

COSTAR GROUP INC
Form 10-Q
May 09, 2008

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 March 31, 2008

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)

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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, 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
Non-accelerated filer

Accelerated filer
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 May 1, 2008, there were 19,527,967 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 March 31,	
	2008	2007
Revenues	\$ 52,264	\$ 44,831
Cost of revenues	19,721	17,826
Gross margin	32,543	27,005
Operating expenses:		
Selling and marketing	10,873	13,166
Software development	3,414	3,070
General and administrative	9,805	8,063
Purchase amortization	1,221	1,270
	25,313	25,569
Income from operations	7,230	1,436
Interest and other income, net	1,938	1,862
Income before income taxes	9,168	3,298
Income tax expense, net	4,126	1,484
Net income	\$ 5,042	\$ 1,814
Net income per share ³ / ₄ basic	\$ 0.26	\$ 0.10
Net income per share ³ / ₄ diluted	\$ 0.26	\$ 0.09
Weighted average outstanding shares ³ / ₄ basic	19,217	18,896
Weighted average outstanding shares ³ / ₄ diluted	19,369	19,207

See accompanying notes.

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

ASSETS	March 31, 2008 (unaudited)	December 31, 2007
Current assets:		
Cash and cash equivalents	\$ 94,706	\$ 57,785
Short-term investments	66,855	129,641
Accounts receivable, less allowance for doubtful accounts of approximately \$3,455 and \$2,959 as of March 31, 2008 and December 31, 2007, respectively	11,708	10,875
Deferred income taxes, net	2,097	2,716
Prepaid expenses and other current assets	3,371	4,661
Total current assets	178,737	205,678
Long-term investments	31,532	¾
Deferred income taxes, net	3,335	2,233
Property and equipment, net	22,714	24,045
Goodwill	61,819	61,854
Intangibles and other assets, net	23,892	25,711
Deposits and other assets	1,485	2,322
Total assets	\$ 323,514	\$ 321,843
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 1,883	\$ 3,299
Accrued wages and commissions	5,894	7,489
Accrued expenses and deferred rent	11,890	16,884
Deferred revenue	10,723	10,374
Income taxes payable	5,167	191
Total current liabilities	35,557	38,237
Deferred income taxes, net	1,089	1,801
Total stockholders' equity	286,868	281,805
Total liabilities and stockholders' equity	\$ 323,514	\$ 321,843

See accompanying notes.

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

	Three Months Ended March 31,	
	2008	2007
Operating activities:		
Net income	\$ 5,042	\$ 1,814
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	2,163	1,744
Amortization	2,119	1,866
Stock-based compensation expense	1,243	1,529
Deferred income tax expense, net	4,126	1,484
Provision for losses on accounts receivable	946	517
Changes in operating assets and liabilities, net of acquisitions	(7,557)	2,189
Net cash provided by operating activities	8,082	11,143
Investing activities:		
Purchases of investments	(1,490)	(26,382)
Sales of investments	31,172	39,225
Purchases of property and equipment and other assets	(1,189)	(2,581)
Acquisition, net of cash acquired	¾	(16,737)
Net cash provided by (used in) investing activities	28,493	(6,475)
Financing activities:		
Proceeds from exercise of stock options	412	362
Net cash provided by financing activities	412	362
Effect of foreign currency exchange rates on cash and cash equivalents	(66)	(71)
Net increase in cash and cash equivalents	36,921	4,959
Cash and cash equivalents at the beginning of period	57,785	38,159
Cash and cash equivalents at the end of period	\$ 94,706	\$ 43,118

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 services to the commercial real estate and related business community and operates within two segments, U.S. and International. The Company’s information 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 March 31, 2008, the results of its operations and its cash flows for the three months ended March 31, 2008 and 2007. 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, 2007.

The results of operations for the three months ended March 31, 2008 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 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. 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 months ended March 31, 2008 and 2007.

COSTAR GROUP, INC.

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

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — (CONTINUED)

Comprehensive Income

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

	Three Months Ended March 31, 2008 2007 (unaudited)	
Net income	\$ 5,042	\$ 1,814
Foreign currency translation adjustment	(64)	(11)
Net unrealized (loss) gain on investments, net of tax	(1,570)	84
Comprehensive income	\$ 3,408	\$ 1,887

The components of accumulated other comprehensive income are as follows (in thousands):

	March 31, 2008 (unaudited)	December 31, 2007
Foreign currency translation adjustment	\$ 5,476	\$ 5,540
Accumulated net unrealized (loss) gain on investments, net of tax	(1,484)	86
Total accumulated other comprehensive income	\$ 3,992	\$ 5,626

