HESHAM SHAABAN, CFA

P = CALL OPTION

P | NEW BEST IDEA (LONG)

AUG 25TH, 2016

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PLEASE SUBMIT QUESTIONS* TO

QA@HEDGEYE.COM

**ANSWERED AT THE END OF THE CALL*

P | LONG THESIS SUMMARY

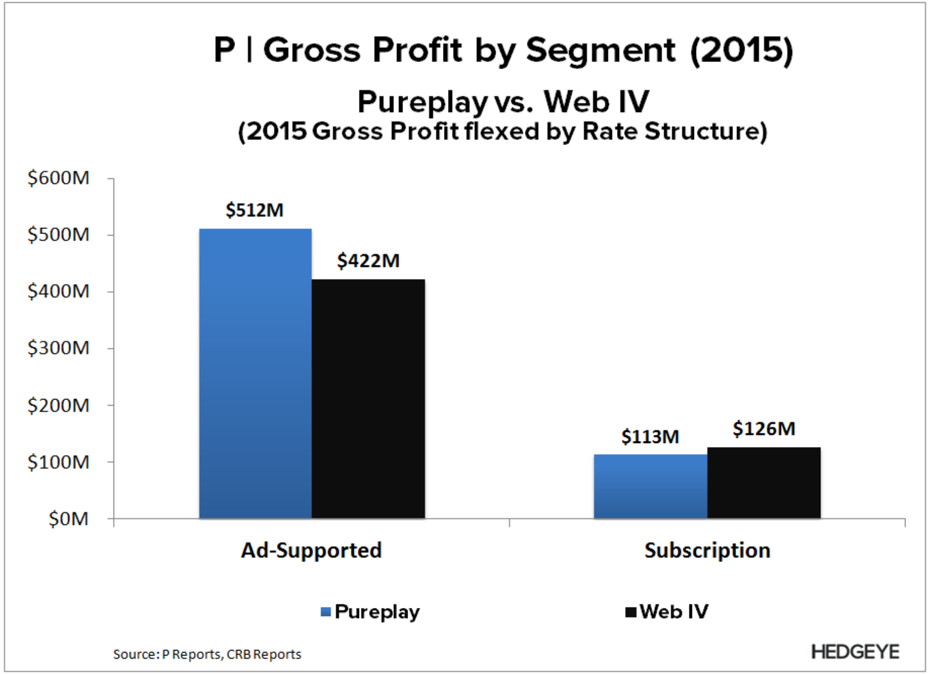
1. **Business Model**: Content Distributor. P must pay for every song it streams, regardless of whether it can monetize those songs (primarily via Advertising)

2. **Analysis:** The ad-supported model is a cash drain since P can't achieve any leverage on its content costs without paying it away to its salesforce. Sub model is more lucrative, but unproven

3. **Outlook:** P is expanding its sub offerings; very little conversion will go a long way in the initial year(s) post expansion since the ad model is so poorly monetized.

4. **Setup**: P either executes on its expanded sub launch or faces growing pressure to sell, which should buoy stock at a minimum. Stock should work either way.

5. **Timing**: Staying long through 2017.



THE SETUP IS BETTER THAN THE FUNDAMENTALS

P already cut guidance, so 2016 is all about interactive. P either makes its expanded sub launch work, or the activist sell-camp steps up the pressure, putting a floor in the stock, if not forcing P to the table

P: KEY POINTS

1

AD MODEL IS SO POORLY MONETIZED THAT…

P's ad-supported model hasn't produce any real operating leverage/cash flow to date, and is now more expensive to run post Web IV. P's 2Q results reinforce our view that its revenue growth is largely tied to its salesforce growth, meaning the model may never cover P's overhead.

2

VERY LITTLE SUB CONVERSION GOES A LONG WAY

The sub model is far more lucrative from both a revenue and margin perspective. The stark difference b/w the two models means the expanded sub launch is a massive growth opportunity, particularly in the initial years, maybe more depending on how aggressively P commits to it

3

BUT WE DON'T REALLY CARE EITHER WAY

P is basically a hedged bet: mgmt either executes on its sub expansion (new deals + revenue) or is forced to entertain acquisition offers if can't do so. Naturally, the former offers more upside, but the stock should end up much higher either way by this time next year, if not sooner.

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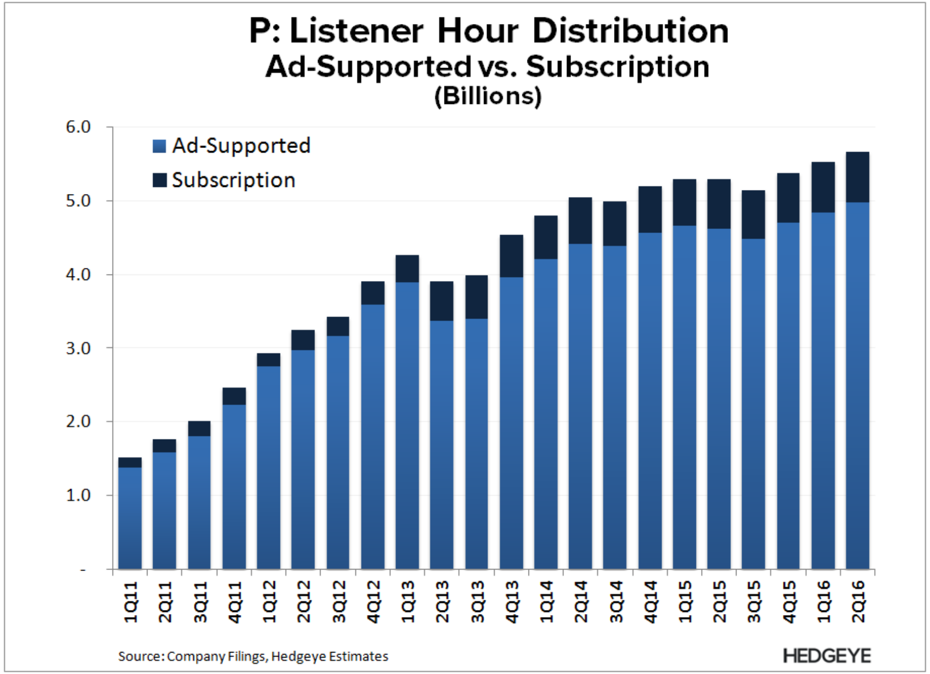
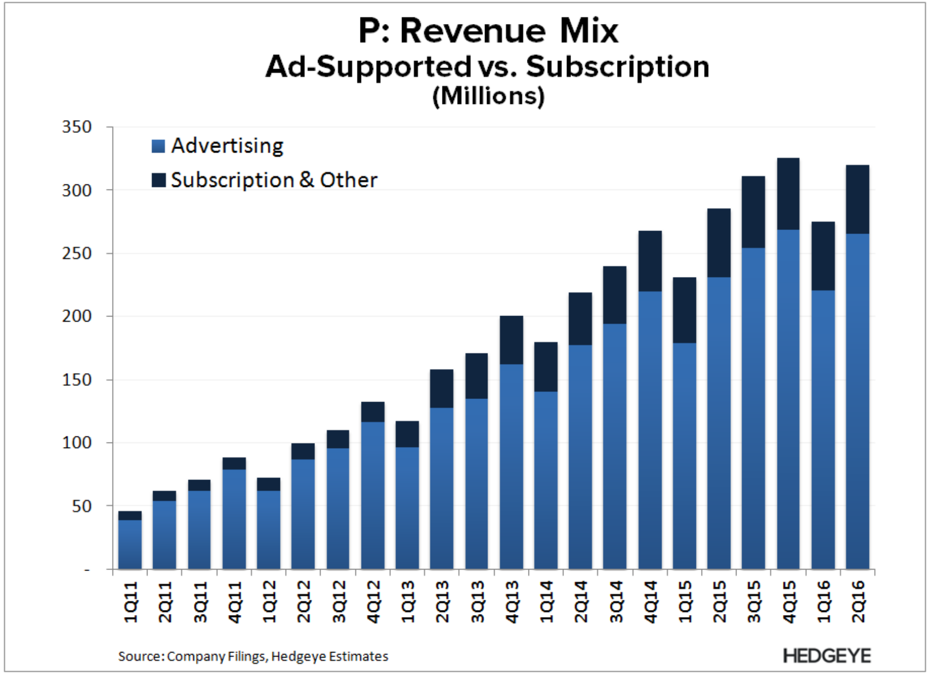
P ≈ AD-SUPPORTED MODEL

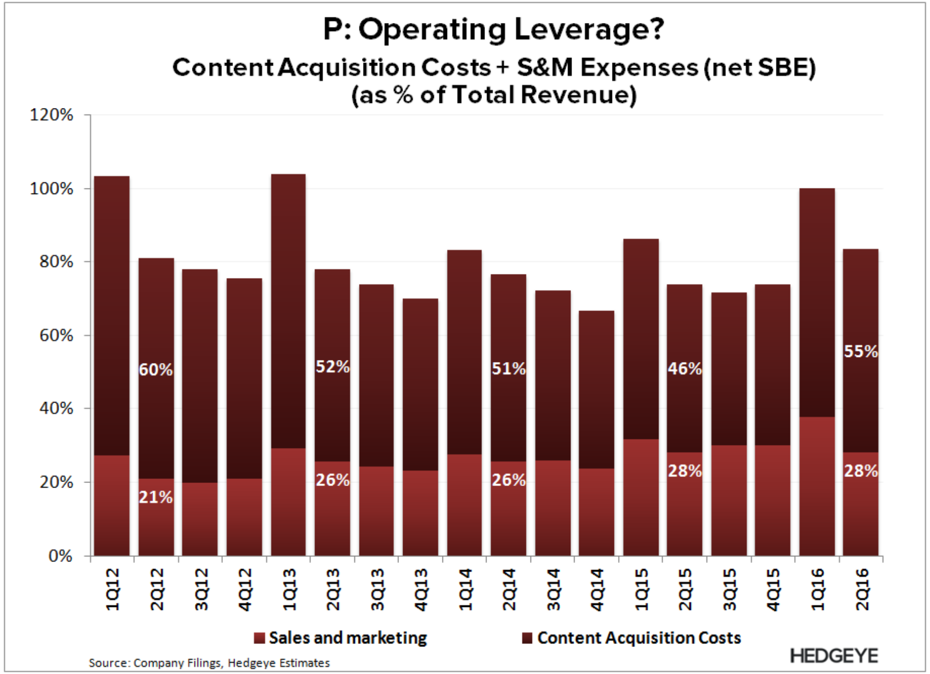


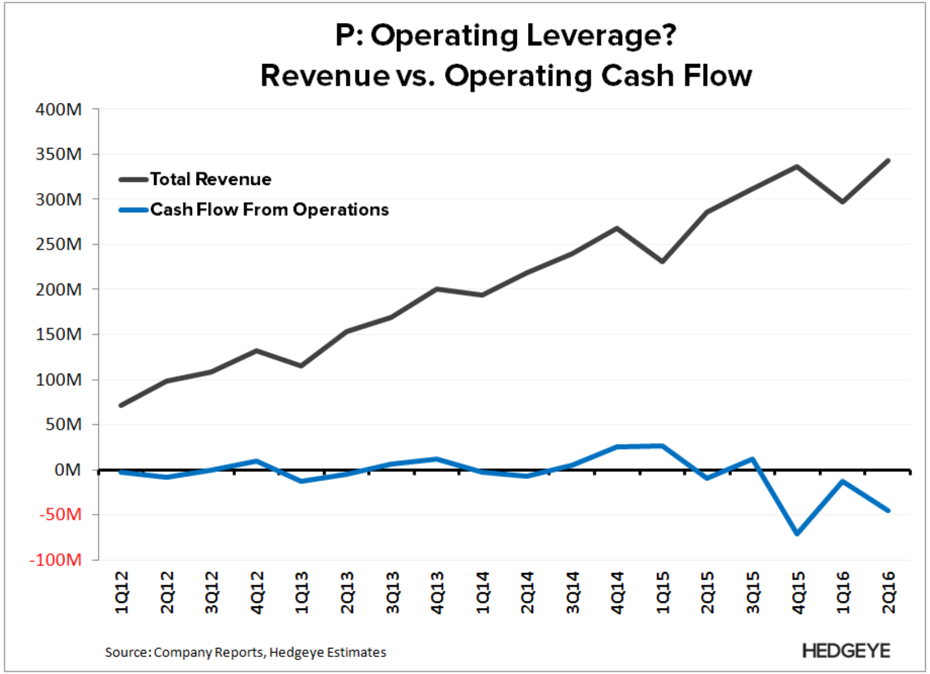


USERS HAVE FAVORED THE FREE PRODUCT, SO P HAS FAVORED THE AD MODEL

Nearly 90% of P's listener hours favor the free (ad-supported) service. There's nothing wrong with an ad-supported model per se, but it's a challenging model to run within this specific industry.

