

Facebook, Inc. (FB)
First Quarter 2017 Results Conference Call
May 3rd, 2017

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 first Quarter 2017 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 first quarter 2017 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 annual report on form 10-K 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 started the year off with a good quarter. Our community continues to grow with more than 1.9 billion people now using Facebook every month and almost 1.3 billion using it every day. Our ads business is doing well, too. Total revenue grew by 49% year-over-year to \$8.0 billion, and advertising revenue was up 51% to \$7.9 billion.

In my letter to our community back in February, I talked about how, for the past decade, Facebook has focused on connecting friends and families. Now, with that foundation, our next focus will be building community.

There's a lot to do here. Building global community is bigger than any one organization, but we can help by developing social infrastructure for community -- for supporting us, for keeping us safe, for informing us, for civic engagement, and for including everyone.

Building a global community that works for everyone starts with building millions of smaller, supportive communities. This is especially important since membership in many physical communities is declining. We recently found that more than 100 million people on Facebook are members of what we call "very meaningful" groups, like parenting or rare disease support groups that are an important part of their support structure. My hope is to help more than a billion people join meaningful groups to strengthen our social fabric over the next few years.

To help build a safe community, we launched Community Help, a tool that allows people to give and get things like food, shelter or transportation in the wake of a natural disaster. We also launched a new fundraising tool that allows people to raise money for themselves, a friend or a cause that isn't already on Facebook.

But it's clear we have more work to do. We're going to continue building new tools to keep people safe on our platform. Over the next year, we'll be adding 3,000 people to our community operations team around the world -- on top of the 4,500 we already have today -- to review the millions of reports we get every week, and to improve the process for doing it quickly.

To help build a more informed community, we made changes to our News Feed ranking to reduce the financial motivation to spread hoaxes. We're working with independent fact checkers to give people more information about whether an article has been disputed. We launched an educational tool at the top of News Feed in 14 countries to help people spot false news. And we're beginning to test Related Articles that appear before you read an article to give you easier access to more perspectives and information.

We're also helping build more civically-engaged communities. In March, we launched Town Hall to help people find and connect with their government representatives on a local, state and federal level in the U.S.. In just the first month, we created more than 1 million new connections between people and their representatives. We also rolled out a tool in France ahead of their election that allows candidates to share statements about where they stand on different policy issues.

These are some of the changes we've made to help people build stronger communities.

Next I want to give a quick update on what we're building over three time horizons: how we're making our core services more useful and engaging right now; how we're building ecosystems around products that a lot of people already use over the next five years; and how we're investing in the technologies that will give more people a voice and make sharing more immersive over the next 10 years.

This quarter we launched a set of new cameras. Photos and video are becoming more common than text, so the camera is becoming more central than the text box in all our apps.

In the Facebook app, you can now swipe right from News Feed to access our new camera with masks,

frames and filters. We've developed new computer vision tools that can apply the style of a painting to a photo or video — and we can do it in real-time on your phone for the first time.

This is part of making the camera the first augmented reality platform. We want to give developers the power to build all kinds of AR tools into the camera so more people can experience augmented reality on their phones. Creating the first open camera platform is a huge step forward, and we're excited to keep pushing augmented reality forward.

We also expanded the Stories format to give people more new ways to share. Instagram Stories now has more than 200 million daily active people using it. And just a couple months after we launched it, WhatsApp Status has more than 175 million daily active people using it. More recently, we also rolled out Messenger Day and Facebook Stories, and we're going to keep putting video at the center of all our services.

Over the next five years, we're going to build ecosystems around our products that a lot of people are already using.

I put Live video in this category. Last month, we announced that one in every five Facebook videos is a live broadcast -- and over the past year, daily watch time for Facebook Live broadcasts has grown by more than 4x. This year we also gave people the ability to go Live in 360.

Messenger is in this category, too. And we just announced that 1.2 billion people use Messenger every month. At F8, we launched the second generation of our Messenger platform and introduced a Discover tab to make it easier to find the best experiences quickly.

Finally over the next 10 years, we're developing consumer use cases around technologies that are a big part of our future, but won't be a big part of the business for a while.

On the connectivity side, in April we successfully simultaneously beamed 16 gigabits of data in each direction between a location on the ground and a Cessna aircraft circling more than 7 km away. Eventually, we're going to use this technology along with Aquila, our solar-powered plane we're building, to beam internet to parts of the world that currently don't have access.

In VR, we launched Facebook Spaces, the first social virtual reality platform that lets you create your own avatar and hang out with your friends. And we also released the Facebook 360 app for Gear VR that makes it easier to discover and experience 360 photos and videos. And we continue to ship Rift and Touch to people everywhere and deliver a strong content ecosystem across both Rift and Gear VR.

