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RUBI - Q1 2018 Rubicon Project Inc Earnings Call

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PRESENTATION

Operator

Welcome to the First Quarter 2018 Rubicon Project Earnings Conference Call. (Operator Instructions) Please note this conference is being recorded.

I would now like to turn the conference over to Mr. Nick Kormeluk. Please go ahead.

Nick Kormeluk

Thank you, operator. Good afternoon, everyone. Welcome to Rubicon Project's First Quarter 2018 Earnings Conference Call. As a reminder, this conference call is being recorded. Joining me on the call today are Michael Barrett, President and CEO; and David Day, our CFO. I would like to point out that we have posted a financial highlights slides to our Investor Relations website to accompany today's presentation.

Before we get started, I would like to remind you that our prepared remarks and answers to questions will include information that might be considered to be forward-looking statements, including but not limited to statements concerning our anticipated financial performance such as revenue, advertising spend, profitability, net income or loss, adjusted EBITDA, earnings per share and cash flow; strategic objectives, including focus on header bidding, mobile, video and private marketplace opportunities; investments in our business; development of our technology; introduction of new offerings; the impact of our acquisition of nToggle and its traffic-shaping technology on our business; scope and duration of client relationships; our fees; business mix; sales growth; client utilization of our offerings; the impact of the European general data protection regulation and other regulatory initiatives; our competitive differentiation; our leadership position in the industry; our market share, market conditions, trends and opportunities; user reach; certain statements regarding future operational performance measures, including ad request, fill rate, advertising spend, take rate, paid impressions and average CPM; the effect of our cost reduction initiatives; and factors that could affect these and other aspects of our business.

These statements are not guarantees of future performance. They reflect our current views with respect to the future events and are based on assumptions and estimates and subject to known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements to be materially different from expectations or results projected or implied by forward-looking statements. A discussion of these and other risks, uncertainties and assumptions is set forth in the company's periodic reports filed with the SEC, including our 2017 annual report on Form 10-K and quarterly reports on Form 10-Q under the headings Risk Factors and Management's Discussion and Analysis of Financial Conditions and Results of Operations. We undertake no obligation to update forward-looking statements or relevant risks.

Our commentary today will include non-GAAP financial measures. Reconciliations between GAAP and non-GAAP metrics for our reported results can be found in our earnings press release and in the financial highlights deck, which we have posted to our Investor Relations website. At times, in response to your questions, we may offer incremental metrics to provide greater insights into the dynamics of our business. Please be advised that this additional detail may be onetime in nature, and we may or may not provide an update on the future of these metrics. I encourage you to visit our Investor Relations website and access our press release, financial highlights deck, periodic SEC reports and webcast replay of today's call to learn more about Rubicon Project.

I will now turn the call over to Michael. Please go ahead.

Michael G. Barrett - *The Rubicon Project, Inc. - President, CEO & Director*

Thank you, Nick. Despite feeling like we just held our Q4 call, which was a short 7 weeks ago, I'm pleased to say that we have seen continued positive trends in both ad spend and revenue growth. Our cost management efforts continue, and we intend to remain very focused on driving additional operational efficiencies in the business. In Q1, we performed slightly better than our indications provided on March 14 in all key financial areas, including ad spend, take rate, revenue and expenses, which David will discuss in more detail.

We recently held a private business event we called our Executive Exchange in New York, which included brands, agencies, DSPs, publishers and other related partners. The time spent with this very senior group of executives was invaluable. We spent time listening and collaborating on their strategic road maps for growing their businesses while adapting to rapidly changing privacy laws; increasing focus on fraud removal; transparency in auction dynamics and pricing; supply path optimization; CapEx challenges; and attention to key growth areas namely, audio, video, mobile app and PMPs. We believe that getting mind shares through client meetings like these will strengthen our relationships and translate it into market share gains for Rubicon Project, as we demonstrate how our growth initiatives and investments are aligned with our clients. Our strategy to provide a high-quality, efficient, broad-reaching exchange resonated extremely well with partners across the board.

