

COSTAR GROUP INC
Form 10-Q
November 04, 2009

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

FORM 10-Q

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

For the quarterly period ended September 30, 2009

OR

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

For the transition period from _____ to _____

Commission file number 0-24531

CoStar Group, Inc.
(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of incorporation or
organization)

52-2091509
(I.R.S. Employer Identification No.)

2 Bethesda Metro Center, 10th Floor
Bethesda, Maryland 20814
(Address of principal executive offices) (zip code)

(301) 215-8300
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was

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required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Securities Exchange Act of 1934.

Large accelerated filer Accelerated filer
Non-accelerated filer Smaller reporting company
(Do not check if a smaller reporting company)

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 31, 2009, there were 20,571,850 shares of the registrant’s common stock outstanding.

COSTAR GROUP, INC.

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PART I — FINANCIAL INFORMATION

Item 1. Financial Statements

COSTAR GROUP, INC.
 CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
 (in thousands, except per share data)
 (unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Revenues	\$53,590	\$53,757	\$155,024	\$159,499
Cost of revenues	19,149	17,613	52,787	55,675
Gross margin	34,441	36,144	102,237	103,824
Operating expenses:				
Selling and marketing	11,630	10,336	30,542	33,330
Software development	3,454	3,122	9,697	9,677
General and administrative	11,564	10,170	33,585	30,074
Purchase amortization	842	1,236	2,530	3,723
	27,490	24,864	76,354	76,804
Income from operations	6,951	11,280	25,883	27,020
Interest and other income, net	263	951	1,027	4,132
Income before income taxes	7,214	12,231	26,910	31,152
Income tax expense, net	2,889	5,586	11,863	14,030
Net income	\$4,325	\$6,645	\$15,047	\$17,122
Net income per share ³ / ₄ basic	\$0.22	\$0.34	\$0.77	\$0.89
Net income per share ³ / ₄ diluted	\$0.22	\$0.34	\$0.76	\$0.88
Weighted average outstanding shares ³ / ₄ basic	19,868	19,393	19,628	19,330

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Weighted average outstanding shares ³ / ₄ diluted	20,084	19,604	19,749	19,535
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See accompanying notes.

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

ASSETS	September 30, 2009 (unaudited)	December 31, 2008
Current assets:		
Cash and cash equivalents	\$200,738	\$159,982
Short-term investments	23,253	35,268
Accounts receivable, less allowance for doubtful accounts of approximately \$3,218 and \$3,213 as of September 30, 2009 and December 31, 2008, respectively	13,811	12,294
Deferred income taxes, net	2,757	2,036
Prepaid expenses and other current assets	4,051	2,903
Total current assets	244,610	212,483
Long-term investments	29,939	29,340
Deferred income taxes, net	6,554	3,392
Property and equipment, net	16,579	16,876
Goodwill	70,218	54,328
Intangibles and other assets, net	22,607	16,421
Deposits and other assets	1,828	1,544
Total assets	\$392,335	\$334,384

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities:		
Accounts payable	\$4,555	\$1,636
Accrued wages and commissions	8,537	7,217
Accrued expenses and deferred rent	11,220	8,934
Deferred revenue	14,213	9,442
Income taxes payable	856	1,907
Total current liabilities	39,381	29,136
Deferred income taxes, net	¾	132
Income taxes payable	1,707	1,695
Total liabilities	41,088	30,963
Total stockholders' equity	351,247	303,421
Total liabilities and stockholders' equity	\$392,335	\$334,384

See accompanying notes.

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

	Nine Months Ended September 30,	
	2009	2008
Operating activities:		
Net income	\$15,047	\$17,122
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	5,596	6,409
Amortization	5,146	6,460
Stock-based compensation expense	5,167	3,891
Leasehold write-off	587	¾
Deferred income tax expense, net	(1,785)	(287)
Provision for losses on accounts receivable	3,633	2,748
Changes in operating assets and liabilities, net of acquisitions:		
Accounts receivable	(2,276)	(4,218)
Prepaid expenses and other current assets	(504)	427
Deposits and other assets	(253)	637
Accounts payable and other liabilities	2,497	(2,925)
Deferred revenue	(1,041)	117
Net cash provided by operating activities	31,814	30,381
Investing activities:		
Purchases of investments	¾	(1,917)
Sales of investments	14,051	53,841
Purchases of property and equipment and other assets	(5,835)	(3,232)
Acquisitions, net of cash acquired	(392)	(3,024)
Net cash provided by investing activities	7,824	45,668
Financing activities:		
Repurchase of restricted stock to satisfy tax withholding obligations	(501)	¾
Proceeds from exercise of stock options	1,007	6,227
Net cash provided by financing activities	506	6,227
Effect of foreign currency exchange rates on cash and cash equivalents	612	(911)
Net increase in cash and cash equivalents	40,756	81,365
Cash and cash equivalents at the beginning of period	159,982	57,785
Cash and cash equivalents at the end of period	\$200,738	\$139,150

See accompanying notes.

COSTAR GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

1. ORGANIZATION

CoStar Group, Inc. (the “Company”) has created a comprehensive, proprietary database of commercial real estate information covering the United States, as well as parts of the United Kingdom and France. Based on its unique database, the Company provides information, marketing and analytic services to the commercial real estate and related business community and operates within two operating segments, U.S. and International. The Company’s information, marketing and analytic services are typically distributed to its clients under subscription-based license agreements, which typically have a minimum term of one year and renew automatically.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation. Accounting policies are consistent for each operating segment.

Interim Financial Statements

The accompanying unaudited condensed consolidated financial statements of the Company have been prepared in accordance with generally accepted accounting principles (“GAAP”) in the United States of America for interim financial information. In the opinion of the Company’s management, the financial statements reflect all adjustments necessary to present fairly the Company’s financial position at September 30, 2009, the results of its operations for the three and nine months ended September 30, 2009 and 2008, and its cash flows for the nine months ended September 30, 2009 and 2008. These adjustments are of a normal recurring nature.

Certain notes and other information have been condensed or omitted from the interim financial statements presented in this Quarterly Report on Form 10-Q. Therefore, these financial statements should be read in conjunction with the Company’s Annual Report on Form 10-K for the year ended December 31, 2008.

The results of operations for the three and nine months ended September 30, 2009 are not necessarily indicative of future financial results.

Use of Estimates

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

Reclassifications

Certain previously reported amounts on the condensed consolidated statements of cash flows have been reclassified to conform to the Company’s current presentation.

Foreign Currency Translation

The Company's functional currency in its foreign locations is the local currency. Assets and liabilities are translated into U.S. dollars as of the balance sheet date. Revenues, expenses, gains and losses are translated at the average exchange rates in effect during each period. Gains and losses resulting from translation are included in accumulated other comprehensive income (loss). Net gains or losses resulting from foreign currency exchange transactions are included in the consolidated statements of operations. There were no material gains or losses from foreign currency exchange transactions for the three and nine months ended September 30, 2009 and 2008.

COSTAR GROUP, INC.

