Pandora (P) Q216 Financial Results Conference Call July 21, 2016

Scripts for: **Tim Westergren, CEO and Founder**
Sara Clemens, COO
Mike Herring, President & Chief Financial Officer
Dominic Paschel, Vice President, Pandora

July 21, 2016

Dominic Paschel

Good afternoon, and welcome to Pandora's second quarter 2016 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 Mike concludes. You can find all of the information I have just described on the Investor Relations section of Pandora.com. On today’s call we have Tim Westergren, Founder and CEO, Mike Herring, President and CFO, and Sara Clemens, COO. With that, let me turn the call over to Tim Westergren, Pandora's CEO.

<u>Tim Westergren</u>

Thanks, Dom, and thank you to everyone for joining the call today.

We continue to make great progress toward our vision of building a complete music marketplace that satisfies the full range of music listening for the consumer, and provides a complete solution for artists. The product is really coming together. As we look to build the next generation Pandora music service, it’s clear that just as we did with the launch of personalized radio, we will be bringing a unique product that will reinvent the category. The size of our audience and the immense amount of preference data we have for the approximately 100 million listeners that visit Pandora every three months will enable us to approach the listener experience in a completely different way: intuitive and easy to use.

In Q2, we continued to execute on our plans while crossing several important milestones. We continue to have very productive negotiations with the three major labels, as well as with our partners in the independent label community. Although these discussions are confidential, we believe that they will result in our being able to deliver the product we want with the right business model, and that the investments we are making today will lead to win-win results as they are delivered, both for Pandora and the music industry as a whole.

Top-line revenue was slightly below expectations in Q2 due to softness in national advertising in the entertainment and telco sectors. Although hours reaccelerated, there is a delay between when the inventory is realized and when we can monetize it. We are confident in our ability to more effectively capture this incremental revenue over time, as we continue to see strong performance and demand for our advertising products.

We feel more confident than ever about the core advertising business due to:

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1. Strong local advertising results, now representing 28% of our revenue
2. An increase in demand for our visual ad product, which has resulted in significant uplift in the eCPM – and the expected year-end launch of new visual ad products, where early betas have already seen great results
3. Continued adoption of native advertising, such as sponsored listening, which is already pacing to exceed our revenue expectations for the year
4. A new high water mark for listener engagement

Our strategy continues to be a focus on high-quality, premium audio advertising, at ad loads that balance strong monetization with increased listener engagement. This allows us to achieve two goals simultaneously (1) rising RPMs which directly drives expanded gross margins and profitability and (2) increasing total listening hours on the platform. We now stream more hours of music on mobile than YouTube streams hours of video in the United States, and are second only to Facebook in total time spent. Ultimately, it is this massive scale that underpins our marketplace strategy.

Pandora now averages 24 hours per listener, per month, a new all-time high, and total hours grew 7% year-on-year, or nearly 400 million hours, to 5.7 billion, also a new all-time high. We view this as a very encouraging data point particularly when you consider the number of free or heavily discounted, on-demand alternatives readily available to consumers. While total users remained essentially flat, we would expect both hours and users to grow over time as we launch new products, and as more people migrate to streaming radio and music services. Along with this migration, so too will dollars continue to shift from traditional radio budgets to digital platforms.

Already, elements of our broad music ecosystem strategy are beginning to take shape. Since Ticketfly has begun joint selling with Pandora they have exceeded their bookings projections.

Why?

Because we are combining ticketing inventory supply with a massive and highly targetable audience of listeners. Venue owners see the power not only to drive ticket sales, but also to more effectively program based on precise knowledge of their customer base. These early results provide a glimpse into the future of live events in our marketplace.

The Uber partnership speaks to the audience growth prospects. Why did Uber put us in the driver's seat? We are the perfect solution for in-car listening, a massive category that remains largely untapped with our current offering. We are the service their drivers and riders use already. In just three weeks, more than 50,000 Uber drivers have used Pandora via the Uber integration, and average daily listening is over 2.5 hours per user. The early adoption numbers are even more encouraging given Uber is still in the process of rolling out the integration to their complete driver audience. Ubiquitous, habitual use is the foundation of our marketplace and we are forging towards that vision.

