

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

Pandora Media, Inc.  
Form 10-Q  
July 31, 2018

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549

# FORM 10-Q

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

For the quarterly period ended **June 30, 2018**

or

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** **94-3352630**  
(State or other jurisdiction of (I.R.S. Employer  
incorporation or organization) Identification No.)

**2101 Webster Street, Suite 1650** **94612**

**Oakland, CA**  
(Address of principal executive offices) (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  Smaller reporting company   
(Do not check if a smaller reporting company) Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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 July 27, 2018 was: 266,318,724.



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**Pandora Media, Inc.**

**FORM 10-Q Quarterly Report**

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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 December 31, 2017	As of June 30, 2018
Assets		
Current assets		
Cash and cash equivalents	\$ 499,597	\$ 292,996
Short-term investments	1,250	127,791
Accounts receivable, net of allowance of \$5,352 at December 31, 2017 and \$5,935 at June 30, 2018	336,429	339,592
Prepaid content acquisition costs	55,668	24,379
Prepaid expenses and other current assets	19,220	21,799
Total current assets	912,164	806,557
Convertible promissory note receivable	35,471	—
Property and equipment, net	116,742	110,583
Goodwill	71,243	178,917
Intangible assets, net	19,409	59,863
Other long-term assets	11,293	12,023
Total assets	\$ 1,166,322	\$ 1,167,943
Liabilities, redeemable convertible preferred stock and stockholders' equity		
Current liabilities		
Accounts payable	\$ 14,896	\$ 17,704
Accrued liabilities	34,535	60,047
Accrued content acquisition costs	97,751	125,791
Accrued compensation	47,635	48,184
Deferred revenue	31,464	43,512
Total current liabilities	226,281	295,238
Long-term debt, net	273,014	250,267
Other long-term liabilities	23,500	25,919
Total liabilities	522,795	571,424
Redeemable convertible preferred stock: 480,000 shares issued and outstanding at December 31, 2017 and 480,000 at June 30, 2018	490,849	505,684
Stockholders' equity		
Common stock: 250,867,462 shares issued and outstanding at December 31, 2017 and 266,317,032 at June 30, 2018	25	27
Additional paid-in capital	1,422,221	1,598,905
Accumulated deficit	(1,269,351)	(1,507,874)
Accumulated other comprehensive loss	(217)	(223)
Total stockholders' equity	152,678	90,835
Total liabilities, redeemable convertible preferred stock and stockholders' equity	\$ 1,166,322	\$ 1,167,943

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)**

	<b>Three months ended</b>		<b>Six months ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2017</b>	<b>2018</b>	<b>2017</b>	<b>2018</b>
Revenue				
Advertising	\$278,204	\$271,056	\$501,512	\$485,624
Subscription and other	68,900	113,738	133,778	218,403
Ticketing service	29,730	—	57,548	—
Total revenue	376,834	384,794	692,838	704,027
Cost of revenue				
Cost of revenue—Content acquisition costs	195,875	226,860	383,295	444,440
Cost of revenue—Other	27,440	32,727	52,972	59,576
Cost of revenue—Ticketing service	20,510	—	39,128	—
Total cost of revenue	243,825	259,587	475,395	504,016
Gross profit	133,009	125,207	217,443	200,011
Operating expenses				
Product development	41,233	40,351	80,821	76,235
Sales and marketing	145,891	125,375	270,993	249,591
General and administrative	57,954	53,617	102,479	95,248
Goodwill impairment	131,997	—	131,997	—
Contract termination fees	23,467	—	23,467	—
Total operating expenses	400,542	219,343	609,757	421,074
Loss from operations	(267,533 )	(94,136 )	(392,314 )	(221,063 )
Interest expense	(7,404 )	(6,745 )	(14,785 )	(14,031 )
Other income, net	78	1,767	307	4,349
Total other expense, net	(7,326 )	(4,978 )	(14,478 )	(9,682 )
Loss before provision for income taxes	(274,859 )	(99,114 )	(406,792 )	(230,745 )
(Provision for) benefit from income taxes	(277 )	7,132	(611 )	7,058
Net loss	\$(275,136 )	\$(91,982 )	\$(407,403 )	\$(223,687 )
Net loss available to common stockholders	\$(289,664 )	\$(99,455 )	\$(421,931 )	\$(238,523 )
Basic and diluted net loss per common share	\$(1.20 )	\$(0.38 )	\$(1.76 )	\$(0.93 )
Weighted-average basic and diluted common shares	241,320	259,822	239,428	256,397

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)**  
**(unaudited)**

	<b>Three months ended</b>		<b>Six months ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2017</b>	<b>2018</b>	<b>2017</b>	<b>2018</b>
Net loss	\$(275,136 )	\$(91,982 )	\$(407,403 )	\$(223,687 )
Change in foreign currency translation adjustment	(62 )	16	129	2
Change in net unrealized gain (loss) on marketable securities	7	8	42	(8 )
Other comprehensive (loss) income	(55 )	24	171	(6 )
Total comprehensive loss	\$(275,191 )	\$(91,958 )	\$(407,232 )	\$(223,693 )

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)**

	<b>Six months ended</b>	
	<b>June 30,</b>	
	<b>2017</b>	<b>2018</b>
Operating activities		
Net loss	\$(407,403 )	\$(223,687 )
Adjustments to reconcile net loss to net cash used in operating activities		
Loss on dispositions	—	2,173
Goodwill impairment	131,997	—
Loss on extinguishment of convertible debt	—	14,600
Depreciation and amortization	35,115	28,062
Stock-based compensation	68,226	53,964
Amortization of premium on investments, net	73	(670 )
Accretion of discount on convertible promissory note receivable	—	(534 )
Other operating activities	186	231
Amortization of debt discount	9,799	10,418
Interest income	—	(810 )
Provision for bad debt	9,274	1,516
Changes in operating assets and liabilities		
Accounts receivable	12,594	16,111
Prepaid content acquisition costs	6,441	31,289
Prepaid expenses and other assets	(9,146 )	(1,346 )
Accounts payable, accrued and other current liabilities	15,072	3,601
Accrued content acquisition costs	(5,475 )	28,040
Accrued compensation	(13,191 )	1,170
Other long-term liabilities	176	(9,027 )
Deferred revenue	4,116	12,047
Reimbursement of cost of leasehold improvements	5,236	894
Net cash used in operating activities	(136,910 )	(31,958 )
Investing activities		
Purchases of property and equipment	(8,541 )	(4,990 )
Internal-use software costs	(10,894 )	(10,578 )
Payments related to acquisition, net of cash acquired	—	(66,924 )
Purchases of investments	—	(164,586 )
Proceeds from maturities of investments	25,274	38,750
Proceeds from cancellation of convertible promissory note receivable	—	34,742
Net cash provided by (used in) investing activities	5,839	(173,586 )
Financing activities		
Proceeds from issuance of redeemable convertible preferred stock	172,500	—
Payments of issuance costs	(12,625 )	(4,516 )
Proceeds from employee stock purchase plan	6,146	2,274
Proceeds from exercise of stock options	3,138	423
Tax withholdings related to net share settlements of restricted stock units	—	(477 )
Net cash provided by (used in) financing activities	169,159	(2,296 )
Effect of exchange rate changes on cash, cash equivalents and restricted cash	292	(18 )
Net increase (decrease) in cash, cash equivalents and restricted cash	38,380	(207,858 )
Cash, cash equivalents and restricted cash at beginning of period	201,820	500,854

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Less: Cash held for sale	(28,101 )	—
Cash, cash equivalents and restricted cash at end of period	\$ 212,099	\$ 292,996
Supplemental disclosures of cash flow information		
Purchases of property and equipment recorded in accounts payable and accrued liabilities	\$ 1,885	\$ 765
Cash paid during the period for interest	\$ 4,827	\$ 3,464
Accretion of preferred stock issuance costs	\$ 13,935	\$ —
Stock dividend payable to preferred stockholders	\$ 595	\$ 14,836
Contingent consideration related to acquisition	\$ —	\$ 5,000
Fair value of shares issued related to acquisition	\$ —	\$ 72,956
Employee stock purchase plan ("ESPP") purchases	\$ 3,306	\$ 3,381
Reconciliation of cash, cash equivalents and restricted cash as shown in the statements of cash flows		
Cash and cash equivalents	\$ 209,581	\$ 292,996
Restricted cash included in other long-term assets line item of Condensed Consolidated Balance Sheets	2,518	—
Total cash, cash equivalents and restricted cash	\$ 212,099	\$ 292,996

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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**

**(unaudited)**

**1. Description of Business and Basis of Presentation**

*Pandora—Streaming Radio Service and On-Demand Music Services*

Pandora is the world's most powerful music discovery platform, offering a personalized experience for each of our listeners wherever and whenever they want to listen to music—whether through mobile devices, car speakers or connected devices in the home.

Pandora is available as an ad-supported radio service, a radio subscription service called Pandora Plus and an on-demand subscription service called Pandora Premium. The majority of our listener hours occur on mobile devices, with the majority of our revenue generated from advertising on our ad-supported service on these devices. With billions of data points that help us understand our users' preferences, we offer both local and national advertisers the opportunity to deliver targeted messages to our listeners using a combination of audio, display and video advertisements. We also generate increasing revenue from subscriptions to Pandora Plus and Pandora Premium. We were incorporated as a California corporation in January 2000 and reincorporated as a Delaware corporation in December 2010. Our principal operations are located in the United States.

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") along with the instructions to Form 10-Q and Article 10 of Securities and Exchange Commission ("SEC") Regulation S-X, 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 year ended December 31, 2017.

Certain changes in presentation have been made to conform the prior period presentation to current period reporting. We have shown the changes in the total of cash, cash equivalents, restricted cash and restricted cash equivalents in the Condensed Consolidated Statements of Cash Flows.

*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 in several areas including, but not limited to determining accrued content acquisition costs, amortization of minimum guarantees under content acquisition agreements, selling prices for elements sold in arrangements with multiple performance obligations, the allowance for doubtful accounts, the fair

value of stock options, the ESPP, the provision for (benefit from) income taxes, fair value of convertible debt, fair value of contingent consideration, fair value of acquired intangible assets and goodwill and the useful lives of acquired intangible assets. 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.

## **2. Summary of Significant Accounting Policies**

Other than discussed below, 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 year ended December 31, 2017.

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**Pandora Media, Inc.**

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

**(unaudited)**

*Revenue Recognition*

Refer to Note 3 "Revenues" in the Notes to Condensed Consolidated Financial Statements for our Revenue Recognition policy.

*Business Combinations, Goodwill and Intangible Assets, net*

We allocate the fair value of purchase consideration to the tangible assets acquired, liabilities assumed, intangible assets acquired based on their estimated fair values. The excess of the fair value of purchase consideration over the fair values of these identifiable assets and liabilities is recorded as goodwill. Additionally, any contingent consideration is recorded at fair value on the acquisition date and classified as a liability. Such valuations require management to make significant estimates and assumptions, especially with respect to intangible assets and contingent consideration. Significant estimates in valuing certain intangible assets include, but are not limited to, future expected cash flows from acquired users, acquired technology, and trade names from a market participant perspective, useful lives and discount rates. Management's estimates of fair value are based upon assumptions believed to be reasonable, but which are inherently uncertain and unpredictable and, as a result, actual results may differ from estimates. During the measurement period, we may record adjustments to the assets acquired and liabilities assumed, with the corresponding offset to goodwill. Upon the conclusion of the measurement period, any subsequent adjustments are recorded to earnings.

We test goodwill and intangible assets with indefinite useful lives for impairment at least annually, or more frequently if events or changes in circumstances indicate that the assets may be impaired. We perform our annual goodwill and intangible asset impairment tests in the fourth quarter of each year.

Acquired finite-lived intangible assets are amortized over the estimated useful lives of the assets, which range from three to eleven years. Acquired finite-lived intangible assets consist primarily of patents, customer relationships, developed technology and trade names resulting from business combinations. We evaluate the recoverability of our intangible assets for potential impairment whenever events or circumstances indicate that the carrying amount of such assets may not be recoverable. Recoverability of these assets is measured by a comparison of the carrying amounts to the future undiscounted cash flows the assets are expected to generate. If such review indicates that the carrying amount of intangible assets is not recoverable, the carrying amount of such assets is reduced to the fair value.

In addition to the recoverability assessment, we routinely review the remaining estimated useful lives of finite-lived intangible assets. If we reduce the estimated useful life assumption for any asset, the remaining unamortized balance would be amortized over the revised estimated useful life. We record the amortization of intangible assets to the financial statement line item in our consolidated statement of operations that the asset directly relates to. To the extent that purchased intangibles are used in revenue generating activities, we record the amortization of these intangible assets to cost of revenue.

*Convertible Senior Notes due 2020 ("2020 Notes")*

We allocate the principal amount of our 2020 Notes between the liability and equity components. The value assigned to the debt components of the 2020 Notes is the estimated fair value as of the issuance date of similar debt without the conversion feature. The difference between the cash proceeds and this estimated fair value represents the value which has been assigned to the equity component. The equity component is recorded to additional paid-in capital and is not

remeasured as long as it continues to meet the conditions for equity classification. The excess of the principal amount of the Notes over the carrying amount of the liability component is recorded as a debt discount, and is being amortized to interest expense using the effective interest method through the December 1, 2020 maturity date. We allocate the total amount of transaction costs incurred to the liability and equity components.

*Convertible Senior Notes due 2023 ("2023 Notes")*

We allocate the principal amount of our 2023 Notes between the liability and equity components. The value assigned to the debt components of the 2023 Notes is the estimated fair value as of the issuance date of similar debt without the conversion feature. The difference between the fair value of the total instrument and this estimated fair value of the debt component represents the value which has been assigned to the equity component. The equity component is recorded to additional paid-in capital and is not remeasured as long as it continues to meet the conditions for equity classification. The excess of the principal amount of the Notes over the carrying amount of the liability component is recorded as a debt discount, and is being amortized t



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**Pandora Media, Inc.**

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

**(unaudited)**

o interest expense using the effective interest method through the December 1, 2023 maturity date. We allocate the total amount of transaction costs incurred to the liability and equity components.

*Concentration of Credit Risk*

For the three and six months ended June 30, 2017 and 2018, we had no customers that accounted for more than 10% of our total revenue. As of December 31, 2017 and June 30, 2018, we had no customers that accounted for more than 10% of our total accounts receivable.

*Recently Issued Accounting Standards*

In February 2016, the FASB issued Accounting Standards Update No. 2016-02, Leases (Topic 842) ("ASU 2016-02"). ASU 2016-02 requires lessees to put most leases on their balance sheets and recognize expenses on their income statements and also eliminates the real estate-specific provisions for all entities. The guidance is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. We expect to adopt ASU 2016-02 as of January 1, 2019 using the modified retrospective method. We are in the process of evaluating the impact of ASU 2016-02 on our consolidated financial statements and expect there to be a material impact related to the recognition of new right of use assets and lease liabilities on our balance sheet for operating leases.

