Rubicon Project

2016 Third Quarter Earnings Conference Call

November 2, 2016, at 4:30 PM Eastern

CORPORATE PARTICIPANTS

Frank Addante – *Chief Financial Officer and Founder*

Greg Raifman – *President*

David Day – *Interim Financial Officer*

Bonnie McBride – *Investor Relations*

PRESENTATION

Operator
Good afternoon and welcome to the Rubicon Project's Third Quarter Earnings Conference Call. All participants will be in listen-only mode. If at any time during the conference you should need assistance, please signal a conference specialist by pressing the star key, followed by zero. As a reminder, this conference call is being recorded and will be available for replay from the Investor Relations section of Rubicon Project's website following this call. After today's presentation we will conduct a question-and-answer session.

I would now like to turn the conference over to Bonnie McBride, Investor Relations. Please go ahead.

Bonnie McBride
Thank you and good afternoon everyone. Welcome to Rubicon Project's 2016 Third Quarter Earnings Conference Call. As a reminder, this conference call is being recorded. Joining me today are Frank Addante, CEO and Founder; Greg Raifman, President; and David Day, our Interim Chief Financial Officer.

Before we get started, I would like to remind our listeners that our prepared remarks and answers to questions will include expectations, predictions, estimates and other information that might be considered to be forward-looking statements, including but not limited to guidance we are providing and other non-historical statements related to our anticipated financial performance, operating and strategic plans, expectations regarding new initiatives, our relationships and business with buyers and sellers using our platform, competitive differentiation, fees and take rate, capital investment and organizational development, our competitive position and market conditions and trends and growth expectations, including growth in Orders, Mobile and Video.

Forward-looking statements involve risks, uncertainties and assumptions and actual results may differ significantly from the results suggested by forward-looking statements for various reasons, including without limitation, if such risks or uncertainties materialize or assumptions prove to be inaccurate. Further, we may adjust our plans and expectations in response to market conditions or other factors. Reported results should not be considered an indication of future performance.

A discussion of these and other risks, uncertainties and assumptions is set forth in the Company's Annual Report on Form 10-K for the year ended December 31, 2015, as well as our quarterly reports on Form 10-Q included under the headings Risk Factors and Management's Discussion and Analysis of Financial Condition and Results of Operations. We undertake no obligation to update forward-looking statements or relevant risks.

Our commentary 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 which we have posted to the Investor Relations website at investor.rubiconproject.com. 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 one-time in nature and we may or may not provide an update in the future on these metrics. I encourage you to visit our Investor Relations website to access our press release, periodic SEC reports, and webcast replay of today's call or learn more about Rubicon Project.

With that, I will turn the call over to Frank.

Frank Addante
Good afternoon everyone. Welcome to Rubicon Project's Q3 Earnings call. I'm going to take a different approach to today's earnings call. I'm not going to go off of a pre-written script. I feel like it's better to just have a direct conversation with our investors about some of the key questions that I think are facing Rubicon Project today. So I'm going to start off with an overview of our financial results and then I'm going to address four key questions.

So, on the financial results, on the top line we reported net revenue of $60.6 million which is at the lower end of our guidance range. On the bottom line, we reported $15.3 million of Adjusted EBITDA which is above our guidance range, and we also announced a cost reduction of $30 million of annualized expenses.

For full year 2016 guidance, we're guiding down on the top line by about $14.5 million. I'd like to note that our cost reductions do not decrease our investments for growth and I believe that this cost reduction puts Rubicon Project in a better position to compete and win, especially in a market where machines are making decisions, not people.

I'm going to address the following four questions. Number one is why did we decrease our guidance for Q4? Number two is whether or not Rubicon Project's strategic position within the market is being threatened. Number three, why we believe that header bidding is providing short-term headwinds, and how the short-term headwinds will turn into long-term tailwinds, and number four is why investors should be bullish on Rubicon Project and why I'm particularly excited about the future prospects of the business. So, let me take these questions one at a time.

Number one, why did we decrease guidance for Q4? As I mentioned in Q3, we saw some of these short-term headwinds from header bidding as well as some other macro level market issues that turned out to be true. I should note that while we did decrease on the top line, we only decreased bottom line by about $1 million. I think this speaks to the strength of the operating levers that we have in our business. We've generated profit while we've been growing top line. We've also been able to generate profit as we have seen some of that top line growth float.

Header bidding is certainly a short-term challenge. We've got some work to do on this. We're working through our plans. This is not an overnight shift. We'll talk about some of the progress that we've made there and while we do expect that this company will return to growth in the not-too-distant future, we also wanted to create some room for us to be able to work through the operations of that; make sure that we're fine-tuning our solution and taking it to the market in the most effective way.

Let's talk about whether or not Rubicon Project's strategic position in the market is being threatened. Let me remind you of the breadth of the Rubicon Project offering. We operate in all the key channels of advertising: desktop, mobile and video. We operate in both the high growth real-time bidding market as well as the high potential orders market. We operate our platform on a global scale and most of our customers are international customers where this is very important. Now, if you compare that to where we're being threatened, we're primarily being threatened in the short term through header bidding in the US and primarily in desktop display. Now, desktop display over time becomes a less and less important market for the advertising market as consumers are shifting their attention towards things like mobile and video and the spend is shifting towards mobile, video and orders, the high-growth markets that we're in. So why don't we talk about how we got here because I think this is really important?

