A couple of weeks ago, Facebook announced that it was acquiring WhatsApp for $19 billion. That sounded like an astoundingly high price to pay for a company with 55 employees and very little revenue in the most recent time period. While WhatsApp's messaging service has almost 450 million users, growing significantly by the day, the business model for WhatsApp, which emphasises that it accepts no advertising and charges users $1/year (after an initial year of free service) seems incapable of delivering the earnings that you would need to sustain the price paid by Facebook.

So, what was Mark Zuckerberg thinking when he made this offer? I don't claim to be a mind reader, but I do not believe that conventional valuation metrics (such as revenue, earnings and cash flows) were behind his offer. Instead, he was playing the pricing game, where you identify the metric that markets seem to be basing stock pricing on, and you deliver more of that metric. Rather than be mysterious, let's take a look at the pricing of social media companies, which includes ad-based companies like Facebook and Twitter, subscription-based businesses like Netflix and some that use a mix of subscription and ads to generate revenue (Pandora and LinkedIn). What they share in common in early 2014 are skyhigh market pricing, paltry revenue and small or negative earnings, for the most part.

Looking at the pricing of these companies, the variable that explains 90% of the pricing differences across companies is not revenue or earnings, but the number of users/subscribers at each company. For better or worse, investors are rewarding companies that have more users by pricing them higher, and they are augmenting that price if the revenue comes from subscriptions (more predictable) than from advertising.

Seen from this perspective, Facebook's game becomes clearer and more understandable. With its 1.2 billion users, Facebook has the largest user base of any of the social media companies, but it is judged by the market both on how much it increases this user base and on how much time these users spend on Facebook. WhatsApp is attractive to Facebook not only because it may bring new users to Facebook but also may increase their engagement in the Facebook
ecosystem. It is true that we do not know how many of WhatsApp's 450 million users are already on Facebook but that is par for the course in acquisitions, where acquirers take actions on faith, rather than numbers.

Are there dangers in playing this game for Facebook? Sure. The market could be overpricing how much a user is worth in future earnings, but if it is, Facebook is at least partially protected by the fact that it is using its own stock to pay for $16 billion of the $19 billion. Should investors also play this game? If you do so, you have to recognise that your success will depend not on your understanding of the company's business or financial statements but in reading market mood and momentum, which can shift quickly and abruptly.

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