In June 2016, the FASB issued Accounting Standards Update No. 2016-13, Credit Losses—Measurement of Credit Losses on Financial Instruments ("ASU 2016-13"). ASU 2016-13 will replace today's incurred loss approach with an expected loss model for instruments measured at amortized cost and require entities to record allowances for available-for-sale debt securities rather than reduce the carrying amount. The guidance is effective for fiscal years beginning after December 15, 2019, and interim periods within that fiscal year, although early adoption is permitted. We are currently evaluating the impact that this standard update will have on our condensed consolidated financial statements.

In June 2018, the FASB issued Accounting Standards Update No. 2018-07, Improvements to Nonemployee Share-Based Payment Accounting ("ASU 2018-07"), which simplifies the accounting for share-based payments granted to nonemployees for goods and services. Under ASU 2018-07, certain guidance on such payments to nonemployees would be aligned with the requirements for share-based payments granted to employees. The guidance is effective for fiscal years beginning after December 15, 2018, and interim periods within that fiscal year, although early adoption is permitted. As we do not have material nonemployee awards, we do not expect the adoption of ASU 2018-07 to have a material impact on our condensed consolidated financial statements.

*Recently Adopted Accounting Standards*

In May 2014, the FASB issued Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers (Topic 606) ("ASU 2014-09"), which amends the existing accounting standards for revenue recognition. ASU 2014-09 outlines a single comprehensive model for entities to use in accounting for revenue. Under the guidance, revenue is recognized when a company transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. We have adopted ASU 2014-09 as of January 1, 2018 using the modified retrospective method applied to those contracts which were not completed as of January 1, 2018. Revenues and contract assets or liabilities for contracts completed prior to January 1, 2018 are presented under Topic 605, and revenues and contract assets and liabilities from contracts which

were not completed or started after December 31, 2017 are presented under Topic 606. The adoption of this guidance does not have a material impact on our consolidated financial statements. Refer to Note 3 "Revenues" in the Notes to Condensed Consolidated Financial Statements for further information.

In August 2016, the FASB issued Accounting Standards Update No. 2016-15, Statement of Cash Flows (Topic 230) Classification of Certain Cash Receipts and Cash Payments ("ASU 2016-15"), which eliminates the diversity in practice related to the classification of certain cash receipts and payments for debt prepayment or extinguishment costs, the maturing of a zero-coupon bond, the settlement of contingent liabilities arising from a business combination, proceeds from insurance settlements, distributions from certain equity method investees and beneficial interests obtained in a financial asset securitization. ASU 2016-15 designates the appropriate cash flow classification, including requirements to allocate certain components of these cash receipts and payments among operating, investing and financing activities. We adopted this guidance effective January 1, 2018, using the retrospective transition approach for all periods presented. The adoption of ASU 2016-15 did not have a material impact on our condensed consolidated financial statements.

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**Pandora Media, Inc.**

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

**(unaudited)**

In November 2016, the FASB issued Accounting Standards Update No. 2016-18, Statement of Cash Flows (Topic 230), Restricted Cash ("ASU 2016-18"). ASU 2016-18 requires amounts generally described as restricted cash and restricted cash equivalents be included with cash and cash equivalents when reconciling the total beginning and ending amounts for the periods shown on the statement of cash flows. The guidance is effective retrospectively for fiscal years beginning after December 15, 2017, and interim periods within that fiscal year. We adopted this guidance effective January 1, 2018, using the retrospective transition approach for all periods presented. The adoption of ASU 2016-18 did not have a material impact on our condensed consolidated financial statements.

In January 2017, the FASB issued Accounting Standards Update No. 2017-01, Business Combinations (Topic 805): Clarifying the Definition of a Business (ASU 2017-01). ASU 2017-01 revises the definition of a business and provides new guidance in evaluating when a set of transferred assets and activities is considered a business. We adopted this guidance effective January 1, 2018, using the prospective approach. The adoption of ASU 2017-01 did not have a material impact on our condensed consolidated financial statements.

**3. Revenues**

*Adoption of ASC Topic 606, "Revenue from Contracts with Customers"*

The new accounting standard under ASC 606 became effective for all public companies with fiscal years beginning after December 15, 2017. On January 1, 2018, we adopted ASC 606 using the modified retrospective method. This method required retrospective application of the new accounting standard to all unfulfilled contracts that were outstanding as of January 1, 2018. Revenues and contract assets or liabilities for contracts completed prior to January 1, 2018, including ticketing revenue related to Ticketfly, are presented under Topic 605, and revenues and contract assets and liabilities from contracts which were not completed or started after December 31, 2017 are presented under Topic 606.

We recorded an immaterial adjustment to opening accumulated deficit as of January 1, 2018 due to the cumulative impact of adopting Topic 606, primarily related to deferred revenue.

*Revenue Recognition*

Revenues are recognized when a contract with a customer exists, and the control of the promised services are transferred to our customers, in an amount that reflects the consideration we expect to receive in exchange for those services. Substantially all of our revenues are generated from contracts with customers in the United States.

*Gross Versus Net Revenue Recognition*

We report revenue on a gross or net basis based on management's assessment of whether we act as a principal or agent in the transaction. To the extent we act as the principal, revenue is reported on a gross basis unless we are unable to determine the amount on a gross basis, in which case we report revenue on a net basis. The determination of whether we act as a principal or an agent in a transaction is based on an evaluation of whether we control the good or service prior to transfer to the customer. We have determined that we act as the principal in all of our revenue streams.

*Advertising Revenue*

We generate advertising revenue primarily from audio, display and video advertising. We generate the majority of our advertising revenue through the delivery of advertising impressions sold on a cost per thousand basis ("CPM"). We also offer advertising on other units of measure, such as cost per engagement ("CPE") and cost per view ("CPV"), under which an advertiser pays us based on the number of times a listener engages with an ad. We consider the performance obligation as the ad insertion on the order, which is a series type performance obligation.

We determine that a contract exists when we have an agreed-to insertion order or a fully executed customer-specific agreement. The duration of our contracts is generally less than one year. Revenue is recognized as performance obligations are satisfied, which generally occurs as ads are delivered through our platform. We generally recognize revenue based on delivery information from our campaign trafficking systems. Certain advertising arrangements include performance obligations other than

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**Pandora Media, Inc.**

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

**(unaudited)**

advertising, such as music events. For these performance obligations, revenue is recognized when the customer obtains control of the promised services, such as when a music event occurs.

Certain customers may receive cash-based incentives or rebates, which are accounted for as variable consideration in the determination of the transaction price. We use the expected value method to estimate the value of such variable consideration to include in the transaction price and reflect changes to such estimates in the period in which they occur. The amount of variable consideration included in revenues is limited to the extent that it is probable that the amount will not be subject to a significant reversal when the uncertainty associated with the variable consideration is subsequently resolved.

Certain contracts include added value (“AV”) elements, under which the customer may receive credits for free advertising services in exchange for advertising spend commitments, either based on total contract amount, defined spend tiers or overall commitments across multiple contracts. We have determined that these AV elements represent a material right to the customer, and therefore are treated as distinct performance obligations. We determine an estimated selling price for these items and include them in the allocation of the transaction price of a contract or series of contracts, as applicable.

Our payment terms vary by the type and location of customers. The time between satisfaction of performance obligations and when payment is due does not exceed one year. For certain services and customer types, upon the execution of a contract, we may require payment before the services are delivered to the customer. These payments are recorded as contract liabilities in our condensed consolidated financial statements.

*Arrangements with multiple performance obligations—Advertising revenue*

Our contracts with customers generally include multiple performance obligations. For such arrangements, we allocate revenue to each performance obligation based on its relative standalone selling price. We generally determine standalone selling prices based on an analysis of the historical prices charged to customers, or by estimating the standalone selling price using expected cost plus margin.

*Subscription and Other Revenue*

Pandora is also available as a radio subscription service called Pandora Plus and an on-demand subscription service called Pandora Premium. Pandora Plus is a paid, ad-free subscription version of the Pandora service that includes replays, additional skipping, offline listening, higher quality audio on supported devices and longer timeout-free listening.

The features of Pandora Plus are also included in Pandora Premium. Pandora Premium is a paid, ad-free version of the Pandora service that offers a unique, on-demand experience, providing users with the ability to search, play and collect songs and albums, build playlists on their own or with the tap of a button the app will automatically generate a playlist based on the user’s listening activity.

We generate revenue for these subscription services on both a direct basis and through subscriptions sold through certain third-party mobile device app stores. For subscriptions sold through third-party mobile device app stores, the subscriber executes a click-through agreement with Pandora outlining the terms and conditions between Pandora and the subscriber upon purchase of the subscription. The mobile device app stores promote the Pandora app through their

e-store, process payments for subscriptions, and retain a percentage of revenue as a fee. We report this revenue gross of the fee retained by the mobile device app stores, as the subscriber is Pandora's customer in the contract and Pandora controls the service prior to the transfer to the subscriber.

Subscription revenue is a series type performance obligation and is recognized net of sales tax amounts collected from subscribers. The enforceable rights in monthly subscription contracts are the monthly service period, whereas the annual subscriptions are cancelable at any time. For monthly subscriptions where there are no cancellation provisions, we recognize revenue on a straight-line basis over the monthly service term. Because of the cancellation clauses for the annual subscriptions, the duration of these contracts is daily, and revenue for these contracts is recognized on a daily ratable basis. Historically, cancellation rates have been immaterial.

Subscription revenue from monthly subscriptions sold indirectly through mobile device app stores may be subject to partners' refund or cancellation terms. Revenues are recognized net of any adjustments for variable consideration, including refunds and other fees, as reported by the partners.

Our payment terms vary based on whether the subscription is sold on a direct basis or through mobile device app stores. Subscriptions sold on a direct basis require payment before the services are delivered to the customer. The payment terms for subscriptions sold through mobile device app stores vary and generally range from 30 to 60 days.

Table of Contents**Pandora Media, Inc.****Notes to Condensed Consolidated Financial Statements - Continued****(unaudited)***Contract Assets and Liabilities*

We record those services which we have delivered and have a right to invoice as a contract asset. We record any payments which are received or due in advance of our performance, and where a contract exists, as contract liabilities. The increase in the deferred revenue balance as of June 30, 2018 is primarily driven by cash payments received or due in advance of satisfying our performance obligations, offset by \$27.0 million of revenues recognized that were included in the deferred revenue balance as of December 31, 2017.

*Practical Expedients and Exemptions*

We generally expense sales commissions when incurred because the duration of the contracts for which we pay commissions are less than one year. These costs are included in the sales and marketing line item of our Condensed Consolidated Statements of Operations.

We do not disclose the value of unsatisfied performance obligations for (i) contracts with an original expected length of one year or less and (ii) contracts for which we recognize revenue at the amount to which we have the right to invoice for services performed.

**4. Cash, Cash Equivalents and Investments**

Cash, cash equivalents and investments consisted of the following:

	As of December 31, 2017	As of June 30, 2018
	(in thousands)	
Cash and cash equivalents		
Cash	\$ 146,294	\$ 169,324
Money market funds	353,303	75,223
Commercial paper	—	38,442
Corporate debt securities	—	10,007
Total cash and cash equivalents	\$ 499,597	\$ 292,996
Short-term investments		
Commercial paper	\$ —	\$ 111,164
Corporate debt securities	1,250	16,627
Total short-term investments	\$ 1,250	\$ 127,791
Cash, cash equivalents and investments	\$ 500,847	\$ 420,787

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

The following table summarizes our available-for-sale securities' adjusted cost, gross unrealized gains, gross unrealized losses and fair value by significant investment category as of June 30, 2018. As of December 31, 2017, the

adjusted cost and fair value by significant investment category are the same.



Table of Contents**Pandora Media, Inc.****Notes to Condensed Consolidated Financial Statements - Continued****(unaudited)**

	As of June 30, 2018		
	Adjusted Cost	Unrealized Losses	Fair Value
	(in thousands)		
Money market funds	\$75,223	\$ —	\$75,223
Commercial paper	149,606	—	149,606
Corporate debt securities	26,642	(8 )	26,634
Total cash equivalents and marketable securities	\$251,471	\$ (8 )	\$251,463

All of our investments have maturities of twelve months or less as of December 31, 2017 and June 30, 2018.

We had no securities that had been in a continuous unrealized loss position for greater than 12 months as of December 31, 2017 and June 30, 2018.

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 and rated "A" by Standard & Poor's or "A2" by Moody's or better for long-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 June 30, 2018 were primarily a result of unfavorable changes in interest rates subsequent to the initial purchase of these securities. As of June 30, 2018, we owned nine securities that were in an unrealized loss position. Based on our cash flow needs, we may be required to sell a portion of these securities prior to maturity. However, we expect to recover the full carrying value of these securities. As a result, no portion of the unrealized losses at June 30, 2018 is deemed to be other-than-temporary, and the unrealized losses are not deemed to be credit losses. When evaluating investments for other-than-temporary impairment, we review 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 our intent to sell, or whether it is more likely than not we will be required to sell the investment before recovery of the investment's amortized cost basis. During the three and six months ended June 30, 2018, we did not recognize any impairment charges. There were no sales of available-for-sale securities during the three and six months ended June 30, 2018.

Table of Contents**Pandora Media, Inc.****Notes to Condensed Consolidated Financial Statements - Continued****(unaudited)****5. Fair Value**

We record cash equivalents and 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.

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 following fair value hierarchy tables categorize information regarding our financial assets and liabilities measured at fair value on a recurring basis at December 31, 2017 and June 30, 2018:

**As of December 31, 2017**  
**Fair Value Measurement Using**  
**Quoted**  
**Prices in**    **Significant**  
**Active Markets**    **Other**  
**for Identical**    **Observable**    **Total**  
**Instruments**    **Inputs**  
**(Level 1)**    **(Level 2)**  
**(in thousands)**

Assets			
Money market funds	\$ 353,303	\$ —	\$ 353,303
Corporate debt securities	—	1,250	1,250
Total assets measured at fair value	\$ 353,303	\$ 1,250	\$ 354,553

**As of June 30, 2018**  
**Fair Value Measurement Using**  
**Quoted**  
**Prices in**    **Significant**  
**Active Markets**    **Other**  
**for Identical**    **Observable**    **Total**  
**Instruments**    **Inputs**  
**(Level 1)**    **(Level 2)**  
**(in thousands)**

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Assets

Money market funds	\$ 75,223	\$ —	\$ 75,223
Commercial paper	—	149,606	149,606
Corporate debt securities	—	26,634	26,634
Total assets measured at fair value	\$ 75,223	\$ 176,240	\$ 251,463

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**Pandora Media, Inc.**

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

**(unaudited)**

Our cash equivalents and short-term investments, excluding money market funds, 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.

As of December 31, 2017 and June 30, 2018, we held no Level 3 assets or liabilities measured on a recurring basis. The fair value of our convertible subordinated promissory note receivable ("Convertible Promissory Note") was calculated on a nonrecurring basis as of September 1, 2017 and was classified as a Level 3 measurement within the fair value hierarchy as of December 31, 2017. The Convertible Promissory Note was canceled on March 30, 2018. Refer to Note 10 "Convertible Promissory Note Receivable" in the Notes to Condensed Consolidated Financial Statements for further details on the cancellation of the Convertible Promissory Note.

