Pandora Media, Inc (P) Memo

Name: Andrew Kouri	College/School: SEAS	Year: 2nd Year

Important Company Financial Data

All amounts in USD

Pandora's EPS (MRQ): -.19
52 Week Range: 7.83 – 26.00
Dividends: None
Shares Outstanding: 164.96M
Short Ratio: N/A
Book Value Per Share (mrq): .64
Rev (ttm): 274.34M
EBITDA: -6.53M
FYE: Jan 31

April 24, 2012 - Short: Pandora Media Inc.

Thesis / Key Points

- No profits, and guidance predicts losses even for FY '13
- Pandora can not capitalize on smartphone or social media growth as much as competitors,
- Lack of dedicated hardware supports the perfectly competitive industry model

Pandora's revenues are based primarily off the **selling of advertising** to allow users to legally stream (listen to but not download) music for free, with a majority of **expenses allocated to the licensing of content**. Since **inception**, Pandora has almost consistently **failed to sustain profits based on this model**. In Pandora's most recent 10-K, the risk of never realizing profits is stated very clearly, centered and in bold: "We have incurred significant operating losses in the past and may not be able to generate sufficient revenue to be profitable." In the company's FY 2013 Guidance, **net loss per share** is expected "to be **between ($0.11) and ($0.16)."** Pandora's start-up level earnings risk do not carry the same upside potential as other inflated companies in the tech bubble, since Pandora is relatively mature. History has shown that their **product** and **business model**, which has been **stagnated** does not have significant earnings power as shown by their negative EBITDA, and since they have no plans to overhaul their service, an inflow of competition will only further these losses.

Pandora's licensing and royalties structure negotiated with EMI and other major record studios does not allow for a Spotify-type service, where users can select the songs they would like to hear, restart, and skip as many tracks as they would like. Pandora states in it's 10-K that a risk with their given fees structure is the ability to "effectively monetize listener hours, **particularly with respect to** listener hours on **mobile devices**." According to an 87-page research report by Morgan Stanley, the world will see a significant shift toward mobile browsing, exceeding computer internet browsing traffic by 2015.

The viral adaption of **Spotify** in the United States was driven largely by the **tight social media (Facebook) integration** of their product. **Pandora** currently **does not have a successful social component** to it, which gave two advantages to competitors: viral product advertising and the ability to see what friends are listening to.

Pandora's product is also misunderstood by other analysts because they fail to see how the **distribution infrastructure** is **sub-optimal**. Unlike Sirius XM, which has implemented their physical satellite hardware in many manufacturer's cars, **Pandora has no dedicated platform**. A subscriber who has made the investment into a Sirius XM receiver can only subscribe to Sirius' product, whereas a smartphone user currently using Pandora for free can use any of a variety of competing free internet radio apps. The "perfect competition" model is exacerbated due to the ease of installing new and free software as better alternative products enter the market.

Further, both major US mobile phone carriers, AT&T and Verizon, eliminated their **unlimited data plans** for new smartphone subscribers. By limiting the amount of data that can be sent to one's phone while on-the-go, it causes users to think twice about using Pandora in their car because it gobbles up valuable cell data at the rate of 60mb/hour. Unlike other premium internet streaming radio services or owning your music, Pandora does not offer an option to avoid data usage by carrying the music files with you.

Misperception

- Brand Loyalty
- Growth Expectations
- Infrastructure

As is evident in my VAR (Exhibits 1 & 2), Pandora has a significant amount of brand recognition; however, I argue that there is a misperception that exists with **brand recognition verses brand loyalty**. Because Pandora was one of the first to the streaming internet radio market, and has generally been well-received, there are 47 million active users of Pandora compared with 13 million active Spotify users. 23% of Spotify's accounts are premium accounts, however. Pandora only generates 13%

of revenues from Pandora One, their $36/year premium service. From my VAR talking to people within the 40-55 years old demographic, most had not heard of Spotify, since it is such a new product. Given Spotify's tremendous success in such a short time in the **well-connected** 18-23 year old **demographic,** I project that it will continue growth in the slower-reacting older demographic as it gets more brand recognition.

