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Pandora (P) Q215 Financial Results Conference Call October 22, 2015

Scripts for: **Brian McAndrews, Chairman, CEO, & President**
Mike Herring, Chief Financial Officer, Pandora
Dominic Paschel, Vice President, Pandora

<u>Dominic Paschel</u>

Good afternoon and welcome to Pandora's third quarter 2015 financial results call for the quarter ended September 30, 2015. Some of our discussions will contain forward-looking statements which may include projected financial results or operating metrics, business strategies, anticipated future products or services, anticipated market demand or opportunities and other forward-looking topics.

These statements are subject to risks, uncertainties, and assumptions. Accordingly, actual results could differ materially. For a discussion of the risks that could cause our results to differ from today's discussion, please refer to the documents we file with the Securities and Exchange Commission.

Also, I would like to remind you that during the course of this conference call, we will discuss non-GAAP measures of our performance. Reconciliations to the most directly comparable GAAP financial measures are provided in the tables in the press release and form 8-K filed earlier this afternoon with the SEC. For your convenience, supplemental information has been included in today's press release and detailed financials are available on the Investor Relations site.

Today's call is available via webcast and a replay will be available for two weeks following the conclusion of the call. We will also post the full text of today’s prepared remarks once Mike concludes. To access the prepared remarks, press release, supplemental financial information, or the webcast replay, please consult the Investor Relations section of Pandora.com. With that, let me turn the call over to Brian McAndrews, Pandora's Chairman and CEO.

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Brian McAndrews

Thanks, Dom, and thank you all for being on the call today. Pandora and the industry in general had a busy quarter. Pandora exited the quarter with strong financial results, and I am excited to discuss our recent efforts to pursue the next phase in the evolution of our strategy to shape the future of music.

I'll begin with the quarter's financial highlights. In the third quarter, our strong monetization engine continued to produce record results, with revenue reaching $311.6 million, an increase of 30% year-over-year. From an earnings perspective, adjusted EBITDA was $30.6 million, and our non-GAAP third quarter net income was $22.9 million, or non-GAAP diluted earnings per share of $0.10. These results exclude one-time items related to a legal settlement and modifications to our licensing strategy, which our CFO, Mike Herring, will detail later.

In terms of listeners, as of the end of September 2015, monthly active users were 78.1 million, up 2% from last year, while total listener hours were 5.14B for the quarter, a 3% increase from this time last year. Let me address these audience growth numbers directly. This was obviously a unique quarter in the streaming music business. The June 30th launch of Apple Music with its 3-month free trial, as well as significant category spending and trial offers across multiple players, brought increased focus to the broader on-demand category during this period. As we discussed on our Q2 call, we expected some short-term impact to our audience growth as listeners tried this highly-promoted new service. I am pleased to say that, given the scale of press and consumer attention on this launch, the impact on our active users and listening hours was muted and was, in fact, consistent with what we experienced during the launch of Apple's radio service in 2013. In fact, despite this increased attention on the on-demand category, we continued to grow both active users and listening hours during the quarter as compared to the prior year. In an evolving marketplace, consumers try new technologies and experiment with other services, and we would naturally expect ebbs and flows in active users and hours as we grow our category leadership.

That said, Pandora has not been standing still, as we made a very exciting acquisition in the quarter, made significant progress in our continuing work to strengthen our relationships with rights holders, and continued to invest in product improvements and innovations across Listeners, Advertisers and Music Makers.

By our estimates, Pandora's share of all US radio listening is now 9.49% as of September 30 2015, up from 9.06% at the same time last year. As measured by comScore, Pandora's total multi-platform unique visitors in September 2015 held constant year-over-year at 84.8 million. In terms of engagement, comScore’s September Mobile Metrix report ranked Pandora as the #1 mobile service in the US in terms of average minutes per user – ahead of Facebook. Pandora’s per-user engagement metrics were more than 20% higher than the next closest mobile service and more than double the next largest mobile *music* service even with our much larger user base.

