

HouseValues, Inc.
Form 10-Q
November 03, 2006
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE ACT OF 1934
For The Quarter Ended September 30, 2006

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE ACT OF 1934
Commission File Number: 000-51032

HouseValues, Inc.

(Exact name of registrant as specified in its charter)

Washington
(State or other jurisdiction of
incorporation or organization)

11332 NE 122nd Way, Kirkland, WA 98034

(Address of principal executive offices, including zip code)

(425) 952-5500

(Registrant's telephone number, including area code)

91-1982679
(IRS Employer

Identification No.)

Edgar Filing: HouseValues, Inc. - Form 10-Q

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 Exchange Act.

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 October 20, 2006, there were outstanding 24,358,400 shares of the registrant's common stock, \$0.001 par value, which is the only class of common stock of the registrant.

Table of Contents

HOUSEVALUES, INC.

FORM 10-Q

Index

	Page
PART I. FINANCIAL INFORMATION	
Item 1. Condensed Consolidated Financial Statements (unaudited)	
<u>Condensed Consolidated Statements of Operations for the three and nine months ended September 30, 2006 and 2005</u>	3
<u>Condensed Consolidated Balance Sheets as of September 30, 2006 and December 31, 2005</u>	4
<u>Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2006 and 2005</u>	5
<u>Notes to Condensed Consolidated Financial Statements</u>	6
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	13
Item 3. <u>Quantitative and Qualitative Disclosures about Market Risk</u>	20
Item 4. <u>Controls and Procedures</u>	20
PART II. OTHER INFORMATION	
Item 1. <u>Legal Proceedings</u>	20
Item 1A. <u>Risk Factors</u>	21
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	30
Item 6. <u>Exhibits</u>	31
<u>SIGNATURE</u>	32

Table of Contents**Item 1. Condensed Consolidated Financial Statements****HouseValues, Inc.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(In thousands, except per share data)****(unaudited)**

	Three months ended September 30,		Nine months ended September 30,	
	2006	2005	2006	2005
Revenues	\$ 23,985	\$ 23,337	\$ 76,722	\$ 61,533
Expenses:				
Sales and marketing (1)	17,303	11,556	49,948	30,582
Technology and product development (1)	3,389	1,823	10,421	4,958
General and administrative (1)	3,813	3,375	11,254	9,321
Depreciation and amortization of property and equipment (2)	1,559	506	3,689	1,262
Amortization of intangible assets	258	151	1,063	454
Total expenses	26,322	17,411	76,375	46,577
(Loss) Income from operations	(2,337)	5,926	347	14,956
Interest income, net	717	491	2,011	1,295
(Loss) Income before income tax (benefit) expense	(1,620)	6,417	2,358	16,251
Income tax (benefit) expense	(157)	2,086	157	5,282
Net (loss) income	\$ (1,463)	\$ 4,331	\$ 2,201	\$ 10,969
Net (loss) income per share:				
Basic	\$ (0.06)	\$ 0.17	\$ 0.09	\$ 0.43
Diluted	\$ (0.06)	\$ 0.16	\$ 0.08	\$ 0.40

(1) Stock-based compensation is included in the expense line items above in the following amounts:

	2006	2005	2006	2005
Sales and marketing	\$ 218	\$ 57	\$ 798	\$ 185
Technology and product development	176	42	578	121
General and administrative	562	175	1,728	523
	\$ 956	\$ 274	\$ 3,104	\$ 829

(2) Depreciation and amortization of property and equipment is allocated as follows:

	2006	2005	2006	2005
Technology and product development	\$ 1,034	\$ 199	\$ 2,154	\$ 430
General and administrative	525	307	1,535	832
	\$ 1,559	\$ 506	\$ 3,689	\$ 1,262

Edgar Filing: HouseValues, Inc. - Form 10-Q

See accompanying notes to condensed consolidated financial statements.

Table of Contents**HouseValues, Inc.****CONDENSED CONSOLIDATED BALANCE SHEETS****(In thousands, except share data)****(unaudited)**

	September 30, 2006	December 31, 2005
Assets		
Current assets:		
Cash and cash equivalents	\$ 50,334	\$ 59,234
Short-term investments	28,575	25,640
Accounts receivable, net of allowance of \$177 and \$242	474	577
Prepaid expenses and other assets	1,541	1,700
Deferred income taxes	1,567	258
Prepaid income taxes	1,278	997
Other current assets	96	579
Total current assets	83,865	88,985
Property and equipment, net of accumulated depreciation of \$7,376 and \$3,689	12,461	11,118
Goodwill	6,815	6,227
Intangible assets, net of accumulated amortization of \$3,066 and \$2,003	3,799	4,853
Other noncurrent assets	408	408
Total assets	\$ 107,348	\$ 111,591
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	\$ 1,308	\$ 1,030
Accrued compensation and benefits	3,574	4,236
Accrued expenses and other current liabilities	5,087	6,529
Deferred rent, current portion	289	289
Deferred revenue	1,554	1,694
Total current liabilities	11,812	13,778
Deferred income taxes	969	726
Deferred rent, less current portion	1,180	1,423
Note payable	1,709	1,600
Total liabilities	15,670	17,527
Shareholders' equity:		
Common stock, par value \$0.001 per share, stated at amounts paid in; authorized 120,000,000 shares; issued and outstanding 24,611,795 and 25,783,980 shares at September 30, 2006 and December 31, 2005	63,901	71,385
Deferred stock-based compensation		(2,897)
Retained earnings	27,777	25,576
Total shareholders' equity	91,678	94,064
Total liabilities and shareholders' equity	\$ 107,348	\$ 111,591

See accompanying notes to condensed consolidated financial statements.

Table of Contents**HouseValues, Inc.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(In thousands)****(unaudited)**

	Nine months ended September 30,	
	2006	2005
Cash flows from operating activities:		
Net income	\$ 2,201	\$ 10,969
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of property and equipment	3,689	1,262
Amortization of intangible assets	1,063	454
Stock-based compensation	3,104	829
Deferred income tax benefit	(1,066)	(412)
Tax benefit from exercises of stock options		1,736
Changes in certain assets and liabilities		
Accounts receivable	103	(209)
Prepaid expenses and other assets	287	(129)
Prepaid income taxes	(188)	
Other current assets	483	1,521
Accounts payable	118	(197)
Accrued compensation and benefits	(662)	1,318
Accrued expenses and other current liabilities	1,282	2,116
Deferred rent	(243)	107
Deferred revenue	(140)	441
Income taxes payable and other	109	39
Net cash provided by operating activities	10,140	19,845
Cash flows from investing activities:		
Purchases of short-term investments	(5,000)	(12,799)
Sales of short-term investments	2,065	4,300
Purchases of property and equipment	(7,235)	(4,984)
Additions to goodwill and intangible assets	(1,335)	(1,155)
Net cash used in investing activities	(11,505)	(14,638)
Cash flows from financing activities:		
Purchase and retirement of common stock	(9,107)	
Proceeds from exercises of stock options and warrants	1,070	848
Tax benefit from exercises of stock options	502	
Issuance costs related to the sale of common stock		(614)
Net cash (used in) provided by financing activities	(7,535)	234
Net (decrease) increase in cash and cash equivalents	(8,900)	5,441
Cash and cash equivalents at beginning of period	59,234	57,562
Cash and cash equivalents at end of period	\$ 50,334	\$ 63,003

See accompanying notes to condensed consolidated financial statements.

Table of Contents

HouseValues, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands except per share amounts)

(unaudited)

Note 1: Summary of Significant Accounting Policies

Nature of Operations

Founded in 1999, HouseValues Inc. provides consumers and real estate professionals with the information and tools they need for success throughout the home buying and selling process. The company's flagship consumer products include HomePages.com, a lifestyle and neighborhood-centric home buying and selling service; TheLoanPage.com, a service that provides current and prospective home owners with competitive mortgage and refinance quotes from leading lenders; HouseValues.com®, a service that provides home sellers with market valuations of their current home; and JustListed.com, a service that alerts home buyers as soon as new homes hit the market that meet their criteria.

Basis of Presentation

The condensed consolidated financial statements are unaudited and include the financial statements of HouseValues, Inc. and its subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the financial statements included in our 2005 Annual Report on Form 10-K. All adjustments necessary for the fair presentation of our results of operations, financial position and cash flows have been included and are of a normal, recurring nature. Operating results for the three and nine months ended September 30, 2006 are not necessarily indicative of results to be expected for a full year.

Use of Estimates

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

Reclassifications

Prior period financial statement amounts have been reclassified to conform to current period presentation.

Summary of significant accounting policies

The significant accounting policies used in the preparation of our consolidated financial statements are disclosed in our 2005 Annual Report on Form 10-K. Updates to our significant accounting policies for 2006 are disclosed below.

Stock-based Compensation

On January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123(R), Share-Based Payment (Revised 2004) (FAS 123R), which requires the measurement and recognition of compensation for all stock-based awards made to employees and directors based on estimated fair values. FAS 123R supersedes previous accounting under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees for periods beginning in 2006.

We adopted FAS 123R using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006. In accordance with the modified prospective transition method, our consolidated financial statements for periods prior to 2006 have not been restated to reflect this change.

Edgar Filing: HouseValues, Inc. - Form 10-Q

Prior to our adoption of FAS 123R, we determined our stock-based compensation expense under the intrinsic value method on a straight-line basis over the vesting period of the options. With the adoption of FAS 123R, this expense has been replaced with stock-based compensation expense determined under the fair value method. Additionally, the deferred compensation in the equity section of our balance sheet has been reclassified to our common stock account.

Stock-based compensation recognized during the current year periods is based on the value of the portion of our stock-based awards earned over that service period, adjusted for expected forfeitures. Stock-based compensation recognized in our 2006 financial statements includes compensation cost for stock-based awards granted prior to, but not fully vested as of December 31, 2005 and additional stock-based awards granted subsequent to December 31, 2005.

Table of Contents

The compensation cost for awards granted prior to 2006 is based on the grant date fair value estimated in accordance with the pro forma provisions of FAS 123 while awards granted in 2006 follow the provisions of FAS 123R to determine the grant date fair value and compensation cost. Compensation cost for all stock-based awards is recognized using the straight-line method.

Upon adoption of FAS 123R, we continue to use the Black-Scholes option pricing model as our method of valuation for stock-based awards. Our determination of the fair value of stock-based awards on the date of grant using this option pricing model is affected by our stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to the expected life of the award, our expected stock price volatility over the expected life of the award and projected exercise behaviors. Although the fair value of stock-based awards is determined in accordance with FAS 123R, the Black-Scholes option pricing model requires the input of highly subjective assumptions, and other reasonable assumptions could provide differing results.

Recent Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board issued FAS 123R which requires all entities to recognize compensation expense in an amount equal to the fair value of share-based payments, such as stock options granted to employees. We adopted FAS 123R during the first quarter of 2006. We have elected to apply FAS 123R on a modified prospective method. Under this method, we apply the fair value method in 2006 and do not restate prior periods. Further, compensation expense for existing grants is recorded for the unvested portion of the fair value compensation expense of those grants over the remaining vesting periods. Stock-based compensation expense has increased substantially from what we have historically disclosed as pro forma compensation expense under the fair value method due to the increased number of option grants issued and the increase in the average option fair value. Also, FAS 123R requires us to change the classification of the tax savings resulting from tax deductions in excess of expense reflected in our financial statements from an operating cash flow to a financing cash flow, impacting our cash flows from operating activities.

