

Facebook 4Q 2015 Earnings Call Transcript

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Deborah Crawford, Investor Relations

Thank you. Good afternoon and welcome to Facebook's fourth quarter earnings conference call.

Joining me today to talk about 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, and 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, our annual report on form 10-K and our most recent 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 will 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.

This has been a good quarter for Facebook and a great end to the year. Our community continued to grow in size and engagement, and we're very pleased with the growth of our business.

Overall, 2014 was a year of great progress for the Facebook community. 1.39 billion people now use Facebook each month and 890 million people daily, an increase of 165 million monthly actives and 133 million daily actives this year. Time spent per person per day across our services continued to rise, growing this quarter by more than 10% compared to last year and this doesn't even include WhatsApp, which joined us late last year.

These milestones show that our community continues to get stronger. But it's not just our community where we've made a lot of progress. 2014 was also a year of big investments in our future.

This year, we made big bets on the next generation of communication and computing platforms by acquiring WhatsApp and Oculus. We focused on serving our community better across all of our products, raising the quality and relevance of content in News Feed, improving our search and video products, and improving the performance and efficiency of our mobile apps. And we continued to invest in our employees and infrastructure, growing our headcount by 45% this year and opening our newest data center in November in Altoona, Iowa.

When you consider the progress of our community and our investments, 2014 was an important year for us and a good sign of how we're thinking about the future.

In the next decade, Facebook is focused on our mission to connect the entire world, welcoming billions of people to our community and connecting many more people to the internet through Internet.org.

To serve the entire world, we need to build products that serve our community and allow people to share different types of content with different audiences. We need to offer new services and infrastructure at greater scale and we need to create new tools and innovate to solve fundamental challenges in the places we want to connect.

Doing this will take a lot of effort over the coming years, and Facebook is going to have to evolve. Similar to our transition to mobile over the last couple of years, now we want to really focus on serving everyone in the world. Our mission has always been to make the world more open and connected, so this is something that we've been preparing for over the last decade. Everything we've achieved in 2014 and over the last ten years has helped us to build a foundation for a future of greater scale. I'm excited for our progress in 2015.

With that in mind, I want to talk about the things that we expect to execute over the next three, five and ten years.

Over the next three years, our main focus is to continue to serve and grow our community by delivering better services for people and businesses around the world.

One sign of our continued growth and engagement is our progress on visual and public content. Nearly 2 billion photos are now shared daily across Facebook, Instagram, Messenger and WhatsApp. Video grew significantly this year to an average of more than 3 billion video views per day on Facebook. And we now have more than 2 billion interactions every week on Facebook between public figures and their fans.

Instagram is also growing and helping people share and consume the most engaging content in different communities across the world. Instagram reached 300 million monthly actives, with more than 70% outside the US. Average time spent using the app also continues to be very strong compared to other mobile services.

Across Facebook and Instagram we've done a very good job on engagement, especially when it comes to helping people find and consume content they like. In 2015, we'll continue working on this, as well as developing more ways for people to share even more moments on Facebook. Five years ago, most of the content shared on Facebook was text and some photos. Today it's primarily photos, with some text and video. Over the next five years we want to keep developing new products and features that help people share the way they want.

When it comes to serving businesses, we've continued to help drive results for businesses of every size around the world. Last week a Deloitte report found that in 2014 Facebook created more than \$225 billion of global economic impact and 4.5 million new jobs. This is an important reminder of the big opportunity we have to create value for businesses, and why we're committed to serving them well. In 2014 we invested aggressively in improving our ad tech and measurement tools, and we're going to continue working to provide new capabilities for marketers. Sheryl will talk about this in one moment.

Next, let's talk about our efforts over the next five years to build the next generation of Facebook services.

We expect WhatsApp and Messenger to connect hundreds of millions of more people and become indispensable services for the world, as well as important contributors to our business. Messenger and

WhatsApp recently achieved impressive new milestones. In November, Messenger reached 500 million monthly actives and at the beginning of January WhatsApp reached 700 million monthly actives, with more than 30 billion messages sent each day. These numbers speak to the quality of both products, and the size of the opportunity ahead to help billions of people communicate and collaborate.

