

SNAP INC. Q1 2023 TRANSCRIPT

OPERATOR

Good afternoon, everyone, and welcome to Snap Inc.'s First Quarter 2023 Earnings Conference Call. At this time, all participants are in a listen-only mode. I would now like to turn the call over to David Ometer, Head of Investor Relations.

DAVID OMETER, HEAD OF INVESTOR RELATIONS

Thank you, and good afternoon, everyone. Welcome to Snap's First Quarter 2023 Earnings Conference Call. With us today are Evan Spiegel, Chief Executive Officer and Co-Founder, Jerry Hunter, Chief Operating Officer, and Derek Andersen, Chief Financial Officer. Please refer to our Investor Relations website at investor.snap.com to find today's press release, slides, investor letter, and investor presentation.

This conference call includes forward-looking statements which are based on our assumptions as of today. Actual results may differ materially from those expressed in these forward-looking statements and we make no obligation to update our disclosures. For more information about factors that may cause actual results to differ materially from forward-looking statements, please refer to the press release we issued today, as well as risks described in our most recent Form 10-K, particularly in the section titled Risk Factors.

Today's call will include both GAAP and non-GAAP measures. Reconciliations between the two can be found in today's press release. Please note that when we discuss all of our expense figures, they will exclude stock-based compensation and related payroll taxes, as well as depreciation and amortization and non-recurring charges. Please refer to our filings with the SEC to understand how we calculate any of the metrics discussed on today's call.

With that, I'd like to turn the call over to Evan.

EVAN SPIEGEL, CHIEF EXECUTIVE OFFICER AND CO-FOUNDER

Hi everyone and thank you all for joining us.

We began the year with an intense focus on growing our community, accelerating our revenue growth, and leading in augmented reality. Our community continues to grow, reaching 383 million daily active users in Q1, and we are working to deepen engagement with our content platform while building innovative new features and services. Our focus on visual communication between friends and family

has distinguished our platform from other internet platforms, and in Q1, we built on this core offering with the introduction of My AI, our new, AI-powered chatbot. At our annual Snap Partner Summit, we made My AI available to all Snapchatters around the world and launched a range of new features, including the ability to add My AI to a conversation with friends, offer Place recommendations from the Snap Map, and suggest more relevant AR Lenses. We are excited about the opportunities we see for more innovation, especially as we look across our application at how AI can further enhance the Snapchatter experience.

We are working to accelerate our revenue growth and we are using this opportunity to make significant improvements to our advertising platform to help drive increased return on investment for our advertising partners. We generated revenue of \$989 million in Q1, a decrease of 7% year-over-year, which was within the forecast range we shared entering the quarter. As expected, demand in Q1 was disrupted by the changes we made to our ad platform to drive more click-through conversions. While these changes are disruptive in the short term, we are optimistic that our ad platform improvements are laying the foundation for future growth. We believe that delivering stronger return on ad spend for our advertising partners will enable us to increase our share of wallet over time in this highly competitive environment.

We made progress diversifying our revenue through Snapchat+, our subscription service that offers exclusive, experimental, and pre-release features, which now has more than 3 million subscribers. We are excited about the launch of AR Enterprise Services (ARES), with our first SaaS offering called Shopping Suite, which helps retailers use our augmented reality platform to drive sales and reduce returns on their own applications and websites. Diversifying our revenue growth is an important strategic initiative, and we believe our leadership in AR technology provides a strong foundation to build enterprise services and deliver a more holistic solution for businesses who are already using our AR technology for advertising.

Despite the challenging operating environment this quarter, we continued to make progress on our path to sustainable profitability by achieving adjusted EBITDA of \$1 million, and generating \$103 million of free cash flow in Q1. As we enter Q2, we reflect on the progress we have made in transforming our business to succeed in an operating environment that has been shaped by platform policy changes, a more challenging macroeconomic environment, and an intensely competitive landscape. We began this transition with the reprioritization of our business last summer to focus on growing our community and deepening engagement, diversifying and accelerating our revenue growth, and leading in augmented reality. As a part of the reprioritization, we took decisive action to reduce our cost structure, and we are pleased to share that we achieved the cost-reduction targets we set in Q3 of last year.

