COSTAR GROUP INC
Form 10-Q
April 27, 2012

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

FORM 10-Q

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

For the quarterly period ended March 31, 2012

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	52-2091509
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

1331 L Street, NW
Washington, DC 20005
(Address of principal executive offices) (zip code)

(202) 346-6500
(Registrant's telephone number, including area code)

(877) 739-0486
(Registrant's facsimile number, including area code)

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

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 x No o

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

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

As of April 20, 2012, there were 25,806,357 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,	
	2012	2011
Revenues	$68,629	$59,618
Cost of revenues	24,334	22,566
Gross margin	44,295	37,052
Operating expenses:		
Selling and marketing	15,550	13,246
Software development	5,015	5,268
General and administrative	14,494	10,899
Purchase amortization	634	543
	35,693	29,956
Income from operations	8,602	7,096
Interest and other income, net	250	202
Income before income taxes	8,852	7,298
Income tax expense, net	3,720	2,766
Net income	$5,132	$4,532
Net income per share — basic	$0.20	$0.22
Net income per share — diluted	$0.20	$0.22
Weighted average outstanding shares — basic	25,128	20,531
Weighted average outstanding shares — diluted	25,528	20,965

See accompanying notes.

COSTAR GROUP, INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(in thousands)
(unaudited)

	Three Months Ended March 31,	
	2012	2011
Net income	$5,132	$4,532
Other comprehensive income, net of tax		
Foreign currency translation adjustment	934	1,052
Net change in unrealized loss on investments, net of tax	(38)	(27)
Total other comprehensive income	896	1,025
Total comprehensive income	$6,028	$5,557

See accompanying notes.

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

	March 31, 2012 (unaudited)	December 31, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	$549,096	$545,280
Short-term investments	2,285	3,515
Accounts receivable, less allowance for doubtful accounts of approximately $2,628 and $2,524 as of March 31, 2012 and December 31, 2011, respectively	16,352	16,589
Deferred income taxes, net	11,166	11,227
Income tax receivable	—	850
Prepaid expenses and other current assets	6,009	5,722
Total current assets	584,908	583,183
Long-term investments	24,534	24,584
Deferred income taxes, net	10,108	10,224
Property and equipment, net	38,584	37,571
Goodwill	92,624	91,784
Intangibles and other assets, net	19,537	20,530
Deposits and other assets	3,456	3,159
Total assets	$773,751	$771,035
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$4,171	$6,010
Accrued wages and commissions	9,827	16,695
Accrued expenses	14,819	12,761
Deferred gain on the sale of building	2,523	2,523
Income taxes payable	2,614	978
Deferred rent	555	544
Deferred revenue	23,234	22,271
Total current liabilities	57,743	61,782
Deferred gain on the sale of building	30,702	31,333
Deferred rent	16,440	16,592
Income taxes payable	2,161	2,151
Total liabilities	107,046	111,858
Total stockholders' equity	666,705	659,177
Total liabilities and stockholders' equity	$773,751	$771,035

See accompanying notes.

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

	Three Months Ended March 31, 2012	2011
Operating activities:		
Net income	$5,132	$4,532
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	2,144	2,309
Amortization	1,176	1,123
Excess tax benefit from stock options	(465)	(595)
Stock-based compensation expense	2,187	2,064
Deferred income tax expense, net	2,675	465
Provision for losses on accounts receivable	358	537
Changes in operating assets and liabilities:		
Accounts receivable	(87)	(3,649)
Prepaid expenses and other current assets	138	1,660
Deposits and other assets	(141)	347
Accounts payable and other liabilities	(7,579)	(2,939)
Deferred revenue	843	1,832
Net cash provided by operating activities	6,381	7,686
Investing activities:		
Settlement of investments	1,245	33
Proceeds from sale of building, net	—	83,553
Purchases of property and equipment and other assets	(3,012)	(5,772)
Net cash (used in) provided by investing activities	(1,767)	77,814
Financing activities:		
Payments of debt issuance costs	(125)	—
Excess tax benefit from stock options	465	595
Repurchase of restricted stock to satisfy tax withholding obligations	(1,611)	(1,476)
Proceeds from exercise of stock options and ESPP	457	1,156
Net cash (used in) provided by financing activities	(814)	275
Effect of foreign currency exchange rates on cash and cash equivalents	16	72
Net increase in cash and cash equivalents	3,816	85,847
Cash and cash equivalents at the beginning of period	545,280	206,405
Cash and cash equivalents at the end of period	$549,096	$292,252

See accompanying notes.

