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PRESENTATION

Operator

Good day, and welcome to the Rubicon Third Quarter Earnings Conference Call and Webcast. (Operator Instructions) Please note this event is being recorded. I would now like to hand the conference over to Mr. Nick Kormeluk. Please go ahead.

Nick Kormeluk ***The Rubicon Project, Inc. - VP of IR & Head of Global Real Estate***

Thank you, operator, and good afternoon, everyone. Welcome to Rubicon Project's Third 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 and other risks, uncertainties and assumptions is set forth in the company's periodic reports filed with the SEC, including our 2017 annual report on Form 10-K and 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 GAAP and non-GAAP metrics for our reported results can be found in our earnings press release and in the financial highlights deck that is posted on our Investor Relations website. At times, in response to your questions, we may offer incremental metrics to provide greater insights into the dynamics of our business. Please be advised that this additional detail may be onetime in nature, and we may or may not provide an update on the future of these metrics. I encourage you to visit our Investor Relations website to access our press release, financial highlights deck, periodic SEC reports and webcast replay of today's call to learn more about Rubicon Project.

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

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

Thank you, Nick. I'm very pleased to report that our business has continued to improve as seen by our higher ad spend growth rate this quarter and continued improvement in our take rate. Year-over-year ad spend growth increased to 24% in Q3 from 16% in Q2 and 10% in first quarter, which marks the third consecutive quarter of double-digit ad spend growth. Ad spend growth, combined with achieving our cost goals, delivered improved financial performance in Q3 and will lead to positive adjusted EBITDA in Q4 as we remain focused on achieving positive free cash flow.

I'll now touch on some of the positive drivers in our business. Our inventory continues to more than double year-over-year. Audio and video drove strong results for us, and we outpaced industry growth rates. We continue to see gains in mobile ad spend this quarter with year-over-year growth of 45%. And importantly, we also grew desktop 6%.

Header bidding continues to evolve as well. And I wanted to make some general comments about its adoption and opportunities. We have seen that even the most sophisticated publishers want help managing the complexities of header bidding. We believe the combination of transparent, open-source wrappers, easy-to-use tools and managed services is the future of header bidding. And we're already offering these solutions to some of our largest sellers.

Secondly, mobile app and video have been slower in their migration to header bidding, mobile app primarily because it has to be done server side since managing the bidding process from within the app is nearly impossible and slower in video, given supply constraints. We see this changing as more long-form premium video supply becomes available via OTT and CTV. Match rates also vary across different types of header bidding and continue to improve over time, especially server side.

So what does this mean? We think this presents a very opportunistic market in front of us in 2019/'20. We enter this next phase in header as a large, growing, independent exchange that offers all header bidding flavors, who can manage and host header wrappers for its publishers, who has the broadest expertise across inventory types and who is known for being trusted, transparent and high quality. We feel really good about our chances in this upcoming fight for share as the industry evolves.

We now have over 1,200 header bidding connections generating more than 80% of our revenue. Our belief is that by the end of next year, almost our entire business will be header bidding. Our Prebid solution continues to gain traction as well as our partnerships with Google and Amazon.

We get quite a few questions about the speed at which we can gain market share with the supply-side consolidation by buyers, the acquisition of AppNexus by AT&T and some of the missteps by competitors in the space. I would say that just as it took time for us to demonstrate ad spend growth and market share gains from adding traffic shaping, removing buyer fees and launching EMR, these new drivers will also take some time to make it from headlines to actual ad spend and revenue gains.

There is no question, we want these market forces to play out faster. However, the great news looking forward is that we believe that significant upside from these drivers has not yet made it into our results, allowing for this growth to be realized in the quarters ahead.

Now that we have made solid progress on stabilizing the business and returning to growth and are getting close to generating profits again, I wanted to share some insights for what our long-term vision for the business is. Some of these goals are aspirational and are not ones that I can assign specific timelines to. But I wanted to share the vision we are working towards.

We aim to be a, if not the, independent leader across all header bidding options, whether it's our own Prebid-powered solutions or via external partners, such as Google, eBay and Amazon TAM. We plan to continue to be the leading independent exchange in video, mobile app and audio, especially as header bidding accelerates growth in these markets in the coming years. We think, over time, the number of exchanges will reduce to very few a number. And we believe a broad offering will be critical and have chosen to invest across all media types, especially the largest and fastest-growing.

