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Profiting from friendship

Jan 28th 2010

From The Economist print edition

Social networks have a better chance of making money than their critics think

ENTREPRENEURS in Silicon Valley, only half-jokingly, call it the URL strategy. The three letters usually stand for Uniform Resource Locator—the unique address of any file that is accessible via the internet. But in the world of internet start-ups, URL has another meaning: Ubiquity first, Revenue Later. This pretty much describes the strategy of most big online social networks, which over the past few years have concentrated on piling on users rather than worrying about profits. That has allowed them to build huge followings, but it has also raised a big question-mark over their ability to make money from the audiences they have put together.

At issue is whether the social-networking industry can come up with a wildly successful form of advertising that propels it to stardom in the same way that Google has been able to make billions of dollars from the targeted ads that run alongside the search results it serves up. Without such a formula, runs the argument, social networks such as Facebook will never amount to much.

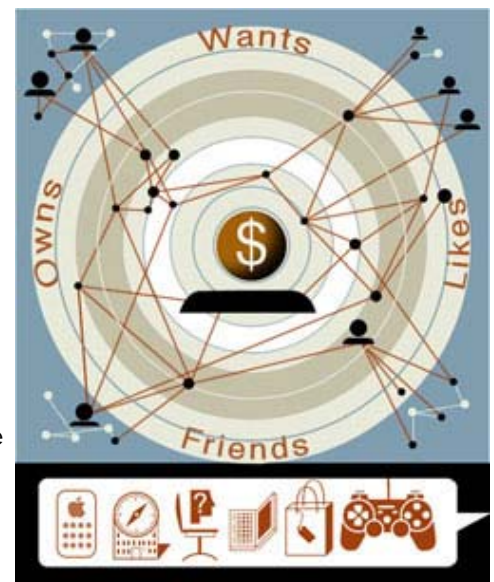
Doubters claim that the networks face two big handicaps. The first is that people logged into social-networking sites are there to hang out with their friends, so they will pay no attention to ads. The second is that because the sites let users generate their own content, they will find it hard to attract advertisers because brands will not want to take the risk of appearing alongside examples of profanity, obscenity or nudity—or all three at once.

Elusive click-throughs

The sceptics have some evidence on their side. Click-through rates on display ads at sites such as Facebook are a small fraction of those that Google commands for its highly targeted search ads. And although marketers love to promote their brands via their own (free) pages on social sites, some are wary of buying ads on them because of those abysmal click-through rates. “We spend the majority of our time engaging with people on these networks, not advertising on them,” says Scott Monty, the head of Ford’s social-media activities. Although user numbers were sharply up last year, the social-networking industry’s revenues in America, its biggest advertising market, rose only by a modest 4% to \$1.2 billion, says eMarketer, a market-research firm.

That was still an achievement, because the total online advertising market shrank in 2009. The picture would have been even brighter without MySpace, whose revenues are thought to have fallen last year. Another drop seems likely this year when a deal that MySpace struck with Google to handle search advertising on its site comes up for renewal. Assuming a new agreement can be reached, it will probably be less generous than the old one, which offered MySpace \$900m over three years if it hit certain minimum traffic targets.

Illustration by Ian Whadcock



The broader outlook for networking sites is more encouraging. This year eMarketer expects revenues to grow by over 7% in spite of MySpace's predicament. ComScore, another market-research firm, has found that one in five display ads viewed by American web users last June ran on social-networking sites, with MySpace still accounting for the biggest chunk of the total. Another study in Britain last August came up with a similar proportion, with telecoms companies and retailers providing a big chunk of the business.

Why are the networks becoming more popular when their click-through rates are so low? One reason is that advertisers are being drawn to the leading sites by their sheer scale. "Facebook's audience is bigger than any TV network that has ever existed on the face of the earth," says Randall Rothenberg, the head of the Interactive Advertising Bureau (IAB). Another thing that has attracted companies is the networks' ability to target ads with laser-like precision, thanks to the data they hold on their users' ages, gender, interests and so forth. Although there are still lingering concerns about brands appearing next to racy content, firms seem more willing to run this risk now that the networks' advertising proposition has become more compelling.

The other reason more money is heading the networks' way is that some advertisers are seeing a great return on their investment. Michael Lynton, the boss of Sony Pictures Entertainment, a film studio, says he was deeply sceptical about using social-networking sites for advertising. Indeed, Mr Lynton is famous for having once declared that nothing good had ever come from the internet, which was a jab at online piracy of film studios' content.

But something good did come from an online experiment that Sony conducted last summer. The studio ran a series of ads on Facebook promoting three of its films after they had just featured in a traditional television campaign. "District 9" was aimed at young men, "Julie & Julia" at middle-aged women and "The Ugly Truth" at younger women. Awareness of the films was measured after the TV ads had run and then again after the web ads had run. Each time the online ads significantly boosted awareness. Mr Lynton says he is now convinced that social networks are radically altering the marketing landscape.