In July 2006, the FASB issued FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109 (FIN 48)*. This Interpretation clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements. FIN 48 requires companies to determine whether it is more likely than not that a tax position will be sustained upon examination by the appropriate taxing authorities before any part of the benefit can be recorded in the financial statements. It also provides guidance on the recognition, measurement and classification of income tax uncertainties, along with any related interest and penalties. We will implement this Interpretation in the first quarter of 2007. We are currently evaluating the potential impact this Interpretation will have on our financial position and results of operations.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements (SFAS 157)*, which provides guidance on how to measure assets and liabilities that use fair value. SFAS 157 will apply whenever another US GAAP standard requires assets or liabilities to be measured at fair value but does not expand the use of fair value to any new circumstances. This standard also will require additional disclosures in both annual and quarterly reports. SFAS 157 will be adopted by us beginning in the first quarter of 2008. We are currently evaluating the potential impact this standard may have on our financial position and results of operations, but do not believe the impact of the adoption will be material.

Note 2: Acquisitions

The Loan Page

In October 2005 we acquired the outstanding stock of The Loan Page, Inc. The Loan Page generates and markets mortgage leads primarily to mortgage lenders, including some of the nation's largest banking and lending institutions. The company was purchased for approximately \$5,247 in cash, assumption of a note payable valued at \$1,590, as well as its remaining liabilities. We also incurred \$147 in transaction costs.

As part of that acquisition we assumed a note payable with a face amount of \$1,680 and a contractual interest rate of 3.55%. Upon acquisition, the note was discounted to a fair value of \$1,590 to reflect an effective yield of 8.2%. The note requires all principal and interest be paid in full on December 22, 2008, a total payment of \$2,000.

Table of Contents

The assets and liabilities acquired in The Loan Page acquisition were assigned the following values at the date of acquisition:

	October 31, 2005 (Date of Acquisition)
Cash	\$ 171
Current assets	546
Restricted cash	330
Intangible asset customer base	1,850
Intangible asset developed technology	1,950
Goodwill	3,324
Current liabilities	(1,068)
Deferred income taxes, net	(119)
Note payable	(1,590)
	\$ 5,394

The Loan Page's results of operations have been included in our consolidated statements of income since November 2005, following completion of the acquisition. The following unaudited pro forma information presents a summary of our results of operations assuming The Loan Page acquisition occurred at the beginning of 2005:

	Three months ended	Nine months ended
	September 30, 2005	September 30, 2005
Revenues	\$ 24,424	\$ 65,186
Net income	\$ 3,689	\$ 9,441
Net income per share basic	\$ 0.14	\$ 0.37
Net income per share diluted	\$ 0.13	\$ 0.34

Soar Solutions

In June 2003, we acquired the stock of Soar Solutions, Inc., a real-estate services company, in exchange for \$1,510 in cash, 200,000 shares of unvested restricted common stock and an earn-out arrangement equal to 5% of specified customer receipts through March 2006. As of September 30, 2006, additional amounts of approximately \$3,532 were paid under the earn-out arrangement. As contingent consideration was earned, the amounts increased the vendor agreements asset to its fair value and excess amounts were recorded as goodwill.

Note 3: Earnings per share

Basic earnings per share is computed using the weighted average number of shares outstanding during the period. Diluted earnings per share uses the weighted average common shares outstanding plus dilutive stock options.

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

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2006	2005	2006	2005
Calculation of basic earnings per share:				
Net (loss) income	\$ (1,463)	\$ 4,331	\$ 2,201	\$ 10,969

Edgar Filing: HouseValues, Inc. - Form 10-Q

Weighted average common shares outstanding	25,404	25,574	25,713	25,291
Dilutive effect of stock options		2,198	1,368	2,152
Diluted Shares	25,404	27,772	27,081	27,443
Basic (loss) earnings per share	\$ (0.06)	\$ 0.17	\$ 0.09	\$ 0.43
Diluted (loss) earnings per share	\$ (0.06)	\$ 0.16	\$ 0.08	\$ 0.40
Antidilutive stock options	1,801	98	1,858	350

Table of Contents**Note 4: Purchase and retirement of common stock**

In July 2006, our Board of Directors authorized us to purchase and retire up to 2,000 shares of our common stock. During the quarter ended September 30, 2006, we purchased 1,661 shares for \$9,374. On October 27, 2006, we completed our authorized purchase of 2,000 shares for a total of \$11,441. The shares were purchased at an average price of \$5.72 and represent approximately 7.7% of the shares outstanding at June 30, 2006.

Note 5: Income Taxes

Tax expense for the year-to-date period ended September 30, 2006 was \$157, or approximately 7% of pre-tax income, while we recognized a tax benefit of \$157 for the quarter. We have used the tax provision for the nine months ended September 30, 2006 because we are unable to provide a reliable estimated annual effective tax rate due to the sensitivity of the calculation at our current estimates of lower operating earnings relative to our tax-exempt interest income. Our effective rate was 33% for the quarter and year-to-date periods ended September 30, 2005.

Note 6: Product line revenues

The following table provides detail of our revenue by product line.

	Three months ended		Nine months ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Real estate product revenues	\$ 21,135	\$ 20,967	\$ 66,763	\$ 57,282
Mortgage product revenues	2,850	2,370	9,959	4,251
Total revenue	\$ 23,985	\$ 23,337	\$ 76,722	\$ 61,533

Note 7: Stock-based compensation plans

Effective January 1, 2006, we adopted FAS 123R, which establishes accounting for stock-based awards exchanged for employee services, using the modified prospective transition method. Accordingly, stock-based compensation cost is measured at grant date based on the fair value of the award, and expensed over the requisite service period. For prior periods, we applied the intrinsic value method and have not restated prior periods, as permitted by FAS 123R.

Determining Fair Value

Valuation and Amortization Method. We estimate the fair value of stock-based awards granted using the Black-Scholes option valuation model. We amortize the fair value of all awards on a straight-line basis over the requisite service periods, which are generally the vesting periods.

Expected Life. The expected life of awards granted represents the period of time that they are expected to be outstanding. We determine the expected life based on our limited historical experience and the estimates of other companies similar to ours, giving consideration to the contractual terms, vesting schedules, pre-vesting and post-vesting forfeitures and employees' expected exercise behavior.

Expected Volatility. We estimate the volatility of our common stock at the date of grant based on the limited historical volatility of our common stock and the experience of what we believe are peer companies based on the similar nature of our industry and option plan characteristics. We have used a volatility factor that considers the historical experience of these peer companies using a period commensurate with the expected life of the award.

Risk-Free Interest Rate. We base the risk-free interest rate used in the Black-Scholes option valuation model on the implied yield currently available on U.S. Treasury zero-coupon issues with an equivalent term to the expected life of the award.

Expected Dividend Yield. We do not anticipate paying any cash dividends in the foreseeable future. Consequently, we use an expected dividend yield of zero in the Black-Scholes option valuation model.

Edgar Filing: HouseValues, Inc. - Form 10-Q

Expected Forfeitures. We use historical data to estimate pre-vesting option forfeitures. We record stock-based compensation only for those awards that are expected to vest.

Table of Contents

The value of each employee option granted during the three and nine month periods ended September 30, 2006 and 2005 were estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	Three months ended		Nine months ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Expected life (in years)	3.0	3.0	3.0	3.1
Weighted average expected volatility	90%	90%	90%	91%
Weighted average risk-free interest rate	4.82%	4.02%	4.72%	4.02%
Expected dividend yield	0%	0%	0%	0%
Weighted average fair value	\$ 3.67	\$ 8.16	\$ 6.56	\$ 8.32

Stock-based Compensation

The following table summarizes stock-based compensation expense related to stock-based awards under FAS 123R for the three and nine month periods ended September 30, 2006:

	Three months ended	Nine months ended
	September 30, 2006	September 30, 2006
Total cost of share-based payment plans	\$ 970	\$ 3,215
Amounts capitalized in internally developed software	(14)	(111)
Amounts charged against income, before income tax benefit	\$ 956	\$ 3,104
Amount of related income tax benefit recognized in income	\$ 59	\$ 196
Amounts recognized in income for amounts previously capitalized in fixed assets	\$ 7	\$ 12

As of September 30, 2006, we had \$9,750 of unrecognized compensation cost related to non-vested stock-based awards granted under all equity compensation plans. We expect to recognize this cost over a weighted average period of 1.42 years.

The following table presents the impact of our adoption of FAS 123R on selected line items from our consolidated financial statements for the three and nine month periods ended September 30, 2006:

	As reported following		If reported following	
	FAS 123R		APB 25	
	Three months ended September 30, 2006	Nine months ended September 30, 2006	Three months ended September 30, 2006	Nine months ended September 30, 2006
Condensed consolidated statement of operations:				
Income (loss) before income tax expense or benefit	\$ (1,620)	\$ 2,358	\$ (941)	\$ 4,662
Net (loss) income	\$ (1,463)	\$ 2,201	\$ (827)	\$ 4,355
Net (loss) income per share				
Basic	\$ (0.06)	\$ 0.09	\$ (0.03)	\$ 0.17
Diluted	\$ (0.06)	\$ 0.08	\$ (0.03)	\$ 0.16

Edgar Filing: HouseValues, Inc. - Form 10-Q

Condensed consolidated statement of cash flows:

Net cash provided by operating activities	\$	10,140	\$	10,642
Net cash used in financing activities	\$	7,535	\$	8,037

Table of Contents**Stock Option Activity**

Options granted, exercised, canceled and expired under all of our stock option plans are summarized as follows:

	Options	Weighted Average Exercise Price	Weighted Average Fair Value	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value
Outstanding at December 31, 2005	4,102,102	\$ 6.93	\$ 4.64		
Options granted	341,200	11.04	6.58		
Options exercised	(488,315)	2.19	0.76		
Options forfeited	(656,961)	12.15	7.37		
Options expired	(10,840)	13.14	9.91		
Outstanding at September 30, 2006	3,287,186	\$ 7.00	\$ 4.86	7.8 years	\$ 6,465
Exercisable at September 30, 2006	1,668,062	\$ 4.60	\$ 3.13	7.0 years	\$ 4,711

As of September 30, 2006, we have reserved an additional 2.0 million shares for future issuance under our stock option plans. We issue new shares for option exercises.

The aggregate intrinsic value of options outstanding at September 30, 2006 and 2005 is calculated as the difference between the market price of the underlying common stock and the exercise price of the options for the options with exercise prices that were lower than the closing market price of our common stock at period end. The total intrinsic value of options exercised and the total fair value of options that vested and were forfeited are included in the following table.