THE AD-MODEL HAS NO LEVERAGE

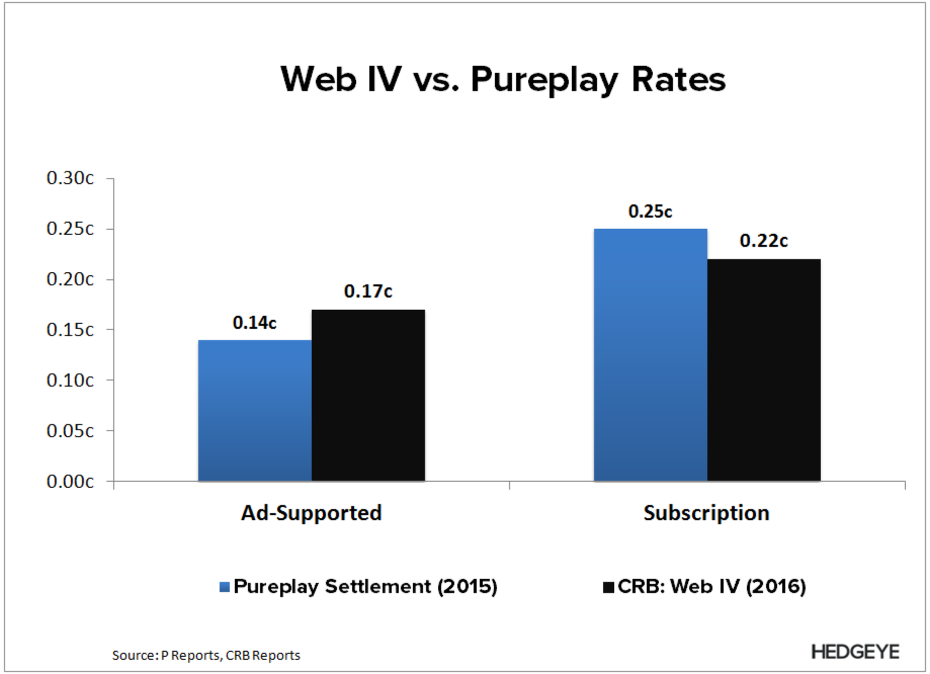


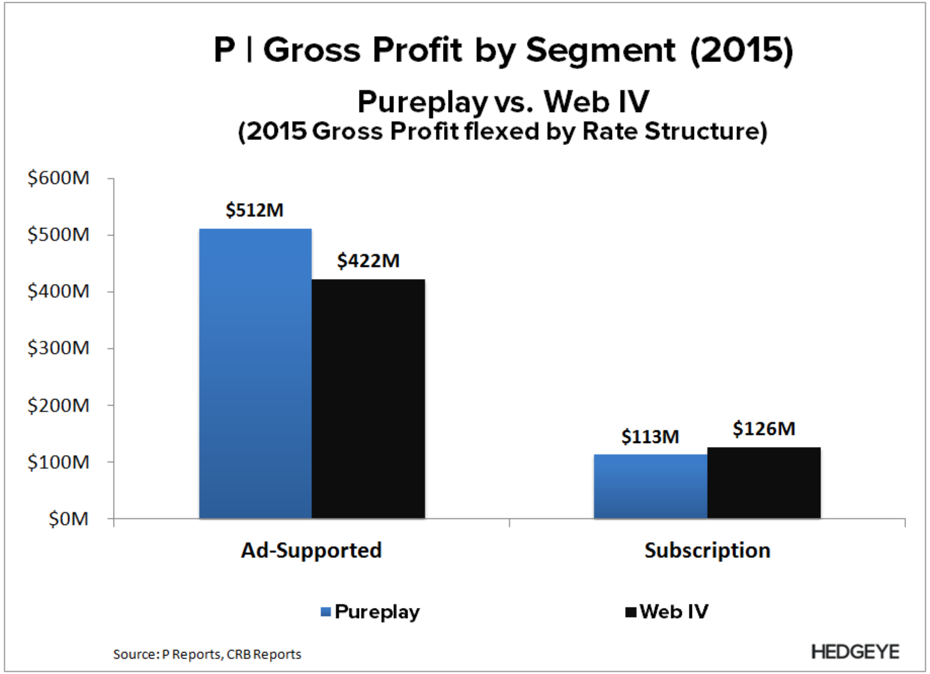


WHAT LEVERAGE P ACHIEVES ON CONTENT IS LOST TO ITS SALESFORCE

Despite consistently rising revenue, P was never able to generate consistent cash flow. Web IV only makes this dynamic worse with ad-supported royalty rates up 21% vs. 2015.

CONTENT COSTS EVEN MORE NOW



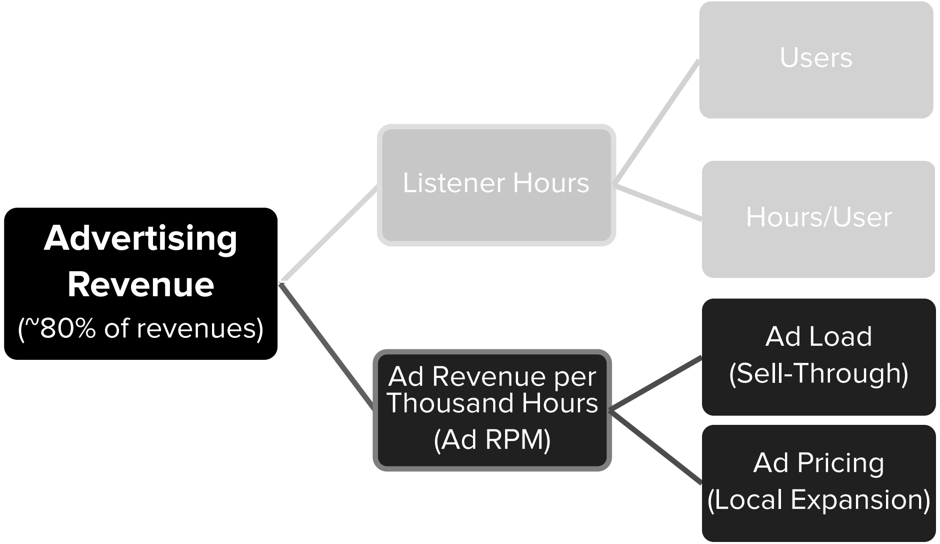


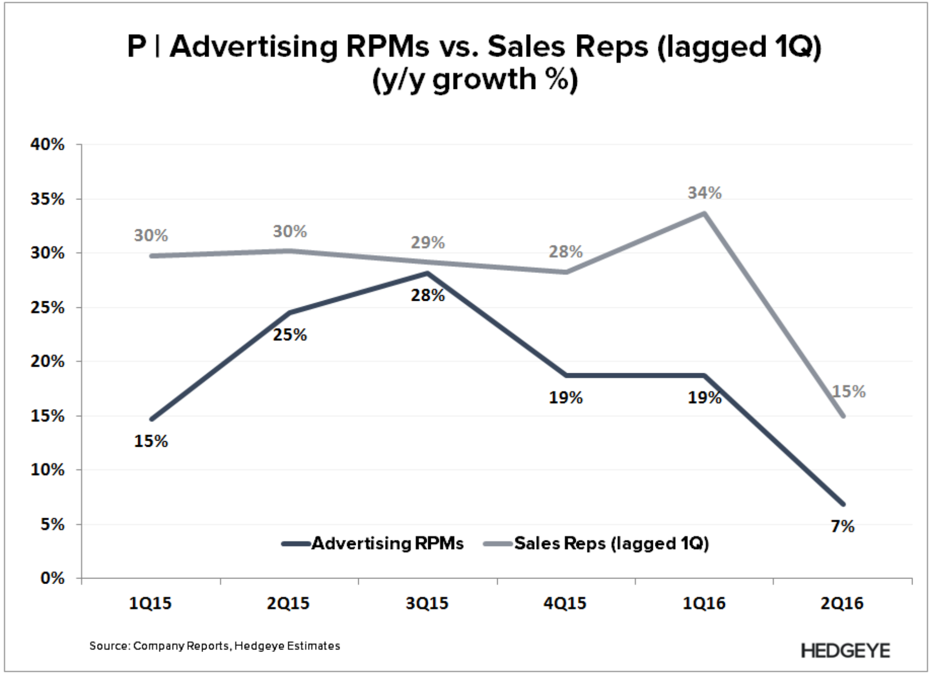
AD-SUPPORTED MODEL MUCH HARDER TO OPERATE POST WEB IV

If we were to apply Web IV rates to P’s 2015 metrics, P would have paid out an extra $90M in ad-supported royalties just on the Web IV rate increase alone.

MONETIZATION IS COST-DEPENDENT

P Advertising Revenue Drivers



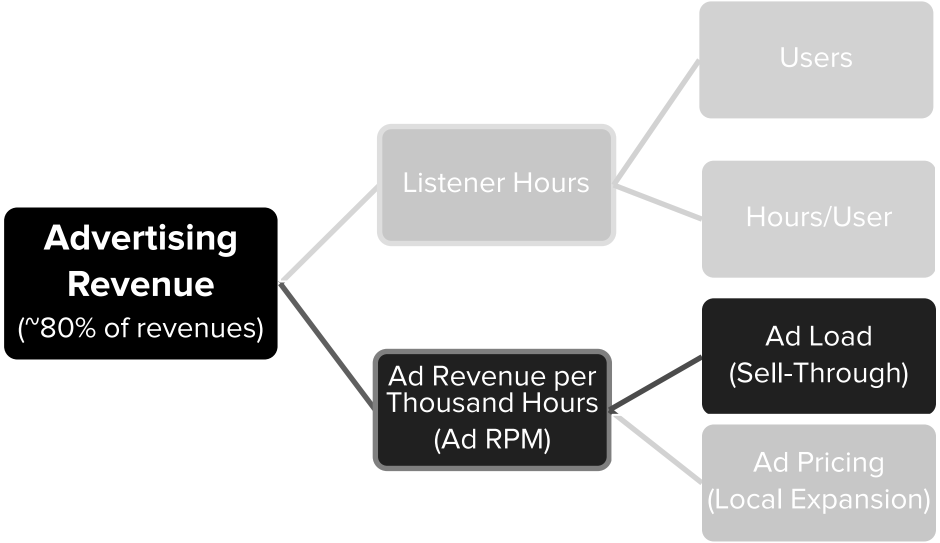


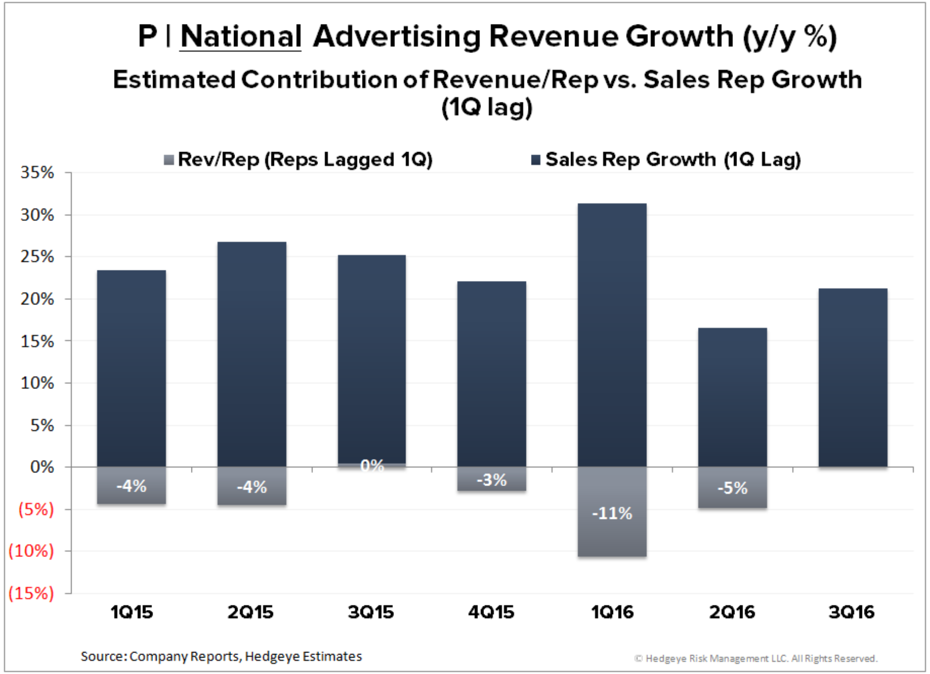
BOTH MONETIZATION DRIVERS ARE DEPENDENT ON HEADCOUNT (EXPENSE)

Listener Hours are essentially P's max available inventory. Ad RPM is how effectively P monetizes that inventory. The latter is largely headcount dependent, which isn't likely to change moving forward.

