

FACEBOOK
Q2 2012 Earnings Call
05:00 PMET July 26, 2012

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 2012 Earnings Conference 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. Thank you. Ms. Crawford, you may begin your conference call.

Deborah Crawford, Director of Investor Relations

Thank you. Good afternoon, and welcome to Facebook's first earnings conference call. Joining me today to talk about our second quarter results are Mark Zuckerberg, CEO; Sheryl Sandberg, COO; and David Ebersman, CFO. Before we get started, I'd like to take this opportunity to remind you that during the course of this call we will make forward-looking statements regarding future events and the future financial performance of the company. We caution you to consider the important risk factors that could cause actual results to differ materially from those in the forward-looking statements, in the press release and this conference call. These risk factors are described in our press release and are more fully detailed under the caption Risk Factors in our final prospectus filed with the SEC on May 18, 2012.

In addition, please note that the date of this conference call is July 26, 2012, and any forward-looking statements that we make today are based on assumptions as of this date. 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. This call is being broadcast on the Internet and is available on the Investor Relations section of the Facebook website at investor.fb.com. A rebroadcast of the call will be available after 6:00 p.m. Pacific Time today. The earnings press release and an accompanying investor presentation are also available on our website. After management's remarks, we will host a Q&A session. And now I'd like to turn the call over to Mark.

Mark Zuckerberg, Founder and Chief Executive Officer

Thank you, Deborah, and thanks to everyone listening for joining Facebook's first earnings call as a public company. We appreciate having the opportunity to speak directly to all of you and to share our perspective on how we're doing in fulfilling our mission of making the world more open and connected. Hopefully you'll come away from today's call with a clear sense of the investments we're making to create value over the long term by making Facebook even more useful for all of the people who use our services worldwide.

We ended June with 955 million monthly active users, over half of whom use Facebook on a daily basis and over half of whom use Facebook for mobile devices. We saw more people using our services at the end of June than at the end of March across all key countries, including 3 million more people in the U.S. Growing the network of people who use Facebook and expanding the social experiences available to them remains the foundation of our effort and the key to the future success. I'm going to focus the rest of my comments today on our top priorities across our product areas for 2012, specifically mobile, platform and social apps.

Let's start with mobile. Mobile is a huge opportunity for Facebook. Our goal is to connect everyone in the world and over the next five years we expect 4 or 5 billion people to have smartphones. That's more than twice as many people as have computers today. So building great services for these devices is essential for us to help people connect. We also think that people are entirely social and having a device with you wherever you are creates more opportunities for sharing and connecting. We're finding that people are quickly adapting to our mobile services. As of the end of June, 543 million people were actively using our mobile services every month – each month. That's 67% more people than the 325 million who were using our mobile services just a year ago. We've also found that people who use our mobile services are more active Facebook users than people who only use our desktop services. On average, mobile users are around 20% more likely to use Facebook on any given day. So mobile not only gives us the potential to connect more people with our services, but it also gives us the ability to provide more value and a more deeply engaging experience.

We don't just want to have the most widely used mobile apps though. We want to build the best apps and we also want to build experiences that are as deeply integrated as possible into every device and mobile app that people use. We're investing very heavily in improving our mobile appropriately, primarily across iOS, Android and the mobile web. This involves building out world-class teams with competencies in different technical stacks, making significant investments in improving the technical foundation of our apps and designing new products and integrated into these mobile systems as deeply as we can. We've made some good progress from the past quarter as we released our Camera app, shipped new releases of messenger, shipped two releases of our Android appropriately, agreed to acquire Instagram and worked with Apple to integrate Facebook into their upcoming release of iOS. Going forward, you should expect to see a frequency of improvement to each of these mobile experiences.

Finally, we're also beginning to demonstrate that we can advertise effectively within the mobile experience. I'll discuss social ads more in a minute, but at a high-level, our Sponsored Stories, which we launched in mobile News Feed earlier this year, have grown quickly and demonstrated early success. Now let's shift platform. We believe one of the biggest opportunities we have is to create the identity and social layers that all new apps and websites can be built on top of. We think almost every product is better when you can experience it with the people you care about so over time we expect almost all of these products should naturally become social. Since there's no way we could ever build all of these ourselves, we're focused on building a successful platform which enables developers to build great social experiences into their own apps by integrating with and exchanging information with Facebook.

Our Platform strategy enables millions of developers to build better products and helps us provide a lot of value to the people who use Facebook. We've already seen how social dynamics can transform industries like gaming and we believe other industries like music are starting to follow as well. Our goal is to make it easy for developers to build these social apps. We do this in two ways. First, by enabling people to design industry apps using Facebook and thereby bringing their real identities, friends and other information to the apps so that the apps can offer a more personalized experience; and second, by enabling people to share what they're doing in these apps with their friends back on Facebook so these apps can get access to our distribution and they can scale and grow quickly. Today, you can download Spotify, login with Facebook and immediately see your music player light up with songs your friends are listening to and recommending. We can imagine a day when you buy a new car and by logging into the car's computer with Facebook, you can similarly have it immediately light up with music, addresses, restaurants, stores and other destinations targeted specifically for you based on your friends and your interests. We believe social products like this will provide better experiences, but

if we're right, then Facebook will be in a unique place to enable these experiences to get built. It's worth calling out that our vision for platform is bigger than what most people perceive. We believe our platform is about bringing social context to apps and providing distribution for apps regardless of what environment they're built in, including mobile apps, websites, or at our canvas on our own website. When many people think about our platform they think only about games that are built inside of the Facebook website directly and not all of the other kinds of apps that developers can build. Our Open Graph platform is what we call the tools we launched last year that enable developers to easily integrate more kinds of actions and experiences with Facebook. Open Graph has already been adopted by many of the most popular websites and mobile apps. Many of the top apps in the iOS and Android app stores are integrated with Facebook. Apps like Spotify, Netflix, Pinterest, FourSquare, Instagram, Arabian Bead, Tumblr, VD, Nike+, SongPop and thousands more have integrated with Open Graph to provide greater social experiences and grow their user bases. Already people are sharing nearly a billion pieces of content each day using Open Graph. These Open Graph integrations enable Facebook users to share more of the content they want with their friends. This helps make our service more engaging overall since there's more content to consume. Additionally, we found that our largest developers also tend to become our largest advertisers, as they look to further boost the distribution they're getting from us. We're still in the early days of our Open Graph effort and we're continually working to improve how it works. A big focus for us right now is giving people more tools to control how they share their information using these integrations. We're also working on improving the distribution that these apps get in exchange for the content they help people share. These are some complex problems that will take time to work out, but you should expect us to make steady progress towards working out this ecosystem.

