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Scripts for:

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<u>Dominic Paschel</u>

Good afternoon, and welcome to Pandora's second quarter 2017 financial results call. Before we begin, let me remind everyone that today's discussion will contain forward-looking statements based on our current assumptions, expectations and beliefs, including projected financial results or operating metrics, business strategies, anticipated future products or services, anticipated market demand or opportunities and other forward-looking topics. For a discussion of the specific risk factors that could cause our actual results to differ materially from today's discussion, please refer to the documents we file with the Securities and Exchange Commission.

Also, during this call, we will discuss non-GAAP measures of our performance. GAAP financial reconciliations and supplemental financial information are provided in the press release filed today with the SEC, and detailed financials are available on our Investor Relations site.

Today's call is available via webcast and a replay will be available for two weeks. We will also post the full text of today's prepared remarks once they have been concluded. You can find all of the information I have just described on the Investor Relations section of Pandora.com. With that, let me turn the call over to Naveen Chopra, Pandora's CFO and Interim CEO.

<u>Naveen Chopra</u>

Refocused Company Strategy

Thanks, Dom, and thank you to everyone for joining the call today. During the quarter, we've taken a number of steps to optimize Pandora's strategic position in order to capture our sizable market opportunity and deliver maximum value to shareholders, listeners, partners and employees. Before we discuss second quarter operational results, let me outline what we've done from a strategic perspective:

- First, we announced changes to our board and management that are intended to bring new expertise and capabilities to our business. I'd like to take this opportunity to thank the prior team for their extensive contributions to Pandora and Tim Westergren in particular for his vision as our founder. Under Tim's watch, Pandora fundamentally changed how people listen to music and created a best-in-class product portfolio that serves many types of music listeners and greatly enhanced our relationships with the music industry.
- We also secured a major investment from SiriusXM, which will dramatically strengthen our balance sheet and bring valuable strategic insights to Pandora. As you know, Sirius's controlling shareholder, Liberty Media, has an impressive track record operating media businesses. Additionally, we see opportunity, as does Sirius, after the requisite government approval, to potentially up-sell, cross-sell and share content or technology.
- Furthermore, we decided to divest a non-core asset, Ticketfly, which will allow us to focus on our key advertising and subscription-based operations while exploring commercial relationships with a broader set of ticketing partners. Together with the proceeds from the Sirius investment, we believe that Pandora's financial future is secure with ample firepower to enable sustained, profitable growth.

These changes present the opportunity to refine our strategic, operational, and financial objectives in light of evolving industry dynamics and changing consumer behavior. We have built a unique ecosystem at Pandora: a very large base of highly engaged listeners that power a compelling advertising business which has significant growth potential thanks to renewed focus on technology and innovation. In addition, we now have the ability to provide fully on-demand listening through our subscription products. These services help retain and grow listeners, in particular younger demographics, and enhance their engagement on our platform in a way that is highly accretive over the long-term. It is this ecosystem approach, that allows us to catalyze and benefit from changing consumer behavior - whether it be the continuing ability to capture listeners from terrestrial radio or the opportunity to engage listeners in the rapidly growing world of connected audio devices. And, we will have the financial resources to pursue these opportunities, among others, and in conjunction with our new partners at Sirius, drive value creation for all of our shareholders.

With that backdrop, I'd now like to discuss second quarter results.

Brief Overview of Q2 Financials

From an operational perspective, Q2 was a solid quarter. We exceeded our revenue guidance thanks to better than expected advertising performance and Adjusted EBITDA came in above the midpoint of our guidance range. Karen Walker, our new Chief Accounting Officer will walk through our detailed results later in the call, but before she does so, I'd like to provide color on some key drivers of the business: Active Users, Advertising, and Subscriptions.

Active Users

For the quarter, Active Users were 76.0 million, representing a 2.7% decline year over year. We are encouraged that the year-over-year rate of decline in Q2 was lower than the 3.3% rate of decline we experienced in Q1. Additionally, the sequential decline of 1% we saw from Q1 to Q2 this year, was lower than the 1.7% decline we experienced from Q1 to Q2 in 2016. And, we're seeing stronger year-over-year engagement, with listeners tuning in an average 26 days per quarter, up 2% vs Q2 2016, and also representing an all-time high.

These improvements are a result of various initiatives we have implemented to retain and acquire listeners. During Q2, we adjusted on- and off-platform marketing efforts to refocus on audience growth versus subscription promotion - broadening the target audience and increasing our direct response spend - to drive new and lapsed users back to the Pandora ecosystem.

