

COSTAR GROUP INC
Form 10-Q
August 08, 2006

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

FORM 10-Q

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

For the quarterly period ended June 30, 2006

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 0-24531

CoStar Group, Inc.

(Exact name of registrant as specified in its charter)

Delaware

*(State or other jurisdiction of
incorporation or organization)*

52-2091509

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

**2 Bethesda Metro Center, 10th Floor
Bethesda, Maryland 20814**

(Address of principal executive offices) (zip code)

(301) 215-8300

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Securities Exchange Act of 1934 (Check One).

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Large accelerated filer

Accelerated filer

Non-accelerated filer

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

As of August 1, 2006 there were 18,867,918 shares of the registrant's common stock outstanding.

COSTAR GROUP, INC.

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CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)
(unaudited)

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2006	2005	2006	2005
Revenues	\$ 38,946	\$ 32,871	\$ 76,220	\$ 64,214
Cost of revenues	12,606	10,836	25,532	21,326
Gross margin	26,340	22,035	50,688	42,888
Operating expenses:				
Selling and marketing	12,109	10,429	23,034	19,922
Software development	3,084	2,545	5,982	4,877
General and administrative	7,633	6,734	15,202	13,630
Purchase amortization	1,116	1,110	2,224	2,228
	23,942	20,818	46,442	40,657
Income from operations	2,398	1,217	4,246	2,231
Other income, net	1,610	719	3,036	1,323
Income before income taxes	4,008	1,936	7,282	3,554
Income tax expense (benefit), net	1,704	793	3,118	1,437
Net income	\$ 2,304	\$ 1,143	\$ 4,164	\$ 2,117
Net income per share — basic	\$ 0.12	\$ 0.06	\$ 0.22	\$ 0.12
Net income per share — diluted	\$ 0.12	\$ 0.06	\$ 0.22	\$ 0.11
Weighted average outstanding shares — basic	18,822	18,366	18,757	18,342
Weighted average outstanding shares — diluted	19,261	18,868	19,187	18,862

See accompanying notes.

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COSTAR GROUP, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands)

	June 30, 2006 (unaudited)	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 37,250	\$ 28,065
Short-term investments	112,979	106,120
Accounts receivable, less allowance for doubtful accounts of approximately \$1,630 and \$1,602 as of June 30, 2006, and December 31, 2005	6,405	5,673
Deferred income taxes, net	4,475	4,475
Prepaid expenses and other current assets	1,975	2,205
Total current assets	163,084	146,538
Deferred income taxes	15,433	18,690
Property and equipment, net	14,447	15,144
Goodwill, net	44,292	43,563
Intangibles and other assets, net	22,277	22,847
Deposits	1,107	1,277
Total assets	\$ 260,640	\$ 248,059
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	\$ 15,473	\$ 14,399
Deferred revenue	8,535	7,638
Total current liabilities	24,008	22,037
Deferred income taxes	1,034	1,226
Total stockholders' equity	235,598	224,796
Total liabilities and stockholders' equity	\$ 260,640	\$ 248,059

See accompanying notes.

Table of Contents**COSTAR GROUP, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(in thousands)****(unaudited)**

	Six Months Ended June 30,	
	2006	2005
Operating activities:		
Net income	\$ 4,164	\$ 2,117
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	2,682	2,945
Amortization	2,992	3,186
Stock based compensation expense related to stock options and restricted stock	1,993	99
Income tax expense, net	2,753	1,437
Provision for losses on accounts receivable	606	233
Changes in operating assets and liabilities, net of acquisitions	611	(4,668)
Net cash provided by operating activities	15,801	5,349
Investing activities:		
Purchases of short-term investments	(61,269)	(130,522)
Sales of short-term investments	54,189	128,369
Purchases of property and equipment and other assets	(3,949)	(5,658)
Acquisitions, net of cash acquired	—	(4,412)
Net cash used in investing activities	(11,029)	(12,223)
Financing activities:		
Proceeds from exercise of stock options	4,341	1,179
Net cash provided by financing activities	4,341	1,179
Effect of foreign currency exchange rates on cash and cash equivalents	72	(95)
Net increase (decrease) in cash and cash equivalents	9,185	(5,790)
Cash and cash equivalents at the beginning of period	28,065	36,807
Cash and cash equivalents at the end of period	\$ 37,250	\$ 31,017

See accompanying notes.