Finally, I'd like to discuss our social ad initiatives. The basic idea here is that the best type of advertising is a message from a friend. Facebook wants to offer advertisers the best tools to create ads that are social. We believe that the more our advertising includes interesting content from people you care about the more marketers will be able to create advertising that adds value to people's experience on Facebook. Advertising on Facebook today is already delivering a compelling ROI even though most advertising on Facebook today isn't social. We believe the experience can be better and more social. For example, if I like a restaurant then my friends might see that I like that place and that's likely a more convincing ad than anything the restaurant would produce on our own. That's an example of lining that social activity in ads. One important aspect of social ads is that since they're based on social activities, they fit into our News Feed product of both mobile and desktop. This is important because mobile users already spend so much time reading their News Feed. So the social ads and News Feed gives us a clear path to building a strong business on mobile. I mentioned earlier that we recently began to roll out our Sponsored Stories in both desktop and mobile News Feed. By the end of June, Sponsored Stories and News Feed was at a run rate of over \$1 million per day in revenue and about half of that is coming from mobile. This is an encouraging start in our effort to generate revenue from the mobile use of Facebook. We know that social ads perform much better than nonsocial ads so our job over the next few years is to increase the percentage of ads that are social and engaging. Overall, I hope my comments here give you a good sense of our priorities around mobile platforms and social ads. We have a lot of interesting things going on here. There are a lot of challenges and these are the types of problems that we like to work on. We're working hard to staff up across the company, especially in the technical groups to make sure that we make progress against these goals. We just announced that we've begun recruiting engineers to work in our London office to help us access talent across Europe. We're pleased that the company and culture are centered on building great products and around our mission to make the world more open and connected. Thanks again for taking the time to be on the call with us on the call today. And now I'd

like to hand it over to Sheryl.

Sheryl K. Sandberg, Chief Operating Officer and Director

Thanks, Mark. I'm going to focus today on Facebook opportunities in the advertising markets and the progress we've made in the past quarter. Our total second quarter revenue of \$1.18 billion, \$992 million came from advertising. This represents a 32% year-over-year increase overall and a 28% increase for advertising. Facebook's power to change the way people and businesses influence each other creates unique advertising opportunities. We offer marketers the ability to reach a mass or targeted audience and establish real and ongoing relationships directly with our customers. Marketers have always known that a recommendation from a friend is one of the most powerful ways to sell their product. Marketing on Facebook is fundamentally different than other mediums because messages can be shared from friend to friend. This is word-of-mouth marketing at an unprecedented scale. In an increasingly crowded world, this is essential for the world's largest global companies as well as the small business around the corner.

We believe we are very well positioned to compete for advertising dollars throughout the entire marketing funnel from the very top where companies focus on generating demand to the bottom where the focus is on compelling demand. The majority of the advertising spend that has migrated online to date has been for demand fulfillment, which happens when a customer already has intent to purchase. Search advertising has been a primary driver of this migration. Facebook is also effective at the bottom of the funnel with gaming being a primary example, but at least we believe that Facebook also helps marketers build brands and generate demand.

This is important because the majority of the \$600 billion global advertising market is spent on demand generation. Over the past quarter, we've made important progress in our modernization efforts in three areas. First, rolling out new app products, second demonstrating the ROI of Facebook ad spend and third making it easier for businesses to advertise with us.

I'll start with the new products we introduced. Earlier this year, we launched Sponsored Stories and Facebook News Feed. Sponsored Stories are regular stories that people see in the News Feed already – updates, likes, comments that are on Facebook every day that a marketer pays to highlight. For example, if I post a positive review of a product that's purchased at Wal-Mart, about 20% of my friends will see the post, depending on things like when they check their News Feed. Using Sponsored Stories, Wal-Mart can take a boost distribution of this post so that a larger percentage of my friends see it.

Delivering social messages in Facebook's News Feed is an extraordinary opportunity for marketers. On the web, people spend more time using Facebook than any other service by far. We believe this is true on mobile devices as well. Moreover, Facebook users spent a large percentage of their time on News Feed. Sponsored Stories enable marketers to interact with their customers where their customers are spending their time. Our early results are encouraging. As measured by click through rates, Sponsored Stories and News Feed performed multiple times better on both desktop and mobile than ads in the right-hand column.

Sponsored Stories and News Feed are the cornerstone of our mobile monetization strategy. News Feed functions in exactly the same way, whether you're on the desktop or phone. This is important because

we avoid the dilemma faced by other industry players where to put out on a smaller screen. With News Feed marketing is incorporated seamlessly into the user experience on mobile devices. We recently enabled our advertisers to buy ads exclusively in mobile News Feed. We're seeing strong interest, particularly from our clients where new mobile is critical for reaching new customers especially in emerging markets.

As always at Facebook, the user experience is paramount. We've been deliberate in introducing Sponsored Stories in a way that maintains the experience users have with our service. As we continue to rollout Sponsored Stories and News Feed, we are carefully monitoring user engagement and sentiment and we're pleased with the results to date.

We believe that Sponsored Stories and News Feed have the potential to be among the most relevant ad formats for marketers. As Mark mentioned, in the short amount of time since the launch, by the end of Q2 we are already generating more than \$1 million a day for this product with approximately half of this generated in mobile. In Q2 we also began testing another new ad product, the Facebook Ad Exchange, or FEx, allows marketers to bid in real-time for ad impressions on Facebook. Real-time bidding is a standard industry process to help advertisers reach the right customer at the right time and it will help us deliver more relevant ads to users. We're in the early of the text with FEx but advertising is strong. Key marketers estimate this market to be approximately \$2 billion in the U.S. alone.

The second area of progress for this quarter has come from our efforts to better demonstrate the effectiveness of ad spend on Facebook. Today nearly every one of the global Ad Age 100 advertisers spends with us every quarter, but today most only allocate a small place of their budget to Facebook even though their customers spend large amounts of time using our service. This imbalance represents a substantial opportunity for us if we can educate the market about the ROI our ads deliver.

