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Facebook, Inc. *(FB)*

Q4 2012 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon. My name is Steve and I will be your conference operator today. At this time, I would like to welcome everyone to the Facebook Fourth Quarter 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. [Operator Instructions] Thank you very much.

Ms. Deborah Crawford, Facebook's Director of Investor Relations, you may begin.

Deborah Crawford

Director of Investor Relations, Facebook, Inc.

Thank you. Good afternoon, and welcome to Facebook's fourth quarter and full year earnings conference call. Joining me today to talk about our results are Mark Zuckerberg, CEO; Sheryl Sandberg, COO; and David Ebersman, CFO.

Before we get started, I would 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 Quarterly Report on Form 10-K filed with the SEC on October 24th, 2012. In addition, please note that the date of this conference call is January 30th, 2013, and any forward-looking statements that we make today are based on the 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 accompanying investor presentation are 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 Elliot Zuckerberg

Chairman & Chief Executive Officer, Facebook, Inc.

Thanks, everyone, for joining us. 2012 was a big year for us. We made this big transition where now there are more people using Facebook on mobile everyday than on desktop. This is challenging for us to navigate since we started off the year with apps that weren't as high quality as we wanted and no ads in our apps at all. But now we're coming out of the year with a strong foundation and a lot of momentum.

Just last week, comScore put out a report saying that Facebook is now 23% of all time spent on apps in the U.S. And one of the next biggest apps is Instagram at 3%. So put together, we're now more than a quarter of the time spent in apps. Today, there's no argument. Facebook is a mobile company. As I've said before, there are three main parts of our strategy. Build the best mobile product, build a platform and services that leverage the social graph, and build a really strong monetization effort – engine.

I'm going to use our time today in the same way I will on most of these calls, to give my assessment of how I think we're doing against each of these big areas. Let's start with mobile. I think more people are starting to understand that mobile is a great opportunity for us. Mobile is the perfect device for Facebook for three reasons. It allows us to reach more people, we have more engagement from the people who we reach and I think we'll also be able to make more money for each minute people spend with us on their mobile devices. But mobile isn't just driving greater engagement on Facebook, mobile enables many new experiences and is growing overall share and across all apps. This creates a very dynamic ecosystem and one where there's a lot of room for us to create even more sharing through Facebook.

Often, doing a good job is just about focusing on basic issues like performance and stability. In December, we released a completely rewritten version of Facebook for Android. This was the Android version of the iOS rewrite we did earlier last year. Neither of these rewrites added big new features, but simply by improving speed and stability, we've made a much better user experience, enabling people to share even more. It's a good example of how early we are in the market that these changes make such a big difference.

Photos and Instagram are doing well, too. We had our best day ever on New Year's Day with more than 600 million photos uploaded to Facebook. Instagram has continued growing very quickly and hopefully we'll have some new milestones to share with you all soon. A lot of what we had to do last year was simply to improve our mobile development process. Now we're there. We moved fast and shipped new versions of our apps on a regular monthly cycle. You have a good version of all the Facebook features you know and want on your phone. So now the next thing we're going to do is get really good at building new mobile first experiences. That's going to be a big theme for us this year. If we do this well, we should be able to bring even more relevant content and connections to more people and continue to deepen their engagement.

Next I want to talk about platform and building new services using the social graph. Normally I'll use this section to talk about what's going on in the ecosystem outside of our company, but this quarter I think we built the most interesting new service using the social graph, Graph Search. This is an early beta product but I'm really excited about it because it's an entirely new kind of search. It's not web search, it's structured search over the whole graph of content that people have mapped out on Facebook. It's good for lots of things that you just wouldn't use a traditional search engine for, seeing where your friends have eaten or traveled to, browsing photos and content your friends posted, finding new people to meet or recruit for a job and many other things.

Some of these are big areas where we think that there's room for much better product. Down the line, if we do this well, this could potentially turn into a meaningful business for us. For now, we're going to continue working to refine the product and roll it out to everyone. Still, I think the way that Graph Search is different from normal web search is a good example of how there is going to be this market for a whole new crop of social services in existing markets today that weren't designed with the principles of real identity and social connections at search.

One platform development that I am really excited by is seeing how well our app install advertising product is doing. Developers are finding that Facebook is a great service for connecting with the right people who want to use their apps and getting a lot of installs. On mobile, our platform already enables developers to help you bring your friends to a developer's app. We also want to be one of the primary ways that developers get new people to their apps in the first place, and with app install ads, we're off to a good, if early, start in achieving that.

Now I want to talk a bit about monetization. Last year was a big year for us here. We started off the year with no ads at all on mobile and we ended up with approximately 23% of our ads revenue coming from mobile in the fourth quarter. That's a pretty amazing change. One of the big drivers of this has been that as we roll out ads to news feed, we found that it barely affected the level of engagement on Facebook. We thought that we can make

this work over time without a big impact if we spent a long time tuning the ads, but the numbers turned out even better than we thought without much tuning. So this has enabled us to show people a few ads in news feed each day. So that means that now we have this news feed ads business that we barely tuned and there's a big opportunity in front of us to make every ad that we're showing a lot better.

The biggest ways we're going to do this are by improving targeting and relevance so we can show everyone content that they care more about and by designing better ad products that aren't just about links and text and images. For targeting, I'm most excited about the work that we're doing on Custom Audiences. Our tool that lets advertisers upload their customer list and target against that and information that is already on Facebook at the same time. For – say, my customers are in some age range and live in some state, you may not know which states your customers live in but if they've shared it on Facebook then it's possible to create these kinds of experiences.

For new ad experiences, I'm looking forward to doing more with different kinds of media. As our news feed design evolves to show richer kinds of stories, that opens up new opportunities to offer different kinds of ads as well. Aside from ads, I do want to temper near-term expectations a little bit on revenue coming from other areas like Gifts or Graph Search. I think these can be big opportunities for us long-term, but for the foreseeable future, the most important thing for us is to continue building out great consumer experiences around these products. We're going to invest in these, but for the next year at least our work around ads will have by far the biggest impact on our business.

