

Facebook, Inc. (FB)
Third Quarter 2017 Results Conference Call
November 1st, 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 third 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 third 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 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.

Our community continues to grow, now with nearly 2.1 billion people using Facebook every month, and nearly 1.4 billion people using it daily. Instagram also hit a big milestone this quarter, now with 500 million daily actives. And we saw good results in the business, where total revenue grew 47% year-over-year and we had our first quarter with more than \$10 billion in revenue.

But none of that matters if our services are used in a way that don't bring people closer together -- or if the foundation of our society is undermined by foreign interference.

I've expressed how upset I am that the Russians tried to use our tools to sow mistrust. We build these tools to help people connect and bring us closer together. And they used them to try to undermine our values. What they did is wrong and we're not going to stand for it.

Now, for those who have followed Facebook, you know that when we set our minds to something, we're going to do it. It may be harder than we realize upfront, it may take longer, and we won't be perfect, but we will get it done. We're bringing the same intensity to these security issues that we've brought to any adversary or challenge that we've faced.

The first step is doing everything we can to help the US government get a complete picture of what happened. We've testified in congress over the past couple of days about the activity we found in last year's election. We're working with congress on legislation to make advertising more transparent. I think this would be very good if it's done well. And even without legislation, we're already moving on our own to bring advertising on Facebook to an even higher standard of transparency than ads on TV or other media. That's because in traditional media, there's no way to see all of the messages an advertiser is showing to different audiences. We're about to start rolling out a tool that lets you see all of the ads a page is running, and also an archive of ads political advertisers have run in the past.

We're also working with other tech companies to help identify and respond to new threats, because as we've now seen, if there's a national security threat involving the internet, it will affect many of the major tech companies. And we've announced a number of steps to help keep this kind of interference off our platform.

This is part of a much bigger focus on protecting the security and integrity of our platform and the safety of our community. It goes beyond elections and it means strengthening all of our systems to prevent abuse and harmful content.

We're doing a lot here with investments both in people and technology. Some of this is focused on finding bad actors and bad behavior. Some is focused on removing false news, hate speech, bullying, and other problematic content that we don't want in our community. We already have about 10,000 people working on safety and security, and we're planning to double that to 20,000 in the next year to better enforce our Community Standards and review ads. In many places, we're doubling or more our engineering efforts focused on security. And we're also building new AI to detect bad content and bad actors -- just like we've done with terrorist propaganda.

I'm dead serious about this, and the reason I'm talking about this on our earnings call is that I've directed our teams to invest so much in security -- on top of the other investments we're making -- that it will significantly impact our profitability going forward, and I wanted our investors to hear that directly from me. I believe this will make our society stronger and in doing so will be good for all of us over the long term. But I want to be clear about what our priority is: protecting our community is more important than maximizing our profits.

So security and the integrity of our services will be a major focus. Beyond this, our focus is on building community. I talked about this last quarter when we changed our mission to focus on building community to bring the world closer together, and that's more important now than ever. And this gets into our roadmap for the next 3, 5 and 10 years.

Over the next three years, the biggest trend in our products will be the growth of video. This goes both for sharing, where we've seen Stories in Instagram and Status in WhatsApp grow very quickly, each with more than 300 million daily actives, and also for consuming video content. We recently launched the Watch tab, where you can discover shows, follow creators, connect with people watching an episode, and join groups with people with similar interests to build the community.

But as video grows, it's important to remember that Facebook is about bringing people closer together and enabling meaningful social interactions; it's not primarily about consuming content passively. Research shows that interacting with friends and family on social media tends to be more meaningful and can be good for our well-being, and that's time well spent. But when we just passively consume content, that may be less true.

When done well, video brings us closer together. We've found that communities formed around video like TV shows or sports create a greater sense of belonging than many other kinds of communities. We've found that Live videos generate 10x the number of interactions and comments as other videos. But too often right now, watching video is just a passive consumption experience. Time spent is not a goal by itself. We want the time people spend on Facebook to encourage meaningful social interactions.

So we're going to focus our products on all the ways to build community around the video that people share and watch. That's something Facebook can uniquely do.

Moving along, over the next five years, I expect us to make some good progress on several newer initiatives.

