Pandora (P) 1Q18 Financial Results Conference Call May 3, 2018

Scripts for:

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May 3, 2018

Derrick Nueman

Good afternoon, and welcome to Pandora's first quarter 2018 earnings 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, the benefit to Pandora from the acquisition of AdsWizz 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 concluded. You can find the information I have just described at investor.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.

Roger Lynch

Introduction

Thanks Derrick and thanks everyone for joining us.

Let me open by saying that I don't think that there has ever been a more exciting time to be doing this job, in this industry, than right now.

I say this for two reasons.

First, as I made clear when I joined Pandora, we have a powerful set of competitive advantages: our brand, our scale, our listener engagement, and our data science. As I also made clear, we have work to do to fully leverage those advantages. Key to that work is stabilizing and growing our audience, and improving our capabilities in ad tech.

Our results this quarter show we're making progress. I'm encouraged by a lot of what I see: improving audience metrics; significant progress developing a more efficient marketing strategy;

and the acceleration of our ad-tech roadmap. While we’re early in our efforts, I’m proud of how hard everyone here is working toward our goals.

The second reason I’m optimistic about Pandora’s future is that, as I said on our last call, we’re entering a “new era” of audio. This opportunity has influenced our strategy and priorities, and it frames almost everything we’re doing, including the progress we’re making.

Right now, there have never been more ways to deliver audio content. There have never been more kinds of audio content. That content has never been more personalized, and the market for it has never been bigger.

Music is at the core of what we do. Whether subscription or ad-supported, we connect consumers to the music and artists they love. Increasingly, the new era of audio means using our technology to drive an engaging consumer experience across all types of audio content. It means ensuring that any content on our platform is easily discovered and socialized, be it a song, a podcast, or new album. It also means providing brands with an end-to-end toolset that allows them to meaningfully connect with listeners everywhere, regardless of whether they experience Pandora on an iPhone, an Alexa-enabled speaker, or any other device, anywhere they are.

Our decision to acquire AdsWizz positions Pandora to be at the center of this expanding and evolving digital audio marketplace. The opportunity is significant, especially with the potential for a good portion of the $28 billion global radio advertising spend to move to digital audio. We intend to lead this market and provide buying and selling solutions across multiple ad formats, for multiple publishers worldwide. AdsWizz puts us in the best position to do just that.

As I mentioned, our results this quarter demonstrate that while we are still in the early innings of a long game, we're making headway. Let me share some highlights with you.

First, I'd like to highlight our efforts to preserve and grow our audience. Changes in the size of our audience are a function of three key variables - recapturing lapsed listeners plus acquiring new listeners, offset by churn of existing listeners. Churn was not the reason for last year's decline in audience. In fact, it improved in 2017. Where Pandora faced a challenge was in recapturing lapsed listeners and acquiring new ones.

In December, we brought on a new CMO with a mandate to change this, and drive a more analytical approach to marketing. This meant shifting from a branding focused strategy to one that leans more heavily on performance marketing.

To this end, in Q1 we began applying ROI based tactics to a number of performance marketing tests, many of which show early promise. For example, in March, for the first time in 18 months we achieved a positive year-over-year comp in the recapture of lapsed listeners. Although still preliminary, our analysis suggests our listener LTVs are a multiple of acquisition cost. The next step for us is to prove we can scale these results - in which case we could profitably increase marketing spend.

We’re also looking to get more out of partnerships. Historically, Pandora has done an impressive job integrating the Pandora service with a variety of devices. These relationships need to expand to include more marketing and brand promotion elements. We are making progress on this and we’ll share new developments as they happen.

Now let me shift to our products.

Our ad-supported tier continues to offer listeners unprecedented functionality and access to the music they love. Premium Access is a new feature that allows our ad-supported and Plus listeners to access our complete on-demand catalog in exchange for viewing a high-value video ad.

It is the richest ad-supported, on-demand mobile music experience on the market and has exciting traction with both ad-supported listeners and Plus subscribers. Approximately 13 million of our listeners have tried it. Further, we’ve seen increased daily engagement, a higher propensity to upgrade to Premium, a skew towards under-25 listeners, and Premium Access was an element of the improved Q1 MAU trajectory. All of this was driven without marketing, and we expect focused marketing support will only increase its success.

Additionally, in the last month we launched personalized soundtracks. These are playlists automatically compiled for our Premium subscribers, based on their unique musical tastes, moods and preferences, using our 75+ machine learning algorithms and curation.

We’re also developing products, expected to launch later this year, that will help further improve our audience trends. This first is in-app voice capability, which will be an important step in making Pandora as easy to use as the radio. The second is our effort around podcasts and other non-music audio content. We expect music will continue to represent the majority of our audience, but podcasts represent a real opportunity to grow: there are 73 million people listening to podcasts every month. In the near-term, you can expect that we’ll begin to add more content to our platform, but our long-term plan is more ambitious: make that content far more relevant, discoverable and shareable than it has ever been with the launch of our Podcast Genome. Further, we think our ability to improve the monetization of non-music content by leveraging capabilities from AdsWizz will make us an attractive distribution partner for leading content owners.

