Q2 2019 Earnings Call | Prepared Remarks | July 31 2019

Edouard Lassalle – VP, IR

Good morning and welcome to Criteo's second quarter 2019 earnings call.

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

During 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. As always, 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.

Today, we will also 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, which is available on our website.

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.

<u>**JB Rudelle –** Co-founder & CEO</u>

Thank you, Ed, and good morning everyone.

On today's call, I'd like to discuss **three main topics**:

- First, our **Q2 performance**,
- Second, our **strategic initiatives**,
- And third, our **priorities** for the next 18 months.

Starting with the **Q2 performance**. We had several positive developments this quarter. I'm aware that, in the last two years, the market questioned our ability to execute on our plans. In Q2, we once again exceeded our guidance for both Revenue ex-TAC and Adjusted EBITDA. While transformation takes time, we are making important progress and feel good about our strategy.

Among the Q2 highlights, our quarterly **net client additions** turned positive and, with 360 net new clients, reached their **highest level** since Q2 2018. This reflects improvements in our midmarket sales productivity. Nevertheless, our long-term ambitions are much higher in this area. As our demand-generation programs ramp up over the coming quarters, we expect this new client-acquisition channel to significantly accelerate net client additions in 2020.

In Q2, our **new solutions** – which include all solutions **outside** of retargeting – grew 61% on a Revenue ex-TAC basis to 10% of total, up from 6% a year ago. This exciting milestone is a great reward for all our teams who have been working so hard to develop them.
All our new solutions leverage one of our most valuable assets: our user graph of 2 billion Criteo IDs. As you may recall, this unique user graph links highly granular shopping data with robust, persistent IDs across multiple devices and user environments. This provides the ability to develop highly attractive marketing scenarios in a flexible way. We believe we have only scratched the surface with our new solutions and there remains a huge potential to sustain strong growth in the years to come.

Within new solutions, we are pleased to see that the new leadership for **Retail Media** has already started to produce positive results. In Q2, our Retail Media business enjoyed reacceleration compared to prior quarters, with growth now back to north of 20% on a Revenue ex-TAC basis.

This reacceleration is happening in a fast-changing environment. Retail clients are asking more and more for a turnkey platform that combines both performance and branding products. To meet these requirements, we are unifying our former Sponsored Products and Commerce Display product into a single solution. As a reminder, Commerce Display is our solution acquired from the former Storetail. The market is also increasingly demanding full transparency, both in terms of pricing and inventory. We adapted rapidly to this change by offering large retailers an innovative transactional-SaaS model. This SaaS model is growing triple digits on a proforma basis and already represents over 30% of our Retail Media business.

Our **app business** grew 21%. While solid again, this is not on par with our ambitions yet. Even if mobile apps continue to gain more and more share of user time, we are witnessing that a lot of retailers still don't invest in apps to fully capture the growing usage. However, we believe it's just a matter of time before mobile apps eventually become a must-have channel for virtually all large and medium retailers. As a result, we continue to invest significantly in this strategic channel.
In particular, we are shipping a new beta version of our app install product as of Q3, with significant improvements around bidding compared to the product we acquired from Manage last year. We are also implementing more client-friendly integration protocols to ease the roll-out of the product across all our different geos. We are excited to test this new enhanced version with our clients in the fall. If those tests are satisfactory, app install should contribute more materially to our overall business in 2020.

Looking now at our **retargeting** business. We saw a low single-digit decline at constant currency. This slight contraction was expected and is mainly driven by the erosion of Web browser usage, as users tend to shift more of their online time to mobile apps. **Two factors** make us confident we will be able to reverse this trend in the midterm. First, as just discussed, even if many retailers have not yet shifted gears towards mobile apps, we expect them **to catch up** at some point and we believe our current investment will pay off. Second, while our retargeting business with large clients is quite mature, we are **still largely under-penetrated** in the lower torso and are not addressing the tail of the market yet. These segments represent a very significant greenfield opportunity for us. Thanks to our strong ongoing commitment to self-service, we are confident we will be able to penetrate these in the years to come.

