Pandora (P) Q417 Financial Results Conference Call February 21, 2018

Scripts for:

Derrick Nueman, Vice President, Pandora

Roger Lynch, President & CEO, Pandora

Naveen Chopra, CFO, Pandora

February 21, 2018

<u>Derrick Nueman</u>

Good afternoon, and welcome to Pandora's fourth 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. On today's call joining me are Roger Lynch, Pandora's President& CEO, and Naveen Chopra, Pandora's Chief Financial Officer. With that, let me turn the call over to Roger, welcome Roger.

Roger Lynch

Introduction

Thanks Derrick and as you all know this is Derrick's first Pandora earnings call and we are excited to have him here.

Good afternoon everyone.

I've now been at Pandora for almost five months, and having had a chance to dig in, I'm even more excited about the opportunity. We continue to set the standard for music discovery and as a result, our users spend more time with Pandora than any other digital publisher (as measured by Comscore). With nearly 75 million monthly active users, Pandora remains the largest streaming audio provider in the United States and is the largest publisher of digital audio advertising. We are well positioned to enter a new era of audio.

What do I mean by this?

- Digital audio is on the verge of massive growth.
- Americans listen to an average of 4.5 hours of audio a day and in the past two years alone, time spent listening to music grew about 40% (source: Nielsen Music, Music 360 Report, 2017).
- This trend is going to continue upward as we see explosive growth in connected and voice activated devices and rapidly increasing consumption of other forms of content, such as podcasts.

- To put it in perspective, we expect 1 out of every 2 people will have a connected device in their home by 2022. This will encourage incremental audio listening.

These trends are early signs of a broader sea change in the world of audio. Just like broadcast video, newsprint, and most other forms of media, audio is transitioning from a one-to-many broadcast experience to a one-to-one model with personalization at the core. This means the $16 billion terrestrial radio market will increasingly move to digital models where listeners enjoy a better experience and advertising can be targeted and data-driven.

As I described last quarter, we are well-positioned to take advantage of this transition but first we need to address our challenges head on. We’re starting to do just that and during Q4 we began executing on many of the initiatives I outlined on the Q3 call. Q4 was an important first step toward these goals.

Naveen will share more specifics about the quarter after I share some highlights on our efforts to drive users, improve monetization, and create long-term operating improvements and leverage.

Active Users

Starting with users...

Although it’s too early to expect the initiatives we identified last quarter to shift the trajectory in our audience metrics, we are pleased with the launch of several important initiatives across product, marketing and partnerships that we expect will improve audience retention and engagement over the course of 2018.

On the product front, we previously highlighted the importance of adding more interactive features to our ad-supported service. In late Q4, we took a major step with the launch of Premium Access.

Premium Access is a product that addresses the largest reason listeners use other services -- they want to listen to a specific song or artist but can't do so without a subscription. With the launch of Premium Access:

- Pandora users can now unlock a window of robust on-demand music listening in exchange for viewing a short video ad.
- They are able to search for a specific song or artist and share direct playlist links with friends.
- This not only delivers a more complete experience to our listeners but it opens new promotional opportunities for artists to feature their latest tracks and albums.
- It also unlocks new rewards-based video inventory for our advertisers.

With this new product offering, we now have more compelling and complete functionality in our mobile ad-supported service than any other competitor.

Premium Access also represents the simplest and easiest way to try Pandora Premium for a limited period of time - an experience that we expect to become a highly effective acquisition channel for our subscription service.

Later this quarter we will start our marketing of Premium Access, engaging artists and creating more doorways -- so that users on our ad-supported service can more easily find the new functionality and search for any artist or song they want. Nonetheless, early results are encouraging: we're seeing higher repeat sessions among Premium Access users, more use of

Premium Access by younger users, and better conversions to our Pandora Premium subscription product, especially by younger listeners.