We've partnered with Nielsen to demonstrate that Facebook ads are not just seen but remembered. Studies of over 500 ad campaigns show that on average Facebook ads drive 98% better ad recalls and 31% higher brand awareness than non-Facebook online ad campaigns. Independent research has also demonstrated that social content significantly increases both ad recall and brand awareness of Facebook ads. This is not surprising since people are more likely to remember a message that comes from a friend.

We recognize that ad recall is important but it's only the first step in delivering results for marketers. Marketers ROI is generated when a cash register rings.

We're making great progress measuring our ability to help marketers generate sales. Independent analysis of more than 60 campaigns, 45 of which were completed in the first half of this year showed that 70% of those campaigns delivered a return on ad spend of three times or better. And 49% of those campaigns delivered a return of five times or better.

I'd like to share a few examples. Electronic Arts recently spent \$2.75 million promoting Battlefield 3 on Facebook. They attributed \$12.1 million of their sales to these ads translating to a 4.4 times return on their Facebook marketing spend. Barclaycard purchased Facebook ads as a part of the direct response strategy to promote NFL team branded credit cards. They targeted the ads to people based on a specific team those people like. Their Facebook ads generated a 40% higher conversion rate than any other online ad platform they used in the campaign. This made their cost per acquisition 48% lower on

Facebook than from other online ads. In total 60% of the approved credit card applications from the campaign came from Facebook.

Wooga, an international games developer used a mobile News Feed to drive installs and its Diamond Dash game. They increased downloads by 26% in the U.S. 29% in Germany and 37% in France all at attractive cost per app installed.

This is just the beginning of our important effort to educate the market about the ROIs Facebook ads deliver. We will continue to work account-by-account and campaign-by-campaign to demonstrate the value we provide.

Finally, our third area of progress has been to make it easier for small and medium-sized businesses to advertise on Facebook. Local business advertising is considered by many to be the Holy Grail of Internet advertising since the market opportunity is so great. This has proven difficult however, because small business owners often lack the time or ability to adopt new technologies. Facebook is uniquely accessible to them as they typically learn to use Facebook by setting up personal profiles and timelines. They then discover the value our service can provide them as business owners.

Many of the world's approximately 60 million business owners are already Facebook users. Over 11 million businesses already have pages on Facebook. Over 7 million of these pages are actively used each and every month. In addition, hundreds of thousands of small businesses advertise with us. By making it easier to create a business page and run ads, we believe we can increase the number of small and local businesses who use our tools. In the last quarter, we began testing simpler ads and easier purchases. For example, page owners can now turn a post into an ad campaign with just a few clicks.

We're still in the early days of building our monetization engine. For the rest of 2012 we plan to focus on the same priorities I have discussed, in particular the ramp up of Sponsored Stories and News Feed. If we are successful working with advertisers to increase the amount of content they generate that is social and engaging enough to promote a News Feed, we believe we should be able to increase our revenue on both PCs and mobile devices. In 2012 and beyond, we will also continue to invest in developing new products, particularly in mobile, and in educating the market on the value we deliver. We believe the world is becoming increasingly social and personal and the future of marketing depends on building where the markets gap. We offer the best tools for marketers to not just participate in but to shape this evolution. This will close the gap between the audience we deliver and our share of advertising budget.

Now I'm happy to turn it over to David to walk you through our financial results for the quarter.

David Ebersman, Chief Financial Officer

Thank you, Sheryl, and good afternoon, everyone. Thanks for joining us on the call today. I'm going to walk you through our Q2 progress against our key financial metrics related to revenue, users and expenses.

As Sheryl mentioned, revenue in the second quarter was up 32% from last year. The strengthening of the dollar cost us a few percentage points of revenue growth, which would've been 36% with constant exchange rates. Ad revenue was up 28% driven by an 18% increase in the number of ads delivered and a 9% increase in the average price per ad.

The increase in ads delivered was primarily due to user growth and also benefited from the net effect of product changes that increased the average number of ads per page relative to last year. Ad impressions continued the recent trend of growing more slowly than users as more of our usage is on mobile devices. This trend is particularly true in markets such as the U.S. where smartphone use is expanding rapidly. The overall number of ads delivered in the U.S. this quarter decreased 2% year-over-year despite a 10% increase in daily users and despite the increase in ads per page from the product changes I mentioned earlier as daily web users in the U.S. declined in favor of mobile users. And we're seeing similar trends in other developed markets.

The 9% increase in price per ad was driven primarily by the United States where CPMs increased by over 20% due in large part to the ramping up of Sponsored Stories and News Feed on both PCs and mobile devices. Sponsored Stories and News Feed are displayed where the users' primary attention is and are stories that we believe users will find engaging based on their interests and connections. That makes Sponsored Stories and the News Feed more relevant resulting in stronger click-through rates and higher prices.

Price per ad also increased significantly in Asia and the rest of world markets. These markets are growing more rapidly in terms of users and therefore are receiving a growing share of our ad impressions each quarter, so we're pleased to see continued improvement in pricing. The relatively faster volume growth in Asia and rest of world does have the effect of reducing our worldwide average price per ad due to the relatively lower pricing in those markets. In Europe, price per ad decreased a few percentage points compared to last year, similar to what we saw in Q1 and we believe due in large part to the overall macro environment there.

Over the long term, we continue to believe that we have a significant opportunity to increase CPMs. There are a number of potential drivers including increasing the number of Sponsored Stories delivered in News Feed across desktop and mobile, improvements in our ad products included better targeting capabilities, increased advertising demand as we continue to demonstrate ROI and as our clients get better at creating social and engaging ads and overall growth and development of online ad markets globally.

Payments revenue for Q2 was \$192 million. For the past three sequential quarters payments revenue has been essentially flat. We believe this trend is due to the fact that gaming in general has been growing mainly on mobile devices whereas our payment system is generally not utilized. We're continuing to invest in the gaming ecosystem on Facebook.com, for example, with our new Facebook App Center, which is designed to help people discover new games and other types of apps as well.

