

Facebook and the Emerging Social Networking Industry

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Introduction

With Microsoft's recent purchase of a 1.6% stake in Facebook for \$240 million [1], expectations for Facebook's future revenues are virtually astronomical. Indeed, our revenues are expected to grow more than 200% to over \$300 million in 2008 [2], but we clearly have a ways to go before we can justify our implied \$15 billion valuation. It has proven surprisingly difficult to generate large advertising revenues from social networking websites, so to maintain our current level of growth we must carefully consider our strategy going forward.

It is our opinion that Facebook needs to focus primarily on deepening its penetration and level of service in its core market of college-age students, even at the expense of expanding to broader markets. Facebook must maintain its unique brand as a clean, professional social network for older students, without allowing users and application makers to corrupt the style of the site. Furthermore, Facebook must consider ways to gain the cooperation of the colleges themselves, in order to deepen its college student user base. Finally, we must look for alternative sources of revenue, as advertising has historically failed to deliver solid revenues on social networking sites.

To understand the reasoning behind this strategy, a brief SWOT analysis is instructive.

Strengths

Facebook's greatest strength is our network of subscribers; specifically, the detailed information we obtain from each and every user. The fact that the post college age group is one of the highest spending demographics helps to make our customer base, and subsequently our detailed data, highly valuable. With such extensive data, it is easy for us to tailor our product, whether it is the advertising we employ now, or some other form of marketing in the future.

Another strength is the advent of our new open format platform. Allowing customers to develop their own third party applications, while still keeping the clean Facebook style, differentiates our product extremely well. Indeed, MySpace, our largest competitor, has developed a reputation for being messy and at times incomprehensible. Combined with our already existing features, third party applications not only increase our ability to reach potential subscribers, but also give existing users a more rewarding experience.

Facebook's other strengths include relationships with other companies such as Amazon and Microsoft, the ease of use of our website, and, potentially, the users that transition from students to alumni. Leveraging our detailed database and our professional relationships with other companies could develop into profitable business ventures in the future. Keeping our website clean and easy to use ensures that we continue to gain and retain subscribers. And finally, since alumni wield tremendous power and influence over their alma maters, the fact that our college student customer base eventually become alumni could prove to be quite advantageous in future dealings with higher education institutions.

Since Facebook's inception, our reputation as a classy and clean social networking site has remained strong. With the addition of each feature, we continue to impart the highest value to our demographic compared to our competition.

Weaknesses

Facebook's greatest weakness is that we have so far been unable to generate nearly as much revenue as might be expected from our large user base and the corresponding user profile information, which ought to help us deliver targeted advertising. This problem is shared by Myspace and other social networking sites – at the moment, the prevailing wisdom is that it is in general very difficult to monetize social networks, and we will need some big new ideas before social network advertising can fulfill the grandiose expectations that have led to Facebook's current valuation [3].

The main difficulty is that social networking sites suffer from extremely low click-through-rates on their ads, despite their presumably excellent potential for highly targeted advertising.

Facebook's CTR has been reported as 0.04% [4], and our 2007 revenues were about \$150 million, or only about \$2.20 per user per year [2]. In comparison, Myspace's revenues from ads alone were over \$30 million per month in March 2007 [5], or at least \$3.50 per user per year, though their CTR is reportedly nothing to brag about either [6]. Though Myspace is doing better, even they have failed to meet the revenue targets set forward by Fox, its parent company [7]. Myspace's limited advantage in advertising may be attributed to their more content-oriented services, in contrast to Facebook's communication-oriented service. Customers are less likely to click on an ad while "talking" with their friends than while browsing a site for user-created content [3].

Our other major weakness is the issue of privacy. Social networking sites like Myspace and Facebook have been exposed to increasingly negative publicity about the dangers of posting personal information online, and the potential for stalking, identity theft, and general invasion of privacy [8-10]. At this point Myspace has a substantial reputation as "potentially unsafe", and Facebook may be reaching that point as well. Such a reputation may pose a significant problem if we wish to expand our college student user base – at this point, universities are far more likely to discourage the use of Facebook than to endorse it. As the cooperation of universities would be highly beneficial, we may need to consider revising our privacy policy to address their concerns.