A central part of our approach to a complete marketplace for music is providing a valuable platform for artists. This quarter we announced that we generated more than $2 billion in all-time royalties paid for artists and songwriters -- just nine months after hitting our $1.5 billion royalties milestone. We are proactively working to ensure that as we launch new products they are fully licensed and the right people are being paid correctly which was the motivation behind our recently announced partnership with Music Reports Inc. (MRI). Mike will provide more details on our partnership shortly, but it is of the utmost importance to us that we implement this open and transparent approach to rights management and set a new standard for the industry as we continue to evolve the platform. Given these many milestones and developments, we feel energized about the next era of Pandora for fans, music makers and advertisers, and as we evolve, we will continue to always do the right thing for Pandora shareholders.

Before I wrap, I want to say a few words of thanks to Peter Chernin, who effective yesterday, concluded his tenure on our board. We're fortunate to have had Peter advising the company for the last 5 years. His contributions, guidance and passion for building enduring companies has helped Pandora navigate a dynamic landscape and position the company for success.

Over the past 15 months the Company has added some of the world's foremost experts in music, technology and digital advertising to the Pandora Board, including: Timothy Leiweke, from AEG; Roger Faxon, from EMI; and Mickie Rosen and Anthony "Tony" Vinciquerra, from Fox.

Now over to Sara and Mike.

<u>Sara Clemens</u>

Thanks Tim.

As I mentioned last quarter, we are operating with our deepest ever bench of product and engineering talent, enabling an accelerating stream of product launches for all three of our key constituencies: fans, music makers and advertisers. Core to realizing our music marketplace vision is delivery of features that are equally delightful for all three of these groups. By driving deeper engagement with listeners, we present more opportunity for music makers and advertisers to connect directly with their fans and customers. The data created by these engagements fuels further refinement of our product and campaign approaches, improving the marketplace as it expands. Today I will cover some highlights from Q2 and speak to the opportunity they represent for Pandora as we look forward to the release of our new services later this year.

We're delighted to announce that Thumbprint radio, which provides a mix of listeners' greatest hits and new music we are confident they will equally love, is now the number one station on Pandora. It achieved this status in less than 6 months, attracting over 14 million total listeners. Under 25 year olds are twice as likely to tune in to Thumbprint as the average listener, and we see a higher level of engagement, a greater level of thumb feedback, and fans spending more time with Pandora. This product is a preview of the kind of dynamic personalization that forms the basis of our next-generation service.

This quarter we launched New Music Stations: genre-based stations which provide a platform for the discovery of emerging artists. In the first 24 hours we had over 1 million stations created. These stations are powerful channels for up and coming artists in building a fan base: artists and bands that are showcased have seen a 10% increase in station adds. This plays forward for artists, as station creates are an input to spinning across Pandora. With emerging artists, for every listener that creates a station, we spin the music to over 45 additional listeners across the service. New Music Stations are a great example of product innovation that benefits fans and artists equally.

We have been experimenting with new forms of content in addition to music with our *Serial* and *This American Life* podcast series. Combined, to-date these stations had close to 10 million listeners stream an episode, with a total of over 20 million episodes streamed. These results confirm that Pandora has the unique ability to leverage its current strengths in music streaming to expand into the go-to destination for discovery of a broad range of audio content. Research confirms that listeners would like to hear more non-music content, but are currently frustrated by discovery. Pandora's ability to surface relevant content to a scaled and engaged audience uniquely positions us to solve this problem. Additionally listeners have confirmed that content offered by Pandora is viewed as more legitimate than unknown sources, increasing both their appetite and willingness to engage with new genres on the platform. We believe half of Pandora users are already consuming non-music content weekly on alternate platforms, demonstrating latent demand. And on the advertiser front, brands that sponsor non-music content are perceived favorably, highlighting strong monetization prospects. We are now exploring scaling these efforts as part of our roadmap.

On the Music Maker front, we have continued momentum with Pandora AMP. Over 300 million Artist Audio Messages have now been heard by fans. We continue to see engagement rates at the top end of social and paid media tools, demonstrating the efficacy of this unique service.