As evidence of this traction, our engagement level to work on partner-specific initiatives to jointly grow revenue following this event has been extremely high. It is no secret that one of the largest trends on the DSP side of our industry is supply path optimization. With the adoption of a client-side header bidding in 2016 and '17, DSPs saw impressions duplicated 4 to 5x, which is expected to dramatically increase further with the move to server-side header bidding. We would not be surprised to see many DSPs dramatically cut the number of exchanges they work with over the next 12 to 24 months. This creates a great opportunity for the most scaled and differentiated exchanges to grab considerable market share. We believe we are extremely well positioned on all critical metrics to do just that. Our key differentiators are buyer-specific bid filtering capabilities, which we call traffic shaping, resulting from our nToggle acquisition; sophisticated buyer tools, including our EMR, or estimated market rate tool; a leading position in audio, video and mobile and PMPs; transparency; inventory quality; service and support; and, last but not least, pricing.

Exchange consolidation, continued strong industry growth in digital advertising, along with the shift to programmatic creates a very unique and attractive market opportunity.

I will now shift to addressing something that is getting a lot of recent industry attention, privacy. This quarter, we saw many more media headlines about privacy in ad tech, ranging from proclamations from industry leaders to new regulation. We are continuously working to embrace industry standards to continue to comply with user preference and consents and collaborate with partners to preserve end users' right to privacy and facilitate our long-term success.

At Rubicon Project, we have always been and will continue to be extremely supportive of end users' right to privacy. Our view is respect for end users' rights is critical, and improving the safety and quality of users experience within digital advertising is good for the industry. We applaud those that embrace and embark on initiatives to advance user privacy and believe that this will help keep the digital media industry growing healthy and viable. As many of you are aware, GDPR, which is the General Data Protection Regulation in the EU, becomes effective on May 25 of this year. So what is its purpose? How is it implemented? And what is Rubicon Project's role? GDPR's purpose is to protect the personal data of European end users. It will protect data by increasing requirements applicable to obtaining consent from end users for accessing their devices and using their personal data. To oversimplify, end users who grant consent agree to share their data, as they have historically. And end users who do not grant consent, will not have their data shared. In the event that consent is not obtained from an end user, buyers will not have access to the information they need to target the specific audiences they are seeking as accurately as they would like, which may lower revenue for us and our publishers.

But it is important to note that generally speaking, the consent collection lies in the hands of the publishers because they have direct relationships with the users. Keep in mind, consents are nothing new in the industry, and these and other terms and conditions have existed for many, many years for privacy and other regulatory compliance. However, the GDPR expands upon previous requirements, and how quickly and effectively each publisher implements its compliance depends on its resources and level of preparedness. It will take some time for publishers to implement their consent collection mechanisms and for the industry generally to adapt to these changes. The Interactive Advertising Bureau Europe, or IAB Europe, has developed a transparency in consent framework, which is a guide digital publishers can use to obtain user consents. We have registered with the IAB Europe and will be listed as a global vendor, along with many other ad tech industry participants. We believe the IAB Europe framework, and perhaps other similar frameworks, will standardize and facilitate the process of obtaining user consents, although it'll probably take some time to reach full implementation. Because of the variety of publisher approaches and common uncertainties and inefficiencies that exist with any new regulation, we anticipate some level of near-term reduction in ad spend and revenue associated with EU impressions.

We believe that ad spend and revenue levels associated with EU-based impressions will improve as requirements become clear, industry standards evolve and the industry adapts.

In Q1, our EU-based ad spend as a percent of our total ad spend was 32%. For Q2, based on the GDPR launch date of May 25, approximately 37 of 91 days could potentially be affected. At the moment, we believe that even with negative -- even with a negative impact from GDPR our Q2 ad spend and revenue will continue to show growth over Q1 on a sequential basis.

