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Like all social media giants, Snapchat's business is all about ads.

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12-15 minutes

Snapchat started as Evan Spiegel's final project for a product design class at Stanford in 2011. The founder and CEO pitched a mobile app that permanently deletes photos and texts after opening them. His classmates thought it was a [terrible idea](#). Now, eight years later, Snapchat—the company's official name is Snap Inc. ([SNAP](#))—has become one of the hottest [social media](#) apps, the kind that feels comfortable turning down a [\\$3 billion offer](#) from Facebook (FB).

Snap went public in March 2017 with a market cap of \$17 billion, which it pushed to \$24.7 billion at \$24 a share during its first day of trading. This bombshell IPO earned Spiegel 37 million shares in Snap stock, worth \$637 million at the time, making him the best-paid CEO of 2017.

Despite its initial success, however, Snap has had a tough time since its IPO. The problems have been many, but they generally stem from Snapchat's failure to grow its user base as quickly as investors were betting it would. Growth has steadily declined since 2016, and the app actually lost two million and one million daily active users "DAU" in Q3 and Q4 of 2018, respectively. And while Snap's stock is again on the rise, the company's future is still uncertain.

In Feb. 2019, when Snap released its 10-K and [annual report](#), it had a market cap of \$9.7 billion—up from a low of \$5 billion in December, but about 60% less than its \$24 billion in March 2017. Snap has a return on equity (ROE) of -48.24% and a current ratio of 4.7.

Snap's Business Model

Snap calls itself "a camera company." It's not. Like other social media giants, it's an advertising company. According to Snap's annual report, 99% of its revenues came from advertising last year. (The other 1% came from Spectacles, sunglasses with built-in cameras that sync with Snapchat. They are Snap's only hardware product.)

Key Takeaways

- Like Facebook and Instagram, Snap sells ad space on its social media platform; Snapchat.
- Since its IPO in March 2017, Snap's market cap fell over 60% by the end of 2018. It is now rising again.
- Snapchat's average revenue per user (ARPU) has increased 37% to \$2.09 in Q4 2018, compared to \$1.53 in Q4 2017.

Snapchat's Core Features

Snap sells ad space on Snapchat, making it impossible for users to avoid exposure to ads if they wish to use the app. To understand how advertising on Snapchat works, it is necessary to first understand Snapchat's features.

- The "Friends Page" is where Snapchat's core function resides; the one Spiegel first pitched at Stanford in 2011. Users can send their friends "Snaps"—photos, videos, or text messages that disappear after they are opened and viewed once. Individual videos can be up to 10 seconds long and can be strung together infinitely.
- With "Stories" users can broadcast Snaps for 24 hours (after which they disappear) to either their Friends or anyone who finds their profile, depending on a user's privacy settings.
- The "Discover Page" (referred to internally as simply "Discover") is situated beneath the horizontally oriented Stories feed, the Discover Page is a feed of popular stories and content created specifically for Snapchat. This content is uploaded by influencers, advertisers, or

partnered media companies—like CNN, ESPN, or E!. Snapchat's algorithms curate this content for individual users based on their locations and preferences.

- The “Snap Map” is a live, geographical representation of Snapchat activity. It shows users popular Stories near them and where their Friends are. Users can opt out of being visible to others on the Snap Map.

Sponsored Lenses

These are animated, interactive augmented reality filters (meaning animated graphics that respond to users' facial movements) that users can lay over their Snaps and Stories. Brands can buy Sponsored Lenses that include messages they want users to see. For example, a film studio might advertise an upcoming superhero movie by purchasing a Sponsored Lens that makes users look like characters from the film. Users can then take selfies and videos with this Sponsored Lens and send them to their Friends or publish them to their Stories.

Snap Ads

This product allows advertisers to use Snapchat's Stories feature like users do. Users are shown these Snap Ads when they flip through their Friends' Stories, when they browse the Snap Map, or when they scroll through the Discover Page. Snap Ads stay live for more than 24 hours, can be longer than user-generated Stories, and can include interactive software and download links.

Original Content Commercials

In October of last year, Snapchat announced a new lineup of 12 original shows with four to five minute episodes it calls “Snap Originals.” These shows, which users can find on the Discover Page, are created especially for consumption on vertical smartphone screens and include six-second, unskippable ads that appear a few times per episode.

Snap Games

In April, Snapchat launched an in-app gaming platform akin to Facebook's. The games are free for users to play. Advertisers can buy ads that are shown when a user opens a game and periodically during lulls in gameplay.

How Advertisers buy Ads on Snapchat

For Snap's first few years, advertisers purchased Sponsored Lenses and Snap Ads through a personalized direct-sales ad team. Then, in June 2017, Snapchat began automating the process. Now, advertisers can buy Snap Ads and Sponsored Lenses through a series of self-serve tools. Businesses of all sizes can use these tools to buy, optimize, and manage their ads. Snap also offers analytics with these tools.

Ad Pricing

Since its introduction of Sponsored Lenses in 2015, Snap's ad pricing has been all over the place. For the first year, **Sponsored Lenses cost between \$300,000 and \$500,000, and Snap Ads a whopping \$750,000.** These were huge sums to charge for access to a platform that was difficult for advertisers to understand and that demanded specially made content that was often impossible to reuse elsewhere.

According to James Douglas—head of media at Reprise, an IPG-owned digital marketing agency —“Brands put them in the penalty box” for those prices (AdAge). As a result, Snap's prices cratered. They reached a low point in June of 2018, when Snap Ads cost \$2.95 per thousand impressions (CPM), compared to \$4.20 on Instagram and about \$5.12 on Facebook's mobile app (AdAge).