While Pandora's ad-supported service remains the biggest part of our business, our subscription products continue to perform well. We added approximately 300 thousand subscribers in Q4 and grew subscription revenue 65% year-on-year, excluding Australia and New Zealand. As much as people want to paint us as either an ad-supported business or a subscription service, I am a firm believer that we need to meet consumers where they are. While we're the largest ad-supported music service and we intend to press this advantage, I see significant opportunity to grow our subscription business and utilize the tactics I've learned from running three other subscription businesses prior to this.

Also on the product front, we have achieved spectacular listener growth through voice-activated devices. In Q4, Pandora listening on voice-activated devices was up 145% year-over-year. Given the expected growth in voice-enabled speakers, we believe this trend will continue. Our continued investment in audio experiences, voice and personalization will help drive sustained momentum in this rapidly evolving market.

During Q4, we also announced a number of device partnerships, including Comcast's Xfinity X1, Sonos, Amazon Fire TV, and Android TV. These are important because they enable our full suite of ad-supported and subscription services, as well as Premium Access in the future, on all the devices consumers care about. This is a critical part of our plan to grow, and these announcements are a taste of what we expect will be many more during 2018.

We have spoken about our intention to expand beyond music by adding podcasts to Pandora's wealth of audio content. Podcasts are the first natural step because of Pandora's ability to address the biggest headwinds to Podcast growth: discoverability and monetization. Our strengths in these areas combined with our advertising scale provide us the ability to bring podcasts to market in a way no one else has to-date.

I also believe that Pandora can make a more effective use of the audience equation: marketing. This past quarter, we announced that we're investing in martech tools that leverage our strength in data science, which we already use very effectively in both our consumer and advertising offerings. We're bringing in a team that can take advantage of this approach, led by our new CMO, Aimee Lapic. I look forward to seeing Aimee's analytics-driven approach and our increased capabilities improving the effectiveness of our marketing spend as we progress throughout the year.

Monetization/Fixing Ad tech

Moving onto monetization...

Last quarter we spoke about our need to invest in ad tech, including increased focus on programmatic, which will leverage many of the strong capabilities we already have -- scale, targeting and innovative ad formats. I am happy to report our programmatic video offering is in beta and yesterday we announced our audio programmatic pilot with Volkswagen, Omnicom Media Group and top DSPs including The Trade Desk, MediaMath and AdsWizz AudioMatic. These offerings are expected to drive RPM growth over time by increasing sell-through and optimizing CPMs.

Of course there are other important ad tech initiatives including new ad formats, ROI measurement, self-serve and better automated tools. We've also mentioned that we are exploring build and buy options to tackle these and we've made meaningful progress on those plans. We'll share further details as 2018 progresses.

Organization Improvements

Shifting to our organizational efforts, we recently announced we've undertaken several steps to fund the strategic priorities I just outlined. As I stated on our Q3 earnings call, we'd first focus on internally funding these investments by reallocating funds within our current cost structure, and we've done just that by identifying approximately $45 million in annualized Adjusted EBITDA cost savings to put toward these efforts. We've also made changes to our org structure to drive more innovation and faster execution. And finally, we're increasing our presence in Atlanta, a city with a rich history in music that also gives us access to a wealth of talent that can be hired and retained at lower costs than in the Bay Area.

Conclusion

In closing, I'm confident that we're taking the right steps to reinvigorate Pandora. This means driving more listeners to our platform and a continued focus on monetization. From launching on-demand for our ad-supported listeners to our programmatic efforts, we made progress on several important initiatives in the last quarter alone. I expect them to help accelerate our business as 2018 progresses and enable us to take full advantage of the rising importance of digital audio. Thanks, and I'll now hand it over to Naveen.

Naveen Chopra

Brief Overview of Q4 Financials

Thanks Roger.

Financially, Q4 came in significantly better than previously expected but more importantly as Roger detailed, we are excited about the progress made on several key initiatives that are critical to improving future financial performance through a return to active user growth and enhanced monetization.

I’m going to share some additional color on our Q4 results and then address guidance. Please note that for the purpose of our comments today, we will exclude Australia, New Zealand and Ticketfly from year-over-year comparisons for revenue, operating expenses, actives and hours.