There is still more we can and intend to do to address the decline in active users. In the relatively near term, we believe that investment in science and technology that optimizes the listener experience via more personalized ad load and innovative ad formats, will help address the component of the active users impact that relates to increases in audio ad load. For example, further enhancing our insertion logic to deliver ads to the right listener at the right time, serving shorter length spots, and incorporating innovative ad products such as "sponsored listening," are all advancements that enable us to increase ad loads without negatively impacting ad-effectiveness or listener retention.

Longer term, active user growth is obviously a function of our ability to extend and evolve our products to meet the changing needs of consumers. To that end, we believe the combination of market trends, our product roadmap, and future marketing initiatives will allow us to materially bend the curve on active users.

In particular, we are well-poised to capitalize on the huge growth being experienced in consumer electronic devices, including the trend toward voice-activation, and more connected automotive interfaces. In the quarter, we saw 9.7 million active users from consumer electronics alone, up 23% year-over-year, with 10% of those incremental CE listeners being new to the Pandora platform. Active users from voice-activated devices - a very natural platform for Pandora - accounted for 1.6M of those, up 282% year-over-year. In the back half of the year, we will deepen our existing relationships with partners like Amazon, Google and Sonos, while also adding new partnerships to expand our suite of over 2,000 connected devices.

New additions in content, including an expansion of curated playlists, will also give listeners more reasons to come to Pandora. And we expect to continue to optimize our marketing and retention efforts with the help of new marketing automation technology.

Meeting our ambitions with regard to user growth won’t be an overnight endeavor, but now with key pieces in place, we are laser-focused, and well-equipped to grow active users which facilitates growth in our advertising business and the opportunity in subscription.

Advertising

For the second quarter, advertising revenue grew approximately 5% year-over-year. Revenue growth was driven by shifting sales from lower-value channels to higher-value channels while simultaneously increasing ad loads. Specifically, average audio ad load increased -- from 3.3 to 5.3 spots per hour relative to the year-ago quarter and overall effective CPMs, meaning our blended realized CPM across all ad formats was consistent with the year-ago quarter and up substantially relative to Q1. CPMs for video and display were up year-over-year by 8% and 22%, respectively, and audio CPMs recovered nicely, up 26% relative to the most recent quarter. Our video advertising business continues on a strong trajectory, with revenue from sponsored listening video up 46% in the first half of 2017 vs 2016, while standard video revenue is up 16% in the same time period. Lastly, local advertising grew 15% year-over-year thanks to the increased efficiency of our local sales teams. It's worth noting that this strong performance in advertising occurred during a quarter in which we were using more inventory than normal for house ads to support the launch of our subscription products. This quarter’s results are also a great example of our ability to generate more value from our ad-supported audience even while listenership levels may not be growing.

Going forward, we expect the trends in our advertising business to continue to improve. Our first half video momentum sets us up nicely for a successful launch of programmatic video and cost-per-view video products in Q3, and our launch of audio programmatic is expected to follow in Q4. Longer-term, we see significant opportunity to increase our share of ad dollars. The radio advertising market continues to be significant, at approximately $15 to $17 billion. And we see further opportunity to expand in local, not only by pulling from broadcast radio, but also from the larger total $50 billion local advertising opportunity, as traditional channels such as local television and newspaper become digital. The shift in listening is evident; the proliferation of earbuds and the adoption of voice-activated devices are also reinvigorating the audio ad marketplace, one which we are very well-positioned to continue to dominate.

Subscription

Q2 marked the full launch of Pandora Premium with the introduction of our marketing campaign in mid-April. Although it is still early days, Premium fills an important need in our product portfolio, and we are encouraged by the high engagement of Premium listeners. On average, hours per listener increases by 43% when a user upgrades from our ad-supported service to Pandora Premium. And both of our subscription products, Plus and Premium, over-index with listeners under the age of 25 with the proportion of new subscribers in this age group growing 72% relative to the same time period in 2016, demonstrating their interest in on-demand product features.

We began converting subscribers from trials in mid-May and ended the quarter with approximately 390,000 Premium subscribers. Q2 total subs grew by 150,000, to 4.86 million subs, due to the fact that a material number of would-be Plus subscribers entered trials for the Premium tier during the quarter. We expected that this dynamic would exist during the early phases of Premium. Overall, 64% of our Premium subscriptions came from our ad-supported tier, and we expect the free-tier will continue to be our primary source of subscribers going forward.

As we progress through the year, we will continue to enhance our premium product and optimize our marketing efforts. We expect to launch new distribution partners, new billing options, and subscriber retention programs. Our primary goal with Pandora Premium is to ensure that we keep consumers who seek fully-interactive listening within the Pandora ecosystem. Our marketing approach reflects this goal as we are now focusing our off-platform promotional efforts on acquiring active users for the ad-supported service and then utilizing a variety of on-platform tools to determine which tier of service will be most "sticky" for any given listener. This model ensures that we are first growing a healthy advertising-supported base of listeners and then layering on subscription “upside” which, by the way, can be done in an economically sound manner due to the low costs of acquisition associated with moving a listener from a free to paid tier. To be clear, we continue to believe that a compelling on-demand product is critical to maintaining and growing our total audience. Without such capabilities, we would risk decline of our user base.