While we continue to grow our share of market, our monetization efforts continue to hit record levels. Total RPMs reached a record high of $60.52 during the quarter, a $12.52 increase year-over-year. Ad RPMs were up 28% year-over-year to a record $56.84. As monetization continues to outpace hours growth, our revenue mix shifts to direct sales versus performance, resulting in higher RPMs and gross profitability.

Our monetization success is also driven by local advertising spend growth which boosts sell-through of premium advertising units and increased pricing across video, display and audio. We have built a **highly** productive, local team of 155 sales professionals that is more than **double** the size of the 2013 local sales force with a strong presence in 39 markets, managing a record 7,000 accounts. During the third quarter, local ad revenue grew 52% year-over-year and represented 25% of total ad revenue. The higher gross profit resulting from these efforts fuels investment in important strategic initiatives, such as our acquisition of Ticketfly, which I’ll discuss in a moment.

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Our new mobile display programmatic offering, which launched in mid-June is quickly gaining momentum, with more than $4 million in revenue so far this year. While we are helping to define and educate marketers on this opportunity, we continue to believe, as our early activity supports, that mobile programmatic has huge potential for Pandora and will result in more meaningful revenue in 2016 and beyond, particularly as we build our multiple device and cross platform capabilities.

As I mentioned earlier, the 3rd quarter was unique in terms of the attention it brought to on-demand streaming services, as well as for the increased level of marketing spending across the category. In anticipation of this, and as we discussed in last quarter's call, we increased our own investment in marketing in the 3rd quarter to help address this challenge. In addition to expanding our efficient direct marketing activities, we also launched our new brand campaign with the theme "the next song matters" across multiple media channels, including, for the first time, television. We view our direct marketing as an investment to engage current and lapsed listeners, as well as attract new listeners in the short-term. We view our brand efforts as a longer-term investment to maintain and grow our category-leading brand position, the strength of which ultimately enables us to expand our offering and execute against our vision. I am happy to report that, due in part to these investments, our core brand metrics experienced strong gains during the 3rd quarter and we continue to enjoy a strong leadership position in the category.

We plan to continue investing to grow our brand leadership in the midst of an evolving market and remind listeners of our unwavering commitment to effortlessly connect each of them with the music they love. This relationship was on display on September 9th, when almost 30 million listeners tuned in for *Listener Love Day* celebrating Pandora's 10-year anniversary with uninterrupted listening. This was a single day listener record for a non-holiday.

Additionally, this afternoon, we took another important step to strengthen our partnership with the music industry, announcing a $90 million dollar settlement with the RIAA and major record labels concerning royalty payments for pre-1972 sound recordings. This progress points to a greater opportunity to work collaboratively toward a bright future for music in a digital era, for those who make it, and the fans who love it.

Let me now turn to a big strategic move we made in Q3: the acquisition of Ticketfly, a company that is using technology to transform live events to make life better for artists, promoters and fans. This is a game-changer for Pandora – and much more importantly – a game-changer for music. Over the past 10 years, we have amassed the largest, most engaged audience in streaming music history. With Ticketfly, we will thrill music lovers and lift ticket sales for artists, as the most effective marketplace for connecting music makers and fans.

Founded in 2008 by Ticketfly CEO Andrew Dreskin, a pioneer in online ticketing, Ticketfly has become a major force in the live events industry. This year, Ticketfly was named one of Fast Company's *"Most Innovative Companies in Music"* with an average of 14 million people visiting Ticketfly.com and its network of client sites each month. In 2014, Ticketfly sold 16 million tickets to more than 90,000 live events, generating more than $500 million in gross transaction value and crossing the $1 billion mark in cumulative gross transaction value. Ticketfly provides ticketing and marketing software for approximately 1,200 leading venues and event promoters across North America and powers more than 600 websites on behalf of its clients, making it the leading provider of website technology to the live events industry.

Ticketfly works with a marquee roster of tastemaker venues and promoters, including the famed 9:30 Club in Washington, D.C., the 19,000-capacity Merriweather Post Pavilion in Maryland and the Pitchfork Music Festival in Chicago.

