Pandora (P) Q416 Financial Results Conference Call February 9, 2017

Scripts for: **Tim Westergren, CEO and Founder**

Mike Herring, President & Chief Financial Officer

Dominic Paschel, Vice President, Pandora

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Dominic Paschel

Good afternoon, and welcome to Pandora's fourth 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 and Mike Herring, President and CFO. With that, let me turn the call over to Tim Westergren, Pandora's CEO.

<u>Tim Westergren</u>

Solid Quarter with Momentum

Thanks, Dom, and thank you to everyone for joining the call today. I'm pleased to share further details regarding our fourth quarter and full year 2016 results. As we previewed in January, we exceeded both our revenue and adjusted EBITDA guidance for the quarter. More specifically, we are reporting the largest quarter in Pandora's history, with $392.6 million in revenue. Mike will discuss details regarding our financials for the quarter and the full year, but before he does I would like to offer some broader perspective on where we are as a company.

2016 was a very significant year for Pandora, with progress on every important front. In Q4 we demonstrated our ability to drive leverage in the ad-supported business while effectively accelerating subscriptions for our paid product. In fact, in Q4 we reignited growth and increased subscribers 12% year-over-year to 4.39 million, and the momentum continues as we exited January with 4.48 million subscribers. We also accelerated our core advertising business with 16% year-over-year growth in Q4 advertising revenue, lifting Q4 ad RPMs to $67.43, an 18% year-over-year growth in our monetization efficiency.

We enter 2017 with a clear set of strategic priorities, and a solid plan to execute against them. We are laser focused on the profitable growth of our ad-supported business, the launch and growth of our subscription products, and a robust artist-to-fan platform to drive ticket sales and engagement across the service. These three strategic pillars operate in harmony with mutually reinforcing revenue streams, and represent the culmination of nearly two decades of investment; an investment that now places Pandora in the position to be a category king.

I would like to briefly touch on three dynamics that underscore our marketplace strategy and demonstrate the progress we are making across multiple dimensions.

The first dynamic is our advertising business. We are in the midst of transforming our strategy around ad insertion and ad load, which we expect will positively impact revenue. In particular a more sophisticated approach to both, coupled with a heavier investment in demand-channel enablement, are improving our efficiency - a trend reflected in our $67.43 Q4 ad RPM. Our ability to reach these levels with a fraction of the ad load endured by broadcast radio leaves plenty of capacity for growth, a capacity we know to be there through extensive testing and data science. This growing utilization of capacity highlights our broader strategy as we look to drive lifetime value of our entire userbase.

Subscription Business Model Transformation

The second dynamic is of course the evolution of our relationship with rightsholders. In September, for the first time in our history, we concluded a comprehensive set of direct licensing agreements with music labels and publishers. The speed of the negotiations, a mere 6 months, was a clear demonstration of the relationships we have built through years of commitment to developing a platform that truly supports artists.

The strength of these partnerships has enabled Pandora to accelerate the expansion of our product offerings into interactive subscription services, and to further fuel our advertising capabilities with valuable new features on the ad-supported product. It has also established a great foundation as we look to partner with artists and their labels and management teams in our go-to-market plan for Premium. And we believe we are uniquely positioned to find win-win marketing strategies with the industry that will accelerate the growth of industry revenues and our business.

The phased roll-out of Pandora Premium is underway -- with select business and music industry partners already live. With the broader launch coming next month we are on the cusp of completing the product portfolio that will drive our long term strategy. And just as with Pandora Plus, where we drove more than 375,000 net new subscribers in Q4, we will leverage our existing audience to attract subscribers to Pandora Premium. Notably, over 70% of new Plus subscribers have been acquired on-platform, virtually free of acquisition cost. This up-sell path will continue to be the centerpiece of our go-to-market strategy for Premium.

Finally, 2016 was a year in which we made great strides with regards to our third dynamic - artist-to-fan connections, including the launch of our redesigned Artist Marketing Platform.. The industry has awoken to the promotional power of the platform, and with the recent inclusion of Pandora spin data in the Billboard Hot 100, this awareness only continues to grow. The adoption of AMP has far exceeded our expectations, with thousands of artists publishing messages heard by Pandora listeners over 600 million times. This has resulted in click through rates averaging 2.6%, with many campaigns reaching much higher levels. These click through rates are 2-8 times higher than those typically seen by paid advertising and social media.