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

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — (CONTINUED)

Comprehensive Income

The components of total comprehensive income were as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
	(unaudited)			
Net income	\$4,325	\$6,645	\$15,047	\$17,122
Foreign currency translation adjustment	(1,402)	(4,584)	3,567	(4,659)
Net unrealized gain (loss) on investments, net of tax	115	(1,483)	2,635	(3,706)
Total comprehensive income	\$3,038	\$578	\$21,249	\$8,757

The components of accumulated other comprehensive loss were as follows (in thousands):

	September 30, 2009	December 31, 2008
	(unaudited)	
Foreign currency translation adjustment	\$(4,954)	\$(8,521)
Accumulated net unrealized loss on investments, net of tax	(2,640)	(5,275)
Total accumulated other comprehensive loss	\$(7,594)	\$(13,796)

Net Income Per Share

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

COSTAR GROUP, INC.

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

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — (CONTINUED)

Net Income Per Share — (Continued)

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Numerator:			(unaudited)	
Net income	\$4,325	\$6,645	\$15,047	\$17,122
Denominator:				
Denominator for basic net income per share $\frac{3}{4}$ weighted-average outstanding shares	19,868	19,393	19,628	19,330
Effect of dilutive securities:				
Stock options and restricted stock	216	211	121	205
Denominator for diluted net income per share $\frac{3}{4}$ weighted-average outstanding shares	20,084	19,604	19,749	19,535
Net income per share $\frac{3}{4}$ basic	\$0.22	\$0.34	\$0.77	\$0.89
Net income per share $\frac{3}{4}$ diluted	\$0.22	\$0.34	\$0.76	\$0.88

Employee stock options with exercise prices greater than the average market price of the Company's common stock were excluded from the diluted calculation as their inclusion would have been anti-dilutive. The following table summarizes the potential common shares excluded from the diluted calculation (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
			(unaudited)	
Employee stock options	373	81	501	88

Stock-Based Compensation

The Company accounts for stock-based compensation in accordance with Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 718, "Compensation – Stock Compensation," which addresses the accounting for share-based payment transactions in which the Company receives employee services in exchange for equity instruments. The statement generally requires that equity instruments issued in such transactions be accounted for using a fair value based method and the fair value of such equity instruments be recognized as expenses in the consolidated statements of operations.

COSTAR GROUP, INC.

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

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — (CONTINUED)

Stock-Based Compensation — (Continued)

Stock-based compensation expense for stock options and restricted stock included in the Company's results of operations for the three and nine months ended September 30, 2009 and 2008, was as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	September 30, 2009	2008	September 30, 2009	2008
			(unaudited)	
Cost of revenues	\$282	\$135	\$593	\$418
Selling and marketing	426	209	1,031	594
Software development	140	72	464	307
General and administrative	1,193	1,046	3,079	2,572
Total stock-based compensation	\$2,041	\$1,462	\$5,167	\$3,891

Options to purchase 22,407 and 88,650 shares were exercised during the three months ended September 30, 2009 and 2008, respectively. Options to purchase 28,618 and 198,434 shares were exercised during the nine months ended September 30, 2009 and 2008, respectively.

Recent Accounting Pronouncements

There have been no developments to the Recent Accounting Pronouncements discussion included in the Company's Annual Report on Form 10-K for the year ended December 31, 2008, including the expected dates of adoption and estimated effects on the Company's consolidated financial statements, except for the following:

In April 2009, the FASB issued an accounting standard codified in ASC 805, "Business Combinations" ("ASC 805"). ASC 805 addresses the initial recognition, measurement and subsequent accounting for assets and liabilities arising from contingencies in a business combination. It requires that such assets acquired or liabilities assumed be initially recognized at fair value at the acquisition date if fair value can be determined during the measurement period. When fair value cannot be determined, companies should typically account for the acquired contingencies using existing guidance. ASC 805 requires that companies expense acquisition and deal-related costs that were previously allowed to be capitalized. ASC 805 also requires that a systematic and rational basis for subsequently measuring and accounting for the assets or liabilities be developed depending on their nature. ASC 805 was effective for contingent assets or liabilities arising from business combinations with an acquisition date on or after January 1, 2009. The adoption of ASC 805 will change the accounting treatment and disclosure for certain specific items in a business combination with an acquisition date subsequent to December 31, 2008. In the third quarter of 2009, the Company expensed acquisition and deal-related costs associated primarily with the acquisition of Property and Portfolio Research, Inc. ("PPR").

COSTAR GROUP, INC.

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

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — (CONTINUED)

Recent Accounting Pronouncements — (Continued)

In April 2009, the FASB issued an accounting standard codified in ASC 820, “Fair Value Measurements and Disclosures” (“ASC 820”). ASC 820 provides additional guidance for determining whether a market is active or inactive, and whether a transaction is distressed. ASC 820 is applicable to all assets and liabilities (financial and non-financial) and will require enhanced disclosures. The Company adopted the provisions of ASC 820 for the interim period ending June 30, 2009. The adoption of ASC 820 did not have a material impact on the Company’s result of operations or financial position, but did require additional disclosures in the Company’s interim financial statements.

In April 2009, the FASB issued an accounting standard codified in ASC 825, “Financial Instruments” (“ASC 825”). ASC 825 requires disclosures in interim reporting periods concerning the fair value of financial instruments that were previously only required in the annual financial statements. The Company adopted the provisions of ASC 825 for the interim period ending June 30, 2009. The adoption of ASC 825 did not have a material impact on the Company’s results of operations or financial position, but did require additional disclosures in the Company’s interim financial statements.

In April 2009, the FASB issued an accounting standard codified in ASC 320, “Investments – Debt and Equity Securities” (“ASC 320”). ASC 320 applies to debt securities. ASC 320 redefines what constitutes an other-than-temporary impairment, defines credit and non-credit components of an other-than-temporary impairment, prescribes their financial statement treatment, and requires enhanced disclosures relating to such impairments. We adopted the provisions of ASC 320 for the interim period ending June 30, 2009. The adoption of ASC 320 did not have a material impact on the Company’s results of operations or financial position, but did require additional disclosures in the Company’s interim financial statements.

In May 2009, the FASB issued an accounting standard codified in ASC 855, “Subsequent Events” (“ASC 855”). ASC 855 establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued. ASC 855 was effective for all interim and annual reporting periods ending after June 15, 2009. This standard has not and is not expected to result in significant changes in the subsequent events that the Company reports, either through recognition or disclosure, in its financial statements.

In June 2009, the FASB issued SFAS No. 166, “Accounting for Transfers of Financial Assets – an amendment of FASB Statement No. 140” (“SFAS 166”). This guidance has not yet been incorporated into the FASB Accounting Standards Codification. SFAS 166 eliminates the concept of a qualifying special-purchase entity from Statement 140 and removes the exception from applying FASB Interpretation No. 46(R), “Consolidation of Variable Interest Entities” to qualifying special-purpose entities. The statement enhances disclosures to provide financial statement users with greater transparency about transfers of financial assets and a transferor’s continuing involvement with transferred financial assets. SFAS 166 will be effective for the first annual reporting period beginning after November 15, 2009. This standard is not expected to materially impact the Company’s results of operations, financial position or related disclosures.

In June 2009, the FASB issued SFAS No. 167, “Amendments to FASB Interpretation No. 46(R)” (“SFAS 167”). This guidance has not yet been incorporated into the FASB Accounting Standards Codification. SFAS 167 addresses conforming changes to Interpretation 46(R) as a result of the issuance of SFAS 166, as well as constituent concerns about the application of certain key provisions of Interpretation 46(R). SFAS 167 will be effective for the first annual reporting period beginning after November 15, 2009. This standard is not expected to materially impact the Company’s

results of operations, financial position or related disclosures.

