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RUBI - Q2 2018 Rubicon Project Inc Earnings Call

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PRESENTATION

Operator

Good afternoon, and welcome to the Rubicon Project Second Quarter Earnings Conference Call. (Operator Instructions) Please note that this event is being recorded.

I would now like to turn the conference over to Nick of Investor Relations. Please go ahead, sir.

Nick Kormeluk

Thank you, operator, and good afternoon, everyone. Welcome to Rubicon Project's Second 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 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 and strategic objectives. These statements are not guarantees of future performance. They reflect our current views with respect to 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 risks and other 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 subsequent filings. We undertake no obligation to update forward-looking statements or relevant risks.

Our commentary today will include non-GAAP financial measures. Reconciliations between non -- between GAAP and non-GAAP measures 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 these -- on the future of these metrics.

I encourage you to visit our Investor Relations website to access our press release, financial highlights deck, periodic SEC reports and webcast replay of today's call to learn more about the 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. I'm very pleased to report that we've made continued progress in our recovery since our last call and have seen healthy acceleration in our ad spend growth. We've seen our year-over-year ad spend growth rate build from 10% in Q1 to 16% in Q2 to above 20% for the start of Q3. This growth, combined with our cost-reduction efforts implemented late in Q1, make us increasingly confident that we will deliver on our goal of being adjusted-EBITDA-positive in the fourth quarter this year.

I will now touch on some of the growth drivers in our business. Audio and video continue to drive meaningful growth for us, and we continue to outpace industry growth rates in gross share again this quarter. On a year-over-year basis, video ad spend grew well over 50%, and audio nearly tripled. We continue to invest and seek ways to support this growth and be a leading exchange for buying video and audio impressions. We also saw a sizable increase in our mobile growth this quarter, in which ad spend grew 40% year-over-year, driven largely by mobile app pushing our mobile mix to over 50% of ad spend.

In Q2 2018, our access to inventory doubled from what we saw in Q2 2017. We now have over 1,000 header bidding connections, generating more than 77% of our revenue. This compares to just over 780 connections and a little over 70% of revenue at the end of Q1. Our Prebid solution continues to gain traction in both client and server side, and we continue to grow our server-side footprint through our partnerships with Google and their exchange bidding technology, also known as eBay as well as with Amazon and their transparent advertising marketplace technology, also known as TAM.

We have built a very powerful model and efficient tools to rapidly add partners on both client side and server side. We have been talking for some time about consolidation in our space, and that a key priority for our client base has been to streamline their supply chain and buy impressions from fewer exchanges since the onset of header bidding. The first catalyst was duplicate impressions generated by client-side header bidding, and now server side is exacerbating this issue in driving consolidation. Some of our demand partners have told us they plan to cut the number of exchanges they work with by more than half in 2018. Through these early stages of consolidation, no major demand partner has stopped buying on our platform. In fact, many have reaffirmed their commitment to work with Rubicon Project over the other exchanges. Our focus on tech innovation, service, breadth of impressions, quality, transparency and efficiency, combined with the competitive total take rate, put us on the winning side of this exchange consolidation. We believe the biggest opportunities from this consolidation are still ahead of us.

Two of the most notable technical differentiators for our clients are our traffic-shaping technology for filtering and prioritizing impressions; and our estimated market rate, also known as EMR, a feature that enables buying platforms to achieve better performance by reducing overbidding without significantly undermining auction win rates. Buying platforms of all sizes continue to opt in to use EMR. On average, platforms using EMR this quarter saw their CPMs decrease by about 20% for header bidding inventory, with less than a 100 basis point trade-off to win rate. The tool plays a key part in achieving best-in-class buyer outcomes while providing consistent revenue streams for our publishers.

In regards to our traffic-shaping technology, we are developing our next-gen evolution, which optimizes ad and bid request to further improve efficiency across our and our clients' infrastructures in a header bidding world. Earlier this year, one midsize DSP client called our traffic-shaping capabilities a game changer, which enabled them to gain access to 10x more traffic without any additional infrastructure cost, generating a 94% lift in win rates and 138% lift in spend.