I'll now get back to discussing some of the current growth drivers in our business. Audio and video continue to be significant growth drivers for us, and we continued to outpace industry growth rates in gross share, with audio revenue nearly tripling and video revenue roughly doubling in Q1 year-over-year. These have been areas where we have invested and worked closely with partners and that we believe should continue to deliver high growth in the future.

In Q1 2018, our access to inventory doubled again over what we saw in Q1 2017. We now have over 780 header bidding connections generating more than 70% of our revenue. This compares to just over 700 connections and a little over 50% of revenue in Q4.

Rubicon Project's Prebid solution continues to gain traction, and we see continued growth from our partnerships with Google and their exchange bidding technology, also known as EB, as well as with Amazon and their transparent advertising marketplace technology, also known as TAM. We have built a powerful model to migrate partners from client-side header to server-side that allows for a very smooth, low-risk transition that continues to drive connection growth.

As our access to inventory has increased, sending the right impression to the right DSP within buyer capacity constraints is critical. Now that our traffic-shaping technology, a capability added through our nToggle acquisition, has been initially deployed in the U.S., we are seeing very encouraging results from DSPs using it.

To date, we are fully rolled out in the U.S. and anticipate being integrated in key markets in Europe by the end of Q2. In the cases where we have it deployed, it's doing exactly what we had hoped. We send less traffic to buyers but a more concentrated bid stream that matches their demand, which results in greater win rates and decreased capital expense for those buyers and increased revenue for sellers. Buyers have told us that this capability is unmatched in the industry. Not only does this benefit our partners, but we will be utilizing traffic-shaping technology to prioritize traffic for Rubicon Project. This is also a contributing factor for the significant reduction in Rubicon Project CapEx projected for 2018 by enabling us to operate much more efficiently without compromising revenue growth.

As I noted at the top of the call, it's been 7 short weeks since we hosted our Q4 earnings call. And in that brief period of time, we have seen increasingly clear signals of our recovery. Year-over-year ad spend continues to grow in the low double digits. Ad spend and revenue is expected to grow sequentially in Q2, even with potential negative impacts of GDPR. And we are seeing modest improvements in take rate, which is very positive given the trends in the last year.

We are very encouraged to see the continuing positive results of the hard work and tough decisions made in the last year to restore Rubicon Project to growth and a clear path to profitability.

With that, I will hand things over to David, who'll go into greater detail regarding our financial performance in Q1 2018.

David L. Day - *The Rubicon Project, Inc. - CFO*

Thanks, Michael. As Michael pointed out, we are happy to report that our financial trends continue to improve. We believe these are signs that our investments in technology, changes in our go-to-market strategy and efforts to improve internal efficiency are becoming more visible in our financial results as we move through 2018. I will briefly cover Q1 results before discussing progress from our cost-reduction efforts and recent unexpected financial trends in more detail.

Turning to our results. For the first quarter of 2018, we generated $211 million in advertising spend, up 10% year-over-year; $24.9 million in revenue; adjusted EBITDA loss of $14.2 million, which included approximately $2.5 million of nonrecurring severance costs, resulting in a loss of $0.44 per share in non-GAAP EPS. The 10% total advertising spend increase in Q1 2018 versus prior year was a bit stronger than the estimate we provided on our last call, as our momentum carried through the last several weeks of the quarter.

The year-over-year increase was driven by a 34% increase in mobile ad spend, offset by a slight 3% decrease in desktop. As Michael indicated, audio and video grew the fastest.

When looking at amounts paid to sellers, or APS, which we referenced last quarter, we had a year-over-year increase of 28% in Q1. This clearly illustrates to our publishers that we are gaining share and delivering more revenue to them. Desktop represented 57% of ad spend mix in the first quarter versus 65% in Q1 of last year. Mobile 43% ad spend share was up from 35% a year ago.

Revenue for the first quarter was down year-over-year due to the elimination of our buyer fees on November 1, 2017, partially offset by the increase in year-over-year ad spend.

