

Facebook, Inc. (FB)
Second Quarter 2016 Results Conference Call
July 27th, 2016

Operator

Good afternoon. My name is Chris and I will be your conference operator today. At this time I would like to welcome everyone to the Facebook second Quarter 2016 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

Good afternoon and welcome to Facebook's second quarter 2016 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 today.

We had another good quarter and first half of the year. Our community continues to grow around the world. 1.7 billion people now use Facebook every month, and 1.1 billion people use it every day. Our business is growing at a healthy rate as well. Total revenue grew by 59% year-over-year to \$6.4 billion, and advertising revenue was up 63% to \$6.2 billion.

Our results show our progress as we work to make the world more open and connected across our three-, five- and ten-year horizons. Over the next three years we are focused on continuing to build our community and help people share more of what matters to them. The next five years are about building our newer products into full ecosystems with developers and businesses. And over the next ten years we are working to build new technologies to help everyone connect in new ways.

I'll give an update on our progress across these areas, starting with how we're working to deliver better experiences for our community and more ways for people to share more of what they care about with anyone they want.

We continue to see excellent growth in our community. Over the past year we have added over 200 million people using Facebook on a monthly basis. And in the second quarter, time spent per person increased double digit percentages year-over-year across Facebook, Instagram and Messenger. And that doesn't even include WhatsApp yet.

One of the biggest opportunities to grow our community is in developing countries where connectivity is less advanced than what we take for granted here at home. So over the past couple of years, we've began making steady improvements to our apps to make them work regardless of the device or connection people are using. We also built a light-weight version of our Android app, called Facebook Lite, that is tuned to work on 2G networks and is now used by more than 100 million people.

We are also working on new tools to help people express themselves and understand what's going on with the people they care about. 10 years ago, most of what we shared and consumed online was text. Now it's photos. And soon, most of it will be videos. We see a world that is video first, with video at the heart of all of our apps and services.

Over the past six months we have been particularly focused on Live video. Live represents a new way to share what's happening in more immediate and creative ways. This quarter Candace Payne's Chewbacca mask video was viewed almost 160 million times. Live is also changing the way we see politics, as news organizations and delegates go Live from the Republican and Democratic conventions. And we have seen in Minnesota and Dallas how Live can shine a light on important moments as they happen.

This quarter we also launched 360 photos. You don't need a special camera to take them – you just take a panorama or use a 360 camera app on your phone and post it. Since we launched, more than 4 million 360 photos have been shared on Facebook -- with 1 million more being shared every week.

We're making good progress on core services within the Facebook app, like Search. A growing way people use search is to find what people are saying about a topic across the more than 2.5 trillion posts in our network. Now, people are doing more than 2 billion searches a day, between looking up people, businesses and other things that they care about. Continuous, steady improvement to services like search are an important part of helping people connect and realizing our mission.

We're also improving the experience for our community by building our business with more engaging ads. We have always emphasized the importance of measurement and value in driving real results for the businesses that use Facebook -- and that means helping them create more relevant and engaging ads.

Over the next five years we are working hard to build ecosystems around some of our newer products.

Instagram now has more than 500 million monthly actives, with more than 300 million daily. Now we're working to make the experience more engaging. Recently, Instagram began to rank its feed because we know that people have a better experience when they see more of the stories they care about. We're already seeing a positive impact in terms of time spent and the amount of content people are sharing. We've also introduced our advertising tools on Instagram and we're seeing marketers engage with people in creative and innovative ways.

In the two years since we separated Messenger from the main Facebook app -- which was a controversial decision at the time -- we've improved performance and given people new ways to express themselves. Now, for the first time, more than 1 billion people are using Messenger every month. I'm also happy with the updates we're making to WhatsApp -- which also has a community of more than 1 billion people. This quarter we launched new desktop apps and end-to-end encryption, and millions of people are using WhatsApp's voice calling features.

The scale we've achieved with our messaging services makes it clear that they are more than just a way to chat with friends. That's why we're also making it easier for people to connect with groups and businesses as well. We are going to keep focusing on this over the next several years.