Over the last year, we have announced a steady stream of efforts aimed at partnering more closely with the music industry. In October 2014, we launched the Artist Marketing Platform, or 'AMP.', which is a suite of tools that helps artists understand, engage and monetize their fan bases. In the first quarter of 2015, we released Artist Audio Messages, giving artists the opportunity to speak directly to fans on the Pandora platform through targeted custom recorded messages. We closed the acquisition of Next Big Sound on July 1st this year, to provide social and contextual insights for artists about their fans and music trends. And, exemplifying the power of our audience and data capabilities, we applied our efforts to the live events space, driving significant ticket sales for acts ranging from one of the most established acts in music, the Rolling Stones, on their stadium tour, to the up-and-coming EDM duo ODESZA.

The extremely positive experience with these programs highlighted the opportunity for Pandora in the live events space and the role we can play to drive value across the board – for fans, artists, promoters and venues. Nearly $11 billion is spent annually across the U.S. live events market through concert fees, sponsorship and advertising, and ancillary revenues like merchandising. The majority of this revenue is earned in the middle of the market - in small and medium sized venues, and at the growing number of festivals across America. Approximately 80% of total artist income is earned through touring, and this market is growing: in 2014 the live events industry in the US grew 22%, with per capita spend on live music reaching $48 in 2014.

Our efforts working with artists over the last year highlighted that there is real opportunity for Pandora to help accelerate that growth. Approximately 40% of tickets go unsold at mid-market concerts, primarily due to lack of consumer awareness of the events. We expect the combination of Pandora and Ticketfly will solve the longstanding problem of event discovery by seamlessly connecting Pandora's over 78 million monthly active music fans to events they'll love. We believe this will enable artists and promoters to sell out more shows and strengthen the bond between artists and their fans that drives additional revenue from streaming, and music and merchandise sales.   Pandora is uniquely placed as a streaming service to be able to do this. As we have repeatedly demonstrated with artists including Jack White and Mumford and Sons, the core Pandora experience provides an unparalleled nationwide promotions platform.

Another challenge in the live events space is that artists, promoters and venues in the mid-market do not have a scaled way to secure promotions revenue and tap the growing demand from advertisers and brands for association with music experiences. Our acquisition of Ticketfly also aims to close these gaps. Over the last few years, Pandora has been working with advertisers and brands to understand how live events can be incorporated into broader experiential campaigns. Our Music Maker Events team runs over 60 live events a year, using the Music Genome to identify bands that resonate with the advertiser's target audience. Add to that our acquisition of Next Big Sound, and we now have the industry's leading proprietary data sources providing deep insights and actionable intelligence about how artists connect with specific audiences.

Further, we have built the best and most productive sales infrastructure in streaming by far. By putting the power and size of the Pandora ad sales team behind the lucrative sponsorship market, we can drive more revenues for Pandora, artists, venues and promoters by connecting our advertisers to the growing number of events and festivals. Today live events sponsorships total $2 billion in the United States. Given our expertise in monetization, Pandora is the perfect partner to help Ticketfly tap into this huge number and ultimately unlock additional dollars and grow the market by connecting advertisers to the middle market of events.

We believe Pandora can ultimately unlock additional dollars and grow the market by connecting advertisers to the middle market of events.

We also plan to create tools for artists, venues and promoters that will enable them access to the insights generated from the Music Genome, Next Big Sound and Ticketfly. We believe this will solve previously intractable problems for the industry such as understanding where their audiences are, how they should tour, which artists to book for which venues, and how to price dynamically across super fans and emerging fans. Pandora, Next Big Sound, and Ticketfly are all deeply data-driven companies. Our joint purpose is to build the world's most powerful music discovery platform that enables everyone in the music ecosystem to benefit and grow their business. Together we can use the insights we have to improve recommendations for fans, create new tools for artists, venues and promoters, and connect advertisers and their customers.

Since I joined Pandora over two years ago, I have been focused on the huge opportunities we have to leverage our industry-leading platform to grow listeners, increase our advertising business and create and capture value by working more closely with the music industry. Ticketfly is the latest – and largest – demonstration of the continuing execution of this strategy. I am very excited about the opportunity this presents for Pandora. Pandora's acquisition of Ticketfly takes the company beyond its Internet radio roots and builds on its progress to become an indispensable partner to music makers and create the leading data-enabled marketplace for artists and fans.

