

PLANETOUT INC  
Form 10-Q  
November 14, 2005

**Table of Contents**

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 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: September 30, 2005**

**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: 000-50879**

**PLANETOUT INC.**

(Exact Name of Registrant as Specified in Its Charter)

**DELAWARE**

(State or Other Jurisdiction of Incorporation or  
Organization)

**94-3391368**

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

**1355 SANSOME STREET, SAN FRANCISCO,  
CALIFORNIA**

(Address of Principal Executive Offices)

**94111**

(Zip Code)

**(415) 834-6500**

(Registrant's Telephone Number, Including Area Code)

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

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 is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).  Yes  No

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 outstanding of the registrant's Common Stock, \$0.001 par value, as of November 2, 2005 was 17,219,320.

**Table of Contents**

**PlanetOut Inc.  
INDEX  
Form 10-Q  
For the Quarter ended September 30, 2005**

	<b>PAGE</b>
<b><u>PART I FINANCIAL INFORMATION</u></b>	3
<u>Item 1 Unaudited Condensed Consolidated Financial Statements</u>	3
<u>Unaudited Condensed Consolidated Balance Sheets as of December 31, 2004 and September 30, 2005</u>	3
<u>Unaudited Condensed Consolidated Statements of Operations for the Three Months Ended September 30, 2004 and 2005 and the Nine Months Ended September 30, 2004 and 2005</u>	4
<u>Unaudited Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2004 and 2005</u>	5
<u>Notes to Unaudited Condensed Consolidated Financial Statements</u>	6
<u>Item 2 Management's Discussion and Analysis on Financial Condition and Results of Operations</u>	11
<u>Item 3 Quantitative and Qualitative Disclosures About Market Risk</u>	28
<u>Item 4 Controls and Procedures</u>	28
<b><u>PART II OTHER INFORMATION</u></b>	29
<u>Item 1 Legal Proceedings</u>	29
<u>Item 2 Unregistered Sales of Equity Securities And Use of Proceeds</u>	29
<u>Item 3 Defaults Upon Senior Securities</u>	30
<u>Item 4 Submission of Matters to a Vote of Security Holders</u>	30
<u>Item 5 Other Information</u>	30
<u>Item 6 Exhibits</u>	31
<b><u>SIGNATURES</u></b>	32
<b><u>EXHIBIT INDEX</u></b>	33
EXHIBIT 31.1	
EXHIBIT 31.2	
EXHIBIT 32.1	
EXHIBIT 32.2	
<u>EXHIBIT 31.1</u>	
<u>EXHIBIT 31.2</u>	
<u>EXHIBIT 32.1</u>	
<u>EXHIBIT 32.2</u>	

**Table of Contents**

**PART I**  
**FINANCIAL INFORMATION**  
**PlanetOut Inc.**

**Item 1. Unaudited Condensed Consolidated Financial Statements****UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS****(in thousands, except per share amount)**

	<b>December 31, 2004</b>	<b>September 30, 2005</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 43,128	\$ 44,149
Accounts receivable, net	2,075	2,188
Prepaid expenses and other current assets	2,209	1,916
Total current assets	47,412	48,253
Property and equipment, net	7,011	7,839
Goodwill	3,403	3,403
Investment in unconsolidated affiliate	57	
Other assets	1,325	1,049
Total assets	\$ 59,208	\$ 60,544
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 2,040	\$ 632
Accrued liabilities	1,469	1,393
Deferred revenue	3,506	4,352
Capital lease obligations, current portion	998	381
Notes payable, current portion	190	189
Total current liabilities	8,203	6,947
Capital lease obligations, less current portion	491	261
Notes payable, less current portion	142	
Deferred rent	1,608	1,781
Total liabilities	10,444	8,989
Stockholders' equity:		
Common stock: \$0.001 par value, 100,000 shares authorized, 16,943 and 17,219 shares issued and outstanding at December 31, 2004 and September 30, 2005, respectively	17	17
Additional paid-in capital	88,387	88,224
Note receivable from stockholder	(603)	(603)
Unearned stock-based compensation	(1,619)	(680)

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Accumulated other comprehensive loss	(106)	(121)
Accumulated deficit	(37,312)	(35,282)
Total stockholders' equity	48,764	51,555
Total liabilities and stockholders' equity	\$ 59,208	\$ 60,544

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

Page 3

---

**Table of Contents**

**PlanetOut Inc.**  
**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(in thousands, except per share amounts)

	Three months ended September 30,		Nine months ended September 30,	
	2004	2005	2004	2005
Revenue:				
Subscription services	\$ 4,328	\$ 5,077	\$ 12,167	\$ 15,102
Advertising services	1,604	2,106	4,414	6,064
Transaction services	378	368	1,278	1,120
Total revenue	6,310	7,551	17,859	22,286
Operating costs and expenses:				
Cost of revenue (inclusive of stock-based compensation expense of \$115 and \$10 for the three months ended September 30, 2004 and 2005, respectively, and \$466 and \$37 for the nine months ended September 30, 2004 and 2005, respectively)	1,941	2,177	6,098	6,622
Sales and marketing (inclusive of stock-based compensation expense of \$149 and \$33 for the three months ended September 30, 2004 and 2005, respectively, and \$436 and \$58 for the nine months ended September 30, 2004 and 2005, respectively)	2,248	2,551	6,234	7,539
General and administrative (inclusive of stock-based compensation expense of \$273 and \$90 for the three months ended September 30, 2004 and 2005, respectively, and \$822 and \$156 for the nine months ended September 30, 2004 and 2005, respectively)	1,263	1,430	3,862	4,293
Depreciation and amortization	645	787	1,673	2,455
Total costs and expenses	6,097	6,945	17,867	20,909
Income (loss) from operations	213	606	(8)	1,377
Equity in net loss of unconsolidated affiliate	(12)	(32)	(44)	(57)
Interest expense	(240)	(20)	(430)	(88)
Other income (expense), net	29	362	61	914
Income (loss) before income taxes	(10)	916	(421)	2,146
Provision for income taxes	(19)	(75)	(24)	(116)

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Net income (loss)	(29)	841	(445)	2,030
Accretion on redeemable convertible preferred stock	(438)		(1,313)	
Net earnings (loss) attributable to common stockholders	\$ (467)	\$ 841	\$ (1,758)	\$ 2,030
Net earnings (loss) per share:				
Basic	\$ (0.25)	\$ 0.05	\$ (0.99)	\$ 0.12
Diluted	\$ (0.25)	\$ 0.05	\$ (0.99)	\$ 0.11
Weighted-average shares used to compute net earnings per share:				
Basic	1,841	17,202	1,780	17,078
Diluted	1,841	18,200	1,780	18,148

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

Page 4

---

**Table of Contents**

**PlanetOut Inc.**  
**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(in thousands)

	Nine months ended September 30,	
	2004	2005
Cash flows from operating activities:		
Net income (loss)	\$ (445)	\$ 2,030
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	1,673	2,455
Amortization of unearned stock-based compensation, net of cancellation	1,655	251
Amortization of deferred rent	115	173
Issuance of stock options and shares in exchange for services	69	
Amortization of debt issuance costs	65	
Loss (gain) on disposal of assets	40	(3)
Equity in net loss of unconsolidated affiliate	44	57
Changes in operating assets and liabilities:		
Accounts receivable	(100)	(113)
Prepaid expenses and other assets	(773)	569
Accounts payable	843	(1,408)
Accrued and other liabilities	(1,517)	(76)
Deferred revenue	647	846
Net cash provided by operating activities	2,316	4,781
Cash flows from investing activities:		
Purchases of property and equipment	(2,102)	(3,246)
Net cash used in investing activities	(2,102)	(3,246)
Cash flows from financing activities:		
Proceeds from exercise of common stock and preferred stock options and warrants	49	525
Repurchase of redeemable convertible preferred stock	(20)	
Principal payments under capital lease obligations and notes payable	(968)	(1,024)
Deferred costs associated with initial public offering	(858)	
Proceeds from senior subordinated promissory note, net of issuance costs	4,909	
Net cash provided by (used in) financing activities	3,112	(499)
Effect of exchange rate on cash and cash equivalents	(16)	(15)
Net increase in cash and cash equivalents	3,310	1,021



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Cash and cash equivalents, beginning of period	2,282	43,128
Cash and cash equivalents, end of period	\$ 5,592	\$ 44,149
Supplemental disclosure of noncash flow investing and financing activities:		
Property and equipment and related maintenance acquired under capital leases	\$ 1,348	\$ 34
Accretion on redeemable convertible preferred stock	\$ 1,313	\$
Unearned stock-based compensation	\$ 3,463	\$ 468
Issuance of common stock warrant in connection with subordinated promissory note	\$ 543	\$

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

Page 5

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**Table of Contents****PlanetOut Inc.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****Note 1 The Company**

Online Partners.com, Inc. ( OLP ) was incorporated in Delaware in October 1997 and PlanetOut Inc. (the Company ) was incorporated in Delaware in December 2000 as a wholly owned subsidiary of OLP for the sole purpose of acquiring all of the capital stock of PlanetOut Corporation ( POC ). The transaction was structured in a manner that resulted in OLP and POC becoming wholly owned subsidiaries of the Company, with the former stockholders of OLP holding a majority of the voting securities of the Company. Accordingly, for accounting purposes, OLP is the accounting acquirer and the historical financial statements of the Company are those of OLP.

The Company is an online media company serving the lesbian, gay, bisexual and transgender, or LGBT, community. Through its Gay.com and PlanetOut.com websites, the Company offers membership based services and features. The Company generates revenue through subscription fees for premium membership services on Gay.com and PlanetOut.com, as well as advertising sales and sales of products and services through its e-commerce site, Kleptomaniac.com.

**Note 2 Basis of Presentation and Summary of Significant Accounting Policies*****Unaudited Interim Financial Information***

The accompanying unaudited condensed consolidated financial statements have been prepared and reflect all adjustments, consisting only of normal recurring adjustments, which in the opinion of management are necessary to state fairly the financial position and the results of operations for the interim periods. The balance sheet at December 31, 2004 has been derived from audited financial statements at that date. The unaudited condensed consolidated financial statements have been prepared in accordance with the regulations of the Securities and Exchange Commission, but omit certain information and footnote disclosure necessary to present the statements in accordance with generally accepted accounting principles. Results of interim periods are not necessarily indicative of results for the entire year. These unaudited condensed consolidated financial statements should be read in conjunction with the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2004.

As of September 30, 2005, the Company had \$44.1 million of cash and cash equivalents. The Company believes that this cash, coupled with anticipated cash flows generated from operations, will be sufficient to meet the Company's capital expenditure, working capital and corporate overhead requirements within the Company's current identified business objectives.

***Use of Estimates***

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting periods. Significant estimates and assumptions made by management include the assessment of collectibility of accounts receivable, the determination of the allowance of doubtful accounts, the determination of the fair market value of its preferred and common stock prior to the Company's initial public offering, the valuation and useful life of its capitalized software and long-lived assets and the valuation of deferred tax asset balances. Actual results could differ from those estimates.

***Property and Equipment***

Property and equipment are stated at cost less accumulated depreciation and amortization. Depreciation is calculated using the straight line method over the estimated useful lives of the related assets ranging from three to five years. Leasehold improvements are amortized over the shorter of their economic lives or lease term, generally ranging from two to seven years. Maintenance and repairs are charged to expense as incurred. When assets are retired or otherwise disposed of, the cost and accumulated depreciation and amortization are removed from the accounts and any resulting gain or loss is reflected in the consolidated statement of operations in the period realized.