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COSTAR GROUP, INC.

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

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — (CONTINUED)

Recent Accounting Pronouncements — (Continued)

In June 2009, the FASB issued an accounting standard codified in ASC 105, “Generally Accepted Accounting Principles” (“ASC 105”). This statement is effective for financial statements issued for interim and annual periods ending after September 15, 2009. This standard did not materially impact the Company’s results of operations or financial position, but did require changes to the disclosures in the Company’s interim financial statements.

In July 2009, the FASB issued Accounting Standards Update No. 2009-05, “Fair Value Measurements and Disclosures (ASC 820) – Measuring Liabilities at Fair Value” (“ASC Update 2009-05”). This standard is intended to improve the consistency with which companies apply fair value measurements guidance to liabilities. ASC Update 2009-05 is effective for the interim and annual periods beginning after September 30, 2009. This standard is not expected to materially impact the Company’s results of operations, financial position or related disclosures.

3. ACQUISITIONS

On April 1, 2008, the Company acquired certain assets of First CLS, Inc. (doing business as the Dorey Companies and DoreyPRO), an Atlanta-based provider of local commercial real estate information for \$3.0 million in initial cash consideration and deferred consideration of \$1.7 million paid during the third quarter of 2009. The First CLS, Inc. acquisition was accounted for using the purchase method of accounting. The purchase price for the acquisition was primarily allocated to customer base. The acquired customer base, which consists of one distinct intangible asset and is composed of acquired customer contracts and the related customer relationships, is being amortized on a 125% declining balance method over ten years. The results of operations of First CLS, Inc. have been consolidated with those of the Company since the date of the acquisition and are not considered material to the consolidated financial statements of the Company. Accordingly, pro forma financial information has not been presented for the acquisition.

On July 17, 2009, the Company acquired all of the issued and outstanding equity securities of PPR, and its wholly owned subsidiary Property and Portfolio Research Ltd., providers of global real estate analysis, market forecasts and credit risk analytics to the commercial real estate industry. The Company acquired PPR from DMG Information, Inc. (“DMGI”) pursuant to a Stock Purchase Agreement in exchange for 572,999 shares of CoStar common stock, which had an aggregate value of approximately \$20.9 million as of the closing date. On July 17, 2009, 433,667 shares were issued to DMGI, and the remaining 139,332 shares were issued to DMGI on September 28, 2009 after taking into account post-closing purchase price adjustments. The purchase accounting is preliminary and is subject to change upon completion of the purchase accounting. The purchase price was allocated to various working capital accounts, developed technology, customer base, trademarks, non-competition agreements and goodwill. The identified intangibles will be amortized over their estimated useful lives. Goodwill will not be amortized, but is subject to annual impairment tests. The results of operations of PPR have been consolidated with those of the Company since the date of the acquisition and are not considered material to the consolidated financial statements of the Company. Accordingly, pro forma financial information has not been presented for the acquisition.

4. INVESTMENTS

The Company accounts for investments in accordance with FASB ASC 320, “Investments – Debt and Equity Securities.” The Company determines the appropriate classification of investments at the time of purchase and reevaluates such designation as of each balance sheet date. The Company considers all of its investments to be available-for-sale. Short-term investments consist of commercial paper, government/federal notes and bonds and

corporate obligations with maturities greater than 90 days at the time of purchase. Available-for-sale short-term investments with contractual maturities beyond one year are classified as current in the Company's consolidated balance sheets because they represent the investment of cash that is available for current operations. Long-term investments consist of variable rate debt instruments with an auction reset feature ("auction rate securities" or "ARS"). Investments are carried at fair market value.

COSTAR GROUP, INC.

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

4. INVESTMENTS — (CONTINUED)

Scheduled maturities of investments classified as available-for-sale as of September 30, 2009 are as follows (in thousands):

Maturity	Fair Value
Due:	
October 1, 2009 ³ / ₄ September 30, 2010	\$2,446
October 1, 2010 ³ / ₄ September 30, 2014	20,306
October 1, 2014 ³ / ₄ September 30, 2019	116
After September 30, 2019	30,324
Available-for-sale investments	\$53,192

The realized gains on the Company's investments for the three months ended September 30, 2009 and 2008 were approximately \$0 and \$124,000, respectively. The realized gains on the Company's investments for the nine months ended September 30, 2009 and 2008 were approximately \$4,000 and \$129,000 respectively. The realized losses on the Company's investments for the three months ended September 30, 2009 and 2008 were approximately \$2,000 and \$332,000, respectively. The realized losses on the Company's investments for the nine months ended September 30, 2009 and 2008 were approximately \$4,000 and \$387,000, respectively.

Unrealized holding gains and losses, net of the related tax effect, on available-for-sale securities are excluded from earnings and are reported as a separate component of other comprehensive income (loss) in stockholders' equity until realized. Realized gains and losses from the sale of available-for-sale securities are determined on a specific-identification basis. A decline in market value of any available-for-sale security below cost that is deemed to be other-than-temporary results in a reduction in carrying amount to fair value. The impairment is charged to earnings and a new cost basis for the security is established. Dividend and interest income are recognized when earned.

As of September 30, 2009, the amortized cost basis and fair value of investments classified as available-for-sale are as follows (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Collateralized debt obligations	\$14,585	\$1	\$(25)	\$14,561
Corporate debt obligations	7,812	378	³ / ₄	8,190
Residential mortgage-backed securities	404	³ / ₄	(4)	400
Government-sponsored enterprise obligations	103	³ / ₄	(1)	102
Auction rate securities	32,925	³ / ₄	(2,986)	29,939
Available-for-sale investments	\$55,829	\$379	\$(3,016)	\$53,192

The unrealized losses on the Company's investments as of September 30, 2009 were generated primarily from changes in interest rates. The losses are considered temporary, as the contractual terms of these investments do not permit the issuer to settle the security at a price less than the amortized cost of the investment. Because the Company does not intend to sell these instruments and it is not more likely than not that the Company will be required to sell these

instruments prior to anticipated recovery, which may be maturity, it does not consider these investments to be other-than-temporarily impaired as of September 30, 2009. See Footnote 5 for details on the fair value of the Company's financial assets.

COSTAR GROUP, INC.

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

4. INVESTMENTS — (CONTINUED)

The components of the Company's investments in an unrealized loss position for more than twelve months consist of the following (in thousands):

	September 30, 2009		December 31, 2008	
	Aggregate Fair Value	Gross Unrealized Losses	Aggregate Fair Value	Gross Unrealized Losses
	(unaudited)			
Collateralized debt obligations	\$ 10,448	\$ (25)	\$ 19,151	\$ (1,323)
Corporate debt securities	¾	¾	2,558	(156)
Residential mortgage-backed securities	400	(4)	427	(15)
Government-sponsored enterprise obligations	102	(1)	¾	¾
Auction rate securities	29,939	(2,986)	¾	¾
	\$ 40,889	\$ (3,016)	\$ 22,136	\$ (1,494)

The components of the Company's investments in an unrealized loss position for less than twelve months consist of the following (in thousands):

	September 30, 2009		December 31, 2008	
	Aggregate Fair Value	Gross Unrealized Losses	Aggregate Fair Value	Gross Unrealized Losses
	(unaudited)			
Collateralized debt obligations	\$¾	\$¾	\$3,022	\$ (84)
Corporate debt securities	¾	¾	3,807	(268)
Residential mortgage-backed securities	¾	¾	36	(1)
Government-sponsored enterprise obligations	¾	¾	130	(14)
Auction rate securities	¾	¾	29,340	(3,710)
	\$¾	\$¾	\$36,335	\$ (4,077)

The gross unrealized gains on the Company's investments as of September 30, 2009 and December 31, 2008 were approximately \$379,000 and \$128,000, respectively.