Search at Facebook is another important effort that we expect to create a lot of value over the next few years, and this quarter we launched updates to Facebook Search to make it easier to find content in posts on mobile and desktop. We're going to continue listening to feedback from our community and taking the time to build a really valuable product here. We're optimistic about our ability to deliver value that only Facebook is able to provide.

Working with developers is the other part of our strategy, and this quarter we continued to make progress with helping developers build, grow, and monetize their apps. In October we rolled out our Audience Network around the world, and since then the number of apps in the network has nearly tripled and impressions served by the network more than quadrupled. In 2015 we'll continue to build upon our long term goal of making Facebook a truly cross-platform platform that allows developers to share their work across every major mobile platform, and we look forward to sharing more details at our next F8 event in San Francisco this March.

Finally, let's talk about our plans over the next decade to connect everyone to the internet through Internet.org and to develop the next generation of computing platforms with Oculus.

Internet.org now has a lot of momentum, and we've now launched free basic internet services in Zambia, Tanzania, Ghana, Kenya and Colombia. More than 150 million people living in these countries now have the option to connect to the internet using Internet.org, and we've already connected 6 of them to the internet who didn't before have access. We're very excited by Internet.org's progress, and the level of interest we're seeing across industries, governments and our community. 2015 is going to be an important year for our long term plans and I expect us to share more updates about our progress here over the coming months.

Oculus continues to make progress towards a future of immersive VR experiences that are part of daily life for millions of people. This month the team had another good showing at CES, and developer interest in the Oculus platform continues to grow.

So that's my update for this quarter. It's been a strong quarter and a good end to an important year for us.

I want to thank everyone in the Facebook community and our employees, partners and stockholders for their support. Thanks to you, our community is growing stronger every day and we're making progress towards making the entire world more open and connected.

Thanks, and now here's Sheryl.

Sheryl Sandberg, COO

Thanks Mark and hi everyone.

Q4 was strong across the board, capping a great year. This was our first quarter with over \$3 billion in ad revenue and over \$2 billion in mobile ad revenue. Q4 ad revenue grew 53% year over year. Mobile ad revenue was 69% of total ad revenue and doubled in the past year. Our growth was strong across all

verticals and marketer segments. We also saw healthy growth around the world, although growth rates outside the US were affected by exchange rates.

Looking back at 2014, our teams made great progress on our three main priorities: capitalizing on the shift to mobile, growing the number of marketers using our ads products, and making our ads more relevant. We believe that the market increasingly understands that we have the leading mobile ad product and are the only platform that delivers people-based marketing at scale.

The shift to mobile is changing the way people consume video. As Mark said, video grew dramatically on Facebook in 2014, especially around global events like the World Cup and the ALS Ice Bucket Challenge. In just one year, the number of video posts per person on Facebook increased 75% globally and 94% in the US. Today, over 50% of people in the US who come to Facebook daily watch at least one video per day. And globally, over 65% of Facebook video views occur on mobile. Marketers have followed this trend and are using video to help people discover and learn about their brands. In Q4, we expanded auto-play video ads internationally. During the holiday season, we saw many clients telling their stories creatively through video.

2014 was also the year we began scaling Instagram ads. In Q4, we rolled out Instagram ads in Australia and Canada. Marketers are excited to have access to the 300 million people who use Instagram and the creativity it inspires. We're seeing beautiful creative and great results from brand marketers across verticals - from insurance and tech to retail and entertainment. For example, as one of our first Instagram video advertisers, Banana Republic developed a series of videos to promote its new BR clothing line. The videos showed fashion sketches from the new collection and drove a 23-point lift in ad recall. While it's still early and we're being deliberate in our roll-out, we believe that Instagram will become core to advertisers' mobile brand building efforts.

We also made progress growing the number of marketers using our ad products. Custom Audiences, our suite of proprietary targeting products, has become an essential tool for segmenting current and potential customers. Conversion tracking, a way for marketers to measure the impact of their campaigns online, is also seeing wider adoption. We've made it easier for businesses of all sizes to plan and manage their ad campaigns and for small businesses to use our targeting tools. Travel company Thomas Cook recently used Facebook in Belgium to reach a broad audience and used custom audiences to send targeted messages to existing customers based on places they'd expressed interest in. They reached 30% of the Belgian population in one day and achieved a 3.85 times return on investment. Results like these are attracting more marketers of all kinds to our platform.