With our new COO structure, which unified our engineering, sales, and product teams, we have brought in three regional presidents across the Americas, EMEA, and APAC, with Ronan Harris leading EMEA, Ajit Mohan leading APAC, and our newest hire, Rob Wilk, leading the Americas. We have also brought in several new engineering and product leaders to accelerate progress with our advertising platform. As this structure has improved coordination and prioritization across each of these teams, we have identified clear opportunities to further invest in our business. For example, we've uncovered opportunities to make targeted investments in ML infrastructure to improve our recommendation systems for content and ads, and we have identified areas for incremental go-to-market investments that we believe will help us to accelerate revenue growth.

Given the progress we have made with our ad platform, the experienced leadership team we have built, the work we have done to reprioritize our cost structure, and the strength of our balance sheet, we believe we are now well positioned to responsibly invest in the acceleration of our topline revenue. While there is still a lot of work to be done, we believe that our large and growing community, track record of innovation, and the changes we have made to drive focus will enable us to make the right investments for our business and realize the long-term growth opportunity we see ahead.

Thank you, and with that we will begin our Q&A session.

OPERATOR

Thank you. We will now begin the question-and-answer session. The first question is from the line of Mark Shmulik with Bernstein. You may proceed.

MARK SHMULIK, BERNSTEIN

Hi. This is Jenny on behalf of Mark Shmulik. Two questions, if we may. Firstly, the investment you've made to build out DR was always going to hurt revenue in the short run. How confident are you that the benefit is still there? And when do you expect to see it? And what markers should we be looking out for?

And then secondly, we've heard from a peer just how much short-form video lifted time spent overall. Any color that you could share on how Spotlight and creator stories is contributing to total time spend? Thank you.

EVAN SPIEGEL, CHIEF EXECUTIVE OFFICER AND CO-FOUNDER

Thanks for the question. Just taking a step back, we've done a lot of work over the last nine months to improve our advertising business, of course, starting with the organizational changes we made, appointing Jerry as our Chief Operating Officer and hiring three new leaders across each of our regions.

We've also hired a ton of strong leaders across monetization engineering and revenue product as well. And so, it's really great to bring that experience into the organization.

And obviously, bringing all these leaders together, reporting to Jerry has really helped everyone get aligned on our strategy. So, we've been making a lot of progress improving the platform. A lot of the early work was really focused on signal recovery using privacy safe integrations, like CAPI, for example, which we've discussed at length previously.

We've also done a lot of work to improve the post click experience with ads, which has made it easier for Snapchatters to convert on platform and really help close the gap between the first-party and third-party metrics reporting, which is really important for advertiser trust. And then, in the quarter, we also rolled out a new 7/0 Pixel Purchase offering for advertisers who want to bid against that objective.

But the biggest change overall that we made in the quarter that was the most disruptive was really the transition to click-based ad interactions across our different advertising formats and then the retraining of our models against those clicks. So prior to these changes, ad interactions across the different content formats, like Spotlight and Stories, were different, which made it a lot more confusing for our community to interact with ads on Snapchat.

So, for example, in Stories, people use a horizontal swipe to move to the next story and then a vertical swipe to open the ad. But on Spotlight, people use a vertical swipe to navigate to the next piece of content and then a tap to open the ad.

And so, now with these changes across Stories and Spotlight, we have click based interactions with ads, which has moved us a lot closer to unifying our overall content experience. And then, of course, we have been retraining our models against these new ad interactions.

So, there are some early green shoots like the growing number of active advertisers, which leads to more advertiser diversity and higher retention of advertisers, which is an important input to long-term growth.