NATIONAL RELIANT ON HEADCOUNT

P Advertising Revenue Drivers



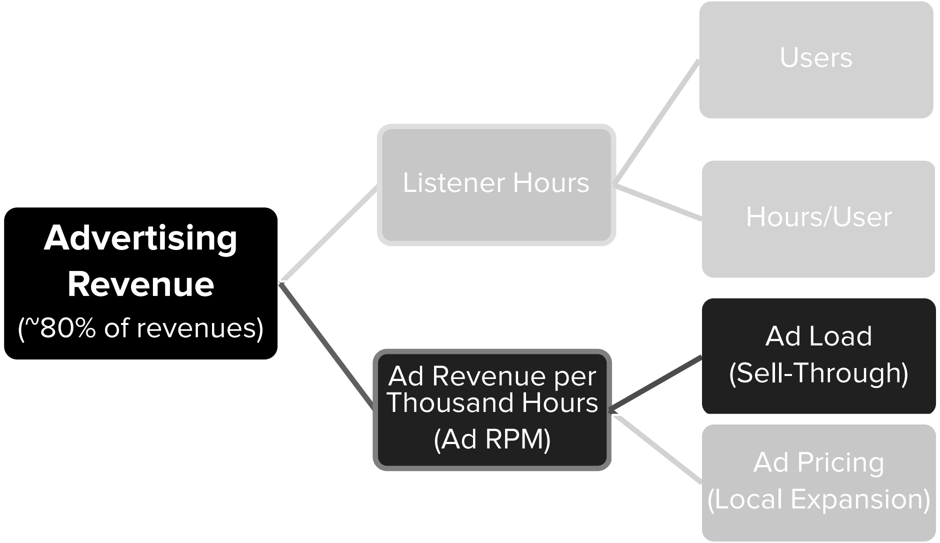


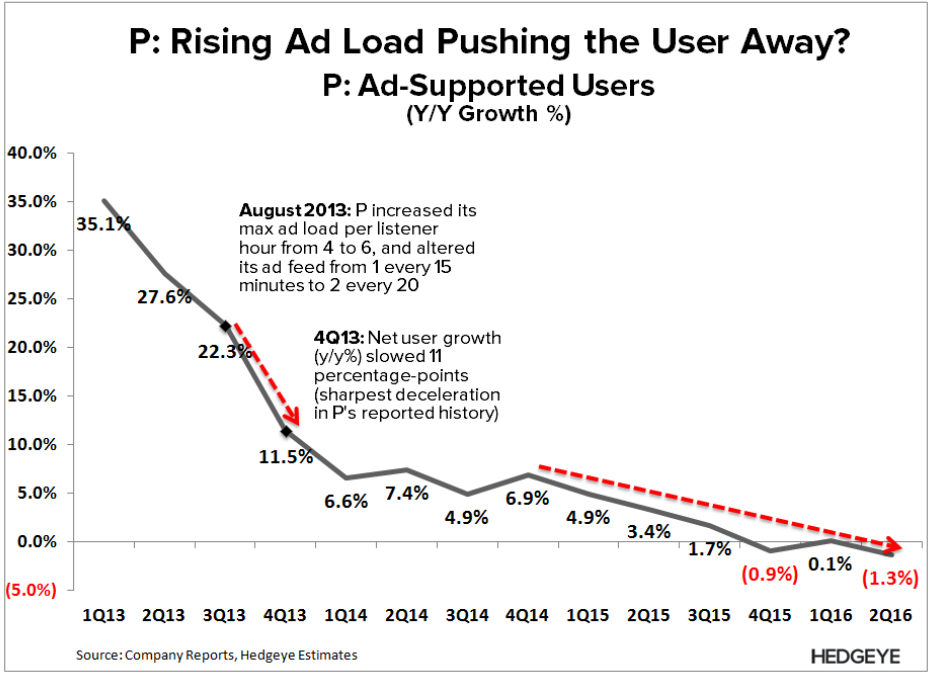
GROWTH HAS BEEN DRIVEN EXCLUSIVITY BY HEADCOUNT SINCE AT LEAST 1Q15

Productivity (revenue/rep) has been declining for as far back as we can calculate it. We suspect the reason why P can't achieve any leverage off its national salesforce is because of P's user base is resistant to ad load

SELL-THROUGH IS ALSO A CHALLENGE

P Advertising Revenue Drivers

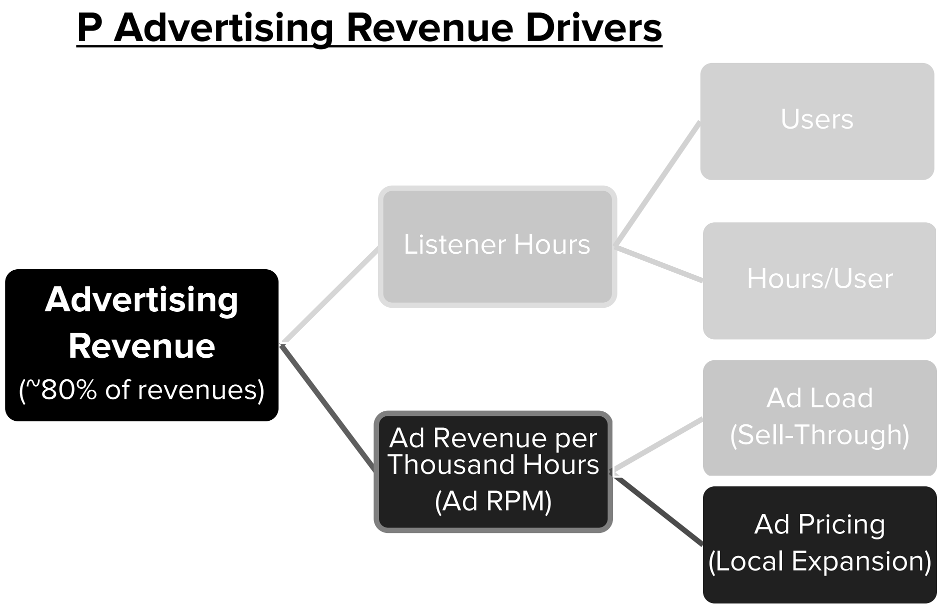


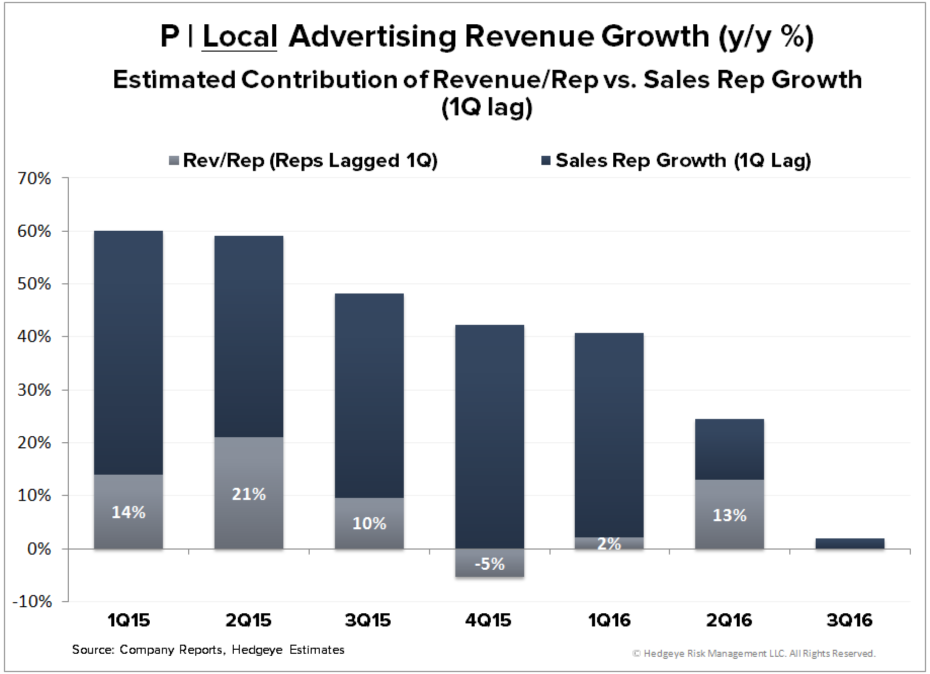


RISING AD LOAD HAS HISTORICALLY BEEN MET WITH USER RESISTANCE

Even if P continues hiring reps to improve sell-through, it likely will come with a waning benefit since P has to be careful about how much it increases ad load on a user base that still has too many free options (we mean Spotify)