I'm also excited about the early progress we're making on our 10-year initiatives. We are investing in new technologies to give more people a voice -- including the 4 billion people around the world who aren't yet online -- and helping more people take advantage of the opportunities that come with the internet.

We're still early in our journey with lots of hard work ahead, but we're making good progress -- like the first successful flight of Aquila, our solar-powered aircraft that will beam internet to places that have never been connected. Eventually, we're going to work with telecom operators and governments around the world to connect people on the outskirts of cities, rural areas and disaster zones where you can't get traditional connectivity today.

We've also been making progress with our initiatives around artificial intelligence and virtual reality. This quarter we announced DeepText, a deep learning-based engine that can understand the context of several thousand posts per second across 20 different languages. This is a long-term project but it also has some near-term benefits, like helping show people more of what they want to see and filtering out what they don't want to see.

We're also investing in new platforms to help people connect and share. We believe that virtual reality can help people share richer experiences and help everyone understand what's going on around the world. It's really early for us in VR but we're hitting some important milestones. As of the second quarter more than 1 million people a month are using Oculus on mobile phones through our Gear VR

partnership with Samsung. More than 300 apps are already available at the Oculus store for Gear VR, we've filled all of our pre-orders for Oculus Rift and we are seeing increasing demand from retail as stores plan for the holidays. While it's still early for augmented reality, we're doing AR research and are seeing lightweight versions of AR technology today in mobile apps like MSQRD.

So that's a recap of the progress we're making in our 10 year plan. We have a saying at Facebook that our journey is only 1% done -- and while I'm happy with our progress, we have a lot more work to do to grow our community and connect the whole world. That means making big investments and taking risks -- focusing not just on what Facebook is, but on what it can be.

I want to thank everyone in our community, all our teams, our partners and our shareholders for being a part of this journey with us.

And now, here's Sheryl.

Sheryl Sandberg, COO

Thanks Mark and hi everyone.

We had a great second quarter. Q2 ad revenue grew 63%. Mobile ad revenue reached \$5.2 billion, up 81% year-over-year, and was approximately 84% of total ad revenue. Our growth was broad-based across verticals, marketer segments and regions.

We're excited to announce that we now have 60 million monthly active business Pages on Facebook. We also continue to grow the number of active advertisers on our platform. This shows that both our free and paid products are providing value to marketers of all sizes around the world.

We continue to focus on our three priorities — capitalizing on the shift to mobile, growing the number of marketers using our ad products, and making our ads more relevant and effective.

First - capitalizing on the shift to mobile.

For 62 years, the advertising industry has gathered in Cannes to celebrate creativity. People have shifted to mobile and marketers know they need to catch up. Mobile is no longer a “nice” to do — it's a “must” do and we're working closely with marketers to help them make this transition.

The best marketers understand that people watch video differently in mobile feed. The goal is to create what we think of “thumb stopping creative” — videos that grab attention in the first few seconds, even without sound. For example, to drive awareness for Sour Patch Kids Gum, Mondelez targeted teens with non-chocolate candy interests. Working with VaynerMedia, Carat, and the Facebook Creative Shop, they created punchy 10-second looping videos tailored for Facebook and Instagram. The campaign helped the Sour Patch Kids portfolio beat sales benchmarks for the entire candy industry.

We're excited to bring more relevant video ads to people both on and off Facebook. In May, we

expanded Audience Network to include video for brand objectives. This means that advertisers can place brand video ads not just on Facebook and Instagram but across a network of apps and sites.

Our second priority is growing the number of marketers using our ad products.

Over a third of small and medium businesses in the U.S. don't have a website — and having a mobile presence is even more difficult and expensive. Creating a business Page on Facebook is as easy as setting up a personal Profile. This is why Facebook Pages are the mobile solution for many of the 60 million businesses using our products each month in the U.S. and around the world.