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

1. ORGANIZATION

CoStar Group, Inc. (the “Company” or “CoStar”) has created a comprehensive, proprietary database of commercial real estate information covering the United States (“U.S.”), as well as parts of the United Kingdom and France. Based on its unique database, the Company provides information 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 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 condensed consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All 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 U.S. generally accepted accounting principles (“GAAP”) 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, 2012, the results of its operations for the three months ended March 31, 2012 and 2011, its other comprehensive income for the three months ended March 31, 2012 and 2011, and its cash flows for the three months ended March 31, 2012 and 2011. 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, 2011.

The results of operations for the three months ended March 31, 2012 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 in 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 dates. 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 condensed consolidated statements of operations. There were no material gains or losses from foreign currency exchange transactions for the three months ended March 31, 2012 and 2011.

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

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — (CONTINUED)

Accumulated Other Comprehensive Loss

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

	March 31, 2012	December 31, 2011
Foreign currency translation adjustment	$(4,956)	$(5,890)
Accumulated net unrealized loss on investments, net of tax	(2,716)	(2,678)
Total accumulated other comprehensive loss	$(7,672)	$(8,568)

Net Income Per Share

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

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

	Three Months Ended March 31,	
	2012	2011
Numerator:		
Net income	$5,132	$4,532
Denominator:		
Denominator for basic net income per share — weighted-average outstanding shares	25,128	20,531
Effect of dilutive securities:		
Stock options and restricted stock	400	434
Denominator for diluted net income per share — weighted-average outstanding shares	25,528	20,965
Net income per share — basic	$0.20	$0.22
Net income per share — diluted	$0.20	$0.22

Employee stock options with exercise prices greater than the average market price of the Company's common stock for the period are excluded from the calculation of diluted net income per share as their inclusion would be anti-dilutive. No potential common shares were excluded from the diluted calculation for the three months ended March 31, 2012 and 2011.

Stock-Based Compensation

Equity instruments issued in exchange for employee services are accounted for using a fair-value based method and the fair value of such equity instruments is recognized as expense in the condensed consolidated statements of operations.

Stock-based compensation cost is measured at the grant date of the share-based awards based on their fair values, and is recognized on a straight line basis as expense over the vesting periods of the awards, net of an estimated forfeiture rate.

Cash flows resulting from excess tax benefits are classified as part of cash flows from operating and financing activities. Excess tax benefits represent tax benefits related to stock-based compensation in excess of the associated deferred tax asset for such equity compensation. Net cash proceeds from the exercise of stock options and the purchase of shares under the Employee Stock Purchase Plan ("ESPP") were approximately $457,000 and $1.2 million for the three months ended March 31, 2012 and 2011, respectively. Approximately $465,000 and $595,000 of excess tax benefits were realized from stock option and award exercises for the three months ended March 31, 2012 and 2011, respectively.

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 issued under equity incentive plans and stock purchases under the ESPP included in the Company's results of operations were as follows (in thousands):

	Three Months Ended March 31,	
	2012	2011
Cost of revenues	$379	$392
Selling and marketing	308	130
Software development	331	284
General and administrative	1,169	1,258
Total stock-based compensation	$2,187	$2,064

Options to purchase 7,567 and 31,498 shares were exercised during the three months ended March 31, 2012 and 2011, respectively.

Capitalized Product Development Costs

Product development costs are expensed as incurred until technological feasibility has been established, at which time such costs are capitalized. Costs are capitalized, to the extent that the capitalizable costs do not exceed the realizable value of such costs, until the product is available for general release to customers. The Company defines the establishment of technological feasibility as the completion of all planning, designing, coding and testing activities that are necessary to establish products that meet design specifications including functions, features and technical performance requirements. The Company's capitalized product development costs had a total net book value of approximately $446,000 and $493,000 as of March 31, 2012 and December 31, 2011, respectively. These capitalized product development costs are included in intangible and other assets in the Company's condensed consolidated balance sheets. Amortization is computed using a straight-line method over the remaining estimated economic life of the product, typically three to five years after the software is ready for its intended use. The Company amortized capitalized product development costs of approximately $47,000 for the three months ended March 31, 2012. No amortization expense for capitalized product development costs was recognized for the three months ended March 31, 2011.