In terms of revenue per user, ARPU increased by double-digit rates in North America, Asia and rest of world and by 8% in Europe and worldwide ARPU was \$1.28 in the quarter. Our higher user growth in geographies with relatively lower revenue works to weigh down worldwide ARPU and the global growth rate.

Staying with user metrics for a minute, we ended June with 955 million monthly users, up 29% from 12 months earlier. On average in June, 552 million people accessed Facebook each day, up 32% from a year ago. Relative to last quarter, Brazil, India and Japan were key contributors to our growth in daily users. 58% of our monthly users were active daily users of the product which we view as a positive measure of user engagement, and in addition, engagement patterns remain steady or grew across user groups as

measured by the percentage of people creating content or providing feedback such as likes or comments and by the amount of content and feedback created per person. We're encouraged that growth and engagement have remained strong as our network has expanded and as we added later adopters to the service. We view this strong engagement as a sign of the utility of the service in the network and as a foundation for everything we're trying to accomplish.

A couple of points on user metrics: First, we reviewed our methodology for estimating users by geography, and as a result have made small adjustments to the geographic distribution of users as of the March 31 measurement date. Second, we also refined and improved our methodology for recognizing what we call duplicate or false accounts. These refinements resulted in an increase in our estimate of duplicate or false accounts relative to our earlier global estimate, primarily driven by emerging markets such as Turkey and Indonesia. Please see Slides 18 and 19 for more details. Since authentic identity is so important to the Facebook experience, we'll continue to try and improve our user management techniques with the goal of ensuring that every account on Facebook represents an authentic unique individual.

Turning now to expenses: In Q2 our GAAP expenses were \$1.93 billion. As planned and described in our prospectus, the biggest expense item was stock-based compensation including associated payroll tax, which totaled \$1.3 billion the quarter, driven by the completion of our IPO and the recognition of expense for RSUs granted between 2007 and 2011, which had a vesting condition tied to the IPO. Please take a look at Slide 9 for more information on the past and expected future flow of stock comp expense. Excluding the effect of stock comp, our remaining expenses increased 60% to \$669 million, driven by head count growth and infrastructure.

Headcount at the end of the quarter was just under 4,000, a year-over-year increase of about 50%. While we will seek to remain disciplined in our spend across the company, hiring top talent remains a key priority enabling us to aggressively pursue the opportunities in mobile, platform and monetization that Mark and Sheryl discussed earlier.

In the second half of 2012, we expect our operating expenses, excluding stock comp, to continue to increase significantly relative to our spend in the second half of last year, probably at a slightly higher growth rate than we observed in Q2. While we ultimately believe Facebook's business model should support attractive operating margins, at this early stage of our growth, investment is a top priority as opposed to managing for a target margin. Therefore, you can expect us to continue an aggressive pace of investment in R&D and infrastructure in particular. We had a GAAP operating loss of \$743 million in the second quarter. Excluding the effect of stock comp, our operating income would've been \$515 million, representing a 43% operating margin. Our effective tax rate for Q2 was 79%, driven by the fact that a portion of our stock comp expense is not tax-deductible. Excluding the effect of stock comp, our tax rate would've been approximately 40%. We expect that over the long run our tax rate will be similar to the rates of other U.S. technology companies that have a similar mix of business inside and outside the U.S. The future reduction in our tax rate will occur gradually over several years.

As described in our prospectus, the amount of cash tax we pay in 2012 and thereafter will be significantly different from the tax provision we report on our P&L due to the deductions we expect to get from vesting of RSUs and exercise of options. At today's stock price, we estimate we will have a tax deduction of around \$13 billion. That would reduce our cash taxes for several years.

Our net loss for Q2 was \$157 million or \$0.08 per share on a GAAP bases. Excluding stock comp, net income in Q2 was \$295 million or \$0.12 per share compared to \$285 million or \$0.12 per share in Q2 last year. We purchased \$413 million of property and equipment in Q2 and acquired another \$52 million of equipment financed through capital leases. As noted in our prospectus, for 2012 we expect to invest approximately \$1.6 billion to \$1.8 billion in capital expenditures, including equipment purchased through capital leases. And we ended Q2 with \$10.2 billion in cash and investments on our balance sheet.

As we look to the second half of 2012 we're encouraged that the network of people using Facebook continues to grow and that engagement a strong. We remain focused on building out better and deeper social experiences for the people who use Facebook while at the same time executing on the monetization strategies and initiatives outlined today.

Thank you for giving us the opportunity to discuss our progress. We're committed to providing you with balanced and thorough disclosure and we welcome your feedback today and in the future in terms of how we can make our communications most helpful to you. On a related note, I want to welcome Deborah Crawford, our new Director of Investor Relations who you heard from at the beginning of the call. Deborah has been with us for three weeks now and we're thrilled to have her leading our IR efforts.

And now we'd like to open the call for questions.

Operator: Your first question comes from the line of Spencer Wang from Credit Suisse. Your line is open.

Q – Spencer Wang - Credit Suisse

Thanks. Good afternoon. I guess maybe for Sheryl, I was wondering with respect to the Facebook advertising exchange, based on some of the initial tests, could you talk about how that may impact monetization as you roll that out? And then the second question is on the Yahoo! patent deal, can you talk about or provide any details on the advertising partnership or the expanded distribution agreement part of it? Thank you.

A – Sheryl Sandberg – Facebook, Inc.

Sure. As for Ad Exchange for a real-time day offer which lets advertisers gain in real-time on a specific ad impression. The goal of this is to show people more relevant ads. This is something third parties have been doing across the web for a while. For us right now we're at a very early alpha stage test so we don't have more information to share. But we're really encouraged by how interested our advertisers and customers because this gives them an opportunity to connect to users, our users, that they're trying to reach to other things they do across the web.

On the Yahoo! deal, the Yahoo! deal had two parts. The first part was a cross license of all the patents and the second part was a partnership where we would work with Yahoo! on tent pole anchor events, such as the Olympics. We were really pleased to sign the Yahoo! deal because it really extended the platform relationship we've had and really brought us back to what was a very good relationship we've had historically with an important client. And I think we'd also like to take the opportunity to congratulate Marissa on her new job at Yahoo!.

Operator: Your next question comes from the line of Mark Mahaney from Citigroup. Your line is open.

