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P - Pandora Media, Inc. Conference Call to Discuss Change in Fiscal Year End

EVENT DATE/TIME: OCTOBER 28, 2013 / 8:30PM GMT

CORPORATE PARTICIPANTS

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Mike Herring *Pandora Media Inc - CFO*

PRESENTATION

Operator

Welcome to Pandora's conference call to discuss the previously disclosed change in fiscal year end. All lines have been placed on mute.

(Operator Instructions)

Opening today's call is Dominic Paschel, Vice President, Pandora.

Dominic Paschel - *Pandora Media Inc - VP*

Good afternoon and welcome to our conference call to discuss and give modeling context to our historical calendar-year results as we prepare to transition from a fiscal year end to a calendar year end. I would like to remind you that during the course of this conference call we may discuss non-GAAP measures of our performance. Reconciliations to the most directly comparable GAAP financial measures are provided in the table in the form 8-K filed last week with the SEC. For your convenience, supplemental information and detailed financials regarding RPM metrics are available on the Investor Relations site.

While this call is intended to focus on historical financial results rather than expectations for future periods, we may at times make forward-looking statements. Our actual results may differ materially from these forward-looking statements. In addition we will discuss historical trends such as seasonality, and future results may not follow these historical trends. For a discussion on known risks and uncertainties that affect our future operating results, we refer you to the documents we file from time to time with the Securities and Exchange Commission, including our annual report on form 10-K for the year ended January 31, 2013, and our quarterly report on form 10-Q for the period ended July 31, 2013.

Today's call is available via webcast, and a replay will be available following the conclusion of the call. To access the press release, supplemental financial information, or the webcast replay, please called consult the IR Section of Pandora.com. With that, let me turn the call over to Mike Herring, Pandora's CFO.

Mike Herring - *Pandora Media Inc - CFO*

Thank you, Dom. As you may recall, during our Q2 earnings call, we announced our intent to transition from a January 31 based fiscal year to a December 31 based fiscal year in order to better align Pandora's business calendar with that of the advertising industry. As part of the transition taking place during the fourth quarter of this calendar year we will report earnings according to our current fiscal cadence for the quarter ended October 31, 2013, followed by a two-month stub period for November and December 2013. During our earnings call for the fiscal Q3 ended October 31, we will provide forward guidance for the two-month stub period ending December 31, 2013. In addition we will provide guidance for the three-month period ending January 31, 2014 as if we were not making the transition, to help you facilitate your understanding of our performance during this transition.

We do not intend to discuss any current or future quarter results or other topics on this call today. Our sole intent is to describe the trends and themes associated with historical calendar financials that we posted on our website last week in order to facilitate your understanding of these results, and to help you model expected results on a standard calendar quarterly basis, going forward. While we will discuss overall trends, we will be paying particular attention to those components of our results that are most affected by the change in reporting year. Please bear in mind that the recasting of our historical figures does not change any numbers that have already been reported. The only change is to the timing as to when the figures are reflected.

With that I will turn to historical results. With the transition to calendar-based quarters the seasonality of our results becomes significantly more apparent. Specifically, in the first calendar quarter, we historically experience reduced advertiser demand after the holidays, which is typical of the advertising industry, leading to a sequential quarterly decrease in advertising revenue. Concurrently we see a rise in content acquisition costs as the contractual annual royalty rate increase of approximately 8% takes effect, as well as increased usage, driven by media streaming devices often received as gifts during the holiday season. In addition, we typically increase our headcount during the first and second calendar quarters, specifically with a focus on our sales teams. Collectively these factors generally result in lower revenue and higher expenses in the first half of the calendar year, leading to our historical net losses in the first and second calendar quarters.

Following the low point in the first quarter we tend to see advertising revenue rise throughout the year as our investments in sales, personnel, and sales initiatives progress, as our listening hours grow and as typical advertising seasonality occurs. In addition, the sequential growth in content acquisition costs flattens during the summer months as our listeners historically moderate their listening activity during vacations and time away from work and school, with sequential growth in content costs picking up -- back up again in the fall when our listeners return from these breaks and increase listener activity. Finally, during the fourth quarter we historically see advertising sales reach their peak during the seasonally strong holiday season.

I will now provide additional context into unique drivers of individual line items within our periodic results. For advertising revenue, during the first half of calendar 2011 a single customer contributed significantly to mobile revenue. Specifically, this customer accounted for approximately 11% of revenue or $5 million in the first calendar quarter of 2011, and approximately 16% of revenue or $10 million in the second calendar quarter of 2011. Also in the third and fourth quarters of calendar 2012 we benefited from political advertising activity which primarily occurs once every two years, coinciding with the midterm and presidential elections. Outside of these nonrecurring events, our advertising revenue has followed expected seasonal trends and reflects growing success in monetizing our listener hours.

