Pandora (P) Q115 Financial Results Conference Call April 23, 2015

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

FINAL – April 23, 2015

Dominic Paschel

Good afternoon and welcome to Pandora's first quarter 2015 financial results call for the quarter ended March 31, 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.

The 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. To access the 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, CEO and President.

Brian McAndrews

Thanks, Dom, and thank you all for being on the call today. I am excited to speak with you regarding our strong start to the year. Today I'll review our first quarter financial highlights and share more details about our activities over the quarter before turning the call over to Mike Herring, our Chief Financial Officer.

Let me begin with a few financial highlights. First quarter revenue reached $230.8 million, an increase of 28% year-over-year on a non-GAAP basis. From an earnings perspective, adjusted EBITDA was a loss of $20.9 million, and our non-GAAP first quarter net loss was $24.9 million, or non-GAAP loss per share of $0.12.

Now, I'll discuss our first quarter results in more detail, starting with audience, where we continue to drive multi-dimensional growth. In terms of listeners, as of the end of March 2015, monthly active users were 79.2 million, an increase of 5% over last March. In terms of engagement, hours per active user increased 5% year-over-year, to 22.3 hours this quarter. This growth in both listeners and engagement resulted in total listener hours growing to 5.3B for the quarter, an 11% increase from this time last year and an all-time high.

Our focus on growing engagement and loyalty continues to pay off, reinforcing Pandora's position as the clear leader in Internet radio and as a growing force in radio overall. By our estimates, and for the first time ever, Pandora's share is now 10% of all US radio listening as of March 2015, up from 9.1% in March 2014. Third-party measurement confirms the scale of our audience. As measured by comScore, Pandora's total multi-platform unique visitors in March 2015 grew by 10% year-over-year to 87.8 million. In addition, comScore confirmed in their March Mobile Metrix Top Properties report that Pandora remains the number one mobile service in the US in terms of engagement, ahead of every other mobile service, including Facebook, Google, and Twitter.

In the first quarter, our growing product and technology organizations executed new integrations to further our listener reach and engagement. Starting with the addition of Pandora music cards in the Google App in February, we helped make it easier for Android users to launch Pandora stations and receive enhanced recommendations based on their context. We also announced integrations into the Amazon Echo and Apple Watch within the past month. These activities allowed us to reach a new milestone of 25 million listener activations on CE devices, and built on our commitment to be available anytime, anywhere Pandora users want to listen. Additionally, our progress with automotive integrations remains strong, as 10 million listeners have now activated Pandora via native in-car integrations.

We continue to drive strong results through our focus on monetization, with strong RPMs for the first quarter of the year. Q1 2015 total RPMs hit $43.53, up 16% year over year on a non-GAAP basis. Ad RPMs were up 15% year over year to $38.30.

As a result of continued expansion of our local ad sales teams over the last year, we accelerated local ad revenue to over 24% of total ad revenue. Mobile monetization continues to show strong momentum with mobile revenue at 78% of total revenue. Further, with 84% of our total listening hours happening on mobile and other devices, there is great opportunity ahead.

Overall, our increased monetization expanded our non-GAAP gross margin 7 percentage points over Q1 2014 to 39%. This significant progress occurred despite the increase in content costs in January due to the scheduled annual step-up in SoundExchange royalty rates, which increased 8% this year. As we execute strongly against our business priorities, we are then able to invest dollars back into the business to further drive margin expansion and growth long-term.

As we lay the ground work for future increased monetization, Pandora's mobile programmatic offerings are live in beta right now with iOS launching in March and Android in April. During beta, we are open to a handful of customers to ensure we are set up to operationally scale the program similarly to what we've done in web. We anticipate mobile programmatic will be generally available for advertisers early in the third quarter. With our user reach, Pandora will be the largest single in-app premium mobile programmatic publisher in the United States. This is a very big deal because approximately 85% of smartphone usage is spent in-app vs. on mobile web, while most "mobile programmatic" offerings are on the mobile web.

Some of the other key investments we are making are towards initiatives managed by our Music Makers Group, which is working to make Pandora an indispensable partner to the music industry.

This team rolled out a large number of successful Artist Programs this past quarter, demonstrating the power of Pandora's platform to create win-wins for music makers and their fans, all while increasing engagement on Pandora.

