

Pandora Media, Inc.
Form 10-Q
November 27, 2013
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

- x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended October 31, 2013

or

- o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from to

Commission File Number: 001-35198

Pandora Media, Inc.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of
incorporation or organization)

94-3352630

(I.R.S. Employer
Identification No.)

2101 Webster Street, Suite 1650

Oakland, CA

(Address of principal executive offices)

94612

(Zip Code)

(510) 451-4100

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted to its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer
(Do not check if a smaller reporting company)

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

The number of shares of registrant's common stock outstanding as of November 21, 2013 was: 194,254,664.

Table of Contents

Pandora Media, Inc.

FORM 10-Q Quarterly Report

Table of Contents

	Page No.
<u>PART I. FINANCIAL INFORMATION</u>	
<u>Item 1. Financial Statements</u>	3
<u>Condensed Consolidated Balance Sheets as of January 31, 2013 and October 31, 2013 (unaudited)</u>	3
<u>Condensed Consolidated Statements of Operations for the Three and Nine Months Ended October 31, 2012 and 2013 (unaudited)</u>	4
<u>Condensed Consolidated Statements of Comprehensive Income (Loss) for the Three and Nine Months Ended October 31, 2012 and 2013 (unaudited)</u>	5
<u>Condensed Consolidated Statements of Cash Flows for the Nine Months Ended October 31, 2012 and 2013 (unaudited)</u>	6
<u>Notes to Condensed Consolidated Financial Statements (unaudited)</u>	7
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	20
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	36
<u>Item 4. Controls and Procedures</u>	36
<u>PART II. OTHER INFORMATION</u>	
<u>Item 1. Legal Proceedings</u>	37
<u>Item 1A. Risk Factors</u>	37
<u>Item 6. Exhibits</u>	62
<u>Signatures</u>	63

Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****Pandora Media, Inc.****Condensed Consolidated Balance Sheets****(In thousands, except share and per share amounts)****(Unaudited)**

	As of January 31, 2013	As of October 31, 2013
Assets		
Current assets:		
Cash and cash equivalents	\$ 65,725	\$ 442,380
Short-term investments	23,247	5,449
Accounts receivable, net of allowance of \$761 at January 31, 2013 and \$1,285 at October 31, 2013	103,410	141,796
Prepaid expenses and other current assets	6,232	10,240
Total current assets	198,614	599,865
Property and equipment, net	17,758	27,768
Other long-term assets	2,460	10,053
Total assets	\$ 218,832	\$ 637,686
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	\$ 4,471	\$ 7,526
Accrued liabilities	7,590	16,747
Accrued royalties	53,083	58,499
Deferred revenue	29,266	43,088
Accrued compensation	21,560	18,037
Total current liabilities	115,970	143,897
Other long-term liabilities	3,873	8,239
Total liabilities	119,843	152,136
Stockholders' equity:		
Common stock, \$0.0001 par value, 1,000,000,000 shares authorized: 172,506,051 shares issued and outstanding at January 31, 2013 and 194,067,320 at October 31, 2013	17	19
Additional paid-in capital	238,552	663,212
Accumulated deficit	(139,574)	(177,648)
Accumulated other comprehensive loss	(6)	(33)
Total stockholders' equity	98,989	485,550
Total liabilities and stockholders' equity	\$ 218,832	\$ 637,686

The accompanying notes are an integral part of the condensed consolidated financial statements.

Table of Contents**Pandora Media, Inc.****Condensed Consolidated Statements of Operations****(In thousands, except per share amounts)****(Unaudited)**

	Three months ended October 31,		Nine months ended October 31,	
	2012	2013	2012	2013
Revenue				
Advertising	\$ 106,258	\$ 144,346	\$ 266,239	\$ 378,012
Subscription services and other	13,747	36,030	35,817	85,229
Total revenue	120,005	180,376	302,056	463,241
Costs and expenses				
Cost of revenue - Content acquisition costs	65,713	86,989	182,053	251,722
Cost of revenue - Other	8,338	12,423	22,769	33,239
Product development	4,371	8,848	12,965	23,807
Sales and marketing	26,714	50,575	73,631	136,452
General and administrative	12,700	23,038	33,914	55,599
Total costs and expenses	117,836	181,873	325,332	500,819
Income (loss) from operations	2,169	(1,497)	(23,276)	(37,578)
Other income (expense)				
Interest income	19	5	76	30
Interest expense	(137)	(167)	(397)	(460)
Other income (expense), net	1	(21)	1	(16)
Income (loss) before provision for income taxes	2,052	(1,680)	(23,596)	(38,024)
Income tax benefit (expense)		(20)	5	(50)
Net income (loss)	\$ 2,052	\$ (1,700)	\$ (23,591)	\$ (38,074)
Basic net income (loss) per share	\$ 0.01	\$ (0.01)	\$ (0.14)	\$ (0.21)
Weighted-average shares used in computing basic per share amounts	169,391	184,676	167,423	177,913
Diluted net income (loss) per share	\$ 0.01	\$ (0.01)	\$ (0.14)	\$ (0.21)
Weighted-average shares used in computing diluted per share amounts	190,278	184,676	167,423	177,913

The accompanying notes are an integral part of the condensed consolidated financial statements.

Table of Contents

Pandora Media, Inc.

Condensed Consolidated Statements of Comprehensive Income (Loss)

(In thousands)

(Unaudited)

	Three months ended October 31,		Nine months ended October 31,	
	2012	2013	2012	2013
Net income (loss)	\$ 2,052	\$ (1,700)	\$ (23,591)	\$ (38,074)
Change in foreign currency translation adjustment	(1)	20	(1)	(30)
Change in net unrealized losses on marketable securities	(2)		1	3
Other comprehensive income (loss)	(3)	20		(27)
Total comprehensive income (loss)	\$ 2,049	\$ (1,680)	\$ (23,591)	\$ (38,101)

The accompanying notes are an integral part of the condensed consolidated financial statements.

Table of Contents**Pandora Media, Inc.****Condensed Consolidated Statements of Cash Flows****(In thousands)****(Unaudited)**

	Nine months ended October 31,	
	2012	2013
Operating activities		
Net loss	\$ (23,591)	\$ (38,074)
Adjustments to reconcile net loss to net cash used in operating activities		
Depreciation and amortization	5,147	8,171
Loss on disposition of assets	23	
Stock-based compensation	18,610	30,570
Amortization of premium on investments	279	57
Amortization of debt issuance costs	198	187
Changes in assets and liabilities		
Accounts receivable	(31,126)	(38,386)
Prepaid expenses and other assets	(2,036)	(4,715)
Accounts payable and accrued liabilities	4,532	13,909
Accrued royalties	10,608	5,416
Accrued compensation	(243)	(3,319)
Deferred revenue	7,744	13,822
Reimbursement of cost of leasehold improvements	1,243	1,555
Net cash used in operating activities	(8,612)	(10,807)
Investing activities		
Purchases of property and equipment	(5,981)	(14,891)
Purchases of patents		(8,000)
Purchases of short-term investments	(50,124)	(20,426)
Proceeds from maturities of short-term investments	73,460	38,160
Payments related to acquisition		(400)
Net cash provided by (used in) investing activities	17,355	(5,557)
Financing activities		
Borrowings under debt arrangements		10,000
Repayments of debt		(10,000)
Proceeds from follow-on offering, net of issuance costs		379,088
Proceeds from issuance of common stock	5,065	14,884
Tax withholdings related to net share settlements of restricted stock units	(208)	(480)
Payment of debt issuance costs in connection with the debt refinancing		(450)
Net cash provided by financing activities	4,857	393,042
Effect of exchange rate changes on cash and cash equivalents	(1)	(23)
Net increase in cash and cash equivalents	13,599	376,655
Cash and cash equivalents at beginning of period	44,126	65,725
Cash and cash equivalents at end of period	\$ 57,725	\$ 442,380

The accompanying notes are an integral part of the condensed consolidated financial statements.

Table of Contents

Pandora Media, Inc.

Notes to Condensed Consolidated Financial Statements

1. Description of Business and Basis of Presentation

Pandora Media, Inc. provides an internet radio service offering a personalized experience for each listener wherever and whenever they want to listen to radio on a wide range of smartphones, tablets, traditional computers and car audio systems, as well as a range of other internet-connected devices. We have pioneered a new form of radio one that uses intrinsic qualities of music to initially create stations and then adapts playlists in real-time based on the individual feedback of each listener. We offer local and national advertisers an opportunity to deliver targeted messages to our listeners using a combination of audio, display and video advertisements. We also offer a paid subscription service which we call Pandora One. We were incorporated as a California corporation in January 2000 and reincorporated as a Delaware corporation in December 2010.

As used herein, Pandora, we, our, the Company and similar terms include Pandora Media, Inc. and its subsidiaries, unless the context indicates otherwise.

Basis of Presentation

The interim unaudited condensed consolidated financial statements and accompanying notes have been prepared in accordance with United States generally accepted accounting principles (U.S. GAAP) and include the accounts of Pandora and our wholly-owned subsidiaries. All intercompany balances and transactions have been eliminated in consolidation. In the opinion of our management, the interim unaudited condensed consolidated financial statements include all adjustments, which include only normal recurring adjustments, necessary for the fair presentation of our financial position for the periods presented. These interim unaudited condensed consolidated financial statements are not necessarily indicative of the results expected for the full fiscal year or for any subsequent period and should be read in conjunction with the audited consolidated financial statements and related notes included in our Annual Report on Form 10-K for the fiscal year ended January 31, 2013.

Follow-on Public Offering

In September 2013, we completed a follow-on public offering in which we sold an aggregate of 15,730,000 shares of our common stock, inclusive of 2,730,000 shares sold pursuant to the exercise by the underwriters of an option to purchase additional shares, at a public offering price of \$25.00 per share. In addition, another 5,200,000 shares were sold by certain selling stockholders. We received aggregate net proceeds of \$379.1 million, after deducting underwriting discounts and commissions and offering expenses from sales of our shares in the offering. We did not receive any of the proceeds from the sales of shares by the selling stockholders.

Use of Estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make certain estimates, judgments and assumptions that affect the reported amounts of assets and liabilities and the related disclosures at the date of the financial statements, as well as the reported amounts of revenue and expenses during the periods presented. Estimates are used for determining accrued royalties, selling prices for elements sold in multiple-element arrangements, the allowance for doubtful accounts, stock-based compensation and income taxes. To the extent there are material differences between these estimates, judgments, or assumptions and actual results, our financial statements could be affected. In many cases, the accounting treatment of a particular transaction is specifically dictated by U.S. GAAP and does not require management's judgment in its application. There are also areas in which management's judgment in selecting among available alternatives would not produce a materially different result.

Table of Contents

Fiscal Year

All references herein to a fiscal year refer to the twelve months ended January 31 of such year, and references to the first, second, third and fourth fiscal quarters refer to the three months ended April 30, July 31, October 31 and January 31, respectively.

We have announced that we will convert our fiscal year to the calendar twelve months ending December 31 to align with the advertising industry's business cycle, effective beginning with the year ending December 31, 2013. As a result, our current fiscal year will be shortened from twelve months to an eleven month transition period that will end on December 31, 2013. As such, we are reporting our third fiscal quarter as the three months ending October 31, 2013, followed by a two month transition period ending December 31, 2013.

Table of Contents

Pandora Media, Inc.

Notes to Condensed Consolidated Financial Statements - Continued

2. Summary of Significant Accounting Policies

There have been no material changes to our significant accounting policies as compared to those described in our Annual Report on Form 10-K for the fiscal year ended January 31, 2013.

Concentration of Credit Risk

For the three and nine months ended October 31, 2012 and 2013, we had no customers that accounted for more than 10% of our total revenue.

As of January 31 and October 31, 2013, we had no customers that accounted for more than 10% of our total accounts receivable.

Recently Issued Accounting Standards

In July 2013, the FASB issued an update to provide guidance on the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward exists. The guidance requires an entity to present an unrecognized tax benefit in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, except for when a net operating loss carryforward is not available as of the reporting date to settle taxes that would result from the disallowance of the tax position or when the entity does not intend to use the deferred tax asset for purposes of reducing the net operating loss carryforward. The guidance is effective for fiscal years beginning after December 15, 2013 and for interim periods within that fiscal year. We do not expect the adoption of this guidance to have a material effect on the consolidated balance sheets.

Table of Contents**Pandora Media, Inc.****Notes to Condensed Consolidated Financial Statements - Continued****3. Cash, Cash Equivalents and Short-term Investments**

Cash, cash equivalents and short-term investments consisted of the following:

	As of January 31, 2013	As of October 31, 2013
	(in thousands)	
Cash and cash equivalents:		
Cash	\$ 22,703	\$ 414,912
Money market funds	32,522	27,468
Commercial paper	10,500	
Corporate debt securities		
Total cash and cash equivalents	\$ 65,725	\$ 442,380
Short-term investments:		
Commercial paper	\$ 13,592	\$ 4,749
Corporate debt securities	9,655	700
Total short-term investments	\$ 23,247	\$ 5,449
Cash, cash equivalents and short-term investments	\$ 88,972	\$ 447,829

Our short-term investments have maturities of less than twelve months and are classified as available-for-sale.

The following tables summarize our available-for-sale securities' adjusted cost, gross unrealized gains, gross unrealized losses and fair value by significant investment category as of January 31 and October 31, 2013.

	As of January 31, 2013 (in thousands)			
	Adjusted Cost	Unrealized Gains	Unrealized Losses	Fair Value
Money market funds	\$ 32,522	\$	\$	\$ 32,522
Commercial paper	24,093		(1)	24,092
Corporate debt securities	9,657		(2)	9,655
Total cash equivalents and marketable securities	\$ 66,272	\$	\$ (3)	\$ 66,269

Edgar Filing: Pandora Media, Inc. - Form 10-Q

	As of October 31, 2013 (in thousands)			
	Adjusted Cost	Unrealized Gains	Unrealized Losses	Fair Value
Money market funds	\$ 27,468	\$	\$	\$ 27,468
Commercial paper	4,749			4,749
Corporate debt securities	700			700
Total cash equivalents and marketable securities	\$ 32,917	\$	\$	\$ 32,917

Table of Contents

Our investment policy requires investments to be investment grade, primarily rated A1 by Standard & Poor's or P1 by Moody's or better for short-term investments, with the objective of minimizing the potential risk of principal loss. In addition, the investment policy limits the amount of credit exposure to any one issuer.

The unrealized losses on our available-for-sale securities as of January 31, 2013 were primarily a result of unfavorable changes in interest rates subsequent to the initial purchase of these securities. As of October 31, 2013, we did not own any securities that were in an unrealized loss position. During the three and nine months ended October 31, 2013, we did not recognize any impairment charges.

Table of Contents

Pandora Media, Inc.

Notes to Condensed Consolidated Financial Statements - Continued

4. Fair Value

We record cash equivalents and short-term investments at fair value. Fair value is an exit price, representing the amount that would be received from the sale of an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. Fair value measurements are required to be disclosed by level within the following fair value hierarchy:

Level 1 Inputs are unadjusted, quoted prices in active markets for identical assets or liabilities at the measurement date.

Level 2 Inputs (other than quoted prices included in Level 1) are either directly or indirectly observable for the asset or liability through correlation with market data at the measurement date and for the duration of the instrument's anticipated life.

Level 3 Inputs lack observable market data to corroborate management's estimate of what market participants would use in pricing the asset or liability at the measurement date. Consideration is given to the risk inherent in the valuation technique and the risk inherent in the inputs to the model. As of January 31 and October 31, 2013 we did not hold any Level 3 assets.

When determining fair value, whenever possible we use observable market data and rely on unobservable inputs only when observable market data is not available.

The fair value of these financial assets and liabilities was determined using the following inputs at January 31 and October 31, 2013:

	Quoted Prices in Active Markets for Identical Instruments (Level 1)	Fair Value Measurement Using Significant Other Observable Inputs (Level 2) (in thousands)	Total
Fair values as of January 31, 2013			
Assets:			

Edgar Filing: Pandora Media, Inc. - Form 10-Q

Money market funds	\$	32,522	\$	\$	32,522
Commercial paper				24,092	24,092
Corporate debt securities				9,655	9,655
Total assets measured at fair value	\$	32,522	\$	33,747	\$ 66,269
Fair values as of October 31, 2013					
Assets:					
Money market funds	\$	27,468	\$	\$	27,468
Commercial paper				4,749	4,749
Corporate debt securities				700	700
Total assets measured at fair value	\$	27,468	\$	5,449	\$ 32,917

Our money market funds are classified as Level 1 within the fair value hierarchy because they are valued primarily using quoted market prices. Our other cash equivalents and short-term investments are classified as Level 2 within the fair value hierarchy because they are valued using professional pricing sources for identical or comparable instruments, rather than direct observations of quoted prices in active markets.

Table of Contents

Pandora Media, Inc.

Notes to Condensed Consolidated Financial Statements - Continued

5. Commitments and Contingencies

Legal Proceedings

We have been in the past, and continue to be, a party to privacy and patent infringement litigation which has consumed, and may continue to consume, financial and managerial resources. We are also from time to time subject to various other legal proceedings and claims arising in the ordinary course of our business. We record a liability when we believe that it is both probable that a loss has been incurred and the amount can be reasonably estimated. Our management periodically evaluates developments that could affect the amount, if any, of liability that we have previously accrued and make adjustments as appropriate. Determining both the likelihood and the estimated amount of a loss requires significant judgment, and management's judgment may be incorrect. We do not believe the ultimate resolution of any pending legal matters is likely to have a material adverse effect on our business, financial position, results of operations or cash flows.

In June 2011, a putative class action lawsuit was filed against Pandora in the United States District Court for the Northern District of California alleging that we unlawfully accessed and transmitted personally identifiable information of the plaintiffs in connection with their use of our Android mobile application. In addition to civil liability, the amended complaint includes allegations of violations of statutes under which criminal penalties could be imposed if we were found liable. Our motion to dismiss the first amended complaint was granted on March 26, 2013. The court allowed the plaintiff to amend his complaint. The second amended complaint, filed May 9, 2013, contains allegations similar to those contained in the previous complaint. Our motion to dismiss the second amended complaint was filed May 30, 2013. The court has not yet ruled on the motion.

In September 2011, a putative class action lawsuit was filed against Pandora in the United States District Court for the Northern District of California alleging that we violated Michigan's video rental privacy law and consumer protection statute by allowing our listeners' listening history to be visible to the public. Our motion to dismiss the complaint was granted on September 28, 2012, judgment was entered on November 14, 2012. The plaintiff appealed the judgment to the U.S. Court of Appeals for the Ninth Circuit. Briefing of the appeal was completed on August 2, 2013. No date has been set for oral argument.

On September 10, 2012, B.E. Technology, LLC filed suit against Pandora in the United States District Court for the Western District of Tennessee alleging that we infringe a B.E. Technology patent and seeking injunctive relief and monetary damages. We filed our answer on December 31, 2012. The parties are engaged in the initial stage of pretrial discovery.

On November 26, 2012, 1st Technology LLC filed suit against Pandora in the U.S. District Court for the Northern District of Illinois alleging patent infringement. The complaint seeks injunctive relief and monetary damages. On November 20, 2013, the parties negotiated mutually acceptable terms of a settlement of the case. On November 21, 2013, the court dismissed the complaint with prejudice, granting the plaintiff

Edgar Filing: Pandora Media, Inc. - Form 10-Q

leave to refile if a written settlement agreement is not signed.

On February 26, 2013, Macrosolve, Inc. filed suit against Pandora in the U.S. District Court for the Eastern District of Texas alleging that we infringe a Macrosolve, Inc. patent and seeks injunctive relief and monetary damages. Our answer and counterclaims were filed on April 22, 2013. The parties are engaged in pretrial discovery.

We currently believe that we have substantial and meritorious defenses to the claims in the lawsuits discussed above and intend to vigorously defend our position.

We are also subject to legal proceedings involving musical work royalty rates. On November 5, 2012, we filed a petition in the rate court established by the consent decree between the American Society of Composers, Authors and Publishers (ASCAP) and the U.S. Department of Justice in the U.S. District Court for the Southern District of New York for the determination of reasonable license fees and terms for the ASCAP consent decree license applicable to the period January 1, 2011 through December 31, 2015.

Table of Contents

On June 11, 2013 we filed a motion for partial summary judgment seeking a determination that as a matter of law the publishers alleged to have withdrawn certain rights of public performance by digital audio transmission from the scope of grant of rights ASCAP could license on behalf of such publishers subsequent to the date of our request for a license from ASCAP were not valid as to our ASCAP consent decree license. On September 17, 2013, our motion for partial summary judgment was granted, alleviating the need to negotiate direct licenses for such purportedly withdrawn performance rights. A trial to determine the royalty rates we will pay ASCAP is set to take place in January 2014.