Our average take rate was 11.8% during the first quarter of 2018, a decrease of 90 basis points sequentially due to a full quarter impact of buyer fee elimination. Take rate is defined as revenue divided by total ad spend.

Operating expenses for the first quarter of 2018 were $53 million, down from $61 million in the same period a year ago, reflecting our cost reduction actions over the past year. On an adjusted EBITDA basis, operating expenses for the first quarter were $39 million, which includes approximately $2.5 million of nonrecurring severance costs as compared to $44.9 million in Q1 2017. The decrease reflects our cost reduction actions over the past year but does not yet include the benefit from actions taken in Q1 2018.

Net loss was $27.8 million in the first quarter of 2018 as compared to a net loss of $15.8 million in the first quarter of 2017. The increase in net loss year-over-year is a result of lower revenue, partially offset by lower operating expenses. Adjusted EBITDA loss was $14.2 million in the first quarter of 2018 as compared to positive adjusted EBITDA of $1.1 million reported in the same period 1 year ago. The decrease in adjusted EBITDA was driven primarily by a decrease in revenue, resulting from a lower take rate, partially offset by lower cash costs, as previously discussed.

Diluted GAAP loss per share was $0.56 for the first quarter of 2018 compared to diluted GAAP loss per share of $0.33 in the same period in 2017. Non-GAAP loss per share in the first quarter of 2018 was $0.44 compared to non-GAAP loss per share of $0.16 reported for the same period in 2017.

Capital expenditures, including purchases of property and equipment as well as capitalized internally used software development costs, were $3 million for the first quarter of 2018. We closed the first quarter of 2018 with $119.3 million in cash and marketable securities, a decrease of $12.3 million from year-end. This reduction resulted from the combined cash operating losses and capital expenditures during the quarter, offset slightly by cash conversion cycle benefit.

Free cash flow for the first quarter of 2018 was negative $12.6 million, for the reasons stated above, as compared to a negative free cash flow of $2.5 million during the first quarter of 2017. We calculate free cash flow as net cash provided by operating activities, less capital expenditures, including capitalized software development costs.

Since the filing of annual tax returns drives our net operating loss calculations, or NOLs, we do not update them quarterly. However, as of December 31, 2017, our total federal NOLs were approximately $240 million, resulting in a tax-affected federal benefit calculation of $50 million, which reflects the new U.S. corporate tax rate of 21%. Our total potential tax-affected NOL benefit, adding state and Canadian benefits to this federal amount, is approximately $65 million.

Regarding cost reduction efforts discussed on our prior earnings call and our goal of being adjusted EBITDA positive in Q4 of 2018, I'm pleased to say we continue to be on track. This comes from the combination of growing ad spend and revenue, together with the impact of our cost-reduction activities initiated in Q1. To recap our cost reduction efforts discussed last quarter, we expect that they will result in the reduction of $44 million or 23% from our total Q4 2017 annualized cost structure of $190 million.

Before I provide performance indicators for Q2, I want to remind you that for Q1 we (inaudible) granularity and detail than we had previously since we reported Q4 results only 2.5 weeks before the end of Q1. We're still early in Q2, and as such, we won't be providing the same level of guidance granularity as we did for Q1 but will provide levels comparable to the last 2 quarters. Quarter-to-date, we have seen year-over-year ad spend growth rates continue in the low double digits, consistent to those observed in latter half of Q1. As Michael pointed out, there are some industry uncertainty around GDPR, which becomes effective on May 25. Regardless of potential GDPR impact, we expect Q2 2018 ad spend and revenue to grow sequentially from Q1.

We expect take rate in Q2 to be at or above the 11.8% take rate level from Q1, which continues to position us as a low-cost provider. We continue to expect that the full benefit of our cost reductions will be realized in the second half of 2018, with operating expenses on an adjusted EBITDA basis reaching $32 million per quarter. Q2 will show a reduction from Q1 as a result of a partial realization of these reductions. We also expect to incur approximately $500,000 in nonrecurring severance costs in Q2. We continue to expect that CapEx will come in below $20 million for the full year, representing a 50% decrease from 2017. A portion of this benefit results from utilizing our traffic-shaping technology to better manage our ad request prioritization and overall ad request efficiency.