HEADCOUNT DRIVING LOCAL TOO

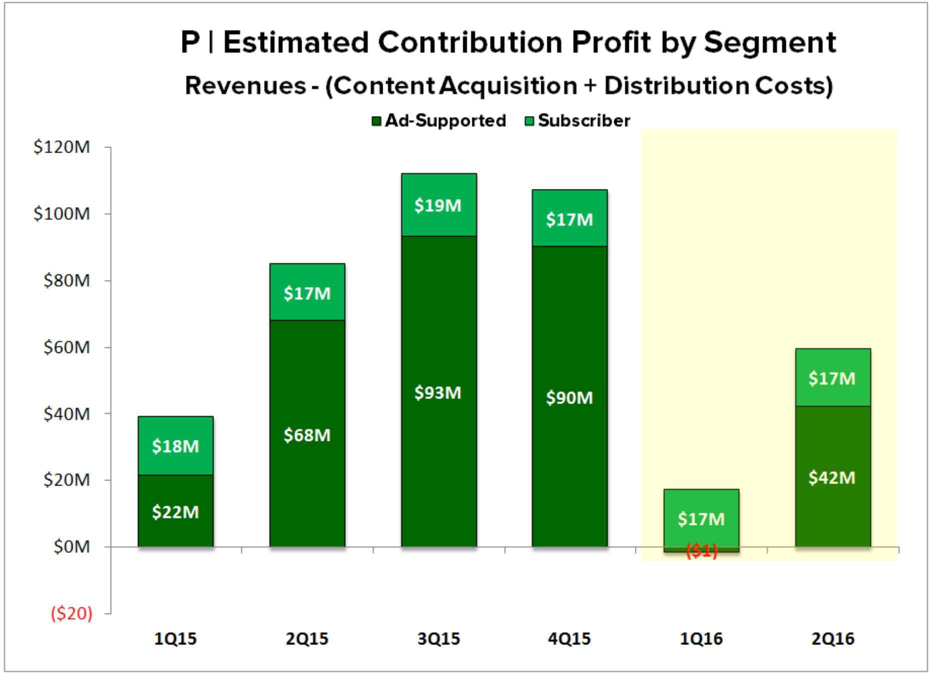


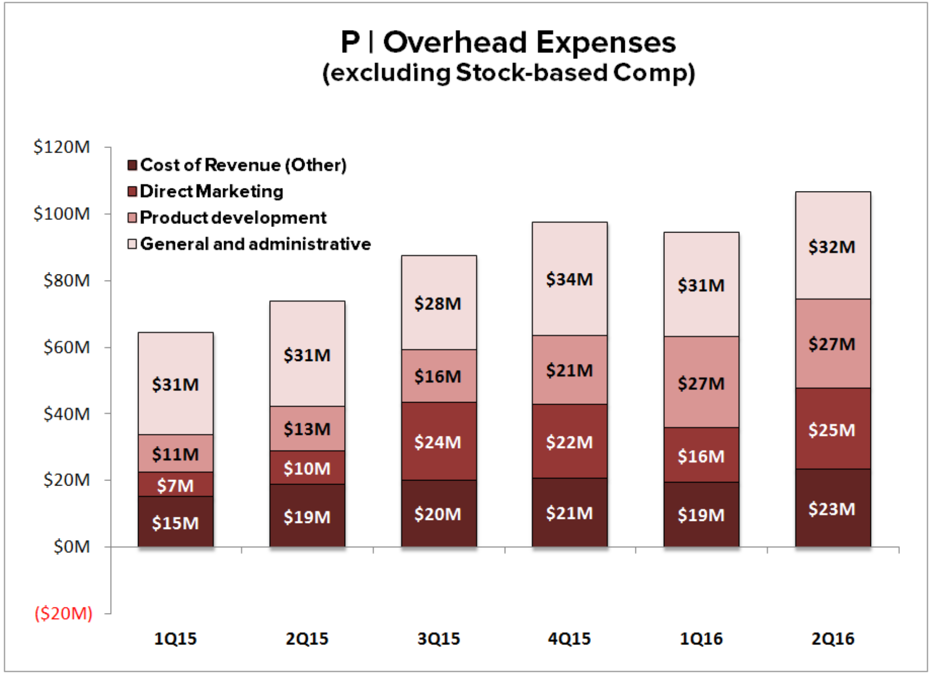


2Q16 RESULTS OFFER A CAUTIONARY TALE FOR PULLING BACK ON HIRING

Historically the largest driver of Local revenue growth had been headcount vs. productivity. Despite improving revenue per/rep, P's 2Q Local revenue growth was almost cut in half vs. 1Q (26% vs. 42%)

MODEL WASN'T BUILT FOR WEB IV ERA





Source: Company Reports, Hedgeye Estimates

P WAS ALREADY STRUGGLING TO COVER OVERHEAD EVEN BEFORE WEB IV

The majority of P's contribution margin has been coming from the ad model. But following the step-up in ad-supported royalty + monetization challenges, P may struggle to monetize its current model anywhere above cost

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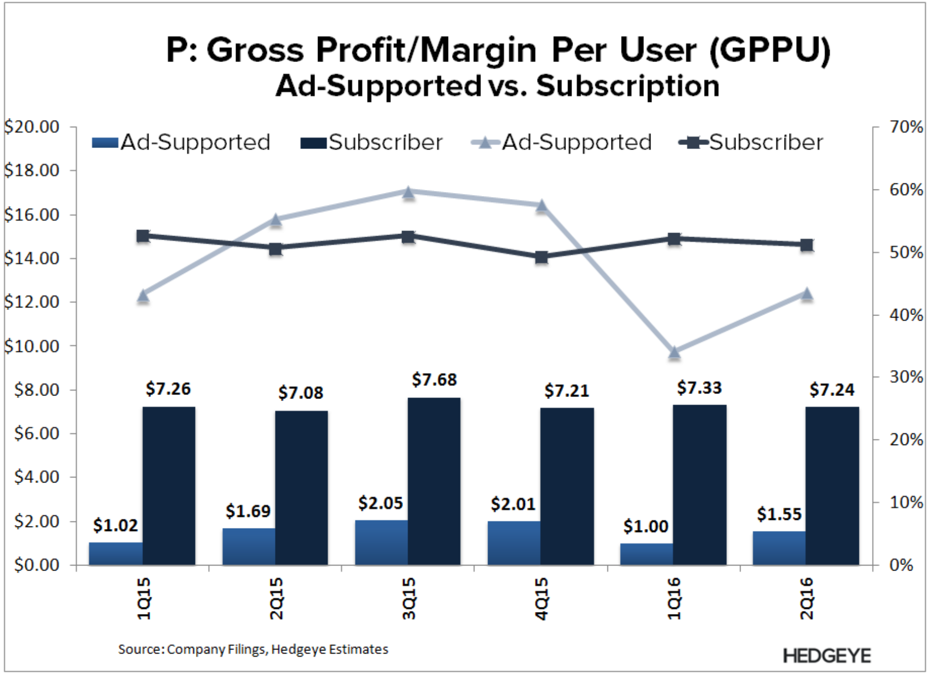
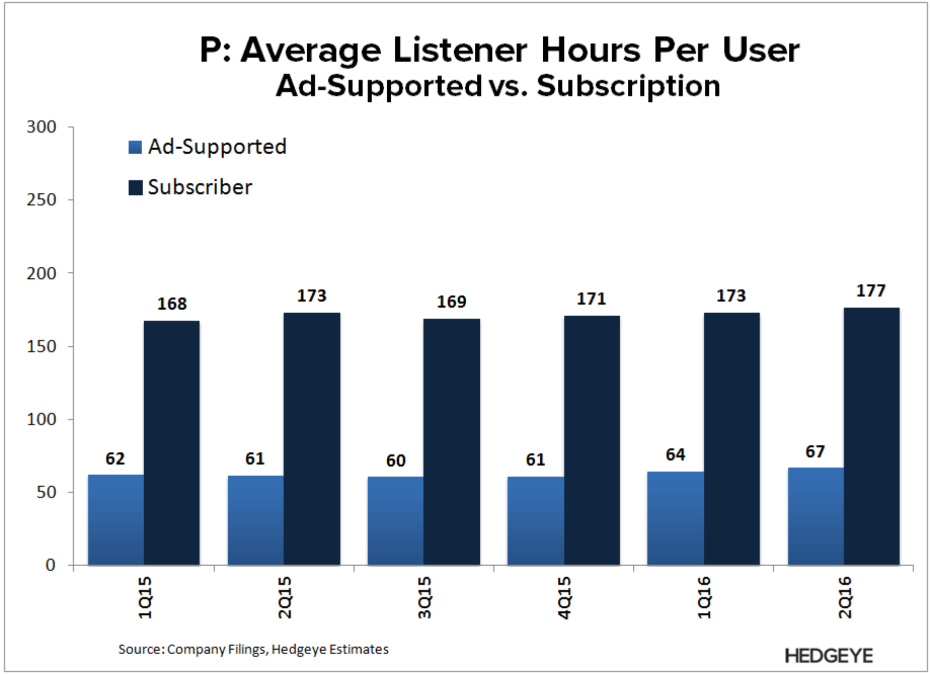
SUBS = BETTER MARGIN PROFILE

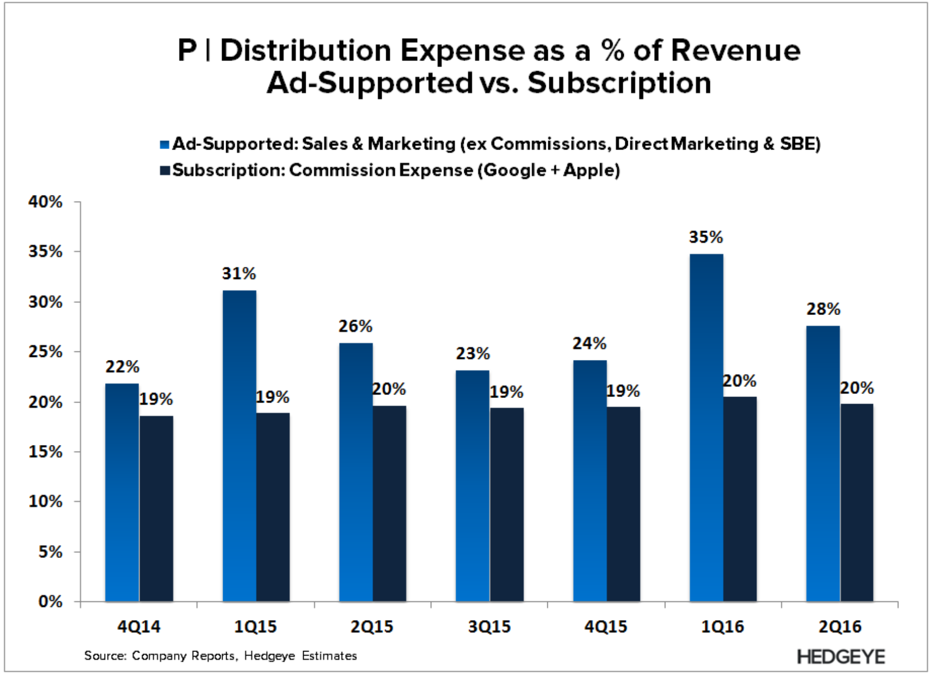




DESPITE CONSIDERABLY HIGHER ROYALTY RATES AND USAGE

P's sub GPPU is almost 5x that of its ad-model despite pre Web-IV royalty rates that were +80% higher on almost 3x the listener hours. Delta also suggests there may be a big opportunity somewhere in between (more later)

SUB = LOWER DISTRIBUTE COSTS



Commission Expense Notes

1. P only pays commissions when user signs up for subscription within the app

2. The historical commission rate was 30%, but P's rate has hovered in the 20% range, suggesting it has had some success bypassing the tax

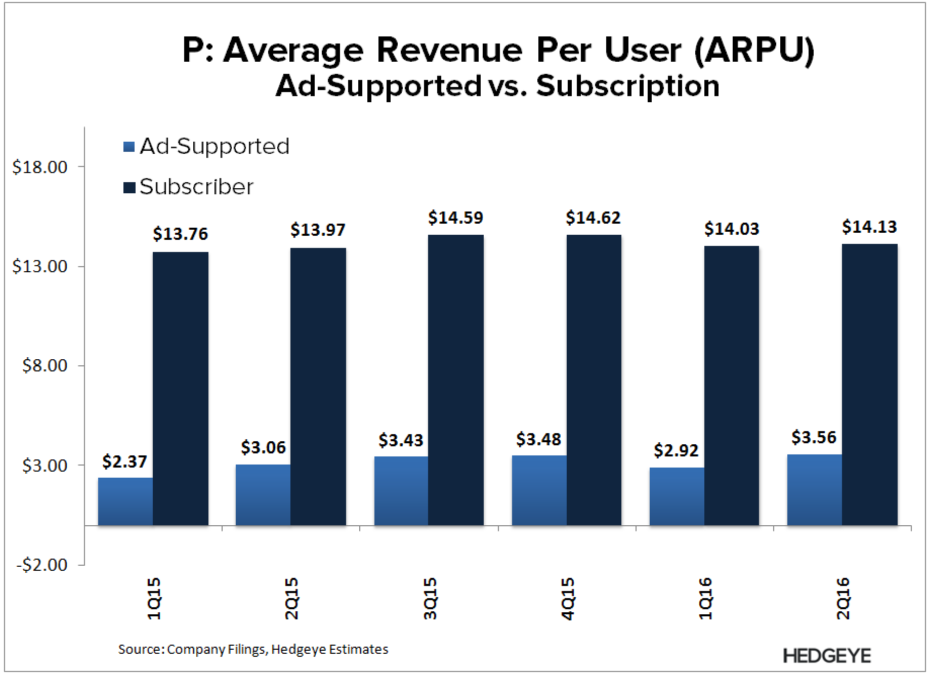
3. Apple just announced a reduction in the commission rate to 15% after the first year. We expect Google may forced to follow suit.