Q4 Revenue

Q4 total revenue was $395.3 million, growing approximately 7% year-over-year. This was driven by a 65% year-over-year increase in subscription revenue partially offset by a year-over-year decline in advertising revenue.

The growth in subscription revenue was driven by subscriber growth and higher ARPUs. In the fourth quarter, we added approximately 300 thousand subscribers, bringing cumulative subscribers to 5.48 million. ARPU increased to $6.08 as strong growth in Pandora Premium subscribers, which have a higher monthly ARPU, continued to offset declines (albeit a slower rate of decline than in Q3) in Plus subscribers.

Q4 advertising revenue was better than our expectations because a greater proportion of ad buys were placed later in the sales cycle than we typically see in the fourth quarter. However, ad revenue fell year-over-year primarily due to the decline in active users. Ad RPM grew 12% year-over-year to a record $75.65 in Q4.

The strong ad RPM reflected a meaningful increase in blended effective CPMs and a slight increase in ad-load, offset by a modest decline in sell-through. It is also worth noting, Mobile ad RPM exceeded Web RPM for the first time ever. Five years ago, mobile ad RPMs were half that of web RPMs. We highlight this because it speaks to the potential of new platforms and ad formats. Today, we have a major focus on driving listening through the new generation of CE devices like smart speakers. Those platforms don't monetize well today due to limitations in ad-tech and relatively nascent advertiser demand. But that will evolve in much the same way mobile has evolved, and we want to ensure that Pandora is positioned to benefit from the continued proliferation of these devices.

Speaking of monetization gains, one of our highest priority initiatives is enabling programmatic sales, and as Roger noted, we continue to make steady progress on that front. We are excited about the potential of our programmatic efforts to enhance sell through and optimize pricing by tapping into new demand, [without having to rely on low priced performance based ad channels as the company did in early 2017]. We believe the combination of programmatic and other ad-tech initiatives will drive continued monetization improvements over time.

Active Users, Hours, and Engagement

Moving to the audience part of the equation, total monthly active users were 74.7 million in Q4, down 6% year-over-year. A few things worth pointing out about these metrics:

- First, we were more conservative with our marketing spend in the back half of 2017 as we felt it was prudent to allow time to further refine Premium Access functionality, leverage in-process martech investments, and build out our marketing ROI framework. While financially disciplined, that approach meant a 46% year-over-year reduction in Q4 paid marketing spend which had an impact on active users.
- And, as I've said before, stabilizing and then growing our audience is of the utmost importance, and we have a number of initiatives underway or launching soon that are designed to both further engage our existing users and re-engage lapsed listeners. Premium

Access is one of the first of these initiatives and early results are encouraging. Although it won't happen overnight, we are bullish about the potential for Premium Access as well as other initiatives on our roadmap, like Non-Music Content, to drive incremental engagement and more listeners.

Content Costs

Total content costs represented approximately 55% of revenue in the fourth quarter. While Q4 Ad LPM was slightly lower versus Q3 at $36.77, we had anticipated a larger sequential decline. Some of the minimum guarantees we incurred in Q3 were avoided, but these benefits were unfortunately, and unexpectedly, largely offset by minimum guarantee payments to other content owners, whose music was not played as frequently as forecasted. We expect ad LPMs to continue to fluctuate a bit due to the impact of MGs and ongoing changes to our arrangements with content owners.

On the subscriber side, Q4 licensing cost per subscriber (or LPU), was $4.41, up from $3.12 last year. These increases are largely driven by the mix shift from Pandora Plus to Premium.

Gross Margin

Non-GAAP gross margin was 38%, compared to 36% in the year-ago quarter. The increase in margin year-over-year was driven by higher ad RPM. We continue to expect gross margins to grow over time with improvements in ad monetization, and as we achieve scale benefits in the subscription side of the business.

Q4 Operating Expenses and Adjusted EBITDA

Turning to operating expenses, for the fourth quarter of 2017 non-GAAP operating expenses declined 6% year-over-year driven by decreases in marketing spend and reduced G&A and S&M headcount.

The combination of better than expected revenue and continued discipline on OpEx led to adjusted EBITDA for the fourth quarter of $5.8 million.