The fair value of our 2023 Notes was calculated on a nonrecurring basis as of May 24, 2018. Refer to Note 11, "Debt Instruments", in the Notes to Condensed Consolidated Financial Statements for the carrying amount and estimated fair value of our 2023 Notes and 2020 Notes (collectively the "Notes"), which are not recorded at fair value as of June 30, 2018.

**6. Commitments and Contingencies**

*Minimum Guarantees and Other Provisions—Content Acquisition Costs*

Certain of our content acquisition agreements contain minimum guarantees, and require that we make upfront minimum guarantee payments. During the three and six months ended June 30, 2018, we prepaid \$102.8 million and \$172.8 million in content acquisition costs related to minimum guarantees. As of June 30, 2018, we have future minimum guarantee commitments of \$237.2 million, of which \$226.2 million will be paid in 2018 and the remainder will be paid thereafter. On a quarterly basis, we record the greater of the cumulative actual content acquisition costs incurred or the cumulative minimum guarantee based on forecasted usage for the minimum guarantee period. The minimum guarantee period is the period of time that the minimum guarantee relates to, as specified in each agreement, which may be annual or a longer period. The cumulative minimum guarantee, based on forecasted usage, considers factors such as listening hours, revenue, subscribers and other terms of each agreement that impact our expected attainment or recoupment of the minimum guarantees based on the relative attribution method.

Several of our content acquisition agreements also include provisions related to the royalty payments and structures of those agreements relative to other content licensing arrangements, which, if triggered, could cause our payments under those agreements to escalate. In addition, record labels, publishers and performing rights organizations ("PROs") with whom we have entered into direct license agreements have the right to audit our content acquisition payments, and any such audit could result in disputes over whether we have paid the proper content acquisition costs. However, as of June 30, 2018, we do not believe it is probable that these provisions of our agreements discussed above will, individually or in the aggregate, have a material adverse effect on our business, financial position, results of operations or cash flows.

*Legal Proceedings*

We have been in the past, and continue to be, a party to various legal proceedings, which have consumed, and may continue to consume, financial and managerial resources. 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.

*Pre-1972 copyright litigation*

On October 2, 2014, Flo & Eddie Inc. filed a class action suit against Pandora Media Inc. in the federal district court for the Central District of California. The complaint alleges misappropriation and conversion in connection with the public performance of sound recordings recorded prior to February 15, 1972. On December 19, 2014, Pandora filed a motion to strike the complaint pursuant to California's Anti-Strategic Lawsuit Against Public Participation ("Anti-SLAPP") statute, which was appealed to the Ninth Circuit Court of Appeals. The district court litigation is currently stayed pending the Ninth Circuit's decision. On December 8, 2016, the Ninth Circuit heard oral arguments on the Anti-SLAPP motion. On March 15, 2017, the

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**Pandora Media, Inc.**

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

**(unaudited)**

Ninth Circuit requested certification to the California Supreme Court on the substantive legal questions. The California Supreme Court has accepted certification and has received all written briefing on the case, but has not yet scheduled oral argument.

Between September 14, 2015 and October 19, 2015, Arthur and Barbara Sheridan filed separate class action suits against the Company in the federal district courts for the Northern District of California and the District of New Jersey. The complaints allege a variety of violations of common law and state copyright statutes, common law misappropriation, unfair competition, conversion, unjust enrichment and violation of rights of publicity arising from allegations that we owe royalties for the public performance of sound recordings recorded prior to February 15, 1972. The actions in California and New Jersey are currently stayed pending the Ninth Circuit's decision in *Flo & Eddie, Inc. v. Pandora Media, Inc.*

On September 7, 2016, Ponderosa Twins Plus One et al. filed a class action suit against the Company alleging claims similar to that of *Flo & Eddie, Inc. v. Pandora Media Inc.* The action is currently stayed in the Northern District of California pending the Ninth Circuit's decision in *Flo & Eddie, Inc. v. Pandora Media, Inc.*

On March 1, 2018, Gusto Records, Inc. filed a suit against the Company alleging claims similar to that of *Flo & Eddie, Inc. v. Pandora Media Inc.* On July 20, 2018, Gusto Records filed an action to dismiss the case without prejudice pursuant to a tolling agreement between the parties.

The outcome of any litigation is inherently uncertain. Except as noted above, we do not believe it is probable that the final outcome of the matters discussed above will, 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.

*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. We have not incurred, do not anticipate incurring and therefore have not accrued for, any material 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 business, financial position, results of operations or cash flows.

**7. Business Combination**

On May 25, 2018, we completed the acquisition of AdsWizz Inc. ("AdsWizz"), a leading digital audio ad technology company with a comprehensive digital audio software suite of solutions that connects audio publishers to the

advertising community, for an aggregate purchase price of \$146.6 million in a combination of cash and common stock. Cash paid was \$73.7 million and 9,588,312 shares of the Company's common stock were issued. The purchase price includes a contingent consideration of \$5.0 million, measured at its fair value, which is dependent on achievement of certain business milestones. In addition to the purchase price, unvested options of AdsWizz were converted into unvested options to acquire our common stock.

Upon acquisition, AdsWizz became a wholly owned subsidiary of Pandora. The acquisition was accounted for as a business combination, and the financial results of AdsWizz are included in our consolidated financial statements from the date of acquisition. Pro forma results of operations related to the acquisition have not been presented because it is not material to our consolidated statements of operations.

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The following table summarizes the allocation of estimated fair values of the net assets acquired during the three months ended June 30, 2018, including the related estimated useful lives, where applicable:

	<b>Estimated fair value (in thousands)</b>	<b>Estimated useful life in years</b>
Finite-lived intangible assets		
Developed technology	\$ 32,000	4
Customer relationships	12,000	4
Trade name	600	4
Total finite-lived intangible assets	\$ 44,600	
Tangible assets acquired, net	1,581	
Deferred tax liabilities	(7,216 )	
Net assets acquired	\$ 38,965	
Goodwill	107,673	
Total fair value consideration	\$ 146,638	

The fair value of assets acquired and liabilities assumed from our acquisition of AdsWizz was based on a preliminary valuation and our estimates and assumptions are subject to change. We will recognize any subsequent adjustments to the purchase price prospectively in the period in which the adjustments are determined. A portion of the purchase price is held in escrow and may be recovered from this escrow amount.

Goodwill generated from the AdsWizz acquisition is primarily attributable to expected synergies from future growth and strategic advances in the digital audio ad technology industry. Goodwill generated during the period is not deductible for tax purposes.

**8. Goodwill and Intangible Assets**

During the three and six months ended June 30, 2018, we completed the acquisition of AdsWizz. The changes in the carrying amount of goodwill for the six months ended June 30, 2018, are as follows:

	<b>6/30/2018 (in thousands)</b>
Balance as of December 31, 2017	\$ 71,243
Goodwill related to acquisition of AdsWizz	107,674
Balance as of June 30, 2018	\$ 178,917

The following summarizes information regarding the gross carrying amounts and accumulated amortization of intangible assets:





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	As of December 31, 2017			As of June 30, 2018		
	Gross Carrying Amount (in thousands)	Accumulated Amortization	Net Carrying Value	Gross Carrying Amount (in thousands)	Accumulated Amortization	Net Carrying Value
Finite-lived intangible assets						
Patents	\$8,030	\$ (3,289)	) \$ 4,741	\$8,030	\$ (3,655)	) \$ 4,375
Developed technology	27,950	(13,608)	) 14,342	59,950	(16,908)	) 43,042
Customer relationships	940	(940)	) —	12,940	(1,238)	) 11,702
Trade names	1,320	(994)	) 326	1,920	(1,175)	) 745
Total finite-lived intangible assets	\$38,240	\$ (18,831)	) \$ 19,409	\$82,840	\$ (22,976)	) \$ 59,864

Note: Amounts may not recalculate due to rounding

Amortization expense of intangible assets was \$4.1 million and \$2.6 million for the three months ended June 30, 2017 and 2018. Amortization expense of intangible assets was \$9.3 million and \$4.1 million for the six months ended June 30, 2017 and 2018.

The following is a schedule of future amortization expense related to finite-lived intangible assets as of June 30, 2018.

	As of June 30, 2018 (in thousands)
Remainder of 2018	\$ 8,605
2019	16,696
2020	16,401
2021	11,877
2022	5,193
Thereafter	1,092
Total future amortization expense	\$ 59,864

**9. Dispositions**

On September 1, 2017, we completed the sale of Ticketfly, our ticketing service segment, to Eventbrite Inc. ("Eventbrite") for an aggregate unadjusted purchase price of \$200.0 million. The aggregate unadjusted purchase price consisted of \$150.0 million in cash and a \$50.0 million Convertible Promissory Note, which were paid and issued at the closing of the transaction. The Convertible Promissory Note was recorded at its fair value at the date of sale, which resulted in a discount of \$13.8 million. The aggregate purchase price was further reduced by \$4.8 million in costs to sell and \$7.5 million in working capital adjustments and certain indemnification provisions, for a net purchase price of \$174.0 million.

On March 30, 2018, we amended our Membership Interest Purchase Agreement ("MIPA") with Eventbrite which resulted in the cancellation of our Convertible Promissory Note for a cancellation fee of \$34.7 million. Upon

completion of the cancellation of the Convertible Promissory Note, the remaining unpaid principal and interest balance were forgiven.

In the six months ended June 30, 2018, we recognized a loss on sale of \$2.1 million related to the cancellation of the Convertible Promissory Note. The loss is included in the general and administrative line item of our Condensed Consolidated Statements of Operations and was based on the cancellation fee of \$34.7 million.

**10. Convertible Promissory Note Receivable**

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On September 1, 2017, we completed the sale of Ticketfly, our ticketing service segment, to Eventbrite for an aggregate unadjusted purchase price of \$200.0 million. The aggregate unadjusted purchase price consists of \$150.0 million in cash and a \$50.0 million Convertible Promissory Note, which were paid and issued at the closing of the transaction. On March 30, 2018, we amended our MIPA with Eventbrite which resulted in the cancellation of our Convertible Promissory Note for a cancellation fee of \$34.7 million. Refer to Note 9, "Dispositions" in the Notes to Condensed Consolidated Financial Statements for further details on the cancellation of the Convertible Promissory Note.

Prior to the cancellation, the Convertible Promissory Note was due five years from its issuance date (the "Convertible Promissory Note Maturity Date") and accrued interest at a rate of 6.5% per annum, payable quarterly in cash or in-kind for the first year at the discretion of Eventbrite, and in cash thereafter. Prior to the Convertible Promissory Note Maturity Date, the Convertible Promissory Note was convertible at our option into shares of Eventbrite's common stock.

The Convertible Promissory Note was recorded at its fair value of \$36.2 million as of the issuance date of September 1, 2017, which resulted in a discount of \$13.8 million. The note was further reduced by \$2.5 million in purchase price adjustments. As of March 30, 2018 ("Cancellation Date"), the balance of the Convertible Promissory Note also included \$1.9 million in interest receivable and \$1.2 million in accretion of the discount, for a total carrying value of \$36.8 million.

The discount on the Convertible Promissory Note was being amortized to interest income using the effective interest method over the period from the date of issuance through the Cancellation Date. The following table outlines the effective interest rate, contractually stated interest income and amortization of the discount for the Convertible Promissory Note for the period from January 1, 2018 through the Cancellation Date.

	(in thousands except for effective interest rate)	
Effective interest rate	14.73	%
Contractually stated interest income	\$ 1,892	
Amortization of discount	\$ 1,221	

**11. Debt Instruments**

Long-term debt, net consisted of the following:

	As of December 31, 2017	As of June 30, 2018
	(in thousands)	
1.75% convertible senior notes due 2020	\$345,000	\$152,100
1.75% convertible senior notes due 2023	—	192,900

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Unamortized discount and deferred issuance costs	(71,986 )	(94,733 )
Long-term debt, net	\$273,014	\$250,267

### *Convertible Debt Offering Due 2020*

On December 9, 2015, we completed an unregistered Rule 144A offering for the issuance of \$345.0 million aggregate principal amount of our 1.75% 2020 Notes. In connection with the issuance of the 2020 Notes, we entered into capped call transactions with the initial purchaser of the 2020 Notes and an additional financial institution ("Capped Call Transactions").

The net proceeds from the sale of the 2020 Notes were approximately \$336.5 million, after deducting the initial purchasers' fees and other estimated expenses. We used approximately \$43.2 million of the net proceeds to pay the cost of the Capped Call Transactions.

On May 24, 2018, we exchanged \$192.9 million in aggregate principal of the 2020 Notes for new 2023 Notes. As a result of the transaction, \$192.9 million in aggregate principal of the 2020 Notes was extinguished. The extinguishment resulted in the derecognition of the carrying value of the debt, including the debt discount, of \$157.4 million. We recognized a loss on exchange of \$14.6 million based on the difference between the carrying value of the exchanged notes and the portion of the consideration allocated to the fair value of the new notes. The loss is included in the general and administrative line item of our

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**Pandora Media, Inc.**

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

**(unaudited)**

Condensed Consolidated Statements of Operations. The carrying value of the existing 2020 notes as of June 30, 2018 is \$152.1 million and will continue to accrete to par using the same effective interest rate when the transaction was executed.

The 2020 Notes are unsecured, senior obligations of Pandora, and interest is payable semi-annually at a rate of 1.75% per annum. The 2020 Notes will mature on December 1, 2020, unless earlier repurchased or redeemed by Pandora or converted in accordance with their terms prior to such date. Prior to July 1, 2020, the 2020 Notes are convertible at the option of holders only upon the occurrence of specified events or during certain periods as further described in Note 9 "Debt Instruments" in our Annual Report on Form 10-K for the year ended December 31, 2017 thereafter, until the second scheduled trading day prior to maturity, the 2020 Notes will be convertible at the option of holders at any time.

The conversion rate for the 2020 Notes is initially 60.9050 shares of common stock per \$1,000 principal amount of the 2020 Notes, which is equivalent to an initial conversion price of approximately \$16.42 per share of our common stock, and is subject to adjustment in certain circumstances.

The 2020 Notes were separated into debt and equity components and assigned a fair value. The value assigned to the debt component is the estimated fair value as of the issuance date of similar debt without the conversion feature. The difference between the cash proceeds and this estimated fair value represents the value which has been assigned to the equity component and recorded as a debt discount. The debt discount is being amortized using the effective interest method over the period from the date of issuance through the December 1, 2020 maturity date. The valuation of the 2020 Notes is further described in Note 9 "Debt Instruments" in our Annual Report on Form 10-K for the year ended December 31, 2017.

The initial debt component of the 2020 Notes was valued at \$233.5 million, based on the contractual cash flows discounted at an appropriate market rate for non-convertible debt at the date of issuance. The carrying value of the permanent equity component reported in additional paid-in-capital was initially valued at \$103.0 million, which is net of \$2.6 million of fees and expenses allocated to the equity component.

*Convertible Debt Offering Due 2023*

On May 24, 2018, we completed an exchange of \$192.9 million in aggregate principal of the 2020 notes in separate transactions with the note holders. Pursuant to the exchange, the note holders received \$192.9 million in aggregate principal of the new 1.75% 2023 Notes.