Debt Issuance Costs

Costs incurred in connection with the issuance of long-term debt are capitalized and amortized as interest expense over the term of the related debt using the effective interest method. The Company's capitalized debt issuance costs were approximately $1.5 million and $900,000 as of March 31, 2012 and December 31, 2011, respectively. The debt issuance costs are associated with the financing commitment received from JPMorgan Chase Bank, N.A. ("J.P. Morgan Bank") on April 27, 2011 and the subsequent term loan facility and revolving credit facility pursuant to the Credit Agreement dated February 16, 2012, by and among CoStar, as borrower, CoStar Realty Information, Inc. ("CoStar Realty"), as co-borrower, the lenders from time to time party thereto and J.P. Morgan Bank, as administrative agent (as amended, the "Credit Agreement"). See Note 14 of the Notes to Condensed Consolidated Financial Statements included in Part I of this Quarterly Report on Form 10-Q for additional information regarding the financing commitment with J.P. Morgan Bank and the Credit Agreement. No amortization expense for debt issuance costs was recognized by the Company for the three months ended March 31, 2012 and 2011.

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, 2011, including the expected dates of adoption and estimated effects on the Company's condensed consolidated financial statements, except for the following:

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

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — (CONTINUED)

Recent Accounting Pronouncements — (Continued)

In May 2011, the FASB issued authoritative guidance to develop common requirements for measuring fair value and for disclosing information about fair value measurements in accordance with GAAP and International Financial Reporting Standards ("IFRS"). This guidance clarifies the intent of the existing fair value measurement and disclosure requirements and modifies principles and requirements for measuring fair value and for disclosing information about fair value measurement. This guidance is effective on a prospective basis for financial statements issued for interim and annual periods beginning after December 15, 2011. This guidance did not have a material impact on the Company's results of operations or financial position, but did require changes to the disclosures in its interim financial statements.

In June 2011, the FASB issued authoritative guidance to improve the comparability, consistency and transparency of financial reporting and to increase the prominence of items reported in other comprehensive income. This guidance requires changes in stockholders' equity to be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. Under the two-statement approach, the first statement should present total net income and its components followed consecutively by a second statement that should present total other comprehensive income, the components of other comprehensive income and the total of comprehensive income. This guidance is effective on a retrospective basis for financial statements issued for interim and annual periods beginning after December 15, 2011. This guidance did not have a material impact on the Company's results of operations or financial position, but did require the addition of the condensed consolidated statements of comprehensive income.

3. ACQUISITION

On October 25, 2011, the Company acquired Virtual Premise, Inc. ("Virtual Premise"), a Software as a Service ("SaaS") provider of real estate information management solutions. Pursuant to the terms of the acquisition agreement, the Company paid approximately $17.2 million in cash, approximately 80% of which was paid on the closing date to the Virtual Premise stockholders and the remaining 20% of which will be held in escrow until paid 270 days after the closing date, subject to use of such funds to satisfy any post-closing net working capital adjustments or indemnification claims made prior to such date. The purchase price was later reduced by approximately $200,000 after taking into account post-closing purchase price adjustments and this amount was paid to the Company on March 1, 2012 from the escrow fund.

The purchase price for the Virtual Premise acquisition was allocated as follows (in thousands):

Acquired trade names and other	$740	
Acquired customer base	3,740	
Acquired database technology	810	
Goodwill	12,205	
Other assets and liabilities	(529	)
Total purchase consideration	$16,966	

This acquisition was accounted for using the acquisition method which requires that, among other things, assets acquired and liabilities assumed be recorded at their fair values as of the acquisition date. The purchase price was allocated to trade names, customer base, database technology, goodwill and various other asset and liability accounts. 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 10 years. The identified intangibles are amortized over their estimated useful lives. Goodwill recorded in connection with this acquisition is not amortized, but is subject to annual impairment tests. The results of operations of Virtual Premise have been consolidated with those of the Company since the date of the acquisition and are not considered material to the Company's condensed consolidated financial statements. Accordingly, pro forma financial information has not been presented for the acquisition. The purchase accounting is preliminary and is subject to change.