	Three months ended		Nine months ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Intrinsic value of options exercised	\$ 778	\$ 1,998	\$ 2,629	\$ 8,794
Fair value of options vested	\$ 1,745	\$ 624	\$ 3,474	\$ 1,368
Fair value of options forfeited	\$ 2,827	\$ 601	\$ 4,842	\$ 1,536

A summary of the changes in our non-vested options during the three and nine month periods ended September 30, 2006 is presented below:

	Three months ended September 30, 2006		Nine months ended September 30, 2006	
	Option Activity	Weighted Average Grant Date Fair Value	Option Activity	Weighted Average Grant Date Fair Value
Non-vested at beginning of period	2,132,099	\$ 7.03	2,644,859	\$ 6.35
Options granted	86,800	3.67	341,200	6.58
Options canceled	(341,643)	8.27	(656,961)	7.37
Options vested	(258,132)	6.73	(709,974)	4.88
Non-vested at end of period	1,619,124	\$ 6.63	1,619,124	\$ 6.63

Table of Contents**Pro Forma Information under FAS 123 and APB 25**

Prior to 2006, we used the intrinsic value method to determine our stock-based compensation. If we had used the fair value method to determine stock-based compensation, our 2005 net income and earnings per share would have been changed to the following pro forma amounts:

	Three months ended		Nine months ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Net (loss) income, as reported	\$ (1,463)	\$ 4,331	\$ 2,201	\$ 10,969
Add: stock-based compensation included in net income, net of tax	897	194	2,908	590
Deduct: total stock-based compensation determined under fair value based method for all awards, net of tax	(897)	(497)	(2,908)	(1,186)
Net income (pro forma for 2005)	\$ (1,463)	\$ 4,028	\$ 2,201	\$ 10,373
Basic net income per share:				
As reported	\$ (0.06)	\$ 0.17	\$ 0.09	\$ 0.43
Pro forma (for 2005)		\$ 0.16		\$ 0.41
Diluted net income loss per share:				
As reported	\$ (0.06)	\$ 0.16	\$ 0.08	\$ 0.40
Pro forma (for 2005)		\$ 0.15		\$ 0.38

Note 8: B&O Tax Audit Settlement

We were under audit by the Washington State Department of Revenue and had received preliminary assessments asserting that substantially all of our revenues should be subject to the Washington state business and occupation tax. Through September 2005, we had accrued \$2,468 for the estimated cost of the assessment, which was our best estimate of our ultimate liability based on the preliminary assessment and subsequent negotiations with the Department of Revenue. In December 2005, we reached an agreement with the state to settle the audit for the period from January 2001 through September 2005 for a total of \$675. As a result, we reduced our accrual to the settlement amount and recorded \$1,793 as a reduction of general and administrative expenses in the fourth quarter of 2005. This settlement was paid in the first quarter of 2006.

Note 9: Supplemental Disclosure of Cash Flow Information

	Nine months ended	
	September 30, 2006	September 30, 2005
Cash paid during the period for income taxes, net of refunds received	\$ 909	\$ 3,918
Noncash investing and financing activities:		
Accrued earn-out payments in connection with acquisitions	\$	\$ 589
Accrued invoices for property and equipment	\$ 133	\$ 438
Accrued invoices for the purchase and retirement of common stock	\$ 267	\$

Table of Contents

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

You should read the following discussion and analysis by our management of our financial condition and results of operations in conjunction with our unaudited condensed consolidated financial statements and the accompanying notes included elsewhere in this Quarterly Report on Form 10-Q. This discussion and other parts of this Quarterly Report on Form 10-Q contain forward-looking statements relating to the Company's anticipated plans, products, services, and financial performance. The words believe, expect, anticipate, intend and similar expressions identify forward-looking statements, but their absence does not mean the statement is not forward-looking. These statements are not guarantees of future performance and are subject to certain risks, uncertainties and assumptions that could cause actual results to differ materially from those anticipated in the forward-looking statements. Factors that could affect the Company's actual results include, but are not limited to, those discussed below in Item 1A of Part II under the heading Risk Factors as well as those described in our Annual Report for the fiscal year ended December 31, 2005, which was filed with the Securities and Exchange Commission on March 10, 2006, our Quarterly Reports on Forms 10-Q for 2006 and in our other Securities and Exchange Commission filings. Given these risks and uncertainties, you should not place undue reliance on these forward-looking statements. The forward-looking statements are made as of the date of this report and the Company assumes no obligation to update any such statements to reflect events or circumstances after the date hereof.

Overview

Revenue for the third quarter of 2006 was \$24.0 million, an increase of 3% compared to the third quarter of 2005 and a decline of 7% compared to the second quarter of 2006. We experienced a net loss of \$1.5 million for the quarter, compared to net income of \$4.3 million for the third quarter of 2005 and net income of \$1.9 million in the second quarter of 2006. Revenues have declined for the past two quarters. While our customer base has increased modestly, we have seen declines in average revenue per customer due to lower average pricing in certain areas where transaction volumes have slowed significantly relative to 2005 as well as deeper penetration into historically underpenetrated markets where pricing tends to be lower. Further, our quarterly operating expenses have increased due in part to our continued commitment to invest in the long-term growth of our business. Additionally, the change in market conditions has resulted in an increase in our media costs to generate consumer leads for our customers.

We provide marketing services to real estate professionals, including real estate agents and mortgage brokers. Currently, most of our revenue is generated from the products we sell to real estate agents, HouseValues and JustListed, as well as our newer product, Showcase. The following business events since January 2005 affect the comparability of operating results for periods presented in this Form 10-Q.

HomePages: In October of 2005, we announced the launch of HomePages, an Internet web site that aids consumers in the home buying and selling process by combining nationwide home listings, high resolution aerial photos, and detailed neighborhood information to provide a comprehensive view of each home and neighborhood. The site features homes for sale and displays detailed information on the nearby schools, parks, shops and local services. HomePages also provides home owners with information on recently sold homes in their neighborhood as well as the ability to get a local expert's estimate of their home's value. Additionally, we are deploying HomePages as the consumer engagement platform for potential new products currently in development.

We offer a web site built on the HomePages platform at no cost to all existing real estate agent customers. We generate revenue by selling online marketing subscriptions, Showcase, to real estate professionals which allow them to feature selected listings on their site. We began generating revenue from this product in January 2006.

Mortgage Service Offerings: During the second quarter of 2005, we announced a new marketing service for mortgage professionals, JustListed Connect, which includes exclusive home buyer leads, a proprietary mortgage customer relationship management tool that enables communication with prospective customers, past clients and local real estate professionals, marketing materials and dedicated training and account management support. We generate revenue from this service offering by charging mortgage customers a monthly fixed fee.

To expand our product offerings to mortgage professionals, we acquired The Loan Page, Inc. on October 31, 2005. The Loan Page marketed leads to mortgage lenders, including some of the nation's largest banking and lending institutions. We paid approximately \$5.2 million in cash and \$1.6 million in assumed debt to acquire The Loan Page and incurred \$0.1 million in costs related to the acquisition.

In the past months, we have expanded our customer base for The Loan Page semi-exclusive leads product to a broader base of individual mortgage brokers, the segment of this market that is similar to our established sales channel to real estate agents. We also continued transitioning some of our mortgage customers from our JustListed Connect product to The Loan Page product during the quarter while continuing to offer both products. This product transition is intended to increase

Table of Contents

average times sold for The Loan Page's semi-exclusive lead generation platform, to enhance mortgage customer retention, and to make additional JustListed inventory available for real estate customers.

For the nine months ended September 30, 2006, revenue from our mortgage products represents 13% of our revenues compared to 7% in 2005.

Expansion Facility: In October of 2005, we entered into a commercial lease agreement for an office/warehouse building located on approximately 2.56 acres of real property located in Yakima, Washington. The new facility will allow us to continue to expand our sales force in the lower cost environment of Yakima. We opened this facility in January 2006 and have started building our sales and support staff at that location.

Results of Operations

In our management's discussion and analysis we compare the third quarter and year-to-date periods in 2006 to the same periods in 2005. With our adoption of FAS 123R, Share-Based Payments in the first quarter of 2006, we believe it is important to provide transparency into the changes in our financial presentation. As a result, we have provided breakdowns of the stock-based compensation included in sales and marketing, technology and product development and general and administrative expenses in the related discussions.

Revenues

	Three months ended		Nine months ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Real Estate Revenues	\$ 21,135	\$ 20,967	\$ 66,763	\$ 57,282
Mortgage Revenues	2,850	2,370	9,959	4,251
Revenues	\$ 23,985	\$ 23,337	\$ 76,722	\$ 61,533

Revenues for the third quarter of 2006 increased 3% over the same quarter in 2005 and 25% for the year-to-date period as compared to 2005 due to the growth of our real estate business and the 2005 launch of our mortgage business. Our real estate revenues increased 17% and 1% year over year and quarter over quarter due to the growth of our JustListed and HouseValues products and the 2006 addition of our HomePages service. Over the past year average core real estate customer count increased 13% while our average real estate revenue per customer decreased 10% when compared with the same period in 2005. Average monthly revenue per real estate customer for the third quarter of 2006 decreased due to the addition of customers in underpenetrated markets, typically lower priced markets coupled with adjustments to realign pricing with demand in markets where transaction volumes have slowed relative to a year ago.

Revenue in the third quarter of 2006 decreased 7% from the second quarter of 2006. Real estate revenues decreased 6% while mortgage revenues declined by 18%. We experienced a 7% decrease in average real estate revenue per customer partially offset by a 1% increase in average real estate core customers for the period. As mentioned above, average real estate revenue per customer decreased due to reduced pricing in response to softening demand in many markets and the addition of customers in under-penetrated markets that tend to be lower priced. More information about the sequential change in real estate revenue and customers is included in the Key Operational Metrics Real Estate Products section of Management's Discussion and Analysis. The decline we saw in mortgage revenues also primarily related to slowing market conditions. While we achieved modest revenue growth in our semi-exclusive lead products, that was offset by the continued decline in revenue from our exclusive lead product.

Given current market conditions, we expect revenue to trend down in the fourth quarter of 2006.

Table of Contents*Sales and Marketing*

	Three months ended		Nine months ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Sales and marketing expense before stock-based compensation	\$ 17,085	\$ 11,499	\$ 49,150	\$ 30,397
Stock-based compensation	218	57	798	185
Total sales and marketing expense	\$ 17,303	\$ 11,556	\$ 49,948	\$ 30,582
As a percentage of revenue:				
Sales and marketing expense before stock-based compensation	71%	50%	64%	50%
Stock-based compensation	1%		1%	
Total sales and marketing expense	72%	50%	65%	50%

Sales and marketing expense increased in total and as a percentage of revenue for the quarter and year-to-date periods ended September 30, 2006 when compared to the same periods last year. While revenue declined, lead generation costs increased due to increased lead obligations and a higher cost of leads than we have experienced in recent history. Additionally our sales headcount increased, a portion of which related to our investment in new business initiatives and the ramp up of our Yakima facility. Sales and marketing expenses related to HomePages and The Loan Page exceeded their revenue contribution in 2006, reflecting new advertising to expand consumer awareness and the hiring of personnel to drive these business initiatives.

Third quarter 2006 sales and marketing expenses increased \$0.9 million over the second quarter of 2006 primarily due to increased payroll expenses and increased cost of leads. Payroll expenses increased as a result of increased headcount and lead generation costs increased reflecting lower consumer response and higher cost of leads.

We expect sales and marketing costs to remain relatively consistent for the rest of 2006 but to increase slightly as a percentage of revenue.

