple's device ubiquity against them in an effort to disrupt its perceived quasi-monopoly on mobile app distribution.

By asking the dedicated *Project Spartan* initial developers to make sure that all mobile apps work in *UIWebView*, Facebook desires such *Spartan* apps to work within the Facebook iPad application itself.

In addition, due to the development and emphasis on *HTML5*, Facebook, with *Project Spartan,* is attempting to break the *Flash* stranglehold on the games developer market for *Zynga* and other partners.

A key component of *Project Spartan* has been the development of *BoltJS*, which is a UI framework that was built by Facebook for the express purpose of helping developers build fantastic mobile applications in *HTML5* and *Javascript*. It is written entirely in *Javascript* and runs in the browser with no back-end server processing required.

Conclusion

Galt Capital research believes that the Facebook Registration Statement will be filed before the end of this year, if not sooner. We also believe that Facebook will be a reporting and public company by no later than 30 April 2012. We do not believe that it will risk the further issues, distraction and potential "taint" in becoming the first "reporting, non-public" company in the history of the United States and all that entails with the SEC.

However, even if this were the case, Galt Capital research believes that under conservative assumptions, the returns associated with an investment in Facebook today most likely are greater than 85% even under such delayed scenario.

The most likely outcome, however, is that a current investment in Facebook offers the unique opportunity for institutions to arbitrage the difference between the most likely outcome in terms of the timing of Facebook's IPO and the recently reported delay. This valuation delta as expressed in a

lower basis should provide a very attractive opportunity for current purchase in the range of the low US$30s.

The most likely rationale for such "misdirection," in our opinion, is the strategic importance of minimizing retention and other distraction issues associated with *Project Spartan* and the other mobile-focused development efforts being undertaken by Facebook over the course of the next 6 months.

With these efforts, Facebook is essentially declaring victory over Google and all other social networking sites and taking aim squarely against Apple and its current dominance in the mobile market.

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