With these successes, Pandora is firmly establishing itself as the premier marketing and promotion platform for artists. And perhaps the most exciting trend is the early data showing a correlation between artist messaging and increased listenership. Here we see artists and listeners engaged in a mutually reinforcing relationship, driving time spent, which ultimately boosts advertising and subscription revenue for Pandora and also propels our ticketing service, as witnessed by yet another record breaking year at

Ticketfly with approximately 25% growth in revenue. In 2016, Ticketfly entered into agreements with some iconic U.S. venues and promoters, ending the year with more than 1,700 venues and promoters, adding more opportunities for artists to connect with their fans. Pandora's targeted messaging is proving to be a remarkably effective driver of ticket sales, across the whole artist spectrum.

The operational efficiency measures announced in January to reduce overall operating costs in 2017 enable us to pursue these strategic priorities while also enabling further investments in product innovation to drive advertising revenue and subscription growth, all while managing toward adjusted EBITDA profitability in 2017.

With all of the elements of our strategy in place, we are entering the year with crisp focus across the business. Simply put, our business goal is to find the right product for each listener that meets them where they are as a consumer, and maximizes their life time value, whether they are an ad-supported listener, a Plus or a Premium subscriber. Ad load, features and pricing are all weapons in our arsenal to achieve that end.

Now over to Mike.

Mike Herring

Thanks, Tim.

I'm also looking forward to 2017 and building on the solid foundation we created in 2016. As we execute on our priorities, we remain committed to the focus and cost discipline that keep us on a path toward our long-term financial targets and helps us manage the business toward profitability. As Tim mentioned, Q4 revenue reached a record high of $392.6 million, while ad RPM’s reached $67.43, an increase of 18% over the same quarter last year. This enabled us to realize leverage against content costs to drive significant contribution margin from the ad supported business, and thus, we meaningfully exceeded our adjusted EBITDA guidance.

A key component of our financial model and long-term profit potential is our ability to grow ad RPMs over ad LPMs. This directly drives the expansion of gross profits in the ad business. Q4's ad RPMs of $67.43 were up 18% from $57.20 in the fourth quarter of 2015, with ad LPMs of $37.07. This increase in ad RPMs was driven by expanded audio ad loads in key demographics and new sources of automated demand driving revenue uplift in display and mobile. And while ongoing ad LPMs increased under the new direct deal structure, in Q4 there were one-time costs associated with the transition to direct deals resulting in the $37 ad LPM. We expect ad LPMs to return to a normalized level of approximately $34 in 2017 and believe the incremental market opportunity from the deals is well worth the near-term expense trade off.

For example, under the new license structure we introduced Pandora Plus at the end of the third quarter and with only a 7-day free trial in our acquisition toolkit, we have generated more than 465,000 net new subscribers since launch.

As Tim highlighted, more than 70 percent of our new subscribers in Q4 came from Pandora's in-app promotion, a strong signal we can drive paid subscribers with minimal customer acquisition costs. In summary, we enter 2017 with a clear focus on driving top line revenue through advertising growth and subscription conversion and improving gross margins by aggressively managing both content costs and operating expenses.

Now, let's walk through our fourth quarter and full year results in more detail.

Q4 & Full Year 2016 Financial Results

Revenue

We ended Q4 with record revenue of $392.6 million, an increase of 17% compared to $336.2 million in revenue for the same quarter last year. Excluding contributions from ticketing services, which I will discuss momentarily, revenue was $373.2 million, an increase of 14% over the year-ago quarter.

Advertising revenue increased in the fourth quarter of 2016 to $313.3 million, compared to $269.0 million in the same quarter last year and drove the beat against our Q4 guidance. Local advertising revenue accounted for 27% of total advertising revenue, and grew 26% year-over-year in Q4.

Fourth quarter subscription and other revenue was $59.8 million, an increase of 5% over $57.0 million in the same period in 2015. Our end of period paid subscribers increased to 4.39 million, an increase of 12% year-over-year.

Specifically in Q4, ticketing revenue was $19.4 million with fourth quarter Gross Transaction Value excluding box office sales of $130 million, growing approximately 30% year-over-year. We transacted approximately 3.8 million fee-generating tickets, excluding box office sales, in the quarter to approximately 1.6 million unique customers. This momentum in customer interactions presents a significant opportunity to leverage Ticketfly's business to drive Premium subscriptions via trial and ticket bundles.

