REALNETWORKS INC
Form POS AM
June 27, 2005

Table of Contents

As filed with the Securities and Exchange Commission on June 27, 2005

Registration No. 333-108777

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Post-Effective
Amendment No. 4 to
Form S-3
REGISTRATION STATEMENT
UNDER
THE SECURITIES ACT OF 1933
RealNetworks, Inc.
(Exact name of Registrant as specified in its charter)

Washington	**2601 Elliott Avenue, Suite 1000**	**91-1628146**
(State or other jurisdiction of incorporation or organization)	**Seattle, Washington 98121**	*(I.R.S. Employer Identification Number)*
	(206) 674-2700	

(Address, including zip code, and telephone number, including area code, of Registrant s principal executive offices)

Robert Kimball
Senior Vice President, Legal and Business Affairs,
General Counsel and Corporate Secretary
RealNetworks, Inc.
2601 Elliott Avenue, Suite 1000
Seattle, Washington 98121
(206) 674-2700
(Name, address, including zip code, and telephone number, including area code, of agent for service)

Copies to:
Patrick J. Schultheis, Esq.
Christian E. Montegut, Esq.
Wilson Sonsini Goodrich & Rosati
Professional Corporation
701 Fifth Avenue, Suite 5100
Seattle, Washington 98104-7036
(206) 883-2699

Approximate date of commencement of proposed sale to the public: From time to time after the effective date of this Registration Statement.

If the only securities being registered on this Form are being offered pursuant to dividend or interest reinvestment plans, please check the following box. o

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, other than securities offered only in connection with dividend or interest reinvestment plans, check the following box. þ

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If delivery of the prospectus is expected to be made pursuant to Rule 434, please check the following box. o

The Registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the Registrant shall file a further amendment which specifically states that this Registration Statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933 or until the Registration Statement shall become effective on such date as the Commission, acting pursuant to said Section 8(a), may determine.

Table of Contents

The information in this prospectus is not complete and may be changed. These securities may not be sold until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and it is not soliciting an offer to buy these securities in any jurisdiction where the offer or sale is not permitted.

SUBJECT TO COMPLETION DATED , 2005

PROSPECTUS

Registration No. 333-108777

$100,000,000
(aggregate principal amount)
RealNetworks, Inc.
Zero Coupon Convertible Subordinated Notes due July 1, 2010
and
10,756,500 Shares of Common Stock Issuable upon Conversion of the Notes

We issued the notes in a private placement on June 17, 2003. This prospectus will be used by selling securityholders to resell their notes and the common stock issuable upon conversion of their notes. We will not receive any proceeds from this offering.

The notes will mature on July 1, 2010. As described in more detail beginning on page 30 of this prospectus, you may convert the notes into shares of our common stock at any time before the close of business on the date of their maturity unless we have previously repurchased the notes, if:

- on any date on or prior to December 31, 2007, the closing sales price of our common stock for at least 20 trading days in the period of the 30 consecutive trading days ending on the date immediately prior to the eleventh trading day of the following fiscal quarter was more than 110% of the then current conversion price of the notes;
- on any date after December 31, 2007, the closing sales price of our common stock is more than 110% of the then current conversion price of the notes;
- on or after July 1, 2008, we elect to call the notes for redemption;
- specified corporate transactions involving the distribution to all or substantially all of our holders of common stock of rights, options, warrants, cash, assets, debt securities or capital stock should occur;
- we become a party to a consolidation, merger or sale of all or substantially all of our assets, which consolidation, merger or sale constitutes a change in control transaction, as described in this prospectus; and
- subject to the exceptions described in this prospectus, during the five business day period after any five consecutive trading-day period in which the average trading prices for the notes for such five trading-day period was less than 95% of the product of the closing sale price of our shares of common stock on a given day and the then current conversion rate for the notes during that period.

The conversion rate is 107.5650 shares of common stock per each $1,000 principal amount of notes, subject to adjustment in certain circumstances. This is equivalent to a conversion price of approximately $9.30 per share.

The notes are subordinated to our existing and future senior indebtedness and effectively subordinated to all indebtedness and all liabilities of our subsidiaries. As of March 31, 2005, we had no outstanding senior debt, and the aggregate amount of indebtedness and other liabilities of our subsidiaries was approximately $22.6 million (excluding intercompany liabilities).

The interest rate on the notes is zero. The notes do not accrete interest.

On or after July 1, 2008, we may redeem the notes in whole or in part at the redemption prices set forth in this prospectus.

On July 1, 2008, or in the event of a change in control transaction, as described in this prospectus, you may require us to repurchase any notes held by you at the repurchase prices set forth in this prospectus.

The notes are not listed on any securities exchange or included in any automated quotation system. Our common stock is quoted on The Nasdaq National Market under the symbol RNWK. The closing sale price of our common stock on June 24, 2005 was $5.00 per share.