5. FAIR VALUE

FASB ASC 820, "Fair Value Measurements and Disclosures" ("ASC 820") establishes a three-tier fair value hierarchy, which categorizes the inputs used in measuring fair value. These tiers include: Level 1, defined as observable inputs such as quoted prices in active markets; Level 2, defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs in which little or no market data exists, therefore requiring an entity to develop its own assumptions.

COSTAR GROUP, INC.

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

5. FAIR VALUE — (CONTINUED)

In accordance with ASC 820, the following table represents the Company's fair value hierarchy for its financial assets (cash, cash equivalents and investments) measured at fair value on a recurring basis as of September 30, 2009 (in thousands):

	Level 1	Level 2	Level 3	Total
Cash	\$125,282	\$¾	\$¾	\$125,282
Money market funds	75,456	¾	¾	75,456
Collateralized debt obligations	¾	14,561	¾	14,561
Corporate debt securities	¾	8,190	¾	8,190
Residential mortgage-backed securities	¾	400	¾	400
Government-sponsored enterprise obligations	¾	102	¾	102
Auction rate securities	¾	¾	29,939	29,939
Total cash, cash equivalents and investments	\$200,738	\$23,253	\$29,939	\$253,930

The Company's Level 2 assets consist of collateralized debt obligations, corporate debt securities, residential mortgage-backed securities and government-sponsored enterprise obligations, which do not have directly observable quoted prices in active markets. The Company's Level 2 assets are valued using matrix pricing, which is an acceptable practical expedient under ASC 820 for inputs.

The Company's Level 3 assets consist of ARS whose underlying assets are primarily student loan securities supported by guarantees from the Federal Family Education Loan Program ("FFELP") of the U.S. Department of Education.

The following tables summarize changes in fair value of the Company's Level 3 assets for the three and nine months ended September 30, 2009 (in thousands):

	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2009
Balance at beginning of period	\$30,110	\$29,340
Unrealized gain (loss) included in other comprehensive income (loss)	(71)	724
Net settlements	(100)	(125)
Balance at September 30, 2009 (unaudited)	\$29,939	\$29,939

COSTAR GROUP, INC.

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

5. FAIR VALUE — (CONTINUED)

The following table summarizes changes in fair value of the Company's Level 3 assets from December 31, 2007 to September 30, 2009 (in thousands):

	Auction Rate Securities
Balance at December 31, 2007	\$53,975
Unrealized loss included in other comprehensive income	(3,710)
Net settlements	(20,925)
Balance at December 31, 2008	\$29,340
Unrealized gain (loss) included in other comprehensive income	¾
Net settlements	¾
Balance at March 31, 2009 (unaudited)	\$29,340
Unrealized gain included in other comprehensive income	795
Net settlements	(25)
Balance at June 30, 2009 (unaudited)	\$30,110
Unrealized loss included in other comprehensive income	(71)
Net settlements	(100)
Balance at September 30, 2009 (unaudited)	\$29,939

ARS are variable rate debt instruments with interest rates that are reset approximately every 28 days. The underlying securities have contractual maturities greater than twenty years. The ARS are recorded at fair value.

As of September 30, 2009, the Company held ARS with \$32.9 million par value, all of which failed to settle at auction. The majority of these investments are of high credit quality with AAA credit ratings and are primarily student loan securities supported by guarantees from the FFELP of the U.S. Department of Education. The Company may not be able to liquidate and fully recover the carrying value of the ARS in the near term. As a result, these securities are classified as long-term investments in the Company's condensed consolidated balance sheet as of September 30, 2009.

While the Company continues to earn interest on its ARS investments at the contractual rate, these investments are not currently trading and therefore do not currently have a readily determinable market value. Accordingly, the estimated fair value of the ARS no longer approximates par value. The Company has used a discounted cash flow model to determine the estimated fair value of its investment in ARS as of September 30, 2009. The assumptions used in preparing the discounted cash flow model include estimates for interest rates, credit spreads, timing and amount of cash flows, liquidity risk premiums, expected holding periods and default risk. Based on this assessment of fair value, as of September 30, 2009, the Company determined there was a total decline in the fair value of its ARS investments of approximately \$3.0 million compared to its par value. The decline was deemed to be a temporary impairment and recorded as an unrealized loss in other comprehensive income (loss) in stockholders' equity. In addition, while a majority of the ARS are currently rated AAA, if the issuers are unable to successfully close future auctions and their credit ratings deteriorate, the Company may be required to record additional unrealized losses in other comprehensive income or an other-than-temporary impairment charge to earnings on these investments. See Footnote 9 related to the ARS arbitration.

COSTAR GROUP, INC.

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

5. FAIR VALUE — (CONTINUED)

Concentration of Credit Risk and Financial Instruments

The Company performs ongoing credit evaluations of its customers' financial condition and generally does not require that its customers' obligations to the Company be secured. The Company maintains reserves for credit losses, and such losses have been within management's expectations. The large size and widespread nature of the Company's customer base and lack of dependence on individual customers mitigate the risk of nonpayment of the Company's accounts receivable. The carrying amount of the accounts receivable approximates the net realizable value. The carrying value of the Company's financial instruments, including cash and cash equivalents, short-term investments, long-term investments, accounts receivable, accounts payable, and accrued expenses, approximates fair value.

6. GOODWILL

The changes in the carrying amount of goodwill by operating segment consist of the following (in thousands):

	United States	International	Total
Goodwill, December 31, 2007	\$30,428	\$ 31,426	\$61,854
Acquisition	1,119	¾	1,119
Effect of foreign currency translation	¾	(8,645)	(8,645)
Goodwill, December 31, 2008	31,547	22,781	54,328
Acquisitions	13,764	¾	13,764
Effect of foreign currency translation	¾	2,271	2,271
Purchase accounting adjustment	(145)	¾	(145)
Goodwill, September 30, 2009 (unaudited)	\$45,166	\$ 25,052	\$70,218

The Company recorded goodwill of approximately \$1.1 million in connection with the First CLS, Inc. acquisition in April 2008, which was decreased by \$145,000 in 2009, upon completion of purchase accounting. Approximately \$1.7 million in additional goodwill was recorded in connection with the First CLS, Inc. acquisition as a result of the payment of deferred consideration of \$1.7 million in August 2009. Additionally, the Company recorded goodwill of approximately \$12.1 million in connection with the PPR acquisition in July 2009.

COSTAR GROUP, INC.

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

7. INTANGIBLES AND OTHER ASSETS

Intangibles and other assets consist of the following (in thousands, except amortization period data):

	September 30, 2009 (unaudited)	December 31, 2008	Weighted-Average Amortization Period (in years)
Building photography	\$11,415	\$11,011	5
Accumulated amortization	(8,773)	(7,711)	
Building photography, net	2,642	3,300	
Acquired database technology	24,589	20,711	4
Accumulated amortization	(20,868)	(20,361)	
Acquired database technology, net	3,721	350	
Acquired customer base	54,875	48,198	10
Accumulated amortization	(40,329)	(37,192)	
Acquired customer base, net	14,546	11,006	
Acquired trade names and other	9,222	7,744	7
Accumulated amortization	(7,524)	(5,979)	
Acquired trade names and other, net	1,698	1,765	
Intangibles and other assets, net	\$22,607	\$16,421	

8. INCOME TAXES

The income tax provision for the nine months ended September 30, 2009 and 2008 reflects an effective tax rate of approximately 44% and 45%, respectively.