The 2023 Notes are unsecured, senior obligations of Pandora, and interest is payable semi-annually at a rate of 1.75% per annum. The 2023 Notes will mature on December 1, 2023, unless earlier repurchased or redeemed by Pandora or converted in accordance with their terms prior to such date. Prior to July 1, 2023, the 2023 Notes are convertible at the option of holders only upon the occurrence of specified events or during certain periods as further described below thereafter, until the second scheduled trading day prior to maturity, the 2023 Notes will be convertible at the option of holders at any time.

The conversion rate for the 2023 Notes is initially 104.4778 shares of common stock per \$1,000 principal amount of the 2023 Notes, which is equivalent to an initial conversion price of approximately \$9.57 per share of our common stock, and is subject to adjustment in certain circumstances.

We will not have the right to redeem the 2023 Notes prior to December 5, 2021. We may redeem all or any portion of the 2023 Notes for cash at our option on or after December 5, 2021 if the last reported sale price of our common stock is at least 130% of the conversion price then in effect for at least 20 trading days, whether or not consecutive, during any 30 consecutive trading day period, including the last trading day of such period, ending on, and including, any of the five trading days immediately preceding the date on which we provide notice of redemption. Any optional redemption of the 2023 Notes will be at a redemption price equal to 100% of the principal amount of the 2023 Notes to be redeemed, plus accrued and unpaid interest to, but excluding, the redemption date. We have the right to settle the 2023 Notes in cash, shares or a combination thereof. The maximum number of shares of common stock the 2023 Notes are convertible into is approximately 27.2 million, and is subject to adjustment under certain circumstances.

The 2023 Notes will be convertible at the option of holders only under the following circumstances:

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Prior to the close of business on the business day immediately preceding July 1, 2023, during any calendar quarter commencing after the calendar quarter ended on September 30, 2018 (and only during such calendar quarter), if the last reported sale price of our common stock for at least 20 trading days (whether or not consecutive), during a period of 30 consecutive trading days ending on the last trading day of the immediately preceding calendar quarter is greater than or equal to 130% of the conversion price on each applicable trading day;

Prior to the close of business on the business day immediately preceding July 1, 2023, during the five business day period after any ten consecutive trading day period (the "measurement period") in which the trading price per \$1,000 principal amount of 2023 Notes for each trading day of the measurement period was less than 98% of the product of the last reported sale price of our common stock and the conversion rate on each such trading day;

Prior to the business day immediately preceding July 1, 2023, upon the occurrence of specified corporate events or

At any time on or after July 1, 2023 until the close of business on the second scheduled trading day immediately preceding the December 1, 2023 maturity date.

Upon the occurrence of a make-whole fundamental change or if we call all or any portion of the 2023 Notes for redemption prior to July 1, 2023, we will, in certain circumstances, increase the conversion rate by a number of additional shares for a holder that elects to convert its 2023 Notes in connection with such make-whole fundamental change or during the related redemption period.

The 2023 Notes were separated into debt and equity components and assigned a fair value. The value assigned to the debt component is the estimated fair value as of the issuance date of similar debt without the conversion feature. The initial debt component of the 2023 Notes was valued at \$124.3 million, which is net of \$3.2 million of fees and expenses allocated to the debt component. The difference between the fair value of the total instrument and this estimated fair value of the debt component represents the value which has been assigned to the equity component. The fair value of the equity component reported in additional paid-in-capital is \$67.3 million, which is net of \$1.7 million of fees and expenses allocated to the equity component. The difference between the principal exchanged, which is par value or \$192.9 million, and the estimated fair value of the new debt represents the amount recorded as a debt discount. The debt discount is being amortized using the effective interest method over the period from the date of issuance through the December 1, 2023 maturity date.

The following tables outlines the effective interest rate, contractually stated interest expense and costs related to the amortization of the discount for the Notes:

	<b>Three months ended</b>			
	<b>June 30,</b>			
	<b>2017</b>	<b>2018</b>	<b>2017</b>	<b>2018</b>
	<b>2020 Notes</b>		<b>2023 Notes</b>	
	<b>(in thousands except for effective interest rate)</b>			
Effective interest rate	10.18 %	10.18 %	N/A	10.38%
Contractually stated interest expense	\$1,493	\$1,119	N/A	\$347
Amortization of discount	\$4,912	\$4,043	N/A	\$979





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	<b>Six months ended</b>			
	<b>June 30,</b>			
	<b>2017</b>	<b>2018</b>	<b>2017</b>	<b>2018</b>
	<b>2020 Notes</b>		<b>2023 Notes</b>	
	<b>(in thousands except for effective interest rate)</b>			
Effective interest rate	10.18	%	10.18	%
	N/A		10.38	%
Contractually stated interest expense	\$3,002	\$2,629	N/A	\$347
Amortization of discount	\$9,799	\$9,438	N/A	\$979

The total estimated fair value of the 2020 Notes and 2023 Notes as of June 30, 2018 was \$145.7 million and \$208.1 million. The fair value was determined using a methodology that combines direct market observations with quantitative pricing models to generate evaluated prices. We consider the fair value of the Notes to be a Level 2 measurement due to the limited trading activity of the Notes.

The closing price of our common stock was \$7.88 on June 30, 2018, which was less than the initial conversion price for the 2020 Notes and 2023 Notes of approximately \$16.42 and \$9.57 per share. As such, the if-converted values of the 2020 Notes and 2023 Notes were less than the principal amounts of \$152.1 million and \$192.9 million.

*Credit Facility*

On December 29, 2017, we entered into a credit facility for an aggregate commitment amount of \$200.0 million, with an option to increase the commitment amount by \$50.0 million and a maturity date of the earliest of December 29, 2022; 120 days prior to the 2020 Notes maturity date of December 1, 2020, provided that the 2020 Notes have not been converted into common stock prior to such date; or 120 days prior to the Series A redeemable convertible preferred stock ("Series A") redemption date of September 22, 2022, provided that the Series A has not been converted into common stock prior to such date. The amount of borrowings available under the credit facility at any time is limited by our monthly accounts receivable balance at such time. The credit facility is further described in Note 9 "Debt Instruments" in our Annual Report on Form 10-K for the year ended December 31, 2017.

As of June 30, 2018, we had no outstanding borrowings, \$1.4 million in letters of credit outstanding and \$193.5 million of available borrowing capacity under the credit facility. We are in compliance with all financial covenants associated with the credit facility as of June 30, 2018.

Table of Contents**Pandora Media, Inc.****Notes to Condensed Consolidated Financial Statements - Continued****(unaudited)****12. Redeemable Convertible Preferred Stock**

In June 2017, we entered into an agreement with Sirius XM Radio, Inc. ("Sirius XM") to sell 480,000 shares of Series A for \$1,000 per share, with gross proceeds of \$480.0 million. The Series A shares were issued in two rounds: an initial closing of 172,500 shares for \$172.5 million that occurred on June 9, 2017 upon signing the agreement with Sirius XM, and an additional closing of 307,500 shares for \$307.5 million that occurred on September 22, 2017. Total proceeds from the initial and additional closing, net of preferred stock issuance costs of \$29.3 million, were \$450.7 million.

The voting rights, conversion feature, redemption feature, fundamental changes and recognition of the Series A is further described in Note 10 "Redeemable Convertible Preferred Stock" in our Annual Report on Form 10-K for the year ended December 31, 2017.

As of December 31, 2017 and June 30, 2018, redeemable convertible preferred stock consisted of the following:

	<b>As of December 31, 2017 (in thousands)</b>	<b>As of June 30, 2018 (in thousands)</b>
Series A redeemable convertible preferred stock	\$ 480,000	\$ 480,000
Issuance costs	(29,318 )	(29,318 )
Accretion of issuance costs	29,318	29,318
Stock dividend payable to preferred stockholders	10,849	25,684
Redeemable convertible preferred stock	\$ 490,849	\$ 505,684

**13. Stock-based Compensation Plans and Awards***Employee Stock-Based Awards*

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

*Stock options*

We measure stock-based compensation expense for stock options at the grant date fair value of the award and recognize expense on a straight-line basis over the requisite service period, which is generally the vesting period. We estimate the fair value of stock options using the Black-Scholes option-pricing model. During the three months ended June 30, 2017 and 2018, we recorded stock-based compensation expense from stock options of approximately \$4.0 million and \$1.4 million. During the six months ended June 30, 2017 and 2018, we recorded stock-based compensation expense from stock options of approximately \$5.9 million and \$2.1 million.

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

	Three months ended June 30,		Six months ended June 30,	
	2017	2018	2017	2018
Expected life (in years)	6.00	2.05 - 5.95	5.93 - 6.05	2.05 - 6.25
Risk-free interest rate	1.92%	2.49 - 2.79 %	1.92 - 2.18%	2.49 - 2.79 %
Expected volatility	61	% 58	% 61	% 58 - 60%
Expected dividend yield	0	% 0	% 0	% 0

*Restricted stock units ("RSUs")*

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The fair value of RSUs is expensed ratably over the vesting period. RSUs typically have an initial annual cliff vest and then vest quarterly thereafter over the service period, which is generally three to four years. During the three months ended June 30, 2017 and 2018, we recorded stock-based compensation expense from RSUs of approximately \$33.4 million and \$25.2 million. During the six months ended June 30, 2017 and 2018, we recorded stock-based compensation expense from RSUs of approximately \$58.8 million and \$49.9 million.

*ESPP*

The ESPP allows eligible employees to purchase shares of our common stock through payroll deductions of up to 15% of their eligible compensation. The ESPP provides for six-month offering periods, commencing in February and August of each year.

We estimate the fair value of shares to be issued under the ESPP on the first day of the offering period using the Black-Scholes valuation model. The inputs to the Black-Scholes option pricing model are our stock price on the first date of the offering period, the risk-free interest rate, the estimated volatility of our stock price over the term of the offering period, the expected term of the offering period and the expected dividend rate. Stock-based compensation expense related to the ESPP is recognized on a straight-line basis over the offering period. Forfeitures are recognized as they occur.

The following assumptions for the Black-Scholes option pricing model were used to determine the per-share fair value of shares to be granted under the ESPP:

	<b>Three months ended June 30,</b>		<b>Six months ended June 30,</b>	
	<b>2017</b>	<b>2018</b>	<b>2017</b>	<b>2018</b>
Expected life (in years)	0.5	0.5	0.5	0.5
Risk-free interest rate	0.65%	1.83%	0.44 - 0.65%	1.13-1.83%
Expected volatility	39 %	57 %	39 - 52%	45-57%
Expected dividend yield	0 %	0 %	0 %	0 %

During the three months ended June 30, 2017 and 2018, we withheld \$3.3 million and \$2.2 million in contributions from employees and recognized \$1.0 million and \$0.8 million of stock-based compensation expense related to the ESPP, respectively. During the six months ended June 30, 2017 and 2018, we withheld \$6.1 million and \$3.6 million in contributions from employees and recognized \$1.9 million and \$1.6 million of stock-based compensation expense related to the ESPP, respectively. In the six months ended June 30, 2017 and 2018, 547,765 and 795,990 shares of common stock were issued under the ESPP. There were no shares of common stock issued under the ESPP in the three months ended June 30, 2017 and 2018.

*Stock-based Compensation Expense*

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

	<b>Three months ended</b>	<b>Six Months Ended</b>
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	<b>June 30,</b>		<b>June 30,</b>	
	<b>2017</b>	<b>2018</b>	<b>2017</b>	<b>2018</b>
	<b>(in thousands)</b>		<b>(in thousands)</b>	
Stock-based compensation expense				
Cost of revenue—Other	\$ 814	\$ 800	\$ 1,629	\$ 1,542
Cost of revenue—Ticketing service	34	—	63	—
Product development	9,422	8,028	17,337	14,445
Sales and marketing	15,102	11,092	28,598	22,909
General and administrative	13,236	7,608	20,599	15,068
Total stock-based compensation expense	\$ 38,608	\$ 27,528	\$ 68,226	\$ 53,964

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

Diluted net loss per common share is computed by giving effect to all potential shares of common stock, including stock options, restricted stock units, market stock units, performance-based RSUs, potential ESPP shares and instruments convertible into common stock, to the extent dilutive. For the three and six months ended June 30, 2017 and 2018, basic net loss per common share was the same as diluted net loss per common share, 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 common share:

	<b>Three months ended June 30,</b>		<b>Six months ended June 30,</b>	
	<b>2017</b>	<b>2018</b>	<b>2017</b>	<b>2018</b>
	<b>(in thousands except per share amounts)</b>			
Numerator				
Net loss	\$ (275,136 )	\$ (91,982 )	\$ (407,403 )	\$ (223,687 )
Less: Stock dividend payable and transaction costs	14,528	7,473	14,528	14,836
Net loss available to common stockholders	(289,664 )	(99,455 )	(421,931 )	(238,523 )
Denominator				
Weighted-average basic and diluted common shares	241,320	259,822	239,428	256,397
Net loss per common share, basic and diluted	\$(1.20 )	\$(0.38 )	\$(1.76 )	\$(0.93 )

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

	<b>As of June 30,</b>	
	<b>2017</b>	<b>2018</b>
	<b>(in thousands)</b>	
Shares issuable upon conversion of preferred stock	16,488	48,163
Restricted stock units	21,739	27,461
Shares issuable upon conversion of 2023 Notes	—	20,154
Options to purchase common stock	9,384	6,541
Performance awards*	1,993	1,016
Shares issuable pursuant to the ESPP	589	988
Total common stock equivalents	50,193	104,323

\*Includes potential common shares outstanding for MSUs and PSUs

On December 9, 2015, we completed an offering of our 1.75% convertible senior notes due 2020. As we have the intention to settle the 2020 Notes either partially or wholly in cash, under the treasury stock method, the 2020 Notes will generally have a dilutive impact on earnings per share if we are in a net income position for the period and if our

average stock price for the period exceeds approximately \$16.42 per share of our common stock, the conversion price of the 2020 Notes. For the period from the issuance of the offering of the 2020 Notes through June 30, 2018, the conversion feature of the 2020 Notes was anti-dilutive, as we were in a net loss position for all periods and our average stock price was less than the conversion price.

In connection with the pricing of the 2020 Notes, we entered into Capped Call Transactions which increase the effective conversion price of the 2020 Notes, and are designed to reduce potential dilution upon conversion of the 2020 Notes. Since the



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**Pandora Media, Inc.**

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

**(unaudited)**

beneficial impact of the capped call is anti-dilutive, it is excluded from the calculation of earnings per share. Refer to Note 11 "Debt Instruments" for further details regarding our 2020 Notes.

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**Pandora Media, Inc.**

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

**(unaudited)**

**15. Restructuring Charges**

*Reductions in Force*

On January 31, 2018, we announced efforts to prioritize our strategic growth initiatives and optimize overall business performance, including a reduction in force plan ("2018 Reduction in Force") affecting approximately 5% of our employee base. Our Board of Directors approved the plan on January 11, 2018 and affected employees were informed of the plan on January 31, 2018. In the six months ended June 30, 2018, we incurred costs and cash expenditures for the 2018 Reduction in Force totaling \$7.6 million, substantially all of which are related to employee severance and benefits costs. These costs are included in the product development, sales and marketing and general and administrative line items of our Condensed Consolidated Statements of Operations. The 2018 Reduction in Force was completed and all amounts were paid in the six months ended June 30, 2018.