Q – Mark Mahaney - Citigroup

Great, and thanks. Two questions for Mark, you talked about user engagement. Have you seen any trends in terms of engagement with the younger cohorts? Anything that indicates a decline in engagement? And then broadly, what do you think about the size of the company? Facebook relative to other leaders in the technology space, runs pretty thin. You've tried to have a pretty lean organization. As you think about the three elements or the three broad growth areas for the company in the future, do you think you – is there any change in your thinking about how big the company physically needs to be? Thanks.

A – Mark Zuckerberg – Facebook, Inc.

Sure. So just to take the first one first, I think what we're seeing is pretty steady growth and engagement in all these cohorts, including the younger ones. So really nothing out of line with the overall metrics there. On your second question about the overall size of the company, we've always been significantly smaller per employee compared to the number of people who we serve in the world, so it's really baked into the company that we have to build systems and software that take into account the leverage that employees here have, and that's actually one of the reasons why a lot of people love working here and one of the biggest reasons why people cite for wanting to join the company and staying here. So it's also effective as strategy, right? I mentioned we believe that all these consumer products and maybe even more than consumer products that people use will become social over time, but we can't build all those things ourselves so we focused on building this platform. Over time it might make sense for us to build more of these things ourselves, but because of the scale that we're at we really focus on the three things that I laid out today, this shift towards mobile is incredibly important, building the highest quality applications and products is really critical, building a platform so that the million and more developers who use Facebook can build these products is the highest leverage thing that we can do and we think that social ads are just going to monetize much better than nonsocial ads as we increase the percent of our overall advertising that has social context in it.

So that's kind of where we are and we're basically growing by trying to find as many talented engineers as we can for the most part. But I think for the foreseeable future we're just going to be way smaller than other companies that address significant or comparable-sized user bases.

Operator: Your next question comes from the line of Jason Maynard from Wells Fargo. Your line is open.

Q – Jason Maynard - Wells Fargo

Hi. Good afternoon, guys. One of the questions that I'm curious on the mobile front, is when you look at monetization I think there's a lot of different views on how this will play out over the next couple of years. And I'm curious just philosophically, do you think that it is important to own the entire experience, i.e., integrated device versus being if you will purely an application? Or do you think it's, if you will, a federated view of kind of a platform feeding into many applications? How do you think about the different scenarios on that front and how that could potentially work for Facebook?

A – Mark Zuckerberg – Facebook, Inc.

Well, Facebook is the most used app on basically every mobile platform. Right? So when we think about what we want to do right now, we want to increase the depth of the experience in addition to just growing users. We thought a lot about this question of – and I even talked about it in my opening remarks today. We want to not just have apps that people use but also be kind of as deeply integrated into these systems as possible. We want to support a development ecosystem where other apps can build on top of Facebook. So that's why you'll see us do things like support Apple in the iOS integration that they wanted to do. There are lots of things that you can build in other operating systems as well

that aren't really like building out a whole phone, which I think wouldn't really make much sense for us to do.

So I think that there's a big opportunity for us here. The amount of time that people spend in the apps is greater. People come to the apps and use Facebook more when they have mobile phones and I think we're really much closer to the beginning here than at the end in terms of what we can do. If you use the apps today they're relatively basic compared to what I think anyone can imagine they would want from their Facebook experience on a phone.

Operator: Your next question comes from the line of Doug Anmuth from JP Morgan. Your line is open.

Q – Doug Anmuth - JP Morgan

Great. Thanks for taking the question. Just wanted to ask two things. First, Sheryl, you provided some color on click-through rates on Sponsored Stories relative to the ads on the right-hand rail. I was hoping you could provide a little bit of color on what you're seeing with pricing here on a relative basis early on? And then, David, perhaps if you could talk a little bit more about the potential for margin expansion going forward? How you're thinking about that potentially into the back half of the year and 2013? Thanks.

A – David Ebersman – Facebook, Inc.

Sure. Thanks for your question, Doug. This is David. I'll start on the pricing and then Sheryl can chime in. So we're very pleased by what we've seen in the early ramp-up of Sponsored Stories in Feed in both desktop and mobile but it's important to note that it's early. So we have a relatively limited amount of volume that we put into the system at this point. I think the test over the second half of the year that we're excited to see happen is working with advertisers to increase demand for Sponsored Stories and Feed, creating better social content that we can put in Feed without having a deleterious effect on the user experience. And seeing where that takes us in terms of clicks and prices and things along those natures. So while early data is quite positive, it is at low volume so we just have to kind of be careful about extrapolating from it.

In terms of margins, not a lot to add to what I said earlier in the call. At this point in time, we are growing the business. We're really focused on the opportunities that we see to invest in and the importance that they could have and should have for the long-term business that we can build. And so we're more focused on making sure that we're positioned to capitalize on what we're trying to do in mobile and platform and social ads and not trying to optimize for a short-term margin target. In the long run I think we have the kind of business that because we have such a large network and so much value comes from the content that is created and distributed by the members of the network, to have a business that works really efficiently.

A – Sheryl Sandberg – Facebook, Inc.

I'll just add one thing, which is why we're not commenting on pricing specifically because it's early, it's really worth noting that higher click-through rates lead to higher CPMs over time even without pricing changes.

Operator: Your next question comes from the line of Herman Leung from Susquehanna. Your line is open.

Q – Herman Leung - Susquehanna

Hello? Hi. Sorry about that. Wondering if we could talk about some of the penetration of some of the social ads that – hold on one second. The social ads that you guys have on the platform. Wondering the level of penetration of social ads that you have today on the site and the opportunity – and I have a quick follow-up.

A – Sheryl Sandberg – Facebook, Inc.

So fewer than half of our ads are social. And it's an increase. We're very focused on increasing the percentage of our ads, which are social in nature. We know from a large number of studies and working with advertisers that the ads that are social have higher engagement rates from users, much higher ROI for advertisers. And driving that percentage up is also – is really important to us. It also feeds into the Sponsored Stories in News Feed strategy that I spent most of my remarks talking about, which is that we put things in News Feed that are most relevant, so the more social context the ads have and the more relevant they are to our users, the more we'll be able to drive up the percentage of our ads that go into News Feed.

A – David Ebersman – Facebook, Inc.

And just to add, just to make sure that we're communicating this clearly, a very small percentage of our ads are Sponsored Stories in News Feed at this point. We just started with that product recently and we're being very careful in terms of the volume that we put into News Feed because it's such a core part of the user experience.