We established a dominant position in desktop display that was largely unthreatened, and we've created a premium solution in this market, and like most companies that have a premium solution in the market that's largely unthreatened, it opens up the opportunity for you to go and raise pricing over time. We did that. The other thing that we did was we shifted our focus to these other high-growth areas. So I'm not saying that we didn't pay attention to the desktop display, we just didn't pay as much attention to it as we did to mobile and video and the other areas like orders that we've been investing very aggressively in. Like most companies that have a dominant position with a superior product in the market that raise pricing, it opens up the opportunity for lower cost providers to enter, even if those lower cost providers are providing a lower quality solution, and that's exactly what's happened to us.

Now, we've got a few things that we need to do. One is we need to get our feature set in place, which we are. We've got to go fine-tune that features set and then three we need to make sure that we've competitively priced it. By no means am I suggesting that we need to go compete on price alone. Again, we have a premium solution in the market, but we've got to make sure that it's competitively priced and pricing actually can become a great lever for us to even further accelerate market share capture in this market, so it does create some great opportunities for us, but let me sort of compare what these solutions look like.

So, you've got Rubicon Project that has desktop, mobile, video, auctions and orders in one place, is able to address our customer needs on a global scale including global demand. We've made great investments into security and brand protection, things that are really important to buyers and sellers. We've got a strong balance sheet; we generate profit which enables us to continue to invest in growth areas as well as innovate for our customers.

Now, you compare that to some of the competition, the smaller competition that we've seen cause some of these headwinds, again, in the desktop US market. They're primarily US-focused. They're primarily header bidding focused. They don't have the orders platform, the strength like we have. They don't have the global reach and scale like Rubicon Project has. They haven't made the same investments into security and brand protection that are important to our customers over the long term. They don't have the balance sheet or the profit to continue to invest in growth areas and to continue to innovate for customers.

So, if you compare those two things like in the mid-term and the long term, I think the winner in that is very clear.

Let's talk about why we believe we can turn these short-term headwinds into long-term tailwinds. First, let me bring you back to the original thesis of Rubicon Project and that was to automate the buying and selling of advertising and to reduce the (inaudible). The automation of advertising is happening. It's happening on a global basis. It's happening across all forms of advertising, and this is something that's become top of mind for the most important companies in the world, and we're not going to move backwards. This is not going to be a market that just goes back to the old manual way of advertising. These markets continue to grow. We've made great investments in all of the key areas. We're also even starting to see progress in adjacent areas that I would have never dreamed of that we'd be doing in just 10 years of operating the company. Things like automating digital billboards, television, radio.

We've talked a lot about header bidding, but again, header bidding opens up just a world of opportunity for us. For us to be able to finally get in front of the ad server, for us to gain access to all of the inventory that exists with a publisher or an application developer not only increases our total addressable market but makes the investments that we made in things like our orders platform so much more important today than ever before.

So while we've got some work to do, we've got a plan in place, we're executing against that plan. We're going to come through it. This is going to be a leaner and meaner and stronger Rubicon Project and I think where this market is moving, again where machines are making decisions versus people, this is a market that Rubicon Project is clearly positioned to win with all the investments that we've made.

So, I'm very excited about our future. We recognize we've got some short-term work to do but I think in a couple of quarters we're going to be having very different conversations.

With that, I'll turn it over to Greg.

Greg Raifman
Thanks Frank, and thanks to all of you for joining us. Today I would like to talk more about our operational and strategic progress in the quarter and then David will discuss our financial results.

To begin with, as Frank highlighted in his opening remarks, although we delivered solid progress in Q3 operationally, we have not yet seen those improvements translate into increased growth in revenues or market share, therefore requiring us to lower our Q4 guidance. In particular, our core business has been challenged by the following three factors. First, header bidding, which has impacted both our desktop and mobile web businesses; second, general softness in the advertising markets due to a number of macroeconomic trends including hesitation from advertisers to spend in advance of the general election; and three, our initiative to reduce overall costs in our business.

First let me address the progress we've made with respect to header bidding, our efforts to regain any lost market share and why we believe Rubicon Project is ultimately well positioned as the industry landscape evolves.

There can be no doubt that header bidding has changed the ad tech ecosystem by creating a level playing field in the real-time bidding marketplace. In this new world order, each supply side platform can compete for all available impressions rather than being predicated on hierarchal relationships. This gives us the opportunity to monetize literally trillions of premium impressions for which we previously were unable to compete.

Let me provide a few data points and some additional color on the market dynamics we are seeing unfold. First, from a pure scale perspective, we now have more than 200 premium publishers utilizing FastLane across more than 1,000 top websites globally. In less than six months we refocused our business from minimal integrations in header bidding to having more integrations with the most premium publishers in the world than any other company. The scale of our business and the depth of our pre-header bidding publisher relationships has allowed us to accelerate penetration into the header bidding market at a far faster rate than most any other smaller solutions are capable.

Second, we are not just onboarding publishers; we are also seeing header bidding grow into share of revenue. In fact, FastLane has increased in average 10% month-over-month for the past six months growing from less than 5% of total advertising spending six months ago to more than 16% of advertising spending through October and we expect it to grow to 20% by December.

Third, header bidding will benefit scale players such Rubicon Project that possess the infrastructure and reach necessary to leverage the much larger addressable market that header bidding has inadvertently created. Today through FastLane we now have the opportunity to compete for more of the available ad impressions previously unavailable to our exchange. This has enabled Rubicon Project to compete for and potentially monetize inventory that was reserved by Google's ad server DFP.

