There's a lot to like about Facebook Credits

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By Eric Grover

Industry watchers generally peg the size of Facebook Inc.'s initial public offering at about $100 billion -- an impressive 27 times 2011 revenue and 100 times net income valuation. At that level, it would be the most highly valued IPO in U.S. history.

The social networking leader reaped 85% of its $3.7 billion in 2011 revenue from targeted advertising. In contrast, competing search-advertising giants Google Inc. and Yahoo! Inc. command significantly weaker though still healthy valuation multiples of 5 times and 3.9 times revenue, respectively.

While advertising is Facebook's mainstay, its nascent payments business contributes 15% of revenue, increased 425% in 2011 and has tremendous upside.

Dominant global traditional payment-card networks MasterCard Inc. and Visa Inc. are valued at 7.5 times and 7.9 times revenue, respectively, and semiproprietary payment networks American Express Co. and Discover Financial Services are valued at 2.1 times and 2.5 times revenue, respectively. All are branded retail payment networks with critical mass. In contrast, while solid businesses, Global Payments Inc. and Heartland Payment Systems Inc. deliver acceptance of the networks' payment products to merchants, struggle to differentiate themselves and are subject to continuing gentle price erosion. Consequently, they command more terrestrial valuation multiples of 1.9 times and .5 times sales, respectively.

Facebook Credits is a payments network, albeit a very narrow one. It enjoys enviable margins, paying a couple of percentage points to load value and charging 30% of the face value of goods sold. But for a merchant selling digital goods with zero marginal cost, paying 30% for sales within Facebook isn't a bad deal.

With 845 million active users, Facebook has ample potential on the spend side of the network. To deliver value, however, requires a network of relevant places users can spend Facebook Credits.

The social network's ability to persuade merchants on- or offline to accept its payment product is far from certain. Its acceptance is substantially one gaming merchant, Zynga Inc., and buyers could well tire spending real dollars buying virtual cows in online games.

The enormous electronic-retail payments opportunity is general-purpose payments, e-commerce, mobile commerce and at the physical point of sale, where 93% of payments still occur.

Established retail networks such as MasterCard and Visa enjoy powerful networks effects and possess an impressive business model, albeit with thinner pricing than Facebook Credits. They also reap profits from enormous operating leverage with their principal costs being largely fixed and revenue driven by inexorable secular electronic payments growth.

The signal issue for aspiring retail general-purpose payment networks is achieving critical mass of spend and acceptance and thereby a relevant and even compelling value proposition for those making and those receiving payments. If, for instance, Facebook could say to merchants 250 million users are keen to earn rewards spending Facebook Credits, that would be of interest. If, however, the only place they can spend is at a handful of online gaming merchants, its appeal and utility will be limited.

Notwithstanding Facebook's stupendous reach, building a broad general-purpose retail payment system would be a challenge. Several billion cardholders use MasterCard and Visa payment products, and more than 35 million merchants worldwide accept them. Gradually, cardholders are gaining the ability to transfer funds to any other cardholder on the network. The utility, convenience, security and network effects are huge.

In 2005 with much fanfare, Debitman Card Inc. promised to lower merchant costs and landed high-profile ones such as Walmart Stores Inc., hoping they would accept and promote it. With the son of a former MasterCard CEO Jason Hogg as CEO and marquee investors including America Online co-founder Steve Case, Goldman, Sachs & Co., Citigroup Inc., Morgan Stanley and Deutsche Bank AG, much ballyhooed Revolution Money Inc. touted lower fees for retailers and better fraud prophylactics. Mondex offered better security and flexibility to load and carry value on the card. Bling Nation provided a mobile phone-based system instead of card-based system and aimed to achieve critical mass aggregating clusters of community banks issuing Bling in lieu of MasterCard and Visa. All hit the skids. Consumers and merchants are very much creatures of habit in payments.

In the e-commerce realm of failures -- putative better mousetraps promising better security and convenience -- have been legion including Digicash Inc., CyberCash Inc., Flooz.com and Beenz.com. Lower cost, better security, novelty and alternative distribution are rarely if ever enough to displace well-established incumbents.

However, the hurdle for payment systems addressing niches such as private-label credit cards, gambling, gaming or digital goods, particularly within proprietary networks, is lower. Home Depot U.S.A. Inc. and Neiman Marcus Inc. derive 25% and 70% of sales, respectively, from their private-label credit cards. When mobile phone operators sell ringtones or games within their network, they often take 20% to 50%.

Near term, harvesting richly priced Facebook Credits and stoking use across a broader range of digital goods sold within Facebook, where competition can be curbed, can deliver high earnings growth. Enabling intranetwork person-to-person payments would enhance overall Facebook value.

Beyond its network, however, Facebook would be better advised to tread cautiously, leveraging networks such as MasterCard and Visa. It could issue co-branded credit and prepaid payment products to both creditworthy users and those with poor or minimal credit history, with highly targeted rewards and promotions based on its rich trove of user data.

Payments should contribute healthy growth, but Facebook isn't going to and shouldn't aspire to be the next MasterCard or Visa.

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