Following the successful October 2014 launch of our Artist Marketing Platform, or "AMP", Pandora launched the next phase with Artist Messaging this quarter. Artist Messaging provides artists with the ability to directly speak to their fans about tour dates, new music or crowd-funding efforts. The early response from artists has been incredibly positive with participating artists ranging from Lenny Kravitz to Mark Ronson.

In addition we have hosted a series of successful events this quarter. In January, we partnered with Jack White to host a live stream of his Madison Square Garden Concert in New York City. To help promote the stream, Jack White and his label Third Man Records created a "Jack White Live" station which included his songs as well as songs from other Third Man Records artists. Over 700,000 of these "Jack White Live" stations were launched and listened to. With regards to the concert itself, our listeners were able to tune in to the live performance through Pandora, and the numbers show just how excited they were to do so. Through our platform, we increased Jack White's live concert audience by 7 times beyond the venue, with 125,000 unique listeners tuning in across the United States. In the week following the event, sales of Jack White's most recent album increased by 41%, an increase that was roughly 4 times higher than music sales lifts experienced by similarly acclaimed musicians who performed at the same venue.

Our annual South by Southwest Discovery Den was another exciting accomplishment, with 38 artists and bands playing to an audience of 30 thousand over 4 days. We also live streamed the concerts, extending the audience by a further 1 million listeners. Reinforcing our belief that Pandora can operate as an extension of the live experience, all artists who performed achieved accelerated engagement with fans on Pandora, and this effect in listening behavior was notable for small and large artists alike. Multiple Grammy winner Wyclef Jean, for example, saw his listening on Pandora increase by 55% in the days following his live Discovery Den performance. We believe that this is a testament to the strength of our listener base and the scale at which we can connect musicians with fans.

Some additional highlights from our Music Maker programs in Q1 include: the International Day of Happiness Custom Curated Mixtape Station that was created in partnership with Pharrell Williams and attracted over 160,000 listeners; our on-platform artist messaging program promoting Diplo and Skrillex's New Year's Eve Performance at Madison Square Garden which drove an impressive 12% click through to ticketing; and our latest installment in our *Thumb Moments* Campaign with Grammy Award-nominated and multi-platinum selling recording artists Fallout Boy.

Finally, we are very excited to have recently partnered with AEG Live and The Rolling Stones as a presale partner for their upcoming *Zip Code* tour. As part of this partnership, we promoted the tour through a custom curated Mixtape Station, including artist content featuring Mick Jagger and Keith Richards that engaged over 300,000 fans. Through this partnership we drove sales of over 53,000 tickets across 13 shows, significantly exceeding our expectations, and selling out our allocation in four markets within hours. This partnership highlights our ability to connect artists with their fans across engaging content on the platform, and to generate significant ticket sales around these experiences.

To further demonstrate our commitment to stronger relationships with Music Makers, I am very excited that Roger Faxon and Tim Leiweke will be joining our Pandora Board of Directors. Roger and Tim are forward-thinkers and bring invaluable experience and expertise in music and entertainment.

Roger has spent his career leading creative businesses, including serving as CEO of EMI Group, which, before its sale in 2012 to Universal Music Group, was among the largest music businesses in the world. Tim has more than 30 years of sports and entertainment experience including as CEO of AEG, the world's second largest presenter of live music and entertainment events, where he helped guide their global expansion.

Both Roger and Tim's experience as leaders in the global music business, including performing and publishing, will be immensely valuable to us as we continue to evolve and execute our strategies around Listeners, Advertisers and Music Makers.

You can read more about Tim and Roger in the press release we issued about their appointments on Monday. I also encourage you to read a great Op Ed piece that Roger wrote for Billboard, sharing his excitement about joining us as we help shape the future of the music industry.

While Roger and Tim are joining Pandora, Bob Kavner and David Sze will be concluding their tenures on the board this June. We're extremely grateful for their contributions and guidance as we've grown our business and positioned Pandora for long-term success.

