Pandora Media, Inc.
Form 10-Q
September 04, 2012
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# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

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# FORM 10-Q

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

**For the quarterly period ended July 31, 2012**

**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**<br>(State or other jurisdiction of<br>incorporation or organization) | **94-3352630**<br>(I.R.S. Employer<br>Identification No.) |
|---|---|
| **2101 Webster Street, Suite 1650**<br>**Oakland, CA**<br>(Address of principal executive offices) | **94612**<br>(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 x No o

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 x No o

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 o | Accelerated filer o |
|---|---|
| Non-accelerated filer x<br>(Do not check if a smaller reporting company) | Smaller reporting company o |

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

The number of shares of registrant s common stock outstanding as of August 29, 2012 was: 168,878,677.

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**Pandora Media, Inc.**

**FORM 10-Q Quarterly Report**

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**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, 2012 | | As of July 31, 2012 |
|---|---|---|---|---|
| Assets | | | | |
| Current assets: | | | | |
| Cash and cash equivalents | $ | 44,126 | $ | 49,539 |
| Short-term investments | | 46,455 | | 32,758 |
| Accounts receivable, net of allowances of $590 and $418 at January 31 and July 31, 2012, respectively | | 66,738 | | 80,387 |
| Prepaid expenses and other current assets | | 2,806 | | 3,551 |
| Total current assets | | 160,125 | | 166,235 |
| Property and equipment, net | | 15,576 | | 16,104 |
| Other assets | | 2,314 | | 2,154 |
| Total assets | $ | 178,015 | $ | 184,493 |
| Liabilities and stockholders equity | | | | |
| Current liabilities: | | | | |
| Accounts payable | $ | 2,053 | $ | 3,473 |
| Accrued liabilities | | 3,838 | | 4,440 |
| Accrued royalties | | 33,822 | | 40,353 |
| Deferred revenue | | 19,232 | | 24,145 |
| Accrued compensation | | 11,962 | | 14,572 |
| Total current liabilities | | 70,907 | | 86,983 |
| Other long-term liabilities | | 2,568 | | 3,292 |
| Total liabilities | | 73,475 | | 90,275 |
| Stockholders equity: | | | | |
| Preferred stock, $0.0001 par value; 10,000,000 shares authorized as of January 31 and July 31, 2012, respectively; no shares issued and outstanding as of January 31 and July 31, 2012 | | | | |
| Common stock, $0.0001 par value: 1,000,000,000 shares authorized as of January 31 and July 31, 2012, respectively; 163,569,361 and 168,452,486 shares issued and outstanding as of January 31 and July 31, 2012, respectively | | 16 | | 17 |
| Additional paid-in capital | | 205,955 | | 221,272 |
| Accumulated deficit | | (101,426) | | (127,069) |
| Accumulated other comprehensive loss | | (5) | | (2) |
| Total stockholders equity | | 104,540 | | 94,218 |
| Total liabilities and stockholders equity | $ | 178,015 | $ | 184,493 |

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

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**Pandora Media, Inc.**

**Condensed Consolidated Statements of Operations**

**(In thousands, except per share amounts)**

**(Unaudited)**

| | Three Months Ended July 31, 2011 | Three Months Ended July 31, 2012 | Six Months Ended July 31, 2011 | Six Months Ended July 31, 2012 |
|---|---|---|---|---|
| Revenue: | | | | |
| Advertising | $ 58,258 | $ 89,384 | $ 101,919 | $ 159,981 |
| Subscription services and other | 8,708 | 11,883 | 16,087 | 22,070 |
| Total revenue | 66,966 | 101,267 | 118,006 | 182,051 |
| Costs and expenses: | | | | |
| Cost of revenue  Content acquisition costs | 33,723 | 60,522 | 62,881 | 116,340 |
| Cost of revenue - Other | 5,460 | 7,514 | 9,820 | 14,431 |
| Product development | 3,426 | 4,475 | 6,157 | 8,594 |
| Marketing and sales | 14,502 | 23,457 | 27,466 | 46,917 |
| General and administrative | 8,410 | 10,602 | 15,353 | 21,214 |
| Total costs and expenses | 65,521 | 106,570 | 121,677 | 207,496 |
| Income (loss) from operations | 1,445 | (5,303) | (3,671) | (25,445) |
| Other income (expense): | | | | |
| Interest income | 1 | 25 | 3 | 57 |
| Interest expense | (261) | (136) | (370) | (260) |
| Other expense, net | (2,976) | | (4,485) | |
| Loss before provision for income taxes | (1,791) | (5,414) | (8,523) | (25,648) |
| Income tax benefit (expense) | (21) | (1) | (43) | 5 |
| Net loss | (1,812) | (5,415) | (8,566) | (25,643) |
| Accretion of redeemable convertible preferred stock | (40) | | (110) | |
| Increase in cumulative dividends payable upon conversion or liquidation of redeemable convertible preferred stock | (1,328) | | (3,648) | |
| Net loss attributable to common stockholders | $ (3,180) | $ (5,415) | $ (12,324) | $ (25,643) |
| Basic and diluted net loss per share attributable to common stockholders | $ (0.04) | $ (0.03) | $ (0.25) | $ (0.15) |
| Weighted-average number of shares used in computing per share amounts | 82,389 | 167,429 | 49,204 | 166,428 |

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

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**Pandora Media, Inc.**

**Condensed Consolidated Statements of Comprehensive Loss**

**(In thousands, except per share amounts)**

**(Unaudited)**

| | Three Months Ended July 31, | | | | Six Months Ended July 31, | | | |
|---|---|---|---|---|---|---|---|---|
| | 2011 | | 2012 | | 2011 | | 2012 | |
| Net loss | $ | (1,812) | $ | (5,415) | $ | (8,566) | $ | (25,643) |
| Other comprehensive loss: | | | | | | | | |
| Change in net unrealized losses on marketable securities | | | | | | | | 3 |
| Other comprehensive loss: | | (1,812) | | (5,415) | | (8,566) | | (25,640) |
| Total comprehensive loss | $ | (1,812) | $ | (5,415) | $ | (8,566) | $ | (25,640) |