There was tremendous amount of attention and concern paid to GDPR this last quarter. We did experience some implementation friction after the effective date of GDPR, which did slightly lower ad spend. We will continue to monitor regulatory guidance and industry practice regarding GDPR and other global privacy regulations.

On the consolidation front, we were also very encouraged to see AppNexus agree to be acquired by AT&T and the implications the deal has for our space. This transaction demonstrates the valuable role that exchanges play in the digital advertising ecosystem, especially those with scale and capacity to process trillions of ad and bid request quarterly and monetize over $1 billion in gross ad spend on an annual basis for publishers. Most importantly, we have the opportunity to compete for market share with clients who prefer to work with truly independent technology partners.

Rubicon has never been more valuable to clients than it is today by continuing to grow publisher revenue while also delivering high-return campaigns for our buyers. In fact, we delivered the largest APS or amounts paid to sellers in the first half of 2018 than we did in any first half in the company's history. We are very well positioned in the attractive and fast-growing programmatic digital advertising market. A recent e-Market report showed that 82.5% of U.S. digital display ads will be bought programmatically in 2018 and will grow to 86% in 2020. Header bidding is a driving force of this growth, and our investments in header are paying off with attractive market segment growth across video, audio and mobile.

As I noted at the start of my remarks, we have clear evidence that the actions we have taken are working and that market opportunities have improved. We are pleased that this is reflected in key areas of Q2 results.

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

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

Thanks, Michael. 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. We made considerable progress toward our near-term goal of being adjusted-EBITDA-positive in Q4 and our bigger goal of being cash-flow-positive by the end of next year.

Turning to Q2 results. For the second quarter of 2018, we generated $28.6 million in revenue; $237.7 million in advertising spend, up 16% year-over-year; and adjusted EBITDA loss of $5.5 million, which included $500,000 of nonrecurring severance costs, resulting in a loss of $0.27 per share in non-GAAP EPS. The 16% total advertising spend increase in Q2 2018 versus prior year was stronger than the low double-digit start to the quarter we mentioned in our Q1 call. The year-over-year increase was driven by a 40% increase in mobile ad spend, with desktop being relatively flat versus prior year. Mobile represented 51% of ad spend mix in the second quarter versus 42% in Q2 of last year.

As Michael indicated, video and audio were the fastest-growing areas. When looking at amounts paid to sellers or APS, which we referenced last quarter, we had a year-over-year increase of 29% in Q2. This is slightly better than the 28% APS growth number we delivered in Q1 2018. This continues to drive great publisher engagement and shows that we are gaining share and delivering more revenue to them. 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 12.1% during the second quarter of 2018, an increase of 30 basis points, sequentially due to some improvement in take rates with publishers following the elimination of buyer fees in November. Take rate is defined as revenue divided by total ad spend.

Operating expenses, which in our case includes cost of revenue, for the second quarter of 2018 were $48 million, down from $54 million in the same period a year ago. On an adjusted EBITDA basis, operating expenses for the second quarter were $34.1 million, which includes $500,000 of nonrecurring severance costs. The declines involved reflect benefits from our recent cost-reduction actions. Net loss was $18 million in the second quarter of 2018 as compared to net loss of $11.6 million in the second 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 $5.5 million in the second quarter of 2018 as compared to positive adjusted EBITDA of $3 million reported for 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 cost as previously discussed.

GAAP loss per share was $0.36 for the second quarter of 2018 compared to GAAP loss per share of $0.24 in the same period in 2017. Non-GAAP loss per share in the second quarter of 2018 was $0.27 compared to non-GAAP loss per share of $0.10 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 second quarter of 2018, bringing the year-to-date 2018 total to $6 million.

