Facebook, Inc. (FB)
Second Quarter 2018 Results Conference Call
July 25th, 2018

Operator
Good afternoon. My name is Mike and I will be your conference operator today. At this time I would like to welcome everyone to the Facebook second quarter 2018 Earnings Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question and answer session. If you would like to ask a question during that time, please press star then the number 1 on your telephone keypad. This call will be recorded. Thank you very much.
Ms. Deborah Crawford, Facebook's Vice President of Investor Relations, you may begin.

Deborah Crawford, VP Investor Relations
Thank you. Good afternoon and welcome to Facebook's second quarter 2018 earnings conference call. Joining me today to discuss our results are Mark Zuckerberg, CEO; Sheryl Sandberg, COO; and Dave Wehner, CFO.

Before we get started, I would like to take this opportunity to remind you that our remarks today will include forward-looking statements. Actual results may differ materially from those contemplated by these forward-looking statements.

Factors that could cause these results to differ materially are set forth in today's press release, and in our quarterly report on form 10-Q filed with the SEC. Any forward-looking statements that we make on this call are based on assumptions as of today and we undertake no obligation to update these statements as a result of new information or future events.

During this call we may present both GAAP and non-GAAP financial measures. A reconciliation of GAAP to non-GAAP measures is included in today's earnings press release. The press release and an accompanying investor presentation are available on our website at investor.fb.com.

And now, I'd like to turn the call over to Mark.

Mark Zuckerberg, CEO
Thanks Deborah, and thanks everyone for joining us today. We had another solid quarter. Revenue grew 42% year-over-year to $13.2 billion. And Facebook now has more than 2.2 billion monthly actives, with almost 1.5 billion using it every day.

For the first time today, we're also releasing how many people use at least one of our apps -- Facebook, WhatsApp, Instagram, or Messenger – and that's 2.5 billion people each month. This number better reflects our community for a couple of reasons. First, it refers to individual people rather than active accounts, so it excludes when people have multiple active accounts on a single app. And second, it reflects that many people use more than one of our services. Dave will explain this in more detail later.

I want to start by talking about all the investments we've made over the last six months to improve safety, security and privacy across our services. This has been a lot of hard work, and it's starting to pay off.

We recently launched two important ad transparency tools: one to let anyone see the ads any page is running -- even if the ads are not targeted to you -- and the other: an archive of ads with political or issue content starting in the US, ready for the midterm elections. These ads are now labeled so you can clearly see who's paying for them. And within the archive, you can see the budget associated with each ad, how many people saw it, and search all ads with political or issue content an advertiser has run for up to seven years.

This level of transparency will mean increased accountability and responsibility for advertisers globally.

Over the next 18 months, there are important elections beyond the US in Brazil, India, and the EU. These will all be real tests for Facebook. But I'm more confident we will get this right given our results during last year's French and German elections, the Alabama special election-- as well as this month's presidential election in Mexico -- where our systems found and removed thousands of fake accounts, pages and groups that violated our policies. Of course security is not a problem you ever fully solve. We face sophisticated, well-funded adversaries who are constantly evolving. But during each election, we learn and improve too.

We're also making progress in the fight against misinformation. We're getting rid of the financial incentives for spammers to create fake news -- much of which is economically motivated. And we stop pages that repeatedly spread false information from buying ads. We also use AI to prevent fake accounts that generate a lot of the problematic content from ever being created in the first place.

Our investments in AI mean we can now remove more bad content quickly because we don't have to wait until after it's reported. It frees our reviewers to work on cases where human expertise is needed to understand the context or nuance of a situation. In Q1, for example, almost 90% of graphic violence content that we removed or added a warning label to was identified using AI. This shift from reactive to proactive detection is a big change -- and it will make Facebook safer for everyone.

I also want to talk about privacy. GDPR was an important moment for our industry. We did see a decline in monthly actives in Europe -- down by about 1 million people as a result. At the same time, it was encouraging to see the vast majority of people affirm that they want us to use context -- including from websites they visit -- to make their ads more relevant and improve their overall product experience.

Looking ahead, we will continue to invest heavily in security and privacy because we have a responsibility to keep people safe. But as I've said on past calls, we're investing so much in security that it will significantly impact our profitability. We're starting to see that this quarter. But in addition to this we also have a responsibility to keep building services that bring people closer together in new ways as well. In light of increased investment in security, we could choose to decrease our investment in new product areas, but we're not going to -- because that wouldn't be the right way to serve our community and because we run this company for the long term, not for the next quarter. Dave will talk about this in a few minutes.