For the 2016 fiscal year, we delivered consolidated total revenue of $1.385 billion, an increase of 19% compared to $1.164 billion in revenue in 2015. Excluding contributions from ticketing services, revenue was $1.298 billion, an increase of 13% over 2015.

Advertising revenue increased 15% to $1.072 billion, compared to $933.3 million in revenue in 2015. Local advertising revenue accounted for a new high of 28% of total advertising revenue in 2016.

Subscription and other revenue was $225.8 million for the full year, an increase of 2% over $220.6 million for 2015.

Ticketfly celebrated another record breaking year, due in large part to excitement around the Ticketfly/Pandora combination, with $86.6 million in revenue or approximately 25% growth year-over-year. In 2016, Ticketfly generated $615 million in gross transaction value, excluding box office sales, crossing the half billion dollar mark with record bookings of six million new tickets, an increase of approximately 25% year-over-year in gross transaction value. In total, Ticketfly sold over 15 million fee generating tickets in 2016 to more than 5 million unique customers.

Adjusted EBITDA

Adjusted EBITDA for the fourth quarter was a loss of $30.4 million, compared to a profit of $24.8 million in the same quarter last year. Adjusted EBITDA differs from GAAP net loss in that it excludes $34.6 million in expense from stock-based compensation, $17.3 million of depreciation and amortization expense, approximately $7.2 million in other expense, and approximately $500 thousand in provision for income taxes.

For the year, adjusted EBITDA was a loss of $119.5 million, compared to a profit of $51.7 million in 2015. Adjusted EBITDA differs from GAAP net loss in that it excludes $138.5 million in expense from stock-based compensation, $60.8 million of depreciation and amortization expense, approximately $24.4 million in other expense, and approximately $200 thousand in benefit from income taxes.

EPS

Fourth quarter 2016 GAAP basic and diluted net loss per share was $0.38. Non-GAAP basic and diluted net loss per share was $0.13, which excludes approximately 34.6 million in stock-based compensation expense, approximately $5.1 million in amortization of intangibles, approximately $1.6 million in amortization of non-recoupable ticketing contract advances and approximately $19.0 million of income tax effects of non-GAAP adjustments. GAAP and non-GAAP basic and diluted EPS were based on 234 million weighted average shares outstanding.

For the year, 2016 GAAP basic and diluted net loss per share was $1.49. Non-GAAP basic and diluted net loss per share was $0.51, which excludes approximately $138.5 million in stock-based compensation expense, approximately $20.5 million in amortization of intangibles, approximately $5.7 million in amortization of non-recoupable ticketing contract advances and approximately $60.5 million of income tax effects of non-GAAP adjustments. GAAP and non-GAAP basic and diluted EPS were based on 231 million weighted average shares outstanding.

Content Costs

Content costs represented 54% of total revenue in Q4.

For the year, content costs represented 53% of total revenue up from 52% in 2015. Total content costs rose by almost $124 million dollars in the year as a result of the new CRB rates enacted in January, the direct deals signed in September and growth in hours, subscribers and revenue.

It's important to highlight that more than $84 million or 68% of the 2016 increase in content costs would have been the result of a one-time step-up in content costs related to the CRB rate change alone, irrespective of engaging in direct deals. And this would have occurred without getting additional beloved consumer features and monetization opportunities such as replay, additional skips and offline listening.

As I mentioned earlier, our ability to drive leverage on these costs in 2016 was dependent on our ability to increase ad RPMs in excess of our ad LPMs. 2016 total ad RPMs were $55.94 increasing by $5.42 or 11% compared to the year ago period. For the year, total ad LPMs were $32.40 increasing by $6.27, or 24% compared to 2015. Despite the step up in costs, our ad RPM growth is keeping pace and we expect it to continue to grow in future years as ad LPMs remain relatively static.

Gross Margin

During the fourth quarter, non-GAAP gross margins were 36%, compared to 50% in the year-ago quarter primarily the result of costs associated with content, as discussed previously.

