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SONOS

Second Quarter Fiscal 2021
Prepared Conference Call Remarks and Q&A Session
May 12, 2021 - 5:00 pm Eastern

Cammeron McLaughlin - VP, Investor Relations

Good afternoon and welcome to Sonos' second quarter fiscal 2021 earnings conference call. I am Cammeron McLaughlin, and with me today are Sonos' CEO, Patrick Spence, Brittany Bagley, CFO and Eddie Lazarus, Chief Legal Officer. For those who joined the call early, today's hold music included highlights from the recently launched artist curated stations by M.I.A and Ghostface Killah on Sonos Radio HD.

Before I hand it over to Patrick, I would like to remind everyone that today's discussion will include forward-looking statements regarding future events and our future financial performance. These statements reflect our views as of today only and should not be considered as representing our views of any subsequent date. These statements are also subject to material risks and uncertainties that could cause actual results to differ materially from expectations reflected in the forward-looking statements. A discussion of these risk factors is fully detailed under the caption “Risk Factors” in our filings with the SEC. During this call, we will also refer to certain non-GAAP financial measures. For information regarding our non-GAAP financials and a reconciliation of GAAP to non-GAAP measures, please refer to today's press release regarding our second quarter results posted to the Investor Relations portion of our website. As a reminder, the press release, supplemental earnings presentation, and conference call transcript will be available on our investor relations website, investors.sonos.com.

I will now turn the call over to Patrick.

Patrick Spence, Chief Executive Officer

Thank you, Cammeron.

We are thrilled to yet again report a record quarter at Sonos. I first want to recognize the fantastic work by our people and our partners during this challenging time. These results are a testament to all of the hard work they put in every day, and I am so proud and grateful.

Our second quarter results exceeded our expectations as we experienced even stronger-than-expected demand for all of our products and our team did an incredible job meeting as much demand as they could in the quarter. As a result of our strong second quarter performance we are increasing our revenue and adjusted EBITDA outlook for the year.

Our strong results are a testament to the fact we have a unique model that serves customers and enables us to continue building a sustainable, profitable business. The power of our business model is that customers can start with one product and expand to more over time, and our customers have proven they do just that.

We are experiencing tremendous demand for our newest product, Roam, from new and existing customers alike. Roam is not only our smartest and most versatile speaker, it's also our most affordable. Roam provides the opportunity for millions of new customers to get started with Sonos, and is the right product at the right time as the weather warms up and we begin to gather again with friends and family.

During the pre-order period, Roam far exceeded our expectations with sales reaching over 150% of our pre-order forecast in our DTC channel. Several hundred journalist reviews have been published globally highlighting the product's incredible sound and ultra portability, with Rolling Stone calling it "the new standard for portable smart speakers. We are confident that we have delivered another fantastic product that customers love and helps the Sonos flywheel.

As we look toward the remainder of fiscal 2021 and beyond, there are three macro trends that will fuel our continued growth.

First, this is the Golden Age of Audio. The sheer volume of music, audiobooks, and podcasts we have access to now is incredible. As more and more people become creators, we believe we will spend even more time with audio, and find interesting new audio formats like social audio.

The second trend is that we are seeing more and more video content going direct-to-home. We have seen a decade of change in the past year, with companies like Disney and HBO bringing the newest movies right into our homes. It's not enough to have a great visual experience - customers are demanding a theater-like audio experience in the home, and that is something we deliver better than anyone.

And the third trend fueling our growth is, “The Great Reshuffling”. This is the untethering of people from their commutes and offices which has enabled people to reevaluate how and where they want to live. Given more and more companies are offering their people - especially the kind of people who are in our target market - the flexibility to work anywhere, we think this will be a multi-year cultural trend that benefits Sonos significantly.

As we look toward our opportunity ahead, we believe that Sonos is just getting started and has barely scratched the surface of our large and growing addressable market.

As of the end of fiscal 2020, we were in 11 million homes, or approximately 9% of the 116 million affluent homes we believe are most addressable for us today in our existing markets. We have a tremendous runway to add tens of millions more households to the Sonos ecosystem.

On the revenue side, based on our upwardly revised fiscal 2021 revenue outlook, Sonos will only account for approximately 9% of the total spend in the $18 billion premium home audio market, and an even smaller fraction of the broader $89 billion global audio market we expect to expand into over the long-term.

We’ve come a long way, but we have a ton of opportunity to take a lot more of the home audio market, and even more as we begin to expand into the broader audio market. This is a huge, and growing market.

We will seize this significant opportunity ahead by focusing on three key strategic initiatives.