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

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**Pandora Media, Inc.**

**Condensed Consolidated Statements of Cash Flows**

**(In thousands)**

**(Unaudited)**

| | Six Months Ended July 31, | |
|---|---|---|
| | **2011** | **2012** |
| Operating Activities | | |
| Net loss | $ (8,566) | $ (25,643) |
| Adjustments to reconcile net loss to net cash provided (used in) by operating activities: | | |
| Depreciation and amortization | 1,715 | 3,336 |
| Loss on disposition of assets | | 23 |
| Stock-based compensation | 3,064 | 11,537 |
| Remeasurement of preferred stock warrants | 4,499 | |
| Amortization of premium on investments | | 192 |
| Amortization of debt issuance cost and debt discount | 58 | 132 |
| Changes in assets and liabilities: | | |
| Accounts receivable | (9,223) | (13,649) |
| Prepaid expenses and other assets | (960) | (676) |
| Accounts payable and accrued liabilities | (1,138) | 1,717 |
| Accrued royalties | 6,434 | 6,531 |
| Accrued compensation | 3,820 | 2,610 |
| Deferred revenue | 3,293 | 4,913 |
| Reimbursement of cost of leasehold improvements | 375 | 1,243 |
| Net cash provided (used in) by operating activities | 3,371 | (7,734) |
| Investing Activities | | |
| Purchases of property and equipment | (5,371) | (3,887) |
| Purchase of short-term investments | | (35,093) |
| Maturities of short-term investments | | 48,560 |
| Net cash provided by (used) in investing activities | (5,371) | 9,580 |
| Financing Activities | | |
| Repayments of debt | (7,596) | |
| Proceeds from exercise of preferred stock warrants | 165 | |
| Proceeds from initial public offering net of offering costs | 91,666 | |
| Proceeds from issuance of common stock | 654 | 3,567 |
| Payment of dividends to preferred stockholders at initial public offering | (30,630) | |
| Net cash provided by financing activities | 54,259 | 3,567 |
| Net increase in cash and cash equivalents | 52,259 | 5,413 |
| Cash and cash equivalents at beginning of period | 43,048 | 44,126 |
| Cash and cash equivalents at end of period | $ 95,307 | $ 49,539 |

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

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**Pandora Media, Inc.**

**Notes to Condensed Consolidated Financial Statements**

## 1. Description of Business and Basis of Presentation

Pandora Media, Inc. (the Company or Pandora ) provides an internet radio service in the United States, offering a personalized experience for each of its listeners. The Company has developed a form of radio that uses intrinsic qualities of music to initially create stations that then adapt playlists in real-time based on the individual feedback of each listener.

The Company was incorporated as a California corporation in January 2000 and reincorporated as a Delaware corporation in December 2010.

***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 the Company and its wholly-owned subsidiaries. All intercompany balances and transactions have been eliminated in consolidation. In the opinion of the Company s management, the interim unaudited condensed consolidated financial statements include all adjustments, which include only normal recurring adjustments, necessary for the fair presentation of the Company s 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 the Company s Annual Report on Form 10-K for the fiscal year ended January 31, 2012.

Certain changes in presentation have been made to conform prior period presentation to current period reporting of the Company s content acquisition costs which are now included as a separate line item component of Cost of Revenue in the Company s Income Statement.

***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 selling prices for elements sold in multiple-element arrangements, the allowance for doubtful accounts, the fair value of common stock through the date of the Company s initial public offering ( IPO ) in June 2011, stock-based compensation, fair values of investments, income taxes, and accrued royalties. To the extent there are material differences between these estimates, judgments, or assumptions and actual results, the Company s 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.

***Fiscal Year***

All references herein to a fiscal year refer to the 12 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.

## 2. Summary of Significant Accounting Policies

There have been no material changes to the Company s significant accounting policies as compared to those described in the Company s Annual Report on Form 10-K for the fiscal year ended January 31, 2012.

***Concentration of Credit Risk***

For the three and six months ended July 31, 2011, the Company had one customer that accounted for 16% and 14%, respectively of the Company s total revenue. For the three and six months ended July 31, 2012, the Company had no customers that accounted for more than 10% of the Company s total revenue.

As of January 31 and July 31, 2012, the Company had no customers that accounted for more than 10% of the Company s total accounts receivable.

***Recently Issued Accounting Standards***

Effective February 1, 2012, the Company adopted Accounting Standards Update ( ASU ) No. 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and International Financial Reporting Standards ( IFRS ). The ASU updates the accounting guidance to clarify and align Fair Value Measurement within U.S. GAAP and International Financial Reporting Standards. In addition, the ASU updates certain requirements for measuring fair value and for disclosure around fair value measurement. It does not require additional fair value measurements and the ASU was not intended to establish valuation standards or affect valuation practices outside of financial reporting. The adoption of ASU 2011-04 did not have a significant impact on the Company s consolidated balance sheets or statements of operations.

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**Pandora Media, Inc.**

**Notes to Condensed Consolidated Financial Statements - Continued**

**3. Composition of Certain Financial Statement Captions**

**Cash, Cash Equivalents and Short-term Investments**

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

| | As of January 31, 2012 | As of July 31, 2012 |
|---|---|---|
| | (in thousands) | |
| Cash and cash equivalents: | | |
| Cash | $ 6,604 | $ 13,107 |
| Money market funds | 31,614 | 31,932 |
| Commercial paper | 2,893 | 3,000 |
| Corporate debt securities | 3,015 | 1,500 |
| Total cash and cash equivalents | $ 44,126 | $ 49,539 |
| Short-term investments: | | |
| Commercial paper | $ 27,587 | $ 19,944 |
| Corporate debt securities | 17,968 | 10,314 |
| U.S. agency notes | 900 | 2,500 |
| Total short-term investments | $ 46,455 | $ 32,758 |
| Cash, cash equivalents and short-term investments | $ 90,581 | $ 82,297 |

The Company s short-term investments have maturities of less than 12 months and are classified as available for sale. As of January 31 and July 31, 2012 the cost basis of the Company s cash and cash equivalents approximated their fair values and as a result, no unrealized gains or losses were recorded as of January 31 and July 31, 2012.

