Pandora (P) 2Q18 Financial Results Conference Call July 31,2018

Scripts for:

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<u>Derrick Nueman</u>

Good afternoon, and welcome to Pandora's second 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.

Finally, we're excluding Ticketfly, Australia and New Zealand from year-over-year comparisons for revenue, operating expenses, actives, and hours as we no longer operate those businesses. You can find year-over-year comparisons that include these businesses in the press release issued earlier today.

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.

Let’s get right to it.

We continue to make progress in our efforts to reinvigorate Pandora, and our results this quarter reflect it:

- Revenue came in better than we expected,
- Year-over-year ad-hours trends improved for the third straight quarter,
- Subscription revenue grew 67%,
- We signed multiple new partnerships,
- We closed the acquisition of AdsWizz,
- And with the cost controls measures we took in Q1, we meaningfully improved opex as a percentage of revenue

Our listener and engagement growth initiatives remain priority number one. Ad-hour trends are moving in the right direction, subscriber additions more than doubled versus the first quarter, and MAU trends are roughly in-line with the improvements we saw last quarter. We are bullish about the potential for these metrics to continue improving through a combination of expanded partnerships, marketing optimization and key product enhancements.

From day one, I have stressed the importance of partnerships. I'm a big believer in the ability of partnerships to create audience growth. In my experience, you get your best customers through partnerships at the lowest cost of acquisition.

This quarter we made a lot of progress. We announced a deal with AT&T through which Pandora Premium is included as a bundling option for AT&T's unlimited data plan. Eligible AT&T customers receive Pandora Premium at no incremental cost. In addition to being a great value for consumers and expanding distribution for Pandora, we expect the deal with AT&T to yield subscribers with higher lifetime value because the bundles have both lower churn and lower acquisition cost.

We also announced a co-marketing deal with Cheddar and partnered with T-Mobile to provide special offers to T-Mobile customers. This is another way to drive subscription trials at attractive costs.

Finally, and importantly, we announced a partnership with Snap that allows their users to share music with anyone they want. I want to point out that this kind of seamless sharing simply would not be possible without Pandora's ad-supported offering, especially our Premium Access feature. This is a great fit for us in terms of audience - we think the integration with Snap will increase engagement with younger users and drive growth for our subscription business. And, it is also a perfect example of the kind of unique partnerships and consumer functionality enabled by our hybrid business model.

We'll continue to establish partnerships with great companies, taking advantage of our industry-leading scale and the flexibility of our three-tiered offering. This will expose the Pandora brand to a larger and larger universe of consumers.

And, of course, we're pairing these partnership efforts with a focus on optimizing our own direct marketing. As we talked about last quarter, we think there is significant opportunity to grow the size and engagement of our audience with increased spend in performance marketing and enhanced CRM capabilities.

Last quarter, I talked about recapturing lapsed users, on-boarding new ones, and reducing churn. We're making initial progress in those efforts. Our focus is on better utilizing data, more effectively personalizing CRM, improving our marketing technology capabilities, optimizing our marketing channels, and increasing conversions.

Our goal is to continuously improve the efficiency of our marketing efforts, and in doing so, to fundamentally shift the marginal cost curve of adding new users lower - driving the curve down, and to the right. As our marketing organization delivers on these fronts, and we realize tangible ROI improvements, you can expect us to be opportunistic in spending more on marketing to accelerate audience growth.

On the product front, we continue to deliver improvements and bring new features to each tier of our offering.

This quarter, our subscription business showed strong results. As of today, we now have over six million paying subscribers.

We also launched family plans for our subscription service in June, adding a key feature that will steer a greater share of new subscribers to direct, higher-margin billing plans. We still have a lot planned for our subscription products, including a student plan, easier signup flows, and expanded device compatibility, but we're excited about the growth we're seeing now.

Premium Access continues to show traction - it is our fastest-growing feature and a critical component of our marketing and partnership efforts. We're seeing a higher propensity for

Premium Access users to upgrade to our subscription product, and it is leading to increased ad hours. Premium Access is also improving engagement with younger users, with more than double the usage by listeners under age 25 compared to usage from eligible listeners on Pandora overall. We'll be expanding the feature to the desktop later this year.

I'm particularly excited about two other items on our product roadmap: voice control and Podcasts. As the market shifts to voice commands in multiple environments - in homes and cars - our in-app voice controls will make Pandora much easier to use. Our Podcast Genome is also tracking toward launch later this year, and will be a significant step forward in discovery and monetization for non-music content. We believe the combination of these two features will make Pandora even more compelling within the car. Voice controls will be a significant step towards making Pandora as easy to use as radio and our Podcast Genome will help us address the 28% of non-music listening on radio.