9. COMMITMENTS AND CONTINGENCIES

The Company and its wholly owned subsidiary CoStar U.K. Limited are defendants in legal proceedings filed in England by Nokia U.K. Limited (“Nokia”) related to obligations under an agreement to sublease certain office space from Nokia. Nokia served its complaint upon the Company in September 2009, and the litigation is in its very early stages. If there is a trial, it is not expected to occur until the second half of 2010. The Company believes that Nokia’s claim is without merit and intends to defend itself vigorously. Since the outcome of these legal proceedings is uncertain at this time, the Company cannot estimate the amount of loss, if any, that could result from an adverse resolution of this matter.

COSTAR GROUP, INC.

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

9. COMMITMENTS AND CONTINGENCIES — (CONTINUED)

On December 23, 2008, the Company initiated a Financial Industry Regulatory Authority (“FINRA”) arbitration against Credit Suisse First Boston (“CSFB”) related to CSFB’s purchase of auction rate securities for the Company’s account. An arbitration hearing has been set for the week of December 7, 2009. Since the outcome of this legal proceeding is uncertain at this time, the Company cannot estimate the amount of gain or loss, if any, that could result from the resolution of this matter.

In November 2007, LoopNet, Inc. (“LoopNet”) filed a complaint in California State court against the Company and its wholly owned subsidiary CoStar Realty Information, Inc. (“CoStar Realty”) related to the Company’s use of information appearing on the public areas of LoopNet’s website. The Company and CoStar Realty filed seven cross claims against LoopNet related to LoopNet’s breach of a prior settlement agreement between the parties and LoopNet’s misuse of the Company’s website. Discovery related to this litigation is ongoing and trial is scheduled for January 2010. The Company believes LoopNet’s claims are without merit and intends to defend itself vigorously. Since the outcome of these legal proceedings is uncertain at this time, the Company cannot estimate the amount of loss, if any, that could result from an adverse resolution of this matter.

Currently, and from time to time, the Company is involved in litigation incidental to the conduct of its business. In accordance with GAAP, the Company makes a provision for a liability when it is both probable that a liability has been incurred and the amount can be reasonably estimated. At the present time, while it is reasonably possible that an unfavorable outcome may occur as a result of the Company’s current litigation, management has concluded that it is not probable that a loss has been incurred in connection with the Company’s current litigation. In addition, the Company is unable to estimate the possible loss or range of loss that could result from an unfavorable outcome and accordingly, the Company has not recognized any liability in the consolidated financial statements for unfavorable results, if any. Legal defense costs are expensed as incurred.

10. SEGMENT REPORTING

Due to the increased size, complexity, and funding requirements associated with the Company’s international expansion, in 2007 the Company began to manage the business geographically in two operating segments, with the primary areas of measurement and decision-making being the U.S. and International, which includes the U.K. and France. The Company’s subscription-based information services, consisting primarily of CoStar Property Professional®, CoStar Tenant®, CoStar COMPS Professional®, and FOCUS™ services, currently generate more than 95% of the Company’s total revenues. CoStar Property Professional, CoStar Tenant, and CoStar COMPS Professional are generally sold as a suite of similar services and comprise the Company’s primary service offering in the U.S. operating segment. FOCUS is the Company’s primary service offering in the International operating segment. Management relies on an internal management reporting process that provides revenue and operating segment EBITDA, which is the Company’s net income before interest, income taxes, depreciation and amortization. Management believes that operating segment EBITDA is an appropriate measure for evaluating the operational performance of our operating segments. EBITDA is used by management to internally measure operating and management performance and to evaluate the performance of the business. However, this measure should be considered in addition to, not as a substitute for or superior to, income from operations or other measures of financial performance prepared in accordance with GAAP.

COSTAR GROUP, INC.

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

10. SEGMENT REPORTING — (CONTINUED)

Summarized information by operating segment was as follows (in thousands):

	Three Months Ended September 30, 2009		Nine Months Ended September 30, 2009	
	2008		2008	
	(unaudited)			
Revenues				
United States	\$48,807	\$48,026	\$141,590	\$141,888
International				
External customers	4,783	5,731	13,434	17,611
Intersegment revenue	308	¾	308	¾
Total international revenue	5,091	5,731	13,742	17,611
Intersegment eliminations	(308)	¾	(308)	¾
Total revenues	\$53,590	\$53,757	\$155,024	\$159,499
EBITDA				
United States	\$10,646	\$15,852	\$37,202	\$42,184
International	(87)	(319)	(577)	(2,295)
Total EBITDA	\$10,559	\$15,533	\$36,625	\$39,889
Reconciliation of EBITDA to net income				
EBITDA	\$10,559	\$15,533	\$36,625	\$39,889
Purchase amortization in cost of revenues	(659)	(585)	(1,641)	(1,772)
Purchase amortization in operating expenses	(842)	(1,236)	(2,530)	(3,723)
Depreciation and other amortization	(2,107)	(2,432)	(6,571)	(7,374)
Interest income, net	263	951	1,027	4,132
Income tax expense, net	(2,889)	(5,586)	(11,863)	(14,030)
Net income	\$4,325	\$6,645	\$15,047	\$17,122

Intersegment revenue is attributable to services performed by Property and Portfolio Research Ltd., a wholly owned subsidiary of PPR, for PPR. Intersegment revenue is recorded at cost plus an agreed margin, which the Company believes approximates fair value. U.S. EBITDA includes a corresponding cost for the services performed by Property and Portfolio Research Ltd. for PPR.

International EBITDA includes a corporate allocation of approximately \$153,000 and \$277,000 for the three months ended September 30, 2009 and 2008, respectively, and \$334,000 and \$887,000 for the nine months ended September 30, 2009 and 2008, respectively. The corporate allocation represents costs incurred for U.S. employees involved in management and expansion activities of the Company's International operating segment.

COSTAR GROUP, INC.

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

10. SEGMENT REPORTING — (CONTINUED)

Summarized information by operating segment consists of the following (in thousands):

	September 30, 2009 (unaudited)	December 31, 2008
Property and equipment, net		
United States	\$ 13,490	\$ 13,927
International	3,089	2,949
Total property and equipment, net	\$ 16,579	\$ 16,876
Goodwill		
United States	\$ 45,166	\$ 31,547
International	25,052	22,781
Total goodwill	\$ 70,218	\$ 54,328
Assets		
United States	\$ 410,589	\$ 353,084
International	45,419	43,474
Total operating segment assets	\$ 456,008	\$ 396,558
Reconciliation of operating segment assets to total assets		
Total operating segment assets	\$ 456,008	\$ 396,558
Investment in subsidiaries	(18,343)	(18,343)
Intercompany receivables	(45,330)	(43,831)
Total assets	\$ 392,335	\$ 334,384
Liabilities		
United States	\$ 33,759	\$ 24,180
International	45,465	40,053
Total operating segment liabilities	\$ 79,224	\$ 64,233
Reconciliation of operating segment liabilities to total liabilities		
Total operating segment liabilities	\$ 79,224	\$ 64,233
Intercompany payables	(38,136)	(33,270)
Total liabilities	\$ 41,088	\$ 30,963

COSTAR GROUP, INC.