Technology and Product Development

	Three months ended		Six months ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Technology and product development expense before stock-based compensation	\$ 3,213	\$ 1,781	\$ 9,843	\$ 4,837
Stock-based compensation	176	42	578	121
Total technology and product development expense	\$ 3,389	\$ 1,823	\$ 10,421	\$ 4,958
As a percentage of revenue:				
Technology and product development expense before stock-based compensation	13%	8%	13%	8%
Stock-based compensation	1%		1%	
Total technology and product development expense	14%	8%	14%	8%

Technology and product development expense increased significantly in absolute dollars and as a percentage of revenue for the quarter and year-to-date periods ended September 30, 2006 as compared to the same periods in 2005, primarily due to payroll and related expenses, including stock-based compensation and contractor expense. Headcount increased 24% as we continued to invest in new product planning and to maintain and improve our existing services, features and infrastructure for our larger customer base.

Edgar Filing: HouseValues, Inc. - Form 10-Q

For the remainder of 2006, we expect product development expenses to stabilize in total dollars but to increase as a percentage of our revenue base. As we implement significant service upgrades and develop new service offerings, costs associated with these activities may be capitalized as internally developed software and web site development costs in accordance with the accounting guidance in AICPA Statement of Position 98-1 and FASB Emerging Issues Task Force Issue No. 00-2.

Table of Contents*General and Administrative*

	Three months ended		Nine months ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
General and administrative expense before stock-based compensation	\$ 3,251	\$ 3,200	\$ 9,526	\$ 8,798
Stock-based compensation	562	175	1,728	523
Total general and administrative expense	\$ 3,813	\$ 3,375	\$ 11,254	\$ 9,321
As a percentage of revenue:				
General and administrative expense before stock-based compensation	14%	13%	13%	14%
Stock-based compensation	2%	1%	2%	1%
Total general and administrative expense	16%	14%	15%	15%

General and administrative expenses increased for the quarter and year-to-date periods ended September 30, 2006 when compared to the same periods last year, primarily due to increased salaries and related expenses (including stock-based compensation and severance) for additional staffing to support the growth in the business, as well as our operations as a public company and increased rent and facilities costs, primarily due to the opening of our Yakima location. Additionally on a year-to-date basis we saw increased credit card fees directly related to the increase in our revenues.

These increases were partially offset by decreases to our state and local tax expense. In December 2005, we reached an agreement with the Washington State Department of Revenue to settle a business and occupation tax audit covering the period from January 2001 through September 2005 for a total of \$0.7 million. Through September 2005, we had accrued \$2.5 million for the estimated cost of the assessment, which was our best estimate of our ultimate liability based on the preliminary assessment and subsequent negotiations with the Department of Revenue. As a result, in the fourth quarter of 2005, we reduced our accrual to the settlement amount and recorded \$1.8 million as a reduction of general and administrative expenses. Additionally we have adjusted our expense rate in 2006.

For the fourth quarter of 2006, we expect general and administrative expenses to remain consistent with current levels and to increase slightly as a percentage of revenue.

Depreciation and Amortization of Property and Equipment

Depreciation and amortization of property and equipment increased year-over-year primarily due to additional depreciation expense on capitalized software development and on workstations and equipment purchased to accommodate our increased headcount. Additionally, in the third quarter of 2006 we recognized \$0.3 million of accelerated depreciation on approximately \$1.0 million of unamortized technology investment in HomePages, that is expected to be retired upon launch of the next major release of the product in early 2007. We plan to recognize the remaining depreciation on this asset through approximately the fourth quarter of 2006.

Because of the additions already made to our capital assets during 2005 and 2006, our future planned additions and the accelerated depreciation being recognized, we expect depreciation expense to increase in absolute dollar amounts and as a percentage of revenue through the fourth quarter of 2006.

Amortization of Intangible Assets

Amortization of intangible assets increased for the quarter and year-to-date periods ended September 30, 2006, when compared to the same periods in 2005. The increase in amortization expense resulted primarily from additions to our intangible assets obtained as part of The Loan Page acquisition in the fourth quarter of 2005.

Interest Income

Edgar Filing: HouseValues, Inc. - Form 10-Q

Interest income increased for the year-to-date period ended September 30, 2006, when compared to the same period in 2005 due to larger average cash and investment balances in 2006 and as well as increased rates of return on investments. Interest income also increased for the third quarter of 2006 compared to the same period in 2005 primarily due to increased rates of return on investments. Overall cash and investment balances declined in the third quarter of 2006 as we purchased and retired 1.7 million shares of our common stock for \$9.4 million, offsetting cash generated from operations. At September 30, 2006, we held \$78.9 million in cash, cash equivalents and short-term investments, compared to \$88.8 million at September 30, 2005.

Table of Contents*Income Taxes*

Tax expense for the year-to-date period ended September 30, 2006 was \$157, or approximately 7% of pre-tax income, while we recognized a tax benefit of \$157 for the quarter. We have used the tax provision for the nine months ended September 30, 2006 because we are unable to provide a reliable estimated annual effective tax rate due to the sensitivity of the calculation at our current estimates of lower operating earnings relative to our tax-exempt interest income. Our effective rate was 33% for the quarter and year-to-date periods ended September 30, 2005.

Critical Accounting Policies and Estimates

Our financial statements are prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, costs and expenses and related disclosures. On an ongoing basis, we evaluate our estimates and assumptions. Accordingly, our actual results may differ from these estimates under different assumptions or conditions. The critical accounting policies that involve significant judgments and estimates used in the preparation of our consolidated financial statements are disclosed in our Annual Report on Form 10-K for the year ended December 31, 2005.

Quarterly Consolidated Statements of Income and Operational Data

The following tables present the unaudited consolidated statements of income data for the seven quarters ended September 30, 2006 in dollars and as a percentage of revenues. This quarterly information has been prepared on the same basis as our audited consolidated financial statements and, in the opinion of our management, reflects all adjustments necessary for a fair representation of the information for the periods presented. This data should be read in conjunction with our audited consolidated financial statements and the related notes included in our 2005 Annual Report on Form 10-K. Operating results for any quarter apply to that quarter only and are not necessarily indicative of results for any future period.

	Mar. 31, 2005	June 30, 2005	Sept. 30, 2005	Dec. 31, 2005	Mar. 31, 2006	June 30, 2006	Sept. 30, 2006
Consolidated Statements of Operations							
Data (in thousands):							
Revenues	\$ 17,619	\$ 20,577	\$ 23,337	\$ 25,177	\$ 26,871	\$ 25,866	\$ 23,985
Expenses:							
Sales and marketing	8,688	10,338	11,556	13,669	16,258	16,387	17,303
Technology and product development	1,396	1,739	1,823	2,692	3,611	3,421	3,389
General and administrative	2,839	3,107	3,375	2,465	3,767	3,674	3,813
Depreciation and amortization of property and equipment	354	402	506	629	1,014	1,116	1,559
Amortization of intangible assets	152	151	151	322	401	404	258
Total expenses	13,429	15,737	17,411	19,777	25,051	25,002	26,322
Income (loss) from operations	4,190	4,840	5,926	5,400	1,820	864	(2,337)
Interest income	318	486	491	579	604	690	717
Income (loss) before income tax expense (benefit)	4,508	5,326	6,417	5,979	2,424	1,554	(1,620)
Income tax expense (benefit)	1,578	1,618	2,086	1,965	654	(340)	(157)
Net income (loss)	\$ 2,930	\$ 3,708	\$ 4,331	\$ 4,014	\$ 1,770	\$ 1,894	\$ (1,463)

Consolidated Statements of Operations
Data as a Percentage of Revenue:

Revenues	100%	100%	100%	100%	100%	100%	100%
Expenses:							
Sales and marketing	49	50	49	54	61	63	72

Edgar Filing: HouseValues, Inc. - Form 10-Q

Technology and product development	8	8	8	11	13	14	14
General and administrative	16	15	14	10	14	14	16
Depreciation and amortization of property and equipment	2	2	2	2	4	4	7
Amortization of intangible assets	1	1	1	1	1	2	1
Total expenses	76	76	74	78	93	97	110
Income (loss) from operations	24	24	26	22	7	3	(10)
Interest income	2	2	2	2	2	3	3
Income (loss) before income tax expense (benefit)	26	26	28	24	9	6	(7)
Income tax expense (benefit)	9	8	9	8	2	(1)	(1)
Net income (loss)	17%	18%	19%	16%	7%	7%	(6%)

Table of Contents**Key Operational Metrics Real Estate Products**

The following table presents operational data related to our real estate products for the seven quarters ended September 30, 2006:

	Mar. 31, 2005	June 30, 2005	Sept. 30, 2005	Dec. 31, 2005	Mar. 31, 2006	June 30, 2006	Sept. 30, 2006
Operational Data:							
Components of revenue (in thousands):							
Real estate core revenue (1)	\$ 16,410	\$ 18,375	\$ 20,267	\$ 21,230	\$ 22,748	\$ 21,993	\$ 20,620
Other real estate revenue (2)	760	770	700	592	488	400	515
Net real estate revenue	\$ 17,170	\$ 19,145	\$ 20,967	\$ 21,822	\$ 23,236	\$ 22,393	\$ 21,135
Core real estate customers, end of period	12,834	13,419	14,968	14,971	15,825	15,993	16,184
Average monthly real estate customer churn rate (3)	6.2%	6.5%	6.3%	7.0%	6.6%	7.4%	7.6%
Average core real estate customers in the quarter (4)	11,931	13,127	14,194	14,970	15,398	15,909	16,089
Average monthly revenue per core real estate customer (5)	\$ 458	\$ 467	\$ 476	\$ 473	\$ 492	\$ 461	\$ 427

- (1) Real estate core revenue consists of revenue for our primary real estate service offerings, HouseValues, JustListed, and HomePages. The customers from these primary service offerings are referred to as core real estate customers.
- (2) Other real estate revenue consists of revenue related to SOAR services, sales of surplus leads to brokers with no minimum commitment, monthly fees for use of our tools, the sales of branded marketing collateral, seminar attendance fees, and advertising.
- (3) Average monthly customer churn is calculated by dividing the number of core customers who canceled during the quarter by the average core customers in the quarter, divided by the number of months in the quarter. Core customers are customers from whom we collect fees for our core revenues. One minus our average monthly churn rate equates to our average monthly retention rate. Our annualized customer retention rate is calculated as average monthly retention raised to the power of 12. Other companies may calculate churn and retention differently, and their churn and retention data may not be directly comparable to ours.
- (4) Average core real estate customers in the quarter are calculated as the average of real estate customers at the beginning and at the end of the quarter.
- (5) Average revenue per core real estate customer is calculated as core real estate revenue for the quarter divided by the average number of core real estate customers in the quarter.

Our core real estate customer count increased by 191 customers during the third quarter of 2006, compared to a net increase of 168 customers in the second quarter of 2006. Ending core real estate customers increased 8% in the third quarter of 2006 compared to the third quarter of 2005.

Average monthly churn for our real estate business was 7.6% for the third quarter of 2006, up from 7.4% in the second quarter of 2006. Monthly churn of 7.6% equates to 92.4% monthly retention which represents a 39% annualized retention rate. We had a higher level of customer additions in the first and third quarters of 2005. Many are now in months twelve through fourteen of the customer life cycle, a time in which we typically see higher than average monthly churn. We expect to continue to experience fluctuations in our churn rate from quarter to quarter.