Leasehold improvements made by the Company and reimbursable by the landlord as tenant incentives are recorded by the

**Table of Contents**

Company as leasehold improvement assets and amortized over a term consistent with the above guidance. The incentives from the landlord are recorded as deferred rent and amortized as reductions to rent expense over the lease term. At December 31, 2004 and September 30, 2005, the balance of these leasehold improvement allowances was \$1,255,000 and \$1,360,000, respectively. During the three and nine months ended September 30, 2005, the Company amortized \$47,000 and \$139,000, respectively, as a reduction of rent expense in the accompanying unaudited condensed consolidated statement of operations. At December 31, 2004 and September 30, 2005, the deferred rent balance attributable to these incentives totaled \$1,218,000 and \$1,184,000, respectively. Future amortization of the balance of these tenant incentives is estimated to be \$47,000 for the three months ended December 31, 2005, \$188,000 each year for 2006 to 2011, and \$11,000 in 2012. At December 31, 2004 and September 30, 2005, the Company had receivable balances for tenant incentives of \$1,255,000 and \$414,000, respectively, recorded under prepaid expenses and other current assets in the accompanying unaudited condensed consolidated balance sheets.

**Internal Use Software and Website Development Costs**

The Company capitalizes internally developed software costs in accordance with the Statement of Position 98-1, Accounting for Costs of Computer Software Developed or Obtained for Internal Use ( SOP 98-1 ) and Emerging Issues Task Force Abstract No. 00-02, Accounting for Web Site Development Costs ( EITF 00-02 ). Capitalized costs are amortized on a straight-line basis over the estimated useful life of the software, generally three years, once it is available for its intended use. During the three months ended September 30, 2004 and 2005, the Company capitalized costs of \$569,000 and \$355,000, respectively, and recorded \$149,000 and \$238,000 of related amortization expense, respectively. During the nine months ended September 30, 2004 and 2005, the Company capitalized costs of \$1,055,000 and \$1,545,000, respectively, and recorded \$359,000 and \$619,000 of related amortization expense, respectively. The capitalized costs for the three and nine months ended September 30, 2005 included \$115,000 and \$830,000, respectively, paid to external consultants and \$416,000 and \$421,000 for the three and nine months ended September 30, 2004, respectively.

**Stock-based Compensation**

The Company accounts for stock-based employee compensation arrangements in accordance with provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, ( APB No. 25 ), and related interpretations. The Company follows the disclosure provisions of Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation ( SFAS No. 123 ), and related interpretations. Under APB No. 25, compensation expense is based on the difference, if any, on the date of the grant, between the fair value of the Company's stock and the exercise price. Employee stock-based compensation determined under APB No. 25 is recognized using the multiple option method prescribed by the Financial Accounting Standards Board Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Awards Plans ( FIN No. 28 ), over the option's vesting period, which is generally two to four years.

The Company accounts for equity instruments issued to non-employees in accordance with SFAS No. 123, Emerging Task Force Issue No. 96-18, Accounting for Equity Instruments that are Issued to Other than Employees for Acquiring, or in Conjunction with Selling, Goods or Services ( EITF 96-18 ) and FIN No. 28. Accordingly, as these equity instruments vest, the Company will be required to remeasure the fair value of the equity instruments at each reporting period prior to vesting and then finally at the vesting date of the equity instruments.

For the purposes of pro forma disclosures, the estimated fair value of the options granted under the Company's stock option plans is amortized to expense over the vesting period of the respective options, which is generally two to four years.

The pro forma disclosures of the difference between compensation cost included in the net loss and the related cost measured by the fair value method as required by SFAS 123, as amended, are presented as follows (in thousands, except per share amounts):

Three months ended September 30,		Nine months ended September 30,	
2004	2005	2004	2005
(unaudited)		(unaudited)	

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Net earnings (loss) attributable to common stockholders, as reported:	\$	(467)	\$	841	\$	(1,758)	\$	2,030
Add: Employee stock-based compensation expense included in reported net income (loss), net of tax		518		133		1,655		251
Less: Total employee stock-based compensation expense determined under fair value, net of tax		(696)		(245)		(2,054)		(646)
Pro forma net earnings (loss) attributable to common stockholders	\$	(645)	\$	729	\$	(2,157)	\$	1,635
Net earnings (loss) per share attributable to common stockholders:								
As reported basic	\$	(0.25)	\$	0.05	\$	(0.99)	\$	0.12
As reported diluted	\$	(0.25)	\$	0.05	\$	(0.99)	\$	0.11
Pro forma basic	\$	(0.35)	\$	0.04	\$	(1.21)	\$	0.10
Pro forma diluted	\$	(0.35)	\$	0.04	\$	(1.21)	\$	0.09

Page 7

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**Table of Contents**

Prior to the Company's IPO, the fair value of each option grant was determined using the minimum value method prescribed by SFAS No. 123. Subsequent to the offering, the fair value was determined using the Black-Scholes model stipulated by SFAS No. 123. The following weighted average assumptions were included in the estimated grant date fair value calculations for the Company's stock option awards:

	<b>Nine months ended September 30, 2004                      2005 (unaudited)</b>	
<b>Preferred stock options:</b>		
Expected lives (in years)	2.5	
Risk free interest rates	2.77 - 4.05%	
Dividend yield	10%	
Volatility	0%	
<b>Common stock options:</b>		
Expected lives (in years)	5.0	5.0
Risk free interest rates	2.77 - 4.05%	3.59 - 4.16%
Dividend yield	0%	0%
Volatility	0%	85%

**Net Income (Loss) Per Share**

Basic income (loss) per share ( Basic EPS ) is computed by dividing net income (loss) available to common shareholders by the sum of the weighted average number of common shares outstanding during the period, net of shares subject to repurchase, using the two-class method. The two-class method is an earnings allocation formula that determines earnings per share for each class of common stock and participating security according to dividends declared (or accumulated) and participation rights in undistributed earnings. Under the two-class method, income from continuing operations (or net income) is reduced by the amount of dividends declared in the current period for each class of stock and by the contractual amount of dividends (or interest on participating income bonds) that must be paid for the current period. The remaining earnings are then allocated to common stock and participating securities to the extent that each security may share in earnings as if all of the earnings for the period had been distributed. The total earnings allocated to each security are determined by adding together the amount allocated for dividends and the amount allocated for a participation feature. The total earnings allocated to each security are then divided by the number of outstanding shares of the security to which the earnings are allocated to determine the earnings per share for the security.

Diluted earnings per share ( Diluted EPS ) gives effect to all dilutive potential common shares outstanding during the period. The computation of Diluted EPS does not assume conversion, exercise or contingent exercise of securities that would have an anti-dilutive effect on earnings as calculated based on the weighted average closing price of our common stock for the period. The dilutive effect of outstanding stock options and warrants is computed using the treasury stock method to the extent such shares are dilutive.

The following table sets forth the computation of basic and diluted net income (loss) attributable to common stockholders (in thousands, except per share amounts):

	<b>Three months ended September 30, 2004                      2005 (unaudited)</b>		<b>Nine months ended September 30, 2004                      2005 (unaudited)</b>	
Numerator:				
Net income (loss)	\$ (29)	\$ 841	\$ (445)	\$ 2,030
	(438)		(1,313)	

## Accretion on redeemable convertible preferred stock

Net earnings (loss) attributable to common stockholders	\$ (467)	\$ 841	\$ (1,758)	\$ 2,030
Denominator:				
Weighted-average shares used to compute basic EPS	1,841	17,202	1,780	17,078
Effect of dilutive securities:				
Dilutive common stock equivalents		998		1,070
Dilutive potential common shares		998		1,070
Weighted-average shares used to compute diluted EPS	1,841	18,200	1,780	18,148
Net earnings per share:				
Basic	\$ (0.25)	\$ 0.05	\$ (0.99)	\$ 0.12
Diluted	\$ (0.25)	\$ 0.05	\$ (0.99)	\$ 0.11

**Table of Contents**

The potential shares, which are excluded from the determination of basic and diluted net income (loss) per share for the nine months ended September 30, 2004 and 2005 as their effect is anti-dilutive, are as follows (in thousands):

	<b>Nine months ended September 30,</b>	
	<b>2004</b>	<b>2005</b>
	<b>(unaudited)</b>	
Redeemable convertible preferred stock	9,272	
Redeemable convertible preferred stock options and warrants	3,493	
Common stock options and warrants	2,273	723
Common stock subject to repurchase	2	2
	<b>15,040</b>	<b>725</b>

**Recent Accounting Pronouncements**

In March 2005, the SEC issued Staff Accounting Bulletin No. 107 (SAB No. 107). SAB No. 107 covers key topics related to the implementation of SFAS No. 123(R) which include the valuation models, expected volatility, expected option term, income tax effects of SFAS No. 123(R), classification of stock-based compensation cost, capitalization of compensation costs, and disclosure requirements. The Company expects the adoption of SAB No. 107 may have a significant adverse impact on its financial position and results of operations upon its adoption of SFAS No. 123(R) in the first quarter of 2006. The Company is currently in the process of evaluating the extent of such impact.

In April 2005, the SEC amended the compliance dates for SFAS No. 123(R), Share-Based Payment. The new rule allows public companies to implement SFAS No. 123(R) at the beginning of their next fiscal year that begins after June 15, 2005. The Company will be required to adopt SFAS No. 123(R) in the first quarter of 2006 and begin to recognize stock-based compensation related to employee equity awards in its condensed consolidated statements of operations using a fair value based method on a prospective basis. Since the Company currently accounts for equity awards granted to its employees using the intrinsic value method under APB No. 25, the Company expects the adoption of SFAS No. 123(R) may have a significant adverse impact on its financial position and results of operations. The Company is currently in the process of evaluating the extent of such impact.

In June 2005, the FASB's Emerging Issues Task Force reached a consensus on Issue No. 05-6, Determining the Amortization Period for Leasehold Improvements Purchased after Lease Inception or Acquired in a Business Combination (EITF 05-6). This guidance requires that leasehold improvements acquired in a business combination or purchased subsequent to the inception of a lease be amortized over the shorter of the useful life of the assets or a term that includes required lease periods and renewals that are reasonably assured at the date of the business combination or purchase. This guidance is applicable only to leasehold improvements that are purchased or acquired in reporting periods beginning after June 29, 2005. The adoption of EITF Issue No. 05-6 will not have a material impact on the Company's financial position or results of operations.

**Table of Contents****Note 3 Other Balance Sheet Components**

	<b>December 31, 2004</b>	<b>September 30, 2005 (unaudited)</b>
<b>Property and equipment (in thousands):</b>		
Computer and network equipment	\$ 7,130	\$ 7,729
Furniture and fixtures	918	1,121
Computer software	1,683	2,381
Leasehold improvements	1,191	1,388
Capitalized software and website development costs	2,919	4,464
	13,841	17,083
Less: Accumulated depreciation and amortization	(6,830)	(9,244)
	\$ 7,011	\$ 7,839

During the three and nine months ended September 30, 2005, depreciation and amortization expense of property and equipment was \$787,000 and \$2,455,000, respectively. During the three and nine months ended September 30, 2004, depreciation and amortization expense of property and equipment was \$645,000 and \$1,654,000, respectively.