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COSTAR GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

1. ORGANIZATION

CoStar Group, Inc. (the “Company”) has created a comprehensive, proprietary database of commercial real estate information for metropolitan areas throughout the United States and the United Kingdom. Based on its unique database, the Company provides information services to the commercial real estate and related business community and operates within one business segment. The information services are typically distributed to its clients under subscription-based license agreements, which have a minimum term of one year and renew automatically.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

Interim Financial Statements

The accompanying unaudited condensed consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information. In the opinion of the Company’s management, the financial statements reflect all adjustments necessary to present fairly the Company’s financial position at June 30, 2006, and the results of its operations for the three and six months ended June 30, 2006 and 2005, and its cash flows for the six months ended June 30, 2006 and 2005. These adjustments are of a normal recurring nature.

Certain notes and other information have been condensed or omitted from the interim financial statements presented in this Quarterly Report on Form 10-Q. Therefore, these financial statements should be read in conjunction with the Company’s Annual Report on Form 10-K for the year ended December 31, 2005, and the Company’s Quarterly Reports on Form 10-Q for the quarters ended June 30, 2005, September 30, 2005 and March 31, 2006.

The results of operations for the three and six months ended June 30, 2006, are not necessarily indicative of future financial results.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Reclassifications

Certain previously reported amounts have been reclassified to conform to the Company’s current presentation.

Foreign Currency Translation

The Company's functional currency in its foreign locations is the local currency. Assets and liabilities are translated into U.S. dollars as of the balance sheet date. Revenues, expenses, gains and losses are translated at the average exchange rates in effect during each period. Gains and losses resulting from translation are included in accumulated other comprehensive income (loss). Net gains or losses resulting from foreign currency exchange

Table of Contents**COSTAR GROUP, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) — (CONTINUED)****2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — (CONTINUED)****Foreign Currency Translation (continued)**

transactions are included in the consolidated statements of operations. The Company had an increase (decrease) in comprehensive income (loss) of approximately \$885,000 and (\$876,000), for the three months ended June 30, 2006 and 2005, respectively, and \$1,105,000 and (\$1,451,000) for the six months ended June 30, 2006 and 2005, respectively, from translation. There were no material gains or losses from foreign currency exchange transactions for the three and six months ended June 30, 2006 and 2005.

Comprehensive Income

During the three months ended June 30, 2006 and 2005, total comprehensive income was approximately \$3.1 million and \$42,000, respectively, and during the six months ended June 30, 2006 and 2005, total comprehensive income was \$5.0 million and \$610,000, respectively. As of June 30, 2006, accumulated comprehensive income included foreign currency translation adjustments of approximately \$2.8 million and an unrealized loss on short-term investments of approximately \$590,000.

Net Income Per Share

Net income per share is computed by dividing net income by the weighted average number of common shares outstanding during the period on a basic and diluted basis. The Company's potentially dilutive securities include stock options and restricted stock. Diluted net income per share considers the impact of potentially dilutive securities except in periods in which there is a net loss as the inclusion of the potentially dilutive common shares would have an anti-dilutive effect.

The following table sets forth the calculation of basic and diluted net income per share (in thousands, except per share data):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Numerator:				
Net income	\$ 2,304	\$ 1,143	\$ 4,164	\$ 2,117
Denominator:				
Denominator for basic net income per share	weighted-average			
outstanding shares	18,822	18,366	18,757	18,342
Effect of dilutive securities:				
Stock options and restricted stock	439	502	430	520
Denominator for diluted net income per share	weighted-average			
outstanding shares	19,261	18,868	19,187	18,862
Net income per share basic	\$ 0.12	\$ 0.06	\$ 0.22	\$ 0.12
Net income per share diluted	\$ 0.12	\$ 0.06	\$ 0.22	\$ 0.11

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COSTAR GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) — (CONTINUED)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — (CONTINUED)

Stock-Based Compensation

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123R “Share Based Payment” (“SFAS 123R”), which addresses the accounting for share-based payment transactions in which the Company receives employee services in exchange for equity instruments. The statement eliminates the Company’s ability to account for share-based compensation transactions as prescribed by Accounting Principles Board Opinion No. 25, “Accounting for Stock Issued to Employees” (“APB No. 25”), and generally requires that equity instruments issued in such transactions be accounted for using a fair-value based method and the fair value of such equity instruments be recognized as expenses in the consolidated statement of operations.