On June 13, 2013, Broadcast Music, Inc. (BMI) filed a petition in the rate court established by the consent decree between BMI and the U.S. Department of Justice in the U.S. District Court for the Southern District of New York for the determination of reasonable fees and terms for the BMI consent decree license applicable to the period January 1, 2013 through December 31, 2017. We filed our response on July 19, 2013. On November 1, 2013, we filed a motion for partial summary judgment seeking a determination that as a matter of law the publishers alleged to have withdrawn certain rights of public performance by digital audio transmission from the scope of grant of rights BMI could license on behalf of such publishers subsequent to the date of our request for a license from BMI were not valid as to our BMI consent decree license.

The outcome of any litigation is inherently uncertain. Based on our current knowledge we believe that the final outcome of the matters discussed above will not likely, individually or in the aggregate, have a material adverse effect on our business, financial position, results of operations or cash flows; however, in light of the uncertainties involved in such matters, there can be no assurance that the outcome of each case or the costs of litigation, regardless of outcome, will not have a material adverse effect on our business. In particular, rate court proceedings could take years to complete, could be very costly and may result in royalty rates that are materially less favorable than rates we currently pay.

Indemnification Agreements, Guarantees and Contingencies

In the ordinary course of business, we are party to certain contractual agreements under which we may provide indemnifications of varying scope, terms and duration to customers, vendors, lessors, business partners and other parties with respect to certain matters, including, but not limited to, losses arising out of breach of such agreements, services to be provided by us or from intellectual property infringement claims made by third parties. In addition, we have entered into indemnification agreements with directors and certain officers and employees that will require us, among other things, to indemnify them against certain liabilities that may arise by reason of their status or service as directors, officers or employees. Such indemnification provisions are accounted for in accordance with guarantor s accounting and disclosure requirements for guarantees, including indirect guarantees of indebtedness of others. To date, we have not incurred, do not anticipate incurring and therefore have not accrued for, any costs related to such indemnification provisions.

While the outcome of these matters cannot be predicted with certainty, we do not believe that the outcome of any claims under indemnification arrangements will have a material adverse effect on our financial position, results of operations or cash flows.

Table of Contents**Pandora Media, Inc.****Notes to Condensed Consolidated Financial Statements Continued****6. Other Long-Term Assets**

Other long-term assets consisted of the following:

	As of January 31, 2013	As of October 31, 2013
	(in thousands)	
Other long-term assets:		
Patents, net of amortization	\$	\$ 7,758
Other	1,631	2,295
Restricted cash	829	
Total other long-term assets	\$ 2,460	\$ 10,053

In June 2013, we purchased certain internet radio-related patents from Yahoo! Inc. for \$8.0 million in cash. We intend to hold these patents as part of our strategy to protect and defend Pandora from patent-related litigation. These patents will be amortized over a period of eleven years.

As part of our original May 2011 credit facility, we had entered into a cash collateral agreement in connection with the issuance of letters of credit that were used to satisfy deposit requirements under facility leases, refer to Note 7 Debt Instruments for more information. In September 2013, we amended the credit facility and terminated the cash collateral agreement. As a result, our outstanding letters of credit no longer required cash collateral and all cash collateral that was considered restricted cash was returned to us in September 2013.

Pending Acquisition

In June 2013, we entered into a local marketing agreement to program KXMZ-FM, a Rapid City, South Dakota-area terrestrial radio station. In addition, we entered into an agreement to purchase the assets of KXMZ-FM for a total purchase price of approximately \$0.6 million in cash, subject to certain closing conditions. As of October 31, 2013, we have paid \$0.4 million of the purchase price, which is included in the other long-term assets line item of our balance sheets.

The completion of the KXMZ-FM acquisition is subject to various closing conditions, which include, but are not limited to, regulatory approval by the Federal Communications Commission. Upon completion of these conditions, we expect to account for this acquisition as a business

combination.

Table of Contents

Pandora Media, Inc.

Notes to Condensed Consolidated Financial Statements - Continued

7. Debt Instruments

In May 2011, we entered into a \$30.0 million credit facility with a syndicate of financial institutions. In September 2013, we amended this credit facility. The amendment increased the aggregate commitment amount from \$30.0 million to \$60.0 million and extended the maturity date from May 12, 2015 to September 12, 2018. The amendment further decreased the interest rate on borrowings by 0.75% to either LIBOR plus 2.00% - 2.25% or an alternate base rate plus 1.00% - 1.25%, both of which are per annum rates based on outstanding borrowings. In addition, the amendment decreased the non-usage fee to 0.375% per annum. The amount of available letters of credit under the amended credit facility was increased from \$5.0 million to \$15.0 million and the annual charge for outstanding letters of credit was reduced by 0.75% to 2.00% - 2.25% per annum based on outstanding borrowings.

The amount of borrowings available under the credit facility at any time is based on our monthly accounts receivable balance at such time, and the amounts borrowed are collateralized by our personal property (including such accounts receivable but excluding intellectual property). The credit facility contains customary events of default, conditions to borrowing and covenants, including restrictions on our ability to dispose of assets, make acquisitions, incur debt, incur liens and make distributions to stockholders. The credit facility also includes a financial covenant requiring the maintenance of minimum liquidity of at least \$5.0 million. During the continuance of an event of a default, the lenders may accelerate amounts outstanding, terminate the credit facility and foreclose on all collateral.

As part of the original credit facility, we had entered into a cash collateral agreement in connection with the issuance of letters of credit that were used to satisfy deposit requirements under facility leases. Under the amended credit facility, the cash collateral agreement was terminated and, as a result, the letters of credit no longer required cash collateral. In connection with the termination of the cash collateral agreement, all cash collateral that was considered restricted cash was returned to us in September 2013.

In July 2013, we borrowed approximately \$10.0 million from the credit facility to enhance our working capital position. This amount was paid off in full in August 2013. As of October 31, 2013, we had no borrowings outstanding, \$4.3 million in letters of credit outstanding and \$55.7 million of available borrowing capacity under the amended credit facility.

Table of Contents

Pandora Media, Inc.

Notes to Condensed Consolidated Financial Statements - Continued

8. Stock-based Compensation Plans and Awards

Our 2011 Equity Incentive Plan (the 2011 Plan) provides for the issuance of stock options, restricted stock units and other stock-based awards. The 2011 Plan is administered by the compensation committee of our board of directors.

Stock Options

The per-share fair value of each stock option was determined on the date of grant using the Black-Scholes option pricing model using the following assumptions:

	Three months ended October 31,		Nine months ended October 31,	
	2012	2013	2012	2013
Expected life (in years)	N/A	6.32	6.67	6.30
Risk-free interest rate	N/A	2.04%	1.52%	1.62%
Expected volatility	N/A	58%	57%	58%
Expected dividend yield	N/A	0%	0%	0%

Restricted Stock Units

The fair value of the restricted stock units (RSUs) is expensed ratably over the vesting period. RSUs vest annually on a cliff basis over the service period, which is generally four years. During the three and nine months ended October 31, 2013, we recorded stock-based compensation expense from RSUs of approximately \$8.7 million and \$21.9 million.

Stock Option Awards with Both a Service Period and a Market Condition

In March 2012, Mr. Joseph Kennedy, the Company's Chief Executive Officer, was granted non-statutory stock options to purchase 800,000 shares of common stock with an exercise price of \$10.63 per share. This award included both a service period and a market vesting condition that stipulated that the award would vest if the 60-day trailing volume weighted average price of our common stock exceeded \$21.00 per share,

Edgar Filing: Pandora Media, Inc. - Form 10-Q

or if there was a sale of the Company for at least \$21.00 per share, in each case prior to July 2017. Upon the market condition being met, the award would vest ratably over four years, beginning in July 2013, subject to severance and change of control acceleration.

We used a Monte Carlo simulation to value the award due to the market vesting condition. The following assumptions were used to value the award using the Monte Carlo simulation: 10-year term, risk-free interest rate of 2.33%, expected volatility of 70% and a beginning stock price of \$10.63. The grant-date fair value for the award was \$6.08 per share.

Announced CEO Departure

In March 2013, we announced that we would begin a process to identify a successor to Mr. Kennedy as CEO, which prompted us to re-evaluate certain estimates and assumptions related to the stock-based compensation expense associated with his awards. As a result of this re-evaluation, we reduced stock-based compensation expense by \$1.7 million during the three months ended April 30, 2013, primarily related to the award with both a service period and a market condition. In September 2013, the market condition for Mr. Kennedy's awards was met and the shares became exercisable as if they had been vesting ratably over four years from July 2013. In the three months ended October 31, 2013, we recorded \$0.6 million in additional stock-based compensation expense in connection with these awards.

Table of Contents*Stock-based Compensation Expense*

Stock-based compensation expense related to all employee and non-employee stock-based awards was as follows (in thousands):

	Three months ended October 31,		Nine months ended October 31,	
	2012	2013	2012	2013
	(in thousands) (unaudited)		(in thousands) (unaudited)	
Stock-based compensation expense:				
Cost of revenue - Other	\$ 333	\$ 562	\$ 900	\$ 1,513
Product development	1,180	2,553	3,351	6,841
Sales and marketing	3,186	5,830	8,854	15,816
General and administrative	2,374	3,702	5,505	6,400
Total stock-based compensation expense	\$ 7,073	\$ 12,647	\$ 18,610	\$ 30,570

Table of Contents**Pandora Media, Inc.****Notes to Condensed Consolidated Financial Statements - Continued****9. Net Income (Loss) Per Share**

Basic net income (loss) per share is computed by dividing the net income (loss) by the weighted-average number of shares of common stock outstanding during the period.

Diluted net income (loss) per share is computed by giving effect to all potential shares of common stock, including stock options and restricted stock units, to the extent dilutive. Basic and diluted net loss per share were the same for the nine months ended October 31, 2012 and for the three and nine months ended October 31, 2013, as the inclusion of all potential common shares outstanding would have been anti-dilutive.

The following table sets forth the computation of historical basic and diluted net income (loss) per share:

	Three months ended October 31,		Nine months ended October 31,	
	2012 (in thousands except per share amounts)	2013 (in thousands except per share amounts)	2012 (in thousands except per share amounts)	2013 (in thousands except per share amounts)
Numerator				
Net income (loss)	\$ 2,052	\$ (1,700)	\$ (23,591)	\$ (38,074)
Denominator				
Weighted-average common shares outstanding used in computing basic net income (loss) per share	169,391	184,676	167,423	177,913
Net income (loss) per share, basic	\$ 0.01	\$ (0.01)	\$ (0.14)	\$ (0.21)
Effect of dilutive options	20,722			
Effect of dilutive restricted stock units	165			
Weighted-average common shares outstanding used in computing diluted net income (loss) per share	190,278	184,676	167,423	177,913
Net income (loss) per share, diluted	\$ 0.01	\$ (0.01)	\$ (0.14)	\$ (0.21)

The following potential common shares outstanding were excluded from the computation of diluted net loss per share because including them would have been anti-dilutive (in thousands):

Edgar Filing: Pandora Media, Inc. - Form 10-Q

	Three months ended		Nine months ended	
	October 31, 2012	October 31, 2013	October 31, 2012	October 31, 2013
	(in thousands)		(in thousands)	
Options to purchase common stock	4,442	23,531	29,016	23,531
Restricted stock units	2,841	10,636	4,290	10,636
Total common stock equivalents	7,283	34,167	33,306	34,167

Table of Contents

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

You should read the following discussion of our financial condition and results of operations in conjunction with the condensed consolidated financial statements and the notes thereto included elsewhere in this Quarterly Report on Form 10-Q and our Annual Report on Form 10-K for the fiscal year ended January 31, 2013 filed with the Securities and Exchange Commission pursuant to the Securities Exchange Act of 1934, as amended (the Exchange Act). All references herein to a fiscal year refer to the twelve months ended January 31 of such year, and references to the first, second, third and fourth fiscal quarters refer to the three months ended April 30, July 31, October 31 and January 31, respectively.

This Quarterly Report on Form 10-Q contains forward-looking statements that involve substantial risks and uncertainties. The statements contained in this Quarterly Report on Form 10-Q that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the Securities Act) and Section 21E of the Exchange Act, including, but not limited to, statements regarding our expectations, beliefs, intentions, strategies, future operations, future financial position, future revenue, projected expenses, plans and objectives of management and economic, competitive and technological trends. In some cases, you can identify forward-looking statements by terms such as anticipate, believe, estimate, expect, intend, may, might, plan, project, will, would, should, could, can, predict, potential, continue, objective, or the negative of these terms, and similar expressions intended to identify forward-looking statements. However, not all forward-looking statements contain these identifying words. These forward-looking statements reflect our current views about future events and involve known risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievement to be materially different from those expressed or implied by the forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those identified below, and those discussed in the section titled Risk Factors included in this Quarterly Report on Form 10-Q and our Annual Report on Form 10-K for the fiscal year ended January 31, 2013. Furthermore, such forward-looking statements speak only as of the date of this report. Except as required by law, we undertake no obligation to update any forward-looking statements to reflect events or circumstances after the date of such statements. We qualify all of our forward-looking statements by these cautionary statements. These and other factors could cause our results to differ materially from those expressed in this Quarterly Report on Form 10-Q.

Some of the industry and market data contained in this Quarterly Report on Form 10-Q are based on independent industry publications, including those generated by Triton Digital Media (Triton) or other publicly available information. This information involves a number of assumptions and limitations. Although we believe that each source is reliable as of its respective date, we have not independently verified the accuracy or completeness of this information.

As used herein, Pandora, the Company, we, our, and similar terms refer to Pandora Media, Inc., unless the context indicates otherwise.

Pandora and other trademarks of ours appearing in this report are our property. This report may contain additional trade names and trademarks of other companies. We do not intend our use or display of other companies' trade names or trademarks to imply an endorsement or sponsorship of us by such companies, or any relationship with any of these companies.

Overview

Edgar Filing: Pandora Media, Inc. - Form 10-Q

Pandora is the leader in internet radio in the United States, offering a personalized experience for each of our listeners wherever and whenever they want to listen to radio on a wide range of smartphones, tablets, traditional computers and car audio systems, as well as a range of other internet-connected devices. The majority of our listener hours occur on mobile devices, with the majority of our revenue generated from advertising on these devices. We have pioneered a new form of radio one that uses intrinsic qualities of music to initially create stations and then adapts playlists in real-time based on the individual feedback of each listener. We offer local and national advertisers an opportunity to deliver targeted messages to our listeners using a combination of audio, display and video advertisements.

As of October 31, 2013, we had more than 200 million registered users, which we define as the total number of accounts that have been created for our service at period end. As of October 31, 2013 more than 175 million registered users have accessed Pandora

Table of Contents

through smartphones and tablets. For the three months ended October 31, 2013, we streamed 4.18 billion hours of radio and as of October 31, 2013, we had 70.9 million active users during the prior 30 day period. According to a September 2013 report by Triton, we have more than a 70% share of internet radio among the top 20 stations and networks in the United States. Since we launched our free, advertising-supported radio service in 2005 our listeners have created over 5.0 billion stations.

At the core of our service is our set of proprietary personalization technologies, including the Music Genome Project and our playlist generating algorithms. The Music Genome Project is a database of over 1,000,000 uniquely analyzed songs from over 100,000 artists, spanning over 500 genres and sub-genres, which we develop one song at a time by evaluating and cataloging each song's particular attributes. When a listener enters a single song, artist or genre to start a station, the Pandora service instantly generates a station that plays music we think that listener will enjoy. Based on listener reactions to the songs we stream, we further tailor the station to match the listener's preferences in real time.

We currently provide the Pandora service through two models:

- *Free Service.* Our free service is advertising-based and allows listeners access to our music and comedy catalogs and personalized playlist generating system for free across all of our delivery platforms.
- *Pandora One.* Pandora One is provided to paying subscribers without any external advertising. Pandora One allows listeners the ability to create more stations, have more daily skips and enjoy higher quality audio on supported devices.

A key element of our strategy is to make the Pandora service available everywhere that there is internet connectivity. To this end, we make the Pandora service available through a variety of distribution channels. In addition to streaming our service to traditional computers, we have developed Pandora mobile device applications or apps for smartphones such as Android, Blackberry and the iPhone and for tablets including the iPad, Android tablets and Amazon Kindle Fire tablets. We distribute those mobile apps free to listeners via app stores. Pandora is now integrated with more than 1,000 connected devices, including automobiles, automotive aftermarket devices and consumer electronic devices.

In June 2012, we entered into agreements that allowed Pandora to launch in New Zealand, Australia and the territories associated with the two countries. The arrangements with PPNZ Music Licensing Limited, which represents recording artists and record companies, and APRA/AMCOS, which represents songwriters, composers and publishers, have not had a material effect on our results of operations to date.

In June 2013, we entered into a local marketing agreement to program KXMZ-FM, a Rapid City, South Dakota-area terrestrial radio station. In addition, we entered into an agreement to purchase the assets of KXMZ-FM for a total purchase price of approximately \$0.6 million in cash, subject to certain closing conditions. These agreements were made in part to allow us to qualify for certain settlement agreements concerning royalties for the public performance of musical works between the Radio Music Licensing Committee (RMLC) and the American Society of Composers, Authors and Publishers (ASCAP) and Broadcast Music, Inc. (BMI), respectively. Completion of the KXMZ-FM acquisition is subject to various closing conditions. These include, but are not limited to, regulatory approval by the Federal Communications Commission. Upon completion of these conditions, the Company expects to account for this acquisition as a business combination.

Edgar Filing: Pandora Media, Inc. - Form 10-Q

In September 2013, we completed a follow-on public offering in which we sold an aggregate of 15,730,000 shares of our common stock, inclusive of 2,730,000 shares sold pursuant to the exercise by the underwriters of an option to purchase additional shares, at a public offering price of \$25.00 per share. In addition, another 5,200,000 shares were sold by certain selling stockholders. We received aggregate net proceeds of \$379.1 million, after deducting underwriting discounts and commissions and offering expenses from sales of our shares in the offering. We did not receive any of the proceeds from the sales of shares by the selling stockholders. We anticipate that we will use the net proceeds of this offering for general corporate purposes, including working capital and capital expenditures. In addition, we may use a portion of the net proceeds for potential acquisitions of businesses, products or technologies, although we have no current agreements or understandings with respect to any such transactions.

Table of Contents

Business Model

We derive the substantial majority of our revenue from the sale of audio, display and video advertising for delivery across our traditional computer-based, mobile and other connected device platforms. We also offer a paid subscription service to listeners, which we call Pandora One. While historically our revenue growth was principally attributable to selling display advertising through our traditional computer-based platform, we now generate a majority of our revenue from mobile and other connected devices and our advertising includes a mix of audio, display and video. This expansion of our services also presents an opportunity for us to reach our audience anytime, anywhere they enjoy music, and therefore offer additional distribution channels to current and potential advertisers for delivery of their advertising messages.

Our advertising strategy focuses on developing our core suite of audio, display and video advertising products and marketing these products to advertisers for delivery across mobile, traditional computer, and other connected device platforms such as automobiles and consumer electronics. Our advertising products allow both local and national advertisers to target and connect with listeners based on attributes including age, gender, zip code and content preferences. We believe that our ability to run multi-platform ad campaigns enables advertisers to target their advertising messages to listeners anytime and anywhere, providing a unique advertising opportunity that is central to our achieving and sustaining profitability. As listenership on our mobile platforms has grown more rapidly than on our other platforms, we have sought to improve our advertising products for the mobile environment to better enable us to develop and market multi-platform advertising solutions. For the nine months ended October 31, 2013 advertising constituted 82% of our total revenue, and we expect that advertising will comprise a substantial majority of our revenue for the foreseeable future.

In 2013, we integrated Pandora's advertising inventory into the leading radio media buying platforms, Mediaocean and STRATA, and we are continuing to enhance the ability of radio advertisers to purchase media on these platforms. Incorporating Triton measurements of our radio audience reach side-by-side with terrestrial radio metrics, these platforms consistently rank Pandora at or near the top in all major radio markets in the United States. In addition, we have invested in building a local sales force in major radio markets. Our integration into standard radio media-buying processes and measurement, and our local ad sales force are key elements of our strategy for expanded penetration of the radio advertising market.

As our mobile listenership increases, we face new challenges in optimizing our advertising products for delivery on mobile and other connected device platforms and monetizing inventory generated by listeners using these platforms. The mobile digital advertising market is at an early stage of development, with lower overall spending levels than traditional online advertising markets, and faces technical challenges due to fragmented platforms and lack of standard audience measurement protocols.