	<b>December 31, 2004</b>	<b>September 30, 2005 (unaudited)</b>
<b>Prepaid expenses and other current assets (in thousands):</b>		
Prepaid expenses and other current assets	\$ 1,262	\$ 1,502
Receivable from landlord for tenant improvement allowance, current portion (Note 2)	947	414
	\$ 2,209	\$ 1,916

	<b>December 31, 2004</b>	<b>September 30, 2005 (unaudited)</b>
<b>Other assets (in thousands):</b>		
Other assets	\$ 838	\$ 831
Receivable from landlord for tenant improvement allowance, less current portion (Note 2)	308	
Interest on note receivable from stockholder	179	218
	\$ 1,325	\$ 1,049

<b>December 31,</b>	<b>September 30,</b>
-------------------------	--------------------------



	2004	2005 (unaudited)
<b>Accrued liabilities (in thousands):</b>		
Accrued payroll and related liabilities	\$ 493	\$ 489
Other accrued liabilities	976	904
	\$ 1,469	\$ 1,393

#### **Note 4 Related Party Transactions**

##### ***Note Receivable***

In May 2001, the Company issued a promissory note to an executive of the Company for \$603,000 to fund the purchase of Series D redeemable convertible preferred stock. The principal and interest are due and payable in May 2006. Interest accrues at a rate of 8.5% per annum or the maximum rate permissible by law, whichever is less and is full recourse. The note is full recourse with respect to \$24,000 in principal payment and the remainder of the principal is non-recourse. The note is collateralized by the shares of common stock and options owned by the executive. Interest income of \$13,000 and \$39,000 was recognized in each of the three and nine months ended September 30, 2004 and 2005, respectively.

##### ***Advertising Agreement***

In November 2001, the Company entered into an advertising agreement with Gay.it S.p.A., an unconsolidated affiliate of which the Company owns 45%. Pursuant to this agreement, the Company received \$43,000 of subscription revenue for each of the three months ended September 30, 2004 and 2005 and \$120,000 and \$142,000 for the nine months ended September 30, 2004 and 2005, respectively. The Company paid Gay.it S.p.A. a referral fee of \$17,000 during each of the three months ended September 30, 2004 and 2005, and \$48,000 and \$57,000 during the nine months ended September 30, 2004 and 2005, respectively.

#### **Note 5 Contingencies**

##### ***Contingencies***

In April 2002, the Company was notified that DIALINK, a French company, had filed a lawsuit in France against it and its French subsidiary, alleging that the Company had improperly used the domain names Gay.net, Gay.com and fr.gay.com in France, as DIALINK alleges that it has exclusive rights to use the word *gay* as a domain name and trademark in France. On June 30, 2005, the French court found that although the Company had not infringed DIALINK's trademark, it had damaged DIALINK through unfair competition. The Court ordered the Company to pay damages of 50,000 (US \$60,000 at September 30, 2005), half to be paid notwithstanding appeal, the other half to be paid after appeal. The Court also enjoined the Company from using *gay* as a trademark or domain name for its services in France. In October, 2005, the Company paid half the damage award as required by the court order and temporarily changed the domain name of its French website, from www.fr.gay.com to www.ooups.com, a domain name the Company has used previously in France. This temporary change may make it more difficult for French users to locate the Company's French website. The Company has accrued the full damage award and plans to appeal the French court's decision.

The Company is not currently subject to any additional significant legal proceedings. The Company may from time to time, however, become a party to various legal proceedings, arising in the ordinary course of business. The Company may also be indirectly affected by administrative or court proceedings or actions in which the Company is not involved but which have general applicability to the Internet industry. The Company does not believe, based on current knowledge, that current legal proceedings or claims are likely to have a material adverse effect on its financial position, results of operations or cash flows.

#### **Note 6 Subsequent Event**

On November 8, 2005, the Company acquired substantially all of the assets of LPI Media Inc., SpecPub, Inc. and Triangle Marketing Services, Inc., privately held companies serving the LGBT community, for a purchase price of approximately \$31.1 million which consisted of \$24.0 million paid in cash and approximately \$7.1 million in the form of a note to the sellers secured by the assets of SpecPub, Inc. and payable in three equal installments in May, August and November 2007, and the reimbursement of certain prepaid and other expenses of approximately \$1.0 million.



**Table of Contents****Item 2. Management's Discussion and Analysis on Financial Condition and Results of Operations**

*The following discussion should be read in conjunction with the financial statements and related notes which appear elsewhere in this document. This discussion contains forward-looking statements that involve risks and uncertainties. In some cases, you can identify forward-looking statements by terminology including would, could, may, will, should, expect, intend, plan, anticipate, believe, estimate, predict, potential or continue, the negative of these terms or other comparable terminology. These statements are only predictions. Forward-looking statements include statements about our business strategy, future operating performance and prospects. You should not place undue reliance on these forward-looking statements. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors, including those discussed below and elsewhere in this document and in our Form 10-K filed March 31, 2005.*

**Overview**

We are a leading global online media company serving the LGBT community. Our network of websites, including our flagship websites Gay.com and PlanetOut.com, allows our members to connect with other members of the LGBT community around the world.

Although we had positive net income in the three and nine months ended September 30, 2005, we have incurred significant losses since our inception. As of September 30, 2005, we had an accumulated deficit of \$35.3 million. We expect to incur significant marketing, engineering and technology, general and administrative and stock-based compensation expenses for the foreseeable future. As a result, we will need to continue to grow revenue and increase our operating margins to maintain and expand our profitability.

**Results of Operations**

The following table sets forth the percentage of total revenue represented by items in our consolidated statements of operations for the periods presented:

	Three months ended September 30, 2004		Nine months ended September 30, 2004	
	2005	2005	2004	2005
	(As a percentage of total revenue; unaudited)			
<b>Consolidated statement of operations data:</b>				
Revenue:				
Subscription services	68.6%	67.2%	68.1%	67.8%
Advertising services	25.4	27.9	24.7	27.2
Transaction services	6.0	4.9	7.2	5.0
Total revenue	100.0	100.0	100.0	100.0
Operating costs and expenses:				
Cost of revenue	30.8	28.8	34.1	29.7
Sales and marketing	35.6	33.8	34.9	33.8
General and administrative	20.0	18.9	21.6	19.3
Depreciation and amortization	10.2	10.5	9.4	11.0
Total costs and expenses	96.6	92.0	100.0	93.8
Income (loss) from operations	3.4	8.0		6.2
Other income (expense), net	(3.6)	4.1	(2.4)	3.4
Income (loss) before income taxes	(0.2)	12.1	(2.4)	9.6

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Provision for income taxes	(0.3)	(1.0)	(0.1)	(0.5)
Net income (loss)	(0.5)%	11.1%	(2.5)%	9.1%

The following provides some explanatory information with respect to our consolidated statements of operations data:

We derive our revenue from three main sources: subscription, advertising and transaction services. For the foreseeable future, we expect subscription and advertising services to remain our largest sources of revenue and to be more of a focus for our internal operations than transaction services.

*Subscription Services.* We charge for subscriptions to our premium membership services on Gay.com and PlanetOut.com. On both of these websites, the set of services for which we offer paid premium memberships includes viewing, searching and replying to profiles, chat, instant messaging and email. The Gay.com paid premium memberships also include premium chat features, video chat and premium content. We currently offer Gay.com membership services in six languages to members who identify themselves as residing in more than 100 countries through Gay.com and localized versions of Gay.com.

**Table of Contents**

During 2003, 2004 and 2005, we have priced our premium membership services as follows, excluding promotional discounts:

***Gay.com Premium Membership Services***

	<b>Yearly</b>	<b>Quarterly</b>	<b>Monthly</b>	<b>Trials</b>
January 2003 to March 2003	\$89.95	\$39.95	\$16.95	\$7.95 7-day trial
March 2003 to May 2004	\$79.95	\$39.95	\$16.95	\$6.95 7-day trial March 2003 to April 2004 \$9.95 7-day trial April 2004 to May 2004
May 2004 to October 2004	\$79.95	\$39.95	\$17.95	\$9.95 7-day trial
October 2004 to present	\$89.95	\$42.95	\$19.95	\$9.95 7-day trial

	<b>Yearly</b>	<b>Quarterly</b>	<b>Monthly</b>	<b>Trials</b>
<b><i>PlanetOut Premium Membership Services</i></b>				\$4.95 3-day trial December 2002 to present
	\$69.95	\$29.95	\$12.95	

**Table of Contents**

In managing our premium membership services, we track a number of operating metrics, including the following:

**Premium Membership Service Operating Metrics**

(excluding free trial promotions)

	2003				2004				2005		
Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY	1Q	2Q
3,776	88,103	91,886	98,445	98,445	105,179	110,598	118,392	127,527	127,527	137,500	145,111
9,053	34,305	37,167	40,721	151,246	42,635	37,582	41,082	44,219	165,518	44,245	41,375
10,641	34,978	33,384	34,162	133,165	35,901	32,163	33,288	35,084	136,436	34,272	33,750
12.1%	13.2%	12.4%	12.0%	12.4%	11.8%	9.9%	9.7%	9.5%	10.1%	8.6%	8.6%
3,412	(673)	3,783	6,559	18,081	6,734	5,419	7,794	9,135	29,082	9,973	7,611
8.3	7.6	8.1	8.4	8.1	8.5	10.1	10.3	10.5	9.9	11.6	12.1

We have calculated these metrics using the following definitions:

*Total Subscribers:* members with an active, paid subscription plan, excluding paid trial subscribers, at the end of the period.

*Gross Additions:* members who initiate a subscription during the period, excluding paid trial subscriptions. Gross Additions during a period equals Net Additions plus Total Churn during that period.

*Total Churn:* total subscription cancellations during the period, including cancellations of paid promotional subscriptions, but excluding cancellations of paid 3- and 7-day trial subscriptions and free promotional subscriptions. Subscription cancellations include subscriptions cancelled due to failed credit cards.

*Churn Rate:* Total Churn divided by the average of the Total Paid Subscribers measured at the beginning and end of the period, divided by the number of months in the period.

*Net Additions:* Total Paid Subscribers at the end of the period minus the Total Paid Subscribers at the beginning of the period.

*Average Lifetime:* Average length of a subscription. Average lifetime equals one hundred percent divided by churn rate for the period.

Because their terms are generally shorter than the periods that we measure, we exclude paid trial subscriptions (currently, 3- and 7-day paid trials) from these operating metrics.

We regularly test different promotional offers, including some free trial promotions. Members who sign up for any of these promotional offers, discounted or free, provide us with payment information and authorize us to bill them at our then regular premium membership service rates, unless they cancel their subscriptions prior to the end of their promotional terms. When these promotional offers are for paid subscriptions to our annual, monthly, or quarterly plans, we include these cancellations in our churn calculations.

However, because free subscribers do not count toward our definition of Total Paid Subscribers, we exclude them from our definition of Total Churn.

Currently, we expect to provide information about these operating results for at least our U.S.-based subscribers through the end of 2005. The operating metrics we report may change as our businesses evolve due to new business initiatives, such as offering more aggressively priced premium services in certain international markets, and corporate development activities, such as our recent acquisition of LPI Media Inc. and related entities which may render current

measures of performance less relevant or obsolete.

We are paid up-front for premium memberships, and we recognize subscription revenue ratably over the subscription period. As of September 30, 2004 and 2005, deferred revenue related to premium membership subscriptions totaled approximately \$2.9 million and \$4.1 million, respectively. Our subscription revenue is not subject to sales or use tax in the United States, but is subject to Value Added Tax, or VAT, in the European Union. Currently, we do not require our subscribers to reimburse us for VAT and we offset this liability against revenue.

*Advertising Services.* We derive advertising revenue principally from advertising contracts in which we typically undertake to deliver a minimum number of impressions to users over a specified time period for a fixed fee. Advertising rates, measured on a number of bases, including on a cost per thousand impressions, or CPM, basis, depend on whether the impressions are for general rotation throughout our network or for targeted audiences through our email newsletters or on our websites.

**Table of Contents**

We recognize advertising revenue ratably in the period in which the advertisement is displayed, provided that we have no significant obligation remaining and the collection of the resulting receivable is reasonably assured, at the lesser of the ratio of impressions delivered over the total number of contracted impressions or the straight-line basis over the term of the contract. To the extent that we do not provide the contracted number of impressions during a specific time period, we defer recognition of the corresponding revenue until the thresholds are achieved.