These securities involve a high degree of risk. See Risk Factors beginning on page 6.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

This prospectus is dated , 2005

TABLE OF CONTENTS

	Page
Summary	1
Risk Factors	6
Disclosure Regarding Forward-Looking Statements	23
Use of Proceeds	24
Description of the Notes	24
Description of Capital Stock	40
Certain United States Federal Income Tax Considerations	42
Selling Securityholders	46
Plan of Distribution	50
Legal Matters	52
Experts	52
Where You Can Find More Information	52
EXHIBIT 12.1	
EXHIBIT 23.1	
EXHIBIT 23.2	

You should rely only on the information contained in this document or to which we have referred you. We have not authorized anyone to provide you with information that is different. This document may only be used where it is legal to sell these securities. You should not assume that the information contained in or incorporated by reference in this prospectus is accurate as of any date other than the date on the front of this prospectus.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

Table of Contents

SUMMARY

The following summary is qualified in its entirety by the more detailed information, including our consolidated financial statements and related notes, included in this prospectus and incorporated in this prospectus by reference. You should carefully consider the information set forth in the section entitled Risk Factors. Unless the context otherwise requires, the terms RealNetworks, we, us and our refer to RealNetworks, Inc., a Washington corporation

RealNetworks, Inc.

We are a leading creator of digital media services and software. Consumers use our services and software to find, play, purchase and manage free and premium digital content, including music, video and games. We also develop and market software products and services that enable the creation, distribution and consumption of digital media, including audio and video. Broadcasters, network operators, media companies and enterprises use our products and services to create and deliver digital media to PCs, mobile phones and consumer electronics devices.

We have pioneered the development of technology for the transmission of digital media over the Internet and the use of that technology to create both free and paid consumer services. As broadband adoption continues to spread, we believe that online consumers will increasingly use and purchase digital media services on the Internet as demonstrated by the rapid growth of our music and games businesses in recent periods. We have also developed a suite of software and products for Internet media delivery for sale to business customers, including our RealServer and Helix products. In recent years, we have increasingly focused our consumer business on providing digital content and services to consumers, including the provision of premium subscription services for the delivery of online music, video and games. In 2003, we acquired Listen.Com, Inc. and its Rhapsody music subscription service to strengthen our digital music offerings and in 2004, we acquired GameHouse, Inc., a developer and distributor of downloadable games, to facilitate growth of our games business.

We have used our technology to create a large base of consumers, network operators and content owners who use our products and services to create, send and receive both free and paid content and we have developed a variety of products and services to connect content providers, broadcasters and advertisers with that user base, including our subscription services. Our strategy is to continue to leverage our Internet media technology and our worldwide user base to increase our sales of digital media products, services and advertising.

We were incorporated in the State of Washington in 1994. Our principal executive offices are located at 2601 Elliott Avenue, Suite 1000, Seattle, Washington 98121 and our telephone number at that location is (206) 674-2700. Our website is *www.realnetworks.com*. The information on our website is not incorporated into this prospectus.

RealNetworks is registered in the U.S. Patent and Trademark Office and in other countries as a trademark of RealNetworks, Inc. Other trademarks of RealNetworks, Inc. used herein include RealOne, RealAudio, RealVideo, RealPlayer, RealOne SuperPass and RealArcade. All other trademarks, service marks, registered trademarks, or registered service marks in this prospectus that are not the property of RealNetworks, Inc. are the property of their respective owners.

The Offering

Securities offered	$100,000,000 principal amount of Zero Coupon Convertible Subordinated Notes due July 1, 2010, and shares of common stock issuable upon conversion of the notes.
Interest	Interest on the notes will be zero.

Table of Contents

Conversion

Unless we have previously redeemed, purchased or repurchased the notes, you will have the right, at your option, to convert your notes, in whole or in part, into shares of our common stock prior to maturity, subject to adjustments described herein, at a rate of 107.5650 shares of common stock per $1,000 principal amount of notes (which is equivalent to a conversion price of approximately $9.30 per share), as follows:

you will have such conversion right in a conversion period (as defined in this prospectus) on any date on or prior to December 31, 2007, if the closing sale price of our common stock for at least 20 trading days in the period of the 30 consecutive trading days ending on the first day of such conversion period was more than 110% of the then current conversion price of the notes;

if, on any date after December 31, 2007, the closing sale price of our common stock is more than 110% of the then current conversion price of the notes, then you will have such conversion right at all times thereafter;

you will have the right to convert the notes until the close of business on the business day prior to the redemption date if we elect to call the notes for redemption on or after July 1, 2008;

if we distribute to all or substantially all holders of our common stock rights, options or warrants entitling them to purchase common stock at less than the closing sale price of our common stock on the day preceding the declaration for such distribution;

if we distribute to all or substantially all holders of our common stock cash, assets, debt securities or capital stock, which distribution has a per share value as determined by our board of directors exceeding 10% of the closing sale price of our common stock on the day preceding the declaration for such distribution; or

if we become a party to a consolidation, merger or sale of all or substantially all of our assets that constitutes a change in control transaction as defined in Description of the Notes Repurchase at Option of Holders Upon a Change in Control.