Growth expectations for Pandora are exaggerated given the historically high growth rate. Pandora states that "Our revenue increased rapidly in each of the fiscal years ended January 31, 2007 through January 31, 2012; however, we expect our revenue growth rate to decline in the future as a result of a variety of factors, including increased competition and the maturation of our business, and we cannot assure you that our revenue will continue to grow or will not decline." Further, Pandora failed to make their content licensed internationally in the "PurePlay settlement of 2009." Because Pandora is currently limited to the US market, it faces the "Google Problem" where it is outside of their immediate control to where they can expand. Spotify, which is a Swedish company, only recently added the United States to its list of countries supported, including Austria, Belgium, Denmark, Faroe Islands, Finland, France, Germany, the Netherlands, Norway, Spain, Sweden, Switzerland, and the United Kingdom.

As mentioned above, the listening infrastructure for Pandora is also a misperception. Pandora's advertising of having "Pandora in your car" is simply an extension of an iPhone application connected by Bluetooth or the iPhone's 30-pin connector. This does not address the issue of data usage or the perfect competition model discussed earlier. See VAR point 1 for more information about the failure of P's auto program.

VAR

- **1:**
  While shopping for cars in August 2011, I visited Honda, Toyota, Volkswagen, Mercedes, Ford, and Chevrolet dealerships. While in their 2012 model cars and playing extensively with the dashboard console interfaces, I noticed that none of these cars had Pandora integration prominently featured. The salespeople made a point of showing me the Sirius XM satellite radio and iTunes/iPod integration that was a feature in every car, but not one salesperson mentioned a special feature regarding Pandora.
- **See exhibits 1-4 for more information about a sample of user's music service preferences**

How It Plays Out

Since Pandora must license all of it's media through SoundExchange, there is limited opportunity to increase operating leverage against competitors. Essentially the only differentiating factor between Pandora's service and other streaming services is the automatic playlist creation, which is already similar to iTunes' Genius. Since there is no fixed user-base (like Sirius XM), users are free to choose whichever streaming platform is offering the most "perks" at any given time. I predict that Pandora will never be able to break even, and will continue to lose investor support and funding as more formidable competitors enter the arena. Further, Pandora's current contracts with the major labels, which are set to expire in 2015, are likely to be renewed at a rate higher than their current costs. This, combined with an increased competition for radio advertisers, will drive Pandora's costs and revenues even further apart. Unless Pandora completely revamps their product and revenue model, P is destined for $0.00.

Risks / What Signs Would Indicate We Are Wrong?

- Profits sooner than Q4 2012
- Users do not become affected by increased advertising presence
- Pandora secures a new contract with ASCAP for rates lower than current rates (highly unlikely)

Signposts / Follow-Up

- Quarterly reports will praise the service's increased "listener hours". Since the company will eventually reach saturation in the US, the only way for them to improve revenues is to increase the amount of time each user uses their service. This means nothing unless actual revenues are increasing.
- Earnings above or below (.11) or (.16) will prove that the Pandora management does not have a firm grasp on their business

Company Description

Pandora is a free and paid internet streaming radio service that automatically selects music you would like to hear based on musical traits of a song or genre you first play. You can create up to 100 stations for free, or pay $36/year for Pandora One, their premium service to get high quality audio, unlimited stations, and no advertisements. 13% of revenues are generated by Pandora One subscription fees, and the rest from online advertising. The service is based out of Oakland, CA and limited to users in the United States. The CEO is Joe Kennedy.