Throughout 2004 and the first nine months of 2005, our primary goals for advertising services included attracting additional advertisers, diversifying our client base and increasing average account size. We have succeeded in these efforts and expect to continue to pursue Fortune 1000 companies and other clients and to provide increasingly customized and targeted advertising campaigns.

In addition to revenue from advertisers who place general online advertisements on our websites, we derive advertising revenue from the sale of online classified directory listings, across a wide spectrum of categories. We expect to expand the scope of our online directory to evolve into a comprehensive resource of LGBT-friendly businesses and services.

*Transaction Services.* Our principal source of transaction services revenue is from sales through Kleptomaniac.com, our e-commerce website and, to a lesser extent, through our other websites. Through Kleptomaniac.com, we offer hundreds of products, including DVDs, music CDs and fashion items, some of which we own and some of which are owned by third-parties. Revenue from Kleptomaniac.com accounted for approximately 53% of our transaction services revenue and approximately 3% of our overall revenue in 2004 and approximately 48% of our transaction services revenue and approximately 2% of our overall revenue for the first nine months of 2005. For those items that we own, we recognize revenue when the product is shipped, net of estimated returns. We recognize commissions for facilitating the sale of third-party products and services when earned, based on reports provided by the vendors or upon cash receipt if no reports are provided.

*Cost of Revenue.* Cost of revenue primarily consists of payroll and employee benefits associated with supporting our subscription-based services and producing and maintaining content for our various websites and newsletters. Other expenses directly related to generating revenue included in cost of revenue include transaction processing fees, computer maintenance, allocated occupancy costs, co-location and Internet connectivity fees, purchased content and cost of goods sold.

We research and test potential improvements to our hardware and software systems in an effort to improve our productivity and enhance our members' experience. We expect to continue to invest in technology and improvements in our websites. We believe costs associated with certain projects have ongoing benefit. If we believe that capitalization criteria in accordance with SOP 98-1 and EITF 00-02 have been met, we capitalize the development costs related to these projects which are amortized on a straight-line basis over the estimated three year useful life of the software. The amortization of capitalized software is included in depreciation and amortization. We expense the costs associated with these projects only when we believe capitalization criteria have not been met.

*Sales and Marketing.* Sales and marketing expense consists of expenses related to selling, marketing and promoting our products and services. Major expense items include:

payroll and benefits for employees involved in sales, client service, customer service, corporate marketing and other support functions;

product and service marketing and promotions;

general corporate marketing and promotions; and

allocated occupancy costs.

*General and Administrative.* General and administrative expense consists primarily of payroll and employee benefits for executive, finance and administrative personnel, allocated occupancy costs, professional fees, insurance and other general corporate expenses.

*Occupancy Costs.* Each of our cost of revenue, sales and marketing and general and administrative expense categories include occupancy costs. The amount of charges from occupancy costs allocated to each of these categories



is based on the headcount associated with each of these categories. In addition, we allocate to the general and administrative expense category the costs of any one-time charges associated with lease terminations.

*Stock-based Compensation and Related Charges.* Each of our cost of revenue, sales and marketing and general and

**Table of Contents**

administrative expense categories include stock-based compensation charges for equity instruments issued to employees, and in some cases, consultants for services. These charges represent the intrinsic value, if any, between the respective exercise price of stock options or stock grants and the fair market value of the underlying stock on the date of grant, or on the reporting date if the option is subject to variable plan accounting.

At September 30, 2005, we had options to acquire 41,318 shares of our capital stock subject to variable plan accounting which requires us to measure the intrinsic value at each reporting date until these options expire, or are exercised or forfeited. In any period, variable plan accounting may result in increases or decreases in stock-based compensation, depending on the estimated fair market value of our capital stock. We amortize deferred stock-based compensation over the vesting periods of the individual options, using the multiple option method. Changes in fair market value will result in stock-based compensation expense or benefit in each period. We recognized total stock-based compensation expense of \$1.7 million in the first nine months of 2004 and \$251,000 in the first nine months of 2005.

At September 30, 2005, we had unearned stock-based compensation of \$680,000, of which \$146,000 will be amortized in the remainder of 2005, \$378,000 will be amortized in 2006, \$146,000 will be amortized in 2007 and \$10,000 will be amortized in 2008. We may recognize additional stock-based compensation expense (benefit) in the future if we grant additional options with an exercise price below the fair market value of our stock.

**Comparison of the Three and Nine Months Ended September 30, 2005 and September 30, 2004**

***Revenue***

Total revenue increased approximately 20%, from \$6.3 million in the three months ended September 30, 2004 to \$7.6 million in the three months ended September 30, 2005. Total revenue for the nine months ended September 30, 2004 and 2005 increased 25% from \$17.9 million to \$22.3 million.

*Subscription Services.* From September 30, 2004 to September 30, 2005, the number of our subscribers grew by approximately 30% from approximately 118,400 to approximately 153,800. As a result of this increase, our subscription revenue for the three months ended September 30, 2004 and 2005 increased approximately 17%, from \$4.3 million to \$5.1 million, respectively. Our subscription revenue for the nine months ended September 30, 2004 and 2005 increased approximately 24% from \$12.2 million to \$15.1 million.

Other factors that contributed to this change in revenue included:

- new features including the offer of subscriptions to popular magazines with premium memberships beginning in May 2004, and the expansion and launch of online features such as expanded messenger services, expanded and searchable who's online features, and the addition of Hot and Buddy lists, among others;

- the launch of automated credit card updating;

- a price increase for our Gay.com membership services in October 2004;

- the migration of approximately 1,400 of our Out&About newsletter subscribers to our premium membership services in December 2004;

- an increase in marketing and promotional activities including targeted price discounts on select subscription plan offerings;

- the effect of periods during the fourth quarter of 2004 and the first quarter of 2005, during which our transaction processing system was not available or did not perform as expected, in part as a result of adding new transaction processing capabilities, subsequent to which we have implemented technology upgrades to help address these issues;

- delays in new feature rollout for our subscription services, which limited subscriber and revenue growth; and

a reduction in subscribers and revenue from our PlanetOut.com premium membership service, as we have concentrated more of our marketing and development activities on our Gay.com premium membership service.

Revenue from our premium membership services made up approximately 98% of subscription revenue in the three months

**Table of Contents**

and the nine months ended September 30, 2004. Revenue from our premium membership services made up all of our subscription revenue in the three months and the nine months ended September 30, 2005.

*Advertising Services.* Our advertising services revenue increased approximately 31%, from \$1.6 million in the three months ended September 30, 2004 to \$2.1 million in the three months ended September 30, 2005. Advertising revenue for the nine months ended September 30, 2004 and 2005 increased 37% from \$4.4 million to \$6.1 million, respectively. The majority of this increase came from increases in online advertising revenue on our flagship websites, Gay.com and PlanetOut.com. Factors that affected our advertising revenue for the three months and the nine months ended September 30, 2005, as compared to the three months and the nine months ended September 30, 2004, included:

the growth in the advertising market generally and in the online advertising market specifically;

the development of new customized sponsorship programs and integrated editorial programming which increased our CPM rate;

the launch of improved website tracking capability in the third quarter of 2005, increasing our ability to monetize our UK site traffic;

the increasing interest of advertisers in targeting the LGBT community; and

the expansion of our Gay.com local service listings during the first nine months of 2005.

For the foreseeable future, we expect online advertising to grow and remain the largest portion of our overall advertising services revenue.

*Transaction Services.* Our transaction services revenue declined 3% from \$378,000 in the three months ended September 30, 2004 to \$368,000 in the three months ended September 30, 2005. For the nine months ended September 30, 2004 and 2005, transaction services revenue declined 12% from \$1.3 million to \$1.1 million, respectively. The decline was largely due to the ongoing shift of internal promotional space on our websites away from Kleptomaniac.com toward our premium membership services and advertising services. This decline also reflects the effects of a leadership transition in the division in the first nine months of 2005. Revenue from Kleptomaniac.com accounted for approximately 43% and 37% of transaction services revenue in the three months ended September 30, 2004 and 2005, respectively. For the nine months ended September 30, 2004 and 2005, revenue from Kleptomaniac.com accounted for approximately 58% and 48% of transaction services revenue, respectively. Transaction revenue from sources other than Kleptomaniac.com, increased 7% to \$231,000 for the three months and 7% to \$581,000 for the nine months ended September 30, 2005 as compared to the same periods in 2004.

**Operating Costs and Expenses**

Total operating expenses grew approximately 14%, from \$6.1 million in the three months ended September 30, 2004 to \$6.9 million in the three months ended September 30, 2005. Operating expenses for the nine months ended September 30, 2004 and 2005 increased 17% from \$17.9 million to \$20.9 million. These numbers include stock-based compensation expenses of \$537,000 and \$133,000 respectively for the three months ended September 30, 2004 and 2005, and \$1,724,000 and \$251,000, respectively, for the nine months ended September 30, 2004 and 2005.

*Cost of Revenue.* Our cost of revenue increased 12% from \$1.9 million in the three months ended September 30, 2004 to \$2.2 million in the three months ended September 30, 2005. This includes an increase of \$81,000 in computer maintenance expenses, an increase of corporate occupancy expenses reflecting the move to our new corporate headquarters, a credit to labor expense for capitalized development costs of \$153,000 in the three months ended September 30, 2004 compared to \$240,000 in the three months ended September 30, 2005, and an increase in salary expenses of \$218,000 for the three months ending September 30, 2005 versus the same period in 2004 reflecting both growth in headcount and salary increases as we increased our investment in technology and engineering support.

For the nine months ended September 30, 2004 and 2005, operating cost of revenue increased 9% from \$6.1 million to \$6.6 million, respectively. This reflects an increase in computer maintenance expenses of \$334,000, an increase in corporate occupancy expenses, an increase in salary expenses of \$295,000 reflecting both growth in

headcount and salary increases as we increased our investment in technology and engineering support. These increases are partially offset by a decrease in stock-based compensation expenses of \$429,000. For the foreseeable future, we expect cost of revenue, exclusive of stock-based

**Table of Contents**

compensation, to increase in absolute dollars as our investment in headcount and other expenses grows.

*Sales and Marketing.* Our sales and marketing expenses increased approximately 13%, from \$2.2 million in the three months ended September 30, 2004 to \$2.6 million in the three months ended September 30, 2005. This reflects an increase in expenses for marketing and promotion of our services of \$86,000, an increase in salary expenses of \$62,000 reflecting increased salaries, expanded headcount and higher occupancy costs due to the relocation of our corporate headquarters.

For the nine months ended September 30, 2004 and 2005, sales and marketing expenses increased 21% from \$6.2 million to \$7.5 million. This principally reflects an increase of \$481,000 in domestic and international expenses for marketing and promotion of our subscription services, an increase in sales and marketing salaries of \$355,000 reflecting expanded headcount, increased salaries and higher occupancy costs due to the relocation of our corporate headquarters. Sales and marketing expenses include a decrease in stock-based compensation expense of \$116,000 and \$378,000, respectively, for the three and nine month periods ended September 30, 2005 compared to the same periods in 2004. For the foreseeable future, we expect sales and marketing expenses, exclusive of stock-based compensation, to increase in absolute dollars as we expand our investment in marketing activities.