In Q3 we also accomplished our goal of achieving scale in terms of pure numbers of header bidding customers. Going forward, we are now turning our focus to optimizing FastLane's additional product performance. In September we began focusing on improving our win rate in each header bidding auction which we currently believe is still too low and is lower than what we typically see in the waterfall environment. The initial successes appear to be promising. In fact we have seen our win rate more than double in header bidding and we have begun to deliver CPM rate increases between 50% to 130% to our clients. In this regard, we believe it will take us an additional one to two quarters to reach the same kind of efficiency and optimization for our FastLane product in header bidding that we realized in the waterfall environment.

Thus, to summarize our header bidding progress to date, we are quickly gaining share and increasing our addressable market of winnable opportunities. We are seeing an acceleration in our win rate which has directly led to an increase in the share of our revenue coming from header bidding and has significantly increased CPMs for our customers. At the same time however, despite exceeding our deployment targets for FastLane integrations in Q3, we are not yet seeing growth in our overall revenue as quickly as we have expected which has contributed to our lower revenue guidance for Q4.

In Q4, we will continue to focus on improving our ability to win more of the auctions for which we are now able to compete, thus turning header bidding into a tailwind capable of propelling revenue growth in 2017.

Now I want to discuss our progress with Mobile, Video, Orders in the third quarter, areas where we are strategically shifting resources to accelerate longer term growth for our business and which now account for over 50% of our overall advertising spending.

Our growth in Mobile has continued to outperform industry rates based on IDC estimates for the first three quarters of 2016. Our mobile advertising spending increased 32% year-over-year in the third quarter and represented 34% of our total business in Q3, up from 33% in Q2. Furthermore, our mobile exchange is now connected to more than 1 billion unique devices globally and 87% of our top customers now use Rubicon Project for both their mobile and desktop advertising business.

As I mentioned in my opening remarks, one area of Mobile that is experiencing some headwinds however is our traditional mobile web business. Unlike our mobile in-app business which is not being impacted by header bidding, and in fact grew 69% year-over-year in Q3, mobile web is impacted by the same dynamics of desktop header bidding. Although we are very pleased with the overall strength of our mobile exchange and our strong growth potential in-app, we expect that mobile web, just as with our traditional desktop business, will continue to be impacted by header bidding through the end of the year. As a result, it was not at all surprising that our total Mobile business was down quarter-over-quarter while still growing 32% year-over-year, as our mobile web business still comprises the majority of our Mobile business overall.

In our Video business, we continue to see strong returns from both buyers and sellers. More than half of our top 100 customers have chosen Rubicon Project to execute their video advertising business, driving this business up by 25% sequentially in Q3. On the sell side, on Video customer more than doubled its video business, growing advertising spending from $2 million to more than $4 million, and on the buyer side our top two video buyers were each up 40% in advertising spending. We also increased the number of video accounts from 187 to 279, a 50% lift overall.

In our Orders business, which incorporates our private marketplace technology, we have seen solid acceleration as well. As of the end of Q3, more than 550 premium publishers have chosen Rubicon Project industry-leading orders technology to power their private marketplace advertising business, growing our Orders business by 43% year-over-year. Helping to fuel this growth in particular are video orders, which are up approximately 900% year-over-year. We expect this growth trend to continue into 2017.

The success of these three initiatives is why we were able to accomplish our goal of having our mobile, video and orders businesses comprise more than 50% of our total advertising spending a full quarter ahead of schedule.

With respect to general market softness, we are also seeing the same market uncertainty that many other companies have communicated during this earnings period, and this has complicated our ability to forecast with the high level of certainty that all of you have come to expect from us. In fact, advertising spending in the second half of this year is not behaving as it has in prior years, likely caused by a number of macroeconomic factors which could include impacts from political season and faster movements to video and mobile.

Last quarter, we spoke with you about a comprehensive realignment of our business that we had undertaken to focus resources and our team on key growth areas. This reorganization was intended to both optimize our investments towards faster growth areas as well as better match our cost structure with our growth rate and instill greater discipline around cost efficiency. By the end of Q3, we had integrated our global revenue teams through the combination of our buyer and seller sales organizations, now managed by our Chief Revenue Officer, as well as the integration of our product and engineering teams into one organization led by the recently named Chief Product and Engineering Officer. We also initiated a global workforce reduction and realignment effort to best support our revised corporate structure which has resulted in the elimination of 19% of our workforce.

Overall, the synergies we realized from this reduction have resulted in $30 million of annualized savings, which will help bring greater focus to our core growth opportunities of Mobile, Video, Orders and header bidding. While we believe these alignment and workforce reductions will have a positive impact on our business overall, our guidance does reflect some short-term impacts from these changes and there will likely be some disruption as we fine-tune our business to take advantage of our future growth drivers.

In closing, we made solid progress both operationally and strategically in the third quarter to establish the strong foundation for growth we set out to build, and we believe that we are setting the stage for the right initiatives to kick in in 2017. The positional strength of our exchange and the leading independent sell side platform it powers will uniquely set our business up to benefit from the growing addressable market header bidding, Mobile, Video, and Orders have generated. Although we still have much work to do, we believe we are very well positioned to win in the long term and we look forward to talking more about our execution and progress again on our Q4 call.

With that, I will turn the call over to David for more detail. Here's David.

David Day
Thank you, Greg. Now to recap our financial results starting with revenue. Before I begin, note that we've adapted our terminology and going forward instead of managed revenue we will now refer to advertising spend which is more descriptive. There is no change to the underlying meaning or calculation which remains advertising spend on our platform.

GAAP revenue for the third quarter of 2016 was $65.8 million representing a year-over-year increase of 2%. Advertising spend for the third quarter of 2016 was $242.8 million representing a year-over-year decrease of 1%. Non-GAAP net revenue for the third quarter of 2016 was $60.6 million representing a year-over-year increase of 5%.