You may also convert your notes into shares of our common stock for the five business day period after any five consecutive trading-day period in which the average trading prices for the notes for such five trading-day period was less than 95% of the average conversion value (as defined in this prospectus) for the notes during that period; provided, however, if, at the time of the conversion, the closing sale price of shares of our common stock is greater than the then current conversion price on the notes and less than or equal to 110% of the then current conversion price on the notes and you surrender your notes for conversion, you will receive, at our option, cash, common stock or a combination of cash and common stock with a value equal to the principal amount of your notes on such conversion date. If we elect to pay you in common stock or in a combination of cash and common stock, our common stock will be valued at 100% of the average closing sale price for

Table of Contents

	the five trading days ending on the third trading day preceding the conversion date. The conversion rate is subject to adjustment upon certain events. See Description of the Notes Conversion Rights.
Subordination	The notes are subordinated to our present and future senior debt, as that term is defined in Description of the Notes Subordination. The notes are also effectively subordinated in right of payment to all indebtedness and other liabilities of our subsidiaries. As of March 31, 2005, we had no outstanding senior debt, and the aggregate amount of indebtedness and other liabilities of our subsidiaries was approximately $22.6 million (excluding intercompany liabilities). The indenture under which the notes were issued does not restrict the incurrence of senior debt by us or the incurrence of indebtedness or liabilities by us or any of our subsidiaries. See Description of the Notes Subordination.
Optional redemption by	On or after July 1, 2008, we have the option to redeem all or a portion of the notes at 100% of the principal amount of the notes. See Description of the Notes Optional Redemption by RealNetworks.
Purchase of the notes at the option of the holder	You may require us to purchase all or a portion of your notes in cash on July 1, 2008, at 100% of the principal amount of the notes. See Description of the Notes Purchase of Notes at the Option of the Holder.
Repurchase at the option of the holders upon a change in control	Upon a change in control, as that term is defined in Description of the Notes Repurchase at Option of Holders Upon a Change in Control, you will have the right, subject to conditions and restrictions, to require us to repurchase some or all of your notes at a price equal to 100% of the principal amount. The repurchase price is payable in cash or, at our option, subject to certain circumstances, in shares of our common stock valued at 95% of the average closing sales prices of the common stock for the five trading days preceding and including the third trading day prior to the repurchase date. See Description of the Notes Repurchase at Option of Holders Upon a Change in Control.
Use of proceeds	We will not receive any of the proceeds from the sale by any selling securityholder of the notes or the underlying common stock into which the notes may be converted.
Events of default	The following are events of default under the indenture for the notes: we fail to pay the principal of any note when due; we fail to pay liquidated damages on any note when due, and such failure continues for 30 days; we fail to provide the notice that we are required to give in the event of a change in control;

Table of Contents

- we fail to perform any other covenant in the indenture and that failure continues for 60 days after written notice to us by the trustee or the holders of at least 25% in aggregate principal amount of outstanding notes;

- we or any of our significant subsidiaries, as defined in the indenture, fail to pay when due, either at its maturity or upon acceleration, any indebtedness under any bonds, debentures, notes or other evidences of indebtedness for money borrowed by us or such subsidiary, or any guarantee thereof, in excess of $25 million if the indebtedness is not discharged, or the acceleration is not annulled, within 30 days after written notice by the trustee or the holders of at least 25% in aggregate principal amount of the outstanding notes; and

- events of bankruptcy, insolvency or reorganization involving us or any significant subsidiary.

See Description of the Notes Events of Default.

Risk Factors

You should read the Risk Factors section, beginning on page 6 of this prospectus, so that you understand the risks associated with an investment in the securities offered with this prospectus.

Table of Contents

Ratio of Earnings to Fixed Charges

The ratio of earnings to fixed charges for each of the periods indicated is as follows:

	Three Months Ended March 31,		Fiscal Year Ended December 31,					
	2004	2005	1999	2000	2001	2002	2003	2004
Ratio of earnings to fixed charges	N/A	1.87	2.73	N/A	N/A	N/A	N/A	N/A
Deficiency of earnings to fixed charges (in 000 s)	$ (10,336)	N/A	N/A	$ (107,155)	$ (78,821)	$ (32,381)	$ (21,307)	$ (22,475)

These computations include us and our consolidated subsidiaries. Ratio of earnings to fixed charges is computed by dividing:

earnings before taxes adjusted for fixed charges by,

fixed charges, which includes interest expense, plus the portion of interest expense under operating leases deemed by us to be representative of the interest factor, plus amortization of debt issuance costs.

Table of Contents

RISK FACTORS

In addition to the other information contained in or incorporated by reference into this prospectus, you should carefully consider the following risk factors before making an investment in the notes or the common stock issuable upon conversion of the notes. If any of the events or circumstances described in the following risks actually occur, our business, financial condition or results of operations could suffer, and the trading price of our common stock and the notes offered by this prospectus could decline. The risks outlined below address many of the risks RealNetworks faces, but it is not an exhaustive list of all of our risks.

Keep these factors in mind when you read forward-looking statements elsewhere in this prospectus and in the documents incorporated by reference into this prospectus. These are statements that relate to our expectations for future events and time periods. Generally, the words, anticipates, expects, intends, plans, believes, seeks, es and similar expressions are intended to identify forward-looking statements. Forward-looking statements involve risks and uncertainties, and future events and circumstances could differ significantly from those anticipated in the forward-looking statements.