*General and Administrative.* Our general and administrative expenses increased approximately 13% from \$1.3 million for the three months ended September 30, 2004 to \$1.4 million for the three months ended September 30, 2005. This change principally reflects an increase in insurance and shareholder fees of \$174,000, reflecting the increased costs of being a public company, an increase in occupancy expenses of \$70,000, reflecting the move to new corporate headquarters, and an increase in accounting fees of \$163,000, reflecting the costs of Sarbanes-Oxley Act compliance work performed in the third quarter of 2005. These increases are partially offset by a decrease in stock-based compensation expenses of \$183,000.

For the nine months ended September 30, 2004 and 2005, general and administrative expenses increased approximately 11% from \$3.9 million to \$4.3 million. This change principally reflects an increase in insurance and shareholder fees of \$446,000, reflecting the increased costs of being a public company, an increase in occupancy expenses of \$476,000, reflecting the move to new corporate headquarters, and an increase in accounting fees of \$470,000, reflecting the costs of Sarbanes-Oxley Act compliance. These increases are partially offset by a decrease in stock-based compensation expenses of \$666,000.

*Depreciation and Amortization.* Our depreciation and amortization expenses grew by approximately 22%, from \$645,000 to \$787,000 in the three months ended September 30, 2004 and September 30, 2005, respectively, and by 47%, from \$1.7 million to \$2.5 million for the nine months ended September 30, 2004 and 2005, respectively, primarily reflecting increased investment in our product development and technology infrastructure. For the foreseeable future, we expect depreciation and amortization costs to increase in absolute dollars with the growth of our investment in hardware, software and capitalized development costs.

*Other Income and Expenses.* Our other income and expense grew from net expenses of \$223,000 to net income of \$310,000 in the three months ended September 30, 2004 and 2005, respectively, and from net expenses of \$413,000 to net income of \$769,000 in the nine months ended September 30, 2004 and 2005, respectively. This year-over-year change includes interest income of \$362,000 in the three months ended September 30, 2005 and \$914,000 in the nine months ended September 30, 2005, based on interest earned on the proceeds from our October 2004 initial public offering.

***Liquidity and Capital Resources***

We have historically financed our operations primarily through public and private sales of equity. During the nine months ended September 30, 2004, net cash provided by operating activities was \$2.3 million, and was primarily attributable to the growth of our advertising and premium subscription services, partially offset by \$1.6 million in payments to settle a lease dispute related to our former San Francisco headquarters facility. During the nine months ended September 30, 2005, net cash provided by operating activities was \$4.8 million, primarily due to the growth of our advertising and premium subscription services and collection of a \$1.0 million receivable for tenant improvements, partially offset by a \$1.4 million outflow due to the reduction in our accounts payable and a \$113,000 increase in our accounts receivable balance. On a year-over-year basis, our accounts payable balance declined by \$1.4 million and our accounts receivable balance increased by \$805,000.

Net cash used in investing activities was \$2.1 million for the nine months ended September 30, 2004, and was primarily attributable to purchases of property and equipment. Net cash used in investing activities was \$3.2 million for the nine months ended September 30, 2005, and was primarily attributable to purchases of hardware, software, property and equipment,

**Table of Contents**

including \$715,000 for capitalization of internally developed software and \$830,000 for capitalization of external product development. While we expect to continue to invest in development and infrastructure in 2005, we also expect to be able to realize tenant improvement allowances associated with the move of our corporate headquarters in the third quarter of 2004.

Net cash provided by financing activities in the nine months ended September 30, 2004 was \$3.1 million and was primarily attributable to the raising of a \$5.0 million senior subordinated promissory note, net of payments of capitalized lease obligations. This note was subsequently repaid in October 2004, following our initial public offering. Net cash used by financing activities in the nine months ended September 30, 2005 was \$499,000 and was primarily attributable to payments of capital lease obligations offset by interest income on the proceeds from our initial public offering. As of September 30, 2005, we had cash and cash equivalents of approximately \$44.1 million.

On November 8, 2005, we acquired substantially all of the assets of LPI Media Inc., SpecPub, Inc. and Triangle Marketing Services, Inc., privately held companies serving the LGBT community, for a purchase price of approximately \$31.1 million which consisted of \$24.0 million paid in cash and approximately \$7.1 million in the form of a note to the sellers secured by the assets of SpecPub, Inc. and payable in three equal installments in May, August and November 2007, and the reimbursement of certain prepaid and other expenses of approximately \$1.0 million.

Our capital requirements depend on many factors, including growth of our revenue, the resources we devote to developing, marketing and selling our services, the timing and extent of our introduction of new features and services, the extent and timing of potential investments or acquisitions and other factors. In particular, our premium membership services consist of prepaid subscriptions that provide cash flows in advance of the actual provision of services. We expect to devote substantial capital resources to expand our product development and marketing efforts, to expand internationally, to complete acquisitions, joint ventures and strategic alliances and for other general corporate activities. In the nine months ended September 30, 2005, we devoted approximately \$715,000 to capitalized labor on internal product development and \$830,000 to capitalized external product development as well as \$2.3 million to advertise and market our products and services both domestically and internationally.

Based on our current operations and planned growth, we expect that our available funds and anticipated cash flows from operations, together with the proceeds from our initial public offering, will be sufficient to meet our expected needs for working capital and capital expenditures for the next twelve months. If we do not have sufficient cash available to finance our operations or potential additional acquisitions, we may be required to obtain additional public or private debt or equity financing. We cannot be certain that additional financing will be available to us on favorable terms when required or at all. If we are unable to raise sufficient funds, we may need to reduce our planned operations and expansion activities.

**Off-balance Sheet Liabilities**

We did not have any off-balance sheet liabilities as of September 30, 2005.

**Other Contractual Commitments**

The following table summarizes our contractual obligations as of September 30, 2005:

	Total	Payments Due by Period			2010 & After
		Remainder of 2005	2006-2007	2008-2009	
			(In thousands)		
<b>Contractual obligations:</b>					
Capital lease obligations	\$ 734	\$ 138	\$ 479	\$ 116	\$ 1
Operating leases	11,266	384	3,735	3,724	3,423
Purchase obligations	315	173	142		
Total contractual obligations:	\$ 12,315	\$ 695	\$ 4,356	\$ 3,840	\$ 3,424

*Capital Lease Obligations.* We hold property and equipment under noncancelable capital leases with varying maturities.



*Operating Leases.* We lease or sublease office space and equipment under cancelable and noncancelable operating leases with various expiration dates through January 20, 2012. In 2002, we terminated our headquarters lease which resulted in a decrease in our rent expense in 2003 compared to 2002. In July 2004, we entered into a new lease for our executive headquarters expiring in January 2012. The new lease is for a larger facility at a higher average cost per square foot and has resulted in an increase in our current occupancy cost. The future minimum lease payments are \$284,000 in 2005; \$1.5 million in 2006; \$1.4 million in 2007; \$1.5 million in 2008 and \$1.5 million in 2009. The lease is cancelable after 2009, with proper notice and payment of a termination fee of \$851,000. We entered into a lease for a new facility for our New York sales office commencing April 1, 2005. The future minimum payments under the terms of this lease are \$50,000 for the remainder of 2005, \$202,000 for 2006, \$206,000 for 2007, \$210,000 for 2008, \$214,000 for 2009 and \$54,000 for 2010. We entered into a lease for a new facility for our London office commencing in July 2005. The future minimum payments under the terms of this

**Table of Contents**

lease are \$41,000 for 2005, \$166,000 per year for 2006 through 2009 and \$83,000 in 2010.

*Purchase Obligations.* In January 2002, we entered into a co-location facility agreement with a third-party service provider. In exchange for providing space for our network servers and committed levels of telecommunications bandwidth, we pay a minimum monthly fee of \$42,000. In the event that bandwidth exceeds an allowed variance from committed levels, we pay for additional bandwidth at a set monthly rate. Future total minimum payments under the co-location facility agreement are \$126,000 for 2005.

In addition, in November 2004, we entered into a software maintenance agreement under which we financed \$332,000 with a vendor. This amount is payable in seven quarterly installments beginning in January 2005. Future total minimum payments under this agreement are \$47,000 for the remainder of 2005 and \$142,000 for 2006.

***Critical Accounting Policies***

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amount of assets, liabilities, revenue and expenses and related disclosure of contingent assets and liabilities.

We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis on which we make judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Because this can vary in each situation, actual results may differ from the estimates under different assumptions and conditions.

We believe the following critical accounting policies require more significant judgments and estimates in the preparation of our consolidated financial statements:

*Capitalized Website Development Costs.* We capitalize the costs of enhancing and developing features for our websites when we believe that the capitalization criteria for these activities have been met in accordance with SOP 98-1 and EITF 00-2 and amortize these costs on a straight-line basis over the estimated useful life of the capitalized application, generally three years. For the three months ended September 30, 2004 and 2005, we capitalized \$569,000 and \$355,000, respectively. For the nine months ended September 30, 2004 and 2005, we capitalized \$1.1 million and \$1.5 million, respectively. We expense the cost of enhancing and developing features for our websites in cost of revenue only when we believe that capitalization criteria have not been met. We exercise judgment in determining when to begin capitalizing costs and the period over which we amortize the capitalized costs. If different judgments were made, it would have an impact on our results of operations.

There have been no significant changes in our critical accounting policies from those listed in our Form 10-K for the fiscal year ended December 31, 2004.

***Seasonality and Inflation***

We anticipate that our business may be affected by the seasonality of certain revenue lines. For example, print and online advertising buys are usually higher approaching year-end and lower at the beginning of a new year than at other points during the year, and sales on Kleptomaniac.com are affected by the holiday season and by the timing of the release of compilations of new seasons of popular television series.

Inflation has not had a significant effect on our revenue or expenses historically and we do not expect it to be a significant factor in the short-term. However, inflation may affect our business in the medium- to long-term. In particular, our operating expenses may be affected by a tightening of the job market, resulting in increased pressure for salary adjustments for existing employees and higher cost of replacement for employees that are terminated or resign.

***Recent Accounting Pronouncements***

In March 2005, the SEC issued Staff Accounting Bulletin No. 107 (SAB No. 107). SAB No. 107 covers key topics related to the implementation of SFAS No. 123(R) which include the valuation models, expected volatility, expected option term, income tax effects of SFAS No. 123(R), classification of stock-based compensation cost, capitalization of compensation costs, and disclosure requirements. We expect the adoption of SAB No. 107 may have a significant adverse impact on our financial position and results of operations upon our adoption of SFAS No. 123(R) in the first quarter of 2006. We are currently in the



**Table of Contents**

process of evaluating the extent of such impact.

In April 2005, the SEC amended the compliance dates for SFAS No. 123(R), Share-Based Payment. The new rule allows public companies to implement SFAS No. 123(R) at the beginning of their next fiscal year that begins after June 15, 2005. We will be required to adopt SFAS No. 123(R) in the first quarter of 2006 and begin to recognize stock-based compensation related to employee equity awards in our condensed consolidated statements of operations using a fair value based method on a prospective basis. Since we currently account for equity awards granted to our employees using the intrinsic value method under APB No. 25, we expect the adoption of SFAS No. 123(R) may have a significant adverse impact on our financial position and results of operations. We are currently in the process of evaluating the extent of such impact.

In June 2005, the FASB's Emerging Issues Task Force reached a consensus on Issue No. 05-6, Determining the Amortization Period for Leasehold Improvements Purchased after Lease Inception or Acquired in a Business Combination ( EITF 05-6 ). This guidance requires that leasehold improvements acquired in a business combination or purchased subsequent to the inception of a lease be amortized over the shorter of the useful life of the assets or a term that includes required lease periods and renewals that are reasonably assured at the date of the business combination or purchase. This guidance is applicable only to leasehold improvements that are purchased or acquired in reporting periods beginning after June 29, 2005. The adoption of EITF Issue No. 05-6 will not have a material impact on our financial position or results of operations.