Last, I’ve previously shared that we needed to improve our advertising technology position, specifically in programmatic, to take advantage of the significant opportunity in digital audio.

The acquisition of AdsWizz will be a big step and signals a clear acceleration of our ad tech capabilities, allowing us to transition from the largest digital audio ad publisher to the largest digital audio ad platform. We believe that combining Pandora’s scale and data with AdsWizz technology will allow us to accelerate growth in digital audio advertising. AdsWizz has customers in 39 countries, and offers a full stack of tools and services ranging from programmatic audio on both the demand and supply sides, to ad serving technology, to ROI measurement, to podcast tools and self-serve capabilities. We highlighted these as important areas of investment in our past two earnings calls, and we’re addressing them.

Naveen will provide a more detailed look at the quarter in a moment, but I'll close with this: while there is a lot of work left to do at Pandora, we're now starting to see results that confirm my early conviction that we have a significant opportunity to improve our audience, monetization, and ultimately, our profitability. Continuing to execute and deliver results across all these fronts will unlock the strategic potential of Pandora.

Speaking of results, let me hand the call over to Naveen.

Naveen Chopra

Thanks Roger.

We made meaningful progress in Q1 on the audience and monetization fronts and posted solid financial results. Before getting into the details of the quarter and our guidance for Q2, I'd like to share some additional thoughts on the Adswizz acquisition.

AdsWizz

Roger spoke about the strategic nature of AdsWizz, and the opportunity we have to transform Pandora from a publisher to a platform. Why does that transformation excite us? Let, me share a few relevant stats. To start, there are 160 million people streaming audio weekly, a number that has more than tripled over the last 8 years. And, despite that growth, digital audio still has room to grow relative to terrestrial radio. Similarly, voice commerce is projected to grow to be a $40 billion industry by the year 2022, up from $2 billion today. These are exciting tailwinds for digital audio advertising, which itself grew 42% year-over-year in the first half of 2017 - and Adswizz expands the ways Pandora can participate in this growth.

Our plans for Adswizz begin with programmatic audio which is a small ecosystem today because a large amount of supply hasn't been aggregated in a single marketplace. With Adswizz we will be taking Pandora, the world’s largest publisher of digital audio advertising supply, and aggregating it with inventory from the world’s other leading audio publishers. As we have seen with comparable marketplaces, this creates powerful network effects: buyers want to go where the inventory resides, and publishers want to be where the demand lives.

How will this create value for Pandora?

Well, first, the network effects I described mean that when we connect inventory from leading publishers like iHeart Media, Deezer, the Global Group, and of course Pandora, with top-tier demand side platforms such as the Trade Desk and MediaMath, we expect the aggregated demand to create an even more robust programmatic channel through which to sell Pandora audio inventory. Over time, this translates to RPM growth.

Second, by owning the aggregation platform, Pandora can participate in transactions beyond the limits of our own publisher audience. Case in point: International. Although we don’t currently have a consumer service outside the US, we now have a role in the growth of the global audio advertising market. This won’t necessarily show up in RPM’s but can be a meaningful source of high-margin advertising revenue.

Third, we plan to use AdsWizz software to accelerate our ad-tech roadmap. This will not only include programmatic functionality, where Adswizz is already powering our beta, but also augments our efforts on new ad formats, self-serve, sales automation, and ROI measurement. In some of these areas, we think our development roadmap can be accelerated by as much as two years. We also believe that continued investment toward this roadmap will benefit other publishers who use the Adswizz platform.

On the cost side, AdsWizz will bring very strong engineering talent, primarily in Romania, and we plan to expand the size of that team. While in the short-term, this means an increase in product development expense, over time, we should see significant benefit as we'll have access to more resources than our current development hub in Oakland, and at lower costs.

Clearly AdsWizz is a very important strategic opportunity for Pandora that should boost overall advertising results over time.

Speaking of results, let me move to the specifics of Q1. And please note that for the purposes of our comments today, we will exclude Australia, New Zealand and Ticketfly from year-over-year comparisons for revenue, operating expenses, actives, and hours.

Q1 Revenue

Q1 total revenue was $319.2 million, growing approximately 12% year-over-year. This includes a 63% year-over-year increase in subscription revenue and better than expected advertising revenue.

The upside in Q1 advertising revenue was driven by two factors: a higher than normal level of in-quarter bookings and a significant uptick in revenue from non-guaranteed channels, such as sponsored listening and CPV video. Both of these dynamics are relatively new and complex to forecast. Overall, ad revenue trends improved versus the fourth quarter of 2017, with a smaller year-over-year decline of 3%. Ad RPM grew 9% year-over-year to $55.52.