On January 12, 2017, we announced a reduction in force plan ("2017 Reduction in Force") affecting approximately 7% of our U.S. employee base, excluding Ticketfly. In the six months ended June 30, 2017, we incurred approximately \$6.0 million of cash expenditures for the 2017 Reduction in Force, substantially all of which were related to employee severance and benefits costs. In the six months ended June 30, 2017, total reduction in force expenses were \$5.6 million, which was lower than cash reduction in force costs due to a credit related to non-cash stock-based compensation expense reversals for unvested equity awards. These costs are included in the cost of revenue—other, product development, sales and marketing and general and administrative line items of our Condensed Consolidated Statements of Operations. The 2017 Reduction in Force was completed and all amounts were paid in 2017.

**16. Income Taxes**

*Tax Cut and Jobs Act (the "Act")*

On December 22, 2017, the Act was signed into law, which enacted significant changes to U.S. tax and related laws. Some of the provisions of the new tax law affecting corporations include, but are not limited to a reduction of the federal corporate income tax rate from 35% to 21%, limiting the interest expense deduction, expensing of cost of acquired qualified property and allowing federal net operating losses generated in taxable years ending after December 31, 2017 to be carried forward indefinitely.

In accordance with ASU 2018-05 and Staff Accounting Bulletin No. 118 ("SAB 118"), we recognized the provisional tax impacts related to the revaluation of net deferred tax assets and the impact of the changes to the limitation on the deductibility of executive compensation, offset with a valuation allowance, during the year ended December 31, 2017. As of June 30, 2018, we have not made any additional measurement period adjustments related to these items. Such adjustments may be necessary in future periods due to, among other things, additional analysis and changes in interpretations and assumptions as applicable and additional regulatory guidance that may be issued. We are continuing to gather information to assess the application of the Act.

*Acquisition of AdsWizz*

As a result of the acquisition of AdsWizz, deferred tax liabilities were established for the book-tax basis difference primarily related to acquired intangible assets. The net deferred tax liabilities provided an additional source of income

to support the realizability of pre-existing deferred tax assets. As a result, during the three and six months ended June 30, 2018, we released \$7.2 million of our valuation allowance and recorded an income tax benefit. Refer to Note 7 "Business Acquisitions" in the Notes to the Condensed Consolidated Financial Statements for further details on the acquisition of AdsWizz.

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A")**

*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 year ended December 31, 2017 filed with the Securities and Exchange Commission pursuant to the Securities Exchange Act of 1934, as amended (the "Exchange Act").*

*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,*

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*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 year ended December 31, 2017. 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.*

*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—Streaming Radio and On-Demand Music Services*

Pandora is the world's most powerful music discovery platform, offering a personalized experience for each of our listeners wherever and whenever they want to listen to music—whether through mobile devices, car speakers or connected devices in the home. Unlike traditional radio that broadcasts the same content at the same time to all of their listeners, we enable our listeners to create personalized stations and playlists, as well as search and play songs and albums on-demand. The Music Genome Project and our content programming algorithms power our ability to predict listener music preferences, play music content suited to the tastes of each individual listener and introduce listeners to the music we think they will love. The Music Genome Project is a database of over 1.5 million uniquely analyzed songs from over 250 thousand artists, spanning over 670 genres and sub-genres, which our team of trained musicologists has developed one song at a time by evaluating and cataloging each song's particular attributes. The Music Genome Project database is a subset of our full catalog available to be played. Over time, our service has evolved by using data science to develop playlisting algorithms that further tailor the listener experience based on individual listener and broader audience reactions to the recordings we pick. With billions of data points collected from our listeners, we are able to use listeners' feedback to fuel our ability to choose exactly the right song for our users. Founded by musicians, Pandora also empowers artists with valuable data and tools to help grow their audience and connect with their fans.

Pandora is available as an ad-supported service, a radio subscription service called Pandora Plus and an on-demand subscription service called Pandora Premium. The majority of our listener hours occur on mobile devices, with the majority of our revenue generated from advertising on our ad-supported radio service on these devices. With billions of data points that help us understand our users' preferences, we offer both local and national advertisers the opportunity to deliver targeted messages to our listeners using a combination of audio, display and video

advertisements. We also generate increasing revenue from our subscription offerings.

For the three months ended June 30, 2018, we streamed 5.09 billion hours of content, and as of June 30, 2018, we had 71.4 million active users during the trailing 30-day period and 5.98 million paid subscribers. Since we launched the Pandora service in 2005 our listeners have created over 13 billion stations.

*Ad-Supported Radio Service*

Our ad-supported service allows listeners to access our music and podcast catalogs and personalized playlist generating system for free across all of our delivery platforms. This service is valued by lean-back listeners, as it uses the Music Genome Project to instantly generate a station that plays music we think that listener will enjoy. Over time, our service has evolved by using data science to further tailor the listener experience based on listener reactions to the content we pick. Listeners also have the ability to add variety to and rename stations, which further allows for the personalization of our service. We recently began

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offering listeners on our ad-supported service the option to gain temporary access to on-demand listening experience, which includes some features of our Pandora Premium service, in exchange for engaging with an ad, which allows advertisers to more deeply engage with a user and create a positive brand experience. We call this experience Premium Access.

### *Subscription Radio Service—Pandora Plus*

Pandora Plus is a paid, ad-free subscription version of the Pandora radio service that also includes replays, additional skipping of songs, offline listening, higher quality audio on supported devices and longer timeout-free listening. This service is valued by listeners who want the ability to have limited interactive features such as skips and replays. Similar to the ad-supported service, the more the listener interacts with the platform, the more we tailor the songs we recommend to the listener.

### *On-Demand Subscription Service—Pandora Premium*

Our on-demand subscription service, Pandora Premium, launched in the United States in April 2017. Pandora Premium is an on-demand version of the Pandora service that offers a unique, on-demand experience, providing users with the ability to search, play and collect songs and albums, build playlists on their own or with the tap of a button, listen to curated playlists and share playlists on social networks. Unique to Pandora, a listener can create partial playlists and have Pandora complete the playlist based on the user's listening activity using the Music Genome Project. The features of Pandora Plus are also included in Pandora Premium.

A key element of our strategy is to make the Pandora service available in any environment that has internet connectivity. To this end, we make the Pandora service available through a variety of distribution channels. In addition to streaming our service to computers, we have developed Pandora mobile device applications ("apps") for smartphones and mobile operating systems, such as the iPhone and Android and for tablets, including the iPad and Android tablets. We distribute those mobile apps free to listeners via app stores. We have also integrated with thousands of consumer electronic and voice-based devices.

We expect to continue to make enhancements to Pandora Plus and Pandora Premium, which will require engineering effort, as well as other resources. In addition, in connection with the launch and continued operation of these services we have entered into direct license agreements with major and independent record labels, some of which include substantial minimum guarantee payments. In order for Pandora Plus and Pandora Premium to be successful, we will need to attract subscribers to these new service offerings. The market for subscription-based music services, including on-demand services, is intensely competitive, and our ability to realize a return on our investments in these service offerings will depend on our ability to leverage the existing audience of our ad-supported service, our brand awareness and our ability to deliver differentiated subscription services with features and functionality that listeners find attractive. Refer to our discussion of these matters in Item 1A—"Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2017.

## **Recent Events**

### *Convertible Debt Exchange*

On May 24, 2018 we exchanged \$192.9 million in aggregate principal of the Convertible Senior Notes due 2020 (the "2020 Notes") for new Convertible Senior Notes due 2023 (the "2023 Notes") (collectively the "Notes"). Pursuant to the exchange, the note holders received \$192.9 million in aggregate principal of the new 1.75% 2023 Notes. The exchange qualified as an extinguishment of the original notes. The extinguishment resulted in the derecognition of the carrying value of the debt, including the debt discount. We recognized a loss on exchange of \$14.6 million based on

the difference between the carrying value of the exchanged notes and the portion of the consideration allocated to the fair value of the new notes. The loss is included in the general and administrative line item of our Condensed Consolidated Statements of Operations. The carrying value of the existing 2020 notes as of June 30, 2018 is \$152.1 million and will continue to accrete to par using the same effective interest rate when the transaction was executed. Refer to Note 11 "Debt Instruments" in the Notes to the Condensed Consolidated Financial Statements for further details on the convertible note exchange.

*Acquisition of AdsWizz Inc. ("AdsWizz")*

On May 25, 2018, we completed the acquisition of AdsWizz Inc. ("AdsWizz"), a leading digital audio ad technology company with a comprehensive digital audio software suite of solutions that connects audio publishers to the advertising community, for an aggregate purchase price of \$146.6 million in a combination of cash and common stock. Cash paid was \$73.7 million and 9,588,312 shares of the Company's common stock were issued. The purchase price includes a contingent consideration of \$5.0 million, measured at its fair value, which is dependent on achievement of certain business milestones. In addition to the purchase price, unvested options of AdsWizz were converted into unvested options to acquire our common

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stock. We recognized goodwill of \$107.7 million, which is primarily attributable to expected synergies from future growth and strategic advances in the digital audio ad technology industry. Refer to Note 7 "Business Acquisitions" in the Notes to the Condensed Consolidated Financial Statements for further details on the acquisition of AdsWizz.

### *Cancellation of Convertible Subordinated Promissory Note Receivable ("Convertible Promissory Note")*

On March 30, 2018, we amended our Membership Interest Purchase Agreement ("MIPA") with Eventbrite, Inc. ("Eventbrite") which resulted in the cancellation of our Convertible Promissory Note for a cancellation fee of \$34.7 million. Upon completion of the cancellation of the Convertible Promissory Note, the remaining unpaid principal and interest balance were forgiven. Refer to Note 9 "Dispositions" in the Notes to the Condensed Consolidated Financial Statements for further details on the cancellation of the Convertible Promissory Note.

## **Factors Affecting our Business Model**

### *Content Acquisition Costs*

For sound recording rights, we pay content acquisition costs based on the terms of direct license agreements with major and independent music labels and distributors for the significant majority of the sound recordings we stream on our ad-supported service, Pandora Plus and Pandora Premium. Depending on the applicable service, these license agreements generally require us to pay either a per-performance fee based on the number of sound recordings we transmit, a percentage of revenue associated with the service, or a per-subscriber minimum amount. Certain of these license agreements require minimum guarantee payments, some of which are paid in advance.

If we have not entered into a direct license agreement with the copyright owner of a particular sound recording that is streamed on our services, we stream that sound recording pursuant to a statutory license and pay the applicable rates set by the Copyright Royalty Board ("CRB") for the period from January 1, 2016 through December 31, 2020 (the "Section 114 Rates"). The 2016 and 2017 rates for non-subscription services, such as our ad-supported service, were set at \$0.0017 per play and the rates for subscription services, such as Pandora Plus, were set at \$0.0022, adjusted for inflation. Effective January 1, 2018, these rates were adjusted for inflation to \$0.0018 per play for non-subscription services and \$0.0023 per play for subscription services. Sound recordings streamed under the statutory license and paid at the CRB-set rates can only be played in radio mode on our services. These sound recordings cannot be played on-demand or offline and are not eligible for replay or additional skips.

Content acquisition costs for musical works are negotiated with and paid to performing rights organizations ("PROs") such as the American Society of Composers, Authors and Publishers ("ASCAP"), Broadcast Music, Inc. ("BMI"), SESAC, Inc. ("SESAC") and Global Music Rights and directly to publishing companies. Content acquisition costs for the streaming of musical works on our ad-supported service are calculated such that each copyright holder receives its usage-based and ownership-based share of a royalty pool equal to 21.5% of the content acquisition costs paid by us for sound recordings on our ad-supported service. Content acquisition costs for the streaming of musical works on our subscription services are equal to the rates determined in accordance with the statutory license set forth in 17 U.S.C. §115 ("Section 115").

The rate structure for the statutory license for reproduction rights under Section 115 expired at the end of 2017. A new rate structure was set in January 2018, covering the period from January 1, 2018 through December 31, 2022, by a three judge CRB panel, and we were one of five commercial music service operators (along with Amazon, Apple, Google and Spotify) that participated in rate-setting proceedings that determined these rates (the "Phonorecords III Proceedings"). The Nashville Songwriters Association International, the National Association of Music Publishers and George Johnson Music Publishing are also participating in the Phonorecords III Proceedings. A trial before the CRB concluded in April 2017, and the CRB rendered a decision in January 2018 ("the Initial Determination"). If the Initial Determination is adopted and affirmed, the "all-in" rate that streaming services, including Pandora, will pay to music



publishers and songwriters for the mechanical rights and performance rights needed in connection with interactive streaming will increase annually between 2018 and 2022: from 11.4% of revenues or 22.0% of label payments in 2018, to 15.1% of revenues or 26.2% of label payments in 2022. Certain per-subscriber minimum royalty floors also apply depending on the type of service. The CRB may elect to modify the Initial Determination at the request of the participants in the Phonorecords III Proceedings, and thereafter the final CRB decision may be appealed for review by the DC Circuit Court of Appeals.

The Phonorecords III Proceedings are important to us because our direct licenses with music publishers use the Section 115 rates. As a result, increases in the Section 115 rates increase our content acquisition costs for our subscription services, which, if such increase were substantial, could materially harm our financial condition and hinder our ability to provide interactive features in our services, or cause one or more of our subscription services to not be economically viable.

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### *Ad-Supported Service*

Our ad-supported service is monetized through the sale of display, audio and video advertisements to national, regional and local advertisers.

Our total number of listener hours is a key driver for both advertising revenue generation opportunities and content acquisition costs, which are the largest component of our ad-related expenses.

*Advertising Revenue.* Listener hours define the number of opportunities we have to sell advertisements. Our ability to attract advertisers depends in large part on our ability to offer sufficient inventory within desired demographics.

*Cost of Revenue—Content Acquisition Costs—Ad-Supported Service.* We pay content acquisition costs to the copyright owners and performers, or their agents, of each sound recording that we stream, as well as to the publishers and songwriters, or their agents, for the musical works embodied in each of those sound recordings, subject to certain exclusions. The majority of the content acquisition costs related to our ad-supported service are driven by direct license agreements with major and independent labels and distributors, as discussed above in "Factors Affecting Our Business Model—Content Acquisition Costs". Certain of these license agreements include minimum guarantee payments, some of which are paid in advance.

As a result of the structure of our license agreements, our ability to achieve and sustain profitability and operating leverage on our ad-supported service depends on our ability to increase our advertising revenue per thousand listener hours ("ad RPM") of streaming through increased advertising revenue across all of our delivery platforms.

### *Subscription Services*

We monetize our subscription services through subscription payments made by users of the services. We drive subscriber growth by providing the world's most powerful music discovery platform, offering a personalized experience for each of our listeners and investing in marketing and free-trials to promote our service.

