Q3 2018 Earnings Call | Prepared Remarks | October 31, 2018

Edouard Lassalle – VP, IR

Good morning and welcome to Criteo's third quarter 2018 earnings call.

With us today are co-founder & CEO JB Rudelle and CFO Benoit Fouilland.

During the course of this call, management will make forward-looking statements. These may include projected financial results or operating metrics, business strategies, anticipated future products and services, anticipated investment and expansion plans, anticipated market demand or opportunities and other forward-looking statements. Such statements are subject to various risks, uncertainties and assumptions.

Actual results and the timing of certain events may differ materially from the results or timing predicted or implied by such forward-looking statements. We do not undertake any obligation to update any forward-looking statements contained herein, except as required by law. In addition, reported results should not be considered as an indication of future performance.

Also, we will discuss non-GAAP measures of our performance. Definitions of such metrics and the reconciliations to the most directly comparable GAAP financial measures were provided in the earnings release published earlier today.

Finally, unless otherwise stated, all growth comparisons made in the course of this call are against the same period in the prior year.

With that, I now turn the call over to JB Rudelle, CEO of Criteo. JB…

JB Rudelle – Co-founder, Chairman & CEO

Thank you, Edouard, and hello everyone.

During Q3, we met the financial objectives we laid out 90 days ago. Despite this achievement, I'm not entirely satisfied with the results, as we are not showing a return to growth yet. As discussed last quarter, the road towards growth will not be linear and we may face temporary setbacks on this path. This said, we **feel good about the transformation plan we have for the future**. While it is too early to provide guidance for next year, it is still our aspiration to return to double-digit growth in the second half of 2019.

Our vision is to **be the advertising platform for the open Internet**. To us, the open internet is an environment enabling direct interactions with audiences and consumers but also fair and transparent access to data and measurement. Despite representing 50% of time spent online, it only captures about 30% of ad spend. This means the open internet is still highly under-monetized. This is because, today, it does not benefit from the same level of technology that the walled gardens enjoy. We seek to be the advertising platform of choice for the open Internet. Using data and technology to improve the monetization of this ecosystem. The opportunity is huge and we believe we are in a good position to be one of the leaders in the space.

To do this, we leverage our **unique commerce data set**. Our "shopper graph" is among the largest global data sets **focused on shoppers**. It has three main components:

- The first is the identity graph, where we match well over a billion users across multiple devices. According to clients, our graph ranks in the top global-3 for exact match capabilities in most of the large countries where we operate.
- The second is the interest map, an aggregated and anonymized view of the shopper data we have from our huge pool of participating clients. Thanks to this highly granular product-level browsing and cross-retailer shopping data, we can support a large range of scenarios for personalized advertising.
- And the third is the measurement network, which helps brands connect advertising dollars to actual sales outcomes. We leverage first-party retail point-of-sale data both digital and in-store, to provide brands with sales attribution down to the product-level.

People often label us as a retargeting company. To be honest, I've never been completely comfortable with this label, because it's a narrow, oversimplified view of what we do. What we actually do is **leverage high-quality first-party data to provide value-added advertising** to clients.

There are many ways to build attractive advertising scenarios on top of high-quality first-party data. So far, we have mainly focused on **Conversion** scenarios, which is the ability to drive immediate sales for a brand or a retailer. In the past year, we have started building extended capabilities to expand our offer to **new upper funnel scenarios**. Leveraging our shopper graph and technology, we offer new advertising scenarios for what we call **Consideration.** This is the ability to engage with a new audience, to drive visits on a site or installations of an app, with no necessary link to immediate sales outcomes. Market research shows that established Consideration tactics are particularly effective at creating user engagement at scale. Our first Consideration product has been Criteo Customer Acquisition, or CCA. In the coming quarters, we will keep iterating and improve CCA while also adding new Consideration scenarios like app install, that I will discuss in more details later on the call.

Beyond our effort to expand into Consideration, we are also planning to go even further up the funnel, by adding **Awareness** scenarios. This is the ability for users to discover a new brand or product without necessarily focusing on immediate interactions with the brand properties.

So, lots of exciting solutions to build ahead of us. Now, to effectively **scale upper funnel advertising scenarios**, we believe we need to excel in two areas:

1) First, we are implementing **our technology platform to be more flexible and modular way**, in order to effectively recombine our assets into new advertising scenarios. For instance, our new identity architecture around hashed emails allows us to offer a CRM onboarding tool that we call Criteo Audience Match, or CAM. As discussed earlier, our very large identity graph provides one of the best match rates in the industry. CAM also leverages other important assets of our platform like shopper data and consent management. Thanks to CAM, we offer a variety of flexible new advertising scenarios that a growing number of clients consume in a modular way. Another example is the big effort we are making to build **self-service tools** for our clients on top of our platform. Still scheduled for release in the first half of next year, we expect these tools to significantly

increase our net client additions in H2 2019. Self-service will also enable clients to **entirely manage their advertising campaigns themselves**, something very important for large digital native players.