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 March 31, 2008 2007 (unaudited)	
Numerator:		
Net income	\$ 5,042	\$ 1,814
Denominator:		
Denominator for basic net income per share $\frac{3}{4}$ weighted-average outstanding shares	19,217	18,896
Effect of dilutive securities:		
Stock options and restricted stock	152	311
Denominator for diluted net income per share $\frac{3}{4}$ weighted-average outstanding shares	19,369	19,207
Net income per share $\frac{3}{4}$ basic	\$ 0.26	\$ 0.10
Net income per share $\frac{3}{4}$ diluted	\$ 0.26	\$ 0.09

Stock-Based Compensation

The Company accounts for stock-based compensation in accordance with Statement of Financial Accounting Standards (“SFAS”) No. 123R “Share Based Payment” (“SFAS 123R”), which addresses the accounting for share-based payment transactions in which the Company receives employee services in exchange for equity instruments. The statement 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.

Stock-based compensation expense for stock options and restricted stock included in the Company’s results of operations for the three months ended March 31, 2008 and 2007, was as follows (in thousands):

	Three Months Ended March 31, 2008 2007 (unaudited)	
Cost of revenues	\$ 162	\$ 254
Selling and marketing	180	379
Software development	124	95
General and administrative	777	801
Total	\$ 1,243	\$ 1,529

COSTAR GROUP, INC.

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

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — (CONTINUED)

Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (“FASB”) issued SFAS No. 157, “Fair Value Measurements” (“SFAS 157”), which defines fair value, establishes a framework for measuring fair value in accordance with GAAP and expands disclosures about fair value measurements. SFAS 157 does not require any new fair value measurements under GAAP and is effective for fiscal years beginning after November 15, 2007. In February 2008, the FASB issued FASB Staff Position (“FSP”) 157-2, “Partial Deferral of the Effective Date of Statement 157”, (“FSP 157-2”), which delays the effective date of SFAS 157 to January 1, 2009 for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the consolidated financial statements on a recurring basis (at least annually). Effective January 1, 2008 the Company adopted the portion of SFAS 157 that was not deferred under FSP 157-2. The adoption of SFAS 157 did not have a material impact on the Company’s results of operations and financial position. The Company is currently assessing the impact on its financial statements for the portion of SFAS 157 that was deferred with the release of FSP 157-2.

In February 2007, the FASB issued SFAS No. 159, “Fair Value Option for Financial Assets and Financial Liabilities — Including an amendment of FASB Statement No. 115” (“SFAS 159”), which permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. SFAS 159 is effective for fiscal years beginning on or after December 31, 2007. The Company adopted SFAS 159 on January 1, 2008 and has elected not to apply the fair value option to any of its financial instruments. The adoption of SFAS 159 did not have a material impact on the Company’s results of operations and financial position.

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), “Business Combinations” (“SFAS 141R”), which will change the accounting for any business combination the Company enters into with an acquisition date after December 31, 2008. Under SFAS 141R, an acquiring entity will be required to recognize all the assets acquired and liabilities assumed in a transaction at the acquisition date fair value with limited exceptions. SFAS 141R will change the accounting treatment and disclosure for certain specific items in a business combination. SFAS 141R will have an impact on accounting for business combinations once adopted but its effect will be dependent upon the specifics of any business combination with an acquisition date subsequent to the date of adoption.

In December 2007, the FASB issued SFAS No. 160, “Noncontrolling Interests in Consolidated Financial Statements—An Amendment of ARB No. 51” (“SFAS 160”), which establishes new accounting and reporting standards for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. SFAS 160 is effective for fiscal years beginning on or after December 15, 2008. The adoption of SFAS 160 is not expected to have a material impact on the Company’s results of operations or financial position.

In April 2008, the FASB issued FASB Staff Position (“FSP”) SFAS 142-3, “Determination of the Useful Life of Intangible Assets” (“FSP 142-3”), which is effective for all fiscal years and interim periods beginning after December 15, 2008. Early adoption of FSP 142-3 is not permitted. FSP 142-3 requires additional footnote disclosures about the impact of the Company’s ability or intent to renew or extend agreements related to existing intangibles or expected future cash flows from those intangibles, how the Company accounts for costs incurred to renew or extend such agreements, the time until the next renewal or extension period by asset class, and the amount of renewal or extension costs capitalized, if any. For any intangibles acquired after December 31, 2008, FSP 142-3 requires that the Company consider its experience regarding renewal and extensions of similar arrangements in determining the useful life. If the Company does not have experience with similar arrangements, FSP 142-3 requires that the Company use the

assumptions of a market participant putting the intangible to its highest and best use in determining the useful life. The Company is currently assessing the impact of FSP 142-3 on its financial statements.