Rock, baby

Another firm that has become convinced of that is Toyota, which last year worked with MySpace to create a competition called "Rock the Space" in which bands were invited to send in demo tapes of their music. Some 18,000 entries were received and MySpace's users voted for the best tape, with a record contract as the prize for the winning band. Doug Frisbie, who oversees social-media marketing for Toyota's American operations, says the promotion exceeded the company's hopes for brand promotion "by a factor of several times."



Both firms' experience suggests that people using social networks are more likely to engage with brands than sceptics think. Mr Lynton also reckons that the networks produce a powerful viral marketing effect because friends use them to tell one another about things they have discovered. Marketers have long known that such recommendations are hugely important in purchase decisions (see chart 5). Social networks are harnessing technology to accelerate this process by, for example, automatically alerting a person's friends when he or she signs up to become the fan of a particular brand or product on a site.

The big question is whether all this will translate into an advertising bonanza. "There is a pretty strong argument to be made that social networks are worth more than they are being given credit for," says Andrew Lipsman, an analyst at comScore. But he cautions that the advertising industry may be slow to recognise the shift that is taking place. In a bid to speed things up, Facebook has struck an alliance with Nielsen to create a series of benchmarks for measuring the impact of social-network advertising on brands. Sheryl Sandberg, Facebook's chief operating officer, says this will allow companies to get feedback on the effectiveness of their campaigns much faster than before.

Facebook has also been experimenting with new kinds of ads designed to draw people in, including some with embedded online polls or videos to which comments can be added. So far it has not come up with a killer format, but that does not seem to be holding it back. The company does not reveal numbers, but its revenues last year are thought to have been at least \$500m and quite possibly more, which helped it to turn cash-flow positive in mid-2009. Against the backdrop of a world economy in recession and a dire advertising market, that is quite an achievement. It also suggests that Facebook can do well using a variety of different ad formats rather than a single, winning one. "There doesn't have to be one enormous, oh my God hit," says the IAB's Mr Rothenberg.

Fun and gains

Nor does there have to be just one advertising-driven business model. In Asia several firms such as Japan's GREE and China's Tencent, which owns QQ, a service that includes a big online social network, are already making healthy profits from sales of games and virtual goods. In 2008 Tencent, which is listed on the Hong Kong Stock Exchange, reported revenues of just over \$1 billion, with \$720m coming from online gaming and sales of items such as digital swords and other virtual goods. Many Asian networks such as South Korea's Cyworld and Japan's Mixi also mint money by selling users custom backgrounds and other paraphernalia that allow them to personalise their network pages.

Inspired by this, firms elsewhere are embracing elements of the Asian model. Hi5, which is based in America and has 60m members around the world, has launched a number of games on its platform and created its own virtual currency, called Hi5 coins, for use in them. Alex St John, the firm's chief technology officer, says that gaming and advertising can easily be combined by, for instance, persuading an advertiser to sponsor a currency used by players.

Ning is targeting gifts rather than games. In October it launched an initiative that allows people who have set up networks on its system to sell customised digital items to their members. These cost anything from 50 cents to \$10, and over 400,000 of them are now being exchanged every month, with Ning splitting the profit equally with its customers. This will add to the revenues that it makes from ad sales and network-management fees. Even Facebook, with its focus on advertising, has a virtual warehouse of birthday cakes, champagne bottles and other goodies.

The beauty of this business for social networks is that the cost of producing and storing virtual inventory is minimal. Moreover, because these are closed markets, networks can fix prices at levels that generate fat margins. To some, the notion that big money can be made from selling make-believe items may seem bizarre. But the practice replicates the physical presents that people give to one another to cement relationships in the real world. Although Asia remains by far the biggest market for digital knick-knacks, Inside Network, a research firm, has estimated that sales of virtual wares in America on many different kinds of websites reached \$1 billion last year and could grow to \$1.6 billion in 2010.

Plain or de luxe?

Another business model that has proved lucrative involves charging users for premium services. The networks that have been best at this have been the business-oriented kind. LinkedIn, for example, provides a free basic service, but asks users to pay a monthly subscription fee of up to \$500 for extras, such as being able to send a larger number of introductory e-mails to other people on the site. The firm, which is said to have revenues of over \$100m a year, also makes money by charging companies for online tools that help them track down talent. This "freemium" model plus a healthy dose of advertising from big brands aiming to reach its affluent audience has helped the network to turn a profit for several years running.

Social networks have also benefited from search engines' desire to get their hands on more content. Twitter signed lucrative deals with Google and Microsoft's Bing search service in October that allow both companies to include tweets from Twitter's database in their search results. Thanks to these transactions the network is rumoured to have made a small profit last year, though it will not confirm this.

This year it plans to start making more money in two ways. The first involves charging firms for services such as tools for analysing discussions on Twitter and for authenticated accounts that let people know tweets they are receiving come from a genuine business. It is also hoping to profit from advertising by serving up targeted ads in the way Google does. Biz Stone, one of the firm's co-founders, reckons that Twitter's fans will be receptive to these because they already use the service to seek out information from others. They regularly share links to commercial sites and one survey last year found that as people twittered, they mentioned specific brands or products in 20% of their updates. That explains why Twitter and other social networks have caught the attention of millions of small businesses, as well as thousands of big ones.

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