Average monthly revenue per real estate customer for the third quarter of 2006 decreased 7% compared to the second quarter of 2006 due to the addition of customers in underpenetrated markets, typically lower priced markets coupled with adjustments to realign pricing with demand in

Edgar Filing: HouseValues, Inc. - Form 10-Q

markets where transaction volumes have slowed relative to a year ago. Average revenue per customer will fluctuate from quarter to quarter, however we expect it may decline over the upcoming quarters as we incorporate lower priced markets into our customer base or see increased pricing pressure in areas where transaction volumes have slowed significantly. Potentially offsetting this trend are sales of additional services we plan to introduce.

Table of Contents**Liquidity and Capital Resources**

The following table presents summary cash flow data:

	Nine months Ended September 30,	
	2006	2005
	(dollars in thousands)	
Cash provided by operating activities	\$ 10,140	\$ 19,845
Cash used in investing activities	\$ (11,505)	\$ (14,638)
Cash provided by (used in) financing activities	\$ (7,535)	\$ 234

Our principal sources of liquidity are our cash, cash equivalents and short-term investments, as well as the cash flow that we generate from our operations.

Cash equivalents consist of money market funds. Short-term investments consist of highly liquid, short-term, adjustable-rate insured municipal notes. These municipal notes are classified as short-term investments available for sale and are reported at fair value, which approximates cost.

Operating Activities

Net cash provided by operating activities primarily consists of net income adjusted for non-cash items and the effect of changes in working capital. Net cash provided by operating activities for the nine months ended September 30, 2006 declined from the same period in 2005 primarily because of the decrease in net income. Increases in non-cash items, depreciation, amortization, and stock-based compensation, were largely offset by changes in working capital accounts. Additionally, the tax benefit realized from the exercise of stock options was classified as an operating cash flow in 2005. In 2006, that tax benefit is classified as a financing cash flow as required with our adoption of FAS 123R.

Investing Activities

Cash used in investing activities for the nine months ended September 30, 2006 decreased by \$3.1 million compared to the same period last year. During the first nine months of 2006, decreases in our net purchases of short-term investments were partially offset by increases in our capital expenditures when compared to the same period last year. Our capital expenditures were primarily related to investments in our customer-facing infrastructure and development costs related to new products and features as well as the purchase of office equipment and leasehold improvements at our new Yakima location.

Financing Activities

Cash used by financing activities for the nine months ended September 30, 2006 increased \$7.8 million primarily due to the purchase and retirement of 1.7 million shares of our common stock during the third quarter of 2006. This was partially offset by the proceeds from exercises of stock options and warrants, and by the tax benefit realized from the exercise of stock options, which is now classified as a financing cash flow as required with our adoption of FAS 123R.

Purchase and Retirement of Common Stock

In July 2006, our Board of Directors authorized a share repurchase program to purchase and retire up to 2.0 million shares of our common stock. During the quarter ended September 30, 2006, we purchased 1.7 million shares for \$9.4 million. On October 27, 2006, we completed our authorized purchase of 2.0 million shares for a total of \$11.4 million. The shares were purchased at an average price of \$5.72 and represent approximately 7.7% of the shares outstanding at June 30, 2006.

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Number of Shares Purchased as Part of a Publicly Announced Plan or Program	Maximum Number of Shares That May Yet Be Purchased Under the Plan
July 21, 2006 - July 31, 2006	118,200	\$ 5.43	118,200	1,881,800

Edgar Filing: HouseValues, Inc. - Form 10-Q

August 1, 2006 - August 31, 2006	1,187,900	\$ 5.59	1,187,900	693,900
September 1, 2006 - September 30, 2006	354,400	\$ 5.89	354,400	339,500
October 1, 2006 - October 27, 2006	339,500	\$ 6.09	339,500	
Total	2,000,000	\$ 5.72	2,000,000	

Table of Contents

On October 27, 2006, our Board of Directors authorized a second share repurchase program to purchase and retire an additional 2.0 million shares of our common stock.

Recent Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board issued FAS 123R which requires all entities to recognize compensation expense in an amount equal to the fair value of share-based payments, such as stock options granted to employees. We adopted FAS 123R during the first quarter of 2006. We have elected to apply FAS 123R on a modified prospective method. Under this method, we apply the fair value method in 2006 and do not restate prior periods. Further, compensation expense for existing grants is recorded for the unvested portion of the fair value compensation expense of those grants over the remaining vesting periods. Stock-based compensation expense has increased substantially from what we have historically disclosed as pro forma compensation expense under the fair value method due to the increased number of option grants issued and the increase in the average option fair value. Also, FAS 123R requires us to change the classification of the tax savings resulting from tax deductions in excess of expense reflected in our financial statements from an operating cash flow to a financing cash flow, impacting our cash flows from operating activities.

In July 2006, the FASB issued FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes – An Interpretation of FASB Statement No. 109 (FIN 48)*. This Interpretation clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements. FIN 48 requires companies to determine whether it is more likely than not that a tax position will be sustained upon examination by the appropriate taxing authorities before any part of the benefit can be recorded in the financial statements. It also provides guidance on the recognition, measurement and classification of income tax uncertainties, along with any related interest and penalties. We will implement this Interpretation in the first quarter of 2007. We are currently evaluating the potential impact this Interpretation will have on our financial position and results of operations.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements (SFAS 157)*, which provides guidance on how to measure assets and liabilities that use fair value. SFAS 157 will apply whenever another US GAAP standard requires assets or liabilities to be measured at fair value but does not expand the use of fair value to any new circumstances. This standard also will require additional disclosures in both annual and quarterly reports. SFAS 157 will be adopted by us beginning in the first quarter of 2008. We are currently evaluating the potential impact this standard may have on our financial position and results of operations, but do not believe the impact of the adoption will be material.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

The primary objective of our investment activities is to preserve principal and liquidity without incurring significant risk. To achieve this objective, we invest in short-term, high-quality, interest-bearing securities. Our investments in debt securities are subject to interest rate risk. To minimize our exposure to an adverse shift in interest rates, we invest in short-term securities and maintain an average maturity of one year or less.

Item 4. Controls and Procedures

(a) *Evaluation of disclosure controls and procedures.* Under the supervision and with the participation of our Company's management, including the Chief Executive Officer and Chief Financial Officer, the Company has evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e)) under the Securities Exchange Act of 1934, as amended. Based on that evaluation, the Company's management, including the Chief Executive Officer and Chief Financial Officer, concluded that the Company's disclosure controls and procedures were effective as of September 30, 2006.

(b) *Changes in internal controls.* We have made no changes in internal control over financial reporting during the third fiscal quarter of 2006 that materially affected or are reasonably likely to materially affect our internal control over financial reporting. We intend to continue to refine our internal control on an ongoing basis as we deem appropriate with a view towards continuous improvement.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Edgar Filing: HouseValues, Inc. - Form 10-Q

From time to time, we may become involved in litigation relating to claims arising from the ordinary course of our business, including actions relating to employment issues. We believe that there are no claims or actions pending or threatened against us, the ultimate disposition of which would have a material adverse effect on us.

Table of Contents

Item 1A. Risk Factors

You should carefully consider the following factors that may affect our business, future operating results and financial condition, as well as other information included in this Quarterly Report. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us or that we currently deem immaterial also may impair our business operations. If any of the following risks actually occur, our business, financial condition and operating results could be materially adversely affected.

We have a limited operating history, our business model is new and evolving and our future operating results are unpredictable.

We were formed in May 1999 and therefore have a limited operating history upon which to evaluate our operations and future prospects. There is little significant historical basis to assess how we will respond to competitive, economic or technological challenges. Our business and prospects must be considered in light of the risks and uncertainties frequently encountered by companies in the early stages of development.

The success of our business model depends on our ability to attract new and retain existing customers and to efficiently generate leads from consumers visiting our web sites. Any failure to execute this strategy could harm our business. Our business model is relatively new and unproven and is still evolving.

We expect that we will continue to increase our expenses, in particular within sales and marketing, as we seek to expand our business. We cannot assure you that our strategies for growth will be successful or that our revenues will increase sufficiently to maintain our current margins or profitability on a quarterly or annual basis.

Our operating results are subject to fluctuations that may cause our stock price to decline.

Our operating results have fluctuated in the past and are likely to continue to do so in the future. Our revenues are unpredictable and may fluctuate from quarter to quarter due to changes in rates of customer adoption and retention, the cyclical nature of the real estate industry, variability in interest rates and other factors outside of our control. In addition, our expenses and revenues may fluctuate from quarter to quarter due to, among other factors, the timing of sales and marketing campaigns. We believe that period-to-period comparisons of our past operating results may not be good indicators of our future performance and should not be relied on to predict the future performance of our stock price. For example, we launched our JustListed.com business in January 2004 which led to rapid revenue growth. We do not expect that we will be able to sustain this revenue growth rate in future quarters as our business matures and the rate of customer growth declines. In addition, we have recently entered the mortgage lead generation business and have also launched a real estate consumer Internet portal. We have limited experience in these areas and may not be successful.

It is possible that in the future our operating results will not meet the expectations of investors, causing the market price of our common stock to decline. In the past, companies that have experienced decreases in the market price of their stock have been subject to securities class action litigation. A securities class action lawsuit against us could result in substantial costs and divert our management's attention from other business concerns.

We may be unable to compete successfully with our current or future competitors.

We operate in a highly competitive environment and expect that competition will continue to be intense. The barriers to entry in our industry are low, making it possible for current or new competitors to adopt certain aspects of our business model without great financial expense, thereby reducing our ability to differentiate our services. All of our services, including online lead generation, online prospect management, online real estate portal content and advertising, and customer coaching and training are provided separately by other companies, and it is possible that one or more of these companies, or a new market entrant, could adopt a business model that competes directly with us.

Our current and potential competitors include:

Traditional Sellers of Advertising to Real Estate and Mortgage Professionals. We compete with traditional sellers of advertising, including local and regional newspapers, local magazines, and rack publications advertising homes for sale, for a share of the marketing dollars that residential real estate and mortgage professionals spend to attract prospective home buyers and sellers and mortgage consumers. Real estate and mortgage professionals may continue to view traditional advertising sources as the most effective means to reach prospective home buyers and sellers and mortgage consumers, leading to a lack of demand for our services. If we fail to persuade these customers to spend marketing dollars on our services, our business and operating results will suffer.

Table of Contents

Internet Media Companies. We compete with large Internet media companies, such as AOL, Google, MSN and Yahoo! for real estate and mortgage professionals' marketing dollars. Some of the large Internet media companies are currently developing enhanced search products, including search products that would allow a user to find real estate or mortgage related search results in a specific city or geographic area. If their existing or new products become a cost-effective way for real estate and mortgage professionals to generate leads, these products may become an attractive alternative to our services, which could decrease demand for our services or increase our online lead generation costs. Additionally, these companies, on which we rely in part for our own advertising and lead generation needs, may develop or acquire products and services that compete directly with our services.

Online Companies Focused on Real Estate and Mortgage Lending. We compete with a variety of online marketing and lead generation companies that focus exclusively on the real estate and mortgage industry. Such companies include Homes.com, Homestore and IAC/InterActiveCorp and its mortgage and real estate business, which includes LendingTree.com and RealEstate.com, all of which have established web sites and compete or may compete for real estate and mortgage professionals' advertising expenditures. HomeStore, one of the largest Internet real estate sites, has recently entered into the lead generation business. In addition, the founder of Expedia.com has a company named Zillow, that is actively focusing on the residential real estate market.