2) Second, to scale upper funnel, we need also to ensure that our sales team is **able to present and sell our multiple advertising scenarios in a way that is as intuitive and easy to understand** as possible for clients. To achieve this, we must complete the ongoing **realignment and training of our sales team**. This is a significant undertaking and has caused variability in our reported results. Given the size of our global sales organization, this is a large scale project spanning several quarters. We are taking this very seriously and with a deliberate careful approach so we minimize negative impact to the business. This also requires us to restore our **net hiring cadence**. As a matter of fact, exiting Q3, we are nearing the pace we need to meet our original hiring goals. Despite this however, employee attrition increased in Q3, leaving us short of our **net employee addition goals**. Recognizing that meeting such goals requires combining strong hiring cadence with **lower attrition**, we have implemented a range of company-wide programs to remediate those drivers. We believe our ongoing actions will allow us to meet our **net employment goals in the coming quarters**. Our anticipation is that doing so will be one of the factors helping restore net client additions as well as revenue growth.

Overall, achieving success in those two areas – a flexible and modular technology platform coupled with an efficient multi-product sales organization - is very much in our hands. Now that we have set clear strategic goals and built plans to address them, success lies primarily in our ability to **focus and deliver disciplined execution**. Although transformations like this can come with a few bumps along the road, we feel good about our strategic plan. As a matter of fact, we began to see **early signs of success with some clients in Q3** and have an optimistic view for what lies ahead in the medium-term.

We are **reinforcing those two big focus areas** with a number of important initiatives. Last June, we announced a **major investment in Artificial Intelligence**, specifically in deep learning technologies. As you know, improving our prediction Engine has been always a major driver of growth historically for Criteo and we believe this next generation of neural network technology could have a similar impact. During the summer, the Artificial Intelligence research team has been busy setting up the computation infrastructure for our new models. In Q4, we will start our first tests with real data. From then, we expect to fine tune our deep learning models and hopefully start to see early commercial impacts in 2019.

We are also significantly accelerating our investments in the **mobile app** ecosystem in Q4. As you know, mobile app usage is growing quickly, very quickly and generates significant ROIs for our clients who invest in the right app experience for their customers. Because the lifetime value of an app customer is typically much higher than on the web, our clients are increasingly asking us for app-focused solutions. As a result, we are investing in this space and this investment brings multiple benefits for us:

1. First, **apps increase our moat.** Delivering in-app advertising products at scale is hard to do and requires significant R&D investments that many players are not equipped to make. As a result, our technology moat gets larger in the world of apps.
2. Second, **apps offer a better monetization environment**. Since our business has been built on delivering superior return on ad spent to clients, the more time shoppers spend in well-designed apps, the easier it becomes for us to deliver strong returns to our clients.
3. Last but not least, **user identification is cleaner in apps** than on the web, as it does not rely on cookies or any browser.

Demonstrating our commitment to app-based solutions, we are delighted to announce that we closed the **acquisition of Manage** on October 29. Manage is a Silicon Valley company with an attractive app install advertising solution. The addition of Manage complements our already significant app Conversion business and allows us to move into upper funnel Consideration solutions in apps. Beyond that, it also expands our client base as Manage serves advertisers not only in our strong verticals of retail and travel, but also in gaming and other app-first areas such as food delivery and ride-sharing. With Manage, we also gain additional technical and commercial talents to accelerate our expansion into the fast-growing app space. Manage is profitable with healthy EBITDA margins as this team has demonstrated disciplined execution. For this asset, we are paying just under 5 times projected EBITDA for 2018.

Speaking of acquisitions, we are pleased with the first steps of our **integration of Storetail**, the French startup we acquired in August. Their platform nicely complements Criteo

Sponsored Products and Criteo Reseller Program. We will now offer a **global monetization solution** for retailers to activate their audience and traffic data to generate more revenue from brands and resellers, both on their site and across the open Internet. This broader monetization approach is receiving very encouraging feedback from retailer clients both in the U.S. and in Europe.

Overall, as we've seen, returning to topline growth will be mainly about disciplined execution and focus. And, to illustrate the confidence we have in our plan for the business, we are also announcing today a **80 million dollar buyback program**. Given the current market conditions and the outlook for our business, we believe this program could create significant shareholder value in the future.