We are pleased to see continuing positive momentum in ad spend and revenue from the investments made over the last year as well as the early benefits from the efficiency initiatives and cost actions that'll benefit the financial performance of Rubicon Project as we move through 2018 and get to positive adjusted EBITDA in Q4 of 2018.

In light of our auction dynamics, filtering technologies, inventory quality controls, broad reach, transparency and attractive pricing, we believe we are the most efficient exchange partner, which puts us in a very strong position to gain share in a growing addressable market. With that, let's open the line for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The first question comes from Jason Kreyer with Craig-Hallum.

Jason Michael Kreyer - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Michael, I just wanted to kind of double click on the commentary you provided on SPO. Maybe you can just kind of shape that opportunity, how you see that playing out as the year progresses? And then, a little bit more detail on what gives you confidence that as that trend continues that you'll gain share as the year goes on?

Michael G. Barrett - *The Rubicon Project, Inc. - President, CEO & Director*

Yes. Good question, Jason. So what we've already seen is we're seeing contraction begin; because we said in previous calls, one of the selling propositions that DSPs had maybe 2 years ago was to brag to marketers, their clients, how many platforms they access inventory on. The number just astounded me and, I mean, the industry was north of 100 platforms. And now I think if you were to ask the Trade Desk or you ask MediaMath or any of the top DSPs, "How many platforms you're accessing inventory from?" That number has definitely fallen. I've heard numbers as low as 60, and that's just a -- they hit the pause button there, and there's going to be continued acceleration in terms of collapsing platforms. It's really being driven by the fact that there's redundancy. They're seeing the same impression on multiple platforms. It's driving their operating costs higher. But this whole idea about transparency and safety and content quality and ad quality really resonate with their marketers. And their marketers are like, "Hey, I am not that comfortable anymore buying these really, really long tail sites on these niche exchanges. I'd much prefer to understand -- I know who the publisher is, where that advertising dollars are going." And so we -- I don't think any of the positive momentum to date is a result of that contraction, but we certainly think that that's going to be a wind in our back as you exit this year, going into 2019. Because I think the next cut from, say, 60 to whatever that number might be, that's definitely going to -- the money is still going to be spent. Some less tertiary platforms will be cut out of the equation, and I think we'll be the benefit. And my confidence in that is largely the feedback from the buyers. They like working with us; they like the technology that we have, particularly nToggle and EMR; and they like the fact that we run a curated, safe, clean transparent marketplace. So all those kind of tough moves that we made definitely are buying -- paying off in a world that's a little bit more buyer-centric than it has been in the past for Rubicon Project.

Jason Michael Kreyer - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Okay. Two on programmatic audio. So maybe you can just give an update on how things are progressing with Spotify? I know you've announced that relationship before. And then second, with Pandora's acquisition of AdsWizz, just wondering if you can handicap if you think there's an opportunity there? Or does that acquisition increase or decrease your ability to work with that company?

Michael G. Barrett - *The Rubicon Project, Inc. - President, CEO & Director*

Yes. Not to get into specifics because, obviously, we don't have permission to talk specifically about our clients, but we've noted in the past that Spotify is one of our largest audio partners. It continues to grow. As our audio numbers grow, so does Spotify's participation in that share. And so it's a real bright spot for us, and we are really excited that we got into it early and helped create that marketplace. As far as AdsWizz is concerned, on the one hand, as it relates to Pandora specifically, they've bought proprietary ad technology. And so I think that once they get settled and they deploy it, there's a good chance that we could be a demand source for them, plugging into their technology. So we remain confident that there is a path to working closely with Pandora. On the other hand, the opportunity is that AdsWizz was used by others in the industry. And generally speaking, when a third-party company is bought by a competitor, it isn't exactly going to increase their spend on that platform. So I think what you're going to see is spend having to find a home somewhere, and I think we may be a good beneficiary of that as well.