Now before I hand it off to Sheryl, there's one more thing I want to discuss. We're at an interesting point in our evolution where there are lots of areas where we need to invest in. We need to build the best mobile experiences, we need to build our platforms and we need to build a really strong monetization engine. We can easily invest our entire engineering team just in building out the nuts and bolts of these areas today. But we also feel like there's an imperative to start planting seeds for tomorrow's businesses as well.

Products like Graph Search that are in beta today but will hopefully grow up to be pillars of the Facebook service and businesses are things that we want to invest in aggressively, and things we feel like it's the right thing for our business over the long term to invest in aggressively. Based on this, we made the decision to continue to grow our head count quickly in 2013, particularly in product development. This will likely cause our expenses to grow at a faster rate than we expect to grow our revenue this year, which means that we aren't operating to maximize our profits this year. We're doing what we think will build the best service and business over the long term.

Finally, I just want to take a minute to thank everyone who works at Facebook. Last year really was an amazing year for us on many levels. We connected 1 billion people. We navigated the transition to becoming a mobile company and we've laid the foundation for some great new products I'm excited to show the world this year. And this is all because we have this unique culture filled with some of the most talented people in the world who are still mission driven, who want to make the world a better place and who work so hard to make the world that place. Thank you all. And thanks to everyone who's on this call for taking the time to be with us today. I look forward to being able to report on all the progress we make next quarter.

And now I'm going to turn the podium over to Sheryl.

Sheryl K. Sandberg

Chief Operating Officer & Director, Facebook, Inc.

Thanks, Mark. So our ad business continued its positive trajectory in the fourth quarter. Total for fourth quarter revenue was \$1.585 billion with \$1.329 billion coming from ads. This represents a 41% increase for advertising

revenue. Ad revenue from news feed increased across the desktop and mobile and in Q4 approximately 23% of our ad revenue came from mobile, up from approximately 14% in Q3.

Our focus in the fourth quarter was to continue improving and scaling the products we launched in 2012. We know that our advertising products are delivering results for marketers and one of the best indicators of this came over the holiday season, when more businesses from big brands to small retailers used us as a core part of their holiday outreach.

Perhaps the biggest highlight in the fourth quarter was the increasing importance of mobile, not just to Facebook but also to our clients. Marketers are realizing more and more that Facebook is one of the best places to reach their customers on mobile because of our unique ability to reach specific target audiences at scale. Another highlight is the traction our Offers and promoted post products, which are really easy to use, have given us at local businesses.

As I described last quarter, our strategy is focused on three priorities; one, building products and tools that create value for every type of marketer; two, proving that value to marketers; and three, taking advantage of the unique opportunity we have in mobile. Starting with the first. We build products that create value for every type of marketer. We continue our focus on four key customer segments, brand marketers, direct marketers, local businesses and developers. For brand marketers, we combine access to the largest community of real people in the world with some of the industry's best targeting capabilities. We now work with every one of the Ad Age Global 100 Advertisers and overall revenue from these clients is growing through consistently with our ad revenue in 2012, which means it significantly outpaced the estimates for overall ad spend from the industry.

In the fourth quarter, we launched a new way for advertisers to buy guaranteed ad impressions with the goal of helping them reach massive audiences on mobile. Walmart used this target block over the important Thanksgiving weekend to deliver 50 million mobile ads to their existing and potential customers. We think this is a really important step in the evolution of mobile advertising as these numbers rival the scale of broader web and TV campaigns.

Increasingly, companies use Facebook as the exclusive channel to launch new products. To share one example, Michael Kors used Facebook to launch a line of new sneakers. Many of the sneakers sold out online and in stores and they achieved a 16 point increase in awareness of the new sneaker among the 36 million people that the campaign reached on Facebook. That's the equivalent of 5.8 million new people in the brand's target audience who are now aware of the new line of shoes.

For direct marketers, the products we launched in third quarter continue to gain traction in Q4 as well. Since we launched our Offers product at the end of September, we have seen stronger advertiser adoption and user engagement with nearly 42 million unique users claiming an offer. Cost per redemption compare favorably to those from e-mail, newspaper, paid search and display media based on data from the Direct Marketing Association. Discounts and promotions are often important tactics for direct marketers, and we think our Offers product is well placed to compete for these media budgets.

As Mark said, one of the products we're most excited about is Custom Audiences, which lets marketers show their ads to exactly the right people by coupling our rich targeting capabilities with their own customer data or data from a third-party. A large retailer, for example, can send one set of ads to customers who typically buy sporting goods and a different set of ads to those who would purchase beauty products, this results in some of the best targeting available on or off line today.

To share one example, JackThreads, an online shopping site for men used Custom Audiences to target specific segments of its customer database and target them with ads for products the company knew were most relevant to them, such as sneakers. As a result, the company achieved a 30% lower cost per acquisition than other platforms and saw a six times return on advertising spend.

It's important to understand that Custom Audiences is not a separate standalone ad product, but rather a targeting capability that can be used with many of our ad products to drive greater accuracy and efficiency. For example, when Custom Audiences is used with Offers, marketers can customize discounts for exactly the right kind of customers.

The Facebook Exchange, or FBX, allows businesses to bid on specific impressions in real-time and it continues to gain momentum and drive solid results for advertisers. Despite only becoming available to all marketers in September, by December FBX served nearly 1 billion impressions daily and supported over 1,300 advertisers each day. Large and small advertisers alike are seeing higher click through rates, lower cost per conversions and strong incremental reaches in FBX.

Revenue from local businesses was particularly strong in the fourth quarter. We're pleased with the number of local business pages that advertise on Facebook nearly doubled since the beginning of 2012. This is due in no small part to our promoted post products, which makes it easier for businesses to create and purchase ads directly from their Facebook page. Almost 500,000 pages have used promoted post. About 30% of these are new advertisers to Facebook and more than 70% have become repeat customers.