This price drop was also fueled by Snap gradually phasing in its self-serve tools, which determine ad prices through programmatic bidding, the same process Facebook uses. This shift is a risky move because it allows advertisers to compare Snap's auctions with Facebook's directly, which are much more competitive.

Things may finally be looking up, though. In Q4 2018, Snap's average ad price **increased** sequentially 3% over Q3, the first time that has happened since it introduced programmatic bidding. There are likely two reasons behind this increase. First, as chief business officer Jeremi Gorman told investors on the company's fourth-quarter earnings call, Snap has seen a steady growth in active advertisers since it

launched programmatic bidding in 2017. And second, Snap has recently added higher-value ads like the unskippable “Commercials” in Snap Originals.

To put it lightly, things have been complicated for Snap since its March 2017 IPO. However, the company's long, painful slide seems to have reached its nadir in Dec. 2018, when share price hit \$4.99. Since then, it's seen a steady rise to about \$14 in June. Snap's average revenue per user (ARPU), a key metric for social media companies, has also shown promising growth. It increased 37% to \$2.09 in Q4 2018, compared to \$1.53 in Q4 2017, and dropped another 20% to \$1.68 in Q1 of 2019.

Facebook's ARPU was \$6.42 at the end of Q1 of 2019.

Future Plans

As part of its strategy to compete in the social media market, Snap is comfortable making risky investments. Some of these, like Spectacles, fail rather spectacularly. Only 150,000 have been sold; the majority of users stopped using them [after a month](#). But others, like Snap Originals' Commercials and the shift to programmatic billing, seem to be beginning to pay off.

New Products

In April, Snap announced three new products at its first-ever partner summit in Los Angeles. These include Snap Games, Snap Scan, and Snap Audience Network. Snap Games is an in-app gaming platform akin to Facebook's. Snap Scan elaborates on Snapchat's augmented reality capabilities, attracting developers by making it easier to add AR features to the platform. Snap Audience Network will allow third party app developers to run Snap Ads on their own platforms. In exchange for selling the ads on behalf of the developer, Snapchat keeps a portion of the ad revenue. Snap Audience Network lets advertisers reach a larger audience and means more ad revenue for Snap.

More Content

According to Snap's fourth quarter earnings call, the company plans to respond to perceived demand for more original and user-generated content on the Discover page. This means more Snap Originals and more content from influencers. These expansions account, in large part, for Snap's plan to deepen engagement with its core demographic—13 to 34 year-olds in the U.S. and Europe—to squeeze more ad revenue out of them.

Android Update

Snap's biggest project for the coming year is to reengineer its Android app. Snapchat has been notoriously slow and buggy on Android smartphones, and is virtually unusable on lower-end Android devices that have slower processing speeds and lower quality cameras. Such is the curse of a social media platform based on data-intensive content like photo, video, and augmented reality. Snap's goal is to make its Android app 20% faster in 2019. Snap executives have been cagey about when this update will be ready.

International Expansion

The Android update also ties into Snap's plans to tap into international markets. Android users vastly outnumber iOS users in developing markets, and Snap estimates its missing out on about two billion potential users because of Snapchat's incompatibility with Android and slower network speeds. However, as with the Android update, details about Snap's plans for international plans are few and far between.

Reeling in Older Users

Snap has also expressed plans to expand their core user base to people who are 34 and older. In a [memo](#) leaked by the website Cheddar, Snap has suggested pitching its app to older users as “a fast way to communicate visually and with close friends.” But this approach was widely regarded with skepticism because other platforms offer the same services, while older users are known to find Snapchat difficult to use. Alternatively, Snap could partner with publishers who better appeal to older users to fill the discover page with content such users might enjoy. However, this is also a long shot.

According to a 2018 survey by Pew Research Center, 69% of American teens (13-17 years old) use Snapchat, behind Youtube with 85% and Instagram with 72%.

Key Challenges

Although Snap has enjoyed a recent rise in stock price, long-term trends don't bode well for the company. Snap's revenue growth is slowing—from 103% in 2017 to 43% in 2018—and with a projected growth rate of 34%, at best, in 2019. Snap's growth rate for ad impressions is also potentially unsustainable. According to its annual report, impressions grew 575% in Q4 of 2017, 278% in Q3 of 2018 and only 179% in Q4 of 2018. On top of that, Snapchat lost users for the first time in 2018, two million in Q3 and one million in Q4, which is a terrible sign for a business that relies on user engagement and CPM for revenue.

If recent developments continue, things may be turning around. Ad sales are up slightly, ad prices are finally rising and new products are on the horizon. Maybe momentum is beginning to shift in Snap's favor. However, when one takes a step back, longer term numbers point to underlying instabilities in Snap's business.

A Concerning History

There are other warning signs that Snap may be in trouble. According to Recode, 10 executives who reported directly to Evan Spiegel have [left Snap](#) since mid-2017. The founder and CEO is reportedly very difficult to work for, which has led to a level of executive turnover that BTIG analyst Rich Greenfield called “simply shocking.”

Snap also has a spotty history with government regulators. In 2014, Snap agreed to settle with the FTC that it had been deceiving its users about the “disappearing nature” of its Snaps. Snap was required to implement stronger privacy measures and agreed to be monitored by an independent party for the next [20 years](#). Also, the DOJ [subpoenaed](#) Snap in Nov. 2018, as part of an ongoing investigation into whether Snap manipulated its IPO.