In summary, Pandora exited Q3 with strong financial results. In a quarter where a large new entrant came into the music streaming landscape and over a hundred million dollars in combined marketing was spent across the sector to drive awareness of a multitude of offerings, Pandora more than held its own for users and hours growth. We aggressively invested to deliver long-term growth and cement Pandora's leadership in music. We believe our acquisition of Ticketfly will be truly transformative, extending our long-standing strength in music discovery to the large and fast-growing world of live events.

With that, I’d like to turn the call over to Mike Herring, our Chief Financial Officer, for more details regarding our financials.

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Mike Herring

Thank you, Brian. Before I walk through our third quarter financials and explain in more detail what's driving our results, I would like to explain the economics of Ticketfly, which will impact the fourth quarter and full year 2015 once closed, but had no impact on the third quarter.

Ticketfly has developed the leading cloud-based software platform for live events, and powers ticketing, digital marketing, analytics, CRM and more on behalf of its clients. In exchange for provision of software to its clients, it is given the right to charge reasonable service fees to ticket buyers. Ticketfly's revenues, which consist primarily of convenience and order processing fees from ticketing operations, will be recognized as tickets are sold, and will be recorded net of the face value of the ticket as Pandora acts as an agent in these transactions. In many cases Ticketfly shares a portion of the service fees with its clients. The portion of the service fee revenue that it shares with its clients will be included within costs of revenue. For the first 9 months of 2015, Ticketfly sold more than 16 million tickets with gross transaction value of more than $530 million. Revenue to Ticketfly was approximately $52 million, with gross profit after the client portion of the fees of approximately $29 million. This translates into an average ticket price of $37.11, which is up 4% from $35.54 in the first 9 months of 2014 and up 20% from $30.99 in the first 9 months of 2013 for advance ticket sales. Depending on the date the transaction closes a portion of the Ticketfly revenue and gross profit will be included in our Q4 and full year 2015 results.

Section One: Discussion of impact of pre-1972 and KXMZ

Moving on to the discussion of Pandora's third quarter 2015, we recorded two significant one-time cumulative charges in the quarter as a result of two steps we are taking to better partner with the music industry. The first charge relates to pre-1972 works where we have agreed to a $90 million settlement with UMG Recordings, Sony Music Entertainment, Capitol Records, Warner Music Group and ABKCO Music and Records for the use of pre-1972 content through the end of 2016. This settlement covers approximately 90% of our pre 1972 spins. We have recorded a cumulative charge, including the effect on the current quarter, of $57.9M to content costs in the quarter, where the remainder of the settlement will be recorded through the end of 2016 according to expected usage patterns. We believe that this settlement avoids ongoing litigation, addresses a point of contention within the industry and opens the door to improved partnership with artists and labels.

In keeping with our strategy to strengthen our relationship with the industry, we have also decided to refresh our approach to publishing rights with the intent of creating a framework for constructive, sustainable, long-term partnerships. In conjunction with our purchase of KXMZ, the broadcast license for which was approved by the FCC this past summer, our strategy had been to utilize a royalty license available to Pandora called the RMLC license from the date that we initiated the KXMZ acquisition in June 2013. Our financial statements have historically reflected this position. However, as a sign of good faith to our publishing partners, we have decided to forgo the application of the RMLC license from June 2013 to September 2015, and the rate associated with that license. As a result, we have recorded a charge of $23.9M to cost of revenue - content acquisition costs in the quarter to reflect a true-up from the RMLC rate for ASCAP and BMI to the rate established by the respective rate courts. We expect to record publisher royalty expenses according to these rates for the remainder of 2015. It should be noted that while we are forgoing the RMLC license for the period from June 2013 to September 2015, an additional key aspect of this strategy was to ensure that we are not subject to publisher withdrawals from the blanket licenses available to us. We therefore intend to file for the RMLC license for ASCAP as of January 1, 2016, because the ASCAP rate court ruling expires at the end of 2015. I want to be clear – we are not taking this step for the royalty rate provided by the RMLC, but for the licensing certainty it provides through 2016 in response to the risk of publisher withdrawals. The BMI ruling extends through 2016 and thus we will not be applying for the RMLC license for BMI as we are not subject to the risk of publisher withdrawals in the short term. Bottom line, we feel like this is the right path to advance our strategy and chart a path forward for music.