We look ahead to how we reach multiple billions in ad spend versus the roughly $1 billion we have today by capturing 10% to 15% market share of our addressable digital programmatic advertising market. We look to consistently grow annual revenue greater than 20%. And we are targeting 25% or greater adjusted EBITDA margins by prudently managing growth, costs and investments.

We are pleased with our market position and progress year-to-date and very excited about the market opportunity that lies ahead of us. We have spent the last 1.5 years-plus since I joined Rubicon investing in our technology, pushing the industry towards transparency, getting pricing right, rightsizing our cost structure and returning the company to ad spend and market share growth. We are pleased that these actions will put us in a position to deliver year-over-year ad spend and revenue growth and be adjusted EBITDA-positive in Q4 this year and be cash flow-positive by the end of 2019.

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

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

Thanks, Michael. We made solid progress during the third quarter towards generating positive adjusted EBITDA, driven by ad spend growth of 24%, an increase in our take rate and managing our expenses, which came in at the target we provided earlier in the year.

Balancing growth and cost reductions is not easy to achieve. And we're pleased with this accomplishment and with our position going forward. With only a $1.4 million adjusted EBITDA loss in Q3, we feel very confident about generating positive adjusted EBITDA in Q4.

Turning to Q3 results. For the third quarter of 2018, we generated $29.7 million in revenue, a 4% sequential increase; $242.2 million in advertising spend, up 24% year-over-year; and adjusted EBITDA loss of $1.4 million, resulting in a loss of $0.18 per share in non-GAAP EPS.

The 24% total advertising spend increase in Q3 2018 versus prior year was meaningfully better than the 16% in Q2 and 10% in Q1 of 2018. The year-over-year increase was driven by a 45% increase in mobile ad spend, and importantly an increase in desktop that Michael cited earlier. Mobile represented 55% of ad spend mix in the third quarter versus 47% in Q3 of last year. As Michael noted, video and audio continue as the fastest-growing areas.

Revenue for the third 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. As noted, this year-over-year comparison will be cycled in this current quarter for 2 of the 3 months of the quarter.

Recently, we have seen buyers benefit from DSPs refining their first price auction bidding algorithms and also from our EMR pricing tool. In addition, we have seen privacy initiatives drive more contextual impression targeting. Both of these factors have put some near-term pressure on CPMs, which is a trend we are monitoring. We believe this CPM movement is to be expected and is customary as our industry continuously adapts to changing factors.

Our average take rate was 12.3% during the third quarter of 2018, an increase of 20 basis points sequentially due to the continued rightsizing of fees from 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 third quarter of 2018 were $44 million, down from $51 million in the same period a year ago, excluding the $90 million goodwill impairment charge in 2017. On an adjusted EBITDA basis, operating expenses, including cost of revenue, for the third quarter were $31.2 million versus $37.5 million in Q3 of 2017. The declines in both reflect benefits from our cost reduction actions during the year.

Net loss was $13.8 million in the third quarter of 2018 as compared to net loss of $104 million in the third quarter of 2017. The decrease in net loss year-over-year was primarily a result of the $90 million goodwill impairment charge in 2017. Adjusted EBITDA was $1.4 million in the third quarter of 2018, representing an improvement as compared to an adjusted EBITDA loss of $2.3 million reported in the same period 1 year ago. The decrease in adjusted EBITDA loss was driven primarily by lower costs, partially offset by lower revenue.

GAAP loss per share was $0.27 for the third quarter of 2018 compared to GAAP loss per share of $2.11 in the same period in 2017, which included the goodwill impairment. Non-GAAP loss per share in the third quarter of 2018 was $0.18 compared to non-GAAP loss per share of $0.14 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 $6 million for the third quarter of 2018, bringing the year-to-date 2018 total to $12 million. We continue to expect that CapEx will come in at roughly $20 million for the full year.