Finally, on the **supply side**, we further expanded our network of direct publisher relationships. In addition to the 3,800 publishers using our **Direct Bidder** on web inventory, we are now directly connected to 200 app developers, about 50% more than in Q1. Further, the Trustworthy Accountability Group certified our inventory quality and fraud prevention, recognizing our best-in-class practices in promoting a **brand safe** environment for our clients.

I would now like to turn to some of the **strategic initiatives** we have implemented recently. While these have no direct impact on our Q2 financials, they are key to the way we're managing our business going forward.

1. **Starting with self-service.** As you are aware, we are working hard to implement self-service capabilities on our platform. Beyond the obvious productivity benefits those tools provide us, we strongly believe that the ability to have their hands on the keyboard is critically important for our clients and their agencies. Overall, giving marketers control and transparency is a key element of our strategy. Speaking of this, we are pleased that a recent Forrester report on Omnichannel Media Management[1] recognized the important investment we are making into our platform. In this survey of the Demand-Side Platform market, Forrester included Criteo as the only pure tech player in the large vendor category, alongside the giant hybrid players, Amazon, Facebook and Google.

Recently, we reached a particularly important milestone in the roll-out of our self-service platform. I am very pleased to share that, starting with the U.S., U.K. and Australia, our **self-registration feature for new clients** is now live. As indicated earlier, self-registration is a must-have to further scale the addition of new small and medium clients. We also continued to make good progress with **other self-service features**, ranging from campaign creation and dynamic creatives to analytics. For example in Q2, 70% of campaigns targeting commerce audiences were created entirely in self-service mode. And almost 100% of our clients' price coupons were fully managed in self-service, up from 75% the prior quarter. These achievements are very encouraging for the upcoming roll-out of our next features.

2. Shifting now to our ongoing **transformation.** As you may recall, one of my key areas of focus over the past year has been to address the execution issues slowing down our growth. One

[1] *Forrester Now Tech: Omnichannel Media Management, Q2 2019, 6/14/19, by Joanna O'Connell, Brigitte Majewski, David Novitzky and Christine Turley, link)*

of the important levers to improve execution is to ensure we have the right talents in place. Compared to a year ago, I have a **completely new executive team**, with the exception of Benoit, my great CFO with whom I've been working with closely since 2012. The General Counsel and leaders of Corporate Communications, People, Retail Media and the APAC region, were brought in from the outside. For R&D, Operations, Web and App product lines, EMEA and Americas regions, we recently promoted strong talents from the inside. I'm very excited with this leadership team and can already feel the **commitment, drive and energy** these new leaders bring to the long-term success of Criteo.

We have also taken advantage of this management change to **strengthen our go-to-market** and improve execution.

- First, recognizing that we are now a truly multi-product company with its own specificities, we now have **three product units** with dedicated product and go-to-market resources: one focuses on **Web**, another focuses on **App and Store**, and the third focuses on **Retail Media**. We believe this new **customer-centric organization** should allow faster and more effective iterations on our product roadmap and go-to-market.
- Second, we took this opportunity to regroup our previously fragmented operations into **one single global team** to support our product units with a transversal Platform, Marketing & Operation team dedicated to best-in-class services for our clients.
- Third, we are bringing the Large Customers and Midmarket organizations in each of our three regions under a **single regional leadership** to share best practices and maximize execution.
- And fourth, we **simplified our management layers** and increased span of control. The immediate benefits are faster communication and decision making.

Overall, we are confident this new organization will bring **additional momentum for our ongoing transformation**.

Looking ahead, we **reiterate our 2019 guidance** for both the topline growth and profitability margin. We also remain focused on executing on our **key priorities** for the next 18 months which are:

1. Grow adoption of **self-service at scale** to add new clients.
2. Grow **full funnel** solutions including **app install** and Web Awareness and Consideration.
3. Continue to invest in **Retail Media** and accelerate our transition towards transactional-SaaS.

4. Reinforce our **identity solutions**, leveraging our key assets in data management.
5. And **effectively manage our expense base** to pave the way for incremental gains in profitability margin in the future.