Operator: Your next question comes from the line of Scott Devitt from Morgan Stanley. Your line is open.

Q – Scott Devitt – Morgan Stanley

Thanks for taking my questions. I have two please. Given the various testing that you always seem to be doing around products and monetization, you've talked a lot today about the success of Sponsored Stories. I was wondering if there are other areas that are looking promising to you based on recent testing? And then secondly, from our calculation the DAU-to-MA ratio declined moderately sequentially, both in North America and Europe and I was wondering what you would attribute that to? Is it seasonality? And what are you doing to drive engagement in those regions? Thanks.

A – Sheryl Sandberg – Facebook, Inc.

I can take the first part. Yes, the Sponsored Stories have shown really, really good results and we are also seeing good results from other ads on the site that have social context. So as we rolled out more ways to make your ads social we see increasing engagement, increasing ROI from those ads. FEx is early but our initial testing shows very promising results for advertisers and they are able to connect what they're doing elsewhere across. It's also worth noting how optimistic we are around our early testing around mobile. You know mobile for itself is an inherently social experience and our service is inherently social. And what people are doing on their mobile devices is consuming their News Feed and sharing. So really the big accomplishment we've had in ads over the last quarter or two as we rolled Sponsored Stories into News Feed and on mobile has been very promising for us because the results show that users engage with those ads and advertisers get a higher ROI from them.

A – David Ebersman – Facebook, Inc.

In terms of that DAU [ph] relative to MAU [ph] comparison, we remain really pleased with the percentage of our monthly users who come back every day. We sort of assumed earlier on in our history that as we see further penetration in the market of people in the world and got into late adopters that, that number would go down; and we've seen that just consistently go up, which I think speaks to the

value of kind of the network effects. The more people that use Facebook, the more interesting it is. The number doesn't tend to move dramatically from quarter to quarter. It's a slow-moving number. It did decline fractionally from Q1 to Q2 as you noted.

I think that two things there: one is that we did make some changes to what we described earlier as background pinging or I think we called it automatic background activity in the prospectus which is when phones contact our servers without there being a user active on the other end, just to download information, we see that on several of the mobile services. It helps you to have more information from Facebook when you do check your phone. We try and understand what that looks like in terms of technically so that we don't count that as usage. And we sort of continually make some changes. That has some impact on the apples-to-apples nature of the DAU comparison June versus March. You asked about seasonality. I don't know that we have a great handle on the seasonality effects as it relates to by month. We tend to see things like holidays, there'll be some drop in daily level of engagement but it depends on what month holidays and other things happen in.

Operator: Your next question comes from the line of Anthony DiClemente from Barclays. Your line is open.

Q – Anthony J. DiClemente (Barclays)

Good afternoon. Thanks for taking the questions. One for Mark and one for David. Mark, wondering if you could give us an update on your acquisition of Instagram? I know it's early but would be curious to hear how the integration and acquisition is helping your efforts on mobile and if there are others out there, other acquisitions like Instagram out there that you see as potentially desirable, and other acquisitions like that one? And then David, just wondering on that outlook, most of the models have 2Q as the lowest quarter of the year in terms of year-over-year growth in revenue. I guess can you validate or confirm that? Is 2Q the lowest quarter of the year in terms of year-over-year growth? Thanks.

A – Mark Zuckerberg – Facebook, Inc.

Sure. So the first one, the acquisition hasn't closed, right? So there's been no integration or anything like that and there will be an update when that happens. In terms of what else we might acquire, I mean our strategy has primarily been to buy companies for talent. We have this very entrepreneurial culture where we want the type of people in private companies to take risks and be the type of people who would want to build out whole companies on their own. And so often the best way to find a lot of those people is to find people who are building companies who may be working on a problem where they think that, that they have more leverage if they joined Facebook. So with the exception of Instagram, most of the acquisitions that we've done fit that category and that will continue to be the approach going forward.

A – David Ebersman – Facebook, Inc.

To your second question, if you start by looking backwards a little bit in terms of how revenue has grown to get us where we are today. A couple years ago we had a couple hundred million dollars in revenue and obviously it's grown a lot. It's sort of a combination of I would say two things. A series of ongoing optimizations that we make every day in trying to make the business work better, increase advertiser demand, better as formats et cetera and then on top of that, major changes that we make like the introduction of payments, which really started impacting the business late last year or fundamental changes to the product and how we advertise on it. And so when we look forward to the second half of this year I think we'll continue to make the kinds of optimizations we're always making, to try and drive more advertising demands, better targeting of ads, et cetera.

But the big priority and the big opportunity for us is what we're doing with Sponsored Stories and News Feed and I think it's just difficult to forecast what that's going to look like because we're still early into it. We started putting Sponsored Stories and News Feed earlier this year but really didn't ramp that up substantially until really June of this year is when the numbers – we started putting more volume in and thus far we feel like we're in a really good position because as we ramped up to where we are today, we see high levels of advertiser demand at good levels of user engagement.

But the forecasting part is difficult because we're going to proceed slowly with this. We want to be sure – the biggest mistake I think we could make is to move too quickly and to find ourselves in a situation where we're having an impact on user engagement that we didn't anticipate or is hard-pressed to manage. So I think as we continue to ramp up we will learn from each change we make and see how quickly or what kind of speed of ramp up makes the most sense. But I think right now trying to forecast that is difficult.

Operator: Your next question comes from the line of Heather Bellini from Goldman Sachs. Your line is open.

Q – Heather Bellini – Goldman Sachs

Great. Thank you very much. I just had a follow-up on that, David. In terms of how fast you – how do you gauge how often to show Sponsored Stories? I mean, what type of feedback are you looking for from people to know that maybe you're showing them too many in News Feed or that you have the ability to maybe put the foot on the gas pedal a little bit more? I also wanted to know if these are rolled out globally at this point so to everybody? And then I guess the last question may be for Mark or Sheryl, how do you see local fitting into the mobile experience? And where do you see advertisers in terms of leveraging what Facebook can offer there?

A – Sheryl Sandberg – Facebook, Inc.