Finally, for developers, we continue to gain traction with our new mobile app install ads. Since their launch in October, they're already being used by 20% of the top 100 grossing iOS apps to accelerate growth. According to research conducted by comScore in December, Facebook is the top driver of awareness of new mobile app downloads and among people who learn about new apps on Facebook, 48% click directly from the Facebook app to download new mobile apps.

Cie Games used this product to drive installs of its new game, Car Town Streets. As a result, they broke into the top 10 games list on iOS in many countries while achieving a 40% lower cost per installation compared to their other advertising. In addition to gaming, we believe this will be a very useful product to help companies and industries like retail, travel and financial services shift their business into mobile.

Next I want to focus on our commitment to provide proving value – proving Facebook value to marketers. We design all of our products to deliver a strong return on investment. Given that we are still a relatively new marketing platform, proving that our ads are effective remains an important and ongoing priority for us. We work with research companies like Nielsen, Aggregate Knowledge and Datalogix to demonstrate how our ads drive sales and help inform our product development.

For example, research from Aggregate Knowledge showed that Facebook is an increasingly powerful tool to help marketers reach more people and drive sales. In a study of fourth quarter marketing campaigns, they found that media plans that included Facebook reached people who would not have seen the campaigns otherwise. In fact, 45% of those reached were reached exclusively through Facebook. The study also found that Facebook had a 68% lower cost per acquisition and drove 24% more new sales than other online channels. We also worked with clients directly to integrate with their own measurement systems so they can better understand the ROI Facebook delivers.

For example, we built a deep relationship with PepsiCo where we worked with its Lay's brand to drive significant sales ahead of plan and a 5x return on ad spend for their Do Us A Flavor campaign on Facebook. In the fourth

quarter, we also made conversion tracking available in beta. Conversion tracking allows marketers of all sizes to more easily measure the impact of their Facebook advertising, whether the Facebook ad is a first ad or the last ad, the person sees before for taking an action.

Finally, I want to discuss how we are continuing to take advantage of the significant opportunity we have in mobile. As mentioned before, approximately 23% of our advertising revenue now comes from mobile. In addition, 65% of our advertisers are now using ads in news feed, which run on both desktop and mobile, up from 50% at the end of the third quarter. Marketers are recognizing that our news feed is the most efficient and effective place to reach their customers, due in large part to the fact that ads in news feed see a higher click through rate and ultimately a lower cost per conversion than ads on the right-hand side of our site. By working with Datalogix, we have shown that ads in news feed also drive more than eight times the incremental off-line sales than ads on the right-hand side.

Clients also recognize that because our users share their real identities on Facebook and because they are logged in when they use Facebook on mobile, we have a unique ability to serve advertising that people find relevant. This is an important competitive advantage for us relative to other mobile platforms and one we think we are very unique in. Overall, we continue to make real progress advancing our advertising strategy. Our revenue and key metrics are growing nicely, and as we look ahead to 2013, we're very confident in the direction of our ad business. Over 1 billion people are on Facebook and we are enabling businesses to engage with them directly wherever they are. Our massive scale, accurate targeting, strength in mobile and new advertising products are driving measurable results for all types of businesses and transforming the way people and businesses connect. We look forward to making even more progress in these areas in the year ahead.

Now I'll hand it over to David.

David A. Ebersman

Chief Financial Officer, Facebook, Inc.

Thanks, Sheryl, and good afternoon, everyone. We're pleased with the progress we made in Q4 against our key financial priorities, growing revenue, investing aggressively in areas critical to our future performance and positioning the company to maximize long-term financial returns. We ended the year with 1.06 billion people using Facebook, up 25% from a year ago. In December, 618 million people accessed Facebook each day on average, up 28% from last year, and we grew monthly and daily users across all geographic regions. Mobile continues to drive our growth. 680 million people access Facebook from mobile devices in December, up 57% versus last year. And the numbers I just mentioned do not include Instagram, which continues to grow at an impressive rate. We ended 2012 with strong engagement across our products and this engagement remains a foundation for everything we're trying to build.

Turning to revenue; in Q4, revenue was up 40% year-over-year or 42% when adjusted for constant exchange rates. Q4 year-over-year growth would have been 34% if adjusted to exclude the additional month of payments transactions we recognized as planned. Ad revenue in Q4 was up 41% or 43% when adjusted for constant exchange rates. Year-over-year advertising growth in Q4 was the strongest of any quarter in 2012, and we view this as a validation of our recent investments in mobile news feed ads, growing our advertiser base and launching new ad products.

In the fourth quarter, ad impressions were up 46% and average price per ad was down 4% compared to last year. These trends were driven by significantly faster impression growth in developing markets such as Asia and Latin America, which have relatively lower pricing and thereby brought down our average price overall. The faster impression growth in developing markets in Q4 was significantly affected by product changes, primarily our

decision to lower the market reserve price or the floor price we accept in our auction, which increased the number of ads shown in these markets. We continue to see positive trends in price per ad in key developed markets, including an 18% increase in average price in the U.S. and Canada in Q4.

Payments and other revenue was \$256 million in Q4. As planned, in Q4, we recognized revenue from four months of payments transactions for accounting reasons detailed in our last 10-Q. Adjusting for the extra month, payments revenues from gains was essentially flat with the fourth quarter of 2011. This past quarter, payments and other revenue also included around \$5 million from sources outside of games primarily user promoted posts and to a lesser extent from our new Gifts product.

Shifting now to expenses; in Q4, our total GAAP expenses were \$1.06 billion. Excluding the impact of stock compensation, total expenses increased 67% to \$849 million, driven primarily by head count and infrastructure. We ended 2012 with just over 4,600 employees, a 44% increase from last year, driven by hiring in our technical groups. We were recently ranked the number one place to work by Glassdoor, which we view as a testament to how strong our culture remains through this period of significant head count growth.