In June 1998, the Company’s Board of Directors adopted the 1998 Stock Incentive Plan (the “1998 Plan”) prior to consummation of the Company’s initial public offering. The 1998 Plan provides for the grant of stock and stock options to officers, directors and employees of the Company and its subsidiaries. The Company has reserved 3,750,000 shares of common stock for issuance under the 1998 Plan. Options granted under the 1998 Plan may be incentive or non-qualified stock options. The exercise price for an incentive stock option may not be less than the fair market value of the Company’s common stock on the date of grant. The vesting period of the options and restricted stock grants is determined by the Board of Directors and is generally four years. Upon the occurrence of a Change of Control, as defined in the 1998 Plan, all outstanding unexercisable options and restricted stock grants under the 1998 Plan immediately become exercisable. Options are not exercisable after the ten-year anniversary of the date of grant and may terminate earlier. The 1998 Plan will terminate in May 2008, unless terminated sooner by the Board of Directors or extended by the Board of Directors and Stockholders of the Company, but will continue to govern unexercised and unexpired stock-based awards under the 1998 Plan.

Under the fair-value recognition provisions of SFAS 123R, stock-based compensation cost is estimated at the grant date based on the fair value of the awards expected to vest and recognized as expense ratably over the requisite service period of the award.

The Company adopted SFAS 123R using the modified prospective method, which requires the application of the accounting standard as of January 1, 2006. In accordance with the modified prospective method, the consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123R. SFAS 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In the pro forma information required under APB No. 25 for the periods prior to 2006, the Company accounted for forfeitures as they occurred. Upon adoption of SFAS 123R, the Company recorded a charge of approximately \$35,000 representing the cumulative effect of a change in accounting principle. This amount was recorded in general and administrative expenses in the accompanying condensed consolidated statements of operations for the period ended March 31, 2006.

Table of Contents**COSTAR GROUP, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) — (CONTINUED)****2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — (CONTINUED)****Stock-Based Compensation (continued)**

The impact of the adoption of SFAS 123R on our results of operations for the three and six months ended June 30, 2006, as compared to the results if the Company had continued to account for stock-based compensation under APB No. 25, was as follows (in thousands, except per share data):

	Three Months Ended June 30, 2006	Six Months Ended June 30, 2006
Income from operations	\$ (709)	\$ (1,501)
Income before taxes	(709)	(1,501)
Net income	(442)	(936)
Basic earnings per share	(0.02)	(0.05)
Diluted earnings per share	(0.02)	(0.05)

SFAS 123R requires cash flows resulting from excess tax benefits to be classified as part of cash flows from financing activities. Excess tax benefits represent tax benefits related to exercised options in excess of the associated deferred tax asset for such options. There were no excess tax benefits as a result of adopting SFAS 123R for the three and six months ended June 30, 2006, and no amounts were classified as an operating cash outflow or a financing cash inflow in the condensed consolidated statement of cash flows.

Stock based compensation expense for stock options and restricted stock included in the Company's results of operations for the three and six months ended June 30, 2006 and 2005, was as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Cost of revenues	\$ 123	\$ —	\$ 151	\$ —
Selling and marketing	296	—	616	—
Software development	46	—	89	—
General and administrative	530	85	1,137	99
Total	\$ 995	\$ 85	\$ 1,993	\$ 99

Net cash proceeds from the exercise of stock options were \$1.7 million and \$4.3 million for the three and six months ended June 30, 2006, respectively. There was no income tax benefit realized from stock option exercises for the three and six months ended June 30, 2006.

Prior to the adoption of SFAS 123R, the Company provided the disclosures required under APB No. 25. Employee stock-based compensation expense recognized under SFAS 123R was not reflected in the Company's results of operations for the three and six-month periods ended June 30, 2005. Previously reported amounts have not been restated in the Company's financial statements.