We closed the third quarter of 2018 with $97 million in cash and marketable securities, a decrease of $7 million from Q2. This reduction resulted primarily from capital expenditures and cash operating losses in the quarter. Free cash flow for the third quarter of 2018 was negative $7.5 million for the reasons stated earlier. We calculate free cash flow as net cash provided by our use in 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 a reminder, as of December 31, 2017, our 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 sharing some indications for our fourth quarter expectations. We expect that year-over-year ad spend growth will be approximately 20%. We expect that take rate in Q4 will approach 13%. We expect Q4 2018 revenue to grow over 20% year-over-year, even with a month of buyer fees in Q4 of last year.

We also expect that adjusted EBITDA operating expenses in Q4, including cost of revenue, will be approximately $32 million, in line with our target discussed at the beginning of the year. As a reminder, we settled the Guardian lawsuit shortly after the end of Q3. And the resolution was not material to our financial results.

We are pleased to report improved financial results, driven by ad spend growth, coupled with benefits from our cost actions. We feel very good about sustainable top line growth, achieving our near-term goal of being adjusted EBITDA-positive in Q4 and being cash flow-positive by the end of next year. With a strengthened competitive position, we look forward to growing market share and showing continued improvement in our future financial results.

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

QUESTIONS AND ANSWERS

Operator

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

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

First question on the take rate improvement. Just if you can give any color on the sequential improvement in Q3 over Q2, more specifically the improvements you're forecasting for Q4. What's driving that? Is that more of a mix shift? Or is that just a renegotiation with sellers?

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

Sure. Jason, it's David. That's really driven mostly by renegotiation, so not much mix shift going on there. I think as we've talked about in the past, we've -- when we got rid of buyer fees, there was really a significant subsidy from buyer fees related to our seller fees. And so this is really just sort of rightsizing those seller fee levels. So we continue to work on that and feel good about our progress.

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

So in other words, there's no anticipated anomalies in your projection for Q4?

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

That's right. There's no mix anomaly. It's really just the impact of our renegotiations that have a little bit bigger impact in Q4 than they did the last couple of quarters.

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

Okay, got it. Michael, some of the color that you gave on just the move to header bidding in mobile app and video. What gives you the confidence that you're in the right place to take some of that market over? And then what do you think is the linchpin that really drives better header bidding adoption in those industries?

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

Yes. Jason, great question. So I think the -- our confidence in our ability to succeed in these areas of opportunity, driven largely by relationships with the publishers. So a lot of the folks that are going to be playing in the ad-supported premium long-form video game are existing publishers already that we've been helping monetize their banners and their web video and their audio for years. And so I think there's a trust there. We are aggressively building out our product suite to be able to be best in class in that area as well. Mobile is a slightly different marketplace. And again, we have a lot of relationships indirect and direct with the mobile app providers. And I think they all look at -- generally speaking, mobile app advertising has been heavily performance-based, mostly app install advertising. And it's worked extraordinarily well. However, that's kind of -- that has a TAM to it, if you will. And all the app guys that we talk to are very desirous of the type of demand that we can bring, which is more brand-centric. And brands have gotten an increasing comfort with the taxonomy we're using for mobile app inventory. So I think that the combination of those relationships and the type of demand that we're bringing to the mobile bodes well for us.

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

That's very helpful. Also some of the long-term growth figures you gave were very helpful. So I just want to express my appreciation for that. In regards to that, David, can you give any color on as we progress over the long term what we should anticipate for incremental margins?

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

We -- yes, I think as we talked about long term, 25% adjusted EBITDA margins. And if you kind of do the math in how you get there, it certainly implies a pretty significant flow-through. So we're not putting any specific numbers out there. But certainly, a majority of the increases that we get are going to flow through from a margin perspective because we continue to have very significant leverage in our model. And at this point, it's -- we've shown that leverage in the past. And we have that leverage at a little higher scale now. But we're now growing into that higher scale.

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

Okay. Last one for me, Michael, it's been somewhere in the ballpark of 53 weeks since you made the move to remove buyer fees. And so just wondering if you can kind of give a summary of what the conversations were with publishers and with DSPs a year ago and how those conversations have progressed. How has that changed to the dialogue that you're having with your customers today?