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

11. RELATED PARTY TRANSACTIONS

In April 2009, the Company entered into an engagement with ghSMART & Company, Inc. (“ghSMART”), a management consulting firm, to evaluate the Company’s sales force senior management and provide guidance with respect to hiring and recruiting best practices for the Company’s sales force. Randy Street, a Partner of ghSMART, is the brother-in-law of the Company’s Chief Executive Officer. Mr. Street has acted and will continue to act as the senior client manager on this project. He has a less than 0.5 percent equity stake in ghSMART. Mr. Street is paid 25 percent of the amounts paid by the Company pursuant to the engagement. Pursuant to the engagement, the Company paid ghSMART approximately \$202,000 plus expenses. The Audit Committee reviewed and approved the engagement with ghSMART prior to commencement of the engagement. In October 2009, the Audit Committee reviewed and approved phase II of the engagement for an additional amount of approximately \$255,000 plus expenses. Mr. Street will act in the same capacity during phase II and receive the same percentage compensation for this portion of the engagement. The Company may enter into additional engagements with ghSMART in the future.

12. SUBSEQUENT EVENTS

On October 19, 2009, CoStar Realty acquired all of the outstanding capital stock of Resolve Technology, Inc., a Delaware corporation (“Resolve Technology”), from its sole stockholder, Eric Forman, pursuant to a Stock Purchase Agreement for approximately \$3.4 million in cash and 25,886 shares of CoStar restricted common stock, which shares are subject to a three-year lockup. The purchase price is subject to certain post-closing adjustments. Additionally, the seller may be entitled to receive (i) a potential deferred cash payout two years after closing based on the incremental growth of Resolve Technology’s revenue, and (ii) other potential deferred cash payouts for successful completion of operational and sales milestones during the period from closing through June 30, 2013, which period may be subject to extension to a date no later than December 31, 2014.

The purchase price for Resolve Technology will be principally allocated to various working capital accounts, developed technology, customer base, trademarks, and goodwill. The identified intangibles will be amortized over their estimated useful lives. Goodwill will not be amortized, but is subject to annual impairment tests.

Subsequent events have been evaluated through November 4, 2009, the date these financial statements were issued.

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

The following Management's Discussion and Analysis of Financial Condition and Results of Operations contains "forward-looking statements," including statements about our beliefs and expectations. See "Cautionary Statement Concerning Forward-Looking Statements" at the end of this Item 2. for additional factors relating to such statements, and see "Risk Factors" in Item 1A. of Part II of this Quarterly Report on Form 10-Q for a discussion of certain risk factors applicable to our business, financial condition and results of operations.

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

Overview

CoStar Group, Inc. ("CoStar") is the number one provider of information, marketing and analytic services to the commercial real estate industry in the U.S. and the U.K. based on the fact that we offer the most comprehensive commercial real estate database available, have the largest research department in the industry, provide more information, marketing and analytic services than any of our competitors and believe we generate more revenues than any of our competitors. We have created a standardized information, marketing and analytic platform where members of the commercial real estate and related business community can continuously interact and facilitate transactions by efficiently exchanging accurate and standardized commercial real estate information. Our integrated suite of online service offerings includes information about space available for lease, comparable sales information, tenant information, information about properties for sale, internet marketing services, information for clients' websites, information about industry professionals and their business relationships, analytic and market forecasting information, data integration, and industry news. Our service offerings span all commercial property types, including office, industrial, retail, land, mixed-use, hospitality and multifamily.

Since 1994, we have expanded the geographical coverage of our existing information and marketing services and developed new information, marketing and analytic services. In addition to internal growth, this expansion included the acquisitions of Chicago ReSource, Inc. in Chicago in 1996 and New Market Systems, Inc. in San Francisco in 1997. In August 1998, we expanded into the Houston region through the acquisition of Houston-based real estate information provider C Data Services, Inc. In January 1999, we expanded further into the Midwest and Florida by acquiring LeaseTrend, Inc. and into Atlanta and Dallas/Fort Worth by acquiring Jamison Research, Inc. In February 2000, we acquired COMPS.COM, Inc., a San Diego-based provider of commercial real estate information. In November 2000, we acquired First Image Technologies, Inc., a California-based provider of commercial real estate software. In September 2002, we expanded further into Portland, Oregon through the acquisition of certain assets of Napier Realty Advisors (doing business as REAL-NET). In January 2003, we established a base in the U.K. with our acquisition of London-based FOCUS Information Limited. In May 2004, we expanded into Tennessee through the acquisition of Peer Market Research, Inc., and in September 2004, we extended our coverage of the U.K. through the acquisition of Scottish Property Network. In September 2004, we strengthened our position in Denver, Colorado through the acquisition of substantially all of the assets of RealComp, Inc., a local comparable sales information provider.

In January 2005, we acquired National Research Bureau, a Connecticut-based provider of U.S. shopping center information. In December 2006, our U.K. subsidiary, CoStar Limited, acquired Grecam S.A.S. ("Grecam"), a provider of commercial property information and market-level surveys, studies and consulting services located in Paris, France. In February 2007, CoStar Limited also acquired Property Investment Exchange Limited ("Propex"), a provider of commercial property information and operator of an electronic platform that facilitates the exchange of investment property located in London, England. In April 2008, we acquired the assets of First CLS, Inc. (doing business as the

Dorey Companies and DoreyPRO), an Atlanta-based provider of local commercial real estate information. Most recently, in July 2009, we acquired Massachusetts-based Property and Portfolio Research, Inc. (“PPR”), a provider of global real estate analysis, market forecasts and credit risk analytics to the commercial real estate industry, and its wholly owned U.K. subsidiary Property and Portfolio Research Ltd., and in October 2009, we acquired Massachusetts-based Resolve Technology, Inc. (“Resolve Technology”), a provider of business intelligence and portfolio management software serving the institutional real estate investment industry. The First CLS, Inc., PPR and Resolve Technology acquisitions are discussed later in this section under the heading “Recent Acquisitions.”

In 2004, we began our expansion into 21 new metropolitan markets throughout the U.S. and began expanding the geographical coverage of many of our existing U.S. and U.K. markets. We completed our expansion into the 21 new markets in the first quarter of 2006. In early 2005, in conjunction with the acquisition of National Research Bureau, we launched a major effort to expand our coverage of retail real estate information. The retail component of our flagship product, CoStar Property Professional, was unveiled in May 2006 at the International Council of Shopping Centers' convention in Las Vegas.

During the second half of 2006, in order to expand the geographical coverage of our service offerings, we began actively researching commercial properties in 81 new Core Based Statistical Areas ("CBSAs") in the U.S., we increased our U.S. field research fleet by adding 89 vehicles and we hired researchers to staff these vehicles. We released our CoStar Property Professional service in the 81 new CBSAs across the U.S. in the fourth quarter of 2007. Throughout our recent expansion efforts, we have remained focused on ensuring that CoStar continues to provide the quality of information our customers expect. As such, we have grown our research operations and plan to continue to grow our research operations slightly in 2009, in order to continue to meet customer expectations.