But I think maybe more importantly, all of these changes have laid the groundwork for us to invest more in running bigger models, with more data and, of course, accelerating the rate of experimentation on our ad platform, which is super important and why we're ramping up our investment in cloud infrastructure to improve our ranking system.

So I think your second question was on Spotlight time spent. We're super excited about the progress we're making with Spotlight. We're now reaching 350 million monthly active users on Spotlight. Time spent is up 170% year-over-year. So that's a really exciting growth area for our business.

OPERATOR

Our next question is from Rich Greenfield with LightShed Partners.

RICH GREENFIELD, LIGHTSHED

Hi. Thanks for taking the question. I got a couple. I guess, given the infrastructure and creator investments that feel pretty vital to reversing the pressure you've seen on engagement in advertising, I guess the question is sort of why aren't you scaling back your AR investments? You talked about off-site partnerships, and I saw last week, things like AR Coke machines or vending machines, like why not scale back AR investments until you're in a better financial position. Obviously, it feels like Meta has got the luxury of sort of walking and chewing gum when I look at like their Metaverse investment. I'm not sure you have that luxury. So how do you think about – how do you balance sort of what you need to reaccelerate your core business versus sort of investing in the future?

And then two, I guess, just sort of high – a big picture question, Evan, of just – obviously, you've got what now is going to be another quarter of revenue declines at least based on your internal forecast in Q2. What gives you confidence that you can return to robust growth? Because I think, obviously, the big challenge here is investor confidence in you and the team.

DEREK ANDERSEN, CHIEF FINANCIAL OFFICER

Hey, Rich. It's Derek speaking. I'm going to start here, and then I'm going to kick it to Evan at the end to expand a little bit. I think taking a step back on the cost structure, as we discussed at our recent Investor Day, we remain committed to balancing our investments and our growth over time and to the generation of adjusted EBITDA profitability and free cash flow over time as well.

As part of that commitment, we took a significant action in Q3 of last year and over the course of the last two quarters to reprioritize our cost structure significantly, and we set a goal to remove \$500 million from our cash cost structure in order to create a path to adjusted EBITDA profitability and positive free cash flow, even at reduced rates of growth.

And as we noted in our letter, we actually exceeded the \$500 million goal. In Q1 of this year, we realized \$533 million in cash cost structure reductions. And that effort cleared the path for us to deliver adjusted EBITDA profitability and more than \$100 million in free cash flow in Q1 despite the 7% decline in revenue year-over-year.

So while we're pleased to have achieved those outcomes amid such a difficult quarter for our top line, we believe that the best path to delivering sustained profitability and free cash flow generation over time lies in accelerating our top line growth and better capturing our ARPU opportunity.

So, for example, the investments we're making in ML infrastructure to support our ad platform, the ML investments to deepen monetizable content engagement and the investments to develop My AI as a new input to understanding user interest and intent are all laser-focused on helping accelerate the top line.

Similarly, the investments we're making in the creator stories program, which you noted, while much smaller in scale are deepening monetizable engagement, and we've been pleased to see this drive really significant growth in impression inventory over the last two quarters.

So you're correct, these investments are collectively expected to put downward pressure on gross margins and adjusted EBITDA profitability in the near term, but we believe these investments will be substantially accretive over time and a critical input to sustain free cash flow generation and growth from there over time.

In other words, our internal forecast for Q2 is not intended to mark a shift in our financial discipline and instead is part of what we see as the path to resuming growth and generation of sustained free cash flow.

And then, in terms of prioritizing our investments to manage our cost structure, I think we really are fortunate that we made significant reductions already over the last six months. And then the work that we've done over a longer period of time to build a strong balance sheet, such that we can make these investments in the very near term to drive growth in a responsible way.

I think the last thing before I turn it over to Evan is just simply that we're going to measure the performance of these investments carefully and they're only going to persist in our cost structure to the extent that they're productive over any reasonable timeframe.