Now, perhaps one of the most important things we've done this year to bring people closer together is to shift News Feed to encourage connection with friends and family over passive consumption of

content. We've launched multiple changes over the last half to News Feed that encouraged more interaction and engagement between people and we plan to keep launching more like this.

Of course connecting isn't limited to News Feed. Now more than 200 million people are members of meaningful groups on Facebook -- these are communities that, upon joining, they become the most important part of your Facebook experience and a big part of your real-world social infrastructure. These are groups for new parents, for people with rare diseases, for volunteering, for military families deployed to a new base, and more. We believe there is a community for everyone on Facebook. The communities often span online and offline, and bring people together in person.

We've found that every great community has an engaged leader. But running a group can take a lot of time, so we have a roadmap to make it easier. That will enable more meaningful groups to get formed, which will help us find relevant ones to recommend to you, and eventually achieve our 5-year goal of helping 1 billion people be a part of meaningful communities. Since the 1970s, there has been a long decline in people joining physical groups around the world, and that has contributed to a broad feeling of loneliness and isolation. But if we can help 1 billion people be a part of something meaningful, that can reverse this trend.

Talking about being part of something meaningful, it's inspiring to see how people are using our fundraising tools to make a difference. Last month, a campaign to raise $1,500 for undocumented children separated from their families at the border ended up going viral and raising more than $20 million from more than half a million donors around the world. This quarter, we added the ability for pages to create and donate to fundraisers for causes they care about too.

This quarter we also reached a milestone with now more than a billion actives on Instagram. It's a moment to reflect on how this acquisition has been an amazing success. When Instagram joined us, the team had only 16 people. Since then, Kevin and the team have built Stories, Direct, and now IGTV. This has been a story of great innovation and product execution. It's also a story of how effective the integration has been. We believe Instagram has been able to use Facebook's infrastructure to grow more than twice as quickly as it would have on its own. A big congratulations to the Instagram team -- and to all the teams across our company that have contributed to this success.

I'm really excited about video too, and this quarter we launched IGTV. People are watching less TV and more video, but most video is not yet optimized for mobile. IGTV will help solve that problem. It's designed specifically for mobile and makes watching long-form, vertical video from creators easy. There's a standalone IGTV app, but you can also watch within the Instagram app. That means the entire Instagram community has been able to use it from the start.

We're also seeing Watch start to grow more quickly on Facebook too. Our teams are focused on building new experiences that help people connect and start conversations. We recently rolled out Watch Party to all groups, so you can watch and chat with friends at the same time. And we're seeing some real traction with some of the original programs -- from the talk show Red Table Talk featuring Jada Pinkett-Smith to SKAM, an interactive series that started in Norway and features a new style of storytelling where the characters have accounts on Facebook and Instagram and key parts of the story are told not just through video but through posts on their pages.

Stories continue to be a big part of the future of sharing too – and they're growing quickly across WhatsApp, Instagram, Facebook and Messenger. While we started off just implementing the basic

stories format, we've now moved well beyond it and have built lots of new features like polls, questions, and collaborative stories in groups and events. We're also making progress developing Stories into a great format for ads. We've made the most progress here on Instagram, but this quarter we started testing Stories ads on Facebook too.

The other major trend we're seeing is the shift to more private messaging. There's a lot to build here. We've been testing payments on WhatsApp in India. It gives people a really simple way to send money to each other and contributes to greater financial inclusion. Of the people who have tested this, feedback and usage have been very strong. All signs point to a lot of people wanting to use this when the government gives us the green light. In the meantime, we've broadened our focus to building this for other countries so we can give more people this ability faster. Over the next five years, we're focused on building out the business ecosystem around messaging on WhatsApp and Messenger.

More broadly, our strategy is to use Facebook's computing infrastructure, business platforms, and security systems to serve people across all of our apps. For example, we made the decision a decade ago to build our own data centers, and we opened our first custom-built data center in 2011. Today, we have six data centers around the globe, and we're working on building eight more. We're using AI systems and our global community operations team to fight spam, harassment, hate speech, and terrorism across all our apps to keep people safe. This is incredibly useful for apps like WhatsApp and Instagram as it helps us manage the challenges of hyper-growth there more effectively.

Beyond apps -- and looking at the next 10 years -- we're making a lot of progress with VR. Our goal is to create a feeling of presence, like you're right there with people you care about even if you might be halfway around the world. Oculus Go is off to a good start, and at $199, it's going to be how a lot of people experience virtual reality for the first time.

Overall, this is a critical year for Facebook. We've made progress preventing abuse, forged ahead with new innovations, and are adapting our services to the new trends of messaging, stories, videos, and groups. As always, thank you all for being a part of this journey, and I'm looking forward to making more progress together.