During the second half of 2009, as a part of our strategy to provide subscribers with tools for conducting primary research and analysis on commercial real estate, we expanded subscribers' capabilities to use CoStar's database of research-verified commercial property information to conduct in-depth analysis and generate reports on trends in sales and leasing activity online. Further, in July 2009, we acquired PPR and its wholly owned subsidiary, providers of global real estate investment analysis and market forecasting.

In connection with our acquisitions of Propex, Grecam and PPR's wholly owned subsidiary Property and Portfolio Research Ltd., we intend to expand the coverage of our service offerings within the U.K. and to integrate our international operations more fully with those in the U.S. We have gained operational efficiencies as a result of consolidating a majority of our U.K. research operations in one location in Glasgow and combining the majority of our remaining U.K. operations in one central location in London.

We intend to eventually introduce a consistent international platform of service offerings. In 2007, we introduced the "CoStar Group" as the brand encompassing our international operations. We believe that our recent U.S. and international expansion and integration efforts have created a platform for long-term growth.

We expect to continue to develop and distribute new services, expand existing services within our current platform, consider strategic acquisitions and expand and develop our sales and marketing organization. For instance, in May 2008, we released CoStar Showcase®, an internet marketing service that provides commercial real estate professionals the opportunity to make their listings accessible to all visitors to our public website, www.CoStar.com, and in July 2009, we expanded subscribers' analytic capabilities to use our online database to conduct in-depth analysis and generate reports on sales and leasing activity. In addition, in July 2009, as described above, we acquired PPR in a stock-for-stock transaction, and in October 2009, we acquired Resolve Technology, which enabled us to provide our customers with additional tools for analyzing commercial real estate markets. Any future expansion could reduce our profitability and increase our capital expenditures. Therefore, while we expect current service offerings to remain profitable, driving overall earnings throughout 2009 and providing substantial cash flow for our business, it is possible that any new investments could cause us to generate losses and negative cash flow from operations in the future.

Current general economic conditions in the U.S. and the world are negatively affecting business operations for our clients and are resulting in more business consolidations and, in certain circumstances, failures. As a result of these economic conditions, we continue to see customer cancellations, reductions of services and failures to pay amounts due to us, although at a slower pace than in previous quarters. If cancellations, reductions of services and failures to pay continue at the current rate or increase, and we are unable to offset the resulting decrease in revenue by increasing sales to new or existing customers, our revenues may decline or grow at reduced rates. Additionally, current economic conditions may cause customers to reduce expenses, and customers may be forced to purchase fewer

services from us or cancel all services. We compete against many other commercial real estate information, marketing and analytic service providers for business. If customers choose to cancel our services for cost-cutting or other reasons, our revenue could decline. The extent and duration of any future continued weakening of the

economy is unknown. The extent and duration of any benefits resulting from any of the governmental or private sector initiatives designed to strengthen the economy are currently unknown and there can be no assurance that those initiatives will be successful in the future. Because of these uncertainties in the current economic environment, we may not be able to accurately forecast our revenue or earnings. However, we continue to believe that the Company is positioned to generate continued, sustained earnings in 2009.

Our financial reporting currency is the U.S. dollar. Changes in exchange rates can significantly affect our reported results and consolidated trends. We believe that our increasing diversification beyond the U.S. economy through our international businesses benefits our shareholders over the long term. We also believe it is important to evaluate our operating results before and after the effect of currency changes, as it may provide a more accurate comparison of our results of operations over historical periods. Currency volatility may continue, which may impact (either positively or negatively) our reported financial results and consolidated trends and comparisons.

We currently issue stock options and/or restricted stock to our officers, directors and employees, and as a result we record additional compensation expense in our consolidated statements of operations. We plan to continue the use of stock-based compensation for our officers, directors and employees, which may include, among other things, restricted stock or stock option grants that typically will require us to record additional compensation expense in our consolidated statements of operations and reduce our net income.

Our subscription-based information services, consisting primarily of CoStar Property Professional, CoStar Tenant, CoStar COMPS Professional, and FOCUS services currently generate more than 95% of our total revenues. CoStar Property Professional, CoStar Tenant, and CoStar COMPS Professional are generally sold as a suite of similar services and comprise our primary service offering in our U.S. operating segment. FOCUS is our primary service offering in our International operating segment. The majority of our contracts for our subscription-based information services typically have a minimum term of one year and renew automatically. Upon renewal, many of the subscription contract rates may change in accordance with contract provisions or as a result of contract renegotiations. To encourage clients to use our services regularly, we generally charge a fixed monthly amount for our subscription-based information services rather than fees based on actual system usage. Contract rates are generally based on the number of sites, number of users, organization size, the client's business focus, geography and the number of services to which a client subscribes. Our subscription clients generally pay contract fees on a monthly basis, but in some cases may pay us on a quarterly or annual basis. We recognize this revenue on a straight-line basis over the life of the contract. Annual and quarterly advance payments result in deferred revenue, substantially reducing the working capital requirements generated by accounts receivable.

For the twelve months ended September 30, 2009 and 2008, our contract renewal rate was approximately 85% and 90%, respectively. As discussed above, our trailing twelve-month contract renewal rate may continue to decline if continuing negative economic conditions lead to greater business failures and/or consolidations, further reductions in customer spending or decreases in the customer base.

Application of Critical Accounting Policies and Estimates

The preparation of financial statements and related disclosures in conformity with generally accepted accounting principles ("GAAP") in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and revenues and expenses during the period reported. The following accounting policies involve a "critical accounting estimate" because they are particularly dependent on estimates and assumptions made by management about matters that are highly uncertain at the time the accounting estimates are made. In addition, while we have used our best estimates based on facts and circumstances available to us at the time, different estimates reasonably could have been used in the current period. Changes in the accounting estimates we use are reasonably likely to occur from period to period, which may have a material impact on the presentation of our financial condition

and results of operations. We review these estimates and assumptions periodically and reflect the effects of revisions in the period that they are determined to be necessary.

Valuation of Long-Lived and Intangible Assets and Goodwill

We assess the impairment of long-lived assets, identifiable intangibles and goodwill whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Judgments made by management relate to the expected useful lives of long-lived assets and our ability to realize any undiscounted cash flows of the carrying amounts of such assets. The accuracy of these judgments may be adversely affected by several factors, including the factors listed below:

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

When we determine that the carrying value of long-lived and identifiable intangible assets may not be recovered based upon the existence of one or more of the above indicators, we test for impairment.

Goodwill and identifiable intangible assets not subject to amortization are tested annually by each reporting unit on October 1st of each year for impairment and are tested for impairment more frequently based upon the existence of one or more of the above indicators. We consider our operating segments, U.S. and International, as our reporting units under Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) ASC 350, “Intangibles – Goodwill and Other,” for consideration of potential impairment of goodwill.

The goodwill impairment test is a two-step process. The first step is to determine the fair value of each reporting unit. We estimate the fair value of each reporting unit based on a projected discounted cash flow model that includes significant assumptions and estimates including our future financial performance and a weighted average cost of capital. The fair value of each reporting unit is compared to the carrying amount of the reporting unit. If the carrying value of the reporting unit exceeds the fair value, then the second step of the process is performed to measure the impairment loss. We measure impairment loss based on a projected discounted cash flow method using a discount rate determined by our management to be commensurate with the risk in our current business model.