Before I turn the call over to Benoit, I wanted to point out that, in conjunction with our earnings release this morning, we posted a supplemental document on our website that answers common investor questions.

With this, I'll turn the call over to Benoit to discuss our performance and guidance in details.

Benoit?

<u>Benoit Fouilland</u> – CFO

Thank you, JB, and good morning everyone.

I will walk you through our Q3 performance and share our guidance for Q4 and 2018.

Revenue was $529 million.

Revenue ex-TAC, our key metric to monitor performance, decreased 2% at constant currency to $223 million. This performance was driven by growth with large clients in the U.S., more than offset by softer performance in the midmarket, primarily in the Americas and EMEA. Revenue ex-TAC includes Storetail's contribution of approximately $0.6 million. Excluding the impact of Search, email and HookLogic Travel, that were discontinued over the past year, Revenue ex-TAC decreased slightly less than 1% at constant currency.

Using the forex assumptions provided in our Q3 outlook, Revenue ex-TAC was $225 million, slightly more than $2 million above the higher end of our guidance. Compared with Q3 2017, FX changes were a tailwind of about 220 basis points to Revenue ex-TAC growth. Overall, currency changes cost us $5 million vs. last year and $2 million more than what we had anticipated when we last provided guidance.

Looking at our **operating highlights**:

- We added **280 net new clients**, roughly in line with our expectations, bringing total client count to over 19,000. We maintained retention at close to 90% for our Criteo marketing solutions, or Customer Acquisition, Audience Match and Dynamic Retargeting. In line with our prior view, we expect to see an improvement in net client additions from the second-half of 2019, following the release of our self-service tools earlier in the year.
- 10% of our live clients used **at least 2 of our products**, compared with only 1% a year ago.
- Revenue ex-TAC from Customer Acquisition, Audience Match, Sponsored Products and Storetail combined **increased 82%** at constant currency, to over 7% of our total business.
- **In-app Revenue ex-TAC** grew 67%. Going forward, we expect to include Manage's results in this category.
- **Same-client Revenue ex-TAC** decreased 5%, compared to a decrease of 3% in Q2, primarily driven by user reach limitations in Safari.
- And last, we continued to increase our **direct access to publishers** by further deploying Criteo Direct Bidder, to now over 2,600 publishers, including Fox News, CBS, Marktplaats, M6 in Q3.

Turning to the **regional performance**.

- In **the Americas**, Revenue ex-TAC was flat at constant currency, despite the impact of user reach limitations in Safari, and grew **1% in the U.S.**, driven by strength with large customers.
- **EMEA** Revenue ex-TAC decreased 5% at constant currency, in line with expectations, driven by relative strength with large clients, offset by the impact of user reach limitations in Safari, softness in midmarket due to the shortfall in sales capacity and approximately $4 million impact from GDPR, below our expectations. We are seeing early positive signs

from our salesforce reorganization in the region and expect the full impact to take a few quarters to filter through results.

- In **APAC**, Revenue ex-TAC decreased 2% at constant currency, in line with expectations, driven by strength in Korea and India, offset by weakness in Japan.

Revenue ex-TAC margin improved 70 basis points to 42%. Similar to the first half 2018, a large part of this improvement was driven by the increased share of mobile app supply, a large portion of which is purchased at lower cost than expected. In line with plans, our margin level has started to normalize and we expect this trend to continue.

Moving to **expenses, other cost of revenue** increased 10%, driven by hosting costs and significant increase in third-party data to complement our identity graph, in line with expectations.

Operating expenses decreased 4%, reflecting a roughly flat headcount over the period and lower equity award compensation expense, driven by FX, attrition and a lower share price over the period, and partially offset by higher bad debt expense. Headcount-related expenses represented 72% of GAAP opex, a slightly lower level than in prior quarters. We ended Q3 with over 2,700 employees –up 1% year-over-year and 2% sequentially-, including about 60 employees from Storetail. As JB discussed, we are taking active steps to improve our hiring cadence and reduce attrition with a specific focus on increasing our average sales rep tenure across the company over the coming quarters.

On a Non-GAAP basis, operating expenses decreased 2% to $138 million, and on a Non-GAAP basis by function:

- **R&D** expenses decreased 2%, despite the 3% increase in headcount to over 670 employees. We expect to grow R&D expenses in Q4 2018.
- **Sales & Operations** opex decreased 1%, driven by a 1% decrease in headcount to close to 1,600, including over 700 quota-carrying employees, as well as higher bad debt provisions. We expect our Sales & Operations headcount to stabilize in Q4.

- And **G&A** expenses decreased 2%, despite a 6% increase in headcount to 490 employees, largely driven by adding new hiring capacity in the HR team.