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Exhibit 1: Surveyed over 70 users from Boston and UVA, with ages ranging from 17-65. When asked which service (out of 8tracks, Grooveshark, iHeartRadio, Last.fm, Pandora, iTunes/iPod, Spotify) used most frequently, users responded:

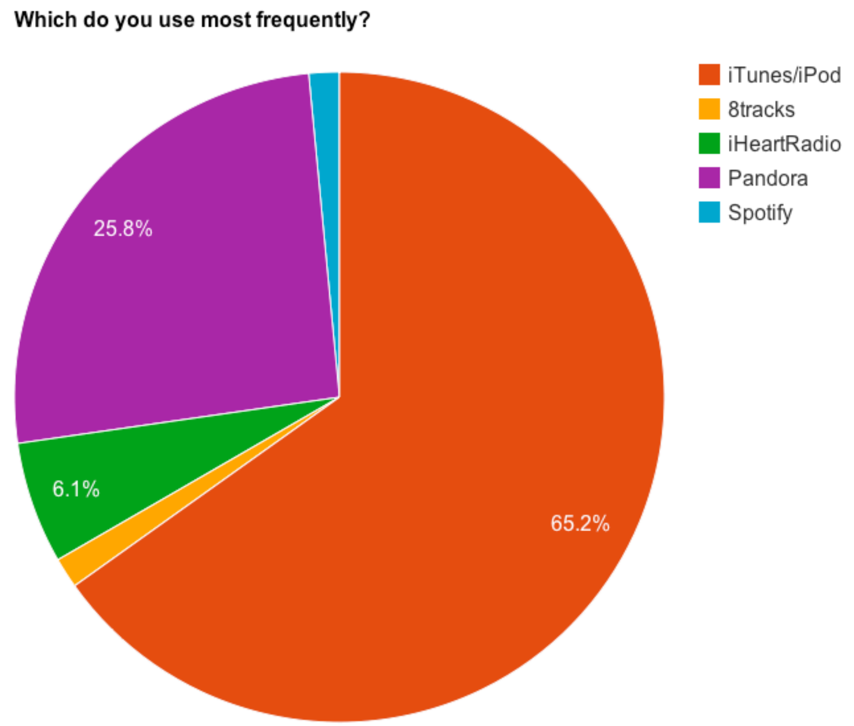

Exhibit 2: Surveyed over 70 users from Boston and UVA, with ages ranging from 17-65. When asked which service (out of 8tracks, Grooveshark, iHeartRadio, Last.fm, Pandora, iTunes/iPod, Spotify) used SECOND most frequently, users responded:

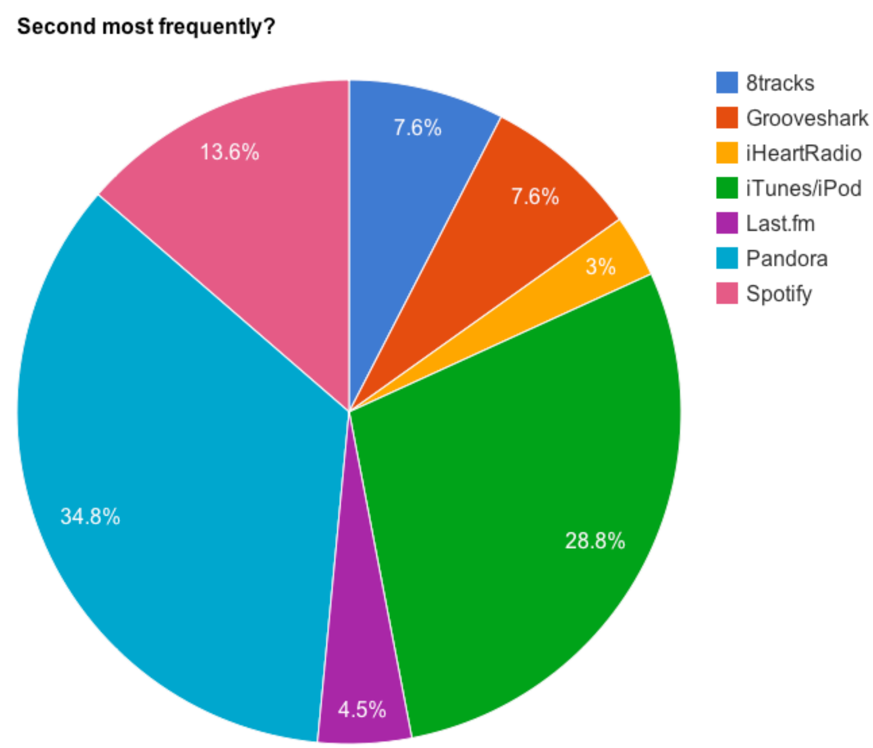

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Exhibit 3: Surveyed over 70 users from Boston and UVA, with ages ranging from 17-65. When whether users prefer streaming or owning their music, users responded:

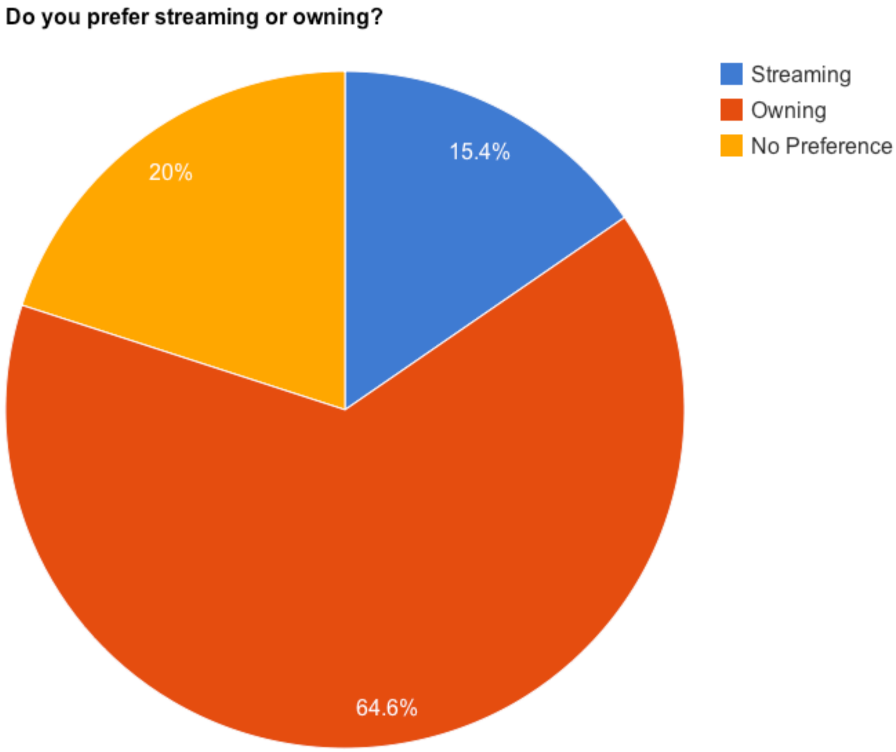
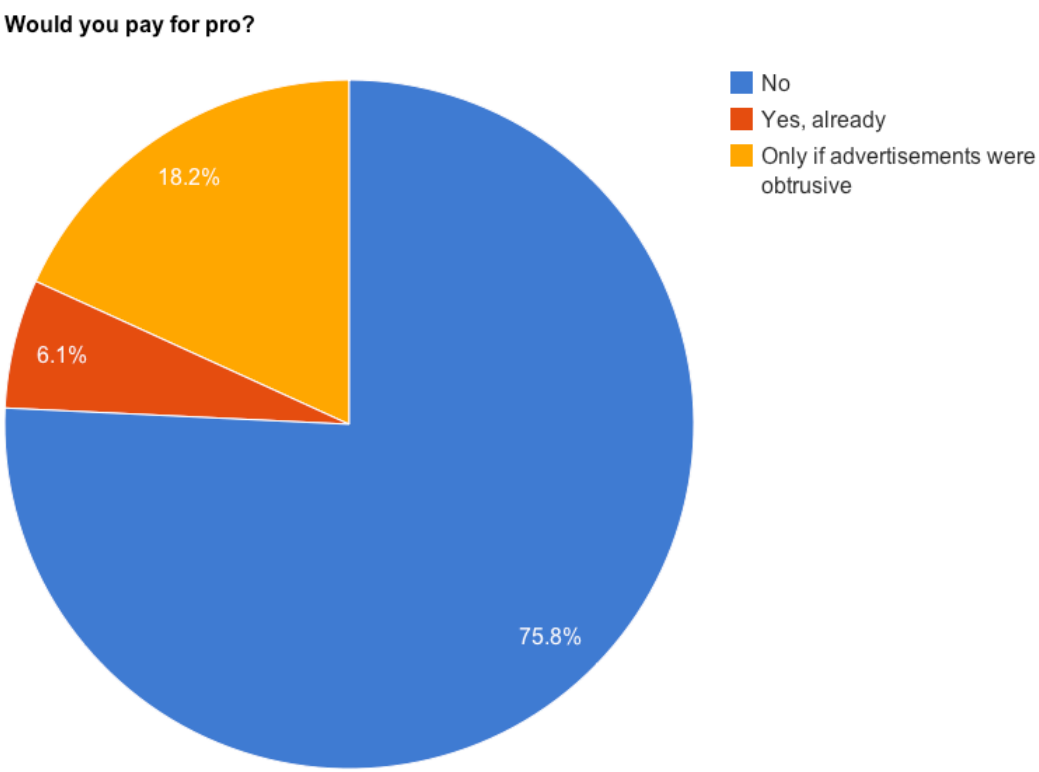