In addition, our strategy includes increasing the number of ad campaigns for traditional computer, mobile and other connected device platforms sold to local advertisers, placing us in more direct competition with broadcast radio for advertiser spending, especially for audio advertisements. By contrast, historically our display advertisers have been predominantly national brands. To successfully monetize our growing listener hours, we may have to convince a substantial base of local advertisers of the benefits of advertising on the Pandora service including demonstrating the effectiveness and relevance of our advertising products, and in particular, audio advertising products, across the range of our delivery platforms.

Growth in our active users and distribution platforms has fueled a corresponding growth in listener hours. Our total number of listener hours is a key driver for both revenue generation opportunities and content acquisition costs, which are the largest component of our operating expenses:

Edgar Filing: Pandora Media, Inc. - Form 10-Q

- *Revenue.* Listener hours define the number of opportunities we have to sell advertisements, which we refer to as inventory. Our ability to attract advertisers depends in large part on our ability to offer sufficient inventory within desired demographics. In turn, our ability to generate revenue depends on the extent to which we are able to sell the inventory we have.

- *Cost of Revenue Content Acquisition Costs.* The number of sound recordings we transmit to users of the Pandora service, as generally reflected by listener hours, drives substantially all of our content acquisition costs, although certain of our

Table of Contents

licensing agreements require us to pay fees for public performances of musical works based on a percentage of revenue.

We pay royalties to the copyright owners (or their agents) of each sound recording that we stream and to the copyright owner (or their agents) of the musical work embodied in that sound recording, subject to certain exclusions. Under U.S. law, we are granted the right to stream any lawfully released sound recordings, subject to compliance with certain statutory and regulatory requirements, and our acquisition of the right to publicly perform the musical work embodied therein.

Royalties for sound recordings are negotiated with and paid to record labels or to SoundExchange, a performance rights organization (PRO) authorized to collect royalties on behalf of all sound recording copyright owners. Royalties for musical works are most often negotiated with and paid to PROs such as ASCAP, BMI and SESAC or directly to publishing companies such as Sony/ATV. Royalties are calculated based on the number of sound recordings streamed, revenue earned or other usage measures. If sound recording copyright owners and users cannot agree on royalty rates, disputes are resolved by the Copyright Royalty Board, or CRB, on intervals established in the Copyright Act. If ASCAP or BMI, acting as agents for musical work copyright owners, and users cannot agree on royalty rates, disputes are resolved in the respective rate court in the U.S. District Court for the Southern District of New York. SESAC does not currently operate under a consent decree, such that if SESAC, acting as agent for musical work copyright owners, and users cannot agree on royalty rates, SESAC may withhold the right to publicly perform musical works in its repertory. If individual musical work copyright owners (e.g., music publishers) that do not affiliate with a PRO and users cannot agree on royalty rates, such music publisher can withhold the right to publicly perform musical works in its repertory. In November 2012, we filed a petition in rate court to request a determination of reasonable fees and terms with ASCAP and in June 2013, BMI filed a petition in rate court to request a determination of reasonable fees and terms for a BMI license. Refer to Note 5 Commitment and Contingencies Legal Proceedings in the Notes to Condensed Consolidated Financial Statements for more information.

We stream spoken word comedy content, for which the underlying literary works are not currently entitled to eligibility for licensing by any PRO for the United States. Rather, pursuant to industry-wide custom and practice, this content is performed absent a specific license from any such performing rights organization. However, we pay royalties to SoundExchange at rates negotiated between representatives of online music services and SoundExchange for the right to stream this spoken word comedy content.

Given the current royalty structures in effect through 2015 with respect to the public performance of sound recordings in the United States, our content acquisition costs increase with each additional listener hour, regardless of whether we are able to generate more revenue. As such, our ability to achieve and sustain profitability and operating leverage depends on our ability to increase our revenue per hour of streaming through increased advertising sales across all of our delivery platforms.

In March 2013, we instituted a 40 hour per month listening limit for our advertising supported service on certain mobile and other connected devices. Listeners who reached this limit could continue to use our ad supported service on these devices by paying \$0.99 for the remainder of the month, could listen to our ad supported service on their desktop or laptop computers, or could purchase Pandora One subscriptions for \$36 per year or approximately \$4 per month. Effective September 2013, we eliminated this limit primarily due to our improved ability to monetize mobile listening hours. Although we have removed the broad 40 hour per month mobile listening limit, we have implemented other more precise measures that we believe will allow us to better manage the growth of mobile content acquisition costs while minimizing adverse effects on the listener experience. In addition, the mobile listening limit drove significant growth in subscribers to our ad-free service, and since removing the limit we do not expect to experience similar growth in subscriptions for the balance of the year.

As the volume of music we stream to listeners in the United States increases, our content acquisition costs will also increase, regardless of whether we are able to generate more revenue. In addition, we expect to invest heavily in our operations to support anticipated future growth.

Edgar Filing: Pandora Media, Inc. - Form 10-Q

One of our key objectives is furthering our market leadership in internet radio, which we believe will strengthen our brand and help us to convince advertisers to allocate spending towards our ad products. As such, a central focus is adding, retaining and engaging listeners to build market share and grow our listener hours. For the foreseeable future, we expect that there will be periods during which our ability to monetize listener hours will lag the growth of listener hours. As our business matures,

Table of Contents

we expect that the growth rate in our listener hours will decline relative to our increased ability to monetize listener hours. However, we expect to incur annual losses on a U.S. GAAP basis in the near term.

Our current strategy is to leverage any improvements in gross margin by investing the additional gross profit in broadening distribution channels, developing innovative and scalable advertising products, increasing utilization of advertising inventory and building out our sales force. These investments are intended to drive further growth in our business through both increased listener hours and monetization of those hours, and as a result we are targeting gradual improvements in gross margins over time. Our planned reinvestment of any resulting incremental gross profit will continue to depress any growth of bottom line profitability. In this regard, we do not expect significant improvements in our earnings for calendar year 2014 relative to the current fiscal year.

Key Metrics

Listener Hours

The table below sets forth our listener hours for the three and nine months ended October 31, 2012 and 2013.

	Three months ended October 31,		Nine months ended October 31,	
	2012	2013	2012	2013
	(in billions)		(in billions)	
Listener hours	3.56	4.18	9.95	12.24

Listener Hours. We track listener hours because it is a key indicator of the growth of our business. We calculate listener hours based on the total bytes served for each track that is requested and served from our servers, as measured by our internal analytics systems, whether or not a listener listens to the entire track. To the extent that third-party measurements of listener hours are not calculated using a similar server-based approach, the third-party measurements may differ from our measurements.

Active Users

The table below sets forth our active users as of January 31, 2013 and October 31, 2013.

	As of January 31, 2013	As of October 31, 2013
		(in millions)
Active users	65.6	70.9

Active Users. Active users are defined as the number of distinct registered users that have requested audio from our servers within the trailing 30 days to the end of the final calendar month of the period. The number of active users may overstate the number of unique individuals who actively use our service within a month as one individual may register for, and use, multiple accounts. We track the number of active users as an additional indicator of the breadth of audience we are reaching at a given time, which is particularly important to potential advertisers.

Table of Contents*Advertising revenue per thousand listener hours (ad RPMs)*

The table below sets forth our ad RPMs, including total, traditional computer and mobile and other connected devices ad RPMs for the three and nine months ended October 31, 2012 and 2013.

	Three months ended October 31,		Nine months ended October 31,	
	2012	2013	2012	2013
Total ad RPMs	\$ 32.40	\$ 40.11	\$ 29.08	\$ 35.47
Traditional computer	58.03	57.54	53.81	54.80
Mobile and other connected devices	25.59	36.00	22.12	30.85

Ad RPMs. We track ad RPMs for our free, advertising supported service because it is a key indicator of our ability to monetize advertising inventory created by our listener hours. We focus on total ad RPMs across all of our delivery platforms. Ad RPMs compare advertising revenue generated in a given period to advertising supported listener hours in the period and we believe such total ad RPMs to be the central top-line indicator for evaluating the results of our monetization efforts. We calculate total ad RPMs by dividing advertising revenue generated by the number of thousands of listener hours of our advertising-based service.

We provide estimates of disaggregated ad RPMs for our traditional computer platform as well as our mobile and other connected devices platforms, which we calculate by dividing the estimated advertising revenue generated through the respective platforms by the number of thousands of listener hours of our advertising-based service delivered through such platforms. While we believe that such disaggregated ad RPMs provide directional insight for evaluating our efforts to monetize our service by platform, we do not validate disaggregated ad RPMs to the level of financial statement reporting. Such metrics should be seen as indicative only and as management's best estimate. We continue to refine our systems and methodologies used to categorize ad RPMs across our delivery platforms. Period-to-period results should not be regarded as precise nor can they be relied upon as indicative of results for future periods. In addition, as our business matures and in response to technological evolutions, we anticipate that the relevant indicators we monitor for evaluating our business may change.

Total ad RPMs. Three and nine months ended October 31, 2012 and 2013. Total ad RPMs increased compared to the respective prior year periods as advertising sales growth outpaced the growth in advertising listener hours. In addition to sales growth, total ad RPMs benefited from measures we implemented in 2013 to better manage the growth of mobile content acquisition costs while minimizing adverse effects on the listener experience.

Traditional computer ad RPMs. Three months ended October 31, 2012 and 2013. Traditional computer ad RPMs decreased minimally compared to the respective prior year period, primarily due to our focus on monetizing mobile inventory.

Traditional computer ad RPMs. Nine months ended October 31, 2012 and 2013. Traditional computer ad RPMs increased compared to the respective prior year period, primarily due to traditional computer revenue growing at a faster pace than listening hours on that platform primarily due to an increase in the average price per ad.

Edgar Filing: Pandora Media, Inc. - Form 10-Q

Mobile and other connected device ad RPMs. Three and nine months ended October 31, 2012 and 2013. Mobile and other connected device ad RPMs increased compared to the respective prior year periods as mobile and other connected devices revenue grew at a faster pace than listening hours on those platforms. In addition to sales growth, mobile and other connected device ad RPMs benefited from measures we implemented in 2013 to better manage the growth of mobile content acquisition costs while minimizing adverse effects on the listener experience.

Table of Contents**Total revenue per thousand listener hours (total RPMs)**

The table below sets forth our total RPMs, including total, traditional computer and mobile and other connected devices total RPMs for the three and nine months ended October 31, 2012 and 2013.

	Three months ended October 31,		Nine months ended October 31,	
	2012	2013	2012	2013
Total RPMs	\$ 33.73	\$ 43.19	\$ 30.34	\$ 37.84
Traditional computer	56.40	57.33	52.20	54.13
Mobile and other connected devices	26.96	39.64	23.31	33.66

Total RPMs. We track revenue per thousand listener hours (total RPMs) for our service because it is a key indicator of our ability to monetize our listener hours. We focus on total RPMs across all of our delivery platforms. Total RPMs compare advertising and subscription services and other revenue generated in a given period to total listener hours in the period. We calculate total RPMs by dividing the total revenue generated by the number of thousands of listener hours.

The estimates used to derive disaggregated total RPMs for our traditional computer platform as well as our mobile and other connected devices platforms are similar to those used to derive ad RPMs. The changes in total RPMs were driven by the same factors mentioned above within the discussion of ad RPMs, with the exception of traditional computer total RPMs.

Traditional computer total RPMs. Three months ended October 31, 2012 and 2013. Traditional computer total RPMs increased compared to the respective prior year period, primarily due to an increase in subscription revenue relative to listener hours as a result of an increase in the more highly-priced monthly subscriptions.

Licensing costs per thousand listener hours (LPMs)

The table below sets forth our total LPMs for the three and nine months ended October 31, 2012 and 2013.

	Three months ended October 31,		Nine months ended October 31,	
	2012	2013	2012	2013
Total LPMs	\$ 18.47	\$ 20.83	\$ 18.29	\$ 20.56

Total LPMs. We track licensing costs per thousand listener hours (LPMs) and analyze them in combination with our analysis of RPMs as they provide a key indicator of our profitability. LPMs are relatively fixed licensing costs with scheduled annual rate increases which drive period over period changes in LPMs. As such, the margin on our business varies principally with variances in ad RPMs and subscription RPMs. Total LPMs in the three and nine months ended October 31, 2013 increased compared to the respective prior year periods primarily due to scheduled rate increases.

Basis of Presentation

Revenue

Advertising Revenue. We generate advertising revenue primarily from display, audio and video advertising, which is typically sold on a cost-per-thousand impressions, or CPM, basis. Advertising campaigns typically range from one to twelve months, and advertisers generally pay us based on a minimum number of delivered impressions or the satisfaction of other criteria, such as click-throughs. We may earn referral revenue when, for example, a listener clicks on an advertisement and signs up for membership with an advertiser. We also have arrangements with advertising agencies and brokers pursuant to which we provide the ability to sell advertising inventory on our service directly to advertisers. We report revenue under these arrangements net of amounts due to agencies and brokers. For the three months ended October 31, 2012 and 2013, advertising revenue accounted for 89% and 80% of our total revenue, respectively. For the nine months ended October 31, 2012 and 2013, advertising revenue accounted for 88% and 82% of our

Table of Contents

total revenue, respectively, and we expect that advertising will comprise a substantial majority of revenue for the foreseeable future. Advertising revenue decreased as a percentage of total revenue due to higher subscription sales partially driven by the implementation of the mobile listening limit.

Subscription Services and Other Revenue. Subscription revenue is generated through the sale of a premium version of the Pandora service which currently includes advertisement-free access and higher audio quality on the devices that support it. Subscription revenue derived from direct sales to listeners is recognized on a straight-line basis over the duration of the subscription period, although in certain cases described below subscription revenue is currently subject to deferral pending the expiration of refund rights. For the three months ended October 31, 2012 and 2013, subscription services and other revenue accounted for 11% and 20% of our total revenue, respectively. For the nine months ended October 31, 2012 and 2013, subscription services and other revenue accounted for 12% and 18% of our total revenue, respectively. Subscription services revenue increased as a percentage of total revenue due to higher subscription sales partially driven by the implementation of the mobile listening limit.

Deferred Revenue. Our deferred revenue consists principally of both prepaid but unrecognized subscription revenue and advertising fees received or billed in advance of the delivery or completion of the delivery of services. Deferred revenue is recognized as revenue when the services are provided and all other revenue recognition criteria have been met.

In addition, subscription revenue derived from sales through some mobile operating systems may be subject to refund or cancellation terms which may affect the timing or amount of the subscription revenue recognition. When refund rights exist, we recognize revenue when services have been provided and the rights lapse or when we have developed sufficient transaction history to estimate a reserve. As of October 31, 2013, we had deferred all revenue subject to certain refund rights totaling approximately \$14.0 million, as we do not currently have sufficient history to estimate a reserve. We expect that we will have sufficient history to estimate the reserve in January 2014. As a result, substantially all of the deferred revenue associated with these subscription refund rights will be reversed in the first quarter of calendar year 2014.

Costs and Expenses

Costs and expenses consist of cost of revenue content acquisition costs, cost of revenue other, product development, sales and marketing and general and administrative expenses. Cost of revenue content acquisition costs are the most significant component of our costs and expenses followed by employee-related costs, which includes stock-based compensation expenses. We expect to continue to hire additional employees in order to support our anticipated growth and our product development initiatives. In any particular period, the timing of additional hires could materially affect our operating expenses, both in absolute dollars and as a percentage of revenue. We anticipate that our costs and expenses will increase in the future.

Cost of revenue Content Acquisition Costs. Principally consist of royalties paid for streaming music or other content to our listeners. Royalties are calculated using negotiated rates documented in master royalty agreements and are based on both percentage of revenue and listening metrics. For example in the three and nine months ended October 31, 2012 and 2013, under some royalty arrangements we paid a fee per public performance of a sound recording, while in other cases we paid royalties based on a percentage of our revenue. In still other cases we pay royalties based on a formula that involves a combination of these metrics.

Edgar Filing: Pandora Media, Inc. - Form 10-Q

We periodically test our royalty calculation methods to ensure we are accurately reporting and paying royalties. Some of our licensors may have the right to audit our playlist and payment records, and any such audit could result in disputes over whether we have paid the proper royalties. If such a dispute were to occur, we could be required to pay additional royalties and the costs of an audit in the event of an underpayment. The amounts involved could be material.

For royalty arrangements under negotiation, we accrue for estimated royalties based on the available facts and circumstances and adjust these estimates as more information becomes available. The results of any finalized negotiation may be materially different from our estimates.

In July 2009 we, together with other webcasters, negotiated new royalty rates on performances with SoundExchange for calendar years 2006 to 2015. The agreement provided alternative rates that were reduced from those eventually established by the

Table of Contents

CRB for calendar years 2006 to 2010 and established new rates for calendar years 2011 to 2015.

Cost of Revenue Other. Consists primarily of hosting, infrastructure and the employee-related costs associated with supporting those functions. Hosting costs consist of content streaming, maintaining our internet radio service and creating and serving advertisements through third-party ad servers. We make payments to third-party ad servers for the period the advertising impressions or click-through actions are delivered or occur, and accordingly, we record this as a cost of revenue in the related period.

Product Development. Consists primarily of employee-related costs, including salaries and benefits related to employees in software engineering, music analysis and product management departments, facilities-related expenses, information technology and costs associated with supporting consumer connected-device manufacturers in implementing our service in their products. We incur product development expenses primarily for improvements to our website and the Pandora app, development of new advertising products and development and enhancement of our personalized station(s) generating system. We have generally expensed product development as incurred. Certain website development and internal use software development costs may be capitalized when specific criteria are met. In such cases, the capitalized amounts are amortized over the useful life of the related application once the application is placed in service. We intend to continue making significant investments in developing new products and enhancing the functionality of our existing products.

Sales and Marketing. Consists primarily of employee-related costs, including salaries, commissions and benefits related to employees in sales, sales support and marketing departments. In addition, sales and marketing expenses include transaction processing fees for subscription purchases on mobile platforms, external sales and marketing expenses such as third-party marketing, branding, advertising and public relations expenses, and facilities-related expenses. We expect sales and marketing expenses to increase as we hire additional personnel to build out our sales and sales support teams.

General and Administrative. Consists primarily of employee-related costs, consisting of salaries and benefits for finance, accounting, legal, internal information technology and other administrative personnel. In addition, general and administrative expenses include professional services costs for outside legal and accounting services, facilities-related expenses and infrastructure costs. We expect general and administrative expenses to increase in future periods as we continue to invest in corporate infrastructure, including adding personnel and systems to our administrative functions.

Provision for Income Taxes. We have historically been subject to income taxes only in the United States. As we expand our operations outside the United States, we have become subject to taxation based on the foreign statutory rates and our effective tax rate could fluctuate accordingly.

Income taxes are computed using the asset and liability method, under which deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities using enacted statutory income tax rates in effect for the year in which the differences are expected to affect taxable income. Valuation allowances are established when necessary to reduce net deferred tax assets to the amount expected to be realized.

Table of Contents

Results of Operations

The following table presents our results of operations for the periods indicated as a percentage of total revenue. The period-to-period comparisons of results are not necessarily indicative of results for future periods.

	Three months ended October 31,		Nine months ended October 31,	
	2012	2013	2012	2013
Revenue:				
Advertising	89%	80%	88%	82%
Subscription services and other	11	20	12	18
Total revenue	100	100	100	100
Costs and expenses:				
Cost of revenue - Content acquisition costs	55	48	60	54
Cost of revenue - Other(1)	7	7	8	7
Product development(1)	4	5	4	5
Sales and marketing(1)	22	28	24	29
General and administrative(1)	11	13	11	12
Total costs and expenses	99	101	108	107
Income (loss) from operations	1	(1)	(8)	(7)
Other income (expense):				
Interest income				
Interest expense				
Other expense, net				
Income (loss) before provision for income taxes	1	(1)	(8)	(7)
Provision for income taxes				
Net income (loss)	1%	(1)%	(8)%	(7)%

(1) Includes stock-based compensation as follows:

Cost of revenue - Other	0.3%	0.3%	0.3%	0.3%
Product development	1.0	1.4	1.1	1.5
Sales and marketing	2.7	3.2	2.9	3.4
General and administrative	2.0	2.1	1.8	1.4

Comparison of the Three and Nine months Ended October 31, 2012 and 2013

Revenue

	Three months ended October 31,			Nine months ended October 31,		
	2012	2013	\$ Change	2012	2013	\$ Change
	(in thousands)			(in thousands)		

Edgar Filing: Pandora Media, Inc. - Form 10-Q

Advertising	\$	106,258	\$	144,346	\$	38,088	\$	266,239	\$	378,012	\$	111,773
Subscription services and other		13,747		36,030		22,283		35,817		85,229		49,412
Total revenue	\$	120,005	\$	180,376	\$	60,371	\$	302,056	\$	463,241	\$	161,185

Table of Contents

Revenue. Three months ended 2012 compared to 2013. Advertising revenue increased \$38.1 million or approximately 35% in the three months ended October 31, 2013, primarily due to an approximate 15% increase in the number of ads delivered, as well as an increase in the average price per ad of approximately 15% due to fluctuations in the sales distribution mix amongst direct sales, third-party network sales, and other channels and the platform mix between traditional computer and mobile and other connected devices. The increase in the number of ads delivered was primarily due to an increase in total advertising listener hours of approximately 10%, which increased the volume of advertising inventory, as well as an increase in our sales force year-over-year to sell such advertising inventory. Subscription revenue increased \$22.3 million, or approximately 160%, due to an increase in the number of subscribers, partially driven by the implementation of the mobile listening limit, which was implemented in March 2013 and eliminated in September 2013.