In messaging, today already more than 20 million businesses are communicating with customers through Messenger. Now we're starting to test business features that make it easier for people to make the same kinds of connections with businesses through WhatsApp.

We rolled out Marketplace to Canada and 17 countries across Europe, giving people the ability to discover, buy, and sell things in their local communities. Today more than 550 million people are using Marketplace and Buy-and-Sell groups on Facebook to connect with other people for transactions.

We're also seeing good progress with Workplace, helping companies connect their own teams internally through their own versions of Facebook. It's been less than a year since we launched Workplace, and today more than 30,000 companies are using it. This quarter, we welcomed on Walmart, the largest employer in the US.

Over the next 10 years, we're working on the foundational technologies needed to bring the world closer together.

I'm proud of the work we're doing with AI. We're now using machine learning in most of our integrity work to keep our community safe. When Hurricane Maria hit Puerto Rico, we used AI to look at satellite imagery and identify where people might live and need connectivity and other resources. Progress in AI can unlock a lot of opportunities, so this quarter we opened a new AI research lab in Montreal and we're building another lab in Paris as well.

This quarter we held Oculus Connect, and we announced Oculus Go -- our first ever all-in-one headset that's great for feeling like you're present with someone when you can't physically be together in

person. It's great for playing games, watching movies, or hanging out with friends. At \$199, we think it's going to help us bring great virtual reality experiences to more people. It ships next year.

At Connect, I also showed off our new Santa Cruz prototype -- which is the first time any company has shown the full experience of positional tracking in a standalone headset and controllers. It's a major technical achievement, and I'm looking forward to getting this into developers' hands next year.

In order to support our community's growth, we need to keep investing in our infrastructure. This quarter, we broke ground on our new Albany data center, and we announced that we'll build our 11th major data center in Henrico County, Virginia. As always, all our new data centers are powered by 100% renewable energy.

These long term investments are important for our community's future. We can do a lot to help people connect through phones and computers, but so much more will be possible in a world where everyone has internet access, where AI improves all our services, and where we can basically teleport anywhere or be with anyone anytime we want.

With all the issues we face, it would be a lot to just invest in addressing those. But we know we also have a responsibility to deliver these fundamental technical and scientific advances to fulfill the promise of bringing people closer together, so we're going to keep making significant investments looking ahead towards the future too.

We've made some real progress this year. Across the board, we have a lot of work to deliver on our mission of bringing the world closer together, but we're committed to rising to the challenge and doing what we need to for our community. Thanks to all of you for being part of this journey, and I'm looking forward to the road ahead.

And now, here's Sheryl to discuss our business.

Sheryl Sandberg, COO

Thanks Mark and hi everyone.

We had a strong third quarter with growth across all regions, marketer segments and verticals. Ad revenue grew 49% year over year. Mobile ad revenue was \$8.9 billion — a 57% year over year increase — making up approximately 88% of total ad revenue.

We're continuing to build our business by focusing on our same three priorities: helping businesses leverage the power of mobile, developing new ad products, and making our ads more relevant and effective.

Today we're announcing that Facebook has over 6 million active advertisers, and we recently announced that Instagram has over 2 million advertisers. The vast majority of these are small and medium sized businesses, which are a major source of innovation and create more than half of all new jobs globally. These businesses often have small ad budgets, so the ability to reach people more effectively is really valuable to them. A great example is Lovebook, a small business in Michigan which lets you make

personalized books for the people you love. During a recent campaign, they used Facebook ads to reach people getting ready to celebrate their first anniversary. They've grown so much from marketing on Facebook that they've been able to hire 10 new employees this year alone. We are proud of the role we are playing in enabling businesses like Lovebook to reach people on mobile, to grow, and to create jobs.

One of our strongest areas this quarter was SMBs in Europe, with revenue growing more than 60% year-over-year. When I was in Germany two months ago, I had a chance to meet Victor, one of the co-founders of Brooklyn Soap Company, which despite its name is based in Hamburg. Victor and his friends came up with the idea for their business while staying in a hostel in Brooklyn. Now they sell their grooming products in 38 countries using mobile video ads on Facebook and Instagram. As a result, their sales increased 62% over the last year. They're one of many small businesses using mobile to find new customers and grow across borders.