EVAN SPIEGEL, CHIEF EXECUTIVE OFFICER AND CO-FOUNDER

Thanks, Rich, for the question. I think as we look at our longer-term opportunity, the thing that really energizes us is just the strength of our community and their engagement. We now reach over 750 million monthly active users. And then, we continue to innovate at a really rapid pace. I think most recently with My AI, which is, I think, a really compelling extension to the messaging experience that people have on Snapchat.

I think more tactically speaking, if you look at the influx of really strong leaders that we now have on the ad side and the ad platform improvements that we're making, that gives us a lot of confidence in our ability to accelerate revenue growth, and it's why we have the confidence to make the investments that Derek mentioned, which I think are going to be really important to moving quickly here.

So I think just looking more broadly at the community and their engagement, we've never been more excited about our opportunity to really serve our community and, of course, realize the long-term potential of our business.

OPERATOR

The next question is from Michael Morris with Guggenheim. Please proceed.

MICHAEL MORRIS, GUGGENHEIM

Appreciate it. A couple of questions on AI. I guess, first, I'd be interested if you can share any early takes from the My AI distribution. I realize it's only been a week or so since it was rolled out more broadly, but would be curious what you've seen from your user base as it pertains to engagement with the product.

And then second, just maybe to expand on what was asked previously, but the broader question of the role of AI and the different functions of the company, driving engagement, helping advertisers with creative, can you share more details on kind of the timeframe to having that kind of functionality available and maybe how you view competition with some of the larger players in the space that are clearly working very hard on this to keep engagement on their own platforms? Thank you.

EVAN SPIEGEL, CHIEF EXECUTIVE OFFICER AND CO-FOUNDER

Yes, of course. So maybe I'll just talk a little bit about the way that we use AI across several core pieces of our business. So I think the three sort of major areas are, of course, messaging, augmented reality and then content/ads.

And so, for a very long time, we've used AI in our ranking system for content and ads. It's really been a core driver of engagement growth for us. And we're going to continue to invest there, including with new and bigger models.

And of course, I think we have a lot of the inputs we need to succeed there in terms of Spotlight submissions, for example, and of course, the audience and the growth we have in time spent in Spotlight, which allows us to explore a lot more content for ranking. So I think we're going to continue our momentum on the content and ad side.

In augmented reality, we've seen AI play a really important role in new Lens experiences, for example. Our ML- driven Lenses have driven a lot of engagement for Snap.

And then, as we look at the longer-term future of augmented reality, we think that the intersection of AR and AI is going to really provide a much more compelling user interface for things like Spectacles into the future. So that's a big research area for us.

And then, on the messaging side, we're really excited about conversational AI because it really plays to our strength as a messaging platform. And we're finding that, in addition to talking to friends and family all day long on Snapchat, people really enjoy communicating with My AI.

So don't have any specific stats to share with you just yet, but we've been managing the rollout really carefully to make sure that the experience is fast despite some of the capacity constraints we're bumping up against. But we're being thoughtful and deliberate with the rollout. We're really excited to get it out to our entire community and we're really pleased with the engagement so far.

OPERATOR

Next question is from Lloyd Walmsley with UBS.

LLOYD WALMSLEY, UBS

Thanks. Two if I can. First, just like what inning are you guys in of rolling out the DR shift to last click in terms of just educating advertisers, training the models and kind of how do you rank the importance of getting that right to drive the faster growth?

And then second one, I wanted to follow up on that last question on My AI. Like, how much do you see this providing you guys with more signal for advertising versus simply driving more engagement? Like, is that a meaningful opportunity for you guys? Anything you can share on early data from that and how you can kind of leverage that for monetization? Thanks.

JERRY HUNTER, CHIEF OPERATING OFFICER

Hi Lloyd. Thanks for that question. This is Jerry and I'll take that first question, and I'll hand it over to Evan for the second. For where we are on the DR changes, we went through a pretty major evolution on the platform. And as we mentioned in the letter, we're making progress across the three areas – investing in observability and measurement, improving the engagement and the quality of the conversions, and increasing that volume pipeline of high-quality engagements and conversions. We think that the big model and UI changes that we made are behind us, but we're still working through some impacts and making some steady progress. We're also going to always be shipping improvements to the platform, but we expect that these future changes are going to be more incremental and less disruptive.