Section Two: Results excluding charges

In terms of our operating results for the third quarter, total revenue for the third quarter was $311.6 million, representing 30% growth from the year-ago quarter and within our guidance range of $310 to $315 million.

Advertising revenue increased 31% in the third quarter of 2015 to $254.7 million, compared to $194.3 million in revenue in the same quarter last year. Third quarter subscription and other revenue was $56.9 million, an increase of 26% over $45.3 million in the same period in 2014.

Content costs, excluding the pre-72 and RLMC-related charges described earlier, were $129.4 million, or 42% of revenue, resulting a Non-GAAP gross margin of 52%.

For the quarter, adjusted EBITDA was $30.6 million, representing a 27% improvement year over year from Q3 2014 and above our guidance range of $25 to $30 million. Adjusted EBITDA excludes expense from the one-time cumulative charges of $81.8 million to cost of revenue – content acquisition costs, $28.8 million in expense from stock-based compensation, $5.8 million of depreciation and amortization expense, approximately $32,000 provision for income taxes, and approximately $36,000 in other income.

Basic and diluted non-GAAP earnings per share net of one-time cumulative charges were $0.11 and $0.10 respectively. Non-GAAP EPS excludes one-time cumulative charges of $81.8 million to cost of revenue – content acquisition, $28.8 million in stock-based compensation expense and approximately $438,000 in amortization of intangibles. Basic and diluted non-GAAP earnings per share also include approximately $2.3 million in income tax effects of non-GAAP adjustments.

Section Three: Consolidated Results Including Impact of Charges

Content costs including the impact of the pre-72 and RMLC-related cumulative one-time charges were $211.3 million. During the quarter, we surpassed more than $1.5 billion in all-time royalties paid as we continue to contribute to the artist economy in a meaningful way.

Third quarter 2015 GAAP basic and diluted loss per share, which includes the impact of cumulative one-time charges, was $0.40. GAAP basic and diluted and non-GAAP basic EPS were based on 212.8 million weighted average shares outstanding. Non-GAAP diluted EPS is based on 222.9 diluted shares outstanding.

As previously mentioned on our past earnings calls this year, we will begin adjusting our non-GAAP income by considering the income tax effects of our non-GAAP adjustments. Prior to 2015, our non-GAAP tax rate was minimal. We are currently forecasting a non-GAAP tax rate of 35% to 40% for the full year 2015, which should be used when calculating non-GAAP net income and non-GAAP EPS. Despite this, we do not expect to pay significant cash income taxes for the foreseeable future due to our net operating loss position.

Q3 2015 total RPMs reached a record high of $60.52 growing by $12.52, or 26%, compared to the year ago period. For the quarter, total LPMs excluding one-time cumulative charges increased 10% year over year to $24.62. Total web RPM and total mobile RPM for the second quarter were $72.14 and $58.44, respectively. Web advertising RPM reached $71.88 and mobile advertising RPM reached $54.31. Year-over-year increases in RPM were driven by higher direct sell-through rates along with an increase in premium pricing, driven by local sales. For the quarter, local advertising revenue represented 25% of total.

Turning to operating expenses, we increased headcount 36% year-over-year to 1,879 employees in the third quarter of calendar year 2015, from 1,380 employees in the same period last year. This was primarily the result of adding new sales people, which increased by over 100 sales people versus the same quarter last year, and we ended the quarter with 454 QBSRs. This headcount does not include Ticketfly, which currently has approximately 160 employees.

For the third quarter of 2015, non-GAAP sales and marketing expense was $93.6 million, or 30% of revenue, compared to $61.9 million, or 26% of revenue in the third quarter of 2014, as we continued to ramp our sales team and our brand and direct marketing activities. Included in sales and marketing expense are commissions on subscriptions that we pay Google and Apple totaling $11.0 million, and $23.5 million in brand, direct response and SEM activities.