Risks Related to Our Consumer Products and Services Business

We have a relatively limited operating history with our online consumer products and services businesses, which make it difficult to evaluate our business.

We have a relatively limited history operating with our online Consumer Products and Services businesses, including our subscription businesses, which now represent over 80% of our revenue. As a result, we have limited financial results from these businesses on which you can assess our future prospects. Our prospects must be considered in light of the risks, expenses and difficulties frequently encountered by companies in new and rapidly evolving businesses. Our Consumer Products and Services revenue and subscriber/user base have grown relatively rapidly in the early phases of the development of these businesses. If these businesses continue to grow, the growth rates we have experienced to date are unlikely to be sustainable.

Our online consumer businesses have generally lower margins than our traditional software license business.

Costs of our online Consumer Products and Services as a percentage of the revenue generated by those businesses are higher than the ratio of costs to revenue in our historical software licensing business. The cost of third party content, in particular, is a substantial percentage of the net revenue we receive from subscribers and end-users and is unlikely to decrease significantly over time as a percentage of net revenue. Our Consumer Products and Services businesses now represent over 80% of our revenue and include our music subscriptions and sales, video subscription services and games subscription and licensing revenue. If our Consumer Products and Services revenue continues to grow as a percentage of our overall revenue, our margins may further decrease which may affect our ability to achieve or sustain profitability.

Our digital content subscription businesses depend on our continuing ability to license compelling content on commercially reasonable terms.

We must continue to obtain compelling digital media content for our video, music and games subscription services in order to maintain and increase subscriptions and subscription service revenue and overall customer satisfaction for these products. In some cases, we have had to pay substantial fees to obtain premium content. In particular, we have had to pay substantial fees to obtain premium video content even though we have limited experience determining what video content will be successful with current and prospective customers. In addition, certain of our content licensing agreements have high fixed costs associated with them, and we have decided not to renew certain of these agreements in recent periods. If we cannot obtain premium digital content for any of our digital content subscription services on commercially reasonable terms, or at all, our business will be harmed.

Table of Contents

Our subscription levels may vary due to the seasonal or periodic nature of some popular content and as we experiment with different types of content offerings.

Some of the most popular premium content that we have offered in our premium video subscription services is seasonal or periodic in nature. Additionally, as we develop our video subscription business, we are experimenting with different types of content to determine what consumers prefer. We have limited experience with these types of offerings and cannot predict how the seasonal or periodic nature of these offerings will impact our subscriber growth rates for these products, future subscriber retention levels or our quarterly financial results.

The success of our subscription services businesses depends upon our ability to add new subscribers and minimize subscriber churn.

If we do not continue to add new subscribers each quarter to our subscription services while minimizing the rate of loss of existing subscribers, our operating results will be adversely impacted. Because Internet subscription content businesses are a relatively new media delivery model and a new business for us, we cannot predict with accuracy our long-term ability to retain subscribers or add new subscribers. Subscribers may cancel their subscriptions to our services for many reasons, including a perception that they do not use the services sufficiently or that the service does not provide enough value, a lack of attractive or exclusive content generally or as compared to competitive service offerings (including Internet piracy), or because customer service issues are not satisfactorily resolved. In addition, the costs of marketing and promotional activities necessary to add new subscribers, and the costs of obtaining content that customers desire, may adversely impact our margins and operating results.

Our online music services depend upon our licensing agreements with the major music label and music publishing companies.

Our online music service offerings depend on music licenses from the major music labels and publishers. The current license agreements are for relatively short terms (some of these licenses will need to be renewed in 2005), and we cannot be sure that the music labels will renew the licenses on commercially viable terms, or at all. Due to the increasing importance of our music services to our overall revenue, the failure of any major music label or publisher to renew these licenses under terms that are acceptable to us will harm our ability to offer successful music subscription services and would harm our operating results.

Music publishing royalty rates for streaming are not yet fully established; a determination of high royalty rates could negatively impact our operating results.

Royalty rates associated with streaming musical compositions in the U.S. and abroad are not fully established with respect to public performances and, if required, reproductions. Public performance licenses are negotiated individually, and we have not yet agreed to rates with all of the performing rights societies for all of our music streaming activities. We may be required to pay a rate that is higher than we expect, or the issue may be submitted to a Rate Court for judicial determination. We have a license agreement with the Harry Fox Agency, an agency that represents music publishers, to use musical compositions as required in the creation and delivery of on-demand streams, but this license agreement does not include a rate. The license agreement anticipates industry-wide agreement on rates, or, if no industry-wide agreement can be reached, determination by a copyright arbitration royalty panel (CARP), an administrative judicial proceeding supervised by the United States Copyright Office. If the rates agreed to or determined by a CARP are higher than we expect, this expense could negatively impact our operating results. The publishing rates associated with our international music streaming services are also not yet determined, and may be higher than our current estimates.

Our consumer businesses face substantial competitive challenges that may prevent us from being successful in those businesses.