Threats

One of Facebook's biggest threats is that the social networking industry has low entry barriers, and is currently viewed as having potential for high profits [1]. The only inputs required to produce a social networking site are a team of programmers and a batch of servers, both of which are readily available with a small investment of capital. Furthermore, while there is of course a large network externality effect that causes users to prefer well-established social networking sites over new entrants, because the social networking services themselves are almost invariably free to use, users can readily adopt a new network without sacrificing their use of Facebook. Thus, there is little we can do to prevent another social networking site from growing at a pace that matches or exceeds our own, though by the same token we will not lose

our existing customer base unless we allow a very similar social network to develop and beat us at our own game.

At the moment, there is little rivalry between the currently established social networks. The other major networks with a large North American user base offer a significantly differentiated service – for example, Myspace is geared toward user content creation through highly customizable profiles [11], and LinkedIn focuses on professional and business networking [12]. Other large social networks offering services similar to Facebook's, such as Hi5 and Friendster, are largely concentrated in foreign markets [13]. Myspace is our biggest direct rival, but they cater to a "mass-market" type of user base, while our user base is closer to the "high-end" side of the spectrum, mainly consisting of college students. Thus, the main threat of competition for our own users comes from new entrants, which may emulate Facebook and develop some critical new feature to draw our customers away. This threat, however, is significantly mitigated by the Facebook App platform. New social networking application providers looking for broad exposure are likely to develop a Facebook App rather than attempt to start their own rival social network.

Opportunities

As the internet has shifted from being a novelty to one of the fixtures of American life, several avenues of expansion have opened for internet companies. Three major areas are of particular interest for a company like Facebook. First is the better use of user information for the purposes of targeted marketing and user service. Second, companies can work on delivering a streamlined purchasing/spending system within this targeting system, so that transactions happen more easily, and hopefully more frequently. Finally, user-created content is, justifiably, an extremely important aspect of many modern internet companies.

Facebook, like several other internet sites, has access to a large amount of information about its users. Since users are required to log into the site in order to use it, it is always aware of which set of database entries corresponds to the current user. As a result, the opportunity for extremely finely targeted advertising is present. With the ability to select ads on a per-user

basis, which hasn't been practical in any other medium prior to the internet, it should be possible for a company to offer advertisers the ability to specify very particular criteria for the viewers of an advertisement. For example, a concert ticket agency would be well-served by advertising all of their upcoming concerts specifically to fans of the bands in the cities where the concerts will occur. An internet company that could offer this sort of ultra-finely targeted advertisement should be able to charge substantially more per ad.

In addition to using their own databases, a company could take advantage of the opportunity to link databases with other companies. If Facebook were to work with Amazon, for example, they could offer users' lists of favorite books, movies, and music in order for Amazon to more successfully target users with suggestions. In exchange, Facebook could gain information about what sorts of items (category and price range) users are inclined to buy online, thus allowing further specific targeting of ads.

Another avenue for the use of information that is specific to social networking sites is the ability to harness friend lists for advertisement. An advertisement that points out, for example, that several of a user's friends have recently purchased a certain brand of computer, or a particular video game, might be effective at harnessing peer pressure to influence users' purchases.

As a complement for targeted advertising, Facebook could offer a streamlined purchasing system, to encourage users to make more quick purchases. If the company were to work on partnerships with its most prominent advertising customers, users could be presented with quick, or even single-click, purchasing of the products being advertised to them. Also, using the contact information, it would be easy to send gifts to friends who are having birthdays, or for other occasions. This service could make internet-savvy consumers happier with the site, as it would become a convenient place for socially-motivated shopping. More importantly, Facebook should be able to charge some sort of commission, or at least a higher ad cost, for advertisements that directly lead to sales like this.