We closed the second quarter of 2018 with $104.3 million in cash and marketable securities, a decrease of $15 million from Q1. This reduction resulted from the combined cash operating losses, capital expenditures and working capital needs in the quarter. Free cash flow for the second quarter of 2018 was negative $15 million for the reasons stated above as compared to a negative free cash flow of $6 million during the second 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. 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.

I will now shift to giving some indications for what we expect in the third quarter. We expect that ad spend will be relatively flat sequentially, which represents year-over-year percentage growth in the low 20s. Keep in mind that last year, we experienced a 4% sequential decline from Q2 to Q3. We expect take rate in Q3 to be at or slightly above the 12.1% take rate level from Q2, which continues to position us as a low-cost provider. We expect Q3 2018 revenue to be flat to slightly up sequentially. We expect that adjusted EBITDA operating expenses in Q3, including cost of revenue, will be approximately $33 million. We continue to expect that CapEx will come in below $20 million for the full year, representing a 50% decrease from 2017. A significant portion of this benefit results from utilizing our traffic-shaping technology to better manage our ad request prioritization and overall ad and bid request efficiency.

We are pleased to see accelerating positive momentum in ad spend and revenue from the investments made over the last year and the improved financial performance driven by the cost actions taken. These both support our near-term goal of being adjusted-EBITDA-positive in Q4 of this year and being cash-flow-positive by the end of next year. With the strengthened competitive position and positive market conditions, we are encouraged by the opportunity to gain share in a growing addressable market and drive leverage through our financial model.

With that, let's open the line for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from Jason Kreyer from Craig-Hallum.

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

Congratulations on the continued progress on the rebuild. So we've seen acceleration in ad spend as the year has progressed. Obviously, in Q2, that was driven more so by the progress you've seen in mobile. Just wondering if you can break that down any further into different pockets. And then what you're seeing right now that gives you confidence in the continued acceleration going in Q3.

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

Yes, I'll start, and then Michael, feel free to weigh in. Yes, as you mentioned, mobile -- not mutually exclusive, but video and audio just continue to be very strong players for us. And I think also the factor that's helped us this quarter is that the desktop is stabilized. In the past, it's been dropping in a greater measure. And so on balance, [if] you know we're not disclosing specific audio and video numbers at this point in time, but there's certainly significant drivers.

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

Jason, it's Michael. I think that the thing that gives us a continued confidence in the growth in ad spend really comes from feedback in the marketplace. We're looking at the number of new clients we're signing up, the number of clients that we had relationships with, that our relationships are only deepening. As you know, we -- there was a big industry event this past quarter in Kan, and we -- the team took close to 50 meetings, and all the feedback was 180 degrees different from this time last year. And so I think, other than the metrics that David shared with you on the specific media types, I think, just generally speaking, feedback from clients have been incredibly positive, and we feel really energized. And clients meaning both publishers and buyers.

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

One of the things you mentioned, the components of the growth. Is there any way to break down further the growth that you're seeing, taking on additional wallet share from your existing customers versus bringing in new publisher and assuming more wallet share there? Any breakdown you can provide?

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

I think that it's -- a lot of our clients are private. And so it's tough to really look at it from a pure share perspective, but here's how we think about it in -- if this doesn't satisfy you, you can ask the question in a different way, but we kind of look at macro reports that kind of say the industry programmatic is growing around 20%. So we don't even feel as though -- and obviously, a year ago, we were still playing major catch-up in this whole header game, right? And so we couldn't be more pleased with the traction that we've gained. But we really think that we really even haven't -- we haven't even started to eat into share that most of what you're seeing is catch-up to our rate flow position. And we haven't seen, I don't think, any benefit to the consolidation we've often talked about, that the tertiary players are the ones that are going to be affected first, but little by little, it's going to get to the core players, and they're simply not going to buy from all of us. And I think that, that will be the -- another wave of momentum that we'll see. So I think we're just heads down, blocking and tackling, regaining the trust of our existing clients and our new clients, getting our fair share. And then I think the next phase of our success would be getting our, say, unfair share and starting to steal share from competitors, if that makes sense.