We've made it easy for business owners to manage their Facebook Page from their mobile device. Over 85% of active business Pages use mobile and 40% of active advertisers have created a Facebook ad on their mobile device. In Q2 we rolled out new tools to make it easier for businesses to promote posts and track performance directly from the Instagram app.

We've worked hard to make becoming an advertiser as easy as possible for these businesses. With just a few steps, and for as little as a few dollars, businesses can boost their posts to reach more people. Simplifying our ad products is key to advertiser acquisition — over 80% of new advertisers in Q2 started with simplified products, like boosted posts.

Once these businesses begin advertising with us, we make it easy for them to take advantage of even our most sophisticated capabilities. For example, Lighting Etc., a third-generation family-owned business, used Facebook and Instagram ads to drive in-store sales. They targeted 25-45-year-old homeowners interested in interior design, living within 35 miles of their showroom in Fort Worth, Texas. It was striking to them that on Facebook the size of our community meant they could reach over 300,000 people even with such specific targeting. They've seen a 40% increase in revenue in 2016 and they attribute this increase to their ads on Facebook and Instagram.

Our third priority is making our ads more effective and relevant.

Our goal is to help our clients grow their businesses — whether it be moving products off shelves, driving online sales or building their brands. Our system constantly looks for the most efficient and effective way to drive these objectives.

Businesses that want to build their brands need to reach a large audience with a compelling story, and they're seeing strong results from immersive formats like Video and Canvas Ads.

Businesses working to acquire new customers need to reach high quality leads and convert them to action. We introduced Lead Ads in Q1 to make it easy for people to fill out forms on mobile devices right from News Feed. In Q2 we made it possible for advertisers to retarget people who opened or completed a Lead Ad form. For example, Nissan Turkey and the SEM Agency used Lead Ads to collect over 20,000 high-quality leads from people interested in buying a new car. They then used retargeting to show relevant ads to people who had completed these Lead Ads and ultimately drove vehicle sales. The cost of a high quality lead was 9.3 times lower on Facebook than all other online media.

Businesses selling products are getting search-like ROI from Dynamic Ads. Dynamic Ads allow advertisers to upload their product catalogue and target people with specific products in real time. Over 300 million people see Dynamic Ads each month and over 2.5 billion unique products have been uploaded by marketers. In Q2 we expanded Dynamic Ads to Instagram and also launched Dynamic Ads for Travel. For example, you can now advertise specific destinations and dates for hotel rooms.

We're pleased with the value we're driving for our partners and the progress we're making across our three priorities. With only a small fraction of our 60 million business Pages advertising, we have a lot of opportunity ahead. We also have a lot of hard work to do to help businesses make the shift to mobile and to drive results for our clients.

I want to thank our clients around the world for their partnership and their ongoing input, which informs our product development. I also want to congratulate our global teams on the results of their hard work and thank them for their dedication to our mission.

Thanks, everyone, and now here's Dave.

David Wehner, CFO

Thanks Sheryl and good afternoon everyone.

Q2 was another strong quarter for Facebook. Total revenue grew 59% to \$6.4 billion, and we generated over \$2 billion in free cash flow.

These results highlight the continued growth and engagement of our global community and the strength of our ads business, as advertisers benefit from our increasingly broad and deep portfolio of targeting, creative and measurement tools.

Let's start with our community metrics.

This past quarter was our strongest quarter in over 3 years in terms of absolute year over year growth of monthly and daily actives on Facebook.

In June, 1.13 billion people used Facebook on an average day, up 17% compared to last year. This daily number represents 66% of the 1.71 billion people who visited Facebook in the month of June. Mobile continues to drive our growth, with over 1 billion people accessing Facebook via mobile devices on an average day in June, up 22% compared to last year.

The growth of our other services also continues to be strong. WhatsApp and Messenger now each have over 1 billion monthly actives, and Instagram recently surpassed 500 million.

Turning now to the financials.

My comments today will focus on our GAAP financial metrics and all of our comparisons are on a year-over-year basis unless otherwise noted. A reconciliation of GAAP to non-GAAP financial metrics is included in our press release and earnings slides.