***Risk Factors***

***We have a history of significant losses. If we do not sustain profitability, our financial condition and stock price could suffer.***

We have experienced significant net losses and we may continue to incur losses in the future given our anticipated increase in sales and marketing expenditures. As of September 30, 2005, our accumulated deficit was approximately \$35.3 million. Although we had positive net income in the three and nine months ended September 30, 2005, we may not be able to sustain or increase profitability in the near future, causing our financial condition to suffer and our stock price to decline.

***If our efforts to attract and retain subscribers are not successful, our revenue will decrease.***

Because most of our revenue is derived from our premium membership services, we must continue to attract and retain subscribers. Many of our new subscribers originate from word-of-mouth referrals from existing subscribers within the LGBT community. If our subscribers do not perceive our service offerings to be of high quality or sufficient breadth, if we introduce new services that are not favorably received or if we fail to introduce compelling new features or enhance our existing offerings, we may not be able to attract new subscribers or retain our current subscribers. Our current content, shopping and personals platforms may not allow us to maximize potential cross-platform synergies and may not provide the most effective platform from which to launch new or improve current services for our members. If there is a delay in our plan to improve and consolidate these platforms, and this delay prevents or delays the development or integration of new features or enhancements to existing features, our subscriber growth could slow. As a result, our revenue would decrease. Our base of likely potential subscribers is also limited to members of the LGBT community, who collectively comprise a small portion of the general adult population.

While seeking to add new subscribers, we must also minimize the loss of existing subscribers. We lose our existing subscribers primarily as a result of cancellations and credit card failures due to expirations or exceeded credit limits. In the three months ended September 30, 2005, our churn rates on our premium membership services, which include subscription cancellations and credit card failures, averaged 7.9% per month excluding cancellations from free trials, or 8.2% including cancellations from free trials. We calculate our average monthly churn over a particular period by dividing the sum of the number of cancellations and credit card failures for that period by the average number of subscribers in that period divided by the number of months in the period. We calculate the average number of subscribers in a given period by adding the number of subscribers at the beginning and the end of the period and dividing by two. Subscribers cancel their subscription to our service for many reasons, including a perception, among some subscribers, that they do not use the service sufficiently, that the service is a poor value and that customer service issues are not satisfactorily resolved. Members may decline to subscribe or existing subscribers may cancel

their subscriptions if our websites experience a disruption or degradation of services, including slow response times or excessive down time due to scheduled or unscheduled hardware or software maintenance or denial of service attacks. We must continually add new subscribers both to replace subscribers who cancel or whose subscriptions are not renewed due to credit card failures and to continue to grow our business beyond our current subscriber

**Table of Contents**

base. If excessive numbers of subscribers cancel our service, we may be required to incur significantly higher marketing expenditures than we currently anticipate to replace these subscribers with new subscribers, which will harm our financial condition.

***Our limited operating history makes it difficult to evaluate our business.***

As a result of our recent growth and limited operating history, it is difficult to forecast our revenue, gross profit, operating expenses, number of subscribers and other financial and operating data. Our inability, or the inability of the financial community at large, to accurately forecast our operating results could cause our subscriber numbers to grow slower or our net profit to be smaller than expected, which could cause a decline in the trading price of our common stock.

***We expect our operating results to fluctuate, which may lead to volatility in our stock price.***

Our operating results have fluctuated in the past and may fluctuate significantly in the future due to a variety of factors, many of which are outside of our control. As a result, we believe that period-over-period comparisons of our operating results are not necessarily meaningful and that you should not rely on the results of one period as an indication of our future or long-term performance. Our operating results in future quarters may be below the expectations of public market analysts and investors, which may result in a decline in our stock price.

***If we fail to manage our growth, our business will suffer.***

We have significantly expanded our operations and anticipate that further expansion will be required to address current and future growth in our customer base and market opportunities. This expansion has placed, and is expected to continue to place, a significant strain on our technological infrastructure, management, operational and financial resources. If we continue to expand our marketing efforts, we may expend cash and create additional expenses, including additional investment in our technological infrastructure, which might harm our financial condition or results of operations. If despite such additional investments our technological infrastructure is unable to keep pace with our subscriber and member growth, members using our services may experience degraded performance and our subscriber growth could slow and our revenue may decline.

***If we are unable to successfully expand our international operations, our business will suffer.***

We offer services and products to the LGBT community outside the United States and we intend to continue to expand our international presence, which may be difficult or take longer than anticipated especially due to international challenges, such as language barriers, currency exchange issues and the fact that the Internet infrastructure in foreign countries may be less advanced than Internet infrastructure in the United States. In September 2005, we began offering our premium services for free for a limited time in some international markets, thereby foregoing some short term revenue in order to develop critical mass in those markets. Expansion into international markets requires significant resources that we may fail to recover by generating additional revenue.

If we are unable to successfully expand our international operations, if our limited time offer of free premium services to some international markets fails to develop critical mass in those markets or, if critical mass is achieved in those markets and members are then unwilling to pay for our premium services after the limited time offer of free premium services ends, our revenue may decline and our profit margins will be reduced.

***Recent and potential future acquisitions could result in operating difficulties and unanticipated liabilities.***

In early November 2005, we significantly expanded our operations by acquiring substantially all of the assets of LPI Media, Inc. and its related entities ( LPI ). In order to address market opportunities and potential growth in our customer base, we anticipate additional expansion in the future, including possible additional acquisitions of third-party assets, technologies or businesses. Such acquisitions may involve the issuance of shares of stock that dilute the interests of our other stockholders, or require us to expend cash, incur debt or assume contingent liabilities. Our recent acquisition of LPI and potential future acquisitions may be associated with a number of risks, including:

- the difficulty of integrating the acquired assets and personnel of the acquired businesses into our operations;
- the distraction of management during the negotiations and potential disruption of our current operations;
- the potential impairment of relationships with and difficulty in attracting and retaining employees of the acquired companies or our employees as a result of the integration of acquired businesses;



**Table of Contents**

the difficulty of integrating the acquired company's accounting, human resources and other administrative systems;

the potential impairment of relationships with subscribers, customers and partners of the acquired companies or our subscribers, customers and partners as a result of the integration of acquired businesses;

the difficulty in attracting and retaining qualified management to lead the combined businesses;

the potential difficulties associated with entering new lines of business with which we have little experience, such as some of the businesses we acquired from LPI;

the difficulty of complying with additional regulatory requirements that may become applicable to us as the result of an acquisition, such as various regulations that may become applicable to us as a result of our acquisition of LPI, including the acquisition of a related entity that produces some content and other materials intended for mature audiences;

the impact of known or unknown liabilities associated with the acquired businesses.

If we are unable to successfully address these or other risks associated with our recent acquisition of LPI or potential future acquisitions, we may be unable to realize the anticipated synergies and benefits of our acquisitions, which could adversely affect our financial condition and results of operations.

***If we do not continue to attract and retain qualified personnel, we may not be able to expand our business.***

Our success depends on the collective experience of our senior executive team and on our ability to hire, train, retain and manage other highly skilled employees. Disruptions in our senior executive team could harm our business and financial results or limit our ability to grow and expand our business. We cannot provide assurance that we will be able to attract and retain a sufficient number of qualified employees or that we will successfully train and manage the employees that we do hire.

***Our success depends, in part, upon the growth of Internet advertising and upon our ability to accurately predict the cost of customized campaigns.***

We compete with traditional media including television, radio and print, in addition to high-traffic websites, such as those operated by Yahoo!, Google, AOL and MSN, for a share of advertisers' total online advertising expenditures. We face the risk that advertisers might find the Internet to be less effective than traditional media in promoting their products or services, and as a result they may reduce or eliminate their expenditures on Internet advertising. Many potential advertisers and advertising agencies have only limited experience advertising on the Internet and historically have not devoted a significant portion of their advertising expenditures to Internet advertising. Additionally, filter software programs that limit or prevent advertisements from being displayed on or delivered to a user's computer are becoming increasingly available. If this type of software becomes widely accepted, it would negatively affect Internet advertising. Our business could be harmed if the market for Internet advertising does not grow.

Currently, we offer advertisers a number of alternatives to advertise their products or services on our websites and to our members, including banner advertisements, rich media advertisements, email campaigns, text links and sponsorships of our channels, topic sections, directories, sweepstakes, awards and other online databases and content. Frequently, advertisers request advertising campaigns consisting of a combination of these offerings, including some that may require custom development. If we are unable to accurately predict the cost of developing these custom campaigns for our advertisers, our expenses will increase and our margins will be reduced.

***If advertisers do not find the LGBT market to be economically profitable, our business will be harmed.***

We focus our services exclusively on the LGBT community. Advertisers and advertising agencies may not consider the LGBT community to be a broad enough or profitable enough market for their advertising budgets, and they may prefer to direct their online advertising expenditures to larger higher-traffic websites that focus on broader markets. If we are unable to attract new advertisers, if our advertising campaigns are unsuccessful with the LGBT



community or if our existing advertisers do not renew their contracts with us, our revenue will decrease and operating results will suffer.

**Table of Contents*****Any significant disruption in service on our websites or in our computer and communications hardware and software systems could harm our business.***

Our ability to attract new visitors, members, subscribers, advertisers and other customers to our websites is critical to our success and largely depends upon the efficient and uninterrupted operation of our computer and communications hardware and software systems. Our systems and operations are vulnerable to damage or interruption from power outages, computer and telecommunications failures, computer viruses, security breaches, catastrophic events and errors in usage by our employees and customers, which could lead to interruption in our service and operations, and loss, misuse or theft of data. Our websites could also be targeted by direct attacks intended to cause a disruption in service or to siphon off customers to other Internet services. Among other risks, our chat rooms may be vulnerable to infestation by software programs or scripts that we refer to as adbots. An adbot is a software program that creates a registration profile, enters a chat room and displays third-party advertisements. Our members' email accounts could be compromised by phishing or other means, and used to send spam email messages clogging our email servers and disrupting our members ability to send and receive email. Any successful attempt by hackers to disrupt our websites services or our internal systems could harm our business, be expensive to remedy and damage our reputation, resulting in a loss of visitors, members, subscribers, advertisers and other customers.

***If we are unable to compete effectively, we may lose market share and our revenue may decline.***

Our markets are intensely competitive and subject to rapid change. We compete with a number of large and small companies, such as vertically integrated Internet portals and specialty focused media that provide online and offline products and services to the LGBT community. In our subscription business, we compete with other online services, such as those offered by Match.com and Yahoo! Personals, as well as an increasing number of other smaller but rapidly growing online companies focused specifically on the LGBT community. In our online advertising business, we compete with a broad variety of content providers. We also compete with offline LGBT media companies, including local newspapers, national and regional magazines, satellite radio and television shows. If we are unable to successfully compete with current and new competitors, we may not be able to achieve or maintain adequate market share, increase our revenue or achieve and maintain profitability.

Some of these competitors have longer operating histories, larger customer bases, greater brand recognition and significantly greater financial, marketing and other resources than we do. Some of our competitors have adopted, and may continue to adopt, aggressive pricing policies and devote substantially more resources to marketing than we do. Some of our competitors have invested and may continue to invest heavily in technology development, thereby improving their existing services or offerings or introducing new services or offerings more quickly than we are able to do. The rapid growth of our online subscription business since our inception may attract direct competition from larger companies with significantly greater financial resources and national brand recognition, such as InterActiveCorp, Microsoft, Time Warner, Viacom or Yahoo! which may choose to increase their focus on the LGBT market. Increased competition may result in reduced operating margins, loss of market share and reduced revenue.