And now here's Sheryl to talk about our business.

Sheryl Sandberg, COO

Hi everyone.

It was a good second quarter with ad revenue growing 42% year over year. Mobile ad revenue was $11.9 billion, a 50% increase year-over-year, making up approximately 91% of total ad revenue. Our growth again was broad-based across regions, marketer segments, and verticals.

We are working to ensure that Facebook is a safe place for people and businesses. We've taken strong steps to address a number of issues including election integrity, fake news, and protecting people's information. One of the most important things we can do to effect change is to increase transparency because transparency leads to greater accountability. For example, when anyone can see any ad on Facebook, advertisers have to stand behind the ads they run. Transparency also allows us to get more

input from our community and from experts around the world so that we can find and fix problems. We wish we could find everything ourselves, but we never will, so we're building tools to make it easier for people to report issues to us.

As Mark mentioned, this quarter we took major steps to make advertising and Pages more transparent. Now anyone can see all the ads a Page is running across Facebook, Instagram, Messenger and Audience Network. You can also learn more about Pages, even if they don't advertise. You can see when a Page was created and if they've changed their name.

For political and issue ads, we're going even further. Advertisers placing ads with political content are now required to verify their identity and location. These ads will be labeled with a disclosure about who paid for them and saved in a searchable archive.

The vast majority of ads on Facebook are run by legitimate organizations — from small businesses looking for new customers, to advocacy groups raising money for their causes. But we've seen that bad actors can misuse our products, too, so we're erring on the side of transparency. We're being intentionally broad in our interpretation of political and issue ads. This includes ads for books about politicians and brand campaigns that touch on national issues. Given our commitment to transparency, we think it's important to apply this policy to more ads rather than fewer.

These steps are just the start. We'll keep looking for ways to improve, and we hope these tools become standard across the industry.

As we make these investments in transparency and accountability, we remain focused on our key priorities: helping businesses leverage the power of mobile, developing innovative ad products, and making our ads more relevant and effective.

First, leveraging the power of mobile.

For businesses, winning on mobile now means winning on video. Globally, people are creating and watching more video — especially on mobile devices. According to eMarketer, nearly a quarter of the world's population will watch video on a mobile phone this year. We see this trend toward video across all of our apps — from people sharing more video with their friends on Facebook, to watching more video from creators on Instagram, to having more video calls on WhatsApp and Messenger.

Marketers are making more video of their own. We're seeing healthy growth in video ads among all advertiser segments. M&Ms UK recently used mobile-optimized 5-second video ads on Facebook and Instagram to introduce M&Ms Mix — a bag of three kinds of M&Ms in one. Their campaign worked, driving results not just for their new product but for the brand overall. Their sales increased by over 10%, and 80% of that came from households that hadn't bought M&Ms in the previous 26 weeks.

Second, developing new ad products.

We know that creating video can be more difficult for small businesses that have fewer resources, so we've launched new tools on Facebook to help anyone make videos that work well on mobile. Last quarter we released Ads Animator, a simple way to create eye-catching video ads using photos and other content that's already on a company's Facebook Page. We're also testing Video Creation Kit, which gives advertisers easy-to-use video templates for different marketing objectives. By learning what performs best across our platform, we can help other businesses succeed.

We're also making it easier to run ads on Instagram and in Stories. Ads in Stories are an immersive, engaging way for people to interact with businesses. When online retailer Overstock wanted to gain new customers and increase furniture sales, they ran video ads in Instagram Stories with a Shop Now button. They saw an 18% increase in return on ad spend and a 20% decrease in cost per acquisition. This quarter, we made it easier for more advertisers to adopt the Stories format. When an advertiser uploads video in a square or horizontal format for feed, we can automatically transform it into the fullscreen vertical format of Stories.

Third, making our ads more relevant and effective.

We're building new products and improving existing ones to ensure advertisers can reach the right audience. For example, Automatic Placements help advertisers get better results by showing ads across our platform wherever they'll perform best and at the lowest cost. SumUp, a German payments startup that helps small businesses accept debit and credit cards, switched from manual to automatic placements and increased sales by 34% in one week.

Advertisers of all sizes want to know if their ads are working and how to make them better, but smaller businesses don't always have this capability. We're changing that. Last year we introduced Test & Learn, a way for advertisers to run variations of their ads and measure the results in just a few steps. We started with tools for direct response advertisers to figure out what drives conversions. In Q2, we added a way for companies to understand the effect of their ads on brand perception. We plan to roll this out to all advertisers — big and small — so they can easily experiment with different strategies and find the ones that work best.

