Pandora (P) Q117 Financial Results Conference Call May 8, 2017

Scripts for:

Dominic Paschel, Vice President, Pandora

Tim Westergren, CEO and Founder

Naveen Chopra, Chief Financial Officer

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Dominic Paschel

Good afternoon, and welcome to Pandora's first quarter 2017 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 Naveen 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 Naveen Chopra, CFO. With that, let me turn the call over to Tim Westergren, Pandora's CEO.

<u>Tim Westergren</u>

KKR and Board

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

The next chapter of Pandora has begun with the launch of Premium, an injection of strategic capital, and the evolution of our board of directors. Today we announced a $150 million investment from KKR, a leading global investment firm. In conjunction with this investment we will also be making some changes to our board of directors. First, Richard Sarnoff, KKR's Head of Media & Communications Private Equity investing in the Americas, will be joining the Pandora Board of Directors. Richard brings a deep passion for music and wealth of experience to the company, including a 15-year leadership role of Bertelsmann where he served as Chairman and President of Bertelsmann Digital Media Investments.

Additionally, two of our long serving board members, Jim Feuille and Peter Gotcher, will be stepping down.. I want to personally thank both Jim and Peter for their dedicated board service over many years. Jim and Peter were early investors in Pandora and have been instrumental in building Pandora into a truly iconic company. Much like Pandora has evolved over time to address consumer's needs, so too must our board bring new expertise to advise Pandora on its next chapter and a continued focus on maximizing shareholder value. A search committee lead by current independent board member Tim Leiweke will lead the search to identify additional new board members for our next chapter.

My warm welcome to Richard, and my sincere and deep thanks to Jim and Peter.

First Quarter

Moving on to our financial performance, I'm excited to share we had a solid first quarter, reflecting re-accelerating growth in number of subscribers, subscriptions revenue and continuing to increase leverage in advertising revenue. Most notably, we successfully launched Pandora Premium, which is off to a terrific start. I'll share more details around the launch in the majority of my prepared remarks. I'm also excited to welcome Naveen Chopra to our management team as CFO. He'll share further details regarding our first quarter and our expectations for Q2 and the rest of the year. Mike Herring, Pandora's President, is also on the call and will join in the Q&A discussion.

To start off, since we launched the limited release of Premium in mid-March, we have seen strong interest and uptake in our suite of subscription offerings. Since that time, we have started approximately 1.3 million trials for our Premium and Plus subscription tiers combined, including more than 500,000 Premium trials. Since Premium only became fully available in mid-April, the ratio of Premium to Plus trial starts is about 50:50. We are also pleased with our unique ability to leverage our massive existing audience to attract subscribers, including those who have lapsed. To date, more than 82% of new trial starts were acquired on-platform-virtually free of acquisition cost-again demonstrating the significant opportunity ahead of us and our marketplace strategy in action. Total subscribers increased approximately 20% since last year.

We had a solid first quarter, with $316.0 million in total revenue—slightly above the midpoint of our guidance range. Our adjusted EBITDA was at the high-end of our guidance range, at a loss of $71.3 million.

During the quarter, we had an increased focus on monetizing and optimizing conversion, revenue and cost containment related to our various tiers of services—Pandora, Pandora Plus and now Pandora Premium.

As a result, our Q1 monthly active users were down 3% year-over-year to 76.7 million. The actives decline in Q1 was primarily driven by our need to address the evolving listening habits of consumers, which we did with the launch of Premium. In addition, during Q1 we placed greater emphasis on up-selling listeners to our subscription tiers vs. acquiring new listeners in our marketing activities. Naveen will address some of the exact details, but the bottom line is going forward we expect to stabilize and resume growth of monthly active users, while continuing to find the right tier of service for our existing active and lapsed listeners.

Also, as we indicated on the last conference call, we would be managing our least profitable ad hours down 5 to 10% for 2017. As part of our efforts to decrease our least profitable ad hours during the first quarter, total listener hours declined 6% year-over-year to 5.21 billion. Overall, we still expect total listener hours to be flat for the year while subscription usage deepens and ramps.