Music. Our online music service offerings face significant competition from traditional offline music distribution competitors and from other online digital music services. Some of these competing services have spent substantial amounts on marketing and have received significant media attention, including Apple s iTunes music download service and Napster s online music subscription service. Microsoft has also begun offering premium music services in conjunction with its Windows Media Player and MSN services, and we also expect increasing competition from online retailers such as Amazon.com and WalMart.com and from Internet portals like Yahoo!, which recently acquired MusicMatch, a provider of personalized music software and services. Our current music service offerings may not be able to compete effectively in this highly competitive market.

Our online music services also face significant competition from free peer-to-peer services, which allow consumers to directly access an expansive array of free content without securing licenses from content providers. The legal status of these free services is uncertain, because although some courts have found that these services violate copyright laws, other services have been found to not violate copyright laws. In addition, enforcement efforts against those in violation have not effectively shut down these services, and there can be no assurance that these services will ever be shut down. The ongoing presence of these free services, even if they are subsequently found to be illegal, substantially impairs the marketability of legitimate services like ours.

Video Products and Services. Our video content services (including our RealOne SuperPass subscription service) face competition from existing competitive alternatives and other emerging services and technologies. We face competition in these markets from traditional media outlets such as television, radio, CDs, DVDs, videocassettes and others. We also face competition from emerging Internet media sources and established companies entering into the Internet media content market, including Time Warner s AOL subsidiary, Microsoft, Apple, Yahoo! and broadband Internet service providers. We expect that, as the market for Internet video content matures, more competitors will enter these new markets, making competition even more intense. Competing services may be able to obtain better or more favorable access to compelling video content than us, may develop better offerings than us and may be able to leverage other assets to promote their offerings.

Games. Our RealArcade service competes with other online distributors of downloadable PC games focused on the non-core, or casual, segment of the games market. Some of these distributors have high volume distribution channels and greater financial resources than us, including Yahoo! Games, MSN Gamezone, Pogo.com and Shockwave. We expect competition to intensify in this market from these and other competitors and no assurance can be made that we will be able to continue to grow our games distribution business or that we will be able to remain competitive in the downloadable games category in the future. We also own and operate GameHouse, a developer of downloadable PC games that competes with other developers of downloadable games for the non-core segment of the market.

We may not be successful in the market for downloadable media and personal music management software.

The market for software products that enable the downloading of media and personal music management software is still evolving. We may be unable to develop a revenue model or sufficient demand to take advantage of this market opportunity. We cannot predict whether consumers will adopt our media player products as their primary application to play, record, download and manage their digital music, especially in light of the fact that Microsoft bundles its competing Windows Media Player with its Windows operating system. Our inability to achieve widespread acceptance for our digital music architecture or widespread distribution of our player products could hold back the development of revenue streams from these market segments, including digital music content, and therefore could harm the prospects for our business.

Table of Contents

Our consumer businesses depend upon effective digital rights management solutions.

Our consumer businesses depend upon effective digital rights management solutions that allow control of accessibility to online digital content. These solutions are important to the economics of these businesses and also to address concerns of content providers regarding online piracy. We cannot be certain that we can develop, license or acquire such solutions, or that content licensors, electronic device makers or consumers will accept them. In addition, consumers may be unwilling to accept the use of digital rights management technologies that limit their use of content, especially with large amounts of free content readily available. We may need to license digital rights management solutions to support our products. No assurance can be given that such solutions will be available to us on reasonable terms or at all. If digital rights management solutions are not effective, or are perceived as not effective, content providers may not be willing to include content in our services, which would harm our business and operating results.

Digital rights management technologies are frequently the subject of hostile attack by third parties seeking to illegally obtain content. If our digital rights management technology is compromised or otherwise malfunctions, we could be subject to lawsuits seeking compensation for any harm caused and our business could be harmed if content providers lose confidence in our ability to protect their content.

Our Harmony Technology may not achieve consumer or market acceptance and may be subject to legal challenge.

We recently created a new digital rights management translation technology called Harmony. Our Harmony technology enables consumers to securely transfer purchased music to digital music devices, including certain versions of the market leading iPod line of digital music players made by Apple Computer, as well as certain devices that use Microsoft Windows Media DRM. Harmony is designed to enable consumers to transfer music purchased from our RealPlayer Music Store to a wide variety of portable music devices, rather than being restricted to a specific portable device. We do not know whether consumers will accept Harmony or whether it will lead to increased sales of any of our consumer products or services or increased usage of our media player products.

There are other risks associated with our Harmony technology, including the risk that Apple will continue to modify its technology to break the interoperability that Harmony provides to consumers, which Apple has done in connection with the release of certain new products. If Apple chooses to continue this course of action, Harmony may no longer work with Apple s products, which could harm our business and reputation, or we may be forced to incur additional development costs to refine Harmony to make it interoperate again. Although we believe our Harmony technology is legal, there is no assurance that a court would agree with our position. If Apple decides to commence litigation against us in order to prevent interoperation with its products, we may be forced to spend money defending their legal challenge, which could harm our operating results.

The success of our music services depend, in part, on interoperability with our customer s music playback hardware.