Our second priority is developing innovative ad products. Video is exploding, and mobile video advertising is a big opportunity. Until recently, ads were only eligible for Ad Breaks if they also ran in News Feed. In Q3, we gave advertisers the option to run ads in videos alone. We're seeing good early results, with >70% of ad breaks up to 15 seconds in length on Facebook and Audience Network viewed to completion, most with the sound on.

As Mark said, Instagram Stories are growing well, too. People and businesses are finding creative new ways to use full screen vertical video in Stories. This quarter we gave advertisers even more flexibility in the content, format and reach of their ads in Stories.

We're also seeing how immersive video and images can help people discover new products on Facebook. We added a new creative template to Collection Ads, which helps retailers bring their catalogs online. West Elm, a home décor company, recently used this template to promote its furniture and home accessories. They targeted people who already get their physical catalog and saw a 5.5% lift in purchases in stores.

Our third priority is making our ads more relevant and effective. In Q3 we introduced new tools powered by machine-learning and automation to help businesses reach people more likely to spend with them. We also simplified the tools for creating ads, making it easier for businesses of all sizes to advertise with us.

It's important for all businesses to reach the right audience — but it's especially important for small businesses that have limited budgets. Targeting allows them to show ads only to the people they want to reach. Neon Retro Arcade in LA is a great example. They advertise to people within 10 miles of their location who are interested in video games and comic books. Last year, they moved their entire ad budget to Facebook and Instagram, and their revenue is up 25%.

Relevance and effectiveness are also about giving businesses more control over where their ads run. In Q3 we clarified which publishers and creators can include ads next to their content. This is good for

creators, who want guidance on how to earn money from their content on Facebook – and it’s good for advertisers, who want transparency and control to make the right decisions for their brands. We’re also working to give advertisers more clarity on where their ads were shown, so they can make more informed choices about where to run them in the future.

I want to close by talking about what we’re doing to protect our platform and help ensure that the ads and content people see on Facebook and Instagram are legitimate and authentic.

When I was in Washington a few weeks ago, I made clear that we are determined to do everything we can do to minimize abuse going forward. As Mark said, we’re investing heavily in new technology and people to review ads and posts. This will enable us to look more closely at the content of the ads, targeting, and the advertiser who submits them – as well as tighten our ads policies, particularly for ads directed at social and political issues. We believe that ads are important to free expression and we will continue to accept ads on issues -- but we will also do our part to elevate the quality of that discourse.

Transparency helps everyone keep advertisers accountable for their messages. We’re working with Congress on new requirements for online political advertising, but we’re not waiting for legislation. We’re building a tool now that will allow anyone to see the ads a Page is running, even if those ads are not targeted to them. We will test it soon in Canada and then in the US in the coming months. For ads related to US federal elections, we’ll start sharing even more information, including an archive of past ads, total amount spent, and demographics about the people the ads reached. We’re also going to require more thorough documentation from these advertisers — and we’ll label their ads so it’s clear who paid for them. We believe these actions will set a new standard for transparency in online ads.

Because the interference on our platform went beyond ads, we’re also increasing transparency around organic content from Pages. We’re looking at ways to provide more information about who is behind a political or issue-based Facebook Page. We believe this will make it harder for deceptive Pages to gain large followings and make it easier for us to identify malicious activity.

We are all committed to getting this right, and to investing in strengthening our platform so we can better serve our community. We are also committed to continuing to help businesses all over the world attract customers, sell their products, and create jobs.

As always, I am grateful to all of our clients for their partnership and to our global Facebook teams for their hard work.

Thanks, and now here’s Dave.

David Wehner, CFO

Thanks Sheryl, and good afternoon everyone.

Q3 was another great quarter for Facebook. We saw continued growth and engagement in our community as well as strong performance in our ads business.

Let's begin with our community metrics.

Daily active users in Q3 reached 1.37 billion, up 16% compared to last year. This number represents 66% of our 2.07 billion monthly active users in Q3. MAUs were up 284 million year-over-year or 16%.

Our community growth was again driven by product improvements, promotional data plans, and Internet.org. Note that in Q3 we began to lap the introduction of promotional data plans from mobile operators in markets like India.

Before going to the financials, let me touch briefly on our ongoing efforts to improve our user estimates.

