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Who Cares About Quarterly EPS for Facebook?

While everyone's focused on quarterly earnings per share in today's call, what really matters is whether FB is investing to sustain growth and return over the long term. CFOs should listen in.

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Later today, when Facebook executives report on their most recent quarterly financial results, many journalists, analysts, and investors will draw sharp comparisons between the actual earnings per share (EPS) results for the quarter and the consensus analyst expectations of 11 cents per share.

The irony is that the vast majority of the drivers of FB's valuation concern how well performance can be sustained over time rather than a mere quarterly result. That's true of all companies, but particularly so for a company trading at such a lofty valuation multiple.

In early trading this morning, FB is valued at just over half the offering price of their initial trading less than six months ago. Many view this as a disaster. But even at the current price of just over $19 per share, the price to forward EPS multiple is about 36x, which is higher than 96% of the companies in the S&P 500.

ANALYSIS

This is a higher valuation than AOL, Baidu, Google, priceline.com, Yahoo!, and Yelp. Only LinkedIn trades at a higher valuation multiple among companies labeled as comparables by CapitalIQ.

Does this suggest that FB is still expensive?

We estimate the cash-on-cash return on capital for FB based on 2012 consensus figures to be 72%, which is higher than 94% of the largest 1000 non-financial US companies. This is extremely high profitability per dollar of investment. Note that this measure of return doesn't include cash as an invested asset and makes other adjustments aimed at better aligning the return measure with valuation.

The consensus forecast for revenue growth for FB is about 28% per year for the next two years. Using a simple discounted EPS approach, investors would need to believe this rate of growth can last five years or so before settling back to a more normal rate in order to believe the current share price is fair. And this analysis assumes the extremely high rates of return stay where they are as well.

So the real question when considering whether the FB share price is too high or too low is not about this quarter's EPS at all. Rather, it's this: can Facebook sustain the high growth and returns for a minimum of five years? Investors should listen closely to the earnings call to judge whether management is making adequate investments to continue to differentiate their offering, attract more and more users, and find ways of turning each user into more and more revenue.

CFOs working for companies in similarly dynamic industries should listen in for the strategic lessons the FB call might provide. Can management sustain growth and returns despite the shift of usage away from PCs and toward greater use of mobile devices? Or is social media such a changing market segment that somebody else will leapfrog them much just as MySpace was leapfrogged? How defensible is the strategic position of Facebook?

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