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AFTER THE IPO

Facebook has an identity crisis

* Can it be a social networking service and an advertising company?

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By MICHAEL HILTZIK,

"The fox," wrote the great philosopher Isaiah Berlin, "knows many things, but the hedgehog knows one big thing." As we think about that big corporate hedgehog Facebook Inc., which just released its first post-IPO earnings report, the question is: What if the one big thing it knows -- that everyone in the world wants to be interconnected through its service -- is wrong?

It's not surprising that Facebook founder Mark Zuckerberg and his fellow executives didn't even nod to that possibility when they presented the results to investment analysts and the media Thursday. Were they to acknowledge that some people might regard Facebook as an impediment to socializing, rather than a lubricant, its whole mystique as a company might evaporate.

That mystique is not what it was even two months ago, at the time of its frenzied initial public offering. The second-quarter results released Thursday showed that user growth has slowed markedly, especially in the mature markets of North America and Europe. In the higher-growth geographic zones of Asia and South America, advertising revenues are relatively lower per user, making those users less desirable, for the moment, than others.

Therein lies the essential contradiction at the heart of the Facebook business model.

On the surface, Facebook hit its financial targets. Overall revenues of \$1.18 billion were a tad higher than Wall Street had projected; advertising revenues as a percentage of the total considerably higher. If one ignored the extraordinary costs the company incurred in converting its employees' and investors' insider shares to public shares, which is only fair, then its profits of \$295 million or 12 cents a share were pretty much what investors expected.

But for a company whose stock price depends almost entirely on what investors expect from it in the future, there was precious little information about what the future holds. And what information Facebook provided didn't sound especially encouraging. That may be why its shares, which had been falling all day ahead of the earnings release, really tumbled in trading after the close, sliding well below its all-time low.

The problem may be that Facebook has a severe identity crisis. As a social networking service and online meeting place, it's a cultural phenomenon. As a commercial enterprise, it's an advertising company. Can it be both things at once?

Facebook Chief Operating Officer Sheryl Sandberg and Chief Financial Officer David Ebersman spent most of their time during their session with analysts explaining why Facebook's advertising model was full of potential. "We're a completely new type of marketing," Sandberg said. "We're not TV, we're not search."

But pushing ads at your community members poses the risk that you'll turn them off, and they'll then turn you off. That's dangerous, if not fatal, for a company whose reputation is so dependent on encompassing a very big community (955 million "monthly active users," a figure that, it must be said, is very squishy).

Zuckerberg & Co. had to field persistent questions about how much advertising integrated into the Facebook experience might be too much. Their answers suggested that they don't know, and therefore they're moving slowly to avoid "degrading" their metrics (that is, driving users away). But that painstaking approach may run afoul of the pressure Facebook is feeling from investors, who will want to see more advertising revenue every

quarter.

Can there be any doubt that Facebook's emergence as an advertising platform is going to change the user experience, and not for the better? Consider "sponsored stories," an innovation that the Facebook executives are extremely proud of.

As far as I can tell from Facebook's description (I'm not the best expert at interpreting Facebook-speak) these are posts you might send your Facebook friends that get especially prominent placement on their pages because an advertiser has paid for that to happen. You might signal by clicking on a "like" button or commenting in a post that you found the new Batman movie thrilling, and presto, your opinion gets highlighted on your friends' news feeds, courtesy of a fee paid by Warner Bros. -- to Facebook, not to you.

Your friends can manipulate their own settings to hide sponsored stories or see fewer of them, but you can't opt out of being used as an advertiser's shill. Does that sound just a tad creepy to you? Me too.

Sandberg rationalized this service by observing that commercial recommendations that come from your circle of friends always have more punch than those that come via a freeway billboard or TV commercial. The implication is that advertisers will therefore pay a premium for sponsored stories.

This is an argument that only an ad salesman could love, however. One wonders how much credibility will still attach to recommendations from your friends on Facebook a year or two from now, when every time they communicate how much they love their AeroPress coffee maker or MacBook Air you have to wonder if the manufacturer hasn't paid to make sure you know it. (Disclosure: No one paid me to mention these fine products in print.)

And one has to wonder how much time you're going to want to spend on Facebook if you have to mentally winnow the secret ads from the legitimate pictures of your friends and their dogs every time you log on.

Facebook's frequent missteps in its treatment of users and their privacy can increasingly be traced back to its impulse to offer a better experience to advertisers, not users and their "friends."

Just last month, it surreptitiously changed users email addresses on their Facebook profiles to facebook.com addresses, presumably to obtain yet another level of access to its users' online activity. Once it was outed, the company apologized for not being "better" about communicating the change in advance. This is becoming known as the Facebook Retreat.

Sandberg correctly observed Thursday that it takes time for marketers to learn how to exploit every new advertising medium. It takes time for customers to figure out how much they're gaining and giving up when their sensibilities are assaulted in new ways and places. That was true of television and continues to be true of Web pages online. Facebook will undergo the same transition, but as it's unique in enlisting its own customers as part of the ads it sends to customers, the transition is bound to be more complicated.

Until it becomes more transparent, no one will know how much time to spend on Facebook, how much to trust it, and how much to pay for its stock.

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Michael Hiltzik's column appears Sundays and Wednesdays, and occasionally on other days. Reach him at mhiltzik@latimes.com, read past columns at latimes.com/hiltzik, check out facebook.com/hiltzik and follow @latimeshiltzik on Twitter.

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PHOTO: FACEBOOK disappointed investors in May with its IPO. The anguish continued Thursday with the firm's first earnings report, which drove down the stock.
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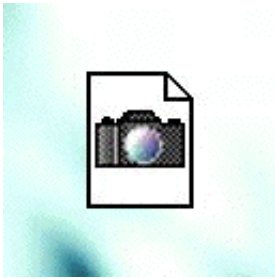


PHOTO: FACEBOOK'S second-quarter results released Thursday showed that user growth has slowed markedly, especially in North America and Europe.

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PHOTOGRAPHER:Jeff Chiu Associated Press



GRAPHIC: By the numbers

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