Jason Michael Kreyer - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Perfect. Maybe just a last one for me. The take rate moving up quarter-over-quarter. Obviously, a positive takeaway, or I guess at least moving up from where you exited last quarter. Can you just give us a sense of how those conversations are happening with the publishers? What the receptivity is to potential increases?

Michael G. Barrett - *The Rubicon Project, Inc. - President, CEO & Director*

Yes. I mean, I think that, as you've seen from the evidence of the increase, albeit modest, I think that -- we've said it before. We became pretty reliant on buy-side fees, maybe to the detriment of market-based fees for publishers. And so in those instances where I think we felt as though we were priced well, well, well below the competition, there was some room for movement. And again, it's a product suite, right, open market, private market, et cetera. So we're talking about a blend of all of those. We maintain our steadfast desire to be a low-priced provider of services. And so we feel as though even with the improvement in take rate, we still find ourselves in that position. And do we have a little bit more room to move?

Perhaps. But the simple fact is I wouldn't anticipate a dramatic increase in take rate. That's not the goal here. The goal here is to become very efficient, to get to the market if not just slightly below market and be able to extol that as a quality of the exchange.

David L. Day - *The Rubicon Project, Inc. - CFO*

And I think the second point there is that I think some have been concerned in the past with these rates dropping. How low can it go? And I think this shows that it's stable, and there is a decent floor, at least in the near term, on those rates.

Operator

The next question comes from Kerry Rice with Needham.

Christian Kerrigan Rice - *Needham & Company, LLC, Research Division - Senior Analyst*

Maybe a corollary to the take rates improving a tad bit and stabilizing and then getting some ad spending recovery. Can you talk a little bit about maybe gross margin? Given the high level of fixed cost, do you see that kind of bouncing back a little bit from maybe Q1? Or do we think about Q1 being roughly stable going forward? And then, the second question is, maybe the dynamic between desktop and mobile. While mobile certainly has improved year-over-year, it's kind of ticked down from Q3 and Q4 of 2017. I don't know if that's just seasonality or maybe if there's something else that's driving that trend to boost desktop a little bit in Q1?

Michael G. Barrett - *The Rubicon Project, Inc. - President, CEO & Director*

Sure. Let me help -- take the second one first. So on the desktop and mobile, yes, not significant changes. Some of our recent growth is been driven by some of our service-side momentum, so Google Exchange bidding. That's a little heavier weighted on the desktop side in the short term. Their mobile and other -- their mobile component will certainly grow more rapidly over time. So we think that mobile will continue to be a growing component of our business and that these fluctuations are just short-term volatility.

David L. Day - *The Rubicon Project, Inc. - CFO*

On the gross margin.

Michael G. Barrett - *The Rubicon Project, Inc. - President, CEO & Director*

Yes. On the gross margin. Yes, like you said, our model is a very leverageable model, and so we're continuing to decrease our costs. And so from a margin perspective, every bit of ad spend and revenue growth drops almost directly to the bottom line. And so, even from a cost of revenue perspective on a gross margin basis, a vast majority of our cost of revenue are more or less fixed, and there's just a small component of that that's variable. So you should see improving margins on that front over time as that ad spend picks up.

Operator

(Operator Instructions) This concludes our question-and-answer session. I would like to turn the conference back over to Michael Barrett for any closing remarks.

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Michael G. Barrett - *The Rubicon Project, Inc. - President, CEO & Director*

I would like to thank all of our employees for their efforts and hard work as well as our partners and shareholders for their support during a very challenging 12 months that has now put us in the current position of showing improved overall company performance.

We look forward to seeing some of you at some of our upcoming financial conferences in May. We will be at SunTrust conference on May 8 in San Francisco, Needham conference in New York on May 16 and the Craig-Hallum conference in Minneapolis on May 30. Thanks, again, for joining the call and have a good evening.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.