Operating Expenses

Turning to operating expenses, while we increased headcount 12% year-over-year to 2,488 employees in 2016, we undertook operational efficiency measures to reduce overall operating costs in 2017. As such, we recently implemented a reduction in our U.S. employee base (excluding Ticketfly) of approximately 7 percent.

For the fourth quarter of 2016, non-GAAP sales and marketing expense was $115.8 million, or 29% of revenue, compared to $96.5 million, or 29% of revenue in the fourth quarter of 2015, as we continued to ramp our sales team to 529 QBSRs at the end of Q4, 153 of which were focused on local markets, and increased brand and direct marketing activities. Approximately 36 QBSRs were impacted by the reduction in force announced early January. While this will reduce our sales capacity temporarily in Q1 2017, it is part of our decision to focus on key competitive advantages around audio advertising and leverage partners in more digitally advanced markets, like display and video. Included in sales and marketing expense in the fourth quarter are commissions on subscriptions that we pay Google and Apple totaling $9.2 million, and $29.5 million in brand, direct response and SEM marketing activities.

Non-GAAP product development expense was $28.6 million for the fourth quarter, or 7% of revenue, an increase of 42% compared to $20.2 million in the fourth quarter of 2015.

Non-GAAP G&A expense was $36.1 million or 9% of revenue, compared to $31.0 million in the same quarter last year or 9% of revenue.

Cash

Turning to the balance sheet, Pandora ended the fourth quarter with $243.3 million in cash and investments compared to $264.0 million at the end of the prior quarter. Cash used by operating activities was $2.6 million for the fourth quarter compared to $71.0 million of cash used by operating activities in the year-ago quarter. Capital expenditures were $13.4 million in the fourth quarter. Internal-use software costs were $7.9 million in the fourth quarter, driven by capitalization of engineering costs associated with the development of new subscription services.

Guidance

For 2017, we estimate total revenues in the range of $1.55 billion to $1.7 billion, or year-over-year growth at the mid-point of approximately 17%. This year, our guidance range is wider than usual due to uncertainty around the speed at which subscription products ramp. We'll provide additional color as our visibility increases throughout the year.

We are reaffirming our previously stated intention to manage the business to 2017 adjusted EBITDA profitability. We are not going to give a specific adjusted EBITDA range for full year 2017 because of the uncertainty around subscription ramp, the mix between advertising and subscription revenue and the associated users and hours, as well as the differing impact each service has on our margins. And while we expect total hours to be up for the year, we are consciously controlling ad-supported hours to manage towards profitability. The subscription revenue ramp, compounded with the mix of advertising and subscription revenue and their associated users and hours, increases the variability of adjusted EBITDA to a point where it would be impractical to provide adjusted EBITDA guidance beyond our first quarter. To be clear, we are managing the company towards full year adjusted EBITDA profitability and our models show that it is achievable across a range of variables related to the ramp of Plus and Premium and current advertising revenue targets. While the mix is variable, the financial model is pretty simple. We expect ad hours to be down anywhere from 5-10% varying by quarter, but our overall audience to increase, as we focus on the most profitable hours as subscriber conversions ramp. In short, this is part of Pandora's model and works to our financial advantage - as ad hours decrease, content costs are moderated while ad RPM increases. In turn, as ad hours move to subscription hours, and users convert to subscribers, subscription revenue and profit per user increases.

For the first quarter of 2017, we estimate total revenues in the range of $310 million to $320 million, achieving year-over-year growth at the mid-point of 6%. Q4 is typically our strongest quarter and we usually experience a 10-15% decrease in revenue as we move from Q4 to Q1. This year, the sequential decline is more pronounced due to the additional contribution in revenue from political advertising in Q4 compounded with the reset in our advertising strategy in Q1.

We estimate adjusted EBITDA for the first quarter to be in the range of an $80 million loss to a $70 million loss, excluding one-time severance costs of approximately $6 million, forecasted stock-based compensation expense of approximately $37 million, forecasted depreciation and amortization expense of approximately $19 million, other expense of approximately $7 million and a provision for income taxes of approximately $300 thousand. This assumes minimal cash taxes.

Basic shares outstanding for the first quarter of 2017 are expected to be approximately 238 million.

To close, I'll just reiterate my excitement about the business transformation taking place. We enter 2017 with a solid and diversified foundation and a focus on managing towards profitability as we get ready to bring to market our complete product portfolio.

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