Our total number of paid subscriptions is a key driver for both subscription revenue and content acquisition costs related to our subscription services, which is the largest component of our subscription-related expenses. In order to drive greater subscription revenue, we must increase the number of new subscribers to our subscription services and minimize the number of current subscribers who discontinue their subscriptions.

*Subscription Revenue.* Our subscription revenue depends upon the number of paid subscriptions we are able to sell and the price that our subscribers pay for those subscriptions. Our ability to attract subscribers depends in large part on our ability to offer features and functionality on our subscription services that are valued by consumers within desired demographics, on terms that are attractive to those consumers, and still enable us to maintain adequate gross margins.

*Cost of Revenue—Content Acquisition Costs—Subscription Services.* We pay content acquisition costs to the copyright owners, performers, songwriters, or their agents, subject to certain exclusions. The majority of our content acquisition costs related to our subscription services are generally driven by direct license agreements with major and independent labels and distributors, PROs and publishers, as discussed above in "Factors Affecting Our Business Model—Content Acquisition Costs". Certain of these license agreements include minimum guarantee payments, some of which are paid in advance.

Given the structure of our license agreements for our subscription services, the majority of our content acquisition costs increase as subscription revenue increases and are subject to minimum guarantee payments. As such, our ability to achieve and sustain profitability and operating leverage on our subscription services depends on our ability to increase our revenue through increased paid subscriptions on terms that maintain an adequate gross margin. Refer to our discussion of these matters in Item 1A—"Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2017.

## **Key Metrics**

The numbers for our key metrics, which include our listener hours, active users, advertising RPM, advertising licensing costs per thousand listener hours ("ad LPM"), paid subscribers, average monthly revenue per paid subscriber ("ARPU") and average monthly licensing costs per paid subscriber ("LPU") are calculated using internal company data. While these numbers are based on what we believe to be reasonable estimates of our user base for the applicable period of measurement, there are inherent

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challenges in measuring usage of our products across large online and mobile populations. In addition, we are continually seeking to improve our estimates of our user base, and such estimates may change due to improvements or changes in our methodology.

*Total Service**Listener hours*

We track listener hours because it is a key indicator of the growth of our business and the engagement of our listeners. We include listener hours related to our non-radio content offerings in the definition of listener hours. These offerings include non-music content such as podcasts, as well as custom music content such as Pandora Premieres and artist mixtapes. 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. For non-music content such as podcasts, episodes are divided into approximately track-length parts, which are treated as tracks under this definition. 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. We have implemented strategic hours control mechanisms, such as time outs, to optimize content acquisition costs for our ad-supported listening, and will continue to use these measures in the future.

The table below sets forth our total listener hours for the three and six months ended June 30, 2017 and 2018.

Service	Three months ended June 30,		Six months ended June 30,	
	2017	2018	2017	2018
	(in billions)		(in billions)	
Advertising	4.19	3.86	8.58	7.71
Subscription	1.03	1.23	1.85	2.34
Total	5.22	5.09	10.43	10.05

*Active users*

We track the number of active users as an additional indicator of the breadth of audience we are reaching at a given time. Beginning with the active users disclosed in this quarterly report, we define active users as the number of distinct registered users, including subscribers, that have consumed content within the trailing 30 days to the end of the final calendar month of the period. We previously defined active users as the number of distinct registered users, including subscribers, that have requested audio from our servers during the same such period. This change in definition would not have materially changed the active users we have reported in any prior period. The number of active users may overstate the number of unique individuals who actively use our service, as one individual may use multiple accounts. To become a registered user, a person must sign-up using an email address or phone number, or access our service using a device with a unique identifier, which we use to create an account for our service.

The table below sets forth our total active users as of June 30, 2017 and 2018.

	As of June 30,	
	2017	2018
	(in millions)	
Active users—all services	76.0	71.4
Advertising-based service		

*Advertising RPM*

We track ad RPM for our non-subscription, ad-supported service because it is a key indicator of our ability to monetize advertising inventory created by our listener hours. We focus on ad RPM across all of our delivery platforms. We believe ad RPM to be the central top-line indicator for evaluating the results of our advertising monetization efforts. Ad RPM is calculated by dividing advertising revenue by the number of thousands of listener hours of our advertising-based service.

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*Advertising LPM*

We track ad LPM for our non-subscription, ad-supported service across all delivery platforms. The content acquisition costs included in our ad LPM calculations are based on the rates set by our license agreements with record labels, PROs and music publishers or the Section 114 Rates if we have not entered into a license agreement with the copyright owner of a particular sound recording.

The table below sets forth our RPM and LPM for our ad-supported service for the three and six months ended June 30, 2017 and 2018.

Three months ended June 30,		Six months ended June 30,					
2017	2018	2017	2018				
RPM* LPM	RPM* LPM	RPM*LPM	RPM*LPM				
Advertising \$66.15	\$35.84	\$68.75	\$36.87	58.34	34.61	62.15	36.61

\*The calculation of RPM does not include revenue generated by Ticketfly (divested) or Next Big Sound.

*Advertising RPM*

For the three and six months ended June 30, 2018 compared to 2017, the increase in ad RPM was primarily due to an increase in the average price per ad due to new advertising products resulting in improved monetization and partially due to a decrease in listener hours.

*Advertising LPM*

For the three and six months ended June 30, 2018 compared to 2017, the increase in ad LPM was primarily due to scheduled increases in rates paid to PROs for our publishing royalties and increased content acquisition costs associated with minimum guarantee accruals related to our direct license agreements with major and independent labels, distributors, PROs and publishers.

*Subscription Services—Total*

*Paid Subscribers*

Paid subscribers are defined as the number of distinct users that have current, paid access to our subscription service as of the end of the period. We track paid subscribers because it is a key indicator of the growth of our subscription services.

The below table sets forth our paid subscribers as of December 31, 2017 and June 30, 2018.

	As of December 31, 2017	As of June 30, 2018
Paid subscribers (in millions)	5.48	5.98

*ARPU and LPU*

ARPU is defined as average monthly revenue per paid subscriber on our subscription services. LPU is defined as average monthly licensing costs per paid subscriber on our subscription services. We believe ARPU to be the central

top-line indicator for evaluating the results of our monetization efforts on our subscription services. We track LPU because it is a key measure of our ability to manage costs for our subscription services. The below table sets forth our ARPU and LPU for our subscription services for the three and six months ended June 30, 2017 and 2018.

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	Three months ended June 30, 2017		Six months ended June 30, 2017		Three months ended June 30, 2018		Six months ended June 30, 2018	
	ARPULPU	ARPULPU	ARPULPU	ARPULPU	ARPULPU	ARPULPU	ARPULPU	ARPULPU
Subscription Services	\$4.82	\$3.11	\$6.52	\$4.78	\$4.79	\$3.03	\$6.41	\$4.72

*Subscription ARPU*

For the three and six months ended June 30, 2018 compared to 2017, the increase in subscription ARPU is primarily due to the increase in subscription revenue related to an increase in Pandora Premium subscribers. Pandora Premium launched in the second quarter of 2017 at a higher price point than Pandora Plus.

*Subscription LPU*

For the three and six months ended June 30, 2018 compared to 2017, the increase in subscription LPU is primarily due to an increase in content acquisition costs associated with Pandora Premium and minimum guarantee accruals related to our direct license agreements with major and independent labels, distributors, PROs and publishers and an increase in rates determined by the Section 115 ruling.

**Basis of Presentation and 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.



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	Three months ended		Six months ended	
	June 30,		June 30,	
	2017	2018	2017	2018
Revenue				
Advertising	74 %	70 %	72 %	69 %
Subscription and other	18	30	19	31
Ticketing service	8	—	8	—
Total revenue	100	100	100	100
Cost of revenue				
Cost of revenue—Content acquisition costs	52	59	55	63
Cost of revenue—Other	7	9	8	8
Cost of revenue—Ticketing service	5	—	6	—
Total cost of revenue	65	67	69	72
Gross profit	35	33	31	28
Operating expenses				
Product development	11	10	12	11
Sales and marketing	39	33	39	35
General and administrative	15	14	15	14
Goodwill impairment	35	—	19	—
Contract termination fees	6 %	— %	3 %	— %
Total operating expenses	106	57	88	60
Loss from operations	(71 )	(24 )	(57 )	(31 )
Interest expense	(2 )	(2 )	(2 )	(2 )
Other income, net	—	—	—	1
Total other expense, net	(2 )	(1 )	(2 )	(1 )
Loss before provision for income taxes	(73 )	(26 )	(59 )	(33 )
(Provision for) benefit from income taxes	—	2	—	1
Net loss	(73 )	(24 )	(59 )	(32 )
Net loss available to common stockholders	(77 )%	(26 )%	(61 )%	(34 )%

(1) Includes stock-based compensation as follows:

Cost of revenue - Other	0.2%	0.2%	0.2%	0.2%
Cost of revenue - Ticketing service	—	—	—	—
Product development	2.5	2.1	2.5	2.1
Sales and marketing	4.0	2.9	4.1	3.3
General and administrative	3.5	2.0	3.0	2.1

Note: Amounts may not recalculate due to rounding

*Revenue*

	Three months ended			Six months ended		
	June 30,			June 30,		
	2017	2018	\$ Change	2017	2018	\$ Change
	(in thousands)			(in thousands)		
Revenue						
Advertising	\$278,204	\$271,056	\$(7,148 )	\$501,512	\$485,624	\$(15,888)
Subscription and other	68,900	113,738	44,838	133,778	218,403	84,625
Ticketing service	29,730	—	(29,730 )	57,548	—	(57,548 )
Total revenue	\$376,834	\$384,794	\$7,960	\$692,838	\$704,027	\$11,189



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*Advertising revenue*

We generate advertising revenue in contracts with customers primarily from audio, display and video advertising. We generate the majority of our advertising revenue through the delivery of advertising impressions sold on a cost per thousand basis ("CPM"). We also offer advertising on other bases such as cost per engagement ("CPE") and cost per view ("CPV"), under which an advertiser pays us based on the number of times a listener engages with an ad. We generally recognize revenues as these deliveries occur. Our contracts for advertising revenues are typically less than twelve months in duration. For the three months ended June 30, 2017 and 2018 and the six months ended June 30, 2017 and 2018, advertising revenue accounted for 74%, 70%, 72% and 69% of our total revenue. We expect that advertising will comprise a substantial majority of revenue for the foreseeable future.

For the three months ended June 30, 2018 compared to 2017, advertising revenue decreased \$7.1 million or 3%, primarily due to a decrease in ad hours resulting in a lower number of ads sold and the termination of our services in Australia and New Zealand. This was offset by an increase in the average price per ad due to new advertising products resulting in improved monetization.

For the six months ended June 30, 2018 compared to 2017, advertising revenue decreased \$15.9 million or 3%, primarily due to a decrease in the number of ads sold and the termination of our services in Australia and New Zealand, offset by an increase in the average price per ad due to new advertising products resulting in improved monetization.

*Subscription and other revenue*

Subscription and other revenue is generated primarily through the sale of monthly or annually paid subscriptions to Pandora Plus and Pandora Premium. The enforceable rights in monthly subscription contracts are the monthly service period, whereas the annual subscriptions are cancelable at any time. For monthly subscriptions where there are no cancellation provisions, we recognize revenue on a straight-line basis over the monthly service term. Because of the cancellation clauses for the annual subscriptions, the duration of these contracts is daily, and revenue for these contracts is recognized on a daily ratable basis. Historically, cancellation rates have been immaterial. For the three months ended June 30, 2017 and 2018 and the six months ended June 30, 2017 and 2018, subscription and other revenue accounted for 18%, 30%, 19% and 31% of our total revenue.

For the three months ended June 30, 2018 compared to 2017, subscription and other revenue increased \$44.8 million or 65%, primarily due to an increase in the number of subscribers and an increase in the average price per paid subscriber due to the growth of Pandora Premium.

For the six months ended June 30, 2018 compared to 2017, subscription and other revenue increased \$84.6 million or 63%, primarily due to an increase in the number of subscribers and an increase in the average price per paid subscriber due to the launch and growth of Pandora Premium.

*Ticketing service*

Ticketing service revenue was generated primarily from service and merchant processing fees generated on ticket sales through the Ticketfly platform. On September 1, 2017, we completed the sale of Ticketfly to Eventbrite. Ticketfly sells tickets to fans for events on behalf of clients and charges a fee per ticket or a percentage of the total convenience charge and order processing fee for its services at the time the ticket for an event is sold. Ticketing service revenue was recorded net of the face value of the ticket at the time of the sale, as Ticketfly generally acts as the agent in these transactions. For the three and six months ended June 30, 2017, ticketing service revenue accounted

for approximately 8% and 8% of our total revenue. There was no ticketing service revenue in the three and six months ended June 30, 2018. Refer to Note 9 "Dispositions" in the Notes to the Condensed Consolidated Financial Statements for further details on the Ticketfly disposition.

*Costs and Expenses*

Cost of revenue consists of cost of revenue—content acquisition costs, cost of revenue—other and cost of revenue—ticketing. Our operating expenses consist of product development, sales and marketing and general and administrative costs. Cost of revenue—content acquisition costs are the largest component of our costs and expenses, followed by employee-related costs, which include stock-based compensation expenses.

*Cost of revenue—Content acquisition costs*

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	Three months ended June 30,			Six months ended June 30,		
	2017	2018	\$ Change	2017	2018	\$ Change
Cost of revenue—Content acquisition cost	\$ 195,875	\$ 226,860	\$ 30,985	\$ 383,295	\$ 444,440	\$ 61,145

Cost of revenue—content acquisition costs primarily consist of licensing fees paid for streaming music or other content to our listeners. We have obtained the rights to stream the majority of sound recordings on our service through direct license agreements, with the costs for such licenses determined according to the terms of each agreement. If we have not entered into a direct license agreement with the copyright owner of a particular sound recording that is streamed on our services, we stream that sound recording pursuant to a statutory license and pay the applicable per play rates set by the CRB. We obtained the rights to the majority of the musical works streamed on our service through direct licensing agreements with PROs or publishers, with the costs for such licenses based on a percentage of the content acquisition costs we paid for sound recordings.

The majority of our content acquisition costs were calculated using negotiated rates in direct license agreements with record labels, music publishers and PROs. Depending on the applicable service, our sound recording license agreements generally require us to pay either a per-performance fee based on the number of sound recordings we transmit, a percentage of revenue associated with the service, or a per-subscriber minimum amount.

For our ad-supported service, the majority of our content acquisition costs for musical works are based on a percentage of content acquisition costs paid for sound recordings.

For our subscription services, content acquisition costs for musical works are determined in accordance with the statutory license set forth in 17 U.S.C. § 115. Certain of our direct license agreements are also subject to minimum guarantee payments, some of which are paid in advance and amortized over the minimum guarantee period. For certain content acquisition arrangements, we accrue for estimated content acquisition costs based on the available facts and circumstances and adjust these estimates as more information becomes available. For additional information, see above in "Factors Affecting Our Business Model—Content Acquisition Costs".