Yet usage trends among our most engaged listeners are consistently at high levels. Hours per active user were approximately 22, while average daily active users remained at peak levels. We continue to explore additional strategies for driving core active listener growth, including the launch last month of our artist-driven marketing campaign called "Sounds Like You." The campaign is still ramping up, with the bulk of it expected to reach consumers this quarter.

Earlier this year, we laid out our 2017 strategic priorities—subscription growth; growth in our advertising business; and increased opportunities to connect artists and fans. Before I give updates on our execution against those priorities, I'd like to give some context on the music industry and consumer experience and why we think our symbiotic ecosystem approach—with offerings for every type of listening—is the right one to capture the long term opportunity.

We believe that we are standing on the cusp of the next Golden Age for music. After a generation-long period of uncertainty in the music industry, revenues are now growing at their fastest rate in nearly 20 years. And for the first time, streaming represents the majority of those revenues.

However, music consumers are still faced with a sub-par listening experience. Frankly, the delivery of streaming music has historically been approached the wrong way. Yes, the transition from physical to digital media was a game-changing phenomenon. But listeners are still subject to a fundamentally retail experience. Instead of an 80,000 square foot warehouse, consumers are now taken to a 40 million song digital storefront and told to find what they want. It should be the other way around. The solution isn't just to help listeners find music, it's to help bring music to listeners. Simplicity is the next frontier in music consumption.

Bringing people the music they love is at the heart of what we do. We've spent 17 years building our Music Genome Project. As Pandora has become the largest online music platform in the U.S., we've amassed a massive amount of very precise preference data from a highly engaged audience, and we are leveraging our unique assets to create the next generation of what streaming music should be—a simple, elegant, and a completely personalized experience that works for all types of listeners, in all formats of listening. We know WHAT people like to listen to, and we also know HOW they like to listen to it. We know the right, unique playlist construction for every one of our listeners. We are able to make it easy to listen to and discover music they love. And in today's environment, that effortlessness is the holy grail for a successful consumer music service.

Now, I'll provide some highlights regarding how we executed against our strategic priorities during the quarter:

Subscription Growth and Pandora Premium Update

With the introduction of Pandora Premium last month, our most important new product since our birth, we aim to do the same thing for on-demand that we did for digital radio—reinventing the experience through simplicity and personalization. On-demand becomes but one feature in an intuitive interactive experience where the music you love finds you. Currently, fewer than 100 million people worldwide pay for streaming music. The vast majority of prospective subscribers have yet to find a service worth paying for. We believe there is significant opportunity ahead of us, and it starts with our own ad-supported and paid radio listeners—where research tells us that approximately 30% are strong candidates for an on-demand tier.

With regard to Premium, the early engagement metrics from our beta period are very encouraging. Nearly HALF of Premium trial listeners used Pandora daily during their first week, significantly higher than non-Premium listeners. Most importantly, approximately half of all early Premium users are taking advantage of features on the tier that are unique to Pandora, including the My Thumbs Up playlist, Linked Playlists, and the "magic wand" that is Add Similar Songs. It is clear that there is significant pent-up demand among Pandora users for features beyond what they have been historically been able to get from our radio tiers—and this provides further confidence in our research that approximately 30% are strong candidates for an on-demand tier.

Advertising Acceleration and Momentum

In our advertising business, we continue to see growth despite a bumpy ad environment. Our careful management of listener hours drove year-over-year growth in ad RPM of 12% in Q1. And we anticipate strong tailwinds as the ad technology investments we are making in the first half of 2017 come online in the seasonally strong second half of the year. Programmatic has led to significantly higher effective CPMs in display. We are excited that the same opportunity will exist for programmatic audio and video. Pandora is laser focused on delivering a solution that is superior and we are bringing these to market later this year. Auto and Consumer Electronics remain our fastest-growing listening and monetization segments, with 26% growth in listening hours and 37% growth in ad RPM. Despite that growth, we believe that these segments are still under-monetized, and our native audio ads are perfectly suited to those formats.