Revenue. Nine months ended 2012 compared to 2013. Advertising revenue increased \$111.8 million or approximately 40% in the nine months ended October 31, 2013, primarily due to an approximate 35% increase in the number of ads delivered, as well as an increase in the average price per ad of approximately 5% due to fluctuations in the sales distribution mix amongst direct sales, third-party network sales, and other channels and the platform mix between traditional computer and mobile and other connected devices. The increase in the number of ads delivered was primarily due to an increase in total advertising listener hours of approximately 15%, which increased the volume of advertising inventory, as well as an increase in our sales force year-over-year to sell such advertising inventory. Subscription revenue increased \$49.4 million, or approximately 140%, due to an increase in the number of subscribers, partially driven by the implementation of the mobile listening limit, which was implemented in March 2013 and eliminated in September 2013.

Costs and Expenses

Cost of Revenue - Content acquisition costs

	Three months ended October 31,			Nine months ended October 31,		
	2012	2013 (in thousands)	\$ Change	2012	2013 (in thousands)	\$ Change
Cost of Revenue - Content acquisition costs	\$ 65,713	\$ 86,989	\$ 21,276	\$ 182,053	\$ 251,722	\$ 69,669

Content acquisition costs as a percentage of advertising revenue:

	Three months ended October 31,		Nine months ended October 31,	
	2012	2013	2012	2013
Traditional computer	32%	35%	34%	35%
Mobile and other connected devices	67%	52%	77%	60%

The majority of our royalties are payable based on a fee per public performance of a sound recording, while in other cases our royalties are payable based on a percentage of our revenue or a formula that involves a combination of per performance and revenue metrics. We estimate our advertising-based content acquisition costs attributable to specific platforms by allocating costs from royalties payable based on a fee per track to the platform for which the track is served and by allocating costs from royalties based on a percentage of our revenue in accordance with the overall percentage of our revenue estimated to be attributable to such platforms. While we believe that comparing disaggregated content

Edgar Filing: Pandora Media, Inc. - Form 10-Q

acquisition costs and revenues across our delivery platforms may provide directional insight for evaluating our efforts to monetize the rapid adoption of our service on mobile and other connected devices, we do not validate such disaggregated metrics to the level of financial statement reporting. We continue to refine our systems

Table of Contents

and methodologies used to categorize such metrics across our delivery platforms and the period-to-period comparisons of results are not necessarily indicative of results for future periods.

Three months ended 2012 compared to 2013. Content acquisition costs increased \$21.3 million due to increased listener hours, higher royalty rates due to scheduled rate increases and increased revenue. Content acquisition costs as a percentage of total revenue decreased from 55% to 48%, primarily due to an increase in advertising sales and the effect of the measures we have adopted to manage the growth of mobile content acquisition costs while minimizing adverse effects on the listener experience, partially offset by scheduled rate increases. Estimated content acquisition costs as a percentage of the advertising revenue attributable to our traditional computer platform increased from 32% to 35%, primarily due to scheduled rate increases. Estimated content acquisition costs as a percentage of the advertising revenue attributable to our mobile and other connected devices platforms decreased from 67% to 52%, primarily due to an increase in advertising sales on those platforms and the effect of measures we have adopted to manage the growth of mobile content acquisition costs while minimizing adverse effects on the listener experience, partially offset by scheduled rate increases.

Nine months ended 2012 compared to 2013. Content acquisition costs increased \$70.0 million due to increased listener hours, higher royalty rates due to scheduled rate increases and increased revenue. Content acquisition costs as a percentage of total revenue decreased from 60% to 54%, primarily due to an increase in advertising sales and the effect of measures we have adopted to manage the growth of mobile content acquisition costs while minimizing adverse effects on the listener experience, partially offset by scheduled rate increases. Estimated content acquisition costs as a percentage of the advertising revenue attributable to our traditional computer platform increased from 34% to 35%, primarily due to scheduled rate increases. Estimated content acquisition costs as a percentage of the advertising revenue attributable to our mobile and other connected devices platforms decreased from 77% to 60%, primarily due to an increase in advertising sales on those platforms and the effect of measures we have adopted to manage the growth of mobile content acquisition costs while minimizing adverse effects on the listener experience, partially offset by scheduled rate increases.

Cost of Revenue Other

		Three months ended October 31,			Nine months ended October 31,		
		2012	2013	\$ Change	2012	2013	\$ Change
		(in thousands)			(in thousands)		
Cost of revenue	Other	\$ 8,338	\$ 12,423	\$ 4,085	\$ 22,769	\$ 33,239	\$ 10,470

Three months ended 2012 compared to 2013. Cost of revenue increased \$4.1 million primarily due to a \$2.6 million increase in hosting and advertising costs driven by an increase in advertising revenue.

Nine months ended 2012 compared to 2013. Cost of revenue increased \$10.5 million primarily due to a \$7.2 million increase in hosting and advertising costs, driven by an increase in advertising revenue, a \$1.9 million increase in employee-related costs and a \$1.6 million increase in facilities and equipment expenses, both of which were driven by an increase in headcount.

Product Development

Edgar Filing: Pandora Media, Inc. - Form 10-Q

	Three months ended October 31,			Nine months ended October 31,		
	2012	2013 (in thousands)	\$ Change	2012	2013 (in thousands)	\$ Change
Product development	\$ 4,371	\$ 8,848	\$ 4,477	\$ 12,965	\$ 23,807	\$ 10,842

Table of Contents

Three months ended 2012 compared to 2013. Product development expenses increased \$4.5 million primarily due to a \$4.3 million increase in employee-related costs driven by an increase in headcount.

Nine months ended 2012 compared to 2013. Product development expenses increased \$10.8 million primarily due to a \$10.4 million increase in employee-related costs driven by an increase in headcount.

Sales and Marketing

	Three months ended October 31,			Nine months ended October 31,		
	2012	2013 (in thousands)	\$ Change	2012	2013 (in thousands)	\$ Change
Sales and marketing	\$ 26,714	\$ 50,575	\$ 23,861	\$ 73,631	\$ 136,452	\$ 62,821

Three months ended 2012 compared to 2013. Sales and marketing expenses increased \$23.9 million primarily due to a \$13.9 million increase in employee-related costs and a \$1.7 million increase in facilities and equipment expenses, both of which were driven by an increase in headcount, a \$5.0 million increase in transaction processing fees for subscription purchases on mobile platforms and a \$3.6 million increase in marketing expenses.

Nine months ended 2012 compared to 2013. Sales and marketing expenses increased \$62.8 million primarily due to a \$38.4 million increase in employee-related costs and a \$4.4 million increase in facilities and equipment expenses, both of which were driven by an increase in headcount, a \$12.9 million increase in transaction processing fees for subscription purchases on mobile platforms and a \$6.7 million increase in marketing expenses.

General and Administrative

	Three months ended October 31,			Nine months ended October 31,		
	2012	2013 (in thousands)	\$ Change	2012	2013 (in thousands)	\$ Change
General and administrative	\$ 12,700	\$ 23,038	\$ 10,338	\$ 33,914	\$ 55,599	\$ 21,685

Three months ended 2012 compared to 2013. General and administrative expenses increased \$10.3 million primarily due to a \$5.1 million increase in professional fees and a \$3.5 million increase in employee-related costs driven by an increase in headcount.

Nine months ended 2012 compared to 2013. General and administrative expenses increased \$21.7 million primarily due to a \$9.4 million increase in professional fees, an \$8.0 million increase in employee-related costs and a \$2.1 million increase in facilities and equipment expenses, both of which were driven by an increase in headcount.

Off-Balance Sheet Arrangements

Our liquidity is not dependent on the use of off-balance sheet financing arrangements and as of October 31, 2013 we had no such arrangements. There has been no material change in our contractual obligations other than in the ordinary course of business since our fiscal year ended January 31, 2013.

Table of Contents

Quarterly Trends

Our operating results fluctuate from quarter to quarter as a result of a variety of factors. We expect our operating results to continue to fluctuate in future quarters.

Our results may reflect the effects of some seasonal trends in listener behavior due to increased internet usage and sales of media-streaming devices during certain vacation and holiday periods. For example, we expect to experience increased usage during the fourth quarter of each calendar year due to the holiday season, and in the first quarter of each calendar year due to increased use of media-streaming devices received as gifts during the holiday season. We may also experience higher advertising sales during the fourth quarter of each calendar year due to greater advertiser demand during the holiday season and lower advertising sales during the first quarter of each calendar year due to seasonally adjusted advertising demand. We believe these seasonal trends have affected, and will continue to affect our operating results, particularly as increases in content acquisition costs from increased usage are not offset by increases in advertising sales in the first calendar quarter. We believe that our business may become more seasonal in the future and that such seasonal variations in listener behavior may result in fluctuations in our financial results.

In addition, expenditures by advertisers tend to be cyclical and discretionary in nature, reflecting overall economic conditions, the economic prospects of specific advertisers or industries, budgeting constraints and buying patterns and a variety of other factors, many of which are outside our control. As a result of these and other factors, the results of any prior quarterly or annual periods should not be relied upon as indications of our future operating performance.

The growth in listener hours on mobile and other connected devices was tempered in the three and nine months ended October 31, 2013 by the implementation of the mobile listening limit for our advertising supported service on certain mobile and other connected devices. Effective September 2013, we eliminated this limit primarily due to our improved ability to monetize mobile listening hours. Although we have removed the broad 40 hour per month mobile listening limit, we have implemented other more precise measures that we believe will allow us to better manage the growth of mobile content acquisition costs while minimizing adverse effects on the listener experience. In addition, the mobile listening limit drove significant growth in subscribers to our ad-free service, and since removing the limit we do not expect to experience similar growth in subscriptions for the balance of the year. To the extent we take steps such as these to affect usage on a particular platform, trends in usage may be obscured or changed and comparisons across periods may not be meaningful.

Liquidity and Capital Resources

As of October 31, 2013, we had cash, cash equivalents and short-term investments totaling \$447.8 million, which consisted of cash and money market funds held at major financial institutions, commercial paper and investment-grade corporate debt securities.

In September 2013, we completed a follow-on public offering in which we sold an aggregate of 15,730,000 shares of our common stock, inclusive of 2,730,000 shares sold pursuant to the exercise by the underwriters of an option to purchase additional shares, at a public offering price of \$25.00 per share. In addition, another 5,200,000 shares were sold by certain selling stockholders. We received aggregate net proceeds of \$379.1 million, after deducting underwriting discounts and commissions and offering expenses from sales of our shares in the offering. We did not receive any of the proceeds from the sales of shares by the selling stockholders.

Our principal uses of cash during the three and nine months ending October 31, 2013 were funding our operations, as described below, and capital expenditures.

Sources of Funds

We believe, based on our current operating plan, that our existing cash and cash equivalents and available borrowings under our credit facility will be sufficient to meet our anticipated cash needs for at least the next twelve months.

Table of Contents

From time to time, we may explore additional financing sources and means to lower our cost of capital, which could include equity, equity-linked and debt financing. In addition, in connection with any future acquisitions, we may require additional funding which may be provided in the form of additional debt, equity or equity-linked financing or a combination thereof. There can be no assurance that any additional financing will be available to us on acceptable terms.

Our Indebtedness

Credit Facility. In May 2011, we entered into a \$30.0 million credit facility with a syndicate of financial institutions. In September 2013, we amended our credit facility. The amendment increased the aggregate commitment amount from \$30.0 million to \$60.0 million, extended the maturity date from May 12, 2015 to September 12, 2018 and decreased the interest rate on borrowings. Refer to Note 7 Debt Instruments in the Notes to Condensed Consolidated Financial Statements for further details regarding our credit facility.

In July 2013, we borrowed approximately \$10.0 million from the credit facility to enhance our working capital position. This amount was paid off in full in August 2013.

Capital Expenditures

Consistent with previous periods, future capital expenditures will primarily focus on acquiring additional hosting equipment and general corporate infrastructure. We believe that our existing cash, cash equivalents, short-term investments and available borrowings are sufficient to fund our anticipated capital expenditures.

Historical Trends

The following table summarizes our cash flow data for the nine months ended October 31, 2012 and 2013.

	Nine months ended October 31,	
	2012	2013
	(in thousands) (unaudited)	
Net cash used in operating activities	\$ (8,612)	\$ (10,807)
Net cash provided by (used in) investing activities	17,355	(5,557)
Net cash provided by financing activities	4,857	393,042

Operating Activities

Edgar Filing: Pandora Media, Inc. - Form 10-Q

In the nine months ended October 31, 2013, net cash used in operating activities was \$10.8 million, including our net loss of \$38.1 million and non-cash charges of \$39.0 million, primarily related to \$30.6 million in stock-based compensation charges. Net cash used in operating activities benefited from a \$13.8 million increase in deferred revenue from the prior period primarily due to an increase in customers purchasing subscriptions for Pandora One, partially driven by the implementation of the mobile listening limit.

In the nine months ended October 31, 2012, net cash used in operating activities was \$8.6 million, primarily due to our net loss of \$23.6 million, offset by non-cash charges of \$24.3 million, primarily related to \$18.6 million in stock-based compensation charges.

Investing Activities

Cash used in investing activities in the nine months ended October 31, 2013 was \$5.6 million primarily due to \$14.9 million for capital expenditures for server equipment and leasehold improvements and \$8.0 million for the purchase of patents, offset by \$17.7 million in net proceeds from maturities of short-term investments.

Table of Contents

Cash provided by investing activities in the nine months ended October 31, 2012 was \$17.4 million, primarily due to \$23.4 million in net proceeds from maturities of short-term investments, offset by \$6.0 million in capital expenditures primarily related to leasehold improvements.

Financing Activities

Cash provided by financing activities in the nine months ended October 31, 2013 was \$393.0 million consisting primarily of net proceeds from the follow-on offering of \$379.1 million and cash proceeds from the issuance of common stock of \$14.9 million.

Cash provided by financing activities in the nine months ended October 31, 2012 was \$4.9 million consisting of proceeds from the issuance of common stock.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations is based upon our condensed consolidated financial statements, which have been prepared in accordance with U.S. GAAP. The preparation of these condensed consolidated financial statements requires us to make estimates, judgments and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses and the related disclosure of contingent assets and liabilities. We base our estimates on historical experience and on various other assumptions that we believe are reasonable under the circumstances. Our estimates form the basis for our judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

An accounting policy is considered to be critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time the estimate is made, and if different estimates that reasonably could have been used, or changes in the accounting estimate that are reasonably likely to occur, could materially impact the condensed consolidated financial statements. We believe that our critical accounting policies reflect the more significant estimates and assumptions used in the preparation of the condensed consolidated financial statements.

Since our Annual Report on Form 10-K for the fiscal year ended January 31, 2013, we have determined that our accounting policy and estimate related to royalties for performance rights is critical.

Royalties for Performance Rights of Musical Works

We incur royalty expenses from our public performance of musical works. This includes royalties that we pay for public performance rights to the owners of those musical works or their agents, such as ASCAP, BMI and SESAC. In 2010 and 2012, we elected to terminate our agreements with ASCAP and BMI, respectively. Recent court proceedings, the purported withdrawal of certain performance rights with respect to certain

Edgar Filing: Pandora Media, Inc. - Form 10-Q

musical works by certain music publishers from the ASCAP and BMI catalogs, and our recent entry into a local marketing agreement to program KXMZ-FM, in part to allow Pandora to qualify for the current ASCAP and BMI license agreements available to owners of one or more commercial radio stations, have highlighted uncertainties for the royalty rates payable to these organizations and to musical copyright owners. We record a liability for public performance royalties based on our best estimate of the amount owed to each licensor, PROs or individual copyright owners, based on historical rates, third-party evidence and legal developments consistent with our past practices. For each quarterly period, we evaluate our estimates to assess the adequacy of recorded liabilities. If actual royalty rates differ from estimates, revisions to the estimated royalty liabilities may be required, which could materially affect our results of operations.

There have been no material changes to our other critical accounting policies and estimates as compared to those described in our Annual Report on Form 10-K for the fiscal year ended January 31, 2013 under the caption Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies and Estimates.

Table of Contents

Item 3. Quantitative and Qualitative Disclosure About Market Risk

Interest Rate Fluctuation Risk

There have been no material changes in our primary market risk exposures or how those exposures are managed from the information disclosed in Part II, Item 7A of our Annual Report on Form 10-K for the fiscal year ended January 31, 2013. For further discussion of quantitative and qualitative disclosures about market risk, reference is made to our Annual Report on Form 10-K.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures, as such term is defined in Rule 13a-15(e) under the Exchange Act, that are designed to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, management recognizes that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. Based on their evaluation at the end of the period covered by this Quarterly Report on Form 10-Q, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures were effective at the reasonable assurance level as of October 31, 2013.

Changes in Internal Control over Financial Reporting

There has been no change in our internal control over financial reporting during the three months ended October 31, 2013 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

The material set forth in Note 5 in the Notes to Condensed Consolidated Financial Statements in Part I, Item 1 of this Quarterly Report on Form 10-Q is incorporated herein by reference.

Item 1A. Risk Factors

Investing in our common stock involves a high degree of risk. Before deciding to invest in our common stock, you should carefully consider each of the risk factors described in Part I - Item 1A. Risk Factors in our Annual Report on Form 10-K for the fiscal year ended January 31, 2013 and all information set forth in this Quarterly Report on Form 10-Q. Those risks and the risks described in this Quarterly Report on Form 10-Q, including in the section entitled Management's Discussion and Analysis of Financial Condition and Results of Operations, could materially harm our business, financial condition, operating results, cash flow and prospects. If that occurs, the trading price of our common stock could decline, and you may lose all or part of your investment.

Internet radio is an emerging market, which makes it difficult to evaluate our current business and future prospects.

Internet radio is an emerging market and our current business and future prospects are difficult to evaluate. The market for internet radio has undergone rapid and dramatic changes in its relatively short history and is subject to significant challenges. As a result, the future revenue and income potential of our business is uncertain. You should consider our business and prospects in light of the risks and difficulties we encounter in this new and rapidly evolving market, which risks and difficulties include, among others:

- our relatively new, evolving and unproven business model;

- our ability to retain our current listenership, build our listener base and increase listener hours;

- our ability to effectively monetize listener hours, particularly with respect to listener hours on mobile devices, by growing our sales of advertising inventory created from growing listener hours and developing compelling ad product solutions that successfully deliver advertisers messages across the range of our delivery platforms while maintaining our listener experience in continually evolving markets;

Edgar Filing: Pandora Media, Inc. - Form 10-Q

- our ability to attract new advertisers, retain existing advertisers and prove to advertisers that our advertising platform is effective enough to justify a pricing structure that is profitable for us;
- our ability to maintain relationships with makers of mobile devices, consumer electronic products and automobiles;
- our operation under an evolving music industry licensing structure including statutory and consent decree licenses that may change or cease to exist, which in turn may result in a significant increase in our operating expenses; and
- our ability to continue to secure the rights to music that attracts listeners to the service on fair and reasonable economic terms.

Failure to successfully address these risks and difficulties, and other challenges associated with operating in a new and emerging market, could inhibit the implementation of our business plan, significantly harm our financial condition, operating results and liquidity and prevent us from achieving or sustaining profitability.

Table of Contents

We have incurred significant operating losses in the past and may not be able to generate sufficient revenue to be profitable.