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Before closing, I’d like to take this opportunity to thank everyone who joined us in person or by webcast for our investor day in March, where our executive leadership team provided a comprehensive look at the 2015 investments we are making to position Pandora for success through 2020 and beyond. As we discussed, 2015 is a year of conviction as we invest to strengthen our industry relationships, improve our product, and deploy the force necessary to further strengthen our ad sales. Given these investments, we will continue to move decisively and assertively to capture the enormous market opportunity before us. We are on track to deliver more than $1 billion in revenue this year as the largest streaming radio service and capture more than 10% of all radio listening in the US. While we still have lots more work to do and investments to make, we are starting the year from a position of strength, and we’re very excited about our future. With that, I’d like to turn the call over to Mike Herring, our Chief Financial Officer for more details regarding our financials.

Mike Herring

Thank you, Brian. I would also like to thank everyone for participating in our investor day last month. We outlined a number of investments we plan to make in 2015 and I'll discuss these investment plans after taking you through our first quarter financials, and what's driving our results, in more detail.

Starting with revenue, we ended the first quarter of 2015 with total revenue of $230.8 million, which was above our guidance range of $220 million to $225 million, representing 28% growth on a non-GAAP basis from the year-ago quarter. The beat was a result of stronger than expected advertising revenue performance, particularly in March, which resulted in advertising revenue growth of 27% in the first quarter of 2015 to $178.7 million, compared to $140.6 million in revenue in the same quarter last year.

Subscription and other revenue was $52.0 million for the first quarter and grew 9% on a GAAP basis sequentially, while decreasing 3% year-over-year on a GAAP basis due to a one-time reversal related to the subscription return reserve of $14.2 million in Q1 2014. On a non-GAAP basis, subscription and other revenue increased 32% from $39.5 million in Q1 2014. Our end of period paid subscribers were 3.78 million, an increase of 11% year-over-year.

The sequential gain of over 200,000 subscriber additions is partially driven by the reinstatement of the annual subscription option in December of 2014 and the mobile app refresh in January 2015.

For the quarter, adjusted EBITDA was a loss of $20.9 million, a 7% improvement year over year from Q1 2014 and substantially better than our provided guidance range of a loss of $35.0 to $30.0 million. Adjusted EBITDA excludes $23.2 million in expense from stock-based compensation, $4.3 million of depreciation and amortization expense, approximately $59,000 of provision for income taxes, and approximately $197,000 in other income. Our

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outperformance on adjusted EBITDA was the result of a combination of better than expected revenue and investments in marketing and events that slipped into the second quarter.

As mentioned in our Q4 call, 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. As expected in the first quarter 2015, our non-GAAP effective tax rate was also minimal due to our non-GAAP net loss position. For the full year 2015, we are currently forecasting a non-GAAP tax rate of approximately 30% to 35% to 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.

First quarter 2015 GAAP basic and diluted loss per share was $0.23. Basic and diluted non-GAAP loss per share was $0.12, which excludes approximately $23.2 million in stock-based compensation expense and approximately $183,000 in amortization of intangibles. GAAP and non-GAAP basic and diluted EPS were based on 209.9 million weighted average shares outstanding.

We continued to improve leverage over content costs, which represented 55% of total revenue in Q1, an improvement of over 500 basis points over Q1 2014 based on non-GAAP total revenue. As we have previously emphasized, our ability to leverage these costs is dependent on our ability to increase RPMs in excess of LPMs. Q1 2015 total RPMs reached $43.53, growing 16% on a non-GAAP basis compared to the year ago period.

Total web RPM and total mobile RPM for the first quarter were $60.13 and $40.47, respectively. Web advertising RPM reached $58.04 and mobile advertising RPM reached $34.92. Our strength and confidence in improved monetization has allowed us to let user hours grow, and with expanding RPMs, we are able to commensurately expand non-GAAP gross margins.

During the first quarter, LPMs were $23.77 and thus non-GAAP gross margins expanded 700 basis points from 32% in the year-ago quarter to 39%, despite the increase in content cost in January due to the scheduled annual step-up in royalties paid to SoundExchange. We expect this trend to continue throughout the year as we make progress toward our gross margin target of 60% of revenue.

Turning to operating expenses, we increased headcount 35% year-over-year to 1,624 employees in the first quarter of calendar year 2015, from 1,205 employees in the same period last year. We have added 74 QBSRs in the first quarter and 99 QBSRs year-over-year, the majority of which were added at the end of Q4 2014 and in Q1. We have added over 90 sales people so far for this cycle, hitting our target, resulting in over 430 total QBSRs, including 138 local sellers in 37 markets. Adding salespeople early in the year is important as they historically ramp over the second and third quarters, fully ramping by the fourth quarter. Moreover, we already have close to 250 sellers that started 2015 fully ramped up and increasing their profitability year-over-year.