In Q4, our GAAP operating income was \$523 million. Excluding stock comp, our non-GAAP operating income was \$736 million, representing a 46% operating margin. Our GAAP tax rate for Q4 was 87% and our non-GAAP tax rate was 41%. For 2013, we expect our non-GAAP tax rate to be a few percentage points higher than the rate in Q4. Additionally, we ended the year with approximately \$5.8 billion in NOL tax loss carry-forwards created by stock compensation. GAAP net income and EPS for the fourth quarter was \$64 million or \$0.03 per share, non-GAAP net income and EPS was \$426 million or \$0.17 per share compared to \$0.15 in Q4 last year. We ended Q4 with \$9.6 billion in cash and investments giving us great flexibility and risk protection.

Looking forward now, we believe we've built a solid foundation for continued growth in 2013 and beyond. In our ads business, we believe we have good momentum and plan to continue investing to grow advertiser demand and improve the quality, engagement and value of our ads, particularly in news feed. In terms of 2013 expectations for Payments, our Games ecosystem continues to show healthy signs of diversification with new kinds of games growing engagement and monetization in Q4. However, we continue to face an offsetting headwind from declining desktop usage in developed markets since our games payments revenue is essentially all from desktop computers. In terms of non-games payments revenue, while we remain excited about the long-term potential of commerce on Facebook, current revenue from user promoted posts and Gifts is very small, and we expect 2013 contributions from these initiatives to remain very small given current run rates.

In terms of infrastructure, we expect CapEx spend in 2013 will be in the neighborhood of \$1.8 billion as we continue to invest in servers, new data centers and network infrastructure to enable us to bring Facebook speedily and reliably to everyone around the world. We're pleased that planned 2013 CapEx spend is up relatively modestly compared to 2012, which came in under forecast at a shade under \$1.6 billion as our investments in software and hardware efficiency are paying off nicely.

As Mark noted, 2013 will be a year of significant investments in areas we believe are critical to drive long-term engagement and monetization, and we plan to continue to hire aggressively to accelerate product development and deliver new products for users and advertisers. As a result of our hiring and investment plans, we expect that our total expenses excluding stock comp will likely grow by somewhere around 50% in 2013, though actual growth will depend on hiring and project decisions we make through the year.

We believe this level of near-term investment is the right strategic decision to enable long-term value creation. We're excited about the potential returns from investing in our product. We continue to feel there's operating

leverage inherent in our business and we're committed to building a highly profitable cash generating business over the long-term.

In summary, we believe we're entering 2013 in a strong position. We're working in very large markets that offer us great opportunities for growth. We have uniquely valuable assets in terms of the size, identity and engagement of the people who use Facebook and we have a fantastic group of employees who have big aspirations to build on our financial performance from 2012.

Now let's open the call for questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from the line of Douglas Anmuth from JPMorgan. Your line is open.

Douglas T. Anmuth
Analyst, JPMorgan Securities LLC

Q

Great. Thanks for taking the question. I just wanted to ask two things. First, can you help us understand the mobile trajectory through 4Q just given the commentary you gave about exiting 3Q at \$270 million run rate and doing a little bit more than \$300 million in the fourth quarter? Did you open up more additional inventory in 4Q from the late 3Q levels? And did you see any notable change in pricing? And then can you also just comment on how you feel about the volume of ad load in the news feed right now on both desktop and mobile? And perhaps, in terms of baseball innings, where you think you are in terms of penetration? Thanks.

David A. Ebersman
Chief Financial Officer, Facebook, Inc.

A

I'll take the first half. So I think the most important thing is that we think mobile can be a huge opportunity for us, and we're really pleased with the progress we made in the fourth quarter. If you compare the averages, Q3 versus Q4, our mobile – well, if you compare the overall revenue, our mobile revenue doubled from Q3 to Q4. And we continue to make progress also in terms of the quality and the relevance of the mobile ads that we show. I think the most important thing here is that we're still really early. A couple quarters ago mobile revenues were 0% of our ads revenue and now we're up to 23% and believe that there's a lot more we can do and a lot of growth ahead of us.

Mark Elliot Zuckerberg
Chairman & Chief Executive Officer, Facebook, Inc.

A

I'll speak to the quality piece. So one of the things that we measure for news feed quality is the amount of feedback that we get, so likes and comments and things like that. And just to give you a sense of the magnitude of these things, the ranking improvements in things that we did over the course of last year improved the amount of feedback in news feed on the order of about 50%. Right? So I think – I don't know if it was quite exactly 50% but it was on that order. And we measure very closely when we take into account advertising and spend in order to rank ads into news feed, we're inherently not showing what would have organically shown up in that slot, so we want to make sure that we're not decreasing quality by a big amount. So what we found was that when we did the test to take out the ads, we were inserting the ads had about a 2% reduction in the amount of likes and comments.

So over the period of last year, we've had on the order of a 50% increase and then a very marginal offset of 2% for putting ads in, which just makes us feel really confident that we're continuing to very strongly net improve the

experience of feed. And that's one of the things that I mentioned in my script before. I wasn't – and we weren't that – we're confident that we can get this to a good place over time in terms of being a good experience, but the amount of the improvements that we've done have just dwarfed the quantitative feedback hit that anything that we've seen on the ads is very promising to us in terms of what we're going to be able to do going forward.

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

Ben Schachter

Analyst, Macquarie Capital (USA), Inc.

Q

Mark, in the comments you said you were looking at different types of media for ads. I was wondering at a high level if you could talk about how that would potentially change the overall Facebook experience? And, if you could give some real examples for how these different types of ad units would come into play. And, then also just separately, engagement; I was wondering if you could give us any update on how you're viewing engagement or any change to how you measure it and any views on how that's going through the quarter. Thanks.

Mark Elliot Zuckerberg

Chairman & Chief Executive Officer, Facebook, Inc.

A

Sure. So, one of the product design principles that we've always had is we want the organic content to be of the same basic types of formats as paid content, right? So, historically, advertisers want really rich things like big pictures or videos and we haven't provided those things historically. But, one of the things that we've done in the last year is you've seen the organic news feed product that consumers use moving towards bigger pictures, richer media and I think you'll continue to see it go in that direction. And, I think that a lot of the success of products like Instagram is because of that. It's a very immersive – even on a small screen, just – it's a wonderful photo product. And, when you have those form factors for the content that gives you the ability to offer those form factors for advertising as well. So, I think you see the trend there in terms of where it's going and that's just naturally going to make it so we can deliver much more engaging advertising experiences than we were traditionally able to do when we didn't have those types of content in the system. David can speak to some of the stats that you were asking about.