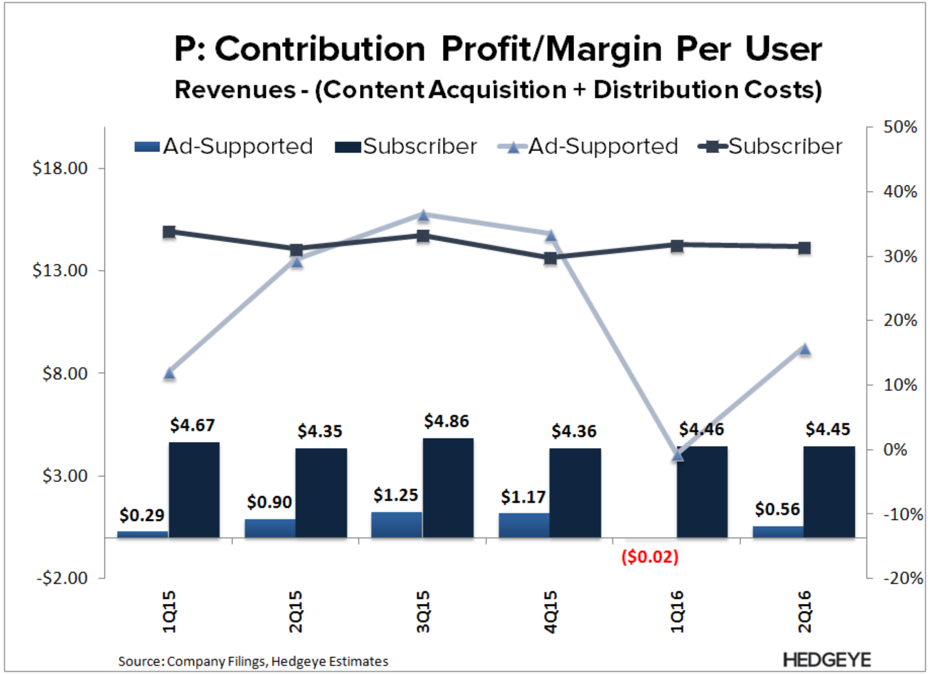
4. P already restricts annual Pandora One subscriptions to its website (link). Spotify offers two different prices for app vs. web signups.

WHICH ARE GETTING EVEN CHEAPER, AND ARE LARGELY AVOIDABLE

Some bears are hung up on the pending headline economics on interactive deals, which may inhibit profitability. But the Apple tax reset mitigates that risk, and P has options to avoid the commission expense altogether.

SUB = BETTER MONETIZED





BOTH FROM A REVENUE AND PROFIT PERSPECTIVE

Remember the sub model should only improve with the lower Web IV royalty rate & the Apple Tax reset, which kicks in 2H16. Ultimately, the sub model is far more viable, question is whether there's a market for it

SUB EXPANSION = VERY BIG DEAL

P: Subscription Revenue Growth Opportunity (vs. 2016 Revenue Guidance)									
Incremental 2017 Revenue Growth from a Tiered Subscription Offering (Conversion vs. Price)*									
Conversion Rate	New Subs	Monthly Price							
		$3.00	$4.00	$5.00	$6.00	$7.00	$8.00	$9.00	$10.00
1.0%	0.8M	1%	2%	3%	3%	4%	4%	5%	6%
2.5%	1.9M	3%	5%	6%	8%	10%	11%	13%	14%
5.0%	3.8M	6%	9%	13%	16%	19%	22%	26%	29%
7.5%	5.7M	9%	14%	19%	24%	29%	33%	38%	43%
10.0%	7.5M	12%	19%	25%	32%	38%	45%	51%	58%
12.5%	9.4M	15%	23%	31%	40%	48%	56%	64%	72%
15.0%	11.3M	18%	28%	38%	47%	57%	67%	77%	86%
17.5%	13.2M	21%	33%	44%	55%	67%	78%	89%	101%
20.0%	15.1M	24%	37%	50%	63%	76%	89%	102%	115%
22.5%	17.0M	27%	42%	57%	71%	86%	100%	115%	130%

NOTES

2016 Guidance $1,395M

1 Growth is computed off of P's Total Revenue (not just Sub revenue)
2 Incremental Revenue Growth is net lost of Ad Revenue from Conversion
3 Assumes no Ad Revenue growth in 2017 (before lost rev from conversion to sub product)
4 Pandora's current conversion rates is roughly 5% (3.9M subs/78.4M total listeners)
4 Spotify has reported Conversion Rates as high as 25%

Source: P reports, Hedgeye Estimates

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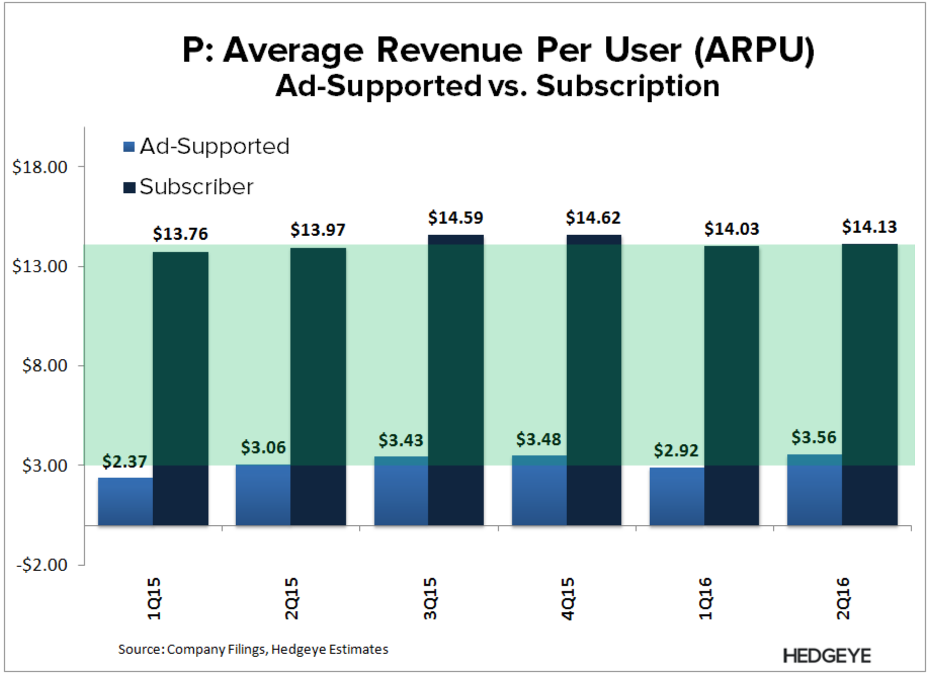
SPECIFICALLY IN THE INITIAL YEAR(S) POST EXPANSION

Remember, the ad-supported model is so poorly monetized that very little sub conversion of its sizable ad-supported base will go a long way toward revenue/margin growth. But right now, we're long P only for year 1

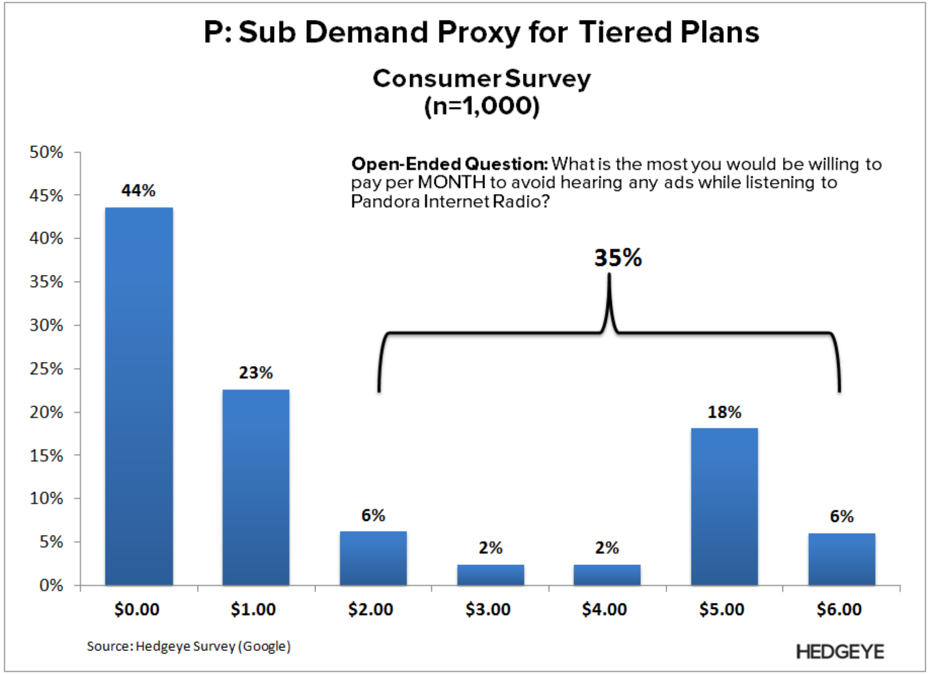
LONGER-TERM COMES DOWN TO MGMT

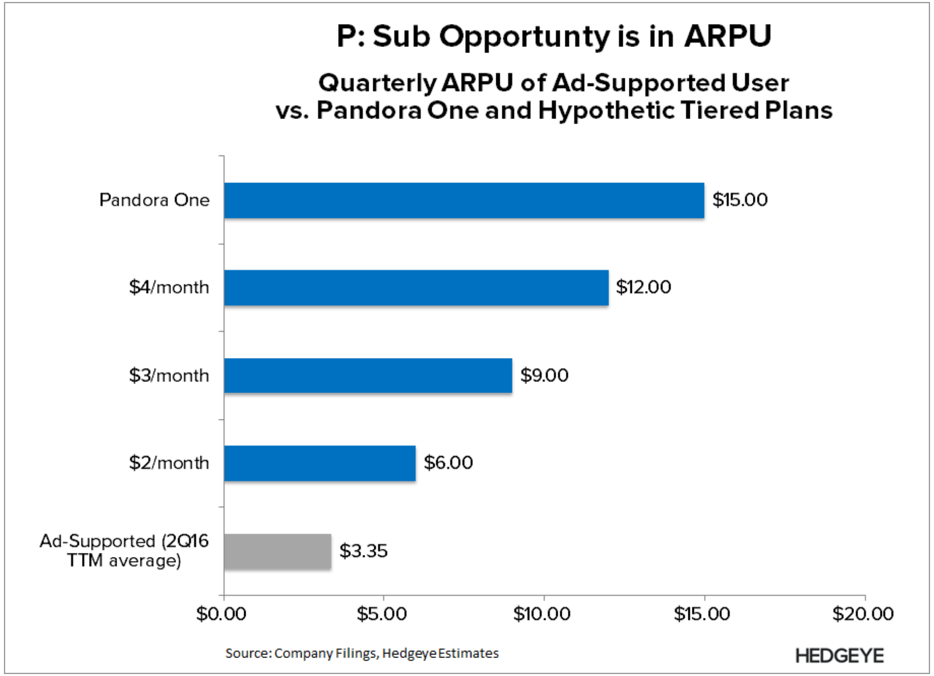


DEPENDS ON HOW AGGRESSIVELY MGMT CHOOSES TO PURSUES IT (TODAY)

Mgmt can launch its expanded sub portfolio and take whatever subs come its way, or it can get creative with its model max out the opportunity. Mgmt has a ton of options **if** its willing to trade paint with its ad supported model

OPTION #1: JUST GET THEM PAYING





THE MIDDLE HAS NEVER BEEN TESTED, COULD BE A SPRINGBOARD

Historically, P has only offered the unlimited subscription or the ad-supported product. Offering something in the middle (e.g. tiering and/or promotions) could eventually drive conversion to Pandora One and/or Interactive