In closing, despite the challenges we discussed, we **feel good about our strategic direction** and our ability to deliver on our plans. As a matter of fact, to underline our confidence in the future of Criteo, I am pleased to announce a **new $80 million share buy-back program**.

With that, I'll turn the call over to Benoit who will walk you through our financials and provide more color on our outlook.

Benoit Fouilland – CFO

Thank you, JB, and good morning everyone from my side as well. As always, I will walk you through our quarterly performance and share our guidance for Q3 and fiscal year 2019.

Revenue was up 1% at constant currency to $528 million. **Revenue ex-TAC**, our key metric to monitor the business, increased 0.3% at constant currency to $224 million. New client business drove our growth this quarter, especially in the midmarket, offsetting a limited decline in our existing-client business, despite continued adoption of our new solutions across the client base.

Using **currency** assumptions supporting our guidance, Revenue ex-TAC reached $225 million before a $1.5 million negative FX impact. Compared to Q2 2018, the FX negative impact was $7 million or 3 points of growth.

Revenue ex-TAC margin declined 50 basis points compared to last year to 42%, in line with our expectations for the margin to normalize from its peaks in the first half of 2018.

We grew the **number of clients** by 4% year-over-year to close to 20,000 and maintained client retention at close to 90% for all solutions combined.

From an existing client standpoint, **same-client Revenue** decreased slightly less than 2% at constant currency, despite higher adoption of our new products, driven by the slight decline in retargeting because of continued softness in the Web. Same-client Revenue **ex-TAC** decreased slightly less than 3% at constant currency.

Turning to the **regional performance**.

- In **the Americas**, Revenue ex-TAC declined about 3% at constant currency, including **-2% in the U.S.** On a Revenue basis, Americas actually grew **+1%** at constant currency, driven by the continued progress of Retail Media and our growing midmarket revenue, offset by limited softness in our large client business.
- **EMEA** Revenue ex-TAC growth turned positive, improving by 6 points from Q1 and reaching 4% at constant currency. This was driven by double-digit growth in midmarket and high double- or triple-digit growth in new solutions, as well as the anniversary of GDPR.

- And, in **APAC**, Revenue ex-TAC declined less than 2% at constant currency, as slower business with large clients in Japan and South-East Asia offset double digit growth in midmarket and continued positive momentum in Korea.

Shifting to **expenses. Other cost of revenue** decreased 3%, driven by a change in our server amortization period, savings in power consumption in our data centers and lower expenses for third-party data. Offsetting this were increased hosting costs and the provision for the French digital tax on Revenue. We now anticipate that the digital tax in Italy and Spain will not apply before 2020, representing a favorable variance of approximately $2 million on a full year basis compared to prior expectations. On a Non-GAAP basis, other cost of revenue increased 22%.

GAAP Operating expenses are flat year-over-year, with higher headcount costs fully offsetting a lower equity awards compensation expense due to the lower stock price over the period. In connection with our company transformation, we incurred restructuring costs of $0.7 million, including $2 million related to cash payroll and facilities expenses that were added back to Adjusted EBITDA, and $1 million of facilities-related depreciation and amortization expense, partially offset by non-cash forfeitures of equity awards. We anticipate this restructuring to generate savings of about $6 million on an annualized cash expense basis.

Headcount-related expenses represented 72% of GAAP opex, down about 300 basis points compared to Q2 last year. We ended the quarter with close to 2,900 employees – an increase of 7% year-over-year, thanks to stronger hiring and continued decrease in employee attrition.

On a Non-GAAP basis, opex grew 2% to $149 million. Looking at these by function:

- **R&D** decreased 6%, largely driven by an increase in our Research Tax Credit, despite a 6% growth in headcount to over 720 R&D and Product engineers.
- **Sales & Operations** increased 7%, driven by a 7% increase in headcount to 1,640 and a $5 million exceptional charge related to an invoicing dispute. Excluding this exceptional charge, Sales & Operations were flat. Sales and account strategists, our so called quota-carrying employees, grew 5% to over 740.
- And **G&A** was flat, largely driven by severance charges that were incurred in Q2 last year, and despite a 10% increase in headcount to 515 employees, including headcount transfers from other functions.