For subscription revenue, we began to offer in-app subscriptions through Apple devices in late Q4 of calendar 2011, which accelerated the pace of our subscription revenue from that period forward. We subsequently began to offer in-app subscription through Google devices in late calendar Q1 of 2013, which had a similar, but smaller effect on subscription revenue. We then experienced a significant step-up in subscribers in the second calendar quarter of calendar 2013, driven by the implementation of the 40 hour mobile listening limit for free mobile listeners. As we have previously disclosed, in September 2013 we removed the mobile listening limit, as we have instituted other tools to moderate mobile listening hour growth.

Consistent with our prior disclosure, we presented a temporary non-GAAP adjustment to revenue to reflect all in-period bookings net of Management's estimate on subscription returns in order to better illustrate the period's activity. As a reminder, because we have a limited operating history with in-app subscription returns, under GAAP we are required to reserve 100% of the revenue associated with this subscription increase until that return right expires, despite all the costs associated with delivering those services, transaction and content fees being incurred in the period. As we expect to have sufficient history to estimate a reserve in January of 2014, the remaining accumulation of these adjustments will be reversed in the first quarter of calendar 2014. Outside of these items, our subscription revenue has seen consistent growth as user adoption of service has increased over time.

Turning to RPMs. Our RPM trend differs when comparing 2011 to 2012 and 2012 to 2013. From 2011 to 2012 our RPMs declined year over year due to the rapid growth in mobile listening, where the growth in ad revenue did not keep pace with the significant increase in mobile listening hours. In addition, mobile RPMs declined from the first half of calendar 2011 to the first half of calendar 2012. This decline was in part due to the nonrecurring spend of the large mobile advertiser in the first half of calendar 2011 that we discussed previously, which had a significant positive impact on revenue in that period. Mobile RPMs increased from the second half of calendar 2011 to the second half of calendar 2012 as our monetization efforts gained momentum.

Separately, web RPMs experienced year-over-year declines from calendar 2011 to calendar 2012 due to an increase in total hours resulting from lifting the listening limit on web devices in September 2011, as well as our increased focus on monetizing our mobile advertising inventory over web inventory. All RPM categories, total, mobile and web, increased from calendar 2012 to calendar 2013, as monetization steadily gained momentum and we benefited from our efforts to moderate mobile listening hours growth as we entered 2013. For content acquisition costs, our lifting of the web listening limit in September 2011 resulted in the subsequent rise in related content costs thereafter. Conversely, when we implemented both a listening limit and other surgical efforts to control content costs on mobile devices late in the first quarter of calendar 2013, we saw a sequential decrease in content costs in the second quarter of calendar 2013. All other periods reflect increasing content costs with an increase in listening hours as the use of our service continued to rise with annual contractual rate increases of approximately 8% in the first calendar quarter of each year, and with the seasonal usage patterns that I discussed previously.

Our operating expense categories generally reflect sequential increases in absolute dollars as we increase investment in headcount to support our significant growth and to achieve our Company objectives. As a percentage of revenue, operating expenses generally decreased throughout the year as we gain sales momentum and operating leverage. Our calendar 2011 results also include activity within our other expense line item that largely relates to the increase in fair value of our outstanding warrants prior to our initial public offering.

Turning to the balance sheet. Our cash and investments fluctuated in calendar 2011 with the initial public offering as well as the payment of our preferred share dividends and our outstanding debt with those proceeds. Subsequent movements in cash have stemmed from normal changes in our working capital, with any periodic fluctuations largely related to timing. One example of the timing impact is our accounts receivable balances tend to be higher at the end of the calendar year than at the end of January given the timing of holiday campaigns and subsequent collections.

In summary, the most notable element in aligning the advertising industry's business cycle is moving January from a fiscal fourth quarter to a calendar first quarter. This results in a substantially favorable effect in our historical fourth-quarter results, and a corresponding unfavorable effect in our historical first-quarter results. For example, calendar Q4 2012 to calendar Q1 2013 reflected 12% sequential decrease in ad revenue, driven by the slowdown in post-holiday advertising spending, a 20% sequential increase in content costs, driven by the annual rate increases, and the increased use of our service on media streaming devices received as holiday gifts, and finally an 18% sequential increase in operating expenses, driven by our investment in new hires to lay the foundation for growth in the coming year. In general we expect these seasonal trends to continue going forward.

To reiterate, on our next financial results call, we will discuss the results for our fiscal third quarter ending October 31, 2013. So no change to the calendar quarters yet. During that call we will provide forward guidance for the two-month stub period ending December 31, 2013, and for a one last time, the three-month period ending January 31, 2014 to help you with the transition and to facilitate the understanding of our performance going forward.

And with that, we will conclude this call. If you have any additional questions, please feel free to reach out directly to Dom or myself. Thank you for your time today.