While our recent initiatives have been focused on bringing Pandora Premium to market, building the largest audio advertising platform on the Web remains a priority. Our direct interactive deals now allow for skips and replays on our ad-supported tier, which has produced incremental opportunities for advertisers to engage with listeners and provides further opportunity to increase advertising monetization. Our ad-supported listeners are engaging at a remarkable level with these features. One of every five listeners given the opportunity for more skips and replays take advantage of it by watching a 30 second video ad. Video inventory per hour increased 27% year-over-year in Q1 as well as increased pricing.

Connecting Artists and Fans

Ticketing continues to exceed our expectations, with revenue growth accelerating 25% year-over-year. And the Artist Marketing Platform, or AMP, was used by more than 2,300 artists to deliver targeted messages and we are quickly approaching 1 billion impressions to their fans.

We believe more strongly than ever that the best way to bring about the next Golden Age of Music is to be able to effectively monetize the entire spectrum of listening, from ad-supported and subscription radio to full on-demand, and to empower artists to harvest the audience scale and engagement on the platform—essentially allowing them to setup storefronts in a massive new marketplace. Pandora is the only music company that is successfully achieving this vision. Our expanded listening tiers will drive greater engagement, which attracts advertisers and sponsors, and the data from all of these offerings is used to fine tune and grow the ecosystem.

Now over to Naveen who joined us in late February as our new CFO. He will walk through the quarterly results and share more detail regarding the balance sheet update.

Naveen Chopra

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Introduction and review of upside opportunity

Thank you, Tim. I'm very excited to be here and look forward to working with you and the team to help craft the next chapter of Pandora. My goals in that regard are simple: make sure we are positioned to deliver the world's best music listening experience and create value for our shareholders. I joined Pandora because I believe there are tangible value creation opportunities that flow from the company's unique and powerful assets. Those assets start with the product, which, as you know, sets the benchmark for a truly personalized music experience—the "holy grail" of music so to speak powered by the foundation of data and the Music Genome Project. This core ability to seamlessly find and play music that each individual listener truly enjoys has yet to be replicated. Pandora's ability to delight users with personalized music curation is laid clear by our incredible mobile user engagement metrics which, at approximately 22 hours per month, exceed those of well-respected services like Facebook, Spotify, and Netflix. Another key asset is the incredible scale we bring to the digital audio advertising market. Pandora is one of the only platforms that can deliver audio, digital, and video ads, at scale, across multiple platforms—mobile, desktop, connected devices and live events. We are the largest radio station in virtually every major market. This is perhaps not a surprise when you take into consideration that nearly 100 million US adults used Pandora in the past quarter. That is almost 1 Pandora listener for every American household. No wonder Pandora is considered an iconic brand. Simply stated, the combination of these assets means Pandora is heavily used, by a lot of people. And with the launch of Pandora Premium we combine a powerful, profitable advertising business with the growth opportunity of a spectacular on-demand audio product being launched into a subscription streaming market that is expected to grow by approximately 70% in the next four years. Together these pieces yield a compelling portfolio of great product, scaled advertising business, and fertile growth opportunity, and they position Pandora to compete with advantages that others don't have.

Strategic Financing

Before addressing Q1 results, I wanted to provide some additional color around the strategic financing agreement we announced in conjunction with today's earnings release. We have negotiated with KKR and their affiliated investment funds on a purchase of $150 million in aggregate principal, 8% convertible preferred stock maturing in 2022 with a conversion price of $13.50 per share. Closing of the transaction is subject to customary closing conditions including regulatory approvals and will close no earlier than June 8, 2017. The transaction also includes a customary fiduciary out in favor of Pandora. Under our agreement with KKR, Pandora also has the right to issue an additional $100 million of such security subject to participation of additional strategic investors. I have prioritized the establishment of a strong balance sheet for the company since arriving on the job two months ago. A strong balance sheet gives us the ability to accelerate growth investments when appropriate, to negotiate the best possible music licensing deals, and to compete aggressively in a rapidly changing, complex market. The proceeds will be used for general corporate purposes including potential investments in areas like such as advertising and marketing technologies, international expansion, and new types of content, if and when such opportunities are both available and yield compelling returns. We intend to be responsible stewards of capital and there should be no confusion about the fact that, even with a completed KKR investment, we will continue to strive for improved operating efficiency as we evolve past the pure investment stage of Pandora Premium.