Subscription revenue growth was driven by an increase in our Premium subscriber base and the associated higher ARPUs. We added approximately 140 thousand net subscribers, bringing cumulative subscribers to 5.63 million. ARPU increased to $6.30 as strong growth in Premium subscribers, which have a higher monthly ARPU, continued to offset declines in Plus subscribers. As a reminder we are continuing to develop a variety of capabilities that have the potential to accelerate subscription growth. The upcoming launch of family plans, expanded acquisition marketing, new partnerships, and enhanced direct billing options can be meaningful drivers of our future growth in subscriptions and subscription gross margin.

Active Users, Hours, and Engagement

Moving to the audience part of the equation, total monthly active users were 72.3 million in Q1, down about 4% year-over-year. This year-over-year trend improved compared to the fourth quarter, due to better retention of existing listeners and more effective recapture of lapsed listeners.

We were also encouraged by the improvement in year over year ad hour trends. Ad hours were down 11% year-on-year in Q1, a material improvement relative to the year-over-year results we saw in Q3 and Q4. It is our expectation that the improvement in YoY trends will continue.

Content Costs

Total content costs represented approximately 68% of revenue in the first quarter. It is worth noting that content cost as a percentage of revenue is typically highest in Q1 due to the seasonality of our advertising business.

Ad LPM was slightly lower versus Q4 at $36.35, and was in line with our expectations. As a reminder, we assume ad LPMs will continue to fluctuate during the year due to the impact of MG accounting and ongoing changes to our arrangements with content owners.

Q1 licensing cost per subscriber (or LPU), was $4.65, up from $2.96 last year. These increases are largely driven by the mix shift from Pandora Plus to Premium.

Gross Margin

Non-GAAP gross margin was 24%, compared to 26% in the year-ago quarter. The year-over-year decrease in margin was caused by minimum guarantees for content rights. Absent MGs, gross margins would have been higher by several hundred basis points. We expect gross margins to increase with improvements in audience engagement, ad monetization, and right-sizing of minimum guarantees.

Q1 Operating Expenses and Adjusted EBITDA

First quarter non-GAAP operating expenses, excluding subscription commissions were basically flat year-over-year. OpEx was lower than expected due to hiring plans that shifted from Q1 to Q2. Our OpEx results reflect a reduction in G&A offset by increases in product development to support our audience growth and ad-tech initiatives. These OpEx changes reflect the resource allocation changes we made as part of our January restructuring. Subscription commissions were up about $8M year-over-year due to growth from our premium product.

The combination of better than expected revenue and to a lesser extent continued discipline on OpEx led to an adjusted EBITDA loss in the first quarter of $73.3 million, which was significantly better than our expectations.

EPS

First quarter 2018 GAAP net loss per share was $0.55. This is based on approximately 253 million weighted average common shares outstanding.

Balance Sheet and Cash Flow

Cash and investments ended the first quarter at $544 million, up from $501 million last quarter. The increase was driven by $17.4 million of operating cash flow and the sale of our Eventbrite note for $34.7 million.

As a reminder, our operating cash flow can fluctuate on a quarterly basis due to the timing of label payments and other working capital. We expect cash to decrease in Q2 due to label prepayments and the cash component of the AdsWizz transaction.

Guidance

Now let's move to guidance where I'll start with some high-level comments.

- First, as highlighted on our last call, our strategic growth initiatives will build over the course of 2018 and beyond. Although we made notable progress this past quarter, we are still in the early stages of our turnaround.
- Second, we expect AdsWizz to close in mid-May and integration with our owned & operated business will take some time. The operating impact of the AdsWizz deal was incorporated in the commentary we provided around 2018 expectations during our last earnings call.
- Third, as I mentioned earlier, an increasing percentage of our advertising bookings are occuring during the quarter. We expect this dynamic, which affects visibility of some ad revenue, to become even more pronounced as programmatic audio moves to general availability later this year.

In terms of specifics, we expect Q2 total revenue to be between [$360] to [$375] million, the midpoint of which reflects 7% growth versus the year ago period and similar seasonality as prior years.

We expect Q2 Adjusted EBITDA to be in the range of a loss of [$45] million to a loss of [$30] million, which at the midpoint represents a roughly $5 million improvement versus the year-ago quarter. As we discussed, we are looking at opportunities to increase marketing spend relative to Q1 to further improve MAU trends. This decision will impact where we fall the Q2 Adjusted EBITDA range I just described but our decision will obviously be made with a focus on ensuring the investment has compelling ROI.

Please note that Adjusted EBITDA differs from GAAP net loss in that it excludes forecasted stock-based compensation expense of approximately $28 million, depreciation and amortization expense of approximately $14 million, restructuring costs of approximately $2 million, other expense of approximately $5 million and provision for income taxes of approximately $400 thousand and assumes minimal cash taxes given our net loss position.

Basic shares outstanding for the second quarter of 2018 are expected to be approximately 262 million. The increase is due to the expected stock component of the AdsWizz transaction.

I'll wrap up by saying that, we're encouraged by the proof points we saw in Q1. Still a lot of work to do, but I see progress in our efforts to stabilize and grow our audience and improve monetization - the combination of which will lead to improved revenue growth and profitability.

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