David A. Ebersman

Chief Financial Officer, Facebook, Inc.

A

So, in terms of engagement, overall, everything continues to go very well. We passed a billion users and in the fourth quarter 59% of them used Facebook on an average day in December, which is up a couple of percent from where we started the year. So, it's just pretty remarkable how as we continue to grow the user base that number continues to go up, really speaks to the value of the service and the importance of mobile which is really driving that. There's another metric we track, which measures the number of people who come to the site in at least six of the last seven days. So, it shows the audience for whom Facebook is a daily experience and that – we ended the year with record highs on that metric as well. So, everything continues to go well. And, our job is to make Facebook a better, more useful products so we can continue to drive new kinds of engagement in the future.

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

Heather A. Bellini

Analyst, Goldman Sachs & Co.

Q

Great, thank you. I had a question for Sheryl and then a question for Mark. Sheryl, I was wondering if you could share with us what you've seen from FBX. I know it's still early but what milestones you're looking to hit with this business in 2013? And then, Mark, just wondering where do you think we are in terms of the social ad revolution?

And, when you look out over the next 12 months, what do you think could surprise you the most in terms of the revenue opportunities that are ahead of you when you look out for 2013? Thanks.

Sheryl K. Sandberg

Chief Operating Officer & Director, Facebook, Inc.

A

So, on FBX, as everyone knows, it's real-time bidding for specific impressions. We're very encouraged by what we see both in terms of marketer demand and ad performance. And, the numbers, as I said in my opening remarks, are getting higher. We see good data from our clients and customers that it's driving more conversions. We have data from one of our customer – one of our clients, Triggitt, that FBX drives 36% more conversions than retargeting anywhere else. Shutterfly had a 4X higher return on ad spend than other platforms and we have a bunch of other examples like that. I would say the importance of FBX is not just the product itself but really what it represents and the other opportunities around making the ads more targeted. So, FBX is one way of making the ads better targeted and then more useful to users, which makes a higher return from advertisers. Custom Audiences is another, but I think what you're seeing from us is a really big push to make our ads higher quality, better for users, higher return for advertisers and FBX is just one of many ways we're working on doing that.

Mark Elliot Zuckerberg

Chairman & Chief Executive Officer, Facebook, Inc.

A

Yeah. And, I will just add to that a little bit but I think you mostly covered it. I think we're really early but what we really expected was to not be able to necessarily show everyone an ad every day because we weren't sure that we had the quality upfront. And that was some of the engagement metrics that I was talking about before. So, we've been positively surprised that the quality has been naturally high and there's been basically no engagement hit at all that's very meaningful. So, what that means is that now – previously, we thought we were going to have to spend 6 to 12 months just tuning in order to be able to get it to a quality level and then incrementally roll out ads; whereas, now we've had them rolled out and now we can go straight into doing the same types of things to improve targeting and improve the quality of the ad format, which obviously when they're fully deployed has much more leverage, those changes, than if we had to wait until we hit different quality thresholds to roll it out more. So, I think we're just pretty early. I don't know – it's not that it's going to go in a completely different direction. I think it's mostly the two things that we've talked about so far, good targeting and good ad formats. And, I think there's just a lot of room to grow in both.

Operator: Your next question comes from the line of Carlos Kirjner from Sanford Bernstein. Your line is now open.

Carlos Kirjner

Analyst, Sanford C. Bernstein & Co. LLC

Q

Thank you. I have two questions. Can you help us understand why ad ARPU in the U.S. grew 27% while it grew only 7% in Europe? Is spend on Facebook that sensitive to macro? And, on the platform, can you help me understand what metric you track to evaluate the progress and adoption of the Facebook platform outside Facebook.com? Is that the number of pages or objects tagged with Open Graph? And, are you in a race with Google – with Google's Knowledge Graph to be the basis of the Semantic Web or can both coexist? Thank you.

David A. Ebersman

Chief Financial Officer, Facebook, Inc.

A

Yeah, Carlos, I'll take the first one. So, I think that when you compare the disclosure we make about the U.S. and Canada to Europe, one of the notable differences is, in Europe as we continue to penetrate that market, we're getting into some of the lower monetizing countries in Europe. So, there's an inter-Europe lower price dynamic

going on where the ads – the places that are growing more rapidly are starting at a lower price point and bringing down the average either on a CPM basis or on an ARPU basis. So, I do think there are macro things that matter in Europe as well but I think that's the bigger point.

Mark Elliot Zuckerberg

Chairman & Chief Executive Officer, Facebook, Inc.

A

Yeah. And, then in terms of the point on structured data, there is Open Graph in order to help developers and people map out all the different connections between things outside of Facebook. But, one of the things that we talked about when we rolled out Graph Search is there are more than a trillion connections between people and things in Facebook today; that's the basis for Graph Search. I think a lot of the goal of having a utility like Graph Search is also to give people a reason to map out more of these structured connections themselves. So, you mentioned the Google comparison. I think we're just coming from a completely different place. Our whole product is people and structured connections to other people and content and things that they like; whereas, traditional web search is the exact opposite. It's completely unstructured. So, I think Google and others may be trying to put in some of the structured foundation but we just have years of having built that up and I think that we're just in a completely different place on that.

Operator: Your next question comes from the line of Youssef Squali from Cantor Fitzgerald. Your line is now open.

Youssef H. Squali

Analyst, Cantor Fitzgerald Securities

Q

Yes, thank you very much. Two questions please. First, starting with David. First, thank you for helping quantify the increase in operating expenses next year. I was wondering if maybe you can help us with the trajectory of that spend throughout the year. How long do you think this investment cycle is it going to be? Is it mostly 2013 or is it – or is this a multiyear cycle? And then maybe, Mark, maybe – can you talk just about the video opportunity for Facebook, video in the news feed that is? So, where are you in that process? Would that be something that organically you guys can do or would that – requires you guys to maybe acquire? Thanks.