In addition, consolidation driven by online service providers involved in the real estate and mortgage industry and Internet media companies could create more potent competitors. For instance, Classified Ventures acquired HomeGain, an online real estate lead generation company. Increased consolidation among online service providers in the residential real estate and mortgage industry could result in additional competitors that have significantly greater resources or greater brand recognition than we do, and that are able to provide a broader and more attractive suite of services to real estate and mortgage professionals than we can.

Real Estate and Mortgage Brokerage Firms. Some real estate and mortgage brokerage firms currently offer services similar to ours, and in the future these firms and other brokerage firms may become direct competitors. A significant percentage of residential real estate and mortgage professionals are affiliated with large national or regional brokerage firms. If these brokerage firms, or smaller independent brokerage firms, decide to provide their agents with a service offering or suite of service offerings similar to ours at a lower cost or free of charge, or if they attempt to restrict the ability of their agents to use our services, demand for our services by real estate and mortgage professionals could decrease.

Many of our existing and potential competitors have longer operating histories, greater name recognition, greater technological capabilities and greater financial, sales, marketing and human resources than we do. These competitors could:

develop services that are as effective as or superior to our services or that achieve greater market acceptance than do our services;

devote greater resources to marketing or selling their services;

make more attractive offers to potential customers or otherwise more effectively attract real estate and mortgage professionals;

withstand price competition more successfully than we can;

provide services similar to ours at no additional cost by bundling them with their other product and service offerings;

make more attractive offers to existing and potential employees or independent contractors than we do;

more effectively negotiate third-party arrangements; and

Edgar Filing: HouseValues, Inc. - Form 10-Q

take advantage of investments, acquisitions or other opportunities more readily than we can.

Any efforts to expand into new lines of business may not be successful, or may take longer than expected to complete.

We have recently expanded our lead generation business into the residential mortgage services industry, in which we have only limited experience. As part of this expansion, in October 2005, we purchased The Loan Page, Inc., a small mortgage lead generator formerly located in San Francisco. In addition, in October 2005, we launched HomePages, an Internet web site that combines aerial maps, in-depth neighborhood information, and nationwide home listings in one integrated web site. These initiatives, and other acquisitions and initiatives we may pursue may not be successful or the anticipated benefits may take longer to realize than expected. Also, we have little or no experience in these areas which may result in errors in the conception, structure or implementation of a strategy to take advantage of available opportunities. We cannot assure you that any new products, acquisitions or other expansion efforts will be successful.

Table of Contents

Any failure to increase the number of our customers would harm our business.

Our growth depends in large part on increasing the number of our customers. However, prospective customers may not be familiar with our services and may be accustomed to using traditional methods of advertising and marketing. To attract more customers, we must convince real estate and mortgage professionals to spend a portion of their advertising and marketing budgets on our services. We cannot assure you that we will be successful in continuing to acquire more customers or that our future sales efforts will be effective. If we reach the point at which we have attempted to sell our services to the majority of residential real estate customers and/or mortgage customers, our ability to further increase the number of customers could be limited. We may not know or be able to estimate when we have reached this point because we currently cannot reliably estimate the total number of residential real estate agents and/or mortgage customers that are actively engaged in the industry during any particular period.

Any failure to retain customers could harm our business.

Our ability to retain customers will depend, in part, on our ability to generate leads from prospective home buyers, sellers and mortgage consumers in quantities demanded by our customers. In addition, our success will depend on our ability to enhance our existing services, develop new technologies that address the increasingly sophisticated and varied needs of customers, respond to technological advances and emerging industry standards and practices in a timely manner and on a cost-effective basis. Our real estate customer contracts and many of our mortgage customer contracts require us to deliver a guaranteed minimum number of leads per month to each customer. We occasionally fail to deliver the number of leads we are required to deliver to a customer in a given month. For example, during the quarter ended September 30, 2006, we were unable to deliver approximately 5.4% of our total guaranteed lead obligations to customers. Our estimated obligation for underdelivered leads at September 30, 2006 was approximately \$0.2 million. If we regularly fail to deliver the number of leads we are required to deliver to a customer, that customer will likely become dissatisfied with our services. In addition, if we do not maintain adequate technical support levels, or continue to improve the ease of use, functionality and features of our Market Leader prospect management system, customer coaching and training offerings, or if customers are dissatisfied with the quality of the leads that we provide, our customer may choose not to extend their contracts for our services.

Agents remain customers typically only for a limited period of time, and we have limited ability to predict how long agents will remain customers.

Our customer contracts typically have an initial term of twelve months, with automatic one-month extensions unless terminated by either party. Some customers have decided not to extend their contracts due to their inability to convert the leads we have provided into closed transactions or dissatisfaction with our services. For example, our real estate average monthly churn rate for the quarter ended September 30, 2006 was 7.6%, compared to 7.4% for the quarter ended June 30, 2006. We calculate average monthly churn by dividing the number of core customers who cancel during the quarter by the average core customers in the quarter, divided by the number of months in the quarter.

We cannot accurately predict how long agents or mortgage professionals will remain customers. If our churn rate increases, our revenue will decline and our business could suffer.

Decreases in customer acquisition or retention may not be immediately reflected in our operating results.

The effect of significant decreases in the number of new and active customers may not be fully reflected in our results of operations until future periods. Much of the revenue we report in each quarter is from agreements entered into during previous quarters. Consequently, a decline in new customer contracts or an increase in cancellations in any one quarter will not necessarily be fully reflected in the revenue reported until the following quarter and may negatively affect our revenue in future quarters. In addition, we may be unable to adjust our cost structure in a timely manner to reflect these reduced revenues.

We have experienced rapid growth which we may not be able to successfully manage.

We have experienced rapid growth in our revenues, expenses and employee headcount. In addition to adding a number of senior individuals to our management team, our overall employee base has grown from 266 employees as of December 31, 2004 to 590 employees as of September 30, 2006. Further, in January 2006, we opened a new facility in Yakima, Washington, which is our first location other than our corporate headquarters. This expansion has placed, and is expected to continue to place, a significant strain on our managerial, operational and financial resources. If we are unable to manage growth effectively, our business could be harmed.

Table of Contents

Acquisitions we may undertake may be unsuccessful and may divert our management's attention and consume significant resources.

We may selectively acquire other businesses, product lines or technologies. For example, in October 2005, we acquired The Loan Page, Inc., a mortgage lead generation company. The successful execution of an acquisition strategy will depend on our ability to identify, negotiate, complete and integrate suitable acquisitions and, if necessary, to obtain satisfactory debt or equity financing. Acquisitions, including the acquisition of The Loan Page, Inc., involve numerous risks, including the following: difficulties in integrating the operations, technologies, and products of the acquired companies; diversion of management's attention from normal daily operations of the business; inability to maintain the key business relationships and the reputations of acquired businesses; entry into markets in which we have limited or no prior experience and in which competitors have stronger market positions; dependence on unfamiliar affiliates and partners; insufficient revenues to offset increased expenses associated with acquisitions; reduction or replacement of the sales of existing services by sales of products or services from acquired lines of business; responsibility for the liabilities of acquired businesses; inability to maintain our internal standards, controls, procedures and policies; and potential loss of key employees of the acquired companies.

In addition, if we finance or otherwise complete acquisitions by issuing equity or convertible debt securities, our existing shareholders may be diluted. Mergers and acquisitions are inherently risky, and we cannot assure you that our acquisitions will be successful. Failure to manage and successfully integrate acquired businesses could harm our business.

We continue to evaluate our system of internal controls over financial reporting and may be required to make enhancements where appropriate, which may require significant resources.

Effective internal controls over financial reporting are necessary for us to provide reliable financial reports and effectively prevent fraud. We have implemented changes to our internal procedures to satisfy the requirements of the Sarbanes-Oxley Act of 2002, which require a company's management and its auditors to evaluate and assess the effectiveness of our internal controls. We are required to continue to evaluate and, where appropriate, enhance our policies, procedures and internal controls. Implementing any necessary changes may take a significant amount of time, money, and management resources and may require specific compliance training of our directors, officers and other personnel. If we fail to maintain the adequacy of our internal controls, as such standards are modified, supplemented or amended from time to time and as our business evolves, we could be subject to regulatory scrutiny and investors could lose confidence in the accuracy and completeness of our financial reports. Given the potential significance of resources required for compliance, we cannot assure you that we will be able to maintain compliance with the requirements of the Sarbanes-Oxley Act.

We rely almost entirely on advertising to generate leads for customers.

We rely heavily on advertising to attract consumers to our web sites and to generate leads. We advertise primarily through online media and television commercials.

Risks Associated with Online Advertising. We rely on online media to attract a significant percentage of the consumers visiting our web sites. Prices for online advertising have increased as a result of increased demand for advertising inventory, which has caused our expenses to increase and result in lower margins. Our advertising contracts with online search engines are typically short-term. If one or more search engines on which we rely for advertising modifies or terminates its relationship with us, our expenses could increase, the number of leads we generate could decrease and our revenues or margins could decline.

Risks Associated with Television Advertising. Television advertising rates depend on a number of factors, including the strength of the national economy and regional economies and the strength of certain industries that advertise frequently. Advertising rates are also subject to cyclical and seasonal fluctuations. If television advertising prices increase significantly, in the absence of more efficient ways to generate leads, our marketing expenses will also increase, which would harm our results of operations.

As the number of leads that we are required to deliver has increased, we have increased the levels of advertising to meet those requirements. We cannot assure you that increases in advertising will result in increases in leads. If the effectiveness of our advertising declines, our business will suffer.

Our business depends on the real estate industry, which is cyclical.

The residential real estate and mortgage markets historically have been subject to economic cycles. An economic slowdown or recession, adverse tax policies, lower availability of credit, increased interest rates, increased unemployment, lower consumer confidence, lower wage and salary levels, war or terrorist attacks or the public perception that any of these conditions may occur could decrease demand for residential real estate or mortgages. Trends in the real estate industry and

Table of Contents

mortgage business are unpredictable; therefore, our operating results, to the extent they reflect changes in the broader real estate industry and mortgage business, may be subject to significant fluctuations.

A sustained increase in interest rates could result in decreased use of our services by prospective home buyers and sellers and mortgage consumers and real estate and mortgage professionals.

The amount of a homeowner's monthly mortgage payment is significantly dependent on interest rate levels. Interest rates have risen from recent historical lows and many economists predict that interest rates will continue to rise in the near future. Increases in interest rates could make housing less affordable and negatively affect the housing and/or purchase money mortgage markets and could also lessen credit demand and negatively affect the mortgage refinancing market. These increases could reduce consumer interest in the services offered through our web sites. A decrease in demand for residential real estate or a decrease in housing affordability could result in a decrease in the number of active real estate and mortgage professionals and a decrease in the amount these individuals are willing to spend on services such as ours.

We may in the future be subject to intellectual property rights claims.