The following tables summarize the Company s available-for-sale securities adjusted cost, gross unrealized gains, gross unrealized losses and fair value by significant investment category as of January 31 and July 31, 2012 (in thousands).

| | As of January 31, 2012 | | | |
|---|---|---|---|---|
| | Adjusted Cost | Unrealized Gains | Unrealized Losses | Fair Value |
| Money market funds | $ 31,614 | $ | $ | $ 31,614 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Commercial paper | | 30,481 | | | | (1) | | 30,480 |
| Corporate debt securities | | 20,987 | | 1 | | (5) | | 20,983 |
| U.S. agency notes | | 900 | | | | | | 900 |
| Total cash equivalents and marketable securities | $ | 83,982 | $ | 1 | $ | (6) | $ | 83,977 |

| | As of July 31, 2012 | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | Adjusted Cost | | Unrealized Gains | | Unrealized Losses | | Fair Value |
| Money market funds | $ | 31,932 | $ | | $ | | $ | 31,932 |
| Commercial paper | | 22,944 | | | | | | 22,944 |
| Corporate debt securities | | 11,816 | | 1 | | (3) | | 11,814 |
| U.S. agency notes | | 2,500 | | | | | | 2,500 |
| Total cash equivalents and marketable securities | $ | 69,192 | $ | 1 | $ | (3) | $ | 69,190 |

The Company s 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 the Company s available-for-sale securities were primarily a result of unfavorable changes in interest rates subsequent to the initial purchase of these securities. As of July 31, 2012, the Company owned 16 securities that were in an unrealized loss position. The Company does not intend nor expect to need to sell these securities before recovering the associated unrealized losses. It expects to recover the full carrying value of these securities. As a result, no portion of the unrealized losses at July 31, 2012 is deemed to be other-than-temporary and the unrealized losses are not deemed to be credit losses. No available-for-sale securities have been in an unrealized loss position for 12 months or more. When evaluating the investments for other-than-temporary impairment, the Company reviews factors such as the length of time and extent to which fair value has been below cost basis, the financial condition of the issuer and any changes thereto, and the Company s intent to sell, or whether it is more likely than not it will be required to sell, the investment before recovery of the investment s amortized cost basis. During the three months ended July 31, 2012, the Company did not recognize any impairment charges.

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**Pandora Media, Inc.**

**Notes to Condensed Consolidated Financial Statements - Continued**

## 4. Fair Value

The Company records 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 July 31, 2012 the Company did not hold any Level 3 assets.

When determining fair value, whenever possible the Company uses observable market data, and relies 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 July 31, 2012:

| | Fair Value Measurement Using | | |
|---|---|---|---|
| | **Quoted Prices in Active Markets for Identical Instruments** | **Significant Other Observable Inputs** | **Total** |

| | (Level 1) | (Level 2) | |
|---|---|---|---|
| | | (in thousands) | |
| Fair values as of January 31, 2012 | | | |
| Assets: | | | |
| Money market funds | $ 31,614 | $ | $ 31,614 |
| Commercial paper | | 30,480 | 30,480 |
| Corporate debt securities | | 20,983 | 20,983 |
| U.S. agency notes | | 900 | 900 |
| Total assets measured at fair value | $ 31,614 | $ 52,363 | $ 83,977 |
| Fair values as of July 31, 2012 | | | |
| Assets: | | | |
| Money market funds | $ 31,932 | $ | $ 31,932 |
| Commercial paper | | 22,944 | 22,944 |
| Corporate debt securities | | 11,814 | 11,814 |
| U.S. agency notes | | 2,500 | 2,500 |
| Total assets measured at fair value | $ 31,932 | $ 37,258 | $ 69,190 |

The Company s money market funds are classified as Level 1 within the fair value hierarchy because they are valued primarily using quoted market prices. The Company s 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.

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**Pandora Media, Inc.**

**Notes to Condensed Consolidated Financial Statements - Continued**

**5. Commitments and Contingencies**

***Legal Proceedings***

Pandora has been in the past, and continues to be, a party to privacy and patent infringement litigation which has consumed, and may continue to consume, financial and managerial resources. The Company is also from time to time subject to various other legal proceedings and claims arising in the ordinary course of its business. Management believes that the liabilities associated with these cases, while possible, are not probable, and therefore the Company has not recorded any accrual for these as of January 31, 2012 and July 31, 2012. Further, any possible range of loss cannot be reasonably estimated at this time. The Company does not believe the ultimate resolution of any pending legal matters is likely to have a material adverse effect on its 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 it unlawfully accessed and transmitted personally identifiable information of the plaintiffs in connection with their use of the Company s 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 the Company were found liable. Pandora s motion to dismiss the first amended complaint was filed on March 23, 2012. No hearing date is currently set.

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 it violated Michigan s video rental privacy law and consumer protection statute by allowing Pandora listeners listening history to be visible to the public. Pandora s motion to dismiss the complaint was filed on November 28, 2011. No hearing date is currently set.

In April 2011, Augme Technologies, Inc. filed a complaint in the United States District Court for the District of Delaware against Pandora alleging patent infringement. The complaint alleges that Pandora infringes an Augme patent and seeks injunctive relief and monetary damages. The parties are currently engaged in pretrial discovery.

The Company currently believes that it has substantial and meritorious defenses to the claims in the lawsuits discussed above and intends to vigorously defend its position.

The outcome of any litigation is inherently uncertain. Based on the Company s current knowledge it believes that the final outcome of the matters discussed above will not likely, individually or in the aggregate, have a material adverse effect on its 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 the Company s business.

***Guarantees and Contingencies***

The Company is party to certain contractual agreements under which it has agreed to provide indemnifications of varying scope and duration for claims by third parties relating to its intellectual property. 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, the Company has not incurred, does not anticipate incurring and therefore has not accrued for, any costs related to such indemnification provisions.

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**Pandora Media, Inc.**

**Notes to Condensed Consolidated Financial Statements - Continued**

## 6. Income Taxes

For the three and six months ended July 31, 2011 the Company recorded income tax expenses of approximately $21,000 and $43,000, respectively. For the three months ended July 31, 2012 the Company recorded income tax expenses of approximately $1,000. For the six months ended July 31, 2012 the Company recorded an income tax benefit of approximately $5,000. The effective tax rates for the three and six months ended July 31, 2012 were less than one percent based on the estimated tax loss for the fiscal year.

There were no material changes to the unrecognized tax benefits in the three and six months ended July 31, 2012 and the Company does not expect significant changes to unrecognized tax benefits through the end of the fiscal year. Because of the Company s history of tax losses, all years remain open to tax audit.