In addition to strengthening our balance sheet with this transaction, we are very excited to be partnering with KKR as the lead investor in this financing and I look forward to working closely with Richard Sarnoff when he joins the board. His broad base of experience at KKR and in the music industry will be welcome along with his support for the long-term vision at Pandora.

First Quarter Performance

With that background, let me quickly review our Q1 results. Generally, Q1 was a solid quarter and performed as anticipated, reflecting the significant seasonality of past years.

Total revenue was $316.0 million, roughly at the mid-point of our guidance range. Advertising revenue was $223.3 million, compared to $220.3 million in the year-ago quarter. While ad revenue experienced only modest year-over-year growth this was accomplished on a base of 10% fewer ad hours by increasing ad loads and successfully maintaining pricing. Growth in advertising revenue would have been higher, however, there were a few factors at play:

First, we had some sizeable network radio upfronts from repeat clients that were signed later in the quarter than expected. We also incurred headwinds from January's workforce reduction which involved quota reassignments for a meaningful number of our salespeople. And lastly, we proactively controlled Q1 listening hours by adjusting timeouts for our least-profitable cohorts, which has the effect of improving adjusted EBITDA but reduces remnant inventory and its related ad revenue.

Ad RPM grew 12% year-over-year to $50.87, an all-time high for the first quarter. Growth was driven by an increase in our average ad-load relative to the year-ago period and generally consistent premium direct pricing. We also continued to have strong performance on video and local, two of our fastest growing segments, for example, local ad sales represent 30% of ad revenue.

Subscription and Ticketing were both positive highlights in the first quarter.

We added 320,000 Pandora Plus subscriptions to end the quarter with 4.71 million total subscriptions. This was the second largest number of net additions we have seen in any quarter since we instituted 40-hour mobile caps in 2013. First quarter subscription and other revenue was $64.9 million, an increase of 19% over the same period in 2016. As a reminder, the subscriber growth was achieved while Pandora Premium was only rolled out to a very limited number of users during the last couple of weeks in the quarter. We are excited about what the success of Pandora Plus suggests about the potential for Premium.

Ticketing revenue in the first quarter was $27.8 million, up 25% year-over year. Bookings saw another record quarter, with first quarter Gross Transaction Value excluding box office sales of $215.0 million, growing approximately 25% year-over-year. We transacted approximately 4.8 million tickets excluding box office sales in the quarter which were purchased by approximately 2 million unique ticket buyers for approximately 44 thousand live events. We also launched fan-to-fan ticket exchanges, with nearly 50 partners signed up to-date, allowing fans to transact.

Active Users

As Tim called out, our Q1 monthly active users were down 3% year-over-year to 76.7 million. We believe the decline in actives during Q1 was primarily caused by marketing activities around on-platform promotion and up-sell communications in preparation for the Premium launch. We have since placed new frequency caps on these promotional tools to avoid the negative effects on monthly active users.

Content Costs

Content costs represented 59% of total revenue in Q1. Our ability to drive leverage on these costs is dependent on our ability to increase ad RPMs in excess of our ad LPMs.

For the quarter, total ad LPMs were $33.44 an increased of $2.96 or 10% compared to the same quarter last year due to the higher cost structure from direct deals signed late 2016. Ad LPMs decreased from Q4. As a reminder Q4 had certain overlapping content costs from prior royalty settlements that temporarily inflated LPMs. Going forward we expect LPMs to maintain Q1 levels.

Gross Margin

The impact of direct deals is also reflected in first quarter, non-GAAP gross margin which was 28%, compared to 31% in the year-ago quarter. Again, the year-over-year decline was primarily the result of costs associated with content.