Other companies, including our current or potential competitors, could make claims against us alleging infringement of their intellectual property rights. We have been subject to and expect to continue to be subject to, claims regarding alleged infringement by us of the patents, trademarks and other intellectual property rights of third parties. Any intellectual property claims, regardless of merit, could be time-consuming and expensive to litigate or settle, and could significantly divert management's attention from other business concerns. We may need to obtain licenses from third parties who allege that we have infringed their rights, but such licenses may not be available on terms acceptable to us or at all.

Our technologies and content may not be able to withstand third-party claims or rights against their use. If we were unable to successfully defend against such claims, we may have to pay damages, stop using the technology or content found to be in violation of a third party's rights, seek a license for the infringing technology or content, or develop alternative non-infringing technology or content. If we are required to obtain a license for the infringing technology or content, it may not be available on reasonable terms, if at all. In addition, developing alternative non-infringing technology or content could require significant effort and expense. If we cannot license or develop technology or content for any infringing aspects of our business, we may be forced to limit our service offerings. Any of these results could reduce our ability to compete effectively and harm our business.

Our trademarks are important to our business. Other companies may own, obtain or claim trademarks that could prevent, limit or interfere with our use of trademarks. If we were unable to use these trademarks, our business would be harmed and we would need to devote substantial resources toward developing different brand identities.

Our business depends on the continued adoption and use of the Internet and email by real estate and mortgage professionals.

Our business model relies on the adoption and ongoing use of the Internet and email by real estate and mortgage professionals. We believe many real estate and mortgage professionals still rely primarily on other forms of communication, such as telephones, mobile phones, fax machines and mail service, to communicate with clients. A broader population of real estate and mortgage professionals must adopt the Internet and email in their businesses for us to significantly expand our business and increase our revenues.

Prospective home buyers and sellers and mortgage consumers may be reluctant to sign up for our services due to general privacy concerns.

Concern among consumers regarding our use of personal information collected on our web sites, such as email addresses, home addresses and geographic preferences, could keep them from using our web sites and thereby reduce the number of leads we generate. Industry-wide events or events with respect to our web sites, including misappropriation of third-party information, security breaches, or changes in industry standards, regulations or laws could deter people from using the Internet or our web sites to conduct transactions that involve the transmission of confidential information, which could harm our business.

We collect personally identifiable information from prospective home buyers and sellers and mortgage consumers and evaluate the use of our Market Leader prospect management system by customers, which could result in additional costs or claims.

We rely on the collection, use and disclosure of personally identifiable information from prospective home buyers and sellers and mortgage consumers and from customers to conduct our business. We disclose our information collection and dissemination practices in a published privacy statement on our web sites, which we may modify from time to time to meet

Table of Contents

operational needs or changes in the law or industry best practices. We may be subject to legal claims, government action and damage to our reputation if we act or are perceived to be acting inconsistently with the terms of our privacy statement, customer expectations or the law. In addition, concern among real estate and mortgage professionals or potential home buyers or sellers and mortgage consumers about our privacy practices could keep them from using our services and require us to alter our business practices or incur significant expenses to educate them about how we use this information. In accordance with our privacy policy, in certain instances we have provided personally identifiable information about potential home buyers and sellers and mortgage consumers to third parties for purposes of analyzing our audience demographics, audience size and other audience characteristics, such as the pages web users spend the most time viewing on our site, the times of day or night that users visit our site, and the order in which users navigate through our site.

The value of our services could be diminished if anti-spam software filters out emails we send.

Our Market Leader prospect management system includes a feature that automatically sends out personalized email messages to prospective home buyers and sellers and mortgage consumers on behalf of customers. In addition, we send a large amount of email to real estate and mortgage professionals as part of our customer acquisition strategy, some of which is unsolicited. In the past, anti-spam software used by Internet service providers and personal computer users has filtered out these email messages as unsolicited email, or spam. If this problem persists or becomes more pervasive, the value of our Market Leader system to customers, and our ability to attract new customers, could be reduced, both of which would harm our business. In addition, it is possible that we may not currently or in the future fully comply with anti-spam legislation, and any failure to comply with such laws could result in penalties or damage our reputation.

Our HomePages and JustListed products rely on information from real estate multiple listing services provided by third parties that we do not control.

Our HomePages website combines aerial maps, in-depth neighborhood information, and for sale home listings, including listings in most of the major metropolitan markets in the United States, in one integrated web site. In addition, in selected markets, including most of the major metropolitan markets in the United States, we provide JustListed agent customers with a feature that allows them to automatically email their prospective clients information about newly available homes that meet the prospective clients' criteria. The for sale home listings information provided by the HomePages website and via the automated email feature of JustListed is supplied only in markets in which our subsidiary, Soar Solutions, has a relationship with the local multiple listing service, or MLS, and in some cases, additionally with the agents' real estate broker. Listings must be sent manually by an agent customer in markets in which Soar Solutions does not have MLS relationships. Soar Solutions agreements with MLSs to display property listings have short terms, or can be terminated by the MLSs, or, in some cases, the broker, with little notice. The success of our HomePages website depends substantially on our continued ability to provide for sale home listings to consumers and to expand listings in markets in which it is not currently available. Our JustListed service depends in part on our continued ability to provide agent customers with an automated listing email tool and our ability to expand listings in markets in which it is not currently available. Our inability to supply this information will harm our business and operating results.

If we fail to comply with the various laws and regulations that govern the real estate industry and mortgage industry, our business may be harmed.

Our business is governed by various federal, state and local laws and regulations governing the real estate industry, including the Real Estate Settlement Procedures Act (RESPA), the Fair Housing Act, state and local real estate and mortgage broker licensing laws, federal and state laws prohibiting unfair and deceptive acts and practices, and federal and state advertising laws. We may not have always been and may not always be in compliance with each of these requirements. Failure to comply with these requirements may result in, among other things, revocation of required licenses, indemnification liability to contract counterparties, class action lawsuits, administrative enforcement actions and civil and criminal liability.

Due to the geographic scope of our operations and the nature of the services we provide, we may be required to obtain and maintain real estate and/or mortgage brokerage licenses in certain states in which we operate. In connection with such licenses, we are required to designate individual licensed brokers of record. We cannot assure you that we are, and will remain at all times, in full compliance with state real estate or mortgage licensing laws and regulations and we may be subject to fines or penalties in the event of any non-compliance. If in the future a state agency were to determine that we are required to obtain a real estate or mortgage brokerage license in that state in order to receive payments or commissions from real estate and mortgage professionals, or if we lose the services of a designated broker, we may be subject to fines or legal penalties or our business operations in that state may be suspended until we obtain the license or replace the designated broker. Any failure to comply with applicable laws and regulations may limit our ability to expand into new markets, offer new products or continue to operate in one or more of our current markets.

Table of Contents

Changes in real estate and mortgage laws and regulations and the rules of industry organizations could restrict our activities, significantly increase our compliance costs and result in increased competition.

States, regulatory organizations and industry participants could enact legislation, regulatory or other policies in the future that could restrict our activities or significantly increase our compliance costs. Moreover, the provision of real estate-related or mortgage services over the Internet is a new and evolving business, and legislators, regulators and industry participants may advocate additional legislative or regulatory initiatives governing the conduct of our business. If new laws or regulations are adopted, or regulatory interpretations are changed, we may be subject to additional legal requirements and incur significant compliance costs, and we could be precluded from certain activities. In addition, federal banking regulators have proposed to include real estate brokerage as an activity that is financial in nature, a definitional change that would permit major financial institutions to enter the real estate brokerage business. Because national banks are already explicitly permitted to engage in web-linking activities, if this proposal is finalized, we could face competition from significant, well-capitalized competitors.

We may be limited in the way in which we market our business or generate revenue by federal law prohibiting referral fees in real estate or mortgage transactions.

RESPA generally prohibits the payment or receipt of fees or any other thing of value for the referral of business related to a residential real estate settlement service, including real estate and mortgage brokerage services. RESPA also prohibits fee shares or splits or unearned fees in connection with the provision of residential real estate settlement services. Notwithstanding these prohibitions, RESPA expressly permits payments pursuant to cooperative brokerage and referral arrangements or agreements between real estate agents and brokers. In addition, RESPA permits payments for goods or facilities furnished or for services actually performed, so long as those payments bear a reasonable relationship to the market value of the goods or facilities furnished or the services performed, excluding the value of any referrals that may be provided in connection with such goods, facilities or services. Failure to comply with RESPA may result in, among other things, administrative enforcement actions, class action lawsuits, and civil and criminal liability.

There has been limited guidance by the appropriate federal regulator or the courts regarding the applicability of RESPA to online marketing relationships for real estate or mortgage services, such as those we provide. Nonetheless, RESPA may restrict our ability to enter into marketing and distribution arrangements with third parties, particularly to the extent that such arrangements may be characterized as involving payments for the referral of residential real estate settlement service business.

We depend on key personnel and cannot assure you that these employees will continue to stay with us.

We depend on our executive officers as well as key sales, technology and other personnel. We employ our executives and key employees on an at-will basis, even if they have employment contracts with us. Furthermore, although we have purchased a key-person life insurance policy for our Chief Executive Officer, we have not purchased key-person life insurance policies for any of our other executive officers or key personnel. Competition for qualified employees is intense in our industry, and the loss of substantial number of qualified employees, or an inability to attract, retain and motivate additional highly skilled employees required for the expansion of our activities, could harm our business.

We rely on our sales force to sell our services and increase revenue. Failure to attract, motivate and retain qualified sales personnel may harm our business.

Our sales force has grown rapidly since inception and we expect our sales force to continue to expand as our business grows. We have high productivity standards for our sales personnel, which in the past has resulted in relatively high turnover. This turnover has required us to expend a substantial amount of time and money to replace sales persons as we expand our business. Competition for qualified sales personnel is intense. Any failure to attract, retain and motivate a sufficient number of qualified sales personnel could impair our ability to generate new customers, which would harm our business.

Our business could be harmed by the actions of third parties over whom we have little or no control.

Prospective home buyers and sellers and mortgage consumers could make a claim against us for the actions of a customer over whom we have little or no control. We do not conduct any due diligence or background checks on new customers or seek information regarding their credentials. We may be liable for content provided by customers that is posted on or disseminated through our web sites. Our insurance may not be adequate to cover us for these liabilities, and, to the extent not covered by insurance, these liabilities could reduce our margins and harm our business.

Table of Contents

Our brand could be harmed if customers do not provide quality service to prospective home buyers and sellers and mortgage consumers.

We rely on customers to promote our brand by providing high-quality service to prospective home buyers and sellers and mortgage consumers. We have little control over the activities of customers. If customers do not provide prospective home buyers and sellers and mortgage consumers with high-quality service, or if they use the functionality of our Market Leader System to send unwanted email to prospective home buyers or sellers, our brand value and our ability to generate leads may diminish.

Our operating results may be subject to seasonality and may vary significantly among quarters during a calendar year.

We are subject to seasonal fluctuations in advertising rates and lead generation. Changing consumer behavior at various times throughout the year affects our advertising expenses. Television advertising is generally more expensive in the fourth calendar quarter in connection with the holiday season.

While individual markets vary, real estate transaction activity tends to progressively increase from January through the summer months, and then gradually slows over the last quarter of the calendar year. The real estate industry generally experiences decreased activity toward the end of the year, which may result in slower lead generation and lower growth rates. In addition, we have recently entered into the mortgage lead generation business and do not have enough experience to ascertain whether or not there are seasonality effects in that business.