We did incur about **$1 million** of temporary savings compared to expectations, largely related to delayed hiring. In line with what we said last quarter, we do not expect to entirely catch up to initial hiring plans by the end of 2018, but instead hope to be back on track in 2019. On the other hand, we incurred approximately $3 million of higher bad debt provisions than expected, mostly on Sears.

Moving to **profitability**, **Adjusted EBITDA declined 11%** at constant currency to $70 million, with Adjusted EBITDA margin declining 260 basis points to 31% of Revenue ex-TAC. Normalizing for temporary savings, the expected negative contribution of Storetail and the higher bad debt provision, Adjusted EBITDA margin was over 32%, down only 130 basis points.

The reported effective **tax rate** was 34%, based on our updated projected tax rate of 32% for 2018. The decrease from 37% last quarter results from updated assumptions to mitigate the impact of the BEAT tax in the U.S. As you may recall, we indicated last quarter that our projected tax rate for the year could go down by 3 to 5 percentage points.

Net income decreased 19% to $18 million, driven by a 22% decrease in Income from Operation, lower financial expense by 65% and 13% decrease in provision from income taxes.

As a result, **Adjusted Net Income per diluted share** decreased 18% to 53 cents.

Cash flow from operations decreased 19% to $50 million, due to a significant increase in income taxes paid, driven by the BEAT tax in the U.S. and the cash payment of 2017 tax in Germany and France. This momentarily drove transformation of Adjusted EBITDA into cash flow from operations to 72%, compared to a normalized 80%.

Capex increased 7%, at 6% of revenue in the quarter, driven by data center equipment and capitalization of development costs for internal projects. We continue to expect 2018 capex to represent approximately 5% of revenue.

As a result, **Free Cash Flow** decreased 39% to $21 million. In the first nine months, Free Cash Flow increased 14% to $95 million, representing 44% of Adjusted EBITDA, a few points above historical average.

Finally, **cash** and cash equivalents increased $45 million from the end of 2017 to $459 million, despite a $44 million net cash outflow for the Storetail acquisition and a $18 million negative forex impact on the cash position over the period.

I will now provide our **guidance** for the fourth quarter and fiscal year 2018. The following forward-looking statements **include contributions from Manage** and reflect our expectations as of today, October 31, 2018.

In Q4 2018, we expect Revenue ex-TAC to be **between $256 million and $262 million** on a reported basis. This implies constant currency growth of -6% to -4%, and assumes a contribution of approximately $3 million from Manage. We expect year-over-year forex changes to be a headwind to reported growth of about 130 basis points. Using FX assumptions underlying the Q3 2018 guidance, our Q4 guidance would be $261 million to $267 million, implying a forex headwind of approximately $5 million.

This year, we are providing a slightly broader guidance range for Q4 to account for the greater variability of our business, in particular around the U.S. Holiday Season. Our guidance is within the full-year range when factoring in year-to-date results, but represents a decline of approximately $4 million at the midpoint compared to our prior **implied** guidance for Q4 at constant scope and forex. This mild reduction can be attributed to sales execution. As part of our go-to-market transformation, we are reallocating sales resources across client accounts, resulting in short-term decrease in sales productivity. We believe this setback is temporary and we feel good about the direction of our transformation plan.

With regards to the full year 2018, **we are reiterating our Revenue ex-TAC growth guidance of -1% to +1% at constant currency**. Compared to 2017, we see forex changes bring in 110 basis points of reported growth, or about $10 million. However, using our assumptions for the Q3 guidance, forex would be a $5 million headwind.

On the profitability side, we expect Q4 2018 Adjusted EBITDA of **between $86 million and $92 million**, including approximately $1million for Manage. Using the forex assumptions underlying the Q3 2018 guidance, our Q4 guidance would be $88 million to $94 million.
For the full year 2018, we are maintaining our full-year 2018 Adjusted EBITDA margin guidance of **between 30% and 32%** of Revenue ex-TAC.

As usual, our FX assumptions supporting guidance for the fourth quarter and fiscal 2018 are included in the earnings release published earlier today.

Before closing, I want to point out that, in addition to the FAQ that JB mentioned, we have added an investor deck on our website with supplemental information on the impact that currency has on our actual results and guidance.

While we are currently working on building our 2019 budget, it is too early to provide guidance for 2019. Our aspiration remains to return to double-digit growth in the second-half of 2019. We will provide our guidance for 2019 when we report Q4 earnings.

With that, we will now take your questions.

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<u>Edouard Lassalle</u> – VP, IR
Thank you [JB/Benoit]. This now concludes our call. We thank everyone for attending today. The IR team is available for any follow-up questions you may have. Good bye everyone and enjoy the rest of your day. Thank you.