In Q2 we launched our first automated Ticketfly integration, enabling all events booked via the Ticketfly Backstage platform to be seamlessly surfaced via the feed of the artist's fans on Pandora. We have been working with Ticketfly promoters and venues, and building integrated campaigns, with considerable success. The most recent highlight is with an Australian artist, Flume. To promote his new album and accompanying world tour, Flume created a custom Mix tape and launched a tour presale supported by audio message, email and a push notification. Pandora sold over 25 thousand tickets in 3 days, and 20% of house tickets for the entire tour. Results were particularly strong at the Ticketfly venue, Forest Hills Stadium, where Pandora and Ticketfly jointly sold 92% of presale tickets.

The strength of Pandora's promotional power, combined with Ticketfly's cloud live events management platform, drove Ticketfly's strongest booking quarter ever. Jam Productions, one of the largest independent promoters in the US, joined Ticketfly in June, bolstering our position in the Chicago market, and maintaining our drumbeat of iconic venues converting to the Ticketfly platform.

In advertising, Pandora continues to build innovative experiences that delight both listeners and advertisers. This quarter we announced the launch of our Visual Advertising Experience, a responsive mobile display unit that activates a creative that automatically adjusts to the size of the phone's screen. This unit includes muted video, and is a new attention-winning opportunity for advertisers on Pandora. After listeners interact with the visual ad, we've seen a doubling of the number of listeners who engage with a brand's landing page for more than 30 seconds.

Across fans, music makers and advertisers, all of our product innovation has one thing in common: it leverages our core scale of radio listening to enable successful launch of new, profitable services. Nowhere will this be more apparent than with the launch of the first wave of our on-demand product later this year.

I'll now turn the call over to Mike to discuss our financials.

Mike Herring

Thank you, Sara.

As this quarter's activities demonstrate, we remain on-track with our five-year plan to scale our platform. This quarter gives us increased confidence in our plan to drive significant gross profits and incremental contribution margin as we respectively grew non-GAAP gross profit and non-GAAP adjusted EBITDA margin by 6 and 12 percentage points respectively. We continue to have a clear path to a 60% non-GAAP gross margin and a 20% non-GAAP operating margin by 2020 in our core radio business.

Driving our gross margin is our ability to expand RPMs versus LPMs, which will remain virtually flat through the next five years, adjusted for inflation. Total ad RPMs grew from $49.94 in the second quarter of 2015 to $53.34 in the second quarter of 2016, with total LPMs flat at approximately $32, thus the entire increase to RPM drives incremental gross margin. This is a key facet of our financial model that is unique to Pandora among industry leaders and speaks directly to our long term profit potential.

Looking long term, as we continue to execute against our music marketplace vision we are actively building the requisite new products and securing the appropriate licensing. To that end we announced a partnership in the second quarter with Music Reports Inc., or MRI. MRI enables us do two things: 1) administer our direct deals with publishers, and 2) scale licenses across the thousands of publishers in the industry. The license agreement we are offering through MRI is publicly available on their website for any publisher to opt in to. Within just a few weeks of launch, more than 1,800 publishers had signed up. One thing to remember is that this agreement only relates to publishing rights for compositions or the songwriter portion, so it doesn't impact our SoundExchange or label direct deals for sound recordings. I'm proud that Pandora's open and transparent approach to rights management is setting a new standard, and is one that the music industry has widely embraced as a fair and improved way of doing things.

We also have begun to secure the sound recording licenses necessary for the next phase of products we intend to launch, including more than two dozen licenses with independent labels already inked and significant progress ingesting the music catalogs necessary to execute on the back end royalty administration of services licensed through direct deals. We also continue to have constructive conversations with other independent labels as well as the three major labels and are optimistic that fair, win-win deals can be negotiated. We believe we have the necessary assets to create a profitable on-demand business: namely the near-term profitability of our core streaming radio business, our large existing audience, and our unique scale of music listening data. Pandora looks forward to partnering to bring new innovative products to fans and music makers that will make significant contributions to our company and shareholder value, as well as to the music industry as a whole.

Now, let's walk through our second quarter results in more detail.