As indicated last quarter, we are effectively managing the cost base and expect Non-GAAP expenses for the remainder of 2019 to **grow slower** than originally planned across all functions.

On the **profitability** side, **Adjusted EBITDA** was over $56 million, 7% above the high end of our guidance at comparable FX, and 16% below Q2 2018 at constant currency. This drove our Adjusted EBITDA margin to 25% of Revenue ex-TAC, down 470 basis points. As you may recall, Adjusted EBITDA was particularly high in Q2 last year as we were significantly behind our hiring plan at that time. Excluding the $5M exceptional charge mentioned earlier, Adjusted EBITDA was $62 million, 17% above the high end of guidance, and driving a margin of 28% of Revenue ex-TAC, down only 230 basis points year-over-year.

Depreciation and amortization expenses decreased 10%, mainly driven by the change in the useful life of our servers from 3 to 5 years, representing approximately $10 million.

Equity awards compensation expense decreased 29% due to the lower stock price and equity forfeitures over the period.
Financial expense increased 35%, due to the impact of forex changes on our hedging positions. And, our effective **tax rate** was 31%, in line with our projected tax rate of 30% for 2019. In Q2 2018, the effective tax rate was 37%, translating into a 34% decrease in the provision for income taxes year over year. The difference between the annual estimated tax rate and the effective tax rate relates to the tax impact of discrete items such as share-based compensation in the United States. Discrete items were immaterial as of Q2 2018 resulting in no difference between the annual estimated tax rate and the effective tax rate.

Net income decreased 15% to $13 million, driven by a 20% decrease in Income from Operations and higher financial expense, despite the lower tax expense. On a Non-GAAP basis, **earnings per diluted share** were 47 cents.

Cash flow from operations increased 31% to $53 million, largely driven by positive changes in working capital and lower taxes paid. Our transformation of Adjusted EBITDA into operating cash flow remained very strong at 94%. **Capex** increased 84% to $33 million, representing 6% of revenue, but only grew 12% on a year-to-date basis, reflecting a catch-up from Q1 in Q2. As a

result, **Free Cash Flow** decreased 10% to $20 million, reaching 36% of Adjusted EBITDA, up from 33% in Q2 2018.
And, **cash** and cash equivalents increased $58 million in the first half to $422 million.

With respect to **capital allocation**, our last shareholder meeting provided us, as requested, with increased flexibility around share buy backs. I am therefore pleased to confirm that our Board of directors has authorized a **new $80 million buyback program**. We intend to execute the program over the next several quarters.

I will now provide our **guidance** for the third quarter and fiscal year 2019. The following forward-looking statements reflect our expectations as of today, July 31, 2019.

For Q3, we expect Revenue ex-TAC **between $219 million and $223 million**. This implies constant currency growth of approximately -2% to 0%. We expect year-over-year forex changes to be neutral to reported growth.
For the full year 2019, we **maintain our expectation to grow Revenue ex-TAC between 0% and +2% at constant currency**. Using current forex assumptions, this means Revenue ex-TAC of about $947 million to $967 million. Compared to 2018, we expect forex changes to negatively impact reported numbers by about $19 million or 190 basis points of growth.

We expect Q3 2019 Adjusted EBITDA **between $57 million and $61 million**.
As for 2019, we **maintain** our expectation of an Adjusted EBITDA margin of **approximately 30% of Revenue ex-TAC**, demonstrating our commitment to profitability. As indicated last quarter, we continue to focus on **effectively managing the cost base** to ensure we deliver on our profitability goals for 2019 and beyond.

As usual, the FX assumptions supporting our guidance for the quarter and the year are included in our earnings release.

In closing, we feel good about **our strategic direction**, remain **focused on execution** and are committed to leveraging our effective financial model to **deliver healthy profitability** over time.

With that, we will now take your questions.

[…Q&A…]

<u>Edouard Lassalle</u> <u>– VP, IR</u>

Thank you, JB and Benoit. This concludes today's call. We thank everyone for attending. The IR team is available for any follow-up. Good bye everyone and enjoy the rest of your day.