As Greg mentioned, the decrease in advertising spend in the third quarter was primarily due to continued headwinds in US desktop spending which declined 12% year-over-year, more than offsetting the 31% year-over-year growth in mobile advertising spend. Advertising spend was composed of 34% mobile and 66% desktop for the third quarter of 2016 compared to 26% mobile and 74% desktop a year ago.

In addition, advertising spend by inventory type was composed of 75% real-time bidding, or RTB, 23% orders and 2% static during the third quarter of 2016 compared to 77% RTB, 16% orders and 7% static in the third quarter of 2015. As mentioned last quarter, static bidding was sunset during the third quarter.

Take rate, which is non-GAAP net revenue divided by total advertising spend, decreased on a sequential quarter basis to 24.9% in the third quarter of 2016 from 25.3% in the second quarter of 2016, a decrease of 40 basis points. In the third quarter of 2015, take rate was 23.7%. The higher take rate in the third quarter of 2016 on a year-over-year basis largely explains why year-over-year GAAP revenue and non-GAAP net revenue increased slightly despite the year-over-year decrease in advertising spend.

Operating expenses for the third quarter of 2016 were $68.2 million, representing a year-over-year decrease of 2%. Operating expenses were lower than we had implied in our outlook due primarily to cost control measures we implemented during the quarter.

Today, we announced a workforce reduction of 125 employees or approximately 19% of our work force. We expect to complete this action and incur pre-tax charges of approximately $4 million in cash expenditures for one-time employee termination benefits during the quarter. The reduction in force is expected to reduce future employee-related costs on an annual basis by approximately $18 million. In addition, we implemented non-head count related operating expense control initiatives that we anticipate will provide additional savings of approximately $12 million annually. We have undertaken these cost control measures to better align our resources with the evolving needs of the business.

Net income was $3.5 million in the third quarter of 2016 compared to a net loss of $3 million in the third quarter of 2015. Note that net income in the third quarter of 2016 included a tax benefit of $5.6 million and the net loss in the third quarter of 2015 included a tax benefit of $2.1 million. Our guidance did not include an estimate for a tax provision or benefit because inclusion of estimated tax impacts at this stage in the Company's development would not be meaningful for investors. Excluding the tax impacts, our pre-tax loss improved by $3.1 million year-over-year.

Adjusted EBITDA was $15.3 million in the third quarter of 2016, representing a year-over-year increase of 21.7%. The outperformance in Adjusted EBITDA relative to our guidance reflects the lower operating expenses I referenced earlier.

GAAP income per share was $0.07 for the third quarter of 2016 compared to GAAP loss per share of $0.07 in the same period in 2015. Non-GAAP earnings per share in the third quarter of 2016 was $0.32 compared to $0.23 reported in the same period in 2015. These amounts included the tax benefits previously referenced.

Capital expenditures were $10 million for the third quarter of 2016. We closed the period with $193.2 million in cash and marketable securities, up $6.3 million from June 30, 2016, and we generated free cash flow of $5.6 million during the third quarter of 2016. We calculate free cash flow as net cash provided by operating activities less capital expenditures, including capitalized software development costs.

Looking ahead, we expect the following for the fourth quarter 2016: GAAP revenue to be between $65 million and $75 million; non-GAAP net revenue to be between $60 million and $68 million; Adjusted EBITDA to be between $10 million and $18 million, and non-GAAP earnings per share to be between $0.08 and $0.16 per share based on approximately 49 million forecasted weighted average shares.

For the full year, we expect the following: GAAP revenue to be between $271 million and $281 million; non-GAAP net revenue to be between $249 million and $257 million; Adjusted EBITDA to be between $59 million and $67 million, and non-GAAP EPS to be between $0.86 and $0.94 per share based on approximately 49 million forecasted weighted average shares. Note that our guidance includes the expected impact of the cost reductions previously mentioned.

We'd like to provide a few comments regarding the guidance. The lower GAAP and non-GAAP net revenue outlook for the full year compared to our prior guidance ranges reflects continued challenging visibility related to the advertising headwinds that Greg outlined previously. Although we don't provide explicit guidance on advertising spend, directionally speaking we expect Q4 2016, advertising spend to decrease compared to Q4 2015, which, as you may recall, was unusually strong and for the same reasons as described earlier.

We expect our take rate in the fourth quarter to continue to decline sequentially as we have seen in the last two quarters; several factors are driving this. One, in certain instances, we are already providing pricing strategies that involve lower fees either on a trial basis or permanently. Another is product mix. For example, an increase in orders as a percentage of our advertising spend will drive a lower take rate since orders carries a lower take rate.

We've decreased our Adjusted EBITDA guidance for the full year by $1 million versus our prior guidance range. This decrease in Adjusted EBITDA guidance reflects the impact of the Adjusted EBITDA beat in Q3 and anticipated spending reductions in Q4 offset by the reduction in expected non-GAAP net revenue.

Lastly, as previously discussed, please note that our non-GAAP EPS guidance for Q4 does not include an estimate for any tax expense or benefit.

In summary, while we have continued near term challenges, I am confident we are prudently managing our financial resources and that this positions us well for longer term success.

QUESTIONS AND ANSWERS

Operator
Ladies and gentlemen, we will now begin the question-and-answer session. Please limit your question to one question and a follow-up. To ask a question, you may press star, then one on your touch-tone phone. If you are using a speaker phone, please pick up your handset before the keys. To withdraw your question, please press star, then two. At this time we will pause for a moment to assemble our roster.

Our first question will come from Brian Fitzgerald from Jefferies. Please go ahead with your question.