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

4. INVESTMENTS

The Company determines the appropriate classification of debt and equity investments at the time of purchase and re-evaluates 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 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 condensed 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, referred to as auction rate securities ("ARS"). Investments are carried at fair market value.

Scheduled maturities of investments classified as available-for-sale as of March 31, 2012 were as follows (in thousands):

Maturity Due:	Fair Value
April 1, 2012 — March 31, 2013	$2,236
April 1, 2013 — March 31, 2017	—
April 1, 2017 — March 31, 2022	49
After March 31, 2022	24,534
Available-for-sale investments	$26,819

The Company had no realized gains on its investments for each of the three months ended March 31, 2012 and 2011. The Company had no realized losses on its investments for each of the three months ended March 31, 2012 and 2011.

Changes in 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 accumulated 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 March 31, 2012, the amortized cost basis and fair value of investments classified as available-for-sale were as follows (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Corporate debt securities	$2,210	$26	$—	$2,236
Government-sponsored enterprise obligations	50	—	(1)	49
Auction rate securities	27,275	—	(2,741)	24,534
Available-for-sale investments	$29,535	$26	$(2,742)	$26,819

As of December 31, 2011, the amortized cost basis and fair value of investments classified as available-for-sale were as follows (in thousands):

	Amortized Cost	Gross Unrealized	Gross Unrealized	Fair Value

		Gains	Losses	
Corporate debt securities	$3,397	$64	$—	$3,461
Government-sponsored enterprise obligations	55	—	(1)	54
Auction rate securities	27,325	—	(2,741)	24,584
Available-for-sale investments	$30,777	$64	$(2,742)	$28,099

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

4. INVESTMENTS — (CONTINUED)

The unrealized losses on the Company's investments as of March 31, 2012 and December 31, 2011 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 more likely than not that the Company will not be required to sell these instruments prior to anticipated recovery, which may be at maturity, the Company does not consider these investments to be other-than-temporarily impaired as of March 31, 2012 and December 31, 2011. See Note 5 of the Notes to Condensed Consolidated Financial Statements included in Part I of this Quarterly Report on Form 10-Q for further discussion on the fair value of the Company's financial assets.

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

	March 31, 2012		December 31, 2011	
	Aggregate Fair Value	Gross Unrealized Losses	Aggregate Fair Value	Gross Unrealized Losses
Government-sponsored enterprise obligations	$49	$(1)	$54	$(1)
Auction rate securities	24,534	(2,741)	24,584	(2,741)
Investments in an unrealized loss position	$24,583	$(2,742)	$24,638	$(2,742)

The Company did not have any investments in an unrealized loss position for less than twelve months as of March 31, 2012 and December 31, 2011, respectively.

5. FAIR VALUE

Fair value is defined as the price that would be received in the sale of an asset or paid to transfer a liability in an orderly transaction between market participants. There is 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 for identical assets; 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 for which little or no market data exists, therefore requiring an entity to develop its own assumptions.

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, 2012 (in thousands):

	Level 1	Level 2	Level 3	Total
Assets:				
Cash	$201,322	$—	$—	$201,322
Money market funds	99,085	—	—	99,085
Commercial paper	248,689	—	—	248,689
Corporate debt securities	—	2,236	—	2,236
Government-sponsored enterprise obligations	—	49	—	49
Auction rate securities	—	—	24,534	24,534
Total assets measured at fair value	$549,096	$2,285	$24,534	$575,915

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

5. FAIR VALUE — (CONTINUED)

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 December 31, 2011 (in thousands):

	Level 1	Level 2	Level 3	Total
Assets:				
Cash	$75,688	$—	$—	$75,688
Money market funds	220,996	—	—	220,996
Commercial paper	248,596	—	—	248,596
Corporate debt securities	—	3,461	—	3,461
Government-sponsored enterprise obligations	—	54	—	54
Auction rate securities	—	—	24,584	24,584
Total assets measured at fair value	$545,280	$3,515	$24,584	$573,379

The Company’s Level 2 assets consist of corporate debt 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.