This has also been an important quarter for ad monetization. We've now closed the AdsWizz transaction and we're encouraged by the enthusiasm we've seen from other publishers who see the benefits of combining their digital audio inventory with Pandora to leverage our massive scale in the US digital audio market [and AdsWizz's programmatic audio ad platform].

Additionally, just this morning we announced the general availability launch of audio programmatic with several major brands involved. This is our first product integration with AdsWizz, which helps us access new demand, optimize pricing and increase efficiency of our ad operations. Our approach here, like all our strategic initiatives, will be deliberate, with a gradual increase in the amount of Pandora inventory sold through audio programmatic. Over time, we expect this to fundamentally increase demand for digital audio, benefitting both Pandora and the publishers that work with us.

We are also rolling out three new audio ad capabilities: Dynamic Audio, Sequential Audio, and Shorter Length Audio - so that advertisers can deliver hyper-personalized campaigns, with automated variation in their creative, at scale.

Between partnerships, marketing, product and monetization, our tactical efforts are proving to be significant and influential, and are showing results. More importantly, these initiatives all operate in support of our broader strategic goals and market opportunity.

Since I first joined Pandora, I've talked about the large and strategic opportunity in digital audio. We're still in the early innings and the market is growing rapidly. There's a significant opportunity for this market to grow even faster by taking share from the approximately $15B US terrestrial radio market.

I believe that Pandora has all the elements necessary to compete and win in digital audio. Our flexibility in having both subscription and ad-supported offerings means we have the most, and best, options when it comes to engaging listeners, working with partners, and as a provider of all audio content - not just music.

Now with AdsWizz, our platform approach to advertising gives us global reach into the digital audio ecosystem anywhere in the world, and we have the best monetization capabilities and tools to leverage that reach. We have all of this, along with the single largest listener base of any streaming service in the US - a base that we intend to grow. We've done a lot of hard work at Pandora with more to do, but everything we are doing is in service of our ultimate goal: cementing Pandora as a leading player in digital audio.

And with that, I'll turn things over to Naveen.

Naveen Chopra

Thanks Roger.

As you heard in Roger's comments, we had a strong Q2. We exceeded our revenue expectations, announced several key partnerships, improved ad hour trends, accelerated subscriber additions, and closed the AdsWizz acquisition.

Before commenting on the specific results, let me remind you that we're excluding Ticketfly, Australia and New Zealand from year-over-year comparisons for revenue, operating expenses, actives, and hours as we no longer operate those businesses. You can find year-over-year comparisons that include these businesses in the press release issued earlier today.

Q2 Revenue

Q2 total revenue was $384.8 million, growing approximately 12% year-over-year. This exceeded the top-end of our revenue guidance by almost $10 million due to better than expected advertising and subscription revenue.

The upside in Q2 advertising revenue was a result of three factors. First, like Q1, we saw a higher level of in-quarter bookings and an uptick in revenue from non-guaranteed channels like sponsored listening and cost-per-view video advertisements. These are the advertising formats used with features like Premium Access. Second, ad hours came in stronger than we anticipated. In fact, ad hours declined 7% year-over-year in Q2, which is much improved relative to the 11% YoY decline last quarter and the 16% decline in Q3 of 2017. Lastly, a small amount of the upside, around $2 million, came from a portion of AdsWizz's revenue being recognized on a gross basis versus the previously expected net basis.

RPMs increased by 4% year-over-year in Q2 despite lower ad loads compared to the year-ago period. Going forward, RPMs will benefit from continued improvements in targeting, sell-through and programmatic but better ad hour trends and CE usage could moderate growth rates.

Subscription revenue growth accelerated to 67% year-over-year reflecting growth in our Premium subscriber base and the associated higher ARPUs. We added approximately 351 thousand net subscribers, more than double last quarter, bringing cumulative paid subscribers to approximately 6 million. The stronger net adds stemmed from a combination of heavier performance marketing, better utilization of CRM and other conversion tools, and a stabilization in Plus users. ARPU increased to $6.52 due to strong growth in Premium subscribers, which have a higher monthly ARPU. Two housekeeping items to be aware of related to our Subscription business. First, our Family Plan was launched late in the quarter and did not have much of an impact on Q2 results. We do expect family plans to be an important growth contributor, and we will be reporting family plan subscribers in a similar fashion as our competitors, counting each listener account in a family plan as a distinct subscriber. This treatment could impact our rate of ARPU growth. Second, in Q3 we will be changing our policy for handling grace periods which slightly benefits ARPU but will be a headwind to net subscriber additions in the quarter. As a reminder, we do not count trials in our subscriber or MAU numbers.