Non-GAAP product development expense was $15.4 million for the third quarter, or 5% of revenue, an increase of 72% compared to $9.0 million in the third quarter of 2014. As we have said previously, we believe product development is an investment to drive revenue 13 to 36 months out, and thus we are committed to increasing our spending in this critical area.

Non-GAAP G&A expense was $28.0 million or 9% of revenue, an increase of 23% compared to $22.8 million in the third quarter of 2014.

Turning to the balance sheet, Pandora ended the second quarter with $442.6 million in cash and investments compared to $461.5 million at the end of the prior quarter. Cash provided by operating activities was $11.9 million for the third quarter compared to $5.2 million in the year-ago quarter. Capital expenditures were $9.4 million in the third quarter. Our cash balance at the end of the quarter does not reflect the cash impact of the initial payment of the pre-72 settlement of $60 million, the RMLC rate catch-up, or the acquisition of Ticketfly, all of which we expect to occur in the fourth quarter, and which we expect to use an aggregate of approximately $250 million in cash.

Now, I'll wrap up with some thoughts regarding our guidance for the calendar year 2015 and the fourth quarter 2015.

Starting with the full year 2015, we estimate total revenues in the range of $1.153 billion to $1.158 billion, or year-over-year growth at the mid-point of approximately 27% on a non-GAAP basis, a reduction of $24.5 million at the midpoint from the prior range given on our Q2 earnings call. While our advertising revenue operations are operating at full strength, our expectation for hours growth year-over-year for the fourth quarter is 3%, limiting the inventory available to drive revenue to the previous range. We have chosen not to chase every dollar in the quarter and instead focus on high-quality monetization, executing on industry partnerships and the integration of the Ticketfly business following the close of that acquisition.

As we have lowered revenue expectations but are continuing to invest in our business, and thus we now expect calendar year 2015 adjusted EBITDA to be in the range of $51 million to $56 million. We are also now expensing the royalty impact of pre-72 works – which in the fourth quarter accounts for an additional approximately $7.3 million in content expense – and our shift in publishing strategy will result in an additional $3.4 million in content expense; so together, an additional $10.7 million in content expense was added to our Q4 forecast not previously included in our estimates. Adjusted EBITDA excludes forecasted stock-based compensation expense of approximately $111 million and forecasted depreciation and amortization expense of approximately $22 million and assumes minimal provision for income taxes given our net loss position for 2015. Diluted shares outstanding for the full year 2015 are expected to be approximately 221 million, which does not include approximately 11.6 million shares of Pandora stock to be issued upon closing of the Ticketfly transaction expected in early November, which will need to be weighted.

For the fourth quarter of 2015, we expect total revenues in the range of $325 million to $330 million, achieving year-over-year growth at the midpoint of 22%. Adjusted EBITDA is expected be in the range of $25 million to $30 million for the fourth quarter. Adjusted EBITDA excludes forecasted stock-based compensation expense of approximately $32 million and forecasted depreciation and amortization expense of approximately $6 million and assumes minimal provision for income taxes given our net loss position for the third quarter. Diluted shares outstanding for the fourth quarter 2015 are expected to be approximately 224 million, again this does not include approximately 11.6 million shares of Pandora stock to be issued upon closing of the Ticketfly transaction expected in early November which will need to be weighted.

In summary, Pandora continues to be an industry leader in music streaming and mobile advertising and we have continued to invest in our business to fuel long-term growth. We are monetizing at an increased rate with RPMs and revenue reaching all-time highs while investing in our strategies to expand and strengthen our relationships with artists, labels, publishers and song writers, and now we are starting to take our core data assets and audience reach to drive new business lines for Pandora and new and greater revenue streams for the music industry in general.

As a reminder, we expect the CRB's final rate determination in December. We are confident in the positions laid forth in our filings and trial presentations to the CRB judges. Regardless of the decision, we believe that certainty is the biggest benefit as we will be able to absorb any rate change and are confident in Pandora's ability to deliver long-term growth. However, we continue to believe a reasonable rate is best for all parties—including the labels, as it fosters investment and innovation in a distribution platform that pays material royalties.

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