Table of Contents**COSTAR GROUP, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) — (CONTINUED)****2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — (CONTINUED)****Stock-Based Compensation (continued)**

The following table illustrates the pro forma effect on operating results and per share information had the Company accounted for stock-based compensation in accordance with SFAS 123R for the three and six months ended June 30, 2005, (in thousands, except per share data):

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Net income	\$ 1,143	\$ 2,117
Add: total stock-based employee compensation expense included in reported net income, net of tax	50	59
Deduct: total stock-based employee compensation expense, net of tax, determined under fair value based method for all awards	(1,108)	(2,289)
Pro forma net income (loss)	\$ 85	\$ (113)
Net income (loss) per share:		
Basic as reported	\$ 0.06	\$ 0.12
Basic pro forma	\$ 0.00	\$ (0.01)
Diluted as reported	\$ 0.06	\$ 0.11
Diluted pro forma	\$ 0.00	\$ (0.01)

The Company estimates the fair value of each option granted on the date of grant using the Black-Scholes option-pricing model, with the assumptions noted in the following table. There were no options granted in the second quarter of 2006.

	Six Months Ended June 30, 2006
Dividend yield	0%
Expected volatility	64%
Risk-free interest rate	4.4%
Expected life (in years)	5

The assumptions above and the estimation of expected forfeitures are based on multiple factors, including historical employee behavior patterns of exercising options and post employment termination behavior, expected future employee option exercise patterns, and the historical volatility of the Company's stock price.

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The following table presents stock option activity for the six months ended June 30, 2006:

	Number of Shares	Weighted Average Exercise Price per Share	Weighted Average Remaining Contract Life (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding at December 31, 2005	1,473,897	\$ 29.76		
Granted	—	—		
Exercised	(175,823)	\$ 24.68		
Expired	—	—		
Canceled	(16,814)	\$ 37.05		
Outstanding at June 30, 2006	1,281,260	\$ 30.36	5.9	\$ 37,762
Exercisable at June 30, 2006	902,067	\$ 27.70	5.1	\$ 28,983

The aggregate intrinsic value is calculated as the difference between (i) the aggregate of the exercise prices of the underlying awards and (ii) the quoted price of the common stock at June 30, 2006, multiplied by 902,000 options that had an exercise price less than the quoted price on that date. The aggregate intrinsic value of options exercised was \$5.2 million and \$1.1 million for the six months ended June 30, 2006 and 2005, respectively, determined as of the date of option exercise. At June 30, 2006, there was \$6.4 million of unrecognized compensation cost related to share-based payments, net of forfeitures, which is expected to be recognized over a weighted-average-period of 2.5 years.

The number of shares available for future stock option and restricted stock grants to employees and directors under the 1998 Plan was 412,976 at June 30, 2006.

The following table presents restricted stock awards activity for the six months ended June 30, 2006:

	Number of Shares	Weighted Average Grant Date Fair Value per Share
Restricted stock at December 31, 2005	72,905	\$ 42.69
Granted	31,688	\$ 56.36
Vested	(7,046)	\$ 38.28
Canceled	(5,279)	\$ 45.28
Restricted stock at June 30, 2006	92,268	\$ 47.58

Table of Contents**COSTAR GROUP, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) — (CONTINUED)****2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — (CONTINUED)****Stock-Based Compensation (continued)**

The following table summarizes our non-vested stock option activity for the six months ended June 30, 2006:

	Number of Shares	Weighted Average Grant Date Fair Value per Share
Non-vested stock options at December 31, 2005	513,443	\$ 24.81
Granted	—	—
Vested	(117,436)	\$ 19.91
Canceled	(16,814)	\$ 25.53
Non-vested stock options at June 30, 2006	379,193	\$ 25.22

Recent Accounting Pronouncements

In June 2006, the Financial Accounting Standards Board (the "FASB") issued FASB Interpretation No. 48 "Accounting for Uncertainty in Income Taxes (an interpretation of FASB Statement No. 109)" which is effective for fiscal years beginning after December 15, 2006 with earlier adoption encouraged. This interpretation was issued to clarify the accounting for uncertainty in income taxes recognized in the financial statements by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. We are currently evaluating the potential impact of this interpretation.

3. ACQUISITION

On January 20, 2005, the Company acquired the assets of National Research Bureau ("NRB"), a leading provider of property information to the shopping center industry, from Claritas, Inc. for approximately \$4.1 million in cash. NRB has over 45 years of experience as a leading provider of information to the retail real estate industry, principally through its Shopping Center Directory distributed in print and on CD-ROM.