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

Yes, market difference, right? So the -- we'll take the buy side first. The interesting phenomenon that's occurred since I joined Rubicon is how much more active marketers are who actually have the wallet, so to speak, and their agency partners. If you were to typify our relationship with the buy side, it probably didn't begin and end with the DSPs. But it was heavily focused on the DSPs. And so now that we're talking to the source of dollar, the idea of removing any friction from a fee base has had very, very positive impact. And so I would characterize -- we figured out the right pricing for the buy side, which is 0. On the sell side, I think that they've seen the flow-through, right? They're seeing greater payments through our publisher revenue. And they couldn't be more enthusiastic about our return to prominence, about our return to -- moving to the first chair of their monetization partners. And we really do think there's a heck of a lot of more runway to go. So all in all, how ever painful it was, and boy, it seems like 530 weeks not 53, but it's all worked out exceedingly well.

Operator

Your next question comes from Matthew Thornton from SunTrust.

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

I know it's been tough, but the numbers look great. On take rate, I'd love to just maybe just get an update there as to where you think the sustainable number is if we think out over the next, I mean, I don't know how long out we can go, but 2 years or so. Love to get an update on your thinking there. And then on the 20%-plus type of ad, I think you called out 20%-plus ad spend and revenue growth is the aspiration per year. I'd love to just get maybe your sense of what you think the industry is growing at. Is it 10%, 15%? So I'd love to get some thoughts there. And then also as we -- how do you think about over the next 1 to 2 years counterbalancing? You called out some of those data privacy issues, so ITP 2.0 and Firefox privacy settings and GDPR. And those are headwinds. And then on the flip side, you've got some of this recent consolidation with AppNexus and AdsWizz and a couple of your direct comps stumbling a little bit recently. So in the context of that 20% -- plus, I'd just love to hear how we should be thinking about the counterbalance of those kind of forces there. And I'll stop there, then I've got a couple of follow-ups.

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

Okay, so I'll start with the take rate. Yes, it's a great question. We think kind of in the nearer term, you've seen the trends we've had. And nearer term on the margin, we think there's room for a little bit of negotiated lift. What happens over time though is the mix shift that we've talked about. And so take rate we think, ultimately, as PMP gross as a percentage of the business, that typically carries a lower take rate. And that will, over time, tend to have a depressing impact on take rate. But at the same time, you're typically buying video and other higher CPM units. And so you're having a much higher flow-through. So you'll see a lower take rate, but it should result in greater ad spend growth. So there's sort of -- in the revenue line, it's net positive. So that's how we see that sort of playing out, hard to sort of say where it's actually at in 2 years. From a market growth perspective, if you look at -- everyone's got different numbers, but they all sort of are somewhat close together. If you look at MAGNA, they've sort of got a 15% kind of CAGR general growth over time. And so we think of the market growth as 15%, maybe a little higher, depending on who you talk to. So that's on market. And do you want to take the privacy?

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

Yes, sure. So privacy, we went through one Apple iteration. Their second just came out, right, in terms of their Intelligent Tracking Prevention. And we've obviously lived through GDPR. And what we normally find is, at first, there's an imbalance. You have a bunch of impressions that used to be targeted prior. Now the ability to data target them is eliminated. But over time, that money sometimes goes off to impressions on the exchange that are able to be targeted. And then of course, with contextual targeting becoming more popular or becoming more valuable over time, you start to see this equilibrium take place. So I think they're disruptive. But long term, I don't think it spells a winter of lower CPMs across the board. And of course, we have much higher value inventory -- if you look ahead, much higher value inventory coming on in the form of video and long-form in premium. Then if you look back the banner era setting -- sunsetting. Overall, we're very hopeful that we're not talking about cookies a year from now, 1.5 years from now. We really do, as an industry, have to stop glomming up the browser or glomming up the page with all bunch of code in order to track folks around the Internet and move much more to an elegant solution on the server with match tables. And we're leading a charge in that on several different initiatives. So we remain hopeful that this automated advertising programmatic data-driven business is still incredibly healthy in the long run.