For the three months ended June 30, 2018 compared to 2017, content acquisition costs increased \$31.0 million or 16% and content acquisition costs as a percentage of total revenue increased from 52% to 59%. The increase is primarily due to an increase in content acquisition costs associated with the growth of Pandora Premium, minimum guarantee accruals related to our direct license agreements with major and independent labels, distributors, PROs and publishers and, to a lesser degree, an increase in rates determined by the Section 115 ruling.

For the six months ended June 30, 2018 compared to 2017, content acquisition costs increased \$61.1 million or 16% and content acquisition costs as a percentage of total revenue increased from 55% to 63%. The increase is primarily due to an increase in content acquisition costs associated with the growth of Pandora Premium, minimum guarantee accruals related to our direct license agreements with major and independent labels, distributors, PROs and publishers and, to a lesser degree, an increase in rates determined by the Section 115 ruling.

*Cost of revenue—Other*

	Three months ended June 30,			Six months ended June 30,		
	2017	2018	\$ Change	2017	2018	\$ Change

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	(in thousands)	(in thousands)	(in thousands)	(in thousands)	(in thousands)	(in thousands)
Cost of revenue—Other	\$27,440	\$32,727	\$ 5,287	\$52,972	\$59,576	\$ 6,604

Cost of revenue—other consists primarily of ad and music serving costs, costs associated with our off-platform revenue, employee-related costs, facilities and equipment costs, other costs of ad sales and amortization expense related to acquired intangible assets and internal-use software. Ad and music serving costs consist of content streaming, maintaining our streaming radio and on-demand subscription services and creating and serving advertisements through third-party ad servers. We make payments to third-party ad servers for the period the advertising impressions are delivered or click-through actions occur, and accordingly, we record this as a cost of revenue in the related period. Costs associated with our off-platform revenue consist

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primarily of costs paid to third party publishers related to revenues generated through the placement of ads on their sites. Employee-related costs include salaries and benefits associated with supporting music and ad-serving functions. Other costs of ad sales include costs related to music events that are included as part of certain of our advertising arrangements.

For the three months ended June 30, 2018 compared to 2017, cost of revenue—other increased \$5.3 million or 19%, primarily due to a \$2.1 million increase in expense related to costs associated with our off-platform revenue, increased spend on audience targeting of \$1.4 million and a \$1.3 million increase in amortization expense of internal-use software related to the launch of Pandora Premium and Premium Access.

For the six months ended June 30, 2018 compared to 2017, cost of revenue—other increased \$6.6 million or 12%, primarily due to a \$3.3 million increase in amortization expense of internal-use software related to the launch of Pandora Premium and Premium Access, a \$2.1 million increase in expense related to costs associated with our off-platform revenue and a \$1.2 million increase in hosting and ad serving due to increased spend on audience targeting.

*Cost of revenue—Ticketing service*

	Three months ended June 30,			Six months ended June 30,		
	2017	2018	\$ Change	2017	2018	\$ Change
	(in thousands)			(in thousands)		
Cost of revenue—Ticketing service	\$20,510	\$	—\$(20,510)	\$39,128	\$	—\$(39,128)

Cost of revenue—ticketing service consisted primarily of ticketing revenue share costs, hosting costs, credit card fees and other cost of revenue and intangible amortization expense. The majority of these costs were related to revenue share costs, which consisted of fees paid to clients for their share of convenience and order processing fees. Intangible amortization expense was related to amortization of developed technology acquired in connection with the Ticketfly acquisition. On September 1, 2017, we completed the sale of Ticketfly to Eventbrite. Refer to Note 9 "Dispositions" in the Notes to the Condensed Consolidated Financial Statements for further details on the Ticketfly disposition.

*Gross margin*

	Three months ended June 30,			Six months ended June 30,		
	2017	2018	\$ Change	2017	2018	\$ Change
	(in thousands)			(in thousands)		
Gross profit						
Total revenue	\$376,834	\$384,794	\$7,960	\$692,838	\$704,027	\$11,189
Total cost of revenue	243,825	259,587	15,762	475,395	504,016	28,621
Gross profit	\$133,009	\$125,207	\$(7,802)	\$217,443	\$200,011	\$(17,432)
Gross margin	35	% 33	%	31	% 28	%

For the three months ended June 30, 2018 compared to 2017, gross margin decreased from 35% to 33%. The decrease is primarily due to an increase in content acquisition costs associated with the growth of Pandora Premium, minimum guarantee accruals related to our direct license agreements with major and independent labels, distributors, PROs and publishers and, to a lesser degree, an increase in rates determined by the Section 115 ruling.

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For the six months ended June 30, 2018 compared to 2017, gross margin decreased from 31% to 28%. The decrease is primarily due to an increase in content acquisition costs associated with the growth of Pandora Premium, minimum guarantee accruals related to our direct license agreements with major and independent labels, distributors, PROs and publishers and, to a lesser degree, an increase in rates determined by the Section 115 ruling.

*Product development*

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	Three months ended June 30, 2018			Six months ended June 30, 2018		
	2017	2018	\$ Change	2017	2018	\$ Change
Product development	\$41,233	\$40,351	\$ (882 )	\$80,821	\$76,235	\$ (4,586 )

Product development consists primarily of employee-related costs, including salaries, benefits and severance related to employees in software engineering, music analysis and product management departments, facilities and equipment costs and amortization expense related to acquired intangible assets. We incur product development expenses primarily for improvements to our platform, development of new services and enhancement of existing services, development of new advertising products and development and enhancement of our personalized playlisting system. We have generally expensed product development as incurred. These amounts are offset by costs that we capitalize to develop software for internal use. Certain internal use software development costs are 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.

For the three months ended June 30, 2018 compared to 2017, product development expense decreased by \$0.9 million or 2%, primarily due to a \$1.0 million increase in capitalized personnel driven by increased software development hours.

For the six months ended June 30, 2018 compared to 2017, product development expenses decreased by \$4.6 million or 6%, primarily due to a \$3.5 million decrease in employee related costs driven by the disposition of Ticketfly and a \$1.9 million decrease in amortization expense of acquired intangible assets related to the launch of Pandora Premium.

*Sales and marketing*

	Three months ended June 30, 2018			Six months ended June 30, 2018		
	2017	2018	\$ Change	2017	2018	\$ Change
Sales and marketing	\$145,891	\$125,375	\$ (20,516)	\$270,993	\$249,591	\$ (21,402)

Sales and marketing consists primarily of employee-related costs, including salaries, commissions, benefits and severance related to employees in sales, sales support, marketing, advertising and industry relations and artist marketing departments and facilities and equipment costs. In addition, sales and marketing expenses include commissions on subscription purchases through mobile app stores ("subscription commissions"), external sales and marketing expenses such as brand marketing, advertising, customer acquisition, direct response and search engine marketing costs, public relations expenses, costs related to music events, agency platform and media measurement expenses and amortization expense related to acquired intangible assets.

For the three months ended June 30, 2018 compared to 2017, sales and marketing expenses decreased \$20.5 million or 14%, primarily due to a \$29.3 million decrease in brand marketing due to decreased marketing spend on campaigns compared to 2017 and a \$12.6 million decrease in employee-related costs driven by a decrease in average headcount primarily related to efficiency initiatives and the sale of Ticketfly. This was offset by a \$13.6 million increase in customer acquisition costs and an \$8.7 million increase in subscription commissions driven by an increase in subscribers as a result of Pandora Premium subscription growth.

For the six months ended June 30, 2018 compared to 2017, sales and marketing expenses decreased \$21.4 million or 8%, primarily due to a \$34.7 million decrease in brand marketing due to decreased marketing spend on campaigns compared to 2017, a \$20.1 million decrease in employee-related costs driven by a decrease in average headcount primarily related to efficiency initiatives and the sale of Ticketfly, a \$3.5 million decrease in client signing bonus amortization and a \$2.4 million decrease in amortization of intangible assets, both due to the sale of Ticketfly. This was offset by a \$22.0 million increase in customer acquisition costs, a \$16.5 million increase in subscription commissions driven by an increase in subscribers as a result of Pandora Premium subscription growth and a \$4.0 million increase in professional fees.

*General and administrative*

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	Three months ended June 30,			Six months ended June 30,		
	2017	2018	\$ Change	2017	2018	\$ Change
	(in thousands)			(in thousands)		
General and administrative	\$57,954	\$53,617	\$(4,337)	\$102,479	\$95,248	\$(7,231)

General and administrative consists primarily of employee-related costs, including salaries, benefits and severance expense for finance, accounting, legal, internal information technology and other administrative personnel, and facilities and equipment costs. In addition, general and administrative expenses include legal expenses, professional fees for outside accounting and other services, credit card fees and sales and other tax expense.

For the three months ended June 30, 2018 compared to 2017, general and administrative expenses decreased \$4.3 million or 7%, primarily due to an \$8.8 million decrease in employee-related costs driven by a decrease in average headcount and prior year executive severance costs, a \$6.1 million decrease in bad debt expense related to our former ticketing service, a \$4.8 million decrease in legal fees due to the rate-setting proceedings under Section 115, a \$1.3 million decrease in sales tax reserve related to the sale of Ticketfly and a \$1.2 million decrease in impairment of internal use software. The decreases are partially offset by a \$14.6 million loss on extinguishment of convertible debt and a \$3.1 million increase in costs related to the acquisition of AdsWizz and the 2018 restructuring plan.

For the six months ended June 30, 2018 compared to 2017, general and administrative expenses decreased \$7.2 million or 7%, primarily due to a \$13.1 million decrease in employee-related costs driven by a decrease in average headcount and prior year executive severance costs, an \$8.8 million decrease in legal fees primarily related to the rate-setting proceedings under Section 115 and an \$7.8 million decrease in bad debt expense related to our former ticketing service. The decreases are partially offset by a \$14.6 million loss on extinguishment of convertible debt and \$7.8 million in costs related to the 2018 restructuring plan and the acquisition of AdsWizz.

*Goodwill impairment*

	Three months ended June 30,			Six months ended June 30,		
	2017	2018	\$ Change	2017	2018	\$ Change
	(in thousands)			(in thousands)		
Goodwill impairment	\$131,997	\$	—\$(131,997)	\$131,997	\$	—\$(131,997)

For the three and six months ended June 30, 2017, goodwill impairment was \$132.0 million and consisted primarily of \$131.7 million of impairment expense related to the write down of Ticketfly goodwill which was based on the fair value of Ticketfly's net assets as implied by the estimated purchase price of \$184.5 million, which includes an aggregate purchase price of \$200.0 million, less estimated purchase price adjustments of \$10.9 million for certain indemnification provisions and costs to sell of \$4.6 million.

*Contract termination fee*

	Three months ended June 30,			Six months ended June 30,		
	2017	2018	\$ Change	2017	2018	\$ Change
	(in thousands)			(in thousands)		
Contract termination fee	\$23,467	\$	—\$(23,467)	\$23,467	\$	—\$(23,467)

For the three and six months ended June 30, 2017, contract termination fees were \$23.5 million and consisted of fees related to the termination of the contractual commitment with KKR Classic Investors L.P. ("KKR"). In May 2017, we entered into an agreement to sell redeemable convertible preferred stock to KKR. In conjunction with the Series A, we terminated the contractual commitment to sell redeemable convertible preferred stock to KKR, which resulted in contract termination fees, including the related legal and professional fees of \$23.5 million in June 2017.

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### *Interest expense*

Interest expense in the three and six months ended June 30, 2017 and 2018 consists primarily of interest expense on our 1.75% 2020 Notes, 1.75% 2023 Notes and our credit facility. Refer to Note 11 "Debt Instruments" in the Notes to Condensed Consolidated Financial Statements for further details on our Notes and credit facility.

### *Provision for income taxes*

We have historically been subject to income taxes in the United States and various foreign jurisdictions. If we expand our operations to other foreign locations, we become subject to taxation based on the applicable foreign statutory rates and our effective tax rate could fluctuate accordingly.

Our provision for income taxes is 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.

On December 22, 2017, the Tax Cut and Jobs Act was signed into law, which enacted significant changes to U.S. tax and related laws. Some of the provisions of the new tax law affecting corporations include, but are not limited to a reduction of the federal corporate income tax rate from 35% to 21%, limiting the interest expense deduction, expensing of cost of acquired qualified property and allowing net operating losses generated in taxable years ending after December 31, 2017 to be carried forward indefinitely. Refer to Note 16 "Income Taxes" in the Notes to Condensed Consolidated Financial Statements for further details on the impact of the new tax law on our consolidated financial statements.

### *Off-Balance Sheet Arrangements*

Our liquidity is not dependent on the use of off-balance sheet financing arrangements and as of June 30, 2018 we had no such arrangements.

### *Contractual Obligations*

There has been no material change in our contractual obligations other than in the ordinary course of business since the year ended December 31, 2017.

## **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.

### *Pandora—Streaming Radio and On-Demand Music Services*

Our results reflect the effects of seasonal trends in listener, subscriber and advertising behavior. During the last quarter of each calendar year, and particularly during the holiday season, we expect to experience both higher advertising sales due to greater advertiser demand during the holiday season and increased usage of our service due to the popularity of holiday music. In addition, in the first quarter of each calendar year, we expect to experience lower advertising sales due to reduced advertiser demand, but sustained higher levels of subscriptions and usage by listeners due to increased use of media-streaming devices and subscriptions received as gifts during the holiday season. We

believe these seasonal trends have affected, and will continue to affect our operating results, particularly if increases in content acquisition costs from increased usage are not offset by increases in advertising sales in the first calendar quarter.

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. Also, as we expand our programmatic offering, trends in our revenue may differ from historical results as programmatic revenue is typically non-guaranteed and less predictable compared to more traditional channels of revenue. 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.

### **Liquidity and Capital Resources**

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As of June 30, 2018, we had cash, cash equivalents and investments totaling \$420.8 million, which primarily consisted of cash and money market funds held at major financial institutions and investment-grade corporate debt securities.

Our principal uses of cash during the three and six months ended June 30, 2018 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 additional sources of funding will be sufficient to meet our anticipated cash needs for at least the next year.

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*

On December 29, 2017, we entered into a credit facility for an aggregate commitment amount of \$200.0 million, with an option to increase the commitment amount by \$50.0 million and a maturity date of the earliest of December 29, 2022; 120 days prior to the 2020 Notes maturity date of December 1, 2020, provided that the 2020 Notes have not been converted into common stock prior to such date; or 120 days prior to the Series A redeemable convertible preferred stock ("Series A") redemption date of September 22, 2022, provided that the Series A have not been converted into common stock prior to such date.

As of June 30, 2018, we had no outstanding borrowings, \$1.4 million in letters of credit outstanding and \$193.5 million of available borrowing capacity under the credit facility. We are in compliance with all financial covenants associated with the credit facility as of June 30, 2018. Refer to Note 11 "Debt Instruments" in the Notes to Consolidated Financial Statements for further details regarding our credit facility.

#### *2020 Notes and 2023 Notes*

On December 9, 2015, we completed an unregistered Rule 144A offering of \$345.0 million aggregate principal amount of our 1.75% 2020 Notes. The net proceeds from the sale of the 2020 Notes were approximately \$336.5 million, after deducting the initial purchaser's fees and other estimated expenses. We used approximately \$43.2 million of the net proceeds to pay the cost of the capped call transactions.