Accounting for Income Taxes

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

Non-GAAP Financial Measures

We prepare and publicly release quarterly unaudited financial statements prepared in accordance with GAAP. We also disclose and discuss certain non-GAAP financial measures in our public releases. Currently, the non-GAAP financial measure that we disclose is EBITDA, which is our net income (loss) before interest, income taxes, depreciation and amortization. We disclose EBITDA on a consolidated and an operating segment basis in our earnings releases, investor conference calls and filings with the Securities and Exchange Commission. The non-GAAP financial measures that we use may not be comparable to similarly titled measures reported by other companies. Also, in the

future, we may disclose different non-GAAP financial measures in order to help our investors more meaningfully evaluate and compare our future results of operations to our previously reported results of operations.

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

EBITDA is used by management to internally measure our operating and management performance and by investors as a supplemental financial measure to evaluate the performance of our business that, when viewed with our GAAP results and the accompanying reconciliation, we believe provides additional information that is useful to gain an understanding of the factors and trends affecting our business. We have spent more than 21 years building our database of commercial real estate information and expanding our markets and services partially through acquisitions of complementary businesses. Due to the expansion of our information, marketing and analytic services, which included acquisitions, our net income (loss) has included significant charges for purchase amortization, depreciation and other amortization. EBITDA excludes these charges and provides meaningful information about the operating performance of our business, apart from charges for purchase amortization, depreciation and other amortization. We believe the disclosure of EBITDA helps investors meaningfully evaluate and compare our performance from quarter to quarter and from year to year. We also believe EBITDA is a measure of our ongoing operating performance because the isolation of non-cash charges, such as amortization and depreciation, and non-operating items, such as interest and income taxes, provides additional information about our cost structure, and, over time, helps track our operating progress. In addition, investors, securities analysts and others have regularly relied on EBITDA to provide a financial measure by which to compare our operating performance against that of other companies in our industry.

Set forth below are descriptions of the financial items that have been excluded from our net income (loss) to calculate EBITDA and the material limitations associated with using this non-GAAP financial measure as compared to net income (loss):

- Purchase amortization in cost of revenues may be useful for investors to consider because it represents the use of our acquired database technology, which is one of the sources of information for our database of commercial real estate information. We do not believe these charges necessarily reflect the current and ongoing cash charges related to our operating cost structure.
- Purchase amortization in operating expenses may be useful for investors to consider because it represents the estimated attrition of our acquired customer base and the diminishing value of any acquired trade names. We do not believe these charges necessarily reflect the current and ongoing cash charges related to our operating cost structure.
- Depreciation and other amortization may be useful for investors to consider because they generally represent the wear and tear on our property and equipment used in our operations. We do not believe these charges necessarily reflect the current and ongoing cash charges related to our operating cost structure.
- The amount of net interest income we generate may be useful for investors to consider and may result in current cash inflows or outflows. However, we do not consider the amount of net interest income to be a representative

component of the day-to-day operating performance of our business.

- Income tax expense (benefit) may be useful for investors to consider because it generally represents the taxes which may be payable for the period and the change in deferred income taxes during the period and may reduce the amount of funds otherwise available for use in our business. However, we do not consider the amount of income tax expense (benefit) to be a representative component of the day-to-day operating performance of our business.

Management compensates for the above-described limitations of using non-GAAP measures by using a non-GAAP measure only to supplement our GAAP results and to provide additional information that is useful to gain an understanding of the factors and trends affecting our business.

The following table shows our EBITDA reconciled to our net income and our cash flows from operating, investing and financing activities for the indicated periods (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Net income	\$4,325	\$6,645	\$15,047	\$17,122
Purchase amortization in cost of revenues	659	585	1,641	1,772
Purchase amortization in operating expenses	842	1,236	2,530	3,723
Depreciation and other amortization	2,107	2,432	6,571	7,374
Interest income, net	(263)	(951)	(1,027)	(4,132)
Income tax expense, net	2,889	5,586	11,863	14,030
EBITDA	\$10,559	\$15,533	\$36,625	\$39,889
Cash flows provided by				
Operating activities	\$12,937	\$14,545	\$31,814	\$30,381
Investing activities	4,171	19,461	7,824	45,668
Financing activities	575	3,456	506	6,227

Comparison of Three Months Ended September 30, 2009 and Three Months Ended September 30, 2008

Revenues. Revenues slightly decreased to \$53.6 million in the third quarter of 2009 from \$53.8 million in the third quarter of 2008. Revenues from our International operations decreased \$1.0 million primarily due to a decrease due to foreign currency fluctuations. Additionally, U.S. revenues declined by approximately \$3.0 million due to decreased sales resulting from a difficult commercial real estate and economic environment. These decreases in revenue were mostly offset by additional revenues of approximately \$3.8 million included as a result of our July 2009 acquisition of PPR. Our subscription-based information services, consisting primarily of CoStar Property Professional, CoStar Tenant, CoStar COMPS Professional and FOCUS, currently generate more than 95% of our total revenues.

Gross Margin. Gross margin decreased to \$34.4 million in the third quarter of 2009 from \$36.1 million in the third quarter of 2008. The gross margin percentage decreased to 64.3% in the third quarter of 2009 from 67.2% in the third quarter of 2008. The decrease in the amount and percentage of gross margin was principally due to an increase in the cost of revenues. Cost of revenues increased to \$19.1 million for the third quarter of 2009 from \$17.6 million for the third quarter of 2008. The increase in the cost of revenues was principally due to additional cost of revenues incurred by PPR and included as a result of our July 2009 acquisition of PPR.

Selling and Marketing Expenses. Selling and marketing expenses increased to \$11.6 million in the third quarter of 2009 from \$10.3 million in the third quarter of 2008, and increased as a percentage of revenues to 21.7% in the third quarter of 2009 from 19.2% in the third quarter of 2008. The increase in the amount and percentage of selling and marketing expenses was primarily due to additional selling and marketing expenses of approximately \$700,000

incurred by PPR and included as a result of our July 2009 acquisition of PPR.

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Software Development Expenses. Software development expenses slightly increased to \$3.5 million in the third quarter of 2009 from \$3.1 million in the third quarter of 2008, and rose slightly as a percentage of revenues to 6.4% in the third quarter of 2009 compared to 5.8% in the third quarter of 2008. The increase in the amount and percentage of software development expense was primarily due to additional software development expenses incurred by PPR and included as a result of our July 2009 acquisition of PPR.

General and Administrative Expenses. General and administrative expenses increased to \$11.6 million in the third quarter of 2009 from \$10.2 million in the third quarter of 2008, and increased as a percentage of revenues to 21.6% in the third quarter of 2009 compared to 18.9% in the third quarter of 2008. The increase in the amount and percentage of general and administrative expenses was primarily due to an increase in acquisition and deal-related costs of approximately \$500,000, an increase in legal fees of approximately \$450,000 and an increase of approximately \$500,000 due to additional general and administrative expenses incurred by PPR and included as a result of our July 2009 acquisition of PPR.

Purchase Amortization. Purchase amortization decreased to approximately \$842,000 in the third quarter of 2009 compared to \$1.2 million in the third quarter of 2008, and was lower as a percentage of revenues at 1.6% in the third quarter of 2009 compared to 2.3% in the third quarter of 2008. The decrease in purchase amortization expense is due to the completion of amortization of certain identifiable intangible assets in 2009.

Interest and Other Income, net. Interest and other income, net decreased to approximately \$263,000 in the third quarter of 2009 from \$951,000 in the third quarter of 2008. The decrease in int