Exhibit 4: Surveyed over 70 users from Boston and UVA, with ages ranging from 17-65. When asked which service (out of 8tracks, Grooveshark, iHeartRadio, Last.fm, Pandora, iTunes/iPod, Spotify) used SECOND most frequently, users responded:



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Ideas for the Club

As a web developer for UVAMarket.com, I have experience with web design and usability, and I would like to see a more functional, dynamic website for MII. I would love to contribute to this project by designing a better system of organization for associates and managers to interact and record all correspondences on this site so that everything is in one place verses being scattered across multiple Google spreadsheets. I am thinking that the site could feature dynamic updating of the portfolios positions as well through use of the Google APIs. I would love to use these APIs to make advanced live-updating charts for each of the positions in the portfolio (each of which could be narrowed down on by one click). Within the page for that position, you would see all of the data in relation to that company and MII. An example of some of the data that could go here would be the initial pitch and associate updates (available for the public to see) and, available only to private members or associates/managers would be all of the internal communications archived in chronological order below the position. This way, when a position gets closed out of, we don't lose all of the research and work we have done for that position, it just goes into the archives, and if we ever decide to reinitiate the position, it will show all of the prior research.

From my experience as an associate, I am also convinced that we can do a better job of communicating digitally by having a tighter integration of calendar responsibilities with the web objects of the website. For example, when a pitch is going to happen, the website would automatically send out notifications to the regular members instead of a manager having to take time to write the email. Another example of a calendar event trigger could be the due date for associate research memos, which would gather the positions that should have update memos uploaded, and automatically assign late, past due, or on-time status to these memos, and file them accordingly.

If I were to be elected as manager, I would be sure we are doing the best we can to recruit from all aspects of the University, not just Comm. School or Econ Majors. As an engineer, I appreciate the value of scientific companies, and I think that there is a wealth of companies we may be ignoring that people in other departments might interact with every day. Of course these students would be free to submit an application for the club, but I am not sure that it is as well known outside of the Comm. School as might be expected.