Brian Fitzgerald
Thanks. Looking at header bidding in video and mobile and in-apps, how far along is that business in development, and I guess what has been the response from clients thus far? Then will the workforce rationalization impact the timeline in terms of rolling out header bidding solutions to video? Thanks.

Greg Raifman
Sure. Brian, this is Greg Raifman. Good question on header bidding. To start with we don't see—let me start with your second question first. We're not seeing or we don't expect to see any slowdown in our development of header bidding because of the cost reduction actions we took today. They were more targeted or I should say focused on G&A generally and sales and marketing and not as focused on product and engineering.

Getting back to it, as we talked about in our scripts at length, I just want to highlight again that our process moving forward in header bidding development has taken a little bit of time. We've seen a lot of really good improvements over the last quarter or two, especially in the desktop arena where it's been most acute, but also in the mobile web area to begin with. Where we've seen improvement is higher CPMs for our customers, which is a win for them. We've also seen higher win rates in the auctions that we participate, which is great. But we realize that we have more work to do because as you all know, we came out of a very dominant position in the waterfall environment pre-header bidding, and a lot of our systems were optimized for that environment. So what we've done over the last couple of quarters and we intend to do for the rest of this year is to really take the opportunity to put our header bidding product, FastLane, into market with a better and more optimized system and solutions for the header bidding environment, not only desktop but also in mobile web, mobile apps. That’s really been our focus for the last couple of quarters and we don't see it impacting the video environment at this point in time.

Brian Fitzgerald
Great. Thanks, Greg.

Operator
Our next question will come from Jason Helfstein of Oppenheimer. Please go ahead.

Male Speaker
This is Alec filling in for Jason. Thanks for taking the question. What is the difference in net revenue for $1 spent in FastLane versus the legacy sell side platform? Then I have a follow-up. Thanks.

David Day
Sure. This is David. There's not a significant difference in the activity that runs through FastLane versus our other RTB activity.

Male Speaker
Okay, thanks. Then one follow-up, if I could. Do we need to wait until FastLane is over 50% of spend to see an inflection of revenue growth for desktop?

Greg Raifman
This is Greg again. Good question. As we pointed out, FastLane is our header bidder product that is gaining share month-over-month-over-month, and we have said that as of the end of October it was in the vicinity of 15% to 16%. So, we're not anticipating it'd be over 50% anytime soon or in the next couple of quarters. We actually see it growing towards about 20% through the end of this year and then beyond it. One thing I think it's important to note is that notwithstanding all the attention we've seen in header bidding over the last year that in fact still the majority of all impressions delivered in programmatic environment are still done in the waterfall; in fact, probably 80% compared to 20% overall, so we don't see us being at 50-plus percent in the next couple quarters.

Male Speaker
Okay. That's very helpful. Thank you.

Operator
Our next question …

Greg Raifman
One last thing to point out, just to make sure we understand. I didn't mention but our FastLane product is in mobile, in-apps, so not only mobile web but mobile in-apps, and our video header bidding product went live in Q4 or this quarter.

Operator
Our next question will come from Andrew Bruckner of RBC. Please go ahead.

Andrew Bruckner
Thank you. I'm wondering if you can just elaborate a little bit on the softness you're seeing on the advertising side? Is it all specific to programmatic? Are there specific verticals that are pulling back? Any reasons that you think might be there? Thank you.

Frank Addante
Sure. So there's a number of factors here, header bidding being one of them. We've talked about just a general slowdown in the desktop display market. It's a particularly interesting year given the election. I think there's a lot of speculation as to what kind of impact that has. We're also looking at Brexit. So there's a combination of things that just really create a lot of noise in the forecasting that make it really sort of difficult to figure out what the impacts are and what those trends will look like in the short term.

Operator
We'll move on to our next question. Our next question will come from Kerry Rice of Needham. Please go ahead.

Kerry Rice
Thank you. Just a few more questions on the header bidding. I think last quarter you had indicated that you thought it would kind of take through the back half of 2016 before you'd start to see maybe the inflection point in header bidding on the desktop for Rubicon. Do you still feel that way? It sounded a little bit like maybe that had been pushed out somewhat into another quarter.

Then when you talk about win rates, can you shed a little bit more light on what you do to have those wins in header bidding so that you can gain more market share versus the solutions out there? Then one additional question on Chango. I think last quarter you had also talked about some challenges or some headwinds there due to a focus on self-service platforms within the industry. Maybe you can give us an update on your work on Chango towards self-service. Thank you.

Frank Addante
Sure, Kerry. Our timeline for header bidding is still very much intact. We've made incredible progress there, as Greg talked about in his part of the script. We've built a product—I should say a feature set. Just to be clear this is a feature set. This is not an entirely new platform or a new product; it's an extension of our existing feature sets just like mobile, video, and orders are. So we built this, took it to market. We brought it to market, got over 200 implementations and we did that very, very quickly and I think that speaks to the strength of our customer base and the position that we have in the market.

Now what we're talking about is tuning. We're very much focused right now on tuning that implementation, making sure that it runs fast, making sure that the algorithms are tuned, making sure that the pricing for that product is correct in all the markets that we serve. That tuning cycle takes a little bit of time, but I'd say the heavy lifting of getting the feature set built and taking it to market has been done. Now we've got to go to optimize the revenue.

With that said, what's more important to us at this point in time is that we want to get the implementations. Given that we are a marketplace business, we want to go build up scale on one side of the marketplace or the other, because typically when we do that the revenue follows, just like other marketplace businesses. It's a same strategy that we take with real-time bidding when we rolled it out, same strategy that we rolled out with mobile that's now turning into us being a top three exchange in just a couple of years; same strategy with video, same strategy with orders. Anytime we launch a new product in the market, that's the approach that we take, and we're taking that same approach here with header bidding and we're very confident about our ability to see great success with that, with the progress that we've already made.