So for Sponsored Stories, in terms of rolling out, what we're doing is we're looking at two things very carefully. We're looking at the social context to make sure it's really relevant, so the better stories we can generate where people are interacting with things that are monetize-able, the more Sponsored Stories we can roll out. We're also looking really clearly at user reaction and the good news for us is that it's easy for us to measure user reaction because we can see if users are sharing, clicking, liking comment, if they're engaging with those stories and we can look at how much they're engaging with those stories relative to others.

We've also been pretty careful even when both of those metrics are high at just limiting the number of Sponsored Stories that we roll out. We've been fairly cautious on only rolling out a certain amount and we intend to be continually cautious as we really work on user demand – on the user perception. We have not ruled out Sponsored Stories and News Feed across all countries, there are certain countries that we're still working out some issues, so it's not entirely globally ruled out.

And with apologies, I'm actually trying to remember the – local, yeah; I knew there was a third part of the question. Yeah, I mean local is huge. We've always talked about it, and I think I mentioned it in my remarks, local is the Holy Grail of Internet. Everyone is about to get people into local, and this is something, certainly in my history of working on this industry, I've spent a lot of time on. The problem is that local businesses are just not very tech-savvy, so if you look at local businesses in the United States, obviously one of the more developed markets, something like more than 40% of them have no web presence at all, so they don't adopt things are really, in our view, might be something that we would

think they would obviously adapt. This is where I think Facebook has a huge competitive advantage because visiting local business owners are using Facebook as users. So while they won't adopt something for their product, they set up their profiles or their timelines and when they use the product, they start to see messages from other businesses, and then they start thinking, wow, this could work for my business as well.

The product we want them to use, which is Pages is also incredibly similar to their timeline or profile and so the leap that the small business owner needs to make is just smaller here, than we think it is with anyone else and the numbers bear that out. We have so many, as I mentioned before, 7 million small businesses that are using their Pages on a monthly basis, which is something we've done without any really targeted marketing effort to them at all, and then hundreds of thousands of those get up-sold into becoming advertisers. Our push, which I mentioned in my remarks, to make it easier for them to advertise, so the thing we rolled out last quarter was just, you can just take a part that you're doing on your page and make it super easy to advertise. I think those things will make a business a really big difference in accelerating this even further.

Operator: Your next question comes from the line of Laura Martin from Needham & Company. Your line is open.

Q – Laura Martin – Needham & Company

Hi, there. Thanks for taking the question. A couple for Mark. So Mark, we've been writing a lot about the optionality or the option value of the Facebook platform globally, and I guess I'm really interested, outside the visible revenue streams, which today are payments and advertising; could you talk through how you're thinking about commerce on this platform? And also video because video is one of the most shared things, as you know? As we think about, over the next three to five years, other revenue streams, how do you think philosophically about what Facebook could become over a longer period of time in terms of revenue streams?

A – Mark Zuckerberg – Facebook, Inc.

Sure. Well, the basic approach that we have for now is because we're building out this platform and other companies can build on top of that. And you can view our businesses and Advertising and Payments business, or you could view it as there will be these companies that helps transform these industries and we will get some portion of those, the value that comes from that, that we're helping to provide, right? So in gaming, for example, we think that we're helping to provide a lot of the value. So we end up from getting a relatively high percentage of the revenue that comes into those companies, whereas in something like music, where some of the media companies that are now getting built using Open Graph, I think we aren't providing quite as much of the percentage of the value as with games, so the overall amount of the revenue that comes to Facebook through whether – whatever the breakdown of ads and payments is, I think will be somewhat less. But a lot of people will do that stuff too.

So I think the real way to think about this is that over time, more and more nuanced experiences will become social, so gaming is such a basic thing that people want to do with their friends, so even with a relatively basic platform, people could build that ecosystem out. Some of the media stuff required more nuance, I think commerce will require a little more and so on. But as we – as these things get built out, I think we'll build out the tools to both enable those products to get built and to be able to capture some percentage of the value that we're helping to create. But I mean I don't really have any more plans that I'm going to share with you today about our product roadmap or anything like that.

A – Sheryl Sandberg – Facebook, Inc.

I think one thing to think about in the commerce area or other areas, like video, is that our view of the world is things becoming increasingly social, and that takes time. Gaming was obviously first. But people are informed, when they purchase things, by their friends and the commerce companies that are really adopting social, are seeing good responses. Facebook is one of them. Facebook is very early on in its history, but it's a truly social shopping experience and they're seeing 20% to 40% of their traffic from Facebook on a daily basis, as well as a very good return on their investment on ads that their CEO's been talking about publicly. We look out at what people's shopping behaviors are and so much of them really how much of their shopping behaviors really are social and we think there's a big opportunity for the social context that we offer to be a major part of how people discover products.

Operator, next question, please?

Operator: Your next question comes from the line of Ken Sena from Evercore Partners. Your line is open.

Q – Ken Sena – Evercore Partners

Hi. Thank you. We hear for marketers a lot that the platform is relatively complicated in terms of the ad products offered and services. How long or how quickly can marketers expect to see that simplified? And then also in terms of the App Center, can you give us any sense of the economics behind that arrangement? And is there a revenue share, and if so, how does that compare to your standard 30% on your platform for payments? And then finally if you could look back over the last few months in terms of going public is there anything that you would redo? Thank you.

A – Sheryl Sandberg – Facebook, Inc.

I'll take the first two and then hand off. When you think about the advertising experience on Facebook, it is complicated today and that's mainly because we're a completely new kind of marketing. We're not TV, we're not search, we are a third medium and that presents a challenge because the messages that talk at consumers on other platforms need to really be adapted and changed for the change to be more inclusive. The right ad on TV or on search is the wrong ad for Facebook. Facebook marketers need to learn how to make their ads really accumulate dialogue with consumers. It's also the measurement challenge.

When you see an ad on Facebook you don't go and click to a purchase right there but you're more likely to search later on and buy a product or to walk into a store and buy a product. So we have the challenge of teaching marketers how to develop social marketing and in working with them so that we can tie the consumer experience we see in a Facebook ad and they're acting with that plan to a purchase that happens later on and that's why we're so focused on the market education. With our clients who have done a lot with us, I think they're learning a lot on those trajectories and seeing very positive returns but it's a long time for the TV market and advertising to be truly understood. It took a lot of time for search and I think we're still on that learning curve with a lot of our clients.