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COSTAR GROUP, INC.

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

3. ACQUISITION

On February 16, 2007, CoStar Limited, a wholly owned U.K. subsidiary of CoStar, acquired all of the outstanding capital stock of Property Investment Exchange Limited (“Propex”) for approximately \$22.0 million, consisting of cash, deferred consideration of approximately \$2.9 million, and 21,526 shares of CoStar common stock. Propex provides web-based commercial property information and operates an electronic platform that facilitates the exchange of investment property in the U.K. Propex’s suite of electronic platforms and listing websites give users access to the U.K. commercial property investment and leasing markets.

The Propex acquisition was accounted for using purchase accounting. The purchase price for the acquisition was primarily allocated to customer base, trade name, and goodwill. The acquired customer base for the acquisition, 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 Propex acquired trade name is being amortized on a straight-line basis over three years. The Company recorded goodwill of approximately \$15.0 million related to the Propex acquisition. Goodwill is not amortized, but is subject to annual impairment tests. The results of operations of Propex 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. FAIR VALUE

In September 2006, the FASB issued SFAS No. 157, “Fair Value Measurements” (“SFAS 157”), which defines fair value, establishes a framework for measuring fair value in accordance with GAAP and expands disclosures about fair value measurements. The Company adopted the provisions of SFAS 157 as of January 1, 2008 for financial instruments. Although the adoption of SFAS 157 did not materially impact its financial position, results of operations, or cash flow, the Company is now required to provide additional disclosures as part of its financial statements.

SFAS 157 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.

In accordance with SFAS 157, 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 March 31, 2008 (in thousands):

	Level 1	Level 2	Level 3	Total
Cash	\$ 7,996	\$ ¾	\$ ¾	\$ 7,996
Money market funds	65,231	¾	¾	65,231
Treasuries	21,479	¾	¾	21,479
Auction rate securities	¾	¾	31,532	31,532
Government-sponsored enterprise obligations	12,810	¾	¾	12,810
Corporate debt securities	¾	54,045	¾	54,045
Total	\$ 107,516	\$ 54,045	\$ 31,532	\$ 193,093

COSTAR GROUP, INC.

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

4. FAIR VALUE — (CONTINUED)

The Company's Level 2 assets consist of corporate debt securities, which do not have directly observable quoted prices in active markets. The Company's corporate debt securities are valued using matrix pricing, which is an acceptable practical expedient under SFAS 157 and classified as Level 2.

The Company's Level 3 assets consist of variable rate debt instruments with an auction reset feature ("auction rate securities" or "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 table presents the Company's Level 3 assets measured at fair value on a recurring basis using significant unobservable inputs as defined in SFAS 157, at March 31, 2008 (in thousands):

	Auction Rate Securities
Balance at December 31, 2007	\$ 53,975
Unrealized loss included in other comprehensive income	(1,600)
Net settlements	(20,843)
Balance at March 31, 2008 (unaudited)	\$ 31,532

ARS are variable rate debt instruments whose interest rates are reset approximately every 28 days. The underlying securities have contractual maturities greater than twenty years. The ARS are recorded at fair value. Typically, the carrying value of ARS approximates fair value due to frequent resetting of the interest rates. As of March 31, 2008, the Company held ARS totaling \$33.1 million all of which failed to settle at auctions. 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 have been reclassified out of short-term investments and into long-term investments in the Company's condensed consolidated balance sheet as of March 31, 2008.

While the Company continues to earn interest on its ARS investments at the maximum 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 March 31, 2008. The assumptions used in preparing the discounted cash flow model include estimates for interest rates, timing and amount of cash flows and expected holding periods of the ARS. Based on this assessment of fair value, as of March 31, 2008, the Company determined there was a decline in the fair value of its ARS investments of approximately \$1.6 million. The decline was deemed to be a temporary impairment and recorded as an unrealized loss in other comprehensive income in stockholders' equity. In addition, while all 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.

COSTAR GROUP, INC.

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

5. 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
Effect of foreign currency translation	³ / ₄	(35)	(35)
Goodwill, March 31, 2008 (unaudited)	\$ 30,428	\$ 31,391	\$ 61,819

6. INTANGIBLES AND OTHER ASSETS

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

	March 31, 2008 (unaudited)	December 31, 2007	Weighted- Average Amortization Period (in years)
Building photography	\$ 11,121	\$ 10,799	5
Accumulated amortization	(7,021)	(6,708)	
Building photography, net	4,100	4,091	
Acquired database technology	21,387	21,390	4
Accumulated amortization	(20,667)	(20,573)	
Acquired database technology, net	720	817	
Acquired customer base	50,873	50,891	10
Accumulated amortization			