The acquisition has been accounted for using purchase accounting. The purchase price was primarily allocated to acquired database technology, customer bases, and goodwill. The acquired database technology is being amortized on a straight-line basis over 5 years. The customer base, which consists of one distinct intangible asset composed of acquired customer contracts and the related customer relationships, is being amortized on a 125% declining balance method over 10 years. Goodwill is not amortized, but is subject to annual impairment tests. The results of operations of NRB have been consolidated with those of the Company since the date of acquisition and are not considered material to the consolidated financial statements of the Company. Accordingly, pro forma financial information has not been presented for the acquisition.

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Goodwill consists of the following (in thousands):

	June 30, 2006	December 31, 2005
Goodwill	\$ 55,515	\$ 54,786
Accumulated amortization	(11,223)	(11,223)
Goodwill, net	\$ 44,292	\$ 43,563

5. INTANGIBLES AND OTHER ASSETS

Intangibles and other assets consist of the following (dollars in thousands):

	June 30, 2006	December 31, 2005	Weighted- Average Amortization Period (in years)
Building photography	\$ 7,963	\$ 5,922	5
Accumulated amortization	(5,111)	(4,853)	
Building photography, net	2,852	1,069	
Acquired database technology	20,720	20,626	4
Accumulated amortization	(19,493)	(19,096)	
Acquired database technology, net	1,227	1,530	
Acquired customer base	43,852	43,324	10
Accumulated amortization	(27,172)	(24,804)	
Acquired customer base, net	16,680	18,520	
Acquired tradename	4,198	4,198	10
Accumulated amortization	(2,680)	(2,470)	
Acquired tradename, net	1,518	1,728	
Intangibles and other assets, net	\$ 22,277	\$ 22,847	

Table of Contents**COSTAR GROUP, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) — (CONTINUED)****6. INCOME TAXES**

The income tax provisions for the six months ended June 30, 2006 and 2005, reflect a 42.9% and 40.4% effective rate, respectively. The increase in the effective rate for the six months ended June 30, 2006, is primarily attributable to the implementation of SFAS 123R, which does not permit a deferred tax asset to be recognized for compensation deductions attributable to incentive stock options. The Company establishes a valuation allowance with respect to deferred tax assets associated with future tax benefits that the Company is not certain it will be able to realize. As of June 30, 2006, the Company continues to maintain a valuation allowance of approximately \$687,000 primarily for future tax benefits associated with certain state net operating loss carryforwards.

7. COMMITMENTS AND CONTINGENCIES

Currently, and from time to time, the Company is involved in litigation incidental to the conduct of its business. The Company is not a party to any lawsuit or proceeding that, in the opinion of management, is likely to have a material adverse effect on its financial position or results of operations.

8. RESTRUCTURING CHARGE

Effective July 21, 2005, the Company closed its research center in Mason, Ohio (the "Mason Operations"). The closing of the Mason Operations resulted in a one-time pre-tax charge of approximately \$2.2 million recorded in the third quarter of 2005. The third quarter restructuring charge included amounts for wages, severance, occupancy and other costs. Below is a summary of the expense recorded and the activity related to restructuring. The estimates have been made based upon management's best estimate of amounts and timing of certain events included in the restructuring plan that will occur in the future. It is possible that the actual outcome of certain events may differ from estimates. Changes will be made to the restructuring accrual at the point that the differences become determinable.

Restructuring expenses (in thousands):

	Accrual balance as of December 31, 2005	2006 charges utilized	Accrual balance as of June 30, 2006
Occupancy	\$ 973	\$ 260	\$ 713
Wages, severance, and other costs	64	64	—
Total restructuring charge	\$ 1,037	\$ 324	\$ 713

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

2.

The following Management's Discussion and Analysis of Financial Condition and Results of Operations contains "forward-looking statements," including statements about our beliefs and expectations. See "Cautionary Statement Concerning Forward-Looking Statements" at the end of this Item 2. for additional factors relating to such statements, and see "Risk Factors" in Item 1A. of Part II of this report for a discussion of certain risk factors applicable to our business, financial condition and results of operations.

The following discussion should be read in conjunction with our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and other filings with the Securities and Exchange Commission and the condensed consolidated financial statements and related notes included in this Quarterly Report on Form 10-Q.