Finally, we made great progress improving ad relevance and measurement. To do this we made significant investments in both our core measurement and targeting tools as well as Ad Tech. Earlier in 2014, we introduced ad buying capabilities based on reach and frequency metrics, which is similar to how brand marketers buy TV ads and therefore enables better cross-comparison. We improved our Ads Manager product to give better insights into ad campaign's audience and impact.

In the fall, we re-launched Atlas to help marketers reach real people and measure results across multiple devices. Omnicom was our first global client, and this month we announced a partnership with Havas to further expand globally. We also invested in Audience Network, which helps marketers extend their campaigns off of Facebook, and LiveRail, which provides publishers with video tools to monetize their inventory more efficiently.

Heading into 2015, we're excited to build on the progress we've made with our core ad products, as well as with newer areas like video, Instagram and ad tech. It's still early days in all of these efforts. There is a lot of hard work to do, and we plan to invest aggressively.

Our ultimate goal is to be a critical business partner to our clients – providing people-based marketing at scale to build their brands and move their products off shelves. Over the past few weeks, I have had a chance to meet with many of our largest global clients and agency partners, and talk about how we can drive real business results for them – making every impression count and every dollar they spend improve their bottom line. Our clients are excited by the opportunity to use video, Instagram, and ads on and off Facebook to reach the right people with the right message. In turn, as our ads become more relevant, we provide a better experience for the people who use Facebook.

Coming off our biggest year ever I want to say a special thank you to the Facebook teams around the world. To our global sales, engineering, product, design, and infrastructure teams, your accomplishments over this past year are the reason our business is in such a great place. To our entire company, I feel lucky to work with you as we stay focused on our priorities and work together to help connect the world. And to our clients, thank you for your partnerships and your trust in us.

Heading into 2015, we have big opportunities and a lot of work ahead.

Thanks, and now here's Dave.

Dave Wehner, CFO

Thanks Sheryl and good afternoon everyone.

Q4 wrapped up a strong year for Facebook. In 2014, our revenue grew 58% to approximately \$12.5B, and we generated over \$3.6B in free cash flow.

We are very pleased with the continuing growth of our network. In December, the number of people using Facebook on an average day increased by 18% compared to last year to 890 million. This daily number represents 64% of the 1.39 billion people who used Facebook during the month.

Mobile remains the primary driver of our growth. We ended the year with 1.19B people using Facebook on mobile in the month. We also continue to see solid growth with Instagram, Messenger and WhatsApp recently crossing 300M, 500M and 700M MAU, respectively.

Turning now to the financials.

All of our comparisons are on a year-over-year basis unless otherwise noted. In addition, as a reminder, our non-GAAP measures exclude stock-based compensation and the amortization of intangibles.

Total revenue in Q4 was \$3.9 billion, up 49%, or 53% on a constant currency basis.

Given how significantly exchange rates have continued to move, we anticipate that this currency headwind will increase in 2015. I will give more color on this later in the call.

Ad revenue was \$3.6 billion, up 53%, or 58% on a constant currency basis.

Mobile ad revenue in Q4 doubled \$2.5 billion or 69% of ad revenue, compared to approximately \$1.2 billion or 53% of ad revenue last year.

Desktop ad revenue was up approximately 1% despite the fact that overall desktop usage was down.

In Q4, the average price per ad increased 335%, while total ad impressions declined 65%. Similar to last quarter, these price-volume trends were primarily driven by the redesign of our right hand column ads which rolled out in the third quarter.

Total Payments and Other Fees revenue was \$257 million, up 7%. Note that the growth was driven by revenue from acquisitions made in the past year. On an organic basis, payments revenue from Games, which represents the substantial majority of our Payments and Other Fees revenue, declined 10% compared to last year. As previously noted, we expect this trend to continue as desktop usage declines.

Turning now to expenses.