On the importance of educating advertisers versus training the models, it's really both. What we've learned from these larger advertisers that we've worked with through this transition is that many are actually finding success now. We work with them to get to a place where they were finding positive ROI and then there's a few that we're still working with to get through the change to get them to positive ROI.

EVAN SPIEGEL, CHIEF EXECUTIVE OFFICER AND CO-FOUNDER

In terms of My AI, our primary focus right now is really on the community experience and trying to drive a lot of value for folks who are using My AI. Of course, the intent signal we get can be used to improve relevance of content or AR experiences, and that's definitely something we're working hard on. My AI can recommend places now and, of course, recommend Lenses. We're really excited to see folks' engagement there.

We are doing some early experimentation around monetization, including things like sponsored links, and I think the team will have more to share at our upcoming NewFronts presentation.

OPERATOR

The next question is from Doug Anmuth with J.P. Morgan.

DOUG ANMUTH, J.P. MORGAN

Hey. This is Katie on for Doug. Thanks for taking the question. Just wanted to dive deeper into some of the monthly revenue cadence. I believe you called out that March was up 21% month-over-month. So I'm just curious if you're seeing real uptick in demand through the course of the quarter? Or is that more a function of easier comps with lapping potentially Russia and Ukraine a year ago? And then just curious if you're seeing any of that improvement continue into April so far. Thanks.

DEREK ANDERSEN, CHIEF FINANCIAL OFFICER

Hey there. It's Derek speaking. I'll take that one. And I think maybe it makes sense to step back and just talk about the journey through Q1 and then what we're seeing into our internal forecast for Q2.

On the macro side, while the macro environment appears to have stabilized, it's stabilized at a much weaker level compared to where we were, for example, a year ago. We continue to be impacted by the platform policy changes and the tough competitive environment as well.

In Q1 specifically, as we shared in our letter, the changes we made to our ad platform were disruptive. And while some advertisers have already recovered to prior levels, and while some new advertisers are finding success under these changes, there are a small number of our top advertisers that have not recovered, and this continues to be a headwind to demand as we start making our way into Q2.

So while we're pleased with the progress we're seeing from many of our advertisers, they are, in many cases, growing off a smaller base and it will take time for this more diverse base of smaller advertisers to drive the overall top line.

In addition, we are concerned as we entered Q2 that there are some advertisers who rely on lift studies that provide measurement signals on a delayed basis. And then this could cause disruption in their spending in Q2 as they experience the initial impact of the changes we made in Q1 on a more delayed basis.

Our internal forecast for Q2, therefore, reflects these challenges as well as the investments we're making to accelerate our progress towards improving our ad platform.

Importantly, we are seeing sequential progress in the business. As we noted in the letter, month-over-month growth in March, for example, was 21%. And this was roughly in line with the seasonality month-over-month that we saw in 2021 and was well ahead of what we observed in 2022, although I'd note 2022 was impacted by the onset of the war in Ukraine.

In addition, our internal forecast calls for, at the midpoint, 5% quarter-over-quarter growth, which is further demonstration of our expectation that we'll see more sequential progress for the business as we navigate the changes. So, hopefully, that gives you a little bit of an understanding of the topography of what we saw in Q1 and how we expect that to transition into the new quarter.

OPERATOR

The next question is from the line of Michael Nathanson with MoffettNathanson.

MICHAEL NATHANSON, MOFFETT NATHANSON

Thanks. Two to Derek. One is, you've done a really nice job driving gross margin in the past few years. As you laid out in the letter, there were a couple of factors that may make it tough this year. Can you give me a sense of where you think gross margins bottom out in the near term just to dimension it for us?