This quarter, we implemented a new methodology to help identify duplicate accounts. As a result, we increased our estimates for duplicate accounts to approximately 10% of worldwide MAUs from our previously disclosed estimate of 6%. Duplicate accounts are those that we believe are used by the same person and represent real activity and engagement on Facebook.

We have also increased our estimate for inauthentic accounts to approximately 2-3% of worldwide MAUs. Inauthentic accounts are largely those that are used for spam and other policy-violating reasons. We continuously monitor and aggressively take down those accounts. These accounts tend to be less active and thus we believe impact DAU less than MAU.

Now turning now to the financials. All comparisons are on a year-over-year basis unless otherwise noted.

Q3 total revenue was \$10.3 billion, up 47% or 45% on a constant currency basis. Foreign exchange tailwinds contributed \$128 million of revenue in Q3.

Q3 total ad revenue was \$10.1 billion, up 49%. On a constant currency basis, our ad revenue growth rate was 47%, down 2 percentage points compared to the growth in Q2.

Ad revenue growth was strong globally, led by Europe and APAC with 56% and 54% growth respectively.

Mobile ad revenue was \$8.9 billion, up 57%.

In Q3, the average price per ad increased 35% and the number of ad impressions served increased 10%, driven primarily by feed ads on Facebook and Instagram. I would note that, compared to a year ago, price is a much more important driver of our ads revenue growth.

Payments & Other Fees revenue was \$186 million, down 5%.

Total expenses were \$5.2 billion, up 34%.

Q3 was our biggest hiring quarter ever. We added over 2,500 people and ended the quarter with over 23,000 employees, up 47% compared to last year.

Operating income was \$5.1 billion, representing a 50% operating margin.

Our tax rate in the third quarter was 10%. Excess tax benefits recognized from share-based compensation decreased our effective tax rate by 6 percentage points, a level that was driven by appreciation in our stock price.

Net income was \$4.7 billion or one dollar and fifty-nine cents per share.

Year-to-date capital expenditures were approximately \$4.5 billion, driven by investments in servers, data centers, office facilities and network infrastructure.

In Q3, we generated over \$4.3 billion in free cash flow and ended the quarter with over \$38 billion in cash and investments.

Year-to-date, we have bought back over \$1 billion of our Class A common stock.

Turning now to the revenue outlook.

Our ads business remains strong. But it's worth noting that in Q3, our year-over-year ad revenue growth rates decelerated for the fifth consecutive quarter on a constant currency basis, and we expect this trend to continue for the foreseeable future.

Going forward, we also expect the growth in advertising revenue will increasingly be driven by price. This is a shift from prior years when growth was primarily driven by increases in supply.

Turning now to expenses.

We anticipate that our full-year 2017 total expenses will grow approximately 35-40% versus our prior range of 40-45%.

We anticipate that full-year 2017 capital expenditures will be approximately \$7 billion.

As mentioned previously, our tax rate will vary based on our stock price. At the current stock price, we would expect that the Q4 rate will be in the low teens.

I also wanted to provide some comments on 2018 expenses and capital expenditures.

Please recognize that these are preliminary estimates as we have not yet finalized our 2018 budget. That said, it is shaping up to be a significant investment year, and I wanted to provide initial guidance to align investors with our most current thinking.

We expect full-year 2018 total expenses will grow approximately 45-60% compared to full-year 2017.

We continue to invest aggressively across the business, but there are three important factors driving an acceleration in our expense growth rates from 2017 levels. First, as Mark outlined in his earlier comments, we are making sizeable security investments in people and technology to strengthen our systems and prevent abuse.

Secondly, we are investing aggressively in video content to support the Watch tab.

Finally, we continue to invest in our long-term initiatives around augmented and virtual reality, AI, and connectivity.

Given our expectation of continued deceleration in revenue growth rates, we expect these significant investments will be net negative on our operating margins.

In addition, we expect to make substantial investments in our infrastructure to support growth and improve our products. As such, we expect full-year 2018 capital expenditures will roughly double from 2017 levels.

We would also anticipate that the full-year 2018 tax rate will be in the mid-teens.

In summary, Q3 was another strong quarter for Facebook across the board. We are excited about the opportunities we see ahead and we will continue to make significant investments to support our growth and our mission.

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