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

No, it does. On EMR, so back in January, you moved to first-price auctions. We talked about EMR at that point in time, and I believe the thought process was they would probably be kind of a short-lived period where EMR would be a helpful tool to buyers. That hasn't really materialized. It seems to me that EMR has been a very helpful tool and a key differentiator in what you guys are doing. So can you help me bridge the gap between from January to today, how the positioning of EMR has changed?

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

Yes. Great question. And I think we're tickled with this success as well. Here's what I thought -- here's what we thought 6 months ago, that it might not be the tool for use by the top DSPs, but it would really benefit DSPs 10 through blank. And what we have seen is a wide adoption of EMR. So that was the first surprise. The second surprise was, sooner or later, every DSP is going to build their own bid-shaping technology. And it might even rival ours. And so, sooner or later, this will be this bridge. And to tell you the truth, we haven't seen that. I think that folks are very pleasantly surprised, our buyers, with our sophistication and with our algos. And I think that we kind of feel as though this is a big longer-term differentiator, and it's not just building the sort of bridge to help people get off the second price to the first price, that this could be kind of a permanent differentiator for the platform, which is really exciting because even if others come up with it, and I'm sure they will, we're on Diversion 2.0 already, which is tweaking win rates in high-value areas. So we're now fine-tuning after a big blunt launch. And so I think [the] -- there are plenty of bright days ahead for EMR.

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

Okay. Try to sneak in a couple of extras here. So following AT&T's acquisition of AppNexus, what I've been hearing is probably more of a move to independence across publishers. And so I'm just wondering if you can provide any thoughts on or any feedback on the conversations that you're having with publishers. Is -- Are you hearing these things? Or is it too early to speculate?

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

I think it's too early to speculate. I think that -- listen, we know that this positioning resonates, the independent positioning, and to be clear, what we mean by that is, we don't own inventory. So we'll never compete with our publishers in selling inventory. And we don't own a sales team that calls on agencies to run money through our DSP. And so we can look at our buyers and our sellers and say, "Hey, we're never going to be in competition with you. We're here to try to make you the most amount of money." AppNexus -- now being owned by a company that owns a lot of content. So they [all will know]. And they have a DSP -- the legacy AppNexus DSP, and they have a really tight marketing relationship with AT&T, which is one of the biggest spenders. There's definitely a concern in the marketplace. I don't -- I wouldn't even begin to say that we're picking up any momentum from it, but I do know that it's helpful that we're the only scaled global independent player out there, and I think it's going to benefit us long term.

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

Perfect. Last one for me. David, you just talked about exiting 2019 free-cash-flow-positive. I just want to make sure we break that down so we're on the same page. You're talking Q4 would be free-cash-flow-positive, Q4 '19? And then, are you talking about that on the basis of like EBITDA less CapEx? Or are you talking like operating cash flow?

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

Yes. Q4 of 2019, that's the target. And defining that as adjusted EBITDA less CapEx. That's correct. Yes, I mean, working capital is really hard to forecast. It adds inflows, and so for the things that we can more directly control for that time period, that's what we're targeting.

Operator

And our next question comes from Matthew Thornton from SunTrust.

Matthew Corey Thornton - *SunTrust Robinson Humphrey, Inc., Research Division - VP*

You guys talked a little bit about AppNexus. I'm also curious about -- audio is a hot area, you guys are one of the bigger players there. Obviously, there was an acquisition -- a vertical acquisition in that space. I'm wondering if you're seeing any ripple effects or benefits or thinking that you're going to get some benefits coming your way from that acquisition.

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

Yes, Matt, it's Michael Barrett. I think it will benefit as twofold: number one, there are definitely clients that were -- AdsWizz clients that will no longer be AdsWizz clients, given who owns the exchange now because of competitive reasons. So I think we stand to pick up share there. But also, I think, given our long-term relationship with Pandora, that there's also the possibility of us bringing demand to the AdsWizz platform so we could actually act as a buyer in that respect, and so I think it's doubly positive for us. And again, I think, as with the overall story, most of the success we've had in audio and overall for the business, I don't think it's come at share shift, it is come at playing catch-up, working hard, bringing the right markets to tool -- bringing right tools to market. And I think those days of being able to catch a break with share shift are still ahead of us. And we look forward to those days when they arrive.