In order for our Rhapsody service and our RealPlayer Music Store to continue to be successful we must design our service to interoperate effectively with a variety of hardware products, including home stereos, car stereos, portable digital audio players, and PCs. We depend on significant cooperation with manufacturers of these products and with software manufacturers that create the operating systems for such hardware devices to achieve our business and design objectives. To date, Apple has not agreed to design its popular iPod line of portable digital audio players to function with our music services and users of our music services must rely on our Harmony technology for interoperability with iPods. If we cannot successfully design our service to interoperate with the music playback devices that our customers own, either through relationships with manufacturers or through our Harmony technology, our business will be harmed.

Table of Contents

We may not be able to successfully operate our software game development business because it is a new business for us, and certain distribution partners for our game development business compete with other products and services we offer.

In 2004, we acquired GameHouse, a developer of downloadable PC games. Game development is a new business for us, and we may not be able to successfully develop and market software games in the future. In addition, certain competitors of our RealArcade service also distribute and promote games developed by GameHouse. No assurance can be made that these distributors will continue to distribute and promote games in the same manner as a result of our acquisition of GameHouse.

Risks Related to Our Business Products and Services Business

Our systems software business has been negatively impacted by the efforts of our competitors, and this business may not return to previous levels.

The aggressive, and we believe illegal, competitive efforts of Microsoft, including the provision of free software and other incentives to induce customers to use its competing technology, have negatively impacted our systems software sales to customers in a variety of business market segments in recent periods. We cannot predict when, or if, we will experience increased demand for our systems software products from customers in these markets.

Our Helix open source initiative is subject to risks associated with open source technology.

There are a number of risks associated with our Helix Community initiative, including risks associated with market and industry acceptance, development processes and software licensing practices, and business models. The broader media technology and product industry may not adopt the Helix DNA Platform and/or the Helix Community as a development platform for media delivery and playback products and third parties may not enhance, develop or introduce technologies or products based on Helix DNA technology. While we have invested substantial resources in the development of the underlying technology within the Helix DNA technology and the Helix Community process itself, the market and industry may not accept them and we may not derive royalty or support revenue from them. The introduction of broadly available open source software licensing and community source licensing may adversely affect sales of our commercial system software products to mobile operators, broadband providers, corporations, government agencies, educational institutions and other business and non-business organizations. In those areas where adoption of the Helix Community and Helix DNA occurs, our community and open source approach means that we no longer exercise sole control over many aspects of the development of the Helix DNA technology. In addition, we designed our commercial open source license to bear royalties when third parties sell products that include Helix DNA technology. To date, however, royalty revenue has not been significant.

Risks Related to Our Business in General

We have a history of losses, and we cannot be sure that we will be able to return to profitability in the future.

We have incurred significant losses since our inception. As of March 31, 2005, we had an accumulated deficit of approximately $302 million. We have had net losses for each year subsequent to the year ended December 31, 1999, and we may not generate sufficient revenue to be profitable on a quarterly or annual basis in the future. In addition, we devote significant resources to developing and enhancing our technology and to selling, marketing and obtaining content for our products and services. As a result, we will need to generate significant revenue to be profitable in the future.

Our operating results are difficult to predict and may fluctuate, which may contribute to fluctuations in our stock price.

As a result of the rapidly changing and uncertain nature of the markets in which we compete, our quarterly and annual revenue and operating results may fluctuate from period-to-period, and period-to-period

Table of Contents

comparisons may not be meaningful. These fluctuations are caused by a number of factors, many of which are beyond our control. In past periods, our operating results have been affected by personnel reductions and related charges, charges relating to losses on excess office facilities, and impairment charges for certain of our equity investments. Our operating results may be adversely affected by similar or other charges or events in future periods, which could cause the trading price of our stock to decline.

Certain of our expense decisions (for example, research and development and sales and marketing efforts, our media content licensing efforts and other business expenditures generally) are based on predictions regarding our business and the markets in which we compete. To the extent that these predictions prove inaccurate, our revenue may not be sufficient to offset these expenditures, and our operating results may be harmed.

Our suit against Microsoft for antitrust violations may not be successful and could harm our financial results.

In December 2003, we filed suit against Microsoft Corporation in the U.S. District Court for the Northern District of California, alleging that Microsoft violated U.S. and California antitrust laws. In our lawsuit, we allege that Microsoft has illegally used its monopoly power to restrict competition, limit consumer choice and attempt to monopolize the field of digital media. We expect that the litigation, if it is not resolved before trial, will carry on for several years. It is not possible to predict accurately how much the litigation will cost, or its duration. The costs of the litigation could have an adverse impact on our operating results in excess of our current expectations. The litigation may also distract our management team from operational matters, which could harm our business results. We may not prevail in our claims against Microsoft, in which case our costs of litigation will not be recovered. Even if we do prevail, the litigation may not be successful in causing Microsoft to alter its anticompetitive behavior. Furthermore, Microsoft s defense strategy may include the assertion of counterclaims against us, as well as leveraging its power in the commercial marketplace to adversely affect our current and potential business relationships, either of which may have an adverse affect on our business results.

Our products and services must compete with the products and services of strong or dominant competitors.