On May 24, 2018, we completed an exchange of \$192.9 million in aggregate principal of the 2020 Notes in separate transactions with the note holders. Pursuant to the exchange, the note holders received \$192.9 million in aggregate principal of the new 1.75% 2023 Notes. Refer to Note 11 "Debt Instruments" in the Notes to Condensed Consolidated Financial Statements for further details on our 2020 and 2023 Notes.

#### *Redeemable Convertible Preferred Stock*

In June 2017, we entered into an agreement with Sirius XM Radio, Inc. ("Sirius XM") to sell 480,000 shares of Series A redeemable convertible preferred stock ("Series A") for \$1,000 per share, with gross proceeds of \$480.0 million. The Series A shares were issued in two rounds: an initial closing of 172,500 shares for \$172.5 million that occurred on June 9, 2017 upon signing the agreement with Sirius XM, and an additional closing of 307,500 shares for \$307.5 million that occurred on September 22, 2017 upon the receipt of antitrust clearance and the completion of other customary closing conditions. Refer to Note 12 "Redeemable Convertible Preferred Stock" in the Notes to Condensed Consolidated Financial Statements for further details on the redeemable convertible preferred stock.

*Capital Expenditures*

Consistent with previous periods, future capital expenditures will primarily focus on acquiring additional hosting and general corporate infrastructure. Our access to capital is adequate to meet our anticipated capital expenditures for our current plans.



Table of Contents*Historical Trends*

The following table summarizes our cash flow data for the six months ended June 30, 2017 and 2018.

	<b>Six months ended</b>	
	<b>June 30,</b>	
	<b>2017</b>	<b>2018</b>
	<b>(in thousands)</b>	
Net cash (used in) provided by operating activities	\$(136,910)	\$(31,958)
Net cash provided by (used in) investing activities	5,839	(173,586)
Net cash provided by (used in) financing activities	169,159	(2,296)

*Operating activities*

In the six months ended June 30, 2018, net cash used in operating activities was \$32.0 million and primarily consisted of our net loss of \$223.7 million, which was partially offset by non-cash charges of \$109.0 million of which the most significant included \$54.0 million in stock-based compensation expense, \$28.1 million in depreciation and amortization expense, \$14.6 million in loss on the extinguishment of our convertible debt and \$10.4 million in amortization of debt discount. Net cash used in operating activities was also partially offset by a decrease in accounts receivable of \$16.1 million, a decrease in prepaid content acquisition costs of \$31.3 million, an increase in accrued content acquisition costs of \$28.0 million and an increase in deferred revenue of \$12.0 million. Net cash used in operating activities decreased by \$105.0 million from the six months ended June 30, 2017, primarily due to a \$183.7 million decrease in our net loss, an increase in positive working capital of \$67.0 million and loss on extinguishment of \$14.6 million, offset by a decrease in goodwill impairment of \$132.0 million, depreciation and amortization expense of \$7.1 million and stock-based compensation expense of \$14.3 million.

*Investing activities*

In the six months ended June 30, 2018, net cash used in investing activities was \$173.6 million and included \$164.6 million in purchases of short-term investments, \$66.9 million in payments related to acquisitions, net of cash acquired and \$15.6 million of capital expenditures for internal-use software, leasehold improvements and server equipment. These payments were offset by \$38.8 million in proceeds from maturities of investments and \$34.7 million in proceeds from the cancellation of the Convertible Promissory Note. Net cash used in investing activities increased by \$179.4 million from the six months ended June 30, 2017, primarily due to the purchase of short-term investments of \$164.6 million and payments related to acquisition of \$66.9 million, offset by net proceeds from the cancellation of the Convertible Promissory Note of \$34.7 million and an increase in proceeds from maturities of investments of \$13.5 million.

*Financing activities*

In the six months ended June 30, 2018, net cash used in financing activities consisted of payment of issuance costs related to the convertible debt exchange and tax withholdings related to net share settlements of restricted stock units. These payments were offset by proceeds from exercise of stock options and the employee stock purchase plan. Net cash used in financing activities increased \$171.5 million from the six months ended June 30, 2017 primarily due to a decrease in proceeds from issuance of redeemable convertible preferred stock of \$172.5 million, a decrease in proceeds from employee stock purchase plan of \$3.9 million and a decrease in proceeds from exercise of stock options of \$2.7 million.

**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

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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.

Other than discussed below, there have been no material changes to our critical accounting policies and estimates as compared to those described in our Annual Report on Form 10-K for the year ended December 31, 2017 under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operations—Critical Accounting Policies and Estimates."

### *Revenue Recognition*

Revenues are recognized when a contract with a customer exists, and the control of the promised services are transferred to our customers, in an amount that reflects the consideration we expect to receive in exchange for those services. Substantially all of our revenues are generated from contracts with customers in the United States.

### *Gross versus net revenue recognition*

We report revenue on a gross or net basis based on management's assessment of whether we act as a principal or agent in the transaction. To the extent we act as the principal, revenue is reported on a gross basis unless we are unable to determine the amount on a gross basis, in which case we report revenue on a net basis. The determination of whether we act as a principal or an agent in a transaction is based on an evaluation of whether we control the good or service prior to transfer to the customer. We have determined that we act as the principal in all of our revenue streams.

### *Advertising Revenue*

We generate advertising revenue primarily from audio, display and video advertising. We generate the majority of our advertising revenue through the delivery of advertising impressions sold on a CPM basis. We also offer advertising on other units of measure, CPE and CPV, under which an advertiser pays us based on the number of times a listener engages with an ad.

We determine that a contract exists when we have an agreed-to insertion order, whether by signature or a fully executed customer-specific agreement. The duration of our contracts is generally less than one year. Revenue is recognized as performance obligations are satisfied, which generally occurs as ads are delivered. We generally recognize revenue based on delivery information from our campaign trafficking systems. Certain advertising arrangements include performance obligations other than advertising, such as music events. For these performance obligations, revenue is recognized when the customer obtains control of the promised services, such as when a music event occurs.

Certain customers may receive cash-based incentives or rebates, which are accounted for as variable consideration in the determination of the transaction price. We use the expected value method to estimate the value of such variable consideration to include in the transaction price and reflect changes to such estimates in the period in which they occur. The amount of variable consideration included in revenues is limited to the extent that it is probable that the amount will not be subject to a significant reversal when the uncertainty associated with the variable consideration is subsequently resolved.

Certain contracts include added value ("AV") elements, under which the customer may receive credits for free advertising services in exchange for advertising spend commitments, either based on total contract amount, defined spend tiers or overall commitments across multiple contracts. We have determined that these AV elements represent a material right to the customer, and therefore are treated as distinct performance obligations. We determine an

estimated selling price for these items and include them in the allocation of the transaction price of a contract or series of contracts, as applicable. If we are unable to accurately estimate the selling price for these items, our advertising revenue could be misstated and have a material adverse effect on our business, financial condition and results of operations.

*Arrangements with multiple performance obligations—Advertising revenue*

Our contracts with customers may include multiple performance obligations. For such arrangements, we allocate revenue to each performance obligation based on its relative standalone selling price. We generally determine standalone selling prices based on an analysis of the historical prices charged to customers, or estimate the stand alone selling price using expected cost plus margin.

*Subscription and Other Revenue*

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We generate revenue for our subscription services on both a direct basis and through subscriptions sold through certain third-party mobile device app stores. For subscriptions sold through third-party mobile device app stores, the subscriber executes a click-through agreement with Pandora outlining the terms and conditions between Pandora and the subscriber upon purchase of the subscription. The mobile device app stores promote the Pandora app through their e-store, process payments for subscriptions, and retain a percentage of revenue as a fee. We report this revenue gross of the fee retained by the mobile device app stores, as the subscriber is Pandora's customer in the contract and controls the service prior to the transfer to the subscriber.

Subscription revenue is a series type performance obligation and is recognized net of sales tax amounts collected from subscribers. The enforceable rights in monthly subscription contracts are the monthly service period, whereas the annual subscriptions are cancelable at any time. Because of the cancellation clauses for the annual subscriptions, the duration of these contracts is daily and are recognized on a daily ratable basis. For monthly subscriptions where there is no cancellation provision, we recognize revenue on a straight-line basis over the monthly service term. Historically, cancellation rates have been immaterial.

Subscription revenue from monthly subscriptions sold indirectly through mobile device app stores may be subject to partners' refund or cancellation terms. Revenues are recognized net of any adjustments, including refunds and other fees, as reported by the partners.

### *Business Combinations, Goodwill and Intangible Assets, net*

We allocate the fair value of purchase consideration to the tangible assets acquired, liabilities assumed, intangible assets acquired based on their estimated fair values. The excess of the fair value of purchase consideration over the fair values of these identifiable assets and liabilities is recorded as goodwill. Additionally, any contingent consideration is recorded at fair value on the acquisition date and classified as a liability. Such valuations require management to make significant estimates and assumptions, especially with respect to intangible assets and contingent consideration. Significant estimates in valuing certain intangible assets include, but are not limited to, future expected cash flows from acquired users, acquired technology, and trade names from a market participant perspective, useful lives and discount rates. Management's estimates of fair value are based upon assumptions believed to be reasonable, but which are inherently uncertain and unpredictable and, as a result, actual results may differ from estimates. During the measurement period, we may record adjustments to the assets acquired and liabilities assumed, with the corresponding offset to goodwill. Upon the conclusion of the measurement period, any subsequent adjustments are recorded to earnings.

We test goodwill and intangible assets with indefinite useful lives for impairment at least annually, or more frequently if events or changes in circumstances indicate that the assets may be impaired. We perform our annual goodwill and intangible asset impairment tests in the fourth quarter of each year.

Acquired finite-lived intangible assets are amortized over the estimated useful lives of the assets, which range from three to eleven years. Acquired finite-lived intangible assets consist primarily of patents, customer relationships, developed technology and trade names resulting from business combinations. We evaluate the recoverability of our intangible assets for potential impairment whenever events or circumstances indicate that the carrying amount of such assets may not be recoverable. Recoverability of these assets is measured by a comparison of the carrying amounts to the future undiscounted cash flows the assets are expected to generate. If such review indicates that the carrying amount of intangible assets is not recoverable, the carrying amount of such assets is reduced to the fair value.

In addition to the recoverability assessment, we routinely review the remaining estimated useful lives of finite-lived intangible assets. If we reduce the estimated useful life assumption for any asset, the remaining unamortized balance would be amortized over the revised estimated useful life. We record the amortization of intangible assets to the

financial statement line item in our consolidated statement of operations that the asset directly relates to. To the extent that purchased intangibles are used in revenue generating activities, we record the amortization of these intangible assets to cost of revenue.

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**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 year ended December 31, 2017. For further discussion of quantitative and qualitative disclosures about market risk, reference is made to our Annual Report on Form 10-K.

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**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 this 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 June 30, 2018.

**Changes in Internal Control over Financial Reporting**

There have been no other changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the period covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect our internal control over financial reporting.



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**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

The material set forth in Note 6 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 associated with the Company's business previously disclosed in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2017. 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.*

There have been no material changes to the Risk Factors described under "Part I—Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2017, other than as set forth below. The risk factor below, which originally appeared in our Annual Report on Form 10-K for the year ended December 31, 2017, has been updated to reflect subsequent developments relevant to such risk factor.

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

We accept subscription payments 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 absorb 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. We last certified our compliance with the Payment Card Industry Data Security Standard, or PCI DSS, version 3.2 as a Level 2 merchant in 2017. As we transition to a Level 1 merchant in 2018, we have been granted an extension to our certification deadline as we work with our payment processors and external assessors to audit our expanded systems. While we plan that we will recertify our compliance with PCI DSS, there is no guarantee that we will maintain PCI DSS compliance. Our failure to comply fully with PCI DSS in the future could 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 could subject us to fines, penalties, damages and civil liability, and could result in the loss of our ability to accept credit and debit card payments. Further, there is no guarantee that PCI DSS 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. 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.

Table of Contents**Item 6. Exhibits**

Exhibit No.	Exhibit Description	Incorporated by Reference			Filing Date	Filed By	Filed Herewith
		Form	File No.	Exhibit			
<u>3.01</u>	<u>Amended and Restated Certificate of Incorporation</u>	S-1/A	333-172215	3.1	4/4/2011		
<u>3.02</u>	<u>Certificate of Amendment to the Amended and Restated Certificate of Incorporation</u>	10-Q	001-35198	3.02	7/26/2016		
<u>3.03</u>	<u>Certificate of Amendment to the Amended and Restated Certificate of Incorporation</u>	8-K	001-35198	3.01	5/24/2018		
<u>3.04</u>	<u>Amended and Restated Bylaws</u>	8-K	001-35198	3.02	5/24/2018		
<u>3.05</u>	<u>Certificate of Designation of Preferences, Rights and Limitations of Series A Convertible Preferred Stock</u>	8-K	001-35198	3.1	6/14/2017		
<u>4.01</u>	<u>Indenture, dated as of June 1, 2018, between the Company and Citibank, N.A., as Trustee</u>	8-K	001-35198	4.1	6/5/2018		
<u>4.02</u>	<u>Form of 1.75% Convertible Senior Note due 2023 (included in Exhibit 4.1)</u>	8-K	001-35198	4.2	6/5/2018		
<u>10.01</u> †	<u>2014 Stock Incentive Plan of AdsWizz Inc.</u>	S-8	333-225529	99.1	6/8/2018		
<u>10.02</u> †	<u>Amendment to the 2014 Stock Incentive Plan of AdsWizz Inc.</u>	S-8	333-225529	99.2	6/8/2018		
<u>10.03</u> †	<u>Form of Employee Inducement Grant Agreement</u>						X
	<u>Certification of the Principal Executive Officer Pursuant to Rule 13a-14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u>						X
<u>31.01</u>	<u>Certification of the Principal Financial Officer Pursuant to Rule 13a-14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u>						X
<u>31.02</u>	<u>Certification of the Principal Executive Officer and Principal Financial Officer Pursuant to 8 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002</u>						X
<u>32.01</u>	<u>XBRL Instance Document - the instance document does not appear in the Interactive Data File because its XBRL tags are embedded within the Inline XBRL document</u>						X
101. INS							X
101. SCH	XBRL Taxonomy Schema Linkbase Document						X
101.CAL	XBRL Taxonomy Calculation Linkbase Document						X

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101.DEF XBRL Taxonomy Definition Linkbase Document	X
101.LAB XBRL Taxonomy Labels Linkbase Document	X
101.PRE XBRL Taxonomy Presentation Linkbase Document	X

Schedules and exhibits have been omitted pursuant to Item 601(b)(2) of Regulation S-K. A copy of any omitted \* schedule or exhibit will be furnished on a supplemental basis to the Securities and Exchange Commission upon request; provided, however that we may request confidential treatment pursuant to Rule 24b-2 of the Securities Exchange Act of 1934, as amended, for any schedules or exhibits so furnished.

Indicates management contract or compensatory plan.

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**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: July 31, 2018 By: /s/ Naveen Chopra  
Naveen Chopra  
Chief Financial Officer  
(Duly Authorized Officer and Principal Financial Officer)