Q2 2016 Financial Results

Q2 Revenue

Starting with revenue, we ended the second quarter of 2016 with record revenue of $343.0 million, an increase of 20% compared to $285.6 million in revenue for the same quarter last year. Excluding contributions from ticketing services, revenue was $320.3 million, an increase of 12% over the year-ago quarter.

Advertising revenue increased 15% in the second quarter of 2016 to $265.1 million, compared to $230.9 million in revenue in the same quarter last year and as Tim mentioned we crossed the milestone of $1 billion in trailing twelve months total advertising revenue. Local advertising revenue accounted for 28% of total advertising revenue in Q2.

Second quarter subscription and other revenue was $55.1 million, an increase of 1% over $54.6 million in the same period in 2015. Our end of period paid subscribers increased approximately 23 thousand to 3.9 million, an increase of approximately 1% year-over-year.

Ticketing revenue in the second quarter was $22.8 million as the Ticketfly business is solidly meeting expectations. Second quarter Gross Transaction Value excluding box office sales was more than $160 million, growing approximately 20% year-over-year. We transacted approximately 3.7 million tickets excluding box office sales in the quarter which were purchased by approximately 1.6 million unique ticket buyers for approximately 38,000 live events - significant growth of approximately 20%, 20% and 30% year-over-year, respectively.

I'll note that while total revenue was slightly lower than our expectations for the quarter, we were able to make up the shortfall through expense controls, as reflected in our EBITDA, which I'll walk you through momentarily.

Our focus this year is on investment in new products and solidifying the core business. Our ad sales continue to grow, without increasing the number of sales heads significantly and maintaining our focus on users, hours and growing engagement. Speaking to engagement, we saw average listening of 24 hours per month, per user, which is two times that of the next largest service in the U.S., as verified by third-party measurement sources. Growing engagement provides additional hours for monetization opportunities and is a leading indicator of listener loyalty and retention.

The incremental revenue growth translated directly to gross profit and to EBITDA. During the second quarter we had $45.7 million in sequential revenue growth and $36 million in non-GAAP gross profit improvement despite hour's growth increasing content costs, improving gross margin by 630 basis points sequentially. We leveraged operating expenses by keeping expenses flat with revenue growth. As a percentage of revenue non-GAAP operating expenses decreased by approximately 600 basis points sequentially resulting in $32.3 million in adjusted EBITDA improvement and an adjusted EBITDA margin improvement of 12 percentage points, which combined with flattening LPMs, provides clear evidence that as we improve monetization, we can see a clear path to profitability. Moving on to EBITDA…

Q2 Adjusted EBITDA

Consolidated adjusted EBITDA for the second quarter was a loss of $25.1 million, compared to a positive $16.3 million in the same quarter last year, and a $32.3M improvement from the first quarter as 71% of the revenue increase sequentially flowed through to EBITDA. Adjusted EBITDA excludes $32.4 million in expense from stock-based compensation, $14.4 million of depreciation and amortization expense, approximately $6.0 million in other expense, and approximately $1.5 million in benefit from income taxes.

Q2 EPS

Second quarter 2016 GAAP net loss per share was ($0.33). Non-GAAP basic and diluted net loss per share was ($0.12), which excludes approximately $32.4 million in stock-based compensation expense, approximately $5.1 million in amortization of intangibles, and approximately $1.3 million in amortization of non-recoupable ticketing contract advances. GAAP and non-GAAP basic and diluted EPS were based on 229.7 million weighted average shares outstanding.

Q2 Content Costs

Content costs represented 51% of total revenue in Q2, a reduction of approximately 600 basis points from Q1. As I mentioned earlier our ability to drive leverage on these costs is dependent on our ability to increase RPMs in excess of our LPMs. Q2 2016 total RPMs reached a record second quarter high of $56.56 increasing by $2.65 or 5% compared to the year ago period. For the quarter, total LPMs increased by $6.64, or 27% compared to the same quarter last year, but grew only half a percent compared to Q1. As a reminder, we expect to see significant LPM growth in 2016 versus 2015, due to the step up in royalty rates. However, over the next four years LPMs will only grow at a rate equal to the CPI index while RPMs will grow based on our ability to continue to improve the monetization of our service.