Matthew Corey Thornton - *SunTrust Robinson Humphrey, Inc., Research Division - VP*

Got you. And then, obviously, there's definitely some headwinds out there, you alluded to GDPR. Definitely curious to hear, maybe, if you're able to kind of quantify a little bit, how you're thinking about the GDPR headwind to ad spend in 2Q? And then, how that kind of shapes? Does it get worse, better, the same in 3Q, 4Q? Love to hear your -- just kind of thoughts, if any incremental thoughts, just around how is ePrivacy shaping the recent California legislation? And obviously, some of the Safari updates that are coming here in September. I'd love to hear your thoughts around some of that stuff as well.

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

Yes. So I think some of those changes will impact certain players in the ecosystem more than they would us. So for instance, in the Safari world, I think that you saw certain buyers being impacted by us, but us as an exchange, given the breadth of our inventory, the breadth of our users, it didn't really have a material impact to us. GDPR definitely -- and obviously, we talked at length about it at our last call. GDPR was a big unknown. We thought we were prepared for it. We thought our -- the whole ecosystem was prepared. We learned at midnight the day it went live that there were glitches, and we've battled through them. But most of the resistance we saw was more in the form of technical than it was in terms of a wholesale change in terms of how we're doing business with the e-users. We know the situation is terribly fluid. We stay on top of it. We have outstanding folks in that area that have seemingly been one step ahead of it all. And they're working hard [at -- we] don't see another shoe to drop anytime soon. It's just an ongoing awareness of the fact that it's important to respect users rates. There's new rules as it relates to the certain users in certain countries. And we're always going to be at the vanguard of that. California, too early to call, but simply put, well-plugged in. We're obviously based in California so that gives us a little bit of advantage being wired into that scene. And ultimately, all this stuff is good for the end user. How we get there sometimes is a little friction-filled, but we are hugely supportive of it, and we'll always kind of play aboveboard on it.

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

Yes. On the ePrivacy front, that legislation is still evolving and developing and probably won't become effective until, perhaps, 2020, maybe at the earliest. And I think having gone through the GDPR processes that we've gone through, there's a template now for folks as they work through the ePrivacy that probably helps facilitate that move and probably lessens the bumps that you might have had otherwise.

Matthew Corey Thornton - *SunTrust Robinson Humphrey, Inc., Research Division - VP*

Got you. And then I guess maybe one more for me. On currency, how are you thinking about just kind of currency headwind? What was the impact in the second quarter? And how you're thinking about in the kind of third quarter, fourth quarter? Just so we can think about the right way to model kind of ad spend in growth.

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

Yes. Currency is really interesting for us because we have a different structure than some other companies. Our -- for revenue purposes, our global structure is on a U.S. functional currency basis. And more than 90% of our buy side demand dollars come in to us in USD. And so we don't have the same kind of exposure that perhaps other companies have. And the exposure we do have might come in, in the form of maybe slightly smaller budgets that are converting from foreign currency budgets to the USD budgets that eventually make their way to us. But they're not -- they're very challenging to quantify. And in this last quarter, we did not really experience any significant measurable impact. And so going forward -- so it's less of a -- currency is really less of an impact for us than for many other companies.

Operator

And this concludes our question-and-answer session. I would now like to turn the conference back over to Michael Barrett for any closing remarks.

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

Yes, thank you. So I'd just like to thank all of our employees for their efforts and hard work as well as our partners and shareholders for their support during our turnaround and the work that remains ahead. We look forward to seeing some of you at some of our investor marketing activities in September. Thank you for joining us for our Q2 results call, and have a good evening.

Operator

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