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

That's helpful. And then maybe just a couple quick follow-ups, if I could. Maybe these are for Michael. You talked a little bit about the number of exchanges coming down to a few. Is that a function of places closing their door? Is it consolidation? And how would you view Rubicon's participation there? I guess, that's the first follow-up. The second follow-up is just any thoughts on macro? Obviously, we've had some turbulence here recently certainly in the equity markets, just love to hear if you've seen any evidence of that out there in the advertising -- kind of in the exchange business. And then just finally and relatedly, when you look at header bidding server side versus client side as well as first-party auction versus second-party auction, I'd love to hear just kind of where you think those debates are shaking out or kind of where we think we're headed and if Rubicon has more chips in the game one versus the other or you guys pretty not caring so much as to how that shakes up. Are you pretty evenly stacked on both? And that would be it for me.

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

Thanks, Matthew. So on the consolidation front, other than just kind of pattern recognition of a maturing industry and knowing that there's still too many players, it's really driven from our conversations with buyers. They very quickly have changed their strategy from trying to find an individual on any platform kind of regardless of their content on that platform, trying to get them at the cheapest price for their client, the marketer, to being very, very concerned about the quality of the content on the exchange and knowing that they don't have to plug into 100 platforms any longer. And so we've talked to many agencies who say they see a future state over time where they're not buying off of more than 8 to 10 platforms. And today, they're still probably in the 40 to 60 neighborhood. So we feel very encouraged about the trend lines. And that's coming straight from the buyers that have all the power because they have the money. So I think that covers the consolidation from our point of view. On the macro, I'm not entirely clear -- the question, but we haven't seen, from a cut and spend or budgets have been told from any of our buyers that they have less money to spend because their clients are cutting ad spend. So I don't know if that answers your question, Matthew.

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

Yes, that's great. I just wondered if there was any evidence of kind of the turbulence in the equity markets kind of seeping into the end markets here, but doesn't sound like you're seeing any signs of that.

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

No, not to date. And then on the header side, the server-to-server and then the auction dynamics, first, for a second. I think we feel, as a company, that it's a better, longer-term approach server-to-server. And so we're putting a lot of energy and effort into it for all the reasons I kind of cited before when we were talking about data privacy. And that is let's get all this stuff off the page, let's get it out of the browser and let's do it on the server. It will be more efficient, effective, more privacy-compliant. And I think that that's where the future is heading and we're a putting a lot of energy and resources into it. It's also great way to crack into the mobile app market, right? If you have one Prebid SDK as opposed to having to glom up your mobile app with 10 monetization SDKs, it really is kind of where the future is heading, so terribly excited about that. As it relates to first versus second, we've obviously moved to first price shop. It's -- bar none, it's the most transparent way to go about it. It's pretty simple, at first price. We also accommodated buyers, as you know, by coming out with an Estimated Market Rate tool, which allowed them to transition from the second price algorithms that they had to a first price world. Google still operates their exchange in second pricing. They'll defend that to the hilt. I think really what we try to do in this is appease both sides of the marketplace. We don't really have a religious stance as to whether first or second is the right way to go. We'll accommodate the marketplace. So you may very well have downstream some publishers wanting to run an auction just on their inventory that's slightly different from the rest of the auction. That's kind of what we alluded to when we talked about the next phase of header bidding and more of a managed, more of an enterprise solution. So I think it will only get more interesting. But as it relates to auction dynamics, whatever it is, we're just going to be transparent about it. We're just going to tell you what it is and you can choose to buy on it or sell on it. If you don't like it, you don't do it. If you like it, you do it. But transparency is the key here. Whether it's second, whether it's first, whether big cash comes back, whatever the case might be, transparency is the most important aspect.

Operator

Thank you. This concludes our question-and-answer session. I would now like to turn the conference back over to Mr. Kormeluk for closing remarks.

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

Actually, this is Michael Barrett. And I would just like to thank all of our employees for their efforts and hard work as well as our partners and shareholders for their support in the last couple of years and putting us in a position to grow market share. We look forward to seeing some of you at some of -- I'm sorry, we look forward to seeing some of you at our presentation at the Craig-Hallum Conference in New York on November 15 and marketing in Boston on November 16. Thank you for joining us for our Q3 results call, and have a good evening.