Underwhelming earnings report could point to bigger problems for Facebook

By Stephen Loiaconi

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WASHINGTON (Circa) — Facebook continued to feel repercussions Thursday after second quarter earnings came in below estimates, disappointing investors, sparking a mass sell-off of stock, and raising doubts about the longevity of the company's business model.

At the closing bell, Facebook stock was down close to 19 percent from Wednesday afternoon at $176.07 per share, wiping out all of its gains so far this calendar year. According to CNBC, it was the biggest one-day loss in stock market history.
On an earnings conference call Wednesday, Chief Financial Officer David Wehner said total revenue for the second quarter was $13.2 billion, a 42 percent increase over 2017 but short of what industry analysts had expected for the first time in three years. Facebook reported 2.23 billion monthly active users, again slightly shy of expectations. The company also introduced a new metric, calculating at least 2.5 billion people used one or more of its applications in June, including Facebook, Instagram, WhatsApp, or Messenger.

Overall, Facebook lost more than $100 billion in market capitalization in 24 hours, and its stock price continued declining in early after-hours trading Thursday. The losses contributed heavily to a 1 percent dip in the Nasdaq for the day.

Founder and CEO Mark Zuckerberg also took a significant hit personally. The 19 percent freefall in stock value equated to a drop of more than $16 billion in his net worth, taking him from number 3 to number 6 on Bloomberg’s list of the world’s richest people. He holds 12.8 percent of Facebook’s outstanding stock.

All of this merits some soul-searching at the Menlo Park, California-based company, economists say.

“There are definite reasons for concern and should encourage reflection on what makes the platform unique or distinctive,” said Dave Chatterjee, associate professor of management information systems at the Terry College of Business at the University of Georgia. “Efforts should be focused on evolving and transforming the platform.”
On the earnings call, Wehner cited several factors cutting into profits, including some that result from deliberate choices the company has made. It has increased focus on building up new features like Stories that are currently less profitable than other revenue streams.

Changes to privacy policies have enabled users to opt out of some data-sharing mechanisms. New privacy rules that went into effect last month in Europe known as the General Data Protection Regulation have also caused some complications.

The underwhelming earnings report comes at a time when Facebook is still struggling to shake off the stink of scandals growing out of ongoing scrutiny of the use of the platform during the 2016 presidential campaign. A March Axios/SurveyMonkey poll found public favorability of the company plummeted by nearly 30 percentage points since October 2017.

Earlier this year, Facebook was slammed over sharing of public user data with Cambridge Analytica, a firm that worked with President Donald Trump's presidential campaign. More recently, it has faced complaints from the right of alleged political bias and from the left for not doing more to combat misinformation and propaganda.

According to Luke Hopkins, co-director of the Center for Retail Innovation at Florida State University, the negative headlines themselves are unlikely to directly undermine Facebook's earnings.

“You can make an argument for the revenue decline being linked to the scandals as Facebook attempts to improve the quality of what content we see,” he said. “The reduction in margins is more likely attributed to
Executives acknowledged steps they have taken to provide security, privacy, and reassurance for customers have cut into their bottom line.

“Looking ahead, we will continue to invest heavily in security and privacy because we have a responsibility to keep people safe,” Zuckerberg said Wednesday. “But as I’ve said on past calls, we’re investing so much in security that it will significantly impact our profitability.”

These measures are driving down profits now, but executives hope they will provide dividends long-term with a safer and happier community of users.
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“We think that’s the right thing to do for the business in terms of ensuring the community’s safety and security and the durability to franchise so those are important investments from an ROI perspective, but they don’t have obviously immediate translation into revenue dollars,” Wehner said.

Given the personal nature of the content and connections people use Facebook for, Chatterjee said it is clearly in Facebook’s interest to ensure users feel comfortable and secure.

“Privacy and security are very important considerations, and investing in them is wise,” he said. “If there is a genuine and sincere commitment to security, privacy, and user needs, Facebook will continue to be the virtual home of choice for many.”

While earnings for the second quarter were disappointing, a bigger drag on Facebook’s stock may be the projection of even slower growth in the months ahead. Wehner warned of deceleration by high single digits in the next few quarters as conditions that dragged down numbers in the last quarter persist.
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"We expect currency to be a slight headwind in the second half versus the tailwinds we have experienced over the last several quarters," he said. "We plan to grow and promote certain engaging experiences like Stories that currently have lower levels of monetization. We are also giving people who use our services more choices around data privacy which may have an impact on our revenue growth."

Also, the effects of GDPR rules on figures coming out of Europe will presumably be more pronounced in the third quarter since it only rolled out toward the end of the last one.

"While the scandals obviously didn’t help, the reason the stock price continues to plummet has more to do with Facebook’s CFO openly stating he expected a decline in revenue and reduction in margins," Hopkins said.