Overview

CoStar is the leading provider of information services to the commercial real estate industry in the United States and the United Kingdom based on the fact that we offer the most comprehensive commercial real estate database available, have the largest research department in the industry, provide more information services than any of our competitors and believe we generate more revenues than any of our competitors. We have created a standardized information platform where the members of the commercial real estate and related business community can continuously interact and facilitate transactions by efficiently exchanging accurate and standardized commercial real estate information. Our integrated suite of online service offerings includes information about space available for lease, comparable sales information, tenant information, information about properties for sale, information for clients' web sites, information about industry professionals and their business relationships, analytic information, data integration, property marketing and industry news.

We completed our initial public offering in July 1998 and received net proceeds of approximately \$22.7 million. In May 1999, we completed a follow-on public offering from which we received net proceeds of approximately \$97.4 million; and, in November 2003, we completed an additional follow-on public offering from which we received net proceeds of approximately \$53.5 million. We have used net proceeds from these offerings to fund the geographic and service expansion of our business, including various strategic acquisitions, and to expand our sales and marketing organization. We expect to use the remainder of the proceeds from these public offerings for development and distribution of new services, expansion of existing services across our current markets, geographic expansion in the U.S. and international markets, strategic acquisitions, working capital and general corporate purposes.

Since 1994, we have expanded the geographical coverage of our existing information services and developed new information services. In addition to internal growth, this expansion included the acquisitions of Chicago ReSource, Inc. in Chicago in 1996 and New Market Systems, Inc. in San Francisco in 1997. In August 1998, we expanded into the Houston region through the acquisition of Houston-based real estate information provider C Data Services, Inc. In January 1999, we expanded further into the Midwest and Florida by acquiring LeaseTrend, Inc. and into Atlanta and Dallas/Fort Worth by acquiring Jamison Research, Inc. In February 2000, we acquired Comps, a San Diego-based provider of commercial real estate information. In November 2000, we acquired First Image Technologies, Inc. In September 2002, we expanded further into Portland, Oregon through the acquisition of certain assets of Napier Realty Advisors d/b/a REAL-NET. In January 2003, we established a base in the United Kingdom with our acquisition of London-based Property Intelligence. In May 2004, we expanded into Tennessee through the acquisition of Peer Market Research, Inc., and in June 2004, we extended our coverage of the United Kingdom through the acquisition of Scottish Property Network. In September 2004, we strengthened our position in Denver, Colorado through the acquisition of substantially all of the assets of RealComp, Inc., a local comparable sales information provider. Finally, in January 2005, we acquired National Research Bureau ("NRB"), a leading provider of U.S. shopping center

information.

Our current expansion plan began in 2004 and included entering 21 new metropolitan markets throughout the United States as well as expanding the geographical boundaries of many of our existing U.S. and U.K. markets

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during 2005 and 2006. As of February 21, 2006, our expansion into the 21 new markets was complete. We expect to continue further geographic expansion in the United States; we may seek additional international geographic expansion; or we may seek to expand our services.

In January 2005, we acquired NRB and announced the launch of a major expansion effort into real estate information for retail properties. A retail component of our flagship product, CoStar Property Professional, was unveiled in May 2006 at the International Council of Shopping Centers' convention in Las Vegas. We believe that the level of demand for detailed, thoroughly researched commercial property information warrants acceleration of our planned four-year expansion effort to offer information services covering a majority of U.S. retail properties. In connection with our retail and geographic expansion, during the third quarter of 2006, we expect to begin actively researching commercial properties in approximately 100 new small or tertiary Metropolitan Statistical Areas ("MSAs") across the United States. We also intend to increase our field research fleet by adding approximately 100 vehicles. We plan to staff the vehicles and support our expanded research efforts by adding additional researchers and other personnel during the third and fourth quarters of 2006. Our current retail and geographic expansion plan has caused, and will continue to cause, our cost structure to escalate in advance of the revenues that we expect to generate from these new markets and services, which may reduce our earnings or earnings growth.

Any future significant expansion could reduce our profitability and significantly increase our capital expenditures. Therefore, while we expect current service offerings in existing markets to remain generally profitable and provide substantial funding for our overall business, it is possible that further overall expansion could cause us to generate losses and negative cash flow from operations in the future.