David A. Ebersman

Chief Financial Officer, Facebook, Inc.

A

So, Youssef, we think we've got some really big and important opportunities right in front of us now and that's driving our decision-making around the level of investment we're making, which is important to us in 2013. That will moderate over time. But, I wouldn't want to make a firm commitment to exactly what it's going to look like in the future because particularly the R&D part of it is going to depend on what the opportunities are and how excited we are about the returns we can get from them.

Sheryl K. Sandberg

Chief Operating Officer & Director, Facebook, Inc.

A

Opportunities for video, not just ads but....

Mark Elliot Zuckerberg

Chairman & Chief Executive Officer, Facebook, Inc.

A

Yeah, I think I touched on some of this earlier in terms of making it – that news feed richer just enables more opportunity for this. There already are the ability for pages to post videos and different content into the systems. We actually have a very large volume of this. Another thing that we have the ability to support is people posting links on other services, right? So, for video advertising, it's not necessarily critical that we host the video. We want

to be the distribution platform for a lot of this stuff but there's definitely an opportunity and over time we'll have more to talk about it.

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

Scott W. Devitt

Analyst, Morgan Stanley & Co. LLC

Q

Thanks. I had a different question on the – that regional ARPU slide, which is – wondering the pace – or maybe where we are now from a Sponsored Story [Sponsored Stories] rollout and relative ad load in the U.S. relative to Europe and Asia. And, then secondly, it looks like the absolute additions of mobile users and mobile-only users was quite strong in the quarter; it was up 25% in terms of mobile ads and 30% in terms of mobile-only ads versus the third quarter. And, Mark mentioned a few areas. I was just wondering if there's any one or two things that really stand out in terms of driving that acceleration. Thanks.

David A. Ebersman

Chief Financial Officer, Facebook, Inc.

A

Okay. In terms of the ARPU by geography, I don't know that I have a lot more color to offer. The – in terms of the mobile news feed rollout, as you would expect with a new advertising product, really in the end of the second quarter and the third quarter it took off first in the U.S. and Europe followed and I think the growth was much more notable for that product area in Asia and the rest of world in the fourth quarter as compared to the third. And that's just the natural progression of how rollouts tend to go for us. In terms of your second question about the increase in mobile users and mobile-only users, which we agree is really important and impressive, I don't know that we would point to any one thing that drove that just as much as continued penetration of smartphones in – around the world in many markets and our ability to make our products better so that people are more inclined to use them.

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

Mark S. Mahaney

Analyst, RBC Capital Markets Equity Research

Q

Great. Thanks. I know it's very early stages, the rollout of the Graph Search, but any early signs of the impact that that has had on engagement? And then, Mark, you mentioned just early on about the new products, maybe some mobile-specific products and features. Any hint as to what those could be? Thanks a lot.

Mark Elliot Zuckerberg

Chairman & Chief Executive Officer, Facebook, Inc.

A

Unfortunately, I don't think there's that much that I can share with you on either of those. On Graph Search, it's still early. I am – this is one of the products that I'm the most excited about that we've built. It is a completely new pillar of our ecosystem, and I think it's going to be an important utility that people use. Right now, the whole strategy around this is it's a beta product and we are primarily rolling it out in order to get more data so we can incorporate the data of how people use it to make ranking better before we do a full rollout. So, right now, it's rolled out to the order of tens or hundreds of thousands of people, not extremely widely. And – so we have data but I don't think anything that is really relevant to share beyond that. In terms of the new experiences, I think the big theme that we're just going to push on mobile is people keep on asking if we're going to build a phone and we're not going to build a phone, all right, because that's – it's not the right strategy for us to build one integrated system where – so, let's say, we sold 10 million units; that will be 1% of users who cares for us, right? But, the big thing for us is we have a billion people using our products and we need to make Facebook really good across all of

the devices that they use and we're going to keep on pushing to get more integrated with the system. When Facebook is a product that people are spending almost 20% of their time or more on phones using, it really should be and I think people want it to be very integrated into all of the different devices that they have and that's what we're going to focus on. So, rather than just building an app that's a version of the functionality that you have today, I think making it so that we can just do – go deeper and deeper I think is going to be a big focus for us.

Operator: Your next question comes from the line of Ross Sandler from Deutsche Bank. Your line is now open.

Ross A. Sandler

Analyst, Deutsche Bank Securities, Inc.

Q

Great. Yeah, just one question for David on the right-hand rail revenue; so based on our math the overall news feed business may have been around \$500 million-ish in the fourth quarter, which would imply about a 10% decline for right-hand rail revenue. Does that make sense directionally? And, if so, can you just talk about how you think right-hand rail is likely to trend in 2013 and can the new ad tools like Custom Audiences help offset the desktop traffic decline that you're seeing in markets like U.S. and Europe? Thanks.

David A. Ebersman

Chief Financial Officer, Facebook, Inc.

A

Yeah, thanks for your question, Ross. For us, the most important metric is that the overall ad revenue increased 41%. I think that the way we think about things it's hard to really separate out the mobile and desktop or feed and right-hand column as separate and distinct businesses because, for most of our ads, marketers will tell us what ad they want to show and to what audience they want us to show the ad and we choose where it goes. It's not true for 100% of the ads, but it's certainly true in the majority case. So, our job is to find the place to put the ads that'll create the most value for the user and the marketer. So, the overall ad revenue number really provides a – just a better sense of how much advertising demand there is in the system that we're able to service. And, over time, we'll continue to experiment with how to optimize that. In general, you can see from the user numbers that the growth in usage is coming from mobile, and particularly in developed markets, the desktop usage continues to be flat or declining. So that's obviously the macro trend that will affect what the future of the right-hand column revenues are.