Despite the investor backlash, the news Wednesday was not all bad. Executives highlighted the continued development and growth of Instagram, which has cleared 1 billion active users.

“When Instagram joined us, the team had only 16 people. Since then, Kevin and the team have built Stories, Direct, and now IGTV,” Zuckerberg said. “This has been a story of great innovation and product execution. It’s also a story of how effective the integration has been.”

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Although monthly user numbers for Facebook were steady in the U.S. and dipped in Europe, the company is seeing significant growth elsewhere. According to Wehner, the 11 percent increase in daily active users came largely from India, Indonesia, and the Philippines. Ad revenue grew by 47 percent in both Europe and the Asia Pacific region.

However, if use continues to trail off in the western world, Chatterjee expects to see the same trend develop in other areas.

“In a highly-connected global environment, it is unrealistic to expect that the company will be able to grow market share in up-and-coming countries,” he said. “If it is losing traction in North America and Europe, it will experience the same elsewhere. People are quick to pick up on trends and value creation potential and will gravitate to newer and more attractive platforms.”

If Wehner’s prediction of increased deceleration throughout the rest of 2018 bears out, the situation could grow considerably worse for Facebook.

“In this very dynamic and flippant world of social media users, at the very first opportunity, people are going to move to cooler and more attractive platforms. Low switching costs encourages such moves,” Chatterjee said.

David Rothschild
@DavMicRot

Just remembered that I have not looked at my @facebook account for a few weeks. People still using that?
5:01 PM - Jul 26, 2018
10  See David Rothschild’s other Tweets
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Zuckerberg stressed Wednesday how much progress the company has made in improving security and transparency surrounding election advertising, and he pointed to several elections around the world since 2016 that have proceeded without incident.

“2018 is a big year and because of the successful results that we’ve seen in a number of elections recently, we feel like our roadmap and our level of preparation is much higher now than it has been and we feel relatively confident going into these elections,” he said at the end of the call.

How much the social media outrage directed at Facebook translates into changes in social media use remains to be seen. According to a survey conducted in April, about 9 percent of Americans said they deleted their Facebook accounts over privacy concerns, but the company’s quarterly data showed no significant change in active U.S. users from the first quarter.

“On the one hand you have a subset of users raging war on Facebook for the data breach and a silent majority who did nothing,” Hopkins said. “Although it appeared the entire world was against Zuckerberg when the #deletefacebook trend erupted, the end result was less concerning as fewer than 10 percent of users actually deleted their accounts.”

Facebook’s woes may run deeper than its current PR headaches, which will likely fade in most users’ minds in time. Monthly user totals in the U.S. and Canada have been steady for several quarters, and there is a finite number of viable potential customers out there.

“When roughly 70 percent of the internet-connected world population logs onto Facebook at least once a month, one had to assume the decline was inevitable,” Hopkins said. “The profit decline is a result of many issues that ultimately point to the business model.”
In the United States, for example, by far the company's most established and stable market, only three-quarters of Internet users are actively on FB. That ratio of PIE to Internet user is worse in other countries, so even full FB saturation in a given market doesn't imply total Facebook adoption. Let's (very) optimistically assume full US-level penetration for any market. Without China and Russia, and taking a 25 percent haircut of people who'll never join or stay (as is the case in the United States), that leaves around 1.8 billion potential Facebook users globally. That's it.

In the first quarter of 2015, Facebook announced it had 1.44 billion users. Based on its check their Facebook feeds as they watch over their herds.

Facebook can't wait for the developing world to get to First World standards of connectivity, so it must create it for them, using ad revenues in the developed world to subsidize this new air force's deployment. In time, monetization will follow usage, as it always does. Money follows eyeballs, even if slowly.

Eventually, Russia, Iran, India, Brazil, and parts of Africa will fall to the Growth team’s patient ministrations. Then, Mark Zuckerberg, like a young Alexander the Great at the Indus River, will weep for having no more world to conquer.

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In light of today's FB call, let's re-assess Chaos Monkeys (written in 2016).

I was half a year and about 100M users (4%) off.

But they hit the growth wall nonetheless.
6:57 PM - Jul 25, 2018 · San Francisco, CA
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Facebook is also facing predictable challenges of being a 14-year-old company in a rapidly-developing field. The new car smell has long since dissipated, and users want something fresh.

"Facebook is not a top draw for the younger generation," Chatterjee said.

The other platforms Facebook has absorbed in recent years, Instagram and WhatsApp, skew toward a young demographic, but flat or declining user numbers for the primary platform on two continents should still be setting off some alarms in Menlo Park.

"The backlashes and controversies relating to data misuse, fake news, and interface redesigns are possible contributors to negative market signals and thereby adversely impacting stock performance," Chatterjee said. "But I believe the overarching factor is the future feasibility and viability of the current business model."
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