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 months ended March 31, 2012 and 2011 (in thousands):

	Three Months Ended March 31,	
	2012	2011
Balance at beginning of period	$24,584	$29,189
Settlements	(50)	(75)
Balance at end of period	$24,534	$29,114

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 March 31, 2012 (in thousands):

	Auction Rate Securities
Balance at December 31, 2007	$53,975
Change in unrealized loss included in other comprehensive loss	(3,710)
Settlements	(20,925)
Balance at December 31, 2008	29,340
Change in unrealized gain included in other comprehensive loss	684
Settlements	(300)
Balance at December 31, 2009	29,724
Change in unrealized gain included in other comprehensive loss	40
Settlements	(575)
Balance at December 31, 2010	29,189
Change in unrealized gain included in other comprehensive loss	245
Settlements	(4,850)
Balance at December 31, 2011	24,584
Settlements	(50)
Balance at March 31, 2012	$24,534

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.

As of March 31, 2012, the Company held ARS with $27.3 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 March 31, 2012.

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. The estimated fair value of the ARS no longer approximates par value. The Company used a discounted cash flow model to determine the estimated fair value of its investment in ARS as of March 31, 2012. The assumptions used in preparing the discounted cash flow model include estimates for interest rates, credit spreads, timing and amount of contractual cash flows, liquidity risk premiums, expected holding periods and default risk. The Company updates the discounted cash flow model on a quarterly basis to reflect any changes in the assumptions used in the model and settlements of ARS investments that occurred during the period.

The only significant unobservable input in the discounted cash flow model is the discount rate. The discount rate used represents the Company's estimate of the yield expected by a market participant on these securities. The average discount rate used as of March 31, 2012 was approximately 4.5%. Selecting another discount rate within the range used in the discounted cash flow model would not result in a significant change to the fair value of the ARS.

Based on this assessment of fair value, as of March 31, 2012, the Company determined there was a decline in the fair value of its ARS investments of approximately $2.7 million. The decline was deemed to be a temporary impairment and recorded as an unrealized loss in accumulated other comprehensive 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/or their credit ratings deteriorate, the Company may be required to record additional unrealized losses in accumulated other comprehensive loss or an other-than-temporary impairment charge to earnings on these investments.

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

5.FAIR VALUE — (CONTINUED)

As of March 31, 2012 and December 31, 2011, the Company had no Level 3 liabilities. As of March 31, 2011, the Company held Level 3 liabilities for deferred consideration related to the October 19, 2009 acquisition of Resolve Technology, Inc. ("Resolve Technology"). The deferred consideration totaled $3.3 million as of March 31, 2011 and included (i) a potential deferred cash payment due approximately two years after closing based on the incremental growth of Resolve Technology's revenue as of September 2011 over its revenue as of September 2009, and (ii) other potential deferred cash payments for successful completion of operational and sales milestones during the period from closing through no later than October 31, 2013, which period was subject to extension by the parties to a date no later than December 31, 2014. On June 24, 2011, the Company made a payment of $500,000 for the successful completion of one of the operational milestones. On September 8, 2011, the Company entered into an agreement to settle all remaining potential deferred cash payments due under the acquisition agreement. Under the terms of the settlement agreement, the Company made a payment of $1.6 million on September 14, 2011 to settle the entire obligation. The Company reversed the remaining $1.2 million of deferred consideration as a reduction to general and administrative expense during the three months ended September 30, 2011.

The following tables summarize changes in fair value of the Company's Level 3 liabilities for the three months ended March 31, 2012 and 2011 (in thousands):

	Three Months Ended March 31,	
	2012	2011
Balance at beginning of period	$—	$3,222
Accretion for period	—	32
Balance at end of period	$—	$3,254

The following table summarizes changes in fair value of the Company's Level 3 liabilities from December 31, 2010 to March 31, 2012 (in thousands):

	Deferred Consideration
Balance at December 31, 2010	$3,222
Accretion for 2011	85
Payments made in 2011	(2,100)
Adjustments made in 2011	(1,207)
Balance at December 31, 2011	—
Activity from January 1, 2012 – March 31, 2012	—
Balance at March 31, 2012	$—

Prior to the settlement on September 8, 2011, the Company used a discounted cash flow model to determine the estimated fair value of its Level 3 liabilities. The significant assumptions used in preparing the discounted cash flow model included the discount rate, estimates for future incremental revenue growth and probabilities for completion of operational and sales milestones.