With that color on some of the key components of the business, I will now turn it over to Karen who will walk through some details on the quarterly results.

Karen Walker

Second Quarter Performance

Thanks Naveen. I'm very excited to be here. I have been a loyal listener and long admirer of the Pandora brand and the unique and powerful listening experience it provides its users. I joined Pandora because I believe that we have superior products and the right strategy to capitalize on the huge opportunity in front of us. I look forward to working with you and the team to help execute the Company's strategy.

Now onto second quarter results. Total revenue for the second quarter was $376.8 million, above the high end of our guidance. Advertising revenue was $278.2 million, compared to $265.1 million in the year-ago quarter growing 5% year-over-year.

Ad RPM grew 24% year-over-year to $66.15, which is a second quarter record, and our second best quarterly ad RPM ever.

Subscription and other revenue was $68.9 million, an increase of 25% over the same period in 2016. Net subscribers increased 24% year-over-year to 4.86 million. Subscription ARPU was $4.82 up from $4.76 in the prior quarter, reflecting a shift from Pandora Plus to Premium. Subscription ARPU was $4.82 in Q2, up from $4.63 from a year ago. We expect to see some fluctuation in the rate of subscriber growth as users come on and off trial subscriptions, and we continue to remain excited about the Pandora Plus and Premium opportunities, as outlined by Naveen earlier.

Content Costs

Ad-related content costs represented 54% of advertising revenue in Q2. For the quarter, ad LPM was $35.84, an increase of 17% compared to the same quarter last year and an increase of 7% from Q1. Relative to the year-ago period, the ad LPM increase reflects the impact of direct deals. Subscription-related content costs represented 66% of subscription revenue in Q2. For the quarter, licensing cost per subscriber (or LPU), was $3.11, an increase of 5% from Q1. The increase in ad LPM and subscription LPU relative to Q1 relates to accruals for certain minimum guarantees and changes in our expectations regarding total subscriber counts and the point in time at which volume discounts are likely to kick-in. We expect content costs to remain above optimized levels until certain subscription thresholds are met.

Gross Margin

Non-GAAP gross margin was 36%, compared to 38% in the year-ago quarter. The decline in margin year-over-year was primarily driven by higher statutory rates under direct-deals versus statutory rates.

Q2 Operating Expenses

Turning to operating expenses, for the second quarter of 2017, non-GAAP sales and marketing expense was $126.6 million, an increase of 20% compared to the second quarter of 2016. The majority of the increase was driven by direct marketing spend for the Premium product launch and brand advertising campaigns, as previewed last quarter. We expect the full-year sales and marketing expense for 2017 to be relatively flat to 2016.

Non-GAAP product development expense was $31.5 million for the second quarter, an increase of 29% compared to the second quarter of 2016, primarily driven by an increase in average headcount and lower capitalized personnel costs following the launch of Pandora Premium. R&D expense is expected to remain relatively flat through the end of the year. We continue to believe that product and service innovation is at the core of our value proposition for both advertisers and consumers, and we intend to continue to prioritize product development investments going forward.

Non-GAAP G&A expense was $44.4 million, an increase of 38% compared to the second quarter of 2016, primarily driven by a number of one-time items, including a $6.6 million charge related to the bankruptcy of a large Ticketfly client, the Pemberton Music Festival. Non-GAAP G&A also included legal fees of $3.8 million related to the rate-setting proceedings under Section 115 of the DMCA, which occur every five years. We expect G&A as a percentage of revenue, as well as absolute dollars, to decline for the remainder of the year.

Adjusted EBITDA

Adjusted EBITDA for the second quarter was a loss of $54.3 million exceeding the midpoint of our guidance range. Had it not been for the previously mentioned bad debt expense for Pemberton, we would have exceeded the high end of our guidance by a significant margin. Q2 Adjusted EBITDA loss was $29.2 million higher than the same period a year ago, primarily due to the increases I described earlier in both sales and marketing and G&A. As Naveen mentioned, we will continue to carefully manage headcount with a focus on the bottom line, while focusing our hiring in high-priority areas. The detailed reconciliation of Adjusted EBITDA to Net Loss is provided in our press release.

EPS

Second quarter 2017 GAAP basic and diluted net loss per share was $1.20. Non-GAAP basic and diluted net loss per share was $0.21. GAAP and non-GAAP basic and diluted EPS were based on 241.3 million weighted average common shares outstanding.