OPTION #1: JUST GET THEM PAYING

P: Subscription Revenue Growth Opportunity (vs. TTM Total Revenue)						
NTM Revenue Growth from Tiered/Promotion Non-Interactive Plans (Conversion vs. Price)*						
Conversion Rate	New Subs	Monthly Price				
		$2.50	$3.00	$3.50	$4.00	$4.50
5.0%	3.8	5%	7%	8%	10%	12%
7.5%	7.5	7%	10%	13%	15%	18%
10.0%	9.4	10%	13%	17%	20%	24%
12.5%	11.3	12%	17%	21%	25%	30%
15.0%	13.2	15%	20%	25%	30%	36%
17.5%	15.1	17%	23%	29%	35%	42%
20.0%	17.0	19%	26%	33%	40%	48%
22.5%	18.8	22%	30%	38%	46%	53%

TTM Ad-Supported Monthlly ARPU (2Q16) $1.12

*Assumptions

1) Incremental Revenue Growth net lost of Ad Revenue from Conversion
2) **Assumes no cannabalization of Pandora One subs into to cheaper tier**
3) Assume Flat Ad Revenue (before lost rev from conversion to sub product)
4) Upper Bound of Conversion Rates based on rates disclosed by Spotify

Source: P reports, Hedgeye Estimates

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7.5%	7.5	(1%)	4%	8%	13%	17%
10.0%	9.4	2%	7%	12%	18%	23%
12.5%	11.3	4%	10%	17%	23%	29%
15.0%	13.2	7%	14%	21%	28%	35%
17.5%	15.1	9%	17%	25%	33%	41%
20.0%	17.0	11%	20%	29%	38%	47%
22.5%	18.8	14%	24%	33%	43%	53%

TTM Ad-Supported Monthlly ARPU (2Q16) $1.12

*Assumptions

1) Incremental Revenue Growth net lost of Ad Revenue from Conversion
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3) Assume Flat Ad Revenue (before lost rev from conversion to sub product)
4) Upper Bound of Conversion Rates based on rates disclosed by Spotify

Source: P reports, Hedgeye Estimates

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COULD ALSO BE A MASSIVE REVENUE GROWTH DRIVER

Remember, the ad-supported model is so poorly monetized that any sub conversion is a net positive at pretty much any price point, even if we assume 100% cannibalization of Pandora One into a cheaper tier

OPTION #1: JUST GET THEM PAYING

P: Revenue/Margin Growth from Promotional Pandora One Plans Exclusive to Plans Registered through Pandora.com				
Price	$2.50	$3.00	$3.50	$4.00
Hours	57.5	57.5	57.5	57.5
Royalties	$1.90	$1.90	$1.90	$1.90
Distribution	-	-	-	-
Profit	**$0.60**	**$1.10**	**$1.60**	**$2.10**
Contribution Margin	24%	37%	46%	53%

Ad-Supported Monthly ARPU (2Q16 TTM)	**$1.12**
Ad-Supported Contribution Margin/User (2Q16 TTM)	**$0.74**

Incremental Per Users Metrics				
Revenue	**$1.38**	**$1.88**	**$2.38**	**$2.88**
vs. Ad-Supported	124%	169%	214%	258%
Contribution Profit	**($0.14)**	**$0.36**	**$0.86**	**$1.36**
vs. Ad-Supported	-19%	49%	116%	183%

Notes

1) Pandora can avoid "Apple Tax" if plan is registered outside app
2) Monthly Cost assumes 15 tracks/hr (4 min/track)
3) Pandora One avg listener hours/month were 57.5hrs (2Q16 TTM average)

Upgrade to Pandora One

Pandora One is $4.99 USD monthly or $54.89 USD annually.

Keep in mind that the annual Pandora One subscription plan is only available through the Pandora website at www.pandora.com/one.

Upgrade through the Pandora Website
Upgrade through iTunes
Upgrade through Google Play or Amazon
Upgrade through Roku

Upgrade through the Pandora website

1. Open your browser and visit www.pandora.com/one.
2. If you are not currently logged in, click **Get Started Now**, then follow the prompts to sign in to your Pandora account.
3. Select your preferred subscription plan: **$4.99 USD/month** or **$54.89 USD/year** (plus tax where applicable).
4. Choose your method of payment:

Source: Company Reports, company website, Hedgeye Estimates

PROMOTIONAL DISCOUNTS ON PANDORA ONE COULD BE MARGIN ACCRETIVE TOO

Once again, the ad model is so poorly monetized that any sub conversion is a net positive at most price points. Offering web-only promotions to bypass the Apple Tax could be both revenue AND margin accretive

OPTION #1: JUST GET THEM PAYING

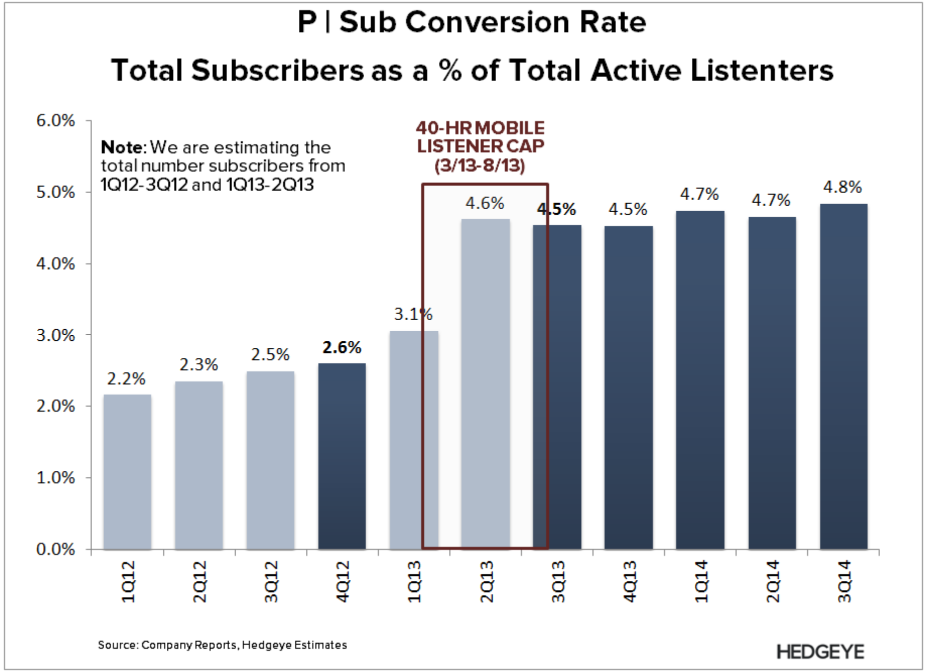
Takeaways

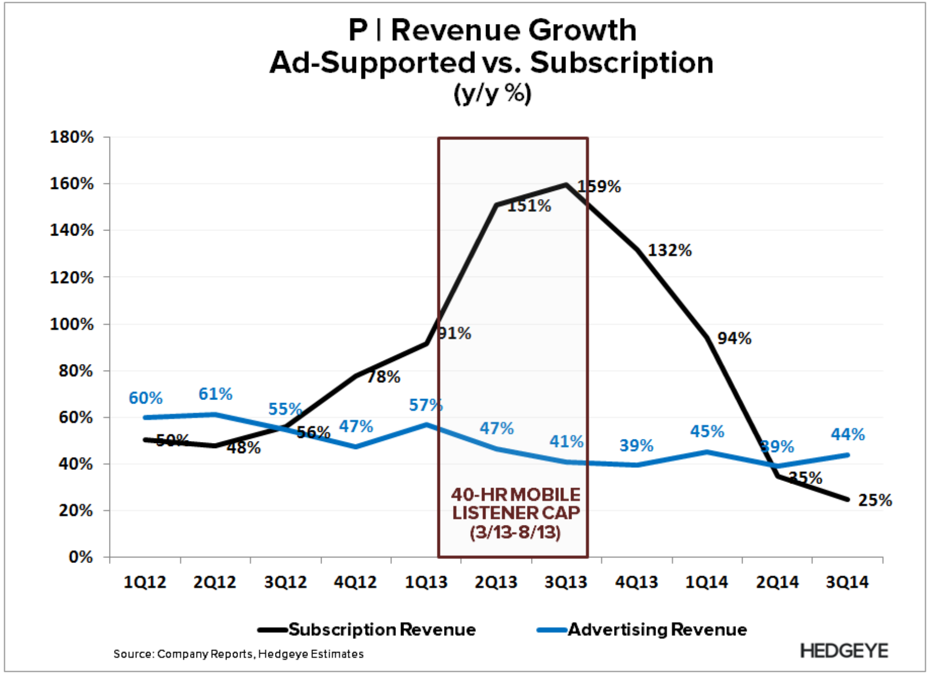
1. The sub market may be bigger than most expect since the middle has never been tested
2. The sub opportunity lives in ARPU since the ad model is so poorly monetized
3. Sub conversion could be both revenue/margin accretive at most price points
4. Paying promo customers more likely to convert (e.g. Day Pass subs have higher conversion)
5. Paying promo customers <u>may</u> be less likely to sign up for a competitor's interactive product

PROMOTIONS/TIERING SERVE AS BOTH A GROWTH DRIVER & SPRINGBOARD

In short, P is in a unique position to both court potential subscribers while drastically improving its financial situation at the same time. Anecdotally, P could possibly build a moat around its users as well.

OPTION #2: CURB THE AD PRODUCT





LISTENER CAP HAS WORKED BEFORE, BUT P MUST WAIT ON SPOTIFY FIRST

The availability of the uncapped free option may be facilitating the user's reluctance to pay. P doesn't have to implement an identical cap to 2013, but could selectively deploy (e.g. heavy users, certain geographies, etc)

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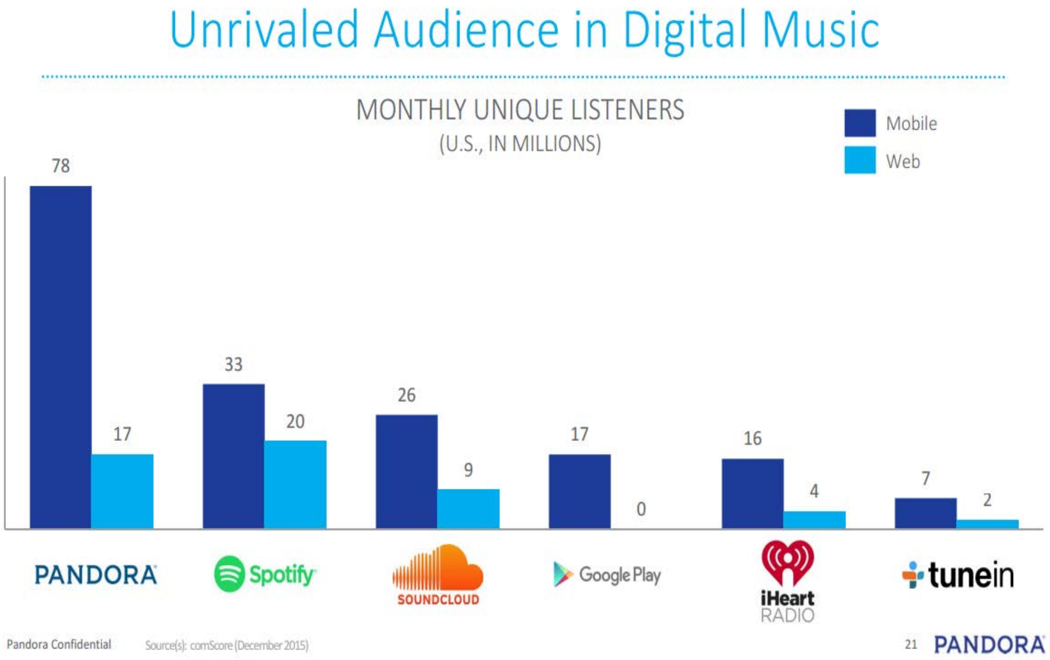