***If we are unable to protect our domain names, our reputation and brand could be harmed if third parties gain rights to, or use, these domain names in a manner that would confuse or impair our ability to attract and retain customers.***

We have registered various domain names relating to our brand, including Gay.com, PlanetOut.com, Kleptomaniac.com and OutandAbout.com. If we fail to maintain these registrations, a third party may be able to gain rights to or cause us to stop using these domain names, which will make it more difficult for users to find our websites and our service. For example, the injunction issued in the DIALINK matter has forced us to temporarily change our domain name in France during our appeal of that decision and may make it more difficult for French users to find our French website. The acquisition and maintenance of domain names are generally regulated by governmental agencies and their designees. The regulation of domain names in the United States may change in the near future. Governing bodies may designate additional top-level domains, such as .eu, in addition to currently available domains such as .biz, .net or .tv, for example, appoint additional domain name registrars or modify the requirements for holding domain names. As a result, we may be unable to acquire or maintain relevant domain names. If a third party acquires domain names similar to ours and engages in a business that may be harmful to our reputation or confusing to our subscribers and other customers, our revenue may decline, and we may incur additional expenses in maintaining our brand and

defending our reputation. Furthermore, the relationship between regulations governing domain names and laws protecting trademarks and similar proprietary rights is unclear. We may be unable to prevent third parties from acquiring domain names that are similar to, infringe upon or otherwise decrease the value of our trademarks and other proprietary rights.

***If we fail to adequately protect our trademarks and other proprietary rights, or if we get involved in intellectual property litigation, our revenue may decline and our expenses may increase.***

We rely on a combination of confidentiality and license agreements with our employees, consultants and third parties with whom we have relationships, as well as trademark, copyright and trade secret protection laws, to protect our proprietary rights. If the protection of our proprietary rights is inadequate to prevent use or appropriation by third parties, the value of our brand

**Table of Contents**

and other intangible assets may be diminished, competitors may be able to more effectively mimic our service and methods of operations, the perception of our business and service to subscribers and potential subscribers may become confused in the marketplace and our ability to attract subscribers and other customers may suffer, resulting in loss of revenue.

The Internet content delivery market is characterized by frequent litigation regarding patent and other intellectual property rights. As a publisher of online content, we face potential liability for negligence, copyright, patent or trademark infringement or other claims based on the nature and content of materials that we publish or distribute. For example, we have received, and may receive in the future, notices or offers from third parties claiming to have intellectual property rights in technologies that we use in our businesses and inviting us to license those rights. Litigation may be necessary in the future to enforce our intellectual property rights, to protect our trade secrets, to determine the validity and scope of the proprietary rights of others or to defend against claims of infringement or invalidity, and we may not prevail in any future litigation. Adverse determinations in litigation could result in the loss of our proprietary rights, subject us to significant liabilities, require us to seek licenses from third parties or prevent us from licensing our technology or selling our products, any of which could seriously harm our business. An adverse determination could also result in the issuance of a cease and desist order, which may force us to discontinue operations through our website or websites. For example, the injunction issued in the DIALINK matter has forced us to temporarily change our domain name in France, during our appeal of that decision and may make it more difficult for French users to find our French website. Intellectual property litigation, whether or not determined in our favor or settled, could be costly, could harm our reputation and could divert the efforts and attention of our management and technical personnel from normal business operations.

***Existing or future government regulation in the United States and other countries could limit our growth and result in loss of revenue.***

We are subject to federal, state, local and international laws affecting companies conducting business on the Internet, including user privacy laws, regulations prohibiting unfair and deceptive trade practices and laws addressing issues such as freedom of expression, pricing and access charges, quality of products and services, taxation, advertising, intellectual property rights, display and production of material intended for mature audiences and information security. In particular, we are currently required, or may in the future be required, to:

conduct background checks on our members prior to allowing them to interact with other members on our websites or, alternatively, provide notice on our websites that we have not conducted background checks on our members, which may result in our members canceling their membership or failing to subscribe or renew their subscription, resulting in reduced revenue;

provide advance notice of any changes to our privacy policies or to our policies on sharing non-public information with third parties, and if our members or subscribers disagree with these policies or changes, they may wish to cancel their membership or subscription, which will reduce our revenue;

with limited exceptions, give consumers the right to prevent sharing of their non-public personal information with unaffiliated third parties, and if a significant portion of our members choose to request that we don't share their information, our advertising revenue that we receive from renting our mailing list to unaffiliated third parties may decline;

provide notice to residents in some states if their personal information was, or is reasonably believed to have been, obtained by an unauthorized person such as a computer hacker, which may result in our members or subscribers deciding to cancel their membership or subscription, reducing our membership base and subscription revenue;

comply with current or future anti-spam legislation by limiting or modifying some of our marketing and advertising efforts, such as email campaigns, which may result in a reduction in our advertising revenue; for instance, two states recently passed legislation creating a do not contact registry for minors that would make it

a criminal violation to send an e-mail message to an address on that state's registry if the e-mail message contained an advertisement for or even a link to a website that offered products or services that minors are prohibited from accessing;

comply with the European Union privacy directive and other international regulatory requirements by modifying the ways in which we collect and share our users' personal information; if these modifications render our services less attractive to our members or subscribers, for example by limiting the amount or type of personal information our members or subscribers could post to their profiles, they may cancel their memberships or subscriptions, resulting in reduced revenue;

qualify to do business in various states and countries, in addition to jurisdictions where we are currently qualified, because our websites are accessible over the Internet in multiple states and countries, which if we fail to so qualify, may prevent us

**Table of Contents**

from enforcing our contracts in these states or countries and may limit our ability to grow our business;

limit our domestic or international expansion because some jurisdictions may limit or prevent access to our services as a result of the availability of some content intended for mature viewing on some of our websites and through some of the businesses we acquired from LPI Media Inc., which may render our services less attractive to our members or subscribers and result in a decline in our revenue; and

limit or prevent access, from some jurisdictions, to some or all of the member-generated content available through our websites, which may render our services less attractive to our members or subscribers and result in a decline in our revenue. For example, in June 2005, the United States Department of Justice (the DOJ) adopted regulations purporting to implement the Child Protection and Obscenity Act of 1988, as amended (the Act), by requiring primary and secondary producers, as defined in the regulations, of certain adult materials to obtain, maintain and make available for inspection specified records, such as a performer's name, address and certain specified forms of photo identification as proof of a performer's age. Failure to properly obtain, maintain or make such records available for inspection upon request of the DOJ could lead to an imposition of penalties, fines or imprisonment. We could be deemed a secondary producer under the Act because we allow our members to display photographic images on our websites as part of member profiles. In addition, we may be deemed a primary producer under the Act because a portion of one of the businesses we acquired in the LPI acquisition are involved in production of content intended for mature audiences. Enforcement of these regulations has been stayed pending resolution of a legal challenge to their constitutionality on the grounds that the regulations exceed the DOJ's statutory authority and violate First Amendment and privacy rights, among others. If the legal challenge is unsuccessful, we will be subject to significant and burdensome recordkeeping compliance requirements and/or we will have to evaluate and implement additional registration and recordkeeping processes and procedures, each of which would result in additional expenses to us. Further, if our members and subscribers feel these additional registration and recordkeeping processes and procedures are too burdensome, this may result in an adverse impact on our subscriber growth and churn which, in turn, will have an adverse effect on our financial condition and results of operations.

The restrictions imposed by, and costs of complying with, current and possible future laws and regulations related to our business could limit our growth and reduce our membership base, revenue and profit margins.

***The risks of transmitting confidential information online, including credit card information, may discourage customers from subscribing to our services or purchasing goods from us.***

In order for the online marketplace to be successful, we and other market participants must be able to transmit confidential information, including credit card information, securely over public networks. Third parties may have the technology or know-how to breach the security of our customer transaction data. Any breach could cause consumers to lose confidence in the security of our websites and choose not to subscribe to our services or purchase goods from us. We cannot guarantee that our security measures will effectively prohibit others from obtaining improper access to our information or that of our users. If a person is able to circumvent our security measures, he or she could destroy or steal valuable information or disrupt our operations. Any security breach could expose us to risks of data loss, litigation and liability and may significantly disrupt our operations and harm our reputation, operating results or financial condition.

***If we are unable to provide satisfactory customer service, we could lose subscribers.***

Our ability to provide satisfactory customer service depends, to a large degree, on the efficient and uninterrupted operation of our customer service center. Any significant disruption or slowdown in our ability to process customer calls resulting from telephone or Internet failures, power or service outages, natural disasters or other events could make it difficult or impossible to provide adequate customer service and support. Further, we may be unable to attract and retain adequate numbers of competent customer service representatives, which is essential in creating a favorable interactive customer experience. If we are unable to continually provide adequate staffing for our customer service operations, our reputation could be harmed and we may lose existing and potential subscribers. In addition, we cannot assure you that email and telephone call volumes will not exceed our present system capacities. If this occurs, we

could experience delays in responding to customer inquiries and addressing customer concerns.

***We may be the target of negative publicity campaigns or other actions by advocacy groups that could disrupt our operations because we serve the LGBT community.***

Advocacy groups may target our business through negative publicity campaigns, lawsuits and boycotts seeking to limit access to our services or otherwise disrupt our operations because we serve the LGBT community. These actions could impair

**Table of Contents**

our ability to attract and retain customers, especially in our advertising business, resulting in decreased revenue, and cause additional financial harm by requiring that we incur significant expenditures to defend our business and by diverting management's attention. Further, some investors, investment banking entities, market makers, lenders and others in the investment community may decide not to invest in our securities or provide financing to us because we serve the LGBT community, which, in turn, may hurt the value of our stock.

***If one or more states or countries successfully assert that we should collect sales or other taxes on the use of the Internet or the online sales of goods and services, our expenses will increase, resulting in lower margins.***

In the United States, federal and state tax authorities are currently exploring the appropriate tax treatment of companies engaged in online commerce, and new state tax regulations may subject us to additional state sales and income taxes, which could increase our expenses and decrease our profit margins.

In 2003, the European Union implemented new rules regarding the collection and payment of value added tax, or VAT. These rules require VAT to be charged on products and services delivered over electronic networks, including software and computer services, as well as information and cultural, artistic, sporting, scientific, educational, entertainment and similar services. These services are now being taxed in the country where the purchaser resides rather than where the supplier is located. Historically, suppliers of digital products and services that existed outside the European Union were not required to collect or remit VAT on digital orders made to purchasers in the European Union. With the implementation of these rules, we are required to collect and remit VAT on digital orders received from purchasers in the European Union, effectively reducing our revenue by the VAT amount because we currently do not pass this cost on to our customers.

We also do not currently collect sales, use or other similar taxes for sales of our subscription services or for physical shipments of goods into states other than California. In the future, one or more local, state or foreign jurisdictions may seek to impose sales, use or other tax collection obligations on us. If these obligations are successfully imposed upon us by a state or other jurisdiction, we may suffer decreased sales into that state or jurisdiction as the effective cost of purchasing goods or services from us will increase for those residing in these states or jurisdictions.

***We may need additional capital and may not be able to raise additional funds on favorable terms or at all, which could increase our costs, limit our ability to grow and dilute the ownership interests of existing stockholders.***

We anticipate that we may need to raise additional capital in the future to facilitate long-term expansion, to respond to competitive pressures or to respond to unanticipated financial requirements. We cannot be certain that we will be able to obtain additional financing on commercially reasonable terms or at all. If we raise additional funds through the issuance of equity, equity-related or debt securities, these securities may have rights, preferences or privileges senior to those of the rights of our common stock, and our stockholders will experience dilution of their ownership interests. A failure to obtain additional financing or an inability to obtain financing on acceptable terms could require us to incur indebtedness that has high rates of interest or substantial restrictive covenants, issue equity securities that will dilute the ownership interests of existing stockholders, or scale back, or fail to address opportunities for expansion or enhancement of, our operations. We cannot assure you that we will not require additional capital in the near future.