Operator: Your next question comes from the line of Neil Doshi with Citi. Your line is now open.

Neil A. Doshi

Analyst, Citigroup Global Markets Inc. (Broker)

Q

Great. Thanks, guys. Mark, could you maybe tell us how far along you are in terms of developing tools and providing more data and metrics to large agencies and advertisers? And then, David, in terms of the gaming declines that we're seeing on Facebook desktop, is there an opportunity for Facebook to help monetize – or to monetize games that are played on Facebook on the mobile side? Thank you.

Mark Elliot Zuckerberg

Chairman & Chief Executive Officer, Facebook, Inc.

A

Yes, these are important. Sheryl has more details on this so I think she should probably take the first one.

Sheryl K. Sandberg

Chief Operating Officer & Director, Facebook, Inc.

A

Yeah. Measurement is really important for us and it's one of the challenges we face. I remember, through the years I've worked on this, we know when search happened people weren't able to measure it and then they figured out how to measure search, and we're a new thing and people need to think about measurement differently. One of the most important things we need to do in the market is help educate people that a click is not really the most important metric for us. In fact, now that we've been able to work with companies to look at in-store sales data, we find that of the people who saw a Facebook ad and then purchased a product in the store, 99% of them never clicked on an ad. So, reeducating the market what the metrics are that are right for us. I would say in terms of our measurement capabilities we're really early. We weren't able to tie into sales data at all until pretty late in 2012. In order to do those studies, we have to work very deeply with retail providers and each client. A lot of our big clients have their own departments that do this measurement and we work with them individually. So, we're pretty early. We're happy with the progress we've made. We launched conversion measurements in – just in mid-December and that's probably available on the system. But, I think we have a lot of opportunity to do a lot more measurements a lot more rapidly. We're particularly excited about our ability to do this on mobile. With customers who have – using their data in a privacy protected way, we can now measure all the way from seeing a Facebook ad on a mobile device through to a purchase in a store and that's pretty exciting capability; we think it's pretty unique in the market.

David A. Ebersman

Chief Financial Officer, Facebook, Inc.

A

So, Neil, your second question was about mobile gaming. It's an interesting question as well. So, what we're seeing now is really strong growth and adoption of our platform in games on both iOS and Android, and we want Facebook to be the default social infrastructure for mobile games and feel like we're making progress in that direction and convincing developers that they'll get more users – more engaged users and better monetizing users if the users are able to connect with their friends and bring their Facebook identity with them. At this point, we don't have any payments integrations with these mobile games but our belief is that, if we can help game developers to grow users' engagement and monetization, it puts us in an interesting position to consider future financial relationships. And, the only other thing I would add is that we really launched or ramped up the mobile app install ads in the fourth quarter and are already seeing that that's a pretty promising way for developers to try and get better distribution for what they've built including games developers and that's a nice first step for us in trying to participate in the mobile gaming ecosystem.

Operator: Your next question comes from the line of Brian Nowak with Nomura. Your line is now open.

Brian T. Nowak

Analyst, Nomura Securities International, Inc.

Q

Thanks. I have two few questions. First one, can you talk at all to some of the engagement trends you're seeing within the demos? Specifically, what are you seeing in those younger post-college demos? Are their engagement trends per user still rising or are they starting to show signs of leveling off? And, then the second one is, when you look at your biggest categories of branded advertisers and where you're at, at this point, what do you see is still the biggest near-term opportunities where Facebook and social budget share is still low and pretty underpenetrated relative to your larger categories? Thanks.

David A. Ebersman

Chief Financial Officer, Facebook, Inc.

A

In terms of engagement, the – as we said, the overall engagement patterns remain really strong for us. We don't break out engagement metrics by self-reported demographics like age. I think the one thing that we can say is that our view is that the overall marketplace is expanding really rapidly here in terms of just the amount of time

people, college age, post-college, are spending connected, sharing with their friends, et cetera, and we think that's great for Facebook and our long-term position because we're a leader in such a rapidly expanding market.

Sheryl K. Sandberg

Chief Operating Officer & Director, Facebook, Inc.

A

I'll take the second part. We think we have really big opportunities across the board with the large brand spenders. If you just look at mobile, what you see, and Mary Meeker just put out a report on this, mobile gets 1% of ad revenue and 10% of time consumed. And so, right there you see a big gap. Our opportunities there are to ramp with the large advertisers, build more deeply internal measurement systems so we can measure, help them use the Custom Audiences and other targeting we offer because right now still a lot of our advertisers aren't using that targeting so they're sending more generic ads to our whole system and that's great. We have the scale to do that but a better ad experience will take advantage of the targeting we offer. We think in – sorry. In mobile, we have particularly – we think we're particularly really uniquely positioned. It's not just that we have unprecedented scale and huge engagement that Mark talked about in his opening statement. We have a natural ad format. One of the big successes of 2012 was putting ads into news feed and having them work, both for our clients on the marketing side but also for our users, the engagement Mark talked about. On mobile, because we have real identity and people are logged in, we have a really unique ability to serve relevant ads. And so, I think particularly in the mobile area, we are positioned in a very strong way compared to anyone else.

Operator: Your next question comes from the line of Justin Post with Bank of America Merrill Lynch. Your line is now open.

Justin Post

Analyst, Bank of America Merrill Lynch

Q

Great. I have a couple of questions. It definitely seems the mobile ramp slowed as the quarter progressed, obviously good numbers versus last quarter. Did you make an effort to maybe pull back some of the ad loads? Or, is there still a lot of opportunity to add more inventory in the mobile news feeds as we look forward? And, then secondly, maybe you could just comment on the health of the payments business. It looks like the U.S. was up quarter-over-quarter even if we back out the extra month. So, was that some of the other new initiatives? Or, did the gaming business get a little bit better in Q4? Thank you.

David A. Ebersman

Chief Financial Officer, Facebook, Inc.