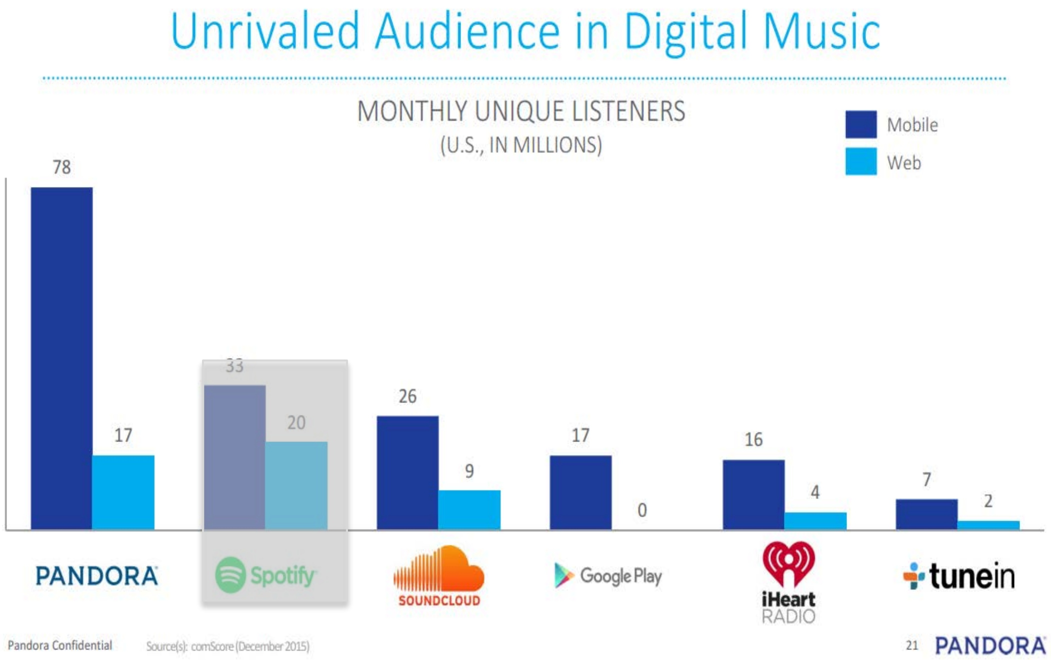
Spotify Notes

1. Free mobile tier has no caps and few limits on what can be streamed (not pay per-track)
2. Spotify pays labels and publishers 55% and 15% of revenue, respectively
3. **Spotify's contracts w/ major labels have supposedly expired (link)**
4. Major labels own ~20% of Spotify
5. **Spotify expected to IPO by end of 2017 (WSJ)**
6. Spotify's convertible debt become more expensive and possibly more dilutive the longer it waits to IPO (WSJ)

BUT SPOTIFY'S FREE TIER PROBABLY WON'T SURVIVE IN ITS CURRENT FORM

The free tier has been a major point of contention within the industry. We suspect that Spotify will have to concede on the free tier in order to get new deals with the majors, which it may need to have in order to IPO.

OPTION #2: CURB THE AD PRODUCT



Mobile Competitor Notes

1. **Souncloud:** Catalog consists mostly of music submitted by independent artists. Interactive licenses may not cover non-interactive rights.

2. **iHeart:** already in financial stress (junk rated debt), has to pay per track under both Webcast and Simulcast

3. **tunein**: Simulcaster, likely pays per track

4. **Google Play**: only Interactive, same as Apple Music, Amazon, etc.

IF SPOTIFY IS FORCED TO CAP/CURB ITS FREE TIER, P CAN EASILY FOLLOW SUIT

First, the user doesn't have too many free mobile options anymore. Second, There's an added benefit of putting the few remaining free competitors at a disadvantage since most couldn't afford to absorb the extra traffic.

OPTION #2: CURB THE AD PRODUCT

Takeaways

1. P's most recent history with listener caps suggest it could be tool to increase sub conversion

2. P doesn't need to implement a broad draconian cap, can selectively deploy

3. Must wait on Spotify first since P runs the risk of sending potential subs their way

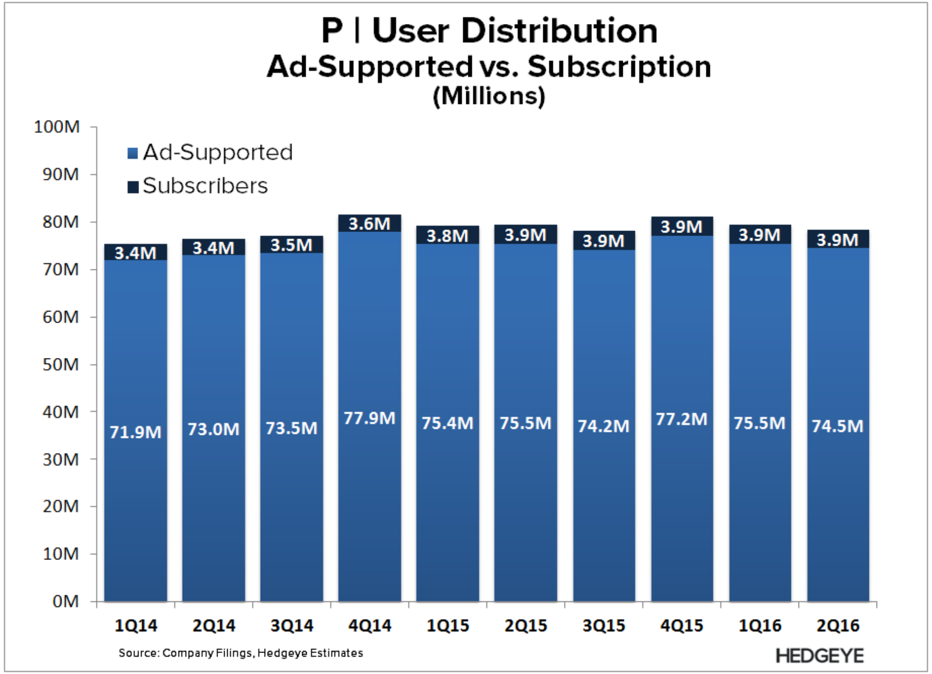
4. If Spotify caps/curtails free tier, P can follow suit since user has few options for free mobile

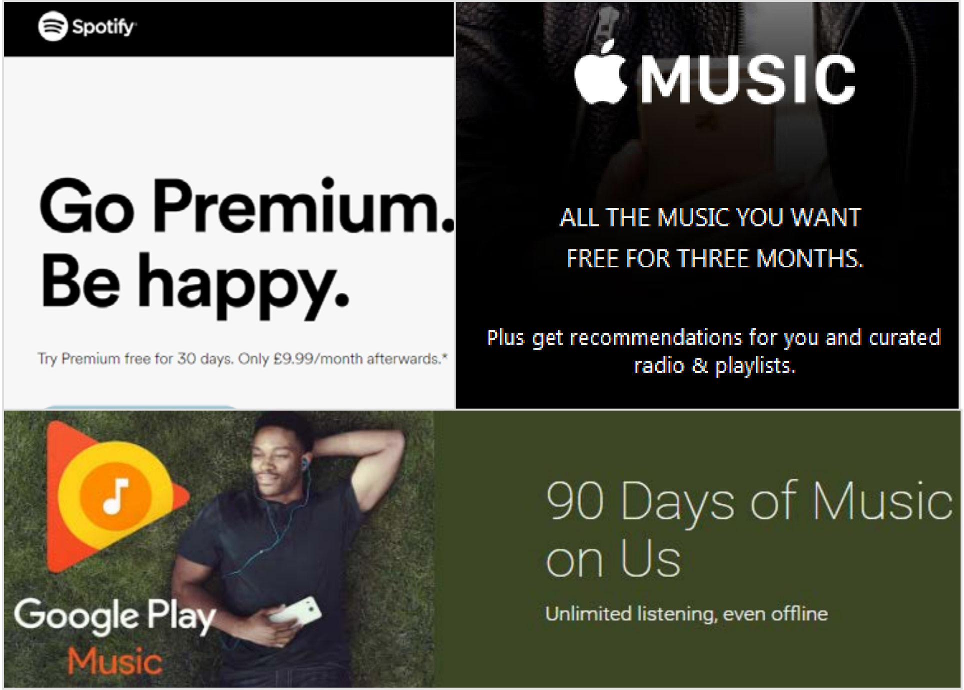
5. If P actually winds up losing users to competition, it actually puts them at a disadvantage

LISTENER CAP MAY HAVE FAVORABLE RISK-REWARD PROFILE

In short, P increases its chances of driving higher sub conversion while sending its excess royalty cost to the few remaining free mobile competitors that probably can't afford to absorb the incremental traffic.

OPTION #3: GIVE AWAY YOUR LUNCH





P CAN'T JUST COMPETE ON MERIT SINCE NO ONE ELSE IS

P may have a huge base of prospects and possibly a better sub product, but P doesn't have a moat around those users, and is basically a new entrant into an established market with a largely commoditized product.

P: KEY POINTS

1

AD MODEL IS SO POORLY MONETIZED THAT...

P's ad-supported model hasn't produce any real operating leverage/cash flow to date, and is now more expensive to run post Web IV. P's 2Q results reinforce our view that its revenue growth is largely tied to its salesforce growth, meaning the model may never cover P's overhead.

2

VERY LITTLE SUB CONVERSION GOES A LONG WAY

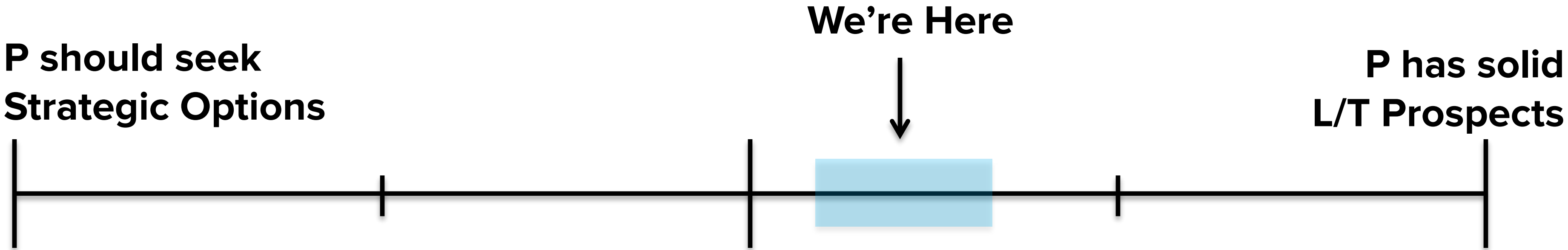
The sub model is far more lucrative from both a revenue and margin perspective. The stark difference b/w the two models means the expanded sub launch is a massive growth opportunity, particularly in the initial years, maybe more depending on how aggressively P commits to it

3

BUT WE DON'T REALLY CARE EITHER WAY

P is basically a hedged bet: mgmt either executes on its sub expansion (new deals + revenue) or is forced to entertain acquisition offers if can't do so. Naturally, the former offers more upside, but the stock should end up much higher either way by this time next year, if not sooner.