Our software and services must compete with strong existing competitors, and new competitors may enter with competitive new products, services and technologies. These market conditions have in the past resulted in, and could likely continue to result in the following consequences, any of which could adversely affect our business, our operating results and the trading price of our stock:

- reduced prices, revenue and margins;
- increased expenses in responding to competitors;
- loss of current and potential customers, market share and market power;
- lengthened sales cycles;
- degradation of our stature in the market and reputation;
- changes in our business and distribution and marketing strategies;
- changes to our products, services, technology, licenses and business practices, and other disruption of our operations;
- strained relationships with partners; and
- pressure to prematurely release products or product enhancements.

Many of our current and potential competitors have longer operating histories, greater name recognition, more employees and significantly greater resources than we do. Our competitors across the breadth of our product line include a number of large and powerful companies, such as Microsoft, Apple Computer, and

Yahoo!. Some of our competitors have in the past and may in the future enter into collaborative arrangements with each other that enable them to better compete with our business.

Microsoft is one of our strongest competitors, and employs highly aggressive tactics against us.

Microsoft is one of our principal competitors in the development and distribution of digital media and media distribution technology. Microsoft s market power in related markets such as personal computer operating systems, office software suites and web browser software give it unique advantages in the digital media markets. We expect that Microsoft will continue to increase pressure in the digital media markets in the future. Microsoft s dominant position in certain parts of the computer and software markets, and its aggressive activities have had, and in the future will likely continue to have, adverse effects on our business and operating results.

We believe that Microsoft has employed, and will likely continue to employ illegal and highly aggressive tactics against us such as leveraging Microsoft s market dominating position in operating systems and servers to distribute and promote its digital media products. We also believe that Microsoft limits exposure to third parties (including us) of the interfaces to its operating systems, which limits the ability of our products to take full advantage of the features and functionality of Microsoft s operating systems and harms our ability to compete effectively with Microsoft. The effects of Microsoft s activities include loss of customers and market share, unnatural pressure on the pricing of our products and continuing costs of developing and revising business strategies in response to these activities.

Any development delays or cost overruns may affect our operating results.

We have experienced development delays and cost overruns in our development efforts in the past and we may encounter such problems in the future. Delays and cost overruns could affect our ability to respond to technological changes, evolving industry standards, competitive developments or customer requirements. Also, our products may contain undetected errors that could cause increased development costs, loss of revenue, adverse publicity, reduced market acceptance of our products or services or lawsuits by customers.

Our business is dependent in part on third party vendors whom we do not control.

Certain of our products and services are dependent in part on the licensing and incorporation of technology from third party vendors. The markets in which we compete are new and rapidly evolving and, in some cases, significant technology innovation occurs at very early-stage companies. In some cases, we rely on the technology of these types of vendors in order to make our products and services more competitive. If the technology of these vendors fails to perform as expected or if key vendors do not continue to support their technology because the vendor has gone out of business or otherwise, then we may incur substantial costs in replacing the products and services, or we may fall behind in our development schedule while we search for a replacement. These costs or the potential delay in the development of our products and services could harm our business and our prospects.

If our products are not able to support the most popular digital media formats, our business will be substantially impaired.

The success of our products and services depends upon our products support for a variety of media formats and wireless data formats. Technical formats and consumer preferences may change over time, and we may be unable to adequately address consumer preferences or fulfill the market demand for new and evolving formats. We may not be able to license technologies, like codecs or digital rights management technology, that obtain widespread consumer and developer use, which would harm consumer and developer acceptance of our products and services. In addition, our codecs and formats may not continue to be in demand or as desirable as other third party codecs and formats, including codecs and formats created by Microsoft or industry standard formats created by MPEG.

Table of Contents

Our mobile products will not be successful if consumers do not use mobile devices to access digital media.

In order for our investments in the development of mobile products to be successful, consumers must adopt and use mobile devices for consumption of digital media. To date, consumers have not widely adopted these products for use in accessing and consuming digital media and if the rate of adoption of these products to consume digital media does not increase, our business could be harmed.

We depend on key personnel who may not continue to work for us.

Our success substantially depends on the continued employment of certain executive officers and key employees, particularly Robert Glaser, our founder, Chairman of the Board and Chief Executive Officer. The loss of the services of Mr. Glaser or other key executive officers or employees could harm our business. If any of these individuals were to leave, we could face high costs and substantial difficulty in hiring qualified successors and could experience a loss in productivity while any such successor obtains the necessary training and experience. If we do not succeed in retaining and motivating existing personnel, our business could be harmed.

Our failure to attract, train or retain highly qualified personnel could harm our business.

Our success also depends on our ability to attract, train or retain qualified personnel in all areas, especially those with management and product development skills. In particular, we must hire and retain experienced management personnel to help us grow and manage our business, and skilled software engineers to further our research and development efforts. At times, we have experienced difficulties in hiring and retaining personnel with the proper training or experience, particularly in technical and media areas.

Competition for qualified personnel is intense, particularly in high-technology centers such as the Pacific Northwest, where our corporate headquarters are located. If we do not succeed in attracting new personnel or in retaining and motivating our current personnel, our business could be harmed.

Our industry is experiencing consolidation that may cause us to lose key relationships and intensify competition.