Beginning on January 1, 2006, we began accounting for stock based compensation under the provisions of SFAS No. 123R, "Share-Based Payment" ("SFAS 123R"), which requires the recognition of the fair value of stock-based compensation. Under the fair value recognition provisions of SFAS 123R, stock-based compensation cost is estimated at the grant date based on the fair value of the awards expected to vest and recognized as expense ratably over the requisite service period of the award. Upon adoption of SFAS 123R in the first quarter of 2006, we recorded a charge in general and administrative expenses in our consolidated statements of operations of approximately \$35,000, representing the cumulative effect of a change in accounting principle.

In 2005, we issued restricted stock instead of stock options to our officers, directors and employees, and as a result we recorded additional compensation expense in our consolidated statement of operations. We plan to continue the use of alternative stock-based compensation for our officers, directors and employees, which may include, among other things, restricted stock grants that typically will require us to record additional compensation expense in our consolidated statement of operations and reduce our net income. We currently expect to incur approximately \$4.0 to \$5.0 million in total equity compensation expense in 2006.

We expect 2006 revenue to grow over 2005 revenue as a result of further penetration of our services in our potential customer base across our platform, successful cross selling of our services to our existing customer base, and continued geographic expansion. We expect EBITDA, which is our net-income before interest, income taxes, depreciation and amortization, for our existing core platform to continue to grow principally due to growth in revenue and we expect overall 2006 EBITDA to increase from 2005 EBITDA including stock option compensation expense related to the 2006 adoption of SFAS 123R. We reconcile EBITDA with our net income in a table set forth under the heading "Non-GAAP Financial Measure."

Our subscription-based information services, consisting primarily of CoStar Property Professional, CoStar Tenant, CoStar COMPS Professional and FOCUS services, currently generate approximately 96% of our total revenues. Our contracts for our subscription-based information services typically have a minimum term of one year and renew automatically. Upon renewal, many of the subscription contract rates may increase in accordance with contract

provisions or as a result of contract renegotiations. To encourage clients to use our services regularly, we generally charge a fixed monthly amount for our subscription-based services rather than fees based on actual system usage. Contract rates are based on the number of sites, number of users, organization size, the client's business focus and the number of services to which a client subscribes. Our subscription clients generally pay contract fees on a monthly basis, but in some cases may pay us on a quarterly or annual basis. We recognize this revenue on a straight-line

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basis over the life of the contract. Annual and quarterly advance payments result in deferred revenue, substantially reducing the working capital requirements generated by accounts receivable.

For the twelve months ended June 30, 2006 and 2005, our contract renewal rates were approximately 94% and 93%, respectively.

Application of Critical Accounting Policies and Estimates

The preparation of financial statements and related disclosures in conformity with Generally Accepted Accounting Principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and revenues and expenses during the period reported. The following accounting policies involve a “critical accounting estimate” because they are particularly dependent on estimates and assumptions made by management about matters that are highly uncertain at the time the accounting estimates are made. In addition, while we have used our best estimates based on facts and circumstances available to us at the time, different estimates reasonably could have been used in the current period. Changes in the accounting estimates we use are reasonably likely to occur from period to period, which may have a material impact on the presentation of our financial condition and results of operations. We review these estimates and assumptions periodically and reflect the effects of revisions in the period that they are determined to be necessary.

Valuation of long-lived and intangible assets and goodwill

We assess the impairment of long-lived assets, identifiable intangibles and goodwill whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors we consider important that could trigger an impairment review include the following:

- Significant underperformance relative to historical or projected future operating results;
- Significant changes in the manner of our use of the acquired assets or the strategy for our overall business;
- Significant negative industry or economic trends; or
- Significant decline in our market capitalization relative to net book value for a sustained period.

When we determine that the carrying value of long-lived and identifiable intangible assets may not be recovered based upon the existence of one or more of the above indicators, we measure any impairment based on a projected discounted cash flow method using a discount rate determined by our management to be commensurate with the risk inherent in our current business model.

Goodwill and identifiable intangible assets not subject to amortization are tested annually on October 1st of each year for impairment, and are tested for impairment more frequently based upon the existence of one or more of the above indicators. We measure any impairment loss to the extent that the carrying amount of the asset exceeds its fair value.

Accounting for Income Taxes

As part of the process of preparing our consolidated financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process requires us to estimate our actual current tax exposure and assess the temporary differences resulting from differing treatment of items, such as deferred revenue or deductibility of certain intangible assets, for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our consolidated balance sheet. We must then also assess the likelihood that our deferred tax assets will be recovered from future taxable income, and to the extent we believe that it is more likely than not that some portion or all of our deferred tax assets will not be realized, we must establish a

valuation allowance. To the extent we establish a valuation allowance or change the allowance in a period, we must reflect the corresponding increase or decrease within the tax provision in the statement of operations for that period.