Cash

Pandora ended the second quarter with $227.6 million in cash and investments compared to $203.0 million at the end of the prior quarter. Cash used in operating activities was $103.5 million for the second quarter and included a number of one-time items such as $23.5 million of fees related to the KKR contract and its termination, and $6.6 million related to the bankruptcy of the Pemberton Music Festival. Cash of $25.6 million for the Ticketfly segment was reclassified as held for sale on our balance sheet along with the total Ticketfly net assets.

Transaction-Related Activities

During the quarter, we initiated several significant non-routine transactions which I'll outline briefly and explain the expected impact of the transactions on 2017 financials:

We executed an investment agreement with Sirius XM, which will allow Sirius to purchase an aggregate of $480.0 million of newly issued Series A preferred stock. The preferred stock has a $1,000 liquidation preference per share convertible into common shares at $10.50 per share. The investment occurs in two stages: the first closed on June 9th and the second will close following regulatory approval, which we expect to occur in Q4. Total proceeds net of transaction fees from the initial closing were $158.6 million.

Also during the quarter, we agreed to sell Ticketfly to Eventbrite for $200 million, which consists of $150 million in cash and a $50 million convertible note receivable, which we expect to close in the back half of August.

On June 27, we announced a plan to discontinue our New Zealand and Australia operations and incurred related restructuring charges, the details of which are included in our 10-Q filing. We are currently winding down the service and beginning in Q3, active users and listener hours from Australia / New Zealand will no longer be included in our total active users and listener hours numbers. For the end of the year, we would have expected 1.3 million active users from the region.

As a result of these activities, we expect a $50-55 million reduction to 2017 revenue. In terms of EBITDA, we don't expect a significant impact given that Ticketfly was operating at near break even, and Australia & New Zealand's contributions were not material.

With that, let me hand the call back to Naveen to discuss guidance.

Naveen Chopra

Thank you, Karen.

Guidance

Before providing our estimates for Q3, I'd like to walk through adjustments to our existing full-year guidance to reflect the changes we announced with Ticketfly and Australia / New Zealand. On our prior call, we guided to an annual revenue range of $1.50 to $1.65 Billion. As previously noted, Ticketfly and ANZ represented $50-$55M of revenue between the anticipated close dates and the end of the fiscal year. So, incorporating the Ticketfly sale and the shutdown of Australia / New Zealand would imply that our previously issued annual guidance was effectively $1.45 to $1.60 billion. With the completion of Q2, we are now able to narrow our 2017 revenue expectations to $1.45 to $1.50 billion. We are lowering the top end of the guidance range to reflect the fact that we are prioritizing the growth and retention of active users rather than aggressively pushing all users to subscriptions. As a result, our expectations for subscriber growth during 2017 have been revised. As I noted earlier, we believe this approach will optimize the overall health and value of our business. Average basic shares outstanding for calendar year 2017 are expected to be approximately 243 million. We are currently forecasting a non-GAAP effective tax rate of approximately 32% to 37% for the full year 2017. However, the Company is not expected to incur any material cash taxes due to its net operating loss position.

For Q3, we expect revenue in the range of $370 to $385 million, reflecting a 14% year-over-year growth rate at the midpoint, when adjusting for the divestiture of Ticketfly. As a reminder, Q3 revenue guidance assumes only two months of sales from Ticketfly. Adjusted EBITDA is expected in the range of a $20 million loss to a $5 million loss. Adjusted EBITDA differs from GAAP net loss in that it excludes forecasted stock-based compensation expense of approximately $32 million, depreciation and amortization expense of approximately $15 million, other expense of $7 million and a provision for income taxes of approximately $0.4 million and assumes minimal cash taxes given our net loss position. Basic shares outstanding for the third quarter of 2017 are expected to be approximately 245 million.

In Summary

In closing, I hope you recognize our renewed focus on two key priorities: (1) growing our overall base of listeners, and (2) continuing to improve monetization of those users. We now have the critical pieces in place to pursue these goals, including:

- A core advertising business which remains the largest publisher of digital audio advertising in the US and which has significant room to grow both its audience and its ability to monetize that audience;
- A subscription business that improves our ability to engage younger listeners and retain those consumers who seek on-demand listening capabilities;
- A strong balance sheet that provides flexibility to operate and invest in ways that continue to drive scale and enhance shareholder value;
- A strong operating team and new board members with a successful track-record operating pioneering media businesses, similar to Pandora;
- And, we continue to enjoy relationships with the music industry that are stronger than ever, assuring the delivery of content to attract and engage listeners.

We look forward to updating you on our progress in all of these areas on our next call.

And now I'll turn the call to the operator, who will open the line for your questions. Operator?