To date, our quarterly revenue growth has diluted any seasonality effects; however, seasonality may have a more pronounced effect on our operating results in the future. If seasonality occurs, investors may be unable to predict our annual operating results based on a quarter-to-quarter comparison of our operating results as our business matures.

Third parties may copy or otherwise obtain and use our proprietary information without authorization or develop similar technology independently.

We currently rely on a combination of copyright, trademark and trade secret laws and confidentiality procedures to establish and protect our proprietary rights. If we fail to successfully enforce our intellectual property rights, the value of our services could be diminished and our business may suffer. Our success depends in large part on our proprietary technology and on our continuing use of our trademarks. We hold six registered trademarks and have sought registration for a number of additional trademarks. We have not sought registration for any copyrights. We have not been issued any patents but we have five pending patent applications. Accordingly, our intellectual property position is more vulnerable than it otherwise would be if it were protected by issued patents, copyrights or additional registered trademarks. We may not receive approval of our various trademark or patent applications, and any trademarks or patents we may be granted may be successfully challenged by others or invalidated. If our trademark or patent applications are not approved or if our trademarks or patents are invalidated, our use of them could be restricted unless we enter into arrangements with these third parties, which might not be possible on commercially reasonable terms, if at all.

We regard substantial elements of our web sites, software tools and applications and underlying technology as proprietary. Despite our precautionary measures, third parties may copy or otherwise obtain and use our proprietary information without authorization or may develop similar technology independently. We may not be able to detect such infringements or may lose any competitive advantage in the market before we do so. In addition, competitors may design around our technology or develop competing technologies substantially similar to ours. Unauthorized parties may attempt to disclose, obtain or use our technology. Our precautions may not prevent misappropriation of our intellectual property, particularly in foreign countries where laws or law enforcement practices may not protect our proprietary rights as fully as in the United States. Any legal action that we may bring to protect our proprietary information could be unsuccessful and expensive and could divert management's attention from other business concerns. Legal standards relating to the validity, enforceability and scope of protection of proprietary rights in Internet-related businesses are uncertain and evolving, and we cannot assure you of the future viability or value of any of our proprietary rights.

We may not be able to protect the web site addresses that are important to our business.

Our web site addresses, or domain names, are important to our business. However, the regulation of domain names is subject to change. We may not be able to obtain or maintain relevant domain names for all the areas of our business. It also may be difficult for us to prevent third parties from acquiring domain names that are similar to ours, that infringe our trademarks or that otherwise decrease the value of our brands.

Table of Contents

Increased government regulation of the Internet and claims under state consumer protection laws could force us to change the manner in which we conduct our business or result in monetary fines or increased costs.

The adoption or modification of laws or regulations relating to the Internet could adversely affect the manner in which we currently conduct our business. In addition, the growth and development of the market for online commerce may lead to more stringent consumer protection laws that may impose additional burdens on us. Laws and regulations directly applicable to communications or commerce over the Internet are becoming more prevalent. In addition, laws applicable to the Internet remain largely unsettled, even in areas where there has been some legislative action. It may take years to determine whether and how existing laws, such as those governing intellectual property, privacy, libel and taxation, apply to the Internet. Changes in Internet laws and regulations could lead to situations in which we are considered to operate or do business in states where customers conduct their business, resulting in potential claims or regulatory action. If we are required to comply with new regulations or new interpretations of existing regulations, or if we are unable to comply with these regulations, our business could be harmed.

We may be subject to claims under state consumer protection statutes if our agent customers are dissatisfied with the quality of our leads, customer service, training programs or contract cancellation policies. These claims could result in monetary fines or require us to change the manner in which we conduct our business, either of which could have a material adverse effect on our business and results of operations. Any of these types of claims, regardless of merit, could be time-consuming, could harm our reputation and could be expensive to litigate or settle.

Changes in government regulation of advertising and customer solicitation could affect our business.

We rely on various marketing channels, such as email and other telecommunications means, to reach real estate and mortgage professionals and prospective home buyers and sellers and mortgage consumers. The laws governing marketing and advertising continue to evolve and we may be subject to restrictions that limit our ability to continue to operate or expand our business and result in legal claims or government action. For example, several jurisdictions have recently proposed or adopted privacy-related laws that restrict or prohibit unsolicited email, commonly known as spam, and that impose significant monetary penalties for violations. One of these laws, the CAN-SPAM Act of 2003, or CAN-SPAM, became effective in the United States on January 1, 2004. CAN-SPAM imposes complex and often burdensome requirements in connection with sending commercial email. The language of CAN-SPAM contains ambiguities. In addition, certain implementing rules have not yet been promulgated, and key provisions of CAN-SPAM have yet to be interpreted by the courts. Depending on how it is interpreted, CAN-SPAM may impose burdens on our email marketing practices and affect features of our Market Leader system and other services we offer or may offer. In addition, states continue to pass legislation regulating email communications and Internet advertising. Some provisions of these laws are ambiguous and have not been interpreted by the courts. These laws may adversely affect our ability to market our services to real estate industry participants in a cost-effective manner and the violation of these laws may result in penalties or damage our reputation.

Our sales activities are or may in the future be subject to laws regulating telemarketing, which could subject us to penalties or limit our ability to market our services.

Both federal and state laws regulate the practice of telemarketing. All 50 states have enacted some form of telemarketing law. In particular, the federal government and a significant number of states have implemented do not call lists. In addition, a number of states require telemarketers to register with the state and post a bond, prohibit automated systems and recorded messages, impose disclosure requirements upon sales calls and require written sales contracts for certain telemarketing transactions. We are subject to certain of these laws, and our failure to register in a jurisdiction where we are required to do so could subject us to penalties, limit our ability to market our services and hamper our ability to enforce contracts in these jurisdictions.

Any failure of our technology to perform satisfactorily could result in lost revenue, damage to our reputation and expenditure of significant resources.

Our technology is relatively new and complex and may in the future be subject to errors, defects or performance problems. In addition, we may encounter problems when we update our technology to expand and enhance its capabilities. Our technology may malfunction or suffer from defects that become apparent only after further use. Furthermore, our services could be rendered unreliable or be perceived as unreliable by customers or prospective home buyers and sellers and mortgage consumers. In such instances, we would need to expend significant resources to address these problems, and may nonetheless be unable to adequately remedy these problems. These problems could result in lost revenue and damage to our reputation.

Table of Contents

Sustained or repeated system failures could significantly impair our operations and lead to customer dissatisfaction.

The continuous and uninterrupted performance of our systems is critical to our success. Our operations depend on our ability to protect these systems against damage from fire, power loss, water, earthquakes, telecommunications failures, viruses, vandalism and other malicious acts and similar unexpected adverse events. Customers and prospective home buyers and sellers and mortgage consumers may become dissatisfied by any system failure that interrupts our ability to provide our services to them.

Our services substantially depend on systems provided by third parties, over whom we have little control. Interruptions in our services could result from the failure of telecommunications providers and other third parties to provide the necessary data communications capacity in the time frame required. Our operations depend on our ability to maintain and protect our computer systems, located at our headquarters in Kirkland, Washington, our call center in Yakima, Washington and at a co-location facility operated by a third party in Kent, Washington. We depend on these third-party providers of Internet communication services to provide continuous and uninterrupted service. We also depend on Internet service providers that provide access to our services. Any disruption in the Internet access provided by third-party providers or any failure of third-party providers to handle higher volumes of user traffic could harm our business.

Our reputation and customer service offerings may be harmed by security breaches.

Unauthorized computer programmers, or hackers, may attempt to penetrate our network security from time to time. A hacker who penetrates our network security could misappropriate proprietary information or cause interruptions in our services. We might be required to expend significant capital and resources to protect against, or to alleviate, problems caused by hackers. We also may not have a timely remedy against a hacker who is able to penetrate our network security. In addition to purposeful security breaches, the inadvertent transmission of computer viruses could adversely affect our systems and harm our business.

The state of California requires that customers who are residents of California be notified if a security breach results in the disclosure of their personal financial account or other information. Other states are considering such notice laws. In addition, other public disclosure laws may require that material security breaches be reported. If such notice is required in the future, our business and reputation could be harmed.

If we do not have access to additional funds on acceptable terms, we may be unable to continue to expand our business or service offerings.

To pursue our current and future business plans, we may choose to seek additional funding through public or private financings, including equity financings, and through other arrangements. Poor financial results, unanticipated expenses or unanticipated opportunities that require financial commitments could give rise to additional financing requirements sooner than we expect. However, financing may be unavailable when we need it or may not be available on acceptable terms. If we raise additional funds by issuing equity or convertible debt securities, the percentage ownership of our existing shareholders would be reduced and these securities might have rights superior to those of our common stock. If we are unable to raise additional funds when we need them, we may be required to delay, scale back or eliminate expenditures for some of our operations or capital expenditures.

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

On December 9, 2004, the Securities and Exchange Commission declared effective our registration statement on Form S-1 (SEC File No. 333-118740) in connection with our initial public offering of common stock. We sold 4,166,667 shares of common stock at \$15.00 per share, for aggregate gross proceeds of \$62.5 million, and selling shareholders sold 2,083,333 shares of common stock at \$15.00 per share, for aggregate gross proceeds of \$31.2 million. We received net proceeds of approximately \$56.1 million after underwriters' discounts and commissions of approximately \$4.4 million and other expenses related to the offering of approximately \$2.0 million. None of the proceeds of the offering that we received were used as payments to our directors or officers (or their associates), or to our affiliates or 10% shareholders. All of the expenses of the offering were direct or indirect payments to others and not payments to our directors or officers (or their associates) or to our affiliates or 10% shareholders. Credit Suisse First Boston LLC and J.P. Morgan Securities Inc. acted as joint book-running managers of the offering, with Piper Jaffray & Co., Thomas Weisel Partners LLC and Pacific Crest Securities Inc. acting as co-managers of the offering.

Through September 30, 2006, we have used approximately \$23.0 million of the proceeds to purchase property and equipment and intangible assets. The remaining proceeds have been invested in money market funds and highly liquid, short-term, adjustable-rate insured municipal notes. Our current and planned use of the proceeds does not represent a material change from the use of proceeds described in the prospectus relating to the Registration Statement.

Table of Contents

Information required by this Item is contained in the section titled Management's Discussion and Analysis of Financial Condition and Results of Operations under the heading Share Repurchase within Part I of this Form 10-Q.

Item 6. Exhibits

Exhibit

Number	Description of Document
31.1	Certification of Ian Morris, Chief Executive Officer of HouseValues, Inc., Pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934 of Item 601 of Regulation S-K.
31.2	Certification of Jacqueline Davidson, Chief Financial Officer of HouseValues, Inc., Pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934 of Item 601 of Regulation S-K.
32.1	Certification of Ian Morris, Chief Executive Officer of HouseValues, Inc. and Jacqueline Davidson, Chief Financial Officer of HouseValues, Inc., Pursuant to 18 U.S.C. Section 1350 of Item 601 of Regulation S-K.

Table of Contents

SIGNATURE

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

HOUSEVALUES, INC.

By: /s/ JACQUELINE DAVIDSON
Jacqueline Davidson
Authorized Officer and Principal Financial Officer
November 3, 2006