Since our inception in 2000, we have incurred significant net operating losses and, as of January 31, 2013, we had an accumulated deficit of \$139.6 million. A key element of our strategy is to increase the number of listeners and listener hours to increase our market penetration, including the number of listener hours on mobile and other connected devices, such as automobiles and consumer electronics. However, as our number of listener hours increases, the royalties we pay for content acquisition also increase. We have not in the past generated, and may not in the future generate, sufficient revenue from the sale of advertising and subscriptions to offset our expenses. While we have generated revenue from our advertising products at a rate that exceeds the growth in listener hours in certain fiscal years for traditional computers and for the fiscal year ending January 31, 2013 for mobile and other connected devices, to date we have not been able to grow our total advertising revenue at a rate that exceeds the growth in our listener hours. Part of the challenge that we face in increasing sales to monetize inventory generated by mobile devices is that radio advertising has traditionally attracted primarily local advertisers and we are still at an early stage of building our sales capability and penetrating local advertising markets. In addition, to the extent that our listener base on mobile platforms may skew to different demographics than we have historically sold on our traditional computer platform, we must identify such demographics and convince advertisers of the capabilities of mobile advertising to maximize advertising inventory utilization across our multi-platform ad campaigns.

If we cannot successfully earn revenue at a rate that exceeds the operational costs associated with increased listener hours, we may not be able to achieve or sustain profitability. In addition, we expect to invest heavily in our operations to support anticipated future growth. As a result of these factors, we expect to continue to incur annual losses on a U.S. GAAP basis in the near term.

Our revenue increased rapidly in each of the fiscal years ended January 31, 2007 through January 31, 2013; however, we expect our revenue growth rate to decline in the future as a result of a variety of factors, including increased competition and the maturation of our business, and we cannot assure you that our revenue will continue to grow or will not decline. You should not consider our historical revenue growth or operating expenses as indicative of our future performance. If our revenue growth rate declines or our operating expenses exceed our expectations, our financial performance will be adversely affected. Further, if our future growth and operating performance fail to meet investor or analyst expectations, it could have a materially negative effect on our stock price.

In addition, in our efforts to increase revenue as the number of listener hours has grown, we have expanded and expect to continue to expand our sales force. If our hiring of additional sales personnel does not result in a sufficient increase in revenue, the cost of this additional headcount will not be offset, which would harm our operating results and financial condition.

Our failure to convince advertisers of the benefits of our service in the future could harm our business.

For our fiscal year ended January 31, 2013 we derived 88% of our revenue from the sale of advertising and expect to continue to derive a substantial majority of our revenue from the sale of advertising in the future. Our ability to attract and retain advertisers, and ultimately to sell our advertising inventory to generate advertising revenue, depends on a number of factors, including:

- increasing the number of listener hours;

Edgar Filing: Pandora Media, Inc. - Form 10-Q

- keeping pace with changes in technology and our competitors;
- competing effectively for advertising dollars from other online marketing and media companies;
- penetrating the market for local radio advertising;
- demonstrating the value of advertisements to reach targeted audiences across all of our delivery platforms, including the value of mobile digital advertising;
- continuing to develop and diversify our advertisement platform, which currently includes delivery of display, audio and video advertising products through multiple delivery channels, including traditional computers, mobile and other connected devices, including automobiles; and

Table of Contents

- coping with ad blocking technologies that have been developed and are likely to continue to be developed that can block the display of our ads.

Our agreements with advertisers are generally short-term or may be terminated at any time by the advertiser. Advertisers that are spending only a small amount of their overall advertising budget on our service may view advertising with us as experimental and unproven and may leave us for competing alternatives at any time. We may never succeed in capturing a greater share of our advertisers' core advertising spending, particularly if we are unable to achieve the scale and market penetration necessary to demonstrate the effectiveness of our advertising platforms, or if our advertising model proves ineffective or not competitive when compared to alternatives. Failure to demonstrate the value of our service would result in reduced spending by, or loss of, existing or potential future advertisers, which would materially harm our revenue and business.

Advertising on mobile devices, such as smartphones, is an emerging phenomenon, and if we are unable to increase revenue from our advertising products delivered to mobile devices, our results of operations will be materially adversely affected.

Our number of listener hours on mobile devices has surpassed listener hours on traditional computers, and we expect that this will continue to be the case. Our mobile listenership has experienced significant growth since we introduced the first mobile version of our service in May 2007. Listener hours on mobile devices and other connected devices constituted approximately 5%, 26%, 54%, 69% and 77% of our total listener hours for fiscal years 2009, 2010, 2011, 2012 and 2013, respectively. We expect this growth to continue, though at a less rapid pace. Digital advertising on mobile devices is an emerging phenomenon, and the percentage of advertising spending allocated to digital advertising on mobile devices is lower than that allocated to traditional online advertising. According to IDC, the percentage of U.S. advertising spending allocated to advertising on mobile devices was less than 1% in 2010, compared to 13% for all online advertising. We must therefore convince advertisers of the capabilities of mobile digital advertising opportunities so that they migrate their advertising spend toward demographics and ad solutions that more effectively utilize mobile inventory. Our cost of content acquisition, or royalty fees for public performances, is currently calculated on the same basis whether a listening hour is consumed on a traditional computer or a mobile device. To date, we have not been able to generate revenue from our advertising products delivered to mobile and other connected devices, such as automobiles and consumer electronics, as effectively as we have for our advertising products served on traditional computers.

Radio advertising has traditionally attracted primarily local advertisers, and we are still at an early stage of building our sales capability to penetrate local advertising markets, which we view as a key challenge in monetizing our listener hours, including listener hours on mobile and other connected devices. In addition, while a substantial amount of our revenue has traditionally been derived from display ads, some display ads may not be currently optimized for use on certain mobile or other connected devices. For example, standard display ads may not be well-suited for use on smartphones due to the size of the device screen and may not be appropriate for smartphones connected to or integrated in automobiles due to safety considerations. Further, some display ads may not be optimized to take advantage of the multimedia capabilities of connected devices. By contrast, audio ads are better-suited for delivery on smartphones connected to or installed in automobiles and across mobile and connected device platforms and video ads can be optimized for a variety of platforms. However, our audio and video advertising products are relatively new and have not been as widely accepted by advertisers as our traditional display ads. In addition, the introduction of audio advertising places us in more direct competition with terrestrial radio, as many advertisers that purchase audio ads focus their spending on terrestrial radio stations who traditionally have strong connections with local advertisers.

We have plans that, if successfully implemented, would increase our number of listener hours on mobile and other connected devices, including efforts to expand the reach of our service by making it available on an increasing number of devices, such as smartphones and devices connected to or installed in automobiles. In order to effectively monetize such increased listener hours, we must, among other things, convince advertisers to migrate spending to nascent advertising markets, penetrate local advertising markets and develop compelling ad product solutions. We cannot assure you that we will be able to effectively monetize inventory generated by listeners using mobile and connected devices, or the time frame on which we may do so.

Table of Contents

If our efforts to attract prospective listeners and to retain existing listeners are not successful, our growth prospects and revenue will be adversely affected.

Our ability to grow our business and generate advertising revenue depends on retaining and expanding our listener base and increasing listener hours. We must convince prospective listeners of the benefits of our service and existing listeners of the continuing value of our service. The more listener hours we stream, the more ad inventory we have to sell. Further, growth in our listener base increases the size of demographic pools targeted by advertisers, which improves our ability to deliver advertising in a manner that maximizes our advertising customers' return on investment and, ultimately, to demonstrate the effectiveness of our advertising solutions and justify a pricing structure that is profitable for us. If we fail to grow our listener base and listener hours, particularly in key demographics such as young adults, we will be unable to grow advertising revenue, and our business will be materially and adversely affected.

Our ability to increase the number of our listeners and listener hours will depend on effectively addressing a number of challenges. We may fail to do so. Some of these challenges include:

- providing listeners with a consistent high quality, user-friendly and personalized experience;

- continuing to build our catalogs of music and comedy content that our listeners enjoy;

- continuing to innovate and keep pace with changes in technology and our competitors; and

- maintaining and building our relationships with makers of consumer products such as mobile devices, other consumer electronic products and automobiles to make our service available through their products.

In addition, we have historically relied heavily on the success of viral marketing to expand consumer awareness of our service. If we are unable to maintain or increase the efficacy of our viral marketing strategy, or if we otherwise decide to expand the reach of our marketing through use of more costly marketing campaigns, we may experience an increase in marketing expenses, which could have an adverse effect on our results of operations. We cannot assure you that we will be successful in maintaining or expanding our listener base and failure to do so would materially reduce our revenue and adversely affect our business, operating results and financial condition.

Further, although we use our number of registered users and our number of active users as indicators of our brand awareness and the growth of our business, the number of registered users and number of active users exceeds the number of unique individuals who register for, or actively use, our service. We define registered users as the total number of accounts that have been created for our service and we define active users as the number of distinct registered users that have requested audio from our servers within the trailing 30 days from the end of each calendar month. To establish an account, a person does not need to provide personally unique information. For this reason a person may have multiple accounts. If the number of actual listeners does not result in an increase in listener hours, then our business may not grow as quickly as we expect, which may harm our business, operating results and financial condition.

We have experienced rapid growth in both listener hours and advertising revenue. We do not expect to be able to sustain these growth rates in the future and our business and operating results may suffer.

We have experienced rapid growth rates in both listener hours and advertising revenue as a result of our growth strategy to commit substantial financial, operational and technical resources to build the Company. As we grow larger and increase our listener base and usage, we expect it will become increasingly difficult to maintain the rate of growth we currently experience. Slower growth could negatively impact our stock price, our ability to hire and retain employees or harm our business in other ways.

If our efforts to attract and retain subscribers are not successful, our business may be adversely affected.

In the first half of fiscal 2014, subscription revenue comprised 17% of our total revenue, compared to 12% in the first half of fiscal 2013. The growth in subscribers and subscription revenue in fiscal 2014 has been driven substantially by the listener hour limit

Table of Contents

we instituted on mobile listeners in March 2013. In September 2013, we removed the mobile listening limit, as we have instituted other tools to moderate mobile listener hour growth. As a result, we do not expect the growth rate we experienced in subscribers in the first half of fiscal 2014 to continue. Furthermore, we expect that a number of listeners who subscribed to Pandora One in response to the mobile listening limit may choose to cancel their subscriptions going forward and return to using our free, ad-supported service. As a result, we presently expect subscriber growth to be lower than in corresponding prior year periods for the near term. Over the longer term, our ability to continue to attract subscribers will depend in part on our ability to consistently provide our subscribers with a quality experience through Pandora One. If Pandora One subscribers do not perceive that offering to be of value, or if we introduce new or adjust existing features or pricing in a manner that is not favorably received by them, we may not be able to attract and retain subscribers. Subscribers may cancel their subscription to our service for many reasons, including a perception that they do not use the service sufficiently, the need to cut household expenses, competitive services provide a better value or experience or as a result in changes in pricing, if any. If our efforts to attract and retain subscribers are not successful, our business, operating results and financial condition may be adversely affected.

If we fail to effectively manage our growth, our business and operating results may suffer.

Our rapid growth has placed, and will continue to place, significant demands on our management and our operational and financial infrastructure. In order to attain and maintain profitability, we will need to recruit, integrate and retain skilled and experienced sales personnel who can demonstrate our value proposition to advertisers and increase the monetization of listener hours, particularly on mobile devices, by developing relationships with both national and local advertisers to convince them to migrate advertising spending to online and mobile digital advertising markets and utilize our advertising product solutions. Continued growth could also strain our ability to maintain reliable service levels for our listeners, effectively monetize our listener hours, develop and improve our operational, financial and management controls, enhance our reporting systems and procedures and recruit, train and retain highly skilled personnel. If our systems do not evolve to meet the increased demands placed on us by an increasing number of advertisers, we may also be unable to meet our obligations under advertising agreements with respect to the timing of our delivery of advertising or other performance obligations. As our operations grow in size, scope and complexity, we will need to improve and upgrade our systems and infrastructure, which will require significant expenditures and allocation of valuable management resources. If we fail to maintain the necessary level of discipline and efficiency and allocate limited resources effectively in our organization as it grows, our business, operating results and financial condition may suffer.

We face, and will continue to face, competition for both listener hours and advertising spending.

We compete with other content providers for listener hours.

We compete for the time and attention of our listeners with other content providers on the basis of a number of factors, including quality of experience, relevance, acceptance and diversity of content, ease of use, price, accessibility, perception of ad load, brand awareness and reputation.

Many of our competitors may leverage their existing infrastructure, brand recognition and content collections to augment their services by offering competing internet radio features to provide listeners with more comprehensive music service delivery choices. We face increasing competition for listeners from a growing variety of businesses that deliver audio media content through mobile phones and other wireless devices.

Edgar Filing: Pandora Media, Inc. - Form 10-Q

Our competitors include terrestrial radio, satellite radio and online radio. Terrestrial radio providers such as CBS and Clear Channel offer their content for free, are well-established and accessible to listeners and offer content, such as news, sports, traffic, weather and talk that we currently do not offer. In addition, many terrestrial radio stations have begun broadcasting digital signals, which provide high-quality audio transmission.

Satellite radio providers, such as Sirius XM, may offer extensive and oftentimes exclusive news, comedy, sports and talk content, national signal coverage and long established automobile integration. In addition, terrestrial radio pays no royalties for its use of sound recordings and satellite radio pays a much lower percentage of revenue, currently 9.0%, than internet radio providers for use

Table of Contents

of sound recordings, giving broadcast and satellite radio companies a significant cost advantage.

Other online radio providers may offer more extensive content libraries than we offer and some may be accessed internationally.

We also compete with providers of on-demand audio media and entertainment which are purchased or available for free and playable on mobile devices, automobiles and in the home. These forms of media may be purchased, downloaded and owned such as iTunes audio files, MP3s, CDs, or accessed from subscription or free online on-demand offerings by music providers such as RDIO, Spotify and Rhapsody or content streams from other online services such as Hulu, VEVO, mtv.com and YouTube. We believe that companies with a combination of financial resources, technical expertise and digital media experience also pose a significant threat of developing competing internet radio and digital audio entertainment technologies. For example, known incumbents in the digital media space such as Apple and Google have recently launched competing services, and they may devote greater resources than we have available, have a more accelerated time frame for deployment and leverage their existing user base and proprietary technologies to provide products and services that our listeners and advertisers may view as superior. Our current and future competitors may have more well-established brand recognition, more established relationships with music publishing companies, consumer product manufacturers, greater financial, technical and other resources, more sophisticated technologies or more experience in the markets in which we compete.

We also compete for listeners on the basis of our presence and visibility as compared with other businesses and software that deliver audio and other content through the internet, mobile devices and consumer products. We face significant competition for listeners from companies promoting their own digital music and content online or through application stores, including several large, well-funded and seasoned participants in the digital media market. Search engines, such as Google, and mobile device application stores, such as the iTunes Store, rank responses to search queries based on the popularity of a website or mobile application, as well as other factors that are outside of our control. Additionally, mobile device application stores often offer users the ability to browse applications by various criteria, such as the number of downloads in a given time period, the length of time since a mobile app was released or updated, or the category in which the application is placed. The websites and mobile applications of our competitors may rank higher than our website and our Pandora app, and our app may be difficult to locate in mobile device application stores, which could draw potential listeners away from our service and toward those of our competitors. In addition, our competitors' products may be pre-loaded or integrated into consumer electronics products or automobiles, creating an initial visibility advantage. If we are unable to compete successfully for listeners against other digital media providers by maintaining and increasing our presence and visibility online, in application stores and in consumer electronics products and automobiles, our listener hours may fail to increase as expected or decline and our advertising sales may suffer.

To compete effectively, we must continue to invest significant resources in the development of our service to enhance the user experience of our listeners. There can be no assurance that we will be able to compete successfully for listeners in the future against existing or new competitors, and failure to do so could result in loss of existing or potential listeners, reduced revenue, increased marketing expenses or diminished brand strength, any of which could harm our business.

We compete for advertising spending with other content providers.

We compete for a share of advertisers' overall marketing budgets with other content providers on a variety of factors including perceived return on investment, effectiveness and relevance of our advertising products, pricing structure and ability to deliver large volumes or precise types of ads to targeted demographics.

Edgar Filing: Pandora Media, Inc. - Form 10-Q

We face significant competition for advertising dollars from terrestrial and, to a lesser extent, satellite radio providers. As many of the advertisers we target have traditionally advertised on terrestrial radio and have less experience with internet radio providers, they may be reluctant to spend for advertising on traditional computers, mobile or other connected device platforms. In addition, terrestrial radio providers as well as other traditional media companies in television and print, such as broadcast television networks such as ABC, CBS, FOX and NBC, cable television channel providers, national newspapers such as the New York Times and the Wall Street Journal and some regional newspapers, enjoy a number of competitive advantages over us in attracting advertisers,

Table of Contents

including large established audiences, longer operating histories, greater brand recognition and a growing presence on the internet.

Although advertisers are allocating an increasing amount of their overall marketing budgets to web and mobile-based ads, such spending lags behind growth in internet and mobile usage, and the market for online and mobile advertising is intensely competitive. As a result, we also compete for advertisers with a range of internet companies, including major internet portals, search engine companies and social media sites. Large internet companies with greater brand recognition, such as Facebook, Google, MSN and Yahoo! have significant numbers of direct sales personnel and substantial proprietary advertising inventory and web traffic that provide a significant competitive advantage and have a significant impact on pricing for internet advertising and web traffic. The trend toward consolidation among online marketing and media companies may also affect pricing and availability of advertising inventory.

In order to compete successfully for advertisers against new and existing competitors, we must continue to invest resources in developing and diversifying our advertisement platform, harnessing listener data and ultimately proving the effectiveness and relevance of our advertising products. Failure to compete successfully against our current or future competitors could result in loss of current or potential advertisers or a reduced share of our advertisers' overall marketing budget, which could adversely affect our pricing and margins, lower our revenue, increase our research and development and marketing expenses and prevent us from achieving or maintaining profitability.

Our ability to increase the number of our listeners will depend in part on our ability to establish and maintain relationships with automakers, automotive suppliers and consumer electronics manufacturers with products that integrate our service.

A key element of our strategy to expand the reach of our service and increase the number of our listeners and listener hours is to establish and maintain relationships with automakers, automotive suppliers and consumer electronics manufacturers that integrate our service into and with their products. Working with certain third-party distribution partners, we currently offer listeners the ability to access our service through a variety of consumer electronics products used in the home and devices connected to or installed in automobiles. We intend to broaden our ability to reach additional listeners, and increase current listener's hours, through other platforms and partners over time. However, reaching agreements with distribution partners can be time consuming, and once an agreement is reached, product design cycles can be lengthy. If we are not successful in maintaining existing and creating new relationships, or if we encounter technological, content licensing or other impediments, our ability to grow our business could be adversely impacted.

Our existing agreements with partners in the automobile and consumer electronics industries generally do not obligate those partners to launch our service in their products. In addition, some automobile manufacturers or their supplier partners may terminate their agreements with us for convenience. Our business could be adversely affected if our automobile partners and consumer electronics partners do not continue to provide access to our service or are unwilling to do so on terms acceptable to us. If we are forced to amend the business terms of our distribution agreements as a result of competitive pressure, our ability to maintain and expand the reach of our service and increase listener hours would be adversely affected, which would reduce our revenue and harm our operating results.

Additionally, we distribute our mobile applications via smartphone application download stores managed by Apple, Google, Amazon, Palm and Research In Motion, or RIM, and such distribution is subject to an application developer license agreement in each case. Should any of these parties reject our app from their application store or amend the terms of their license in such a way that inhibits our ability to distribute the Pandora apps via their application store, or negatively impacts our economics in such distribution, our ability to increase listener hours and sell advertising would be adversely affected, which would reduce our revenue and harm our operating results.

Table of Contents

If we are unable to continue to make our technology compatible with the technologies of third-party distribution partners who make our service available to our listeners through mobile devices, consumer electronic products and automobiles, we may not remain competitive and our business may fail to grow or decline.

In order to deliver music everywhere our listeners want to hear it, our service must be compatible with mobile, consumer electronic, automobile and website technologies. Our service is accessible in part through Pandora-developed or third-party developed applications that hardware manufacturers embed in, and distribute through, their devices. Connected devices and their underlying technology are constantly evolving. As internet connectivity of automobiles, mobile devices and other consumer electronic products expands and as new internet-connected products are introduced, we must constantly adapt our technology. It is difficult to keep pace with the continual release of new devices and technological advances in digital media delivery and predict the problems we may encounter in developing versions of our applications for these new devices and delivery channels. It may become increasingly challenging to do so in the future. In particular, the technology used for streaming the Pandora service in automobiles remains at an early stage and may not result in a seamless customer experience. If automobile and consumer electronics makers fail to make products that are compatible with our technology or we fail to adapt our technology to evolving requirements, our ability to grow or sustain the reach of our service, increase listener hours and sell advertising could be adversely affected.