As social networking sites are maturing, they are beginning to offer more all-inclusive experiences. Instant messaging, dating services, music applications, journal hosting, and other such applications are helping to lock users in to spend more of their time on Facebook,

MySpace, or other such sites. A good source of services like these, which could be further expanded by Facebook, is user-created content. Already, Facebook has released a developer platform, in order to allow applications to be written and deployed on the site. Two major directions of improvement could allow the site to better harness the power of its users. The first is to more actively integrate popular and well-written applications into facebook.com. Google's gmail is one of many applications that were integrated into google.com after being an employee's side project. Facebook could similarly make the best applications into core features, so that all users of the site would have access to them without having to find and download them. The other direction is easing the challenges of developing applications and other content so that users with less programming expertise could develop their own applications. In either case, improving user-created content on facebook.com wouldn't directly increase revenues, but would serve as a method to expand the services of the site, and more strongly latch on to users, in order to keep them on the site.

The danger, however, with user-created content is that it threatens to remove the major differences between Facebook and the larger MySpace. The two are mainly differentiable because of a different demographic, and because Facebook explicitly maintains a uniform interface and graphical style, whereas MySpace encourages extreme customization of each user's page. In order to still please their older audience, which is largely college students and graduates, Facebook should work to maintain distance from the MySpace, lowest common denominator model, rather than try to fight over users, and ultimately face a price war for advertisers.

A Strategy for Facebook

The key to maintaining control of the college-age social networking market is to develop a collaborative relationship with the colleges themselves. At the moment, Facebook is understandably considered to be a "waste of time" by college administrators, but in fact both Facebook and the college stand to gain from some degree of collaboration.

On the college's side, the obvious benefit is organizational – services such as class registration, organization of clubs and activities, advertisement of events or purchase of required textbooks

can all be implemented in a centralized and highly convenient manner using the Facebook platform. It is not difficult to imagine a set of free online applications that are vastly superior to the hodgepodge of online services many colleges provide at the moment, usually at significant expense.

For Facebook, the most obvious benefit from a close relationship with a college is that the college could help bring new users into the network. At new-student orientations, for example, colleges could promote their Facebook groups, and encourage students to join them. As a result, new students without accounts would be compelled to create them. Other opportunities for colleges to take advantage of Facebook as a coordination and communication tool would, in addition, all serve as free marketing of the site, to ensure maximum penetration.

With cooperation from a college, Facebook could then offer many services in order to tie users in to the website, and encourage them to visit it frequently. If users were able to keep their course schedules updated on Facebook, it could be used to help form study groups or, if professors were to get accounts, to enable communication about scheduling changes, guest speakers, etc. (In a more far-fetched scenario, registrars could be linked to the site, therefore automatically keeping students' schedules up to date) Facebook is already widely used to schedule and organize parties and other events, and increasing penetration would only increase the viability of this feature. In addition, the site could specifically promote clubs and teams using the site to organize themselves. All of these features would serve to make sure Facebook becomes a one-stop organization and communication site for any college student.

With an established base of college students and a high penetration into that demographic, the important issue for Facebook would be how to monetize its users. Perhaps the most promising method to do that would be to work with Amazon (with which Facebook already has a working relationship) to sell textbooks and other college supplies to students. If it were to maintain accurate information about the classes that students are in, the site could work with Amazon to deduce which textbooks and reference books correspond to which class based upon students' purchases, and then offer a shopping cart prefilled with the required books to users who haven't yet bought them from Amazon. This form of advertising, which seems like it would be

highly effective, could be a very strong revenue stream for Facebook. Similar targeting for things like job advertisement, summer courses, and other services that are specific to college students could similarly be made more accurate, and thus more profitable, given a close relationship with colleges and a deep penetration into the student demographic.

Most of these changes do not introduce new vulnerabilities to rivals. The strength of Facebook's ability to serve colleges is basically proportional to its penetration into the student population, so the main effective way to compete with Facebook at securing college participation would be to grow to rival it in size. As we mentioned before, many of the existing features of Facebook help to preclude this from happening. It is conceivable that attempting to move in as a more dominant controller of college student networking would encourage per-college rivals to spring up, if students/administration feel that Facebook is encroaching. The diversity and stability of the services we offer should help discourage such small scale competitors, though, as the costs to effectively compete at a small scale should be prohibitively high. Particularly with the changes to the privacy policy mentioned above, we should face no new threats to our customer base.