The Internet and media distribution industries are undergoing substantial change, which has resulted in increasing consolidation and formation of strategic relationships. We expect this consolidation and strategic partnering to continue. Acquisitions or other consolidating transactions could harm us in a number of ways, including:

- we could lose strategic relationships if our strategic partners are acquired by or enter into relationships with a competitor (which could cause us to lose access to distribution, content, technology and other resources);
- we could lose customers if competitors or users of competing technologies consolidate with our current or potential customers; and
- our current competitors could become stronger, or new competitors could form, from consolidations.

Any of these events could put us at a competitive disadvantage, which could cause us to lose customers, revenue and market share. Consolidation could also force us to expend greater resources to meet new or additional competitive threats, which could also harm our operating results.

Potential acquisitions involve risks that could harm our business and impair our ability to realize potential benefits from acquisitions.

As part of our business strategy, we have acquired technologies and businesses in the past, and expect that we will continue to do so in the future. The failure to adequately address the financial, legal and operational risks raised by acquisitions of technology and businesses could harm our business and prevent us from realizing the benefits of the acquisitions. Financial risks related to acquisitions may harm our financial position, reported operating results or stock price, and include:

- potential equity dilution, use of cash resources and incurrence of debt and contingent liabilities in funding acquisitions;
- large write-offs and difficulties in assessment of the relative percentages of in-process research and development expense that can be immediately written off as compared to the amount which must be amortized over the appropriate life of the asset; and
- amortization expenses related to other intangible assets.

Acquisitions also involve operational risks that could harm our existing operations or prevent realization of anticipated benefits from an acquisition. These operational risks include:

- difficulties and expenses in assimilating the operations, products, technology, information systems or personnel of the acquired company and difficulties in retaining key management or employees of the acquired company;
- diversion of management s attention from other business concerns and the potential disruption of our ongoing business;
- impairment of relationships with employees, affiliates, advertisers or content providers of our business or the acquired business;
- the assumption of known and unknown liabilities of the acquired company, including intellectual property claims; and
- entrance into markets in which we have no direct prior experience.

We acquired Listen in 2003 and the operations associated with Listen have remained in San Francisco. This is our first experience operating and integrating a substantial acquired business in a remote location. The geographic separation could increase the operational risks described above. We also acquired GameHouse, Inc. in 2004. The acquisition of GameHouse is our first attempt to operate and manage a content creation business. We may not be successful in operating this type of business, which could harm our business and our prospects.

Acquisition-related costs could cause significant fluctuation in our net income (loss).

Previous acquisitions have resulted in significant expenses, including amortization of purchased technology, charges for in-process research and development and amortization of acquired identifiable intangible assets, which are reflected in our operating expenses. New acquisitions and any potential future impairment of the value of purchased assets could have a significant negative impact on our future operating results.

Our strategic investments may not be successful and we may have to recognize expenses in our income statement in connection with these investments.

We have made, and in the future we may continue to make, strategic investments in other companies, including joint ventures. These investments often involve immature and unproven businesses and technologies, and involve a high degree of risk. We could lose the entire amount of our investment. We also may be required to record on our financial statements significant charges from reductions in the value of our strategic investments, and, potentially from the net losses of the companies in which we invest. We have taken these charges in the past, and these charges could adversely impact our reported operating results in the future. No assurance can be made that we will realize the anticipated benefits from any strategic investment.

Table of Contents

Changes in network infrastructure, transmission methods and protocols, and broadband technologies pose risks to our business.

Our products and services depend upon the means by which users access media content over the Internet and wireless networks. If popular technologies, transmission methods and protocols used for accessing digital media content change, and we do not timely and successfully adapt our products and services to these new technologies, transmission methods and protocols, our reputation could be damaged, use of our technologies and products would decrease, and our business and operating results would be harmed.

Development of new technologies, products and services for new transmission infrastructure could increase our vulnerability to competitors by enabling the emergence of new competitors, such as traditional broadcast and cable television companies, which have significant control over access to content, substantial resources and established relationships with media providers. Our current competitors may also develop relationships with, or ownership interests in, companies that have significant access to or control over the broadband transmission infrastructure or content.

We need to develop relationships with manufacturers of non-PC media and communication devices to grow our business.

Access to the Internet through devices other than a personal computer, such as personal digital assistants, cellular telephones, television set-top devices, game consoles and Internet appliances, has increased dramatically and is expected to continue to increase. Manufacturers of these types of products are increasingly investing in media-related applications. If a substantial number of alternative device manufacturers do not license and incorporate our technology into their devices, we may fail to capitalize on the opportunity to deliver digital media to non-PC devices. A failure to develop revenue-generating relationships with a sufficient number of device manufacturers could harm our business prospects. We have invested significant resources in adapting our technologies and products to these new technologies, networks and devices (wireless networks in particular), and we will not recoup these investments if they are not widely adopted for accessing data and multimedia content. In addition, our ability to reach customers in these markets is often controlled by large network operators and our success in these markets is dependent on our ability to secure relationships with these key operators.

Emerging new standards for non-PC devices could harm our business if our products and technologies are not compatible with the new standards.

We do not believe that complete standards have emerged with respect to non-PC wireless and cable-based systems. If we do not successfully