Q2 Gross Margin

During the second quarter, non-GAAP gross margins were 38%, compared to 48% in the year-ago quarter primarily the result of costs associated with content, as discussed previously. Sequentially, gross margins improved 630 basis points from Q1.

Q2 Operating Expenses

Turning to operating expenses, we increased headcount 34% year-over-year to 2,334 employees at the end of the second quarter of calendar year 2016, from 1,746 employees in the same period last year.

For the second quarter of 2016, non-GAAP sales and marketing expense was $105.7 million, or 31% of revenue, compared to $80.7 million, or 28% of revenue in the second quarter of 2015, as we continued to ramp our sales team to 508 QBSRs at the end of Q2, 154 of which were focused on local markets, and increased our brand and direct marketing activities. Included in sales and marketing expense in the second quarter are commissions on subscriptions that we pay Google and Apple totaling $10.9 million, and $24.5 million in brand, direct response and SEM activities. The recent changes to Apple's in-app subscription policies will result in savings to Pandora in future commissions due for subscriptions sold through their platform. In the second half of 2016 we expect to see savings of $2.5 and $2.7 million in Q3 and Q4, respectively, but over the long term these changes are beneficial to our business model as we launch and grow new subscription businesses.

Non-GAAP product development expense was $24.7 million for the second quarter, or 7% of revenue, an increase of 85% compared to $13.4 million in the second quarter of 2015, driven by

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significant organic investment in engineering resources and the acquisition of Next Big Sound and Ticketfly and the employees from Rdio in 2015. As we have said previously, we believe product development is an investment in innovation to drive revenue 13 to 36 months out, and thus we remain committed to increasing our spending in this critical area.

Non-GAAP G&A expense was $31.9 million or 9% of revenue, compared to $31.2 million in the same quarter last year or 11% of revenue.

Cash

Turning to the balance sheet, Pandora ended the second quarter with $311.3 million in cash and investments compared to $382.5 million at the end of the prior quarter. Cash used by operating activities was $45.5 million for the second quarter compared to $9.9 million of cash used by operating activities in the year-ago quarter driven in part by the timing of routine working capital movements. Capital expenditures were $20.2 million in the second quarter, primarily driven by server equipment and office buildouts. Internal-use software costs were $7.1 million in the second quarter, driven by capitalization of engineering costs associated with the development of new subscription services.

Guidance

Now, I'll wrap up with some thoughts regarding our guidance for the calendar year 2016 and the third quarter.

First, regarding calendar year 2016, due to softness in national advertising in the second quarter and uncertainty around political spending we are lowering our full year revenue outlook to a range of $1.385 billion to $1.405 billion, or year-over-year growth at the mid-point of approximately 20%.

We expect calendar year 2016 adjusted EBITDA loss be in the range of $70 million to $50 million, consistent with our prior guidance. Adjusted EBITDA excludes forecasted stock-based compensation expense of approximately $142 million, depreciation and amortization expense of approximately $62 million, and a benefit from income taxes of approximately $0.3 million, and assumes minimal cash taxes, given our net loss position for the year.

Basic shares outstanding for the calendar year 2016 are expected to be approximately 231 million. We are also forecasting a non-GAAP effective tax rate between 30% and 35% cumulatively for the year.

For the third quarter of 2016, we expect total revenues in the range of $360 million to $370 million, achieving year-over-year growth at the mid-point of 17%.

With LPMs approximately flat quarter-over-quarter we expect the sequential quarterly revenue growth to flow directly to gross profit and materially to the bottom line, thus Adjusted EBITDA for the quarter will improve sequentially to a range of a loss of $5 million to a profit of $5 million for the third quarter. Adjusted EBITDA excludes forecasted stock-based compensation expense of approximately $35 million, depreciation and amortization expense of approximately $16 million, and a provision for income taxes of approximately $500,000, and assumes minimal cash taxes.

Basic shares outstanding for the third quarter of 2016 are expected to be approximately 233 million.

In summary, we are on-track with our long-term plan and executing against our strategy. The trajectory of the business in the second quarter gives us further confidence that we have the right plan in place to realize our vision and create shareholder value, and we remain excited about the opportunities and our future as we evolve our platform and build a massive marketplace for music.

And with that we’re ready to take some questions. Operator?