As people share more video, as we explore more things like augmented reality, and as we build more tools to keep our community safe, we're going to keep investing aggressively in the infrastructure we need to grow and serve our community. That's why we announced that our next two new data centers will be built in Odense, Denmark and Papillion, Nebraska.

We've made some good progress, but we have a lot more to do to help build community and connect the world. I want to thank our community, our teams, our partners, and all of you for being a part of this journey with us.

Now, here's Sheryl.

Sheryl Sandberg, COO

Thanks Mark and hi everyone.

We had a strong first quarter and a great start to the year.

Q1 ad revenue grew 51% year over year. Mobile ad revenue was \$6.7 billion, up 58% year-over-year, and was approximately 85% of total ad revenue. Growth again this quarter was broad-based across regions, marketer segments, and verticals.

Our goal is to build meaningful connections between businesses and people. We're doing this by focusing on 3 key priorities: helping businesses leverage the power of mobile, developing innovative ad products, and making our ads more relevant and effective.

Our first priority is helping businesses leverage the power of mobile.

More businesses around the world are shifting to marketing on mobile. Over 70 million businesses are now using Facebook Pages around the world on a monthly basis, and more and more of them are becoming advertisers. We also recently announced that over 5 million businesses are actively advertising on Facebook, including more than 1 million in emerging markets. Most of these advertisers start by using our free Pages product because it's easy to use.

People are increasingly recognizing that the small screen is big. Our Creative Hub is providing tools that make it easier to create ads optimized for mobile – what we talk about as “thumb-stopping creative”. Marketers can see previews of their ads across Facebook and Instagram before rolling them out and get tips to help drive business results.

Our second priority is developing innovative ad products that help businesses make the most out of their campaigns.

We continue to improve Dynamic Ads which enable advertisers to promote their full range of products across all devices. Advertisers can now target Dynamic Ads to broad audiences and are seeing great results. Last week, I visited home retailer Wayfair in Boston. They used Dynamic Ads to reach a large audience with personalized recommendations from their catalog of over 8 million items. By finding higher revenue customers at a lower cost, the campaign beat Wayfair's return on ad spend goal by more than 20%.

We're also helping marketers use video to capture shoppers' attention. People are watching more video on Facebook than ever before and it's changing how they connect with businesses. In a recent study Facebook commissioned with Kantar, 30% of mobile shoppers said video is the best way to discover new products.

This quarter, we introduced a new ad format called Collection. Collection helps marketers tell stories on mobile by combining creative videos or photos with product images. Clicking on the products leads to an immersive shopping experience, driving purchase consideration and ultimately sales. For example, Adidas which is how you pronounce them at their headquarters and its agency iProspect created a video highlighting the innovative features of its ZNE Road Trip Hoodie. Using our Collection ad format, Adidas featured 4 more items from their product catalog below the video. They saw a 5.3 times return on ad spend and a 1.8 times decrease in cost per conversion. It's still early for this new format, but it's a great example of how we can deliver innovative mobile experiences that work for advertisers and work for people.

This quarter we also launched full screen, sound-on ads in Instagram Stories. Advertisers can now reach over 200 million daily actives on Stories to do everything from building brands to selling products.

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

Measurement is critical. We recently introduced new and expanded verification partnerships, and committed to audits with the Media Rating Council. Whether marketers are trying to get people to buy something on their website or in their store, we now have systems in place to help them measure results and third-party partnerships to verify those results. These are important steps as we continue to build the advertiser trust.

Bud Light's NFL campaign is a great example. To promote the designs of their new team-specific cans, Bud Light took a national and regional approach. They ran video ads featuring the new cans to people ages 21-49 in the US. Then they also ran more targeted ads in each region, featuring the 2 cans of the teams playing each other. Using Facebook polling and Oracle data cloud, they saw a 24-point lift in ad recall and a 4.4 times return on ad sales.

We know marketers want to compare results across platforms and placements. Historically we've enabled larger marketers to do this. In Q1, we started testing a set of advanced measurement tools that make it easier for marketers of all sizes to compare the effectiveness of Facebook, Instagram and Audience Network alongside other publishers.

We are off to a strong start in 2017. We are helping marketers leverage the power of mobile, developing innovative ad products, and delivering proven and measurable results. We are excited about the growing adoption of our platforms and we are going to continue to invest in helping businesses and people connect.

Thanks and now here's Dave.

David Wehner, CFO

Thanks Sheryl and good afternoon everyone.