## 7. Debt Instruments

On May 13, 2011, the Company entered into a $30 million credit facility with a syndicate of financial institutions. The amount of borrowings available under the credit facility at any time is based on the Company s monthly accounts receivable balance at such time, and the amounts borrowed are collateralized by the Company s personal property (including such accounts receivable but excluding intellectual property). Under the credit facility, the Company can request up to $5 million in letters of credit be issued by the financial institutions.

The credit facility contains customary events of default, conditions to borrowing and covenants, including restrictions on the Company s 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 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 of July 31, 2012, the Company had $520,000 in letters of credit outstanding and had $29.48 million of available borrowing capacity under the credit facility. On December 30, 2011, the Company entered into a cash collateral agreement in connection with the issuance of letters of credit which were used to satisfy deposit requirements under facility leases. As of July 31, 2012, the $520,000 cash collateral was considered to be restricted cash. The amount is included in other assets on the Company s balance sheet.

Total debt issuance costs associated with the credit facility were $1.0 million, which are being amortized as interest expense over the four-year term of the credit facility agreement. For the three and six months ended July 31, 2012, $0.1 million and $0.1 million, respectively, of debt

issuance costs were amortized and included in interest expense.

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**Pandora Media, Inc.**

**Notes to Condensed Consolidated Financial Statements - Continued**

**8. Stock-based Compensation Plans and Awards**

The Company s 2011 Equity Incentive Plan (the 2011 Plan ) provides for the issuance of stock options, restricted stock units and other stock-based awards. Each fiscal year, (beginning with the fiscal year that commenced February 1, 2012 and ending with the fiscal year commencing February 1, 2021), the number of shares in the reserve under the 2011 Plan may be increased by the lesser of (x) 10,000,000 shares, (y) 4.0% of the outstanding shares of common stock on the last day of the prior fiscal year or (z) another amount determined by the Company s board of directors. For the fiscal year beginning February 1, 2012, 4.0% of the outstanding shares of common stock as of January 31, 2012 were added to the number of shares in the reserve. The 2011 Plan is scheduled to terminate in 2021, unless the board of directors determines otherwise. The 2011 Plan is administered by the compensation committee of the board of directors of the Company.

***Valuation of Awards***

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 July 31, | | Six Months Ended July 31, | |
|---|---|---|---|---|
| | **2011** | **2012** | **2011** | **2012** |
| Expected life (in years) | 5.82-6.08 | N/A | 5.73-7.02 | 6.67 |
| Risk-free interest rate | 1.70-2.78% | N/A | 1.70-3.30% | 1.52% |
| Expected volatility | 54% | N/A | 54-57% | 57% |
| Expected dividend yield | 0% | N/A | 0% | 0% |

*Stock Options*

No stock options were granted during the three months ended July 31, 2012. A summary of stock option activity for the six months ended July 31, 2012 is as follows:

| | Options Outstanding Stock Options | Weighted-Average Exercise Price | Aggregate(1) Intrinsic Value |
|---|---|---|---|

| | | | (in thousands, except share and per share data) | | |
|---|---|---|---|---|---|
| Balance as of January 31, 2012 | 34,810,926 | $ | 2.43 | $ | 379,355 |
| Granted | 1,350,000 | | 10.63 | | |
| Exercised | (4,732,848) | | 0.75 | | |
| Cancelled | (991,217) | | 4.67 | | |
| Balance as of July 31, 2012 | 30,436,861 | $ | 2.99 | $ | 223,993 |
| Equity awards available for grant at July 31, 2012 | 14,274,993 | | | | |

(1) Amounts represent the difference between the exercise price and the fair value of common stock at period end for all in the money options outstanding based on the fair value per share of common stock.

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**Pandora Media, Inc.**

**Notes to Condensed Consolidated Financial Statements - Continued**

*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, generally four years.

During the three and six months ended July 31, 2012, the Company recorded stock-based compensation expense related to RSUs of approximately $2.3 million and $4.1 million, respectively. As of July 31, 2012, total compensation cost not yet recognized of approximately $37.4 million related to non-vested RSUs, is expected to be recognized over a weighted average period of 3.40 years.

The following table summarizes the activities for our RSUs for the six months ended July 31, 2012:

| | Number of Shares | Weighted-Average Grant-Date Fair Value |
|---|---|---|
| Unvested at January 31, 2012 | 1,426,975 | $ 12.03 |
| Granted | 2,265,800 | 11.76 |
| Vested | (4,200) | 17.78 |
| Canceled | (97,733) | 12.73 |
| Unvested at July 31, 2012 | 3,590,842 | $ 11.83 |

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

On March 22, 2012, Mr. Joseph Kennedy, the Company s Chief Executive Officer, was granted a non-statutory stock option to purchase 800,000 shares of common stock. This option grant to Mr. Kennedy was intended to be in lieu of an annual equity grant for fiscal 2014. This option includes both a service period and a market vesting condition. The stock option will vest if the 60-day trailing volume weighted average price of the Company s common stock exceeds $21.00 per share, or if there is a sale of the Company for at least $21.00 per share, in each case prior to July 6, 2017. If the market condition is met, the performance option will vest ratably over four years, beginning on July 6, 2013, subject to severance and change of control acceleration. To the extent that the market condition is not met, the option will not vest and will be cancelled. The Company used a binomial model to value the option with a market condition. The Company used Monte Carlo simulation techniques that incorporate assumptions as provided by management for the term of option from grant date (in years), risk-free interest rate, stock price volatility and beginning stock price. The Company does not adjust compensation cost recognition for subsequent changes in the expected outcome of the market-vesting conditions.

The following assumptions were used to value the grant using the Monte-Carlo simulation option pricing model: 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 option was $6.08. As of July 31, 2012, the remaining unrecognized compensation expense of approximately $4.3 million related to this grant is expected to be recognized over a period of 4.9 years.

***Stock-based Compensation Expenses***

The weighted-average fair value of stock option grants was $8.58 and $4.50 for the three and six months ended July 31, 2011, respectively and $6.02 for the six months ended July 31, 2012. No stock options were granted during the three months ended July 31, 2012. As of July 31, 2012, total compensation cost related to stock options granted, but not yet recognized, was approximately $40.5 million which the Company expects to recognize over a weighted-average period of approximately 2.5 years.