Consumer tastes and preferences can change in rapid and unpredictable ways and consumer acceptance of these products depends on the marketing, technical and other efforts of third-party manufacturers, which is beyond our control. If consumers fail to accept the products of the companies with whom we partner or if we fail to establish relationships with makers of leading consumer products, our business could be adversely affected.

Unavailability of, or fluctuations in, third-party measurements of our audience may adversely affect our ability to grow advertising revenue.

Selling ads, locally and nationally, requires that we demonstrate to advertisers that our service has substantial reach and usage. Third-party measurements may not reflect our true listening audience and their underlying methodologies are subject to change at any time. In addition, the methodologies we apply to measure the key metrics that we use to monitor and manage our business may differ from the methodologies used by third-party measurement service providers. For example, we calculate listener hours based on the total bytes served for each track that is requested and served from our servers, as measured by our internal analytics systems, whether or not a listener listens to the entire track. By contrast, certain third-party measurement service providers may calculate and report the number of listener hours using a client-based approach, which measures time elapsed during listening sessions. Measurement technologies for mobile and consumer electronic devices may be even less reliable in quantifying the reach and usage of our service, and it is not clear whether such technologies will integrate with our systems or uniformly and comprehensively reflect the reach and usage of our service. While we have been working with third-party measurement service providers, these providers have not yet developed uniform measurement systems that comprehensively measure the reach and usage of our service. In order to demonstrate to potential advertisers the benefits of our service, we must supplement third-party measurement data with our internal research, which may be perceived as less valuable than third-party numbers. If such third-party measurement providers report lower metrics than we do, or if there is wide variance among reported metrics, our ability to convince advertisers of the benefits of our service could be adversely affected.

The lack of accurate cross-platform measurements for internet radio and broadcast radio may adversely affect our ability to grow advertising revenue.

Pandora has invested substantial resources to create accurate cross-platform measurements for internet radio and broadcast radio in the major automated media-buying platforms, creating a one-stop shop that enables media buyers to compare internet radio audience reach with terrestrial

Edgar Filing: Pandora Media, Inc. - Form 10-Q

radio audience reach using traditional broadcast radio metrics. To achieve this result, we currently rely on third parties such as Triton to quantify the reach and usage of our service and on media buying companies to provide Internet radio metrics side-by-side with terrestrial radio metrics in media-buying platforms.

We have also partnered with media buying companies that show internet radio measurements alongside terrestrial metrics in the media buying systems that media buyers use to purchase advertising. Media buying companies receive measurement metrics from third parties, such as Triton for internet radio and Arbitron and Nielsen for more traditional media like terrestrial radio and television. Media buying companies may choose not to show, or may be prohibited by third party measurement services that measure terrestrial radio and other traditional media from showing, internet radio metrics alongside traditional terrestrial metrics. Our ability to realize our long-term potential will be significantly affected by our success in these advertising initiatives, and there is no assurance we will

Table of Contents

achieve substantial penetration of these advertising markets.

Our success depends upon the continued acceptance of online advertising as an alternative or supplement to offline advertising.

The percentage of the advertising market allocated to online advertising lags the percentage of consumer online consumption by a significant degree. Growth of our business will depend in large part on the reduction or elimination of this gap between online and offline advertising spending, which may not happen in a way or to the extent that we currently expect. Many advertisers still have limited experience with online advertising and may continue to devote significant portions of their advertising budgets to traditional, offline advertising media. Accordingly, we continue to compete for advertising dollars with traditional media, including broadcast radio.

Although advertisers as a whole are spending an increasing amount of their overall advertising budget on online advertising, we face a number of challenges in growing our advertising revenue. We compete for advertising dollars with significantly larger and more established online marketing and media companies such as Facebook, Google, MSN and Yahoo!. We believe that the continued growth and acceptance of our online advertising products will depend on the perceived effectiveness and the acceptance of online advertising models generally, which is outside of our control. Any lack of growth in the market for online advertising could result in reduced revenue or increased marketing expenses, which would harm our operating results and financial condition.

We operate under and pay royalties pursuant to statutory licensing structures for the reproduction and public performance of sound recordings that could change or cease to exist, which would adversely affect our business.

We currently operate under statutory licensing regimes and structures that may change or cease to exist. We must pay performance rights royalties for the digital audio transmission of sound recordings. Subject to our ongoing compliance with numerous statutory conditions and regulatory requirements for a noninteractive service, we are permitted to operate under a federal statutory license that allows the streaming in the U.S. of any sound recording lawfully released to the public. We are also permitted to make reproductions of sound recordings on computer servers pursuant to a separate statutory license designed to facilitate the making of transmissions. There is no guarantee that these licenses will continue to be available or that we will continue to be eligible to operate under these statutory licenses. For example, if a court were to determine that we operate an interactive streaming service or make reproductions of sound recordings outside the statutory license, we would have to negotiate license agreements with sound recording copyright owners individually, a time consuming and expensive undertaking that could jeopardize our ability to stream a significant percentage of the music currently in our library and could result in royalty costs that are prohibitively expensive. In addition, if copyright owners object to the functionality or transmission methods of our service, we could lose our eligibility to operate under the statutory licenses. Our ability to avoid negotiating separate agreements with the many copyright owners of sound recordings currently used on our service depends on these two statutory licenses, and if we were to no longer qualify for operation under, or violate the provisions of the statutory licenses, we could be subject to significant liability for copyright infringement and may no longer be able to operate under our existing licensing regime. For our fiscal year ended January 31, 2013 we incurred SoundExchange related content acquisition costs representing 55.9% of our total revenue for that period.

The rates to be paid for the streaming of sound recordings pursuant to the statutory licenses can be established by either negotiation or through a rate proceeding conducted by the Copyright Royalty Board, or CRB, a tribunal established within the U.S. Library of Congress. In 2007, the CRB set royalty rates for the online streaming of sound recordings for 2006 through 2010 that were so high that the cost for streaming sound recordings alone would have been unsustainable under our current business model. In response to the lobbying efforts of internet webcasters, including us, Congress passed the Webcaster Settlement Acts of 2008 and 2009, which permitted webcasters and SoundExchange, the sole entity designated by the CRB to collect and distribute the statutory royalties paid by internet webcasters such as us, to negotiate alternative rates to

Edgar Filing: Pandora Media, Inc. - Form 10-Q

those established by the CRB for the years 2006 through 2015. In July 2009, certain webcasters reached an agreement with SoundExchange, establishing alternative, non-precedential rates below those eventually established by the CRB. The reduced alternative rates and rate structures under this agreement will apply through 2015, but may not be considered by the CRB if and when it conducts a proceeding to establish royalty rates for the years 2016 through 2020. There can be no assurance that the per performance rates established by the CRB for the period 2016 through 2020 will not exceed the rates actually paid by us or the rates previously established by the CRB for the years 2011 through 2015. We do not

Table of Contents

know what rates will be available to us commencing January 1, 2016 and there is no guarantee that the royalty structure that emerged from the negotiations with SoundExchange pursuant to the Webcaster Settlement Acts will be available after 2015. The CRB, which still has rate-making authority over us upon expiration of our agreement with SoundExchange, has consistently established royalty rates, including those established for the years 2011 through 2015 that would, if paid by us, consume an unsustainable percentage of our revenue. If we are unable to reach a new agreement for commercially reasonable rates with SoundExchange as the representative for sound recording copyright owners entitled to receive statutory royalties for the period 2016 through 2020, then our content acquisition costs may significantly increase, which could materially harm our financial condition and inhibit the implementation of our business plan.

In addition, the royalties that we pay to SoundExchange for the streaming of sound recordings are calculated using a per performance rate. While we believe that the mechanisms we use to track performances are sufficient to ensure that we are accurately reporting and paying royalties, our ability to do so depends in part on our ability to maintain these mechanisms as new devices are introduced and incumbent technologies evolve. Any understatement or overstatement of performances could result in our paying lower or higher royalties to SoundExchange than we actually owed, which could in turn affect our financial condition and results of operations.

We depend upon third-party licenses for the right to publicly perform musical works and a change to or loss of these licenses could increase our content acquisition costs, reduce the sound recordings that we perform on the service or adversely affect our ability to retain and expand our listener base, and therefore could adversely affect our business.

To secure the rights to publicly perform musical works embodied in sound recordings over the internet, we obtain licenses from or for the benefit of copyright owners and pay royalties to copyright owners or their agents. Copyright owners of musical works are vigilant in protecting their rights and currently are seeking substantial increases in the rates applicable to the public performance of such works. There is no guarantee that the licenses available to us now will continue to be available in the future or that such licenses will be available at the royalty rates associated with the current licenses. If we are unable to secure and maintain rights to publicly perform musical works or if we cannot do so on terms that are acceptable to us, our ability to perform music content to our listeners, and consequently our ability to attract and retain both listeners and advertisers, will be adversely impacted.

Copyright owners of musical works have traditionally relied on performance rights organizations to negotiate so-called blanket licenses with copyright users. We have traditionally obtained the rights to publicly perform musical works embodied in sound recordings over the internet from, and pay and have paid license fees to, the three major performance rights organizations in the United States: American Society of Composers, Authors and Publishers, or ASCAP, Broadcast Music, Inc., or BMI, and SESAC, Inc., or SESAC. These organizations represent the rights of affiliated songwriters and music publishers, negotiate with copyright users such as us, collect royalties and distribute those royalties to the copyright owners they represent. Performing rights organizations and musical work copyright owners with whom we have entered into direct licenses have or may have the right to audit our playlists and royalty payments, and any such audit could result in disputes over whether we have paid the proper royalties. If such a dispute were to occur, we could be required to pay additional royalties and audit fees. The amounts involved could be material. We currently operate under a final agreement with SESAC, however, this agreement is subject to termination by either party in accordance with its terms at the end of each yearly term, and there is no guarantee that the associated royalty rate available to us now will be available to us in the future. We currently operate under interim agreements with BMI and ASCAP, which pursuant to their respective consent decrees entered into with the U.S. Department of Justice cannot refuse to grant us licenses for the public performance of the musical works in their respective repertoires. The number of works administered by ASCAP and BMI may fluctuate over time and may be subject to the withdrawal of certain rights by individual ASCAP and BMI-affiliated music publishers for certain types of transmissions by certain types of services, such as Pandora. The decrease in the works licensed by ASCAP and BMI may require more direct licensing by Pandora with individual music publishers. Rates payable to ASCAP and BMI can be set, in the absence of a negotiated agreement, by the respective rate courts established pursuant to such decrees in the U.S. District Court for the Southern District of New York. SESAC and individual publishers are not subject to a mandatory licensing obligation and could withhold the rights to all of the musical works which they own or administer. The loss of the musical works represented by ASCAP, BMI and SESAC or individual publishers could diminish the appeal of our service to listeners, as we would not be able to perform sound recordings if we did not have authorization to publicly perform the musical works embodied in such sound recordings.

Table of Contents

In 2010, we elected to terminate our prior agreement with ASCAP as of December 31, 2010 and in 2012 we elected to terminate our prior agreement with BMI as of December 31, 2012 because we believed that the royalty rates and terms sought by ASCAP and BMI were in excess of rates paid by our largest competitors. Notwithstanding our termination of these agreements, the musical works administered by ASCAP and BMI are licensed to us pursuant to the provisions of their respective consent decrees, although there is a question before the BMI rate court as to whether the BMI repertory may be diminished during the term of our consent decree licenses if certain BMI member publishers purportedly withdraw certain performance rights from BMI for certain types of transmissions by certain types of licensees such as Pandora. To the extent the BMI repertory may diminish during the term of our consent decree license, our content acquisition costs could be increased by the need to obtain direct licenses from individual music publishers for such rights, the number of sound recordings that we perform on the service may be reduced or our ability to retain and expand our listener base could be adversely affected. A similar issue with respect to purported withdrawals exists in our pending rate case with ASCAP, for which summary judgment ruling on the issue is subject to appeal. We may also pay reduced amounts to ASCAP and BMI if their repertories are reduced and the rate set for those repertories is adjusted to reflect the diminished size of the catalog of licensable musical works. In September 2011, we changed the method we used to calculate royalties due to ASCAP following the execution of an interim arrangement for the period commencing January 1, 2011, pending a final determination of new rates.

In November 2012, we filed a petition in rate court to request a determination of reasonable fees and terms with ASCAP and in June 2013, BMI filed a petition in rate court to request a determination of reasonable fees and terms with BMI. The rate court proceedings can take years to complete and can be very costly. There is no guarantee that final rates established by mutual agreement or by a rate court determination would establish royalty rates more favorable to us than those we previously paid pursuant our terminated agreements with ASCAP and/or BMI or those that we pay pursuant to our interim arrangements with ASCAP and/or BMI.

Recent court proceedings, the purported withdrawal of certain music publishers from the ASCAP and BMI catalogs, and our recent entry into a local marketing agreement to program KXMZ-FM, in part to allow Pandora to qualify for the current ASCAP and BMI license agreements available to owners of one or more commercial radio stations, have highlighted uncertainties for the royalty rates payable to these organizations. For example, we could be liable for both increased royalty rates going forward and a potential true-up of royalty payments in excess of any interim royalties paid for the period following December 31, 2010 with respect to ASCAP and/or for the period following December 31, 2012 with respect to BMI. We record a liability for public performance royalties based on our best estimate of the amount owed to each organization based on historical rates, third-party evidence and legal developments. For each quarterly period, we evaluate our estimates to assess the adequacy of recorded liabilities. If actual royalty rates differ from estimates, revisions to the estimated royalty liabilities may be required, which could materially affect our results of operations. For our fiscal year ended January 31, 2013, we incurred content acquisition costs for the public performance of musical works representing 4.3% of our total revenue for that period.

We do not currently pay so-called mechanical royalties to music publishers for the reproduction and distribution of musical works embodied in transitory copies used to make streams audible to our listeners. Although not currently a matter of dispute, if music publishers were to change their position and seek that we pay mechanical royalties, and a final judgment were entered by a court requiring that payment, our royalty obligations could increase significantly, which would increase our operating expenses and harm our business and financial interests.

In May 2011, we started streaming spoken word comedy content, for which the underlying literary works are not currently entitled to eligibility for licensing by any performing rights organization in the United States. While pursuant to industry-wide custom and practice this content is performed absent a specific license from any such performing rights organization, there can be no assurance that this will not change or that we will not otherwise become subject to additional licensing costs for spoken word comedy content imposed by performing rights organizations in the future or be subject to damages for copyright infringement.

Table of Contents

If music publishers effectuate withdraws of all or a portion of their musical works from performing rights organizations for public performances by means of digital transmissions, then we may be forced to enter into direct licensing agreements with these publishers at rates higher than those we currently pay, or we may be unable to reach agreement with these publishers at all, which could adversely affect our business, our ability to attract and retain listeners, financial condition and results of operations.

If music publishers effectuate withdraws of all or a portion of their catalogs from ASCAP, BMI or SESAC, we may no longer be able to obtain licenses for such publisher's withdrawn catalogs. Under these circumstances, we would either need to enter into direct licensing arrangements with such music publishers or remove those musical works from the service, including any sound recordings in which such musical works are embodied. Publishers have signaled their intent to withdraw all or a portion of their catalogs from ASCAP and BMI and we have entered into direct licenses with publishers to enable Pandora to continue to perform their works while Pandora continues to pursue other legal remedies. Although we continue to be licensed by the PROs, it is currently unclear what specific effect a publisher's purported limited withdrawal of rights to public performances by means of digital transmissions from a PRO would have on us. If we are unable to reach an agreement with respect to the repertoire of any music publisher which successfully withdraws all or a portion of its catalog(s) from a PRO, or if we are forced to enter into direct licensing agreements with such publishers at rates higher than those currently set by the PROs (or higher than those set by the U.S. District Court having supervisory authority over ASCAP and BMI) for the performance of musical works, or if there is uncertainty as to what rights are administered by any particular PRO or publisher, our ability to stream music content to our listeners may be limited or our content acquisition costs may increase, and this could adversely affect our business, financial condition and results of operations.

If we fail to accurately predict and play music or comedy content that our listeners enjoy, we may fail to retain existing and attract new listeners.

We believe that a key differentiating factor between the Pandora service and other music content providers is our ability to predict music that our listeners will enjoy. Our personalized playlist generating system, based on the Music Genome Project and our proprietary algorithms, is designed to enable us to predict listener music preferences and select music content tailored to our listeners' individual music tastes. We have invested, and will continue to invest, significant resources in refining these technologies; however, we cannot assure you that such investments will yield an attractive return or that such refinements will be effective. The effectiveness of our personalized playlist generating system depends in part on our ability to gather and effectively analyze large amounts of listener data and listener feedback and we have no assurance that we will continue to be successful in enticing listeners to give a thumbs-up or thumbs-down to enough songs for our database to effectively predict and select new and existing songs. In addition, our ability to offer listeners songs that they have not previously heard and impart a sense of discovery depends on our ability to acquire and appropriately categorize additional tracks that will appeal to our listeners' diverse and changing tastes. While we have more than 1,000,000 songs in our catalog, we must continuously identify and analyze additional tracks that our listeners will enjoy and we may not effectively do so. Further, many of our competitors currently have larger catalogs than we offer and they may be more effective in providing their listeners with a more appealing listener experience.

We also provide comedy content on Pandora, an offering that is designed to predict what our listeners will enjoy using technology similar to the technology that we use to generate personalized playlists for music. The risks that apply to predicting our listeners' musical tastes apply to comedy to an even greater extent, particularly as we lack experience with content other than music, do not yet have a large set of data on listener preferences for comedy and have a much smaller comedy catalog as compared to music. Our ability to predict and select music or comedy content that our listeners enjoy is critical to the perceived value of our service among listeners and failure to make accurate predictions would adversely affect our ability to attract and retain listeners, increase listener hours and sell advertising.

Loss of agreements with the makers of mobile devices, renegotiation of such agreements on less favorable terms or other actions these third parties may take could harm our business.

Most of our agreements with makers of mobile operating systems and devices through which our service may be accessed, including Apple, RIM and Google, are short-term or can be cancelled at any time with little or no prior notice or penalty. The loss of these agreements, or the renegotiation of these agreements on less favorable economic or other terms, could limit the reach of our service and its attractiveness to advertisers. Some of these mobile device makers, including Apple, are now, or may in the future become, competitors of ours, and could stop allowing or supporting access to our service through their products for competitive reasons. Furthermore, because devices providing access to our service are not manufactured and sold by us, we cannot guarantee that these companies will ensure that their devices perform reliably, and any faulty connection between these devices and our service may result in consumer dissatisfaction toward us, which could damage our brand.

Table of Contents

We rely upon an agreement with DoubleClick, which is owned by Google, for delivering and monitoring our ads. Failure to renew the agreement on favorable terms, or termination of the agreement, could adversely affect our business.

We use DoubleClick's ad-serving platform to deliver and monitor ads for our service. There can be no assurance that our agreement with DoubleClick, which is owned by Google, will be extended or renewed upon expiration, that we will be able to extend or renew our agreement with DoubleClick on terms and conditions favorable to us or that we could identify another alternative vendor to take its place. Our agreement with DoubleClick also allows DoubleClick to terminate our relationship before the expiration of the agreement on the occurrence of certain events, including material breach of the agreement by us, and to suspend provision of the services if DoubleClick determines that our use of its service violates certain security, technology or content standards.

If we are unable to implement and maintain effective internal control over financial reporting in the future, the accuracy and timeliness of our financial reporting may be adversely affected.

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, we are required to furnish a report by our management on our internal control over financial reporting. The report contains, among other matters, an assessment of the effectiveness of our internal control over financial reporting as of the end of our fiscal year, including a statement as to whether or not our internal control over financial reporting is effective. This assessment must include disclosure of any material weaknesses in our internal control over financial reporting identified by management.

While we have determined that our internal control over financial reporting was effective as of January 31, 2013, as indicated in our Management's Annual Report on Internal Control over Financial Reporting included in our Annual Report on Form 10-K for the fiscal year ended January 31, 2013, we must continue to monitor and assess our internal control over financial reporting. If our management identifies one or more material weaknesses in our internal control over financial reporting and such weakness remains uncorrected at fiscal year-end, we will be unable to assert such internal control is effective at fiscal year-end. If we are unable to assert that our internal control over financial reporting is effective at fiscal year-end (or if our independent registered public accounting firm is unable to express an opinion on the effectiveness of our internal controls or concludes that we have a material weakness in our internal controls), we could lose investor confidence in the accuracy and completeness of our financial reports, which could have a material adverse effect on our business and price of our common stock.