A

On the mobile side, I think that it's just really important to recognize we're very early in this. So, of course, we're still making changes in terms of what ads we show, how we select them, how many we show to different users and under different circumstances. So, this is still very early in the process of us trying to learn how to optimize that business as we develop it. Our perspective is that we're still – we still have a lot of opportunity there. In terms of payments, I think that what you said is generally true. Note that this year, as opposed to last year, we do have a little bit of revenue from non-game sources as I said. So, you've got to neutralize or back that out if you want to compare games to games year-over-year. But having said that, if you make the year-over-year comparison, we do, as I said, we see – as I said earlier, we see a nice diversification happening in games. And, it's a very interesting business to try and even think about projecting going forward because some of the trends are really quite positive. But, you have to be mindful of the macro trend that we're not growing the essence of this user base in the developed markets right now.

Operator: Your next question comes from the line of Jordan Rohan with Stifel, Nicolaus. Your line is now open.

Jordan E. Rohan

Analyst, Stifel, Nicolaus & Co., Inc.

Q

Thanks. I have a couple of questions. Any chance you can clarify more than just the impression volume metrics that you gave on FBX? Importantly, when do you anticipate mobile news feed will be accessible through that platform? Separately, and given the promise of Gifts in e-commerce, why does it seem to be a business that you characterize as very small in the near term? What are the impediments to future growth so that you could call it big enough to matter or an important part of 2013 revenue mix? Thank you.

Sheryl K. Sandberg

Chief Operating Officer & Director, Facebook, Inc.

A

On the first one, on FBX, when it's available – no, but we just have nothing to share on that at this point.

David A. Ebersman

Chief Financial Officer, Facebook, Inc.

A

So, second question on Gifts, I think that I really can just reiterate what Mark said earlier, which is that the focus for right now is trying to figure out what the right product is. We think Gifts is – if done well, can be a very natural and positive part of the Facebook experience. So, for example, when you're wishing someone a happy birthday, the ability to send a gift along with that and just figuring out how the product needs to work, what the interfaces are, what the selection of products is, how the payment process works, all of that stuff is what we're going to have to optimize to make the product grow as you're asking. And, we're going to try to do that. That'll be something that we work on in 2013.

Operator: Your next question comes from the line of Brian Pitz with Jefferies. Your line is now open.

Brian J. Pitz

Analyst, Jefferies & Co., Inc.

Q

Thank you. Two questions. Mark, could you give us some examples of the kind of mobile-first experiences you're working on that you mentioned at the beginning of the call? And, also any comments on how integration with iOS 6 is benefiting your overall mobile strategy? Thanks.

Mark Elliot Zuckerberg

Chairman & Chief Executive Officer, Facebook, Inc.

A

I don't really think I can say any more about things that we're developing than directionally what I've already said. On iOS, there are two really big platforms out there today – there are three. It's Android, iOS, and mobile web. And, where we basically are the strategies for each of those are a bit different. So, mobile web, there's a limit to how – to the depth of how deep you can get into the system, but we can go as deep as anyone else that we feel pretty good about that and we think that our mobile web experience is really good and has on the same order of magnitude of users as our apps so that's actually really good. For Android, and then I'll get to iOS last, Android is a very dynamic and open platform as long as Google keeps it that way. And, there's actually – even though our relationship with Google isn't one where the companies really talk, it – we are able to do a bunch of things because they have an open platform that lets us get fairly deep into the system and build some really great experiences which I think will be – which we're excited on – about working on. An example that we have already that I can talk about is for messenger, on Android you can build a messaging app that can actually do SMS on the phone, right? You can't do that on iOS because, on iOS, iOS controls the SMS on the phone. But, on Android you can build something that does that and our messenger app does that. So that's a good kind of example of what we can do on Android. On iOS, because it's a more locked down system, the way that you can do deeper integrations is by working directly with Apple, right? And, they've been a great partner for us so far and we're really excited about

doing more there and people enjoy the integration that we have with them today to be able to share photos and share webpages from anywhere across the experience when you're on your iPhone or iPad and we're really happy with it. So, I don't think that there's any meaningful numbers to share their but qualitatively I think it's a really good experience and I'm really happy with the partnership that we have with them.

Deborah Crawford

Director of Investor Relations, Facebook, Inc.

A

Operator, we have time for one last question.

Operator: Okay. So, your last question comes from the line of Ken Sena with Evercore Partners. Your line is now open.

Ken Sena

Analyst, Evercore Partners (Securities)

Q

Thank you. Can you maybe give some color behind your decision to lower the price on the – the pricing floor on the marketplace? And, also can I get a – just a clarification on FBX? Are you doing about 1 billion impressions per day? And, then also within the 22% mobile number, is there any FBX within that? Thank you.

Sheryl K. Sandberg

Chief Operating Officer & Director, Facebook, Inc.

A

On the last, we're doing – you're correct, we're doing 1 billion impressions per day, and FBX is not available now on mobile.

David A. Ebersman

Chief Financial Officer, Facebook, Inc.

A

On the reserve price, we're always iterating and experimenting to optimize what we show for the user experience and for our business performance. The price floor has been something we've had in place. It's way below the average prices and the purpose of it has been to both support higher prices and limit poor quality ads. Over time, we've developed other tools that help us to achieve those objectives so the floor has become less important for us. And, there's – interestingly, there's some non-intuitive benefits also that we've been realizing which is that small businesses, as you can imagine, often create some of the highest quality and most highly engaging ads on Facebook. It makes sense because your local coffee shop feels like part of the community you live in and seeing an ad from them fits naturally into the experience that you want on Facebook. And, small businesses are often the lowest bidders in our auction. So, by lowering the floor, if we can bring in more small businesses into our network, get them comfortable advertising with us and hopefully ramp them up over time that should be a good thing. As I said, for the changes we happen to make this quarter, the impact was really primarily in international markets because the price floor really wasn't coming into play in most of the developed markets anyway.

Deborah Crawford

Director of Investor Relations, Facebook, Inc.

That's it. Thank you for joining us today. We really appreciate your time, and we look forward to speaking with you again next quarter.

Operator: Ladies and gentlemen, this concludes today's conference call. You may now disconnect.

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