The total grant date fair value of stock options vested during the three and six months ended July 31, 2011was $1.1 million and $1.8 million, respectively.  For the three and six months ended July 31, 2012 the total grant date fair value of stock options vested was $4.6 million and $8.0 million, respectively. The aggregate intrinsic value of all options and warrants exercised during the three and six months ended July 31, 2011 was $23.2 million and $27.5 million, respectively.  For the three and six months ended July 31, 2012 the aggregate intrinsic value of all options and warrants exercised was $19.2 million and $51.6 million, respectively.

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

| | Three Months Ended July 31, | | Six Months Ended July 31, | |
|---|---|---|---|---|
| | **2011** | **2012** | **2011** | **2012** |
| | **(unaudited)** | | **(unaudited)** | |
| Stock-based compensation expenses: | | | | |
| Cost of revenue - Other | $ 148 | $ 304 | $ 212 | $ 567 |
| Product development | 413 | 1,185 | 590 | 2,171 |
| Marketing and sales | 1,079 | 2,738 | 1,502 | 5,668 |
| General and administrative | 488 | 1,810 | 760 | 3,131 |
| Total stock-based compensation, recorded in costs and expenses | $ 2,128 | $ 6,037 | $ 3,064 | $ 11,537 |

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**Pandora Media, Inc.**

**Notes to Condensed Consolidated Financial Statements - Continued**

## 9. Net Loss Per Share

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

Diluted net income per share is computed by giving effect to all potential shares of common stock, including stock options, restricted stock units, convertible preferred stock warrants and redeemable convertible preferred stock, to the extent dilutive. Basic and diluted net loss per share was the same for the three months and six months ended July 31, 2011 and 2012 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 loss per share (in thousands except per share amounts):

| | Three Months Ended July 31, | | Six Months Ended July 31, | |
|---|---|---|---|---|
| | 2011 | 2012 | 2011 | 2012 |
| **Numerator** | | | | |
| Net loss | $ (1,812) | $ (5,415) | $ (8,566) | $ (25,643) |
| Accretion of redeemable convertible preferred stock | (40) | | (110) | |
| Increase in cumulative dividends payable upon conversion or liquidation of redeemable convertible preferred stock | (1,328) | | (3,648) | |
| Net loss attributable to common stockholders | $ (3,180) | $ (5,415) | $ (12,324) | $ (25,643) |
| **Denominator** | | | | |
| Weighted-average common shares outstanding used in computing basic and diluted net loss per share | 82,389 | 167,429 | 49,204 | 166,428 |
| Net loss per share, basic and diluted | $ (0.04) | $ (0.03) | $ (0.25) | $ (0.15) |

For the three and six months ended July 31, 2011 net loss was increased by the cumulative dividends payable upon conversion or liquidation of redeemable convertible preferred shares earned during the three and six months ended July 31, 2011 through the conversion at the close of the

IPO in June 2011.

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):

| | As of July 31, | |
|---|---|---|
| | **2011** | **2012** |
| Options to purchase common stock | 36,894 | 30,437 |
| Warrants to purchase common stock | 155 | |
| Restricted stock units | | 3,591 |
| Total common stock equivalents | 37,049 | 34,028 |

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**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, 2012 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 12 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 and plans and objectives of management. 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, 2012. 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 or ( 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**

Pandora is the leader in internet radio in the United States, offering a personalized experience for each of our listeners. 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. As of July 31, 2012, we had approximately 150 million registered users, which we define as the total number of accounts that have been created for our service at period end. As of July 31, 2012 approximately 100 million registered users have accessed Pandora through smartphones and tablets. For the three months ended July 31, 2012, we streamed 3.30 billion hours of radio and as of July 31, 2012, we had 54.9 million active users during the prior 30 day period. According to a June 2012 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 3.2 billion stations.

Since we started the Music Genome Project in 2000, we have continuously built our song catalog, refined the genotyping model and developed proprietary algorithms for building personalized playlists for our listeners based both on our analysis and feedback data from our listeners.

Our comedy service leverages similar technology to the technology underlying the Music Genome Project, allowing a listener to choose a favorite comedian or a genre as a seed to start a station and then give feedback to personalize that station.

The mobile version of our Pandora service, the Pandora app, is available for smartphones including the iPhone, Android and Blackberry phones, and for tablets including the iPad, Android tablets and Blackberry Playbook.

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One key element of our strategy is to make the Pandora service available everywhere that there is internet connectivity. To this end, we partner with manufacturers of home entertainment systems and other consumer electronics products to integrate the Pandora service with their products. We also develop relationships with major automobile manufacturers and their suppliers to integrate the Pandora service with automobiles. We are currently available on models of BMW, Buick, Chevrolet, Ford, GMC, Honda, Hyundai, Lexus, Lincoln, Mercedes-Benz, MINI, Scion and Toyota. Additionally, Acura, Cadillac, Kia, Mazda, Nissan and Suzuki have publicly announced their plans for future Pandora integrations.

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

**Business Model**

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

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 expenses, which are the largest component of total costs.

- *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*. Listener hours drive substantially all of our content acquisition costs, although certain of our licensing agreements require us to pay fees for public performances based on a percentage of revenue.

With respect to each sound recording streamed to each listener, we pay royalties to the copyright owners both of sound recordings and of the underlying musical works, subject to certain exclusions, and we record these royalties as content acquisition costs. Under U.S. law, we are guaranteed the right to stream any lawfully released sound recordings. Royalties for sound recordings are negotiated with and paid through SoundExchange. Royalties for musical works are negotiated with and paid through publishing companies such as Entertainment World Inc. or EMI; or performance rights organizations such as the American Society of Composers, Authors and Publishers, or ASCAP; Broadcast Music, Inc., or BMI; and SESAC Inc. or SESAC. Royalties are calculated using negotiated rates documented in master royalty agreements and based on sound recordings streamed, revenue earned or other usage measures. If we cannot agree on royalty rates, the dispute will be resolved by the Copyright Royalty Board, or CRB, in the case of SoundExchange, and by the rate court in the case of ASCAP and BMI. 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 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 federally negotiated rates for the right to stream this spoken word comedy content.

