

Favorable FX Rates Mask Expense Creep at Facebook

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Facebook Earnings

Facebook released its Q2 2018 earnings last Wednesday. **The company missed on both revenue projections and global daily active users (DAUs), causing the stock to sell off as much as 24% in after-hours trading.** It was largely painted as a growth issue, but we wanted to dig deeper to understand Facebook's expense trajectory after a [recent Bloomberg article](#) highlighted the company's record lobbying spending during the second quarter.

Zuckerberg Commentary

What was the first topic Zuckerberg covered during the Q2 2018 earnings call? The company's investments to improve safety, security, and privacy across its platforms. In our view, these investments are directly related to the Cambridge Analytica issue, accusations of election interference, and congressional inquiries about data security. Below are two of the investments highlighted on the call.

- **Ad Transparency Tools:** According to Zuckerberg, the tools "let anyone see the ads any page is running even if the ads aren't targeted to you". Sheryl Sandberg, Facebook's COO, added that political and issue ads will be labeled with a disclosure about who paid for them and then saved in a searchable archive.
- **Artificial Intelligence (AI):** Per Zuckerberg, this is used to "prevent fake accounts that generate a lot of the problematic content from ever being created in the first place". He stated that

the AI investments allow Facebook to remove more bad content more quickly.

According to Zuckerberg, the company “will continue to invest heavily in security and privacy because we have a responsibility to keep people safe.” How will these investments impact the company’s margins?

Zuckerberg cautioned during the earnings call: “But, as I've said on past calls, we're investing so much in security that it will significantly impact our profitability. We're starting to see that this quarter.”

Expense Growth in the Business Model

While reading the Q2 2018 10-Q, we noted an increase in the company’s expense base as a percentage of revenue during both the first six months and second quarter year over year. However, we think the margins actually compressed more after looking at revenue year over year.

In the 10-Q, the company stated that the “**general weakening of the U.S. dollar relative to certain foreign currencies in the second quarter and the first six months of 2018 compared to the same periods in 2017 had a favorable impact on revenue**”. How much? According to the company, if it had translated 2018 revenue using the exchange rates from the second quarter and first six months of 2017, revenue would decrease by \$373 million and \$908 million respectively. Below is a table showing the actual results for the second quarter of both 2017 and 2018. In addition, we added a column to reflect the Q2 2018 results on a constant currency basis. **As shown below, income from operations as a percentage of revenue decreased 4.5% year over year after accounting for currency fluctuations during Q2 2018.**

	Three Months Ended June 30,					
	2018		2017		Constant Currency Adjustment	Currency Adjusted Number
	(in millions)					
Revenue	\$ 13,231		\$ 9,321		\$ 373	\$ 12,858
Costs and expenses:						
Cost of revenue	2,214	16.7%	1,237	13.3%		2,214
Research and development	2,523	19.1%	1,919	20.6%		2,523
Marketing and sales	1,855	14.0%	1,124	12.1%		1,855
General and administrative	776	5.9%	640	6.9%		776
Total costs and expenses	7,368	55.7%	4,920	52.8%		7,368
Income from operations	5,863	44.3%	4,401	47.2%		5,490

Our Takeaways

In our view, the increased expenses in the first half of 2018 are directly related to Facebook’s ongoing data privacy issues. You may have noticed Facebook’s recent ad campaigns, on platforms like Hulu, discussing security and data privacy. We think this expense, along with similar ads, is housed in the marketing and sales expense line. **While the company did highlight an increase in the average price paid per ad and number of ads delivered, the expense side of the income statement is what concerns us.**

[As we wrote about earlier this year](#), Facebook’s business model is built around a free platform with advertising based on user data. If the company is required to manage data in a different way or hire additional employees, margins may continue to compress. **As a result, we still wouldn’t be buyers of social media stocks at current levels. The risks of margin compression and valuations are too elevated in our view.**



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