On the Chango question, a couple of things I want to note here, and I'm glad you brought this up. One is, at the time that we decided to do the Chango acquisition, if you rewind where Rubicon Project was at the time, we were primarily a desktop company. We'd made investments in mobile and video and orders that hadn't achieved scale yet. Of course, we felt very good about the prospects of those markets but when we were looking at just the desktop market, what we were trying to do was to try to find where we were going to see growth at the kind of growth rates that we saw in the past, so greater than 50% growth in the desktop market and relying on just the DSPs that were integrated in our platform to get there. Looking at that over a couple of years out, it was challenging to see how we were going to get $0.5 billion of new spend coming from the DSPs in 2016, and then another $1 billion of new spend over the next couple of years.

If you look at what's happened since then, a couple of things have happened. One is our mobile, video and orders (inaudible) have really taken off. some are at scale, some are achieving scale, so that really accelerates and expands our addressable market, faster than we could have predicted at least at the time. Then if you look header bidding now, header bidding opens up a whole new world of opportunities that didn't exist a couple of years ago.

Hindsight is always 20/20. We invested in Chango to go see growth in the desktop market. Now we're seeing growth in all these other markets. The good news I guess there is that we're able to achieve growth beyond Chango. Like we said last quarter, Chango didn't work out exactly how we expected it. Net net, I think we're better for doing it than for not given that our Orders business has really benefited a lot from that. We probably wouldn't have invested in that asset to the level that we did.

Kerry Rice
Is there some sense or thought maybe then you're going to focus less on that business and more just on your core business? Obviously, it's mobile and header bidding then, it sounds like.

Frank Addante
Yes, that is a fair statement for sure. I think our sell side position is the strongest position. It's something that we've been able to continue to build on. If you look again, we launched a mobile business, a mobile feature set into the market in just a couple of years. That's a $300 million advertising spend business. We launched videos in the market. As we said last quarter, we're expecting that to be a $100 million advertising spend business in 2017. We launched orders in the market in just a couple of years. That's a $225 million, approximately in 2016, business, and now we're looking at header bidding as another growth driver for us. Us being able to leverage that sell side position and grow is our strongest asset right now, and I think new opportunities have emerged that enable us to leverage that.

Kerry Rice
Okay. Thank you very much.

Operator
Our next question will come from Brent Huff of Stephens. Please go ahead.

Brent Huff
Good afternoon. Thanks for taking my questions. One is just to follow up on the question that I think was asked before, but not sure if you guys got to it. Can you talk a little bit more about how the conversations go that you're having with your clients; you're trying to win back some of the market share. As you install and trying to sell your header bidding solution, what is the driver of that? Is it pricing? Is it functionality? Is it speed in the browser? That's one question.

Then the second, can you talk a little bit more about muscle versus fat and the $30 million that you're cutting and what you were worried about maybe cutting too much, or kind of where those priorities were? Thank you.

Greg Raifman
Of course. Greg here. So let's start by saying, to begin with we haven't lost any clients to date, and I think that's important to recognize. Where we saw some impression leakage earlier this year, we are now working pretty actively to regain it. As a consequence, what we have been doing is trying to redo our header bidding product, to be more elegant, to be faster, to be simpler, to be more effective in the header bidding environment as compared to the waterfall environment. So a lot of conversations with clients have to do with a combination of things—of course, what is our pricing with respect to it, and we analyze our pricing all the time. We want to maximize the return that we have for our customers, at the same time maximizing the opportunity for Rubicon Project. So, from one perspective, we've been focused on spending the last couple of quarters to really re-tool our products to be the most effective possible, and the preliminary results are very promising. As I mentioned, we're seeing higher CPMs because of the results of our efforts. Number two is we're seeing greater win rates and that's because we're now starting to, as Frank talked about, tune it better. We have a lot of plans for that through the rest of this year, so we really do think that we will see better results from our header bidding product starting in Q1 and Q2 of next year, and we remain very optimistic there.

Our clients are very pleased. As Frank mentioned, our business in header bidding has grown very rapidly over the last couple of quarters, to the point that it's a business unto itself. We can get the actual numbers for you, but I think we generated over $80 million in advertising spend already this year in just header bidding as compared to the waterfall, which is done in basically two quarters and catching up with a lot of companies that have been working on it for several years.

So with that, let me turn it over to Frank who will give you more details on the restructuring and cost-reduction efforts that we did today.

Frank Addante
Yes. Hi Brett. So, muscle versus fat is a good question. I just want to make it clear, we are not cutting anything that would prohibit us from growing. We do see a lot of growth opportunity in the business, as I just described. I also want to be clear that our cost-cutting measures here are offensive, not defensive. A number of things have evolved in the market, some which have created some headwinds that we've talked about, and some that create new opportunities for us.

Let me kind of break down the fat versus muscle, meaning where do we see some of these cuts. One is what I would consider to be education. For 10 years now, we've been trying to educate the market on the benefits of automation and programmatic and mobile advertising and orders, and things like Native, so there's been a lot of upside educational efforts, and when a company is in growth mode you typically want to do that to get as many people on your platform as fast as you can. The story that I've told our team here is it's kind of like the Facebook commercial, where they're talking about launching solar planes because they're trying to get more people online. We've invested a lot in education trying to get people really to embrace programmatic and automation.