Given the royalty structures in effect 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. To date, we have not been able to generate additional revenue from our advertising products as rapidly as we have been able to grow our listener hours on mobile and other connected devices, which have experienced significant growth.

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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 nascent, 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 across the range of our delivery platforms.

In fiscal 2011 and 2012, we substantially increased our expenditures for product development, marketing and sales and general and administrative expenses to generate growth and provide support infrastructure for that anticipated growth. We expect increased levels of operating expenses into the future.

Our total revenue has grown from $67.0 million and $118.0 million in the three and six months ended July 31, 2011, respectively, to $101.3 million and $182.1 million in the three and six months ended July 31, 2012, respectively. At the same time, our total costs and expenses have grown from $65.5 million and $121.7 million in the three and six months ended July 31, 2011, respectively, to $106.6 and $207.5 million in the three and six months ended July 31, 2012, respectively, principally as a result of the growth in content acquisition costs. 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. 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 in listener hours. While in the long-term, to the extent our business matures and our market leadership becomes more comprehensive, we expect that the growth rate in our listener hours will decline relative to our increased ability to monetize listener hours, we do not expect to be profitable on an annual basis in the near term.

**Key Metrics:**

| | **Three Months Ended July 31,** | | **Six Months Ended July 31,** | |
|---|---|---|---|---|
| | **2011** | **2012** | **2011** | **2012** |
| Listener hours (in billions) | 1.83 | 3.30 | 3.45 | 6.39 |

| | **As of January 31, 2012** | **As of July 31, 2012** |
|---|---|---|
| Active users (end of period, in millions) | 47.6 | 54.9 |

***Advertising revenue per thousand listener hours***

| | Trailing Twelve Months Ended July 31,(1) | | Three Months Ended July 31, | | Six Months Ended July 31, | |
|---|---|---|---|---|---|---|
| | **2011** | **2012** | **2011** | **2012** | **2011** | **2012** |
| Total | $ 33.6 | $ 29.2 | $ 35.3 | $ 29.5 | $ 32.8 | $ 27.2 |
| Traditional computer | 65.2 | 56.9 | 69.9 | 57.1 | 62.2 | 51.6 |
| Mobile and other connected devices | 18.7 | 20.4 | 23.7 | 22.2 | 21.4 | 20.2 |

**(1)** Trailing twelve months measure ad RPMs over the periods from August 1, 2010 to July 31, 2011 and from August 1, 2011 to July 31, 2012.

*Listener Hours.* We track listener hours because it is a key indicator of the growth of our business. We also 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.

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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. We believe this server-based approach is the best methodology to forecast advertising inventory given that advertisements are frequently served in between tracks and are often served upon triggers such as a listener clicking thumbs-down or choosing to skip a 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. A*ctive 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.

*Ad RPMs*. We track advertising revenue per thousand listener hours for our free, advertising supported service ( ad RPMs ) 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. RPMs compare advertising revenue generated in a given period to advertising supported listener hours in the period, calculated on a trailing twelve months basis 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 we generate by the number of thousands of listener hours of our advertising-based service.

We also provide estimates of disaggregated total and 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 RPMs provide directional insight for evaluating our efforts to monetize our service by platform, we do not validate disaggregated 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 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 over the trailing twelve months ended July 31, 2012 and the three and six months ended July 31, 2012 decreased compared to the respective prior year periods due to the continuing shift in the platform mix between traditional computer and mobile and other connected devices as well as an increase in listener hours, in part the result of the effective elimination of the 40 hour per month free listening cap on traditional computers in September 2011 which created increased advertising inventory not fully offset by advertising sales.

Traditional computer ad RPMs over the trailing twelve months ended July 31, 2012 and in the three and six month periods ended July 31, 2012 decreased compared to the respective prior year periods, primarily due to listener hours growing at a faster pace than revenue due in part to the effective elimination of the 40 hour per month free listening cap which created increased listener hours not fully offset by increased advertising sales.

Mobile and other connected device ad RPMs over the trailing twelve months ended July 31, 2012 increased to approximately $20.4 from approximately $18.7 over the twelve months ended July 31, 2011 primarily due to mobile and connected device revenue growing at a faster pace than listening hours driven by our continued focus on monetizing our mobile inventory including the introduction of new advertising products for these devices.

Mobile and other connected device ad RPMs decreased to approximately $22.2 and $20.2 from approximately $23.7 and $21.4 in the three and six months ended July 31, 2012, compared to the three and six months ended July 31, 2011, respectively, primarily due to listener hours growing at a faster pace than revenue as well as the fact that the three and six month periods ended July 31, 2011 include revenue from one advertiser that accounted for 16% and 14%, respectively, of total revenue through premium sales.

Although we monitor RPM to evaluate our business, to provide additional context regarding the factors driving this ratio, total advertising revenue increased by approximately 69% during the trailing twelve months ended July 31, 2012, with advertising revenue on mobile and other connected devices increasing by approximately 138% and advertising revenue on traditional computers increasing by approximately 27%. Total advertising revenue increased by 53% and 57% during the three and six months ended July 31, 2012, compared to the prior year periods, with advertising revenue on mobile and other connected devices increasing by approximately 81% and 92% respectively, and advertising revenue on traditional computers increasing by approximately 25% and 26% respectively.

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In addition to ad RPMs, we also track total RPMs, which measures total revenue, including both advertising and subscription services and other revenue, compared to total listener hours. We calculate total RPMs by dividing the estimated total revenue generated through the respective platforms by the total number of thousands of listener hours delivered through such platforms. While we believe that such disaggregated total RPMs provide directional insight for evaluating our efforts to monetize our service by platform, we do not validate disaggregated total RPMs to the level of financial statement reporting. Such metrics should be seen as indicative only and as management s best estimate. Total RPMs over the trailing twelve months ended July 31, 2012 decreased to approximately $30.3 from approximately $34.9 over the trailing twelve months ended July 31, 2011. Within this, mobile and other connected device total RPMs increased to approximately $21.5 from $19.8 and traditional computer total RPMs decreased to $54.0 from $61.3 over this same period. These changes were driven by the same factors mentioned above within the discussion of ad RPMs.

**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 12 months, and advertisers generally pay us based on a minimum number of impressions delivered 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 July 31, 2011 and 2012, respectively, advertising revenue accounted for 87% and 88% of our total revenue. For the six months ended July 31, 2011 and 2012, respectively, advertising revenue accounted for 86% and 88% of our total revenue. We expect that advertising will comprise a substantial majority of revenue for the foreseeable future.