Our business and prospects depend on the strength of our brand and failure to maintain and enhance our brand would harm our ability to expand our base of listeners, advertisers and other partners.

Maintaining and enhancing the Pandora brand is critical to expanding our base of listeners, advertisers and other partners. Maintaining and enhancing our brand will depend largely on our ability to continue to develop and provide an innovative and high quality experience for our listeners and attract advertisers, content owners and automobile, mobile device and other consumer electronic product manufacturers to work with us, which we may not do successfully.

Our brand may be impaired by a number of other factors, including service outages, data privacy and security issues, listener perception of ad load and exploitation of our trademarks by others without permission. In addition, if our partners fail to maintain high standards for products that integrate our service, fail to display our trademarks on their products in breach of our agreements with them, or use our trademarks incorrectly or in an unauthorized manner or if we partner with manufacturers of products that our listeners reject, the strength of our brand could be adversely

Edgar Filing: Pandora Media, Inc. - Form 10-Q

affected. Further, our efforts to achieve a more equitable royalty structure for our business may have an adverse impact on our relationship with artists, which could in turn diminish the perception of our brand. In addition, there is a risk that the word "Pandora" could become so commonly used that we lose protection for this trademark, which could result in other people using the word "Pandora" to refer to their own products, thus diminishing the strength of our brand.

We have not historically incurred significant expenses to establish and maintain our brand. However, if we are unable to maintain the growth rate in the number of our listeners, we may be required to expend greater resources on advertising, marketing and other

Table of Contents

brand-building efforts to preserve and enhance consumer awareness of our brand which would adversely affect our operating results and may not be effective.

We depend on key personnel to operate our business, and if we are unable to retain, attract and integrate qualified personnel, our ability to develop and successfully grow our business could be harmed.

We believe that our future success is highly dependent on the contributions of our executive officers as well as our ability to attract and retain highly skilled and experienced sales, technical and other personnel. All of our employees, including our executive officers, are free to terminate their employment relationship with us at any time, and their knowledge of our business and industry may be difficult to replace. Qualified individuals are in high demand, particularly in the digital media industry, and we may incur significant costs to attract them. In addition, competition for qualified personnel is particularly intense in the San Francisco Bay Area, where our headquarters are located. If we are unable to attract and retain our executive officers and key employees, we may not be able to achieve our strategic objectives, and our business could be harmed. In addition, we believe that our key executives have developed highly successful and effective working relationships. If one or more of these individuals leave, we may not be able to fully integrate new executives or replicate the current dynamic and working relationships that have developed among our executive officers and other key personnel, and our operations could suffer.

Interruptions or delays in service arising from our own systems or from our third-party vendors could impair the delivery of our service and harm our business.

We rely on systems housed in our own facilities and upon third-party vendors, including bandwidth providers and data center facilities located in California and Virginia, to enable listeners to receive our content in a dependable, timely and efficient manner. We have experienced and expect to continue to experience periodic service interruptions and delays involving our own systems and those of our third-party vendors. We do not currently maintain a live fail-over capability that would allow us to switch our streaming operations from one facility to another in the event of a service outage. Both our own facilities and those of our third-party vendors are vulnerable to damage or interruption from earthquakes, floods, fires, power loss, telecommunications failures and similar events. They also are subject to break-ins, sabotage, intentional acts of vandalism, the failure of physical, administrative, technical and cyber security measures, terrorist acts, natural disasters, human error, the financial insolvency of our third-party vendors and other unanticipated problems or events. The occurrence of any of these events could result in interruptions in our service and to unauthorized access to, or alteration of, the content and data contained on our systems and that these third-party vendors store and deliver on our behalf.

We exercise no control over our third-party vendors, which makes us vulnerable to any errors, interruptions, or delays in their operations. Any disruption in the services provided by these vendors could have significant adverse impacts on our business reputation, customer relations and operating results. Upon expiration or termination of any of our agreements with third-party vendors, we may not be able to replace the services provided to us in a timely manner or on terms and conditions, including service levels and cost, that are favorable to us, and a transition from one vendor to another vendor could subject us to operational delays and inefficiencies until the transition is complete.

Our operating results may fluctuate, which makes our results difficult to predict and could cause our results to fall short of expectations.

Edgar Filing: Pandora Media, Inc. - Form 10-Q

Our revenue and operating results could vary significantly from quarter to quarter and year to year because of a variety of factors, many of which are outside our control. As a result, comparing our operating results on a period-to-period basis may not be meaningful. In addition to other risk factors discussed in this Risk Factors section, factors that may contribute to the variability of our quarterly and annual results include:

- our ability to retain our current listenership, build our listener base and increase listener hours;
- our ability to more effectively monetize mobile listener hours by increasing the sale of mobile advertising inventory as the number of listener hours on mobile devices grow;

Edgar Filing: Pandora Media, Inc. - Form 10-Q

Table of Contents

- our ability to attract and retain existing advertisers and prove that our advertising products are effective enough to justify a pricing structure that is profitable for us;
- our ability to effectively manage our growth;
- our ability to continue to operate under the statutory licenses set forth in the Digital Millennium Copyright Act (DMCA) and the Digital Performance Right in Sound Recordings Act (DPRA);
- our ability to enjoy the benefit of voluntarily negotiated rates that are below those established by the CRB for the rate periods 2006 through 2010 and 2011 through 2015 or any successor periods commencing with the rate period 2016 through 2020;
- our ability to enjoy the benefits of collective licensing available through performing rights organizations;
- our ability to secure licenses to musical works that may be withdrawn from performing rights organizations;
- the effects of increased competition in our business;
- our ability to keep pace with changes in technology and our competitors;
- interruptions in service, whether or not we are responsible for such interruptions, and any related impact on our reputation;
- costs associated with defending any litigation, including intellectual property infringement litigation;
- our ability to pursue, and the timing of, entry into new geographic or content markets and, if pursued, our management of this expansion;
- the impact of general economic conditions on our revenue and expenses; and

- changes in government regulation affecting our business.

Seasonal variations in listener and advertising behavior may also cause fluctuations in our financial results. We expect to experience some effects of seasonal trends in listener behavior due to increased internet usage and sales of media-streaming devices during certain vacation and holiday periods. For example, we expect to experience increased usage during the fourth quarter of each calendar year due to the holiday season, and in the first quarter of each calendar year due to increased use of media-streaming devices received as gifts during the holiday season. We may also experience higher advertising sales during the fourth quarter of each calendar year due to greater advertiser demand during the holiday season. In addition, expenditures by advertisers tend to be cyclical and discretionary in nature, reflecting overall economic conditions, the economic prospects of specific advertisers or industries, budgeting constraints and buying patterns and a variety of other factors, many of which are outside our control. While we believe these seasonal trends have affected and will continue to affect our quarterly results, our trajectory of rapid growth may have overshadowed these effects to date. We believe that our business may become more seasonal in the future and that such seasonal variations in listener behavior may result in fluctuations in our financial results.

Failure to protect our intellectual property could substantially harm our business and operating results.

The success of our business depends, in part, on our ability to protect and enforce our trade secrets, trademarks, copyrights and patents and all of our other intellectual property rights, including our intellectual property rights underlying the Pandora service. We attempt to protect our intellectual property under trade secret, trademark, copyright and patent law, and through a combination of employee and third-party nondisclosure agreements, other contractual restrictions, technological measures and other methods. These afford only limited protection. Despite our efforts to protect our intellectual property rights and trade secrets, unauthorized parties may attempt to copy aspects of our song selection technology or obtain and use our trade secrets and other confidential information. Moreover, policing our intellectual property rights is difficult, costly and may not always be effective.

Table of Contents

We have filed, and may in the future file, patent applications. It is possible, however, that these innovations may not be protectable. In addition, given the cost, effort, risks and downside of obtaining patent protection, including the requirement to ultimately disclose the invention to the public, we may choose not to seek patent protection for certain innovations. However, such patent protection could later prove to be important to our business. Furthermore, there is always the possibility that our patent applications may not issue as granted patents, that the scope of the protection gained will be insufficient or that an issued patent may be deemed invalid or unenforceable. We also cannot guarantee that any of our present or future patents or other intellectual property rights will not lapse or be invalidated, circumvented, challenged or abandoned, that our intellectual property rights will provide competitive advantages to us, that our ability to assert our intellectual property rights against potential competitors or to settle current or future disputes will not be limited by our relationships with third parties, that any of our pending or future patent applications will have the coverage originally sought, that our intellectual property rights will be enforced in jurisdictions where competition may be intense or where legal protection may be weak, or that we will not lose the ability to assert our intellectual property rights against or to license our technology to others and collect royalties or other payments.

We have registered Pandora, Music Genome Project and other marks as trademarks in the United States. Nevertheless, competitors may adopt service names similar to ours, or purchase our trademarks and confusingly similar terms as keywords in internet search engine advertising programs, thereby impeding our ability to build brand identity and possibly leading to confusion among our listeners or advertising customers. In addition, there could be potential trade name or trademark infringement claims brought by owners of other registered trademarks or trademarks that incorporate variations of the term Pandora or our other trademarks. Any claims or customer confusion related to our trademarks could damage our reputation and brand and substantially harm our business and operating results.

We currently own the www.pandora.com internet domain name and various other related domain names. Domain names are generally regulated by internet regulatory bodies. If we lose the ability to use a domain name in a particular country, we would be forced either to incur significant additional expenses to market our solutions within that country or to elect not to sell solutions in that country. Either result could harm our business and operating results. The regulation of domain names in the United States and in foreign countries is subject to change. Regulatory bodies could establish additional top-level domains, appoint additional domain name registrars or modify the requirements for holding domain names. As a result, we may not be able to acquire or maintain the domain names that utilize our brand names in the United States or other countries in which we may conduct business in the future.

In order to protect our trade secrets and other confidential information, we rely in part on confidentiality agreements with our employees, consultants and third parties with whom we have relationships. These agreements may not effectively prevent disclosure of trade secrets and other confidential information and may not provide an adequate remedy in the event of misappropriation of trade secrets or any unauthorized disclosure of trade secrets and other confidential information. In addition, others may independently discover our trade secrets and confidential information, and in some such cases we might not be able to assert any trade secret rights against such parties. Costly and time-consuming litigation could be necessary to enforce and determine the scope of our trade secret rights and related confidentiality and nondisclosure provisions, and failure to obtain or maintain trade secret protection, or our competitors' obtainment of our trade secrets or independent development of unpatented technology similar to ours or competing technologies, could adversely affect our competitive business position.

Litigation or proceedings before the U.S. Patent and Trademark Office or other governmental authorities and administrative bodies in the United States and abroad may be necessary in the future to enforce our intellectual property rights, to protect our patent rights, trademarks, trade secrets and domain names and to determine the validity and scope of the proprietary rights of others. Our efforts to enforce or protect our proprietary rights may be ineffective and could result in substantial costs and diversion of resources and management time, each of which could substantially harm our operating results.

Although we take steps to protect our intellectual property as discussed above, there can be no assurance, however, that changes in law will not be implemented, or changes in interpretation of such laws will occur, that will affect our ability to protect and enforce our patents and other

Edgar Filing: Pandora Media, Inc. - Form 10-Q

intellectual property, including as a result of the 2011 passage of the America Invents Act of 2011 (which codifies several significant changes to the U.S. patent laws and will remain subject to certain rule-making and interpretation, including changing from a first to invent to a first inventor to file system, limiting where a patentee may file a patent suit, requiring the apportionment of patent damages, replacing interference proceedings with derivation actions, and creating a post-grant opposition process to

Table of Contents

challenge patents after they have issued).

Assertions by third parties of violations under state law with respect to the public performance and reproduction of pre-1972 sound recordings could result in significant costs and substantially harm our business and operating results.

Sound recordings made on or after February 15, 1972 fall within the scope of federal copyright protection. Subject to our ongoing compliance with numerous federal statutory conditions and regulatory requirements for a non-interactive service, we are permitted to operate under a statutory license that allows the streaming in the U.S. of any such sound recording lawfully released to the public and permits us to make reproductions of such sound recordings on computer servers pursuant to a separate statutory license designed to facilitate the making of such transmissions.

By contrast, protection of sound recordings created prior to February 15, 1972 (pre-1972 sound recordings) remains governed by a patchwork of state statutory and common laws. Copyright owners of pre-1972 sound recordings have recently commenced litigation against Sirius XM Radio Inc., alleging violations of numerous state statutory and common laws with respect to the unauthorized reproduction and public performance of pre-1972 sound recordings, seeking, among other things, restitution, disgorgement of profits, exemplary and punitive damages as well as injunctive relief prohibiting further violation of those copyright owners' alleged exclusive rights. Copyright owners of pre-1972 sound recordings appear to allege that no similar statutory or common law framework exists for the reproduction and public performance of pre-1972 sound recordings. Similar litigation could be brought against the company for similar claims. If we are sued and found liable for the violation of the exclusive rights of any pre-1972 sound recording copyright owners, then we could be subject to liability, the amount of which could be significant. If we are required to obtain licenses from individual sound recording copyright owners for the reproduction and public performance of pre-1972 sound recordings, then the time, effort and cost of securing such licenses could be significant and could harm our business and operating results. If we are required to obtain licenses for pre-1972 sound recordings to avoid liability and are unable to secure such licenses, then we may have to remove pre-1972 sound recordings from our service, which could harm our ability to attract and retain users.

Assertions by third parties of infringement or other violation by us of their intellectual property rights could result in significant costs and substantially harm our business and operating results.

Internet, technology and media companies are frequently subject to litigation based on allegations of infringement, misappropriation or other violations of intellectual property rights. Some internet, technology and media companies, including some of our competitors, own large numbers of patents, copyrights, trademarks and trade secrets, which they may use to assert claims against us. Third parties have asserted, and may in the future assert, that we have infringed, misappropriated or otherwise violated their intellectual property rights. In addition, various federal and state laws and regulations govern the intellectual property and related rights associated with sound recordings and musical works. Existing laws and regulations are evolving and subject to different interpretations, and various federal and state legislative or regulatory bodies may expand current or enact new laws or regulations. We cannot assure you that we are not infringing or violating any third-party intellectual property rights.

We cannot predict whether assertions of third-party intellectual property rights or any infringement or misappropriation claims arising from such assertions will substantially harm our business and operating results. If we are forced to defend against any infringement or misappropriation claims, we may be required to expend significant time and financial resources on the defense of such claims, even if without merit, settled out of court, or determined in our favor. Furthermore, an adverse outcome of a dispute may require us to pay damages, potentially including treble damages and attorneys' fees, if we are found to have willfully infringed a party's intellectual property; cease making, licensing or using solutions that are alleged to infringe or misappropriate the intellectual property of others; expend additional development resources to redesign our

Edgar Filing: Pandora Media, Inc. - Form 10-Q

solutions; enter into potentially unfavorable royalty or license agreements in order to obtain the right to use necessary technologies, content, or materials; and to indemnify our partners and other third parties. Royalty or licensing agreements, if required or desirable, may be unavailable on terms acceptable to us, or at all, and may require significant royalty payments and other expenditures. In addition, any lawsuits regarding intellectual property rights, regardless of their success, could be expensive to resolve and would divert the time and attention of our management and technical personnel.

Table of Contents

We may require additional capital to pursue our business objectives and respond to business opportunities, challenges or unforeseen circumstances. If capital is not available to us, our business, operating results and financial condition may be harmed.

We may require additional capital to operate or expand our business. In addition, some of our current or future strategic initiatives, including entry into non-music content channels, such as comedy, or international markets, may require substantial additional capital resources before they begin to generate revenue. Additional funds may not be available when we need them, on terms that are acceptable to us, or at all. For example, our current credit facility contains restrictive covenants relating to our capital raising activities and other financial and operational matters, and any debt financing secured by us in the future could involve further restrictive covenants, which may make it more difficult for us to obtain additional capital and to pursue business opportunities. In addition, volatility in the credit markets may have an adverse effect on our ability to obtain debt financing. If we do not have funds available to enhance our solutions, maintain the competitiveness of our technology and pursue business opportunities, we may not be able to service our existing listeners, acquire new listeners or attract or retain advertising customers, each of which could inhibit the implementation of our business plan and materially harm our operating results.

We may acquire other companies or technologies, which could divert our management's attention, result in additional dilution to our stockholders and otherwise disrupt our operations and harm our operating results.

We may in the future seek to acquire or invest in businesses, products or technologies that we believe could complement or expand our service, enhance our technical capabilities or otherwise offer growth opportunities. The pursuit of potential acquisitions may divert the attention of management and cause us to incur various expenses in identifying, investigating and pursuing suitable acquisitions, whether or not they are consummated.

In addition, we do not have any experience in acquiring other businesses. If we acquire additional businesses, we may not be able to integrate the acquired personnel, operations and technologies successfully, or effectively manage the combined business following the acquisition. We also may not achieve the anticipated benefits from the acquired business due to a number of factors, including:

- unanticipated costs or liabilities associated with the acquisition;

- incurrence of acquisition-related costs;

- diversion of management's attention from other business concerns;

- harm to our existing business relationships with business partners and advertisers as a result of the acquisition;

- harm to our brand and reputation;

- the potential loss of key employees;
- use of resources that are needed in other parts of our business; and
- use of substantial portions of our available cash to consummate the acquisition.

In addition, a significant portion of the purchase price of companies we acquire may be allocated to acquired goodwill and other intangible assets, which must be assessed for impairment at least annually. In the future, if our acquisitions do not yield expected returns, we may be required to take charges to our operating results based on this impairment assessment process.

Acquisitions could also result in dilutive issuances of equity securities or the incurrence of debt, which could adversely affect our operating results. In addition, if an acquired business fails to meet our expectations, our operating results, business and financial condition may suffer.

Table of Contents

We face many risks associated with our long-term plan to expand our operations outside of the United States, including difficulties obtaining rights to publicly perform or communicate to the public music on favorable terms.

Expanding our operations into international markets is an element of our long-term strategy. For example, we recently began publicly performing and communicating to the public music and engaging with listeners in New Zealand, Australia and the associated territories. However, offering our service outside of the United States involves numerous risks and challenges. Most importantly, while United States copyright law provides a statutory licensing regime for the public performance of sound recordings to listeners within the United States, there is no equivalent statutory licensing regime available outside of the United States, and many of the other licensing alternatives currently available in other countries are not commercially viable. Currently, the licensing terms offered by rights organizations and individual copyright owners in most countries outside the United States are prohibitively expensive. Addressing licensing structure and royalty rate issues in the United States required us to make very substantial investments of time, capital and other resources, and our business could have failed if such investments had not succeeded. Addressing these issues in foreign jurisdictions may require a commensurate investment by us, and there can be no assurance that we would succeed or achieve any return on this investment.

In addition, international expansion exposes us to other risks such as:

- the need to modify our technology and sell our solutions in non-English speaking countries;

- the need to localize our service to foreign customers' preferences and customs;

- the need to conform our marketing and advertising efforts with the laws and regulations of foreign jurisdictions, including, but not limited to, the use of any personal information about our listeners;

- the need to amend existing agreements and to enter into new agreements with automakers, automotive suppliers, consumer electronics manufacturers with products that integrate our service, and others in order to provide that service in foreign countries;

- difficulties in managing operations due to language barriers, distance, staffing, cultural differences and business infrastructure constraints and domestic laws regulating corporations that operated internationally;

- our lack of experience in marketing, and encouraging viral marketing growth without incurring significant marketing expenses, in foreign countries;

- application of foreign laws and regulations to us;

- fluctuations in currency exchange rates;
- reduced or ineffective protection of our intellectual property rights in some countries; and
- potential adverse tax consequences associated with foreign operations and revenue.

Further, in jurisdictions where copyright protection has been insufficient to protect against widespread music piracy, achieving market acceptance of our service may prove difficult as we would need to convince listeners to stream our service when they could otherwise download the same music for free. As a result of these obstacles, we may find it impossible or prohibitively expensive to enter or sustain our presence in foreign markets, or entry into foreign markets could be delayed, which could hinder our ability to grow our business.

Expansion of our operations into non-music content, including our launch of comedy, subjects us to additional business, legal, financial and competitive risks.