For the first quarter of 2015, non-GAAP sales and marketing expense was $72.9 million, or 32% of revenue, compared to $53.6 million, or 30% of non-GAAP revenue in the first quarter of 2014. Included in sales and marketing expense are commissions on subscriptions that we pay Google and Apple totaling $9.8 million, and $7.4 million in external brand, direct response and SEM marketing activities. We spent less than we had initially targeted in brand, events marketing, and music makers group activities, as we shifted some of these activities to Q2.

Non-GAAP product development expense was $11.3 million for the first quarter, or 5% of revenue, consistent with our spend as a percentage of total non-GAAP revenue in the prior year. We added 24 software engineers in the quarter and now have 194 software engineers on staff, up 54% year-over-year *(Note to Mike: If you include software engineering and tech ops –*

which we did not last quarter – we added 29 engineers and tech ops people in the quarter and now have 232 engineers and tech ops people on staff, up 49% year-over-year). We often say product and development is an investment to drive revenue 13 to 36 months out, and thus we plan to increase our spending in this critical area.

Non-GAAP G&A expense was $30.5 million or 13% of revenue, an increase of 42% compared to $21.4 million in the prior year.

Turning to the balance sheet, Pandora ended the first quarter with $481.3 million in cash and investments compared to $458.8 million at the end of the prior quarter. Cash provided by operating activities was $27.0 million for the first quarter compared to cash used in operating activities of $2.1 million in the year-ago quarter. The strong performance in cash from operations was partly driven by the re-introduction of our annual subscription option. Capital expenditures were $5.9 million in the first quarter.

We had a very good quarter, performing on-plan or better than expected across the board, with some expenses originally anticipated for the first quarter shifting to Q2. With this in mind, I'll wrap up with some thoughts regarding our guidance for the calendar year 2015 and the second quarter 2015.

Starting with the full year 2015, we estimate total revenues in the range of $1.16 billion to $1.18 billion, or year-over-year growth at the mid-point of approximately 29% based on 2014 non-GAAP total revenues, up from the prior range of $1.15 billion to $1.17 billion given in our quarter ended December 31 call in February.

We expect calendar year 2015 adjusted EBITDA to be in the range of $75 million to $85 million, up from the prior range of $70 million to $80 million. Adjusted EBITDA excludes forecasted stock-based compensation expense of approximately $122 million and forecasted depreciation and amortization expense of approximately $23 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. While we outperformed our expectations for adjusted EBITDA in Q1 by approximately $10M, some of the expenditures we planned for the first quarter were delayed to the second quarter, and thus the positive impact to adjusted EBITDA for the year from this over-performance only partially translated to full year upside.

For the second quarter of 2015, we expect total revenues in the range of $280 million to $285 million, or year-over-year growth at the midpoint of 29%, and in the quarter we will cross over the milestone of a billion dollar run rate in annual revenue. Adjusted EBITDA is expected be in the range of $8 million to $13 million for the second quarter. Adjusted EBITDA excludes forecasted stock-based compensation expense of approximately $31 million and forecasted depreciation and amortization expense of approximately $5 million and assumes minimal provision for income taxes given our net loss position for the second quarter. Diluted shares outstanding for the second quarter 2015 are expected to be approximately 219 million.

In summary, we continue to execute well across our strategic initiatives and invest in our business to fuel growth long-term. This is a year of conviction at Pandora, to build on our leading industry position and continue to invest for success.

As a reminder, the CRB trail portion for Web IV starts in May with closing arguments in June. Much of it will be closed, so we caution against drawing premature conclusions based on partial information. We expect the activity will generate media attention and headlines, but I want to remind you that the core of our argument has not changed. We are confident in our position, and believe our rate proposal is entirely reasonable and fully supported by the available evidence. Further, we strongly believe that our rate proposal will serve to benefit the entire music ecosystem. While the next few quarters may be noisy on this front, we don't expect a final decision until December. We appreciate your understanding of this lengthy and often opaque process.

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