Active Users, Hours, and Engagement

Moving to the audience part of the equation, total monthly active users were 71.4 million in Q2, showing a year-over-year decline at approximately the same rate as the first quarter. Although we are still evolving our marketing efforts, in Q2 we were successful in accelerating subscriber growth and increasing engagement with our ad-supported product, as evidenced by the improvement in ad hour trends we just referenced. We see these metrics as leading indicators that our marketing investments are having an impact and we expect MAU improvement to follow as the combination of our marketing efforts, partnership agreements, and product improvements gain traction.

Content Costs

Total content costs represented approximately 59% of revenue in the second quarter. As expected, this was a marked improvement relative to Q1 as content cost as a percentage of revenue is typically highest in Q1 due to the seasonality of our advertising business.

Q2 Ad LPM was slightly higher than Q1 at $36.87, but 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 minimum guarantee accounting and ongoing changes to our arrangements with content owners.

Q2 licensing cost per subscriber (or LPU), was $4.78, up from $3.11 last year. These increases are largely driven by the mix shift from Pandora Plus to Premium.

Gross Margin

Non-GAAP gross margin was 33%, compared to 37% in the year-ago quarter. The year-over-year decrease in margin was caused by minimum guarantees for content rights. Like last quarter, absent the impact of MGs, gross margins would have been higher by several hundred basis points. We expect gross margins to increase in the future with improvements in audience engagement, ad monetization, and right-sizing of minimum guarantees.

Operating Expenses and Adjusted EBITDA

Second quarter non-GAAP operating expenses, excluding subscription commissions were up about $9.9 million sequentially. This was driven by expected increases in product development and marketing spend, some of which was related to the addition of AdsWizz. Subscription commissions were up about $9 million year-over-year due to growth from our premium product. Our focus on operating efficiency continues to bear fruit as evidenced by the fact that operating expenses excluding subscription commissions and external marketing were approximately 33% of revenue in Q2 2018, vs. 37% of revenue in the year ago quarter.

Adjusted EBITDA loss in the second quarter was $34.6 million, near the high-end of our guidance range despite a $7.5 million increase in sequential marketing spend.

EPS

Second quarter 2018 GAAP net loss per share was $0.38. There were two unforecasted items specific to the quarter worth highlighting: We took a non-cash charge of $14.6 million related to our convertible debt exchange and a benefit of $7.2 million in tax expense for the release of a valuation allowance associated with the AdsWizz acquisition. The combination of these unforecasted items along with restructuring and AdsWizz transaction costs reduced overall EPS by $0.04. Our weighted average common shares outstanding was approximately 260 million shares, and the sequential increase was driven primarily by the 9.6 million shares we issued in relation to our AdsWizz acquisition.

Balance Sheet and Cash Flow

Cash and investments ended the second quarter at $421 million. As expected, this was down from last quarter due to the closing of the AdsWizz transaction and label prepayments.

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 Q3 due to label prepayments.

Guidance

Now let's move to guidance. As we've highlighted on past calls, our strategic growth initiatives will build over the course of 2018 and beyond. Although we've continued to make notable progress, we are still in the early stages of what we view as a long game. In terms of specific numbers for Q3:

We expect Q3 total revenue to be between [$390] million to [$405] million, the midpoint of which implies 10% growth versus the year ago period. Our revenue guidance reflects the fact that we project continued momentum in our subscription business albeit at a moderated growth rate as we are no longer growing off a small revenue base. Additionally, we expect an improvement in the year-over-year trend for advertising revenue, aided in-part, by the inclusion of AdsWizz-related revenue.

We expect Q3 Adjusted EBITDA to be in the range of a loss of [$10] million to a loss of [$25] million. Our Adjusted EBITDA guidance includes a significant increase in marketing investment. In fact, we currently plan to spend at least [$10] million more on marketing compared to the year-ago quarter. Additionally, the way in which we spend will be very different, with almost all our media budget allocated to highly targeted, performance-based digital advertising. We will continue to be opportunistic with marketing spend, especially if we can drive results similar to this past quarter, where we saw strong subscriber additions and improvement in ad hour trends.

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 $17 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 third quarter of 2018 are expected to be approximately 269 million.

I’ll wrap up by saying that we’re encouraged by the progress we’ve made this quarter. Roger has said this, and I’ll say it too: there’s still a lot of work to do, but we’re on the right path with solid revenue growth, improving audience metrics and improving Adjusted EBITDA.

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