The thing is that our results are so strong. The ROI results I talked about in my remarks where we've now done 60 campaigns, if you talk to CMOs those ROI results are getting up to three times their ad spend or five times their ad spend but are truly good compared very favorably with anything else marketers do. And so our view is that if our ads work and we continue to make our ads work and they work for advertisers and our users we'll be able to educate the market over time. How quickly that will happen will depend, but we feel like we're on a good part of our growth trajectory.

In terms of the App Center, the global App Center is that we believe social discovery will lead to app installs. You are more likely to want to use an app your friends are using than you are one that in your population represents. Right now we are not offering paybacks so the revenue share as you're talking about is not something we have a product to deal with right now.

A – David Ebersman – Facebook, Inc.

And you asked about lessons learned looking backwards. Obviously we're disappointed about how the stock is traded but the important thing for us to stay focused on the fact that we're the same company now as we were before. We've got the same opportunity in front of us to build something really important and valuable over time and if we stay focused on building great products we expect and we want to be judged based on the quality of the experience as we build on the value we can create over the long term.

Operator: Your next question comes from the line of Ben Schachter from Macquarie. Your line is open.

Q – Ben Schachter - Macquarie

Hi, guys. I have some phone problems so I apologize if you got these already but one question for Mark and one for David. David, when you're thinking about visibility into the back half of the year on how quickly ad revenue is ramping, how does that look versus sort of expectations that were earlier in the quarter pre- IPO? And then a similar question on the OpEx growth. Do have more visibility, less visibility? How do things look now versus where they were just before IPO? And then, Mark, on the topic of information in the News Feed that the user did not specifically ask for, trending stories or trending video and certainly Sponsored Stories, beyond click through rate how do you think about measuring and understanding that user experience so you know not to go over the edge and degrade the user experience? Thanks.

A – David Ebersman – Facebook, Inc.

Sure. So I mean in terms of the methodology for building News Feed and at any given point we have a lot of different tests and different algorithms running and we measure engagement of everything downstream from News Feed in the whole system, where it's obviously clicks and engagement and feedback in News Feed, how many people want to share but also how many page views. And how much time people spend on Facebook overall, ad performance, everything, down to all of the different tweets that we do in News Feed and user sentiment as well.

So I think we have pretty robust systems that are built out around this and one of the things that I think is pretty interesting is what we've seen is that we can put in good sponsored content and have it not degrade those metrics. So that's really what we're trying to do is we're rolling some of these Sponsored Stories out more conservatively because we want to make sure that the quality is very high. And we're basically continuing to run those tests to make sure that we are producing the best product that we can.

A – Mark Zuckerberg – Facebook, Inc.

So, Ben, thanks for your question on the looking-forward part. I think the two things you asked are pretty different, at least from my standpoint. Trying to project operating expenses is while not easy or precise, we have a fair amount of understanding of how things are trending and what we expect to spend in the second half of the year. So that's why we provided a little bit more specifics in my opening remarks and my prepared remarks about what we expect in terms of operating expense growth. I think revenue growth is just harder to predict. And it's particularly harder to predict when you're really focusing on a new product that you're in the early stages of launching as we are with Sponsored Stories

and News Feed. So as I said we're pleased with where we are, where we were at the end of June, where we are now and that's going to make, we hope, a sizable impact on what kinds of performance we can deliver. Not just in the second half of the year but over a longer-term horizon because we think this can be fundamentally a really important marketing product.

A – Sheryl Sandberg – Facebook, Inc.

Operator, we have time for one last question.

Operator: Your last question comes from the line of Dan Salmon from BMO Capital Markets. Your line is open.

Q – Dan Salmon – BMO Capital Markets

Hi. Good afternoon, guys. My question was on the preferred-marketer developer program where I think jumped to around 330 formal partners today with a great many of them qualified for apps. But around 50 or so and I think around 20 – 50 for ads, 20 for insights. And I just wanted to see what your expectations are to see those numbers both of the total number of PMD developers growing and then those two categories in particular?

A – Sheryl Sandberg – Facebook, Inc.

I think we're very optimistic about our platform partners. Our goal is to take everything people do or at least close to everything people do and make it social. And what we do is provide technology for our platform partners to do that. How many people go into specific programs is not the thing we most focus on. We focus a lot on how many developers out there are using our tools, how many of the apps that are growing quickly, how many of the services people are growing quickly are using tools like Open Graph as well as ads so that we can build an ecosystem.

Mark said in his remarks that we really believe that we are going to provide the identity and the social layer for everything that happens across Web, across mobile. Given the size of our Graph, the engagement people have with us, which even as we grow is not just staying flat but in many ways is increasing. We're very optimistic that if you are choosing to develop the service you would choose to do it with us. We really consider ourselves a partnership company and that means that we want to take social companies and make them big and big companies and make them social because we think bringing what Facebook provides, such as your friends, makes every service better.

Operator: I will now turn the call back over to management.

David Ebersman, Chief Financial Officer

All right. Thank you very much. We're grateful to all of you for joining us today and we look forward to speaking with you again next time.

Operator: This concludes today's conference call. You may now disconnect.

Forward Looking Statements

This transcript contains forward-looking statements, which are subject to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. All statements contained in this transcript other than statements of historical fact, including statements regarding our

future results of operations and financial position, our business strategy and plans, and our objectives for future operations, are forward-looking statements. These forward-looking statements are only predictions and may differ materially from actual results due to a variety of factors including: our ability to retain or increase users and engagement levels, including mobile engagement; our ability to monetize our mobile products; our ability to expand the Facebook Platform; competition; privacy concerns; security breaches; evolving laws and regulations; and our ability to manage growth and geographically-dispersed operations. These and other potential risks and uncertainties that could cause actual results to differ from the results predicted are more fully detailed under the caption “Risk Factors” in our final prospectus filed with the SEC on May 18, 2012, which is available on our Investor Relations website at investor.fb.com and on the SEC website at www.sec.gov. Additional information will also be set forth in our Quarterly Report on Form 10-Q for the quarter ended June 30, 2012. In addition, please note that the date of this transcript is July 26, 2012, and any forward-looking statements contained herein are based on assumptions that we believe to be reasonable as of this date. We undertake no obligation to update these statements as a result of new information or future events.