*Subscription Services and Other Revenue*. We generate subscription revenue through the sale and activation of access to a premium version of the Pandora service for $36 per year or, on some devices, $4 per month, which currently includes an ad free environment and, on devices that support it, higher quality audio. We receive the full amount of the subscription payment, net of any applicable commissions and processing fees at the time of sale; however, subscription revenue is recognized on a straight-line basis over the subscription period. For the three months ended July 31, 2011 and 2012, subscription services and other revenue accounted for 13% and 12%, respectively, of our total revenue. For the six months ended July 31, 2011 and 2012, subscription services and other revenue accounted for 14% and 12%, respectively, of our total revenue.

*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.

***Costs and Expenses***

Costs and expenses consist of cost of revenue-content acquisition costs, costs of revenue-other, product development, marketing and sales, general and administrative. 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 employees in order to support our anticipated growth. 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*. Cost of Revenue -Content acquisition costs principally consist of royalties payable 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 listener metrics. The majority of our royalties are payable based on a fee per track, while in other cases our royalties are payable based on a percentage of our revenue.

We periodically test our royalty calculation methods to ensure we are accurately reporting and paying royalties. Publishing companies such as EMI Entertainment World, Inc., ( EMI ), and the performance rights organizations 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 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.

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In 2009 we, together with other webcasters, negotiated new royalty rates for performances with SoundExchange for calendar years 2006 to 2015. The agreement reduced rates originally established by the Copyright Royalty Board for calendar years 2006 to 2010 and established new rates for calendar years 2011 to 2015.

*Cost of Revenue - Other.* Cost of revenue - Other consists of hosting costs, infrastructure and the employee and 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. Infrastructure costs consist of equipment, software, facilities and depreciation. 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*. Product development expenses consist of employee compensation, information technology, consulting, facilities-related expenses 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.

*Marketing and Sales*. Marketing and sales expenses consist of employee and employee-related costs including salaries, commissions and benefits related to employees in sales, marketing and advertising departments. In addition, marketing and sales expenses include external sales and marketing expenses such as third-party marketing, branding, advertising and public relations expenses, and infrastructure costs such as facility and other supporting overhead costs. We expect marketing and sales expenses to increase as we hire additional personnel to build out our sales force and ad operations team and expand our business development team to establish relationships with manufacturers of an increasing number of connected devices.

*General and Administrative*. General and administrative expenses include employee and 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, and infrastructure costs for facility, supporting overhead costs and merchant and other transaction costs, such as credit card fees. We expect to incur additional expenses in future periods as we continue to invest in corporate infrastructure, including adding personnel and systems to our finance and administrative functions.

*Provision for Income Taxes*. Since our inception, we have been subject to income taxes only in the United States. Now that we have begun to expand our operations outside the United States, we will 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.

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**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 July 31, | | Six Months Ended July 31, | |
|---|---|---|---|---|
| | 2011(2) | 2012(2) | 2011(2) | 2012(2) |
| | (unaudited) | | (unaudited) | |
| Revenue: | | | | |
| Advertising | 87% | 88% | 86% | 88% |
| Subscription services and other | 13 | 12 | 14 | 12 |
| Total revenue | 100 | 100 | 100 | 100 |
| Costs and expenses: | | | | |
| Cost of revenue Content acquisition costs | 50 | 60 | 53 | 64 |
| Cost of revenue Other(1) | 8 | 7 | 8 | 8 |
| Product development(1) | 5 | 4 | 5 | 5 |
| Marketing and sales(1) | 22 | 23 | 23 | 26 |
| General and administrative(1) | 13 | 10 | 13 | 12 |
| Total costs and expenses | 98 | 105 | 103 | 114 |
| Income (loss) from operations | 1 | (5) | (3) | (14) |
| Other income (expense): | | | | |
| Interest income | | | | |
| Interest expense | | | | |
| Other expense, net | (4) | | (4) | |
| Income (loss) before provision for income taxes | (3) | (5) | (7) | (14) |
| Provision for income taxes | | | | |
| Net income (loss) | (3)% | (5)% | (7)% | (14)% |

(1) Includes stock-based compensation as follows:

| | | | | |
|---|---|---|---|---|
| Cost of revenue - Other | 0.2% | 0.3% | 0.2% | 0.3% |
| Product development | 0.6 | 1.2 | 0.5 | 1.2 |
| Marketing and sales | 1.6 | 2.7 | 1.3 | 3.1 |
| General and administrative | 0.7 | 1.8 | 0.6 | 1.7 |

(2) Amounts may not sum due to rounding

**Comparison of the Three and Six Months Ended July 31, 2011 and 2012**

***Revenue***

| | Three Months Ended July 31, | | | Six Months Ended July 31, | | |
|---|---|---|---|---|---|---|
| | 2011 | 2012 | $ Change | 2011 | 2012 | $ Change |
| | | (in thousands) | | | (in thousands) | |
| Advertising | $ 58,258 | $ 89,384 | $ 31,126 | $ 101,919 | $ 159,981 | $ 58,062 |
| Subscription services and other | 8,708 | 11,883 | 3,175 | 16,087 | 22,070 | 5,983 |
| Total revenue | $ 66,966 | $ 101,267 | $ 34,301 | 118,006 | 182,051 | 64,045 |

| | Trailing Twelve Months Ended July 31, | | Three Months Ended July 31, | | Six Months Ended July 31, | |
|---|---|---|---|---|---|---|
| | 2011 | 2012 | 2011 | 2012 | 2011 | 2012 |
| Total ad RPMs | $ 33.3 | $ 29.2 | $ 35.3 | $ 29.5 | $ 32.8 | $ 27.2 |

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*Three months ended 2011 compared to 2012.* Advertising revenue increased $31.1 million or approximately 54% in the three months ended July 31, 2012, primarily due to an approximate 112% increase in the number of ads delivered, partially offset by a decrease in the average price per ad of approximately 27% 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 listener hours of approximately 80% which increased the volume of advertising inventory as well as an increase in our sales force by approximately 80% year-over-year to sell such advertising inventory. Subscription revenue increased $3.2 million due to an increase in the number of subscribers.