As always, I am grateful to our teams around the world. Their work over the past several months has helped millions of businesses grow and created new levels of transparency in advertising. I'd also like to thank our partners and the businesses of all sizes who turn to us to reach their customers and give us the feedback that helps make us better.

Thank you, and now here's Dave.

David Wehner, CFO
Thanks Sheryl and good afternoon, everyone.

Let's start with our community metrics.

Daily active users on Facebook reached 1.47 billion, up 11% compared to last year, led by growth in India, Indonesia, and the Philippines. This number represents approximately 66% of the 2.23 billion monthly active users in Q2. MAUs were up 228M or 11% compared to last year. It is worth noting that MAU and DAU in Europe were both down slightly quarter-over-quarter due to the GDPR rollout, consistent with the outlook we gave on the Q1 call.

As Mark mentioned, we are also introducing a family-wide audience metric. 2.5 billion people worldwide used one of our applications in June. This is our best estimate of our de-duplicated audience across Facebook, Instagram, Messenger, and WhatsApp. We believe this number better reflects the size of our community and the fact that many people are using more than one of these services.

Note that for comparison purposes, the Facebook MAU number does count multiple accounts for a single user when such accounts exist, and we estimate those represent approximately 10% of our Facebook MAUs as previously disclosed in the limitation of key metrics section in our SEC filings. The family audience metric only counts a single user in these instances.

Turning now to the financials.

All comparisons are on a year-over-year basis unless otherwise noted.

Q2 total revenue was $13.2 billion, up 42% or 38% on a constant currency basis. Foreign exchange tailwinds contributed approximately $370 million of revenue in Q2.

Q2 ad revenue was $13.0 billion, up 42% or 38% on a constant currency basis.

In terms of ad revenue by region, Europe and Asia Pacific both grew fastest at 47% each and benefitted from foreign exchange tailwinds. I'd note that European ad revenue growth decelerated more quickly than other regions and was impacted primarily by reduced currency tailwinds and, to a lesser extent, the rollout of GDPR.

Mobile ad revenue was $11.9 billion, up 50% and represents approximately 91% of ad revenue.

In Q2, the average price per ad increased 17% and the number of ad impressions served across our services increased 21%, driven primarily by ads in feed on Instagram and Facebook.

Payments & other fees revenue was $193 million, up 23%.

Turning now to expenses.

Total expenses were $7.4 billion, up 50%.

We ended Q2 with over 30,000 full-time employees, up 47% compared to last year.

Operating income was $5.9 billion, representing a 44% operating margin.

Our effective tax rate in the quarter was 13%.

Net income was $5.1 billion or $1.74 per share.

Capital expenditures were $3.5 billion, driven by investments in data centers, servers, network infrastructure, and office facilities.

In Q2, we generated $2.8 billion in free cash flow and ended the quarter with approximately $42 billion in cash and investments.

And in the second quarter, we bought back approximately $3.2 billion of our Class A common stock.

Turning now to the revenue outlook.

Our total revenue growth rate decelerated approximately 7 percentage points in Q2 compared to Q1. Our total revenue growth rates will continue to decelerate in the second half of 2018, and we expect our revenue growth rates to decline by high single digit percentages from prior quarters sequentially in both Q3 and Q4.

There are several factors contributing to that deceleration. For example, we expect currency to be a slight headwind in the second half vs. the tailwinds we have experienced over the last several quarters. We plan to grow and promote certain engaging experiences like Stories that currently have lower levels of monetization. We are also giving people who use our services more choices around data privacy which may have an impact on our revenue growth.

Turning now to expenses.

We continue to expect that full-year 2018 total expenses will grow in the range of 50-60% compared to last year. In addition to increases in core product development and infrastructure, this growth is driven by increasing investments in areas like safety & security, AR/VR, marketing, and content acquisition.

Looking beyond 2018, we anticipate that total expense growth will exceed revenue growth in 2019. Over the next several years, we would anticipate that our operating margins will trend towards the mid-30s on a percentage basis.

We expect full-year 2018 capital expenditures will be approximately $15 billion, driven by investments in data centers, servers, network infrastructure, and office facilities. We plan to continue to grow capital expenditures beyond 2018 to support global growth and our ongoing product needs.

Turning now to tax. At current stock prices, we expect that our full-year 2018 tax rate will be in mid-teens but that our Q3 tax rate will be 25-30% due to a one-time charge related to a recent court ruling in the IRS vs. Altera case. As a reminder, fluctuations in our stock price will impact our tax rate.

In summary, our community and business growth remain solid. Our financial strength has enabled us to invest heavily to improve our ability to serve our global community through our existing family of apps as well as to prepare us for the future.

With that, operator, let's open up the call for questions.