Leveraging a college-age audience for more focused advertising

In addition to deepening its user base, Facebook can further capitalize on the college students it already has now by increasing the total amount of advertising and applications dedicated to products that sell well in that particular age group. For example, an application in the spirit of iTunes is likely to be profitable, as a large portion of digital music consumers are college-age [14]. Facebook already has an application called iLike [15], which offers music-integration services similar to those of Myspace, but we can take that a step further and actually sell music directly from the Facebook website. There would be a definite synergy in the integration of a service that allows instant music purchases together with a service like iLike, which allows users to share their playlists and music samples with friends.

This avenue of expansion faces extremely high levels of competition from Myspace. Typically, Myspace has marketed itself as a music-centric networking site by, among other things, offering customizable music players on each user's homepage very early after its launch. As it has

developed, Myspace has established itself as a very powerful promotional tool for bands of any size, often serving as the primary website for a band. As a result of this, attempting to move into music marketing risks a strong reaction from our rival, causing them to leverage their tools and content to push us out of that market. As a result, we should only focus on music vending inasmuch as we can maintain it as specifically within our demographic and non-threatening to Myspace's hegemony on that front.

Other potentially lucrative targets for focused advertising and services include DVDs, video games, books, and clothing. Facebook could greatly benefit from its current relationship with Amazon by extending their integration to allow something like Amazon's "one-click-shopping" directly from the Facebook website. We could take a small fee for each purchase Amazon receives through the Facebook website, and Amazon would benefit from the deal through a modest increase in sales. Furthermore, these types of consumer items are naturally conducive to producing social "peer pressure" ads, in which an ad mentions which friends of yours like a particular band, movie, game, or brand. These may potentially produce significantly higher click-through-rates than generic, impersonal banner ads.

This faces little risk of competition, as Amazon and other vendors have deep budgets for marketing of this sort, provided it is successful. We only have to be concerned, as in most of the points mentioned above, if we fail to hold on to our position as a unique provider for our specific demographic.

Retention of users after college

As for the future, Facebook's college base holds very promising potential returns. Students eventually graduate and go on to lead successful careers. With their sharp increase in disposable income, retaining people past college is a profitable and yet still untapped possible revenue source. With Facebook's already existing extensive information on each of its subscribers, the value added by retaining them past the college age is quite large. LinkedIn has already demonstrated the existence of demand for and the value derived from professional networking. Facebook could leverage its existing knowledge of its subscribers to recruiters and

corporations looking to hire. Corporations themselves could even develop profiles and third party applications to educate potential hires. This would allow further leveraging for Facebook; this time leveraging info and perhaps a streamlined resume and application process to students for desirable companies to work for.

Learning from LinkedIn's approach, Facebook could tailor a whole separate site and/or profile structure for new young professionals. This would increase the switching cost when comparing Facebook to other professional networking sites. (Facebook could also just outright buyout LinkedIn and incorporate it into their business model). Now that the former college students have a career, they are more apt to spend money and thus be more responsive to online advertising. Furthermore, this prospect of subscriber retention could further help Facebook with potential dealings with college institutions themselves. Successful demonstration of subscriber retention could persuade colleges that Facebook does indeed have the means to boost alumni contributions, the main motivation for said institutions to join Facebook's "community."

Through catering to the job interests of soon-to-be-graduating students, and then their future change in spending habits and preferences, Facebook can retain their subscribers past college. Leveraging their vast database of information would also allow Facebook to assimilate companies and recruiters looking to hire. Moreover, successful subscriber retention would help Facebook demonstrate to college and university institutions that they can help them boost alumni contributions, which is a large motivator for said institutions. All around, retaining people past college is lucrative for all parties involved: graduates/young professionals/alumni, corporations, higher education institutions, and, of course, Facebook.

Conclusion

Though our future revenue projections are extremely aggressive, it will be possible to meet them if we focus exclusively on the college-age user base that has served us well so far. By offering increased integration with the overall college experience as well as more elaborate

advertising schemes than simple banner ads, Facebook can realize its potential for future growth.

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