*Six months ended 2011 compared to 2012.* Advertising revenue increased $58.1 million or approximately 57% in the six months ended July 31, 2012, primarily due to an approximate 103% increase in the number of ads delivered, partially offset by the aforementioned decrease in the average price per ad of approximately 23% 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 listener hours of approximately 85% which increased the volume of advertising inventory, as well as an increase in our sales force by approximately 80% year-over-year to sell such advertising inventory. Subscription revenue increased $6.0 million due to an increase in the number of subscribers.

Total ad RPMs over the trailing twelve months ended July 31, 2012 and three and six months ended July 31, 2012 decreased compared to the respective prior year periods primarily due to listener hours growing at a faster pace than revenue, in part the result of the effective elimination of the 40 hour per month free listening cap on traditional computers in September 2011 which created increased advertising inventory not fully offset by advertising sales, as well as a lower percentage of advertising inventory being sold directly to advertisers by Pandora s sales team during the period ending July 31, 2012. This decrease in the percentage of advertising inventory being sold directly to advertisers by Pandora s sales team was due in part to the fact that the three and six month periods ended July 31, 2011 included direct sales revenue from one advertiser that accounted for 16% and 14% respectively, of total revenue.

***Costs and Expenses***

*Cost of Revenue - Content acquisition costs*

| | Three Months Ended July 31, | | | Six Months Ended July 31, | | |
|---|---|---|---|---|---|---|
| | 2011 | 2012 | $ Change | 2011 | 2012 | $ Change |
| | (in thousands) | | | (in thousands) | | |
| Cost of Revenue - Content acquisition costs | $ 33,723 | $ 60,522 | $ 26,799 | $ 62,881 | $ 116,340 | $ 53,459 |

The following table presents our estimated content acquisition costs for our advertising-based service attributable to our traditional computer platform and our mobile and other connected devices platforms as percentages of the estimated advertising revenue attributable to such platforms.

| | Three Months Ended July 31, | Six Months Ended July 31, |
|---|---|---|

| | 2011 | 2012 | 2011 | 2012 |
|---|---|---|---|---|
| Traditional computer | 25% | 32% | 27% | 35% |
| Mobile and other connected devices | 72% | 77% | 79% | 85% |

The majority of our royalties are payable based on a fee per track, while in other cases our royalties are payable based on a percentage of our revenue. 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 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 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.

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*Three months ended 2011 compared to 2012.* Content acquisition costs increased $26.8 million due to increased royalty payments driven by increased listener hours and higher royalty rates due to scheduled rate increases and higher revenue. Content acquisition costs as a percentage of total revenue increased from 50% to 60%, primarily due to the growth in listener hours on mobile devices for which we have not been able to as effectively generate revenue as compared to listener hours on traditional computers and to the rate increases. Estimated content acquisition costs as a percentage of the revenue attributable to our traditional computer platform increased from 25% to 32%, primarily due to the effective elimination of the 40 hour per month free listening cap on traditional computers, which created increased listener hours not fully offset by increased advertising sales, as well as the rate increases. Estimated content acquisition costs as a percentage of the revenue attributable to our mobile and other connected devices platforms increased from 72% to 77%, primarily due to an increase in listener hours on these platforms not fully offset by increased advertising sales, as well as the three months ending July 31, 2011 including revenue from one advertiser that accounted for 16% of total revenue made through premium sales.

*Six months ended 2011 compared to 2012.* Content acquisition costs increased $53.5 million due to increased royalty payments driven by increased listener hours and higher royalty rates due to scheduled rate increases and higher revenue. . Content acquisition costs as a percentage of total revenue increased from 53% to 64%, primarily due to the growth in listener hours on mobile devices for which we have not been able to as effectively generate revenue as compared to listener hours on traditional computers. Estimated content acquisition costs as a percentage of the revenue attributable to our traditional computer platform increased from 27% to 35%, primarily due to the effective elimination of the 40 hour per month free listening cap on traditional computers, which created increased listener hours not fully offset by increased advertising sales. Estimated content acquisition costs as a percentage of the revenue attributable to our mobile and other connected devices platforms increased from 79% to 85%, primarily due to an increase in listener hours on these platforms not fully offset by increased advertising sales, as well as the six months ended July 31, 2011 including revenue from one advertiser that accounted for 14 % of total revenue made through premium sales.

*Cost of Revenue - Other*

| | | Three Months Ended July 31, | | | Six Months Ended July 31, | | |
|---|---|---|---|---|---|---|---|
| | | **2011** | **2012** | **$ Change** | **2011** | **2012** | **$ Change** |
| | | | **(in thousands)** | | | **(in thousands)** | |
| Cost of revenue | Other | $ 5,460 | $ 7,514 | $ 2,054 | $ 9,820 | $ 14,431 | $ 4,611 |

*Three months ended 2011 compared to 2012.* Cost of revenue increased $2.1 million primarily due to a $0.9 million increase in hosting services costs as a result of an 80% increase in listener hours, $0.4 million higher employee-related expenses driven primarily by a 24% increase in period ending headcount and $0.6 million due to higher infrastructure costs.

*Six months ended 2011 compared to 2012.* Cost of revenue increased $4.6 million primarily due to a $1.8 million increase in hosting services costs as a result of an 85% increase in listener hours, $1.2 million higher employee-related expenses driven primarily by a 24% increase in period ending headcount and $1.3 million due to higher infrastructure costs.

*Product Development*

| | Three Months Ended July 31, | | | Six Months Ended July 31, | | |
|---|---|---|---|---|---|---|
| | 2011 | 2012 (in thousands) | $ Change | 2011 | 2012 (in thousands) | $ Change |
| Product development | $ 3,426 | $ 4,475 | $ 1,049 | $ 6,157 | $ 8,594 | $ 2,437 |

*Three months ended 2011 compared to 2012.* Product development expenses increased $1.0 million primarily due to $1.2 million higher employee-related expenses driven by a 14% increase in period ending headcount.

*Six months ended 2011 compared to 2012.* Product development expenses increased $2.4 million primarily due to $2.7 million higher employee-related expenses driven by a 14% increase in period ending headcount, partially offset by lower professional services fees.

*Marketing and Sales*

| | Three Months Ended July 31, | Six Months Ended July 31, |
|---|---|---|
| | 2011 | |