As of June 30, 2006, we continued to maintain a valuation allowance of approximately \$687,000 primarily for certain net operating loss carryforwards. At June 30, 2006, we had net operating loss carryforwards for federal

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income tax purposes of approximately \$63.0 million, which expire, if unused, from the year 2013 through the year 2023. Our decision to maintain only a minimal valuation allowance on our deferred tax asset was based on our expectation that we will recognize taxable income from operations in the future, which will enable us to use our net operating loss carryforwards. We believe our expectation that we will recognize taxable income in the future is supported by our increase in net earnings over the last three years, our revenue growth, renewal rates with our existing customers, and our business model, which permits some control over future costs. We will continue to evaluate our expectation of future taxable income during each quarter. If we are unable to conclude that it is more likely than not that we will realize the future tax benefits associated with our deferred tax assets, then we may be required to establish a valuation allowance against some or all of the deferred tax assets.

For the foreseeable future, we expect to record income tax expense on our results from operations at an effective rate of approximately 42.5% to 43.5%. For at least the next two years, however, we expect the majority of our taxable income to be offset by our net operating loss carryforwards. As a result, we expect our cash payments for taxes to be limited primarily to federal alternative minimum taxes and to state income taxes in certain states.

In determining the quarterly annual provision for income taxes, we use an estimated annual effective tax rate based on expected annual income by jurisdiction, statutory tax rates, permanent timing difference, and tax planning opportunities available in the various jurisdictions in which we operate.

Non-GAAP Financial Measure

We prepare and publicly release quarterly unaudited financial statements prepared in accordance with GAAP. We also disclose and discuss certain non-GAAP financial measures in our public releases. Currently, the non-GAAP financial measure that we disclose is EBITDA, which is our net income before interest, income taxes, depreciation and amortization. We disclose EBITDA in our earnings releases, investor conference calls and filings with the Securities and Exchange Commission. The non-GAAP financial measure that we use may not be comparable to similarly titled measures reported by other companies. Also, in the future, we may disclose different non-GAAP financial measures in order to help our investors more meaningfully evaluate and compare our future results of operations to our previously reported results of operations.

We view EBITDA as an operating performance measure and as such we believe that the GAAP financial measure most directly comparable to it is net income. In calculating EBITDA we exclude from net income the financial items that we believe should be separately identified to provide additional analysis of the financial components of the day-to-day operation of our business. We have outlined below the type and scope of these exclusions and the material limitations on the use of these non-GAAP financial measures as a result of these exclusions. EBITDA is not a measurement of financial performance under GAAP and should not be considered as a measure of liquidity, as an alternative to net income or as an indicator of any other measure of performance derived in accordance with GAAP. Investors and potential investors in our securities should not rely on EBITDA as a substitute for any GAAP financial measure, including net income. In addition, we urge investors and potential investors in our securities to carefully review the reconciliation of EBITDA to net income set forth below, in our earnings releases and in other filings with the Securities and Exchange Commission and to carefully review the GAAP financial information included as part of our Quarterly Reports on Form 10-Q and our Annual Reports on Form 10-K that are filed with the Securities and Exchange Commission, as well as our quarterly earnings releases, and compare the GAAP financial information with our EBITDA.

EBITDA is used by management to internally measure our operating and management performance and by investors as a supplemental financial measure to evaluate the performance of our business. We believe that EBITDA, when viewed with our GAAP results and the accompanying reconciliation, provides additional information that is useful to gain an understanding of the factors and trends affecting our business. We have spent more than 18 years building our

database of commercial real estate information and expanding our markets and services partially through acquisitions of complementary businesses. Due to the expansion of our information services, which included acquisitions, our net income has included significant charges for purchase amortization, depreciation and other amortization. EBITDA excludes these charges and provides meaningful information about the operating performance of our business, apart from charges for purchase amortization, depreciation and other amortization. We believe the disclosure of EBITDA helps investors meaningfully evaluate and compare our performance from quarter to quarter and from year to year. We also believe EBITDA is a measure of our ongoing