First, the expansion of our brand - this is all about understanding our customers better than anyone and how we’re evolving our brand and marketing strategies to reach more of those customers. Moving forward, you’ll see us continue to partner with other premium brands as we invite a broader swath of consumers into the Sonos experience.

To support the launch of Roam for example, we have partnered with The North Face. Together, we’ll showcase Roam’s durability, portability and of course sound quality.   More on that in a few months.

Second, the expansion of our offerings - we have a tremendous opportunity ahead just in the categories we play in today, but we have ambitious plans to expand into new categories, to expand into new customer segments, and to layer services on top of everything we do.

We remain focused on our efforts to introduce at least two new products each year and have already exceeded this target for fiscal 2021. Thus far, we have introduced Sonos Radio HD, Roam, and taken our first step into auto with our partnership with Audi. And we’re not done. Some of you may have seen recent social media posts from IKEA and Sonos. We are excited about the products we're working on together and are looking forward to sharing more in the near future. Our long-term product roadmap remains robust and we are excited to unveil what comes next over time.

As it relates to services, we continue to be pleased with our early success with Sonos Radio and Radio HD. Sonos Radio remains the third most listened to music service on our platform, and we remain focused on our long-term aspirations to reach over 500,000 subscribers to Radio HD. We see significant opportunities in services over the long-term.

Third, driving operational excellence to achieve sustainable, profitable growth for the long term. You are seeing us continue to execute ahead of our plan and deliver margin expansion and healthy top-line growth.

In conclusion, I've never been more excited about our future at Sonos. We continue to see strong demand and we are in the best position we have ever been. We have a huge opportunity in front of us and we are just getting started.

Now I'll turn the call over to Eddie to provide a brief update on our Google litigation.

Eddie Lazarus, Chief Legal Officer

Thanks Patrick. Let me provide a brief update on our case against Google.

As background, and as I shared at our investor event in March, we estimate that Google infringes over 150 U.S. utility patents from 30 different patent families. All of those patent families are still alive and we continue to obtain high-value patents from them. We included 5 patents in our action against Google at the International Trade Commission. That's basically the limit of what you can fit in one case. Those patents were directed to grouping and synchronizing playback amongst smart devices, volume control for a group and individual devices, stereo pairing, and setup.

We just recently finished trial in the ITC and remain confident in the strength of our case. We had expected a preliminary decision on May 11, however, as those of you following the case know, the presiding judge extended the timeline for decision to August 13th of this year due to his increased workload as he assumed the cases of another judge who recently retired.

We look forward to that decision, but in the meantime we are very pleased to share an update regarding another matter with Google. We are pleased to report that a court in Germany has just granted a preliminary injunction against a European Google affiliate for infringing a Sonos patent that enables and controls the transfer of media content from a mobile phone or tablet to one or more playback devices. The order prohibits the offer or sale in Germany of Google's Cast technology, some aspects of which implicate the Sonos patent at issue, and encompasses such products as the Pixel 4a smartphone, Nest Audio speakers, and the

YouTube Music app. We see the ruling as a powerful demonstration of the strength of Sonos' patent portfolio and our conviction that Google is a widespread infringer of our IP.

Let me now turn the call over to Brittany to provide more details on our results and our outlook.

Brittany Bagley, Chief Financial Officer

Thank you, Eddie.

We are excited to report another quarter of stellar results, further solidifying our ability to deliver a record year. The strong demand for our products, and the fact that our customers have proven they will wait as we work to supply their orders, further demonstrates the power of our offering and brand.

Let me add some color to our results starting with the second quarter:

We delivered adjusted EBITDA of $48.5 million compared to a loss of $28.4 million last year. Our adjusted EBITDA margin expanded to 14.6% during the quarter. We were able to deliver this tremendous result due to exceptionally strong gross margins, top-line growth and ongoing operating expense leverage. This is also the first Q2 in our history where we have been net income positive, and we are pleased to see more consistent profitability across our quarters.

Revenue in the quarter increased 90%, to nearly $333 million. This anniversaried the 17% year-over-year revenue decline in the prior year quarter, which stemmed from partner inventory rebalancing and retail store closures at the start of the COVID-19 pandemic. The outperformance vs. expectations was largely a result of our ability to fulfill more demand. This was driven by ongoing supply chain capacity investments as well as improved shipping and logistics processes. Even with the improved supply position in the quarter, we continue to be out of stock on a number of our products which further points to the strong demand we are seeing.

The Americas grew 90% and EMEA grew 100%, or 83% on a constant currency basis. APAC grew 56%. The Americas and EMEA both continued to see incredibly strong demand across our products. APAC grew slightly less quickly than our other regions given the softness in IKEA. IKEA continues to be impacted by store closures and a transition in our product cycle. As Patrick has mentioned, we are working on a new product release with them, which we will share more details on in the near future.