The second is startup costs for Mobile, Video and Orders. Again, we made a lot of these investments, we did them concurrently. There's more startup costs, say, upfront, in advance of revenue, like we've talked about, but we don't have to continue to invest at the same levels once we see scale in those markets, and we feel like in some of those markets we're at scale and some we're very, very close. So, that leverages our network effects, that leverages our existing channel to customers.

The third is internal automation. These are things that we don't get paid for from our customers, but they're things that you're going to see benefit from, as you're seeing now with the leverage in our model, you know, automating customers support, automating business operations, automating the way that we process cash in the business.

The fourth area here is investments in our cloud. We talked a lot about this. Again, we don't get paid for this from the customer; however, our cloud benefits us in our ability to process market share and do so incredibly efficiently, run our business efficiently. So, things like custom engineering hardware is specifically focused for low-cost, high-speed, low-latency operations, and programming silicon, and the way that we design our networks and connect to our customers. Particularly, I should note, in a header bidding world, it puts us in a tremendous position, because if you look at Moore's Law, machines get faster and cheaper every year, and in this world we are prime positioned to really see the benefits of our cloud to process that at scale and to do so more efficiently than anyone else.

The last couple of points on the muscle versus fat. Look, when you're growth mode, there's an acceptable level of bloating or underperformance. Let's say you can have an initiative that's performing at 50%. You'll take that because 50% growth is better than zero percent growth. When you're optimizing the business for profitability of your bottom line, you want to see those initiatives at 80% or 100% plus. The buy side investments that we've talked about already, some of those haven't worked out as we expected. Then lastly, it's a smaller point, but I think an important one—we have some public company costs, things like Sarbanes-Oxley compliance. We made the choice to invest in those concurrently with all those other growth areas that we were talking about because we saw those growth opportunities. So, a lot of those things are behind us, so we don't need to continue to invest in them in the future.

Brett Huff
Great. Thank you.

Operator
Our next question will come from Matthew Thornton of SunTrust. Please go ahead.

Matthew Thornton
Yes. Hey guys, thanks for taking the question; a couple, if I could. I guess the first one, just a modelling question. If I look at the guidance, it seems to imply that your expense base will be up fairly significantly sequentially, yet obviously you're executing kind of cost reductions gradually, so I'm trying to see if there's anything that I'm missing there. Then secondly, I guess, just in terms of what inning we're in in terms of—it may be a bigger picture and it's probably for Frank or Greg—when we think about header bidding, what inning are we in as it relates as US desktop, mobile, including in-app, as well as international, which is probably in an earlier inning, maybe any sense as to where we are. Then, I guess the combat to header bidding—I know you guys were involved in the Google kind of First Look program. I'd love to get your thoughts on just how that's progressing and how you see that as compared to header bidding as a solution, in general. Thanks, guys.

David Day
Great, thanks. So, on the first question about costs, we have put in some significant cost-saving measures. There are a few costs related to some of our—opex-related costs related to our data

center buildout that are shifting a bit from Q3 to Q4, so there's a little bit of noise from that perspective, and then there are a few costs related to some of the normal year-end types of activities, audit and other types of things, but there's no significant foundational shift.

Greg Raifman
Matthew, Greg here. Let me answer your last two questions. First of all, Google First Look program is progressing. It's very early days for that. We're willing participants. Google has been quite a good partner of ours and we're happy to accommodate them. Anything that will enhance the user's experience or the consumer's experience, we're obviously onboard for that, so we're working with them to integrate effectively, but there's a lot more to come on that later.

With respect to header bidding and what inning we're in, I'd have to say we're still in the early innings. There's so much more work to be done as an industry here. There's a lot of cost that has been generated as a result of header bidding. There's been waste. There's a lot of inefficiency. There's a lot of good that's come out of it, but there's also a lot of waste which is why we initially had trepidations about the industry moving so quickly in this, because it's not quite as efficient and elegant as the server side solutions that we have been proposing to date. There's more to come in the mobile arena that we haven't really seen to date that we're working on. Keep in mind it's still a North America phenomenon and 80% of the revenues are still outside of header bidding. So, it's really unclear as to the direction this will go long term, but we of course will be eager to participate in it because if our customers are seeking this kind of capability, we're going to provide it for them.

Let me turn it back over to you guys because we're kind of running out of time. We want to make sure we get to all the questions.

Operator
Our next question will come from Jason Kreyer of Craig-Hallum. Please go ahead.

Jason Kreyer
Hey, guys. Thanks a lot for taking my questions. I'm just wondering if you can talk a little bit about the utilization of FastLane in Q3? You talked about 200 new implementations in the quarter. I think that will continue to scale as you move forward, but as you're making tweaks to that platform, I'm just trying to understand if we saw the full benefit from those 200 implementations in Q3 or if we'll continue to see incremental benefits as we move into Q4 and 2017.

Greg Raifman
We absolutely have not seen the full benefit of it. In fact, we're not close to seeing the full benefit of FastLane to date, and you'll be hearing more about that over the course of the next couple of quarters.

Jason Kreyer
Okay. Then on take rates, if you can give any qualitative thoughts on take rates. I was a little surprised to see the increase in orders in the quarter, which would typically drive a lower take rate, but we saw take rates higher than I was expecting, a little bit higher year-over-year, and so maybe you can run through by segment what take rates look like.

Frank Addante
Yes, sure, Jason. So, look, we've guided that take rates will come down over time. I think we're starting to see some of that in our reported financials; we think that will continue to be the case

going forward. Look, we operate a lot more of a complex business than we did a couple of years ago, many products and many different markets, and they all have varying take rates. We don't break out our take rates by individual products, but I think, overall, you can expect that take rates will continue to come down over time. I think we're efficiently positioned to do that.