And then, you just mentioned in that last answer about some small number of advertisers who have not yet returned to prior spending levels, what's causing that issue? And what alleviates that headwind to improve that situation? Thanks.

DEREK ANDERSEN, CHIEF FINANCIAL OFFICER

Sure. So starting on the gross margins, I think one of the things that's challenging here, obviously, is that, especially over any long period of time, gross margins are going to be impacted significantly by the top line revenue growth rate and, in particular, top line revenue growth rate relative to our investments in infrastructure and so on. So I would say it starts with expectations around revenue on the top line.

What we tried to do here, though, is give you an understanding of where we are investing on the cost of revenue side and some magnitude to help you model out and sensitize where gross margins might head. So, specifically, one really big component, the largest component of cost of revenue is infrastructure cost per DAU.

We shared in the letter that we expected sequentially that's likely to rise \$0.08 to \$0.12 off of the \$0.59 base that we saw in the current quarter. And that's really reflective of the significant investments we're looking at for ML infrastructure.

The largest portion of that is designed specifically to drive optimization and performance of the ad platform. A smaller minority share of that, but still significant, is investments in ML to drive depth of engagement on the content platform. And of course, that drives directly into monetizable content and top line as well. And then a smaller minority portion is the investment in My AI, which again is directly attributable to contributing to the top line in the form of better understanding of user interest and intent.

So, I think, in terms of other aspects of what's happening in cost of revenue and gross margins, over the last two quarters, we've taken an annualized \$84 million out of fixed content cost, that's a little over \$20 million a quarter. And we saw that benefit come on over the course of Q4 and then into Q1.

And so, that's been offsetting the cost of the creator rev share program over the last couple of quarters. As we start to lap those fixed cost investments reduction, sorry, in the back half of this year and hopefully continue to see great success with that creator story program, that will put a little bit of new pressure on those margins in the back half of the year, assuming continued success there.

But importantly, that program is rev share based and, therefore, scales with monetization. So, hopefully, that gives you a little bit of a sense of what's happening with gross margins and an ability to sort of think about how that will move with revenue over time.

And then, I think in terms of what we're seeing on top advertisers over the quarter, we've got advertisers who performed exceptionally well under the prior paradigm. As Jerry laid out earlier, we made a number of changes to the ad platform and folks who are particularly sophisticated prior to those are going to take time to recover and become equally sophisticated under the new ad unit design and interaction design, as well as tweaking their models to perform in a new environment, and that's not something that's going to happen quickly.

But we're working hard with those partners to help them with signal and modeling and development and performance and all of the investments that we're pouring into our ML infrastructure again are intended to contribute to that recovery. So, hopefully, that gives you a sense for how that's evolving.

OPERATOR

Our last question comes from Tom Champion with Piper Sandler.

TOM CHAMPION, PIPER SANDLER

Hi, good afternoon. Derek, curious if you could just talk about your advertising verticals and the pockets of strength and where it's weaker and how you're working with clients to build kind of relevant tools by vertical? Thank you.

DEREK ANDERSEN, CHIEF FINANCIAL OFFICER

Sure. I think, actually, I might ask Jerry to step in on that one. We've seen a continuation of strength in some of the same verticals we've been talking about for a few quarters, but he can probably talk a little bit more about some of the work that we're doing to support specific verticals under the new ad changes.

JERRY HUNTER, CHIEF OPERATING OFFICER

Yeah, largely, we're working with advertisers on CAPI and making sure that we're collecting information and signals. We're also orienting both the sales force as well as our product team that actually works with customers to work directly with these customers and build tooling that helps them find the performance that they're looking for.

And so, we're doing these customer by customer, and we've seen some positive – some very positive signals from some of these customers, where we've gotten them to get to a stronger ROAS post changes. We also have a bunch of other customers we're working with directly to improve their ROAS.

OPERATOR

This concludes our question-and-answer session as well as Snap Inc.'s first quarter 2023 earnings conference call. Thank you for attending today's session. You may now disconnect.