Sonos Speaker revenue was up 130% year-over-year driven in part by comping the 27% decline in Q2 last year, and particularly helped by the continued success of Arc and Sub. Sonos System Products revenue increased 10%, comping 22% growth last year, and driven by the continued strength of our installer channel and component products. Partner products and other revenue increased 16%, driven by accessories and Sonance, offset by lower IKEA revenue.

Gross margins were incredibly strong in the quarter and reached a record 49.8%, an improvement of 810 basis points vs. last year, of which 300 basis points is due to lower tariff expense. We had approximately $2 million of net tariff expense impacting gross profit during the second quarter.

Excluding tariffs, the 510 bps of gross margin improvement was primarily due to comping our "At Home With Sonos" promotion last year, as well as a shift into higher margin products and channels, and fixed cost leverage on the higher Q2 sales volume. This gross margin expansion comes even with an increase in component costs as well as ongoing higher industry wide shipping and logistics costs.

Turning to operating expenses, we saw significant leverage during the second quarter, largely due to the benefit of higher second quarter revenue. We experienced year-over-year increases in all opex lines as a result of increasing investment to support our higher top-line growth, this year and into the future. We also have higher incentive compensation assumptions given our increased outlook.

During the second quarter, we used $39 million in cash from operations and had negative free cash flow of $47 million, largely due to the timing of working capital and accrued expenses driven by seasonality. We are ending the quarter with $639 million in cash and cash equivalents which puts us in a strong position to invest organically in our business, pursue M&A, and return capital to shareholders through our authorized share repurchase. We currently have no debt on our balance sheet as we paid down our outstanding $25 million of debt in January.

Overall we believe Q2 demonstrates a really impressive quarter for the company and helps us deliver on a strong fiscal 2021.

Now turning to our outlook.

Despite our outperformance in Q2, as I'm sure you're largely aware, the global supply situation has only gotten more challenging as we look towards the second half of the year. We, and others across the industry, are seeing significant increases in constraints on a variety of components. Our team continues to work tirelessly to mitigate as much as we can to deliver on the incredible demand. We appreciate that our customers have proven that they will wait for our products, which is continuing to help us navigate through this challenge and deliver tremendous results.

Obviously this has been a difficult year to forecast. We remain aware of the continued uncertainty in the broader macro environment but feel confident in our fiscal 2021 outlook given our strong first half performance and the continued strong demand for our products as we enter the remainder of the year. We are providing the best update we can given what we see from a demand perspective, and what we currently know about the global supply chain.

With those considerations in mind, we are increasing our adjusted EBITDA to $225 million to $250 million, up from our prior outlook of $195 million to $225 million and well ahead of our initial fiscal 2021 guidance of $170 million to $205 million. This new outlook represents 13.8% to 14.9% adjusted EBITDA margins. This is an expansion of 560 to 670 basis points from the prior year.

We are maintaining our gross margin outlook of 46.0% to 46.5% because we expect increasing costs of components, the need for additional air freight to mitigate the impact of the industry-wide supply shortages, and a smaller benefit from product mix. We continue to have $27.5 million of tariff refunds we expect to receive. However, as a reminder, given the timing is uncertain, this is not included in our outlook and will be recognized only upon acceptance of the refund requests. We will continue to call out this impact each quarter for transparency.

As we stated last quarter, we expect to continue making additional opex investments in our product, marketing,and operations to support the higher revenue volumes and long-term growth initiatives. We also expect higher incentive compensation to support the increased top-line growth and profitability, while delivering on attractive opex leverage for the year.

We are increasing our total revenue for fiscal 2021 to $1.625 billion to $1.675 billion, representing growth of 23% to 26%. Excluding the 53rd week from fiscal 2020, this represents growth of 25% to 29% for the year. This compares to our prior outlook of $1.525 billion to $1.575 billion provided last quarter and our initial fiscal 2021 revenue guidance of $1.44 billion to $1.5 billion provided at the start of the year.

Even as the world begins to open up again, the demand for our products has never been stronger. We're incredibly pleased with what we have been able to deliver in Q2. We are focused on continued execution to deliver on our increased fiscal 2021 outlook, which is significantly higher than what we set out to deliver at the start of the year. As a reminder we have a tremendous opportunity ahead of us. There is a clear path to achieving our fiscal 2024 targets of $2.25 billion in revenue, 45% to 47% sustainable gross margins, and 15% to 18% adjusted EBITDA margins.

With that I would like to turn the call over to questions.