Q1 was a strong quarter for Facebook. We continued to see healthy growth and engagement trends across our community as well as broad based growth in our ads business.

Let's start with our community metrics.

In March, 1.28 billion people visited Facebook on an average day, up 18% compared to last year. This daily number represented 66% of the 1.94 billion people that visited Facebook during the month of March, which was up 282 million or 17% compared to last year. Our community growth in Q1 was driven by product improvements, Internet.org, and ongoing third party promotional data plans in markets like India. Note that we do not control the timing or terms of these promotions.

Before diving into the financials, I want to highlight that we are no longer reporting non-GAAP expenses, income, tax rate or EPS. Given that stock is an important part of our compensation structure, we believe that investors should focus on our financial performance with stock-based compensation included.

Turning now to the financials. All of our comparisons are on a year-over-year basis unless otherwise noted.

Q1 total revenue was \$8.0 billion, up 49%. Ad revenue was \$7.9 billion, up 51%. Exchange rates did not affect our overall growth rate this quarter as headwinds in certain currencies were offset by tailwinds in others.

In terms of regional advertising growth, Rest of World and Asia Pacific were our strongest growers in percentage terms at 66% and 60% respectively. Both regions benefitted from particularly strong advertiser demand. Europe and North America both grew at 47%.

Mobile ad revenue was \$6.7 billion, up 58% and represented approximately 85% of ad revenue. Desktop ad revenue grew 22%, despite a decline in desktop usage, and was aided by our recent efforts to limit the impact of ad blocking technologies, which we began in Q3 of last year.

Our mobile ads business continued to be driven by healthy supply and demand dynamics.

In Q1, the average price per ad increased 14% and the total number of ad impressions served increased 32%, primarily driven by mobile feed ads.

Payments and Other Fees revenue was \$175 million, down 3%.

Q1 total expenses were \$4.7 billion, up 40%.

In 2017, we have continued to accelerate our hiring efforts. We added over 1,700 employees in Q1 – predominantly in technical and recruiting functions – and ended the quarter with approximately 18,800 employees, up 38% compared to last year. This marked an acceleration from the 34% growth rate in Q4.

Q1 operating income was \$3.3 billion, representing a 41% margin.

Our tax rate was 10%, which reflects the adoption of ASU 2016-09 in the fourth quarter.

Excluding this adoption, our tax rate would have been approximately 9 percentage points higher. Note that the new accounting guidance does not impact the cash taxes we pay, but merely how the tax provision is presented under GAAP, whereby now excess tax benefits are flowing through the P&L and in this quarter positively impacted EPS.

Net income was \$3.1 billion, or \$1.04 per share.

Q1 capital expenditures were approximately \$1.3 billion, driven by investments in data centers, servers, office facilities and network infrastructure. In Q1, we also broke ground on our ninth data center in Nebraska.

We generated approximately \$3.8 billion in free cash flow.

In the first quarter, we repurchased \$228 million of our Class A common stock and used \$771 million in cash for taxes paid related to the net share settlement of equity awards.

We ended the quarter with \$32.3 billion in cash and investments.

Turning now to the outlook.

With regards to revenue, we continue to expect that our ad revenue growth rates will come down meaningfully over the course of 2017. We expect that ad load will play a less significant factor in driving revenue growth after mid-2017. We also expect desktop ad revenue growth rates to slow in the third quarter when we begin to lap our efforts to limit the impact of ad blockers.

We continue to expect that our full-year 2017 Payments & Other Fees revenue will decline compared to full-year 2016. As a reminder, Payments & Other Fees revenue is primarily generated from payments related to games played on personal computers.

Turning to the expense outlook, we continue to expect that full-year 2017 GAAP expenses will grow 40-50% compared to full-year 2016. I would note that as we look into 2017 and beyond there are going to be a number of initiatives we believe are valuable to the community and to the company in the long term but are going to be net negative on our operating margins.

We are embarking on a significant ramp up in infrastructure supporting global growth, and we continue to expect that full-year 2017 capital expenditures will be in the range of \$7-\$7.5 billion dollars which is up over 50% compared to last year.

Turning now to tax. As we noted in the last call, under the new accounting guidance our tax rate will vary based on our stock price. At current stock prices, we expect that our Q2 and full-year 2017 tax rates will both be in the mid-teens, so up from the first quarter rate.

In summary, Q1 was a strong quarter and a great start to the year.

Growth in the Facebook community remains strong. Engagement across our family of apps is healthy and growing. And advertiser demand from our growing base of marketers is robust. Importantly, we continue to invest aggressively to build our business and drive value for our community over the long term.

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