***Our executive offices and our data center are located in the San Francisco Bay area. In the event of an earthquake, other natural or man-made disaster, or power loss, our operations could be interrupted, resulting in lower revenue.***

Our executive offices and our data center are located in the San Francisco Bay area. Our business and operations could be disrupted in the event of electrical blackouts, fires, floods, earthquakes, power losses, telecommunications failures, break-ins or similar events. Because the San Francisco Bay area is located in an earthquake-sensitive area, we are particularly susceptible to the risk of damage to, or total destruction of, our systems and infrastructure. We are not insured against any losses or expenses that arise from a disruption to our business due to earthquakes. Further, the State of California has experienced deficiencies in its power supply over the last few years, resulting in occasional rolling blackouts. If rolling blackouts or other disruptions in power occur, our business and operations could be disrupted, and we will lose revenue.

***Recent and proposed regulations related to equity compensation could adversely affect our ability to attract and retain key personnel.***



We have used stock options and other long-term incentives as a fundamental component of our employee compensation packages. We believe that stock options and other long-term equity incentives directly motivate our employees to maximize long-term stockholder value and, through the use of vesting, encourage employees to remain with our company. Several

**Table of Contents**

regulatory agencies and entities are considering regulatory changes that could make it more difficult or expensive for us to grant stock options to employees. For example, the Financial Accounting Standards Board has adopted changes to the U.S. generally accepted accounting principles that will require us to record a charge to earnings for employee stock option grants. In addition, regulations implemented by the Nasdaq National Market generally requiring stockholder approval for all stock option plans could make it more difficult for us to grant options to employees in the future. To the extent that new regulations make it more difficult or expensive to grant stock options to employees, we may incur increased compensation costs, change our equity compensation strategy or find it difficult to attract, retain and motivate employees, each of which could materially and adversely affect our business.

***In the event we are unable to satisfy regulatory requirements relating to internal control over financial reporting, or if these internal controls are not effective, our business and our stock price could suffer.***

Section 404 of the Sarbanes-Oxley Act of 2002 requires companies to do a comprehensive and costly evaluation of their internal controls. As a result, our management will be required to perform an evaluation of our internal control over financial reporting and have our independent registered public accounting firm attest to such evaluations. We have prepared an internal plan of action for compliance, which includes a timeline and scheduled activities with respect to preparation of such evaluation. Our efforts to comply with Section 404 and related regulations regarding our management's required assessment of internal control over financial reporting and our independent registered public accounting firm's attestation of that assessment has required, and continues to require, the commitment of significant financial and managerial resources. If we fail to timely complete this evaluation, or if our independent registered public accounting firm cannot timely attest to our evaluation, we could be subject to regulatory scrutiny and a loss of public confidence in our internal controls, which could have an adverse effect on our business and our stock price.

***Our stock price may be volatile and you may lose all or a part of your investment.***

Since our initial public offering in October 2004, our stock price has been and may continue to be subject to wide fluctuations. From October 14, 2004 through September 30, 2005, the closing sale prices of our common stock on the Nasdaq ranged from \$6.25 to \$13.60 per share. Our stock price may fluctuate in response to a number of events and factors, such as quarterly variations in our operating results, changes in financial estimates and recommendations by securities analysts and the operating and stock price performance of other companies that investors or analysts deem comparable to us.

In addition, the stock markets have experienced significant price and trading volume fluctuations, and the market prices of Internet-related and e-commerce companies in particular have been extremely volatile and have recently experienced sharp share price and trading volume changes. These broad market fluctuations may impact the trading price of our common stock. In the past, following periods of volatility in the market price of a public company's securities, securities class action litigation has often been instituted against that company. This type of litigation could result in substantial costs to us and a likely diversion of our management's attention.

***Provisions in our charter documents and under Delaware law could discourage a takeover that stockholders may consider favorable.***

Our charter documents may discourage, delay or prevent a merger or acquisition that a stockholder may consider favorable because they will:

- authorize our board of directors, without stockholder approval, to issue up to 5,000,000 shares of undesignated preferred stock;

- provide for a classified board of directors;

- prohibit our stockholders from acting by written consent;

- establish advance notice requirements for proposing matters to be approved by stockholders at stockholder meetings; and

- prohibit stockholders from calling a special meeting of stockholders.

As a Delaware corporation, we are also subject to Delaware law anti-takeover provisions. Under Delaware law, a corporation may not engage in a business combination with any holder of 15% or more of its capital stock unless the holder has held the stock for three years or, among other things, the board of directors has approved the transaction. Our board of directors could rely on Delaware law to prevent or delay an acquisition of us.

**Table of Contents**

**Item 3. Qualitative and Quantitative Disclosures About Market Risk**

The primary objective of our investment activities is to preserve principal while at the same time maximizing yields without significantly increasing risk. To achieve this objective, we maintain our portfolio in primarily money market funds.

We do not use derivative financial instruments in our investment portfolio and have no foreign exchange contracts. Our financial instruments consist of cash and cash equivalents, trade accounts receivable, accounts payable and long-term obligations. We consider investments in highly-liquid instruments purchased with a remaining maturity of 90 days or less at the date of purchase to be cash equivalents. Our exposure to market risk for changes in interest rates relates primarily to our short-term investments and short-term obligations; thus, fluctuations in interest rates may have a material impact on the fair value of these securities. A hypothetical 1% increase or decrease in interest rates would increase (decrease) our earnings or loss by approximately \$106,000 per quarter.

Our operations have been conducted primarily in United States currency and as such have not been subject to material foreign currency exchange rate risk. However, the growth in our international operations is increasing our exposure to foreign currency fluctuations as well as other risks typical of international operations, including, but not limited to differing economic conditions, changes in political climate, differing tax structures and other regulations and restrictions. Accordingly, our future results could be materially adversely impacted by changes in these or other factors. We translate income statement amounts that are denominated in foreign currency into U.S. dollars at the average exchange rates in each applicable period. To the extent the U.S. dollar weakens against foreign currencies, the translation of these foreign currency denominated transactions results in increased net revenue operating expenses and net income. Conversely, our net revenue operating expenses and net income will decrease when the U.S. dollar strengthens against foreign currencies. The effect of foreign exchange rate fluctuations for 2004 and the first nine months of 2005 were not material.

**Item 4. Controls and Procedures**

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's 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.

As of September 30, 2005, the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective at the reasonable-assurance level.

There has been no change in our internal control over financial reporting during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**Table of Contents****PART II OTHER INFORMATION****Item 1. Legal Proceedings.**

In April 2002, we were notified that DIALINK, a French company, had filed a lawsuit in France against us and our French subsidiary, alleging that we had improperly used the domain names Gay.net, Gay.com and fr.gay.com in France, as DIALINK alleges that it has exclusive rights to use the word gay as a trademark in France. On June 30, 2005, the French court found that although we had not infringed DIALINK's trademark, we had damaged DIALINK through unfair competition. The Court ordered us to pay damages of 50,000 (US \$60,000 at September 30, 2005), half to be paid notwithstanding appeal, the other half to be paid after appeal. The Court also enjoined us from using gay as a domain name for our services in France. In October 2005, we paid half the damage award as required by the court order and temporarily changed the domain name of our French website, from www.fr.gay.com to www.ooups.com, a domain name we have used previously in France. This temporary change may make it more difficult for French users to locate our French website. We have accrued the full damage award and plan to appeal the French court's decision.

We are not currently subject to any additional significant legal proceedings. We may from time to time, however, become a party to various legal proceedings, arising in the ordinary course of business. We may also be indirectly affected by administrative or court proceedings or actions in which we are not involved but which have general applicability to the Internet industry. We do not believe, based on current knowledge, that current legal proceedings or claims are likely to have a material adverse effect on our financial position, results of operations or cash flows.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.**

On October 13, 2004, a registration statement on Form S-1 (No. 333-114988) was declared effective by the Securities and Exchange Commission, pursuant to which 5,347,500 shares of common stock were offered and sold by us at a price of \$9.00 per share, generating total proceeds, net of underwriting discounts and commissions and issuance costs of approximately \$42.9 million. In connection with the offering, we incurred approximately \$2.9 million in underwriting discounts and commissions and approximately \$1.9 million in other related expenses. The managing underwriters were SG Cowen & Co., LLC, RBC Capital Markets Corporation and WR Hambrecht + Co, LLC. We have used the net proceeds from our initial public offering to invest in short-term, investment grade interest-bearing securities, to pay off the principal and interest under our senior subordinated promissory note and for working capital needs. We may use a portion of the net proceeds to acquire or invest in products and technologies that are complementary to our own, although no portion of the net proceeds has been allocated for any specific acquisition. None of the net proceeds of the initial public offering were paid directly or indirectly to any director, officer, general partner of PlanetOut or their associates, persons owning 10% or more of any class of our or our affiliates' equity securities.

From the time of receipt through December 31, 2004, the proceeds were applied toward repayment of the principal and interest of the senior subordinated note in the amount of \$5,031,000. The remaining proceeds of \$37,869,000 are being used as working capital and are included within cash and cash equivalents. We expect that the use of the remaining proceeds will conform to the intended use of proceeds as described in our initial public offering prospectus filed on October 14, 2004.

**Issuer Purchases of Equity Securities.**

Period	(a) Total Number of Shares Purchased (1)	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs
July 1, 2005				
July 31, 2005		\$		

August 1, 2005	
August 31, 2005	\$
September 1, 2005	
September 30, 2005	\$
Total	\$

(1) PlanetOut does not have any publicly announced plans or programs to repurchase shares of its common stock.

**Table of Contents**

**Item 3. Defaults Upon Senior Securities.**

Not Applicable.

**Item 4. Submission of Matters to a Vote of Security Holders.**

No matters were submitted to a vote of securityholders during the third quarter of 2005.

**Item 5. Other Information.**

Not Applicable.

Page 30

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**Table of Contents**

**Item 6. Exhibits**

**(a) Exhibits**

**Exhibit**

**Number**

**Description of Documents**

- 3.1 Amended and Restated Certificate of Incorporation, as currently in effect (filed as Exhibit 3.3 to our Registration Statement on Form S-1, File No. 333-114988, initially filed on April 29, 2004, declared effective on October 13, 2004, and incorporated herein by reference).
- 3.2 Amended and Restated Bylaws, as currently in effect (filed as Exhibit 3.4 to our Registration Statement on Form S-1, File No. 333-114988, initially filed on April 29, 2004, declared effective on October 13, 2004, and incorporated herein by reference).
- 4.1 Specimen of Common Stock Certificate (filed as Exhibit 4.1 to our Registration Statement on Form S-1, File No. 333-114988, initially filed on April 29, 2004, declared effective on October 13, 2004, and incorporated herein by reference).
- 31.1 Certificate of Chief Executive Officer pursuant to the Securities Exchange Act Rules 13a-14(a) and 15d-14(a) as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certificate of Chief Financial Officer pursuant to the Securities Exchange Act Rules 13a-14(a) and 15d-14(a) as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certificate of Chief Executive Officer pursuant to Section 18 U.S.C section 1350.
- 32.2 Certificate of Chief Financial Officer pursuant to Section 18 U.S.C. section 1350.



**Table of Contents**

**SIGNATURES**

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

**PLANETOUT INC.**

Date: November 11, 2005

By: /s/ Jeffrey T. Soukup  
Jeffrey T. Soukup  
*Chief Financial Officer*  
*(Principal Financial and Accounting Officer)*

Page 32

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**Table of Contents**

**EXHIBIT INDEX**

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