Q1 Operating Expenses

Turning to operating expenses, for the first quarter of 2017, non-GAAP sales and marketing expense was $104.3 million, or 33% of revenue, an increase of 3% compared to the first quarter of 2016, as a result of an increase in headcount year-over-year.

Non-GAAP product development expense was $29.1 million for the first quarter, or 9% of revenue, an increase of 15% compared to the first quarter of 2016. We continue to believe that product and service innovation is at the core of our value proposition and we intend to continue to prioritize product development investments going forward.

Non-GAAP G&A expense was $35.5 million or 11% of revenue, roughly flat as a percentage of revenue compared to the same quarter last year.

Adjusted EBITDA

Consolidated adjusted EBITDA for the first quarter was a loss of $71.3 million coming in near the high-end of our guidance range. The strong result on adjusted EBITDA was achieved by ongoing focus on cost discipline across the organization. Adjusted EBITDA excludes stock-based compensation, depreciation and amortization, and other item the details of which are contained within our press release.

EPS

First quarter 2017 GAAP basic and diluted net loss per share was $0.56. Non-GAAP basic and diluted net loss per share was $0.24. GAAP and non-GAAP basic and diluted EPS were based on 238 million weighted average shares outstanding.

Cash

Pandora ended the first quarter with $203.0 million in cash and investments compared to $243.3 million at the end of the prior quarter. Cash used by operating activities was $36.0 million for the first quarter compared to $13.1 million in the year-ago quarter. Capital expenditures were $2.0 million in the first quarter. Internal-use software costs were $7.8 million in the first quarter, driven by capitalization of engineering expense associated with the development of new subscription services.

Guidance

Now, I'll wrap up with some thoughts regarding our full-year guidance, as well as our expectations for the second quarter.

We are excited about the launch of Pandora Premium and its potential as it begins to ramp. We expect revenue to build throughout the year and we are confident in our strategy based on leveraging a suite of products that works together to strengthen our value proposition. Our expectation is that topline growth in 2017 will be heavily loaded towards the back half. Due to issues with third-party billing integrations, the ramp of Premium from mid-March to general availability took longer than expected. Since Premium only fully launched in mid-April and the vast majority of Premium users will remain in trial mode during Q2, and subscription revenue will not ramp significantly until the third and fourth quarter.

Additionally, the advertising business has historically demonstrated significant seasonality that further weights revenue toward the back half. Pandora previously issued full-year revenue guidance with a wide range in light the unknowns related to the timing and ramp of Premium revenue, which again, we expect to occur primarily in Q3 and Q4. While we are excited to have formally launched Premium, we now expect full-year revenue in the range of $1.5B to $1.65B, taking into account the fact that Premium launched later than expected and is only 20 days into the commercial launch of a transformative new product.

For Q2 we expect revenue in the range of $360 million to $375 million and adjusted EBITDA in the range of a $65 million loss to a $50 million loss. Incorporated in this guidance are several important factors. Specifically, with respect to the advertising business, although we did have some revenue move from Q1 to Q2, our forecast reflects the fact that historical sequential growth rates between Q1 and Q2 have proven to be a reliable way to project our ad sales opportunity in the first half of the year. For subscriptions, we have built our forecasts expecting demand generation initiatives to build as the quarter progresses. Perhaps most important, our AEBITDA guidance illustrates that we expect sales and marketing expenses to be significantly higher in Q2 than the year-ago period due to the launch marketing activities and is expected to decline in the remaining quarters as the launch campaign transitions to a sustained marketing mode.

Lastly, some housekeeping items in relation to our guidance. The reconciliation of our adjusted EBITDA guidance to GAAP is contained in our press release and we anticipate a year to date non-GAAP effective tax rate between 30% and 37%.

I want to finish by emphasizing my excitement about the potential that lies ahead to drive growth through Pandora's unique assets. As I said earlier, the formula of great product, existing scale, and fertile growth opportunity is one I find highly attractive and more importantly, it is a formula which can create real value for shareholders, and indeed, all stakeholders -- users, artists, and the music industry.

We will now open to your questions, operator