Expansion of our operations into delivery of non-music content stations involves numerous risks and challenges, including increased capital requirements, new competitors and the need to develop new strategic relationships. For example, in May 2011, we started streaming spoken word comedy content, for which the underlying literary works are not currently entitled to eligibility for licensing by any performing rights organization in the United States. Rather, pursuant to industry-wide custom and practice, this

Table of Contents

content is performed absent a specific license from any such performing rights organization or individual rights owners although royalties are paid to SoundExchange for the public performance of the sound recordings in which such literary works are embodied. Further, growth into this new area may require changes to our existing business model and cost structure, modifications to our infrastructure and exposure to new regulatory and legal risks, including infringement liability, any of which may require expertise in which we have little or no experience. There is no guarantee that we will be able to generate sufficient revenue from advertising sales associated with comedy content to offset the costs of maintaining comedy stations or the royalties paid for such comedy stations. For example, many of the mainstream advertisers that choose to place ads on our music stations may choose not to advertise on our comedy stations because of the sometimes explicit nature of comedy content. Further, we have established a reputation as an online music provider and our ability to gain acceptance and listenership for comedy content stations, and thus our ability to attract advertisers on comedy stations, is not certain. Failure to obtain or retain rights to comedy content on acceptable terms, or at all, to successfully monetize and generate revenues from such content, or to effectively manage the numerous risks and challenges associated with such expansion could adversely affect our revenues and profitability. To the extent we choose, in the future, to offer additional types of content beyond music and comedy, such as news, talk and sports programming, we will be subject to many of these same risks.

Our ability to use our net operating loss carryforwards and certain other tax attributes may be limited.

At January 31, 2013, we had federal net operating loss carryforwards of approximately \$180.8 million and tax credit carryforwards of approximately \$2.5 million. At January 31, 2013, we had state net operating loss carryforwards of approximately \$203.8 million and tax credit carryforwards of approximately \$4.3 million. Under Sections 382 and 383 of the Internal Revenue Code of 1986, as amended, or the Code, if a corporation undergoes an ownership change, the corporation's ability to use its pre-change net operating loss carryforwards and other pre-change tax attributes, such as research tax credits, to offset its post-change income may be limited. In general, an ownership change will occur if there is a cumulative change in our ownership by 5-percent shareholders that exceeds 50 percentage points over a rolling three-year period. Similar rules may apply under state tax laws. As a result of prior equity issuances and other transactions in our stock, we have previously experienced ownership changes under section 382 of the Code and comparable state tax laws. We may also experience ownership changes in the future as a result of future transactions in our stock. As a result, if we earn net taxable income, our ability to use our pre-change net operating loss carryforwards or other pre-change tax attributes to offset United States federal and state taxable income is subject to limitations.

We could be subject to additional income tax liabilities.

We are subject to income taxes in the United States and numerous foreign jurisdictions. Significant judgment is required in evaluating and estimating our worldwide income tax provision and accruals for these taxes. For example, our effective tax rates could be adversely affected by earnings being lower than anticipated in countries where we have lower statutory tax rates and higher than anticipated in countries where we have higher statutory tax rates, by losses incurred in jurisdictions for which we are not able to realize the related tax benefit, by changes in foreign currency exchange rates, by changes in the valuation of our deferred tax assets and liabilities, or by changes in the relevant tax, accounting and other laws, regulations, principles and interpretations. We are also subject to tax audits in various jurisdictions, and such jurisdictions may assess additional income tax liabilities against us.

If we cannot maintain our corporate culture as we grow, we could lose the innovation, teamwork and focus that contribute crucially to our business.

We believe that a critical component of our success is our corporate culture, which we believe fosters innovation, encourages teamwork, cultivates creativity and promotes focus on execution. We have invested substantial time, energy and resources in building a highly collaborative

Edgar Filing: Pandora Media, Inc. - Form 10-Q

team that works together effectively in a non-hierarchical environment designed to promote openness, honesty, mutual respect and pursuit of common goals. As we continue to develop the infrastructure of a public company and grow, we may find it difficult to maintain these valuable aspects of our corporate culture. Any failure to preserve our culture could negatively impact our future success, including our ability to attract and retain employees, encourage innovation and teamwork and effectively focus on and pursue our corporate objectives.

Table of Contents

Federal, state and industry regulations as well as self-regulation related to privacy and data security concerns pose the threat of lawsuits and other liability, require us to expend significant resources, and may hinder our ability and our advertisers' ability to deliver relevant advertising.

We collect and utilize demographic and other information, including personally identifiable information, from and about our listeners as they interact with our service. For example, to register for a Pandora account, our listeners must provide the following information: age, gender, zip code and e-mail address. Listeners must also provide their credit card or debit card numbers and other billing information in connection with additional service offerings. We also may collect information from our listeners when they enter information on their profile page, post comments on other listeners' pages, use other community or social networking features that are part of our service, participate in polls or contests or sign up to receive e-mail newsletters. Further, we and third parties use tracking technologies, including cookies and related technologies, to help us manage and track our listeners' interactions with our service and deliver relevant advertising. Third parties may, without our knowledge or consent, illegally obtain, transmit or utilize our listeners' personally identifiable information, or data associated with particular users or devices.

Various federal and state laws and regulations, as well as the laws of foreign jurisdictions in which we may choose to operate, govern the collection, use, retention, sharing and security of the data we receive from and about our listeners. Privacy groups and government bodies have increasingly scrutinized the ways in which companies link personal identities and data associated with particular users or devices with data collected through the internet, and we expect such scrutiny to continue to increase. Alleged violations of laws and regulations relating to privacy and data security, and any relevant claims, may expose us to potential liability and may require us to expend significant resources in responding to and defending such allegations and claims. Claims or allegations that we have violated laws and regulations relating to privacy and data security have resulted and could in the future result in negative publicity and a loss of confidence in us by our listeners and our advertisers, and may subject us to fines by credit card companies and loss of our ability to accept credit and debit card payments.

Existing privacy-related laws and regulations are evolving and subject to potentially differing interpretations, and various federal and state legislative and regulatory bodies, as well as foreign legislative and regulatory bodies, may expand current or enact new laws regarding privacy and data security-related matters. We may find it necessary or desirable to join self-regulatory bodies or other privacy-related organizations that require compliance with their rules pertaining to privacy and data security. We also may be bound by contractual obligations that limit our ability to collect, use, disclose, and leverage listener data and to derive economic value from it. New laws, amendments to or re-interpretations of existing laws, rules of self-regulatory bodies, industry standards and contractual obligations, as well as changes in our listeners' expectations and demands regarding privacy and data security, may limit our ability to collect, use, and disclose, and to leverage and derive economic value from listener data. We may also be required to expend significant resources to adapt to these changes and to develop new ways to deliver relevant advertising or otherwise provide value to our advertisers. In particular, government regulators have proposed do not track mechanisms, and requirements that users affirmatively opt-in to certain types of data collection that, if enacted into law or adopted by self-regulatory bodies or as part of industry standards, could significantly hinder our ability to collect and use data relating to listeners. Restrictions on our ability to collect, access and harness listener data, or to use or disclose listener data or any profiles that we develop using such data, would in turn limit our ability to stream personalized music content to our listeners and offer targeted advertising opportunities to our advertising customers, each of which are critical to the success of our business.

We have incurred, and will continue to incur, expenses to comply with privacy and security standards and protocols imposed by law, regulation, self-regulatory bodies, industry standards and contractual obligations. Increased regulation of data utilization and distribution practices, including self-regulation and industry standards, could increase our cost of operation, limit our ability to grow our operations or otherwise adversely affect our business.

If our security systems are breached, we may face civil liability and public perception of our security measures could be diminished, either of which would negatively affect our ability to attract listeners and advertisers.

Techniques used to gain unauthorized access are constantly evolving, and we may be unable to anticipate or prevent unauthorized access to data pertaining to our listeners, including credit card and debit card information and other personally identifiable information. Like all internet services, our service, which is supported by our own systems and those of third-party vendors, is vulnerable to computer viruses, internet worms, break-ins, phishing attacks, attempts to overload servers with

Table of Contents

denial-of-service, attempts to access our servers to stream music or acquire playlists, or other attacks and similar disruptions from unauthorized use of our and third-party vendor computer systems, any of which could lead to system interruptions, delays, or shutdowns, causing loss of critical data or the unauthorized access to personally identifiable information. If an actual or perceived breach of security occurs of our systems or a vendor's systems, we may face civil liability and public perception of our security measures could be diminished, either of which would negatively affect our ability to attract listeners, which in turn would harm our efforts to attract and retain advertisers. We also would be required to expend significant resources to mitigate the breach of security and to address related matters. Unauthorized access to music or playlists would potentially create additional royalty obligations with no corresponding revenue.

We cannot control the actions of third parties who may have access to the listener data we collect. The integration of the Pandora service with applications provided by third parties represents a significant growth opportunity for us, but we may not be able to control such third parties' use of listeners' data, ensure their compliance with the terms of our privacy policies, or prevent unauthorized access to, or use or disclosure of, listener information, any of which could hinder or prevent our efforts with respect to growth opportunity. In addition, these third party vendors may become the victim of security breaches, or have practices that may result in a breach and we may be responsible for those third party acts or failures to act.

Any failure, or perceived failure, by us to maintain the security of data relating to our listeners and employees, to comply with our posted privacy policy, laws and regulations, rules of self-regulatory organizations, industry standards and contractual provisions to which we may be bound, could result in the loss of confidence in us, or result in actions against us by governmental entities or others, all of which could result in litigation and financial losses, and could potentially cause us to lose listeners, advertisers, revenue and employees.

We are subject to a number of risks related to credit card and debit card payments we accept.

We accept payments exclusively through credit and debit card transactions. For credit and debit card payments, we pay interchange and other fees, which may increase over time. An increase in those fees would require us to either increase the prices we charge for our products, which could cause us to lose subscribers and subscription revenue, or suffer an increase in our operating expenses, either of which could harm our operating results.

If we or any of our processing vendors have problems with our billing software, or the billing software malfunctions, it could have an adverse effect on our subscriber satisfaction and could cause one or more of the major credit card companies to disallow our continued use of their payment products. In addition, if our billing software fails to work properly and, as a result, we do not automatically charge our subscribers credit cards on a timely basis or at all, or there are issues with financial insolvency of our third-party vendors or other unanticipated problems or events, we could lose subscription revenue, which would harm our operating results.

We are also subject to payment card association operating rules, certification requirements and rules governing electronic funds transfers, which could change or be reinterpreted to make it more difficult for us to comply. Currently, we are implementing the steps that are required for us to become fully compliant with the Payment Card Industry, or PCI, Data Security Standard, or PCI DSS, a security standard with which companies that collect, store or transmit certain data regarding credit and debit cards, credit and debit card holders and credit and debit card transactions are required to comply. Our failure to comply fully with PCI DSS may violate payment card association operating rules, federal and state laws and regulations and the terms of our contracts with payment processors and merchant banks. Such failure to comply fully also may subject us to fines, penalties, damages and civil liability, and may result in the loss of our ability to accept credit and debit card payments. Further, there is no guarantee that, even if PCI DSS compliance is achieved, we will maintain PCI DSS compliance or that such compliance will prevent illegal or improper use of our payment systems or the theft, loss, or misuse of data pertaining to credit and debit cards, credit and debit card holders and

credit and debit card transactions.

If we fail to adequately control fraudulent credit card transactions, we may face civil liability, diminished public perception of our security measures and significantly higher credit card-related costs, each of which could adversely affect our business, financial condition and results of operations.

Table of Contents

If we are unable to maintain our chargeback rate or refund rates at acceptable levels, credit card and debit card companies may increase our transaction fees or terminate their relationships with us. Any increases in our credit card and debit card fees could adversely affect our results of operations, particularly if we elect not to raise our rates for our service to offset the increase. The termination of our ability to process payments on any major credit or debit card would significantly impair our ability to operate our business.

If we fail to detect click fraud or other invalid clicks on ads, we could lose the confidence of our advertisers, which would cause our business to suffer.

Our business relies on delivering positive results to our advertising customers. We are exposed to the risk of fraudulent and other invalid clicks or conversions that advertisers may perceive as undesirable. A major source of invalid clicks could result from click fraud where a listener intentionally clicks on ads for reasons other than to access the underlying content of the ads. If fraudulent or other malicious activity is perpetrated by others and we are unable to detect and prevent it, or if we choose to manage traffic quality in a way that advertisers find unsatisfactory, the affected advertisers may experience or perceive a reduced return on their investment in our advertising products, which could lead to dissatisfaction with our advertising programs, refusals to pay, refund demands or withdrawal of future business. This could damage our brand and lead to a loss of advertisers and revenue.

Our success depends upon the continued acceptance of online advertising as an alternative or supplement to offline advertising.

The percentage of the advertising market allocated to online advertising lags the percentage of consumer offline consumption by a significant degree. Growth of our business will depend in large part on the reduction or elimination of this gap between online and offline advertising spending, which may not happen. Many advertisers still have limited experience with online advertising and may continue to devote significant portions of their advertising budgets to traditional, offline advertising media. Accordingly, we continue to compete for advertising dollars with traditional media, including broadcast radio.

Although advertisers as a whole are spending an increasing amount of their overall advertising budget on online advertising, we face a number of challenges in growing our advertising revenue. We compete for advertising dollars with significantly larger and more established online marketing and media companies such as Facebook, Google, MSN and Yahoo!. We believe that the continued growth and acceptance of our online advertising products will depend on the perceived effectiveness and the acceptance of online advertising models generally, which is outside of our control. Any lack of growth in the market for online advertising could result in reduced revenue or increased marketing expenses, which would harm our operating results and financial condition.

Some of our services and technologies may use open source software, which may restrict how we use or distribute our service or require that we release the source code of certain services subject to those licenses.

Some of our services and technologies may incorporate software licensed under so-called open source licenses, including, but not limited to, the GNU General Public License and the GNU Lesser General Public License. Such open source licenses typically require that source code subject to the license be made available to the public and that any modifications or derivative works to open source software continue to be licensed under open source licenses. Few courts have interpreted open source licenses, and the manner in which these licenses may be interpreted and enforced is therefore subject to some uncertainty. We rely on multiple software programmers to design our proprietary technologies, and we do

Edgar Filing: Pandora Media, Inc. - Form 10-Q

not exercise complete control over the development efforts of our programmers and we cannot be certain that our programmers have not incorporated open source software into our proprietary products and technologies or that they will not do so in the future. In the event that portions of our proprietary technology are determined to be subject to an open source license, we could be required to publicly release the affected portions of our source code, re-engineer all or a portion of our technologies, or otherwise be limited in the licensing of our technologies, each of which could reduce or eliminate the value of our services and technologies and materially and adversely affect our ability to sustain and grow our business.

Table of Contents

Government regulation of the internet is evolving, and unfavorable developments could have an adverse effect on our operating results.

We are subject to general business regulations and laws, as well as regulations and laws specific to the internet. Such laws and regulations cover taxation, user privacy, data collection and protection, copyrights, electronic contracts, sales procedures, automatic subscription renewals, credit card processing procedures, consumer protections, broadband internet access and content restrictions. We cannot guarantee that we have been or will be fully compliant in every jurisdiction, as it is not entirely clear how existing laws and regulations governing issues such as privacy, taxation and consumer protection apply to the internet. Moreover, as internet commerce continues to evolve, increasing regulation by federal, state and foreign agencies becomes more likely. The adoption of any laws or regulations that adversely affect the popularity or growth in use of the internet, including laws limiting internet neutrality, could decrease listener demand for our service offerings and increase our cost of doing business. Future regulations, or changes in laws and regulations or their existing interpretations or applications, could also hinder our operational flexibility, raise compliance costs and result in additional historical or future liabilities for us, resulting in adverse impacts on our business and our operating results.

We could be adversely affected by regulatory restrictions on the use of mobile and other electronic devices in motor vehicles and legal claims are possible from use of such devices while driving.

Regulatory and consumer agencies have increasingly focused on distraction to drivers that may be associated with use of mobile and other devices in motor vehicles. In 2010, the U.S. Department of Transportation identified driver distraction as a top priority, and in February 2012, the National Highway Traffic Safety Administration (the NHTSA) proposed new voluntary guidelines for visual-manual devices not related to the driving task that are integrated into motor vehicles. NHTSA also intends to propose guidelines applicable to after-market and portable devices that may be used in motor vehicles. Regulatory restrictions on how drivers and passengers in motor vehicles may engage with devices on which our service is broadcast could inhibit our ability to increase listener hours and generate ad revenue, which would harm our operating results. In addition, concerns over driver distraction due to use of mobile and other electronic devices to access our service in motor vehicles could result in litigation and negative publicity.

We rely on third parties to provide software and related services necessary for the operation of our business.

We incorporate and include third-party software into and with our applications and service offerings and expect to continue to do so. The operation of our applications and service offerings could be impaired if errors occur in the third-party software that we use. It may be more difficult for us to correct any defects in third-party software because the development and maintenance of the software is not within our control. Accordingly, our business could be adversely affected in the event of any errors in this software. There can be no assurance that any third-party licensors will continue to make their software available to us on acceptable terms, to invest the appropriate levels of resources in their software to maintain and enhance its capabilities, or to remain in business. Any impairment in our relationship with these third-party licensors could harm our ability to maintain and expand the reach of our service, increase listener hours and sell advertising each of which could harm our operating results, cash flow and financial condition.

The impact of worldwide economic conditions, including the effect on advertising budgets and discretionary entertainment spending behavior, may adversely affect our business and operating results.

Edgar Filing: Pandora Media, Inc. - Form 10-Q

Our financial condition is affected by worldwide economic conditions and their impact on advertising spending. Expenditures by advertisers generally tend to reflect overall economic conditions, and to the extent that the economy continues to stagnate, reductions in spending by advertisers could have a serious adverse impact on our business. In addition, we provide an entertainment service, and payment for our Pandora One subscription service may be considered discretionary on the part of some of our current and prospective subscribers or listeners who may choose to use a competing free service or to listen to Pandora without subscribing. To the extent that overall economic conditions reduce spending on discretionary activities, our ability to retain current and obtain new subscribers could be hindered, which could reduce our subscription revenue and negatively impact our business.

Table of Contents

Our business is subject to the risks of earthquakes, fires, floods and other natural catastrophic events and to interruption by man-made problems such as computer viruses or terrorism.

Our systems and operations are vulnerable to damage or interruption from earthquakes, fires, floods, power losses, telecommunications failures, terrorist attacks, acts of war, human errors, break-ins or similar events. For example, a significant natural disaster, such as an earthquake, fire or flood, could have a material adverse impact on our business, operating results and financial condition, and our insurance coverage may be insufficient to compensate us for losses that may occur. Our principal executive offices are located in the San Francisco Bay Area, a region known for seismic activity. In addition, acts of terrorism could cause disruptions in our business or the economy as a whole. Our servers may also be vulnerable to computer viruses, break-ins and similar disruptions from unauthorized tampering with our computer systems, which could lead to interruptions, delays, loss of critical data or the unauthorized disclosure of confidential customer data. We currently have very limited disaster recovery capability, and our business interruption insurance may be insufficient to compensate us for losses that may occur. As we rely heavily on our servers, computer and communications systems and the internet to conduct our business and provide high quality service to our listeners, such disruptions could negatively impact our ability to run our business, result in loss of existing or potential listeners and advertisers and increased maintenance costs, which would adversely affect our operating results and financial condition.

Table of Contents**Item 6. Exhibits**

Exhibit No.	Exhibit Description	Form	Incorporated by Reference			Filed By	Filed Herewith
			File No.	Exhibit	Filing Date		
10.15	Amendment and Restatement Agreement to Credit Agreement among Pandora Media, Inc., the Lenders party thereto and JPMorgan Chase Bank, N.A. as Administrative Agent, dated as of September 12, 2013						X
10.25	Offer Letter with Brian McAndrews, dated September 11, 2013						X
31.01	Certification of the Principal Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act						X
31.02	Certification of the Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act						X
32.01	Certification of the Principal Executive Officer and Principal Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act						X
101	Interactive Data Files Pursuant to Rule 405 of Regulation S-T: (i) Condensed Balance Sheets as of October 31, 2013 and January 31, 2013, (ii) Condensed Statements of Operations for the Three and Nine months ended October 31, 2013 and 2012, (iii) Condensed Statements of Comprehensive Loss for the Three and Nine months Ended October 31, 2013 and 2012, (iv) Condensed Statements of Cash Flows for the Nine months ended October 31, 2013 and 2012 and (v) Notes to Condensed Financial Statements						X

Indicates management contract or compensatory plan.

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, Pandora Media, Inc. has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

PANDORA MEDIA, INC.

Date: November 26, 2013

By:

/s/ Michael S. Herring
Michael S. Herring
Executive Vice President and Chief
Financial Officer

(Duly Authorized Officer and Principal Financial and
Accounting Officer)