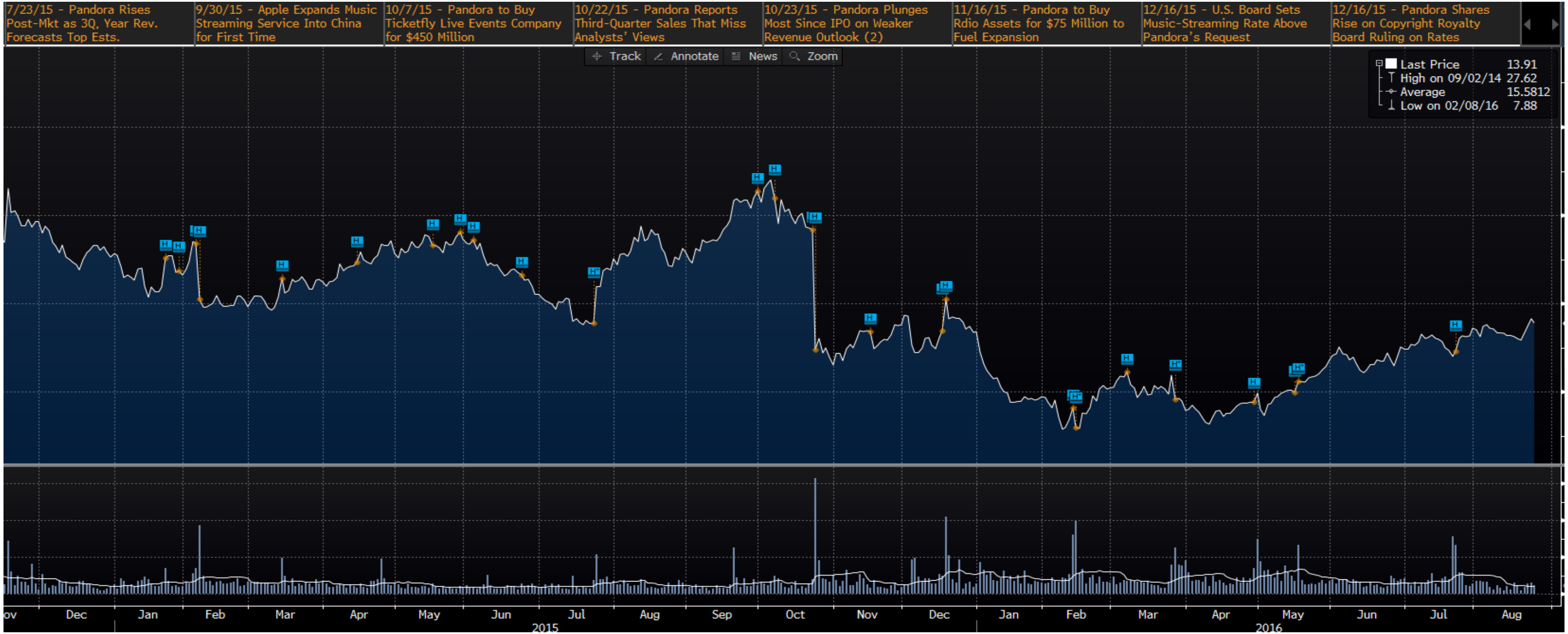
TWO SCHOOLS OF THROUGHT



MOST INVESTORS ARE SOMEWHERE IN BETWEEN (WE ARE TOO)

We believe the sub business should take priority since it's the more viable model in a post Web IV world, but its longer-term prospects really depend on how aggressively mgmt chooses to pursue it (covered in prior section)

BUT P RUNNING OUT OF EXCUSES

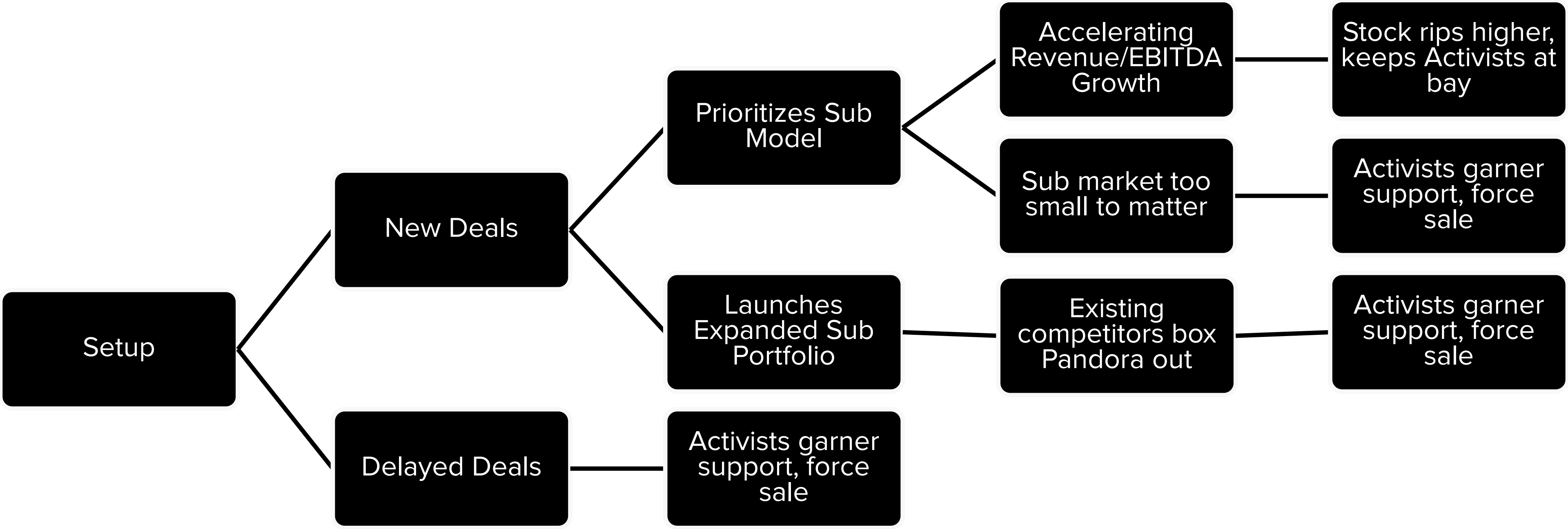


EXPANDED SUB LAUNCH COULD BE MGMT'S LAST STAND

2015 can be been characterized as poorly managed Web IV expectations, questionable acquisitions, and disappointing Ad revenues. The rocky start to 2016 only exacerbates what has been a very frustrating position

Source: Bloomberg

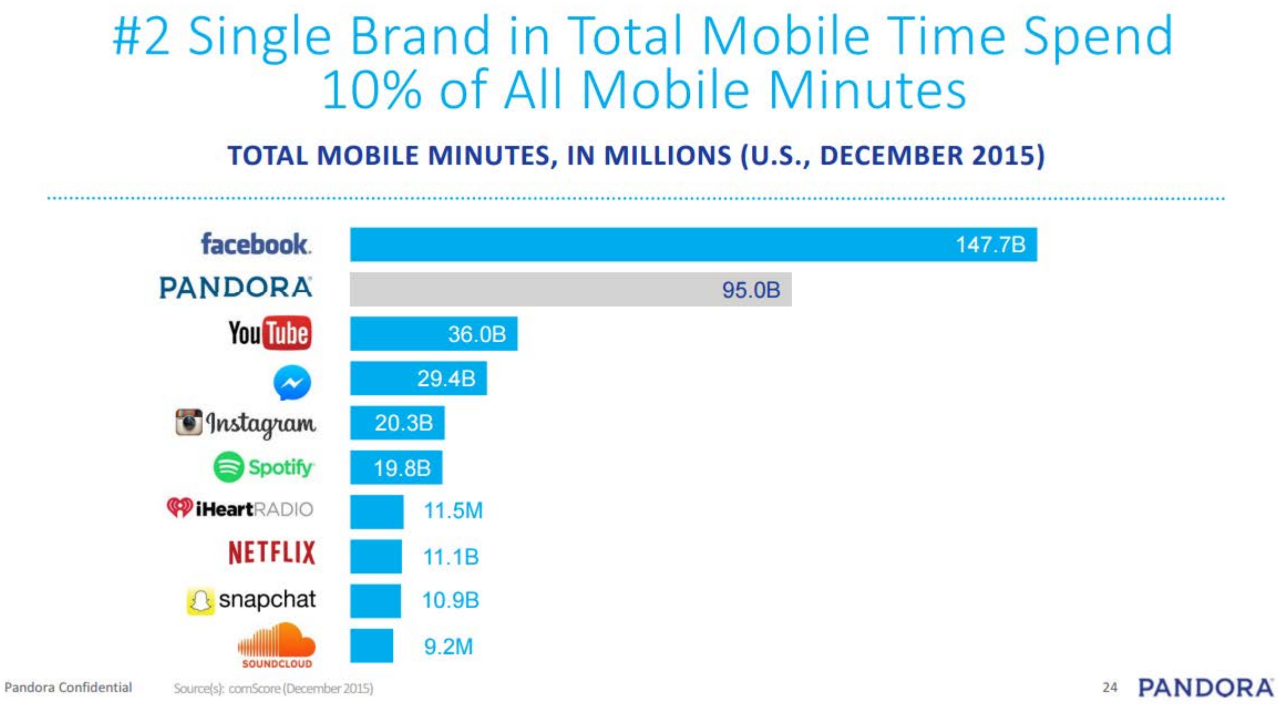
P | ALL ROADS LEAD TO ROME (HIGHER)



STOCK WORKS EITHER WAY (EXECUTE OR SELL)

Either mgmt executes on its expanded sub launch or facing increasing pressure to sell the company, which we suspect would be met with limited investor resistance if expanded sub launch sputters out.

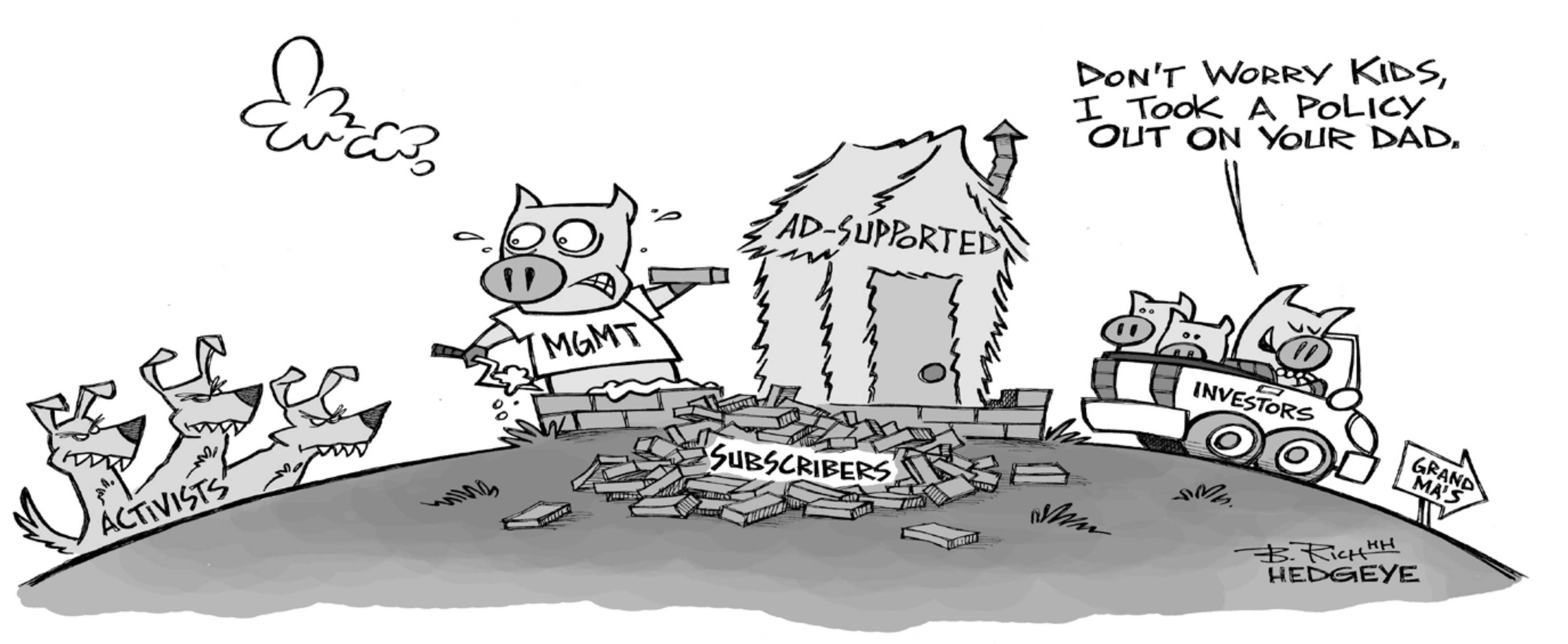
AND BY SALE, WE MEAN BIDDING WAR



IMPOSSIBLE TO REPLICATE THAT TYPE OF ENGAGEMENT ORGANICALLY

Probably a major reason why music streaming has become the new tech battleground. P's monetization deficiencies are irrelevant; the pitch would be about what the acquirer could do with that level of engagement.

P = CALL OPTION



WE'LL BE FINE EITHER WAY (MEANING THE LONGS)

This is not a bull vs. bear story: It's a mgmt vs. activist story. It doesn't matter who wins, because the long side of the trade should win out either way. P.s. If you're still short, please tell us why...

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