We have and will continue to look for opportunities to improve operating leverage, while focusing investment in high-priority areas. This was the basis for the company-wide reorganization we announced in January. The reorg resulted in annualized savings of approximately $45 million in adjusted EBITDA. The savings will be reinvested in growth initiatives. The key point here is that our focus on efficiency enables us to make material growth investments without creating incremental headwinds to profitability or cash flow.

EPS

Fourth quarter 2017 GAAP net loss per share was $0.21. This is based on approximately 250 million weighted average common shares outstanding.

Balance Sheet and Cash Flow

Cash and investments ended the fourth quarter slightly up at $500.8 million, with $7.9 million of cash provided by operating activities.

Guidance

Now let’s move to guidance.

As we’ve referenced there are a number of moving pieces in our business this year. The timing of ad-tech developments, label negotiations, new content launches, distribution partnerships, marketing changes, and ongoing cost-efficiency efforts have the potential to materially impact short-term results. Therefore we think it’s prudent to avoid specific annual guidance until we have additional data points. For now we will provide some high-level direction regarding our expectations for the year and then provide specific guidance for Q1.

- We expect top line growth in 2018 to come from the subscription side of our business and we're taking actions to stabilize audience and improve monetization that will ultimately lead to growth in advertising revenue.
- Because we are expecting strong subscription revenue growth, subscription commissions will grow. Other than this increase in commissions, operating expenses, will represent a lower percentage of revenue in full-year 2018 than in 2017.
- Our ambition is to deliver additional efficiencies beyond the $45 million of reinvested savings we previously identified. The additional efficiencies should come through tighter business processes, automation, expansion in lower-cost locations and management of content costs.
- And, we anticipate meaningful improvement in operating cash flow in 2018 versus 2017.

With that context for the full year, I'd like to address Q1 more specifically. As noted, many of our growth initiatives are still in early stages and their impact will build over the course of 2018. This means that Q1 will incur a lot of the same ad revenue headwinds as the 2H of 2017. We expect Q1 total revenue in the range of $295 to $305 million, the midpoint of which reflects 5% growth versus the year ago period when adjusting for Ticketfly and ANZ. A couple things to note about our Q1 revenue guide:

- We expect typical seasonality in 2018 which means Q1 is the weakest quarter for advertising revenue with significant pick-up from Q2 through Q4.
- Our Q1 revenue guidance assumes continued subscription growth offset by a year-over-year decline in advertising revenue.

We expect adjusted EBITDA in Q1 of 2018 to be in the range of a loss of $100 million to a loss of $90 million, which you will notice, is lower than the year ago period. This is a function of minimum guarantees and, to a lesser extent, the year-over-year decline in ad revenue. However, we think Q1 is a relatively unique quarter and that there should be significant sequential and year-over-year improvement in adjusted EBITDA as we move into Q2. In fact, cumulative adjusted EBITDA for the Q2 through Q4 period will be meaningfully improved versus the comparable period in 2017.

Please note that Adjusted EBITDA differs from GAAP net loss in that it excludes forecasted stock based compensation expense of approximately $29 million, depreciation and amortization expense of approximately $14 million, restructuring costs of approximately $9 million, other expense of approximately $5 million and provision for income taxes of approximately $300 thousand and assumes minimal cash taxes given our net loss position.

Basic shares outstanding for the first quarter of 2018 are expected to be approximately 255 million.

Before we open the call for questions, I want to underscore a point that Roger made in his remarks about our long-term outlook and the growing importance of audio. We are bullish about creating value in this business by combining our existing assets, namely the scale of our audience and strengths in ad-based monetization, personalization, and data with the execution plan we detailed last quarter. That plan includes a number of initiatives to reinvigorate audience metrics and restore growth in advertising revenue. I think it's a smart plan, and one which we will continue to optimize. As we highlighted in Q3, it's not an overnight plan, meaning there will be some bumpiness as we invest for the future. But that bumpiness does not change our conviction regarding the long term opportunity and the potential to deliver improved returns for our shareholders.

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