Total Q2 revenue was \$6.4 billion, up 59%. Q2 ad revenue was \$6.2 billion, up 63%. Exchange rates did not impact our overall revenue growth rates this quarter as headwinds in certain currencies were offset by tailwinds in others.

US & Canada and Asia-Pacific were our fastest growing regions with advertising growth rates of 69% and 67%, respectively.

Mobile ad revenue was \$5.2 billion, up 81% and representing approximately 84% of total ad revenue.

Let's turn to the supply and demand factors that continue to drive our growth. Advertiser demand was particularly strong in Q2 across a broad range of verticals and advertiser objectives. Additionally, supply-side factors including growth in users, time spent and ad load all contributed to our Q2 revenue growth.

In Q2, the average price per ad increased 9%, while total ad impressions increased 49%. The reported increase in price was again driven by the continued mix shift towards mobile where we show only higher-priced News Feed ads compared to the mix of News Feed ads and lower priced right-hand column ads on personal computers.

The 49% increase in total ad impressions was driven primarily by growth in ad impressions served in the Facebook mobile News Feed, where the majority of our ads are shown.

Payments & Other Fees revenue was \$197 million, down 8%. Remember that Payments & Other Fees revenue is largely generated from games played on personal computers which has declined as people spend less time on their PCs.

Q2 total expenses were \$3.7 billion, up 33%, inclusive of \$825 million of share based compensation expenses and related payroll taxes as well as \$193 million of amortization of intangible assets.

Q2 operating income was \$2.7 billion, representing a 43% operating margin. We continue to be pleased with the profitable growth of the business while we invest for the long-term.

We ended Q2 with approximately 14,500 employees, up 32% year-over-year. We added approximately 900 employees in the quarter with the majority of those in technical functions. We are seeing continued success with our efforts to hire top talent in a market that remains very competitive.

Our Q2 tax rate was 26%.

GAAP net income was approximately \$2.1 billion or \$0.71 per share.

Q2 capital expenditures were \$1 billion. Year-to-date, capital expenditures totaled \$2.1 billion, driven by investments in data centers, servers, office buildings and network infrastructure.

Facebook generated over \$4 billion in free cash flow in the first half of 2016, and as of June 30th, we had over \$23 billion in cash and investments.

Turning now to the outlook. First, some color on revenue.

We have been pleased with the strength of our advertising revenue in the first half of 2016. As I discussed on our last call, while we expect the main drivers of our advertising revenue growth will continue throughout 2016, we will face tougher comparables given the accelerating growth rates reported in 2015 and we anticipate lower advertising revenue growth rates in each successive quarter in 2016.

Additionally, we anticipate ad load on Facebook will continue to grow modestly over the next 12-months and then will be a less significant factor driving revenue growth after mid-2017. Since ad load has been one of the important factors in our recent strong period of revenue growth, we expect our ability to grow revenue will be impacted accordingly.

Turning now to expenses.

Based on our updated view of the remainder of the year, we are tightening our expense guidance ranges. We expect that full-year 2016 total GAAP expense growth will be approximately 30-35% narrowed from our prior range of 30-40%

We expect full-year 2016 amortization expenses to be approximately \$700-\$800 million, and that full-year 2016 stock-based compensation expenses to be approximately \$3.1-\$3.3 billion.

Accordingly we anticipate that our total Non-GAAP expenses, which exclude stock based compensation and amortization, will grow in the range of 45-50%, narrowed from our prior range of 45-55%.

We anticipate full-year 2016 capital expenditures to be approximately \$4.5 billion as we invest to support the rapid growth of the business.

Finally, we expect that our Q3 and full year 2016 tax rates will be similar to our Q2 rates.

In summary, Q2 was another great quarter for Facebook, illustrated by the strong growth and engagement of our global community and continued broad-based strength in our ads business. We're pleased with the results, and we will continue to invest in order to best position Facebook for our long-term growth opportunities.

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