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 estimated inherent credit losses, and such losses have been within management's expectations. The large size and widespread nature of the Company's customer base and the Company's lack of dependence on any individual customer mitigates 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 accounts receivable, accounts payable and accrued expenses, approximates fair value.

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

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, 2010	$55,260	$24,342	$79,602
Acquisitions	12,205	—	12,205
Effect of foreign currency translation	—	(23)	(23)
Goodwill, December 31, 2011	67,465	24,319	91,784
Effect of foreign currency translation	—	840	840
Goodwill, March 31, 2012	$67,465	$25,159	$92,624

The Company recorded goodwill of approximately $12.2 million in connection with the October 2011 acquisition of Virtual Premise.

7. INTANGIBLES AND OTHER ASSETS

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

	March 31, 2012	December 31, 2011	Weighted-Average Amortization Period (in years)
Capitalized product development cost	$2,140	$2,140	4
Accumulated amortization	(1,694)	(1,647)	
Capitalized product development cost, net	446	493	
Building photography	12,155	12,031	5
Accumulated amortization	(11,291)	(11,122)	
Building photography, net	864	909	
Acquired database technology	25,206	25,140	4
Accumulated amortization	(21,833)	(21,477)	
Acquired database technology, net	3,373	3,663	
Acquired customer base	59,032	58,576	10
Accumulated amortization	(46,057)	(45,055)	
Acquired customer base, net	12,975	13,521	
Acquired trade names and other	10,510	10,376	7
Accumulated amortization	(8,631)	(8,432)	
Acquired trade names and other, net	1,879	1,944	
Intangibles and other assets, net	$19,537	$20,530	

8. INCOME TAXES

The income tax provision for the three months ended March 31, 2012 and 2011 reflects an effective tax rate of approximately 42% and 38%, respectively.

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9. COMMITMENTS AND CONTINGENCIES

The Company leases office facilities and office equipment under various noncancelable-operating leases. The leases contain various renewal options. See Note 12 of the Notes to Condensed Consolidated Financial Statements included in Part I of this Quarterly Report on Form 10-Q for further details on the lease entered into by CoStar Realty and GLL L-Street 1331, LLC ("GLL") on February 2, 2011.

On April 27, 2011, the Company signed a definitive agreement to acquire LoopNet, Inc. ("LoopNet") (NASDAQ: LOOP), pursuant to which Lonestar Acquisition Sub, Inc., a wholly owned subsidiary of the Company, will be merged with and into LoopNet, with LoopNet surviving as a wholly-owned subsidiary of the Company. Subject to the terms of the merger agreement, at the effective time of the merger, (a) each outstanding share of LoopNet common stock will be converted into the right to receive a unit consisting of (i) $16.50 in cash, without interest (the "Common Stock Cash Consideration") and (ii) 0.03702 shares of CoStar common stock (the "Common Stock Stock Consideration"), and (b) each outstanding share of LoopNet Series A Convertible Preferred Stock, unless previously converted into LoopNet common stock, will be converted into the right to receive a unit consisting of (i) the product of 148.80952 multiplied by the Common Stock Cash Consideration and (ii) the product of 148.80952 multiplied by the Common Stock Stock Consideration, representing a total equity value of approximately $860.0 million and an enterprise value of $762.0 million as of April 27, 2011. Subject to the terms and conditions of the merger agreement, at the effective time of the merger, each of LoopNet's outstanding equity awards (including stock options and restricted stock units), whether vested or unvested, will be canceled in exchange for cash and/or shares of Company common stock (depending on the type of award and the exercise price of the award, if any) based on the LoopNet common stock merger consideration less, in the case of a stock option, the per share exercise price. The boards of directors of both companies have unanimously approved the transaction, and the holders of a majority of the outstanding shares of LoopNet's common stock and Series A Preferred Stock, voting together as a single class on an as-co