Our Q4 total GAAP expenses were \$2.7 billion, up 87%, and non-GAAP expenses were \$1.6 billion, up 50%.

GAAP expense growth was driven primarily by significant stock-based compensation and amortization expenses related to the WhatsApp acquisition.

Non-GAAP expense growth was driven primarily by increases in headcount-related costs, cost of revenue and marketing expenses.

On a full-year basis, our 2014 GAAP expenses were \$7.4 billion, up 47%, and our non-GAAP expenses were \$5.3 billion, up 34%.

We ended the year with roughly 9,200 total employees, up 45%. Overall, we remain very pleased with our ability to attract and retain top-tier talent.

GAAP operating income was \$1.1 billion in Q4, representing a 29% operating margin, down from 44% last year, again primarily due to expenses related to our recent large acquisitions.

Non-GAAP operating income was \$2.2 billion in Q4, representing a 58% operating margin, consistent with the margin last year.

Interest and other income and expense was a net expense of \$19 million in Q4 vs. a net expense of \$3 million in Q4 last year. This increase in expense was primarily due to foreign exchange losses resulting from the periodic re-measurement of our foreign currency balances during the period.

In Q4, we benefited from the reinstatement of the R&D tax credit. Our GAAP tax rate was 37% but would have been approximately 42% excluding the benefit of the tax credit. Our Q4 non-GAAP tax rate was 31% and would have been approximately 32% excluding this benefit.

Q4 net income was \$701 million or \$0.25 per share, and non-GAAP net income was \$1.5 billion or \$0.54 per share.

In 2014, we spent \$1.8 billion on CapEx and generated over \$3.6 billion of free cash flow. We ended 2014 with \$11.2 billion in cash and investments and a net operating loss carryforward of approximately \$4.5 billion.

Turning now to the outlook.

Let me start with revenue. We are still in the early stages of building out many aspects of our ads business and remain optimistic about our long-term opportunities.

Looking at 2015, there are a couple of things I want to note.

The first involves how the recent movements in exchange rates might impact our 2015 revenue.

Assuming exchange rates were to remain constant at today's levels, we would expect that our total revenue in 2015 would be approximately 5% lower than it would be under 2014 exchange rates. Note this 5% represents the expected reduction in 2015 total revenue, not the reduction in the year-over-year growth rate.

And second, we are reporting revenue from Atlas, LiveRail and the Audience Network on a net, not a gross, basis so the growth in those products will have less of an impact on our overall reported revenue growth in 2015.

Turning now to expenses. We are tightening our ranges modestly given the better visibility into 2015 spending. We expect that our full-year 2015 total GAAP expenses will increase 55-70% compared to 2014. We expect that our 2015 total non-GAAP expenses will increase 50-65%.

A simple way of thinking about our investments is across three categories: people, product and infrastructure.

On the people side, we enter 2015 with 45% more employees than we did a year ago, and we will continue to invest in and grow the talent base throughout the year.

In terms of product, we are investing to build great experiences for people, marketers and developers, ranging from our existing products and services to newer initiatives such as ad tech, Internet.org, Oculus and WhatsApp. We'll also invest in marketing to support all of these initiatives, which, as I noted, was a driver of expense growth in Q4.

Turning to infrastructure. We continue to build out our global infrastructure to enable billions of people around the world to connect, message and share with each other. We will be investing in data centers, our network, and servers to grow our existing services and support newer initiatives such as video and our global connectivity efforts through Internet.org. We anticipate our 2015 CapEx will be in the neighborhood of \$2.7-\$3.2 billion.

We expect stock-based compensation for 2015 to be in the range of \$3-\$3.3 billion, approximately half of which is related to our prior acquisitions, most notably WhatsApp.

We expect amortization expenses for 2015 to be approximately \$700-800 million.

And finally, we anticipate our Q1 and full-year 2015 GAAP tax rates to be in the mid-to-high 40s and non-GAAP rates to be in the mid-to-high 30s.

In summary, Q4 capped off a great year for Facebook in which we executed well and also made some very important investments for our future. In 2015, we are focused on continuing to execute on the business and investing in our long-term mission and success.

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