David Day
Hi, it's David. I'll just add one comment. The other dynamic that's going on is our static bidding business has been decreasing and we terminated that business in the third quarter, and that does have similar take rates to our Orders business, so part of the increase that you see in the Orders business is offset by the lower static bidding portion.

Jason Kreyer
Thanks, David.

Operator
Our next question will come from Mark Kelley of Citigroup. Please go ahead.

Mark Kelley
Hi, guys. Thanks for taking my question, just a quick one. You've got a lot of smaller competitors that are maybe solely focused on header bidding. Are you seeing more competitors enter the market or has that been pretty stable? At what point do you think scale really matters, and of course to hinder some of these smaller players where maybe the barriers of entry get a little bit higher, your know, for just header bidding focused guys. Thanks.

Frank Addante
Mark, I think it's been pretty stable. Again, while there are hundreds of ad tech companies out there, there's really just a handful of exchanges or SSQs or header bidders, whatever you want to call them. Scale does matter, and I think you're starting to see that scale matter with us right now. I mean for us to go and build this feature set, take it to market, get 200 plus integrations so quickly, I think that scale really does matter, and that's on the sell side, by the way. On the buy side, there's global demand, all the DSPs that you want to be able to connect to. The inventory quality, the safety of the marketplace, all those things are real major factors. Just like we've seen in these other markets that we've entered, mobile, international markets, orders, the scale helps us to take those things to market and do so very competitively, and then start to build moats around what we do.

Operator
Our next question will come from Lee Krowl of B. Riley. Please go ahead.

Lee Krowl
Thanks guys, for taking my questions, two really quick. I'm just curious if you guys saw any impact in the quarter from ad-blocking software. Then, also, just looking at the stock price and a very cash-rich balance sheet, just any thoughts strategically, particularly as it relates to any tuck-in M&A to increase technology robustness, or just all-out share repurchases? Thanks.

Frank Addante
Yes, sure. Ad-blocking has been something that is top of mind for us as really an opportunity. We are not seeing any meaningful impact on the business from ad-blocking today, that we can see. However, if you look at the consumer experience and what consumers are saying, they basically have one of two choices; it's either to see all ads or block all ads. Rubicon Project, given the position that we're in where we reach and touch a billion consumers across more than

50% of their Internet experience, we think that there's a better way that best serves the buyers of advertising, the sellers of advertising, and the consumers.

In terms of M&A, this is a company that has been acquisitive, both as a private company and as a public company. We've done seven deals. So, we're constantly looking at ways that we can advance our product roadmap, add to our technology. If we can more quickly accelerate a share to build up one side of our marketplace or the other, so we can accelerate and fuel some of those marketplace network effects, we certainly want to look at those. We recognize that we've got a significant cash balance and if and when there are the right opportunities to put that to work, we will, but with that said, the bar for us is very high. There's a big difference between spending a balance sheet and investing it, and we want to make sure that the things that we do exhibit excellence in engineering, have a really high quality team, are a very high quality offering, and things that we think are sustainable over the long term.

Operator
Our next question will come from Rich Tullo of Albert Fried and Company. Please go ahead.

Richard Tullo
Thanks. Thank you very much for taking my question. This is kind of a 40,000 feet in the air kind of a question. What are you doing culture-wise to ensure that RUBI has the bandwidth to predict and address points of disruption? It seems like things are constantly changing. The big telco mergers and acquisitions may mean more change is on the way; change is going to be fast and radical rather than slow and evolutionary. So what are you doing to prepare for the next header bidding that's on the horizon, because there's always going to be something, I think, in this industry?

Frank Addante
Yes, I think that's absolutely fair. Ten years ago when we started the company, the only competitors that we had were Google, Yahoo!, Microsoft, AOL, very, very large giants, so from day one we've been in a market that's highly competitive, and the way that we've been able to compete in that market, gain share and sustain the business has been to really innovate and use that agility to be able to innovate ahead of the large companies in the space, built upon marketplace network effects. Marketplace businesses are very difficult to displace, and even us, while we've seen some of these shorter term headwinds, I think you're seeing pretty rapid response to them, in terms of our implementations with header bidding. Then the third is data. Our algorithms now have almost 10 years of data. So our algorithms know what happens to supply and demand curves when there's an election, they know what happens when Fourth of July falls on a Tuesday versus a Saturday, they understand when there are major sporting events, they understand the different trends overall and that's what's enabled our platform to compete and win and perform in the market overall, so we want to continue to fuel all three of those things: innovation, marketplace network effects and the data which is the lifeblood that makes our algorithms work and perform.

You mentioned culture and I think that's a wonderful question. We've traditionally invested heavily in products and making sure that we solve the market's problems through products. We went through a period of time, appropriately so, where we invested more, after our IPO, in Sales and Marketing, which a lot of that equates to the education costs that I mentioned before. In this market that's now, you're continuing to move faster towards a market which is a machine-driven market, making machines, making decisions, versus the sort of old world, people-driven, martini lunch decision making, and that's where we're best positioned, and I think we feel better competing in that type of market than we do in the type of market where you've got to invest in a lot of these educational costs and wining and dining customers.

Operator
Ladies and gentlemen, this will conclude our question-and-answer session. I would like to turn the conference back over to Management for any closing remarks.

CONCLUSION

Bonnie McBride
Thank you everyone for joining us today. We look forward to talking to you throughout the fourth quarter and updating you again on our fourth quarter and year-end conference call sometime in early February.

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